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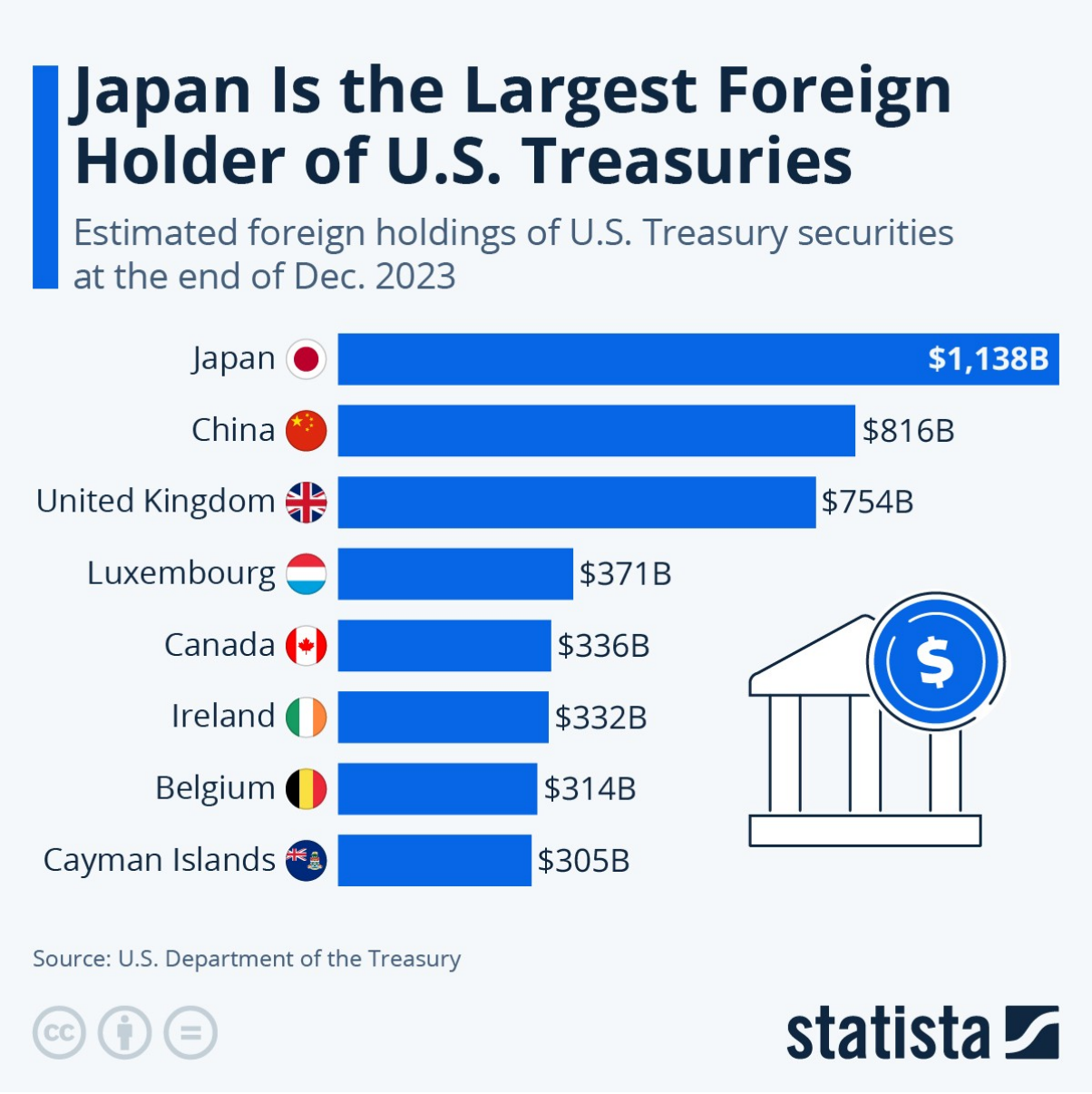
The Weak Yen Trap: Japan's Carry Trade, Dollar Dependence, and Treasury Holdings

