

# Forex Medium-Term Outlook

January 30, 2026

## Overview of Outlook

USD/JPY fluctuated wildly again in January. JPY has continued to weaken alongside rising interest rates in the new year due to the political situation in Japan. Speculation about Japan-U.S. currency policy coordination has at times pulled USD/JPY down, but this should be considered a transient development, as the benefit to the U.S. from a continued weak USD are unclear. Regarding currency policy, it is important to note that compared with 2024, when JPY was trading around 160 to the dollar, the current overseas interest rate and speculative positioning environment is not as favorable for policymakers seeking to reverse JPY depreciation. Since JPY selling is not as overheated as it was back then, doubts remain about the extent to which the situation can be reversed through artificial means. While some are hoping that the BOJ will purchase government bonds, such a policy would likely fuel a weaker JPY, and if this leads to renewed discussion of currency intervention, it would have amounted to no more than stirring up trouble. It is safer to refrain from excessive expectations of the BOJ's government bond purchases. Looking at forex market trends as a whole last year, it seems that the currencies of East Asian countries likely to become embroiled in conflict, including Japan, were shunned. In the past, Japan's net external assets were considered a factor in JPY appreciation, but this was during a time of stability overseas. Now, with no guarantees that Japan's net external assets will be preserved in the event of a crisis, it would not be surprising if they were considered a factor in JPY depreciation. JPY supply and demand concerns seem to be easing, but real interest rates and geopolitical risks are weighing the currency down.

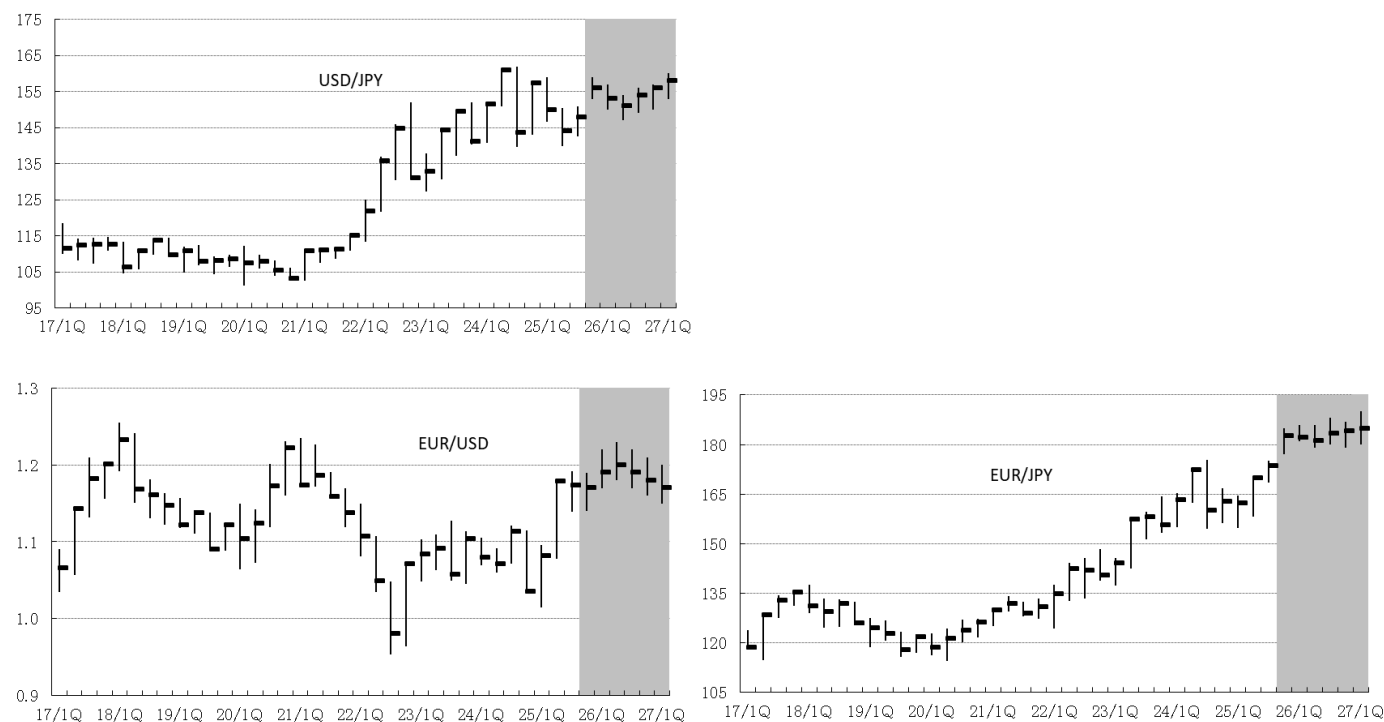
EUR strengthened in January. As USD weakness prevails across forex markets, the onus of currency appreciation is increasingly falling on EUR and CHF. One must be prepared for a suspension of rate cuts or even the implementation of a rate hike to come up in the context of discussions about the ECB's next move during the current forecasting period. While unlikely during 2026, expectations of higher regional interest rates may emerge as 2027 approaches. However, given that the Fed's next move is still expected to be a rate cut, EUR will likely strengthen against USD, and with an even more pronounced margin against JPY. The Trump administration's words and actions remain erratic, so the incentive to de-dollarize is unlikely to disappear from the financial markets. Incidentally, EUR/USD based on purchasing power parity is around 1.28. If this is taken as the base, EUR/JPY will remain high at around 186 even if USD/JPY falls to 145. Globally, as JPY weakness alongside USD weakness becomes the norm, cross-JPY rates are seeing significant spikes that are difficult to recover. Even though most of the focus tends to be on USD/JPY, the risk for investors and businesses is that large spikes in cross-JPY rates may become the norm.

## Summary Table of Forecasts

	2026 Jan (Actual)	Feb-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2027 Jan-Mar
USD/JPY	152.10 ~ 159.45 (153.51)	150 ~ 157 (153)	147 ~ 154 (151)	149 ~ 156 (154)	150 ~ 157 (156)	153 ~ 160 (158)
EUR/USD	1.1572 ~ 1.2084 (1.1932)	1.17 ~ 1.22 (1.19)	1.18 ~ 1.23 (1.20)	1.17 ~ 1.22 (1.19)	1.16 ~ 1.21 (1.18)	1.15 ~ 1.20 (1.17)
EUR/JPY	181.80 ~ 186.87 (183.20)	181 ~ 186 (182)	179 ~ 186 (181)	180 ~ 188 (183)	179 ~ 187 (184)	180 ~ 190 (185)

(Notes) 1. Actual results released around 10 am TKY time on 30 January 2026. 2. Source by Bloomberg  
3. Forecasts in parentheses are quarter-end levels.

## Exchange Rate Trends & Forecasts

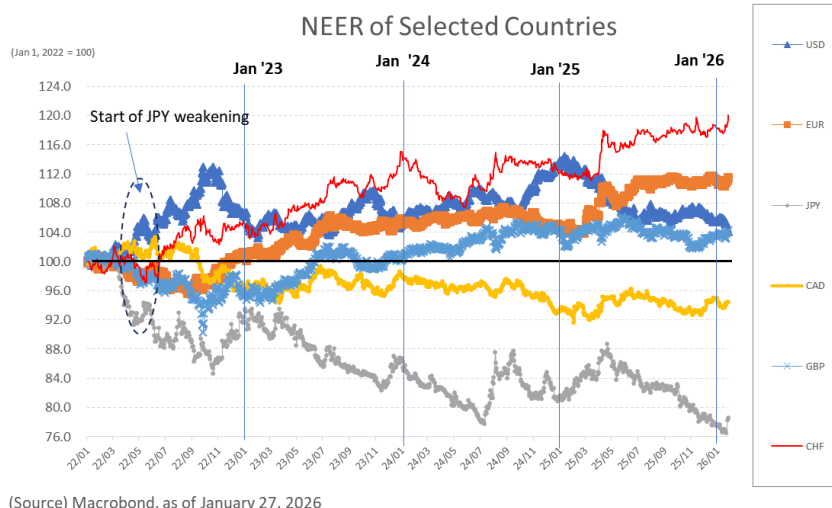


## USD/JPY Outlook - Fifth Year of JPY Weakness and Crisis-Currency Selling Risk

### JPY Now and Going forward – How to Escape a Fifth Year of JPY Weakness

#### *Fifth Year of JPY Weakness*

JPY's sharp depreciation starting March 2022 was initially predicted to end when the U.S. cut interest rates or the BOJ raised interest rates, with structural explanations for JPY depreciation being brushed aside as groundless. However, despite both Fed rate cuts and BOJ rate hikes, the current phase of JPY weakness has not ended and will enter its fifth year in 2026. As the figure to the right shows, JPY has been shunned regardless of whether USD is strengthening or weakening over the past four years, leading me to believe that the concerns I have raised in this report and in my books, namely that we should focus on

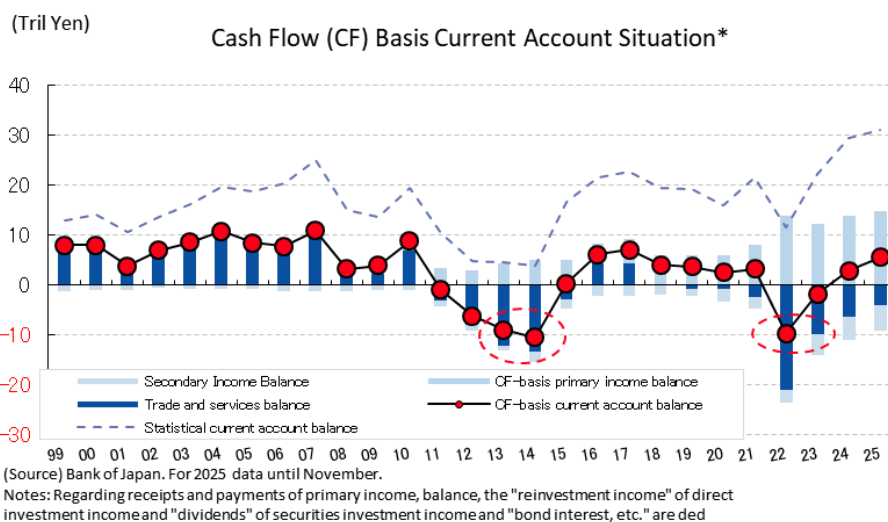


(Source) Macrobond, as of January 27, 2026

Japan-specific analysis rather than analyzing JPY based on overseas developments, have been appropriate. With inflation becoming a social issue today, avoiding a fifth year of JPY weakness is arguably a top political and economic priority for Japan, so how can we escape a fifth year of JPY weakness?

