



# JAPAN

May 2024

## 2024 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR JAPAN

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 2024 Article IV consultation with Japan, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its May 6, 2024 consideration of the staff report that concluded the Article IV consultation with Japan.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 6, 2024, following discussions that ended on April 4, 2024, 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 April 15, 2024.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Japan.

The documents listed below will be separately released.

Selected Issues  
Financial System Stability Assessment

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**International Monetary Fund**  
**Washington, D.C.**



## IMF Executive Board Concludes 2024 Article IV Consultation with Japan

FOR IMMEDIATE RELEASE

**Washington, DC – May 13, 2024:** On May 6, 2024, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with Japan. This also included a discussion of the findings of the Financial Sector Assessment Program (FSAP) exercise for Japan.<sup>2</sup>

The Japanese economy continues to grow after the pandemic, with broad-based price increases following three decades of low inflation. In 2023Q2, real GDP surpassed the peak level in 2019Q3, and the output gap is estimated to have closed. However, the recovery remains uneven. While goods and services exports have risen above the pre-pandemic peak, private consumption and investment remain below. Headline inflation has been above two percent (y/y) since April 2022. Measures of underlying inflation show that the current above-target inflation is broad-based across products and services for the first time in three decades. The passthrough from inflation to wages has started to pick up. The current account surplus increased to 3.4 percent of GDP in 2023, with the external position in 2023 assessed as broadly in line with the level implied by medium-term fundamentals and desirable policies.

Growth is expected to continue, with a pick-up in consumption later this year. Growth is projected to decelerate to 0.9 percent in 2024, owing to fading of one-off factors supporting growth in 2023, including a surge in tourism. Consumption is expected to pick-up in the latter half of 2024 and 2025 due to the combination of rising nominal wages, following the strong Shunto settlement in 2024, and lower headline inflation lifting real wages. Core inflation is expected to decline gradually as the effect of higher import prices wanes but is projected to stay above the two-percent target until the second half of 2025. The primary fiscal deficit is expected to remain elevated at 6.4 percent in 2024, reflecting the impact of the latest fiscal stimulus package. The current account surplus is expected to increase slightly to 3.5 percent of GDP supported by exports. An aging and declining population will continue to be a major macroeconomic challenge in the medium to long term.

Risks to growth and inflation are broadly balanced. For growth, downside risks include a slowdown in the global economy, deepening geoeconomic fragmentation, and more volatile food and energy prices. On the domestic side, the main downside risks are weak consumption related to negative real wage growth, more acute labor shortages that could constrain activity, and a return to a zero-inflation environment. On the upside, additional recovery of inbound tourism and a stronger global economy could support growth. For inflation, upside risks stem

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

<sup>2</sup> Under the FSAP, the IMF assesses the stability of the financial system, and not that of individual institutions. The FSAP assists in identifying key sources of systemic risk and suggests policies to help enhance resilience to shocks and contagion. In member countries with financial sectors deemed by the IMF to be systemically important, it is a mandatory part of Article IV surveillance, and in the case of the Japan it is supposed to take place every five years. The last FSAP exercise took place in 2017.

from backward-looking inflation expectations and significantly strong-than-expected wages following the spring wage negotiations. Downside risks could come from a faster decline in global goods and import prices.

The Japanese financial system has withstood a series of shocks but confronts several challenges. Key risks to macrofinancial stability at the current juncture stem from three main sources of vulnerability: the sizable security holdings of financial institutions under mark-to-market accounting, some banks' notable foreign currency exposures, and signs of overheating in parts of the real estate markets. The systemic risk analysis conducted as part of the FSAP suggests that the financial system is broadly resilient to a range of adverse macrofinancial shocks but some areas merit attention and close monitoring. Risks from climate change and growing digitalization, including cyber risks, also need to be carefully monitored. Financial sector policies have been strengthened in recent years, but further steps are warranted to maintain financial stability in an evolving risk environment.

### **Executive Board Assessment<sup>3</sup>**

Executive Directors welcomed that growth of the Japanese economy is expected to continue, supported by a pick-up in consumption, with broad based price increases following three decades of low inflation. Noting that while risks to growth and inflation are broadly balanced, Directors emphasized the need for steadfast policy implementation against the longer-term challenge of low productivity growth due to population aging and labor market rigidity.

Directors stressed that fiscal consolidation is needed to rebuild fiscal buffers and ensure debt sustainability, underpinned by both revenue and expenditure measures. In this context, they emphasized that any new spending should be offset by higher revenues or savings elsewhere in the budget given a closed output gap and high debt-to-GDP ratio, and that growth-friendly fiscal consolidation should be supported by a strengthened and more disciplined medium-term fiscal framework.

Directors agreed that further hikes in the short-term policy rate should proceed at a gradual pace and be data-dependent, given balanced risks to inflation and mixed signals in recent data. They concurred that state-contingent purchases of Japanese Government Bonds by the Bank of Japan will help mitigate excessive shifts in yields that could undermine macro-financial stability during this historic policy transition. More broadly, Directors emphasized that a clear and effective communication strategy that continues to underscore factors behind the pace of policy rate increases will be key. They underscored that Japan's longstanding commitment to a flexible exchange rate regime will help absorb shocks and support monetary policy's focus on price stability.

Directors supported the key findings and policy recommendations of the 2024 Financial Sector Assessment Program. While welcoming that the financial system is broadly resilient, they noted that market risks for financial institutions warrant close monitoring and potential vulnerabilities in parts of the real estate sector call for a macroprudential response. Directors concurred that the evolving and challenging risk environment underscores the need to fill remaining gaps in the financial sector oversight and crisis management framework. They also

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<sup>3</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.

agreed that staffing resources need to be increased significantly to enhance the supervision and resolution of financial institutions.

Directors concurred that further structural policies are needed to support fertility, female leaders, startups, and a green economy, with labor market reforms at the forefront of the agenda. They agreed that these reforms should include a further expansion of childcare facilities, progress on workstyle reforms, reducing labor market dualism, and greater firm dynamism.

**Table 1. Japan: Selected Economic Indicators, 2020–25**

	Nominal GDP: US\$ 4,213 billion (2023) Population: 125 million (2023)			GDP per capita: US\$ 33,806 (2023) Quota: SDR 30.8 billion (2023)		
	2020	2021	2022	2023 Est.	2024 Proj.	2025
	<i>(In percent change)</i>					
<b>Growth</b>						
Real GDP	-4.1	2.6	1.0	1.9	0.9	1.0
Domestic demand	-3.3	1.5	1.5	0.9	0.8	1.1
Private consumption	-4.4	0.8	2.2	0.6	0.3	0.9
Gross Private Fixed Investment	-5.4	0.4	1.0	1.9	1.9	1.5
Business investment	-4.9	0.5	1.9	2.1	2.3	1.8
Residential investment	-7.7	-0.3	-3.5	1.1	-0.1	0.3
Government consumption	2.4	3.4	1.7	0.9	1.3	0.7
Public investment	3.5	-1.8	-9.6	2.8	0.1	-0.2
Stockbuilding	-0.5	0.5	0.3	-0.1	-0.1	0.1
Net exports	-0.9	1.1	-0.5	0.9	0.2	0.0
Exports of goods and services	-11.6	11.9	5.3	3.0	3.3	1.7
Imports of goods and services	-6.8	5.1	7.9	-1.3	2.2	2.0
Output Gap	-2.9	-1.6	-0.9	0.2	0.1	0.0
	<i>(In percent change, period average)</i>					
<b>Inflation</b>						
Headline CPI	0.0	-0.2	2.5	3.3	2.2	2.1
GDP deflator	0.9	-0.2	0.3	3.8	2.3	2.3
	<i>(In percent of GDP)</i>					
<b>Government</b>						
Revenue	35.5	36.4	37.6	36.5	35.8	36.5
Expenditure	44.5	42.5	41.9	42.2	42.3	39.7
Overall Balance	-9.1	-6.1	-4.4	-5.8	-6.5	-3.2
Primary balance	-8.4	-5.5	-3.9	-5.6	-6.4	-3.0
Structural primary balance	-7.5	-4.8	-3.9	-5.7	-6.5	-3.0
Public debt, gross	258.3	253.9	248.7	252.4	254.6	252.6
	<i>(In percent change, end-of-period)</i>					
<b>Macro-financial</b>						
Base money	19.2	8.5	-5.6	6.3	2.3	2.3
Broad money	7.3	2.9	2.2	2.1	1.5	2.0
Credit to the private sector	6.1	1.9	4.2	4.4	2.6	1.9
Non-financial corporate debt in percent of GDP	151.8	155.0	159.4	155.2	156.8	156.5
	<i>(In percent)</i>					
<b>Interest rate</b>						
Overnight call rate, uncollateralized (end-of-period)	0.0	0.0	0.0	0.0	...	...
10-year JGB yield (end-of-period)	0.0	0.1	0.4	0.6	...	...
	<i>(In billions of USD)</i>					
<b>Balance of payments</b>						
Current account balance	149.9	196.4	84.5	144.7	142.6	149.7
Percent of GDP	3.0	3.9	2.0	3.4	3.5	3.5
Trade balance	26.6	16.4	-117.5	-49.1	-31.4	-28.9
Percent of GDP	0.5	0.3	-2.8	-1.2	-0.8	-0.7
Exports of goods, f.o.b.	630.6	749.2	751.8	713.2	728.6	754.9
Imports of goods, f.o.b.	604.0	732.7	869.4	762.2	759.9	783.8
Energy imports	89.1	127.8	195.5	152.6	143.0	128.9
	<i>(In percent of GDP)</i>					
FDI, net	1.7	3.5	2.9	3.8	3.0	2.7
Portfolio Investment	0.8	-3.9	-3.4	4.7	-0.7	-1.0
	<i>(In billions of USD)</i>					
Change in reserves	10.9	62.8	-47.4	29.8	11.5	11.5
Total reserves minus gold (in billions of US\$)	1348.2	1356.2	1178.3	1238.5	...	...
	<i>(In units, period average)</i>					
<b>Exchange rates</b>						
Yen/dollar rate	106.8	109.8	131.5	140.5	...	...
Yen/euro rate	121.9	129.9	138.6	152.0	...	...
Real effective exchange rate (ULC-based, 2010=100)	75.3	73.5	62.0	56.4	...	...
Real effective exchange rate (CPI-based, 2010=100)	77.3	70.7	61.0	58.0	...	...
	<i>(In percent)</i>					
<b>Demographic Indicators</b>						
Population Growth	-0.3	-0.3	-0.3	-0.4	-0.5	-0.5
Old-age dependency	48.3	48.7	48.9	49.3	49.8	50.3

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



# JAPAN

## STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION

April 15, 2024

### KEY ISSUES

**Context.** The Japanese economy continues to grow after the pandemic, with broad-based price increases following three decades of low inflation. The “new form of capitalism” agenda and children-related policies are key priorities for the Kishida administration, but the fiscal burden has increased.

**Outlook and risks.** Growth is expected to continue, with a pick-up in consumption later this year. Core inflation will decline gradually, but is projected to stay above the two-percent target until the second half of 2025. The output gap is expected to be slightly positive until 2025. Risks to growth and inflation are broadly balanced.

#### Policy lines.

- **Fiscal** consolidation is needed to rebuild fiscal buffers and ensure debt sustainability. Any new spending should be offset by higher revenues or savings elsewhere in the budget. Growth-friendly fiscal consolidation should be supported by a strengthened and more disciplined medium-term fiscal framework.
- Given balanced risks to inflation and mixed signals in recent data, further hikes in the short-term **policy rate** should proceed at a gradual pace. A clear and effective communication strategy that continues to underscore factors that support a gradual and cautious pace of policy rate increases will also be key.
- The **financial** system is broadly resilient, but interest rate and foreign currency exposure related risks for banks warrant close monitoring. Potential vulnerabilities in parts of the real estate sector call for further risk oversight and a macroprudential policy response. Policies to safeguard the financial system include further strengthening the risk-based supervision and resolution frameworks.
- Further **structural** reforms are needed to support fertility, female leaders, startups, and a green economy, with labor market reforms at the forefront of the agenda. These reforms include a further expansion of childcare facilities, progress on workstyle reforms, reducing labor market dualism, and greater firm dynamism.

Approved By  
**Sanjaya Panth (APD)**  
**and Kenneth Kang**  
**(SPR)**

Discussions with officials took place between January 25 and February 9, 2024, with follow up virtual meetings in mid-March and early April with the Bank of Japan and the Ministry of Finance to discuss subsequent economic and policy developments. The team comprised Ranil Salgado (mission chief), Kohei Asao, Yan Carrière-Swallow, Purva Khera, Chris Redl, TengTeng Xu (all APD), Salih Fendoglu (MCM), and Haruki Seitani (OAP). Executive Director Jun Mizuguchi, Alternate Executive Director Shuntaro Hara, Nada Choueiri (APD), and Heedon Kang (MCM) joined some meetings. The First Deputy Managing Director, Martin Kaufman (her advisor), and some mission members met with Finance Minister Suzuki and Bank of Japan Governor Ueda. Danila Smirnov (APD) assisted with analytical work and drafting this report, and Seble Abebe and Kaustubh Chahande (both APD) assisted in the preparation of this report.

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## CONTEXT

**1. The Japanese economy continues to grow after the pandemic, with broad-based price increases following three decades of low inflation.** After faltering somewhat in 2022 amid relatively slower domestic reopening and supply chain disruptions, growth picked up again in 2023 but is expected to moderate going forward amid still elevated inflation. Initially driven by cost-push factors, inflation is increasingly demand driven as the output gap closes and labor shortage intensifies. The main longer-term challenge remains low productivity growth due to population aging and labor market rigidity.

**2. The “new form of capitalism” agenda<sup>1</sup> and children-related policies are key priorities for the Kishida administration, but the fiscal burden has increased.** Under the “new form of capitalism” agenda, the government continues to promote investment in priority areas, including science and technology, startups and innovation, green transformation (GX), and digital transformation (DX). Against the backdrop of an aging and declining population, the government announced children-related policies to address low birthrates and to provide support to families. While these reform priorities are important to ensure a green, inclusive, and sustainable recovery, many of the new policy initiatives have no concrete revenue offsetting measures. The recent rise in fiscal spending with limited attention paid in the political sphere to debt sustainability, coupled with announced tax cuts,<sup>2</sup> increases Japan’s fiscal burden, and worsens its debt-to-GDP ratio.

## RECENT DEVELOPMENTS

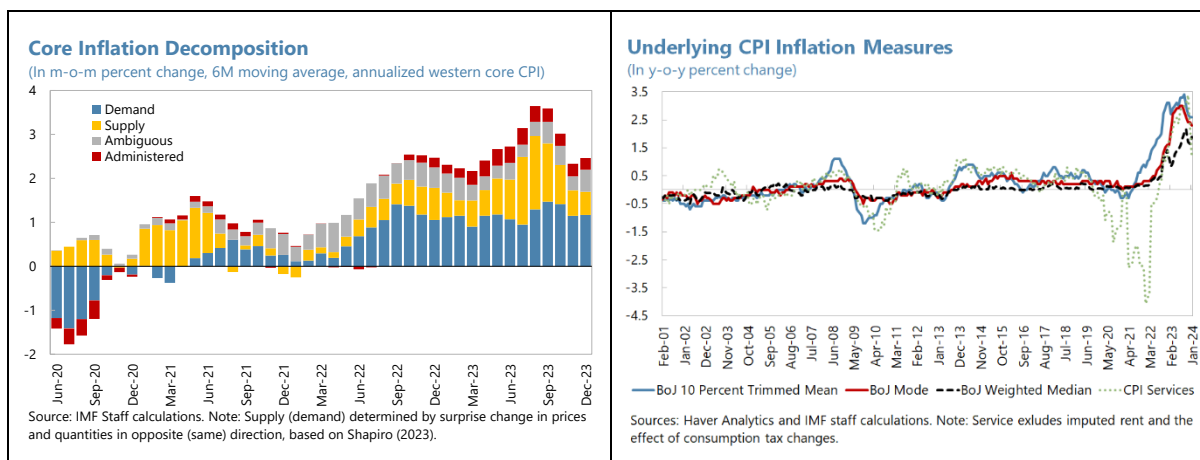
**3. Growth picked up in 2023 led by net exports (Figure 1).** In 2023Q2, real GDP surpassed the peak level in 2019Q3, and the output gap is estimated to have closed. However, the recovery remains uneven. While goods and services exports have risen above the pre-pandemic peak, private consumption and investment remain below. Households and corporates have accumulated excess savings from pandemic support measures and higher profits. GDP growth waned in the second half of 2023, on the back of weaker consumption (following negative real wage growth) and reached 1.9 percent for the full year.

**4. Core inflation (excluding fresh food and energy) seems to have peaked at a high level and is becoming demand driven.** Headline inflation has been above two percent (y/y) since April 2022 (Figure 2). Both pent-up domestic demand and inbound tourism have contributed to the inflation momentum. Since the border reopening in October 2022, the number of inbound tourists has more than quadrupled and rose above the pre-pandemic level in October 2023, with travel receipts five percent higher in 2023Q3 compared with 2019Q3. Survey-based medium-term inflation expectations for firms have been above the Bank of Japan’s (BoJ’s) 2-percent inflation target since

<sup>1</sup> See [“Grand Design and Action Plan for a New Form of Capitalism” \(June 2023\)](#).

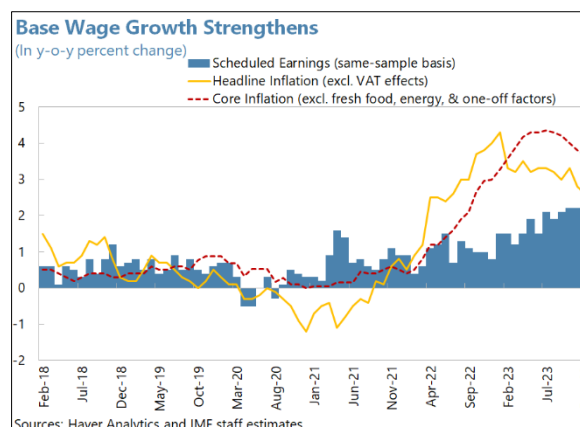
<sup>2</sup> The authorities announced a reduction in income and local residential tax in November 2023. It will be applied to all income earners except for those earning above 20 million JPY annually (less than one percent of population). The tax reduction amounts to 40,000 JPY (\$275) per person and is set to be implemented from June 2024.

2022Q3. Average household inflation expectations in the BoJ opinion survey are at record high levels since 2006. Measures of underlying inflation show that the current above-target inflation is broad-based across products and services for the first time in three decades.



**5. The passthrough from inflation to wages has started to pick up.** The labor market

remains tight, with labor force participation at 63 percent (a 24 year high) and the unemployment rate at 2.6 percent. Nominal wage growth has averaged 2 percent since May 2023 and remained above 2 percent since September, on a same-sample basis, but remains below that of core inflation. Wage growth is significantly influenced by the annual spring wage negotiations, which gave workers a 2.1 percent rise in base pay in 2023 (a sizable increase from the 0.6 percent in 2022). Japan’s main trade union (Rengo) announced a 5.3 percent rise in headline wage (about 3.6 percent in base pay) in the first two rounds of results in 2024, the highest pay hike in three decades, and the main business federation (Keidanren) has endorsed strong wage increases.

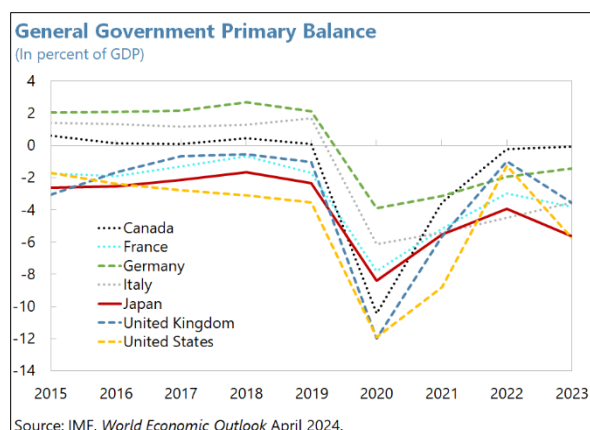


**6. The Japanese authorities announced a sizable new fiscal stimulus package in early November.**

Staff estimates that the new above-the-line public spending of general government amounts to about 2.3 percent of GDP, and together with the planned tax cut (0.7 percent of the GDP), the total fiscal impact would be about 3 percent of GDP.<sup>3</sup> The stimulus package covers five pillars: 1) mitigate the impact of inflation on households (a personal income tax cut, cash transfers to low-income households, and an extension of energy subsidies); 2) support for companies to offer

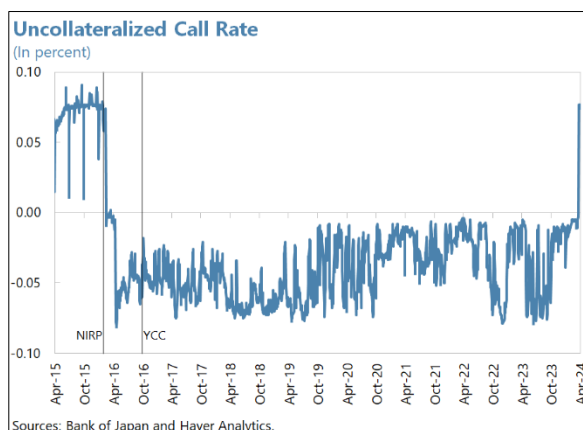
<sup>3</sup> The headline amount of the fiscal package stood at about 4.3 percent (public spending at about 3.6 percent and tax cut at about 0.7 percent). However, the package includes already announced measures (e.g., defense).

sustained wage hikes; 3) domestic investment (including artificial intelligence/space research subsidies and semiconductor-related investment); 4) social reform to address declining population, including children-related policies; and 5) national resilience (national security, disaster prevention/mitigation). Compared with other G7 economies, the primary deficit in Japan has remained elevated at over 5 percent of GDP since the pandemic, with limited fiscal consolidation. The debt-to-GDP ratio stood at around 252 percent of GDP in 2023.



**7. The BoJ ended its negative interest rate policy (NIRP) and overhauled its exceptional monetary policy framework at the March 2024 monetary policy meeting.** Given growing confidence that the 2-percent inflation target would be achieved in a sustainable manner over the policy horizon,<sup>4</sup> the BoJ:

- **Abolished Yield Curve Control and transitioned back to a standard short-term policy rate targeting framework.** The BoJ will no longer target a particular level of the 10-year Japanese government bond (JGB) yield, eliminating all hard and soft targets or bands.<sup>5</sup>
- **Hiked the short-term policy rate for the first time since February 2007.** The BoJ ended its 8-year long NIRP and shifted back to the uncollateralized overnight call rate as its main policy target. The policy rate band increased by about 10 bps to range from 0 to 0.1 percent (from -0.1 to 0 percent previously under the NIRP).<sup>6</sup>
- **Exited Quantitative and Qualitative Easing (QQE) while maintaining its JGB purchases.** The BoJ will maintain its gross JGB purchases at around the current average (recently about 6 trillion yen per month) across maturities broadly keeping its holdings of JGBs unchanged as previous JGB holdings mature. JGB purchases could



<sup>4</sup> The horizon for the March meeting is the period up to end-March 2026.

