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Forex Medium-Term Outlook

September 1, 2026

Overview of Outlook

In August, USD/JPY was pushed down toward the 155 level, partly due to the effects of coordinated currency intervention by Japan and the U.S., but it has since been gradually recovering. The crucial question is what Japanese policymakers will do while they have the U.S. Treasury, their strongest ally, on their side. The ideal course of action would be to demonstrate fiscal discipline and clearly signal a stance of sustained interest rate hikes; however, the market does not yet fully trust Japan's commitment to this, which may explain the simultaneous weakening of JPY weakness and rising JPY interest rates. Further, concerns regarding supply and demand have not disappeared. As I have feared in previous columns, Japan's trade deficit has clearly begun to widen since June. One of the factors driving JPY weakness that I most feared starting March was the scenario in which, once alternative crude oil procurement normalized, high prices combined with normal volumes would cause Japan's trade deficit to expand extremely rapidly. Unfortunately, that is exactly what is happening. With regard to supply-demand forecasts going forward, again, things are unfolding as forecast, suggesting that Japan's trade deficit for the full year of 2026 will likely fall within the JPY5-8 trillion range. If we assume USD/JPY around JPY160 and crude oil prices around USD80 per barrel in 2027, and factor in the cessation of Japan's strategic oil reserve releases, it would not be surprising to see Japan's 2027 trade deficit approach JPY10 trillion. Of course, the outcome depends on the situation in the Middle East, but it would be risky to simply assume at this stage that JPY supply and demand will improve in 2027. Under these circumstances, there is no denying the impression that the BOJ's interest rate hikes are lagging behind developments in the forex market, nor can we rule out BOJ rates climbing to between 2.00% and 2.50%.

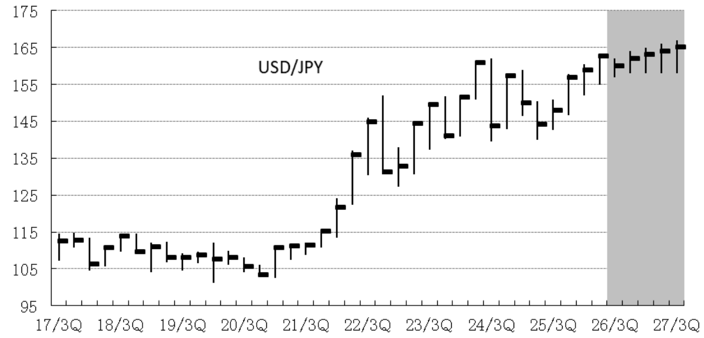
Meanwhile, EUR held firm throughout August. Having resumed interest rate hikes in June, the ECB is now widely expected to raise rates again in September. Overall, economic and inflation conditions in the euro area remain stable, and ECB monetary policy appears to be highly predictable. Although about two rate hikes are expected during the forecast period, futures markets have priced in the view that a third hike will not be necessary, and statements by senior ECB officials also suggest this will be the case. Even considering the Europe-U.S. interest rate differential, it is difficult to envision a scenario where EUR's investment appeal falls significantly below that of USD. A major shift in the current outlook may only occur in the event of a sharp spike in commodity prices. That said, based on the ECB's current baseline scenario, it is also true that the ECB is unlikely to feel compelled to implement any substantial rate hike unless prices exceed USD100 per barrel. A more immediate threat is the drop in water levels in the River Rhine, which is a vital artery for European logistics, caused by the recent extreme heat. This serves to drive inflation by creating supply constraints. As water levels typically drop further with the approach of autumn, one must watch out for the possibility of a sharp decline in Rhine water levels fueling expectations of an ECB rate hike.

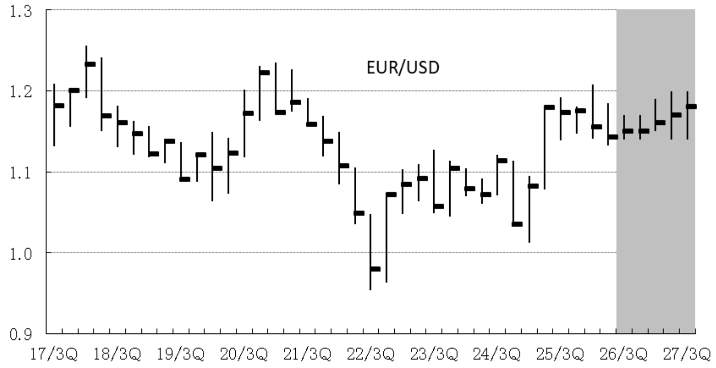
Summary Table of Forecasts

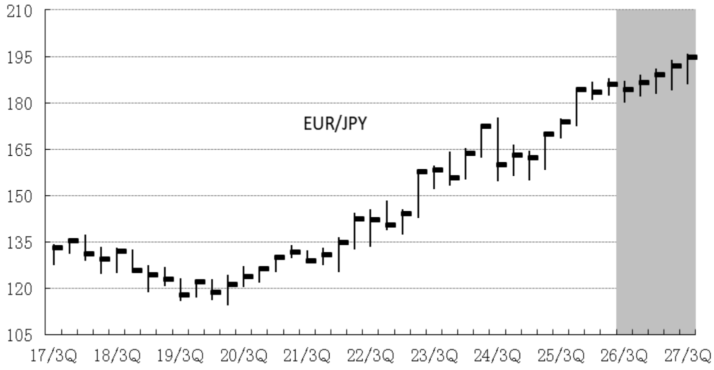
	2026 Jan-Aug (Actual)	Sep	Oct-Dec	2027 Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	152.10 ～ 163.99 (159.80)	157 ～ 162 (160)	158 ～ 164 (162)	158 ～ 165 (163)	158 ～ 166 (164)	158 ～ 167 (165)
EUR/USD	1.1325 ～ 1.2084 (1.1618)	1.14 ～ 1.17 (1.15)	1.14 ～ 1.17 (1.15)	1.15 ～ 1.19 (1.16)	1.14 ～ 1.20 (1.17)	1.14 ～ 1.20 (1.18)
EUR/JPY	179.44 ～ 187.95 (185.62)	180 ～ 187 (184)	182 ～ 189 (186)	183 ～ 191 (189)	184 ～ 194 (192)	186 ～ 196 (195)

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

Exchange Rate Trends & Forecasts







USD/JPY Outlook - No Change in Global View Even After Joint U.S.-Japan Intervention

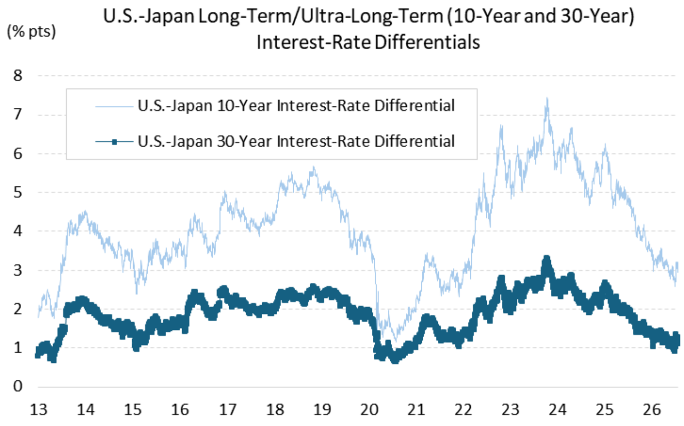
JPY Now and Going Forward – How to Interpret U.S.-Japan Joint Intervention

The U.S. Can Change Supply-Demand Balance

USD/JPY plummeted sharply in early August, driven by speculation of U.S. and Japanese monetary policies. In addition to statements from Japanese authorities, U.S. Treasury Secretary Scott Bessent also noted, “The Japanese yen seems very undervalued to me. The currency is very cheap.” Subsequently, as per media reports, the U.S. Department of the Treasury appears to have conducted market interventions using other currencies (EUR, etc.). The recent U.S.-Japan joint intervention was the first in 15 years; the last time this happened was when JPY surged to 75 to the dollar following the March 2011 Tohoku earthquake and tsunami. As I pointed out in January this year, during the turmoil following the joint rate check by U.S. and Japanese authorities, the likelihood of JPY appreciation is extremely high if U.S. and Japanese currency policies align. The history of the floating exchange rate system itself has largely been shaped by rate directions and levels desired by the U.S. <u>So long as this is the case, one has no choice but to set aside any analysis of the fundamentals, including interest rates and supply and demand, as only the U.S. has the power to engineer changes in supply and demand</u>.

U.S. Treasury Yields are The Real Concern

Assuming that the U.S. currency authorities continue to provide sustained cooperation in correcting JPY weakness, that would be a game changer. However, why should the U.S. go so far to help Japan? As they say, there is no such thing as a free lunch, so one would do well to understand the reason behind the U.S. offer of help. The most obvious reason may be the impact on U.S. bond yields. As is well known, <u>the weak-JPY trend since spring has begun to acquire the characteristics of a “sell Japan” trend, with JPY being sold off in parallel with Japanese government bonds (JGBs) in some cases</u>. In other words, JPY interest rates have been pushed up alongside JPY depreciation, thereby weakening the relative appeal of U.S. bond yields. The U.S.-Japan long-term and ultra-long-term interest-rate differentials are not particularly noteworthy from a historical

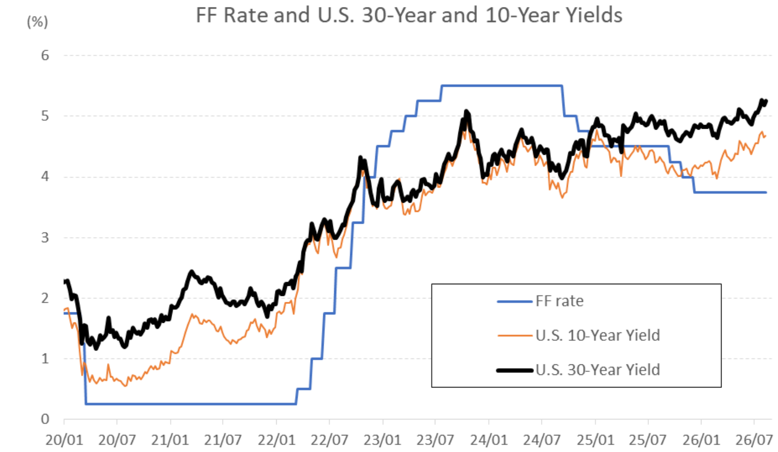


(Source) macrobond; prepared by the Global Foreign Exchange Department, Mizuo Bank standpoint, but the fact is that they have been consistently shrinking since the start of the second Trump administration (see graph on the previous page).

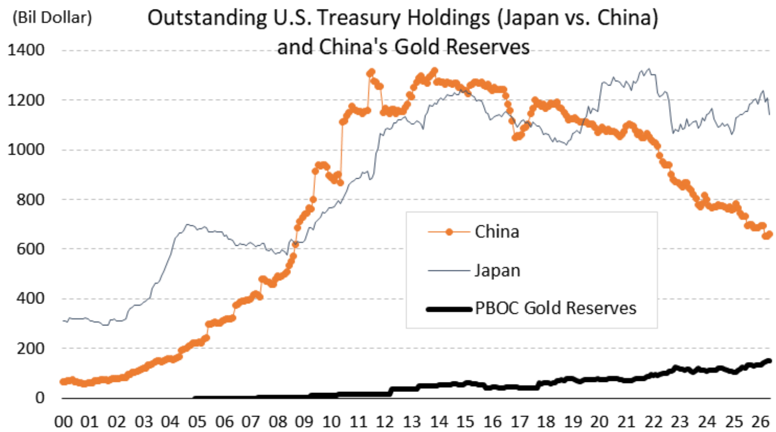
Looking back, one remembers reports following the Davos meeting in late January this year that Bessent had expressed strong concern to Japanese Finance Minister Satsuki Katayama on the sharp rise in JGB yields and the possibility of the effects spilling over into the U.S. bond market. This resulted in joint rate checks by U.S. and Japanese authorities subsequently. Recently, U.S. 30-year yields were widely reported to have briefly hit 5.2%, the highest in 19 years, on July 30, resulting in similar developments subsequently. This is not a coincidence. The U.S. Treasury Department's real concern is not JPY weakness, but rather its impact on U.S. Treasury yields as a spillover effect. This theory is also backed by the fact that the Treasury Department embarked on a buyback of long-term and ultra-long-term Treasuries in August. The recent currency intervention by the Treasury Department involved selling EUR to buy JPY, probably because of concern that selling USD to buy JPY would further push up U.S. interest rates based on the market's perception of the intervention as USD (U.S. Treasuries) sell-off. Selling EUR (euro area bonds) instead assuaged this concern.

