

Forex Medium-Term Outlook

August 1, 2025

Overview of Outlook

USD/JPY rise gained momentum in July. Before the House of Councillors election, financial markets were focused on the possibility of a major defeat for the LDP and Komeito, leading to the resignation of the Ishiba administration and political instability. This was ruled out when Prime Minister Ishiba announced he would continue in office. The avoidance of a crazy scenario with the rise of a successor with stronger expansionary fiscal tendencies and sympathy for the expansionary fiscal policies advocated by the opposition parties, resulting in an acceleration of reflationary policies amid inflation was good news for JPY and the Japanese economy. U.S.-Japan negotiations, which had been weighing on market sentiment, have also reached a tentative conclusion, removing uncertainty and clearing the path for the BOJ to consider raising interest rates. While the status quo was maintained at the July meeting, one should be prepared for multiple rate hikes during the current forecast period. With the Fed also expected to cut interest rates around the same time, the upper bound of USD/JPY could be temporarily weighed down, but this is unlikely to be sustained. Concerns about USD's status as a reserve currency, which had been smoldering since April, have clearly receded, and the prospect of a unilateral shift away from USD is fading. The risk scenario during the forecast period likely remains linked to Japanese politics. Although the Ishiba administration avoided resignation, its policy environment will undoubtedly become more restrictive. Speculation about a snap general election of the House of Representatives rises from time to time. If that were to occur, both the ruling and opposition parties could once again begin seeking an expansionary fiscal policy. The possibility of a Japanese-style "Truss Shock" (triggered by former UK prime minister Liz Truss' policies) is low, but cannot be completely ruled out.

EUR weakened in July. News of a U.S.-EU tariff agreement in late July prompted some EUR buying, but the currency plummeted following reports that German and French leaders were unhappy with the agreement, and market sentiment remains tense. However, as of the time of writing, there have been no reports of the agreement being overturned, and things appear likely to proceed based on the ECB's base case scenario. As a result, the need for further rate cuts has significantly diminished, and only one more rate cut is expected during the forecast period. If interest rates below the neutral rate are avoided, EUR is likely to remain strong. EUR remains stronger than can be justified given the U.S.-European interest rate differential even though doubts about USD's status as a reserve currency are no longer fueling USD selling and EUR buying as they once did. My basic understanding is that expectations of higher interest rates in the region prevent EUR from weakening easily. That said, a careful verification of hard data is necessary before concluding a "rotation from USD to Europe" based on only six months of gains. While there will be no major collapse, a rapid rise in EUR, as seen earlier in the year, cannot be taken for granted.

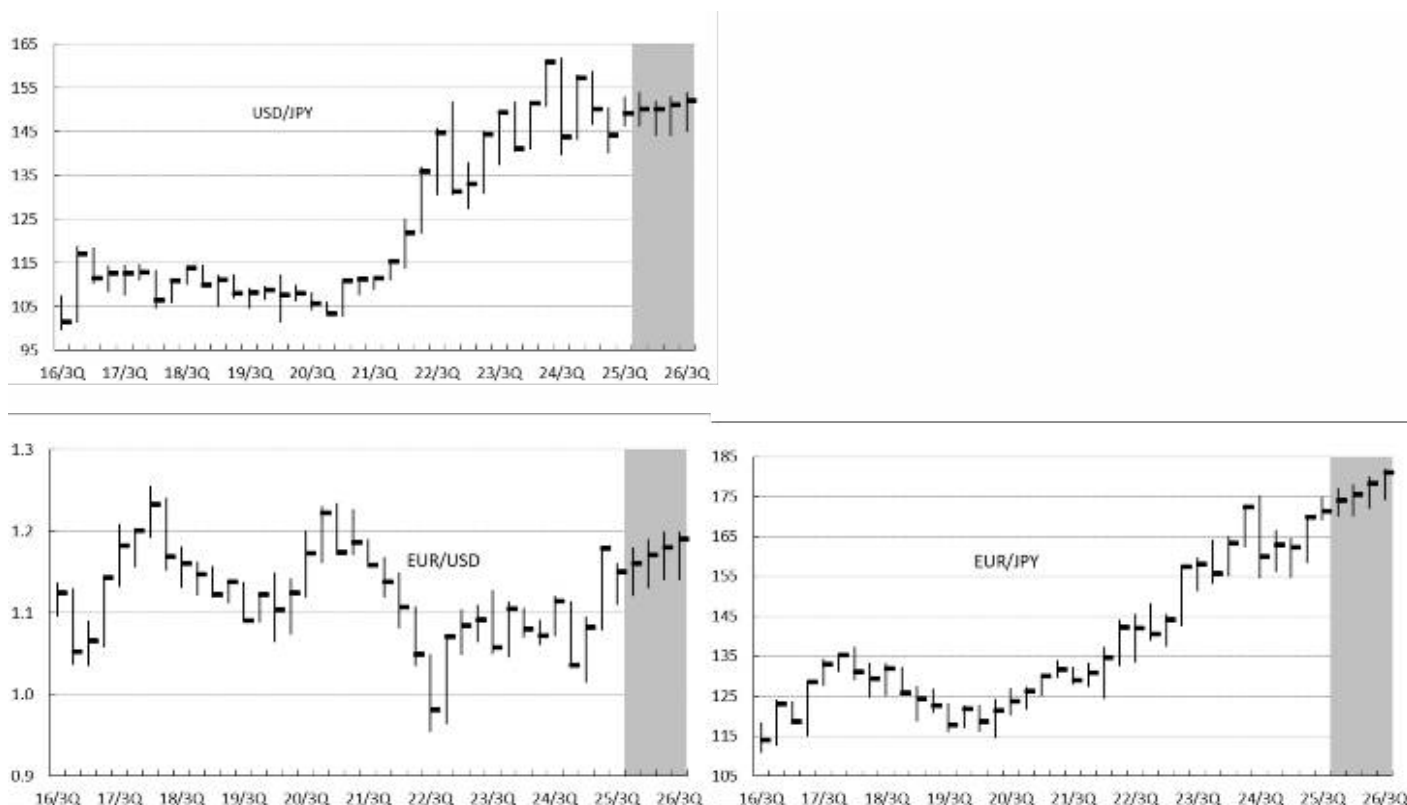
Summary Table of Forecasts

	2025			2026		
	Jan-July (Actual)	Aug-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	139.89 ~ 158.88 (150.73)	146 ~ 153 (149)	146 ~ 154 (150)	144 ~ 152 (150)	144 ~ 153 (151)	145 ~ 154 (152)
EUR/USD	1.0125 ~ 1.1830 (1.1423)	1.11 ~ 1.16 (1.15)	1.12 ~ 1.18 (1.16)	1.13 ~ 1.19 (1.17)	1.14 ~ 1.20 (1.18)	1.14 ~ 1.20 (1.19)
EUR/JPY	155.63 ~ 173.85 (172.20)	169 ~ 175 (171)	170 ~ 177 (174)	170 ~ 178 (176)	172 ~ 180 (178)	174 ~ 182 (181)

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

3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



USD/JPY Outlook - Likelihood of Japanese Truss Shock

U.S.-Japan Tariff Negotiations Now and Going Forward – JPY Weakness as Tariff Buffer

Mutual Pain-Sharing Between Automobile and Agriculture Sectors?

On July 22, U.S. President Donald Trump announced that Japan and the U.S. had reached a final agreement in tariff negotiations. The agreement set a reciprocal tariff of 15% on Japan and pledged USD 550 billion in investment from Japan to the U.S. It further stated that Japan had pledged to open its markets to automobiles and agricultural products, especially rice. Trump heaped praise on the agreement as “the largest agreement in history.” Along with the EU, Japan’s 15% tariff rate is the lowest for countries and regions with a trade surplus with the U.S. The tariff rate for automobiles, which had been Japan’s red line, was also set at 15%. One assumes Japan put up a good fight, given the initial U.S. stance of a non-negotiable 25% tariff rate on automobiles.

Of course, the actual outcome of the negotiation was that Japan was forced to accept a 15% automobile tariff that did not previously exist, promise to invest in the U.S., and open its markets to automobiles and agricultural products, including rice. Minister in charge of Economic Revitalization of Japan Ryosei Akazawa had previously stated that Japan would never compromise on agriculture to protect automobiles in its tariff negotiations with the U.S. Indeed, given that the agreement has resulted in mutual pain for both automobiles and agriculture, one could say that he has made good on his word. The financial markets have welcomed the dispelling of uncertainty with the agreement, but the interesting question going forward is how the BOJ will view it. As an aside, the fact that the basic agreement was announced right after the Upper House election likely helped Ishiba’s continuation as prime minister.