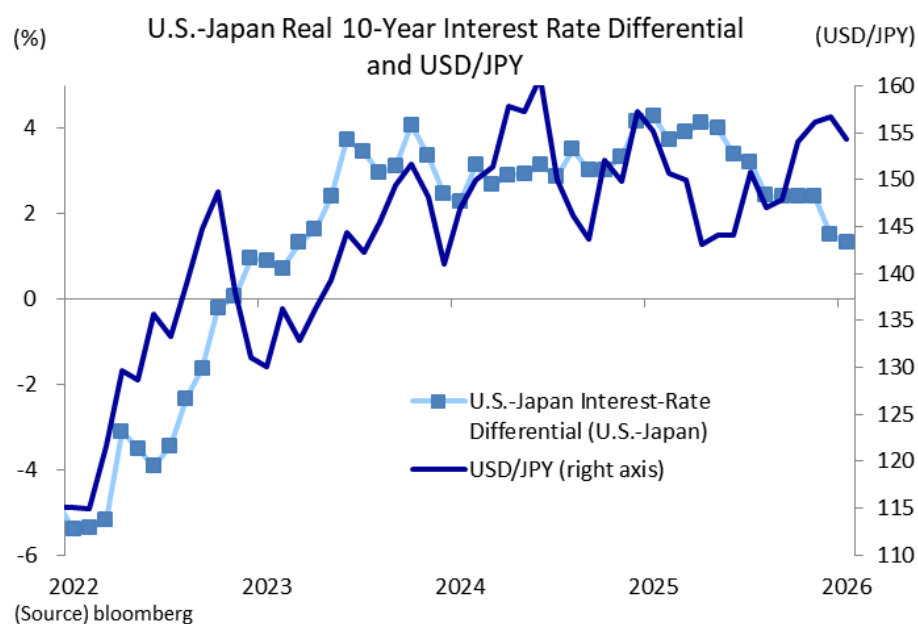
To escape a problem, one must first identify its cause. Of course, with regard to JPY depreciation over the past four years, not just have there been multiple contributing causes, the causes have also been changing constantly. In 2022-23, the first half of the JPY weakness phase, one can safely say it was the shift in supply and demand, symbolized by the expanding trade deficit, that drove JPY selling. Japan's 2022 and 2023 trade deficits were, respectively, its largest ever (at approx. -JPY 20 trillion) and third-largest ever (at approx. -JPY 9.5 trillion), and based on my

calculations, even the current account balance may have been in the red based on cash flows (CF; see graph). Under those circumstances, it was inevitable that JPY would continue to weaken. In 2024, while the CF-based current account balance returned to a surplus with the narrowing of the trade deficit, the real U.S.-Japan interest rate differential widened and remained high, and this appears to have supported JPY weakness during 2023-24 (discussed below). In 2025, the trade deficit continued to shrink, further improving the CF-based current account surplus, but the real U.S.-Japan interest rate differential remained significant despite narrowing, likely supporting JPY weakness. Further, specifically during the first half of 2025, JPY was avoided amid a de-dollarization trend because of Japan's high reliance on the U.S. However, since October 2025, there has been a Japan-specific factor supporting JPY weakness – namely intensified selling of JPY and Japanese government bonds (JGBs) due to concerns of reflation under the Takaichi administration.



#### Crucial to Raise Real Interest Rates

While the shift in JPY supply and demand does not necessarily signal JPY appreciation, it also does not signal accelerating JPY depreciation and is, therefore, likely to remain a neutral factor in 2026. Given this, the key issue remains the Japan-U.S. real interest rate differential, particularly Japan's real interest rate (see graph). Ironically, the BOJ administration under Governor Kazuo Ueda, which was tasked with normalizing monetary policy, has adopted a stronger degree of easing than the Haruhiko Kuroda administration, but JPY weakness cannot be corrected without correcting low JPY interest rates. The Summary of Opinions at the Monetary Policy Meeting on December 18 and 19, 2025, released



by the BOJ on December 29, 2025, contained the view that "Japan's real policy interest rate is by far at the lowest level globally," with a Policy Board member acknowledging that "there is still considerable distance to the neutral interest rate level." The same Policy Board member also argued that "the Bank should adjust the degree of monetary accommodation with intervals of a few months in mind for the time being." While this hawkish opinion, likely from either Takata Hajime or Tamura Naoki, cannot be interpreted as the consensus of the Policy Board, there is no doubt that the financial market's conservative assumption of an interest rate hike "every six months" is driving JPY depreciation. Overcoming this conservative assumption could be the quickest way to correct JPY weakness. In this context, expectations for an April rate hike are emerging, but they are not yet a majority opinion.

### *The Takaichi Administration Should Simply Communicate the Truth*

The troubling thing is that the financial markets' conservative expectations for interest rate hikes are the result of taking political motives into consideration. In essence, financial markets are confident in their assumption that continued interest rate hikes will not be tolerated under the Takaichi administration. In this context, as I will discuss in detail below, given that the FY2026 budget is being compiled in a "responsible" manner, it seems appropriate for the administration to confidently communicate the current state of affairs as they are. Objectively speaking, the Takaichi government did raise interest rates within three months of taking office, and the FY2026 budget looks relatively sound. It makes sense, therefore, to argue that actively communicating the Takaichi administration's "welcome policy U-turn" would help suppress JPY weakness and rising interest rates, thereby demonstrating that the excessive fears in the financial markets since last October were largely misplaced. As the figure above shows, while the real interest rate differential has widened considerably, JPY depreciation appears to have gone even further than warranted by this.

However, the real state of affairs remains unclear. It is true that the Takaichi administration's communications since the start of the new year have been marked by warnings against expansionary fiscal and monetary policy, and the markets have taken solace in this. However, at a January 19 press conference, Takaichi emphasized that the real challenge was to implement a "responsible aggressive fiscal policy" that would "help break free from the shackles of excessive fiscal austerity." She also noted that the FY2026 budget requests had already been locked in before she took office, stating, "This is a major reform requiring two years – we will begin reviewing the budget compilation guidelines, including expenditure ceilings, starting with the initial budget requests this summer, and it will take two years until the budget for the next fiscal year is enacted." This seems to suggest, in other words, "the FY2026 budget proposal is not as large as I expected, so I would like to consider a supplementary budget or further expand the FY2027 budget proposal." If true, the simultaneous weakening of JPY and rising of JPY interest rates will not be easily corrected.

### *Deviation from Initial Concerns*

Let us set aside such speculation about the FY2026 budget proposal for the time being. Currently, much of the coverage surrounding the FY2026 budget has focused on its largest-on-record JPY 122.3 trillion initial budget proposal. However, it is true that there are positive aspects that deviate from initial concerns, such as maintaining new government bond issuance at around JPY 20 trillion and lowering the public debt dependency ratio (24.2%) compared to FY2025. The ballooning of the FY2026 budget is not the result of aggressive fiscal expansion, but rather of rising government bond expenses, i.e., higher interest rates, which form the basis for calculations. Going by just the snapshot available at the current time, there are no signs of a shift to expansionary fiscal policy that reflationary thinking would suggest. Of course, the apparent reduction in public debt dependency ratio is only due to a one-time, exceptional reduction in transfers from the general account to a special account. The increase in new government bond issuance despite rising tax revenues also suggests that fiscal discipline is not being maintained. Nevertheless, it is true that the budget proposal does indicate a deviation from market concerns of unrestrained fiscal policy operation since last October.

Still, given that the bond and forex markets remain suspicious, communicating the truth effectively and honestly have the potential to overturn market expectations. Perhaps the administration is afraid that reporting the truth would contradict its previously declared commitment to reflationary policies. However, the Consumer Price Index (CPI, aggregate) has exceeded +2% for 45 consecutive months. In light of this, it would not come as a surprise if the government declared an end to deflation and accordingly tightened fiscal and monetary policy compared with previous periods. It is far more puzzling that the government continues to describe the current situation as deflationary while society demands measures to combat rising prices. All it needs to do is boldly declare an end to deflation and communicate that it is formulating a "responsible" fiscal policy and implementing monetary tightening. If the Takaichi administration, which enjoys strong public support, cannot do it, the declaration of an end to deflation will be semi-permanently shelved.

Another thing I have repeatedly pointed out is the need for the administration to rein in the rapid-fire messages supporting expansionary fiscal and monetary policies from economic advisors around the prime minister. Ultimately, as long as such noise exists, the impact of the Takaichi administration's policies, no matter how beneficial, will be diminished. The reality is that current fiscal policies are no more expansionary than monetary policies are accommodative, and it would be a good idea to simply emphasize this fact.

Also, it would be interesting to know how experts who supported the administration by loudly calling for expansionary fiscal and monetary policies view the recent interest rate hike and budget proposal over the past three months.

### *Do Your Best and Leave the Rest Up to God*

The hysteria in the bond and forex markets is likely to subside if the soundness of the initial budget proposal is maintained in terms of fiscal policy, and the fact that the BOJ may implement a reasonable interest rate hike is successfully communicated in terms of monetary policy. As discussed below, JPY supply and demand is also gradually improving, so it should be easier to contain JPY selling than in 2022-23.

However, these are all discussions related to domestic circumstances in Japan. The forex market assumption that sound fiscal policy and hawkish monetary policy will correct JPY weakness is premised on overseas interest rates, particularly U.S. interest rates, remaining stable or declining. While it is unlikely either the Fed or the ECB will raise interest rates in 2026, it is also true that there are doubts as to the sustainability of their rate cut phases. To the markets, which only envision extreme scenarios, "end of rate cut phase" and "start of rate hike phase" are the same thing. At the least, market interest rates are assumed to rise following the end of a rate cut phase. The two central banks in Oceania (Australia and New Zealand) have already begun raising interest rates, while the ECB has semi-declared a halt to its



rate cuts. With nearly one-third of FOMC members beginning to show reluctance to further cuts, it is not impossible that the Fed will turn hawkish in 2H of 2026.

In sum, the factors necessary for Japan to escape a fifth year of JPY weakness include, (1) an interest rate hike by the BOJ to at least the lower limit of the neutral rate (1.25-1.50%), and (2) the Takaichi administration clearly communicating its economic policy management as is, i.e., not indicating a reflationary bias. In addition to these, one also hopes that overseas central banks will remain dovish. In other words, this is a situation of doing one's best and leaving the rest up to God.

Given that forex rates always involve more than one party, it is inevitable to end up relying to some extent on external developments. Japanese policymakers eager to curb JPY depreciation may find it difficult to singlehandedly achieve this, but they must at least demonstrate their commitment to doing their utmost.

