Japan: 2014 Article IV Consultation-Staff Report; and Press Release

INTERNATIONAL MONETARY FUND

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JAPAN

July 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; AND PRESS RELEASE

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 2014 Article IV consultation with Japan, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 23, 2014, following discussions that ended on May 30, 2014, 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 3, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of July 23, 2014 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its July 23, 2014 consideration of the staff report that concluded the Article IV consultation with Japan.

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

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JAPAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

July 3, 2014

KEY ISSUES

Abenomics is gaining traction, but progress across the three arrows has been uneven and medium-term risks remain substantial. Inflation has risen, a consumption tax increase has been implemented, and there are signs of a transition to private-led growth. However, structural reforms have progressed slowly and a medium-term fiscal plan beyond 2015 is still to be articulated. Uncertainty is therefore high whether the recovery and exit from deflation will become self sustained under current policies.

More forceful growth reforms are needed to overcome structural headwinds to raising growth and ending deflation The next round of structural reforms should lift labor supply, reduce labor market duality, enhance risk capital provision, and accelerate agricultural and services sector deregulation. Corporate governance reforms already underway could help reduce firms' preference for large cash holdings.

A concrete medium-term fiscal reform plan is urgently needed. Given very high levels of public debt, implementation of the second consumption tax increase is critical to establish a track record of fiscal discipline. Adoption of a concrete medium-term fiscal consolidation plan beyond 2015 would build confidence in the sustainability of public finances and allow more flexibility to respond to downside risks. Plans to lower the corporate tax rate have growth benefits, but should proceed in combination with measures to offset revenue losses and be consistent with plans to restore fiscal sustainability.

Monetary policy is appropriately accommodative. With inflation and inflation expectations increasing, no further easing is needed at this point. In case downside risks to the inflation outlook materialize, the Bank of Japan (BoJ) should act swiftly through further and/or longer-dated asset purchases. Communication should focus on achieving 2 percent inflation *in a stable manner* aided by a more transparent presentation of the BoJ's forecast and underlying assumptions.

The financial sector remains stable. Portfolio rebalancing by financial institutions and investors is desirable but also raises new risks, including from greater overseas engagement. In regional banks, limited growth opportunities and low net interest margins could further undermine core profitability and weaken capital buffers. Supervisors should continue to be proactive in monitoring these risks.

Japan's external position is assessed as broadly in balance—compared to moderately undervalued last year—because of structural changes in the external sector, including from the offshoring of production and sustained high energy imports, which have become more apparent.

Launching all three arrows will create benefits for the region and the global economy. Spillovers via the trade channel and capital flows are expected to increase in coming years with uncertain net effects—higher exports and capital outflows—in the short term. As long as Japan continues to proceed with its reforms, incomes will rise and fiscal risks decline, which will be positive for the global economy.

Approved By
Jerry Schiff and Tamim Bayoumi

Discussions took place in Tokyo from May 19–30, 2014. The staff team comprised J. Schiff (head), S. Danninger, D. Botman, M. Nabar, J. Kang, I. Saito (all APD), S. Arslanalp (MCM), R. de Mooij (FAD), and G. Ganelli and C. Aoyagi (OAP). Mr. Faruqee (RES) join for spillover discussions. Messrs. Momma, Hishikawa and Masuhara (OED) also participated in the discussions. Messrs. Lipton and Rhee held meetings with senior officials. Ms. Abebe and Mr. Ramirez assisted in this report's preparation. The mission was assisted by OAP staff.

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BACKGROUND AND CONTEXT

1. **About one and half years ago Japan adopted a new economic revival plan dubbed the "three arrows of Abenomics".** The three-pronged strategy combines aggressive monetary easing, flexible fiscal policy, and structural reforms to end decades' long deflation, raise growth, and lower public debt.

2. **Since then, economic policies progressed along several dimensions.**

- *Arrow I—aggressive monetary easing has continued as planned*. Asset purchases under the BoJ's Quantitative and Qualitative Monetary Easing (QQE) program are being executed at the planned pace and the BoJ's balance sheet grew to 52 percent of GDP by end-May 2014. Policy Board members have maintained their forecast of reaching 2 percent inflation in or around fiscal year 2015, which is considered a key marker towards achieving the BoJ's price stability target of *2 percent inflation in a stable manner.*

- *Arrow II—fiscal policy has shifted from stimulus to revenue policy*. After adopting two stimulus packages in early 2013 and 2014, discussions have turned to tax reform. With a higher consumption tax rate of 8 percent in place, attention has shifted to the next planned increase, to 10 percent, in October 2015. A decision is expected by the end of this year and will take into account various factors, including economic performance in the third quarter. The government is also reviewing options for reducing the corporate income tax (CIT) rate to stimulate investment. The size of the rate cut and offsetting measures have yet to be determined.

- *Arrow III—gradual albeit limited progress on structural reforms* (Annex I). Discussions since the fall of 2013 led to a few concrete outcomes. Reforms that are being implemented include an electricity sector reform, a bill to encourage farmland consolidation, governance and investment reforms at the Government Pension Investment Fund (GPIF), and the adoption of a corporate Stewardship Code. Large areas of Japan, including Tokyo, have recently been designated as Special Economic Zones (SEZs) with concrete reform plans yet to be announced. Finally, progress on labor market reforms has been limited with the exception of raising the number of childcare facilities to facilitate the employment of women. On June 24, the government unveiled an update of its growth strategy, which includes plans to lower the corporate income tax rate and additional corporate governance reforms among other measures (Annex I).

3. **The political environment for further reform remains favorable with about two years left until the next scheduled national elections.** The ruling coalition enjoys large majorities in both Houses of the Diet. Prime Minister Abe's approval rating has declined, but remains relatively high at around 50 percent.

4. **For Abenomics to succeed, reforms need to be comprehensive and sustained for an extended period.** This would help secure the new inflation target and generate powerful synergies

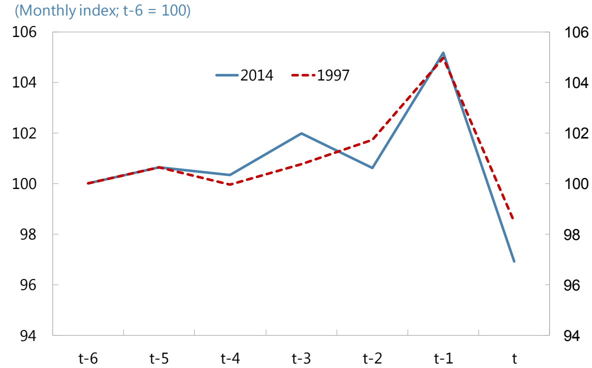
to overcome structural headwinds from a shrinking labor force and a large fiscal adjustment need. This year's policy discussions focused on how to solidify Abenomics' early gains.

ABENOMICS: GAINING TRACTION BUT RISKS REMAIN

A. Recent Developments

5. After a brief slowdown, growth rebounded sharply in early 2014 (Figure 1)**.** GDP growth accelerated to 6.7 percent (q/q, saar) in the first quarter of 2014, exceeding market expectations by a wide margin. The two main drivers were strong rush demand ahead of the consumption tax increase and a sharp rise in private nonresidential investment. Net exports remained a drag on growth.

Japan: Synthetic Real Consumption
(Monthly index; t-6 = 100)



Source: Cabinet Office / Haver Analytics.

- *Private consumption*. Last-minute consumer spending ahead of the April 1 consumption tax rate increase lifted private consumption growth to 9.2 percent (q/q, saar). The acceleration was similar in magnitude to the pick up of demand ahead of the 1997 tax increase (from 3 to 5 percent). High frequency data indicate that private consumption declined in April, broadly as expected.

- *Business investment* expanded substantially faster than projected. Private nonresidential investment grew by 34.2 percent (q/q, saar) in the first quarter, the second highest pace since the bubble burst in early 1990s. Staff estimates that ¼ to ⅓ of the increase could be related to temporary factors[1], with the remaining part related to fundamentals: high corporate profitability, an aging capital stock—more than 16 years on average in manufacturing sector—and rapidly rising capacity utilization.

- *Exports* recovered slower than expected given the yen depreciation and external demand when benchmarked against an empirical model for export growth (Figure 2). Customs trade data[2] show that real exports of goods declined by 1.0 percent (q/q, sa) in the first quarter, mainly because of weak external demand, but also because of limited passthrough of the depreciation to export prices in local currencies and competitiveness problems in the external sector (Appendix III).

[1] Institutions which are not obliged to charge consumption tax on their services (such as financial sector institutions, hospitals, and small firms) frontloaded purchases of investment goods on which they pay consumption tax.

[2] Because of changes in the BOP statistics, national accounts data on exports and imports in the first quarter of 2014 are not comparable with data from 2013 (Table 1).

- *Imports*, on the other hand, were pushed up by demand for consumer items ahead of the consumption tax increase (e.g. tablets, smartphones) and grew by 4.6 percent in the first quarter (q/q, sa).[3] This trend reversed in April, when imports declined sharply (9.9 percent, m/m, sa) in line with declining consumption.

- *Labor markets tightened and capacity constraints started to bind.* Excess capacity has shrunk to pre-2008 levels and the unemployment rate declined to 3.5 percent in May with labor shortages particularly acute in construction, health and hospitality services**.**

6. Capital and foreign exchange markets have been relatively stable this year. As a result of the BoJ's aggressive asset purchases, Japanese government bonds (JGBs) yield remained near historic lows of 60–65 basis points for 10-year bonds. Negative real lending rates aided a notable pickup in bank lending, including to small and medium-size enterprises (SMEs) (Figure 3). After rising 57 percent in 2013, equity markets have moderated somewhat (about 7¼ percent) and the real effective exchange rate (REER) has been broadly unchanged since the beginning of the year (Figure 4).

B. Outlook and Risks

7. After a brief contraction, growth is expected to return to a moderate yet still above-potential pace later this year. An uneven quarterly growth profile reflects the advancing of domestic demand in the first quarter and a corresponding payback in the second quarter (-3.7 percent q/q, saar). The baseline assumes a return to moderate growth in the second half of the year, with a gradual handoff from stimulus to private sector-led growth. GDP is projected to grow 1.6 percent in 2014 for the year as a whole before decelerating to 1.1 percent in 2015 on unwinding fiscal stimulus (Table 1).

- *Business investment* is forecast to contribute more than 1 percent to GDP growth in 2014. Cyclical factors are providing a push for the recovery, including from tight capacity constraints—businesses report capacity utilization near pre-2008 levels (Tankan survey)—and tax incentives for replacing old capital stock. In addition, structural factors, including healthy corporate balance sheets and improved business growth expectations (Cabinet Office survey), provide a fertile ground for a continuation of investment spending (Figure 5).[3]

- *Private consumption* is expected to slow substantially in the second half of the year contributing 0.4 percent to GDP growth this year. Real incomes are forecast to decline moderately as the effects of higher inflation—2¾ percent in 2014 due to the tax increase—is mostly offset by nominal labor income growth of about 2½ percent.[4] A decline in the savings rate by

[3] See J. S. Kang (2014), "Balance Sheet Repair and Corporate Investment in Japan", draft IMF Working Paper.

[4] Nominal labor income growth of 2.5 percent comprises (i) a 1 percent increase from overtime pay, bonuses; (ii) a first rise in base wages of 0.5 percent for regular workers in several years; and (iii) employment ground of 0.5 percent. The reversal of a 10 percent public sector wage cut after the earthquake adds another 0.4 percent.

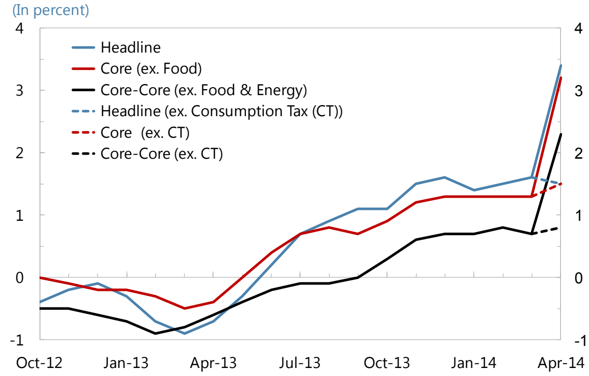
0.5 percentage point, similar to experiences in other countries following VAT tax rate increases, is expected to sustain consumption in the second half of the year.

- *Exports* are forecast to grow moderately this year, supported by improving global growth and benefitting from a delayed response to the yen depreciation since late 2012. Historically, Japan's trade balance has started to improve about 1–1½ years after a large depreciation.

8. **Under the baseline, potential growth will increase modestly over the medium term.** Structural bottlenecks pose an impediment to a sustained recovery (Box 1). With labor supply declining as a result of demographic changes and structural rigidities constraining productivity growth and labor reallocation, potential growth is currently estimated at about ½ percent. The investment recovery and some benefits from structural reforms, including from raising female labor supply and deregulation, is estimated to increase potential growth to 1 percent over the medium term.[5] An ambitious push on structural reforms and the effect of ending deflation on private initiative pose upside risks.

9. **Inflation is projected to reach 2 percent over the medium term and interest rates are expected to rise slowly.** Headline and core inflation excluding food and energy, have risen to about 1.7 and 0.7 percent in April (y/y), respectively, excluding the effects of the consumption tax increase. Price increases are still related to last year's large depreciation, although inflation of non-tradable items has begun to rise recently (Figure 6). Because of the consumption tax increase, headline inflation is projected to temporarily rise to an annual average rate of 2.8 percent in 2014, assuming full pass-through of the tax increase to final prices.[6] Underlying inflation is projected to slow temporarily—and is forecast at 1.1 percent this year—as the pass-through from the yen depreciation comes to an end. With the output gap—estimated at about -1 percent in 2014—closing steadily and inflation expectations rising, inflation is projected to increase to 2 percent by 2017 (Table 4).[7] Because of rising inflation expectations, long-term interest

Year on Year Inflation
(In percent)



Source: Cabinet Office / Haver Analytics

[5] Potential growth estimates are based on a production function approach. The projected increase in potential growth by 0.5 percent comprises the net effect of a rise in the capital stock (0.6 percent) modest productivity improvements (0.1 percent) and a declining contribution from labor (0.2 percent).

[6] In April, headline CPI rose to 3.4 percent (y/y) from 1.6 percent in March, broadly consistent with full pass-through.

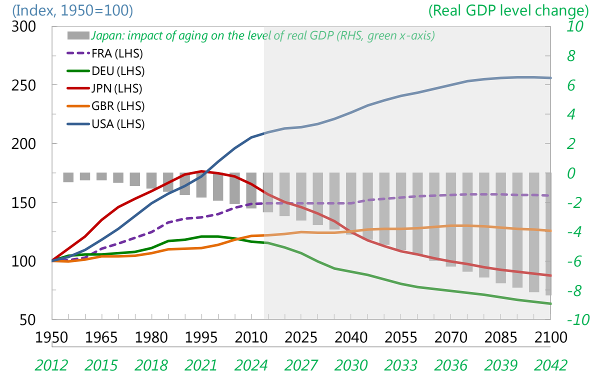
[7] Staff's forecast is based on an estimated expectations-augmented Philips curve, using quarterly data over q1-1981 to q3-2013 with inflation expectations, the output gap, crude oil price index, and corporate goods inflation (to capture cost-push factors) as the main determinants. The effects from higher inflation expectations are uncertain but correlations between long-term inflation expectations and actual inflation could be substantial. In 2005 correlations ranged between 0.6 and 0.75, depending on the measure of inflation (headline, core, core-core).

rates are expected to gradually increase over the medium-term, but are flat in the near-term as a result of QQE.

Box 1. Structural Impediments to Private-Sector Led Growth[1]

The foundations for private-sector led growth and a durable exit from deflation remain uncertain. Because of further declines in the working-age population (text chart), staff projects potential growth not to increase above the pre-earthquake level of 1 percent by 2017 despite rising private investment and steady productivity growth.

Working-age Population, 1950-2050

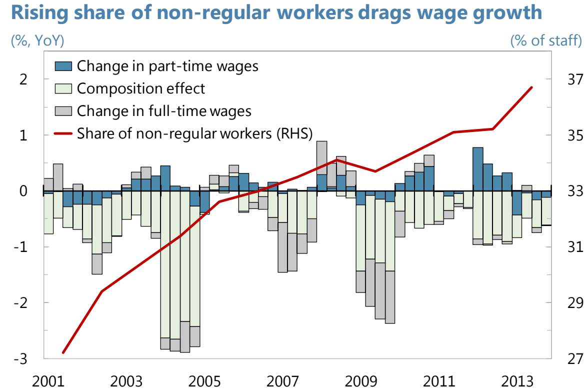


Source: U.N. and Anderson, Botman, and Hunt (2014), "Aging and Deflation", IMF WP forthcoming.

Headwinds from various structural factors hold back the recovery in staff's baseline.

- **Structural impediments to wage growth** include the rising share of non-regular and part-time workers, particularly in the services sector, with less bargaining power, productivity growth, and lower wage levels (text chart). Low horizontal mobility of regular workers between firms amid high mobility within firms has mitigated the effects of a tight labor market on wages.

Rising share of non-regular workers drags wage growth



Source: Haver Analytics, IMF staff estimates

- **Impediments to investment**[2] include the weak SME sector, which accounts for nearly 70 percent of total employment and over half of manufacturing value-added, but may not have benefitted from Abenomics due to rising import costs. Population aging is dampening prospects for future demand growth—a key determinant for domestic investment.

- **Displacement of exports.** Sales of Japanese subsidiaries are now exceeding exports from Japan. This trend is likely to persist under Abenomics, and will likely mean slower export growth. With rising incomes in regional trading partners, demand for commodities and consumer durables and services is expected to grow relative to investment goods, where Japan has had a comparative advantage.

- **Greater import penetration** in markets where Japan used to have strong competitiveness, such as electrical machinery, raises concerns that Japanese firms have structurally lost competitiveness.

- **Higher energy costs.** High imports of natural gas since 2011, which have been a major reason for the weaker trade balance, could affect competitiveness and spur a further movement of production abroad.

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[1] Prepared by J. S. Kang (APD).

[2] See J. S. Kang (2014), "Balance Sheet Repair and Corporate Investment in Japan", draft IMF Working Paper.

10. Near-term risks to the outlook are balanced, but the sustainability of the recovery over the medium term is at risk (Annex II).

- *Near term*. On the domestic side, the start of a positive investment-inventory cycle could raise demand and lift growth above staff's baseline in the short term. Also, public investment spending has been constrained by absorption capacity and could grow faster than expected if access to (foreign) labor improves. These risks are broadly offset by the possibility of a sharper-than-expected moderation of growth in China or among ASEAN countries. This could lead to negative inward spillovers, which would affect Japan more strongly than other advanced economies (directly or via spillbacks) given its supply chain linkages and through its role as a supplier of capital goods (2013 and 2014 Spillover Reports). Geopolitical risks, including in Ukraine, could raise energy prices and adversely affect businesses.

- *Medium term.* Substantial uncertainty remains as to whether higher growth and inflation can be sustained over the longer term. Fiscal consolidation needs to proceed for a long time and the impact on growth could be larger than in the baseline. Together with a failure to implement high-impact structural reforms, this could erode confidence and limit gains in potential growth. As growth falls back and inflation momentum weakens, monetary policy could become overburdened and, with increasingly limited ability for policies to restore fiscal sustainability, the risk premium on government securities could rise (see "incomplete Abenomics" 2013 IMF Staff Report). Given the large JGB holdings by the financial sector, this would pose substantial financial stability risks. Such an outcome would have important spillovers via reduced demand for imports and tighter financing conditions in Japan and overseas (See Box 1.5 in the 2014 Regional Economic Outlook for Asia and Pacific). A sudden spike in bond yields remains the main tail risk over the medium term.

In the event downside risks emerge, the government should continue with fiscal reforms, but in order to restore growth, inflation, and confidence in Abenomics, monetary and structural policies should respond. The scope for additional fiscal stimulus is limited in the absence of a concrete medium-term fiscal strategy beyond 2015. In a tail event of a widespread loss of faith in the sustainability of public finances, further fiscal consolidation would be needed to forestall a rise in risk premia and interest rates.

The Authorities' Views

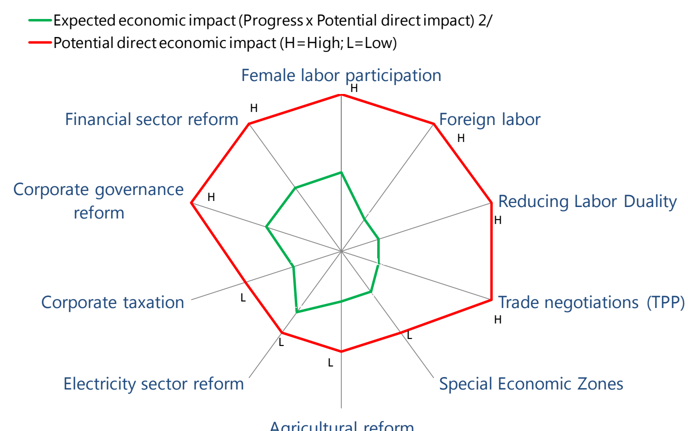
11. The authorities emphasized that the economy appears well positioned to weather the consumption tax increase. They highlighted that fiscal stimulus spending would be frontloaded, limiting the growth slowdown beginning in the second quarter. They noted that the rise in base wages and bonuses would support sentiment and domestic demand over the coming period. The authorities broadly shared staff's risk assessment but noted that many businesses were already anticipating slower growth in China and had begun to adjust their investment and expansion plans accordingly.

12. The BoJ expected a faster rise of inflation in the near term than staff. Like staff, they anticipated that inflation would stay around 1¼ percent for some time due to the waning effects of last year's yen depreciation. However, they expected inflation to rise again in the second half of this fiscal year as the narrowing of the output gap would exert upward price pressure while inflation expectations would be pushed up further with the increase in actual inflation. They also saw the rapid labor market tightening and rising capacity utilization rates amid sluggish potential growth as signs that the output gap was already broadly closed. Regarding risks, the BoJ suggested the possibility that price stability may come in sight before potential growth picks up, highlighting the importance of accelerating the pace of structural reforms.

