



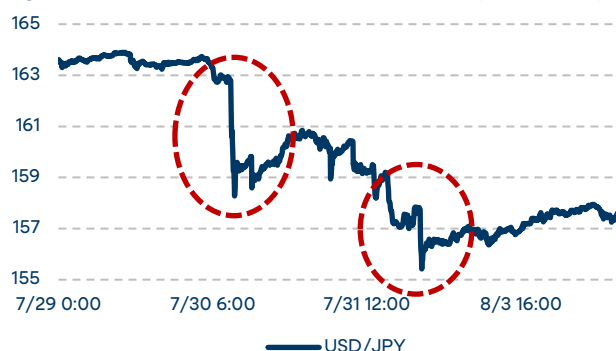
Yen Intervention: Q&A

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Headlines

- **What happened last week:** Treasury confirmed it stepped into the Yen market last Friday (July 31st), purchasing Yen for the first time since 1998, funded via sales of US-owned Euro assets. Japan's Ministry of Finance (MoF) intervened the same day and the prior day, marking this as a rare coordinated joint intervention by both parties to strengthen the Yen.
- **What drove this event:** The Yen has been weakening over the past several months as fiscal and inflation concerns in Japan have increased. Given Japan's reliance on imports, this weakening creates domestic economic pain which sets the stage for intervention. The dollar weakened independently in response to the July FOMC meeting, which created more favorable conditions to stage an intervention specifically last week.
- **Why this matters:** The MoF sits on over \$1tn in FX reserves, with much of it invested in UST. UST sales by Japan to finance intervention could have very significant implications for UST yields and swap spreads, both on the mechanics of intervention and the market perception of UST selling by the largest foreign owner of UST. **The joint intervention is meaningful – Sec. Bessent is keenly aware of the optics of Japan sales at a time when the US's fiscal position is worsening.**
- **What it means for long-dated Treasuries:** Long-dated Treasury yields did not appear to respond to the large Yen strengthening on the 30th but increased alongside interventions on the 31st. Swap spreads did not exhibit the expected response to an intervention on either day, suggesting yields may have been responding to alternative headlines. MoF has typically funded interventions through sales or run-offs of short-dated UST assets, or through using cash on hand. It is very unlikely that MoF would sell even intermediate tenor UST to fund future interventions.
- **What happens going forward:** The interventions seem to have been successful – the Yen has appreciated ~4% against the dollar since last Thursday's open (7/30) and is now about 1% weaker than the trailing 1yr average level. Should MoF decide that further intervention is necessary in the coming days and weeks, there are tools available to minimize the odds of asset sales, but it will remain to be seen if they are used.

Figure 1: Yen interventions last week (USD/JPY)



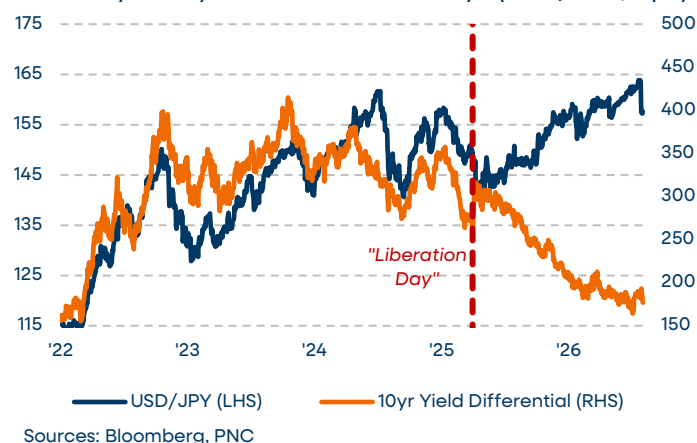
Sources: Bloomberg, PNC



Why did the Yen get so weak in the first place?

FX is in theory a reflection of the real interest rate differentials that exist in the two countries being compared – if one can get a higher real rate of return in the USA, why not sell Yen-denominated assets and swap the proceeds into dollars so you can purchase the higher yielding USD asset (this is the FX carry trade)! Indeed, over the last few years, we can see a reasonably strong relationship in an even simpler expression of this behavior – the Yen has weakened and strengthened in concert with the differential between 10yr nominal UST and nominal JGB.

