

Forex Medium-Term Outlook

April 30, 2025

Overview of Outlook

USD/JPY fell sharply in April. This is not owing to a reevaluation of JPY, which has undergone across-the-board depreciation over the past three years, but rather due to all currencies, including JPY, being pushed up by USD weakness. The structural vulnerability of JPY, which is this report's understanding of the main reason behind its weakness, continues. However, forex rates always involve two parties, and the Trump administration's grand ambition to reorganize the Bretton Woods system is a reality the world has been facing since April. This has resulted in USD weakening as countries around the world begin to abandon the U.S. Structural changes in the Japanese economy may be an important factor for Japan, but they are insignificant in the face of a reorganization of the international financial system. As the U.S. becomes more isolationist, more countries/regions are trying to distance themselves from a USD-dominated financial system, and if this is the real cause of USD weakness, structural changes in the Japanese economy will no longer serve to explain USD/JPY rate trends. If USD continues to depreciate, JPY will inevitably appreciate to some certain extent, but this is not what the Trump administration wants. My main forecast scenario is that the Trump administration will try to save face by revising its tariff policy, leading to USD recovery against JPY. The argument that USD will be devalued through international coordination in something like a second Plaza Accord is merely a narrative created by the media and markets. This report views the possibility as no more than a risk scenario. In the second half of the forecasting period, JPY could appreciate in response to a Fed interest rate cut, but its structural weakness will ensure a firm lower limit for USD/JPY.

EUR appreciation strengthened in April, but largely as a result of USD depreciation amid a loss of confidence in the currency. The ECB seems likely to continue with its rate cut path for the time being, as Trump tariffs are expected to exert downward pressure on the regional economy. In all honesty, the situation is not conducive to buying EUR, but as changes in the international financial order and the resulting USD decline became major market themes in April, USD selling dominated and determined currency rates. At the ECB's April Governing Council meeting, concerns were expressed about the possibility of disinflationary pressure being imported via EUR strength, so ECB operations are likely to be premised on a rate-cut path for the time being. Given that EUR/USD has a stable correlation with the Europe-U.S. interest rate differential, a unilateral EUR appreciation like in April may be difficult to expect going forward. My forecast range for EUR may have to be upwardly revised, but I do not think it necessary to revise the overall path at this stage. Europe is currently exploring its own FTA strategy independent of the U.S. While its impact is not expected to become apparent during the current forecasting period, it will be important to watch how JPY is affected through changes in Europe-Japan trade relations as the EU forges stronger ties with Asia going forward.

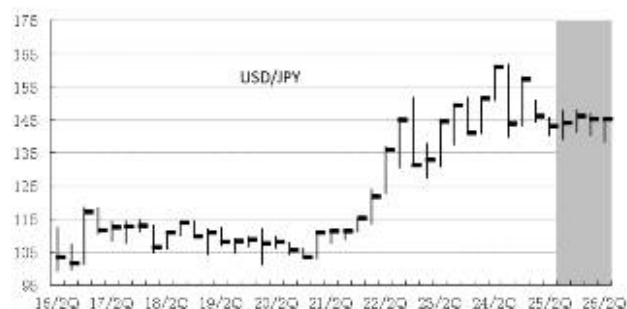
Summary Table of Forecasts

	2025				2026	
	Jan-Apr (Actual)	May-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
USD/JPY	139.89 ~ 158.88 (142.42)	140 ~ 146 (143)	139 ~ 148 (144)	141 ~ 148 (146)	140 ~ 147 (145)	138 ~ 146 (145)
EUR/USD	1.0125 ~ 1.1575 (1.1383)	1.09 ~ 1.15 (1.13)	1.08 ~ 1.14 (1.12)	1.06 ~ 1.12 (1.09)	1.05 ~ 1.11 (1.08)	1.05 ~ 1.11 (1.10)
EUR/JPY	155.63 ~ 164.52 (162.02)	158 ~ 165 (162)	156 ~ 164 (161)	155 ~ 164 (159)	154 ~ 163 (157)	153 ~ 162 (160)

(Notes) 1. Actual results released around 10 am TKY time on 30 April 2025. 2. Source by Bloomberg

3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts

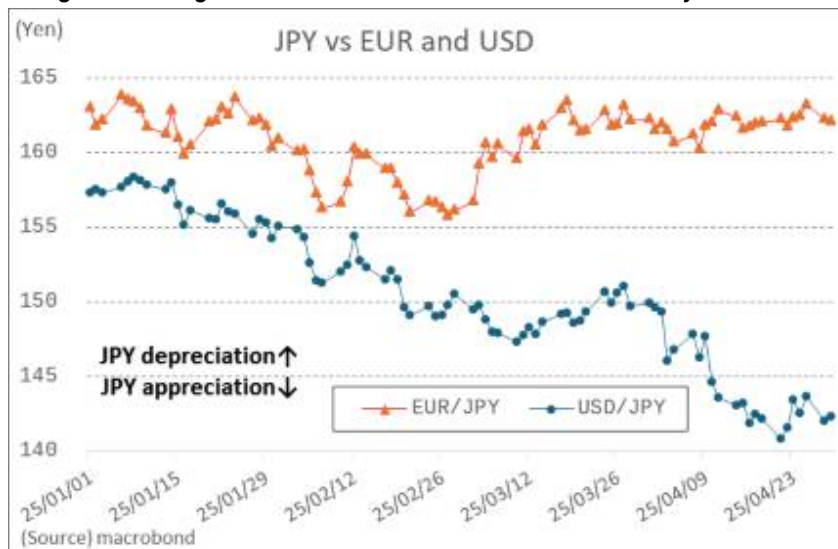


USD/JPY Outlook - Weak-JPY Scenario Edging Toward USD-Decline Scenario

JPY Rates Now and Going Forward – Structural Changes in Japan vs. Reorganization of the International Financial System

Important to Weigh Structural Changes in Japan against Reorganization of the International Financial System

USD/JPY plummeted temporarily to the 139 range in April. This was largely due to concerns over U.S.-Japan tariff negotiations, but it is important to emphasize that the trend is essentially the result of a move away from the U.S. following the reckless actions of the second Trump administration, not due to Japan buying. The graph to the right shows the trends of JPY against USD and EUR since the beginning of the year. While JPY's appreciation against USD is significant, the currency has remained roughly flat against EUR. In other words, the fall of USD/JPY is not owing to a reevaluation of JPY, which has undergone across-the-board depreciation over the past three years, but rather due to all currencies, including JPY, being pushed up by USD weakness.

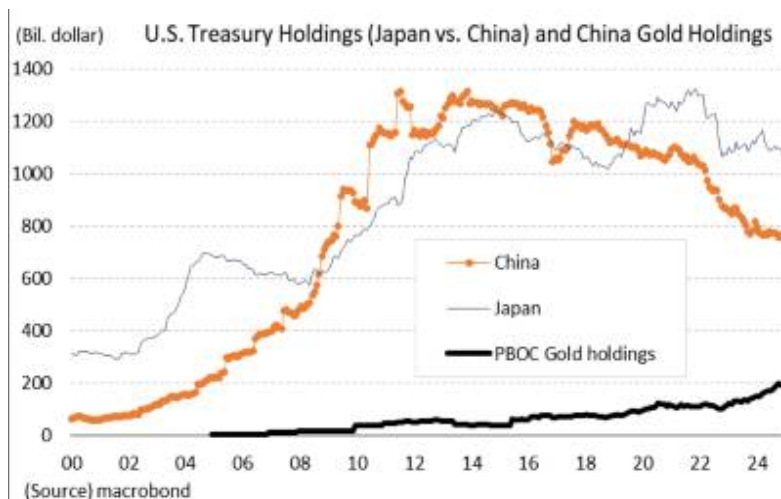


This report's basic understanding that "the structural changes in the JPY environment, as symbolized by changes in Japan's balance of payments structure, is the reason behind JPY weakness," remains valid. Japan's current account balance is saddled with trade and digital-related deficits that promote JPY selling in the markets, but still posts an overall surplus based on a primary income surplus that is not repatriated to Japan. This situation has not been resolved at all.

However, forex rates always involve two parties, and a reality the world has been facing since April is the Trump administration's grand ambition to reorganize the Bretton Woods system and the resulting weakening of USD amid a U.S.-abandonment trend (Secretary of the Treasury Scott Bessent said during the 2024 presidential election campaign that he wanted to be involved in a realignment of the Bretton Woods system). Structural changes in the Japanese economy may be an important factor for Japan, but they are insignificant in the face of a reorganization of the international financial system. It is not only JPY that has appreciated as USD weakens, but also European currencies including CHF, EUR, and GBP. In fact, market expectations of currency appreciation as a result of USD weakening are

higher for European currencies than for JPY. To repeat, therefore, the recent USD/JPY trend is not the result of JPY being reevaluated.

