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Forex Medium-Term Outlook

December 26, 2025

Overview of Outlook

USD/JPY remained strong in December. It appears that the year will end with no end in sight for the simultaneous JPY weakening and JPY interest rate rise, driven by reflationary expectations from the Takaichi administration. There is widespread disappointment at JPY's weakening despite an interest rate hike, but one must remember that the BOJ, with limited cards (a 25bp rate hike) at its disposal, is not omnipotent; the reality is that it is being forced to clean up the mess left by its own reflationary policies. A political change is required to change the current situation. The government would do well to rein in statements suggesting unrestrained reflationary policies from those close to it, and then appeal to the market with a positive change of heart. Given that JPY is depreciating against a weak USD, as has been the case in 2025, analyzing JPY solely against USD no longer fully captures what is happening. The effective exchange rate and other factors are better indicators of recent JPY trends. JPY weakness appears to be driven mainly by two factors – extremely low real interest rates and changes in the JPY supply-demand structure. The latter, which was a major issue in recent years, is, however, showing signs of improvement, so the focus is shifting to the former. Now entering its fifth year, JPY weakness will likely require interest rate solutions, but correcting it may require raising the policy interest rate to around 1.50%. The political feasibility of this is unclear, but Japan should be concerned by the fact that rate-cut phases elsewhere are coming to an end even as Japan dilly-dallies over rate hikes. Rising interest rates overseas is bad news for Japan, which is trying to contain JPY depreciation.

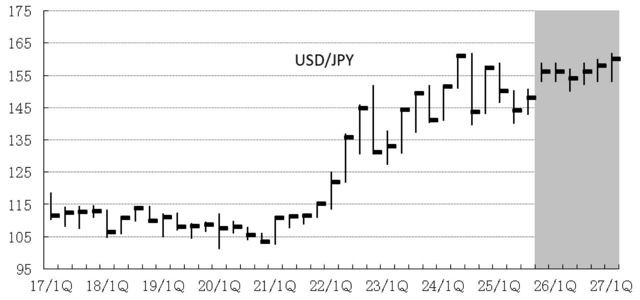
Meanwhile, EUR strengthened in December. As for the ECB's next move, the end of rate cuts is a given, but some market participants are also beginning to speculate about when the Bank may begin to start raising interest rates again. In this sense, there is a growing contrast between the ECB and the Fed, which has scope for further rate cuts, making EUR more likely to appreciate against USD. This would cause EUR to appreciate even more strongly against JPY, which is weakening even when compared with USD, making it entirely possible for EUR/JPY to reach 190 during the current forecast period. One should be prepared for the ECB's next move to be an interest rate hike, as March and June 2026 staff macroeconomic projections show gradual improvements. The ReArm Europe plan, which received favorable reviews from the euro area markets in 2025, will be gradually implemented from 2026 onward, which may also support a hawkish monetary policy stance. On the other hand, Germany, which is supposed to be the euro area's economic engine, is facing an economic contraction so severe as to be dubbed a "free fall," so we may still be some way away from consecutive interest rate hikes. One must also remember the historical precedent in the euro area, where an accommodative monetary stance was maintained for the surrounding countries out of consideration for "ailing Germany," thereby overheating these economies and triggering the European debt crisis. The euro area's economic and financial conditions must be assessed based on such long-term perspectives.

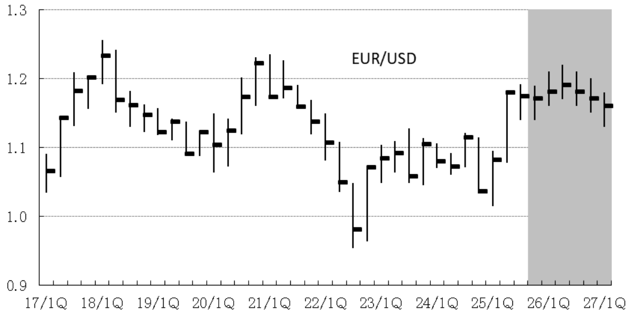
Summary Table of Forecasts

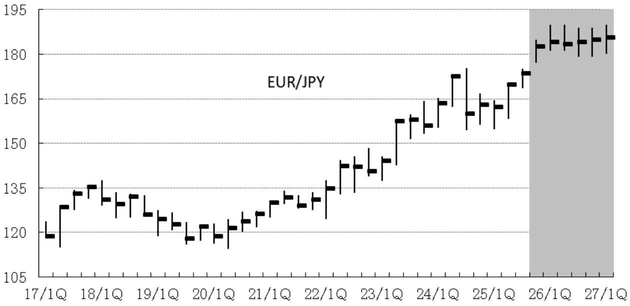
	2025 Jan-Dec (Actual)	2026 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2027 Jan-Mar
USD/JPY	139.89 ～ 158.88 (156.42)	153 ～ 159 (156)	150 ～ 157 (154)	152 ～ 159 (156)	153 ～ 160 (158)	153 ～ 162 (160)
EUR/USD	1.0125 ～ 1.1918 (1.1785)	1.16 ～ 1.21 (1.18)	1.17 ～ 1.22 (1.19)	1.16 ～ 1.21 (1.18)	1.15 ～ 1.20 (1.17)	1.13 ～ 1.18 (1.16)
EUR/JPY	155.63 ～ 184.91 (184.37)	181 ～ 190 (184)	181 ～ 190 (183)	179 ～ 189 (184)	179 ～ 189 (185)	180 ～ 190 (186)

(Notes) 1. Actual results released around 10 am TKY time on 26 December 2025. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts







USD/JPY Outlook - Japanese Economy Faces “Painful Choice” in 2026

JPY Now and Going forward – Beyond “JPY Depreciation Against Weak USD”

De-Dollarization and 25 Years of Being Linked With USD

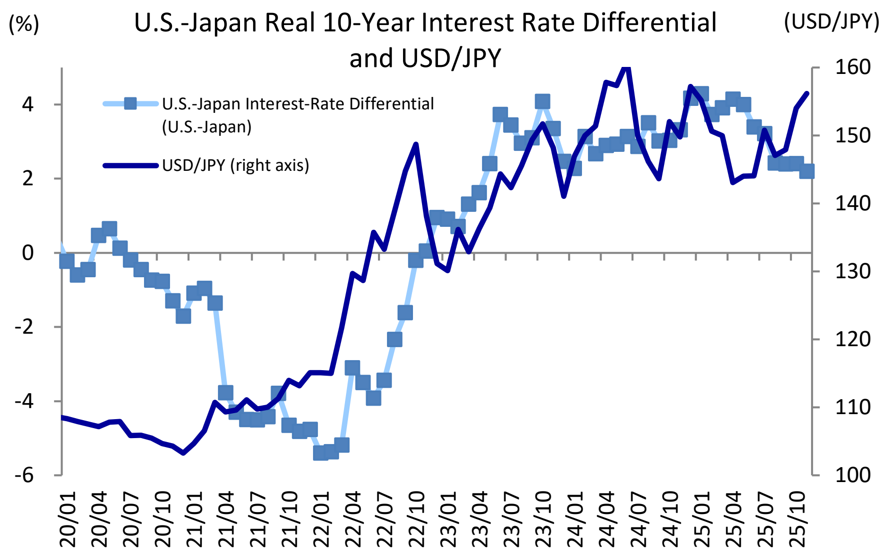
JPY depreciation did not end in 2025. De-dollarization became a theme starting April, as the second Trump administration deepened its isolationist stance, forcing USD into a historic, across-the-board decline. At one point in July, USD’s nominal effective exchange rate (NEER) decline widened to approximately -7% YTD. During this period, European currencies, led by EUR and CHF, were bought as USD weakened through July, but JPY was generally sold alongside USD. I believe this is owing to a perception of shared risk thanks to Japan’s high economic and security dependence on the U.S. <u>JPY depreciation amid USD weakness is a rare market phenomenon, and if the trend continues, the direction of JPY will become even more difficult to predict</u>.

Incidentally, the EUR buying spurt was driven by the belief that the European rearmament plan would achieve strategic independence in terms of security, and that the adoption of joint bonds as a funding source would also improve EUR’s status as a safe asset. <u>For roughly six months starting April, the main theme in the forex market was the erosion of USD’s status as a reserve currency. In that context, it was only logical that JPY was shunned due to the perception that Japan is tied to the U.S., while EUR was favored as Europe was seen as striving for independence</u>.