## Currency and Monetary Policy Now and Going Forward – Increasing “Currencification” of Monetary Policy and Intervention Considerations

### *Overseas Economic Recovery Seen as a Risk*

At the BOJ's January Monetary Policy Meeting (MPM), the target for the uncollateralized overnight call rate, the policy interest rate, was maintained at 0.75%. However, the decision was not unanimous, with Takata opposed to maintaining the status quo, based on the belief that “the price stability target had been more or less achieved and that, with overseas economies being in a recovery phase, risks to prices in Japan were skewed to the upside.” While various causal relationships are assumed between overseas economic recovery and upside risks to prices in Japan, Takata, with his background in financial markets, is likely conscious of the sequence of overseas economic recovery → foreign central banks halting rate cuts and eventually shifting to rate hikes → widening domestic-foreign interest rate differentials, as noted above.

Foreign central banks, once they change direction, tend to continue adjusting interest rates in that direction for a sustained period of time. If that happens, the downward pressure on JPY would be far greater than it is now, leading directly to imported inflationary pressures. It is only natural to think that it would be better to preempt the situation by raising interest rates.

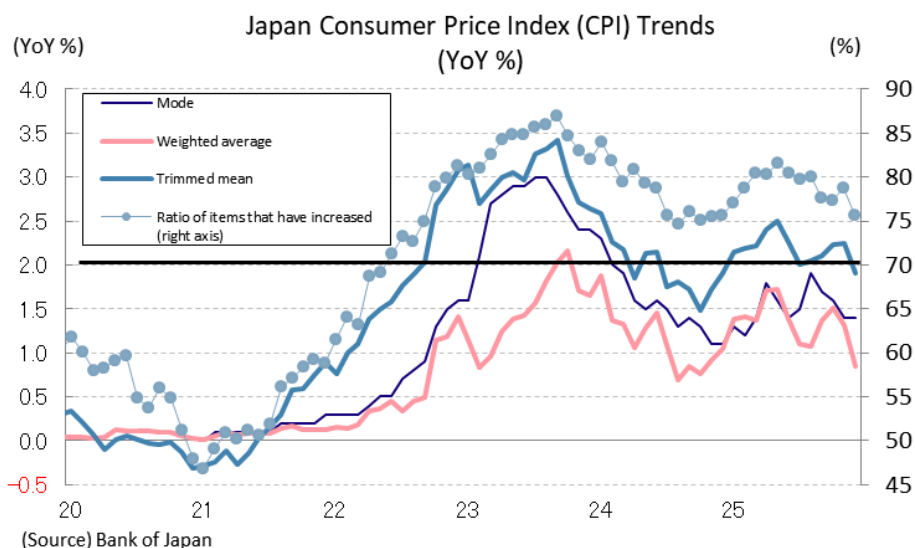
### *JGB Purchases Will Amount to No More than Stirring Up Trouble*

As expected, the press conference featured many questions about the BOJ's concerns regarding the sharp rise in long-term interest rates. Ueda described the pace of interest rate increases as “quite rapid,” noting that financial markets were reassessing their perceptions of Japan's economy, prices, and fiscal policy. He also noted that the easing of supply and demand due to end-of-term factors was affecting ultra-long-term bonds. While the much-anticipated flexible purchases of government bonds were discussed, the conditions for their implementation were not specified, with Ueda merely emphasizing that the Bank shared the government's understanding that maintaining long-term fiscal confidence was important. Judging from the tone of the press conference, there seemed little intention to actually take action.

The BOJ's decision is wise. With some talk of the possibility of JPY-buying intervention in terms of currency policy, accelerating monetary policy easing (even in a technical manner that does not affect the policy stance) is likely to call into question the consistency between monetary and currency policies, and is not a decision that can be made lightly. “Flexible purchases” would likely encourage accelerated JPY selling in exchange for suppressed interest rates, and responding to such JPY depreciation with JPY-buying intervention would amount to no more than stirring up trouble.

### *Underlying Inflation – An Easy-to-Use Concept*

With regard to the core CPI (CPI excluding fresh food) for FY2025-27, the Outlook Report forecast was mostly unchanged from the previous (October) forecast at +2.7%, +1.9%, and +2.0%, respectively. Given that the forecasts converge on +2%, the view that “underlying inflation was likely to remain sluggish” was removed, confirming the continuation of the gradual interest rate hike path. However, with core CPI expected to be dampened in the near term in reaction to last year's food price hikes, it remains to be seen how the Bank will justify rate hikes going forward. Given that underlying inflation has been used to justify a “tentative decision to maintain the status quo” (i.e., postpone a rate hike) in the past, the same could be used also to justify a “tentative decision to raise interest rates” going forward. The “underlying inflation” is a highly versatile concept given that its real state is never



clear. Of course, it can be argued that the downward pressure on core CPI expected in 2026 is a temporary phenomenon resulting from rice prices, i.e., that it has not affected the underlying trend. However, as shown in the figure, underlying inflation rates are not currently trending upward, with all three indicators below +2%. If both inflation and growth slow, the only reason left for an interest rate hike would be to curb JPY depreciation. The more interest rates are raised, the greater the already occurring “currencification” of monetary policy.

#### *Behind the Curve with Respect to JPY Depreciation*

Currently, I expect two interest rate hikes this year, but this also depends on the JPY depreciation trend. In his press conference, Ueda acknowledged that protracted JPY depreciation would be a factor pushing up the inflation rate in the near term. He also stated, “We are paying attention to the possibility that domestic prices’ response to exchange rates is strengthening,” and “We must pay careful attention even to small movements,” giving the impression that the Bank is paying much more attention to exchange rates. In the end, Japan is in a situation where interest rates are being adjusted on the basis of JPY depreciation trends. It would be fair to say, therefore, that the BOJ is “behind the curve” with respect to JPY depreciation. However, since prices (inflation) move in response to JPY rates, the BOJ is also behind the curve with respect to inflation. While speculation in the forex market is centered on whether or not currency policy (forex intervention) will be implemented, the policy priority should be monetary policy aimed at raising the extremely low real interest rates, and currency policy only to forcibly remove stubbornly residual downward pressure on JPY (say due to excessive speculation). Most analysts in Japan are getting this priority wrong. If currency intervention too fails to relieve the pressure, eventually capital controls will be on the table. Of course, there is no need to be overly concerned about the Japanese economy at the present time, but emerging concerns about overseas investment through NISA do seem to hint, to some extent, at discussions about the need for capital controls.

The success of the 2024 currency intervention, when JPY was trading around 160, is frequently recalled (details below), but it must be noted that expectations of a stronger downward trend in U.S. interest rates were heightened at that time, with the phrase “Fed pivot” (i.e., Fed’s shift to interest rate cuts) trending. This is precisely why, following repeated JPY-buying interventions between April and July, USD/JPY suddenly reversed direction after the Fed resumed rate cuts in September 2024. At the current time, however, major

**Japan's Currency Policy Since 2022**

Date	Timing/Circumstances of Intervention	Intervention amount (JPY)	Notes
Sept 22, 2022	USD/JPY approx. 145.90	2.8382 trillion	The first yen-buying intervention in 24 years; announced on the same day by Finance Minister Jun'ichi Suzuki
Oct 21, 2022	USD/JPY approx. 151.94	5.6202 trillion	A covert middle-of-night intervention; the largest ever at the time
Oct 24, 2022	USD/JPY approx. 149.70	0.7296 trillion	Another covert intervention the next morning
Apr 29, 2024	USD/JPY approx. 160.24	5.9185 trillion	The largest ever; intervention timed to coincide with thin trading on the Showa Day holiday
May 2, 2024	USD/JPY approx. 157.50	3.8700 trillion	Carried out in the early hours of the morning NY time following an FOMC meeting
July 11, 2024	USD/JPY approx. 161.76	3.1678 trillion	Intervention strategically accelerated USD depreciation immediately after the U.S. CPI was released
July 12, 2024	USD/JPY approx. 158.99	2.3670 trillion	Follow-up intervention in the Tokyo market the next day

(Source) Created by the author using data from the Ministry of Finance, etc.

overseas central banks are nearing the end of their rate cut phases. As Takata noted, the recovery of overseas economies could directly lead to domestic inflationary pressures via JPY depreciation. Given that Japan already experiences chronic inflation of over 2%, it seems prudent to raise interest rates at least to a level considered neutral and settle the issue of extremely low real interest rates. As the supply and demand structure improves, a one-stroke offensive on interest rates will likely ease the downward pressure on JPY.

The problem is that political decisions are not as easy as such logic would suggest. Based on current reports, it does not seem certain that the Takaichi administration will achieve a landslide victory in the election of the House of Representatives. If the ruling party only secures a partial victory and remains in a weak position, it will end up having to give in to many of the opposition’s demands. Even if the ruling party wins in a landslide, the predominant market expectation is likely to be for “responsible aggressive fiscal policy,” which would invite simultaneous JPY depreciation and rising interest rates. Regardless of whether the ruling or opposition party wins, a consumption tax cut is likely to be the next move, so the chances of completely ending the simultaneous JPY depreciation and rising interest rates appear slim at this point.

#### *The Narrative of U.S. Cooperation*

In late January, USD/JPY fell sharply amid speculation about coordinated U.S.-Japan currency intervention, including rate checks. The situation has since calmed down, with U.S. Treasury Secretary Scott Bessent denying the existence of plans for intervention and expressing support for a strong USD. However, since rate checks themselves have not been denied, the truth remains a mystery. USD/JPY has continued trading with a heavy upper side as it struggles to adjust to the dubious narrative of serious U.S. cooperation in correcting JPY weakness (through rate checks). Looking back at history, there is no precedent for such cooperation, so if it becomes the norm, USD/JPY will find it difficult to stabilize at 160.

In the forex market, where there is always a counterparty, if the interests of both parties align, and they take measures to move in the desired direction, their efforts are certain to bear fruit. This is even more true if the counterparty is the U.S., the country with the world’s reserve currency.

