Annex VII. Assessment of Japan's External Sector

	Japan	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) has remained at about 60 percent of GDP over 2013-17, with assets reaching 184 percent and liabilities reaching 124 percent in 2017. In the medium term the NIIP is projected to rise to about 77 percent with current account (CA) surpluses, before gradually stabilizing due to population aging. **Assessment**. Vulnerabilities are limited (equity and direct investment comprise a rising share of liabilities, now at 36 percent of total). Assets are diversified geographically and by risk classes. The NIIP generated net annual investment income of 3.6 percent of GDP in 2017.	**Overall Assessment**: *The 2018 external position is projected to be broadly consistent with medium-term fundamentals and desirable policies.* A continued accommodative stance by the Bank of Japan is consistent with the objective of reflating the economy, and needs to be accompanied by bold structural reforms and a credible and specific medium-term fiscal consolidation plan to maintain an external position consistent with medium-term fundamentals. **Potential policy responses**: A more forceful and coordinated policy package is needed to raise growth and inflation in a sustainable manner. This includes structural measures to boost wages, increase labor supply, reduce labor market duality, enhance risk capital provision, reduce barriers to entry in some industries, and accelerate agricultural and professional services sector deregulation. Fiscal consolidation should proceed in a gradual manner anchored by a credible medium-term fiscal framework. These 'desirable' policies are expected to support growth, imports and prices, and maintain an external position in line with fundamentals over the medium term.
Current account	**Background**. In line with growing national savings, the CA surplus has risen since 2013, reaching 4 percent of GDP in 2017, driven mainly by an improvement in the trade balance which was largely underpinned by lower energy prices. In 2017, the CA surplus increased by 0.1 percent of GDP relative to 2016, due to an improvement in the income balance, as the fall in the goods balance was offset by a higher services balance. The CA surplus is expected to shrink in 2018 to 3.6 percent of GDP, reflecting smaller income and goods trade balances. Japan's CA is positive because of high corporate saving in excess of domestic investment opportunities, and a sizable income account owing to its large NFA position. The income balance continues to account for most of the current account surplus (90 percent in 2017 and over 95 percent in the first half of 2018). **Assessment**. The 2017 CA assessment uses the EBA model, where the estimated cyclically-adjusted CA of 3.6 percent of GDP is adjusted upward by 0.1 percent to reflect temporary factors (elevated energy imports with the nuclear power plant shutdown). EBA estimates the 2017 cyclically-adjusted CA norm at 3.2 percent of GDP, with a standard error of 1.3 percent of GDP. Staff estimates a 2017 CA norm range between 1.9 and 4.5 percent of GDP. The underlying 2017 CA gap midpoint is therefore assessed to be 0.5 percent of GDP (with CA gap range between -0.8 and 1.8), delivering that the 2017 CA is in line with the CA level consistent with fundamentals and desirable policies. Using 2018 projections, the EBA model estimates the 2018 cyclically-adjusted CA norm at 3.3 percent of GDP, with a standard error of 1.2 percent of GDP. Staff estimates a 2018 CA norm range between 2.0 and 4.5 percent of GDP. The projected CA gap midpoint in 2018 is therefore assessed to be 0.2 percent of GDP (with CA gap range between -1.1 and 1.4), preliminarily delivering that the projected 2018 CA is in line with the CA level consistent with fundamentals and desirable policies. However, the large unexplained portion of the EBA CA gap suggests that important bottlenecks to investment and consumption remain.	
CA Assessment: 2018 projections	Projected CA 3.6; Cycl. Adj. CA 3.5; EBA CA Norm 3.3; EBA CA Gap 0.2; Staff Adj. 0.0; Staff CA Gap 0.2	
Real exchange rate	**Background**. After depreciating substantially during 2013-15, the average real effective exchange rate (REER) appreciated substantially during 2016. In 2017, the average REER weakened by 4.9 percent relative to 2016, reflecting a significant nominal yen depreciation at the end of 2016 related in part to rising global interest rates following the U.S. election. Estimates through September 2018, show that the REER has depreciated by 0.2 percent relative to the 2017 average while it has appreciated by 2.9 percent relative to end-2017. **Assessment**. The EBA REER Index and Level models estimate the 2017 average REER to be 17-18 percent lower than the level consistent with fundamentals and desirable policies, mainly from a large unexplained residual. Because of absent Japan-specific factors in the model, less weight is given to the EBA REER models. Using the staff-assessed 2017 CA gap range as reference and a staff-estimated semi-elasticity of 0.14 yields an indicative range for the 2017 REER gap as -13 to 6 percent with a midpoint of -4 percent. Taking into consideration that this broad REER gap range is due to the low semi-elasticity, the 2017 REER is assessed as in line with the level consistent with fundamentals and desirable policies. Following a parallel method using the projected 2018 CA gap range, the 2018 REER is preliminary assessed as in line with the level consistent with fundamentals and desirable policies.	
Capital and financial accounts: flows and policy measures	**Background**. Portfolio outflows continued during most of 2017 – though at a slower pace than in 2016 – as institutional investors continued to diversify overseas and FDI outflows continued. Net short yen positions have prevailed since Q2 2017, but after end-March net positions are balanced. **Assessment**. Vulnerabilities are limited (inward investment tends to be equity-based and home bias of Japanese investors remains strong). So far there have been no large spillovers from Yield Curve Control to financial conditions in other economies (interest rates, credit growth). If outflows from Japan accelerate, they could provide an offset to tighter domestic financial conditions in the region due to normalization of policy rates in other advanced economies.	
FX intervention and reserves level	**Background**. Reserves are about 25 percent of GDP, on legacy accumulation. There has been no FX intervention in recent years. **Assessment**. The exchange rate is free floating. Interventions are isolated (last in 2011) to reduce short-term volatility and disorderly exchange rate movements.	
Technical Background Notes		