As the U.S. becomes more isolationist, more countries/regions are trying to distance themselves from a USD-dominated financial system, and if this is the real cause of USD weakness, structural changes in the Japanese economy will no longer serve to explain USD/JPY rate trends. We do not have clear evidence of which economic entities are currently withdrawing funds from USD-denominated assets. However, it has been known for the past 15 years that China is replacing U.S. Treasuries with gold in its forex reserves, and there is evidence of this (see graph). It is quite possible that China pulled the trigger amid intensification of the tariff war. Further, given the upward trend of CHF and EUR, it is also plausible that a rotation from USD-denominated assets to European currency-denominated assets is taking place. For example, there is speculation that the upward trend in the Norwegian krone seen since the second week of April is due to a rebalancing by the country's pension funds (although there is no quantitative evidence regarding this). If we bet on USD falling and U.S. interest rates soaring based on the assumption of the Bretton Woods realignment continuing, JPY will continue to appreciate to a certain extent.

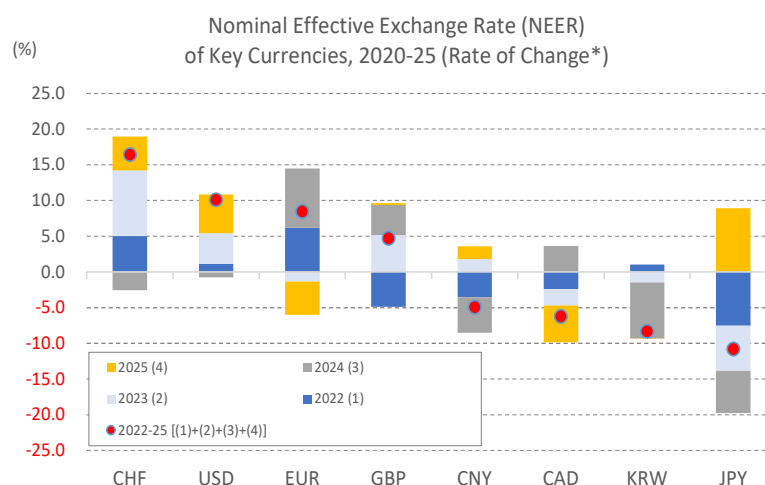


Main Scenario is Across-the-Board USD Weakening Amid Trend Correction

However, this is not what the Trump administration wants. The decision to suspend the mutual tariffs for 90 days is interpreted as having been prompted by the sudden rise in U.S. Treasury yields (the sudden fall in U.S. Treasury prices). The move to dismiss Fed Chairman Powell over differences in policy views was also reconsidered in the wake of turmoil in the financial markets. Japan, which is completely dependent on the U.S. for security, is the world's largest holder of U.S. Treasuries and is likely to remain a stable investor, but as mentioned above, other investors, including China, are not so submissive. More investors are likely to emerge going forward who bet on a USD collapse scenario in the face of communication that is clearly irrational. Ultimately, given that the current situation is just as damaging for the U.S., my main scenario predicts that the Trump administration will try to revise its tariff policy while attempting to save face. Therefore, I stand by my view that across-the-board USD decline as seen in April is unsustainable. Of course, given the level of commotion, it may take some time for U.S. interest rates to settle down, but if the situation becomes uncontrollable, the Fed may begin purchasing U.S. government bonds while emphasizing that there is no change in the policy stance to suppress inflation, as one of the roles of the central bank is to respond to systemic risks. USD's status as the world's key currency is guaranteed by the fact that the whole world holds U.S. Treasury bonds, certain types of economic transactions require USD, and unlimited swaps with the Fed are necessary in times of emergency. In short, the fact that one needs USD when in trouble is what makes USD the key currency. However, there are also rumors that the Trump administration is considering taxing foreigners' U.S. Treasury bond holdings or extending the maturity of these bonds. As a result, "needing USD when in trouble" is rapidly turning into "holding USD spells trouble." A currency that is costly to hold and has limited use cannot serve as a key currency. However, neither President Trump nor Treasury Secretary Bessent are contemplating abandoning key currency status for USD. Such a proposal would be unlikely to see the light of day.

Current Status of JPY as Indicated by Its NEER

Returning to JPY, a look at its nominal effective exchange rate (NEER) over the past three years indicates that the currency's decline during 2024 has been reversed (see graph). To put it differently, the decline of 2022-2023 is yet to be reversed, and this was very large for JPY compared to other currencies. In this regard, my position in this report has been that JPY selling encouraged by the domestic-foreign interest-rate differential is not sufficient to explain the level of JPY depreciation. Speculation of a potential "second Plaza Accord" and a resultant sharp JPY appreciation remains persistent, but JPY strength based on supply and demand at the current time, when trade deficits have become the norm, is vastly different from that in the 1980s, when trade surpluses exceeding +JPY10 trillion were regularly posted (details



later). Can we expect the same level of price movements as in the 1980s even if tariff negotiations aimed to induce JPY appreciation? As confirmed at the February U.S.-Japan summit, U.S.-Japan tariff negotiations could end up boosting imports to the U.S. from various sectors. This impression remains unchanged after Bessent's meeting with Minister in charge of Economic Revitalization of Japan Ryosei Akazawa and Minister of Finance Katsunobu Kato. While it would be desirable for the Trump administration to back down, that would simultaneously encourage the expansion of Japan's trade deficit. In the first place, the idea that trade negotiations could encourage JPY appreciation is itself based on an obsolete understanding of Japan's strength. If there is a possibility of sharp JPY appreciation within a short timeframe, it would clearly be driven by an increase in JPY's real interest rate. In fact, given the discrepancy between inflation and real interest rates in Japan, such a development cannot be entirely ruled out. The question is – can the Japanese economy withstand a sharp rise in interest rates that would close its real interest rate gap with the U.S.? It would likely impose a further economic weakening, and it is hard to imagine that leading to JPY appreciation.

Should One Bet on USD Falling?

I will discuss the speculation about a second Plaza Accord, which is a hot topic, in greater detail below, but for now, let me say that it is not sensible to bet on the possibility of it happening. Things are very different now than they were in 1985, from the volume of transactions in the forex market, the diversity of players, and the state of international relations, to the fundamentals of the Japanese economy. In short, one must understand that it is impossible to induce changes in exchange rates through international cooperation in this day and age.

As seen in April, the weakening of USD goes hand in hand with a sharp rise in U.S. Treasury yields, so the U.S. promoting further USD weakness would amount to its accepting a further surge in U.S. Treasury yields. If that happened, the possibility of JPY strengthening to the 130 or 120 range could not be ruled out. However, betting on JPY appreciation based on such a development is tantamount to betting on the decline of USD, and one must ask oneself if this is really a realistic scenario? Would the Trump administration, with its aim of making America great again, abandon the enormous privilege of USD being the world's reserve currency? I find it extremely difficult to believe this is possible. JPY appreciating against a sentiment of USD decline is my biggest risk scenario, but the possibility of it coming to fruition is low.

U.S. Trade Policy Now and Going Forward – How to Read the Mar-a-Lago Accord

Revisiting the Mar-a-Lago Accord

Every move by the Trump administration, which is shaking up the international financial markets, is said to be in accordance with the contents of the paper “A User's Guide to Restructuring the Global Trading System” published in November 2024 by Stephen Miran, chairman of the Council of Economic Advisers (CEA). The paper covers a wide range of topics, but from the perspective of the forex market, it is noteworthy that it points out USD

overvaluation as the main cause of the chronic trade deficit and decline of the manufacturing industry in the U.S. Miran's analysis is that, with the strengthening of USD due to large demand as a reserve currency, the U.S.' competitiveness in the manufacturing sector has deteriorated. The framework proposed to resolve this is what is popularly called the Mar-a-Lago Accord. The paper calls it “a 21st Century version of a multilateral currency agreement.” The contents of the agreement can be summarized as (1) intentional devaluation of USD, (2) ultra-long-term maturity of U.S. Treasury bonds, (3) linking of security and economic policies, and (4) strategic use of tariffs (see table). Point (1) is the reason the Mar-a-Lago Accord is attracting attention as being similar to the 1985 Plaza Accord, but it must be noted that the former is characterized by an integration of security and economy-related discussions, which have remained separate so far. In fact, the most distinctive feature of the Mar-a-Lago Accord is the integrated operation of currency, trade, and security policies. When discussions are presented in this framework, countries such as Japan and South Korea (especially those in Asia and Oceania), which are greatly dependent on the U.S. for security, are at a loss for how to refuse. However, Japan is the world's largest holder of U.S. Treasuries, and other Asian countries are also major forex reserve nations with large holdings of U.S. Treasuries. Request (2) does not seem reasonable, but it may be the main intention of the U.S., which it hopes to achieve by threatening (1), (3), and (4).

Gist of the Mar-a-Lago Accord

	Specific measures	Notes
(1)	Intentional USD devaluation	Improving U.S. export competitiveness by correcting USD strength
(2)	Ultra-long-term U.S. Treasuries	Converting foreign-government-held U.S. Treasuries into ultra-long-term 100-year bonds, thereby lowering risk of short-term capital outflows
(3)	Linking of security & economic policies	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)	Strategic use of tariffs	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"

Climate Too Different From 1985

Regarding point (1), which is attracting widespread attention in the forex markets, even if one understands the principle, there is still the question of what measures ought to be taken. As already discussed in detail, repeating the Plaza Accord may not be realistically possible. The table below compares the differences between 1985 and the present in terms of seven points.

