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Japan: 2007 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Japan, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 24, 2007, with the officials of Japan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 12, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 27, 2007 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Japan

Approved by Daniel Citrin and G. Russell Kincaid

July 12, 2007

- **This report is based on discussions held in Tokyo during May 14–24.** The staff team was headed by Mr. Citrin (APD). Mr. Lipsky joined the mission for the final round of policy discussions. Messrs. Kashiwagi and Kitahara (both OED) also participated.

- **Counterparts.** The mission met with Bank of Japan (BoJ) Governor Fukui, Minister of State for Economic and Fiscal Policy Ota, Minister for Financial Services Yamamoto, Vice Minister of Finance for International Affairs Watanabe, BoJ Deputy Governor Iwata, Member of the BoJ Policy Board Suda, and other senior officials, academics, and private sector representatives.

- **Context of past surveillance.** In recent years, the Fund and the authorities have agreed on the broad policy priorities—implementing an appropriate post-deflation monetary framework, pursuing medium-term fiscal consolidation, further strengthening the financial and corporate sectors, and stepping up productivity-boosting reforms. Compared to the authorities, the Fund has advocated a somewhat faster pace of reforms, inter alia to strengthen growth prospects in the context of population aging and promote an orderly adjustment of global imbalances.

- **Japan's exchange rate is market determined.** Japan has accepted the obligations of Article VIII. The exchange system is free of restrictions on the making of current international transactions, with the exceptions of those notified to the Fund in accordance with Executive Board Decision 144-(52/51) and UN-sanctioned restrictions on external payments for security reasons.

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EXECUTIVE SUMMARY

- **Japan's economic expansion has entered into its sixth year.** GDP growth has been above potential, while the external position remains strong. The health of the banking system continues to improve, and corporate profits are at record highs. CPI inflation has been very weak, due mostly to moderate wage growth and global competitive pressures.

- **The outlook remains favorable, with growth increasingly driven by domestic demand.** The risks are evenly balanced with downside risks mainly from the external side, while a tightening labor market could feed into faster consumption.

- **Fiscal consolidation has proceeded faster than expected, but the public debt ratio is still high.** The primary deficit for the general government (excluding social security) is projected to decline to about 1 percent of GDP in FY2007 (fiscal year starting in April). However, the public debt ratio remains uncomfortably high and, on a net basis, is rising.

- **With little signs of inflation pressures or worrisome financial imbalances, the Bank of Japan has opted for a very gradual pace of tightening**. Low interest rates have supported the expansion, but they have also contributed to capital outflows that have weakened the yen. The yen remains below its long-term equilibrium value in real effective terms.

- **Japan continues to make progress in structural reforms.** Initiatives are underway to streamline product regulation, reform the public sectors, improve labor utilization, and foster competition and trade.

Key issues and policy discussions

- **A faster pace of fiscal consolidation would buy policy insurance against shocks and help cope with the cost of population aging.** Given the size of the adjustment and uncertainties surrounding future spending cuts, revenue measures are needed. Among possible measures, raising the consumption tax would be more equitable and supportive of growth.

- **With little inflation ahead, monetary policy should remain supportive and attuned to a broad appraisal of the economy and prices.** Continued efforts to improve communications would help strengthen the monetary framework and anchor inflation expectations.

- **Financial policies are focused on the challenges ahead.** A growing appetite for risky assets—both domestic and foreign—calls for continued regulatory vigilance and sound risk management. Other key challenges include further developing the capital markets, raising bank core profitability, and managing the reforms of the government financial institutions.

- **Broader structural reforms are needed to boost productivity and competitiveness.** The reform priorities are to increase labor market flexibility and promote competition through greater market opening and further deregulation.

- **The authorities' policy intentions are broadly appropriate to promote an orderly adjustment of Japan's external imbalance**—and the yen should continue to be market determined.

I. Introduction

1. **Japan's current expansion has gone hand in hand with increased integration with the global economy.** Emergence from a decade of economic stagnation began in 2002 with an export-led recovery that helped jumpstart growth and break a cycle of falling prices and financial instability. Five years later, growth has become more broad-based, confidence has improved, and Japan's engagement with the global economy has deepened. Trade openness is advancing; Japanese investors are seeking higher returns overseas; and foreign participation in Japan's capital markets and economy is expanding.

Japan: Indicators of Global Engagement

	Average 1995–2001	2006
	(In percent)	
Trade Openness 1/	20.2	32.1
Financial Openness		
FDI + portfolio investment / GDP 2/	4.5	7.5
Share of foreign ownership		
Equity (Tokyo Stock Exchange) 3/	15.1	28.0
Bonds (JGB)	0.1	5.8
Share of foreign securities in Japanese assets (percent) 4/	2.2	5.6

Sources: CIEC database, and Fund staff estimates.
1/ Ratio of exports and imports of goods and services to GDP.
2/ Ratio of foreign direct investment and portfolio assets and liabilities to GDP.
3/ Fiscal year data.
4/ 1995–2001 figure is that of 1997.

2. **Globalization is adding new dimensions to Japan's macroeconomic and financial policies.** Together with benefits for the world and Japan, closer financial and trade ties are bringing two-way channels for spillovers as well as new challenges. What are the implications for policymaking? Do policy requirements differ from a domestic and a multilateral perspective? What are the tradeoffs, if any, between domestic and external objectives? This year's Article IV discussions explored the main *policy challenges facing Japan in a more globalized world.*

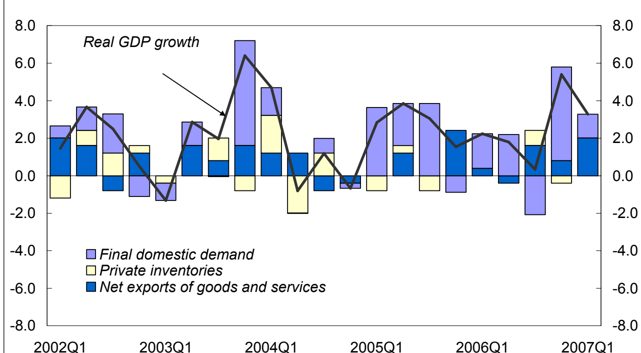
II. Economic Developments

Background

3. **Japan's economic expansion has entered its sixth year.**

- *GDP growth has been above potential.* Growth in 2006 averaged 2.2 percent, though the quarterly pattern was uneven (Figure 1; Table 1). After slowing in mid year, private consumption rebounded in the fourth quarter and activity regained pace. With renewed momentum in domestic demand, GDP grew at an annual rate of 3.3 percent in the first quarter of 2007.

Contributions to GDP Growth

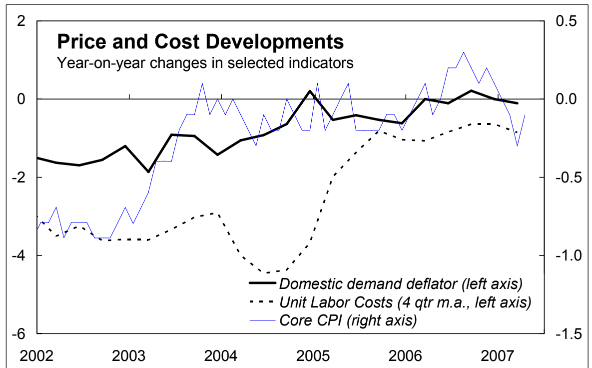


Sources: Global Insight, Nomura database.

- *Price pressures remain absent.* Core CPI inflation (excluding fresh food) in 2006 was only 0.1 percent (y/y) and lately has dipped below zero—mainly due to lower energy and telecommunication prices. The GDP deflator fell by 0.9 percent (y/y) last year and by 0.3 percent in the first quarter of 2007 (Box 1).

Box 1. Why is Japan's Inflation So Low?

Throughout the current expansion, most measures of inflation have remained weak. Since early 2002, core CPI (excluding fresh food) has fallen at an average annual rate of about ¼ percent (y-on-y), along with other broader price indicators. Inflation has been negative in spite of a closing output gap and loose financial conditions—including a depreciating yen. A rebasing of the CPI in August 2006, which gave greater weight to information and communication technology (ICT) goods and services, reduced measured inflation by about ½ percentage points in the first half of 2006.



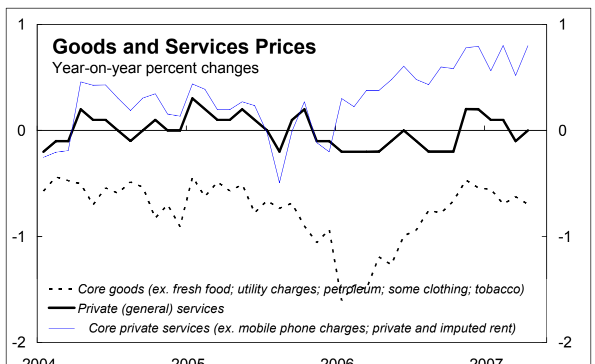
Source: Haver Analytics.

Persistent absence of inflation could reflect a negative output gap as well as other factors. Staff estimates the output gap about *minus* ½ percent (i.e., some slack remains). Official estimates are positive but close to zero, and may reflect downward biases in estimated potential growth after protracted stagnation. Either way, the gap alone does not seem to be the main cause of low inflation. Four additional likely factors are:

- **Low inflation expectations.** Surveys and proxies of inflation expectations derived from indexed bonds point to inflation expectations remaining very low. Low inflation expectations in turn may reflect Japan's history of low trend inflation (which averaged about 2¼ percent during 1980–1994 before deflation set in).

- **Persistent wage moderation.** Changes in labor markets are dampening cost-push pressures. Wage moderation reflects, among other things, aggressive cost containment by restructuring firms, the replacement of retiring high-wage workers with younger lower paid ones, and pervasive hires under non-regular contracts.

- **Reduction in pricing power.** There have been persistent differences in price behavior between goods and services. Since the mid-1990s, core goods prices have trended downward—reflecting heightened competition and technological progress in Japan as elsewhere. By contrast, service sector prices have generally been rising—although weakly since 2001. Service price inflation nonetheless is still well below that in other G-7 countries. These trends suggests that deregulation, productivity growth, and globalization have increased competitive pressures and market contestability, limiting pricing power in many sectors (WEO, April 2006).



Sources: Statistics Bureau and Fund staff estimates.

- **Domestic regional factors.** Regional developments are also creating a downdraft on aggregate price indices. While major metropolitan areas have thriving economies, other regions are still struggling with weak activity. (For example, in April, nearly half of the prefectural capitals had negative core inflation and a shrinking population.)

All these factors have contributed to a flattening—and a downward shift—of the Phillips curve, and explain a persistently low inflation in the upswing.

- *Labor markets continue to tighten, but wage growth is still sluggish.* The unemployment rate fell to 3.8 percent in May, its lowest level in nine years. Nonetheless, average wages languish, in part because of shifts in the composition of employment (Box 1). However, compensation of employees (which includes bonuses) has been growing at about 1 percent on average for the last three years.

- *Financial underpinnings have improved.* Bank NPL ratios fell further in 2006, and capital ratios improved. Corporate profits are at record highs—and gearing ratios at a 50-year low. With lending rates low and stock prices rising, financial conditions remain easy. The yield curve has steepened since a year ago, with the 10-year rate at nearly 2 percent. And the recovery in land prices has now spread from selected cities to the entire country (Figure 2; Table 3).

- *Japan's external position remains very strong* (Figure 3). Boosted by investment income, the current account surplus widened last year to nearly 4 percent of GDP. Record net capital outflows provided an offset (Box 2). The current account strengthened modestly also in the first quarter of 2007. Valuation effects and accrued income have propelled official reserves to around $900 billion. Intervention has not taken place since March 2004.

- *The yen has depreciated against major currencies*. During 2006, it fell 5½ percent and 6¼ percent against the U.S. dollar and the euro, respectively. After depreciating more this year, the real effective yen is at its weakest in about 20 years. On a bilateral basis, widening interest rate differentials and a fading home bias have driven the yen to all-time lows against the euro and some "target currencies" in carry trades. Against the U.S. dollar, the yen is somewhat under its most recent five-year average.

Outlook and risks

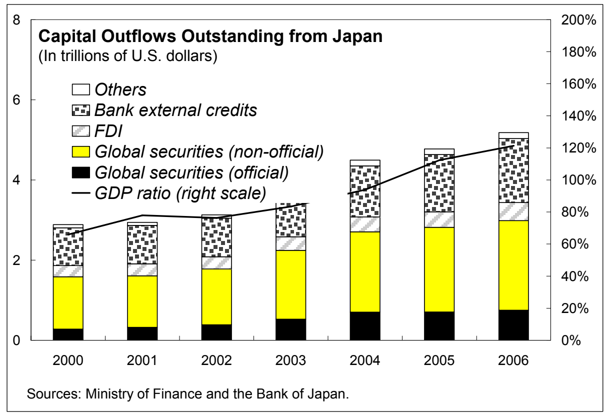
4. **In the near term, GDP is expected to grow at an annual pace of around 2¼ percent and the risks are balanced.**

- *Baseline.* On an annual average basis, GDP growth is projected at 2.6 percent for 2007 and 2.0 percent for 2008, increasingly driven by domestic demand. With activity close to full capacity, CPI inflation is expected to pick up, but very slowly. The current account surplus is expected to remain around 4 percent of GDP in 2007–08.

- *Risks.* Downside risks stem mostly from the external environment and include an unanticipated slowdown in the United States, volatile energy prices, and global financial turbulence. Also, household spending could be held back by uncertainties about entitlements and tax reforms. On the upside, a tight labor market could lead to faster wage gains and consumption growth. Exports could also overperform, given the depreciated yen and the strong regional outlook.

Box 2. Recent Developments and Outlook for Japanese Capital Outflows

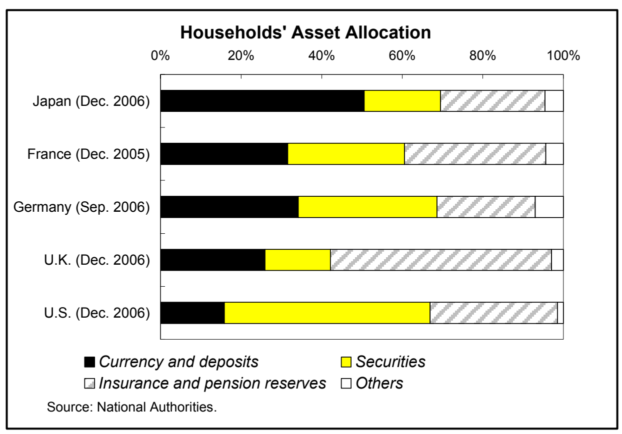
To diversify their portfolios and earn higher returns, investors have increasingly turned overseas. The stock of capital investments abroad by Japanese residents has almost doubled since 2000 (to just above 120 percent of GDP), mainly from growth in private holdings.[1]



Retail investments through mutual funds have been the main source of these flows, followed by pension funds. Deregulation that allowed banks in 1998 (and Japan Post in 2005) to sell mutual funds directly to customers helped households shift from low-interest deposits to higher-yielding global securities, mainly sovereign bonds. More recently, there has been some shift in securities investment from bonds to equities. Outward FDI has also picked up, particularly to emerging Asia, supported by credits from Japanese banks.

Recent capital outflows have also involved carry trades—the practice of borrowing in yen to purchase higher-yielding assets in other currencies—and other speculative flows. Low market volatility and widening interest rate differentials have raised the incentives for such trades. Market participants report two approaches that are becoming popular, but are difficult to track. First, in some markets, creditors are issuing yen-linked loans or debt to borrowers trying to take advantage of low Japanese interest rates. However, creditors have reportedly shed currency risk by using cross-currency swaps, transferring the exchange rate risk to the borrower.[2] Second, foreign exchange trading has become popular among individual investors in Japan, who can leverage (up to 10–20 times) deposits in margin accounts to take currency positions. The actual leverage of Japanese investors is not known, but deposits have grown rapidly and have reached about $5¾ billion at the end of May 2007. Data on the size of outstanding positions for yen-linked loans and margin trading are generally unavailable on a detailed and timely basis.

