

# Forex Medium-Term Outlook

June 1, 2026

## Overview of Outlook

USD/JPY remained high in May. The trend did not change despite the implementation of a JPY-buying currency intervention from late April through early May. However, persistent speculation that Japan’s monetary policy since 2014 has been strongly focused on the 160-yen level seems to be causing a resistance to any increase beyond that level, so some effect may be recognized in this respect. In terms of JPY supply and demand, the biggest concern is that rising mineral fuel prices will widen Japan’s trade deficit and lead to another phase of JPY depreciation similar to 2022. As I have been saying in this report since March, the widening of the deficit may only be confirmed in the June or July trade balance, given the schedule of crude oil reserve releases, so I will keep an eye on the data. In terms of interest rates, while the BOJ’s next move is certain to be an interest rate hike, market attention is likely to shift to the pace of rate hikes, given that the Fed and the ECB are also expected to resume rate hikes. From the perspective of curbing JPY depreciation, this is the development that had been most feared, and the BOJ will need to change from its previous gradualism. Given the inflation stemming from currency depreciation, the theoretically required policy mix involves tightening all three of currency, monetary, and fiscal policies. If the forex markets take note of the BOJ’s hesitation to raise interest rates, JPY selling could well accelerate. On the other hand, a JPY-appreciation risk factor is the disappearance of the real U.S.-Japan long-term interest-rate differential, which has long driven JPY depreciation. It is important to know that, so long as the appropriate policy mix is adopted, there is a good possibility that JPY depreciation will be corrected to a significant extent.

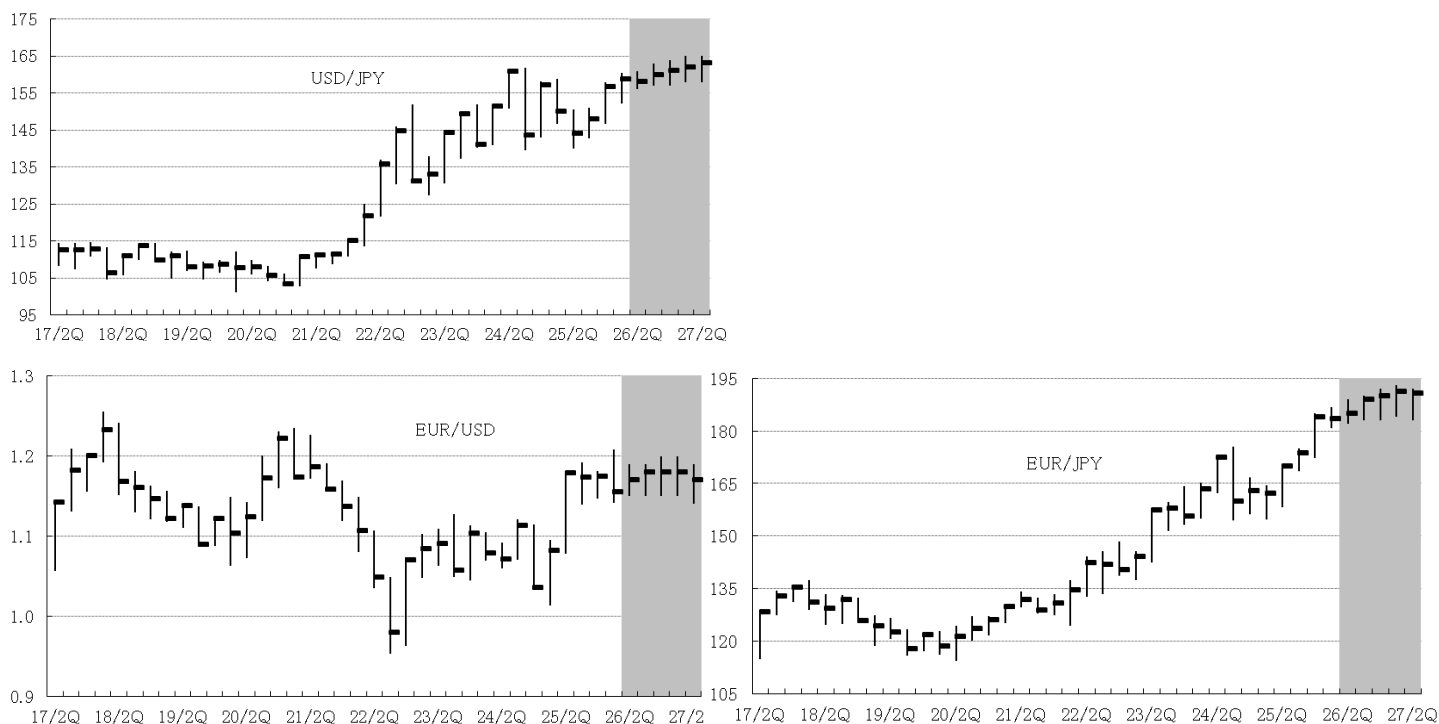
EUR weakened somewhat in May. With the ECB likely to be the first of the three major central banks (BOJ, Fed, and ECB) to raise interest rates, EUR buying can be expected for the time being from the perspective of domestic-international interest-rate differentials. As ECB President Christine Lagarde has noted, a deviation from the ECB’s baseline macroeconomic forecast is already apparent, and the markets have fully priced in two interest rate hikes this year, making the ECB appear more hawkish than both the BOJ and the Fed. Further, while “central bank independence” is often a topic of discussion when it comes to the BOJ and the Fed, the assessment that the ECB faces no such risk will likely be seen as a factor supporting EUR in the long run. On the other hand, the uncertainty surrounding the political situation in Europe is much greater than that surrounding its economic and financial situations. The historic defeat of the ruling party in UK local elections in early May has intensified the atmosphere of a rightward shift in European politics, even though the UK is outside the euro area. Indeed, France and Germany are also facing unstable political situations, and political changes there could lead to expansionary fiscal policies. In particular, it seems very likely that a far-right candidate will win the 2027 presidential election in France, and the impact of this on regional politics, and consequently on the economic and financial situations centering on the regional bond market, must be closely watched.

### Summary Table of Forecasts

	2026	Jun	Jul-Sep	Oct-Dec	2027	Apr-Jun
	Jan-May (Actual)				Jan-Mar	
<b>USD/JPY</b>	152.10 ~ 160.72 (159.49)	156 ~ 161 (158)	157 ~ 163 (160)	157 ~ 164 (161)	158 ~ 165 (162)	158 ~ 165 (163)
<b>EUR/USD</b>	1.1409 ~ 1.2084 (1.1645)	1.15 ~ 1.19 (1.17)	1.15 ~ 1.19 (1.18)	1.15 ~ 1.20 (1.18)	1.15 ~ 1.20 (1.18)	1.14 ~ 1.19 (1.17)
<b>EUR/JPY</b>	180.84 ~ 187.95 (185.72)	182 ~ 189 (185)	183 ~ 190 (189)	183 ~ 192 (190)	184 ~ 193 (191)	183 ~ 192 (191)

(Notes) 1. Actual results released around 11 am TKY time on 1 June 2026. 2. Source by Bloomberg  
3. Forecasts in parentheses are quarter-end levels.

## Exchange Rate Trends & Forecasts



## USD/JPY Outlook - Japanese Economy and JPY's Painful Realization of "No Free Lunch"

### Forex Markets Now and Going Forward – The Right Policy Mix

#### *U.S.-Japan Finance Chiefs Confirm Good Relations*

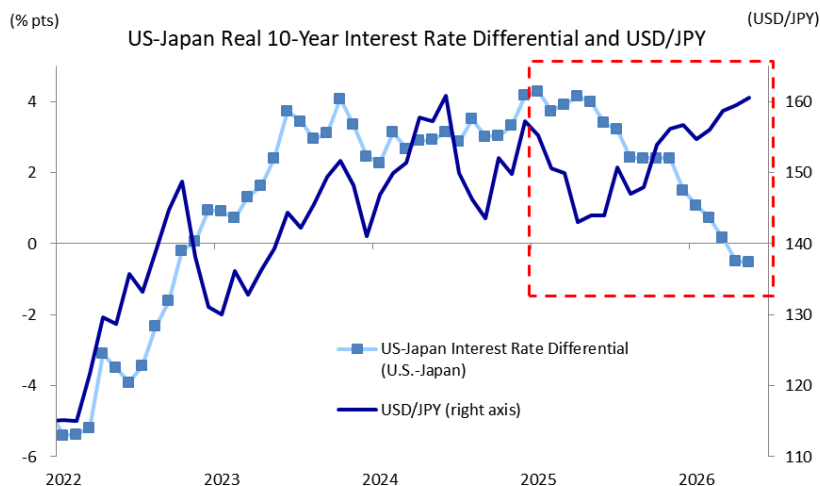
Forex markets in May took note of the fact that U.S. Treasury Secretary Scott Bessent had visited Japan and met with Japanese Minister of Finance Satsuki Katayama on May 12 and that he had also met and spoke with BOJ Governor Kazuo Ueda in Paris on May 19. The news headlines in this regard were mostly predictable (with the content of the articles also being perfectly reasonable), so they did not become a major trading factor in themselves. However, the moderate headlines aside, the fact that the good relations between the two countries were reaffirmed is by no means insignificant. After the meeting, Katayama stated, "Japan and the U.S. have been coordinating very closely regarding recent exchange rate developments. We also strongly reaffirmed continued cooperation in line with the Japan-U.S. joint statement issued last September, which explicitly addresses intervention." Meanwhile, Bessent posted on X, "I was pleased to reaffirm the strong economic partnership between the United States and Japan. The level of communication and coordination between our teams in addressing undesirable, excess volatility in currency markets continues to be constant and robust." Overall, this was an opportunity to confirm that U.S. and Japanese monetary authorities are continuing to cooperate closely. Earlier this year, at the Davos meeting in late January, Bessent had stated in response to the sharp rise in U.S. long-term interest rates, "it's very difficult to disaggregate the market reaction from what's going on endogenously in Japan." He also did not hide his displeasure with the surge in Japanese government bond (JGB) yields, saying, "I've been in touch with my economic counterpart in Japan, and I am sure that they will begin saying the things that will calm the market down." Given the tone of most reports at that time, which suggested U.S. monetary authorities' dissatisfaction with Japan, this reaffirmation of good relations is a significant change.

