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Forex Medium-Term Outlook

April 30, 2026

Overview of Outlook

USD/JPY stayed high in April. The market is still mainly driven by the situation in the Middle East, specifically the security situation in the Strait of Hormuz and resource price fluctuations. There are still concerns that rising prices of mineral fuels, led by crude oil, will widen Japan's trade deficit and lead to a 2022-type JPY depreciation. The timing of the collapse of JPY supply and demand depends on when and how much of its crude oil reserves Japan releases, but at the current rate, one expects to see a change in the trade balance for June-July. In other words, the actual supply and demand environment has not yet deteriorated, but anticipation of its future deterioration is already driving JPY depreciation via speculative JPY selling. One could say it is a market where real demand and speculation are reinforcing each other, and the situation may not be without basis. Meanwhile, it is also important to note that the real interest rate trend, a very important driver of exchange rates, is supporting a stronger JPY. The current phase of JPY depreciation is being driven by a rapid expansion of not just the trade deficit but also the U.S.-Japan real interest rate differential. Over the past year, the real U.S.-Japan 10-year interest rate differential has shrunk to less than a quarter of its previous size, which would lead to expectations of JPY strengthening under normal circumstances. Perhaps this is currently being overlooked in the face of the overwhelming worsening of the JPY supply-demand climate, which is a much more powerful factor. Further, during the current forecasting period, a scenario whereby rising JPY interest rates cause turmoil in overseas bond markets and limits the BOJ's ability to raise interest rates should be viewed as a JPY depreciation risk factor.

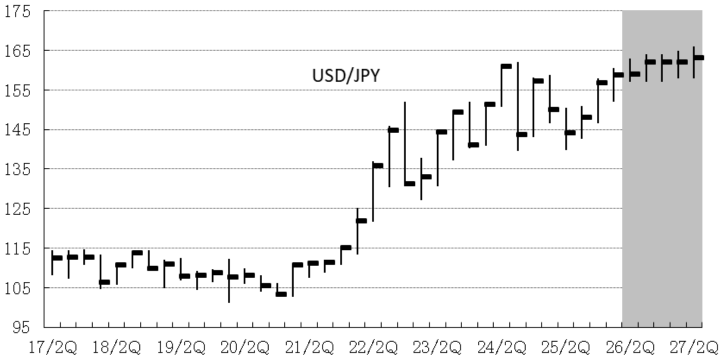
EUR remained firm in April despite the continued predominance of safe-haven USD buying. There are several possible reasons for this, but the main ones seem to be: (1) no change in the underlying de-dollarization trend, (2) sharp hawkish shift in the outlook for the ECB's policy interest rate, and (3) continued strength of the regional supply-demand structure. The most obvious reason may be (2). Following the attack on Iran, expectations of "just under one rate cut by the ECB this year" switched dramatically to three interest rate hikes being priced in at one point. Even at the time of writing, despite expectations having receded somewhat, two interest rate hikes are still being priced in for this year. There is an impression that EUR is merely being bought in line with the Europe-U.S. interest rate differential. Again, from a longer-term perspective, point (3) cannot be overlooked. The size of the euro area's 2025 current account balance was second only to China. Given this solid demand for EUR, it is only natural that it would see a buying bias. In the very long term, with a shift toward nuclear power being considered as part of the region's power mix, EUR can be expected to be reborn as a more robust currency. EUR appreciation may slow down in the latter half of the forecast period, partly due to the Fed's interest rate cut phase coming to an end, but a firm trend overall is anticipated for the currency.

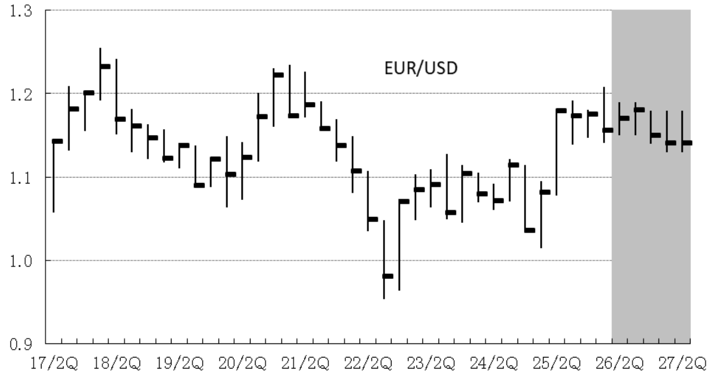
Summary Table of Forecasts

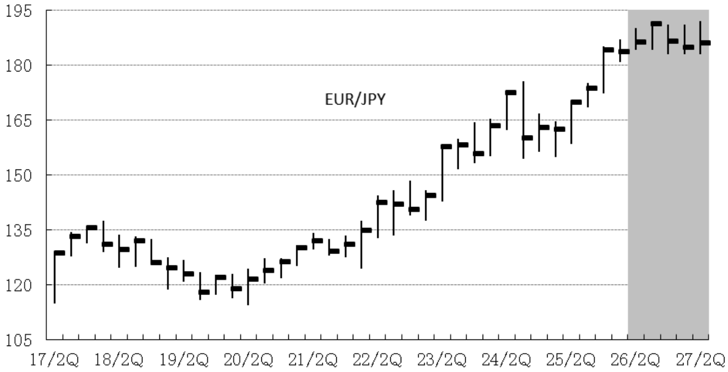
	2026 Jan-Apr (Actual)	May-Jun	Jul-Sep	Oct-Dec	2027 Jan-Mar	Apr-Jun
USD/JPY	152.10 ～ 160.48 (160.30)	157 ～ 163 (159)	157 ～ 164 (162)	157 ～ 164 (162)	158 ～ 165 (162)	158 ～ 166 (163)
EUR/USD	1.1409 ～ 1.2084 (1.1679)	1.15 ～ 1.19 (1.17)	1.15 ～ 1.19 (1.18)	1.14 ～ 1.18 (1.15)	1.13 ～ 1.18 (1.14)	1.13 ～ 1.18 (1.14)
EUR/JPY	180.84 ～ 187.95 (187.22)	184 ～ 190 (186)	184 ～ 192 (191)	183 ～ 191 (186)	183 ～ 191 (185)	183 ～ 192 (186)

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

Exchange Rate Trends & Forecasts







USD/JPY Outlook - Both Real Demand and Speculation Propping up JPY Selling

JPY Supply-Demand Climate: JPY Selling Continues in Anticipation of Trade Deficit Cliff

Approaching "Trade Deficit Cliff"

USD/JPY continued to fluctuate around 160 in April. Following the Iran attacks, speculative JPY selling has been leading the trend in the forex market based on the logic of "rising crude oil prices → widening Japanese trade deficit → increased JPY selling pressure," which is a rational reaction in that it incorporates changes in Japan's fundamentals. However, even if the logic itself is correct, it is important to note that its particulars are complex. As already reported, Japan has begun a phased release of its oil reserves. Since the released reserves will substitute for imports, the widening of the trade deficit will be postponed (or suppressed) for several months. Therefore, the trade balance in the immediate future (e.g., March through May) is unlikely to be as bad as market participants fear. However, the current situation merely involves substituting existing oil reserves for oil that would otherwise be imported, and if this policy becomes unsustainable, things could change drastically.

This drastic change could be described as a "cliff." This is because, with the end of reserve releases, oil imports will first rise as fresh imports replace supply previously drawn from reserves. In addition, depleted reserves will need to be replenished, leading to a sharp increase in import volumes relative to prior months. If crude oil prices have also risen at that time, JPY depreciation will further amplify the financial burden in JPY terms.

In other words, at a certain point, the value of Japanese crude oil imports could rise sharply due to a combination of volume, price, and exchange rate, potentially forcing a sharp increase in Japan's trade deficit and leading to a situation that could be described as a "trade deficit cliff." One needs to be mentally prepared for this "certain point." Based on currently available information, a second release of reserves (worth 20 days of oil) has been decided for May. Even assuming there is no third release and the widening of the trade deficit is able to be avoided up to May, changes could be seen in the trade statistics by June or, at the latest, by July, the data for which would typically become available in July and August. However, the increase in import value for liquefied natural gas (LNG) and coal, which do not have large stockpiles, may be reflected earlier.

Predicting the Timing of the "Cliff"

Of course, given that market players are already prepared for a potential widening of the trade deficit due to the current turmoil, it is unclear how much the already volatile forex market will react in the event that it does. However, it is difficult to accurately predict the timing and extent of impact to the trade deficit from the three factors of quantity, price, and exchange rates, so a larger-than-expected trade deficit cliff could significantly change expectations and accelerate JPY selling. Accurately predicting changes in import volume and associated import value is difficult, but going by the reserve release status and the expected arrival time of (expensive) crude oil procured from distant locations other than the Middle East, it is possible to make a rough prediction regarding the timing of a trade deficit cliff.

According to the Status of Oil Reserves published by the Agency for Natural Resources and Energy, Japan had oil reserves to cover ≈ 215 days (132 days of national reserves, 80 days of private reserves, and 3 days of joint stockpile with oil-producing countries) as of April 20. At that point, the first release (45 days' worth), being implemented since March, was sufficient to get through to the end of April, and the second release (20 days' worth, to be implemented sometime in May) was expected to cover the remainder of May. During this period, with imports being substituted by reserves, a temporary improvement in the trade balance is natural. In fact, the March trade statistics were favorable. However, this is only a temporary improvement. For example, say the second release is used up by the end of May. If transit through the Strait of Hormuz resumes by then, expensive crude oil imports will resume starting June (see table). At that point, imports previously substituted by stockpile drawdowns will rebound, while additional imports for restocking will compound the effect, resulting in a marked surge in import volumes relative to normal levels. The increase in oil spot prices and the worsened terms of trade for Japan due to JPY depreciation must also be taken into account as factors further pushing up the import value. With all three factors – volume, price, and exchange rate – likely to contribute to import expansion from June (data released starting July), the Japanese economy may face a trade deficit cliff at that time.