Given their large structural nature, capital outflows are likely to remain large, with a growing share to Asia. Currency and deposits account for nearly half of households' portfolios—a significantly higher proportion than in other advanced countries. As such, there is significant potential for households to increase their overseas investments. The ongoing decline in home bias should only add to the momentum for holding global securities. Although the U.S. and Western Europe currently receive much of these flows, Asia's share (around 10 percent) is rapidly rising, including for FDI.



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[1] In contrast, capital inflows to Japan have been much smaller. Overseas investors currently hold around $2½ trillion in Japanese securities and loans.

[2] For example, in Korea, yen-denominated loans are estimated to have increased by around $5 billion in 2006. However, the amount is small compared to the stock of won-denominated loans ($300 billion in the housing sector).

5. **Over the medium term, GDP growth reverts to potential.**

- *Medium-term baseline.* In the central scenario, GDP growth moderates to potential (estimated at 1.7 percent). This trajectory assumes a continued strengthening of the financial sector, efficiency gains from corporate restructuring, a shrinking labor force, and fiscal consolidation in line with the authorities' latest reference path. The current account balance narrows modestly by 2012 with a decline in private saving as population ages, while investment remains strong. Inflation picks up gradually as the economy operates close to capacity.

Japan: Medium-Term Projections, 2006–12

(Percentage change from the previous period, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012
Real GDP 1/	2.2	2.6	2.0	1.9	1.8	1.7	1.7
Total domestic demand	1.4	1.7	1.9	1.9	1.8	1.8	1.8
Net exports (contribution)	0.8	0.8	0.1	0.1	0.0	0.0	0.0
Unemployment rate (percent)	4.1	3.9	3.9	3.8	3.8	3.8	3.8
CPI inflation 2/	0.2	0.0	0.5	1.3	1.5	1.5	1.5
Saving-investment balances 3/							
Private	5.2	5.1	4.6	4.1	3.7	3.3	3.1
Public	-1.3	-0.9	-0.6	-0.5	-0.2	0.1	0.3
Current Account Balance 3/	3.9	4.2	4.0	3.7	3.4	3.4	3.4
Trade Balance 3/	1.9	2.1	1.9	1.9	1.8	1.7	1.6

Sources: Global Insight, Nomura database; and Fund staff estimates.

1/ Annual growth rates and contributions are calculated from seasonally adjusted data.

2/ For 2006, the inflation figure is based on the average of monthly data.

3/ In percent of GDP.

- *Reform scenarios*. Implementation of reforms, such as those announced in the context of the IMF Multilateral Consultation (MC), would strengthen the medium-term outlook, perhaps boosting long-term growth to nearly 2 percent (Annex I). Further structural reforms that build on the MC commitments would lift growth prospects—and strengthen the yen—more significantly. Over the longer term, potential growth could increase by about ½ percentage point over the baseline if an ambitious reform agenda is pursued.[1] Under this scenario, the current account surplus would narrow and the yen would appreciate in real terms over time. However, sustained capital outflows, productivity gains in the non-tradables sector, and a policy mix tilted toward fiscal austerity are likely to slow the adjustment.

[1] Detailed recommendations on reform priorities are in Annex I of last year's Article IV report (IMF Country Report No. 06/276).

Reform Scenarios
(Percentage point deviation from baseline)

	Multilateral Consultation				Broader Structural Reforms			
	Year 1	Year 3	Year 6	Year 11	Year 1	Year 3	Year 6	Year 11
Real GDP (level)	0.0	0.1	0.6	1.8	0.0	0.3	1.5	3.6
Potential Growth in Japan	...	0.1	0.2	0.3	...	0.3	0.5	0.5
Current account (percent of GDP)	-0.1	-0.2	0.0	0.1	-0.3	-0.3	0.0	0.1
Government debt (percent of GDP)	0.0	-0.2	-0.8	-2.3	0.0	-1.1	-1.9	-4.9

Source: Fund staff estimates.

The authorities' views

6. **The authorities broadly concurred with these assessments.**

- *Near-term growth and inflation.* Both the Bank of Japan (BoJ) and the Cabinet Office shared the view that the expansion remains on solid ground.[2] They expect that consumer prices will recover once temporary factors play out, given tighter profit margins, strong labor demand, and output already above potential. As for downside risks, BoJ officials are of the view that strong demand from the rest of Asia and Europe has so far limited the impact of the U.S. slowdown on Japan's exports but that developments in the global economy need to be watched closely. They also noted that vigilance is warranted against the risk that expectations of very low interest rates—regardless of output and price conditions—become entrenched and distort asset prices.

Staff and Authorities Forecasts, FY2006-FY2008

	Real GDP			Inflation 1/		
	FY2006	FY2007	FY2008	FY2006	FY2007	FY2008
Staff 2/	2.0	2.3	1.9	0.3	0.2	0.5
BoJ Policy Board 3/						
October 2006	2.4	2.1		0.3	0.5	
April 2007		2.1	2.1		0.1	0.5
Government 4/						
January 2007	1.9	2.0		0.3	0.5	

1/ The staff and government forecast headline CPI; the BoJ forecasts core CPI.
2/ Actual figures for FY2006 CPI inflation; FY2007-08 are latest staff forecasts.
3/ Median forecast of BoJ Board members.
4/ Cabinet Office, *Fiscal 2007 Economic Outlook* (January 2007).

- *Medium-term outlook.* Potential growth is currently estimated at or somewhat above 1½ percent per year by both the BoJ and the Cabinet Office.[3] However, the Cabinet Office considered that it could rise to 2.4 percent under a far-reaching reform plan in the works (paragraph 33).

[2] The Cabinet Office projections have not been updated yet.

[3] This is a bit less than in the staff's baseline, owing to different methodologies.

III. POLICY CHALLENGES IN A MORE GLOBALIZED WORLD

A. Reducing the Public Debt Ratio to Achieve Fiscal Sustainability

Fiscal consolidation has proceeded faster than expected. Nonetheless, a worrisome fiscal situation calls for continued efforts to put the public debt ratio firmly on a downward path. Consolidation might slow the current account adjustment, but this seems a reasonable price to pay for better long-term growth prospects.

Background

7. **Despite better-than-expected fiscal outturns, the public (net) debt ratio at above 80 percent remains one of the highest among OECD countries—and is still rising.**

- *Consolidation is proceeding.* There has been noteworthy progress, thanks to cyclical revenue buoyancy (particularly in corporate taxes) and sustained expenditure restraint (Table 2). The primary deficit for the general government (excluding social security) is thus projected to decline to about 1 percent of GDP in FY2007 from over 5 percent four years ago. However, the public debt ratio remains uncomfortably high and—on a net basis—is not yet stabilized.

- *The medium-term fiscal strategy.* The goals and timeline in the authorities' revised fiscal projections released in early 2007 are basically unchanged from last year (Box in Annex III). Given past overperformance, this implies only a modest additional adjustment in the primary balance, going forward—¼ percent of GDP annually through FY2011. Additional issues relate to the underlying assumptions, which entail a favorable growth-interest rate differential.

Japan: Baseline Fiscal Outlook
(In percent of GDP, fiscal year basis)

		Est.	Proj.				
	2005	2006	2007	2008	2009	2010	2011
General government							
Revenue	29.9	30.4	31.3	31.7	32.1	32.5	32.8
Expenditure	34.1	34.3	34.8	35.1	35.4	35.4	35.5
Balance	-4.3	-4.0	-3.5	-3.4	-3.3	-2.9	-2.7
Primary balance excluding social security	-2.8	-2.1	-1.2	-0.8	-0.9	-0.3	0.1
Structural balance 1/	-4.0	-3.9	-3.5	-3.5	-3.3	-2.9	-2.7
Net debt (calendar year)	84.0	87.1	89.1	90.7	91.7	92.2	92.4

Sources: Ministry of Finance and Fund staff estimates.
1/ Excluding bank support.

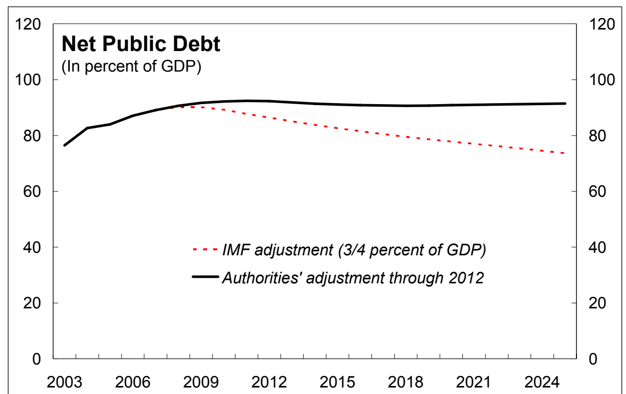
- *Tax reforms.* The authorities' consolidation strategy does not factor in major new tax initiatives. However, discussions on comprehensive tax reforms are expected to start after the July Upper House elections. In the background, the possibility of earmarking any increase in the consumption tax rate (which at 5 percent is low by international standards) for social security spending has been raised.

- *Other fiscal reforms.* With a view to improving expenditure control and budgetary transparency, the Diet enacted a law inter alia to gradually reduce the number of Special Accounts and their ability to borrow, and enhance oversight of the budget process. Stock taking of recent social security reforms are planned for 2009 (pensions) and 2010 (healthcare).

Policy issues and staff views

8. **With the outlook still favorable, the mission reiterated the need for faster consolidation.**

- *Near-term fiscal stance.* The FY2007 budget is passed, but savings should be sought and an expansionary supplementary budget should be avoided.
- *The case for faster consolidation.* Looking ahead, there is a compelling case to save past gains and bring forward the timing for curbing the debt ratio. Faster progress will buy "policy insurance" against shocks and create fiscal space to accommodate rapid population aging.
- *Bringing down the debt ratio.* An adjustment to the primary balance of the general government (excluding social security) of about ¾ percent of GDP per year on average during 2007–12 (or nearly ½ percent of GDP more than in the authorities' reference path) would begin to reduce the debt ratio in 2010, rather than merely stabilize it.[4] The extra effort would imply a primary surplus target (excluding social security) of 1¾ to 2¼ percent of GDP by FY2011. (Including social security, the target would be 1 to 1½ percent of GDP.)



Source: Fund staff estimates. See Annex III for assumptions.

9. **Every effort should be made to stick to earlier commitments to reduce public expenditures but additional revenue measures seem unavoidable, given the size of the adjustment and uncertainties about future spending cuts.**

- *Expenditure and tax measures.* So far, the linchpin of the government's strategy for medium-term fiscal adjustment has been expenditure cuts. Although there is still room for further savings (e.g., in public works and administration, and through additional entitlement reform), limits may be in sight. Revenue measures could be best identified in the context of a broad reform of the tax system (Box 3).[5] Options include: (i) raising the consumption tax; (ii) revising the corporate tax system; (iii) widening the income tax base; and (iv) strengthening tax administration, including through tax payer identification numbers.

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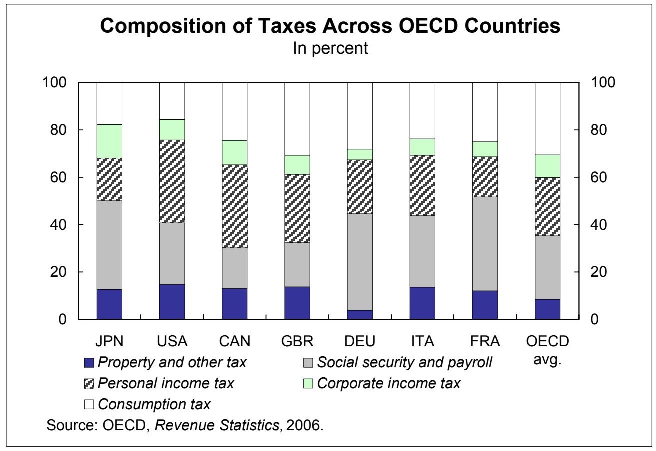
[4] Country Report No. 06/276 presents model-based estimates of the gains from faster fiscal adjustment.
[5] The mission made a presentation to the government's Tax Commission on the challenges to tax policy from globalization. Further discussion of the issues is presented in the accompanying *Selected Issues* paper.

Box 3. Tax Policy Challenges from Aging and Globalization

The tax system in Japan faces increasing pressures from aging and globalization. Looming spending pressures have raised the need for additional revenue, while globalization has complicated tax setting by making capital more mobile. Any fundamental reform of Japan's tax system would need to focus on its three pillars—the corporate income tax (CIT), the consumption tax, and the personal income tax (PIT)—and take account of these wider forces.



Corporate taxation. The CIT in Japan is a more important source of revenue than in other OECD countries, reflecting partly its high statutory (around 40 percent) and average effective rates. With growing pressures from Japanese corporations to lower rates to international norms, the challenge will be to maintain revenue while enhancing Japan's international competitiveness. Possible measures include limiting depreciation allowances or shifting away from tax credits for R&D to more targeted spending, such as on R&D, that have clearer social benefits. More radical reform possibilities include further restricting interest deductibility, as in Germany, or providing an allowance for the cost of equity finance.

Consumption tax. Japan derives a smaller share of its tax revenue (9½ percent) from this source than any other OECD country with a VAT (19½ percent on average). Raising the VAT is an obvious option with its own merits. Unlike taxing capital income, a consumption tax does not distort savings decisions, helps spread the burden more evenly across generations and tends to support faster growth in the long run. To the extent that additional revenue from the VAT is spent on the most disadvantaged, including through social security benefits, the net impact would be more progressive.

Personal income tax. The yield of the PIT is among the lowest in the OECD at 4¾ percent of GDP, due mainly to the low tax base. Base-broadening measures such as reducing basic exemptions and covering more self-employed could generate revenue without significant labor market distortions given the fairly low marginal rates, especially at lower incomes. In terms of broader reforms, the "dual income tax" pioneered in the Nordic countries (which applies a flat rate to all capital income and a progressive schedule for labor income) could be considered as a compromise between the difficulty of taxing capital income and the desire for progressivity.

- *Raising the consumption tax.* Consumption tax reform has been a controversial political issue for some time. Yet, compared with alternative revenue-enhancing measures, a consumption tax hike would be more supportive of growth and spread the burden more evenly across generations.[6] Earmarking any increase to fund social security is worth considering on pragmatic grounds, particularly if the alternative is no action at all.

10. **Fiscal consolidation could have favorable international spillovers.** All considered, restoring Japan's fiscal health is in the world's interest since it would strengthen medium-term growth and limit financial risks.

- *Growth and the current account.* Any negative impact of consolidation on GDP growth and the current account is likely to be small and could be more than offset by productivity- and confidence-boosting structural reforms.[7]

- *Risk premia.* Securing fiscal sustainability could also help stabilize risk premia in the JGB market—the world's largest sovereign bond market—where volatility could pick up with greater foreign participation and a declining home bias.

The authorities' views and policy intentions

11. **Officials agreed that further consolidation is necessary, but stressed the need to focus on spending cuts before a tax reform strategy is put in place.**

- *The revised medium-term projections*. They noted that the latest medium-term reference path built on earlier commitments to reduce spending and did not speculate on the possible role of revenue measures, pending the outcome of the tax reform debate. Future updates could factor in more ambitious targets or an accelerated timeline, depending on the scope of agreed tax changes and the economic outlook.

- *Expenditure policy*. For now, the authorities place top priority on curbing public expenditure. While the broad envelope of the savings necessary to attain the medium-term goal of a primary balance (excluding social security) was decided in 2006, year by year implementation still requires tough choices. With less likelihood of additional tax buoyancy, the fiscal adjustment along the revised reference path reflected, in the authorities' view, a realistic effort. The mission acknowledged the point, but thought that the credibility of the fiscal strategy would benefit from an early start of a national debate on revenue-side measures, in light of spending pressures from population aging.

