

Forex Medium-Term Outlook

July 1, 2026

Overview of Outlook

In June, USD/JPY remained stable at the 160 level. Despite notifications of JPY-buying interventions since late April, the trend has failed to be reversed, and USD/JPY continues to edge higher. Of course, caution over Japan's currency policy may be why the rate has remained around the 160 level, but JPY selling continues unabated, driven by strong speculation over the widening gap between domestic and overseas monetary policies. Even as JPY supply-demand concerns ease with the fall in crude oil prices, concerns regarding interest rates have emerged to take their place, causing a shift in the market's focus. With regard to the former, it will take a couple of months for the drop in crude oil prices to reflect in the improvement of the trade balance, so heightened pressure to sell JPY remains the likely scenario for now. Given the Fed and ECB's pace of rate hikes, the BOJ will have to implement at least one more rate hike in 2026 and two rate hikes in 2027 if it wants to curb JPY selling driven by domestic-overseas interest-rate differentials. In other words, one would have to anticipate a cumulative 75-bp rate hike by the end of 2027. Of course, there is no guarantee this would halt JPY selling, but it would be necessary to implement consecutive rate hikes to bring interest rates up to the assumed neutral interest rate level in order to align monetary and currency policy objectives. Depending on currency movements, it is not impossible for rates to continue being increased beyond the neutral rate level, and this would raise concerns over adverse effects on the economy and financial markets, but currency defense does entail being forced into undesirable rate hikes.

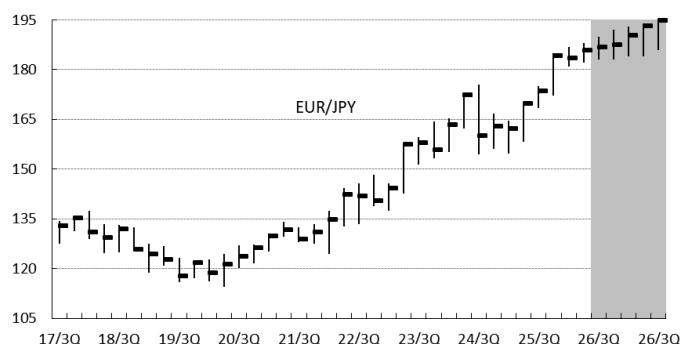
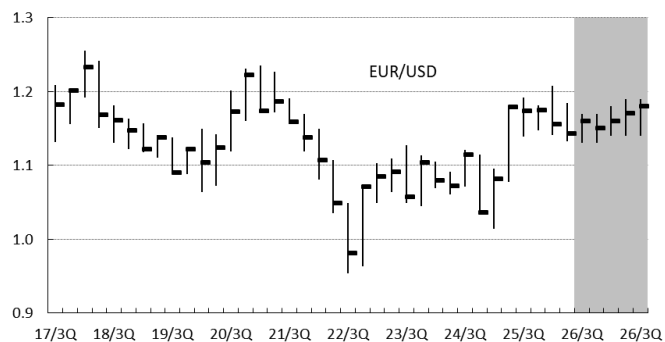
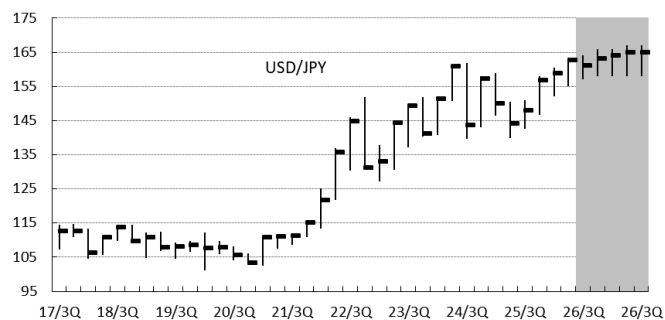
Meanwhile, EUR weakened in June. Although the ECB was the first among the major central banks (of Japan, the U.S., and Europe) to move to raise interest rates, EUR has been forced to retreat as USD buying intensifies amid growing expectations of a hawkish turn in the Fed's stance. Of course, given its interest rate outlook for the year, EUR is still expected to perform strongly, but amid rising expectations of Fed rate hikes, it is less likely to strengthen unilaterally, as it has done this past year. Of course, while my main forecast scenario for the ECB currently involves a standard 25-bp rate hike, a more aggressive 50-bp move is possible depending on inflation trends going forward. If that happens, EUR could regain upward momentum. On the political front, the European Commission has begun articulating serious concerns regarding the EU's widening trade deficit with China, with speculation mounting that it might resort to sanctions similar to those implemented by the U.S. From a medium/long-term perspective, this issue touches upon EUR's supply-demand structure and warrants continuous monitoring. Japan must pay attention to the EU's concerns and policy responses as its own key industries face similar risks from China's "structural overcapacity," i.e., the export of deflationary pressures.

Summary Table of Forecasts

	2026			2027		
	Jan-Jun (Actual)	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
USD/JPY	152.10 ~ 162.77 (162.68)	157 ~ 164 (161)	158 ~ 166 (163)	158 ~ 166 (164)	158 ~ 167 (165)	158 ~ 167 (165)
EUR/USD	1.1325 ~ 1.2084 (1.1409)	1.13 ~ 1.17 (1.16)	1.13 ~ 1.17 (1.15)	1.14 ~ 1.18 (1.16)	1.14 ~ 1.19 (1.17)	1.14 ~ 1.19 (1.18)
EUR/JPY	180.84 ~ 187.95 (185.62)	183 ~ 190 (187)	183 ~ 192 (187)	184 ~ 193 (190)	184 ~ 194 (193)	186 ~ 196 (195)

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

Exchange Rate Trends & Forecasts



USD/JPY Outlook - What Lies Beyond 1.00%?

BOJ Monetary Policy Now and Going Forward – Preparing for Rate Hikes Beyond the Neutral Rate

Bi-Directional Decision-Making Fails to Halt JPY Depreciation

At its June Monetary Policy Meeting (MPM), the BOJ decided to raise the policy interest rate by 25 bp to 1.00%, in line with market expectations. This marked the first rate hike in six months, since last December, and brought the policy rate to its highest level in 31 years. As the decision had been almost fully priced in, it did not trigger much volatility in interest rate or forex markets.

The policy statement explicitly noted that “the risk of a significant slowdown in the economy (due to the situation in the Middle East) appears to have decreased compared with a while ago,” suggesting that this was a factor behind the BOJ’s rate hike decision. It also emphasized the ongoing nature of the rate-hiking cycle, stating that “the Bank will continue to raise the policy interest rate and adjust the degree of monetary accommodation.” Meanwhile, regarding its plan for purchasing long-term Japanese government bonds (JGBs), the BOJ confirmed that it would continue monthly reductions in the purchase amount for the rest of the current fiscal year but would halt these reductions from April 2027 onward. In a situation where large rate hikes are thought necessary for curbing JPY depreciation, it is natural for decisions suggesting both rate hikes and rate cuts to be less impactful, and indeed, JPY has continued to depreciate even after the rate hike.

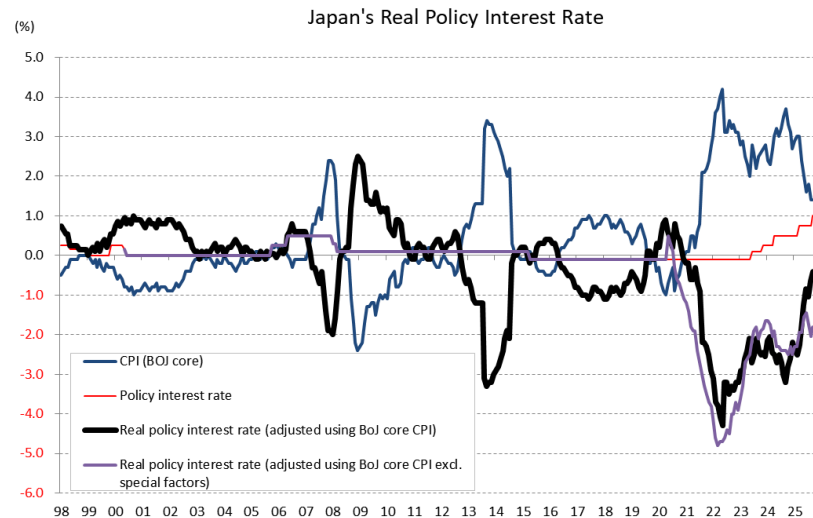
Are We Approaching the End of the Rate-Hike Phase?

One notable aspect of this meeting was the removal of the phrase “given that real interest rates are at significantly low levels” prefacing the statement regarding the Bank’s intention to “continue to raise the policy interest rate and adjust the degree of monetary accommodation.” When asked about this change, BOJ Deputy Governor Shinichi Uchida explained that the Bank considered it more appropriate to evaluate and explain the overall degree of monetary accommodation than to focus on the gap relative to real interest rates, indicating that this was merely a revision of the Bank’s communication method.

However, speculation regarding a potential end to the rate-hike phase may emerge going forward. A BOJ paper released in late March estimated the natural interest rate to be in the $\approx -0.9\%$ to $+0.5\%$ range. Assuming a 2% inflation rate, this implies a neutral policy interest rate of roughly between +1.1% and +2.5%. The current policy rate of 1.00% is already approaching the lower end of that range. The prevailing economic and financial conditions, however, are not conducive to halting rate hikes, which is why the Bank states that it will “continue to raise the policy interest rate,” but the fact that current real interest rates can no longer be characterized as being at “significantly low levels” is a major change. If things go as expected, the Bank may signal that it is approaching the end of its rate-hike phase after another two or three rate hikes.