### Three Differences Compared With 2024

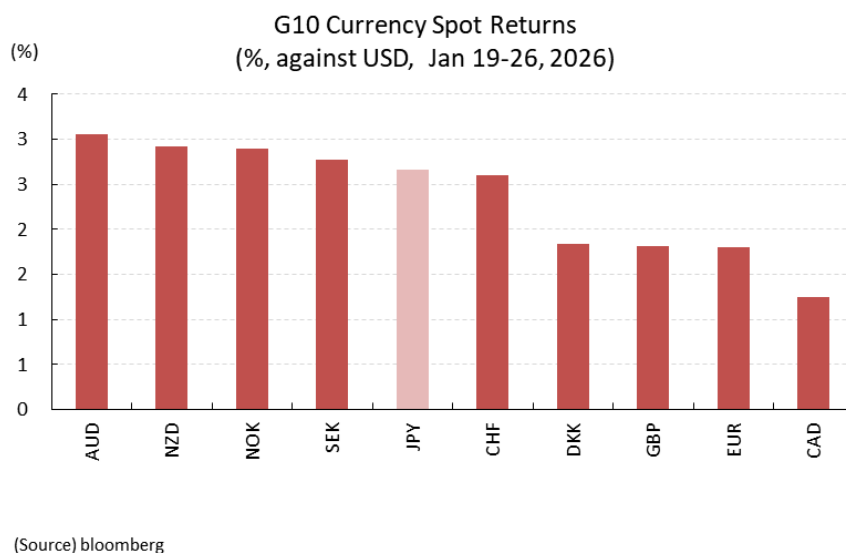
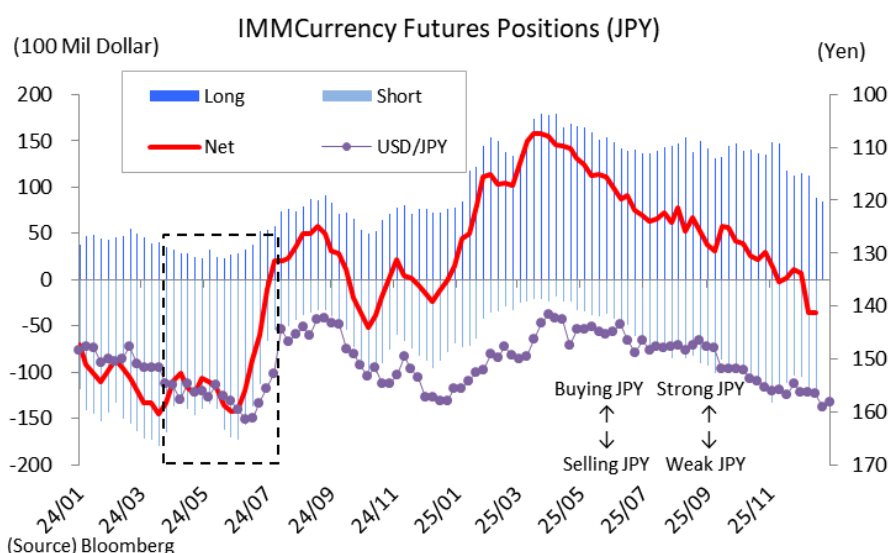
Since the political situation is impossible to know, we can only speculate. However, I believe there are three major differences between the present 160 yen-to-the-dollar level and that recorded during April-July 2024. Two of these differences suggest JPY appreciation will not last, and the third is a factor that promotes JPY appreciation. How long will the current, seemingly decisive, coordinated Japan-U.S. policy push USD/JPY downward? I would like to consider this briefly.

The first difference mentioned above is the Fed's monetary policy stance. The expectation of lower U.S. interest rates, symbolized by the phrase "Fed pivot," does not exist this time round. In 2024, the U.S. was pursuing monetary policy favoring a weaker USD while Japan was pursuing monetary policy favoring a stronger JPY, making the switch to JPY appreciation against USD inevitable. This time round, the Fed is nearing the end of its rate cut phase, and it is unclear to what extent USD will continue to weaken against JPY. Given the experience of 2025, when USD weakness did not significantly strengthen JPY, it is natural to assume that JPY could weaken when U.S. interest rates bottom out.

Another difference is the extent of overheating. The trends in speculative positions are quite different between 2024 and now. While currency intervention is a highly effective policy for eliminating excessively biased speculative positions, it is doubtful whether such positions even exist today. For example, JPY had a net short position of approximately -USD 3.5 billion in IMM currency futures contracts as of January 20, 2026. By contrast, the JPY short position between April and July 2024 averaged -USD 11.8 billion. Net short positions to the tune of -USD 10 billion were the established trend at that time (see graph above). Further, as discussed below, the massive trade deficits from 2022-2023 were carried over due to settlement time lags. The JPY160 level in 2024 was, therefore, achieved as the combined result of both speculative trading and actual demand being inclined toward shorting JPY. That level of overheating clearly does not exist at the current time. In 2024, the JPY160 level was the "climax" of selling, which is in contrast to the present, where JPY160 is the normal level, leaving less scope for artificial interventions to correct the level. The recent forex-rate volatility was primarily between USD and JPY, but looking at the rate of change of various currencies against USD in the one week between January 19 and 26, JPY appreciation was not particularly large, showing only a moderate rebound compared with other G10 currencies (see graph below). Even with the powerful narrative of coordinated intervention by the U.S. and Japan, JPY rebound was just average.

### Smaller Trade Deficit This Time

The aforementioned two points point to the potential for JPY depreciation to remain sustained, but the third point – the size of the trade deficit – offers hope for a reversal. Assuming that the trade balance impacts the forex market with a lag of about two years, then just as the 2022-23 trade deficit strongly affected JPY in 2024, the 2024-25 trade deficit will have a significant impact on JPY in 2026. Of course, this is merely a rough calculation. If a massive trade deficit suddenly emerges, as in 2022, it may not be fully covered by forward exchange contracts and could immediately manifest as a flow (2022 saw JPY collapse amid the largest trade deficit on record, as is well known). While I will refrain from discussing the detailed relationship between the trade deficit and the exchange rate here, one major difference is that, statistically, the scale of JPY selling based on real demand has subsided significantly compared to that time. This could make it easier for an artificial flow of JPY buying against USD to be effective. However, taking the



first two points above into consideration, I believe that, USD/JPY may gradually return to its original state once the recent volatility settles down.

### *The Narrative's Shelf Life*

The key question in this story, however, is – how long will the powerful narrative that even the U.S. is serious about correcting JPY weakness last? For the purpose of this discussion, let us leave aside the question of whether there was any actual coordination. Even without actual intervention, the possibility of a coordinated intervention, including rate checks, remains a concern. In that context, the question becomes – to what extent will the Trump administration continue to cooperate sincerely and in the long term in efforts to correct JPY weakness against USD? Given past history, it is unlikely that the Trump administration would cooperate without something in return. The decision to cooperate was likely based on the benefit to the U.S. of correcting JPY weakness. What that benefit is remains unclear as of the time of writing. Is it an increase in Japan's defense spending, a postponement of the consumption tax cut, or permission for the BOJ to raise interest rates?

In line with the Trump administration's thinking, which is theoretically based on the ideas of Chairman Stephen Miran of the Council of Economic Advisers (CEA), the stable absorption of U.S. Treasury bonds is a top priority. As a result of the continued collapse of the ultra-long-term sector of Japanese government bonds (a sharp rise in ultra-long-term interest rates) seen in January, yields are approaching those of U.S. bonds of the same maturity. For example, after the rate check scandal, the 30-year bond yield is currently around 3.6% in Japan, compared to the 4.8% for U.S. bonds. Before the turmoil, Japanese 30-year bond yields had risen to around 3.9%. If this situation continues, we can expect a shift in investors from U.S. government bonds to Japanese government bonds, which would not be pleasant for the Trump administration. Under these circumstances, it is possible that the correction of JPY depreciation was an opportunity to curb the selling of Japanese government bonds. In essence, the intention may have been to cooperate in an attempt to stabilize the U.S. bond market.

However, this is simply speculation. Since actual currency intervention requires Japan to sell U.S. Treasury bonds, perhaps the only viable option was to use the threat of an intervention, through rate checks, as they did this time (Bessent has clearly stated that no currency intervention has taken place as of the time of writing). Other possible background factors contributing to the turmoil could have been U.S. skepticism toward the Takaichi administration's "responsible aggressive fiscal policy," which could potentially manifest as criticism of upcoming consumption tax cuts or seeking an understanding regarding rate hikes by the BOJ. While such blatant interference in domestic affairs is generally unlikely, it is not impossible that such threats served as a barter for the selling off of U.S. Treasury bonds. Of course, given that every action of the Trump administration deviates from normal behavior, its interference in Japan's domestic affairs would hardly be surprising.

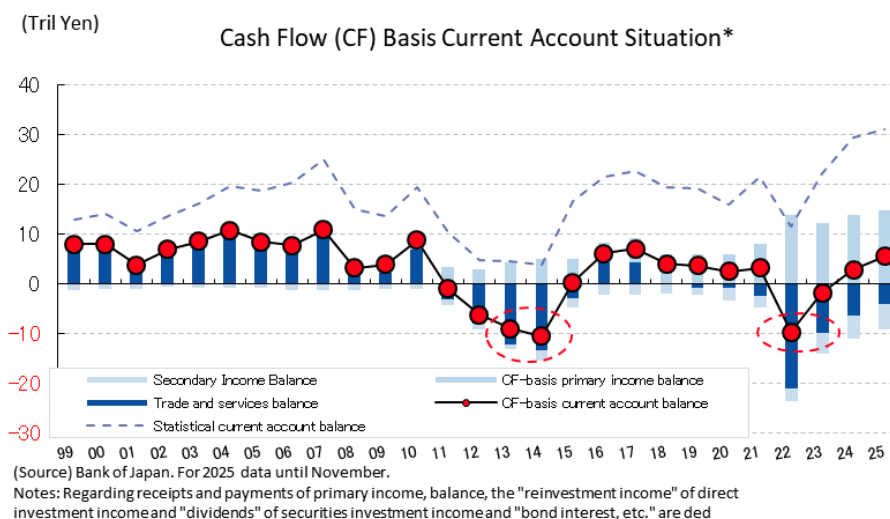
Moreover, it is questionable whether a weaker USD is desirable for the Trump administration. Given that even a weaker USD is unable to boost U.S. export volume, the only direct impact of a weaker USD, coupled with reciprocal tariffs, would be imported inflationary pressures. With USD already experiencing a chronic, significant weakening against major currencies other than JPY, what would the benefit of helping weaken USD even more be? One could argue that it could indirectly help absorb ultra-long-term U.S. Treasury bonds, but is that enough to warrant continued cooperation? Of course, this is ultimately a political issue, and as a mere economist, I do not have an answer to the question.

One thing, however, is certain. Ultimately, the biggest focus will be on whether or not skepticism about Japan's "responsible aggressive fiscal policy" can be dispelled. This is only natural, since that is where the issue began. No matter how much JPY and JPY-denominated bond selling is artificially curtailed, the trend cannot be guaranteed indefinitely. What is needed is to root out the seeds of anxiety in the financial markets.

## **JPY Supply-Demand Environment – Improvement from “Worst” to “Worse than Usual” and “Bad”**

### *CF Current Account Balance Helping Improve JPY Supply-Demand Situation*

Amid intensifying discussions about monetary policies and JPY forex rate fluctuations, it is important to note the fundamental fact that the JPY supply-demand environment is improving. As previously mentioned in this article, the JPY supply-demand structure had been skewed toward JPY selling but improved significantly in 2025. I estimate that Japan's cash flow-based (CF) current account balance for the January-November 2025 period will be an approximately JPY5.6 trillion surplus (see graph), so this balance is already returning to pre-pandemic levels. Japan's statistical current account surplus for the January-November 2025 period is record high of approximately JPY31.2





trillion – the largest surplus ever recorded on a full-year basis – so the situation in which JPY buying is at lower levels despite the current account surplus remains unchanged. However, given that Japan recorded CF current account deficits in 2022-23 period, it is safe to say that JPY depreciation pressures stemming from JPY supply-demand structure changes have eased considerably. This is welcome news for the sake of avoiding a “fifth consecutive year of JPY weakness”.

