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Forex Medium-Term Outlook

December 25, 2024

Overview of Outlook

USD/JPY recovered and continued to increase in December. With contrasting communication from the BOJ and the Fed, predictions of the resumption of JPY depreciation are gaining ground. During the current forecasting period, investors may still be able to gain from JPY appreciation during the January-March quarter against the backdrop of the BOJ and the Fed moving in opposite directions, with rate hikes and rate cuts, respectively. However, both central banks are expected to halt their policy normalization efforts from the April-June period onward. Given the nature of market expectations that tend to factor in extreme developments, there could even be a phase from mid-2025 through 2H of the year when the markets factor in a rate hike by the Fed. On the other hand, when it comes to JPY supply and demand, while Japan's trade deficit is expected to shrink as resource prices stabilize, the cash-flow-based (CF-based) current account balance is expected to remain neutral, with no significant improvement, as the travel surplus peaks and the digital deficit continues to expand. Moreover, household JPY selling associated with the new NISA scheme is likely to remain significant despite a possible decline compared with 2024. Taking all this into account, there will continue to be a larger number of people wanting to sell JPY than those who want to buy it. In sum, one could say that the JPY supply-demand climate is expected to be its best in three years, but the interest-rate climate is likely to become challenging, with the end of rate cuts by the Fed becoming an issue. Under such circumstances, my main forecast scenario is that USD/JPY will consistently increase during the latter half of the forecasting period. As a risk scenario, it is not outside the realm of possibility that the BOJ could be forced to implement consecutive rate hikes in an attempt to defend JPY in phases when USD/JPY remains stable at 160 or higher.

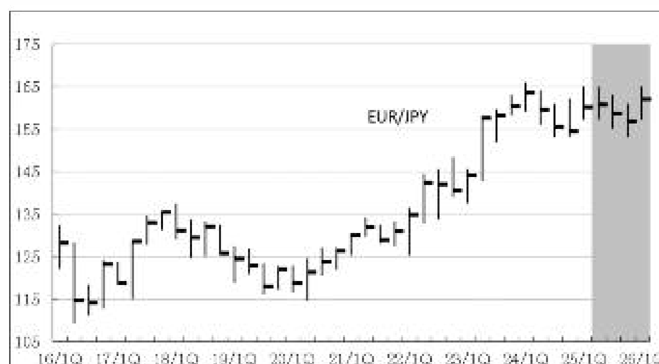
EUR continued to weaken in December. The headwinds against the currency remain strong as political uncertainty adds to an already fragile economy. Amid lackluster economic and financial situations in Germany as well as across the region, the German and French governments collapsed one after the other. To make matters worse, fresh elections will not be held until February 2025 in Germany and until after July 2025 in France. When it comes to external factors, concerns about additional tariffs expected under the next Trump administration are damaging the business confidence of companies in the region. It is literally a situation of troubles both at home and abroad. In contrast to the U.S. economy, which is stably growing at above its potential growth rate, the German economy, which leads the region, is expected to post zero percent growth rate in 2025. This will directly translate to a difference in the number of interest rate cuts by the Fed and the ECB during the current forecasting period. To be specific, the ECB is expected to implement 4-5 rate cuts in 2025, while the Fed is likely to implement 1-2 cuts, which is a significant difference. As a result, EUR/USD could even fall below parity for the first time since 2022. To add to all this, the upcoming Trump administration may pressure major European nations to increase their defense spending, potentially leading to greater friction between euro member states and the European Commission (EC) over fiscal discipline, and this could become a factor promoting the sale of EUR.

Summary Table of Forecasts

	2024 Jan-Dec (Actual)	2025 Jan-Mar	Apr-Jun	Ju-Sep	Oct-Dec	2026 Jan-Mar
USD/JPY	139.58 ～ 161.96 (157.30)	152 ～ 160 (154)	153 ～ 162 (156)	154 ～ 163 (157)	154 ～ 163 (160)	155 ～ 164 (162)
EUR/USD	1.0332 ～ 1.1214 (1.0408)	1.01 ～ 1.06 (1.04)	1.00 ～ 1.05 (1.03)	0.98 ～ 1.03 (1.01)	0.96 ～ 1.01 (0.98)	0.98 ～ 1.03 (1.00)
EUR/JPY	154.94 ～ 175.42 (163.35)	157 ～ 165 (160)	157 ～ 165 (161)	155 ～ 163 (159)	153 ～ 161 (157)	157 ～ 165 (162)

(Notes) 1. Actual results released around 10am TKY time on 25 DECEMBER 2024. 2. Source by Bloomberg
3. Forecasts in parentheses are quarter-end levels.

Exchange Rate Trends & Forecasts



USD/JPY Outlook - Supply-Demand in Equilibrium; Interest Rates Point to Resumption of JPY Depreciation

Key Factors Determining JPY Rate Trend in 2025 – Supply-Demand Analysis

Key Points for Forecasting JPY in 2025 – Supply and Demand

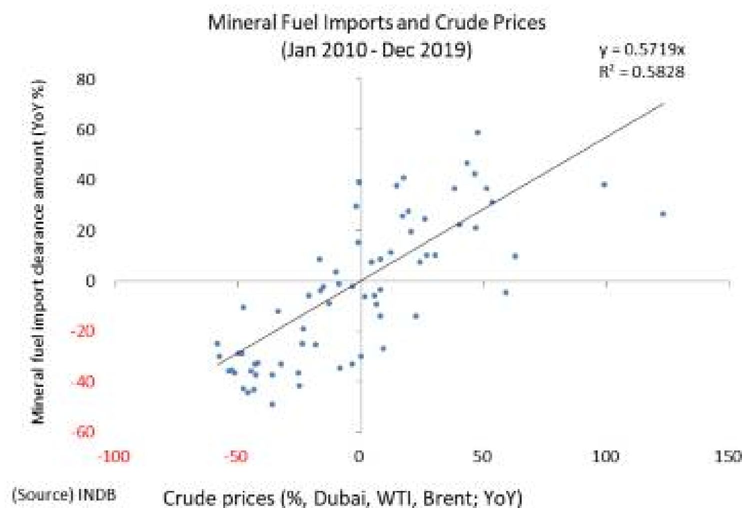
I would like to summarize the key points for forecasting JPY rates in 2025 from two perspectives: (1) supply and demand, and (2) interest rates. I will begin with (1), which has always been the stronger focus of my analyses. To begin with the conclusion, based on the information currently available, I expect the supply-demand environment to continue to be neutral in 2025, as it was in 2024 (of course, as the figures for 2024 are not yet confirmed at the time of writing this report, a substantial number of them are my own estimates). The current account balance, which holds the key to supply and demand analysis, is difficult to predict precisely as it depends on a variety of factors, including resource prices, exchange rates, economic disparities with other countries, and geopolitical risks, but it is worth presenting even a rough prediction. Last year too, I presented a rough prediction of the current account balance, and it turned out not to be too far removed from the reality, and it proved useful for formulating my outlook, so I would like to share my projections again this year based on information available at the current time.

First, as resource prices and JPY depreciation level off, I predict that the trade balance, which is a key factor determining the current account balance, will post a smaller deficit. Crude oil prices are still the most important variable to consider when predicting the trade balance. In this regard, the annual average price of crude oil (per barrel) in recent years has been about USD100 in 2022, and about USD80 in 2023 and 2024. I will refrain from predicting the price of crude oil in 2025, but many expect it to fall owing to weaker demand amid sluggish economic growth in China. Many additionally believe that supply will be relatively strong as a result of the second Trump administration's proactive preferential policies for the oil industry and calls for increased oil production (although, of course, it takes a long time for production to actually be increased). There are also predictions to the contrary of higher crude oil prices resulting from heightened geopolitical risks due to Trump's diplomatic stances. However, I find predictions of a fall in resource prices due to the rolling back of excessive environmental regulations and an increase in the supply of fossil fuels to be more persuasive. Meanwhile,

there are strong concerns that the mutual imposition of additional tariffs will slow global economic growth and reduce the demand for goods overall, which is also a rational prediction.

If Crude Prices Remain Stably Below USD70…

The fact of the matter is that crude oil prices have been weak since Trump's election, and have been falling below USD70 off and on at the time of writing. If we assume a USD70 average price for crude oil in 2025, that would be a 13% decline from the previous year. Taking data from January 2014 through December 2019 (the five years before the pandemic) as representative of normal times, a 1% change in crude oil prices amounts to a 0.6% change mineral fuels (see graph). This means that a -13% change in crude oil prices will amount to a decrease in the import value of mineral fuels by just under -8%. Since mineral fuels account for about a quarter of Japan's total imports, we can assume that total imports will be pushed down by about 2%. Japan's imports amounted to around JPY110.2 trillion in 2023, so a 2% decline in imports will improve the trade balance by about JPY2.2 trillion. This is just for crude oil imports; the actual impact is likely to extend also to other major import categories, such as raw materials (wood, etc.), manufactured products classified by raw material (iron and steel, nonferrous metals, etc.), and chemical products (pharmaceuticals, etc.), the unit prices of which are influenced by crude oil prices. Of course, the above are only rough estimates, but <u>if crude oil prices remain level below USD70, this will contribute to improving the overall trade balance by trillions of JPY</u>.



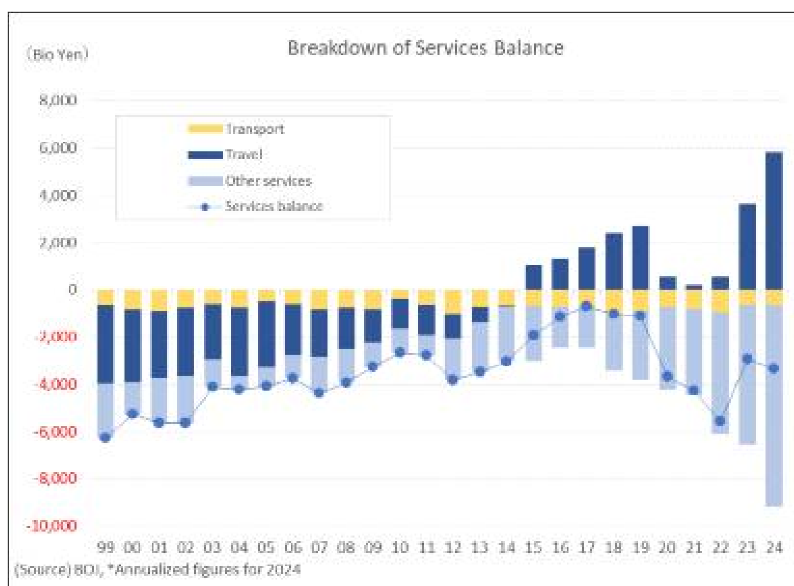
Going simply by such assumptions about import trends, it seems highly likely that the trade balance will improve in 2025. However, if global economic growth is dampened in the wake of trade wars started by the second Trump administration, export growth will inevitably decline. It is difficult to say anything for certain on this point. For Japan, in particular, there are concerns that its prized automobile exports to the U.S. will be targeted for additional tariffs. If that happens, overall improvement in the trade balance will be limited. With no certainty regarding export growth, it may be difficult to return to pre-2019 trade balance levels (an average of approx. +JPY240 billion over the five years from 2015 to 2019, and approx. -JPY2.6 trillion over the 10 years from 2010 to 2019) in 2025. <u>If we assume an around -JPY6 trillion trade deficit level for 2024, even with an improvement, only around -JPY3 trillion to -JPY4 trillion can be expected for 2025</u>. Even if this is only a fifth of the largest ever deficit recorded (approx. -JPY20 trillion for 2022), it is still a historically large deficit for Japan. However, this may be the new normal.

