

Forex Medium-Term Outlook

February 27, 2026

Overview of Outlook

USD/JPY remained volatile in February. Japan’s political situation remains the main market driver, with the future of fiscal policy, including tax cuts, and reactions to BOJ personnel changes serving as trading factors and creating volatile conditions in the market. It is precisely at such a time, when qualitative factors obscure clarity, that an honest look at hard data becomes important. The 2025 current account balance, even when viewed in terms of cash flows (CF), suggests that the phase of JPY depreciation driven by supply and demand distortions may be coming to an end. This is one factor that could make it difficult for USD/JPY to hit the 160 level. However, the financial account deficit, which is the counterpart to the current account surplus, is largely driven by foreign direct investment, and this is likely to be dominated by outright JPY selling, even on a CF basis. Further, given that Japan is expected to make a direct investment of USD550 billion in the U.S. over the next three years, the supply and demand structure will continue to be dominated by JPY selling, even though the worst is past. During the current forecasting period, a key risk is the extent of real impact from de-dollarization. U.S. securities investment trends for 2025 reveal dwindling inflows into U.S. Treasuries, so de-dollarization concerns remain. One must remain vigilant about the risk of persistently high U.S. interest rates forcing a correction in overheated U.S. stock prices. With stocks now accounting for 40% of U.S. household financial assets, the negative wealth effect in such a scenario cannot be overlooked, and if the Fed were to slash interest rates in response, it could lead to an unexpected JPY appreciation.

EUR weakened slightly in February, but remains strong YTD. Given the ECB’s concerns about EUR strength, as expressed at the Governing Council meeting, many believe it will be difficult for EUR/USD to rise beyond 1.20. However, EUR remains significantly undervalued relative to its purchasing power parity (PPP), and the ECB has clearly stated that it has no intention of taking any special measures to address the ongoing EUR appreciation. Considering the U.S.-Europe monetary policy gap and the building momentum toward de-dollarization, I expect EUR/USD to remain firm. While some may expect further interest rate cuts given EUR strength and declining inflation growth, the key ECB move to watch out for this year is whether the ECB will pause rate cuts and wait for the right timing to switch to communication suggesting rate hikes from 2H of the year or later. From a longer-term perspective, the EU is facing a historic turning point in both politics and diplomacy. France’s emphasis on nuclear sharing with Germany will be an important point of discussion in drawing up a grand design for Europe’s overall security strategy. This could ultimately pave the way for the joint bonds (defense bonds), as France strongly desires. With expectations building for EUR as an alternative to USD in light of de-dollarization, I would like to analyze whether EUR’s value will be strengthened alongside the EU’s structural evolution.

Summary Table of Forecasts

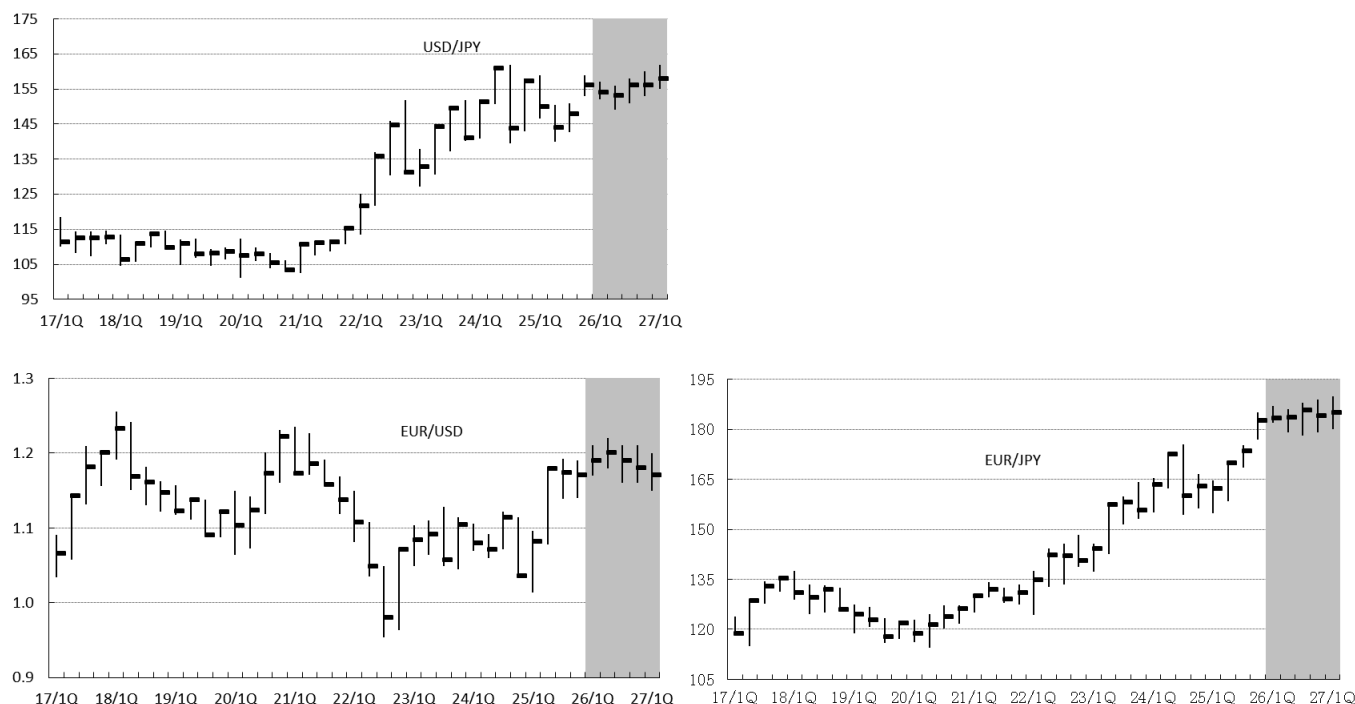
	2026					2027
	Jan-Feb (Actual)	Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
USD/JPY	152.10 ~ 159.45 (155.90)	152 ~ 157 (154)	149 ~ 156 (153)	151 ~ 158 (156)	153 ~ 160 (156)	155 ~ 162 (158)
EUR/USD	1.1572 ~ 1.2084 (1.1797)	1.17 ~ 1.21 (1.19)	1.18 ~ 1.22 (1.20)	1.16 ~ 1.21 (1.19)	1.16 ~ 1.21 (1.18)	1.15 ~ 1.20 (1.17)
EUR/JPY	180.84 ~ 186.87 (183.89)	182 ~ 187 (183)	179 ~ 186 (184)	178 ~ 188 (186)	179 ~ 189 (184)	180 ~ 190 (185)

(Notes) 1. Actual results released around 10 am TKY time on 27 February 2026. 2. Source by Bloomberg

3. Forecasts in parentheses are quarter-end levels.

USD Index (JPY/EUR=50/50)

Exchange Rate Trends & Forecasts

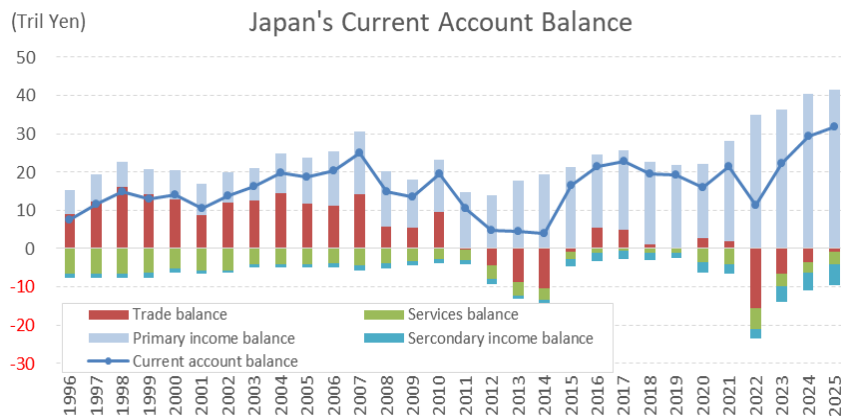


USD/JPY Outlook - JPY Fails to Appreciate Despite Record Current Account Surplus

JPY Supply and Demand Climate – Overview of 2025 Balance of Payments

Record Current Account Surplus and a “Mature Creditor Nation”

While JPY remains weak against the backdrop of domestic and international political and economic developments, the Ministry of Finance released its full-year Balance of Payments statistics for 2025 in February. It is important to keep an eye on the current state of JPY supply and demand as trends unsupported by hard data are unsustainable. As discussed below, recent years’ trend of JPY depreciation driven by supply and demand distortions may be coming to an end. It has already been reported that Japan posted an all-time record current account surplus for the second year in a row, at JPY 31.8799 trillion. Breaking this down, the trade deficit was -JPY 848.7



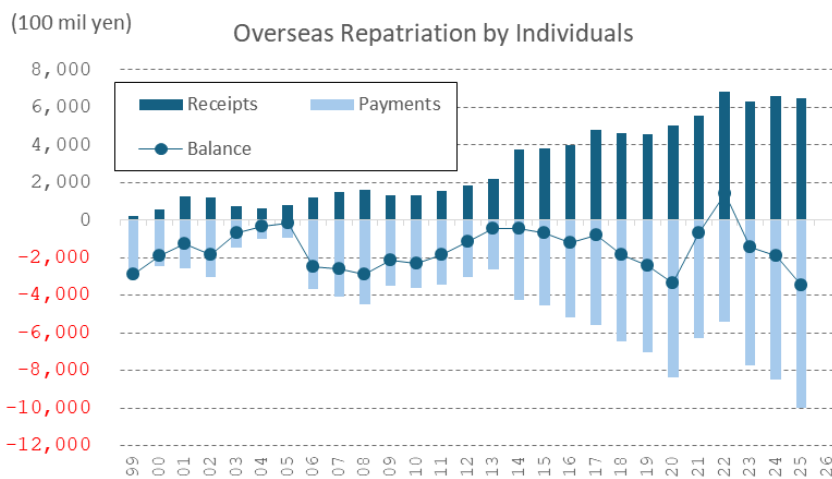
(Source) Ministry of Finance

billion (compared with -JPY 3.6602 trillion for the previous year’s actual figure; below, unless otherwise specified, all figures are previous year’s actuals), the services deficit was -JPY 3.3928 trillion (compared with -JPY 2.7765 trillion), the primary income surplus was +JPY 41.5903 trillion (compared with JPY 39.7201 trillion), and the secondary income deficit was -JPY 5.4688 trillion (compared with -JPY 4.5965 trillion). Overall, the improvement in the trade deficit and primary income surplus contributed to the yoy growth in the current account surplus (see graph). Given that the average trade deficit (on a balance of payments basis) over the 10 years prior to 2019 was approx. -JPY 3.5 trillion, it can be said that the abnormal supply and demand distortion caused by the war and pandemic finally underwent significant correction in 2025. However, the fact that JPY depreciation has not been corrected despite this is something that must be seriously analyzed.