Persistently High U.S. Interest Rates Have Become the Achilles Heel of the U.S. Economy

With de-dollarization already an issue, persistently high U.S. interest rates resulting from the selling off of U.S. Treasuries is a huge risk for the U.S. economy, so it is quite rational for the U.S. to attempt to eliminate the "sell Japan" trend both in name and reality. The recent wholehearted cooperation is understandable if one interprets it as part of the effort to counter the de-dollarization trend. Recent actions by the U.S. become even easier to understand when one views them in the context of developments in the past few years. The fact is that U.S. Treasury yields have clearly resisted downward momentum in recent years. About two years ago, in September 2024, when the Fed began its rate cut phase, U.S. 30-year yields were at around 4.0%, while 10-year yields were at around 3.7%. The Fed implemented six rate cuts (totaling -175bp) between then and December 2025, but neither 30-year nor 10-year yields have fallen from their September 2024 level (see graph to the right, top). Despite rate cuts by the Fed, Treasury yields continued to rise. Of course, one could interpret this as the result of better economic performance thanks to the rate cuts, but there is also some suspicion that this is the result of a structural decline in demand for U.S. Treasuries, or in other words, that attempts to manipulate market interest rates did not go as planned. In fact, there has been news of China and other countries replacing their U.S. Treasury holdings with gold during this period (see graph, bottom), and gold prices have been hitting all-time highs intermittently.



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



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

The real problem is this: Persistently high U.S. interest rates give rise to the suspicion that U.S. stocks, which have continued to post new highs, are overvalued. Given that equities account for roughly 40% of the financial assets of U.S. households, any correction in U.S. stock prices would dampen personal consumption through the negative wealth effect, thereby making high interest rates an Achilles' heel for the U.S. economy as a whole. It would appear that Treasury was forced to act when the problem of high U.S. interest rates, originally the by-product of the de-dollarization trend, was further compounded by the sell-Japan trend.

Stable Absorption of U.S. Treasuries is Top Priority

As I have repeatedly explained in this report since last year, the theoretical pillar of the second Trump administration is a paper by Stephen Miran, chair of the President's Council of Economic Advisors (CEA), in which he argues that the stable absorption of U.S. Treasuries is a paramount objective. Specifically, the paper argues that the reserve currency (U.S. Treasuries) and security arrangements the U.S. provides its partners are "global public goods," and focuses on getting allies and countries that have a trade surplus with the U.S. to share the cost of maintaining these goods (burden-sharing). However, the excessive zeal with which the second Trump administration went about this triggered a de-dollarization (selling off of U.S. Treasuries) trend. One of the boldest and most direct concrete proposals for achieving the absorption and stabilization of U.S. Treasuries in Miran's paper included forcibly converting U.S. Treasuries already held by foreign governments including Japan and China (as foreign reserves) into ultra-long-term bonds with 100-year maturities (effectively perpetual bonds). The aim was, clearly, to prevent foreign governments from selling U.S. Treasuries in the short term, thereby locking in borrowed funds over the long term, stabilizing the supply-demand dynamics of the U.S. bond markets, and preventing sharp spikes in U.S. interest rates driven by overseas factors.

The narrowing of U.S.-Japan bond interest rate differentials, even if originally triggered by the sell-Japan trend, is feared to accelerate the de-dollarization trend. Ultimately, therefore, the U.S. Treasury Department's support for Japan's currency policy should be understood as a countermeasure against the de-dollarization trend.

Currency Policy Cannot Fight A Lone Battle

Both the Japanese and U.S. governments are now taking strong stances against speculative JPY selling that is not based on real demand, emphasizing their aim to stabilize the markets. However, as an analyst of JPY weakness from the perspective of structural changes in Japan's balance of payments in recent years, I think speculative JPY selling is troublesome precisely because it is based on actual demand trends. The ongoing phase of JPY weakness, which began in 2022, is closely tied to that year's all-time record-high trade deficit, and the acceleration of JPY weakness again this year is also, undoubtedly, due to concerns of a repeat of 2022 amid geopolitical risks and high resource prices. Of course, the level of speculative JPY selling is also at a historical high, and in fact, roughly 70% of the JPY net short positions from the IMM currency futures transactions were liquidated in the week following the joint intervention. This led to USD/JPY falling from the level of 164 to 155, an inevitable outcome given that interventions have the effect of wiping out accumulated speculative positions.

However, the flip side is that this is as far as policy measures can go in terms of effectiveness. Speculative positions are, naturally, bound to be liquidated at some point. And at such times, there is a risk of unexpected JPY appreciation as speculators accumulate JPY long positions betting on an artificial intervention by the Japanese and U.S. authorities. However, joint intervention cannot help lower Japan's trade deficit or other forex outflows associated with the new-era economy, such as digital deficits and payment toward insurance services. Should Japan lose U.S. support, it is very likely that JPY will depreciate again as speculative JPY long positions are unwound and compound the impact of actual-demand-based JPY selling. Ultimately, unless Japan corrects its expansionary fiscal and monetary policies alongside recent currency intervention efforts, it will be a situation of currency policy fighting a lone battle. In theory, it is difficult to expect sufficient results from such an approach. Given its position of cooperation with Japan, I am frankly curious to know what the Treasury Department's understanding is regarding the policy mix in this situation.

At any rate, it is difficult to reasonably predict how long the JPY appreciation trend will continue, given that it depends on how long the U.S. and Japanese authorities can sustain their cooperative stance. For instance, if U.S. yields begin to decline and settle at moderate levels, will the U.S. be willing to continue pouring its own funds into propping up JPY? Of course, given that this is a political matter, I do not really understand how things will ultimately play out. However, going by the words and actions of the Trump administration so far, it may be too optimistic to assume that the U.S. will continue to lend its support without expecting something in return.

Currency Policy Must not be Made to Do All the Heavy Lifting

Incidentally, immediately after the joint intervention became known, Japan's Vice Minister of Finance for International Affairs, Atsushi Mimura, called it the "culmination of a U.S.-Japan currency alliance." With Katayama also noting the implementation of a joint intervention, all the keypersons related to U.S. and Japanese currency policies, including Japan's finance minister and her American counterpart (Bessent) as well as vice minister Mimura have now acknowledged the event before the publication of official statistics. As customary, indications have been given that the two governments will not hesitate to implement a second or third round of joint intervention, resulting in clear upside resistance for USD/JPY.

Many issues will have to be considered going forward, but one hopes Japan will avoid using currency policy as the only tool to fight JPY depreciation. As the authorities say time and again, forex interventions are no more than countermeasures to even out excessive fluctuations resulting from speculative trade. Except in the case of countries or regions that plan the specific level and direction of their domestic currency, such as Singapore and Hong Kong, the normalization of currency intervention is not expected. At the present time, Japanese currency policy is aiming for a stronger domestic currency through joint intervention with the U.S., but the country's monetary policy remains accommodative, as does its fiscal policy, typified by lower consumption taxes and gasoline subsidies. As a result, the currency policy seems to be fighting a lone battle while in conflict with monetary and fiscal policies. As I have argued many times in previous editions of this report, it is vital for currency and monetary policies to be consistent with each other; in Japan's case, they are not (see table). To be consistent with its currency policy (JPY buying forex interventions), Japan's monetary policy would involve

Policy Mix Combinations

	Monetary Policy	Fiscal Policy	Currency Policy	Policy Intent	Example
(1)	**Easing**	**Easing**	**Weak currency**	**Escape recession**	
(2)	Easing	Easing	Strong currency	Unsustainable	**Japan as it is?**
(3)	**Easing**	**Tightening**	**Weak currency**	**Economic support**	
(4)	Easing	Tightening	Strong currency	Unsustainable	
(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	**U.S. as it is?**
(8)	**Tightening**	**Tightening**	**Strong currency**	**Prevent economic overheating**	**Japan as it should be?**

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

rate hikes while fiscal policy would have to be tightened. However, what is happening instead is that currency policy has been left to fight JPY depreciation unsupported, resulting in a continued depletion of forex reserves.
For instance, JPY-buying/USD-selling forex interventions held between April and August amounted to a total of around JPY 27 trillion, and Japan's forex reserves had also fallen from their peak at approximately JPY 220 trillion in February this year, to JPY 205 trillion or so as of the end of July, and are likely to have fallen another notch by the end of August. A rough estimate suggests that, if interventions continue at the current monthly pace, Japan's forex reserves will be close to depletion a year from now (of course, this also means that Japan has the capacity to continue interventions at this rate for another year). In other words, it is vital for Japan to take the necessary measures while its forex reserves are still significant (details later). If mutually contradictory currency, monetary, and fiscal policies are kept unchanged while forex reserves dwindle, speculative pressures from the financial markets will get amplified.

If Truly a "Currency Alliance"
Going by the textbook definition, the phrase "currency alliance" used by Mimura would mean something similar to the Exchange Rate Mechanism (ERM) used by the EU (more precisely the European Commission) in the past, where the exchange rate between the currencies of the alliance partners is set to be in a specific range and triggers currency intervention measures when the rate either exceeds or falls short of the range. For instance, if the U.S. and Japanese currency authorities agree on a 155-160 or 150-160 range as the USD/JPY rate ceiling, currency interventions would be mechanically implemented anytime JPY weakened beyond that range. I do believe Mimura merely used the phrase "currency alliance" to strongly express a symbolic stance, but given that from a strictly theoretical standpoint, the framework of an alliance could extend to the level explained above, the words must be considered as a risk factor when preparing forecasts. If true, USD/JPY may no longer renew record highs going forward. In this sense, Mimura's recent communication will serve as a strong deterrent against JPY depreciation going forward. However (details later), it is a double-edged sword, given that it also comes with the risk of normalizing rate formation based entirely on U.S. factors.