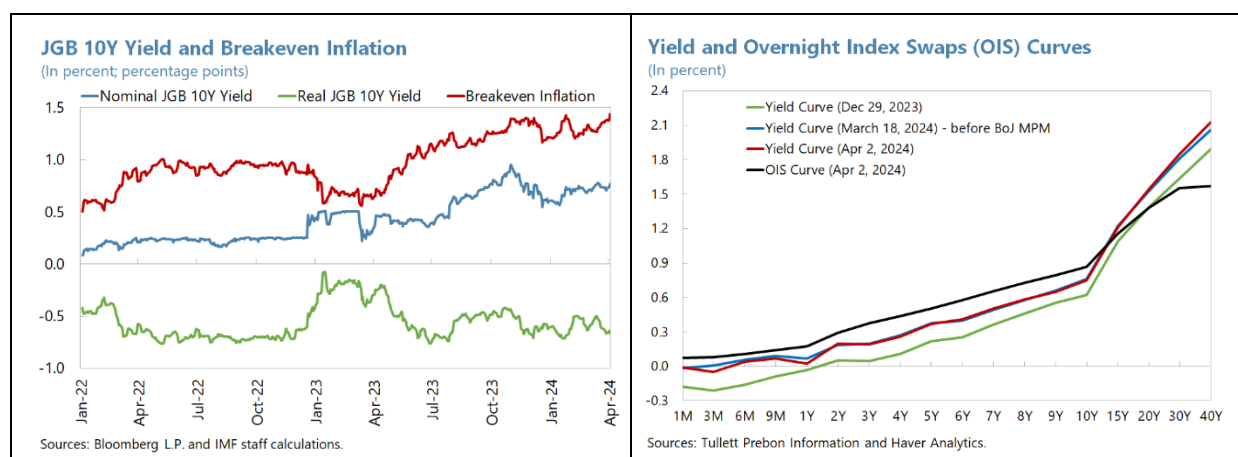
<sup>5</sup> At its meetings in July 2023, the central bank announced that it would allow the yield on 10-year JGBs to rise up to one percent (from 0.5 percent previously). In October, it stated that the 1 percent upper bound for the 10-year JGB yield would henceforth serve as a “reference” for its market operations rather than a hard cap.

<sup>6</sup> Under the new single-tier system, there is a single interest rate on excess reserves of 0.1 percent (with the rate on required reserves at 0 percent). Previously, the BoJ used a three-tier reserve remuneration system with three categories of interest rates at -0.1, 0 and 0.1 percent, where -0.1 percent was the policy rate.

be increased if needed to prevent a rapid rise in long-term rates. Risk asset purchases under the “qualitative” part of QQE will end, with an immediate halt to purchases of exchange traded funds (ETFs) and Japan real estate investment trusts (J-REITs) and gradual reductions of commercial paper and corporate bond purchases which will then be discontinued in about a year.

- **Stated that accommodative financial conditions will be maintained for the time being,** as long-term inflation expectations have not yet been anchored at 2 percent.<sup>7</sup> The BoJ also abolished its ‘inflation overshooting commitment’ under which it committed to increase the monetary base until the inflation rate (CPI less fresh food) stays above the 2 percent target in a stable manner.

The market reaction has thus far been muted, as this policy shift was widely anticipated. 10-year JGB yields continue to hover below 0.8 percent (as of April 2), while the exchange rate has continued to depreciate (see para 10).

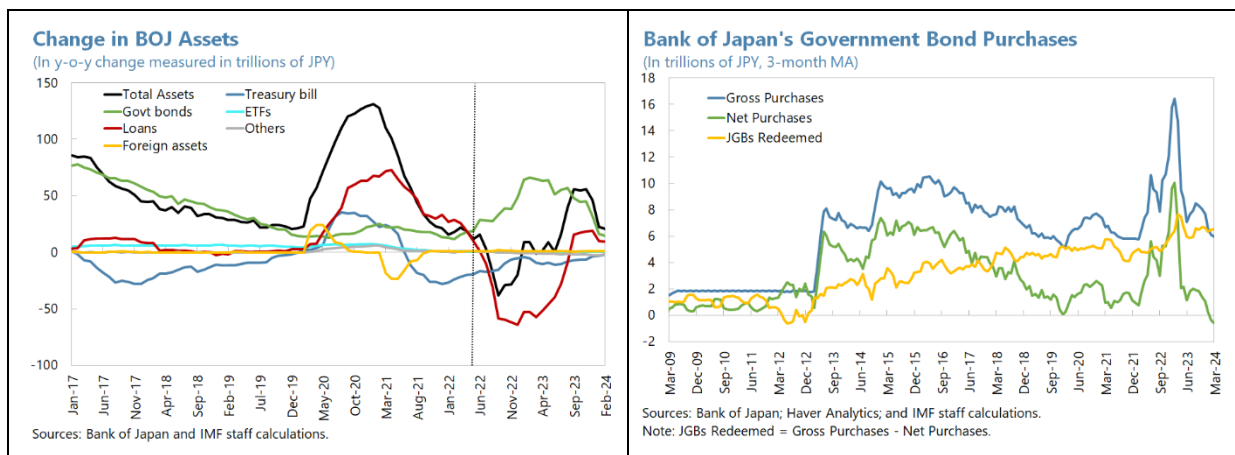


## 8. Scaling back of asset purchases by the BoJ had already been underway prior to March.

While the BoJ’s balance sheet continued to expand by close to 6.5 percent y/y in December 2023 mainly driven by its JGB purchases, these declined significantly towards end-2023. The BoJ’s net JGB purchases have been trending down since November 2023 and were hovering close to zero, i.e., the BoJ is purchasing enough to roll-over the amount of maturing JGBs. Moreover, the BoJ’s purchases of ETFs were already at an all-time low in 2023, and purchases of J-REITs had halted since June 2022. The BoJ has also unwound all its COVID-related increases in exposures to commercial papers and partly unwound those related to corporate bonds.

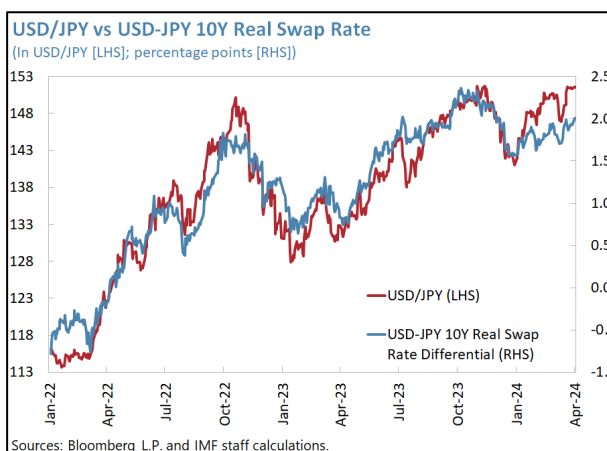
**9. However, monetary policy continues to remain ultra-accommodative.** While long-term interest rates have increased and the yield curve has steepened over time, higher realized inflation and inflation expectations have led to lower and negative real short- and long-term rates.

<sup>7</sup> The BoJ follows a range of measures of inflation expectation – both survey- and market-based. Some market-based measures of inflation expectations remain below two percent.



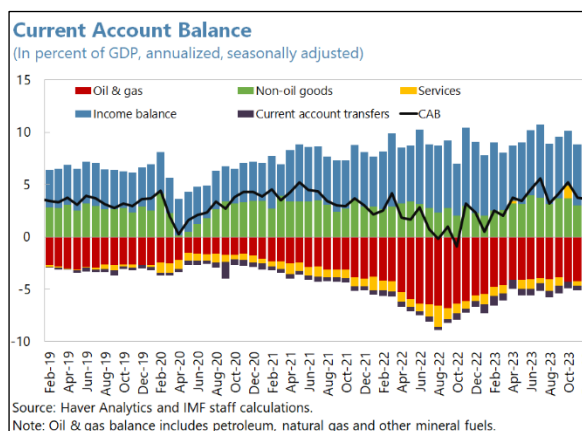
**10. The divergence in monetary policy between Japan and its peers has led to downward pressure on the yen (Figure 4).**

The yen weakened by about 9 percent against the U.S. dollar (US\$) in 2023, partly in line with widening (real) interest rate differentials vis-à-vis the United States (U.S.). In 2024, the yen depreciated by more than 7 percent (as of March 29), despite some narrowing in those differentials since around October 2023. After intervening to defend the yen in September and October 2022, the authorities have refrained from any intervention although they strengthened verbal warnings after the US\$-yen breached 150 in October and November 2023, as well as in February and March 2024, indicating that they stand ready to take action if there is excessive movement. Empirical analysis suggests that yen depreciation during 2023 was broadly in line with interest rate differentials until around October 2023. In recent months, however, there has been an increasing and significant role played by carry trade positions (proxied by net non-commercial short positions in the yen). Discussions with market participants indicate that carry trades have increased as the perceived risk of a strong reversal in the yen (i.e., appreciation) has decreased.



**11. On a preliminary basis, the external position in 2023 is assessed as broadly in line with the level implied by medium-term fundamentals and desirable policies (Annex I).**

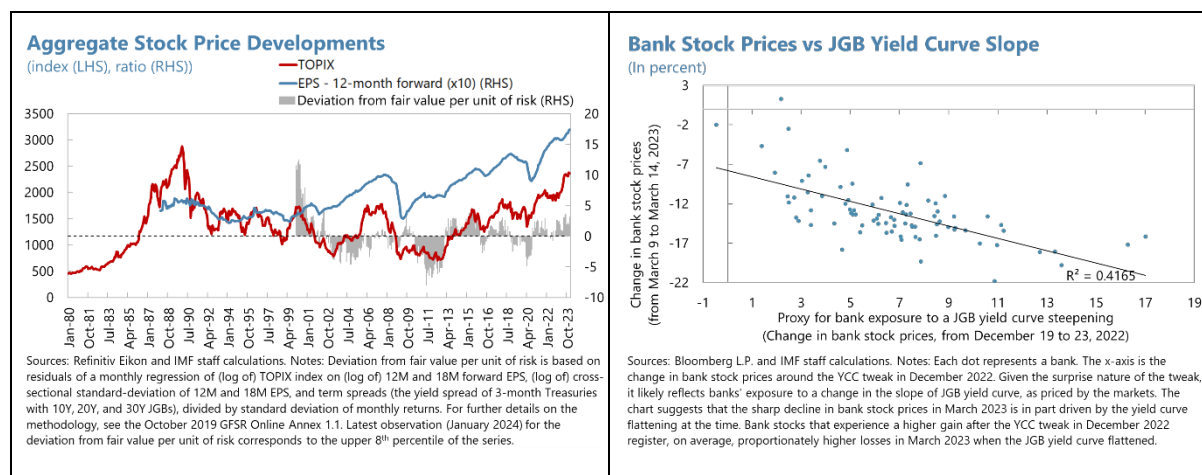
The current account surplus increased to 3.4 percent of GDP in 2023 from 2 percent in 2022. Inbound tourism and a pickup in auto exports (as supply disruptions faded) boosted exports while lower commodity prices reduced imports. The primary income surplus remains



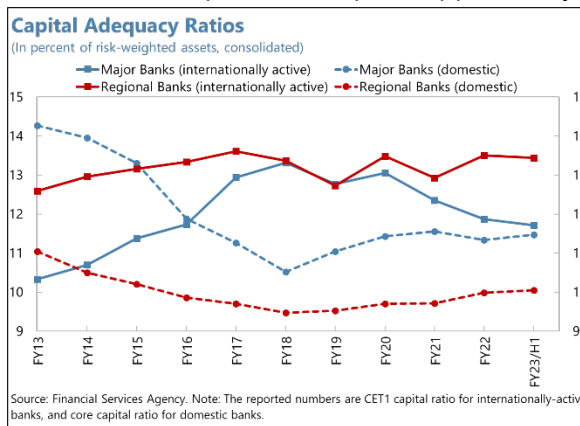
strong supported by yen depreciation and a high stock of net foreign assets at 80 percent of GDP as of end-September 2023.

**12. The financial sector has benefitted from the domestic rebound and higher overseas profits and has been resilient to global shocks.**

- **Stock market.** Stock market indices reached multi-decade highs, driven in part by higher corporate earnings amidst domestic growth, the weaker yen, inflation, and strong foreign interest.<sup>8</sup> Equity valuations have risen across all sectors since January 2023, with most sectors up by more than 20 percent, and the TOPIX banking sector index having gained more than 50 percent, with the economic rebound and a steeper yield curve as tailwinds.



- **Banks.** The banking sector on aggregate continues to be well-capitalized, in part supported by net gains from equity holdings, and maintains sizeable liquidity buffers. Non-performing or special-mention loans<sup>9</sup> remain at record low levels (e.g., at 0.7 percent for major banks as of end-September 2023). Japanese mega banking groups posted strong profit growth in the first half of the fiscal year (a 70 percent increase y/y), owing to widening overseas lending margins, portfolio rebalancing into higher-yield overseas debt securities, and a weaker yen.

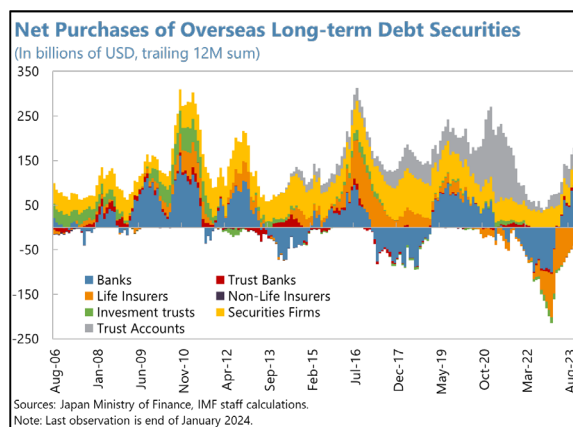


<sup>8</sup> Net stock purchases in the prime/upper-segment market by foreigners was about US\$24 billion in 2023, a record level since 2014 (JPX). Strong foreign interest continued in January 2024 (US\$14 billion). Another reason for the attractiveness of yen-denominated assets could be the indirect exposure to the broader Asia region for some global asset managers.

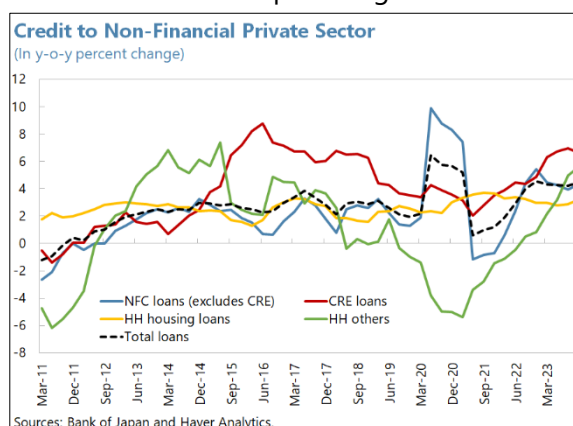
<sup>9</sup> Special-mention loans are those not yet classified as non-performing but in principle show signs of potential weakness.



- *Non-banks.* Insurers, the second largest sector among financials, continue to maintain good profitability on aggregate and are well capitalized based on statutory solvency margins. Life insurers reduced their foreign currency hedging in FY2022, amid a significant rise in hedging costs (while continuing to maintain their overseas holdings on aggregate). The Government Pension and Investment Fund (GPIF) maintains a healthy long-term investment return, with mark-to-market losses on domestic bond holdings (amid higher interest rates) more than offset by net gains from equity holdings.



- *Credit to the private non-financial sector.* Credit to the non-financial corporates grew robust at 3.6 percent y/y, driven mainly by stronger demand. Corporate bankruptcies have increased mainly owing to, according to the Tokyo Shoko Research's survey, rising prices and labor shortages, and largely confined to services and small firms. Commercial real estate (CRE) loans grew strongly at 6.6 percent y/y, and housing loans moderately above historical averages at 3.2 percent y/y. The credit-to-GDP gap<sup>10</sup> decreased by 6 percentage points y/y from 22 percent in June 2022. Netting out accumulated corporate cash and deposits, the credit-to-GDP gap is estimated to be 14 percent.



## OUTLOOK AND RISKS

**13. Growth is expected to continue, with a pick-up in consumption later this year.** Growth is projected to decelerate to 0.9 percent in 2024, owing to fading of one-off factors supporting growth in 2023, including a surge in tourism. After remaining weak in the first half of 2024 due to the impact of protracted negative real wage growth, consumption is expected to pick-up in the latter half of 2024 and 2025, raising growth in 2025, due to the combination of rising nominal wages, following the strong Shunto settlement in 2024, and lower headline inflation lifting real wages. Growth is expected to slow gradually over the medium term due to population aging, with

<sup>10</sup> Defined as the deviation between the total credit-to-GDP ratio and its long-term trend, where the trend is estimated with a one-sided Hodrick-Prescott filter with a large lambda consistent with long financial cycles (lambda was set at 400,000).

the output gap remaining slightly positive until 2025.<sup>11</sup> The primary fiscal deficit is expected to remain elevated at 6.4 percent in 2024, reflecting the impact of the latest fiscal stimulus package. The current account surplus is expected to increase slightly to 3.5 percent of GDP supported by exports.

**14. Core inflation is expected to decline gradually as the effect of higher import prices wanes but is projected to stay above two percent until the second half of 2025.** The underlying inflation momentum is slowing as the effect of yen depreciation and border reopening wanes. However, the deceleration will be gradual due to a closed output gap and further wage growth (Figure 5).<sup>12</sup> Given the strong results of the 2024 Shunto wage negotiations we expect another year of robust wage growth. This will help support inflation to stay above two percent until 2025.

**15. An aging and declining population will continue to be a major macroeconomic challenge in the medium to long term.** The primary deficit in percent of GDP is projected to decline in the near term as the stimulus measures phase out, but to rise in the medium and long term to accommodate age-related spending pressures.<sup>13</sup> Potential growth is expected to decline in the medium term to just below 0.5 percent, after the dividends from higher female labor force participation fade. Headline inflation is expected to moderate to around 2 percent in the medium term, in-line with the BOJ's 2 percent inflation target. The current account surplus is expected to remain close to 3.4 percent of GDP in the medium term.

**16. Risks to growth and inflation are broadly balanced.** For growth, downside risks include a slowdown in the global economy (including in China), deepening geoeconomic fragmentation, and more volatile food and energy prices. On the domestic side, the main downside risks are weak consumption related to negative real wage growth, more acute labor shortages that could constrain activity, a return to a zero-inflation environment, and potential price correction amidst signs of overheating in parts of the real estate markets. On the upside, additional recovery of inbound tourism and a stronger global economy could support growth. For inflation, upside risks stem from backward-looking inflation expectations, significantly stronger-than-expected wages following the spring wage negotiations, and uncertainty relating to exchange rate pass through in a new positive inflation regime. Downside risks could come from a faster decline in global goods and import prices (Annex II).

<sup>11</sup> On a per capita basis Japan's growth is expected to remain close G7 average in the medium term.

<sup>12</sup> Liu and others (*forthcoming*) provide evidence that core inflation will remain persistent based on the positive output gap, continued strength in tourist arrivals as well as sticky inflation expectations (which remain above 2 percent).

<sup>13</sup> Higher inflation affects fiscal aggregates and debt through multiple channels, including 1) higher spending in response to inflation; 2) higher income taxes due to the bracket creep effect; 3) more favorable real interest rate-growth dynamics that supports lower debt levels in the near term; and 4) higher policy interest rates (at a later stage to contain inflation), which will raise the cost of borrowing and worsen debt dynamics.



## Authorities' Views

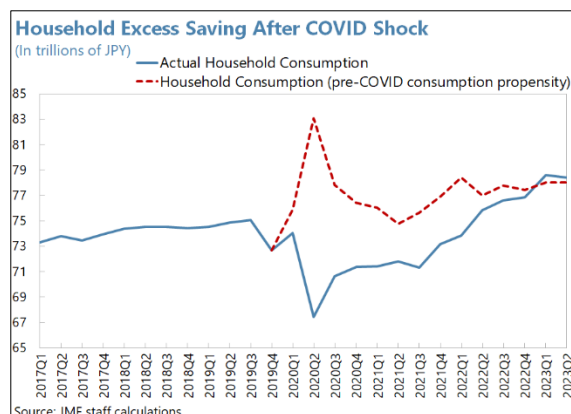
**17. The authorities broadly agreed with the Fund staff's assessment on the economic outlook and near-term risks.** Like staff, they expected real GDP growth to decelerate in 2024, as one-off factors supporting growth in 2023 fade. Nevertheless, they projected growth to remain above potential supported by stronger consumption and investment, before gradually converging to a rate consistent with medium-term potential. On Shunto wage negotiations, they expected higher wage increases this year. They emphasized the importance of domestic factors in driving inflation so far and projected inflation to decline in 2024, as external supply shocks fade. The authorities concurred with the preliminary assessment that Japan's 2023 external position was broadly in line with medium-term fundamentals and desirable policies.

## ECONOMIC POLICIES

*Policy discussions focused on the need to tighten fiscal policy and the extent of accommodation needed for monetary policy amid persistent inflation and a closed output gap in the near-term, while addressing potential financial stability risks associated with a rise in interest rates. As regards the medium term, discussions highlighted the importance of strengthening the medium-term fiscal framework and advancing wide-ranging structural reforms to support potential growth.*

### A. How Can Japan Ensure Fiscal Sustainability?

**18. Given a closed output gap and high debt-to-GDP, the large, not-well-targeted fiscal stimulus in the November package was not warranted.** Additional expenditure should be better targeted and offset by higher revenues or savings elsewhere. The proposed reduction in income tax and local residential tax is untargeted. Given the temporary nature of the tax cut (for one year) and Japanese households' low propensity to consume (with households having excess savings of about 10 percent of GDP from pandemic-related measures), the untargeted income tax cut is expected to have a limited impact on growth, while worsening the debt dynamics. In addition, energy subsidies<sup>14</sup> can distort energy consumption and hamper decarbonization initiatives and should be replaced with targeted transfers to vulnerable households (see Annex V in [2023 Japan Article IV Staff Report](#)).