On the surface, Japan’s status as a “mature creditor nation” earning money through investment rather than trade is becoming more apparent. However, receipts from foreign assets are not returned to the domestic market, so comparisons with the glory days of the former British Empire are difficult. Japan’s travel surplus in the services account has surpassed the JPY 6 trillion mark for the second consecutive year (a record-high surplus), functioning as a channel

for actively earning foreign currency, but this is also offset by the digital deficit, which has ballooned to approx. JPY 6.7 trillion (details later). It is unlikely that this structure will change significantly in the near future.

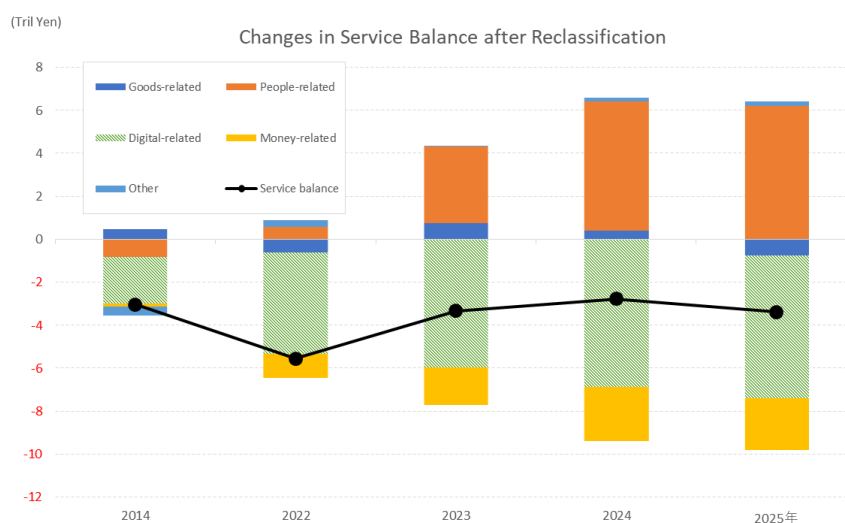
Overall, problems with the balance of payments structure remain, raising the question of whether Japan really has a real economy. Incidentally, while the total amount is not significant, looking at “personal overseas remittances” in the secondary income account, remittances from foreigners living in Japan to their home countries are increasing, reaching JPY 1 trillion for the first time (see graph). With the number of foreign workers in Japan on the rise, it is worth keeping a close eye on the possibility that this item could become a major source of JPY selling in the future.



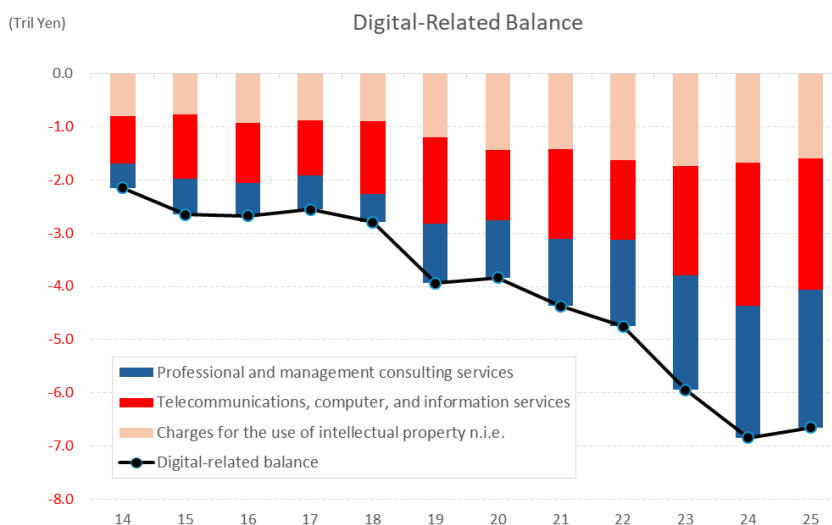
(Source) macrobond

The Services Balance Beginning to be Compressed

When the services balance is broken down into Goods, People, Digital, Money, and Other, the People-related balance, roughly equivalent to the travel balance, is in surplus at approx. +JPY 6.2 trillion, while the Digital-related balance is in deficit at approx. -JPY 6.7 trillion. Further, the Money-related balance, which comprises reinsurance payments to overseas entities, has also ballooned to approx. -JPY 2.4 trillion, resulting in an overall widening services deficit (see graph to the right, top). While the People- and Digital-related balances are roughly even as of 2025, the same pattern is unlikely to play out in 2026, when the impact of Chinese tourists refraining from visiting Japan becomes more apparent. The Digital deficit for 2025 fell by -2.8% yoy, the first decrease in five years, but this may partly be due to the relatively moderate level of JPY’s yoy depreciation. While precise predictions are difficult, the situation is likely to continue into 2026, with the People-related surplus continuing to offset the Digital-related deficit, while the Money-related balance manifests as a deficit in the services balance. Having said that, checking the monthly statistics for the extent of decline in the number of Chinese visitors to Japan will be important in gaining an overview of the services balance for the year. Incidentally, when examining the Digital-related balance by component (see graph, bottom), over half of this is accounted for by professional and management consulting services (approx. -2.6 trillion JPY), which includes online/internet advertising fees; and telecommunications, computer, and information services (approx. -2.6 trillion JPY), which includes cloud service usage fees. In addition to this, there are charges for the use of intellectual property n.i.e. (approx. -1.6 trillion JPY).

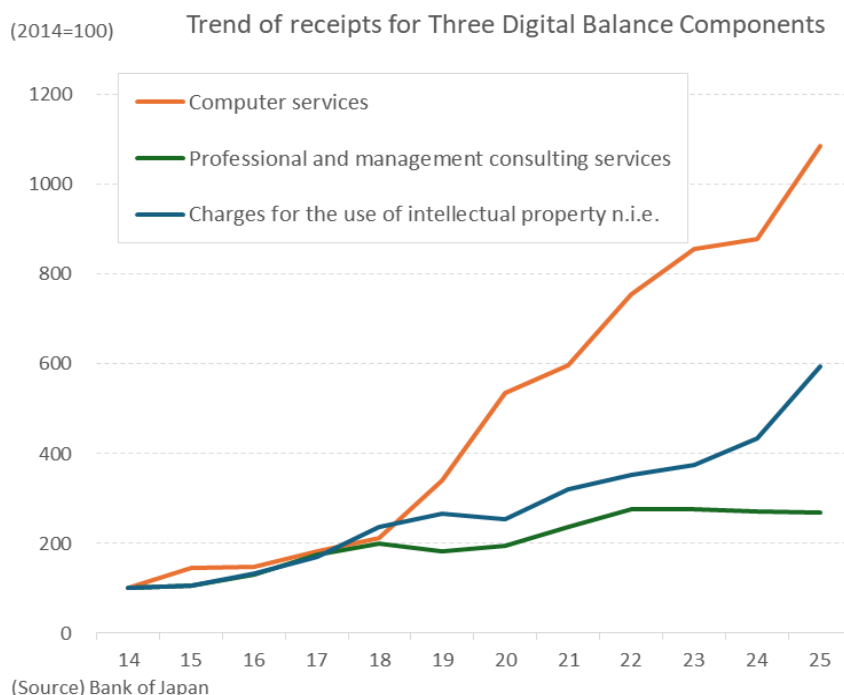


(Source) Created by the author based on the Bank of Japan paper entitled “Globalization of Service Transactions from the Perspective of Balance of Payments Statistics.”



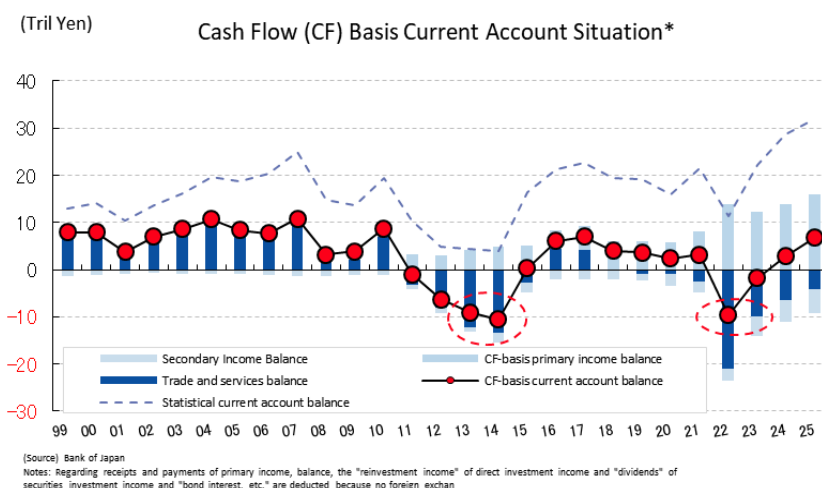
(Source) Bank of Japan

Charges for the use of intellectual property includes “license fees for copyrights, software, music, video, academic content, etc.,” specifically software services like Office 365 and subscription-based video and music streaming services. As a result, payments naturally exceed revenues, but this figure also includes receipts from content services related to manga, anime, and games, which are Japan’s forte. Content receipts (total receipts from computer services and charges for the use of intellectual property) posted an all-time record high of approx. JPY +3.2 trillion (up from approx. +JPY 2.5 trillion last year), and could be seen as contributing to the reduction of the Digital deficit. Given that the Digital deficit has actually declined yoy, the contribution from content receipts should be recognized. As the graph shows, the growth in content receipts was mainly centered on computer services, which includes downloadable game sales, among other things.



End of Supply and Demand Distortion

The CF-based current account balance, which I compute to assess the direct impact on forex supply and demand, is projected to post a surplus of approx. +JPY 6.8 trillion for the full year of 2025. While this is only around a fifth of the statistical surplus, it is still the largest in eight years since 2017 (see graph). It is fair to say, therefore, that the supply and demand distortions that have driven JPY rates since 2022 seem to have largely faded. However, in the financial accounts, JPY selling flows, which likely have a direct impact on forex rates, continue. This was pointed out even in the U.S. Semiannual Report on International Economic and Exchange Rate Policies (the FX Report for short) released at the end of January.



The combination of robust outward direct investment and sluggish inward direct investment remains unchanged, with net direct investment flows of approx. JPY 33 trillion (or -JPY 33 trillion since there is a net outflow). Outright JPY selling, driven by the corporate sector, remains significant. Also mentioned in the FX Report is Japan’s foreign securities investment via investment trusts, which is a proxy for NISA-related household JPY selling, which posted a net purchase (i.e., a net outflow) of approx. JPY 7 trillion. While this is the smallest figure in three years, it remains sizeable. Of course, it is not easy to determine whether JPY selling or buying was higher when currency hedging patterns are also taken into account, but based on the above, it is easy to see why even the largest-ever current account surplus on a statistical basis and a CF-based current account surplus close to JPY 7 trillion would fail to directly result in JPY strengthening.

