



**ASIA AND PACIFIC  
DEPARTMENT**

# **Japan: Economic Outlook and Policy Priorities**

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# Roadmap

## I. Outlook and policy priorities

- Outlook and risks
- Key policy recommendations
  - Fiscal policy
  - Monetary policy
  - Financial sector policy
  - Structural policy

## II. IMF research highlights

- Model-based analysis of post-pandemic fiscal policy path
- Options for revenue mobilization
- Low for long rates and bank profitability
- Climate change policy options
- Climate finance in Japan
- Digitalizing the Japanese economy

## III. Summary

# Asia remains the world's growth engine

**Growth Projections: Selected Asia  
(percent change from a year earlier)**

	World	Asia	AEs	EMDEs	Australia	China	Japan	Korea	India	ASEAN	PICs and Small States
2021	6.1	6.5	3.6	7.2	4.7	8.1	1.6	4.0	8.9	3.1	4.2
2022	3.6	4.9	2.7	5.4	4.2	4.4	2.4	2.5	8.2	5.1	4.7
Revision: Jan. 2022 to Apr. 2022	-0.8	-0.5	-0.6	-0.5	0.1	-0.4	-0.9	-0.5	-0.8	-0.2	-0.8
Revision: Oct. 2021 to Jan. 2022	-0.4	-0.3	-0.1	-0.4	0.0	-0.8	0.1	-0.3	0.5	-0.2	0.0
2023	3.6	5.1	2.7	5.6	2.5	5.1	2.3	2.9	6.9	5.6	5.4

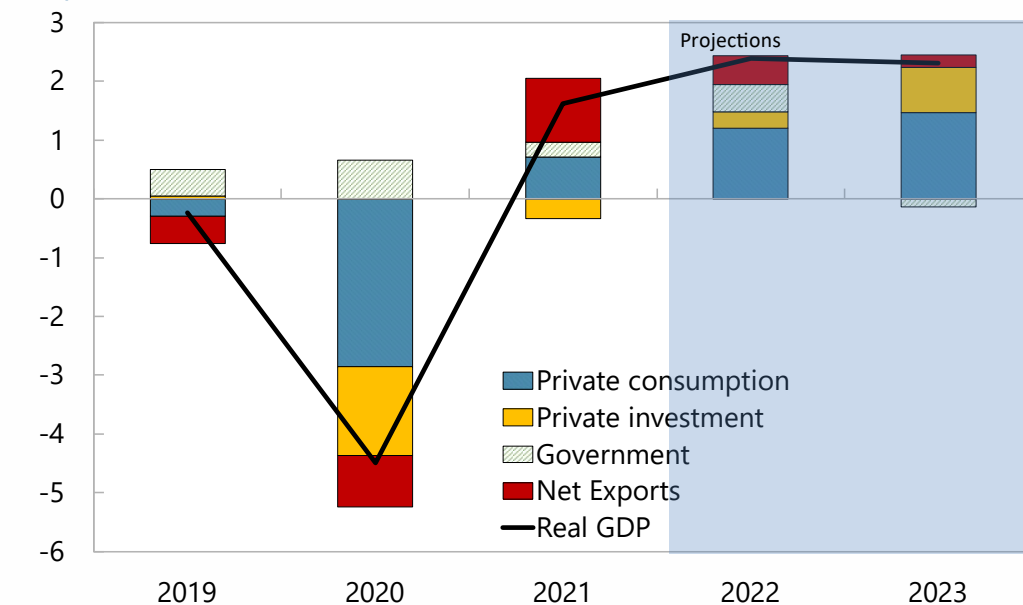
Source: IMF World Economic Outlook, April 2022.

# Japan's economic recovery is expected to continue in 2022 despite strong headwinds

Growth in 2022 is underpinned by fiscal support and pent-up demand...

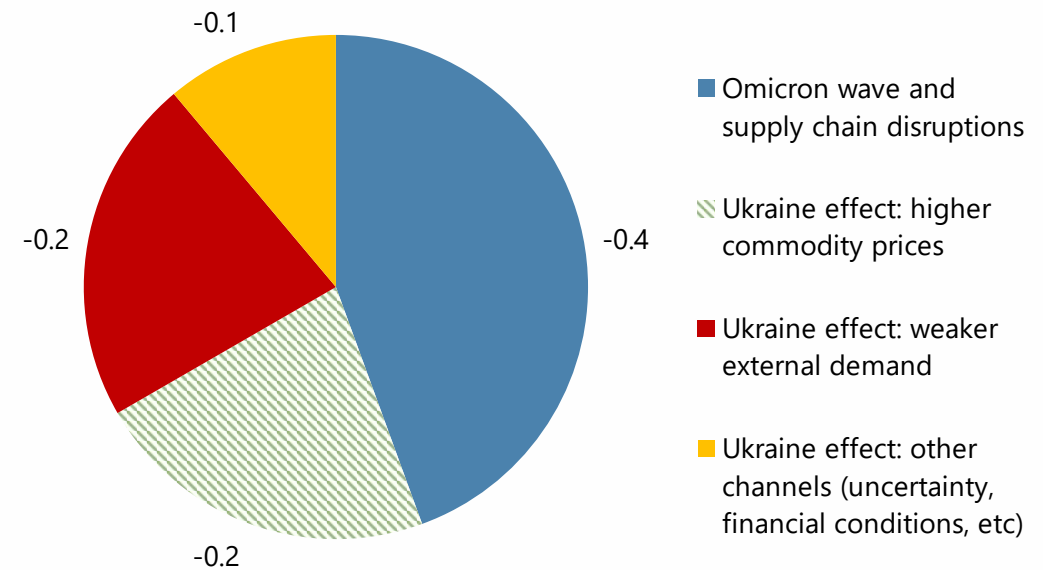
... but the war in Ukraine and the omicron wave in Q1 have slowed the recovery.

Japan: Real GDP Growth  
(in percent)



Sources: Haver and IMF Staff Projections

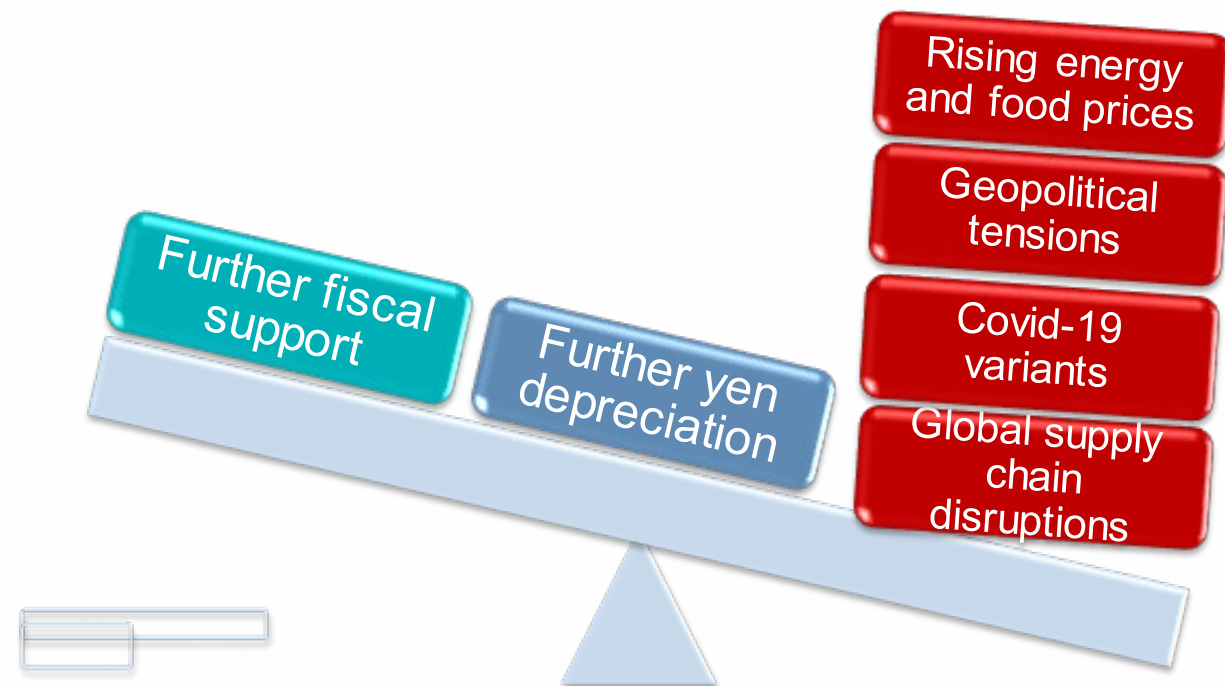
Downward Revision to 2022 Growth  
(relative to January WEO, in percentage point)



Sources: IMF Staff Calculation

# However, downside risks dominate

- Risks are **tilted towards the downside** mainly due to the pandemic and the war in Ukraine.
- **Faster-than-expected monetary policy tightening** in the US and other AEs could lead to further yen depreciation
  - **Positive effects:** improve Japan's export competitiveness and help achieve the two-percent inflation target
  - **Negative effects:** reduce firms' profit margin if prices cannot adjust fully and dampen consumer demand
- A **new fiscal package** was announced to soften the impact of rising oil prices.

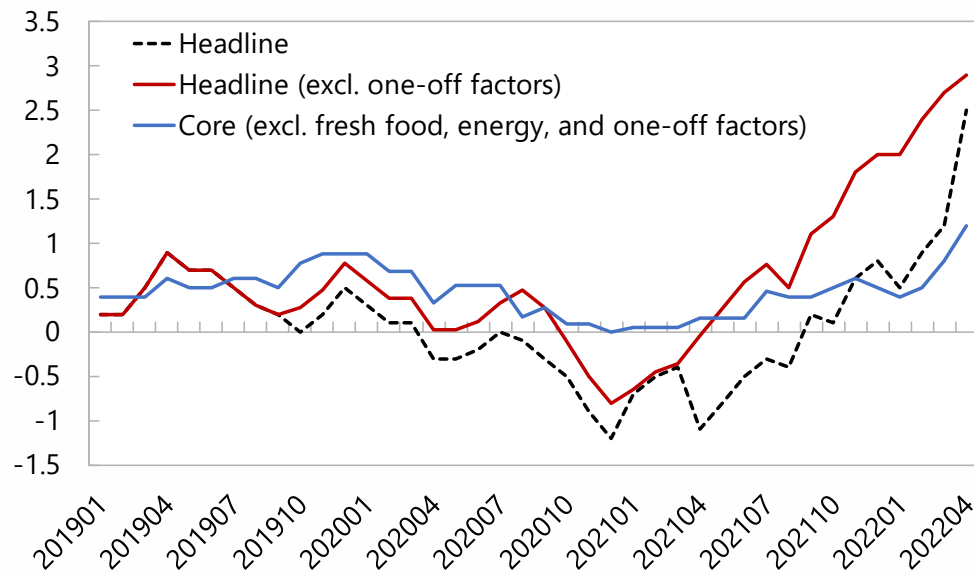


# Headline inflation is accelerating but underlying core inflation remains subdued

So far, headline inflation is driven by external cost-push factors

## Japan: Inflation Indicators

(in percent)



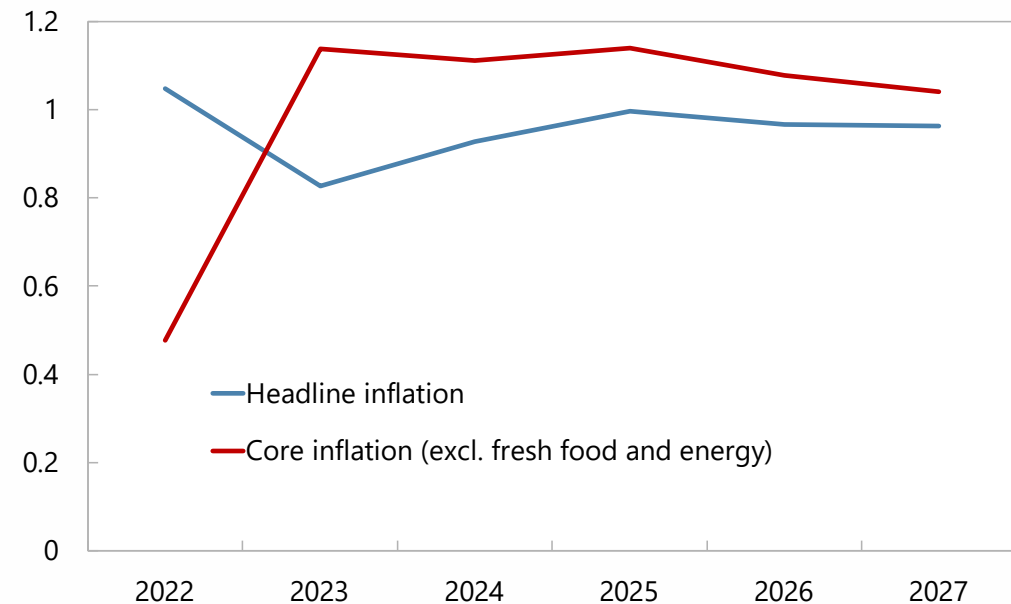
Sources: Haver and Staff Calculation.

Note: the effect of the VAT rate hike is excluded from all series.

Inflation is projected to remain below the BoJ's 2 percent target over the medium term.