Oil Reserve Release and Trade Statistics (Customs Basis) Simulation(*)

Month in question	Month of data release	Oil supply/releases	Trade blaance outlook	Expected market reaction
Mar	Apr	Start of 1st release	**Firm:** Imports down starting 2H of the month due to reserve release, narrowing the deficit	None
Apr	May	1st release amount consumed	**Significant Improvement:** Reserve release in full operation, significantly suppressing import costs	None
May	June	Start of 2nd release	**Level:** First release (80 million barrels) depleted. **Second release (20 days' worth) implemented**	None
June onward	July onward	･2nd release amount consumed ･Replacement crude starts arriving ･Stockpile replenishment	**Rapid Deficit Expansion: All imports at high prices; With no releases, high import volume increases, high prices, and JPY weak in forex markets, resulting in a "trade deficit cliff"**	**Strong JPY selling**

(Source) Prepared from various reports by the Global Foreign Exchange Department, Mizuo Bank,
*Assuming 20 days' worth of oil reserves to be released in May, and no third release

Specifically, how much of a deficit expansion should one expect? According to 2025 customs statistics, crude oil and refined oil imports amounted to ≈ 863 million barrels in terms of volume, and about JPY 9.62 trillion in terms of value. This translates to ≈ JPY 11,147 per barrel, or about USD 74.3 per barrel at the average 2025 USD/JPY exchange rate (≈ 150). If we use the current price of USD 100 per barrel, and the current USD/JPY exchange rate of ≈ 160, the value of crude oil and refined oil imports would increase from ≈ JPY 9.62 trillion to ≈ JPY 13.8 trillion, an increase of ≈ JPY 4.2 trillion. This is a dramatic increase considering that the total trade deficit for the full year of 2025 was ≈ -JPY 2.6 trillion. Note, moreover, this figure only covers crude oil and refined oil.

Much Earlier Timing of Cliff for Mineral Fuel as a Whole

It goes without saying that resources are not limited to crude oil. If going by customs statistics, the calculations must apply to mineral fuels overall. In the example above, a simplistic interpretation is that the JPY-denominated price of crude oil would increase from JPY 11,147 per barrel (USD 74.3 x 150) to JPY 16,000 per barrel (USD 100 x 160), an ≈ 43.5% increase. If, however, we reinterpret the figure as pertaining to all mineral fuels, including LNG, coal, and petroleum products other than crude oil, the increases are as shown in the chart. Japan initially held ≈ 240 days' worth of crude oil reserves, but has nowhere close

Simulation of Impact on Mineral Fuels as a Whole (*)

Item	2025 actuals	Estimated based on current terms	Increase in import value	Notes
Crude and refined oil	9.62	13.81	4.19	Import suppressed for 2-3 months due to reserve releases
Liquefied natural gas (LNG)	5.7	8.18	2.48	Low stockpiles, directly leading to deficits
Coal	3.34	4.79	1.45	Direct impact on power generation costs
Petroleum products/other	3.48	4.99	1.51	Gasoline, naptha, etc.
(Total) Mineral fuels	22.14	31.77	9.63	≈JPY 10 trillion increase in annual burden Share of imports up from ≈20% to ≈30%

(Source) Prepared by the Global Foreign Exchange Department, Mizuo Bank using Customs Statistics from the Ministry of Finance, etc.
*Assuming USD/JPY=160 and crude oil and refined oil prices are USD 100/barrel, the JPY-denominated import value for 2025 will increase by 43.5%
This growth rate is also applied to other mineral fuel items in the calculations. In reality, there will naturally be variations in the actual increase.

to such massive national reserves for LNG or coal. For example, LNG storage presents challenges, and reserves are typically limited to about 2-3 weeks' worth. As reported, attacks on Qatar's industrial zones are said to have damaged nearly 20% of the country's LNG production capacity, leading to reported defaults on contracts with countries such as China, South Korea, and Italy. As a result, even if Japan's dependence on Qatar for LNG had been lower, LNG prices would have been driven up as these countries scrambled to find alternative sources. Further, the high price of LNG is causing a global shift in demand towards cheaper coal, which in turn is driving up coal prices. Thus, this domino-effect surge in mineral fuel prices is steadily hollowing out Japan's trade balance structure.

If, as estimated in the chart on the previous page, the increase in LNG and coal imports alone amounts to ≈ JPY 4 trillion, this portion may be reflected in customs statistics from April onward, pushing up the trade deficit to that extent. In a purely a hypothetical scenario where events unfold as per my estimation, it may not be surprising to see an overall ≈ JPY 10 trillion increase in mineral fuel imports. Incidentally, if mineral fuel alone exceeds JPY 30 trillion, this would result in ≈ 30% of Japan's total imports (≈ JPY 114 trillion in 2025) being energy costs. Compare this with the first oil shock (1973), when crude oil's share in total imports rose sharply, but the weaker JPY offset this by boosting Japanese exports of consumer electronics and automobiles. This time, however, such a virtuous cycle is not at play, and Japan is facing a more permanent deficit trend thanks to the digital deficit and other payments further exacerbated by the weaker JPY.

Incidentally, in 2022, the year with the largest trade deficit on record, Japan's mineral fuels imports amounted to ≈ JPY 33 trillion, which is very close to the ≈ JPY 32 trillion figure shown in the chart on the previous page. However, as already discussed, as long as stockpile releases continue, there may be periods when the trade deficit actually shrinks as imports are substituted (this will naturally keep down the calendar year trade deficit as a result). This report does not predict the number or timing of stockpile releases, but merely assumes that they will stop after the second release in May. If new developments unfold, new calculations will have to be made (ultimately, it is just a question of the "cliff" being postponed).

Inevitable Impact on BOJ's Policy Management

While it is premature to discuss the impact on Japan's Consumer Price Index (CPI), if the prices of electricity (weight 3.44%), gasoline/kerosene (weight 2.60%), and gas (weight 1.08%) were all to rise by 30%, the CPI would be pushed up by 1.03 pp, 0.78 pp, and 0.32 pp respectively, totaling more than 2 pp. Starting from a baseline CPI inflation rate of around 2%, this implies a rise to roughly 4-5%. If Japan is forced to continue gasoline subsidies and other policies to keep energy prices down for consumers, concerns about the country's fiscal health could lead to JPY selling. However, as all this is hypothetical at this point, I will refrain from going into details here.

If the BOJ's priority when faced with a combination of JPY depreciation and rising prices is to curb inflation expectations, its only option would be to raise interest rates. However, at its April meeting, the Bank prioritized maintaining the status quo based on the assessment that the upward pressure on inflation was in equilibrium with the downward pressure on the economy (details later). Given increasing concerns regarding the stagnation of the Japanese economy amid expanding trade losses, it is uncertain to what extent consistent rate hikes will be supported politically, economically, or socially. Many market participants previously expected two interest rate hikes this year as their main forecast scenario, but following the attacks on Iran, perhaps one should be prepared for an acceleration to three or even four rate hikes this year. At the time of writing, however, financial markets are still pricing in slightly less than two interest rate hikes.

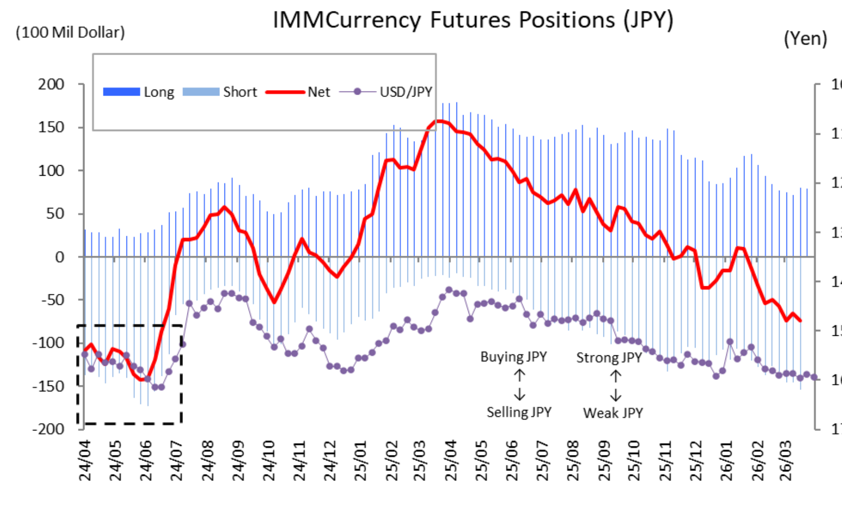
Forex Markets Now and Going Forward – Real Demand and Speculation Reinforcing Each Other

Real Demand and Speculation Reinforcing Each Other

At the time of writing, a temporary ceasefire is holding between the U.S. and Iran, resulting in a strong sense of relief. However, passage through the Strait of Hormuz is far from normal, and there is still fear of a drawn-out conflict fueled by the use of oil reserves. While crude oil prices have stopped rising further, they remain in the high range of USD 90-100, and if this state of affairs continues, Japan's import value could still be pushed up by ≈ USD5-8 trillion.