However, when USD bottomed out in mid-September, JPY failed to be chosen as a partner in this trend; rather, it has further plummeted since October. This clearly coincides with Sanae Takaichi’s election as LDP president on October 4, and is the result of the ongoing expansionary fiscal and monetary policies causing the currency’s erosion to become a hot topic. Looking at it this way, JPY’s market performance reflects a focus on the risk of being tied to USD in 1H of FY 2025 and on the risk surrounding the Takaichi administration in 2H of FY 2025. <u>In short, JPY performance in 2025 was characterized by a lack of buying power regardless of USD strength or weakness, and this will likely be a key point for 2026 and beyond</u>.

Key Points for 2026 Outlook

Given the current situation, how should one formulate the forecast for 2026? Let me briefly outline the key points. On the interest rate front, BOJ Governor Kazuo Ueda has expressed concern about the extremely low level of real interest rates, which suggests that the BOJ will continue with rate hikes. Starting 2022, the U.S.-Japan real 10-year interest-rate differential rapidly widened, demonstrating a stable correlation with JPY depreciation. Since the beginning of 2024, this interest-rate differential has remained roughly flat or narrowed slightly. In 2024, the BOJ ended its negative interest rate policy in March and implemented an additional rate hike in July, while the Fed began a phase of rate cuts in September. In 2025, the BOJ implemented a further rate hike in January, while the Fed further cut rates in September. This has significantly narrowed the U.S.-Japan nominal interest rate differential. However, since Japan's inflation rate has remained higher than that of the U.S. since mid-2024, the real interest rate differential has remained wide, with not much change (see graph). This may be seen as one reason why JPY weakness has not been corrected.



(Source) bloomberg

To correct JPY weakness, I believe the policy interest rate needs to be raised to at least around 1.50%. It is unclear whether the Takaichi administration would be able to tolerate such a hawkish stance. However, given Japan's concerns about a weak currency, it would be logical to consider raising interest rates in order to correct the unusually low real interest rate level before jumping into a currency policy fix (forex intervention). Japan has no choice but to accept either JPY weakness or higher interest rates now. Given the strong public opinion against JPY weakness, it may be difficult to avoid higher interest rates.

In this sense, if the Takaichi administration is unable to tolerate the required interest rate hikes, this could prove to be a major JPY depreciation risk. A clear-eyed analysis of the Japanese economy reveals that Japan must accept the pain of either JPY depreciation or higher interest rates (details below). Politically, JPY weakness may be the more acceptable option (again, details later).

Japan-China Relations Are a Risk Factor on the Supply-Demand Side

Let us take a look at JPY supply and demand. Between 2022 and 2024, as I will explain in detail later, extraordinary conditions caused by the pandemic and war resulted in enormous statistical current account surpluses but small cash-flow-based (CF-based) current account surpluses. It is my suspicion that in 2022 and 2023, Japan's CF-based current account balance was actually in deficit. However, even on a CF basis, 2025 posted a current account surplus comparable to that of 2019 and prior, with the JPY supply and demand environment continuing to improve. It is unfortunate that risks arising from Japan's ties to the U.S. and reflationary concerns surrounding the Takaichi administration have prolonged JPY weakness.

Barring a sudden rise in crude oil prices, a CF-based current account surplus similar to that of 2025 is possible in 2026. However, one ongoing supply-demand risk is the extent to which Japan-China relations will continue to deteriorate in the wake of Prime Minister Takaichi's remarks regarding a Taiwan emergency, and the extent to which this will cut into Japan's travel surplus. Japan's services deficit in recent years has been kept in check by the travel surplus offsetting its widening digital deficit. The recent turmoil is adding to growing concerns of inbound tourism demand peaking, so the services deficit may no longer help to significantly shrink the overall goods and services deficit.

If, just as the expanding trade deficit finally begins to stabilize, the travel surplus begins to decline, causing the overall services deficit to widen, the supply-demand climate may remain largely unchanged from 2025 or even worsen. China has also announced a policy to once again suspend imports of Japanese seafood, which itself will lead to a widening deficit due to restrictions on Japanese exports. More such factors are likely to emerge with each passing moment if the restoration of relations is delayed, and their implications will have to be considered on a case-by-case basis.

Controlling the Flow of Information

Given the volatility in the bond and forex markets since the Takaichi administration took office, I think the government and ruling party need to control the flow of information. For instance, in the October-December period, even as Finance Minister Satsuki Katayama expressed concern about JPY weakness, private economists who serve as economic advisors to the government called for postponing interest rate hikes, a very large supplementary budget, and even the need for currency intervention.

As of the time of writing, the situation has not changed significantly, and one cannot help feel that this is complicating the BOJ's already shaky rate-hike intent (details later). Of course, the government's views on fiscal, currency, and monetary policy are primarily disseminated through communication from the finance minister or BOJ governor.

However, financial markets are impulsive, and attention-grabbing information from economists close to the government can easily influence behavior (this is particularly true for overseas investors). At a time when market turmoil is a concern, it would be safer for the administration to exercise some control over unrestrained rhetoric.

The Need for a Multifaceted Analysis of JPY Weakness

JPY depreciation, which began in 2022, is entering its fifth year in 2026. Understanding this phenomenon, which can no longer be described as temporary, requires a multifaceted analysis. This means tracking JPY movements not just against USD, but also based on its effective exchange rate, as mentioned earlier; viewing the domestic-foreign interest rate differential on a real rather than nominal basis; and of course, also taking into account fundamental factors such as supply and demand and fiscal conditions. In the forex market, USD/JPY and the nominal U.S.-Japan interest rate differential are often plotted on the same graph, which makes it easy to focus on the correlation between the two. This approach was successful in the past because JPY interest rates were static, which created a stable direct correlation between USD/JPY and USD interest rates. Now that Japan has returned to an "era of interest rates" with inflation, it has become necessary to also examine the implications of the changes in the economic and financial conditions behind the rise in JPY interest rates.

Regarding the simultaneous JPY depreciation and rise in JPY interest rates, which began in earnest in 2025, it is necessary to begin our analysis while also keeping in mind the possibility that a certain fiscal risk premium is being demanded. Is JPY depreciation against a weakening USD a temporary phenomenon? Or is it the new normal? 2026 may reveal the answer to this question.

BOJ Monetary Policy Now and Going Forward – Monetary Policy Turning into Currency Policy

Dual Messaging Aimed at the Markets and the Political Establishment

At its December 18-19 Monetary Policy Meeting (MPM), the BOJ raised the short-term interest rate (uncollateralized overnight call rate) by 25 bp from 0.50% to 0.75%. As reported, this is the highest policy interest rate in 30 years. While the nominal value has no inherent meaning, it is a symbolic event suggesting Japan's transition from deflation to inflation. Of course, as stated in the official statement, "real interest rates are at significantly low levels," which is why JPY weakness is not being corrected. The accompanying document, "(Reference) Decision at the December 2025 Monetary Policy Meeting," states, "Real interest rates are expected to remain significantly negative, and accommodative financial conditions will continue to firmly support economic activity" (the underlined portion is highlighted in red in the document). It then goes on to state, "(the Bank) will continue to raise the policy interest rate and adjust the degree of monetary accommodation," indicating the stance that this is simply an "adjustment of the degree of monetary accommodation," not a "tightening." The dual messaging – one to the market to say, "monetary policy remains accommodative and will continue to be tightened," another to the political establishment saying, "monetary policy has been tightened but remains accommodative" – reveals the BOJ's anguish at being forced to navigate a difficult path.

Note, moreover, that the Ueda administration, which has to clean up the mess left by the reflationary policies of the former BOJ administration under Haruhiko Kuroda, has been marching forward with determination, having successfully lifted interest rates out of the negative and brought them to the highest level in 30 years. Despite the mixed reviews, this normalization process deserves praise. JPY depreciation has not ended, but this is not entirely the fault of the BOJ, and it is not fair to criticize the Ueda administration for it.

The Neutral Interest Rate Controversy and JPY Weakness

Following the MPM, the question I received the most inquiries about was, "Why did JPY weaken despite the rate hike?" Intuitively, one suspects this was due to the prominence of the message that monetary policy was still accommodative. However, a more fundamental reason may be that a 25bp rate hike is insufficient to offset the strong inflation expectations fanned by the Takaichi administration.

