

## Forex Medium-Term Outlook

June 30, 2025

### Overview of Outlook

USD/JPY once again lacked direction in June. The currency pair temporarily climbed as a result of safe-haven USD buying in response to the risk event in the Middle East, but the trend quickly subsided with news of a ceasefire. Amid uncertainty surrounding tariff negotiations, neither the BOJ nor the Fed have made their policy stance clear, resulting in limited exchange rate movement. However, going by the JPY supply-demand climate as reflected by the balance of payments and other data, the situation does not seem conducive to JPY buying. In general, USD/JPY lacked direction in June owing to a dearth of catalysts, but with the conclusion of tariff negotiations in sight, things are unlikely to remain this way from July onward. Further, with regard to monetary policy, the Fed is expected to cut rates in September in light of weakening economic and financial indicators, and some say this is weighing down USD/JPY. There is also an undeniable likelihood of the BOJ raising interest rates sometime before the end of October, which puts the focus on the extent to which the narrowing U.S.-Japan interest-rate differential will push down USD/JPY. My basic understanding is that there is not much scope for USD/JPY to fall, given the historical accumulation of JPY long positions. As for risk scenarios, the June Semiannual Report on International Economic and Exchange Rate Policies contained some somewhat worrying statements regarding Japan, which should be noted. The U.S. Department of the Treasury has hinted at concerns that Japanese public pension management funds, as typified by the GPIF, are too heavily weighted in favor of foreign currency-denominated assets. Should a political trend emerge to correct this, that would constitute a major JPY appreciation risk.

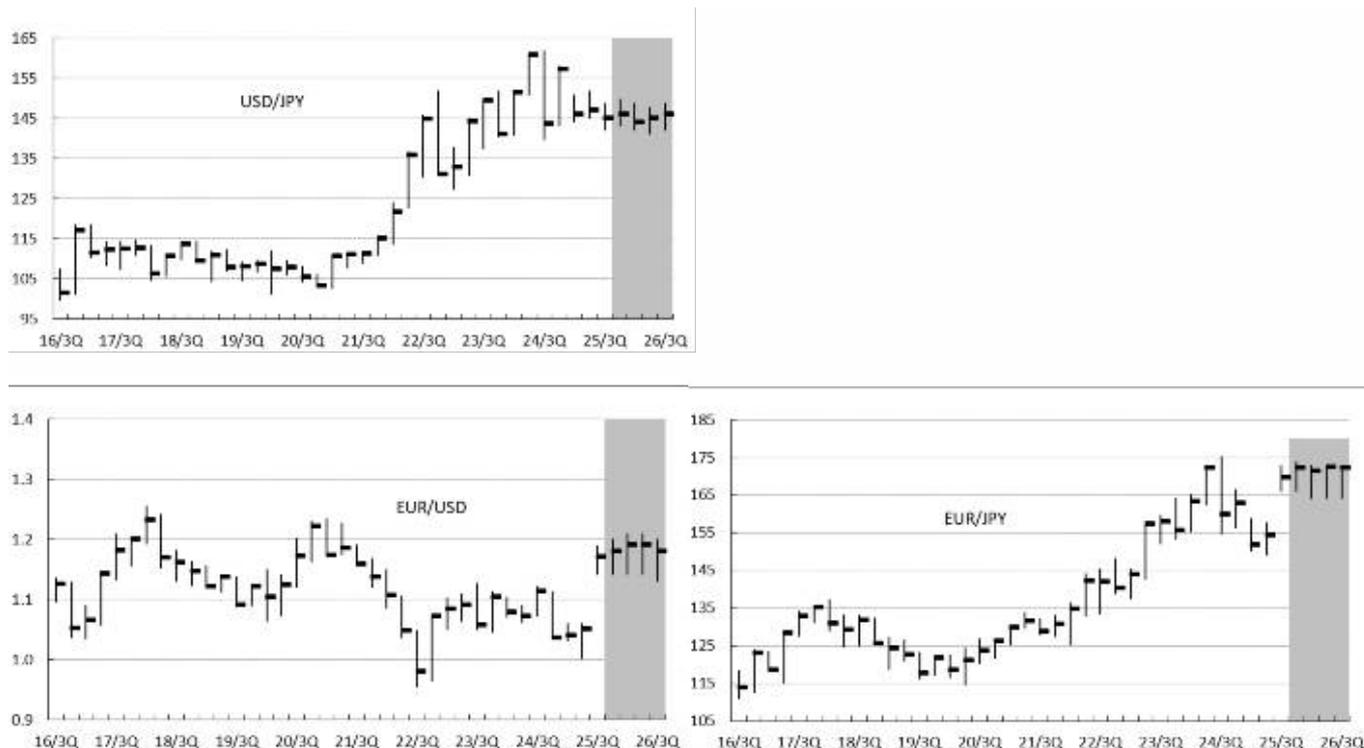
EUR strengthened in June. Far from weakening in the face of the safe-haven USD buying trend, the currency was bought back heavily as market sentiment improved. The truth about the rotation of funds from the U.S. to Europe, which has been a hot topic since April, is unclear, but the trend cannot be completely denied, given U.S. securities investment data for April. The NATO summit's decision to increase the defense spending target and the associated European rearmament plan have given rise to expectations of an expansionary fiscal policy and capital stock accumulation in the region. In theory, this will boost the euro area's potential growth rate, and a desirable interest rate increase in the regional market will promote EUR buying. Another factor that will encourage EUR buying is the ECB's monetary policy, which is expected to freeze interest rate cuts from July onward. However, the upward trend in EUR/USD seen since April was clearly not justified by the Europe-U.S. interest-rate differential. Rather, it was a price formation that factored in the collapse of the USD-dominated global financial system. The ECB's suspension of interest rate cuts will certainly lead to EUR buying, but assuming the return of some measure of sanity in the Trump administration's tariff and other policies, it may be difficult for EUR to remain strong solely based on the narrowing Europe-U.S. interest-rate differential.

### Summary Table of Forecasts

	2025			2026		
	Jan-June (Actual)	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	139.89 ~ 158.88 (144.62)	142 ~ 149 (145)	143 ~ 150 (146)	142 ~ 149 (144)	141 ~ 148 (145)	142 ~ 149 (146)
EUR/USD	1.0125 ~ 1.1754 (1.1718)	1.14 ~ 1.19 (1.17)	1.14 ~ 1.20 (1.18)	1.14 ~ 1.21 (1.19)	1.14 ~ 1.21 (1.19)	1.13 ~ 1.20 (1.18)
EUR/JPY	155.63 ~ 169.80 (169.46)	166 ~ 173 (170)	166 ~ 174 (172)	164 ~ 173 (171)	164 ~ 173 (173)	164 ~ 173 (172)

(Notes) 1. Actual results released around 10 am TKY time on 30 June 2025. 2. Source by Bloomberg  
3. Forecasts in parentheses are quarter-end levels.

### Exchange Rate Trends & Forecasts



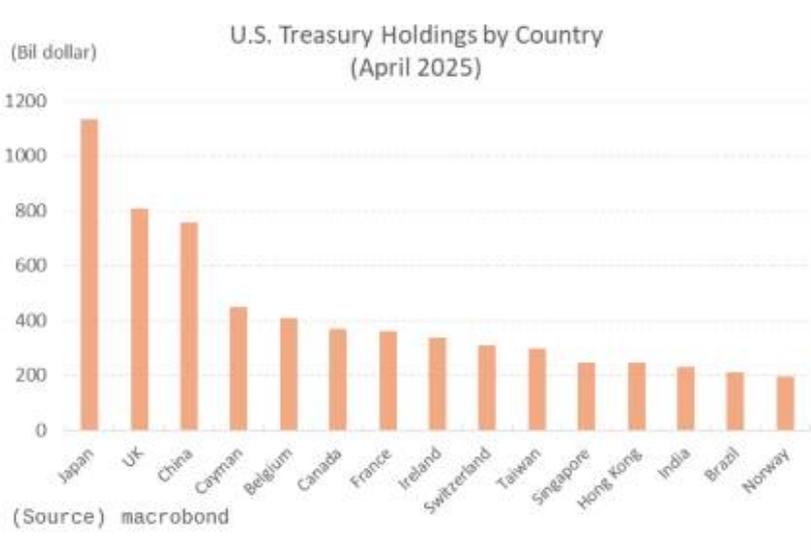
### USD/JPY Outlook - Is There a “Decoupling from the U.S.” Trend?

#### Understanding Current Forex Market Trends – Is There a “Decoupling from the U.S.” Trend?

##### Examining the “Decoupling from the U.S.” Trend

At the time of writing, tensions between Israel and Iran have subsided, but after the clashes broke out on June 13, the forex market saw a clear across-the-board USD appreciation. Safe-haven USD buying soared amid fears of World War III, causing USD/JPY to temporarily shoot up to the 148 range. USD’s appreciation against JPY was particularly significant, but even otherwise, USD was quite resilient despite concerns of a global rotation into European assets. In other words, despite widespread talk of the decline of USD since April, based on speculation of an imminent end to the USD-dominated international financial system, safe-haven USD buying proved to be the stronger factor determining rate trends.

I have consistently kept my distance from discussing the decline of USD since the topic surfaced on “Liberation Day” (April 2). There are several reasons for this, but my basic stance has been to avoid talking of such a serious issue before it is backed by capital flows. In this connection, the U.S. Treasury Department released its International Capital Data (TIC data) for April on June 18. Most headlines focused on outstanding U.S. Treasury holdings as of the end of April, reporting that Treasury holdings by foreigners was only marginally down from the previous month, having declined by USD36 billion to USD9.01 trillion, that Japan was the largest holder, and that China had reduced its holdings, albeit only slightly. However, countries such as the UK, Cayman Islands, and Belgium, which are among the top holders of U.S. Treasury bonds after Japan and China, seem likely to have been registered as “financial centers,” so data obtained from outstanding U.S. Treasury holdings alone seems insufficient to draw any conclusions (see graph). At best, the increase or decrease in China’s holdings could be an issue, but it is possible that China’s holdings are also

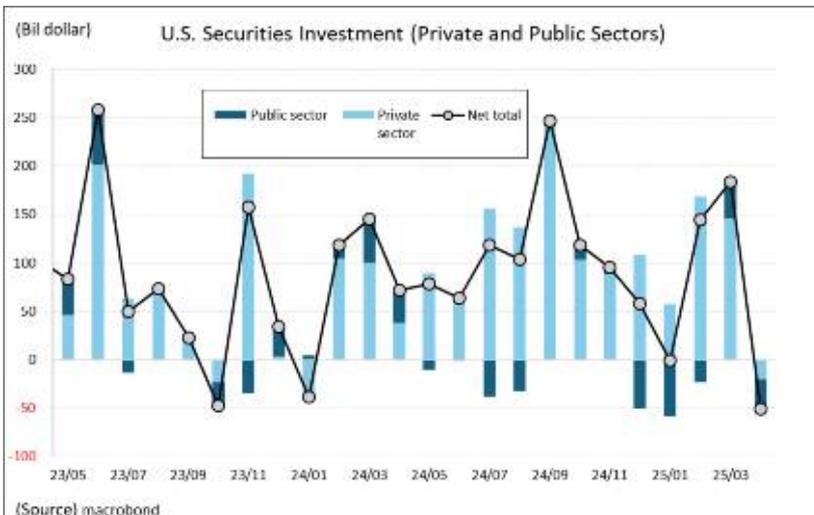


held via the UK or Belgium, so carefully tracking movement by country/region on a monthly basis will be necessary for accurately grasping the situation and formulating an outlook.

Even so, market interest following the release of actual data was surprisingly low given all the fuss over decoupling from the U.S. and the decline of USD. One reason for this may be that TIC data is complex and difficult to understand, but I would like to discuss it here, focusing on its underreported aspects.

