July 2009
IMF Country Report No. 09/210

Japan: 2009 Article IV Consultation—Staff Report; Staff Statement; 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 2009 Article IV consultation with Japan, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 20, 2009, 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 June 17, 2009. 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 staff statement of July 6, 2009, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 6, 2009, 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.

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INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 2009 Article IV Consultation

Prepared by the Staff Representatives for the 2009 Consultation with Japan

Approved by James Gordon and Tamim Bayoumi

June 17, 2009

- **This report is based on discussions held in Tokyo during May 12–20.** The team comprised Messrs. Gordon (Head), Kang, Sommer, Syed, and Tokuoka (all APD), Mr. Espinosa (MCM), and Mr. Steinberg (OAP). Mr. Lipsky joined the mission for the policy discussions. Messrs. Kotegawa and Yamaoka (both OED) also participated.

- **Counterparts.** The mission met with Minister of Finance and Financial Services Yosano, Bank of Japan (BoJ) Governor Shirakawa, Vice-Minister of Finance for International Affairs Shinohara, BoJ Deputy Governors Nishimura and Yamaguchi, and other senior officials, academics, and private sector representatives.

- **Context of past surveillance.** In recent consultations, the Fund and the authorities have agreed on the broad policy priorities—pursuing medium-term fiscal consolidation, further strengthening the financial and corporate sectors, and stepping up productivity-enhancing reforms. Before the onset of the global crisis, the Fund advocated that fiscal consolidation and structural reforms proceed at a somewhat faster pace to strengthen growth prospects in the context of population aging and promote an orderly adjustment of global imbalances.

- **Selected Issues Papers** will explore issues related to Japan public debt finances, cross-border financial spillovers, and the health of the corporate sector.

- **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

Context: The global recession has derailed Japan's export-led boom. Despite recent signs of stabilization at home and abroad, the outlook remains uncertain. Fiscal and monetary stimulus will provide a timely boost to the economy but a sustained recovery will ultimately depend on an upturn overseas. The economy is expected to contract by 6 percent in 2009 and grow modestly by 1¾ percent next year, while inflation is projected to remain negative through 2011. Over the medium term, potential growth could fall given the challenges with reorienting production away from exports and lower investment due to tighter corporate financing, highlighting the need for reforms to rebalance growth to domestic sources.

Policy messages:

- Fiscal policy has provided timely and needed stimulus to the economy and should remain flexible to address further downside risks. At the same time, given the sharp increase in public debt and aging population, priority should be given to clarifying a medium-term fiscal consolidation strategy to be implemented once the recovery takes hold.
- The monetary policy response has been well-calibrated, but additional credit easing measures may be needed should downside risks materialize.
- Financial policies should continue to strengthen the resilience of the financial system, while promoting corporate restructuring would help lay the foundation for a sustained recovery.
- Efforts to rebalance growth toward domestic demand will be critical to supporting living standards and fiscal sustainability.

I. INTRODUCTION

1. **The global crisis has highlighted Japan's close integration with the rest of the world.** Japan's dependence on manufacturing exports helped lift the economy during the 2003–07 global boom, but also left it highly exposed to the collapse in external demand and financial spillovers last year. At the same time, domestic demand, which had contributed significantly to the expansion, faltered in the face of slowing exports and tight financial conditions. The result has been the most severe recession in decades. The authorities have responded with forceful measures to stabilize financial markets and support activity, but given Japan's close links with the rest of the world, a sustained recovery will hinge on the timing and strength of the global upturn.

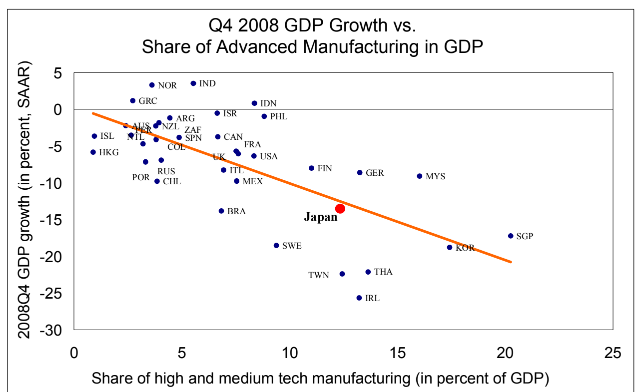
2. **Against this backdrop, this year's Article IV consultation reviewed the mix of policies employed by the authorities to support near-term growth and preserve financial stability, while discussing reforms to help rebalance growth toward domestic**

sources in the medium term. The sizeable fiscal stimulus is judged to be appropriate given the depth of the slump, but the large buildup in public debt from an already high base requires that attention be paid to the medium-term strategy to secure fiscal sustainability. The Bank of Japan's (BoJ) policy rate has effectively hit the zero bound, while macroeconomic benefits from extraordinary monetary measures need to be weighed against risks to the BoJ's balance sheet and from market distortions. Financial policies should continue to strengthen the system's resilience and improve the efficiency of intermediation, while broad-based reforms to create new investment and job opportunities are required to rebalance Japan's growth to domestic demand. The sharp downturn and political uncertainties surrounding the Lower House elections this summer have added to the challenges in implementing fiscal and structural reforms.

II. Economic Developments

3. **Japan's specialization in advanced manufacturing exports has served the economy well in the past, but became its Achilles heel during the global recession (Figure 1).**

- *Activity.* After expanding robustly by 2.3 percent in 2007, GDP contracted by 0.7 percent last year. The economy ran out of steam in Q2 2008 as exports to non-U.S. destinations started to falter and contracted sharply after the collapse of Lehman Brothers in September, which led to a slump in demand for big-ticket durable goods such as cars, IT, and machinery. Tightening financial conditions, sizeable economic slack, and a deteriorating labor market have also undermined business investment and private consumption. GDP fell by about 14 percent (s.a.a.r.) in both Q4 2008 and Q1 2009—the worst outturn among the G-7. That said, industrial production stabilized around March as progress was made on inventory adjustment, and survey data suggest output could make up considerable ground during Q2 2009.

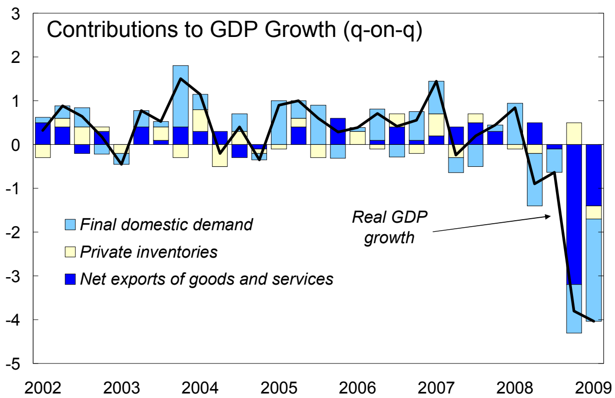


Sources: UNIDO database; and IMF staff calculations.

- *Inflation.* With lower global commodity prices, CPI inflation eased from its high of 2.3 percent in July 2008 to –0.1 percent y-o-y in April 2009. Core inflation, which on staff's definition excludes both fuel and food prices, also turned negative as the output gap widened to about –8 percent—about twice as large as after the 1997 banking crisis. While available measures are imprecise, short-term inflation expectations appear to have declined considerably.

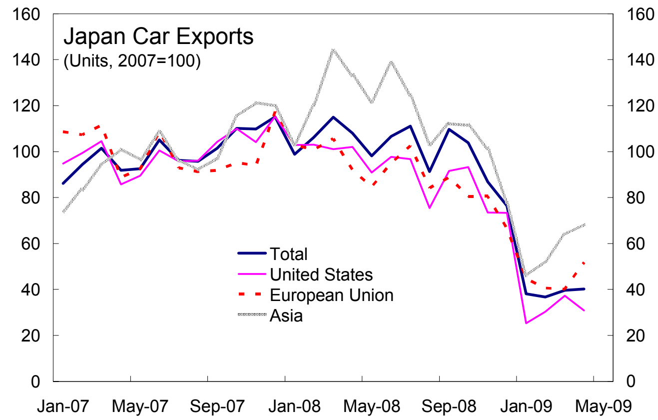
Figure 1. Japan Has Been Hit Hard by The Global Recession

The Japanese economy has contracted sharply …



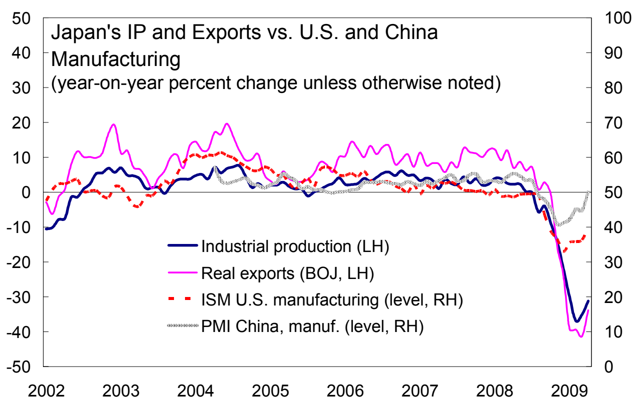
Source: Global Insight, Nomura database.

… as its exports of durable goods, particularly automobiles, collapsed.



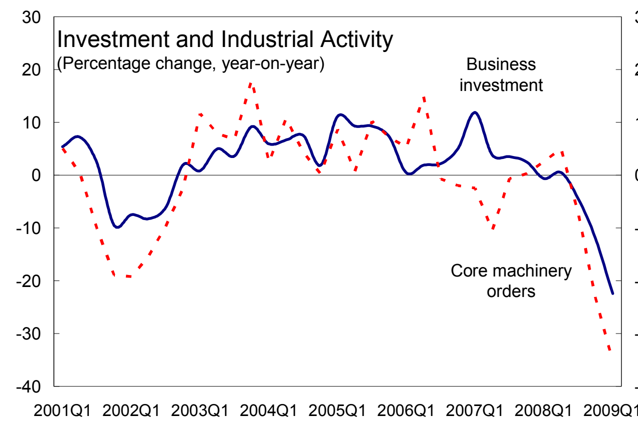
Source: CEIC Database.

Although high frequency indicators point to a slowing pace of decline in external demand …



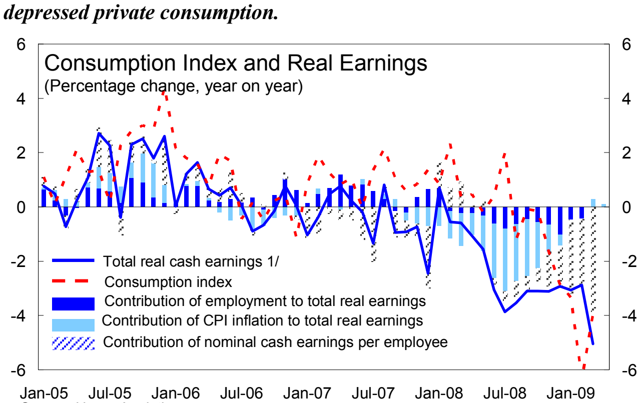
Sources: Haver Analytics and Global Insight.

… large spare capacity and tight financial conditions have amplified the negative spillovers to business investment …



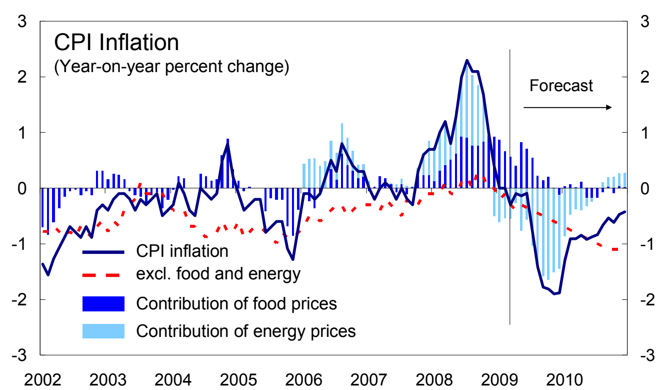
Source: Nomura Database.

… while a worsening labor market and heightened uncertainty have depressed private consumption.



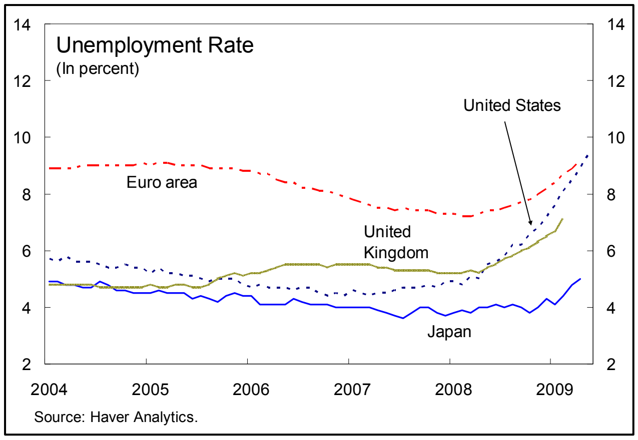
Source: Haver Analytics.
1/ Total real cash earnings = (employment) times (nominal cash earnings per employee) divided by CPI.

Meanwhile, a widening output gap is likely to cause prices to fall until 2011.



Note: The contribution of energy prices to inflation cannot be calculated using the current method prior to 2006.
Source: Haver Analytics.

- *Labor market*. Firms have responded to the recession by significantly cutting cash compensation (–2.5 percent y-o-y) and employment of temporary workers. The unemployment rate has jumped from 3.8 percent last October to 5.0 percent in April 2009, but has increased by considerably less than in the United States or Europe.



- *Exchange rate.* Despite a worsening trade balance, the yen has appreciated by about 25 percent in real effective terms since August 2008, supported by unwinding carry trades as well as narrowing interest rate differentials against key currencies. The exchange rate has remained volatile reflecting shifts in global risk appetite, with investors typically buying the yen during periods of market instability.

- *Current account balance.* Falling exports, the strong yen, and lower returns from overseas investments have narrowed the current account surplus from a record 4.8 percent of GDP in 2007 to an annualized 1.4 percent of GDP in Q1 2009.

4. **Japan's financial markets have stabilized from the after-shocks of the Lehman Brothers collapse, but some stresses persist (Figure 2).**

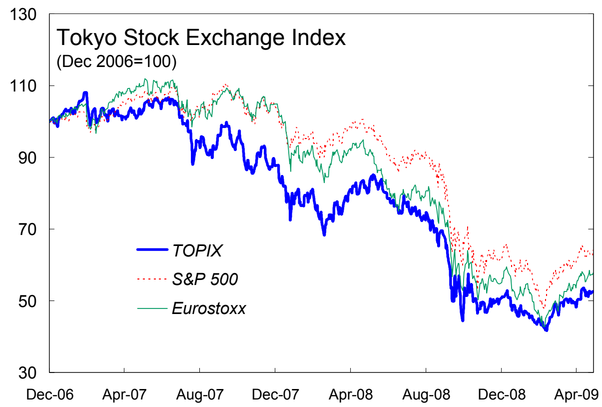
- *Stock markets.* In line with global trends, the Japanese stock market has rebounded since March on signs that the worst of the downturn is behind, but remains about 40 percent below the end-2007 levels.

- *Money markets.* The 3-month yen LIBOR-OIS spread, an indicator of counterparty risk, has come down to near pre-Lehman levels and remains below the equivalent U.S. dollar and euro spreads. Although the BoJ's yen and dollar liquidity operations (Appendix I) have helped to stabilize short-term money markets, 6-month TIBOR and the negative 5-year basis FX swap spread point to continued tightness in longer-term funding.

- *Credit markets.* Bank lending rates have declined following BoJ's policy rate cuts, although falling inflation has pushed up real rates. Corporate bond spreads have come down for AA-rated companies but remain sharply higher for lower-rated firms. Meanwhile, activity in the securitization market remains dormant.

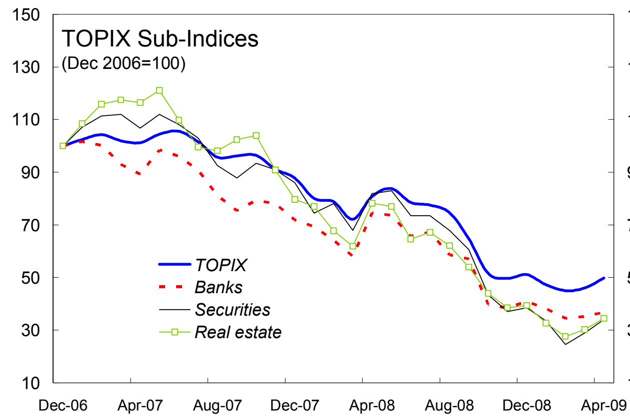
Figure 2. Japan: Financial Markets are Stabilizing, Although Stresses Remain

Equity prices have shown signs of recovery, in line with other major markets…



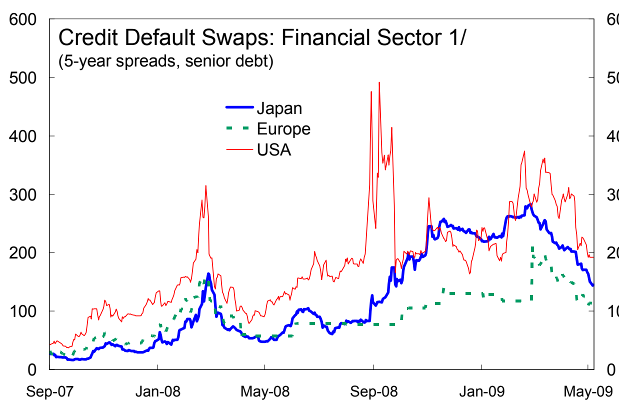
Sources: CEIC and Bloomberg.

…but banks, securities firms, and real estate companies have lagged behind.



