

# Forex Medium-Term Outlook

May 30, 2025

## Overview of Outlook

USD/JPY lacked direction in May. There is some improvement in market sentiment amid reports of U.S. tariff agreements with the UK and China, but the situation remains unpredictable as tensions with the EU have intensified. Further, even as confusion over tariff negotiations subsides, the U.S. government's fiscal health has become a point of contention, and persistently high U.S. interest rates have emerged as a cause for concern. USD also rises and falls as the markets swing between optimism and pessimism, so any analysis of the fundamentals seems unlikely to prove beneficial. A big change, however, is that the narrative that U.S. President Donald Trump and his administration want a weak USD (which we heard throughout April and May) is finally coming to an end. Following JPY in April, TWD (New Taiwan dollar) and KRW were also caught up in this narrative in May, but official statements put the narrative to rest in the end. As for USD/JPY, it was confirmed following the meeting between Japanese Finance Minister Katsunobu Kato and U.S. Treasury Secretary Scott Bessent that current rates reflect the fundamentals. At the very least, it seems clear that the main issue pertaining to U.S.-Japan negotiations is automobiles, not exchange rates, so JPY is unlikely to appreciate unreasonably as in April. One would do well to respond calmly by buying on the dip during phases of USD depreciation due to factors such as speculation of a second Plaza Accord. When it comes to monetary policy, dovish expectations may inevitably increase starting early 2026 in anticipation of a new Fed administration following the end of current Fed Chair Jerome Powell's term. However, for the remainder of this year, it may be difficult to bet on USD weakening due to Fed rate cuts. Given the magnitude of the recent speculative JPY buying, this feeling will only intensify going forward.

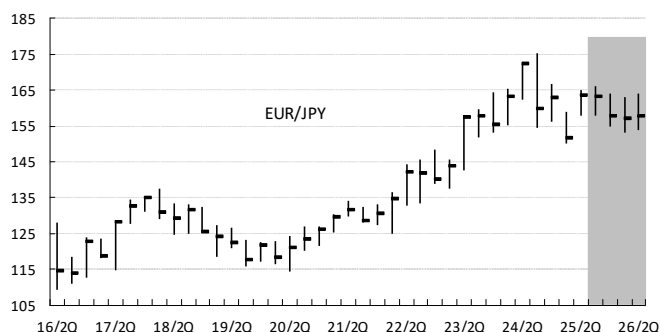
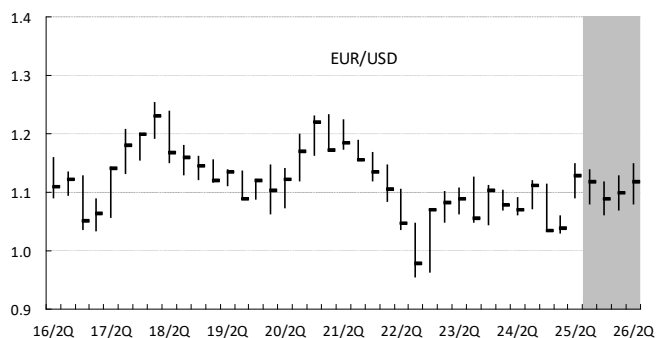
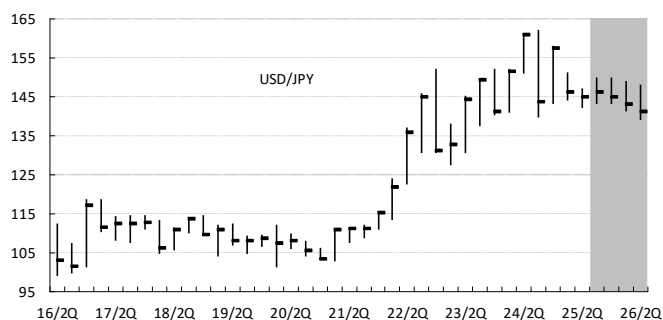
EUR also experienced periods of rudderlessness in May. In principle, EUR strength due to loss of confidence in USD continues, but as some clarity emerges in the tariff turmoil, market participants are also refraining from unilateral buying or selling. Although the U.S. has made some compromises with China and the UK, it continues to be harsh with the EU, and there is no sign of things calming down anytime soon. Unlike other key economies, which are trying to appease the Trump administration, the EU continues to take it head-on, and even intuitively speaking, the EU and the U.S. seem rather incompatible. As far as the EU's economic and financial situation goes, inflation is stable at around +2%, but the ECB is likely to continue with its rate-cut policy based on the assumption that wage growth will continue to slow for some time to come. The EUR/USD uptrend since April is clearly not justified by the Europe-U.S. interest rate differential. It is likely due to anticipation of the once-strong USD-based financial system collapsing. Although this scenario is unlikely to materialize during the current forecast period, some are speculating about a rotation from the U.S. to Europe, and if true, one will have to expect EUR to remain firm (which will also lead to a heavy upper bound for USD/JPY). There is no sign of the damaged trust in the U.S. being restored anytime soon, so EUR/USD is likely to remain firm despite the ECB's rate cuts.

## Summary Table of Forecasts

	2025				2026	
	Jan-May (Actual)	Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	139.89 ~ 158.88 (143.74)	142 ~ 147 (145)	143 ~ 150 (146)	143 ~ 150 (145)	141 ~ 149 (143)	139 ~ 148 (141)
EUR/USD	1.0125 ~ 1.1575 (1.1374)	1.09 ~ 1.15 (1.13)	1.08 ~ 1.14 (1.12)	1.06 ~ 1.12 (1.09)	1.07 ~ 1.13 (1.10)	1.08 ~ 1.15 (1.12)
EUR/JPY	155.63 ~ 165.20 (163.48)	158 ~ 165 (164)	158 ~ 166 (164)	155 ~ 164 (158)	153 ~ 163 (157)	154 ~ 164 (158)

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

## Exchange Rate Trends & Forecasts



## USD/JPY Outlook - End of “U.S. Seeks USD Weakness” Narrative

### U.S.-Japan Tariff Negotiations Now and Going Forward – Persistent Narrative that U.S. Seeks USD Weakness

#### *Narrative Strikes Three Times in a Row*

Following from April, USD continued to weaken in May amid speculation that the U.S. sought the strengthening of the currencies of countries with a trade surplus with the U.S. This resulted in an upsurge in Asian currencies in particular. JPY rose sharply in April, while TWD surged during the Japanese Golden Week in May. The trend further extended to KRW. For example, the trigger for KRW's sudden rise was an article<sup>1</sup> by Bloomberg, which cited sources mentioning a meeting between South Korea's Deputy Minister for International Affairs, Ministry of Economy and Finance, Choi Ji-young, and U.S. Assistant Secretary for International Finance, Department of the Treasury, Robert Kaproth, in Milan on May 5. The article mentioned that the two men had discussed foreign exchange rates and speculated on a coordinated effort between their two countries to appreciate KRW against USD. However, having read it multiple times, I was not able to find any mention of when, between whom, and in what form an official agreement on exchange rates was discussed or announced. At best, the article said, “Investors increasingly believe that exchange rates will be discussed in future U.S.-South Korea trade talks.” Of course, it is not clear who these investors are.

The article went on to say that JPY had also been bought as part of an associated trend, as JPY strength is part of the U.S.-induced USD weakening expected by the market. The market is extremely reactive, and speculative buying extends even to unrelated currencies despite the absence of official statements. However, the speculation itself stems from the report in question, making it seem like a self-fulfilling prophecy. This is the third time such a thing has happened – JPY and TWD were also bought on speculation despite the lack of any official statement on the part of the U.S. seeking USD weakness. Media reports of this kind introduce the views of multiple analysts and are often filled with speculation that the Trump administration “could” seek to induce USD weakness.

#### *End of Speculation of a Second Plaza Accord*

As I have said before, I think the idea that the U.S. would attempt to induce a weaker USD as part of tariff negotiations is essentially a narrative created by the media and market participants. It is true that Trump intermittently expresses a preference for a weaker USD, but this has been going on since before he took office the first time, and is not a new development. Even Steve Miran, chairman of the Council of Economic Advisers (CEA), who wrote the so-called Mar-a-Lago Accord (see table on the next page) paper, which outlined a comprehensive package of tariff, currency, and security policies, including the handling of U.S. Treasury bonds, explained in an exclusive interview with the Yomiuri Shimbun that ran on April 17 that his plan (the Mar-a-Lago Accord proposal) did not reflect government policy.

<sup>1</sup> Bloomberg article dated May 14, 2025, the Japanese version of which is titled “U.S.-Korea Senior Officials Discuss Exchange Rate Policy, Won Surges Sharply – Yen Also Rises on Speculative Buying.”

He also said he did not think exchange rates were likely to become a key issue in tariff negotiations. Bessent also told reporters in Washington on April 23 that the U.S. had “absolutely no currency targets” (in its negotiations with Japan), making it clear that the U.S. would not expect Japan to strengthen JPY to some rate level set by the U.S. Of course, one could say that this is simply their outward stance, while their true intentions are different. However, a fundamental question arises as to what extent market participants and the media need to doubt something that the CEA chairman and the Treasury Secretary are denying at this point. Adding speculation to speculation will only result in barbershop chatter.