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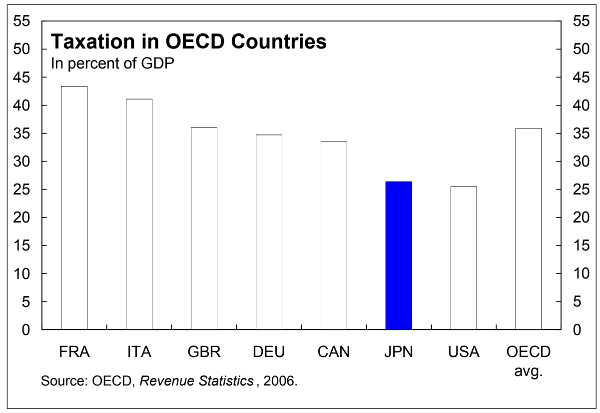
[6] See IMF Country Report No. 06/276 for an analysis of the impact on growth from an increase in the consumption tax.

[7] This was the message from model-based simulations done for the 2005 Article IV consultation. See IMF Country Report No. 05/272.

- *Tax reform.* Officials did not disagree and noted an improved public sentiment: opinion surveys indicate that the general public is increasingly willing to trade off higher taxes for more certain social entitlements. The intention is to reopen discussions on the medium-term fiscal strategy, including comprehensive tax reforms, in the fall and flesh out proposals by end-FY2007. Discussions on tax reforms would focus on the challenges arising from the aging society, globalization, and the widening income inequality.



Source: OECD, *Revenue Statistics*, 2006.

12. **Regarding the further internationalization of the JGB market, the authorities saw foreign participation as a very positive development.** A larger international presence could at the margin add to volatility, but over the longer run a more diverse investor base will make the market more resilient (for example, to shifts in the asset portfolio of Japan Post as government's divestment proceeds).

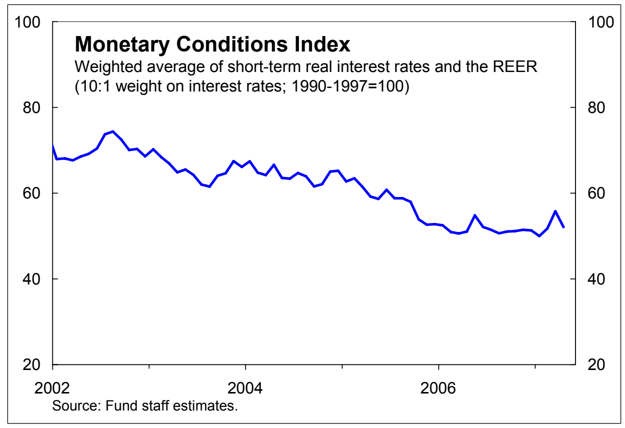
B. Monetary and Exchange Rate Policies in a More Globalized World

With fiscal policy firmly focused on consolidation, monetary policy should continue to target price stability and output growth. This calls for removing accommodation only gradually—which may imply sustained capital outflows and a weak yen for some time to come. The BoJ should continue efforts to improve communication to help anchor inflation expectations and facilitate policy implementation. The authorities' commitment to a market-determined exchange rate remains appropriate.

Background

13. **Since exiting from its quantitative easing policy in March 2006, the BoJ has tried to strike a balance between its desire to "normalize" monetary conditions and the danger of premature tightening.** Higher rates would reconstitute room for maneuver and forestall financial imbalances like those at the root of the late 1980s bubble economy. Then again, too rapid rate hikes could stop the expansion in its tracks, rekindle deflation, and worsen the debt dynamics.

- *Gradual normalization.* The BoJ has opted for a very gradual pace of tightening—two quarter-point hikes in the past year. This pace has been consistent with a virtual absence of inflation (under the BoJ's "first perspective" for assessing the policy requirements) and no signs of frothy asset markets or other financial imbalances (under the more forward-looking "second perspective").[8]

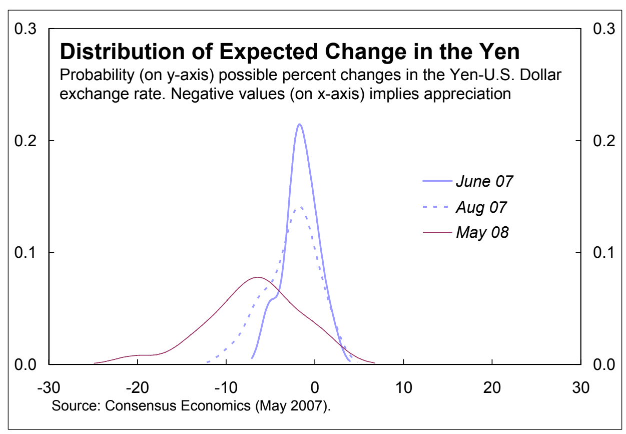


- *Monetary stance.* Conditions are supportive, thanks to a weak yen and low real interest rates. Revived bank lending points to an improved transmission channel for policy, going forward.

- *Communication strategy.* Long-term interest rates remain low and stable, partly reflecting the BoJ's success in convincing the market that short rates will rise gradually. However, one year after its introduction, the BoJ's post-deflation monetary framework is still viewed by market participants as offering insufficient guidance on policy intentions. Criticism has also been leveled against the lower bound of the BoJ Policy Board's "understanding of price stability"—zero to 2 percent CPI inflation. This summary of Board members' opinions was reviewed in April, but left unchanged.

14. **The yen remains undervalued relative to its estimated medium-term level, but markets see little risk of rapid appreciation in the near future.**

- *Longer-term valuation.* Subject to large margins of statistical uncertainty, the estimates by the IMF's Consultative Group on Exchange Rates indicate that the yen is misaligned relative to its longer-term level in real effective terms—partly the result of years of deflation in Japan while prices were growing in its trading partners.[9] Relatedly, the current account surplus is estimated to be above its long-term norm of about 2 percent of GDP.



- *Market assessments.* Most analysts also consider the currency undervalued, but by less. Over a five-year period, the expected change in the real effective yen implied by forward interest rates is about 11 percent. On a bilateral basis, recent *Consensus* (median)

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[8] For example, land prices bottomed out on a national level only in early 2007, and stocks market trends have been broadly in line with those in other advanced economies.

[9] As discussed below in paragraphs 18 and 43, misalignment of the yen relative to its longer-term equilibrium value in real terms does not imply inappropriate policies.

projections indicate an anticipated appreciation of the yen against the dollar of about 18 percent—one third of which could occur over the next year.

- *Risk of position reversal.* In line with this view, implied volatility in option markets suggests only a modest risk of large near-term swings in the yen.

Policy issues and staff views

15. **Japan's low interest rates are contributing to global liquidity and a weaker yen, but with inflation near zero, the BoJ should remain focused on domestic price stability and growth.**

- *External vs. internal considerations.* At first glance, the policy requirements from an international and domestic perspective appear at odds.
  - On the one hand, low interest rates contribute to capital outflows that complicate policy decisions in recipient countries (by putting upward pressure on their exchange rates). A persistently weak yen could also fan a protectionist backlash abroad. Arguably, an accelerated tightening cycle in Japan could slow the more interest rate-sensitive outflows, support the yen, and safeguard open trade.
  - On the other hand, low inflation calls for only a gradual return to a more neutral stance, informed by how incoming data change the perceived balance of risks for growth and prices.

- *The primacy of domestic objectives*. In fact, it is not obvious that a different policy mix aimed at a stronger yen entails benefits that outweigh the attendant costs and risks. For example, a rebalancing toward looser fiscal policy and tighter credit conditions could be considered, but there is no room for fiscal easing and a monetary tightening sufficient to dampen outflows could be a counterproductive drag on the Japanese economy, stoke deflation, and work against reducing global imbalances.[10] On the whole, the global economy seems better off with a gradual pace of monetary withdrawal in Japan that would secure a continued expansion with benefits elsewhere.

- *Managing international spillovers.* Under these circumstances, prudential regulations, particularly in recipient countries, and greater market discipline would be the first-best policies to manage the risks from rising capital outflows from Japan. Greater cross-border sharing of information by regulators, including on speculative flows, could also highlight potential vulnerabilities.

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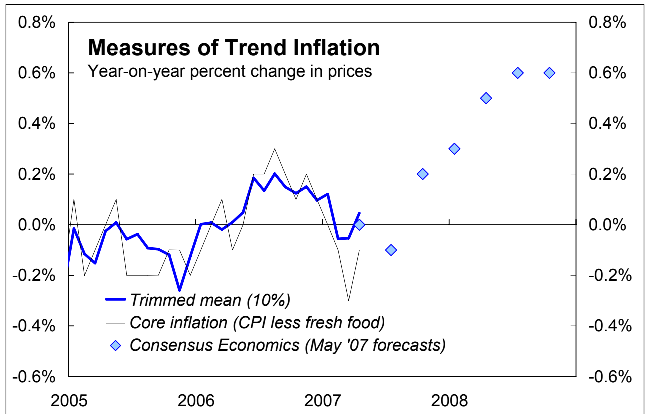
[10] Simulation based on the IMF's Global Economic Model show that a 200 basis point increase in the BoJ's policy rate combined with a fiscal expansion of about 1 percent of GDP reduces growth by about ¾ percentage point below baseline, restarts deflation, and increases the debt ratio with little change in the external surplus. Higher interest rates would also create capital losses for banks and insurers with large bond portfolios.

16. **With little inflation ahead, the mission argued that policy rates need to increase only gradually.**

- *Policy stance in the near term.* With no signs of price pressures or worrisome financial imbalances, a rate hike should be delayed until inflation expectations have recovered and prospective CPI inflation is firmly positive. A cautious approach along these lines would contribute to an environment with a "safety margin" against negative shocks and a return of entrenched deflation.



Sources: Fund staff estimates, Statistics Bureau, and Consensus Economics.

17. **Regarding the BoJ's one-year old monetary framework, discussions centered on how to lift inflation expectations and improve communication.**

- *Anchoring expectations.* In the mission's view, inflation expectations (which appeared to have weakened according to indexed bond prices and some surveys) would be better anchored in positive territory if BoJ communications emphasized that most Policy Board members assess price stability as ranges for CPI inflation with medians close to 1 percent. This emphasis could shift attention away from the often criticized—and misunderstood—zero lower bound of the Board's "understanding of price stability" and support the view that the BoJ would not consider stable CPI inflation at about 1 percent as a policy concern, in and of itself. Signals along these lines could help expand the buffer against a recurrence of deflation.

- *More communication of risks.* The mission noted that communication with the market could also be enhanced through more frequent releases of forward-looking analysis of risks, in the period between the publications of the BoJ's semi-annual *Outlook.* While interim assessments of the *Outlook* have been provided, they could benefit from a more systematic coverage of risks.

18. **Japan's policy of a market-determined exchange rate remains appropriate.**

- *The exchange rate*. The current level of the exchange rate is adding staying power to the expansion without unmanageable domestic side effects. For example, inflation remains extremely subdued, suggesting that rising import prices are not a threat to price stability. And record-high profits at exporting corporates are supporting business investment and personal income (through more generous dividend distributions). On the downside, there are strains at importing firms (a contributing factor to sluggish wage growth) and protectionism overseas is a risk.

- *The impact of capital outflows*. Both structural (i.e., longer-term) and speculative investment flows are depressing the external value of the yen, in spite of the current account surplus. The unwinding of defensive post-bubble financial postures and the search for more diversified portfolios are boosting demand for foreign currency assets by Japanese investors. Low nominal yields on yen assets and very low volatility are also feeding capital outflows, including leveraged carry trades of uncertain size. Some of these factors are likely to create persistent headwinds for a yen appreciation in the period ahead.[11] A deep foreign exchange market and the presence of institutional and retail investors with relatively long horizons mitigate the risks of a sudden shift in sentiment that could trigger a disruptive unwinding of capital flows.

- *External adjustment over the longer term*. Over time, Japan's current account surplus is expected to narrow and the yen to strengthen in real terms. With domestic policies appropriately focused on the pursuit of growth and price stability, the eventual adjustment of the current account will be facilitated not by a change in the current and prospective macroeconomic policy mix, but by far-reaching structural reforms that promote a broad-based increase in labor productivity and the return to capital. As highlighted in the context of the IMF's Multilateral Consultation, these reforms hold out the promise of more vigorous domestic demand and greater capital inflows, which will be accompanied by a stronger real effective yen and a slower accumulation of net foreign assets. On balance, the authorities' intentions regarding macroeconomic, financial, and structural policies are consistent with sustaining both domestic and external stability.

- *Intervention policy.* Against this background, the mission continued to support the official policy that the external value of the yen should remain market determined and appropriate action will only be taken to counter disruptive exchange rate movements. In the context of orderly market conditions, official intervention to absorb excess volatility is not warranted at present. Moreover, with structural capital outflows behind the yen's weakness, official foreign exchange intervention to strengthen the yen would be of uncertain effectiveness and damage the credibility of the authorities' policy. By the same token, the yen should be allowed to appreciate if upward pressures emerge, since the economy can now cope with a stronger currency.

The authorities' views and policy intentions

19. **BoJ officials agreed that monetary action should be geared to domestic conditions, but noted that international spillovers could nonetheless affect policy.**

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[11] Chapter II of *Selected Issues* paper accompanying this report presents econometric evidence on the influence of capital flows on the medium-term dynamics of the yen. The paper finds that in the case of the yen-dollar rate, nontrade factors, such as capital flows related to portfolio rebalancing, are likely to delay the adjustment of the rate to its long-term equilibrium value.

Comparatively low interest rates may be weakening the yen, but this is how the monetary transmission mechanism works. Since the BoJ does not target the exchange rate, the yen enters the economic calculus only indirectly. For example, under the "second perspective" of its framework (which considers low-probability but high-cost financial imbalances a policy concern), the BoJ weighs the risks of imbalances elsewhere feeding back into Japan. This risk does not seems serious at present.

20. **As for the near-term conduct of policy, the BoJ restated its intention to remove monetary accommodation gradually, provided that the expansion continues as expected and financial imbalances do not emerge.** A forward-looking approach to policymaking should not attach undue weight to recent inflation developments which have been weaker than anticipated because of temporary factors. Looking ahead, the signs are for a bottoming out of the CPI and a more secure toehold for inflation. Nonetheless, a broad appraisal of the economy and prices will guide policy decisions, not just prospective CPI developments. The gradual monetary tightening already priced in the yield curve was, in the authorities' view, consistent with their current assessment of outlook and risks.

21. **On communications, the BoJ thought it was doing a good job fostering transparency without tying its hands.**

- *Lifting inflation expectations.* The BoJ noted that it already emphasizes the median view behind the "understanding of price stability" in some official releases. However, a balanced representation of the Policy Board's views could not just highlight the central tendency and gloss over the diversity of opinions. Regarding the currently limited "safety margin" against deflation, the BoJ thought that this vulnerability would dissipate as reflation gathered momentum in the years ahead. Finally, the authorities cautioned against reading too much into surveys of inflation expectations (or break-even inflation from indexed bonds), which typically mirrored recent price developments. In their assessment, longer-term expectations remained stable.

- *Communication strategy.* The BoJ officials made three points. First, major changes in the outlook could be communicated as needed through a wide variety of channels. Second, policymakers value greatly the ability to express freely their own views—and without resorting to "code words." Finally, good communication does not mean spoon feeding information to markets. In particular, outreach should not give away the timing of future policy moves—markets should decide on their own, and set asset prices accordingly.

22. **The authorities agreed that exchange rate policy should continue to be market determined.** Ministry of Finance officials reaffirmed that their policy is unchanged. There is no case for intervention as long as conditions remained orderly and the external value of the yen remained in line with fundamental drivers—currently including structural capital outflows. The authorities thought that any risks associated with speculative carry trades are manageable, since these are likely a fraction of the more stable outflows related to portfolio

rebalancing. Nonetheless, they continue to monitor market developments closely—and warn investors against one-sided risks.

23. **The authorities remained skeptical of estimated deviations of the exchange rate from its medium- or long-term value based on an "equilibrium" current account.** First, the notion of a deviation from a longer-term equilibrium does not appear relevant for a market-determined exchange rate like the yen's. Second, the concept does not take into due account trends in capital flows: financial globalization may have made seemingly large external imbalances sustainable. Third, the role of exchange rate movements in the adjustment is overplayed. For example, Japan's current account surplus had recently reflected rising net investment income in the face of a declining trade balance—a trend that would mute the sensitivity of the external balance to changes in the yen exchange rate. Overall, the officials cautioned strongly against an unqualified public release of staff estimates of exchange rate undervaluation relative to an estimated long-term value which, in their views, do not adequately factor in non-trade fundamentals such as capital flows—and could be misread as forecasts by observers unaware of these issues.