In this context, as mentioned at the start, soaring crude and other resource prices, and their implications for Japan's fragile trade balance, are driving JPY selling in the forex market. With crude at the center of this dynamic, intermittent reports of potential government and ruling party intervention in futures markets reinforce the view that elevated resource prices are underpinning the ongoing JPY weakness. A broader interpretation is that JPY is weakening due to a fiscal risk premium resulting from continuous fiscal stimulus, such as gasoline subsidies, being implemented to address soaring resource prices. Indeed, the yield on 10-year Japanese government bonds has surpassed 2.5%, reaching its highest level in ≈ 29 years, since 1997, indicating that the bond market, in addition to the forex market, is being significantly affected by resource prices.

Regarding fluctuations in the forex market, the key issue is whether they reflect changes in real demand, i.e., actual flows, or speculation based on unfounded expectations. The former can be rephrased as a "change in the fundamentals." In this sense, the current JPY weakness is probably due to real demand and speculation reinforcing each other as speculative trading anticipates a change in fundamentals. However, as mentioned above, the trade balance is difficult to predict accurately due to the impact of stockpile releases, and in reality, no major change in fundamentals has occurred yet. The release of oil reserves is a special factor that is preventing a clear surge in imports for March-May (as reported in April-June). In fact, the trade balance for March saw a record high surplus of +667 billion JPY, the highest level in ≈ 5 years and 4 months. However, it is widely acknowledged that the deficit is bound to widen, and in that sense, the speculative intent to exploit the situation has a certain legitimacy. Speculators are already at work, with JPY positions in IMM currency futures transactions reaching a short position of -USD 7.44 billion as of April 21 (see graph). This is the largest JPY selling since July 23, 2024. If things proceed as expected, speculation will continue to lead JPY selling for now, with real demand taking over by the start of summer.

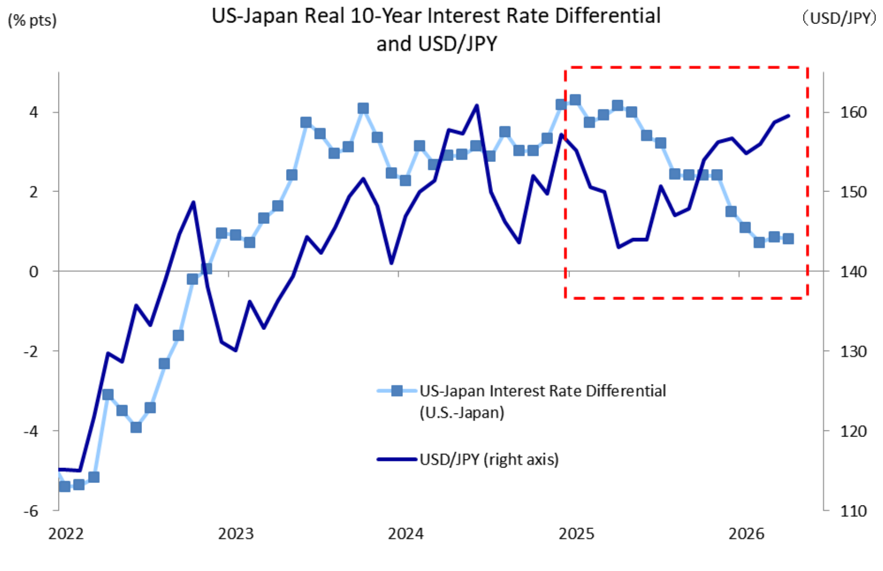


(Source) Bloomberg; prepared by the Global Foreign Exchange Department, Mizuo Bank

Of course, if there is a third or subsequent release, the timing of the handover (from speculation to real demand) will be delayed, and if ceasefire negotiations are successful and the conflict ends, the damage itself will be minor or fail to manifest. With too many possible scenarios in this regard, I will make do with assuming, for the moment, that the second stockpile release in May will be the last one.

Significantly Narrowed U.S.-Japan Real Interest Rate Differential

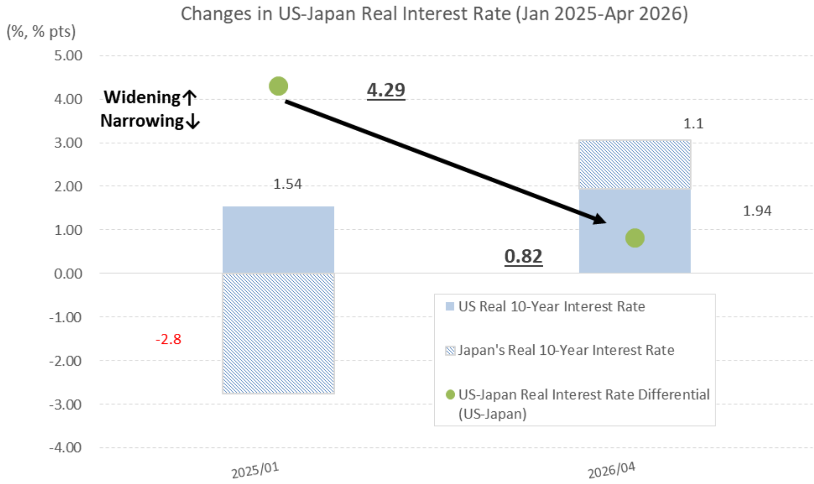
Up to this point, the discussion has been from the perspective of real demand and speculation. <u>However, it is also important to note that the trend in real interest rates, a very important driver of exchange rates, is supporting JPY appreciation</u>. The current JPY depreciation phase has been driven by the rapid expansion of not just the trade deficit but also the U.S.-Japan real interest rate differential (see graph). As of the time of writing, however, the U.S.-Japan real 10-year interest rate differential has fallen below 100 bp. Within the current JPY depreciation phase, this is the same as the level seen around January-February 2023, when USD/JPY was in the 130 JPY range. Looking back at the period since January 2025, U.S. real interest rates have risen by about +40 bp, while Japanese real interest rates have risen by as much as +390 bp (see graph). As a result, the interest rate differential between the two is down to less than 100 bp. <u>If the market were truly driven by the real interest rate differential, the USD/JPY trend would be very different from what it currently is, striving for the 160 level.</u> <u>The dramatic narrowing of the real interest rate differential undoubtedly promotes JPY appreciation, but perhaps it is not being viewed as a significant factor in the face of the overwhelming JPY selling pressure from real demand and speculation reinforcing each other</u>. Incidentally, JPY supply and demand in 2023, when the real U.S.-Japan 10-year interest rate differential was similar to the current level, also exerted strong JPY selling pressure – the previous year (2022) had seen the largest trade deficit on record (≈ -JPY 20 trillion), while 2023 posted the fourth largest (≈ -JPY 9.5 trillion). No doubt, USD/JPY was driven by supply and demand changes during that period too. The difference between now and then, however, is that there was also strong speculation at that time that the real U.S.-Japan interest rate differential was likely to further widen, reflecting expectations of higher interest rates in Europe and the U.S. It is likely, therefore, that the real interest rate differential, in addition to supply and demand, was a variable that explained JPY depreciation at that time.



(Source) Bloomberg; prepared by the Global Foreign Exchange Department, Mizuo Bank

Expectation of Higher Interest Rates in Europe and the U.S.

The speculation surrounding real interest rate differentials may be similar now to what it was then. Of course, unlike then, the BOJ now maintains a positive stance towards raising interest rates. However, as will be discussed later, a rate hike as the BOJ's next move is by no means guaranteed. Meanwhile, Fed rate-cut expectations are largely fading, and multiple rate hikes by the ECB this year have already been priced in. The possibility that the Fed and ECB will raise interest rates at a faster pace than the BOJ this year cannot be ruled out. Therefore, it is not impossible that expectations of a widening of real interest-rate differentials from current low levels is driving JPY selling. One thing is for certain – if the BOJ's priority is to curb JPY depreciation, it has no reason to hesitate in raising interest rates.



(Source) Bloomberg; prepared by the Global Foreign Exchange Department, Mizuo Bank

Taking all this into account, it seems that all the important variables, namely real demand, speculation, and interest rate expectations, are justifying JPY selling. The solution to this problem, unfortunately, depends entirely on the opening of the Strait of Hormuz for passage. It is reasonable to think this way since, as I have said repeatedly, all the speculation stems from rising resource prices. What Japan can do domestically in this situation is to put its very abundant reserves (by international standards) to efficient use while accepting commensurate restrictions on economic activity (frugality) to prepare for a protracted conflict. Already, some countries in Asia and Oceania (South Korea, Thailand, the Philippines, Australia, etc.) are taking such measures. Even if such measures prove to be unwarranted, no harm is done. As mentioned above, if the recent JPY selling is partly due to the fiscal risk premium, then perhaps leaving gasoline prices high without subsidies and suppressing demand might lead to JPY strengthening. At any rate, given finite reserves, frugality will be necessary at some point so long as there is no end in sight.

Under current circumstances, the downside risk to USD/JPY (JPY appreciation) is limited; rather, the pair having clearly surpassed the 160 level, the upside risk (JPY depreciation) is of greater concern. While the real interest rate differential is showing undeniable signs of pulling JPY back up, the overwhelming reality of supply and demand makes it difficult to foresee a resolution to JPY depreciation. Currently, with this unfortunate scenario seemingly on the horizon, speculators have no reason to stop selling JPY. A temporary ceasefire seems to be holding as of the time of writing. If the ceasefire is continuously extended in a piecemeal manner, a reversal of speculative JPY selling could be expected. However, given U.S. President Donald Trump's unstable rhetoric, betting on this scenario is also risky.