The official statement released following the meeting between Kato and Bessent on May 21 read, “They reaffirmed their shared belief that exchange rates should be market determined and that, at present, the USD/JPY rate reflects fundamentals.” I believe this puts an end to the narrative that the U.S. wants to weaken USD or that there is going to be a second Plaza Accord, and I urge the experts and media who have been engaged in peddling semi-conspiracy theories to reflect seriously on this.

### Gist of the Mar-a-Lago Accord

	Specific measures	Notes
(1)	<b>Intentional USD devaluation</b>	Improving U.S. export competitiveness by correcting USD strength
(2)	<b>Ultra-long-term U.S. Treasuries</b>	Converting foreign-government-held U.S. Treasuries into ultra-long-term 100-year bonds, thereby lowering risk of short-term capital outflows
(3)	<b>Linking of security &amp; economic policies</b>	Asking countries under U.S. security umbrella to shoulder their fair share of defense costs and hold U.S. Treasuries over the long term
(4)	<b>Strategic use of tariffs</b>	Using tariffs to encourage trading partners to revise their policies

(Source): Compiled by author based on "A User's Guide to Restructuring the Global Trading System"

### *Weaker USD Just a Tool; Situation Remains Unchanged*

My view is that the second Trump administration's goal is to revive manufacturing with the aim of reviving the military industry, and “reducing the trade deficit” is merely another way to say the same thing. The means to achieve this goal are weaker exchange rates (USD depreciation), tariffs, non-tariff barriers, and getting security partners to bear their fair share of the burden of a security umbrella. However, the more the U.S. attempts to weaken USD, the more U.S. treasury bonds get sold (pushing up U.S. interest rates), so one suspects this is a tool the authorities now want to avoid. Of course, it is possible that Trump, whose ideas are stuck in the 1980s, truly wants to weaken USD, but at present there is no evidence to confirm his seriousness.

Having said that, the idea that the Trump administration is seeking to weaken USD is likely to gain market credibility based on circumstantial evidence, and the media is likely to buy into this narrative for some time to come. That being the case, it becomes important to determine how long the influence of the news report in question will last by considering when, by whom, and in what form an official agreement on exchange rates was discussed and announced.

As was the case recently, the currencies of Asian nations with large trade surpluses with the U.S. are the most susceptible to the USD depreciation narrative (details below). So much so that the phrase “reverse Asian currency crisis” trended in May. However, if Asian countries really end up letting go of their U.S. Treasury holdings and focus on selling USD, there is no doubt that the U.S. economy would suffer the biggest damage. I will discuss this point in detail as a risk scenario.

### *First Batter Woes*

In May, the most attention-grabbing tariff talks were between the U.S. and China. On May 12, following ministerial-level talks in Geneva, the two countries agreed to mutually lower tariffs, with the U.S. lowering tariffs on imports from China from 145% to 30%, and China lowering tariffs on imports from the U.S. from 125% to 10%, each for 90 days. The impact of this news, that the two sides would cut tariffs by 115pp each, was big enough to end the tariff-driven market conditions that had continued since April 2nd. The reason for the higher (30%) U.S. tariff rate is a punitive 20% tariff to counter synthetic drugs coming into the U.S. from China in addition to the 10% reciprocal tariff.

However, it is unclear how the above agreement was reached. A full-on “fistfight” with tariffs over 100% cannot be sustained over the long term. Given the magnitude of what would be lost in that time, perhaps this is an attempt by the U.S. to revert to square one and think about things for 90 days. In this context, Trump's use of the word “reset” makes sense. Then again, there still remains the possibility of concerns over U.S.-China talks resurfacing at some point.

Meanwhile, how should Japan view the fact that the U.S. prioritized an agreement with China, its biggest adversary, over Japan, its ally, which made a grand gesture by being the first to come to the negotiating table? Of course, the first agreement was reached with the UK, even before China. The fact that countries that began negotiations later have overtaken Japan is concerning, as it may indicate that U.S.-Japan negotiations are not going well. Was Japan not picked first because it was the easiest for the U.S. to deal with and the perfect country for the Trump administration to

deliver a quick win? At least, that is what I had thought. However, it may be that the Japanese government's red line (elimination of 25% tariffs on automobile imports) is a bigger sticking point than expected, resulting in negotiations dragging. Leaving aside the UK, which has a trade deficit with the U.S. and never had an additional reciprocal tariff imposed on it to begin with, it is unclear why China, the country with the largest trade surplus with the U.S., is being let off with no more than a flat 10% reciprocal tariff. Could it be that Trump, whose ideas are still stuck in the 1980s and 1990s, is more obsessed with putting an end to countries earning a trade surplus with the U.S. through automobile exports?

On May 23, Ryosei Akazawa, Minister in charge of Economic Revitalization of Japan, visited the U.S. for the third time, but going by just the few reports trickling in, it is unclear how much progress has been made on negotiations. However, as Prime Minister Shigeru Ishiba and Akazawa have repeatedly emphasized, Japan has made it clear to the U.S. that it will firmly reject any provisional agreement that does not include a provision on automobile tariffs. The U.S., for its part, insists that the current negotiations are on mutual tariffs, and the 25% automobile tariff is irrelevant as it is not a mutual tariff. It appears that multiple rounds of negotiations have become necessary to attempt to bridge this gap. The issue is clearly not USD depreciation, as being hyped by the media and market participants, but the treatment of Japanese auto exports to the U.S.

#### *A Bizarre Scheme - Reimporting Japanese Cars*

Regarding the 25% tariff on automobiles, the U.S. and UK have agreed on a special 10% tariff rate for U.S. auto imports from the UK up to 100,000 units per year. Trump says he will not offer other countries a similar special quota, but Japan could aim for a similar approach. Of course, some will say that even a 10% special quota tariff is a loss, but neither China nor the UK have been able to achieve an elimination of the 10% portion. It seems obvious, therefore, that the 10% portion is the Trump administration's red line.

Of course, the perfect score for Japan would be to achieve the elimination of that 10%, but if negotiations collapse in the process of aiming for the perfect score, and a reciprocal tariff of 24% is imposed, the score crashes to 0. At any rate, assuming that the Trump administration will no longer be in power four years from now, a compromise score of 70 or 80 points is not bad (although there is a good chance that the post-Trump administration will resemble the current administration). While a 10% increase in costs is a painful blow, it seems better than being forced to swallow the full reciprocal tariff rate, the calculation of which is based on questionable grounds.

Some reports have speculated that Japanese auto imports from the U.S. can be boosted by reimporting Japanese cars manufactured in the U.S. This is a bizarre and foolish idea. It is well-known that Japanese cars use auto parts exported from Japan, and these auto parts have been subjected to a 25% tariff since May 3. Do those speculating about the reimport of Japanese cars manufactured in the U.S. mean to imply that Japanese companies would pay 25% tariffs to import auto parts from Japan just to manufacture cars in the U.S. that can then be exported back to Japan? This, combined with JPY weakness and USD strength, would make reimported Japanese cars extremely expensive, giving Japanese people living in Japan no reason to buy them. As a result, the price of reimported Japanese cars would have to be adjusted to match the price of domestic cars, with Japanese automakers naturally bearing the difference.

Would such a reimport policy result in enough sales of U.S.-manufactured Japanese cars to trigger an increase in production? If it does, it could certainly boost employment and wages in the U.S., but only at the expense of Japanese automakers, which will be pushed deeper into losses with greater sales. Moreover, it is unclear whether such a policy would have any positive impact for Trump himself, since it does not boost the sale of American cars per se. Such a policy would certainly contribute to reducing Japan's trade surplus with the U.S., but it is essentially a bizarre ploy with not much to gain from. Of course, it may still be considered if the apparent effect of improving the trade balance will appease Trump.

#### *What can be done?*

So, what can Japan do? As mentioned above, it may be difficult to get the flat 10% reciprocal tariffs eliminated. With Japanese Upper House elections expected to be held on July 20, Japanese negotiators may be hoping for some kind of concession to make up for the flat 10% reciprocal tariff. This is especially true given the current poor approval ratings of the government and ruling party. Hopes are slim as Trump has already stated that there will be no repetition of the British approach, but the idea of a variable tariff rate on automobile exports to the U.S. may still be worth thinking about. Dividing exports into quotas with 25%, 10%, 5%, and 0% tariff rates will spread out the pain. Of course, this is merely an "armchair proposal," as putting it to practice would be very complicated. I will, therefore, refrain from discussing it lightly, but if Trump cannot compromise on the 25% automobile tariff and would like to keep up the pretense, he will have to offer some other concession to make it acceptable. Establishing tariff rate tiers seems like an easy compromise.