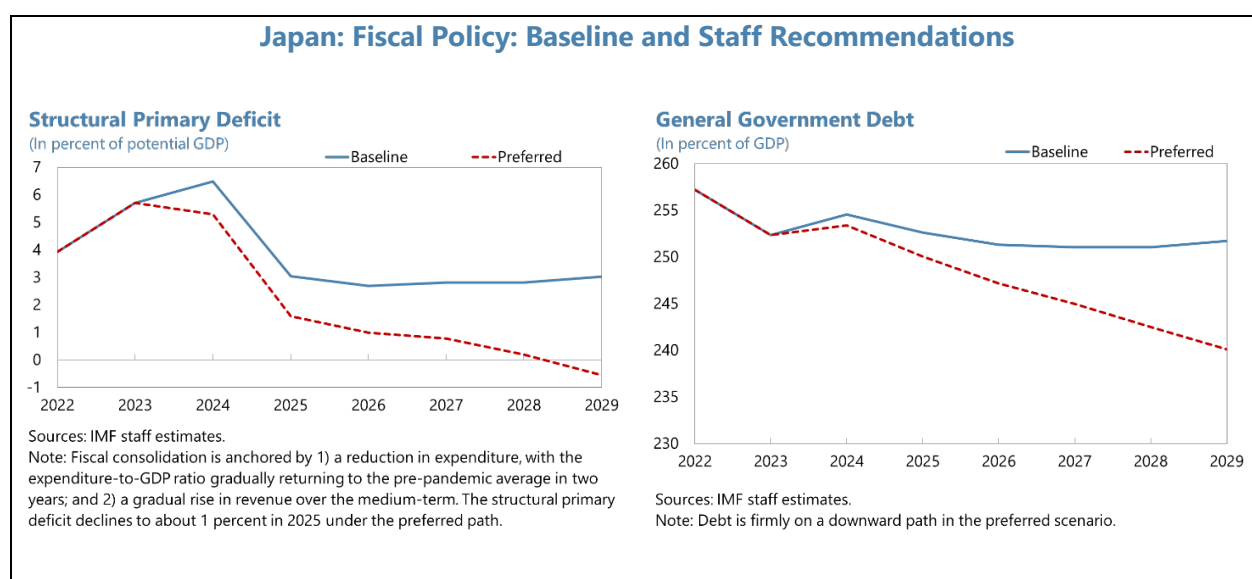


**19. Under current policies, the public debt-to-GDP ratio will increase steadily in the long term to accommodate age-related spending pressures** (Figure 6). Additional planned spending

<sup>14</sup> Gasoline subsidies started in January 2022 and gas/electricity subsidies started in January 2023. The authorities have repeatedly extended the end date. In March 2024, they announced that they will end the gas/electricity subsidies in end-May, but will extend the gasoline subsidies further.

on defense, GX, DX and children-related policies are also expected to weigh on the fiscal balance and should be offset by sustainable revenues.<sup>15</sup> In the near and medium term, the real interest rate-growth dynamic will remain favorable and support lower debt levels, despite a gradual rise in interest rates. However, lower potential growth reflecting an aging and declining working age population will push up debt levels in the long term. The sovereign risk and debt sustainability analysis found that gross financing needs are elevated, but rollover risks are mitigated by the large domestic investor base and by the debt profile, with the overall risks of debt distress assessed as moderate (Annex III).

**20. Fiscal consolidation is needed to rebuild fiscal buffers and ensure debt sustainability, underpinned by both revenue and expenditure measures.** Although Japan still has some fiscal space in the near term, the recent stimulus measures lead to a further narrowing of that space. Staff recommends a significantly faster fiscal consolidation than the baseline, given the pressure on debt in the long term. This can be achieved by limiting untargeted transfers with a low fiscal multiplier<sup>16</sup> or phasing out pandemic-related measures and energy subsidies, while mobilizing revenues to offset additional expenditure policies. Detailed proposals are as follows:



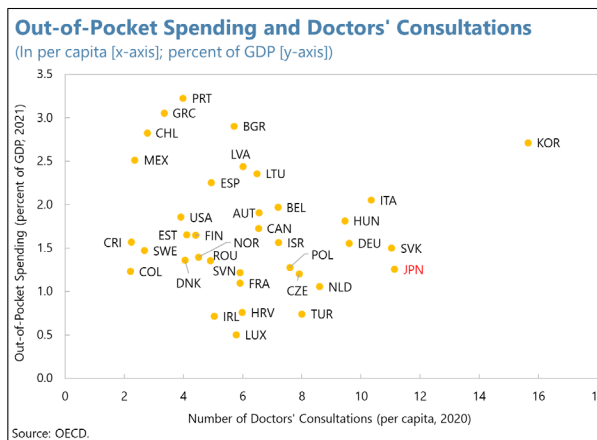
- *Revenue mobilization.* The announced plans to offset increased expenditures on defense, GX, and children-related policies lack a specific timeline and sustainable revenue sources. Since elevated spending is expected to persist in the longer term, it is crucial to enhance tax mobilization. The following revenue mobilization options should be considered: i) unifying and increasing the consumption tax rate; ii) strengthening financial income taxation for high-income

<sup>15</sup> The impact of expenditure on defense, GX, and children-related spending on debt-to-GDP from the FY2024 budget could be approximately 1.3, 0.1, and 0.2 percent of GDP, respectively. On DX, though a comprehensive figure is not available, the budget allocation to the Digital Agency in FY23 (sum of the initial and supplementary budget) is about 0.1 percent of GDP.

<sup>16</sup> In-line with muted spending of excess savings, non-targeted transfer measures to households are estimated to have a fiscal multiplier of 0.1 and other transfer measures mostly at around 0.2. See Annex III of the 2022 Japan Article IV staff report.

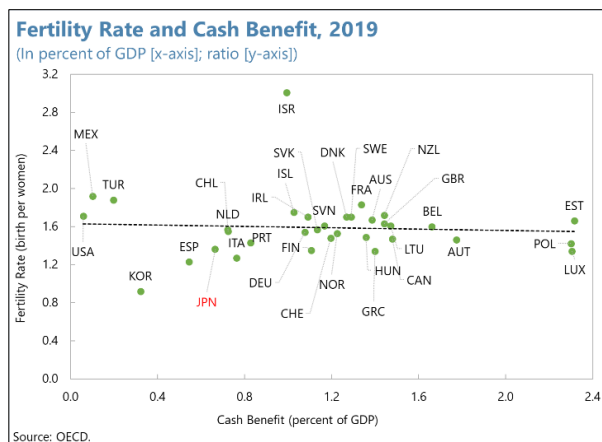
earners; iii) reinforcing property taxation by eliminating preferential treatment for residential land; iv) rationalizing allowances and deductions in personal income taxation, v) unifying the lower corporate income tax rate for SMEs with the standard rate, and vi) increasing premiums for social insurance (IMF, 2022).

- *Health expenditure.* Japan's public health expenditure is one of the highest in the world (WHO Global Health Expenditure Database), with the spending pressure rising due to an aging population. The relatively low out-of-pocket spending may have contributed to a high usage of medical consultations compared with peers. Reforms to contain the cost of health care while preserving its qualities should be considered. These include 1) an increase in copayments for high-income or wealthy seniors;<sup>17</sup> 2) higher usage of generic or over-the-counter drugs;



3) increased adoption of prescription refilling; 4) enhanced preventative medical care; and 5) more targeted covered services and drugs.

- *Children-related spending.* There is limited evidence that untargeted cash transfers are effective in supporting fertility, based on international experience. The efficiency of children-related spending could be enhanced through a further expansion of childcare facilities and workstyle and labor market reforms, which could also close gender gaps.

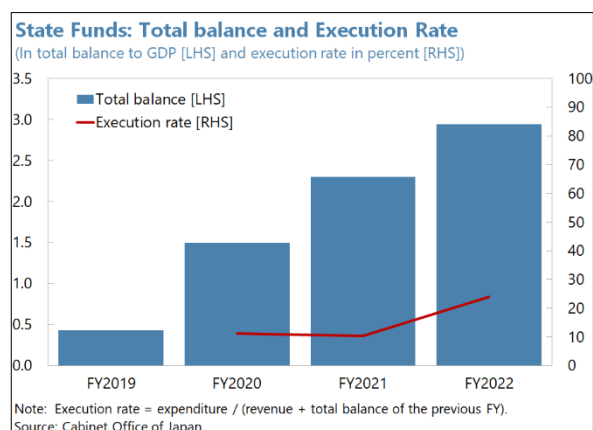


- *SME support.* Some pandemic-related measures and subsidies initiated before pandemic are still in effect. A comprehensive assessment of the necessity and effectiveness of these measures is needed to rationalize expenditure and to improve productivity.

<sup>17</sup> In December 2023, the authorities presented a draft policy reform package that includes raising copayment of wealthy seniors for medical and long-term care services, consistent with recommendations from the 2023 Japan Article IV.

## 21. The authorities should continue to strengthen the medium-term fiscal framework, as planned in FY2024:<sup>18</sup>

- *More realistic assumptions.* Fiscal policy planning should be grounded in more realistic assumptions on growth, revenue, and expenditure measures. An independent fiscal council could be tasked with evaluating the realism of macro-projections and monitoring progress on the medium-term fiscal strategy.
- *Discipline the formulation of supplementary budgets.* Budget expenditures ceilings set in the initial budgets do not work well in controlling final government expenditures given the established practice of adopting supplementary budgets. This practice breaks the link between the annual budget and medium-term fiscal targets, undermining the credibility of the medium-term fiscal framework. Specifically, the absence of effective budgetary rules to cap the size and scope of supplementary budgets often leads to the inclusion of measures with less urgency. The budget process should be reformed to ensure that expansionary supplementary budgets are limited to unexpected large economic shocks. Policy priorities with less urgency or those that could be identified earlier should be taken up in the context of the initial budget discussions.
- *Strengthen the governance of state funds.* While state funds are financed through the annual budget process, once financed they are typically outside the annual budgetary control system by the national government (they can be carried over to the next fiscal year without review). Approximately one-third of them do not have a specified termination point. This weak governance structure leads to inefficiencies in spending and undermines budgetary discipline. The authorities should set a clear exit plan for each state fund and strengthen execution oversight and reporting to enhance better fiscal management.



### Authorities' Views

## 22. The authorities noted that Japan has not faced sovereign risk events for a long time.

Regarding the tax cuts in 2024, they expressed the need to support households in the current environment of negative real wage growth. Over the medium to long term, they noted the need to ensure sustainable revenues to offset higher expenditures in defense, GX, and childcare. They highlighted that additional efforts are required to contain rising health and long-term expenditures due to aging and to improve the efficiency of services provision.

<sup>18</sup> [The Basic Policy on Economic and Fiscal Management and Reform 2023](#) indicates that the authorities will examine and verify the progress of integrated economic and fiscal reforms in FY2024.

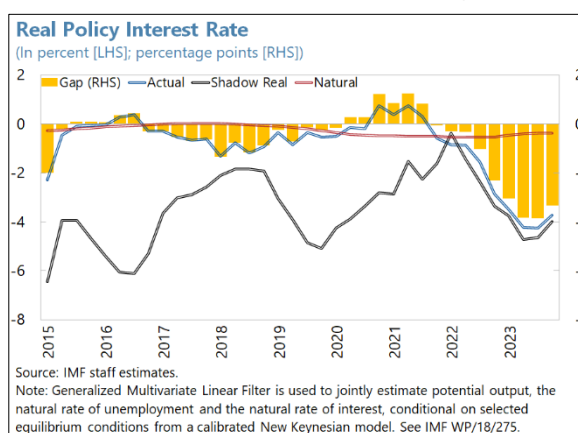
### 23. They remain committed to meeting the FY2025 fiscal target, while noting challenges.

While a stronger-than-expected fiscal outturn in FY2022 puts the government closer to achieving its primary balance target by FY2025, they acknowledged that substantial consolidation over the next two years is required to achieve the target. They noted that it is necessary to continue normalizing the budgetary framework after the COVID-19 and the subsequent shocks, while facing the end of their three-year expenditure benchmark up to FY2024, but remained undecided about the fiscal management framework after FY2025.

## B. A Path to Bringing Inflation to Target

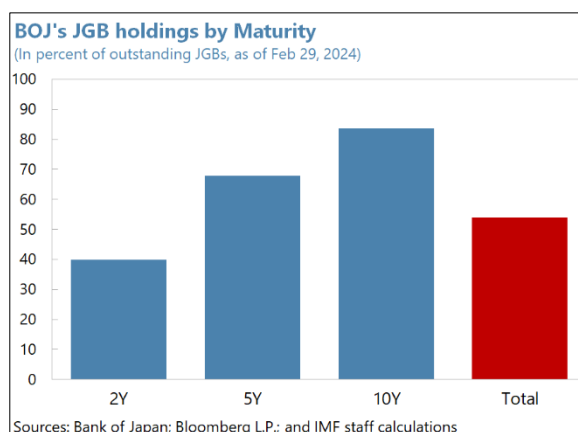
### 24. Inflation is expected to converge in the medium term to BoJ's two-percent target. The

return of sustained inflation follows a persistently above-target inflation outturn for some time now and reflects: (i) higher inflation expectations for a prolonged period for the first time in decades (Figure 2); (ii) in 2023, the highest base wage growth since 1995 followed by an even higher projected base pay wage growth in 2024 amid strong corporate earnings and intensifying labor shortages, which will in turn support private demand; and (iii) a historical high degree of monetary policy accommodation—with a real interest rate much lower than the estimated neutral.



### 25. Hence, we welcome the BoJ's recent policy shifts which are closely in line with staff's recommendations in the [Staff Concluding Statement of the 2024 Article IV Mission](#).

These shifts will help anchor inflation and inflation expectations at the 2 percent target. Moreover, these changes will also: (i) allow the yield curve to be driven by market forces and underlying economic factors—although the large stock of BoJ's JGB holdings will continue to put downward pressure on yields;<sup>19</sup> (ii) support financial institutions' profitability—which had been eroded since YCC by limited gains from maturity transformation—as well as stability by potentially reducing the incentives for exposure to riskier asset portfolios in search of higher yields; and (iii) allow for a smoother transition to a neutral monetary policy stance.<sup>20</sup>



<sup>19</sup> BoJ owns close to 85 percent of outstanding 10-year JGBs and 54 percent of all JGBs.

<sup>20</sup> Nominal neutral rate estimates for Japan range from 1 to 2 percent based on different methodologies.

**26. If the baseline inflation forecast bears out, the BoJ should continue to gradually raise the policy rate** over its policy horizon (i.e., three years). Given balanced risks to inflation and mixed signals in recent data<sup>21</sup> combined with Japan's long history of deflation, this will continue to keep monetary policy and financial conditions accommodative, while giving the BoJ time to confirm the strength of the incoming data. A clear and effective communication strategy by the BoJ that continues to underscore factors that support a gradual and cautious pace/timing of policy rate increases will help anchor market expectations and further support a smooth transition ([October 2023 WEO Chapter 2](#)). This strategy would also minimize disruption from outward spillovers to other sovereign debt markets, where Japanese investors hold large positions.

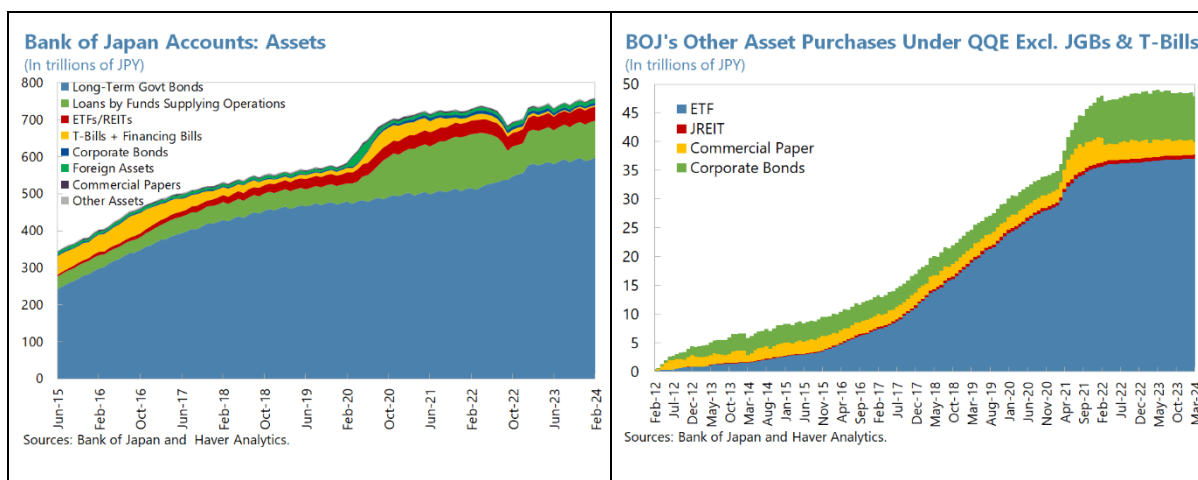
**27. The recent policy shifts will likely reduce the size of and lower the risks to the BoJ's balance sheet.** Given its very large balance sheet at 126 percent of GDP, reducing its size could help lower risks of the BoJ facing losses—from a negative yield spread between assets and liabilities as short-term interest rates rise further.<sup>22</sup> Government bonds constitute close to 80 percent of the BoJ's balance sheet as of February 2024. Given that annual redemptions of the BoJ's JGBs holdings are in the range of 70-80 trillion yen, the plan to continue with JGB monthly purchases at broadly the same amount as before (currently about 6 trillion yen) could see the BoJ's holdings of JGBs roughly stay constant in nominal terms. With an official end to risky asset purchases going forward, commercial paper and corporate bonds (these constitute close to 1.1 percent of BoJ's assets) would also automatically roll-off and lead to a marginal decline in the size of the BoJ's balance sheet as they mature. In the case of ETFs and J-REITs, which constitute a relatively larger share (5 percent) and do not mature automatically, the BoJ should consider a strategy to eventually unload them.<sup>23</sup>

**28. The BoJ's plans to continue JGB purchases will mitigate excessive shifts in yields that could undermine financial stability.** Continuing reinvesting close to the same amount as maturing JGBs will help avoid abrupt shifts in the bond-market supply-demand conditions and sharp increases in term premiums, while avoiding further balance sheet accommodation. Moreover, state-contingent purchases of JGBs in the event of a rapid rise in long-term rates will help maintain financial stability. Going forward, the BoJ should formulate a concrete strategy on how to eventually unwind some of its bond holdings over the medium to long term while minimizing related financial market disruptions.

<sup>21</sup> Industrial production fell sharply in January, and retail sales growth edged down to 2.4 percent y/y in January (from 5 percent y/y in November). However, consumer and business sentiment has been trending up in recent months.

<sup>22</sup> Note that the BoJ uses the amortized cost method to value its government bond holdings, and hence any valuation losses on government bond holdings will only affect the BoJ's balance sheet if and when it sells the bonds before maturity.

<sup>23</sup> This largely consists of ETFs. Holdings of J-REITs are very small at less than 0.1 percent of BoJ's balance sheet.



**29. Japan's longstanding commitment to a flexible exchange rate regime will help absorb shocks and support monetary policy's focus on price stability.** At the same time, it will also help maintain an external position in line with fundamentals. The use of foreign exchange intervention (FXI) should be limited to exceptional circumstances such as when economies are vulnerable to sharp currency fluctuations because of unhedged exposures, shallow markets, or because inflation expectations are at risk of de-anchoring. In such cases, FXI may be useful to mitigate the adverse effects of excessive exchange rate movements that pose significant risks to macroeconomic and financial stability, including if markets turn disorderly.

### **Authorities' Views**

**30. The BoJ emphasized that future rate hikes will be very gradual and that accommodative monetary conditions are needed for the time being, given the current outlook for economic activity and prices.** With the better-than-expected results of the first round of the Shunto wage negotiations, BoJ officials expect real wages to turn positive going forward which would support private consumption and keep inflation at target. However, they are cautious about the downside risks to inflation, given the long history of a deflationary mindset across the Japanese population and see the risk of inflation accelerating in the near-term as rather low. Given the high uncertainty around Japan's economic outlook, they refrained from committing to a specific path for future interest rates.

**31. The BoJ credited its consistent and well-telegraphed communication strategy as proving to be effective through this historic policy transition.** Immediate market reaction to the policy shift was muted with no disruptive effects. The BoJ's commitment to keep monetary policy accommodative and continue its purchases of maturing JGBs also helped. BoJ officials clarified that they would limit the increase in the amount of JGB purchases only in case of rapid rise in long-term interest rates and would largely leave the yield curve/price formation to markets. They do not see the impact of discontinuing purchases of other risk assets on market conditions to be significant.



**32. The authorities expressed concerns about the one-sided and rapid pace of yen depreciation since the beginning of 2024.** They pointed out, among other factors, that speculative trading was behind such moves with net non-commercial yen short positions expanding rapidly. They reiterated that excess volatility is undesirable as it can have adverse implications for the economy, while remaining committed to market-determined exchange rates.

### C. Preserving Financial Stability

**33. Systemic risks to financial stability remain broadly unchanged since last year, reflecting robust economic activity and financial institutions maintaining adequate capital and liquidity buffers.** Key risks to macro-financial stability stem from an abrupt slowdown in global growth and a surge in inflationary pressures that could lead to a potential increase in foreign and domestic interest rates and financial market volatility. These risks, if materialized, could interact with three key sources of vulnerabilities in the financial system, as identified by the FSAP: the sizable holdings by financial institutions of securities under mark-to-market accounting, some banks' notable foreign currency exposures, and signs of overheating in parts of the real estate markets. A gradual pace of increase in domestic short-term interest rates, if/when conditions warrant (¶26), and BOJ's commitment to increase the amount of JGB purchases in case of a rapid increase in long-term rates (¶28) will provide greater flexibility to financial institutions to adjust after decades-long ultra-low rates, and help to ensure that financial stability risks remain contained.

**34. The systemic risk analysis of the FSAP suggests that the financial system is broadly resilient, but some areas merit attention and close monitoring.** Banks and insurers are, in aggregate, well able to maintain their solvency positions under a hypothetical adverse scenario with low global growth and a sharp rise in interest rates, though some may be susceptible to stress. Liquidity risks for banks are contained at the system level due to ample liquidity in yen, but some banks could face liquidity shortfalls under a stress scenario, due, in part, to their sizeable liability-side foreign-currency (FX) exposures and undrawn FX commitments. Investment funds generally appear to be able to accommodate severe but plausible redemption shocks, but less-liquid funds could contribute to amplifying stress in financial markets. Domestic contagion risks based on bilateral exposures appear limited due to the strong capital and liquidity positions of major financial institutions—however, broader changes in market sentiment or valuation changes in common asset holdings could exacerbate such risks. Cross-border spillovers could be sizeable, given Japan's large creditor status (see also [2023 Japan Article IV Staff Report](#) and [October 2023 Asia-Pacific Regional Economic Outlook](#)). Climate risk analysis, while uncertain, suggests that banks have notable exposures to emission intensive sectors but at a system level may be resilient to a transition to net zero emissions by 2050.

**35. Potential vulnerabilities in the real estate sector call for further risk oversight and a macroprudential policy response.**<sup>24</sup> FSAP household stress testing analysis suggests that

<sup>24</sup> The house price-to-income ratio is 30 percent higher than its long-term trend, indicating deterioration in affordability. Model estimates suggest that both the residential and commercial real estate markets appear

(continued)



borrower-based macroprudential measures would help households be more resilient to potential adverse macro-financial shocks—with a mild adverse impact on aggregate credit growth—and can complement the industry practice of the 5-year/125 percent rule.<sup>25</sup> Furthermore, the CRE sector, which has been under pressure globally, also warrants attention. The direct exposure of Japanese banks to overseas CRE market appears limited on aggregate (BOJ, 2023), though supervisors should remain mindful of potential risks depending on exposures to different CRE segments, and possible spillovers from overseas CRE markets to domestic CRE markets, for example, through a potential tightening of global financial conditions. They should continue to monitor domestic CRE markets closely given banks' more material exposure to domestic than overseas CRE markets. Considering also signs of overheating in part of the real estate markets, as indicated by the FSAP, the authorities should remain vigilant on potential risks from possible price corrections in the event of adverse shocks.