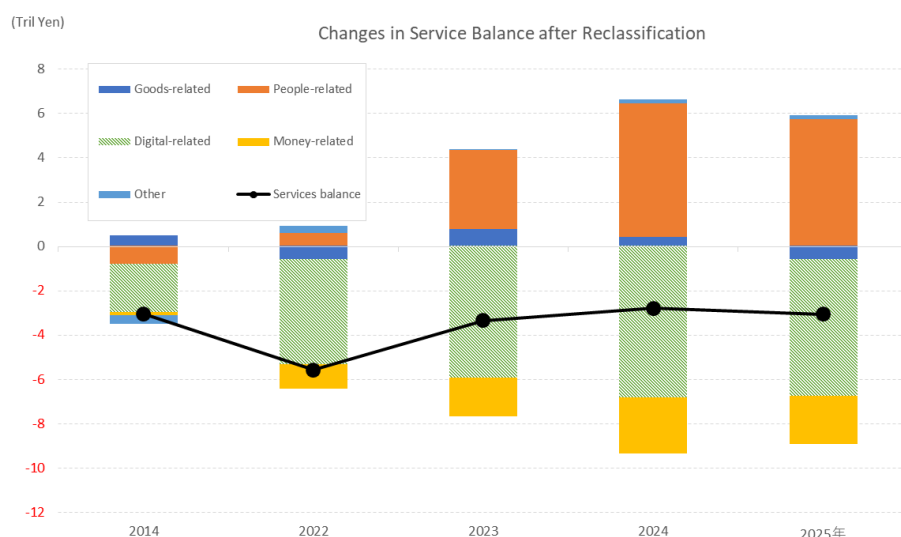
Additionally, JPY positions in IMM currency futures turned net short at USD3.55 billion as of January 13, marking the first JPY net short position in four weeks (since the week ending December 16, 2025; see chart above). While there is a possibility that JPY short positions will accumulate going forward, it is important to recognize the likelihood that JPY depreciation due to futures position unwinding has come to an end for the time being. In light of current circumstances, it appears that the main drivers of JPY depreciation may be shifting from the previous supply-demand environment to such issues as “low real interest rates” and “crisis currency selling”.

### Services Deficit Roughly Stable

This article has long been monitoring signs of structural change in Japan's services balance, and it now appears that Japan's 2025 services balance is likely to remain at roughly the same as the 2024 balance. The travel surplus (roughly equivalent to the people-related surplus in the graph) for the January-November 2025 period was JPY5.8641 trillion, which is within sight of attaining the level of the 2024 full-year surplus (JPY6.1172 trillion), the largest such surplus ever. Although there has been some impact from political factors discouraging Chinese tourists from coming to Japan, it appears unlikely that Japan's travel surplus will be significantly smaller in 2025 than it was in 2024. Meanwhile, the

January-November 2025 digital deficit is JPY6.1737 trillion, roughly the same as the full-year 2024 digital deficit (JPY6.8454 trillion). However, the goods-related balance was a surplus for 2024 but has become a deficit in 2025, so the “other services deficit” (including the digital deficit) totaled JPY8.2734 trillion for the January-November 2025 period, already exceeding the full-year 2024 other services deficit (JPY8.1713 trillion). The goods-related deficit reflects a shrinkage of the surplus in industrial property royalties (such as royalties received from overseas subsidiaries), the only surplus item in the “other services balance”, and an expansion of the deficit in research and development services. Consequently, the full-year 2025 services balance is expected to be a deficit of around JPY3 trillion, roughly unchanged from the full-year 2024 figure (JPY2.7765 trillion).

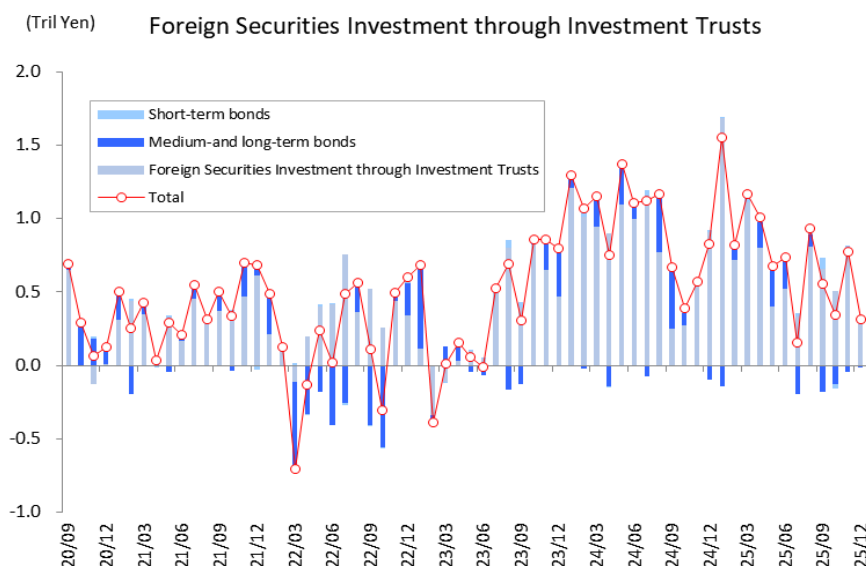
However, in 2026, when Chinese tourists' travel restrictions come into full effect, the balance between the people-related surplus and the digital deficit will be somewhat disrupted, so the services deficit may widen. During 2026, if Japanese exports shrink due to Trump tariffs and the country's imports also decline due to falling resource prices and weak domestic demand, the trade deficit will be of a magnitude similar to the 2025 trade deficit, but the overall trade and services deficit will expand owing to the travel surplus shrinkage. While the deficit won't be large enough to drive JPY depreciation as it did in 2022 or 2023, a deficit is a deficit, and it will not be possible to cite that deficit as a factor that could promote JPY appreciation.



(Source) Created by the author based on the Bank of Japan paper entitled “Globalization of Service Transactions from the Perspective of Balance of Payments Statistics”.

### Improvement from “Worst” to “Worse than Usual” and “Bad”

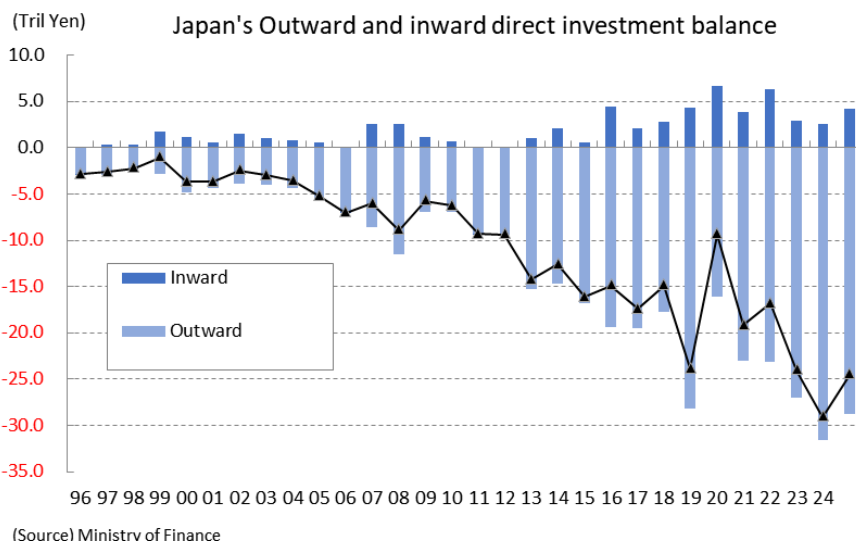
Full-year 2025 figures from the Ministry of Finance's “International Transactions in Securities” report have become available. Looking at those figures by investor type, one finds that foreign securities investment via investment trust management companies (hereinafter referred to as investment trusts, whose activities directly reflect the recent surge in “household JPY selling”) had net purchases of +JPY9.447 trillion. That is a large number but it represents a slowdown compared to the full-year 2024 figure of +JPY11.5069 trillion. As discussed in previous issues of this article, it



(Source) Ministry of Finance, macrobond

seems reasonable to conclude that investment resources are becoming constrained as Japan's real income environment deteriorates due to the effects of JPY depreciation and inflation. On this point, an expert opined in the January 21 edition of the Nihon Keizai Shimbun newspaper (Nikkei) that the various factors promoting JPY selling (such as individual investors' purchases of overseas assets using NISA accounts and life insurance companies' investments in foreign bonds) have already peaked out. While this is not incorrect, it seems overly hasty to say that a system (the NISA tax-exempt investment system) that has only been in place for two years has "peaked out" simply because there were fewer investments in the second year than in the first. To begin with, JPY selling of over JPY9 trillion is a huge amount, nearly double the amount of JPY buying resulting from the current account balance on a cash flow basis. If seeking factors that could reverse JPY depreciation and promote JPY appreciation, we should look for such situations as one in which overseas securities investments via investment trusts actually shifted to become net sales of overseas securities via investment trusts. At this point, the most encouraging comment one can make about the decrease in overseas securities investments via investment trusts is that it could slow the pace of JPY selling.

Incidentally, this discussion of securities investment flows pertains to the financial account within balance of payments statistics. My understanding is that flows via investment trusts are attracting attention because NISA-related outward securities investments are often not currency-hedged and have expanded to a scale never before seen. Looking at other components of the financial account, one finds that outward direct investment (directly linked to outright JPY selling) attained a record magnitude of -JPY31.6 trillion in 2024, and was fairly close to that magnitude in 2025 (totaling -JPY28.7 trillion for the January-November period). While the balance of payments figures as a whole



give the impression that JPY-selling pressures have receded compared to their levels in 2022, it is important to note that this is not the same as saying that JPY-buying pressure is emerging.

My view is that the JPY supply-demand environment was at its worst in 2022, then improved to become only slightly worse than normal in 2023 and 2024, and finally has become just normally bad from 2025 onwards. Since Japan's trade deficit has not turned into a trade surplus, the fundamental fact that "more entities want to sell JPY" remains unchanged.

#### *Magma Pressure Promoting JPY Appreciation?*

Regarding topics related to the JPY supply-demand environment, the number of inquiries I have received about the unwinding of JPY carry trades has increased significantly. On January 4, the electronic version of the Nihon Keizai Shimbun (Nikkei) posted an article entitled "'Heliocentric Theory' Ends 30 Years of JPY Weakness: Prepare for Market Drastic Change." There has been a lot of related news coverage, and it appears that the issue is raising widespread concerns.

