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The yen: a perennial patient that could be saved by a US dollar peg

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Summary

Die Geschichte der Devisenmarktinterventionen Japans ist lang. Gebracht haben sie wenig. Eine Bindung des Yen an den Dollar würde nicht nur den Yen, sondern auch die kranke Wirtschaft Japans und sogar das ganze Weltfinanzsystem stabilisieren.

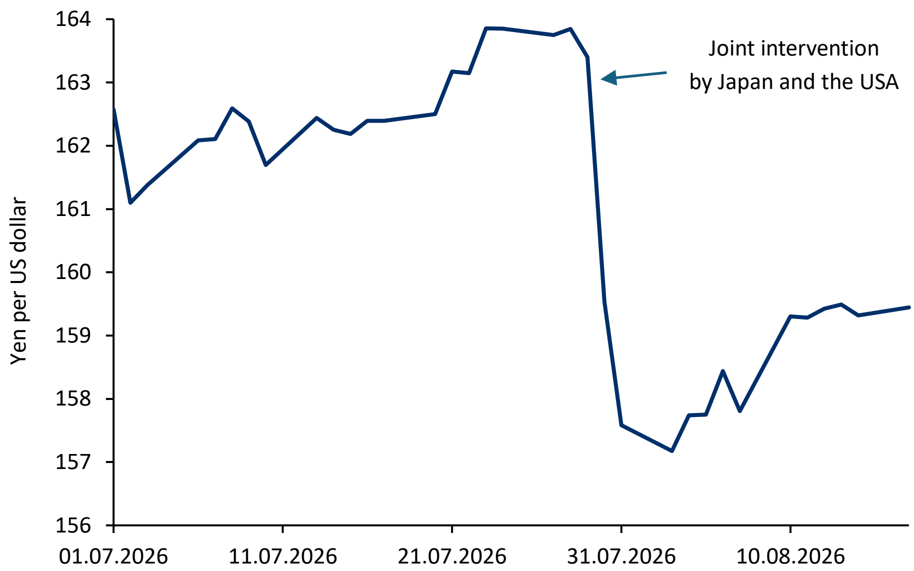
Abstract

Japan has a long history of foreign exchange interventions, with little to show for it. Pegging the yen to the US dollar could help stabilise not only the yen, but also Japan’s ailing economy – and even the global financial system.

1. Japan and the USA intervene against the weak yen

Japan is suffering from a weak yen. Having reached an all-time high of less than JPY 75.35 per US dollar on 31 October 2011, the yen was trading at almost JPY 164 per US dollar by the end of July 2026. While every depreciation is welcomed by Japan's export industry, discontent among the Japanese population is growing as the cost of imported food and energy rises. This is particularly painful given that Japan's economy has struggled since the 1990s and real wages have remained under pressure.

Figure 1: Yen per US dollar: daily data, July and August 2026



Source: LSEG.

Initial interventions by Japan's Ministry of Finance earlier this year had failed to bear fruit. As a result, Japan and the USA recently intervened jointly in the foreign exchange market (Schnabl 2026). Japan's Prime Minister, Sanae Takaichi, was keen to halt the decline in her popularity. The USA, meanwhile, is thought to have wanted to pre-empt further sales of US Treasuries to finance Japan's yen purchases.

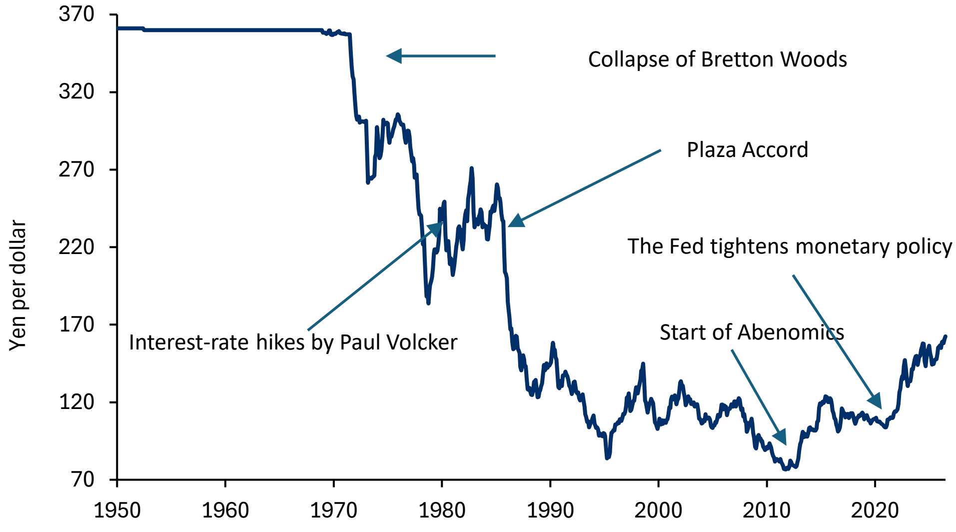
The USA rarely intervenes in foreign exchange markets. The news from Washington therefore attracted considerable attention in international financial markets. The yen appreciated sharply (see Figure 1). Before long, however, it resumed its decline. It seems that nothing can halt its downward pull. What can save the yen?