As discussed in the past, Japan has already offered to expand its imports of U.S. liquefied natural gas (LNG), agricultural products, and defense equipment, while also announcing greater direct investment by Japanese companies. The Japanese government is unlikely to accept a settlement in which the only concession in return for all this is the elimination of the reciprocal tariff surcharge (in the first place, the additional reciprocal tariff itself is unacceptable as its calculation is based on shaky grounds). The Japanese government's red line is likely to be the elimination of the 25% automobile tariff in addition to reciprocal tariff surcharge. At the time of writing, there are reports that Akazawa is considering a fourth visit to the U.S., and he has been heard to say that Japan would prefer an agreement to be reached by the end of June. As Bessent has also made similar statements, one hopes that a Japan-U.S. agreement will be reached by the end of June.

Even in the worst case, however, one can expect (as during previous negotiations with the Trump administration) that the two sides may agree on July 9 to a policy of "no tax while negotiations are ongoing." For example, some Japanese



companies are believed to currently be considering direct investment in the U.S., but it is unreasonable to expect them to finalize their decision by July 9. The most likely scenario is that Japan may be able to use ongoing negotiations as a shield to delay tariff enforcement. This would also allow Trump to save face by extending the timeline needed to reach a deal.

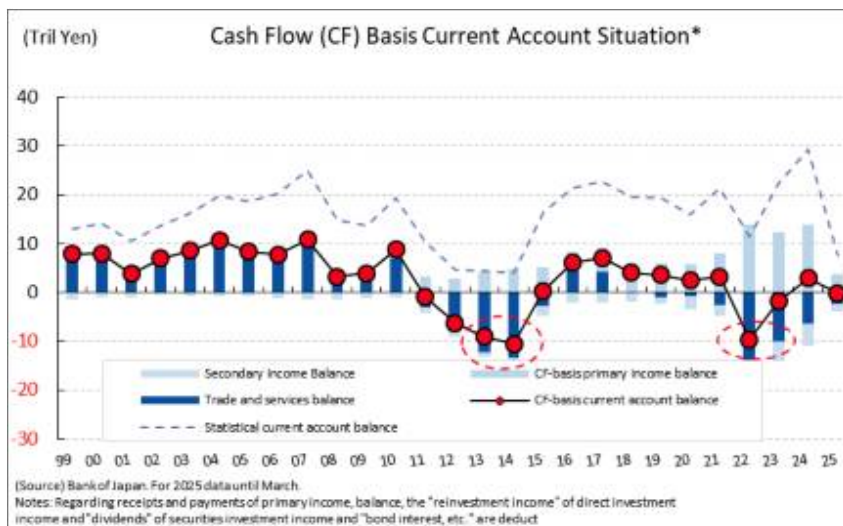
## JPY Supply-Demand Climate – JPY Sale Momentum Remains Essentially Unchanged

### JPY Supply and Demand Remain Balanced

In May, USD/JPY temporarily recovered to the 148 range for the first time in a month, but it subsequently fell back and is now stuck in the 142-148 range. However, as the biggest JPY long position in history, which I have been paying attention to for some time, continues to unwind, the situation remains conducive to JPY depreciation, so USD/JPY is unlikely to crash. Also, I would like to reiterate that the JPY supply-demand climate is tilted in favor of net JPY selling. On May 12, Japan's March Balance of Payments were released. I would like to take stock of it as it will help understand the JPY supply-demand climate for the January-March 2025 quarter. For the January-March quarter, the statistical current account balance was +JPY7.4907 trillion. This is the largest surplus recorded for the January-March quarter since the current records began. However, the current account balance based on cash flows (CF), which I take a look at periodically, was -JPY200 billion, indicating a more-or-less neutral level.

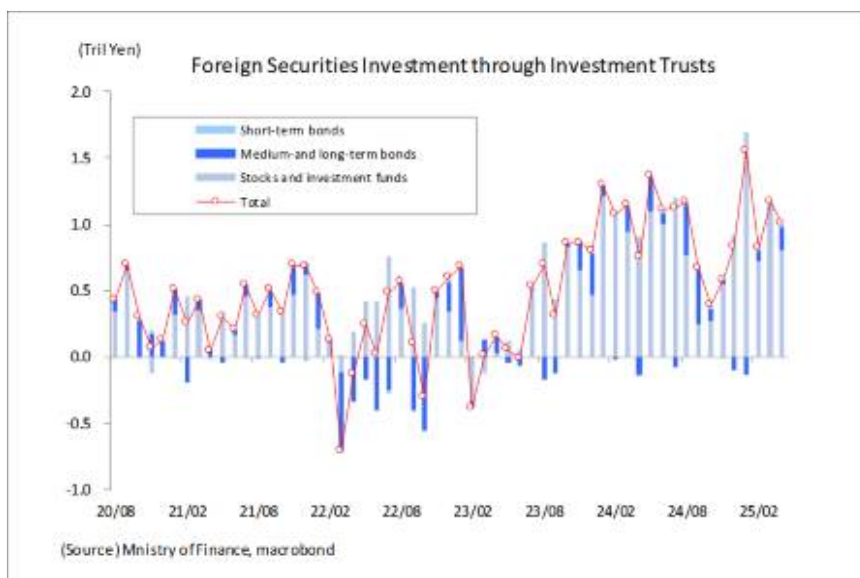
I will refrain from going into detail again regarding the concept of a CF-based current account balance, but will provide a brief recap. Almost all of Japan's current account surplus is made up of primary income surplus, which is the return on past investments. However, even though the contents of the primary income surplus – which includes profits earned by the overseas subsidiaries of Japanese companies and the interest and dividend income generated by Japanese holdings of overseas securities such as U.S. Treasury bonds and U.S. stocks – are statistically recorded as a surplus, in practice, a considerable portion of it is earned in foreign currency and reinvested as foreign currency. This portion of the surplus needs to be deducted when analyzing the JPY supply and demand. The CF-based primary income balance and, in turn, the CF-based current account balance based on it are, therefore, calculated by making the above deduction.

For the 2025 January-March quarter, the primary income balance secured a fairly large surplus of about +JPY3.7 trillion even on a CF basis (statistically about +JPY11.4 trillion), but this was offset by a trade and services deficit of around -JPY2.4 trillion combined with a secondary income deficit worth -JPY1.5 trillion or so, resulting in a near-equilibrium level. As usual, the JPY supply-demand climate is not as good as the statistical surplus indicates. In April, risk aversion increased to levels comparable to that following the collapse of Lehman Brothers, and there was even speculation of an induced JPY appreciation following U.S.-Japan talks, but in the end USD/JPY only momentarily dipped below the 140 level. As I have said many times before, while the impact of political factors is inevitable in the short term, price movements not supported by the supply and demand structure are unsustainable.



### Household JPY Selling Remains Robust as of April

The strength of JPY selling can be confirmed from the trend of International Transactions in Securities for April, which were released at the same time as the March Balance of Payments. Outward securities investment via investment trust management companies, which is attracting attention as a proxy variable for household JPY selling since the launch of the New NISA scheme last year, posted a net acquisition of +JPY1.067 trillion for April. This follows a net acquisition of +JPY1.1658 trillion for March, making it the second consecutive month of net acquisitions over +JPY1 trillion for the first time since July-August 2024. The total net acquisition amount for January-April this year has reached +JPY4.5486 trillion.



surpassing figures for the same period last year (+JPY4.267 trillion) and setting a new record high.

Considering the turmoil in the market caused by the announcement of reciprocal tariffs during the first week of April, the investment appetite of the household sector does not appear to have been significantly damaged. However, looking back at the market turmoil in August last year, the slowdown in investment was confirmed not during the same month, but in the following month or two. Similarly, this time, given the difficulty of nimbly adjusting NISA Accumulation scheme settings for the current month, the net acquisition amount is likely to be affected with a delay. I would like to keep an eye out for the extent of decline in household JPY selling during May and June. However, given the rise in stock prices starting May, there is little sense of a major turning point in the trend of net acquisitions, especially of Equity and Investment fund shares.

There is very little in currently available statistical data to suggest that JPY has fully extricated itself from a net-selling structure in terms of basic supply and demand. Of course, the Trump administration's reckless actions will likely continue to lead to USD depreciation, and JPY appreciation against across-the-board USD decline. However, it is important to remember that this is merely a temporary USD weakness masking JPY weakness, and that a net-selling structure remains unchanged when it comes to JPY supply and demand.

## **Supplement: Outlook for Digital Deficits – Projections Based on METI model**

### *Future of Digital Deficits as Indicated by New Estimation Model*

In examining the JPY supply demand environment, I have, in this report, focused on the possible expansion of the services deficit, and in particular on the digital deficit. In this regard, the Minister's Secretariat of the Ministry of Economy, Trade and Industry (METI), through its Young Professionals' New Policy Project PIVOT, published a report titled "Digital Economy Report: Survival Strategy in a Sanctuary-Free Digital Market, a World Overwhelmed by Data" (hereafter: the Report) on April 30, 2025. Since I was also involved as a reviewer in the preparation of this report starting from its draft stage, I have received a fair number of inquiries on the topic. I would like to take this opportunity to share my understanding of the situation.

The Report begins by defining the present as the era of "sanctuary-free digital markets," and touching upon the core point that selling hardware is no longer possible without selling software, which determines the value-added service. In short, the idea is that services (software) are a prerequisite for selling products (hardware). Further, since data is needed to create software, the report argues that the reality of an era of sanctuary-free digital markets is a world where data overwhelms everything.