Incidentally, on December 6th, the Japan Foreign Trade Council (JFTC) released a trade forecast by the seven major general trading companies[1], which predicted a trade surplus of about +JPY2 trillion for fiscal 2025 (April 2025 to March 2026). The forecast is based on macro analysis as well as detailed calculations of demand for individual products based on internal and external interviews with each trading company. To the extent that it is based on a bottom-up analysis, the forecast is more granular than my own. Although the figures are different, the JFTC forecast also emphasizes the idea that the trade balance will improve as imports decrease more than exports, particularly emphasizing the impact of resource prices as well as JPY depreciation leveling out and pushing down import value. <u>At this time, the consensus seems to be that there will be an improvement in the trade balance in 2025 compared with 2024</u>.

Will Intellectual Labor Prevail over Physical Labor?

It is even more difficult to make estimates about the other categories. We may safely assume that the primary and secondary income balance will be roughly the same as in 2024, at +JPY40 trillion and -JPY4 trillion, respectively. Of course, these figures are based on adding the figure for January to October 2024, which is known at the time of writing, with the figure for November-December 2023, assuming a similar performance for these months in 2024. The final results for calendar year 2024 will only be available in February 2025.

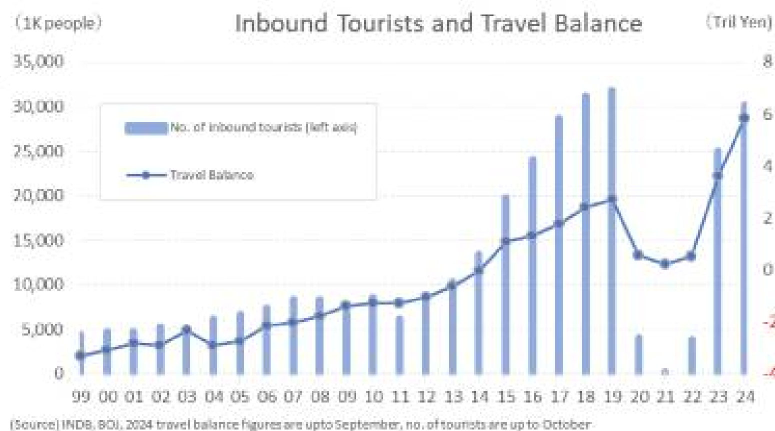
<u>Next, how should we view the remaining category, i.e., the services balance (see graph)? In this regard, two changes seem certain</u>. One is a peaking of the travel surplus, and the other is the continued growth of the other services deficit, mainly driven by the digital deficit. Both of these



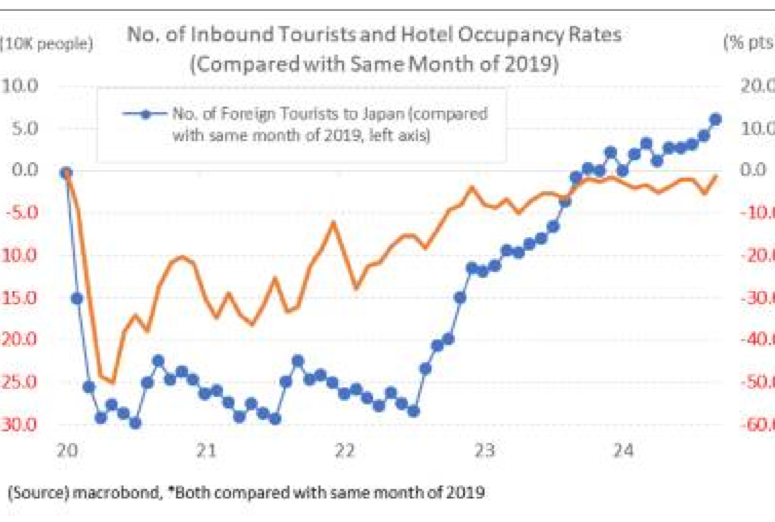
[1] ITOCHU Corporation, Sumitomo Corporation, Sojitz Corporation, Toyota Tsusho Corporation, Marubeni Corporation, Mitsui & Co., Ltd., and Mitsubishi Corporation

are developments that indicate a worsening of JPY supply and demand (tending toward JPY selling). As the graph shows, the services balance in recent years has been characterized by the travel surplus being cancelled out by the growing other services (i.e., digital) deficit. In non-technical terms, this can be called a battle between "intellectual vs. physical" labor. Given Japan's declining population, one can be certain that intellectual labor will prevail over physical labor going forward, but it remains to be seen whether there will be any signs of that in 2025. In conclusion, Japan may, in 2025, barely manage to keep its services deficit at the same level as in recent years. It is important to keep in mind, however, that the steadily growing digital deficit cannot continue to be offset by a travel surplus.

First of all, the yoy growth in the travel balance will slow. Many people seem to have forgotten, but Japan had border control measures in place until March 2023. In the global economy, where normalcy had already returned by then, this was pointed out as an extremely unusual case. Compared with the approx. +JPY3.6 trillion travel surplus for 2023, which was the highest on record until then, the 2024 travel surplus may be even higher, somewhere in the +JPY5-trillion range, possibly close to +JPY6 trillion. This yoy increase is mainly due to the travel balance for the January-March quarter of 2023 being suppressed by government policy (if we compare the figures for the January-March period alone, the surplus doubled from +JPY661.5 billion in 2023 to +JPY1.255 trillion in 2024). A similar level of yoy growth cannot be expected in 2025. In other words, 2025 will be a year in which we can finally ascertain the fundamental strength of growth in the travel balance unrelated to the pandemic. In this regard, it will be interesting to see if the travel surplus peaks in 2025, with the leveling out of labor shortages and JPY depreciation as well as domestic concerns about overtourism. Incidentally, the hotel occupancy rate has not yet exceeded 2019 levels, and in fact show signs of sluggish growth (see graph below right). If the travel surplus remains at the same level as in 2024, it may amount to about +JPY5 trillion, but could decline to somewhere between +JPY4 trillion and +JPY5 trillion if it peaks in a more pronounced way.



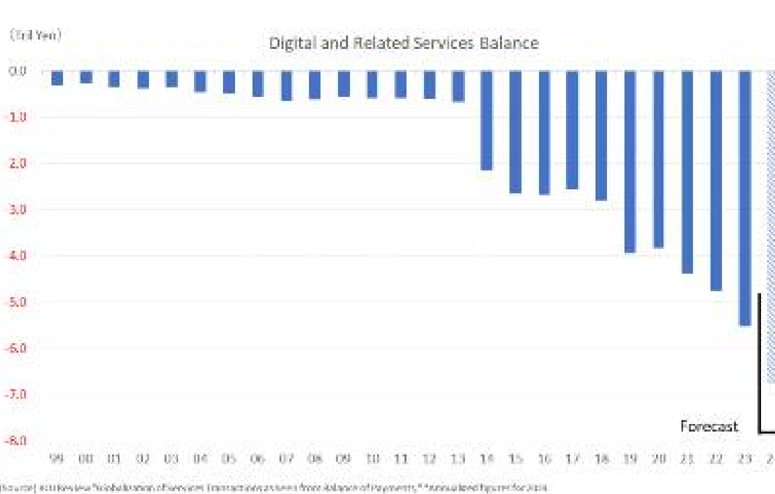
(Source) JNTO, BOJ, 2024 travel balance figures are up to September, no. of tourists are up to October



(Source) macrobond, *Both compared with same month of 2019

The Digital Deficit Will Continue to Grow

In contrast to the travel surplus, the other services deficit is also hitting new record highs each year, with the total for January to October 2024 reaching approx. -JPY7.1 trillion, which is higher than the deficit for the whole of 2023 (approx. -JPY5.9 trillion). Of this, the deficit resulting from payments toward digital and related services (hereinafter referred to as the digital deficit), which has been attracting attention in recent years, accounts for the largest part, at approx. -JPY5.6 trillion. For comparison, taking the 2023 trade balance as an example, Japan's liquefied natural gas (LNG) imports were approx. -JPY6.5 trillion, while coal imports were approx. -JPY5.8 trillion (crude oil imports were approx. -JPY11.4 trillion). In other words, digital services supplied by U.S. IT giants represented by GAFAM (Google, Amazon, Facebook, Apple, Microsoft) are now built into economic activity as necessities comparable to natural resources. The nature of these services is such that their price elasticity of demand is extremely low, so consumption will continue unabated even if prices are raised. As the figure shows, the digital deficit has expanded rapidly since the pandemic. Even if the sharp expansion in deficit for 2022 and 2023 can be attributed to JPY depreciation, the trend itself began in 2020, which makes it reasonable to assume that the expansion is purely due to a rapid expansion in demand for these digital services. Nor is there any reason for the trend to end in 2025. Incidentally, the minutes of the first Ministry of Finance meeting to discuss the "Challenges and Solutions for the Japanese Economy as Indicated by the Balance of Payments," in which I also participated as a committee member, state that "The background to the digital deficit expansion is the



distribution of remote learning tools to students and others during the COVID-19 pandemic, but this includes an element of investment in our youth." Thanks to the pandemic, remote meetings, classes, and seminars have become common in all spheres of life, not limited to education. With AI also expected to be increasingly adopted in corporate and educational situations going forward, an end to this trend in the near future is difficult to imagine.
According to my calculations, Japan's digital deficit will hit approx. -JPY7 trillion in 2024. As for yoy rate of change in the digital deficit, the 10-year average is around +13% (this is the longest period for which an average can be calculated as the trend only began in 2014). Assuming the same rate of deficit expansion, and an approx. -JPY7 trillion deficit for 2024, the 2025 digital deficit would be around -JPY7.7 trillion, and nearly -JPY8 trillion for the other services deficit as a whole. If we assume the transport balance to be the same as last year, at -JPY600 billion, the services deficit on the whole will be about -JPY3.6 trillion (other services deficit -JPY8 trillion, transport deficit -JPY600 billion, travel surplus +JPY5 trillion). This level of deficit is similar to that of recent years. It seems apt to say that Japan is working desperately to stop the deficit from expanding by earning foreign currency through physical work (tourism industry) to pay for intellectual work (digital services). However, with the population continuing to decline, the physical work Japan can put in will inevitably fall behind the intellectual work required, so the country needs to prepare for a time when the services deficit expansion can no longer be reined in.