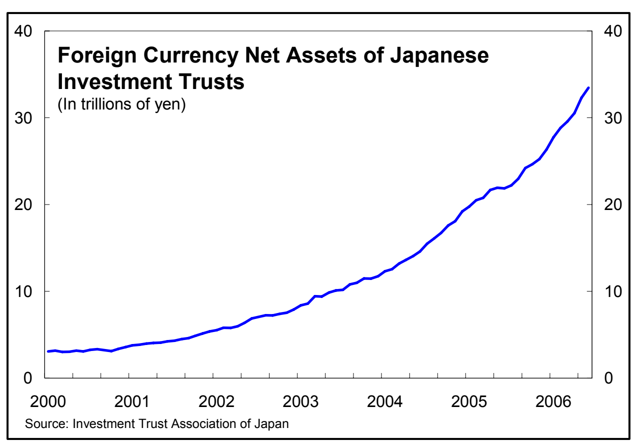
C. Financial Policies for Enhancing Integration and Intermediation

Greater capital flows from and to Japan have enhanced the global intermediation of savings, but they have also created the potential for sudden reversals and financial turbulence. To reap more fully the benefits from integration, financial policies should focus on ways to better manage these risks and enhance intermediation. On the domestic front, the priorities are to raise bank core profitability and develop further the capital markets.

Background

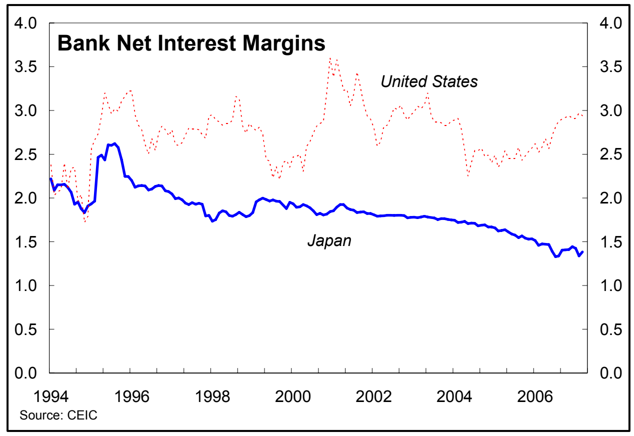
24. **Over the past several years, Japanese retail investors have emerged as a major source of capital outflows, while foreign participation in the Japanese financial markets has increased.**

- *Investment trust funds.* Japanese overseas investment through trust funds has grown by about 50 percent annually since 2003, reaching ¥33 trillion ($280 billion) in May 2007. Retail investors have focused on sovereign bonds in mature economies but recently emerging market bond funds and higher-yielding equity products are becoming more popular. Given household's large holdings of cash and deposits, the potential for further outflows, particularly to the rest of Asia, is large.



- *Inward investment.* Along with improving fundamentals, foreign participation in Japanese markets has increased. Capital inflows, especially to the equity and JGB markets, have picked up. Nonetheless, foreign ownership remains low, and the size of Japan's financial markets lags behind those in other industrial countries.

25. **The financial sector's health and intermediation have improved, but challenges remain.**



- *Bank core profits remain weak.* In FY2006, bank core profits fell, as net interest margins continued to narrow and remain below those in other advanced countries. Regional banks still lag behind their major peers.[12] Profits are likely to come under pressure with competition from foreign entrants and privatized government financial institutions (GFIs).

- *GFI downsizing*. In October 2007, Japan Post will place the savings and life insurance units under a separate holding company and start divestment in 2010–11. The government also plans to halve the loan portfolio of eight GFIs (now worth nearly 20 percent of GDP) by 2008.

- *Consumer finance.* A law has capped some lending rates and opened the door for litigations between borrowers and finance companies. Refunds of excessive payments are straining the capital positions of many lenders and shaking up the industry.

Policy issues and staff views

26. **Regarding capital flows, the objective should be to promote sound risk management and develop further the capital markets.**

- *Enhance investor awareness*. For retail investors, regulators should continue to ensure that brokerage firms provide adequate warning of the risks in foreign currency or highly leveraged investments.

- *Capital market development*. Deeper and more diversified local capital markets—such as for credit derivatives and asset-backed securities—would help intermediate more efficiently cross-border capital flows and improve returns on Japan's large pool of

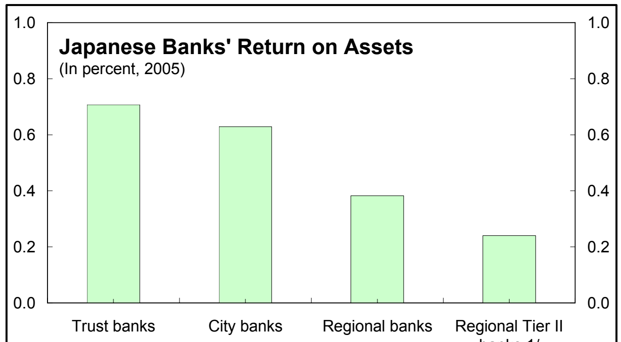
[12] A *Selected Issues* chapter analyzes the comparative efficiency of regional banks.

savings. Greater foreign participation could promote local expertise and strengthen competition.

27. **In the mission's view, the key to higher bank profitability is to strengthen lending practices, bolster bank efficiency, and diversify income sources.**

- *Strengthening lending practices.* Despite progress in bank restructuring, lending margins remain compressed, as banks rely heavily on collateral or relationship lending to guide their credit decisions. A broader sharing of credit information across both banks and nonbanks would support more risk-based (as opposed to collateral based) lending, and foster a market for loan securitization and credit-risk transfer. Further reforms to the regulations governing collateral could help banks secure a wider range of moveable assets to better meet the needs of technology start-ups and SMEs in the service sector.

- *Enhancing regional bank efficiency.* Regional banks suffer from low efficiency and have been unable to exploit economies of scale. A greater pooling of resources and activities, such as risk management and information processing, could lower costs and facilitate consolidation.

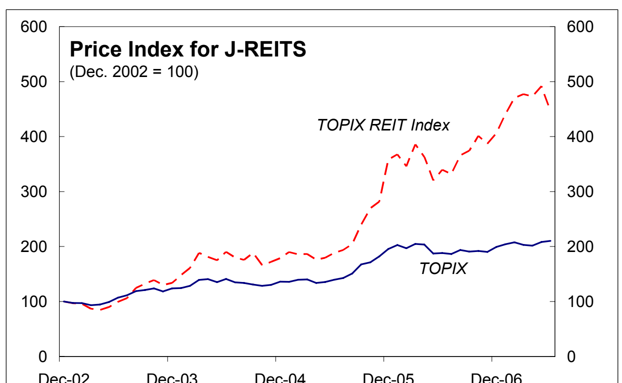


Source: Japanese Bankers' Association.
1/ There are 45 Regional Tier II banks, formerly mutual banks, operating mainly in local areas. Compared to regional banks, Tier II banks are smaller and belong to the Second Association of Regional Banks.

- *Diversifying income sources.* Further deregulation and development of the capital markets could expand non-interest income but would require appropriate changes in supervision.

28. **While the soundness and robustness of the financial system has improved, the mission noted that regulators will need to be mindful of emerging risks and longer-term structural changes.**

- *Possible risks.* The rapid growth and narrow spreads in the J-REIT (Japan Real Estate Investment Trust) market are a potential concern. Establishing reliable price benchmarks and greater transparency would enhance price discovery and risk management. Problems in the consumer finance industry should also be closely followed.



Source: CEIC.

- *Managing GFI reform.* Reform of the GFIs, particularly Japan Post, needs to be carefully managed to ensure a level playing field for all institutions. For Japan Post, it will be important that the successor savings and insurance entities be supervised in the same manner as private institutions and not be allowed to offer new products until the conditions for equal competition are clearly established.

The authorities' views and policy intentions

29. **The authorities agreed that policies should continue to focus on the risks from greater capital flows, the low profitability of banks, and GFI reform.**

- *Supervision and regulations.* On cross-border capital flows, the authorities noted the need for close monitoring (including of hedge funds) and a flexible regulatory structure. In their view, the 2006 Financial Instruments and Exchange Law will strengthen investor protection across products and sectors.

- *Raising bank profitability.* Officials saw diversifying income sources and enhancing risk management as key priorities for boosting bank profits. They agreed that a broader sharing of credit information would strengthen risk management and financial stability and noted progress under the new consumer finance law. Basel II, which began in March 2007, will also help. Regional banks have strived to reduce costs by sharing computer systems and, in some cases, merging, and should be encouraged to do more.

- *Japan Post.* The FSA will supervise the savings and insurance entities in the same manner as private financial institutions and ensure that they have sound risk management systems in place to avoid possible disruptions.

- *Emerging risks.* The authorities are monitoring closely the rapid growth in the J-REIT markets and have warned institutions on attendant risks. For the consumer finance sector, losses have risen sharply, but are within provisioning levels, and the overall impact on credit and consumer spending is likely to be minimal.

30. **Regarding the further development of capital markets, the authorities' strategy centers around enhancing Tokyo's appeal as an international financial center.** Ideas include relaxing barriers between banks and securities firms and consolidating financial exchanges. Although the proposals are in the early stage of discussion, the mission saw potential for banks to diversify into new business lines and for attracting more foreign investment.

D. Structural Reforms to Boost Productivity and Competitiveness

Broader reforms are needed to raise potential growth and strengthen Japan's international competitiveness. Steps to improve the allocation of resources would also help tackle *emerging inequalities (Box 4). The government is implementing reforms on various fronts, but the agenda could be broadened.*

Background

31. **Japan continues to make progress in structural reforms, including with undertakings made in the Multilateral Consultation (MC).** Initiatives have been underway for some time to streamline product market regulation and the public sector, improve labor utilization, and foster competition and trade. Over the last few months, advances have been made in fulfilling several of the MC commitments (Annex I). For example, rules governing M&A involving a foreign company have been clarified, privately run job placement centers have been set up on a pilot basis, workers marginalized by post-bubble labor shedding are being offered new opportunities, and new Economic Partnership Agreements (EPAs) are under consideration.

Policy issues and staff views

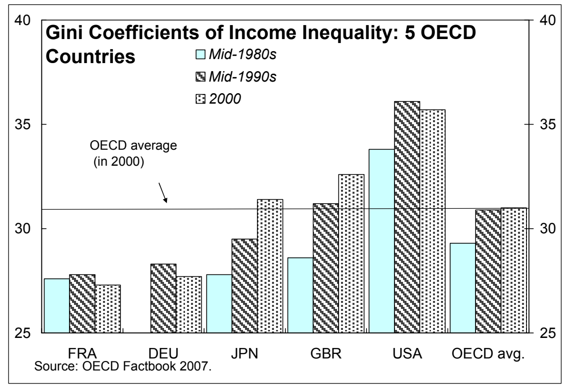
32. **That said, there is still room for deepening reforms in a number of areas.**

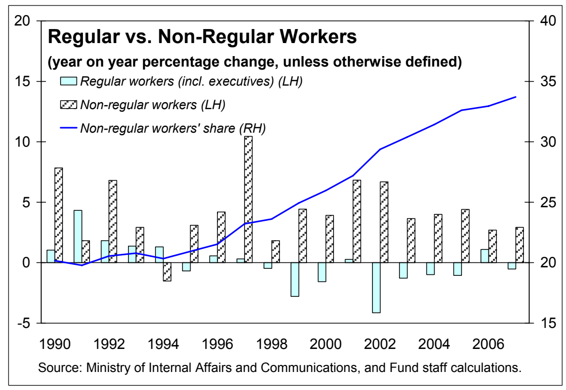
- *Enhancing labor market performance.* Labor utilization would improve with more flexible work arrangements, clearer rules for dismissal or layoffs, greater portability of pensions, and more balanced conditions between regular and temporary workers (e.g., as regards employment protection, social insurance coverage, and training opportunities). A more liberal immigration policy could also play a role.

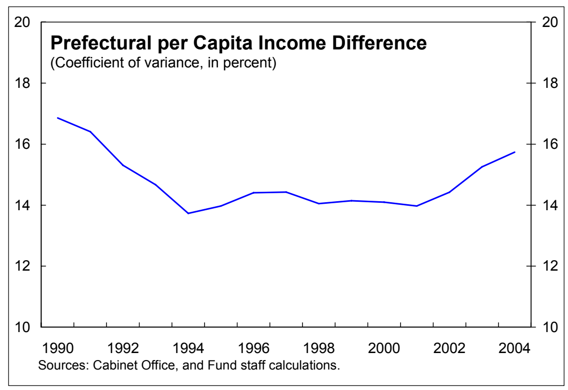
- *Strengthening competition.* Further deregulation and market opening (notably, in services) is necessary to unlock productivity gains.[13] Continued rolling out of successful reforms in the Special Zones and steps to enhance the effectiveness of the Fair Trade Commission could be key to this end.

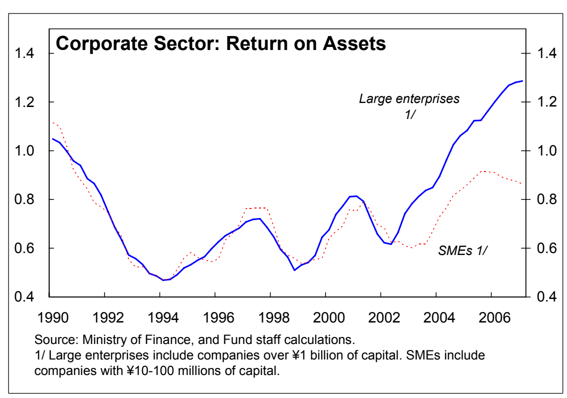
[13] A *Selected Issues* chapter looks at ways to increase productivity in services.

Box 4. Japan's Emerging Economic Dualities









Globalization, technological change, and an aging population have contributed to widening economic disparities, raising concerns that the benefits of Japan's expansion are not being evenly shared. These disparities include those within the labor market, across sectors, between large and small firms, and across regions.

Income inequality. After falling steadily during Japan's high growth post-war period, income inequality, as measured by the Gini coefficient, has risen steadily and now exceeds the OECD average. The rise reflects several factors, including the increasing number of elderly households as well as a widening gap among those 35 years or younger who were more severely affected by the economic stagnation of the late-1990s.

Labor market. Growing inequality is also related to shifts in the labor markets. One notable feature of the recent expansion has been the rise in the share of non-regular workers in the labor force to 34 percent of the labor force in 2007 compared to 20 percent in 1990. In response to global competitive pressures, firms have shifted to hiring mainly non-regular workers who typically earn around 40 percent less than regular worker and are easier to dismiss, although recently this shift has slowed.

Regional inequality. After falling steadily since 1990, income disparities across prefectures also began to rise in 2001, as the more urban and export-oriented regions have exhibited faster growth.

Industrial disparities. Dualities are also emerging across industries, as those with closer links to exports and advanced technology production have benefited more from the expansion. Within manufacturing, IT production since 2000 has increased by about 50 percent while output of non-IT firms has remained nearly flat. The gap between large and small companies in terms of profitability has also widened, reflecting SMEs' larger exposure to the domestic economy.

Structural reforms that enhance market flexibility could help to address these emerging gaps. As highlighted in the April 2007 WEO, Japan is not alone in feeling the effects from globalization and technological change. However, unlike other advanced countries, Japan's labor market institutions may have exacerbated the impact on reducing labor's share in income. Policies to enhance labor market flexibility, improve the financial system, and strengthen competition could help the economy to adjust more quickly in response to these emerging dualities.

