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JAPAN

2013 ARTICLE IV CONSULTATION

August 2013

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 2013 Article IV consultation with Japan, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 31, 2013, with the officials of Japan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 12, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Press Release** summarizing the views of the Executive Board as expressed during its July 31, 2013 discussion of the staff report that concluded the Article IV consultation.

The documents listed below have 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 2013 ARTICLE IV CONSULTATION

July 12, 2013

KEY ISSUES

The Japanese authorities have embarked on an ambitious agenda to raise growth and exit deflation. The new policy framework—"three-arrows" of Abenomics comprising aggressive monetary easing, flexible fiscal policy, and structural reforms—provides a unique opportunity to end decades-long deflation and sluggish growth, and reverse the rise of public debt.

The new policies are buoying the near-term outlook. Unprecedented monetary easing supported by fiscal stimulus is leading to a pickup in domestic demand with GDP growth projected at 2 percent this year and inflation rising gradually.

However, all three arrows need to be launched for the policies to succeed. Uncertainty about the ambition of fiscal and structural reforms is adding to underlying risks. The government has recently outlined broad growth and fiscal strategies, but specific measures or a more concrete timetable in some areas remain to be formulated. Incomplete progress on fiscal and structural reforms could weigh on confidence and undermine the success of the new policy framework.

With its new monetary policy framework, the BoJ has taken the lead to end deflation. Careful communication and continued flexibility in implementing its policies is needed to contain financial market volatility and ensure an effective transmission of its easing policies.

However, a credible medium-term fiscal plan should be adopted as quickly as possible as fiscal risks have risen further. Raising the consumption tax rate to 10 percent, while maintaining a uniform rate by 2015 is an essential first step, but the government also needs to formulate a concrete set of growth-friendly revenue and expenditure measures for implementation in the medium term to achieve a declining debt-to-GDP ratio.

In addition, the government's structural reforms need to be concrete and comprehensive. To generate growth synergies, measures should include deregulation in agriculture and domestic services, lifting constraints to the provision of risk capital, reducing Japan's excessive labor market duality, reforming the tax system to stimulate investment, and further relaxing immigration requirements to areas with labor shortages.

Comprehensive reforms are also needed to further strengthen financial sector stability. They can reduce banks' bond holdings and create lending opportunities at home and abroad. However, new challenges could also arise, particularly for regional banks, if fiscal and growth reforms disappoint.

If a full package of reforms is implemented, the current moderate exchange rate undervaluation would be eliminated over time and the global economy would benefit. Failure to follow through on fiscal and structural reforms could, however, lead to overreliance on monetary policy with negative consequences for Japan and the global economy.

Approved By
Jerry Schiff and Tamim Bayoumi

Discussions took place in Tokyo from May 21–31, 2013. The staff team comprised J. Schiff (head), S. Danninger, D. Botman, J. Kang, W. Lam, I. Saito (all APD), S. Arslanalp (MCM), M. Das (RES) and G. Ganelli (OAP). Messrs. Lipton and Singh joined the meetings with senior officials. Ms. Mateos y Lago (APD) and Mr. Christou (EUR) presented the 2013 Spillover Report. Messrs. Momma, Shimoda, and Takimura (OED) also participated in the discussions. The mission met with BoJ Governor Kuroda, Finance Minister Aso, Economic and Fiscal Policy Minister Amari, FSA Commissioner Hatanaka, and other senior government officials and representatives of NGOs, the business association, and the labor unions. The mission was assisted by OAP staff.

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BACKGROUND AND CONTEXT

1. **In December, the new government announced an ambitious policy framework to end decades-long deflation and raise growth.** The "three-arrows" of Abenomics approach (aggressive monetary easing, flexible fiscal policy, and structural reforms) calls for a coordinated policy effort by the Bank of Japan (BoJ) and the government to jumpstart the economy and create sustained growth synergies through bold structural reforms.

2. **The announcement of the new policy regime was followed by a quick set of actions.**

- **Fiscal stimulus.** In February, the Diet approved 1.4 percent of GDP of new debt-financed spending to be executed during 2013–14.
- **A new monetary policy framework.** In April, the BoJ introduced the quantitative and qualitative monetary easing (QQME) framework to achieve its 2 percent inflation target with a time horizon of about two years. Under QQME, the BoJ aims to double the monetary base—its new operational target—by 2014 to around 55 percent of GDP. Monetary easing was broadened to include longer-dated government securities, and purchases of risk assets were expanded. The BoJ also committed to continue with easing until 2 percent inflation is achieved in a stable manner.
- **Outlines of fiscal and growth strategies.** In June, the government reaffirmed its fiscal consolidation goals of halving the primary deficit by FY2015—from the FY2010 level—and achieving a primary surplus by FY2020, with measures to be developed in the coming months. The announcement also included a broad outline of a comprehensive growth strategy, which targets to raise investment, employment, and productivity, with details to be developed beginning this summer.

3. **Upper House elections in July may increase the ruling coalition's current political momentum to push forward its policy agenda.** Following a landslide victory in December, Prime Minister Shinzo Abe's approval ratings remain high. The Liberal Democratic Party, together with its junior partner, New Komeito, has a two-thirds majority in the Lower House, but currently does not have a majority in the Upper House.

4. **Against the background of structural and external headwinds, Japan now needs to follow through with concrete growth and fiscal reforms.** The task of raising growth is made more difficult by a rapidly aging labor force and the need to start with fiscal consolidation to maintain confidence in the sustainability of public finances. A still sluggish global recovery and volatile global financial markets are further complicating the task. Hence, this year's Article IV consultation focused on the key elements of a comprehensive reform package to lift Japan out of a high-debt, low-growth, and mild-deflation environment that has generated substantial financial and fiscal vulnerabilities and poses a risk to economic stability at home and via spillovers abroad.

A STIMULUS-DRIVEN BUT UNCERTAIN RECOVERY

A. Recent Developments

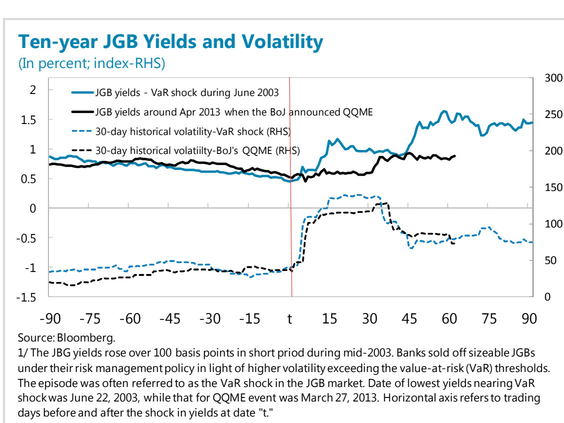
5. Financial and exchange markets were buoyant in early 2013 and the immediate aftermath of QQME. From September 2012 to mid-May 2013, the Nikkei rose by about 80 percent, with large gains for export-oriented firms and financial institutions. The rise in the stock market occurred in tandem with the strong depreciation of the yen (down 17 percent in real effective terms between end-December 2012 and end-June 2013). Upon adoption of the BoJ's new policy framework in April, bond yields declined briefly to historic lows with the 10-year rate reaching 45 basis points.

6. Growth accelerated sharply in early 2013 (Figure 1). First quarter GDP growth jumped to 4.1 percent (SAAR) after two quarters of stagnation. Wealth effects from rising equity values stimulated consumption, particularly of luxury goods. A rebound in real export growth (+3.8 percent, q/q) was helped by strong regional demand and a weaker yen. Private investment was flat, as it tends to lag rather than lead exports and because of uncertainty about future growth and corporate tax policies. These generally positive developments were confirmed in May through a further rise in industrial production (2 percent m/m) and retail sales (1.5 percent m/m).

7. Although there has been some reversal lately, inflation expectations have increased and headline inflation is slowly rising (Figure 2)**.** Inflation is still lagging at −0.3 percent (y/y) in May, but prices have been rising for three months on a sequential basis. The latter is consistent with the increase in long-term inflation expectations since end 2012, albeit even at their peak they were still well below the BoJ's inflation target. Indicators of inflation expectations derived from inflation-linked bonds (also known as break-even rates) have trended down since late May, possibly reflecting a reassessment of future growth following the outline of the government's growth strategy (though the liquidity of those bonds is relatively thin). Overseas factors might also have played a role as a similar decline is observed in the U.S. following the revised market expectation of an earlier exit from quantitative easing.

8. In recent months, financial markets have corrected and volatility has increased, driven by domestic and overseas factors. In mid-April, Japanese Government Bond (JGB) market volatility reached levels similar to the 2003 VaR-shock episode, although yields rose by less as banks have since upgraded their risk-management capabilities. Likewise, the Nikkei declined by 20 percent from the peak and the yen appreciated by 5–10 percent against the U.S. dollar in nominal terms. There appear to be three interrelated factors behind these developments. First, domestic financial institutions are reevaluating the net effect on yields of likely higher inflation and large JGB purchases by the BoJ.

Ten-year JGB Yields and Volatility
(In percent; index-RHS)



Source: Bloomberg.
1/ The JBG yields rose over 100 basis points in short priod during mid-2003. Banks sold off sizeable JGBs under their risk management policy in light of higher volatility exceeding the value-at-risk (VaR) thresholds. The episode was often referred to as the VaR shock in the JGB market. Date of lowest yields nearing VaR shock was June 22, 2003, while that for QQME event was March 27, 2013. Horizontal axis refers to trading days before and after the shock in yields at date "t."

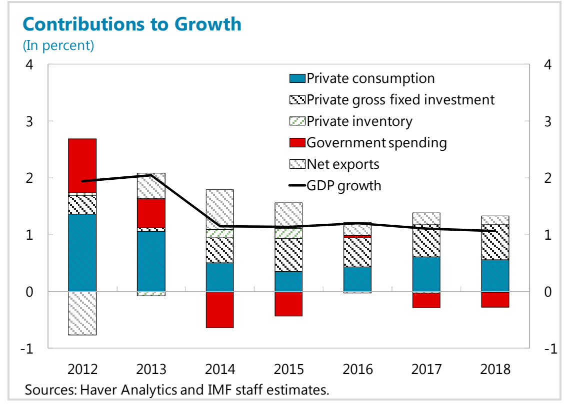
Second, questions emerged about the strength of Japan's new growth strategy. Third, these moves coincided with rising yields and volatility overseas amid a general repricing of risk in global markets. More recently, JGB-yield volatility has declined, although it remains elevated as also indicated by rates on swaptions and options on JGB futures.

9. The depreciation of the yen has occurred without a notable pickup in net capital outflows or improvement in the current account (Figure 3). The steady depreciation since November 2012 reflected several factors, including the new monetary policy framework, the reversal of safe haven effects, and a structural weakening of the trade balance from higher energy imports. Since the beginning of 2013, residents have been net sellers of foreign bonds and equities, while nonresidents have been selling Japanese bonds and notes, but buying equities instead. Indeed, large changes in the yen often appear to coincide with changes in derivatives positions that are taken in anticipation of real capital in- or outflows. The current account surplus has continued to decline as a result of high energy imports, although exports have rebounded helped by recovering exports to China since the trough in November 2012 and a weaker yen.

B. Outlook for Growth and External Stability

10. Buoyed by stimulus, the near-term outlook has improved considerably (Table 1). Business conditions have continued to improve as indicated by the second-quarter Tankan Survey results released on July 1. Growth in 2013 is projected at 2 percent, mainly as a result of the new fiscal stimulus and monetary easing feeding through to private consumption and with some lag to investment. A strengthening of external demand—helped by depreciation—and frontloading of consumption and residential investment ahead of the April 2014 consumption tax increase would further support the recovery. In 2014, growth is expected to moderate to 1.2 percent as a continued pickup in private domestic demand is offset by fiscal withdrawal from the consumption tax increase and an unwinding of reconstruction spending (2¼ percent of GDP), as well as weaker global growth.

11. The outlook for inflation depends critically on how inflation expectations adapt to the new framework. Inflation is projected to gradually increase to 0.7 percent by end-2013 as growth improves, inflation expectations rise, and the pass-through of yen depreciation on prices of imported goods becomes more complete. In 2014, headline inflation will temporarily reach 2.9 percent due to the consumption tax increase, but underlying inflation will be closer to 1¼ percent. As staff assumes that Japan's Philips curve will remain relatively flat—with a slope of about 0.2-0.25—the forecast is based on a substantial increase in inflation expectations.



12. The medium-term outlook is favorable, but unusually uncertain. With QQME, the BoJ has fundamentally changed its monetary policy approach and there is little policy experience to draw on in how to escape from a sustained deflation. Moreover, only broad outlines of structural and fiscal reforms have been announced—as a result, the baseline is based on a partial launch of the three

arrows[1]—leaving uncertainty about long-term growth and fiscal risks on the table. An uncertain energy outlook further complicates the assessment. Bearing this in mind, staff's baseline estimates project that inflation will reach 2 percent in the medium term while potential growth converges to the pre-global financial crisis level of about 1 percent as a result of a pickup in the pace of capital accumulation.

13. Following the recent depreciation, the yen appears to be moderately undervalued, although as long as a full package of reforms is implemented, this would not be seen as problematic (Table 2 and Appendix I).

- **The current account is moderately stronger vis-à-vis its value implied by fundamentals and desirable policies, but its future path is difficult to ascertain.** Taking into account the delayed impact of the large depreciation since last year and the effect of the higher energy imports on the trade balance, the underlying current account appears moderately stronger than implied by fundamentals and desirable policies with a midpoint estimate of ½ percent of GDP. However, this point estimate has a wide range from 1 percent of GDP weaker to 2 percent of GDP stronger as a result of the estimated bands around the underlying current account and the current account norm. For the former, the range is 2.5-4.5 percent of GDP as a result of uncertainty about the permanence of elevated energy imports and different trade elasticities. The range for the latter, the current account norm, is 2.5-3.5 percent of GDP and a result of different estimates how the new macroeconomic framework will affect fundamentals and desirable policies (e.g. higher long-run growth and long-term fiscal adjustment). In sum, the wide ranges around the point estimates reflect the difficulties in quantifying the implications of the ongoing policy regime shift on the current account and its norm: a rise in inflation could weaken the trade balance by appreciating the real exchange rate, fiscal consolidation would strengthen the current account, but its effects would be smaller if growth picks up as a result of structural reforms.
- **The current exchange rate is estimated to be moderately undervalued with a midpoint estimate of 5 percent, but with an unusually wide range of -20 percent undervaluation to +10 percent overvaluation.** The large bands are symmetric to the above calculated ESR bands for the current account and also reflect the substantial uncertainty about external sector developments given the major changes in the economic framework and also take account of the high exchange rate volatility. Staff expects the real effective exchange rate to return to a level consistent with fundamentals as long as monetary easing is accompanied by comprehensive fiscal and structural reforms involving all three arrows of Abenomics, which would generate higher inflation and growth.

C. Risks and Spillovers

14. External risks are to the downside (Appendix II). These include a slowdown in emerging markets, in particular in China, or a protracted period of slower growth in Europe. Spillovers from

[1] Staff's baseline expects that potential growth would rise over the medium-term to about 1 percent similar to the pre-global –financial-crisis level as a result of a pickup in the pace of capital accumulation. This projection assumes no further fiscal consolidation beyond 2015 and a modest additional increase in growth from rising investment in anticipation of Trans-Pacific Partnership (TPP) membership. A more substantial increase in potential growth would require concrete and broad-based reforms as outlined in this report.

lower exports could be amplified by weaker domestic demand due to depressed equity prices and more feeble business and consumer confidence. The effects on the outlook from possible exit from easy monetary policy in the U.S. are uncertain. Key spillover channels include potential effects on the yen and nominal interest rates as well as capital outflows from emerging markets with ramifications for Japan's exports. A weaker or more uncertain global environment matters more at this juncture as it would affect confidence and therefore the change in expectations that is needed for the new policy framework to achieve its objectives.

15. However, domestic risks dominate and have important spillover implications. On the upside, deregulating domestic services and agriculture, strengthening labor markets, and enhancing the availability of risk capital, could raise trend growth to 2 percent over a decade.[2] This, together with fiscal consolidation beyond 2015, would support a rise in future income and a reduction in precautionary savings, boosting demand in the near term, and accelerate the attainment of the inflation target (Box 1, complete Abenomics). With regard to spillovers, in this case, higher growth in Japan and easier global financing conditions would over time more than offset the effect of exchange rate appreciation in trading partners (Box 2). A reopening of remaining nuclear plants would provide further upside to growth and the external position. Aside from larger than expected fiscal multipliers that could slow growth in 2014–15, key downside risks include:

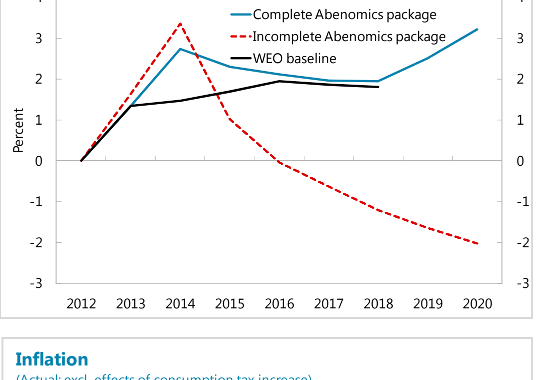
- **Absence of credible fiscal consolidation and growth plans** (Box 1, incomplete Abenomics). Without concrete measures, the new macroeconomic framework lacks credibility and may fail to raise growth and inflation expectations. Monetary policy might become overburdened and the rest of the world could be negatively affected through a weaker yen. Using the IMF's Flexible System of Global Models, an illustrative simulation suggests that a sustained 10 percent fall in the yen real effective exchange rate by itself would affect growth in the rest of the world by a very small negative amount (0.03 percent annually at its trough), with a few selected countries (e.g., China, Germany, Korea) losing out by 0.1 or 0.2 percent (see 2013 Spillover Report).
- **Credible fiscal consolidation and growth plans, but Abenomics does not work.** Despite all arrows being fired, inertia in inflation expectations, rigid wages, or structural factors (such as the deflationary effects of population aging) could imply that growth and inflation remain stuck, overburdening monetary policy to support activity and prevent yields from rising. With greater uncertainty about fiscal and financial stability, this may trigger capital outflows and exchange rate depreciation, undermining not only Japan's recovery, but also adversely affecting trading partners especially in the region.
- **Tail risks.** Given high debt, a self fulfilling sell-off of JGBs due to the lack of a convincing debt-reduction strategy remains a possibility and markets could shift their perception of BoJ bond purchases toward debt monetization. Yields could spike, undermining domestic and global financial stability, increasing the risk of a reversal in emerging market capital flows, and putting pressure on the BoJ to maintain an accommodative stance for longer, possibly at the cost of its credibility and ability to efficiently manage inflation.

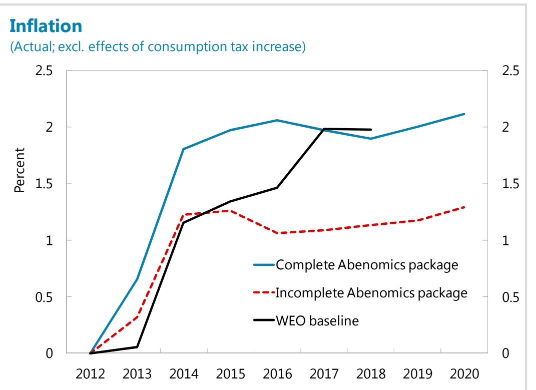
[2] See "Japan's Growth Challenge: What Needs to be Done and What can be Achieved?" in Japan: Selected Issues, 2012, IMF Country Report No. 12/209.