## Japan: Inflation Forecast

(April WEO)



Sources: IMF Staff Projections

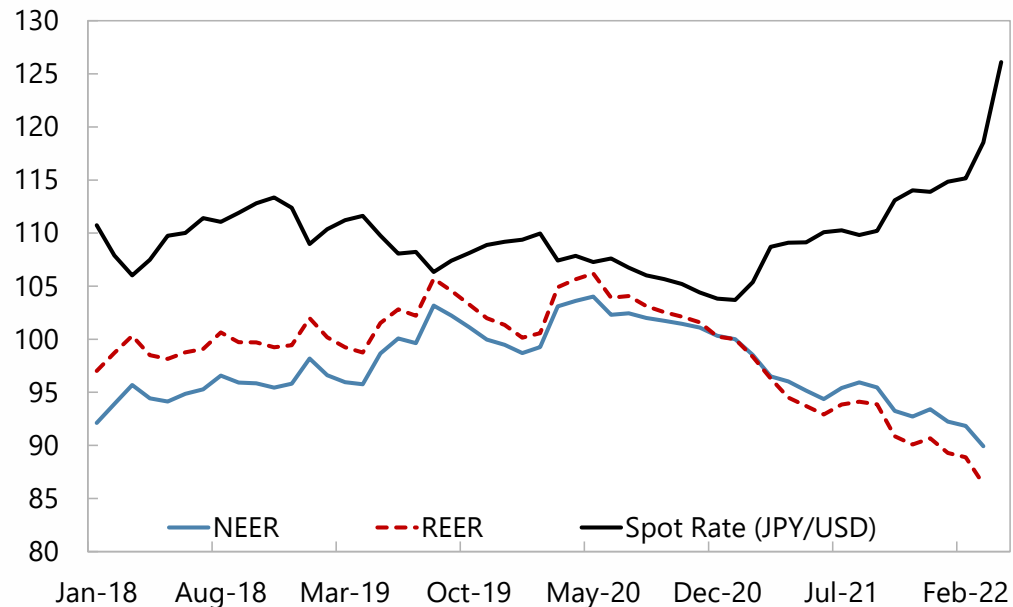
# The recent depreciation of the yen reflects a change in fundamentals, mainly policy divergence

Yen sharply depreciated in early 2022, coincided with...

...a shift toward a tighter monetary policy stance by other key central banks.

## Exchange Rates

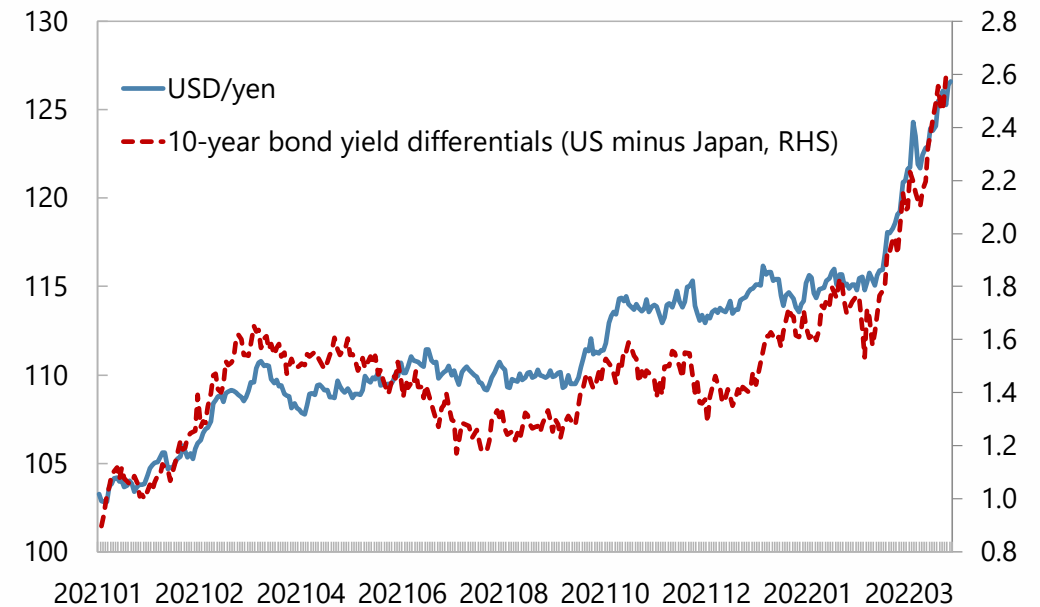
(Index)



Sources: INS and Haver Analytic.

## Exchange Rate and Interest Rate Differential

(2021-2022)



Sources: Haver

# Japan's fiscal policy responded decisively to the pandemic, helping mitigate the downturn

Japan: Size of Fiscal Responses to the COVID-19  
(In trillion JPY)

	April 2020 package	FY2020 second suppl. budget (May 2020)	December 2020 package	November 2021 package	COVID-19 Reserve Fund
Above-the-line measures after adjustment	32.0	13.6	18.8	26.3	12.3
<b>Total</b>	<b>103.0 (18.5 percent of 2022 GDP)</b>				

Sources: Ministry of Finance, the Cabinet Office, IMF staff estimates.

Note: See Annex III of 2022 Article IV Consultation Staff Report for details of IMF staff's adjustments. The April 2022 package that was announced after release of the Staff Report is not included.

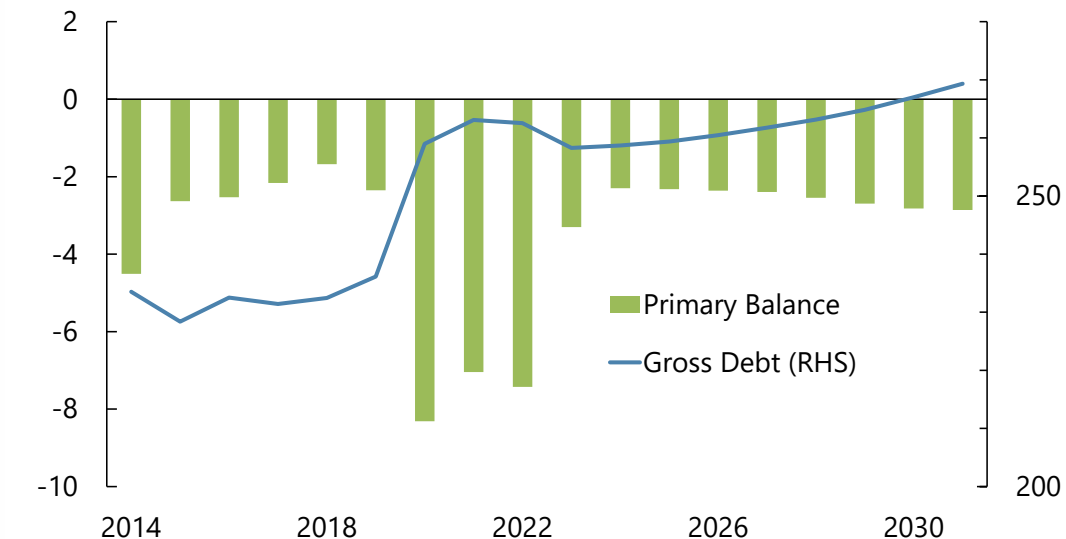
- Japan's fiscal response to the pandemic amounted to **about 19 percent of GDP**.
- Two recent packages (November 2021 and April 2022) will provide needed near-term support. However,
  - Fiscal measures could have focused more on economic transformation and promotion of **a digital and green recovery**.
  - Some measures could have been better targeted (e.g., cash transfer to child-rearing households).



# Near-term fiscal support should be followed by medium-term fiscal consolidation

**Fiscal stance in 2022 is expected to be supportive. In the long-run, debt sustainability concerns could rise...**

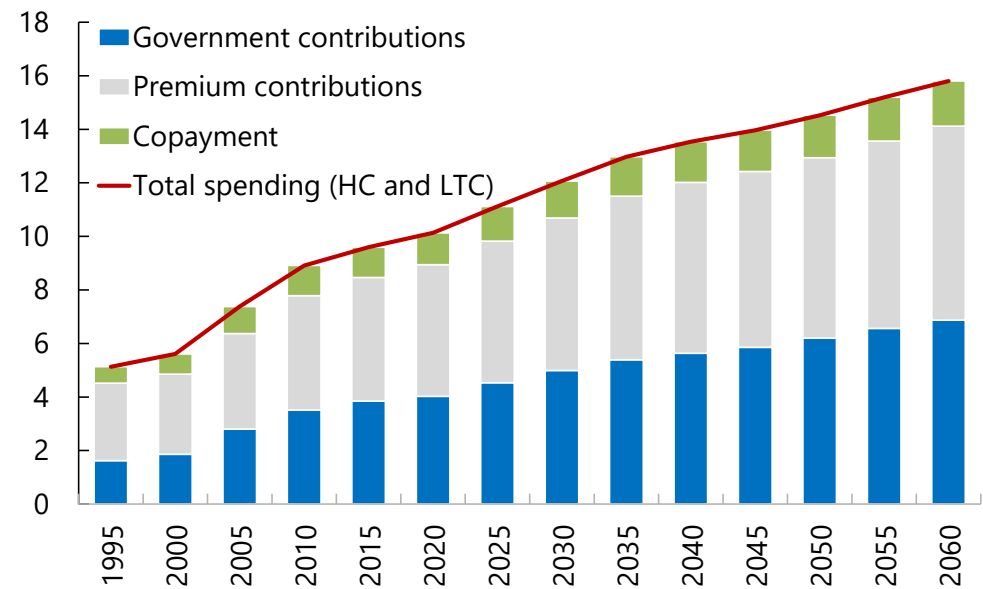
**Japan: Gross Public Debt and Primary Balance 1/**  
(In percent of GDP)



Sources: Cabinet Office; and IMF staff estimates and projections.  
1/ Gross debt of the general government including the social security fund.

**...on the back of rising age-related expenditures, pointing to a need for fiscal consolidation.**

**Financing of Health Care and Long-Term Care**  
(In percent of GDP)



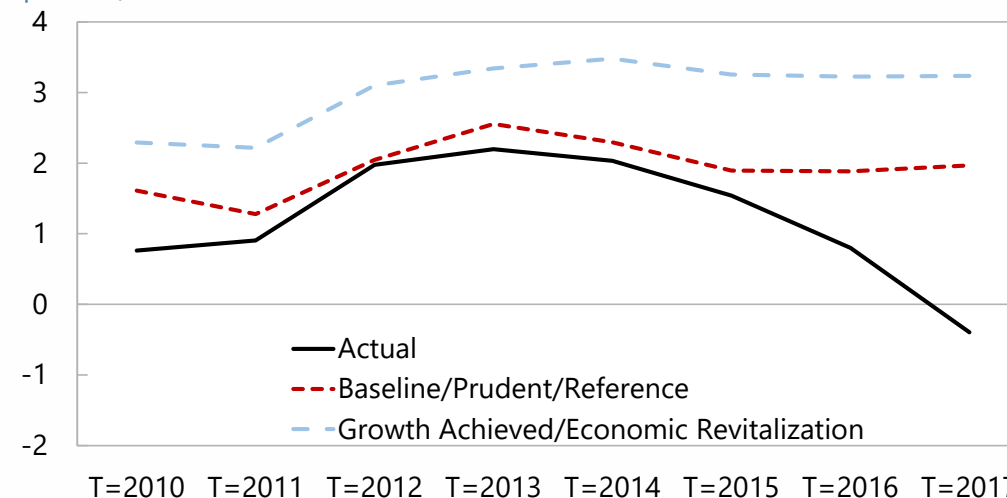
Sources: Ministry of Health, Labor, and Welfare; IMF World Economic Outlook database; and IMF staff estimates.

# A credible medium-term fiscal framework would help such a transition

- The framework should be
  - **Well-specified**
  - Based on **conservative projections**
  - Sustain the **growth momentum**
  - **Predictable**
- Fiscal adjustment on the expenditure side should focus on **age-related spending**:
  - Promote **generic drugs**
  - Limit the scope of **covered services and drugs**
  - Shorten the **duration of in-patient care**
  - Increase **out-of-pocket spending by the non-poor elderly**

## Japan: Cabinet Office's Nominal GDP Growth Projections 1/

(In percent)



Sources: Cabinet Office and IMF Staff estimates

1/ Compound average growth rate of nominal GDP of 3-year ahead (T+3) over that of the previous year (T-1). Fiscal-year basis. Projections are as of January each year except 2010 (June), 2013 (August) and 2015 (February).