Japan's Monetary Policy Now and Going Forward – Interest Rate Hikes No Longer Certain

How to Interpret the 3 Dissenting Votes

At its April 27-28 Monetary Policy Meeting (MPM), the BOJ decided, as expected by the market, to keep the target level of the uncollateralized overnight call rate unchanged at 0.75%. Rising oil prices, stemming from the tense situation in the Middle East, are clearly seen as an inflationary factor, but also as exerting downward pressure on the economy through worsening terms of trade. The decision to forgo an interest rate hike seems to have been based on the assessment that the relative weighting of these risks was difficult. While the logic behind the decision was in line with expectations, three of the nine policy board members – including leaders of the hawkish faction Hajime Takata and Naoki Tamura, as well as Junko Nakagawa – voted against the proposal. This is the first time under the Kazuo Ueda administration that three members have voted against a proposal. All three warned of upside risks to inflation, suggesting they were concerned that leaving low real interest rates unchecked would worsen the current situation through a weaker JPY.

Indeed, the Outlook for Economic Activity and Prices report ("Outlook Report;" see chart) included a significant upward revision to the inflation outlook. The FY2026 yoy growth rate projection (median value) for CPI excluding fresh food (core CPI) was upwardly revised by +0.9 pp from the previous forecast (January) to +2.8%, while the FY2027 projection was upwardly revised by +0.3 pp to +2.3% (the newly added FY2028 projection was +2.0%). The report stated its baseline scenario was developed "based on the assumption that, regarding the situation in the Middle East, (…) with the impact expected to ease, crude oil prices will decline, and large-scale disruptions in supply chains will not occur," and that "crude oil prices are expected to decline (…) to the range of around 70-80 dollars per barrel toward the end of the projection period." This is the reason for the convergence to a +2.0% projection for FY2028. Meanwhile, real GDP growth rate projections were downwardly revised to +0.5% (a -0.5pp decrease) for FY2026, and +0.7% (a -0.1pp decrease) for FY2027, while GDP was expected to recover to +0.8% in FY2028. With higher inflation and lower growth rate projections for most of the forecast period, a frank assessment of the situation would be that it increasingly resembles stagflation. <u>Interest rate hikes would be considered if there were concerns about runaway inflation expectations, but no such urgency seems to have been evident this time</u>.

Majority Forecast of BOJ Policy Board Members (Yoy, %)

	Real GDP	CPI (excluding fresh foods)
FY2025	1.0～1.0 <1.0>	2.7
Forecast as of January	0.8～0.9 <0.9>	2.7～2.8 <2.7>
FY2026	0.4～0.7 <0.5>	2.8～3.0 <2.8>
Forecast as of January	0.8～1.0 <1.0>	1.9～2.0 <1.9>
FY2027	0.6～0.8 <0.7>	2.3～2.4 <2.3>
Forecast as of January	0.8～1.0 <0.8>	1.9～2.2 <2.0>
FY2028	0.7～0.8 <0.8>	2.0～2.2 <2.0>

Note: Median forecast of policy board members within < >

(Source) Bank of Japan; prepared by the Global Foreign Exchange Department, Mizuo Bank

Of course, it must be said that the premise to the main forecast scenario, that ongoing tensions in the Middle East will subside, is quite subject to change. If ceasefire talks break down, the urgency for interest rate hikes will intensify even further.

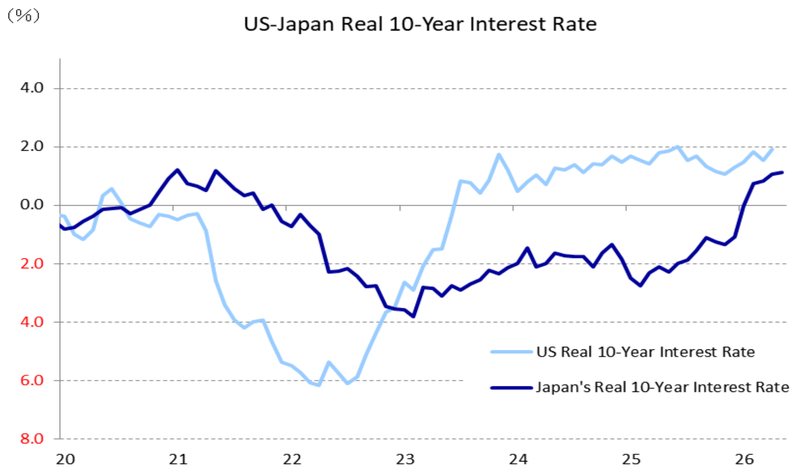
Is a Rate Hike in June or July Really Possible?

<u>The part of the Outlook Report that most caught my attention was the statement, "it is necessary to pay due attention, in particular, to keep the risk of inflation significantly deviating upward from materializing and thereby exerting an adverse impact on the economy afterward</u>." Taken at face value, this seems to mean that, even if tensions in the Middle East escalate unexpectedly and oil prices rise, the downward pressure on the economy will be considered to outweigh the upward pressure on inflation, thereby encouraging the status quo to be maintained.

In fact, a similar situation unfolded last year. An interest rate hike that was considered certain in April was postponed to December following the April 2 reciprocal tariff shock, with "uncertainty" being used as the key phrase. If the BOJ's basic stance is to "wait and see" in response to uncertainties stemming from external shocks, then there is a possibility that the rate hike in June or July, considered a certainty in the market, could be derailed. Further, with reports of stagnation of real economic activity (such as suspended production of certain products) resulting from oil and, therefore, naphtha shortages beginning to emerge, it may be politically necessary to avoid an economically restraining interest rate hike. There is currently an unspoken understanding in the markets that despite being postponed in April, a rate hike will be implemented in June or July at the latest, but <u>depending on the situation in Iran and the resulting domestic political response, it is entirely possible that even June or July will be difficult. The forex markets do not seem to have factored in such a possibility (no rate hike in June or July) as of the current time, and it has to be said that this constitutes a JPY depreciation risk</u>.

Power Structure of the Policy Board One Year from Now

In the long term, one should also keep an eye on the possibility of the Policy Board's easing bias strengthening. Of the three policy board members who advocated for a rate hike and voted against the decision to maintain the status quo this time, Nakagawa's term ends in June this year, while Takata and Tamura's terms end in July 2027. Nakagawa, it has already been decided, will be replaced by Ayano Sato, a board member with strong reflationary views. Given the strong reflationary leanings of the two recent appointments to the Policy Board, including Sato, it is natural to anticipate a similar trend when it comes to the appointment of successors to Takata and Tamura under the current administration.



(Source) Bloomberg; prepared by the Global Foreign Exchange Department, Mizuo Bank

While Nakagawa's policy ideology was not particularly clear during her tenure, Takata and Tamura were viewed as leaders of the hawkish faction, and replacing them with individuals strongly inclined towards reflationary policies would have significant implications, shifting the balance of power within the Policy Board considerably toward easing.

While board members who support reflationary policies do not necessarily advocate for interest rate cuts, maintaining the status quo amid rising inflation would constitute a strengthening of easing in real terms. Under these circumstances, the longer the status quo is maintained, the greater the downward pressure on JPY, and looking ahead to next year, one has to take into account the possibility that U.S. interest rates, which have so far been stable, will begin to rise. If we factor in a halt in interest rate cuts (or a resumption of interest rate hikes) by the Fed, then, from the perspective of responding to JPY depreciation, a move by the BOJ to accelerate the pace of its rate hikes would be no more than a "conservative" response. At the April FOMC meeting, three members cast opposing votes because they felt the monetary policy statement suggested a move toward easing, making the possibility of further interest rate cuts extremely low (details later). As the figure on the previous page shows, U.S. real interest rates have remained largely flat over the past two years, and it is important not to forget that this was, in fact, a bonus period in terms of curbing JPY depreciation. In other words, it is worth noting with seriousness that JPY depreciation was not able to be curtailed despite U.S. real interest rates remaining flat.

Of course, the appointment of policy board members is not factored into currency trading a year or more in advance, so any impact from this factor will only be seen in currency transactions from early 2027 onward. However, given the BOJ's tendency since April 2025 to "wait and see," multiple rate hikes this year seems difficult to achieve. Therefore, one must be prepared for the possibility of a future where the policy board composition becomes even more reflationary while the policy interest rate remains around 1.00%. In that scenario, in terms of the "impossible trinity," Japan may see a future where it has abandoned "exchange rate stability" and decided to put up with JPY weakness while continuing to prefer low interest rates in terms of an "independent monetary policy." The Japanese economy has recently been facing a painful choice between JPY weakness and rising interest rates, and it seems that asset price movements will have to be predicted based on the possibility of the former being chosen for now.

U.S. Monetary Policy Now and Going Forward – Interest Rate Cuts Difficult Under the Next Administration

Majority Dissenting Votes at the FOMC

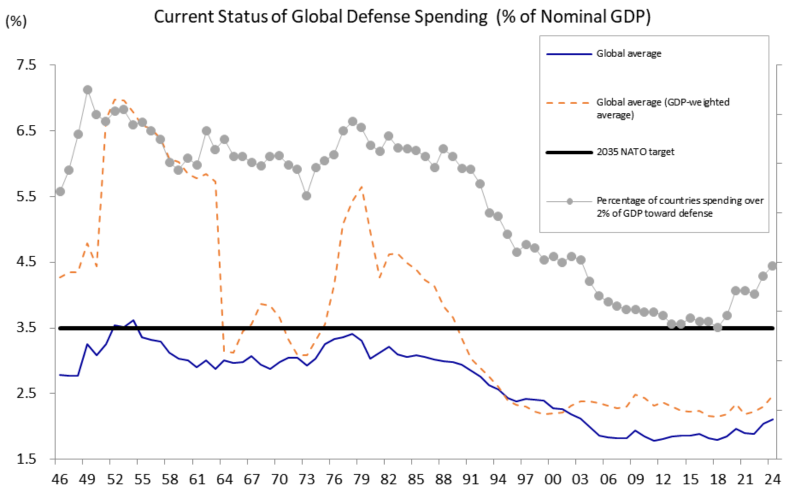
The FOMC also decided to keep the policy interest rate unchanged at its meeting held on April 28-29. The statement retained its previous wording suggesting that the "next move" could be easing, stating that "the Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals," which was opposed by FOMC members Beth Hammak (Cleveland Fed President), Neel Kashkari (Minneapolis Fed President), and Lorie Logan (Dallas Fed President), who were in favor of keeping rates unchanged. A fourth dissenter is believed to have been Governor Stephen Miran, who advocates for interest rate cuts. Despite the statement clearly acknowledging uncertainties, including inflation risks, from "developments in the Middle East (which) are contributing to a high level of uncertainty about the economic outlook," the opposition to leaving the possibility of easing clearly stood out. This is the first time since October 1992 that there have been as many as four dissenting votes at an FOMC meeting.