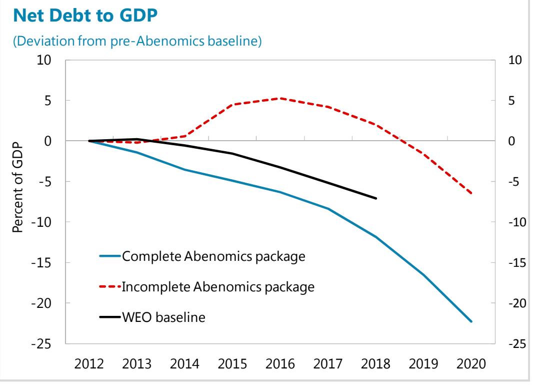
Box 1. The Potential Effects of Japan's New Policies on Growth, Inflation, and Debt[1]

The IMF's new G20MOD is used to illustrate the potential implications of a complete and incomplete policy scenario relative to a pre-Abenomics baseline. Alongside the latest WEO baseline, we consider the following two scenarios, which both include the adoption of a medium-term fiscal consolidation plan with 1 percent of GDP in adjustment each year after 2015:[2]

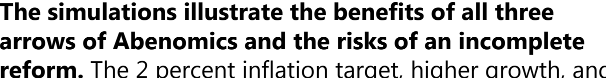
1. **Incomplete Abenomics package:** The fiscal stimulus adopted by the Diet in February boosts activity in the short term. Inflation expectations adjust to QQME, but in a sluggish manner. Potential growth remains stuck due to the absence of ambitious structural reforms. The authorities adopt further fiscal stimulus to close the output gap and boost inflation in the near term. Medium-term fiscal adjustment and a rising risk premium (given the need to tap foreign investors as the financing requirement remains high amid declining private savings) cause output and public debt to eventually fall below the pre-Abenomics baseline.[3]
2. **Complete Abenomics package:** The authorities adopt ambitious structural reforms that raise trend growth from 1 to 2 percent over the next decade.[4] In combination with QQME and medium-term fiscal consolidation, the complete package aligns inflation expectations quickly with the new target. Structural reform and fiscal consolidation are mutually reinforcing: the government's financing requirement falls, while private savings recover, preventing the rise in the sovereign risk premium.







Staff's baseline projections (July 2013 WEO Update, only up to 2018) lie in between these illustrative scenarios. Consistent with policies adopted so far, the baseline incorporates the effects of aggressive monetary easing as well as fiscal adjustment through 2015 (but no further consolidation after that) and only modest gains from structural reforms, specifically higher investment in anticipation of TPP membership. As a result, inflation gradually converges to the target as the output gap closes over the medium term and inflation expectations rise as a result of QQME. However, there are only modest gains in reducing fiscal risks and raising potential growth, leaving important tail risks on the table.



The simulations illustrate the benefits of all three arrows of Abenomics and the risks of an incomplete reform. The 2 percent inflation target, higher growth, and lower fiscal risks will only be achieved in a speedy and sustained manner under a full package of reforms. If inflation expectations are sluggish and the authorities resort to further fiscal stimulus, debt rises over the medium term, increasing fiscal consolidation needs and possibly risking a spike in yields, which would threaten financial stability. Ambitious structural reforms are also essential to offset underlying deflationary pressures from population aging (see IMF 2013 Japan: Selected Issues Chapter 3).

[1] Prepared by D. Botman (APD), B. Hunt and R. Lalonde (both RES).

[2] The scenarios discussed here expand on those in the IMF 2013 Spillover Report. Specifically, it includes a simulation with sticky inflation expectations. The 2013 Spillover Report also includes a sensitivity analysis with greater exchange rate depreciation.

[3] Accumulation of net debt would be slower than in the pre-Abenomics baseline over the medium-term (third chart), but the actual ratio would continue to increase as deficits remain high.

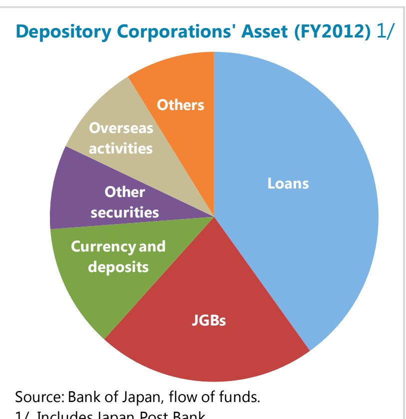
[4] See IMF (2012), Japan: Selected Issues Chapter 2, for a description of reforms that could yield such an increase in growth.

Box 2. Spillovers of Japan's New Macroeconomic Policies[1]

Spillover channels of a successful effort to revitalize Japan are likely to operate through higher growth in Japan, the exchange rate, and financial inter-linkages. Illustrative simulations using the IMF's G20MOD suggest that if all three arrows of Abenomics are successfully deployed, spillovers to the global economy are modest, but positive at about 0-0.1 percent of GDP in the short term to about 0.3 percent in the long term. Short-term effects of yen depreciation on competitiveness in other countries is offset over time by the positive effects from higher growth in Japan and lower interest rates in trading partners as a result of greater capital inflows and lower sovereign risk in Japan. In addition, the reforms would also take an important tail risk from a spike in JGB yields off the table, which would have large global repercussions. That said, sharper yen depreciation by about 10 percent, relative to a gradual depreciation in the model's baseline, implies marginally slower growth (0.03 percent annually at its trough) in the rest of the world with selected countries (e.g., China, Germany, Korea) losing out by 0.1 to 0.2 percent in the near term before recovering in the long term. Also, an analysis in the 2013 Spillover Report, which imputes the effects of QQME on global financial markets from an event study into the IMF's G35 model, shows small short-lived negative growth effects.

In the near term, spillovers could be more complex and varied than predicted by the model. Potential capital outflows could be larger than model estimates due to a rebalancing of financial institutions' portfolios from holding domestic debt to foreign assets. Past trends suggest that only a modest share of these additional flows would go to the rest of Asia, with the majority going to other advanced economies with deep and liquid debt markets. The effects of capital inflows on recipient countries would also depend on the state of the cycle. For economies with rapid credit growth and rising asset prices, additional capital flows would raise risks of overheating. On the other hand, easier financing conditions would be beneficial for economies where there is still substantial slack, inflation is less of a concern, or are experiencing outflows from other regions (for example deleveraging by European banks).

Depository Corporations' Asset (FY2012) 1/



Source: Bank of Japan, flow of funds.
1/ Includes Japan Post Bank.

Supply-chain considerations also have important spillover implications as they influence the effects of yen depreciation on trading partners, as well as on Japan. The effect of yen depreciation on price competitiveness of neighboring countries is mitigated by the significant amount of imported intermediate inputs that are embodied in their final exports. Moreover, significant portions of Japanese domestic final demand and gross exports are value added imported from other Asian countries, which would therefore benefit from higher growth in Japan.

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[1] Prepared by J.S. Kang (APD). See IMF 2013 Spillover Report and its background papers for a detailed discussion.

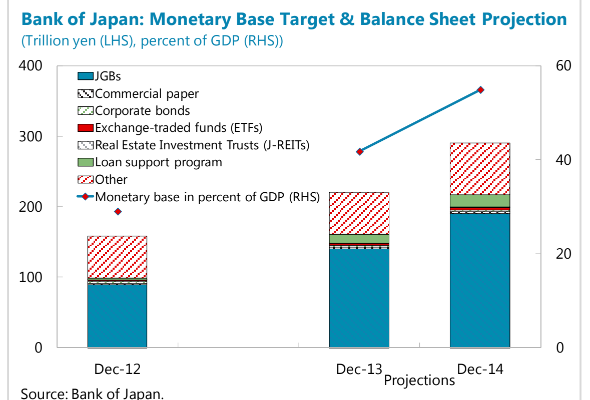
The Authorities' Views

16. The authorities broadly agreed with staff on the near-term outlook. The government's near-term growth forecast is similar to staff's. The BoJ Board Member's median forecast implied a faster rise in inflation expectations and closing of the output gap, but officials agreed that the exact path of inflation is subject to uncertainty. They also noted that a growth strategy and fiscal reforms would support the speedy attainment of the inflation target. As the main risks to the outlook, the authorities noted continued uncertainty about the prospects for Europe and a deeper-than-expected slowdown in China.

17. The authorities emphasized that new policies are targeted towards meeting the domestic objective of ending deflation and supporting growth, and agreed with staff that spillovers from these policies would be positive. They saw the yen's movement as determined by the market reflecting various fundamentals, while stressing unusually high uncertainty associated with the staff's exchange rate assessment. The authorities agreed with staff's assessment that overall spillovers of successful Abenomics would be positive, as stronger growth in Japan should benefit the rest of the world.

A FRESH START TO END DEFLATION

18. With QQME, the BoJ has embarked on an unprecedented effort to raise inflation above historical levels. After decades of mild deflation, the BoJ has entered unchartered policy territory by targeting 2 percent inflation. With interest rates at the zero bound, the BoJ needs to rely on unconventional policies



Source: Bank of Japan.

19. The transmission channel of QQME has four interconnected components (Figure 2):

- **Reducing long-term real interest rates and risk premia.** QQME has the potential to lower the term premium through purchases of longer-dated government securities. Additional purchases of risk assets (commercial paper, corporate bonds, exchange-traded funds, and Japan real estate investment trusts) would contribute to higher business investment, durable goods consumption and residential investment by reducing the funding cost of firms and households, improving firms' balance sheets, and through the wealth effect.
- **Portfolio rebalancing.** BoJ purchases exceed net issuance of government securities over the next two years, particularly in the 5–10 year segment, which would lead to portfolio rebalancing among investors and financial institutions including toward riskier assets and credit extension at home or abroad.
- **Raising inflation expectations**, including through stronger communication, would lower long-term real interest rates, thereby stimulating near-term activity.

- **Exchange rate depreciation**. Exchange rate depreciation, which is a product of these channels, is a crucial mechanism for QQME to work as it would raise import prices as well as support higher inflation by helping to close the output gap.

20. Transmission is in its early stages, with some positive signs. Nominal yields across maturities are broadly similar to end-2012 levels and volatility has risen, but this partly reflects external factors. Private asset prices have increased substantially. On the other hand, banks have mostly held higher liquidity from fewer JGB purchases as excess reserves at the BoJ and portfolio rebalancing will likely remain gradual depending on further increases in credit demand. Inflation expectations have gradually picked up, albeit still well below the inflation target and there has been a partial reversal recently. Although bonuses have started to increase, basic wages have yet to rise, which would be important to stimulate inflation expectations and support purchasing power once inflation starts to rise.

Policy Issues and Staff's Views

21. The BoJ's new monetary policy framework is a sweeping enhancement compared to the previous Asset-Purchase Program. Although the transmission channels are the same, the impact of QQME on inflation is expected to be larger as a result of:

- **A departure from gradualism** with greater effects on interest rates and incentives for portfolio rebalancing through a doubling of the monetary base via large-scale asset purchases and a shift to longer-dated JGBs and private assets.
- **Strong communication and forward guidance,** which facilitates a rise in inflation expectations, through the setting of a clear time frame for achieving 2 percent inflation, extending the forecast horizon by one year, and by announcing that QQME will continue for as long as it is necessary for maintaining the inflation target in a stable manner.

The joint policy statement between the BoJ and the government is further improving transmission by raising expectations of reform synergies, although the BoJ's operational independence in meeting its mandate must remain unaffected.

22. The BoJ should recalibrate its easing policies in the event inflation does not pick up as envisaged or JGB market volatility rises again. Depending on the factors preventing inflation from rising, a scaling-up of asset purchases or adjusting its composition could be considered to maintain effective transmission of QQME. Likewise, a return to high volatility in JGB markets would require conducting asset purchases in a flexible manner and strong communication, including that the BoJ is prepared to prevent disorderly movements in nominal JGB yields. In this regard, the actions taken by the BoJ since May, including realigning the maturity and frequency of bond purchases and enhancing communication with market participants, have been appropriate.

23. Complementary growth and fiscal reforms are essential for raising inflation in a durable manner. A robust rise in inflation hinges critically on a rise in inflation expectations, which depends not only on monetary easing, but also on the credibility of medium-term fiscal and growth reforms. Fiscal reforms are needed to provide assurances concerning fiscal and financial stability. Structural reforms that create a more flexible and open economy are critical to support real incomes

and to overcome headwinds from inertia in inflation expectations, rigid wages, and the deflationary effects of population aging. If these reforms are successfully implemented, staff estimates that 2 percent inflation could be achieved over the horizon targeted by the BoJ.

24. The BoJ should begin planning early to address exit risks. While exit is still far off, when the time comes near, guiding market expectations about the future of monetary policy puts a premium on strong communication. Likewise, although at the moment unrealized capital losses from asset purchases—estimated at 1–2 percent of GDP[3]—appear manageable, balance sheet risks will rise substantially as QQME proceeds, which could complicate the exit from unconventional policies. Although buying longer-dated assets is essential for the monetary transmission channel to work, it also raises exit risks and distinguishes a future exit from the experience during 2005-06. In this regard, indemnification against capital losses on bond holdings could be considered, but needs to be weighed against the potential rise in fiscal risks from rising contingent liabilities.

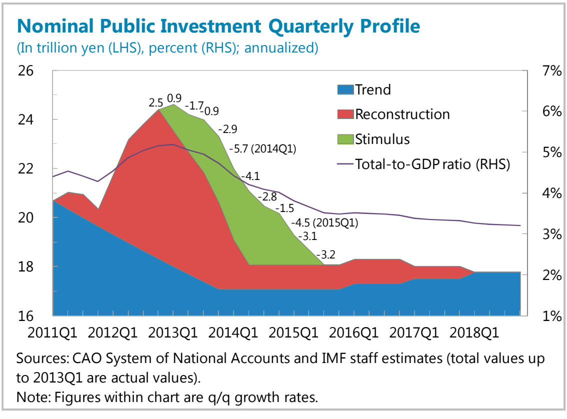
The Authorities' Views

25. The authorities broadly agreed with the staff's policy recommendations and viewed recent financial market developments as consistent with their new objectives. They emphasized that bond market volatility had occurred in two phases. First, in the immediate aftermath of the QQME announcement, government bond yields exhibited unusual volatility largely due to the positive surprise on the size and composition of the program, which affected liquidity in certain JGB market segments. The second phase in early May was triggered by external events and was also partly due to financial institutions' attachment of a greater credibility to the inflation target being reached. Volatility was being addressed through stronger communication and more frequent market interactions, which had been effective also because the bond market is dominated by domestic investors. Officials also noted that policies should be given time to work as the QQME clearly differentiates itself from the gradualism or incremental approach adopted in the past. The authorities explained that it was too early to publicly discuss the exit strategy, but much could be learned from their experience in 2005–06 as well as the possibly nearer term exit by the U.S. Federal Reserve, and it would be important that long-term rates are well anchored at the time of exit.

[3] See IMF (2013), Unconventional Monetary Policies - Recent Experiences and Prospects.

ENSURING FISCAL SUSTAINABILITY

26. The fiscal policy stance in 2013 is expansionary due to new stimulus, but substantial consolidation is in the pipeline for the next two years (Figure 4 and Table 3). The fiscal stimulus adopted by the Diet back in February amounts to 1.4 percent of GDP in new debt-financed spending to be implemented during 2013–14, more than offsetting slowing earthquake reconstruction spending this year. As a result, the structural primary balance in 2013 is projected to widen by ½ percentage point to -8.9 percent. In 2014–15, a significant fiscal withdrawal is planned—by 2¼ and 1¼ percent of GDP respectively—as a result of the two-step increase in the consumption tax rate to 10 percent and the waning of stimulus and reconstruction spending. Nonetheless, the public debt ratio is projected to continue to rise with net debt approaching 160 percent of GDP in the medium term as a result of the still sizeable primary deficit.



Sources: CAO System of National Accounts and IMF staff estimates (total values up to 2013Q1 are actual values).
Note: Figures within chart are q/q growth rates.

Policy Issues and Staff's Views

27. Fiscal risks have risen in the past year as stimulus has delayed adjustment. Yields on government debt remain near historic lows, hovering around 0.8–0.9 percent for 10-year bonds. Underlying upward pressure on interest rates from deteriorating fiscal conditions is assessed to be substantial, however, albeit masked by BoJ purchases and growing demand for liquid assets due to aging (Box 3). Changes in risk perceptions can occur suddenly and even a modest increase of risk premia by 100 basis points could undermine financial stability in particular in conjunction with other risks.

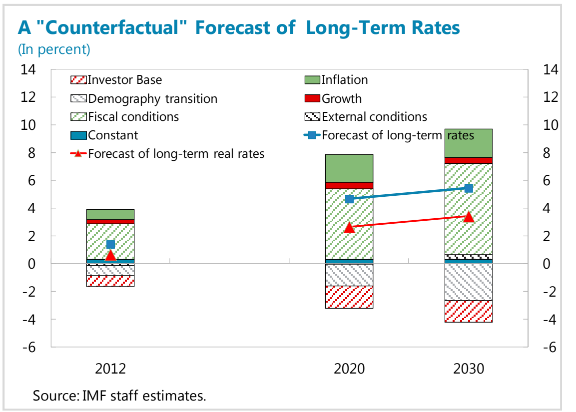
28. Raising the consumption tax rate is an essential first step to contain fiscal vulnerabilities. The scheduled tax increases in April 2014 and October 2015 should proceed as planned as they are critical to maintain confidence in the ability of the government to address the fiscal problem. Introducing multiple rates should be avoided as it would severely dilute revenue gains, complicate tax administration, and impose a costly administrative burden on small and medium-sized enterprises (SMEs). Instead, targeted transfers could be considered to compensate low-income households, facilitated over the medium term by the implementation of the recently adopted unique identification numbers.

29. To bring public debt firmly on a downward path, an ambitious and concrete consolidation plan beyond 2015 is urgently needed. Achieving the authorities' fiscal goals published in June would possibly only slow the pace of general government debt accumulation over time. Instead, to contain fiscal risks, staff sees a need to target a declining debt-to-GDP ratio, which requires structural fiscal consolidation of 11 percent of GDP over the next decade. The increases of the consumption tax rate to 10 percent by 2015, together with expiring stimulus and reconstruction

spending and measures to contain growth in spending would account for about half of this adjustment. Concrete measures for the remaining structural fiscal adjustment of 5.5 percent of GDP, to take effect after 2015, therefore need to be urgently spelled out. While higher-than-expected nominal growth from a complete macroeconomic reform package could generate some fiscal dividends, these should be saved to serve as a buffer against potential shocks to the fiscal position and higher-than-expected social spending especially on health care (Box 4 and Appendix III).

Box 3. Low Sovereign Yields Despite High Public Debt: Are Fiscal Concerns Overblown?[1]

Upward pressures on long-term JGB yields from high public debt have been offset by other factors, but these could change over time. The assessment is based on an econometric panel analysis of long-term sovereign yields in 12 advanced countries covering the period 1990–2012, which extends a previous study by assessing the role of the investor base in affecting yields, and applies the results to Japan.[2] Low and stable long-term rates in Japan primarily result from declining growth potential, disinflation, a high share of domestic bond holdings (stable investor base), and population aging (preference for safe assets) since the mid-2000s, which more than offset the impact of deteriorating fiscal conditions (chart, left bar). A 1 percentage point rise in the net public debt-to-GDP ratio would increase long-term yields by 2–4 basis points, although this effect has declined after the global financial crisis in light of global uncertainty and the related flight to safe assets. A sustained current account surplus also tends to lower long-term rates, but the result is not statistically and economically significant.



Purchases by the BoJ over the next few years are likely to suppress a rise in long-term rates, but underlying pressure on yields is likely to rise. Long-term rates would, without fiscal adjustment beyond 2015, be expected to rise by 4 percentage points to near 5½ percent between 2012 and 2030 (blue squares in the chart), of which deterioration in fiscal conditions contributes some 3½ percentage points (about 3 percentage points from the projected rise of the net public debt ratio from 134 percent in 2012 to near 210 percent of GDP by 2030 and ½ percentage point from large fiscal deficits). Rising inflation and shrinking external surpluses would add another 2 and ½ percentage point respectively to nominal yields, although the net increase would be much smaller because of population aging (-1¼ percentage points), BoJ purchases (-¾ percentage points), and other factors (chart).

In a positive reform scenario, the rise in yields could be contained to a sustainable level. Under an upside scenario with a full policy package (Box 1), higher growth and inflation would lead to an increase of nominal yields, but beneficial effects from lower public debt ratios would contain the increase such that long-term nominal rates would be stable at about 4 percent amid a declining debt-to-GDP ratio.

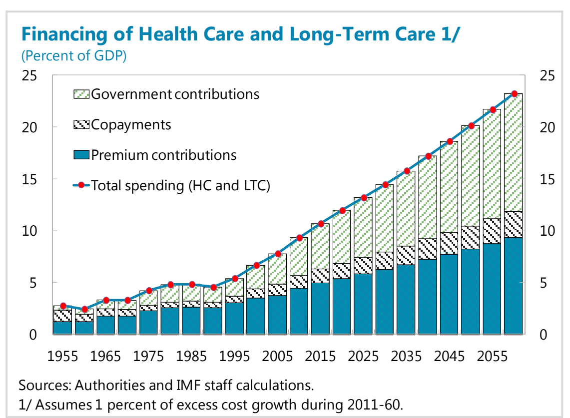
[1] Prepared by W. R. Lam (APD). For details, see Selected Issues Paper, Chapter I.