GROWTH REFORMS VITAL TO ABENOMICS' SUCCESS

13. Structural reforms hold the key for faster growth. Measures to raise labor supply and employment would directly offset the drag on growth from an aging-related decline in the labor force. A more flexible economy would further encourage investment and productivity growth. Such a comprehensive reform program, by lifting confidence, would stimulate demand already in the near term and improve monetary policy transmission.

Japan's Structural Reforms: Potential Direct Impact and Progress /1



Sources: Staff estimates; See Annex 1.
1/ Direct impact refers to macroeconomic growth effect, excluding potential spillovers or synergies from complementary reforms.
2/ Progress assessed as likelihood of full reform implementation (25, 50, 75, or 100 percent)

Policy Issues and Staff's Views

14. The government adopted a revised growth strategy in June, but left many details undefined. Flagship reforms include plans to reduce the corporate income tax rate from over 35 percent to below 30 percent with the exact size of the cut, timeframe, and financing to be determined. Other important measures—some of which also lack specific timeframes— are further corporate governance reforms to encourage a more productive use of corporate savings and labor market reforms by possibly removing tax disincentives for women to work, greater use of foreign labor in health and household services, and measures to incentivize a shift from overtime- to performance-based remuneration. Few concrete measures were announced on agricultural reform or the role of SEZs.

15. Since last year, reforms are progressing in a number of areas, but more forceful measures are needed to tackle growth impediments. While assessing the growth impact of structural reforms is inherently difficult, staff estimates that ongoing reforms could help lift potential growth to around 1 percent. But in order to raise trend growth above 1 percent, more ambitious reforms are needed in addition to implementing announced plans.

16. Additional measures that would be needed include:

- *Raising the employment of women, older workers, and foreign labor.* Fully implementing plans to increase the availability of child care, gradually raising the retirement age, and relaxing immigration restrictions in areas with labor shortages could raise labor supply. Another important area is addressing labor market duality between regular and non-regular workers which contributes to subpar productivity growth because the time-limited and less protected contracts for non-regular workers lead to reduced training and effort. Encouraging the use of modified labor contracts to bridge this gap would stimulate productivity growth and increase the pass-through of labor market tightness into higher wages (Figure 7).[8]

- *Enhancing risk capital provision (Box 2).* Measures should focus on increasing credit to new growth projects, for instance, by improving lenders' access to credit registries, encouraging more asset based lending, and removing barriers to entry and exit of SMEs. Revisions to GPIF's investment strategy would provide further risk capital and lead to changes in investment strategies among other institutional investors. The introduction of individual savings accounts has been a positive step. Consideration could be given to extending the 5-year term limit and gradually raising the maximum contribution limit.

- *Implementing comprehensive corporate governance reform (Box 3).* Complementing the recently introduced Stewardship Code for institutional investors with a corporate governance code for firms and introducing measures to expand the use of independent outside directors would strengthen firms' governance and potentially unlock corporate savings for more growth-effective use.

- *Deregulating agriculture and domestic services sectors* to raise productivity and encourage inward foreign investment.[9] In this regard, early guidance on the modus operandi in the recently designated special zones could reduce uncertainty and boost investment.

- *Benefits from a Trans-Pacific Partnership agreement* could be substantial, provided it will eliminate most tariffs and non-tariff and investment barriers in Japan—with growth gaining about 0.2 percent per year.[10]

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[8] See C. Aoyagi and G. Ganelli (2013), "The Path to Higher Growth: Does Revamping Japan's Dual Labor Market Matter?", IMF Working Paper 13/202.

[9] Staff analysis using prefectural data suggests that land consolidation could increase long-term productivity by up to 30 percent, although the sector as a whole accounts for only 1 percent of GDP.

[10] See P. A. Petri, M. G. Plummer, and F. Zhai (2012), "The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment", Peterson Institute for International Economics and East-West Center.

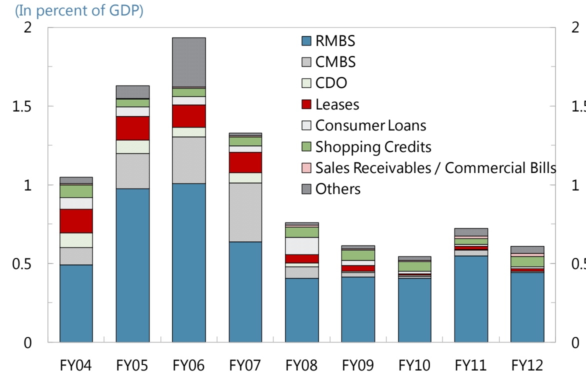
Box 2. Facilitating (Risk) Capital[1]

The authorities have taken a number of steps to strengthen the financial sector's ability to provide risk capital to the economy and facilitate more portfolio rebalancing abroad. The launch of tax-free investment savings accounts (NISA) encourages Japanese households—with more than US$16 trillion in financial assets—to put more savings into stocks and investment trusts. The extension of BoJ facilities stimulates bank lending and supports economic growth, while establishing a new ROE-focused index (JPX Nikkei 400) encourages a greater focus on corporate governance and profitability.

Additional policy efforts should focus on intermediation (securitization and venture capital) and facilitate take-up on the demand side (exit and entry, corporate restructuring). Specifically:

- **Securitization.** There is room for boosting securitization activity backed by small business loans, possibly by encouraging more information sharing across multiple credit registries on repayment and default history of individual firms and by further easing terms on BoJ facilities (lower funding costs, longer maturity loans) for asset-backed lending.

Securitization Products Issuance by Underlying Assets
(In percent of GDP)



Source: Japan Securities Dealers Association, CEIC, and Staff Estimates

- **Venture capital** firms have typically been less prominent in Japan than in other OECD countries (Nabar and Syed, 2011). Together with improvements in the GPIF governance structure, a further shift in targets toward riskier assets, such as venture capital could spur faster growth in funding for new businesses (as was seen in the US with the 1979 reform of the Employment Retirement Income Security Act allowing pension funds to invest in high risk assets including venture capital).

- **Restructuring and exit of nonviable SMEs.** Entry and exit rates of SMEs in Japan are on average about a third of those in advanced countries (Lam and Shin, 2012). The persistence of nonviable firms, kept afloat in part by credit guarantees, supervisory forbearance, and restructured loans impedes credit intermediation and risk taking in several ways—by deterring entry of new firms, expansion of healthy firms, and by eroding risk assessment capabilities at banks. Achieving turnover rates that reflect underlying fundamentals would require encouraging more out-of-court voluntary workouts to minimize stigma associated with bankruptcy and consolidating regional banks whose capital buffers are weakened if they were to call in non-performing loans. At the same time, small business entry could be facilitated by reducing the time and cost of starting businesses—streamlining business registration procedures and upgrading credit registries and personal credit information.

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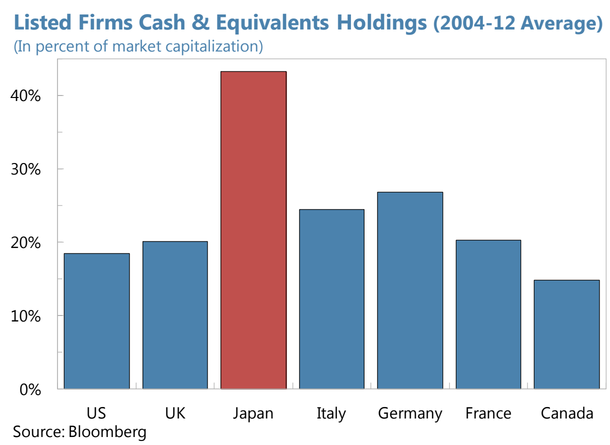
[1] Prepared by S. Arslanalp (MCM) and M. Nabar (APD).

The Authorities' Views

17. The authorities emphasized that a broad range of growth reforms is in train. The number of childcare facilities was rapidly expanding and measures to improve corporate governance showed early success with the adoption of the Stewardship Code by many financial institutions. They further highlighted that the measures taken so far have the potential to deliver significant growth payoffs. Already it was possible to see an impact on corporate profitability and base wages are going up for the first time in 15 years. They anticipated that the measures in the new growth strategy would add further support to private sector-led growth through additional concrete measures, but felt that the full impact of the structural reforms is likely to take a while to materialize and gains in potential growth were difficult to quantify. Depending on the scenario, they estimated real growth to range between 1¼ and 2¼ percent in the medium- to long-term. In the near term, confidence effects from structural reforms could already support the recovery by boosting investment.

Box 3. Unstash Japan's Corporate Cash[1]

Firms' preference for holding large cash buffers is likely limiting the scope for increasing wages, dividends, and investment. Cash holdings by Japanese companies are large compared with other G-7 countries (text chart). The existing literature suggests that corporate governance is a significant determinant of cash holdings and that Japan has lower scores in this area compared to other G-7 countries regarding firm-level governance attributes covering: board composition; audit quality; shareholder rights; and ownership structure and compensation.



Staff analysis finds that corporate governance reform could help reduce firms' large cash holdings. An empirical analysis based on a panel of Japanese companies suggests that improving corporate governance—proxied in the regression by an index summarizing company disclosure of governance data—could significantly reduce corporate cash holdings. Reform options include complementing the recently introduced Stewardship Code[2] for institutional investors with a corporate governance code for firms, and measures to expand the use of independent outside directors beyond current plans.

[1] Prepared by C. Aoyagi and G. Ganelli (OAP). See C. Aoyagi and G. Ganelli (2014), "Unstash the Cash! Corporate Governance Reform in Japan"; draft IMF Working Paper.

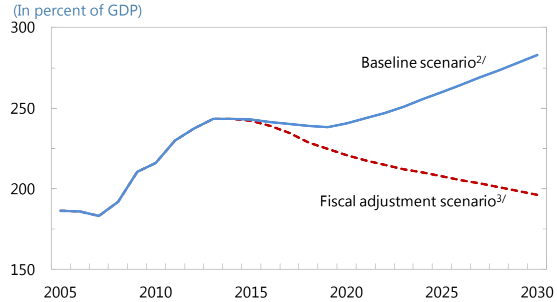
[2] A Stewardship Code is a set of principles for institutional investors to help improve long-term returns to shareholders and the efficient exercise of fiduciary responsibilities.

MAINTAINING FOCUS ON FISCAL SUSTAINABILITY

18. Japan's fiscal balance is projected to improve over the near term, but longer-term plans remain undefined. The structural primary deficit is estimated to shrink by an annual average of 1 percent of GDP during 2014–16 after weakening modestly in 2013 to -7.0 percent of GDP on account of new stimulus spending (Table 2 and Figure 8). This adjustment in staff's baseline assumes that the consumption tax rate will be raised to 10 percent, previous stimulus winds down, and commitments to current public expenditure containment are met (in sum 2¼ percent of GDP). But even with these measures, the authorities may not achieve their G20 goal of halving the primary deficit by FY 2015 to 3.3 percent of GDP (and this target would slip out of reach with a corporate income tax rate cut or the introduction of multiple consumption tax rates).[11] No fiscal consolidation plans beyond 2015 have been announced to reach the G20 commitment of primary balance by FY 2020, which would stabilize the debt-to-GDP ratio, but not bring it down.

Japan: Gross Public Debt 1/

(In percent of GDP)



Sources: Cabinet Office; and staff estimates and projections.
1/ Gross debt of the general government including the social security fund.
2/ Withdrawal of fiscal stimulus and consumption tax increases to 10 percent in 2015 are assumed.
3/ Policy adjustment scenario assumes a 8.5 percent of GDP improvement (baseline scenario+6¼ points) in the structural primary balance between 2015 and 2020.

Policy Issues and Staff's Views

19. Even after factoring in the anticipated second stage increase of the consumption tax, further consolidation is needed to contain large fiscal risks. The consumption tax rate increase in April to 8 percent was a major achievement, but is only a first step towards fiscal sustainability. Staff's debt sustainability analysis (DSA), which assumes implementation of both consumption tax rate increases, shows that the gross debt-to-GDP ratio continues rising beyond the medium-term. Without further policy measures, the fiscal position is unsustainable (chart, DSA Annex V). Staff estimates that after 2015 a further fiscal adjustment of 6¼ percent of GDP is needed under the baseline to put the debt-to-GDP ratio firmly on a downward trajectory. A gradual adjustment pace would strike the right balance between reversing the debt dynamics in a decisive manner and safeguarding the recovery.

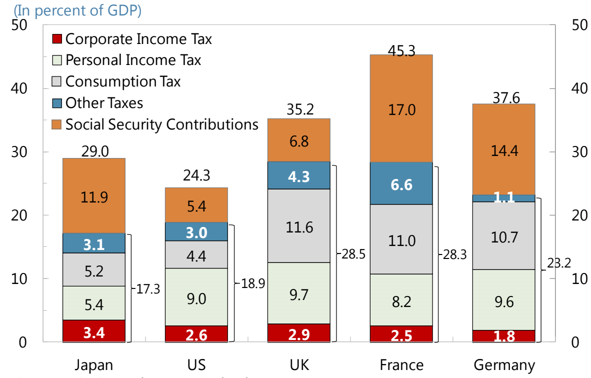
20. The second consumption tax rate increase in 2015 to 10 percent with a uniform rate should be confirmed. Raising the tax rate further at a moderate pace would help establish fiscal policy credibility. Staff estimates that fiscal consolidation in 2015 would slow growth by ½ percent, leaving growth in 2015/16 still above potential under the baseline. There is a valid concern, however, that the higher consumption tax could harm low-income households. These equity considerations would be best addressed through the existing subsidies—which could be improved once the new tax identification numbers are introduced—instead of reducing rates on essential items, as this

[11] The authorities' target is defined on a consolidated central and local government basis.

would hurt efficiency, increase compliance and administrative costs, and result in permanent revenue losses.[12]

21. A post-2015 fiscal consolidation plan is urgently needed and should include further revenue measures and entitlement reforms. Such a plan should be as growth friendly and equitable as possible and would allow more near-term flexibility to respond to downside risks. Options (see text table) include gradually increasing the consumption tax to at least 15 percent, broadening the personal income tax base, and taking measures to contain pension and health care spending.[13] Reforms of the spousal deduction from the personal income tax and threshold below which dependent spouses are exempted from paying social security contributions should be reviewed to remove disincentives to female labor force participation. A restructuring of the currently untargeted wage deductions scheme, which creates incentives for firms to expand their payroll to reduce the corporate income tax liabilities, could further enhance efficiency while raising revenue.[14]

General Government Tax and Social Security Revenue, 2012
(In percent of GDP)



Sources: OECD and IMF WEO database.

22. Reforms of the fiscal framework could help safeguard hard-won consolidation gains. As the fiscal adjustment will span a decade, consolidation gains should be safeguarded through a stronger fiscal framework grounded in medium-term rules to curb expenditures and limits on the use of supplementary budgets.

23. The government recently decided to move ahead with a CIT rate cut to below 30 percent, with details and an exact timeframe to be determined. Reducing the CIT rate would have economic benefits, but would require offsetting fiscal measures to prevent a further rise in fiscal risks (Box 4). Revenue losses could range between ½ to 1 percent of GDP depending on the size of the rate reduction (text table below). Staff analysis shows that a CIT cut raises investment and growth, but not sufficiently to make them self-financing. There is some scope for CIT base broadening, but an elimination of the most distortionary allowances or incentives, such as those for SMEs, would provide only limited revenue gains. Removal of some key allowances, for instance for

[12] K. Kang, M. Keen, M. Pradhan and R. de Mooij, 2011 "Raising the Consumption Tax in Japan: Why, When, How?," IMF Staff Discussion Notes 11/13.

[13] K. Kashiwase, M. Nozaki, and K. Tokuoka (2012), "Pension Reforms in Japan", IMF Working Paper 12/285.

[14] Wage earners can claim standard deductions that rise with income up to a certain threshold and are substantially higher than actual expenses or similar deductions in other countries. These deductions create incentives for SMEs to incorporate and distribute profits through directors' salaries, thereby reducing corporate income tax liabilities. For more details, see R. de Mooij and I. Saito (2014), "Japan's Corporate Income Tax: Facts, Issues and Reform Option", draft IMF Working Paper.

Research and Development (R&D) expenses, could weaken the positive investment effects of a rate cut and should be avoided (Figure 8).

24. **To limit fiscal risks while maximizing the economic impact, a new tax schedule should be announced upfront, but phased in over time.** This would help reduce the revenue costs and allow offsetting measures to be introduced over time to limit their growth impact. As an alternative to a CIT rate cut, consideration could be given to opt for an Allowance for Corporate Equity (ACE) system, which would be a more cost effective way of encouraging investment and has recently been adopted in some advanced and emerging economies.

Options for Fiscal Policy Adjustment Until 2020

(Excluding reconstruction spending, in percentage points of GDP)

	Estimates of Authorities' Current Plan	IMF's Additional Adjustment Options
Total Savings	**2¼**	**6¼**
of which		
Revenue	**1.0**	**2.5**
Increase consumption tax rate from 8 to 10 1/	1.0	
Increase consumption tax rate from 10 to 15		2.5
Cut corporate tax rate (details unknown)	-	
Cut corporate tax rate (from 34.6 to 25-30 percent)		-0.5 to -1.0
Broaden corporate income tax base	+	+
Broaden personal income tax base (including a reduction of the wage deduction)		0.5 to 1.0
Eliminate preferential tax treatment for pension benefit income 2/		¼
Collect pension contributions from dependent spouses of workers covered by the employees' insurance 2/		¼
Collect health insurance premiums from dependent spouses of workers covered by the employees' insurance		+
Reduce pension payroll tax		-0.5
Introduce carbon tax 3/		+
Raise inheritance tax further	+	+
Expenditure	**1¼**	**3¾**
Withdraw the recent stimulus	¾	
Curb growth rate of nominal non-social security spending (excluding interest payments) 4/	¾	1.5
Limit annual nominal growth in social security spending (excluding the items below) 5/	-¼	1¾
Raise pension eligibility age to 67 or higher 2/		¼
Reduce benefits for wealthy retirees 2/		¼

Note: Staff estimates; '-' and '+' refers to unidentified costs or savings

1/ Introducing multiple rates would reduce additional revenue.

2/ Lower bound estimate of Kashiwase, Nozaki, and Tokuoka, 2012 (IMF Working Paper 12/285).

3/ Fiscal savings are assumed to be 0.1 percentage points of GDP or lower and spent on energy saving initiatives.

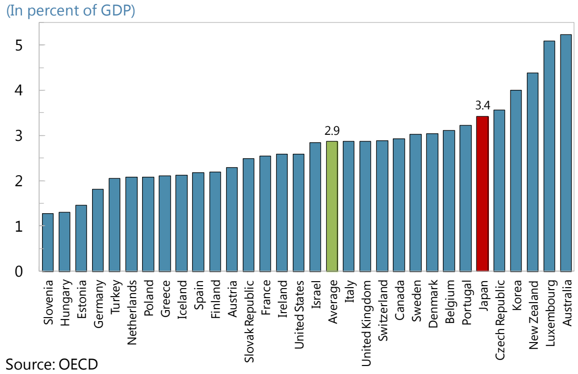
4/ Freezing expenditure in nominal terms.

5/ Annual nominal growth at ½-1 percent. The authorities plan to use part of additional revenue from the second-stage consumption tax hike to increase social security spending.

Box 4. Reforming the Corporate Income Tax System[1]

The government announced in June plans to reduce the CIT rate as a way to stimulate the economy. The Japanese statutory rate (34.6 percent) and revenue to GDP ratio (3.4 percent) are among the highest in the OECD, some 5 percentage points higher than in other G7 economies.

OECD: Corporate Income Tax Revenue (2012)
(In percent of GDP)



Source: OECD
Note: Chile and Mexico data unavailable. Norway excluded (10.4%).

Despite recent reforms, Japan's CIT system is relatively distortionary and complex. In 2012, the statutory rate was already lowered by 5 percentage points following a shift to territorial taxation in 2009, but large distortions remain. Differences in treatment between debt and equity financing and between incorporated and unincorporated firms are large and lead to distortions and arbitrage. A large number of special tax incentives has reduced transparency and effectiveness. Varying rates by region, firm size, and income level creates further distortions.

A CIT rate cut could have a positive yet limited impact on investment, including through higher inward FDI. International evidence suggests that a 5 percentage point CIT rate cut may increase investment by some 2 or 3 percent. Japan-specific estimates point to potentially smaller effects. FDI is expected to rise too, but given that inbound FDI is relatively small in Japan, effects through this channel may not be very large.

A CIT rate cut is unlikely to be self-financing. Revenue effects are generally based on static assessments when designing a comprehensive tax reform. Combining international experience with Japan-specific features suggests that the dynamic long-run effects following a CIT cut may be mitigated by perhaps 10–30 percent, far from fully offsetting its impact. The short-run fiscal costs can be reduced by gradually phasing in the tax reduction to reduce the windfall gain on returns to past investment. In the long run, other taxes need to be raised, such as the consumption tax; or the local CIT could be replaced by local property taxes.

Revenue gains from base broadening are limited, but streamlining tax incentives including those for SMEs is needed. Tax incentives come at an estimated overall revenue loss of 0.2 percent of GDP at the central government level. Some of these incentives may be justified on efficiency grounds, including for stimulating R&D. The generosity of depreciation allowances and loss carry forwards is also comparable to that in peer countries. The number of tax incentives in Japan is very large, however, and not all seem effective, particularly those applicable to SMEs, including special reduced rates, which can in fact be distortionary.

An Allowance for Corporate Equity (ACE) could stimulate investment, with minimal fiscal costs in the short run. Introducing an ACE would directly reduce the cost of equity financing, thus boosting incentives to invest. Moreover, it also eliminates debt bias, which gives incentives for excessive debt accumulation, making firms more vulnerable to shocks. If an ACE is applied only to new equity, as recently introduced in Italy, revenue losses will be incurred only gradually. The investment stimulus per yen of tax relief is thus maximized.

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[1] Prepared by R. de Mooij (FAD) and I. Saito (APD). See also de Mooij and Saito (2014) "Japan's Corporate Income Tax: Facts, Issues and Reform Options", draft IMF Working Paper.