Figure 1: Japan's U.S. Treasury holdings



Introduction

Japan's economy is caught in a difficult position. Growth has remained stubbornly low, public debt has climbed above 250% of GDP, and the Bank of Japan (BoJ) has kept interest rates near zero for the better part of three decades (Shiratsuka, 2025). The result is a yen that has been structurally weak against most major currencies for years. That weakness has a silver lining for Japanese exporters, but it has also turned Japan into the world's preferred funding currency for carry trades, a strategy in which investors borrow cheaply in yen and deploy those funds into higher-yielding

assets abroad (Fong, 2010; Hattori & Shin, 2009). At the same time, Japan has quietly accumulated over one trillion dollars in U.S. Treasury securities, making it the single largest foreign holder of American government debt (Statista, 2024). Together, these two facts have locked Japan into what this paper calls a "weak yen trap," a situation where the policy options available to the BoJ are far narrower than they appear.

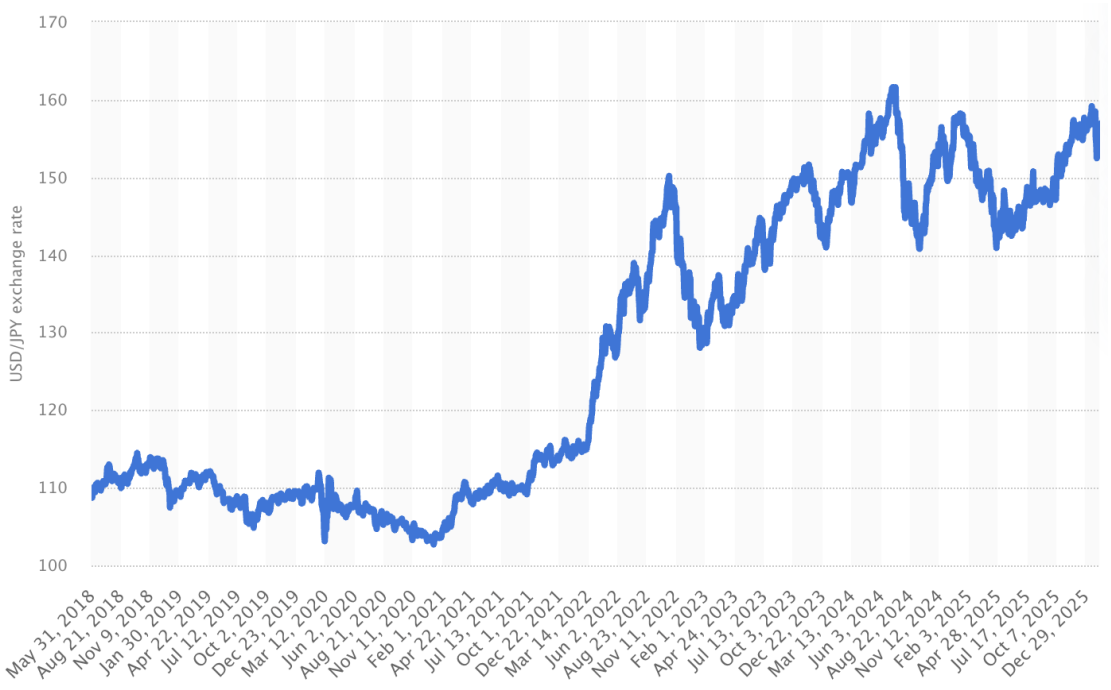
This paper explores how persistently low rates feed carry trades that keep the yen depressed, while Japan's enormous Treasury portfolio ties it tightly to movements in U.S. monetary policy (Jiang et al., 2024; McKinnon, 2012). Yield curve control deepened this bind by artificially suppressing rates even as inflation began to stir globally (Shiratsuka, 2025). History offers a warning: previous episodes of carry trade unwinding, most notably during the subprime crisis, sent shockwaves through global financial markets (Hattori & Shin, 2009).