[2] Ichiue, H., and Y. Shimizu, 2012, "Determinants of Long-Term Yields: A Panel Data Analysis of Major Countries and Decomposition of Yields of Japan and the US," Bank of Japan Working Paper No.12-E-7.

Box 4. A Further Fiscal Risk—Health Spending and Financing in Japan[1]

Japan's health system is generally regarded as cost effective, but spending pressures are nonetheless evident. The Japanese system has very favorable health outcomes (e.g., longevity), despite the fact that overall spending-to-GDP ratio is around the average of OECD. However, public and private spending on healthcare and long-term care (HC/LTC) more than doubled during the last two decades, reaching 9.4 percent of GDP in 2010. While about half of the past increase originates from population aging, the rest can be attributed to excess-cost-growth (ECG) defined as spending per person in excess of per capita GDP growth after controlling for the effect of demographic change. Extrapolating past trends, HC/LTC spending would increase by as much as 5 percentage points of GDP during 2010–30, with equal parts coming from further population aging and annual ECG of 1 percent.

Japan could face serious challenges in financing HC/LTC spending. The government's contribution on HC/LTC reached nearly 3¾ percent of GDP in 2010, accounting for 39 percent of total health care financing. Given the current financing structure, with 1 percent of annual ECG, the government's contributions would reach 6½ percent of GDP by 2030 (text chart). On the other hand, various reforms, including raising the effective copayment rates by 5 percentage points, increasing efficiency of using health care resources and strengthening reliance on generics, could save 1.8 percent of GDP, thereby partly offsetting the expected rise in spending.



Sources: Authorities and IMF staff calculations.
1/ Assumes 1 percent of excess cost growth during 2011-60.

Given the already high fiscal adjustment needs and rapid aging, deep-seated reforms may be needed to contain rising expenditures. Further increases in copayment rates and cuts in and a review of government-controlled prices of medical services could be considered to address the funding gap. Although projections of long-term spending trends are uncertain, even a moderate rise in health system funding needs poses a downside risk to the fiscal sustainability given the already difficult fiscal situation.

[1] Prepared by K. Kashiwase and I. Saito (both APD), and M. Nozaki (FAD). For details, see Selected Issues Paper, Chapter II.

30. Such a medium-term plan should be as growth friendly as possible. Given the magnitude of the needed adjustment, broadly equal efforts on both the revenue and spending side are needed. The fiscal reform should also encompass measures that stimulate incentives to work and invest, and address equity concerns. Key elements could include (see text table on page 18 for details):

- Gradually increasing the consumption tax to a uniform rate of at least 15 percent, as it is a stable source of revenue in an aging society, one of the least distortionary taxes, and easy to administer. It would also be fairer than other taxes in addressing inequities between young and old generations.

- Broadening the personal income tax base to raise revenue and improve work incentives, including by reducing exemptions for pension income and eliminating the tax deduction for dependent spouses.
- Lowering the corporate income tax rate from 35 percent to improve incentives to invest, and reducing the payroll tax to stimulate labor effort. Such a general rate reduction would build upon the recently introduced tax incentives for R&D and investment.
- Containing rising health care costs, for example by increasing copayment rates, making more efficient use of hospital resources, and relying more on generics.
- Reducing pension spending, including by raising the eligibility age over time to 67, collecting contributions from dependent spouses,[4] and clawing back benefits from wealthy retirees. These savings could fund the reduction in payroll taxes and targeted transfers to low-income households.
- Strengthening the fiscal framework by adopting medium-term rules to curb expenditure in the context of multi-year budget planning, and limiting the conditions under which supplementary budgets can be used so that hard-won savings cannot easily be spent.

31. With such a plan in place, some fiscal space would be created to smooth the fiscal adjustment in 2014–15, should growth fall substantially below the baseline. Given elevated fiscal risks, monetary policy should be the first line of defense against significant downside risks. In such a case, acceleration or a change in the composition of asset purchases possibly toward more private assets could be considered, as well as a powerful communication strategy to underscore the BoJ’s commitment to achieving its inflation target. Regardless of cyclical conditions, the successive increases in the consumption tax rate should proceed as planned. However, if activity slows substantially, growth-friendly fiscal measures could be considered depending on the degree of commitment to a concrete fiscal consolidation plan that puts debt on a downward path.

[4] This could also reduce disincentives for second earners to work as currently dependent spouses of employees are exempted from paying premiums if their annual earnings are below 1.3 million yen.

Options for Fiscal Adjustment Between end-2011 and 2020

(Excluding reconstruction spending, in percentage points of GDP)

	Staff Estimates of Authorities' Current Plan	Adjustment Options	
Consumption tax rate (In percent, currently at 5 percent)	10	15	
Corporate tax rate (In percent, currently at 35 percent) 1/	35	25-30	
Fiscal consolidation measures			
Revenue			
Increase consumption tax	2.5	5.0	
Cut corporate tax		-0.75	
Broaden personal income tax base		0.75	
Eliminate preferential tax treatment for pension benefit income		¼	5/
Collect pension contributions from dependent spouses of workers covered by the Employees' Insurance		¼	5/
Collect health insurance premiums from dependent spouses of workers covered by the Employees' Insurance		✔	
Reduce pension payroll tax		-0.5	
Introduce carbon tax 2/	✔	✔	
Raise inheritance tax further		✔	
Expenditure			
Withdraw financial crisis fiscal stimulus	1.0	1.0	
Withdraw the recent stimulus	1.0	1.0	
Curb growth rate of nominal non-social security spending (excluding interest payments)	1.5	2.5	3/
Limit annual nominal growth in social security spending (excluding the items below)	-0.5	1.0	4/
Raise pension eligibility age to 67 or higher		¼	5/
Reduce benefits for wealthy retirees		¼	5/
Total savings	5.5	11.0	

1/ Excluding the temporary tax increase for reconstruction.
2/ The fiscal savings are assumed to be around 0.1 percentage points of GDP or lower. The savings are assumed to be spent on energy saving initiatives.
3/ Freezing expenditure in nominal terms.
4/ Annual nominal growth at 1-1½ percent.
5/ Lower bound estimate of Kashiwase, Nozaki, and Tokuoka, 2012, IMF Working Paper 12/285.

The Authorities' Views

32. The authorities noted that fiscal stimulus was necessary to revive the economy despite further adding to public debt and said that they would advance fiscal consolidation while promoting economic growth. They expected that the stimulus passed in February would contribute to sufficiently favorable economic conditions to proceed with the first stage of the consumption tax increase. In general, they pointed out that higher growth was essential to address fiscal problems and within this context emphasized the importance of structural reforms, but would also continue flexible fiscal policy that takes into account economic conditions, especially if growth were to disappoint.

33. The authorities recognized the need for further fiscal consolidation beyond 2015. They stressed their commitment to fiscal consolidation and would formulate a concrete mid-term fiscal plan in the summer. They took note of staff's proposal on concrete fiscal consolidation measures beyond 2015, including further hike of the consumption tax rate, although they considered it premature to endorse any possible measures at this time.

34. The authorities aimed to create a positive cycle between economic revitalization and fiscal consolidation. They also noted that it is important to prepare a medium-term fiscal plan setting out as detailed fiscal consolidation measures as possible. The authorities also indicated that their debt management strategy would continue to aim for lengthening the maturity of government debt, while remaining cognizant of interest rate risk in the financial system.

REVIVING GROWTH THROUGH STRUCTURAL REFORMS

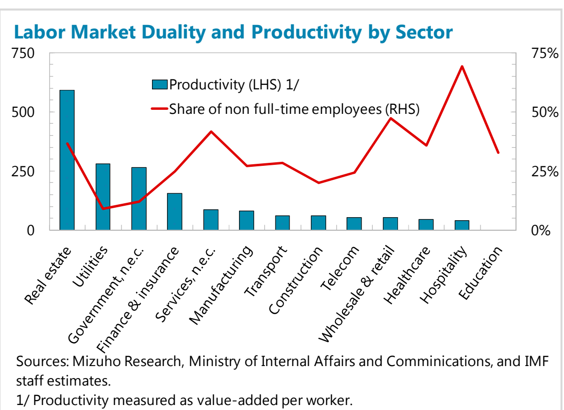
35. Ambitious structural reforms are essential for the overall success of the new policies. A more flexible economy is needed to raise productivity and wages and to reduce fiscal risks. Expectations of higher incomes down the road would support economic activity and the exit from deflation already in the near term. As noted during last year's consultation (Appendix IV), important synergies exist between aggressive monetary easing, medium-term fiscal consolidation, and structural reforms and each arrow being successfully launched is a necessary condition for the others to succeed (Figure 5 and Table 4).

36. The government's new growth strategy includes several ambitious goals, but specific measures or a more concrete timetable in some areas remain to be formulated. The strategy targets average annual real growth of 2 percent over the next 10 years, as well as doubling inward FDIs and agricultural exports by 2020. It reiterates the government's intent to partake in the Trans-Pacific Partnership (TPP) and to raise the employment of women, promote labor mobility across industries including by expanding the role of the private sector in providing job-matching services, and to institute special economic zones to experiment with deregulation. It also pledges to bring annual private investment back to its pre-Lehman shock level (70 trillion yen, or 14 percent of GDP) including through tax incentives. The government is also formulating a plan for reinforcing corporate governance and has indicated that it will liberalize the energy market by separating generation and transmission activities.

Policy Issues and Staff's Views

37. The next round of announcements should include more concrete and decisive steps to create broader growth synergies. The government's participation in the TPP negotiations and its intention to eliminate waiting lists on kindergartens and day-cares, which would support the employment of women, are important steps. Going forward, the strategy should avoid a sector-specific ("picking winners") approach and over-reliance on tax incentives/subsidies that characterized past plans that ultimately proved to be unsuccessful. Some measures could be adopted quickly, for example in the area of raising the employment of women, which would give and important signal about the government's commitment to reforms. In general, key measures should include:

- Deregulating agriculture and domestic services sectors to raise productivity and competition, and to encourage inward foreign investment.
- Enhancing the dynamism of the SME sector, including by phasing out costly government support measures (e.g., full value credit guarantees) and increasing risk capital for start-ups. Other measures include improving the timeliness of data in the SME credit registry, encouraging more asset-based lending, and reducing the reliance on personal guarantees.[5]
- Implementing steps to reduce labor market duality and increase productivity, including clarifying the legal framework for limited regular ("gentei seishain") contracts. To ensure that greater flexibility is rewarded through new employment opportunities, complementary measures to strengthen job matching and assist workers during periods of temporary unemployment should be considered (Box 5).
- Building on the recent relaxation of immigration requirements by expanding it to areas where there are labor shortages, such as in long-term nursing care.



Labor Market Duality and Productivity by Sector

Sources: Mizuho Research, Ministry of Internal Affairs and Comminications, and IMF staff estimates.
1/ Productivity measured as value-added per worker.

Increases in potential growth from these reforms could be sizeable,[6] although precise estimates are difficult to pin down.

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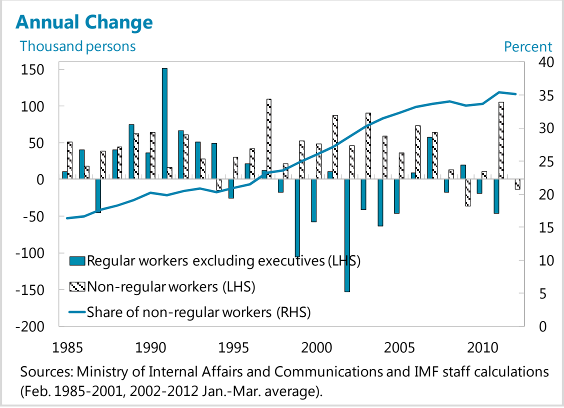
[5] R. Lam and J. Shin, 2012, "What Role Can Financial Policies Play in Revitalizing SMEs in Japan," IMF Working Paper 12/291.

[6] Based on estimates presented in IMF (2012), Japan: Selected Issues Chapter 2, an increase in the female labor force participation rate to the G-7 average and a rise in old age labor force participation could raise the growth potential by 0.25 percent. Immigration equivalent to a rise of Japan's labor force by 1 percent distributed over a decade could yield another 0.1-0.2 percent higher growth per year. Financial sector reforms that raise risk capital and induce a restructuring of the SME sectors could lift long-term growth by about 0.2 percentage points. Other structural reforms, which are likely to have a substantial impact on long-term growth, but are difficult to quantify, are: non-trade effects of TPP participation on reforming domestic markets via greater market access; productivity gains from reducing labor market duality, and efficiency gains from deregulation in agriculture and domestic services.

Box 5. The Path to Higher Growth: Does Revamping Japan's Dual Labor Market Matter?[1]

The share of non-regular workers, which was below 20 percent before the bursting of the bubble in the early 1990s, has now reached 35 percent (text chart). Compared to regular workers, non-regular workers have much lower level of job security, are paid lower wages and receive significantly less social insurance coverage. About 70 percent of non-regular workers are women. Low value-added service sectors are highly reliant on non-regular work. Japan's share of temporary workers—a proxy of labor market duality available for international comparisons—is above the OECD average.



Sources: Ministry of Internal Affairs and Communications and IMF staff calculations (Feb. 1985-2001, 2002-2012 Jan.-Mar. average).

The macroeconomic costs of excessive labor market duality are likely to be substantial. Japan's large labor market duality has likely resulted in reduced productivity and growth, by lowering firms' incentives to train non-regular workers, and through reduced workers' effort due to low job satisfaction.[2] Staff estimates that the *ceteris paribus* effect of reforms that would reduce the difference in employment protection between regular and temporary workers could bring the share of non-regular workers in Japan below 30 percent. Reducing labor duality could have substantial macroeconomic benefits—for example, Dolado, Ortigueira, and Stucchi (2011)[3] find that 20 percent of the productivity slowdown in Spanish manufacturing between 1992 and 2005 is due to reliance on temporary work.

Reducing the difference in employment protection between regular and non-regular workers would significantly reduce labor market duality in Japan. Steps to reduce labor market duality and increase flexibility could include clarifying the legal framework for limited regular ("gentei seishain") contracts, which would increase their usage. To ensure that greater flexibility is also rewarded through new employment opportunities, complementary measures to strengthen job matching and support systems should be considered.

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[1] Prepared by C. Aoyagi and G. Ganelli (both OAP). For technical details, see the Selected Issues Paper.

[2] Fukao and others, 2007, "Deferred Compensation: Evidence from Employer-Employee Matched Data from Japan," Hi-Stat Discussion Paper No. 187; and Kawaguchi and others, 2006, "Are Wage-Tenure Profiles Steeper than Productivity-Tenure Profiles? Evidence from Japanese Establishment Data from the Census of Manufacturers and the Basic Survey Wage Structure," Hi-Stat Discussion Paper No. 189.

[3] Dolado, J., S. Ortigueira, and R. Stucchi, 2011, "Does Dual Employment Protection Affect TFP? Evidence from Spanish Manufacturing Firms," Economics Working Papers 1137.

The Authorities' Views

38. The authorities agreed with the need to implement growth-enhancing structural reforms (the third arrow of Abenomics). They were committed to create new trade rules through TPP participation and lay the foundation for larger trade agreements. They further stressed that the growth strategy, which was presented on June 14, is a first step and that a window of opportunity was opening for Japan to implement growth-enhancing reforms. They were confident that the new reforms would succeed in raising female labor participation, promoting private investment, increasing productivity in agriculture, and reallocating workers to fast growing sectors.

ENHANCING FINANCIAL SECTOR STABILITY

39. Major banks have benefited from buoyant capital markets and an improved outlook (Figure 6 and Table 5). The 2012 Financial Sector Assessment Program (FSAP) Update found that the financial system was generally sound (Figure 7 and Table 6). Since last year, capital positions of major financial institutions have improved due to strong equity performance, rising income from securities trading, and capital gains on JGBs and foreign asset holdings, while credit costs in banks remain limited. Profits for internationally active banks have also risen due to relatively high net interest margins on overseas loans, which rose by 20 percent (y/y). Further expansion abroad would be another channel through, which the new policy framework could generate positive spillovers to the region (Box 6).

40. Nonetheless, overall low profitability and high interest rate risks remain a concern. Financial institutions, particularly regional and shinkin banks, face elevated risks from narrow net-domestic-interest margins (around 1 percent), large holdings of JGBs and equities, and potentially rising credit risks from household mortgages as well as SMEs in light of the welcome expiration of the SME Financing Facilitation Act in March. At the current juncture, uncertainty about interest rate movements may put further pressure on bank profitability, especially for those that rely on interest income from long-duration JGBs, and on the asset allocation of major life insurers.

Policy Issues and Staff's Views

41. A complete package of reforms could further strengthen financial system soundness. Declining JGB holdings by banks as a result of QQME could reduce exposures to interest rate risks. Rising stock prices are giving banks and insurers an opportunity to divest their equity holdings to reduce exposure to market risk. By solidifying financial stability, these factors would enhance the role of the financial sector in promoting growth by extending more risk-based capital, provided that banks strengthen their credit-assessment capabilities.

Box 6. Will Japanese Financial Institutions Continue to Expand Abroad Under the New Policies?[1]

Cross-border activity of Japanese financial institutions has risen over the past few years, particularly to the Asian region. Since the global crisis in 2008 overseas claims by Japanese banks have grown annually on average by about 8 percent and by 19 percent in the Asia Pacific region. Major Japanese banks have attained an important global and regional presence, particularly in areas of syndicated lending and project finance. This trend could be affected under the government's new policy framework. There are concerns that an improved domestic outlook and a weaker yen could lead to a more inward focus to satisfy rising credit demand.

Based on a cross-country panel analysis, global and regional factors play a more important role than domestic push factors in banks' overseas activities. Low global uncertainty (measured by the VIX index) and a high growth differential between destination and domestic growth prospects are important drivers for banks' rising foreign claims. For instance, a 1 percentage point increase in the real growth differential could increase the foreign claims by about 0.3-1.6 percentage point. Applying the estimates to Japanese banks suggests that about 40 percent of the rise in claims to Asia is due to a decline of global uncertainty, while regional factors contribute another 20–25 percent. Among home factors, domestic push factors through a substitution between domestic and foreign credit contributed only a small share to the overseas expansion of about 5 percentage points. The remainder is accounted for by strong financial fundamentals of domestic banks. Stronger domestic growth in Japan as a result of the BoJ's asset purchases could mitigate the pace of growth in overseas lending, but is unlikely to reverse a long-standing trend because empirical estimates suggest that global and regional factors play a more prominent role.

Foreign Consolidated Claims of Japanese Banks 1/

(In percent)	Year-on-year growth	Cumulative growth from 2005-2008	Cumulative growth since end-2008	Share of total consolidated claims
All countries	0.1	72.6	37.0	100.0
Europe, of which:	10.8	83.3	2.5	25.4
Pheripheral European countries 2/	-1.2	73.8	-22.5	2.8
Core European countries 3/	15.1	88.6	7.0	17.0
United States	8.1	67.0	42.1	43.6
Asia Pacific, of which:	13.4	124.1	102.9	15.9
Advanced	17.2	126.9	105.6	9.9
Emerging	7.6	119.5	98.7	5.9
Offshore centers	4.4	19.2	62.4	12.4

Source: BIS.
1/ As of September 2012.
2/ Pheripheral European countries include Italy, Ireland, Greece, Portugal, and Spain.
3/ Core European countries include France, Germany, Switzerland, and United Kingdom.

A sustained overseas expansion by Japanese banks would benefit mainly countries in the Asian region. The relative resilience of Japanese banks during the global financial crisis has allowed them to take on further foreign exposures and ease financing conditions that might have tightened otherwise from the deleveraging of European banks. Given long-term growth prospects, a continued expansion to Asia is likely and would provide stability during the scale back of European banks and periods of market volatility.

[1] Prepared by W. R. Lam (APD). For details, see Selected Issues Paper.

42. However, the new framework also presents challenges, particularly if the government's reforms remain incomplete. Specifically, risks to stability in regional banks could rise if credit demand in Japan's regions would continue to be sluggish. As a result, regional banks may increasingly rely on interest income from long-duration JGBs, creating further exposure to interest rate risk. If the policy framework lacks credible fiscal and growth reforms, such risks could intensify further. The new framework will likely encourage further overseas expansion, which could expose banks to currency-funding and, in particular, maturity-mismatch risks as many banks still rely on short-term dollar funding to finance foreign loans, with the foreign-currency denominated loans to deposit ratio at around 130 percent on average.