#### *Hoping U.S.-Japan Monetary Cooperation is Genuine*

In this context, forex market participants are expected to encounter higher upside resistance for USD/JPY going forward. One can infer from Katayama's statement at the press conference following her meeting with Bessent – "I hope you will understand that we discussed a variety of matters and further strengthened our cooperation" – that the forex markets will assume that Japan's monetary policy will move to suppress USD/JPY in the event of a significant JPY depreciation (especially exceeding 160 to the dollar) with the understanding of the U.S. Given that the late January FOMC minutes explicitly acknowledge rate checks by the New York Fed on behalf of the U.S. Treasury in what attracted widespread attention as "coordinated U.S.-Japan rate checks," cooperation between the Japanese and U.S. monetary authorities should be considered genuine, not a bluff. The simultaneous weakening of JPY and rising of JPY interest rates, which could lead to higher U.S. Treasury yields, is something the U.S. cannot ignore. Practically speaking, given the recent meeting and the history of regular intervention around JPY160 to the dollar since April 2024, many market participants are likely to hesitate before betting on USD/JPY levels above 160.

### Disappearance of U.S.-Japan Long-Term Real Interest-Rate Differential

In the near term, it has become more difficult for USD/JPY to continue rising beyond its recent high (over 162) unless Japan's trade deficit increases dramatically or the U.S.-Japan real interest-rate differential widens significantly. The U.S.-Japan long-term real interest-rate differential, for its part, is virtually non-existent as of the present time (see graph). As of May 26, net JPY short positions in IMM currency futures trading had also expanded to levels not seen since July 2024, when USD/JPY hit a new high. Under such circumstances, USD/JPY seems highly likely to experience pullbacks, regardless of their sustainability. Of course, a dramatic increase in Japan's trade deficit is a scenario that cannot be ruled out at the present time. Based on my estimates, described in previous issues of



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

this report, if crude oil prices remain at USD90-100 per barrel, Japan's imports could increase by JPY5-8 trillion yoy, which is sufficient to cause a dramatic increase in the country's trade deficit. As a result, USD/JPY may remain in the 155-160 range seen since March. Having said that, a central banker may say that the risks are tilted downward (toward a stronger JPY). Nothing can be said for certain regarding the trade deficit, as it depends on the navigability of the Strait of Hormuz and the pace of crude reserve releases. However, if crude oil prices remain high, it will be of little comfort to Japan even if a ceasefire is achieved.

### Current Status of BOJ Rate Hikes

In formulating the near-term outlook, the key is to look at the coherence of the policy mix. Mathematically, there are eight possible combinations for a country's economic policy mix (including monetary, fiscal, and currency policies), but since monetary and currency policy theoretically move in the same direction, we are left with only four combinations after excluding the unsustainable combinations. Japan would like to aim for combinations (6) or (8) in the figure, but its present policy mix is the theoretically unsustainable combination (2), with action being taken on the currency policy front (exchange rate intervention) but not on the monetary policy front (interest rate hikes), and a supplementary budget being

Policy Mix Combinations

	Monetary Policy	Fiscal Policy	Currency Policy	Policy Intent	Example
(1)	Easing	Easing	Weak currency	Escape recession, avoid deflationary spiral	US
(2)	Easing	Easing	Strong currency	Unsustainable	Japan as it is?
(3)	Easing	Tightening	Weak currency	Economic support	
(4)	Easing	Tightening	Strong currency	Unsustainable	Japan as it is?
(5)	Tightening	Easing	Weak currency	Unsustainable	
(6)	Tightening	Easing	Strong currency	Reduce current account surplus, prevent economic overheating (though less aggressively than (8))	Euro area
(7)	Tightening	Tightening	Weak currency	Unsustainable	
(8)	Tightening	Tightening	Strong currency	Prevent economic overheating	Japan as it should be?

(Source) Prepared by the Global Foreign Exchange Department, Mizuho Bank

compiled. Assuming an increasingly aggressive currency policy, a corresponding monetary policy mix would naturally involve raising interest rates, which leaves us with options (6) and (8), but given present inflationary conditions, (8) seems most appropriate. However, in reality, while both Japanese and U.S. currency policies are aligned in pushing down USD/JPY (JPY appreciation against USD), Japan's monetary policy remains unchanged, leaving the real policy interest rate in negative territory. This is a situation that will be difficult to sustain.

Incidentally, the "Summary of Opinions at the Monetary Policy Meeting" for the April meeting, published on May 12, included the opinion that "it is quite possible that the Bank will raise the policy interest rate from the next MPM onward, even if the future course of the situation in the Middle East remains unclear." This indicates a recognition that interests can be raised regardless of the situation, provided the impact on the domestic economy can be assessed. This aligns with Governor Ueda's statement that "a decision to raise interest rates is possible even if the Strait of Hormuz is blocked." At this point, there is not much justification for skipping June and waiting until July, so a June rate hike cannot be ruled out.

The problem is that the markets have not fully priced in a second rate hike, even looking ahead up to the December meeting. Given that Japan and the U.S. are moving in tandem toward JPY strengthening against USD, the assumption that interest rate hikes will be limited to one or two this year seems an underestimation. In most developed countries, the orthodox method is for monetary policy to take the lead, and for currency policy (intervention) to be considered only if currency depreciation persists. However, in Japan, for some reason, all the focus, especially in the media, seems to be on currency policy implementation or the lack of it, with monetary policy responses being ignored altogether. This is

quite peculiar. Continuing intervention while leaving real interest rates negative is like continuing to pour water into a leaky bucket. The standard approach is to first implement multiple interest rate hikes and gauge the market's reaction. It is highly likely that the authorities will settle on such a response over time.

Based on this understanding, one should anticipate not just one, but two or three interest rate hikes by the BOJ this year. If that happens, correcting the JPY depreciation trend may take time, given supply-demand distortions (specifically, the widening trade deficit), but I fear one must be prepared for a considerable correction in Japanese stock prices, which have been gaining momentum.

## The Japanese Economy Now and Going Forward – Keen Realization of “No Free Lunch”

### Currency Continues to Weaken Even as Interest Rates Rise

In May, the rise in JPY interest rates attracted considerable attention. On May 19, the yield on 10-year Japanese government bonds (JGBs) temporarily hit the 2.8% level, the highest level in 29 and a half years, raising concerns about its impact on the domestic economic and financial situation. The rise in interest rates is a global phenomenon not unique to Japan, with many pointing to the persistently high crude oil prices due to the situation in Iran, upward inflation expectations, and ultimately, the hawkish leaning of central banks as contributing factors. Linking to more immediate factors, the acceleration of the U.S. consumer and producer price indices (CPI and PPI) has almost completely eliminated expectations of Fed interest rate cuts, which appears to have triggered the rise in interest rates. The ECB has already decided on a June interest rate hike.