- *Trade liberalization.* To enhance benefits for all, the network of bilateral EPAs should work effectively on a regional basis (e.g., through regional cumulation of origin to facilitate the sourcing of inputs) and include low and secure "most favored nation" (MFN) tariffs. At the same time, Japan could also play a leadership role in encouraging its EPA partners to lower their MFN tariffs and work toward an ambitious Doha Round agreement (Annex II).
- *Agricultural reform.* Recent steps on eligibility criteria should facilitate a shift in farm support from trade barriers to direct income assistance. Reforms of agricultural cooperatives and land use could support moves to allow nationwide entry of joint-stock companies.

The authorities' views and policy intentions

33. **The authorities have outlined action plans for further reforms in the *2007 Basic Policies*.** The document (released after the mission) lays out in broad contour a strategy to enhance Japans' growth potential, capitalize on the opportunities offered by globalization, modernize fiscal structures and intergovernmental relations, and strengthen the education system. In particular:

- *Boosting productivity.* A key objective of the strategy is to boost by 50 percent labor productivity growth in five years. Improved labor utilization and greater dynamism at SMEs and in services will be pursued (among other things) by fostering deregulation, the accumulation of human capital, and IT investment. A "job card" system to facilitate hiring decisions and labor mobility through an official record of individual employment histories is also under development.
- *Addressing globalization*. The economy's growth potential will also be raised by (at least) tripling the number of preferential trade agreements and EPAs in force over the next two years and by strengthening further the financial and capital markets. Steps to improve the flexibility of the labor market and the resilience of regional economies are also on the agenda. A plan for agricultural reforms will be elaborated this fall.

34. **The authorities saw a rapid conclusion to the Doha Round as important for Japan and the rest of the world.** They noted that their recent extension of duty and quota-free access to 98 percent of tariff lines has increased access for LDCs. In their bilateral EPAs, they are seeking to include clear liberal rules of origin with regional cumulation to promote a regional supply chain.

IV. Staff Appraisal

35. **The economic outlook for Japan remains favorable.** Growth has become more broad-based, as robust corporate profits continue to lift business investment and external demand, particularly in Asia, remains strong. Although wages continue to be sluggish, the labor market is tightening and the quality of jobs is improving. These positive developments

have propelled the expansion—the longest in Japan's post-war history—into its sixth year and are expected to continue over the near term. Inflation remains disappointedly low, due mainly to temporary factors and global competitive pressures, but should rise gradually as the economy operates close to potential.

36. **The expansion has been accompanied by increased integration with the global economy.** Japan's openness to trade is rising, while a fading home bias and low domestic interest rates have encouraged Japanese investors to seek higher returns overseas. At the same time, improving prospects at home have boosted foreign participation in the corporate and financial sectors. Closer financial and trade integration have also created two-way channels for spillovers and added a new dimension to policy making.

37. **The favorable economic performance has been supported by appropriate macroeconomic and structural policies, but important tasks remain on the policy agenda.** The priorities are to secure fiscal sustainability, to further strengthen the financial system, and to boost productivity through deeper structural reforms. Achieving these goals will help Japan not only to cope with the cost of an aging society and improve medium-term growth prospects, but also to facilitate the adjustment to the quickening pace of globalization.

38. **Significant progress has been made in reducing the fiscal imbalance, but more is needed.** Buoyant corporate tax revenue and spending cuts have helped to reduce the deficit and stabilize the public debt ratio. Public debt remains uncomfortably high and pressures from an aging society are mounting. Although robust growth ahead may ease the urgency of adjustment, a stepped-up pace of consolidation will buy "policy insurance" against shocks and support private spending by alleviating concerns on social entitlements. Faster progress could also bolster market confidence as the JGB market becomes more globalized.

39. **Given the size of the task, additional revenue measures are needed.** Revenue measures could be best identified in the context of a broad reform of the tax system that addresses the challenges posed by Japan's aging society and globalization. Among the possible measures, increasing the consumption tax has the benefit of being more supportive of growth and more equitable across generations.

40. **Monetary policy remains appropriately accommodative in the very low inflation environment.** Given the muted outlook for prices and absence of worrisome financial imbalances, monetary policy should remain supportive. The return to a neutral monetary stance should proceed in tandem with improved inflation prospects. To better guide expectations, communications of the monetary framework could rely on additional forward-looking policy statements. A greater emphasis of the 1 percent median within the Policy Board members' range of understanding on price stability could also contribute to anchor expectations firmly in positive territory.

41. **With the health of the banking system improving, financial policies are rightly focused on the challenges ahead.** A growing appetite for investing in risky assets—both

domestic and foreign—calls for continued regulatory vigilance and sound risk management. For banks, the priorities are to raise core profitability by diversifying income sources and enhancing lending practices. Further development of the capital markets will strengthen the financial system, help allocate more efficiently Japan's large savings, and ultimately promote growth and efficiency in the economy at large. The reform of the government financial institutions should be managed carefully to ensure a level playing field for all institutions.

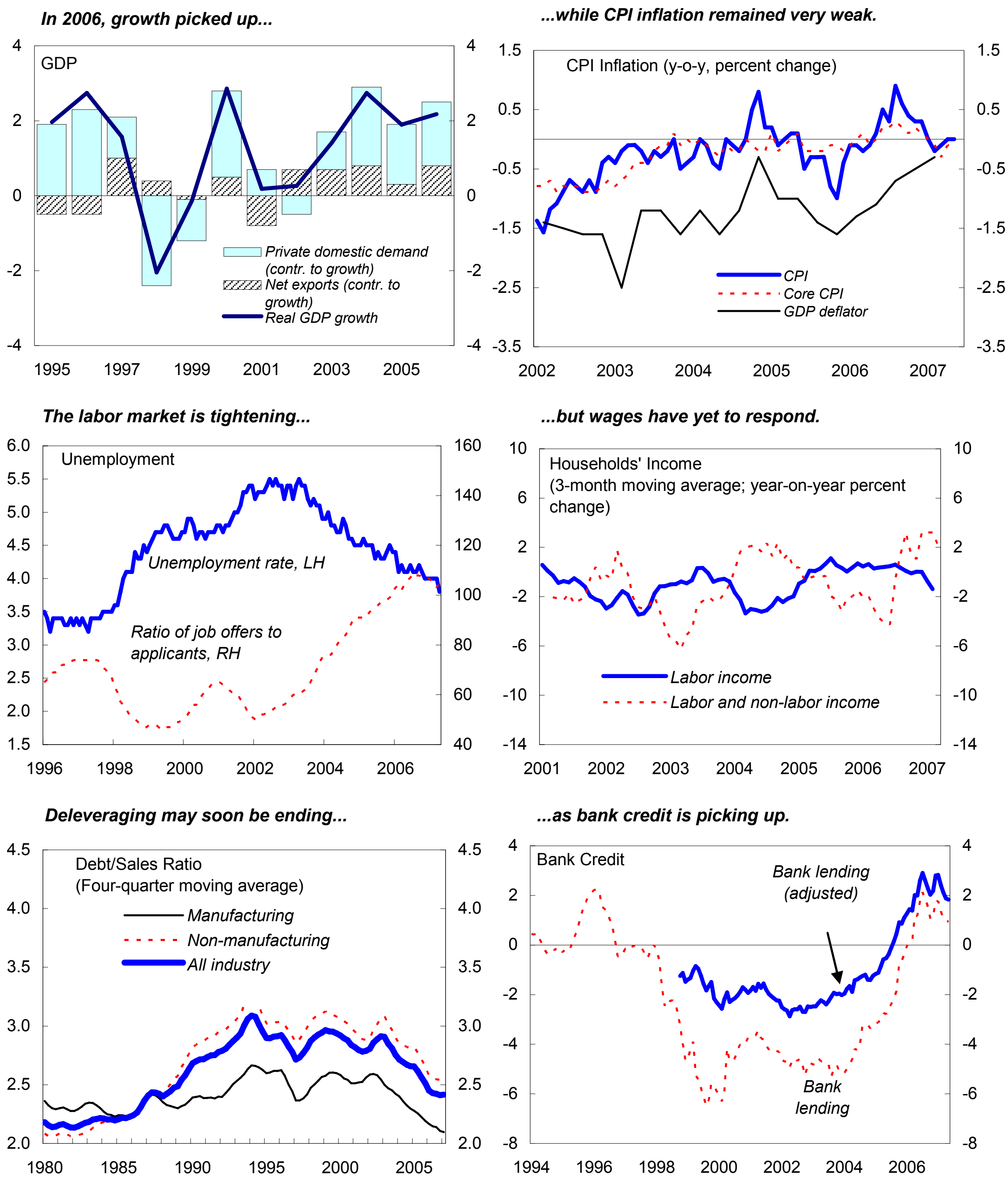
42. **More broadly, deeper structural reforms are needed to improve Japan's growth potential and international competitiveness.** As highlighted by the recent Multilateral Consultations, the broad reform priorities are to improve labor utilization and promote competition through greater market opening and further deregulation.

43. **The authorities' policy intentions are broadly appropriate to promote an orderly reduction of Japan's large current account surplus—and the yen should continue to be market determined.** The yen appears to be misaligned relative to its long-term value in real effective terms, notwithstanding the correct focus of macroeconomic and structural policies. A narrowing of Japan's current account to its longer-term equilibrium level will be facilitated by policy reforms that support domestic demand and capital inflows, paving the way for a stronger yen over time. However, the external adjustment will likely be protracted in part because of persistent capital outflows linked to portfolio rebalancing by Japanese retail and institutional investors.

44. **Finally, in expanding bilateral trade, Japan should also look multilaterally to secure a balanced and ambitious Doha Round agreement.** Lowering tariffs on a most favored nation–basis globally would limit the discrimination inherent in preferential trade agreements, while using rules of origin provisions would ensure that bilateral Economic Partnership Agreements work effectively on a regional level.

45. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

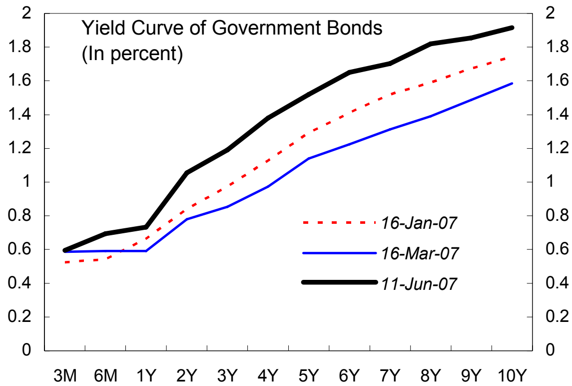
Figure 1. Japan: Output, Inflation, Corporations and Banks



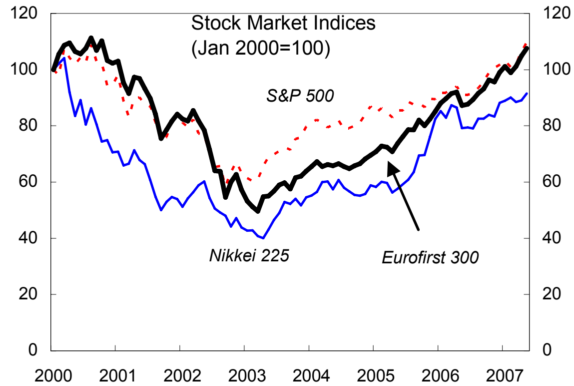
Sources: Haver Analytics; CEIC; FSA; Ministry of Finance.

Figure 2. Japan: Financial Markets

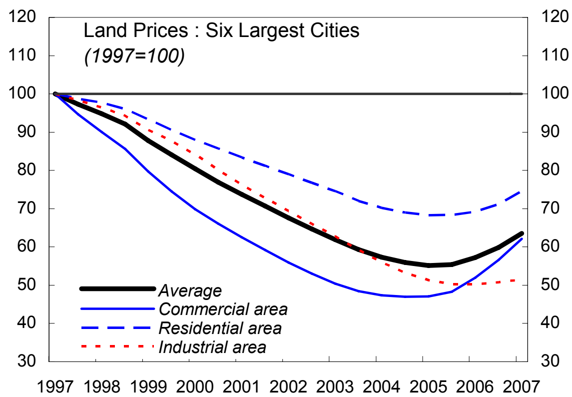
The yield curve has steepened...



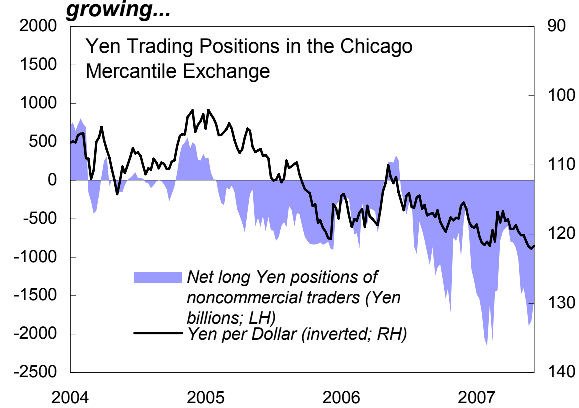
...while equity prices have risen in line with other mature markets.



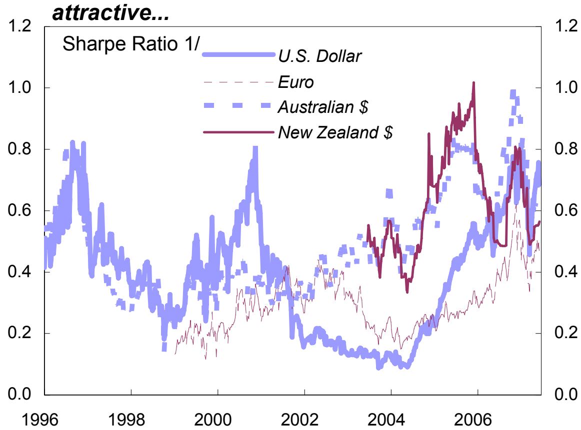
Land prices are recovering.



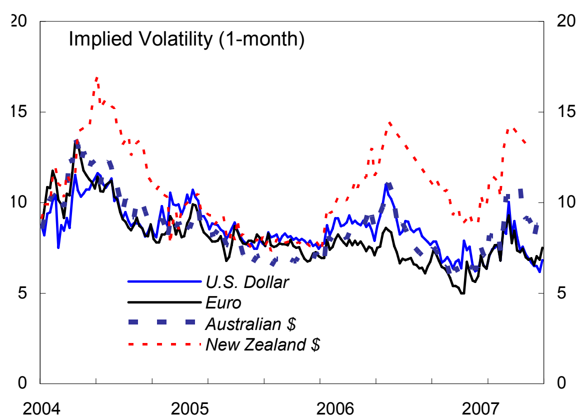
Since February, net short yen positions are growing...



...as "carry" target currencies remain attractive...



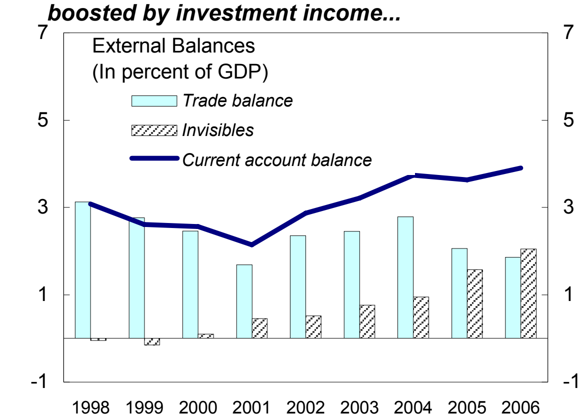
...in part because of low volatility.



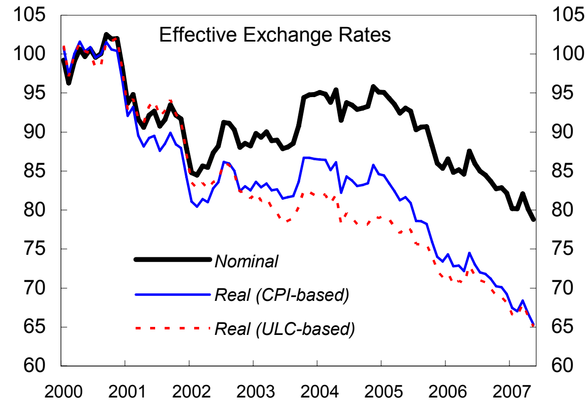
Sources: Tullet Prebon; Bloomberg; CEIC; Nomura database; Reuters.
1/ The Sharpe ratio (defined as: 1-month interest rate differential divided by implied volatility in bilateral exchange rate) is a measure of the risk adjusted return on Yen carry trade.