Policy Rate Could Surpass the Neutral Rate if JPY Weakness Persists

The critical question is – at the juncture when interest rates are raised to the neutral interest rate level, what will the JPY exchange rate be? If JPY remains weak even after the policy interest rate enters the neutral rate range, the possibility of further rate hikes beyond the neutral rate range cannot be ruled out. Since February 1999, when the uncollateralized overnight call rate was adopted as the target of monetary policy guidance, Japan has never implemented clear monetary tightening through steady rate hikes to push up real interest rates. The real policy rate was significantly positive only during periods of negative inflation (see graph).



(Source) bloomberg; prepared by the Global Foreign Exchange Department, Mizuho Bank
Note: June 2026 CPI is assumed to be unchanged from May.

Currently, based on the May Consumer Price Index (excluding fresh food;

hereinafter “core CPI”), the real policy rate is -0.40% (1.00% minus 1.40%), indicating that a return to positive territory is within reach. However, because the CPI is being artificially suppressed by factors such as the waiver of high school tuition fees and gasoline subsidies, the “actual” real policy rate is probably lower. If one excludes the special factors that have been in play since April this year, the core CPI climbs to +2.8% yoy, so one could argue that the “actual real policy interest rate” is -1.80% (1.00% minus 2.80%). As long as concerns over JPY weakness persist, suspicions that the real policy interest rate are lower than assumed will remain, and this may continue to be cited as a reason for further rate hikes. Since rate hikes are now viewed as unavoidable for defending JPY, forex market trends may determine whether rates will be raised beyond the neutral rate in 2027 and beyond.

Terminal Rate may be 1.50% or 1.75%

What future developments can we anticipate? The statement released following the recent MPM noted that “there is a risk of underlying CPI inflation deviating upward to a level above the price stability target of 2 percent.” Essentially, rate hikes are expected to continue for now, amid concerns about falling behind the curve. Indeed, the Summary of Opinions at the Monetary Policy Meeting released a few days later confirmed views suggesting this. Nevertheless, significant uncertainty remains. While the policy rate was raised to 1.00% as expected, Policy Board members retained divergent outlooks regarding various points. Specifically, Toichiro Asada opposed the rate hike, Hajime Takata and Naoki Tamura dissented regarding the price outlook, with the latter also opposed to the JGB purchase plan. Although a consensus, with the exception of Asada, was reached on the rate hike this time, Policy Board members do not have uniform outlooks regarding economic and financial conditions going forward, and this creates the impression of heightened uncertainty surrounding near-term policy management.

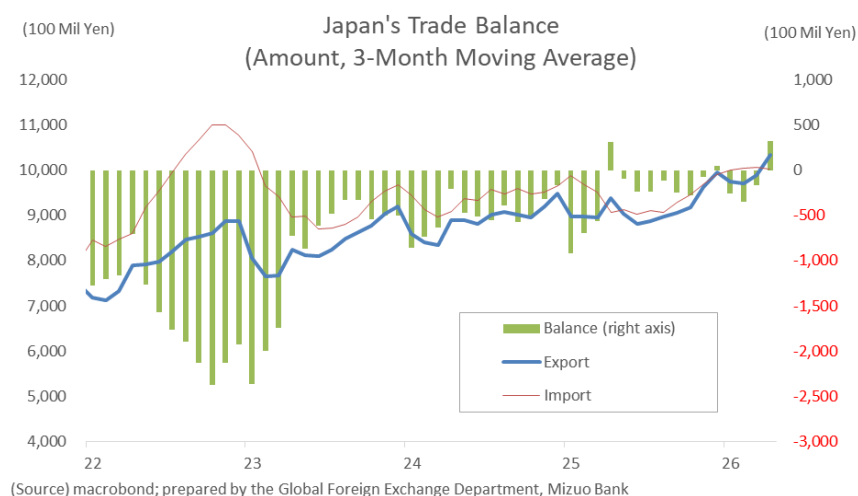
Regarding the terminal rate, opinions currently range from 1.50% to 2.00%. However, there is a possibility that the Fed as well as the ECB will resume rate hikes within the year and continue on a tightening path through at least the end of 2027 (implementing at least three rate hikes each). From the perspective of curbing JPY depreciation, there is strong concern that this could widen the domestic-foreign interest-rate differential and exacerbate the JPY selling pressure unless the BOJ implemented at least one more rate hike in 2026 and two in 2027. This would add up to a further 75bp rate hike by the BOJ, bringing the policy interest rate to 1.75% by the end of 2027.

Regardless of when the next rate hike takes place, the policy climate ahead is bound to differ significantly from the past two years, as the pace of tightening relative to the U.S. and Europe becomes the focal point. Given that the forex market inherently involves other players, one must be prepared for the inevitability that there will be less and less room to prioritize domestic political, economic, or financial conditions going forward.

JPY Supply and Demand Climate – Meaning of “Secured Alternative Procurement”

Ripple Effects of “Securing Alternative Procurement”

On June 11, after a meeting with relevant cabinet ministers on the situation in the Middle East in the Prime Minister’s Office, Prime Minister Sanae Takaichi announced that the proportion of crude oil procured via routes other than the Strait of Hormuz would reach “≈ 100% yoy in July.” This is a positive development for Japan amid intermittent reports of other Asian nations facing oil procurement shortages. Meanwhile, as I have already warned in previous issues of this report, the return to normal crude oil import volumes is a critical factor that will determine the JPY rate outlook. In other words, it is highly likely that the normalization of crude oil imports in volume terms will coincide with when the trade balance falls off a cliff. It

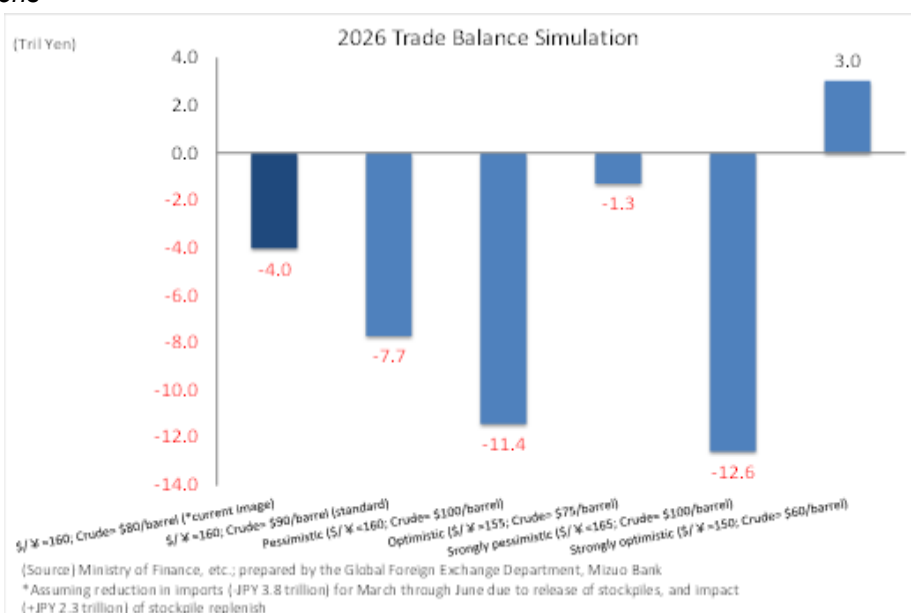


could, therefore, serve as a pivotal point for the JPY supply-demand outlook, and therefore, for the JPY outlook itself.

The significant improvement in Japan’s trade balance through April resulted from the fact that import volumes dropped even more sharply than crude oil prices surged, thereby preventing the increase in import value (calculated as price x import volume) from materializing (see graph). While economic and financial conditions since March this year bear a striking resemblance to the situation seen from March 2022 onward, an actual deterioration in the JPY supply-demand balance has not yet occurred. For context, crisis erupted in March 2022 and imports began to surge starting May, leading to an average monthly trade deficit of ≈JPY 2 trillion between May and December. This resulted in a record annual trade deficit of ≈JPY 20 trillion that year, a development that marked the starting point of the current phase of JPY depreciation. While a direct comparison is difficult, partly because the pandemic caused prices of non-resource components of the trade balance (e.g., pharmaceuticals) also to surge in 2022, a monthly trade deficit of ≈JPY 2 trillion persisting for the six months starting July would result in an annual trade deficit of ≈JPY 12 trillion.

Trade Balance: Scenario-Based Simulations

It is worth noting that 2022, 2014, and 2013, in descending order, are the three years Japan has posted a trade deficit exceeding JPY 10 trillion. JPY depreciated significantly against USD in each of these years, falling by 13.9%, 13.7%, and 21.4%, respectively. While it is good news for Japanese society that the government has secured alternative sources of procurement, it is also important to note when analyzing the situation that this is highly likely to trigger a deterioration in the JPY supply and demand balance. Of course, forex trading volumes are overwhelmingly driven by speculative trading rather than actual demand reflecting the trade balance. A question I frequently get asked is – what exactly drives speculative trading? Speculators do not just buy and sell back and forth without a basis. Even without bringing up the



mentioned empirical patterns, given that a widening trade deficit leads directly to JPY selling, it is natural that an anticipated deterioration in real demand would spur speculative activity aligned with that trend. It is important to recognize the fundamental principle that shifts in real demand act as a trigger for speculation.

Keeping this in mind, it is important to form a clear image of how the trade deficit may evolve in the near term. The figure to the right presents simulations of the trade balance for the remainder of the year based on five scenarios: standard, pessimistic, optimistic, strongly pessimistic, and strongly optimistic. These projections are based on reports that Japan will have achieved full alternative procurement by July, and assume a reduction in imports (worth -JPY 4.6 trillion) due to the release of stockpiles during the four months from March through June, as well as an increase in imports (worth +JPY 2.8 trillion) to replenish depleted stockpiles during the six months from July through December.

The calculation method is straightforward. Assuming an annual mineral fuel import value of JPY 25 trillion (\approx JPY 26 trillion in 2024 and \approx JPY 22 trillion in 2025), the monthly import value is roughly JPY 2.1 trillion, totaling \approx -JPY 8.4 trillion over the four months from March to June. Given that crude oil and petroleum products account for about 55% of this total (\approx 54% in 2024 and \approx 55% in 2025), it is estimated that the stockpile release covered \approx -JPY 4.6 trillion of imports.