43. Recent progress on regulatory reform will help to contain risks to financial stability. The authorities have made important progress with the implementation of FSAP Update recommendations (Appendix V). Basel III implementation has commenced in March, which will strengthen capital standards of internationally active banks in a phased manner. Improvements have also been introduced regarding the stress testing methodology to incorporate a more thematic risk assessment for the banking system. Furthermore, the authorities have submitted legislation to the Diet on bringing large exposure limits for banks in line with international best practices and establishing an orderly resolution regime for financial institutions. As part of international efforts, the cross-border risk monitoring arrangements with foreign supervisors have deepened.

44. Going forward, it will be important to strengthen capital standards beyond current plans and mitigate foreign-exchange funding risks. At the moment, regional and shinkin banks are having modest unrealized gains on securities holdings. However, once interest rates start to rise, these gains may turn into losses. In this regard, excluding unrealized losses from capital-adequacy ratios may reduce incentives for domestically oriented banks to raise new capital and, particularly for regional and shinkin banks; it would discourage addressing interest rate risk. Banks with overseas activities should continue to mitigate foreign-funding risks by raising deposits overseas and by issuing long-term foreign-denominated debt. For insurers, the solvency assessment should be based on an economic valuation, such as by taking into account the full time horizon of insurance contracts to better reflect the underlying risks on liabilities. Finally, Japan Post Bank's expansion plans into lending and other businesses would carry important risks given its limited credit-risk assessment expertise in these areas and potential repercussions for other financial institutions.

The Authorities' Views

45. The authorities welcomed the assessment of implementation of FSAP recommendations and considered supervision to be broadly appropriate at the current juncture.

- On the treatment of unrealized gains and losses on security holdings for domestically oriented banks, the authorities stated that their intention is to mitigate procyclicality of capital levels as gains and losses vary over the cycle. In addition, transparency is ensured since unrealized gains and losses are within the scope of accounting disclosure. In this context, they did not foresee that problems in risk management would materialize. They noted that they pay due attention to

risks from security holdings and try to capture such risks at an early stage by means of close monitoring.

- As for foreign-exchange funding risks, they recognized the need of continued close monitoring and emphasized that banks should continue to secure foreign-exchange funding in the markets, whereas the existing central banks swap arrangement provide a backstop on liquidity as a last resort in case of unexpectedly large external shocks. The authorities also noted that they designate liquidity risk associated with foreign currencies as one of the risk areas that require due attention in the supervisory policy for major banks against the background of the ongoing rise in their overseas exposure.
- On the solvency assessment for insurers based on an economic valuation, they intend to deliberate such an assessment, taking into account ongoing international discussions, such as those at the International Association of Insurance Supervisors.
- As for Japan Post Bank's expansion plans, they intend to proceed on an assessment with due consideration of required elements such as ensuring fair competition, following legal processes.

STAFF APPRAISAL

46. The authorities' new policies are buoying the near-term outlook. Unprecedented monetary easing supported by fiscal stimulus is supporting growth, which is projected to reach 2 percent in 2013. Inflation expectations have risen, albeit to levels still well below the 2 percent inflation target. Risks to the outlook are to the downside and related to a slowdown in Europe and emerging economies and incomplete domestic reforms.

47. All three arrows need to be launched for the policies to succeed and benefit the global economy. The absence of credible fiscal and structural reforms could weigh on confidence and undermine the success of the started reforms. This would not only be detrimental to Japan, but also for the rest of the world, especially emerging Asia, as monetary policy would become overburdened and further depreciation would adversely affect trading partners. As Japan's debt would remain unsustainable, a global tail risk of a spike in yields and volatile capital flows would remain on the table

48. With its new monetary policy framework, the BoJ has made an important contribution to end deflation. Careful communication and continued flexibility in implementing its policies is needed to contain financial market volatility and ensure an effective transmission of its easing policies. However, complementary growth and fiscal reforms are essential for raising inflation in a durable manner.

49. A credible medium-term fiscal plan should be adopted as quickly as possible as fiscal risks have risen further. Reducing public debt requires a fiscal adjustment of 11 percent of GDP over a decade. Raising the consumption tax rate to 10 percent by 2015, while maintaining a uniform rate, is an essential first step. Beyond 2015, a concrete set of growth-friendly revenue and expenditure measures is needed to bring down debt. There is little room for further fiscal stimulus,

and new support measures should only be considered if growth declines substantially and a credible medium-term fiscal strategy is in place.

50. In addition, the government's structural reforms need to be concrete and comprehensive. The government's participation in the TPP negotiations and its plans to raise the employment of women are welcome, but only first steps. To generate growth synergies, concrete measures should be adopted quickly and include deregulation in agriculture and domestic services, providing more risk capital to corporates, reducing Japan's excessive labor market duality, tax reform to stimulate incentives to invest, and further relaxing immigration requirements to areas with labor shortages.

51. A successful launch of all three arrows and enhancement of the regulatory framework would further strengthen financial sector stability. The main financial stability benefit of a successful implementation of Abenomics would be a reduction in banks' holdings of JGBs and new lending opportunities at home. However, new challenges could also arise, particularly for regional banks if fiscal and growth reforms disappoint. Despite recent progress on regulatory reform, capital standards, especially for regional banks should be strengthened and foreign-funding risks of major banks carefully monitored. Japan Post Bank's expansion plans into lending and other businesses would carry important risks.

52. The current exchange rate appears moderately undervalued compared with medium-term fundamentals and desirable policies. However, there is very large uncertainty about the assessment given the major changes in the economic framework. The external position is expected to return to a level consistent with fundamentals as long as monetary easing pursues domestic goals and is accompanied by comprehensive fiscal and structural reforms.

53. A complete package of reforms will likely create positive spillovers, but near-term effects could be more mixed. Higher growth in Japan, easier global financing conditions from fiscal reforms, as well as supply-chain effects would more than offset the effects from exchange rate appreciation in trading partners. Failure to follow through on fiscal and structural reforms could, however, lead to overreliance on monetary policy with negative consequences for Japan and the global economy.

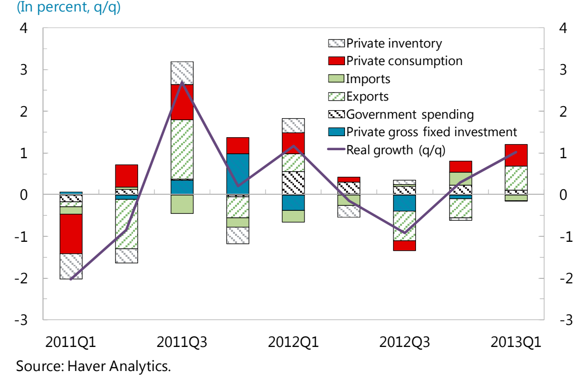
54. It is recommended that the next Article IV consultation take place on the standard 12 month cycle.

Figure 1. Recent Economic Developments and Outlook

First-quarter GDP growth rose to 4.1 percent (SAAR) after two quarters of stagnation helped by strong consumption and exports…

Contributions to Growth (SA)

(In percent, q/q)

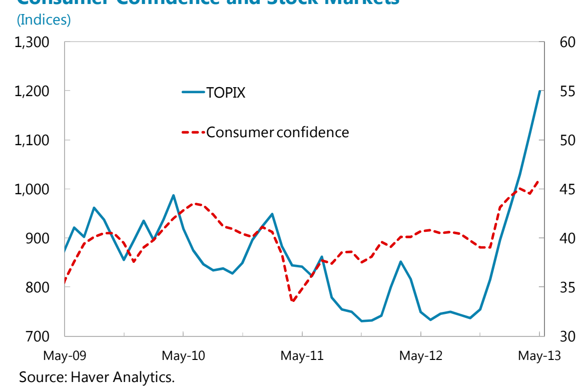


Source: Haver Analytics.

… due to rising consumer confidence, the wealth effect from the surge in equities, and a weaker yen.

Consumer Confidence and Stock Markets

(Indices)

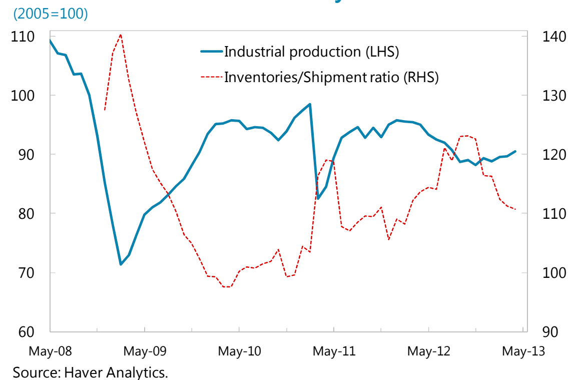


Source: Haver Analytics.

Private investment has remained flat given previous high inventory, although industrial production is picking up.

Industrial Production and Inventory

(2005=100)

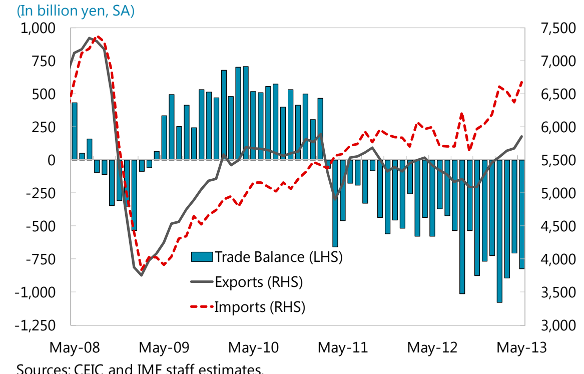


Source: Haver Analytics.

Trade deficits have been sizeable despite rising export against the background of higher energy imports.

Trade balance

(In billion yen, SA)

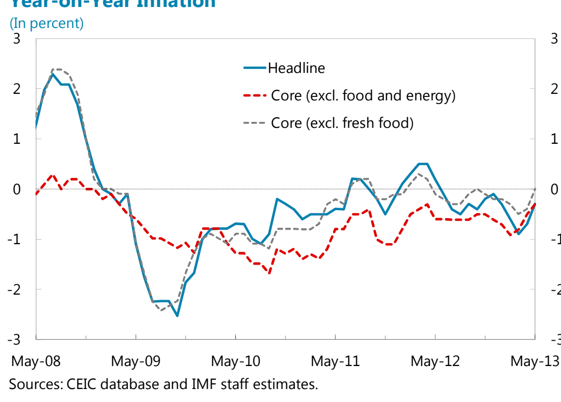


Sources: CEIC and IMF staff estimates.

Year-on-year inflation remains sluggish.

Year-on-Year Inflation

(In percent)

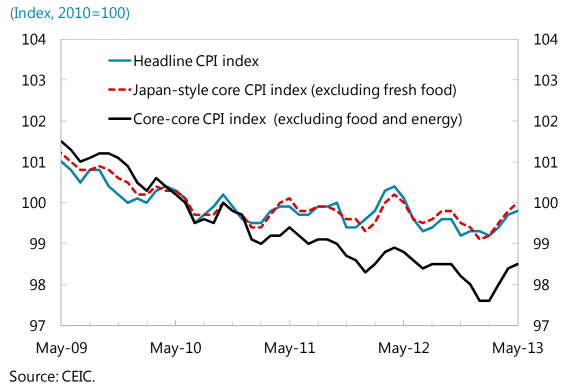


Sources: CEIC database and IMF staff estimates.

Although volatile, there are signs that prices are picking up gradually on a sequential basis.

Consumer Price Index

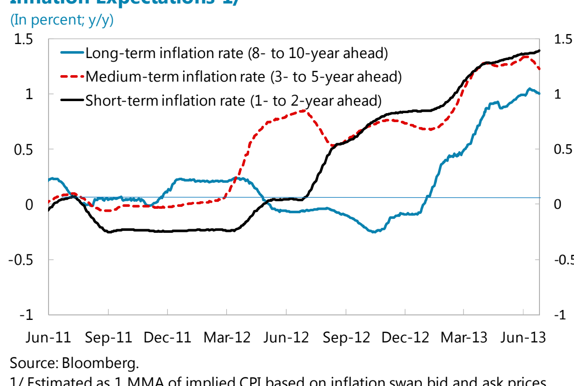
(Index, 2010=100)



Source: CEIC.

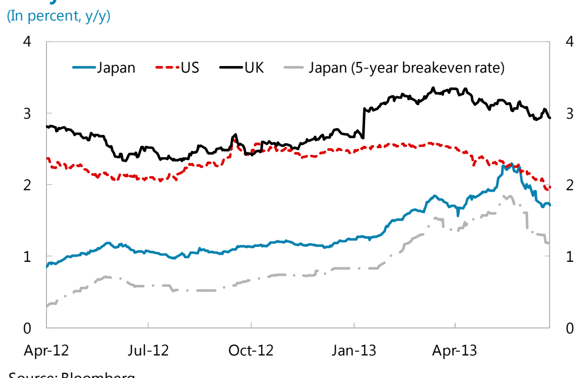
Figure 2. Inflation and Monetary Policy

Market indicators on inflation expectations have risen over the past few months ...



Source: Bloomberg.
1/ Estimated as 1 MMA of implied CPI based on inflation swap bid and ask prices.

... although indicators of long-term inflation expectations from break-even rates have started to decline recently.



Source: Bloomberg.

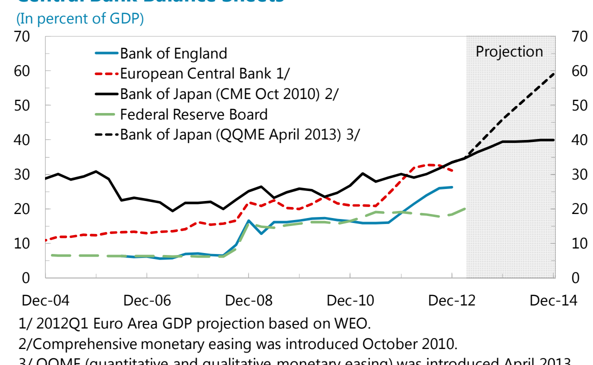
The Bank of Japan has introduced its new quantitative and qualitative monetary easing (QQME) framework in April,

BoJ Monetary Base & Balance Sheet Protection

(In trillions of yen)	Dec-12	Dec-13	Dec-14
		Projections	
Monetary base	138	200	270
(in percent of GDP)	*29*	*42*	*55*
BoJ balance sheet			
Total assets	158	220	290
(in percent of GDP)	*33*	*46*	*59*
JGBs	89	140	190
Commercial paper	2.1	2.2	2.2
Corporate bonds	2.9	3.2	3.2
Exchange-traded funds (ETFs)	1.5	2.5	3.5
Real Estate Investment Trusts (J-REITs)	0.11	0.14	0.17
Loan support program	3.3	13	18
Other	59	59	73
Total liabilities	134	195	265
Bank notes	87	88	90
Current deposits	47	107	175

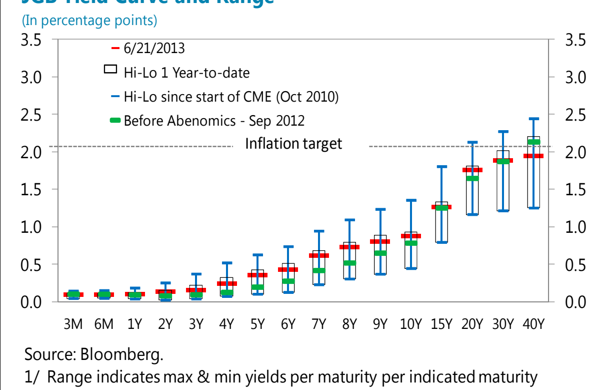
Source: Bank of Japan.

... which would make its balance sheet the largest among key central banks in percent of GDP.



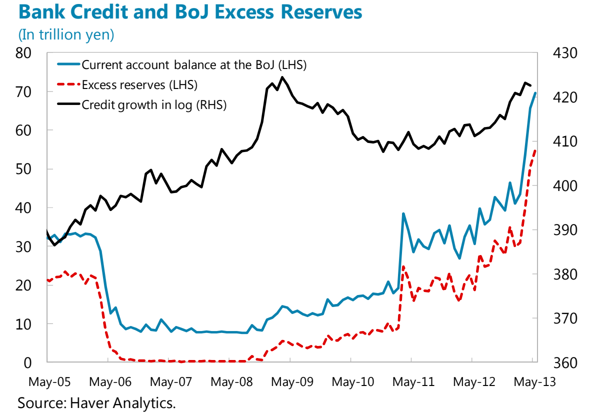
1/ 2012Q1 Euro Area GDP projection based on WEO.
2/Comprehensive monetary easing was introduced October 2010.
3/ QQME (quantitative and qualitative monetary easing) was introduced April 2013.
Source: Bank of Japan, Haver Analytics, WEO, and Eurostat.

The policy effect on the yield curve has so far been mixed...



Source: Bloomberg.
1/ Range indicates max & min yields per maturity per indicated maturity

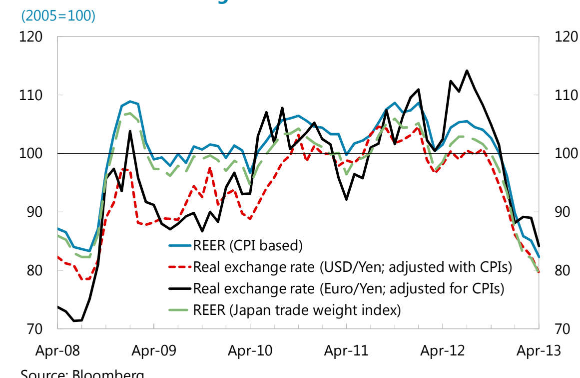
... and the portfolio rebalancing so far has mainly led to higher excess reserves.



Source: Haver Analytics.

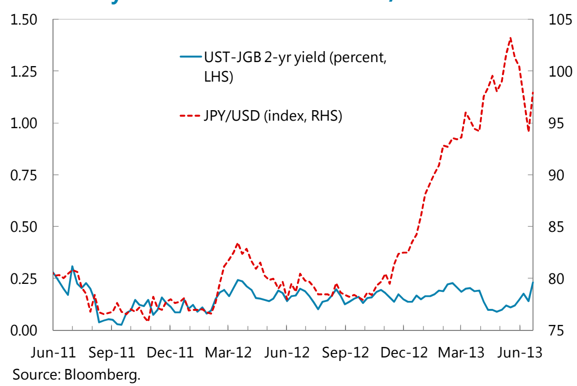
Figure 3. External Sector Developments

The yen has depreciated by about 20 percent since last June in real effective terms, …



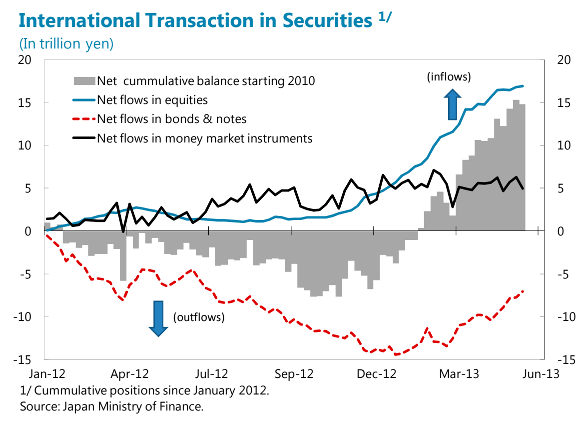
Source: Bloomberg

…and no longer tracks the close relationship with the 2-year interest differential between U.S. Treasuries and JGBs.



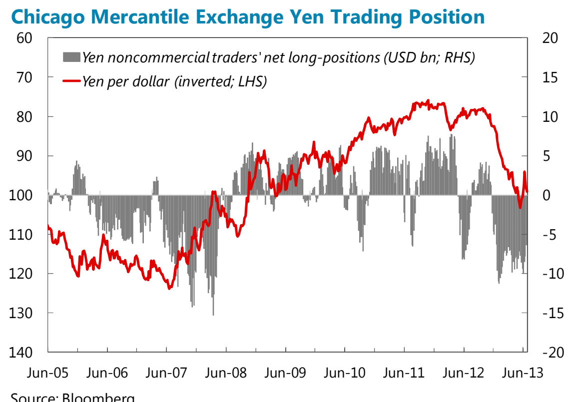
Source: Bloomberg.

Yet, there have not been significant portfolio outflows while foreign inflows into domestic equities have been large.



