

Forex Medium-Term Outlook

September 30, 2025

Overview of Outlook

USD/JPY remained stable in September. Despite a significant deterioration in U.S. job data, the resulting resumption of Fed rate cuts, the Trump administration's undermining of the Fed's independence, and other factors driving USD selling, JPY has yet to recover. While many other currencies gain against USD, JPY remains weak. The BOJ's monetary policy has clearly become more hawkish, with a rate hike expected as early as October. However, despite the narrowing of the U.S.-Japan interest-rate gap led by an increase in JPY interest rates, USD/JPY has not fallen. There is probably more than one reason for this, but some believe that rising JPY interest rates and JPY weakness are coexisting as a result of concerns about Japan's political situation and the resulting expansionary fiscal policy. Further, the higher Trump tariffs on automobiles only went into effect in September, and some believe that an October rate hike is unlikely given the need for impact assessment. In Europe, bond markets, particularly in the UK, are becoming increasingly fragile, raising the risk that Japan, which also has a large government debt burden, could be hit by a JPY and bond sell-off. During the era of JPY strength, bond market panics were constrained by the zero-interest-rate limit as a stopper, but in the era of JPY weakness, there is nothing to stop the increase in yields, making this an unexpected risk Japanese markets should prepare for. The JPY supply and demand environment remains biased toward net JPY selling, and the narrowing interest rate differential has not led to a stronger JPY either. I, therefore, see an upside potential for USD/JPY during the latter half of the forecast period.

EUR held firm in September. The contrast between the Fed, which resumed rate cuts, and the ECB, where senior officials have hinted at halting rate cuts and even resuming rate hikes, is stark, and EUR/USD is being propped up by the Europe-U.S. interest-rate differential. However, this may not be the only reason for EUR strength. The issue of whether USD's status as a reserve currency has been undermined, which has been a hot topic since April, overlaps with the question of which new reserve currency will emerge as a result, and many are pinning their hopes on EUR. While Europe's lack of military independence and safe assets has been considered structural weaknesses for EUR when compared with USD, this situation is slowly but surely beginning to change. If the ReArm Europe Plan leads to the emergence of a common bond market, EUR's status as a reserve currency will likely be strengthened more than ever before. Currently, against the prevailing view that there is no alternative to USD, gold (a stateless currency) has emerged as a reserve asset. However, it cannot be denied that EUR's YTD appreciation may reflect a rotation from the U.S. to Europe. In the second half of the current forecasting period, there may be limited scope for further appreciation of EUR as the Fed reaches its limit for cutting rates. However, it seems quite likely that EUR is entering a structural phase in which a drastic collapse of the currency is less likely.

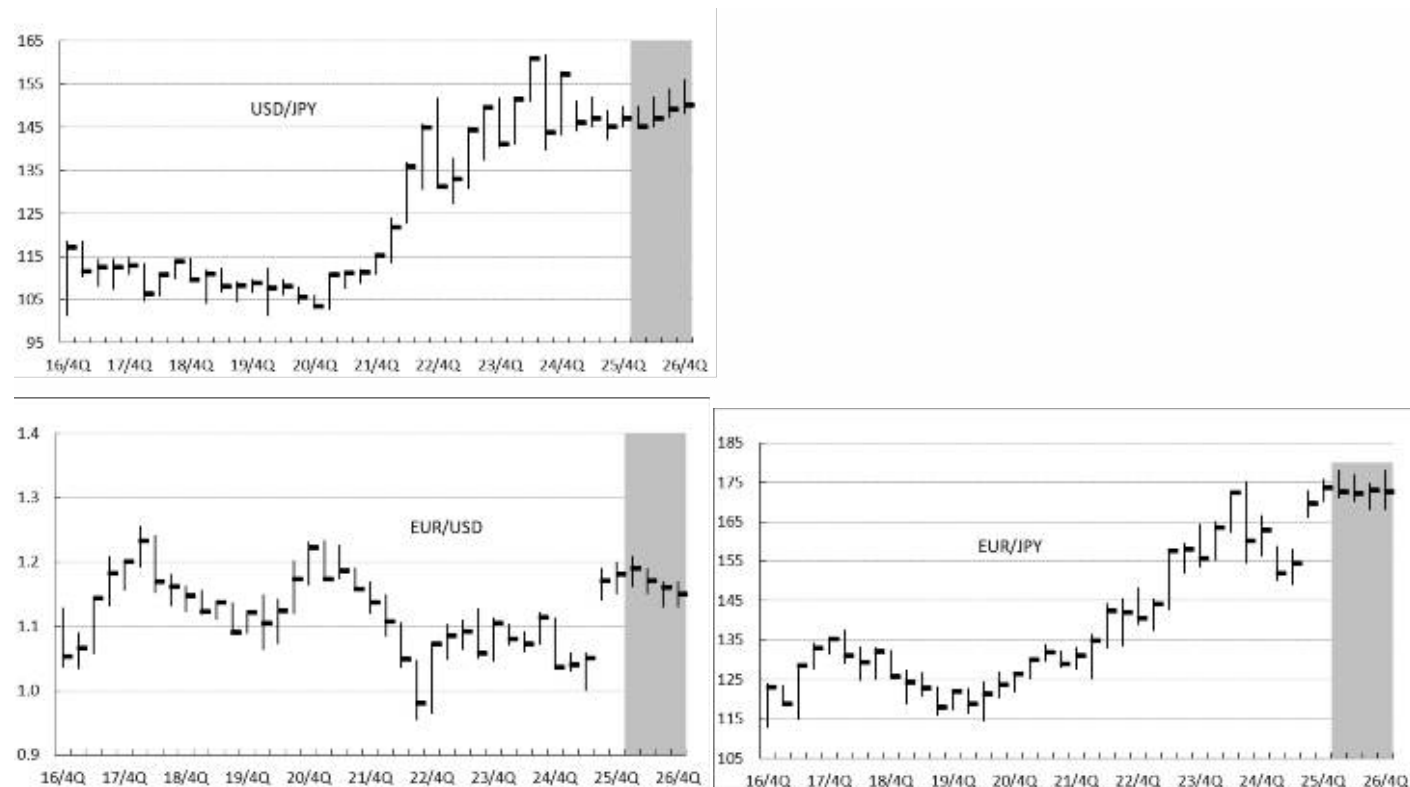
Summary Table of Forecasts

	2025 Jan-Sep (Actual)	Oct-Dec	2026 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	139.89 ~ 158.88 (148.73)	145 ~ 150 (147)	145 ~ 150 (145)	145 ~ 152 (147)	147 ~ 154 (149)	148 ~ 156 (150)
EUR/USD	1.0125 ~ 1.1918 (1.1721)	1.15 ~ 1.20 (1.18)	1.16 ~ 1.21 (1.19)	1.15 ~ 1.19 (1.17)	1.13 ~ 1.17 (1.16)	1.13 ~ 1.17 (1.15)
EUR/JPY	155.63 ~ 175.02 (174.40)	170 ~ 176 (173)	171 ~ 178 (173)	170 ~ 177 (172)	168 ~ 175 (173)	168 ~ 178 (173)

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

3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



USD/JPY Outlook - Potential Risk to JPY from Situation in Europe

Japan and U.S. Currency Policies Now and Going Forward: Asia's Forex Reserves Under Scrutiny

Highlights of the Joint Statement

A joint statement from the Japanese and U.S. finance ministers was suddenly released on the morning of September 12 (Japan time). Japan-U.S. trade negotiations, which have been in full swing since April, were structured so that Akazawa Ryosei, Minister in charge of Economic Revitalization, would be responsible for tariff negotiations, while Katsunobu Kato, Minister of Finance, would be in charge of forex-related talks. The statement included standard exchange rate phrases, such as, "They reaffirmed that exchange rates should be market determined and that excess volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability." This is not significantly different from the content reaffirmed at G7 or G20 finance ministers' meetings.

In fact, Finance Minister Kato stated that the statement was "based on previous discussions at the G7 and other forums" and "will not affect our current approach." Consequently, there have been no significant exchange rate fluctuations since the statement, but the statement also included the following two worrying points:

- (1) they agreed that other government investment vehicles such as pension funds continue to invest abroad for risk-adjusted return and diversification purposes, not targeting exchange rates for competitive purposes**
- (2) they commit to public disclosure of foreign exchange reserves data and forward positions on a monthly basis as well as the currency composition of foreign exchange reserves on an annual basis according to the IMF's Data Template on International Reserves and Foreign Currency Liquidity**

While these points are not of immediate interest to the markets, they are of great importance to the forex market in the long run, and I would like to delve deeper into them here.

As Forewarned in the FX Report

Point (1) above was already brought up in the Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States (FX Report) released on June 5, and I took it up for discussion in this report at the time. Specifically, the June FX Report stated, "government investment vehicles, such as large public pension funds, should invest abroad for risk-adjusted return and diversification purposes, and not to target the exchange rate for competitive

purposes,” which is quite similar to the recent joint statement. At the time, I had raised the following concerns about the statement:

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

I have no way of knowing the real intention behind the statement in point (1), but it seems that such a statement would be unfounded unless U.S. authorities believed that Japan’s public pension management may be contributing, to some extent or other, to JPY depreciation. As I have noted in previous issues of this report, the proportion of foreign currency-denominated assets in the GPIF’s core portfolio has more than doubled in the past 10 years (see table).