For example, the aforementioned Nikkei article discussed the risk that if Japan's world-leading net foreign assets were to be unwound or repatriated, it could generate intense JPY appreciation pressure. This is theoretically a scenario that should always be kept in mind, but given that people have been discussing the factors that are actually preventing those net foreign assets from returning to Japan, it is somewhat disconcerting to see such asset repatriation characterized as a risk. The article states that – "the overseas money that could become the magma pressure for JPY appreciation is enormous" – and spotlights such situations as reinvestment income from 1996 to 2024 totaling JPY118 trillion and "exceeding JPY10 trillion annually over the past four years" and "net foreign assets swelling 6.3-fold over 25 years, from JPY85 trillion in 1999 to JPY533 trillion in 2024." However, the retention of massive assets overseas reflects the fact that the corporate owners of those funds perceived no investment opportunities with sufficiently high expected rates of return within Japan, so there is no reason for those assets to return to Japan unless the corporate sector's perception of conditions and opportunities in the Japanese economy dramatically change. This is something that I can assert with confidence, based on my position as someone who interacts with people from a variety of business corporations on a daily basis.

Describing the huge quantity of Japan's net external assets as a potential "magma pressure for JPY appreciation" seems to overly downplay the fact that the assets are purposely being kept overseas in light of the chronic state of Japanese economic conditions. Of course, the article's argument is conditional on the premise that macroeconomic policies under the Takaichi administration succeed and domestic demand in the Japanese economy revives. That said, every Japanese government administration in recent decades has advocated measures to stimulate domestic demand, and the results of those stimulus measures have been consistently unimpressive. In any case, I cannot agree with the expectation that Japanese companies (which have invested overseas over many years owing to diverse factors including JPY appreciation, the trend of decline in Japan's population, and rigid employment regulations) will return simply because of such factors as JPY depreciation or a rise in JPY interest rates. Given that the importance of economic security is currently becoming emphasized to a degree unprecedented in post-war history, there might be a

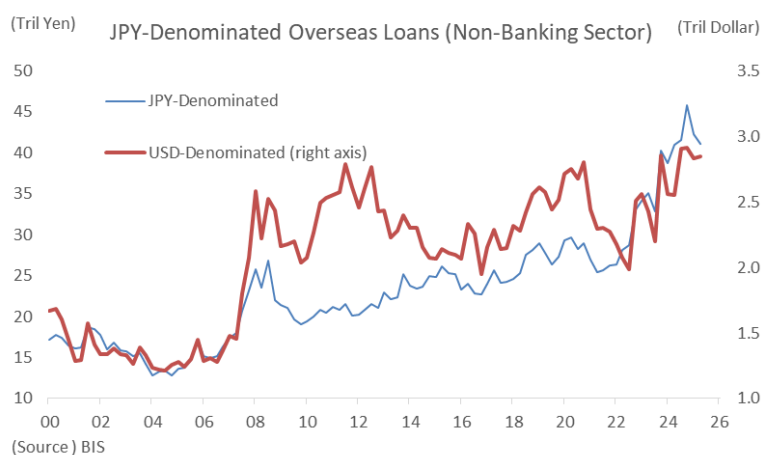
rational incentive to encourage asset and business repatriation regardless of the cost. Even in that regard, however, rather than being forced to focus on the Japanese economy, which is constrained by demographic trends, the option of friend-shoring – targeting friendly nations – also comes into play. The return of net foreign assets to Japan, which has been described as a potential “magma pressure for JPY appreciation”, is something Japan’s government and ruling party are seeking, and is a scenario that the country hopes for rather than a risk to be wary of.

### *Is JPY-Carry-Trade-Unwinding Magma Pressure?*

The previous subsection discusses why the scenario outlined in the article is unlikely to unfold with respect to corporate behavior, but there is indeed a possibility that the scenario could take shape with respect to investor behavior. If the Japanese economy continues to return to a world with interest rates and prices, the appeal of investments in Japan will increase, and there is a possibility that domestic and foreign economic entities will send capital to Japan. In particular, if there were anticipation of a continuous rise in JPY interest rates that could conceivably motivate an “unwinding of JPY carry trades” trend, the potential for such a trend could become a plausible rationale for speculative JPY buying. This was also a frequently cited argument for speculative JPY buying following the so-called Ueda Shock in August 2024. As expectations for the BOJ to raise interest rates grow, a prominent argument has been made that “since a considerable share of global financial market liquidity is sourced from JPY carry trades, if JPY interest rates rise, JPY funds that has been raised will be repaid, and all types of assets will be sold off for cash”.

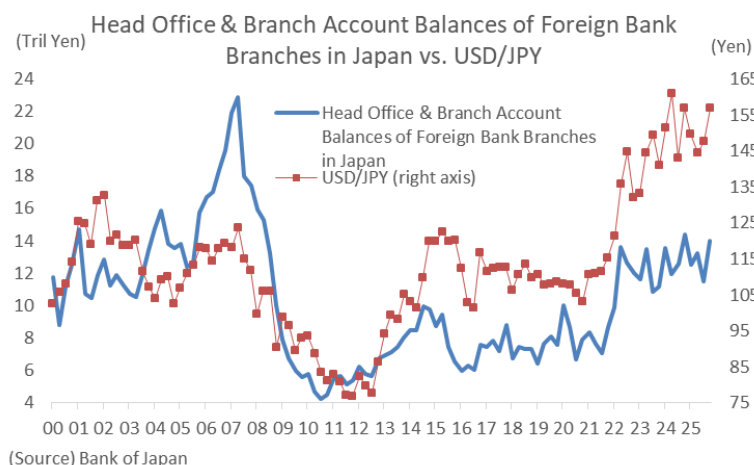
This argument is logical, but the actual JPY carry trades situation is difficult to accurately assess. Intuitively, one gets the feeling that there must be some truth to the “magma is building up” concept. While there are few means to accurately gauge the JPY carry trade balance, analysts often monitor trends in (a) overseas JPY-denominated loans (non-bank sector) within BIS international credit statistics and (b) movements in the head office-branch accounts (asset side) of foreign banks in Japan published by the BOJ.

For example, the (a) JPY-denominated loan balance has been increasing sharply since March 2022, when JPY’s depreciation accelerated (see graph). While it is natural for JPY-denominated loan balances to surge amid JPY weakness, growth is also evident in USD-denominated balances. That said, while the level of JPY-denominated balances is by far the highest ever, the level of USD-denominated balances is roughly in line with previous record highs. This suggests that carry trades alone may not fully explain the unprecedented JPY weakness. Furthermore, JPY-denominated loan balances surged from 2005 to 2007, the so-called JPY depreciation bubble period. While



the unwinding of those positions was also said to have triggered the subsequent super-strong JPY, the levels never returned to pre-2005 levels throughout the 2008-2012 period. One could emphasize that the super-strong JPY trend was able to take shape despite this, but it bears remembering that Japan was a major trade surplus country at the time, so there was ample actual demand for JPY. Even if JPY carry trades are massive and powerful, it is questionable whether they can explain all the volatility.

Furthermore, the (b) head office/branch accounts of foreign banks in Japan have expanded rapidly since 2021 and have remained high, so it is natural to be wary of room for a reversal. That said, the balance is still only about half of what it was during JPY’s 2005-07 depreciation bubble period. Looking at the graph, it appears that the head office/branch accounts began to move in 2021, and USD/JPY



began to move in 2022 with a lag, so it is worth questioning the causality. That said, following post-Lehman regulatory tightening, the banking sector must maintain its Liquidity Coverage Ratio (LCR). It is impossible to determine from these statistics alone whether the movement is aimed at holding HQLA (High-Quality Liquid Assets) for regulatory compliance or is speculative carry trade aimed at capturing interest rate differentials.

Furthermore, the statistics from the BIS and the BOJ only represent figures for on-balance-sheet transactions, and there is no doubt that JPY funding through currency swaps is significantly larger. If we include such off-balance-sheet transactions, the JPY carry trade balance could indeed reach a scale that could literally be described as a magma-like mass (though it may not have reached that level). In any case, the BIS and BOJ figures that are often used analytically are only the tip of the iceberg.

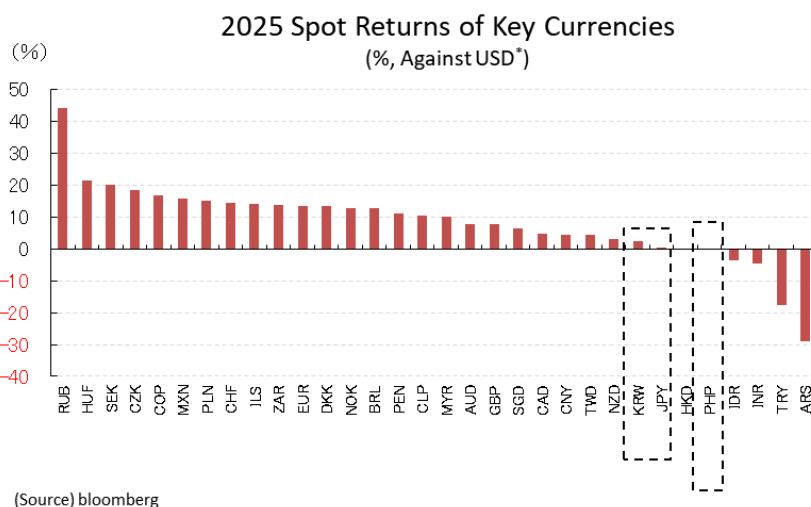
### *JPY Appreciation Risk Could Exist, But More-Realistic Risk from Overseas Central Bank Policies*

However, the materialization of the JPY appreciation outlook based on unwinding JPY carry trades requires the expectation that the widened real interest rate differential will narrow significantly and sustainably. Should this occur, the magnitude of the shock would indeed be substantial. On the other hand, this cannot occur without the coinciding of two conditions – the BOJ raises interest rates at a rapid pace, and foreign central banks remain cautious and continue to lower interest rates for the time being. It is safe to classify the “unwinding of net external assets and JPY carry trades leads to an ultra-strong JPY” scenario as a risk scenario that would be significant if it were to occur but is not very likely at present. While it is important from a risk management perspective to recognize that the potential magnitude of that risk is huge, the more realistic risk for the Japanese economy today is the growing possibility that central banks in Europe and the U.S. will complete a full cycle of rate cuts and return to a rate hike phase, potentially restarting the JPY depreciation trend.