Figure 3. Japan: External Sector, Monetary and Fiscal Policy

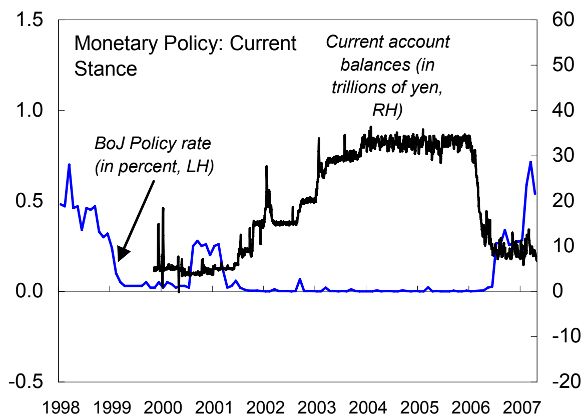
In 2006, the current account surplus rose, boosted by investment income...



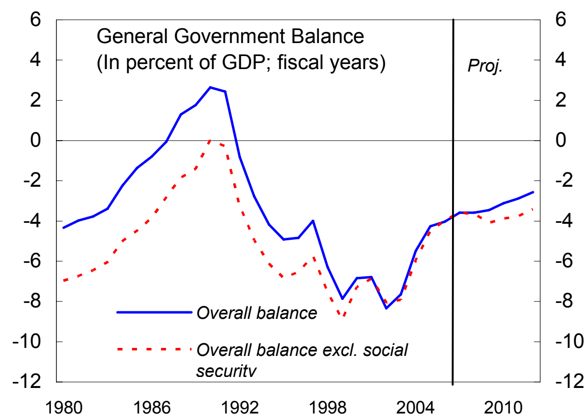
...while the REER is at record lows.



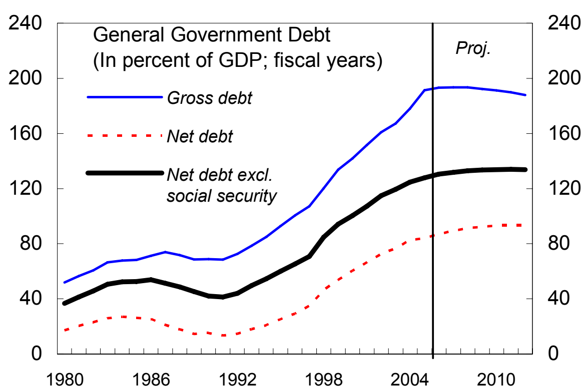
Monetary policy remains accomodative...



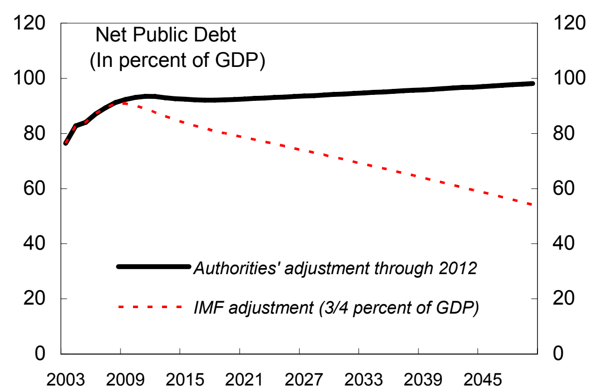
...and fiscal consolidation is proceeding.



The public debt ratio is still rising...



...underscoring the need for faster consolidation.



Sources: CEIC; Nomura; INS, Information Notice System; Ministry of Finance; Bank of Japan; and staff calculations.

Table 1. Japan: Selected Economic Indicators, 2003–08

Nominal GDP: US$4,365 billion (2006)
Population: 127.7 million (2006)
GDP per capita: US$34,170 (2006)
Quota: SDR 13,312.8 million

					Proj.	
	2003	2004	2005	2006	2007	2008
Growth (percent change) 1/						
Real GDP	1.4	2.7	1.9	2.2	2.6	2.0
Domestic demand	0.8	1.9	1.7	1.4	1.7	1.9
Private consumption	0.4	1.6	1.6	0.8	1.7	2.0
Residential investment	-1.0	1.9	-1.3	1.0	0.8	1.4
Business investment	4.4	5.6	6.6	7.5	4.4	3.8
Government consumption	2.3	1.9	1.7	0.4	0.8	1.0
Public investment	-10.8	-9.0	-6.2	-7.4	-3.8	-2.8
Stockbuilding 2/	0.2	0.3	-0.1	0.1	0.0	0.0
Net exports 2/	0.7	0.8	0.3	0.8	0.8	0.1
Exports of goods and services	9.2	13.9	7.0	9.6	7.5	5.3
Imports of goods and services	3.9	8.1	5.8	4.5	2.8	6.6
Inflation (annual average)						
CPI (SA) 3/	-0.2	0.0	-0.6	0.2	0.0	0.5
CPI (NSA) 3/	-0.2	0.0	-0.3	0.2	0.0	0.5
GDP deflator	-1.6	-1.1	-1.3	-0.9	-0.7	0.1
Unemployment rate (annual average)	5.3	4.7	4.4	4.1	3.9	3.9
Government (percent of GDP, fiscal year basis)						
General government						
Revenue	28.0	28.6	29.9	30.4	31.3	31.7
Expenditure	35.6	34.1	34.1	34.3	34.8	35.1
Balance	-7.7	-5.5	-4.3	-4.0	-3.5	-3.4
Primary Balance	-6.3	-4.4	-3.5	-2.8	-2.0	-1.6
Primary Balance excluding social security	-5.7	-4.0	-2.8	-2.1	-1.2	-0.8
Money and credit (percent change, end-period)						
Base money	13.2	4.2	1.0	-20.0	-4.1 5/	...
M2 plus CDs (period average)	1.7	1.9	1.8	1.1	1.8 5/	...
Domestic credit	3.9	-1.2	-0.3	-0.9	-1.3 6/	...
Bank lending (after adjustment)	-2.0	-1.2	1.1	2.8	1.6 5/	...
Interest rate						
Three-month CD rate (annual average)	0.09	0.06	0.06	0.22	0.50 5/	0.55 7/
Official discount rate (end-period)	0.10	0.10	0.10	0.40	0.75 5/	...
Balance of payments (in billions of US$)						
Current account balance	136.2	172.1	165.7	170.4	181.7	175.8
Percent of GDP	3.2	3.7	3.6	3.9	4.2	4.0
Trade balance	104.0	128.5	93.8	81.1	91.2	84.9
Percent of GDP	2.5	2.8	2.1	1.9	2.1	1.9
Exports of goods, f.o.b.	449.2	539.1	567.4	615.7	636.0	662.4
Imports of goods, f.o.b.	345.2	410.6	473.6	534.6	544.7	577.5
Oil imports (trade basis)	59.2	72.4	99.2	123.3	119.7	124.7
Terms of trade (percent change)	1.7	-2.2	-5.2	-6.9	-0.5	-1.3
Change in reserves	188.1	161.0	22.3	32.0	...	...
Total reserves minus gold (in billions of US$)	663.3	833.8	834.3	879.7	897.6 5/	...
Exchange rates (annual average)						
Yen/dollar rate	115.9	108.2	110.2	116.3	122.6 5/	123.4 7/
Yen/euro rate	131.1	134.5	137.3	146.0	164.8 5/	168.2 7/
Real effective exchange rate 4/	80.6	79.7	76.0	70.5	64.1 5/	...

Sources: Global Insight, Nomura database; IMF, Competitiveness Indicators System; and Fund staff estimates and projections as of June 25, 2007.

1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ Contribution to GDP growth.
3/ Annual growth rates are calculated from annual averages of monthly data.
4/ Based on normalized unit labor costs; 2000=100.
5/ June 2007.
6/ April 2007.
7/ July 11, 2007.

Table 2. Japan: General Government Operations, 2002–07 1/

(In percent of GDP)

	2002	2003	2004	2005	2006 Est.	2007 Proj.
Total revenue	28.7	28.0	28.6	29.9	30.4	31.3
Taxes and fines	16.2	15.7	16.3	17.3	17.8	18.6
Social security premiums	10.6	10.5	10.5	10.6	10.7	10.9
Property income	1.7	1.5	1.5	1.8	1.6	1.7
Total expenditure	37.0	35.6	34.1	34.1	34.3	34.8
Current	31.1	30.9	30.7	30.5	31.0	31.5
Consumption	11.9	11.9	11.8	11.7	11.6	11.5
(less) Depreciation	-2.9	-2.9	-3.1	-3.1	-3.1	-3.1
Social security benefits	15.6	15.7	15.9	16.1	16.3	16.5
Other current	3.5	3.6	3.5	3.4	3.4	3.4
Interest paid	2.9	2.7	2.5	2.4	2.7	3.2
Capital	5.9	4.8	3.4	3.6	3.3	3.3
Investment	4.7	4.3	3.7	3.7	3.2	3.1
Land acquisition	0.6	0.6	0.4	0.4	0.4	0.3
Capital transfers	0.6	-0.1	-0.8	-0.5	-0.2	-0.1
Of which : Bank support	0.3	0.0	0.0	0.0	0.0	0.0
Balance	-8.3	-7.7	-5.5	-4.3	-4.0	-3.5
Primary balance	-6.9	-6.3	-4.4	-3.5	-2.8	-2.0
Excluding social security	-5.6	-5.7	-4.0	-2.8	-2.1	-1.2
Structural balance 2/	-7.0	-6.9	-4.9	-4.0	-3.9	-3.5
			(Calendar year)			
Total revenue	29.1	28.8	28.1	29.4	30.2	31.0
Taxes and fines	16.5	16.0	15.9	16.8	17.7	18.4
Social security premiums	10.5	10.9	10.4	10.6	10.7	10.8
Property income	1.8	1.6	1.5	1.7	1.6	1.6
Total expenditure	37.1	36.8	34.2	34.2	34.3	34.7
Current	31.2	31.2	30.7	30.7	30.9	31.3
Consumption	12.0	12.0	11.8	11.8	11.7	11.5
(less) Depreciation	-2.8	-2.9	-3.0	-3.1	-3.1	-3.1
Social security benefits	15.5	15.7	15.8	16.1	16.3	16.5
Other current	3.5	3.6	3.5	3.5	3.4	3.4
Interest paid	3.0	2.7	2.5	2.4	2.6	3.0
Capital	5.9	5.6	3.5	3.5	3.4	3.3
Investment	4.8	4.3	3.9	3.7	3.3	3.1
Land acquisition	0.6	0.6	0.5	0.4	0.4	0.3
Capital transfers	0.5	0.7	-0.9	-0.6	-0.3	-0.1
Of which : Bank support	0.2	0.1	0.0	0.0	0.0	0.0
Balance	-8.0	-8.0	-6.2	-4.8	-4.1	-3.6
Primary balance	-6.6	-6.7	-5.0	-4.0	-3.0	-2.2
Excluding social security	-5.5	-6.0	-4.7	-3.5	-2.3	-1.4
Structural balance 2/	-6.8	-6.9	-5.7	-4.4	-3.9	-3.7
Debt (In percent of GDP, calendar year)						
Gross	160.9	167.2	178.1	191.4	193.1	193.1
Net	72.6	76.5	82.7	84.0	87.1	89.1
Memorandum items :						
Nominal GDP (FY, trillion yen)	489.9	493.7	498.3	503.3	510.4	519.2
Nominal GDP (CY, trillion yen)	491.3	490.3	498.3	501.3	507.7	517.3

Source: Fund staff estimates.

1/ Estimated from the National Income Accounts data. The fiscal year is April through March.

2/ Excluding bank support.

Table 3. Japan: External and Financial Indicators, 2002–07

(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007 Latest
External indicators						
Real exports of goods and services (percent change)	7.4	9.2	14.0	6.9	9.6	…
Real imports of goods and services (percent change)	0.9	3.9	8.1	5.9	4.6	…
Terms of trade (percent change)	1.0	1.7	-2.2	-5.2	-6.9	…
Current account balance	2.9	3.2	3.7	3.6	3.9	…
Capital and financial account balance	-1.7	1.5	0.3	-2.7	-2.5	…
Of which :						
Inward portfolio investment	-0.5	1.9	4.3	4.0	4.6	…
Inward direct investment	0.2	0.1	0.2	0.1	-0.1	…
Other investment liabilities (net)	1.6	4.4	0.4	-1.4	-4.0	…
Total reserves minus gold (US$ billion)	461.2	663.3	833.8	834.3	879.7	897.6
In months of imports of goods and services	14.0	18.1	19.1	17.0	16.3	…
Broad money (M2 + CDs) to reserves ratio	1.1	0.9	0.8	0.8	0.7	0.7
Foreign assets of DMBs (US$ billion)	975.4	938.4	1081.7	1255.6	…	…
Foreign liabilities of DMBs (US$ billion)	710.4	681.7	748.8	819.8	…	…
Net international investment position (US$ billion)	1,462.2	1,613.6	1,784.5	1,531.8	…	…
Of which :						
External loan liabilities	668.0	721.7	839.0	860.2	…	…
External public sector debt (gross) 1/	189.1	205.6	319.0	383.2	…	…
External loan liabilities to exports ratio	1.5	1.4	1.4	1.3	…	…
External interest payments to exports (in percent) 2/	2.3	1.7	1.4	1.7	2.5	…
Nominal effective exchange rate (percent change)	-4.5	3.1	3.9	-3.2	-7.0	-6.1
Financial market indicators						
General government gross debt	160.9	167.2	178.1	191.4	193.1	...
Interest rates (percent, end-year)						
3-month General collateral repo rate	0.01	0.01	0.01	0.01	0.47	0.60
3-month General collateral repo rate, real	0.31	0.41	-0.19	0.41	0.67	0.60
3-month interest rate spread vis-à-vis U.S.	-1.19	-0.89	-2.19	-3.88	-4.37	-4.27
Stock market index (TOPIX, percent change, end-year) 3/	-18.3	23.8	10.2	43.5	1.9	11.1
Banking sector risk indicators						
Total loans to assets (in percent)	38.2	34.6	32.6	31.0	28.6	...
Total loans to deposits (in percent)	87.3	81.9	78.8	78.4	79.5	...
Share of real estate sector in total lending (in percent)	14.6	13.8	16.0	16.5	16.5	...
Share of nonperforming loans in total loans						
(In percent, end-fiscal year) 4/	7.2	5.2	2.9	1.8	1.5	...
Risk-weighted capital ratio (in percent, end-fiscal year) 4/	9.4	11.2	11.6	12.2	13.1	...

Sources: Global Insight, Nomura Database; IMF, International Financial Statistics; Fitch IBCA; and Fund staff estimates.

1/ Public sector debt securities and other loan liabilities.

2/ Other investment income, debit.

3/ Twelve-month percent change for the latest figure.

4/ Major banks. Capital ratio is on a nonconsolidated basis.