The report has many noteworthy portions, but Chapter 2, "Current Structural Problems Suggested by the Digital Deficit" provides an extremely interesting analysis that overlaps with my past discussions regarding the digital deficit in this report. Discussions of the digital deficit often use a classification presented in the August 2023 BOJ Review's "Globalization of Services Trade as Seen in Balance of Payments Statistics." I too use this classification, which I call the "BOJ classification," in my book *The Truth of JPY Weakness – Japan Masquerading as a Current Account Surplus Nation*. The BOJ classification, however, is based on remittance information submitted by companies under the Foreign Exchange and Foreign Trade Act, which gives rise to the possibility that the information submitted by different companies may be reflecting different realities (for example, the possibility that the same transaction type may be recorded under different expense items by Company A and Company B cannot be ruled out).

Further, another point I consider to be problematic is that digital-related income and expenditures as defined under the BOJ classification include transactions that are not necessarily related to digital services. A typical example would be "professional and management consulting services," which literally involves payment toward management consulting services, but cannot be separated from the digital-related income category due to statistical constraints. Even within "telecommunications, computer, and information services," which are extremely relevant to the digital deficit, non-digital elements are mixed in. For instance, computer services include "hardware consulting, maintenance, and repair," and information services include "library and archival services, payments for the use of archive services."

To overcome these challenges, the Report has constructed the "PIVOT Digital Deficit Estimation Model" and prepared estimates based on the financial information (securities reports) of major companies, thereby providing extremely insightful current situation analysis and future predictions. The new estimation model reclassifies the three Balance of Payments items constituting digital-related transactions (professional and management consulting services, computer services, and royalties and license fees) into eight business categories (management consulting, systems integration, applications, middleware, computing resource infrastructure, digital advertising, digital transactions, and entertainment-related services) for estimation purposes.

These classifications and estimations are noteworthy in the sense that they reflect a higher degree of purity in digital transactions compared with the BOJ analysis. Below, I summarize the main points.

### *The Digital Deficit in 2035...*

Of particular interest this time is the digital deficit forecast for 2035, presented as part of the "Estimated digital deficit scenarios in a sanctuary-free digital market." To cut to the chase, the deficit is estimated to be approx. -JPY18 trillion in the base scenario and approx. -JPY28 trillion in the pessimistic scenario. The Report states that the base scenario "will see further expansion of the deficit in areas where foreign companies have a large domestic share, such as applications, digital advertising, and digital transactions," while the pessimistic scenario envisages Japanese companies losing their share to foreign companies in areas they are barely holding on to at the present time (such as receipts/payments for systems integration services and Japanese platform businesses overseas).

I am not particularly surprised by the above large deficit estimates as my own previously presented long-term forecast estimated an approx. -JPY17 trillion digital-related deficit in 2030. I previously made a long-term prediction that the era

of -JPY10-trillion service deficits would arrive by 2030 and argued that the impact of this on JPY supply and demand could not be overlooked. However, in the case of the digital deficits pessimistic scenario (about -JPY28 trillion) presented above coming true, even an era of -JPY20-trillion service deficits is possible.

### *The Hidden Digital Deficit Problem*

In addition to the above estimations, the Report argues that, with sanctuary-free digital markets, the trade balance is not irrelevant to digital deficits, expressing concern of the impact of digital deficits on the trade balance. This is also an important point that has not been given sufficient consideration in previous discussions. As mentioned earlier, and as my readers probably also know from their daily lives, many of the “products” we use today come built-in with digital “services.” However, if these products are imported with the services built in, they may not be recognized as contributing to the digital deficit. The Report describes the deficit from such services as a “hidden digital deficit.” Specifically, it mentions two points as worthy of attention: “device-specific software (a hidden digital deficit)” and “SDX (Software-Defined Everything) leading to the decline in sales of existing devices (SDX deficit).” As is well known, vehicles whose functions and performance are defined by software and can be updated using software are called SDVs (Software-Defined Vehicles), and these are recognized as a threat to Japan’s automobile industry. Here, the price of “device-specific software,” which is assumed to include firmware, dedicated OS, middleware, etc. that are built into the automobile, is recorded in the trade balance as part of the balance of “goods” trade.

Take the example of the Google (Alphabet) Android Automotive OS, which drives maps and navigation for automobiles. Another service provided through Microsoft’s cloud service (Azure) is remote updates of vehicle software (Over-the-Air, or OTA update) without having to take the vehicle to a repair shop, which has now become commonplace. In principle, such transactions should be recorded under research and development services or royalties and license fees in the services balance, but if they are acquired as built-in vehicle-related services, they may be hidden within the trade deficit, and in that sense, the Report considers them part of the hidden digital deficit.

### *Deficit of up to -JPY45 Trillion Caused by Servicification of Manufacturing*

The Report then goes on to express concern that hardware manufacturing will be suppressed if data and software are suppressed, resulting in the suppression of goods export and the expansion of the trade deficit. This relates to the second point mentioned above, i.e., the decline in sales of existing devices due to SDX (the “SDX deficit”). This has, in fact, been a matter of frequent concern in recent years. For instance, in the case of automobiles, the Report worries that rise of SDVs will “take away the share of traditional internal combustion engine vehicles, causing the trade deficit to expand.” This could happen, for example, with the rising sales of Tesla and BYD, which end up suppressing the sales volume of Japanese cars. The report adds an SDX deficit of up to approximately -JPY13.5 trillion to the hidden digital deficit of up to approximately -JPY3.8 trillion due to software and data in the automotive, industrial equipment, and communications equipment sectors, giving a total deficit of approx. -JPY17.3 trillion. Taking this into account, the broader digital deficit is estimated to balloon up to approx. -JPY45 trillion (-JPY28 trillion + -JPY17.3 trillion). In this way, the automotive industry, which is the backbone of the Japanese economy, could suffer great damage in a sanctuary-free digital market.

Although the Report distinguishes between “hidden digital deficit” and “SDX deficit,” it would not be inappropriate to use the term “hidden digital deficit” for both these concepts, in the sense that data supremacy will allow foreign companies to dominate digital services, thereby widening the deficit and reducing the Japanese economy’s ability to earn foreign currency. Incidentally, the fourth interim report of the Industrial Structure Council’s Committee on New Direction of Economic and Industrial Policies, published on April 22, 2025, mentions “the creation of a business environment that competes globally not only through volume but also through high value-addition (e.g., Manufacturing X transformation) based on digitalization and servicification.” This discussion also relates to the hidden digital deficit, and the expression “servicification of manufacturing” is apt.

### *What Should Japan Aim for?*

Given this situation, what efforts are being made by governments around the world, and what example should Japan, which is relatively lagging (i.e., has a relatively large digital deficit), follow? The pertinent question is – where is Japan positioned in comparison with other countries around the world? The Report discusses Japan’s current position and future prospects in digital trade in Chapter 4, titled “International Government Trends and Policy Suggestions for Strategy Implementation.” The Report points out that 40 of the 91 countries surveyed have a digital deficit, indicating that this is a global problem. But in terms of the ratio of digital-related balance to GDP for countries with a GDP of over USD100 billion (53 out of the 91 countries surveyed), Japan ranks very low at No. 49 when intellectual property rights are not included.<sup>2</sup> It is necessary to accept that, while a digital deficit is not a problem unique to Japan, Japan is especially lagging.

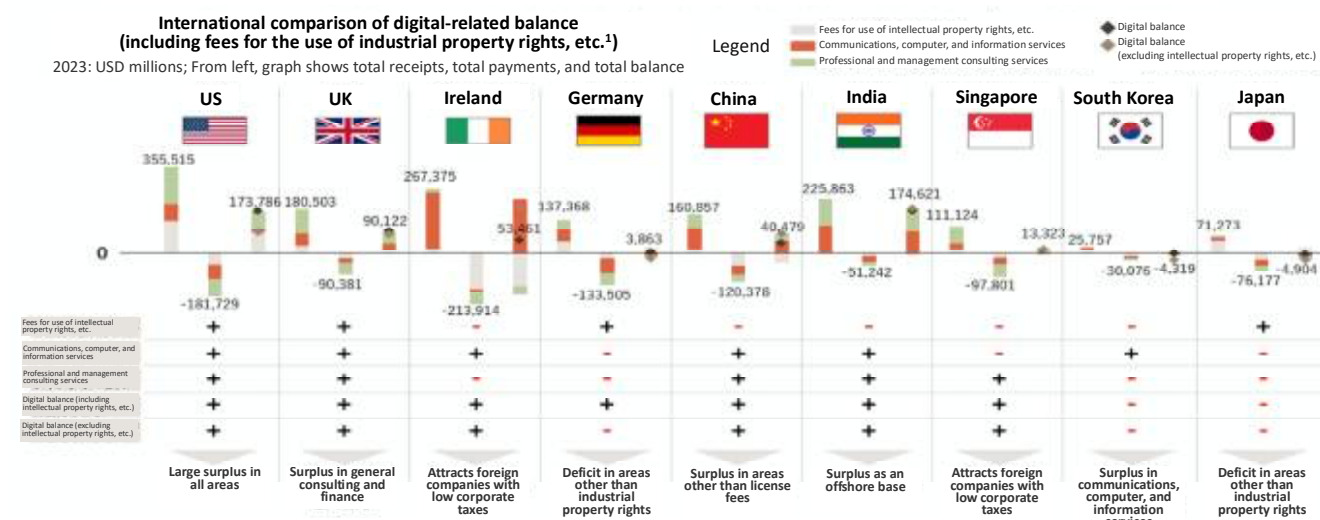
The report focuses on the U.S., the United Kingdom, Ireland, Germany, China, India, and Singapore as eight major countries that either have a surplus or a small deficit in their digital-related balances. It classifies the balances of these countries into four categories based on development factors and market factors, and then presents strategies to be taken.