Figure 2: Yen followed the 10yr Yield Differential (10yr UST – 10yr JGB) until “Liberation Day” (USD/JPY, bps)



This relationship has clearly broken down post-“Liberation Day”. Some of this is perhaps predictable – the Bank of Japan (BoJ) only started hiking in early 2024, and their policy rate remains the lowest amongst peer central banks. While the Fed has been easing during this period, thus helping to close the interest rate differential, some of this damage has likely been done, especially in light of signs that BoJ is unwilling to keep hiking in the near term. In addition to inflation worries, fiscal concerns have emerged over the year – the current Japanese administration intends to carry through with promises of very significant tax cuts (on consumption taxes applied to food) combined with infrastructure spending. While these are intended to be paid for via “non-tax revenue” and “spending reforms,” markets are skeptical that it can be paid for without increasing

deficits. The JGB 2s10s curve has steepened significantly as these fiscal and inflation concerns have gotten priced into the curve and come alongside the weakening of the Yen in the year.

Figure 3: Since “Liberation Day”, Yen has tracked the JGB curve (USD/JPY, bps)

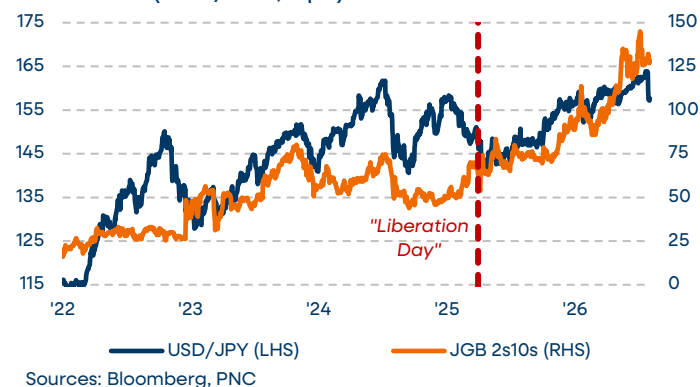
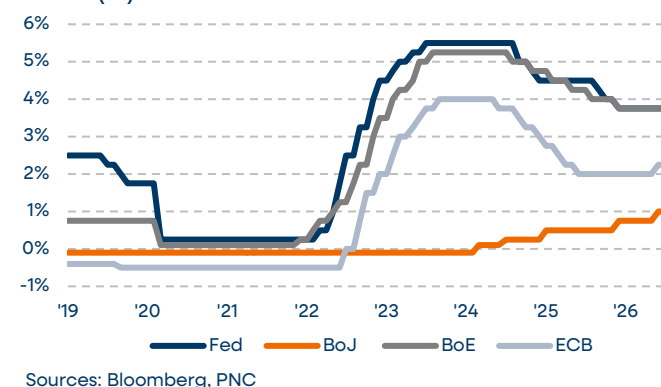


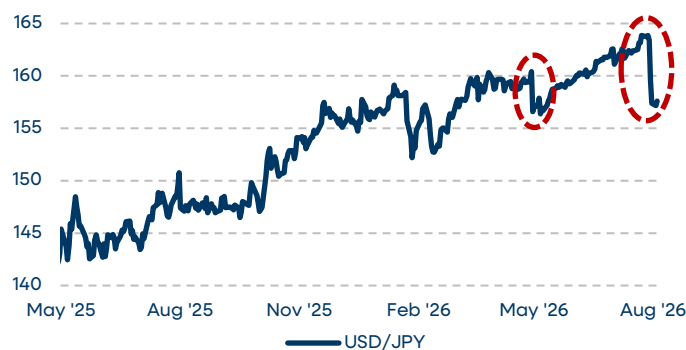
Figure 4: BoJ policy rate is lower than peer central banks (%)



Last week’s intervention is the 2nd one of the year – MoF intervened when the USD/JPY cross breached 160 at the end of April. That intervention was somewhat short-lived – it took about 2 months for the MoF’s impact to be reversed by the market. The use of open-market interventions can be effective at short-time horizons, but it’s difficult for the impact to be durable on longer-term time horizons given the underlying reasons for Yen weakening.