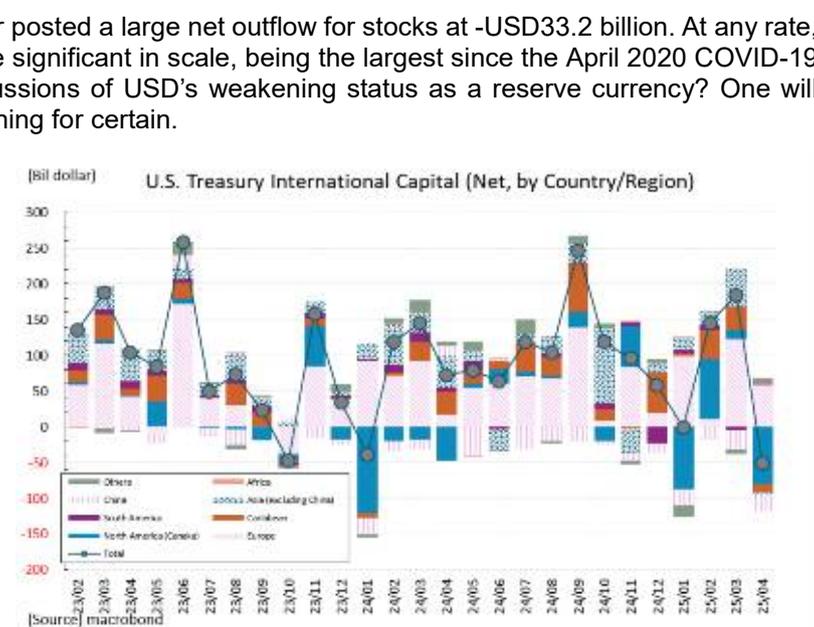
**What Trends by Sector and Country/Region Reveal**

The graph shows long-term securities investment (buying and selling) trends in the U.S. categorized by private and public sectors. The private sector saw a net outflow of -USD20.5 billion, while the public sector saw a net outflow of -USD30.1 billion, totaling a net outflow of -USD50.6 billion. By product, for U.S. Treasury bonds, the private sector posted a net outflow of -USD46.8 billion while the public sector posted a net inflow of +USD6 billion. In other words, as of April, there is no confirmed trend of a move away from U.S. Treasury bonds led by overseas financial entities. Further, the private sector, which posted a net outflow for U.S. Treasury bonds, recorded a net inflow of +USD15.9 billion for corporate bonds and +USD14.3 billion for stocks, so it is not yet possible to judge that there is a “move away from the U.S.” Incidentally, the public sector posted a large net outflow for stocks at -USD33.2 billion. At any rate, the overall net outflow of -USD50.6 billion is quite significant in scale, being the largest since the April 2020 COVID-19 pandemic crisis. But does it really warrant discussions of USD’s weakening status as a reserve currency? One will have to monitor data for May onward to say anything for certain.



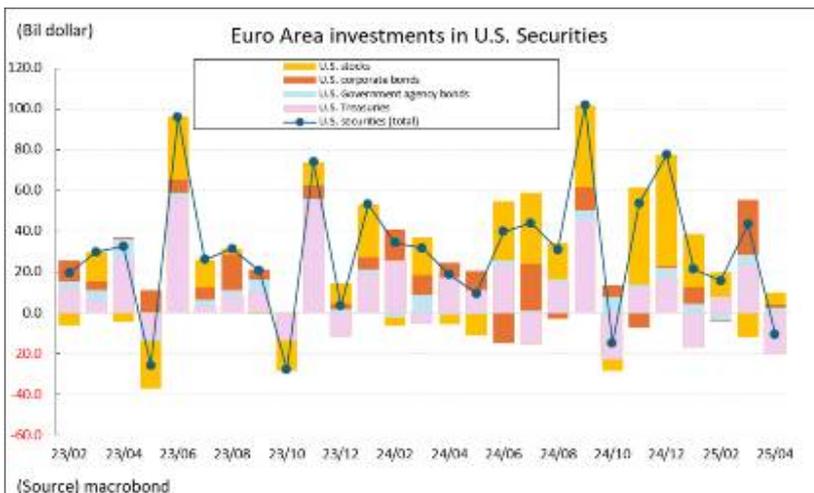
In the context of the move away from the U.S.,

Europe has been attracting attention as a possible destination. To verify whether this is true, it is necessary to check the flows by country and region. As the figure to the right shows, there was a +USD58.8 billion net inflow from Europe to the U.S., while the major net outflow destination was North America, at -USD80.8 billion, led by Canada. There was, indeed, a large net outflow pertaining to U.S. Treasury bonds (-USD57.7 billion) from Canada. This may be the aftermath of rising tensions between the U.S. and Canada since the start of the second Trump administration, even before “Liberation Day.” At any rate, there is no evidence of a large withdrawal of funds from Europe in April, with Canada being the major player.



**Interpreting Europe as the Destination**

However, if we look deeper, while Europe did record a net inflow of +USD58.8 billion, the euro area recorded a net outflow of -USD10.6 billion, mainly due to U.S. Treasuries (see graph). By product, U.S. Treasuries alone were significantly large at -USD20.6 billion. The only reason Europe as a whole recorded a net inflow was because the UK recorded a net inflow of +USD67.6 billion for all products (U.S. Treasuries, government agency bonds, corporate bonds, and stocks). However, as UK trends are thought to largely reflect its flows as an international financial center, it may be necessary to consider the rest of Europe separately from the UK in order to verify the argument that Europe is a destination for funds leaving the U.S. Incidentally, based on the Norwegian krone’s sudden appreciation in April, it was pointed out that the country’s pension funds may have initiated



a large-scale unwinding (selling) of U.S. assets. Norway did post a net outflow of -USD4.9 billion for April (see graph), but it is possible that this was simply a reaction to the net inflow of +USD26 billion for March, mainly due to U.S. Treasuries. It will be important to keep an eye on similar developments for May onward.

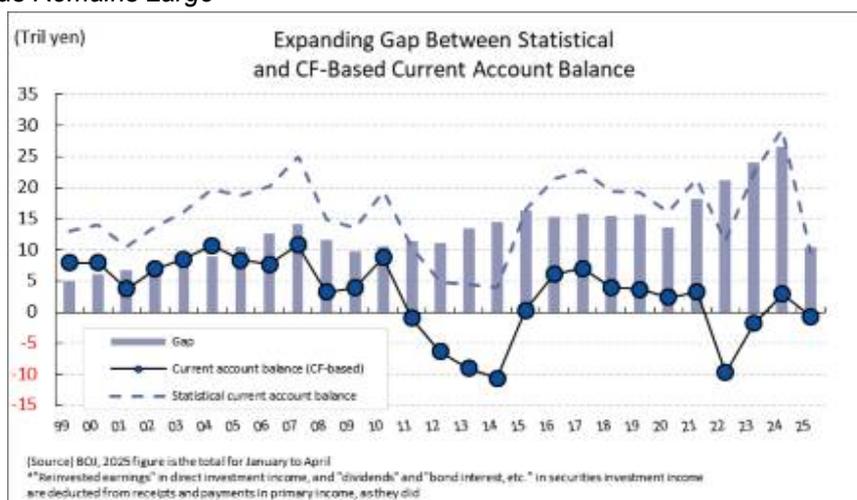
In practical terms, given that EUR has been especially strong since Liberation Day, the aforementioned net outflow of funds from the U.S. to the euro area may be important as evidence supporting the rotation of funds from the U.S. to Europe. At any rate, there has been a series of capital outflows from the U.S. since Liberation Day, strengthening the debate about the U.S. potentially losing its status as reserve currency, a discussion that is still simmering. However, before making such a serious claim as USD losing its status as reserve currency, it is important to steadily monitor TIC data and other capital flow statistics that can be captured, and to adopt an analytical approach to understanding the signs of change therein.

U.S. Treasuries, government agency bonds, corporate bonds, and stocks

### JPY Supply-Demand Environment – Household JPY Selling Shows no Sign of Slowing

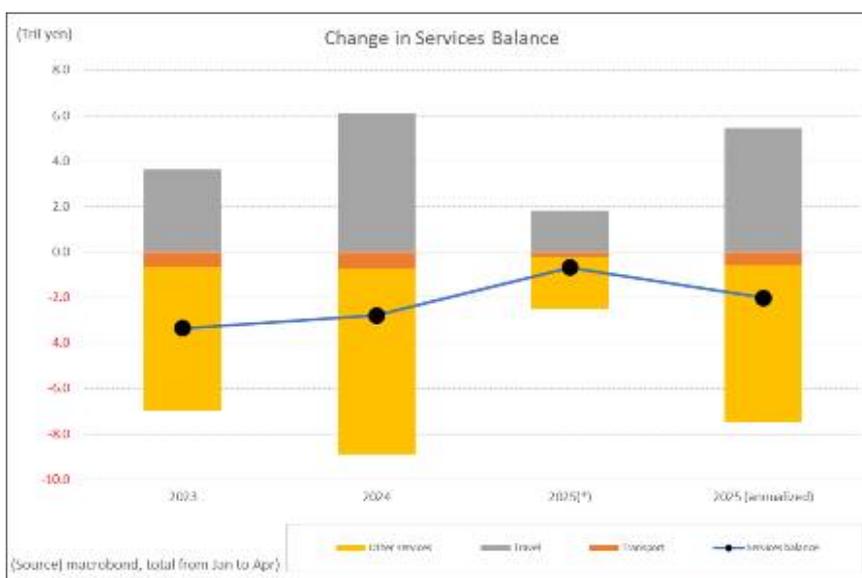
#### Gap Between Statistical and CF-Based Surplus Remains Large

USD/JPY fluctuated wildly in June, but a look at the basic JPY supply-demand climate shows that the net JPY selling trend has not changed much. Japan's current account surplus continues to grow at a record high pace, posting +JPY9.7487 trillion for the January-April quarter. Within this, the trade balance posted a deficit of -JPY1.7143 trillion and the services balance posted a deficit of -JPY1.4394 trillion, but the primary income balance posted a huge surplus of +JPY15.029 trillion, resulting in an overall surplus being maintained. However, the current account balance on a cash flow (CF) basis, which excludes reinvested earnings and portfolio investment earnings that are unlikely to be repatriated from the primary income surplus, posted a deficit of -JPY672 billion, so the contrast between the "statistical surplus" and the "CF-based deficit" remains strong. In fact, looking back at the period since February, USD/JPY has never stably fallen below the 140 level despite speculative JPY buying accumulating to historic levels. The background to this seems to be the very basic fact that there are more people who want to sell JPY than there are people who want to buy it. Incidentally, as mentioned above, the services balance, which includes two highly timely categories – namely the travel surplus and the digital deficit – posted a -JPY1.4394 trillion deficit for January to April combined. Looking at the breakdown, the travel balance was +JPY1.8243 trillion, the largest ever surplus for the January-April period, but it was not enough to offset the -JPY2.4852 trillion digital deficit, leaving the services balance in a slight deficit overall. It seems clear that the foreign currency outflow from digital transactions cannot be ignored. As I have stated in previous reports, in the medium to long term, it is inevitable that the services balance deficit will determine the composition of the current account balance on a cash flow basis.