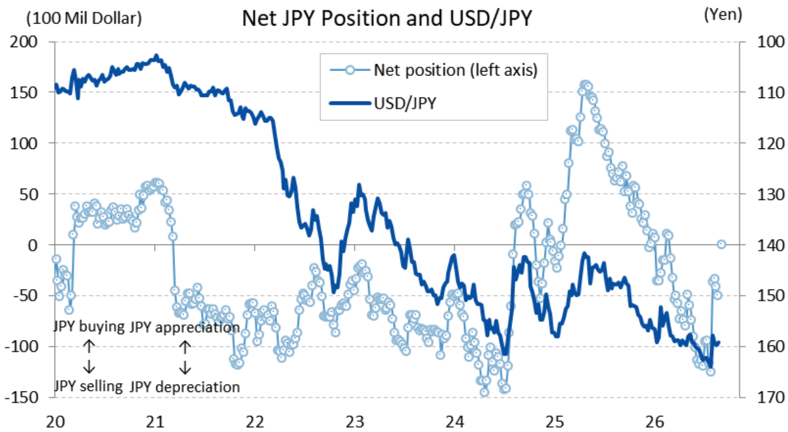
The Most Important Question is – What Should Japan Do Now
The most important question here is – what should Japan do now, while it has the support of its most powerful ally, the U.S. Treasury Department? There is uncertainty regarding sustainability in two areas: the sustainability of Japan's forex reserves, and the sustainability of the U.S.' supportive stance. The former requires no explanation, nor is there any doubt about the uncertain nature of the latter. Assuming that recent actions by the U.S. were triggered by an increase in U.S. long-term and ultra-long-term yields, U.S. cooperation in the face of JPY depreciation could become less proactive once U.S. bond yields stabilize.
In fact, the joint intervention did correct JPY weakness, but since it did not bring down JPY interest rates substantially, there remains the likelihood that the U.S.' original objective was not met (it seems very likely that this is why U.S. authorities decided to buy back long-term and ultra-long-term U.S. Treasuries at a later date). Of course, this is merely speculation on my part, and it is not altogether impossible that the objective was really to help alliance partner Japan based on the understanding that JPY is excessively undervalued. Indeed, there are those who warn of systemic risks originating from Japan if JPY continues to depreciate alongside the rise in JPY interest rates, so there is reason to address the issue for its own sake.
At any rate, assuming that U.S. support will continue indefinitely is undeniably dangerous, so the priority should be to consider what Japan must do while U.S. support is still available. In this context, no complicated policies are required of Japan. Steady progress in implementing the orthodox policies expected by the markets should suffice. First, in terms of monetary policy, it is necessary to commit to gradual but steady interest rate hikes in order to create conditions where JPY rates are supported by real interest rates. If there is a surge in uncontrollable JPY selling, a +50bp or +75bp rate hike could be implemented to contain JPY depreciation in one fell swoop. Of course, such drastic measures may not be necessary so long as the current U.S.-Japan currency cooperation is in place. The first thing one hopes for from the BOJ, therefore, is a steady implementation of +25bp rate hikes to bring the real policy interest rate up to a positive level. Of course, I do not intend to say that this will reverse the JPY depreciation trend. Given that JPY depreciation is the cause and rate hikes are the effect, the BOJ is unable to exit its current reactive stance vis-à-vis market movements. To reverse the trend to JPY appreciation merely through a correction in policy interest rates, the BOJ would have to go over and above market expectations to implement, say, a +50bp rate hike. However, such moves are impractical given their impact on the real economy.
Meanwhile, the best move in terms of fiscal policy is to clearly indicate a sense of discipline. Specifically, it would be helpful to restrain the expansion of supplementary budgets and express a commitment to achieving a primary balance surplus. A primary balance surplus does not necessarily contradict the "Basic Policy," which advocates lowering the outstanding debt to nominal GDP ratio. Of course, separate practical discussions are necessary to determine the extent to which expenditures need to be cut, but unless market participants' impression of lax fiscal management is corrected, potential JPY selling pressure will remain. Whether regarding monetary or fiscal policy, the most effective approach is to demonstrate sincerity through orthodox measures rather than relying on unconventional arguments. That, rather than currency policy doing all the heavy lifting, is the only way to fully leverage this rare instance of U.S.-Japan currency policy coordination and maximize its impact.

JPY Supply-Demand Climate – Overviewing 1H of 2026

Situations Conducive to Speculative JPY Selling

Amid low liquidity conditions due to Japanese market participants being away for the summer holiday period, there were concerns that a joint U.S.-Japan intervention could trigger a sharp JPY appreciation, but the basic trend of JPY weakness has continued. JPY, which had appreciated to 155 to the dollar at one point, weakened again to the level of 158-159 and remains there stably at the time of writing this report. Ultimately, the true nature of the current weak-JPY phase is that, even if speculative JPY selling is rolled back, real-demand-led JPY selling remains. As feared right from the beginning, the likelihood remains of currency interventions becoming events that mainly offer buying opportunities in both speculative and real-demand-led trading. Again, as mentioned above, in order to ensure sustained impact from joint interventions, monetary and fiscal policies must work in tandem with currency policy; unfortunately, the markets remain doubtful about Japan's policies in this regard.

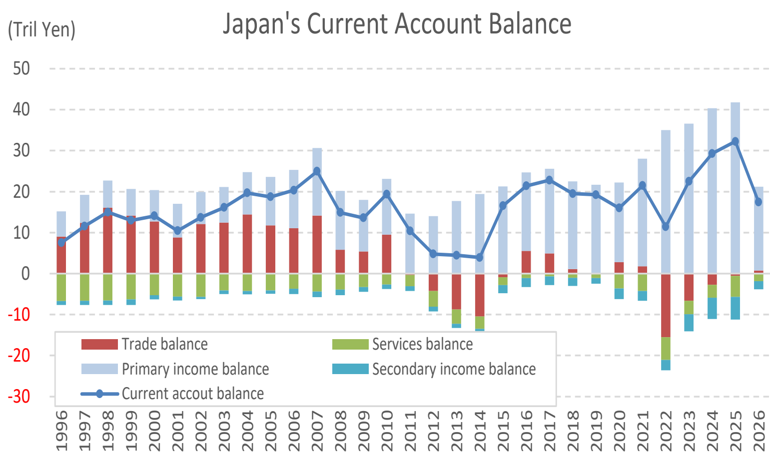
Following the joint intervention, the JPY net short position as seen in IMM currency futures transactions shrank to about a quarter of their previous level in two weeks (between July 28 and August 11), from roughly -USD 12.5 billion to -USD 3.3 billion. Simply going by the facts, the intervention, which wiped out roughly 70% of speculative JPY selling, temporarily pushed USD/JPY down from 164 to 155, but failed to generate sustained impact similar to the kind seen two years ago. One might say that the battle line was redrawn at the psychologically significant JPY160 threshold, but now we are faced with the prospect of an environment in which traders can readily engage in JPY selling, given the drastic reduction in JPY short positions.



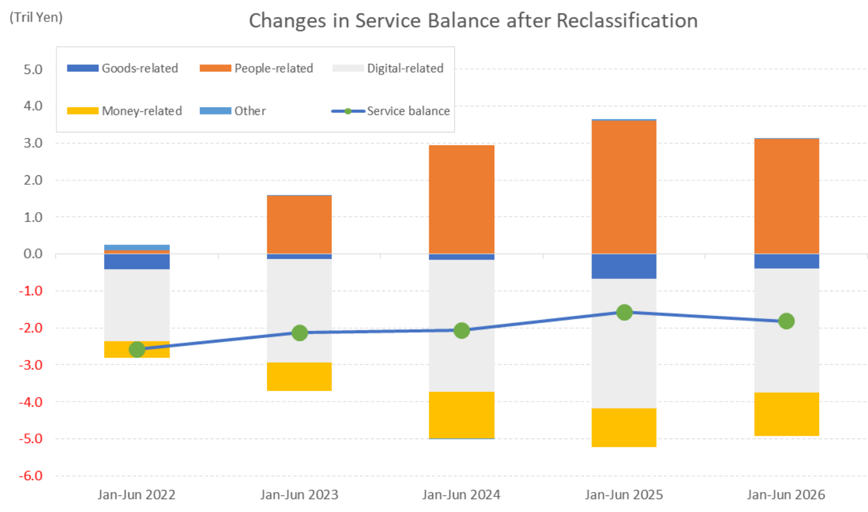
(Source) CFTC and Bloomberg; prepared by the Global Foreign Exchange Department, Mizuho Bank

Real Demand – Services-Related Changes Are Noteworthy

In contrast to speculative trade trends, what are the trends among companies and other entities engaging in actual demand-led JPY selling? I would like to provide an overview based on Japan's balance of payments for 1H (January-June) of 2026, the data for which was released by the Ministry of Finance on August 10 (all figures below pertain to 1H of 2026 unless otherwise stated). The headlines widely reported that Japan had posted its highest ever current account surplus for 1H at +JPY 17.4292 trillion, and especially that this was supported by a primary income surplus worth +JPY 20.4194 trillion (which was also the highest ever recorded for 1H). The fact that the trade balance had posted a surplus in 1H for the first time since 2021, at +JPY 742.1 billion, also received special attention. It was pointed out that this was structurally driven by a +12.8% yoy increase in exports (outpacing the +8.4% yoy increase in imports), led by semiconductor and other electronic parts exports to Asian markets, but that is not all. The unexpected strength of semiconductor exports is certainly a happy development, but let us not forget that the release of crude oil reserves for the majority of 1H (March through June) also had an import-substitution effect. Without that policy effect, imports would have grown by a much higher percentage, so the fact that 1H posted a trade surplus this year is not a very useful datapoint.



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



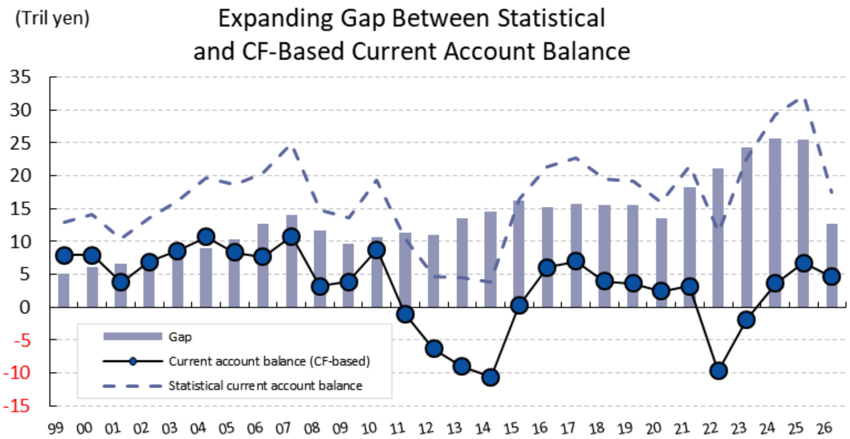
(Source) Bank of Japan; prepared by the Global Foreign Exchange Department, Mizuo Bank

Rather, I would like to focus on the services deficit having expanded from last year's -JPY 1.5785 trillion to -JPY 1.8223 trillion this year as being a meaningful indicator of the trend going forward. This is the result of the travel surplus shrinking from last year's +JPY 3.6553 trillion to +JPY 3.1328 trillion. Meanwhile, the digital deficit shrank from -JPY 3.4782 trillion to -JPY 3.3616 trillion, providing a golden opportunity for the expanding digital deficit to shrink. However, the overall digital deficit ended up expanding because the travel surplus shrank more than the digital deficit did. Of course, as the figure shows, the overall services deficit is not poised to expand dramatically if the relationship between the people-related and digital-related balances remains at its present level. However, the general understanding is that the digital deficit has scope for further expansion even as the maturing of the inbound tourism market is pointed out. As a result, the services deficit has the potential for expansion, and it would not be surprising to see it expand to the tune of -JPY 10 trillion in the 2030s as per my long-term forecasts. The services balance for 1H of 2026 was slightly concerning because of the implications it contained for the trend going forward.

To provide a rough overview of the current account balance for 1H of 2026, therefore, the improvement in trade balance (posting a surplus) was a short-term development resulting from the release of oil reserves, but the deterioration in the services balance (deficit expansion) reflected a gentle long-term trend. Consequently, my view is that the situation is worryingly indicative of a net selling outlook for JPY.

Insufficient Improvement in CF-Based Balance

Taking all this into account, I would like to assess the above current account balance, which continues to post statistical all-time record surpluses, on the basis of cash flows (CF), and think about what to focus on for 2H of the year.