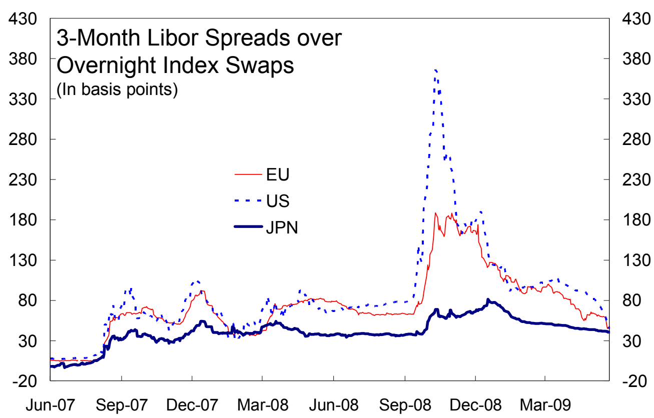
Sources: CEIC and Bloomberg.

Bank CDS spreads remain elevated.



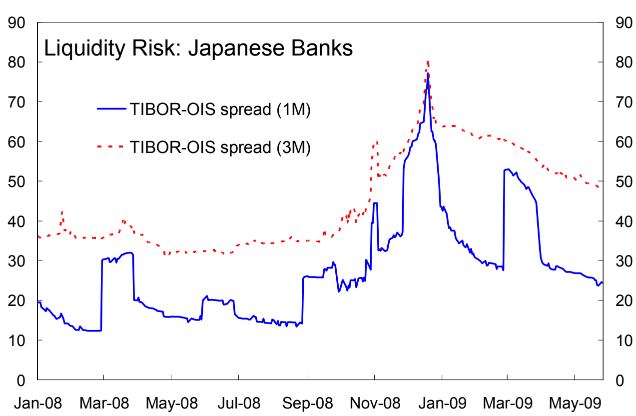
Source: Bloomberg.

Money market stresses have been less pronounced in Japan than in other advanced economies …



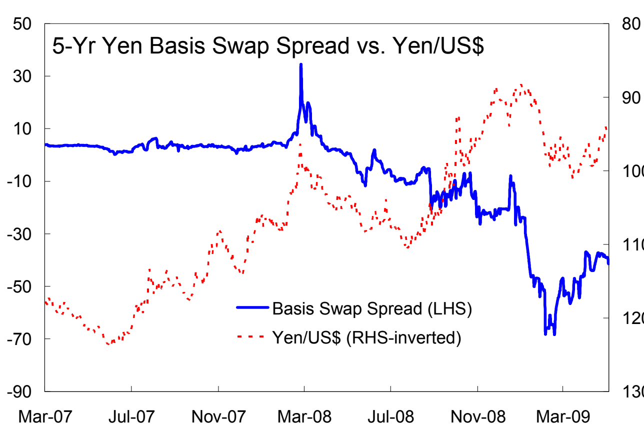
Sources: Bloomberg, Reuters, CEIC database, and staff calculations.

… with the liquidity premia easing after the financial year-end.



Source: Bloomberg.

However, long-term dollar funding remains tight.



Source: Bloomberg.

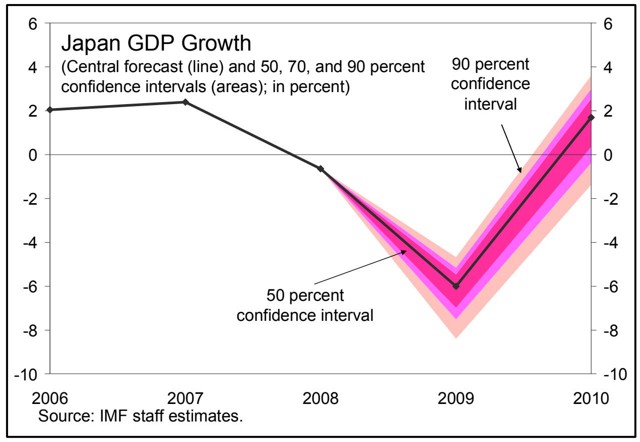
1/ iTraxx Financial for Europe; average of eight major banks, securities, and insurances for Japan; and average of five major commercial and investment banks for the US.

III. Outlook and Risks

Staff's Assessment

5. **Despite recent signs of stabilization at home and abroad, the outlook remains uncertain. Policy stimulus will provide a much-needed boost to the economy but a sustained recovery will ultimately depend on an upturn overseas.**

- *Baseline.* Staff projects GDP to fall by a record 6 percent in 2009, before expanding by 1¾ percent in 2010. Progress with inventory adjustment and ample fiscal stimulus will lift growth in the quarters ahead. However, with corporations cutting labor costs and investment and domestic financial conditions remaining tight (due in part to the strong yen and strict lending attitudes of banks), a sustained recovery will likely only emerge during the course of 2010 and will hinge critically on improving global financial conditions and trade. Given significant economic slack, inflation is projected to remain negative until 2011. In the short term, the current account surplus is expected to remain around 1¾ percent of GDP.



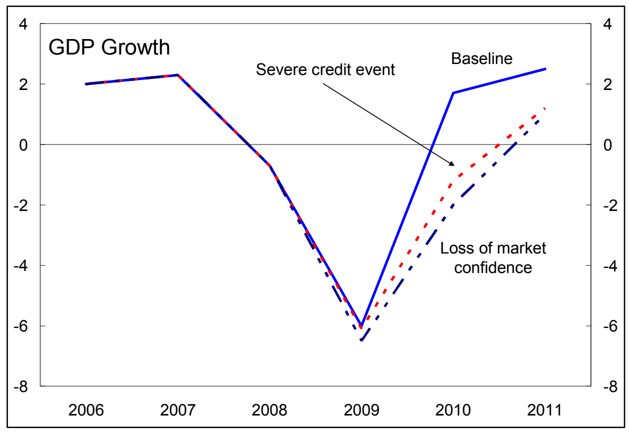
- *Risks.* The risks to the outlook remain tilted to the downside and stem from the deteriorating labor market, tight domestic financial conditions, and external uncertainties. On the upside, faster-than-expected growth in China could bolster Japan's manufacturing exports, although the benefits would likely be limited given the low import content of China's fiscal stimulus. Inflation risks are also tilted to the downside owing to the downside growth risks and uncertainties about how inflation expectations will respond to a protracted slowdown.

6. **Staff projections are characterized by an exceptional degree of uncertainty.** Tail-risk scenarios involving another severe credit event similar to the collapse of Lehman Brothers or loss of market confidence in the sustainability of public finances around the world would severely deepen the current recession, although the likelihood of such events appears low (Box 1). In an optimistic scenario, strong policy responses could boost confidence and jump start a robust recovery by initiating a virtuous cycle of stronger growth, lower risk aversion, and higher spending.

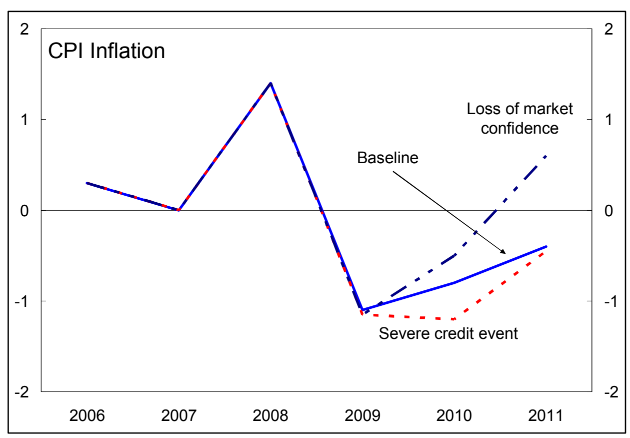
Box 1. Analysis of Tail-Risk Scenarios

Two downside tail-risk scenarios are explored using the new IMF's Global Projection Model (GPM).

- *Severe credit event*. Should global financial strains intensify again, the Japanese economy would face another sharp drop in its durable goods exports as foreign corporations—already producing well below capacity—would scale back investment, while overseas consumers would be forced to further reduce their debt. Even with carry trades largely unwound, repatriation of profits and investment by cash-strapped Japanese entities could push up the value of the yen, further deepening the recession. Bank lending attitudes would tighten globally owing to difficulties with refinancing, rising nonperforming loans, and (in Japan's case) banks' losses on equity holdings.[1/] In the absence of further fiscal stimulus, output could fall by about -1½ percent in 2010 (3 percentage points below the baseline), with growth very weak throughout 2011. Inflation would remain negative until 2012, while the policy rate would need to be kept close to zero until the following year to offset deflationary risks.



- *Loss of market confidence*. Should markets lose confidence in the sustainability of public debt in several major economies, government bond yields would increase sharply reflecting higher inflation expectations and solvency concerns.[2/] Governments would need to withdraw fiscal stimulus to restore credibility, further undermining domestic demand. The short-term impact on the Japanese economy could be even more severe than in the credit event scenario—output could contract by around 2 percent in 2010 with higher inflation expectations gradually turning into upward pricing pressures despite sizeable economic slack. The GPM model suggests that inflationary pressures could force tightening of monetary policy during the course of 2011, much earlier than in the severe credit event scenario.



1/ Bank lending attitudes are assumed to tighten globally from current levels by about ½ of the cumulative tightening since summer 2007.

2/ The scenario assumes an increase in inflation expectations by 2 percentage points and up to a 1 percentage point increase in term premia in the United States and Japan.

The Authorities' Views

7. **The authorities broadly agreed with staff's assessment of the outlook and risks.**

- *Near-term outlook for growth and inflation.* In the April *Outlook* report, the BoJ Policy Board projected GDP to contract by 3.1 percent in FY2009 and grow by 1.2 percent in FY2010, which is broadly consistent with staff's projections on a fiscal year basis.[1] The Policy Board forecasted core inflation (excl. fresh food) to remain negative in both years, with the FY2010 central projection at –1 percent.

- *Risks.* The BoJ agreed that risks to growth were tilted to the downside, arising primarily from a possible adverse feedback loop between financial and economic activity globally as well as in Japan. A structural downgrade of medium-term growth expectations by Japanese corporations could also undermine domestic investment and employment. The BoJ considered the inflation outlook as highly uncertain reflecting ambiguities about the growth outlook, the behavior of inflation expectations, and the likely path for commodity prices.

IV. Policies to Support Growth and Preserve Financial Stability

The authorities have provided a significant boost to the economy and support to financial markets through fiscal, monetary, and financial policies. Along with cutting the policy rate to close to zero, the BoJ has taken a range of measures to stabilize financial markets and facilitate corporate financing, including through asset purchases. Given the severity of the recession and limits on monetary policy from the zero bound, fiscal policy has been required to provide sizeable stimulus, although with the rapid increase in public debt, a plan to secure medium-term debt sustainability is needed. Monetary and fiscal policy action has been supplemented by financial measures to safeguard the banking system and maintain the flow of credit, especially to distressed SMEs.

A. Fiscal Policy Priorities

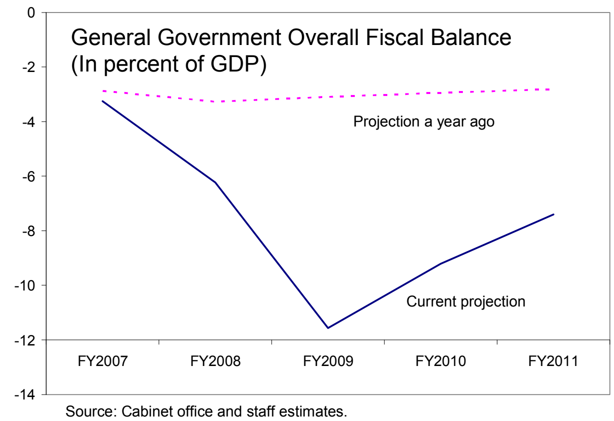
Background

8. **After several years of improvement, the fiscal balance has sharply deteriorated, reflecting the weak economy as well as discretionary measures (Figure 3).**

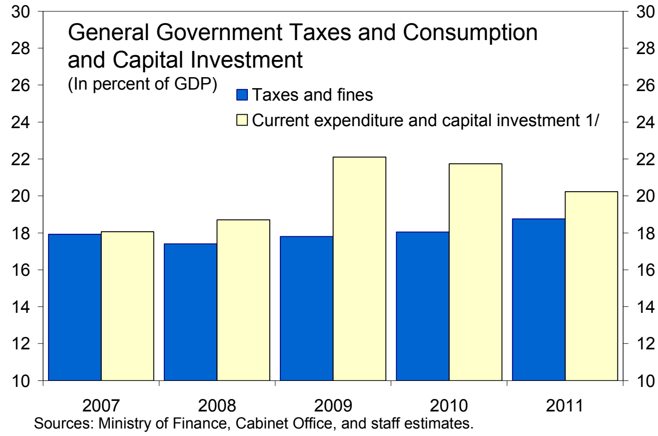
[1] The fiscal year begins in April.

Figure 3. Japan: Fiscal Policy Challenges

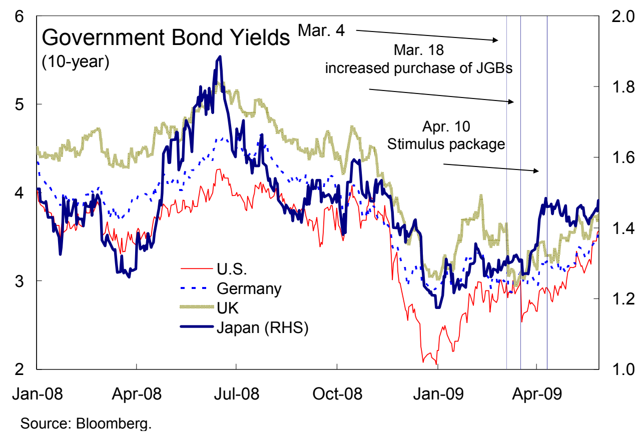
The fiscal balance has sharply deteriorated …



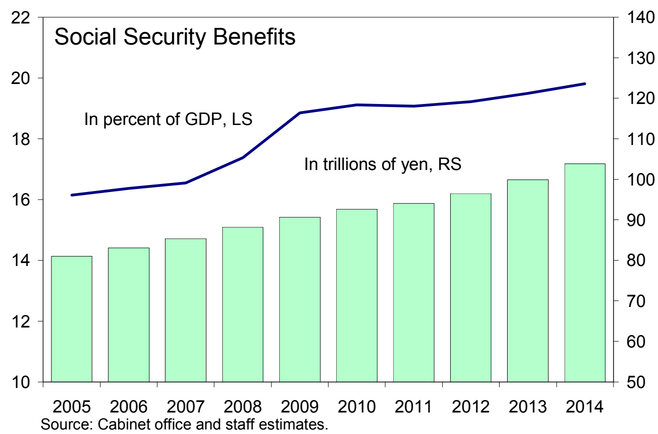
… reflecting higher discretionary spending and automatic stabilizers.



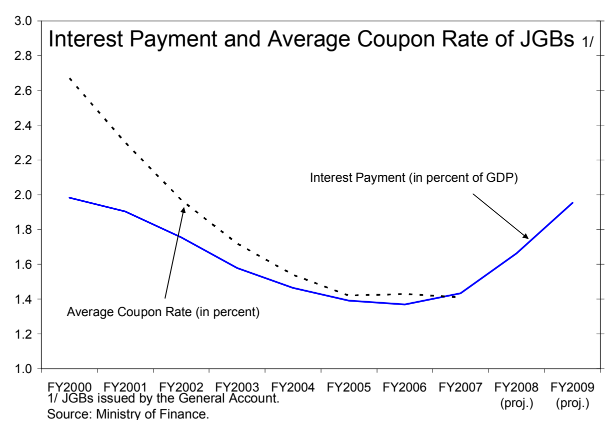
Market yields have risen on improving risk appetite of investors and prospects for greater JGB supply.



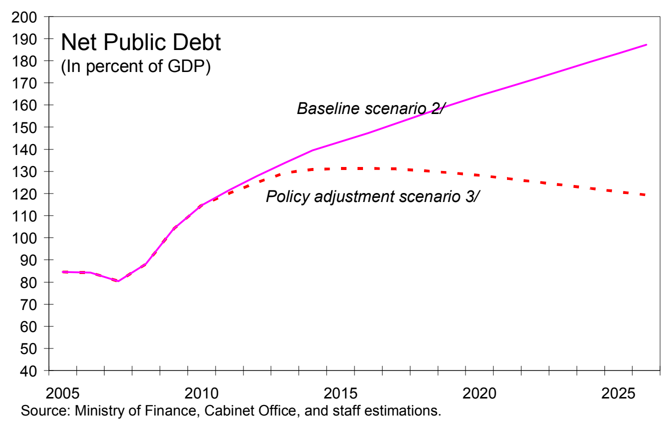
Going forward, social security costs are expected to rise…



… along with interest payments on the growing debt ...

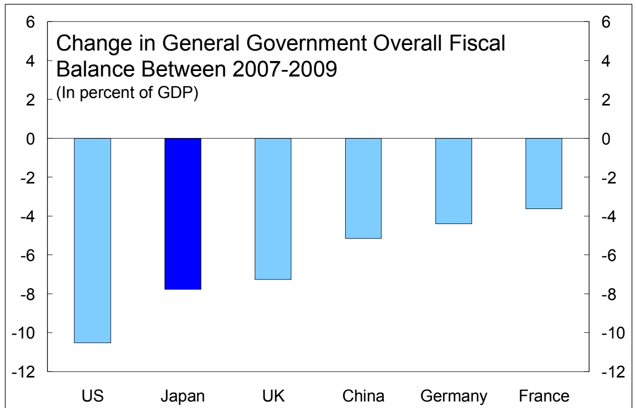


… requiring significant fiscal adjustment to stabilize the net debt ratio.



1/ Excluding social security benefits and interest payment.
2/ Projections are based the assumption that the authorities will maintain their current policies (no consumption tax increase is assumed) and that real interest rate/growth differential will gradually converge to about ¾ percent.
3/ Includes an increase in the consumption tax rate by 5 percentage points starting in 2011 and a further fiscal adjustment by 2.5 percent of GDP after 2014 (see Appendix II for details).

