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Japan: Authorities push against a strong dollar and oil

The Iran conflict has triggered fresh policy challenges for Japan. The Ministry of Finance has resumed yen intervention but will struggle to reverse depreciation while the Iran conflict remains unresolved. The Bank of Japan is close to hiking and reconsidering its bond tapering path. We expect a reduction in purchases announced in June, and a hike by July.

Key Takeaways

- The MoF's currency intervention is likely to reduce yen volatility, rather than deliver a lasting reversal of recent depreciation pressures, while the dollar remains supported by geopolitical risk and higher energy prices.
- Sustained yen appreciation would require a shift in the fundamentals, especially lower geopolitical risk, easing energy pressures, and a more supportive rates backdrop.
- We expect the BoJ to pair gradual interest rate hikes with a slower pace or complete freeze of bond tapering, likely signalling changes to the purchase path in June and a 25bps rate hike by July.
- Continued coordination between the MoF and BoJ to stabilise the yen and contain pressure in the JGB market amid rising fiscal and geopolitical risks is likely.
- But the backdrop for the yen and JGBs will remain challenging for as long the Strait of Hormuz remains closed.

Mixed results from prior intervention cycles

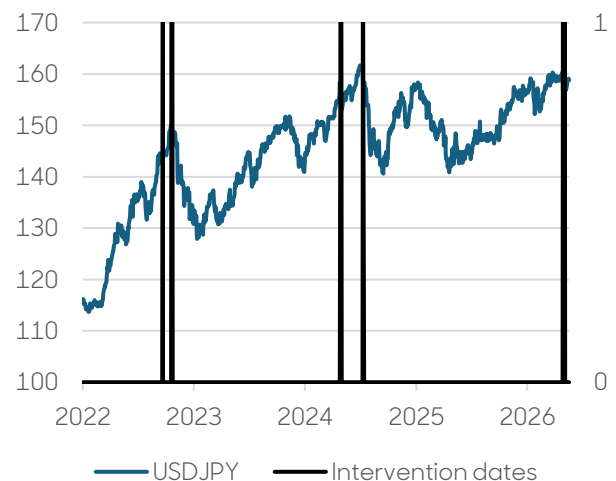
Japan's Ministry of Finance (MoF) resumed yen intervention, seemingly trying to defend a 160 ceiling on

USDJPY. The MoF spent ¥11.73trn between late April and early May – a time when the geopolitical and macro environment is materially different from previous intervention cycles.

Stabilising the currency will prove more challenging while the dollar is heavily influenced by global events, and we expect further verbal or direct intervention will be needed to keep the yen stable.

Prior intervention cycles failed to produce durable currency strength (see Figure 1).

Figure 1: Latest intervention has been less effective than prior efforts to support the yen



Source: Bloomberg, Aberdeen, May 2026



In 2022, a weak yen fuelled higher import-price inflation and pushed Cabinet approval rates lower.

Intervention through September and October created a "pain zone" for investors, with USDJPY moving toward the low-130s by early 2023.

However, the backdrop was more favourable to yen intervention at the time. US Treasury yields were declining, and markets were priced for a dovish Fed pivot. USDJPY closely tracked changes in the US-Japan rate differential.

In 2024, total yen purchases reached ¥15 trillion over multiple operations. The Bank of Japan (BoJ) had exited negative rates and yield curve control policies and FX intervention were suddenly perceived as credible. This led to a sharp rally in the yen and widespread selling of risk assets as yen-funded carry trades quickly reversed. The BoJ had to shift back to dovish communication to stem the spillovers of intervention.

Providing a volatility floor, not a trend reversal ...

Japan holds the world's second largest FX reserves at approximately \$1.17trn in April, providing substantial firepower for intervention.

Since 30 April, the MoF has spent an estimated \$65bn (5.5% of total reserves) supporting the yen. The timing of the intervention was designed to maximise its effect during the lower trading volumes observed during Golden Week, a holiday period between 29 April and 5 May. However, by mid-May the yen had surrendered the bulk of the gains achieved through these measures.

... fundamentals need to shift for sustained yen appreciation

The current environment stands in stark contrast to prior intervention episodes.

First, the USD has been the primary beneficiary of the geopolitical risk-off rotations, with safe haven demand reinforced each time the Middle East conflict escalates.

Positive momentum on USD may remain in place while the conflict continues. Asia FX, including the yen, has been vulnerable against this backdrop. But a geopolitical shift could trigger a sharp reversal in USD, alleviating pressure on the yen.

