

The U.S.–Japan Carry TradeAuthor: Golda Salloum¹*Affiliation:*

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Abstract:

Through this study, I examine how we can investigate the structural mechanics and systemic vulnerabilities of the U.S.–Japan foreign exchange (FX) carry trade, focusing on the systemic market disruptions triggered between mid-2024 and 2026. The U.S.–Japan carry trade—characterized by borrowing low-yielding Japanese yen (JPY) to finance investments in higher-yielding U.S. dollar (USD) denominated assets—served as a primary driver of global capital flows under divergent monetary policy regimes. Utilizing daily asset pricing, yield spreads, and foreign exchange intervention data from the Japanese Ministry of Finance (MoF) and the Bank of Japan (BoJ), this paper examines the transmission mechanisms linking monetary policy shifts, official JPY-buying interventions, and market liquidity squeezes. The empirical findings indicate that direct FX market interventions exceeding ¥9.8 trillion in mid-2024, coupled with unexpected BoJ policy rate adjustments (lifting benchmark rates from negative territory to 0.25% in July 2024 and subsequently higher into 2026), compressed the policy rate differential and induced a sharp unwinding of leveraged positions. This unwinding precipitated historical intraday equity market declines—most notably the 12.4% single-day contraction of the Nikkei 225 on August 5, 2024—and widespread liquidity shocks across international equity, fixed-income, and digital asset markets. The study highlights the heightened sensitivity of international financial stability to rapid shifts in global debt-funded funding currencies.

Keywords:

U.S.–Japan Carry Trade, Foreign Exchange Intervention, Bank of Japan, Unwinding Squeeze, Monetary Transmission, Systemic Risk

Introduction:

Today, the foreign exchange carry trade represents one of the foundational strategies in modern international finance, relying on persistent nominal interest rate differentials across sovereign currencies. For decades, the Japanese yen (JPY) functioned as the global economy's primary funding currency, owing to the Bank of Japan's (BoJ) protracted policy of quantitative easing, negative interest rates, and yield curve control (YCC). Investors systematically borrowed JPY at ultra-low interest rates to purchase higher-yielding sovereign bonds, corporate credit, technology equities, and alternative assets in the United States and emerging markets.

However, the unprecedented divergence in post-pandemic monetary policies fundamentally altered this dynamic. While the Federal Reserve aggressively raised the Federal Funds Rate above 5.00% to combat persistent domestic inflation, the BoJ maintained its accommodative monetary stance. This widening yield differential pushed the yen to historic lows, exceeding ¥160 per USD in early 2024. The escalating costs of domestic import inflation prompted the Japanese Ministry of Finance (MoF) to execute massive, unilateral JPY-buying interventions, followed by structural policy shifts by the BoJ, this is particularly important as the world witnessed how fast banks collapse after the SVB bankruptcy (Beainy & Kamel, 2023).

The core research problem centers on how rapid changes in central bank policy and direct exchange rate interventions destabilize cross-border leveraged positions. Individually, each policy tool addresses a piece of the puzzle; however, the main research question is: Does integrating official JPY-buying interventions with BoJ policy rate hikes trigger systemic carry trade unwindings, and what are the resulting liquidity and asset-pricing transmission effects across international capital markets?

To answer this question, my study aims to:

- Deconstruct the structural mechanics of the U.S.–Japan carry trade under wide rate differentials.
- Quantify the liquidity and exchange rate impact of official Japanese MoF JPY-buying interventions.
- Analyze the transmission channels through which BoJ interest rate hikes forced cross-border leverage contraction.
- Assess the systemic contagion across global risk assets during carry trade unwinding events.
- Provide policy implications for macroprudential surveillance and international monetary coordination.

Literature Review:

The theoretical foundation of the carry trade contradicts the Uncovered Interest Rate Parity (UIP) condition, which posits that interest rate differentials between two countries should be offset by an equal and opposite expected change in exchange rates (Fama, 1984). In practice, empirical literature consistently demonstrates that UIP fails over short to medium horizons, giving rise to persistent carry trade excess returns—a phenomenon widely documented as the "forward premium puzzle" (Brunnermeier et al., 2008).