The BOJ's messaging undoubtedly encouraged JPY selling. As the rate hike itself was a given, it was thought that the key point at this meeting was to foster expectations that this was not the end. Some speculated that raising the estimated neutral interest rate could be used as a tactic, but Ueda provided no concrete information, merely stating, "Estimates vary considerably, making it difficult to get right in advance. (…) We will re-estimate as necessary." Regarding the level, he stated, "Even after raising interest rates, we are still some way away from the lower bound of the neutral rate." Given that the current interest rate level 0.75% is still slightly (25bp) lower than the previous lower limit of the neutral rate (1.00%), nothing has changed. Nor was there any reason to hope that this was not the end of rate hikes. If it is expected that real JPY interest rates will remain stable at low levels, JPY selling will continue. One wonders what the intention behind repeated information releases about revisions to the neutral interest rate estimates since early December really was. Those information releases seem to have been unnecessary.

Of course, even if the lower bound of the estimated neutral interest rate range (currently 1.00-2.50%) had been raised to 1.50%, in a market that interprets the "lower bound of the estimated range" to be the "practical upper bound," JPY selling may quickly have resumed based on the assumption that the Bank would raise rates three more times (totaling +75bp) at most. After all, revising the neutral interest rate estimate or publishing it on a timely basis is just a tool for buying time. Deciding to withdraw from such endeavors may be a bold decision on the part of the Bank, as history and other countries' experience shows that forex market counterplay knows no bounds.

No matter how one looks at it, the JPY exchange rate is the biggest explanatory variable in the BOJ's current policymaking, so monetary policy has inevitably become currency policy. Once monetary policy becomes currency policy, lofty and sophisticated ideas such as estimating the natural interest rate (i.e., neutral interest rate) become meaningless, and policy decisions end up at the mercy of forex rates. It would be wise on the BOJ's part to decide not to release estimates rather than have those estimates used as playthings by the markets.

Rethinking Reflationary Policy is the Only Option

Overall, the BOJ is doing its best. The real problem is that, given the strong political stance favoring reflation, JPY selling cannot be fully contained. It is unclear where the neutral interest rate (more precisely, the terminal rate for the current rate hike phase) lies. Even assuming it is 1.75%, an estimate that is higher than the market consensus, that only indicates four more rate hikes (a total of +100 bp). Given the imminent end of rate cuts by the ECB and the Fed (details below), the BOJ would have liked to correct JPY depreciation as much as possible with a single rate hike. Unfortunately, its rate hike ended up accelerating JPY depreciation instead. Perhaps it was inevitable. The BOJ is fighting this battle alone, even as economic advisors to the prime minister take turns preaching the effectiveness of expansionary fiscal and monetary policies through various media outlets, and this is also disseminated to overseas markets in English. This acts as noise for the BOJ in its effort to maximize the impact of a single rate hike. In other words, a +25bp rate hike gets drowned out amid inflation expectations being fanned by the Takaichi administration. As mentioned above, interest rates have not kept pace with the rising speed of inflation expectations. Of course, the BOJ also bears some responsibility for repeating its assertion, in the face of rising inflation, that given the underlying trend, it is still too early (to implement aggressive rate hikes). However, this too may have been a decision made after carefully considering the appropriate distance from politics.

As mentioned above, some argue that the BOJ's communications emphasizing low real interest rates and accommodative monetary policy are fueling JPY depreciation. But would a rate hike of +50 bp or +75 bp have been sufficient? Indeed, a rate hike of this magnitude might have curbed JPY depreciation. However, it would undoubtedly have caused the Nikkei average to plummet, weakened consumer and investment appetite in the Japanese economy, and led to strong criticism as the "Second Ueda Shock," following from the August 2024 one. Ultimately, the only option was to raise interest rates by +25 bp. This is precisely why the government and the BOJ must work together to communicate cautiously and maximize the impact of each rate hike. To restore stability to the bond and forex markets, they must curb the dissemination of information about unrestrained reflationary policies and demonstrate to the market that the Takaichi administration has changed course in a positive direction.

One must refrain from holding the BOJ all-powerful in its monetary policy, and causing discussions to become superficial. Japan is unique among developed countries in its argument for entrusting its economic policy (monetary policy) entirely on the central bank.

Japanese Economy Now and Going Forward – A Painful Choice

Japan Must Put up With Higher Interest Rates in 2026

"Will JPY appreciate if the BOJ raises interest rates?" This has been one of the most frequently asked questions in 2025. The December MPM saw accelerated JPY selling following a rate hike, but as mentioned above, this situation is likely to repeat unless the government's basic stance changes to some extent. For the BOJ, anything more than 25bp per rate hike will be difficult. Having said that, the ongoing JPY depreciation phase is very likely to be driven by changes in the JPY supply and demand structure and extremely low real JPY interest rates, and the BOJ's rate hike is a move to directly correct the latter. It would not be wrong, therefore, to say that repeated rate hikes are likely to help curb JPY depreciation. Even considering the still wide U.S.-Japan interest rate differential, JPY depreciation since October appears somewhat excessive. If the BOJ were to suddenly shift to a clearly hawkish stance, there is a chance JPY would appreciate, accompanied by significant volatility.

Trilemma of International Finance

		Adopting countries			
	Policy objective	U.S.	Japan	Euro area, HK, etc.	China, etc.
1	Independent monetary policy	○	△～○	×	△～○(※)
2	Free capital movement	○	○	○	×
3	Stable exchange rates	×	△～○	○	△～○

(Source) Prepared by the author

*However, in the case of China, the State Council is responsible for monetary policy operation.

Having said that, the current situation of raising interest rates to prevent JPY from weakening is essentially a currency policy move, and going by the "monetary trilemma," one can say a "stable exchange rate" is being traded for a "sovereign monetary policy" (see graph). In my books, this report, and various media outlets, I have stated that "Japan is at a point where it must tolerate either JPY weakness or rising interest rates." In reality, the Japanese economy is at a point where it has decided to tolerate rising interest rates because it can no longer tolerate JPY depreciation. Over the past three years, Japan has continued to intervene in the forex market by buying JPY and selling USD while keeping real interest rates extremely low. In other words, it has been working to escape the monetary trilemma because it does not want to tolerate either a weaker JPY or rising interest rates.

However, currency intervention is a political issue involving other parties and is difficult to normalize given the technical limit to selling one's own currency. Ultimately, Japan has been unable to escape the monetary trilemma and has reluctantly embarked on interest rate hikes. However, even if raising interest rates manages to halt JPY depreciation, it will shift the market phenomenon the public must tolerate from exchange rate problems to interest rate problems, and does not fundamentally solve the problem. This development was inevitable when the BOJ embarked on quantitative tightening (QT), but the Takaichi administration's arrival has triggered an unexpectedly early alarm from the bond markets.

Is JPY Weakness Politically More Palatable?

I mentioned that the market phenomenon the public must tolerate has shifted from exchange rate to interest rate problems without fundamentally solving anything, but in reality, rising interest rates may be more painful than JPY weakness. If interest rates continue to rise in exchange for reining in JPY depreciation, this will naturally reduce consumption and investment appetite among households and businesses, thereby curbing economic growth. In the case of JPY weakness and inflation, the deterioration of the real income environment dampened consumption and investment appetite. Regardless of the cause, the outcome seems to be the same for the household sector.

In the case of JPY weakness, however, a number of economic entities benefit from it, including large corporations and the export manufacturing and tourism industries. Even for households, their growing investment in foreign currency-denominated assets can serve as a defense against inflation led by JPY weakness. On the other hand, rising interest rates pose a headwind for most economic entities. While the boost in interest income for the private sector is a positive, this is not comparable to the boost to corporate profits from JPY depreciation and the accompanying stock market appreciation (and the associated wealth effect). Rising interest rates may be especially painful for the working generation, with modest assets (and mortgages to pay). Rigorous calculations and verifications are needed to say anything for sure, but it is possible that a broader segment of the population would generally find a rate hike to be more difficult to put up with.

When it comes to political decisions, we must also remember that the Takaichi administration's support base leans toward the younger generations. This being the case, JPY weakness seems likely to be the better political option than higher interest rates.

