

Forex Medium-Term Outlook

September 30, 2026

Overview of Outlook

USD/JPY fell significantly in September following strong remarks aimed at correcting JPY weakness from senior government officials in both Japan and the U.S., but eventually recovered some of its previous level. The trend is exactly the same as that seen in August, when JPY strengthened following a joint intervention early August but soon weakened again. This compels me to point out, as I did in last month's issue of this report, that the key factor here is what action Japanese policymakers will take while they have the support of their strongest ally, the U.S. Department of the Treasury. The most obvious path would be to sincerely adopt a stance of fiscal discipline and continued rate hikes. However, looking at the JPY supply-demand climate, Japan's trade deficit has begun to widen significantly, as previously predicted in this report. Given Japan's shift from the Middle East to the U.S. for crude oil procurement, high crude oil prices may continue to affect the Japanese economy over the long term. Since 2022, the Japanese economy and financial world have faced a choice between higher interest rates and weaker JPY, and accepted the latter. Recently, however, there is an increasing sense that interest rate hikes are unavoidable. If protecting the currency were the main consideration, even a rate of 2.25% or 2.50%, which is much higher than the perceived neutral interest rate, ought not to be beyond reach. However, politics and public opinion at the time will dictate which choice is made. If the public decides that JPY depreciation is preferable to further interest rate hikes, the BOJ will stop raising interest rates, and JPY depreciation could enter a new phase. This must be noted as a potential scenario of JPY depreciating beyond expectation.

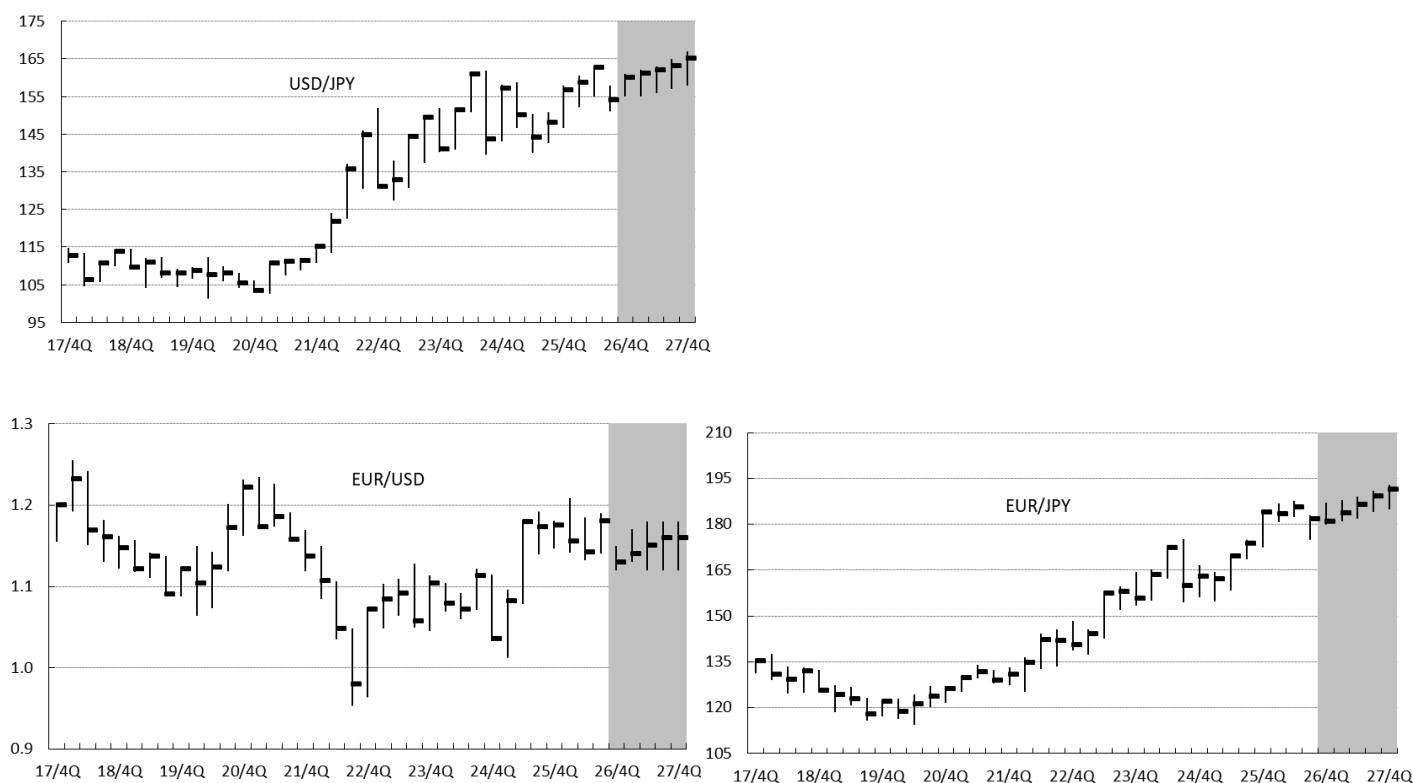
EUR weakened in September. There was speculation of an early end to ECB rate hikes ECB last month, but with the sharp rise in commodity prices, several additional rate hikes have now been factored in. Until last month, markets were predicting only one more rate hike before the current ECB rate hike phase ended. This prediction has suddenly changed to one rate hike this year, and three rate hikes by April 2027. Note my prediction in last month's issue of this report that a "major shift in the current outlook may only occur in the event of a sharp spike in commodity prices." Given that natural gas and other commodity prices have clearly risen above the level mentioned in the ECB's risk scenario, it is not surprising for the markets to factor in additional rate hikes. Taking into account the present level of energy prices, the ECB staff macroeconomic projections can merely serve as reference; inflation expectations formulated in response to rising inflation risks seem likely to strengthen further going forward. Having said that, the Fed is also pivoting to an increasingly hawkish stance, which makes it more difficult to argue (as one could until last month) that the ECB's relatively more hawkish stance makes EUR liable to be bought. On the political front, the popularity of a far-right party in German regional elections is attracting attention, and the French presidential elections remain a potential cause of turmoil going forward.

Summary Table of Forecasts

	2026 Jan-Sep (Actual)	Oct-Dec	2027 Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
USD/JPY	152.10 ~ 163.99 (157.12)	155 ~ 161 (160)	155 ~ 162 (161)	156 ~ 163 (162)	157 ~ 165 (163)	158 ~ 167 (165)
EUR/USD	1.1325 ~ 1.2084 (1.1339)	1.12 ~ 1.15 (1.13)	1.13 ~ 1.17 (1.14)	1.12 ~ 1.18 (1.15)	1.12 ~ 1.18 (1.16)	1.12 ~ 1.18 (1.16)
EUR/JPY	177.86 ~ 187.95 (178.16)	180 ~ 187 (181)	181 ~ 188 (184)	182 ~ 189 (186)	184 ~ 191 (189)	185 ~ 193 (191)

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

Exchange Rate Trends & Forecasts



USD/JPY Outlook - Statements by Key Officials Do Not Change General Trend

JPY Rates Now and Going Forward – Need to Reevaluate Current Rates

Need to Reevaluate Current Rates

Strong remarks aimed at correcting JPY weakness were heard from senior government officials in both Japan and the U.S. in September. In particular, in the wake of JPY appreciation provoked by U.S. Secretary of the Treasury Scott Bessent, there was a concerted spate of media reports on the anticipated end of the weak-JPY phase. Most of the analyses offered qualitative impressions and were quite similar, emphasizing that, with U.S. currency policy becoming earnestly involved, this was just the start of the correction of JPY weakness. Subsequently JPY weakened again, and perhaps a similar pattern will be seen intermittently going forward. To me, however, being blindly led by Bessent's remarks seems fraught with risk. In last month's issue of this report, in the section titled "No Change in Global View Even After Joint U.S.-Japan Intervention," I confirmed that there was no need to revise my weak-JPY outlook. My basic understanding remains the same this month. It is true that the history of the floating exchange rate system is also the history of JPY strength, as well as a history reflecting the intent of U.S. currency policy. It is, therefore, understandable to feel apprehensive about recent USD/JPY rate trends, which have suddenly taken on a political hue. In practice, given that it is difficult to fully understand all the cards Bessent may be holding in reserve, there may be scope for considering the pronouncement that "the correction of JPY weakness has only just begun." However, one must also ask – have the fundamentals surrounding JPY rates really changed? At a time like this, when it is easy to be swayed by qualitative narratives, I would like to verify the current state of affairs using quantitative data.

Have the Factors Causing JPY Weakness Been Eliminated?

What one really needs to consider at this moment is not how dramatic the communication from U.S. and Japanese senior government officials have been, but whether the causes of JPY weakness as pointed out over the past four years have fundamentally changed. The validity of a forecast cannot be assured without doing this.