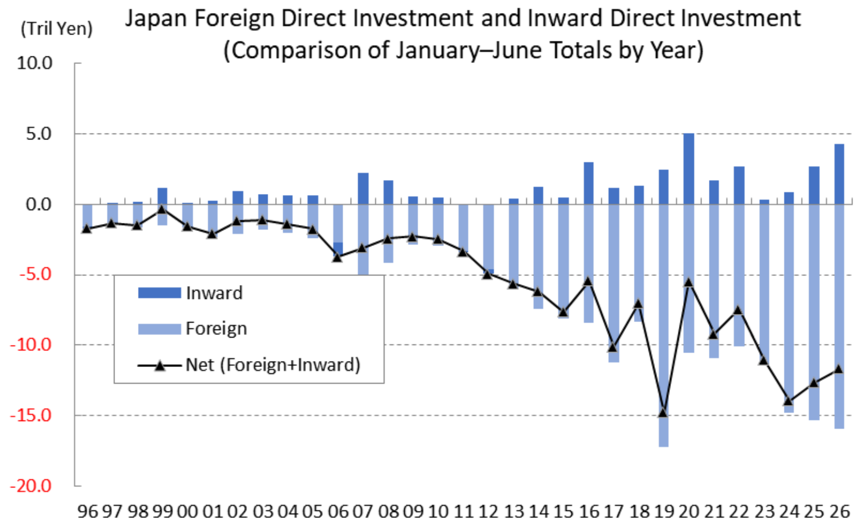


(Source) Bank of Japan; prepared by the Global Foreign Exchange Department, Mizuo Bank. 2026 figure is the total for January to June.
*"Reinvested earnings" in direct investment income, and "dividends" and "bond interest, etc." in portfolio investment income are deducted from receipts and payments in primary income, as they are assumed not to involve foreign exchange transactions.

As is generally understood, the key pillar of Japan's enormous current account surplus continues to be its primary income surplus. As discussed frequently in this report, I think one of the biggest issues facing the Japanese economy is the fact that a large portion of its assets are outside the country, with no plans in sight for them to be repatriated to Japan. If we discuss this theoretically just within the framework of the balance of payments, we come to the understanding that statistical figures do not necessarily coincide with figures based on actual cash flow, as I have also emphasized in my 2024 book The True Nature of JPY Weakness: Japan Masquerading as a Surplus Nation (published by Nikkei BP), and this understanding holds true also for 1H of 2026. As the figure shows, the statistical figures have increasingly diverged from CF-based figures since 2022. As of 1H of 2026, the statistical figure shows a current account surplus of approximately +JPY 17.4 trillion, while the CF-based figure is barely a quarter of that at +JPY 4.6 trillion. Of course, it must be admitted that the CF-based figure, while significantly smaller than the statistical one, has been posting relatively larger surpluses in recent years, indicating some improvement in the JPY supply-demand balance.

JPY Selling Continues in Financial Balance Too

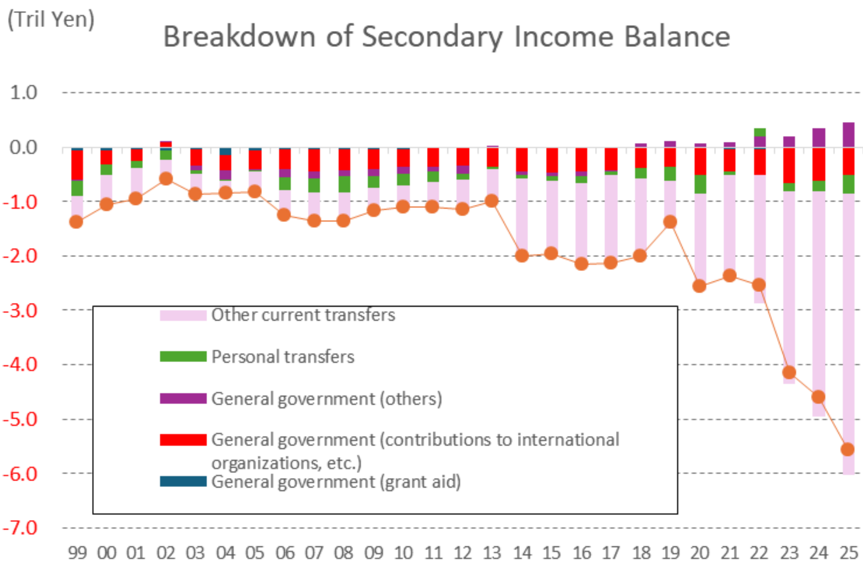
However, focusing merely on the positives does not offer a balanced view. Taking a look at the financial balance (see graph), which pairs against the current account balance, we see growth in inflows from inward direct investment at an all-time record high (to the tune of +JPY 4.2624 trillion), but the same is also true of outward direct investment (posting all-time record high outflow growth at -JPY 15.9038 trillion), resulting in a continued net outflow of over -JPY 10 trillion (perhaps the same figure on a CF basis). Ultimately, on a CF-basis, while it is true that there is an increase in JPY buying in the current account, there is also an increase in JPY selling (direct investment) in the financial account, and this could be why the weak-JPY trend was unable to be curbed.



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

What To Watch For in 2H of 2026

What is the outlook for 2H of 2026 onward? With respect to the current account balance, the first thing to note is that a deterioration in the trade balance compared with 1H is a given. Going by the various media reports, however, there seems to be little awareness of this inevitable trend, and if media reports are any indication of market expectations, one cannot help but be somewhat concerned. On top of that, as mentioned above, the odds of a yoy expansion in the services deficit, driven by the digital deficit against the background of inbound tourism demand peaking, is high. Any short-sighted optimism of the digital deficit being offset by the travel surplus is dangerous – notice the contrast between the former, which is expanding as a trend, and the latter, which is feared to have peaked. One must take care not to be misled by analyses that confuse current figures with future outlooks. Further, against the background of payments toward reinsurance services, the secondary income balance for 1H of 2026 posted a deficit of -JPY 1.9281 trillion, the fourth largest deficit ever for 1H of a year, and if historical trends are any indication, a secondary income deficit of -JPY 4 to 5 trillion can be expected for the entire year 2026 (see graph). This deficit is second only to the digital deficit (shy of -JPY 7 trillion) in monetary value. This will bring other fixed costs, such as the import of defense equipment, also into scrutiny.



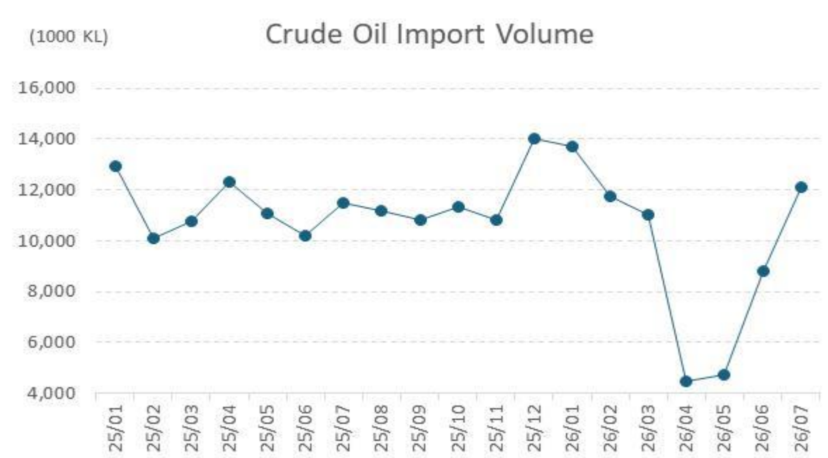
(Source) macrobond; prepared by the Global Foreign Exchange Department, Mizuo Bank

Meanwhile, the financial balance, as explained above, is projected to continue being shaped by the large net outflows in direct investment. If Japan is compelled to make direct investments into the U.S. worth USD 550 billion (roughly JPY 80 trillion) under the second Trump administration, one has to assume that JPY selling will continue at a pace stronger than at present, led by direct outward investment. The financial balance also includes household JPY selling, which is not hedged against forex risks. Looking at securities investment by sector from designated reporting institutions, net purchases (i.e., JPY outflows) worth a total of +JPY 6.5 trillion were posted for the period from January through July. While there are some positive developments, including the slower pace of expansion in the digital deficit for 1H of 2026, the increase in inward direct investment, and a potential recovery in demand for inbound tourism should China change its stance, none of the above are capable of reversing existing JPY selling pressures, only of slightly lessening them.

Oil Imports Return

Let us take a more detailed look at the trade balance, which is key to understanding JPY supply and demand. Japan's July trade balance, as released by the MOF on August 20, posted a deficit for the third consecutive month, at -JPY 634.5 billion, the largest deficit in six months. The total deficit for January through July was not that large at -JPY 1.7 trillion, but needless to say that this was due to a temporary drop in imports resulting from the release of crude oil reserves. At the present time, while exports, led by semiconductors and electronic parts, remain robust, the deficit continues to widen amid the anticipated surge in crude oil imports. Of course, this development was anticipated, and the accelerated pace of JPY depreciation since July may not be unrelated to this.

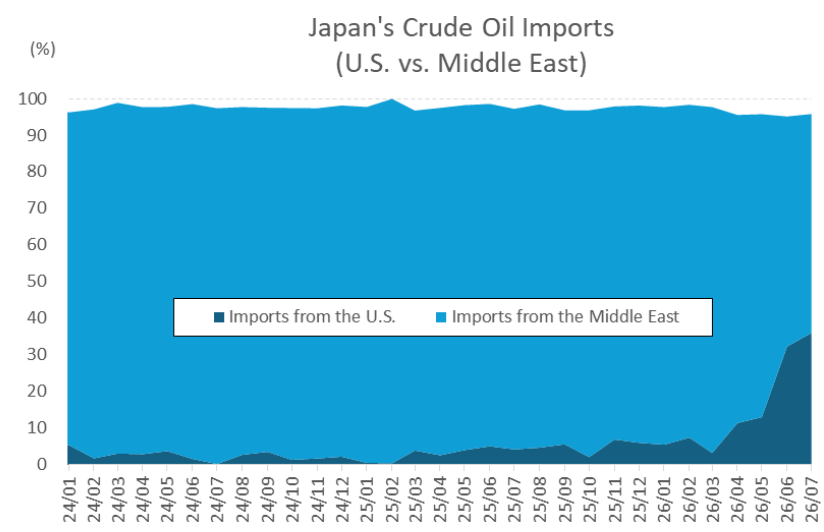
Crude oil imports, which had stalled following the deterioration in the situation in the Middle East, have been recovering since June, and (see graph) had recovered to levels seen before the Iran attacks as of July. Import value = price x volume, but while import volumes were kept at low levels, the import value did not increase despite the jump in crude oil prices. If alternative procurement becomes normalized, the higher prices multiplied by regular import volumes will result in the trade deficit expanding steeply as though "falling off a cliff." This is a scenario I have been warning against as a potential cause of JPY depreciation since March. Unfortunately, my fears appear to be coming true.



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

Reliance on Middle Eastern Oil Now Under 60%

It would be no exaggeration to say that the focus of Japan's trade balance, specifically resource imports, has shifted from volume-based factors to price-based factors starting June. This trend became even more pronounced in July, and is likely to continue in the same vein in August. However, there is reason to suspect that price-related factors may not be transient. As already reported, the primary alternative source of oil procurement is the U.S. As of July, while Japan's reliance on the Middle East for oil fell to 59.8%, its reliance on the U.S. surged to 36.1% (see graph). The fact that reliance on the Middle East, which had been over 90% (94.4%) as of March this year, plummeted to under 60% is an extremely big change. As previously discussed, the need to diversify procurement routes remains an important priority even if the turmoil in the Middle East ends, and given Japan's current relationship with the U.S., perhaps the recent trend is inevitable to some extent. The fact that Japan is now forced to continue buying crude oil at prices a notch higher than previously is a structural change that undeniably suggests JPY depreciation.