Incidentally, the January FX Report (details later) clearly stated that “Japan’s primary income is not fully repatriated to Japan, which limits appreciation pressure on JPY from the current account surplus.” This suggests that it is unlikely that Japan will be criticized for JPY depreciation despite its large current account surplus, going forward. While the situation poses challenges for the Japanese economy, it is actually favorable for the U.S., which is seeking to attract investment from Japan.

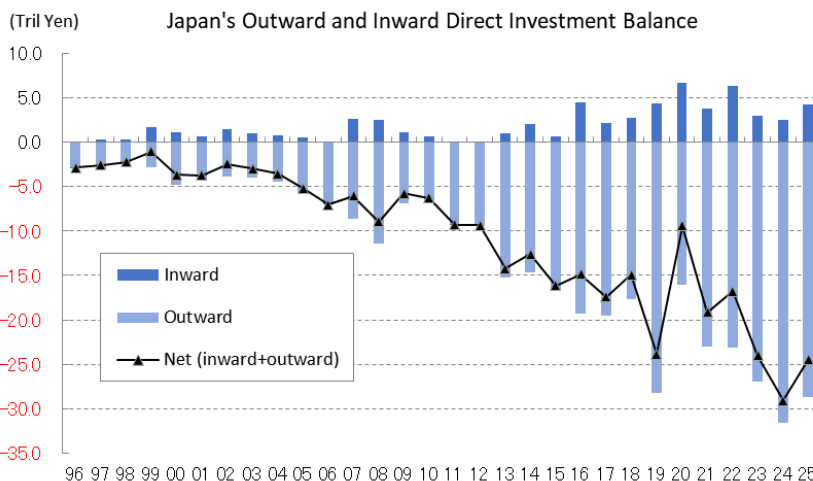
Inward FDI Posts Record High

However, it is important to note that while JPY-buying pressure from the CF-based current account side appears to be limited, JPY-selling pressure from the financial account remains significant. Regarding the financial account deficit, which is the counterpart to the current account surplus, most of the -JPY 25.6023 trillion net acquisition (negative to indicate net outflows) is owing to direct investment.

The figure reflects the sum of outward direct investment (-JPY 32.785 trillion) and inward direct investment (+JPY 7.1827 trillion), of which the former remains overwhelmingly larger. However, it is also important to note that both figures are actually at their highest since records began. This strengthens the likelihood that Japan's national inward FDI strategy is working.

When discussed in terms of outstanding balance, the currently known outstanding balance of inward FDI as of the end of 2024 is approx. JPY 53.3 trillion. Given that the average pace of growth over the past 10 years has been approx. +8.5%, that amounts to an inward FDI flow of approx. +JPY 4.5 trillion per year. By this standard, the approx. +JPY 7.2 trillion flow in 2025 is a very sizeable increase.

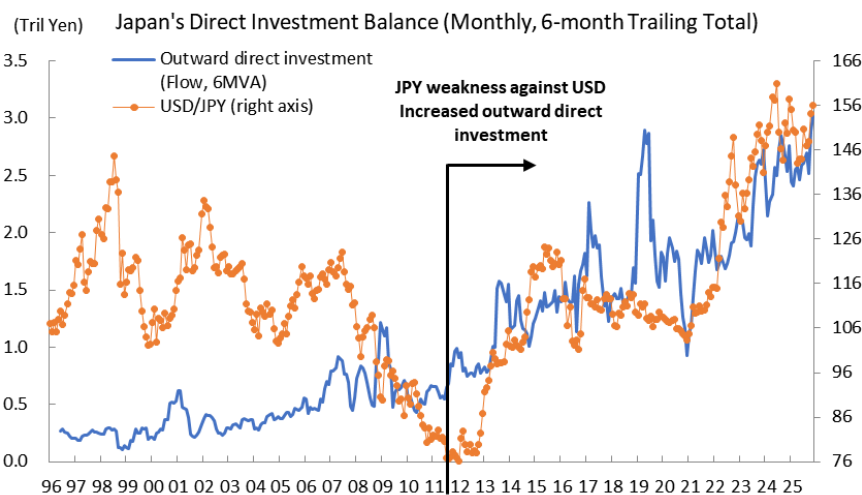
Incidentally, the Ministry of Economy, Trade, and Industry (METI) has established a "Study Group on the Ideal Approach to Developing Japan's Location Environment in Light of Global Environmental Changes, etc.," of which I am a member. We are at a stage where we can expect that constructive discussions between industry, government, and academia will lead to various policies, not limited to exchange rates, that will promote inward FDI.¹ At the very least, it seems clear that macro-level discussions alone are insufficient, and that the key to boosting inward FDI lies in interdisciplinary discussions that also encompass semi-macro and micro-levels.



(Source) Ministry of Finance

Significance of USD 550 Billion Size of Expected Japanese Investments in the U.S.

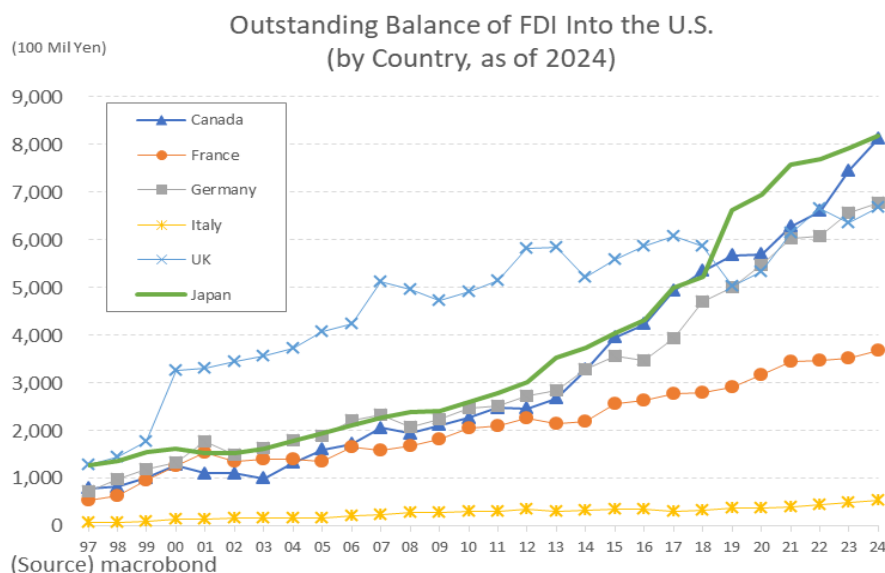
As discussed below, the FX Report released on January 29, 2026, acknowledged that "Japan's financial account deficit was 4.8% of GDP in the four quarters through June 2025 and reflected the activities of Japan's large, internationally active institutional investors, banks, insurance companies, and corporate conglomerates with ever-increasing manufacturing presences in overseas markets. Outbound direct investment accounted for the majority of net capital outflows from Japan during the report period." With some media reports reporting on the specific details of the USD550 billion in investment and loans to the U.S. under the Japan-U.S. tariff agreement, the Trump administration has no incentive to criticize FDI as a factor in JPY depreciation. It is more likely to be welcomed than criticized.



(Source) Ministry of Finance

¹ Please see my presentation delivered at the second meeting; (Reference material) Second Meeting of the Study Group on the Ideal Approach to Developing Japan's Location Environment in Light of Global Environmental Changes, etc., METI; (Reference material 4) Presentation materials, committee member Daisuke Karakama.

For now, there will be some focus on the impact on Japan's financial account of the USD550 billion investment in the U.S. as agreed with the second Trump administration. Assuming USD550 billion, or JPY 85 trillion, invested over the next three years, up to the end of Trump's term in January 2029, this translates into JPY 28.3 trillion per year in direct investment in the U.S. Japan's global outward direct investment has averaged approx. JPY 30.4 trillion per year over the past three years, and approx. JPY 27.5 trillion per year over the past five years. Adding investment funds worth approx. JPY 28.3 trillion in new projects in the U.S. alone bloats the global figure up to unprecedented levels. Of course, in reality, "concluded contracts" and "actual capital flows" are



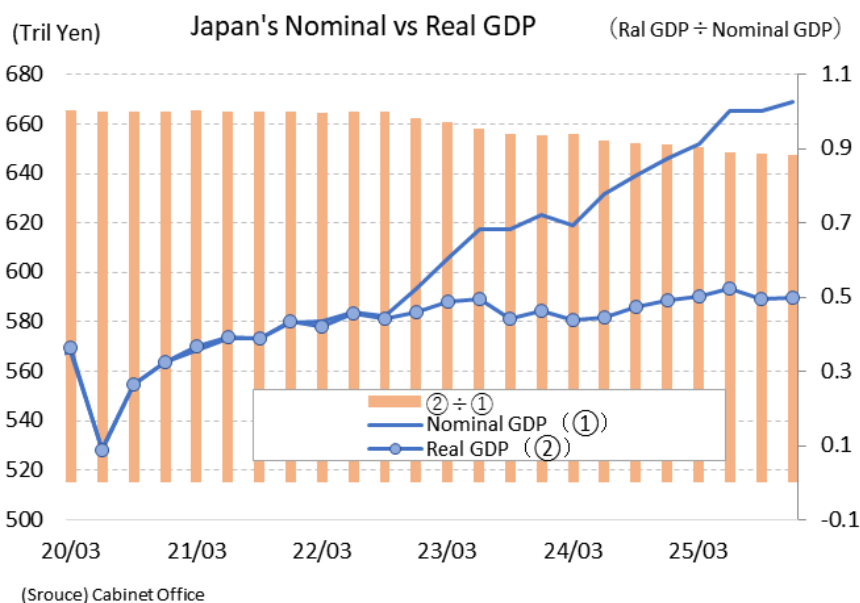
not the same thing. For example, Japanese outward direct investment in the U.S. averaged USD 31.2 billion over the three years from 2022 to 2024, and USD44.6 billion over the five years from 2020 to 2024. The allocation of the USD550 billion will likely be decided through negotiations between the two countries over the next three years, with the investment itself possibly to be implemented over the course of a decade (for instance, USD550 billion invested at the pace of USD44.6 billion a year would take 12.33 years). However, even at this pace, it is a fact that Japanese FDI in the U.S. will increase on an unprecedented scale, which, needless to say, is a factor for JPY depreciation. Given that FDI flows appear to include a relatively large proportion of outright transactions, it would be inappropriate to discuss this without considering its impact on the exchange rate.

While it is encouraging, as noted at the start, that inward FDI is on the rise, it appears that an unprecedented pace of increase in outward FDI from Japan (especially to the US) has become established policy, and this could result in no change, or even an intensification, in JPY selling pressure.