JPY Weakness as Buffer

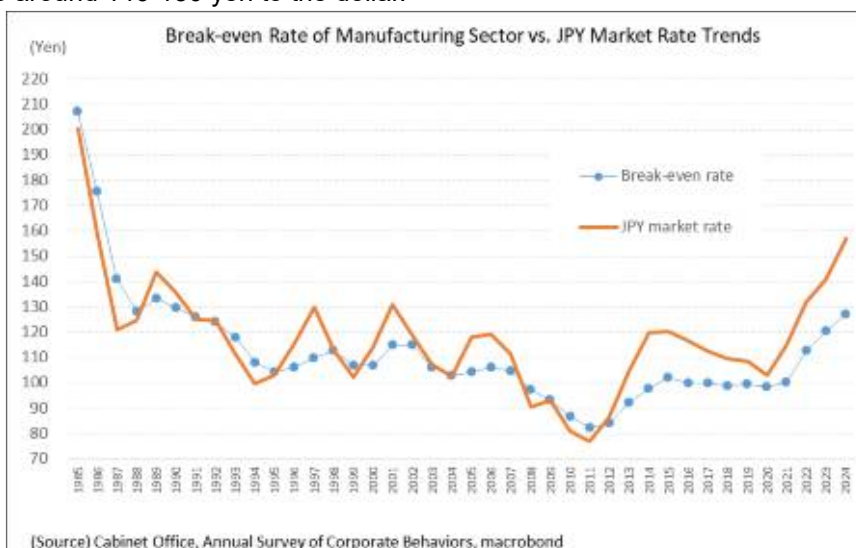
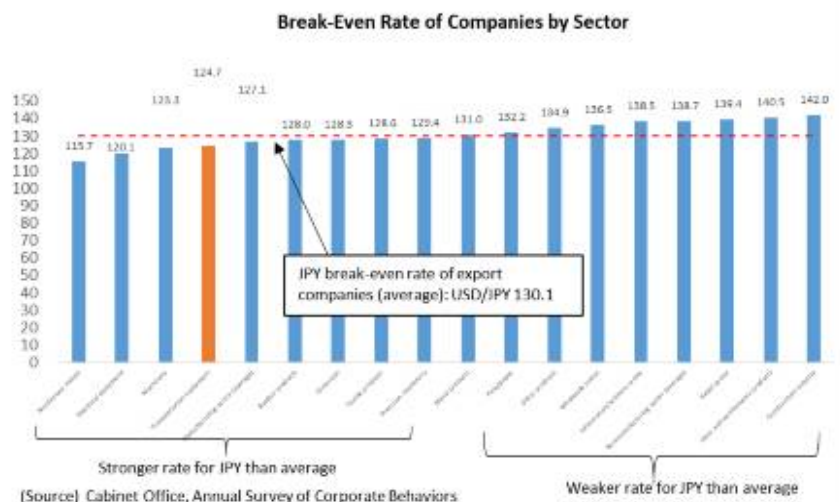
Let us get a sense of the impact of a 15% tariff rate. According to the Annual Survey of Corporate Behavior released by the Cabinet Office in February this year, the break-even rate for the automobile industry is JPY125, meaning that a 144 or higher rate for USD/JPY would be able to absorb a 15% tariff ($125 \times 1.15 = 144$). As long as USD/JPY remains stable between JPY145 and JPY150, a 15% tariff is generally considered to be an absorbable rate. Moreover, if the tariffs could be passed on to sales prices to some extent, the necessary depreciation of JPY against USD would be more modest (the Trump administration has expressed its intent to prevent this from happening, but whether that can be done remains to be seen). Further, since the break-even rate for the export industry as a whole is JPY130, a 15% tariff could be absorbed if USD/JPY is 150 or higher (see graph). Looking solely at the three variables of tariff rate, break-even rate, and market rate, a 15% tariff would not be enough to bring the Japanese economy to a halt. As shown in the graph, the break-even rate for export companies as a whole is JPY130.1, while that for the manufacturing industry as a whole is JPY127.1, which is significantly on the side of JPY strength compared with the market rate, so a 15% tariff rate can be absorbed by JPY depreciation to around 146-150 yen to the dollar.

Thus, there seems no doubt that a high USD/JPY will provide a cushion against the Trump tariffs. Looking back at the period of extreme JPY appreciation following the collapse of Lehman Brothers, when the break-even rate was in the 80s or 90s, some might think even a 25% tariff could be easily absorbed. What is the actual break-even rate? I have no way of knowing and would like to avoid discussing it lightly, as it is probably different for each company in any case. However, JPY weakness pushes up raw material costs, likely pushing up the overall break-even rate. The graph to the right shows historical trends of both break-even and market rates, which are both indeed strongly correlated. This is

consistent with the comments I receive from business people I meet with on a daily basis. To begin with, the prices of production factors, including labor, are completely different now than they were in the 2010s, so it would be unfair to compare the break-even rate then and now using the same forex rate yardstick. With the Trump tariffs in particular, the negative impact of JPY strength is felt when exporting, while its benefits are not realized when importing, which makes the break-even rate even more complex.

Should the BOJ Act to Curb Inflation or Mitigate Tariff Impact?

Given the above circumstances, the BOJ will be in a tight spot when it comes to policymaking. The BOJ has been holding off on raising interest rates due to uncertainty surrounding the Trump tariffs, fearing that strong uncertainty could dampen household and corporate spending and investment. However, in light of the above discussion, holding off on rate hikes to maintain JPY weakness against USD would also mitigate the negative impact of the Trump tariffs. There is certainly an incentive to postpone rate hikes given that even a 15% increase is sure to worsen export companies' profitability. While this approach may be derided as "currency policy in the form of monetary policy," it would not be surprising to see an economic policy response given that a 15% increase in tariffs is equivalent to a 15% JPY appreciation against USD for export companies. In the real world, a 15% fluctuation in forex rates would be highly likely to invite a currency intervention. Still, since the BOJ cannot counter Trump's tariffs through a JPY-selling currency intervention, it is not inconceivable for it to at least mitigate the negative impact by holding off on interest rate hikes. Having said that, ignoring rising prices to mitigate the negative impact of tariffs is fundamentally unjustified and a painful choice for the BOJ to make, especially given that it was a major issue in the Upper House election. It could also accelerate the rise in JPY interest rates, especially in the ultra-long-term bond market. By and large, for the BOJ, this is a question of choosing between protecting export companies and pursuing its price stability mandate. However, if the 15% tariffs were to reduce profits for the automobile sector, which is the Japanese economy's backbone, this could break the wage and price growth virtuous cycle, which is the basis for interest rate hikes in the first place. Thinking that



far ahead, holding off on interest rate hikes could be sufficiently justified. To repeat myself, the BOJ's policy environment has become extremely restrictive.

Even So, Considering Rate Hikes is Desirable

Though a difficult decision to take, I still believe that it is best to implement rate hikes and spare no effort to contain domestic inflationary pressures. For one thing, even though a settlement has been reached, the situation surrounding the Trump tariffs remains fluid, and it may not be appropriate to implement monetary policy responses yet. Even if, in an extreme scenario, the additional tariffs were suddenly lowered or eliminated, it could still be difficult to lower domestic inflation expectations that have risen amid sustained JPY weakness. For example, on July 8, Policy Board Member Junko Koeda pointed out that food prices had risen more than expected, and expressed concern about "the possibility of secondary effects on Japan's perceived inflation, household inflation expectations, and ultimately underlying inflation." This comment was made to caution against the risk of uncontrolled inflation. While there is no need to rush to raise interest rates, it is important to note that guiding interest rates lower as a counter to additional tariffs is a double-edged sword that is permissive of weak-JPY-led inflation.

Japan's Political Situation Now and Going Forward – Restrictions on Foreigners a Major Issue Going Forward

Election Results: A Major Defeat, but Worst-Case Scenario Avoided

In the 27th House of Councillors election, the LDP-Komeito coalition government won only 47 seats. This gives it a total seat count of less than 50 including seats not up for election in the House of Councillors overall, which involves a loss of majority. This is the first time since the party's founding in 1955 that an LDP-led government has lost both houses of parliament (of course, the LDP-led coalition did lose majority in both houses in 2009, when it suffered a major defeat to the Democratic Party of Japan in the Lower House election, but that was when the LDP was not in power).

The financial markets, however, responded calmly. Before the House of Councillors election, financial markets were focused on the possibility of a major defeat for the LDP and Komeito, leading to the resignation of the Ishiba administration and political instability. This was ruled out when Prime Minister Ishiba announced that he would continue in office, bringing a sense of relief to both domestic and international market participants. The crazy scenario of the rise of a successor (such as Sanae Takaichi) with stronger expansionary fiscal tendencies and the acceleration of reflationary policies amid inflation with rising sympathy for the expansionary fiscal policies advocated by the opposition parties was avoided. This brought relief, and JPY was clearly bought back on the morning of Monday, July 21, as soon as the Tokyo market opened following the weekend.

As mentioned above, an agreement on U.S.-Japan tariffs was already in sight around the time of the Upper House election, so a resignation of the Ishiba administration was unlikely. However, if we focus on the number of Upper House seats won by the LDP alone (39), this is greater than the number of seats won by the first Shinzo Abe administration following the 2007 Upper House election (37), and the LDP coalition is predicted to scrape together a majority through the admission of some independent members. The general assessment is that this is a major defeat for the ruling coalition, but that the worst-case scenario has been avoided. The default scenario for the moment is that the Ishiba administration will continue.

Simmering Speculation of a Snap General Election

It seems clear that managing the Diet has become significantly more difficult since the election. Also, given that the "down with Ishiba" sentiment is unlikely to completely disappear before the next snap general election, JPY buying immediately following announcement of his continuation can be interpreted as market participants taking advantage of a buying opportunity. Various rumors are circulating regarding the expansion of the coalition framework and opposition alliances in the near term. Based on the premise that partial agreement is possible depending on the policy, some likely alliance candidates are the Constitutional Democratic Party of Japan (CDP), led by Yoshihiko Noda, who is considered to have close ties with Prime Minister Ishiba, and the Japan Innovation Party (JIP). Going by policy discussions before the election, "partial agreement depending on policy" essentially means agreement may be possible on an expansionary fiscal policy.

During a TV Tokyo election special, Noda had stated, "The people have said no to the LDP government. It is unthinkable to form a coalition with a party that has been rejected," but going by the CDP's stance, it is unlikely to allow the cash handouts it advocates to be blocked. The same is true for other opposition parties. In fact, it is quite likely that the government would be forced to accept demands of a consumption tax cut (i.e., reduced tax rate) because "handouts alone are not sufficient." Given that the ruling party is a minority in both houses of the Diet, the specter of a snap general election will be raised every time Diet operations stall. This will inevitably strengthen a mood that encourages an expansionary fiscal policy either through handouts or tax cuts as at the current time. A "triple decline" (simultaneous decline in share prices, bond prices, and JPY) scenario has been avoided for now, but it could well return in the near future.

Of course, it may not altogether be fair to lay the full blame for the LDP's crushing defeat on the Ishiba administration. Given the extent of inflation entrenchment and real wage sluggishness, a harsh judgment was likely whatever the party in power and whoever the prime minister. In fact, the opposition parties only ever talk about consumption tax cuts and other expansionary fiscal policies, so inflation levels may have been even worse if they had been in power. At least, this is how financial markets perceive it, since expectations of triple-decline are closely related to a change in government. Memory of the 2022 Truss Shock is still fresh, and Japan can not afford to dismiss it entirely as someone else's problem, but there is no sense of urgency in Japanese politics. Some media reports have interpreted the

election results as a verdict in favor of tax cuts over handouts, so, as noted above, the temptation to cut consumption taxes is unlikely to disappear in the future.