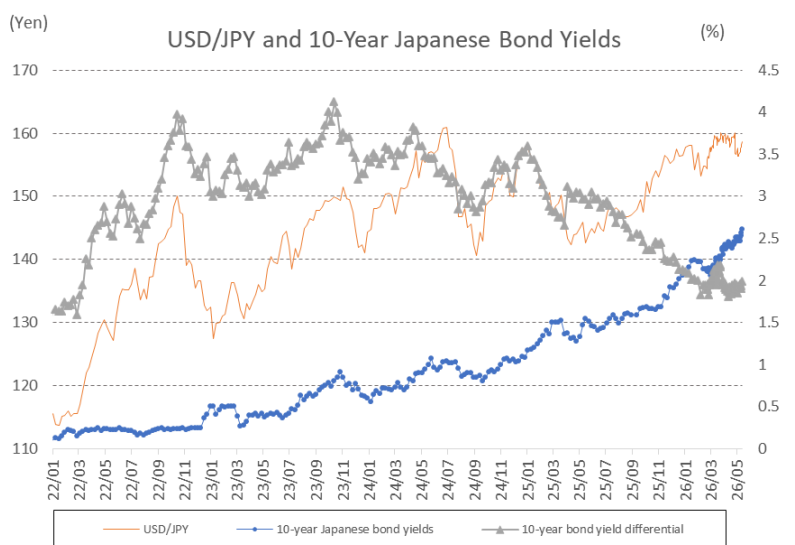
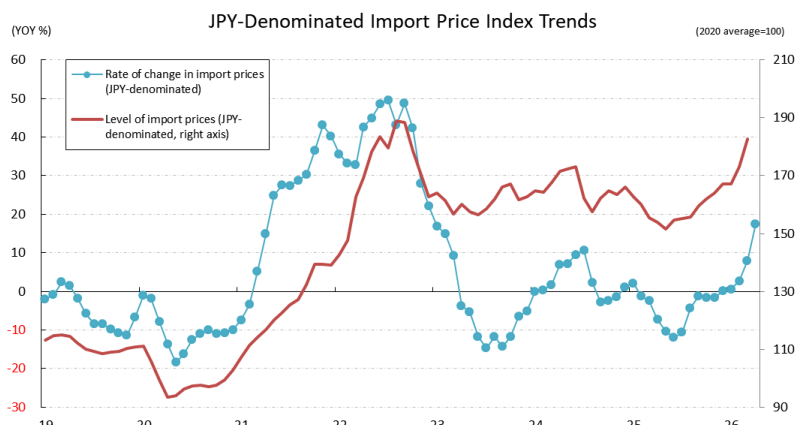
What is unique to Japan, however, is the weakening of the domestic currency along with rising interest rates. While the decision to compile a supplementary budget, initially denied by the government, may have influenced the May 19 spurt, JPY interest rates had been rising since before then. The increase in fiscal risk premiums is likely related, but it does not seem to be the primary reason. Given recent trends, focusing on the correlation with JPY depreciation should be prioritized.

### JPY Depreciation → Inflation → Rising JPY Interest Rates

Since there is not just one factor driving rising interest rates, it is risky to limit the discussion to a single point. However, one would do well to consider its correlation with the current state of the Japanese economy, where inflationary pressures are being imported via rising import prices driven by JPY depreciation. Given this fact, there emerges a clear progression from JPY depreciation → inflation → rising JPY interest rates. The JPY-denominated import price index is definitely accelerating at the current time (see graph on the top right), and it is easy to imagine this influencing the inflation expectations of the man on the street via the CPI. It would be premature to simply interpret JPY selling as a loss of confidence in government bonds, and by extension, in the government and the BOJ. However, it is logical that as JPY weakens, inflation will progress; and as interest rate hikes become necessary to control inflation, JPY interest rates will be pushed up. In fact, looking back at the relationship between USD/JPY and interest rates during the ongoing phase of JPY depreciation, there has been no correlation with the 10-year U.S.-Japan interest-rate differential since 2025, while the correlation between Japan's 10-year interest rate and JPY depreciation has remained stable from the start.

Since 2022, JPY interest rates have been increasing in parallel with JPY depreciation (see graph, bottom), and a careless explanation for this would be that investors have been “selling Japan,” but the reality is that interest rates have been raised to counteract inflationary pressures stemming from JPY depreciation.

If JPY depreciation is the factor behind rising JPY interest rates, then unless that factor is identified and eliminated, the pace of JPY interest rate increases will not slow. The reason for focusing specifically on



the “pace” is that, as mentioned above, there is more than one factor driving the rise in JPY interest rates – even if JPY depreciation were to end, the JGB-selling trend is unlikely to cease as concerns about Japan’s low potential economic growth rate and the BOJ’s independence remain. However, since JPY depreciation has recently been the starting point of many critical analyses of the Japanese economy, JPY interest rates are quite likely to stabilize with the end of JPY depreciation.

### A Repeat of 2022

In other words, interest rates will continue to rise unless JPY stops depreciating, which is a problem. As I have repeatedly argued in this report and in my books, my position is that a structural change in JPY supply and demand underlies the JPY depreciation trend. The fact that the current phase of JPY depreciation began in 2022, the year that also saw the largest trade deficit on record, is not mere coincidence (see table). With similar causes (wartime crisis) causing similar outcomes (high resource prices) at the present time, it is natural to imagine a similar impact on exchange rates (accelerated JPY selling). What is different from four years ago is that the Strait of Hormuz, a vital lifeline for Japan’s crude oil procurement, has been cut off this time, and as of the time of writing, there are almost no signs of crude oil prices normalizing.

Some reports indicated that the government was considering intervention in crude oil futures, although this has not happened yet. If resource prices have distorted supply and demand sufficiently to accelerate JPY depreciation and, consequently, push up JPY interest rates, then it may be somewhat logical (though not recommended) to intervene in correcting crude oil prices.

### No Magic Bullet for a Sudden Turnaround

Mineral fuels comprise 20-25% of Japan’s imports, and Japan relies on the Middle East for 90% of its crude oil. Therefore, it is particularly vulnerable to geopolitical risks originating in the Middle East. This is an unavoidable structural problem Japan faces irrespective of the ruling administration. However, there is something that can be done: given the ongoing JPY-depreciation-led inflation, the policy mix required of Japan is to tighten all three of currency, monetary, and fiscal policies. Unfortunately, except for its currency policy, which is aimed at curbing JPY depreciation, the country’s monetary and fiscal policies continue to be inflation-inducing. Whereas combination (8) in the figure on p. 4 is what is needed, Japan is currently implementing combination (2). My prediction, however, is that, whether or not it desires it, Japan’s policy mix will move toward (8), with multiple interest rate hikes.

Of course, drastic tightening of neither monetary policy (by raising interest rates) nor fiscal policy (by suspending consumption tax cuts or reducing fuel subsidies, for instance) would do anything to bring down crude oil prices, which remains the fundamental pain point. However, if JPY could be somewhat strengthened by tightening currency, monetary, and fiscal policies, Japan’s import value in JPY could be brought down. Inflationary pressure would still remain, but that would not be unique to Japan; other Asian and European countries are in the same predicament. Japan is not the only one suffering. Resource-rich countries aside, if inflationary pressures could be relieved solely through discretionary macroeconomic policies, no country would have to struggle. Ultimately, the only option is to find the right combination of sound economic policies. In Japanese economic policy discourse, there is a tendency to expect one-shot solutions, but such a thing does not exist for any country.

### No Free Lunch

I keenly feel that there is no such thing as a free lunch. Ongoing fiscal policy measures including gasoline subsidies are mitigating the pain of inflation for Japanese society to the extent that the public is less conscious of inflationary pressures from energy prices compared to other countries. The fact is – it has become commonplace for countries around the world to conduct economic activities under demand-suppressing measures. It is difficult to understand why Japan should be spared from the same. The price for this pain mitigation is JPY depreciation and rising JPY interest rates. Even if energy prices are kept low, we are paying additional costs through forex and interest rates. This is a literal manifestation of the “no free lunch” principle. If we were to find a silver lining in this cloud of misfortune, it could be that this series of events will eliminate the tendency in Japanese policy discourse to seek simplistic one-shot solutions to complex problems. Ultimately, people only learn from experience.

**Japan's Worst Ten Trade Deficits and USD/JPY**

	Trade balance (tril yen)	JPY Percentage Change Against USD (YoY)
(1) 2022	-20.3	-13.9
(2) 2014	-12.8	-13.7
(3) 2013	-11.5	-21.4
(4) 2023	-9.5	-7.6
(5) 2012	-6.9	-12.8
(6) 2024	-5.6	-11.5
(7) 2015	-2.8	-0.4
(8) 2025	-2.9	0.3
(9) 1980	-2.6	15.5
(10) 2011	-2.6	5.2

(Source) Ministry of Finance and Bloomberg; prepared by the Global Foreign Exchange Department, Mizuho Bank, \*Figures for period since 1973

The JPY percentage change against USD compares year-end rates of the year in question with that of the previous year (data from Bloomberg)

## JPY Supply and Demand Situation – Supply-Demand Balance Begins to Collapse Starting with the Service Balance

### FY2025 Figures are Meaningless

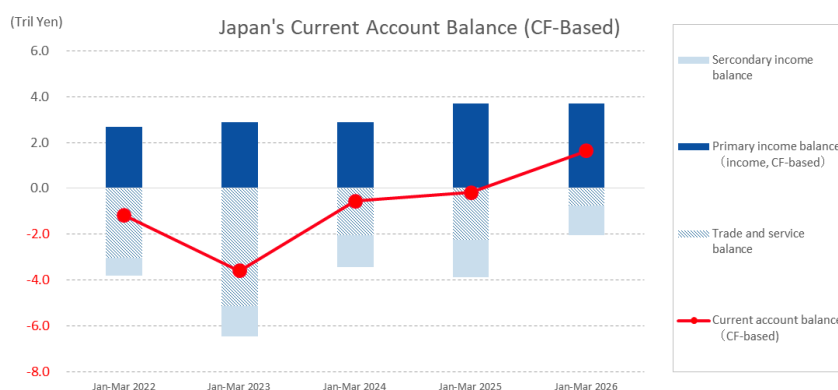
On May 13, Japan’s March balance of payments was released. The headlines highlight the fact that, with all the monthly figures for FY2025 now available, the current account surplus for the year had posted a record high for the third year in a row, at +JPY34.5218 trillion. In particular, the primary income surplus, which is the central pillar of the current account surplus, posted a record high for the fifth year in a row, at +JPY42.2809 trillion. Further, the trade balance had posted its first surplus in five years on an annual basis, at +JPY1.3631 trillion.