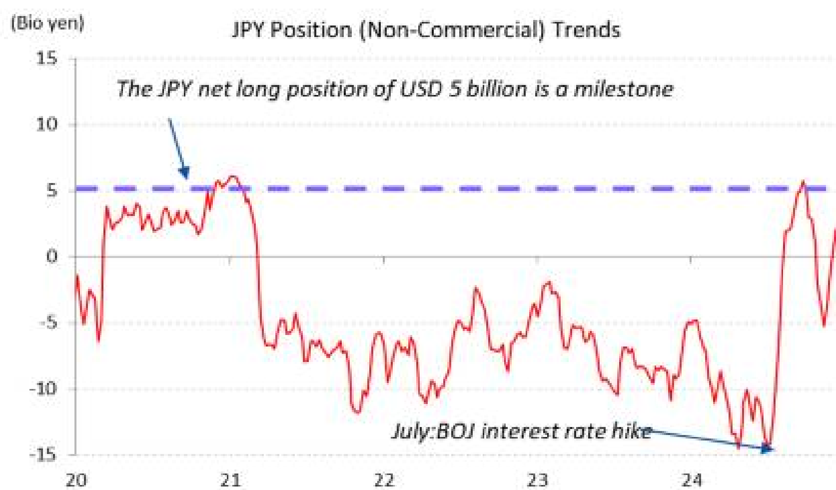
CF-based Current Account Balance Forecast to Remain Neutral

The chart to the right presents a numeric summary of the aforementioned details. I want to restate that the current account balance is affected by many variables, the actual outcomes of which are highly variable. However, since I receive numerous inquiries about the outlook for the CF-based current account balance, I have presented it here as shown in the chart. Incidentally, I had shared a similar chart in last year's Mizuho Market Topic, putting the 2024 CF-based current account balance at a surplus of about +JPY3 trillion. As of the present time, the figure for the January-October period is a surplus of around +JPY1.5 trillion, so my prediction was not too far off the mark. Of course, even if my prediction of the CF-based current account balance were to be accurate, that does not guarantee the accuracy of my JPY outlook, but it can be said that a JPY appreciation trend would not continue too long in a situation where a large CF-based current account deficit is in sight. Supplementally using supply-demand information could help avoid large miscalculations.
To calculate the CF-based current account balance, I have averaged and applied the primary income balance JPY conversion percentage (percentage of primary income surplus that can definitely be expected to result in JPY buying) for the last five years for which final annual data is available (2019-2023).
Estimating the CF-based current account balance for 2025 using this figure gives around +JPY1.0 trillion. It seems safe to view this as a roughly neutral balance. Real-demand-led JPY selling, as in 2022 and 2023, is unlikely to be replicated, and I expect it to be a year when JPY rate trends are relatively more influenced by interest-rate differentials, i.e., speculative JPY selling. Incidentally, the same was true of 2024. As I have explained before in this report, volatility tends to increase when real demand remains close to equilibrium and speculation dominates market trends. JPY could undergo sharp appreciation similar to what we saw in early August and late November 2024, and this could be accompanied by volatility in Japanese share prices (see graph above). If such events become chronic, they could make it difficult for the BOJ to continue with policy normalization.

Possible Outcome of CF-Based Current Account Balance for 2025

	Item	Amount (JPY trillions)	Notes
(1)	Trade balance	-4.0	Improves due to fall in crude prices
(2)	Services balance	-3.6	
	Travel	5.0	Growth momentum arrested. Eventually peaks.
	Transport	-0.6	Assuming similar to 2024*
	Other services	-8.0	Digital deficit in -JPY7.5~8.0 trillion range?
(3)	Primary income balance	39.8	Assuming similar to 2024*
(4)	Primary income balance (CF-based)	12.9	*Assuming avg. JPY conversion percentage of past 5 years (37%)
(5)	Secondary income balance	-4.3	Assuming similar to 2024*
	Current account balance (CF-based)	1.0	(1)+(2)+(4)+(5)
	Current account balance (statistical)	27.9	(1)+(2)+(3)+(5)

(Source) Prepared by author using BOJ data, *Calculated using actual figures for Jan-Oct 2024, and assuming same figures as 2023 for Nov and Dec.

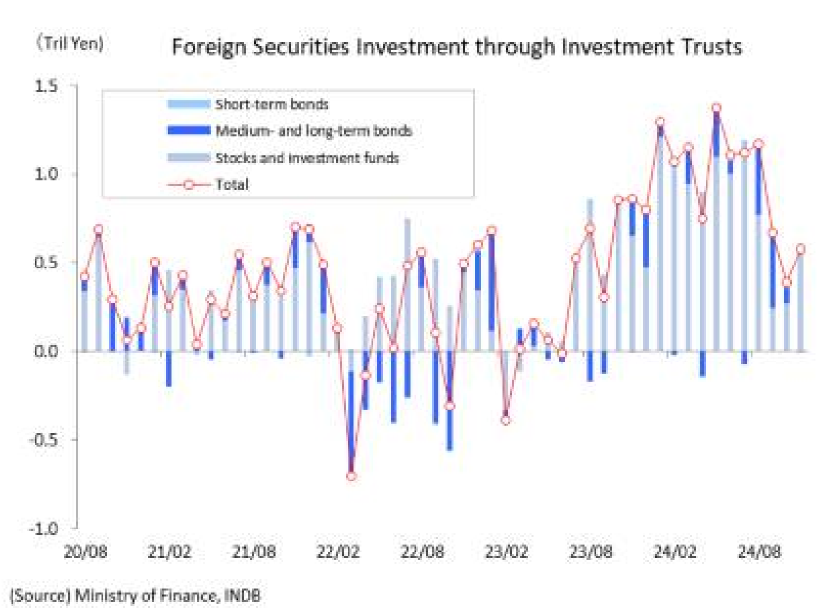


(Source) CFTC, Bloomberg

When discussing the forex outlook, it is important to make clear whether ongoing exchange rate fluctuations are driven by real demand or speculation. This helps to estimate the sustainability of the market fluctuations as well as giving a better idea of the possible range of fluctuations. It also facilitates detailed explanations in the event of unexpected developments. Please note that explanations that only take into account the expansion or contraction of U.S.-Japan interest-rate differentials do nothing more than follow the momentum of speculative trading.

The Future of Household JPY Selling

Despite titling it "Supply and Demand," the discussion so far has been on the current account balance. Of course, it cannot be denied that the current account balance is the most appropriate figure for painting a picture of the supply and demand climate. This year, however, household JPY selling due to the new NISA scheme and other factors is also said to have contributed to JPY depreciation. How should this be viewed? As I have feared in previous issues of this report, foreign securities investment via investment trusts, which attracts attention as the proxy variable for household JPY selling, has slowed down significantly since September 2024 (see graph). To give some figures, the total foreign securities investment for the period from January through November 2024 was +JPY10.6792 trillion. Compared with the +JPY4.5447 trillion for all of 2023, it would be reasonable to assume that a few new sellers emerged in the JPY market in 2024. However, one wonders if this is a permanent phenomenon.

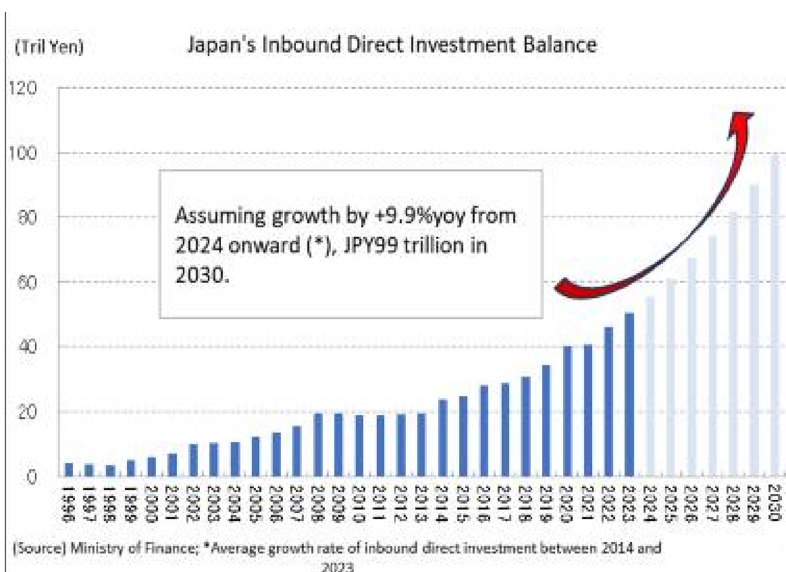


(Source) Ministry of Finance, INDB

It is still too early to tell. As the figure shows, the momentum weakened significantly starting September, but the reasons for this are not altogether clear. Perhaps the initial momentum was in celebration of Japan's kick-off as an asset management center with the beginning of 2024, or it could be that the momentum petered off after August 5, the Reiwa version of Black Monday. It could even be that investments will fall off from around September every year as investors find they have used up their annual Growth NISA quota (JPY2.4 million per year). However, if the average monthly buying pace is assumed to be that seen over the past three months (September through November), i.e., around +JPY350 billion, the annual figure will shrink to +JPY4.2 trillion. This is almost the same as in 2023, and could imply a significant lessening of downward pressure on JPY. Given an increase in the quota of tax-free investments, it would be irrational of investors to return to the pre-2023 pace of net purchases, but it may be unreasonable to take for granted an over +JPY10 trillion annual net purchase of foreign securities (i.e., JPY selling). If household JPY selling runs out of steam, it could limit further JPY depreciation.

Will Inward Direct Investments Increase Stably?

If the CF-based current account balance remains at the same level as in 2024, and household JPY selling shrinks, the downward pressure on JPY from the supply-demand side is likely to weaken. To add to this, there is also an interesting trend in the direction of JPY buying. This relates to the Japanese government's promotion of inward direct investment. As of now, the government has set an inward direct investment target of JPY100 trillion by 2030. Since the figure stood at JPY50 trillion at the end of 2023, over JPY7 trillion a year of investment including for 2024 will be required for achieving the target. However, inward direct investment only increased by +JPY1.6 trillion during the first nine months of 2024 (which is around +JPY2.1 trillion when annualized). If 2024 ends with only JPY2 trillion or so of inward direct investment, an average of +JPY8 trillion [(JPY50 trillion-JPY2 trillion)/6 years] will be required for the years 2025~30 in order to achieve the government's target. If such a scale could be achieved in terms of direct investment flows, which are likely to be outright transactions, that would be quite significant. For example, at the rate of +JPY8 trillion/year, inward direct investment could offset household JPY selling. Though lacking momentum at the current time, continued growth in inward direct investment is quite likely, given government support for it. This is something that will, to some extent, offset the JPY selling pressure.



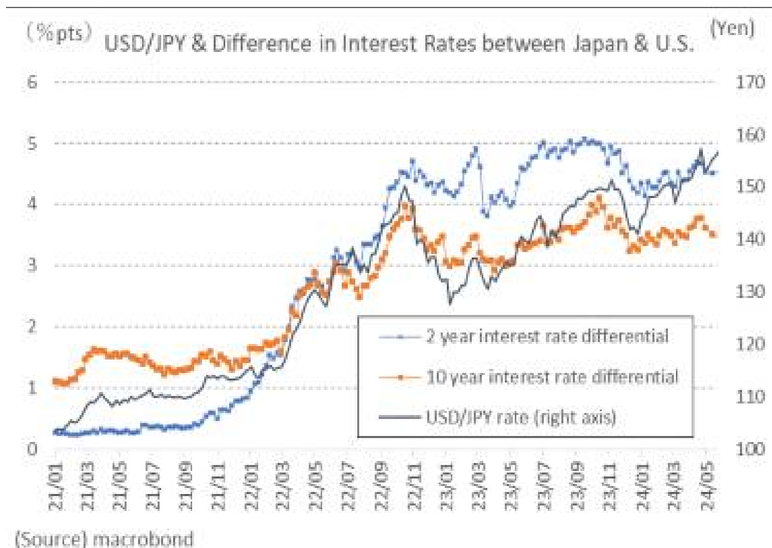
(Source) Ministry of Finance; *Average growth rate of inbound direct investment between 2014 and 2023

Overall, the supply-demand climate is not conducive to a repeat of the JPY depreciation trend seen in 2022 and 2023, so any weakening of JPY that does take place is likely to be driven primarily by speculation about U.S. and Japanese policy interest rates. This warrants a discussion of the policy interest rate trajectories of the BOJ and the Fed. The next section discusses interest rates and other factors that could cause USD/JPY to fluctuate.