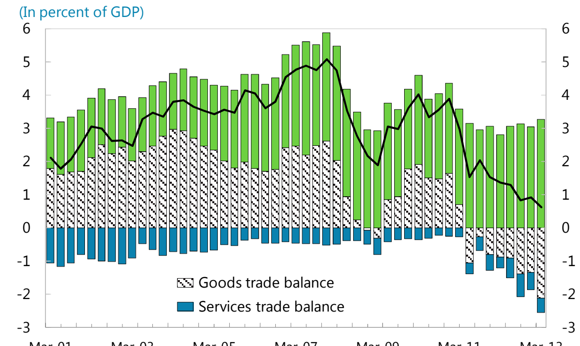
1/ Cummulative positions since January 2012.
Source: Japan Ministry of Finance.

Derivative flows may explain the sharp adjustment in the yen as yen-short positions, reached levels seen before 2007.



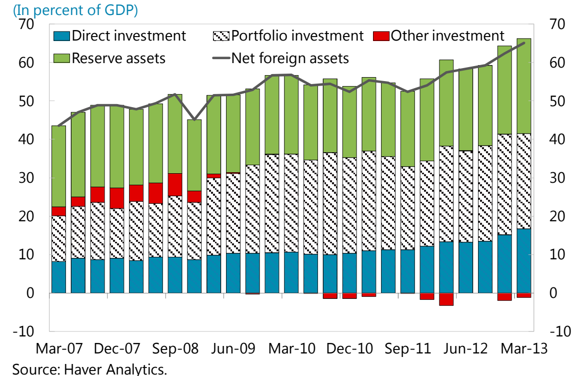
Source: Bloomberg.

Trade deficits have widened in 2012, but the current account has stayed in surplus …



Source: Haver Analytics.

… because of a large and stable income account surpluses supported by earnings from foreign asset holdings.

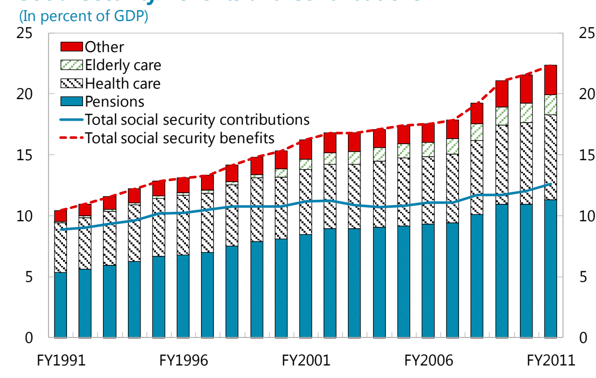


Source: Haver Analytics.

Figure 4. Fiscal Developments

Social security benefits have risen steadily, and the gap with social contributions is expanding...

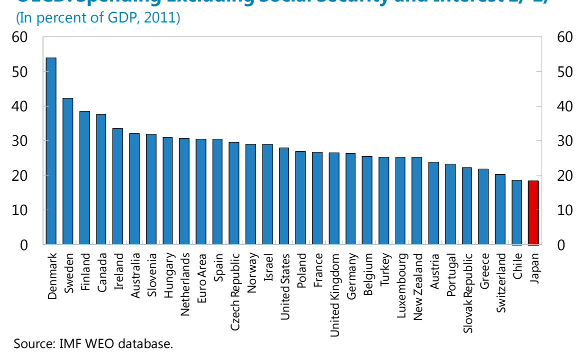
Social Security Benefits and Contributions
(In percent of GDP)



Sources: Japanese Ministry of Health, Labor and Welfare; and IMF staff estimates.

...while non-social security spending has remained the lowest among OECD economies.

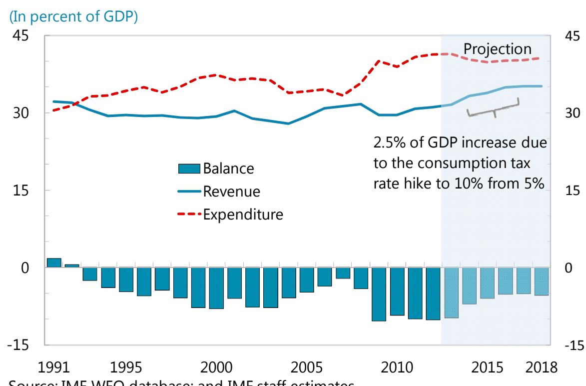
OECD: Spending Excluding Social Security and Interest 1/ 2/
(In percent of GDP, 2011)



Source: IMF WEO database.
1/ OECD countries with missing data (e.g., Italy) are not reported here.
2/ General government basis.

Stagnating revenue has also contributed to large deficits...

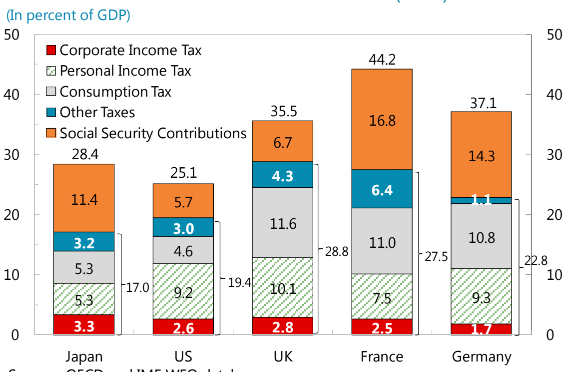
General Government Fiscal Balance
(In percent of GDP)



Source: IMF WEO database; and IMF staff estimates.

and tax reform is crucial as Japan's revenue is relatively low.

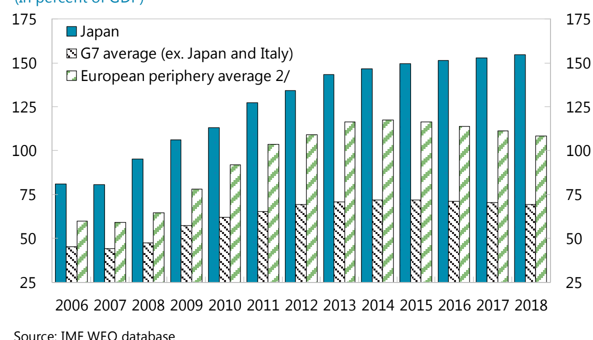
General Government Tax and SS Revenue (2011)
(In percent of GDP)



Sources: OECD and IMF WEO database.

Without further fiscal adjustment, net public debt is projected to rise unlike in other advanced economies.

WEO Baseline Projections for General Government Net Debt 1/
(In percent of GDP)



Source: IMF WEO database
1/ Net debt is defined as gross debt minus financial assets.
2/ Greece, Ireland, Italy, Portugal and Spain.

In the future, Japan may need to rely more on foreign investors given the narrowing gap between private assets and government liabilities.

Flow of Funds
(In trillion yen, end of period)

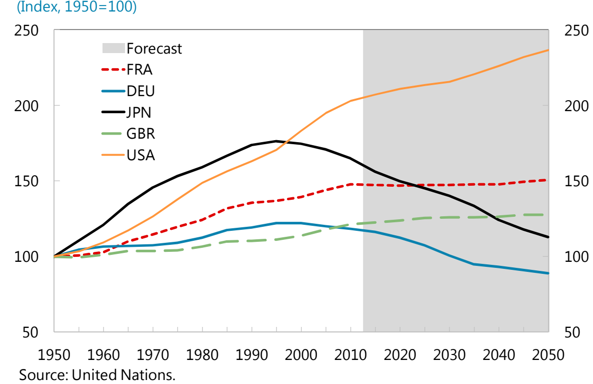
General government: gross financial liability
Households: gross financial asset
Non-financial corporations: gross financial asset

1997 2000 2003 2006 2009 2012

Source: BoJ (Flow of Funds).

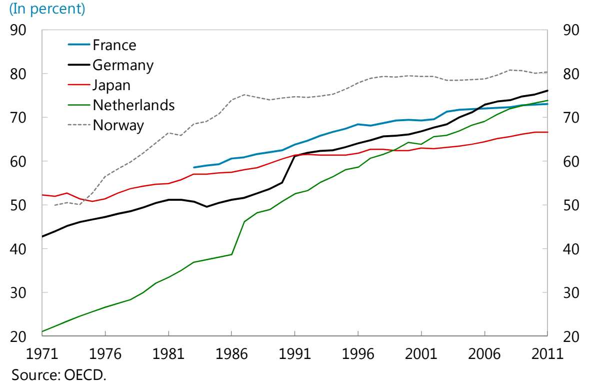
Figure 5. Structural Issues

Raising labor force participation is necessary as the working-age population continues to fall over the next decades …



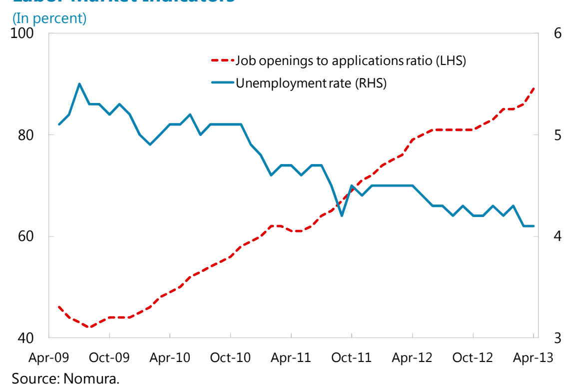
Source: United Nations.

… such as by raising the female labor participation rate, which is well below the OECD average.



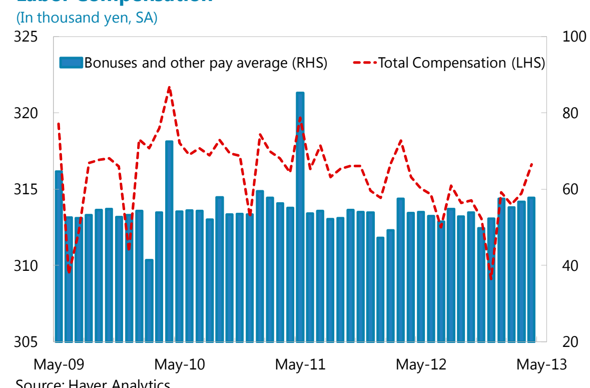
Source: OECD.

The labor market has recovered with falling unemployment…



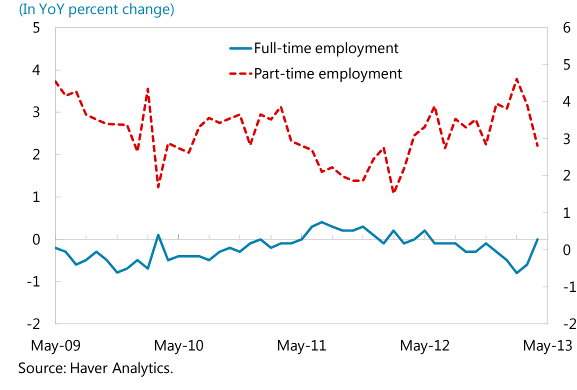
Source: Nomura.

… but labor compensation has lagged behind.



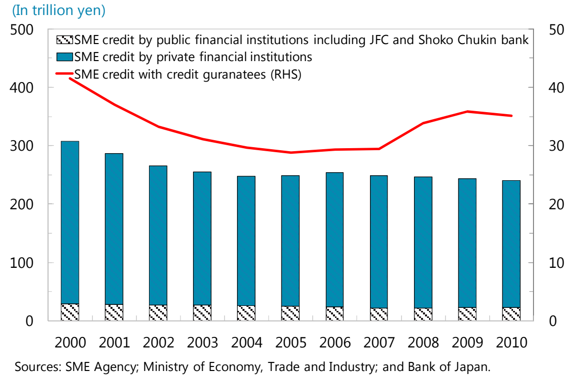
Source: Haver Analytics.

The duality of the labor market is large and rising.



Source: Haver Analytics.

Meanwhile, the SMEs are supported by credit guarantees that delay necessary restructuring.

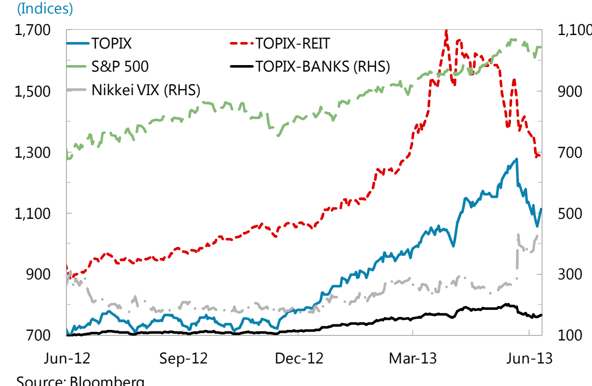


Sources: SME Agency; Ministry of Economy, Trade and Industry; and Bank of Japan.

Figure 6. Financial Market Developments

Equities rose by almost 80 percent from September to May, but have come down due to domestic and overseas factors.

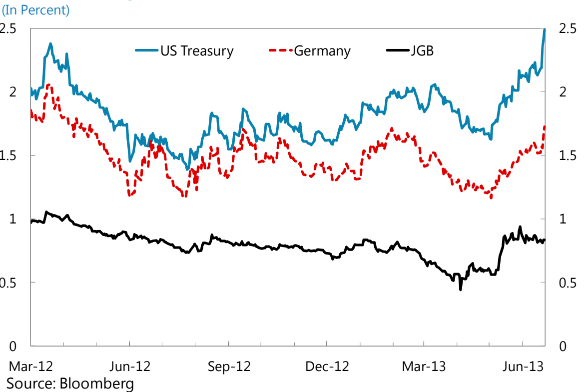
Equity Markets
(Indices)



Source: Bloomberg

Sovereign bond yields have increased to levels in early 2012, in part driven by a rise of interest rates abroad.

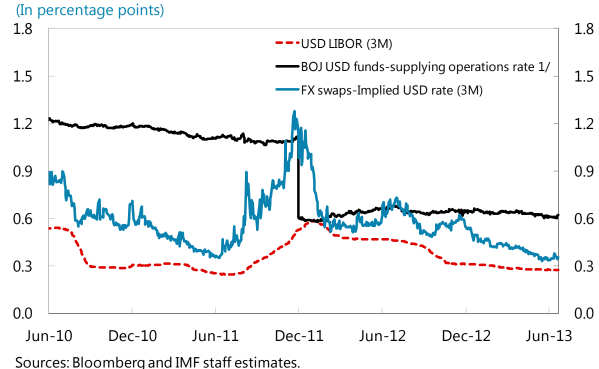
10-Year Sovereign Bond Yields
(In Percent)



Source: Bloomberg

Despite higher volatility in equities, bond, and foreign exchange markets, dollar funding cost remains stable, …

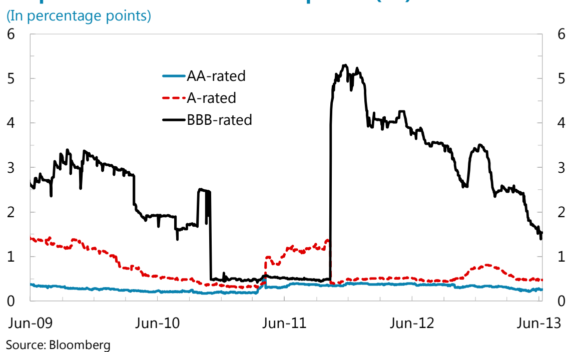
USD Funding Cost in Japan
(In percentage points)



Sources: Bloomberg and IMF staff estimates.
1/ USD OIS + 100 bps until Nov. 29, 2011 and OIS rate + 50 bps afterwards.

… and financing conditions for firms are accommodative.

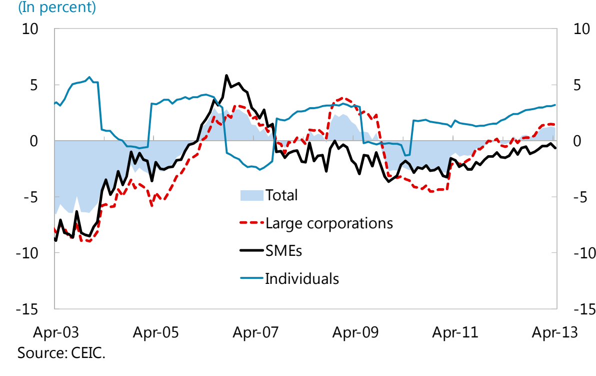
Corporate-Government Bonds Spreads (5Y) 1/
(In percentage points)



Source: Bloomberg
1/ Large spike in BBB-rated corporate yields in late 2011 due in part to TEPCO downgrade. Sharp decline in late 2010 due to credit upgrade of large corporate issuer.

Improved business sentiment could raise credit demand, which has steadily recovered since the second half of 2012.

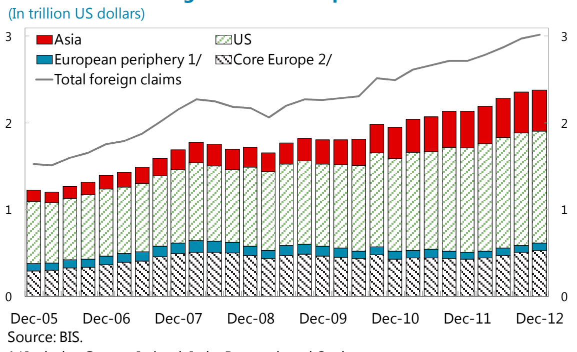
Year-on-Year Growth in Bank Lending to Corporates
(In percent)



Source: CEIC.

With banks' JGB holdings expected to fall under QQME, expansion overseas, particularly to Asia, will continue.

Consolidated Foreign Claims for Japanese Banks
(In trillion US dollars)



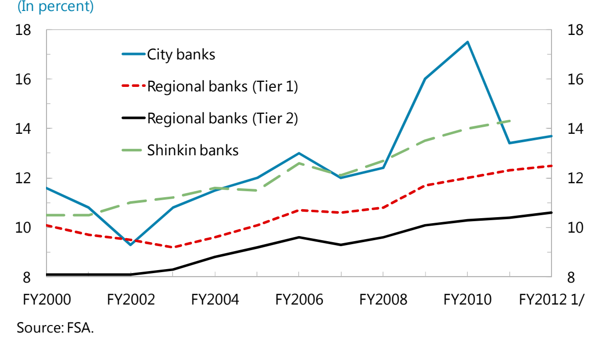
Source: BIS.
1/ Includes Greece, Ireland, Italy, Portugal, and Spain.
2/ Includes Germany, France, UK, and Switzerland.

Figure 7. Financial Soundness Indicators

Major banks have enhanced their capital in advance of Basel III implementation which commenced in March 2013.

Regulatory Capital to Risk-Weighted Assets

(In percent)

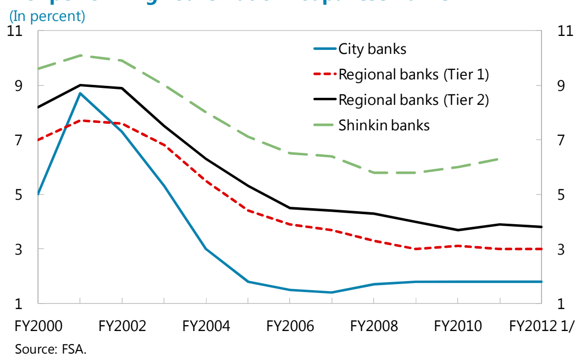


Source: FSA.
1/ As of end of of fiscal year (i.e. end-March of following year) except for FY2012 refers to half-year ending September 2012.

Nonperforming loan ratios have fallen since 2000s, although they are still high for smaller banks.

Nonperforming Loans Ratio in Japanese Banks

(In percent)

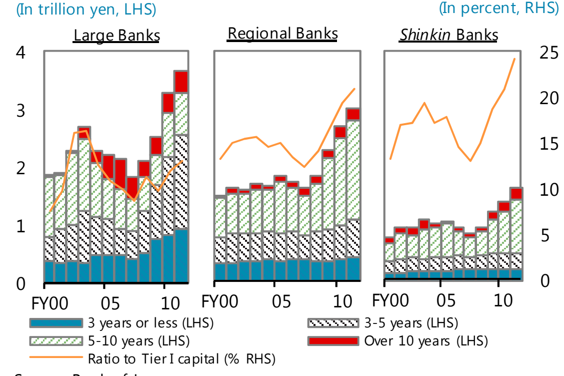


Source: FSA.
1/ As of end of of fiscal year (i.e. end-March of following year) except for FY2012 refers to half-year ending September 2012.