One has no choice but to conclude that everything is different. As is often stated, the scope and depth of the forex market are very different from 40 years ago. First, looking at point (2), the average daily trading volume, which was USD600 billion in 1986, has expanded over tenfold to about USD7.5 trillion in 2022, as per a survey by the Bank for International Settlements (BIS). Further, in connection with point (3), it must be noted that market participants are diversifying. Individual investors simply did not have so much influence in the 1980s, and institutional investors have also expanded significantly. As market participants become more diverse and the market itself becomes larger, the sway of governments and central banks has clearly declined.

Is Plaza Accord 2.0 Possible?

	Point	1985 (year of Plaza Accord)	2025 (Present)
(1)	Exchange rate system (*1)	Managed (& government-led) floating exchange rate system	Free floating exchange rate system (market-driven)
(2)	(Daily) Forex trading volume (*2)	Approx. USD 600 billion	Over USD 7.5 trillion
(3)	Government/central bank price-control capabilities	High	Lower due to diverse players and large scale of market
(4)	Position of Japanese economy	"Japan as Number One," 15% share of global economy	Dropped to 4th place; approx. 4% share of global economy
(5)	JPY fundamentals	JPY weak despite trade surplus; 10-year interest rates over 6%	JPY weak due to trade deficit; 10-year interest rates around 1.5%
(6)	International framework	Western camp strongly united due to Cold War; G5 (Japan, U.S., Germany, France, UK) united	G7 member states not on same page
(7)	China's influence	None	Rivals the U.S.; Large holder of U.S. Treasuries and plays important role in supply chain

(Source) Prepared by author, *1: In 1985, there was already a free floating exchange rate system in place, but it was possible to "manage" it through government and central bank intervention as appropriate

Moving on to point (6), it is necessary to take into account that the international community no longer cooperates and, therefore, is unlikely to come to an "agreement" on anything. In 1985, because of the Cold War, there was a clear dichotomy of "G5 vs. the Soviet Union," and the Western camp was united. The global economy was also structurally divided along the lines of "capitalism vs. communism," and the Plaza Accord had the purpose of deflating the U.S. Congress, which was leaning toward protectionism, by correcting USD strength to preserve the free trade system. At the present time, however, the U.S. seems to be voluntarily isolating itself and retreating into the shell of protectionism, while also using threats to coerce other countries into cooperating. The international community no longer has a reason to cooperate and help guide USD in the direction that the U.S. wants. In other words, the U.S. is attempting to tame a forex market that has grown to an enormous size, without the help of a unified front to counter it, so the effect is likely to be limited. To the contrary, over the longer term, there may even be cause for concern of excessive USD depreciation, necessitating international cooperation (such as a second Louvre Accord) to contain it. However, it is doubtful that the international community would be willing to help at such a time.

JPY No Longer the Same Currency

Above all, as points (4) and (5) indicate, it should be noted that Japan's fundamentals are completely different. In the 1980s, Japan was one of the world's strongest economic powers, as symbolized by the best-selling book titled "Japan as Number One." In fact, Japan accounted for about 15% of the global economy at that time. By contrast, the Japanese economy's current share in the world economy is 4%, barely a quarter of its past weight. Consistent with this, JPY's fundamentals have also changed drastically. In the early 1980s, JPY was weak despite a trade surplus, now it is weak because of a trade deficit. The Trump administration claims that Japan is attempting to induce a weaker JPY, but the recent JPY weakness is the inevitable result of low Japanese interest rates and a trade deficit, not a market phenomenon that Japan wants. The U.S. does have the power to reverse this trend, but would that involve a USD-selling/JPY-buying forex intervention? As I have argued many times, the U.S. is, in principle, unlikely to want this, especially in a situation where the market's inability to absorb U.S. Treasury bonds is resulting in a sharp rise in yields. Ultimately, all Japan needs in terms of monetary policy is for the BOJ to raise interest rates. The Japanese 10-year bond yield, which was over 6% in 1985, is now no more than 1.5% despite having risen to some extent. JPY in 1985 and JPY in 2025 are, therefore, completely different currencies, and there is a limit to the extent to which today's JPY can be strengthened. However, as I always say, forex rates involve two parties and the structural weakness of JPY can indeed coexist with JPY appreciation against USD.

Mar-a-Lago Accord Not Just About Currency Policy

To repeat, the Mar-a-Lago Accord is not about currency policy, but rather aims to reach a comprehensive political agreement covering currency, trade, and security policies. Its purpose is understood to be the revival of U.S. manufacturing. However, its economic demands, which includes converting foreign-held U.S. Treasuries to 100-year bonds and unilaterally weakening USD, are extremely selfish, which is why tariff and security threats are required to pressure allies. If we take this into account, editorials that focus only on the correction of USD strength (as seen frequently in the Japanese media) seem to lack balance and perspective. In the first place, what the Trump administration wants is not USD weakness but a reduction in the trade deficit. At present, given that USD weakness and rising U.S. interest rates have become two sides of the same coin, it is difficult to forecast USD depreciation as the main scenario without betting on the collapse of USD's dominance in the global economy. A more direct and immediately effective solution to reducing the trade deficit would be for the partner country to increase its imports, in addition to tariffs.

In Japan's case, perhaps JPY appreciation in proportion with BOJ interest rate hikes is inevitable, but Japan may also be able to come to terms with the Trump administration by increasing imports of defense equipment, energy, and agricultural products, among other things. Frameworks such as a Plaza Accord 2.0 or the proposed Mar-a-Lago Accord would involve comprehensive political agreements, and must be understood and evaluated from a wider perspective than merely as factors influencing forex trading.

U.S. Economy Now and Going Forward – Can the Trump Administration Withstand the J-Curve Effect?

Effects of Tariffs Will Not be Seen Immediately

The basic problem awareness of the Trump administration, both during its first term and now, is that trade deficits are bad; eliminate them requires a weak USD; and low U.S. interest rates would be desirable in line with this. Reciprocal tariffs, as the term itself indicates, appear to have the intent of "mutual" benefit, but the broader calculation may be that they are expected to eliminate the trade deficit. As previously explained, the grounds for such a calculation are nonsensical and do not need to be considered, but it is undoubtedly based on the idea that tariffs will raise import prices, resulting in a decline in import volume, thereby improving the balance of payments. One way of theoretically verifying this idea is what is called the "Marshall-Lerner condition."

Fluctuations in the trade balance in response to exchange rate fluctuations are theoretically evaluated based on whether the Marshall-Lerner condition is met. The Marshall-Lerner condition states that "a currency depreciation (or devaluation) will improve a country's trade balance if the sum of the absolute values of the price elasticities of demand for exports and imports is greater than 1." Here, "price elasticity" is a measure of sensitivity in terms of the extent to which the volume (here, the volume of exports and imports) changes when the price changes by 1%. For example, if car sale volume increases by 3% when the price falls by 10%, the price elasticity would be 0.3. The Marshall-Lerner condition examines (A) the price elasticity of exports, which measures how much foreign countries will buy when the domestic currency becomes cheaper and exports appear cheaper, and (B) the price elasticity of imports, which measures how much the domestic market will cut back on imports when the domestic currency becomes cheaper and imports become more expensive. If the sum of (A) and (B) exceeds 1, we can assume that the trade balance is improving due to a weaker currency. (Note: (B) always carries a negative sign to express the extent of decline. Therefore, the absolute value of (B) is added to (A) when summing the two.)

If we apply this idea to the Trump administration's policies, we can estimate how much the volume of exports and imports will change in response to export/import price fluctuations due to exchange rates and tariffs. In practical terms, an increase in U.S. import prices due to additional tariffs is the same as an increase in U.S. import prices due to USD depreciation. Either way, the Trump administration's idea that imposing tariffs will raise import prices and lower import volumes, thereby improving the balance of payments, is premised on the Marshall-Lerner condition being met in the U.S.

Since the inauguration of the second Trump administration, USD has weakened and tariffs have been enforced, so if the Marshall-Lerner condition is met, one can expect a decline in the U.S. trade deficit through greater exports and lower imports. The problem is import/export volumes do not respond to import/export price fluctuations right away. This is natural due to the constraints of existing contracts and existing facilities. Theoretically, the Marshall-Lerner condition does not hold in the short term, and we are faced with the phenomenon of import value increasing significantly for a while due to currency depreciation, which causes the trade deficit to expand. Over time, the weakening of the domestic currency pushes up export volume, gradually shrinking the trade deficit or turning it into an expanding trade surplus. In other words, the trade balance will temporarily worsen before it begins to improve, in a phenomenon known as the J-curve effect.

I will refrain from further theoretical explanations, but it should be noted that direct intervention to manipulate import/export prices does not immediately produce the desired effect.