Historically, during the first oil crisis in 1973, both Japan and the U.S. responded to economic stagnation with expansionary fiscal policy. This resulted in further inflation, and both countries had to learn about the ineffectiveness of Keynesian policy, which advocates responding to recessions with expansionary fiscal policy, the hard way. Despite the steep surge in prices, they were unable to recognize the error of their expansionary fiscal policies. This time again, unless inflation overshoots to the extent that the pain of JPY weakness and high interest rates forces us to learn, the fiscal policy stance may not change significantly.

No Avoiding Interest Rate Hikes

Throughout history and around the world, the first prescription for chronic inflation is interest rate hikes, no questions asked. This is true regardless of which party is in power or who is prime minister. As the financial markets demonstrated during this election campaign, expansionary fiscal policies such as handouts and tax cuts contribute to rising interest rates and JPY weakness due to the damage to government finances. This is exactly what happened. While a triple decline was avoided following the ruling party's crushing defeat, interest rates and USD/JPY remain high. This likely reflects caution about future expansionary fiscal policies. Raising interest rates would force the economy into a contractionary equilibrium, which is expected to calm soaring inflation.

Of course, such policy decisions are unpopular, but it is precisely because they are unpopular that they are made by politically independent central banks with a high level of expertise. Further, expansionary fiscal policies could mitigate the pain associated with a contractionary equilibrium, provided inflation subsides. It is important to remember that fiscal and monetary policies are primarily tools for smoothing out the economic cycle fluctuations. In this regard, perhaps we have entered an era in which the BOJ's dignity as a central bank will be put to the test.

Will Restrictions on Foreigners Become an Issue Going Forward?

Social insurance premiums, which significantly erode the working-age population's disposable income, were not an issue this time either. They were mentioned briefly by some, including the Japan Innovation Party, but drew little attention. While lower social insurance premiums would contribute more to improving take-home pay compared with handouts or tax cuts, people are, as usual, drawn to easy-to-understand short-term schemes such as handouts and tax cuts. To complicate matters, inflation hurts those with relatively low incomes and higher propensity to consume more, but this is also the group most easily lured in by handouts and tax cuts. This creates a structure in which the policies such people support ultimately ending up causing them pain. But there is a cognitive lag between "expansionary fiscal policy" and "accelerating inflation," and it is not easy to recognize this when voting.

Incidentally, many analysts have suggested that expansionary fiscal policy themes such as consumption tax cuts and handouts aside, restrictions on foreigners attracted greater attention during the final stages of the recent election campaign. Indeed, the rapid rise of Sanseito (the Party of Do it Yourself) supports this. If this is the case, restrictions on foreigners and consumption tax cuts may become key issues in upcoming national elections, while issues like national defense and social security premiums are brushed aside. While online images and stories of unreasonable behavior by foreign visitors to Japan do not necessarily reflect reality in its entirety, politics can be driven by such perceptions. This is similar to the situation in Britain, where the fear that immigrants were threatening the lives of British citizens led to Brexit. At that time, far-right groups in the UK popularized slogans such as "We want our borders back," leading to Britain's exit from the EU. However, numerous related studies (including those by the Bank of England and the London School of Economics) have found that, while immigration may have partially limited the wages of low-skill workers, it had no significant impact on the foundations of the British economy. Media reports and politics inspired by such reports only exacerbated public anxiety, preventing the British people from trying to understand the true nature of the situation. It is only natural for people to be sensitive to threats coming from outside their borders, and any firsthand experience to back their fears would rapidly expand support for such ideas.

Returning to Japan, it is true that the rapid expansion of inbound tourism is causing inconveniences, large or small, to the lives of Japanese citizens. Firsthand experiences of such inconveniences create a situation in which support for "Japanese First" could expand unhindered. Right or wrong, this is the direction in which public opinion is moving.

Restricting Foreigners Promotes Further JPY Weakness

Such public sentiments result in policy trends in favor of restricting foreign capital and people. As a specific example, I would like to focus on the impact of restricting foreign capital and people on Japan's travel surplus as well as stock, real estate, and other asset prices, which is in complete contradiction to the direction previously pursued by the government and ruling parties. For example, in June of this year, the government and ruling parties set ambitious goals of achieving a JPY120 trillion inward foreign direct investment balance by 2030 and a JPY150 trillion balance as early as possible in the 2030s. Facing a labor shortage and a relative lack of capital, Japan needs foreign assistance, and I believe this policy direction is appropriate. However, the recent election results indicate a swing in the opposite direction from this open-minded approach. Given that older generations tend to vote for traditional parties, led by the LDP, while younger generations tend to vote for new parties such as the Party of Do It Yourself or the Democratic Party for the People, this inward-looking trend seems sure to intensify as the population declines.

This could even undermine the stability of Japanese government bonds (JGBs) and JPY. For example, if we look at Japan's balance of payments statistics, travel accounts for Japan's single largest source of foreign currency revenue. If public opinion heats up and policies aimed at curbing inbound tourism gain momentum, this would have to be interpreted as a factor contributing to JPY depreciation. This is not an idle theory; Europe, led by Spain, is currently taking measures to combat overtourism, such as restricting cruise ship port calls and passenger numbers. As for JGBs, the fact is that they are slowly but surely losing their domestic character, which makes any idea of "not relying on

foreign capital” unrealistic. Would foreign investors actively invest in a country that politically advocates the exclusion of foreigners and foreign capital? As I have argued in previous reports, “achieving a JPY120 trillion inward foreign direct investment balance by 2030 and a JPY150 trillion balance as early as possible in the 2030s” is an ambitious goal. It will require policy responses to remove all the obstacles.

Of course, if the “Japanese First” public opinion grows stronger, Japan will have no choice but to accept it, and similar trends are certainly occurring in Europe and the U.S. This does not necessarily indicate a discriminatory stance. However, Japan is facing the fastest rate of population decline among the world’s developed countries. This is why ideas such as making Japan a tourism capital of the world and promoting inward FDI have been touted as policies to utilize foreign “capital” and “people” – in other words, as a way to take advantage of JPY weakness. It must not be forgotten that Japan’s economic and financial situations are too difficult to overcome on its own.

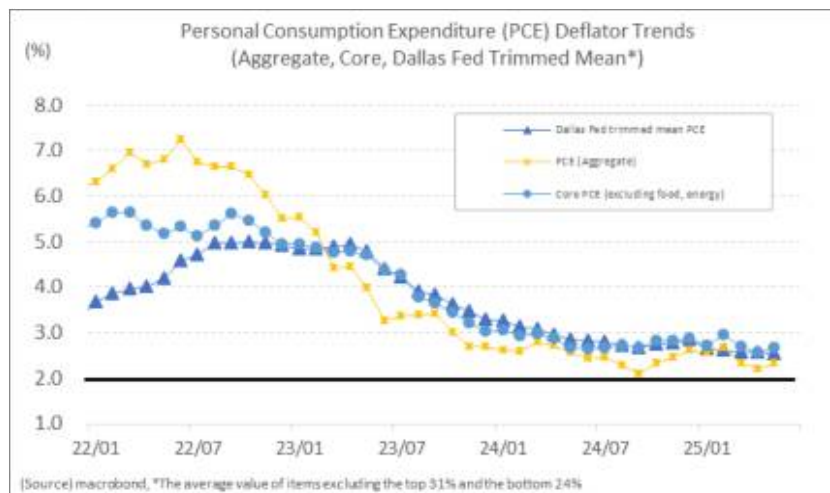
U.S. Monetary Policy Now and Going Forward – Trouble Brewing for End of Year Onward

No Information on September Rate Cut

At the July FOMC meeting, the federal funds (FF) rate target range was kept unchanged at 4.25%-4.5%. Two members – Fed Vice Chair Michelle Bowman and Governor Christopher Waller, who have frequently spoken sympathetically about President Trump – voted against the decision, arguing for a 25bp rate cut. However, this is difficult to take at face value, as it could also be a strategic move to position themselves as potential candidates for the Fed Chair role. (The last time two governors cast opposing votes was in December 1993). Fed Chair Jerome Powell made no statements suggesting a September rate cut, which was temporarily priced in by financial markets at around 0.8 times. The strong results for the April-June quarter U.S. real GDP may have been a factor. The overall hawkish stance resulted in a rise in U.S. interest rates, stocks being sold, and USD being bought.

Concerns about Inflation Rates Beyond the Year-End

As Powell mentioned in his press conference, the Fed seems uncertain how to move at the present time, given the uncertainty (around the timing and extent) of the impact of tariff hikes on inflation. While the most recent June Consumer Price Index (CPI, core basis, excluding food and energy) was +2.8% yoy, it is not a significant jump, but sooner or later, the impact of the Trump tariffs will begin to be passed on to consumers. The Trump administration is attempting to contain this trend through investigations and monitoring, but there are likely limits to what it can do. The current trend is not causing much of a problem, likely due to the fact that companies operating in the U.S. have ample inventory, having purchased goods ahead of the tariff implementation. Naturally, the cost of inventory held is still pre-tariff, so there is no chance of any impact on inflation at this early stage. (Further, given the phased implementation and exceptions to some tariffs, the pass-through will likely be limited.)



However, the corporate sector cannot afford to absorb the entire impact of the tariffs. In a speech at an academic conference in mid-July, New York Fed President John Williams said, “I expect tariffs to boost inflation by about 1 percentage point over the second half of this year and the first part of next year.” If this prediction plays out as expected, the U.S. inflation rate will temporarily settle in the 3% range from the end of this year through the first half of 2026.

A Very Troubling Situation

Williams’s forecast, if true, is extremely troubling. This is because expectations regarding the post-Powell regime will strengthen starting year-end of this year and during 1H of 2026. As a result, a situation could emerge in which personnel changes increase the likelihood of a rate cut, while statistics (tariff inflation) do not justify it. How would financial markets respond in this situation? They would likely begin to price in the idea that rate cuts without regard for inflation are unsustainable, leading to persistently strong USD, and U.S. interest rates reluctant to weaken. If Williams’ forecast is taken at face value, base effects would likely result in high inflation rates through the end of 2026. However, given the worsening real income environment due to tariffs, downward pressure on inflation may also be exerted, and the pass-through may not be as strong as expected. There is still too much unknown about the actual impact (even to the Fed). However, it is true that price pass-through by companies, which has not yet occurred, will gradually begin, and given the current inflation rate, it is quite possible that inflation could reach the 3% range. It is common sense to assume that it would be difficult to continue cutting interest rates repeatedly while inflation remains above 3%. Of course, the Fed will likely argue that the inflation boost from tariffs is temporary, and that is a valid explanation. However, financial markets will likely react hysterically to any upward fluctuations in inflation indicators, and if rate cuts are forcibly implemented during a phase of inflation, there is the danger of interest rates spiking due to fears of inflation acceleration.