The Japanese Economy Now and Going Forward – Nominal vs. Real Diverge Significantly

Nominal vs. Real Figures Diverge Significantly

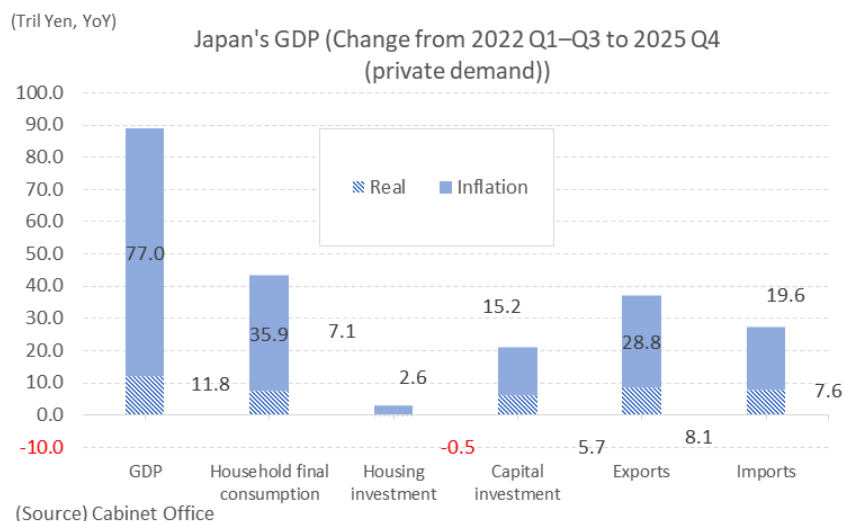
Looking back at February, markets continued to be dominated by Japan's political situation, with the future of fiscal policy, including tax cuts, and reactions to BOJ personnel changes serving as trading factors and creating volatile conditions. It is precisely at such a time, when qualitative factors obscure clarity, that an honest look at hard data becomes important. A troubling aspect of the Japanese economy at present is that, while there is some let up on ongoing and near-term inflationary pressures, cumulative past inflationary pressures are resulting in vulnerabilities. This becomes clear when we compare nominal vs. real GDP (see graph). The GDP figures (preliminary) for the October-December 2025 quarter, released on February 16, revealed that real GDP growth rate excluding the effects of price fluctuations remain roughly flat at +0.1% qoq (+0.2% annualized; hereafter, all figures are qoq unless otherwise stated).



While a recovery in housing investment and personal consumption has led to a recovery in growth for the first time in two quarters, the rate of growth was still well below the median of market forecasts (+0.4%). It has been pointed out that exports have slowed (-0.3%) due to the impact of the Trump tariffs. Even if we accept already published analyses related to demand components, the discrepancy between real and nominal GDP is too large to be explained away. To be specific, the ratio of real GDP (JPY 590 trillion) to nominal GDP (JPY 669 trillion) has fallen to 0.88 as of the October-December 2025 quarter. For the

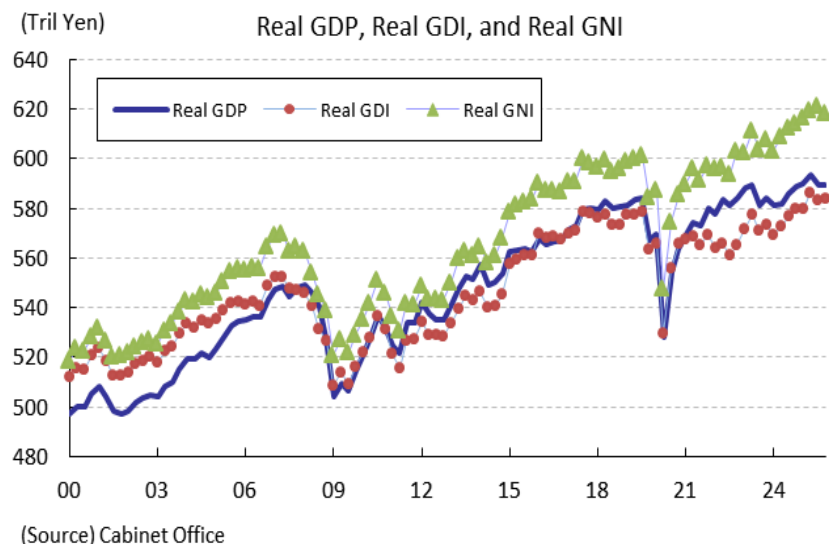
January-March quarter of 2022, immediately before the start of the current phase of JPY depreciation, this ratio was 1.00.

Incidentally, if we take the January-March 2022 quarter as the starting point and calculate the difference with nominal GDP for the October-December 2025 quarter, just under 90% of the increase can be explained by inflation (see graph). Looking at individual demand components, personal consumption increased by approx. JPY 43 trillion in nominal terms, with roughly JPY 36 trillion of that coming from inflation, i.e., price hikes. Naturally, this translates into higher tax collections, resulting in increased tax payments flowing from the household sector through the corporate sector to the government sector, significantly improving outstanding government debt as a percentage of nominal GDP. This is the fundamental theory of inflation tax. The question we need to ask here is – can the BOJ opt to raise interest rates, having addressed the problem of inflation eroding real growth?



Appropriate Analytical Approach to the Japanese Economy

Japan's GDP statistics now have an established structure of "real gross national income (GNI) > real gross domestic product (GDP) > real gross domestic income (GDI)" (see graph). Since March 2022, the outflow of income overseas due to the combined effects of a weak JPY and high resource prices has become a hot topic. However, this fact cannot be captured by headline real GDP; it must be understood through real GDI, instead. As the names suggest, real GDP captures a country's economic activity from a production perspective, while real GDI captures it from an income perspective. The formula is "real GDP + trading gains (or losses) = real GDI." Real GDP, which captures economic volume changes solely from a production

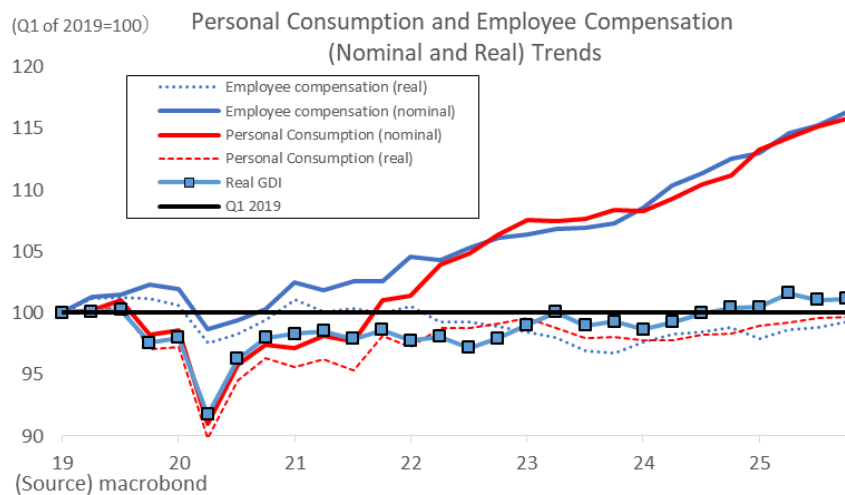


perspective, cannot account for fluctuations in purchasing power resulting from fluctuations in export and import values. Given that a chronically weak JPY fuels import-led inflation and erodes the purchasing power of households and businesses, and that this moreover has political and economic implications, it is clearly more important to focus on real GDI than on real GDP. Needless to say, real GDI is weaker than real GDP due to growing trade losses.

Further, rather than GDP, which is the total added value of goods and services produced "domestically" over a certain period, if we consider income earned by Japanese "citizens" over a certain period, including income earned by overseas branches of Japanese companies, we would look at real GNI, which can be calculated by adding the primary income surplus to real GDI. As one might expect from the enormous primary income surplus, real GNI is far larger than real GDP, as much as 4.9% or so larger for 2025. However, as I have repeatedly argued in this report based on structural changes in the balance of payments, a primary income surplus is essentially a flow with little return to the domestic economy. Given this, GDP and GDI are closer to the actual lived reality of the Japanese people compared with GNI, and real GDI is the more accurate measure than both real GNI and real GDP. In any case, it is clear that discussions of real rather than nominal figures are becoming increasingly important. Further, emphasizing income measures over production measures and "domestic" over "national" in measuring value addition is undoubtedly the appropriate analytical approach for evaluating the Japanese economy.

The Relationship between Economic Normalization and Widening Inequality

Incidentally, the weight of inflation tax becomes even clearer when comparing the discrepancy between nominal and real figures for employee compensation and personal consumption. The lack of growth in real GDI, a measure of income, intuitively suggests that real employee compensation, including wages and bonuses, has also not grown. Further, because employee compensation includes social insurance contributions (such as employees' pension insurance, health insurance, and employment insurance) paid by companies, the average citizen's take-home pay is even smaller than employee compensation. The figure compares trends in nominal and real employee compensation, personal consumption, and real GDI. The trend of general price increases acting as an inflation tax, thereby suppressing real employee compensation and real personal consumption, is clearly consistent with the sluggish real GDI trend. Specifically, using the January-March 2019 quarter as the base (set at 100), employee compensation has grown by more than 15% to 116.3 on a nominal basis, but declined to 99.3 on a real basis. Similarly, personal consumption has risen to 115.8 on a nominal basis but declined to 99.7 on a real basis. Incidentally, real GDI has increased slightly, to 101.1.



The trend of general price increases acting as an inflation tax, thereby suppressing real employee compensation and real personal consumption, is clearly consistent with the sluggish real GDI trend. Specifically, using the January-March 2019 quarter as the base (set at 100), employee compensation has grown by more than 15% to 116.3 on a nominal basis, but declined to 99.3 on a real basis. Similarly, personal consumption has risen to 115.8 on a nominal basis but declined to 99.7 on a real basis. Incidentally, real GDI has increased slightly, to 101.1.

It may be true, as some say, that the Japanese economy has “normalized” the idea of living in a world with inflation and interest rates, but if actual growth remains stagnant, the result will be the widening of disparities between those with assets (such as stocks and real estate, the face value of which increase in response to inflation) and those without. At the very least, when discussing GDP, one must strive to grasp the current state of the Japanese economy by considering both nominal and real-world measures while also keeping an eye on GDI.

U.S. Currency Policy – An Updated Perspective

Both USD Weakness and Strength are a Problem?

Although it received little coverage in Japanese media, the introductory passages of U.S. FX Report offered many interesting insights and were well worth analyzing. Media reports noted that no trading partners or regions had been designated “currency manipulators,” and that Thailand had joined China, Japan, South Korea, Taiwan, Singapore, Vietnam, Germany, Ireland, and Switzerland in the “watch list” (a list of countries closely monitored for suspected currency manipulation) due to its large trade surplus with the US. Regarding Japan, the deletion of calls for an interest rate hike was also widely reported. Even before the report was released, the relationship between Japan's public pension management and JPY weakness had been gaining attention, but this issue had already featured in the FX Report released last June, as well as in the joint statement by the U.S. and Japanese finance ministers last September, so it is not particularly new for those who have been closely following the matter (both the June FX Report and the September joint statement were discussed in relevant editions of this report).