# Fiscal adjustment will require revenue mobilization efforts

## Japan: Options for Revenue Mobilization

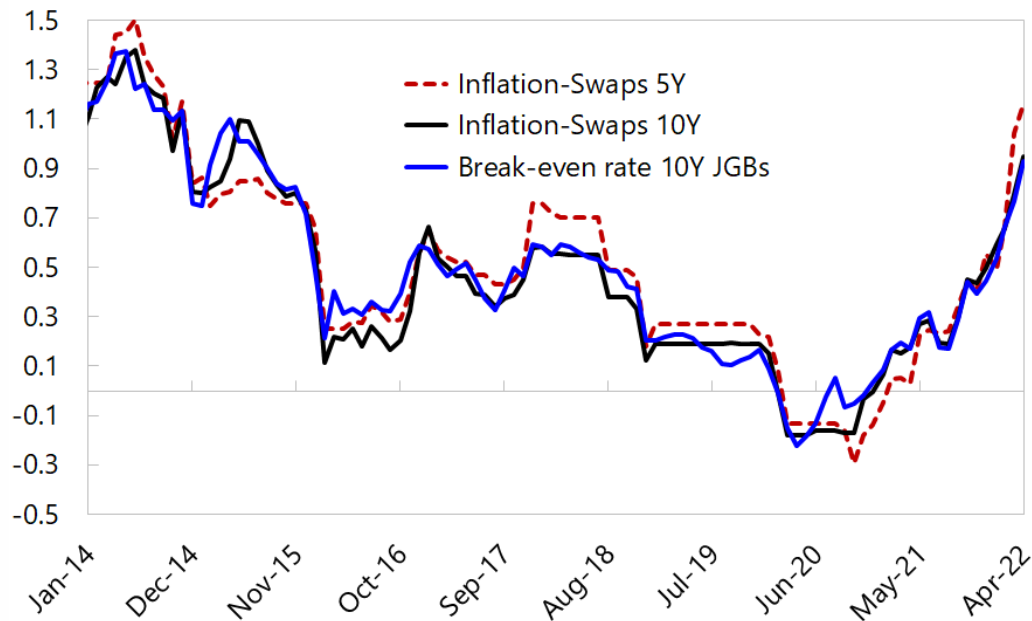
Tax handle	Reform options	Revenue implications (% of GDP)	Mobilize revenues?	Growth- friendly?	Address distributional concerns?
Consumption tax	Raise the tax rate to 15 percent	2 1/2	✓	✓	
	Replace the reduced rate with a targeted tax credit scheme	Neutral		✓	✓
Property tax	Eliminate the preferential treatment for residential land	0.5	✓	✓	(✓)
Personal income tax	Streamline the pension and employment income deductions	0.3	✓		✓
	Raise the tax rate for capital income to 25 percent	0.1	✓		✓
Corporate income tax	Merge the special rate for SMEs with the standard rate	0.1	✓	✓	
	Introduce an Allowance for Corporate Equity	Depends on its design/impact on output		✓	
Environmental tax	Raise the rate of TCCM (Tax for Climate Change Mitigation)	0.3	✓		

# The BoJ's commitment to maintain monetary easing until the 2 percent target is reached durably is appropriate

Underlying inflation and inflation expectations remain below the 2% target

## Inflation Expectations

(In percent YoY)

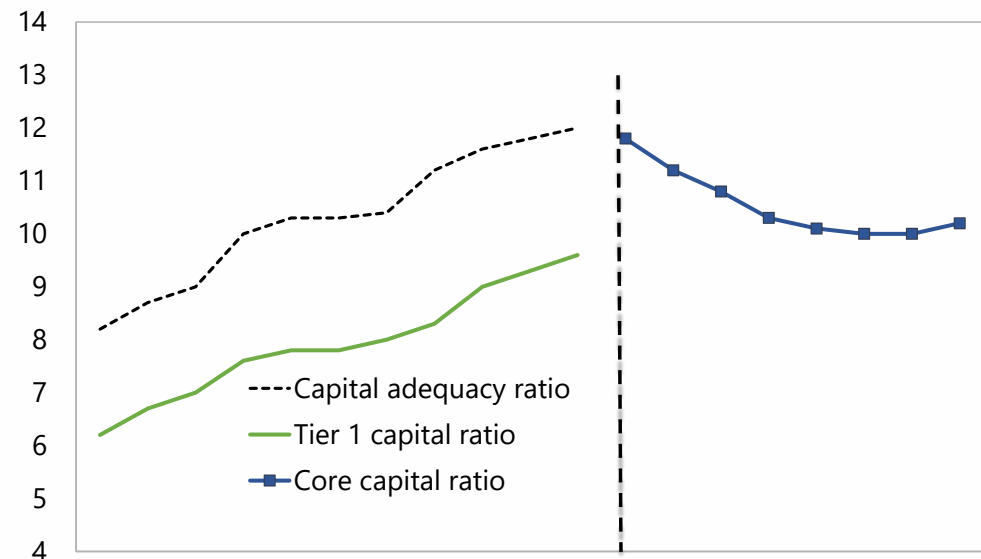


Sources: Bloomberg L.P.; and IMF staff estimates.

Further measures could be considered to make easing more sustainable

## Japan: Bank Capital of Regional Banks

(Percent of risk-weighted assets)



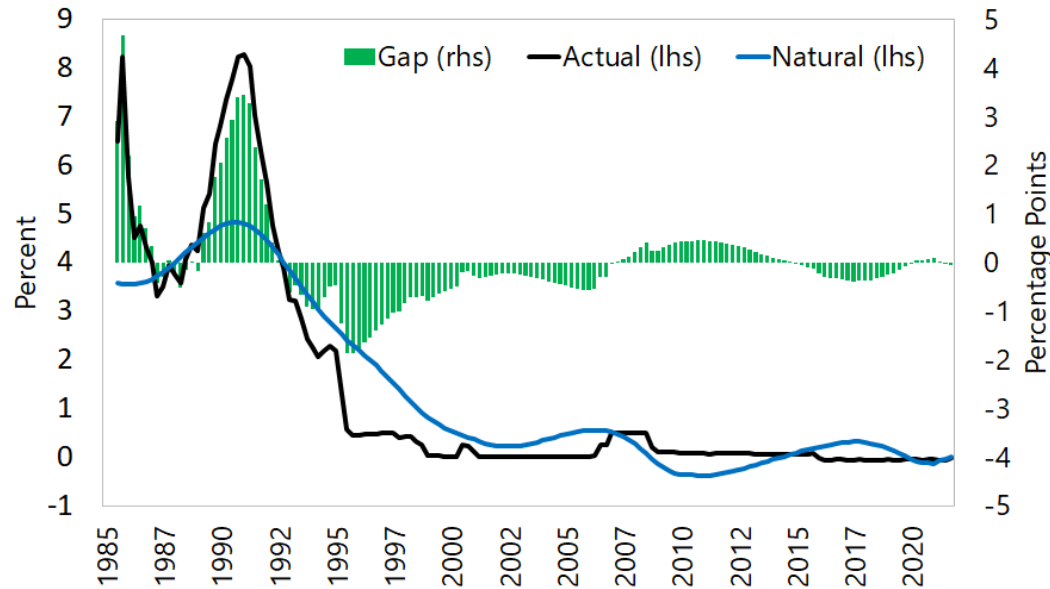
FY2002 FY2004 FY2006 FY2008 FY2010 FY2012 FY2014 FY2016 FY2018 FY2020

Source: Bank of Japan.

# Enhancing the stimulative impact of monetary policy

The low natural rate of interest and subdued inflation expectations have limited the effective monetary easing

Japan: Nominal Policy Interest Rate

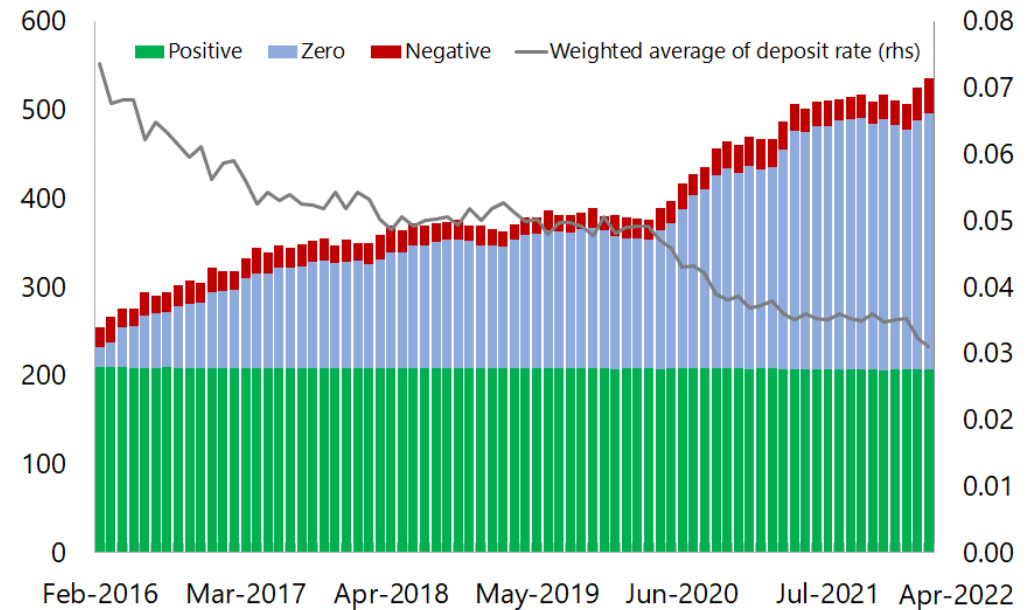


Source: IMF Staff estimates.

Note: Generalized Multivariate Linear Filter is used to jointly estimate potential output, the natural rate of unemployment and the natural rate of interest, conditional on selected equilibrium conditions from a calibrated New Keynesian model.

The impact of negative interest rates is constrained by the small share of bank reserves subject to negative rates

BoJ Current Account Balances and Average Renumeration Rate (JPY trillion)

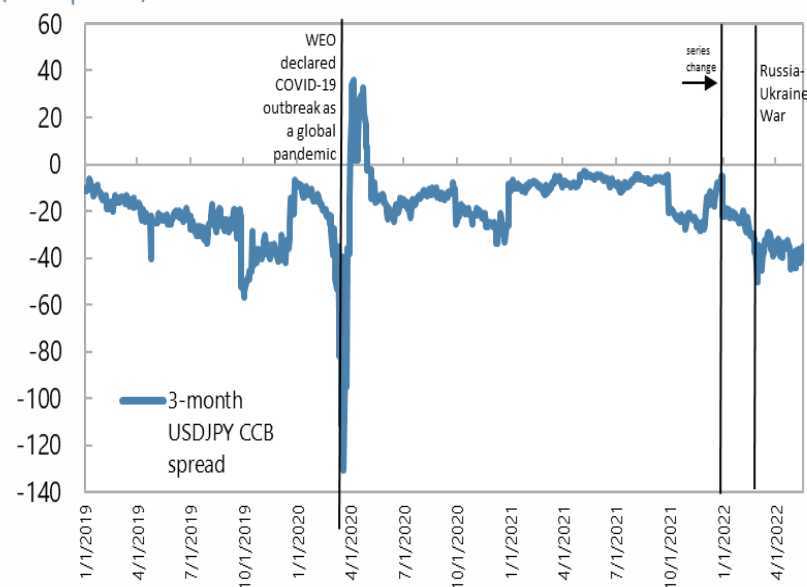


Sources: Bank of Japan and IMF staff estimates

# The impact of the pandemic on the financial sector has been moderate

**Coordinated swap line arrangements with the Federal Reserve helped ease international dollar funding stress.**

**US dollar funding stress in international wholesale markets**  
(basis points)

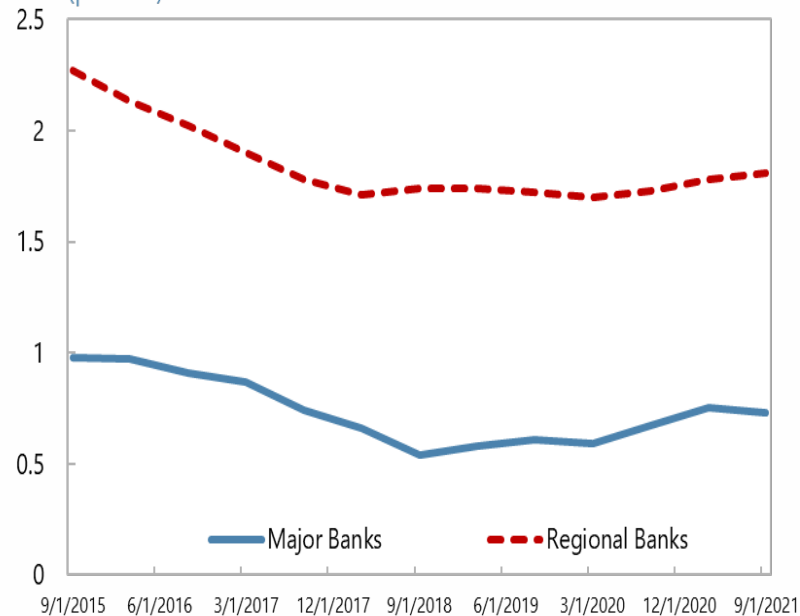


Sources: Bloomberg

**Strong and pro-active policy support by the FSA and the BoJ helped the financial sector to weather the pandemic and avoid potential adverse spillover effects on the financial sector.**

**Non-performing loans ratio**

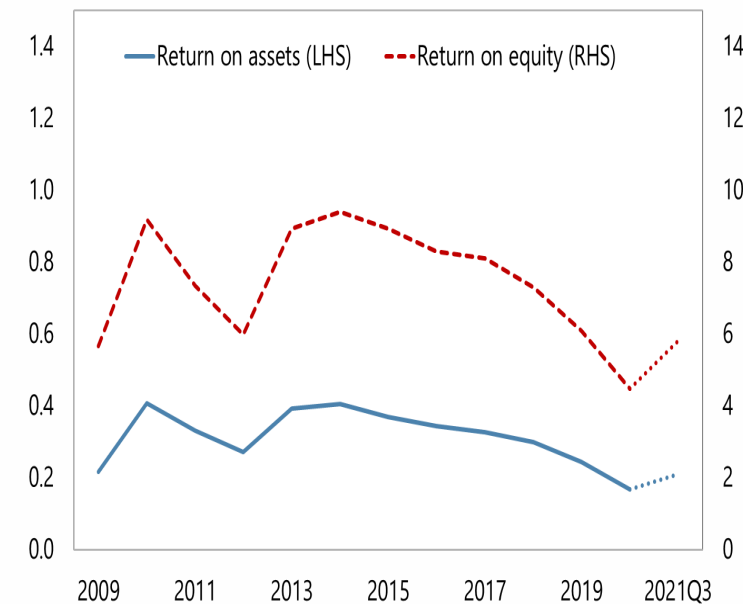
(percent)



Sources: Japanese Bankers Association.