## Risks to My Main Scenario – Concept of Asian Crisis Currencies

### *The Asian “Crisis Currencies” of Japan, South Korea, and the Philippines*

Over the past year, I have been closely monitoring the risk that Japan’s considerable economic and security dependence on the United States may be causing JPY to weaken in response to USD-selling. This kind of risk is not limited to JPY – currencies of countries likely to be on the front lines of a regional emergency in Asia (such as the South Korean won (KRW) and the Philippine peso (PHP)) also weakened last year. Of course, the Chinese Yuan (RMB) and the New Taiwan Dollar (TWD) also performed poorly against USD (see graph). Furthermore, while it is generally accepted that some kind of Taiwan emergency is likely to arise eventually, some military analysts anticipate that such a Taiwan crisis will be synchronized with a



Korean Peninsula crisis, so it is understandable that KRW is attracting increasing attention. There are various metrics for assessing security dependence levels, but it is a simple fact that outside of the United States, Japan is the country with the largest number of U.S. military bases and facilities, and Japan consequentially is the country hosting the largest number of overseas U.S. military personnel. It goes without saying that these figures reflect the U.S. military's strategic priorities in the East Asia and Indo-Pacific region. Some simulations suggest that the only way China could succeed in a Taiwan emergency is if Japan did not cooperate with the US, but Japan can be considered to have legitimate interests related to such a conflict, during which JPY would be positioned as an crisis currency. After Japan, the country with the next largest number of U.S. military bases and facilities is Germany, which is a key to the defense of Europe and also serves as a logistical support base for operations in the Middle East and Africa. Next is South Korea, which would be directly involved in any contingency on the Korean Peninsula. It is often noted that Japan is burdened with a particularly high Host Nation Support (HNS) cost-sharing ratio with respect to U.S. military bases, as Japan's HNS ratio is about 75%, while the HNS ratios of South Korea and Germany are about 40% and 30%, respectively.

While the Philippines may not stand out in such quantitative comparisons, its geographical importance is well known. In 2023, the Philippines signed an agreement under the Enhanced Defense Cooperation Agreement (EDCA) to increase the number of bases available to the U.S. military (EDCA bases) from five to nine, and has been widely reported that three of the four additional bases are located in areas close to Taiwan. By establishing EDCA bases in the Philippines, the United States has established a capability to conduct pincer attacks on Taiwan from Okinawa in the north and the Philippines in the south. The Philippines does not have to shoulder expensive HNS costs as do Japan and South Korea, but as it lacks significant military capabilities of its own, it is completely reliant on U.S. military aid for its national survival. Thus, if the U.S. becomes more isolationist and begins decreasing its involvement in the East Asia/Indo-Pacific region, the Philippines is likely to be among the first countries to suffer from heightened awareness of the greater risks of military conflicts. In this respect, there are similar rationales for the weaknesses of JPY and PHP. It may still be too early to integrate such groupings into this article's main forecast scenario but, given forex trends in 2025, we should be aware that we may be entering an era in which one should optimally give due attention to evaluating how forex rate movements relate to the framework of Asian crisis currencies.



### Isn't AUD an Crisis Currency?

Expanding the discussion to include Oceania, one will note that Australia has very strong security ties with the United States, as it is a member of AUKUS (a trilateral security cooperation framework between the United States, the United Kingdom, and Australia) and is being given access to U.S. nuclear submarine technology that had previously been provided only to the UK. However, AUD is expected to rise against the USD by just under 8% in 2025, the third-largest increase among Asia-Oceania currencies after the Malaysian ringgit (MYR) and Thai baht (THB, see graph). If one focuses the discussion on security issues, it is not surprising that Australia, which is likely to remain in the strategic hinterland, is seen as less susceptible to war than Japan, South Korea, and the Philippines, which are on the front lines and likely to be directly attacked in the event of a contingency in Taiwan or on the Korean Peninsula.

Moreover, AUD is the currency of a resource-rich country. Japanese and South Korean products (such as semiconductors and automobiles) could be manufactured in China, but Australia's resources (such as high-quality iron ore) would be more-difficult to replace. If you control another country's economic choke points, it doesn't matter so much if the other country also controls your economic choke points. As AUD has the advantage of being the currency of a country that should be able to effectively stand up to China, it is likely to remain relatively strong and not be shunned in times of crisis. This is a short-term assessment, however, and from a long-term perspective it must be taken into consideration that China progressively eliminating this vulnerability by undertaking investments to secure huge alternative resource reserves, such as the Simandou iron ore mine in Guinea. It will likely take considerable time before China obtains sufficient alternative resource sources, but the increase in such resource sources poses a growing risk for Australia.

By the way, from the perspective of the "next move" in orthodox monetary policy, the Reserve Bank of Australia (RBA) is expected to become the second major central bank to hike interest rates after the BOJ's recent hike. Unlike JPY, however, AUD has remained strong against the USD. This could simply be attributed to the difference between JPY, whose policy interest rates in real terms are still in deep negative territory, and AUD, which offers policy rates in positive territory in real terms, but it is also possible that it reflects a positive evaluation of AUD's abovementioned greater insulation from geopolitical risks. Incidentally, the U.S. real policy interest rate is (at around +1% (3.75% - 2.70% inflation)) slightly above Australia's (at around +0.2% (3.60% - 3.40% inflation)), but the real policy interest rate differential is negligible given expectations of an RBA rate hike.

### Overview of Other Asian Currencies

Investors emphasizing geopolitical risks are likely to classify TWD, RMB, KRW, and JPY as "crisis currencies" or "conflict-affected currencies of countries potentially involved in disputes". However, there are other Asian currencies associated with similar concerns. The table below gives an overview of the various concerns. For instance, THB appears to be a currency with a relatively high level of concerns. Should the US and China engage in armed conflict, the South China Sea could be blockaded, making it highly likely that tourist flows from the three major Asian powers—Japan, China, and South Korea—would cease. Furthermore, the Pacific side of the Philippine Sea might also be blockaded. If so, flights carrying tourists from North America would likely be grounded. For travelers from Europe, the prevailing interpretation would likely be an abstract notion that "East Asia is at war". Consequently, the tourism industry across all of Southeast Asia, including Japan, South Korea, and Thailand, would fundamentally face a significant decline in demand. While Thailand is often cited as a prime example of a country for which tourism accounts for a large share of the domestic economy, Japan – which has recently offset its digital deficit with a travel surplus – cannot afford to view this as someone else's problem. As is well known, Thailand is also a major production base for Japanese automobile manufacturers. Should Japan become a party to the conflict, parts supply from Japan to Thailand would inevitably stall, constraining Japan's finished vehicle exports. In any case, Thailand's economic fundamentals as a trade surplus nation would be shaken.

On the other hand, while the Indian rupee (INR) and Indonesian rupiah (IDR) were currencies shunned last year due to individual factors, if a real crisis were to occur, they might be more readily selected for Asian portfolios based on their image as "relatively better options." Both are countries with strong domestic demand, making them less susceptible to external shocks. Indonesia, moreover, also possesses the advantage of being a resource-rich nation. Furthermore, should the South China Sea or Philippine Sea become unusable as shipping lanes due to conflict, vessels traveling east to Japan and South Korea, for example, would need to pass through Indonesia. Indonesia possesses this geographical advantage. While concerns about current fiscal laxity need addressing, in times of crisis specifically,



Indonesia – with its traditionally neutral diplomatic stance – has the potential to become a key player controlling chokepoints across various fronts, alongside its diverse resources. Financial markets, particularly foreign exchange markets, are likely to value such clear strengths. Analyzing JPY exchange rates from the perspective of Asian crisis currencies raises the possibility of price movements deviating significantly from past patterns. This should be considered a risk factor warranting vigilance regarding JPY exchange rates not just in 2026, but for the foreseeable future.

#### East Asia and Indo-Pacific Region Contingencies and Perceived Impact on Currencies

Currency	Depreciation Risk	Likely Outcomes During Contingency	Investor Perception During Contingency
KRW	Very High	Seoul's proximity to the military demarcation line makes its geographical vulnerability significant. Furthermore, a blockade of the Taiwan Strait would make securing sea lanes difficult, posing challenges to securing resources.	Many likely anticipate <u>a flight of domestic and international capital in anticipation of a domestic economic downturn.</u>
TWD	Very High	A naval blockade would physically disrupt economic activity. Combined with cyberattacks by the Chinese military, Taiwan's financial system would become isolated from the world.	It is likely that free financial transactions would also become physically difficult. Many likely anticipate a flight of domestic and international capital in anticipation of domestic economic stagnation.
JPY	High	U.S. military bases in Japan risk becoming targets of attack. Taiwan, a key player in a potential conflict, would face direct attack. Furthermore, over 10% of Japan's outward FDI is in China – would this be abandoned?	<u>Concerns over fiscal expansion due to being a conflict party, economic stagnation from halted land, sea, and air supply chains. Net foreign assets shift from a premium to a discount factor.</u>
CNY	High	Sanctions such as the blocking of SWIFT would be expected. Supply chains via the East China Sea would be cut off. China's role as a key international supply chain element would end. Strict capital controls are inevitable.	Offshore yuan (CNH) plummets, but onshore yuan (CNY) remains flat. <u>A state of severe constraints on "capital mobility" becomes entrenched.</u> The reform and opening-up policy ends in both name and substance.
THB	Fairly high	Any crisis in East Asia and the Indo-Pacific would severely impact tourism, which accounts for 20% of GDP. China is the largest source of visitors. Many Japanese companies have factories there, making supply chain disruptions a major concern.	This is associated with a decrease in exports of goods and services, raising concerns about <u>THB selling pressures stemming from the supply-demand situation.</u> There are worries that finished vehicle exports to Japan could be halted.
AUD	Neutral	Australia is highly dependent on exports to China. A slowdown in the Chinese economy would directly lead to a slowdown in Australian exports. However, in the short term, China's reliance on Australian iron ore may prevent major disruptions.	In the short term, <u>China and Australia are in a mutually assured destruction relationship,</u> so major pessimism is restrained. In the long term, however, China will gradually develop alternative sources for iron ore, which could be a factor contributing to a shift away from AUD.
INR	Low	Geographical distance from an East Asian crisis could conceivably cause India to be considered as an alternative base for China. It may be preferred as a relatively safe haven. But if a Taiwan contingency arises, would India not strike behind China's back? What about a preemptive Chinese attack anticipating this?	<u>It has a relatively low level of dependence on external demand.</u> However, if a crisis destabilizes sea lanes from the Middle East and drives up crude oil prices, the trade deficit would widen.
IDR	Low	Remote from conflict zones and resilient to surging resource prices. Should the South China Sea become a combat zone, ships bound for Japan and South Korea would need to pass through Indonesia. This positions the country to control strategic chokepoints in both security and economic terms.	<u>Its neutrality, based on its traditional "non-aligned" diplomacy, diverse resources, and geographical importance are likely to provide investors with reassurance in times of crisis.</u> While its inherent fiscal risks require close monitoring, <u>it may be relatively favored within Asian portfolios.</u>

## EUR Outlook – Rate Cut Halt Supports EUR Firmness

### EUR Area Monetary Policies Now and Going Forward – An Era of Major Cross-JPY Exchange Rate Fluctuation Risks

#### End of Rate Cut Phase Confirmed

EUR has remained firm against both JPY and USD, with EUR/USD surpassing USD1.20 on January 27 for the first time since June 2021. Although EUR/USD has subsequently decreased somewhat, EUR remains generally firm. In line with these developments, the Account of the December 18 ECB Governing Council meeting (released on January 22) provided additional confidence that the ECB's interest rate cut phase was coming to an end. The Account confirms that market participants do not anticipate further rate cuts in 2026, expecting essentially no change followed by a “next move” of rate hikes starting in 2027 or later. This view aligns with the ECB's fundamental stance. The Account's final “Monetary policy decisions and communication” section, which provides guidance on monetary policy management, clearly states that – “Given the Governing Council's medium-term orientation [...] the current market pricing of interest rates was seen as consistent with the latest [inflation] fixings and in line with the Governing Council's reaction function.” This clearly signals that the ECB understands market expectations and shares those expectations.