The Authorities' Views

25. The authorities considered the increase of the consumption tax a success and agreed that the second rate increase would be an important contribution to restoring fiscal sustainability. Despite widespread concerns, early indications were that growth implications of the tax increase were moderate and the decline in consumption had started to level off in May. Officials noted that ample fiscal stimulus was in train to prevent the economy from stalling. A decision on the second consumption tax increase is expected by the end of this year, taking into account several factors including economic conditions in the third quarter. The introduction of multiple rates on basic items was under discussion to address equity concerns, but required careful consideration given potential administrative and revenue costs.[15]

26. The authorities agreed that fiscal measures needed to be identified beyond 2015 to stabilize and bring down the debt-to-GDP ratio. They noted that the Fiscal System Council, an advisory body to the Finance Minister, had published long-term fiscal projections on an internationally comparable basis, which quantified the size of the required adjustment. The projections showed that, while public pension expenditure will stabilize, health and long-term care expenditures are expected to rise substantially. They noted that even under favorable macroeconomic conditions, there remained a sizeable gap vis-a-vis the FY 2020 primary balance target and noted that a concrete medium-term fiscal plan would be formulated in 2015.

27. The authorities explained that the costs and benefits of a CIT rate reduction had been intensively debated. Views within the government varied on the size of the growth benefits, but there was broad agreement that a tax rate reduction was not self-financing and base-broadening measures were under discussion to secure offsetting financial resources. Compensating measures were thus seen as necessary to make a rate cut compatible with the government's long-term goal of achieving primary balance by FY 2020.

MONETARY POLICY: STAYING THE COURSE

28. Implementation of the QQE framework has been smooth and transmission has gradually strengthened. After some initial bond market volatility, 10-year JGB yields have fluctuated in a narrow range around 60 bps since last summer. Together with rising inflation, this has contributed to a further decline in real lending rates. Financial institutions have started to rebalance their portfolios and banks have reduced JGB holdings (from 22 percent in end-2012 to below 19 percent of total assets by end March 2014) (Box 5). Still, insurance companies and private pension funds have kept asset allocations broadly unchanged. Finally, market and survey measures of long-term inflation expectations have risen to between 1¼–1½ percent and, after having been unchanged since last fall, have begun to rise again recently.

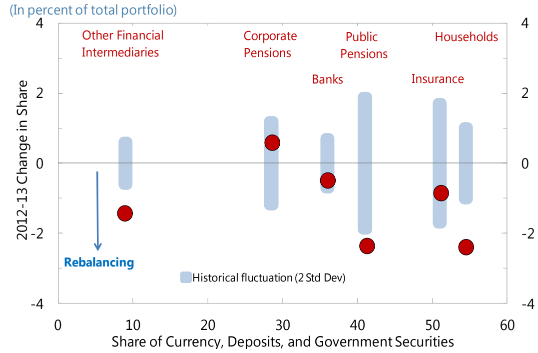
[15] Introduction of multiple rates would require adoption of an invoice-credit mechanism in line with the vast majority of OECD member countries with a valued added tax.

Box 5. Portfolio Rebalancing and Capital Outflows[1]

The success of Abenomics depends to a large extent on whether Japanese investors rebalance their portfolios towards higher yielding assets thereby lowering borrowing costs and intermediating risk capital.

A moderate shift of portfolios towards higher yielding assets is underway. The share of currency, deposits, and central and local government securities has declined for households, public pensions, and other financial intermediaries such as securities investment trusts (chart).

Currency, Deposits & Government Bonds Holdings (Dec-2013)
(In percent of total portfolio)



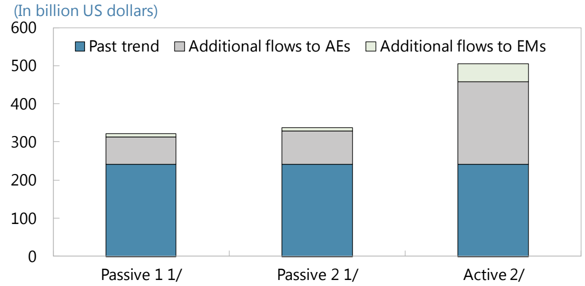
Source: Bank of Japan Flow of Funds, Haver, and Staff Estimates

Portfolio rebalancing will likely accelerate over the near term.

- *Rising domestic credit demand.* Business lending has risen at the fastest pace since 2008. The latest loan officer survey shows a continued rise in credit demand in 2014.
- *Ample intermediation capacity.* Banks' capital ratios are higher than at any time during the last decade, and loan-loss reserves are at pre-global financial crisis levels. The large share of excess reserves is depressing profits and raising incentives to increase lending to new and riskier projects.
- *Review of investment strategies*. The Government Pension Investment Fund, with 27 percent of GDP in assets under management, adjusted its targets from JGBs towards other assets including foreign bonds and equities in June 2013. Given the size of the fund, this change will likely have knock-on effects to other institutional investors.
- *Negative real returns on household deposits.* Japanese household hold more than 55 percent of their assets, or about 875 trillion yen (180 percent of GDP) in the form of bank deposits. With headline inflation estimated at 2¾ percent this year, real returns are negative. The introduction of new tax-incentivized saving accounts in 2014 could facilitate a rebalancing process.
- *A widening of the interest rate differential with the US.* Since mid-2013 benchmark yield differentials between Yen and US dollar denominated securities has widened, raising incentives to expand the share of foreign assets in investor portfolios.

Rebalancing could result in higher portfolio outflows. An illustrative scenario analysis under different behavioral assumptions for institutional investors shows that additional outflows could range between USD 80–260 billion (chart). Although only a small share—about 20 percent—would likely go to emerging economies, the effects could be large enough to ease financing conditions. While instructive, the exercise is partial in nature and does not incorporate exchange rate effects, nor include potential flows associated with a rebalancing by households or firms (FDI).

Potential Capital Outflows
(In billion US dollars)



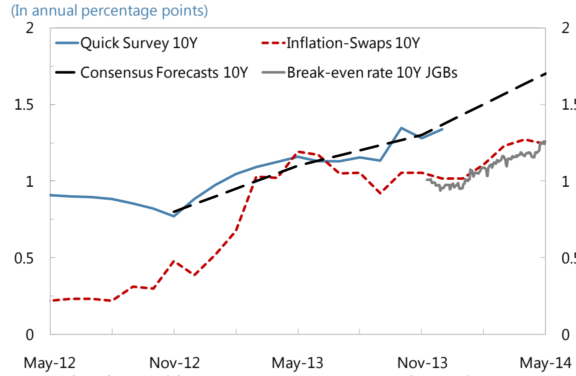
Assumptions: 1/ Financial institutions maintain investment strategies (2010/20122/013H2 avg.) except GPIF reduction of JGB holdings to its benchmark range lower-limit to purchase foreign assets. Banks increase domestic lending at 2013 pace, while increasing foreign investment to maintain 2013 ROA. Foreign assets returns assumed at 2% and 1.5% under scenarios 1 and 2 respectively.
2/ GPIF reduces domestic-bond holdings to 45% of total assets while increasing domestic stocks and foreign assets equally; insurance companies reduce JGB purchases to 2/3 of current pace to increase foreign investment. Other investors (e.g., investment trusts) accelerate pace of foreign investment about 50%. Banks domestic lending increase at 2008 peak pace, while overseas lending is as in 2011. Banks buy foreign assets amounting to half of additional reserves.
Source: IMF staff estmates.

[1] Prepared by M. Nabar and J. S. Kang (APD).

Policy Issues and Staff's Views

29. Monetary policy is appropriately accommodative and no further easing is needed at this point. With actual and expected inflation steadily progressing toward the 2-percent target (anticipated by 2016–17 in Staff's baseline), increasing asset purchases now is not necessary. Rather policy space should be preserved to address downside risks. Since the current aggressive pace of monetary easing may need to be maintained for an extended period, clarifying asset-purchase plans post end-2014 could further enhance transparency.

Long Term Inflation Expectations
(In annual percentage points)



Source: Bloomberg, Quick Survey, Consensus Forecasts, and IMF estimates.

30. The BoJ should act quickly if actual or expected inflation stagnates or growth disappoints. Policy options include expanding purchases of private assets and government bonds, and further lengthening the maturities of assets being purchased. The latter would accelerate portfolio rebalancing by insurance companies and pension funds and reduce banks' duration risks further, thereby facilitating risk taking. In addition, there is room to expand special lending facilities, including by increasing the size, reducing the funding cost, and lengthening the term beyond the current 4 years. The impact of these latter measures is, however, likely small, given already very easy financing conditions.

31. Over time, sustained easing without complementary reforms would raise risks to financial stability and complicate the exit. Asset purchases are already unprecedented: each year that the QQE program is maintained, the BoJ will add approximately 5 percent of the outstanding stock of JGBs to its existing holdings, estimated at 23 percent at end 2014. Continuing with QQE in its current form for too long could impair market liquidity or give rise to financial stability risks as asset prices could become disconnected from fundamentals. As such, there are clear risks from potentially overburdening monetary policy. Therefore, structural and fiscal reforms are critical to strengthen policy transmission in a sustained manner and facilitate an earlier exit from QQE.

32. Although exit still remains far off, planning for it should continue. Because of the larger share of longer dated securities on the BoJ's balance sheet, a passive strategy as used in 2005/06 of rolling off maturing bonds would require more time to complete and imply higher interest rate risk. Indemnification against capital losses from rising interest rates (as large as 1¼ percent of GDP for a 100 bps rise) could be considered, but needs to be weighed against the potential fiscal risk from these contingent liabilities.

33. BoJ communication has been effective, but more could be done going forward to help anchor expectations. The BoJ should continue to highlight the overarching goal of achieving the inflation target in a stable manner, but could clarify the indicators used to assess whether inflation is on track. In due course, the criteria for determining whether inflation has been sustainably achieved could be spelled out, which would also help guide expectations when there is a need to adjust the asset-purchase program and facilitate preparations for eventual exit.

The Authorities' Views

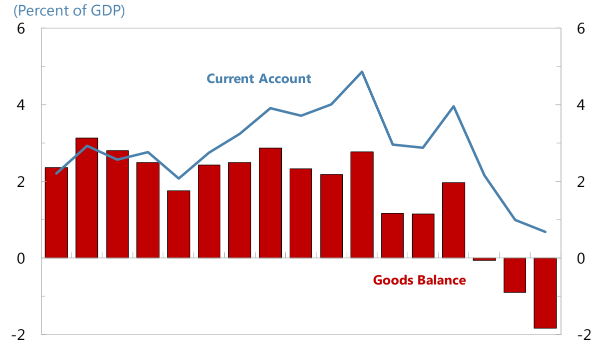
34. The BoJ stressed that it has come halfway towards reaching its inflation target, and views that the progress will continue, albeit with reduced tailwinds this year. Tailwinds from last year's depreciation were fading and the near-term evolution of inflation expectations remained uncertain. The BoJ expected inflation to start increasing again towards the end of the year, reaching around 2 percent—the price stability target—in or around fiscal year 2015, but was ready to act if inflation began to trail off the expected path. In this regard, they felt that the parameters of QQE beyond end-2014 could be extrapolated from the current path since the BoJ's forward guidance already conveys the idea that the easing stance will be maintained as long as it is necessary to achieve the inflation target in a stable manner. They cautioned, however, that they will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

35. The BoJ agreed that there was room to augment the communication strategy, but thought that providing specific forward guidance at this time could be counterproductive. They preferred to use speeches and press conferences by BoJ Policy Board members to help explain developments and its forecast. With inflation outcomes beginning to influence expectations in the right direction, they felt that providing specific information at this stage on indicators to help track progress toward 2 percent was not necessary to help anchor expectations. Rather the BoJ felt it would be counterproductive to provide more explicit guidance given the uncertain path of inflation towards 2 percent. Officials also pointed out that recently the US Federal Reserve and the Bank of England had backed away from state contingent forward guidance. Nevertheless, as inflation approaches the target, the BoJ would continue to examine the effectiveness of its communication strategy so as to achieve 2 percent inflation in a stable manner. With regard to exit, they noted that they would apply a wide range of tools and draw on the BoJ's own experience in 2005/06 and closely watch other central banks, including the U.S. Federal Reserve and The Bank of England.

THE EXTERNAL POSITION AND SPILLOVERS

36. The current account surplus declined further in 2013 to 0.7 percent of GDP. Although the yen depreciated by about 23¾ percent between October 2012–April 2014 (reversing a 27¾ percent real appreciation during July 2007–September 2012), so far this has failed to arrest the decline in Japan's trade balance. After declining for two years, the goods trade deficit deteriorated by another 1 percentage point of GDP to 1.8 percent in 2013 as a result of higher imports of energy products

Japan: Current Account and Goods Balance
(Percent of GDP)



Source: CEIC Asia database

and consumer goods and flat exports (Figure 2). A rising income balance surplus from higher interest income on overseas investment moderated the impact.

A. External Sector Assessment

37. Taking last year's trade developments into account, the yen is assessed as broadly consistent with medium-term fundamentals and desirable policies (Annex III). The assessment takes temporary factors affecting the trade balance into account as well as structural shifts in the external sector, the effects of which have become more apparent during the last year.

- *Structural factors* are exerting a drag on the trade balance and making it less responsive to the movement of the yen. The rising share of offshore production—exceeding 20 percent of overall manufacturing output—and Japan's upstream position in the global supply chain have reduced the sensitivity of exports to fluctuations in the yen.[16] On the import side, with the supply of domestic nuclear power likely to be permanently lower, a portion of the current elevated energy imports will persist. Finally, imports of consumer electronics and IT devices have soared during the last few years and structurally increased the import share in Japan's domestic final demand. Staff estimates that these effects lead to a permanent trade deficit, which is more than offset by a surplus on the income account. As a result, the current account norm is estimated at around 2 percent of GDP—about 1½ percentage point of GDP lower than assessed last year.

- *Temporary factors* have also weakened Japan's trade balance, including due to rush demand ahead of the consumption tax increase. The expectation is that the external balance will strengthen—to a surplus of around 2 percent of GDP over the medium to long term— as these effects fade and exports pick up in line with past lags.

38. For the time being, there is large uncertainty about Japan's external assessment. In addition to the above factors, the assessment assumes the implementation of desirable macroeconomic policies and in the case of Japan this requires full implementation of all three arrows of Abenomics. The effects of the new policies on the external balance are uncertain given that they are trying to accomplish several goals – accelerate growth, lift inflation, lower public debt. As the policies are being implemented, the assessment will be revisited in the future as outcomes become clearer.

B. Spillovers

39. Spillovers have been mild during the first year of Abenomics. Exports have changed little in response to the weaker yen and capital flows through overseas' bank lending and investment (FDI) have remained broadly in line with past trends (Table 3). Although net capital outflows by Japanese investors picked up in the second half of 2013—mainly to advanced

[16] See 2014 Spring APD REO Chapter 3 for more details on changes in Japan's position in the supply chain.

countries—this was more than offset by non-resident inflows into Japan (particularly into equities). More recently, net inflows have turned positive again after a period of outflows in January/February.

40. Spillovers are likely to rise over the near term as exports and imports adjust to the weaker yen, potentially adversely affecting competitors, at least in the near term. Spillovers through capital markets are also expected to rise as Japanese investors, especially, banks, pension funds, and insurance companies, start diversifying their investments overseas. These outflows will help to cushion the effects of tightening global financial conditions, including in emerging markets (EMs). A scenario analysis shows that portfolio rebalancing by banks and institutional investors could lead to additional capital outflows of up to US$260 billion (Box 5)—almost doubling the size of foreign portfolio investment and bank lending relative to past trends—over the near to medium term. Some of these flows would go to EMs, moderating tightening financial conditions. Under a global downside risks scenario with sharply tighter global financial conditions and growth disappointments in several EMs (2014 Spillover Report),[17] growth would slow substantially in Japan with negative feedback effects via trade and supply-chain channels. A slowdown in Japan would feed back to trading partners in the region, in particular suppliers to Japanese exporters and producers of final goods.

41. As long as Japan continues to proceed with its reform agenda, positive spillovers will dominate over the medium-term. Under the baseline, completing all three arrows continues to be the preferred policy package for both Japan and the global economy as it would avoid overburdening monetary policy and undue weakening of the yen, boost import demand through higher growth while strengthening Japan's competitiveness, and removing an important tail risk by restoring fiscal sustainability. During a growth slowdown, allowing fiscal stimulus to play a larger role would help minimize potential spillovers to the rest of the world. This underscores the need for a concrete medium-term fiscal strategy beyond 2015, which would create room for more fiscal flexibility.

The Authorities' Views

42. The authorities expressed skepticism about the assessment of the external position. They highlighted considerable uncertainty whether the current account would rise to around 2 percent of GDP as expected by staff. The factors cited for this uncertainty included persistently high oil prices, the continuation of relocation of production abroad, and declining competitiveness in some manufacturing sectors.

43. The authorities agreed that spillovers of successful Abenomics would likely be positive. They noted that spillovers had been benign so far and that potential capital outflows could help ease financing conditions of EMs in the region. They also added that spillovers through the

[17] The scenario assumes a sooner than expected tightening of financial conditions (by 100 basis points largely through higher term premia) in advanced economies, resulting from perceptions of stability concerns, rather than through stronger economic growth. This is combined with a deeper than expected structural slowdown in EMs of ½ percentage point annual growth over the next three years.

trade channel would be more limited than in past episodes of large depreciations due to structural factors, including from the offshoring of production. The authorities were somewhat skeptical about staff's estimates that growth spillovers from EMs were larger for Japan than for other advanced economies.

FINANCIAL SECTOR: REBALANCING RISKS

44. Financial sector health has improved, but further gains could prove more challenging. Banks have benefitted from higher equity market valuations and growing loan books. Amid low credit costs and declining loan loss provisioning, capital positions have strengthened and internationally-active banks remain on track to meet Basel III capital requirements. Moreover, QQE has reduced interest rate risk for major banks which have sold part of their JGB holdings to the BoJ, while regional banks have been slow to shed their holdings given more limited lending opportunities, (Table 5). Insurance companies have maintained their solvency margin ratios at levels well above 200 percent—the regulatory threshold to take corrective actions—and their investments in overseas assets and domestic stocks have remained broadly the same over the last year.

Policy Issues and Staff's Views

45. The search for higher yield by Japanese investors, while welcome, could generate new risks. Declining net interest margins on domestic loans and rising excess reserves are exerting pressure on banks' core profitability. Interest rate risk for regional banks remains high and profitability pressures are most evident in this sector (2012 FSAP Update). As banks plan to rebalance their portfolios, they may incur new risks in a number of areas:

- *Major banks* continue to expand abroad, suggesting that securing stable and long-term dollar funding will increasingly become a challenge. Supervisors should continue to encourage these banks to strengthen their funding sources, such as by reducing their reliance on foreign exchange swaps, issuing longer term dollar-denominated bonds, and building a depositor base in overseas operations. Cross-border collateral arrangements for banks—already in place with Singapore and Thailand and agreed to be established with Indonesia—could also help reduce local currency funding risks in overseas markets.[18]

- *Regional banks*. The authorities should continue to strengthen capital standards of domestically-active banks, including by reassessing the treatment of unrealized losses in capital. The authorities should further consider developing a strategy to establish a stronger regional banking sector, including through private sector-led consolidation, as recommended by the 2012 FSAP Update.

[18] Under these arrangements, Japanese banks can draw funding from the host overseas central bank by pledging JGBs as collateral with the host central bank.

As for Japan Post bank, with plans underway to sell a part of the government's share held through Japan Post Holdings, due care should be given to possible implications. In particular, any potential expansion of Japan Post into new lending bears risks given limited expertise and through implications for other financial institutions. In addition, remaining AML/CFT deficiencies should be addressed swiftly in line with the Public Statement on Japan published by the Financial Action Task Force in June 2014.

The Authorities' Views

46. The authorities highlighted that financial system soundness had further improved, pointing to rising capital adequacy ratios and low Nonperforming Loan (NPL) ratios. They noted that they are paying close attention to the profitability and risk-management practices of major and regional banks, including interest rate risk from JGB holdings and foreign exchange funding risk from banks' expansion abroad. The banking supervisor agreed that core business profits of banks were decreasing and that they needed continuous efforts to increase their earnings at home and abroad with appropriate risk management.

- As for regional banks, the authorities stated that they recognized the need for each regional bank to consider its mid- and long-term business strategy in response to structural challenges, such as demographic trends in an aging society. They noted that business consolidation should be determined based on each banks' voluntary judgment, while the FSA will continue to encourage the top management of banks to take on a leadership role in recognizing the business challenges and identifying ways to address them.

- On the treatment of unrealized losses on security holdings for domestically-active banks, the authorities reiterated their view that the treatment is necessary for mitigating pro-cyclicality of capital levels as gains and losses vary over the cycle. In their view, the current treatment does not provide banks an incentive to increase exposure to securities, as they pay close attention to risks from security holdings and try to capture such risks at an early stage. Finally, transparency is ensured since unrealized gains and losses are within the scope of accounting disclosure.

The FSA also stressed that it was focused on strengthening the role of the financial sector in supporting growth, emphasizing the need for banks to be more proactive in nurturing new businesses and providing high quality financial services.

STAFF APPRAISAL

47. The economy is expected to grow at an above potential pace in 2014, but medium-term risks remain substantial. Although there will be an inevitable contraction in the second quarter as payback for the elevated demand seen prior to the consumption tax increase, the underlying growth momentum is strengthening as seen in tight labor markets and strong investment in the first quarter. A successful handover to a sustained and private demand-led recovery requires however further action on several fronts.

48. More forceful growth reforms are needed to overcome structural headwinds to raising growth and ending deflation The next round of structural reforms should lift labor supply, reduce labor market duality, enhance risk capital provision, and continue with agricultural and services sector deregulation. Corporate governance reforms already underway could help reduce firms' preference for large cash holdings.