**Japan: Bank Profitability**

(percent)

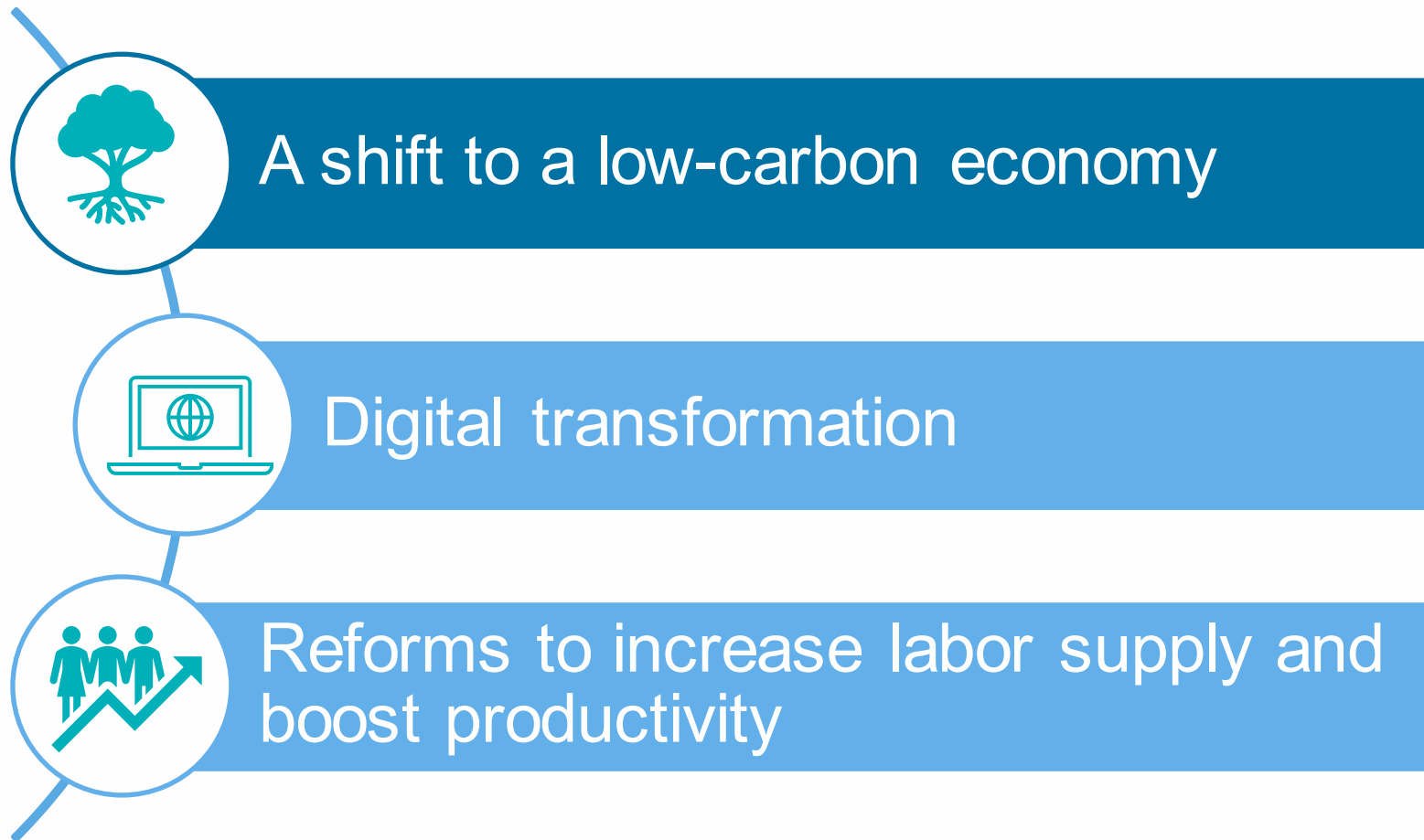


Source: IMF Financial Soundness Indicators database and staff estimates for end-September 2021.

# Financial supervision should remain vigilant to contain vulnerabilities

- A policy priority is to **avoid resources locked in non-viable firms**, which could hinder medium/long-term growth.
- **Pandemic-related financial support should be gradually phased out** as the pandemic recedes.
  - Government loan guarantee and concessional loan programs should be scaled down once the recovery takes hold, and **the public credit guarantee ratio should be lowered** further from the current 80-100 percent.
- **Medium-term structural headwinds** to the profitability of the sector continue (low interest rates and demographics challenges).
  - Several measures undertaken to **increase banking sector profitability** are welcome (BoJ's special deposit facility for regional banks, subsidies or enactments incentivizing regional bank consolidation).

# After the pandemic, comprehensive reforms will be needed to promote strong, sustainable, and inclusive growth.

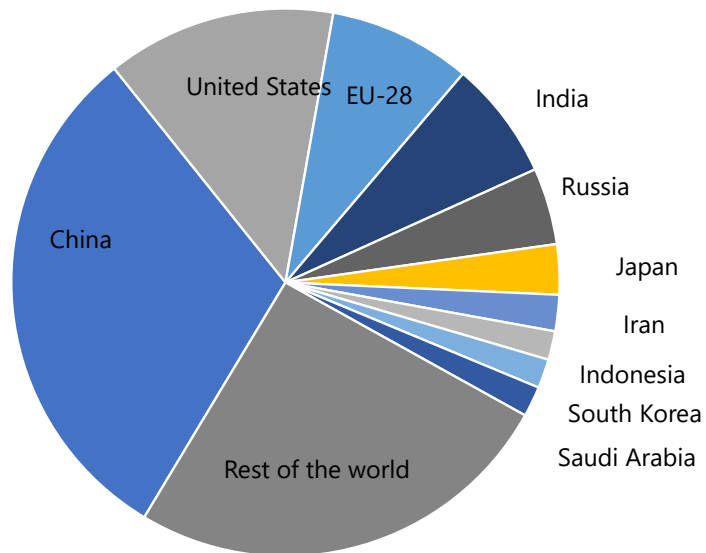




# Japan's carbon neutrality commitment is an important and positive step.

Japan, the world's sixth largest carbon emitter, committed to reduce net GHG emission to zero by 2050.

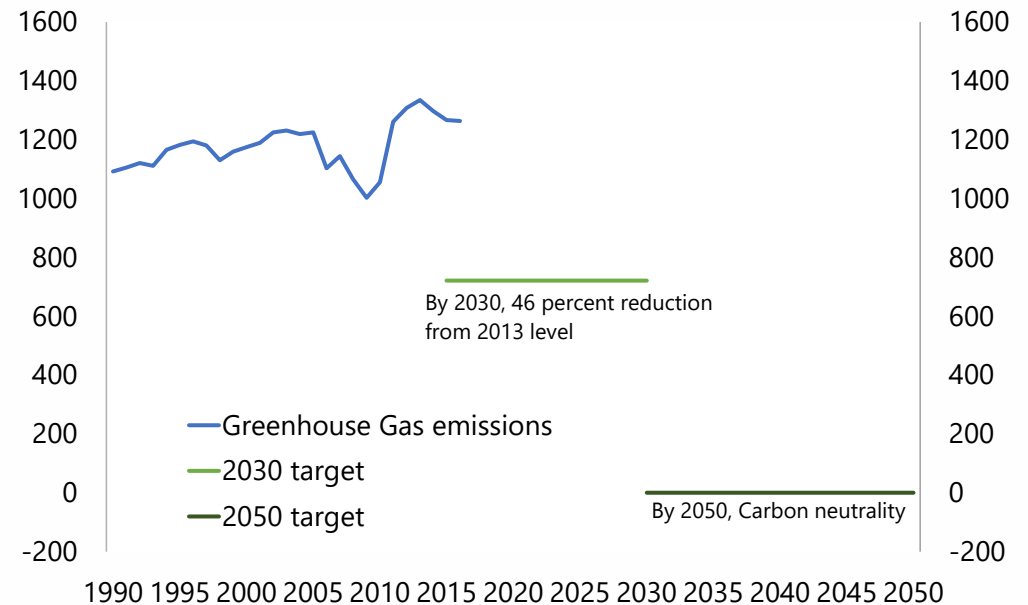
**Annual CO2 Emissions by Country**  
(Percent of total, 2020 data)



Source: Our World in Data.

Further efforts to execute the emission target could be considered.

**Japan: Greenhouse Gas Emissions Targets**  
(Millions of tons of CO2)



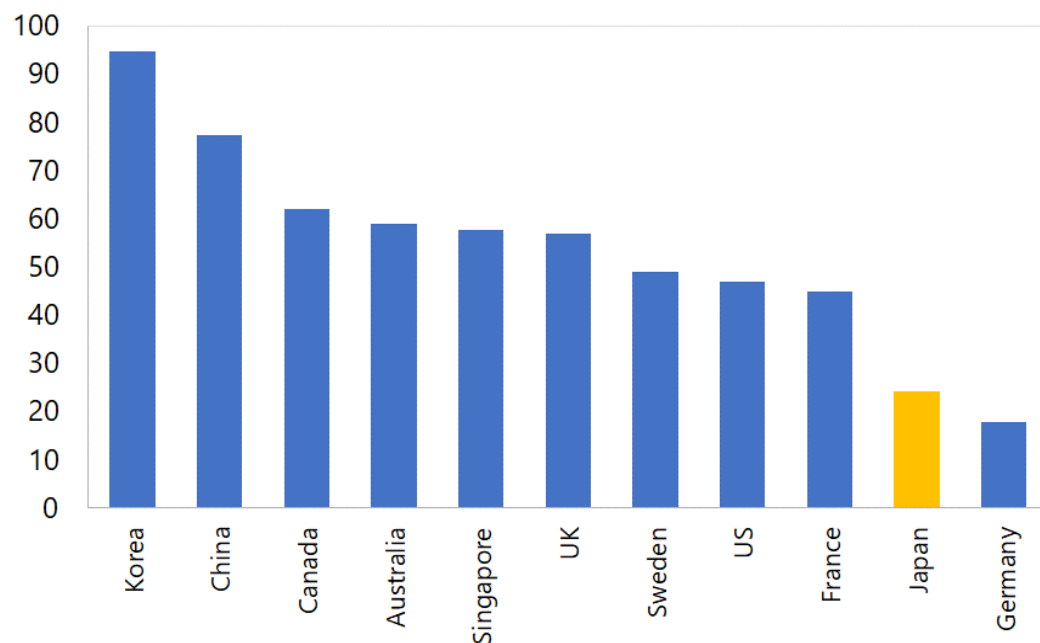
Sources: Our World in Data; IMF staff calculations.

# Progress towards digital transformation would help boost productivity.

Digital adoption by businesses, government, and the financial sector lags other countries.

## Cashless Payments

(In percent of total payment transactions, 2018)

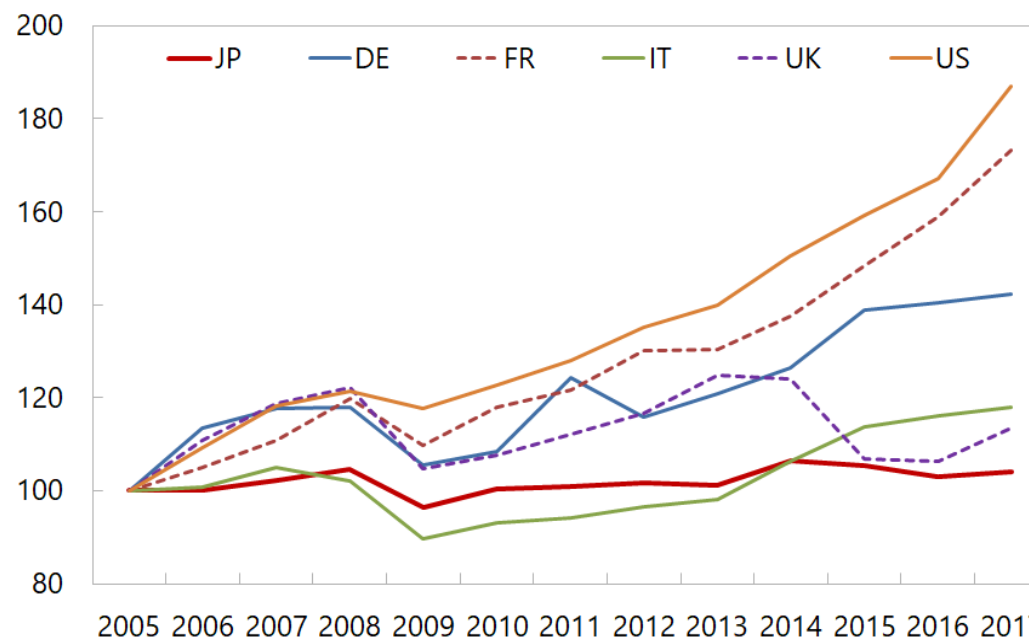


Sources: Payments Japan, BIS, Euromonitor International

Recent initiatives to encourage digitalization in the private sector could catalyze digital investment.