The CEFP Must Show How the Domar Condition Holds True

First of all, rising interest rates are crucially different from JPY depreciation in that they directly increase the burden on national finances. JPY depreciation contributes to improving fiscal conditions via an inflation tax, while rising interest rates worsen them. As interest rates rise, the debt servicing costs will gradually increase for the government, starting with the refinancing portion. Moreover, the uninterrupted growth in nominal GDP will come to a halt if inflation settles as a result of ending JPY depreciation. If that happens, would the "net debt outstanding ÷ nominal GDP" ratio, which the Council on Economic and Fiscal Policy (CEFP) under the Takaichi administration touts as a fiscal indicator for an inflationary era, continue to improve? If one assumes interest rate hikes accompanying an expansionary fiscal path, the CEFP owes an explanation for the causal relationship between the BOJ's interest rate hikes and improvement in the net debt outstanding ÷ nominal GDP ratio. Given that reflationists argue that rising debt leads to higher interest rates and a stronger JPY (the Mundell-Fleming controversy), it is reasonable to conclude that the rise in interest rates accompanying an expansionary fiscal policy is premised on this mechanism.

The Domar condition states that as long as nominal GDP growth (g) exceeds nominal long-term interest rates (r), i.e., $r<g$, the ratio of government debt to nominal GDP will remain stable. The debate is essentially over whether the Domar condition holds true, and it can be said to be the theoretical backbone of the CEFP's argument. The key rationale behind the expansionary fiscal policy advocated by reflationists is that increasing debt is not a problem because it will provide the earning power (economic growth) to repay that debt (hence upholding the Domar condition). However, if so, the following questions must be answered: How can growth rate above long-term interest rates be achieved under rising interest rates that will dampen private demand? What exactly are the growth drivers? There are no convincing answers to these questions yet.

"This is How it Should Work in Theory" is not Acceptable

At the very least, anyone advocating for expansionary fiscal policy based on the Domar condition ($r<g$) must explain these three points: (1) the negative impact of rising interest rates on economic growth; (2) the negative impact of rising interest rates on interest payments; and (3) the positive impact of expansionary fiscal policy on economic growth. They must show evidence of the Domar condition being met by the positive impact from (3) being greater than the negative impact from (1) and (2) combined.

"This is how it Should Work in Theory" is not acceptable – the simultaneous JPY depreciation and increase in interest rates since October have raised doubts about exactly this. Various arguments are made about this in economic forums, but it is an undeniable fact that the present unfavorable market conditions are the result of losing the trust of financial markets, which are the main source of funding. One hopes that policymakers will take this situation seriously.

As mentioned above, rising interest rates will likely cause greater pain to the public than JPY depreciation. To what extent will expansionary fiscal policy boost which parts of the real economy, leading to the establishment of the Domar condition? A detailed explanation is called for, now that the government is championing fiscal indicators for an inflationary era.

U.S. Monetary Policy Now and Going Forward – Clouds Hang Over 2026 Rate Cut Path

Powell Administration Rate Cuts Hit a Wall

At the final FOMC meeting of the year, the Fed decided to lower the federal funds (FF) rate by 25 bp for the third consecutive meeting, setting the target range for the FF funds rate at 3.50% to 3.75%. Three members voted against the decision, and the statement was somewhat cautious regarding the timing of the next rate cut, saying "the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks." Fed Chair Jerome

Powell noted, "The adjustments to our policy stance since September bring it within a range of plausible estimates of neutral and leave us well positioned to determine the extent and timing of additional adjustments to our policy rate." The term "well positioned" is frequently used also by ECB President Christine Lagarde, suggesting that the Fed and the ECB may both be in a wait-and-see mood.

Deepening internal conflicts within the Fed will inevitably become key to formulating policy outlooks. The number of dissenting votes in favor of maintaining interest rates increased from one to two (President Jeffrey Schmid of the Kansas City Fed joined by President Austan Goolsbee of the Chicago Fed), and Governor Stephen Miran voted against the move, arguing for a 50bp cut, making the financial situation more complicated.

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

FOMC Date	2025	2026	2027	2028	Longer run
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%
Dec-25	3.625%	3.375%	3.125%	3.125%	3.0000%

(Source) FRB

Looking at FOMC members' FF rate projections (median value, dot plot), six members supported an FF rate level (median of the target range or level) of 3.875% at the end of 2025, which would amount to maintaining the target range at 3.75% to 4.00%. This means that, in addition to the two regional Fed presidents with voting rights, four others potentially voted against the move. It appears that uniting regional Fed presidents wary of inflation risks in favor of a rate cut may no longer be easy.

Taking a deeper look at the dot plot projections for 2026, seven of the 19 participants predicted no rate cuts in 2026, four predicted one additional rate cut, four predicted two, two predicted three, and one predicted four, indicating a diverse range of opinions. Despite a cumulative 75bp rate cut in September, October, and December, the FF rate projection for the end of 2026 remains unchanged in the dot plot (see chart). As Powell stated, the series of rate cuts likely signaled that economic and financial conditions have stabilized and no further policy changes are needed.

Likely Just One Rate Cut in 2026; Two at Most

Looking at the Summary of Economic Projections (SEP) by FOMC members, real GDP growth forecasts were revised upward, unemployment remained flat, and inflation was revised slightly downward. The impact of the hike in tariffs is expected to peak in the January-March quarter of 2026, and some also predict a limited impact. Therefore, concerns that Trump tariffs will drive up inflation have not materialized at this time. However, Powell remained cautious on this point, stating that there were diverse opinions among members regarding the risk of Trump tariff effects persisting longer than expected and the risk of labor market tightening. A scenario in which inflation could rise going forward has also not been ruled out. Several regional Fed presidents appear to be paying attention to such a scenario judging from the distribution of projections in the dot plot.

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

	2025	2026	2027	2028	Long-term outlook
Real GDP growth rate (As of September)	1.7 (1.6)	2.3 (1.8)	2.0 (1.9)	1.9 (1.8)	1.8 (1.8)
Unemployment rate (As of September)	4.5 (4.5)	4.4 (4.4)	4.2 (4.3)	4.2 (4.2)	4.2 (4.2)
PCE deflator rate (As of September)	2.9 (3.0)	2.4 (2.6)	2.1 (2.1)	2.0 (2.0)	2.0 (2.0)
PCE core inflation rate (As of September)	3.0 (3.1)	2.5 (2.6)	2.1 (2.1)	2.0 (2.0)	

(Source) FRB

Under these circumstances, it seems wise to assume that there will be at most two rate cuts in 2026, but more likely just one. As previously discussed in this report, once the new administration takes office, it is quite possible that it will turn out not to be as dovish as suggested, with fewer rate cuts than assumed. Such a situation could trigger a renewed U.S. interest rate increase and USD strength.

Fed and BOJ Political Responses Likely to Diverge

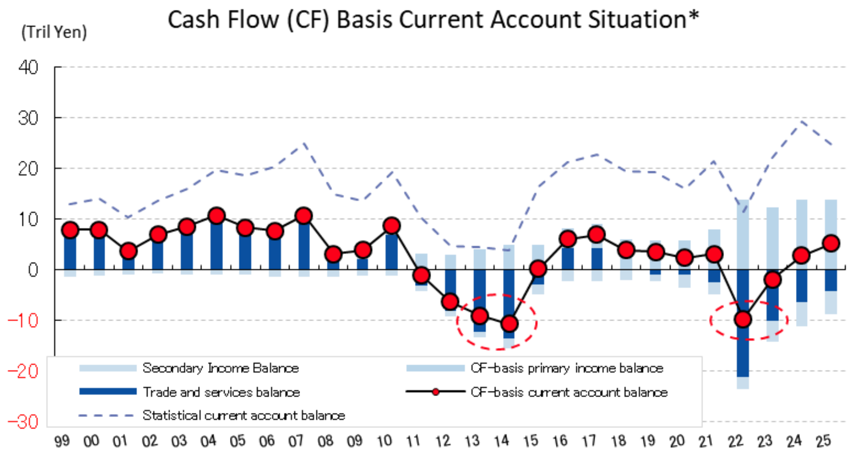
Overall, the impression from the recent FOMC meeting is that the Fed is unlikely to be able to cut interest rates as much as expected, further propping up USD/JPY, which remains elevated. Currently, the BOJ is tasked with curbing JPY depreciation through interest rates, but the outlook is highly uncertain. As mentioned above, the December interest rate hike did not curb JPY depreciation; instead, it accelerated it due to the perception that rate hikes had reached an end. On December 3, Reuters quoted a senior economic ministry official as saying, "Takaichi is extremely wary of losing public support due to an economic downturn caused by a rate hike. Having asserted that the government will take responsibility, she can see that the opposition parties will press her on how she proposes to do so." It is true that, leaving aside the December rate hike, which had been planned in advance, for monetary policy decisions made from 2026 onward, the opposition parties are certain to press the Takaichi administration to accept responsibility for everything including BOJ rate hikes. Reaching the real interest rate level of early 2022 will likely require raising the policy interest rate to 1.50%, but the hurdle for the Takaichi administration to approve such a rate hike appears high.