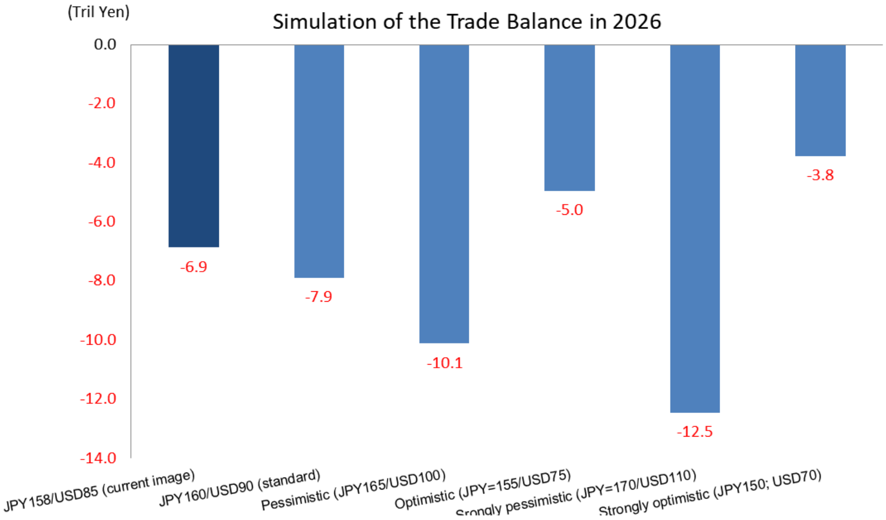


(Source) macrobond; prepared by the Global Foreign Exchange Department, Mizuho Bank

Further, given that the trade balance tends to reflect prices from roughly two months prior, the August trade deficit expansion may be somewhat modest given the dip in crude oil prices in June. However, this is unlikely to shape the trend going forward, as prices have been stable at the mid-80-dollar level per barrel since July.

Updating my Trade Balance Simulation

As the weak-JPY phase enters its fifth year and the situation becomes more dire, when headline figures improve even for a couple or three months, there is a tendency to argue that the structural downward pressure on JPY has receded. This is understandable as a manifestation of wishful thinking. However, the true nature of the situation can only be understood by distinguishing between temporary and more persistent factors responsible for the improvement and assessing which is likely to prevail as a trend going forward. The significant improvement in trade balance for 1H of 2026 resulted from the combination of a temporary policy (releasing oil reserves) and more persistent factors including the peaking of inbound tourism demand and persistently high digital deficits. The improvement in trade balance or the worsening of the service balance – it seems clear which of the two should be taken more seriously. Given that the JPY depreciation trend has not been reversed even following joint intervention by U.S. and Japanese authorities, it is important to earnestly examine Japan's ideal monetary and fiscal policy stances while facing the reality that more people want to sell JPY than buy it.



(Source) Ministry of Finance; prepared by the Global Foreign Exchange Department, Mizuo Bank
*From July onward, we assume that 60% of the reserves released will be replenished by year-end (approximately JPY2.8 trillion). The baseline cost is based on the JPY150/USD80 level, and will vary depending on the scenario.

Before I end this section, let me update my trade balance simulation. We already have actual figures for the January-July period, which has posted a total trade deficit of approx. -JPY 1.7 trillion. Additionally, we also know mineral fuel prices and the average crude oil price for the period in question. Based on this information, I would like to update my simulation of the trade balance for the rest of this year. My simulation will assume a 60% recovery of depleted reserves within the year. To lead with the conclusion, the situation is evolving in line with the simulation I prepared in March this year, and even taking into account already-released actual figures, the trade balance for the entire year 2026 is expected to fall in the -JPY 5-8 trillion range. Of course, as the final figures depend on variables such as exchange rates and crude oil price, which tend to fluctuate significantly, there is room for some deviation from projected figures, but it seems highly likely that the trade deficit for 2026 will be close to twice that of last year (when it was roughly -JPY 2.9 trillion). Thanks partly to the release of reserves, the situation is not as severe as it could have been, but the deficit is widening nonetheless.

As for whether improvement can be expected in 2027, there is no guarantee that this will be the case. If oil reserves had not been available for use, my estimate suggests that this year's deficit could have been close to -JPY 5 trillion larger. If so, the trade deficit for 2026 as a whole could have hit the -JPY 10-12 trillion mark.

Going by experience, a trade deficit in excess of -JPY 10 trillion is, with a high probability, likely to invite substantial JPY depreciation. For 2027, if we assume no release of reserves, USD/JPY around the level of 160, and crude oil prices around 80 dollars/barrel, it would not be surprising to see a trade deficit close to -JPY 10 trillion. Of course, whether this happens will depend on the situation in the Middle East, but it is risky to definitively conclude at this point that the trade balance for 2027 will improve year-on-year.

BOJ Monetary Policy Now and Going Forward – Growing Expectations for Unilateral Rate Hikes

Assessing the BOJ's Current Position

As mentioned above, having temporarily slid to the 155 level from its year-to-date high at close to 164 following the U.S.-Japan joint currency intervention, USD/JPY subsequently rose and remains at around 157-158 as of the time of writing this report. While the markets are wary of the possibility of a second or third round of joint interventions, there seems to be a temporary lull. Through his various media interviews, Treasury Secretary Bessent has clearly been urging Japan to implement monetary policy consistent with the JPY-buying currency intervention, leading to a sudden strengthening in already-smoldering expectations of a BOJ rate hike at the September 17-18 Monetary Policy Meeting (MPM).

Following the July MPM, BOJ Governor Kazuo Ueda said, "We are more conscious than ever of inflation risks and hope to discuss them earnestly from the next meeting onward." In the Outlook Report released following the July meeting, the balance of risks to the economic outlook was upwardly revised from the April view that "particularly for fiscal 2026 - risks to economic activity are skewed to the downside" to "risks to economic activity are generally balanced." Meanwhile, risks to prices remained unchanged at "skewed to the upside" (though the focus is on a broader range of risks rather than based narrowly on commodity prices). Also, the phrase "there is a risk of underlying CPI inflation deviating upward to a level above the price stability target of 2 percent," which appeared following the June meeting, was retained in July, with Ueda also underscoring at his press conference, "If monetary conditions are judged to be accommodative, the pace of rate hikes could be hastened," clearly indicating vigilance against falling behind the curve. Amid awareness of upside risks to both economic activity and prices, there is no doubt the next move will be a rate hike, and there were already hints that the timing of the rate hike is not far off.

Government Also on Board with Rate Hikes Following U.S.-Japan Joint Intervention

If the BOJ implements a rate hike in September, that would amount to one rate hike per quarter, which is an extremely rapid pace of rate hikes. Inevitably, the gap between the BOJ and government's stance will be in focus. However, following the U.S.-Japan joint forex intervention (and Bessent's remarks urging rate hikes), the view that the government has given the go-ahead is gaining traction. To begin with, BOJ rate hikes for some time to come are not aimed at cooling an overheated economy, but rather at not falling behind the curve, which is easy for the government to get on board with. If the BOJ falls behind the curve, there could be a substantial depreciation of JPY and increase in JPY interest rates, potentially necessitating a larger rate hike. That is bound to have a negative impact on Japan's economy and finances, so the ongoing rate hikes are also a preventive measure against such a prospect.

Further, the July Outlook Report (The Bank's View), having stated that "there are various risks to the outlook," clearly mentioned "future developments in foreign exchange rates" as a risk factor in addition to the situation in the Middle East and developments in global AI-related demand. The BOJ and the government share the understanding that future developments in foreign exchange rates is a risk factor, with Bessent also emphasizing that BOJ rate hikes are necessary to sustain the impact of the joint forex intervention. With all the stars aligned, there remains very little reason to oppose a rate hike.

Understanding the Terminal Rate and the Neutral Interest Rate

Going by the aforementioned circumstances, I would not be surprised to see one BOJ rate hike in September and another one in October or December this year. I am frequently asked whether I think this will curb JPY depreciation, and my answer is that that may be difficult. Even intuitively speaking, it is difficult to imagine a +25bp rate hike reversing JPY selling pressures strong enough to require joint intervention by U.S. and Japanese authorities.

Also, as explained above, the causal relationship is that rate hikes became possible only because of JPY weakness. Of course, there is a possibility of the rate hike helping stop the JPY freefall, but it is difficult to imagine a mere +25bp rate hike reversing the weak-JPY trend. Ultimately, it is the JPY depreciation trend that has brought the government, the BOJ, and the market participants (i.e., Japanese society) all to the shared understanding that early rate hikes are necessary, meaning that it is the JPY depreciation trend that created an atmosphere conducive to rate hikes. In this sense, the BOJ is behind the curve even vis-à-vis the forex markets, let alone the economic and price situations (i.e., underlying inflation). For monetary policy alone to steer JPY toward appreciation, the BOJ would have to make a move that goes beyond market expectations (say, a +50bp rate hike), but it is not realistic to expect such a move.

Of course, this does not mean progressive +25bp rate hikes are meaningless. As explained above, the most important first step for Japan right now is to align its currency and monetary policies, so the BOJ must first clearly signal such an intent by raising interest rates to 1.25%, so that it can exceed the lower bound of the estimated neutral interest rate range (1.1%-2.5%). In this context, it is natural to wonder what the true neutral interest rate is. Here, if the underlying inflation rate is already higher than +2%, the neutral interest rate is also likely to be at least around 2%.

If so, it would not be surprising to set the terminal rate (i.e., the end point of rate hikes) at a higher level. Given that the BOJ has fallen behind the curve with respect to forex markets, it could decide to raise rates to the 2.25% or 2.50% level to signal tightening monetary conditions to the markets. To begin with, the idea that it is sufficient to raise rates to the neutral interest rate level only applies when fiscal, monetary, and currency policies are progressing steadily. If they are somewhat behind the curve (with respect to the forex markets), it is inevitable to assume a somewhat higher policy interest rate level. Of course, even if such a level were to be reached, that would happen only in 2027 or beyond, but a risk scenario in which JPY weakness warrants a policy interest rate higher than the neutral interest rate level should be taken seriously.

Overview of Outlook

In August, USD/JPY was pushed down toward the JPY155 level – partly due to the effects of coordinated currency intervention by Japan and the U.S. – but it has since been gradually recovering. The crucial question is what Japanese policymakers will do while they have the U.S. Treasury – their "strongest ally" – on their side. The ideal course of action would be to demonstrate fiscal discipline and clearly signal a stance of sustained interest rate hikes; however, the market does not yet fully trust Japan's commitment to this, which likely explains the simultaneous occurrence of JPY weakness and rising JPY interest rates. Furthermore, concerns regarding supply and demand have not disappeared. As I have expressed concern about in previous columns, Japan's trade deficit has clearly begun to widen since June. One of the factors driving JPY weakness that I have most feared since March is the scenario in which – once alternative crude oil procurement normalizes – high prices combined with normal volumes may cause the Japan's trade deficit to expand extremely rapidly. Unfortunately, that is exactly what is happening. Reality is unfolding in line with supply-demand forecasts, suggesting Japan's trade deficit for the full year of 2026 will likely fall within the JPY5-8 trillion range. If we assume USD/JPY will be at around JPY160 and crude oil prices will be around USD80 per barrel in 2027 – and factor in the cessation of Japan's strategic oil reserve releases – it would not be surprising to see Japan's 2027 trade deficit approach JPY10 trillion. Of course, the outcome depends on the situation in the Middle East, but it would be risky to simply assume at this stage that the supply-demand balance will improve in 2027. Under these circumstances, there is no denying the impression that the BOJ's interest rate hikes are lagging behind developments in the forex market, and it is also undeniable that BOJ rates could rise to between 2.00% and 2.50%.

Meanwhile, EUR held firm throughout August. Having resumed interest rate hikes in June, the ECB is now widely expected to raise rates again in September. Overall, economic and inflation conditions in the euro area remain stable, and ECB monetary policy appears to be highly predictable. Although about two rate hikes are expected during the forecast period, futures markets have priced in the view that a third hike will not be necessary, and statements by senior ECB officials also suggest this will be the case. Even considering the Europe-U.S. interest rate differential, it is difficult to envision a scenario where EUR's investment appeal falls significantly below that of USD. A major shift in the current outlook would likely only occur in the event of a sharp spike in commodity prices. That said, based on the ECB's current baseline scenario, it is also true that unless prices exceed USD100 per barrel, it is unlikely the ECB would be forced to implement substantial rate hikes. A more immediate threat is the drop in water levels on the Rhine – a vital artery for European logistics – caused by the recent extreme heat. This development acts as a driver of inflation by creating supply constraints. As water levels typically drop further as autumn approaches, we should remain vigilant, as a sharp decline could fuel expectations of an ECB rate hike.