It is difficult to list all of the points that need to be considered, but some of the causes of JPY selling that have been mentioned so far include (1) the protracted ultra-low interest-rate climate, (2) the structural change in JPY supply and demand, as reflected in Japan's trade deficits, and (3) the chronic nature of Japan's expansionary fiscal policies. Of these, the only one that has clearly changed is (1), and it is unquestionably true that the series of supportive remarks from Bessent has triggered a major change in the policy environment. Having said that, with the Fed and the ECB also expected to raise interest rates at the rate of +25bp per hike, even a major rate hike by the BOJ will have no special significance when it comes to correcting USD/JPY. Some are already beginning to suggest that forex market expectations cannot be exceeded by anything less than a +50bp rate hike, so while a BOJ rate hike may be able to

help curb further JPY depreciation, it may not be able to promote JPY appreciation. This is obvious even from market trends following the September BOJ and Fed meetings.

As of the writing of this report, the markets have factored in a faster pace of rate hikes by the BOJ compared with the Fed and the ECB, but interest rate levels themselves are not expected to catch up. The bigger question, however, is – will the Japanese political establishment, economy, and public be able to tolerate three more rate hikes by July next year. This part will depend on public opinion (details later) and is something to beware of as potentially causing unexpected JPY depreciation.

With regard to (3) above, given that the government retains the option of lowering the consumption tax and has tabled an all-time record high preliminary budget request, it is difficult to deny that the fiscal policy is expansionary. If one takes a generous view and assumes that no supplementary budget will be compiled for FY27, it may be possible to see this as a step toward fiscal soundness, but market participants using this as a reason for buying JPY are likely to be a very small minority.

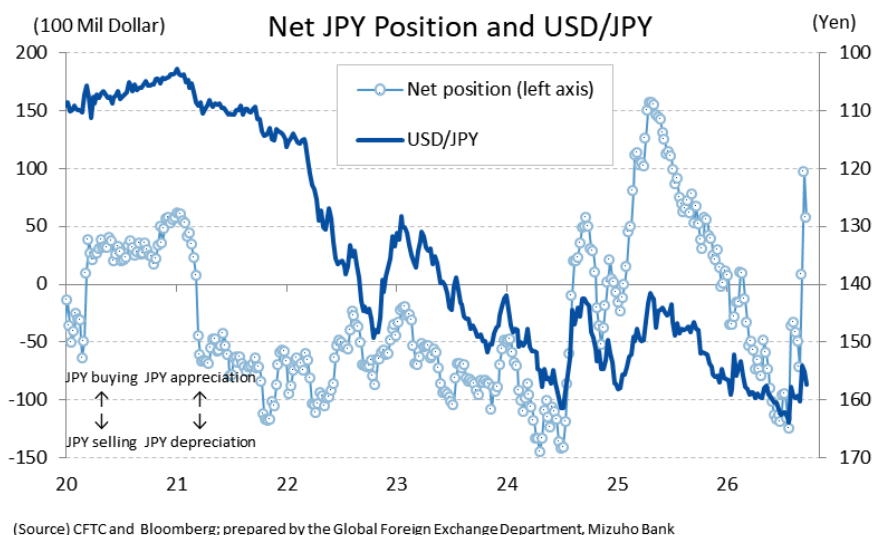
JPY Appreciation Cannot Fully Offset High Crude Prices

The biggest issue, however, is with cause (2). Whichever way you think about it, the situation in this regard is moving toward heightened downward pressure on JPY. I will present my JPY supply-demand forecast for the year taking into account the August trade statistics in a later section, but if we assume a USD/JPY rate of 153 and crude prices at USD 100/barrel (which are the levels at the time of writing this report), Japan's trade deficit for 2026 is likely to hit roughly -JPY 9 trillion. Had it not been for the import reduction achieved by releasing crude oil reserves (worth roughly -JPY 5 trillion as per my estimates), the trade deficit would have been the second highest on record at roughly -JPY 14 trillion, following from the 2022 figure (about -JPY 20 trillion). Given that there are no signs of a major reversal (decline) in crude oil prices, even if USD/JPY were to fall to 145 or so, if crude oil prices remain at USD 100/barrel or so, the trade deficit will only improve by roughly JPY 1 trillion to -JPY 8 trillion or so. Again, if USD/JPY fell to 145 but crude oil prices rose to USD 110/barrel, the trade deficit will deteriorate to roughly -JPY 9.5 trillion or so. With the import value being more sensitive to crude oil prices than to USD/JPY, no major improvement in the trade deficit is possible even with a significant correction of JPY weakness if crude oil prices remain high. Consequently, JPY-selling pressure is likely to persist.

True Test of JPY-Buying Resolve

In fact, the Tokyo forex markets have been battling the surety of a widening trade deficit since June amid efforts to secure alternative procurement routes that bypass the Strait of Hormuz. It is unreasonable to ignore this reality and expect the tides to turn based on strong remarks by Bessent and qualitative declarations “that the correction of JPY weakness has only just begun.” Given the impulsive nature of the forex market, it is not impossible that market forces betting on Bessent's influence could help reverse the trend, but that is no excuse to turn a blind eye to the actual state of affairs as indicated by the quantitative data. My view is that, one must take the situation in the Middle East and its impact on crude oil prices at least as seriously as Bessent's remarks when it comes to gauging JPY rates for the time being.

IMM currency futures transaction data as of September 22 shows a significant accumulation of JPY long positions, to the tune of +JPY 5.72 billion. Causes (1) to (3) discussed in prior sections notwithstanding, it is untenable for JPY long positions to continue accumulating at this pace. The motives required for covering shorts and adding to longs are different. Bessent's remarks triggered a rapid unwinding of short positions, but it could merely have been the perfect excuse for traders to lock in a profit. The effectiveness of Bessent's remarks in provoking an accumulation of long positions, however, remains somewhat uncertain. One could argue that this is a true test of speculative JPY buying resolve, but unless a significant change in the fundamentals can be predicted, I remain unconvinced.



JPY Supply and Demand Climate – Start of a Clear Collapse in Demand

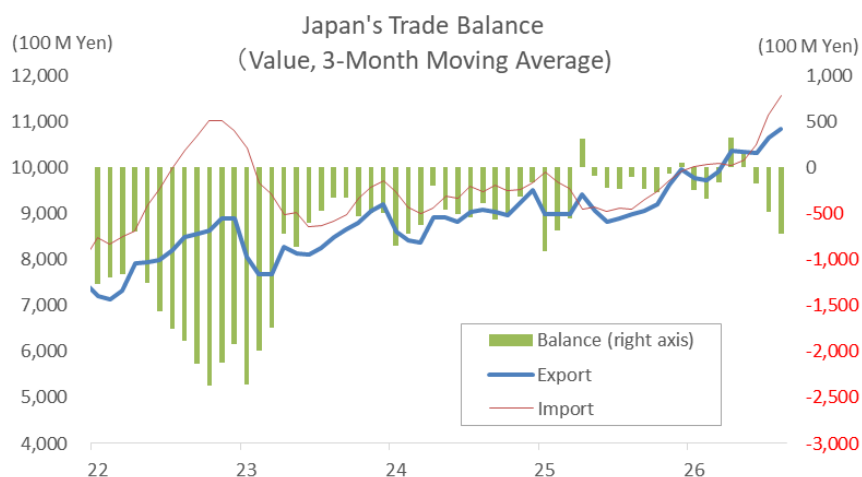
Fading Levels of Blind Faith in Bessent

As mentioned above, though JPY appreciated gradually following remarks from Bessent and other senior officials, it eventually slipped back again toward the end of the month. Even if a revision of expectations is attempted through strategically placed official remarks, the fact remains that a certain number of market participants who need to sell JPY and buy USD for practical purposes exist in the Tokyo forex market. While each of their circumstances may differ, while analyzing trends, it becomes obvious that the larger Japan's trade deficit, the larger the number of such participants will be. Official statements have the ability to influence market trends only when they align with the direction of the fundamentals, such as interest rates and supply and demand. Repeating without solid backing from the fundamentals that the rates are bound to reverse because the Treasury Secretary said so is not analysis but opinion. Of course, the authorities may reveal a "secret weapon" going forward that they have not yet revealed, and we could see increased JPY buying again at that time. However, one reason why JPY ultimately weakened again is probably because an increasing number of market participants began to lose confidence in the existence of this "secret weapon."