- *Recent fiscal developments.* The consolidated fiscal deficit is projected to widen from 3¼ percent of GDP in FY2007 to about 11½ percent of GDP in FY2009. The main factors include a sharp decline in tax revenues (especially corporate tax, which could fall by nearly 2 percent of GDP), sizeable stimulus, and rising social security expenditures including an increase in the central government's contribution to the national pension system from ⅓ to ½ of payouts. Net debt is projected to reach 100 percent of GDP this year (220 percent of GDP in gross terms).



Sources: National authorities; IMF staff estimates.

- *Nature of stimulus.* At roughly 5 percent of GDP, stimulus spending is larger than the G-20 average and is focused on cash payments, public works, and employment support. Other measures include subsidies for energy-efficient purchases, a higher gift tax exemption to support spending, and vocational training to boost productivity.[2] Many of the tax measures are one-off and are set to expire over the next three years. Stimulus spending combined with automatic stabilizers is estimated to boost the economy by around 2¾ percent in 2009 and 2 percent in 2010.

Japan's Fiscal Expansion 1/
(In percent of GDP)

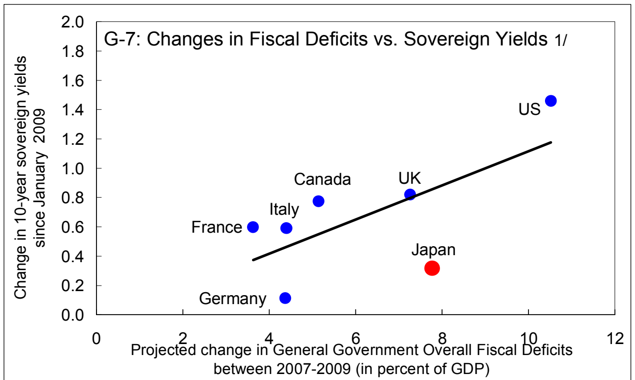
	Budget Size	Impact on GDP Level
Stimulus spending		
2009	2.6	1.7
2010	2.2	1.1
Of which: The April 2009 stimulus package	3.2	2.0
Financial measures 2/	0.6	
Transfers to local governments 3/	0.5	
Social securities	0.4	
Employment support	0.4	
Subsidies for energy efficient products	0.3	
Others	0.9	
Automatic stabilizers		
2009		1.1
2010		1.0
Total fiscal expansion incl. automatic stabilizers		
2009		2.8
2010		2.1

Sources: MoF, CaO and staff estimates.
1/ Relative to 2007.
2/ Includes support for SMEs through capital injection into government affiliated financial institutions.
3/ A large portion is intended to be spent on public investment.

- *Authorities' medium-term consolidation plan.* Given the surge in the deficit, the government's prior commitment of achieving primary balance (excluding the social security fund) by FY2011 is now out of reach. In December 2008, the authorities outlined a medium-term commitment for revenue and social security reform, which calls—conditional on economic recovery—for new revenue legislation by FY2011, including an increase in the consumption tax.

[2] For details, see "Summary of the Policy Package to Address Economic Crisis" at http://www5.cao.go.jp/keizai1/2009/0420summary-english.pdf.

- *Market reactions.* The 10-year JGB yield has picked up by around 30 bps since the beginning of the year on improving risk appetite of investors and prospects for greater JGB supply. However, the increase has been smaller than for U.S. Treasuries and U.K. gilts, which may reflect to some extent the small share of JGBs held by foreign investors.



Sources: WEO, Bloomberg, National authorities, and IMF staff estimates.
1/ As of June 2009.

Policy Issues and Staff Views

9. **Fiscal policy has provided a timely and needed boost to the economy and should remain flexible to address further downside risks.**

- *Near-term fiscal stance.* Current stimulus appears to provide adequate support to growth under the baseline. If the recession persists longer than expected, additional stimulus could be provided in FY2010, with a continued emphasis on measures that are targeted and reversible, such as accelerated depreciation of capital expenditure in sectors with high growth potential or tax changes that bring forward consumption.

- *Impact on public debt.* On current trends, net public debt could rise to about 140 percent of GDP (240 percent in gross terms) by 2014. The government's contingent liabilities are also rising with the rapid expansion of SME lending guarantees (budgeted at ¥30 trillion) and other financial support.

10. **At the same time, given the increase in public debt and fiscal pressures from an aging society, priority should be given to clarifying the medium-term consolidation strategy.**

- *Design of medium-term strategy.* In outlining such a strategy, a sensible option would be to shift away from the current practice of targeting the primary balance to a cap on the public debt ratio over the medium term in order to put the debt ratio firmly on a downward path and strengthen public awareness of the need for fiscal consolidation.[3] Whatever the target chosen to lower the debt ratio over time, the consolidation plan will likely require expenditure measures (e.g., through further savings in public

[3] For instance, staff analysis suggests that capping net debt at 130 percent of GDP (230 percent of GDP in gross terms) would require an adjustment in the primary balance of around 1.5 percent of GDP annually during 2011–15. After 2015, further measures would be needed to place the debt ratio on a downward path. See Appendix II for an analysis of the medium-term debt position.

administration, investment, and health care costs) and comprehensive tax reforms, including a commitment to raise the consumption tax after the recovery takes hold.

- *Pension reforms.* Priorities include addressing generational inequalities and securing stable revenues for the central government's increased contributions to the national pension plan, particularly as uncertainties about the system's benefits may be weighing on consumption. This year's actuarial update provides an opportunity to reassess the system's financial position in light of changes in the outlook, and consider if any parametric changes (such as increasing the retirement age) are needed.

- *Public debt management.* To help finance the stimulus measures, gross JGB issuances are expected to rise to as high as 30 percent of GDP in FY2009. Short-term financing risks appear contained given the limited foreign ownership of JGBs and large pool of domestic savings. Nevertheless, the capacity of the market to absorb JGBs will likely diminish over time as population aging reduces savings inflows and reforms improve financial intermediation, underscoring the need for fiscal consolidation (Box 2).

The Authorities' Responses and Policy Intentions

11. **The authorities expected a significant lift from the stimulus and reaffirmed their commitment to medium-term fiscal consolidation.**

- *Fiscal stimulus.* The authorities attached high importance to supporting employment[4] and stressed that benefits from the stimulus measures should extend at least through FY2010 given the schedule for implementation. The authorities shared the view that the near-term fiscal stance should remain flexible in the face of downside risks.

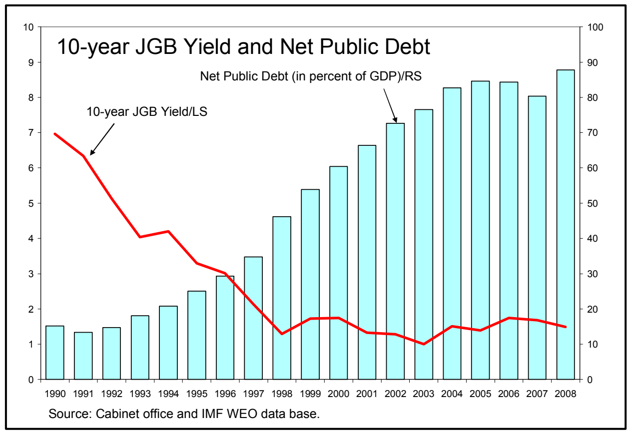
- *Medium-term fiscal sustainability and public pensions.* The authorities stressed that their commitment to pursue medium-term fiscal consolidation was critical for maintaining market confidence. They agreed that greater emphasis on the debt ratio could help raise public support for fiscal consolidation and supplement a primary balance target to guide annual budget planning, and despite the current political climate, plan to unveil additional details of the new fiscal targets in the June *Basic Policies*. As for the public pension system, the authorities did not see an immediate need for parametric changes, although they acknowledged that the objective of raising the compliance rate for contributions from about 60 to 80 percent in the medium term may prove challenging.

- *Public debt management.* The authorities considered their close communication with the market to have helped facilitate larger issuances of JGBs and stabilize yields.

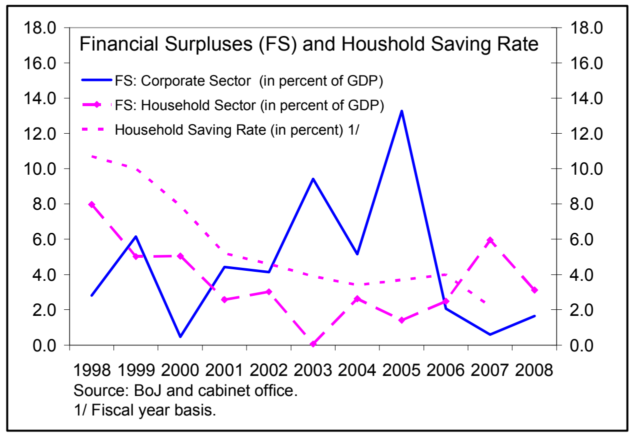
[4] The authorities project that employment measures could help maintain about 1.3 million jobs a year, or about 2 percent of the labor force.

Box 2. Market Challenges to Financing Japan's Fiscal Stimulus[1/]

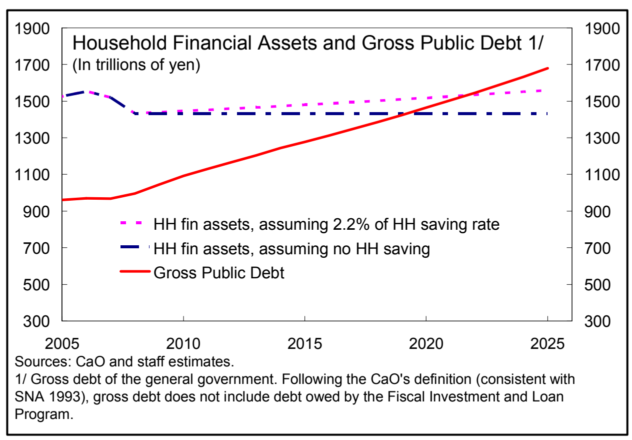
Despite the significant widening of the deficit, the JGB market appears so far to have had little difficulty in absorbing the new debt. JGB yields have remained below 2 percent over the past 10 years, during a period when net public debt increased by 40 percent of GDP, suggesting that JGB yields thus far have not been sensitive to changes in the fiscal position. This may be due to some factors specific to Japan, such as (until recently) high household saving rates, stable institutional investors, and strong home bias. In addition, the large financial surpluses of the corporate sector since the early 2000s may have played a role in providing funds to the JGB market through the banking system.



Going forward, these favorable market conditions are likely to diminish. Japan is undergoing rapid population aging, which has lowered the household savings rate and may over time limit the JGB market's absorptive capacity for new debt. Financial reforms that have given institutional investors more flexibility could also hinder the market capacity. For example, the Japan Post Bank (previously the postal savings) and the national pension funds are now looking to expand their investments in risky assets, and are no longer required to accept JGBs from the Fiscal Investment and Loan Program (FILP).



To maintain smooth financing of public debt, fundamental fiscal reform at an early stage is critical. Staff's simulation suggests that without policy adjustment, gross public debt would rise sharply and exceed the level of household financial assets within eleven years. At this point or even before, other sources of funding could become more important, including from overseas.



1/ See accompanying Selected Issues Paper on the "The Outlook for Financing Japan's Public Debt ."

While recognizing the decline in demand for JGBs with population aging, they saw little short-term financing risk given the still large pool of domestic savings, and were hopeful that the investor base could be diversified, including among foreign investors.

B. Supporting Growth with Monetary Policy

Background

12. **The BoJ has adopted a three-pronged strategy to support the economy involving policy rate cuts, measures to ensure the stability of financial markets, and steps to facilitate corporate financing (Figure 4).**

- *Interest rate policy.* In late 2008, the BoJ reduced its policy rate in two steps from 50 to 10 basis points—effectively hitting the zero bound—amid rapidly increasing economic slack and emerging downward pressures on prices.
- *Additional easing measures.* The BoJ has maintained stability in financial markets and improved access to corporate financing through a number of measures, including significant liquidity injections, considerable broadening of the range of eligible collateral, special funds-supplying operations to facilitate corporate financing, U.S. dollar funds-supplying operations, and higher volume of JGB purchases. In addition, the BoJ has purchased outright high-rated commercial paper and corporate bonds (see Appendix I for more details).
- *Buttressing the financial system.* As a back-stop to the financial system, the BoJ has resumed its purchases of banks' stockholdings, although purchases thus far have been limited. The BoJ has also offered to provide subordinated loans to banks to support their capital base.

13. **Partly in response to monetary and credit easing, borrowing rates have fallen considerably from previous highs, while bank credit growth has picked up as firms have managed to shift from market financing.** This sets Japan apart from other major advanced economies such as the United States and Euro area where bank credit growth has fallen sharply in response to the need for deleveraging. However, despite the recent improvement, overall financial conditions remain tight given the strong yen, elevated risk premia, stricter lending attitudes of financial institutions, and low stock prices.

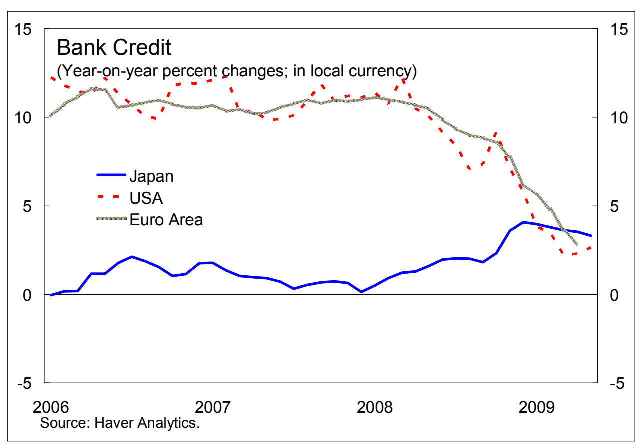
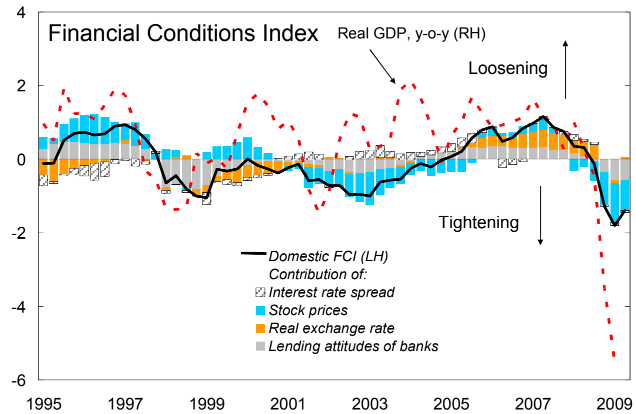


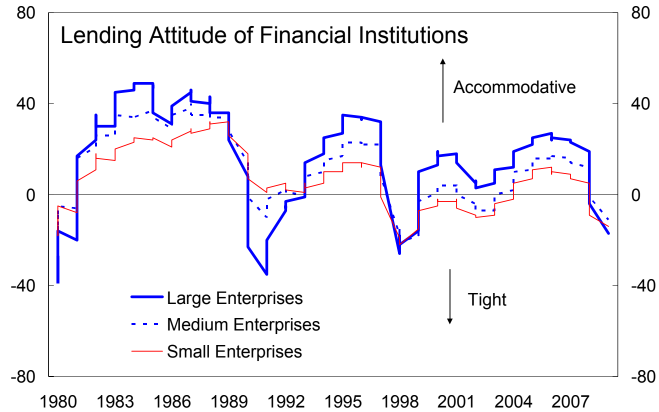
Figure 4. Japan: Monetary Policy and Credit Conditions

Financial conditions remain tight …



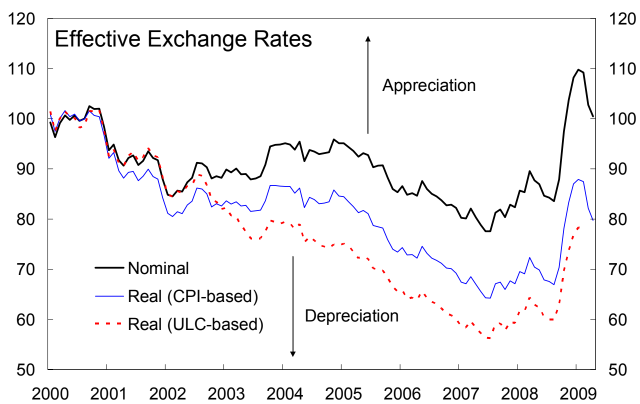
Source: IMF staff estimates.

… in part due to stricter lending attitudes of banks …



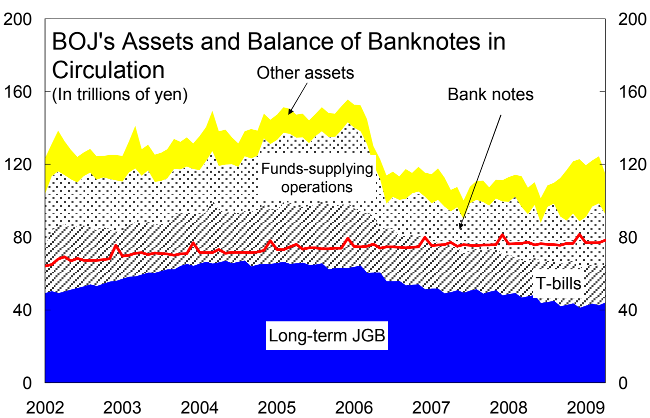
Source: Tankan Survey, Bloomberg.

… and the strong yen.