In a situation where the Fed, despite political will, is unable to cut interest rates to the extent expected, and the BOJ, in line with political will, is unable to raise interest rates to the extent expected, the real U.S.-Japan interest rate

differential will remain unchanged, and JPY weakness will not be corrected. The contrast between the Fed, which does not succumb to political pressure, and the BOJ, which does, may also become the focus of attention. In light of the monetary trilemma mentioned above, the question for Japan now is whether to choose JPY weakness or rising interest rates as its preferred type of pain. From the perspective of politics, which prioritizes short-term public support, JPY weakness is more likely to be chosen, as it results in higher stock and asset prices.
Increasingly, the word "pause" is being used in conjunction with interest rate cuts by major central banks including the Fed and the ECB (details later). This should ideally trigger a sense of crisis in the Japanese economy, suffering from JPY depreciation as it is. If the Fed and ECB begin to consider the possibility of raising interest rates under these circumstances, the next phase of JPY depreciation for Japan will begin from the current JPY150 level.

JPY Supply and Demand Climate – Equilibrium Between "Human" vs. "Digital" Balances Breaking Down

On Track to Record-breaking Current Account Surplus for the Second Consecutive Year
Let us take a more detailed look at the JPY supply-demand climate. In December, the Ministry of Finance released Japan's October balance of payments statistics. The headline highlighted the +JPY2.8335 trillion current account surplus, the largest single-month surplus ever recorded for October. As usual, this was supported by a primary income surplus of JPY3.4646 trillion, also the largest single-month surplus ever recorded for October. The YTD current account surplus stands at JPY27.6793 trillion, putting it within sight of the record +JPY29.3719 trillion surplus for 2024, with two months still remaining. A current account surplus of JPY1.6926 trillion each is all that is needed for November and December to match the 2024 full-year current account surplus. Given that the current account surplus for November-December 2024 was JPY4.4107 trillion, 2025 is almost certain to set a new record for the largest current account surplus for the second year in a row.
Of course, in terms of cash flow, i.e., the amount actually converted into JPY, the total for January-October was about +JPY5.3 trillion, which is roughly one-fifth of the statistical surplus, but it is undeniable that the JPY supply and demand climate is improving. Incidentally, two factors are responsible for the improvement in the CF-based current account balance: 1) the primary income surplus is being converted into JPY at a slightly higher pace than last year, and 2) the trade deficit is shrinking. Regarding (1), the CF-based primary income surplus for the full year of 2024 was approximately +JPY13.9 trillion, and the same level has already been reached for the January-October 2025 period.



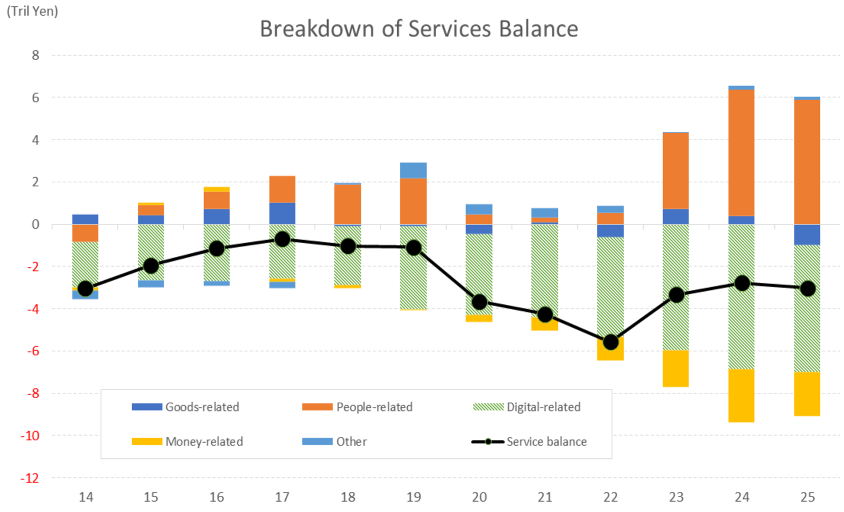
(Source) Bank of Japan. For 2025 data until October.
Notes: Regarding receipts and payments of primary income, balance, the "reinvestment income" of direct investment income and "dividends" of securities investment income and "bond interest, etc." are de

JPY conversion from the primary income surplus is likely to be even larger for the full year of 2025.

Lackluster Trade Balance via Both Imports and Exports
Point (2) above represents a larger improvement. The trade deficit for the January-October period totaled -JPY3.8336 trillion in 2024, but less than half that at -JPY1.5258 trillion this year. While changes in the structure of the services balance (discussed below) remain an important issue in the medium to long term, it is the trade deficit that has had a decisive impact on JPY supply and demand since 2022 (largest on record in 2022, fourth-largest in 2023, and sixth-largest in 2024 in terms of deficit value).
In light of this, trade balance figures will be important when considering the JPY supply and demand structure for 2026. Many are predicting a yoy decline in Japan's exports due to impact from the Trump tariffs. However, given that the 15% reciprocal tariff imposed on Japan is the lowest imposed on U.S. trade partners globally, it is unlikely that Japanese products alone will be at a competitive disadvantage, so one is not overly pessimistic. Rather, as long as JPY remains weak, exports may remain strong on a value basis. Meanwhile, there may be a decline in Japanese exports to China, including general machinery (e.g., semiconductor manufacturing equipment) and electrical equipment (e.g., semiconductors and other electronic components) as the Chinese economic stagnation deepens due to the direct impact of exports to the U.S., the ongoing slowdown in real economic growth, and the U.S.-China trade friction. Overall, I predict Japan's exports will remain roughly flat or decline. On the other hand, assuming a stabilization of resource prices, imports are not expected to show any significant upswing. Assuming Chinese economic stagnation, exports will decline, but imports will also decline correspondingly as resource prices stabilize. With both exports and imports contracting, my current basic understanding is that this will be a year in which we can hope for an overall improvement in the trade balance.

Will the "People" vs. "Digital" Balance Equilibrium be Disrupted in 2026?

Even if the trade balance improves slightly, there is a risk that the services balance will crumble in 2026. For the January-October period this year, the services deficit was -JPY2.8115 trillion, only slightly different from last year's -JPY3.0552 trillion. When broken down into five categories: goods, people, digital, money, and other, the people-related surplus, which is roughly equivalent to the travel surplus, was +JPY5.4425 trillion, while the digital-related balance was -JPY5.6044 trillion, roughly the same. Japan's services balance remains in a tug-of-war between the people and digital categories, with digital dominating slightly. Add in the deficit from monetary transactions (-JPY1.9497 trillion) reflecting overseas reinsurance payments, and the overall picture is a deficit of around JPY3 trillion.



(Source) Bank of Japan "Globalization of Service Transactions from the Perspective of Balance of Payamemts Statistics."
*Data for 2025 was annualized.

However, given the current situation, there are serious doubts about whether this pattern can be maintained in 2026. As is well known, a solution to the diplomatic standoff with China remains elusive; rather a further deterioration in relations seems likely. Numerous reports have surfaced regarding a wave of cancellations by Chinese tourists, but it may be some time before the statistical figures can be confirmed. If a large number of Chinese tourists, who are the biggest spenders among foreign visitors to Japan, keep away from Japan, the travel surplus will undoubtedly decline. Amid existing concerns about overtourism, the "that's fine" sentiment is understandable, but things are not that simple if we consider the medium- to long-term JPY supply-demand balance from the perspective of forex rates. It is thanks to the expanding travel surplus that the services deficit has remained moderate in spite of the expanding digital deficit. The travel surplus in 2025 may post an all-time high at just under JPY7 trillion, but it will not be that much larger than in 2024 (JPY6.1172 trillion). The post-pandemic jump in yoy performance can no longer be taken for granted, and the fact that the recent tensions with China coincide with the travel surplus approaching a plateau may not yet be fully recognized. If relations with China continue to deteriorate, the equilibrium between the people and digital balance will be disrupted, resulting in a larger services deficit than the previous year for 2026.