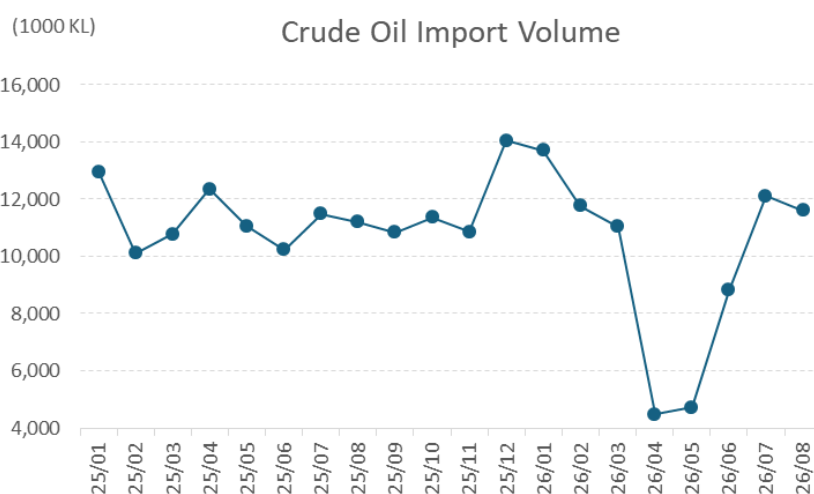
Trade Deficit Widens as Expected

Japan's August trade statistics, released in September, are important for understanding the direction suggested by the fundamentals. In this report, I have continued to update my trade balance simulation on a regular basis since March, and have predicted a deterioration in the trade balance accompanied by JPY weakening from July onward. For the past six months, one of my key assumptions in this report has been that, once alternative crude oil sourcing is normalized, higher prices and regular import volumes will combine to cause the trade deficit to "fall off the cliff" (undergo a sudden sharp expansion). Things are, indeed, proceeding as per my predictions. JPY rates since the Iran attacks have been quite volatile, thanks to currency policy coordination between the U.S. and Japan and the subsequent strengthening of rate hike forecasts, but the trade deficit has by-and-large been steadily declining as predicted, and JPY rates seem to be influenced by this as of the moment. In August, Japan's trade balance was -JPY 1.1056 trillion, a deficit for the fourth month in a row, and the level was also the highest seen in seven months, since January, when trade was affected by the Chinese New Year. While exports continued their considerable expansion, at +19.3% yoy, driven by semiconductors and other electronic parts, imports grew even more substantially, at +28.0% yoy, resulting in a widening of the deficit. The phenomenal growth in semiconductor and other electronic parts exports, at +52.7%yoy, was outpaced by imports of raw and crude oil at +58.7% yoy.

As I will explain later, the impact of rising crude oil prices on customs statistics seem highly likely to become persistent with the diversification of procurement channels, so this bloating of the import value may only just have begun. In other words, the trend seen in August could well continue for the time being. Of course, there is now turmoil surrounding Saudi Arabia's East-West Pipeline as well as the Bab-al-Mandeb Strait linking to the Red Sea, which were considered near-term alternatives to the Strait of Hormuz. In other words, just as crude oil import volumes had finally returned to normal (posting +3.6% yoy for August; see graph), there is now a risk of them being suppressed again, resulting in the need for the release of crude oil reserves again. If so, there will be a repeat of the sharp narrowing followed by rapid expansion of the trade deficit as seen from March this year.



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



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Increasingly Sticky Crude Oil Prices and Structural Changes in the Lag

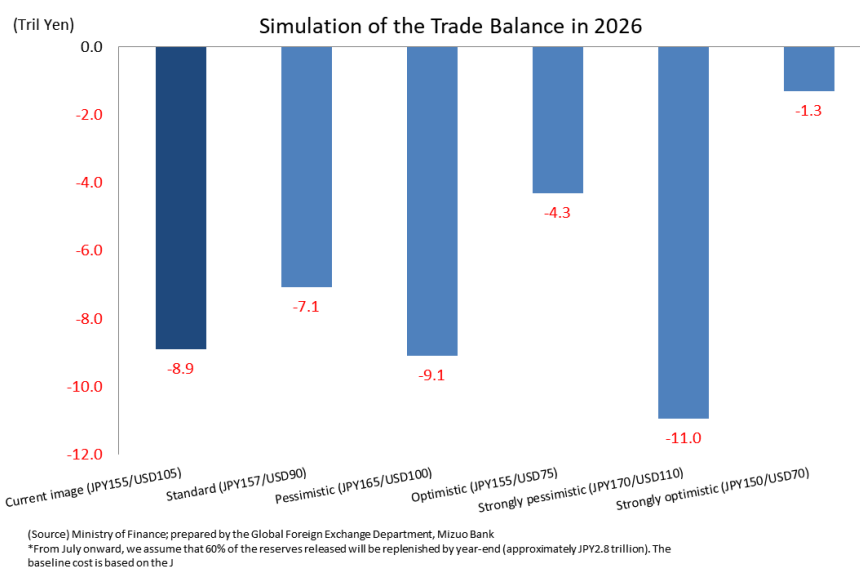
This is my own speculation, but it seems likely that an increase in U.S. crude oil imports will result in greater “stickiness” of the impact of crude oil prices on trade statistics. It has been noted, based on experience, that crude oil prices tend to be reflected in import value with a lag of around two months. This is based on the assumption that the previous month’s average price is referenced when calculating the price of crude oil being loaded. This creates a one-month time lag. Further, it has traditionally taken just under a month for very large crude carriers (VLCCs) to complete the journey from the Middle East (Persian Gulf) to Japan, which was the route for a majority of Japan’s crude oil imports. Since the entire process, including cargo handling, took roughly a month, the assumption was that transit caused a one-month time lag. Of course, these are rough assumptions based on experience, and there may be other factors to take into account for more precise practical analyses, but I have taken the above structural framework as a reference when analyzing JPY supply and demand.

The share of U.S. crude oil in Japanese crude imports has increased greatly since June. Naturally, this would be transported to Japan via a different route, which significantly changes the transit time. For instance, it takes 30-40 days via the Panama Canal, and roughly 45 days via the Cape of Good Hope (at the southern tip of Africa), both of which are longer than the route from the Middle East. While the distance is shorter in the case of the former, vessel size restrictions mean that medium-sized tankers rather than VLCCs need to be used, which increases the number of trips made. VLCCs can be used in the case of the latter, but it is a longer route in terms of the number of days required. I will not go into the details here, but switching from the Middle East to the U.S. for crude oil procurement could increase the transit time from roughly a month previously to roughly 1.5-2.0 months.

This means that, the “roughly 2-month” time lag for crude oil prices to be reflected in custom statistics (as suggested by experience so far) could now be extended to a time lag of 2.5-3.0 months. In other words, it could take up to one quarter (three months) for crude oil price fluctuations to be reflected in import value going forward. In other words, even after crude oil prices have peaked, since U.S. crude oil purchased at high prices will arrive in Japan with a time lag, the trade deficit will take longer to shrink, and JPY-selling pressure based on actual demand may become persistently protracted. In considering the JPY rate outlook using quantitative data, one may need to factor in this structural change in the time lag resulting from a diversification of procurement routes.

New Trade Balance Simulation

With this structural change in the time lag related to shipping times adding to already volatile exchange rates and crude oil prices, forecasting the trade balance has become more difficult. Originally, I assumed a USD/JPY rate of 157 and crude oil price of USD 90/barrel for my standard forecast scenario in this report. While I would like to keep the assumed USD/JPY rate unchanged, my impression is that crude oil prices have gone up slightly. Since the trade balance tends to be more sensitive to crude prices, I fear the trade deficit could be larger than originally predicted in the standard scenario at this rate. While the simulation puts the trade deficit at -JPY 7 trillion to -JPY 9 trillion, the lower bound of the deficit could improve to -JPY 5 trillion to -JPY 6 trillion if Japan holds off on reserve replenishment. At any rate, with a trade deficit nearly twice that of the previous year’s -JPY 2.9 trillion predicted for 2026, correcting JPY weakness remains difficult from the JPY supply-demand side.