The global economic environment, however, has changed dramatically since March. The FY2025 trade balance improved partly due to strong exports of semiconductors and electronic components to Asia, but largely owing to a decrease in mineral fuel imports compared with the previous year. Specifically, crude oil prices had fallen by 13.3% to USD71.41 per barrel. This, however, is no longer the case, so there is no reason to be complacent about the 2025 figures. It is only a matter of time before Japan stops releasing its reserves, starts importing expensive crude oil, and sees the impact on its balance sheet in the not-too-distant future. It is precisely this anticipation that is strongly driving speculative JPY selling. As of the time of writing, it has been reported that there will be no third release of reserves. Therefore, the June trade statistics (to be released in July) may reflect the recent surge in fuel prices and JPY depreciation. These figures will attract significant attention from forex market participants.

### 1Q of 2026 was a Promising Start

In Japan, after reporting extensively on calendar year figures, fiscal year figures are also widely reported. However, since calendar year figures are easier to compare globally, I will refrain from going deeper into the final fiscal year figures. Instead, now that January-March 2026 figures are available, let me summarize the JPY supply and demand climate for 1Q of 2026 and compare it to recent years (see graph).

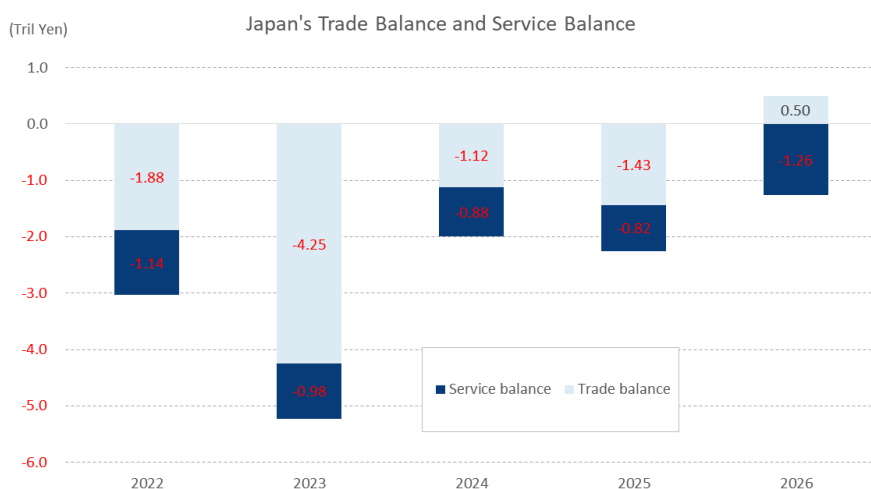
As I have repeatedly argued in past issues of this report as well as in my books, it is necessary to understand the real supply and demand for JPY by distinguishing parts of the current account surplus that result in a cash flow (CF-based current account surplus) from the statistical current account surplus, which includes reinvestment income, which remains as foreign currency in the host country, and securities investment income, which is likely to be reinvested and compounded. In this regard, I must mention that, while the statistical current account surplus for the January-March quarter of this year was +JPY9.5452 trillion, the CF-based current account surplus was only about +JPY1.6 trillion. However, this is the first CF-based current account surplus for the January-March period in the past five years (directly corresponding to the current JPY depreciation phase). Had it not been for the Iran attacks, the ongoing phase of JPY depreciation driven by structural distortions in the supply and demand may have ended in 2026.



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

### Largest Services Deficit in Five Years

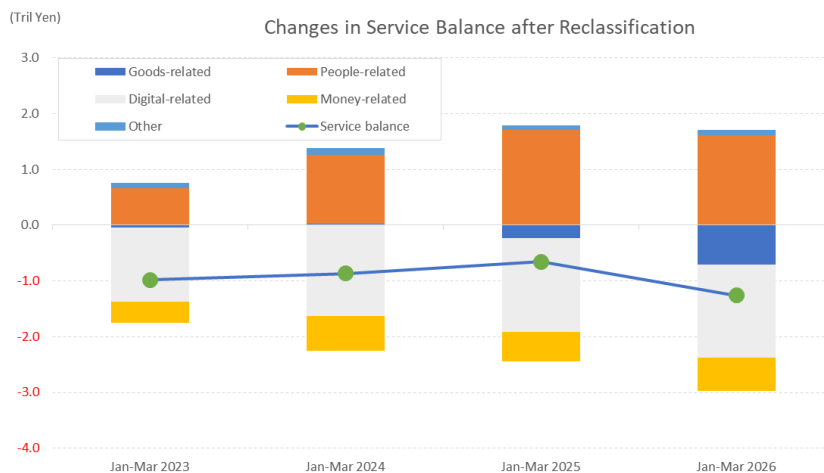
The breakdown of the deficit is cause for concern. As the figure shows, the biggest reason for an improvement in the JPY supply and demand climate compared to previous years is the significant reduction in the trade and services deficit, or more specifically, as mentioned earlier, the fact that the trade balance turned positive for the first time in five years. However, whether a robust trade balance can be maintained depends essentially on the situation in Iran, and in terms of the immediate domestic situation, it also depends on the release of crude oil reserves. Since the timeframe for this depends on the government’s release policy, a confident prediction is difficult, but it is almost certain that the deficit will widen over time. The present improvement in the trade balance is merely a snapshot. The trade balance should rather be factored in as a negative factor when formulating future forecasts.



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

What about the services balance? As shown in the figure below, the services deficit for the January-March quarter was actually the largest in the past five years. This is largely due to a widening deficit in goods-related payments (-JPY237.7 billion → -JPY704 billion) caused by increased payments toward research and development services. However, the people-related payments balance, which is primarily driven by the prized travel balance, also saw a slight decline in surplus (+JPY1.7144 trillion → +JPY1.6126 trillion). Further, the digital-related payments balance remained high at -JPY1.665 trillion, almost unchanged from the previous year (-JPY1.6727 trillion). Globally, airfares are rising, and some low-cost airlines have already begun to suspend operations. In Japan's case, the halt in inflow of Chinese tourists is also likely to continue. A shrinking travel surplus is almost a foregone conclusion. Taking all this into account, a deterioration in the balance of payments in both trade and services seems inevitable for 2026. It is precisely because this can be predicted with a relatively high degree of certainty that oft-discussed speculative movements seem likely to favor JPY selling.

Meanwhile, with JGB yields soaring, real interest rates themselves are trending upward. Given the ongoing discussions about Japan and the U.S. coordinating monetary policy around 160 yen to the dollar, USD/JPY seems likely to remain volatile between 155 and 160 for some time. If the Fed and the ECB resume rate hikes in the midst of this delicate balancing act, that could be a catalyst for USD/JPY to reach new highs. Based on the information released by the FOMC and ECB Governing Council in June, the outlook for 2H of this year may have to be significantly revised.

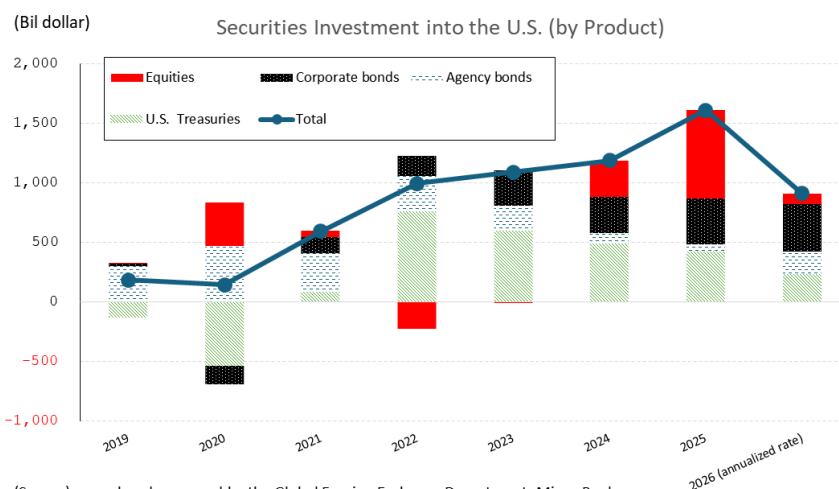


(Source) Bank of Japan; prepared by the Global Foreign Exchange Department, Mizuho Bank

## U.S. Monetary Policy Now and Going Forward – Impressions of the Warsh Administration

### Trump's Unchanging Call for Interest Rate Cuts

On May 4, when the Tokyo market was closed, U.S. President Donald Trump posted on his social media account, Truth Social, "Too Late" is a DISASTER for America! Interest Rates too high!" His words can be interpreted as a call for interest rates to be cut soon. However, given the current mood among FOMC members as confirmed at the April FOMC meeting, the new Warsh administration may not be able to reach a consensus on continuous interest rate cuts anytime soon. Of course, even if monetary policy were to be run in accordance with Trump's wishes, there is no guarantee that U.S. interest rate movements would meet his expectations. As I have repeatedly stated in this report in the context of de-dollarization, market interest rates in the U.S. have continued to rise in opposition to interest rate cuts since September 2024 (see graph).