History of U.S. Trade Balance and USD

The pertinent question is – is the Marshall-Lerner condition met in the U.S.? My strong impression, based on a long-term perspective, is that the condition is met slowly when USD depreciates and right away when USD appreciates. Simply speaking, USD depreciation has a weak effect in terms of shrinking the trade deficit, but USD appreciation has a strong effect in terms of expanding the trade deficit. Below, I would like to review the trends over the past 20 years or so since 2000.

For example, from 2002 to around 2008, USD (NEER) was on a significantly downward trend. Specifically (details later), USD was on a decline from 2002 to September 2008 when the collapse of Lehman Brothers intensified emergency USD buying. Incidentally, USD's NEER declined by just under 30% between 2002 and 2008. However, the

U.S. trade deficit did not shrink during this period; rather, it nearly doubled from approximately -USD475 billion in 2002 to approximately -USD840 billion in 2006. The trade deficit finally stopped expanding after peaking in 2006. It took about five years after USD began to weaken to finally begin to see an improvement in the balance of payments. To repeat, even if the U.S. manages to improve its global export climate by weakening USD and imposing tariffs, existing contracts and production facility constraints will prevent export volume from increasing right away. In the meantime, U.S. households and companies will be forced to buy the same volume of imports at higher prices as a result of USD depreciation and tariffs. It can be said that the coexistence of USD depreciation and trade deficit expansion during 2001-06 was a manifestation of the J-curve effect.

After 2007, the export volume began to increase with a delay, and the import volume also began to be effectively suppressed, slowing the pace of trade deficit expansion. The Marshall-Lerner condition was met during this time. However, the USD depreciation trend lasted only through 1H of 2008. The Lehman Brothers collapse, which occurred in September 2008, triggered emergency USD buying, which resulted in sharp USD appreciation starting 2009. In theory, this is a situation in which a short-term inverted J-curve effect (short-term currency appreciation leading to an expansion of domestic currency-denominated export value, resulting in an improvement in the trade balance) is expected. To be sure, the trade deficit did decrease by over 40% from approximately -USD830 billion in 2008 to approximately -USD510 billion in 2009. Based on the figures alone, the developments on the ground seem to be in line with the theory. However, the figures reflect a sudden drop in resource prices and a sharp decline in import volume due to the shrinking of domestic demand amid a severe economic downturn. In other words, this was a special case almost unrelated to exchange rate fluctuations. Of course, it is possible to say that the improvement in export competitiveness through USD depreciation in the early 2000s suppressed the re-expansion of the trade deficit after 2009. However, even from that perspective, the fact is that it took about eight years for USD depreciation to contribute to an improvement in the trade balance.

Collapse of Lehman Brothers and Trump 1.0

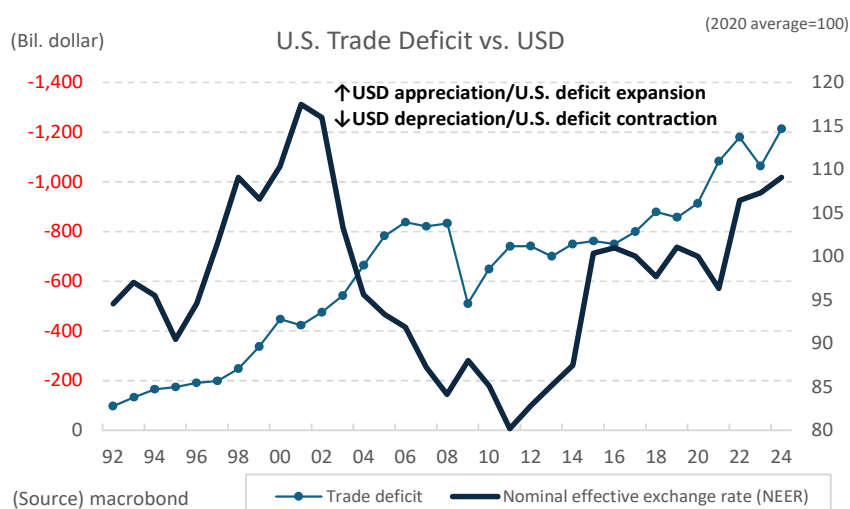
As shown in the graph, USD's NEER peaked in 2009, after which it began to decline and continued to do so until 2011. It is generally believed that USD stabilized at a low level as a result of the Fed implementing an unconventional monetary policy for the first time in history. Around this time, from 2010-2016, the U.S. trade deficit remained more-or-less flat, so it may seem that USD depreciation brought about an immediate short-term improvement. However, 2010 was also when then U.S. President Barack Obama announced the plan to double exports over the subsequent five years and create two million new jobs. There were also structural changes in the U.S. economy, such as a decline in energy imports due to the shale revolution starting 2012. It cannot be said, therefore, that the exchange rate was solely responsible for preventing an expansion of the trade deficit during this time.

The USD appreciation trend was curtailed to some extent again starting 2017. Looking at the trade balance at that time, the trade deficit expanded due to the tax cuts implemented in the first year of the first Trump administration, the accompanying economic expansion, and the resulting increase in imports. If we assume that USD weakness caused this short-term expansion of the deficit, we could say this was a textbook case of the J-curve effect. However, it is also possible that the income effect of tax cuts and other factors boosted domestic demand, resulting in an increase in imports. In reality, both factors are likely to have contributed.

Subsequently, the U.S.-China trade friction intensified during the first Trump administration from 2019 onward, and tariff and other measures dampened imports from China and contributed to shrinking the deficit to some extent. However, given that the trade deficit showed a gentle expansion from 2017 through 2020 under the first Trump administration (see graph), it is questionable whether the effect of tariffs should be actively acknowledged – because, while U.S. trade with China shows a definite narrowing of the trade deficit from around this time, the overall U.S. trade deficit has not shrunk noticeably. Incidentally, USD's NEER fell during 2020-21, after the pandemic began, resulting in a short-term trade deficit expansion from the J-curve effect. However, the trade deficit continued to expand further even after USD began to rise sharply in 2022 (to be precise, the deficit did shrink slightly in 2023 as imports decreased due to the domestic economic slowdown). Overall, though, amid successive emergencies including the pandemic and wars, the U.S. trade deficit has expanded since 2020 regardless of USD strength or weakness.

Immediate During USD Appreciation and Gradual During USD Depreciation

Above was a brief look at USD NEER movements and the U.S. trade deficit over the past 20 years or so. While acknowledging that the price elasticity is ideally computed using quantitative analysis to verify the fulfillment of the Marshall-Lerner condition, my overall impression is that the U.S. trade deficit expanded clearly during phases of USD appreciation but contracted (or rather halted expansion) only gradually during phases of USD depreciation. Over the longer term (5 to 10 years), one can say that the Marshall-Lerner condition is met, but even so, the likelihood of a



short-term J-curve effect cannot be overlooked when USD weakens. On the other hand, the trade deficit expands immediately when USD strengthens, with no strong signs of an inverse J-curve effect (short-term currency strengthening leading to an expansion of domestic-currency-denominated export value, thereby improving the trade balance). One suspects that this is because domestic demand responds strongly to lower import prices caused by the strong USD, while export prices are prone to losing competitiveness internationally.

Of course, as we saw along the way, balance of payment changes arise from various factors, including the magnitude of income effects due to domestic and international economic conditions, fluctuations in energy prices, and transformations in tariff and non-tariff barriers, as discussed above. This makes it difficult to predict whether the Marshall-Lerner condition is valid for the U.S. trade balance. However, going by history and theory at least, it seems unlikely that the U.S. trade deficit will shrink in the short term regardless of efforts by the Trump administration to guide USD lower or obstruct imports from other countries through tariff policies. Even if such policies work, they could take 5-10 years to become effective. In other words, the results may not become apparent during the current Trump administration's term in office.

Rather, the J-curve effect, which is the expansion of the trade deficit due to USD weakness, is likely to occur during the current Trump presidency. Is President Trump capable of accepting this calmly? The idea of reducing the trade deficit by weakening USD and imposing tariffs is an orthodox one, but unless policymakers take into account the time delay before policy effects are realized, they will be surprised by the short-term expansion of the trade deficit and the import of inflationary pressures. In the case of the Trump administration, possible actions upon being surprised could be further strengthening tariffs, forcing the Fed to lower interest rates, or forcing trading partners to devalue their currencies. All of these are pointless. Unless sensible advisors, such as Treasury Secretary Bessent, do their part, this fruitless "no-winner tariff war" will only lead to an accumulation of casualties.