**36. Financial sector oversight has improved, but further actions are needed to ensure stability and resilience in an evolving environment.** The Financial Services Agency (FSA) should develop a revised supervisory risk methodology to draw a complete risk profile of institutions for tracking risks and adjusting resources more effectively. They should revamp the Early Warning System (EWS) with more forward-looking metrics, especially for credit and liquidity risks, and establish quantitative minimum liquidity requirements for non-internationally active banks. Supervisors should be given the power to set and adjust individual bank capital ratios above the minimum requirements in response to the bank's specific risk profile and financial position. Explicit provision needs to be made in the law to ensure the priority of financial safety and stability in FSA's mandate, in keeping with current policy and practice. For insurance supervision, the FSA should boost efforts to transition to a more comprehensive, risk-based, pro-active approach. The FSA should also ensure a more in-depth and forward-looking assessment of the investment fund sector, broadening the coverage of on-site inspections and conducting stress testing. Against the backdrop of growing global cybersecurity risks, the regulatory and supervisory frameworks of cybersecurity need to be enhanced. To facilitate these improvements in financial sector oversight, an overarching critical step is to increase resources significantly.

**37. The authorities should continue to strengthen systemic risk assessment and the institutional underpinning for macroprudential policy coordination.** Stronger inter-agency coordination on risk monitoring and data sharing, including by establishing the Financial Monitoring Council, underscores the authorities' forward momentum. Recent data initiatives, including "Common Data Platform", are welcome, and the authorities should continue efforts to enhance its breadth in light of evolving risks. A stronger institutional framework for macroprudential policy making, including by assigning a formal mandate to the Council for Cooperation on Financial Stability (CCFS), would help to clarify the accountability framework and enhance transparency in decision making.

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overvalued by, on average, 17 and 30 percent, respectively. Moreover, the loan-to-income (LTI) ratio, the share of households with a high debt-service-ratio, and the share of floating rate mortgages have also been rising steadily.

<sup>25</sup> The rule prescribes only infrequent changes in annuity payments (every 5 years) and limits the change in payments to at most 25 percent at a time (see, e.g., <https://www.mlit.go.jp/common/000109268.pdf>).

**38. The authorities should also enhance the financial safety net and crisis management framework.** More banks should be subjected to recovery and resolution planning requirements. The authorities should continue to ensure an effective recovery and resolution (planning) regime for systemic-in-failure insurers and central counterparties (CCPs) that is consistent with pertinent international standards and guidance. Moreover, the scope of institutions eligible to receive emergency liquidity assistance (ELA) could be further expanded to systemic NBFIs, prioritizing CCPs.

### ***Authorities' Views***

**39. The authorities broadly agreed on the sources of vulnerabilities underlying the financial system and highlighted some nuance in views.** The authorities noted that Japanese banks have remained resilient to foreign currency funding risks and have been more cautious in expanding overseas lending recently, especially to riskier borrowers. They also emphasized that banks have been actively managing risks against rising interest rates, including via portfolio rebalancing and the use of hedging tools. They agreed on signs of overheating in parts of the real estate markets, while office demand has been solid compared to overseas CRE markets, but noted that they remain vigilant to overseas and domestic real estate market developments. They do not assess risks to housing loans as an immediate concern, considering the quite low historical record of credit costs as well as the industry practice of the 5-year/125-percent rule.

**40. The authorities agreed with the overall direction of the FSAP's recommendations and underlined their commitment to further strengthen the financial regulatory and supervisory approaches.** The authorities broadly concurred with most of the FSAP recommendations but expressed some reservations in a few areas. They assess the current institutional framework for macroprudential policy as effective and do not see a need to assign a formal mandate to the CCFS. Noting the historical experience with quantitative restrictions on real-estate related loans, they underscored the potential adverse effects of introducing borrower-based macroprudential measures. They also emphasized that the Act on the establishment of the FSA does not include economic growth or international competitiveness as a policy goal, and that the FSA prioritizes financial safety and financial stability through its practice and policies. They welcomed the positive assessment on the progress made on the crisis readiness framework since the last FSAP and expressed their commitment to further strengthen the framework in the evolving financial landscape.

## **D. Alternative Scenario: What Would Deteriorating Market Confidence Look Like?**

**41. We consider an alternative scenario where sizable additional fiscal stimulus would lead to weakened market confidence.** The scenario assumes that additional fiscal spending in FY2024 and FY2025 (without revenue offsetting measures) means that the primary balance would deteriorate by close to 5 percent of GDP relative to the baseline.<sup>26</sup> The stimulus, in the context of a closed output gap

<sup>26</sup> In 2024, the primary deficit would be about two standard deviations above the baseline.

and high debt and gross financing needs, would trigger a deterioration in market confidence that is driven by both the size and the persistence of the fiscal deficits (over a five-year horizon). Long-term (10-year) government bond yields would reach around 3.5 percent (more than 200-basis point increase compared with the baseline), coupled with an initial depreciation of the yen. The deterioration of market confidence would be mostly manifested as a sharp rise in the sovereign risk premium.

**42. Under such a scenario, increased fiscal spending would raise inflation and inflation expectations initially.** Given the impact of the fiscal stimulus on core inflation, the BoJ would need to raise short-term interest rates at a faster pace. Together with higher term premium, this would affect growth negatively, further increasing the government’s borrowing costs and gross financing needs, worsening the interest rate-growth dynamics, and putting pressure on the debt trajectory. Given Japan’s highly backward-looking formation of inflation expectations, inflation would stay higher for a few years and need a strong monetary response initially (see [2023 Japan Article IV Staff Report](#)). The impact from the financial tightening would continue to overwhelm any benefit from the fiscal stimulus over the medium-term.

**43. If interest rates were to rise sharply, this could have notable financial stability implications.** Valuation losses on yen-denominated securities<sup>27</sup> and potential elevation in credit costs given the prevalence of floating-rate loans could weigh on banks. On balance, improved net interest margins, commensurate with the steepening of the yield curve, would serve as a risk-mitigating factor (see [IMF, 2023a](#)). Japanese NBFIs do not engage in liability-driven investment (unlike those in some peer economies), though continued vigilance is warranted in case potential vulnerabilities arise.

**44. The alternative scenario helps to underscore the importance of fiscal discipline and the need to tighten fiscal spending in the near term.** While the alternative scenario illustrates a possible tail risk event, “unfunded” fiscal stimulus coupled with tax cuts have led to a loss of market confidence in other advanced economies, with even more severe outcomes than the one depicted in this example.

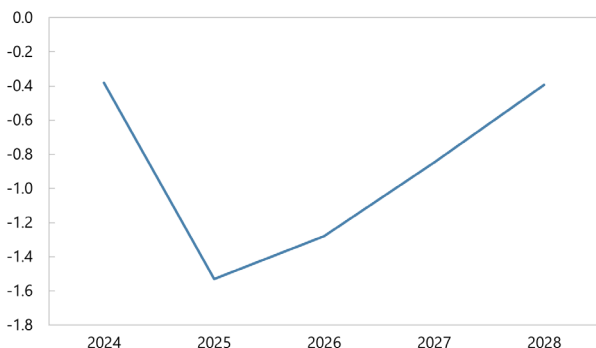
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<sup>27</sup> Banks, in principle, can endure valuation losses on securities holdings for extended periods, if they have sufficient capital buffers and unless they need to realize those losses prematurely in case of a sharp increase in liquidity needs. The liquidity stress test conducted as part of the Japan FSAP has found that potential two-way feedback between solvency and liquidity risks would be limited. April and October 2023 issues of the BOJ’s Financial System Report document that a large majority of deposits are small, retail deposits—that tend to be sticky and largely insured. The penetration of online banking services is rising but lags international peers.

### Japan: Alternative Scenario with Deteriorating Market Confidence

#### Real GDP Growth

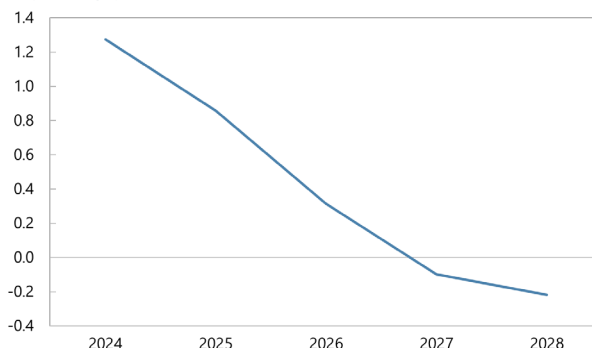
(In percentage points difference from baseline)



Source: IMF staff estimations.

#### Headline Inflation

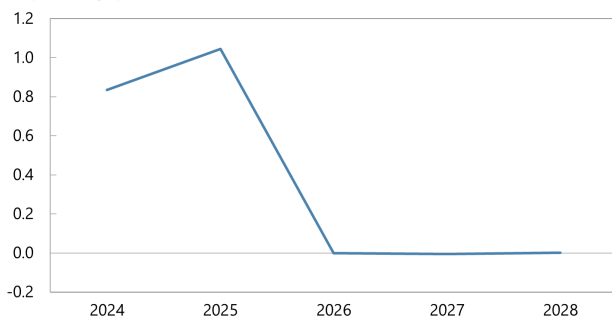
(In percentage points difference from baseline)



Source: IMF staff estimations.

#### Policy Interest Rate

(In percentage points difference from baseline)

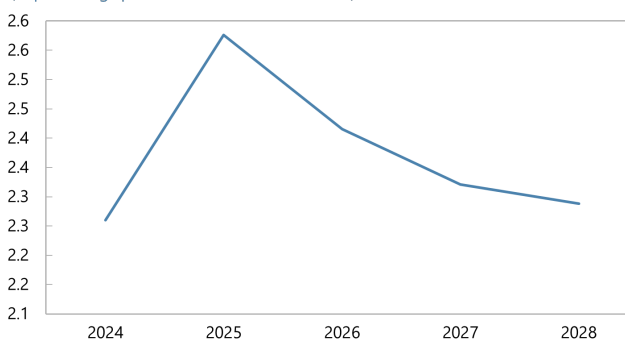


Source: IMF staff estimations.

Note: Under the alternative scenario, the policy interest rate would peak at about 100 basis points above the baseline.

#### Long-Term Interest Rate

(In percentage points difference from baseline)

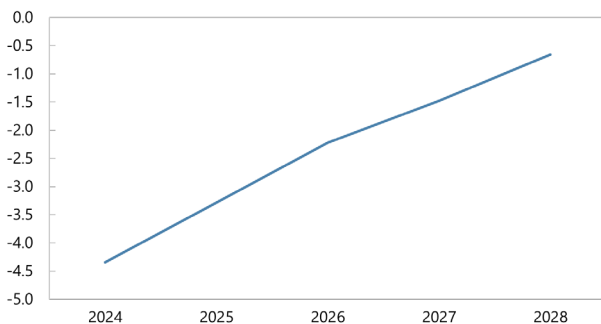


Source: IMF staff estimations.

Note: Under the alternative scenario, the long-term interest rate (10 year government bond yield) would peak at about 260 basis points above the baseline.

#### General Government Primary Balance

(In percentage points difference from baseline)

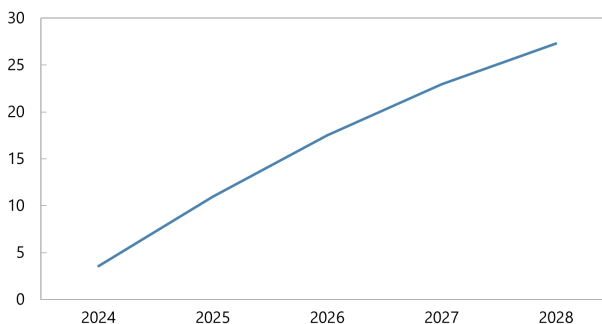


Source: IMF staff estimations.

Note: Under the alternative scenario, the primary-deficit-to-GDP ratio would peak at about 4.3 percentage points above the baseline, with a gradual moderation in the simulation horizon.

#### General Government Net Debt

(In percentage points difference from baseline)



Source: IMF staff estimations.

Note: Under the alternative scenario, the net-debt-to-GDP ratio would rise to 27 percentage points above the baseline by 2028.

Note: The alternative scenario was estimated using the [Flexible System of Global Models \(FSGM\)](#).

### Authorities' Views

**45. The authorities welcomed the inclusion of an alternative scenario to recognize the impacts of various risks.** However, they noted difficulties in quantifying a threshold above which excessive spending may lead to a deterioration of market confidence or cause intolerable

inflationary pressure at the current juncture, and expected further analyses on the nexus between government spending and inflationary pressure.

## E. How Can Structural Policies Best Support Japan’s Growth Potential?

*Further structural reforms are needed to support fertility, promote female leaders, advance a more equal society, accelerate startups and innovation, and transition to a green economy, with labor market reforms at the forefront of the reform agenda.*

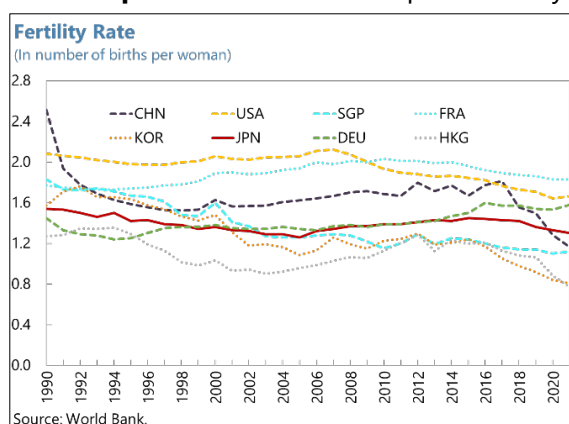
### Supporting Japan’s Fertility and Promoting Female Leaders

#### 46. Japan’s fertility has been on a declining path in the past three decades. Japan’s fertility

rate (1.26 in 2022) is one of the lowest among G7 economies, but it remains higher than other East Asian advanced economies. The authorities have announced initiatives to support Japan’s fertility and formulated the “Future Strategy for Children” in December 2023, aimed to increase children-related spending by 3.6 trillion yen (approximately 0.6 percent of GDP) per year by FY2028.

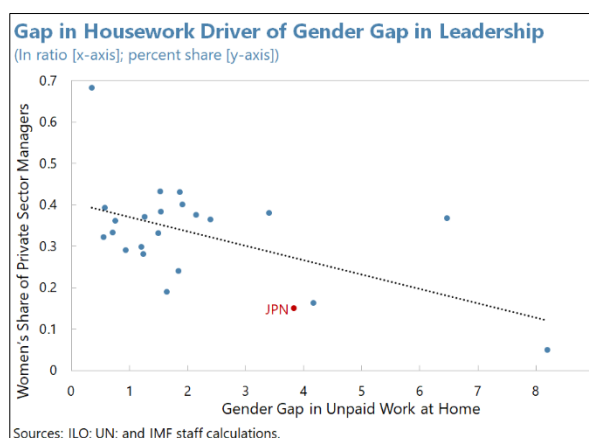
Additionally, the government announced plans to double the budget allocation for the Children and Families Agency or that per child by early 2030s.

The strategy also includes plans to promote co-parenting and to expand childcare facilities.



#### 47. Female representation in managerial and policy-making positions remains low. While

there has been some improvement, Japan continues to lag considerably when it comes to women leaders both in the public and private sector. This is largely driven by the lack of burden sharing in homecare and relatedly high prevalence of females in part-time and non-career track employment. For example, women spend more than five times of hours on unpaid work than men, greater than in other countries, based on [OECD data](#). The Japanese work culture, wherein full-time workers are expected to put in long hours at the office, further reinforces the gender gap, compounding the traditional division of labor between men and women. Part-time or non-career track roles often offer few benefits, training, or paths to career advancement (see *2024 Japan Article IV Selected Issues Paper “Why such few women in leadership positions in Japan?”*).



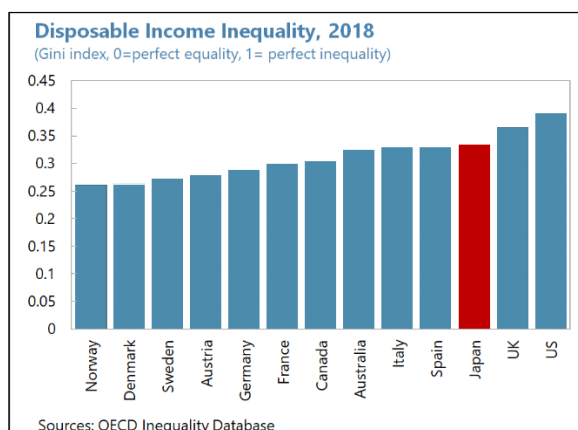
**48. Further expansion of childcare facilities and progress on workstyle and labor market reforms are key to improve career prospects for women, which in turn would also support Japan’s fertility rate.**

- *Expanding childcare facilities and resources and facilitating fathers’ contribution to home/child-care.* A further expansion of childcare facilities, particularly for children aged 0-2, could help support fertility. Attracting foreign workers to address labor shortages (e.g., nursery teachers) could complement the support provided by childcare facilities. At the same time, offering stronger incentives for the use of paternity leave—which while growing, remains low—can alleviate the burden of childcare on mothers (see *2024 Japan Article IV Selected Issues Paper “Japan’s Fertility: More Children Please”*)
- *Reforming current employment practices.* Facilitating a cultural shift at the workplace by further expanding the use of telework and flexible working schedules could support women’s ability to participate in the labor force (particularly for those with young children) while also allowing men to share more home-care burden.
- *Labor market reforms.* While the government has been successful in increasing female labor force participation over the last decade, a substantial gender gap remains. A large share of female workers are non-regular and non-career track workers with lower wages and limited skill development and career advancement opportunities. Reducing labor-market dualism, encouraging merit-based promotions, and facilitating more job mobility can expand career prospects for women and to support Japan’s fertility rate.

**Advancing a More Equal Society**

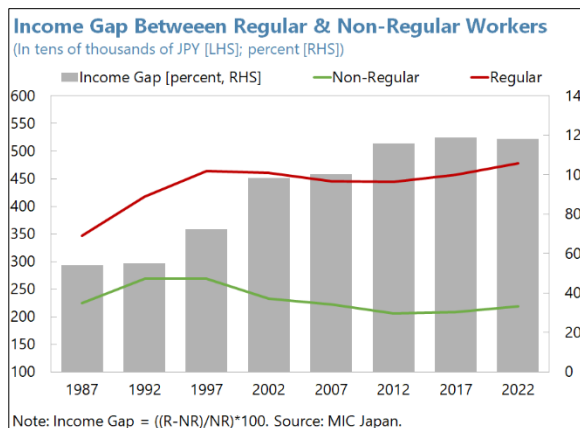
**49. Market income inequality in Japan has increased and is now close to the OECD average.**

Wage inequality, driven by increased segmentation in the labor market, is an important driver of overall income inequality. Labor income inequality is found to drive more than 80 percent of overall income inequality across households, reflecting dualism in the labor market, with regular workers receiving significantly higher hourly wages. Moreover, while the increase in female labor force participation and employment has helped lower inequality in the last decade, this has also been offset by women being mostly employed in low-paid part-time nonregular jobs (see [IMF, 2023b](#)).



**50. Reducing labor market dualism, and better targeting of existing social benefit programs can help advance a more equal society.** The redistributive effects of social transfers have helped lower income inequality. However, with high public debt limiting the scope for greater

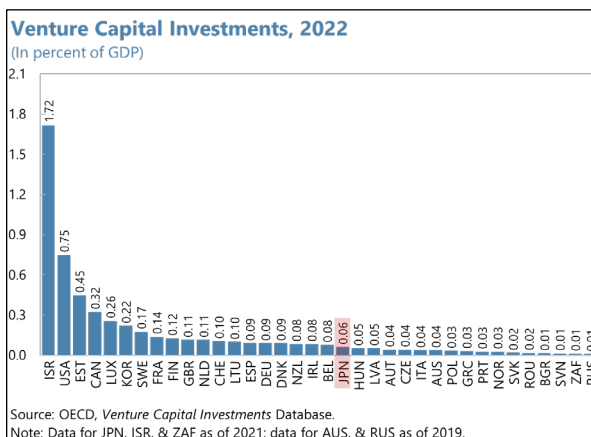
broad-based social spending, social transfers should be better targeted to protect the most vulnerable population. Moreover, reforms to reduce labor market dualism<sup>28</sup> and removing the disincentives in the social security system that limit working hours are more sustainable ways to achieve a more equal society (see 2024 Japan AIV Selected Issues Paper “Sustainable Path to Inclusive Growth in Japan: How to tackle income inequality?”).



### Accelerating Startups and Innovation

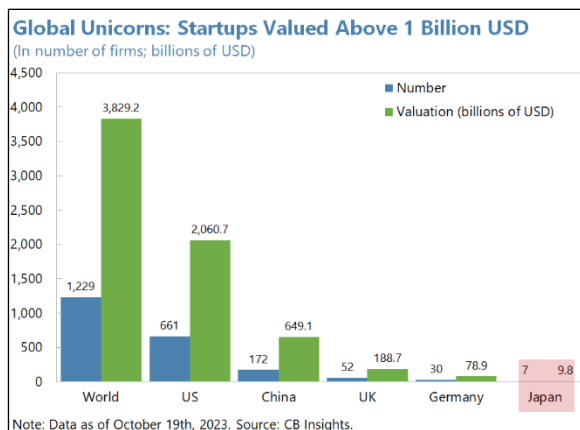
#### 51. Japan’s startup ecosystem has grown gradually in recent years, but with scope for further expansion.

Startups in Japan tend to be smaller compared with those in other countries, with relatively low venture capital equity funding as a share of GDP. An important feature of venture capital in Japan is the critical role that large Japanese corporations play in funding startups through corporate venture capital (CVC) units, given their sizable cash holdings.<sup>29</sup> The government continues to support startups and venture capital funding, including promoting startup incubators in central Tokyo. On financing, the Japan Investment Corporation launched a 200-billion-yen [venture growth fund](#) in 2023 to support later stage startups to create unicorns and to target early-stage startups beyond deep tech and life sciences.



#### 52. Improving access to equity funding, more flexibility in labor markets, and greater firm dynamism can help support startups and innovation.

Better access to equity funding is crucial for startups to grow, innovate, and exit successfully (see 2024 Japan Article IV Selected Issues Paper “Startups and Venture Capital in Japan: How to Grow?”). Dynamic firm entry and exit can help encourage entrepreneurship, innovation, and more efficient allocation of resources. A more flexible labor market and a shift



<sup>28</sup> As suggested in Aoyagi and Ganelli (2013), one reform option is to introduce a Single Open-Ended Contract for all newly hired workers, complemented by a shift towards a model that combines labor market flexibility and security.