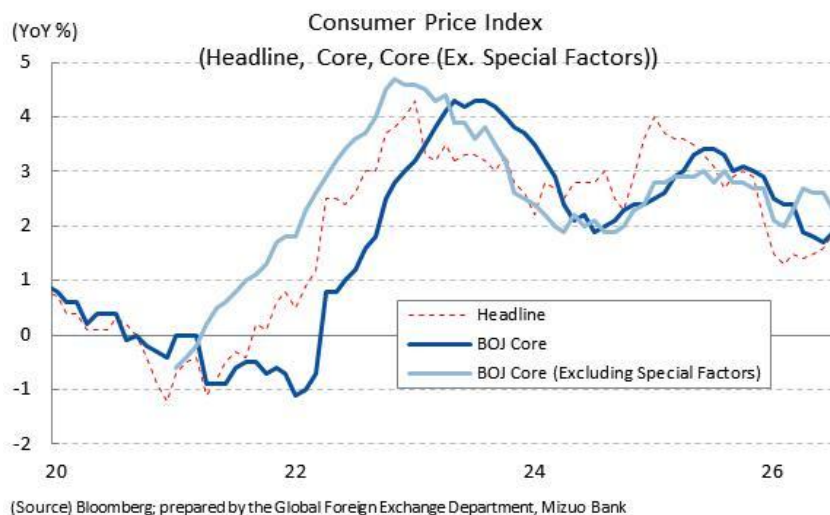


BOJ Monetary Policies Now and Going Forward – Rate Hike Card Wasted

Wasted Rate Hike Card

At its September 18 Monetary Policy Meeting (MPM), the BOJ decided to increase its target for the uncollateralized overnight call rate to 1.25% by a majority vote. This is the highest the rate has been in 31 years, since 1995. This rate hike comes roughly three months after the previous one in June. Incidentally, the pace of rate hikes since exiting negative interest rates in March 2024 was viewed as once in six months, so the recent rate hike could be seen as signaling an increase in the pace. The rate hike decision was not unanimous, with Policy Board members Asada Toichiro and Sato Ayano dissenting, which had a major impact (details later). Asada’s reason for dissenting was that “with the rate of increase in the [BOJ Core] CPI (all items less fresh food) being below 2 percent recently, it could not necessarily be said that the economic situation was strong.” Sato’s reason was that “current economic and price developments did not appear to have substantially accelerated compared to before, and in this context, it was not appropriate for the Bank to raise the policy interest rate at this time.”

In other words, both the dissenting members felt that inflation was not strong enough, which is an argument that is rather difficult to comprehend. It is widely known that the modest inflation growth since spring is attributable to policy factors such as energy subsidies and high school tuition fee waivers. For instance, the average growth rate of the BOJ Core CPI between March and July has been +1.9% yoy (all yoy figures below), consistently remaining below 2%. However, if you remove policy-related and other special factors, the average growth rate for the same period rises to +2.5% (see graph). It would be interesting to learn how the above two



Policy Board members factored in such growth figures published by none other than the BOJ itself when considering policy-related decisions. Of course, Japan's reliance of foreign imports for its energy needs is especially high among major nations, and it is not unusual to view its conspicuously low inflation rate as exceptional. One must humbly accept the stability created by discretionary macroeconomic policies in assessing the state of Japan's economy and prices.

At any rate, from a currency defense standpoint, it is unfortunate that the two dissenting votes based on questionable logic resulted in an invaluable rate hike triggering JPY selling in the forex markets. The official statement also cited three factors – namely high crude oil prices, increase in AI-related demand, and JPY weakness – as upside risks to prices. The first two apply also to the U.S. and Europe, but JPY weakness is unique to Japan and warrants careful monitoring.

Policy Environment Reflects Internal and External Pressures

Originally, there were expectations that the more hawkish members of the Policy Board (Takata Hajime and Tamura Naoki) would propose a +50bp rate hike, with some fearing that JPY may continue to weaken unless they did. In the event, it turned out that even a modest +25bp rate hike decision was not unanimous, revealing internal divisions within the Policy Board. Whatever the truth of the matter may be, the markets perceive the two dissenters as having been appointed with political motives. Their dissenting votes amid strong calls for tighter monetary policy from the U.S. completely neutralized the already waning clout of Treasury Secretary Bessent. This was also one of the reasons behind JPY rate volatility following the meeting.

The markets could have paid more attention to BOJ Governor Kazuo Ueda's remark at his press conference that the "phase has changed," or his other remarks emphasizing that +50bp rate hikes and other specific measures could be implemented going forward depending on inflation trends. Ultimately, however, the effectiveness of these remarks was also canceled out by the internal discord. As I have argued repeatedly in past issues of this report, the September rate hike itself was an action suggested in the July Outlook Report. The U.S.-Japan joint currency intervention and remarks by Bessent merely smoothed the way for implementing the rate hike.

Unfortunately, it would appear that not only did the BOJ's independent decision to implement a +25bp rate hike based on its own analysis end up being misunderstood as caving to external pressure, the effectiveness of that decision was also nullified by internal pressures. One can only imagine the challenges faced by the BOJ leadership in this policy environment beset by troubles both internally and externally. Moreover, as already reported, there are reports of a potential rate check, causing JPY rates to shoot up before the long weekend. There seems to be an ongoing cycle of JPY weakness caused by monetary policy (communications) that is then suppressed using currency policy measures. As I have argued many times, unless monetary and currency policy are both consistent and face the same direction, the battle to defend the currency is prone to drag on with no end in sight.

Surpassing the Neutral Interest Rate and Significant JPY Depreciation

When the markets sell JPY following a monetary policy decision to raise interest rates, they are communicating that the rate hike was "too little too late," and urging policymakers to do more. This is the situation that is called "being behind the curve." Let us assume that the neutral interest rate is close to 2% as the market assumes. If the BOJ is behind the curve, there is no guarantee that the neutral interest rate level will serve as the end point of rate hikes (terminal rate). Considering the possibility that the delay will end up necessitating an even more restrictive policy environment, the 2% neutral interest rate level may be no more than a transit point, with the situation demanding a policy interest rate exceeding that level. If monetary and currency policies continue to contradict each other as they did this time, rate hikes cannot be used as an effective currency defense card, so one must be prepared for the policy interest rate to approach and then pass the 2% mark, which is viewed as the neutral interest rate level. If things come to this, it seems very likely that USD/JPY will become established at the 160 level. In this report, I have been consistently warning of this scenario unfolding.

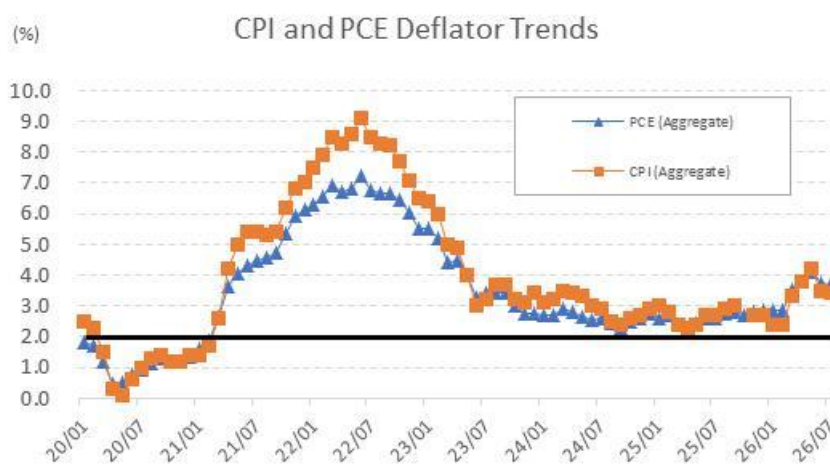
Further, while the two dissenting votes may become a regular feature of rate hike decisions going forward, the fact remains that the majority of voters are in favor, so the hysterical market response is likely to gradually fade away. The real risk is that, following the appointment of new Policy Board members next July, the number of dissenting votes could double to four (or more). Of course, decisions can still be passed with a 5-4 majority vote, but this would

significantly raise the hurdles for achieving consensus, and market responses similar to the recent one can naturally be expected. In such a situation, the BOJ may put off forcibly implementing rate hikes and rely instead on currency policy measures alone. Naturally, this would hasten the pace at which the country's forex reserves are depleted, raising concerns of emboldening speculative traders. This is one of the key downside risks to JPY during the current forecasting period.

U.S. Monetary Policy Now and Going Forward – Curbing JPY Depreciation will be Increasingly Challenging

The Start of a Rate-Hike Phase

A +25bp rate hike was decided as per market expectations at the September 15-16 FOMC meeting, bringing the target range for the federal funds (FF) rates to 3.75-4.00%. The 12 voting members all supported the rate hike. This was the first rate hike in three years and two months, since July 2023, and it marked an end to the rate cut phase that began in September 2024 in its second year. In his press conference after the meeting, Fed Chair Kevin Warsh clearly indicated the need to contain inflation, saying “inflation is too high and has been for too long,” and “too many categories are still posting increases above 3 percent on both a 6- and 12-month basis.” In fact, inflation has consistently been growing at a rate consistently above the +2% target in recent months (see graph) and, as is widely known, market interest rates showed a clear rise after the FF rate target range was kept unchanged twice in a row following Warsh's appointment as Fed chair (immediately before the meeting, U.S. 10-year interest rates hit the 5% level during trading hours for the first time since 2023). Naturally, the Committee had no choice but to raise rates. While this is merely my speculation, could it be that Warsh deliberately maintained the status quo in order to make U.S. President Donald Trump realize the need for a rate hike? As he has stated several times, Warsh is of the opinion that the financial markets should learn to think for themselves rather than wait to be fed information. It seems possible that his approach to communicating with the president is based on the same idea. After all, a rate hike necessitated by market pressures is less likely to cause political friction.