If the government's stated plans hold true, stockpile replenishment via alternative procurement should commence from July onward. However, considering factors such as tanker shipping capacity, domestic tank storage limits and, above all, the current international situation, it would be difficult to immediately replenish the entire JPY4.6 trillion worth of released stockpiles (as the process must occur alongside regular imports). Restoring stockpiles will take place gradually, over time. In my calculations, I assume that \approx 60% of the released stockpiles will be restored during 2H of the year, and 60% of JPY 4.6 trillion is roughly +JPY 2.8 trillion.

Replenishment Costs Exceed Savings from Release

This is where the problem arises. The savings from the release of stockpiled crude oil are not the same as the cost of the crude oil to be purchased to replenish the stockpiles. The latter is, naturally, more expensive. In my simulation, I calculated the savings from stockpile releases assuming USD/JPY to be 150 and crude oil prices to be USD 80 per barrel. Meanwhile, the cost of the "replenishment" crude oil is based on USD/JPY being 160 and crude oil prices being USD 90 per barrel in the standard scenario. At this level of cost increase, replenishing 60% of the stockpile within the year would cost \approx JPY 3.1 trillion. Nevertheless, looking strictly at the current year, with a reduction of about JPY 4.6 trillion offset by a replenishment cost of about JPY 3.1 trillion, there remains a net benefit of \approx JPY 1.5 trillion from the stockpile release. This underscores the significant impact of the release. Note that USD/JPY and crude oil price assumptions reflect annual averages and do not necessarily reflect current market levels.

While the standard scenario assumes a USD/JPY rate of 160 and a crude oil price of USD 90 per barrel, estimating an annual trade deficit of \approx JPY 7 trillion, the fact is that crude oil prices have recently fallen to around USD 75 per barrel amid growing expectations of a ceasefire agreement. If these conditions persist, the annual trade deficit will shrink to \approx JPY 4 trillion. However, given persistently high USD/JPY levels around the 160 level, an expansion of the trade deficit compared with the previous year (\approx 2.9 trillion JPY) remains unavoidable. At the time of writing, the outcome appears likely to fall somewhere between the standard and optimistic scenarios. If so, the trade deficit for 2026 could fall in the range of JPY 2-5 trillion. Thanks to stockpile releases, the annual trade deficit may remain at a level roughly half that of 2022 even in the pessimistic scenario, and this could be seen as good news. Incidentally, there is at least a two-month lag before crude oil prices are reflected in customs statistics, so the trade balance is unlikely to improve right away¹.

Self-Help Required on the Interest Rate Front

For Japan, which relies heavily on overseas sources for resources, securing a clear path for procurement in terms of volume is a highly positive development, as it establishes the foundation for social life. The accompanying trade deficit expansion and JPY weakening are unavoidable consequences that may simply have to be accepted as problems that are difficult to resolve through Japan's own efforts. On the other hand, interest rates are an area where self-help is possible, and given the difficulty of controlling the supply-demand dynamics, it is crucial to demonstrate a proactive stance on raising interest rates to keep speculative forces in check in order to curb JPY depreciation. While supply-demand conditions are largely beyond Japan's control, interest rates represent an area where the country needs to (and can) shape its own environment.

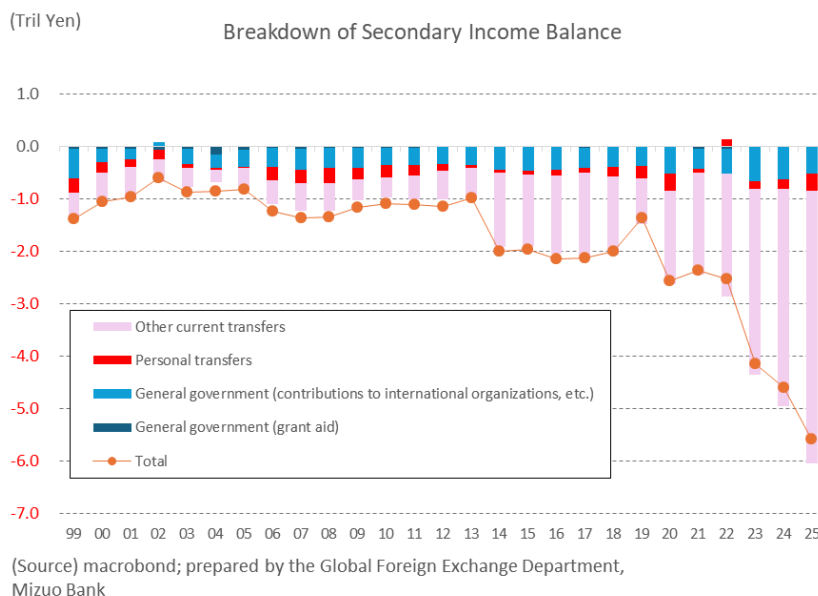
If a widening trade deficit from July onward is inevitable, the second-best strategy might be to maintain expectations for rate hikes at the July and subsequent meetings (potentially even consecutive rate hikes) in addition to the June rate hike. In fact, given that JPY depreciation did not halt even when crude oil prices plummeted on hopes of a ceasefire, it seems likely that, even more than JPY supply-demand concerns, domestic-foreign interest-rate differential concerns (compounded by the sharp hawkish pivot of the Fed and the ECB) are emerging as the main driver for JPY selling. The U.S.-Japan (10-year) interest-rate differential has steadily narrowed and even inverted, but JPY selling persists. This may be based on (1) expectations of rate hike resumption by the Fed, and (2) speculation that Japan's inflation rate is being artificially suppressed (implying an actually lower real JPY interest rate level). I think the only solution to dispelling such doubts is to raise interest rates beyond market expectations. While the BOJ's insistence on maintaining the status quo citing uncertainty is understandable, from the perspective of curbing JPY depreciation, the risk of speculative forces exploiting this stance is significant.

Secondary Income Deficit Rivaling the Digital Deficit

Since 2022, this report has explored the structural factors driving JPY depreciation, including the widening trade deficit, the issue of overseas earnings by Japanese firms (which contribute to the primary income surplus) not being repatriated back to Japan, and the expanding digital deficit. These issues have gained considerable recognition, and arguments attributing JPY weakness solely to the U.S.-Japan interest-rate differential have receded somewhat compared to the past.

¹ For details, please refer to the June 22, 2026, issue of Mizuho Market Topics, titled "Speculative JPY Selling Enters Danger Zone."

However, a nation's balance of payments reflects the full spectrum of its economic activity, requiring constant vigilance regarding various shifts. This time, I would like to highlight the rapid expansion of Japan's secondary income deficit. The secondary income balance is defined as an account that reflects unrequited transfers of funds between residents and non-residents. It typically records items such as government and private-sector grants, contributions to international organizations, donations, gifts, and remittances sent home by foreign workers. As the figure shows, the deficit, which stood at JPY 1.37 trillion in 2019 (pre-pandemic), has ballooned over fourfold to JPY 5.5743 trillion as of 2025. Having remained relatively stable at around JPY 1 trillion between 1999 and 2013 and around JPY 2 trillion from 2014 to 2021, the deficit has expanded sharply over the past three years or so. This is undoubtedly a distinct shift. A deficit in the range of JPY 5 to 6 trillion is too large to ignore within the context of the overall current account balance. For comparison, the digital deficit, which has garnered considerable attention in recent years, is of a similar scale, hovering between JPY 6 and 7 trillion. The primary driver of the secondary income deficit is the "other current transfers" balance, which alone accounts for a deficit exceeding JPY 5 trillion (see graph).

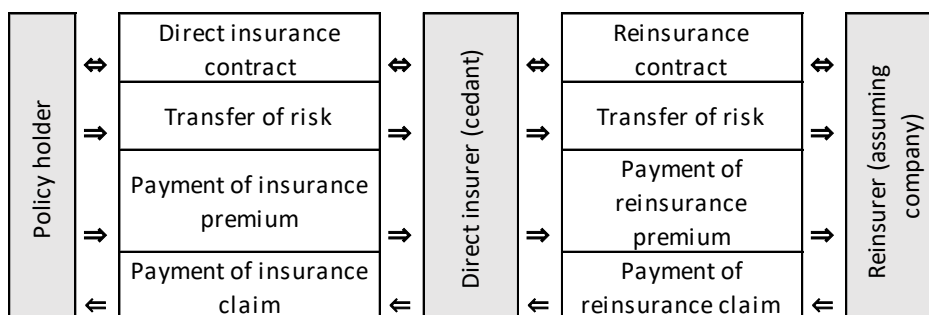


Reinsurance Transactions and the Balance of Payments

The recent sharp expansion of the secondary income deficit is driven not by traditional items such as government grant aid, but by "other current transfers," which reflect movements associated with reinsurance transactions. Let me briefly explain the fundamentals of insurance transactions, as they are important for understanding what is happening in the balance of payments statistics.

Reinsurance is a transaction in which an insurance company pays a premium to another insurance company (a reinsurer) to transfer some or all of the risk associated with its own underwritten policies to that reinsurer. In this context, the original insurer is called the "primary insurer" (or "ceding company"), while the reinsurer is called the "assuming company." Generally, insurance premiums paid by policyholders to insurance companies comprise (1) net premium + (2) expense loading. Item (1) represents the funds allocated for future payouts (such as insurance claims), while item (2) covers the insurance company's operating expenses (including profit). The same logic applies to reinsurance transactions, where reinsurance premium = (1) net premium + (2) expense loading. When such reinsurance transactions take place between domestic and foreign insurance companies, they are captured in the balance of payments statistics. Specifically, item (1) is recorded under "other current transfers" in the secondary income account, while item (2) falls under "insurance and pension services" in the services account. I presented detailed discussions of the increasing trend in payments from Japan to overseas reinsurance companies in my book *The True Nature of JPY Weakness – Japan Masquerading as a Surplus Nation*, and in the Final Report of the Study Group on "Challenges and Prescriptions for the Japanese Economy as Seen from the Balance of Payments" (held from March to July 2024), but those discussions focused solely on item (2), i.e., the services balance. The foreign currency outflow (deficit) associated with item (1) concerns the secondary income balance. Payments toward expense loading (roughly equivalent to the profit component for overseas reinsurers) are recorded in (2) the services balance (specifically, insurance and pension services) because they represent Japanese insurance companies purchasing services provided by overseas reinsurers.