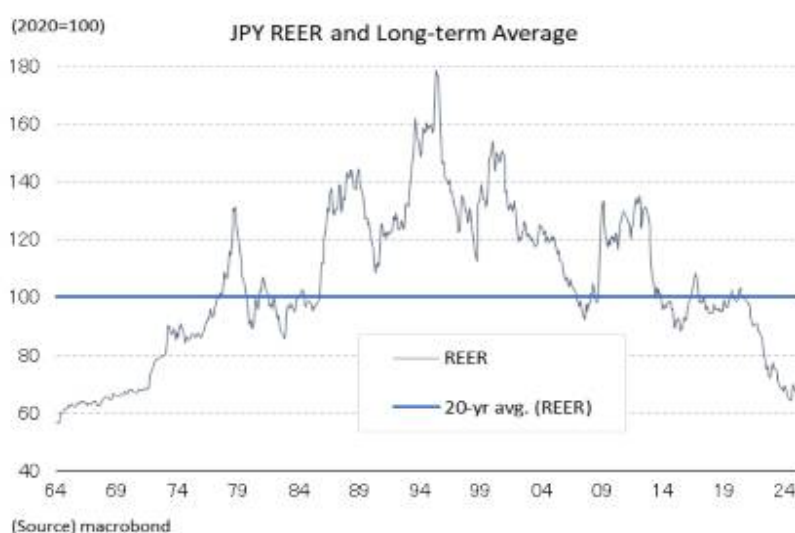
Risks to My Main Scenario – Has Japan's Inbound Tourism Peaked?

Nominal JPY Appreciation's Impact on Travel Exports

As already discussed, the biggest risk in forecasting JPY exchange rates is a continuation of a "USD decline scenario" in which USD continues to weaken across the board and USD/JPY falls to JPY130 or even JPY120. This would be tantamount to a second Plaza Accord (discussed at the beginning of this year as a potential black swan event), which could have a devastating impact not only on the forex market but on international financial markets as a whole. Moreover, there are currently other risk factors that are grounds for considerable concern.

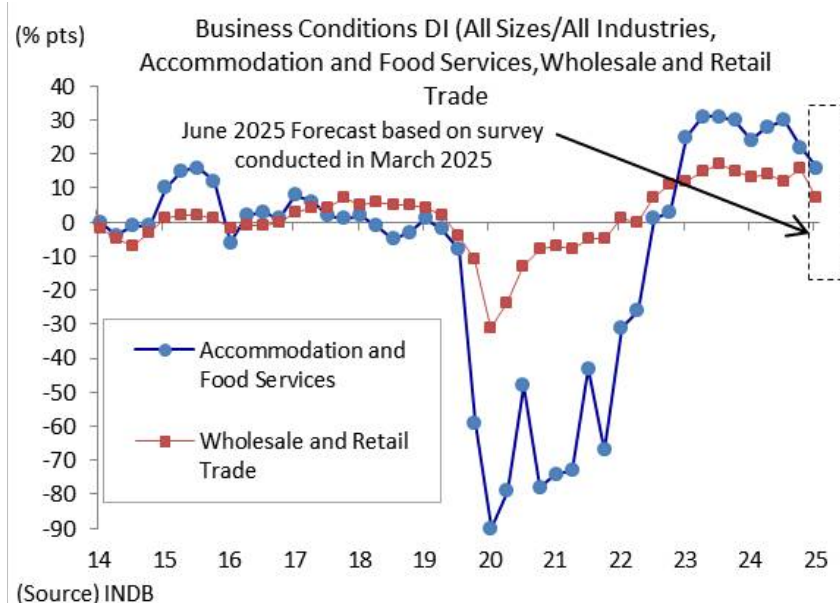
USD/JPY plummeted by margins as great as -7% in April, and one cannot help wondering about the potential effect of this trend on the Japanese economy. Of course there is probably no need to panic about the JPY appreciation trend itself, given that trade deficits have already become the norm for Japan and that JPY depreciation-related inflation has already caused a major problem in the deceleration of the country's real economic growth rate. When the excessive strength of JPY was a societal problem (until around 2012), it restrained Japan's export volumes and raised concerns about potential downturns in domestic production, income, and consumption figures, but since Japan has already lost most of its export base power, such issues are unlikely to present severe challenges at this point.

Japan is currently exporting a large amount of services (rather than goods) related to inbound tourism, however, and JPY appreciation does have the potential to restrain such services exports, although it is still too early to have serious concerns about that. Looking at USD/JPY trends since March 2022, one finds that JPY had depreciated against USD by up to about 30% and that the margin of depreciation has recently been reduced to about 20%, so there are still no indications that forex trends will cause Japanese travel exports to lose their competitiveness in the near future. Moreover, regardless of the nominal-basis trends, it is clear that there are as yet almost no signs of recovery in JPY's real-basis effective exchange rate (REER), which takes into account the difference between domestic and foreign prices (see graph). The consumption of goods and services in Japan still appears to be advantageous from foreigners' perspectives, so it does not seem likely that JPY's recent strengthening will cause a significant drop in Japan's travel surplus any time soon.



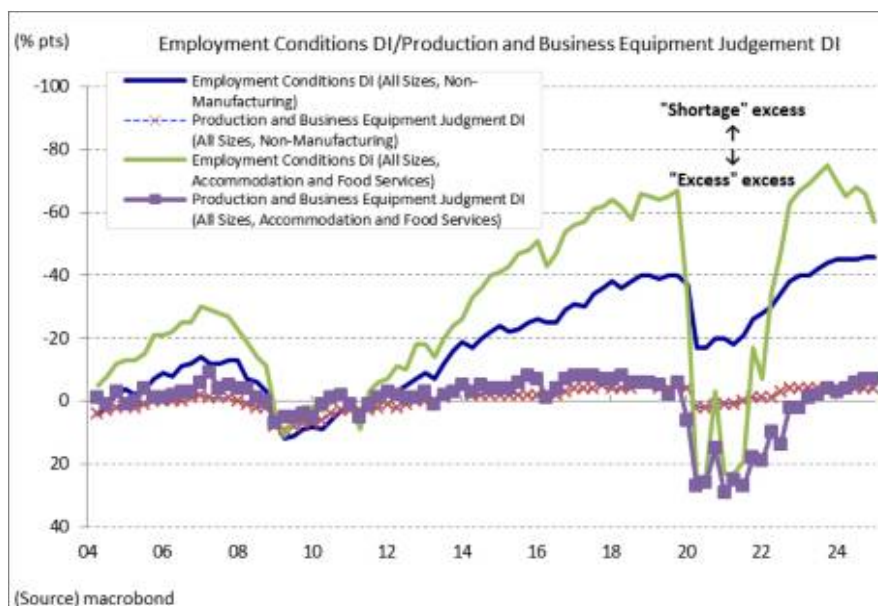
Doubts about Prospective Growth in Inbound Travel-Related Demand

However, this article has long argued that Japan's travel surplus growth may soon be peaking out. While attention during the 2022-2024 period was focused on increases in travel from levels temporarily depressed by COVID pandemic-related restrictions, 2025 is thought to be a year in which the fundamental strength of inbound travel-related demand will be tested. This is because of concerns that Japan will eventually become unable to handle inbound travel-related demand growth owing to labor supply constraints, and the effects of such labor supply constraints are, in fact, beginning to appear. In the BOJ's Tankan survey released on April 1, the business condition judgment diffusion index figures for Accommodations, Eating & Drinking services industries and Wholesaling & Retailing industries indicate expectations that those industries' business conditions will become harsher three months from now (see graph). There is probably more than one reason for this, but possible reasons include the stagnation of operating capacity utilization rates due to labor supply constraints and the worsening of Japanese people's real income environment. Given recent forex trends, the fact that JPY's depreciation has peaked out should probably be added as an additional factor creating business headwinds. While Japan's inbound travel-related demand may not have peaked out yet at this point, it is clearly becoming difficult to maintain business confidence in related domestic industries based on expectations of strong inbound travel-related demand alone.



Significance of Labor Shortage Easing?

Besides the business condition figures, there are other statistics that suggest inbound travel-related demand may be peaking out. There has long been a trend of deterioration in the Tankan report's Employment Conditions Diffusion Index (DI, calculated by subtracting the percentage of "insufficient employment" responses from the percentage of "excessive employment" responses) for Accommodations, Eating & Drinking services industries, but that DI has actually improved somewhat. The graph on the right shows that the perception of a labor shortage has clearly eased since peaking in October 2023 at -75, improving to -57 as of April 2025. While the labor shortage is still at a high level, the improvement cannot be ignored. The graph also shows that



the employment conditions DI for all non-manufacturing industries has continued to gradually deteriorate, so the labor shortage easing is a phenomenon limited to the Accommodations, Eating & Drinking services industries. The significance of these disparate trends is not yet clear at this point, but they could be interpreted as indicating that there is a decline in inbound travel-related demand.

Looking at the employment conditions DI trends in all individual industry categories as of April, one finds that the Accommodations, Eating & Drinking services category had the third-largest negative margin, which was lower than that of the Construction category and the Transport and Postal activity category. Because Accommodations, Eating & Drinking services had previously been the industry category with the worst labor shortages by an overwhelmingly large margin, the alleviation of that industry category's labor shortage is a cause for concern from the perspective of people who have been monitoring the situation over time.