The December 2025 Eurosystem staff macroeconomic projections for the euro area anticipate that the headline inflation rate (as measured by the Harmonised Index of Consumer Prices (HICP)) will average 2.1% in 2025, and descend to 1.9% in 2026 and 1.8% in 2027, before inching up again to 2.0% in 2028. Expectations for ECB interest rate hikes, if not in 2026, then at least from 2027 onwards, are in line with the staff projections. The Governing Council found that, although negotiated wage growth remained volatile, it had decelerated as expected, falling to 1.9% in the third quarter from 4.0% in the second quarter, partly reflecting lump-sum payments in Germany that were made in 2024 but not repeated in 2025. The Account states that Governing Council members' view was that –

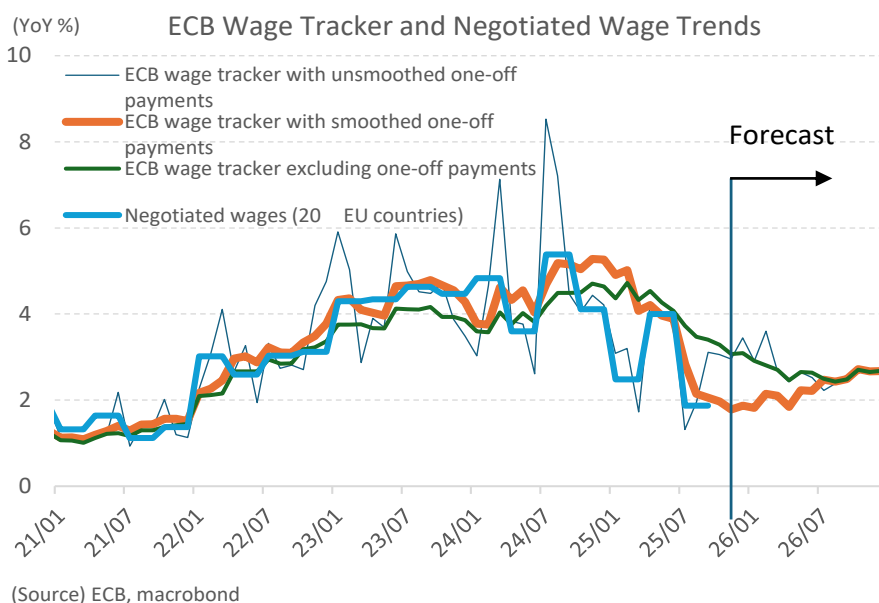
– “Compensation per employee had risen by more than expected in the September staff projections. Still, forward-looking indicators, such as the ECB's wage tracker and surveys on wage expectations, suggested that wage growth would ease in the coming quarters, before stabilising somewhat below 3% towards the end of 2026.” It appears that the Governing Council recognizes that underlying upward wage pressures remain. In any case, there seems to be no need to expect any interest rate cuts in the foreseeable future.

#### Impact of ReArm Europe Plan

Regarding the future of the euro area economy, the impact of the EUR800 billion ReArm Europe Plan announced last March will be significant, and the December Governing Council meeting also discussed the question of how to understand the effects of increased defense spending on the economy. When new spending on this scale is undertaken by the public sector, the theoretical issue at stake is whether new spending will crowd out private investment, or whether it will stimulate private investment and promote growth. While Japan, already operating at full employment, primarily worries about the former, the latter (the so-called multiplier effect) is expected to be substantial in the euro area.

The ReArm Europe Plan was designed to address changing regional security dynamics and not to boost the euro area economy, however, so one should not be overly optimistic in projecting its impact on the real economy. In this regard, the Account states that – “as defence spending was predominantly about managing external security risks, it was argued that the fiscal multiplier on output was likely to be low.” In particular, it was pointed out that – “Higher defence spending was essentially trying to control potential damage. Therefore, since much of it was intended to avoid a worse outcome, the point was made that it was unlikely to durably increase the potential of the economy.” Governing Council members expressed concerns that, in an era when defense spending becomes large, people will become more reluctant to consume and invest, thereby slowing growth in economic output. On the other hand, it was also argued that – “the fiscal multipliers from defence spending might be higher than those assumed in the staff projections, depending on the share of spending that went on imports and research and development.” The Governing Council's current stance is that it is unclear whether the ReArm Europe Plan will have significant positive or negative economic effects, but it appears that the council does not consider it inevitable that the plan will have negative effects.

One thing is certain – rising geopolitical tensions and increased defense spending are putting increasing pressure on euro area finances – and the report clearly stated that there was consensus on this point. So long as fiscal deficits

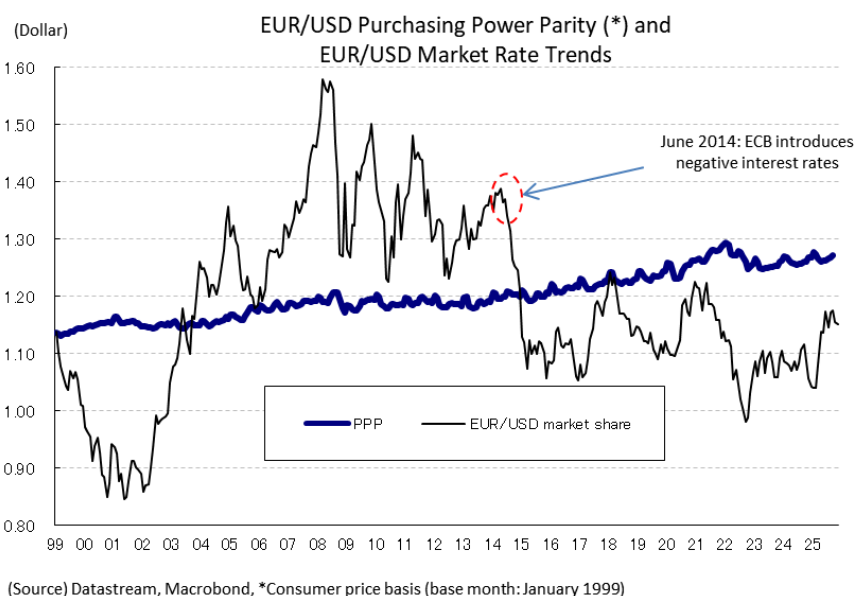
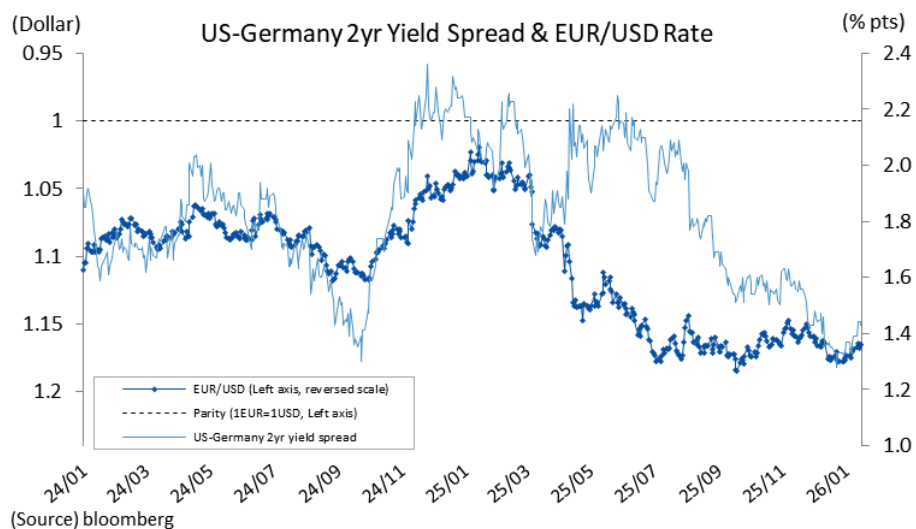


remain elevated, future room for policy adjustments will be limited, raising concerns that resilience to future shocks could weaken over the medium-to-long term. However, It can be argued that, under the Stability and Growth Pact (SGP), the euro area has been maintaining an excessively tight fiscal stance. Given the precariousness of Europe's security dependence on the United States, easing fiscal constraints could be considered a responsible and proactive kind of fiscal expansion. It seems likely that EUR's strong performance over the past year reflects a generally favorable interpretation of the euro area's fiscal expansion.

### Risks and EUR Outlook

The December Governing Council meeting's Account states that – “most members viewed the risks surrounding the inflation outlook as two-sided, with some members judging that the distribution of risks had shifted up since the previous meeting, while recognising that downside risks remained important.” It would therefore be fair to conclude that it is premature to say that a rate cut within the year is 100% off the table. However, the Account also points out that – “the range of data surprises in 2025 had been more contained than in any other year over the past two decades in spite of the high level of geopolitical uncertainty, underlining the euro area's resilience.” Given the current state of EUR/USD, which is moving closely in line with the Europe-U.S. interest rate differential, it seems prudent to consider that upside potential remains greater, especially as the symmetry between the ECB and the Fed continues to be a key factor. An additional EUR tailwind can be expected to stem from President Trump's open efforts to promote USD depreciation.

Since EUR's inception, the euro area has consistently experienced disinflation relative to the United States, theoretically creating conditions for EUR/USD to rise on a purchasing power parity (PPP) basis. Furthermore, the euro area has maintained its position as the world's largest current account surplus region, thereby strengthening EUR's supply-demand situation. At the time this article was written, EUR/USD's PPP-based level was around EUR1.28, meaning that if USD/JPY were to fall to JPY145, EUR/JPY would be around JPY186. In January, CHF/JPY attracted attention for surpassing JPY200, but as the “weak JPY vs weak USD” situation has become the global norm, cross-JPY exchange rates have become prone to large fluctuations and less likely to recover from those fluctuations. While discussions of forex trends tend to focus on USD/JPY, it is important to be aware of the major risks cross-JPY exchange rate fluctuations pose to investors and businesses.



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