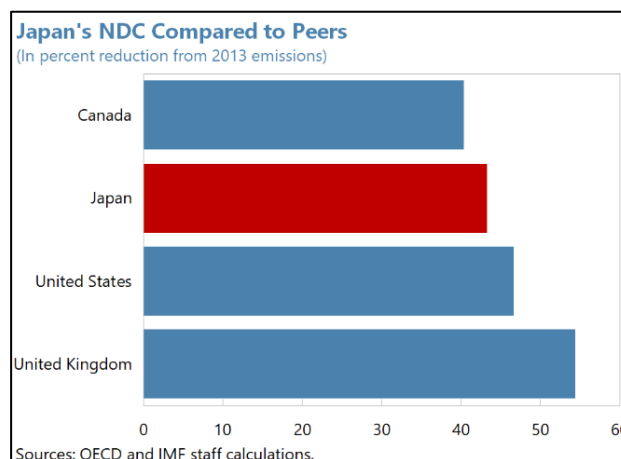
<sup>29</sup> See PitchBook (2023), “The State of CVCs in Japan”.



away from the lifelong employment system could encourage talented individuals to consider setting up startups and to have a second chance in case they fail.

## Transitioning to a Green Economy

**53. Japan remains committed to achieving its green transformation.** Japan is the seventh largest emitter of global Greenhouse Gas (GHG) and has taken important steps on climate mitigation. The interim target of a 46 percent reduction in GHG emissions by 2030, relative to 2013 levels, aligns Japan with most other advanced economies. In addition, Japan proactively participates in global mitigation initiatives, including proposing the establishment of the “Article 6 Implementation Partnership Center” at the G7, aimed to develop institutional arrangements for high integrity carbon markets. Both the FSA and the BoJ have actively engaged with the Bank of International Settlements (BIS) on climate finance. Japan has also pledged to end new construction of domestic unabated coal power plants. Japan is one of the biggest contributors to the United Nation’s Green Climate Fund (\$1.5 billion) and the IMF’s Resilience and Sustainability Trust (\$6.6 billion).



**54. Additional policies would be needed to reach Japan’s climate targets.** While expanding carbon pricing and introducing carbon credits trading are broadly in line with previous staff advice ([IMF, 2022](#)), further details of the plans are needed. A policy mix comprising of additional infrastructure investment, green subsidies, and carbon prices would likely be required to meet Japan’s NDC target. Given the potentially adverse distributional effects of carbon pricing, it is crucial to protect the vulnerable population (e.g., through targeted cash transfers) in the transition to a green economy (Annex IV). Furthermore, the phasing out of untargeted subsidies for gas, electricity, and fuel would support the transition.

## Continuing Other Reforms

**55. Reform efforts in digitalization and corporate governance should continue.** The Digital Agency should continue to coordinate and implement policies to digitalize the public sector. Better data sharing between central and local governments and standardizing local government IT system can help improve the targeting of transfers to the most vulnerable households. Ensuring effective corporate governance practices and improved disclosure standards are needed.

**56. Japan should continue to work actively with international partners to strengthen the rules-based multilateral trading system.** Japan should prioritize its global leadership role to promote more open, stable, and transparent trade policies at the WTO and in regional trade agreements. The U.S.-Japan Critical Minerals Agreement demonstrates an interest in finding



common ground on trade issues between close partners. At the same time, it is important that trade agreements are used for further integration among members and not as tools that discriminate across trade partners and can worsen geoeconomic fragmentation.

**57. Industrial policies (IP) should be pursued cautiously and remain narrowly targeted to specific objectives where externalities or market failures prevent effective market solutions and aim to minimize trade and investment distortions.** Against the backdrop of other advanced economies (AEs) engaging in IP, Japan initiated the “New Direction of Economic and Industrial Policy” in 2021 to promote GX, DX, economic security, startups, and SMEs. Moreover, the latest fiscal stimulus package includes subsidies to support advanced technology research and development. Pursuit of and competition among advanced economies over IP could lead to further strains in the global supply chain, technological fragmentation, rising input costs, increased trade tensions, and reduced international cooperation—outcomes that could undermine Japan’s broad support of the strong multilateral trading system. Furthermore, IP should avoid favoring domestic producers over imports or creating incentives that lead to a fragmentation of the global system for trade and investment.

**58. Japan has taken steps to address risks of transnational aspects of corruption,<sup>30</sup> but more efforts are needed.** Out of the world’s 500 largest multinational enterprises, 27 are headquartered in Japan, and the country has a significant outward FDI position, including in high-risk jurisdictions. Japan has updated guidelines on combating foreign bribery and enhancing engagement with private sector and should continue to implement the OECD Phase 4 recommendations (Annex V). The authorities should also require all companies to file with the beneficial ownership registry introduced in 2022, ensure implementation of customer due diligence requirements on new key gatekeepers, and clarify obligations of foreign politically exposed persons and corporate customers.

### ***Authorities’ Views***

**59. The authorities agreed with the importance of supporting fertility and promoting female leaders.** They concurred that an expansion of childcare facilities, more flexible work arrangements, and reducing labor market dualism are key. They noted that past progress in expanding childcare facilities contributed to stabilizing the fertility rate in Japan compared with other advanced Asian economies. They also noted that drastic strengthening of measures to cope with the declining birthrate, which is called “Acceleration Plan for Child and Childrearing Support” (about 3.6 trillion yen annually), was intended to show strong commitment to supporting fertility.

**60. They introduced analyses highlighting that ageing and capital gains are the key drivers of recent income inequality in Japan.** Using a more comprehensive dataset in comparison to staff’s analysis, they find that the top 1 percent and 10 percent income shares in Japan are lower

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<sup>30</sup> Japan volunteered to have its legal and institutional frameworks assessed in the context of bilateral surveillance for purposes of determining whether it: (a) criminalizes and prosecutes the bribery of foreign public officials; and (b) has an effective AML/CFT system that is designed to prevent foreign officials from concealing the proceeds of corruption.

than these for the U.S. and at similar levels to European countries in 2019. From the results of the analyses, it was indicated that increases in female/elderly labor force participation have been an income equalizing force, furthermore divergence in wage income has not been the main driver of recent inequality.

**61. The authorities are committed to accelerating startups and achieving emission reduction targets, while noting the importance of industrial policies.** On startups, they reiterated their commitment to strengthen funding for startups and diversify exit strategy, promote open innovation, and further develop human resources, as outlined in the “Startup Development Five-Year Plan”. On GX, they agreed with staff’s emphasis on carbon pricing and underscored the importance of determining the appropriate carbon price level. On industrial and trade policies, the authorities highlighted Japan’s continued efforts to promote open, stable, and transparent trade policies while they also emphasized the importance of ensuring supply chain resilience.

## STAFF APPRAISAL

**62. Growth is expected to continue, with risks broadly balanced.** Core inflation will decline gradually as the effect of higher import prices wanes but is projected to stay above the two-percent target until the second half of 2025. The output gap is expected to be slightly positive until 2025. The primary fiscal deficit is expected to remain elevated, reflecting the impact of the latest fiscal stimulus package. The external position is assessed as broadly in line with the level implied by medium-term fundamentals and desirable policies. Risks to growth and inflation are broadly balanced.

**63. Fiscal consolidation is needed to rebuild fiscal buffers and ensure debt sustainability, underpinned by both revenue and expenditure measures.** Although Japan still has some fiscal space in the near term, the recent stimulus measures lead to a further narrowing of that space. Any new spending should be offset by higher revenues or savings elsewhere in the budget given a closed output gap and high debt-to-GDP. Under current policies, the public debt-to-GDP ratio will increase steadily in the long term to accommodate age-related spending pressures. Growth-friendly fiscal consolidation should be supported by a strengthened and more disciplined medium-term fiscal framework.

**64. The BoJ’s recent policy shift will help anchor inflation at the 2 percent target and facilitate a smoother transition towards a neutral stance.** Given balanced risks to inflation and mixed signals in recent data, further hikes in the short-term policy rate should proceed at a gradual pace. The BoJ’s state-contingent purchases of JGBs will help mitigate excessive shifts in yields that could undermine financial stability during this historic policy transition. A clear and effective communication strategy that continues to underscore factors that support a gradual and cautious pace of policy rate increases will also be key. Japan’s longstanding commitment to a flexible exchange rate will help absorb shocks and support monetary policy’s focus on price stability.

**65. The financial system is broadly resilient, but some areas warrant close monitoring.** These include potential risks due to sizeable securities holdings of financial institutions and some

banks' notable foreign currency exposures. Potential vulnerabilities in the real estate sector call for further risk oversight and a macroprudential policy response. While financial sector oversight has improved, further actions are needed to improve risk-based supervision. Systemic risk assessment and the institutional arrangement for macroprudential policy coordination should be further strengthened, including by assigning a formal mandate to the CCFS. Furthermore, the financial safety net and crisis management framework should be enhanced.

**66. Further structural reforms are needed to support fertility, female leaders, startups, and a green economy.** Further expansion of childcare facilities and progress on workstyle and labor market reforms are key to improve career prospects for women, which in turn would also support Japan's fertility rate. Reducing labor market dualism, and better targeting of existing social benefit programs can help advance a more equal society. Improving access to equity funding, more flexibility in labor markets, and greater firm dynamism can help support startups and innovation. Additional policies, including further clarifications on the planned measures, would be needed to reach Japan's climate targets.

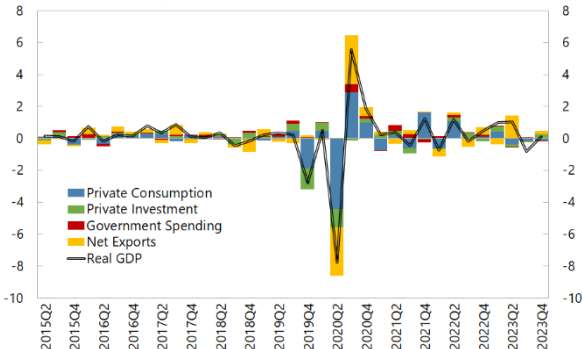
**67. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.**

**Figure 1. Japan: Recent Economic Developments**

*Strong domestic demand has supported growth post re-opening but has slowed in the latest data...*

**Contributions to Real GDP Growth**

(In q-o-q percent change, chained 2015p SAAR)

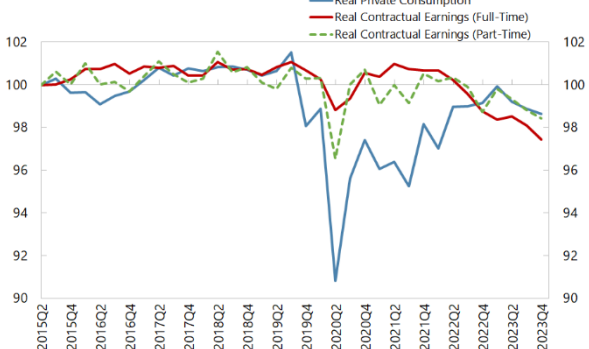


Sources: Cabinet Office of Japan; Haver Analytics; and IMF staff calculations.

*...in part due to the drag on consumption from negative real wage growth in the past year.*

**Real Wage and Real Consumption Growth**

(In index, 2015Q2=100)

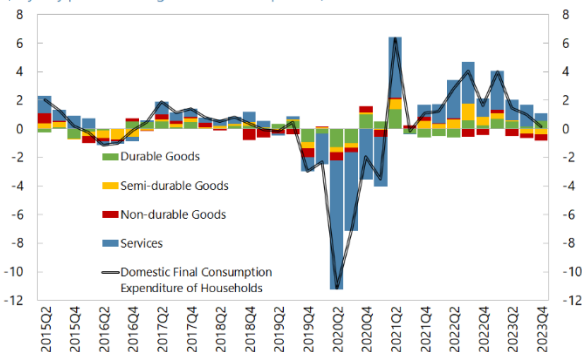


Sources: Haver Analytics and IMF staff calculations.

*Slowing consumption growth has driven weaker goods demand.*

**Domestic Final Household Consumption Expenditure by Type**

(In y-o-y percent change, chained 2015p SAAR)

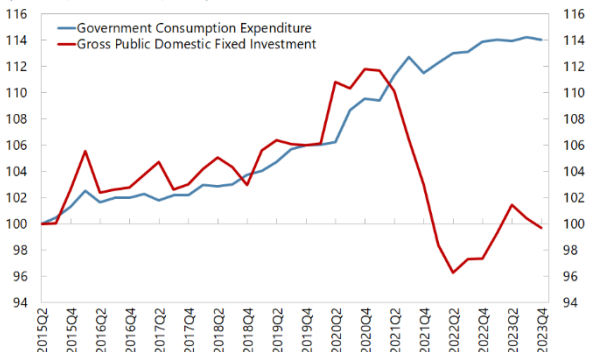


Sources: Cabinet Office of Japan; Haver Analytics; and IMF staff calculations.

*Real public investment has been revised upward and has grown robustly until 2023Q3.*

**Real Government Consumption and Investment**

(In index, 2015Q2=100, SAAR)

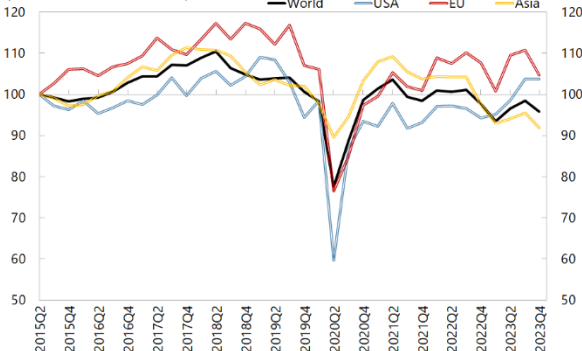


Sources: Cabinet Office of Japan; Haver Analytics; and IMF staff calculations.

*Real Export growth remains strongest in the EU; however, exports to China and the U.S. have picked up recently.*

**Real Export by Destination**

(In index, 2015Q2=100, SA)

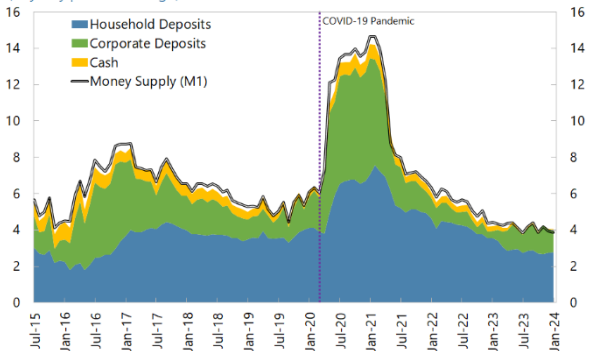


Sources: Japan Ministry of Finance; Haver Analytics; and IMF staff calculations.

*Money supply growth has decelerated in the last year after the exceptional expansion during the pandemic*

**Contributions to Growth in Money Stock**

(In y-o-y percent change)



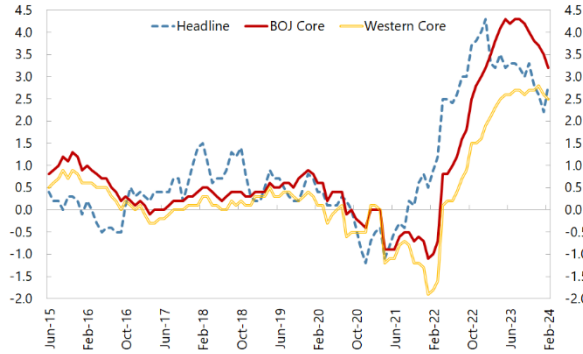
Sources: Bank of Japan, Haver Analytics, and IMF staff calculations.

**Figure 2. Japan: Inflation Developments**

Headline and BOJ core inflation remain well above target but appear to have peaked...

**Inflation**

(In y-o-y percent change, NSA)

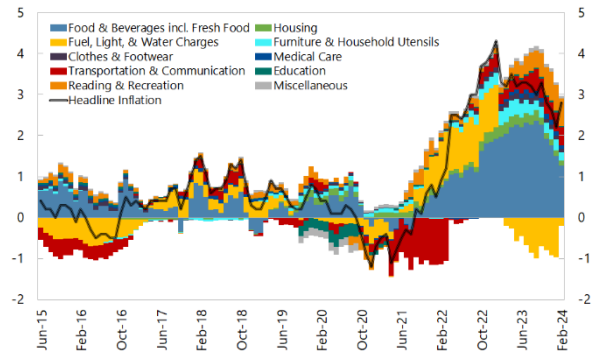


Sources: Japan Ministry of Internal Affairs and Communications; and Haver Analytics.

...as the contribution from higher goods prices wanes.

**Contributions to Headline Inflation**

(In y-o-y percent change, NSA)

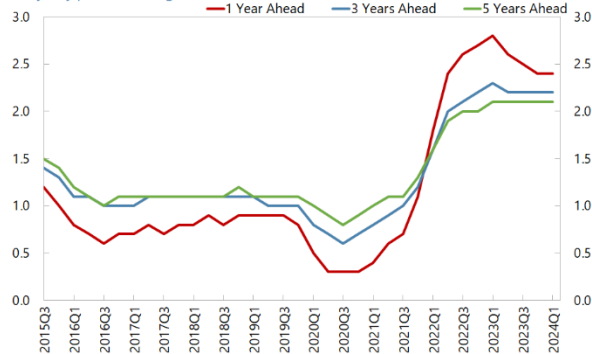


Sources: Ministry of Internal Affairs & Communications; Haver Analytics; and IMF staff calculations.

Survey based measures of inflation expectations have moderated but remain above target...

**Average Inflation Outlook from Tankan Survey**

(In y-o-y percent change)

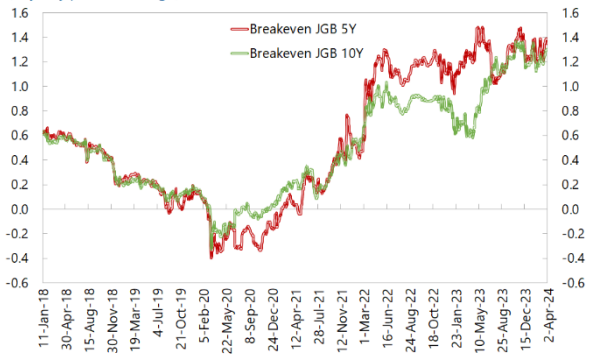


Sources: Bank of Japan and Haver Analytics.

...while inflation expectations in financial markets have continued to rise.

**Inflation Expectations**

(In y-o-y percent change)

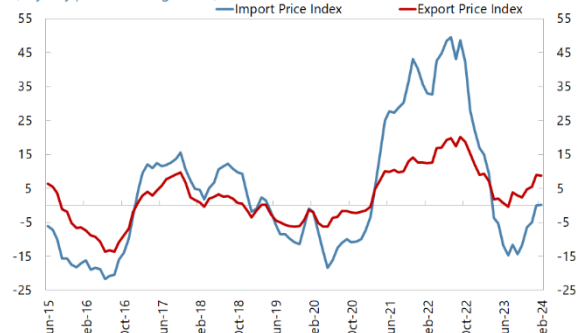


Source: Bloomberg L.P.

Import prices have declined sharply following the normalization of supply-chain pressures.

**Export & Import Price Indices, Yen Basis**

(In y-o-y percent change, NSA)

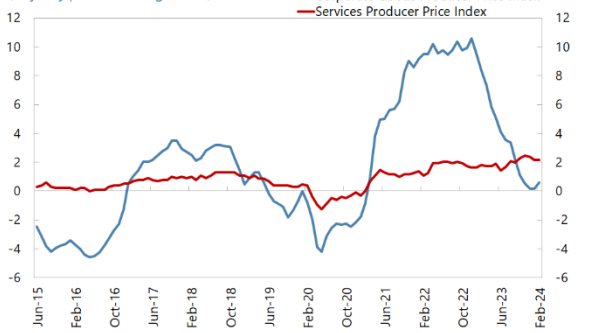


Sources: Bank of Japan and Haver Analytics.

...with goods-based producer prices moving in-line with import prices. Services inflation has been steady at 2 percent in the last year.

**Producer Price Indices**

(In y-o-y percent change, NSA)

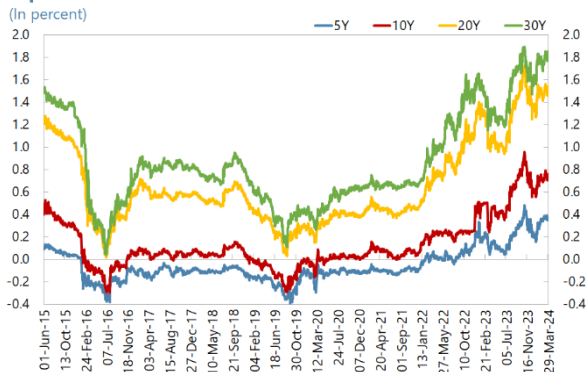


Sources: Bank of Japan and Haver Analytics. Note: Data from source excludes the effects of change in consumption tax.

**Figure 3. Japan: Monetary and Credit Conditions**

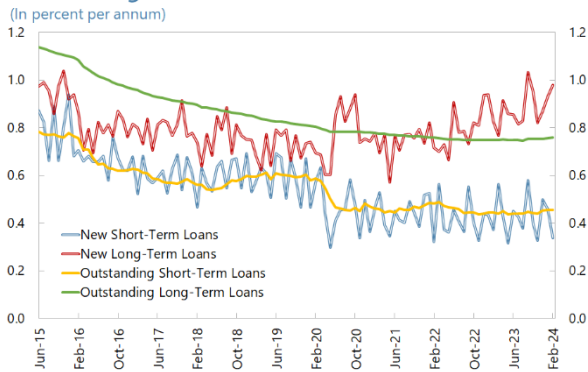
Modifications to YCC have allowed further rise in long-term nominal interest rates.

**Japanese Government Bond Yields**



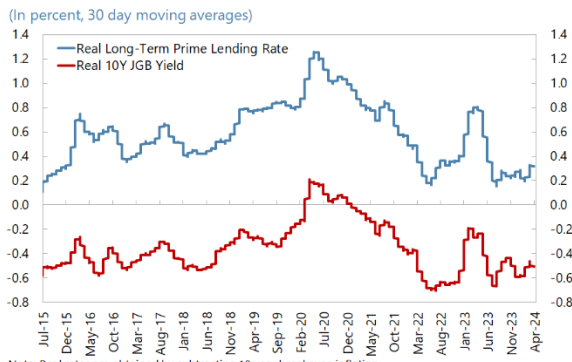
However, lending rates continue to remain low due to unchanged short-term policy rate

**Bank Lending Rates**



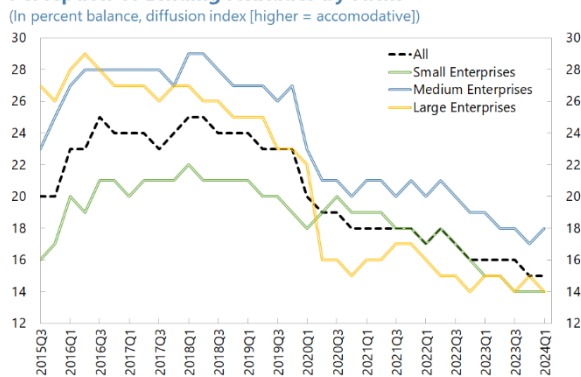
With rising inflation and inflation expectations real long-term interest rates have declined...