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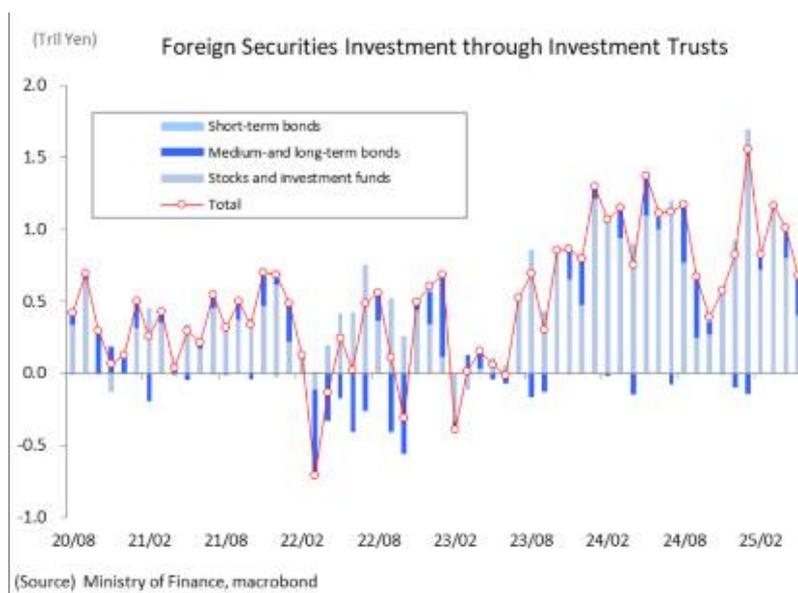


#### Household JPY Selling Trends Similar to Last Year

Japan's International Transactions in Securities (based on reports from designated major investors) were released at the same time as its current account balance. As always, I would like to focus on the trend of outward securities investment via investment trust management companies (investment trusts) as a proxy variable for household JPY selling. How did the household sector behave in May following the "reciprocal tariff shock" in April, which was described as being on the scale of the collapse of Lehman Brothers? Essentially, while a decline in investment appetite can be confirmed, a change in trend cannot yet be declared. Outward securities investment via investment trusts posted +JPY678 billion, the lowest level in six months since November last year. Equity and investment fund shares posted

+JPY398.7 billion, down to half the previous month's +JPY801.4 billion, and less than 40% of the +JPY1.1098 trillion two months ago. Given that the tariff policy can only be expected to lower corporate profits, the decline in appetite for stock acquisition is quite rational.

However, medium- to long-term bonds posted +JPY251.4 billion, the highest level of net buying in eight months since September last year. September last year was the month after the big crash in the wake of "Reiwa Black Monday" (August 5, 2024), and in this report at the time, we focused on the trends of the household sector, which took a flexible approach to overseas investment by reducing stocks and increasing bonds. It is interesting that the same behavior is being shown this time, the month after the big crash. Perhaps what this means for overseas securities investment via investment trusts is that, rather than a sell-off, crashes trigger a shift from stocks to bonds. This shows a considerable level of financial literacy. Assuming last year's pattern is followed, after the Reiwa Black Monday last year, there was a three-month (September-November) period of cautious risk avoidance before a recovery from December onward. Whether the pattern will be repeated this time depends on the Trump administration's decision on reciprocal tariffs on July 9, but with JPY weakness and high prices persisting domestically, there is little sense that households, eyeing overseas markets, will stop selling JPY.



## BOJ Monetary Policies Now and Going Forward – Going Above and Beyond

### *Going Above and Beyond*

At the BOJ's June 16-17 Monetary Policy Meeting, the bank decided to keep its policy interest rate (unsecured overnight call rate) at 0.5%. As for the pace of government bond purchases from April 2026, which was a matter of interest in the markets, the Bank decided to slow down its pace of purchase reductions. As expected, the pace will be lowered from JPY400 billion per quarter to JPY200 billion per quarter. Regarding the reason for slowing the pace of reduction, BOJ Governor Kazuo Ueda explained that proceeding with the reduction too quickly could result in abnormal government bond interest rate volatility, which would negatively affect the economy, and that the Bank was proceeding cautiously so as not to trigger the side effects of large-scale easing. It does seem that the Bank has been giving due consideration to the turmoil in the ultra-long-term bond market, which has been attracting attention, since April. If Ueda's words can be taken at face value, the sharp rise in ultra-long-term interest rates since April are to be interpreted as an "abnormal volatility." High volatility may be in the nature of the ultra-long-term bond market, which has a limited number of participants to begin with, but the BOJ seems unable to fully reconcile itself to this fact.

As the BOJ has argued for some time, the main aim of the phased reduction in purchases (quantitative tightening; QT) is to restore the damaged functioning of the bond market. If the Bank were to strictly adhere to what is necessary, there would be no need to slow the pace of reductions. If adhering to the original QT pace of JPY400 billion per quarter causes turbulence in the bond market, it would be reasonable to interpret that the issuance plan is out of sync with market realities. If the aim is to restore market function, they should have just continued with the "JPY400 billion per quarter" plan at the very least. In fact, when asked why the Bank decided on a JPY200 billion reduction, Ueda said that there would have been advantages to continuing with JPY400 billion, but that they had taken market stability into consideration. The negative impact of the sharp rise in ultra-long-term interest rates on regional bank management and the government's bond issuance plans appear to have been given priority.

Perhaps the recent decision reflects going above and beyond duty to show kindness to the bond market. However, another possible factor behind the BOJ's decision may be that it wanted to avoid being accused of triggering a market collapse by going against market expectations as in August last year. With national elections looming in July, it may be important to avoid an Ueda Shock 2.0 at all costs.

### *The Price of Kindness*

Of course, even at a reduction pace of JPY200 billion, the BOJ's long-term government bond holdings will still be on a downward path, which moderates the kindness to the bond market. Taking into account the series of redemptions coming up, and assuming a continuation of the new plan as is, the outstanding balance of long-term government bond holdings is expected to fall to around JPY500 trillion in March 2027 from the current JPY577 trillion. This is a reduction of about 16% from the JPY592 trillion in June 2024 when QT began. As a result, monthly government bond purchases, which were just under JPY6 trillion at the start of QT, will be down to around JPY2 trillion by the January-March 2027 period. This will gradually ease the downward pressure on long-term interest rates (the so-called stock effect) caused by the BOJ's large holdings of government bonds, so it may be easy to see periods of high volatility similar to the one since April this year. The problem is that, if the markets end up expecting a response from the BOJ similar to the recent

one each time there is an increase in volatility, this could inevitably increase the expectations for QT to be suspended altogether. In fact, even this time, the markets were expecting the BOJ to suggest a suspension of QT after having lowered the pace of monthly purchases to around JPY2 trillion by the January-March 2027 period. In the event, the BOJ did not reveal any policy for the April-June 2027 period onward, and some argue that this itself indicates a hawkish stance. However, given the recent precedent, it is likely that the momentum will grow for a slower pace of reductions and the suspension of QT depending on how the bond market behaves going forward.

This structure of reading any increase in interest rates as an “abnormal volatility” and expecting QT adjustments is similar to past situations when rate hikes were expected every time JPY weakened. As Governor Ueda aptly stated, doing nothing and sticking to the status quo would have increased predictability in the financial markets.

#### June 2014 “Interim Evaluation” an Important Variable

The focus going forward will be on the timing of QT termination, not on the pace of reductions. At the recent meeting, the BOJ announced its intention to conduct another interim evaluation of QT in June 2026, one year from now. At that time, a more detailed picture of the lower limit of monthly purchases is likely to be shared. In this regard, the minutes of the Bond Market Group Meeting held in May show that there are a variety of opinions, ranging from JPY1 trillion to JPY3 trillion in increments of JPY500 billion, regarding the monthly purchase amount that would lead to the end of QT. In other words, there is no consensus at this time. While there is no need to consider such forecasts right now, the fact is that the handling of QT, to be decided in June 2026, is likely to become an important variable determining medium-term forecasts for various asset prices. As a risk scenario, it may be necessary to consider whether the bond market will hold up until the interim evaluation. This time, because the timing of the interim evaluation happened to coincide with the turmoil in the ultra-long-term bond market, expectations of a lower pace of reductions could be met, but if a similar turmoil occurs again within the year, it may be more difficult to deal with.

#### Higher Interest Rates or Weaker JPY?

Since QT comes with the hedge statement, “In the event of a sharp rise in long-term interest rates, we will flexibly conduct measures such as increasing the amount of bond purchases, fixed-rate purchase operations, and Funds-Supplying Operations against Pooled Collateral,” such ad hoc measures could be used to deal with any emergencies that arise before the next interim evaluation. However, any such response will inevitably be accompanied by JPY depreciation. Forced, under current circumstances, to choose between a rise in interest rates or JPY depreciation, the BOJ chose “kindness to the bond markets,” i.e., a policy aimed at suppressing higher interest rates, this time. Fortunately, the decision was modest and triggered only limited JPY depreciation in response. However, it is unlikely that the forex market response will remain muted if an increase in purchases or fixed-rate purchase operations are implemented going forward. There is significant concern that every bond market turbulence will trigger expectations of appropriate action (kindness to the bond market), and JPY weakness will progress or remain unresolved as a result.

## U.S. Monetary Policies Now and Going Forward – Implications for USD/JPY

### *Selling USD in Anticipation of a USD Decline” vs. “Buying USD Due to Weaker Rate-Cut Expectations”*

As expected, the FOMC unanimously decided in its June 17-18 meeting to keep the target range for the federal funds (FF) rate, i.e., the policy interest rate, unchanged at 4.25-4.50% for the fourth consecutive time. The statement pointed out that “uncertainty about the economic outlook has diminished but remains elevated.” Since the Trump administration’s next move is unpredictable, the only way to objectively gauge the Fed’s next move is based on the trends in the Staff Economic Outlook (SEP) (see table). In this regard, the SEP downwardly revised its growth rate projection while upwardly revising its inflation rate projection, while Powell acknowledged that the impact of tariff rate hikes could be either temporary or somewhat persistent. FOMC members’ FF rate projections (the dot plot) for the end of 2025 through 2027 were 3.875% → 3.625% → 3.375%, respectively, with 2026 and 2027 projections revised upward by +25bp compared to last time (March). As for the 2025 projections, while its median value remained the same as last time, it is noteworthy that the number of members

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

	2025	2026	2027	Long-term outlook
Real GDP growth rate (As of March)	1.4 (1.7)	1.6 (1.8)	1.8 (1.8)	1.8 (1.8)
Unemployment rate (As of March)	4.5 (4.4)	4.5 (4.3)	4.4 (4.3)	4.2 (4.2)
PCE deflator rate (As of March)	3.0 (2.7)	2.4 (2.2)	2.1 (2.0)	2.0 (2.0)
PCE core inflation rate (As of March)	3.1 (2.8)	2.4 (2.2)	2.1 (2.0)	

(Source) FRB

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%
Jun-25	3.875%	3.625%	3.375%	3.0000%

(Source) FRB

predicting no change from the status quo increased from four (last time) to seven. Overall, it can be said that the dot chart has been revised in a slightly more hawkish direction. Note that the neutral interest rate remains at 3.00%, which means that the policy interest rate will continue to exceed this rate during the forecast period.

#### *Next Rate Cut in or After September*

Despite the dot plot's clearly hawkish correction, USD/JPY did not respond with an upswing. This was surprising given historic levels of JPY long position accumulation. However, as Powell also noted, even FOMC members who forecast no rate cuts in 2025 expect several rate cuts in 2026. In other words, the emphasis may be on the fact that the "next move" will still be a rate cut. With the next moves of the Fed and the BOJ being a rate cut by the former and a rate hike by the latter, USD/JPY's top-heaviness is certainly understandable. For the time being, "USD selling in anticipation of a USD decline" and "USD buying due to weaker rate-cut expectations" may balance each other out.