2. Japan's long struggle with the strong yen

After the Second World War, under the Bretton Woods System, the Japanese yen was pegged to the US dollar for many years at JPY 360 per dollar. This dollar peg, imposed by the USA, formed the backbone of the rise of the Japanese economy after the war. However, following the collapse of the Bretton Woods System, the yen's appreciation against the dollar caused difficulties for Japan's export industry. Throughout the 1970s, the Bank of Japan therefore repeatedly intervened to counter the yen's appreciation. This did nothing to change the ongoing upward trend (see Figure 2). It was not until the early 1980s when the Chair of the Federal Reserve, Paul Volcker, raised interest rates to combat inflation that the yen depreciated (see Figure 2).

This, however, gave rise to a large Japanese trade surplus, which was viewed with great suspicion in the USA (McKinnon and Ohno, 1997). Buoyed by the weaker yen, Japanese industry increasingly displaced US companies in their home market. Political opposition mounted, culminating in September 1985, when the five largest industrialised economies met at New York's Plaza Hotel and announced their intention to bring about an appreciation of the yen (Funabashi 1988). The signal to international financial markets that straightforward currency gains could be made by buying yen triggered a rush into the yen. The yen appreciated far beyond its intended target, by almost 50 per cent (see Figure 2), plunging the export-dependent Japanese economy into a deep crisis.

Figure 2: Yen per US dollar, 1950 – 2026



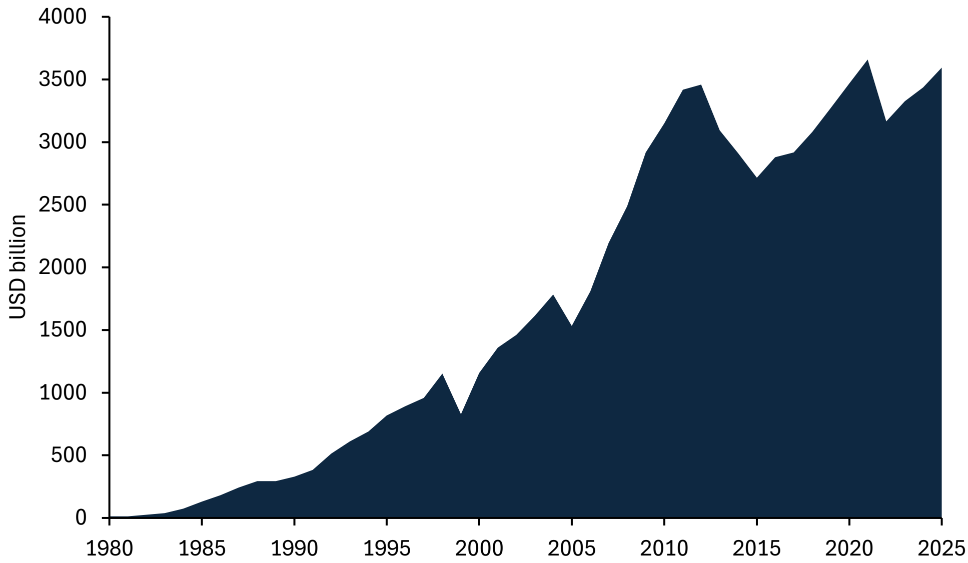
Source: IMF.

Japanese exporters were keen to defend their market share in the USA, even though the yen's appreciation threatened to make their products, priced in dollars, significantly more expensive there. They therefore passed on only part of the exchange-rate-driven price increases to US consumers, accepted shrinking profit margins, and cut costs through wide-ranging rationalisation measures. As a result, the competitiveness of Japanese industry continued to rise, the trade imbalance between the USA and Japan persisted, and the trade conflict between the two countries continued. In addition, the Bank of Japan attempted to halt the appreciation by cutting its policy rate. While falling interest rates made it easier for Japanese companies to make the investments needed to reduce costs, the cheap money simultaneously fuelled a speculative bubble in equity and property markets, further stoked by the vision of Japan as a future global economic leader.