U.S. Currency/Fiscal Policies Now and Going Forward – Implications of Coordinated Intervention

Need to Redefine "National Wealth"

During July there were periods when Japanese Finance Minister Satsuki Katayama's statement that she – "wishes to pursue measures to encourage households and pension funds, including the Government Pension Investment Fund (GPIF), to increase their investments in Japanese financial assets" – was viewed as a financial market-moving factor, and speculation regarding the possibility of such measures continues to linger. As the specific policy changes implied by this statement, as well as their timing, remained unclear at the time this article was written, I will refrain from discussing them in detail.

Regardless of the specific measures under consideration, however, it should be recognized that there is indeed a need to encourage a return flow of Japanese overseas funds into domestic investments. As I have long argued in this column and in my books, Japan is a country recording "masked surpluses" owing to the fact that the government, corporations, and households hold abundant foreign-currency-denominated assets that are not flowing back into Japan, and there is a fundamental need for policies that address that situation. Japan is among the world's top countries regarding the magnitude of its net external assets, and that strong net external asset position is undoubtedly a source of the country's wealth, but if that wealth is not benefiting the Japanese people, then there is a clear need to redefine the meaning of "national wealth". The fact that Japan holds a large amount of assets outside its borders was once generally understood to be a factor contributing to JPY's strength, but since the beginning of 2026 I have been emphasizing in various venues that, given the current high level of recurrent and new geopolitical risk factors, the high level of foreign assets can become a forex discount factor rather than a premium factor for JPY. We need to seriously examine why the value of JPY is declining in both nominal and real terms despite Japan's massive positive net balance of foreign assets. Based on an understanding of that situation, I believe greater consideration of how to encourage overseas fund repatriation is, in principle, a step in the right direction, regardless of whether the focus is on the management of pension assets or on other issues.

Attention on Public Pension Fund Management for over a Year

It should be noted that the possibility of structural adjustments to the investment portfolios of the GPIF and other major pension funds has been discussed intermittently since last year, so it is not really a new issue. It first drew attention in June 2025, when the newly released U.S. Semiannual Report on International Economic and Exchange Rate Policies (IEERP) stated that – "government investment vehicles, such as large public pension funds, should invest abroad for risk-adjusted return and diversification purposes, and not to target the exchange rate for competitive purposes." I speculated in a previous edition of this article that that portion of the IEERP might lead to public pension portfolio restructuring, but it attracted little attention at the time.

The next time the issue drew attention was three months later, on September 12, 2025, when the Joint Statement by the U.S. and Japanese Finance Ministers (Scott Bessent and former Japanese Finance Minister Katsunobu Katō) was released. They agreed that such government investment vehicles such as pension funds should to invest abroad for risk-adjusted return and diversification purposes and not target exchange rates for competitive purposes, which is basically the same as the IEERP prescription. So the fact that U.S. monetary authorities have been taking an increasingly strong interest in the portfolio of Japan's public pension funds has been a topic of considerable attention for more than a year already.

Potential for Mid-Term Portfolio Reviews

Incidentally, while some observers seem to think it might be difficult to adjust the GPIF's investment portfolio now that GPIF has already entered its fifth medium-term target period (FY2025–2029), it is important to note that this is not necessarily the case. The GPIF's FY2026 Plan states that – "the Management Committee will consider reviewing the basic portfolio when deemed necessary, such as in the event of potential rapid market fluctuations." In fact, during the GPIF's second medium-term target period (FY2010-2014), the shares of foreign stocks and bonds were increased from 12% to 25% and from 11% to 15%, respectively, in October 2014, before the target period ended (on March 31, 2015). Setting aside the question of whether this timing was influenced by political considerations, there clearly is a precedent for revising the GPIF's basic portfolio structure midway through target periods.

Given the current potential for rapid market fluctuations in forex or bond markets, it cannot be entirely ruled out that the GPIF portfolio might be adjusted before the end of fiscal 2029, even if the likelihood is low. For example, if the pace of BOJ interest rate hikes exceeds expectations and causes Japanese government bond yields to rise to a level deemed stable and sufficient for sustaining pension finances, there would clearly be a diminished need for the GPIF to burden itself with foreign exchange risks by continuing to hold foreign currency assets accounting for roughly 50% of its investment portfolio. If the real economy or interest rate environment undergoes unexpectedly large changes, the very premises of the portfolio may be undermined, providing a strong justification for a mid-term portfolio review.

Portfolio Rebalancing Simulations

target period (2025-2029) plan stipulates that foreign bonds and foreign stocks will each account for 25% of the total investment portfolio, so that foreign currency-denominated assets collectively account for 50% of the portfolio. What kind of impact should be expected if the foreign stocks and foreign bonds proportions were each reduced by 10 percentage points, lowering the overall proportion of foreign currency-denominated assets from 50% to 30%? The investment portfolio values of the three leading mutual aid associations that that adhere to GPIF's portfolio structure adjustments – the Federation of Local Government Employees' Mutual Aid Associations (PAL: JPY21,052.6 billion, as

of the end of March 2026), the Federation of National Government Employees' Mutual Aid Associations (KKR: JPY11,490.2 billion, as of the end of December 2025), and The Promotion and Mutual Aid Corporation for Private Schools of Japan (PMAC: JPY4,786.6 billion, as of the end of December 2025) – total approximately JPY37.3 trillion. The GPIF's investment portfolio was worth approximately JPY293.6437 trillion (as of the end of March 2026), so the combined assets under management of the GPIF and three leading mutual aid associations is JPY330.9731 trillion (approximately JPY331 trillion; see table). Of course, since there are other pension funds that emulate the GPIF investment portfolio structure, the actual figure of investments that would be affected by t GPIC portfolio restructuring would be even larger. In the case that GPIF portfolio allocation is changed as mentioned above (foreign currency assets reduced from 50% to 30%), for example, we can assume that foreign-currency-denominated assets before the change amounted to approximately JPY165.5 trillion (50% of the approximately JPY331 trillion total) and foreign-currency-denominated assets after the change (reduced to a 30% portfolio share) would amount to approximately JPY99.3 trillion. The approximately JPY66.2 trillion reduction (JPY331 trillion - JPY99.3 trillion) would manifest itself as JPY purchases. The annual scale of JPY purchases would vary depending on the timeframe over which the adjustment is carried out, but assuming the adjustment is carried out steadily over the five-year medium-term investment period, one can anticipate annual JPY purchases amounting to JPY13 trillion or more (roughly equal to 66.2/5) are projected (see table on previous page). To put that into perspective, one may note that the foreign currency-denominated asset share of the GPIF investment portfolio structure during the first medium-term target period (FY2006–FY2009) was set at 17%, comprising 8% in foreign bonds and 9% in foreign stocks.
In the case that GPIF reduces its foreign currency asset share 30 percentage points, from the current level to 20%, a total of approximately JPY99.2 trillion in JPY buying would be anticipated. Assuming the rebalancing is completed over five years, this would cause approximately JPY20 trillion in JPY purchases per year. Japan's largest trade deficit ever, recorded in 2022, was approximately -JPY20 trillion, and the country's second-largest deficit was approximately -JPY13 trillion in 2014. A GPIF policy decision to reduce the proportion of its foreign currency-denominated assets by 20 to 30 percentage points would create structural upward pressure on JPY on an annual basis that would offset even these deficits, and the upward pressure would persist for several years. There is great room for debate regarding the merits and demerits of such a policy change, but if implemented, the policy change would undoubtedly have to be considered a very strong factor promoting JPY appreciation.

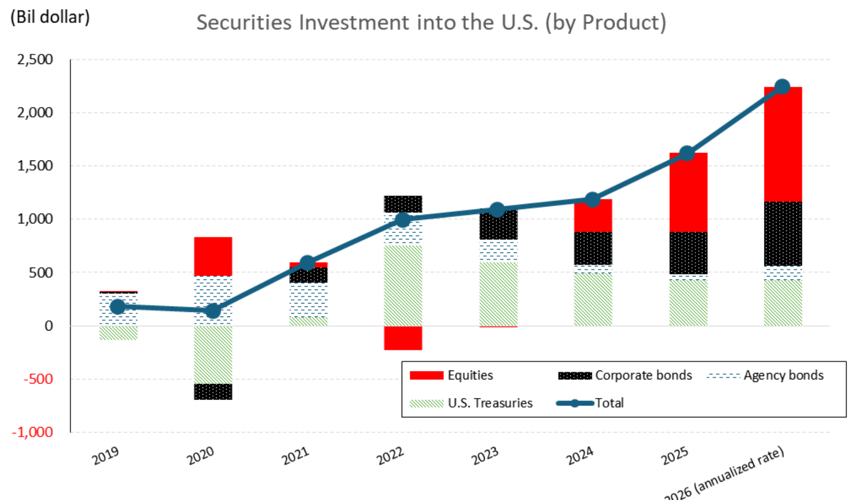
Increasingly Evident Concerns
There were significant movements in bond and forex markets on August 20. The previous day, the U.S. Treasury Department abruptly announced a plan to increase its buyback program for ultra-long-term government bonds, setting a policy to at least double the per-operation repurchase limit for outstanding bonds with remaining maturities of 10-20 years and 20-30 years. Since the U.S. government's overall funding plan remains largely unchanged, the reduction in liquidity for long- and ultra-long-term bonds implies a shift toward relying more on short-term debt issuance. From a macroeconomic perspective, the new policy does not alter the U.S. economy's monetary base, so it should not be interpreted as a shift toward a more accommodative stance in fiscal or monetary policy management.
The new policy clearly reflects the U.S. Treasury's determination to prevent further increases in interest rates within the long- and ultra-long-term segments. Given that the global rise in interest rates from mid- to late August was largely driven by climbing U.S. Treasury yields, the market reacted immediately to the announcement with bond buying, and the resulting drop in yields provided support for stock prices. In forex markets, USD weakened across the board in direct response to the decline in U.S. interest rates. The impact largely dissipated within a week of the announcement, however, quickly exposing the limitations of the measure as a mere stopgap solution.

Coordinated Intervention a Case of "Charity Begins at Home"
The coordinated U.S.-Japan intervention and recent buyback program expansion appear to indicate that the U.S. Treasury is not actually so worried about JPY weakness itself but is concerned about the upward pressure on U.S. Treasury yields generated as a side-effect of JPY weakness. There is no doubt that the U.S. is focused on stubbornly high interest rates, particularly on the long- and ultra-long-term sectors. Immediately prior to both the Japan-U.S. joint exchange rate review in January and the coordinated intervention from late July to early August, the rising yields on ultra-long-term bonds (such as the 30-year Treasury) had been attracting attention. Ultimately, long- and ultra-long-term interest rates have become a policy decision-making trigger.
Even before this, the second Trump administration' isolationism (or "Donroe doctrine") had encouraged a shift away from USD and U.S. Treasuries that prevented U.S. Treasury yields from decreasing despite interest rate cuts (see the upper graph on page 4). The impression that control over market interest rates was becoming precarious is not a new development, as it existed since 2025. As discussed below, my fundamental view is that U.S. interest rates' stubbornly high levels are a deeply rooted, long-term issue that cannot be resolved through superficial market interventions. Specific concerns include the fact that high interest rates complicate fiscal management and, more importantly, could promote a perception that U.S. stocks are overvalued. Given the persistent claims of a U.S. stock market bubble in recent years, such a scenario could potentially trigger a market correction. Should stock prices face a significant correction, the fact that equities account for over 40% of U.S. household financial assets raises fears that private consumption would be squeezed via a negative wealth effect (it is well known that private consumption drives 60% of the U.S. economy). Such a situation would be unacceptable with the midterm elections approaching. It is worth noting that the current buyback measure will remain in effect until November 4, the day after the midterm elections.
In any case, it was precisely because of concerns over persistently high U.S. interest rates that coordinated intervention by Japan and the U.S. was necessary to curb a scenario in which "sell Japan" sentiment manifested in selling of JPY and Japanese government bonds would drive up yields on Japanese bonds and reduce the relative investment appeal of U.S. Treasuries. The intervention can be presumed to have been a literal case of "charity begins

at home", driven primarily by U.S. concern for its own financial situation. In other words, the coordinated intervention was an attempt to neutralize overseas (Japanese) factors contributing to rising U.S. interest rates, while the recent buyback was an attempt to address domestic (U.S.) factors.