Going forward, while the markets will be interested in the timing of the next Fed rate cut, the possibility that it will not take place this year can no longer be ignored, given that the Fed's inflation assessment is leaning somewhat to the upside. The central banks of Japan, the U.S., and Europe are all taking the same basic stance that it would be appropriate to maintain the status quo until the outlook for tariff policy becomes clearer. Powell himself has stated that he expects greater clarity to emerge over the summer. Assuming that post-September uncertainties are dispelled, it is possible that a long-awaited rate cut will take place in September. Of course, the assumption is that hard data, including employment statistics, will worsen in the meantime.

At the time of writing, future FOMC rate cuts are factored in at just under 20% for July and nearly 100% for September, but the situation is fluid and current figures are not very useful. As I have mentioned from time to time, my basic understanding is that with speculative JPY buying at historically high levels, there is not much room for USD/JPY to fall even with a narrowing of the U.S.-Japan interest rate gap.

### **Risks to My Main Scenario – Pension Fund Management and JPY Depreciation Risks**

#### *A Tariff Policy Support Tool*

As noted above, the United States has been able to manage its monetary policies without any major disruptions while concurrently undertaking some new currency policy initiatives. On June 5, the U.S. Treasury Department published the latest edition of its semiannual Report on Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States (Forex Policy Report). While that edition does not designate any country as a "currency manipulator", the report's "watch list" has grown (with the addition of Ireland and Switzerland) to include nine countries (see table on next page). Taiwan and Switzerland meet the U.S. criteria for being designated a currency manipulator ((1) significant trade surplus with the United States, (2) material current account surplus with the United States, and (3) persistent one-sided forex market intervention), but the report's overall assessment was that they should not be given that designation. Although the report found that China meets only one of the criteria, it expressed concerns about China's huge trade surplus with the United States and the extremely opaque nature of information on China's currency intervention activities, and it clearly indicated a possibility that China may be designated a currency manipulator in the future. As discussed in previous editions of this article, the Forex Policy Report's significance under the Trump administration is different from that under previous administrations. The original idea behind the Forex Policy Report was that, if a country was designated a "currency manipulator", the United States would undertake bilateral negotiations with that country to force it to review its monetary policies and trade practices and, if no agreement could be reached, the United States would increase its tariffs on that country's exports and impose other restrictions on those exports. In other words, the "currency manipulator" designations and "watch list" listings were significant because they could lead to U.S. trade sanctions such as tariffs and non-tariff trade barriers.

Under the Trump administration, however, such sanctions are commonplace regardless of Forex Policy Report assessments, and this change has clearly diminished the report's importance. There were expectations that that the report would designate China as a currency manipulator, which would have been a major development, but it appears that a compromise was reached on rare earth trade and other issues in the telephone conversation between President Trump and Chinese President Xi Jinping just before the report was released, and that resolution has greatly alleviated the serious concerns about that situation in financial markets.

Of course, that doesn't mean the report has become meaningless. The Trade Facilitation and Trade Enforcement Act of 2015 (TFTEA) requires the U.S. Treasury Department to submit a Forex Policy Report to the U.S. Congress twice a year. This report allows stakeholders (especially politicians) who are not ordinarily focused on economic and financial developments to recognize the existence of trade-related situations that could be considered unfair. Unlike President Trump's trade policies, which tend to be irregularly imposed and explained, the Forex Policy Report methodically evaluates other countries behavior based on quantitative data. Although the report's criteria are somewhat rough, they are more convincing than the standards President Trump's employs in his bilateral tariff negotiations, and the report itself can be expected to continue playing a supporting role in the Trump administration's tariff policy management. At the very least, it should be understood that Forex Policy Report findings are certainly among the issues addressed when countries are negotiating with the United States..

So the Forex Policy Report can be considered a supplementary tool for helping implement the Trump administration's trade policies. When the report was released, U.S. Treasury Secretary Bessent stated that – "Treasury will use all available tools at its disposal to implement strong countermeasures against unfair currency practices." – emphasizing an intention to deal strictly with any moves that appear to be currency manipulation. It appears that people seeking to analyze forex markets still cannot afford to disregard the semi-annual Forex Policy Reports.

Current Status of the Assessment of U.S.'s Key Trading Partners					
Country	(1) Trade surplus with the U.S.	(2) Current account surplus	(3) Currency intervention	Monitoring list	Notes
Mexico	✓				
Canada					
China	✓			○	Designation as currency manipulator imminent due to opaque currency intervention information
Japan	✓	✓		○	
Germany	✓	✓		○	
South Korea	✓	✓		○	
Italy		✓			
India					
Taiwan	✓	✓	✓	○	Overall assessment that there was no intentionally unfair currency manipulation
France					
Switzerland	✓	✓	✓	○	Overall assessment that there was no intentionally unfair currency manipulation
Viet Nam	✓		✓	○	
Malaysia					
Thailand		✓			
Singapore	✓	✓		○	
UK					
Belgium					
Brazil					
Ireland	✓	✓		○	

(Source) U.S. Department of the Treasury

\*For the past one year, if (1) is USD15 billion or more, (2) is 3% of GDP or more, and (3) is if the country has implemented a domestic-currency selling intervention in 8 or more of the last 12 months.

### Demands on Japan

Although the latest Forex Policy Report praises Japan's transparency regarding its currency intervention, it also makes the following two noteworthy points, the first about monetary policy management and the second about public pension fund management.

- **BOJ policy tightening should continue to proceed in response to domestic economic fundamentals including growth and inflation, supporting a normalization of the JPY weakness against USD and a much-needed structural rebalancing of bilateral trade**
- **Treasury also stresses that government investment vehicles, such as large public pension funds, should invest abroad for risk-adjusted return and diversification purposes, and not to target the exchange rate for competitive purposes**

The first sentence basically says the BOJ should continue tightening monetary policies in line with domestic economic conditions, which will strengthen JPY against USD and promote a rebalancing of U.S.-Japan trade. In short, it supports BOJ rate hikes, asserting that continuing to raise interest rates will contribute to the national interests of both countries. However, the narrative that the second Trump administration is actively seeking to weaken USD and strengthen JPY is a narrative created by the news media, and it should be noted that, regardless of what President Trump may have said, Treasury Secretary Bessent and other U.S. representatives in trade negotiations have never expressed the goal of weakening USD against JPY. It appears clear that the both Japanese and U.S. finance ministers have confirmed that current USD/JPY level is roughly in line with the fundamentals.

Even if one assumes that the two countries are merely pretending to accept the current USD/JPY level and that the United States may suddenly ask Japan to promote JPY appreciation in the future, there are only three tools Japan can use to promote such JPY appreciation – (1) monetary policy (interest rate hikes), (2) currency policy (foreign exchange intervention by buying JPY and selling USD), and (3) capital controls. Option (3) is out of the question, and option (2), which would involve selling U.S. Treasury bonds, is not something the United States would want either. The report also notes that as a member of the G7, Japan has a strong commitment not to manipulate the exchange rate through domestic policies. Given that, the only tool left is (1) monetary policy, which basically means interest rate hikes. This point is obvious even if the report does not express it directly.

Given that, currently, Japan has extremely low real interest rate levels, has not corrected JPY's excessive depreciation, and is struggling with excessively high inflation rates, it is logical to suggest that Japan should raise interest rates to moderate JPY depreciation. Moreover, that is something the BOJ has been doing even before it was asked to do so. There will likely be people who interpret statements in the latest Forex Policy Report as suggesting various conspiracy theories, but I consider the statements as simply acknowledging the nature of Japan's current situation.

### Pension Fund Investments in Line with Currency Policy?

The second Forex Policy Report point mentioned above is that Japan’s “government investment vehicles, such as large public pension funds, should invest abroad for risk-adjusted return and diversification purposes, and not to target the exchange rate for competitive purposes.” This point (more innovative than the first point) appears to be a simple criticism of the portfolios of such institutions as the Government Pension Investment Fund (GPIF). The report suggests that such institutions should not be making investments with the aim of manipulating exchange rates but, naturally, the Japanese government, the BOJ, or the GPIF have never expressed such an aim or intention. However, the share of foreign-currency-denominated assets in GPIF’s basic portfolio has doubled over the past 15 years (see graph), and that is certainly conspicuous and noteworthy. Looking back, one finds that suspicions about investments aimed at manipulating exchange rates grew considerably on October 31, 2014, which happened to be the day the BOJ implemented its ‘Halloween easing’ easing measures (QQE2) as well as the day the GPIF announced changes to its basic portfolio structure, raising the share of foreign currency-denominated assets from 23% to 40% and reducing the share of Japanese government bonds from 60% to 35%. It was at the same time that the BOJ decided to increase its annual government bond purchases by JPY10-20 trillion. Given that the GPIF decided to reduce its government bond purchases at a time when the BOJ was increasing its government bond purchases, it is highly likely that this was viewed by overseas market participants in particular as an attempt to utilize pension funds to manipulate price levels.

Needless to say, the combination of a decline in JPY interest rates due to additional easing and the increase in foreign currency-denominated asset purchases by GPIF led to a rapid depreciation of JPY against USD. Then-GPIF Chairman Takahiro Mitani said that it was pure coincidence that the BOJ and GPIF policy changes happened on the same day, and then-Prime Minister Abe said the GPIF reforms were not for the purpose of raising stock prices, but given the reflationary policies Japan was implementing at the time, it proved impossible to dispel suspicions about the policy changes.

The day before those decisions were made (October 30, 2014), Prime Minister Abe stated that in order to ensure stable pension payments in the future, it was necessary to flexibly review the GPIF’s basic portfolio structure in light of the post-deflation economic and investment environment. More than a decade has passed since the Halloween easing, and at this point the Japanese economy clearly could not be described as having deflationary characteristics, but that was not yet the case in 2014. If deflation is assumed, then domestic currency appreciation is theoretically justified, but if inflation is assumed, then domestic currency depreciation (against foreign currencies) is theoretically justified. In hindsight, given the subsequent economic and financial situations, it can be said that the 2014 basic portfolio structure change was wise and led to higher levels of realized returns. Now that JPY’s real effective exchange rate (REER) has weakened to its lowest level in half a century, however, it is unclear whether increasing investments in foreign currency-denominated assets at the same pace will be beneficial (see graph). In that sense, some of the Forex Policy Report’s points are worth considering (disregarding the issue of whether countries have a right to interfere with the pension asset management policies of other countries).

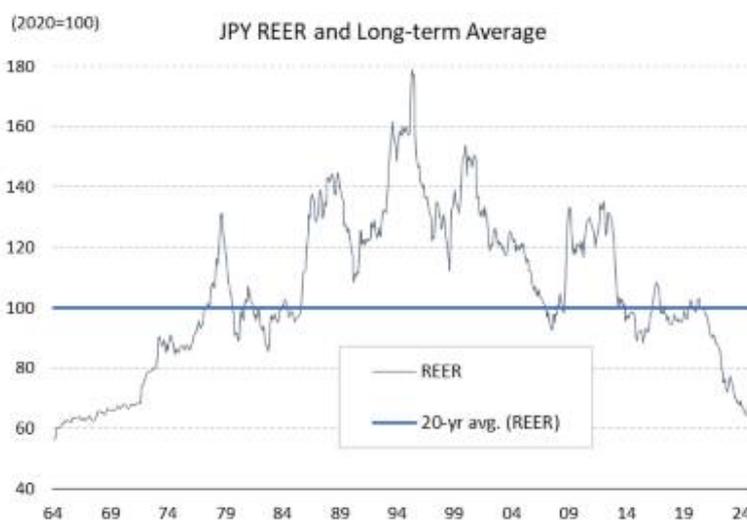
### Impact on JPY Supply-Demand Situation from Pension Fund Investment Structure Changes

As GPIF’s 2024 year-end investment balance was approximately JPY260 trillion, reducing the share of its foreign currency-denominated assets by 5 percentage points would cause a JPY13 trillion JPY buyback. This is on a scale that would offset the much-talked-about “household JPY selling” trend, which caused about JPY11.5 trillion of JPY selling in 2024. It is well known that GPIF’s basic portfolio structure functions as a de facto benchmark for other investment entities, particularly Japan’s three major mutual aid societies (Federation of National Public Service Personnel Mutual Aid Associations (KKR), Pension Fund Association for Local Government Officials (Chikyoren), and The Promotion and Mutual Aid Assoc. for Private Schools of Japan (Shigaku Kyosai)), which tend to attract attention in connection with GPIF. The three major mutual aid societies’ investment balances amount to approximately JPY30 trillion, which,

**GPIF, changes to basic portfolio (% , percentage of total assets)**

	Foreign securities	Foreign equity	Total foreign assets
FY2006–FY2009	8	9	17
June 2013–Oct 2014	11	12	23
Oct 2014–Mar 2015	15	25	40
FY2020–FY2024	25	25	50

(Source) GPIF



(Source) macrobond

when combined with GPIF's, brings the total close to JPY300 trillion. Given the scale of assets involved, it is obvious that changes to GPIF's basic portfolio structure could have a significant impact on forex flows.

