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FX Focus: Japanese Yen Likely in a Range Until Oil Prices Reverse

Short-dated US–Japan rate spreads have almost halved since the U.S. Federal Reserve began to cut rates in September 2024 and Bank of Japan started to lift rates in March 2024. Spreads are expected to narrow further. But periodic bouts of Japanese Yen (JPY) strength based on narrowing rate spreads have been short lived, with weakness the general trend since the start of COVID as markets focus on Japan's debt sustainability, terms of trade deterioration, and stagflation risks due to the Middle East conflict. This leaves intervention as the only tool to stabilize the currency until there is a significant and sustainable reversal in oil prices.

- Late last week, Japan intervened to stem Yen weakness after USDJPY spot passed 160 to levels last seen in July 2024 and close to JPY's lowest levels in nearly 40 years. With a market positioned short and expecting further Yen weakness, the timing of intervention amid thin holiday trading brought an exaggerated but short-lived response and saw JPY strengthen as much as 3.2% on May 1.
- The intervention should not have been a surprise given prior multiple warnings from Japan's Ministry of Finance of the need to take stern action ahead of the May 4-6 Golden Week break should Yen weaken significantly. Analysts believe Japan likely spent ~USD34.5 billion in intervention funds to prop up the Yen. The last time this happened was in 2024 when Japan likely spent ~USD100 billion after USDJPY's rise to ~160.17 – 161.76.
- Both decisions to intervene demonstrate Japanese policymakers attempts to draw a "line in the sand" at ~160. Japanese officials say they remain in "extremely close contact" with the U.S., a reminder of when American authorities began rate checks in January aimed at supporting Yen when USDJPY approached 160. However, while Japan may have succeeded in stemming further Yen weakness for now, they have been unsuccessful in reversing the overall negative sentiment in Yen even as it remains undervalued relative to US–Japan rate differentials, the primary driver of Yen sentiment.
- Short-dated US–Japan short rate spreads have almost halved (Fed Funds less BoJ's overnight rate spreads have dropped from +550 basis points to +287.5 basis points) since the U.S. Federal Reserve began to cut rates in September 2024 and Bank of Japan started to raise rates in March 2024. Rate spreads are expected to narrow further as the Fed likely maintains a flat rate trajectory this year and BoJ potentially hikes a further 50 bps. Narrowing yield spreads ought to make the "yen carry trade" less appealing and its unwinding should strengthen Yen (as it did between July - September 2024). But several factors explain the current Yen weakness:

1. The Bank of Japan's cautious stance in addressing higher inflation risks and the Japanese government's loosening of the fiscal purse to ease the burden of higher inflation on households has led to easier financial conditions
2. Japan's fiscal vulnerabilities and deteriorating terms of trade amid stagflation risks (a combination of a stagnant economy and rising inflation) due to the sharp rise in energy prices has slowed repatriation from foreign investments into Japanese Government Bonds (JGBs)
3. Offshore investors in Japanese equities have been reluctant to take bets on the currency by largely FX hedging stock purchases

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- Japan is perhaps more highly exposed to the Middle East conflict than other developed G10 economies as it imports 90% of its crude from the Gulf – with ~70% traveling through the Straits of Hormuz. At ~160.00, the cost of crude has surged to more than 60% of what it was in January, extending the terms-of-trade shock into an energy shock for Japanese households. With Prime Minister Sanae Takaichi's government also running a record fiscal stimulus (¥122.3T budget) directly into a supply-side energy war, concerns about Japan's fiscal sustainability have risen sharply.

BOTTOM LINE: It seems Japanese policymakers are in a very difficult situation. A faster pace of fiscal/monetary tightening amid elevated stagflation risks would likely create more downside risks to Japan's growth. But with markets focused on debt, trade vulnerability and stagflation, Yen stability increasingly depends on intervention. Policy intervention and action statements may make 160 a very significant hurdle, but downside in USDJPY also appears limited until oil prices show signs of a significant and sustainable reversal. Until then, risks to Yen remain towards continuing weakness.

FIGURE 2: Japanese intervention to contain Yen weakness (May 2022 - Current)

Source: Bloomberg, May 3, 2026. **Past performance is no guarantee of future results. Real results may vary.**

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