Before discussing portions of the report related to Japan, I would like to mention that the report's Executive Summary section offered some new insights. For example, there is a section titled “Symmetrical pattern of intervention” that states, “Treasury is monitoring more broadly the extent to which intervention by our trading partners is broadly two-sided, and whether economies that choose to smooth exchange rate movements do so to resist depreciation pressure in the same manner as they do to resist appreciation pressure.” In short, the implication is that, regardless of excessive USD weakness or strength, interventions that result in excessive fluctuation are not acceptable. This may be due to de-dollarization trends, that have been a hot topic since last April, and the resulting high U.S. Treasury yields. Perhaps the U.S. authorities are beginning to feel that they would like to see USD weaken somewhat but not too much, and it will be interesting to see if this turns out to be the case.

Finally, an Updated Perspective on Japan's Current Account Surplus

While news headlines focused on the deletion of calls for a BOJ interest rate hike, this is not unnatural, given that the BOJ has, in fact, raised interest rates and is maintaining that course. The better news is that a more accurate understanding of the structure of Japan's current account surplus is emerging. The Report acknowledges that Japan's current account surplus is the byproduct of its “substantial primary income surplus (...that is) not fully repatriated to Japan, which limits appreciation pressure on JPY from the current account surplus.” This is the very point that I have repeatedly analyzed and asserted in this report and in my book *The True Nature of JPY Weakness: Japan Masquerading as a Current Account Surplus Nation*, and it has finally been stated in the FX Report. This more accurate understanding of Japan's current situation, namely that JPY is weak despite the country's current account surplus, will likely reduce the unreasonable demands on Japan going forward. Contrary to appearances, Japan's current account surplus structure is not conducive to JPY strength. Also noteworthy in the FX Report was the

significant amount of space devoted to the discussion of Japan's financial account balance, which is unusual for a report on exchange rate policies (regarding the financial account balance, please see the section on Japan's balance of payments above).

New NISA Also Mentioned

The Report also touches on trends in Japanese outbound securities investment, stating, "Over the long term, Japanese residents are likely to continue to seek foreign assets alongside their growing investment in domestic equities to diversify portfolios and earn higher returns, particularly as domestic inflation settles at a higher level. One factor that is driving such diversification is the government's effort to expand households' tax-free allowance for investments through the Nippon Individual Savings Account (NISA), a move that has contributed to higher resident purchases of foreign equities since January 2024." In short, Japanese households are expected to continue investing in foreign securities through NISA as well as allocating some of their financial assets to domestic risk assets going forward.

As seen above, while the report appears to recognize corporate and household flows as one factor contributing to JPY depreciation, it does not go beyond an analysis of these trends to criticize them, given that both foreign direct investment and foreign securities investment are ultimately private economic activities. It merely presents these flows as facts in its analysis of the current situation. Also, Japanese FDI in the U.S. is something the Trump administration desires, and is therefore more likely to be welcomed.

Public Pension Management Issue Remains Unchanged

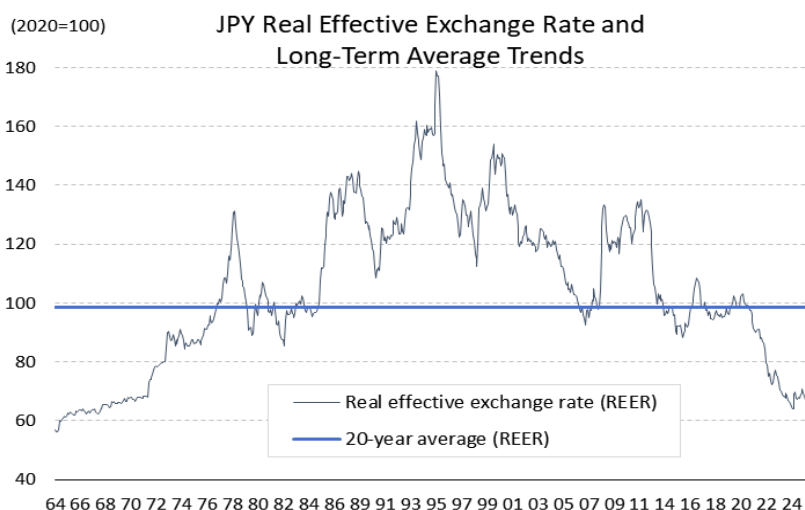
The issue of public pension management has been carried over unchanged from the previous report (September). Because this is not a private economic activity, it is probably easier to incorporate political demands into. This time, in addition to GPIF, the Japan Post Bank and other entities have also been pointed out to be holding sizeable foreign currency assets. However, this has not been specifically criticized as being responsible for JPY depreciation, nor are there any calls for portfolio adjustment. For example, the report states that "In (October) 2014, GPIF adjusted its portfolio allocation to increase the shares of foreign bonds and equities (in response to the "Halloween Easing"). The allocation shift prompted broader resident capital outflows from Japan and led to market speculation that the GPIF's decision figured in a broader government effort to weaken JPY." The wording emphasizes that this was "market speculation," rather than stating it as the Treasury Department's position.

The Report also notes, however, that "GPIF is funded in JPY, primarily from pension premiums and government contributions. To the extent it invests abroad, it exchanges that JPY for foreign currency," thereby highlighting the need for forex transactions. Perhaps the implication is that this promotes JPY weakness. A Bloomberg report dated January 27, 2026, and titled "Japan's Bond Meltdown Spurs Questions Over \$1.8 Trillion Pension Giant's Next Move" discussed the possibility of GPIF readjusting its recently adjusted (in fiscal 2025) basic portfolio mix. (The report quotes the GPIF as saying, "it can evaluate and revise its strategic asset allocation "as necessary" outside of the usual five-year review cycle.") Such speculation is not unfounded; it is quite possible given the contents of the FX Report, and is a scenario market participants should be prepared for.

"Break From Historic Tendency"

The Report's section on exchange rates clearly states that JPY depreciation is due to "wide policy interest rate differentials between Japan and its major trading partners, and the prospects for more expansionary fiscal policies under a new Japanese government." At one time, there was a lot of buzz surrounding the Mundell-Fleming model, which argues that expansionary fiscal policy leads to higher interest rates and a stronger JPY. However, it appears that U.S. monetary authorities, at least, do not believe this to be the case.

The "rate check" controversy in late January was resolved when it became clear that no actual intervention had been carried out, but speculation that the U.S. is concerned about the Japanese government's expansionary fiscal policy and the resulting combination of JPY weakness and higher interest rates continues to simmer in the market. The Report cites the IMF's external sector assessment, the most recent of which "assessed Japan's external position in 2024 to be broadly in line with fundamentals and desirable policies," and also "assessed JPY to be undervalued by 3.3% on a real effective (REER) basis." Though JPY is assessed as being undervalued, given that its REER has fallen to levels last seen in the 1960s, the assessment that it can reach fair value with just a 3.3% increase gives the impression that JPY's true value has declined considerably (see graph). The Report concludes with a section on intervention policy, which notes that "Japan's interventions from 2022-24 to resist depreciation were a break from its historic tendency to resist JPY appreciation." This indicates a recognition that JPY has clearly entered a new phase, historically speaking.



Objectively summarizing the Report's coverage of Japan, the Treasury Department appears to recognize the following factors as driving JPY depreciation: (1) changes in the current account structure; (2) external risk-taking by the household and corporate sectors; (3) portfolio adjustments in public pension management; and (4) a political trend toward expansionary fiscal policy. Of these, (1) and (2) are decisions made by private economic actors and are unlikely to lead to calls for adjustments. (3) and (4), on the other hand, may be subject to change, depending on Japan's assessment of its relationship with the Trump administration. Trends related to (3), in particular, which have been discussed since last summer and reported on intermittently, could significantly affect market expectations. Therefore, it is an important risk factor to bear in mind for the time being.

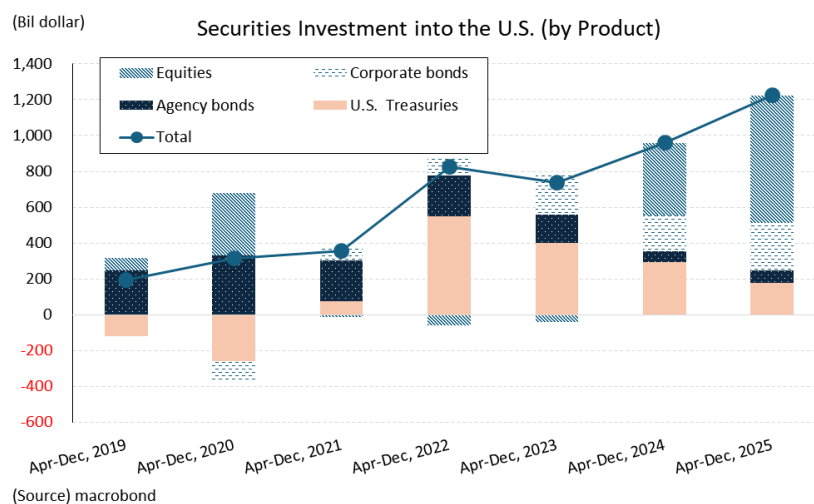
Risks to My Main Scenario – De-Dollarization and Stock Market Correction Concerns

De-Dollarization Trend Undeniable

On February 20, the U.S. Supreme Court ruled the Trump tariffs imposed under the International Emergency Economic Powers Act (IEEPA) unconstitutional. While there has been some confusion, with replacement tariffs fluctuating between 10-15% overnight, the ruling itself was in line with the market's expectations, and has not led to the same level of uproar as seen last April. This appears to be largely due to Treasury Secretary Bessent's statement that, assuming replacement tariffs go into effect, they "will result in virtually unchanged tariff revenue in 2026," and the conclusion that even if tax revenue were to fall short, it would not lead to increased Treasury bond issuance. A major concern is that a decline in tariff revenues could push up Treasury yields, leading to a significant correction in stock prices, but this appears unlikely at this point. Of course, it is unclear how credible Bessent's words are, so some level of increased Treasury bond issuance may be inevitable. If that happens, it may become increasingly difficult for persistently high U.S. interest rates to fall.

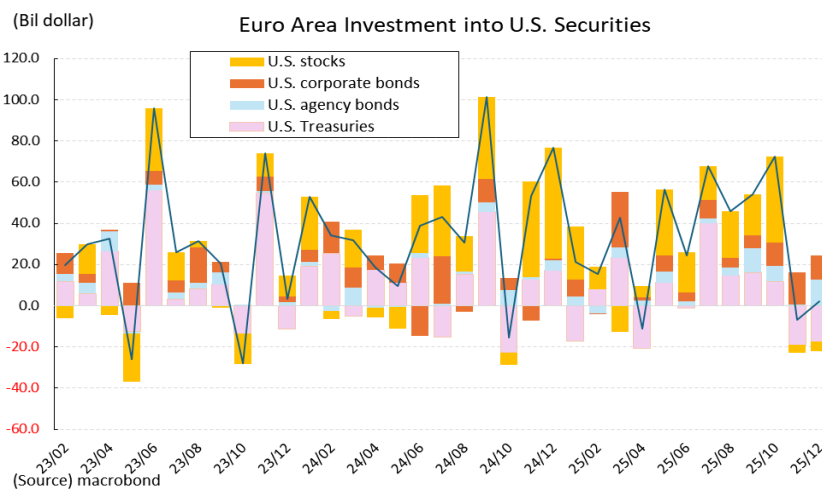
In connection with concern about U.S. interest rates, one must pay some attention to current hard data. On February 18, the Treasury Department released its December 2025 Treasury International Capital (TIC) data. This makes it possible to trace capital flows for April to December 2025, when de-dollarization became a hot topic following the announcement of reciprocal tariffs. To take a quick look at the situation, long-term securities investment into the U.S. recorded a total net inflow of USD1.2253 trillion during this period, a significant increase of 27.7% compared to the same period last year. However, a breakdown by product shows that investment in U.S. Treasuries fell 39.4% to USD179.8 billion, posting the smallest inflow in four years since 2021. Net inflows into stocks, which recorded a significant increase of USD711.6 billion, up 74.9%, were what boosted the overall investment inflow.