While the following is largely speculation, it is worth noting that promoting JPY appreciation via currency intervention could be considered to blatantly promote U.S. Treasury bond selling in contravention of G7 agreements, but such a downside could be alleviated by modifying pension fund management policies. With the Japan-U.S. tariff negotiations ongoing, I'm sure I'm not the only one pondering various possibilities. As the main forecast scenario anticipates a JPY supply-demand situation characterized by net JPY selling, I feel that the biggest risk factors associated with the latest Forex Policy Report include possible influences on the pace of BOJ interest rate hikes as well as possible influences on the portfolio management of GPIF and other public pension funds.

## EUR Outlook – Asset Rotation Expectations Remain Strong

### EUR Area Monetary Policies Now and Going Forward – End of Interest Rate Cut Phase Approaching

#### End of Interest Rate Cut Phase

The June 5 ECB Governing Council meeting decided to lower the deposit facility rate 25 basis points, to 2.00%, becoming the seventh consecutive Governing Council meeting to implement a rate cut. (The June rate cut was the eighth since the rate cut phase began in June 2024.) As discussed below, however, given the euro area economic and price environment, it is unclear whether the regional economic and financial situation is weak enough to require further rate cuts. Given that inflation rates are stable at around 2%, and that the end of ECB interest rate cuts was considered before April 2 (declared by U.S. President Trump to be “Liberation Day”, from which time he would launch trade policies designed to liberate the United States from ‘unfair’ trade relationships), I had predicted that there might be a rate cut at the June Governing Council meeting, a decision on whether to halt the rate cuts would be likely to be made at the July 24 Governing Council meeting. At the post-Governing Council-meeting press conference on June 5, a reporter posed the question – “Would you say the monetary stance has now shifted to neutral or is it still restrictive even slightly?” – and ECB President Christine Lagarde replied that – “We have just nearly concluded a cycle of monetary policy that dealt with a series of shocks – pandemic, war in Ukraine, energy crisis – and I think we have done that decently well.” – and that response seemed to be a clear suggestion that the rate cut phase had ended. She also said at the press conference that – “with today’s cut, at the current level of interest rates, we believe that we are in a good position to navigate the uncertain conditions that will be coming up” – and that seems to rule out a need for further rate cuts. As discussed below, however, given the fact that the latest Eurosystem staff projections include a main scenario forecast as well as forecasts for alternative scenarios, we should keep in mind that the Governing Council’s judgment could become more-flexible at any time for innumerable reasons.

#### Interpreting the Staff Projections

The baseline scenario of the latest revised staff projections anticipates that the euro area’s real GDP growth rate will be +0.9% in 2025, +1.1% in 2026, and +1.3% in 2027. Compared to the previous projections (released in March), the forecast for 2026 has been lowered by 0.1 percentage point, but in any case the GDP growth rate is expected to be roughly flat throughout the forecast period. Ultimately, however, it will be difficult for the ECB to make any major changes to the policies anticipated at the April Governing Council meeting until it obtains a

reasonable understanding of how the Trump tariffs will develop after July 9. Meanwhile, the euro area inflation rate (HICP consumer price index) forecast has been lowered by -0.3 percentage point to +2.0% for 2025 and by -0.3 percentage point to +1.6% for 2026, although the +2.0% rate forecast for 2027 has not been adjusted. The downward revision of inflation rates for the 2025-26 period reflects the way in which the energy price decline trend and the EUR appreciation trend seen since the beginning of 2025 are producing a disinflationary effect, and that situation is likely to have been a factor promoting the decision to cut interest rates in June.

In addition to the baseline scenario, however, the latest revised staff projections present forecasts for two alternative illustrative scenarios (a “mild” scenario and a “severe” scenario), making a total of three forecast scenarios. The mild scenario foresees the removal of bilateral tariffs between the United States and the EU (i.e. “zero-for-zero” tariffs) and a rapid reduction in trade policy uncertainty to pre-2018 levels. Under such a scenario, the real GDP growth rate would be 0.3-0.4 percentage points stronger in the 2025-26 period than in the baseline scenario, while inflation would be 0.1 percentage point higher in the 2026-27 period. However, since the inflation rate outlook is unlikely to change significantly, a shift back to a rate hike phase cannot be expected.

The severe scenario foresees that the high U.S. tariffs announced on Liberation Day will be applied and that the EU will impose import tariffs on U.S. products in retaliation. It also assumes that the rate of U.S. tariffs on Chinese products will remain at the high level (about 120%) seen before the tariffs were suspended on May 12. Under such a scenario, GDP growth rates and inflation rates would both be considerably lower throughout the projection horizon. If the severe scenario were to actually occur, a policy interest rate below the neutral rate (estimated to be in the 1.75-2.25% range) would clearly be needed, so multiple interest rate cuts would be justified. It seems to me that a severe alternative scenario is more likely than a mild alternative scenario.

It is worth noting that the baseline scenario assumes that U.S. import tariffs on goods will be higher than they were forecast to be as of March 2025, but that all current temporary suspensions of tariffs will continue into the second half of the forecast period. In this case, U.S. import tariff rates are expected to increase by 10 percentage points from

	As of June 2025 (% YoY)			Change since previous forecast (percentage points)		
	2025	2026	2027	2025	2026	2027
<b>Basic scenario as of June 2025</b>						
Real GDP	0.9	1.1	1.3	0	-0.1	0
Euro Area HICP	2	1.6	2	-0.3	-0.3	0
Core HICP	2.4	1.9	1.9	0.2	-0.1	0
<b>Risk scenario (mild)</b>						
Real GDP	1.2	1.5	1.4	0.3	0.3	0.1
Euro Area HICP	2	1.7	2.1	-0.3	-0.2	0.1
<b>Risk scenario (severe)</b>						
Real GDP	0.5	0.7	1.1	-0.4	-0.5	-0.2
Euro Area HICP	2	1.5	1.8	-0.3	-0.4	-0.2

(Source) ECB

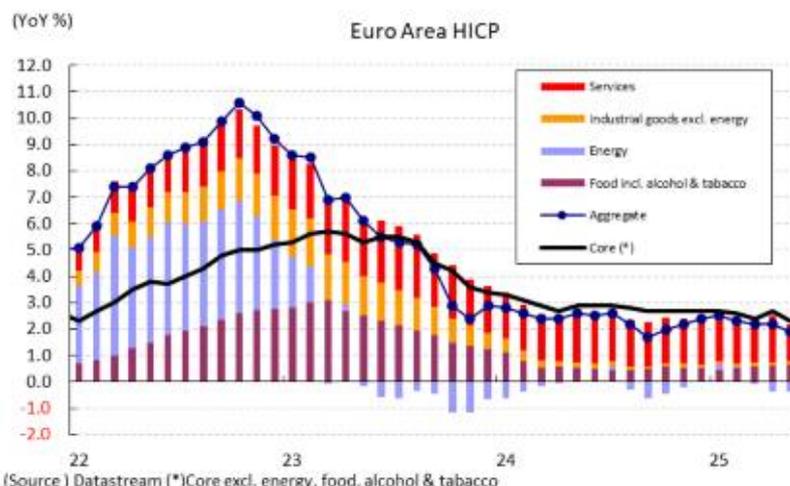
roughly zero to for all countries except China, so it will be anticipated that the 10% uniform portion of reciprocal tariffs will not be abolished after all. At this point in time, the EU and all other countries have no choice but to incorporate the 10% reciprocal tariff rate outlook in their baseline projection scenarios.

### Discerning Whether Inflation Downtrend is Temporary

In light of current inflation and economic trends, an ECB decision to halt its interest rate cuts would be understandable. Overviewing the euro area inflation trend, the May HICP growth rate was +1.9% (down -0.3 percentage point from +2.2% in the previous month), falling below the +2% level for the first time in eight months (since September 2024).

The deceleration of inflation rates largely reflected a combination of a continued decline in energy prices and a sharp slowdown in the growth of services prices. Energy prices fell considerably in April and May (down 3.5% yoy and 3.6% yoy, respectively) and such energy price declines have been steadily pushing down euro area inflation rates recently.

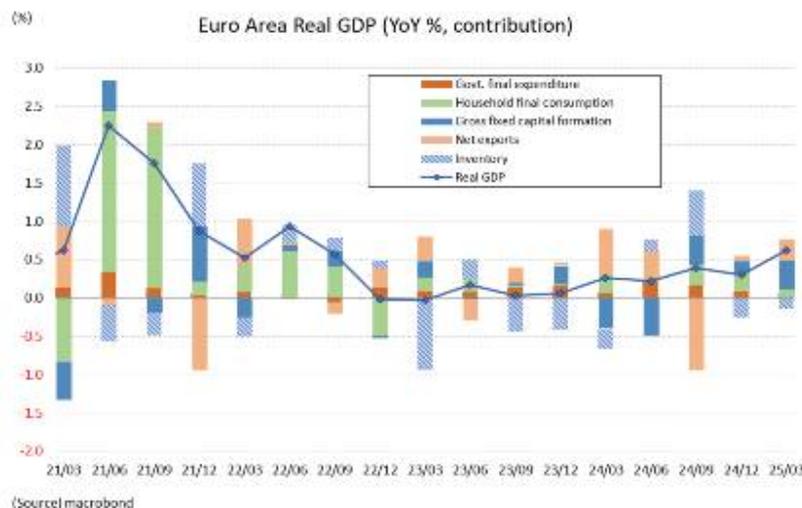
A particularly noteworthy change in May was the deceleration of the services price growth rate (an 0.8-percentage-point deceleration from +4.0% to +3.2%), and in response, the rate of growth in core HICP (excluding food and energy) also fell sharply, from +2.7% to +2.3%. Until May, the high rate of growth in core HICP was considered one of the chief obstacles to interest rate cuts, so it appears clear that the recent easing of inflationary pressures prompted the rate cut at the June Governing Council meeting. However, the timing of the Easter holidays in April was different from usual, and accommodation prices and airfares temporarily rose in line with travel-related demand. Given that, the +4.0% rate of growth in services prices during April can be considered anomalous, and the average +3.6% services inflation rate for April and May would probably more-accurately represent the actual services inflation situation. In light of that and the fact that the average services inflation rate for the January-March period was +3.7%, it can be said that there has actually been no significant change in the services inflation rate, despite the tightness of the employment and wage environment. The reason why comments made at the June Governing Council meeting suggested an end to interest rate cuts was probably because the ECB still has doubts about the persistence of euro area inflation pressures.