Accommodations, Eating & Drinking Services Industries' Production Capacity DI Deterioration

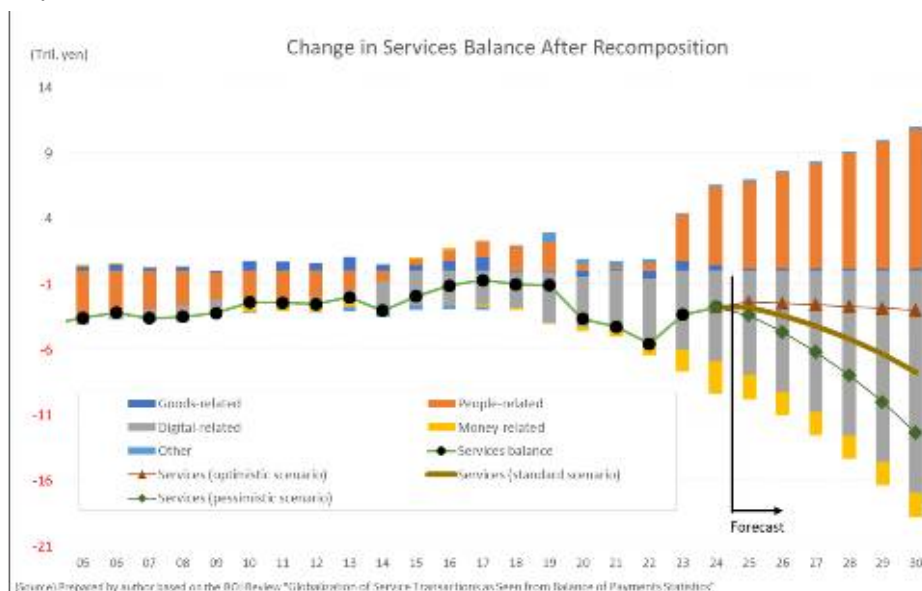
The BOJ's January Outlook Report calculated capital-labor substitution elasticity levels for individual industry categories and pointed out that service and construction industries are facing serious labor shortages due to their low capital-labor substitution elasticity levels, which attracted a lot of attention. Industries that entail the face-to-face provision of services (such as the Accommodations, Eating & Drinking services industries) have exceptionally low capital-labor substitutability levels and exceptionally high capital-labor complementarity levels, so when such industries face labor shortages, they are more likely to face situations in which they cannot operate their facilities. Consequentially, such industries are statistically likely to have both a positive labor input gap and a negative capital input gap. The Outlook Report argued that the negative capital input gap should not simply be seen as indicating that "facilities are not being used" – it should also be seen as indicating that that "facilities cannot be used even if the owners would like to use them".

The graph above shows that the Employment Conditions DI for non-manufacturing industries is negative by a considerable margin and the index for Accommodations, Eating & Drinking services industries is negative by an even greater margin, suggesting severe labor shortages. At the same time, however, those industries' Production Capacity DIs are roughly at a neutral levels, suggesting that the industries have roughly sufficient facilities and do not require much additional capital investments. However, a closer look at the Accommodations, Eating & Drinking services industries' Production Capacity DI indicates that those industries' sense of facility shortages is growing, albeit very slowly. This could mean that the labor shortages are easing, making it possible to secure sufficient personnel to operate facilities, so that supply constraints related to facilities are beginning to be felt. If this is the case, it is possible that inbound travel-related demand has not declined and that Accommodations, Eating & Drinking services industries have succeeded in securing personnel and are beginning to capture new demand (although this possibility does not harmonize with widespread predictions of a worsening economic outlook). The trend of increase in Accommodations, Eating & Drinking services industries' Production Capacity DI merits additional analysis and elucidation.

Tariffs Likely to Reduce Japan's Travel Surplus?

Many previous editions of this article have noted the important role the growing travel surplus is playing in helping offset the country's expanding digital deficit within Japan's services balance. If the travel surplus plateaus, it is likely that digital deficit growth will cause Japan's services deficit to expand, which in itself may cause outright JPY selling to become dominant. I have predicted that such a situation will come sooner or later, and that annual Japanese services deficits of roughly JPY10 trillion can be expected to become the norm during the 2030s. It is worth noting in this regard that, although the Trump administration's tariff strategy is currently focused primarily on trade balances, there are grounds for

concern about how that strategy may affect people's travel. Even if there is no direct negative impact on travel, the tariff strategy is clearly exerting downward pressure on the global economy, so it would not be surprising if the pressure cause shrinkage in external demand itself. Just as worsening global economic conditions will cause decreases in exports of automobiles and other products, it can be expected that worsening global economic conditions will also cause decreases in service exports such as those related to travel. If the Trump administration's policies reduce Japan's inbound travel-related demand (the country's only remaining means of actively acquiring foreign currency), that in itself would be a factor promoting JPY depreciation from a supply-demand perspective.



EUR Outlook – EUR Strength Considered an Emerging Risk Factor?

EUR Area Monetary Policies Now and Going Forward – Importance of June Staff Projections

Resetting of ECB Monetary Policy Stance

The ECB's April 17 Governing Council meeting decided to lower its three key interest rates by 25 basis points, becoming the sixth consecutive Governing Council meeting to implement a rate cut. The statement of the previous Governing Council meeting on March 6 included the phrase – “Our monetary policy is becoming meaningfully less restrictive” – which was widely interpreted as suggesting that ECB rate cuts would be halted after the April meeting, so the focus of attention regarding the April meeting was on whether or not a halt to rate cuts would be announced. However, the world has changed dramatically since the Trump administration announced its reciprocal tariff policy on April 2, and the paragraph describing the ECB's monetary policy stance was completely cut from the April 17 Governing Council meeting's statement. In this regard, a reporter at the post-meeting press conference asked – “In your policy statement and also in your remarks now, you no longer characterise the policy stance on the restrictive/neutral/accommodative spectrum. I would be quite interested in why you decided to do that and what kind of conclusions we are to draw from that.” In response, ECB President Lagarde emphasized that the degree of restrictiveness was only meaningful insofar as policy interest rates can be compared to the neutral rate and – “the neutral rate [...] is a concept that works for a shock-free world. [...] And anybody in this room who thinks that we are in a shock-free world would, I suggest, maybe raise their hand or have their head examined.”

In the absence of Trump administration's tariff policy, the ECB's rate cut could be considered “neutral” or “accommodative” in light of the robust economic situation, but in the presence of the tariff policy, the rate cut might possibly be considered “restrictive” in light of the potential fragility of economic situation, so it appears the ECB concluded that it was just too difficult to summarily describe the nature of its policy stance at this point. In any case, while it had previously appeared that the ECB was on the brink of discontinuing its interest rate cuts course, it has now become difficult to make a clear forecast of prospective ECB policy decisions.

Likelihood that ECB Prefers Additional Rate Cuts

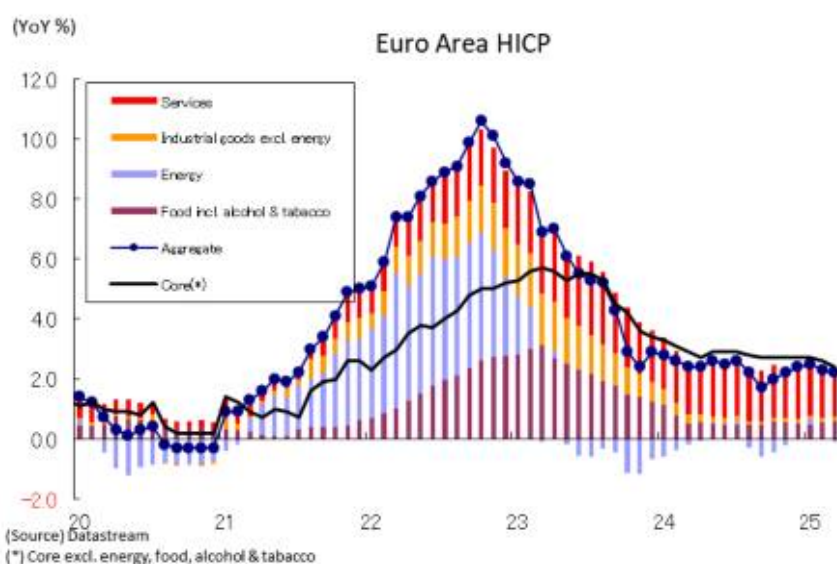
Although the ECB monetary policy stance has been reset, it is clear that the balance of risk factors is skewed to the downside, which in itself suggests that the ECB would prefer to prolong its interest rate cut policy. Regarding policy-related discussions within the Governing Council, President Lagarde said – “there were a number of governors who a few weeks ago would have argued in favour of [an interest rate cut] skip, [...] but I can assure you that it was a unanimous [decision to implement the interest rate cut].” It appears that the possibility of a 50bp rate cut was also mentioned although no governor actually argued for a 50bp rate cut. Given that the possibility of pausing rate cuts was discussed at the March Governing Council meeting but there was mention of a 50bp rate cut at the April Governing Council meeting, there appears to be a basis for anticipating that the ECB's “next move” is more likely to be a rate cut than a decision to maintain the status quo.