Interest Rates Suggest JPY Appreciation; Supply-Demand Suggest Depreciation?

Most straightforward forecasts predict that the BOJ will continue its steady interest rate hike trajectory in 2026, correcting the extremely low real interest rate. Looking at the U.S., the Fed is also expected to operate with a strong dovish bias under a Trump-leaning chair, so it is natural to assume a narrowing of the real interest rate differential between Japan and the U.S. If this assumption is met and there is no significant deterioration in the JPY supply and demand balance, it may be possible to avoid a year of JPY depreciation for the first time in four years. However, year-end monetary policy predictions for the coming year tend to have a high degree of uncertainty.

By contrast, it is relatively more likely that the travel surplus will decline due to tense Japan-China relations, and the overall services deficit will expand led by the digital deficit going forward. While the existence of a digital deficit is widely known, its impact on the services deficit has not received much attention thanks to the expanding travel surplus. With the Japanese economy facing labor supply constraints, it was inevitable that the travel surplus, driven by the tourism industry, would plateau sooner or later, but 2026 may be the year that this becomes visible. This will be an important point in analyzing JPY supply and demand going forward.

Risks to My Main Scenario – Frightening Risk of Further JPY Depreciation in 2026

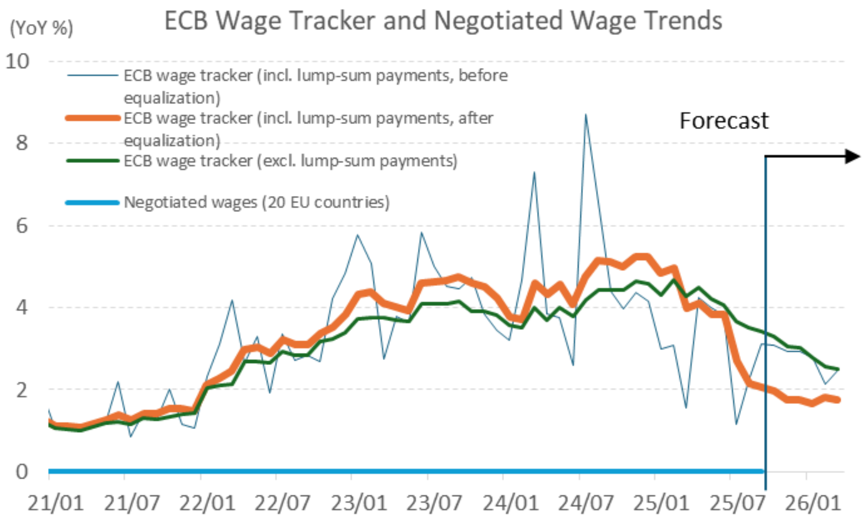
Western Central Banks Gradually Returning to Inflation Vigilance?

The BOJ's December 19 interest rate hike has not corrected JPY's excessive depreciation, and the financial markets can be expected to continue debating the questions of "how many more rate hikes are possible" and "whether the hikes will eventually restrain the JPY depreciation trend." Those questions are focused on the relationship between JPY interest rates and JPY exchange rates in isolation, however, and if overseas interest rates begin rising again, any temporary JPY depreciation corrections achieved via JPY interest rate hikes may quickly be rolled back. As discussed above, current FOMC members' views suggest that the number of Fed interest rate cuts in 2026 is likely to be limited. The upcoming addition of Trump-supporters as Fed chairman and new FOMC members may strengthen support for dovish policies, but there will remain a risk that politically motivated monetary easing policies will fuel inflationary expectations. Given that risk of unnecessarily boosting inflation expectations, the Fed may well have concluded that status quo maintenance would be wiser than additional interest rate reductions. In any case, there is no reason to anticipate that current concerns (particularly evident among regional Fed bank presidents) about potential inflationary pressures on employment and wage markets will recede in 2026.

Regarding the ECB, which has paused its interest rate cuts for quite some time, ECB Executive Board Member Isabel Schnabel said on December 8 – “both markets and survey participants expect that the next rate move is going to be a hike, albeit not anytime soon. [...] I’m rather comfortable with those expectations.” Even in September, Executive Board Member Schnabel said – “I think the point where central banks around the world start to hike interest rates again may come earlier than many people currently think.” – suggesting that the “next move” might be a rate hike. Furthermore, Reuters reported on December 3 that ECB Chief Economist Philip Lane had said euro area inflation rates had recently been rising, casting doubt on the ECB’s forecast of an inflation rate decline in early 2026. The ECB had forecast that the euro area consumer price index (HICP) would be pushed downward in early 2026 due to the base effect of falling energy prices, but it appears that the actual situation may have unexpectedly deviated from the expected scenario. <u>While the Fed and ECB may not yet be prepared to explicitly state they will begin shifting emphasis toward inflation countermeasures, the banks’ recent communications do suggest that we are not in a situation in which where we can blindly take it for granted that that the “next moves” will be rate cuts</u>.

ECB and Fed Quick to Change Course

Given the above situation, <u>it may be best to reconsider our expectations regarding 2026 policy moves by the Fed and ECB – the key question may not be “how many rate cuts they can make,” but rather “whether they will stop cutting rates” or even “whether they will hint at prospective rate hikes</u>.” Looking at the period through September 2026, current expectations are that the ECB will implement zero rate cut rates and the Fed will implement about two rate cuts. The anticipated degree of rate cuts is so low that it would not be so surprising to see small monetary policy posture shifts move expectations away from cuts and perhaps even toward interest rate hikes. Although ECB Executive Board Member Schnabel did mention the possibility of a rate hike, an ECB rate hike in 2026 does not seem realistic in light of prospective deceleration in the pace of wage increases (see graph on next page), but this should not be considered a basis for factoring in additional interest rate cuts. <u>Some wage tracker indices (particularly those that include lump-sum payments and are equalized) even appear to suggest that wage declines are bottoming out</u>. On November 26, one week before his December 3 comments mentioned above, ECB Chief Economist Lane said in an interview that – “We’re confident [sustainability of inflation at 2%] is going to happen because everything we look at tells us wage dynamics are set to decelerate further.” <u>Looking at that statement along with the December 3 comments, however, it seems possible that that it is simply difficult at this time to confidently project the prospective pace of wage increases</u>.



(Source) ECB, macrobond

<u>In any case, while the BOJ adjusts its monetary policy course very slowly (requiring several months to carefully consider a single +25bp rate hike), the Fed and ECB, once they have decided to change their monetary policy course, have a strong tendency to continue adjusting their policy rates in the new direction for quite some time</u>. Accordingly, although it may be difficult for the Fed or ECB to actually change course toward raising interest rates in 2026 (still a risk scenario), it should be recognized that there is a real risk that, as soon as such a course change is hinted at, financial market participants will immediately face market conditions reflecting a period of anticipated rate hikes. Since the markets tend to only price in the most extreme scenarios, <u>the moment the central banks indicate the possibility of a rate hike, the markets will initiate the game of predicting the “first rate hike”. Accordingly, one should be particularly wary about possible developments during the second half of 2026</u>.

<u>The most frightening potential scenario is one in which the Fed and the ECB both terminate their rate cuts while the BOJ continues to hesitate to further hike interest rates</u>. It is not yet clear exactly what level USD/JPY would be at the time such a scenario takes shape, but <u>it is possible that the next period of JPY depreciation could start with USD/JPY at roughly its current level (around JPY150)</u>. Of course, such a scenario will not take shape if JPY interest rates are gradually raised, but because the Japanese government and the BOJ are not likely to have the courage to raise rates at the same pace as Europe and the United States, they cannot be expected to resolutely maintain policies designed to correct JPY’s excessive weakness. This article has already discussed how 2026 will likely be a year in which the Japanese economy suffers painful side-effects of seeking “exchange rate stability” amid the “international financial trilemma.” If it becomes clear that European and American central banks will cease their rate cuts, the intensity of that pain will inevitably increase.