<sup>2</sup> Technically, intellectual property rights and related items should not be included as they include industrial property rights, but due to statistical constraints in the EU, the only options for international comparisons are to either include intellectual property rights or to exclude them entirely. Japan’s surplus in intellectual property rights and related items stems from receipts of industrial property rights, specifically royalties from parent-subsidiary transactions related to overseas automobile production, and does not indicate dominance in the digital sector.



I will refrain from going into detail on all of these classifications, but the four categories are (a) large developed market type (e.g. the U.S., China), (b) international market expansion type (e.g. the UK, South Korea), (c) foreign capital attraction type (e.g. Ireland, Singapore), and (d) low-cost offshore type (e.g. India), and it has been pointed out that Japan should aim for (b) international market expansion type. The international market expansion type is defined as “a model in which cutting-edge R&D in the digital field is conducted by universities and public research institutes, competitiveness is fostered by pairing digital-related industries with core industries in which the country in question has a comparative advantage, and international market expansion is proactively undertaken given the small size of the domestic market, thereby increasing profits for each item that makes up the digital-related balance.” In the case of Japan, automobiles and machine tools are trade surplus items, so one assumes that it is these industries that will be paired with digital-related industries.

**Table 11 Comparison of Major Countries’ Digital-Related Balance**  
(Including Fees for the Use of Industrial Property Rights, Etc.)



For example, neighboring South Korea is considered an international market expansion type of market, and while it records losses in intellectual property rights royalties and professional and management consulting services, it records a small surplus in communications, computer, and information services, which keeps its digital deficit small. South Korean companies such as NAVER and Kakao boast high domestic market shares in Internet services, which is what is thought to be suppressing overpayment to overseas companies in applications, middleware, and digital advertising businesses. In short, foreign companies are unable to enter because domestic companies are strong.

The UK, also an international market expansion type, is a digital surplus country. This is due to the fact that statistically, professional and management consulting services are recorded in the digital-related balance, and there are many global consulting firms headquartered in London. This is not necessarily related to the digital field, but it has also been pointed out that the UK posts net receipts in the applications business, which benefits from the country's strengths in finance and accounting. In this sense, it is obvious that the UK is characteristic of an international market expansion type digital economy that makes use of the industries in which it has a comparative advantage.

Other countries such as Israel and Finland are also mentioned as falling into the international market expansion type category by successfully using the strategy of “digital x industry of comparative advantage.” Israel has an advantage in military technology, while Finland has an advantage in communications infrastructure technology with Nokia at its core, and the Report points out that both countries post a net receipt of foreign currency. The question now is whether Japan, with the automotive industry as its base, can follow the example of these countries.

### Woes of a “Semi-Superpower”

Of course, even without having to cite the examples of other countries, it is clear that Japan, which is on a fixed path of domestic market decline due to its declining population, has no choice but to expand into overseas markets. However, to complicate matters, Japan's domestic market of over 100 million people is still quite large despite a dwindling population. The Report points out that this may have led to strategic mistakes by Japanese companies. Specifically, it points out that this may be contributing to the complacency of Japanese companies, which are content with the size of the domestic market and fail to aim for overseas expansion, preferring nationwide expansion as an option instead. Such companies feel that, rather than expanding into overseas markets, diversifying their services and products in the domestic market and aiming to create synergy effects will increase their valuation and help them meet investor expectations for fundraising. By contrast, companies in countries such as South Korea, Israel, and Finland probably had a greater sense of crisis, knowing that they could not survive unless they looked overseas from the beginning. This is an issue has been pointed out for many years now, including in the Japanese consumer electronics industry.

Domestic investors in such Japanese companies tend to think that overseas expansion comes with a high ROE risk in the case of business models that do not incorporate overseas markets from the beginning, and that diversifying domestically allows for a safer exit strategy. Meanwhile, overseas investors tend to take a harsher view. They say it is unclear what Japan's Right to Win is in the red ocean of the U.S. market, which gives them no compelling reason to



invest. In short, the Report points out that Japan's status as a "semi-superpower" creates a dilemma for domestic managers as well as for domestic and foreign investors. This is a rather persuasive point.

### *Lessons to be Learned from Israel*

The Report proposes several measures to help break Japan out of its deadlock, including UK- and South-Korea-style programs for supporting the overseas expansion for domestic companies, and startup support modeled after the Israel's Yozma Program. Since introducing all of the measures would be difficult, I would like to provide an overview of the Yozma Program here. The Yozma Program is a framework created and launched by the government of Israel in 1993 with the aim of developing an ecosystem for fostering high-tech companies. It is an example of a policy measure that has successfully attracted overseas venture capital (VC).

The total budget for the program is USD100 million, of which USD20 million is directly invested by the government in startup companies, while the remaining USD80 million is in the form of joint investment with overseas private VC companies through 10 funds that have been set up. Further, after 5 years of the fund's operation, the government's portion of investment can be purchased by a private-sector VC company for the same amount as the initial investment plus interest at the rate of 5-7%, and incentives are designed to allow the government to withdraw its involvement smoothly. The investment targets are domestic high-tech startups in Israel, and the selection of appropriate targets is up to the fund manager, not the government. Since government-led industrial policies are rarely effective, this is a rather beneficial mechanism.

The Yozma Program has, in fact, significantly increased Israel's VC procurement, and a new program called "Yozma Fund 2.0" was launched in 2024. Further, the Yozma Program inspired South Korea's Foreign VC Investment Fund (FVCIF) program, which was launched in 2013 as an initiative to attract overseas VCs, and its track record in contributing to the creation of a startup ecosystem in South Korea has also been confirmed.

Naturally, Japan would like to learn from the experience of these countries. The Report points out that Japanese companies, investors, and the government lack (1) the funds, (2) the human resources, and (3) the data necessary for building an international market entry model, but the Yozma Program may offer a hint for how to solve problem (1). Also, given that Japan's low wage levels result in the inferiority of its human resources (2), the introduction of programs such as the Yozma Program or FVCIF to solve the first problem (1), could certainly lead to a breakthrough in reducing Japan's digital deficit.

Incidentally, the Report also presents an interesting analysis of the current state of digital talent in Japan, stating that it is not that Japan does not have excellent talent on the policy or industry sides, but rather that the talent pool is concentrated in a few digital companies that are on the lobbying side, rather than in the government or in companies that have not made much progress toward the digital shift due to low wages. Also, not engaging directly in either policy or industry has structurally become Japan's most optimal strategy for digital talent. If so, it seems inevitable that programs such as the Yozma Program or FVCIF will be the key to overcoming the current deadlock by achieving a breakthrough in funding.

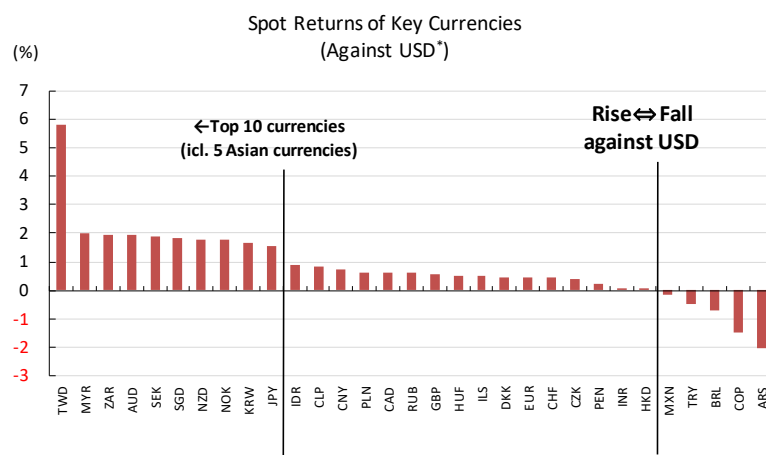
The Report includes many other important points that should be addressed, but the best thing about it is that it does not indulge in the kind of defeatist optimism often seen in public discourse regarding the digital deficit, such as that the deficit is not a bad thing in itself and should be used to create high-value-added goods and services in other fields. Throughout its analysis, the Report not only does a good job in encouraging a sense of crisis that Japan will be swallowed up if it continues on its current path, it also seeks to learn how to overcome the crisis using examples from other countries. I would like to make use of my learnings from the Report in my own future analysis.