Taking all these factors into account, the rational move for the Fed may be to cut rates before the effects of tariffs become apparent. As of the time of writing, the probability of a rate cut as priced in by the financial markets has fallen to 60% for September, but has risen to 80-150% for October and December. The logic of cutting rates before inflation accelerates significantly may seem perverse at first glance, but it is not impossible given the complex political situation.

JPY Supply and Demand – Household JPY Selling Shows no Sign of Abating

A 10% Foreign Currency Share is in Sight

According to the BOJ's Flow of Funds Accounts (preliminary) as of the end of March 2025, household financial assets stood at JPY2,194.7 trillion, down slightly from the record high of the previous period, but up 0.3% compared with the same period of the previous year (see table). Compared to a quarter-century ago (as of the end of March 2000), financial assets themselves had increased by approximately JPY794 trillion. Separating this increase into JPY-denominated assets and foreign-currency-denominated assets reveals that the former increased by approximately JPY702.3 trillion and the latter increased by approximately JPY91.3 trillion, so the increase is overwhelmingly driven by the former. However, as a percentage of total assets, foreign-currency-denominated assets increased more than fivefold, from 0.9% to 4.8%, while JPY-denominated assets declined by 3.8 pp, from 99.1% to 95.2%. However, as I have mentioned in previous reports, foreign currency-denominated life insurance, which has seen large sales in recent years, are not included in this table due to statistical constraints. They are included, instead, as part of insurance, pensions, and standardized guarantee schemes (JPY570.7 trillion). Assuming that 5% of insurance, pensions, and standardized guarantee schemes are foreign currency-denominated, the foreign currency asset ratio would rise to 6%. If we assume that 10% of insurance, pensions, and standardized guarantee schemes are in foreign currency, the foreign currency asset ratio would rise to 7%. Taking all this into account, we could see 10% of household financial assets being foreign currency denominated in the near future, or this may already be the case. For example, if we assume that 20% of insurance, pensions, and standardized guarantee schemes are foreign currency-denominated products, the foreign currency asset ratio would already be in excess of 10%.

Incidentally, the item with the largest increase in ratio over the quarter century was stocks and capital investments in JPY-denominated assets (+2.4 pp), followed by investment trusts in foreign currency-denominated assets (+2.3 pp). Meanwhile, the largest decline was seen in JPY-denominated cash and deposits (down 2.3 pp), followed by foreign-currency-denominated government bonds (down 2.2 pp). Over the past quarter century, a rebalancing trend has been observed, with JPY-denominated cash, deposits, and government bonds being liquidated and transferred to foreign-currency-denominated investment trusts. This likely signifies an unintended shift in asset composition from deflation-optimal to inflation-optimal.

Composition of Japanese Household Financial Assets
(as of the end of MAR 2025)

	Amount (¥trillion)	Share (%)
Total assets	2,194.7	100.0
Foreign currency nature	104.5	4.8
Foreign currency deposit	7.3	0.3
Foreign investment in securities	37.6	1.7
Investment trust	59.5	2.7
Yen character	2,090.2	95.2
Cash and deposits (excluding foreign currency deposits)	1,112.2	50.7
Government bonds, etc.	31.5	1.4
Stocks and investments	268.4	12.2
Investment trusts (excluding foreign currency portion)	76.0	3.5
Insurance and pension reserves	570.7	26.0
Deposits, etc.	31.4	1.4

Composition of Japanese Household Financial Assets
(as of the end of MAR 2000)

	Amount (¥trillion)	Share (%)
Total assets	1,401.1	100.0
Foreign currency nature	13.2	0.9
Foreign currency deposit	3.1	0.2
Foreign investment in securities	4.7	0.3
Investment trust	5.3	0.4
Yen character	1,387.9	99.1
Cash and deposits (excluding foreign currency deposits)	741.6	52.9
Government bonds, etc.	50.6	3.6
Stocks and investments	138.3	9.9
Investment trusts (excluding foreign currency portion)	52.2	3.7
Insurance and pension reserves	369.9	26.4
Deposits, etc.	35.3	2.5

Changes from the end of MAR
2000 to the end of MAR 2025

Amount (¥trillion)	Share (%)
793.5	
91.3	3.8
4.2	0.1
32.9	1.4
54.2	2.3
702.3	▲ 3.8
370.6	▲ 2.3
▲ 19.1	▲ 2.2
130.0	2.4
23.7	▲ 0.3
200.8	▲ 0.4
▲ 3.9	▲ 1.1

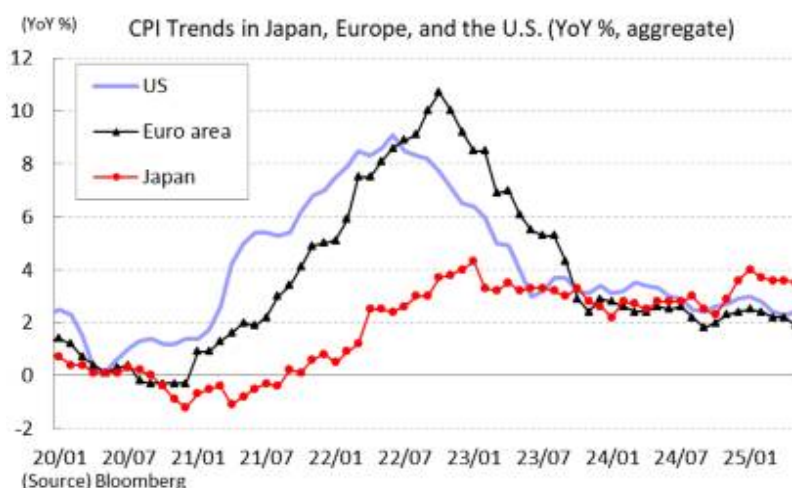
Source: Bank of Japan, Flow of Funds Statistics

Decline in Investment Appetite Temporary?

However, these graphs only reflect the situation as of the end of March this year. The big shock to financial markets occurred after April 2, so we will need to wait for the June end Flow of Funds Accounts statistics for details. In this connection, there is some noteworthy news. According to a survey by the QUICK Asset Management Research Institute, the estimated inflow of funds into domestic open-ended publicly offered equity investment trusts (excluding ETFs) in June, calculated as the amount of new investments minus cancellations and redemptions, was JPY406.4 billion, less than half of the confirmed graph for the previous month (JPY877.8 billion). This is the lowest level in a year and a half since December 2023 (JPY305.3 billion), the lowest since the launch of New NISA, and the first time it has fallen below JPY1 trillion for two consecutive months since the launch of New NISA. As we saw following the crash last August, the question of whether investment appetite in domestic and foreign mutual funds and securities will continue is once again a hot topic.

However, with the domestic economy and financial situation clearly leaning toward inflation, how likely is it that these funds will return to JPY-denominated cash, deposits, and government bonds? While it is true that a rebalancing toward government bonds could be justified given the rising JPY interest rate, Japan's inflation rate remains relatively high compared to Europe and the U.S. (see graph), and a weaker JPY is justified in terms of purchasing power parity.

There are likely multiple reasons for the current decline in household investment appetite, but it is probably not because investors believe, at this time, that Japan is on the verge of returning to deflation. Given the strong JPY-selling pressure stemming from shifts in the supply-demand structure, the tight domestic employment and wage environment, and the short-term impact of imported inflation due to tariff policies, it is unlikely that the Japanese economy will be able to avoid inflationary pressures for the time being. The decline in investment appetite seen since this spring is likely merely a result of a decline in risk tolerance due to growing uncertainty, so I believe it may simply be a temporary slowdown.



Government Making Steady Progress Toward Target

Incidentally, the number of NISA accounts continues to grow steadily. As of the end of March 2025 (preliminary graphs), there were 26,469,325 accounts. This represents an increase of more than 880,000 accounts in just three months since the end of December 2024 (25,586,460 accounts), for which final graphs are available. The government's target is 34 million accounts by 2027, and if the current pace can be maintained over the two years and nine months (33 months = 11 quarters) until the end of December 2027, this target will likely be easily achieved. Incidentally, the NISA account balance (target balance: JPY56 trillion by 2027) was not disclosed in the March preliminary graphs, but stood at JPY52,635,984,660,000 in the final graphs for the end of December 2024. The preliminary graphs for the end of March 2025 only disclosed the purchase amount, which was JPY6,603,277,280,000. When these graphs are combined (approximately JPY52.6 trillion + approximately JPY6.6 trillion = JPY59.2 trillion), it appears that the target balance has already been achieved. This was already known in March of this year through comparison with data from the Japan Securities Dealers Association, but this is the first time that we have been able to get a sense of it from official statistics released by the Financial Services Agency. However, the government and ruling parties will only officially declare the target achieved when the final graphs for the end of March 2025 are announced, which will likely only be in September this year.

The rapid pace at which the balance target has been reached, surpassing the number of accounts, may be due to an unexpectedly strong desire to invest, but more likely due to historical JPY weakness, which has helped drive the balance upward.

Younger Generation Continues to "Flee Savings"

Examining the data by age using final graphs as of the end of December 2024, we can see a continued marked increase in investment enthusiasm among younger generations (see table). As of the end of March 2014, when the old NISA was launched, more than half of the accounts were held by people aged 60 or older. However, as of the end of December 2024, this proportion is around 25%.

Over the same period, the share of accounts held by the working generation, primarily those in their 30s and 40s, has rapidly increased.