Table 4. Japan: Balance of Payments, 2001–06

	2000	2001	2002	2003	2004	2005	2006
	(In billions of U.S. dollars)						
Current account	**119.6**	**87.8**	**112.6**	**136.2**	**172.1**	**165.7**	**170.4**
Trade balance	114.9	69.2	92.5	104.0	128.5	93.8	81.1
Exports	459.6	383.5	395.7	449.2	539.1	567.4	615.7
Imports	344.6	314.4	303.2	345.2	410.6	473.6	534.6
Invisibles	4.7	18.6	20.1	32.2	43.6	71.8	89.3
Nonfactor services	-45.9	-42.7	-40.7	-31.4	-34.3	-24.1	-18.2
Investment income	60.4	69.3	65.9	71.3	85.8	103.6	118.2
Labor income	0.0	0.0	-0.1	-0.1	-0.1	-0.1	0.0
Net transfers	-9.8	-7.9	-4.9	-7.5	-7.9	-7.6	-10.7
	(In percent of GDP)						
Current balance	2.6	2.1	2.9	3.2	3.7	3.6	3.9
Trade balance	2.5	1.7	2.4	2.5	2.8	2.1	1.9
Invisibles	0.1	0.5	0.5	0.8	0.9	1.6	2.0
Nonfactor services	-1.0	-1.0	-1.0	-0.7	-0.7	-0.5	-0.4
Investment income	1.3	1.7	1.7	1.7	1.9	2.3	2.7
Labor income	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net transfers	-0.2	-0.2	-0.1	-0.2	-0.2	-0.2	-0.2
	(In billions of U.S. dollars)						
Capital account	-9.3	-2.9	-3.3	-4.0	-4.8	-4.9	-4.7
Financial account	-127.3	-88.6	-109.5	-115.5	-138.5	-144.8	-134.7
Direct investment, net	-23.4	-32.3	-23.0	-22.5	-23.3	-42.2	-56.7
Direct investment abroad	-31.6	-38.5	-32.0	-28.8	-31.1	-45.4	-50.2
Foreign direct investment in Japan	8.2	6.2	9.1	6.3	7.8	3.2	-6.4
Portfolio investment, net	-35.1	-46.8	-105.8	-97.3	24.6	-12.0	127.4
Of which: Official	72.9	17.4	1.7	5.7	95.1	52.6	104.6
Inflows	-82.8	-107.0	-86.7	-177.9	-173.7	-196.2	-71.8
Outflows	47.7	60.3	-19.1	80.6	198.3	184.1	199.2
Other investment, net	-19.5	31.5	66.0	192.4	21.1	-68.2	-173.4
Of which: Official	-4.2	2.2	0.2	8.8	4.1	25.6	-24.8
Inflows	102.9	147.2	116.0	215.3	8.1	122.5	57.6
Outflows	-122.4	-115.7	-50.0	-22.9	13.0	-190.7	-231.0
Reserve assets	-49.3	-41.1	-46.7	-188.1	-161.0	-22.3	-32.0
Errors and omissions, net	17.0	3.7	0.2	-16.8	-28.8	-16.1	-31.0
Memorandum items :							
Nominal GDP (US$ billion)	4667.4	4095.5	3918.3	4229.1	4605.9	4548.6	4365.1
Net foreign assets (NFA)/GDP	28.8	35.2	39.4	39.4	39.8	43.9	49.7
Return on NFA (In percent)	4.5	4.8	4.3	4.3	4.7	5.2	5.5

Sources: Global Insight, Nomura database; and Fund staff calculations.

ANNEX I. JAPAN: POLICY PROGRESS AND PLANS RELEVANT TO THE IMFC STRATEGY[1]

Over the past year, developments in Japan's policies related to the IMFC strategy included:

- **Incentives to encourage young and female labor force participation.** Expenditures for reducing skills mismatches for women and younger workers have been included in the FY2007 budget, and tax relief for FY2007–08 expenditures on child care has been raised. A stronger law on equal job opportunity has been passed and will take effect in FY2007. Job placement services have been partly liberalized.
- **Measures to enhance competition.** A new antimonopoly law granting stronger authority to the Fair Trade Commission was enacted in April 2005 and has been effective since January 2006.
- **Advancing fiscal consolidation**. In order to forestall a possible loss of confidence to the economy, which could result in adverse external spillovers, and in order to achieve sustainable private demand-led growth, the government has been making every effort to advance fiscal consolidation. In the FY2007 budget, the issuance of new government bonds is reduced by ¥4.5 trillion (15 percent in year-on-year terms), the largest such reduction in history. As a result, the primary deficit of the central and local governments combined will be reduced from 1.7 percent of GDP in FY2006 to 0.6 percent of GDP in FY2007.

Looking forward, Japan's policy plans include the following:

- **Labor market reforms.** A bill to extend pension coverage to temporary workers is in the works, and some job placement services are under "market testing" with a view toward further liberalization. Reform priorities (to be elaborated in June), for inclusion in the cabinet's Basic Policies for FY2007, include enhancing labor mobility and market attachment, and retraining marginalized workers.
- **Facilitating inward foreign direct investment (FDI).** The tax treatment of mergers and acquisitions involving non-cash transactions is under parliamentary debate. The government will implement the program for acceleration of FDI in Japan in order to achieve its strategic goal to increase the FDI stock to 5 percent of GDP by 2010.
- **Strengthening competition in key sectors.** The importance of raising productivity, especially in the non-tradable sector, is well recognized. The government has worked out modalities for rolling out the deregulation measures in the "Special Zones for Structural Reform." A draft bill for reform and eventual privatization of some government-owned financial institutions is under legislative review. A Council of Economic and Fiscal Policy committee is looking at ways to promote additional Economic Partnership Agreements bilaterally and regionally. Agricultural and immigration reforms will also be addressed.
- **Further advancing fiscal consolidation.** The government has set fiscal targets to reduce the debt-to-GDP ratio in a stable manner by the mid 2010s and, as a first step, to achieve a surplus in the primary balance of the central and local government combined by 2011.

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[1] As reported by the authorities in the IMF Press Release 07/72 of April 14, 2007 (www.imf.org).

ANNEX II. JAPAN'S ECONOMIC PARTNERSHIP AGREEMENTS (EPAS): UPDATE AND ISSUES

1. **Extensive global trade relationships give Japan a strong interest in a liberal, non-discriminatory trade system, but also a role in helping shape regional trade relations.** Japan has entered EPAs with Singapore (2002), Mexico (2005), and Malaysia (2006), and signed EPAs with the Philippines (2006), Brunei, Chile, and Thailand (all in 2007). Negotiations are underway with ASEAN, Korea, Indonesia, and Vietnam and, more recently, Australia, the GCC, India, and Switzerland. Japan is also interested in EPAs with the EU and the United States, and by 2009, the authorities aim to sign twelve EPAs.

2. **Evolving regional trade relations raise several broad issues for Japan.** As non-discriminatory trade reforms have helped to more tightly integrate regional manufacturing trade, preferential arrangements run the risk of fracturing, instead of reinforcing, this trade. The issue arises as to whether overlapping bilateral/sub-regional arrangements, which discriminate against the largest bilateral flows in the region (among China, Japan, and Korea), should evolve toward a broader pan-regional EPA. Some proposals include a "ASEAN Plus Three" (China, Japan, Korea), an "ASEAN Plus Six" (Australia, China, India, Japan, Korea, New Zealand), and a FTA of the Asia Pacific, but no single structure has emerged.

3. **A pan-regional approach to rules of origins (RoO) and their cumulation would support greater regional integration, even without a full regional structure.**[1] Restrictive RoO encourage PTA partners to source inputs from one another to qualify a final product for preference, extending protection given by each country to producers in partner countries. In its EPA negotiations with ASEAN, Japan proposes relatively transparent and liberal RoO—a value-added criterion to convey preference and (alternatively) a change in tariff classification criterion (CTC),[2] a relatively liberal and transparent approach, as RoO in some FTAs are very sector specific. Japan also expects its agreement with ASEAN to allow cumulation of origin throughout ASEAN and Japan. Such regional cumulation provisions mimic advantages of regional, versus bilateral and sub-regional, agreements. The Pan-European Cumulation System (PECS) brought common RoO and regional cumulation to the Euro-Mediterranean area from the late 1990s and may provide important lessons in this regard.

4. **Agricultural reforms within EPAs should be balanced with MFN-based reforms**. Japan has so far limited agriculture's role in EPAs, but this may prove increasingly difficult as it pursues EPAs with major farm exporters. Bilateral agricultural reforms could lead to subsequent MFN-based reforms. However, the risk in this sequencing is that preferential access to those heavily-protected markets in Japan could cause significant trade diversion—and possibly trade tensions. As EPAs extend further to agriculture, it will be important that they be balanced with MFN-based reforms, either unilaterally or in the Doha Round.

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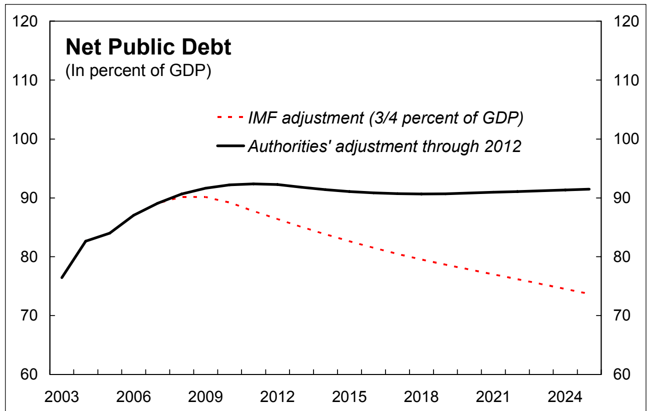
[1] RoO determine whether a shipment of goods has originated in a partner country and is eligible for preferences.
[2] The CTC criterion is applied at the 6-digit (relatively liberal) or, for some sectors, at more aggregate levels.

ANNEX III. JAPAN: PUBLIC SECTOR DEBT SUSTAINABILITY ANALYSIS

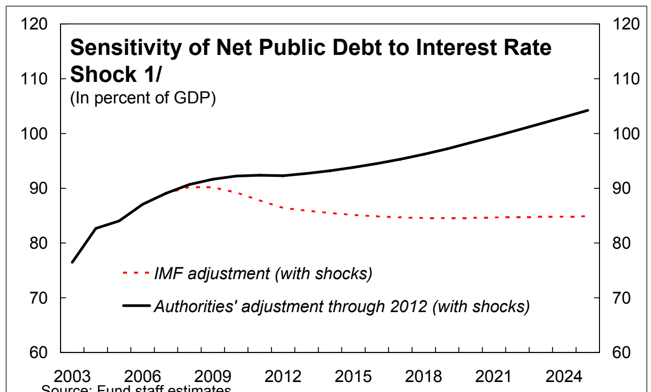
1. **The staff has updated its assessment of Japan's medium-term public debt sustainability, on the basis of the government's announced fiscal goals.** (The macroeconomic assumptions are based on the latest WEO.) The goals of the authorities' plan are two-fold: first to achieve a primary surplus (excluding social security) by FY2011, then to reduce the debt-to-GDP ratio by the mid-2010s (Box). The baseline scenario assumes the five-year expenditure-reduction plan (FY2007–11) under the Basic Policies 2006, and the same pace of consolidation in FY2012. The projections also include the 2009 increase in the central government's state contribution to the pension fund and other recent pension and medical care reforms.



Source: Fund staff estimates.

2. **The analysis suggests that the authorities are likely to achieve their goal of a primary surplus by 2011, but fall short of reducing the debt ratio.** Under the authorities' medium-term plans, the net public debt ratio is projected to stabilize at above 90 percent of GDP. Further adjustment is needed to put the debt ratio on a downward path.

3. **The analysis highlights the sensitivity of the debt dynamics to an interest rate shock and the benefits from a faster pace of consolidation.** For example, with a 100 basis point increase in the real interest rate (more than a one-standard deviation shock) from 2010 onwards, the debt-to-GDP ratio would reach 106 percent by 2025 and keep rising. Under the staff's proposed scenario which envisions an earlier and larger adjustment in the primary balance excluding social security amounting to ½ percent of GDP a year more than in the authorities' reference path, the debt ratio would still fall somewhat and stabilize at around 87 percent of GDP.



Source: Fund staff estimates.
1/ Permanent 100 basis point shock to real interest rate from 2010 and unchanged primary balance.

Public Sector Debt Sustainability Framework, 2002–2012
(In percent of GDP, unless otherwise indicated)

	Actual				Proj.			Projections						
	2002	2003	2004	2005	2006			2007	2008	2009	2010	2011	2012	
								I. Baseline Projections						**Debt-primary balance 10/**
Public sector debt 1/	72.6	76.5	82.7	84.0	87.1			**89.1**	**90.7**	**91.6**	**92.2**	**92.4**	**92.3**	**0.1**
o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Change in public sector debt	6.3	3.9	6.2	1.3	3.1			2.0	1.6	1.0	0.6	0.2	-0.1	
Identified debt-creating flows (4+7+12)	8.9	8.1	4.9	4.3	3.1			2.0	1.6	1.0	0.6	0.2	-0.1	
Primary deficit	6.6	6.7	5.0	4.0	3.0			2.2	1.7	1.3	0.7	0.2	-0.2	
Revenue and grants	29.1	28.7	28.1	29.4	30.2			31.0	31.7	32.0	32.4	32.7	33.1	
Primary (noninterest) expenditure	35.7	35.4	33.0	33.3	33.3			33.2	33.3	33.3	33.1	33.0	32.9	
Automatic debt dynamics 2/	2.3	1.5	0.0	0.4	0.0			-0.2	-0.1	-0.3	-0.2	-0.1	0.1	
Contribution from interest rate/growth differential 3/	2.3	1.5	0.0	0.4	0.0			-0.2	-0.1	-0.3	-0.2	-0.1	0.1	
Of which contribution from real interest rate	2.4	2.5	2.0	1.9	1.8			2.0	1.6	1.4	1.4	1.5	1.6	
Of which contribution from real GDP growth	-0.2	-1.1	-2.0	-1.5	-1.8			-2.2	-1.7	-1.7	-1.6	-1.6	-1.6	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3)	-2.6	-4.3	1.3	-3.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	249.7	266.1	294.7	286.1	287.9			286.9	286.4	286.2	284.9	282.2	279.0	
Gross financing need 5/	30.9	32.5	32.0	32.2	32.0			32.3	32.7	32.9	32.8	32.7	32.5	
in billions of U.S. dollars	1213.5	1376.9	1472.7	1466.6	1397.4	10-Year	10-Year	1387.3	1447.1	1504.2	1547.3	1586.3	1623.6	
Key Macroeconomic and Fiscal Assumptions						Historical Average	Standard Deviation							Projected Average
Real GDP growth (in percent)	0.3	1.5	2.7	1.9	2.2	1.1	1.5	2.6	2.0	1.9	1.8	1.7	1.7	1.8
Average nominal interest rate on public debt (in percent) 6/	2.1	1.8	1.5	1.0	1.3	2.5	1.2	1.7	2.0	2.3	2.6	2.8	3.0	2.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.6	3.4	2.6	2.3	2.2	3.5	0.8	2.3	1.9	1.6	1.6	1.7	1.8	1.7
Nominal appreciation (increase in US dollar value of local currency, in percent)	9.9	12.0	7.1	-1.7	-5.4	1.3	10.7	-3.5	1.1	0.5	0.3	0.2	0.1	0.4
Inflation rate (GDP deflator, in percent)	-1.5	-1.6	-1.1	-1.3	-0.9	-1.0	0.8	-0.7	0.1	0.7	1.0	1.1	1.2	0.8
Growth of real primary spending (deflated by GDP deflator, in percent)	1.1	0.6	-4.2	2.8	2.0	1.0	2.7	2.5	2.3	1.8	1.0	1.4	1.5	1.6
Primary deficit	6.6	6.7	5.0	4.0	3.0	4.9	1.4	2.2	1.7	1.3	0.7	0.2	-0.2	0.8
A. Alternative Scenarios								**II. Stress Tests for Public Debt Ratio**						**Debt-primary balance 10/**
A1. Key variables are at their historical averages in 2007-2012 7/								**89.1**	**96.1**	**103.2**	**110.6**	**118.0**	**125.7**	**2.9**
A2. No policy change (constant primary balance) in 2007-2012								**89.1**	**91.2**	**93.0**	**95.1**	**97.2**	**99.4**	**0.1**
B. Bound Tests														
B1. Real interest rate is at baseline plus one standard deviations								**89.1**	**91.0**	**92.4**	**93.3**	**93.9**	**94.2**	**0.5**
B2. Real GDP growth is at baseline minus one-half standard deviation								**89.1**	**91.6**	**93.8**	**95.8**	**97.7**	**99.6**	**0.8**
deviation								**89.1**	**91.4**	**93.1**	**94.4**	**95.2**	**95.9**	**0.1**
B4. Combination of B1-B3 using one-quarter standard deviation shocks								**89.1**	**91.5**	**93.4**	**94.9**	**96.0**	**96.8**	**0.6**
B5. One time 30 percent real depreciation in 2008 9/								**89.1**	**90.7**	**91.6**	**92.2**	**92.4**	**92.3**	**0.1**
2008								**89.1**	**100.7**	**101.6**	**102.2**	**102.3**	**102.2**	**0.1**

Source: Fund staff estimates.
1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ The implied change in other key variables under this scenario is discussed in the text.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex III (continued).
Box. Japan's Medium-Term Fiscal Plans

The government's medium-term fiscal plan revolves around a reference path for the primary deficit of the general government (excluding social security) that is updated every year. In recent vintages, the overarching objectives have been laid out in two phases: achieve balance by FY2011 and start reducing the debt ratio by the mid-2010s**.** In July 2006, the target date for a primary balance was brought forward to FY2011. The related trajectory for the primary deficit implied a yearly adjustment of ½ percent of GDP, on average, based largely on a 25 percent cut in discretionary spending over 5 years.