## Risks to My Main Scenario – Concern about Asian Countries' U.S. Treasury Selling

### Reverse Asian Currency Crisis

As mentioned above, many Asian countries' currencies appreciated considerably against USD during early May, and the situation became a hot topic in the forex market to the point that many market participants began calling it a "reverse Asian currency crisis". On May 5 (U.S. time), the TWD (the New Taiwan dollar) rose to its highest level against USD in about three years (since April 2022). It appears that that the single-day margin of TWD/USD fluctuation on that day was the largest seen since 1988 and that that fluctuation reflected growing speculation that Taiwan had agreed to a TWD/USD adjustment in upcoming tariff negotiations with the United States. That same day, Taiwan President Lai Ching-te sought to calm the situation by issuing an impromptu statement that – "Precisely because the cause of the Taiwan-U.S. trade deficit has nothing to do with the exchange rate, the exchange rate issue will naturally not be mentioned in negotiations between Taiwan and the United States." The governor of Taiwan's central bank, Yang Chin-long, also clearly warned against a speculation-driven rise in TWD, stating at a press conference that, "We solemnly urge market commentators not to speculate irresponsibly about the foreign exchange market."

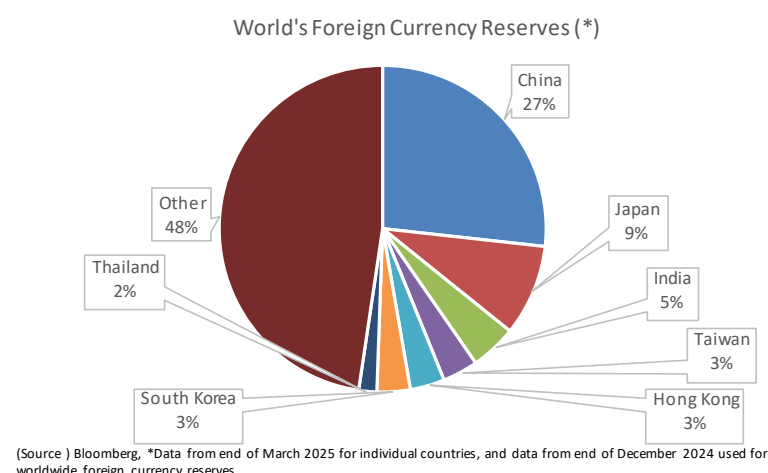
Looking at changes in the values of major currencies against USD during early May, one finds a noteworthy uptrend in TWD and other Asian currencies (see graph). The uptrend seems to be largely attributable to growing expectations that Asian countries with large surpluses in their trade with the United States would be forced to allow their currencies to be revalued upward against USD. It is reasonable to describe this situation as a "reverse Asian currency crisis", but it cannot be denied that the crisis was largely driven by general expectations that had no concrete basis. These contributing factors and forex rate movements are very similar to those affecting JPY in April, when attention was focused on U.S.-Japan trade negotiations. It should not be forgotten that the sharp drop of USD/JPY during April finally bottomed out after Japanese and U.S. officials confirmed that exchange rates were not an issue in the U.S.-Japan tariff negotiations. JPY appreciated against US owing to expectations about Japan-U.S. negotiations despite a lack of relevant statements from the authorities and retreated somewhat after official denials of exchange rate discussions. Similarly, as the lack of evidence that the United States had made any demand for the appreciation of TWD or other Asian currencies became increasingly apparent, those currencies also ended up depreciating somewhat from their recent peaks.



(Source) bloomberg, \*Up to May 1-7 for 2025

### Half the World's Forex Reserves in Asia

If, as the forex market expects, Asian financial authorities eventually agree with the United States to promote the appreciation of their currencies against USD, the own-currency appreciation promotion method will involve the use of each country's forex reserves to sell USD and buy local currencies. It can therefore be expected that there will be a corresponding scale of U.S. Treasury selling operations and, given the huge capabilities of Asian financial authorities, this could pose great risks for financial markets. The latest IMF-COFER data indicates that the world's total forex reserve balance (excluding gold) amounted to approximately USD12.4 trillion at the end of December 2024, and a considerable share of that balance was held by Asian countries. For example, as of the end of March 2025, China had approximately USD3.3 trillion of forex reserves, Japan approximately USD1.1 trillion, India approximately USD570 billion, Taiwan approximately USD440 billion, Hong Kong approximately USD420 billion, South Korea approximately USD400 billion, and Thailand approximately USD220 billion, all of which are very large figures. These seven countries



(Source) Bloomberg, \*Data from end of March 2025 for individual countries, and data from end of December 2024 used for worldwide foreign currency reserves

together hold about USD6.5 trillion of forex reserves, just over half of the world's total forex reserves. There is a three-month lag in the COFER data, but the overall picture is unlikely to change significantly.

The sudden rise of U.S. interest rates in April sparked speculation that it was the result of a departure of long-term capital from European pension funds and the like, but if the departure of reserve money from Asian financial authorities were to occur, it would have an equal or greater impact. When focusing solely on forex market trends, the situation can certainly be described as a reverse Asian currency crisis, but if Asian currencies appreciate and current trends of decrease in resource prices and strong currencies continue, Japan, South Korea, and other countries highly dependent on resource imports could see a dramatic improvement in their terms of trade, which could promote rises in their domestic real wage levels. On the other hand, there are grounds for concern that an unwanted surge in U.S. interest rates will have a direct impact on the real economy in the United States.

### *On Brink of Believing USD Depreciation is the Objective*

During May, the fact that the United States recorded its largest-ever trade deficit in March became a hot topic. Of course, the size of the March deficit reflects a last-minute rush to export to the United States prior to the imposition of prohibitively high tariffs, but as was discussed in last month's edition of this article, the U.S. trade balance has the characteristic of being strongly impacted by the J-curve effect when USD weakens. (The J-curve effect describes how a country's trade balance initially worsens after a currency depreciation or devaluation before it improves over time.) Even without a last-minute surge of exports to the United States, one should assume that USD weakness may coexist with U.S. trade deficit expansion over periods of a year or more. While it is not what President Trump is seeking, there is a high likelihood of a persistent U.S. trade deficit expansion trend.

One can gain a better understanding of the current situation if one considers the fundamental factors that have caused the United States to continue recording large trade deficits. As the country owning the world's principal reserve currency, the United States has continued to receive huge capital inflows from overseas that enable it to maintain a financial account surplus even when its current account (trade) balance is in deficit. Asian countries' purchases of U.S. Treasury bonds contribute to those huge capital inflows, so policies that force Asian countries to sell U.S. Treasury bonds can clearly be said to be undermining the foundation of the world's principal reserve currency. So long as such self-destructive policies are maintained, we may see a repeat of the situation in early April, when USD plummeted and U.S. interest rates soared at the same time as funds were withdrawn from U.S. Treasury bonds and U.S. stocks. If large volumes of Asian countries' forex reserves were to be shifted away from U.S. assets in this way, it could fundamentally change the U.S. Treasury bond market absorption structure. That is not seem to be what the Trump administration is seeking, but if the chaotic market conditions seen since April continue, the markets may come to willy-nilly conclude that that indeed is the U.S. objective even if the United States explicitly denies it.

If that happens, it may become even more difficult to control the USD depreciation trend, and appreciation of other currencies against USD will become inevitable. In fact, the currencies of Japan, Taiwan, and South Korea have already strengthened despite those countries' repeated official assertions that exchange rates are not an issue related to the ongoing tariff negotiations. It seems quite possible that a strong self-perpetuating USD depreciation trend could become the mainstream scenario amid an unabated stream of official statements denying that such a trend is desired or likely. I am not yet in a position to assess the likelihood of such an outcome, but if the anticipated degrees and speeds of progress in tariff negotiations with various countries are not achieved, the risk of such an outcome could become quite high.

### *U.S. Treasury Bonds Downgraded*

Even if the United States does not itself move to promote USD depreciation, there is a general perception that USD's value is in danger. On May 16, a leading U.S.-based credit rating agency, Moody's, announced that it would downgrade the United States' long-term issuer rating and senior unsecured bond rating by one notch from the highest "Aaa" (equivalent to an S&P "AAA" rating) to "Aa1" (equivalent to an S&P "AA" rating) Since Fitch and S&P Global had previously withdrawn their top ratings, U.S. government bonds no longer have top ratings from any of the major credit rating agencies. In light of the fact that there is no viable substitute for U.S. government bonds, the two previous U.S. government bond rating downgrades were perceived as symbolic actions that did not have concrete repercussions in financial markets.

S&P Global downgraded U.S. Treasuries on August 8, 2011, and Fitch downgraded U.S. Treasuries on August 1, 2023. On the day of the S&P Global downgrade, the Dow Jones Industrial Average fell by about 5.5%, the sixth largest one-day decline in history at the time, but the Fitch downgrade was accompanied by only a small decline in stock prices. Both downgrades caused temporary rises in U.S. long-term interest rates, but the rises were not sustained. Immediately after the Fitch downgrade, a large increase in the U.S. 10-year interest rate attracted attention, but that increase was generally considered to reflect the concurrent release of strong U.S. economic indicator data (specifically, the U.S. July ADP employment report) that was strengthening expectations of a Fed interest rate hike. So it can be said that previous U.S. government bond rating downgrades did not actually undermine the markets' fundamental confidence in U.S. Treasury bonds or cause confidence in USD as the world's principal reserve currency to waver.