The decline in inflows into U.S. Treasuries and the increase in inflows into U.S. stocks could be a sign that investors think U.S. companies are still worth investing in even if the U.S. government under the Trump administration cannot be trusted. In any case, this hard data is consistent with the reality of U.S. Treasury yields remaining high while U.S. stock prices continue to rise, and concerns about de-dollarization remain deep-rooted. While the unconstitutionality ruling did not lead to a further rise in U.S. interest rates, hard data suggests that fundamental concerns have not yet been allayed.

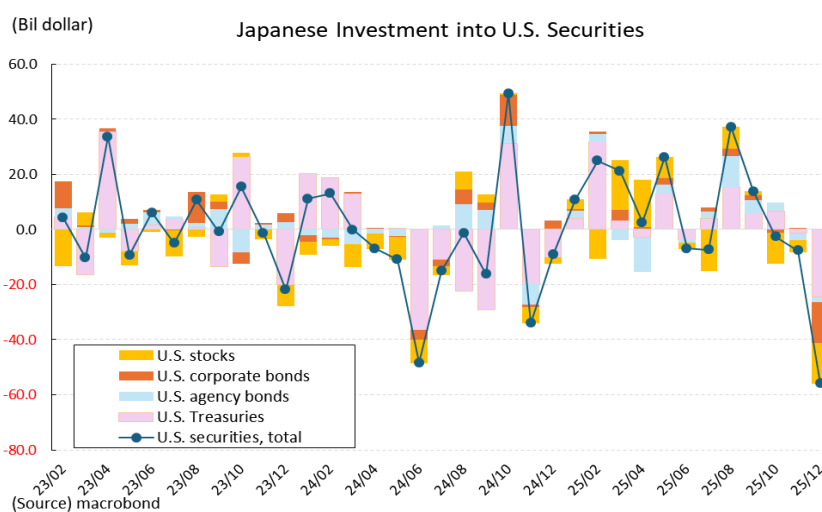


Notable Actions from the Euro Area and Japan

When examining individual countries and regions, the behavior of the euro area is of interest, given the ongoing trend of capital rotation from the U.S. to Europe in the context of de-dollarization over the past year. For the April-December period, capital inflows from the euro area into the U.S. fell 14.4% to +USD305.6 billion compared with +USD357.1 billion for the same period in 2024. This trend is driven by a sharp decline in inflows into U.S. Treasuries, down 66.3% from +USD105 billion to +USD35.3 billion. While inflows into U.S. stocks are increasing globally, those from Europe fell 24.9% to +USD149.2 billion, compared with +USD 198.6 billion in 2024, confirming an overall slowdown in capital inflows from the euro area to the U.S.



Incidentally, Japan's behavior was also intriguing. As the graph shows, Japanese investments in the U.S. saw net selling of securities across all product categories in December, with U.S. Treasuries leading the way. While this could be interpreted as investors streamlining positions and securing cash as they approach the end of the year, it is nonetheless a unique move. Given that Japan's newly issued 10-year government bonds made the headlines in December last year for reaching the highest yields in approx. 26 years (since August 1998), it is possible that the relative attractiveness of Japanese government bonds led to net selling of U.S. Treasury bonds. This arbitrage-driven linkage between the two markets may have been the reason behind Bessent's somewhat impatient comments at the Davos meeting.



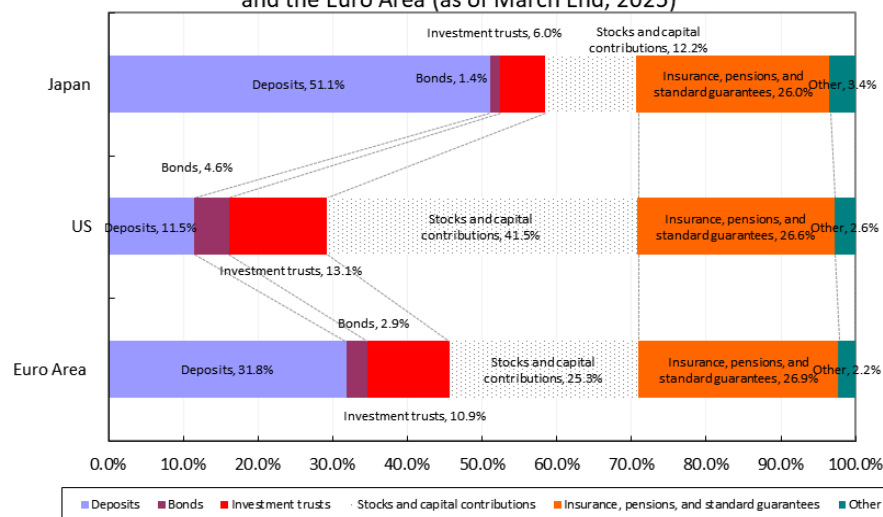
Given the interest-rate differential trends between Japan and other countries, the increased flow of capital is healthy. Further, there may also have been an exit from U.S. stocks, regarding which there was already a sense of caution against the backdrop of their unilateral rise throughout the year, in anticipation of a future strengthening of the Nikkei Average, fueled by expectations of reflationary policies by the Takaichi administration.

De-Dollarization Directly Linked to U.S. Economic Risks

Looking at other countries and regions, we can point to China's continued significant net selling of U.S. Treasuries, and Norway, where pension fund management tends to be closely watched, also notably selling U.S. Treasuries. However, the overall picture remains unchanged: "Dwindling inflows into U.S. Treasuries are being offset by inflows into U.S. stocks." This interpretation seems to express the complex market psychology of distrust in the U.S. government and trust in U.S. companies. However, if the de-dollarization trend and the resulting decline in U.S. Treasury investment continue, it is logical to assume that U.S. interest rates will remain high, unintended by the Fed, and this will force a correction in U.S. stocks.

Given that stocks now account for more than 40% of U.S. household financial

Household Financial Asset Composition in Japan, the U.S., and the Euro Area (as of March End, 2025)



(Source) Bank of Japan, FRB, ECB

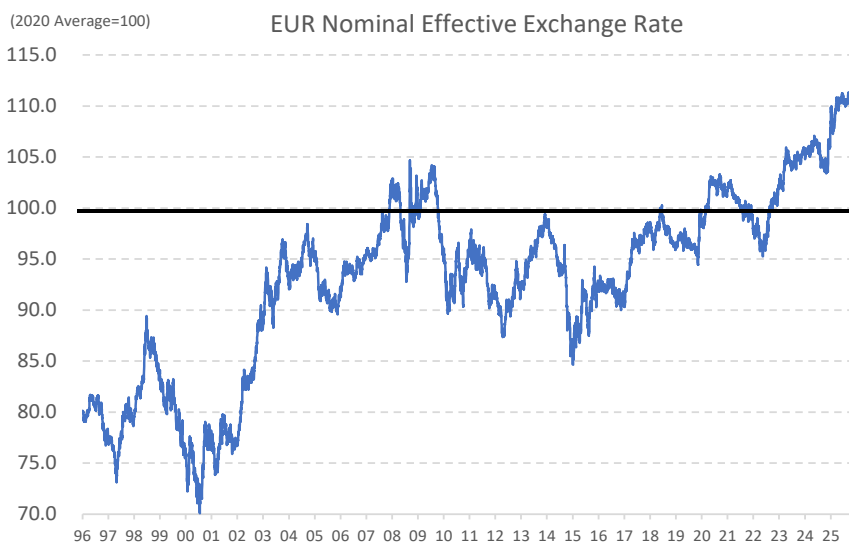
assets (see graph), the most realistic risk is that this could lead to a negative wealth effect, which could stagnate consumption and investment, leading to a recession. If it seems likely that the Fed's successive rate cuts will lead to JPY appreciation, is it not likely that the Fed will suddenly shift to a dovish stance in the face of such an event? One should be wary of stock price adjustments caused by de-dollarization and the corresponding Fed actions as risk factors in 2026.

EUR Outlook – How Long Can the ECB Tolerate EUR Appreciation?

EUR Area Monetary Policies Now and Going Forward – EUR Strength Already Factored In

EUR Appreciation in Line with Baseline Scenario

The February 5 ECB Governing Council meeting was the fifth consecutive Governing Council meeting to decide to keep the policy interest rate (deposit facility rate) unchanged at 2.0%. As anticipated in previous media reports, media coverage of the meeting largely focused on the extent to which the Governing Council meeting discussed EUR appreciation and expressed related concerns. In this regard, the first questioner at the post-meeting press conference asked – “Has the recent [EUR] appreciation against the dollar perhaps increased any concerns in the Governing Council that inflation might turn out lower than expected?” In response, ECB President Lagarde said – “On the exchange rate, because I know that this is a question that has been on the mind of some, [...] we always keep a close eye on exchange rate developments, and the Governing Council discussed this matter today.



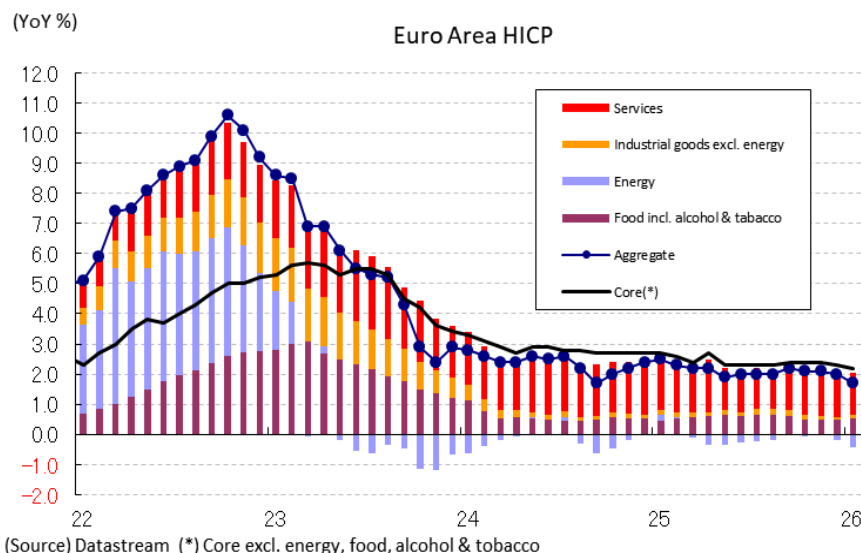
What we observed collectively is that the dollar has depreciated measurably against the euro, but not in the last few days. But since March 2025.” She then made clear that no special measures would be taken in response, stating – “we concluded that the impact of exchange rate appreciation since last year is incorporated in our baseline.” – and added some historical perspective by noting that – “the current range within which the euro relative to the dollar is evolving is very much in line with the overall average of that exchange rate between the euro and the dollar for as long as the euro has been around.” While the recent pace of EUR appreciation has indeed been fast, even faster appreciation has been seen at various points, particularly during EUR’s early years (see graph).