Interest rate risks remain a key challenge for the financial system, particularly for regional and shinkin banks…

Interest Rate Risk of Domestic Bondholders (100 BPV)

(In trillion yen, LHS) (In percent, RHS)

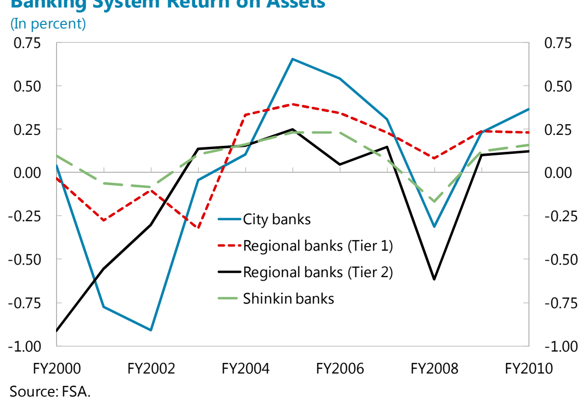


Source: Bank of Japan.
1/ Latest data as of end-March 2012.

… and banks profitability remains below the levels of the mid-2000s.

Banking System Return on Assets

(In percent)

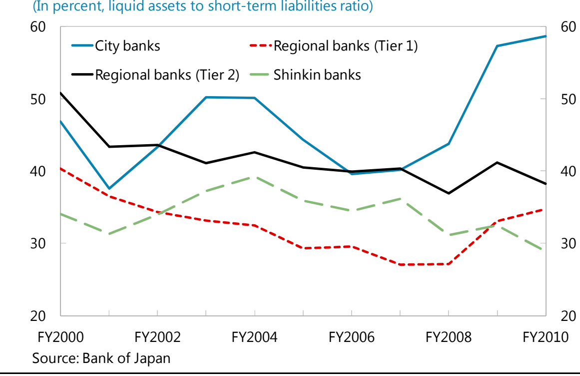


Source: FSA.

Liquidity in the banking system remains high given the easing measures by the BoJ…

Liquidity of Japanese Banks

(In percent, liquid assets to short-term liabilities ratio)

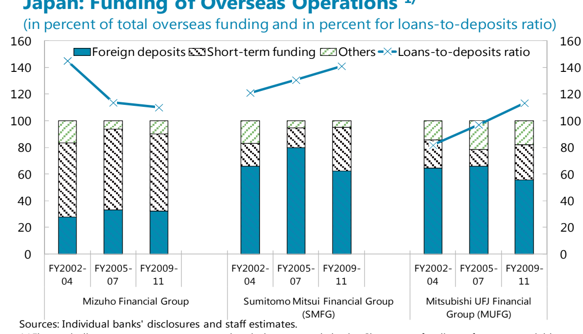


Source: Bank of Japan

… although funding risks for overseas loan may increase as banks continue to expand their cross border activities.

Japan: Funding of Overseas Operations 1/

(in percent of total overseas funding and in percent for loans-to-deposits ratio)



Sources: Individual banks' disclosures and staff estimates.
1/ Figures indicate an average across stated periods on a yearly basis. Short-term funding refers to negotiable certificates of deposits, calls money, repos, and borrowed money. Data on loans-to-deposits ratio are based on each financial group in a consolidated basis, while overseas funding is based on individual banks in each financial group on a consolidated basis.

Table 1. Selected Economic Indicators

Nominal GDP: US$ 5,959 billion (2012)
Population: 128 million (2012)
GDP per capita: US$ 46,716 (2012)
Quota: SDR 15,629 million (2012)

	2008	2009	2010	2011	2012	2013	2014
						Proj.	
Growth (percent change) 1/							
Real GDP	-1.0	-5.5	4.7	-0.6	1.9	2.0	1.2
Domestic demand	-1.3	-4.0	2.9	0.3	2.8	1.7	0.5
Private consumption	-0.9	-0.7	2.8	0.4	2.3	1.8	0.9
Gross Private Fixed Investment	-3.3	-14.7	-0.5	3.7	2.1	0.4	2.9
Government consumption	-0.1	2.3	1.9	1.4	2.4	2.0	0.0
Public investment	-7.4	7.0	0.7	-7.5	12.5	3.0	-15.4
Stockbuilding 2/	0.2	-1.5	0.9	-0.4	0.0	-0.1	0.2
Net exports 2/	0.2	-2.0	2.0	-0.8	-0.8	0.5	0.7
Exports of goods and services	1.4	-24.2	24.4	-0.4	-0.1	4.8	7.8
Imports of goods and services	0.3	-15.7	11.1	5.9	5.4	2.2	4.0
Inflation (annual average)							
CPI 3/	1.4	-1.3	-0.7	-0.3	0.0	0.1	2.9
GDP deflator	-1.3	-0.5	-2.2	-1.9	-0.9	-1.7	1.5
Unemployment rate (annual average)	4.0	5.1	5.1	4.6	4.4	4.1	4.1
Government (percent of GDP)							
General government							
Revenue	31.6	29.6	29.6	30.8	31.1	31.6	33.2
Expenditure	35.7	40.0	38.9	40.8	41.3	41.3	40.3
Overall Balance	-4.1	-10.4	-9.3	-9.9	-10.1	-9.8	-7.1
Primary balance	-3.8	-9.9	-8.6	-9.1	-9.3	-9.0	-6.3
Public debt, gross	191.8	210.2	216.0	230.3	238.0	246.9	247.5
Money and credit (percent change, end-period)							
Base money	0.1	5.8	4.8	15.2	7.0	...	...
M2 (period average)	2.1	2.7	2.8	2.7	2.5	...	...
Domestic credit	1.8	0.5	1.3	1.8	2.5	...	...
Bank lending	4.6	-0.9	-1.8	0.7	1.4	...	...
Interest rate							
Overnight call rate, uncollateralized (end-period)	0.10	0.09	0.08	0.08	0.08	...	...
Three-month CD rate (annual average)	0.5	0.3	0.3	0.3	0.3	...	...
Official discount rate (end-period)	0.4	0.3	0.3	0.3	0.3	...	...
Balance of payments (in billions of US$)							
Current account balance	159.9	146.6	204.0	119.3	60.4	62.5	85.7
Percent of GDP	3.3	2.9	3.7	2.0	1.0	1.3	1.7
Trade balance	38.5	43.3	91.0	-20.6	-73.2	-56.6	-28.9
Percent of GDP	0.8	0.9	1.7	-0.3	-1.2	-1.2	-0.6
Exports of goods, f.o.b.	746.7	545.2	730.1	787.9	769.6	803.6	873.8
Imports of goods, f.o.b.	-708.2	-501.9	-639.1	-808.5	-842.8	-860.2	-902.7
Oil imports (trade basis)	190.6	99.9	134.3	182.5	196.9	197.1	195.3
FDI, net (percent of GDP)	-2.2	-1.2	-1.1	-1.9	-2.0	-2.0	-2.0
Terms of trade (percent change)	-9.6	19.5	-3.3	-7.9	0.3	1.9	0.2
Change in reserves	-30.8	-27.2	-44.3	-177.3	37.9	-15.0	-23.5
Total reserves minus gold (in billions of US$)	1,009.4	1,022.2	1,061.5	1,258.2	1,227.2	...	...
Exchange rates (annual average)							
Yen/dollar rate	103.4	93.6	87.8	79.8	79.8	...	...
Yen/euro rate	152.1	130.3	116.5	111.0	102.6	...	...
Real effective exchange rate (ULC-based) 4/	89.7	108.2	109.8	118.5	119.7	...	...
Real effective exchange rate (CPI-based)	90.1	101.5	102.7	104.5	103.2	...	...

Sources: Global Insight, Nomura database; IMF, Competitiveness Indicators System; and IMF staff estimates and projections as of June 20, 2013.
1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ Contribution to GDP growth.
3/ Effect of consumption tax increase in 2014.
4/ Based on normalized unit labor costs; 2005=100.

Table 2. External Sector Summary

	2008	2009	2010	2011	2012
Balance of payments	*(In billions of U.S. dollars)*				
Current account balance	160	147	204	119	60
Trade balance (goods)	38	43	91	-21	-73
Exports of goods	747	545	730	788	770
Imports of goods	-708	-502	-639	-808	-843
Services balance	-20.8	-20.4	-16.1	-22.2	-31.2
Income balance	155.3	135.9	141.5	176.0	179.2
Credits	215.3	179.7	181.9	227.7	235.1
Debits	-60.0	-43.9	-40.4	-51.7	-55.9
Current net transfers	-13.1	-12.3	-12.4	-13.8	-14.2
Capital account	-5.6	-5.0	-5.0	0.5	-1.0
Financial account	-204.6	-176.1	-239.9	-158.6	-64.7
Direct investment, net	-106.3	-62.6	-58.9	-110.6	-121.0
Portfolio investment, net	-294.7	-217.6	-154.1	155.5	-38.5
Other investment, net	227.2	131.3	17.5	-26.3	56.9
Reserve assets	-30.8	-27.2	-44.3	-177.3	37.9
Errors and omissions, net	50.3	34.5	40.8	38.8	5.2
	(In percent of GDP)				
Current account balance	3.3	2.9	3.7	2.0	1.0
Trade balance (goods)	0.8	0.9	1.7	-0.3	-1.2
Exports of goods	15.4	10.8	13.3	13.4	12.9
Imports of goods	-14.6	-10.0	-11.6	-13.7	-14.1
Services balance	-0.4	-0.4	-0.3	-0.4	-0.5
Income balance	3.2	2.7	2.6	3.0	3.0
Global assumptions					
Exchange Rate (¥/US$)	103.4	93.6	87.8	79.8	79.8
(Percent change)	-12.2	-9.5	-6.2	-9.1	0.0
Oil prices (US$/barrel)	97.0	61.8	79.0	104.0	105.0
(Percent change)	36.4	-36.3	27.9	31.6	1.0
Memorandum items :					
Nominal GDP (US$ billion)	4,850	5,035	5,495	5,901	5,959
Net foreign assets (NFA)/GDP, US$ basis	51	57	56.2	57.9	57.5
Return on NFA (in percent), US$ basis	6.3	4.7	4.6	5.2	5.2
Net export contribution to growth	0.2	-2.0	2.0	-0.8	-0.8

Sources: Haver Analytics, Japanese authorities, and IMF staff estimates.

Table 3. General Government Operations

(In percent of GDP)

	2008	2009	2010	2011	2012	2013	2014
					Estimates	Projections	
Total revenue	31.6	29.6	29.6	30.8	31.1	31.6	33.2
Taxes 1/	18.1	15.9	16.1	16.6	17.0	17.2	18.4
Social security contributions	11.5	11.8	11.8	12.5	12.6	12.7	12.9
Grants	11.0	13.9	13.5	0.0	0.0	0.0	0.0
Other revenue	2.1	1.9	1.7	1.7	1.5	1.6	1.9
o/w interest income	1.8	1.7	1.5	1.4	1.3	1.4	1.7
Total expenditure	35.7	40.0	38.9	40.8	41.3	41.3	40.3
Expense	31.7	35.4	35.0	36.2	37.1	37.2	36.5
Compensation of employees	6.2	6.4	6.1	6.3	...	...	...
Use of goods and services	3.2	3.7	3.7	3.8	...	...	...
Consumption of fixed capital	2.9	3.1	3.0	3.0	3.0	3.0	3.0
Interest	2.0	2.0	2.0	2.1	2.1	2.0	2.0
Grants	11.1	14.1	13.6	14.9	...	...	...
Social security benefits	17.4	19.5	19.7	20.6	20.8	21.1	21.1
Other expense	-11.2	-13.4	-13.2	-14.5	...	...	...
Net acquisition of nonfinancial assets	1.2	1.6	1.0	1.5	1.1	1.1	0.8
Acquisitions of nonfinancial assets	4.0	4.6	3.9	4.5	4.1	4.2	3.8
o/w public investment	3.0	3.4	3.3	3.2	3.7	3.9	3.5
o/w land acquisition	0.4	0.4	0.4	0.3	0.4	0.3	0.3
Consumption of fixed capital	-2.9	-3.1	-3.0	-3.0	-3.0	-3.0	-3.0
Net lending/borrowing (overall balance)	-4.1	-10.4	-9.3	-9.9	-10.1	-9.8	-7.1
Primary balance	-3.8	-9.9	-8.6	-9.1	-9.3	-9.0	-6.3
Excluding social security fund	-3.6	-9.3	-8.2	-9.0	-9.1	-8.6	-5.7
Structural balance	-3.5	-7.4	-7.9	-8.5	-9.2	-9.5	-6.9
Structural primary balance	-3.4	-7.1	-7.4	-7.8	-8.4	-8.9	-6.6
Financing	4.1	10.4	9.3	9.9	10.1	9.8	7.1
Net issuance of debt securities	1.1	10.1	10.0	...	...	...	...
Other	3.0	0.3	-0.7	...	...	...	...
Stock positions 2/							
Debt							
Gross 3/	191.8	210.2	216.0	232.9	238.0	246.9	247.5
Net	95.3	106.2	113.1	127.4	134.4	144.3	148.3
Net worth	21.7	15.8	6.3	-3.9	...	...	...
Nonfinancial assets	117.0	122.0	119.4	120.4	...	...	...
Fixed assets (excluding land)	90.2	94.6	93.4	95.0	...	...	...
Land	26.5	27.0	25.7	25.0	...	...	...
Other	0.2	0.4	0.4	0.4	...	...	...
Net financial worth	-95.3	-106.2	-113.1	-124.3	...	...	...
Financial assets	96.5	104.1	102.8	102.8	...	...	...
Currency and deposits	17.9	17.0	16.5	16.5	...	...	...
Loans	4.2	6.0	6.7	6.6	...	...	...
Securities other than shares	28.1	26.8	26.4	25.7	...	...	...
Shares and other equities	19.9	22.8	24.0	22.9	...	...	...
o/w shares	6.4	8.1	9.4	8.3	...	...	...
Financial derivatives	0.0	0.0	0.0	0.0	...	...	...
Other financial assets	26.4	31.4	29.3	31.2	...	...	...
Liabilities	191.8	210.2	216.0	227.2	...	...	...
Loans	34.3	36.0	34.6	34.0	...	...	...
Securities other than shares	146.3	161.5	170.2	181.8	...	...	...
Equities	4.6	4.9	4.9	5.0	...	...	...
Financial derivatives	0.0	0.0	0.0	0.0	...	...	...
Other liabilities	6.7	7.9	6.2	6.4	...	...	...
Memorandum item:							
Nominal GDP (CY, trillion yen)	501.2	471.1	482.4	470.6	475.5	477.0	489.9

Sources: Japan Cabinet Office; IMF staff estimates and projections.
1/ Including fines.
2/ Market value basis.
3/ Nonconsolidated basis.

Table 4. Medium-Term Projections

	2011	2012	2013	2014	2015	2016	2017	2018
			Projections					
			(Percent change)					
Real GDP	-0.6	1.9	2.0	1.2	1.1	1.2	1.1	1.1
Total domestic demand	0.3	2.8	1.7	0.5	0.7	1.0	0.9	0.9
Net exports (contribution)	-0.8	-0.8	0.5	0.7	0.5	0.2	0.2	0.2
Unemployment rate (percent)	4.6	4.4	4.1	4.1	4.1	4.1	4.0	4.0
Headline CPI inflation (average)	-0.3	0.0	0.1	2.9	1.9	1.9	2.0	2.0
memo item: without planned consumption tax increases	-0.3	0.0	0.1	1.2	1.6	1.9	2.0	2.0
Output gap (in percent of potential output)	-3.7	-2.3	-0.9	-0.5	-0.3	0.0	0.1	0.1
			(In percent of GDP)					
Overall fiscal balance	-9.9	-10.1	-9.8	-7.1	-6.0	-5.2	-5.1	-5.4
Primary balance	-9.1	-9.3	-9.0	-6.3	-5.1	-4.0	-3.5	-3.2
General government debt								
Gross	232.9	238.0	246.9	247.5	249.0	249.0	248.4	248.3
Net	127.4	134.4	144.3	148.3	152.2	154.6	156.2	158.2
External current account balance	2.0	1.0	1.3	1.7	1.9	1.8	1.7	1.7
National savings	22.0	21.6	22.2	22.5	22.7	22.9	23.1	23.5
Private	24.3	23.5	23.7	21.5	21.2	20.7	20.9	21.7
Public	-2.3	-1.9	-1.4	0.9	1.5	2.3	2.2	1.8
National investment	20.0	20.6	21.0	20.7	20.8	21.1	21.4	21.8
Private	15.6	15.7	15.9	16.4	17.1	17.5	17.9	18.4
Public	4.4	4.9	5.0	4.3	3.8	3.7	3.5	3.4

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

Table 5. External and Financial Indicators

(In percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012
External indicators					
Real exports of goods and services (percent change)	1.4	-24.2	24.4	-0.4	-0.1
Real imports of goods and services (percent change)	0.3	-15.7	11.1	5.9	5.4
Terms of trade (percent change)	-9.6	19.5	-3.3	-7.9	0.3
Current account balance	3.3	2.9	3.7	2.0	1.0
Capital and financial account balance	-4.2	-3.3	-3.9	0.0	-1.6
Of which :					
Inward portfolio investment	-2.1	-1.1	2.0	4.4	1.9
Inward direct investment	0.5	0.2	0.0	0.0	0.0
Other investment liabilities (net)	4.2	2.4	0.1	-0.7	1.1
Total reserves minus gold (US$ billion)	1,009.4	1,022.2	1,061.5	1,258.2	1,227.2
In months of imports of goods and services	14.3	19.8	16.6	15.9	14.8
Broad money (M2 + CDs) to reserves ratio	69.0	76.8	80.6	77.1	80.7
Foreign assets of ODCs (US$ billion)	1,859.7	1,872.6	2,113.4	2,423.2	2,892.8
Foreign liabilities of ODCs (US$ billion)	1,017.2	1,169.9	1,276.3	1,411.6	1,781.0
Net international investment position (US$ billion)	2,189.4	2,855.5	2,876.0	3,191.2	3,721.8
Of which :					
External loan liabilities	740.1	873.7	1,038.7	1,234.9	1,277.4
External public sector debt (gross) 1/	620.8	640.2	752.3	1,095.6	1,141.1
External loan liabilities to exports ratio	0.9	1.4	1.2	1.4	1.5
External interest payments to exports (in percent) 2/	1.9	1.7	0.9	0.8	0.8
Nominal effective exchange rate (percent change, period avg)	11.7	14.4	4.4	5.8	1.2
Financial market indicators					
General government gross debt	191.8	210.2	216.0	230.3	238.0
Stock market index (TOPIX, percent change, end-year) 3/	-28.5	-26.9	2.1	-7.3	-6.4
Banking sector risk indicators					
Total loans to assets (in percent)	27.9	27.8	26.8	26.5	26.6
Total loans to deposits (in percent)	79.2	75.9	73.2	71.4	71.0
Share of real estate sector in total lending (in percent)	19.0	20.6	20.8	20.6	20.3
Share of nonperforming loans in total loans					
(In percent, end-fiscal year) 4/	1.6	1.7	1.7	1.7	...
Risk-weighted capital ratio (in percent, end-fiscal year) 4/	12.4	15.8	17.3	18.0	...

Sources: Global Insight, Nomura Database; IMF, International Financial Statistics; Fitch IBCA; and IMF staff estimates.
1/ Public sector debt securities and other loan liabilities.
2/ Other investment income, debit.
3/ Twelve-month percent change for the latest figure.
4/ Major banks. Capital ratio is on a nonconsolidated basis.