### Stable Inflation Expectations and Limited Effects of EUR Strength

Market-based inflation expectations (the five-year in five years inflation swap break-even inflation rate (5-year BEI), see graph) that the ECB has traditionally emphasized) are stable at +2%, so there is no perception that the ECB might be forced to lower interest rates to prevent disinflation. It is true that the continued EUR appreciation trend seen since the beginning of the year will have a disinflationary effect, but it is generally understood that this effect is not very large. Since the beginning of the year, EUR has appreciated by more than +13% against USD and by more than +5% on a nominal effective exchange rate (NEER) basis. A paper published by the ECB in April 2020<sup>1</sup> estimates that a 1% change in the NEER-basis EUR exchange rate will cause a 0.04 percentage point change in the euro area HICP growth rate, so a +5% change in the NEER-basis EUR exchange rate can be expected to depress the HICP growth rate by about -0.20 percentage point, which is not a very significant margin of change.

It is believed that ECB intended to consider suspending its interest rate cuts at its April Governing Council meeting but that the U.S. announcement of mutual tariff proposals delayed a related decision. The ECB was considering suspending interest rate cuts because it appeared that the robustness of the euro area economy had been confirmed. In this regard, it is worth noting that euro area real GDP for the first quarter of 2025 was up 0.6% from the previous quarter, more than double the growth rate seen in previous quarter (+0.3% qoq). However, this largely reflected a sharp increase in exports



<sup>1</sup> Please see the ECB Occasional Paper Series research article No. 241, entitled "Exchange rate pass-through in the euro area and EU countries" (ECB, April 2020) <https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op241~c7c3080d60.en.pdf?6f43dfcc77c4d7633aaaa0fbaecd174f>

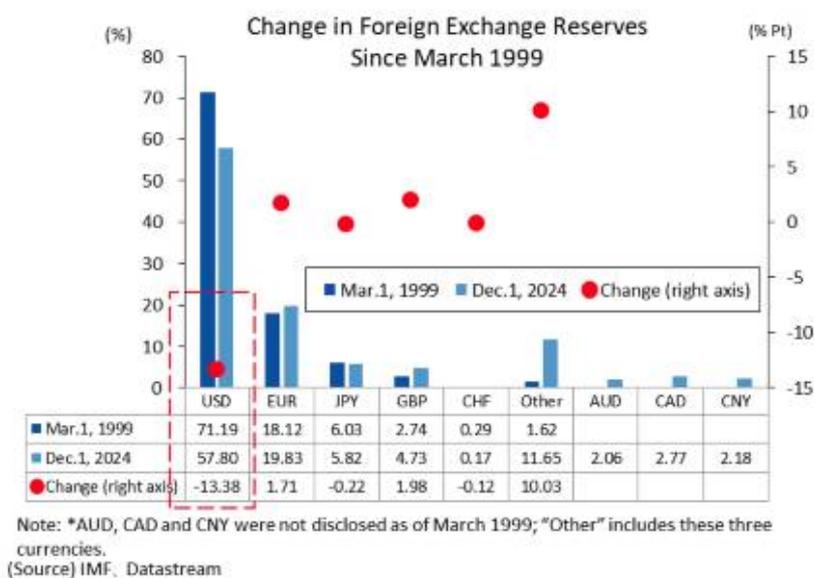
to the United States from Germany and Ireland in anticipation of Trump tariffs expected to be imposed in the second half of the year, so it cannot be said to be an accurate indication of the euro area economy’s fundamental strength. Some degree of GDP growth deceleration appears inevitable due to the effects of tariff policies from the April-June quarter onwards. The current deposit facility interest rate (2.00%) is already at the midpoint of the ECB’s estimated neutral interest rate range (1.75-2.25%). In light of that estimated range, it can be argued that the ECB may maintain “neutral” policy posture even after one more rate cut, but any more than that will cause it to adopt an accommodative posture. Thus, although it does not appear that the euro area’s economic and inflation situations have softened to a degree that would justify an accommodative monetary posture, it does seem possible that the ECB might consider it has the leeway for one more rate cut.

**USD Weakening Alone Won’t Make EUR the Top Key Currency**

Returning to the post-June-Governing Council-meeting press conference, questions were asked about the potential for changes to the USD-centered global monetary system, which has been a hot topic in financial markets since April this year. One reporter said – “my second question is on the role of the euro: the Governor of Banca d’Italia, Fabio Panetta, warned in his speech on 30 May in his concluding remarks that the recent US depreciation raised important questions about the future structure of the international monetary system and the dominant role of the US dollar as both a reserve and a trade invoicing currency. [...] What do you think is happening now with the dollar? And also what could be the implications for us, for the role of the euro and hopefully also euro-denominated safe assets?” President Lagarde responded that – “I happen to be very much on the same page as [Governor Panetta]. I gave a speech in Berlin about ten days ago now [...] in which I tried to identify the key pillars that would need to be consolidated and further developed if the euro was to play a critical role as an international reserve currency. And my conclusion is that there is an opportunity, which is opening now, to strengthen the role of the euro as an international currency as to take it further towards possibly the international reserve currency of choice.” The potential collapse of the USD-dominant global monetary system and the rise of EUR are probably the topics that ECB officials have been most frequently asked about recently.

It should be understood, however, that a weakening of USD dominance will not automatically make EUR the international reserve currency of choice. After President Lagarde mentioned the possibility that EUR could become the international reserve currency of choice, she elaborated on that situation, saying – “But my conclusion is that it is not going to be granted to us. It should not be taken as a given, and it will require in particular that Member States, the Commission and the European Council make very substantive decisions that will have to do with consolidating the economic and geopolitical role of Europe, that will simplify, streamline and develop the role of the capital markets union in particular – the savings and investments union, if you will, but particularly the capital markets union.” I think this is a very reasonable statement. The graph shows that, although USD’s share of the world’s foreign exchange reserves has indeed fallen dramatically over the past quarter century, the contemporaneous rise in EUR’s share of reserves has been much smaller than the drop in USD’s share.

Statistical limitations make it difficult to say for sure, but it is highly likely that the reserves have been diversified through additions of such currencies as CAD, RMB, and AUD rather than EUR. President Lagarde argues that – “Member States, the Commission and the European Council make very substantive decisions that will have to do with consolidating the economic and geopolitical role of Europe” – but the reserve currencies world is not so simple that a general judgement that USD is no longer supreme will spur a general trend of EUR buying. Unless EUR can gain a strong reserve currency status, it will not be able to strengthen its status as a key currency.



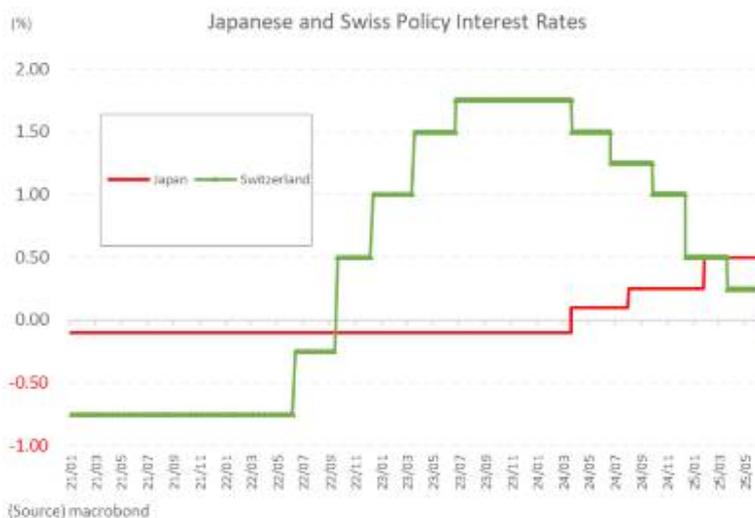
It is worth noting that in 2008 (the 10th anniversary of EUR’s launch), the European Commission published a commemorative paper entitled – “EMU@10 Successes and challenges after 10 years of Economic and Monetary Union” – and I was one of the authors. The conclusion at that time was that EUR did not have an ambition to challenge USD and replace it as an international key currency – it would be a huge and internationally important currency but would remain principally a regional currency. Neoliberalism was still in full swing at that time, however, so people had no basis for imagining the current behavior of the United States. Now that the United States has become more isolated and the EU has become an entity that directly challenges U.S. values, will be very interesting to see whether the EU will begin fostering ambitions it did not previously have. I would like to discuss this topic in greater depth on another occasion.

## European Currencies Now and Going Forward – Asset Rotation Expectations

### Switzerland’s Appeal and Interest Rates’ Fading Importance

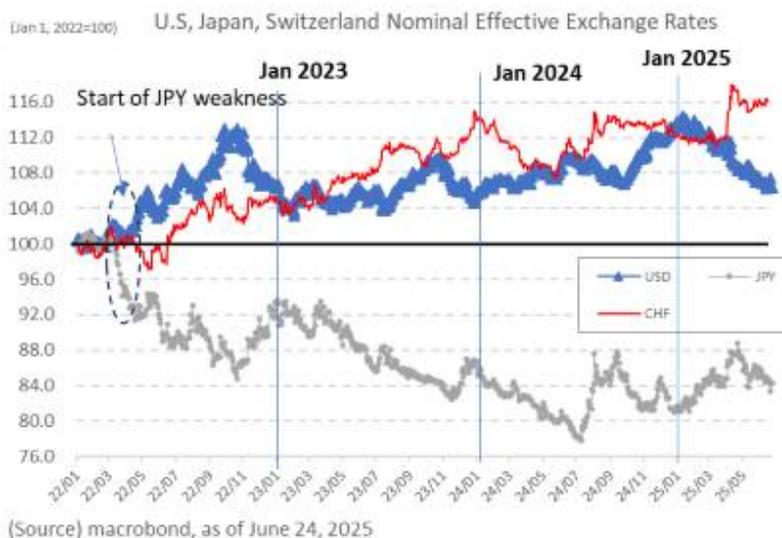
During June, USD became increasingly attractive in the forex market as a safe harbor asset amid growing awareness of Middle East risk factors. The market started to unwind after Israel reported a ceasefire with Iran on June 23, but when one compares changes in G10 currency valuations against USD during the five business days from June 13 (when the Israel-Iran conflict broke out) to June 20, one finds that European currencies generally realized strong performances. Listing currencies from lower to higher rates of depreciation, one finds EUR depreciated -0.23%, DKK -0.24%, AUD -0.54%, CHF -0.78%, and GBP -0.88%. Although the traditional pattern of “emergency situation USD buying” is still evident, it can be said that the recent forex rate movements suggest the possibility of a trend of rotation into European assets.

As the ECB, the Danish central bank, and the Swiss National Bank (SNB) are all in the process of lowering interest rates, it is clear that monetary policy and interest rates are not currently the main drivers of the rotation. In particular, the SNB cut interest rates by an additional 25 basis points on June 19, returning to zero-level interest rates for the first time in about three years (see graph). Despite simmering speculation that the SNB’s “next move” may be reinstating negative interest rates, the trend of increase in CHF buying has been unstoppable, probably reflecting the appeal of Switzerland’s accumulating trade surplus, stable government debt situation, controlled inflation situation, and established position as a geopolitically neutral country<sup>2</sup>. The rate of change in Switzerland’s consumer price index (CPI) has intermittently sunk into negative territory. Japan’s experience seeking to control JPY appreciation demonstrated the general rule that “deflationary currencies will appreciate”, and CHF is now the leading example of that rule.



### Sharp Contrast Between CHF and JPY

As argued in previous editions of this article, CHF and JPY were once considered currencies with similar safe haven currency characteristics, but the gap between them has grown extremely wide. As the graph shows, on nominal effective exchange rate (NEER) bases, CHF has continued strengthening more than USD, while the trend of JPY avoidance has been clearly evident. As mentioned, CPI growth rates in Japan remain high compared to those Europe and the United States, making CHF/JPY a deflationary currency/inflationary currency rate that is inevitably destined to rapidly rise in light of purchasing power parity (PPP) differentials. Looking at monetary policies, it is clear that the “BOJ’s hawkish stance” and the “SNB’s dovish stance” are likely to coexist for the time being.