## ICT Capital Investment

(2005=100)



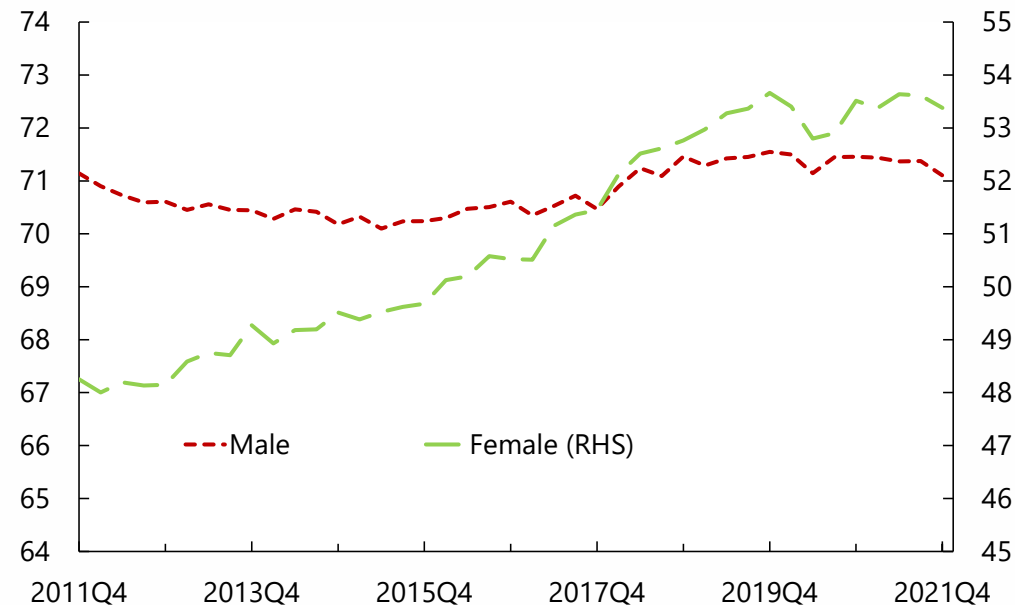
Sources: EUKLEMS, Staff Calculation

# Accelerating reforms will be critical to improve growth potential and income distribution.

Given the demographic challenges, reforms to increase labor supply, including for female and older workers, should be prioritized.

## Labor Force Participation Rate

(In percent)

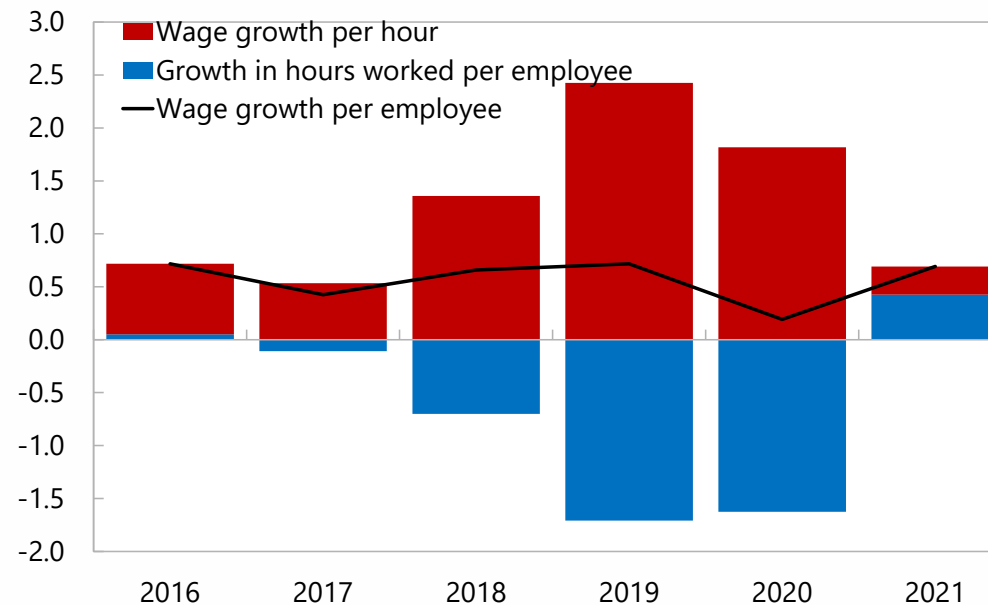


Source: Ministry of Internal Affairs and Communications.

Skill training and reforms to eliminate productivity and wage gaps could boost labor productivity and wages as well as income equality.

## Nominal Wage Growth per Full-Time Employee

(Average annual rate, in percent)



Source: Haver Analytics.

# Roadmap

## I. Outlook and policy priorities

- Outlook and risks
- Key policy recommendations
  - Fiscal policy
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  - Structural policy

## II. IMF research highlights

- **Post-pandemic fiscal policy: Implications from the Buffer-Stock Model of Government**
- **Options for revenue mobilization**
- **Low for long rates and bank profitability**
- **Climate change policy options**
- **Climate finance in Japan**
- **Digitalizing the Japanese economy**

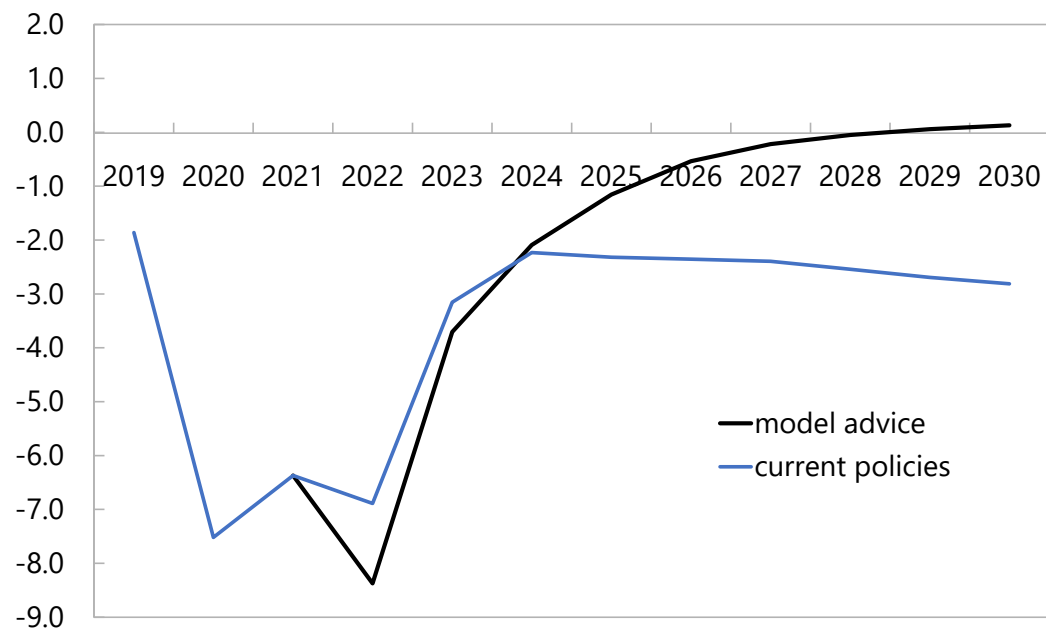
## III. Summary

# **Post-pandemic Fiscal Policy: Implications from the Buffer-Stock Model of Government**

# A stochastic structural model advises optimal pace of unwinding the fiscal stimulus for Japan

## Structural Primary Balance

(General Government, percent of potential GDP)



Sources: IMF staff calculations.

- Our model-based analysis presents the optimal fiscal policy path, taking account of a trade-off between **output stabilization** and **debt sustainability**.

### Near-term

- The model suggests a **wider structural primary deficit in 2022**.
- Policy implication: In response to the Omicron spread and the war in Ukraine, the government could deploy the contingent measures included in recent economic packages decisively **to minimize hysteresis**.

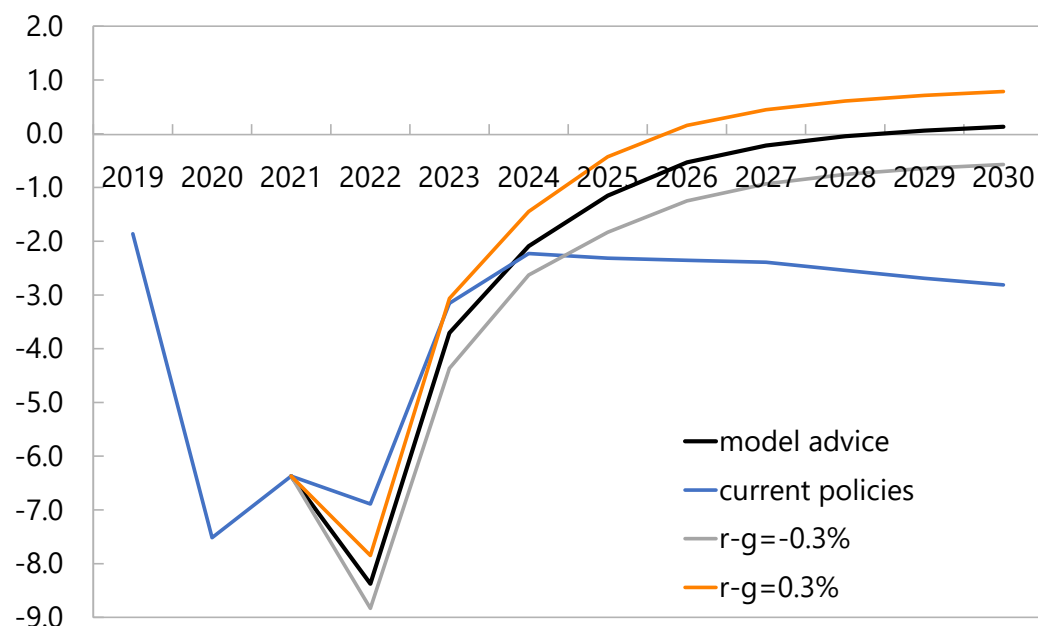
### Medium-term

- After 2024, the model advice deviates from the current policy scenario, recommending **gradual fiscal consolidation** to stabilize debt and rebuild fiscal buffers.

# The recommended pace of consolidation depends on the r-g assumptions

## Structural Primary Balance

(General Government, percent of potential GDP)



Sources: IMF staff calculations.

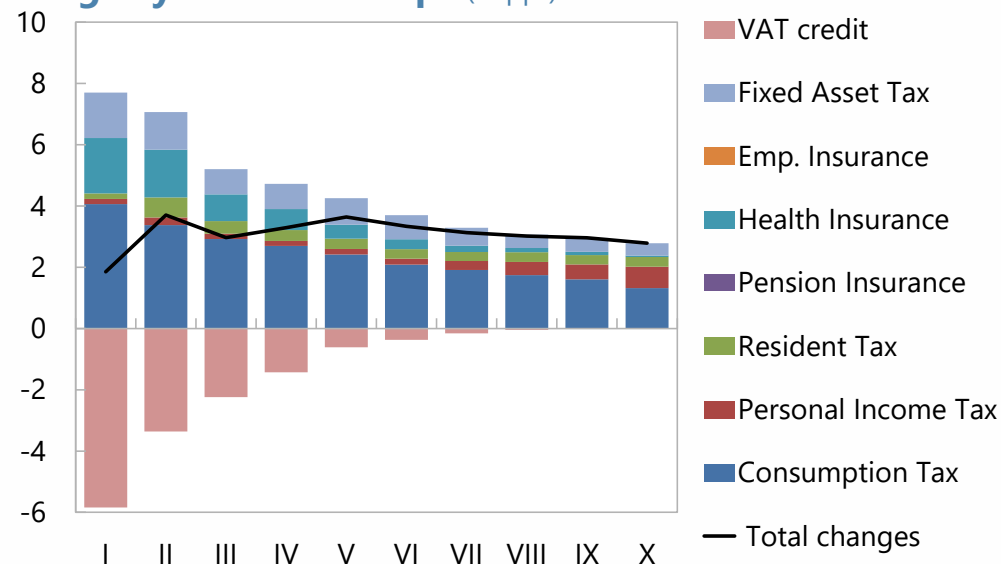
- Our baseline model-advice builds on an assumption that the interest rate is equal to growth in the long-run ( $r-g=0$ ).
  - With a small downward change ( $r-g=-0.3$ ), the model suggests a **more gradual fiscal consolidation**.
  - With a small upward change ( $r-g=0.3$ ), the **structural primary balance should be higher** than in the baseline.
- Given sensitivity of the model results to r-g, the medium-term fiscal framework could include a **contingency plan** that is readily implementable in cases of unfavorable developments of economic growth and/or interest rates.

# Options for Revenue Mobilization



# Distributional implications of revenue mobilization

Japan: Change in Tax Burden Relative to the Current Policy Settings by Income Groups (in ppt)



Sources: KHPS, IMF Staff calculations.

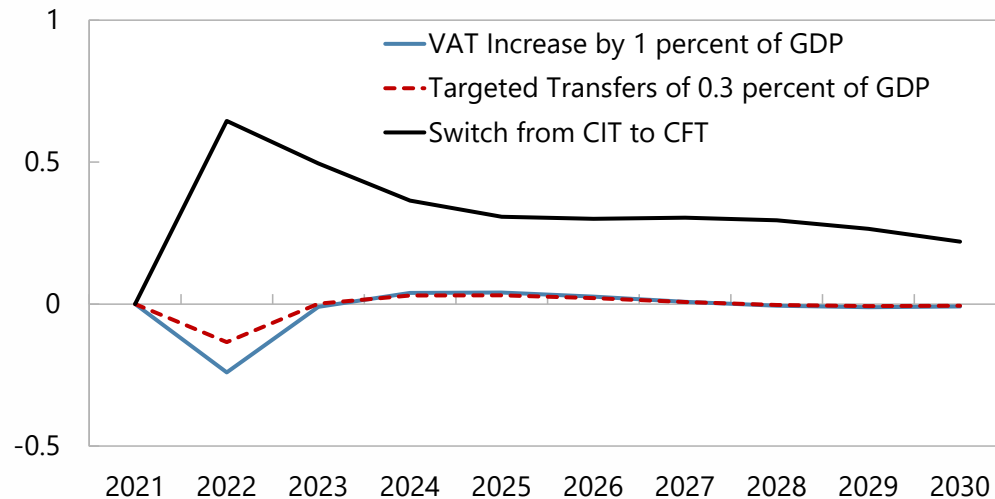
Note: The data for this analysis, the Keio Household Panel Survey (KHPS), was provided by the Panel Data Research Center at Keio University.