Although the three dissenting votes on the statement came as a surprise, concerns about the statement retaining an easing bias were seen even in the March meeting's minutes. Given the likelihood of prolonged turmoil in the Middle East, it appears that some members who feel strongly about the matter decided to take action. Further, this is Fed Chair Jerome Powell's last FOMC meeting, and the votes could be seen as an internal warning to prevent him from succumbing to political demands for interest rate cuts before handing over to the new administration under Kevin Warsh. At any rate, three members have already voted against rate cuts, and judging from the dot plot, several more may share similar views. Therefore, regardless of incoming Chairman Warsh's intentions, it will be quite difficult to reach a consensus on sustained rate cuts.

Coincidentally, both the Fed and the BOJ appear to be internally divided when it comes to maintaining their hitherto policy paths. Looking ahead, it is worth noting that some FOMC members may even argue that interest rate hikes, not cuts, are necessary. The three members who voted against rate cuts this time could come out with such an argument at any time. If, at that time, the BOJ's rate-hike pace is still moderate, the widening real interest rate differential would directly translate to downward pressure on JPY. Judging from the U.S.-Japan meetings in April, the possibility of such a development is by no means low. The BOJ, it is important to note, cannot afford to leisurely contemplate rate hikes if it wants to contain JPY depreciation.

Risks to My Main Scenario – Significance of Warnings Sounded by WEO and GFSR

Expansion of Defense Spending Now the Global Norm



(Source) IMF; prepared by the Global Foreign Exchange Department, Mizuo Bank

The second chapter of the IMF's April 2026 World Economic Outlook (WEO) was an analysis titled "Defense Spending: Macroeconomic Consequences and Trade-Offs" that was released ahead of the rest of the report. This chapter was highly insightful regarding the medium- to long-term outlook for JPY, and deserves attention. The chapter extracts and analyzes data on "large defense spending booms" pertaining to 164 countries since the end of World War II (1946 onward). According to the data, half of the world's countries had increased their defense budgets between 2020 and 2024, with ≈ 40% of countries spending more than 2% of their nominal GDP on defense by 2024. Moreover, as the figure shows, the ratio has been on a significant upward trend since bottoming out at 27% in 2018. Given the current situation and the June 2025 NATO summit's target (to be achieved by 2035) of over 5% of GDP for member states' defense spending, including on related investments, and over 3.5% for core defense spending, it is reasonable to consider this defense spending boom as the established course of the global economy for the foreseeable future. If such massive fiscal spending becomes permanent and entrenched, it is natural to consider its impact on and implications for the macroeconomy. In the case of Japan, even if we only consider JPY supply and demand, the impact is by no means small.

Economic Significance of the Defense Spending Boom

As the use of "Trade-Offs" in the title of Chapter 2 suggests, even if expanding defense spending in the interest of self-defense is unavoidable, there are concerns that it will result in an unbearable macroeconomic burden. In short, the report points out that the scaling up of defense spending prompted by a rise in geopolitical tensions could place irreversible structural burdens on inflation, fiscal health, and current accounts of countries. It further warns that a deterioration in the fiscal and current account balances is inevitable, especially for countries and regions that rely heavily on imports for defense equipment. As U.S.-made products account for the majority of global arms exports, this warning is particularly relevant to countries that are close allies of the U.S. and highly dependent on it for security (details later).

While the report merely presents the economic and financial implications of increased defense spending for various countries from a historical perspective, its conclusions seem to reinforce the theory of structural JPY depreciation, which has gained attention in recent years. For instance, the report points out that defense spending booms usually last for over 2.5 years, during which time defense spending increases by ≈ 2.7 pp relative to GDP, with about two-thirds of this increase resulting in budget deficits. It further noted regarding the overall fiscal situation that the budget deficit worsens by ≈ 2.6 pp relative to GDP, and that public debt increases by ≈ 7 pp within three years of the start of military buildup. Importantly, it expressed concern that, while such scaling up of defense spending could boost economic activity in the short term (particularly through increased consumption and investment in the defense sector), it could also bring about inflationary pressures and present other significant challenges in the medium term.

As widely known, Japan has also moved to expand its defense spending, aiming to reach 2% of GDP (including toward related expenditures) by FY2027. For a long time, Japan managed to keep its defense spending below 1% of GDP, but it is now on the verge of doubling it. If the IMF analysis above is right, the current boom in defense spending could push up government debt and inflation in the medium to long term. Already, some point to the current weakness of JPY as a reflection of the fiscal risk premium, and the trend seems highly likely to bring about an irreversible increase in downward pressure on JPY.

Incidentally, the report also points out that public debt jumps 14 pp as a percentage of GDP and social security spending decreases in real times during times of war. In other words, if high inflation due to increased defense spending is assumed, public spending on pensions, healthcare, education, and other aspects of national life and welfare will be suppressed in real terms, even if nominal levels are maintained. If fiscal expansion is undertaken to compensate for this, that would increase the fiscal risk. From this perspective, there is reason to be concerned about the downward pressure on JPY in line with the fiscal risk premium.

Peacetime enables the allocation of resources to things other than defense spending, creating more scope for supporting the lives of citizens. We need to adopt the broader perspective that we are entering an era where these benefits, which could be called "peace dividends," will disappear. In terms of asset prices, this is likely to weigh down stock prices.

Digital Deficit Similar to Expansion of Defense Spending

However, it is not entirely impossible that the increasing downward pressure on JPY in line with the fiscal risk premium is merely a temporary, speculation-driven phenomenon. A larger issue is the impact on JPY supply and demand. Expanded defense spending is not a domestic phenomenon involving only the country in question; the procurement of advanced defense equipment is contingent on purchases from overseas, particularly the U.S. The report points out that the arms sales of the world's largest defense companies have doubled in real terms over the past 20 years. While specific country names are not mentioned, given that some studies indicate that ≈ 40% of global arms exports[1] are U.S.-made, it is undeniable that the boom in defense spending directly translates to increased sales and profits for U.S. companies (incidentally, the EU accounts for about 30% of global arms exports). It is well known that many of the top military companies (Lockheed Martin, RTX, Boeing, etc.) are U.S. companies.

Ultimately, increased defense spending by various countries translates statistically to increased imports from the U.S. Further, once this becomes national policy, it will remain a permanent import, unaffected by economic cycles, for the foreseeable future. In this context, when allied nations, including Japan, purchase advanced defense equipment from the U.S., it is done through the “Foreign Military Sales (FMS)” framework, an intergovernmental transaction structure. The framework’s guiding principle is that the United States, as part of its own security policy, “kindly sells” weapons to its allies. As a result, it is widely known for terms that are highly favorable to the seller: prices are set by the United States, payment is required in advance in principle, and delivery schedules and prices remain subject to change. Given that transactions are conducted under the FMS, and U.S. products hold an overwhelming market share, “increased defense spending by other countries” has an aspect of guaranteeing a permanent income transfer to the U.S.

Incidentally, in the sense that these are essential goods the price determination and quality of which are entrusted to overseas entities (i.e., that they are imports with low price elasticity of demand), they are similar to oil, traditionally, and to digital services supplied by GAFAM (Google, Apple, Facebook, Amazon, Microsoft) more recently. Both are economic transactions that irreversibly increase foreign currency payments abroad and can become a structural deficit factor, thus signifying a change that indicates a rise in structural selling pressure on JPY.

Could Increased Defense Spending Boost the Economy?

Incidentally, in connection with increased defense spending, some point out that it is not all negative for the economy if you take the multiplier effect into account. However, such cases are not the majority. The IMF report also points out that as long as procurement is carried out from overseas in accordance with the Foreign Military Sales (FMS), the multiplier effect cannot be expected. For clarification, the multiplier effect is an effect on the economy ultimately exceeding the initial investment amount, due to an increase in government spending or investment, which triggers a chain reaction of consumption and investment in the private and other sectors. In the case of a JPY 10 billion investment, if the multiplier is 1.3, that would mean that the investment had an effect on the economy worth JPY 13 billion.

The report concludes that the multiplier for defense spending is close to 1 on average, but fluctuates greatly depending on how spending is maintained, financed, and allocated, and how much equipment is imported. For example, expanded defense spending that is largely consumed (e.g., missiles simply purchased from the U.S.) and primarily financed through budget deficits may boost short-term demand but do not lead to increased productivity. For this reason, they require close coordination with monetary policy (from the perspective of controlling inflation).

For instance, if Japan purchases a missile that costs JPY 500 million from the U.S., statistically, this only increases imports, resulting in no multiplier effect and no concern about fueling inflation. However, the imported missile would trigger a slight economic stimulus due to deployment, storage, training, and maintenance by domestic companies, and if financing relies on government bond issuance, it would boost GDP on paper. However, if this directly leads to tax increases in the future, the multiplier effect could be zero or even negative. I will refrain from going into further details here.