49. A concrete medium-term fiscal reform plan is urgently needed. Successive consumption tax increases are critical to establish a track record of fiscal discipline given very high levels of public debt. Early adoption of a concrete medium-term fiscal consolidation plan beyond 2015 would build confidence in the sustainability of public finances and allow more near-term flexibility to respond to downside risks. Plans to lower the corporate tax rate have growth benefits, but should proceed only in combination with measures to offset revenue losses consistent with plans to restore fiscal sustainability.

50. Monetary policy is appropriately accommodative. With inflation and inflation expectations increasing, no further easing is needed at this point. In case downside risks to the inflation outlook materialize, the BoJ should act swiftly through further and/or longer-dated asset purchases. Communication should focus on achieving 2 percent inflation *in a stable manner* aided by a more transparent presentation of the BoJ's forecast and underlying assumptions, including clarifying post-2014 asset purchase plans.

51. The financial sector remains stable. Portfolio rebalancing by financial institutions and investors is desirable and would help support growth by providing more risk capital. But it also raises new risks, including from greater overseas engagement. In regional banks, limited growth opportunities and low net interest margins could further undermine core profitability and weaken capital buffers. Supervisors should continue to be proactive in monitoring these risks.

52. Japan's external position is assessed as broadly in balance compared to moderately undervalued last year. The unexpected lack of an export response to the large yen depreciation appeared the result of underlying structural changes in the external sector. These include the offshoring of production and losses in competitiveness in specific sectors. Sustained high energy imports needs have further weakened the trade response to the depreciation.

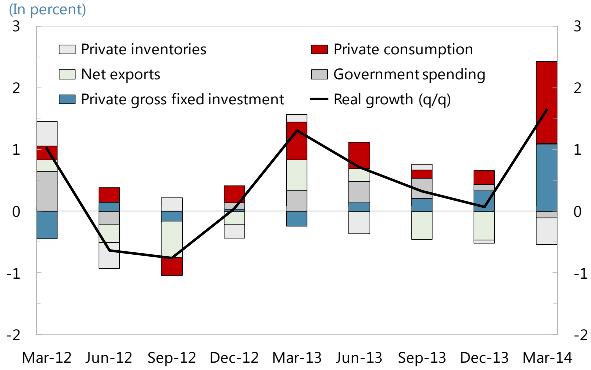
53. Launching all three arrows will create benefits for the region and the global economy. Spillovers via the trade channel and capital flows are expected to increase this year with uncertain net effects—higher exports but capital outflows—in the short term. As long as Japan continues to proceed with its reforms, incomes will rise while fiscal risks decline, which will be positive for the global economy.

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

Figure 1. Japan: Economic Developments and Outlook

Growth rebounded sharply in 2014Q1 on consumption frontloading and strong business investment.

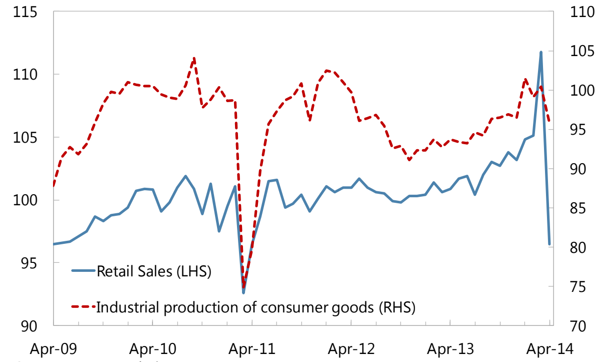
Contributions to QoQ Growth (SA)
(In percent)



Source: Haver Analytics

Payback from consumption frontloading was substantial in April…

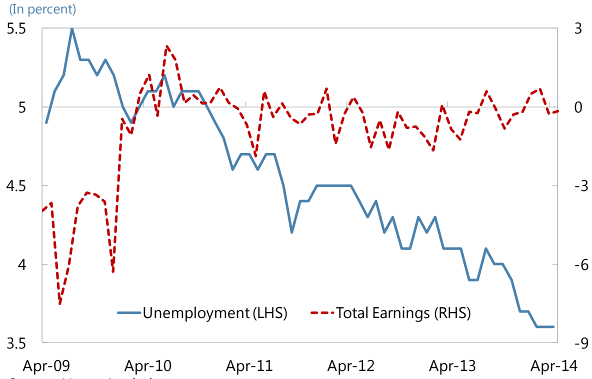
Retail sales and consumer goods production
(Index, 2010 = 100, SA)



Source: Haver Analytics

…but strong employment growth and slowly rising earnings are offsetting this effect.

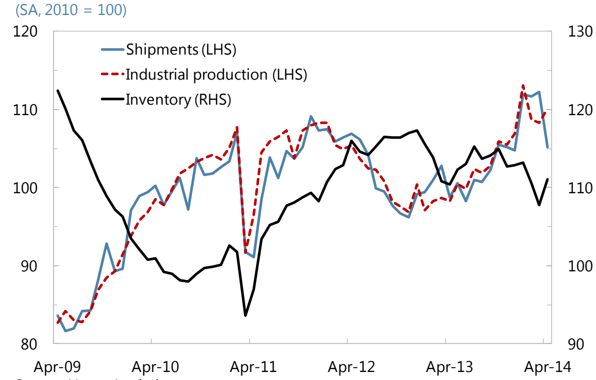
Wages Annual Growth and Unemployment
(In percent)



Source: Haver Analytics

Replacement investment has accelerated due to an aging capital stock as well as strong corporate earnings.

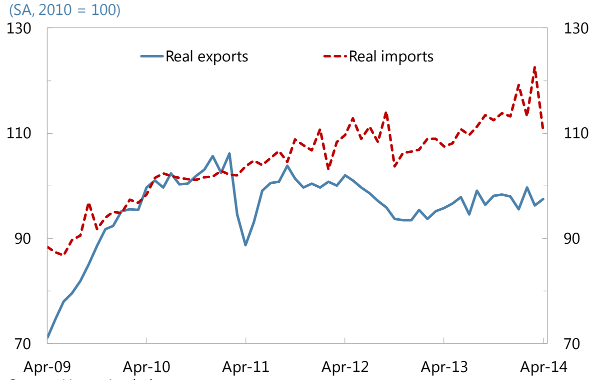
Investment Goods
(SA, 2010 = 100)



Source: Haver Analytics

Imports are falling with unwinding frontloading demand, but export recovery remains subdued.

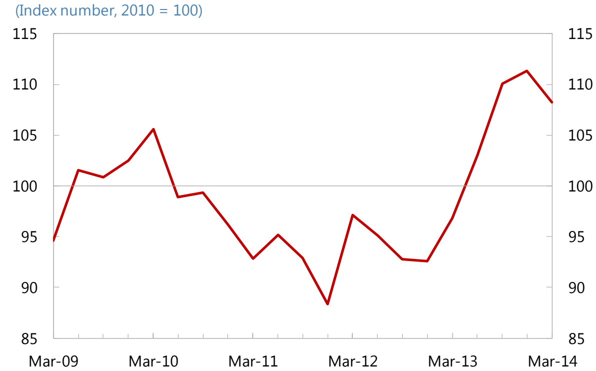
Real Exports and Imports
(SA, 2010 = 100)



Source: Haver Analytics

Implementation of public works has been delayed in recent months due to labor shortages.

Japan Public investment (SA)
(Index number, 2010 = 100)



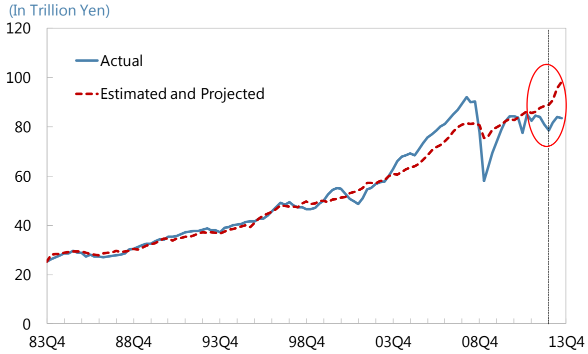
Source: CAO, via Haver Analytics

Figure 2. Japan: External Developments

Exports have risen by less compared to model predictions…

Japan: Real Exports[1/]

(In Trillion Yen)

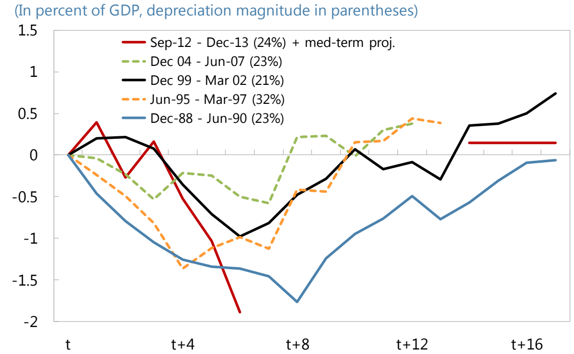


1/ Estimated up to 2012Q4
Source: IMF staff calculations

…and J-curve effects are more drawn out after large depreciations (trough after 6–8 quarters).

Periods of Yen Depreciation and the Trade Balance

(In percent of GDP, depreciation magnitude in parentheses)

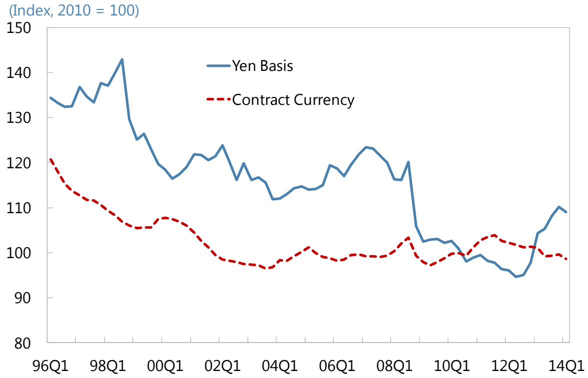


Note: *t* indicates quarter of onset of depreciation period
Source: IMF staff estimates

The weak trade balance is related to unchanged export prices in contract currency…

Exports Prices (all commodities)

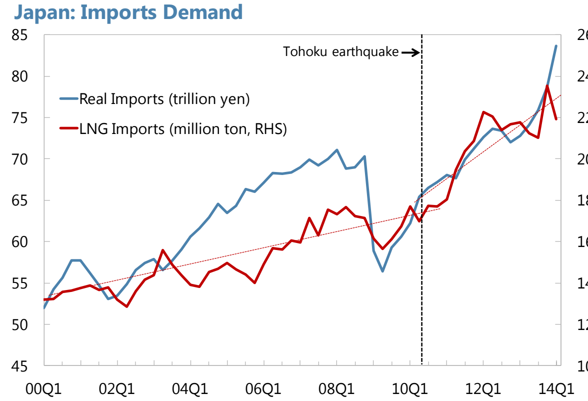
(Index, 2010 = 100)



Source: IMF staff estimates.

…and elevated import demand for energy products.

Japan: Imports Demand

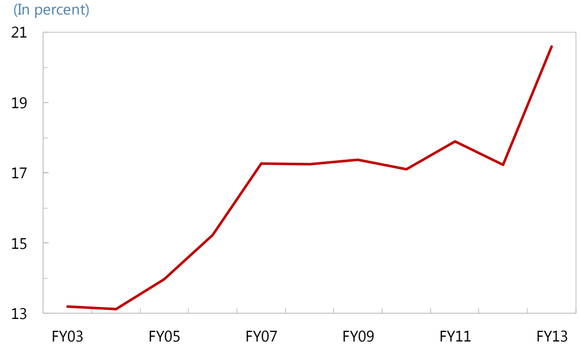


Source: IMF staff estimates

Other factors slowing exports are acceleration of overseas production…

Japanese Overseas-Production Ratio[1/]

(In percent)

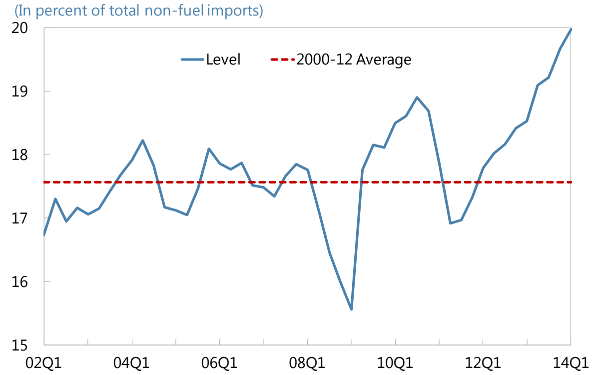


1/ Japanese production volume overseas to Japanese global production volume
Source: IMF staff estimates

…and increased competition in traditional sectors of strength (e.g., electronic imports).

Imports of Electrical Machinery

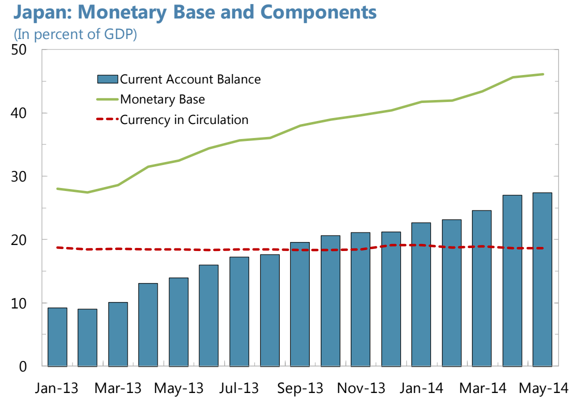
(In percent of total non-fuel imports)



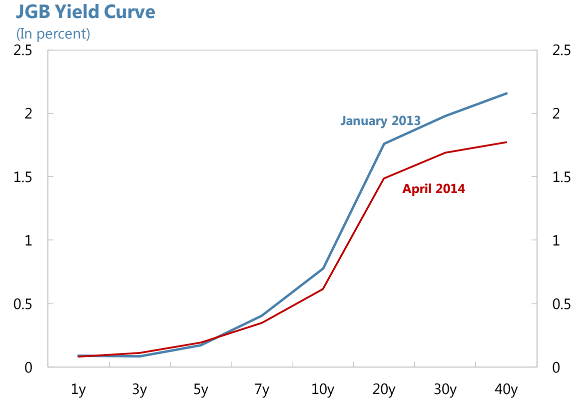
Source: IMF staff estimates

Figure 3. Japan: Monetary Policy Transmission

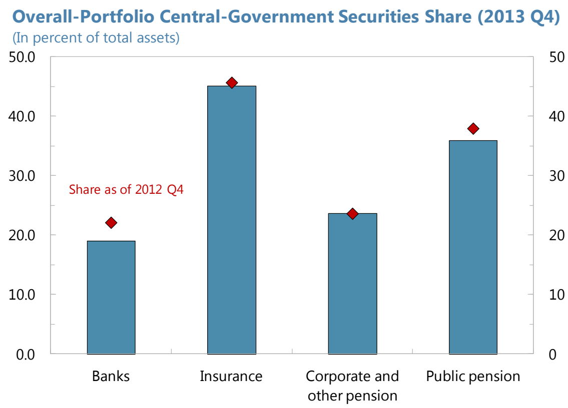
The monetary base has expanded rapidly…



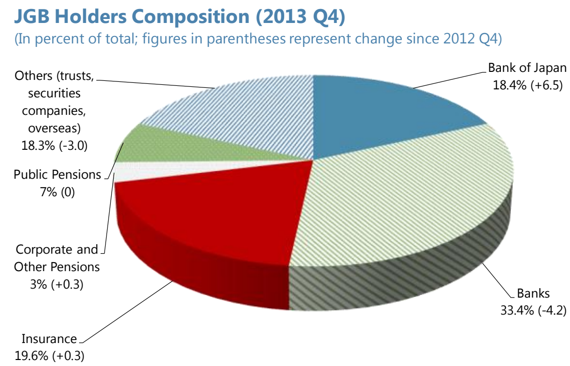
…flattening the yield curve further.



Portfolio rebalancing has mainly occurred among banks…

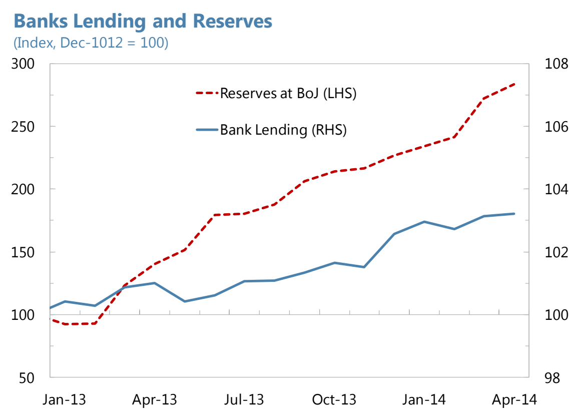


…which have reduced their JGB holdings.

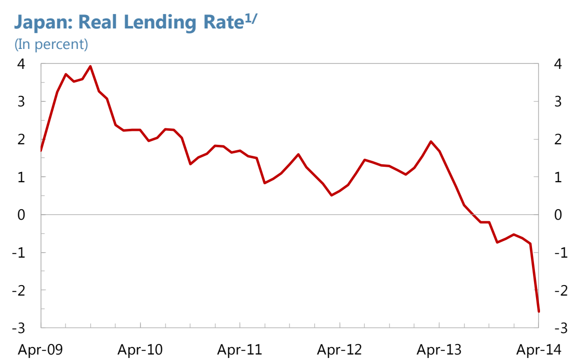


Source: IMF staff estimates.

Excess reserves have risen only partially offset by rising bank lending…



…and real lending rates have declined since Abenomics.

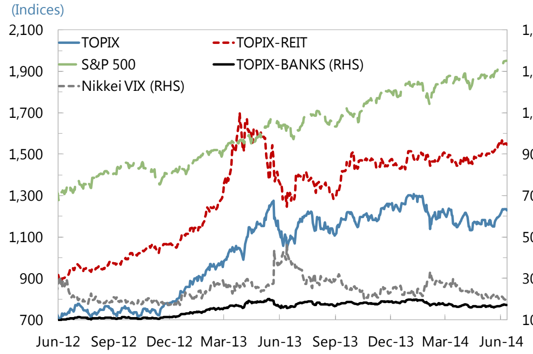


1/ Average long-term loan rate minus CPI YoY percent change across all banks.
Source: CEIC Asia database and Haver Analytics Japan database.

Figure 4. Financial Markets Developments

Equities rose almost 80 percent from September 2012 to May 2013, but this year have corrected.

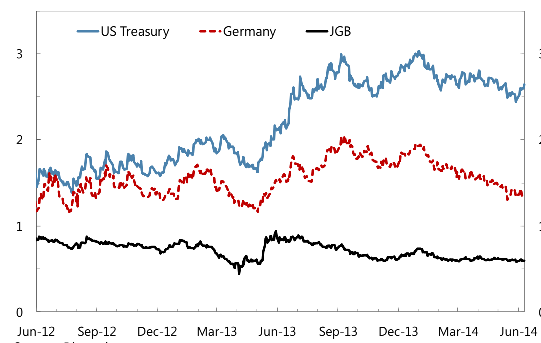
Equity Markets
(Indices)



Source: Bloomberg

Sovereign bond yields remain near historic lows despite the normalization of interest rates abroad.

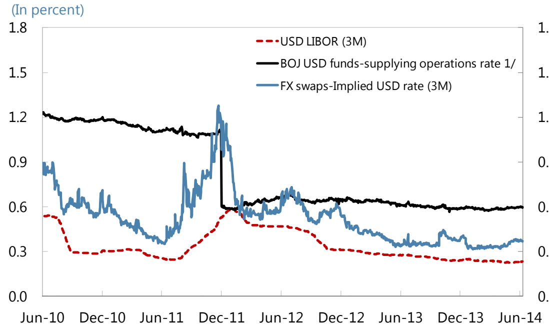
10-Year Sovereign Bond Yields
(In Percent)



Source: Bloomberg

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

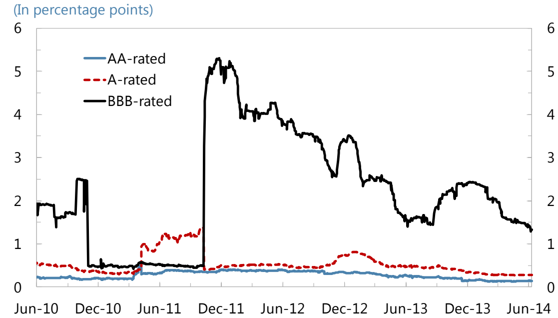
USD Funding Cost in Japan
(In percent)



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 stay highly accommodative.

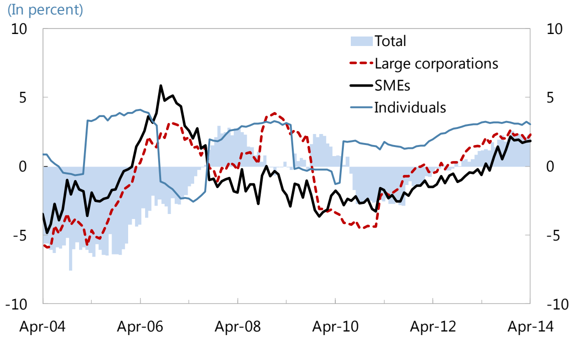
Corporate-Government Bonds Spreads (5Y) 1/
(In percentage points)



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 sentiment has stimulated demand for credit, which has recovered since the second half of 2012.

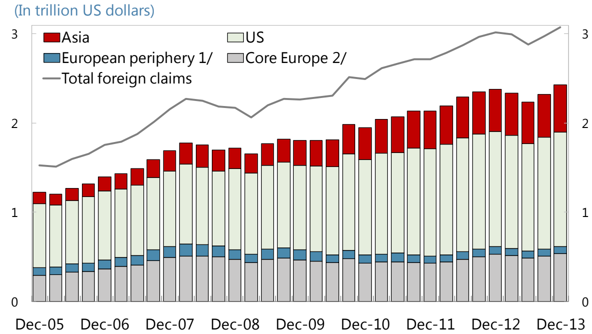
Japan: YoY Growth in Bank Lending to Corporates
(In percent)



Source: CEIC.

As banks' exposures to JGBs have declined under QQE, creating capacity for major banks to further expand overseas, particularly to Asia.