- A static micro-simulation is conducted to study distributional effects of six tax reform options:
  - Lower the ceiling of the **Employment Income Deduction** of the Personal Income Tax from 1.95 to 1.5 million JPY
  - Lower the floor and the ceiling of the **Pension Income Deduction** of the Personal Income Tax to 0.55 million JPY and 1.5 million JPY, respectively
  - Raise the **VAT standard rate** to 15 percent, with no reduced rate
  - Raise the **capital income tax rate** to 25 percent
  - Eliminate the preferential treatment of residential land in the **Fixed Asset Tax**
  - Introduce a **VAT credit** (equivalent to the GST Credit in Canada)
- Simulation results after every option is implemented show:
  - **A tax burden for each decile increases by 2 to 4 percentage points**
  - Before considering a VAT credit, roughly a half of the increase in the tax burden in every decile is explained **by a rise in the burden of the consumption tax**
  - Redistributive effect of a **VAT credit scheme** is large

# Dynamic effects of tax reforms

## Real GDP growth

(ppt difference from the baseline)



Sources: GIMF simulations.

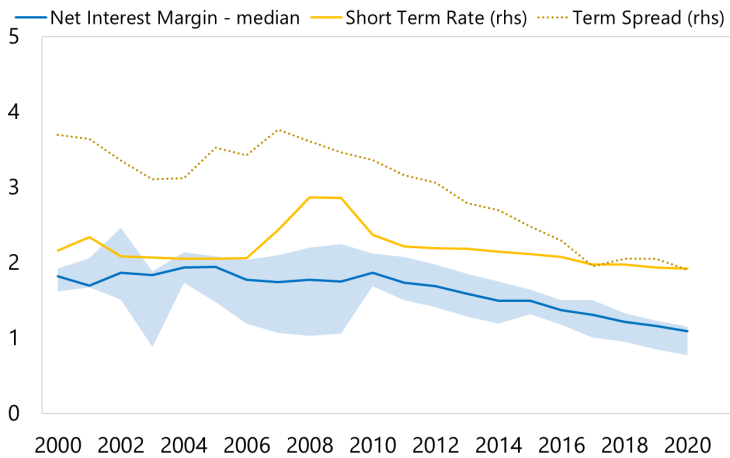
Note: The blue line traces out the impact of Option 1, the red dashed line shows the impact of both Options 1 and 2, and the black line illustrates the impact of all three options.

- The IMF's **Global Integrated Monetary and Fiscal Model (GIMF)** simulation is conducted to study dynamic effects of three tax reform options:
  1. A permanent increase in **consumption tax** revenues by 1 percent of GDP
  2. An increase in **targeted transfers** by 0.3 percent of GDP, in order to offset the impact of the consumption tax hike on vulnerable households
  3. A shift from the current Corporate Income Tax (CIT) to a **Cash Flow Tax (CFT)** (as a proxy for an Allowance for Corporate Equity) in a revenue-neutral manner
- Simulation results:
  - Adding **targeted transfers mitigates** the impact of the consumption tax increase on output growth.
  - **A shift to a CFT results in output growth** for an extended period.

# **Low for Long Rates and Bank Profitability**

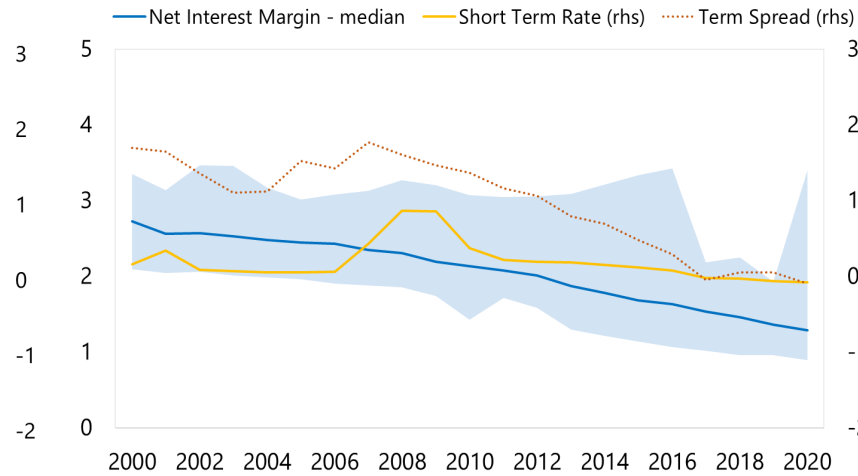
# Prolonged monetary accommodation and structural shifts have weighed significantly on bank profitability

**City Banks**  
(In percent)



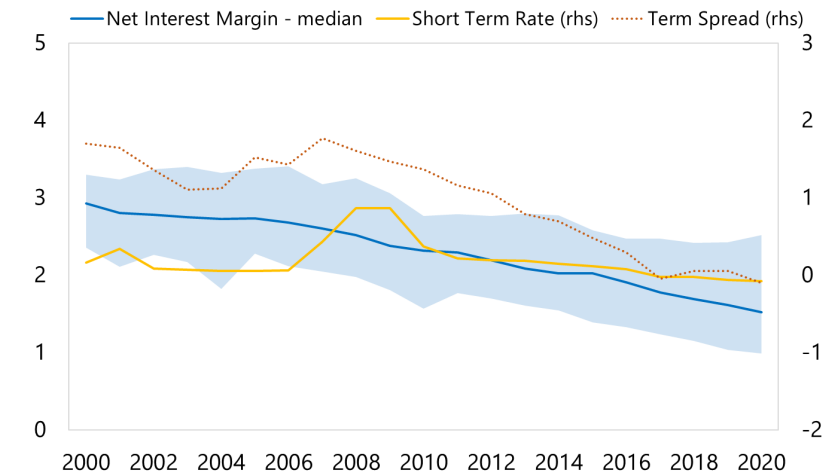
Sources: Japanese Bankers Association; IMF staff calculations.

**Regional Banks I**  
(In percent)



Sources: Japanese Bankers Association; IMF staff calculations.

**Regional Banks II**  
(In percent)

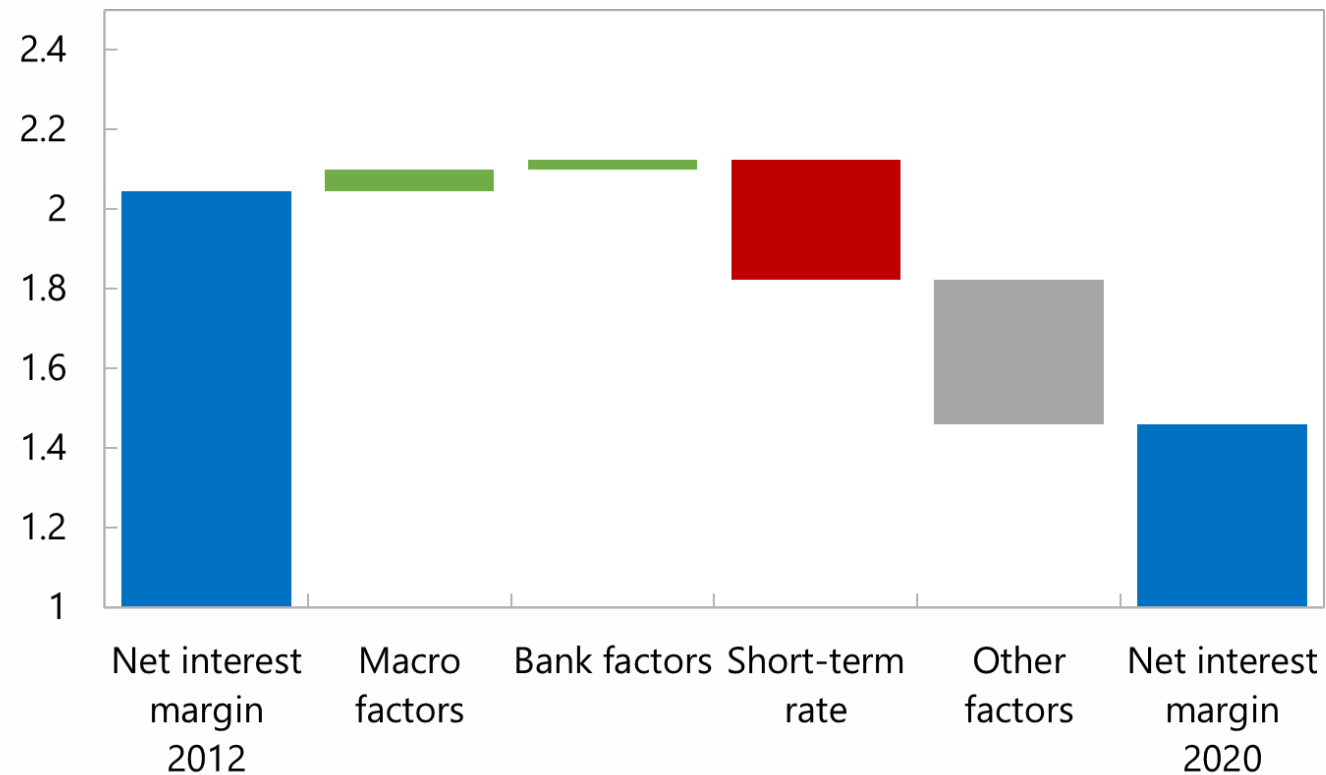


Sources: Japanese Bankers Association; IMF staff calculations.

Note: The highlighted area in blue represents the minimum and maximum of the net interest margin in that particular year.

# Japan's accommodative monetary policy stance remains appropriate, but should be accompanied by measures to safeguard financial stability.

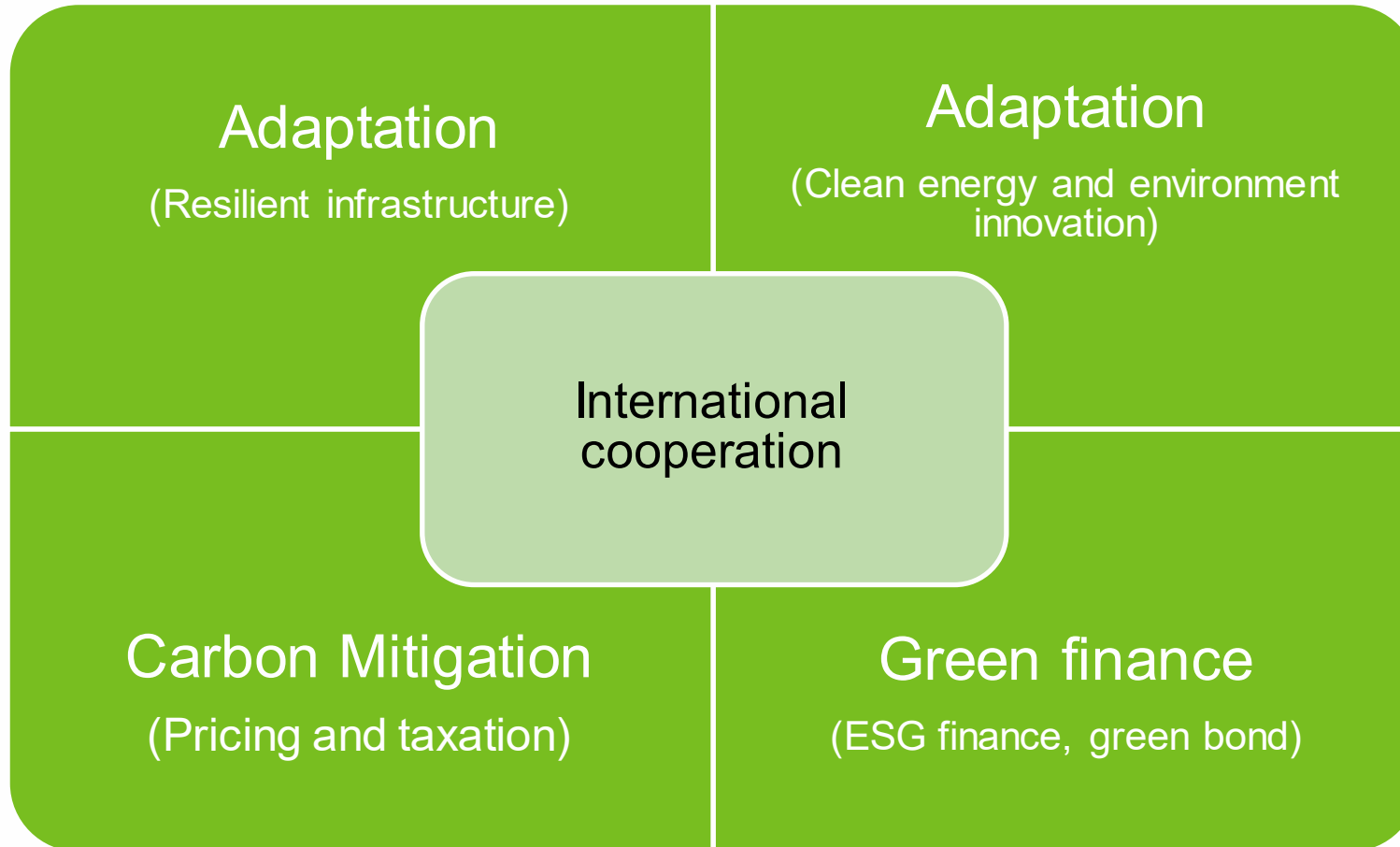
Contributions to the Change in Net Interest Margins  
(Percent, all banks)



Source: IMF Staff Estimates.