### *Tax Cuts' Potential Downsides*

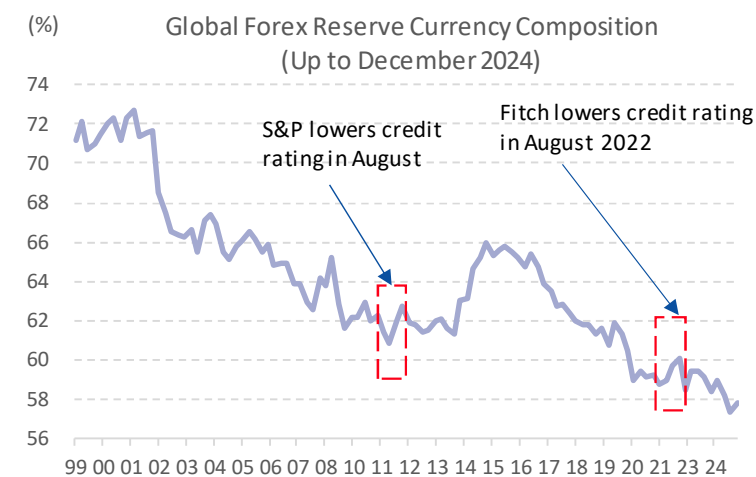
However, questioning the permanence of USD's status as the world's principal reserve currency has become a major financial market theme since President Trump declared April 2, 2025, to be "Liberation Day", from which time he would launch tariff policies and other trade policies designed to liberate the United States from 'unfair' trade relationships. While financial markets' reaction to the latest credit rating downgrade has been limited, I and many other people are worried that the downgrade could trigger a sharp rise in U.S. interest rates.

The financial markets appeared to be strengthening somewhat following the soft landing of the U.S.-China tariff talks, but it appears that concerns about the possibility of an uptrend in U.S. interest rates stemming from factors related to fiscal budget issues have subsequently been becoming more prominent. Ironically, some people are speculating that, as concerns over tariff policies subside, tax revenues (including those obtainable via tariffs) may decrease and thereby promote a rise in U.S. interest rates. Under these circumstances, the tax cuts that were previously expected to improve market sentiment became more likely to be interpreted as negative news that could lead to a – “rising fiscal concerns → rising U.S. interest rates → falling stock prices” – sequence, and the shift to greater concern about fiscal budget issues has now been strengthened by Moody’s downgrading of U.S. Treasuries. At this point, it appears that the feasibility of stimulating the U.S. economy through expansionary fiscal policies has been considerably diminished.

Moody’s reasons for the latest rating downgrade include such standard issues as the expanding fiscal deficit and the increasing burden of interest payments due to rising interest rates, as well as an estimate that an extension of the Trump tax cuts introduced in 2017 will cause the federal government’s primary budget deficit (excluding interest payments) to increase by about USD4 trillion over the next 10 years. In other words, the extension of the tax cuts could be a factor causing consideration of an additional rating downgrade, to which the markets would be likely to respond by raising interest rates. In this connection, it is worth noting that the possibility of a consumption tax rate cut is currently a hot topic in Japan, but some believe that the reason Japan’s government bonds have been able to maintain an investment grade rating despite the huge volume of government debt and low economic growth rates is because there remains leeway to raise the consumption tax rate, which is still at a low level compared to other countries. Given this, it is clear that the increasingly prominent opposition party proposals to reduce the consumption tax rate are potentially quite dangerous.

### *Loss of Key Currency Status only Gradually*

While I wrote above that previous U.S. government bond rating downgrades did not actually cause confidence in USD as the world’s principal reserve currency to waver, there are now worrying signs that such confidence in USD may actually be starting to waver. If USD really does lose its status as the world’s principal reserve currency at some point in the future, it will not happen suddenly. It will be more likely lose its status through a protracted weakening process while remaining somewhat supported by previously accumulated momentum. Previous editions of this article have discussed USD’s key roles in light of money’s three main functions (value storage,



(Source) macrobond

value measurement, and exchange), and USD’s share of the world’s forex reserves reflects its value storage functionality, but this share has been trending downward for many years (see graph). Until about a decade ago, not many people would have thought it possible that USD’s share of the world’s forex reserves could fall below 60%. If this is a sign of USD gradually losing its world’s principal reserve currency status, one should be wary of developments that may undermine USD’s value unit function, such as the BRICS initiatives to promote a shift away from the universal USD-denomination of crude oil trading. Such concerns have existed for some time, but the latest rating downgrade may have added a bit of momentum to the gradual trend, so it is possible that USD may be somewhat more weakened and U.S. interest rates somewhat more boosted than they were by the previous two downgrades. However, recent history has demonstrated that there are as yet no real alternatives to USD as the world’s principal reserve currency, and classic logic suggests that – amid an uptrend in geopolitical risks – the dominant military power of the United States and the associated stability of USD will come to be valued more even more highly.



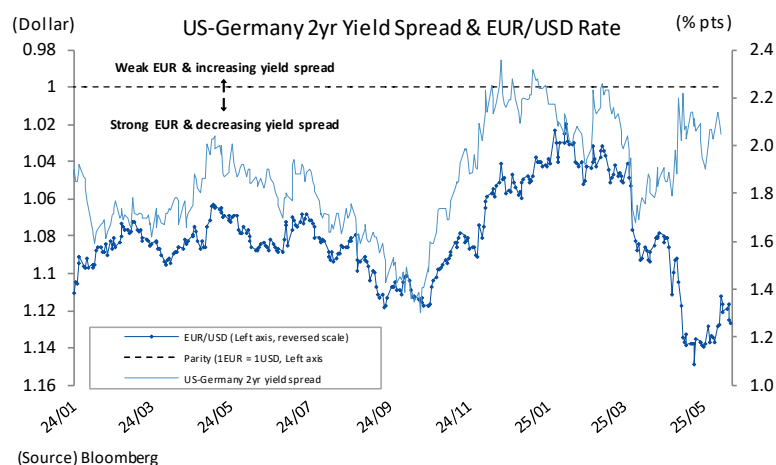
## EUR Outlook – Questionable Sustainability of EUR Strength

### EUR Now and Going Forward – EUR Not Reflecting Europe-U.S. Interest Rate Differential

#### Basis of EUR Strength

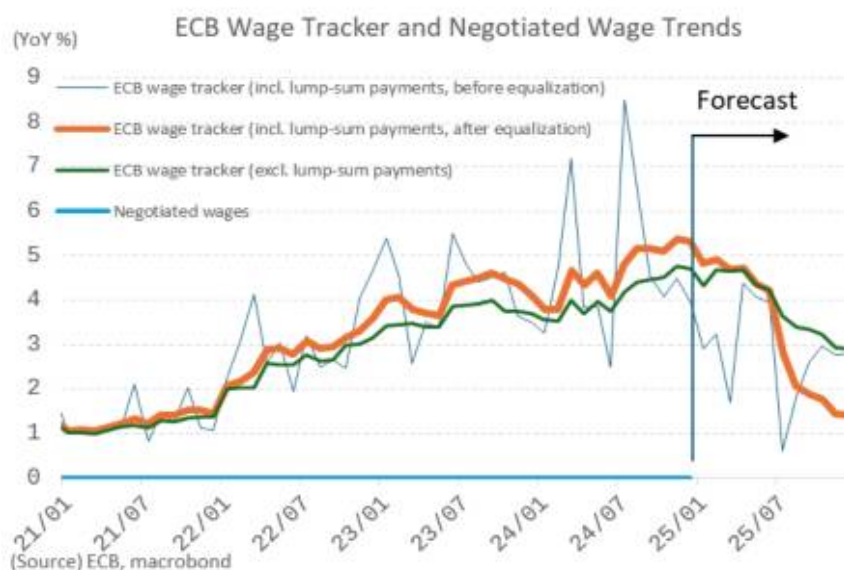
While the Japanese and U.S. ultra-long-term bond markets have undergone some turmoil, euro area financial markets have remained relatively calm, and EUR has continued to be particularly strong. It was not uncommon early this year to hear voices predicting that EUR would fall below parity against USD due an expected broadening of the Europe-U.S. interest rate differential. However, the various EU economic reform measures approved in March are expected to promote expansionary fiscal policies that support the euro area economy and this, combined with the Trump administration's reckless actions since April, has considerably strengthened EUR's investment appeal. This trend has been reflected in speculative positions in IMM currency futures trading (see graph). As of May 13, net EUR long positions reached a peak of +USD11.9 billion, the highest level in about eight months (since September 3, 2024) and, although there has been some unwinding of those positions, net EUR long positions remained at the high level of +USD10.5 billion as of May 20.

