

FX Weekly - Yen surges, central banks in focus

ABN AMRO Research · 2026-09-11 · English original

The yen strengthened sharply as markets increased their expectations for Bank of Japan rate hikes... but higher energy prices later weighed on the currency. The euro gave back some gains as rising energy prices and US Treasury yields supported the US dollar. The ECB's 25-basis-point hike had little impact on the euro. The Bank of England is likely to adopt a slightly more hawkish tone next week. A near-term rate hike remains unlikely, but risks are rising. The UK government is expected to use targeted tax increases to address fiscal pressures while avoiding major spending cuts. We expect EUR/GBP to rise modestly and GBP/USD to remain slightly stronger, with end-2026 forecasts unchanged at 0.86 and 1.36, respectively.

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Yen on the move

In last week's FX Weekly, we highlighted three policy-related risks for the US dollar. First, the Fed might not meet market expectations for a rate hike next week. Second, a higher risk premium could push up US Treasury yields. Third, another coordinated US-Japan intervention could support a recovery in the yen. In the end, the yen strengthened sharply and unsettled currency markets, but the main trigger was expectations for more rate hikes by the Bank of Japan. Markets now fully price in a rate increase next week and see a strong chance of another hike by year-end. In this environment, investors are reluctant to hold short-yen positions. The yen rose strongly, particularly against the US dollar and the euro, which also pushed EUR/USD higher. However, the yen came under renewed pressure on Thursday as energy prices surged. Japan is a major importer of oil and gas, so higher energy costs tend to weigh on its currency.

ECB and EUR/USD

The euro also gave back some of its earlier gains. This was not mainly due to the ECB's decision. Instead, the rise in energy prices and US Treasury yields supported the US dollar broadly. As widely expected, the ECB raised its policy rate by 25 basis points (see more here). The decision, statement and press conference had only a limited effect on the euro. Financial markets price in at least one more rate hike this year with a possibility of another rate hike in December. This should keep the euro supported. Attention now turns to today's US CPI data and next week's meetings of the Fed, the Bank of England (more on this below) and the Bank of Japan.

GBP outlook: BoE to lean more hawkish...

The MPC meets next week amid a significant rise in energy prices compared to when it last met on 30 July. Recent commentary from centrists on the Committee however suggest continued broad comfort with the current policy stance, in contrast to hawks and financial markets, which now price more than three rate hikes over the next 12 months. For instance, on 8 September governor Bailey pointed to already tight financial conditions including the 'largest rise in mortgage rates in the G7', while deputy

governor Ramsden said that while he is 'very conscious of upside risks' to inflation, he thought the 'domestic position' with regards inflation looked 'relatively benign'. Indeed, the labour market remains somewhat on the softer side, albeit bottoming out of late, while wage growth is now broadly consistent with the BoE meeting its 2% target over the medium term. Bailey and Ramsden's views are crucial to tilting the balance on the Committee in favour of hikes, so until we see signs of a meaningful shift in their views, near-term rate hikes look unlikely. At next week's meeting, we do expect some hawkish shift in the views expressed, but the vote split will probably remain the same, and the centrists are likely to stop short of explicitly signalling future support for rate hikes.

Our view is that the risks of the BoE tightening policy have risen, but probably not sufficiently to drive rate hikes just yet. The policy rate in the UK is already mildly restrictive, and tighter financial conditions in the form of higher long-term rates are probably sufficient – alongside a softish labour market – to keep inflation expectations anchored. Still, as for the ECB, the longer elevated inflation persists, the bigger the chance that this stance will change. For now, our base case remains for a long hold by the BoE, followed by a resumption of rate cuts next year.

...and Healey to steer steady fiscal course

The other key focus for markets is the upcoming budget on 28 October from new chancellor John Healey. Healey has an immediate fiscal hole to plug if he wants to keep markets convinced of the government's commitment to its fiscal rules, and given how sensitive bond markets are right now, he is likely to deliver. The energy shock has meant a likely halving in the fiscal headroom the government has to meeting its fiscal rules compared with Rachel Reeves' last budget in 2025, and while new PM Andy Burnham has said the government needs to be 'really serious' on cutting welfare spending, at this budget we are more likely to see additional tax rises rather than major spending cuts. Given the government's manifesto commitments not to raise income tax & VAT, it is likely to lean on special targeted taxes such as (perhaps) a tax on banks and/or a higher windfall tax on energy companies. All told, we think Healey will do enough to keep markets on side, but given the fiscal constraints we do not expect any ambitious policies to boost growth, and only small, targeted relief to households hardest hit by the energy shock.

GBP outlook

Given our BoE and fiscal outlook we expect some upward bias in EUR/GBP this year because the difference in monetary policy between the ECB and the BoE. We also maintain a slight upward bias for GBP/USD, reflecting our expectation of broader US dollar weakness over our forecast horizon. We keep our forecasts unchanged. Our forecast for the end of 2026 for EUR/GBP stands at 0.86 and for GBP/USD 1.36.

Source: <https://www.abnamro.com/research/en/our-research/fx-weekly-yen-surges-central-banks-in-focus>