But EUR/USD Still Merits Monitoring

However, President Lagarde also said regarding EUR exchange rates that – “we always monitor whether the impact is passing through as expected and how it affects our reaction function.” The ECB’s statements and press conferences have not made it clear whether the current Governing Council has reached a consensus about its optimal stance regarding EUR appreciation. Market commentary in early 2026 often referred to ECB Vice President Luis de Guindos’s statement during a July 1, 2025, Bloomberg TV interview that – “I think that 1.17 and 1.20 [EUR/USD] is something that we can overlook a little bit. Something beyond that, it would be much more complicated, but 1.20 is perfectly acceptable.” In fact, given that EUR/USD quickly retreated after briefly touching the USD1.20 level, there appear to be market expectations that this level will be seen as a defense line. Additionally, in a January 27 interview with the Financial Times, the Austrian central bank governor (Martin Kocher, historically considered to be rather hawkish) boldly stated that – “If the euro appreciates further and further, at some stage this might create of course a certain necessity to react in terms of monetary policy [because of exchange rates’ indirect effects on inflation].” It is not surprising that such a discussion is emerging, given that EUR is the currency most affected by USD’s current weakness. However, since the EUR/USD1.20 level is 6% below the EUR/USD purchasing power parity exchange rate level (1.28), it seems premature at this stage for monetary policy to be employed for currency management objectives. In this regard, the natural conclusion (as President Lagarde noted) is that EUR/USD remains within the range of historical fluctuations and does not require special measures in response. Regardless of what Governor Kocher said, Vice President de Guindos is not arguing that interest rate cuts should be used to curb EUR’s appreciation but has been expressing the view that boosting the regional economy will be difficult unless greater political and geopolitical uncertainties are resolved. In the abovementioned TV interview he stated that – “a further cut in interest rates will not help to improve the economy. What we need is certainty: certainty on trade policies, on tariffs, on fiscal policy.” That seems to be a sound argument.

Falling Inflation Rates Not Problematic

A key point observers were seeking to learn from the latest Governing Council meeting is the ECB’s assessment of the recent downward trend in euro area inflation rates. This point inspired such questions at the press conference as – “Under what conditions of inflation undershooting would the ECB consider easing monetary policy? How long and how far below 2%?” The decline in inflation rates during the first quarter of 2026, driven by base effects from energy prices, was essentially in line with the ECB’s expectations, although concerns remained at the end of 2025 that the inflation rates might be stubbornly persistent. Eurostat’s preliminary flash estimate of January 2026 headline inflation (as measured by the Harmonised



Index of Consumer Prices (HICP)), released on February 4, was a 1.7% yoy rate, the lowest such rate seen since September 2024. However, this was driven by falling energy prices and was not a surprise (it was in line with market expectations). In fact, the rate of core inflation was 2.2%, still above 2%, which suggests no need for further rate cuts. President Lagarde dismissed lingering concerns about the outlook, stating – “We will have more data and intelligence coming out of the March exercise [Eurosysteem staff macroeconomic projections], but there is nothing that is really changing the baseline at all.”

There are always likely to be voices hoping for further interest rate cuts based on current data related to EUR appreciation or decelerating inflation rates, but it appears likely that the ECB’s plan entails halting interest rate cuts for the time being and waiting for the right timing in the latter half of the year for a shift to signaling a potential transition to rate hikes.

Strengthening EUR’s Reserve Currency Status

One week after the Governing Council meeting, on February 14, the ECB announced it was strengthening the Eurosystem repo facility for central banks (EUREP) to make it more flexible and effective in supporting monetary policy transmission. This was widely reported in media articles with such titles as – “ECB Strengthens EUR Liquidity Provision—Expanding Its International Role.” It is worth briefly discussing the significance of this initiative. From the ECB’s perspective, it is a strategic measure for strengthening EUR’s reserve currency status, and it is a noteworthy development to keep in mind, especially as discussions about issuing defense bonds through a joint bond scheme appear likely to gain momentum.

In June 2020, in the midst of the covid-19 pandemic, the ECB decided to establish EUREP as a backstop to provide precautionary EUR repo lines to non-euro-area central banks. EUREP was designed to protect the ECB’s monetary policy transmission channels amid various kinds of market dysfunction caused by the pandemic, and it enabled financial institutions to meet their EUR liquidity needs even at the height of the crisis. Under EUREP, euro area central banks ((≈ the Eurosystem) can provide EUR liquidity to non-euro-area central banks in exchange for appropriate collateral (mainly EUR-denominated bonds issued by euro area central governments and international organizations). However, this remained strictly a “contingency framework”.

In its press release on this subject, the ECB announced that all central banks will be able to use the EUR liquidity facility “unless excluded on the grounds of, in particular, money laundering, terrorist financing or international sanctions.” Applications and approvals were previously possible only after a crisis had occurred, but the establishment of EUREP as a permanent facility means that central banks will now be able to borrow funds at any time after going through the required procedures, so long as they hold eligible collateral in advance. This shift from an “emergency or contingency framework” to a “peacetime framework” will help bolster EUR’s international liquidity.

About the Eurosystem Repo Facility for Central Banks (EUREP)

Item	Previously (2020 to Q2 of 2026)	Currently (from Q3 of 2026)
Nature of access	Temporary/emergency measure	Standing access
Usage procedure	Approved and decided on a per-case basis by the ECB’s Governing Council after a crisis occurs	<u>In principle, access is open to all central banks in advance and available immediately</u>
Scope	Broad range of central banks outside the euro area	In principle, all central banks, unless excluded for reasons of money laundering, terrorist financing, or international sanctions
Main objectives	Avoiding market disruptions due to specific crises	Ensuring liquidity of EUR-denominated assets during peacetime

(Source) ECB

Driving a Wedge into the “Donroe Doctrine”

The most critical factor for central banks holding EUR-denominated assets as foreign exchange reserves is the question of whether they can quickly convert those assets into cash (EUR) when financial markets become dysfunctional. So long as EUREP remained an “emergency framework”, central banks seeking to liquidate their EUR-denominated assets would have had to apply for and await the ECB’s permission amid chaotic conditions. Now, however, the guaranteed “peacetime framework” is reassuring central banks that they will be able to liquidate their EUR-denominated assets at any time (provided the requisite conditions are met).

These ECB actions followed the lead of the Fed. The Fed has a standing swap framework that allows it to supply USD without collateral to five major central banks (the BOJ, ECB, Bank of England (BOE), Bank of Canada (BOC), and Swiss National Bank (SNB)), and from 2021 onwards, it has made the FIMA (Foreign and International Monetary Authorities) repo facility permanent for “central banks that do not have swap agreements”. (FIMA was introduced in 2020 and made permanent in 2021.) So EUREP’s transformation into a permanent non-emergency facility has made it the ECB’s version of FIMA, and it marks a fairly significant step forward in the sense that EUREP now performs a function that was previously offered by the Fed but not by the ECB. Amid growing concerns about USD’s ability to maintain its dominant global reserve currency status, the ECB’s strengthening of EUREP could be considered the thin edge of a wedge being driven into USD’s global hegemony.

Many market participants consider USD’s reserve currency status to be safeguarded by Fed promises to supply USD through standing swap arrangements and FIMA, even in the event of USD shortages. However, there are widespread concerns about the ramifications of the second Trump administration’s isolationist policies (often referred to as the “Donroe Doctrine”, a nickname created by combining President Donald Trump’s first name with the well-known “Monroe Doctrine”, through which U.S. President James Monroe in 1823 established separate spheres of influence by declaring the Americas off-limits for European intervention while promising U.S. non-interference in European affairs). The “Donroe Doctrine” has engendered doubts about whether USD supplies are truly guaranteed in times of crisis, and those doubts have led to claims that USD’s reserve currency status is being undermined. The establishment of EUREP as a permanent institution offers a global financial system overly dependent on USD an alternative safe haven currency – EUR. From the ECB’s perspective, EUREP’s strengthening can also be seen as a means of augmenting the euro area’s strategic independence in economic and financial terms and alleviating the influence of the United States. It is particularly important to recognize the various aspects of the EUREP strengthening initiative in light of ongoing discussions about the need for Europe to establish greater strategic independence from the U.S. in security matters as well as in light of associated debates about introducing defense bonds as a form of joint bonds.

Many media and market players seem to be expecting rapid changes. It should be clearly recognized, however, that enhancing EUR’s reserve currency status will not happen overnight but will require the steady accumulation of policy initiatives akin to the strengthening of EUREP.

EUR Area Politico-Economic Situation Now and Going Forward – Joint EU Defense Bonds Represent Progress toward “EU 4.0”

Vance and Rubio Make the Same Argument

The Munich Security Conference (MSC 2026) on February 13-14 produced a series of eye-catching headlines, and while there were many points of interest, I would like to focus on just two of those in this article. It was particularly noteworthy that the keynote speech by the top U.S. MSC 2026 participant was more conciliatory than the corresponding speech at MSC 2025. The second noteworthy point was that France and Germany confirmed at MSC 2026 that they have begun strategic talks on a possible joint European nuclear deterrent. At MSC 2025, U.S. Vice President JD Vance completely rejected the standard policy views of European elites, saying – “The threat that I worry the most about vis-à-vis Europe is not Russia, it’s not China, it’s not any other external actor. And what I worry about is the threat from within, the retreat of Europe from some of its most fundamental values.” He explicitly stated that the primary danger to the continent was not an external military power, but rather internal issues related to democratic values and free speech. He also made headlines for his audacious act of visiting Germany during the German general election, expressing his support for the populist Alternative for Germany (AfD) party, and declining to meet with German Chancellor Olaf Scholz while holding a separate meeting with AfD leader Alice Weidel. Since his days as a senator, Vice President Vance has strongly advocated reducing U.S. spending on European security, and at MSC 2025 he argued that that it – “makes sense to stop writing blank checks to governments that refuse to defend themselves” – and strongly called for Europe to take a more proactive role in the Ukraine war. By clearly articulating the idea that the problem is not Russia, but European elites, Vice President Vance’s powerful MSC 2025 speech could be seen as a historic turning point that considerably widened the distance between the U.S. and the EU.