Table 6. Financial Soundness Indicators for Japanese Deposit-Taking Institutions 1/

*

(In percent)

	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012 1/
Capital adequacy 2/ 3/													
I1. Regulatory capital to risk-weighted assets	11.1	10.5	9.5	10.5	11.1	11.6	12.2	11.6	11.8	14.1	14.9	15.4	15.4
I2. Regulatory Tier 1 capital to risk-weighted assets	7.0	6.4	5.8	6.5	7.0	7.3	8.0	8.1	8.1	10.5	11.5	11.9	12.2
I3. Nonperforming loans net of provisions to capital	...	111.4	106.2	64.7	39.2	25.8	21.5	24.2	30.8	22.7	22.2	21.4	21.4
Asset quality 2/													
I4. Nonperforming loans to total gross loans	6.3	8.4	7.4	5.8	4.0	2.9	2.5	2.4	2.4	2.5	2.4	2.4	2.4
Earnings and profitability													
I6. Return on assets	-0.1	-0.6	-0.6	-0.1	0.2	0.5	0.4	0.3	-0.2	0.2	0.3	...	...
I7. Return on equity	-1.2	-13.9	-16.4	-3.0	4.9	15.1	11.4	6.7	-5.7	5.5	6.9	...	...
I8. Interest margin to gross income	70.6	105.7	118.6	73.6	75.2	66.5	67.4	71.4	94.4	73.9	70.5	...	...
I9. Noninterest expenses to gross income	57.1	80.1	93.8	58.4	60.6	54.2	57.5	62.1	82.3	63.2	62.6	...	...
Liquidity													
I10. Liquid assets to total assets	13.5	14.6	18.6	20.6	20.8	18.7	16.8	16.1	17.3	21.6	23.2	...	...
I11. Liquid assets to short-term liabilities	45.3	37.7	41.0	45.0	44.5	39.6	36.5	36.1	38.4	48.8	50.1	...	...
Other													
I13. Capital to assets 4/	4.7	4.2	3.4	3.9	4.2	4.9	5.3	4.5	3.6	4.8	4.7	4.8	4.9
I18. Trading income to total income 5/	14.8	10.0	10.2	13.3	9.4	6.9	6.2	7.7	7.7	7.5	9.0	9.0	...
I19. Personnel expenses to noninterest expenses 6/	47.3	46.7	46.3	46.0	43.3	42.8	40.4	39.8	42.1	45.6	45.0	45.3	...
I25. Net open position in equities to capital 7/	120.9	117.3	93.4	98.5	88.2	89.1	84.6	73.5	63.5	54.9	48.0	43.8	...

1/ End of of fiscal year (i.e. end-March of following year). FY2012 refers to half-year ending September 2012. Figures include city banks and regional banks, but not shinkin banks (consolidated basis).
2/ The figures in I.1~I.4 are aggregated with the unconsolidated basis data.
3/ The figures in I.1 and I.2 are rounded down less than a unit. The other figures are rounded up less than a unit.
4/ I13 Capital to Assets = Net Assets / Total Assets
5/ I18 Trading income to total income = (Market Return Gains on sales of bonds + Gains on redemption of bonds + Gain on sales of stocks and other securities) / Ordinary profit.
6/ I19 Personnel expenses to noninterest expenses = Labor cost/Operating Cost
7/ I25 Net open position in equities to capital = Equity / Net asset

Appendix I. Assessment of Japan's External Sector

Staff's external sector evaluation concludes that the external position is moderately stronger than implied by fundamentals (and the exchange rate moderately undervalued). This assessment is based on the following considerations.

External balance assessment (EBA). This year's EBA results were calculated using the current account (CA) and average real effective exchange rate (REER) based on the average for 2012. The EBA results for Japan indicate that the CA is moderately weaker by 2¼ percent of GDP, and the REER moderately stronger by about 8 percent, than the levels implied by fundamentals and desirable policies.

Recent developments. Between the reference period for the 2012 EBA and June 2013, the REER depreciated 18-20 percent, reflecting several factors, including the new monetary framework, the reversal of safe haven effects and a structural weakening of the trade balance from higher energy imports. As of mid-2013, however, the CA has negligibly responded to this depreciation.

Extrapolation of the EBA results to mid-2013. Reflecting the significant external sector developments since end 2012, staff's assessment of the external position is based on extrapolation of the EBA results to mid-2013. This extrapolation, which draws on a wide range of inputs including staff's judgment to adjust the CA and REER gaps, is subject to an unusual degree of uncertainty. This assessment takes into account the following factors:

- The new macro policy framework: staff assesses that implementing credible fiscal and structural reforms will shift the economy to a higher-growth, higher-inflation equilibrium, consistent with real effective appreciation and a lower equilibrium current account (norm). A lower CA norm may also result from a potentially different set of desirable policies consistent with higher equilibrium growth, e.g., a flatter medium-term fiscal adjustment path. Reflecting these considerations, staff's assessment is that the CA norm lies in a fairly wide range around 2.5 percent of GDP.
- The lagged impact of depreciation and higher energy costs: the EBA results estimated the cyclically-adjusted CA in 2012 of 1¼ percent of GDP, to be about 2¼ percent of GDP weaker than the EBA CA norm, but these estimates do not reflect the lagged impact of depreciation or a temporary weakening of the trade balance from higher energy imports. Taking into account the impact of the large depreciation of the yen using a range of the relevant trade elasticities, and adjusting the current account for the impact of temporary energy shortages on the trade balance, staff estimates the underlying CA in mid-2013 lie in a range around 3 percent of GDP with a large up- and downside margin.
- **Bands around the CA gap**: staff derives the CA gap using the extrapolated CA norm and the cyclically adjusted CA. Reflecting the ranges in each of these underlying terms, staff's assessment is that the CA gap lies in a range of -1 to +2 percent of GDP, with a midpoint estimate of 0.5 percent.
- **CGER methodology.** Estimates using the CGER methodology, based on a reference period of February-March 2013 indicate an undervaluation of 23 percent using the ERER approach, while

both the MB (current account) and external sustainability approach suggest CA gaps of about -0.5 percent.

Overall external sector report (ESR) assessment. Taking into account the EBA results, a major shift in the policy framework, recent external sector developments and uncertainty about the exact size of the underlying CA, staff estimates that the current account gap ranges from 1 percent of GDP weaker to 2 percent of GDP stronger than implied by fundamentals and desirable policies. Furthermore, adjusting the EBA REER results for the sharp depreciation since 2012 staff assesses that the REER is moderately undervalued with a mid-point of -5 percent, but an unusually wide range of -20 percent undervaluation to 10 percent overvaluation reflecting significant uncertainty and market volatility.

Appendix II. Risk Assessment Matrix

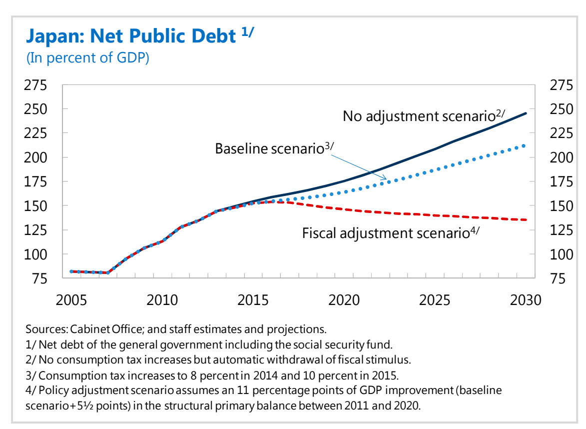
Overall Level of Concern		
	Likelihood (Over next 1–3 years)	**Impact and Policy Response**
➢ **Successful reflation following comprehensive reforms** ⇧	**Medium** Aggressive monetary policy easing and a credible medium-term fiscal and growth strategy could lead to a virtuous cycle of high growth and positive inflation.	**High** Increased inflation expectations would help lowering expected real interest rates and thereby stimulate activity, as well as leading to positive inflation. It would improve debt dynamics, minimizing the negative effect of consolidation on growth. *Policy response:* The BoJ should prepare a credible exit strategy and the government should save any fiscal overperformance.
➢ **New policy package fails to stimulate private activity** ⇩	**Medium** Despite a package of bold reforms, inflation and activity may not pick up substantially because of structural factors such as population aging or inertia in inflation expectation and the wage-setting process.	**Medium/High** Growth in 2013–14 would be substantially below the baseline projections. The burden of closing the output gap and moving inflation expectations could fall back toward fiscal policy, further increasing fiscal sustainability risks. *Policy response:* The BoJ's QQME could be recalibrated, including the pace and composition of asset purchases. If the authorities commit to a sufficiently ambitious and credible fiscal consolidation plan by passing concrete measures, even if they take effect over the medium term, the 2014–15 fiscal withdrawal could be made more gradual, but the consumption tax increase should proceed as planned.
➢ **Japanese bond market stress** ⇩	**Medium** Disappointing growth reforms and lack of concrete fiscal measures to bring down public debt could trigger a significant rise in the risk premium. The BoJ would increasingly have to replace domestic investors in financing public debt, which could lead to greater volatility in bond markets and a rise in the risk premium.	**High** It would lead to a loss of confidence and have severe financial market repercussions, undermining the recovery of domestic demand. The 2012 FSAP Update indicates that even a modest increase in the risk premium by 100bps could undermine financial stability and worsen debt dynamics. *Policy response:* The BoJ needs to increase the size and accelerate the pace of bond purchases to assure investors and the authorities should front-load fiscal adjustment and commit to ambitious structural reforms to contain risks. The government should confirm the two-step consumption tax increases.
➢ **Deeper than expected slowdown in EMs** ⇩	**Medium** Disappointing activity in emerging markets would bring about a reassessment that the cycle is more mature and that trend growth will be lower than previously thought. This could be triggered by financial stresses or setbacks in fiscal and labor market reform efforts that could affect confidence, FDI inflows, and private investment.	**Medium** Exports would decline owing to weak demand from emerging economies and domestic demand would fall due to depressed equity prices and weaker business and consumer confidence, making escaping deflation more difficult. G-RAM simulations show that a fall in private investment in the BRICS by 10 percent in 2013 would lower Japanese GDP by more than 1 percent in near term relative to the WEO baseline. *Policy response*: Bold implementation of structural reforms is important to boost domestic demand. Automatic stabilizers are small and should be complemented with targeted, but limited fiscal support measures, but it would not be advisable to delay implementation of the increase in the consumption tax rate. The pace of BoJ asset purchases could be accelerated.
➢ **Protracted period of slower European growth** ⇩	**High** The effects of public and private sector deleveraging on the real economy may be larger than currently expected, potentially spurring debt-deflation dynamics. Financial market fragmentation would become entrenched, unemployment remains high, and investment remains subdued, reducing potential output. Core economies weaken due to trade links and confidence effects, reducing medium-term growth in the euro area to around ¾ percent.	**Low/Medium** Exports would decline owing to weak global demand and safe-haven effects, and the fiscal balance would deteriorate due to an increased sovereign risk premium. G-RAM simulations show that a fall in investment in the euro area by 3 and 5 percent in 2013 and 2014, respectively, would not only deteriorate export performance, but also lower domestic demand through financial linkages, leading to contraction of real GDP by about 1 percentage point in the medium term relative to the WEO baseline. *Policy response*: Same as for a "deeper than expected slowdown in Ems."

Appendix III. Public Sector Debt Sustainability Analysis

This appendix presents three scenarios and their sensitivity analyses: (i) no adjustment scenario; (ii) baseline scenario (staff's estimate of the authorities' current plan); and (iii) fiscal adjustment scenario (see Table 1 on page 18 for specifics). Staff recommends a structural adjustment of at least 11 percent of GDP to put the debt ratio on a declining path.

Baseline macroeconomic assumptions. Both real GDP growth and GDP deflator rates beyond 2018, the last year in the WEO projection, are assumed to be similar to the ones in 2018, 1 and 1.2 respectively. As a result, nominal GDP growth is around 2.2 percent per annum beyond 2018.[1] The nominal interest rate-growth differential is assumed to converge to 1 percent (about the pre-crisis average since 2000) over the long run. Consequently, the effective nominal interest rate is assumed to rise to 3.2 percent (compared to about 1 percent currently) over the long run.

No adjustment scenario. Without the planned consumption tax increases, net debt (defined here as general government net debt, including the social security fund) is projected to rise to about 245 percent of GDP (335 percent of GDP on a gross debt basis) by 2030. The no adjustment scenario assumes winding down of the past and current stimuli (1 percent of GDP each) and modest expenditure adjustment (1½ percent of GDP) between end-2011 and 2020, which altogether improves the structural primary balance by 3½ percent of GDP over the next decade. The scenario does not assume an increase in the risk premium, which would worsen debt dynamics.



Japan: Net Public Debt 1/
(In percent of GDP)

Sources: Cabinet Office; and staff estimates and projections.
1/ Net debt of the general government including the social security fund.
2/ No consumption tax increases but automatic withdrawal of fiscal stimulus.
3/ Consumption tax increases to 8 percent in 2014 and 10 percent in 2015.
4/ Policy adjustment scenario assumes an 11 percentage points of GDP improvement (baseline scenario+5½ points) in the structural primary balance between 2011 and 2020.

Baseline scenario. Staff estimates that the authorities' current plan (Table 1, page 18, left column), including the two-stage consumption tax rate increases from 5 to 8 percent in 2014 and then to 10 percent in 2015, together with the above-mentioned expenditure adjustment, would improve the structural primary balance by 5½ percent of GDP over the next decade. This factors in staff's assumption that around a quarter of the revenue gain from the consumption tax hike will be spent on social security as government's plan, and that the single rate structure of the consumption tax will be kept.[2] Even with this adjustment, however, the net debt-to-GDP ratio would steadily climb to around 210 percent of GDP (300 percent of GDP on a gross debt basis) by 2030.

Fiscal adjustment scenario. Achieving debt sustainability will require that Japan puts its debt-to-GDP ratio on a clear downward path. Staff estimates that this requires an 11 percent of GDP

[1] It is assumed that additional fiscal consolidation on top of the baseline scenario has no impact on growth (zero multiplier) as a credible fiscal plan enhances confidence and consolidation measures are designed to reduce distortions. Thus, key macroeconomic assumptions are the same under the three scenarios.

[2] Measures to address the regressivity of the consumption tax rate hike are likely to be implemented, but not considered here.

improvement of the structural primary balance over the next decade (Table 1, page 18, right column).[3] In addition to the baseline scenario, this comprises another 5 percentage points increase in the consumption tax rate (2.5 percent of GDP) and expenditure reforms that result in savings of 3 percent of GDP (e.g., containing social security and non-social security spending).[4] Under this scenario, the net debt-to-GDP ratio is projected to peak at around 155 percent in 2016 and decline to 135 percent of GDP (225 percent of GDP on a gross debt basis) by 2030.

Sensitivity Analysis

A complete package of reforms would provide an upside scenario. Ambitious structural reforms together with staff's policy adjustment scenario could lead to faster attainment of the inflation target and higher potential growth (Box 1). This would reduce the debt ratio by an additional 5 percentage points of GDP by 2030 as higher nominal GDP growth reduces the debt ratio, thanks to a higher denominator (nominal GDP) until the effective nominal interest rate catches up.

Overall, debt dynamics are subject to downside risks however, for the following reasons:

- **A higher interest rate growth differential** (baseline: 1 percent in the long run) would lead to a faster pace of debt accumulation (Table III.1). A 1 percent rise in the differential undoes the declining in the debt trajectory under the fiscal adjustment scenario, while a 4 percent differential yields an explosive path for the debt ratio.
- **Historical shocks:** stochastic simulations considering shocks to growth, inflation, and interest rates, based on historical patterns, further illustrates the sensitivity of the debt dynamics to macroeconomics factors. Even with an 11 percent of GDP improvement in the structural primary balance, the debt ratio is explosive with a 25 percent probability (Figure III.1, left). To achieve a declining debt trajectory with a 90 percent probability, an additional adjustment of 5 percent of GDP is needed (Figure III.1, right).
- **Contingent liabilities:** the debt position looks worse once contingent liabilities are taken into account. Including government guaranteed bonds and borrowing would add around 10 percentage points of GDP to the general government debt. Adding contingent liabilities associated with Tokyo Electric Power Company (TEPCO)[5] and regional banks[6] would have a modest impact on debt (3 percentage points in total at maximum). In addition, there are a few special accounts of the central government that are not included in the general government. The

[3] Beyond 2020, the social security balance (defined as social security premiums minus benefits) is likely to worsen (for example, see Box 4 on rising health care expenditures). Thus, offsetting measures would be needed to maintain the 11 percentage point improvement from 2021 onwards.

[4] More specifically, the fiscal adjustment scenario assumes additional revenue increases of 0.5, 1, and 1 percent of GDP in 2016, 2017, and 2018, respectively. It also includes an additional spending reduction of 0.6 percent of GDP per year between 2016 and 2020.

[5] TEPCO is liable for compensation for residents who lived in the neighborhood of the nuclear plants damaged by the March 2011 earthquake and tsunami. Capital injection and reaching the limit of government guaranteed bond issuance would amount to 9 trillion yen (around 2 percent of GDP) in liabilities.

[6] The 2012 FSAP estimated that capital shortfall in regional banks could be ¾ percent of GDP based on a number of shocks involving a 100 basis point increase in bond yields.

largest one is the Special Account of Fiscal Investment and Loan Program, which holds 169 trillion yen (36 percent of GDP) in asset and 158 trillion yen (34 percent of GDP) in liabilities as of March 2012.

Table III.1. Sensitivity Analysis of Debt Sustainability

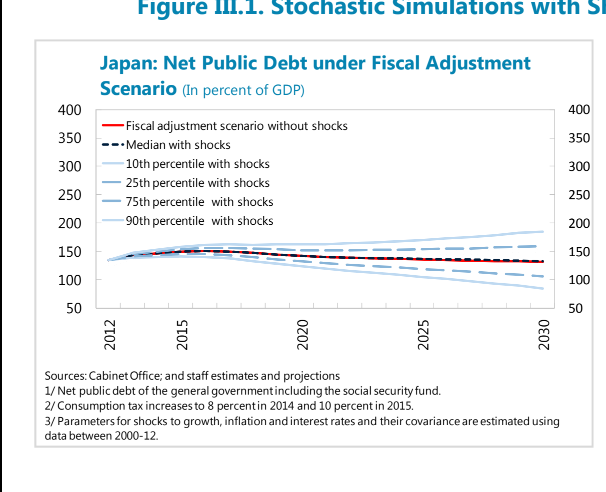
(In percent of GDP).

	Nominal Interest Rate Growth Differential over the Long Term (in percent)	Structural Primary Balance Improvement Bet end-2011 and 2020	2010	2011	2012	2015	2020	2030
Net debt								
No adjustment scenario	1.0 (baseline)	3.5	113	127	134	154	176	245
	2.0	3.5	113	127	134	155	183	275
	4.0	3.5	113	127	134	157	197	347
Baseline scenario	1.0 (baseline)	5.5	113	127	134	152	164	212
	2.0	5.5	113	127	134	153	171	240
	4.0	5.5	113	127	134	154	185	306
Fiscal adjustment scenario	1.0 (baseline)	11.0	113	127	134	152	146	135
	2.0	11.0	113	127	134	153	152	158
	4.0	11.0	113	127	134	154	166	213
Target pre-crisis (2007) level in 2030	1.0 (baseline)	13.3	113	127	133	143	127	80
	2.0	14.4	113	127	132	142	127	80
	4.0	16.6	113	127	132	141	128	80
Gross debt								
No adjustment scenario	1.0 (baseline)	3.5	216	230	238	251	266	335
	2.0	3.5	216	230	238	252	273	365
	4.0	3.5	216	230	238	253	287	437
Baseline scenario	1.0 (baseline)	5.5	216	230	238	249	254	302
	2.0	5.5	216	230	238	250	261	330
	4.0	5.5	216	230	238	251	275	396
Fiscal adjustment scenario	1.0 (baseline)	11.0	216	230	238	249	236	225
	2.0	11.0	216	230	238	250	242	248
	4.0	11.0	216	230	238	251	256	303
Target pre-crisis (2007) level in 2030	1.0 (baseline)	13.3	216	230	236	240	217	171
	2.0	14.4	216	230	236	239	217	171
	4.0	16.6	216	230	236	238	218	171

Source: Cabinet Office, and staff estimates.

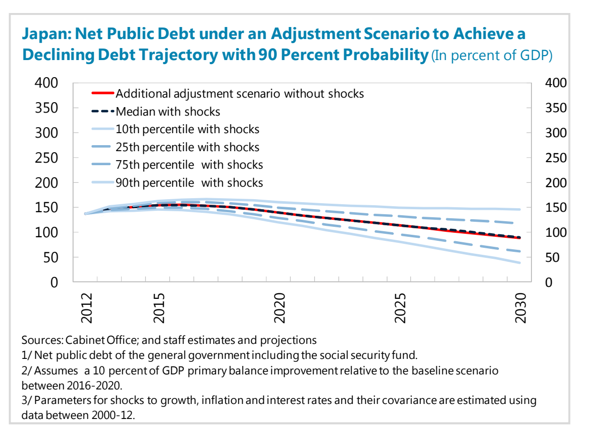
Figure III.1. Stochastic Simulations with Shocks to Growth, Inflation and Interest Rates

Japan: Net Public Debt under Fiscal Adjustment Scenario (In percent of GDP)



Sources: Cabinet Office; and staff estimates and projections
1/ Net public debt of the general government including the social security fund.
2/ Consumption tax increases to 8 percent in 2014 and 10 percent in 2015.
3/ Parameters for shocks to growth, inflation and interest rates and their covariance are estimated using data between 2000-12.