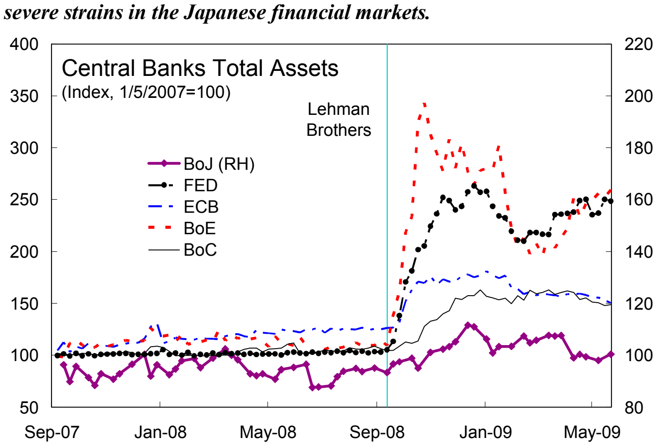
Sources: INS, Information Notice System, Global Data Source, and staff estimates.

With the policy rate reduced to 0.1 percent, the Bank of Japan undertook some credit easing measures …



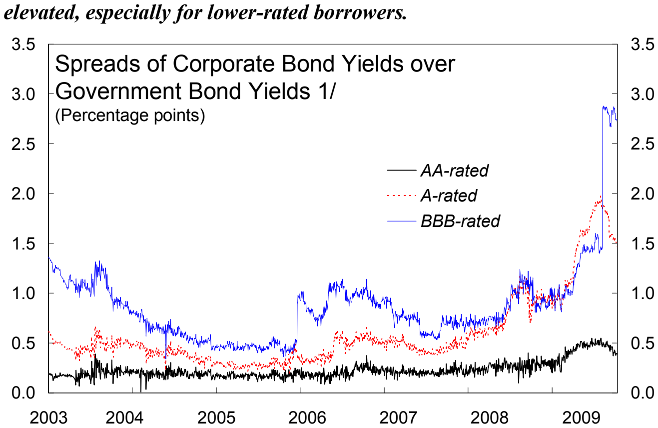
Source: Haver Analytics and BOJ Web site.

… but on a smaller scale than other leading central banks reflecting less severe strains in the Japanese financial markets.



Sources: Haver Analytics and Bloomberg.

Despite some easing after year-end, lending spreads remain highly elevated, especially for lower-rated borrowers.



Source: CEIC database.

1/ Bond yields are with 5-year maturity. The ratings are of R&I.

Policy Issues and Staff Views

14. **The BoJ's policy response to the crisis has been well-calibrated. Should downside risks materialize, further steps may be needed.**

- *Near-term stance.* In light of the significant widening of the output gap and downward pressures on prices, monetary policy appropriately remains accommodative.[5] With the credit channel still functional and fiscal policy expansionary, the current accommodative stance can be expected to provide meaningful support to growth during the downturn.

- *Addressing financial strains.* Should the outlook deteriorate and financial stresses re-emerge, the BoJ could expand its easing operations. In such circumstances, the BoJ could consider relaxing the eligibility criteria for commercial paper and corporate bond purchases or extending the maturity of its operations for corporate financing and its FX swap facility to help reduce the cost of longer-term funding. The BoJ could also increase its JGB purchases to facilitate money market operations.

15. **Further enhancements to the BoJ's communication strategy might be useful.** Adopting the three-pronged strategy has been helpful in explaining the BoJ's policy intentions across a broad range of areas. Communication has also been enhanced by the publication of two-year forecasts for growth and inflation and more comprehensive discussion of risk factors. However, a gap has emerged between the BoJ Policy Board's two-year inflation forecast and its medium-term understanding of price stability.[6] In the current deflationary environment, clarifying the time horizon over which inflation is expected to return to a range consistent with this understanding could help anchor medium-term inflation expectations in positive territory. Although the case may be less compelling than during the period of quantitative easing, a commitment to maintaining low interest rates until prices recover might also help cap longer-term rates in the period ahead.

16. **The BoJ should continue to minimize risks to its balance sheet, while mapping out an exit strategy for unwinding its policies.** The balance sheet risks so far appear manageable given the short duration and high quality of its asset purchases. However, should downside risks materialize, the BoJ will need to weigh carefully the macroeconomic benefits from additional easing measures against the risks of impairing the BoJ balance sheet and

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[5] A simple Taylor rule with a weight of 0.5 on the output gap and 1.5 on the deviation of projected inflation from the median of BoJ Policy Board's understanding of price stability (headline inflation of 0–2 percent) implies an optimal policy rate of about –5 percent compared with the current rate of 0.1 percent.

[6] In the BoJ's April *Outlook* report, the FY2010 forecast of the majority of the BoJ Policy Board members for core inflation (excl. fresh food) was between –0.8 and –1.1 percent, well below the Policy Board members' understanding of price stability.

distorting market functions. In this case, as is well recognized by the BoJ, a clear delineation of the role of fiscal and monetary policies would help protect against such risks.

The Authorities' Responses and Policy Intentions

17. **BoJ officials stressed the importance of clearly identifying the goals of monetary policy in the current environment.**[7]

- *Monetary policy stance.* The BoJ reiterated that it is paying attention to the downside risks to activity and prices as it aims to return Japan's economy to a sustainable growth path with price stability. However, since Japan's expansion earlier this decade was partly based on an unsustainable build-up of various excesses overseas, a protracted adjustment is inevitable. Rather than attempting to fully offset the downturn, monetary policy should aim to smooth the adjustment and prevent a freefall of the economy.

- *Risks and benefits of additional easing measures.* Although financial conditions were assessed by the BoJ as "severe" in its recent *Outlook* report, policy measures including CP and corporate bond purchases have helped boost confidence by providing a back-stop for banks to sell their holdings. If financial conditions deteriorate again, the BoJ agreed that additional policy measures could be considered. However, the authorities pointed out the risks of prolonged market interventions in slowing down the pace of restructuring and hindering market activity. They also made clear that increased purchases of JGBs were not intended to finance the deficit or target long-term yields.

18. **Effective communication entails a careful explanation of the process through which the economy can return to a sustainable growth path with price stability.** The BoJ noted that with considerable uncertainty about the outlook, longer-term definitive forecasts that attempted to reconcile current projections of deflation with the 0–2 percent understanding of price stability would not be reliable and could deviate significantly from actual outcomes, reducing public confidence in the central bank's assessment of economic trends. Furthermore, committing to low interest rates by relying only on developments in inflation (or inflation forecasts) may not be suitable given the need to monitor multiple aspects of the economy, including asset prices and conditions in the financial system.

19. **The BoJ intends to exit from its easing policies in an orderly manner when economic and financial conditions permit.** The BoJ saw its credit easing as effective but

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[7] The BoJ's Policy Board bases its monetary policy decisions on the short-term outlook for economic activity and prices, as well as an assessment of longer-term risks from financial imbalances, including asset bubbles. In this respect, the BoJ's monetary policy framework already implements some of the recent proposals on how central banks should respond to emerging imbalances.

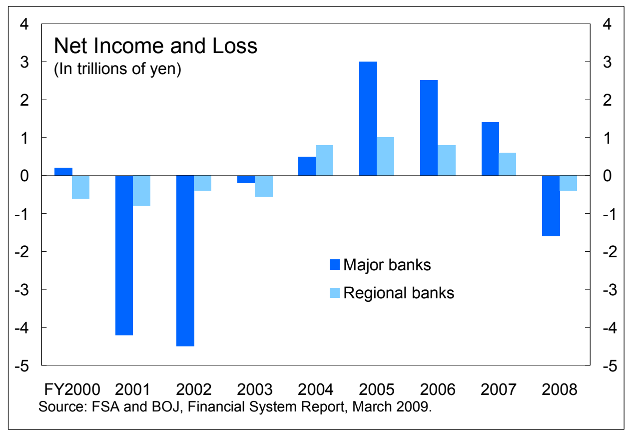
was concerned about creating market distortions.[8] The BoJ has sufficient instruments (such as the ability to issue its own bills and pay interest on reserves) to facilitate an orderly exit. Moreover, many of its existing operations will unwind automatically either due to a pre-set expiration date or a built-in loss of attractiveness once market conditions normalize. However, the decision on the timing of exit could be complicated by uncertainties about the outlook.

C. Policies to Strengthen the Financial and Corporate Sectors

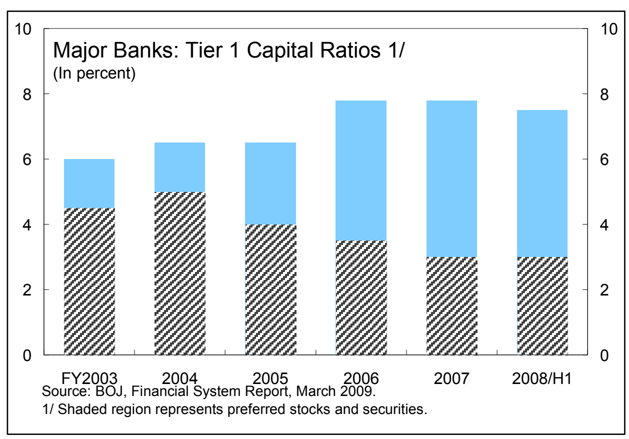
Background

20. **Bank profits have declined on rising credit costs and large losses on equity holdings (Figure 5)**.

- *Bank profitability.* In FY2008, both major and regional banks recorded their first aggregate net losses in five years, reflecting higher credit costs, lower fee income, and losses on equity holdings (which have been much larger than losses on subprime and other structured assets). Given the sharp slowdown, NPL ratios for major banks rose for the first time in seven years, while falling marginally for regional banks.[9]



- *Bank capital.* Major banks have raised over ¥3 trillion in private capital over the past year, helping to maintain their Tier 1 capital at close to 7¾ percent during FY2008. The share of preferred stock and hybrid instruments in Tier 1 capital remains high for major banks, at between 20 to 60 percent, but has been declining over time, while core Tier 1 capital or tangible common equity measures are correspondingly lower. For regional banks (which do not have much preferred equity), Tier 1 ratios have also remained broadly steady at around 8 percent.



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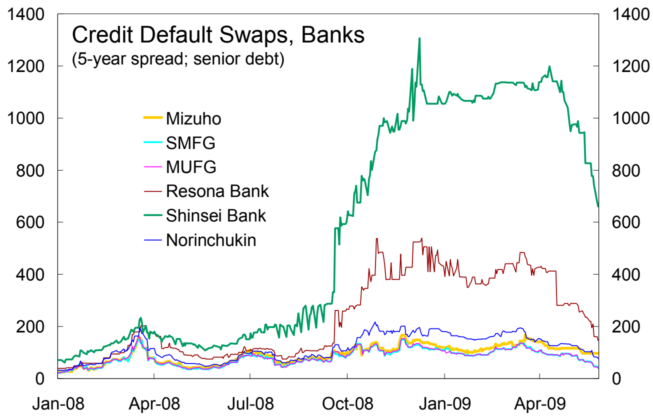
[8] For example, the BoJ's operations have helped push down a-1+ CP yields below the comparable T-bill rate.

[9] In November 2008, the FSA revised the criteria for nonperforming loans to exclude certain restructured loans to SMEs with a credible plan to rehabilitate their business within 10 years.

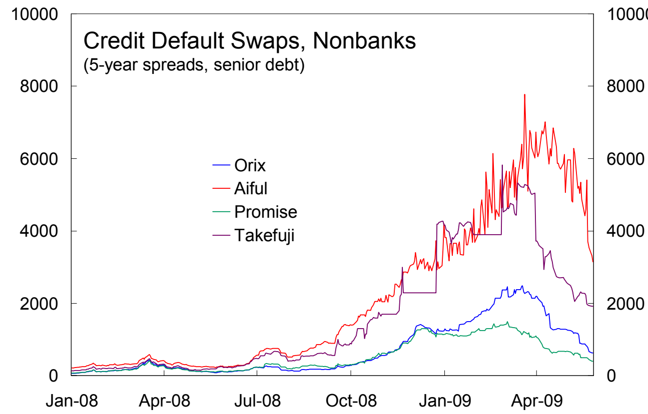
Figure 5. Japan: Financial Sector Vulnerabilities

The CDS spreads for banks have come down significantly from their peaks …



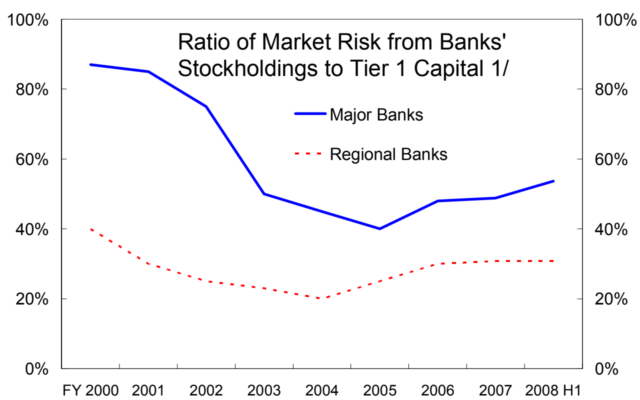
Sources: Bloomberg and staff calculations.

…including for consumer finance companies.



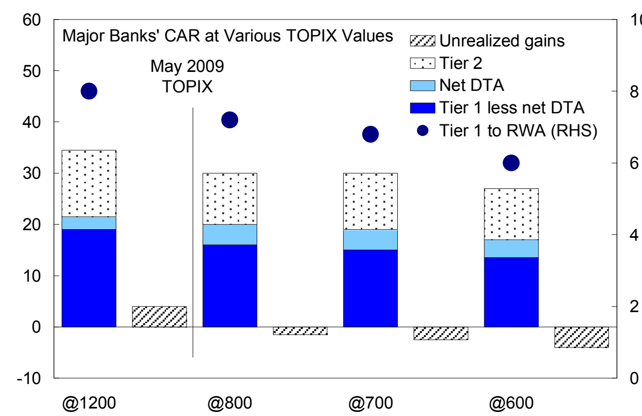
Sources: Bloomberg and staff calculations.

Banks' shareholdings remain a key source of risk…



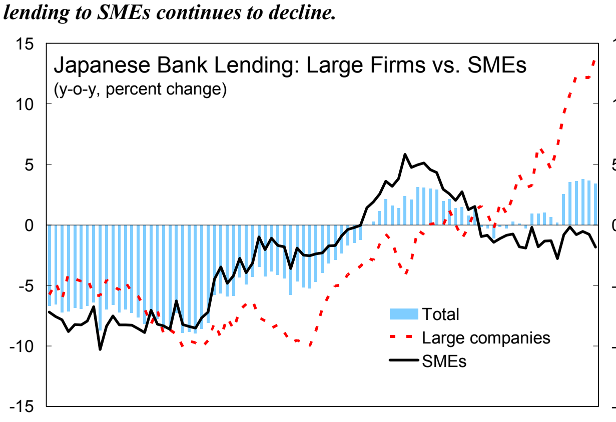
Source: BoJ Financial System Report, March 2009.
1/ BoJ estimates measured by 1-year, 99 percent VAR using the TOPIX.

… leaving banks vulnerable to declines in equity prices.



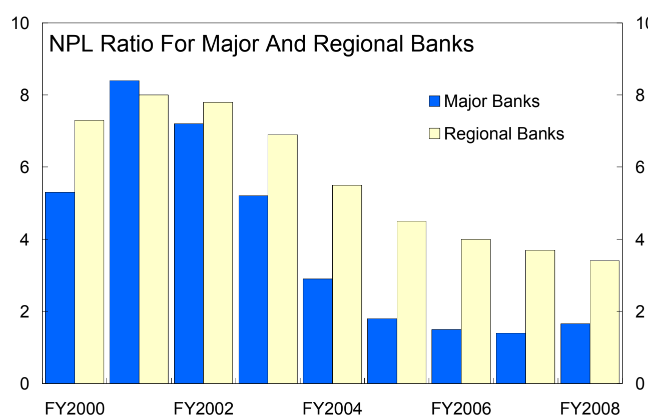
Source: Fitch.

Bank lending to large corporations has increased significantly, while lending to SMEs continues to decline.



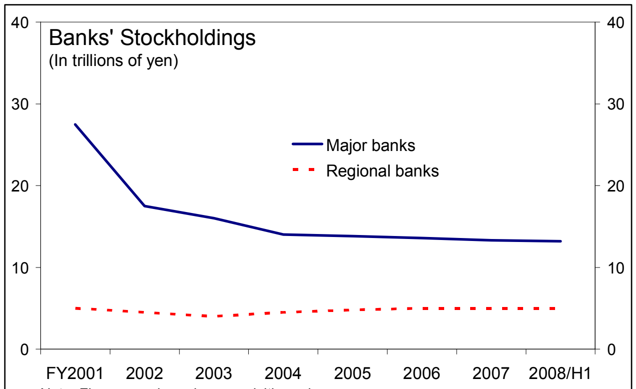
Source: CEIC.

… but NPLs and credit risks from a slowing economy are likely to pick up.



Source: FSA.

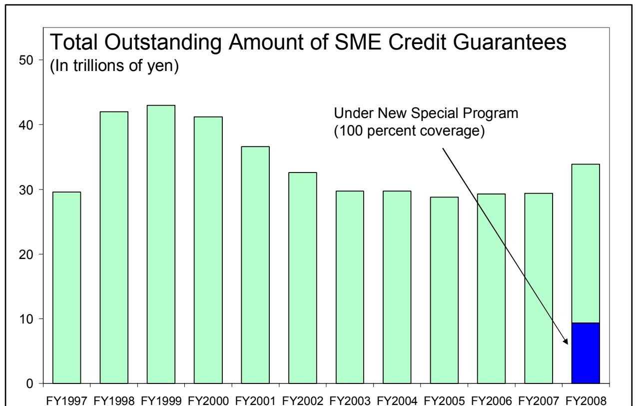
- *Bank equity holdings.* While major banks' shareholdings halved between FY2001 and FY2004, these holdings represent nearly half of Tier 1 capital and remain a key source of market risk (as was realized when equity prices collapsed during the crisis). That said, the equity stakes are relatively long-term investments as they mainly reflect cross-shareholdings with key borrowers and related investors.