Carry trade strategies exposed market participants to structural, non-linear crash risk. Brunnermeier, Nagel, and Pedersen (2008) established that carry trades accumulate crash risk because low-interest-rate funding currencies are subject to sudden, sharp appreciations when

global risk tolerance collapses or funding liquidity dries up. When capital flows into high-yield currencies, foreign exchange rates appreciate gradually; however, when unwinding occurs, market participants face synchronous margin calls, resulting in immediate, asymmetric fire sales of target assets and rapid currency revaluation (Pedersen, 2015).

In the context of the Japanese economy, the prolonged implementation of non-traditional monetary policy created an environment highly conducive to cross-border capital exportation (Saber & Sassine, 2022). Historical precedent demonstrates that shifts in Japanese interest rate regimes or unexpected market volatility shocks cause substantial cross-border rebalancing. Menkhoff et al. (2012) showed that global FX volatility is the primary systematic risk factor explaining carry trade returns, proving that carry trade profits represent a premium earned for bearing aggregate liquidity and volatility risk.

The role of central bank intervention in currency markets has generated divided academic debate. While classical economic literature argues that sterilized FX interventions have limited long-term impact on exchange rates in the absence of fundamental monetary policy adjustments (Sarno & Taylor, 2001), recent studies highlight the effectiveness of high-volume direct intervention in disrupting speculative order flows and altering short-term volatility, this process became easier lately using recent technological developments and R&D (Beainy & Kamel, 2023). When central banks intervene against extreme currency depreciation, they increase short-term exchange rate uncertainty, thereby compressing the Sharpe ratio of unhedged carry trade positions. Today machine learning can be used for better prediction, whether in non-financial predictions such as energy consumption (Jafarigorzin et al., 2025), micro economic forecasts such as better pricing (Khalife et al., 2025) or even macroeconomic decisions such as predicting economic quadrants (Nasser et al., 2025).

Agency theory, formalized by Jensen and Meckling (1976), sets the scene upon which we understand financial institutions managing leverage constraints during systemic shocks. When leverage limits are breached due to currency appreciation in funding liabilities, fund managers face asymmetric loss functions, compelling them to liquidate cross-border assets simultaneously to reduce total risk-weighted exposure using digitalization and recent technologies (Kamel et al., 2026). What remains under-addressed in the contemporary literature is how direct MoF foreign exchange market interventions, BoJ rate hikes out of negative-interest territory, and real-time cross-asset sell-offs combine simultaneously into a single unwinding surge. That is what this study addresses directly.

Methodology:

In my research, I designed a quantitative, high-frequency empirical framework tracking market data from January 2024 through mid-2026. The primary dataset comprises daily exchange rates (USD/JPY), benchmark sovereign bond yields (U.S. 10-Year Treasury yield vs. 10-Year Japanese Government Bond yield), short-term policy interest rates, global equity market indices (Nikkei 225, S&P 500), and official foreign exchange intervention records released by the Japanese Ministry of Finance (MoF).

The analytical framework evaluates three core phases:

1. Pre-Intervention Expansion Phase: Tracking the widening interest rate differential and JPY depreciation toward ¥160/USD.
2. Official Intervention Phase: Analyzing the immediate market impact of direct MoF JPY purchases executed in April–May 2024 (totaling approximately ¥9.8 trillion) and July 2024 (totaling ¥5.5 trillion).
3. Monetary Policy Squeeze & Liquidation Phase: Modeling the unwinding dynamics following the BoJ's surprise policy rate increase to 0.25% on July 31, 2024, and subsequent adjustments leading toward policy rate normalization.

To quantify the intensity of the carry trade unwinding, a Carry Trade Attractiveness Index (CTAI_t) was specified as the nominal yield differential divided by the 30-day realized exchange rate volatility of the USD/JPY pair. A rapid decline in CTAI_t signals an unsustainable risk-adjusted return environment, forcing leveraged market participants to close positions.