Figure 5: Recent Yen interventions over a year of continued weakening (USD/JPY)



Sources: Bloomberg, PNC

The more structural answer to Yen depreciation given the circumstances might be for either BoJ to hike rates even more aggressively or for the political leadership to back off from the stimulus plans, but this requires significant tolerance for domestic economic pain. **Another option, and a more durable one than direct market intervention, is capital controls** (explicit or implicit). While the Japanese government is unlikely to use an explicit capital control to this end, it can use soft ones, such as encouraging major private investors in Japan to rotate into domestic financial assets and away from foreign ones.

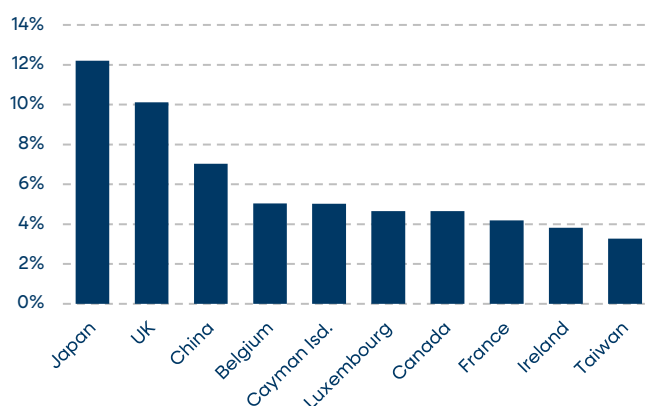
Japan's Finance minister publicly indicated that they were exploring measures to encourage domestic Japanese pension funds to rotate further into Yen-denominated assets. If measures are enacted (or firms are "verbally cajoled"), it would likely lead to rather significant selling of dollar assets and purchases of Yen assets – doubly strengthening the Yen and likely putting downward pressure on JGB yields (to the degree they are bought). We'd expect an opposite effect on the dollar and UST yields, to the degree that USTs are rotated out of across large Japanese fixed income buyers (pensions and beyond).

How does this get the US to intervene with Japan?

The MoF is a very significant owner of dollar assets and Japan is the largest single foreign holder of UST assets. Between the potential for MoF to sell UST to

fund future interventions and for the Japanese private sector to rotate into Yen assets at the expense of UST, UST yields face a large negative exposure to Japanese actions associated with a weaker Yen.

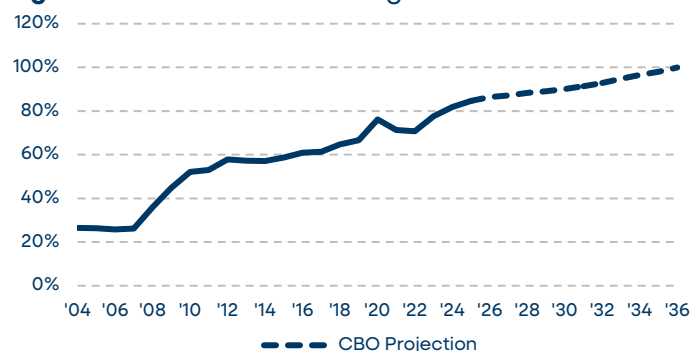
Figure 6: Japan is the single largest foreign holder of UST securities (%)



Sources: Bloomberg, PNC

The US fiscal position has already worsened in recent years and increasing attention has been paid to how yield-sensitive entities, such as hedge funds, have increasingly become the marginal bidder of UST. This would only grow if there is large-scale selling of UST, be it from MoF or from private accounts rotating back into domestic currency assets.

With projected deficits over the next few years firmly around the 6% of GDP mark, Treasury has an incentive to *at least protect and hope to expand* the universe of relatively yield-insensitive buyers of UST. Coordinated interventions to stave off asset sales by the largest foreign reserve manager clearly fits into that incentive.