Note: Figures are based on acquisition prices.
Source: BOJ, Financial System Report, March 2009.

- *Policy support.* The authorities have adopted measures to bolster capital and promote lending, including setting aside ¥12 trillion for public capital injections and up to ¥21 trillion for purchases of bank stockholdings (including the BoJ scheme). However, only a handful of regional banks have so far applied for public capital despite the generous terms and limited conditionality.

21. **At the same time, the corporate sector faces risks from a prolonged downturn.** Profits of manufacturers have plummeted along with the collapse in foreign demand and the stronger yen. With access to market financing tight, large corporations, who entered the recession with strong balance sheets, have increasingly turned to banks for funding. On the other hand, bank lending to SMEs continues to decline, despite the expansion of credit guarantees by the government.[10] More generally, SMEs and lower-rated firms have been hit hard by the recession and continue to face financing difficulties given their weaker financial position (Box 3).



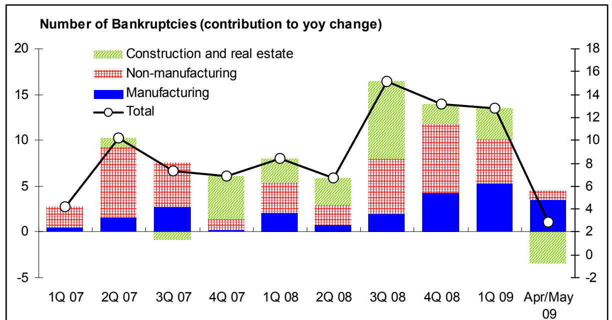
Source: National Federation of Credit Guarantee Corporations; METI.

[10] As part of the stimulus plan, special credit guarantees of nearly ¥10 trillion have been extended to cover around 490,000 SMEs since October 2008, in some cases replacing existing guarantees. These special guarantees provide 100 percent coverage (up from 80 percent compared to standard guarantees) and for some loans, extend for as long as 10 years.

Box 3. Challenges from the Current Crisis Facing SMEs

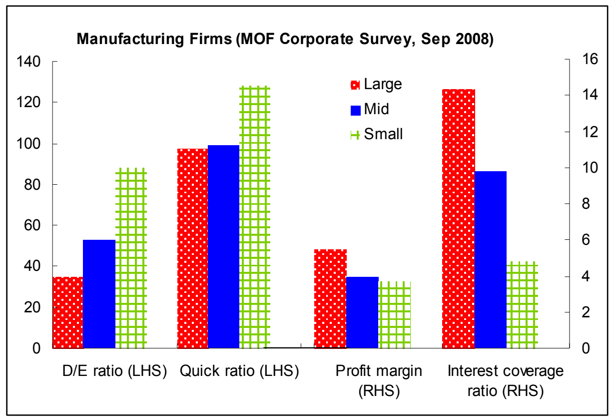
SMEs are an important part of the Japanese economy.[1] SMEs account for over 50 percent manufacturing shipment and 25 percent of exports and investment. They span many industries (e.g., 90 percent are in services) and historically have served as key suppliers to large manufacturing firms. SMEs account for nearly 70 percent of employment and in recent years have been a major source of jobs for the economy.

SMEs were hit hard by the global slowdown whose shock rippled down the entire supply chain. Large manufacturers responded to the shock by slashing production and cutting costs, including from their SME suppliers. Shrinking cashflow and tighter financial conditions have put a strain on SMEs, forcing many to either consolidate or exit. Bankruptcies have steadily increased, particularly among small manufacturing firms.

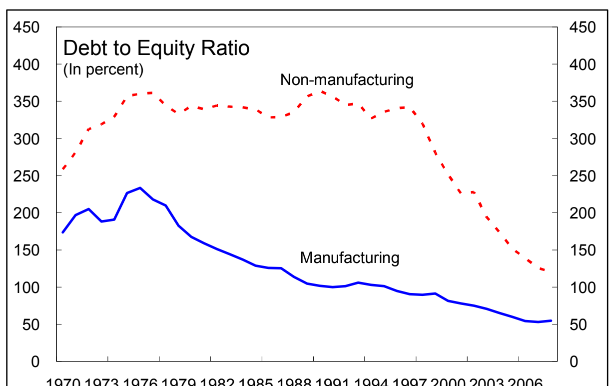


Source: Shoko Research

Structural weaknesses have also left SMEs vulnerable to the crisis. Prior to the crisis, SMEs suffered from significantly higher leverage and lower profitability than larger firms who benefited from the aggressive deleveraging after the banking crisis. Debt-equity ratios for SMEs remain nearly three times as high and profitability, as measured by the interest coverage ratios (ICR), four times lower compared to large firms. Although SMEs appear more liquid, this to some extent reflects their limited access to market financing, leading them to rely more on retained earnings for their working capital.



Promoting further restructuring of the SME sector could generate new investment opportunities and support the rebalancing process. Restructuring through either out-of-court workouts or the bankruptcy system could help SMEs to strengthen their balance sheets, improve core profitability, and reorient themselves to the new global environment, much in the way that the large corporations did after the banking crisis. With their greater domestic orientation, a vibrant SME sector could also help absorb shifts in labor from large corporations who are adjusting to a period of slower global demand. In particular, with profitability much lower and leverage ratios almost twice as high in non-manufacturing, there appears to be significant scope for further restructuring in the services sector.



Source: CEIC database.

1/ See accompanying *Selected Issues* paper on the Current Challenges Facing SMEs in Japan.

Policy Issues and Staff Views

22. **In the current environment, financial policies should continue to strengthen the resilience of the system.** Government and BoJ measures have been effective in stabilizing the financial system and facilitating corporate financing, but risks of a corrosive feedback loop between financial strains and weakening activity remain. To address such risks, policies should focus on:

- *Strengthening bank capital and profitability.* To enhance the level and quality of capital in the system, public funds could be targeted to help restructure and/or merge weak banks and facilitate the raising of private capital.[11] Such consolidation would also help address the long-standing structural problem of low profitability and excess capacity, particularly for some regional and smaller banks.

- *Reducing risks from bank equity holdings.* Further reductions in stockholdings are taking place gradually under the Basel-II approach of applying higher capital charges on bank equity holdings from 2014. In the current environment, public purchases of equities from banks have proved challenging given some banks' unrealized losses. A possible alternative would be to provide some ring-fencing or partial insurance to protect bank balance sheets from declining equity prices in exchange for the banks committing to reduce their holdings when prices recover.

- *Resolving systemically important nonbanks.* The current global crisis has highlighted the need in Japan, as elsewhere, for establishing resolution frameworks for addressing liquidity and solvency problems of systemically important nonbanks such as life insurance companies.

- *Restarting the market for securitization*. Reflecting difficulties in the real estate and consumer finance markets, issuances of securitized products fell by 45 percent in FY2008. Steps to jumpstart securitization, such as by providing partial government guarantees on asset-backed securities, could help SMEs, REITs, and nonbanks regain access to this market.

23. **Measures to promote corporate restructuring could help the economy adjust to the severe downturn.** A public asset management company, similar to the Industrial Revitalization Corporation of Japan (IRCJ), could be restarted to assist banks in working out viable but distressed firms by providing new financing and helping resolve creditor disputes.

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[11] The BoJ conducts comprehensive and rigorous macro stress tests in its semi-annual *Financial System Report*. The stress tests outlined in its March 2009 report suggest that some banks could face capital shortfalls if the growth outlook deteriorates and the stock market declines again. Specifically, Tier 1 capital ratios in FY2009 for the bottom 10 percent of banks would fall below the level in the late 1990s and early 2000s under a scenario with GDP growth of –4 percent in FY2009 and the TOPIX falling to the same level as its bottom after the collapse of the bubble economy.

Guidelines for out-of-court workouts were introduced in 2001 to facilitate large-scale restructuring and could be adapted to also assist small and medium-sized cases. For court-led restructuring, streamlining procedures for smaller firms or expanding the availability of financing could help encourage distressed firms make better use of the Civil Rehabilitation Law.[12]

24. **As the crisis eases, exceptional interventions in the financial and corporate sectors will need to be smoothly unwound.** Public financial support to corporations and regulatory forbearance, if sustained for too long, could hinder market discipline and needed balance sheet adjustments. In addition, the sizeable increase in SME credit guarantees raises the risk of large fiscal costs while slowing the pace of restructuring.[13]

25. **To address these risks, a transparent exit strategy is needed, to be implemented as soon as conditions normalize, with the broad aim of protecting government solvency, while preserving financial stability and promoting restructuring.** For instance, reverting to partial coverage or a more risk-based scheme on SME lending might encourage banks to take actions against distressed borrowers, and could be a part of an exit strategy for allowing markets to drive the restructuring process. Companies that default under the guarantee scheme could be promptly sold to the Resolution and Collection Corporation (RCC) or to the private sector for restructuring. Corporations that receive public capital injections should continue to operate on a commercial basis with clear criteria for exit to avoid propping up nonviable firms.[14]

The Authorities' Responses and Policy Intentions

26. **The authorities broadly shared staff's assessment of policy priorities, but saw less need for pre-emptive actions.**

- *Strengthening bank capital and profitability.* Based on their stress tests of the banking system, the supervisors considered the overall level of bank capital to be sufficient. Thus their broad policy intention was to ensure credit availability, rather than to promote restructuring or consolidation, which should be guided by individual banks'

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[12] The law effective since 2000 allows existing management to operate the firm under a court-approved rehabilitation plan.

[13] Japan's experience with credit guarantees after its banking crisis highlights the risks associated with their rapid expansion on generous terms. A similar program in 1998 extended nearly ¥29 trillion in credit guarantees with 100 percent coverage, resulting in net losses to the government of around ¥2 trillion. The program expired in 2001 and reverted back to a partial coverage scheme.

[14] See Caballero, R., Hoshi, T., and Kashyap, A., 2008, "Zombie Lending and Depressed Restructuring in Japan", *American Economic Review*, Vol. 98 (December) for an analysis of how the persistence of so-called "zombie" firms in the late 1990s depressed job creation and investment for healthy firms.

commercial interests. They pointed out that their existing capital injection schemes were working and expected additional smaller banks to apply. The authorities believed that applying tangible common equity measures to Japan was not appropriate at this moment given the banking system's more stable sources of funding, long investment horizon of preferred shareholders, and lower exposure to "toxic assets". Moreover, a shift away from Tier 1 to common equity measures could lead to uncertainty over regulatory capital and contribute to pro-cyclical behavior by banks.

- *Reducing risks from bank equity holdings.* While the regulatory forbearance on unrealized equity losses at regional banks could be considered as a form of ring-fencing,[15] the authorities were skeptical about applying such a strategy more explicitly, citing concerns about potential moral hazard and risks to taxpayers. Nevertheless, they continue to encourage banks to enhance their risk management processes, while offering to purchase stocks from banks at market prices.

- *Resolving systemically important nonbanks.* Given their generally sound financial position, the authorities saw little urgent need at this stage to establish a special framework for resolving large systemic nonbanking institutions but would continue participating in global discussions on this issue.

- *Restarting securitization*. The authorities recognized the importance of reviving securitization and have taken steps to enhance the transparency and reliability of the market, including by encouraging securities dealers to ensure traceability of securitized products and by regulating credit rating agencies.

27. **The authorities broadly agreed with the staff's assessment of the corporate sector, but did not see substantial risks from the SME lending program.** The authorities viewed credit guarantees as crucial for supporting SME employment, which accounts for almost 70 percent of the labor force. To promote restructuring, the authorities noted that a new law is currently being discussed by the Diet to establish a public asset management company, similar to the ICRJ, that would provide financial support for restructuring, with a focus on medium-sized firms.

[15] Following a temporary change in capital adequacy requirements in November 2008, regional banks subject to domestic standards are no longer required to deduct unrealized losses on securities from Tier 1 capital.

V. Exchange Rate and External Stability

Policy Issues and Staff Views

28. **According to staff analysis, the current value of the yen is consistent with medium-term fundamentals.**

- *Exchange rate assessment.* In terms of the IMF's Consultative Group on Exchange Rates (CGER)'s three analytical methods, the yen's effective exchange rate was estimated close to its medium-term equilibrium value as of March 2009. The real effective exchange rate is also currently close to its long- term average since 1990.

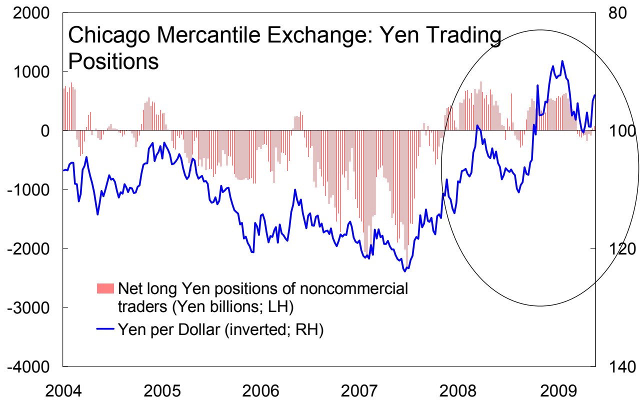
- *Exchange rate framework.* Despite rapid appreciation of the yen (Figure 6), the authorities have not intervened in foreign exchange markets. The staff continues to support the official policy that the exchange rate should be market determined, with intervention only justified to counter disruptive exchange rate movements.

29. **With the significant unwinding of yen carry trade positions, risks to external stability from financial spillovers have declined.** Vulnerabilities from cross-border exposures—both to and from Japan—do not appear significant and have fallen over time (Box 4). Looking ahead, however, a rebound in global risks appetite could reignite carry trades, including among retail investors, and bring these linkages back into play more forcefully. With the stronger yen, FDI outflows from Japan have picked up, especially to the United States and emerging Asia (notably India, Korea, and Vietnam). In the short term, the tax exemption on dividends paid by overseas subsidiaries, which took effect in April, could support financial inflows.

30. **Over the medium term, Japan's current account surplus will likely remain close to its equilibrium level.** The medium-term current account balance is projected at around 1½ percent of GDP—close to the estimated equilibrium level (about 1¾ percent), but well below the levels typical earlier this decade (3½ percent during 2002–07) owing to lower export demand, reduced asset returns, and population aging. The narrowing current account surplus will help facilitate global rebalancing, although the severe impact of the downturn on Japan, together with the possibility of sustained lower external demand, point to the need for accelerated reforms to rebalance growth toward domestic demand.

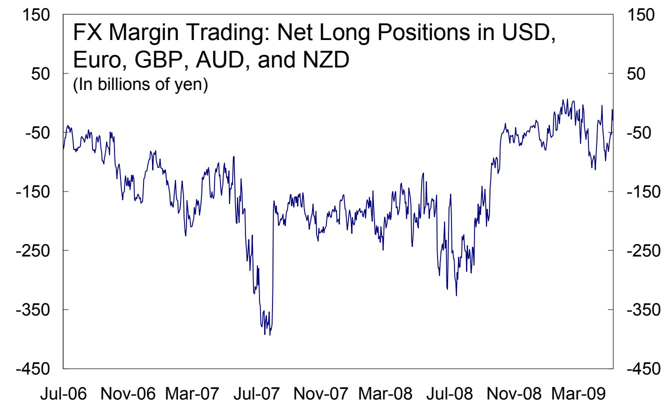
Figure 6. Japan: Exchange Rate and Capital Flows

The yen has appreciated significantly since the onset of the global financial turmoil as carry trades were unwound, including by both noncommercial traders…



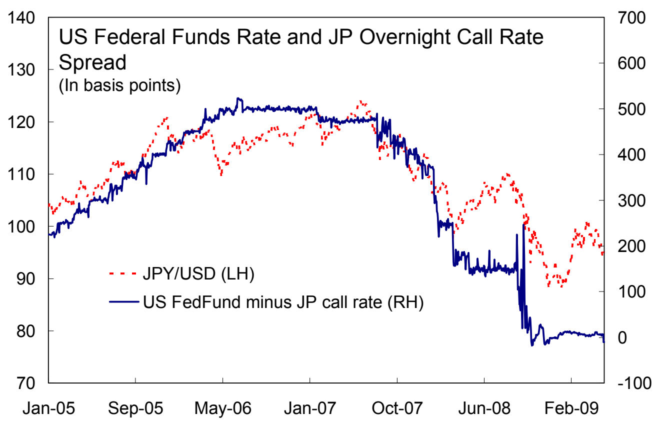
Sources: Bloomberg and staff calculations.

..and FX margin investors, who have been liquidating their short yen positions…



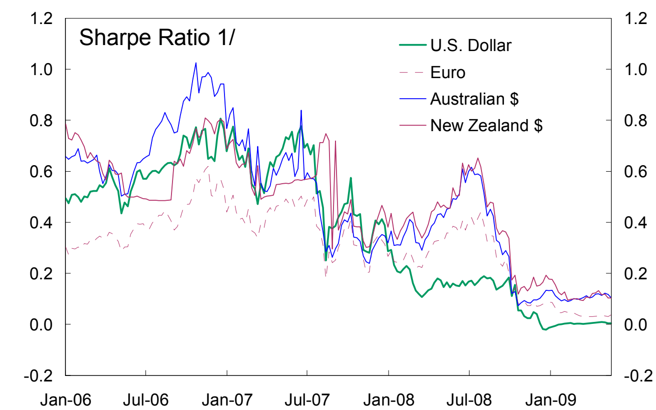
Source: Tokyo Financial Exchange.