The top share has shifted from those in their 60s to those in their 50s, and now those in their 30s and 40s are closing in on the 50s. Interest in asset management is clearly stronger among the working generation, likely reflecting a desire to protect their assets. While people in their mid-40s and older, like myself, have overwhelmingly longer experience and memories of the Japanese economy struggling with a chronically strong JPY, those in their 20s and 30s are increasingly aware of the Japanese economy struggling with inflation due to a weak JPY. Younger generations have a stronger sense of resignation when it comes to JPY-denominated assets, and this has led to a desire to invest in

Comparison of the Number of NISA Accounts by Age Group

	Number of accounts (End of MAR 2014)	Share	Number of accounts (End of DEC 2014)	Share	Change in share (% pts)
Total number	6,503,951	100.0%	25,586,460	100.0%	-
10 s			119,872	0.5%	-
20 s	209,144	3.2%	2,950,112	11.5%	8.3%
30 s	501,895	7.7%	4,486,512	17.5%	9.8%
40 s	823,581	12.7%	4,923,179	19.2%	6.5%
50 s	1,078,784	16.6%	4,951,402	19.4%	2.8%
60 s	1,874,228	28.8%	3,770,942	14.7%	-14.1%
70 s	1,490,993	22.9%	2,839,669	11.1%	-11.8%
80 s and above	525,326	8.1%	1,544,862	6.0%	-2.1%

Source: Author from the Financial Services Agency

overseas assets, particularly in U.S. stocks. It is undeniable that this has contributed to the current JPY depreciation, and it is likely to have an impact going forward.

While the current investment behavior of this younger generation indicates a shift from savings to investment, it is more convincing to describe it as a “flight from savings” rooted in a defensive mindset that continuing with JPY-denominated assets may not be a good idea. It is a sad state of affairs. When asset management data is broken down by age, it becomes clear that the generations who will be responsible for the future of Japan have the least hopes for Japan.

BOJ Monetary Policy Now and Going Forward – Fog Not Yet Completely Cleared

Cannot Let Guard Down Following 15% Tariff Agreement

At its July Monetary Policy Meeting, the BOJ decided to maintain its target for the uncollateralized overnight call rate at 0.5%. This marks the fourth consecutive meeting since the January rate hike at which the status quo was maintained, and the decision was unanimous. In its previous statement, the BOJ had noted that there was extreme uncertainty surrounding overseas economic and price trends, reflecting the uncertainty surrounding the Trump tariffs. This statement has now been revised to state that “high uncertainty continues regarding future trade policies in various countries.” This suggests that caution has eased somewhat, and the fog is beginning to clear toward a rate hike. However, as BOJ Governor Kazuo Ueda said, “The fog is unlikely to clear all at once.”

The relevant section continues, “...if uncertainty persists, the focus on cost reduction could intensify. Under these circumstances, the trend of reflecting rising prices in wages may weaken.” As discussed in the past, the lack of a written agreement regarding the 15% tariff has led to concerns about the fluidity of the situation, and the BOJ appears to share this view. Further, even if 15% is a “good deal” (compared with 25%), it will still represent additional costs for companies, raising concerns that it could be used as a reason to curb wage increases. This is precisely what the BOJ means when it says “the focus on cost reduction could intensify.”

In short, the BOJ is not as positive about the 15% agreement as financial markets assume. Since its previous monetary policy decision was based on the assumption that some progress would be made in the tariff negotiations, the BOJ's argument may be that a settlement in itself is not enough to trigger a policy change.

The October Rate Hike Could be a Focus Point

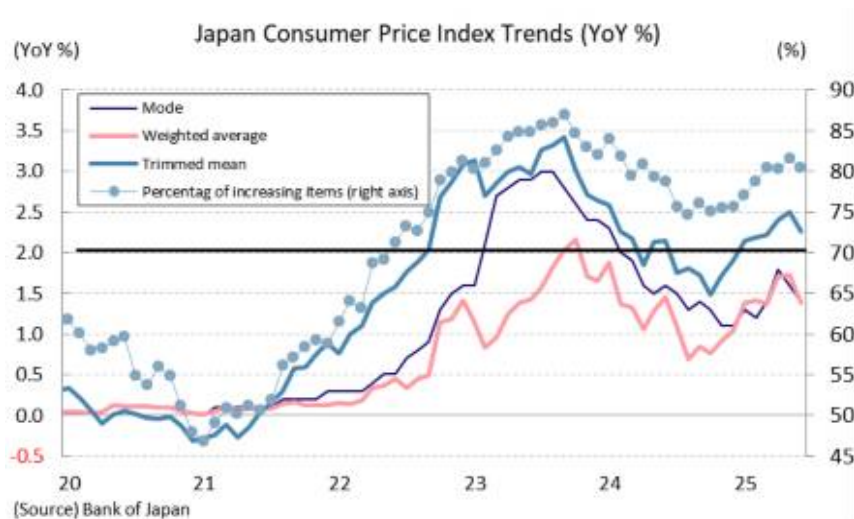
Following the January rate hike, the Japanese economy was essentially in a position to justify a further rate hike. However, since April, the BOJ has maintained a wait-and-see approach, as the impact of the Trump tariffs is unclear. This time, the reasons for this wait-and-see approach have faded, and there is no doubt that the distance to further rate hikes has shrunk. However, the BOJ's basic understanding appears to be that the distance has not shrunk as much as the market had hoped. Unless the situation improves dramatically, a September rate hike will be difficult, and whether a rate hike is possible in October, alongside the release of the Outlook Report, will likely be a key focus. To put it differently, barring major problems, an October rate hike seems likely. The BOJ's basic position since last year has been that it will proceed with a steady rate hike if the situation is in line with the Outlook Report's forecast. In this regard, the latest Outlook Report significantly raises the outlook for the Consumer Price Index (CPI, core, excluding fresh food) for fiscal 2025 by 0.5 pp, from +2.2% to +2.7% (see table). This upward revision in the space of three months is likely to have been unexpected even for the BOJ, and it undoubtedly provided the impetus for a rate hike. However, since the outlook for fiscal 2026 and fiscal 2027 were only raised by 0.1 pp each, the BOJ's stance seems to be that there is no need to make a fuss about the recent upward revision since the CPI growth rate is expected to cool down eventually.

Majority Outlook, BOJ Policy Board Members (YoY %)

	Real GDP	CPI (excluding fresh foods)
FY2025	0.5~0.7 <0.6>	2.7~2.8 <2.7>
Outlook as of April	0.4~0.6 <0.5>	2.0~2.3 <2.2>
FY2026	0.7~0.9 <0.7>	1.6~2.0 <1.8>
Outlook as of April	0.6~0.8 <0.7>	1.6~1.8 <1.7>
FY2027	0.9~1.0 <1.0>	1.8~2.0 <2.0>
Outlook as of April	0.8~1.0 <1.0>	1.8~2.0 <1.9>

Note: Figures in <> indicate median value of Policy Board Members' projections; (Source) BOJ

Governor Ueda also stated, “Monetary policy will not be influenced solely by an increase in the inflation outlook,” emphasizing that a mere upward revision in the Outlook Report does not lead directly to a rate hike decision. He went on to explain that “underlying inflation is closer to 2% than before,” but this is essentially another way of saying that underlying inflation has not yet reached 2%. Ultimately, thanks to it not being clear what “underlying inflation” actually means, there is once again a communication gap between financial markets and the BOJ, as usual. Many of the “indicators that help gain an understanding of underlying inflation rates” published monthly by the BOJ have been consistently above +2% (see graph). It could be no easy task to maintain the status quo when headline CPI readings exceed +3% as a norm. At this point, a reasonably likely scenario for 2025 is one rate hike by October, followed by two more in 2026, with interest rates potentially rising above 1%, the lower limit of the neutral interest rate. Ironically, JPY depreciation has accelerated since the BOJ began the recent status quo trend, and depending on the extent of JPY depreciation, there should be room to consider the possibility of a rate hike in September.



Risks to My Main Scenario – Possibility of a Japanese Truss Shock?

A Japanese Version of the UK's Truss Shock?

In July, anticipation of changes in Japanese politics and increases in JPY interest rates promoted a surge in the selling of JPY and bonds. Particularly noteworthy factors promoting the selling included opposition parties' calls for expansionary fiscal policy in an era of inflation along with a persistent belief that, having transitioned from majority government to minority government status, the LDP-Komeito coalition would not be able to resist those calls. The LDP-Komeito coalition led by Prime Minister Shigeru Ishiba retained control of the government following the election, and JPY strengthened after tariff negotiations with the United States were concluded, however, creating considerable doubts about the plausibility of the “JPY selling due to fiscal concerns” theory, although it is true that there is a stronger-than-previously perception that JPY weakness is associated with concerns about prospective trends in government spending.

Against this backdrop, many media articles have suggested that the scenes seen in Japan during July are reminiscent of the so-called “Truss shock” that occurred in the UK in September and October of 2022. Indeed, regarding JPY interest rates, the uptrend in ultra-long-term interest rates (such as 20-, 30-, and 40-year rates) has continued to attract attention since April, and 10-year interest rates reached levels around 1.60% during July. The JPY interest rate uptrend has coincided with a period of JPY weakness, so it is understandable that there is growing speculation that this could be a sign of a debt crisis. Although it is quite unlikely that anything as severe as the Truss shock is underway, I believe one should be cautious about applying past arguments – such as “Japanese government bonds are fine because they are purchased by domestic investors” and the “the bonds are fine because Japan has a very high level of net external assets along with a current account surplus” arguments – to the present situation.

Review of the Truss Shock

Let's start by briefly reviewing what happened during the Truss Shock. Prime Minister Mary Elizabeth Truss took office in September 2022 (replacing Prime Minister Boris Johnson, who was forced to resign following a scandal) and announced that she would implement an expansionary fiscal policy centered on large-scale tax cuts, which had been a major concern in financial markets even before she took office. Specifically, she announced an economic policy (commonly known as a “mini-budget”) centered on abolishing the top income tax rate, halting plans to raise corporate tax rates, reducing national insurance contributions, and reducing stamp duty (see table). In response, long-term interest rates

Tax Reduction Policies of Truss Administration (mini-budget)

Policy	Details
Abolition of highest bracket of income tax	45% → abolished (highest bracket becomes 40%)
Abandonment of corporate tax hike	Abandonment of plans to raise from 19% → 25%
Lowering of National Insurance (NI) premiums	Abandonment of 1.25pt raise
Stamp duty reduction	Tax exemption for real estate purchases
Energy price control measures	Caps for households; approx. GBP60 billion (six months') worth

(Source) Compiled by author from various media reports

in the UK government bond market soared, however, and concerns about the potential collapse of many UK pension funds led the Bank of England (BOE) to begin unlimited purchases of long-term bonds. Furthermore, GBP/USD hit its lowest level since 1985 (USD1.035), and the FTSE stock price index plummeted to its lowest level in a year. Financial markets became dominated by a “sell UK” mood. In addition, although it is extremely unusual for the IMF to comment on the economic policy management of developed countries, it did issue an emergency statement in this regard. Financial markets gradually regained calmness thanks to the BOE's intervention, but confidence in Prime Minister Truss never recovered, and she was ultimately forced to resign on October 20, 2022, just 45 days after taking office. This was the end of the Truss shock, which was unfortunate in its timing, as it coincided with the BOE embarking on quantitative tightening (QT) measures as part of its rollback of post-pandemic easing measures, and it also demonstrated the potentially enormous risks of managing economic policy in ways that ignore warning signs from financial markets.