**Real Interest Rates**



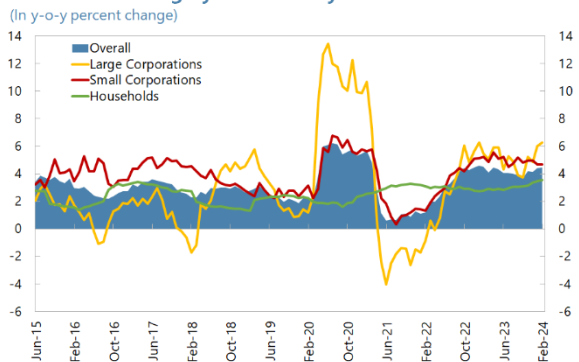
Firms' perception of bank lending attitudes continue to remain broadly accommodative.

**Perception of Lending Attitudes by Firms**



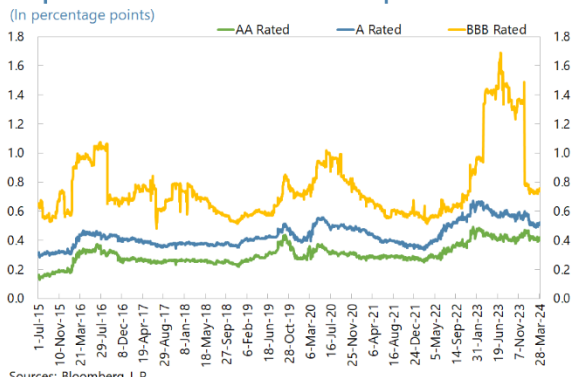
...supporting strong credit growth to firms amidst higher raw material costs

**Growth in Lending by Domestically Licensed Banks**



Corporate bond spreads have somewhat stabilized amidst strong corporate earnings.

**Corporate - Government 5 Year Bonds Spreads**



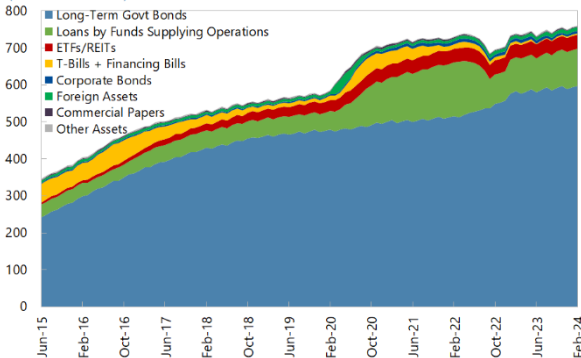


**Figure 3. Japan: Monetary and Credit Conditions (concluded)**

*Balance sheet accommodation by the BoJ has continued...*

**Bank of Japan Accounts: Assets**

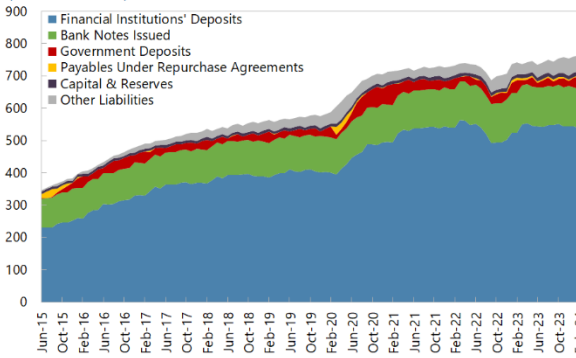
(In trillions of JPY)



Sources: Bank of Japan and Haver Analytics.

**Bank of Japan Accounts: Liabilities**

(In trillions of JPY)

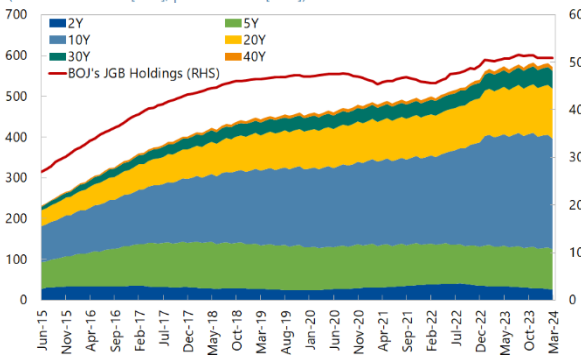


Sources: Bank of Japan and Haver Analytics.

*...due to scheduled and unscheduled purchases of JGBs...*

**Bank of Japan's JGB Holdings by Maturity**

(In trillions of Yen [LHS]; percent share[RHS])

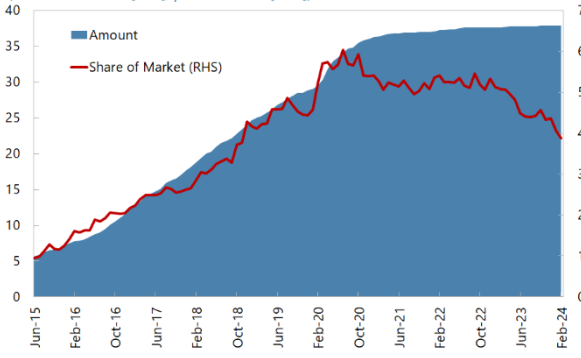


Sources: Bank of Japan and Haver Analytics.

*BoJ's purchases of ETFs and J-REITs are at a historical low after rising sharply in response to the pandemic.*

**Bank of Japan's Outstanding ETFs and REITs**

(In trillions of Yen [LHS]; percent share [RHS])

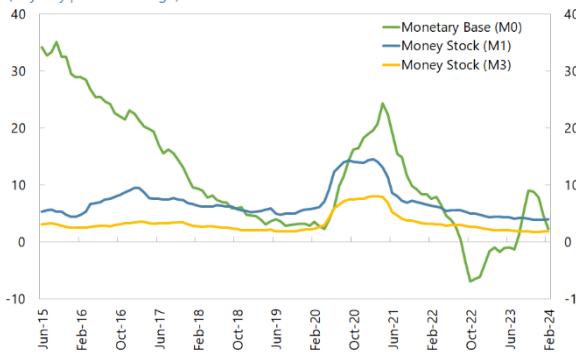


Sources: Bank of Japan; Investment Trust Association; Haver Analytics; & IMF staff calculations.

*...while also leading to an expansion of the monetary base.*

**Money Stock**

(In y-o-y percent change)

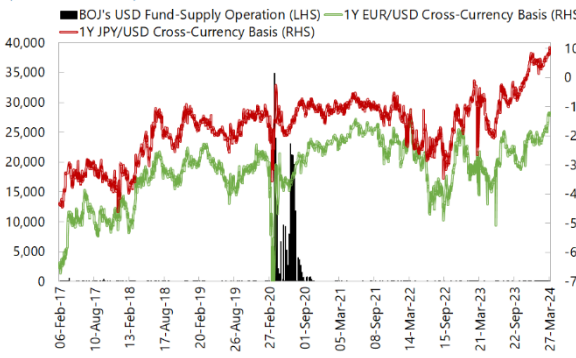


Sources: Bank of Japan and Haver Analytics.

*Cross-currency basis for yen against the U.S. dollar has narrowed recently.*

**Bank of Japan Lending - USD Funds-Supplying Operation**

(In millions of USD)



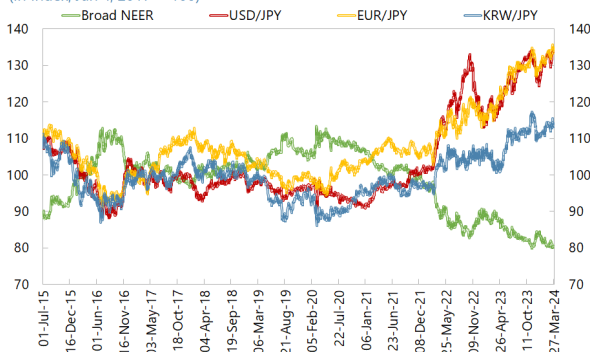
Sources: Bank of Japan; Haver Analytics; and Thomson Reuters Eikon.

**Figure 4. Japan: Financial Markets Developments**

The yen has depreciated sharply against other major currencies and trading partners in most of 2023...

**Selected Exchange Rates**

(In index, Jan 4, 2017 = 100)

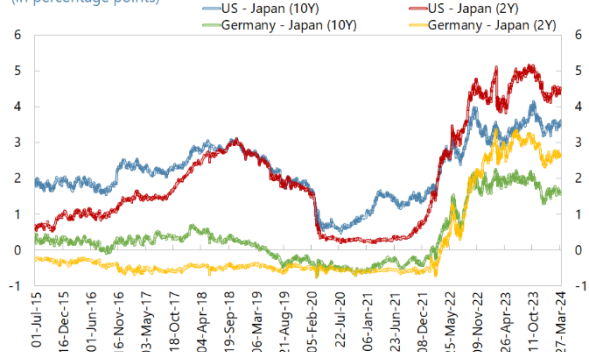


Sources: Bank of Japan; Bank of Korea; J.P. Morgan; and IMF staff calculations.

...largely driven by the monetary policy divergence between Japan and other major countries, reflected in higher interest rate differentials.

**Interest Differentials**

(In percentage points)

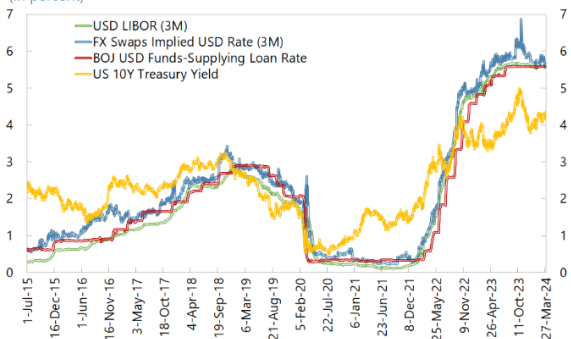


Sources: Tullett Prebon Information and Haver Analytics.

Concurrently, higher overseas rates have pushed up foreign funding costs, including for the US dollar.

**USD Funding Cost in Japan**

(In percent)

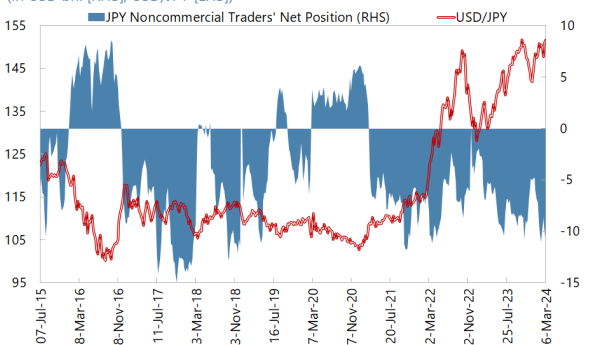


Sources: Bloomberg LP; Haver Analytics; and IMF staff calculations.

Short yen positions remain elevated since early 2022, ...

**CFTC Net Noncommercial Positions on Yen**

(In USD bn. [RHS]; USD/JPY [LHS])

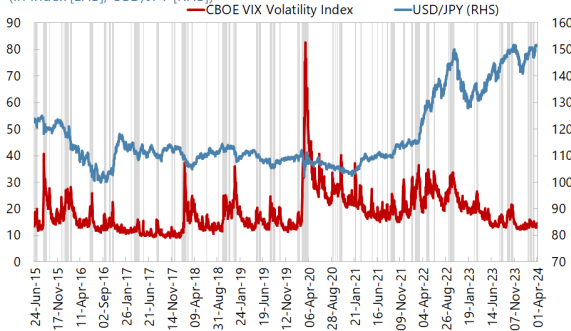


Sources: Commodity Futures Trading Commission; Wall Street Journal; and Haver Analytics.

and safe haven flows remain muted.

**VIX Index and Exchange Rate**

(In index [LHS]; USD/JPY [RHS])

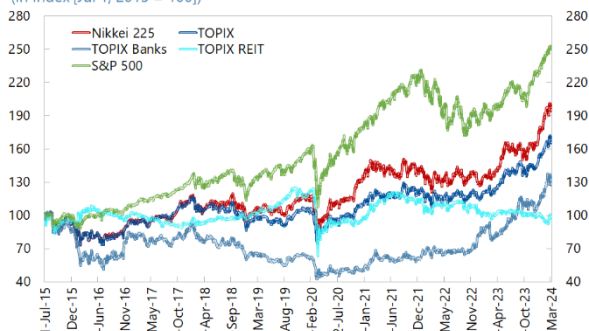


Sources: Wall Street Journal and Haver Analytics. Note: Shaded areas refer to risk-off episodes with VIX one std. deviation above 60-day MA.

Japanese equities reached historical highs in nominal yen terms, amid strong earnings, inflation and a weaker yen.

**Equity Markets**

(In index [Jul 1, 2015 = 100])



Sources: Financial Times; Japan Exchange Group; Standard & Poor's; and Haver Analytics.

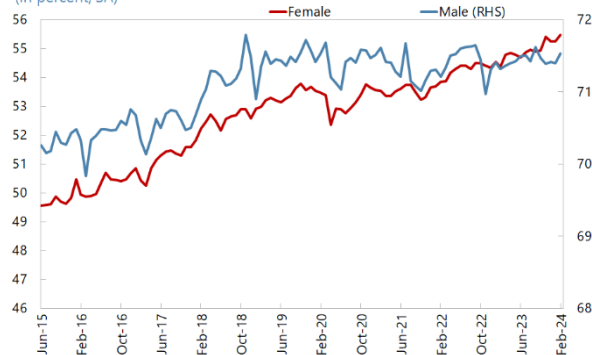


**Figure 5. Japan: Labor Market and Wage Developments**

Labor force participation has risen for both male and females in 2023.

**Labor Force Participation Rate**

(In percent, SA)

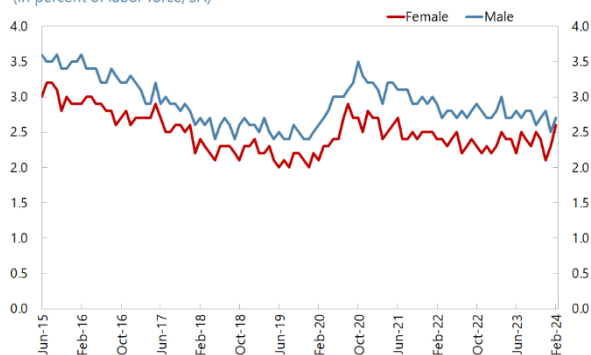


Sources: Ministry of Internal Affairs and Communications and Haver Analytics.

The unemployment remains near historic lows reflecting a tight labor market...

**Unemployment Rate**

(In percent of labor force, SA)

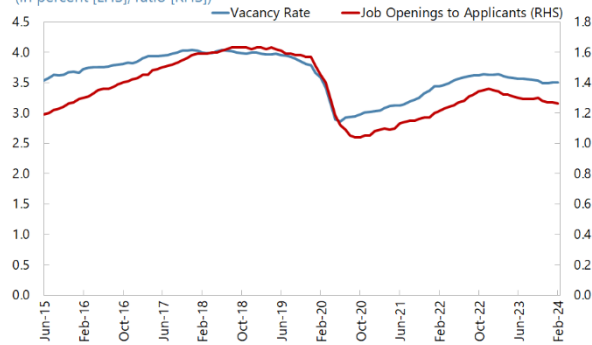


Sources: Ministry of Internal Affairs and Communications and Haver Analytics.

...with vacancy rates and the job openings remaining elevated following their post re-opening rise....

**Vacancy Rate & Ratio of Job Openings to Applicants**

(In percent [LHS]; ratio [RHS])

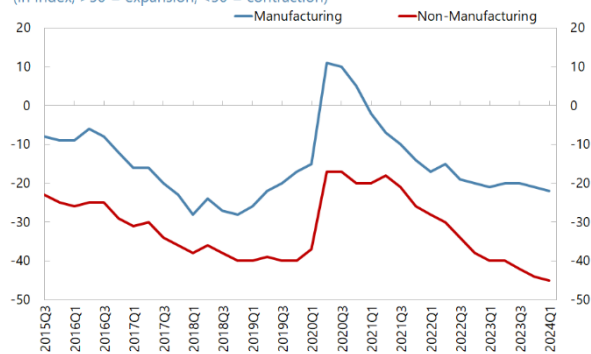


Sources: Ministry of Health, Labour, & Welfare; and Haver Analytics. Note: Data are seasonally adjusted. Vacancy rate is the number of available jobs that remain unfilled as a percentage of the available labor force.

... as reflected in worsening labor shortages.

**Tankan Enterprise Survey: Employment Conditions**

(In index; >50 = expansion, <50 = contraction)

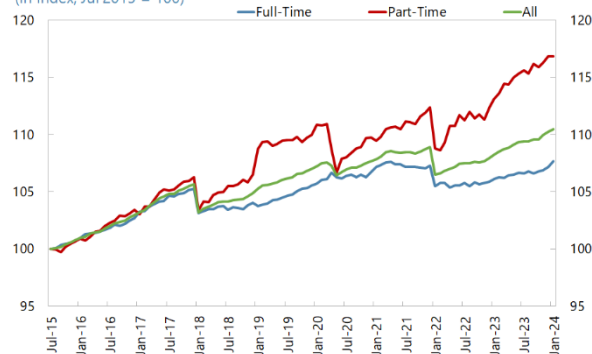


Sources: Bank of Japan, Tankan Survey; and Haver Analytics.

Demand for part-time workers continues to be very strong and positive growth has been seen in full-time employees in 2023.

**Growth of Regular Employees by Type**

(In index, Jul 2015 = 100)

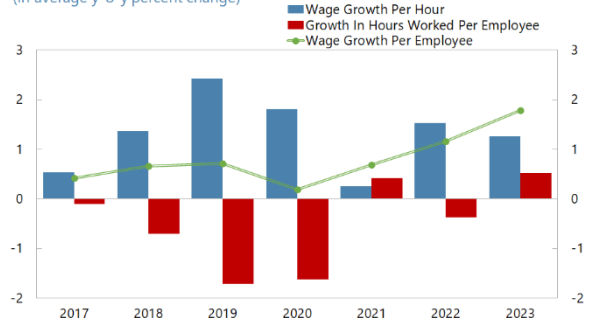


Sources: Ministry of Internal Affairs & Communications; Haver Analytics; & IMF staff calculations.

The tightness of the labor market is increasingly reflected in wage growth.

**Nominal Wage Growth per Full-Time Employee**

(In average y-o-y percent change)

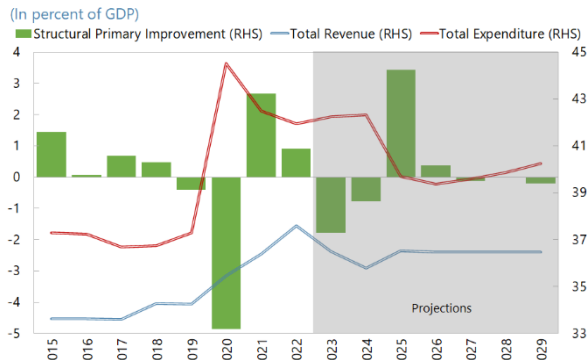


Sources: Ministry of Health, Labour, & Welfare, Monthly Labor Survey - Common Business Establishments; Haver Analytics; and IMF staff calculations.

**Figure 6. Japan: Fiscal Developments and Sustainability**

The fiscal balance is projected to improve moderately in the near term, before worsening further in the medium term.

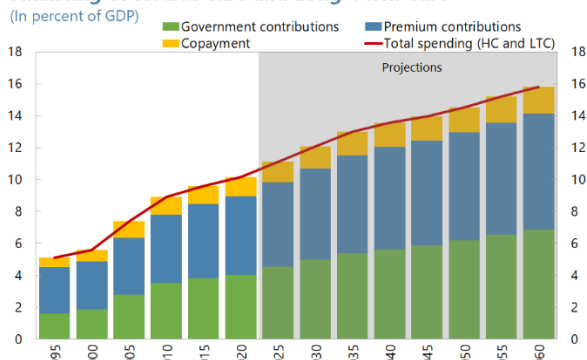
**General Government Fiscal Balance**



Sources: IMF, *World Economic Outlook*; and IMF staff estimates.

Expenditures on health and long-term care are projected to rise due to an aging population...

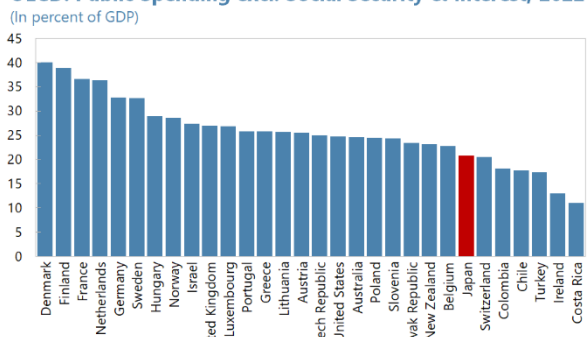
**Financing of Health Care and Long-Term Care**



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

Relative to peers, Japan's share of non-social security spending has remained low...

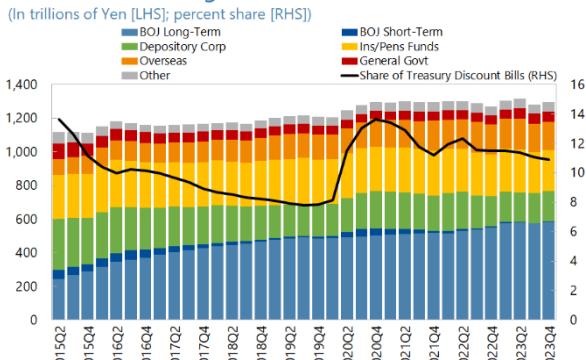
**OECD: Public Spending excl. Social Security & Interest, 2022**



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.  
Note: OECD countries with missing data have been omitted.

JGBs are mostly held by the BOJ and domestic investors, with a gradual decline in the share of short-term debt.

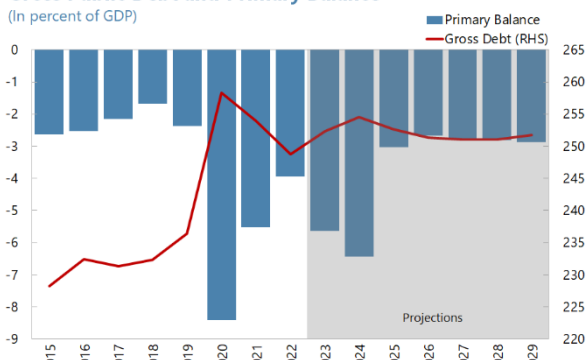
**Public Debt Financing**



Sources: Bank of Japan; Haver Analytics; and IMF staff calculations.

...and posing risks to Japan's fiscal sustainability.