…in the face of narrowing interest differentials against key currencies and higher risk aversion …



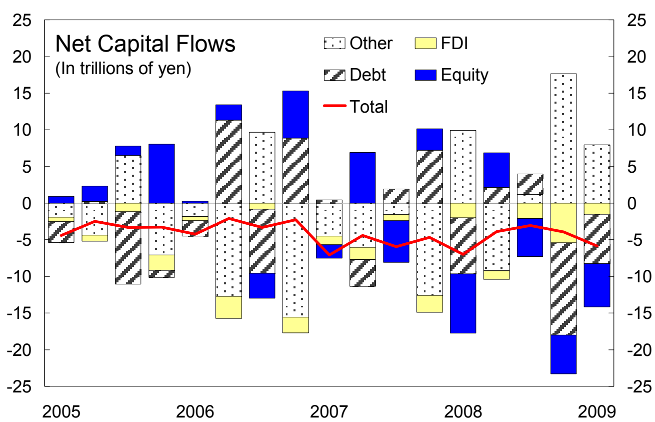
Source: CEIC database.

…which reduced the risk-adjusted returns on carry trades.



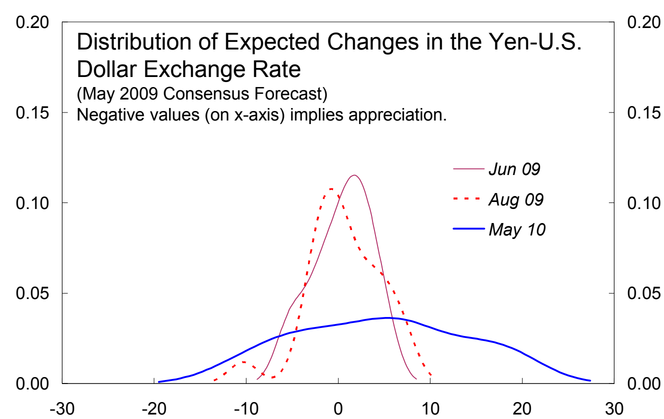
Sources: Bloomberg and staff estimates.

Record portfolio outflows have been offset by a retrenchment in short-term overseas lending.



Sources: CEIC Data Company Ltd. and staff calculations.

With key global interest rates approaching zero and the uncertain global outlook, there is little consensus on the yen's future direction.

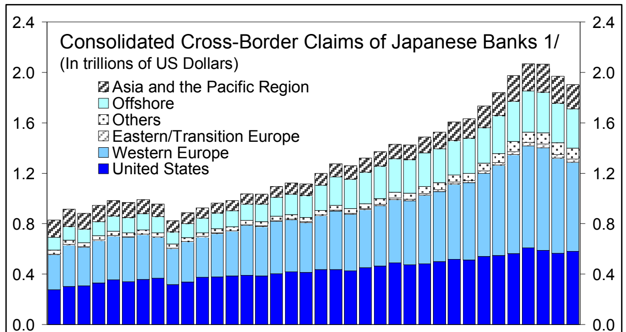


Sources: Consensus Forecast and staff calculations.

1/ The Sharpe ratio (defined as the 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.

Box 4. Assessing Risks to External Stability from Financial Spillovers

Cross-border claims of the Japanese financial system have expanded in recent years reflecting increasing financial integration. While overseas exposures remain relatively low compared with U.S. and European banks, Japanese banks have been re-establishing global operations that had been scaled back during the "lost decade". Since mid-2002, Japanese banks' cross-border claims have more than doubled from $800 billion to around $2 trillion, with Western Europe accounting for more than 40 percent of the increase. Exposures to the US and Western Europe account for more than two-thirds of total overseas claims, but lending to the rest of Asia, in particular China and Korea, has also picked up since 2003.



Source: BoJ, "Consolidated International Banking Statistics in Japan."
1/ Consolidated cross-border claims in all currencies and local claims in non-local currencies of Japanese banks to each country and region.

However, overseas exposures have fallen since the second half of 2008, reflecting factors such as unwinding yen carry trades and a retrenchment of Japanese institutions' external funding commitments. Various proxies for overseas yen funding—including bank lending to foreign institutions, foreign bank borrowing in Japanese money markets, foreign exchange margin trading and short-yen positions of non-commercial traders—suggest that carry trade positions have been unwinding in the face of the global crisis.

Network analysis suggests that risks to Japan's external stability arising from cross-border banking spillovers—both to and from Japan—appear low and have generally fallen over the past year.[1] Analysis considers an extreme scenario with a country defaulting on all its cross-border liabilities, in turn triggering a global liquidity squeeze. Tracking the full range of domino effects from one economy to another following this shock, Japan emerges as one of the most resilient systems in the group of 16 BIS reporting economies:

- *Spillovers to Japan.* No country default would lead to a depletion of the Japanese banking sector's capital, although the U.K. and the U.S. defaults would inflict significant capital impairment. Interestingly, the vulnerability of the Japanese banking sector has decreased from its March 2008 peak.
- *Spillovers from Japan.* The failure of the Japanese banking system would not trigger the failure of any other banking system but would lead to significant capital losses in Switzerland, France and Australia. Japan has the fourth largest impact on the U.S. banking system after the U.K., France, and Germany.

Banking Spillovers to and from Japan:
Capital Impairment following credit and funding shock

	Dec-07	Mar-08	Dec-08
Trigger Country:	(in percent of pre-shock capital)		
France	-16.9	-38.2	-14.5
Germany	-18.0	-20.0	-33.0
United Kingdom	Fully impaired		-49.5
United States	Fully impaired		-97.5
Affected Country:			
France	-16.3	-24.8	-36.9
Switzerland	-84.4	-85.1	-59.5
Australia	-1.4	-18.5	-18.7
United States	-4.0	-12.9	-12.2

1/ A Selected Issues paper assesses potentially systemic linkages using network and CoRisk analysis, as featured in Chapter 2 of the April 2009 GFSR.

The Authorities' Views

31. **The authorities noted the difficulties in identifying the factors behind the recent movements in the exchange rate.** They reaffirmed their commitment to a market determined exchange rate and saw no case for intervention in the foreign exchange market as long as conditions remained orderly, consistent with the G-7 policy stance. The authorities again voiced skepticism about current account-based estimates of "equilibrium" exchange rates which in their view do not adequately account for structural capital flows (such as declining home bias), a serious omission in the case of Japan.

VI. Policies to Rebalance Growth in the Medium Term

Since overseas deleveraging is likely to constrain external demand for a prolonged period, measures to rebalance growth toward domestic demand will be critical to supporting living standards and securing fiscal sustainability.

Background

32. **The IMF's Multilateral Consultation during 2006–07 identified reform priorities for Japan in the areas of product and labor market liberalization, inward FDI, and financial market development to help boost domestic demand.** Reform progress has been slow due to a lack of political consensus and the steep decline in economic activity.

- *Liberalizing product markets*. The government signed economic partnership agreements (EPAs) with Vietnam and Switzerland, and made some limited progress in opening up protected markets such as nursing.
- *Labor reforms*. Several steps were taken to protect vulnerable workers during the recession, in particular, by relaxing the eligibility criteria for employment insurance. Minimum overtime pay will also be raised from April 2010 and a compensatory leave option in lieu of higher overtime payments will be introduced at firms upon agreement with their employees.

Policy Issues and Staff Views

33. **The prospects of a protracted period of weaker external demand lend greater immediacy to the long-standing need to rebalance growth.** On current policies, potential growth could fall from about 1¾ percent in 2007 to close to 1 percent over the medium term, as investment rates decline with tighter corporate financing and structural rigidities slow the necessary reallocation of labor and capital to more productive uses.

34. **Given the need to absorb excess labor and reallocate capital, the short-term emphasis should be on reforms which create new investment and job opportunities.**

Further deregulation of the agricultural and services sectors—including medical, child, and elderly care—could create new drivers for growth and job creation.[16] Further reforms in the areas of inward FDI and financial market development, and steps to facilitate SME restructuring could also support rebalancing. In light of the sharp increase in unemployment, difficult labor market reforms could be put on hold for now, but pressures to reduce market flexibility should be resisted.

The Authorities' Responses and Policy Intentions

35. **Beyond the immediate challenge of filling in for falling external demand, the authorities recognized the need for Japan to become less dependent on export-led growth and to maintain competitiveness, including through reforms to secure fiscal sustainability.**

- *Social safety net*. Recent measures have focused on improving social protection of nonregular workers, providing partial coverage of corporate payroll expenses, and expanding retraining programs. The government will announce in its June *Basic Policies* further steps to provide better safety net and vocational programs without reducing labor market flexibility.

- *Medium-term priorities*. The authorities agreed that medium-term rebalancing would require structural reforms to boost household incomes. In particular, wage growth had been sluggish even before the onset of financial turmoil amid pressures from globalization, technological changes, and labor market dualities.[17] The authorities also saw pent-up demand for social services such as child care or long-term elderly care, such that removing supply side constraints could boost potential output. Promoting green, low-carbon technology (including through the current stimulus package) would also help increase domestic value added, while potentially creating new export industries.

VII. Staff Appraisal

36. **Japan faces a difficult set of immediate and longer-term challenges.** While Japan was not at the center of the global financial crisis, the collapse in external demand and financial spillovers have plunged the economy into a severe recession and exposed its continued dependence on export-led growth. The authorities are taking appropriate steps to support the economy, but despite such actions, the outlook remains uncertain and a sustained recovery depends crucially on the strength of the global upturn.

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[16] The priorities for deregulation in services were discussed in detail in Chapter V of IMF Country Report No. 07/281.

[17] For a detailed analysis of factors underpinning weak wage growth in Japan, see Sommer, M.: "Why Are Japanese Wages So Sluggish?" IMF Working Paper 09/97.

37. **In the near-term, policies should continue to support growth, while preserving financial stability.**

- *The BoJ's policy response—including policy rate cuts, measures to ensure the stability of financial markets, and steps to facilitate corporate financing—has been timely and effective.* In staff's view, monetary policy needs to remain accommodative in the period ahead, with the BoJ standing ready to provide further credit easing in the event the outlook deteriorates or financial stresses reappear.

- *Fiscal policy should also remain flexible to address further downside risks.* The stimulus packages in 2008 and 2009 have provided valuable support to the economy. Further measures may be necessary should the downturn prove more protracted, with continued emphasis on measures that are targeted and temporary.

- *Financial policies should continue to focus on strengthening the resilience of the system to a protracted slowdown.* Priorities going forward should be to strengthen bank profitability and capital, reduce risks from bank equity holdings, and promote the restructuring of distressed but viable firms.

38. **The extraordinary nature of current policies calls for an orderly exit when the economy recovers.** In light of the rapid rise in public debt and fiscal pressures from the aging society, it will be important to outline a clear fiscal consolidation strategy to take effect once the crisis abates. In addition to new targets that aim to put the debt ratio firmly on a downward path, securing medium-term fiscal sustainability will likely require expenditure measures and comprehensive tax reforms, including a commitment to raise the consumption tax after the recovery takes hold. The BoJ has sufficient instruments to facilitate an orderly exit from its monetary and credit easing policies, with many of its market operations set to unwind automatically when conditions normalize. The exit from financial sector interventions should be guided by the need to preserve financial stability, protect government solvency, and promote needed restructuring. Again, the challenge will be to determine the proper timing and conditions for withdrawing such support.

39. **Structural reforms are needed to help rebalance growth over the medium term.** In this context, efforts to deregulate the agricultural and services sectors—including medical, child, and elderly care—could create new drivers for growth and job creation. Further reforms to encourage inward FDI, financial market development, and product market flexibility could also support rebalancing and help Japan adjust to changes in the global economy.

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

Table 1. Japan: Selected Economic Indicators, 2005–10

Nominal GDP: US$4,910 billion (2008)
Population: 127.7 million (2008)
GDP per capita: US$38,454 (2008)
Quota: SDR 13,312.8 million

					Proj.		
	2005	2006	2007	2008	2009		2010
Growth (percent change) 1/							
Real GDP	1.9	2.0	2.3	-0.7	-6.0		1.7
Domestic demand	1.7	1.2	1.2	-0.9	-3.4		1.2
Private consumption	1.3	1.5	0.7	0.6	-1.0		0.6
Residential investment	-1.5	0.5	-9.7	-7.6	-5.2		-2.3
Business investment	9.2	2.3	5.7	-4.0	-21.4		-1.4
Government consumption	1.6	0.4	1.9	0.8	2.9		3.2
Public investment	-10.1	-5.7	-7.3	-6.9	12.9		9.6
Stockbuilding 2/	-0.1	0.2	0.3	-0.2	-0.2		0.0
Net exports 2/	0.3	0.8	1.1	0.2	-2.9		0.5
Exports of goods and services	7.0	9.7	8.4	1.8	-29.3		4.6
Imports of goods and services	5.8	4.2	1.5	0.9	-16.2		0.0
Inflation (annual average)							
CPI 3/	-0.3	0.3	0.0	1.4	-1.1		-0.8
GDP deflator	-1.2	-0.9	-0.7	-0.9	1.0		-1.0
Unemployment rate (annual average)	4.4	4.1	3.9	4.0	5.1		5.8
Government (percent of GDP, fiscal year basis)							
General government							
Revenue	29.9	30.8	31.4	30.1	30.6		31.1
Expenditure	34.5	34.2	34.6	36.8	42.2		40.5
Balance	-4.5	-3.4	-3.3	-6.7	-11.6		-9.4
Primary Balance	-3.8	-2.7	-2.6	-5.6	-10.3		-7.9
Primary Balance excluding social security	-3.1	-1.8	-1.5	-3.9	-8.3		-5.9
Public Debt, gross (calendar year basis)	191.6	191.3	187.8	196.7	217.4		226.3
Money and credit (percent change, end-period)							
Base money	1.0	-20.0	0.4	1.8	7.9	5/	...
M2 (period average)	1.9	0.7	2.1	1.8	2.6	6/	...
Domestic credit	-0.1	-3.0	-2.1	1.7	2.3	7/	...
Bank lending (after adjustment)	1.1	2.8	0.8	4.6	3.9	5/	...
Interest rate							
Overnight call rate, uncollateralized (end-period)	0.00	0.28	0.46	0.10	0.10	5/	...
Three-month CD rate (annual average)	0.06	0.22	0.51	0.51	0.33	8/	...
Official discount rate (end-period)	0.10	0.40	0.75	0.30	0.30	5/	...
Balance of payments (in billions of US$)							
Current account balance	165.7	170.4	211.0	157.1	92.0		81.5
Percent of GDP	3.6	3.9	4.8	3.2	1.8		1.7
Trade balance	93.8	81.1	105.1	38.4	-8.5		-9.7
Percent of GDP	2.1	1.9	2.4	0.8	-0.2		-0.2
Exports of goods, f.o.b.	567.4	615.7	678.4	746.5	507.5		549.5
Imports of goods, f.o.b.	473.6	534.6	573.3	708.0	516.0		559.3
Oil imports (trade basis)	99.2	123.3	130.1	190.6	138.8		169.5
FDI, net (percent of GDP)	-0.9	-1.3	-1.2	-2.2	-1.5		-1.4
Terms of trade (percent change)	-5.2	-6.8	-2.1	-9.6	12.6		-6.3
Change in reserves	22.3	32.0	36.5	30.8	...		...
Total reserves minus gold (in billions of US$)	834.3	879.7	952.8	1009.4	1000.0	5/	...
Exchange rates (annual average)							
Yen/dollar rate	110.2	116.3	117.8	103.4	98.2	8/	...
Yen/euro rate	137.3	146.0	161.4	152.1	136.2	8/	...
Real effective exchange rate 4/	70.8	63.2	58.3	64.7	72.3	6/	...
Real effective exchange rate (CPI-based)	79.4	72.0	66.6	72.7	80.4	5/	...

Sources: Global Insight, Nomura database; IMF, Competitiveness Indicators System; and Fund staff estimates and projections as of June 12, 2009.

1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ Contribution to GDP growth.
3/ Based on published annual averages of the CPI index.
4/ Based on normalized unit labor costs; 2000=100.
5/ May 2009.
6/ April 2009.
7/ March 2009.
8/ June 15, 2009.