Arguments Against Likelihood of a Japanese Truss Shock

It is important to understand the potential for Japan to face a similar version of the Truss Shock (hereafter referred to as a Japanese Truss Shock).

People who believe the potential is minimal tend to focus on the following four points:

- 1) The UK records current account deficits, while Japan records current account surpluses.**
- 2) The UK has net external debt, while Japan has net external assets.**
- 3) The majority of Japanese government bonds are absorbed domestically.**
- 4) Although Japan's “government debt/nominal GDP” ratio is high, its “government interest payments/GDP” ratio is not as high as the UK's.**

These factors are by no means as convincing as many people believe, however, and I will begin by explaining the weaknesses of points (1) and (2). Regular readers of this monthly article will immediately realize the difficulty of arguing that Japan's economy is robust owing to those two points. It is true, of course, that Japan's situation is much stronger than the UK's with respect to current account balances and consequential net external asset (or debt) balances. When one compares current account balances as percentages of nominal GDP in 2024, the UK ranks 36th out of 41 countries classified as developed countries in the IMF's World Economic Outlook, at -3.4%. In contrast to that, Japan ranks 17th, at +4.8%. In terms of current account balance value, the UK ranks 39th, at -USD122.7 billion, while Japan ranks 3rd, at +USD193 billion.

World's Top Net Creditor & Net Debtor Countries

(Top & Bottom 10 Countries, Trillion Dollars)

Country	Net Creditor	Country	Net Debtor
Germany	3.64	US	-26.23
Japan	3.49	Brazil	-0.75
China	3.30	Spain	-0.73
Hong Kong	2.04	France	-0.62
Norway	1.74	Mexico	-0.59
Canada	1.72	Australia	-0.42
Switzerland	1.34	India	-0.37
South Korea	1.15	UK	-0.35

(Source) IMF

Because the accumulation of these annual current account surpluses (point (1)) becomes net external assets (point (2)), the net external asset gap between the UK (a net external debtor) and Japan (a net external asset holder) has inevitably become extremely large. At the end of 2024, the UK was a net external debtor with net external debt totaling USD351.3 billion, while Japan was a net external asset holder with net external assets amounting to USD3.49 trillion. It is worth noting that the UK ranks 103rd in the world regarding net external asset levels while Japan ranks second, just after 1st ranked Germany and before 3rd ranked China (see table). In terms of external economic sector robustness, Japan is incomparably superior to the UK.

A “Mature Creditor Nation” Only Superficially

However, that external economic sector robustness may not effectively promote JPY appreciation. This article has repeatedly argued that there is a strong possibility that Japan's current account surpluses (principally supported by primary income surpluses) and Japan's net external assets (of which direct investments comprise nearly 60%) will not return to Japan. Japan does acquire and hold amounts of foreign currency that are large in numerical terms, but the question of whether those amounts are sufficient to support JPY is another matter. In general, Japan and other countries that record trade surpluses will thereby generate sustained demand for their currencies. In contrast, however, a large share of Japan's primary income surpluses is in the form of interest and dividends on securities as well as the retained earnings of overseas subsidiaries, and these funds are largely reinvested in foreign currencies to take advantage of higher compound interest rates available outside Japan. Japan's primary income surplus is the country's source of foreign currency acquisition in statistical terms, but one has to give due consideration to where that foreign currency goes after its acquisition.

Do the facts that Japan records current account surpluses and has net external assets make a Japanese Truss Shock unlikely? I think it would be dangerous to assume that a Japanese Truss Shock is unlikely. Balance of payments development stage theory would suggest that Japan is a “mature creditor nation” – it is not dependent on capital inflows from

its financial accounts, but capital inflows from current account surpluses have supported its domestic financial circulation structure, including that for government bonds. However, my hypothesis recently has been that Japan is actually recording current account deficits on a cash flow basis, meaning that Japan’s current account surpluses are not actually helping support JPY. Although Japan can be considered a “mature creditor nation” based on statistics, it actually also has some characteristics of a “debt-discharging nation”. Based on statistics, one can say it is superficially true that the UK is an “immature debtor nation” incomparably weaker than Japan – a “mature creditor nation” – but I don’t think that is the key point. If one assumes that Japan’s primary income surplus will not be repatriated, then the country’s “mature creditor nation” status is only a superficial veneer (see table).

On the other hand, the UK is an international financial center structured to be dependent on financial account surpluses (capital inflows). Given that, it is clear that such actions as those of the Truss government that openly defied financial markets’ expectations and encouraged capital outflows from fast-moving financial products, could lead directly to severe turmoil in the UK, and that is exactly what happened. I do not think Japan is as vulnerable as the UK to such a scenario, but I consider it important to note that Japan and the UK are not necessarily as disparate as one might think based on balance of payments statistics.

Balance of Payment Stages

Status of supply & demand?

	(1) Young debtor	(2) Mature debtor	(3) Debt reducer	(4) Young creditor	(5) Mature creditor	(6) Asset liquidator
Current account balance	Deficit	Deficit	Surplus	Major Surplus	Surplus	Deficit
Goods & services balance	Deficit	Surplus	Major Surplus	Surplus	Deficit	Deficit
Primary income balance	Deficit	Deficit	Deficit	Surplus	Major Surplus	Surplus
Net external assets	Deficit	Deficit	Deficit	Surplus	Major Surplus	Surplus
Financial balance	Surplus	Surplus	Deficit	Major Deficit	Deficit	Surplus
Example	UK		China	Japan until 2012 or so	Japan	US

(Source) Compiled by author

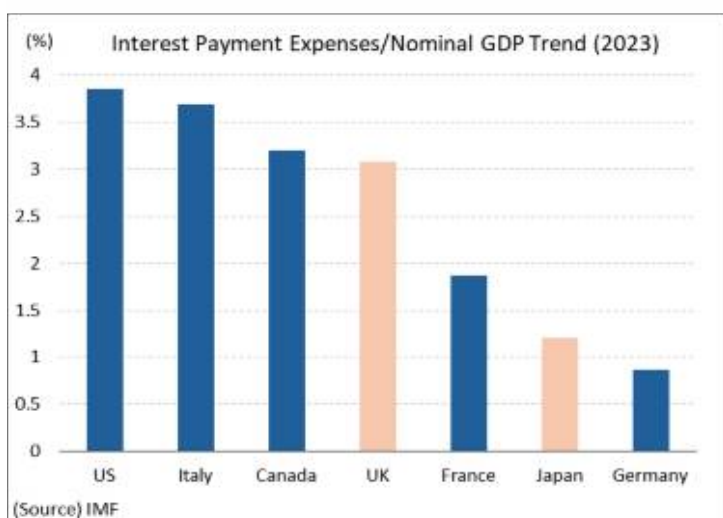
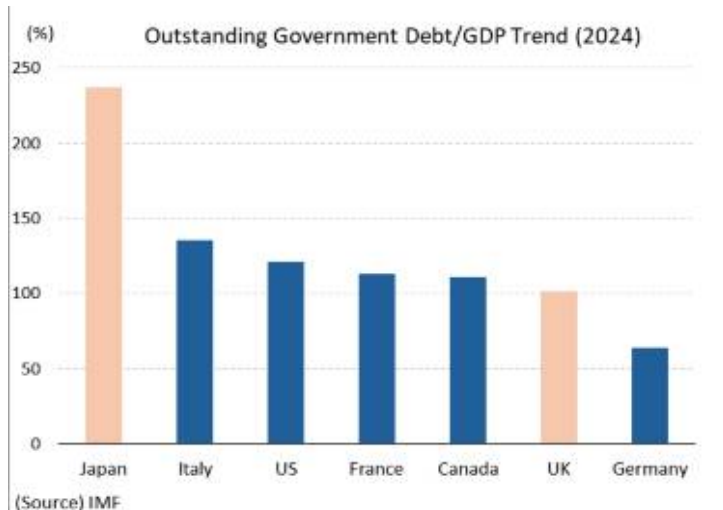
Comparing Debt-Related Figures

So, what kind of impression does one get from comparing the Japanese and UK government debt-related graphs in points (3) and (4)? Regarding point (3), it has been pointed out for many years that the more-than-90% share of Japanese government bonds (JGBs) held domestically is a strength. This is still basically true today, although there are signs of change. Over the past quarter century (March 2000 to March 2025), the overseas sector’s share of JGB holdings (including short-term T-bills) has risen from 5.0% to 11.6%. (Excluding T-bills, the share rises only slightly, from 5.1% to 6.0%.) While the BOJ remains the largest holder (with a 45% share), it has been reducing its purchases since July 2024 and has essentially announced that there will be a gradual downward trend in its holding share going forward. It is worth noting that Japan’s current situation is similar to the Truss Shock in that Truss announced her expansionary fiscal policy at the same time the BOE began reducing its government bond purchases.

Needless to say, foreign investors generally tend to be quicker than domestic investors to sell their JGB holdings. If the Japanese government adopts more-expansionary fiscal policies, some foreign investors would immediately sell their Japan-related investments just as foreign investors sold UK-related investments during the Truss Shock. At that time, financial market participants criticized the UK, saying that cutting taxes at a time of high inflation rates was irrational, but statements made during Japan’s recent election suggest that it would not be surprising if the exact same thing were to happen in Japan. In fact, the instability in Japan’s ultra-long-term bond market that has been attracting attention since April has been attributed not only to life insurance companies’ efforts to respond to regulations, but also to the large market presence of foreign investors. Of course, it is possible that Japan’s huge volume of net external assets may enable it to “buy time” more effectively than the UK, a net external debtor. It is problematic that most of the net external assets will not actually “return to Japan”, but just under 40% of the net external assets are foreign exchange reserves (as of the end of 2024), and that portion will be a source of funds that can be utilized for policy purposes. As Japan’s declining birthrate and demographic graying are expected to promote a savings drawdown, however, Japan’s current account surpluses and net external assets are expected to sooner or later begin shrinking, and such a trend would be bad news from the perspective of overseas investors holding JGBs.