Reinsurance mechanism



(Source) July 2024 of *Finance*, Ministry of Finance; prepared by the Global Foreign Exchange Department, Mizuo Bank

Another general principle in insurance transactions is the “principle of equivalence” (or balance of income and outgo), whereby the total premiums paid by all policyholders (plus investment income) are theoretically designed to match the total insurance payouts, benefits, and expenses paid by the insurance company. This principle applies to reinsurance contracts as well, with the net premium component of reinsurance premiums paid by primary insurers (cedents) expected, in the long run, to offset the reinsurance payouts made by the reinsurer (assuming company). This is why, when it comes to reinsurance transactions, net premiums and reinsurance payouts (which offset each other over the long term) are recorded under “other current transfers” within the secondary income balance (see table).

Reinsurance Premium Calculation

Reinsurance Transaction Items	Classification under the BOP Statistics
Reinsurance premium (net premium)	Secondary income account > Other current transfers
Reinsurance premium (expense loading)	Service account > Insurance and pension services
Reinsurance recoveries	Secondary income account > Other current transfers

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

JPY-Selling Driven by Effort to Hedge Against Japan-Related Risks

Of course, the principle of equivalence is based on expected values and involves a time lag. It does not play out over the short term, so a deficit arises until the lag is closed. The July 2024 issue of *Finance*, the Finance Ministry’s policy publication, analyzed reinsurance market trends based on the balance of payments statistics. It noted that “outward reinsurance premiums have risen, driven by factors such as natural disasters and an increase in foreign-currency-denominated insurance contracts, leading to a widening net deficit in the ‘other current transfers’ component of the secondary income balance.”² Amid the increasing severity of natural disasters and the rapid growth of risks faced by Japanese companies expanding globally, domestic non-life insurers are unable to shoulder the entire burden themselves, and are purchasing reinsurance (outward reinsurance) on a large scale from major global reinsurance markets in the U.S., the UK, and Bermuda.

It should be noted that, because global reinsurance companies are profit-driven enterprises, the net premiums they charge naturally include a risk premium to compensate for assuming uncertainty in addition to the cost based purely on the probability of loss (expected loss). Therefore, in reality, net premiums and reinsurance payouts do not perfectly offset one another. This risk premium component acts as a structural factor driving JPY selling for the Japanese side (i.e., Japan’s current account balance).

Incidentally, insurance transactions are not the only factor driving the deficit in “other current transfers.” It is well known that Japan’s primary income surplus has been pushed to historic highs thanks to an increase in foreign direct investment (M&A; setting up of local factories) by Japanese companies in response to the shrinking domestic market. What receives less attention is the resulting increase in tax payments to foreign governments. “Current taxes,” including corporate taxes levied by foreign governments on locally earned income or wealth, are also recorded as outflows under the secondary income balance.

To summarize, one could interpret this as a situation where the secondary income deficit is structurally expanding as a byproduct of Japan’s overall globalization and risk diversification efforts. Put differently, JPY depreciation is being driven by a collective move within the private sector, including both households and corporations, to hedge against Japan-related risks.

No Prospect of Lower Insurance Premiums

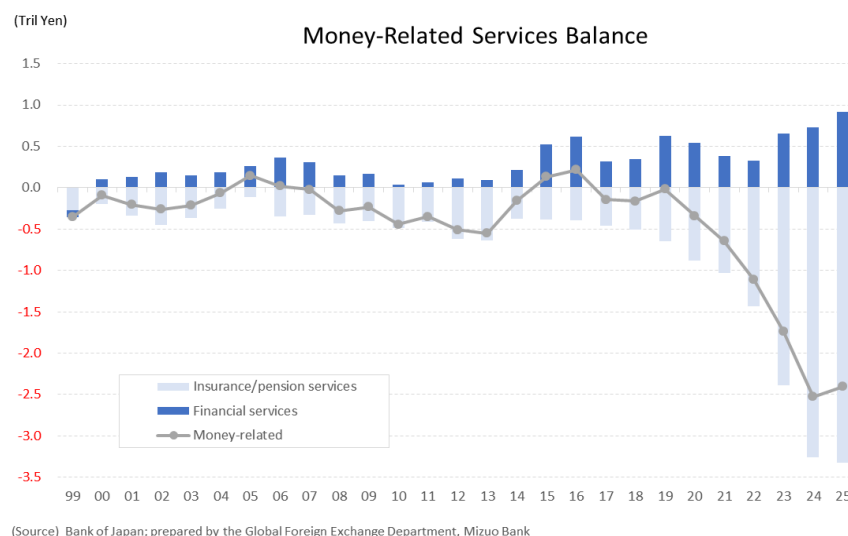
The problem is what happens going forward. The vulnerability associated with insurance-related capital outflows could easily become a much more pressing concern with any deterioration in the situation in the Middle East. It is well known that the risk of military attack on vessels navigating the Strait of Hormuz has risen. Inevitably, war risk insurance premiums for these vessels have skyrocketed. For instance, reports indicated that insurance premium rates for ships traversing the strait surged roughly twelvefold, from $\approx 0.25\%$ of the vessel’s value prior to the attacks on Iran, to 3% by March 4, following the start of attacks on February 28.³ A de facto economic blockade of the strait emerged as a result of the exorbitant premiums quoted by insurers recognizing the high risk in the area, and this situation has not yet fully normalized.

Under these circumstances, the massive war risk insurance premiums borne by Japanese shipping and energy companies are paid to overseas reinsurers (assuming the risk) via Japanese non-life insurance companies (the primary insurers or cedents). In balance of payments accounting, these reinsurance premiums paid by the cedent to the reinsurer are split into the net premium portion, corresponding to future claims payouts, which is recorded under “other current transfers” in the secondary income account, and the expense loading portion, covering operating expenses and profits, which is recorded under “insurance and pension services” in the services account. Both transactions result in selling JPY.

² Yoshiko Kurumizawa and Yuya Kinoshita, “Trends in the Reinsurance Market as Seen from the Balance of Payments Statistics,” *Finance*, Ministry of Finance, July 2024.

³ Financial Times “Gulf insurance costs soar 12-fold despite Trump guarantee,” Mar 4, 2026

However, there are also cases where Japanese non-life insurance companies pay reinsurance premiums to overseas subsidiaries or affiliates within their own corporate groups that operate reinsurance businesses. In such cases, the subsidiary's earnings are repatriated to Japan as receipts (e.g., dividends and distributed branch earnings from direct investment) under the primary income account. In other words, a significant portion of the expanding deficit in the secondary income account is being offset by the expanding surplus in the primary income account. Of course, the offsetting effect does not appear to be dominant as of the present time, given that deficits in "other current transfers" and "insurance and pension services" are expanding. The 1973 oil shock was a case where a widening trade deficit, triggered simply by a surge in crude oil prices, fueled JPY selling. By contrast, the current shock involves not only a widening trade deficit but also a massive outflow of insurance premiums resulting from the globalization of corporate activities. This is contributing to the expansion of the secondary income and services deficits (see figure on previous page). In sum, when it comes to the current account, the widening deficits in three areas, namely trade, services, and secondary income, are concerning. As long as instability in the Middle East persists, this structure of deficits seems unlikely to improve significantly.



The 1973 oil shock was a case where a widening trade deficit, triggered simply by a surge in crude oil prices, fueled JPY selling. By contrast, the current shock involves not only a widening trade deficit but also a massive outflow of insurance premiums resulting from the globalization of corporate activities. This is contributing to the expansion of the secondary income and services deficits (see figure on previous page).

In sum, when it comes to the current account, the widening deficits in three areas, namely trade, services, and secondary income, are concerning. As long as instability in the Middle East persists, this structure of deficits seems unlikely to improve significantly.

Wartime Structural Depreciation of JPY

Viewed in this light, the widening secondary income deficit observed in recent years is not related to economic cycles, but appears to be part of a major structural shift in the current account. The reinsurance needs of domestic non-life insurers appear linked to three factors: (1) household currency diversification (i.e., foreign-currency-denominated insurance) risks, (2) climate change risks, and (3) geopolitical risks. Each of these factors seems likely to persist to some extent. In recent years, digital-related deficits and R&D service deficits have drawn attention as new sources of structural JPY selling pressure that reflect Japan's declining competitiveness. Insurance premium payments, reflected in the secondary income (and services) accounts are now reaching a comparable scale.

As previously mentioned, if the demand for reinsurance is due to a move by Japanese companies and households looking toward the global landscape to hedge against risks to the Japanese economy and JPY, then the deficit in the relevant balance-of-payments item will probably continue to widen until such time as the situation in Japan improves. At the very least, "other current transfers" appear to be a structural factor contributing to JPY depreciation in times of war. If insurance premium payments rise in response to pessimism or geopolitical crises, we may be entering an era where, during times of crisis, JPY selling becomes an increasingly entrenched phenomenon in addition to rising resource prices. In any case, using shifts in the balance of payments as a starting point, I intend to continue monitoring the changes affecting JPY and, by extension, the Japanese economy.