Table 2. Japan: General Government Operations, 2004–2010 1/

(In percent of GDP)

	2004	2005	2006	2007	2008	2009 Proj.	2010 Proj.
				(Fiscal year)			
Total revenue	28.6	29.9	30.8	31.4	30.1	30.6	31.1
Taxes and fines	16.3	17.3	17.8	18.0	17.0	17.3	17.7
Social security premiums	10.5	10.6	10.8	11.1	11.2	11.4	11.5
Property income	1.5	1.8	2.0	2.0	1.6	1.6	1.5
Total expenditure	34.0	34.5	34.2	34.7	36.8	42.2	40.5
Current	30.7	30.7	30.5	31.2	33.4	37.5	36.4
Consumption	11.8	11.6	11.5	11.6	12.1	12.9	12.9
(less) Depreciation	-3.1	-3.1	-3.1	-3.1	-3.2	-3.1	-3.1
Social security benefits	15.9	16.2	16.3	16.7	17.8	19.1	19.3
Other current	3.5	3.5	3.4	3.6	4.0	5.8	4.2
Interest paid	2.5	2.4	2.5	2.5	2.7	2.9	3.0
Capital	3.4	3.8	3.7	3.4	3.4	4.6	4.2
Investment	3.7	3.6	3.2	3.0	3.0	4.1	3.7
Land acquisition	0.4	0.7	0.4	0.4	0.4	0.5	0.4
Capital transfers	-0.8	-0.4	0.0	0.0	0.0	0.0	0.0
Of which : Bank support	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance	-5.5	-4.5	-3.4	-3.3	-6.7	-11.6	-9.4
Primary balance	-4.4	-3.8	-2.7	-2.6	-5.6	-10.3	-7.9
Excluding social security	-4.0	-3.1	-1.8	-1.5	-3.9	-8.3	-5.9
Structural balance 2/	-5.0	-4.3	-3.3	-3.3	-5.2	-8.4	-6.6
				(Calendar year)			
Total revenue	28.1	29.4	30.7	31.0	30.1	30.7	31.0
Taxes and fines	15.9	16.8	17.7	17.9	17.1	17.4	17.7
Social security premiums	10.4	10.6	10.8	10.9	11.1	11.4	11.5
Property income	1.5	1.7	1.9	2.0	1.6	1.6	1.5
Total expenditure	34.2	34.4	34.7	33.6	35.9	41.0	41.2
Current	30.7	30.7	30.6	30.8	32.5	36.8	36.7
Consumption	11.8	11.7	11.5	11.5	11.9	12.8	12.9
(less) Depreciation	-3.0	-3.1	-3.1	-3.1	-3.1	-3.1	-3.1
Social security benefits	15.8	16.1	16.4	16.5	17.4	19.0	19.3
Other current	3.5	3.6	3.4	3.4	3.8	5.4	4.6
Interest paid	2.5	2.4	2.4	2.5	2.6	2.8	3.0
Capital	3.5	3.7	4.1	2.7	3.3	4.2	4.5
Investment	3.9	3.6	3.3	3.1	3.0	3.7	4.1
Land acquisition	0.5	0.6	0.4	0.4	0.3	0.5	0.4
Capital transfers	-0.9	-0.5	0.3	-0.7	0.0	0.0	0.0
Of which : Bank support	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance	-6.2	-5.0	-4.0	-2.5	-5.8	-10.3	-10.3
Primary balance	-5.0	-4.2	-3.4	-1.9	-4.9	-9.0	-8.8
Excluding social security	-4.7	-3.7	-2.6	-1.0	-3.3	-7.1	-6.8
Structural balance 2/	-5.7	-4.7	-3.8	-2.6	-5.2	-7.0	-7.4
Debt (In percent of GDP, calendar year)							
Gross	178.1	191.6	191.3	187.7	196.6	217.4	226.3
Net	82.7	84.6	84.3	80.4	88.1	104.1	114.7
Memorandum items :							
Nominal GDP (FY, trillion yen)	498.5	503.2	510.9	515.8	497.6	481.8	486.3
Nominal GDP (CY, trillion yen)	498.3	501.7	507.4	515.8	507.5	481.7	484.9

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, 2004–09

(In percent of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008	Latest 2009
External indicators						
Real exports of goods and services (percent change)	13.9	7.0	9.7	8.4	1.8	…
Real imports of goods and services (percent change)	8.1	5.8	4.2	1.5	0.9	…
Terms of trade (percent change)	-2.2	-5.2	-6.8	-2.1	-9.6	…
Current account balance	3.7	3.6	3.9	4.8	3.2	…
Capital and financial account balance	0.3	-2.7	-2.5	-4.4	-4.2	…
Of which :						
Inward portfolio investment	4.3	4.0	4.6	4.5	-2.2	…
Inward direct investment	0.2	0.1	-0.1	0.5	0.5	…
Other investment liabilities (net)	0.4	-1.4	-4.0	-4.7	4.2	…
Total reserves minus gold (US$ billion)	833.8	834.3	879.7	952.8	1009.4	1000.0
In months of imports of goods and services	19.1	17.0	16.3	16.4	14.3	…
Broad money (M2 + CDs) to reserves ratio	0.8	0.8	0.7	0.6	0.7	0.8
Foreign assets of DMBs (US$ billion)	1088.0	1283.0	1200.9	1369.9	1662.4	…
Foreign liabilities of DMBs (US$ billion)	752.6	831.2	759.4	765.9	1099.9	…
Net international investment position (US$ billion)	1717.3	1639.5	1849.4	2125.0	2181.8	…
Of which :						
External loan liabilities	839.0	860.2	733.9	721.1	739.9	…
External public sector debt (gross) 1/	319.0	383.2	422.3	581.0	620.6	…
External loan liabilities to exports ratio	1.4	1.3	1.0	0.9	0.9	…
External interest payments to exports (in percent) 2/	1.4	1.7	2.5	2.5	1.9	…
Nominal effective exchange rate (percent change, period avg)	3.9	-3.2	-7.0	-5.0	12.4	15.9
Financial market indicators						
General government gross debt	178.1	191.6	191.3	187.7	196.6	…
Interest rates (percent, end-year)						
3-month General collateral repo rate 3/	0.01	0.01	0.47	0.60	0.22	0.18
3-month General collateral repo rate, real 3/	-0.19	0.41	0.17	-0.10	-0.18	0.29
3-month interest rate spread vis-à-vis U.S.	-2.19	-3.88	-4.37	-4.36	0.22	0.02
Stock market index (TOPIX, percent change, end-year) 4/	10.2	43.5	1.9	-12.2	-41.8	-36.2
Banking sector risk indicators						
Total loans to assets (in percent)	32.6	31.0	28.6	26.9	27.9	...
Total loans to deposits (in percent)	78.8	78.4	79.5	77.5	79.2	...
Share of real estate sector in total lending (in percent)	16.0	16.5	18.9	19.2	18.9	...
Share of nonperforming loans in total loans						
(In percent, end-fiscal year) 5/	2.9	1.8	1.5	1.4	1.7	...
Risk-weighted capital ratio (in percent, end-fiscal year) 5/ 6/	11.6	12.2	13.1	12.3	11.7	11.3

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/ 3-month Tokyo repo rate since October 2007.

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

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

6/ 2008 refers to first half of FY2008.

Table 4. Japan: Balance of Payments, 2003–08

	2003	2004	2005	2006	2007	2008
			(In billions of U.S. dollars)			
Current account	136.2	172.1	165.7	170.4	211.0	157.1
Trade balance	104.0	128.5	93.8	81.1	105.1	38.4
Exports	449.2	539.1	567.4	615.7	678.4	746.5
Imports	345.2	410.6	473.6	534.6	573.3	708.0
Invisibles	32.2	43.6	71.8	89.3	105.9	118.6
Nonfactor services	-31.4	-34.3	-24.1	-18.2	-21.2	-20.8
Investment income	71.3	85.8	103.6	118.2	138.7	152.6
Net transfers	-7.5	-7.9	-7.6	-10.7	-11.6	-13.1
			(In percent of GDP)			
Current account	3.2	3.7	3.6	3.9	4.8	3.2
Trade balance	2.5	2.8	2.1	1.9	2.4	0.8
Invisibles	0.8	0.9	1.6	2.0	2.4	2.4
Nonfactor services	-0.7	-0.7	-0.5	-0.4	-0.5	-0.4
Investment income	1.7	1.9	2.3	2.7	3.2	3.1
Net transfers	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3
			(In billions of U.S. dollars)			
Capital account	-4.0	-4.8	-4.9	-4.7	-4.1	-5.6
Financial account	-115.5	-138.5	-144.8	-134.7	-224.3	-204.6
Direct investment, net	-22.5	-23.3	-42.2	-56.7	-51.7	-106.2
Direct investment abroad	-28.8	-31.1	-45.4	-50.2	-73.7	-130.9
Foreign direct investment in Japan	6.3	7.8	3.2	-6.4	22.0	24.7
Portfolio investment, net	-97.3	24.6	-12.0	127.4	68.3	-298.7
Of which: Official	5.7	95.1	52.6	104.6	177.5	-27.2
Inflows	-177.9	-173.7	-196.2	-71.8	-127.2	-191.8
Outflows	80.6	198.3	184.1	199.2	195.4	-106.8
Other investment, net	192.4	21.1	-68.2	-173.4	-204.4	231.0
Of which: Official	8.8	4.1	25.6	-24.8	0.4	111.5
Inflows	215.3	8.1	122.5	57.6	-65.9	420.4
Outflows	-22.9	13.0	-190.7	-231.0	-138.5	-189.4
Reserve assets	-188.1	-161.0	-22.3	-32.0	-36.5	-30.8
Errors and omissions, net	-16.8	-28.8	-16.1	-31.0	17.4	53.1
Memorandum items:						
Nominal GDP (US$ billion)	4237.3	4607.6	4561.0	4363.3	4380.7	4915.1
Net foreign assets (NFA)/GDP	39.4	39.8	43.9	49.7	54.0	52.0
Return on NFA (In percent)	4.3	4.7	5.2	5.5	5.9	6.0

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

Table 5. Japan: Medium-Term Projections, 2007–14

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

	2007	2008	2009	2010	2011	2012	2013	2014
Real GDP	2.3	-0.7	-6.0	1.7	2.5	3.0	2.6	2.0
Total domestic demand	1.2	-0.9	-3.4	1.2	1.6	2.1	2.1	1.8
Net exports (contribution)	1.1	0.2	-2.9	0.5	1.0	1.0	0.6	0.3
Unemployment rate (percent)	3.9	4.0	5.1	5.8	5.6	5.3	4.6	4.3
CPI inflation	0.0	1.4	-1.1	-0.8	-0.4	0.1	0.6	0.8
Output gap	0.2	-1.7	-7.9	-6.8	-4.9	-2.8	-1.2	-0.4
Overall fiscal balance (fiscal years) 1/	-3.3	-6.7	-11.6	-9.4	-7.7	-7.4	-7.5	-7.5
Primary balance	-2.6	-5.6	-10.3	-7.9	-5.9	-5.5	-5.2	-5.0
Primary balance excl. social security	-1.5	-3.9	-8.3	-5.9	-4.2	-3.6	-3.4	-3.1
Debt (calendar years) 1/								
Gross	187.7	196.6	217.4	226.3	230.4	234.0	236.8	239.3
Net	80.4	88.1	104.1	114.7	121.6	128.0	133.8	139.5
Current Account Balance 1/	4.8	3.2	1.8	1.7	2.3	2.1	1.7	1.5

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

1/ In percent of GDP.

Appendix I. Japan: Recent Financial and Corporate Sector Support Measures

As part of its three-pronged strategy to address financial strains,[1] the BoJ reduced its policy rate from 0.5 to 0.1 percent and took measures to:

- *Ensure the stability of financial markets.* The BoJ broadened the range of eligible collateral adding REIT-issued debt, loans on deeds to municipal governments and some FX-denominated foreign government bonds. As for JGB repo operations, linkers, floaters, and ultra-long JGBs were added as eligible collateral. The BoJ also introduced unlimited U.S. dollar funds-supplying operations at a fixed rate via a swap line with the Fed, increased purchases of the JGBs (from ¥14.4 trillion to ¥21.6 trillion per year), started remunerating bank reserves, and made significant liquidity injections at the turn of calendar and fiscal years.
- *Facilitate corporate financing.* The BoJ introduced short-term unlimited fund supplying operations against corporate debt collateral, while increasing the frequency, size and range of eligible instruments for its CP repo and corporate debt operations (minimum eligible collateral rating for corporate bonds and loans was broadened from A to BBB). It has also adopted more direct "credit easing" measures by buying eligible commercial paper (grade a-1 or better; up to ¥3 trillion) and corporate bonds (rated A or above, with residual maturity of less than 1 year; up to ¥1 trillion) directly from banks.

To buttress financial system stability, the BoJ has separately offered to provide ¥1 trillion in subordinated loans to banks and re-started purchases of bank-owned stocks of up to ¥1 trillion.

Other public institutions have also taken steps in these areas:

- *Financial stability.* The government has set aside ¥12 trillion to recapitalize weak banks and will offer to purchase banks' stockholdings worth up to ¥20 trillion. Accounting rules on unrealized losses on securities holdings have been relaxed for domestic banks to help boost their reported capital ratios.
- *Facilitating corporate financing.* The government has supported SME financing through ¥30 trillion in budgeted new guarantees and around ¥15 trillion in loan support. To prevent large-scale layoffs and bankruptcies, additional funds have been made available to the DBJ: ¥10 trillion for loans, ¥2 trillion in public capital for injection into nonfinancial corporations, and ¥2 trillion for CP purchases. At the same time, moral suasion is being applied by the FSA for banks not to cut back on lending to healthy corporations. Separately, The MoF will lend ¥500 billion in foreign exchange reserves to JBIC to help Japanese companies meet their overseas funding needs.

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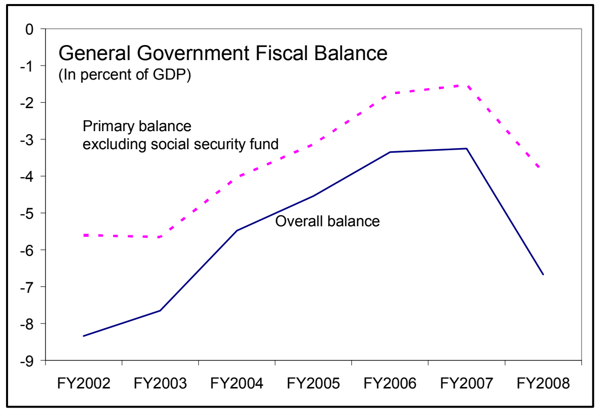
[1] For more details, see http://www.boj.or.jp/en/type/exp/seisaku_cfc/index.htm

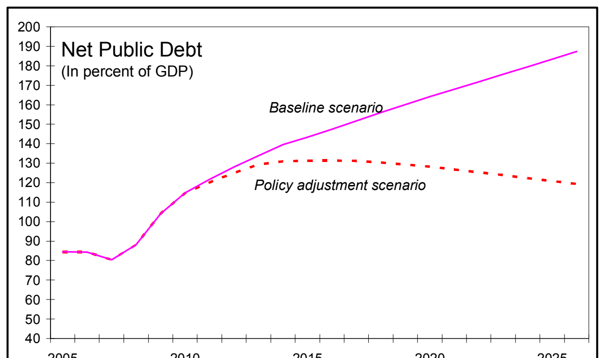
APPENDIX II. JAPAN: PUBLIC SECTOR DEBT SUSTAINABILITY

Background

In 2002, Japan set a target of achieving primary balance of the general government (excluding the social security fund) by the early 2010s. Subsequently, in *Basic Policies 2006*, the authorities announced a FY2011 target for achieving primary balance, and formulated a plan to cut expenditures by Y11-14 trillion (2-3 percent of GDP) over 5 years.[2] Until FY2007, there was steady progress in fiscal consolidation, reflecting tight expenditure controls and buoyant tax revenues. However, after several years of improvement, the fiscal deficit reversed substantially in FY2008 following the sharp economic contraction leaving the target of primary balance now out of reach.



In light of the recent developments, the authorities have abandoned the target of primary balance. The authorities have committed to take necessary legislative action by FY2011 to implement—conditional on an economic recovery—comprehensive revenue reforms including the consumption tax hike.[3] While timelines for actual implementation are not clear, the Council on Economic and Fiscal Policy is expected to present more details of the new fiscal targets in its *Basic Policies 2009* in June.



Source: Ministry of Finance, Cabinet Office, and staff estimations.

Debt Sustainability Analysis

Against this background, the staff has updated its assessment of Japan's medium-term public debt sustainability. The baseline scenario assumes the authorities' current policies with no increase in the consumption tax. Under the staff's policy adjustment scenario, the consumption tax would be increased by 5 percentage points starting in 2011 (3 percentage

[2] *Basic Policy 2006* also committed to reduce the debt/GDP ratio through the 2010s, but did not specify a target level.

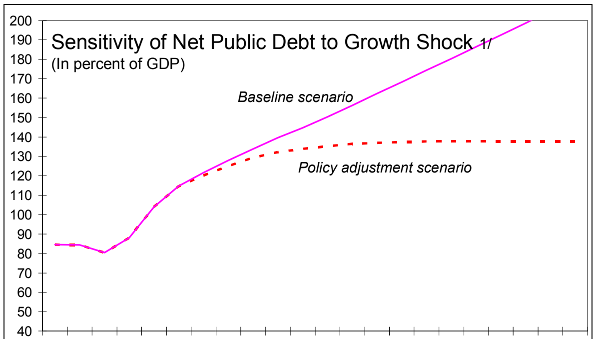
[3] Specifically, the cabinet decision in December 2008 reads: "The government will take the necessary legislative action by FY2011 in order to promptly implement the fundamental reform of the tax system including that of the consumption tax on the condition that an upturn in the Japanese economy is achieved through intensive efforts toward economic recovery within next three years starting from FY2008".

points in 2011 and 2 percentage points in 2014), while the authorities would make additional expenditure cuts of about 1.0 percent of GDP relative to the baseline between 2014–15.[4] After 2015, a further adjustment (1.5 percent of GDP) is assumed in this scenario. Both scenarios are based on the staff's macroeconomic assumptions, and focus on net debt of the general government including the social security fund.

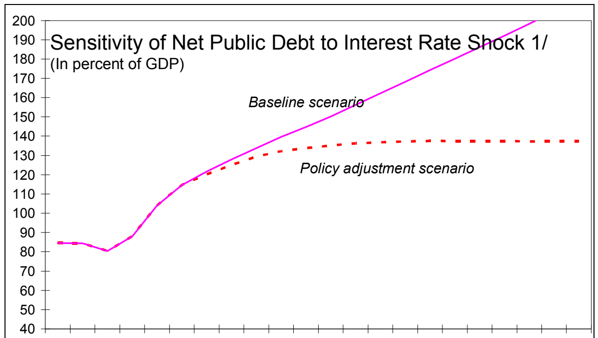
Medium-term Macroeconomic Assumptions	
Nominal interest rate on public debt	2.9
Real GDP growth	1.2
Inflation rate	1.0

The analysis suggests that without policy adjustment net public debt is likely to continue rising over the medium-term. Under the baseline scenario, the debt/GDP ratio exceeds 150 percent in 2018, while under the policy adjustment scenario, the debt/GDP ratio would peak at around 130 percent in 2015 and then decline. *The analysis also implies that under a plausible assumption where interest rates exceed the growth rate, primary balance would not be sufficient to stabilize the net debt/GDP ratio.*[5]

The debt dynamics are sensitive to macroeconomic assumptions and underscore the benefits of policy adjustment. For example, with a 1 percentage point decline in GDP growth or a 100 basis point increase in interest rate from 2012 onwards, net debt is projected to reach 200 percent of GDP by 2025 in the baseline scenario, while under the policy adjustment scenario, net debt would stabilize.