Japan: Net Public Debt under an Adjustment Scenario to Achieve a Declining Debt Trajectory with 90 Percent Probability (In percent of GDP)



Sources: Cabinet Office; and staff estimates and projections
1/ Net public debt of the general government including the social security fund.
2/ Assumes a 10 percent of GDP primary balance improvement relative to the baseline scenario between 2016-2020.
3/ Parameters for shocks to growth, inflation and interest rates and their covariance are estimated using data between 2000-12.

Appendix IV. Main Recommendations of the 2012 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal Policy:	
Passage of a consumption tax rate increase to demonstrate a commitment to fiscal reform and sustain investor confidence.	The Diet passed legislation of a two-step increase of the consumption tax rate from 5 to 8 percent in April 2014 and to 10 percent in October 2015. A final decision on implementation of the first step is scheduled for this fall.
Further commitment to *fiscal reform* to bring down public debt over the medium term. The adjustment should be designed to minimize the negative growth impact and address equity concerns, including: • *Increasing* the consumption tax to a uniform rate of at least 15 percent, closer to OECD averages. • *Cutting* the corporate tax rate further beyond the planned reduction to improve investment incentives. • *Broadening* the personal income tax base, including by reducing the exemption for pension income and eliminating tax deduction for dependent spouses. • Reducing social security spending by raising the pension retirement age to above 65 years, collecting contributions from dependent spouses, and clawing back wealthy retirees benefits. • *Introducing a taxpayer identification system* to allow for a more effective targeting of social transfers.	In June 2013, the government reaffirmed its fiscal adjustment objectives of halving the primary deficits by FY2015 and achieving a primary surplus by FY2020. The Diet passed a supplementary budget in February 2013 as part of the policy package to stimulate growth (about 1½ percent of GDP). The Diet revised the corporate tax act to temporarily give tax credits for investment, research and development, and employment in March 2013. It also approved increasing tax burden on inheritance. The Diet passed the bill to introduce the social security and tax number system in May 2013.
Monetary Policy:	
Forceful monetary easing to exit deflation beyond current plans, including by extending the maturity of JGB purchases beyond 3 years and scaling up the purchases of risky assets such as corporate bonds, commercial paper, ETFs, and securitized SME loans. Enhancing the BoJ's communication to increase the effectiveness of monetary policy.	The BoJ introduced the QQME in April 2013 to achieve 2 percent inflation with a time horizon of about two years. It shifted to a monetary base target and plans to double it in two years primarily by purchases of government bonds while lengthening the maturity of bond purchases. The BoJ also strengthened its policy commitment.
Financial Sector Policy:	
The Financial System Stability Assessment (FSSA) made several key recommendations on risk monitoring, prudential framework, crisis resolution, and implementation of the global regulatory reform (see Annex V).	The authorities have made important progress on several regulatory areas in line with the FSAP Update recommendations (see Annex V).
Growth Strategy	
• *Increasing* female and elderly labor participation through improving access to childcare, and raising the retirement age to above 65 years, and introducing a uniform regular employment contract that gradually increases employment protection. Broaden the current immigration "points-based" system to meet labor shortages in childcare and long-term elderly care. • *Raising* productivity through increased FDI inflows and encouraging investment by easing regulations and joining the TPP Agreement. • *Improving* financial intermediation by scaling down government backed guarantees for SME loans, phasing out the temporary SME Financing Facilitation Act, reducing the government's role in channeling credit, and encouraging the use of asset-based lending to increase risk capital provision.	The government announced structural reforms throughout 2012 and 2013, including through: • participation in the TPP negotiations; • increased availability of child daycare centers, including by providing public financial support to small-scale childcare services, and allowing more private corporations to run childcare facilities. • adoption of a broad outline of a growth strategy targeting real growth of 2 percent over the next decade, and doubling of inward FDI and agricultural exports. Measures to be developed aim at raising the employment of women, greater labor mobility across sectors, deregulation through special economic zones, and measures to raise investment. • *SME restructuring*. The SME Financing Facilitation Act expired as scheduled.

Appendix V. FSAP Follow Up: Recent Reforms and Pending Issues

The 2012 Financial System Stability Assessment (FSSA) Update made several recommendations to further strengthen the financial system. It recommended enhancing the monitoring of systemic risks, including from financial institutions' exposure to Japanese Government Bonds (JGBs) and equities. It also recommended the authorities to strengthen their prudential framework, including by raising capital requirements for domestically active banks, tightening banks' large exposure lending limits, strengthening the solvency assessment for insurers, and improving the resolution framework for nonbank financial institutions. The authorities agreed with most FSSA recommendations and noted they would continue to monitor financial stability risks closely.

Since then, important progress has been made in several areas. These include:

- **Developing the framework for regular thematic risk assessments and bottom-up stress tests.** The BoJ has refined the top-down stress test methodology for the banking system. In line with the Annual Supervisory Policy, the Financial Services Agency (FSA) has requested some of the major banking groups to conduct bottom-up stress tests based on common scenarios. The FSA has conducted a horizontal review of the results as well as the models used by the banks for stress testing.
- **Implementing Basel III for internationally active banks starting in March 2013**, which will strengthen capital standards in a phased manner. Basel III will have a gradual negative impact on Tier 1 capital ratios of major banks over the medium term (by up to 3 percentage points, according to FSAP estimates). Nevertheless, banks are likely to meet the new capital requirements reflecting their high initial capital buffers, and the gradual phase-in of Basel III rules that provides time to build capital through retained earnings. Two large broker-dealers are also implementing Basel III rules.
- **Developing new capital adequacy rules for domestically active banks**, which can strengthen soundness of regional and shinkin banks. FSA's new rules, which will start from March 2014, will raise the quality of capital by setting "core-capital," which consists of high loss-absorbency instruments, as regulatory capital while keeping the minimum ratio of 4 percent. However, under the new rule, the temporary measure introduced in 2008 that allows domestic banks to exclude unrealized losses on securities holdings from capital would become permanent. This treatment needs close monitoring of market risk of securities holdings, including in relation to their significant government bond holdings.
- **Strengthening large exposure limits for banks.** The FSA has submitted a bill to the Diet that would cap the volume of bank lending to a company and its subsidiaries at 25 percent of a lender's capital, in line with international best practices, down from the current 40 percent. Although the impact of this measure is expected to be manageable for most banks, the bill includes a transitional measure that tolerates a temporary breach under the FSA approval, in case this would require a sharp cut in lending to specific companies.
- **Strengthening resolution plans for all systemically relevant banks and nonbank financial institutions.** The FSA submitted a bill to the Diet to establish an orderly resolution regime for financial institutions, in order to address risks that may spread across financial markets. The FSA

is formulating recovery and resolution plans for globally systemically important financial institutions and other systemically important nonbanks, in line with the schedule agreed at the Financial Stability Board (FSB).

- **Reducing excessive credit support on SMEs.** As the SME Financing Facilitation Act ended in March 2013 as scheduled, FSA continues to encourage financial institutions to make efforts to ensure provisions of funds to SMEs. The usage of credit guarantees has been gradually reduced from the peak of 36 trillion yen in FY2009 to 32 trillion yen in FY2012. Policy initiatives to further reduce the reliance of SMEs on credit supports remain necessary.
- **Deepening cross-border risk monitoring arrangements with foreign supervisory authorities.** The FSA and BoJ have signed the Multilateral Framework for sharing the information of globally systemically important banks collected thorough the FSB Data Gaps initiative in early 2013, following discussion at the FSB. As the new macroeconomic policy will likely encourage further overseas expansion by internationally active banks, cross-border risk monitoring arrangements, such as the Data Gaps initiative can help monitoring of risks from activities abroad, including foreign exchange funding risks.

- **Staff recommended further efforts to build on these achievements.** In particular, staff recommended strengthening capital standards of domestically active banks beyond current plans, including by reassessing the treatment of unrealized losses in capital, continued close monitoring of rising foreign-exchange funding risks from overseas activities of internationally active banks, passage of legislation on tightening large exposure limits and establishing an orderly resolution regime for financial institutions, and phasing out the full credit guarantees to SMEs to restore credit discipline. Staff also supported the authorities' consideration to introduce economic value-based solvency regimes to enhance the required solvency margins for insurers.

INTERNATIONAL MONETARY FUND

JAPAN

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 12, 2013

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

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FUND RELATIONS

(As of June 30, 2013)

Membership Status: Joined August 13, 1952; Article VIII

General Resources Account:

	SDR Million	% Quota
Quota	15,628.50	100.00
Fund holdings of currency	15,100.35	96.62
Reserve Tranche Position	528.51	3.38
Lending to the Fund		
New Arrangements to Borrow	8,458.28	

SDR Department:

	SDR Million	%Allocation
Net cumulative allocation	12,284.97	100.00
Holdings	12,958.00	105.48

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Obligations to Fund:[1]

(**SDR Million; Based on Existing Use of Resources and Present Holdings of SDRs):**

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest		0.07	0.07	0.07	0.07
Total		0.07	0.07	0.07	0.07

Exchange Rate Arrangement:

Japan maintains a free floating exchange rate regime. Since the 2012 Article IV consultation, Japan has not had foreign exchange intervention. The ministry of finance publishes foreign exchange intervention information on its website. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions imposed solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144–(52/51).

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Framework:

Japan underwent an assessment of its AML/CFT framework against the AML/CFT standard by the Financial Action Task Force (FATF) and the Asia/Pacific Group (APG) in 2008. Significant deficiencies were identified, notably with respect to customer due diligence (CDD) requirements, transparency of legal entities, the criminalization of terrorist financing and the freezing of terrorist assets. Since then, Japan has taken important steps to remedy some of the shortcomings identified. According to Japan's May 2013 follow-up report to the FATF (page 3), further action is nevertheless required, notably with a view to strengthening CDD rules and enabling appropriate freezing of terrorist assets. In addition, further improvements seem necessary to increase the transparency (and thus limit the misuse) of legal entities. No dates have been set for Japan's next mutual evaluation.

Article IV Consultation:

The 2012 Article IV consultation discussions were held during May 30–June 12, 2012; the Executive Board discussed the Staff Report (IMF Country Report No. 12/208 and concluded the consultation on July 10, 2012. The concluding statement, staff report, staff supplement, selected issues paper, and PIN were all published.

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 13, 2013)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	June 2013	June 2013	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/10/2013	6/12/2013	Every 10 days	Every 10 days	Every 10 days		
Reserve/Base Money	May 2013	June 2013	M	M	M	LO, LO, LO, LO	O, O, O, O, O
Broad Money	May 2013	June 2013	M	M	M		
International Investment Position	2013 Q1	June 2013	Q	Q	Q		
Central Bank Balance Sheet	6/10/2013	6/12/2013	Every 10 days	Every 10 days	Every 10 days		
Consolidated Balance Sheet of the Banking System	April 2013	June 2013	M	M	M		
Interest Rates[2]	June 2013	June 2013	D	D	D		
Consumer Price Index	April 2013	May 2013	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2011	January 2013	A	A	A	O, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2011	January 2013	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	March 2013	May 2013	Q	Q	Q		
External Current Account Balance	April 2013	June 2013	M	M	M	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	April 2013	June 2013	M	M	M		
GDP/GNP	2013 Q1	June 2013	Q	Q	Q	O, O, O, O,	LO, LO, O, O, LNO
Gross External Debt	Mar 2013	June 2013	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.

INTERNATIONAL MONETARY FUND

COM
COMMUNICATIONS DEPARTMENT

Press Release No. 13/296
FOR IMMEDIATE RELEASE
August 5, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation Discussions with Japan

On July 31, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation discussions with Japan.[1]

The new government announced in December 2012 a new policy framework to end decades-long deflation and raise growth. The new policy regime calls for a coordinated policy effort by the Bank of Japan (BoJ) and the government to jumpstart the economy and create sustained growth synergies through bold structural reforms. The announcement was followed by a quick set of actions.

On the back of this new policy framework, growth accelerated sharply in early 2013. First quarter GDP growth rose to 4.1 percent (seasonally adjusted annual rate) after two quarters of stagnation. Rising equity values stimulated consumption and exports rebounded supported by strong regional demand and a weaker yen. Inflation expectations have started to increase and actual inflation recorded positive growth in June.

Financial and exchange markets were buoyant in early 2013 and the immediate aftermath of Quantitative and Qualitative Monetary Easing (QQME). From September 2012 to mid-May 2013 the Nikkei stock index rose by about 80 percent, but temporarily dropped sharply by around 15 percent. As of end June, the yen has depreciated by about 20 percent in real effective terms since mid-2012. Ten-year bond yields have remained unchanged around 80-90 basis points since the beginning of the year, although they briefly declined to historic lows of about 45 basis points after the announcement of QQME.

The near-term outlook has improved considerably, buoyed by stimulus. The Japanese economy is expected to grow by about 2 percent, mainly as a result of the new fiscal stimulus and monetary easing feeding through to private consumption and with some lag to investment. A strengthening of external demand, helped by depreciation, and frontloading of consumption

[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. An explanation of any qualifiers used in summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

ahead of the April 2014 consumption tax increase further supports the recovery. In 2014, growth is expected to moderate to 1.2 percent as a continued pick-up in private domestic demand is offset by fiscal withdrawal from the consumption tax increase—from 5 to 8 percent—and an unwinding of reconstruction spending. Over the medium term, growth is expected to converge to 1 percent as a recovery in investment is offset by a slowdown in labor supply due to population aging.

Capital positions of major financial institutions have improved due to strong equity performance, rising income from securities trading, and capital gains on Japanese Government Bonds and foreign asset holdings, while credit costs in banks remain limited. Profits for internationally active banks have also risen due to relatively high net interest margins on overseas loans, which rose by 20 percent (year-on-year). Implementation of Basel III requirement has commenced in March 2013.

Executive Board Assessment

Executive Directors noted that Japan's near-term economic prospects have improved with the adoption of vigorous macroeconomic policies combining fiscal stimulus with unprecedented monetary easing. Directors agreed, however, that the growth outlook is subject to significant risks, primarily stemming from incomplete domestic reforms and a weaker external environment, and that sustained implementation of the authorities' reform program is the best way to minimize these risks.

Directors welcomed the new monetary policy framework, which should make an important contribution to end deflation. They noted that careful communication and flexibility in execution are essential to contain market volatility and ensure effective policy transmission. At the same time, some Directors encouraged the authorities to prepare plans for an eventual exit from quantitative and qualitative monetary easing, even if that exit likely remains far off into the future.

Directors concurred that a credible medium-term fiscal plan should be adopted promptly to contain fiscal risks and reduce policy uncertainty. They noted that bringing down public debt as a share of GDP will require a significant adjustment over the next decade. In this regard, Directors generally supported the authorities' plans to double the consumption tax rate by 2015, although a few Directors expressed concern over the possible adverse impact on growth. Directors also underscored that additional revenue and expenditure measures will be needed beyond 2015.

Directors took note of the staff's assessment that the exchange rate is moderately undervalued at present, but stressed the large margin of uncertainty surrounding this assessment in the wake of the recent changes in the macroeconomic policy framework.

Directors noted that the financial system is generally sound, but low profitability and exposure to interest rate risk remain a concern. They agreed that the successful implementation of a comprehensive structural reform package would contribute to enhancing financial sector

stability. Directors welcomed recent progress on regulatory reform, but called for a strengthening of capital standards for regional banks, and for careful monitoring of foreign-funding by major banks.

Directors stressed that the new monetary framework should be supported by wide-ranging structural reforms, which can play a key role in the authorities' efforts to eradicate deflationary expectations and achieve self-sustaining growth. They called for steadfast implementation of a comprehensive agenda focused on reducing excessive labor market duality, deregulating agriculture and services, revitalizing small and medium enterprises, eliminating constraints on the provision of risk capital to firms, creating fiscal incentives to work and invest, and further relaxing immigration requirements. Directors welcomed the government's steps to boost the employment of women, and also, generally, its intention to join the Trans-Pacific Partnership.

Japan: Selected Economic Indicators, 2008–14

Nominal GDP: US$ 5,959 billion (2012)
Population: 128 million (2012)
GDP per capita: US$ 46,716 (2012)
Quota: SDR 15,629 million (2012)

	2008	2009	2010	2011	2012	2013	2014
						Proj.	
Growth (percent change) 1/							
Real GDP	-1.0	-5.5	4.7	-0.6	1.9	2.0	1.2
Domestic demand	-1.3	-4.0	2.9	0.3	2.8	1.7	0.5
Private consumption	-0.9	-0.7	2.8	0.4	2.3	1.8	0.9
Gross Private Fixed Investment	-3.3	-14.7	-0.5	3.7	2.1	0.4	2.9
Government consumption	-0.1	2.3	1.9	1.4	2.4	2.0	0.0
Public investment	-7.4	7.0	0.7	-7.5	12.5	3.0	-15.4
Stockbuilding 2/	0.2	-1.5	0.9	-0.4	0.0	-0.1	0.2
Net exports 2/	0.2	-2.0	2.0	-0.8	-0.8	0.5	0.7
Exports of goods and services	1.4	-24.2	24.4	-0.4	-0.1	4.8	7.8
Imports of goods and services	0.3	-15.7	11.1	5.9	5.4	2.2	4.0
Inflation (annual average)							
CPI 3/	1.4	-1.3	-0.7	-0.3	0.0	0.1	2.9
GDP deflator	-1.3	-0.5	-2.2	-1.9	-0.9	-1.7	1.5
Unemployment rate (annual average)	4.0	5.1	5.1	4.6	4.4	4.1	4.1
Government (percent of GDP)							
General government							
Revenue	31.6	29.6	29.6	30.8	31.1	31.6	33.2
Expenditure	35.7	40.0	38.9	40.8	41.3	41.3	40.3
Overall Balance	-4.1	-10.4	-9.3	-9.9	-10.1	-9.8	-7.1
Primary Balance	-3.8	-9.9	-8.6	-9.1	-9.3	-9.0	-6.3
Public debt, gross	191.8	210.2	216.0	230.3	238.0	246.9	247.5
Money and credit (percent change, end-period)							
Base money	0.1	5.8	4.8	15.2	7.0	…	…
M2 (period average)	2.1	2.7	2.8	2.7	2.5	…	…
Domestic credit	1.8	0.5	1.3	1.8	2.5	…	…
Bank lending	4.6	-0.9	-1.8	0.7	1.4	…	…
Interest rate							
Overnight call rate, uncollateralized (end-period)	0.10	0.09	0.08	0.08	0.08	…	…
Three-month CD rate (annual average)	0.5	0.3	0.3	0.3	0.3	…	…
Official discount rate (end-period)	0.4	0.3	0.3	0.3	0.3	…	…
Balance of payments (in billions of US$)							
Current account balance	159.9	146.6	204.0	119.3	60.4	62.5	85.7
Percent of GDP	3.3	2.9	3.7	2.0	1.0	1.3	1.7
Trade balance	38.5	43.3	91.0	-20.6	-73.2	-56.6	-28.9
Percent of GDP	0.8	0.9	1.7	-0.3	-1.2	-1.2	-0.6
Exports of goods, f.o.b.	746.7	545.2	730.1	787.9	769.6	803.6	873.8
Imports of goods, f.o.b.	-708.2	-501.9	-639.1	-808.5	-842.8	-860.2	-902.7
Oil imports (trade basis)	190.6	99.9	134.3	182.5	196.9	197.1	195.3
FDI, net (percent of GDP)	-2.2	-1.2	-1.1	-1.9	-2.0	-2.0	-2.0
Terms of trade (percent change)	-9.6	19.5	-3.3	-7.9	0.3	1.9	0.2
Change in reserves	-30.8	-27.2	-44.3	-177.3	37.9	-15.0	-23.5
Total reserves minus gold (in billions of US$)	1,009.4	1,022.2	1,061.5	1,258.2	1,227.2	…	…
Exchange rates (annual average)							
Yen/dollar rate	103.4	93.6	87.8	79.8	79.8	…	…
Yen/euro rate	152.1	130.3	116.5	111.0	102.6	…	…
Real effective exchange rate (ULC – based) 4/	89.7	108.2	109.8	118.5	119.7	…	…
Real effective exchange rate (CPI-based)	90.1	101.5	102.7	104.5	103.2	…	…

Sources: Global Insight, Nomura database; IMF, Competitiveness Indicators System; and IMF staff estimates and projections as of June 20, 2013.
1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ Contribution to GDP growth.
3/ Effect of consumption tax increase in 2014.
4/ Based on normalized unit labor costs; 2005=100.