# Climate Change Policy Options

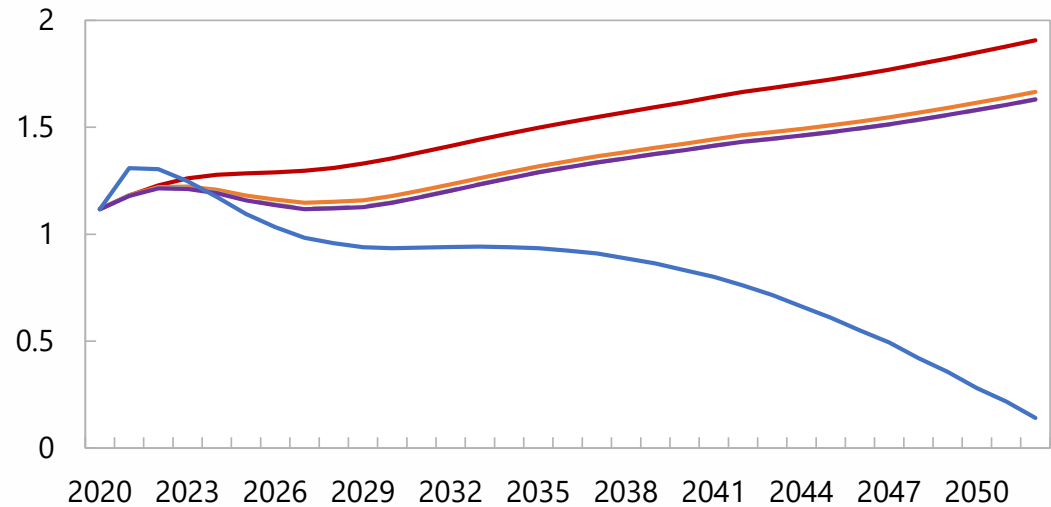
# Japan's Climate Change Policies



# A comprehensive policy package—including green investment and more reliance on carbon prices—could have net positive growth impacts in the near- and medium-term

## Japan: CO2 Emissions

(Gigatons of CO2)

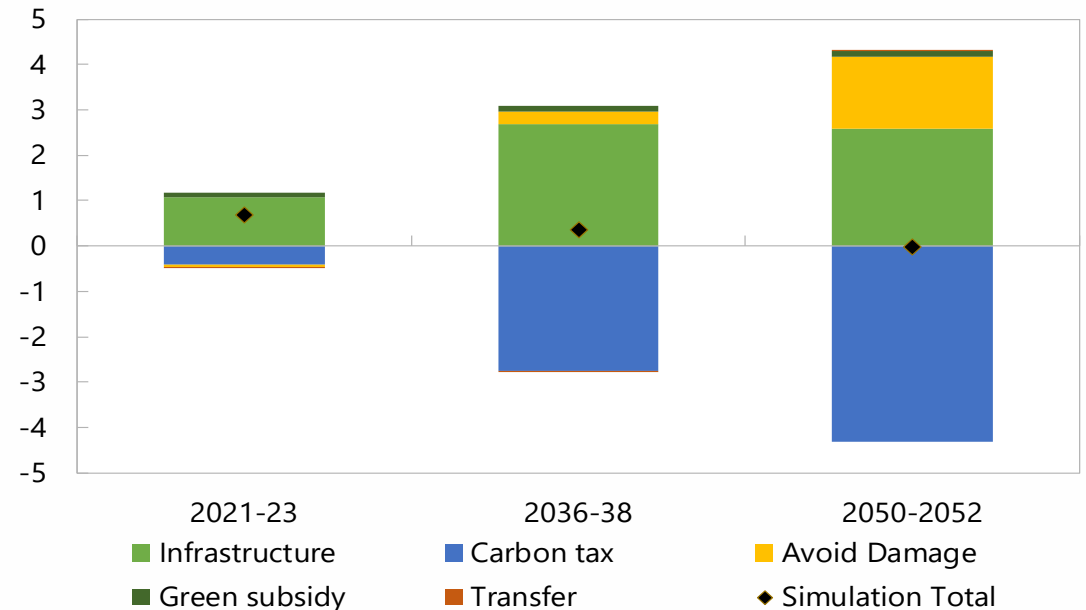


- (1) Baseline
- (2) 1 + Deviation of Infrastructure
- (3) 2 + Deviation of Green subsidy
- (4) 3 + Deviation of Transfer
- (5) 4 + Deviation of Carbon Price

Source: IMF staff calculations.

## Japan: Impacts on Real GDP

(Deviation from baseline, percent)



Source: IMF staff calculations.

Avoid damage indicates the estimated benefits (output gains) of climate change policies that will reduce climate-related damages over the medium- to long-term.

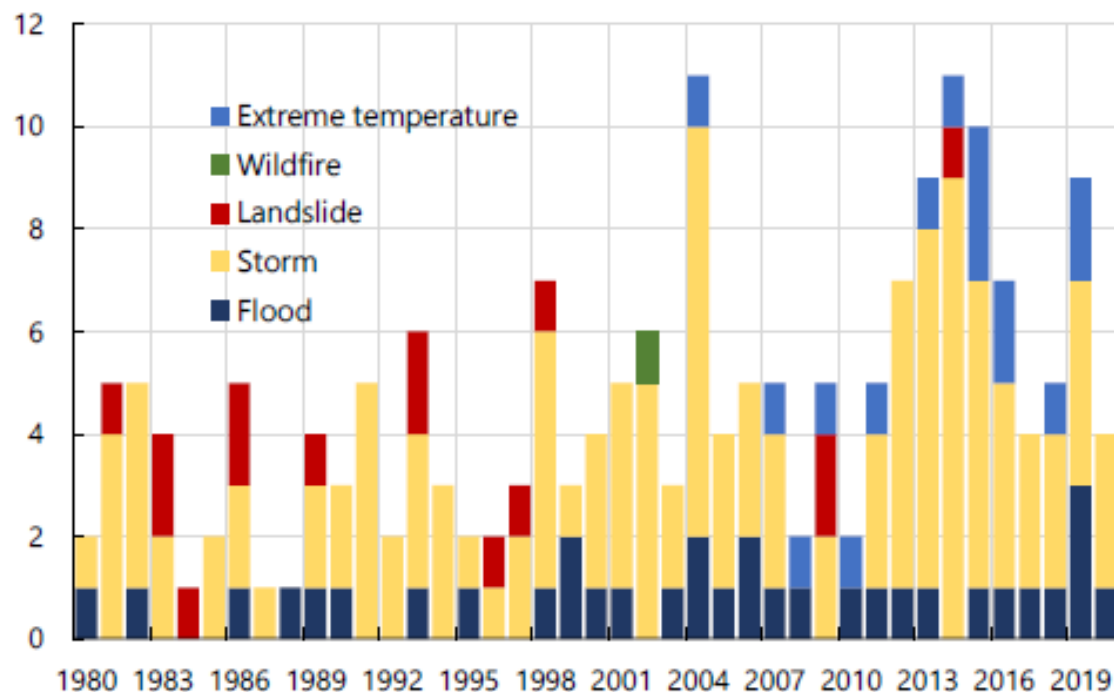


# Climate Finance in Japan

# Japan is exposed to climate physical and transition risks.

Natural disasters have occurred more frequently in Japan. Climate change is expected to increase the frequency and severity of extreme weather events.

Frequency of Natural Disasters in Japan

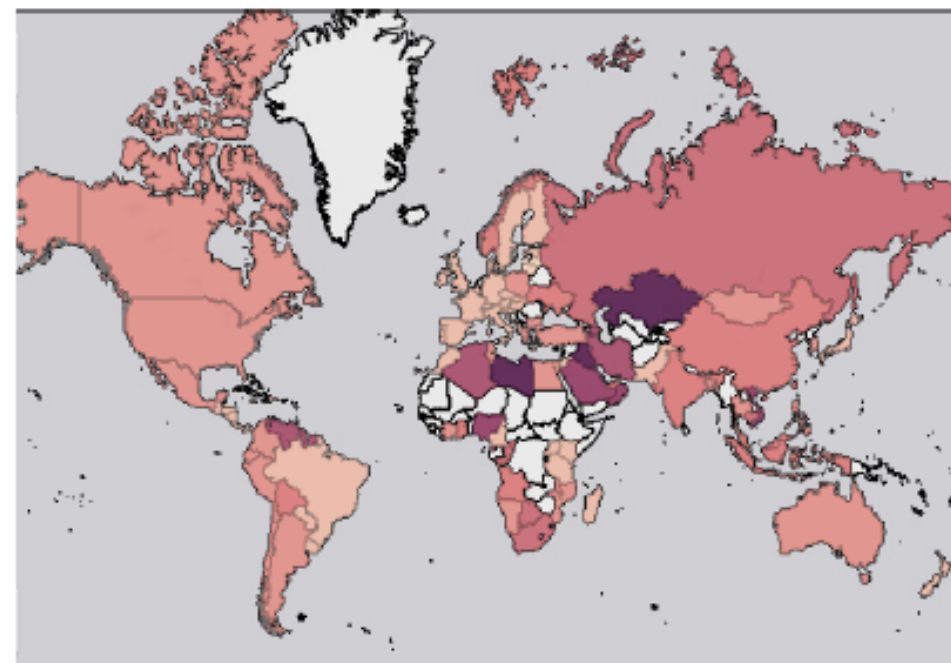


Source: EM-DAT

On transitional risks, reaching net zero GHG emissions by 2050 will require higher carbon pricing and large shifts in Japan's economic structure.

Exposure to Low-Carbon Economy Transition

(Darker shades indicate higher exposure; 2019)



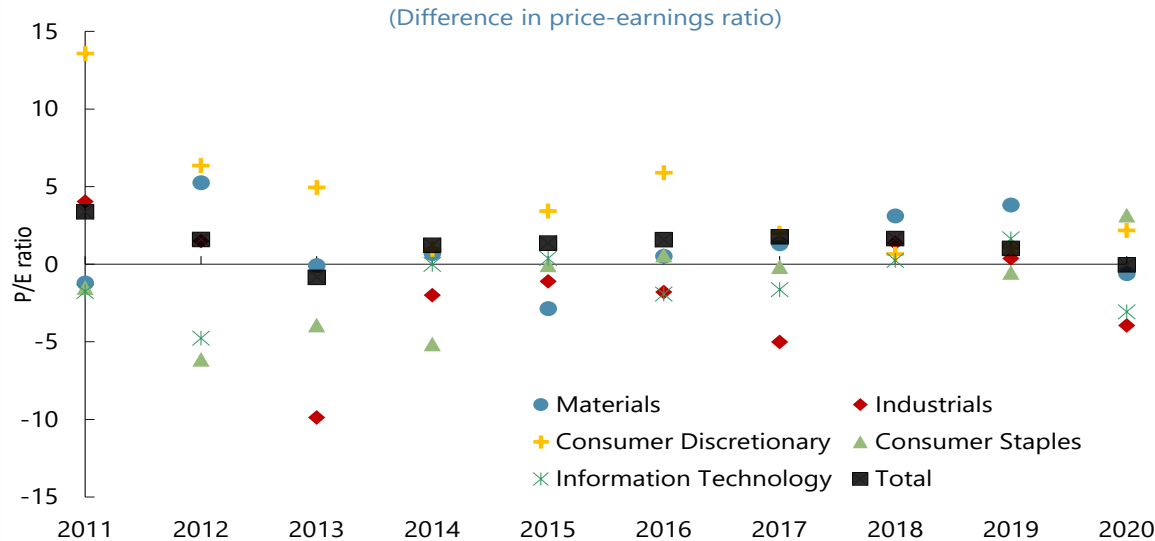
Source: Peszko et al. 2020, Chapter 5, via climatedata.imf.org

# Progress is being made in greening the financial system, but additional efforts will be needed.

Stock market valuations in Japan do not appear to reflect firms' emission intensities.