U.S. Monetary Policy Now and Going Forward – Welcome Reforms to Communication

Half of All Members Support At Least One Rate Hike This Year

At the Federal Open Market Committee (FOMC) meeting held on June 16-17, it was unanimously decided to keep the federal funds (FF) rate target range unchanged at 3.50-3.75%. FOMC members' policy rate projections (the "dot plot") changed to expect a single rate hike, a revision that aligns with market expectations that have evolved following the Iran attack. This effectively negates, both in name and in fact, any development that could accelerate the Fed's pivot to a more dovish stance under its new Chair Kevin Warsh, with strong ties to the Trump administration. This is an unforeseen outcome, given the repeated friction between former Fed Chair Jerome Powell and President Donald Trump over the need for rate cuts since last year.

There may be no real point focusing on the dot plot, given the uncertainty over its handling going forward (details later), but of the 19 FOMC members, Warsh refrained from submitting a projection, but nine of the remaining 18 members anticipated at least one rate hike within the year. However, the projection of "at least one rate hike this year" is based on the median. The mode still favored retaining the status quo, with eight members supporting it. If we additionally take into account that Walsh's stance is fluid, it would be premature to conclude at this point that the Fed has made a clear hawkish pivot. In this sense, the Fed's stance is in sharp contrast to that of the ECB, which seems more unambiguous in its hawkish pivot. That said, considering that the "next move" prior to the Iran attacks seemed certain to be an interest rate cut, the global landscape has indeed shifted significantly over the past three months. In the Summary of Economic Projections (SEP), forecasts for real GDP growth and the unemployment rate remain unchanged, while the inflation outlook for 2026 has been sharply raised (from 2.7% to 3.6%). This makes the situation difficult to resume rate-cut discussions in the near future.

Welcome Reforms to Communication

This time, the statement of intent regarding reforms under the new Warsh administration drew more attention than the actual policy decision itself. As part of a broader reform agenda (covering communication, the balance sheet, data utilization, productivity and employment, and the inflation framework), Warsh outlined a policy to fundamentally overhaul how monetary policy is conducted and how information is communicated. As part of these reforms, the FOMC statement has been streamlined to less than half its previous length, with the section on interest rate projections removed. The statement now contains only 131 words of factual information, and Warsh himself refrained from providing a projection for the dot plot. During the press conference, he noted, “I did not submit a (...) dot. For me, it’s not helpful in the conduct of policy.” He added, “I noted that all the submissions were coming in with pencils, you know those kinds with the big erasers,” pointing at the fact that such projections get revised almost immediately. He outlined a plan to review the Fed’s overall communication strategy by the end of the year, including, “press conferences, dots, meetings, (...) transcripts, minutes.”

Critics argue that these moves amount to a refusal to “engage with the market,” but I do not necessarily share that view. Quite to the contrary, I find them to be moves in the right direction. As many market participants know, dot plot projections rarely come true, and the contents of Fed chair press conferences are hardly written in stone. While intended to enhance policy predictability, such communication tools have often generated market noise by diverging from forecasts. The dot plot was introduced under the Bernanke regime in the wake of the 2008 Global Financial Crisis as a “powerful forward guidance tool” to communicate the Fed’s intent to keep interest rates low for an extended period. I have long felt that continuing to use it out of inertia, even after interest rates have normalized, does more harm than good. Abolishing it in the near future is unlikely to have any adverse effects.

Similarly, it was in 2019, under the Powell administration, that the frequency of press conferences was doubled from the previous four-a-year (aligned with SEP releases) schedule to eight times a year, one after each meeting, with the view to instilling the idea that “every meeting is a live meeting.” As in the case of the dot plot, this was intended to boost policy predictability, yet it does not appear to have achieved that goal.

The premise that “providing more information makes financial markets more efficient” holds true only when that information is certain. In the realm of monetary policy management, where decisions are ultimately “data-dependent,” transparency can sometimes have the opposite effect. Especially when economic and financial conditions are calm, there is little point in the chair holding a press conference that may simply provide fodder for trading. If press conferences are scaled back to four a year under Warsh, that too is unlikely to present a significant problem.

Shift in Theme Behind JPY-Selling

The implications for the USD/JPY exchange rate have not changed drastically following the FOMC meeting, but one must bear in mind that correcting JPY depreciation remains difficult. With a ceasefire agreement between the U.S. and Iran in sight, crude oil prices have fallen sharply, and share prices have risen, indicating that asset price adjustments are proceeding as expected. Across the board in the forex market, there is also a growing sentiment in favor of buying back USD. Yet, JPY is the one currency not being bought back. Ultimately, the fundamental trend observed in effective exchange rates since 2022, reflecting a sentiment that “JPY is the one currency nobody wants,” appears to persist. Perhaps it is important to take a step back and view the situation from a longer timeframe, but the fact is that good news regarding the stabilization of the situation in the Middle East and a narrow escape from further deterioration in the JPY supply-demand balance is already being overshadowed by bad news in the shape of the looming prospect of Western central banks resuming interest rate hikes. In other words, the market’s focus may be shifting from “JPY selling driven by supply and demand” to “JPY selling driven by the widening monetary policy gap.” As always, my conclusion is that the most orthodox way for Japan to proactively curb JPY selling at this stage is to implement sustained interest rate hikes as part of its monetary policy.

Risks to My Main Scenario – Long-Term Outlook of the Services Deficit; Preparing for the JPY10-Trillion Deficit Era

Long-Term Outlook of the Services Balance

Currently, there are still concerns that the trade balance could deteriorate due to the turmoil in the Middle East, but thanks to ample support from stockpile releases, no significant expansion of the deficit has materialized. Please see my simulations above regarding this point. I have also consistently maintained that, while the trade balance in goods is important, one must also pay attention to the trade balance in services. My forex outlooks since last year have incorporated the view that an era of -JPY 10 trillion in services deficit is not an unrealistic scenario over the longer term, and that discussions regarding the services balance should, therefore, focus more on the future than on the present. Looking at Japan’s balance of payments, the trade deficit has exceeded -JPY 10

USD/JPY and Japan's Worst 10 Trade and Services Deficits

	Trade	Services	Trade and Services	Rate of Change of JPY Against USD
2022	-15.5	-5.6	-21.1	14.8
2014	-10.5	-3.0	-13.5	13.7
2013	-8.8	-3.5	-12.3	22.1
2023	-6.5	-2.9	-9.4	7.0
2012	-4.3	-3.8	-8.1	11.3
2024	-3.7	-2.8	-6.4	11.7
2025	-0.8	-3.4	-4.2	-1.2
2011	-0.3	-2.8	-3.1	-4.8
2015	-0.9	-1.9	-2.8	0.5
2021	1.8	-4.2	-2.5	11.4

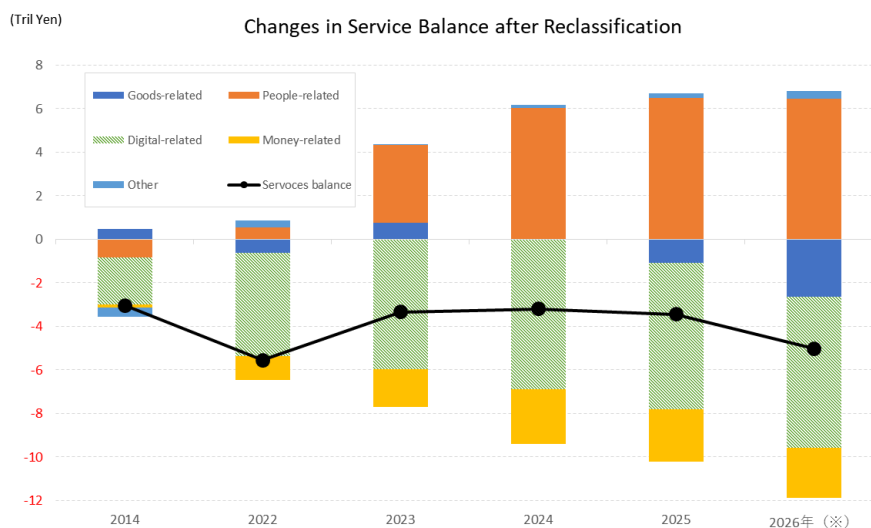
(Source) Bank of Japan, Bloomberg; prepared by the Global Foreign Exchange Department, Mizuho Bank *Earliest available data is for 1985

trillion only twice in history (2022 and 2014), with 2022 being the highest on record, and even then the services balance was no more than -JPY 5.6 trillion. Therefore, if the services deficit alone were to hit -JPY 10 trillion, that would represent a historic shift in the JPY supply-demand structure. Currently, the underlying trend of Japan's services balance is determined by the extent to which the travel surplus can offset the steadily growing digital deficit. In fact, it is entirely thanks to the substantial travel balance holding strong that Japan's overall services deficit has remained flat rather than expanding.

However, given labor supply constraints, there is limited upside potential in the Japanese economy for the labor-intensive tourism industry (primarily comprising accommodation and food services). The capital-intensive digital industry, on the other hand, continues to have significant growth potential, bolstered also by the recent AI boom. Consequently, a scenario I have long feared is a widening of the services deficit as it gets taken over by the digital deficit (as well as deficits in areas like insurance services discussed earlier).

The Collapse of the "People vs. Digital" Equilibrium

As the graph to the right shows, the travel surplus (essentially the people-related surplus) has barely managed to offset the digital-related deficit up to 2025, but there are signs that this balance will begin to unravel from 2026 onward. Currently, attention is focused on the potential for a rapid expansion of the trade deficit for the first time since 2022, and financial market discussions tend to gravitate toward that issue. Meanwhile, the potential widening of the services deficit seems to be attracting very little interest, even though it remains an important issue. To give an example familiar to many, if we look specifically at digital services, the number of people who began paying for AI services within the last year has increased significantly. This development will soon be reflected in the statistics.