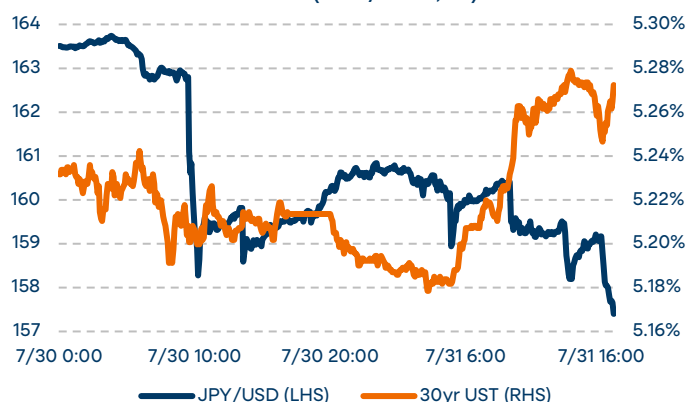
**Figure 7: UST debt outstanding ex-Fed as % of GDP**

Sources: Bloomberg, CBO, PNC

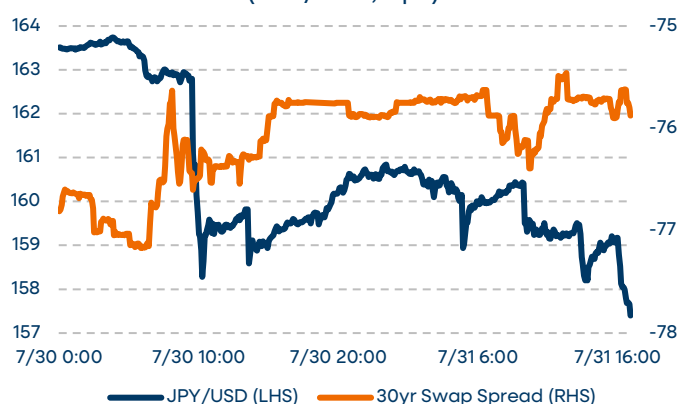
For the US, the biggest benefit of joint intervention is heading off any of the more drastic options that Japan could pursue to boost the Yen. The US gets to control what assets get sold to finance Yen purchases when it's intervening as well, which allows the Treasury to pick what it can sell at perceived minimal negative cost to UST yields rates. If effective, US intervention could help prevent Japan from using something that would wreak havoc in the Treasury market.

What does this mean for long-dated Treasuries?

MoF has typically funded interventions through sales or run-offs of short-dated UST assets, or through using cash on hand. It is very unlikely that MoF would move to sell even intermediate tenor UST to fund future run-offs. Mechanically, this limits the impact we should see on long-dated yields. Looking at intraday data from last week, it appears that 30yr UST yields sold-off around the same time we see signs of Yen intervention - however, 30yr swap spreads become less negative at the same time period, which is the opposite behavior that we'd expect if the long-end was responding to intervention. It's not clear that the 30yr yield move was necessarily driven by the interventions, especially as there were also significant overnight headlines relating to the Iran conflict that day.

Figure 8: 30yr UST yields did increase alongside interventions on the 31st (JPY/USD, %)

Sources: Bloomberg, PNC

Figure 9: Swap spreads did not respond materially to either intervention (JPY/USD, bps)

Sources: Bloomberg, PNC

Impacts of subsequent intervention on longer-dated yields, if it comes at all, would come through some kind of market-perception channel. But this likely requires interventions to be interpreted as signaling reduced demand over the longer-term for US Treasuries from MoF or foreign reserve managers in general. While this is a possibility, it represents more of a tail-risk in our view. Interventions are by nature temporary and unlikely to signal much to the market about the MoF's long-term demand for UST assets.

The more likely channel to impact longer-dated UST is through contagion of the current fiscal worries in Japan into a global fiscal expansion story - while possible, this will likely require more time and more evidence that global fiscal debt issuance is overwhelming global demand for said assets (at current yields). We had mentioned the possibility of



Japan imposing quasi-capital controls to rotate domestic fixed income managers into JGBs at the expense of foreign asset holdings - this could be broadly impactful across the UST curve given the magnitude of these holdings. Whether or not Japan implements such measures remains a relevant open question to monitor.