Key Points Regarding JPY Exchange Rates in 2025 – Interest Rate Analyses

Interest-Rate-Differential Issues in 2025

The above sections of this article overview key 2025 forex outlook points from the perspective of the JPY supply-demand situation, but what about the perspective of interest rates? As the phrase "data dependent" suggests, central banks are not actually omniscient regarding future developments but tend to simply respond to the momentum of current events and data. In light of that, I do not see much point in discussing the longer-term JPY outlook as part of a game of predicting the number of interest rate hikes and cuts based on monetary policy management and policy interest rate trajectories. Central banks' interest rate adjustments are in fact an important explanatory variable, but I believe there are more important things to consider when discussing JPY's depreciation over the past three years or so. When considering six-month or one-year outlooks, however, it would not be appropriate to ignore the fact that inter-country interest rate differentials determine the relative strength and weakness of relevant countries' currencies (see graph). The following sections of this article seek to clearly explain how I am forecasting 2025 USD/JPY trends based on current interest rate trends.



(Source) macrobond

U.S. Neutral Interest Rate May be Underestimated

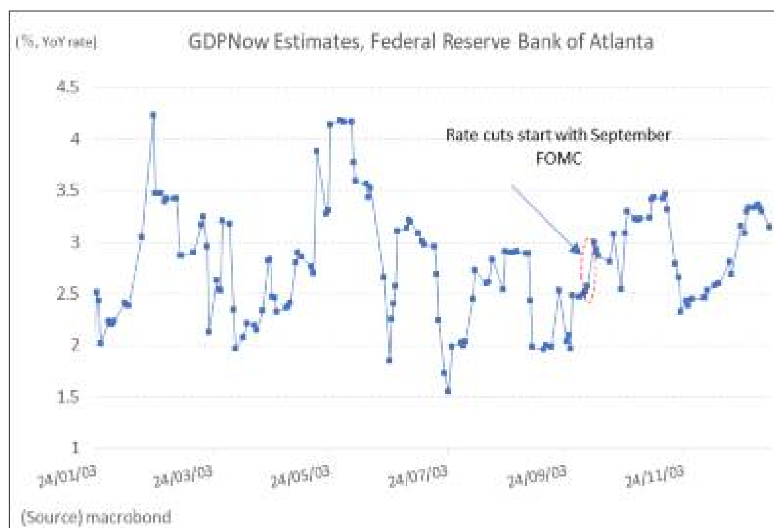
The first issue is what Fed's policy management decisions can be anticipated. Currently, I am assuming that there will be two Fed rate cuts in the first half of 2025, and I am allowing for a risk scenario in which there may be three cuts. At the FOMC meeting held on December 17-18, the members' policy interest rate outlook (dot chart) indicated two rate cuts in 2025 (see chart). Aside from the issue of how many cuts there may be, I expect that the issue of when rate cuts should be discontinued will remain a hot topic during the first half of the year. As I have repeatedly argued in this article, 2025 is the year when the end of Fed rate cuts will become a point of contention. As can be seen from Fed Chairman Powell's statement at his December press conference that – "I would say we are though in a new phase in the (rate cut) process" – it seems safe to assume that the environment supportive of JPY appreciation premised on Fed rate cuts is unlikely to last.

Policy Interest Rate Outlook as of Each Year End (Median Estimate)

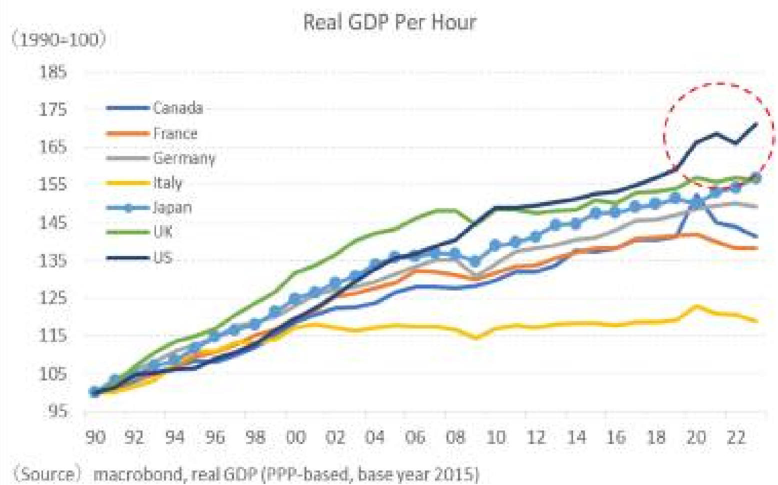
FOMC Date	2024	2025	2026	2027	Longer run
Sep-23	5.125%	3.875%	2.875%	—	2.500%
Dec-23	4.625%	3.625%	2.875%	—	2.500%
Mar-24	4.625%	3.875%	3.125%	—	2.5625%
Jun-24	5.125%	4.125%	3.125%	—	2.7500%
Sep-24	4.375%	3.375%	2.875%	2.875%	2.8750%
Dec-24	4.375%	3.875%	3.375%	3.125%	3.0000%

(Source) FRB

Fed Chairman Powell's comment that the interest rate cuts that began in September have entered a "new phase" in December is a clear indication of a change of heart. This may perhaps reflect a possibility that the neutral interest rate assumed by the Fed was too low. The latest dot chart's long-term interest rate outlook (the "Longer run" figures, which can be considered to represent the neutral interest rate) is 3.00%, which is about +15bp higher than that of the previous dot chart in September. However, this may still objectively be considered too low. For example, the Atlanta Fed's "GDP Now" real-time GDP tracking model consistently suggests GDP growth of over 3%, compared to a potential growth rate of just over 2% (see graph). Given this situation and the fact that the personal consumption expenditure (PCE) deflator has consistently remained in the +2% range, it is fundamentally difficult to justify a need for an interest rate cut. According to estimates by the Congressional Budget Office (CBO) presented in the spring of 2024, the U.S. potential growth rate (real) was 2.2%. This suggests that, if the actual inflation rate fluctuates around the +2% level, then the neutral interest rate would be in the high 3% to low 4% range. If this is the case, it would not be surprising if interest rates were to be cut one or two more times (by a margin of -25bp to -50bp). This would not deviate too much from the December dot chart figures.



(Source) macrobond



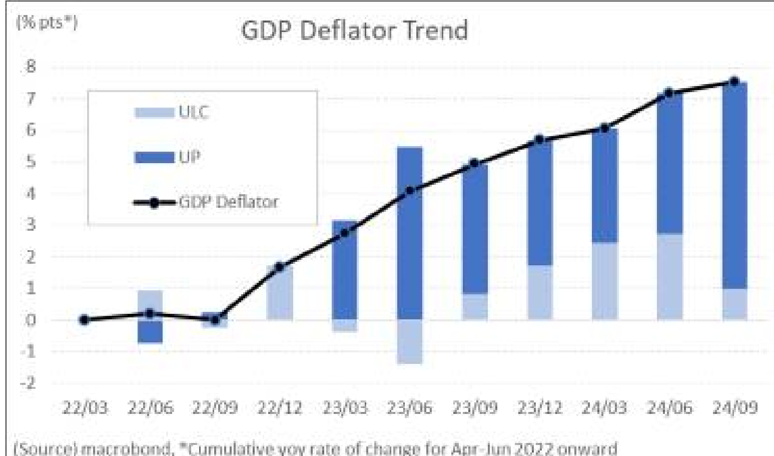
(Source) macrobond, real GDP (PPP-based, base year 2015)

Furthermore, the CBO's estimated potential growth rate of 2.2% may be an underestimate. As you can see from the graph, U.S. labor productivity (≈ real GDP per hour) has clearly risen far above the rest of the major countries due to labor market changes triggered by the pandemic. This is likely to have pushed up the potential growth rate and therefore the neutral interest rate. However, it can be argued that the dot chart's "Longer run" figures indicate the neutral interest rate only with a significant margin of error, and it seems reasonable to assume that the error margin is in an upward direction. In summary, the Fed is likely to cut interest rates about twice in the first half of 2025, and even if the BOJ proves capable of raising interest rates during the same period, such hikes will likely be limited to about two (more on the BOJ later). As a result, my basic understanding is that the tapering of Japanese and U.S. monetary policies and the corresponding tendencies toward JPY appreciation and USD depreciation are guaranteed to persist through the end of this fiscal year. Up to this point, this discussion has deliberately avoided mentioning the second Trump administration's behavior, as it is impossible to predict. However, given that there is little doubt that the Trump administration's policy mix will be inflationary and that the real economy is already strong, it would be reasonable to assume that the number of prospective Fed interest rate cuts will be limited. Given the United States' current economic, financial, and political situations, there is certainly no urgent need to cut interest rates.
In light of this situation, rather than the issue of "how many interest cuts", it is likely that 2025 will be a year in which the main issue will be "when to end interest rate cuts". If that proves true, then the precise "number of rate cuts" will be a relatively minor issue. The upcoming interest rate cuts are of course precautionary cuts, as Fed is not facing a crisis calling for the kind of unconventional response measures that have become common since the Lehman Shock. It would not be surprising if the Fed ultimately ended up with a total of five or six rate cuts in 25bp increments (a total reduction margin of 125bp to 150bp). In light of the trajectory of U.S. interest rates alone, I think it is reasonable to anticipate that JPY will resume its depreciation trend after mid-2025.

As for the BOJ's policy trajectory...

On the other hand, how should we be considering the BOJ's policy trajectory? At its December 19 Monetary Policy Meeting, the BOJ kept the target for the policy interest rate (the overnight unsecured call rate) at 0.25% for the third consecutive meeting. As Japan's economic and financial situations were confirmed to be in line with the July and October Outlook Reports, it is understandable that the somewhat hawkish BOJ Board Member Naoki Tamura would propose a +25bp interest rate hike. Nevertheless, BOJ Governor Kazuo Ueda explained the reason for maintaining the status quo by saying – "We felt that we needed more information, such as that related to spring labor offensives, to confirm the strengthening of a virtuous cycle of wage and price rises. Moreover, the outlook for overseas economies, including the US, is unclear, and there is uncertainty about the incoming U.S. government's prospective economic policies."
This gist of his explanation is that, while the BOJ policy aimed at raising interest rates remains unchanged, the bank could not make a decision at this time in view of uncertainties surrounding the "2025 spring labor offensive" and the "second Trump administration". But it is clearly unlikely that those two types of uncertainties will be dispelled by the time of the BOJ's next policy meeting on January 24. Ultimately, the financial markets are pricing in an additional interest rate hike but shifting the timing of that expected hike from the previous "December or January" to "January or March", and the two kinds of uncertainties mentioned above suggest that a March timing is more likely.