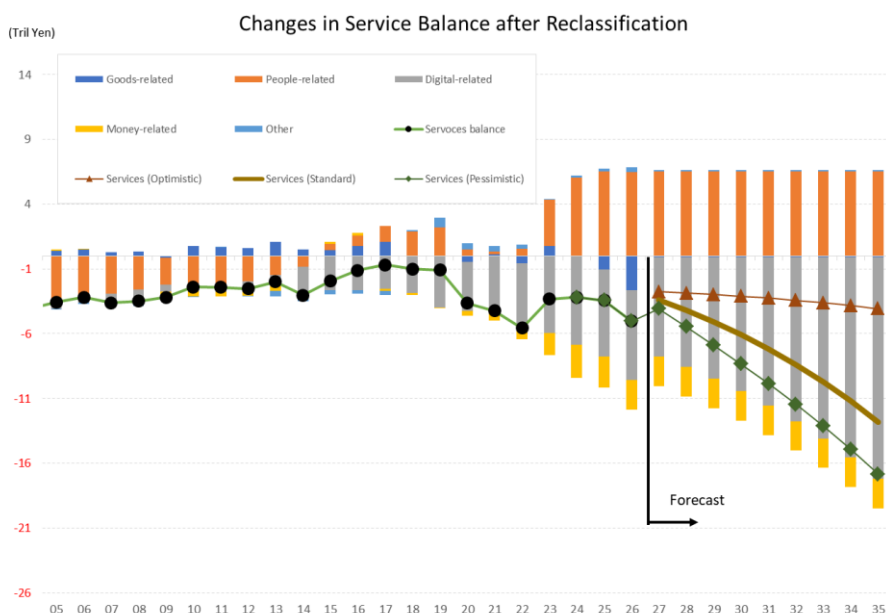


(Source) Bank of Japan; prepared by the Global Foreign Exchange Department, Mizuho Bank

Further, as discussed in detail above (from page 7 onward), there has been a surge in reinsurance transactions, with insurance companies paying reinsurance premiums to overseas reinsurers to offload a portion of risk. Statistically, these appear as deficits in the secondary income and the insurance and pension services balances. These are reflected under the "financial-related balance" in the figure on the previous page, and it is obvious at a glance that they have swelled to levels that can no longer be ignored (around -JPY 2.5 trillion). Additionally, with resource prices spiking and geopolitical instability rising following the Iran attacks, the cost of international travel is on the rise. This has sparked concern that countries reliant on travel surpluses may inevitably see their foreign currency earning channels narrow for the time being. Japan's case being compounded by the ongoing deterioration of its relations with China, maintaining a travel surplus at 2025 levels may be the best it can hope for.

Are Deficits Exceeding JPY 10 Trillion Inevitable by 2035?

The graph to the right presents a long-term simulation of the services deficit based on balance-of-payments statistics for 1Q of 2026. The three scenarios, standard, optimistic, and pessimistic, are differentiated primarily by the projected trajectory of the people-related balance. Specifically, the people-related balance projections assume a plateauing of the travel balance at 2025 levels in the standard scenario, and a continuous 10% annual decline from the 2025 peak in the pessimistic scenario, factoring in the aforementioned global situation as well as deteriorating Japan-China relations. Conversely, the optimistic scenario assumes a continuous 10% annual increase. While both the pessimistic and optimistic scenarios rely on rather extreme assumptions,



(Source) Bank of Japan; prepared by the Global Foreign Exchange Department, Mizuho Bank. 2026 figures are annualized.

the current climate suggests that, at least for now, the pessimistic scenario is more likely to materialize than the optimistic one. Realizing the optimistic scenario would require, at the very least, a drastic improvement in both volume (the number of foreign visitors) and value (unit prices and per-capita spending) in the tourism sector.

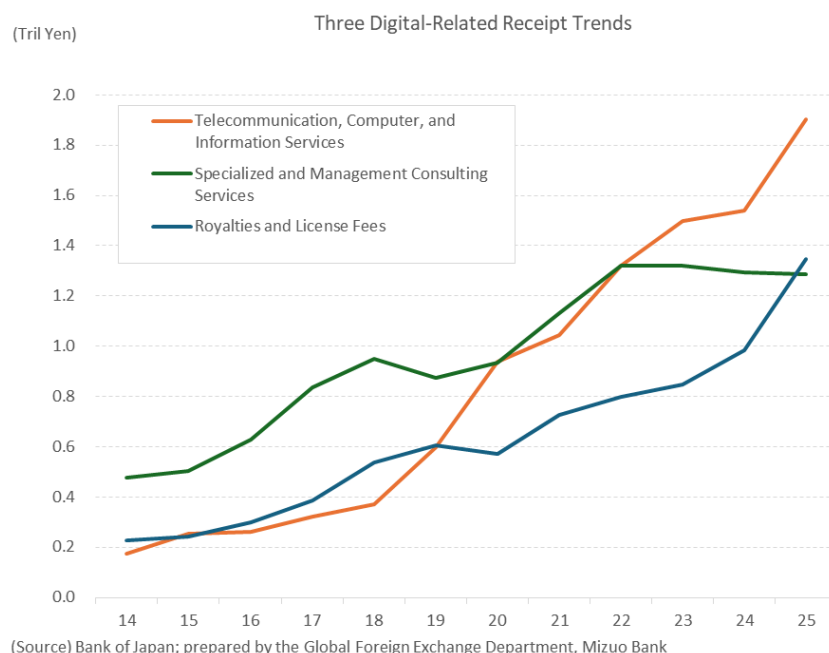
A realistic projection may lie somewhere between the standard and pessimistic scenarios. Estimating the services trade deficit for 2035 based on my simulations yields approximate figures of -JPY 12.8 trillion (deficit) for the standard scenario and -JPY 16.8 trillion (deficit) for the pessimistic scenario, suggesting a realistic deficit in the neighborhood of -JPY 14.8 trillion. For reference, the optimistic scenario projects a deficit of \approx -JPY 4.1 trillion. Given that the average deficit over the past three years (2023-2025) was \approx -JPY 3.3 trillion, the forecast indicates that it would be difficult to keep the services trade deficit from rising above current levels even under the optimistic scenario, which itself is quite unrealistic.

Of course, this simulation is premised on the digital-related deficit continuing to expand at the average rate recorded over the past three years (i.e., around +10%). If that rate were lowered to around +5%, the projected services deficit for 2035 under the standard scenario would shrink to \approx -JPY 6.5 trillion, which is still roughly twice the current level. Incidentally, if the rate were set at a very conservative +1%, the deficit would shrink to about -JPY 3.3 trillion, but it is difficult to imagine that the growth in platform fees set by major U.S. tech companies would remain so modest.

Receipts from Japanese Content are a Ray of Hope

This simulation is based on my own subjective assumptions; of course, the results could vary widely depending on the premise chosen for each item. Yet, even with a balanced distribution of scenarios, it has to be said that the services deficit seems highly likely to expand over the medium to long term. A surprise development that could reverse this trend may be, not the rapid growth of domestic digital platforms, but rather the non-linear surge in receipts from Japanese content (manga, games, anime, music, and video – five categories included in the digital-related balance), which is already showing a gradual upward trend. In the Telecommunication, Computer, and Information Services category, online game sales (including digital downloads and in-app purchases for mobile games) are contributing to increased receipts, while the Royalties and License Fees category is seeing growth driven by licensing rights for manga, games, and anime. It is evident that growth in these areas is substantial (see graph).

Having said that, there are currently no clear prospects for substantial growth in this area, enough to offset payments to overseas platform operators and significantly reduce the digital deficit. At any rate, I fear that the services balance will attract increasing attention as a factor contributing to JPY depreciation alongside the trade balance going forward.



EUR Outlook – Interest Rate Hikes and Incipient Protectionism

EUR Area Monetary Policies Now and Going Forward – Start of Interest Rate Hike Phase

“Not an Insurance Measure”

At its June 11 Governing Council meeting, the ECB raised its deposit facility rate by 25 basis points, from 2.00% to 2.25%. This is the ECB’s first rate hike in approximately three years, since September 2023. Since the attack on Iran, the ECB’s shift toward rate hikes had already become a foregone conclusion, so the move came as no surprise. The decision was unanimous, and ECB President Lagarde explained at the post-Governing Council-meeting press conference that – “We did not discuss or debate any other alternative proposal.” It is the first rate hike by a G7 central bank since the attack on Iran.

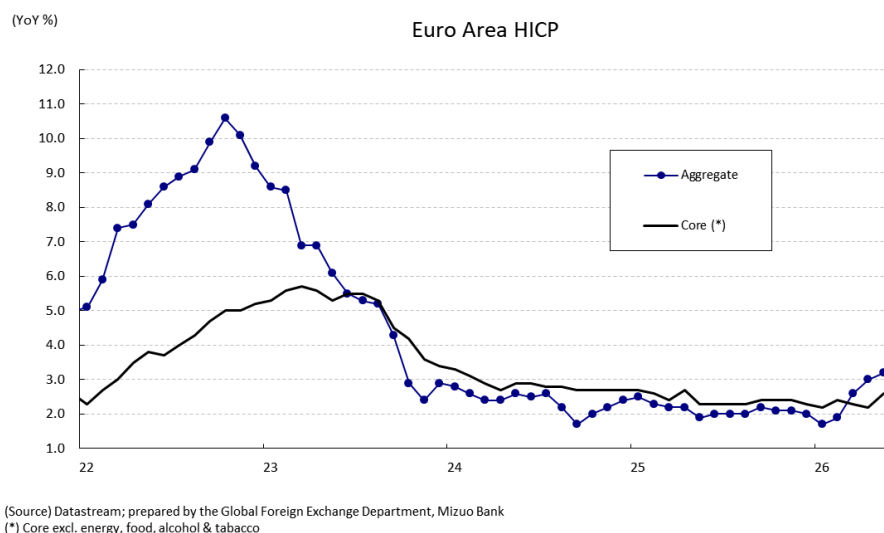
The key point to note this time is that the ECB emphasized the rate hike was not a “preemptive” measure or “insurance” measure taken to counter future inflation risks, but rather a response to the current situation. In response to the first question posed at the press conference, President Lagarde said – “I’ve read here and there that the ECB will make an “insurance decision”, it will be an insurance matter, it will be a pre-emptive rate decision. It’s not at all the way we had our discussions, really.”