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

Dot Plot Diverges from SEP

Immediately following the meeting, Trump posted on Truth Social saying, “LOWER THE INTEREST RATES FOR THE UNITED STATES OF AMERICA, AND FAST!” having presented his theory that “Interest Rates in the United States should be 1%, or less, because we are the Best Credit in the World — BY FAR.” Earlier this month, Trump had posted saying, “The Fed Board, with its great new leader, must get smart - BE PATRIOTS for a change.” There has been no change in Trump's preference for low interest rates even after the inauguration of the new Fed administration under Warsh. While there has been no overt criticism of Warsh himself so far, it will be interesting to see how long the relationship between the two men remains amicable amid rate hikes coinciding with falling U.S. share prices.

Regardless of Trump's words and actions, it is safe to assume that there will be additional rate hikes. The dot plot, which shows the FF rate projections of all FOMC members excluding Warsh, no longer carries the same weight it once did, but it is still worth taking note of for reference. In the latest dot plot, 12 members predicted one more rate hike to be implemented in one of the two meetings remaining this year (October and December), while four members predicted two rate hikes, and two members predicted no rate hikes. The median was 1 more rate hike for 2026 and none for 2027. However, looking at the

FRB Economic Projections (General outlook, %), *As of Sep 2026

	2026	2027	2028	2029	Long-term outlook
Real GDP growth rate (As of June)	2.3 (2.2)	2.4 (2.3)	2.2 (2.2)	2.1	2.0 (2.0)
Unemployment rate (As of June)	4.1 (4.3)	4.1 (4.3)	4.1 (4.2)	4.1	4.2 (4.2)
PCE deflator rate (As of June)	3.7 (3.6)	2.3 (2.3)	2.1 (2.0)	2.0	2.0 (2.0)
PCE core inflation rate (As of June)	3.4 (3.3)	2.5 (2.5)	2.2 (2.1)	2.0	

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

summary of economic projections (SEP), also by FOMC members, the core personal consumption expenditure (PCE) deflator is projected to converge at 2% only in 2029 (see table). In other words, the dot plot and SEP seem to be

contradicting each other. Incidentally, interest rate futures markets have factored in one more rate hike for 2026 and 2-3 rate hikes for 2027 as of the writing of this report, revealing a conflict between market expectations and the dot plot as well. I think it is likely that, sooner or later, the FOMC's assumed rate hike path will be raised, and the Fed's communications will adopt a more hawkish tone.

The Contest Remains Close Even After 3 BOJ Rate Hikes

Following the meeting, USD/JPY surged; it is possible that many observers concluded that it would be difficult for the Japanese government/BOJ to contain JPY weakness for some time to come. On the supply-demand side, the situation is increasingly exerting downward pressure on JPY with a trade deficit of over -JPY 1 trillion posted for a single month (August), and now it has to be said that there are headwinds for Japan in its efforts to curb JPY weakness from the interest rate side as well. In the end, though market participants had factored in several rate hikes by the BOJ, they are now factoring in a similar number of rate hikes by the Fed too. In fact, the pace of rate hikes factored in for the BOJ is rather slower than that factored in for the Fed; from a nominal perspective, therefore, the U.S.-Japan official interest-rate differential is expected to continue at its current level.

Taking domestic political and economic situations into consideration, it is difficult to say whether both countries will, indeed, be able to implement consecutive rate hikes smoothly, but it is certainly a painful truth for the Japanese economy if the BOJ's interest rate level cannot catch up with that of the Fed even after three rate hikes. Even if it had been true that three rate hikes by the BOJ in the next year or so would have relieved the downward pressure on JPY, the impact of higher crude oil prices are likely to weigh down the trade balance for some time to come, with a longer time-lag than previously (as explained above, transit times for crude oil transport to Japan will inevitably lengthen). Under such circumstances, my position (at the risk of repeating myself) is that it is dangerous to gleefully declare a shift to JPY appreciation based solely on stern warnings to the markets by Bessent. Of course, it is important to continue paying attention to major signals to the market derived from remarks by key officials, but the crucial point is to verify the validity of a forecast based on the current state and future outlook of fundamental economic indicators.

Risk to my Main Forecast Scenario – When the Public Accepts JPY Weakness

Markets Becoming Desensitized to Remarks by Officials

Following an online meeting between Bessent and Japan's Finance Minister Satsuki Katayama stated at a press conference, "We reaffirmed that the undervaluation of the yen – which was also discussed at the Japan-U.S. summit – is a problem." Bessent also posted on X saying, "We discussed the desirability of a strong yen that reflects Japan's strong economic fundamentals, and the importance of staying in close communication on currency markets." The forex markets immediately reacted, causing USD/JPY to fall sharply from the 158 to 156 level. The above remarks come on the heels of Trump expressing concern over JPY's depreciation to Prime Minister Sanae Takaichi at the U.S.-Japan summit meeting held on September 22, indicating strong upward pressure on JPY from the U.S. The markets' reaction is, therefore, natural, given the possibility of specific measures (such as joint currency interventions, as a symbolic example) suddenly being implemented.

However, the fact remains that the markets are becoming desensitized to such remarks from key officials. Bessent, especially, has been repeatedly issuing stern warnings, including his famous "I am the house now" remark, but can he really do anything other than implement a joint currency intervention – does he really have any measures that could fundamentally reverse market participants' weak-JPY expectations? Even if communications heat up, without any change in the measures to back up these communications, the only result will be an increasing distance between expectations and reality. As I have said in past issues of this report, the Japan-side factors cited over the past few years as promoting JPY weakness have been (1) the distortion of JPY supply-demand, as reflected in the trade statistics, (2) delayed rate hikes in monetary policy, and (3) loss of fiscal policy discipline. The forex markets are urging actions aimed at correcting of each of the above factors. Senior officials simply confirming what the vast majority already know – namely that a stronger JPY is desirable – is insufficient to reverse expectations.

The Rate Hike Logic

With regard to (2) above, it must be noted that the BOJ recently raised its official interest rate to 1.25% at its September MPM. In this context, as mentioned above regarding the BOJ, unless monetary and currency policy are both consistent and face the same direction, the neutral interest rate level may be no more than a transit point for BOJ interest rate hikes. This is because rate hikes will not work on forex market trends (JPY weakness) as expected, resulting in additional rate hikes with no effect. The problem is that rate hikes, even if ineffective in changing forex market trends, will have an impact on the economy – specifically in suppressing the economy. Since this report provides economic and financial analysis centering on forex market trends, it tends to focus on decisions to implement successive rate hikes from the perspective of curbing JPY depreciation. Whether or not a 2.25-2.50% official interest rate level can be accepted when the impact on the Japanese economy as a whole is considered is a different question. There may come a point when it is felt that rate hikes should be ended even at the risk of some JPY depreciation, and when the public begins to call for this, JPY depreciation could enter a new phase (details later).

In my various lectures and seminars, I do in fact get questions from people who ask if the Japanese economy can, indeed, tolerate rate hikes to that level. My response tends to be that, in the context of protecting the currency, the issue of whether the Japanese economy can tolerate a certain level of rate hikes or not is beside the point. In practice, the current phase of rate hikes is clearly attempting to suppress JPY weakness based on the view that this is a factor contributing to economic stagnation. If so, it follows that the logic behind rate hikes is to continue them despite their

side effects until JPY decline is halted. Historically, and around the world, the fact is that rate hikes intended as currency-defense measures have been painful decisions that require sacrificing economic growth.

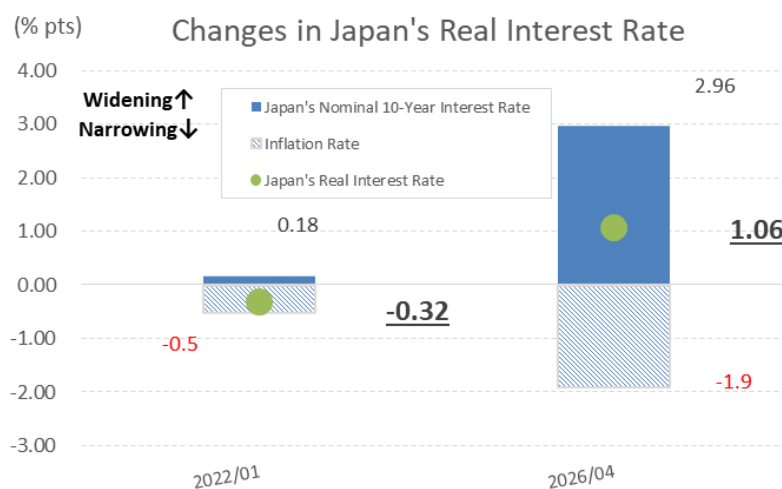
Neutral Interest Rates Already Exceeded in Terms of Real 10-Year Interest Rates?

