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Japan's Rate Normalization: Repatriation, Carry Trades and Global Capital Flows

For nearly three decades, Japan stood apart from most developed economies. By the **1980s**, Japan had become the **world's second-largest economy**, and its GDP reached **$5.54 trillion by 1995**, reflecting the momentum built during the bubble years of its economy. Persistent low inflation, weak wage growth and repeated episodes of deflation pushed the Bank of Japan (BoJ) toward increasingly **unconventional monetary policies.**

Interest rates remained close to zero, government bond yields were heavily compressed, and the currency, the yen, became one of the cheapest major currencies to borrow. Theses conditions have shaped not only **the Japanese economy,** but also **global capital allocation** encouraging Japanese investors to **search abroad for yield** while supporting the widespread use of the yen as a funding currency.

Japan's monetary regime is now changing, a fitting reminder of **mujō**, the Japanese idea that **no state is permanent**.

On 18 September, just two days after the US Federal Reserve raised rates, the Bank of Japan also tightened monetary policy, lifting its policy rate from **1.00% to 1.25%, its highest level in 31 years**. This move extends a normalization cycle that began when the BoJ **ended negative interest rates in 2024**, while Japanese government bond yields have also moved sharply higher.

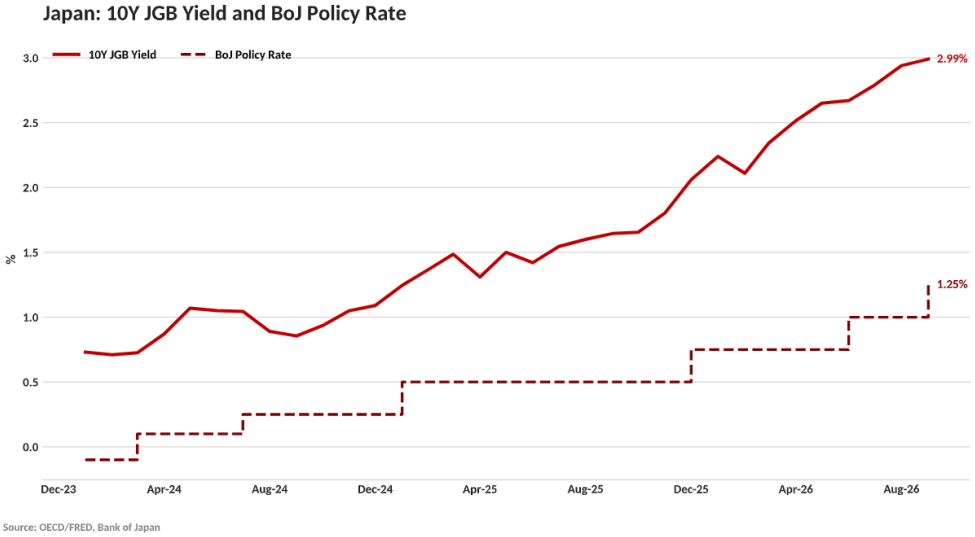
This raise a much broader macro question:

What happens to global capital flows when one of the world's largest pools of savings no longer needs to leave home in search of yield?

1.How Japan Transmits to Global Markets, The Two Channels: Repatriation and Carry Trade

Higher Japanese rates matter because they can change where Japanese capital is allocated

For years, low domestic yields pushed banks, insurers and institutionals to look abroad for returns, particularly in US and European fixed income showing highest yields (2.88% and 1.55% avg 10Y). As Japanese government bond yields rise, this **tradeoff becomes less obvious.** For Japanese institutions, the relevant comparison is not simply between headline Treasury and JGB yields. What matters increasingly is the return on foreign bonds **after FX hedging costs**, relative to the yield available domestically.



As JGB yields rise and currency hedging reduces the effective return on foreign bonds, domestic fixed income becomes relatively more attractive without the same FX exposure. This creates the possibility of **domestic capital repatriation**: Japanese investors may gradually reduce their exposure to foreign assets and reallocate part of that capital back into Japan.