This raises the central question driving the paper: Does Japan's massive dollar exposure prevent the Bank of Japan from raising interest rates? Carry trades thrive precisely because rates stay low (Fong, 2010), and Japan's Treasury holdings mean any shift in U.S. policy cycles directly feeds back into Japanese balance sheets, making tightening at home an especially fraught proposition (Jiang et al., 2024; Statista, 2024).

The paper proceeds as follows. Section 1 lays out the theory of carry trades and global financial cycles. Section 2 reviews BoJ policy, with particular attention to how yield curve control worked in practice. Section 3 examines yen carry trade dynamics. Section 4 unpacks Japan's Treasury holdings and the institutional exposures that often go undiscussed. Section 5 assembles the full trap mechanism. Section 6 considers the risks this poses both globally and for the Japanese economy itself.

Main Body

Figure 2: USD/JPY FX rate, up to Feb 5, 2026



Japan's prolonged low-interest-rate policy and massive U.S. Treasury holdings create a tight bind for the Bank of Japan. Low rates fuel yen carry trades that weaken the currency further, while dollar assets expose Japan to U.S. policy shifts. This "weak yen trap" makes tightening policy risky. The core question is: Does Japan's dollar exposure hold back the Bank of Japan from raising rates?

1. Carry Trades and Global Financial Cycles

Carry trades work by exploiting interest rate gaps between currencies. The basic mechanics are simple. An investor borrows in a low-interest-rate currency, the yen in this case, then converts that loan into a higher-yielding currency such as the U.S. dollar or an emerging market currency. The investor then parks the converted funds in higher-return assets abroad and pockets the difference between the low borrowing cost in yen and the higher return earned elsewhere. Because this process requires selling yen to buy foreign currency, it puts constant downward pressure on the yen's exchange rate (Fong, 2010). And the weaker the yen gets, the cheaper it becomes to repay the original yen loan in real terms, which makes the trade even more attractive and draws in more participants, reinforcing the cycle.

Across different market conditions, yen carry trades have historically delivered strong risk-adjusted returns, even after accounting for the occasional sharp reversal (Fong, 2010). The persistent interest rate differentials that make these trades possible have long prompted calls for international monetary reform to address the resulting imbalances (McKinnon, 2012).

Japan's centrality to global carry dynamics became impossible to ignore during the subprime crisis. Yen-funded leverage had built up extensively through banks and broker-dealers. When risk sentiment soured, carry positions unwound rapidly. Investors rushed to sell their foreign holdings, convert the proceeds back into yen, and close out their loans. The sudden surge in yen demand pushed the currency up sharply within a matter of weeks, compressing broker-dealer balance sheets and contributing to the broader market sell-off (Hattori & Shin, 2009). Carry trades, it turned out, were not just passive bets on interest rate differentials; they were amplifiers of global financial stress.

An additional layer comes from the role of U.S. Treasuries as the world's premier safe asset. Foreign demand for Treasuries links holders to the global financial cycle in ways that constrain their own monetary autonomy. When U.S. financial conditions tighten, the effects ripple outward, shaping risk appetite and funding conditions even in countries with their own independent currencies (Jiang et al., 2024). Japan sits squarely at this intersection, functioning simultaneously as the world's leading carry funding currency and one of its largest Treasury holders.

2. Bank of Japan Policy, Yield Curve Control, and the Weak Yen

The Bank of Japan anchored its ultra-loose stance through a policy called yield curve control (YCC), which ran from 2016 to 2024. To appreciate why this mattered so much, it helps to understand how YCC differed from conventional monetary policy. Under a normal framework, a central bank sets a short-term interest rate and allows longer-term rates to be determined by the bond market. YCC went considerably further. The BoJ set an explicit target for the yield on 10-year Japanese Government Bonds (JGBs), keeping it pinned near zero per cent. To enforce that target, the BoJ committed to buying unlimited quantities of JGBs whenever yields threatened to rise above the cap. In effect, it became the dominant and at times only meaningful buyer in the Japanese bond market.