Japan's Low Government Interest Payments/GDP Ratio

Next, I would like to discuss point (4). It is widely known that Japan has an exceptionally high government debt/GDP ratio by global standards, but some argue that, because Japan's government interest payments/GDP ratio is not as high as the UK's, the likelihood of a Japanese Truss shock is quite low. In 2024, Japan's government debt/nominal GDP ratio was 236.7%, the highest in the world, and the UK's ratio was 101.2%, which, while not low, is still less than half the level of Japan's ratio (see graph, above). Focusing on this ratio alone it appears that the potential for a Japanese Truss shock is cause for considerable concern, but the situation appears quite different when one focuses on the amount of interest payments. Japan's government interest payments/GDP ratio (this ratio is for 2023) was restrained to 1.2%, while the UK's corresponding ratio was higher, at 3.1%. It is worth noting that in 2021 (the year prior to the Truss shock), the UK's interest payments/GDP ratio was 2.8% – almost twice Japan's 1.5% ratio that year. It would be unreasonable to use this as a basis for arguing that Japan is safe, however, as Japan's low interest payments/GDP ratio reflects relentless efforts to keep interest rates stable at low levels, and when one considers the BOJ's policy interest rate uptrend that began in spring 2024 and is expected to persist going forward, it is clear that previous situations are no longer indicative of future situations. While the 2023 government interest payments/GDP ratios of 3.1% for the UK and 1.2% for Japan (see graph, below) did make Japan appear to be more resilient to interest rate uptrends, if Japanese interest rates rise and remain at high levels, attention will once again be focused on the government debt/GDP ratio and pessimistic views of Japan are likely to be intensified.



Analyzing current and prospective trends as extensions of past trends would not be appropriate from a risk management perspective.

Defensive Walls Stabilizing JGB Market No Longer So Thick

Thus far, I have examined the possibility of a Japanese Truss shock from the perspective of Japan's external economic sector performance and government debt level. This examination does not address all the issues that could affect the likelihood of a Japanese Truss shock, but it does highlight the key fact that one can no longer rely on the current account surplus, net external assets, and low interest rate situations that have until now been thought of as defensive walls stabilizing the Japanese government bond market. Given that, considering the situation objectively, it would be difficult to completely rule out the possibility of a Japanese Truss shock. In the days when Japan's huge current account surpluses and net external assets functioned as defensive walls against shocks, there existed two helpful situations – (1) most of the current account surplus was a trade surplus, and the associated funds could be expected to return to Japan and (2) much of the net external assets were in the form of securities and the associated funds could be expected to return to Japan – that no longer exist. The situation is quite different at this point. Now that Japan's entire current account surplus is attributable to a primary income surplus destined to remain overseas and that more than half of Japan's net external assets are direct investments destined to remain overseas, it is important to recognize that what previously appeared to be a thick defensive wall is not actually so thick.

Turning Point Stemming from Corporate Behavior Changes

It is worth considering how Japan's current account surplus and net external assets came to be structured as they are currently. Japanese outward direct investment accelerated from around 2010, Japan's trade balance began trending toward deficits from around 2012, and the Japanese economy has not experienced a period of JPY appreciation since 2013, an important fact this article has mentioned innumerable times. Since then, Japan's primary income surplus (the return on past investments) has accumulated and the country's current account surplus has been maintained, but a large portion of the surpluses ultimately came to be reinvested overseas. As a result, Japan's current account balance has become lower when measured on a cash flow basis, and that has promoted a chronic JPY depreciation trend. The chronic JPY depreciation trend is promoting inbound demand expansion, which in turn causes the importation of inflationary pressures. This along with domestic labor shortages are pushing up nominal wages, which will inevitably

accelerate rises in consumer price indices and other general inflation indices. All these trends have made it more difficult for the BOJ to maintain its low-interest-rate policy. While Japan's government interest payments/GDP ratio being lower than the that of the UK is a key factor cited by those arguing against the likelihood of a Japanese Truss Shock, those arguments assume that a low interest rate policy will be maintained, and this assumption is becoming increasingly questionable.

In short, the structure of Japan's external economic sector began dramatically changing from the moment the country's corporate sector shifted its focus from earning money in Japan to earning money overseas, and I believe this shift is at the root of the current trends of JPY depreciation and interest rates rises. I do not intend to provoke excessive concern that a Japanese Truss shock may be imminent, but if such a thing does occur sometime in the future, it will surely be attributable to Japanese corporate behavior changes that began from around 2010. In any case, it should be clear that the factors previously cited to argue that a Japanese Truss shock is quite unlikely are not necessarily valid any more. If the implementation of economic policies that ignore this fact accelerates, rising concerns about the potential for a Japanese Truss shock would likely encourage sustained JPY selling.

EUR Outlook – U.S.-to-Europe Asset Rotation Expectations

EUR Area Monetary Policies Now and Going Forward – Confirmation of Baseline Projection Scenario

Eventuation of Staff Projection's Baseline Scenario

The ECB's July 24 Governing Council meeting decided not to cut interest rates for the first time in eight meetings. It was the first Governing Council meeting to maintain the status quo since the July 2024 Governing Council meeting, exactly one year ago. At the June Governing Council meeting, President Christine Lagarde emphasized that the ECB was already – “in a good position to navigate the uncertain conditions that will be coming up.” – suggesting that further rate cuts were ruled out, so the July Governing Council meeting's decision can be considered to be in line with President Lagarde's hints the previous month.

The current level of ECB's deposit facility rate (2.00%) happens to be at the midpoint of the ECB's estimation of the euro area's neutral interest rate range (1.75% to 2.25%), and in that sense, ECB is likely to continue to be in a “good position”. At the post-Governing Council-meeting press conference, President Lagarde reiterated her previous explanation that, given the uncertainty related to such factors as trade, tariffs and non-tariff trade barriers – “We are in this wait-and-watch situation, and any monetary policy decision will for the future be decided on the basis of data, will be decided meeting-by-meeting, is not predetermined by any particular path.” – and she would therefore not have much new to say until the uncertainty level had decreased. Ironically, just three days after the Governing Council meeting (July 27), U.S.-EU negotiations culminated in a decision that the reciprocal tariff rate would be set at 15%, exactly half the 30% rate that had previously been feared. Of the three scenarios (base, mild, and severe) presented in the ECB's June staff projections, a 15% reciprocal tariff rate corresponds most closely to the base scenario, so the 15% rate is unlikely to have a major impact on policy decisions in the near term. (There should be no need for significant interest rate cuts.)

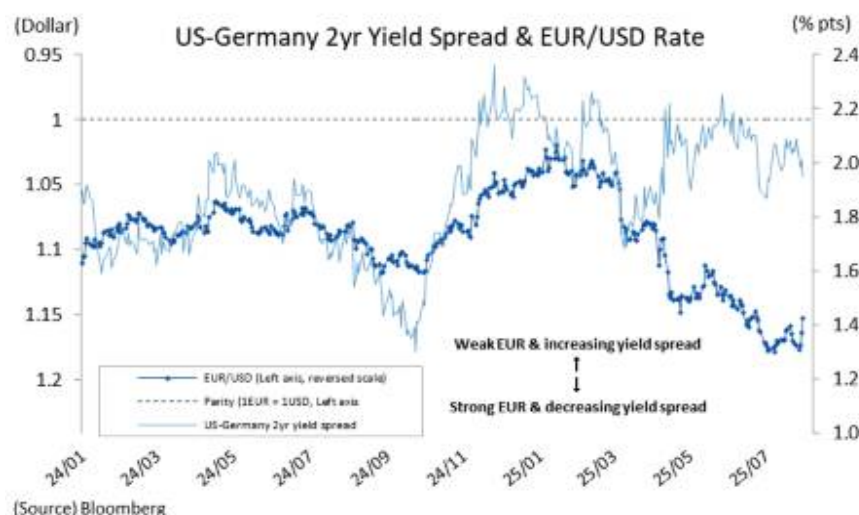
ECB Staff Projections (As of June 2025)

	As of June 2025 (% YoY)			Change since previous forecast (% pts)		
	2025	2026	2027	2025	2026	2027
Basic scenario as of June 2025						
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
Risk scenario (mild)						
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
Risk scenario (severe)						
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

Expectations the Baseline Scenario will Persist

The ECB is planning to stimulate the euro area economy without lowering interest rates significantly below the neutral interest rate, and financial market expectations are aligned with this objective. Following the conclusion of U.S.-EU trade negotiations in July, the prevailing view is that there will be no more ECB interest rate cuts this year, but this is an expectation that took shape immediately after the trade agreement was reached, and it will be difficult to confidently project future events until it becomes possible to understand more clearly how the agreement's provision to require the euro area to make USD600 billion of investments in the U.S. will actually be implemented from August. While this article currently expects one more ECB interest rate cut during the forecast period, it is important to note that, in any case, an interest rate decrease to below the estimated neutral rate is likely to be avoided, so the EUR strength seen since the start of the year is likely to be maintained going forward. Because of President Trump's comments in support of USD strength during July, doubts about USD's reserve currency status are no longer fueling USD selling and EUR buying as they once were. However, EUR remains strong against USD to a degree that is not easy to justify given the U.S.-Europe interest rate differential. Although it would be risky to assume the EUR appreciation seen since the beginning of the year will continue, it seems difficult to imagine a situation during the forecast period in which EUR/USD falls below USD1.10 again and remains stable at that level. Given President Christine Lagarde's statement at the press conference that – “We have essentially closed that disinflationary cycle that we battled over the last months” – we should not expect a continuation of ECB interest rate cuts. In contrast, it is generally considered certain that the Fed's “next move” during the forecast period will be a rate