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



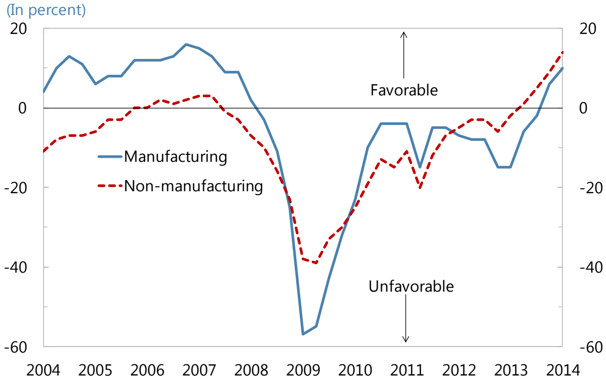
Source: BIS.
1/ Includes Greece, Ireland, Italy, Portugal, and Spain.
2/ Includes Germany, France, UK, and Switzerland.

Figure 5. Japan: Corporate Sector Developments

Business fundamentals are strong across a wide range of sectors…

Tankan: Overall Enterprise Business Conditions

(In percent)

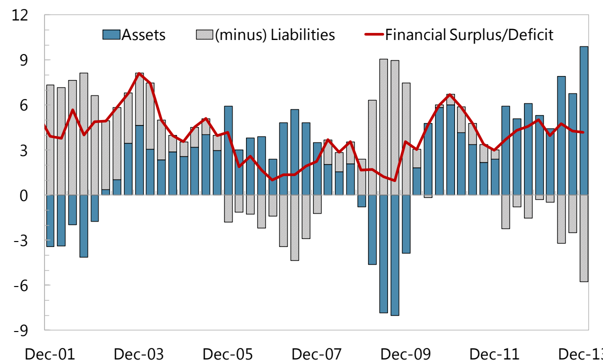


Source: Bank of Japan via Nomura.

…and corporate savings are high.

Private Nonfinancial Corporates Financial Surplus/Deficit

(In percent of GDP, 4QMA)

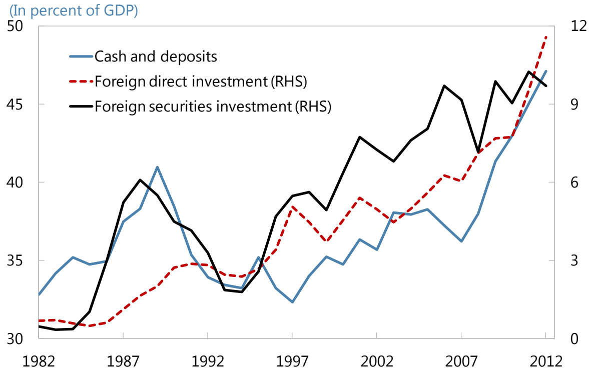


Source: Haver Analytics; and IMF staff estimates

Since late 1990s, firms have increased overseas investment as well as cash holdings…

Cash and Overseas Investment

(In percent of GDP)

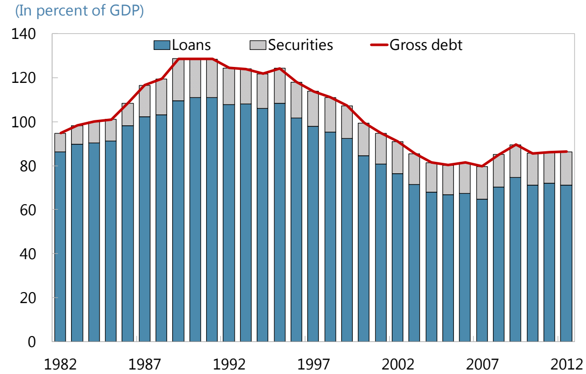


Source: Haver Analytics; and IMF staff estimates

… while reducing their debt, leading to improvements in their financial health.

Japan: Corporate Sector Gross debt

(In percent of GDP)

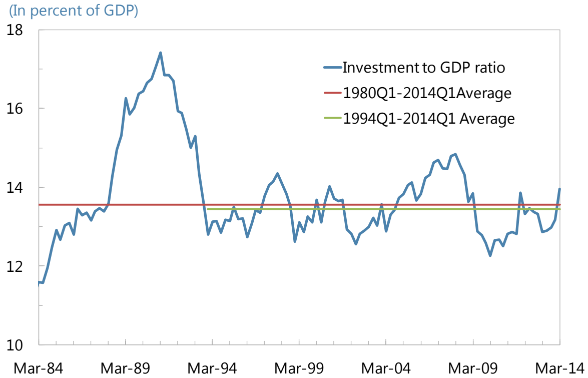


Source: Haver Analytics; and IMF staff estimates

However, non-residential investment has been slow to recover until recently…

Business Fixed Investment

(In percent of GDP)

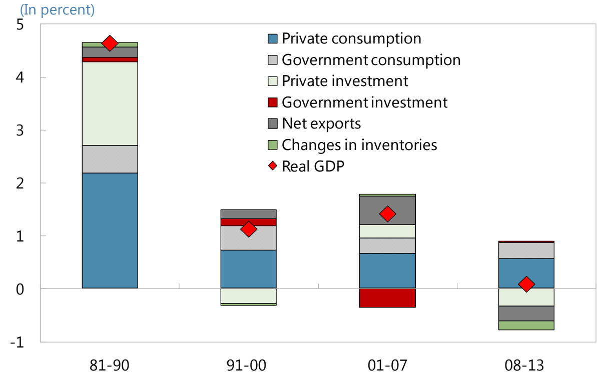


Source: Haver Analytics; and IMF staff estimates.

…becoming a drag to growth after the crisis.

Contribution to annual growth

(In percent)



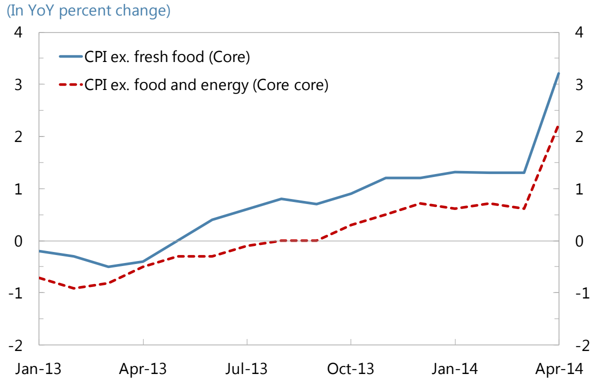
Source: Haver Analytics; and IMF staff estimates

Figure 6. Japan: Inflation and Inflation Expectations

Price increases are becoming more broad-based as the consumption tax increase is being fully passed through…

Japan CPI Core Inflation

(In YoY percent change)

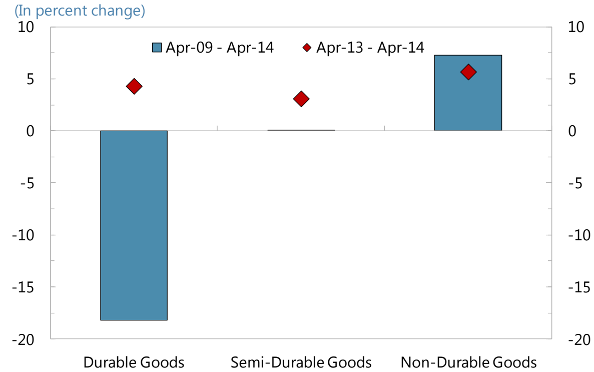


Source: CEIC Asia Database and IMF staff estimates

…and extending to consumer durable goods, which have seen the steepest declines in prices in recent years…

Consumer Goods Prices

(In percent change)

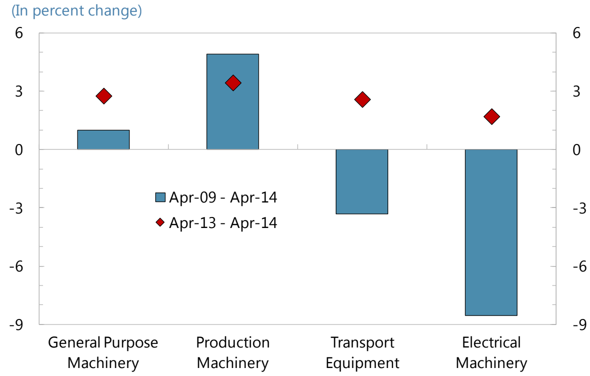


Source: CEIC and IMF staff estimates

… and capital input prices are also picking up.

Capital Goods Prices: Machinery & Transport Equipment

(In percent change)

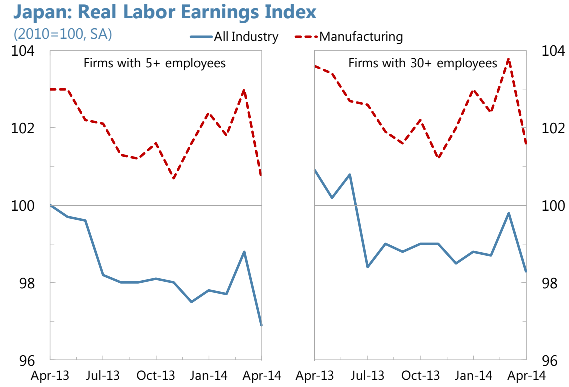


Sources: CEIC and IMF staff estimates

However, real earnings have declined as prices went up in April on account of the consumption tax increase.

Japan: Real Labor Earnings Index

(2010=100, SA)

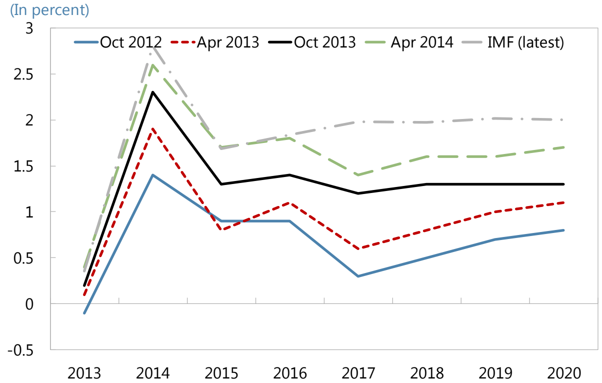


Source: CEIC

Although initially skeptical, professional forecasters are gradually adjusting their expectations upwards.

IMF and Consensus Inflation Forecasts 5-10 Years Ahead

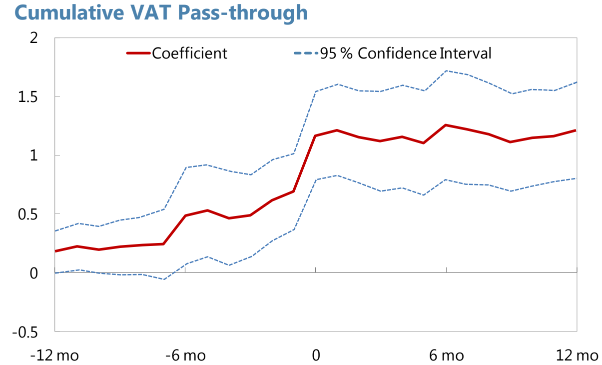
(In percent)



Source: Conscensus Forecasts and IMF Staff estimates.

Cross country evidence shows that pass-through from VAT increases is generally about 1, but the timing is uncertain.

Cumulative VAT Pass-through



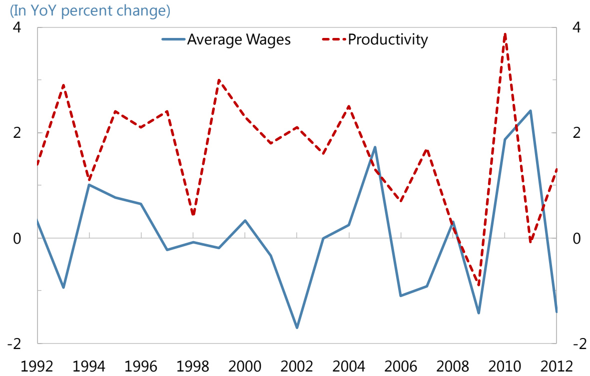
Note: Cumulative sum of pass-through coefficients. Confidence interval reflects panel-clustered standard errors.

Source: IMF staff estimates

Figure 7. Labor and Wages

Japan's real wage growth has been lagging productivity growth for the last twenty year...

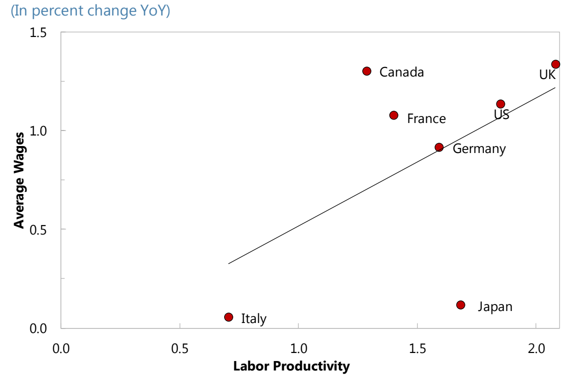
Labor Productivity and Average Wages Growth
(In YoY percent change)



Source: OECD

...and is exceptionally low compared to other G-7 countries.

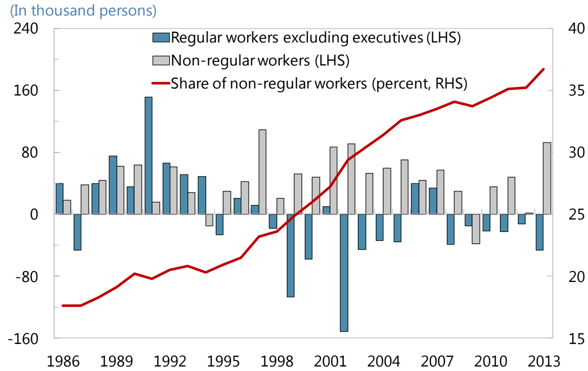
Real Wage and Labor Productivity Growth (1991–2012)
(In percent change YoY)



Source: OECD: and IMF staff calculations.

The share of non-regular workers increased rapidly in the last two decade...

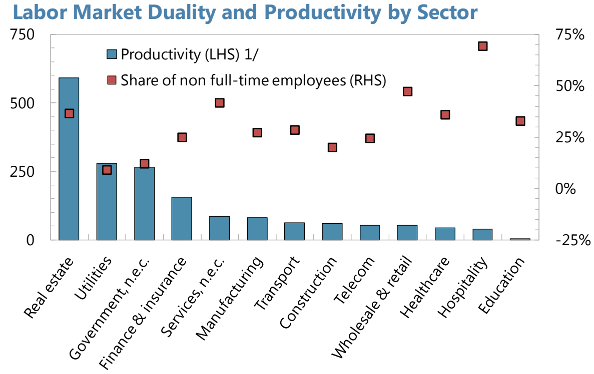
Annual Employment Change Decomposition
(In thousand persons)



Source: Ministry of Internal Affairs and Communications, and IMF staff calculations.

...moderating productivity growth...

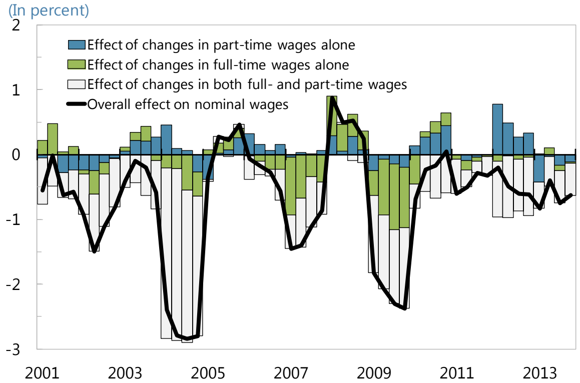
Labor Market Duality and Productivity by Sector



1/ Productivity measured as value-added per worker.
Source: Mizuho research, Ministry of Internal Affairs & Comminications, IMF staff estimates.

...as well as depressing wage growth.

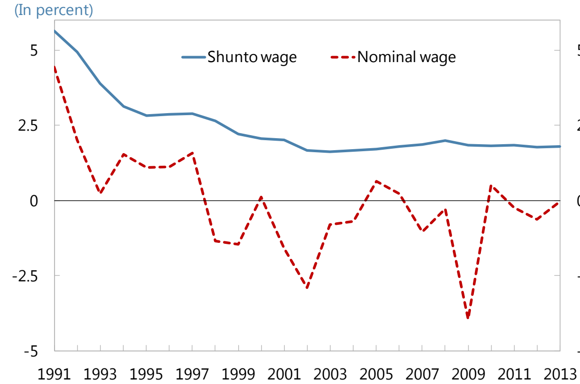
Contributions to Wages YoY Growth
(In percent)



Source: Haver Analytics, IMF staff estimates

Other factors depressing wages include waning influence of annual wage negotiations for regular workers (Shunto negotiations) on aggregate wage growth.

Japan: Wage Growth
(In percent)



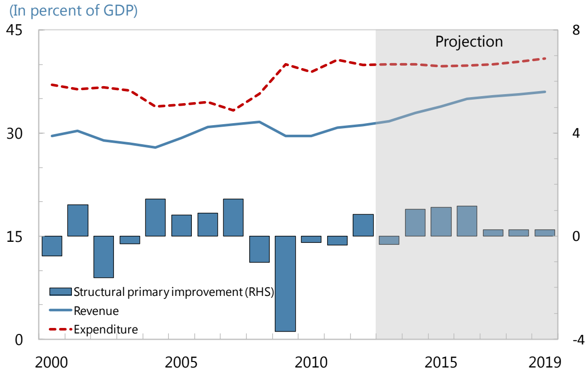
Source: Ministry of Health. Labor and Welfare

Figure 8. Japan: Fiscal Developments and Tax Reform

A modest consolidation is in the pipeline, but deficits are projected to remain.

General Government Fiscal Balance

(In percent of GDP)

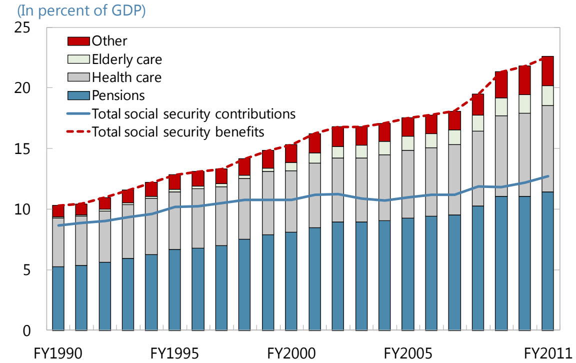


Source: WEO database; and IMF staff estimates.

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

Social Security Benefits and Contributions

(In percent of GDP)

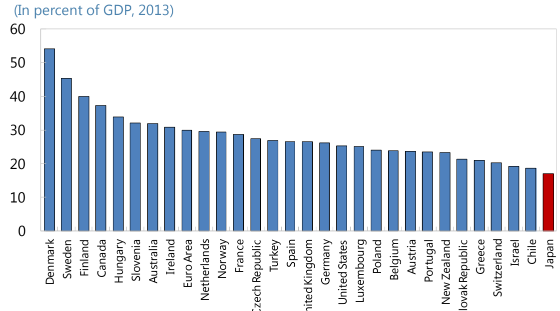


Sources: National Institute of Population and Social Security Research

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

OECD: Spending excluding Social Security and Interest 1/ 2/

(In percent of GDP, 2013)



Source: IMF WEO database.

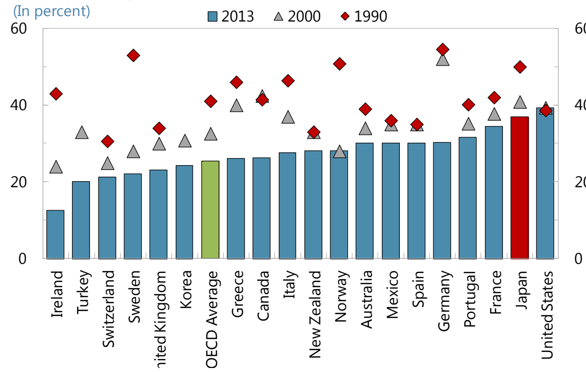
1/ OECD countries with missing data (e.g., Italy) are not reported here.

2/ General government basis.

Tax reform is crucial as Japan's revenue is relatively low, but cutting the corporate income tax rate could make a consolidation package more growth-friendly.

CIT Statutory Rate: Selected OECD Economies

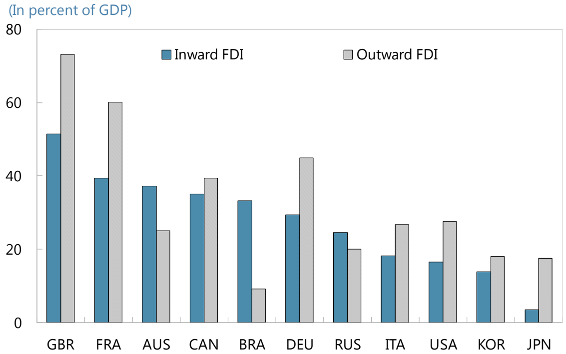
(In percent)



In addition to a relatively large negative impact on the economy, a high corporate income tax is expected to discourage inward FDI and promote outward FDI.

Stock of FDI

(In percent of GDP)



Sources: IMF Coordinated Direct Investment Survey.

Overall, economic impact of a corporate income tax cut is positive, but far from making it self-financing.