While this revision proved a major success from an operational perspective, it is also true that, in theory, its structure gives the impression of a bias. To briefly recapitulate the history behind this structure, on October 31, 2014, the BOJ, under the leadership of former governor Haruhiko Kuroda, embarked on a massive additional easing program called the Halloween Easing, under which it decided to increase its annual government bond purchases by JPY 10-20 trillion. On the same day, GPIF announced portfolio changes, significantly raising the proportion of foreign currency-denominated assets in its basic portfolio from 23% to 40% and reducing government bonds from 60% to 35%. Given the GPIF’s reduction of JGB purchases and increase in foreign-currency-denominated asset purchases coinciding with the BOJ’s increase in JGB purchases, it is easy to see why international market participants, not just in the U.S., would view this as market manipulation using pension funds. The U.S. administration under President Donald Trump may simply be expressing dissatisfaction at this state of affairs now, given Trump’s preference for a weaker USD. Openly calling for USD selling (JPY buying) intervention through the sale of U.S. Treasuries could have a contagious effect, but USD selling as a result of correcting imbalanced pension management is unlikely to cause a major uproar (of course, the U.S. has no right to interfere in another country’s pension management).

JPY 30 Trillion Worth of JPY Buying?

GPIF’s basic portfolio for the five-year period from fiscal 2025 to fiscal 2029 has just been finalized, so the next change in basic policy will be after fiscal 2030. By that time, the current Trump administration will no longer be in office. However, if we assume some kind of action in light of point (1) in the Japan-U.S. joint statement following tariff negotiations, adjustments are possible within the limit of permissible deviation from the basic portfolio. For example, the current plan allows for deviations of ± 5 pp for foreign bonds and ± 6 pp for foreign stocks (25% target for each). If, say, the share of foreign currency-denominated assets were to be reduced by approximately 10 pp, assuming current total assets (JPY 260.243 trillion as of the end of 1Q of fiscal 2025), this could induce JPY buying to the tune of approximately JPY 26 trillion.

GPIF’s basic portfolio serves as a de facto benchmark for other investment managers, especially for the three key mutual aid pension plans (National Public Service Personnel Mutual Aid, Local Public Service Personnel Mutual Aid Association, and Mutual Aid Corporation for Private School Personnel), which tend to attract attention in conjunction with GPIF. Incidentally, the three key mutual aid pension plans managed assets totaling approx. JPY 30 trillion, so a 10-pp reduction in foreign currency-denominated assets from this amount would result in JPY buying to the tune of roughly JPY 3 trillion. In other words, the combined JPY buying from GPIF and the three key mutual aid pension plans would be roughly JPY 29 trillion. Intuitively, this JPY buying, approaching JPY 30 trillion, would represent a massive flow capable of absorbing roughly 80% of the cumulative trade and services deficit (JPY -37.4 trillion) of the ongoing weak-JPY phase (calculating for the three years from 2022 to 2024). Of course, this flow will not materialize in the short term, but this is an important point to consider when analyzing the JPY rate outlook over the medium to long term.

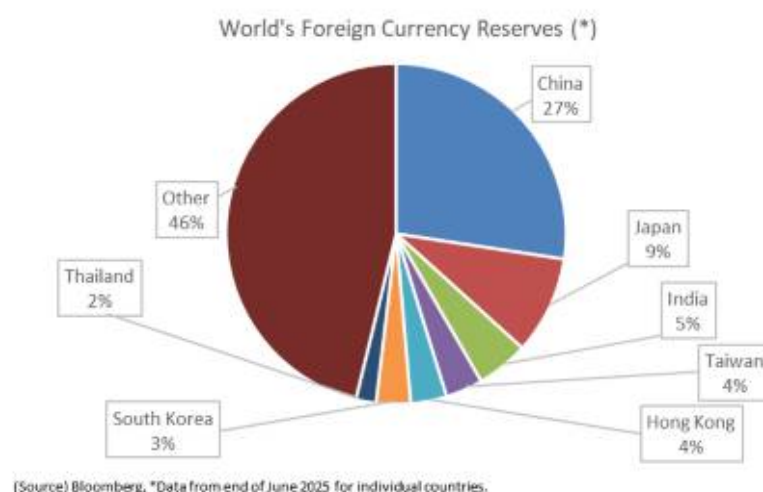
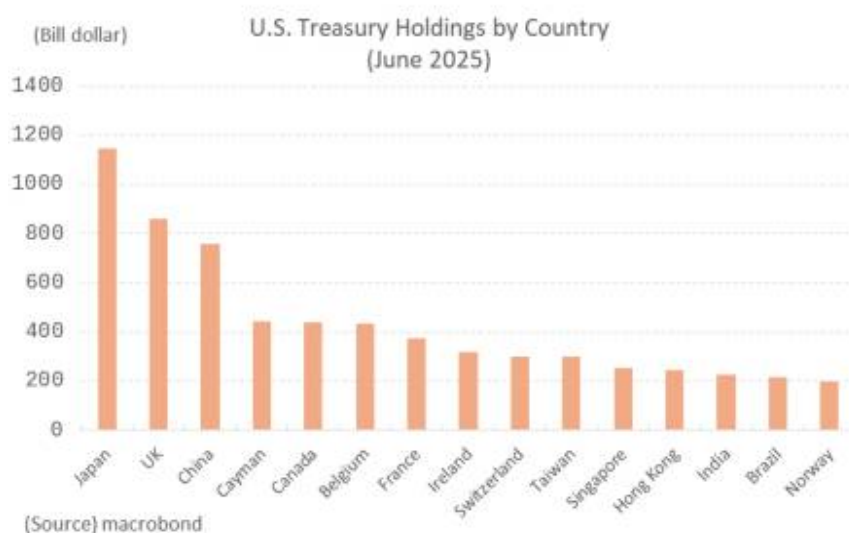
GPIF, changes to basic portfolio (% , percentage of total assets)

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

(Source) GPIF

Implication of Calling for the Publication of Forex Reserve Currency Composition

Point (2), which requires the publication of the forex reserve currency composition, is interesting. I would like to point out that this is not unique to Japan – it is a requirement that could be made of various other Asian countries going forward. As I have been pointing out in this report for some time, USD's share within forex reserves has been on the decline. It is possible that requiring the periodic publication of the forex reserve currency composition was considered a way to curb this trend, at least among pro-American countries. Taking this into account, Asian countries, where 60% of the world's forex reserves are concentrated, would naturally be the most likely targets for such a demand. Based on the U.S. Department of the Treasury's Treasury International Capital (TIC) data, Japan is already the world's largest holder of U.S. Treasuries (see graph to the right, top and bottom), so it is unsurprising for the U.S. to want to solidify this status and continue the stable absorption of U.S. Treasuries by requiring disclosure. However, Japan may only be the first country of which such a demand is made (being an easy target); the U.S. government's aim may be to get other Asian countries with large forex reserves (such as India, Taiwan, Hong Kong, and South Korea) to also start publishing their forex reserve composition on a regular basis. In fact, in his "March-a-Lago Accord," Stephen Miran, Chairman of



Trump's Council of Economic Advisers (and Fed governor), originally included a strategic item on extending the maturity of overseas-held U.S. Treasuries (specifically, converting short-term debt to longer-term debt, and ultimately replacing it with 100-year bonds). As in the case of tariffs, the recent move to mandate Japan's disclosure of its forex reserve currency composition seems to be based on Miran's paper. In fact, it would be more accurate to say that Miran's paper intended for the U.S. to pay high interest on 100-year bonds while taxing U.S. Treasury bonds held overseas. One should probably be prepared for the possibility of such surprising proposals going forward.

BOJ Monetary Policy Now and Going Forward – Is an October Rate Hike Certain?

BOJ Exploits Lame-Duck Political Situation to Start Selling ETFs

At the BOJ's September 18-19 Monetary Policy Meeting (MPM), the target for the uncollateralized overnight call rate was kept at around 0.50% by a majority vote. Policy Board members Hajime Takata and Naoki Tamura proposed raising the rate to 0.75%, but this was rejected by the majority. Another highlight was the unanimous vote in favor of the BOJ starting to sell its exchange-traded fund (ETF) and real estate investment trust (REIT) holdings. I would like to summarize my assessment of each of these points and the future outlook.