EUR Outlook – Interest Rate Hikes Suddenly Attracting Greater Attention as the "Next Move"

EUR Area Monetary Policies Now and Going Forward – The ECB's Focus on Neutral Interest Rates

Approaching the Inflation Rate Target

ECB Staff Macroeconomic Projections (December 2025) (%)

	2025	2026	2027	2028
HICP	**2.1**	**1.9**	**1.8**	**2.0**
(previous: Sep 2025)	2.1	1.7	1.9	-
Core HICP	**2.4**	**2.2**	**1.9**	**2.0**
(previous: Sep 2025)	2.4	1.9	1.8	-
Real GDP	1.4	1.2	1.4	1.4
(previous: Sep 2025)	1.2	1.0	1.3	-

(Source) ECB, EUR/USD exchange rate for 2025 assumed to be 1.13 and for 2026-28 assumed to be 1.16.
*Core excludes energy and food

The ECB's Governing Council meeting on December 18 decided to keep the deposit facility rate and other key policy rates unchanged – the fourth consecutive meeting to maintain the status quo. The meeting's decision was in line with market expectations and was unanimous. At the post-meeting press conference, ECB President Christine Lagarde rejected the idea of continued rate cuts, which was also generally in accord with market expectations. At the September 11 Governing Council meeting (two meetings prior to the December meeting), ECB President Lagarde asserted – "Let me say this: the disinflationary process is over" – and the ECB continues to disseminate information in line with this basic understanding. This time, President Lagarde did not commit to a future policy rate trajectory, stating – "in the current situation, with the degree of uncertainty that we are facing, we simply cannot offer forward guidance." – but the newly released December Eurosystem staff projections increase the forecast rates of 2026 growth in both real GDP and the HICP euro area consumer price index (headline and core HICP rates; see chart). It is particularly noteworthy that the September forecasts of 2026 HICP growth rates were below 2% overall, with the comprehensive-basis rate forecast to be 1.7% and the core-basis rate forecast to be 1.9%, but these rate forecasts have been raised to 1.9% and 2.2%, respectively. This makes the prospect of the ECB realizing its +2% inflation target seem more likely, so, unless new risk factors emerge, it appears safe to assume that the ECB's current round of interest rate cuts has come to an end. As discussed below, there is now a greater risk that the ECB will resume interest rate hikes than continue interest rate cuts.

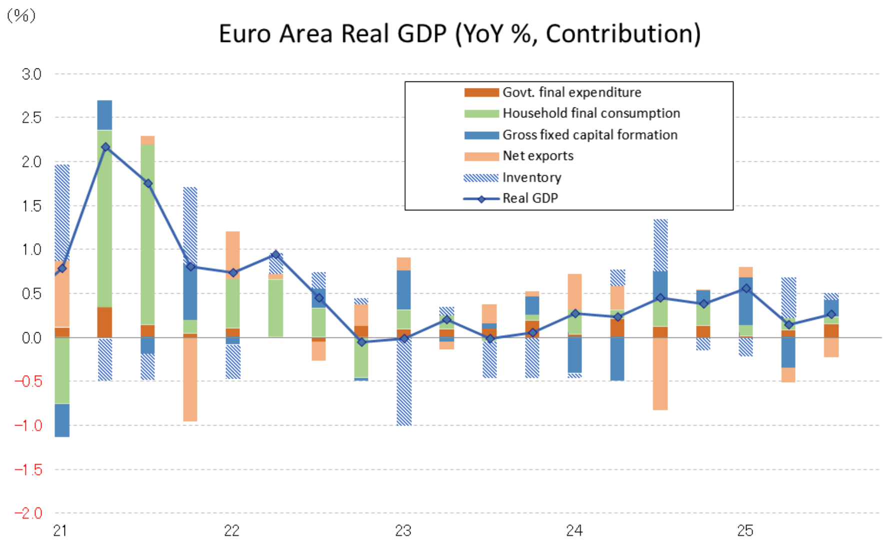
Wage Growth Rates Still a Hot Topic

In early December, ECB Chief Economist Philip Lane expressed concern that wage growth was not slowing as expected, and this point received considerable attention at the post-Governing Council-meeting press conference. One reporter asked – "The higher inflation in 2026 was justified, or explained, with higher services inflation. [...] it was on an upward trajectory in the past few months. How concerned are you about service inflation overall? Could this be turned into a nasty surprise?" President Lagarde responded – "thank you for focusing on inflation on services because it's clearly one domain that we will be attentive to, going forward. So, you are right that services inflation has increased. [...] So there is a trend that we look at carefully. A lot of that is related, based on the staff study, to wages. And wages have surprised us to the upside." After summarizing wage-related survey results, President Lagarde went on to say – "we are attentive [to the wage situation] because while we believe that a lot of the catch-up, for instance, has taken place, a lot of the one-off specific payments have occurred, we were surprised, between September and December in our projection, and that is reflected in our numbers. So we are humble, we look at as many details and data [...] to see what's likely to happen."

It is worth noting that the upward revision of the real GDP growth rate is consistent with strong wage growth. The Governing Council is suggesting that the background to this strong wage growth is a greater-than-expected increase in the capital investment of the corporate sector as a whole, and the Governing Council is also giving attention to the possibility of changes in the euro area's economic structure. As discussed below, the economic structure changes could potentially cause the ECB to increase its estimate of the neutral interest rate level, which can provide a major clue about the ECB's "next move."

Attention Currently Focused on March Staff Projections

Some senior ECB officials, led by German-born ECB Executive Board Member Isabel Schnabel, have begun to talk about raising interest rates as the ECB's "next move," but it would be safer to think of the "next" in that phrase as referring to Governing Council meetings from mid-2026 onwards rather than to the next one or two meetings. As it is unlikely that actual data will differ greatly from December staff projection figures, it is likely that the ECB will continue slowly shifting toward interest rate hikes based on revised staff projection figures that will become available in March and June. If the March revised projection figures suggest that inflation rates will rise further and exceed 2% on a comprehensive basis, that could lead to serious consideration of raising the policy interest rates as the "next move."



(Source) macrobond

As mentioned above, the December Governing Council meeting discussed the strength of the euro area's real economy, particularly as seen in the increase in corporate capital investments. President Lagarde alluded to the possibility that increased appetite for capital investment due to the rise of AI is boosting the GDP growth rate, stating – "private sector [...] investment, based on the data that we collect, based on the surveys that we conduct, is largely attributable to the development of AI. And AI takes multi-facets, but certainly computer capacity, telecommunication, additional investment in intangible – more than tangible – CapEx is really characteristic of what we are seeing at the moment." She then said – "So that is something that we can already analyse, but I think we will be able to go a bit deeper in February, as we will see a bit of a longer interval to determine whether that's a long-lasting fact that is characteristic of this new growth, but that is clearly in play." The capital spending surges suggests a possibility that the euro area economy's potential growth rate and the corresponding natural interest rate (or neutral interest rate) may be rising. Although it would still be considered too early for a rate hike, it seems safe to assume that a consensus has been reached within the Governing Council that rate cuts are no longer necessary. (It is worth noting that when a reporter at the press conference said – "The first question, unfortunately also on rates; The discussion today, was there any discussion about a cut today or about hikes today [...] ?" – President Lagarde quickly responded – "I don't have to wait for your second question. The answer is no.") Given this situation, the question of when and how the to shift the ECB's information dissemination focus toward interest rate hikes will be a key issue in 2026. The revision staff projecting released in March will be symbolically important in this regard, although it can also be expected that considerable attention will be focused on the economic analyses presented at the February 4-5 Governing Council meeting.