Estimated effects of a hypothetical lower CIT rate by 1 %of GDP

	Long-run effect (in percentage change)
Investment	5½
- Cost-of-capital effect	4
- Cash-flow effect	1
- Foreign direct investment	½
Wages	3½
GDP	2
Revenue implications	
- Short run (static/assumption)	1
- Long run	0.7-0.9

Notes: See De Mooij and Saito 2014, IMF Working Paper

Table 1. Japan: Selected Economic Indicators, 2009–15

Nominal GDP: US$ 4,900 Billion (2013)
Population: 127 Million (2013)
GDP per capita: US$ 38,478 2013)
Quota: SDR 15.6 Billion (2013)

	2009	2010	2011	2012	2013	2014	2015
						Proj.	
Growth (percent change) 1/							
Real GDP	-5.5	4.7	-0.5	1.4	1.5	1.6	1.1
Domestic demand	-4.0	2.9	0.4	2.3	1.8	1.8	0.8
Private consumption	-0.7	2.8	0.3	2.0	2.0	0.7	0.7
Gross Private Fixed Investment	-14.7	-0.5	4.3	3.5	0.3	6.7	3.9
Government consumption	2.3	1.9	1.2	1.7	2.0	1.2	0.5
Public investment	7.0	0.7	-8.2	2.8	11.4	3.9	-9.6
Stockbuilding 2/	-1.5	0.9	-0.2	0.1	-0.3	-0.2	0.0
Net exports 2/	-2.0	2.0	-0.8	-0.7	-0.2	0.0	0.2
Exports of goods and services 3/	-24.2	24.4	-0.4	-0.1	1.7	7.2	3.5
Imports of goods and services 3/	-15.7	11.1	5.9	5.3	3.4	8.2	2.8
Inflation (annual average)							
CPI 4/	-1.3	-0.7	-0.3	0.0	0.4	2.8	2.1
GDP deflator	-0.5	-2.2	-1.9	-0.9	-0.6	1.4	1.6
Unemployment rate (annual average)	5.1	5.0	4.6	4.3	4.0	3.9	3.9
Government (percent of GDP)							
General government							
Revenue	29.6	29.6	30.8	31.2	31.7	33.0	33.8
Expenditure	40.0	38.9	40.6	39.9	40.0	40.0	39.7
Overall Balance	-10.4	-9.3	-9.8	-8.7	-8.3	-7.0	-5.9
Primary balance	-9.9	-8.6	-9.0	-7.8	-7.6	-6.3	-5.0
Public debt, gross	210.2	216.0	229.8	237.3	243.4	243.2	242.7
Money and credit (percent change, end-period)							
Base money	5.8	4.8	15.2	7.0	34.4	...	...
M2 (period average)	2.7	2.8	2.7	2.5	3.6	...	...
Domestic credit	1.3	1.2	0.6	3.5	4.7	...	...
Bank lending	-0.9	-1.8	0.7	1.3	2.2	...	...
Interest rate							
Overnight call rate, uncollateralized (end-period)	0.09	0.08	0.08	0.08	0.07	...	...
Three-month CD rate (annual average)	0.3	0.3	0.3	0.3	0.2	...	...
Official discount rate (end-period)	0.3	0.3	0.3	0.3	0.3	...	...
Balance of payments (in billions of US$)							
Current account balance	145.3	217.5	127.0	58.7	33.1	59.9	63.9
Percent of GDP	2.9	4.0	2.1	1.0	0.7	1.2	1.3
Trade balance	57.6	108.4	-4.1	-53.5	-89.9	-63.1	-59.5
Percent of GDP	1.1	2.0	-0.1	-0.9	-1.8	-1.3	-1.2
Exports of goods, f.o.b.	546.3	733.6	789.0	776.5	695.0	715.8	766.1
Imports of goods, f.o.b.	-488.8	-625.1	-793.1	-830.0	-784.9	-778.9	-825.6
Oil imports (trade basis)	99.9	134.3	182.5	196.9	184.9	192.4	191.4
FDI, net (percent of GDP)	1.2	1.3	2.0	2.0	2.7	2.2	2.2
Terms of trade (percent change)	19.5	-3.3	-7.5	0.8	-2.9	1.8	-2.3
Change in reserves	27.0	43.2	172.8	-38.2	39.5	-4.5	-7.2
Total reserves minus gold (in billions of US$)	1,022.2	1,061.5	1,258.2	1,227.2	1,237.3	...	...
Exchange rates (annual average)							
Yen/dollar rate	93.6	87.8	79.8	79.8	97.6	...	...
Yen/euro rate	130.3	116.5	111.0	102.6	129.6	...	...
Real effective exchange rate (ULC-based) 5/	108.2	109.8	118.5	119.7	96.7	...	...
Real effective exchange rate (CPI-based)	98.9	100.0	101.7	100.3	80.1	...	...

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/ For 2014 export and import growth rates are inflated because of changes in the compilation of BoP statistics (BPM6) implying a break in the series relative to previous years.
4/ Including the effects of consumption tax increases in 2014 and 2015.
5/ Based on normalized unit labor costs; 2005=100.

Table 2. Japan: General Government Operations, 2010–15
(In percent of GDP)

	2010	2011	2012	2013	2014	2015
				Est.	Proj.	
Total revenue	29.6	30.8	31.2	31.7	33.0	33.8
Taxes 1/	16.1	16.6	16.8	17.1	17.9	18.8
Social security contributions	11.8	12.5	12.8	13.0	13.2	13.3
Grants	13.5	0.0	0.0	0.0	0.0	0.0
Other revenue	1.7	1.7	1.6	1.7	1.9	1.7
o/w interest income	1.5	1.4	1.3	1.4	1.6	1.5
Total expenditure	38.9	40.6	39.9	40.0	40.0	39.7
Expense	35.0	36.1	36.1	36.1	36.0	36.0
Compensation of employees	6.1	6.3	6.1	...	...	...
Use of goods and services	3.7	3.8	3.8	...	...	...
Consumption of fixed capital	3.0	3.0	3.0	3.0	3.0	2.9
Interest	2.0	2.1	2.1	2.0	1.9	2.0
Grants	13.6	14.9	14.7	...	...	...
Social security benefits	19.7	20.5	20.7	20.8	20.6	20.6
Other expense	-13.2	-14.5	-14.3	...	...	...
Net acquisition of nonfinancial assets	1.0	1.5	0.8	0.9	1.0	0.7
Acquisitions of nonfinancial assets	3.9	4.5	3.8	3.9	4.0	3.6
o/w public investment	3.3	3.1	3.2	3.6	3.7	3.4
o/w land acquisition	0.4	0.3	0.3	0.3	0.3	0.3
Consumption of fixed capital	-3.0	-3.0	-3.0	-3.0	-3.0	-2.9
Net lending/borrowing (overall balance)	-9.3	-9.8	-8.7	-8.3	-7.0	-5.9
Primary balance	-8.6	-9.0	-7.8	-7.6	-6.3	-5.0
Excluding social security fund	-8.2	-9.0	-8.0	-7.6	-6.3	-5.1
Structural balance	-7.8	-8.3	-7.6	-7.8	-6.7	-5.7
Structural primary balance	-7.2	-7.5	-6.7	-7.0	-6.0	-4.9
Financing	9.3	9.8	8.7	8.3	7.0	5.9
Net issuance of debt securities	10.2	8.7	7.4	...	...	...
Other	-0.9	1.2	1.3	...	...	...
Stock positions 2/						
Debt						
Gross 3/	216.0	231.8	238.8	243.4	243.2	242.7
Net	113.1	127.3	129.5	134.2	136.8	138.4
Net worth	6.5	-3.6	-8.0	...	...	...
Nonfinancial assets	119.6	120.7	119.1	...	...	...
Fixed assets (excluding land)	93.6	95.1	93.9	...	...	...
Land	25.7	25.1	24.7	...	...	...
Other	0.4	0.4	0.5	...	...	...
Net financial worth	-113.1	-124.3	-127.1	...	...	...
Financial assets	102.8	102.1	107.4	...	...	...
Currency and deposits	16.5	16.1	15.9	...	...	...
Loans	6.7	6.7	7.1	...	...	...
Securities other than shares	26.4	25.6	25.4	...	...	...
Shares and other equities	24.0	22.9	24.8	...	...	...
o/w shares	9.4	8.6	10.4	...	...	...
Financial derivatives	0.0	0.0	0.0	...	...	...
Other financial assets	29.3	30.8	34.1	...	...	...
Liabilities	216.0	226.4	234.5	...	...	...
Loans	34.6	34.0	33.9	...	...	...
Securities other than shares	170.2	181.9	189.8	...	...	...
Equities	4.9	5.0	5.0	...	...	...
Financial derivatives	0.0	0.0	0.0	...	...	...
Other liabilities	6.2	5.5	5.8	...	...	...
Memorandum item :						
Nominal GDP (CY, trillion yen)	482.4	471.3	473.8	478.0	492.7	505.8

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

Table 3. Japan: External Sector Summary, 2008–19

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
									Projections			
Balance of payments						*(In billions of U.S. dollars)*						
Current account balance	144	145	217	127	59	33	60	64	71	76	77	89
Trade balance (goods)	56	58	108	-4	-54	-90	-63	-59	-58	-56	-62	-53
Exports of goods	751	546	734	789	776	695	716	766	804	847	890	938
Imports of goods	-695	-489	-625	-793	-830	-785	-779	-826	-862	-903	-951	-991
Services balance	-38.0	-34.9	-33.6	-38.4	-50.6	-35.6	-35.6	-35.6	-35.6	-35.6	-35.6	-35.6
Income balance	138.7	135.0	155.1	183.2	177.1	168.8	168.7	169.1	174.7	178.1	184.7	188.0
Credits	193.5	175.7	201.8	233.8	231.8	222.1	219.0	219.3	227.6	231.9	240.2	244.5
Debits	-54.7	-40.7	-46.7	-50.6	-54.7	-53.3	-50.2	-50.2	-52.9	-53.8	-55.4	-56.5
Current net transfers	-13.1	-12.4	-12.4	-13.9	-14.3	-10.1	-10.0	-10.0	-10.0	-10.0	-10.0	-10.0
Capital account	-5.4	-5.0	-4.9	0.4	-1.0	-7.6	-4.0	-4.1	-4.1	-4.1	-4.1	-4.1
Financial account	210.0	183.1	265.3	182.6	54.2	-73.6	55.9	59.8	67.0	72.2	73.4	85.3
Direct investment, net	86.3	61.2	71.2	116.7	119.1	133.4	105.1	111.1	109.4	116.1	114.2	121.8
Portfolio investment, net	278.5	219.1	150.9	-162.0	40.4	-261.1	9.9	10.2	7.8	7.1	5.0	9.5
Other investment, net	-185.8	-124.3	-0.1	55.1	-67.0	14.6	-54.6	-54.3	-52.1	-51.8	-48.7	-47.8
Reserve assets	31.0	27.0	43.2	172.8	-38.2	39.5	-4.5	-7.2	1.8	0.9	2.8	1.8
Errors and omissions, net	47.7	32.7	41.0	38.4	3.9	-42.2	0.0	0.0	0.0	0.0	0.0	0.0
						(In percent of GDP)						
Current account balance	3.0	2.9	4.0	2.1	1.0	0.7	1.2	1.3	1.4	1.4	1.4	1.5
Trade balance (goods)	1.2	1.1	2.0	-0.1	-0.9	-1.8	-1.3	-1.2	-1.1	-1.0	-1.1	-0.9
Exports of goods	15.5	10.9	13.3	13.3	13.1	14.2	14.8	15.1	15.3	15.5	15.7	16.0
Imports of goods	-14.3	-9.7	-11.4	-13.4	-14.0	-16.0	-16.1	-16.3	-16.4	-16.5	-16.8	-16.9
Services balance	-0.8	-0.7	-0.6	-0.6	-0.9	-0.7	-0.7	-0.7	-0.7	-0.7	-0.6	-0.6
Income balance	2.9	2.7	2.8	3.1	3.0	3.4	3.5	3.3	3.3	3.3	3.3	3.2
Global assumptions												
Exchange Rate (¥/US$)	103.4	93.6	87.8	79.8	79.8	97.6	101.7	99.7	98.8	97.4	96.2	95.0
(Percent change)	-12.2	-9.5	-6.2	-9.1	0.0	22.3	4.2	-1.9	-0.9	-1.4	-1.2	-1.3
Oil prices (US$/barrel)	97.0	61.8	79.0	104.0	105.0	104.1	104.1	99.6	95.1	92.3	90.6	89.4
(Percent change)	36.4	-36.3	27.9	31.6	1.0	-0.9	0.1	-4.3	-4.6	-2.9	-1.9	-1.4
Memorandum items :												
Nominal GDP (US$ billion)	4,850	5,035	5,495	5,911	5,937	4,900	4,844	5071	5253	5459	5664	5875
Net foreign assets (NFA)/GDP, US$ basis	51	57	56.2	57.8	57.7	69.1	69.9	67.0	64.6	62.2	59.9	57.7
Return on NFA (in percent), US$ basis	5.6	4.7	5.0	5.4	5.2	5.0	5.0	5.0	5.2	5.3	5.4	5.6
Net export contribution to growth	0.2	-2.0	2.0	-0.8	-0.7	-0.2	0.0	0.2	0.1	0.1	0.1	0.1

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

Table 4. Japan: Medium-Term Projections, 2012–19

	2012	2013	2014	2015	2016	2017	2018	2019
			Projections					
				(Percent change)				
Real GDP	1.4	1.5	1.6	1.1	0.9	1.0	1.0	1.1
Total domestic demand	2.3	1.8	1.8	0.8	0.7	0.9	0.9	1.1
Net exports (contribution)	-0.7	-0.2	0.0	0.2	0.1	0.1	0.1	0.1
Unemployment rate (percent)	4.3	4.0	3.9	3.9	4.0	3.9	4.0	4.0
Headline CPI inflation (average)	0.0	0.4	2.8	2.1	2.7	2.0	2.0	2.0
memo item: without planned consumption tax increases	0.0	0.4	1.1	1.3	1.8	2.0	2.0	2.0
Output gap (in percent of potential output)	-3.1	-2.1	-1.1	-0.7	-0.4	0.0	0.0	0.0
				(In percent of GDP)				
Overall fiscal balance	-8.7	-8.3	-7.0	-5.9	-4.8	-4.6	-4.7	-4.8
Primary balance	-7.8	-7.6	-6.3	-5.0	-3.8	-3.4	-3.2	-3.0
General government debt								
Gross	238.8	243.4	243.2	242.7	241.2	240.1	239.0	238.2
Net	129.5	134.2	136.8	138.4	138.8	139.1	139.0	138.9
External current account balance	1.0	0.7	1.2	1.3	1.4	1.4	1.4	1.5
National savings	21.8	21.7	23.1	23.1	23.3	23.8	24.1	24.8
Private	22.7	21.9	21.9	21.1	20.5	21.0	21.4	22.3
Public	-0.9	-0.2	1.2	2.1	2.8	2.8	2.7	2.5
National investment	20.8	21.0	21.9	21.9	21.9	22.4	22.8	23.3
Private	16.3	16.1	16.7	17.2	17.9	18.4	18.9	19.4
Public	4.4	5.0	5.2	4.6	4.1	4.0	3.9	3.8

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

Table 5. Japan: FSIs for Deposit-taking Institutions: All Banks

	2010 Mar	2011 Mar	2012 Mar	2013 Mar	2013 Sep
	(In percent)				
Capital adequacy					
Total capital ratio 1/2/	13.3	13.8	14.2	14.7	14.9
Tier 1 ratio 1/2/	9.9	10.7	11.3	12.2	12.5
NPL net of provisions/capital 1/3/	22.7	22.2	21.4	19.2	17.8
Asset quality					
Non-performing loans (NPL) to total loans ratio 1/3/	2.5	2.4	2.4	2.3	2.1
Sectoral distribution of loans 3/4/					
Residents	94.8	94.0	93.8	92.5	91.9
Deposit-takers	8.0	7.7	8.2	9.1	7.3
Central bank	0.0	0.0	0.0	0.0	0.0
Other financial corporations	10.0	9.3	9.5	9.3	9.4
General government	7.1	7.7	7.9	8.1	8.3
Non-financial corporations	35.0	34.4	34.0	32.5	32.7
Other domestic sectors	34.7	34.8	34.2	33.5	34.2
Non-residents	5.2	6.0	6.2	7.5	8.1
Earnings and profitability					
Return on assets 1/3/	0.2	0.3	0.3	0.3	0.4
Return on equity 1/3/	5.5	6.9	6.5	7.6	8.9
Interest margin	1.6	1.5	1.5	1.4	1.3
Net interest income/gross income 1/3/	74	70	69	66	64
Non-interest expenses/gross income 1/3/	63	63	63	62	60
Personnel cost/operating cost 1/3/	48	48	…	44	…
Liquidity					
Liquid assets/total assets 1/3/	22	23	24	24	22
Liquid assets/short-term liabilities 1/3/	44	45	46	44	41
Loan/deposit 1/3/	77	75	75	75	76
Other					
Capital/total assets 1/2/	4.4	4.7	4.7	5.5	5.6
Risk-weighted assets/total assets	49	45	43	42	42
Trading income/total income 1/3/	…	…	…	9.7	…
Gross derivative asset/capital 1/3/	71	61	54	51	41
Gross derivative liability/capital 1/3/	65	57	52	50	40

Sources: Japanese authorities and IMF staff calculations.
1/ Including city banks and regional banks and but not shinkin banks.
2/ Aggregated based on a consolidated basis.
3/ Aggregated based on an unconsolidated basis.
4/ Including all deposit-taking institutions in Japan.

Annex I. Japan: New Growth Strategy and Status of Structural Reforms

Abenomics' Third Arrow: Key Measures and Status

Update of Growth Strategy on June 24, 2014			
	On June 24, the Abe cabinet approved a revised growth strategy, which lays out a roadmap for further "3rd arrow" reforms. The strategy lists a menu of measures with many details to be defined. Key measures include plans to reduce the corporate income tax rate from over 35 percent to below 30 percent (size, timeframe and financing under discussion) and further corporate governance reforms to encourage a more productive use of corporate savings. The strategy also mentions labor market reforms by possibly removing tax disincentives for women to work, greater use of foreign labor in health and household services, and measures to incentivize a shift from overtime- to performance-based remuneration. Few concrete measures were announced on agricultural reform or the role of Special Economic Zones.		
Policy area	**Key measures planned by the authorities and status**	**IMF advice**	**Size of impact if comprehensive reform consistent with IMF advice is**
Labor Market			
Female labor participation	Increase childcare facilities and childcare leave benefits (implementation ongoing). Removal of tax and social security disincentives for working spouses (under discussion). Expanded internship program for reemployment of women.	Increasing the availability of child care. Eliminating tax and social security distortions.	An increase in the FLP rate to the G-7 average-- combined with a rise in old age labor force participation--could raise potential growth by 0.25 percent per year (Source: 2013 Art. IV Report).
Foreign labor	Relaxation of current points-based preferential immigration system (under discussion). Expanding trainee program for immigrant workers in construction from 2015 (decided). Expanding the trainee program also for other sectors beyond construction and including nursing in the program (under discussion). Use SEZs to encourage use of foreign human resources (under discussion).	Relaxation of immigration requirements, especially, in sectors with labor shortages.	Immigration equivalent to a rise of Japan's labor force by 1 percent distributed over a decade could increase potential growth by 0.1-0.2 percent per year (2013 Art. IV).
Reducing Labor Duality	Encourage use of 'limited regular' contracts to reduce labor market duality and increase productivity (under discussion). Expand subsidies for job mobility (decided from budget 2015). Discussion underway to ease non-regular work rules (Bills related to dispatched workers and fixed-term workers submitted to the current Diet).	Implementing steps to reduce labor market duality and increase productivity, including clarifying the legal framework for limited regular contracts.	Substantial reduction in labor market duality would increase productivity and would be likely to have a substantial impact on potential growth, but difficult to quantify (Aoyagi and Ganelli IMF WP 13/202).
Deregulation			
Special Economic Zones (deregulation)	Six areas designated on March 28, 2014--including Tokyo and Osaka--accounting for about 40 percent of GDP. Expected deregulation includes easing restrictions on land use and medical practices, agriculture reform, and creation of new businesses. SEZs are expected to propose specific measures--to be vetted by a national committee--in the near future.	Using SEZs as a laboratory for reforms to be implemented at the national level.	Unlikely to have a significant growth effect in short term. Potentially laboratory for country-wide reform.
Agricultural reform	Land banks to increase farm size established. Review of rice production adjustments ongoing (*gentan* system to end by FY 2018). Various strategies for opening of agricultural markets being discussed.	Fully deregulating agriculture to raise productivity and competition.	Full deregulation in agriculture could boost productivity by up to 30 percent albeit sector size is small in percent of GDP (IMF estimates).