Main Scenario – Steady Wage Increases of up to 0.75%



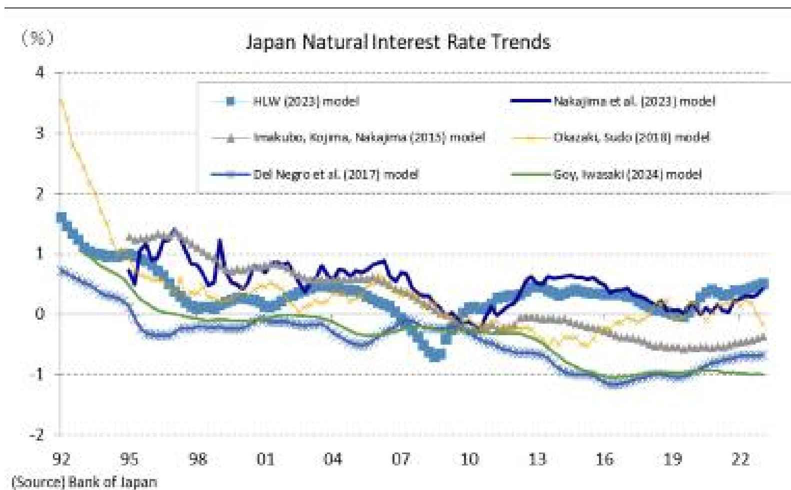
(Source) macrobond, *Cumulative yoy rate of change for Apr-Jun 2022 onward

However, Governor Ueda also stated that this does not necessarily mean that the BOJ must await the mid-March receipt of data on the results of spring wage negotiation offensive at large companies, so it would be dangerous to assume that a March timing is assured. In a November 30 interview with the Nikkei Shimbun, Governor Ueda said – "In terms of wages, what kind of momentum will the 2025 spring offensive create? We'll have to wait to find out. It will take a little more time to confirm that, but that doesn't mean we can't make a decision on monetary policy without waiting that long." – meaning that he does not rule out the possibility of making policy changes even before the results of the spring offensive are clear. His statements in the interview were consistent with his words subsequently spoken at the December press conference.

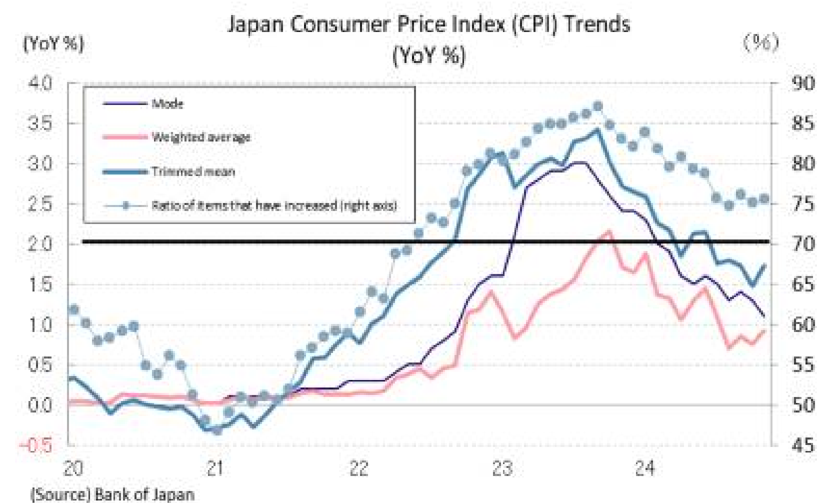
Given the current mood in Japan, it would not be surprising if the BOJ were to assume that wage growth in 2025 will be as strong as it was 2024 without waiting for mid-March receipt of data on the results of spring wage negotiation offensive at large companies. For example, it was reported in late November that the net profits of listed companies for the April-September 2024 period reached a record high level for the fourth consecutive year. There is a general expectation that prospective wage increases will be reasonable, and companies seem to have sufficient funds to pay the increased wages. This situation can also be confirmed with macro-economic statistics. For example, Japan's GDP deflator, an indicator of homemade domestic inflation that excludes the effects of import costs, has clearly been rising over the past three years (see graph). The associated price increases can be attributed to either the corporate sector or the household sector. From the perspective of economic analysis, they will be interpreted as corresponding to operating surplus (UP: Unit Profit) in the corporate sector and to unit labor cost (ULC: Unit Labor Cost) in the household sector. Since April-June 2022, the cumulative total of qoq changes in Japan's GDP deflator has been about 21 percentage points, while the cumulative rise in UP for the same period was about 15 percentage points. In other words, about 70% of the profits gained from price increases during the current weak JPY phase have been distributed to the corporate sector, and about 30% to the household sector. Since the second half of 2023, there are signs of a gradual increase in distributions to ULC, but these do not seem sufficient in light of the magnitude of the price increases. Thus, the momentum for wage increases reflected in the 2024 spring labor offensive results can be viewed as a delayed passing on of price increases realized since 2022, and it is likely that distributions from companies (UP) to households (ULC) will continue in a similar context during 2025.

Given this situation and expectations of "historic wage increases" in March and April, it is highly likely that the BOJ will decide to raise interest rates further. Taking exchange rate trends into account, the current main forecast scenario is that interest rates will be raised about twice in the three BOJ policy meetings to be held between January and April, raising the policy interest rate to 0.75%. The reason I see an opportunity to capitalize on a JPY appreciation trend through the January-March quarter of 2025 is because I anticipate that USD/JPY could be pushed downward due to JPY interest rates during this time period. On the other hand, from April-June quarter onward, attention can be expected to be focused on the "end of Fed interest rate cuts", so it can be confidently anticipated that there will be fewer temporary USD/JPY dips from that time.

Need to Challenge the 1% Neutral Interest Rate Theory?



Any BOJ rate hike to above the 0.75% level must be evaluated in comparison with the neutral interest rate. In the BOJ working paper "Recent Trends in Measuring the Natural Interest Rate" (published in August 2024), the natural interest rate is generally presented as being in the "-1.0% to +0.5%" range (see graph above right). If an inflation rate of 2% is assumed, the neutral interest rate (≈ natural interest rate + inflation rate) is "+1.0% to +2.5%". Based on currently available information, it can be said that the most conservative (dovish) assumption for the neutral interest rate is 1%, and there are indications that this 1% neutral interest rate assumption is fairly close to the financial market consensus. However, one must carefully consider whether an inflation rate of 2% should really be assumed. If the inflation rate is 1.5%, the neutral interest rate would be +0.5% to +2.0%, and if the inflation rate is 1.0%, the neutral interest rate would be +0% to +1.5%. It is true that Japan's current CPI is stable at 2%, but if this is considered to be a temporary inflation uptick reflecting JPY depreciation, one could say that 0% or 0.5% is the neutral interest rate. Such assumptions lead one to conclude that the neutral interest rate is "the neutral interest rate amid the current situation". Even if this assumption is too pessimistic, if Japan's inflation rate is anchored at just under 2%, it is possible to think of the neutral interest rate as being at the 0.75% level. Incidentally, the BOJ regularly publishes working papers entitled "Indicators for Capturing Underlying Inflation Rates", and the December 2024 edition of that paper suggests that Japan's inflation rate is already below 2% on multiple measures (see graph below right), so an inflation rate of just under 2% can be said to be a realistic assumption.



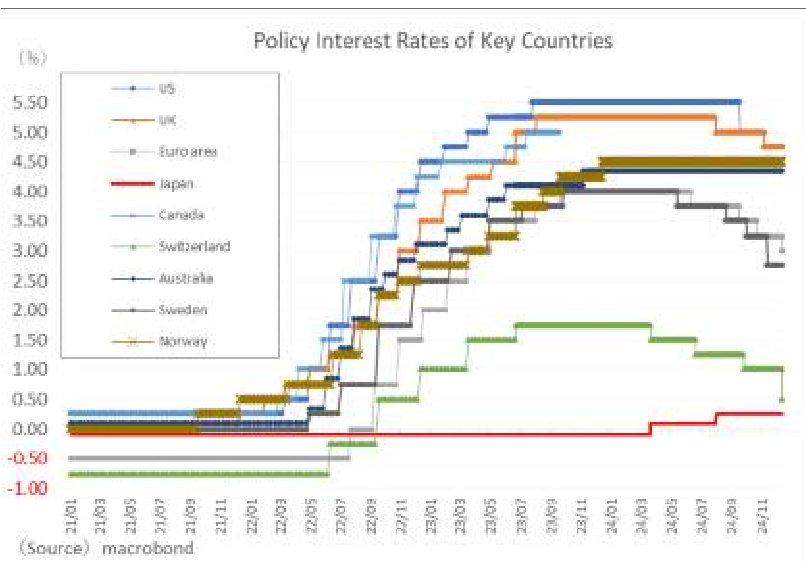
If that is the case then, assuming an inflation rate of 2%, a rate hike to 1% would be justified, but if an inflation rate below that is assumed, then there is reason to assume that the rate hike will be limited to 0.75%. My main forecast

scenario anticipates that the BOJ will initially raise its policy rate to 0.75% and that, even if things proceed normally, the rate may subsequently rise to 1.00%.

***Supplement: JPY as Compared to CHF – Factors Determining Currencies' Strength and Weakness**

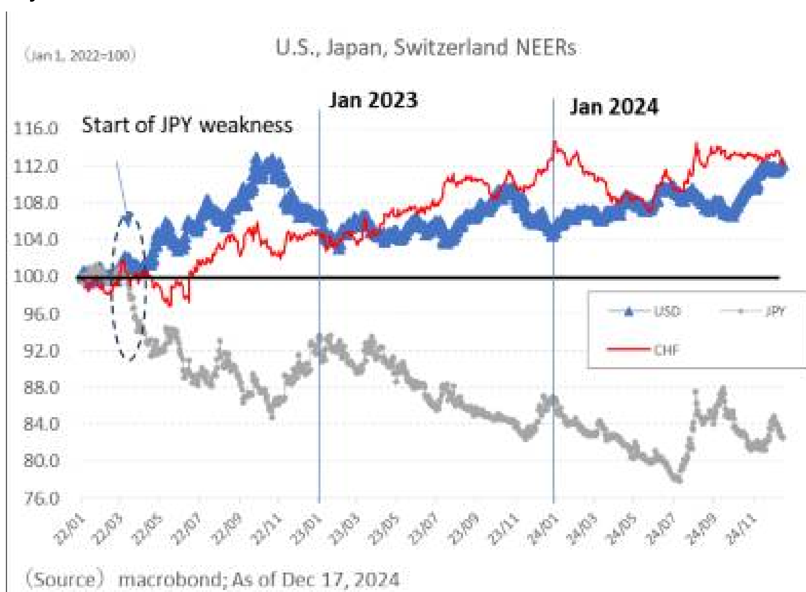
SNB Considers Reinstating Negative Interest Rates

On December 12, it was widely reported that the Swiss National Bank (SNB) had decided to cut interest rates by 50bp. The SNB's interest rate cuts, which began in March 2024, have reached a cumulative total of 125bp, cutting the bank's policy interest rate to +0.5%, the lowest level in two years (since November 2022). It is likely that the policy interest rates of the BOJ and the SNB will be at comparable levels at some point in 2025, and I would like to share my thoughts on the forex market implications of that situation based on due consideration of the monetary policy environments in Switzerland and Japan. Accompanying its December rate cut decision, the SNB has altered the interest-rate-cut-announcement wording seen in the statement of its previous policy meeting on September 26 to delete text suggesting that further cuts will be necessary over coming quarters, and the latest meeting statement suggests that the bank has paused its cuts for the time being. However, SNB President Martin Schlegel, who only took office on October 1, 2024, has not denied the possibility of further interest rate cuts and has suggested that he would not hesitate to reinstate negative interest rates if necessary. He also stated that he is prepared to intervene in the forex market (by selling CHF), and he indicated that the SNB was resolved to mobilize all of its monetary and monetary policies to stop the current disinflationary situation. While the SNB's inflation rate target range is 0%-to-2% yoy, the most recent actual figure for November was +0.7%, indicating that the risk of insufficient inflation was slightly stronger than that of excessive inflation. Published in December based on the assumption that the current 0.5% policy interest rate is maintained, the SNB's 2024-2026 inflation rate forecast anticipates a generally downward trend in inflation rates – from +1.1% in 2024, to +0.3% in 2025, and to +0.8% in 2026. It appears that, although the deletion of meeting statement wording related to prospective rate cuts was intended to indicate that the latest rate cut is considered to be sufficient to deal with requirements over the short-to-medium term, it would be reasonable to conclude that, even if the next meeting maintains the status quo, the SNB has not changed its intention to further cut rates if inflation trends require such cuts.