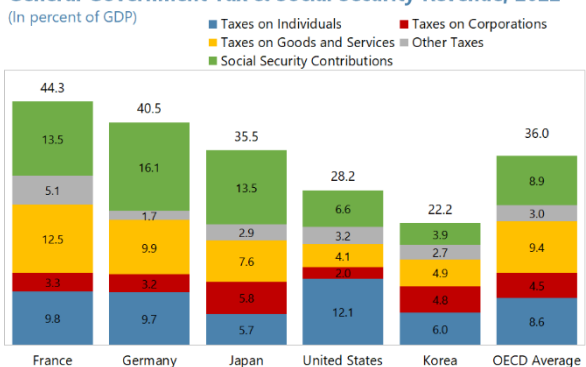
**Gross Public Debt and Primary Balance**



Sources: Cabinet Office of Japan and IMF staff estimates.

...and there is room for further revenue mobilization.

**General Government Tax & Social Security Revenue, 2022**



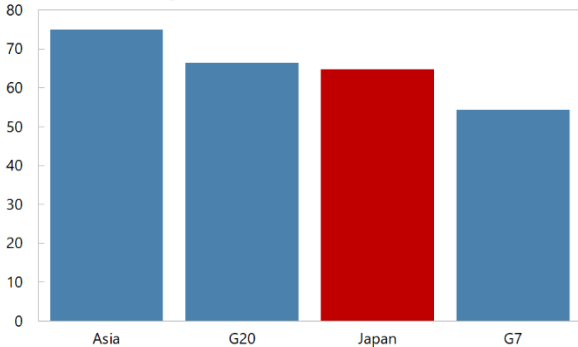
Sources: Cabinet Office of Japan; and IMF, *World Economic Outlook*; and IMF staff calculations.

**Figure 7. Japan: Climate Change**

Among major advanced economies, Japan is one of the most vulnerable countries to climate change.

**Global Climate Risk Index**

(In index, 2000-19 average)

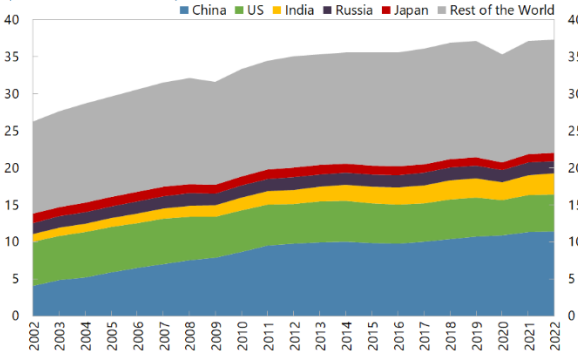


Source: German Watch, *Global Climate Risk Index 2021*.

...the country is one of the top carbon emitters globally, exposing it to transition risks.

**Global CO2 Emissions**

(In billions of metric tons)

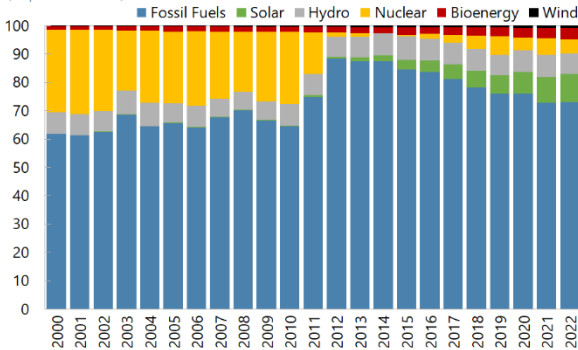


Sources: Global Carbon Atlas and Haver Analytics.

While fossil fuels remain the most important source of electricity production, the share of electricity from renewable sources is rising.

**Share of Electricity Production by Source**

(In percent share)

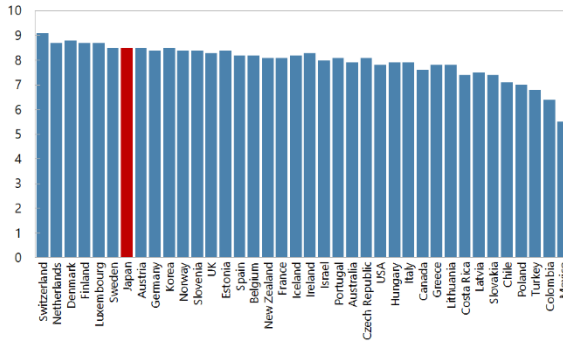


Source: Ember.

While Japan has strong adaptive capacity to handle climate-related risks to physical exposures...

**OECD: Climate Change Coping Capacity, 2023**

(In index, 0-10 [higher score means more capacity to cope with climate change risk])

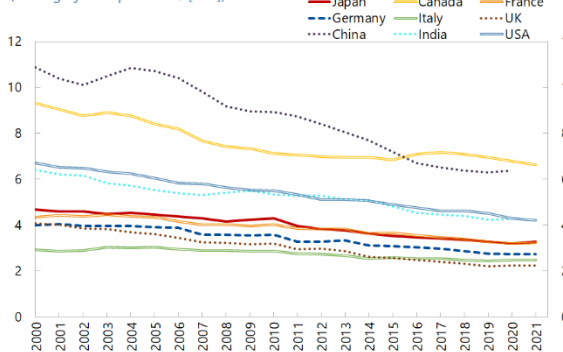


Sources: Index for Risk Management (INFORM); and Haver Analytics.

The energy intensity of GDP has declined in Japan, but less so compared with some other large economies.

**Energy Intensity: Primary Energy Consumption per GDP**

(In mega-joules per 2017\$ [PPP])

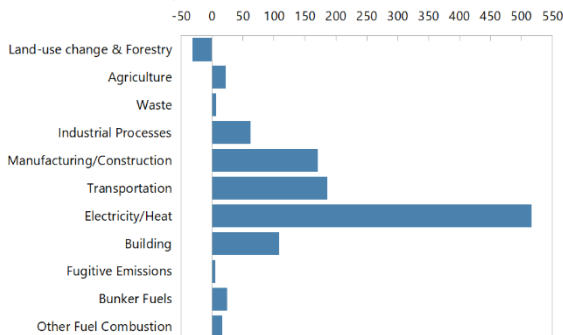


Source: World Bank.

Electricity and heat production, transportation, manufacturing, and construction are the largest emitters.

**Greenhouse Gas Emissions by Sector, 2020**

(In million tons of CO<sub>2</sub> equivalent)



Source: Climate Watch; World Resource Institute; and Haver Analytics.

**Table 1. Japan: Selected Economic Indicators, 2021-29**

	Nominal GDP: US\$ 4,213 Billion (2023) Population: 125 Million (2023)			GDP per capita: US\$ 33,806 (2023) Quota: SDR 30.8 billion (2023)					
	2021	2022	2023	2024	2025	2026	2027	2028	2029
			Est.	Proj.					
<i>(In percent change)</i>									
Growth									
Real GDP	2.6	1.0	1.9	0.9	1.0	0.8	0.6	0.6	0.4
Domestic demand	1.5	1.5	0.9	0.8	1.1	0.6	0.6	0.5	0.4
Private consumption	0.8	2.2	0.6	0.3	0.9	0.6	0.6	0.4	0.2
Gross Private Fixed Investment	0.4	1.0	1.9	1.9	1.5	0.6	0.3	0.3	0.3
Business investment	0.5	1.9	2.1	2.3	1.8	0.8	0.4	0.4	0.4
Residential investment	-0.3	-3.5	1.1	-0.1	0.3	0.0	0.0	0.0	0.0
Government consumption	3.4	1.7	0.9	1.3	0.7	1.0	0.9	1.2	1.2
Public investment	-1.8	-9.6	2.8	0.1	-0.2	-0.2	-0.3	-0.3	-0.3
Stockbuilding	0.5	0.3	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0
Net exports	1.1	-0.5	0.9	0.2	0.0	0.2	0.0	0.0	0.0
Exports of goods and services	11.9	5.3	3.0	3.3	1.7	2.5	1.8	1.6	1.5
Imports of goods and services	5.1	7.9	-1.3	2.2	2.0	1.7	1.6	1.4	1.3
Output Gap	-1.6	-0.9	0.2	0.1	0.0	0.0	0.0	0.0	0.0
<i>(In percent change, period average)</i>									
Inflation									
Headline CPI	-0.2	2.5	3.3	2.2	2.1	2.0	2.0	2.0	2.0
GDP deflator	-0.2	0.3	3.8	2.3	2.3	2.1	2.0	2.0	1.9
<i>(In percent of GDP)</i>									
Government									
Revenue	36.4	37.6	36.5	35.8	36.5	36.5	36.5	36.5	36.5
Expenditure	42.5	41.9	42.2	42.3	39.7	39.4	39.6	39.9	40.2
Overall Balance	-6.1	-4.4	-5.8	-6.5	-3.2	-2.9	-3.1	-3.4	-3.8
Primary balance	-5.5	-3.9	-5.6	-6.4	-3.0	-2.7	-2.8	-2.8	-2.9
Structural primary balance	-4.8	-3.9	-5.7	-6.5	-3.0	-2.7	-2.8	-2.8	-3.0
Public debt, gross	253.9	248.7	252.4	254.6	252.6	251.3	251.0	251.0	251.7
<i>(In percent change, end-of-period)</i>									
Macro-financial									
Base money	8.5	-5.6	6.3	2.3	2.3	2.6	2.6	2.5	2.4
Broad money	2.9	2.2	2.1	1.5	2.0	2.1	2.1	2.0	1.6
Credit to the private sector	1.9	4.2	4.4	2.6	1.9	1.9	1.6	1.3	1.3
Non-financial corporate debt in percent of GDP	155.0	159.4	155.2	156.8	156.5	155.5	155.7	156.7	156.6
<i>(In percent)</i>									
Interest rate									
Overnight call rate, uncollateralized (end-of-period)	0.0	0.0	0.0	...	...	...	...	...	...
10-year JGB yield (end-of-period)	0.1	0.4	0.6	...	...	...	...	...	...
<i>(In billions of USD)</i>									
Balance of payments									
Current account balance	196.4	84.5	144.7	142.6	149.7	162.6	161.5	165.5	154.5
Percent of GDP	3.9	2.0	3.4	3.5	3.5	3.6	3.5	3.4	3.1
Trade balance	16.4	-117.5	-49.1	-31.4	-28.9	-20.5	-19.4	-17.8	-19.1
Percent of GDP	0.3	-2.8	-1.2	-0.8	-0.7	-0.5	-0.4	-0.4	-0.4
Exports of goods, f.o.b.	749.2	751.8	713.2	728.6	754.9	784.0	799.9	818.3	835.6
Imports of goods, f.o.b.	732.7	869.4	762.2	759.9	783.8	804.5	819.2	836.0	854.7
Energy imports	127.8	195.5	152.6	143.0	128.9	118.6	111.0	105.3	100.8
<i>(In percent of GDP)</i>									
FDI, net	3.5	2.9	3.8	3.0	2.7	2.9	2.8	2.8	2.7
Portfolio Investment	-3.9	-3.4	4.7	-0.7	-1.0	-1.0	-0.3	0.5	-0.4
<i>(In billions of USD)</i>									
Change in reserves	62.8	-47.4	29.8	11.5	11.5	11.5	11.5	11.5	11.5
Total reserves minus gold (in billions of US\$)	1356.2	1178.3	1238.5	...	...	...	...	...	...
<i>(In units, period average)</i>									
Exchange rates									
Yen/dollar rate	109.8	131.5	140.5	...	...	...	...	...	...
Yen/euro rate	129.9	138.6	152.0	...	...	...	...	...	...
Real effective exchange rate (ULC-based, 2010=100)	73.5	62.0	56.4	...	...	...	...	...	...
Real effective exchange rate (CPI-based, 2010=100)	70.7	61.0	58.0	...	...	...	...	...	...
<i>(In percent)</i>									
Demographic Indicators									
Population Growth	-0.3	-0.3	-0.4	-0.5	-0.5	-0.5	-0.5	-0.6	-0.6
Old-age dependency	48.7	48.9	49.3	49.8	50.3	50.7	51.1	51.5	52.0

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

Table 2. Japan: Monetary Authority Accounts and Monetary Survey, 2020-29

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
							Proj.			
	<i>(In trillions of JPY)</i>									
<b>Monetary Authority</b>										
Net foreign assets	-19.5	-17.5	-25.7	-28.9	-29.7	-29.1	-28.8	-28.3	-28.1	-28.2
Net domestic assets	637.1	699.6	694.1	701.4	717.8	732.8	750.8	768.8	786.8	804.8
Net domestic credit	674.7	741.7	716.2	737.4	753.7	768.7	786.7	804.7	822.7	840.7
Net credit to non-financial public sector	437.3	454.3	479.7	486.1	496.1	516.1	534.1	552.1	570.1	588.1
Credit to the private sector	9.7	10.4	9.5	7.9	7.9	7.9	7.9	7.9	7.9	7.9
Net credit to financial corporations	227.7	277.1	227.0	243.8	249.8	244.8	244.8	244.8	244.8	244.8
Other items net	-37.6	-42.2	-22.1	-36.0	-36.0	-36.0	-36.0	-36.0	-36.0	-36.0
Monetary base	617.6	670.1	632.4	672.5	688.1	703.7	722.0	740.4	758.6	776.6
<b>Monetary Survey (Depository Corporations)</b>										
Net foreign assets	92.8	95.5	92.2	92.7	100.9	105.6	110.9	115.6	121.0	127.4
Net domestic assets	1,443.1	1,497.3	1,560.1	1,593.2	1,548.8	1,577.1	1,607.9	1,638.7	1,669.2	1,691.8
Net domestic credit	1,566.8	1,609.3	1,590.8	1,633.5	1,626.3	1,659.7	1,695.4	1,731.2	1,766.8	1,787.3
Net credit to nonfinancial public sector	698.7	704.3	700.3	713.8	688.2	707.8	729.1	752.3	777.6	787.9
Credit to the private sector	651.3	663.6	691.4	722.0	740.5	754.2	768.7	781.3	791.5	801.7
Net credit to other financial institutions	216.8	241.4	199.1	197.6	197.6	197.6	197.6	197.6	197.6	197.6
Other items net	-123.7	-112.0	-30.7	-40.3	-77.5	-82.5	-87.5	-92.5	-97.5	-95.5
Broad money	1,513.5	1,558.1	1,592.4	1,625.9	1,649.7	1,682.7	1,718.8	1,754.3	1,790.3	1,819.1
Currency in circulation	112.4	116.2	119.1	115.4	132.4	138.1	143.6	148.7	154.0	159.1
Current deposits	854.9	911.4	951.4	999.4	1,000.3	1,021.6	1,046.2	1,070.6	1,095.3	1,113.0
Other deposits	546.2	530.4	521.9	511.0	517.0	523.0	529.0	535.0	541.0	547.0
	<i>(In percent of GDP)</i>									
Net credit to other financial institutions	40.2	43.7	35.6	33.4	32.4	31.3	30.4	29.6	28.9	28.2
Credit to the private sector from depository corporations	120.6	120.1	123.5	122.0	121.3	119.5	118.3	117.2	115.7	114.5
Corporate debt (includes loans and securities other than shares)	151.8	155.0	159.4	155.2	156.8	156.5	155.5	155.7	156.7	156.6
Corporate debt (includes loans and securities other than shares), trilli	819.2	856.6	892.0	918.5	957.1	987.6	1,010.4	1,038.0	1,071.6	1,096.9
Household debt in percent of disposable income	112.4	118.9	120.9	121.7	121.4	122.1	122.0	121.3	120.6	117.9
	<i>(In y-o-y percent change)</i>									
Base money	19.2	8.5	-5.6	6.3	2.3	2.3	2.6	2.6	2.5	2.4
Broad money	7.3	2.9	2.2	2.1	1.5	2.0	2.1	2.1	2.0	1.6
Credit to the private sector from depository corporations	6.1	1.9	4.2	4.4	2.6	1.9	1.9	1.6	1.3	1.3
Corporate loans by domestically licensed banks	7.9	-0.2	5.8	6.0	6.0	5.5	5.1	4.9	4.9	5.0
Housing loans	3.0	3.5	2.8	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Credit to the private sector from all financial institutions	6.8	2.5	1.9	4.5	2.6	1.9	2.0	1.7	1.4	1.4
Memorandum items:										
Velocity of broad money	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Money multiplier (broad money)	2.5	2.3	2.5	2.4	2.4	2.4	2.4	2.4	2.4	2.3
Loan-to-deposit ratio (percent) 1/	53.4	53.0	55.1	56.6	58.6	59.7	60.6	61.6	62.6	64.0

Sources: Bank of Japan; Haver; IMF staff estimates and projections.

1/ Defined as the ratio of credits to the private sector and net credit to other financial institutions to customer deposits.

Table 3. Japan: External Sector Summary, 2021-29

	2021	2022	2023	2024	2025	2026	2027	2028	2029
				Proj.					
<b>Balance of Payments</b>									
	<i>(In billions of USD)</i>								
Current account balance	196.4	84.5	144.7	142.6	149.7	162.6	161.5	165.5	154.5
Trade balance (goods)	16.4	-117.5	-49.1	-31.4	-28.9	-20.5	-19.4	-17.8	-19.1
Exports of goods	749.2	751.8	713.2	728.6	754.9	784.0	799.9	818.3	835.6
Imports of goods	732.7	869.4	762.2	759.9	783.8	804.5	819.2	836.0	854.7
Imports of goods, Oil	88.9	131.3	105.6	99.0	89.2	82.1	76.8	72.9	69.8
Services balance	-38.6	-42.3	-23.4	-16.1	-12.3	-8.7	-8.9	-9.2	-9.5
Credits	183.6	211.1	218.7	226.6	231.8	237.1	237.1	237.1	237.1
Debits	211.8	219.9	228.2	236.9	245.9	255.3	255.3	255.3	255.3
Income balance	240.1	263.4	246.6	215.4	217.3	219.2	214.7	214.9	203.0
Credits	347.0	376.2	396.2	323.4	324.2	329.8	327.5	323.6	305.9
Debits	106.9	112.8	149.6	108.0	106.9	110.7	112.8	108.7	102.9
Current net transfers	-21.5	-19.1	-29.4	-25.4	-26.4	-27.4	-24.9	-22.4	-19.9
Capital account	-3.8	-0.9	-2.9	-2.6	-2.3	-2.4	-2.6	-2.6	-2.8
Financial account	153.5	48.4	163.1	140.0	147.4	160.1	158.9	162.9	151.7
Direct investment, net	174.9	122.4	159.0	122.4	116.7	132.7	132.0	137.2	131.5
Portfolio investment, net	-198.3	-143.0	196.6	-28.3	-42.2	-43.4	-14.2	22.8	-18.1
Other investment, net	94.1	78.0	-266.7	-10.1	16.8	14.8	-15.0	-53.0	-17.7
Financial derivatives, net	19.9	38.4	44.5	44.5	44.5	44.5	44.5	44.5	44.5
Reserve assets	62.8	-47.4	29.8	11.5	11.5	11.5	11.5	11.5	11.5
Errors and omissions, net	-39.0	-35.2	21.3	0.0	0.0	0.0	0.0	0.0	0.0
	<i>(In percent of GDP)</i>								
Current account balance	3.9	2.0	3.4	3.5	3.5	3.6	3.5	3.4	3.1
Trade balance (goods)	0.3	-2.8	-1.2	-0.8	-0.7	-0.5	-0.4	-0.4	-0.4
Exports of goods	14.9	17.7	16.9	17.7	17.5	17.4	17.2	16.9	16.9
Imports of goods	14.6	20.4	18.1	18.5	18.2	17.9	17.6	17.3	17.3
Services balance	-0.8	-1.0	-0.6	-0.4	-0.3	-0.2	-0.2	-0.2	-0.2
Income balance	4.8	6.2	5.9	5.2	5.0	4.9	4.6	4.4	4.1
<b>Global Assumptions</b>									
Oil prices (US\$/barrel)	69.2	96.4	80.6	78.6	73.7	70.6	68.7	67.8	67.5
<i>(Percent change)</i>	65.8	39.2	-16.4	-2.5	-6.3	-4.2	-2.6	-1.3	-0.4
<i>Memorandum items:</i>									
Nominal GDP (US\$ billion)	5,034.6	4,256.4	4,212.9	4,110.5	4,310.4	4,499.5	4,649.1	4,836.3	4,944.7
Net foreign assets (NFA)/GDP, US\$ basis	73.1	72.6	80.0	85.4	84.9	84.9	85.6	85.6	86.8
Return on NFA (in percent), US\$ basis	6.5	8.5	7.3	6.1	5.9	5.7	5.4	5.2	4.7
Net export contribution to growth	1.1	-0.5	0.9	0.2	0.0	0.2	0.0	0.0	0.0

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

**Table 4. Japan: General Government Operations, 2020-29**  
(In percent of GDP)

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
	Proj.									
Total revenue	35.5	36.4	37.6	36.5	35.8	36.5	36.5	36.5	36.5	36.5
Taxes 1/	19.7	20.7	21.6	20.4	19.9	20.7	20.7	20.8	20.8	20.8
Social contributions	13.6	13.7	13.8	13.8	13.8	13.8	13.8	13.8	13.8	13.8
o/w Social security contributions	13.2	13.3	13.4	13.5	13.5	13.5	13.5	13.5	13.5	13.5
Other revenue	2.1	2.0	2.2	2.3	2.1	2.0	1.9	1.8	1.8	1.8
o/w interest income	1.0	1.0	1.1	1.1	1.1	1.0	1.0	0.9	0.9	0.9
Total expenditure	44.5	42.5	41.9	42.2	42.3	39.7	39.4	39.6	39.9	40.2
Expense	43.6	41.7	41.6	41.5	41.4	38.9	38.6	38.8	39.1	39.5
Consumption	11.7	11.8	12.3	11.6	11.5	11.3	11.1	11.0	11.0	11.0
Social benefits	21.9	22.1	22.3	21.8	21.6	21.5	21.5	21.6	21.7	21.8
o/w Social security benefits	19.5	19.4	19.3	18.9	18.8	18.8	18.8	18.9	18.9	18.9
Interest	1.6	1.6	1.5	1.2	1.2	1.2	1.2	1.2	1.5	1.8
Other expense	8.3	6.2	5.5	6.9	7.1	4.9	4.8	5.0	4.9	4.9
(Memo) Compensation of employees 2/	5.3	5.2	5.2	...	...	...	...	...	...	...
(Memo) Use of goods and services 2/	4.0	4.3	4.5	...	...	...	...	...	...	...
Net investment in nonfinancial assets	0.9	0.8	0.4	0.8	0.9	0.8	0.8	0.7	0.7	0.7
Gross investment in nonfinancial assets	4.5	4.4	4.1	4.1	4.0	4.0	3.9	3.9	3.8	3.8
o/w public investment	4.2	4.2	3.9	3.9	3.9	3.8	3.8	3.7	3.7	3.7
o/w land acquisition	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
(less) Consumption of fixed capital	3.6	3.6	3.7	3.3	3.1	3.1	3.1	3.1	3.1	3.1
Net lending/borrowing (overall balance)	-9.1	-6.1	-4.4	-5.8	-6.5	-3.2	-2.9	-3.1	-3.4	-3.8
Excluding social security fund	-9.6	-6.8	-5.3	-6.6	-7.2	-3.8	-3.5	-3.7	-4.0	-4.4
Primary balance	-8.4	-5.5	-3.9	-5.6	-6.4	-3.0	-2.7	-2.8	-2.8	-2.9
Structural balance 3/	-8.1	-5.4	-4.3	-5.8	-6.6	-3.2	-2.9	-3.1	-3.4	-3.9
Structural primary balance 3/	-7.5	-4.8	-3.9	-5.7	-6.5	-3.0	-2.7	-2.8	-2.8	-3.0
Stock positions 4/										
Debt										
Gross 5/	258.3	253.9	248.7	252.4	254.6	252.6	251.3	251.0	251.0	251.7
Net	162.0	156.4	150.3	155.9	157.7	155.7	154.1	153.3	152.9	152.9
Net worth	12.8	21.4	31.6	...	...	...	...	...	...	...
Nonfinancial assets	144.8	147.0	150.9	...	...	...	...	...	...	...
Produced assets	122.6	125.0	128.8	...	...	...	...	...	...	...
Non-produced assets	22.2	22.0	22.1	...	...	...	...	...	...	...
Net financial worth	-132.0	-125.6	-119.3	...	...	...	...	...	...	...
Financial assets	129.6	131.8	133.1	...	...	...	...	...	...	...
Monetary Gold and SDR, etc.	0.4	1.4	1.6	...	...	...	...	...	...	...
Currency and deposits	22.6	17.4	19.6	...	...	...	...	...	...	...
Loans	3.5	3.3	3.5	...	...	...	...	...	...	...
Debt securities	12.4	13.6	13.3	...	...	...	...	...	...	...
Equity and investment fund shares	33.3	34.2	34.7	...	...	...	...	...	...	...
o/w shares	12.7	13.5	13.5	...	...	...	...	...	...	...
Insurance, pension and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...	...
Other financial assets	57.4	61.7	60.4	...	...	...	...	...	...	...
Liabilities	261.6	257.4	252.4	...	...	...	...	...	...	...
Monetary Gold and SDR, etc.	0.3	1.2	1.3	...	...	...	...	...	...	...
Currency and deposits	0.0	0.0	0.0	...	...	...	...	...	...	...
Loans	28.0	26.4	26.5	...	...	...	...	...	...	...
Debt securities	218.9	214.2	209.8	...	...	...	...	...	...	...
Equity and investment fund shares	3.3	3.4	3.6	...	...	...	...	...	...	...
Insurance, pension and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...	...
Other liabilities	11.0	12.1	11.1	...	...	...	...	...	...	...
Memorandum item:										
Nominal GDP (trillion yen)	539.8	552.6	559.7	591.9	610.4	631.0	649.7	666.6	683.9	700.4

Sources: Japan Cabinet Office; IMF staff estimates and projections.