Policy area	Key measures planned by the authorities and status	IMF advice	Size of impact if comprehensive reform consistent with IMF advice is
Deregulation			
Electricity sector reform	First fundamental reform in 60 years to be completed by 2020, including (i) a gradual opening of grid, (ii) liberalization of the retail electricity sector, and (iii) legal separation between electricity generators and distributors and abolish retail price regulation. Legislation regarding part (i) and (ii) passed.		Likely to have a substantial impact on potential growth. Economic impact difficult to quantify.
Business Sector			
Corporate governance reform	Published Japan's Stewardship code for institutional investors, which 127 institutional investors have agreed to adopt as of end May 2014. Current Diet session amended the Companies Act with measures which would strengthen corporate governance, including by strengthening audit functions and introducing outside independent directors on a "comply or explain" basis. Introduction of a corporate governance code for firms (under discussion).	Implementing comprehensive corporate governance reform, including by complementing the Stewardship Code for institutional investors with a corporate governance code for firms, and adopting measures to expand the use of outside directors beyond current plans.	More efficient corporate decision making by raising shareholders' power could result in unlocking excessive corporate savings. Economic impact difficult to quantify but likely to be substantial (see Aoyagi and Ganelli 2014, forthcoming IMF WP).
Corporate taxation	Reduction of corporate tax rate (from 34.6 percent) with offsetting measures (intention to go ahead publicly announced by PM Abe but with details to be specified later). Government internal discussions ongoing about elimination/reduction of existing tax incentives.	CIT reform is desirable as part of a comprehensive medium term fiscal consolidation package.	CIT rate cut is likely to be good for investment and growth, but not self-financing, so compensatory measures will need to be identified.
Trade			
Trade negotiations (TPP)	Started participating in negotiation of the ambitious 12-nation free trade plan in July, 2013: More negotiating to do after multi-lateral talks failed in Singapore in February, 2014. Japan-US remain far apart on the issue of tariff reduction/elimination of Japan's "sacred" agricultural products.	Joining the TPP Agreement and use it as an opportunity to deregulate protected sectors.	Comprehensive deal: 0.1- 0.2 higher growth p.a. (Peterson Institute)
Financial Sector			
Financial sector reform	GPIF to shift away from JGBs towards other assets (proposed in November 2013). New stock market index including only profitable companies (launched in January 2014). Tax-free investment accounts (NISA) to encourage shifting household savings away from cash (launched in January 2014).	Phasing out the full credit guarantees to SMEs. Strengthening capital standards of domestic banks and monitoring of risks from overseas activities of internationally active banks.	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 (Source: 2013 Art. IV Report).
Wage Policy			
Coordination of wage setting	Tripartite Commission. Tax incentives for increasing wages introduced in 2013.	Tax incentives could be expanded and better targeted. A higher than usual increase in the minimum wage could be considered to raise base wages.	Likely to have a substantial impact on short term growth and help Abenomics transition to a private-sector lead phase.
Source: Staff estimates.	Degree of progress of reforms: Significant	Medium progress	Limited progress

Annex II. Japan: Risk Assessment Matrix[1]

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 rates and thereby stimulate activity as well as leading to sustained 2-percent 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.
➢ **Protracted period of slower growth in advanced and emerging economies**	**High** The recovery in the U.S. could be weaker than expected, while the recovery is much more subdued in the euro area. EMs may not recover back to their pre-crisis growth paths. Implementation of Japan's three-pronged recovery strategy could be less successful.	**High** GRAM simulations show that Japanese GDP growth could be lower by 2–3 percent relative to the baseline. *Policy response:* The BoJ's QQE could be recalibrated, including the pace and composition of asset purchases. If the authorities commit to a concrete and credible fiscal consolidation plan by passing concrete measures, the 2014–15 fiscal withdrawal could be made more gradual, but the second round of consumption tax increase should proceed as planned.
➢ **Bond market stress from a reassessment in sovereign risk in Japan**	**Medium** Disappointing growth reforms and lack of concrete fiscal measures to bring down public debt could trigger a significant rise in the risk premium.	**High** The 2012 FSAP Update indicates that an increase in the sovereign risk premium by 200bps could undermine financial stability and worsen debt dynamics. *Policy response:* BoJ bond purchases should be increased, fiscal adjustment frontloaded, and ambitious structural reforms implemented to contain risks. The government should confirm the second-round of the consumption tax increase.
➢ **Surges in global financial market volatility, triggered by revised market expectations on UMP exit**	**High** Bouts of market volatility and higher-than-expected increases in long-term rates could occur as a result of AEs' exiting from unconventional monetary policy.	**Low** Strong growth in the U.S. would support exports and a widening of the interest rate differential would facilitate portfolio rebalancing. However, these effects would be offset by safe-haven effects, lower exports to EMs, and falling confidence. *Policy response*: The BoJ could recalibrate the QQE depending on market developments. Bold implementation of structural reforms is important to boost domestic demand and maintain confidence.
➢ **A sharp increase in geopolitical tensions surrounding Russia/Ukraine**	**Medium** Doubts about whether Ukraine will consistently make timely commercial and financial payments, both internally and externally; financial and trade disruptions; contagion; a further slowdown in Russia; and uncertainty all trigger a re-pricing of risks and heightened volatility in financial markets.	**Low** While financial and trade linkages with Eastern Europe are weak, Russia is an important source of mineral fuel imports. If global oil and gas prices increase by 15 and 10 percent, respectively, the trade balance would deteriorate by about 0.6 percent of GDP in 2014. Furthermore, the yen could strengthen from safe-haven effects undermining exports and progress on inflation. *Policy response*: Ambitious structural reforms are important to boost domestic demand and confidence. Albeit small, automatic stabilizers should be allowed to operate. The pace of BoJ asset purchases could be accelerated.
➢ **Disruptions triggered by geopolitical incidents in East Asia**	**Low** An incident in the East China Sea could lead to disruptions in financial flows, and possibly trade routes with a direct impact on global market sentiment and a flight to safety.	**Medium** The already subdued recovery of exports would stall not only due to close trade links with neighboring economies but also due to potential yen appreciation on safe-haven effects. *Policy response*: If the authorities commit to a credible fiscal consolidation plan by passing concrete measures, the near-term fiscal withdrawal could be made more gradual. Ambitious structural reforms are important to boost domestic demand and the pace of BoJ asset purchases could be accelerated.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non mutually exclusive risks may interact and materialize jointly.

Annex III. Assessment of Japan's External Sector

	Japan	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) position has risen to over 60 percent of GDP in 2013 (from 35 percent ten years ago). In the medium term, despite likely valuation effects, it is projected to stabilize around 70 percent of GDP, in light of the outlook for the current account, as private saving declines with aging. **Assessment**. Vulnerabilities are limited. Japan's positive NIIP generates sizable investment income (average 3 percent of GDP over the past five years). Risks on assets and their returns are also diversified geographically and in terms of investment type.	**Overall Assessment**: *The external position is broadly consistent with medium-term fundamentals and desirable policies*. However, a large degree of uncertainty around specific estimates must be acknowledged. **Potential policy responses**: Policy gaps for Japan are primarily of internal rather than external sustainability. Full implementation of the fiscal and structural reform arrows of Abenomics is needed to close the policy gaps. Fiscal consolidation would raise national savings above the baseline forecast, more than offsetting the decline in private saving from aging, and raise the current account surplus. Ambitious structural reforms including liberalizing trade through the approval of trade agreements could partially offset this by boosting productivity, domestic income, and imports.
Current account	**Background**. The 2013 current account (CA) surplus narrowed to 0.7 percent of GDP (0.8 percent cyclically-adjusted). Despite the yen depreciation, exports recovered only sluggishly due to a combination of a higher share of overseas production, competitiveness problems in traditional strongholds such as consumer electronics, and slow pass-through of the depreciation to lower export prices. Imports remained elevated as a result of temporarily high demand for fossil fuels and greater import penetration in certain areas, such as handsets. In 2014, the current account is projected to rise to 1.2 percent of GDP as exports recover and the fiscal deficit declines, although energy imports are likely to remain high in the near-term. **Assessment**. Correcting for temporarily higher energy imports, delayed effects of depreciation on the trade balance, and elevated rush demand for imports ahead of the 2014 consumption tax hike, staff estimates the underlying, cyclically-adjusted CA to be about 1-1 ¼ percentage point higher than estimated by the EBA CA regression model. Adjusting for the full impact of the new macro policy framework under Abenomics and structurally lower export elasticities, staff estimates the CA norm to be 2 percent of GDP, just under 1 percentage point lower than the EBA estimate (see notes 1,2,3 in technical background). Staff assesses the underlying CA to be in line with fundamentals and desirable policies (compared to the EBA estimated gap: 2 percent). Uncertainties around the assessment suggest a wide range of +/-1½ percent of GDP around a midpoint of zero (see note 4, in technical background).	
Real exchange rate	**Background**. After having depreciated by close to 20 percent between 2012 and 2013, the real effective exchange rate (REER) depreciated by another 5 percent by May 2014 relative to the average value in 2013. This is in part due to a sustained trade deficit and widening long term interest rate differentials relative to the U.S. (related to asynchronous stances of the U.S. Federal Reserve and the Bank of Japan). **Assessment**. The EBA REER regression model assesses the 2013 average REER to be 14 percent weaker compared to the level consistent with fundamentals and desirable policies, primarily from a large unexplained residual while the policy gap is close to zero (the specification does not include fiscal P*). The EBA REER model however does not capture e unusual factors affecting the REER – large short speculative positions against the currency used to hedge long equity exposures in the domestic stock market, temporarily higher energy imports, and a sudden widening of long-term sovereign spreads relative to other advanced economies. There is therefore a high degree of uncertainty in the model estimates. Instead, using the CA gap range as reference, staff assess a midpoint of zero with indicative ranges of -15 percent undervaluation to +15 percent overvaluation for 2013. (see notes 4 and 5 in technical background).	
Capital and financial accounts: flows and policy measures	**Background**. The appreciation and recent depreciation of the yen since the global financial crisis have not been associated with notable capital in- or outflows. Instead, the main driver of exchange rate movements appears to be the derivative position, reflecting hedging as well as speculative positions. The scale of the new monetary easing policy could result in some spillovers, notably a larger flow of capital to the region's other economies. **Assessment**. Safe haven flows imply limited vulnerabilities to global financial instability.	
FX intervention and reserves level	**Background**. Reserves are higher than in other reserve asset issuers (about 20 percent of GDP) on legacy accumulation. The exchange rate is free floating and the level of the yen is market determined. **Assessment**. Staff assess isolated foreign exchange interventions during safe haven periods as directed toward reducing short-term volatility, with ambiguous effects on the level of the exchange rate.	

Technical Background Notes	1/ The new macro policy framework under Abenomics will translate into higher domestic demand, inflation, and productivity, which lead to a smaller required fiscal adjustment than under the EBA CA model – i.e. the policy gap is smaller than estimated by EBA. 2/ Export elasticities are structurally lower because offshoring of production and a higher share of intermediate goods exports makes Japanese exports less sensitive to yen fluctuations than in the past. 3/ The norm is positive because of high corporate saving in excess of domestic investment opportunities, low residential investment, and a sizable income account owing to the large NFA position and favorable return differential on assets relative to liabilities. 4/ Large bands around the CA midpoint estimate are the result of three factors, each contributing about ½ a percent of GDP to the +/- 1.5 percent of GDP range: (i) varying estimates of the reversal of temporary effects on the underlying current account balance, in particular fossil fuel imports; (ii) difficult to quantify CA implications of Abenomics policies via higher growth and productivity and the effects on fiscal adjustment needs; and (iii) uncertain long-run trade balance effects of structural changes, such as increased overseas production and reduced competitiveness of tradables in some sectors. Ranges around these adjustments to the CA balance are assumed to be symmetric and not correlated with each other. 5/ This large range for the REER gap is associated with a narrow range for the CA gap because lower trade elasticities have reduced the sensitivity of the CA to REER changes.

Annex IV. Japan: Main Recommendations of the 2013 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal Policy:	
Implementation of the consumption tax rate increase to 10 percent by October 2015 while avoiding multiple rates.	The consumption tax rate was increased to 8 percent in April.
An ambitious and concrete consolidation plan beyond 2015 to bring public debt firmly on downward path. The medium-term fiscal plan should be as growth friendly as possible, including:	The Diet passed a supplementary budget in early 2014 to support near-term growth (1.2 percent of GDP over two years).
• *Increasing* the consumption tax gradually to a uniform rate of at least 15 percent. • *Broadening* the personal income tax base, including by reducing the exemption for pension income and eliminating tax deduction for dependent spouses. • *Lowering* the corporate tax rate to improve investment incentives and reducing payroll tax to simulate labor effort. • *R*educing pension spending by raising pension retirement age to 67, collecting contributions from dependent spouses, and clawing back benefits from wealthy retirees. • *Strengthening* the fiscal framework by adopting medium-term rules to curb expenditure and limiting the conditions under which supplementary budgets can be used.	In March 2014 the Diet repealed a temporary increase of the corporate tax rate and brought the corporate income tax rate back to 34.6 percent (by about 3 ppt).
Monetary Policy:	
The BoJ should continue with QQE but recalibrate its easing policies in the event inflation does not pick up or JGB market volatility rises.	The BoJ maintains the pace of asset purchases under its QQE framework.
The BoJ should begin planning early to address exit risks, including considering indemnification against capital losses on bond holdings.	In March 2014, The BoJ extended the loan support program by another one year and doubled the size of its funding amount.
Financial Sector Policy:	
Strengthening capital standards for domestically oriented banks by including unrealized losses from capital adequacy ratio (FSAP update).	The FSA strengthened CAR standards from March 2014, which will raise the quality of capital by setting "core-capital" as regulatory capital, while keeping the minimum ratio of 4 percent.
Mitigating foreign-exchange funding risks for banks with overseas activities by raising deposits overseas and by issuing long-term foreign-denominated debt.	The authorities are monitoring forex funding risks, including through frequently checking liquidity positions. The BoJ established cross-border collateral arrangements with Singapore and Thailand, and agreed to establish one with Indonesia, to help reduce local-currency funding risks in overseas markets.
Assessing the solvency of insurers on economic valuation (FSAP update).	
Growth Strategy	
Deregulating agriculture and domestic services sectors to raise productivity and competition, and to encourage inward foreign investment.	The Diet approved several bills, including ones to designate national strategic special zones, facilitate farmland consolidation, and reform the electricity sector and employment system (see Annex I). On June 24, the government unveiled an update of its growth strategy. Main measures included plans to lower the corporate income tax rate and further corporate governance reforms.
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.	
Implementing steps to reduce labor market duality and increase flexibility, including clarifying the legal framework for limited regular (“gentei seishain”) contracts.	
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.	

Annex V. Japan: Debt Sustainability Analysis

Assumptions. The analysis is based on the following key macroeconomic projections and policy assumptions (Table 4): real growth is projected to slow to 1 percent during 2015–19 and then remain at that level beyond the medium-term assuming moderate gains from currently approved structural policies. Monetary policy is assumed to remain accommodative until the 2 percent inflation target is reached in a stable manner around 2017/18. Fiscal policy assumes the implementation of the second stage of the consumption tax rate increase, but only small further adjustments after 2015. As a result, long-term interest rates are projected to pick up with rising inflation expectations to 3.5 percent on new bond issuances, but because of the average maturity of government bonds of around 6.5 years (including financing bills), the nominal effective interest rate on public debt is lower and rises gradually to 1.7 percent in 2019, implying an interest-growth differential of -0.7 with nominal GDP growth rate of 2.4 percent. As a result, the overall fiscal balance will remain around 4.6–4.8 percent of GDP during 2016–19 with a slowly improving primary balance and rising interest payments.

Assessment. Japan's public debt is unsustainable under the current policy settings. Although the gross debt to GDP ratio is projected to stabilize at around 240 percent of GDP during the WEO projection period due to a declining primary deficit and a favorable differential between interest and growth rates compared to past values, complementary analysis covering up to 2030 shows that the debt ratio will start increasing again in 2020, reaching around 280 percent of GDP in 2030. The net debt to GDP ratio is assumed to move in a similar way, although it is lower by around 100 percent of GDP, reflecting Japan's large financial assets.

Financing Needs. Japan's gross financing needs (defined as the public sector deficit, plus all maturing debt) were 55 percent of GDP in 2014, the highest among the advanced economies. As the primary deficit declines, the gross financing needs are estimated to fall as well, although they remain exceptionally large at 52 percent of GDP in 2019. Although the government intends to lengthen the average maturity of JGBs, as no specifics have been provided, a similar maturity structure to the one in 2014 is assumed for the projection period.

Debt Profile. The debt financing conditions are helped in the medium-term by a number of factors. The 10-year bond yield has been at a record low and its spread against the US is negative at around 200 basis points. The external financing requirement, incorporating the current account surplus, is well below the lower threshold at 9 percent of GDP. This reflects the fact that foreign holding of JGBs is quite low at 7 percent. In addition, there are no direct risks related to exchange rates as no debt is denominated in foreign currencies, which is also assumed for the future.

Net Debt. Given the large financial assets held by the government, net debt is also an important indicator for Japan. It should be noted, however, that not all the financial assets are available for debt repayment or easy to liquidate as for example, they include assets for future pension payments. The financial-assets-to-GDP ratio is assumed to gradually decline from 109 percent in 2012 to 99 percent in 2019 partly due to scheduled asset sales to fund part of earthquake reconstruction spending. Therefore, the net-debt-to-GDP ratio is projected to increase more than the gross ratio during 2012–19.

Realism of Baseline Assumptions.

- Past assumptions on real growth[1] have not been too optimistic or pessimistic compared to peer countries. Although past projections of the GDP deflator were on the optimistic side, the difference with actual values is small.

- Past assumptions on the primary balance have been neither too optimistic nor pessimistic. The size of Japan's 3-year adjustment on a cyclically adjusted primary balance (CAPB) basis is in the top quintile of the historical experience for high-debt market access countries, but the CAPB level is on the lowest end (large deficit). Staff believes that the pace of fiscal consolidation in 2014–16 of around 1 percentage point of GDP per annum is appropriate, balancing the high deficit and debt on one hand, with the need to end deflation and revive growth on the other.

- Implicit growth without fiscal adjustment is higher than potential for the projection period, but this is due to supportive monetary easing and the confidence effect that fiscal consolidation is assumed to bring about. Here the fiscal multiplier is assumed to be 0.5, which is lower than the default value of 1. The reasons for this include that about half of the fiscal consolidation is assumed to come from revenue measures (mainly consumption tax increases), there are partly offsetting rate reductions in more distortionary taxes, while expenditure reductions are recommended to take place in areas with relatively lower multipliers such as pension payments to the wealthy.

[1] Optimistic growth projections for 2011 are mainly due to the earthquake.

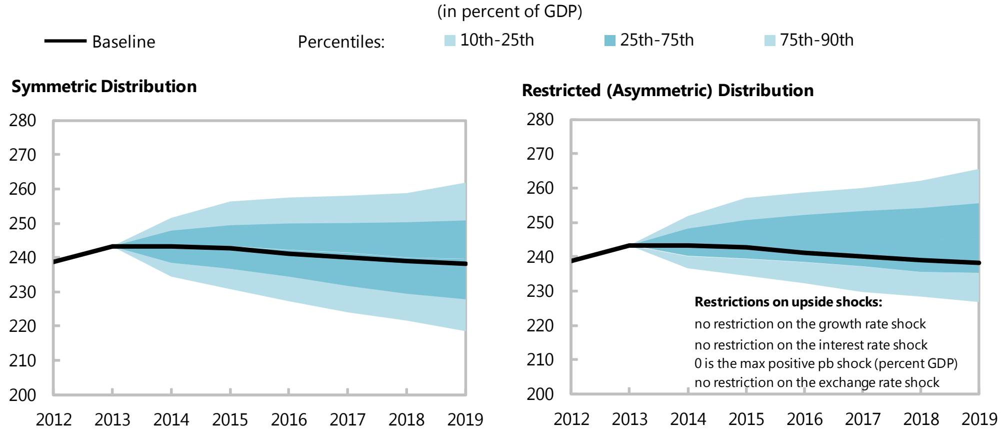
Japan: Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

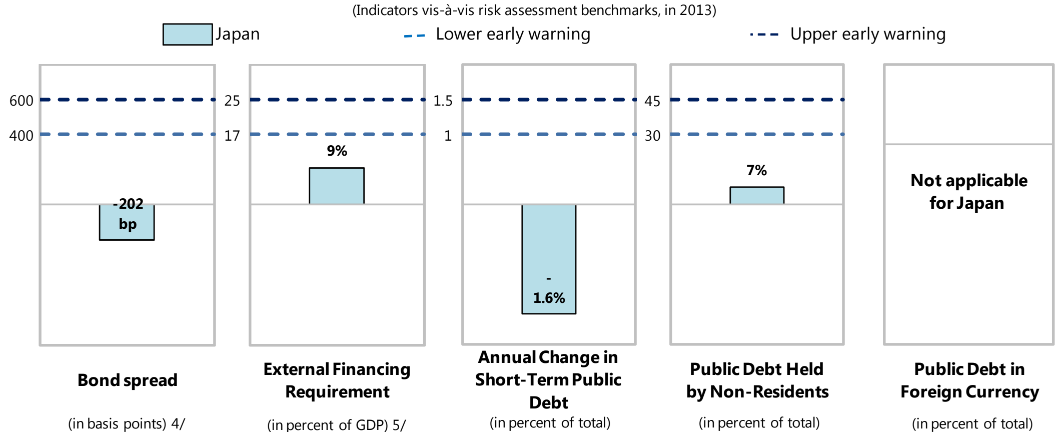
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

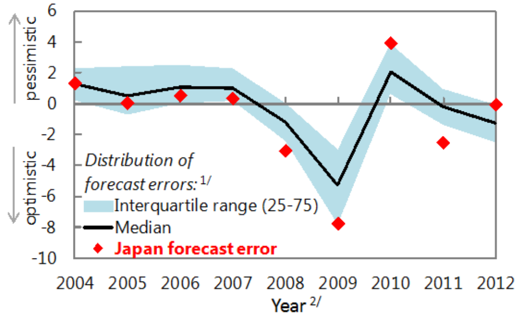
4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 25-Mar-14 through 25-Jun-14.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

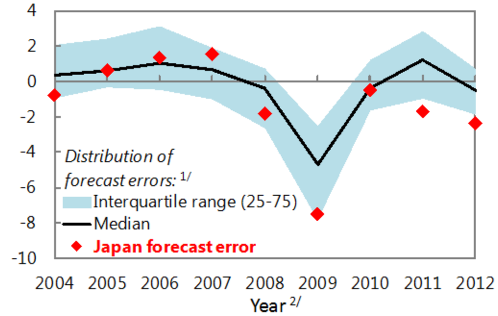
Japan: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

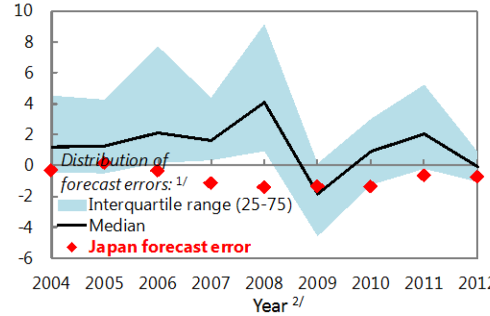
Real GDP Growth
(in percent, actual-projection)
Japan median forecast error, 2004-2012: 0.03
Has a percentile rank of: 43%



Primary Balance
(in percent of GDP, actual-projection)
Japan median forecast error, 2004-2012: -0.76
Has a percentile rank of: 34%

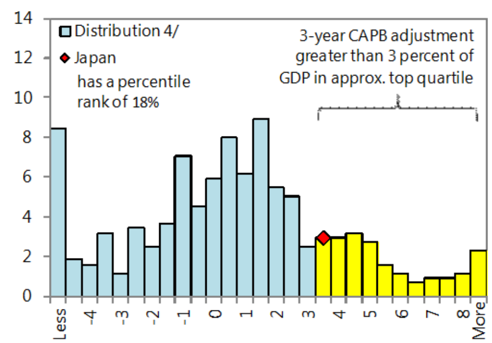


Inflation (Deflator)
(in percent, actual-projection)
Japan median forecast error, 2004-2012: -0.73
Has a percentile rank of: 6%