INTERNATIONAL MONETARY FUND

JAPAN

November 6, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department (In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of September 30, 2018)

Membership Status: Joined: August 13, 1952; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	30,820.50	100.00
IMF's Holdings of Currency (Holdings Rate)	26,505.84	86.00
Reserve Tranche Position	4,315.32	14.00
Lending to the Fund		
New Arrangements to Borrow	3,414.07	

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	12,284.97	100.00
Holdings	13,423.80	109.27

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Millions)	Amount Drawn (SDR Millions)
Stand-By	Mar 11, 1964	Mar 10, 1965	305.00	0.00
Stand-By	Jan 19, 1962	Jan 18, 1963	305.00	0.00

Overdue Obligations and Projected Payments to Fund [1]
(SDR Million; based on existing use of resources and present holdings of SDRs):

		Forthcoming			
	2018	2019	2020	2021	2022
Principal					
Charges/Interest		**0.20**	**0.20**	**0.20**	**0.20**
Total		**0.20**	**0.20**	**0.20**	**0.20**

[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.

Exchange Arrangement:

Japan maintains a free floating exchange rate regime. There has been no foreign exchange intervention in recent years (last in 2011). 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).

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 the 2014 Article IV mission, Japan has made significant progress in its commitment to strengthening its AML/CFT legal framework through the FATF standards, notably by enacting the Amendment Act on Prevention of Transfer of Criminal Proceeds, the Act to Amend the Terrorism Financing Act, and the Terrorist Assets Freezing Act. Japan will continue to be monitored by the FATF on its progress including the issuance of subsidiary legislations to implement the enacted Acts.

Article IV Consultation:

The 2017 Article IV consultation discussions were held during June 6–20, 2017; the Executive Board discussed the Staff Report (IMF Country Report No. 17/242) and concluded the consultation on July 26, 2017. The concluding statement, staff report, selected issues paper, and press release were all published.

FSAP:

A mandatory FSAP has been conducted in time for the 2017 Article IV consultation, in line with the five-year cycle for members or members' territories with financial sectors that are determined to be systemically important pursuant to Decision No. 15495-(13/111), adopted December 6, 2013. The Financial System Stability Assessment (FSSA) report for the 2017 assessment has been published (Country Report No.17/244) and is available on the web at: https://www.imf.org/en/Publications/CR/Issues/2017/07/31/Japan-Financial-System-Stability-Assessment-45151.

Technical Assistance: None

Resident Representatives: None

Japan: 2018 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Japan

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