If rate hikes are continued, there will come a time when they begin to curb both household and corporate sector consumption and investment activities. While interest rates on housing loans, which the media loves to bring up, are an obvious area of impact, corporate investment activities will also see changes. It is difficult to specify what level of interest rates will prove fatal for the Japanese economy, but at the current time, the median of market forecasts seem to suggest that the fear of derailing the economy is unlikely to emerge until interest rates begin to approach the assumed neutral interest rate level of 2.00%. In this context, Japan's real 10-year interest rate level has already hit roughly 1% (assuming a nominal yield of roughly 3% minus a Bank of Japan core inflation rate of about 2%), surpassing the real potential growth rate, which is assumed to be close to zero percent. Given that Japan's fiscal status is a matter of great concern in the financial (especially bond) markets, some think that the long-term interest rate level, which also factors in fiscal risk premium, has a larger impact than the official interest rate does.

If such a view is given priority, BOJ rate hikes may end before the official interest rate reaches the 2.00% level. If so, the Japanese economy will have to accept some level of JPY depreciation in exchange for the end of rate hikes, which could launch a new phase of USD/JPY battling at the 160 level.

Analyzing the Factors of Real Interest Rate Rise

If we categorize the factors of real interest rate rise over the past four years into inflation-related and nominal-interest-rate-related factors, the latter have a greater contribution (see graph). These include (1) the loosening of bond market supply and demand due to a gradual reduction in the BOJ's government bond purchases (quantitative tightening), and (2) heightened caution among private financial institutions regarding bond prices resulting from the BOJ's move to unwind its ultra-low interest-rate policy. With price support from the BOJ gone (both from supply-demand and price sides), it is reasonable to assume that the risk premium (fiscal premium), which had until then been masked, had to be normally priced in. If it is simply a question of the risk premium, which had so far been hidden, becoming apparent, there is no need for excessive pessimism (or optimism). However, if fears surrounding proactive fiscal expansion, symbolized by consumption tax cuts, are also factored in, a revision of the fiscal stance may be useful for bringing down the market interest rates.



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

Relying on Households to Absorb Government Bonds?

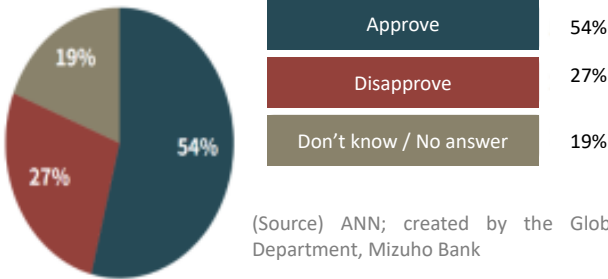
If, however, the current political administration's basic stance regarding fiscal policy remains unchanged, this may give rise to the idea of radically changing the existing structure through which government bonds are absorbed. The fact that government bond products with improved features aimed at individual investors are being considered with a view to increasing the household sector's government bond absorption capacity can be understood against this background. In fact, as of the writing of this report, the 10-year floating-rate government bond yield (for the September offering) stands at 1.95%, which is higher than the variable mortgage rates that have been a source of concern. In theory, this should result in households considering a shift from JPY-denominated cash and deposits to government bonds going forward. Considering that available JPY-denominated cash and deposits exceed JPY 1100, it will be interesting to see to what extent such a move contributes to suppressing real interest rate levels. Incidentally, the household sector's bond (i.e., government bond) holding ratio in the U.S. and euro area are under 5% and 3%, respectively, while that in Japan is under 1.5%. Not to say that the U.S. and European ratios are ideal, but when interest rates are positive, a larger number of investors find earning bond yields more attractive than the convenience of holding cash and deposits, which inevitably raises the ratio of bond holders. Whether the handover of government bond absorption from the BOJ to the household sector will proceed smoothly is a key factor in determining whether or not the current rate hike phase can achieve a soft landing.

New JPY Depreciation Phase Could Begin Depending on Public Opinion

Since 2022, the Japanese economy and financial world have faced a choice between higher interest rates and weaker JPY, and accepted the latter. Recently, however, there is an increasing sense that interest rate hikes are unavoidable. Politics and public opinion at the time dictate which choice is made. In this context, the latest public opinion poll (September ANN survey, implemented on September 19-20, 2026), implemented right after the BOJ MPM is a useful point of reference. The survey revealed massive support for rate hikes, with 54% responding that they “approve,” while only 27% responded that they “disapprove” (a considerable gap). Public opinion at the current time is tilted heavily in favor of curtailing JPY depreciation. Having said that, there is no guarantee that this opinion will remain the same forever. At some point, if the public decides that they want rate hikes to end, the political establishment cannot afford to overlook this. When the public decides that JPY depreciation is preferable to further interest rate hikes, the BOJ will stop raising interest rates, and JPY depreciation could enter a new phase. This must be noted as a potential scenario of JPY depreciating beyond expectation. The reason central banks are given a measure of independence is so that they remain capable of implementing unpopular decisions if the experts believe that such decisions are correct. However, looking at the BOJ’s policy operations so far, it is difficult to imagine it being capable of quietly implementing decisions that the public vehemently opposes. While not something that is of concern in the near term, this is one of the downside risks to take into account going forward.

BOJ Interest Rate Hike

The Bank of Japan has decided to raise its policy interest rate to 1.25%. Do you approve or disapprove of this decision?



(Source) ANN; created by the Global Foreign Exchange Department, Mizuho Bank

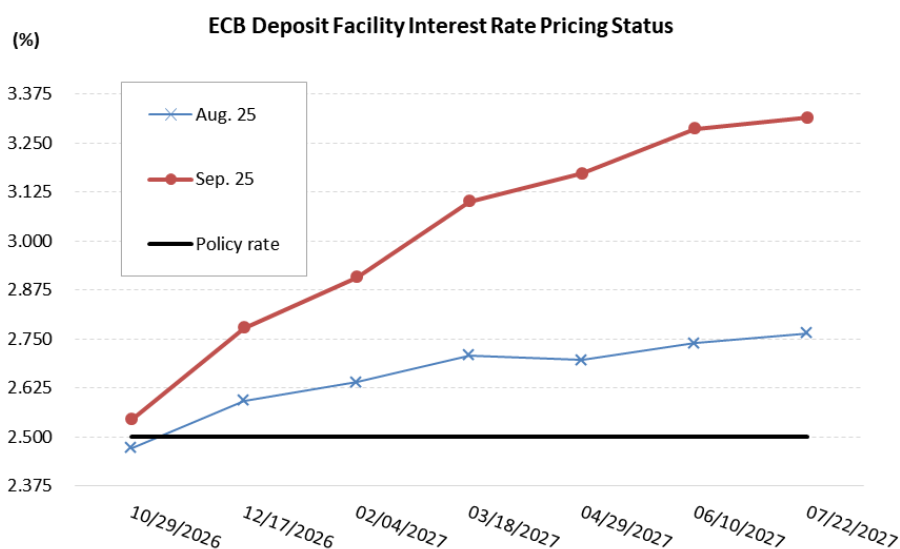
EUR Outlook – Rising Interest Rate Hike Expectations and Political Uncertainty in Germany

EUR Area Monetary Policies Now and Going Forward – Back to Square One on Interest Rate Hikes

Pricing-In of Interest Rate Hikes Reverted to Pre-Iran-Attack Levels

At its September 10 Governing Council meeting, the ECB decided to raise its key policy rate (the deposit facility rate) by 25 basis points, to 2.50% – the first rate hike since the June 11 hike. The meeting's statement concisely explains the rationale, saying – “The conflict in the Middle East continues to generate inflation pressures, and inflation is set to remain well above target for an extended period.” At the time of the meeting, the most recent euro area Consumer Price Index (HICP) figure (for August) showed a strong overall-basis increase of 3.3%, with energy prices surging by 14.3% – the largest increase since the attacks on Iran began. The price of North Sea Brent crude futures (the benchmark for European crude oil prices) exceeded USD95 per barrel as of August 29, and natural gas prices also remained stubbornly high. This situation was compounded by various supply constraint factors, such as agricultural commodity price increases owing to an extreme heatwave and European logistics network disruptions caused by low water levels in the Rhine River. As electricity demand peaks during the winter months, it is anticipated that supply side inflationary pressures are likely to intensify further.