By suppressing borrowing costs across the entire yield curve rather than just at short maturities, YCC guaranteed cheap credit at every horizon. This kept Japanese rates well below those of the United States and other major economies (Shiratsuka, 2025) and widened the interest rate differentials that make carry trades so profitable. The BoJ's bond purchases became so large in scale that it eventually held the majority of all outstanding JGBs, illustrating just how deeply the policy warped normal market functioning.

In the short run, low rates and a weak yen supported Japanese exports. But the policy also entrenched Japan's status as a funding currency. Markets came to expect the BoJ to stay accommodative indefinitely, which widened interest gaps further and invited even more carry trade activity (Fong, 2010). When inflation finally picked up globally after 2021, the BoJ was slow to respond, partly because it was locked into YCC commitments that were difficult to exit without triggering sharp yield spikes and significant losses on its own bond holdings (Shiratsuka, 2025). Staying in the trap had become, paradoxically, the path of least resistance (McKinnon, 2012).

3. Yen Carry Trade Dynamics

Yen carry trades tend to follow a recognisable pattern: slow, steady gains during periods of calm, followed by sudden and severe reversals when sentiment shifts. Research confirms that yen carry strategies have historically outperformed simple benchmarks across different risk environments, suggesting the premium on offer is genuine and

not just compensation for tail risk (Fong, 2010). Low volatility and the market's confidence in continued BoJ accommodation make yen borrowing a reliable foundation for leverage.

The subprime episode remains the clearest demonstration of what happens when the music stops. Carry positions had accumulated steadily through the first half of 2007, channelled through banks that were intermediating funds into riskier assets. The unwind, when it came in August 2007, was swift and brutal. The yen rose roughly 10% over just a few weeks, broker-dealer balance sheets contracted sharply as leveraged positions were closed, and equity markets fell in tandem (Hattori & Shin, 2009). Japan was not a passive bystander to the crisis; its carry trade dynamics actively amplified it.

More recent patterns echo these concerns. The aggressive monetary easing of the post-2020 period widened the gap between U.S. and Japanese interest rates to historically large levels. Carry flows almost certainly moved into U.S. assets and emerging market bonds during this period, quietly accumulating leverage that would need to be unwound if and when the BoJ moved toward normalisation (Jiang et al., 2024).

4. Treasury Holdings and Dollar Ties

Japan holds over one trillion dollars in U.S. Treasury securities, placing it ahead of China and the United Kingdom as the largest foreign owner of American government debt (Statista, 2024). For the government and the central bank, these holdings serve as a reserve asset and a source of ammunition for currency intervention: selling Treasuries raises dollars that can be used to buy yen during sharp depreciations, providing a natural stabiliser for the exchange rate.

But the sovereign-level exposure is only part of the story. Japanese commercial banks, life insurers, and pension funds have also spent decades accumulating dollar-denominated assets, driven by the simple fact that domestic returns were too low to meet their investment targets. Unable to earn adequate returns on JGBs or domestic loans at near-zero rates, these institutions borrowed in yen and invested in U.S. Treasuries, corporate bonds, and other dollar assets. The result is a structural foreign exchange mismatch sitting at the heart of the Japanese financial system: liabilities in yen, assets in dollars.

The consequences of this mismatch become acute the moment the BoJ considers raising rates. Three channels of damage open up simultaneously. First, higher Japanese rates would cause the yen to appreciate, which means the dollar-denominated assets on institutional balance sheets would be worth less in yen terms. For any institution that borrowed in yen to fund those investments, this is a direct foreign exchange loss that eats into capital. Second, if a yen spike triggers a global risk-off episode, U.S. Treasury yields could also rise as carry trades unwind, pushing down the mark-to-market value of the very bonds these institutions hold. Third, higher domestic funding costs would squeeze net interest margins for banks already sitting on low-yielding legacy loan portfolios. Each of these channels would be painful on its own; the prospect of all three occurring at once is what makes BoJ tightening feel genuinely dangerous.