"USD Selling" Deeply Rooted

The question is whether these measures will stem the rise in U.S. interest rates in the long- and ultra-long-term sectors, and fundamentally, I believe this will be difficult. The economic effect of the buyback is similar to that of a "twist operation" (buying long-term (ultra-long-term) bonds and selling short-term bonds), and the buyback does not suggest that U.S. fiscal management has regained discipline, nor, most importantly, that the Trump administration's isolationist behavior will change. Given this, there is no reason for the "USD selling" trend to subside, and there are likely limits to how much U.S. interest rates can fall. After all, the erosion of USD's key global currency status stems from the historical reality of declining U.S. hegemony, and that erosion cannot be expected to be halted by such stopgap measures as twist operations. The U.S. Treasury Department's Treasury International Capital (TIC) data shows that while capital inflows into the U.S. remain robust, the vast majority are directed toward the corporate sector (equities and corporate bonds), whereas inflows into the government sector (Treasuries and agency bonds) are clearly dwindling (see graph). This data is highly revealing, reflecting a market sentiment that "U.S. corporations are trustworthy, but the U.S. government is not", and it is unlikely that this trend will change significantly even with the recent new measures. In fact, the measures could even fuel concerns that the government is merely trying to prolong an expansionary fiscal stance through stopgap fixes, potentially triggering greater USD selling.



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

While the buyback program expansion had a significant impact because it was executed at an unexpected time (and in a market with low liquidity), there was never any reason to expect a lasting effect, and the interest rate and forex markets are already reverting to their previous states. Forex and bond markets share a common characteristic in that policy interventions designed to counter fundamentals yield only temporary results. The current situation is that the U.S.-Iran ceasefire agreement is increasingly shaky and crude oil prices remain elevated, so upward pressure on interest rates is likely to persist globally for the foreseeable future. Technical stopgap measures might trigger a temporary weakening of USD against JPY during the forecast period, but any such trend is unlikely to be sustained. Despite USD/JPY fluctuations, JPY's effective exchange rate has been on a downward trend during the past few years. Setting aside global trends, fundamentally, it seems reasonable to assume that downward pressure on JPY will persist to some extent.

Risks to My Main Scenario – JPY Depreciation Risks Acknowledged with Candor

Candor from Treasury Secretary Bessent

Following the coordinated intervention, remarks made by U.S. Treasury Secretary Scott Bessent to various media outlets drew significant attention. For instance, regarding the current state and outlook of the BOJ's monetary policy, reports highlighted comments made in late August such as: "I am confident that BOJ Governor Ueda will do the right thing," "Japan must follow it with monetary and fiscal policies that support the currency," and "it's my belief that the Japanese government and the BOJ will do the things that will lead to a stronger JPY." It would be fair to interpret these remarks as a strong call for interest rate hikes. They suggest that, given the U.S. is providing support through its currency policy stance, it does not want to tolerate monetary policies that contradict this stance.

As I noted above – "Whether regarding monetary or fiscal policy, the most effective approach is to demonstrate sincerity through orthodox measures rather than relying on unconventional arguments. That, rather than currency policy doing all the heavy lifting, is the only way to fully leverage this rare instance of U.S.-Japan currency policy coordination and maximize its impact." – and I believe the above-cited remarks by Treasury Secretary Bessent were in line with this view. In light of this, it seems inevitable that the BOJ will make monetary policy decisions consistent with currency policy at its September 17-18 Monetary Policy Meeting, and it appears that the likelihood of a 25-basis-point rate hike has suddenly increased. Coordination across various sectors will be necessary to align the directions of fiscal, currency, and monetary policies.

In addition, Treasury Secretary Bessent is reported to have said – "Speculators who lean too hard on the carry trade will be put on notice." – but he did not suggest that he thought carry trades would disappear completely. Since differences in neutral interest rates among countries are determined by differences in potential growth rates, it is unlikely that the real-basis Japan-U.S. interest rate differential will narrow significantly, so it is also unlikely that carry trades (selling JPY and buying USD) will come to an end. In short, the conclusion seems to be that "while interest rate hikes and fiscal discipline are certainly necessary, they will not eradicate JPY-selling."

Simply Promoting the Theoretically Correct Path

Regarding the USD/JPY situation since August, Japan secured U.S. cooperation to achieve its policy goal of reversing JPY depreciation but, seemingly as a condition for that support, was subjected to strong pressure regarding the nature of its independent monetary policy. However, it is highly unusual that a country struggling with currency depreciation maintains its policy interest rate in negative territory on a real basis. Treasury Secretary Bessent's remarks were neither particularly political nor coercive; they simply advocated for a theoretically sound course of action. If a country is going to buy its own currency to defend it, raising interest rates is a logically consistent course of action.

Furthermore, regarding the selling of EUR in connection with the intervention, Secretary Bessent noted that EUR was trading at a level close to its fair value and that he had reassured his European counterparts by explaining that the sales were a mere reallocation of forex reserves. His argument is that while EUR/JPY did not warrant intervention, the sales were conducted to rebalance the composition of U.S. forex reserves, which had become distorted following JPY-buying/USD-selling operations. While this explanation seems plausible at first glance, it appears that, by selling EUR while Japanese authorities were selling USD, the U.S. Treasury was also seeking to restrain the simultaneous occurrence of USD weakening and U.S. interest rate rises.

Dangerous to Delay Corrective Measures

Treasury Secretary Bessent has also noted in an August 4 CNBC interview that – "If the yen weakens, other currencies will follow. [...] The level of the yen can create other problems or trigger competitive currency devaluations, which is not sound." – highlighting the risk that JPY weakness could lead to a sell-off of Asian currencies in general. He emphasized similar points in an interview with the Nihon Keizai Shimbun newspaper (Nikkei). Specifically, regarding the transmission of systemic risk, he argued that – "The Asian financial crisis of the 1990s had a sharp JPY depreciation as one of its triggers." Amid the concurrent occurrence of JPY weakness and rising JPY interest rates, it is reasonable to be concerned that a sharp rise in Japanese government bond yields could directly lead to an increase in systemic risk beginning with regional banks, so attempts to curb JPY depreciation as part of preventive measures are understandable. Curbing JPY depreciation to mitigate systemic risk appears to be one of the major goals of the U.S. forex intervention (with the other goal being the containment of U.S. Treasury yields).

Secretary Bessent has repeatedly pledged unwavering cooperation with Japan, which he described as an outstanding military and economic ally, and he stated in the Nikkei interview that – "If it benefits the U.S. economy and taxpayers and helps stabilize the global economy, we will do whatever is necessary to support Japan." This is very reassuring for Japan to hear as it seeks to curb JPY's depreciation. However, <u>there is also concern that if this situation continues for a sufficiently long time, the forex market might internalize an unwritten rule that "JPY cannot stabilize without U.S. support</u>." As mentioned, once U.S. Treasury yields stabilize, the U.S. may have less incentive to actively work toward stabilizing JPY. There are grounds for fearing that JPY could be driven even lower if U.S. support were suddenly to be withdrawn, so efforts to return to normal conditions as soon as possible are extremely important.

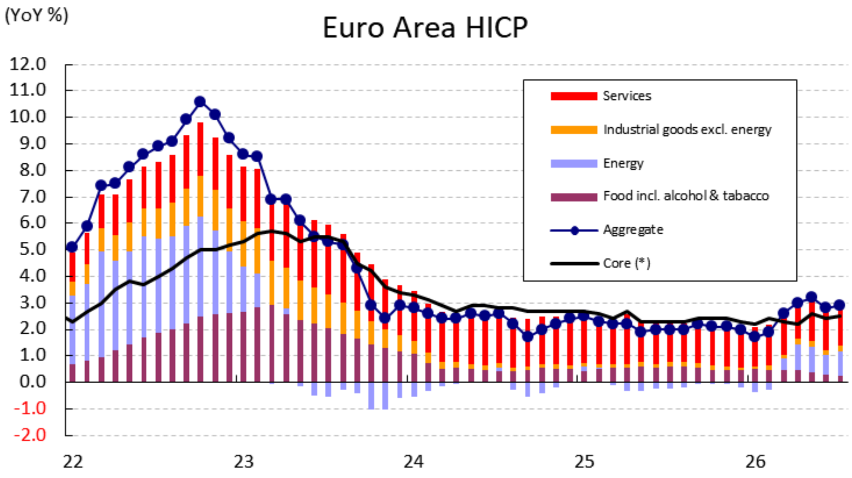
What matters most is that necessary actions are implemented during the period when powerful support is still available. It clearly would be prudent to bring this unusual situation to a close sooner rather than later.

EUR Outlook – End of ECB Rate-Hike Phase in Sight

EUR Area Monetary Policies Now and Going Forward – Projecting Remaining Number of Rate Hikes

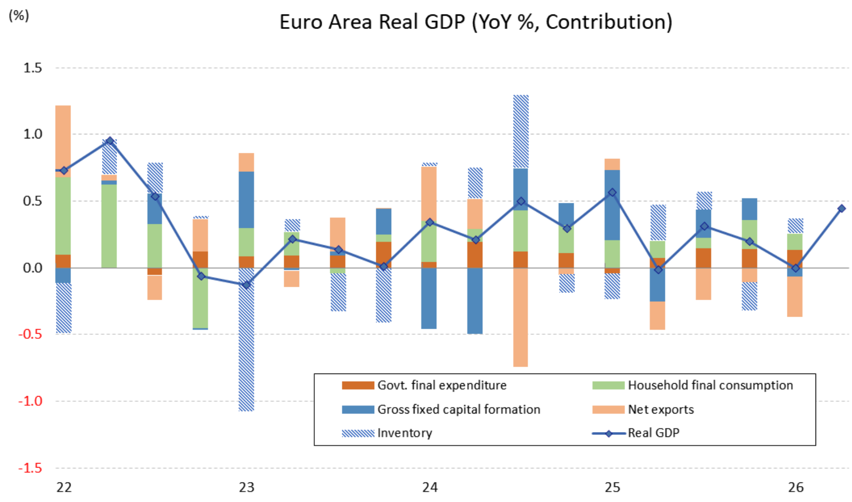
Inflation and Growth Indicators Still Solid

ECB Chief Economist Philip Lane made headlines with his comments during an August 18, 2026 interview on RTÉ's Morning Ireland radio show regarding the euro area's Harmonised Index of Consumer Prices (HICP). He said the inflation outlook – "very much depends on whether there is a resolution to the [Iran] crisis. So it's really an uncertain situation. It is not like the 10% we had in 2022, but 3% is still well above the 2% target that we have." This was a clear signal from Chief Economist Lane, who oversees economic and price developments at the ECB, that he views inflation risks as skewed to the upside, and it offers a significant clue about the ECB's "next move." In fact, with energy-prices as well as services-price inflation remaining robust, the HICP growth rate has been hovering around 3% (see graph), and many analyses suggest that heat wave-induced droughts will lead to poor crop yields that further boost inflation rates, particularly regarding food prices (the ECB made this point in its June monthly report). Furthermore, on August 26, ECB Executive Board member Isabel Schnabel urged additional rate hikes, stating – "At the current policy interest rate, it is unlikely that inflation will return to target in the medium term, so further tightening will be necessary." It is highly likely that a decision to raise interest rates will be made at the September ECB Governing Council meeting.