Similar Interest Rate Levels but Contrasting Monetary Policies

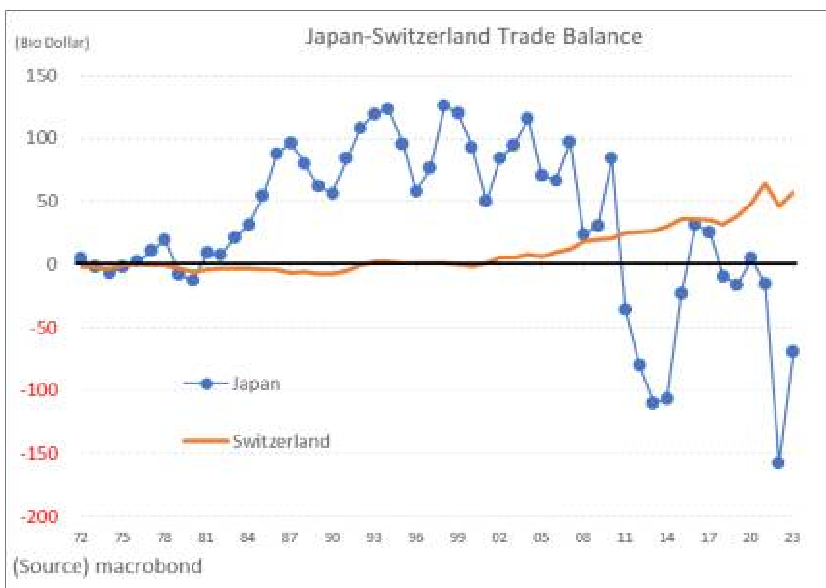
As mentioned above, if things continue as they are, the day when the SNB and the BOJ will have similar policy interest rate levels is not far off. In fact, currently available information suggests a possibility that SNB's policy interest rate will become lower than the BOJ's during 2025. Except for rare periods when multiple negative policy interest rates were competing to reach the lowest absolute value, it is extremely rare for Japan's policy interest rate not to be the lowest among developed countries. Even if the SNB and BOJ policy interest rate levels become similar, however, it is worth noting that two banks' monetary policy direction and domestic currency-related concerns are diametrically opposite. CHF has continuously been the strongest developed country currency at almost all times since the current JPY depreciation phase began. Even though USD's strength has been in the spotlight during much of this phase, there have been only a few times when CHF was not stronger than USD. Looking at rates of change in nominal effective exchange rates (NEERs) from the beginning of January 2022 to the beginning of December 2024 (see graph), one finds that CHF has risen by about 14%, while JPY has fallen by about 16%. To understand the nature of trends in CHF and JPY over past 30 years, it is worth noting that, since early 1995 (during the period from January 3, 1995 through December 16, 2024), CHF has risen against USD by about 47%, while JPY has fallen against USD by about 34%. Overviewing trends among G7 currencies, one finds that JPY is the currency with the largest fluctuation against CHF



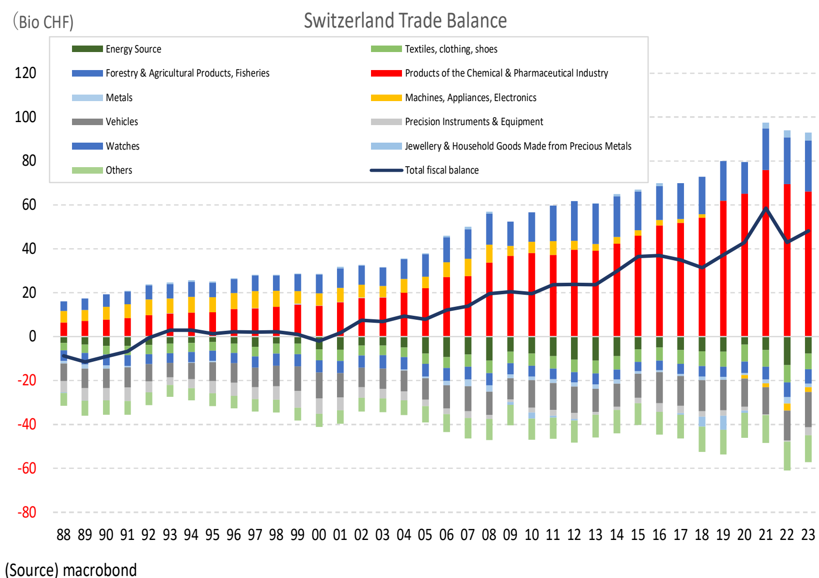
over the past 30 years. (Among G10 currencies, however, the Norwegian krone's (NOK's) -39% exceeds JPY's -34%.) It is rare to see the degree of contrast between major currencies that one can see between JPY and CHF.
When one compares the situation of the SNB with that of the BOJ, the contrast between "a central bank struggling with a strong currency" and "a central bank struggling with a weak currency" is very clear. The SNB is plagued by a situation in which its currency is relentlessly appreciating despite moves to lower the policy interest rate, while the BOJ is plagued by a situation in which its currency is not appreciating despite moves to increase its policy interest rate.
What is the reason behind the stark difference between these two currencies, which were once considered the forex market's two major safe haven currencies? During the period from 2008 to 2012, when financial markets were shaken by the Lehman Shock and the European debt crisis, both JPY and CHF were bought reflexively whenever the markets' risk tolerance levels declined, and both the BOJ and the SNB were desperately trying to reduce the strength of their currencies (along with associated disinflationary pressures). Looking back over the past decade or so, however, one finds that CHF has continued to appreciate while JPY has continued to depreciate.

Key Differences Based on Trade Balances

I will not present a detailed analysis here but, as previous editions of this article have argued, I believe the discussion should be focused primarily on the JPY supply-demand situation rather than on interest rates. The graph (above right) shows trends in the trade balances of Switzerland and Japan over the past 50 years. Switzerland began recording trade surpluses in the early 2000s, and those surpluses have been on an accelerating uptrend from the time of the financial crisis through the present day. In contrast, Japan began recording trade deficits after 2011 as the effects of the financial crisis began to subside, partly due to the impact of the Great East Japan Earthquake. I have argued many times that JPY passed a historic turning point around 2011-12, and the importance of that turning point is particularly clear when JPY trends are compared with CHF trends.
Analyzing the reasons why Switzerland has been able to maintain trade surplus expansion unaffected by recessions or a the strength of its currency is a topic for another time, but one can speculate that, despite challenges associated with CHF appreciation, the country has been able to pass on export price increases owing to its strengths related to such high-value-added products as pharmaceuticals and watches (see graph, below right). It is worth noting that unconventional monetary policies implemented following the financial crisis promoted a global uptrend in asset prices, and this uptrend has also been seen in the prices of the kinds of luxury watches that Switzerland is renowned for. As a country's ability to continuously earn foreign currency will ultimately be reflected in the strength of that country's currency, it should be recognized that forex rate trends cannot be explained simply by comparing countries' interest rate levels.



(Source) macrobond



(Source) macrobond

Risks to My Main Scenario – Possibility of Sharp USD Interest Rate Fall or Sudden JPY Interest Rate Rise?

Scenario of a U.S. Interest Rate Drop Accompanied by JPY Appreciation

When discussing the 2025 outlook's key points from an interest rate analysis perspective, I predicted that the Fed and the BOJ would discontinue their policy adjustments (interest rate cuts by the Fed and interest rates hikes by the BOJ) during the first half of the year. Simply put, the outlook is that JPY appreciation due to narrowing of the Japan-U.S. interest rate gap can only be expected through the January-March 2025 period. This assumption seems to be close to the core of market forecasts, but it is still worth considering the likelihood that that the assumption might be belied by a sharp fall in U.S. interest rates or a sharp rise in Japanese interest rates. These likelihoods are briefly considered below.

The first question to consider is, are conditions conducive to a sudden cut in U.S. interest rates and an accompanying JPY appreciation trend? If there are such conditions, it would be a situation in which systemic risks are increasing.

A recent example of such a situation relates to the March 2023 collapse of Silicon Valley Bank (SVB), which completely changed the landscape of the financial markets. When a sense of crisis about the financial system's stability arises, it is often accompanied by strengthening of expectations for a large-margin interest rate cut designed to prevent the spreading of impacts. In the month of SVB's collapse, the U.S. 10-year interest rate was depressed by a maximum of about 60 basis points, and USD/JPY also plummeted from roughly JPY137 to about JPY130. There are currently no signs of critical imbalances in the U.S. economic and financial situation, but if such imbalances were to emerge, one could expect JPY to sharply appreciate against USD. On the other hand, it would difficult to find a basis for anticipating significant appreciation of JPY against USD in the absence of concerns about a financial crisis. It also seems possible that a rise in geopolitical risks could justify monetary policy relaxation, but such a rise in geopolitical risks could well be accompanied by increases in resource prices, which might justify calls for tighter monetary policies. It is impossible to confidently determine in advance the nature of developments following the emergence of a sense of crisis about a financial system's stability.

It is also possible that expectations of interest rate cuts might suddenly grow if U.S. economic indicators deteriorate significantly, as was the case with respect to the U.S. July employment statistics released in early August 2024. However, it is difficult to imagine the occurrence of a seismic shift in the U.S. economy in the absence of an exogenous shock factor. In fact, in August, considerable attention was focused on a trend of improvement indicated by U.S. economic indicators for the following month, which promoted a U.S. interest rate uptrend and USD appreciation. While similar developments regarding the temporary deterioration of U.S. economic indicators is likely in 2025, one should not exaggerate the impact of a single month's economic indicators as a basis for anticipating that interest rate cuts will accelerate.