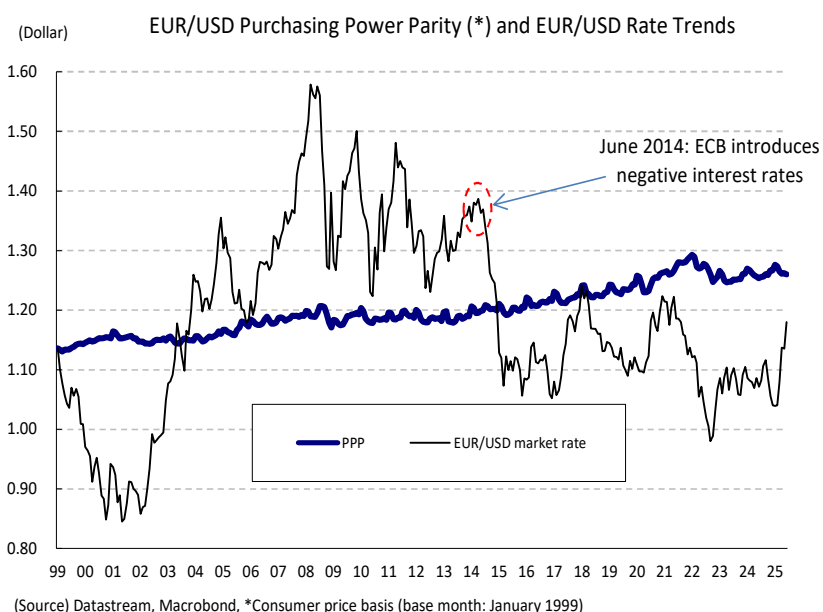
(Source) Bloomberg

cut although it remains difficult to anticipate the timing of that cut. Assuming that euro area interest rates will rise in the future, this article is anticipating that EUR's strength will be sustained.

EUR Now and Going Forward – Asset Rotation Expectations Going Forward

Effects of Inflation Rates, Supply-Demand Situations, and Interest Rates on EUR/USD

In July, EUR briefly strengthened against USD, with EUR/USD reaching around USD1.18, its highest level since the beginning of the year. The EUR uptrend has subsided somewhat since the end of July and, with doubts lingering about USD's reserve currency status, the question of whether there will be structural shift to greater EUR buying is an issue that will remain important going forward beyond the forecast period. It is worth noting that, on a purchasing power parity basis (PPP, calculated using a 1999-base consumer price index), EUR/USD should be roughly USD1.26, so even when EUR/USD is at 1.18, EUR is still undervalued by around 6% (see graph). As the euro area's consumer price index-based inflation rates have long lagged behind those of the United States, the PPP-based EUR/USD level has been showing a gradual rise. Furthermore, the



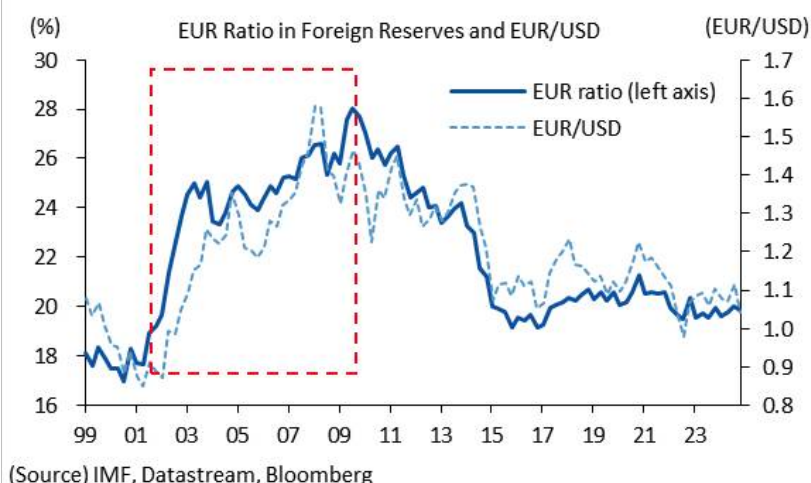
(Source) Datastream, Macrobond, *Consumer price basis (base month: January 1999)

euro area has the world's largest current account surplus (reflecting Germany's export performance), and (unlike Japan) this is almost entirely driven by trade surpluses that promote steady high levels of outright EUR buying. The gist of my book "Ready for the Japanization of Eurozone, Euro and ECB" (Toyo Keizai Shinposha, 2014) is that EUR is a currency with strong fundamentals in terms of both inflation rates and supply-demand situations, so it has the potential to become a safe haven currency. In light of recent forex market movements, one could say that that basic logic is visibly in operation at this time.

However, although EUR has benefited from fundamental strengths based on slower inflation rates and a solid supply-demand relationship, EUR/USD has remained weak and sluggish for a long time. This is solely due to the fact that negative interest rates were long the norm in the euro area from 2014 and, even after the negative interest rate policy was discontinued, EUR's investment attractiveness has remained inferior in light of the Europe-U.S. interest rate differential. The graph shows that, since the negative interest rate policy's introduction in June 2014, EUR's value against USD has consistently fallen below the PPP level as well as the 1.20 level. Immediately after the Ukraine war, rising resource prices pushed Germany's trade balance to the brink of a deficit, exacerbating the EUR supply-demand situation, and EUR even fell below parity with USD, although it has subsequently continued to recover. The unilateral rise in EUR/USD despite the lack of a significant amount of change in the Europe-U.S. interest rate differential has led to expectations of a trend of rotation from USD into European assets. It is worth keeping this trend in mind and continuing to monitor related indicators.

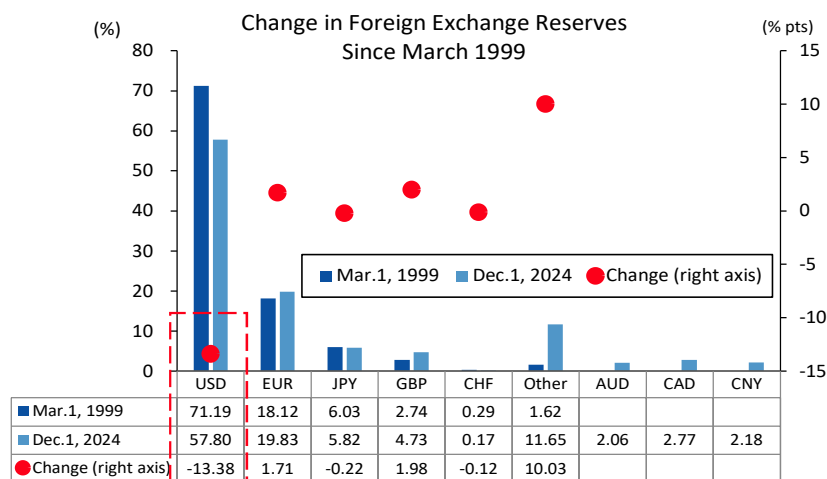
Differences from the Europhoria Era

Looking back, one finds that EUR/USD reached an all-time high of USD1.604 on September 30, 2008 (see graph, above). Following EUR's launch in 1999, EUR/USD rose steadily, and it showed an additional spurt of particularly rapid growth in the 2005-2008 period. I was working at the European Commission's Directorate-General for Economic and Financial Affairs during that period, when the term "europhoria" (a combination of "euro" and "euphoria") was coined and it was widely expected that EUR might become a major reserve currency. In some senses, the atmosphere then was similar to that of today, featuring high expectations regarding EUR's ability to replace USD, and back in 2008 there was a strong statistical basis for such expectations. The graph above shows changes in EUR's share of global foreign exchange reserves along with movements in EUR/USD. The period enclosed by the red-dotted box was the europhoria period, during which EUR's share of global foreign exchange reserves actually rose to 28%. That level has subsequently never been re-attained and, over the past decade, EUR's



(Source) IMF, Datastream, Bloomberg

share of global foreign exchange reserves has generally remained at levels around 20%. The second Trump administration's aggressive assertiveness and the EU's efforts to become more strategically autonomous have recently caused a significant increase in consideration of EUR's potential to serve as a second global reserve currency, but there is no quantitative evidence that EUR is increasing its presence as a store of value. Of course, the euphoria era required nearly a decade to boost EUR's share of global foreign exchange reserves by about 10 percentage points, so it is too early to make a judgment about how that share might increase going forward. As President Lagarde stated during the press conference following the June Governing Council meeting, however, one cannot anticipate that EUR will become a more-important international currency simply because of USD related problems. Looking at the trend in global foreign exchange reserve management, one finds that many countries are diversifying from USD by increasing the shares of such assets as CAD, AUD, and RMB in their reserves, and this reserves diversification theme appears likely to continue (see the graph and chart on the previous page). Many previous issues of this article have emphasized the importance of this reserves diversification theme. The mere fact the EUR has been strong for a short six-month period is not a strong basis for anticipating a major asset rotation from USD to Europe or EUR's transition into the world's second reserve currency.



Note: *AUD, CAD and CNY were not disclosed as of March 1999; "Other" includes these three currencies.

(Source) IMF, Datastream

Asset Rotation and EUR's Reserve Currency Status are Long-Term Themes

The most conspicuous difference between the euphoria era and the current era is that the current trend of EUR appreciation is largely attributable to the Trump administration's aggressively assertive policies, while the optimistic expectations regarding the euro area economy that existed during the euphoria era have largely faded away. Although the European rearmament plan is being viewed positively by the financial markets, it was partly imposed by the Trump administration. Moreover, the details are still being finalized, so the final form and scale remain unclear. As discussed in many previous editions of this article, the most important aspect of the pandemic recovery plan and the joint bond issuance plan accompanying the European rearmament plan is the question of whether these plans will help overcome the EU's final and greatest challenge – that of fiscal integration. In that sense, one could say that current expectations are more grounded in reality than the vague enthusiasm of the euphoria era. Given the long-term nature of plans to strengthen the EU, however, achieving progress will require some time, in the meantime, the EUR appreciation trend is likely to be slowed or reversed each time the Fed halts its interest rate cuts or the Trump administration resolves a tariff-related trade problem. At such times, financial markets will likely forget about such long-term themes as a major asset rotation from USD to Europe or EUR's transition into the world's second reserve currency, but even so, it will continue to be important to monitor the latest trends in foreign exchange reserve ratios and U.S. securities investment statistics (particularly the U.S. Treasury Department's Treasury International Capital (TIC) data).

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