3. The long suffering under the strong yen

The bursting of the bubble in the early 1990s triggered a major property and financial crisis, which peaked in 1998 with the collapse of some of Japan's largest banks and investment houses. The government sought to counter the crisis through a debt-financed expansion of public spending. Successive cuts to the policy rate not only kept the government's interest burden manageable but also led to a persistent outflow of capital from Japan. Households, banks and pension funds built up substantial foreign assets. Carry trades emerged: investors borrowed at low interest rates in Japan and invested the proceeds in higher-yielding countries.

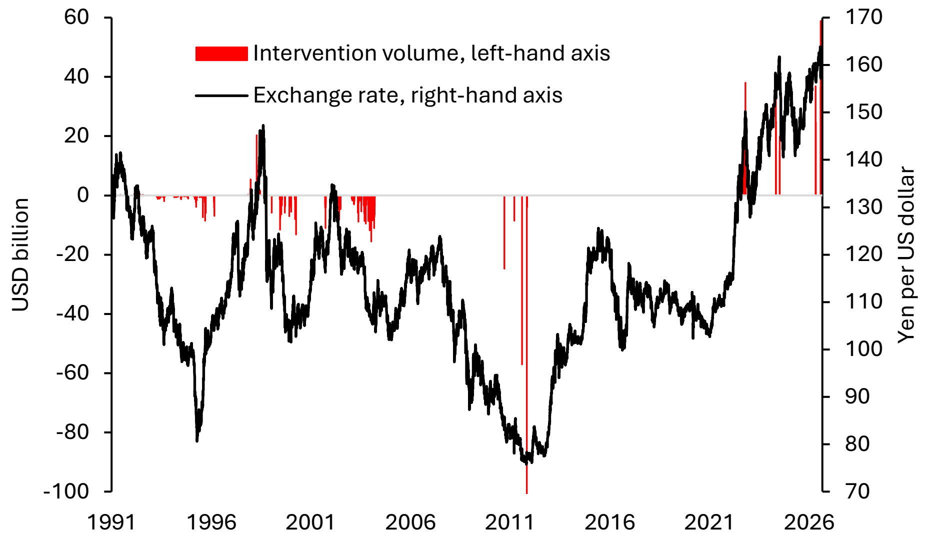
Figure 3: Japan's net foreign assets, 1980–2025



Source: Oxford Economics.

Contrary to expectations, these capital outflows came along with a weak yen, but with a strong one, which reinforced recession and deflation in Japan (Schnabl 2001). This is because Japan's net foreign assets kept rising, owing to persistent current account surpluses and net capital exports. At the end of 2025, they were around USD 3.5 trillion (see Figure 3). Since these foreign holdings are denominated predominantly in foreign currencies – above all in US dollars – expectations of appreciation developed as a result. If these net foreign assets were converted back into yen – for example, in the event of a major earthquake in the Tokyo area – the yen would appreciate sharply. Japan's Ministry of Finance and the Bank of Japan have repeatedly intervened against appreciation, as Figure 4 shows.

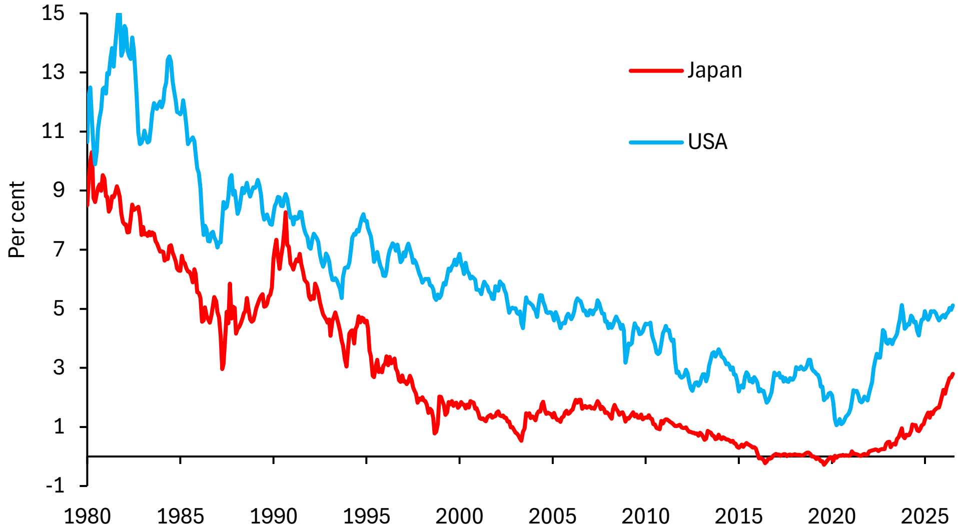
Figure 4: Japan's foreign exchange interventions