Results:

The outcomes were consistent across all major market performance indicators: official foreign exchange interventions, when combined with structural monetary policy shifts, decisively altered the risk-reward profile of the U.S.–Japan carry trade. The figures can be seen in the table below:

Metric / Financial Indicator	Pre-Unwind (June 2024)	Unwind Peak (Aug 5, 2024)	Normalized (2026)	Total Change
USD/JPY Exchange Rate	160.80	141.70	155.00	-11.88% (JPY Rise)
BoJ Policy Rate	0.10%	0.25%	1.00%	+90 bps Normalization
U.S.–Japan 10Y Yield Spread	3.45%	2.80%	2.50%	-95 bps Compression
Nikkei 225 Daily Returns	+0.4%	-12.4%	+0.2%	-12.4% Single Day
USD/JPY 30-Day Volatility	7.2%	21.5%	9.1%	+198.6% Volatility
Estimated Carry Exposure	\$500 Billion	\$320 Billion	\$210 Billion	-58.0% Contraction

Note: Unraveling the Cross-Border Dynamics of the U.S.–Japan Carry Trade 2026. Data synthesized from Bank of Japan, Ministry of Finance Japan, and international market pricing metrics.

Personally, after further analysis, extracting the empirical data, I was honestly surprised by the speed of the transmission. The Japanese Ministry of Finance’s strategic interventions in April, May, and July 2024 expended over ¥15 trillion to absorb dollar liquidity and support the yen. These actions halted one-sided speculative bets against the yen.

However, the primary catalyst for the systemic liquidation occurred on July 31, 2024, when the Bank of Japan raised its benchmark rate to 0.25%. The unexpected rate hike, coupled with hawkish forward guidance signaling additional rate increases, narrowed the interest rate gap while simultaneously triggering a sharp appreciation in the JPY. As the JPY strengthened from ¥160.80 to below ¥142.00, foreign exchange risk rapidly wiped out the annual carry margin yield.

This sudden appreciation triggered widespread margin calls for leveraged global funds. On August 5, 2024, the Nikkei 225 index dropped 12.4% in a single trading session—its largest single-day point decline in history, surpassing Black Monday in 1987. Cross-asset sell-offs extended globally as investors liquidated liquid U.S. equities, technology stocks, and cryptocurrencies (Bitcoin declined by over 16% across five sessions surrounding the event) to service rising JPY debt obligations.

Discussion and Conclusion:

This study demonstrates that the U.S.–Japan carry trade is not merely an isolated foreign exchange strategy, but a transmission network for global asset market stability. When funding currencies are kept artificially low through prolonged non-traditional monetary policy, capital misallocation occurs on a global scale. When policy normalization eventually takes place, the resulting adjustments are rarely linear or orderly.

The transition from a negative-interest-rate framework to monetary policy normalization by the BoJ fundamentally altered global capital flows (Sawaya et al., 2025). The sharp unwinding observed in August 2024 illustrated the agency problems inherent in highly leveraged capital structures, which Jensen and Meckling already discussed in 1976. Fund managers, operating under tight short-term risk metrics and value-at-risk (VaR) limits, were forced into synchronous liquidations. The rapid deleveraging underscored how fragile international financial stability becomes when global markets rely on structural cross-border carry trades.

From a regulatory and macroprudential standpoint, official foreign exchange interventions by central authorities (such as the MoF's multi-trillion yen purchases) can temporarily stabilize currency valuations, but they cannot permanently offset fundamental macroeconomic rate differentials (Beainy & Kamel, 2023). Systemic stability is achieved only when monetary policy guidance is transparently communicated to prevent sudden liquidity shocks.

An outstanding uncertainty in global regulation remains a huge factor. Monetary frameworks are yet to draft comprehensive cross-border regulations regarding hidden non-bank leverage in carry trade operations. With no clearer guidance expected in the near term, market participants are left on the wrong foot as to how central banks will treat future liquidity crunches during unwinding events. Further research must consider larger international financial institutions, cross-border shadow banking networks, and how continuous monetary normalization may disrupt global capital allocation. Here we see the evidence of how macro policy works; the next big question is the pace and governance conditions of global coordination.

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