In contrast, the more moderate tone of U.S. Secretary of State Marco Rubio’s keynote speech at MSC 2026 was conspicuous. Media headlines emphasized the strong conciliatory nature of his stance, giving particular attention to his statement that – “in a time of headlines heralding the end of the transatlantic era, let it be known and clear to all that this is neither our goal nor our wish – because for us Americans, our home may be in the Western Hemisphere, but we will always be a child of Europe.” That said, the true intentions of both Vice President Vance and Secretary of State Rubio are largely the same. Secretary of State Rubio stated – “We do not seek to separate, but to revitalize an old friendship and renew the greatest civilization in human history. What we want is a reinvigorated alliance that recognizes that what has ailed our societies is not just a set of bad policies but a malaise of hopelessness and complacency.” – and he prefaced that statement by saying – “we do not want allies to rationalize the broken status quo rather than reckon with

what is necessary to fix it[.]” However, the “what is necessary” he refers to is largely a plea for Europe to become more-proactively engaged in the Ukraine war and, ultimately, in defending against Russia. The United States wants its allies to pay their fair share of military expenses, and for Europe, that means more-active involvement in defending against Russia. The only difference between the keynote speeches at MSC 2025 and MSC 2026 is that Vice President Vance called for this in an aggressive tone while Secretary of State Rubio called for it in a conciliatory tone. While European Commission President Ursula von der Leyen and several other high-ranking EU officials expressed relief following Rubio’s speech, former Lithuanian Foreign Minister Gabrielius Landsbergis posed on X that – “This was not a departure from the general position of the US administration. It was simply delivered in more polite terms.” – and that seems to be a quite accurate interpretation.

Significance of Germany-France Nuclear Cooperation

Another major headline-garnering development at MSC 2026 was the confirmation that France and Germany have begun strategic talks on a possible joint European nuclear deterrent. In his opening speech on February 13, German Chancellor Friedrich Merz revealed that he has begun discussions with French President Emmanuel Macron regarding what kind of cooperative measures their countries might undertake to create a joint European nuclear deterrent. Germany is being forced to revise its previous security strategy that entailed excessive dependence on the United States and will fundamentally become unable to continue relying on the U.S. nuclear umbrella, so it seems inevitable that France’s nuclear arsenal will have to be employed to create a new EU nuclear umbrella. Germany and France have traditionally avoided this kind of initiative, as it could upset the power balance between the two countries but, given that Germany appears to be entering a prolonged period of economic stagnation, it seems that Germany may have no alternative means of substantively strengthening Europe’s defense capabilities. Increasing mentions of a “European Army” concept and other factors indicate that concerted European efforts to achieve greater strategic security independence will proceed ineluctably for the foreseeable future.

However, it is an EU tradition that, even when a general agreement about an issue is achieved, arguments about financial arrangements often will disrupt progress in negotiating specific proposals. Financial markets have been focusing attention on prospective funding methods for the ReArm Europe Plan announced last March. If France’s voice becomes stronger in the future, one wonders how that might affect the Security Action For Europe (SAFE) financial instrument, which accounts for EUR150 billion of the EUR800 billion ReArm Europe Plan.

Currently, the ReArm Europe Plan calls for EUR650 billion to be funded by expanded defense spending on the parts of individual countries and for the remaining EUR150 billion to be raised through the issuance of EU joint bonds through SAFE (although the bonds are technically speaking to be loans). The fact that funds are to be raised via joint bond issuance has attracted attention as representing a milestone along the path toward the EU’s fiscal integration but, strictly speaking, the funds will merely be loans from the EU, with associated obligations to make repayments to the EU. For example, if Italy receives a EUR10 billion “loan” from SAFE, it will be obligated to repay it. In contrast, if the plan were structured to provide grants instead of loans, the EU as a whole would be responsible for repayment – the EUR10 billion would be repaid by all 27 EU countries in proportion to their relative economic size (and their share of the EU budget). That would effectively authorize fiscal transfers to individual countries, which would be a major milestone along the path toward the EU’s fiscal integration. Therefore, strictly speaking, SAFE has not yet achieved

Differences between NGEU and SAFE

Item	Pandemic response (NGEU)	ReArm Europe Plan
Fund name	NextGenerationEU	SAFE (Security Action for Europe)
Total amount	Approx. EUR806.9 billion	EUR 150 billion
Grant to loan ratio	Grant: approx. 42% (EUR 338 billion) Loan: approx. 48% (EUR 385.8 billion) *The remaining 10% allocated as addition to programs included in the existing EU budget	Loan: 100%
Repayment responsibility	Grant: EU member states Loan: Borrowing country	Borrowing country
Issuance/lending period	2021 to end of 2026	2025~ (operational)
Repayment (redemption) deadline	2028-2058	Max. 25-30 years
Degree of fiscal integration	Permitted for grant portion	Not in the nature of fiscal integration, strictly speaking
Germany’s stance	Accepted as a one-off measure by Merkel administration	Merz administration approved only loans

(Source) Created by the author

the feat that has been hailed as a “European Hamiltonian moment” (named after Alexander Hamilton, the first U.S. Treasury Secretary, who in 1790 engineered a “financial revolution” enabling the central U.S. government to create collective debt instruments). However, it appears that many financial market players have mistakenly given it this recognition by confusing SAFE loans with a move toward permanent joint debt, and this misunderstanding was compounded by the fact that the March 2025 announcement of SAFE and the ReArm Europe Plan corresponded to the timing of Germany’s historic move to loosen and bypass its constitutional “debt brake” (Schuldenbremse) to allow for massive new borrowing in the 2026 budget and beyond.

Renovating and Expanding Gaullism

Meanwhile, roughly 45% of the EUR800 billion Next Generation EU (NGEU) bonds issued during the pandemic were “grants.” To repay these, the EU decided to introduce its own revenue sources, such as a plastic tax – a tax on the volume of non-recycled plastic packaging waste generated in each EU country. This process of creating new revenue sources for new expenditures closely resembles the fiscal management process of unified countries. Germany has emphasized since then that this was a “one-off exception”, and German Chancellor Merz is wary of applying the “grant” scheme to the current SAFE agreement, but France, on the other hand, is in favor of that. French President Macron has explained that his aim is to solidify the EU as a single political and economic bloc by making joint bonds in the defense sector (EU defense bonds) permanent. His argument that EU defense bonds should be created not merely as a means of financing but as a catalyst for EU integration is fairly persuasive.

During the period Charles de Gaulle served as president of France (1959-1969), France refused to become a satellite state of either of the two Cold War superpowers (the United States and the Soviet Union) and instead chose to create its own nuclear deterrent and pursue an independent diplomatic course. Reflecting its “Gaullist” intent to become independent from the U.S.-led defense structure, in 1966, France removed its forces from NATO’s military command structure and ordered all foreign military personnel to leave French soil. President Macron is seeking to renovate “Gaullism” and expand its geographic scope to enable strategic autonomy for Europe as a whole. He is still striving to achieve progress toward that goal, although he has less than a year and three months left in his term in office.

Germany Accepts “Greenland Moment” Concept

Since the beginning of February, President Macron has used the “Greenland moment” phrase in interviews with several European newspapers, thereby suggesting that U.S.-Europe tensions related to Greenland should be seen as a “strategic wake-up call for all of Europe” regarding the need to embark on reforms to unify and strengthen Europe. He also expressed his ambition for EU joint debt issuance, stating – “Now is the time to launch a common borrowing capacity for these future expenditures, future-oriented eurobonds. We need large-scale European plans to finance the best projects.”² In fact, if it is difficult for individual EU countries to expand their budgets, this kind of collaborative borrowing and funding approach may be the only realistic option.

Germany has so far been resisting such arguments, so it continues to appear unlikely that SAFE will be funded by “grants” in a manner that promotes EU fiscal integration. A year ago, Germany finally lifted its debt brake law, enabling increased spending on defense and infrastructure projects, and this move was well received in financial markets. However, that change relates exclusively to Germany’s national budget and should not be interpreted as suggesting that Germany has become more inclined to promote the EU’s financial integration. In this regard, there has been little progress since the protracted period following the debt crisis when Germany was led by Chancellor Angela Merkel. In light of the Trump administration’s sustained criticisms of Europe, President Macron’s argument is likely correct – it is quite logical to propose that EU member states should share the cost of improving Europe’s overall defense capabilities. The fact is that Europe simply felt no pressing need to recognize that logic during peaceful times, so it shirked the undertaking and funding of defense projects that should have been continuously sustained. While Germany and France have shown signs of compromise on such major issues as cooperation related to nuclear weapons, the countries were ultimately unable to agree on the joint fighter jet element of the Future Combat Air System (FCAS) project, and it was reported just last November that they would narrow the scope of their FCAS cooperation to the Combat Cloud, a high-tech command and control architecture.³ This is yet another example of how, even when France and Germany agree about cooperation in general terms, they chronically clash and stumble over more-specific issues.

Looking back, it is worth noting that the European debt crisis and covid-19 pandemic were emergencies that transcended national borders and inflicted damage throughout the euro area, forcing Germany to accept the need for greater integration and enabling the EU to take the plunge into creating an unprecedented joint debt issuance scheme. The current international and domestic pressures on the EU to upgrade its defense capabilities are similar in that they are transcending national borders and inflicting damage throughout the euro area. Although it will require some time, I believe there is a high possibility that the concept of joint EU defense bonds structured to provide grants will realized, either as means of funding all or a portion of SAFE, or as a funding method for a different project.

Evolution Toward “EU 4.0”

Having decided with Germany to cooperate in connection with nuclear weapons, France may now be positioned to further emphasize the need for EU defense bonds to fund the EU’s overall security strategy. As mentioned above, achieving strategic autonomy from the United States will require greater defense spending expansion than ever before, and if individual EU member states do not have the financial means to fully enable this expansion, the EU will inevitably have no choice but to consider supplementing individual countries’ efforts with joint EU bonds. Furthermore, as the issuance of NGEU bonds (intended for pandemic recovery) will end at the end of 2026, sustaining the discussion about EU defense bonds will be crucial for preventing a general fading of interest in the EUR reserve currency status issue.

This article has repeatedly argued that the EU has successfully realized major structural changes (despite facing resistance from Germany) each time it has had to overcome such major crises as the debt crisis and the covid-19 pandemic. I consider that the EU was “EU 1.0” at the time of its creation, became upgraded to “EU 2.0” with the introduction of bailout funds and unconventional ECB policies amid the European debt crisis, and then advanced to “EU 3.0” when it ushered in joint bonds designed to facilitate recovery from the covid-19 pandemic. Should EU defense

² BBC “Macron urges Europe to start acting like world power”, 10. Feb 2016

³ Reuters “Berlin and Paris discuss scrapping plan to jointly build fighter jet, FT says”, 18 Nov. 2025

bonds become a permanent institution as a form of joint debt, it would mark a turning point in the EU's evolution toward "EU 4.0." That said, I think the mere fact that fiscal integration (joint debt; long considered a perennial challenge since the euro area's inception) is now on the table for discussion represents significant progress toward "EU 4.0."

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