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

If U.S. hegemony and USD's status as a reserve currency are both deteriorating, then it is possible that demand for U.S. Treasuries is fundamentally declining. Since the U.S. Treasury Department's Treasury Investment Commission (TIC) data also suggests that investment in U.S. Treasuries may be thinning (see graph), Trump's reasoning that the Fed is to blame for failing to bring down market interest rates may be fundamentally flawed. The possibility that Trump's own policies have increased the unpredictability of U.S. politics and economics, thereby causing a decline in demand for U.S. treasuries (and promoting the push toward de-dollarization) cannot be ruled out.

### "The Fed is Not Independent from the Government"

The first FOMC meeting under new Fed Chair Kevin Warsh will be held on June 16-17, and it will be interesting to see how consistent it is with Trump's policy intentions. While Warsh himself is generally recognized as a hawkish commentator, there is still no consensus on how he might navigate the difficult situation of dealing with pressure from the president to cut interest rates while also taking into consideration the Trump administration's inflation-inducing policy package including high tariffs, immigration restrictions, and tax cuts (not to mention soaring inflation expectations thanks to the Iran attacks). Some argue that Warsh, who was appointed with an expectation of loyalty, cannot simply ignore his relationship with the political leadership. However, when pressed by senators about whether he would comply with the president's demands for interest rate cuts at his Senate Banking Committee confirmation

hearing in April, Warsh emphasized the essential nature of central bank independence and stated, “The president never asked me to predetermine, commit, fix, decide on any interest rate decision.” Further, at Warsh’s inauguration ceremony on May 22, Trump encouraged him, saying, “Don’t look at me, don’t look at anybody. Just do your own thing, and do a great job.” Within the FOMC, arguments in favor of interest rate cuts are fading, so it may be natural to assume that Warsh will largely be spared any pressure from the president or FOMC bias toward lowering rates. If anything, in a speech<sup>1</sup> in March 2010, 16 years ago, Warsh said, “The Fed is not independent from government. It is independent within government. And elected representatives have every right to redraw the central bank’s authority,” and included the caveat “even if a fuller reading of economic history considers it unwise.” In other words, monetary policy can be influenced by the government’s intentions, and such actions have historically been tolerated even if they were unwise. While Warsh made no such statements at his recent confirmation hearing, it is worth noting that the new Fed administration under him may be surprisingly dovish given its chair’s relationship with the political administration.

**Balancing “Operational Independence” and “Political Coordination”**

If the new Warsh administration finds itself caught between operational independence and political coordination, and the market perceives a greater emphasis on the latter, there will be renewed focus on de-dollarization, potentially increasing the risk of USD weakening and U.S. interest rates rising simultaneously. While the likelihood of it happening remains low, concern has been smoldering since last year that the new Fed administration under Warsh could further intensify the move away from USD, which has been accelerating

**Similarities between the Nixon and Trump Eras**

Issues	Nixon (1969-1974)	Trump (2025-present)	Similarity
Trade policies	10% import surcharge	Reciprocal tariff policy (flat 10%, variable surcharge rate)	Protectionist
Currency policies	Suspension of USD-gold convertibility	Mar-a-Lago Agreement’s weaker USD orientation	Weak USD
Financial policies	Pressure on Fed Chairman Burns	Pressure on Fed Chairman Powell	Low interest rates
Foreign policies	[Nixon Doctrine] Require allies to increase their defense burden and reduce direct U.S. military intervention	[America First] Demand increased defense spending from NATO allies, Japan, and South Korea	Requirement that allies shoulder their fair share of security costs
Objectives	End the Bretton Woods system	Desire for Bretton Woods 2.0	Lowering the cost of hegemonic power
Risks	Stagflation	Stagflation	Policy of monetary easing amid inflation

(Source) Various materials; prepared by the Global Foreign Exchange Department, Mizuho Bank

under the second Trump administration. Of course, thanks to Warsh’s longstanding reputation as a hawk, coupled with the turmoil surrounding the Iran attacks, concerns about the Fed’s politicization seem to be fading, but it is still a risk scenario I would like to keep an eye on.

Warsh’s historical perspective (“even if a fuller reading of economic history considers it unwise”) seems to be based on the Fed administration under Arthur Burns in the 1970s, which neglected inflation. Market participants should note that the Warsh administration is on the brink of becoming a “second Burns administration.” As discussed in past issues of Mizuho Market Topics,<sup>2</sup> many have pointed out the similarities between Trump and former U.S. President Richard Nixon in their relationships with the Fed (see table), and such discussions could come into the spotlight again depending on the actions of the Warsh administration. That could trigger another round of USD weakening alongside rising U.S. interest rates, but the important thing to remember is that JPY continued to weaken last year even while this was a hot topic.

**Risks to My Main Scenario – “Central Bank Independence” Once Again Under Scrutiny**

**Quiet Erosion of Central Bank Independence**

On May 7, ECB Executive Board Member Isabel Schnabel delivered a speech entitled “The quiet erosion of central bank independence”. While doubts about central bank independence are a frequent topic of discussion in the United States and Japan, the ECB – as an international organization working on behalf of numerous EU member states – continues to be perceived as relatively sound. In fact, I have long believed that the foundations of EUR’s strength include the ECB’s relative immunity to political interference as well as observers’ general tendency to focus on the euro area’s economic and financial prospects over the medium-to-long term future, particularly as the EU pursues strategies for reducing its dependence on the United States. Schnabel’s speech discusses in detail central banks’ currently precarious situation, the mechanisms that threaten central banks’ independence, and prescriptions for protecting that independence. The Fed’s new leadership under Chair Kevin Warsh (who took office in May) will inevitably face scrutiny regarding its relationship with the Trump administration, and BOJ’s recent interest rate hikes is also widely assumed to reflect its relationship with Japan’s government. During the forecast period, the question of whether there will be a process of “central bank independence” erosion will be a key theme worth paying close attention to.

**Fiscal Dominance and Financial Dominance**

Executive Board Member Isabel Schnabel’s speech makes an interesting observation that central bank independence is not generally being eroded by brazen political pressures – although that is happening in the United States – but rather that the erosion is proceeding in a more subtle and quiet manner. The speech notes that the quiet erosion is

<sup>1</sup> FRB, “An Ode to Independence,” March 26, 2010

<sup>2</sup> For instance, please see Mizuho Market Topics dated August 13, 2025 (“A Comparison of Nixon and Trump: A Frightening Outcome”) and August 14, 2025 (“A Comparison of Nixon and Trump: The Cost of Managing a Hegemonic Power”).

largely being driven by two factors – fiscal dominance and financial dominance – that are both becoming major points of contention in discussions of the world’s leading central banks..

Fiscal dominance is an issue frequently debated in Japan in connection with the question of BOJ independence. When government debt is at a high level, if the central bank raises interest rates to curb inflation, the government’s interest payment burden becomes heavier and jeopardizes fiscal sustainability. There are growing concerns that the BOJ and other central banks in this situation will be forced to give priority to fiscal sustainability and will therefore find it difficult to raise interest rates to levels needed to effectively control inflation. In other words, it is feared that the main objective of monetary policy may increasingly shift from the promotion of price stability to the defence of the government’s financial position, leading to a gradual and quiet erosion of central bank independence. Such doubts regarding the effects of fiscal dominance on the BOJ’s independence are increasingly being cited as a reason for JPY’s depreciation in recent years.

The concept of financial dominance is a similarly interesting topic. Schnabel points out that in recent years there has been a resurgence of deregulation movements that reduce financial system resilience, arguing that – “Financial dominance arises when the fragility of the financial system effectively constrains the central bank’s ability to preserve price stability. A central bank that cannot raise rates without risking financial disturbances or a financial crisis is not free to fulfil its price stability mandate.” In short, her view is that sound financial regulation is necessary to maintain financial system stability; otherwise, there is a greater likelihood that it will frequently be argued that monetary easing is required to sustain that stability.