Furthermore, President Lagarde explicitly stated that – “Our [rate hike] discussions were predicated on, obviously, the major energy shock that we have observed since the beginning of March.” – and emphasized that the rate hike was strictly a measure in response to inflationary pressures caused by the sharp rise in commodity prices. She clearly asserted that the hike was not just a one-off preemptive or insurance measure but a – “monetary policy decision [...] that is [...] robust across all [forecast] scenarios” and that if not implemented would have had a negative impact on economic and financial conditions. Given that, one can anticipate that the ECB’s interest rate hike phase will continue unless inflationary pressures are alleviated – and, in fact, this seems highly likely. The newly revised Eurosystem staff macroeconomic projections indicate the euro area economic and financial conditions in the region are by no means solid, so the situation is not one in which it would be acceptable to claim interest rates were being hiked simply as a precaution. The ECB thus feels a need to explain the logic that “although the economy is weakening, urgent action is needed to curb inflation”, and that is why President Lagarde was insistent that the hike was not a preemptive or insurance measure.

Furthermore, even after President Lagarde offered this explanation, a reporter asked – “[Y]ou clearly said this rate hike isn’t an insurance hike. What is it then? Is it the start of a new hiking cycle, or what else?” Lagarde responded with a valid point, stating that since the staff projections suggest upward revisions of inflation rates for the time being – “I did say that it’s not an insurance policy interest rate decision, simply because it’s a good monetary policy interest rate decision.” President Lagarde avoided explicitly confirming that this is the beginning of an interest rate hike phase, but since she clearly indicated the hike was not a temporary “preemptive” or “insurance” measure, financial market participants would be wise to brace themselves for a series of additional hikes going forward.

Multi-Scenario Approach Becomes Norm

The newly revised staff projections and the interest rate hike are consistent with each other. The real GDP growth forecast for 2026/2027/2028 was revised to +0.8%/+1.2%/+1.5%, a 0.1 percentage point downward revision for 2026 and 2027 and a 0.1 percentage point upward revision for 2028 compared to the previous forecast (released in March), so the overall GDP growth outlook is largely unchanged. However, the euro area Harmonized Index of Consumer Prices (HICP) forecast for 2026/2027/2028 was revised to +3.0%/+2.3%/+2.0%, reflecting a +0.4 percentage point upward revision for 2026, a +0.3 percentage point upward revision for 2027, and a +0.1 percentage point upward revision for 2028. It seems clear that the ECB decided to raise interest rates after evaluating this acceleration of inflation as the manifestation of a crisis. As President Lagarde stated, the decision to raise interest rates in response to the likelihood of an uptrend in inflation rates is a “sensible monetary policy decision” for a central bank. Conversely, in Japan – where various fiscal measures (such as energy subsidies and tuition-free education) have prevented inflationary pressures from becoming visible – the necessity of such policy responses is difficult to understand intuitively.



It should be noted that these discussions are focused on the ECB's baseline projection scenario. In an effort to enhance the predictability of its policies, the ECB has made it a standard practice to present multiple forecast scenarios when crises increase the level of uncertainty. In addition to the two downside scenarios (the "adverse scenario" and the "severe scenario") presented at the March Governing Council meeting, an upside scenario called the "milder scenario" was added at the June Governing Council meeting, bringing the total number of scenarios to four (see table). Regarding this, President Lagarde explained that – "[T]he decision that we took today to

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

Item	Year	Baseline scenario as of March	Current baseline scenario	Milder scenario	Adverse scenario	Severe scenario
Real GDP	2025	1.5	1.5	1.5	1.5	1.5
	2026	0.9	0.8	0.8	0.7	0.5
	2027	1.3	1.2	1.4	0.9	0.4
	2028	1.4	1.5	1.6	1.5	1.6
HICP	2025	2.1	2.1	2.1	2.1	2.1
	2026	2.6	3	2.9	3.3	4
	2027	2	2.3	1.8	3	5.3
	2028	2.1	2	1.8	2.3	3
Core HICP (*)	2025	2.4	2.4	2.4	2.4	2.4
	2026	2.3	2.5	2.4	2.5	2.5
	2027	2.2	2.5	2.3	2.7	3.8
	2028	2.1	2.2	2.1	2.3	2.9

(Source) ECB; prepared by the Global Foreign Exchange Department, Mizuho Bank, *Excluding energy, food, alcohol, and tobacco.

increase by 25 basis points all our interest rates is robust across the three scenarios: the two updated adverse and severe, but also the milder scenario, which obviously is more positive and something that we should not neglect, but which is at this point in time unlikely to materialise. But we still thought that it was our duty to look at both sides." In light of this, it appears that presenting alternative projection scenarios in both upward and downward directions will be a standard ECB practice in situations marked by high uncertainty levels.

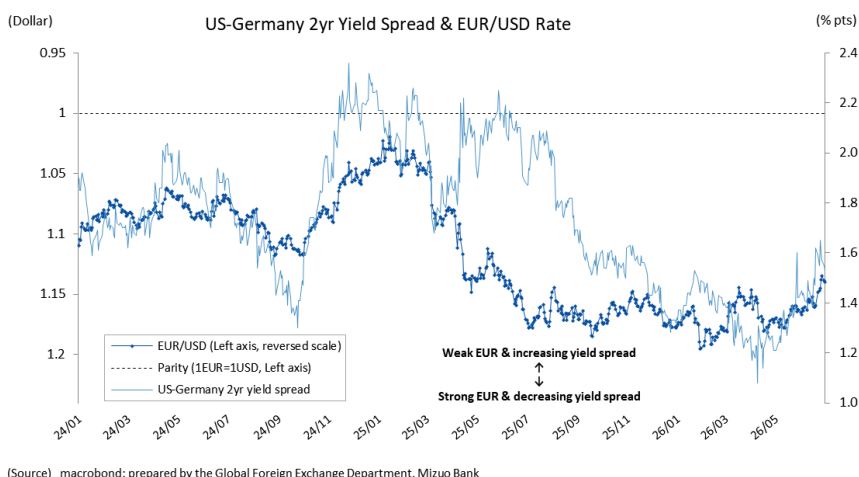
The different scenarios' data generally diverge with respect to energy prices, uncertainty, indirect and secondary spillover effects, and fiscal and monetary policy responses, but the newly added "milder scenario" shares the same assumptions as the baseline scenario with the exception of energy prices. The milder scenario assumes that – "the oil price drops to USD 88 per barrel and gas prices to €41 per MWh in the third quarter of 2026 [gas prices are currently just below GBP41 per MWh] and they are around 15-20% below the baseline levels throughout the horizon. This projected path likely reflects investors' expectations that the conflict could be resolved very swiftly, leading to a rapid normalisation of global oil and gas markets and a return of prices to their pre-war levels by the end of 2026." – although President Lagarde has stated that these trends are unlikely.

Incidentally, the baseline scenario for 2026/2027/2028 projects that crude oil prices will fall to USD96.9/82.2/77.1, but current reports of intermittent armed conflict make even this projection seem somewhat optimistic. It seems likely that the even more optimistic milder scenario is just a pretext utilized to emphasize the symmetry of upside and downside risks. President Lagarde stated during the press conference that – "[the interest rate hike is] a monetary policy decision that stands and that is, as we say in the monetary policy statement, robust across all scenarios, including the mild one." – and this statement may have more significance than it superficially appears to have. While this is speculation, the statement seems to reveal her intent to emphasize that the interest rate hike is consistent with all scenarios, and not invalidated even under the milder scenario that assumes the end of Middle East turmoil. This might be considered to suggest that the current inflation uptrend is no longer a temporary phenomenon caused by an energy shock, so that a corresponding number of rate hikes will be necessary. If this is true, then it appears that there is merit in adding the "milder scenario" to the mix. As discussed below, the main issue the ECB Governing Council is now addressing appears to be a choice between a large-margin, forceful interest rate hike or a small-margin, milder hike based on "seeing through noise".

"Seeing Through Noise" Versus "Forceful Decision"

On the other hand, the severe scenario assumes that – "relative to the baseline, oil prices rise by around 60% and gas prices double, reaching USD 166 per barrel and €98 per MWh respectively in the third quarter [of 2026]." Even in the less extreme adverse scenario – "the oil price increases to USD 122 per barrel and gas prices to €60 per MWh in the third quarter and they remain around 20-30% above the baseline levels throughout the horizon[...]" As was the case at the March Governing Council meeting, where the risk scenarios were first presented, questions along the lines of "Which risk scenario most closely matches the current situation?" were raised during the press conference, but President Lagarde avoided giving a clear answer. However, while overall basis HICP is projected to during 2026 reach +2.9% under the milder scenario, +4.0% under the severe scenario, and +3.3% under the deteriorating scenario, it already began exceeding +3% this past April (see graph above). The current inflation situation falls between that of the base scenario and the adverse scenario, so if interest rate hikes are required to return to the base scenario, such hikes are likely to continue for some time.

Incidentally, during the press conference, President Lagarde indicated that the rate hike decision was not a “forceful decision”, but it was also not a situation in which the ECB could “see through” the noise to determine that a problematic shock would be “limited and short-lived”. A “forceful decision” presumably would refer to a rate hike of 50 basis points or more. In short, given the current situation, “seeing through” is inappropriate but a “forceful decision” would be excessive – it therefore appears that a 25-basis-point rate hike (a standard response) is the appropriate course of action. As of June 13, the market had priced in approximately 1.7 ECB rate hikes by April of next year. As this more than the market projection of about 1.3 Fed rate hikes, it is likely to provide near-term support for EUR/USD. In fact, this EUR/USD strength can be confirmed to be in line with the U.S.-Germany interest rate spread (see graph).