Taken together, this institutional exposure means that raising rates is not simply a macroeconomic adjustment. It carries real risks to the solvency and stability of large parts of the Japanese financial sector, which in turn constrains what the BoJ feels able to do.

At the sovereign level, the bind is equally real. U.S. rate hikes reduce the market value of Japan's Treasury portfolio, inflicting mark-to-market losses at a time when public debt already exceeds 250% of GDP (Shiratsuka, 2025). Japan cannot sell its holdings quickly without disrupting U.S. bond markets and risking significant diplomatic and financial fallout. The dollar safety dynamic described by Jiang et al. (2024) captures this well: global demand for Treasuries locks holders into the cycle, with U.S. tightening hurting foreign balance sheets and dampening their appetite for rate hikes of their own.

5. The Trap Mechanism

The weak yen trap is best understood as a self-reinforcing loop with three interlocking components: persistently low domestic rates, carry trade dynamics, and the accumulation of dollar assets.

Low BoJ rates create the conditions for carry trades to flourish. Investors borrow in yen, sell that yen to buy foreign currency, and invest in higher-yielding assets abroad. This process weakens the yen, which boosts export competitiveness and keeps domestic inflation expectations anchored, giving the BoJ political cover to stay accommodative. As more carry traders pile in, the yen weakens further, making yen-denominated borrowing even cheaper in real terms and attracting

yet more activity. Dollar assets accumulate on both institutional and sovereign balance sheets as the logical destination for this outbound capital flow (Fong, 2010; Hattori & Shin, 2009; Statista, 2024).

Tightening runs into obstacles on two fronts at once. Domestically, any move toward higher rates risks triggering sharp volatility in JGB yields and crystallising mark-to-market losses on the BoJ's enormous bond portfolio (Shiratsuka, 2025). For Japanese financial institutions with large dollar balance sheets, tightening opens the FX loss channels described in Section 4. Internationally, a meaningful appreciation of the yen would force carry traders to unwind positions rapidly, with the kind of disorderly deleveraging that played out in 2007 as the worst-case scenario (Hattori & Shin, 2009). Any simultaneous rise in U.S. Treasury yields would compound the damage through the sovereign and institutional portfolio channels (Jiang et al., 2024).

What makes this a trap rather than just a difficult situation is the credibility problem at its core. Any signal from the BoJ that rates might rise accelerates carry unwinds before the hike even happens. Those unwinds threaten financial stability, giving the BoJ reason to pause or reverse course. The market then reads that hesitation as confirmation that rates will stay low, which invites more carry trade activity and deepens the dependence (McKinnon, 2012). The trap tightens with each cycle.

6. Global Stability Risks

The global stakes of a disorderly yen reversal are significant. A rapid carry unwind would put pressure on risk assets across the board, with emerging market bonds and equities likely taking the heaviest hits. Large-scale Treasury sales by Japan, whether forced by FX intervention needs or institutional balance sheet repair, would ripple through U.S. bond markets at a moment when the dollar's reserve currency status is already subject to debate (Jiang et al., 2024). The subprime crisis offered a preview of how far these dynamics can travel: yen carry positions penetrated deep into the broker-dealer funding chains that underpinned global credit markets, and their unwind accelerated the spread of stress (Hattori & Shin, 2009). Today's positions are larger and the financial system is more complex.

The domestic costs of staying in the trap, however, deserve equal attention. A persistently weak yen raises the yen-denominated price of energy and food imports, both of which Japan depends on heavily given its limited domestic resource base. This import-cost inflation acts as a stealth tax on households, particularly lower-income families that spend a larger proportion of their budgets on necessities. The gains from yen weakness flow disproportionately to large exporters and their shareholders, while ordinary consumers bear the costs. The distributional consequences are real and growing.