On the other hand, the report also points out that expanding defense spending by prioritizing domestic public investment over imports and fostering a more integrated market for military equipment production could support long-term productivity improvements. In this scenario, since productivity increases are involved, there is no need to worry about inflation. As I am not an expert in the military field, I cannot offer a detailed discussion, but given Japan’s situation, where defense equipment purchases from the U.S. are frequently discussed, it seems difficult to expect a multiplier effect.

In short, while expanding defense spending may yield security returns in the form of stronger national defense capabilities, the IMF’s point is that achieving economic returns from increased productivity that promotes economic growth will be difficult under the current spending structure. Taking all this into account, if a structure is established whereby Japanese defense prime contractors (a group of large companies that directly contract with the Ministry of Defense) also benefit, Japan should be able to ride a timely defense spending boom that could serve as a virtuous cycle of defense spending and economic growth. However, I will leave the discussion of the means and timeframe for this to experts.

A Defense Spending Boom to Reinforce USD’s Reserve Currency Status

Finally, though a slight digression from the other points discussed in the report, I believe the defense spending boom is also significant when considering themes such as de-dollarization and the damage to USD’s reserve currency status, which have been points of contention since last year. Certainly, increased defense spending contributes to an increase in the U.S. government’s own debt, and this is one reason why doubts arise about USD’s status as a reserve currency.

However, given the realities described above, the more allies increase their defense spending, the easier it becomes for those funds to flow back into the U.S. government sector through the corporate sector (through tax collection). This would make it easier for the U.S. as a whole to accelerate research and development (R&D) in next-generation technologies (AI, space, unmanned weapons, etc.). If such a thing as a virtuous cycle of defense spending and economic growth exists, the U.S. seems to be in a good position to enjoy it. While the recent IMF report does not go so far as to draw that conclusion, the existence of a mechanism by which increased geopolitical risk ultimately reinforces the U.S. military-industrial complex and USD’s status as a reserve currency is undeniable.

[1] According to the Stockholm International Peace Research Institute (SIPRI) in Sweden, the U.S. will account for 42% of global arms exports during the five-year period from 2021 to 2025. (Source: SIPRI “Trends in International Arms Transfers, 2025”)

GFSR Focuses on Rising JPY Interest Rates

Meanwhile, Chapter 1 of the Global Financial Stability Report (GFSR), published alongside the WEO, discusses the international impact of rising JPY interest rates in a box titled "Rising Japanese Government Bond Yields Could Affect Global Asset Allocation."

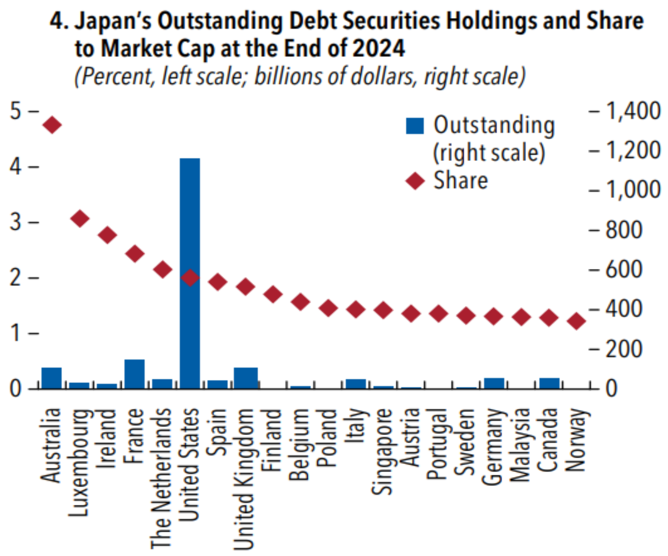
The analysis is fairly standard, expressing concern that as Japan returns to positive interest rates, Japanese institutional investors, who hold a very large amount of overseas bond holdings globally, may repatriate their assets from overseas to domestic markets, potentially causing disruption to international financial markets. It also states that rising JPY interest rates relatively diminish the attractiveness of foreign bond investments – a very common point.

The report points out that Japanese institutional investors are suffering significant unrealized losses due to rising JPY interest rates, stating that Japan's four major life insurance companies (Dai-ichi Life Insurance, Meiji Yasuda, Nippon Life Insurance, and Sumitomo Life Insurance) have reported a combined unrealized loss of JPY 13.2 trillion, an increase from ≈ JPY 11 trillion at the end of the third quarter of 2025. It also states that the impact of the reallocation of domestic investments in response to rising yields is a concern, and warns that the unwinding of JPY carry trades will affect global capital flows as investors re-evaluate the relative values between markets. The report also highlights the actions of specific institutional investors that could be sources of market fluctuations, noting that Nippon Life Insurance is planning a JPY 3 trillion shift of funds this year, selling low-yielding Japanese government bonds and switching to higher-yielding ones, following a JPY 2 trillion asset reallocation last fiscal year.

On the other hand, the report also notes that, given the current structure of Japan's government bond absorption, where pension funds typically review their investment guidelines only about once in five years, and the BOJ remains the largest domestic holder of JGBs, accounting for 51% of outstanding JGBs as of the end of June 2025, an acute shock (of the kind that would accelerate market movements) will be mitigated. Overall, the basic assessment appears to be that "while there are risks, they are unlikely to result in a market shock." Incidentally, going by the context of the document, the "JPY carry trade" referred to in the IMF report implicitly refers to foreign securities investments made by Japanese institutional investors (primarily life insurers and pension funds) using JPY as capital. It does not refer to the short-term trades frequently observed in forex market by overseas speculators targeting the U.S.-Japan interest rate differential.

"Magma" Built up Over 30 Years Causing Concern

Of course, the reallocation of investments in response to changes in domestic and international interest rate levels is not unique to Japan; it can occur in any country or region. However, the reason this issue tends to be highlighted in Japan is likely due to the fact that, over the past 30 years or so, Japan has had virtually no domestic interest rate, leading to the assumption that domestic institutional investors' positions are likely to be heavily skewed toward overseas assets (particularly U.S. assets). To use a cliché, the situation is similar to "magma building up." As generally known, Japanese institutional investors are major investors into U.S. Treasuries and euro area government bonds. Naturally, if JPY interest rates rise, causing a relative change in value of domestic to foreign bonds, some foreign bonds are bound to be sold off. The recent edition of the GFSR provides an international comparison of the share of Japanese institutional investors' holdings in various countries' bond markets (see graph). While, of course, their holdings of U.S. Treasuries are overwhelmingly large in terms of outstanding balances, in terms of the proportion of holdings relative to the country's market size, Japanese institutional investors have a relatively large influence also in Australia and some euro area countries (Ireland, France, the Netherlands, etc.). There is concern, for example, that a reversal of JPY carry trades due to rising JPY interest rates could shake up the French government bond market, which is already prone to fiscal health concerns.



(Source) IMF"GFSR, Apr 2026"; prepared by the Global Foreign Exchange Department, Mizuo Bank

Box 1.1 of the GFSR, which is a report aimed at identifying and mitigating systemic risk, delivers a warning: namely that Japan's return to positive interest rates marks a historical turning point in international capital flows, and preparations are needed to minimize disruption; that national authorities would do well to reassess the presence of Japanese investors in their respective financial systems and strengthen their resilience to shocks; and that the world is entering a phase where international policy coordination and oversight are necessary.

Can the BOJ Raise Interest Rates Even if Overseas Interest Rates Rise?

To put it simply, the BOJ's current monetary policy is thought to be raising the debt costs of other countries and worsening their fiscal conditions. However, concerns about such monetary policy spillover effects have always been a problem in the relationship between the Fed and other countries (especially developing countries). Given the unwritten rule that monetary policy is, in principle, conducted according to the domestic economic and financial conditions of each country, there is fundamentally no justification for asking the BOJ to adjust its rate hike pace taking into account the government bond yields of other countries. Whatever shock results from the BOJ's monetary policies will have to be managed through vigilance and monitoring by national authorities in each country.

However, given that the GFSR has explicitly stated it as a risk, if European, especially French, bond markets or even the U.S. bond market were to be disrupted, the BOJ would likely be required to halt rate hikes due to “disruption in international financial markets,” and other countries might call for more minute communication. <u>The BOJ’s distance from domestic politics often attracts attention when it comes to its policy management, but amid concerns that continuous interest rate hikes will have a significant impact on overseas bond markets, the possibility of external pressures making it difficult for the BOJ to raise interest rates should also be considered a potential risk going forward</u>.