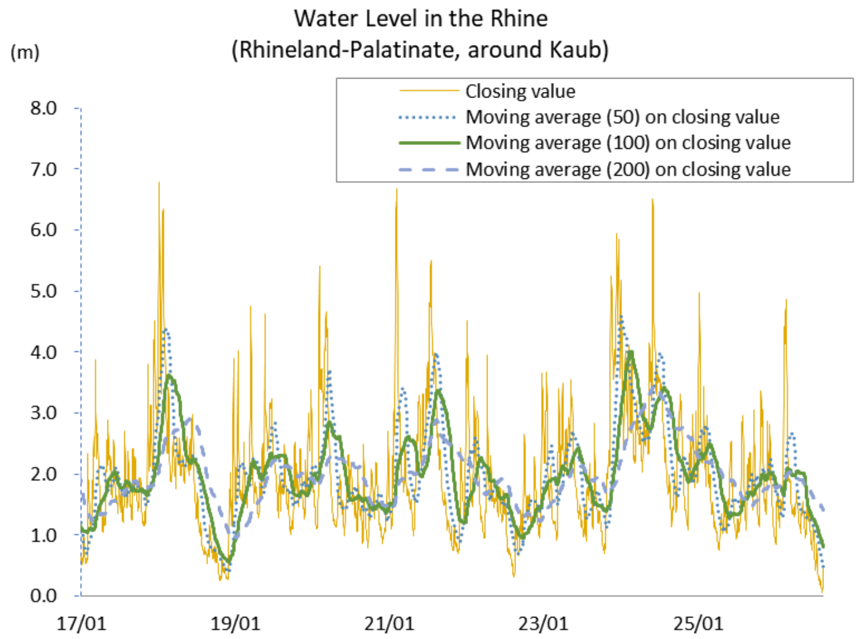
(*) Core excl. energy, food, alcohol & tobacco
(Source) Datastream; prepared by the Global Foreign Exchange Department, Mizuho Bank

In addition, economic indicators released since the July Governing Council meeting have been consistently strong across the board. For example, the euro area real GDP growth rate for the April-June quarter was 0.4% qoq and 1.8% on an annualized basis, so the regional economy has been maintaining a growth pace above "cruising speed" (market consensus forecasts were 0.2% and 0.8%, respectively; see graph on the right). This confirms the economy has bottomed-out after recording zero-growth in the January-March quarter, so statistics are suggesting that the impact of Iran-related hostilities has been limited. Led by Germany, countries are beginning to shift toward expansionary fiscal policies as part of Europe's rearmament plan, and many analysts believe this is supporting domestic demand. This comes as no surprise, as many observers have been anticipating such effects from as early as last spring, and this robust growth along with the solid HICP growth figures can be seen to justify interest rate hikes.



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

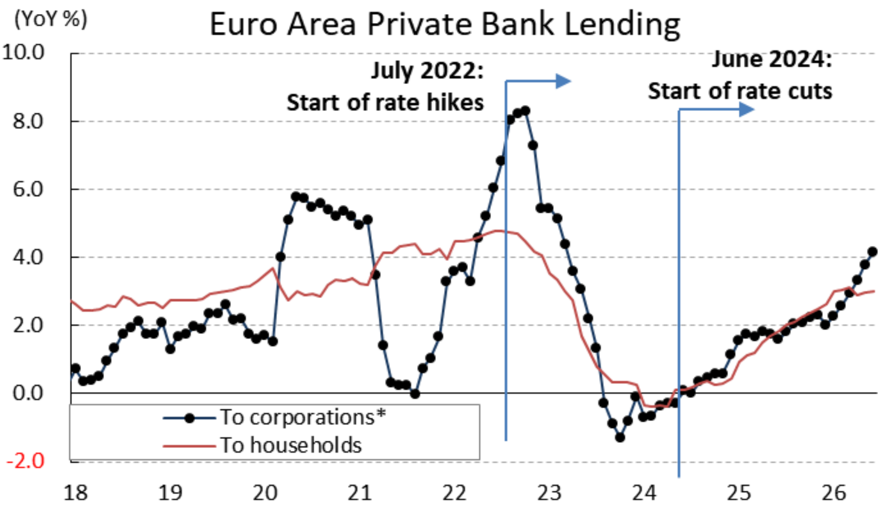
Rhine River Water Levels – Tightening Supply Constraints



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

Another major factor affecting euro area economic conditions and inflation trends is a dramatic drop in water levels on the Rhine River (a vital artery for European logistics) caused by extremely hot weather. The low water levels make it difficult for ships to navigate as they normally would, affecting the operations of various industrial facilities and power plants located along the river. There are concerns that even those vessels still capable of navigating the river will face restrictions, such as limits on cargo weight. The euro area economy has faced this phenomenon intermittently (with similar discussions arising in 2018 and 2022), but water levels have now fallen to historic lows, as shown in the graph on the right. Historically, the water levels tend to drop seasonally from summer through fall, so it is possible that related problems will become even more apparent in the future and could lead to tangible economic damage, such as the suspension of operations at factories and power plants. The economic impact of related supply constraints would be likely to dampen growth rates while simultaneously elevating inflationary pressures. While it is debatable whether interest rate hikes are the appropriate response to supply constraints, the ECB remains vigilant about second-round effects, so there is a possibility it may consider the supply constraints to be an inflationary factor that cannot be ignored.

Credit Growth also Remains Robust



(Source) ECBs; preparedby the Global Foreign Exchange Department, Mizuo Bank, *To non-financial corporations

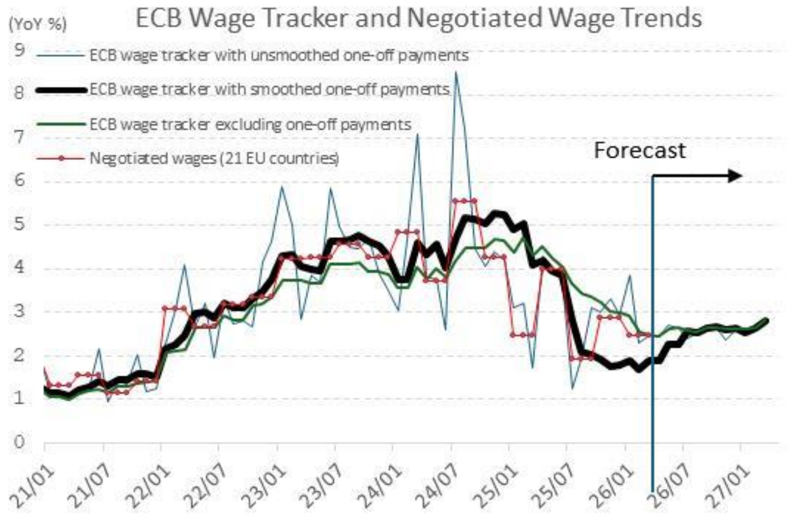
While growth rates of GDP and HICP are undoubtedly the key metrics used to gauge the ECB's "next move," there is also a well-established, stable relationship between changes in policy rates and intra-regional credit trends. The start of the rate-hiking cycle in July 2022 and the commencement of rate cuts in June 2024 served as turning points for the contraction and expansion, respectively, of private-sector lending in the region. In particular, the initiation of rate hikes in July 2022 was timed to counteract a surge in credit accompanied by sharp rise in HICP growth (see graph above). The rate of credit growth now is not as rapid as it was then, but growth in lending to both businesses and households is accelerating. Given this situation and Governor Lane's expressed concern about the HICP growth rates running above the target level, it is not at all surprising that the EBC's "next move" is widely expected to be a rate hike. The graph shows that lending to businesses has been growing at a fairly rapid pace since the start of 2026.

Looking back at 2022–23, both the Fed and ECB overlooked temporary inflationary spikes driven by soaring energy prices, causing them to later see a need to expand the margin of their rate hikes to 75 basis points. Looking back now, it is clear that that period was characterized by simultaneous strong growth in both lending and HICP, and this suggests that the currently observed lending growth trend could possibly be considered a basis for additional rate hikes.

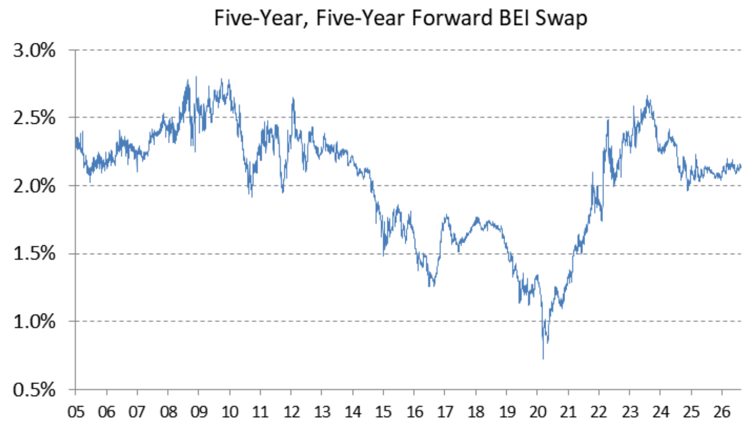
That said, ECB President Lagarde noted at the press conference following the July Governing Council meeting that the latest survey showed a tightening of lending standards among banks in the region, indicating her awareness that credit conditions may have been starting to tighten. Given that the effects of rate hikes generally take time to materialize, even if rate hikes can be justified based on strong lending activity, the limit is likely one or two more hikes at most. In any case, a fair assessment would be that current economic, inflation, and financial indicators justify at least "a 25-basis-point rate hike."

Wages Expected to Stabilize

Finally, let us examine wage trends, which are considered the most important lagging indicator. The rate of growth in negotiated wages is now expected to level off. The latest ECB wage tracker figures (based on figures including one-time payments before smoothing) suggest an outlook of approximately 2.6% yoy growth in negotiated wages for all of 2026, and approximately 2.5% yoy growth in the October-December 2026 quarter. Given that the growth rate was approximately 3.0% last year, it cannot be said that a wage-price spiral is occurring. Since the ECB interprets a negotiated wage growth rate in the 2–3% range as consistent with its 2% inflation target, the situation does not call for significant interest rate hikes. Consistent with this wage outlook, market-based inflation expectations (particularly the 5-year-forward 5-year inflation swaps that the ECB traditionally places great emphasis on) have also stabilized at around 2%, so there appears to be no cause for concern that secondary spillover effects will intensify and accelerate a wage-price spiral (see graph below). Against this backdrop, when this article was written, the interest rate futures market had priced in 1.7 rate hikes by the end of this year and two by March of next year – with a third hike not yet factored in. Even Executive Board member Schnabel (considered a leading hawk) has endorsed these market expectations, stating that financial markets – "seem to understand our reaction function very well." The fact that even such a staunch hawk as Executive Board member Schnabel envisions no more than two rate hikes in the foreseeable future provides a key insight for anticipating ECB policies going forward.



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



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

USD100+ Oil Would Pose Risk

Economic growth and inflation conditions in the euro area remain stable overall, so the ECB's policy management is highly predictable. If anything were to change the situation, the most likely trigger would be significant commodity price volatility. It seems unlikely that upside commodity price risks will materialize in the immediate future, however, because the June ECB staff projections' baseline scenario assumes per barrel crude oil prices of USD96.9 in 2026, USD82.2 in 2027, and USD77.1 in 2028. Crude oil prices have averaged in the USD80 range since June, suggesting a downside risk for 2026 and a scenario largely in line with expectations for 2027. In other words, there is still sufficient leeway for crude oil prices to rise without undermining the baseline scenario, indicating a robust outlook. If crude oil prices were to consistently exceed USD100 in the second half of 2026, market expectations for interest rate hikes could intensify, but this is not a scenario that can be reasonably anticipated at present, so it remains strictly a risk scenario. Following a rate hike to 2.50% and the release of revised staff macroeconomic projections at the September Governing Council meeting, the ECB is expected to shift to a "wait-and-see" stance regarding the rate hike's impact and to maintain the status quo for the remainder of the year.

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