Prolonged low rates also distort how capital is allocated across the economy. Japanese banks, squeezed between near-zero lending rates and their need to generate returns for depositors, have been pushed steadily toward riskier and more complex foreign investments. This perpetuates the very dollar exposure problem identified in Section 4 and crowds out domestic investment in productive capacity. Japan's sluggish productivity growth over the past two decades is partly a story about capital being misallocated by a financial system trapped in a low-rate environment.

The fiscal dimension is perhaps the most sobering. Japan's debt already exceeds 250% of GDP, and even a modest sustained rise in JGB yields would significantly increase the government's debt servicing burden as bonds mature and are refinanced at higher rates. The BoJ's own balance sheet adds another layer of fragility: with the central bank holding the majority of outstanding JGBs, rate normalisation would generate losses that could ultimately require recapitalisation from the Treasury, adding to the very debt pile that makes normalisation so difficult in the first place. It is a feedback loop between monetary policy and public finances that erodes the BoJ's practical independence over time.

Japan's predicament, then, is not simply a monetary policy puzzle. It is a window into the structural tensions of the dollar-centric global financial system, where the demand for safe assets binds creditor nations in ways that are quietly corrosive of their policy autonomy (Jiang et al., 2024; McKinnon, 2012).

Conclusion

Japan's weak yen trap is the product of decades of policy choices that have compounded into a situation where almost every exit route carries serious risks. Yield curve control kept borrowing costs suppressed across the entire maturity spectrum, not just at short maturities, by having the BoJ commit to unlimited JGB purchases to hold 10-year yields near zero. This turbo-charged the interest rate differentials that make yen carry trades profitable, while the BoJ's ballooning balance sheet made the eventual exit from the policy fraught (Shiratsuka, 2025; Fong, 2010). Investors took full advantage, building leveraged positions worldwide on the back of cheap yen funding and creating a stock of carry trades that could unwind badly if the yen were to rise sharply (McKinnon, 2012; Hattori & Shin, 2009).

Meanwhile, Japan's over one trillion dollars in U.S. Treasury holdings locked it into a different kind of dependency, one shaped by U.S. monetary cycles rather than domestic conditions (Statista, 2024; Jiang et al., 2024). What makes this exposure particularly constraining is that it extends well beyond the government's balance sheet. Japanese banks, insurers, and pension funds borrowed in yen for years to invest in dollar assets, creating a structural FX mismatch that turns any BoJ rate hike into a potential balance sheet crisis for large parts of the domestic financial sector. This institutional dimension is easy to overlook but it is central to understanding why the BoJ has moved so cautiously. The trap persists because staying loose avoids immediate pain across all these channels, even as it deepens yen weakness, squeezes household purchasing power, distorts capital allocation, and continues to build vulnerabilities that would have to be absorbed eventually.

Japan's situation also illuminates something important about the dollar-centric global financial system. When a country accumulates Treasuries on the scale Japan has, it is not simply holding a reserve asset; it is accepting a degree of monetary subordination to the U.S. financial cycle. Carry trades amplify this dynamic, turning what is nominally a domestic monetary policy decision into a variable with global consequences (Jiang et al., 2024; McKinnon, 2012). The subprime crisis made this visible in the most dramatic way possible (Hattori & Shin, 2009).

A gradual and well-signalled BoJ normalisation, combined with macroprudential measures to limit the build-up of unhedged institutional FX exposure, would be the most defensible path out. Broader international coordination on interest rate differentials could help blunt the carry trade dynamics that make unilateral action so costly (McKinnon, 2012). Neither is straightforward in practice, and political pressures around debt and growth make the status quo persistently attractive. Future research could usefully model the trap formally, track institutional FX exposures with higher frequency data, or draw comparisons with Switzerland, which faces its own version of the funding currency problem. Japan's experience stands as a reminder that for creditor nations, dollar dominance is not a free lunch.

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