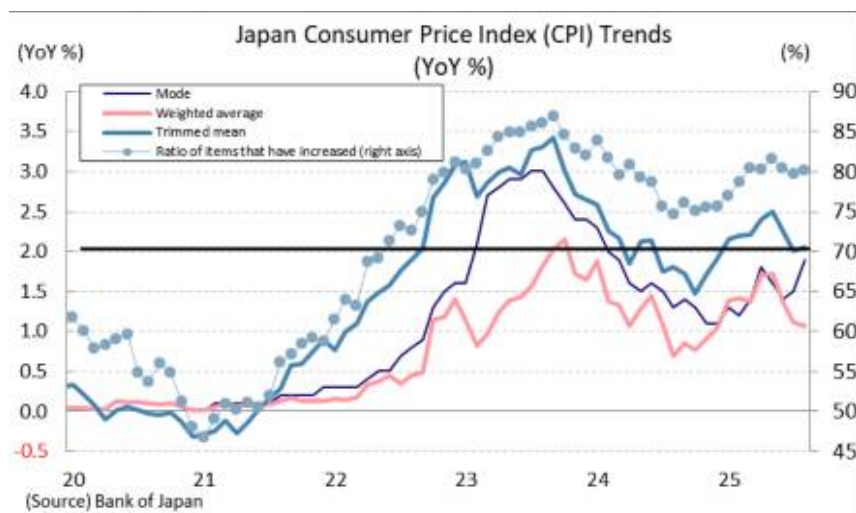
First, many market participants would like to view the former as holding great significance. Indeed, expectations for a rate hike at the October MPM have suddenly risen following the rate hike proposal by two members, and barring any significant deviation from the economic and price outlook (the Outlook Report), the possibility of a rate hike cannot be denied. However, realistically speaking, I think the odds are 50-50 at best (details later).

Regarding the latter, if the BOJ follows its ongoing basic policy of selling approximately JPY 330 billion worth of ETFs per year, assuming the current book value of its ETF holdings (JPY 37.1862 trillion as of September 10), it would take 112.68 years to complete the sale. While ETF sale was considered the BOJ's final and most crucial step toward normalizing the balance sheet, its impact may be limited by this extremely thin, long-term implementation. The Nikkei Stock Average plunged in the wake of news of the ETF sale decision, but has since recovered some of the fall and regained stability. BOJ Governor Kazuo Ueda did not provide a clear reason for the timing of the decision, merely saying, "The market is gradually normalizing, and such measures are no longer necessary." Perhaps the BOJ viewed the present time as favorable for the decision, given the weak position of the lame-duck political administration and

stock prices renewing record highs on a daily basis. Moreover, if the operation is to last for over 100 years, the impact is likely to be minimal.

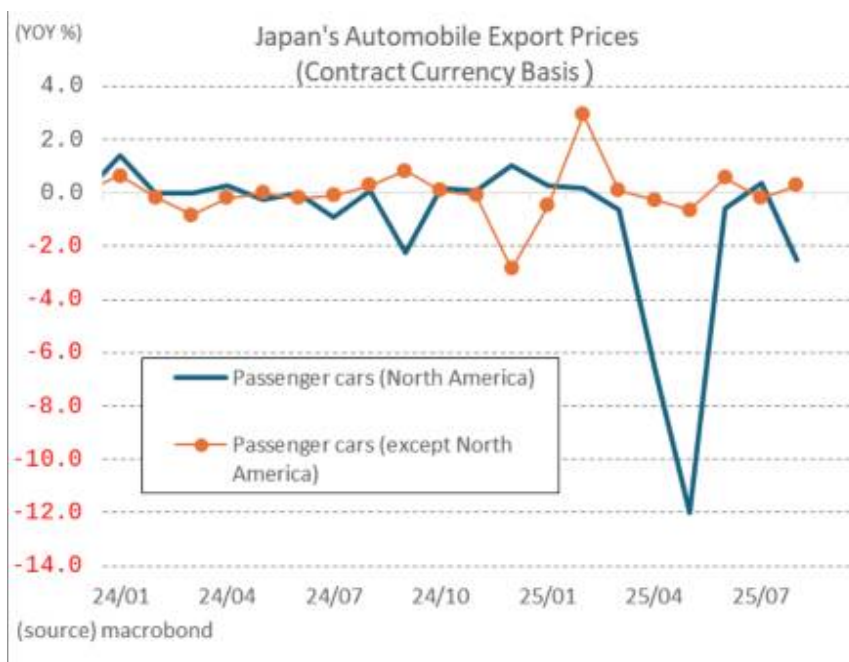
Is an October Rate Hike Certain?

Going forward, the ETF sale operation will proceed quietly and probably be forgotten amid the daily hustle and bustle. The bigger issue is the outlook for a rate hike. Some say the recent rate-hike proposal from two Policy Board members has made it easier to move toward a rate hike in October. It is true that the Policy Board is beginning to show signs of a rift, and it would be unsurprising if other members were to follow suit. However, the odds of a rate hike in October are still 50-50 at best. When asked about the current underlying inflation rate, Ueda replied, "It is still slightly below 2%, but in the process of approaching 2%. The impact of U.S. tariff policies and other factors are likely to become more pronounced in the coming months, and we must be mindful of the risk of a downturn in the economy and prices." The tone is neutral to dovish in my opinion. Takata and Tamura being the most hawkish members of the Policy Board, it is difficult to judge whether their opinions signal a rate hike. With extremely low real interest rates, the weak-JPY-led inflation is undoubtedly suppressing Japan's real economic growth rate. I agree with Takata and Tamura that a rate hike is necessary. However, the CPI excluding food and energy (the European and U.S. equivalent of core CPI) showed no acceleration, rising 1.6% yoy in August, and the BOJ's underlying price index is also currently trending downward (see graph). Given these circumstances, it is difficult to be certain whether the environment is more supportive of a rate hike in October than it was in July or September, when the Bank decided to maintain the status quo. Given the recent words and actions of the Governor and Deputy Governor, it is entirely possible that the BOJ will wait until December or the next Outlook Report in January to implement a rate hike. In fact, as of the time of writing, financial markets have priced in only one rate hike within the next six months, at 68% for October, 81% for December, 99% for January, and 112% for March. If the BOJ were to proceed with an October rate hike despite inflation conditions remaining largely unchanged, a possible explanation could be a combination of Takata and Tamura's arguments; something to the effect: "The norm of no inflation has already changed, and the price stability target has been achieved by and large; there is, in fact, a heightened risk of inflation rising further. Under these circumstances, we have determined that there is an increasing need to bring the current policy rate closer to the neutral rate." Lack of consistency with previous policy notwithstanding, I agree with the intent.



Will Impact of Tariffs Become Clearer in October?

However, even in light of the above intent, the December meeting may be the earliest possible time for a further rate hike. After all, the impact of the Trump tariffs is yet to become apparent. As previously reported, the handling of automobile tariffs was only finalized in September, with the reduction from 25% to 15% in real terms taking place on September 16. Until this reduction in tariffs was decided, the Japanese auto industry was likely weathering the impact of tariffs by temporarily lowering contract currency (local currency) prices. This assumption is backed by the sharp drop in car price indices for passenger cars to North America in May (see graph). Given that local sales prices cannot be adjusted flexibly in response to headlines during an ongoing negotiation phase, it is rational for companies to temporarily shoulder the burden of additional tariffs and keep local currency prices flat.



However, now that the Japan-U.S. agreement has been tentatively concluded, Japanese auto companies are faced with two choices in light of the 15% tariff: (1) secure corporate profits by raising contract currency prices, or (2) secure export volume by maintaining (already lowered) contract currency prices. In the case of (1), a decline in corporate

profits due to a decline in export volume is a concern. In the case of (2), a decline in corporate profits along with sales is a concern, even if export volume remains flat. Ultimately, with an additional 15% cost imposed, there is no escaping the fact that corporate profits will decline. Taking this into consideration, nominal wage growth in fiscal 2026 is by no means certain, making it extremely inconvenient for the BOJ, which is pursuing a virtuous cycle of wage and price growth. It would be quite difficult to determine the extent to which such developments should be a cause for concern by the end of October.

Important indicators to watch out in the near term for businesses include the BOJ's Tankan survey, to be released on October 1, financial results of major companies, to be released in November, and winter bonuses, to be released in December. In other words, the BOJ would find it easier to explain its additional rate hike if the decision were made in December. My main forecast scenario for the timing of the additional rate hike is December, followed by October, and then January 2026. In any case, one should be prepared for an increase to 0.75% by the time the January Outlook Report is released.

U.S. Monetary Policy Now and Going Forward – Undermining of Fed's Independence Increasingly Obvious

Even Trump Supporters Disagree with Miran

In September, the FOMC lowered the target range for federal funds (FF) by 25 basis points to 4.00%-4.25%, the first rate cut in nine months, as expected. Miran, newly appointed as Fed governor earlier than some expected, cast an opposing vote, arguing for a larger (50 bp) cut, but this behavior was also expected by the market. His voting position aside, the fact that the Chairman of the CEA, a key government position, gets to cast a vote as a Fed governor, even if only for a short period, is inappropriate in every way, and this alone seems likely to push down USD.

Meanwhile, Fed Chair Jerome Powell stated in a press conference that the labor market "is no longer solid," and described the simultaneous concerns of rising inflation and slow hiring as "highly unusual." While this explanation is largely in line with expectations, it is interesting to note that Vice Chair Michelle Bowman and Governor Christopher Waller, who are often mentioned as Trump supporters and potential candidates for the next Fed chair, avoided expressing support for Miran's position. This could be due to differences in their stagflation risk perceptions, or due to a desire for consistency in explanations after taking over as chair.