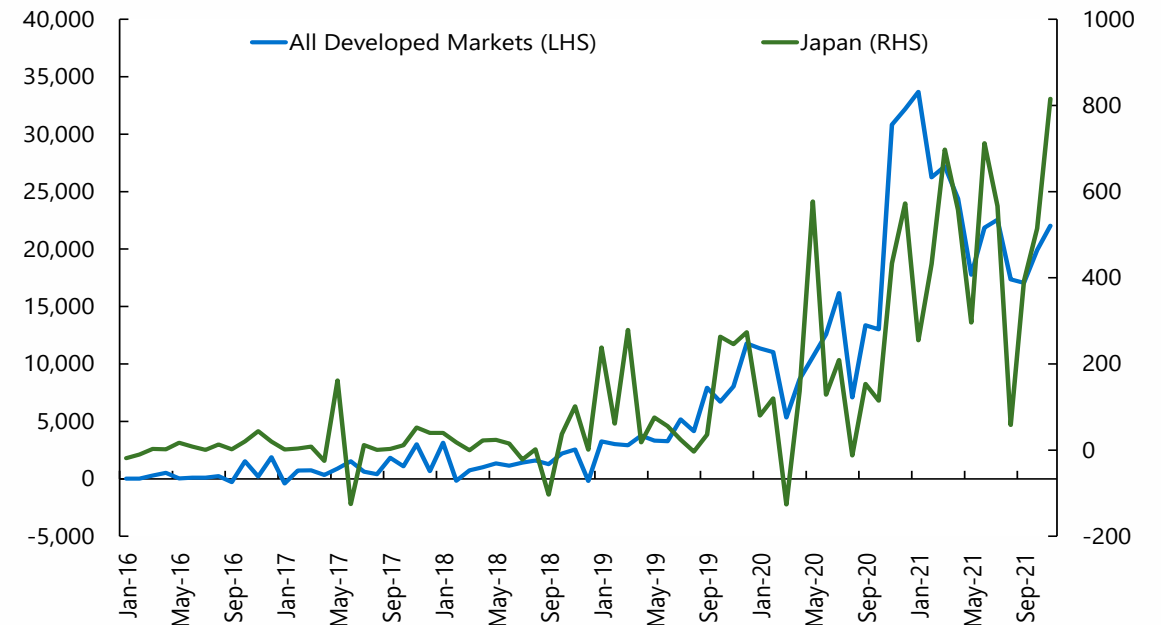
Flows into sustainability themed funds have been strong in Japan, in line with the global trend.

Valuation Difference between High and Low GHG Emitters



Source: Bloomberg and IMF staff calculation.  
 Note: "total" includes all 11 sectors according to the GICS sector classification. Emission intensity measured by GHG emissions scaled by assets.

ESG Equity Fund Flows  
 (Millions of US Dollars)



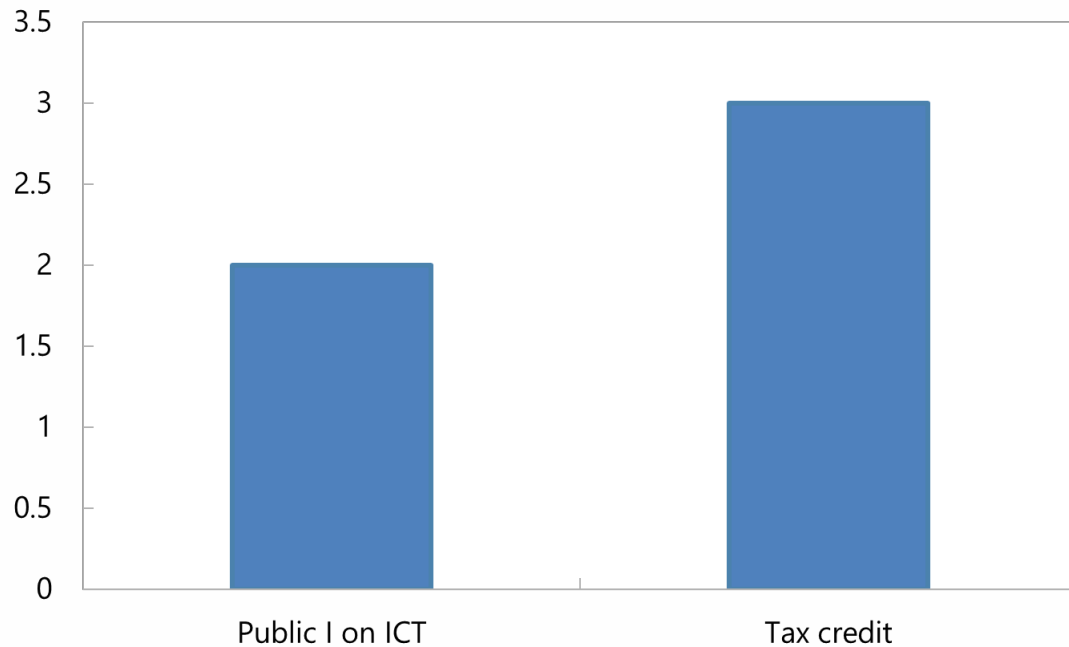
Sources: EPFR

# **Digitalizing the Japanese Economy**

# The government's digital transformation strategy will help boost productivity and growth

The planned increase in public ICT investment and a new tax credit can boost ICT investment by 5 percent

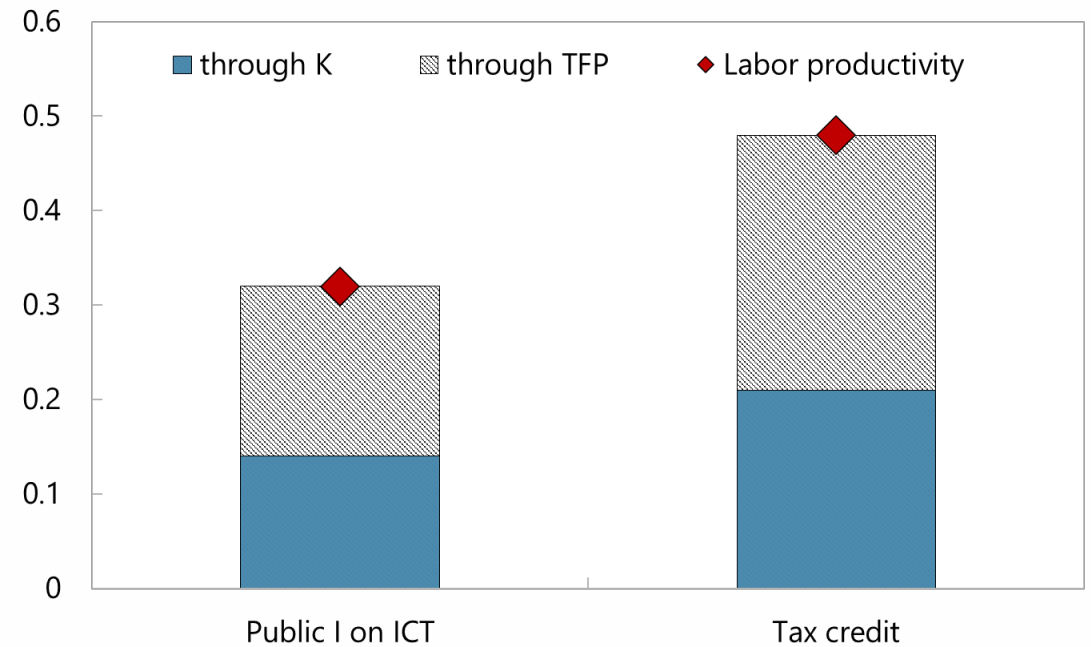
Response of ICT investment to policies  
(in percent)



Source: Staff Calculation

This translates into a 0.8% increase in labor productivity, higher than the average increase of 0.4% over 2010-19

Boost to labor productivity  
(in percent)



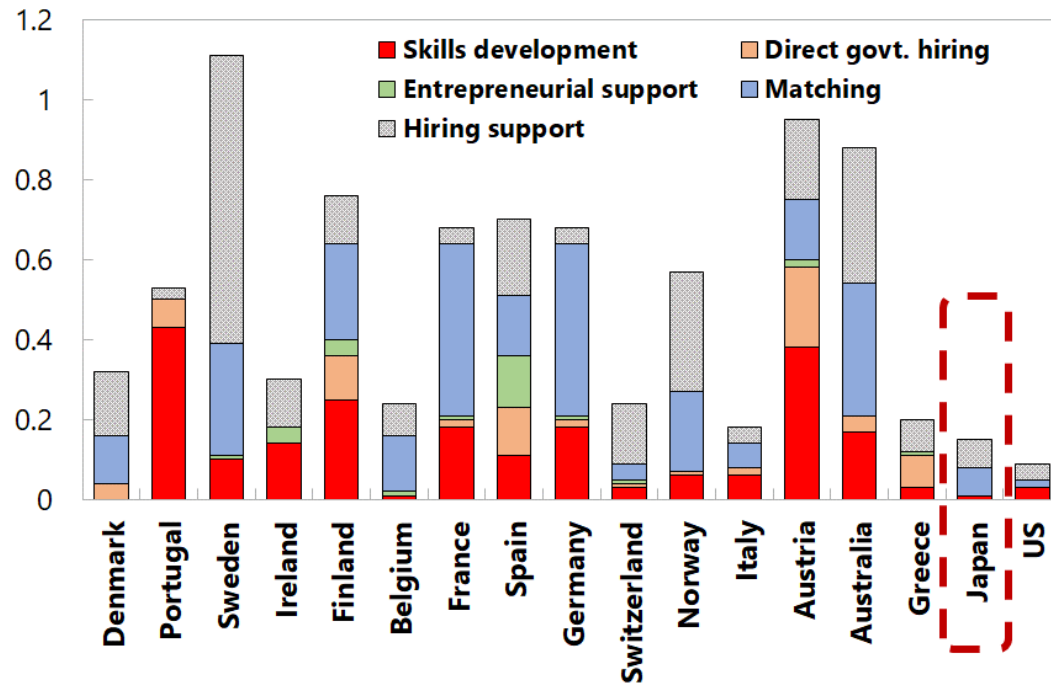
Source: Staff Calculation

# Further measures are needed to ensure a safe and inclusive digital transition of the Japanese economy

Investing in labor training on IT and digital related skills, including digital financial literacy should be prioritized

Strengthening cybersecurity, consumer and data protection will help build the public's trust in the digital economy

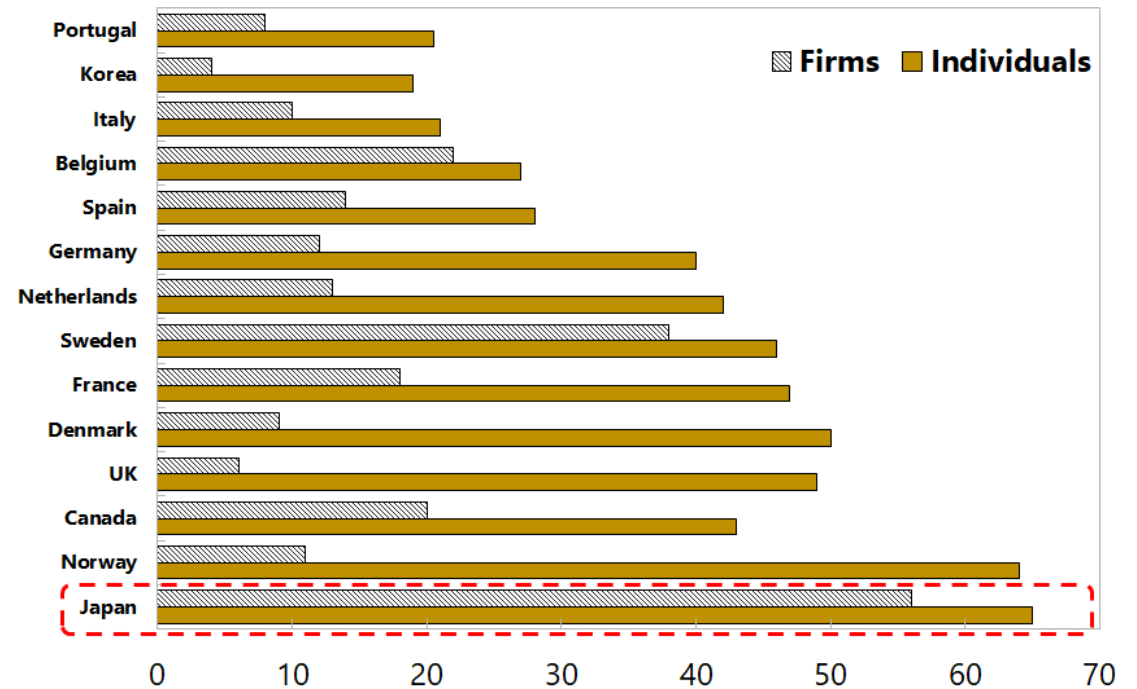
Government spending on proactive labor market policies (% of GDP, 2018)



Sources: OECD data, Public expenditure and participant stocks on labor market policies

Low Digital Security in Japan

(% who have experiences online security incidents, 2018-19)



Sources: OECD Digital Economy Papers No. 283 (June, 2019)

# Roadmap

## I. Outlook and policy priorities

- Outlook and risks
- Key policy recommendations
  - Fiscal policy
  - Monetary policy
  - Financial sector policy
  - Structural policy

## II. IMF research highlights

- Post-pandemic fiscal policy: Implications from the Buffer-Stock Model of Government
- Options for revenue mobilization
- Low for long rates and bank profitability
- Climate change policy options
- Climate finance in Japan
- Digitalizing the Japanese economy

## III. Summary

# Japan: Outlook and policies

- The recovery is expected to continue in 2022. Consumption will lead the recovery, with pent-up demand being unwound. There is **significant uncertainty** around the outlook, including from the war in Ukraine.
- **Near-term policy support to underpin the recovery.** Fiscal policies should be **supportive** in the short-run, while shifting towards facilitating **resource reallocation**. The BoJ should **maintain monetary accommodation**.
- **Medium- and longer-term policies to build back better after the pandemic.**
  - **Fiscal buffers should be rebuilt gradually** once the recovery takes hold, guided by a medium-term fiscal framework underpinned by concrete policy plans.
  - The BoJ should maintain monetary policy accommodation while **taking further measures to make that stance more sustainable**.
  - Financial supervision should remain vigilant to contain vulnerabilities.
  - **Digital and green transformations** could be leveraged to promote strong, sustainable, and inclusive growth after the pandemic. Reinvigorating **reforms to increase labor supply, boost productivity, and support investment** would lift potential growth and facilitate reflation.



# Thank You!

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