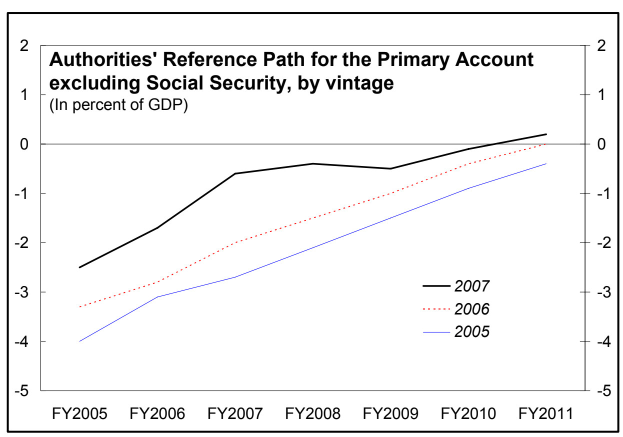
Authorities' Scenario: Main Assumptions 1/
(Average, FY2008-11)

	Growth Scenario	Risk Scenario
(In percentage)		
Nominal GDP Growth	3.4	2.1
Real GDP Growth	2.3	1.2
Long-term Interest Rate	3.4	3.0
Primary Balance in FY2011 (excluding Social Security)	0.2	-0.4

1/ A ¥14.3 trillion of expenditure cut is envisaged from FY2007-11 in the following areas:
Social Securities' Expenditure: ¥1.6 trillion.
Government Wage Bill: ¥2.6 trillion.
Public Works: ¥5.6 trillion.
Others (including ODA): ¥4.5 trillion.

In January 2007, the fiscal plan was updated to reflect recent progress. The plan incorporates the better than expected FY2005 and FY2006 outturns and the FY2007 budget, as well as new macroeconomic assumptions:

- *The new plan presents two scenarios.* Under a "Growth" scenario, the primary deficit turns into a surplus in FY2011 with the gross debt to GDP ratio stabilizing a year earlier. Under a less favorable "Risk" scenario, a primary balance will not be secured and the debt ratio continues to rise.
- *The required adjustment is centered on spending cuts.* In the "Growth" scenario about ¥14 trillion (or 2½ percent of GDP) of cumulative savings is required and could be achieved exclusively by limiting spending in public works, social security, and the civil service. In this scenario, no revenue measures are needed.



The new plan suffers from shortcomings and fails to capitalize on past gains. For example, it provides no guidance as to where a central trajectory bounded by the "Growth" and "Risk" paths may lie. The "Growth" scenario relies on optimistic assumptions, (e.g., a very favorable growth rate-interest rate differential). The plan also implies little adjustment during FY2008–11—in the "Growth" trajectory, the primary deficit (excluding social security) declines by only about 0.2 percent of GDP per year. By contrast, the primary balance fell by about 3 percent between FY2004 and FY2007, implying that the authorities do not capitalize on the remarkable advances made through FY2007.

INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by Asia and Pacific Department
(In consultation with other departments)

July 12, 2007

Contents Page

APPENDIX I. JAPAN—STATISTICAL ISSUES

Statistical Issues: Economic and financial data provided to the Fund are considered adequate for surveillance purposes. Japan subscribes to the Special Data Dissemination Standard (SDDS) and meets the SDDS specifications for the coverage, periodicity, and timeliness of data. The Japanese authorities hosted a data module mission for a Report on the Observance of Standards and Codes (data ROSC) in September 12–28, 2005. The Report on Observance of Standards and Codes - Data Module, Response by the Authorities, and Detailed Assessments Using the Data Quality Assessment Framework (DQAF) were published March 17, 2006 and are available at http://www.imf.org/external/pubs/ft/scr/2006/cr06115.pdf.

Japan: Table of Common Indicators Required for Surveillance (as of July 10, 2007)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	7/10/07	7/10/07	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/07	7/07	M	M	M		
Reserve/Base Money	6/07	7/07	M	M	M	LO, LO, LO, LO	O, O, O, O, O
Broad Money	6/07	7/07	M	M	M		
Central Bank Balance Sheet	6/30/07	7/3/07	Every 10 days	Every 10 days	Every 10 days		
Consolidated Balance Sheet of the Banking System	5/07	6/07	M	M	M		
Interest Rates[2]	7/10/07	7/10/07	D	D	D		
Consumer Price Index	5/07	6/07	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005	12/06	A	A	A	O, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2005	12/06	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/07	6/07	Q	Q	Q		
External Current Account Balance	4/07	6//07	M	M	M	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	4/07	6//07	M	M	M		
GDP/GNP	2007 Q1	6/07	Q	Q	Q	O, O, O, O,	LO, LO, O, O, LNO
Gross External Debt	3/07	6/07	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC or the Substantive Update (published on May 17, 2006, and based on the findings of the mission that took place during September 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data and its assessment, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

APPENDIX II. JAPAN—FUND RELATIONS
(As of May 31, 2007)

I. **Membership Status**: Joined 8/13/52; Article VIII

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	13,312.80	100.00
Fund holdings of currency	12,267.59	92.15
Reserve position in Fund	1,045.91	7.86

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	891.69	100.00
Holdings	1,897.04	212.75

IV. **Outstanding Purchases and Loans**: None

V. **Latest Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

Japan maintains a floating exchange rate regime. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions maintained against the Taliban, Al-Qaeda, the former Iraqi regime, and others, pursuant to UN Security Council Resolutions 1267, 1333, 1390, 1373, 1483, and 1532. These restrictions were notified to the Fund (EBD/02/52 and EBD/04/111) in accordance with Executive Board Decision No. 144–(52/51).

VIII. **Article IV Consultation**:

The 2006 Article IV consultation discussions were held during May 15–24 2006; the Executive Board discussed the Staff Report (IMF Country Report No. 06/275) and concluded the consultation on July 21, 2006. The staff report, staff supplement, selected issues paper, and PIN were all published.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 07/96
FOR IMMEDIATE RELEASE
August 6, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with Japan

On July 27, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Japan.[1]

Background

The current economic expansion is well into its sixth year. In 2006, GDP grew at 2.2 percent, led mainly by business investment and net exports. After slowing in mid-year, private consumption rebounded and activity has regained pace. Labor markets continue to tighten, but wage growth is still sluggish. Inflation remains low, as core CPI inflation (excluding fresh food) averaged 0.1 percent (year-on-year) in 2006 and since February, has dipped below zero—mainly due to lower energy and communication prices. The GDP deflator continues to fall, but the pace of decline has moderated and other indices, such as service and land prices, are on a rising trend.

Japan's external position remains strong. Boosted by investment income, the current account surplus widened in 2006 to nearly 4 percent of GDP, despite a shrinking trade balance. Financial outflows also picked up, reflecting mainly the secular decline in investor home bias and to a lesser extent, yen-financed carry trades. Japan's exchange rate is market-determined, and there have been no official interventions in the foreign exchange market since March 2004. In 2006, the yen depreciated against the U.S. dollar and the euro by 5½ percent and

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

6¼ percent, respectively. After depreciating more this year, the yen in real effective terms is at its weakest in about 20 years.

The financial and corporate sectors continue to strengthen. Bank nonperforming loans fell further in 2006, while capital ratios improved. Progress at regional banks has been more uneven. Corporate profits reached record highs, and leverage is at a 50-year low. With lending rates favorable and stock prices rising, financial conditions remain easy.

Fiscal consolidation has proceeded faster than expected, but the public debt ratio is still high. Supported by buoyant corporate tax collection and sustained spending cuts, the primary deficit for the general government (excluding social security) is projected to decline further to about 1 percent of GDP in FY2007 from over 5 percent of GDP four years ago. However, at above 80 percent of GDP, net public debt is one of the highest among Organisation for Economic Co-operation and Development (OECD) countries and is still rising.

Monetary conditions remain supportive of the expansion. With no signs of inflation pressures or worrisome financial imbalances, the Bank of Japan (BoJ) has opted for a gradual pace of adjustment—two quarter point hikes since July 2006.

The near-term economic outlook is favorable. GDP growth is projected at 2.6 percent in 2007 and 2.0 percent in 2008, increasingly driven by domestic demand. With activity close to full capacity, CPI inflation is expected to pick up, but very slowly. The risks are balanced, with downside risks mostly external (an unanticipated slowdown in the United States, volatile energy prices, or global financial turbulence), while a tightening labor market could lead to faster consumption.

Over the medium term, growth is expected to slow to potential—estimated at around 1.7 percent—and for the current account to narrow modestly. This scenario assumes a continued strengthening of the financial and corporate sectors, a shrinking labor force, and fiscal consolidation in line with the authorities' plans. Deeper structural reforms could raise potential growth and narrow further the current account.

Executive Board Assessment

Executive Directors welcomed Japan's continued economic expansion and its solid underpinnings. Supported by appropriate macroeconomic and structural policies, growth has become more broad-based; the financial and corporate sectors have strengthened further, and the labor market continues to improve. Directors took note that inflation remains very low but expected it to pick up gradually as the economy operates close to full capacity.

Directors observed that Japan's recovery has been accompanied by greater financial and trade linkages with the global economy that are creating new challenges for policies. In this regard, Directors stressed that achieving fiscal sustainability, promoting sustained non-inflationary growth, strengthening further the financial system, and boosting productivity through additional structural reforms would help Japan reap more fully the benefits from globalization.

Directors commended the authorities for the progress in reducing the fiscal deficit. They noted, however, that the public debt-to-GDP ratio still remains uncomfortably high, and most Directors encouraged the authorities to accelerate the pace of consolidation. Directors agreed that putting the debt ratio firmly on a downward trajectory will make room for the fiscal costs of population aging, buy "policy insurance" against adverse shocks, support private confidence, and improve overall growth prospects with positive international spillovers.

Most Directors considered that given the size of the task at hand, additional revenue measures will be needed, including for base broadening. They indicated that revenue measures could be best identified in the context of a broad reform of the tax system that addresses the challenges posed by Japan's aging society and globalization. Among possible measures, increasing the consumption tax has the benefit of being less detrimental to growth and equitable across generations. Some Directors, however, viewed the authorities' focus on expenditure adjustments as broadly appropriate at this juncture.

Directors considered that monetary policy remains appropriately accommodative, given very muted inflation risks. Some Directors pointed out that low interest rates in Japan are contributing to capital outflows, including speculative carry trades, that complicate policy setting in some recipient countries. On balance, Directors agreed that monetary policy should remain focused on domestic price stability. With no signs of worrisome financial imbalances, a return to a neutral monetary stance should proceed in tandem with inflation prospects. Many Directors considered that to better guide expectations, communication of the monetary framework could rely more on forward-looking policy statements and a greater emphasis on the 1 percent median within the Policy Board members' range of understanding on price stability.

Directors felt that, with the health of the banking system improving, financial policies are rightly focused on the challenges ahead. They urged the authorities to maintain regulatory vigilance and ensure sound risk management by financial institutions in the face of a growing appetite for risky assets. Directors also highlighted the need to raise core profitability of banks, press ahead with reforms of government financial institutions, and further develop the capital markets.

Directors stressed that deeper structural reforms are needed to improve Japan's growth potential and competitiveness. The reform priorities are to improve labor utilization and promote competition through greater market opening and further deregulation. As highlighted by the recent Multilateral Consultation, such reforms would also facilitate an orderly resolution of global current account imbalances.

Directors agreed that the yen should continue to be market determined. They noted the staff's assessment that—notwithstanding the appropriate focus of macroeconomic and structural policies—the yen appears to be undervalued relative to its longer-term value in real effective terms, although this reflects, in part, a waning home bias of Japanese investors and their greater demand for foreign assets. Several Directors noted factors that the Consultative Group on Exchange Rate Issues (CGER) methodology does not fully take into account, including in cases where the exchange rate is market determined. Directors felt that the yen could be expected to appreciate over time, supported by policy reforms to boost domestic demand—although capital outflows related to Japanese portfolio rebalancing might slow the adjustment.

In this regard, Directors supported the authorities' policy of limiting intervention to counter disruptive exchange rate movements. Continued careful monitoring of exchange rate developments and their impact on the regional and global economy will be needed in the period ahead.

Directors urged the Japanese authorities to do their utmost to help secure a balanced and ambitious Doha Round agreement and seek provisions in Economic Partnership Agreements that limit trade diversion and work effectively on a regional level.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2007 Article IV Consultation with Japan is also available.

Japan: Selected Economic Indicators

	2003	2004	2005	2006	Proj. 2007	
Real GDP	1.4	2.7	1.9	2.2	2.6	
Private consumption	0.4	1.6	1.6	0.8	1.7	
Nonresidential investment	4.4	5.6	6.6	7.5	4.4	
Residential investment	-1.0	1.9	-1.3	1.0	0.8	
Public investment	-10.8	-9.0	-6.2	-7.4	-3.8	
Public consumption	2.3	1.9	1.7	0.4	0.8	
Stockbuilding (contribution to growth)	0.2	0.3	-0.1	0.1	0.0	
Foreign balance (contribution to growth)	0.7	0.8	0.3	0.8	0.8	
Exports of goods and services	9.2	13.9	7.0	9.6	7.5	
Imports of goods and services	3.9	8.1	5.8	4.5	2.8	
Inflation						
GDP deflator	-1.6	-1.1	-1.3	-0.9	-0.7	
CPI (SA) 1/	-0.2	0.0	-0.6	0.2	0.0	
CPI (NSA) 1/	-0.2	0.0	-0.3	0.2	0.0	
Unemployment rate (period average, percent)	5.3	4.7	4.4	4.1	3.9	
Current account balance						
Billions of U.S. dollars	136.2	172.1	165.7	170.4	181.7	
Percent of GDP	3.2	3.7	3.6	3.9	4.2	
General government balances (percent of GDP, FY)						
Balance including social security	-7.7	-5.5	-4.3	-4.0	-3.5	
Balance excluding social security	-7.9	-6.0	-4.5	-3.9	-3.5	
Structural balance 2/	-6.9	-4.9	-4.0	-3.9	-3.5	
Money and credit (12-month growth rate; end						
Base money	13.2	4.2	1.0	-20.0	-4.1	3/
M2 + CDs (period average) 4/	1.7	1.9	1.8	1.1	1.8	3/
Bank lending 4/	-2.0	-1.2	1.1	2.8	1.6	3/
Exchange and interest rates (period average)						
Yen/dollar rate	115.9	108.2	110.2	116.3	119.3	5/
Yen/euro rate	131.1	134.5	137.3	146.0	163.6	5/
Real effective exchange rate 6/	80.6	79.7	76.0	70.5	64.1	6/
3-month CD rate	0.09	0.06	0.06	0.22	0.55	5/
10-year government bond yield	1.00	1.51	1.39	1.74	1.80	5/

Sources: Global Insight, Nomura database and Fund staff estimates and projections.

1/ Annual growth rates are calculated from annual averages of monthly data.

2/ Including social security, excluding bank support.

3/ June 2007.

4/ From April 1998 onward, data reflect the inclusion of foreign banks, foreign trust banks and Shinkin banks in the monetary survey.

5/ July 31, 2007.

6/ Based on normalized unit labor costs; 2000 = 100. Figure for 2007 is as of June.