The mechanism matters globally because Japan is one of **the world's largest pools of saving**. At the end of 2025, Japanese investors held around **¥1,806tn in foreign assets**, including roughly **¥769tn in portfolio investments**. If repatriation becomes significant, foreign bond prices could come under pressure and yields could rise, tightening financial conditions well beyond Japan.

The second transmission channel is the **yen carry trade**. For years, investors could borrow cheaply in yen and reinvest the proceeds in higher-yielding assets abroad.

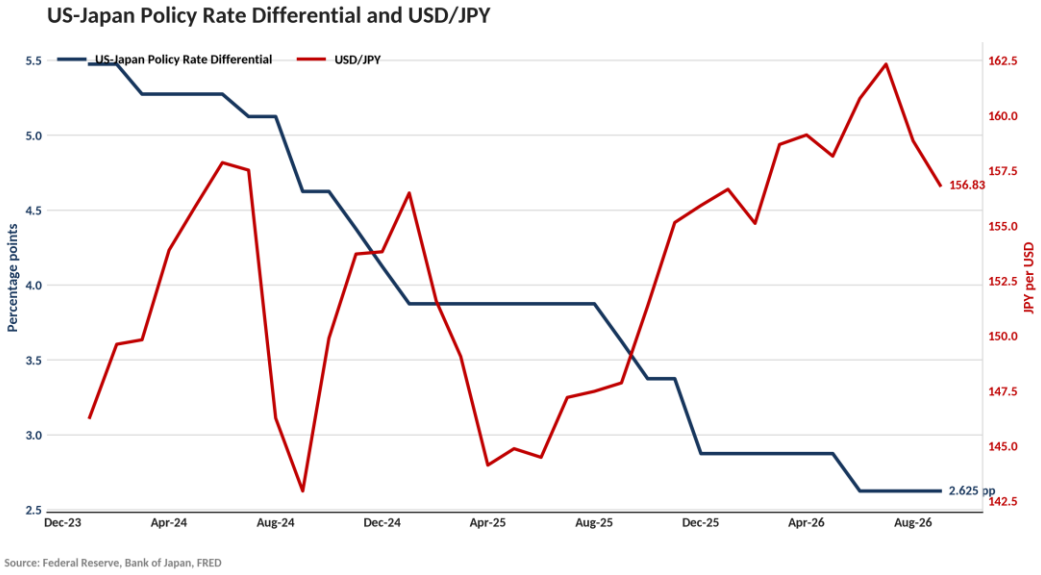
The latest Fed and BoJ decisions show why **expectations matter more than the headline move**. Both central banks raised rates by 25 basis points, so the current US–Japan rate differential barely changed. What matters now is how that gap is expected to evolve.

2. Policy Divergence: Why the Carry Trade May Persist ?

My view is that the Fed still has room to remain restrictive. US headline inflation remains elevated at **3.4% year-on-year in August 2026**, well above the Fed's 2% objective, while Chair Kevin Warsh has made clear that the Fed is **prepared to act** if inflation remains persistent.

The BoJ, by contrast, still appears more cautious. Its latest 25 bp hike passed by only **7 votes to 2**, with two board members favoring more patience. To me, this reinforces the idea that Japanese normalization is likely to remain gradual.

If this policy divergence persists, the US–Japan rate differential **could remain wide** enough to preserve the attractiveness of the yen carry trade. The **real risk** comes from a **reversal in expectations**: faster BoJ tightening or eventual Fed cuts would narrow the spread, encourage carry-trade unwinds and potentially strengthen the yen.



3. What to Watch Next?

The next stage of the story will depend on how quickly expectations around both central bank evolve.

The key indicators to watch are **USD/JPY**, the **US-Japan rate differential**, **JGB yields** and **Japanese portfolio flows**. A stronger yen combined with rising JGB yields would be an early sign that capital repatriation is gaining momentum. On the other hand, if US yields remain high and the BoJ continues to normalize only gradually, the carry trade could remain resilient

For me, the key macro question is therefore simple: **at what point do Japanese yields become attractive enough to materially change global capital flows?**

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Sources: Bank of Japan, Federal Reserve, Japan Ministry of Finance, US Bureau of Labor Statistics, Bloomberg. Data as of September 2026