Dot Plot Also Fails to Follow Miran's Lead

In the FOMC members' summary of economic projections (SEP), the growth rate projections were slightly upwardly revised, but unemployment and inflation projections remained unchanged. This is understandable taking into account the multiple rate cuts (including the recent one) projected in the dot plot going forward. Going by their dot plot projections, one can infer that nine members expect to see two more 25bp rate cuts, which is the median

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

FOMC Date	2025	2026	2027	2028	Longer run
Mar-24	3.875%	3.125%	—	—	2.5625%
Jun-24	4.125%	3.125%	—	—	2.7500%
Sep-24	3.375%	2.875%	2.875%	—	2.8750%
Dec-24	3.875%	3.375%	3.125%	—	3.0000%
Mar-25	3.875%	3.375%	3.125%	—	3.0000%
Jun-25	3.875%	3.625%	3.375%	—	3.0000%
Sep-25	3.625%	3.375%	3.125%	3.125%	3.0000%

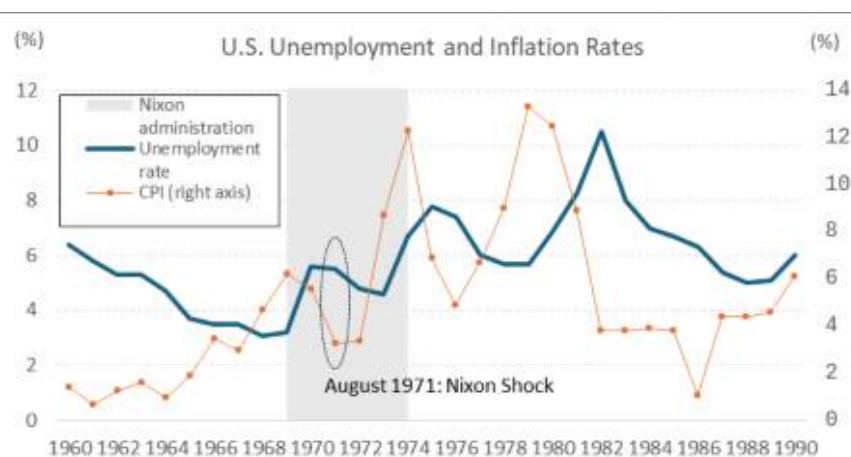
(Source) FRB

number of rate cuts. One member (obviously Miran) is calling for the FF rate to be lowered to the neutral rate level of 2.75-3.00% by the end of the year, which would indicate three more 50bp rate cuts including the recent one.

Note that Treasury Secretary Scott Bessent has stated his desire to maintain FF rates below the neutral rate level through 2026, and the dot plot clearly reflects this government policy. This indicates a gradual but steady thinning of the line between the government and the central bank. Of course, given that financial markets shape expectations along the median, a continuation of the current situation may not pose a major problem. However, if the Fed chair and vice chair additionally begin to toe the government line, the median itself could be revised closer to government expectations. While the outcome of the recent FOMC meeting was generally in line with expectations, it was significant in that the undermining of central bank independence, which had already been feared, became more obvious.

Reminiscent of the Nixon Administration

The question before the Fed right now is whether rate cuts or rate hikes are the most appropriate response to stagflation. The U.S. government's desire to lower policy rates to below the neutral level, while ignoring inflation hovering around +3% yoy, risks undesirable increase in interest rates and USD appreciation in the medium to long term. In a previous issue of this report, I reviewed the historical context in which the Nixon administration exerted similar political pressure on the Fed under then governor Arthur Burns, resulting in USD appreciation (and rising interest rates) that led to the Plaza Accord. Like the current administration, the Nixon



(Source) macrobond

administration too sought to revive the real economy through low interest rates and USD weakness, but ultimately ended up in a disastrous situation with rising unemployment and inflation. While this would be a tough decision for the Fed to take politically, a rational first move would be to maintain the FF rate above the neutral level while waiting to see how things develop in order to ensure inflation is contained.

Of course, this would be a politically unpopular measure, with the Trump administration facing midterm elections next year, but this is precisely why the Fed is guaranteed political independence – so that it can make wise decisions even when they are unpopular.

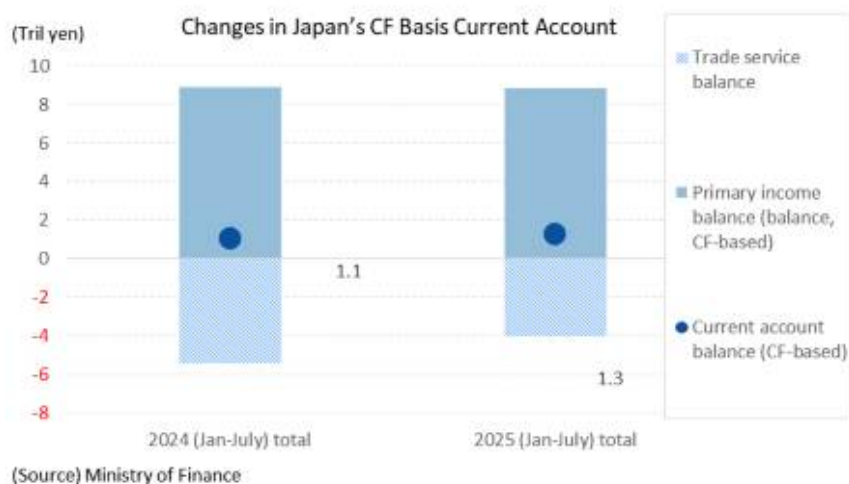
Incidentally, the dominant view is that the Nixon administration's pressure on the Fed under Burns to lower interest rates was politically motivated, with President Nixon's reelection in mind. The current Fed administration's rate cuts are merely adjustments while maintaining the rate above the neutral rate, so there are no major concerns. The real concern is – could the Fed under a new chair repeat the mistakes of the Nixon administration? This is one of the key issues in forecasting the outlook for 2026.

JPY Supply and Demand – Improving Supply and Demand Climate

JPY Supply and Demand Climate Largely the Same as Last Year

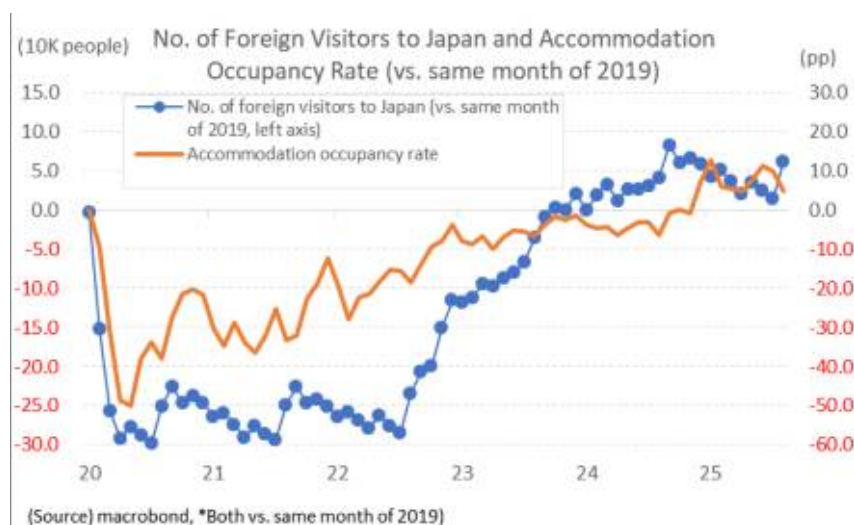
In September, USD/JPY lacked clear direction in the absence of decisive factors one way or the other. Amid conflicting information regarding Japan's political situation and Fed rate cuts, there are no clear clues as to the direction of USD/JPY. It is precisely in these circumstances that it is important to maintain a bigger perspective, focusing on changes in the structure of JPY supply and demand. Japan's July balance of payments was released on September 8. The current account balance continues to enjoy a large surplus, driven primarily by a primary income surplus. For the January-July period, the total was approximately JPY +17.2 trillion, on track to surpass last year's record (the current account surplus for the January-July period last year totaled roughly JPY +16.7 trillion).

However, my calculation of the current account surplus based on cash flows (CF) for January through July this year is only around JPY +1.3 trillion, which is not a significant change from last year, when JPY was consistently weakening (see graph). I would like to stress that while the statistical surplus continues to be large, the CF-based surplus (more relevant in practical terms) is not. Note, further, that financial balance trends, which include Japanese foreign securities investment and foreign direct investment do not reveal much change in the JPY supply and demand structure leaning toward net JPY selling. This should be considered one of the reasons why JPY depreciation has not been resolved despite the significant narrowing of the gap between U.S. and Japanese monetary policy.