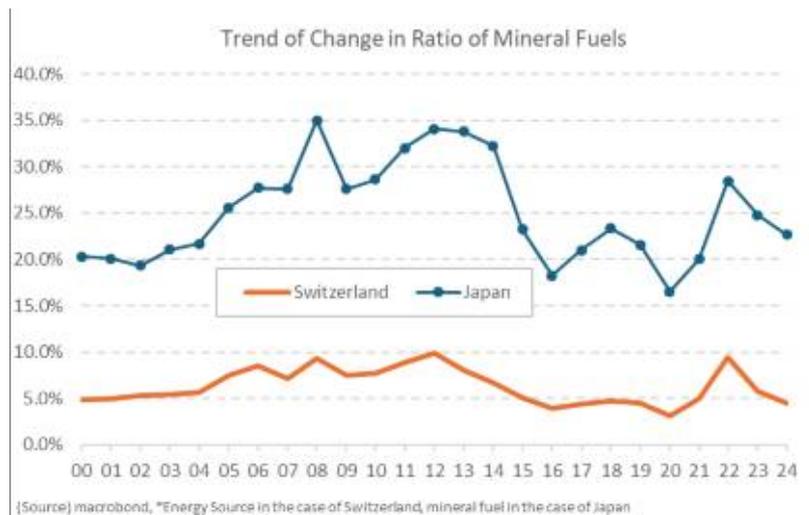


This is reflected in the Japan/Switzerland policy interest rate gap, which has already expanded to 50 basis points, but although JPY is associated with higher interest rate levels than CHF, there is no sign of JPY’s weakness against CHF being alleviated. The price-side contrast between Japanese inflation and Swiss deflation and the supply-demand side contrast between Japanese trade deficits and Swiss trade surpluses are ultimately promoting JPY depreciation against CHF, while the oft rumored effect of domestic-foreign interest rate differentials appear unlikely to play a major role in this situation. Those insistent on assessing the effects of interest rates will find it easier to understand the current situation by focusing on the fact that real interest rate levels (nominal interest rates - inflation rates) are clearly higher in Switzerland than in Japan. (This comparison has the same basis as the PPP differentials mentioned above.) Also mentioned above is the fact that Switzerland is considered to have a lower level

<sup>2</sup> Please see the April 23, 2025 Market Topic article entitled, “Lessons from the Swiss franc, which remains the strongest currency.”

of relevant geopolitical risks, as the country has made itself a kind of neutral buffer zone, and that low geopolitical risk level contrasts with the relatively high level of Japan, which could become involved in responses to Taiwan-related emergencies.

Also mentioned above is the fact that, although the situation had become more calm at the time of writing, Japan and Switzerland have shown widely disparate levels of resilience in situations where geopolitical risk factors boost crude oil prices. As has generally been the case since March 2022, resource price uptrends will promote growth in Japan's trade deficit and increase pressures to sell JPY. Fuels account for approximately 25% of Japan's total imports but only around 5% of Switzerland's imports, enabling Switzerland to show considerably more resilience regarding risk factors liable to affect fuel prices. The disturbing reality is that CHF is consistently superior to JPY – it is difficult to find any dimension in which CHF is inferior to JPY.



### Rotation to European Assets

Although I would like to discuss this situation in greater depth on another occasion, it is worth noting that the currency that showed the strongest performance after June 13 was USD, which had been rumored to be losing its reserve currency status and to be subjected to a methodical devaluation (a second Plaza Accord). USD's post-June 13 performance reflected the phenomenon known as "buying USD in times of crisis." Ultimately, the simple logic of the "as war risks increase, apparently strong currencies are bought" truism proved that it remained as valid as ever – the fact that USD is favored during crises is a natural forex market development reflects a fundamental principle that has not changed since ancient times. As previous editions of this article have repeatedly argued, even if the United States actually was seen to be actively striving to devalue USD, it would remain self-evident that, overall, the disadvantages of USD depreciation would clearly outweigh the benefits. My view is that concerns that the second Trump administration wants to weaken USD are principally based on a spurious new media narrative.

On the other hand, even if the United States does not actively seek to devalue USD, it is undeniable that other countries may scale down their use of USD as a reaction to the second Trump administration's behavior and thereby cause a passive USD devaluation process. As mentioned above, European currencies have remained strong even amid the rampant "emergency USD buying" situation. At the time this article was written (June 30), EUR and CHF had risen against USD by +13.3% and +13.6%, respectively, since the start of 2025. EUR has been appreciating since Liberation Day, rising +8% in the period from April 2 to June 30. That makes it the European currency with the second largest appreciation margin, after CHF's +10%, and the GBP also showed a strong performance, rising +5.5%. As mentioned above, I intend to continue striving to elucidate the significance of such forex rate movements based on Treasury International Capital (TIC) data from the U.S. Treasury Department and similar data from other sources.

## EU Security Strategy – A European Hamiltonian Moment

### European Rearmament Begins

On May 27, the European Commission approved Security Action For Europe (SAFE), a financial instrument that will provide up to EUR150 billion in loans to EU member states to fund rearmament investments. Some reports have referred to it as an rearmament financing fund, but since it is designed to promote the overall strengthening of defense systems, it is nonoptimal to focus exclusively on "armaments" or "weapons". As this article has previously confirmed, SAFE is part of the EUR800 billion ReArm Europe Plan agreed to at the EU Special Summit in March this year. From the beginning, plans have called for EUR150 billion of the EUR800 billion to be shouldered by the European Commission via jointly issued bonds, with the remaining EUR650 billion to be covered by budget increases by individual member states. It seems that the procedures required to enable SAFE's legally compliant implementation have been completed. All these initiatives can be considered political measures aimed at preparing to respond to the NATO summit described below – these initiatives have established a financial support system for rearmament at the EU level.

Going forward, the European Commission will use the low-interest, long-term funds raised through joint bonds to provide loans for joint defense projects in accordance with the provisions of SAFE. Aimed at strengthening defense capabilities by bolstering the European Defence Technological and Industrial Base (EDTIB), SAFE is designed specifically "to improve the production capacity of the defense industry in Europe and establish systems for rapidly supplying necessary equipment". Since the European Commission uses the creditworthiness of EU member states to fund SAFE, the terms of SAFE fund usage are strict. SAFE funds can only be employed when member states jointly procure defense equipment, and specific conditions include the requirement that "at least two member states must be involved, and more than 65% of the procurement must come from the EU, the European Economic Area (EEA), or Ukraine".

Because the funds raised via SAFE are to be provided to entities within the EU and provisions have been made to promote the creation of joint procurement systems, it can be expected that SAFE will directly provide a significant boost to the EU economy. Strictly speaking, participation remains possible for countries with which the EU has concluded security and defense partnerships, other EU candidate and potential EU candidate countries, as well as other countries, but SAFE essentially calls for an increase in defense spending within the EU. The EU has already been able to maintain expansionary fiscal policies within the constraints of the Stability and Growth Pact (SGP), and it is anticipated that SAFE may boost the EU's potential growth rate.

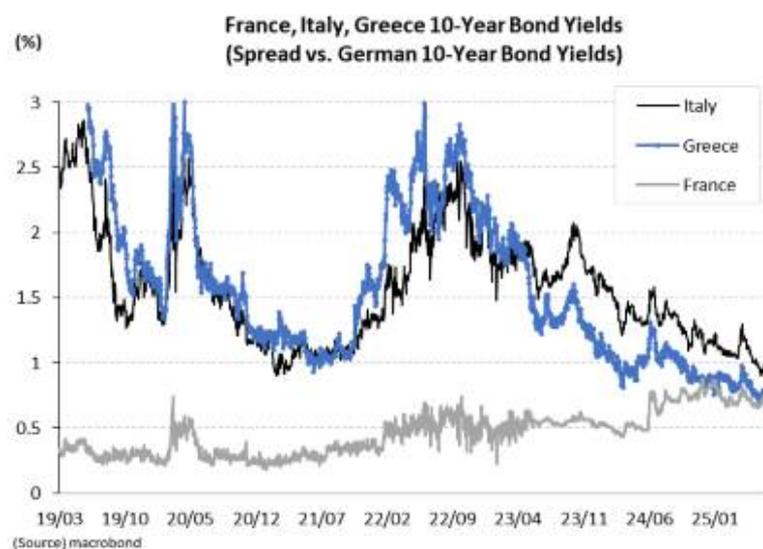
### *A European Hamiltonian Moment*

The moment when the United States underwent a transformative shift toward fiscal integration is sometimes called the “Hamiltonian Moment”, after Alexander Hamilton, the United States’ first Treasury Secretary, who worked hard to commonize the debts of individual U.S. states (fiscal integration) and laid the foundation for today’s USD. As is generally understood, following the May 2021 Economic and Financial Affairs Council (ECOFIN) meeting, it became legally possible for the EU to raise funds through the issuance of EU bonds (NextGenerationEU recovery fund bonds, or NGEU bonds) totaling EUR750 billion, and there is now a basis for wondering whether the NGEU bond issuance may turn out to be a European version of the Hamiltonian Moment. Previous editions of this article devoted considerable attention to this situation as it took shape. It has only been about four years since the first issuance of NGEU bonds, and plans call for NGEU bond issuance to continue until 2026, so it is still too early to judge whether NGEU bonds have become a catalyst promoting the EU’s integration.

It is worth noting, however, that it was the covid pandemic crisis that made possible the major step to common EU bond issuance, and the current rearmament crisis is expected to have a similar effect in spurring additional progress toward greater EU integration. Numerous previous editions of this article have pointed out that the EU has a history of realizing additional integration processes each time it overcomes a major crisis. For example, the European Commission and the ECB created various financial safety nets following the 2009 debt crisis, and the pandemic created a precedent for joint EU bonds. Currently, war-related concerns are encouraging the EU to regularize its use of joint bonds. It may require considerable time for EU joint bonds to become considered a safe asset on a par with U.S. Treasury bonds, but it should be noted that the size of SAFE may well grow to exceed the current EUR150 billion limit, particularly given expectations that, after the second Trump administration, future U.S. government administrations will continue encouraging Europe to become more strategically independent. The United States does not believe it has the capabilities to be confidently on the brink of war with two major powers (Russia and China) at the same time, so it naturally has a desire to give Europe more responsibility for dealing with Russia, and it can be expected that this desire will persist.

Many people throughout the EU also desire greater strategic independence from the United States, a characteristic goal of French diplomacy since the de Gaulle era (although some EU member states have complained that the phrase “rearmament of Europe” phrase is excessively provocative). About eight years ago (on May 28, 2017), German Chancellor Angela Merkel predicted that Europe would need more independence in the future, saying – “The era in which we could fully rely on others is over to some extent. [...] We Europeans truly have to take our fate into our own hands [...] we have to recognize that we Europeans must fight for our own future and destiny.” This appears to reflect a German perspective that may cause Germany to expand the scope of its expansionary fiscal policy initiatives to areas other than rearmament.

Now that it has become difficult to rely on U.S. military support, the EU’s initiatives to accumulate funds (mainly for defense spending) through common EU bond issuance and to shift toward the promotion of expansionary fiscal policies seem to be somewhat irreversible developments. Since the end of the pandemic, for example, the gaps between the yields of German government bonds and other EU countries’ government bonds have greatly diminished – now French and Greek bond yields are now almost at the same level, and Italian bond yields are descending to levels close to that (see graph). This could be seen as a temporary trend, but if the current situation continues, it could be interpreted as indicating that a world is taking shape in which exchange rate risks and fiscal risks are progressively equalized. It does in fact appear that NGEU bonds and SAFE are acting as catalysts promoting a European version of the Hamiltonian moment.