Risk Scenario of Sudden BOJ Policy Interest Rate Rise

On the other hand, is there a significant likelihood that JPY interest rates might rise more than expected? Specifically, is it possible that the BOJ might not stop at the 1.00% level but will elevate its policy rate to 1.50% or 2.00%? Of course, if one assumes that the Japanese economy's natural interest rate is higher than expected, around +0.5% for example, it might be justified to stipulate a neutral interest rate of up to around 2.5%. However, the raising of interest rates to that extent would not generally be considered a positive situation in which the Japanese economy was stronger and the natural rate of interest higher than expected – it would be more likely to be perceived as a rather desperately defensive and reactionary situation. If the BOJ's policy interest rate in 2025 were to remain at or above 1.00%, it would suggest a shift to policies even more obviously focused on currency defense measures than currently, in which case USD/JPY would be likely to surge upward into the JPY160 range, with some predicting it could reach JPY170 or JPY180. That is a risk scenario worth keeping in mind.

It appears that the BOJ's March 2024 discontinuation of negative interest rates was impelled by the momentum of wage increases, but the additional rate hike in July seems to be a reaction to the growing risk of inflation caused by JPY weakness. Given that, it appears that financial markets have since the summer come to feel that if JPY weakens, interest rate hikes will be priced in, and that if the JPY weakening trend subsides, expectations that the status quo will be maintained will grow stronger. The weight of exchange rates in the BOJ's policy reaction function has clearly become larger, and in the interview with BOJ Governor Ueda mentioned above, he is quoted as saying – "If JPY weakens further when the inflation rate is starting to exceed 2%, it will be a risky situation for the BOJ, and in some cases we will have to respond."

Currency exchange rates indicate the external value of a currency just as a country's domestic price index (CPI) indicates the domestic value of that currency – they are two sides of the same coin. The situation in Japan – where the government (Ministry of Finance) and the BOJ try to control JPY's external and internal value separately – is unique in the global context, so interest rate hikes impelled by JPY weakness are not inherently strange. The problem is that when market expectations focus on the conversion of monetary policy into currency policy, it tends to promote rampant speculative transactions immediately before and after monetary policy meetings, such as JPY selling to encourage interest rate hikes and JPY buying to realize profits at times of interest rate hikes. While this kind of thing is common in emerging countries prone to bouts of currency depreciation, it is rare in developed countries. To prevent this, the BOJ needs to make every effort to convincingly communicate the message that "exchange rates and monetary policy are not directly related" and to continue raising interest rates while promoting a virtuous cycle of wage and price increases. However, I believe that policy interest rate hikes based on this logic will be limited to a maximum range of 0.75-to-1.00%. If BOJ policy rates exceed 1.00% and continue increasing, it would suggest that a different logic (perhaps a defensive currency policy logic) is being pushed to the forefront. If interest rate hike expectations remain strong even after the main policy rate exceeds 1.00%, then USD/JPY may well remain steady above JPY160 (generally considered in the forex market to be the point at which JPY selling intervention will commence). It may be reasonable to anticipate a possibility of such a development, albeit as a risk scenario, during the second half of 2025, when the "end of interest rate cuts" by the Fed becomes a point of contention.

EUR Outlook – Internal and External Troubles Raise Specter of EUR Falling below Parity with USD

EUR Area Monetary Policies Now and Going Forward – Policy Interest Rate Target below Neutral Interest Rate Level?

Across-the-Board Downward Revisions of Staff Projections

The December 12 ECB Governing Council meeting became the third consecutive Governing Council meeting to reduce interest rates by 25 basis points, lowering the deposit facility rate, which is attracting particular attention from financial markets, from 3.25% to 3.00%. Regarding the euro area's real economy, the meeting's statement explained that the unexpectedly strong growth rate seen in the July-September quarter probably reflected strong summer consumption related to such one-off factors as the Olympic games as well as to firms building up inventories but that that uptrend was not expected to be sustainable, as manufacturing is still contracting and growth in services is slowing. This assessment appears likely to be correct in light of movements in both soft and hard data since October.

ECB Staff Macroeconomic Projections (December 2024) (%)

	2024	2025	2026	2027
HICP	**2.4**	**2.1**	**1.9**	**2.1**
(previous: Sep 2024)	2.5	2.2	1.9	-
Core HICP	**2.9**	**2.3**	**1.9**	**1.9**
(previous: Sep 2024)	2.9	2.3	2	-
Real GDP	0.7	1.1	1.4	1.3
(previous: Sep 2024)	0.8	1.3	1.5	-

(Source) ECB, EUR/USD exchange rate for 2024-27 assumed to be between 1.06 and 1.08

*Core excludes energy and food

Looking at the December staff projections (see chart), one finds that real GDP growth rates are now forecast to recover gradually from +0.7% to +1.1% and +1.4% during the three years from 2024 to 2026, but these figures reflect downward revisions of -0.1 point, -0.2 point, and -0.1 point, respectively, from the previous forecast (in September). Consistent with these real GDP growth rate forecasts, the domestic consumer price index (HICP, overall) is also expected to slow gradually from +2.4%, to +2.1% and +1.9%, which reflect downward revisions of -0.1 point, -0.1 point, and -0.0 point, respectively, from the previous forecast. The meeting's statement notes that geopolitical factors may generate both upside and downside risks with respect to inflation rates. If President-elect Trump is able to quickly arrange a Russia-Ukraine ceasefire, the euro area, which has been dependent on energy procurement from Russia, might benefit considerably (although it remains unlikely that natural gas imports from Russia will return to previous levels). In any case, since the December staff projections have revised GDP growth and inflation rates downward throughout the forecast period, the ECB's interest rate cut can be said to be a policy decision in line with the fundamentals.

Interest Rate Reduction Margin to Expand to -50bp in January?

The December GC meeting's statement features significant changes from the previous version of the statement. Until now, the following two statements have served to ensure that the ECB's monetary policy remains restrictive:

- **We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner**
- **We will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim**

This time, however, the former sentence has been revised to read as follows, and the latter sentence has been deleted:

- **The Governing Council is determined to ensure that inflation stabilises sustainably at its 2% medium-term target**

In any case, the latest interest rate reduction has already lowered the policy interest rate to a level not restrictive for the real economy, indicating there may be need in the future to consider undershooting by depressing the rate to below 2%. At the post-Governing Council-meeting press conference, several questions were posed about the deletion of the "We will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim." sentence, suggesting that this might hint about the possibility of significant rate cuts at the next Governing Council meeting and subsequently. In response, ECB President Christine Lagarde said that she does not anticipate such larger-margin cuts and revealed that – "There were some discussions, with some proposals to consider possibly 50 basis points. But the overall agreement to which everybody rallied was that 25 basis points was actually the right decision." Given that services inflation rate is still in the vicinity of +4.0% yoy, I believe it would be overly hasty to advance to a 50bp rate cut, and President Lagarde also mentioned the significance of the stubbornly high services inflation rate level at the press conference. At the time this article was written, the financial markets were completely pricing in a 25bp cut at the January 30 Governing Council meeting but have not shown signs of pricing in a 50bp cut. For the time being, it appears that the markets consider the Governing Council's arguments and intentions to be reasonable.

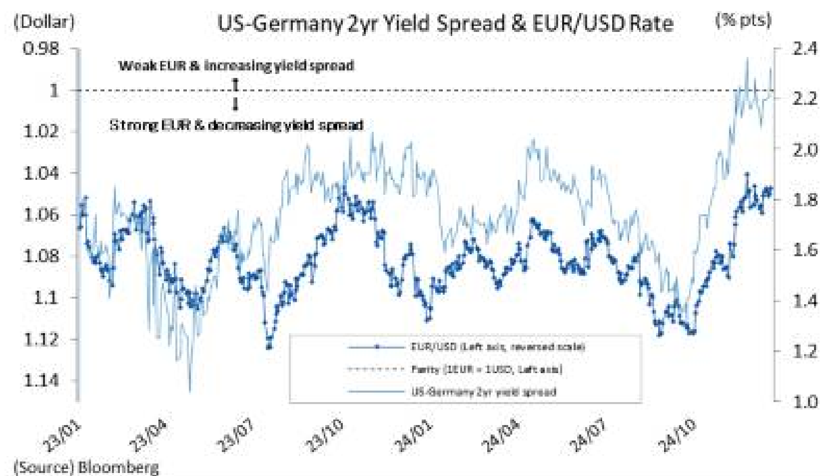
Neutral Interest Rate Level May be as High as 2.5%

Another reporter at the press conference asked whether there had been any discussion about the neutral interest rate in connection with the deletion of the “We will keep policy rates sufficiently
restrictive for as long as necessary to achieve this aim.” sentence. It is natural that this question should arise, since the neutral interest rate level serves as a basis for judging whether monetary policy is restrictive or not. However, President Lagarde clearly denied this, and simply replied that – “We will continue to be data dependent. We will continue to decide meeting by meeting.”

Nevertheless, at the end of the press conference, another reporter insistently asked about President Lagarde’s personal view on the neutral interest rate, to which Lagarde replied that – “I think this issue of the neutral rate is one that we will probably debate more and further, as we get closer to where it eventually is”. She also mentioned that – “the conventional wisdom around the table is that [the neutral rate] is probably a little higher than where it was before” – and explained that an ECB staff analysis from about a year ago estimated that the neutral interest rate was in the 1.75%-to-2.5% range. The upper limit of 2.5% is two more rate cuts away, but given the euro area’s current economic situation, it would seem quite justified for the ECB policy interest rate to fall somewhat below the neutral interest rate. In any case, there appears to be a solid basis for anticipating the next ECB rate cut of -25bp in January.

EUR Burdened by both Political and Economic Factors

Many questions were asked at the press conference about uncertainties associated with the United States’ incoming Trump administration (especially regarding risks related to trade frictions and tariffs), but it appears that from the ECB’s perspective, U.S. political factors are being largely overshadowed by concerns related to political developments within the euro area. The successive falls of governments in two major euro area countries – Germany in November and France in December – are expected to inevitably present challenges to the euro area economy. Moreover, the fall of those governments will require elections to be held – in February 2025 in Germany and sometime after July 2025 in France – and there are strong expectations that the results of those elections will once again be inconclusive. In particular, Germany’s faltering political systems appear to be unable to promote sufficiently strong support for policy corrections despite the fact that the government’s mismanagement of energy policies is directly linked to sharp deterioration of domestic companies’ performances. Currently, the financial markets are factoring in four ECB interest rate cuts (for a total reduction of 100bp) by June 2025, and just under five cuts (for a total reduction of almost 125bp) by October. Five cuts would bring the deposit facility rate to 1.75%, the lower limit of the ECB’s estimation of the neutral interest rate, so it appears that the markets are basing their expectations on data from the December Governing Council meeting and press conference.



On the other hand, despite great uncertainty, the United States is expected to have an inflation-inducing policy mix, and the U.S. economy is actually now growing at a rate above its potential growth rate (currently estimated to be just over 2%). As a result, the EUR-USD interest rate differential is expected to widen (see graph above), so my view remains that it will not at all be surprising to see EUR fall below parity with USD during the forecast period.

European Politics Now and Going Forward – Internal and External Challenges

Government Collapses and Non-Centrist Party Growth in Germany and France

In just two months (from November through December), the governments of Germany and France collapsed one after the other. While analyses of important upcoming political factors tend to focus on the second Trump administration’s prospective policies, the fact that the political situations of two core EU/euro area countries are in flux cannot be overlooked. As France and Germany each has its own unique circumstances and different political systems, we will refrain from undertaking a detailed projection of the countries’ future political trajectories, but it is still worth noting that one thing the countries clearly have in common is a rise in the popularity of far-right and far-left parties along with a resulting shift toward multi-party coalitions.