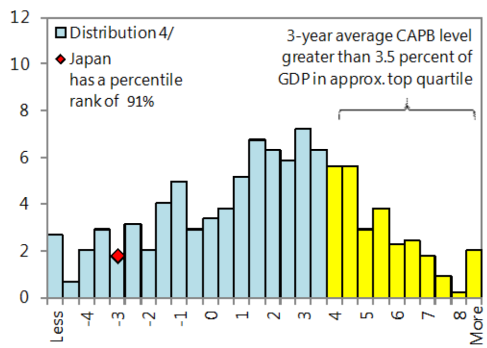


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

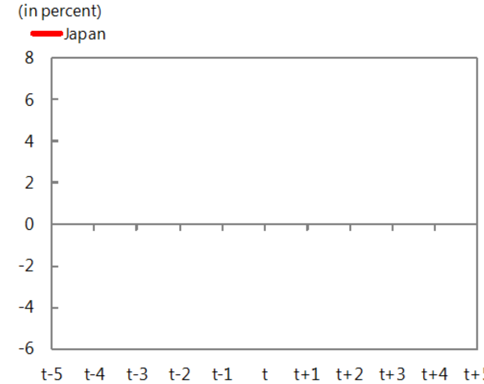


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Japan.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Japan: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario
(in percent of GDP unless otherwise indicated)

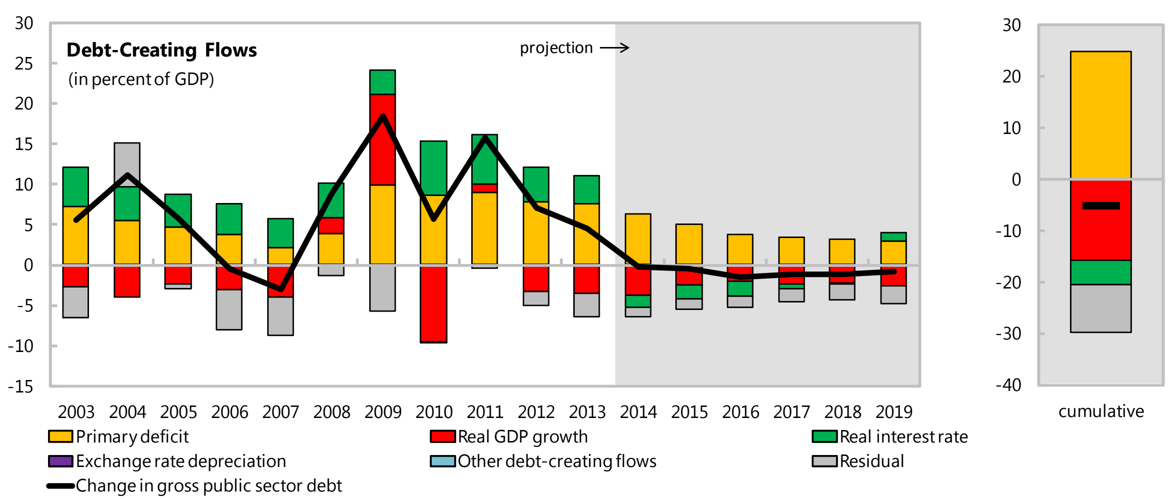
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2003-2011 [2]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	195.0	238.8	243.4	243.2	242.7	241.2	240.1	239.0	238.2
Public gross financing needs		58.1	57.8	54.8	55.9	54.7	53.3	52.5	52.3
Net public debt	93.9	129.5	134.2	136.8	138.4	138.8	139.1	139.0	138.9
Real GDP growth (in percent)	0.8	1.4	1.5	1.6	1.1	0.9	1.0	1.0	1.1
Inflation (GDP deflator, in percent)	-1.4	-0.9	-0.6	1.4	1.6	1.8	1.4	1.5	1.3
Nominal GDP growth (in percent)	-0.6	0.5	0.9	3.1	2.7	2.7	2.4	2.5	2.4
Effective interest rate (in percent) [4]	1.0	0.9	0.8	0.8	0.8	1.0	1.2	1.4	1.7

As of June 25, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		-199
5Y CDS (bp)		37
Ratings	Foreign	Local
Moody's	Aa3	Aa3
S&Ps	AA-u	AA-u
Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	7.5	7.0	4.6	-0.2	-0.4	-1.5	-1.1	-1.1	-0.8	-5.1	
Identified debt-creating flows	9.3	8.7	7.4	1.0	0.7	-0.2	0.5	0.8	1.4	4.2	
Primary deficit	6.1	7.8	7.6	6.3	5.0	3.8	3.4	3.2	3.0	24.7	-1.6
Primary (noninterest) revenue and grants	28.3	30.0	30.5	31.8	32.6	33.7	33.7	33.8	33.8	199.4	
Primary (noninterest) expenditure	34.4	37.8	38.0	38.1	37.7	37.5	37.2	37.0	36.8	224.1	
Automatic debt dynamics [5]	3.2	0.9	-0.1	-5.3	-4.3	-4.0	-2.9	-2.4	-1.6	-20.6	
Interest rate/growth differential [6]	3.2	0.9	-0.1	-5.3	-4.3	-4.0	-2.9	-2.4	-1.6	-20.6	
Of which: real interest rate	4.5	4.2	3.5	-1.5	-1.8	-1.9	-0.5	-0.1	1.1	-4.8	
Of which: real GDP growth	-1.3	-3.3	-3.6	-3.8	-2.5	-2.0	-2.4	-2.3	-2.6	-15.7	
Exchange rate depreciation [7]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	-1.8	-1.7	-2.9	-1.2	-1.2	-1.3	-1.6	-1.9	-2.2	-9.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

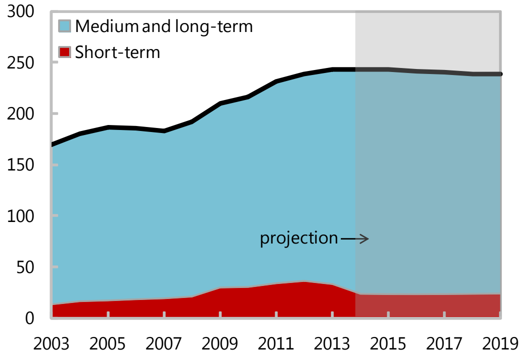
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Japan: Public DSA – Composition of Public Debt and Alternative Scenario

Composition of Public Debt

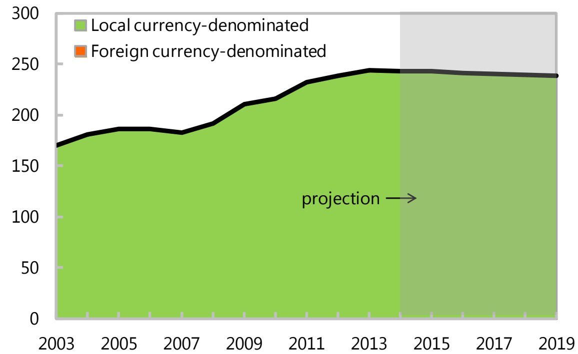
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

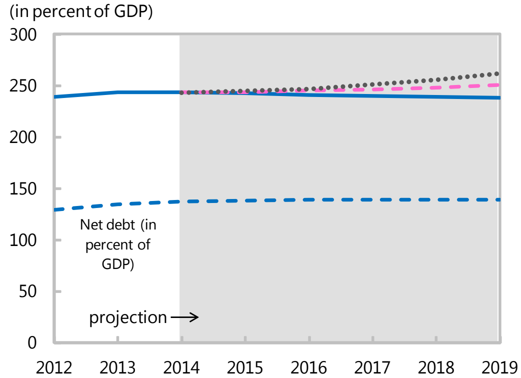


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

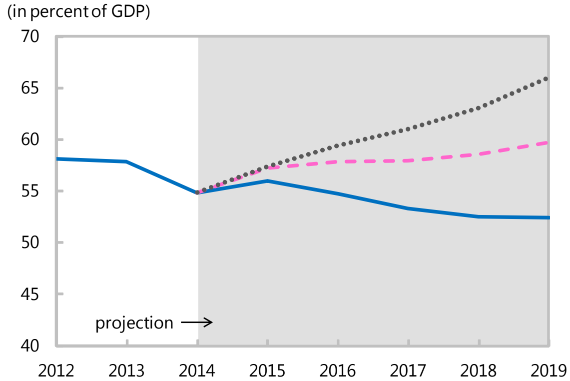
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	1.6	1.1	0.9	1.0	1.0	1.1
Inflation	1.4	1.6	1.8	1.4	1.5	1.3
Primary Balance	-6.3	-5.0	-3.8	-3.4	-3.2	-3.0
Effective interest rate	0.8	0.8	1.0	1.2	1.4	1.7
Constant Primary Balance Scenario						
Real GDP growth	1.6	1.1	0.9	1.0	1.0	1.1
Inflation	1.4	1.6	1.8	1.4	1.5	1.3
Primary Balance	-6.3	-6.3	-6.3	-6.3	-6.3	-6.3
Effective interest rate	0.8	0.8	1.0	1.2	1.4	1.7

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	1.6	0.8	0.8	0.8	0.8	0.8
Inflation	1.4	1.6	1.8	1.4	1.5	1.3
Primary Balance	-6.3	-6.3	-6.3	-6.3	-6.3	-6.3
Effective interest rate	0.8	0.8	1.6	2.0	2.5	2.9

Source: IMF staff.

Shocks and Stress Tests

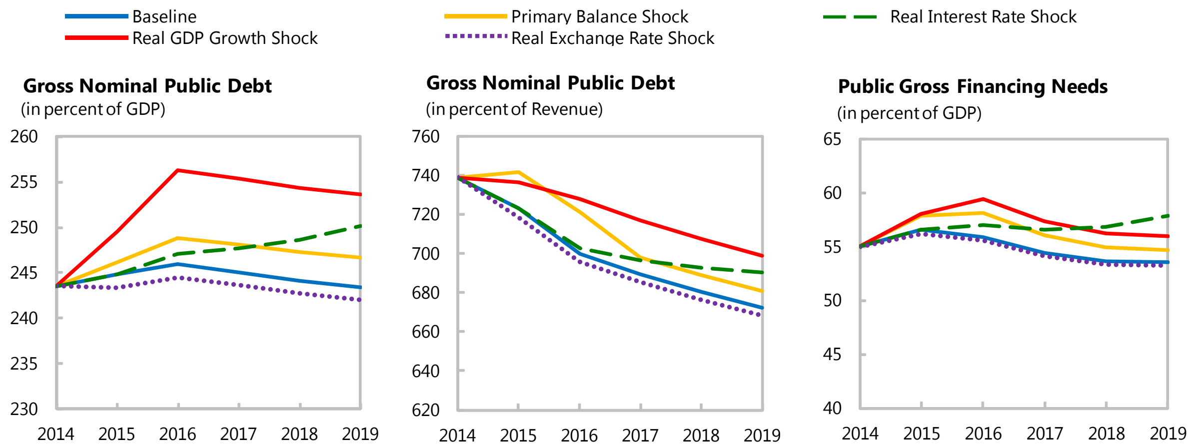
- *Fan chart.* The fan chart, which incorporates feedback effects between macroeconomic variables and relies on historical data to calibrate shocks, illustrates additional risks around the baseline. For example, under the worst quartile case, the debt to GDP ratio could reach around 250 percent of GDP in 2019, more than 10 percentage points higher than in the baseline.
- *Primary balance shock.* The impact is estimated to be modest. The improvement in the primary balance underperforms by half of the 10-year historical standard deviation of changes in the primary balance, compared to the baseline. Additional borrowing cost of 25 basis points per 1 percent of GDP worsening of the deficit is assumed. The gross debt to GDP ratio will be higher by around 3 percent of GDP in 2019 than the baseline.
- *Growth shock.* The impact on the debt ratio is the second largest among the shock scenarios. Real output growth rates are lower by a half of the 10-year historical standard deviation of changes in growth, compared to the baseline, for 2 years starting in 2015. As a result, the primary balance deteriorates, leading to higher interest rates as in the primary balance shock scenario. Also, a decline in inflation is assumed at a rate of 0.25 percentage point per 1 point decrease in growth. The impact is relatively large, bringing the debt ratio to around 255 percent of GDP, around 10 percentage point increase relative to the baseline.
- *Interest rate shock.* The effect becomes larger with the passage of time. A spike in JGB yields is an important medium-term tail risk. A shock of 200 basis points is assumed to happen in 2014 and stay for the rest of the period. Although increasing only gradually due to the average maturity of around 6.5 years, the effective interest rate is higher by around 1 percentage point in 2019 than the baseline, with the debt ratio higher by around 7 points. The difference with the baseline does not look very large, but such a shock could have a material effect on the financial sector with possible knock-on effects on the debt ratio and could lead to distress in the financial sector (see next shock).
- *Interest rate and contingent liability shock.* The impact is by far the largest among the scenarios. A one-time capital injection equivalent to 2.5 percent of banking sector assets (approximately 10 percent of regional banks assets) will increase government spending by 3.4 percent of GDP. The interest rate is assumed to rise by 25bp each percentage point increase in the primary deficit. This is also combined with real GDP growth shock. As a result, the debt ratio will increase to around 260 percent of GDP in 2019, more than 20 percentage points higher than in the baseline.

Longer-term Projections and Risks. Despite the relatively stable fiscal outlook in the medium term, the gross and net debt to GDP ratios are projected to start increasing in 2020 and reach around 280 percent and 180 percent of GDP, respectively (see text chart on page 14). This increase is a reflection of a gradual rise in the interest rate-growth differential towards the historical average of 1.[2] One important downside risk is a larger increase in public health spending than assumed in the baseline (Kashiwase, Nozaki, and Saito 2014). Maintaining the same macroeconomic assumptions as in the baseline, this would imply a debt ratio of 295 percent of GDP, about 15 percentage points higher than in the baseline. Another downside risk stems from possible macroeconomic shocks. Stochastic simulations, using a similar method to the one for the fan charts above, show that even with the recommended fiscal adjustment over the medium term, the debt ratio will remain at a high level with a 25 percent probability.

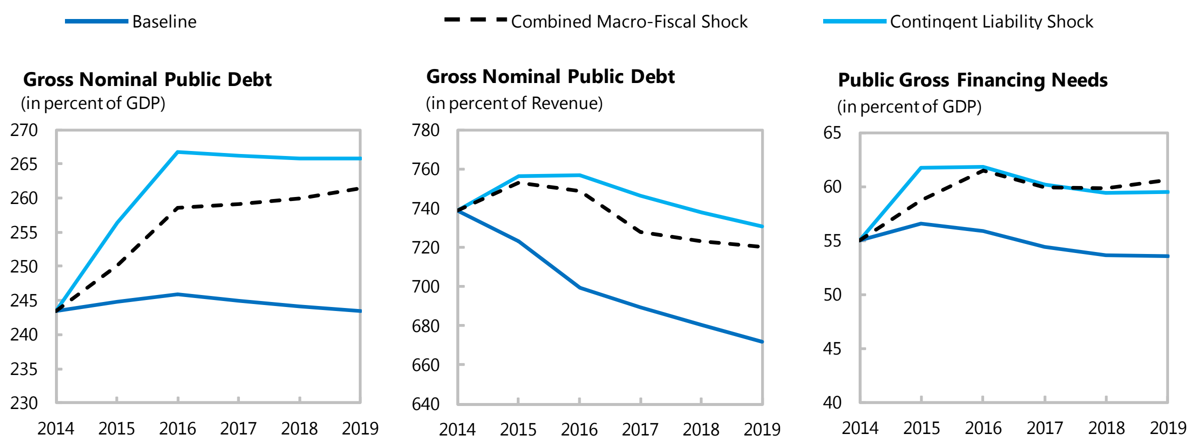
[2] The differential is currently lower than the historical average, estimated at around 0 in 2013, partly reflecting exceptional monetary easing.

Japan: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	1.4	1.0	0.7	1.0	1.0	1.1
Inflation	1.6	1.0	0.9	1.4	1.4	1.3
Primary balance	-6.4	-6.6	-5.4	-3.6	-3.4	-3.1
Effective interest rate	0.8	0.9	1.1	1.3	1.5	1.8
Real Interest Rate Shock						
Real GDP growth	1.4	1.0	0.7	1.0	1.0	1.1
Inflation	1.6	1.0	0.9	1.4	1.4	1.3
Primary balance	-6.4	-5.2	-4.0	-3.6	-3.4	-3.1
Effective interest rate	0.8	0.9	1.4	1.8	2.2	2.6
Combined Shock						
Real GDP growth	1.4	-0.4	-0.7	1.0	1.0	1.1
Inflation	1.6	0.7	0.6	1.4	1.4	1.3
Primary balance	-6.4	-6.6	-6.0	-3.6	-3.4	-3.1
Effective interest rate	0.8	0.9	1.5	1.8	2.2	2.7

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	1.4	-0.4	-0.7	1.0	1.0	1.1
Inflation	1.6	0.7	0.6	1.4	1.4	1.3
Primary balance	-6.4	-5.9	-5.3	-3.6	-3.4	-3.1
Effective interest rate	0.8	0.9	1.0	1.3	1.5	1.8
Real Exchange Rate Shock						
Real GDP growth	1.4	1.0	0.7	1.0	1.0	1.1
Inflation	1.6	1.7	0.9	1.4	1.4	1.3
Primary balance	-6.4	-5.2	-4.0	-3.6	-3.4	-3.1
Effective interest rate	0.8	0.9	1.0	1.2	1.4	1.7
Contingent Liability Shock						
Real GDP growth	1.4	-1.7	-2.0	1.0	1.0	1.1
Inflation	1.6	0.4	0.3	1.4	1.4	1.3
Primary balance	-6.4	-8.6	-4.0	-3.6	-3.4	-3.1
Effective interest rate	0.8	0.9	1.2	1.5	1.8	2.1

Source: IMF staff.

INTERNATIONAL MONETARY FUND

JAPAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 3, 2014

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

CONTENTS

FUND RELATIONS

(As of April 30, 2014)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	15,628.50	100.00
Fund holdings of currency (Exchange Rate)	15,032.43	96.19
Reserve Tranche Position	596.27	3.82
Lending to the Fund		
New Arrangements to Borrow	8,159.61	

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	12,284.97	100.00
Holdings	13,045.56	106.19

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund[1]

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.08	0.08	0.08	0.08	0.08
Total	**0.08**	**0.08**	**0.08**	**0.08**	**0.08**

Exchange Rate Arrangement:

Japan maintains a free floating exchange rate regime. Since the 2013 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. The FATF urges Japan to promptly meet its commitment to address these AML/CFT deficiencies, including through the adoption of the necessary legislation. No dates have been set for Japan's next mutual evaluation.

Article IV Consultation:

The 2013 Article IV consultation discussions were held during May 21–31, 2013; the Executive Board discussed the Staff Report (IMF Country Report No. 13/253 and concluded the consultation on July 12, 2013. 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 10, 2014)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	June 2014	June 2014	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/31/2014	6/3/2014	Every 10 days	Every 10 days	Every 10 days		
Reserve/Base Money	May 2014	June 2014	M	M	M		
Broad Money	May 2014	June 2014	M	M	M		
International Investment Position	2013 Q1	June 2013	Q	Q	Q	LO, LO, LO, LO	O, O, O, O, O
Central Bank Balance Sheet	5/31/2014	6/3/2014	Every 10 days	Every 10 days	Every 10 days		
Consolidated Balance Sheet of the Banking System	April 2014	June 2014	M	M	M		
Interest Rates[2]	June 2014	June 2014	D	D	D		
Consumer Price Index	April 2014	May 2014	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2012	January 2014	A	A	A	O, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2012	January 2014	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	March 2014	May 2014	Q	Q	Q		
External Current Account Balance	April 2014	June 2014	M	M	M		
Exports and Imports of Goods and Services	April 2014	June 2014	M	M	M	O, O, LO, O	LO, O, O, O, O
GDP/GNP	2013 Q1	May/June 2013	Q	Q	Q	O, O, O, O,	LO, LO, O, O, LNO
Gross External Debt	March 2014	June 2014	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 and extra budgetary funds), local governments, and social security funds.
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.

Statement by the IMF Staff Representative on Japan
July 23, 2014

1. This statement contains information that has become available since the Staff Report was circulated to the Executive Board on July 8, 2014. This information does not alter the staff's broad assessment of policy issues and recommendations contained in the staff report.

2. Recent data releases paint a mixed picture but are broadly consistent with staff's view that the economic contraction following the consumption tax increase will be short-lived, with the economy returning to a moderate pace of recovery from the third quarter. In terms of the details:

- Private consumption rebounded in May, with the real synthetic consumption index up by 1.3 percent (m/m), and consumer confidence continued to edge up in June (41.1 from 39.3 in May).
- Private machinery orders (excluding volatile items) fell sharply in May (19.5 percent m/m). In contrast, industrial production rebounded in May (0.7 percent m/m) and large firms have upgraded their capital spending plan for this fiscal year (7.4 percent annual, compared to 0.1 percent three month ago), according to the Tankan survey.
- In line with staff's baseline, the effects of the latest fiscal stimulus are beginning to be felt, with contract values of public works orders and public machinery orders rising sharply in May (14.0 percent and 22.4 percent m/m, respectively).
- The current account surplus widened in May (about 0.9 percent of GDP), in line with staff's expectation of delayed J-curve effects.
- Headline and core (excluding food and energy) inflation without the effect of the consumption tax increase declined to 1.6 and 0.5 percent (y/y) in May, in line with staff's projection.

3. The Bank of Japan kept its policy unchanged during its July 15 monetary policy meeting, noting that Japan's economy is recovering moderately as a trend.

4. Financial market indicators remain stable. The benchmark 10-year JGB yield has declined slightly to 54 basis points and equities have risen by about 1.4 percent thus far in July, while the yen has fluctuated in a narrow range around ¥101 per U.S. dollar.