At the time this article was written, the markets were pricing in a roughly 80% probability of a rate cut at the next Governing Council meeting on June 5, and the markets were also pricing in the likelihood of an additional rate cut at the September 11 meeting. So the markets are now pricing in two more interest rate cuts this year, and it can be said that the bases for previous forecasts of a halt to interest rate cuts from April have been completely eliminated. Given that there is no end in sight for U.S.-China trade frictions and that underlying inflationary pressures in the euro area have become weaker than before (see graph), it seems reasonable for the time being to anticipate additional ECB interest rate cuts and focus on seeking to forecast the timing of those cuts.

It is worth noting that the risk assessment section of the April Governing Council meeting's statement now mentions the possibility that EUR appreciation could reduce inflationary pressures in the euro area. This possibility will remain so long as the trend of across-the-board USD depreciation continues.

Emphasis on Importance of June Governing Council Meeting

At the press conference, President Lagarde said – “the impact on inflation and the net impact on inflation is less than clear at this point in time. So there is so much ongoing, some of which will probably settle a bit by our June meeting”

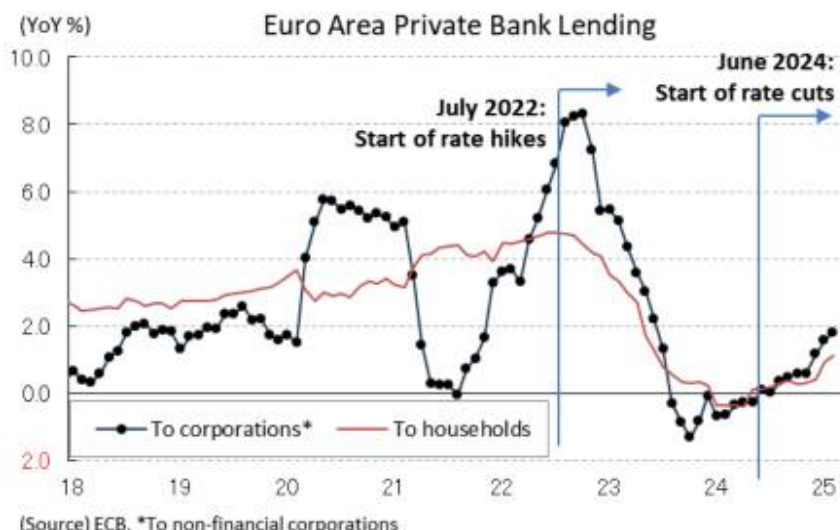


– and emphasized that the ECB would know more about the overall situation at next ECB Governing Council meeting (on June 5), although she noted that President Trump's 90-day deadline for resolving tariff negotiations will come somewhat after that meeting. President Lagarde repeatedly stated that the ECB would be data-dependent and rely on the revised staff projections that will become available at the time of the June Governing Council meeting, so it is likely that final decisions on prospective policies will not be made until those projections can be discussed at the July meeting. A reporter asked whether the level of uncertainty had decreased since the announcement of the Trump administration's tariff policy, which was considered an uncertain factor at the March Governing Council meeting, but President Lagarde said that the level of uncertainty will remain high so long as the related negotiations are still ongoing, the situation will become much more clear in June, and she could only reiterate that the ECB is committed to acting on a data-dependent basis. More specifically, President Lagarde noted that the impact of the EU's negotiating stance and responses to U.S. proposals will be assessed within the June staff projections, so the information in those projections can be expected to be extremely important regardless of whether the June meeting approves another interest rate cut or not.

Cutting Interest Rates to Restrain EUR Appreciation?

The Governing Council meeting's statement mentioned that – “Falling global energy prices and appreciation of the euro could put further downward pressure on inflation” – and the forex market has noted that lowering interest rates can be seen as a rational means of moderating such downward pressure. This is the exact opposite of the scenario anticipated at the beginning of the year, in which the Europe-U.S. disparity in economic conditions would cause EUR to fall below parity against USD, but the Trump administration's policies are continuing to cause all currencies to appreciate against USD, and European currencies are expected to be in particularly strong demand as USD alternatives. Moreover,

as was mentioned during the press conference, it is also expected that tariff policies may cause exports from countries with excess production capacity to flow into the euro area, and this suggests that disinflationary pressures may increase further as the oversupply situation within the euro area intensifies. Although the ECB cannot control tariff policies, it can exert some influence on EUR exchange rates by raising and lowering its policy interest rates, so it can be said that it has been inevitable that rate cuts would be an appealing “next move” for the ECB. On the other hand, it will be important for the ECB to closely monitor whether continued interest rate cuts will promote excessive bank lending (see graph) and whether nominal wage growth will continue to be sufficiently restrained. The strong upward momentum currently seen in bank lending and nominal wages merits particular attention.



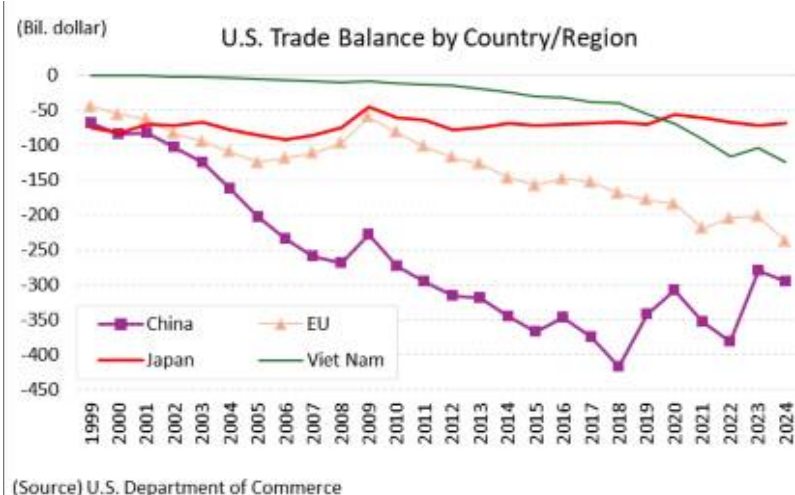
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U.S.-EU Negotiations Now and Going Forward – Strategies for Diversifying Trade Relations

EU is United States' Largest Trading Partner

On April 25, President Trump reportedly claimed that the United States and Japan were “very close to a deal” regarding his new tariff measures. Many people argue that President Trump chose to begin his tariff-related negotiations with Japan first because factors including Japan's reliance on the United States for security make it likely that the country will accept U.S. demands without much resistance or frictions. If Japan can make significant concessions, it will demonstrate the potential influence of reciprocal tariffs to the entire world. If negotiations with the first negotiation partner were to prove difficult, it could negatively affect the outcomes of subsequent negotiations. President Trump has stated that there will be no further postponements after the current 90-day pause on higher reciprocal tariffs, and if this is true, it will be quite important to arrange favorable deals during the pause period.

On the other hand, not all countries are as tractable as Japan. Of course China is clearly positioned as the arch-enemy in the trade arena, but the EU is another highly influential trade partner that the Trump administration will have to reach an agreement with. Frankly speaking, if one considers the economic effects alone, the United States should be giving higher priority to its negotiations with the EU than it does to its negotiations with Japan. In fact, it is not China but the EU that is the United States' largest trading partner in terms of U.S. imports and exports. Looking at U.S. trade volume (exports + imports) in 2024, one finds that trade with the EU amounted to about USD982 billion, while trade with China was only about USD584 billion. Looking at U.S. trade balances for 2024, one finds that the U.S. trade deficit with the EU was about USD237 billion, slightly smaller than the USD295 billion deficit with China, but given the recent trend of decrease in U.S.-China trade, it is likely that the deficit with the EU is now the United States' largest trade deficit.



EU's Formidable Negotiating Power

However, the EU is a formidable negotiating partner, particularly in light of President Trump's goal of achieving results within 90 days. President Trump is considered to excel at arranging bilateral negotiations, but such bilateral negotiations do not necessarily work so smoothly in the case of the EU. EU laws (especially the fundamental Lisbon Treaty) strictly define the authority scopes of the EU (≈ the

Three Areas of Competence Conferred on the EU

Competence conferred on the EU	Characteristics	Specific Areas
Exclusive Competence	EU has sole legislative authority and competence. Member States can only act in accordance with EU rules.	Commercial policy , monetary policy, competition policy (antitrust law), customs policy , marine policy (management of marine resources)
Shared Competence	Both the EU and Member States have competence and both can legislate. However, Member States can only act within the scope of EU legislation.	Environment, transport, energy , consumer protection, labor law, immigration and asylum policy (in part), etc.
Supporting Competence	Member States take the lead. The EU can only be involved through support, coordination, or promotion.	Education, culture, tourism, health (healthcare), industrial policy, etc.