EUR Outlook – EUR Withstands "Safe-Haven USD Buying"

EUR Now and Going Forward – Real Demand Supporting EUR Firmness

EUR Remains Firm Two Months after Attack on Iran

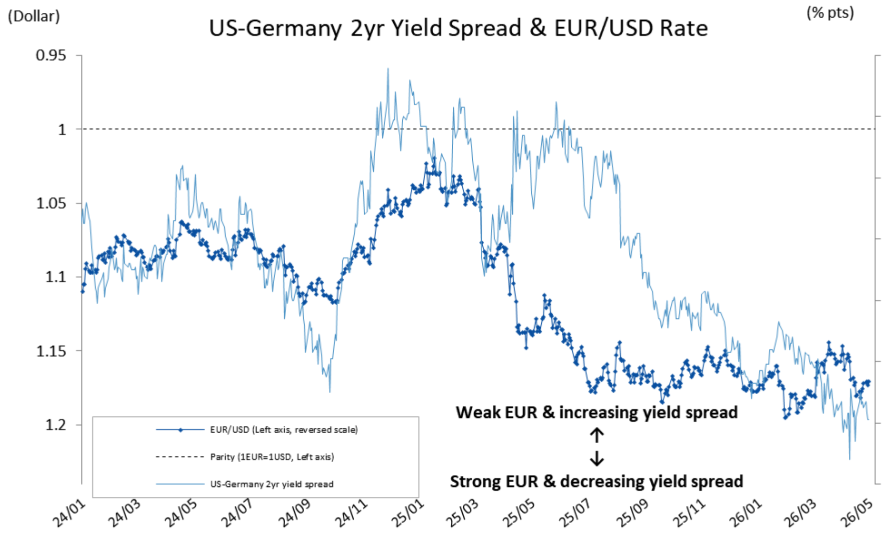
Since the attack on Iran, two full months have passed, during which the forex market was dominated by a "safe-haven USD buying" trend that put downward pressure on all currencies other than USD. Many people have recently been evaluating EUR's "reserve currency status" as having improved relative to USD, and it is interesting in that regard to note that EUR has generally remained firm during the past two months. Looking at nominal effective exchange rates (NEERs), for example, one finds that EUR's NEER remained largely unchanged (declining just 0.1%) during the period from February 27 (immediately after the attack) to April 21 (the time this article was written). During that period, the USD and JPY NEERs rose 0.4% and fell 1.7%, respectively. So it is fair to conclude that EUR did not succumb to the pressures stemming from the "safe-haven USD buying" trend. It is likely that numerous factors have been promoting EUR's resilience, but the main ones appear to be: (1) the continued underlying "USD selling" trend; (2) the changed ECB policy rate outlook reflecting the ECB's sharp shift toward hawkishness; and (3) the persistently solid state of the EUR supply-demand structure.

Regarding point (1), it is important to note that "short-term liquidity demand for USD" and "confidence in USD as a reserve currency" are fundamentally distinct issues with very different time horizons. Historically, during times of war, the selling of highly liquid assets (such as gold and stocks) and shifting of funds to USD-denominated assets (which offer the highest liquidity) has been a reflexive response that has been repeated many times and does not necessarily reflect a long-term trend of increasing confidence in USD. Numerous previous editions of this article have pointed out that the IMF's Composition of Foreign Exchange Reserves (COFER) and other data clearly show that demand for USD as a store of value has declined – and cracks are slowly but surely appearing in the foundation of USD's reserve currency dominance. USD remains the world's strongest currency, but confidence in USD is not as strong as it once was.

At the time this article was written, tensions with Iran appeared to be easing, causing the "safe-haven USD buying" trend to gradually weaken, while the scale of EUR selling was limited and EUR was regaining strength.

ECB's Sudden Shift toward Hawkishness

The most likely reason seems to be point (2). Financial markets had previously priced in "just under one ECB rate cut this year", but expectations shifted dramatically following the attack on Iran and, at the time this article was written, the markets were anticipating "just over three ECB rate hikes this year". While expectations regarding Fed hawkishness have also strengthened following the attack on Iran, it is rare to see expectations regarding a major central bank's prospective policies change so dramatically as expectations regarding ECB policies recently have.

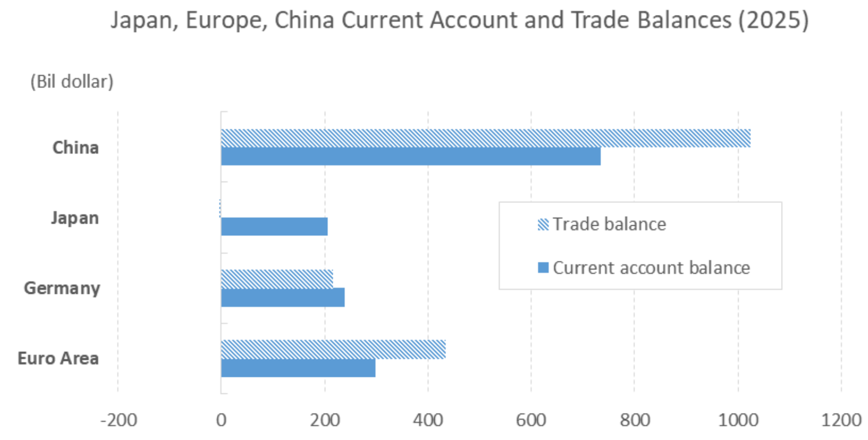


(Source) macrobond; prepared by the Global Foreign Exchange Department, Mizuo Bank

Looking back at the period after March 2022, it is noteworthy that sharply rising crude oil and natural gas prices considerably elevated both actual and anticipated inflation rates in the euro area, which is heavily dependent on resource imports. Although that inflation surge was caused by a supply shock, the markets seem to understand the ECB's strong desire to avoid repeating the mistakes made during that period, when rising inflation rates had secondary ripple effects boosting wages and costs in diverse economic sectors. Furthermore, although many observers now have doubts about the independence of national central banks, it is widely believed that the ECB's unusual structure as an international central bank working on behalf of numerous countries has made it less susceptible to pressures from individual countries and therefore more independent. Surprisingly, the ability to implement interest rate hikes without unduly emphasizing political considerations may be considered one of the ECB's exceptional strengths. As the graph shows, there has been considerable shrinkage in the expected magnitude of the U.S.-Europe interest rate gap, and this trend has helped keep EUR/USD firm.

One of the World's Three Largest Current Account Surpluses

Point (2) appears crucial for assessing short-term exchange rate trends, while point (3) is equally important regarding longer-term trends. Although the euro area's 2025 current account surplus was down yoy, to EUR255 billion, that was the world's second-largest current account (trade) surplus, after that of China. It goes without saying that most of that euro area surplus was generated by Germany, which in 2025 recorded current account and trade surpluses of approximately EUR203 billion and EUR184 billion, respectively. Given the solid EUR real supply-demand situation associated with those surpluses, it is only natural that there has been a general bias toward EUR buying.



(Source) Ministry of Finance, ECB, Deutsche Bundesbank, SAFE; prepared by the Global Foreign Exchange Department, Mizuo Bank

As of 2025, the world's three largest current account surplus countries/regions were the euro area, China, and Japan. However, Japan is in a unique situation that can be clearly seen when one compares the country's huge record-high current account surplus with its quite large trade deficit, which is particularly significant regarding forex trends, as it is the trade balance that directly entails outright currency transactions. While China and the euro area (centered on Germany) are fundamentally large current account surplus countries supported by trade surpluses, Japan is a large current account surplus country despite recording trade deficits. There is no doubt that Japan's chronic trade deficits are the factor harmonizing the seemingly contradictory realities of persistently high current account surpluses and chronic JPY weakness. The trade deficits require the selling of JPY in exchange for other currencies, and that situation is compounded by a structural problem stemming from the fact that Japanese companies have not been arranging for their overseas earnings to flow back into Japan's domestic economy. While I will set aside the discussion of Japan's situation for now, it is important to note that the supportive EUR real supply-demand environment would strongly counteract any factors that might tend to promote EUR depreciation.

Increasing Emphasis on Energy Security and Increasing EUR Resilience

Nevertheless, the euro area also has its vulnerabilities. As mentioned above, while not to the same extent as Japan's economy, the euro area's economy also relies heavily on external sources for resource procurement. In 2025, for example, energy items accounted for about 20-25% of Japanese imports and roughly 15-20% of euro area imports. It is interesting to note that energy items accounted for only about 4-6% of Switzerland's imports, and it is worth discussing that situation in connection with CHF's recent resilience to energy shocks, but I will address that in a future edition of this article.

Crude oil and natural gas prices surged following Russia's invasion of Ukraine in March 2022, and it is worth recalling that EUR/USD fell below parity at that time. While there were various reasons for that EUR weakening, I suspect that that trend was greatly promoted by the disappearance of Germany's trade surplus by mid-2022, which significantly worsened the EUR supply-demand environment. If the situation in the Middle East continues to deteriorate and resource prices remain high, there is a possibility of a similar situation occurring again. If EUR were to sharply weaken in the near future, it would likely be owing to a sudden change in the Middle East situation and an associated surge in resource prices. That is a scenario that cannot be ruled out.

While the euro area will remain quite vulnerable to energy price shocks in the short-term future, the region appears resolved to effectively decrease that vulnerability over time. In early March, European Commission President Ursula von der Leyen made headlines by admitting at an international conference that the nuclear phase-out policy was a "strategic mistake" and proclaiming that the EU's basic policy going forward would be to proactively increase nuclear power generation capabilities. The movement to re-evaluate nuclear power as a clean energy source and accelerate investment in next-generation small modular reactors (SMRs) is a discussion that relates to various issues in addition to mere decarbonization strategies. While the policy turnabout offers a good basis for criticizing Europe's lack of staunch dedication to its putative principles, it should be acknowledged that changing circumstances and extremely harsh challenges require appropriate strategic adjustments. Forced to begin taking measures to decrease its long-standing vulnerabilities stemming from excessive dependence on external energy sources, the euro area has begun rebuilding its energy security systems with an eye to also enhancing the stability of its current account (trade) balance.

By building an energy self-sufficiency system based on renewable energy and nuclear power, the euro area aims to establish a robust external balance structure capable of withstanding volatile resource price fluctuations. The EU has repeatedly leveraged crises to drive progress – as seem in the creation of bailout schemes during the debt crisis and joint bond schemes during the pandemic – and it is now seizing the opportunity presented by the resource price surge to embark on energy structure reforms.