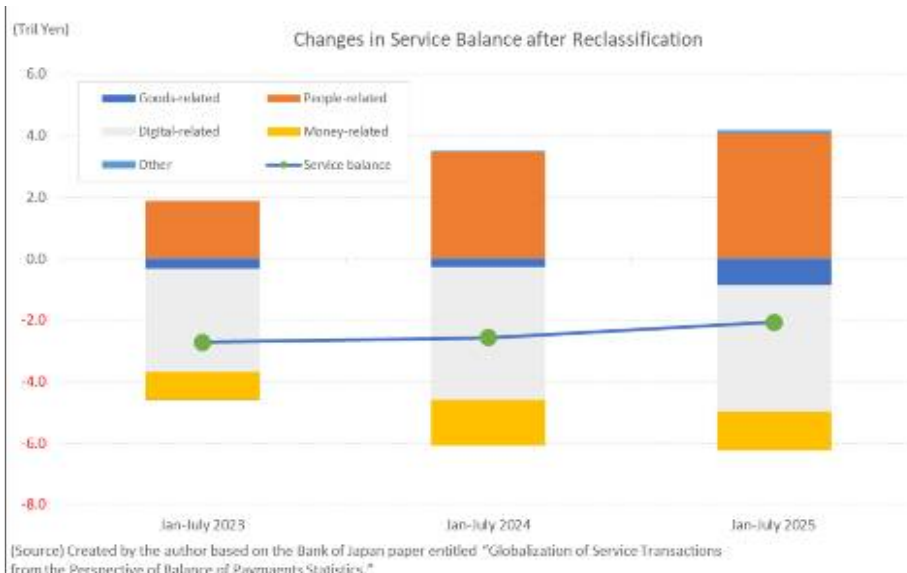


Impact of Peak in Inbound Tourism

In terms of the impact on JPY supply and demand, recent trends in inbound tourism demand are also a cause for concern. According to the July Occupancy Statistics released by the Japan Tourism Agency, the total number of overnight stays at domestic hotels, inns, and other accommodation facilities decreased by 1.4% yoy, marking the second consecutive month of decline and showing yoy decline in stays by both Japanese and foreign visitors. The number of foreign visitors in July was down 2.5% yoy. The number of foreign visitors to Japan showed growth exceeding pre-pandemic levels in 2024, but growth has plateaued since the start of 2025, as has the occupancy rate (see graph). While the bottoming out of JPY rates and overseas economic slowdown are most commonly cited as the reasons for this, it must be noted that rumors of a potential major earthquake in Japan in June or July also attracted significant attention, especially on social media.



Regardless of the reason, the plateauing of inbound tourism demand will significantly impact JPY supply and demand via a decline in the travel surplus. As the graph shows, the total services deficit for the first seven months of the year was -JPY 2.0657 trillion, a slight improvement from the same period last year (-JPY 2.5705 trillion). However, the structure remains the same, with the inbound tourism (people-related) surplus continuing to offset the growing digital deficit. If, as described above, inbound tourism demand has indeed plateaued, the overall services deficit could begin to grow, driven by the growing digital deficit. While such a trend is not obvious from the balance of payments statistics at present, it is quite likely to become a reality going forward unless the digital deficit shrinks for some reason. With “the digital deficit” trending as a topic in recent years, it is easy to mistake it for being a factor in the ongoing JPY weakness. It is, however, more of a long-term JPY depreciation factor as it gradually but surely proceeds to determine the size of the services deficit.



Moreover, rather than viewing the digital deficit as a factor influencing the exchange rate, it is far more important to see it as a semi-permanent drag on the Japanese economy. As I have argued in previous issues of this report, I believe that digital service imports should be treated the same as crude oil imports, as a permanent cost to be borne by the Japanese economy. Rather than focusing on trivial details such as their relation to JPY depreciation, I intend to continue analyzing Japan’s digital deficits and other structural changes in its balance of payments as key issues determining the shape of the Japanese economy.

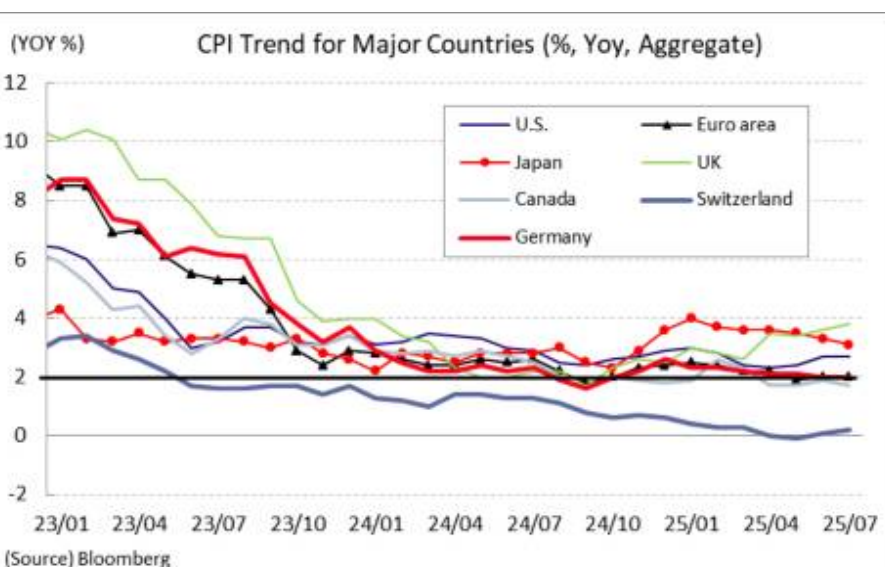
Risks to My Main Forecast Scenario – Potential Risks to JPY and JPY Interest Rates from Situation in Europe

UK Concerns Suddenly Growing

There has been an increase in disturbing reports from the European bond market. In September, political uncertainty in France led to the country’s 10-year bond yield drawing attention for surpassing that of Italy. This was the first time this had happened since 1999. Even before these developments in France, the UK bond market had been attracting intermittent attention – for instance, on September 2, when the 10-year UK bond yield briefly surpassed 4.85%. This created quite a stir, as the level surpassed yields seen during the September 2022 shock to the economy caused by the Liz Truss administration (“the Truss shock”). Incidentally, the yield remains high at 4.70% at the time of writing (September 30).

Looking at other euro area 10-year government bond yields, France and Italy, both facing political uncertainty, are at 3.53%, Spain is at 3.26%, and Greece is at 3.38%. In the U.S., where fiscal concerns have been high since “Liberation Day,” the 10-year government bond yield is 4.14%. It seems obvious that the UK bond market is under particularly high stress even among developed countries. While the background to this situation can be discussed from a variety of perspectives, strong concerns about stagflation is the brief explanation. While UK inflation growth (discussed based on the headline CPI) slowed to around +2% in 2024, the growth rate clearly bottomed out and has been accelerating since the start of 2025. The latest figure (August) was +3.8%, which is exceptionally strong even among the G7 countries. However, even as inflation rises, economic growth is slowing, with the real GDP growth rate for the April-June quarter of 2025 falling to +0.3% qoq, a clear slowdown from the January-March quarter’s +0.7% qoq.

Given these circumstances, speculation is growing that the Bank of England’s (BOE) next move will be to cut interest rates, as the Bank goes into response mode to fight stagflation, which is literally “economic stagnation plus inflation.” In



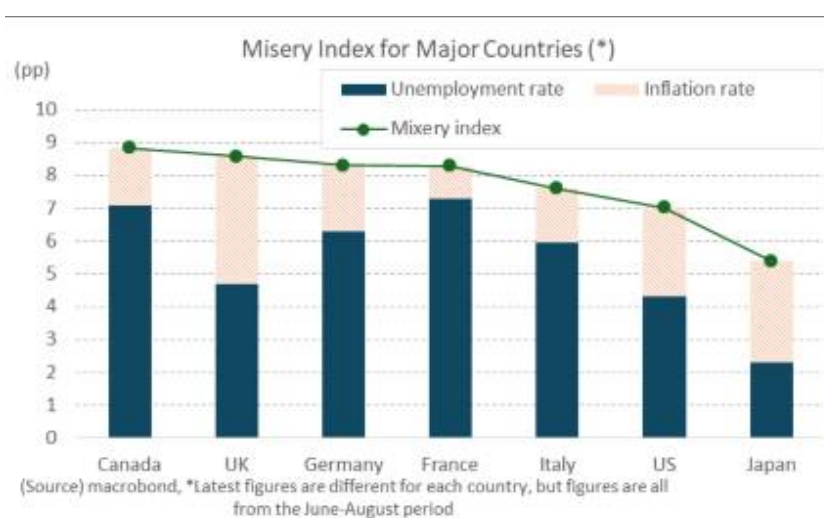
his annual report to the House of Commons Treasury Committee on September 3, Alan Taylor, an external member of the BOE's Monetary Policy Committee (MPC), stated, "We are getting closer to that soft landing (for the UK economy) now, but we are also in a fragile moment, and monetary policy will need to be carefully calibrated in the coming months to keep us on track." This suggests a stance supporting interest rate cuts to prop up the real economy while ignoring short-term inflation trends. Incidentally, Taylor himself supported a 50bp rate cut at the August MPM (for the first time in history, the MPC voted twice at the August MPM – a 50bp cut was favored in the first round, and a 25bp cut was favored in the second).