### *Fiscal Dominance Steadily Progressing*

Regarding factors promoting fiscal dominance recently, Executive Board Member Schnabel noted that – “defence spending is rising sharply across NATO members, and the investment needs of the green and digital transitions add further pressure on public finances, amplified by rising interest burdens.” Her speech cited IMF projections of U.S. and Chinese government debt trends indicating that China’s debt-to-GDP ratio may rise from 99% in 2025 to 127% by 2031 while the U.S. ratio may increase from 124% to 142% over the same period. The key problem related to such debt growth lies in the fact that the financial markets’ capacity to absorb such a rising debt issuance volume is not guaranteed. The speech pointed out that – “By early 2025, hedge funds’ share of secondary market trading had increased to around one-third in the market for US Treasuries and to even higher levels in that for euro area sovereign bonds.” As the proportion of holdings by such price-sensitive investors increases, demand for long-term government bonds becomes more volatile, leading to a bear steepening of the yield curve. Given the increasingly less reliable demand for long-duration sovereign debt, many countries are actually shortening the average maturity of the debt they issue (see graph). The insulation that longer average maturities once provided is being progressively eroded, causing the fiscal consequences of monetary tightening to be felt faster and more acutely and thereby further increasing fiscal dominance pressures on monetary policy management.

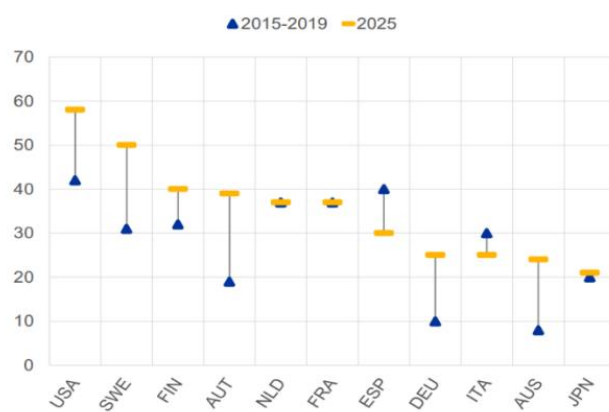
In the case of Japan, the degree of this maturities shortening has been small due to the long-standing low-interest-rate policy, but the country faces the problem of an extremely large volume of outstanding debt. It is necessary to recognize that, while the full effects of fiscal dominance may not materialize immediately, they will be severe over the long term. Although JPY’s current weakness cannot be said to be completely attributable to fiscal dominance, fiscal dominance does appear to be playing a role in promoting that weakness.

### *Monetary Dominance – Growing Cause for Concern*

Regarding financial dominance, after noting that some of the post-Lehman regulatory tightening has been somewhat excessive and has a potential to encourage deleveraging (credit contraction), Executive Board Member Schnabel stated that – “A periodic review of what has and has not worked is legitimate and necessary for a framework now in place for over a decade.” She pointed out that many banks currently hold high-quality liquid assets that exceed prudential regulatory requirements, but that – “they may be reluctant to draw them down in periods of stress for fear of signalling weakness, as also observed during the pandemic. A buffer that cannot be used is not fully serving its purpose, like in Charles Goodhart’s famous example of the last taxi that never leaves the station.” (Goodhart uses a fable about local bylaws requiring a taxi to always remain at a station, making it completely off-limits to passengers, to critique such strict central bank liquidity mandates as the Liquidity Coverage Ratio. If regulators require banks to keep a mandatory cash buffer “at all times” to withstand crises, banks become afraid to use it in an actual emergency.) She therefore expressed some understanding of moves to ease financial regulations, stating that the ECB is also – “offering concrete proposals to cut undue complexity, while preserving resilience and adhering to internationally agreed standards.”

On the other hand, if the regulatory easing trend goes too far, as was the case after 2008 (the Lehman Shock), systemic risks will increase, making it more difficult for central banks to tighten monetary policy in the future – and that

**Government bill issuance**  
(% share of gross borrowing)



Sources: OECD (2026), Global Debt Report 2026: Sustaining Debt Market Resilience Under Growing Pressure.

Prepared by the Global Foreign Exchange Department, Mizuho Bank

is the situation known as financial dominance. Schnabel argues that, while fiscal dominance is already a significant concern, monetary dominance more likely to cause crises in the future.

### *Three Necessary Measures*

Based on her observations regarding the current situation, Executive Board Member Schnabel argues three things are needed to halt the quiet erosion of central bank independence and enable central banks to continue fulfilling their mission – (1) maintaining sound fiscal frameworks, (2) maintaining robust financial regulations, and (3) strictly adhering to mandates and establishing clear operational boundaries.

Points (1) and (2) are self-evident, while point (3) is rarely discussed, and Schnabel emphasizes regarding point (3) that, to preserve central bank independence, central banks must “firmly remain within their mandates” and continue to clearly explain the rationales behind their decisions. Indeed, when overviewing the history of central bank policy management, one can see that there have been some times when central banks felt it necessary to deviate from their mandates in response to changing times and special economic and financial conditions. Schnabel criticized the blurring of the boundary between monetary and fiscal policy, particularly regarding central bank asset purchases, stating that the rationale for asset purchase programs has not always been convincing and that those programs have influenced asset allocation issues in ways that should be the responsibility of politicians. Interpreted more broadly, this suggests that monetary policy should primarily rely on adjustments to policy interest rates and that central banks should maintain a distance from non-traditional policies to avoid encroaching on areas that should be handled by politicians. This reflects the standard policy perspective of ECB Governing Council members from traditional German backgrounds, and that perspective must be taken into account when interpreting those Governing Council members’ views.

The ECB under President Christine Lagarde has been giving considerable attention to climate change-related measures, and there has long been criticism that those measures are a central bank overreach into the political sphere. In her speech, Executive Board member Schnabel argues that – “Climate change [...] creates significant risks for financial stability [...]. Hence, considering the consequences of climate change for price and financial stability lies at the core of central banks’ and supervisors’ mandates.” – although I do not necessarily agree with this argument, largely because the timeframe for central banks’ “interest rate adjustments, asset purchases, and regulatory responses” is too different from the timeframe for “climate change issues”. For example, it would be extremely difficult to demonstrate how purchasing the corporate bonds of companies proactively working to alleviate environmental issues will ultimately contribute to solving the overall climate change problem. The benefits of such bond purchases would be highly difficult to verify and even if they could be verified, those benefits would only be manifested tens of thousands or even millions of years from now. Central banks should not be actively implementing climate change-related measures since it is difficult to take responsibility for and verify the consequences of those measures. Moreover, no other central bank has been showing as much interest in climate change as the ECB, and Schnabel’s argument that climate change poses financial stability risks really seems to be an attempt to justify the ECB’s unusual behavior.

That said, the gist of point (3) is that “blurring of the boundary between monetary and fiscal policy” will provide logical justifications for political efforts to reduce central banks’ independence, and I fully agree with this point. One clear example of such a boundary blurring is the BOJ’s efforts to reduce stock market volatility by purchasing ETFs – creating a massive ETF portfolio that is expected to require over a century to unwind. Given that the ETF purchases have impacted stock price movements and asset allocation, there is a clear possibility that the BOJ will be accused of having encroached on the realm of politics, which Executive Board Member Schnabel suggests could possibly have a negative effect on the BOJ’s independence going forward.

### *Central Bank Independence “Not a Matter of Preference”*

Executive Board Member Schnabel’s recent speech emphasized that central banks’ “de jure independence” alone is insufficient and that it is crucial to sustain efforts to maintain “de facto independence”.

She warned that – “The alternative – allowing fiscal and financial dominance to quietly erode the space for monetary policy amid blurred mandates – would progressively hollow out independence and ultimately lead to higher inflation and lower growth.” BOJ interest rate hikes typically spur widespread concerns within Japan about whether the domestic economy can withstand the pressure, and one gets the impression that those concerns exert a significant influence on BOJ policy management. Given that Japan has become accustomed to ultra-low interest rates for over 30 years, it may be inevitable that the cultural climate makes it difficult to gain public support for interest rate hikes (perhaps more so than in other countries). But the ironic truth is that central banks have generally been granted independence precisely so they can do “what is right” even when they lack public support for doing that.

Schnabel concluded her speech by saying – “Central bank independence is not a technocratic preference. It is a commitment to protect the value of money for everyone.” It has been rare in recent years for “central bank independence” to be discussed with such a strong sense of urgency, but any perceived breach of that independence could trigger a significant reaction in financial markets. It is particularly important that countries currently struggling with trends of currency depreciation and rising interest rates should take Executive Board Member Schnabel’s arguments to heart.