(Source) The European Commission

European Commission) and member states. Of these, the authorities that the EU can legislate and exercise alone are called exclusive competences, but they are limited to only five areas (see table). Trade policy and tariff policy are within such areas, so President Trump will be seeking to revise reciprocal tariffs with the European Commission (the EU's executive branch) rather than with the governments of EU member states. It is worth noting regarding forex matters (which was a topic of discussion in the U.S.-Japan negotiations) that 20 of the 27 EU countries are euro area states that the European Commission will represent in negotiations, but seven countries use their own currencies and those countries' governments will represent those countries in negotiations. Basically, many of the issues likely to be affected by tariff negotiations are related to the EU's exclusive authority or competences. On the other hand, the Trump administration has demanded that Europe shoulder its share of the burden of financing its "security umbrella", and it has characteristically brought this up in conjunction with discussions on economic matters. It is worth noting that EU national security matters are in principle not delegated to the European Commission but are the exclusive domain of member state governments, so negotiations with member state governments will be necessary in the case of security matters.

At the time this article was written (immediately after the Japan-U.S. negotiations), Italy's Prime Minister Meloni had traveled to the United States, and it was reported that the level of Trump-Meloni friendship was so high that it could be compared to the friendship between President Trump and Japan's former Prime Minister Abe. However, the issues confirmed in discussions with Prime Minister Meloni were limited to Italy (as a single EU member state) increasing its defense budget and purchasing LNG from the United States. This reflects the fact that security is an area that is an exclusive competence of EU member state governments while energy policy is a shared competence of the EU and its member states. However, no progress has been made in discussions on the crucial issue of tariffs and non-tariff barriers, an area in which the EU has exclusive competence and the European Commission will be the decision-maker. More precisely, consensus will need to be reached at the European Council (the so-called EU summit) before decisions can be made. In practice, it has been reported that European Commissioner for Trade and Economic Security Maroš Šefčovič is negotiating on the EU side and USTR Representative Jamieson Greer is negotiating on the U.S. side.

It is generally understood that negotiating procedural matters with the EU ordinarily requires considerable amounts of time, so it is quite questionable whether U.S.-EU negotiations will actually make much progress within 90 days. I

am quite skeptical about how much progress can be made in such a limited time frame. So one wonders whether the United States will impose reciprocal tariffs due to the insufficient progress of negotiations or make a special provision to extend the negotiations. President Trump is currently saying the reciprocal tariffs will be imposed, but it will not really be clear whether an extension of negotiations will be possible until the last minute. If the principal impediment to an agreement is simply time-consuming procedural issues, the United States may be inclined to allow for an exceptional extension of negotiations.

EU Planning to Address Its Digital Deficit?

Currently, the Trump administration's additional tariffs imposed on the EU are as follows. A 25% tariff on steel and aluminum products went into effect on March 12. A 25% tariff on automobiles and auto components went into effect on automobiles on April 3, and is scheduled to go into effect on components on May 3. The world-shaking reciprocal tariffs are estimated to place an additional 20% tax rate on EU exports atop the flat 10% rate, for a total of 30%. As mentioned, however, there is a 90-day moratorium on the additional 20% rate, so only the 10% rate is currently in effect.

The EU is not retaliating against all of these measures. In response to the 25% tariff on steel and aluminum products, the EU has only proposed (on April 9) a 25% tariff on some U.S. products (including almonds, orange juice, poultry, soybeans, steel, aluminum, and tobacco). As mentioned, however, the Trump administration decided on April 10 to allow a 90-day moratorium on the implementation of its steel and aluminum product tariffs, so the EU's retaliatory tariffs will also be suspended for 90 days. But the United States is already imposing the 10% flat tax, and the EU is positioned to consider retaliatory tariffs against this. The EU has proposed to the United States a "zero-zero" agreement that would mutually eliminate tariffs on all industrial products, but the Trump administration has rejected this and is currently pressuring the EU to make concessions in the areas of automobiles and agricultural products. If the negotiations continue to make little progress and do not generate a settlement within 90 days, the EU may propose and implement retaliatory measures different from those mentioned above. The currently most prominent example of such retaliatory measures is said to be a tax on digital services. On April 10, European Commission President Ursula von der Leyen suggested the possibility of taking strong retaliatory measures, including taxing major U.S. IT companies, if negotiations over tariffs with the Trump administration break down. Specifically, she suggested the possibility of taxing major U.S. IT companies' advertising revenues. It is logical to conclude that, if a trade surplus in goods is problematic, then a trade surplus in services must also be problematic.

It is worth noting that the EU has created a legal framework designed to counter economic coercion from non-EU countries called the Anti-Coercion Instrument (ACI), and this framework came into effect on December 27, 2023. The EU has been considering this kind of framework in light of its experiences during the first Trump administration as well as the increasing number of cases since the COVID pandemic and the start of the war in Ukraine in which resource and energy supplies have been used as political weapons, but such a framework has never been actually put into operation. If the operation of ACI is considered, the European Commission will consult the European Council regarding a wide range of potential ACI-based countermeasures, including raising tariffs, restricting imports and exports, restricting direct investment, and restricting access to financial services and capital markets. In short, the ACI makes it possible for the EU to do what the second Trump administration is already doing, and I anticipate that the EU's surprising "next move" could well involve using the ACI to address the EU's digital deficit with the United States.

Comparing the EU Negotiating Stance with Japan's

If the EU really does take retaliatory measures based on the principle that services trade surpluses are as problematic as goods trade surpluses, people would surely ask why Japan is remaining silent about its large digital deficit. There are certainly people within the Japanese government who are aware of the seriousness of Japan's digital deficit situation but, judging from news reports, that situation has not been brought up in the U.S.-Japan tariff discussions, probably reflecting the degree to which Japan relies on the United States for security. As noted above, the EU is not retaliating against all U.S. tariff initiatives, and that suggests that (even though Europe is now trying to assert some independence regarding Russia-related security discussions) Europe is hoping to maintain some degree of U.S. support for its security.

Japan does not have the leeway needed to consider military independence, and that probably explains why the country is not proactively expressing complaints about its digital deficit. Rather than clearly identifying and complaining about the problem and thereby potentially angering the United States, Japan appears to have concluded that has no choice but to take a more obtuse or moderate approach. Moreover, there are no obvious alternatives to many U.S. platform service providers, so if supply constraints arise at some point, it may end up being the Japanese people who suffer.

EU Relations with China and Other Asian Countries

The fact that the EU is pursuing a strategy to increase the diversity of its trade partners has attracted surprisingly little attention. Since the European Commission announced its fundamental "Open, Sustainable and Assertive Trade Policy" in February 2021, the EU has made steady progress in its efforts to arrange additional free trade agreements (FTAs). The EU is seeking to conclude an FTA with India (which is attracting attention as an alternative market to China) by the end of 2025, and it finalized an FTA agreement with Mercosur (Brazil, Argentina, Uruguay, Paraguay) in December last year (although the agreement has not yet been ratified due to opposition from some EU member states). As they share the common goal of reducing their dependence on the United States, the EU and Mexico finalized an FTA agreement on January 17, 2025, to update their previous "Global Agreement". In addition to the FTA with India just mentioned, the EU is engaged in ongoing FTA negotiations with such Asian countries as Thailand,

Malaysia, and Singapore, all of which are under the U.S. “security umbrella” and are therefore not positioned to undertake hard-nosed tariff-related negotiations with the United States. It is worth noting that, aiming to address its digital deficit with the United States, the EU has concluded digital trade agreements (DTA) with South Korea and Singapore and is currently negotiating similar DTAs with India and Thailand. Perhaps most importantly, on April 10, European Commission President von der Leyen revealed that the EU is considering joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). This revelation came immediately after the U.S. announcement of reciprocal tariffs, and it is essentially a call for both the EU and Asian countries to reduce their dependence on the United States.

By the way, although it was not a trade negotiation, European Commission President von der Leyen also held a telephone conversation with China’s Premier Li Qiang on April 8, 2025. While the conversation was largely ceremonial in marking the 50th anniversary of the establishment of EU-China diplomatic relations, it also had the aim of further strengthening EU-China relations and addressing international trade issues, and the associated European Commission statement emphasized the shared responsibility of Europe and China, as two of the world’s largest markets, to support a strong, reformed trading system that is free, fair, and founded on a level playing field. The significance of that meeting is probably two-fold – the EU’s approach to China will (1) provide leverage in tariff negotiations with the United States and (2) allow China to intervene in the Ukraine war peace process currently being led by the United States and Russia. Regarding point (1), besides joining the CPTPP as mentioned above, if the EU shifts toward expanding its trade with China, it will provide leverage in negotiations with the United States. The EU’s approach to managing relations with China as articulated by European Commission President von der Leyen in March 2023 is centered on “de-risking” rather than “decoupling”, so if the EU and Chinese interests are aligned, the repair of their relations could proceed quickly. Point (2) does not require much explanation. Remaining firm in its position that Ukraine should decide the terms of peace, the EU is hoping that it can cooperate with China to guide Russia in that direction, and it is quite possible that the EU will seek to strengthen its trade relations with China as a means of making that objective more feasible. While the amount of EU-related news in Japan is limited, it would be beneficial for Japanese to note that the EU is demonstrating ways in which a non-U.S.-centric trade order can be built. EU-Asian ties can be expected to progressively strengthen, and it will be important to understand and forecast how such ties along with changing Japan-Europe trade patterns may affect JPY exchange rates in the future.

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