How much does MoF have at its disposal for future interventions?

As we noted, MoF sits on ~\$1tn in FX reserves – about \$162bln of this in “cash and cash-like instruments”, with the remainder invested into longer dated assets. While we don’t know for certain, there’s evidence that there’s at least around \$100bln held at the foreign RRP facility (this is a quasi-deposit account at the Fed made available to foreign official entities). **Media reports indicate that the MoF interventions last week equated to \$95bln in USD reserves – that would still leave plenty of reserves, but we suspect that the amount used in 2 days last week is at the MoF’s upper limit of comfort.** We don’t currently have insight into the breakdown of where the money came from – MoF releases FX reserve data on a monthly cadence (the next release, covering July month-end balances, is slated for August 7th), and to the degree that Foreign RRP balances or the FIMA facility were used, we get Fed H.4.1 data at the end of Thursday (August 6th).

What does Treasury have at its disposal?

We don’t know what the size of the US intervention was, but we know how many Euro assets the US owned going into the Friday interventions. US FX assets are evenly split between the ESF and the Fed, with each holding \$13bln in Euro-denominated assets and \$6bln in Yen assets (PRIOR to the intervention). \$26bln is the maximum Euro assets that could have been sold to intervene in the Yen market.

The ESF exists for purposes of intervening in FX markets – beyond the aforementioned FX reserves invested in Euro and Yen assets, the ESF has ~\$25bln in dollar assets invested in non-marketable UST (one-day maturity), and another \$172bln in SDRs. The \$25bln in dollar assets can be redeemed to fund FX

interventions, but requires the non-marketable debt to be converted to marketable debt (i.e. Treasury will need to auction off more T-bills or something). SDRs can be monetized in two ways: by trading them for currency of another denomination from another country’s central bank/Treasury equivalent, or by “selling” them to the Fed in exchange for US dollars.

Trading the SDRs for Euro (or some other non-dollar currency) would be a way of getting more non-USD to use to buy Yen, but it requires a partner country willing to give up currency for SDRs – this might be harder to find given the stance of US foreign policy in the past year. The Fed monetization option essentially results in an expansion of the Fed’s balance sheet – the Fed “buys” SDRs, which then sit on its balance sheet (more Fed assets), offset by money created and deposited into the TGA (more Fed liabilities). The newly created dollars could be used to intervene in Yen markets without selling off new Treasury debt of any tenor, but the optics of expansion of the Fed’s balance sheet in this manner could be complicated.

What is FIMA and how does it work?

The FIMA facility (foreign and international monetary authorities repo facility) is an equivalent facility of the Standing Repo operation (SRP), with access granted to foreign central banks and similar entities. Such entities can borrow US dollars against UST assets that they custody at the NY Fed from this facility, with the loan set up as a repo transaction. The cost of borrowing is fixed at the SRP rate (top of the Fed funds band), and there is a \$60bln/day counterparty limit. The repo loans are overnight maturity, but can be rolled each day.

The primary use case of the FIMA is to avoid fire-sales of UST assets by foreign reserve managers and such – instead of monetizing USTs by selling on the open market, they can borrow against them straight from the Fed (this action expands the Fed’s balance sheet – FIMA loans appear as Fed assets, offset by newly created Fed reserve liabilities). This limits the market impact of any sales or private market repo borrowing that would have otherwise happened. Japan Finance Minister Katayama has publicly said that MoF intends to use the FIMA facility in future interventions after Bessent publicly highlighted the facility, but we note



there are some challenges to its use. Unless the loan is perpetually rolled, BoJ will at some point need to pay back loans from FIMA, which inherently means it will need to raise dollars from some alternative source in the future. In this sense, FIMA usage *defers* UST sales into the future, it does not necessarily replace sales *permanently*.

From the US perspective, this could still be a win, as the FIMA loan allows for potential UST sales to be deferred to a time when the market might be better able to absorb it. It's less clear to us how this is favorable for Japan though – sales still need to happen eventually, and the FIMA is more expensive than current market repo rates. Whether or not the FIMA gains traction for such use remains to be seen.



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