Given the unexpectedly rapid rate of inflation, the decision to raise interest rates was quite reasonable, as ECB President Lagarde emphasized at the press conference, stating, “our [inflation] projections are [above the] target. So, the decision that we took today – which was, by the way, a unanimous decision, – was a no-brainer.” As discussed below, the energy price surge has clearly exceeded the ECB's expectations, causing the prospective rate hike scenario – which until a month ago was thought to be “one more hike and done” – to become “one more this year, and three by next April” (see graph). While inflation expectations and the associated rate hike outlook had stabilized at once point, one now gets a strong impression that the situation has reverted to what it was right after the initial March-April attacks on Iran.



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

Staff Projections Merely Reference Figures

The newly revised ECB staff economic projections released in September, have increased both growth and inflation rates over previously predicted rates, reflecting the impact of higher-than-expected energy prices and the euro area economy's continued resilience. As discussed below, however, the projection figures should essentially be considered as reference figures that reflect the ECB's current expectations about future developments that are quite hard to predict. Compared

ECB Staff Macroeconomic Projections (Baseline scenarios and risk scenarios); all figures are YoY changes.

Item	Year	Baseline scenario as of June	Current baseline scenario	Milder scenario	Adverse scenario	Severe scenario
Real GDP	2026	0.8	0.9	0.9	0.9	0.8
	2027	1.2	1.4	1.5	1.1	0.4
	2028	1.5	1.5	1.6	1.4	1.4
HICP	2026	3	3	2.9	3.1	3.3
	2027	2.3	2.5	1.9	3.2	5.4
	2028	2	2.1	1.8	2.3	3.2
Core HICP (*)	2026	2.5	2.5	2.5	2.5	2.5
	2027	2.5	2.6	2.5	2.8	3.5
	2028	2.2	2.3	2.2	2.4	3.2

(Source) ECB; prepared by the Global Foreign Exchange Department, Mizuo Bank, *Excluding energy, food,

to the previous projections revised in June, the projected growth rate has been raised from +0.8% to +0.9% for 2026 and from +1.2% to +1.4% for 2027, while remaining unchanged at +1.5% for 2028. Regarding the overall-basis HICP growth rate, the forecast for 2026 remains unchanged at +3.0%, while the forecasts for 2027 and 2028 were revised upward from +2.3% to +2.5% and from +2.0% to +2.1%, respectively. With respect to the core-basis HICP growth rate, the forecast for 2026 remains unchanged at +2.5%, while the forecasts for 2027 and 2028 have been raised from +2.5% to +2.6% and from +2.2% to +2.3%, respectively. So the ECB is expecting increasingly high economic growth and underlying inflation rates, and it is reasonable to anticipate that additional interest rate hikes will be implemented in line

with that expectation. The problem is that these projections are basically tentative forecasts subject to upward revisions.

Significant Gap Between Assumed and Actual Energy Prices

The energy prices outlook is a key basis for evaluating the euro area economy's overall near-term outlook. The meeting's statement notes that – "The outlook remains highly uncertain, with upside risks to inflation and downside risks to economic growth." This suggests we are entering a difficult phase in which policymakers must plan their "next move" while constantly weighing the costs of leaving inflation unchecked against the costs of restraining growth through interest rate hikes. However, the current situation suggests that it is the "cost of leaving inflation unchecked" that is likely to be viewed as the relatively significant concern.

This is particularly likely to be true given that the recent energy prices surge does not appear to have been factored into the latest staff projections. Looking at the assumptions underlying the latest projections compared to those of the previous forecast, one finds expectations of lower crude oil and agricultural commodity prices, higher natural gas and electricity prices, EUR weakening, largely flat interest rates, and rising stock prices. For example, regarding crude oil prices, the projections report states that – "Oil prices have declined and are assumed to average USD 88 per barrel in the third quarter of 2026." – and this assumption represents a slight divergence from current levels, which have already surpassed USD100 per barrel. Of course, since the assumption is of an average for the entire third quarter (July–September), a divergence from current prices is to be expected. However, looking at the assumptions for the full-year outlook, the projections assume a downward trend – USD89.5 for 2026, USD78.0 for 2027, and USD73.6 for 2028 – and compared to the previous forecast, these figures have been revised downward by USD7.6, USD5.1, and USD4.6, respectively. As prices are now hovering around USD100, it is only natural to conclude that, barring a change in the trend, an upward revision to the inflation outlook in the December staff projections will be inevitable. The situation regarding natural gas is even more critical. At the post-meeting press conference, a reporter asked – "in June, your adverse scenario had gas at 60 euro [per MWh], we're now at 82. So, how close is the euro area today to the adverse scenario becoming the baseline?" The full-year projections assumptions do indeed anticipate a downward trend, with the gas price projected to be at EUR51.0 for 2026, EUR43.3 for 2027, and EUR30.3 for 2028. Leaving aside the figures for 2027 and 2028, it should be noted that the gas price is now 1.5 times higher than the baseline assumption of EUR51.0 for 2026.

In light of the current energy prices situation, that assumption must be considered merely a reference figure, and it is understandable that the markets are pricing in ECB interest rate hikes expected to be implemented in October or December. Moreover, the ECB's wage tracker and other indicators suggest that one cannot expect the euro area's employment and wage conditions to be strong enough to keep pace with the upward trend in inflation rates. While the regional economy is now showing surprising resilience, it may become necessary when anticipating additional ECB interest rate hikes to keep a close watch on stagflation risk levels. It is worth noting that, to a certain extent, this need to consider both inflation rates and stagflation risks also applies to those anticipating additional BOJ interest rate hikes.

Supplement: German Politics Now and Going Forward – "Firewall" on the Verge of Collapse

Has the Time Finally Come?

While turmoil in financial markets (driven primarily by rising US interest rates) dominates the headlines, a look at the political landscape reveals that Germany, Europe's leading economic power, is facing a historic turning point. This relates to the landslide victory achieved by the far-right "Alternative for Germany (AfD)" party in the state election held on September 6 in Saxony-Anhalt, located in eastern Germany. The AfD secured 39 of 83 available seats in Saxony-Anhalt's regional parliament (Landtag). Although it narrowly missed an absolute majority in the Landtag, it garnered a remarkable 43.8% of the vote, more than double the share of the Christian Democratic Union (CDU), which is the senior party in the coalition leading Germany's federal government.

Many of those who regularly follow German politics will likely feel that these results suggest that "the time has finally come", meaning that Germany's long-standing method of suppressing far-right parties may no longer be effective. Ever since the end of the second world war, there has been an unwritten rule among Germany's major political parties that generally prohibits the participation of far-right forces in government and specifically bans coalitions with far-right parties. Over the past decade or so, this convention (known in German as the "Brandmauer" or "firewall") has repeatedly been pushed to the brink of collapse, only to narrowly survive. As shown in the table, the major parties have successfully worked together to keep the AfD outside the firewall and out of the running for power in both the federal and state governments. In the 2025 federal parliamentary election, the AfD doubled its support from 10.3% in the previous election (2021) to 20.8%, surpassing the ruling Social Democratic Party (SPD, 16.4%), which was then the senior party in the coalition leading Germany's federal government headed by then-Chancellor Olaf Scholz. At that point, the AfD became Germany's second-largest party behind the CDU/CSU (28.5%). (The CDU is permanently allied with its Bavarian sister party (the Christian Social Union (CSU) in the German Bundestag, but the CSU operates exclusively in the state of Bavaria, while the CDU operates in the other fifteen German states.) In that election, the AfD secured 152 seats (up 69 from the previous term), resulting in a far-right party occupying roughly one-quarter of the Bundestag.

While the AfD's presence in national politics has become impossible to ignore, a look back at recent state elections reveals that it was merely a matter of time before the party would win this kind of landslide victory. In the state legislative elections held two years ago (2024) in three eastern states, the AfD secured 32.8% of the vote in Thuringia, and it was widely noted that this was the first time a far-right party had become the largest party in a post-war German state election. In the other two states where elections were held at the same time, the AfD secured second place, garnering 30.6% of the vote in Saxony and 29.2% in Brandenburg. However, the firewall was maintained in both states, as the other parties flatly refused to enter into coalition negotiations with the AfD.

It is worth noting that at levels below the state (such as municipalities and counties) there are already cases where governance is impossible without the AfD. For example, in the June 2023 runoff election for district administrator in Sonneberg, Thuringia, an AfD candidate won 52.8% of the vote and became the district's first AfD administrator. Similarly, in the December 2023 mayoral election in Pirna, Saxony, an AfD candidate secured 38.5% of the vote in the runoff and became the city's first AfD mayor. Cracks in the "firewall" had already begun to appear at the grassroots level of local government, as evidenced by the CDU party leader making remarks that hinted at cooperation with the AfD at the local level, only to be forced to retract them later. Thuringia has been a particular source of controversy. During the state's ministerial-president election in February 2020, a Free Democratic Party (FDP) candidate won by securing votes not only from his own party and the CDU but also from the AfD. The emergence of a leader backed by the far-right sparked a fierce backlash as the first instance of the firewall collapsing, and the FDP candidate in question was forced to resign just a few days later.