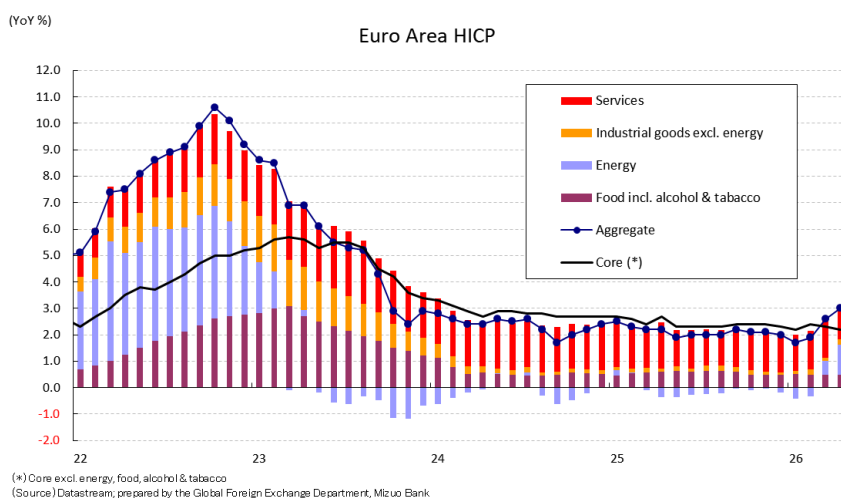
## EUR Outlook – Instability Due to Political Situation

### EUR Now and Going Forward – Resurrection of Trichet Era Phrase

#### ECB Foreshadows June Interest Rate Hike

At its April 30 meeting, the ECB Governing Council decided to keep policy rates unchanged for the seventh consecutive meeting. Reflecting the acceleration of growth in the euro area's April Harmonized Index of Consumer Prices (HICP) from 2.6% yoy in March to 3.0% yoy in April, however, the Governing Council meeting's statement showed growing concerns about inflation. At the post meeting press conference, ECB President Lagarde stated that – “We debated the decision that we have unanimously taken today, but we also debated, at length and in depth, a decision to possibly hike.” She repeatedly stated at the press conference that it would be more-appropriate to make policy

adjustments in June, because a lot of necessary information would become available following the release of the June Eurosystem staff macroeconomic projections. It is a common ECB practice to say that requisite information will be available at a later meeting (when updated staff projections are released) and then to adjust interest rates at that later meeting, so it appears highly likely that the deposit facility rate will be raised from 2.00% to 2.25% at the June 11 meeting. The meeting's statement said that “As the period of high energy prices extends, the likely impact on broader inflation through indirect and second-round effects intensifies”, and several reporters at the press conference asked about whether the ECB should be hurrying to respond to second round effects in June or should wait. President Lagarde stated in response that the ECB planned to by June review considerable information about whether there were actually second-round effects, including – “many, many elements from the wage setting, the hiring, the selling price revisions, [and] the commodity prices.” – expressing the view that it would be risky to attempt to evaluate the current situation without awaiting an analysis of the June staff projection data. Regarding second-round effects, Japan is facing roughly the same situation, but it was striking much less urgency about this is being expressed in Japan compared to the urgency conveyed at the press conference.



#### Resurrection of “We Will Closely Monitor” Phrase

The high probability of a June interest rate hike is evident from the appearance of the classic “we will closely monitor” phrase in the April Governing Council meeting’s statement. (“We will closely monitor the situation and follow a data-dependent and meeting-by-meeting approach to determining the appropriate monetary policy stance.”) During the term of ECB President Claude Trichet (2003-2011), this phrase was frequently used as a signal to foreshadow a policy change at the next Governing Council meeting. The phrase fell out of use after the Trichet era but appears to have now made a comeback. Naturally, a reporter at the press conference noted that the phrase foreshadowed rate hikes during the Trichet era and questioned the intention behind using this phrase this time. President Lagarde responded that – “I try not to be exceedingly coded.” – so she wasn’t trying to use subtle linguistic hints, but she added that – “on the basis of, number one, the hard data that we are getting, on the basis of the worsening of our risk assessment, you will have noted that the nice word “tilted” has been removed and that we are not saying long-term versus short-term, we are looking throughout the period and considered that risk is to the downside for growth and to the upside for inflation.” She also noted that amid current uncertainty, the “closely monitor” phrase was simply designed to emphasize the need to – “revisit the situation on the basis of the data, the projection, the sensitivity analysis, the updated scenarios, and then we will take a decision.” Many financial market participants felt that the late April BOJ meeting’ emphasis on the “twin issue” (stemming from rising crude oil prices) of downside risks to economic growth and upside risks to inflation rates actually made the BOJ’s intentions harder to understand, so using the “we will closely monitor” phrase can be considered a reasonable way to emphasize that it remains unclear at this point whether downside or upside risks should be considered more important.

#### Deviating from Baseline Scenario

But the meeting offered a significant clue about the likelihood of the next rate hike in the form of an acknowledgment that the situation is diverging from the ECB’s baseline scenario. The first question posed by a reporter at the press conference was – “the statement says that the upside risks to inflation and the downside risks to growth have intensified. Where does this new risk assessment leave the ECB between its baseline, its adverse and the severe scenario[...]?” President Lagarde initially seemed to avoid a straight answer, saying – “I’m not going to tell you whether we are closer to the baseline, or scenario one, or scenario two, because I think that what we have debated over the course of yesterday and today with the Governing Council, is where are we relative to the baseline?” However, she continued her response, saying – “And the conclusion is that we are certainly moving away from the

baseline. Where to exactly, at what point in between baseline and other scenarios is, I'm not sure, the most relevant assessment." In any case, since she acknowledged a deviation from the main scenario (the most desirable scenario from the Governing Council's perspective), there is no doubt that some form of policy response is necessary to bring the situation back on track. It appears the ECB will be the first among the central banks of Japan, the U.S., and Europe to shift course toward raising interest rates following the attack on Iran, and unless the situation changes, we should be mindful of the possibility of consecutive ECB rate hikes in July and September. The Account of the April Governing Council meeting notes that – "A number of members noted that the decision was a close call and that they would not have opposed raising rates at the current meeting had this been on the table. Increasing interest rates at the current meeting would have sent an even stronger signal of determination to bring inflation back to target in a timely manner. The option value of waiting to raise policy rates had decreased since the last meeting, and it had become increasingly unlikely that a "looking through" approach without any monetary policy action would be appropriate."

## European Politics Now and Going Forward – 2027 Will Be a Time of Trials

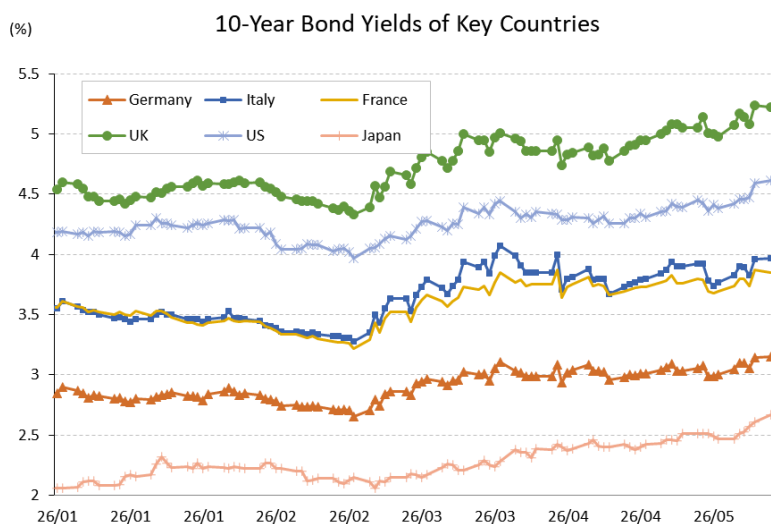
### *Political Instability in Europe*

EUR has remained firm since last year, as the erratic behavior of the second Trump administration has been viewed critically in financial markets while the fundamental stance of Europe (particularly the EU) in efforts to counter that has been received favorably. Regarding monetary policy, while central bank independence has become a point of contention in the United States and Japan, the ECB has continued to conduct its policy operations steadily and stably, thanks to the fact that it operates as a consensus-driven international organization. The shift since the attack on Iran from expectations of ECB interest rate cuts to expectations of significant ECB rate hikes appears to reflect market participants' confidence that the ECB will be the first to seriously address rising inflation risks. Regardless of economic and financial conditions, however, the historical pattern in Europe is that political instability leads to various problems that often spiral into stubborn quagmires. Once again, there has recently been a noticeable rise in political instability in major European countries, and that political instability is beginning to have a negative impact on financial markets.

### *British Politics as the Flashpoint*

While numerous European countries are currently experiencing political instability, many observers suggest that political turmoil in the UK is a key factor promoting a global uptrend in interest rates (see graph). In the U.K. local elections held on May 7, the ruling Labour Party suffered a historic defeat, losing more than 1,400 seats, and the yield on 10-year UK government bonds, which was already relatively high among G7 nations, has now risen to levels not seen in about 18 years. For comparison, the yield of the 10-year government bonds of France is at a 17-year high while the yield of German bonds is at a 15-year high and the yield of Japanese bonds is at a 29.5-year high. The UK local election results are particularly significant in that they clearly show voter dissatisfaction directed at both major traditional parties. Both the center-left ruling Labour Party and center-right opposition Conservative Party failed to gain support, while the right-wing populist party Reform UK won with the largest share of the vote, followed closely by the left-wing Green Party. This represents a complete defeat for the two major parties (Labour and Conservative) that have long dominated British politics. Following the crushing defeat, it has been reported that more than 90 Labour MPs have demanded Prime Minister Kier Starmer's resignation, and several government ministers have resigned en masse.