It will be important to see what the ECB's next monetary policy move will be, however, and it is currently expected that the ECB will decide what to do at its July Governing Council meeting based on the staff projections that will be available in June. It seems quite likely that the ECB will sustain its interest rate reduction posture after June, particularly given the 50bp interest rate cut proposed by some participants at the April 17 Governing Council meeting, but it bears remembering that the April meeting was impacted by confusion about how to respond to the April 2 "Liberation Day" declaration. In any case, the ECB cannot be expected to make any major decisions until July 9, when the outcome of the tariff negotiations will become clear, so it is highly likely that the June 5 Governing Council meeting will maintain the status quo, and the decision on whether to halt the rate cuts will be made at the July 24 Governing Council meeting. The main factor supporting EUR's current strength is not the Europe-U.S. interest rate differential but a general anticipation of USD weakening.



### Euro Area Inflation Rates Still High

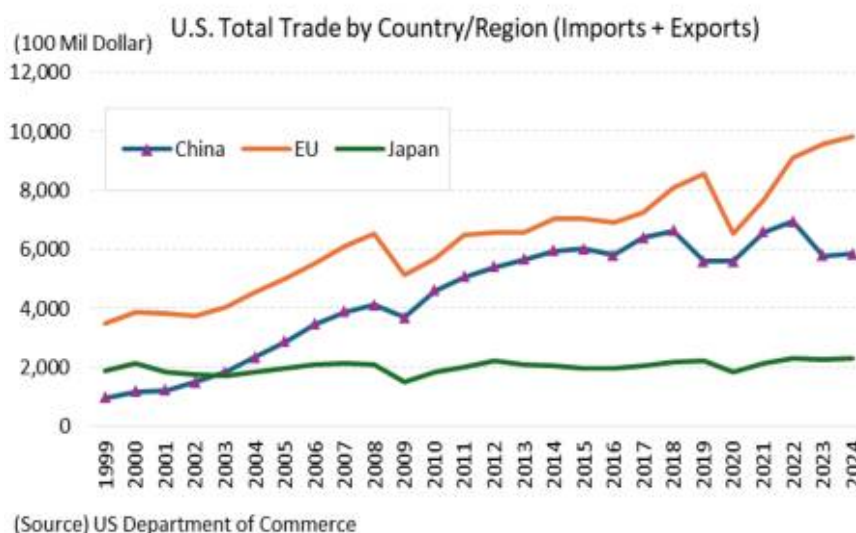
Euro area inflation rates – a key determinant of the ECB's prospective rate cut decisions – remain quite high – although the rate of growth in the HICP euro area consumer price index has settled at around 2% on an overall basis, the core basis growth rate remains high in the upper portion of the 2-3% range. Although the actual height of inflation rates does not seem to be a major problem, the stickiness of inflationary pressures is likely to be a concern. The inflationary pressures stemming from energy price rises have already dissipated, and it currently appears that inflationary pressures in the services sector are the most important factors sustaining euro area inflation rates. In other words, the region's strong employment and wage situation is pushing prices upward, and this is the explanatory variable that the ECB needs to be most wary of. The ECB's wage tracker is still forecasting that wage growth will decelerate toward the end of the year, and that outlook makes it easier to argue for a forward-looking interest rate cut. As mentioned, EUR's current strength largely reflects general anticipation of USD weakening and, although the euro area economy is showing signs of recovery, it should be noted that the ECB's policy interest rates are not trending upward. As shown in the graph on the previous page, it is clear that EUR/USD is at a significantly different level from the level suggested by the U.S.-Germany interest rate differential. Given this and the imbalance in speculative positions, there is clearly a risk that a U.S.-EU negotiation soft landing could trigger a substantial amount of EUR selling. In light of the fact that the Trump administration has been showing more hostility towards the EU than to China in recent months, however, the likelihood of a U.S.-EU negotiation soft landing seems small. This outlook is precisely why market expectations are leaning in a direction that appears to be strengthening EUR, but there remains considerable leeway for doubting whether the euro area's economic and financial situation is really attractive enough to justify EUR's current level of strength.



### Euro Area Tariff Negotiations – Situation Turning Out As Was Feared

#### Lack of Progress in U.S.-EU Negotiations

On May 23, President Trump announced his intention to impose a 50% tariff on all U.S. imports from the EU. Specifically, he told reporters at the White House – “I’m not looking for a deal [with the EU]. We’ve set the deal — it’s at 50%.” – and declared the 50% tariff rate would take effect on June 1. European Commission President Ursula von der Leyen subsequently spoke with President Trump by phone and requested a delay in the imposition of the tariffs, however, and the effective date of the tariff rate was postponed until July 9. U.S. tariffs on imports from the EU previously were to include a 10% baseline tariff and a 20% reciprocal tariff, but barring progress in U.S.-EU negotiations the tariff rate will be boosted to 50%, and U.S.-EU



relations are not showing signs of improving in general. The United States may not anticipate actually imposing a 50% tariff rate – it is quite likely that it is simply using the threat of such a rate to prod the EU into engaging more actively in negotiations.

This is a development that I have anticipated for some time<sup>3</sup>, as I have been arguing that, compared to China, the EU is likely to more-stubbornly resist U.S. trade negotiation threats. Most of the United States' major trade partners have basically submitted to tyrannical U.S. demands and are seeking solutions through dialog rather than retaliation. The UK (which has reached a final agreement with the United States) and Japan (said to be close to such a final agreement) are perfect examples of this. (The U.S.-China situation currently seems more akin to a truce following repeated rounds of threats and counter threats.) Such countries as the UK and Japan are seeking to use various strategies to satisfy U.S. demands and appease the United States, but the EU has steadfastly maintained a head-on confrontation approach and, moreover, the European Commission and EU member states appear to have negotiating positions that differ from each other in some areas of negotiation. All in all, the EU is an extremely troublesome negotiation partner, yet it is the United States' largest trading partner (see graph on previous page), so President Trump has to strongly emphasize his negotiations with the EU. Strictly speaking, the EU has also put forward constructive counterproposals – such as a proposal to increase imports of U.S. liquefied natural gas and a “zero-for-zero” deal to eliminate tariffs on both sides' industrial products – so it has made some efforts to reach an agreement. However, it appears that the EU's retaliatory tariffs have provoked President Trump and delayed progress in negotiations.

### *Japan Cannot Emulate the EU*

As of May 25, after his call with European Commission President von der Leyen, President Trump told reporters that it was a “very good call” and expressed his positive feelings about agreeing to the deadline extension. European Commission President von der Leyen reportedly insisted during the call that – “To reach a good deal, we would need the time until July 9.” There is wide speculation that, eager to make trade negotiations progress rapidly, President Trump simply proposed the 50% tariff rate to expedite negotiations that were not progressing as quickly as he had hoped. There are various views on about the results, but overall it appears that the EU has so far managed to avoid quickly submitting to U.S. demands and that the EU may possibly end up successfully defending many of its interests in line with its insistence on mutual respect.

Some people have opined that Japan should follow the example of the EU and strive to reject U.S. trade negotiation demands, and while I understand the sentiment underlying such opinions, I think it is pointless to compare the positions of the EU and Japan. Japan and the EU have fundamentally different security strategies and fundamentally different ways of interacting with the United States. Currently, the United States' biggest security-related objective is preventing a Taiwan crisis, and it is seeking to shift resources to East Asia in line with that objective. The Trump administration's efforts to withdraw from the war in Ukraine war also reflect the need to shift resources to East Asia, as the United States no longer has the ability to deal with China while investing large amounts of resources in diverse other regions. Consequently, the EU has been encouraged to become more militarily independent – it will benefit from the U.S. security umbrella less than previously but will be able to speak out more-independently than previously.

Although it is not being viewed as a material factor in financial markets, Germany began stationing troops permanently in Lithuania from May 22, the first time German troops have been posted abroad since World War II. The more such moves proceed, the stronger the EU's position for negotiating with the United States should be. As the roles of the United States and European countries within NATO are restructured, the U.S.-EU power balance is also becoming more even, so the EU should not be compared to Japan, which remains completely incapable of dealing with a regional emergency without U.S. assistance. (Regarding non-EU European countries, the UK not comparable in another sense, as is one of the rare countries recording trade deficits with the United States, so there are few U.S.-UK trade frictions to contend with.) Even if it true that it is the somewhat-more-even U.S.-EU power balance that is encouraging the EU to undertake a tit-for-tat retaliatory tariff battle, however, there is certainly no guarantee that the EU's negotiations with the United States will go well for the EU. In any case, it is only natural that the EU and Japan should adopt different approaches to dealing with U.S. trade-related demands, and it will not be clear whether the EU or Japan will gain or lose more as a result of the negotiations until those negotiations are completed. For example, it is noteworthy that the EU and Japan both are recording digital deficits with the United States and that the EU has adopted an aggressive attitude toward U.S. digital service providers – however, it is not yet clear how successful the EU approach will prove going forward, and it is quite clear that Japan is not positioned to emulate the EU approach.

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<sup>3</sup> Please see the April 28, 2025 edition of Mizuho Market Topic, entitled “EU's U.S. Strategy – Including “Tax on Digital Deficits”” and the May 9, 2025 edition of Mizuho Market Topic, entitled “Following the U.S.-UK Agreement – U.S.-EU Negotiations Become a Concern”.

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