In light of this situation, there are growing concerns about the possibility of a repeat of 1976, namely, the need for an IMF bailout. Of course, the current situation is quite different from that in 1976, when the economy was experiencing inflation rates exceeding 20%, negative growth, a resulting sharp GBP depreciation, and difficulty issuing new government bonds. It is true that the UK is experiencing stagflation, but IMF bailouts seem a bit of a leap given that market financing continues, albeit at a high cost.

Japan's Position in the Misery Index

However, financial market trends are not based on whether something is really true. So long as a large number of market participants believe a narrative, that narrative will shape asset prices. Since the beginning of this year, interest rates have risen frequently in the U.S., even before the UK, due to fiscal risk concerns. Confidence in USD and U.S. Treasuries is likely to remain a key issue in light of the government's interference in Fed personnel decisions. Can Japan remain unaffected by these unprecedented tensions in the UK and U.S. bond and forex markets? While many developed countries are experiencing signs of stagflation to varying degrees, the possibility of the UK's turmoil spreading to Japan is worth considering.

For example, when looking at the misery index (unemployment rate + inflation rate; most recent figures for each country), Canada, the UK, and Germany rank highest, respectively, while Japan ranks lowest. However, this is the result of extremely low unemployment in Japan thanks to the Japanese-style employment system (see graph). Looking at inflation rate alone, Japan ranks second only to the UK, and is followed by the U.S. Meanwhile, the sustainability of an extremely low unemployment rate thanks to the Japanese-style employment system is being called into question due to labor shortages. There is also room for debate as to how positively it should be viewed. Japan is currently experiencing the pain of stagflation (persistently high prices suppressing real economic growth), and many market participants probably recall Japan when they see the UK's plight.



Potential Risks to Japan from Situation in Europe

Japan's unending struggle with JPY depreciation should also be considered. This is because the impact of a panic during a phase of JPY appreciation on the bond market is fundamentally different from that during a phase of JPY depreciation. Panic during JPY appreciation is accompanied by falling interest rates (higher bond prices), but this is limited by the zero interest rate constraint. This is the reason why the Japanese economy, which suffered chronically from JPY strength, consistently enjoyed an ultra-low interest rate environment. However, panic during JPY depreciation carries the risk of rising interest rates (lower bond prices), and this risk is unlimited. Naturally, a panic during JPY depreciation is more likely to create profit opportunities for speculators, and the bond market could well get caught up in this. Plans to use the UK's crisis as a hook to launch a similar panic in Japan would not be surprising.

In light of this, it may be dangerous to dismiss the turmoil in the UK markets as something that does not concern Japan. Given the robustness of Japan's external economic sector, as symbolized by its current account surplus, there is no reason for Japan to follow in the UK's footsteps and raise interest rates or depreciate its currency due to fiscal risk. However, a pattern has been observed since April of market participants selling JPY and Japanese government bonds due to perceived fiscal risk. Both the House of Representatives election last year and the House of Councillors election this year were accompanied by a weakening of JPY and rising JPY interest rates. Political instability due to the ruling party's defeat and resulting concerns about an expansionary fiscal policy have frequently been cited as reasons for this. Regardless of the truth or validity of these claims, the situation is certainly cause for unease, given that national elections in Japan have rarely influenced trading in the past.

To reiterate, speculative traders do not particularly care whether or not something is theoretically sound. As I have repeatedly argued in past issues of this report, the current account surplus, traditionally considered a firewall, is surprisingly small when viewed on a CF basis, with over half of net external assets being made up of direct investments that may never be repatriated. Given these conditions, it would not be surprising if speculators were to decide that it would be worth taking a risk. When fiscal risks in major overseas countries become a topic of discussion, one risk scenario is potential JPY depreciation and higher JPY interest rates resulting from the situation overseas.

EUR Outlook – Reevaluating EUR's Reserve Currency Status

EUR Area Monetary Policies Now and Going Forward –Keeping the Status Quo while Looking Out for Rate Hike Opportunities

ECB Aligned with Market Expectations

The September 11 ECB Governing Council meeting was the second consecutive Governing Council meeting to decide to keep the deposit facility interest rate and other major policy interest rates unchanged. That decision was in line with market expectations and did not cause any major market disruption. At the post-meeting press conference, ECB President Christine Lagarde denied a need for additional interest rate cuts, and that statement also did not diverge significantly from market expectations. Regarding the ECB's "next move", both financial markets and the ECB itself appear to be expecting the policy status quo will be maintained for the time being and, now that the U.S.-EU tariff agreement has been tentatively concluded, it does not seem likely that any new factors might change that anticipation of status quo maintenance. Regarding the putative end of the ECB's recent round of interest rate reductions, the first reporter to pose a question at the press conference asked – "Economists believe the ECB's easing cycle is over. With the outlook broadly unchanged, as you mentioned, would you say they're right and would you say everybody on the Governing Council agrees on that assessment?" President Lagarde began her response to that question by saying – "Let me say this: the disinflationary process is over[.]" – and that can be considered a fairly frank statement. However, she went on to clearly deny that the ECB was on a predetermined policy path, reaffirming that the ECB would make data-dependent policy decisions on a meeting-by-meeting basis, and later in the press conference she reiterated the well-known statement she made at her inaugural press conference in 2019 – "I'm neither a hawk nor a dove, I'm an owl." So while acknowledging that interest rate cuts may have come to an end for the time being, she did not neglect to qualify and hedge that statement.

Owls are a symbol of wisdom in Greek mythology, and they have the noteworthy ability to rotate their heads 270 degrees to keep an eye on their surroundings. At the press conference, Lagarde extended her owl metaphor by stating – "I'm an owl, because I want, number one, to see everything that happens around me. It's not 360 degrees, but it's a pretty large diameter that I can look at, and I want to come to my conclusions having heard all colleagues around the table."

Staff Projections Unchanged

The ECB has become more-confident in explaining its prospective policies because the level of uncertainty about upcoming trends has declined, as reflected in the fact that the September Eurosystem staff projections remain largely unchanged from the previous projections (released in June). The ECB's basic view is that the economic scenario is developing in line with projections, so there is no need to revise monetary policies.

ECB Staff Macroeconomic Projections (September 2025)

(%)

	2025	2026	2027
HICP	2.1	1.7	1.9
(previous: Jun 2025)	2.0	1.6	2.0
Core HICP	2.4	1.9	1.8
(previous: Jun 2025)	2.4	1.9	1.9
Real GDP	1.2	1.0	1.3
(previous: Jun 2025)	0.9	1.1	1.3

(Source) ECB, EUR/USD exchange rate for 2025 assumed to be 1.13 and for 2025-27 assumed to be 1.16.

*Core excludes energy and food

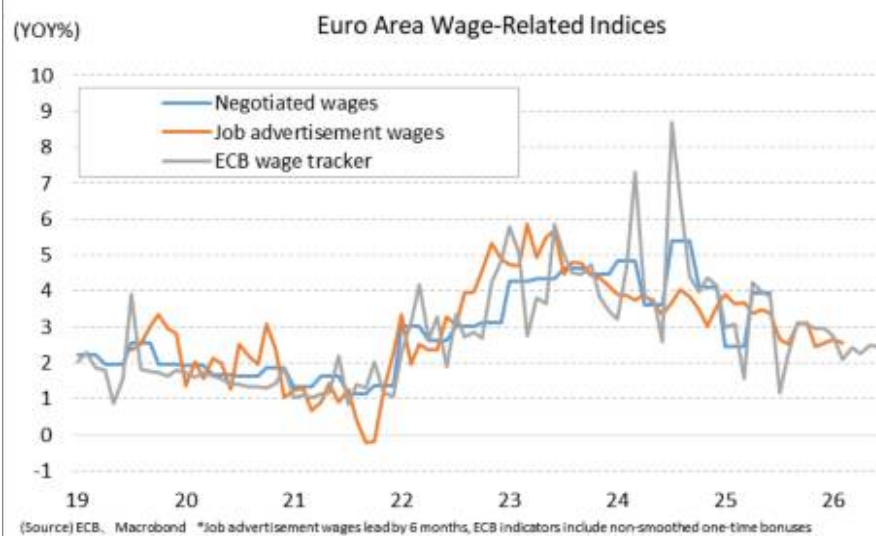
The September projections of euro area consumer price index (HICP) changes in 2025/2026/2027 are +2.1%/+1.7%/+1.9% – compared with the June projections, the 2025 and 2026 figures were each increased by 0.1 percentage point, while the 2027 figure was reduced by 0.1 percentage point. Another reporter at the press conference asked – "You said that inflation is projected to be at target over the medium term, yet the projection for 2027 is at 1.9%, so below 2% for the second year in a row. So where does below target start?" In response, President Lagarde explained that the downward revision to the 2027 HICP growth rate was – "on account of the exchange rate impact with the lag effect that it usually has, and this is factored into our projections. That explains to you the fat 1.9%. We have indicated very clearly in our strategy that minimal deviations – if they remain minimal and not long-lasting – will not necessarily justify any particular movement." Since the beginning of the year, EUR has appreciated against USD by more than 13%, and EUR on a nominal effective exchange rate basis has appreciated by more than 6%. It is not unreasonable to anticipate that lower EUR-denominated import prices will push down euro area inflation rates. The only inflation rate risk factor is that from the fourth quarter of 2025 through the end of 2026, the policy directions of the ECB and the Fed will be in direct conflict, so it cannot be ruled out that additional EUR appreciation may further depress the HICP growth rate. People will be closely watching to see what, if any, adjustments are made to prospective HICP growth rates in the December staff projections.