Given the current situation, Prime Minister Starmer's resignation is inevitable, but the search for a successor is proving difficult. He is literally a lame duck, clinging to power despite being unwanted, simply because there is no suitable replacement. The current parliament's term expires in the summer of 2029. Given that the ruling Labour party maintains an overwhelming majority in Parliament despite low approval ratings, the conventional wisdom would be that it would not risk losing power by voluntarily calling a snap election. However, the results of the local elections and the ensuing chaos can no longer be described as "conventional", and there is a possibility that Prime Minister Starmer will be replaced by a new prime minister before the end of the year, followed by a general election in early 2027 to seek a mandate from the public. It would be optimal if the ruling Labour party could take the lead in managing the situation, but if its internal divisions deepen further and key bills or budget proposals are defeated in Parliament due to defections from within the party, governing will become extremely difficult. In that case, dissolving Parliament would also become necessary. Reform UK is expected to make significant gains in the next general election, and it has core policies (focused on massive tax cuts) that are extremely fiscally expansionary, which inevitably raises such concerns as those currently promoting the trend of increase in U.K. interest rates. Seeking to avoid repeating the mistakes that caused the so-called "Truss shock" that occurred when UK Prime Minister Mary Elizabeth Truss took office in September 2022 and



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

announced that she would implement an expansionary fiscal policy centered on large-scale tax cuts, causing long-term UK government bond yields to soar, Reform UK states that it will course-correct by thoroughly reducing government waste and regulations (moving toward a smaller government) before implementing tax cuts. However, it would be reasonable to describe a situation in which the UK's political stability may be entrusted to a right-wing populist party as a crisis.

### *Similar Situations in Germany and France*

In addition to the UK's destabilization, it should be noted that the political situations in the two largest EU countries (Germany and France) are also dire. France's Macron administration has been intermittently plagued by political instability and saw its approval rating plummet to roughly 21% in a May 2026 opinion poll. Two years have passed since President Macron's defeat in the snap general election of summer 2024 – a move often described as his “gamble” – and while there have been three changes in prime ministers during this period, the situation is only getting worse. While his domestic policies have been poorly received, his foreign policies aimed at increasing strategic independence from the United States have been viewed favorably by financial markets, and one might have expected this to boost his domestic approval ratings, but that has not been the case. The notion that “domestic missteps can be offset by foreign policy successes” has not held true in France, and the centrist forces led by President Macron have completely lost their ability to rally support.

Given the current situation, the emergence of a far-right president in France's spring 2027 presidential election must be considered a realistic threat. Marine Le Pen, who effectively leads the National Rally (RN) party, has been sentenced to a ban from public office due to past allegations of embezzlement of public funds, and the verdict on her appeal is expected this summer. Depending on the outcome, she may announce her candidacy for the 2027 presidential election. The momentum the RN demonstrated in the 2024 general election remains strong, and recent opinion polls show Le Pen pulling far ahead of her opponents. Even if Le Pen does not run, however, the RN's current leader, Jordan Bardella, is also highly popular, raising concerns about the RN's prospective expansionary fiscal policies.

German politics are also in turmoil, as the Merz coalition that barely managed to form a government a year ago has already seen its approval ratings plummet to an all-time low. Economic growth is being stifled by long-standing issues regarding Germany's energy mix and a deteriorating trade balance resulting from worsening relations with China and Russia, enabling the far-right Alternative for Germany (AfD) party to become the most popular party at both national and local levels. Given the historical factors that have led mainstream parties to spurn cooperation with the AfD, the task of forming stable government coalitions has become an extremely complex puzzle. Coalition governments formed merely to secure a majority are prone to becoming a case of “same bed, different dreams,” and consistent policies are hardly to be expected. In the current climate, while consensus is easier to reach on policies that allow for fiscal spending in areas such as defense and infrastructure, fundamental problems – such as the high costs inherent in the energy structure – remain unresolved due to the already implemented policy of phasing out nuclear power.

Thus, the current reality is that the three major European powers – the United Kingdom, France, and Germany – which are expected to serve as a counterweight to the United States, have suffered severe setbacks in their domestic politics and are now unable to move forward. Amid pessimism in financial markets since last year regarding the widespread “flight from USD”, Europe has been viewed as a relatively better alternative, and there has been a prevailing forex market preference for euro area assets and a prevailing bond and currency market preference for EU assets, causing EUR to perform strongly against USD. However, financial markets' positive assessments have not directly translated into the resolution of European countries' public discontents. Rather than comparative advantages over other countries, European voters are seeking improvements in their daily lives (particularly in the form of rising real wages).

As higher inflation rates are likely to become chronic in Europe unless the Iran war situation is quickly resolved, it must be said that significant improvements in European voters' situations seems unlikely.

### *Political Ideology is Largely Irrelevant*

Ultimately, whether East or West, political instability seems unavoidable for the foreseeable future as long as inflation persists. In Europe, since the 2008 global financial crisis, resentment toward the elite for not understanding the plight of the common man has morphed into enthusiastic support for anti-EU populist forces on both the left and the right. It is significant to note that this is common to both the left and the right. I think it is irrelevant to view this from the lens of political ideology, whether leftwing or rightwing, as ordinary people probably do not hold strong political views but are merely venting their dissatisfaction with the current situation by railing against the ruling administration. For example, when the Victor Orbán government in Hungary was voted out, many claimed that this marked the beginning of a “reversal of the rightward shift,” but is that really true? Could it be that there was no rightward shift to begin with – just a growing national resentment against the government because of hardships faced by the man on the street? The result of this sentiment in Hungary was the Orbán administration, and Italy, Spain, Austria, and other countries have seen similar phenomena. The Georgia Meloni government in Italy, for instance, was initially viewed with concern as being far-right, but later underwent a course correction. Even so, public opinion did not turn against it. This is likely because the Meloni government was not formed by a radical rightward shift in public sentiment.

Further, as seen above, the UK, even after having achieved the right-leaning goal of leaving the EU, has gone on to vote in Reform UK as the most popular party. During the 2015-16 Brexit debates, control from Brussels (the European Commission) was said to be the root of the problem, but even after the removal of that control, public support for right-wing parties remains unchanged. Perhaps it is simply that a right-wing party with easy-to-understand rhetoric happened to benefit from the discontent against the incumbent administration.

Sometimes, politics can be strongly influenced by a nostalgia for the past. Britain applied to join the EU (then the EC) in 1973 based on the sentiment that this was “an unrepeatable opportunity for a nation that lost an empire to gain a continent.” However, having joined, some chose to leave based on the argument that they had lost their sovereignty and

that things had been better before. This is discussed in detail in historian Agnes Arnold-Forster's book, *Nostalgia: A History of a Dangerous Emotion*, which I would recommend as a good read for anyone interested in the subject. (I also contributed a book review to the *Weekly Toyo Keizai*<sup>3</sup>).

#### *European Politics in 2027 – A Source of Concern*

2027 may turn out to be a very concerning year for European politics. If Reform UK comes to power following the UK general election, and the RN takes power after the French presidential election, the center of gravity of European politics will shift sharply toward the far right. Both far-right and far-left parties advocate for expansionary fiscal policies to gain public support. If resource prices remain high due to the situation in Iran continuing, both the ECB and the Bank of England (BOE) are likely to choose rate hikes as their next move, intensifying the headwinds for bond markets.

When politics leans toward extreme positions, expansionary stances are favored in discretionary macroeconomic policies. This is especially true for fiscal policy, which is highly susceptible to public opinion. During such times, central banks are expected more than ever to quietly cool inflation through (potentially unpopular) monetary policy implemented by experts, independently of the political establishment. During the forecast period, the ECB and BOE's next moves are likely to be rate hikes. Under such circumstances, it may become difficult for the BOJ to maintain its gradual approach of considering a +25 bp rate hike every few months, as it has done so far. The ECB is likely to be the first to raise interest rates at its June Governing Council meeting, and looking ahead to the rest of the year, it seems quite likely the Fed will follow suit. Of course, given that every country has its own economic and financial realities, the BOJ trying to match its European and U.S. counterparts in terms of the pace of rate hikes may not be the undisputedly correct option. However, given Japan's commitment to free capital movement, the BOJ must manage its rate hikes at a pace comparable to its key counterparts in Europe and the U.S. if it wants to prevent further JPY depreciation.

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<sup>3</sup> Karakama, Daisuke. "Reclaiming the Good Old Days: A Dangerous Longing Created by Modern Uncertainty." *Weekly Toyo Keizai*, 2026. <https://toyokeizai.net/reports/-/920585?display=b>

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