Steady Growth in AfD Voter Support

Year	Election/Event	AFD Share of Votes	Outline/Impact on Firewall National Election	National Policies
2013	Foundation/Federal Election	4.70%	Founded on an anti-EUR platform; failed to enter the national parliament due to missing the 5% electoral threshold.	
2014	State Elections in Three Eastern States	9.7% ~ 12.2%	Won seats in states such as Saxony and Thuringia; major parties began adopting a stance of refusing cooperation (the "firewall")	
2017	Federal Election	12.60%	Entered the national parliament for the first time as the third-largest party; major parties more strongly declared a "firewall" refusing AfD participation in any coalition.	○
2019	State Elections in Three Eastern States	23.4% ~ 27.5%	Secured over 20% of the vote in the east, surging to become the second-largest party in each state; pressure on the "firewall" intensified further.	
2020	Thuringia Government Crisis	-	An FDP candidate was elected state minister-president with AfD votes (resigning days later); this sparked a massive backlash as the first instance of the "firewall" effectively collapsing.	
2021	Federal Election / Saxony-Anhalt State Election	10.3% (national) / 20.8% (state)	Saw a slight decline at the national level but maintained solid support in eastern states.	○
2023	Local Mayoral Elections (Runoffs)	38.5% ~ 52.8%	Won district administrator and mayoral posts in Thuringia and Saxony for the first time; the wavering of the "firewall" at the local level became pronounced.	
2024	State Elections in Three Eastern States	29.2% ~ 32.8%	Became the largest party in Thuringia (the first time a far-right party achieved this in the post-war era), though a total refusal of cooperation by other parties prevented them from taking power.	
2025	Federal Election	20.80%	The party surged to become the second-largest force in national politics, garnering 20.80% of the vote (double its previous support level). The emergence of this massive opposition party caused the difficulty of maintaining the "firewall" to skyrocket.	○
Sep 2026	Saxony-Anhalt State Election	43.80%	The party achieved a historic landslide victory (placing first) with 43.80% of the vote, coming within a whisker of an absolute majority. With the upstart left-wing party BSW signaling a willingness to cooperate on specific issues, the firewall faced its most critical threat of collapse.	

(Source) Various sources; created by the Global Foreign Exchange Department, Mizuho Bank

Thus, in the thirteen years since its 2013 founding, the AfD has steadily grown into a force that makes its presence felt throughout the landscape of German politics. In light of this protracted trend of growing support, it gradually became clear that if the first-ever far-right-led state government were to be formed it would not be a particularly big surprise.

Deciding Vote Lies with Emerging Left

At the time this article was written, it had not yet been decided whether an AfD-led state government will be formed in Saxony-Anhalt. Unlike traditional political parties, an emerging left-wing party, the Sara Wagenknecht Alliance (BSW), is reportedly open to cooperating with the AfD, and there is speculation that the two parties may find common ground on key issues such as immigration policy, sanctions against Russia, and military aid to Ukraine. Furthermore, the AfD and BSW share a common perspective in their relatively hardline critical stance toward the EU, so collaboration appears quite possible if they can find compromises on such issues as social security policy.

According Saxony-Anhalt state's procedure for electing the minister-president, if no candidate secures a majority of the total number of state parliament members in the first round of voting, a second vote must be held within seven days. If a decision is still not reached, a parliamentary vote to determine whether to dissolve the legislature and hold a new election must take place within the following 14 days. If a motion to dissolve the legislature and hold a new election fails to pass with a majority, a third vote to elect the minister-president is held immediately, and the candidate who secures a majority of the votes actually cast (as opposed to a majority of the total number of members) is elected minister-president. If the criterion shifts to a "majority of votes cast," the BSW could potentially enable the election of an AfD minister-president by abstaining from voting, so the upstart left-wing party effectively holds the deciding vote.

Democratic Legitimacy of “Firewall”

As recent examples have shown, as long as support for the AfD remained at around 20 to 30 percent, it was barely possible for coalitions among the established parties to exclude the party from government. It is not easy, however, to exclude a party that holds more than 40 percent of the vote on its own. Creating a majority coalition while excluding the AfD would require cooperation among multiple parties with significant policy differences. In other words, maintaining the “firewall” would necessitate forming a coalition government that sets aside all party ideologies and unites solely around an anti-AfD stance. Would the parties be willing to pay the price of abandoning their own political principles just to exclude the AfD?

Of course, refusing to cooperate with the AfD out of deep remorse for the actions of a particularly notorious German right-wing party in the past could also be seen as a matter of principle. Yet, there are grounds for concern that arranging unprincipled alliances that disregard each party's core beliefs could potentially alienate voters and, ironically, further increase support for the AfD. Although the historical context is weighty, questions will inevitably arise as to whether it is truly “democratic” to exclude a party that has secured more than 40 percent of the popular vote on its own. From an outside perspective, it may seem that blindly clinging to the firewall at all costs runs counter to the will of the people and is thereby jeopardizing the basis of support for the firewall. The situation may not be so simple as it seems, however, as there is a strong tendency in Germany to consider history as divided into just two eras – “before the Nazis” and “after the Nazis”.

It should be noted that a portion of the AfD's surge is attributable to protest votes against such traditional parties as the CDU/CSU and SPD, so it is highly likely that similar scenes will play out in future state elections and ultimately destabilize Germany's current federal government coalition led by Chancellor Friedrich Merz. As the CDU's vote share in the Saxony-Anhalt state election fell by half compared to the previous election (dropping from 37.1% to 17.2%), it is evident that conservative-leaning German voters have been shifting their support from the CDU to the AfD. While the current economic downturn has been largely driven by Germany's strained relations with China and Russia and cannot be blamed solely on the Merz administration, there is no doubt that the downturn stems largely from policies enacted under the Angela Merkel administration, so the rise in critical protest votes against the CDU comes as no surprise. (Angela Merkel served as the Chairwoman of the CDU from 2000 to 2018 and led Germany as Federal Chancellor from 2005 to 2021.)

Persistent East-West Divide

As is evident from the background described above, the AfD's surge has so far been concentrated primarily in states formerly within East Germany, such as Thuringia, Saxony, Brandenburg, and Saxony-Anhalt. This suggests that a primary driving force behind the AfD's rise may be the persistent disparity between the economic strength of German states formerly within East Germany and those formerly within West Germany. This disparity, which has continued to exist even three decades after Germany's reunification, is believed to be promoting a profound sense of alienation among people in former East German states. Many commentators have noted that people in the eastern regions have long felt they have been treated as second-class citizens and that this economic and psychological divide has fostered deep despair and anger in the eastern regions toward Germany's national political establishment. In reality, almost all the headquarters of the major global corporations listed in Germany's benchmark DAX stock index are in the western states, while the eastern states have been unable to break free from an economic structure centered on companies that generally play subordinate, subcontractor-like roles. As a result, the East-West disparity regarding average wages and household asset levels remains significant, and there has been a continued East-to-West migration of young people, particularly women and those with higher levels of education. Accelerating depopulation in Eastern provincial cities and rural areas is another factor fostering a sense of alienation.

Since German reunification was actually an absorption of the East by the West, a structure became firmly established in which most leading positions in society (in such diverse fields as politics, economics, the judiciary, academia, and the media) are held by people from West Germany. Incidentally, while former Chancellor Merkel is often considered to be Germany's first chancellor from East Germany, it is interesting to note that she was actually born in the West German city of Hamburg and moved with her family to what was then East Germany (the German Democratic Republic) when she was just a few weeks old, although most people will still agree that her upbringing in East Germany had a significant influence on her mindset. The perception among people in eastern states that the western states are unilaterally adopting misguided policies for the entirety of Germany has fostered growing resentment along with increasing distrust of the federal government and mainstream news media. The huge financial and societal burdens generated by Germany's climate change countermeasures and liberal refugee acceptance policies have solidified a view that the wealthy westerners are irresponsibly destroying easterners' livelihoods and culture, and this has generated a strong impetus for such emerging political parties as the AfD.

Given recent developments, the AfD should be viewed not as a temporary wave of populism, but as a structural defensive reaction of Eastern society born of entrenched inequality – in short, the AfD has firmly established itself as “the voice of the East”. The next federal election, scheduled to take place by March 2029, will likely occur against the backdrop of an unprecedented economic slump in Germany. If the AfD at that time becomes the dominant force in some state governments, it might mark the beginning of a broader long-term shift.

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