Next Topic – Bond Market Stability

As of early September, some senior ECB officials (including Executive Board Member Isabel Schnabel) were already talking about resuming interest rate hikes. A reporter at the press conference pointed this out, but President Lagarde avoided giving a clear response and evaded the question by saying there are – "risks to the upside and risks to the downside." Of course, if the ECB's mood were to become supportive of an interest rate hike, such a shift would likely be

some time in the second half of 2026 or subsequently, but it seems fairly certain that the recent rate cut period has ended and the ECB has entered a mode in which its basic policy is to maintain the status quo for the time being. As stated in the Account of the July 23-24 Governing Council meeting, “keeping interest rates unchanged was seen as a robust approach to managing shocks and two-sided inflation risks across a wide range of plausible scenarios.” Going forward, it is actually the stability of government bond markets that appears likely to merit increasing concern. As exemplified by the UK situation (discussed below), the potential for sudden and major bond market collapses considerably increases during periods of stagflation, so determining the optimal measures for preventing such collapses is becoming an important consideration worldwide. At the latest post-Governing Council-meeting press conference, a question was raised as to whether the ECB would consider activating the Transmission Protection Instrument (TPI) with respect to France, a country shaken by political instability. While it many financial market participants have probably forgotten about it by now, the TPI (a framework for unlimited ECB purchases of government bonds) was launched at the July 2022 Governing Council meeting, primarily in response to political instability in Italy. Since the TPI is a tool that can be used in situations where a government is such desperate straits that it is unable to issue bonds, it would be considered an excessive measure to apply to France at this time. However, the discussion of TPI usage reflects the fact that government bond markets’ increasing vulnerability is becoming a growing concern from both political and economic perspectives.

Government bond markets’ vulnerability (as already seen in the UK) is attracting growing attention. Amid concerns about the possibility of inflation rates bottoming out and rising in the euro area and elsewhere throughout the world, inflation-tolerant fiscal and monetary policies may face higher hurdles in the future. In this regard, the BOE’s move to cut interest rates out of consideration for the real economy, despite persistently high inflation rates, has widely been perceived as risky monetary policy approach, and that approach has indeed elicited a harsh reaction from the bond market. What about the euro area? Judging from the movements in job advertisement wages and the ECB wage tracker, which are leading indicators of



changes in employment and wage statistics (see graph), it appears that the euro area’s inflation rate is on track to bottom out for the time being, so there is no apparent need for the ECB to embark on interest rate cuts that could lead to an upside risk of inflation. It is likely that the latest Governing Council meeting thoroughly discussed this current and prospective situation. The ECB’s most important task over the next year will likely be to maintain the status quo while keeping an eye out for an opportunity to begin raising interest rates. And it is worth noting once more that this ECB positioning is quite different from that of the Fed, which has the key task of discovering how many more interest rate cuts it can implement. This article anticipates that these circumstances will enable EUR to maintain resilient strength against USD owing to the Europe-U.S. interest rate differential.

EUR Now and Going Forward – Reconsidering EUR’s Future Reserve Currency Status

Reconsidering EUR’s Reserve Currency Status

EUR has remained firm since the start of the year. There is a general perception that the United States has become increasingly isolated since the second Trump administration’s inauguration, and USD’s status as a reserve currency has become a point of contention in the forex market as well as in other financial markets. In particular, there are concerns about whether USD’s reserve currency status is weakening and whether other currencies may as a result strengthen their reserve currency statuses. If USD’s reserve currency status were to greatly weaken, the most likely result would be a shift from a system in which USD foreign currency reserves are overwhelmingly dominant to a system in which foreign currency reserves are maintained in a greater number of currencies, so one should probably envision the emergence of a “USD plus alpha” system in which USD continues to be dominant although somewhat less so. When considering the outlook for financial markets, it is important to understand which currencies are likely to become parts of the “alpha” component.

In this regard, people will naturally be inclined to focus on EUR as a potential rival to USD, and many are seeking to understand EUR’s current strength in that context. In fact, EUR’s supervisor, the ECB, has begun making frequent references to this issue. Is EUR worthy of becoming a second major reserve currency? It is worth reviewing the issue in light of recent arguments presented by the ECB.

Awareness of Opportunities

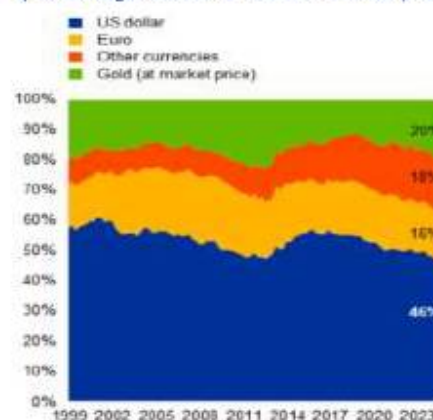
On June 17, 2025, EBC President Lagarde published an “ECB Blog” post under her own name on the ECB website entitled “Europe’s ‘global euro’ moment”, and that post was also featured in the UK-based Financial Times newspaper on that day. The blog post is based on analysis of an ECB report entitled “The international role of the euro” (posted on the ECB website on June 11), which indicates that the ECB has considerable interest in EUR’s internationalization.

In her post, President Lagarde notes that uncertainty related to USD’s dominant role “offers opportunities for Europe to take greater control of its own destiny and for the euro to gain global prominence.” She does not simply argue that a diminishment of USD dominance will automatically lead to EUR’s acquisition of a more-dominant role, however, pointing out that – “such a step towards greater international prominence for our currency will not happen by default: it must be earned.” I have noted in previous editions of this article that President Lagarde’s stance is a perfectly natural one given that, although USD’s share of global foreign exchange reserves has decreased, EUR’s share has barely increased at all. The mere fact that EUR trading volume is currently second only to USD trading volume does not mean EUR will automatically gain a greater reserve currency status, however, and there are probably many investors who have already completely given up on the idea of holding EUR over protracted time periods. President Lagarde herself has occasionally mentioned such points at press conferences.

As noted in the ECB’s “The international role of the euro” report, the total amount of gold held by the world’s central banks as of the end of 2024 was 36,000 tons. (This is almost as high as the 38,000 ton level seen in 1965, when the gold standard was an integral part of the Bretton Woods system, which pegged USD to gold at \$35 per ounce.) It has already been pointed out that when gold is evaluated at current market prices, gold’s share of global foreign exchange reserves is roughly 20%, exceeding EUR’s 16% share (see graph). It is worth noting that, since gold’s share of global foreign exchange reserves averaged about 10% of its current share during the 2010s, the margin of growth in that share is truly astonishing. Returning to the topic of EUR, Lagarde’s statement that EUR “will not be automatically chosen” could be seen as a warning that she is giving to herself, given the reality that it was not EUR, but gold and resource-rich country currencies (such as AUD and CAD) that have recently been chosen as alternatives to USD within foreign exchange reserves. It can be said that President Lagarde is aware that EUR is facing opportunities, but she is also aware that taking advantage of the opportunities will require efforts.

a) World Foreign Currency Reserve Composition

(Percentages based on current market prices)



Three Pillars of Reserve Currencies

So what kind of efforts are needed? President Lagarde writes that – “For the euro to reach its full potential, Europe must strengthen three foundational pillars: geopolitical credibility, economic resilience and legal and institutional integrity.”

President Lagarde cites “geopolitical credibility” based on the recognition that countries prioritize “geopolitical factors” over “economic rationality” when selecting a reserve currency. She points out that the EU is the largest trading partner of 72 countries and its trade volume accounts for 40% of global GDP (so the EU is a major geopolitical force) and that 40% of global trade transactions are EUR-denominated (so EUR should also be considered strong in terms of economic rationality). She goes on to argue that to ensure that EUR meets reserve currency-related responsibilities, the ECB has arranged swap lines and repo lines with other central banks that will enable the provision of sufficient EUR liquidity even in the case of crises.