Source: Ministry of Finance, Cabinet Office, and staff estimations.
1/ Permanent 1 percentage point shock to growth rate from 2012 and unchanged primary balance.



Source: Ministry of Finance, Cabinet Office, and staff estimations.
1/ Permanent 100 basis point shock to interest rate from 2012 and unchanged primary balance.

[4] These measures together with unwinding of the stimulus would lead to an adjustment in the primary balance by 1.5 percent of GDP annually during 2011–15.

[5] On the other hand, the adjustment scenario targets the debt/GDP ratio of 130 percent in 2015 and achieves overall balance around 2020.

Table Japan: Public Sector Debt Sustainability Framework, 2005-2014
(In percent of GDP, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Debt-stabilizing primary balance 9/
1 **Net public sector debt 1/**	**84.6**	**84.3**	**80.4**	**88.1**	**104.1**	**114.7**	**121.6**	**128.0**	**133.8**	**139.5**	**0.5**
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	
2 Change in public sector debt	1.9	-0.2	-3.9	7.7	16.0	10.6	7.0	6.4	5.8	5.7	
3 Identified debt-creating flows (4+7+12)	4.5	3.1	1.2	7.1	15.0	9.6	6.1	5.3	4.8	5.5	
4 Primary deficit	4.2	3.4	1.9	4.8	8.8	8.8	6.4	5.6	5.3	5.1	
5 Revenue and grants	29.4	30.7	31.1	30.1	30.7	31.0	31.8	32.2	32.5	32.9	
6 Primary (noninterest) expenditure 2/	33.6	34.1	33.0	34.9	39.6	39.8	38.2	37.8	37.8	38.0	
7 Automatic debt dynamics 3/	0.3	-0.3	-0.7	2.3	5.9	0.8	-0.3	-0.3	-0.5	0.4	
8 Contribution from interest rate/growth differential 4/	0.3	-0.3	-0.7	2.3	5.9	0.8	-0.3	-0.3	-0.5	-0.6	
9 Of which contribution from real interest rate	1.8	1.4	1.2	1.7	0.4	2.5	2.5	3.3	2.8	2.1	
10 Of which contribution from real GDP growth	-1.6	-1.7	-1.9	0.6	5.5	-1.7	-2.9	-3.6	-3.3	-2.6	
11 Contribution from exchange rate depreciation 5/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.1	0.2	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities 6/	0.0	0.0	0.0	0.1	0.2	0.0	0.0	0.0	0.0	0.0	
15 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	
16 Residual, including asset changes (2-3)	-2.6	-3.3	-5.1	0.6	1.0	1.0	0.9	1.0	1.1	0.2	
Public sector debt-to-revenue ratio 1/	288.1	274.5	258.8	292.9	338.9	370.3	382.5	397.9	411.3	423.6	
Gross financing need 7/	32.5	31.7	29.6	33.6	42.4	45.8	46.4	48.0	49.9	51.9	
in billions of U.S. dollars	1480.5	1382.8	1296.0	1654.1	…	…	…	…	…	…	
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	1.9	2.0	2.3	-0.7	-6.0	1.7	2.5	3.0	2.6	2.0	
Average nominal interest rate on public debt (in percent) 8/	1.0	0.8	0.8	1.2	1.3	1.4	1.5	1.5	1.7	1.9	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.2	1.7	1.5	2.0	0.4	2.4	2.2	2.7	2.2	1.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-1.7	-5.4	-1.2	14.1	…	…	…	…	…	…	
Inflation rate (GDP deflator, in percent)	-1.2	-0.9	-0.7	-0.9	1.0	-1.0	-0.7	-1.2	-0.5	0.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.5	3.6	-1.1	5.3	7.0	1.7	-1.6	1.9	2.8	2.6	
Primary deficit	4.2	3.4	1.9	4.8	8.8	8.8	6.4	5.6	5.3	5.1	

1/ Covers the general government.
2/ Excludes capital injections into Japan Finance Corporation to support the special SME credit guarantee program (with 100 percent loss coverage).
3/ 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).
4/ The real interest rate contribution is derived from the denominator in footnote 3/ as r - π (1+g) and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 3/ as ae(1+r).
6/ Assumes that the total size of the special SME credit guarantee program (with 100 percent loss coverage) will reach ¥20 trillion and that the loss rate will be 7.5 percent.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that real growth is at its potential and other key variables (real interest rate and debt stock) remain at the level of the last projection year.

INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 2009 Article IV Consultation—Informational Annex

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

June 16, 2009

Contents Page

ANNEX 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 June 8, 2009)

	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]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	June 2009	June 2009	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2009	June 2009	M	M	M		
Reserve/Base Money	May 2009	June 2009	M	M	M	LO, LO, LO, LO	O, O, O, O, O
Broad Money	May 2009	June 2009	M	M	M		
Central Bank Balance Sheet	5/31/09	6/2/09	Every 10 days	Every 10 days	Every 10 days		
Consolidated Balance Sheet of the Banking System	Apr 2009	June 2009	M	M	M		
Interest Rates[2]	June 2008	June 2008	D	D	D		
Consumer Price Index	May 2009	May 2009	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2007	Feb 2009	A	A	A	O, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2007	Feb 2009	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar 2009	May 2009	Q	Q	Q		
External Current Account Balance	Apr 2009	June 2009	M	M	M	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	Apr 2009	June 2009	M	M	M		
GDP/GNP	2009 Q1	May 2009	Q	Q	Q	O, O, O, O,	LO, LO, O, O, LNO
Gross External Debt	Mar 2009	June 2009	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.

ANNEX II. JAPAN—FUND RELATIONS
(As of April 30, 2009)

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	11,187.48	84.04
Reserve position in Fund	2,125.95	15.97

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	891.69	100.00
Holdings	1,944.39	218.06

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.

VIII. **Article IV Consultation**:

The 2008 Article IV consultation discussions were held during May 13–22, 2008; the Executive Board discussed the Staff Report (IMF Country Report No. 08/253) and concluded the consultation on July 21, 2008. The concluding statement, staff report, staff supplement, selected issues paper, and PIN were all published.

Statement by the IMF Staff Representatives on Japan
July 6, 2009

1. This statement contains information that has become available since the Staff Report was circulated to the Executive Board on June 17, 2009. This information does not alter the staff's broad assessment of policy issues and recommendations contained in the staff report.

2. Recent data suggest that economic activity rebounded in the second quarter. Exports and industrial production grew strongly in May (by over 5 percent m-o-m) on the back of progress with inventory adjustment in the IT and auto sectors. Meanwhile, benefits of fiscal stimulus are beginning to be felt, with public works sharply higher and consumer spending edging up. Sizeable fiscal and monetary stimulus should help the economy maintain positive growth in the next few quarters. The June *Tankan* survey confirms some improvement in business sentiment, but mostly among large manufacturers, while business conditions for SMEs remain difficult. Looking ahead, Japanese corporates see downside risks from overcapacity, tight corporate financing, and external uncertainties. The large economic slack continues to exert downward pressures on prices—core inflation excluding food and energy has fallen to –½ percent (y-o-y). On balance, the recent data are broadly consistent with staff's growth and inflation projections.

3. The Bank of Japan (BoJ) kept its target rate unchanged at 0.1 percent during its monetary policy meeting on June 15–16, citing downside risks to the outlook. Given the stabilizing economy and some improvement in financial conditions, no new credit easing measures were announced. The benchmark 10-year JGB yield has recently fallen in line with global movements, by about 20 bps since mid-June.

4. The government released its FY2009 *Basic Policies* on June 23. On the fiscal front, the government committed to a new medium-term target of halving the primary deficit (excluding the social security fund) within 5 years, and achieving primary balance within 10 years. The government also intends to stabilize the debt-to-GDP ratio by the mid-2010s and to put it on a downward path during the early 2020s. However, no numerical targets for the debt ratio were specified. According to fiscal projections by the Council on Economic and Fiscal Policy, achieving these commitments would require raising the consumption tax by 7 percentage points, implying an adjustment of 3½ percent of GDP in the primary balance. While less ambitious than the 5 percent of GDP deficit adjustment under the staff's preferred scenario (primarily due to lower spending cuts), the thrust of these proposals is in line with staff's recommendations, and attention now needs to shift to articulating specific measures for achieving the medium-term targets. Other reform agenda focuses on enhancing the social safety net, including through broader eligibility for health care and unemployment benefits. The government also intends to boost its support to green industries as a way of raising potential growth.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/XX
FOR IMMEDIATE RELEASE
July 15, 2009

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

IMF Executive Board Concludes 2009 Article IV Consultation with Japan

On July 6, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Japan.[1]

Background

Although Japan was not at the center of the initial crisis, the collapse in external demand and financial spillovers have plunged the economy into a severe recession. After expanding robustly by 2.3 percent in 2007, GDP contracted by 0.7 percent last year. GDP fell by about 14 percent SAAR in both Q4 2008 and Q1 2009, led by a sharp decline in external demand for Japan's manufacturing exports, although production data have recently stabilized. Core inflation, which on staff's definition excludes both fuel and food prices, has turned negative. Meanwhile, the unemployment rate has jumped to 5.2 percent in May 2009.

Japan's financial markets have stabilized from the after-shocks of the Lehman Brothers collapse last September, but some stresses persist. The Japanese stock market has rebounded since March, but remains about 40 percent below end-2007 levels. The yen has appreciated by about 20 percent in real effective terms since August 2008, supported by unwinding carry trades and narrowing interest rate differentials against key currencies. Bank lending rates have declined following Bank of Japan's (BoJ) policy rate cuts, although falling inflation has pushed up real rates. Corporate bond spreads remain low for high-rated companies but have increased sharply for lower-rated firms.

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[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.

The fiscal balance has sharply deteriorated after improving for several years. While fiscal stimulus spending combined with automatic stabilizers will give a timely and needed boost to growth, it carries a significant fiscal cost. With the overall fiscal deficit projected to widen to about 11½ percent of GDP in FY2009, net debt is projected to reach 100 percent of GDP this year (220 percent of GDP in gross terms). The government has announced new medium-term targets in the FY2009 *Basic Policies*, including halving the primary deficit (excluding the social security fund) within 5 years and achieving primary balance within 10 years. The government has also committed to stabilizing the debt-to-GDP ratio by the mid-2010s and placing it on a downward path during the early 2020s.

Monetary policy has been accommodative. The BoJ reduced its policy rate from 50 to 10 basis points in late-2008. The BoJ also supported stability in financial markets through significant liquidity injections, broadening the range of accepted collateral, larger volume of JGB purchases, and U.S. dollar funds-supplying operations. In addition, the BoJ took steps to improve the availability of corporate financing, in particular, through unlimited funds-supplying operations against corporate debt collateral and outright purchases of high-quality commercial paper and corporate bonds. As a back-stop to the financial system, the BoJ has also resumed its purchases of banks' stockholdings and offered to provide subordinated loans to banks to support their capital base.

Financial policies are focusing on strengthening the resilience of the financial system. The authorities have adopted further measures to bolster capital and promote lending, while providing regulatory forbearance on unrealized equity losses at regional banks subject to domestic standards. At the same time, they have expanded the government's lending guarantee program to stabilize SME lending.

Despite recent tentative signs of stabilization at home and abroad, the outlook remains uncertain. Staff projects GDP to fall by 6 percent in 2009, before expanding by 1¾ percent in 2010. A sustained recovery will likely emerge during the course of 2010 but will hinge critically on improvement in overseas lending conditions and trade. Inflation is projected to remain negative until 2011. The current account surplus is expected to fall to 1½ percent of GDP in the short term, well below the levels typical earlier this decade. The risks to the outlook remain tilted to the downside, stemming from the rapidly deteriorating labor market, tight domestic financial conditions, and external uncertainties. On current policies, potential growth could fall from about 1¾ percent in 2007 to close to 1 percent over the medium term as investment rates decline due to tighter corporate financing and structural rigidities slow rebalancing of growth toward domestic sources.

Executive Board Assessment

While Japan was not at the initial epicenter of the global crisis, the ensuing collapse in external demand and financial spillovers have plunged the economy into a severe recession. Directors commended the authorities for their well-calibrated response, which is providing a much-needed boost to the economy. They expected a sustained recovery to take hold next year, in line with a pick up in global growth, with inflation in mildly negative territory during the slowdown. However, Directors emphasized that the outlook is exceptionally uncertain. Notwithstanding recent signs of stabilization, risks are tilted to the downside due to a deteriorating labor market, still-tight financial conditions, and lingering uncertainties about global growth.

In these circumstances, Directors recognized that Japan faces a distinct set of immediate and longer-term challenges. They agreed with the authorities that the focus of near-term policies should be to support growth and preserve financial stability. Once the economy recovers, attention will need to turn to implementing an exit strategy from the exceptional policy interventions necessitated by the crisis and to stepping up reforms for rebalancing growth. Determining the appropriate timing, speed, and conditions for unwinding support will be key.

Directors welcomed the support being provided by the fiscal stimulus packages, and emphasized the need for continued flexibility to address further downside risks. A longer or more severe recession could call for additional targeted and reversible measures next year. Noting the rapid rise in public debt and the aging population, Directors welcomed the authorities' medium-term consolidation strategy to be implemented once the recovery takes hold. In addition to new targets aimed at placing the debt ratio firmly on a downward path and careful debt management, such a strategy will likely require expenditure cuts as well as comprehensive tax reform, including an increase in the consumption tax after the recovery takes hold.

On the monetary front, Directors commended the authorities for their wide-ranging actions, which have helped to stabilize financial markets and facilitate corporate financing. The accommodative stance was seen as appropriate given the significant output gap and deflationary pressures. Going forward, most Directors supported additional credit easing measures should downside risks materialize or financial stresses resurface, while minimizing risks to the Bank of Japan's balance sheet. A few Directors suggested that clarifying the horizon over which inflation is expected to return toward the Bank of Japan's understanding of price stability could anchor expectations. With regard to the medium-term, Directors noted that the Bank of Japan has sufficient instruments to facilitate an orderly exit, and that many of its credit easing measures are set to expire automatically. The challenge will be to assess the appropriate timing and to clearly communicate the exit strategy to guide expectations.

Directors supported the authorities' commitment to a market-determined exchange rate. Following a sharp appreciation during the crisis, the yen appears in line with its longer-term equilibrium value according to IMF staff estimates.

Directors welcomed the steps taken to stabilize the financial system. The authorities should continue to strengthen the resilience of the system, notably by bolstering bank profitability and capital and reducing risks from their equity holdings. At the same time, promoting restructuring of viable but distressed firms could help the economy adjust to the downturn. Exit from financial and corporate sector interventions should be guided by the need to preserve financial stability, protect government solvency, and facilitate needed restructuring.

Over the medium-term, Directors encouraged the authorities to press ahead with structural reforms, including deregulating the agricultural and service sectors, enhancing product market flexibility, further developing financial markets, and encouraging inward foreign direct investment. While reform priorities are clear, their urgency has increased in the wake of the crisis. By rebalancing growth toward domestic demand, such reforms will help Japan adjust to structural shifts in the global economy. Directors also welcomed the recent steps to strengthen the social safety net.

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Japan: Selected Economic Indicators

	2005	2006	2007	2008	Proj. 2009	
Real GDP	1.9	2.0	2.3	-0.7	-6.0	
Private consumption	1.3	1.5	0.7	0.6	-1.0	
Nonresidential investment	9.2	2.3	5.7	-4.0	-21.4	
Residential investment	-1.5	0.5	-9.7	-7.6	-5.2	
Public investment	-10.1	-5.7	-7.3	-6.9	12.9	
Public consumption	1.6	0.4	1.9	0.8	2.9	
Stockbuilding (contribution to growth)	-0.1	0.2	0.3	-0.2	-0.2	
Foreign balance (contribution to growth)	0.3	0.8	1.1	0.2	-2.9	
Exports of goods and services	7.0	9.7	8.4	1.8	-29.3	
Imports of goods and services	5.8	4.2	1.5	0.9	-16.2	
Inflation						
GDP deflator	-1.2	-0.9	-0.7	-0.9	1.0	
CPI (SA) 1/	-0.6	0.2	0.1	1.4	-1.1	
CPI (NSA) 1/	-0.3	0.2	0.1	1.4	-1.1	
Unemployment rate (period average, percent)	4.4	4.1	3.9	4.0	5.1	
Current account balance						
Billions of U.S. dollars	165.7	170.4	211.0	157.1	92.0	
Percent of GDP	3.6	3.9	4.8	3.2	1.8	
General government balances (percent of GDP, FY)						
Balance including social security	-4.5	-3.4	-3.3	-6.7	-11.6	
Balance excluding social security	-4.8	-3.4	-3.0	-5.5	-10.2	
Structural balance 2/	-4.3	-3.3	-3.3	-5.2	-8.4	
Money and credit (12-month growth rate; end period)						
Base money	1.0	-20.0	0.4	1.8	6.4	3/
M2 (period average)	1.9	0.7	2.1	1.8	2.5	3/
Bank lending 4/	1.1	2.8	0.8	4.6	3.1	3/
Exchange and interest rates (period average)						
Yen/dollar rate	110.2	116.3	117.8	103.4	94.2	5/
Yen/euro rate	137.3	146.0	161.4	152.1	131.2	5/
Real effective exchange rate 6/	70.8	63.2	58.3	64.7	72.8	6/
3-month CD rate	0.06	0.22	0.51	0.51	0.33	5/
10-year government bond yield	1.39	1.74	1.68	1.49	1.30	5/

Sources: Global Insight, Nomura database and IMF 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 2009.

4/ Data reflect the inclusion of foreign banks, foreign trusts banks and Shinkin banks in the monetary survey.

5/ July 8, 2009.

6/ Based on normalized unit labor costs; 2000 = 100. Figure for 2009 is as of May.