Source: LSEG, Japan, Ministry of Finance. Negative values = dollar purchases/yen sales against yen appreciation. Positive values = yen purchases/dollar sales against yen depreciation. Figures for 2026 are estimates from the financial press.

As foreign exchange interventions only have a short-term effect, however, the Bank of Japan had to keep interest rates below those of the USA in order to prevent expectations of yen appreciation from taking hold. Should such expectations become entrenched, Japanese investors with dollar-denominated assets – households, banks, and pension funds – would face the prospect of valuation losses in yen terms and would rush to convert their dollar holdings back into yen as quickly as possible (McKinnon and Schnabl 2006). As investors would seek to move before others in order to avoid losses, this could trigger another run on the yen, similar to that following the Plaza Agreement. Carry trades would need to be unwound, very likely causing further turbulence in international financial markets. In line with the open interest rate parity theory, lower interest rates in Japan than in the USA (Figure 5) were thus associated for many years with an appreciation of the yen against the dollar. The higher interest income available in the USA relative to Japan was effectively "offset" by the depreciation of the dollar against the yen.

Figure 5: Japan and the USA: yields on 10-year government bonds



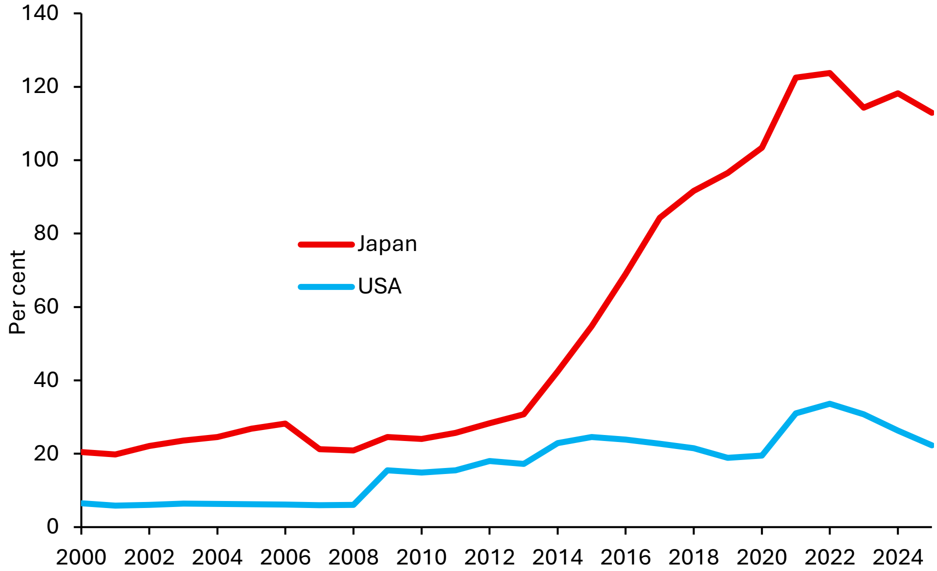
Source: LSEG.

4. The Bank of Japan is caught in a bind, and the yen depreciates

The Bank of Japan's increasingly expansionary monetary policy gradually evolved into a policy of persistent yen depreciation. During his second term in office, beginning in January 2013, Prime Minister Shinzo Abe announced further large-scale, debt-financed government spending as a remedy for the economy's prolonged stagnation. The Bank of Japan bought government bonds on a large scale to keep the government's interest burden manageable. As a share of GDP, the Bank of Japan's balance sheet expanded far more sharply than that of the US Federal Reserve (Figure 6). This triggered an initial bout of yen depreciation that lasted until the end of 2015.