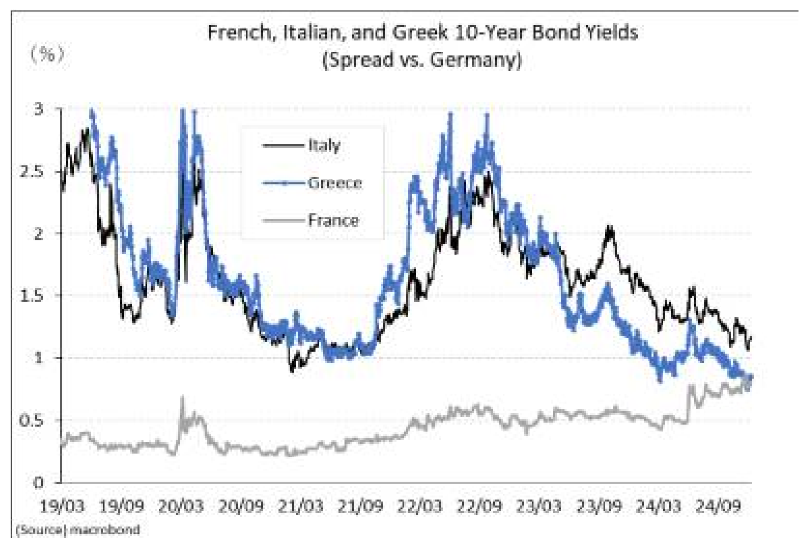
These trends were clearly evident in the state elections in three former East German states in September this year. The far-right Alternative for Germany (AfD) party, which was formed in response to the European debt crisis, received 32.8% of the vote in Thuringia, 30.6% in Saxony, and 29.2% in Brandenburg. Meanwhile, the far-left Zahra-Wagenknecht Union (BSW) party, which was only launched in January this year, received 15.8% of the vote in Thuringia, 11.8% in Saxony, and 13.5% in Brandenburg. In other words, non-traditional parties on both the left and right won more than 40% of all votes in the former East German region. Incidentally, a December 16 POLITICO poll regarding the German general election scheduled for February 2025 found 19% of voter support for the AfD and 6% for the BSW, so the two non-centrist parties combined have a support rate of 25% and must therefore be considered major parties not only at the state level but also at the federal level. The rising support for the two non-centrist parties is approaching the 31% support level of the Christian Democratic Union (CDU)/Christian Social Union (CSU). It is worth

noting that the support level of Germany's current ruling party, the Social Democratic Party (SPD), is only 17%, so the SPD is now on an independent basis clearly weaker than the AfD. For historical reasons, far-right ideologies are widely considered to be taboo in Germany, so the AfD will not be allowed to enter the government, but the AfD's burgeoning strength suggests that the conventional political parties are no longer able to fully respond to the wishes of a great many Germans.

The situation in France is similar. The recent passage of a motion of no confidence in the Barnier cabinet resulted from cooperation between the far-right National Rally (RN) party and the left-wing New Popular Front (NFP) coalition. In the general election of July 2024, the RN became the largest party in the first round of voting, but the NFP and the center-right ruling coalition led by President Macron cooperatively blocked the RN with the intention of preventing the appointment of a far-right prime minister. Just as in Germany, there has been a clear rightward shift of public opinion but the reflection of that shift within the government has been blocked by the political system. The biggest reason why the NFP has changed its position in the past four months is that, although it has won the largest share of parliamentary seats, its bid to nominate a prime minister in the September prime ministerial nomination process was unsuccessful because the NFP's candidates could not obtain support from the RN and were not in line with President Macron's own inclinations. The NFP had been eager to move for a motion of no confidence in the cabinet since the new government's inauguration as it appears that it was unable to reach agreement with the government regarding next year's budget, and the alignment of the interests of the RN and NFP led to the passage of the motion of no confidence. In France, general elections for the lower house can only be held once a year, so the next election will not be until after July 2025. The vote of no confidence rejecting President Macron's prime ministerial appointment suggests that President Macron will continue having difficulty maintaining a cohesive government going forward.

EUR Selling Reflecting Internal EU Disputes

Currently, the impact of French political turbulence seems to be reaching the forex market through the bond market. In the bond market, it has been confirmed that France has overtaken Greece in terms of 10-year bond yields (see graph), and in the forex market, this has promoted EUR selling. Increasing support for far-right or far-left parties tends to push fiscal policy in the direction of expansion as governments seek to pander to public opinion. In that sense, it is less useful to analyze these increasingly popular non-centrist parties based on the left-right ideological spectrum and more useful to consider such parties as non-mainstream parties advocating anti-globalization and anti-establishment policies in line with their supporters' educational and income levels. (It would be more accurate to view non-centrist parties as reflecting a socio-economic top-bottom conflict rather than an ideological left-right conflict.) Looking back at history, it is self-evident that the EU is often seen as a symbol of "the establishment" and that both far-right and far-left parties therefore tend to repeatedly clash with the EU.



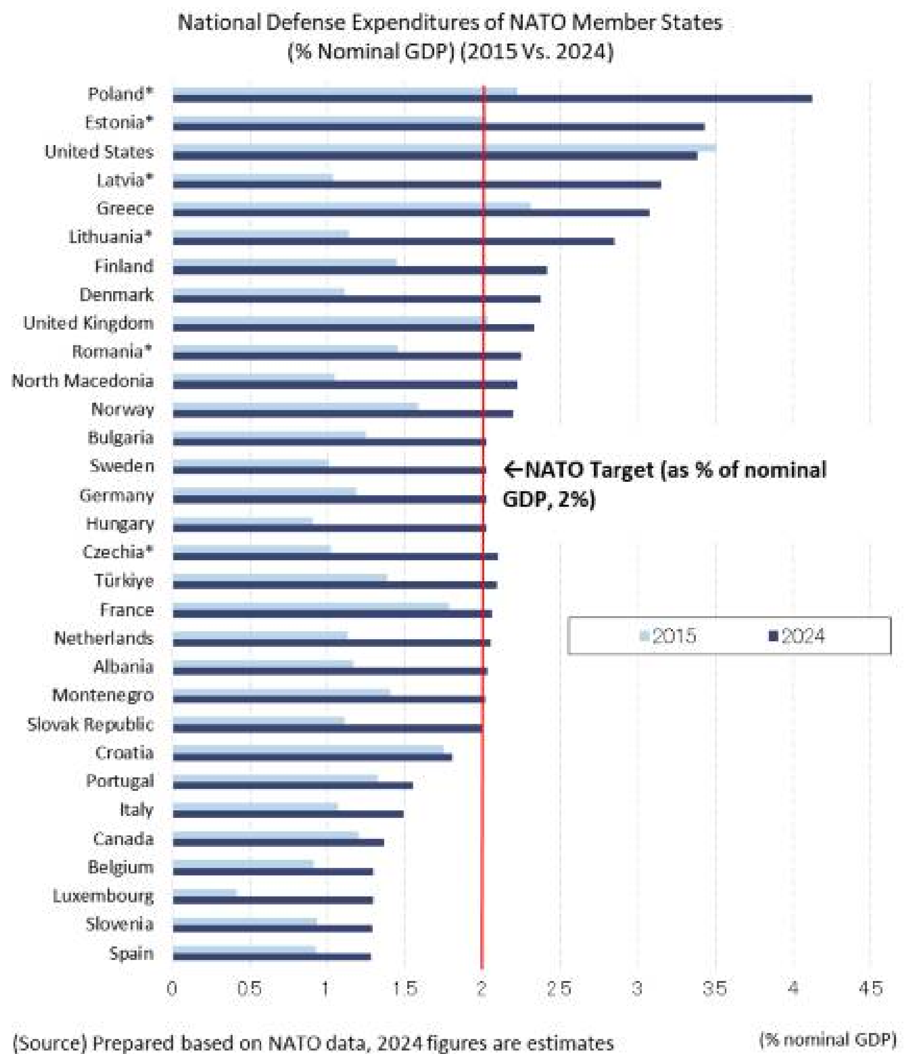
The EU's Stability and Growth Pact (SGP) will be reinstated in 2024, re-imposing fiscal policy constraints, but such constraints can be seen as extremely incompatible with the growing power of non-centrist parties. For example, some within the RN party are calling for a reduction to France's budget contributions to the EU, but moves to arbitrarily revise such contribution levels, which are determined based on GDP and population sizes, could have a huge impact on the EU budget and cannot be expected to be easily accepted. Nonetheless, RN appeals to domestic voters portraying France's EU budget contributions as excessive and wastefully utilized are still likely to find receptive audiences. In such ways, in addition to simple concerns about the issuance of government bonds, it appears that increasing strife between such core EU countries as Germany and France and the European Commission will cause the squandering of the EU's political resources, and this is being cited as a rationale for selling EUR.

Looming Showdown with Trump and Resurgent Defense Spending Issue

The timing of the EU's upsurge of internal strife can be considered extremely unfortunate in light of the prospective global situation in 2025. There is a risk that the upsurge of internal strife will unnecessarily raise concerns about the EU's ability to deal with trade frictions expected to emerge during the second Trump administration. As previously reported, European Commission President Ursula von der Leyen and ECB President Lagarde have already emphasized a reconciliatory approach, calling for "negotiations, not retaliation", and proposals such as those for increasing imports of U.S. liquefied natural gas (LNG) have already been discussed. But tariffs are not the only issue that is likely to become a point of contention. The issue of increasing EU countries' defense spending, which Trump has long been advocating, has some aspects that appear logical from the U.S. perspective, so it will be difficult for EU countries to argue against it. Since his first administration, President-elect Trump has harshly criticized NATO member countries that cannot achieve the "2% of nominal GDP" defense spending target, and he has even mentioned a possibility that the U.S. military may not comply with its defense obligations in light of this problem. Fortunately, while the overwhelming majority of NATO member states were not attaining the 2% defense spending target during the first

Trump administration, most are now on track to achieve the target, and Germany and France are no exception (see graph).

However, the U.S. and the UK have begun aggressively seeking to elevate the defense spending target. There were media reports amid the presidential election that the Trump team wanted to raise the 2% target to 3%, but in December, new reports emerged stating that Trump's transition team had told European officials of its intention to hike the target level to 5%. At the time of the NATO Foreign Ministers' Meeting on December 4, British Foreign Secretary David Lammy expressed his support for Trump's stance, saying – "I think Donald Trump is right to say that the 2% was set in some ways in less challenging times and all allies right across the family should be looking beyond that 2%." – and he also reiterated the UK's commitment to increase its defense spending to 2.5% of GDP and urged other NATO members to do the same. It remains unclear how high a new target level might be, but a mood is building that 2% is not sufficient. Increasing defense spending will directly promote the expansion of each NATO member's fiscal spending, which is likely to generate SGP-related frictions between the European Commission and EU member states, especially such major members as Germany and France. The increasingly rapid pace of change in the political landscapes of Germany and France is a highly significant trend. As the underlying weakness of its real economy becomes increasingly apparent, the euro area is facing an wide array of serious internal and external political challenges, and in light of that, it would seem extremely difficult to be bullish on EUR in 2025.



(Source) Prepared based on NATO data, 2024 figures are estimates

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