### *Benefits Beyond Defense Spending*

If a “world of equalized exchange rate and fiscal risks” takes shape, more EU member states will be able to raise funds at lower interest rates than before. Consequently, EU member states may find it easier to launch expansionary fiscal policies in areas other than defense. Soon after the launch of EUR, expectations for a “world of equalized exchange rate and fiscal risks” grew prematurely, enabling southern European countries and other EU countries with loose fiscal policies to become dramatically extravagant by taking advantage of the creditworthiness of such core EU

countries as Germany and France and ultimately culminating in the European debt crisis. At the time, neither the European Commission nor the ECB had a safety net systems for preventing or alleviating the crisis, which thus became prolonged and increasingly severe. At present, however, the European Commission has the European Stability Mechanism (ESM), and the ECB has many tools, including the unlimited purchase program for short- and medium-term bonds (OMT). Having already experienced the European debt crisis, the EU has created strict and well-developed systems for monitoring member state budgets, so it is highly unlikely that the European debt crisis will be repeated.

As the EU shifts toward expansionary fiscal policies, such countries as Germany may be forced to pay higher interest rates than before, but southern European countries will be positioned to enjoy lower interest rates than before. Germany's balanced fiscal policies were widely considered to be excessively strict, and rising interest rates in Germany will not cause major problems. Germany has long benefited from an excessively weak common currency that facilitated its exports but now will have to accept somewhat higher interest rates that reflect the EU's greater fiscal integration. On the other hand, southern European countries have long dealt with challenges stemming from an excessively strong common currency but will now enjoy somewhat lower interest rates in return. These recent developments should ideally have been considered one of the objectives of establishing a common currency area. As Europe now progressively promotes greater strategic independence along with greater fiscal integration, the key question now is how close the EU can get to that ideal objective. The SAFE framework is expected to be a major milestone marking progress toward that objective.

#### *Europe Now Positioned to Achieve Strategic Autonomy*

Another important event related to European security was the June 25 NATO summit meeting, which gave NATO member countries the task of increasing their defense budgets to 5% of nominal GDP by 2035. Raising NATO member countries' defense budget targets to above the previous 2% of nominal GDP target level is an issue that President Trump has emphasized since his first administration. No concrete action to boost the targets was taken previously, but the outbreak of war in Ukraine and dramatic military capability expansion in China have made it difficult for Europe to continue ignoring the scantiness of NATO countries' military spending. As previous editions of this article have argued, the Trump administration's military spending-related demands on Europe are logical, and it can be said that the recent defense spending target level hike is exactly what is required and is justified amid current circumstances. As China's military power grows, U.S. military resources will inevitably be shifted to the Asian region and committed to such tasks as deterring a Taiwan emergency.

The shift of U.S. military resources to Asia suggests that the task of dealing with Russia will be consigned to Europe, and the EU has drafted the ReArm Europe Plan to create the capabilities required to carry out that task. There have for many years been calls (mainly by France) for Europe to augment its strategic autonomy, and it is finally apparent that Europe is positioned to make great progress toward that objective.

### Satisfactory Results for both Europe and the U.S.

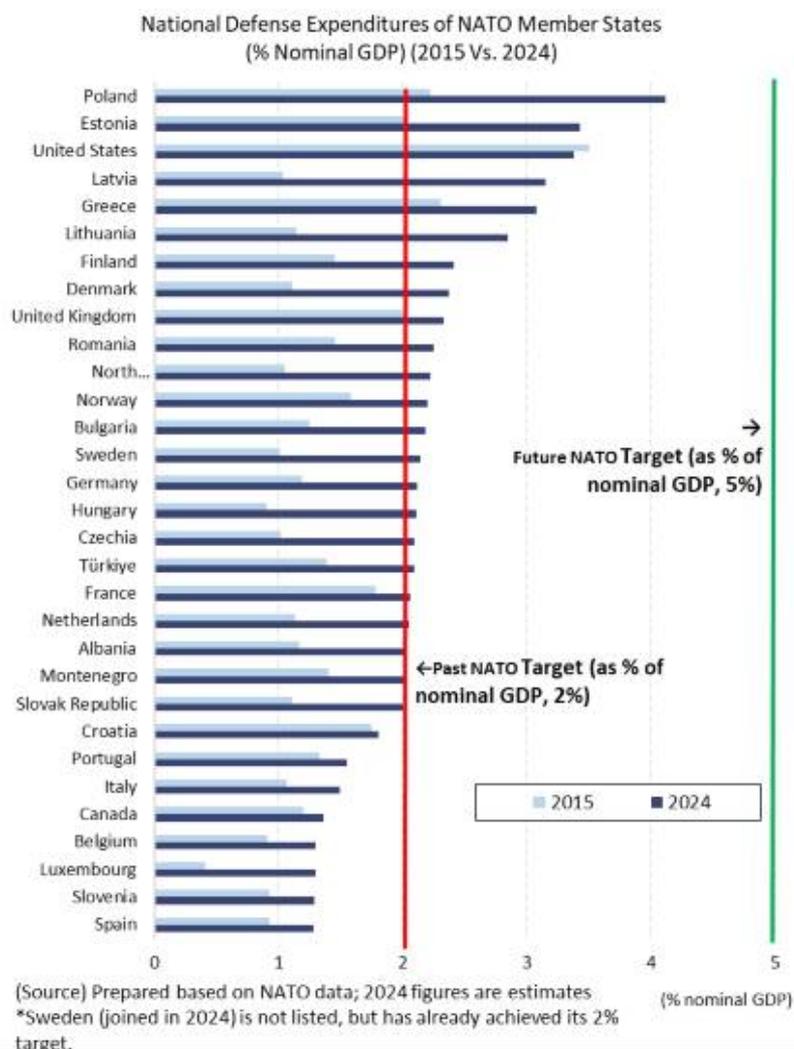
The NATO meeting achieved results considered satisfactory from the perspectives of both Europe and the United States. The graph on the right shows that most NATO member states were quite far away from attaining the 2% defense spending target 10 years ago but most of the states reached the target in 2024. Making sure to allocate “5% of nominal GDP” to defense spending by 2035 is an ambitious goal for all NATO member states, including the US, but the need for greater defense spending is increasingly clear. If Europe augments its own military resources, it will enable U.S. military resources to be progressively shifted to the Asian region. While President Trump had previously been quite critical and dismissive of NATO, he expressed very positive sentiments about the alliance following the summit meeting, saying – “We’re with them [NATO members] all the way” and “I think the summit was fantastic. It was a big success.” It is only speculation at this point, but given that the Trump administration seems to give a high priority to its concerns about allies’ military spending levels, there appears to be grounds for hope that the NATO summit’s success will have a positive impact on the outcome of U.S.-EU trade negotiations, which remains unclear.

From the perspective of Europe, the NATO summit was a great success in the sense that it appears to have softened the stance of President Trump, who during his first administration had threatened to abandon NATO’s collective self-defense requirement or even withdraw from NATO. President Trump is now saying positive things about NATO. The statement issued after the latest NATO summit clearly states that – “We reaffirm our ironclad commitment to collective defence as enshrined in Article 5 of the Washington Treaty – that an attack on one is an attack on all.” The EU-centered rearmament strategy that has been developed since this past March appears, for the time being, to have achieved the desired results.

### Can Concerted Crisis Consciousness be Maintained for a Decade?

The only concern is that there remain frictions with the United States as a result of Spain's insistence that it can fulfill its defense obligations even while spending just 2.1% of nominal GDP on defense. Having already allocated large amounts of resources to social welfare programs, Spain finds it difficult to expand defense spending, and the weakness of its current minority government makes it difficult to reach a bipartisan agreement. As a result, only Spain is allowed “flexibility to determine its own sovereign path”, although it has argued that it can meet NATO’s military capability targets while spending only 2.1% of its nominal GDP. The agreement allows Spain to submit annual plans to demonstrate progress, with a review scheduled for 2029. Naturally, President Trump is not convinced by Spain’s arguments, and he is threatening to make Spain pay “twice as much”, implying doubled tariffs on Spanish goods to offset their lower defense contributions. While U.S.-Spanish trade relations should basically remain within the framework of U.S.-EU negotiations, there is now a prospect that Spanish exports will be singled out for retaliatory tariffs.

It is unlikely that U.S.-Spain frictions will lead to general U.S.-EU frictions, but Spain's attitude is evidence that there are big differences in awareness of the insufficient defense spending problem within the EU. Member states geographically close to Russia (such as the Baltic states, Poland, and Northern European countries) are concerned that they will become “the next Ukraine”, and Poland and Estonia already allocate more military spending as a percentage of nominal GDP than the United States. Given such large attitude differences among EU member states, one wonders whether it will be possible to achieve the long-term goal over the 10 years through 2035 and then sustain the higher spending levels throughout the region. Over the medium-to-long-term, sustaining European countries’ concerted efforts to boost defense spending through means including in the issuance of joint bonds will be an important objective, and achieving that objective will be a key factor enabling Europe to maintain good relations with the United States.



However, I believe that these military spending issues are unlikely to cause a rift within the region. Strictly speaking, NATO's current 5% of nominal GDP defense spending target encompasses 3.5% for actual defense spending along with another 1.5% for broadly defined "security spending", including spending on such infrastructure development projects as those to create roads that may become necessary in the event of emergencies. Having endorsed the NATO spending target, EU members now have the leeway to increase their infrastructure spending in ways that supersede EU fiscal spending restrictions, and such infrastructure spending is likely to boost the regional economy. For example, Germany created a EUR500 billion infrastructure investment fund this March after a series of constitutional amendments and strategic fiscal maneuvers, including a move to exclude defense and security-related expenditures from the borrowing limits imposed by its debt brake law. In the long run, such augmented infrastructure investment is likely to promote greater accumulation of capital stock in the EU economy and boost the EU economy's potential growth rate.

### *Augmenting Japan's Defense Spending*

There is also a need to consider how these events in Europe are likely to impact Japan. Under the National Security Strategy it formulated in 2022, Japan has set a goal of increasing the level of its defense spending to 2% of nominal GDP by fiscal 2027. It would be difficult to be confident that Japan's 2% defense spending target will be sufficient, however, particularly given that Japan could become involved in Taiwan-related emergency situations that are among the biggest foci of the U.S. security strategy. Japan is likely to serve as an important military base for dealing with whatever such emergency situation may arise. As JPY has considerably depreciated since the National Security Strategy was formulated, it is quite reasonable to argue that attaining the original 2% spending target will not actually be sufficient to enable the originally envisioned increase in military power, so it seems inevitable that the target level will be raised. This past March, U.S. Under Secretary of Defense Elbridge Colby testified before the U.S. Congress that – "Japan should be spending at least 3% of GDP on defense as soon as possible".

There have intermittently been media reports speculating that the cards Japan could potentially play in Japan-U.S. tariff negotiations could include proposals to increase the cost of stationing U.S. troops in Japan and to expand Japan's defense spending, and the recent decision to augment NATO members' defense spending could be a factor that finally tips the balance in favor of a Japanese decision to expand its defense spending. I had been hoping to see more information about such a decision released at the time of the NATO summit, but such information was not forthcoming as Prime Minister Ishiba cancelled his planned NATO summit attendance at the last minute. That was somewhat disappointing. Expanding Japan's defense spending will put constant pressure on government bond issuance and elevate ultra-long-term JPY interest rates, which are already attracting considerable attention. If various domestic and international factors cause JPY interest rates to trend upwards, how will the BOJ control that trend and how will the forex market evaluate it? We are entering an era in which a proper understanding of international security issues is an additional necessary basis for forecasting the outlook for various kinds of asset prices.

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