While acknowledging the economic rationality of EUR usage, however, President Lagarde goes on to state that – “Real confidence, however, rests on hard facts. Investors seek regions that honour their alliances.” Her argument appears to be based on research by Barry Eichengreen, Livia Chițu, and Arnaud Mehl, whose 2017 working paper, “Mars or Mercury? The Geopolitics of International Currency Choice”, suggests that military alliances boost the proportion of a partner’s currency in foreign reserve holdings by approximately 30 percentage points. It is questionable whether a single currency’s foreign exchange reserve ratio can actually increase by 30 points in an era of increasing reserve currency multipolarity, but given the increasing incidence of international conflicts in various regions, there is no doubt that geopolitical credibility is becoming more important compared to mere economic rationality. This is clearly evidenced by the fact that China and Russia are reducing the proportion of their assets that are USD-denominated, and there are undoubtedly many less-extreme examples of the growing importance of geopolitical credibility. In this regard, President Lagarde states that – “Europe is undergoing a major shift towards rebuilding its hard power, which should also help bolster global confidence in the euro.” It is true that Europe has allowed its military forces to become excessively weak, and the argument that European rearmament measures will enhance EUR’s geopolitical credibility is logically persuasive.

Key Importance of Safe Assets

It is worth noting that the abovementioned “Mars or Mercury?” paper refers to the idea that economic and financial factors are important when selecting a reserve currency as the Mercury hypothesis and refers to the idea that geopolitical and security factors are important as the Mars hypothesis. President Lagarde’s “geopolitical credibility” pillar corresponds to Mars hypothesis, and her “economic resilience” pillar acknowledges the importance of the Mercury hypothesis. The EUR trade settlement ratio and measures to ensure EUR liquidity in times of crisis she cites are also

associated with the Mercury hypothesis, and she goes on to further emphasize the importance of economic strength by writing that – “Successful [reserve currency] issuers typically offer a trio of key features: strong growth, to attract investment; deep and liquid capital markets, to support large transactions; and an ample supply of safe assets.” It should be recognized that Europe has structural vulnerabilities related to those three points.

There is a particularly large Europe-U.S. gap regarding the supply of high-quality safe assets, and President Lagarde notes that – “outstanding sovereign bonds with at least a AA rating amount to just under 50% of GDP in the EU, versus over 100% in the US.” In light of that problem, she states that – “Joint financing of public goods, like defence, could create more safe assets.”

Now that the EU is leaning toward rearmament, it is beginning to become apparent that EU bond-based financing may become a permanent feature of EU rearmament programs if not other EU programs. In addition to its lack of military or security independence, the EU has been suffering from the incomplete state of its members fiscal integration – although economic and financial analyses have raised concerns about EU weakness in these regards, the concerns have been ignored for many years. Prospective progress in fiscal integration may perhaps be slow, but if the EU’s fiscal integration progresses, EU bonds are recognized as a new safe asset, and the EU bond market therefore deepens, EUR’s reserve currency status will certainly be strengthened.

President Lagarde’s third pillar of “legal and institutional integrity” relates to the objective of strengthening the EU as an issuing entity. The goal of bolstering investor confidence in the EU is challenging, as the EU’s structure and mechanisms tend to be rather complex and non-transparent, and President Lagarde herself acknowledged that problem, writing – “Admittedly, the EU is not easy to understand from the outside.” However, she also emphasizes that the rule of law is deeply rooted in the EU and the independence of the ECB is guaranteed, and that these – “are critical comparative advantages the EU should leverage.” Given the current state of the Fed, it should indeed be recognized that the ECB is overwhelmingly superior to the Fed regarding the issue of central bank independence. Being comprised of 27 member states, however, the EU cannot make progress in various areas without unanimous agreement of its member states, and its structural lack of quick decision-making capabilities is a clear weakness. In this regard, Lagarde suggests that – “More qualified majority voting in critical areas would enable Europe to speak with one voice.” It is generally understood that the EU is chronically slow to respond to various issues owing to internal squabbles, so there would appear to be a very strong basis for her suggestion. It is likely that many financial market participants are averse to holding EUR because they consider the EU’s legal systems and institutions to be insufficiently reliable, consistent, and sustainable.

Impermanence of Current System

Near the end of her blog post, President Lagarde notes that – “Shifts in global currency dominance have happened before. This moment of change is an opportunity for Europe: it is a ‘global euro’ moment.” While the current dominant currency system may appear to be permanent to people in any given era, currency systems have undergone numerous major changes in just the past century (see table). From the early 1900s until World War I (1914), there was a gold standard forex system centered on GBP, which was backed by overwhelming scale of Great Britain’s industrial power, trade network, and financial markets.

During the interwar period (1914 to the early 1940s), Great Britain faced financial difficulties, causing GBP to weaken, while the United States become a creditor nation and began acquiring large amounts of gold. There was a dual reserve currency system during this period, with GBP fluctuating and USD rising.

In essence, that period marked the beginning of the unipolar USD dominance that continues to this day. Following World War II, the U.S.-led Bretton Woods system was sustained for just under 30 years (1944-1971). Each country’s exchange rate was fixed against USD (with a fluctuation band of $\pm 1\%$), and the system’s gold standard guaranteed the exchange of USD for gold at USD35 per ounce. This was an era in which the United States led the creation of the IMF and World Bank, and the foundations of today’s international financial systems were established. During this era, the United States’ overwhelming economic size, gold reserves, and military power guaranteed USD’s status as the world’s reserve currency, and USD’s dominant reserve currency status has not significantly changed since then.

The 1971 Nixon Shock discontinued gold-USD convertibility and caused the collapse of the Bretton Woods system, leading to the introduction of a floating exchange rate system. It seemed likely at that time that USD’s dominant reserve currency status might be shaken, but that did not happen, largely because the previous gold-based currency system was replaced from 1973 by a petrodollar system in which crude oil transactions were settled in USD and the settlement proceeds were invested in U.S. Treasury bonds. It is widely believed that the petrodollar system resulted from a secret U.S.-Saudi Arabia agreement, although the system’s emergence can be seen as inevitable, given the wide-ranging support for using the United States’ overwhelming military power to provide security (and arms exports) to oil-exporting countries and given oil-exporting countries’ needs to safely invest their export proceeds. It should be noted that, even before the mandatory USD-denominated oil export settlement system took shape, USD-denominated settlements were

History of Key Currencies

Period	Key currency	Other major currencies	Notes	Forex system
~1914	GBP	None	GBP dominates global trade Gold standard with GBP as key currency	Fixed rate
1914~1944	GBP, USD	None	Interwar period between WWI and WWII USD emerges after Britain’s WWI defeat	Fixed rate
1944~1971	USD	GBP	Bretton Woods system launched Gold standard with USD as key currency	Fixed rate
1971~1999	USD	DEM, JPY	Gold standard collapses with Nixon Shock Floating exchange rates introduced	Floating rate
1999~2009	USD	EUR	EUR share in forex reserves approaches 30% but subsequently declines	Floating rate
2009~present	USD	EUR, CNY	RMB currency zone formed Increasing demand for gold as a stateless currency	Floating rate

already becoming a dominant business practice as USD progressively replaced GBP as the world's dominant reserve currency.

Although international trade transactions in such other currencies as RMB are increasing, the petrodollar system has not yet collapsed, and USD's global dominance has consequentially remained intact. The creation of EUR in 1999 seemed to have the potential to undermine USD's dominance, but as mentioned above, it was difficult for a currency that could not provide safe assets to become a dominant reserve currency. (The EU was lacking sufficient strength regarding the second of President Lagarde's three pillars – 'economic resilience'.) China's Belt and Road Initiative has expanded the scope of RMB-based transaction settlements, but it is generally thought that China is inspiring insufficient trust. (The country is not sufficiently strong regarding the third of President Lagarde's three pillars – 'legal and institutional integrity'.) The fact that there still appears to be no alternative to USD among national currencies is the reason why the use of gold – a kind of stateless currency – is on the rise.

Looking back at the past century, it appears that the lifespan of the USD-based single-reserve-currency system has been unusually lengthy. There is no basis for predicting the USD-centered system's collapse any time soon, but one should be prepared for the system to be progressively adjusted to some extent. Already, one can see that USD's share of global forex reserves is falling as gold's share rises. Slowly but surely, the signs of future currency system adjustments are beginning to emerge. Moreover, as the EU continues to implement various structural reforms, there may be room for a reconsideration of EUR's potential to increase its share of global forex reserves.

Strengthening EUR's Status with EU Joint Bonds

One thing that could realistically be expected to strengthen EUR's potential reserve currency status in the foreseeable future might be the expanded use of funds raised through EU joint bonds. Such EU joint bond issuance has so far been limited to areas in which EU members clearly share regional objectives – such as post-pandemic recovery and defense programs – but if the EU truly wants to strengthen EUR's reserve currency status, it should consider the more-general use of joint bond issuance as an expansionary fiscal tool to promote stronger economic conditions in member states. For example, the EU could employ joint bonds to assist member states that fall below the region's average economic growth rate or exceed the region's average inflation rate for a certain period of time. This may sound impractical, given the EU's (particularly the euro area's) history of repeated internal disputes about the equitable allotment of financial burdens.

However, it is worth recalling ECB President Lagarde's assertion at the end of her blog post, that – “This moment of change is an opportunity for Europe: it is a “global euro” moment. To seize it and enhance the euro's role in the international monetary system, we must act decisively as a united Europe taking greater control of its own destiny.” The EU has long found it difficult to implement measures to increase its members' fiscal integration, but making a more-resolute push to realize such measures is the kind of “decisive action” that many Europeans are hoping to see.

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