European Political Economics Now and Going Forward – Rise of European Protectionism

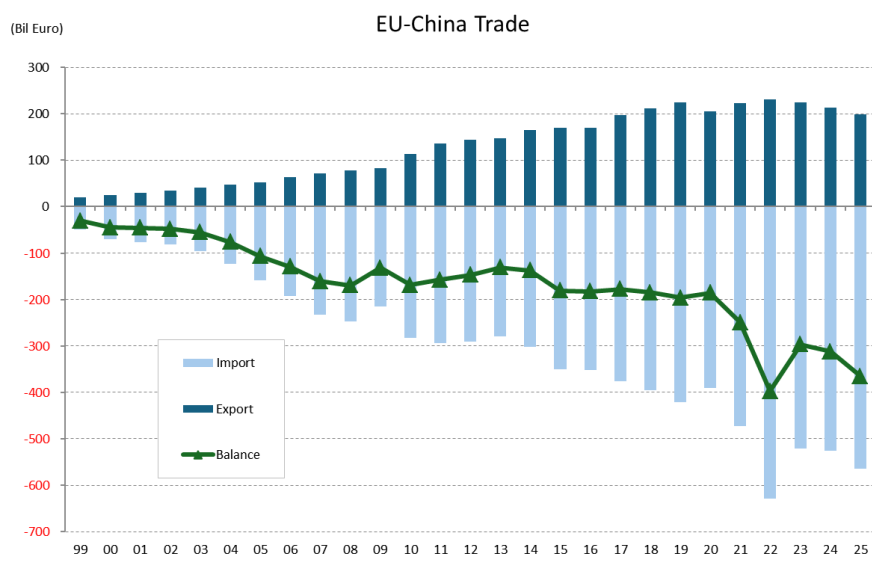
Double Standard?

At the June 18–19 European Council summit, the EU decided to instruct the European Commission to consider measures to reduce its trade deficit with China. Following the meeting, European Commission President Ursula von der Leyen stated that – “we had a productive discussion on structural overcapacities and the impact on global imbalances. [...] Over the past 5 years, imports from China into the EU have increased by 45%. Last year, the EU recorded its largest-ever trade deficit with China - EUR 360 billion. That is a deficit of EUR 1 billion per day. And for the first time, all Member States had a trade deficit. This is not just about cheap imports. We see overcapacities that erode our own manufacturing base. And this is simply not sustainable. [...] The Commission will take this forward. And the topic will remain high on our common agenda.”

While the statement did not go into detail, it is well known that China is investing enormous national resources in such strategic industries as electric vehicles (EVs), lithium-ion batteries, and solar panels. Furthermore, while companies in Japan, the U.S., and Europe incur high costs to comply with strict environmental regulations – such as limits on carbon dioxide emissions and industrial waste disposal – as well as labor rights protections regarding minimum wages, working hours, and safety standards, China pays little attention to these issues. Consequently, China gains a cost advantage (a phenomenon known as “social dumping”). The EU’s concerns are understandable given that the euro area’s private sector currently has the mission of singlehandedly attempting to counter China’s approach – which could be described as state capitalism – and government intervention appears warranted.

It is worth examining the actual figures.

Regarding the goods trade balance, the EU’s trade deficit with China in 2025 approached a record high of approximately EUR360 billion and, as noted in the statement, has been on a clear upward trend over the past five years (see graph). Incidentally, the EU’s largest trade deficit to date was in 2022 (-EUR398 billion), when the pandemic occurred and imports of medical supplies from China increased globally. While this was an unprecedented scale at the time, it was accepted as an unavoidable and temporary level. Although the deficit narrowed in 2023, it has subsequently been gradually expanding and deficit levels similar to that of 2022 now seem likely to become the norm. The EU’s current stance is that this situation cannot be overlooked.



News media have reported that there are voices within the EU calling for measures modeled after the United States’ Trade Act Section 301, which imposes punitive tariffs on countries engaging in unfair trade practices (Nikkei, June 20), and such countries as France are reportedly advocating for restrictions on EU imports of low-cost electric vehicles and

renewable energy-related products from China. More than a year after April 2, 2025 (declared by President Trump to be “Liberation Day”, from which time he would launch trade policies designed to liberate the United States from ‘unfair’ trade relationships), it now appears that that the EU has begun following in the footsteps of the United States. It should also be noted that European Commission President von der Leyen has long criticized the Trump administration’s protectionist behavior by contrasting it with free trade agreements promoted by the EU, remarking at the 2026 Davos Forum that – “[W]e are choosing fair trade over tariffs. Partnership over isolation.” President von der Leyen stated that – “On one hand, we must avoid dependencies that can be weaponized. This means we are accelerating on de-risking, not decoupling. On the other hand, we will keep protecting our market from unfair practices.” – and it would not be surprising if observers were to consider this approach to be quite similar to the Trump administration’s protectionist behavior, despite her efforts to emphasize “de-risking, not decoupling”. While it is commonplace in EU politics to champion grand concepts only to reverse course the next day, the fact that the EU is willing to abandon its position – which was intended to serve as a counterweight to the U.S. as the standard-bearer of the free trade camp – in order to restrict imports from China reflects a strong sense of concern within the bloc, regardless of whether this approach is right or wrong.

Usual EU Pattern – Agreeing in Principle but Disagreeing on Specifics

That said, as is often the case, even when the EU shares a common understanding of the overall issues, it fails to present a united front when it comes to deciding on specific actions to take. As previously reported, some countries, including Spain, are said to be maintaining a cautious stance. While some countries, such as France, prioritize protecting their domestic manufacturing sectors above all else, others – such as Germany and Spain – rely on the Chinese market as a major export destination for their products (including luxury cars, machinery, and agricultural goods). It is a common occurrence in the EU for public decision-making to diverge from the reality of concrete decision making behind the scenes (see table). Moreover, precisely because China is such a massive market, the interests of major member states (and their corporate sectors) are particularly prone to clash. While President

EU Countries' Intentions Regarding Trade with China

Country name	Trade stance	Main exports to China	Targets/Concerns regarding Retaliation from China	Special Characteristics/ Background
Germany	Cautious	Luxury cars, industrial robots, chemical products	Tariff increases on large-displacement vehicles (concern)	Although declining from its peak, China remains a significant market for automobile exports.
Spain	Cautious	Pork and pork products, olive oil	Anti-dumping investigation related to pork exports	The EU's largest pork producer, and China is its largest export market.
France	Hardline	Aircraft, luxury goods, cognac	Anti-dumping investigation into cognac exports	Low dependence on China market for domestic automobile exports, so positioned to prioritize domestic market protection.
Netherlands	Moderate?	Semiconductor manufacturing equipment (ASML), dairy products	Opposition to semiconductor regulations	Having cutting-edge lithography equipment (ASML), so caught between U.S. security requirements and China's enormous demand.
Italy	Moderate?	High-end fashion, industrial machinery, pharmaceuticals	(Currently avoiding direct retaliation)	Withdrawing from China's Belt and Road Initiative and aligning more-closely with EU/US, but China remains a huge market for luxury goods.

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

von der Leyen’s recent statement proclaims that “dependencies that can be weaponized” should be avoided, if the EU were to impose punitive tariffs, China would not fail to exploit that vulnerability. Based on past examples, China is likely to take retaliatory measures that precisely target the EU’s weak points. For example, China could target specific weak points (exports) of each member state, such as cognac to strike at France, pork to silence Spain, or luxury cars to deter Germany. Even if the EU espouses the lofty ideal of “protecting all of Europe from China’s unfair deflationary exports” from a macroeconomic perspective, the EU’s structural weakness lies in the fact that domestic circumstances in each country – such as backlash from farmers and the automotive industry – could stand in the way of this goal. In fact, despite loudly proclaiming concern about serious problems, President von der Leyen’s statement confirms the basic policy of dialogue with China, and this is likely a concession to certain member states that wish to avoid a cycle of escalating tit-for-tat retaliation measures. Regardless of what specific proposals the European Commission puts forward this fall, the process of reconciling the complex interests among member states and reaching an agreement – whether by unanimous consent or a qualified majority⁴ – is expected to be extremely difficult.

Implications for Japan

This situation has significant implications for Japan as well. With its core automobile industry, Japan is also in a position to be wary of China’s “structural overcapacity” and efforts to export its domestic deflationary pressures. While the deflationary pressures stemming from China in the early 2000s largely centered on such items as apparel, currently the focus has shifted to products with higher added value, such as electric vehicles (EVs), inexpensive steel, and chemical

⁴ Qualified Majority Voting (QMV): A decision-making method used in the European Council (EU summit). In order to pass a particular bill or other legislation, two conditions must be met simultaneously: “approval from more than 55% of all member states (more than 15 out of 27 countries)” and “the population of the countries that approve must account for more than 65% of the total population of the EU.”

products. It is essential for Japan to take the EU's current concerns seriously, given concerns about the potential impact on industries that form the backbone of the Japanese economy. The United States has already imposed a 100% tariff on Chinese-made EVs, but if the EU also closes its doors, China's surplus products – left with nowhere else to go – may flood into markets with looser regulations, such as those of Japan and Southeast Asia.

As a country that is an ally of the United States and shares common values with the EU, Japan is well-positioned to take resolute measures against unfair trade practices in line with the U.S. and European stances. Faced with state capitalism – where the playing field is clearly uneven – Japan must take some action or its markets will be unilaterally exploited. On the other hand, “decoupling” – completely severing ties with China, with which we are inextricably linked geographically and economically – is not a realistic option. Under the “de-risking” banner, Japan must undertake sophisticated cost-benefit analyses to carefully identify the core technologies and industries that must be protected while orchestrating shrewd trade strategies that allow for compromises regarding other technologies and industries. The EU shares similar concerns with Japan, and such EU moves as the recent recantation of the nuclear power phase-out policy can provide Japan with much food for thought about what kinds of policy reforms it should be considering.

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