The euro area's measures to decrease vulnerabilities associated with excessive dependence on energy imports appear likely to make EUR a more-resilient currency that is less susceptible to external shocks. Steady progress in stabilizing and increasing the euro area's current account balance can be expected to also have the effect of progressively strengthening EUR's reserve currency status. Anticipating a substantial buttressing of EUR's reserve currency status requires a long-term perspective, but it is worth keeping EUR's fundamental strengths in mind without being overly distracted by short-term market fluctuations.

Supplement: Implications of Hungary's General Election — Signs of a New Trend in European Politics?

EU Liberation from a Trojan Horse

Hungary's April 12 general elections resulted in the defeat of Prime Minister Orbán – who had exercised authoritarian leadership for 16 years – and his ruling party, Fidesz (Fidesz – Hungarian Civic Alliance). The recently established center-right opposition party TISZA (the Respect and Freedom Party), led by Péter Magyar, secured an overwhelming victory, winning the two-thirds majority of National Assembly seats needed to amend Hungary's constitution without assistance from other parties. Hungary, under Prime Minister Orbán, who was sometimes called the "Trump of Eastern Europe," had served as a link between the United States and Russia, both of which wanted to promote a "Hungary First" ideology that called for resisting certain EU edicts. As an EU member state with veto power, Hungary has for many years acted like a "Trojan horse" by undermining EU decision-making from within at critical junctures. The removal of this obstacle is a long-awaited development for the EU that can be expected to expedite the speed of future EU decision-making processes.

When the EU was considering sanctions against Russia in 2022, for example, Hungary cited its energy security needs as a rationale for requiring significant revisions to the sanctions. Specifically, while an agreement was reached to ban the sea transport of Russian oil, a concession was secured that allowed imports via pipeline. Consequently, while Germany and most other EU countries have suffered from rising energy costs, Hungary has continued to enjoy inexpensive Russian crude oil imports, and Russia has benefited from retaining a portion of its European oil export market. In 2023, Hungary single-handedly blocked the EU's proposed EUR50 billion long-term support framework for Ukraine, demanding as a condition for its approval the release of approximately EUR10.2 billion in funds owed to Hungary that the European Commission had frozen as a sanction against Hungary's domestic policies, and those funds were eventually released. Although the anti-Hungary sanctions were designed to maintain the EU's "rule of law" principle, that principle ultimately had to be compromised in view of the great importance of providing the aid to Ukraine. There are countless other instances of clashes between Western European EU member states and Hungary under Prime Minister Orbán.

There has recently been increasing momentum within the EU behind a general shift toward greater support for parties on the right side of the political spectrum and, as discussed below, it remains unclear whether Prime Minister Orbán's defeat might reflect an incipient reversal of that trend. In any case, however, the apparent moderation of the political stance of a country that has long been considered a Trojan Horse within the EU can be expected to generate considerable benefits for the EU as it seeks to deepen its political and economic integration. In the near term, the departure of the Orbán government (which claimed Hungary's need for Russian natural gas was more important than supporting unified EU diplomacy) is expected to enable the EU to create a more comprehensively harmonized energy security policy and to more-effectively provide support for Ukraine and enforce sanctions against Russia.

An "Illiberal Democracy" Defying Common Sense

Over the past 16 years, the Orbán administration has operated under the banner of "illiberal democracy" (defined as democratic, but focused on national, Christian, and conservative values rather than mainstream Western liberal principles), employing tactics such as arbitrary changes to the electoral system (favoring the current government), monopolistic control of the media, and the erosion of judicial independence. While utilizing democratic procedures, it has worked to hollow out the very essence of democracy. Measures attracting particular attention from the financial markets included those taken in 2013, during the early days of the Orbán administration, to reduce the independence of Hungary's central bank, the Hungarian National Bank (Magyar Nemzeti Bank or MNB).

Specifically, György Matolcsy, former Minister of Economy and Prime Minister Orbán's right-hand man, was appointed governor of the MNB, and ultra-low interest rate policies and lending programs for small and medium-sized enterprises – aligned with the government's focus on prioritizing economic growth – began to be forcefully implemented. Furthermore, a scandal emerged in 2016 in which the MNB was accused of providing favors to Prime Minister Orbán and Governor Matolcsy through donations to multiple foundations. This was interpreted by critics as reflecting a complete lack of Western moral values within the Orbán administration.

While the EU is an union of nations based on shared fundamental values – such as respect for democracy, the rule of law, human rights, and free market economy functions – Hungary under the Orbán administration has often been considered to give insufficient regard to those values, and it has therefore frequently clashed with the European Commission. Regarding the scandal surrounding the MNB, the European Commission has repeatedly issued warnings that the diversion of central bank funds into the government budget – an act akin to monetary financing of fiscal budgets – constitutes a violation of the Treaty on the Functioning of the European Union (specifically, Article 123, which prohibits "the granting of credit by central banks to the public sector"). The Orbán administration has continued to ignore those warnings, dismissing them as "interference in sovereignty", leading the European Commission to freeze approximately EUR30 billion in contributions from various funds as a punitive sanction. This is a significant amount for the Hungarian economy, which has a nominal GDP of EUR200 billion. While some of this (approximately EUR10 billion) was released in connection with the Ukraine aid deal mentioned above, roughly EUR20 billion worth of funds remained frozen at the time this article was written.

New Government Seeking to Reclaim EU Funds

It remains unclear exactly what remedial actions the new Magyar government will be taking but, given that it secured a landslide victory on a clearly pro-EU platform, it is expected to make various concessions to the EU, such as those regarding the rectification of central bank-related corruption and restoration of judicial independence. If the "rule of law" mechanism dysfunctions (specifically corruption and violations of judicial independence) that were neglected under the

Orbán government are resolved, contributions from the frozen EU funds will resume, boosting Hungary's economy. Under the Orbán administration, Hungary was plagued by discriminatory taxation of foreign-owned companies and opaque public procurement systems, making the country an extremely opaque investment destination that investors tended to avoid. In this regard, the new Magyar government has pledged to gradually phase out taxation provisions that discriminate against foreign companies. While this will result in a decrease in tax revenue, the assumption is that Hungary's adherence to the "rule of law" will enable it to obtain greater EU funds that can be used to move ahead with important reform measures.

The planned reforms are collectively referred to as the "Hungarian New Deal", and their success hinges, above all else, on the new government's ability to mend relations with the EU. If appropriate domestic reforms lead to increased capital inflows, it will promote a deepening of EU integration and serve as a tailwind for EUR and EUR-denominated bonds.

A Turning Point in International Politics and Economics?

It is worth considering the possible implications of the Orbán administration's departure for trends in international politics and the global economy. Superficially, it appears that it could be a turning point signaling an end to the general shift toward the right in international politics, but is it really significant in that way? Certainly, Prime Minister Orbán was a figure that symbolically represented the rising popularity of right-wing (nationalistic and populist) forces both within and outside the EU. In June 2024, for example, Orbán cooperated with such far-right parties as Austria's Freedom Party (FPÖ) and the Czech Republic's ANO 2011 to create the "Patriots for Europe (PfE)" anti-EU group within the European Parliament. Orbán also maintained close ties with right-wing forces in various countries – such as France's National Rally (RN; considered the frontrunner in France's 2027 presidential election), Italy's League (Lega), the Netherlands' Party for Freedom (PVV), and Spain's Vox party – and his departure might force these right-wing forces to revise their strategies. Looking outside Europe, the Trump administration has openly expressed support for right-wing forces in Europe, and Russia has also joined this trend. In particular, in its National Security Strategy (NSS) released in December 2025, the Trump administration condemned the EU system – led by the European Commission (EU bureaucrats) – as undemocratic, and announced a policy of supporting the return of sovereignty from the EU to individual EU member nations. That NSS appears to be a strategy for destabilizing the EU from within to facilitate US cooperation with such congenial countries as Orbán-led Hungary and, given this background, one could interpret Orbán's failure as a Trump failure. Italy's Prime Minister Giorgia Meloni recently failed to secure a national referendum agreement on her pet judicial reform project, and some commentators are suggest that this reflected voter alienation and opposition stemming from Meloni's right-leaning views and her close ties with the Trump administration.

However, Prime Minister Orbán's departure does not necessarily mean the disappearance of the PfE anti-EU faction. Moreover, one could reasonably argue that Orbán's election loss is simply an additional example of a traditional pattern, in which existing governments find it difficult to maintain their voter support amid macroeconomic environments characterized by high rates of inflation and low rates of economic growth. When people are struggling financially, their dissatisfaction with the status quo makes them more receptive to extreme political views on both right and left ends of the political spectrum. So, despite the increasing popularity of right-wing and populist parties in Europe, there are still insufficient grounds to confidently state that EU citizens' fundamental ideology has been shifting to the right. And while there has been a general rise in the popularity of European right-wing and populist parties since the Lehman Shock and European debt crisis, it is still too early to confidently state that recent events in Hungary represent the start of a reversal of that trend. In fact, it should be remembered that Hungary's new prime minister Magyar was an insider in the Orbán-led government who became a whistleblower and through social media and other means managed to win over the domestic conservative base before ultimately bringing down the Orbán government. The shift from Orbán to Magyar does demonstrate that the sustainability of even apparently powerful radical nationalist regimes is not guaranteed, and in that sense it could mark a turning point in international politics.

Already, the Hungarian forint has surged to a four-year high in financial markets, and the country's stock index has also reached a new all-time high, indicating a significant improvement in investor sentiment. There is no doubt that consolidating these trends will help promote sustained capital inflows into the euro area, which in turn should strengthen EUR exchange rates and increase the depth of the region's bond markets. For now, it will be worth closely monitoring the initial moves of Hungary's new government and seeking to assess and anticipate the impact of those moves on EU politics and the euro area economy.

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