Second, Japan imports the bulk of the energy it needs, leaving the economy's terms of trade highly exposed to the Middle East conflict via crude oil, LNG and refined-product prices. Improvement here is expected to be

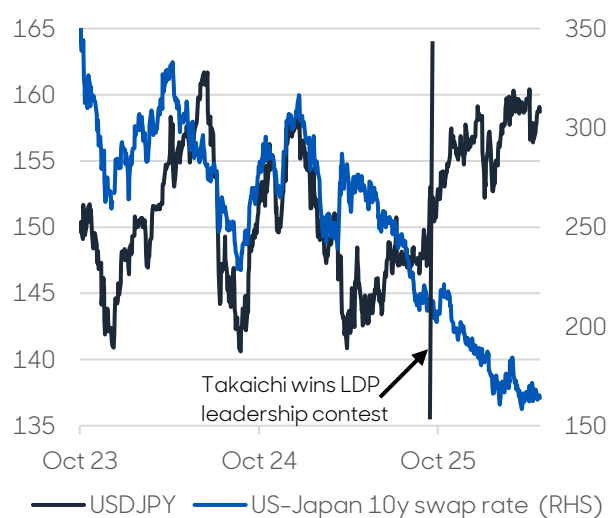
slow. Even if the conflict ended, it could take several weeks before traffic through the Strait of Hormuz returns to pre-war norms.

Third, rate differentials could return as a driver of USDJPY. The US Treasury (UST) – Japanese Government Bond (JGB) rate differential has compressed dramatically over the past two years.

This is primarily in line with central bank policy. The Fed began its easing cycle while the BoJ ended yield curve control and started hiking. Having spent years in negative territory, front-end Japanese yields finally pushed back above 0%.

Historically, USDJPY had closely tracked US and Japanese bond yield differentials, the wider the gap the weaker the yen. However, this relationship broke down last year as Sanae Takaichi took over as Japan's first female prime minister and the "Takaichi trade" of weaker yen, higher equities, and higher bond yields took hold (see Figure 2).

Figure 2: USDJPY vs rate differential gaps out with new PM



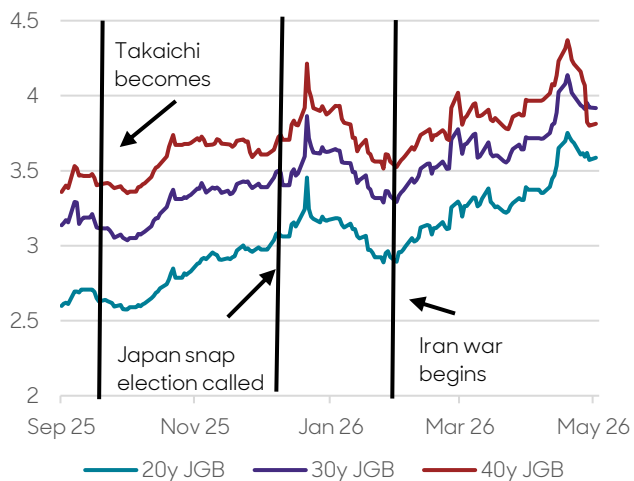
Source: Bloomberg, Aberdeen, May 2026

Investors feared that Takaichi would implement excessive fiscal expansion in an attempt to reflate the economy.

However, the PM had been relatively conservative in her policies and emphasised the importance of fiscal discipline in an attempt to calm bond investors. Still, her success in stabilising bond yields has been derailed this year with the onset of the Iran conflict (see Figure 3).



Figure 3: JGB yields buffeted by fiscal fears



Source: Bloomberg, Aberdeen, May 2026

FX investors are no longer trading pure carry. A broader mix of fiscal risks, energy shocks and BoJ credibility are all at play.

Gradual policy hikes and a slower pace of tapering are likely

Fiscal risks are rising again as the Iran conflict has increased expectations for additional spending. Having held out for many weeks, insisting on fiscal discipline, Takaichi has finally agreed her government will compile a new supplementary budget worth more than ¥3trn. While funding details have not been confirmed, fresh bond issuance is expected to form part of the financing mix.

Increased fiscal spending could add further volatility to an already fragile bond environment. This will keep the BoJ on a gradual pace of tightening: we expect the BoJ to hike by 25bps to 1% by July and remain on hold for the rest of the year.

However, the recent surge in super long yields has prompted the BoJ to reconsider its JGB taper programme, and changes are likely to be announced in the 16 June policy meeting.

Officials have started consulting banks, insurers and institutional investors ahead of the June policy meeting. A BoJ survey of participants released on 21 May revealed views were split on whether the central bank should continue tapering or stop altogether.

Weak, super-long auctions and rising fiscal concerns amid Middle East tensions support the case for a slower pace of tapering or even a freeze of purchases around current levels.

The BoJ formally announced its quantitative tightening program in June 2024. Details were outlined in July, and purchase reductions began August of that year.

The current bond purchase framework has the monthly purchases declining gradually, by approximately JPY200bn per quarter through FY2027.

However, it still holds roughly 50% of all JGBs outstanding. This means that even modest reductions in purchases change market liquidity dynamics significantly.

A complicated policy mix

We expect the BoJ to navigate the policy path this summer with a combination of a 25bps rate hike and slower pace of QT.

The June meeting is likely to focus on a discussion of the pace of purchases alongside the impact of the war on the economy and markets.

The MoF's parallel move to reduce super-long bond issuance and shift supply toward shorter maturities, combined with a slower pace of taper, could help stabilise JGB yields.

But, ultimately, when it comes to the yen and JGBs, the backdrop of the Iran conflict, high oil prices, dollar strength and related fiscal fears is proving very challenging for officials to navigate. These challenges are likely to persist while the Strait of Hormuz remains blocked.

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