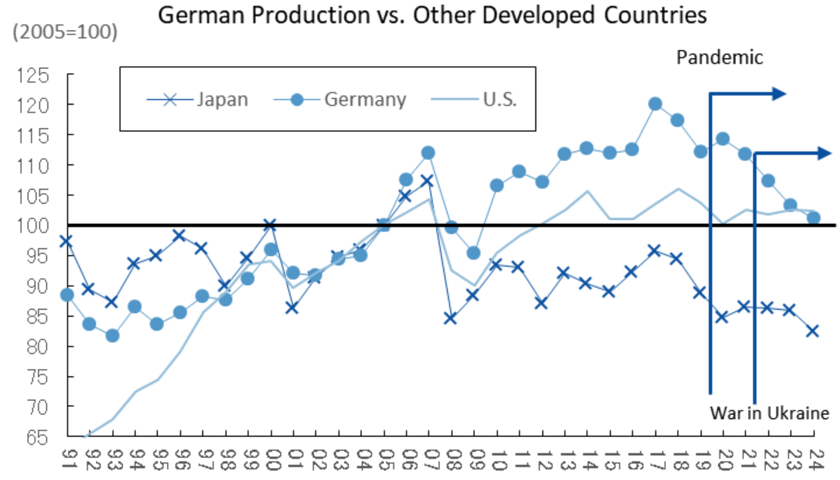
The Euro Area Economy Now and Going Forward – Germany in Freefall

Germany's Economy "in Freefall"

In its "Industry Report December 2025" publication (released on December 2), the Federation of German Industry (BDI) presented a pessimistic analysis, predicting that Germany's industrial production in 2025 will be down 2.0% yoy. That day, BDI President Peter Leibinger made a statement described Germany's economy a being "in free fall" and called for stronger efforts to rescue the country's industrial sector. The March 2025 projection of German GDP growth in 2025 was for -0.5% negative growth, so it has subsequently turned out that business activities have contracted four times faster than previously expected. In February and March of 2025, Germany's government (led by Chancellor Friedrich Merz) suspended government borrowing limits imposed by the country's 2009 debt brake law (limiting new federal borrowing to 0.35% of GDP) and announced the creation of a EUR500 billion infrastructure fund, so the German and other European economies were in an upswing state at that time.

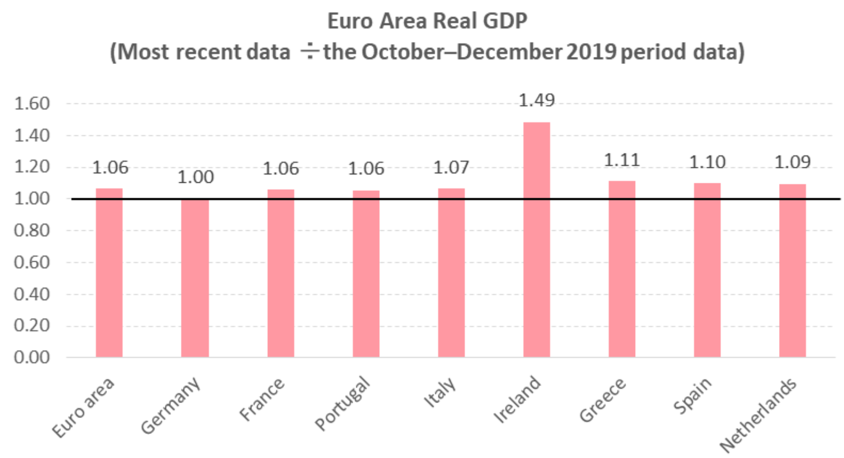
President Leibinger's statement criticized the government's response, saying – "The business location [Germany] is in free fall" – and – "Every month without decisive structural reforms costs further jobs and prosperity and massively restricts the state's future room for maneuver." He also noted with despair that Germany's current economic slump is – "not a cyclical downturn, but a structural decline". There is no single cause for the German economy's dire situation, but three key factors appear responsible: 1) the sudden rise in energy costs due to the war in Ukraine, 2) the sudden rise in energy costs due to the shutdown of nuclear power plants, and 3) the loss of external demand due to the deterioration of relations with China.

Taking industrial production as an example, the graph shows that U.S. and Japanese production levels fell from 2019 to 2020 and subsequently remained roughly flat, while German production increased slightly in the pandemic year (2020), but then began trending downward, and from 2022 onwards has been sharply declining in a manner that can be described without any exaggeration as a “free fall”. On the other hand, Japanese production is in a different dimension, being considerably diminished from roughly 2007, remaining weak subsequently, and falling further in 2024 due to the effects of inflation caused by JPY depreciation. Although this article will not go into detail about Japanese production trends, it is clear that Japan’s situation is grave to a degree comparable with that of Germany’s.



(Source) Macrobond

Contrast Between Merkel Era and Post-Merkel Era
The graph on the right compares the real GDP levels of euro area member states currently with levels recorded just before the pandemic (October-December 2019). It clearly shows that Germany is the only country that has barely grown (if figures are extended to three decimal points one finds German GDP did expand to 1.001 times its size in the fourth quarter of 2019). Leaving aside the exceptional example of Ireland (as that country is the base of a global pharmaceutical company that has recently recorded sharply rising exports of vaccines and medicines), euro area GDP as a whole is up around 6% since just before the pandemic, with countries other than Germany achieving growth in the 6-10% range. These statistics clearly show just how uniquely bad Germany’s situation is within the euro area.



(Source) Bloomberg

The graph of production levels uses 2005 as the base year (2005 = 100) to clarify the nature of trends seen since the start of German governments led by Chancellor Angela Merkel. Under Chancellor Merkel’s leadership, Germany promoted the procurement of cheap natural gas from Russia and accelerated exports, particularly of automobiles, to China, its largest customer. As a result, the country’s industrial production in 2017 was 20% higher than it was in 2005. The positive impact of that industrial production rise was clearly reflected in the labor market conditions (see graph below), as Germany’s unemployment rate rose only three times during Merkel’s 16 years in power – in 2005 following the Lehman shock (up 0.4 percentage point yoy), in 2012 at the peak of the European debt crisis (up 0.1 percentage point yoy), and in 2020, the first year of the pandemic (up 1.1 percentage point yoy). During her time in office (from 2005 to 2021), Germany’s unemployment rate fell to less than half its initial level (from 11.3% to 5.2%), and while her political methods and policies have been met with mixed appraisals, it can undoubtedly be said that her 16 years in office were a golden age for Germany’s economy. Since 2022, well into the post-Merkel era, however, Germany’s unemployment rate has been rising at a rate of 0.3 to 0.4 percentage point per year, reflecting the sharp decline seen in the country’s industrial production levels. It is no exaggeration to say that Germany’s economic history since 2000 is clearly divided into quite disparate pre-Merkel and post-Merkel periods. Currently, Germany is paying for the Merkel governments’ shortcomings and mistakes, including

(Source) macrobond

decisions to rely excessively on economic ties with China and Russia, to idealistically phase-out nuclear energy plants, and to abruptly open the country up to huge numbers of migrant refugees.

Germany Presents the ECB with Diverse Challenges

If the current situation (in which Germany alone seems to be deteriorating economically) continues, there are concerns about the impact it will have on the ECB's monetary policy management. The ECB was established only slightly more than a quarter-century ago, but looking back at the bank's short history, it is clear that economic disparities between Germany and the rest of the euro area have always presented the ECB with special challenges. The underlying cause of the European debt crisis that erupted in 2009 was the ECB's efforts during the early 2000s to keep interest rates low and stable in line with the needs of Germany's struggling economy, leading to excessive investment in other euro area countries, particularly those in southern Europe. During the protracted economic slump following the European debt crisis, however, the ECB maintained low interest rates in response to weak economic conditions in euro area states other than Germany, and the disparately strong economic conditions in Germany often caused German ECB Governing Council members to promote overly hawkish stances at Governing Council meetings that were out of step with Governing Council members from other euro area countries.

It was around this time that the German Bundesbank president and a German Governing Council member resigned mid-term in protest. Large economic strength disparities between Germany and other euro area countries have periodically generated major frictions, suggesting that the euro area is not a genuine optimal currency area (OCA)).

Germany's increasing economic weakness has been inspiring the "sick man (of Europe) returns" media theme, and if the weakness is prolonged, the ECB will not be able to ignore the German economy's needs, so it will be pressured to adopt monetary easing policies inappropriate for other euro area countries. There have yet to emerge any signs of this, but given history's inclination to repeat itself, the ECB must sustain vigilant wariness over the medium-to-long term to avoid offering the accommodative environment Germany requires and thereby causing economic overheating and accelerating inflation throughout euro area countries other than Germany. The various Germany-specific issues may seem to be distractions from the central issues dictating the ECB's "next move", but it must be acknowledged that, for better or worse, Germany will always be the hub of euro area political and economic challenges, and the short- and long-term implications of a serious slump in Germany's economy merit careful consideration.

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