When uncertainty in international financial markets increased after 2014, following the end of China's investment boom, many carry trades were unwound and upward pressure on the yen returned. From 2022 onwards, when the Federal Reserve and the ECB raised interest rates sharply to combat inflation while the Bank of Japan barely followed suit (Figure 7), the yen once again came under downward pressure. There is little prospect of this situation changing in the near future. The Bank of Japan has limited scope to shrink its balance sheet, as doing so would substantially increase the Japanese government's interest burden. Moreover, decisive interest rate increases could trigger a sharp appreciation of the yen, reducing the yen value of the foreign assets held by pension funds and banks and potentially giving rise to a new financial crisis (Schnabl and Schürmann 2024).

Figure 6: Central bank balance sheets as a share of GDP



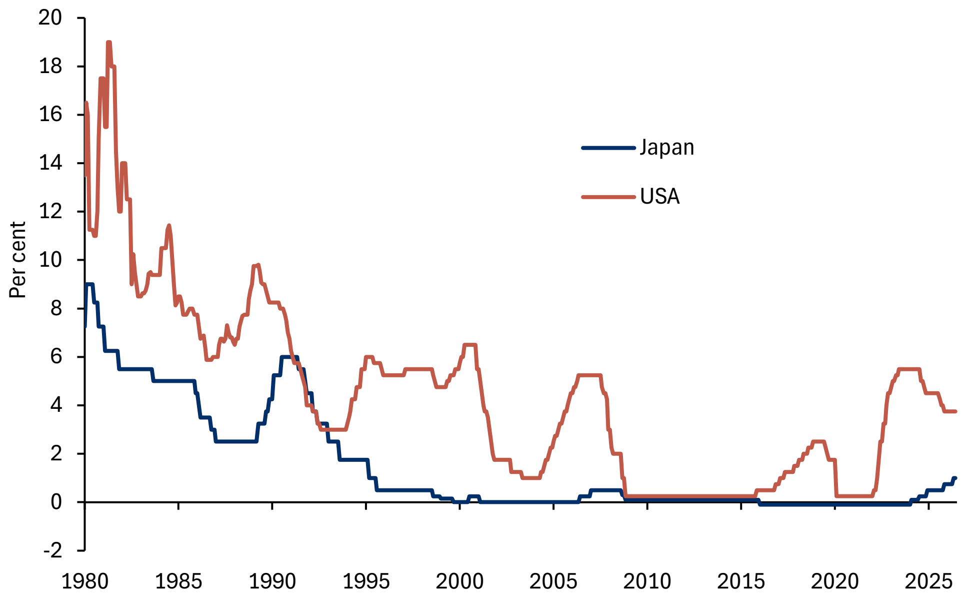
Source: Bank of Japan, Fed, IMF.

5. Options for Japan's exchange rate policy

Accordingly, the Bank of Japan has been very cautious in raising policy rates since the mid-1990s, particularly compared with the USA (Figure 7). At the same time, the Fed has not only raised its policy rate but also reduced the size of its balance sheet. The new Fed Chair, Kevin Warsh, intends to shrink the balance sheet even further, while the Bank of Japan has little scope to reduce its own balance sheet, as a share of GDP, to a comparable level. This points to a monetary policy tug-of-war that is likely to end decisively in favour of the USA. This raises the question of a new currency policy strategy for Japan that could stabilise the yen on a lasting basis.

Given that repeated manipulation of the exchange rate in the past has fuelled speculation and crises, with hindsight it would have been better if Japan, as a large, closed economy, had allowed the exchange rate to float freely. By now, however, a flexible exchange rate is no longer an option, given the high level of government debt and the enormous net foreign assets denominated in foreign currency. Moreover, this heavily ageing country lacks the strength to stabilise its currency through higher interest rates. Persistently low interest rates have made companies complacent, leaving them fearful of higher financing costs.

Figure 7: Japan and the USA: policy rates



Source: Bank of Japan, LSEG.

It would therefore be preferable to peg the yen firmly to the US dollar. This would eliminate the risk of sharp yen appreciation or depreciation and the resulting turbulence in international financial markets. The associated rise in interest rates towards US levels would force Japan to cut government spending and would compel companies to become more efficient – both important prerequisites for Japan's economic recovery.

The recent joint intervention with the USA, for which US Treasury Secretary Scott Bessent also called for a further interest-rate increase in Japan, can be seen as a first step in this direction. Were Japan to peg the yen firmly to the dollar, the USA would secure an important holder of US Treasuries. This would, in turn, help stabilise the international financial system.

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