1/ Including fines.

2/ Fiscal year basis.

3/ In percent of potential GDP.

4/ Market value basis.

5/ Nonconsolidated basis.



Table 5. Japan: Medium-Term Projections, 2021-29

	2021	2022	2023	2024	2025	2026	2027	2028	2029
			Est.	Proj.					
	<i>(In percent change)</i>								
Real GDP	2.6	1.0	1.9	0.9	1.0	0.8	0.6	0.6	0.4
Private final consumption	0.8	2.2	0.6	0.3	0.9	0.6	0.6	0.4	0.2
Government consumption	3.4	1.7	0.9	1.3	0.7	1.0	0.9	1.2	1.2
Gross Private fixed investment	0.4	1.0	1.9	1.9	1.5	0.6	0.3	0.3	0.3
Public investment	-1.8	-9.6	2.8	0.1	-0.2	-0.2	-0.3	-0.3	-0.3
Stockbuilding (contribution to growth)	0.5	0.3	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0
Exports	11.9	5.3	3.0	3.3	1.7	2.5	1.8	1.6	1.5
Imports	5.1	7.9	-1.3	2.2	2.0	1.7	1.6	1.4	1.3
Total domestic demand	1.5	1.5	0.9	0.8	1.1	0.6	0.6	0.5	0.4
Net exports (contribution)	1.1	-0.5	0.9	0.2	0.0	0.2	0.0	0.0	0.0
Real GDP per Capita	2.8	1.2	2.4	1.3	1.5	1.3	1.1	1.1	1.0
Private final consumption per Capita	1.1	2.4	1.1	0.8	1.4	1.1	1.1	1.0	0.8
Unemployment rate (percent)	2.8	2.6	2.6	2.5	2.5	2.5	2.5	2.5	2.5
Headline CPI inflation (average)	-0.2	2.5	3.3	2.2	2.1	2.0	2.0	2.0	2.0
Output gap (in percent of potential output)	-1.6	-0.9	0.2	0.1	0.0	0.0	0.0	0.0	0.0
	<i>(In percent of GDP)</i>								
Overall fiscal balance	-6.1	-4.4	-5.8	-6.5	-3.2	-2.9	-3.1	-3.4	-3.8
Primary balance	-5.5	-3.9	-5.6	-6.4	-3.0	-2.7	-2.8	-2.8	-2.9
General government debt									
Gross	253.9	248.7	252.4	254.6	252.6	251.3	251.0	251.0	251.7
Net	156.4	150.3	155.9	157.7	155.7	154.1	153.3	152.9	152.9
Current account balance	3.9	2.0	3.4	3.5	3.5	3.6	3.5	3.4	3.1
National savings	29.6	28.6	29.6	29.8	29.9	29.9	29.7	29.5	29.3
Private	31.3	28.6	31.0	31.9	28.7	28.5	28.5	28.6	28.7
Public	-1.6	0.0	-1.4	-2.1	1.2	1.4	1.2	0.9	0.5
National investment	25.7	26.6	26.2	26.3	26.4	26.3	26.2	26.1	26.2
Private	20.2	21.4	21.0	21.2	21.4	21.3	21.3	21.2	21.3
Public	5.5	5.2	5.2	5.1	5.0	5.0	4.9	4.9	4.9

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

**Table 6. Japan: Financial Soundness Indicators, 2018-23 1/**

	2018	2019	2020	2021	2022	2023
<b>Capital Adequacy</b>						
Regulatory capital to risk-weighted assets 2/3/	17.1	17.2	16.4	16.6	15.4	14.9
Regulatory tier 1 capital to risk-weighted assets	14.9	15.1	14.3	14.6	13.8	13.4
NPL net of provisions/capital 2/4/	4.8	4.3	4.8	5.7	6.9	4.9
<b>Asset Quality</b>						
Non-performing loans (NPL) to total loans ratio 2/4/	1.1	1.1	1.1	1.2	1.3	1.2
Sectoral distribution of loans 4/5/						
Residents	90.2	90.5	89.1	...	...	...
Deposit-takers	5.0	5.0	4.6	...	...	...
Central bank	0.0	0.0	2.2	...	...	...
Other financial corporations	9.6	10.2	10.0	...	...	...
General government	8.7	8.4	7.9	...	...	...
Non-financial corporations	36.1	36.4	35.3	...	...	...
Other domestic sectors	30.8	30.6	29.1	...	...	...
Non-residents	9.8	9.5	10.9	...	...	...
<b>Earnings and Profitability</b>						
Return on assets 2/4/	0.2	0.1	-0.1	0.1	0.1	0.2
Return on equity 2/4/	5.4	2.3	-1.3	3.5	2.6	5.8
Interest margin	1.1	1.1	1.0	0.9	0.9	1.1
Net interest income to gross income 2/4/	62.2	70.4	60.3	63.5	69.1	66.6
Non-interest expenses to gross income 2/4/	69.0	82.7	73.5	70.7	69.8	70.4
Personnel expenses to non-interest expenses 2/4/	44.2	43.7	43.0	42.9	42.7	43.8
<b>Liquidity</b>						
Liquid assets to total assets 2/4/	29.6	29.4	29.5	34.4	35.8	33.3
Liquid assets to short-term liabilities 2/4/	49.9	49.2	47.4	52.6	53.3	50.8
Non-interbank loans-to-customer-deposits 2/4/	71.7	71.7	71.9	67.8	67.3	68.1
<b>Other</b>						
Capital-to-total assets 2/3/	5.2	5.2	4.7	4.6	4.3	4.1
Gross derivative asset to capital 2/4/	35.8	35.2	55.8	43.3	57.1	75.9
Gross derivative liability to capital 2/4/	33.2	33.7	52.0	42.7	59.9	79.9

Sources: IMF, Financial Soundness Indicators (FSI) database.

1/ Data for these series are for Q1 of each year.

2/ Including city banks and regional banks but not shinkin banks.

3/ Aggregated based on a consolidated basis.

4/ Aggregated based on an unconsolidated basis.

5/ Including all deposit-taking institutions in Japan.

## Annex I. External Sector Assessment

<p><b>Overall Assessment:</b> <i>On a preliminary basis, the external position in 2023 is assessed as broadly in line with the level implied by medium-term fundamentals and desirable policies.</i> The CA surplus increased to 3.4 percent of GDP in 2023 from 2 percent in 2022. The lower primary income surplus is more than offset by higher inbound tourism and auto exports (as supply disruptions fade) and reduced imports from lower commodity prices. Japan's CA surplus is expected to continue over the medium term, mainly driven by its primary income surplus, arising from a large positive NIIP and a high rate of return on net foreign assets.</p> <p><b>Potential Policy Responses:</b> Policies focused on structural reforms and fiscal sustainability (a credible and specific medium-term fiscal consolidation plan) are needed to maintain an external position consistent with medium-term fundamentals and desirable policies. These 'desirable' policies will help shift the drivers of the economy from an unsustainable public saving-investment position to one driven by the private sector and raise Japan's potential growth over the medium term. Priority should be given to labor market and fiscal reforms that support private demand, raise potential growth, and promote digital and green investment. While fiscal consolidation will push the CA surplus higher, this would be offset by higher investment and a decrease in private savings from pandemic-era highs and due to demographic-related declines. Industrial policies should be pursued cautiously and remain narrowly targeted to specific objectives where externalities or market failures prevent effective market solutions and aim to minimize trade and investment distortions. Japan's global leadership role to promote more open, stable, and transparent trade policies in regional/multilateral trade agreements should be prioritized.</p>						
<p><b>Foreign Asset and Liability Position and Trajectory</b></p>	<p><b>Background.</b> Japan's NIIP rose to 80 percent of GDP at the end of 2023, from 72.6 percent in 2022, and significantly higher than the pre-pandemic (2016–19) average of 61.7 percent. This was driven by an increase in both net FDI and portfolio outflows and the positive valuation effects from yen depreciation. Japan holds the world's largest stock of net foreign assets, valued at \$3.4 trillion at the end of 2023.</p> <p><b>Assessment.</b> Japan's foreign asset holdings are well diversified, both by geography and risk classes. As of end-2023, gross foreign assets largely comprised portfolio investment accounting for about 41 percent of the total, followed by FDI with 21 percent. Of that portfolio investment, about 22 percent was yen denominated and 53 percent dollar denominated. In the event of yen appreciation against the dollar, the risk of negative valuation effects could materialize. Vulnerabilities associated with liabilities are contained, given that equity and direct investment account for about 33 percent of gross foreign liabilities. Owing to the continued depreciation of the yen, the NIIP is projected to generate a net annual investment income return of 7.3 percent in 2023, lower than 8.5 percent in 2022, but still significantly larger than the pre-pandemic (2016–19) average of 6.3 percent. Japan's large positive NIIP is partly related to the asset accumulation for old-age consumption; a gradual decumulation of such assets is expected over the long term.</p>					
2023 (% GDP)	NIIP: 80.0	Gross Assets: 247.6	Debt Assets: 88.7	Gross Liab.: 167.6	Debt Liab.: 95.2	
<p><b>Current Account</b></p>	<p><b>Background.</b> Japan's CA surplus reflects a sizable income balance owing to its large net foreign asset position. The CA surplus increased to 3.4 percent of GDP in 2023 from 2 percent in 2022. The merchandise trade deficit improved from -2.8 percent of GDP in 2022 to -1.2 percent in 2023, driven by lower prices for commodity imports. Offshoring of production over the years has limited the positive impact of yen depreciation on exports, while auto exports have surged at the back of supply side improvements. The surge in inbound tourism also boosted the services balance which improved from a deficit of 1 percent in 2022 to 0.6 percent in 2023. The income balance declined to 5.9 percent from a historic high of 6.2 percent of GDP in 2022. The lower primary income balance is more than offset by a 2 percent of GDP improvement in overall trade (good &amp; services) balance. In the medium term, the CA balance is projected to average 3.4 percent.</p> <p><b>Assessment.</b> The 2023 cyclically adjusted CA is 3.6 percent of GDP, and the cyclically adjusted CA norm is 4 percent of GDP (with a range between 2.9 and 5.1 percent of GDP). The 2023 CA gap midpoint is assessed at -0.4 percent of GDP, with a range between -1.5 and 0.7 percent of GDP. The EBA-identified policy gaps reflect relatively greater medium-term fiscal consolidation needs, as well as a positive credit gap, in relation to medium-term desired policy.<sup>1</sup> The unexplained residual of the assessment potentially reflects structural impediments and country-specific factors not included in the model, such as investment bottlenecks, including entrepreneurship entry barriers and corporate savings distortions.</p>					
2023 (% GDP)	CA: 3.4	Cycl. Adj. CA: 3.6	EBA Norm: 4.0	EBA Gap: -0.4	Staff Adjustors: 0.0	Staff Gap: -0.4

<b>Real Exchange Rate</b>	<p><b>Background.</b> The REER continued to depreciate in 2023 by close to 5 percent, following a depreciation of 14 percent in 2022. This reflects relatively higher inflation in Japan’s major trading partners combined with the yen’s nominal depreciation against major currencies as a result of widening real interest rate differentials amid global monetary tightening.</p> <p><b>Assessment.</b> The IMF staff CA gap implies a REER gap of 2.1 percent in 2023 (with an estimated elasticity of 0.18 applied). The EBA REER level and index models deliver gaps of –32.4 and –35.8 percent, respectively. Consistent with the IMF staff CA gap, the REER gap is assessed to be in the range of –4.2 to 8.4 percent, with a midpoint of 2.1 percent.</p>
<b>Capital and Financial Accounts: Flows and Policy Measures</b>	<p><b>Background.</b> The financial account recorded net outflows in 2023, mirroring the CA surplus, and increase to 3.9 percent of GDP in 2023 from 1.1 percent in 2022. Net FDI outflows at 3.8 percent of GDP are primarily driven by outward FDI flows to Asia, Europe, and North America. Net portfolio outflows at 4.7 percent of GDP, in comparison to net inflows of 3.4 percent of GDP in 2022, reflect lower demand for yen-denominated assets due to divergence in monetary policy.</p> <p><b>Assessment.</b> Vulnerabilities are limited. Inward investment tends to be equity based, and the home bias of Japanese investors is strong. So far, outward spillovers from Japan’s policies to financial conditions in other economies (interest rates, credit growth) are contained.</p>
<b>FX Intervention and Reserves Level</b>	<p><b>Background.</b> Reflecting legacy accumulation, reserves stood at \$1.1 trillion, or about 26 percent of GDP, at the end of 2022. They have remained broadly unchanged in 2023.</p> <p><b>Assessment.</b> The exchange rate is free floating and there have been no FX interventions in 2023. FX interventions should be isolated and limited to addressing disorderly market conditions.</p>
<p><sup>1</sup> IMF staff recommends allowing the estimated credit-to-GDP gap to decline gradually over the medium-term from its currently estimated level of 16.5 percent (14.4 percent net of corporate savings) with a corresponding policy setting (P*) for the credit-to-GDP gap in five years of 7.3 percent of GDP. This is consistent with the reduction envisaged earlier in the 2022/23 External Sector Report.</p>	

## Annex II. Risk Assessment Matrix<sup>1</sup>

Source of Risk	Likelihood	Source	Expected Impact	Main Impacts → Recommended Policy Actions
Intensification of regional conflict(s).	<b>High</b>	External	<b>Medium</b>	Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, FDI and financial flows, and payment systems, and lead to refugee flows. → continue to pursue open market policies and enhance supply chain resilience.
Commodity price volatility	<b>High</b>	External	<b>Medium</b>	A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability. → Allow pass-through of commodity prices while mitigating the impact on the most vulnerable with targeted policies.
Abrupt global slowdown or recession	<b>Medium</b>	External	<b>High</b>	Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs. → Fiscal and monetary easing to support aggregate demand.
Monetary policy miscalibration.	<b>Medium</b>	External	<b>High</b>	Amid high economic uncertainty and financial sector fragility, major central banks pause monetary policy tightening or pivot to loosen policy stance prematurely, de-anchoring inflation expectations, triggering a wage-price spiral and spillovers to financial markets. → BOJ adjusts short-term rate in line with achieving its inflation target.
Systemic financial instability.	<b>Medium</b>	External	<b>Medium</b>	Sharp swings in real interest rates and risk premia, and asset repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing market dislocations and adverse cross-border spillovers → BOJ adjusts macroprudential buffers to reduce stress on domestic banks.
Sovereign debt distress.	<b>Medium</b>	External	<b>Low</b>	Domino effects of higher global interest rates, a growth slowdown in AEs, and/or disorderly debt events in some EMDEs spillover to other highly indebted countries, resulting in capital outflows, an increase in risk premia, and loss of market access. → As a safe-haven currency Yen appreciation may offset recent depreciation, no policy response unless disorderly market conditions merit FX intervention.

<sup>1</sup> 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 ("L" (low) is meant to indicate a probability below 10 percent, "M" (medium) a probability between 10 percent and 30 percent, and "H" (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.

Source of Risk	Likelihood	Source	Expected Impact	Main Impacts → Recommended Policy Actions
Deepening geoeconomic fragmentation.	High	External	High	Broader and deeper conflict(s) and weakened international cooperation result in a more rapid reconfiguration of trade and FDI, supply disruptions, protectionism, technological and payments systems fragmentation, rising input costs, financial instability, a fracturing of international monetary and financial systems, and lower potential growth. → Continue to pursue open market policies and enhance supply chain resilience.
Extreme climate events.	Medium	External	High	Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability. → Strengthen climate adaptation and mitigation efforts and provide relief to affected households.
Cyberthreats	Medium	External	High	Cyberattacks on physical or digital infrastructure (including digital currency and crypto assets ecosystems) or misuse of AI technologies trigger financial and economic instability. → Take pre-emptive measures to prevent cyberattacks and do contingent planning to build resilience if there is an attack.
Social discontent.	Medium	External	Low	High inflation, real income loss, and spillovers from crises in other countries (including migration) worsen inequality, trigger social discontent. → Fiscal policy uses targeted transfer to support low-income households.
Disorderly energy transition.	Medium	External	Medium	A disorderly shift to net-zero emissions (e.g., owing to shortages in critical metals) and climate policy uncertainty cause supply disruptions, stranded assets, market volatility, and subdued investment and growth. → Reduce uncertainty with clear communication, clarify further planned measures on carbon pricing and carbon credits trading, scale up clean energy projects, diversify energy suppliers, and protect the vulnerable population in the transition to a green economy.
Labor shortages constrain activity	Medium	Domestic	Medium	Insufficient immigration and a slowing of the rise in labor force participation leads to persistent labor shortages constraining investment and growth. → Strengthen policies to support female labor force participation, improve visa access for migrant workers.
Bond market stress from a reassessment of sovereign risk	Medium	Domestic	High	An increase in the sovereign risk premium would worsen public debt dynamics and cause distress in the financial sector. → Adopt a credible medium-term fiscal consolidation to put debt on a downward path.

## Annex III. Sovereign Risk and Debt Sustainability Analysis

*Fiscal policy remains accommodative, following the sizeable fiscal response in the last three years to support households through COVID-19 and to spillovers from the war in Ukraine, and the fiscal stimulus announced in November. Nonetheless, the public debt is projected to fall over the medium term due to robust real GDP growth and favorable real interest rates. Over the long term, risks of debt distress are moderate, debt is projected to rise due to pressures from an aging population and a high debt stabilizing primary balance. Gross financing needs are elevated, but the medium-term risks of debt distress are judged to be moderate as rollover risks are mitigated by the large domestic investor base and by the debt profile. A credible medium-term fiscal adjustment containing social security spending and a revenue-enhancing tax reform is warranted to put public debt on a downward path in the long term.*

1. **Background.** With headline inflation reaching levels not seen since 1990, fiscal policy has continued to support households and firms to adjust with new measures announced in November totaling 2.5 percent of GDP. This follows two years of exceptional fiscal support in the wake of COVID-19 and the spillovers from the war in Ukraine. Despite elevated interest rates globally, sovereign borrowing costs remain low underpinned by accommodative monetary policy. By mid-November, the yen had weakened by about 16 percent against the U.S. dollar due to diverging monetary policies between the Bank of Japan and other central banks in advanced economies.
2. **Baseline.** Staff's baseline scenario is based on the budget for FY2023 and the fiscal package adopted in November 2023. Under this baseline, the primary deficit will remain elevated in 2023-4 before the effect of policy support is phased out in 2025. Public debt is projected to rise over the long term mainly driven by age-related spending pressures and by a less favorable interest-growth differential. However, near and medium-term debt dynamics are favorable thanks to strong real GDP growth in 2022-3 and negative real interest rates: gross public debt is projected to fall from 257 percent of GDP in 2022 to 250 percent of GDP in 2032.
3. **Realism.** Historical forecasts point to some pessimism in staff's projections for the primary deficit and public debt. Having said that, the projected debt path is within the normal historical range observed in peer countries. The projected fiscal adjustment appears as an outlier compared with historical and cross-country experience but is realistic given the exceptional circumstances of the last three years.
4. **Risks and mitigating factors.** High and rising debt levels under the baseline erode fiscal buffers and expose Japan to a range of shocks. The debt-to-GDP ratio could jump significantly if growth slumps and could rise gradually (given the debt profile) but persistently if interest rates increase., mitigating factors include: a long average maturity of close to 9 years that significantly limits the pass-through from higher yields to effective interest rates and a large domestic investor base. The projected rise in the effective interest rate on debt is less than half that of the projected increase in the yield on 10-year JGBs over the same horizon. For JGBs, the domestic investor base includes the BoJ (52 percent), banks (13 percent), insurance companies (23 percent), and pension funds (3 percent). Foreigner investors comprise only



6.5 percent of JGB holdings. Near and medium-term risks are moderately improved relative to the 2023 Article IV due to a more favorable balance between real interest rates and growth.

**5. Long-term risks.** Japan's aging population puts significant pressure on GFN and debt levels in the long term, in particular exposure to rising healthcare costs should those rise faster than expected. These risks remain manageable given the horizon at which they are expected to be realized, underscoring the importance of credible medium-term fiscal adjustment to address them. However, these risks highlight the need for structural reforms to contain age related spending as well as policies to boost labor market participation. Longer term risks remain broadly similar to the 2023 Article IV.

Figure 1. Japan: Risk of Sovereign Stress

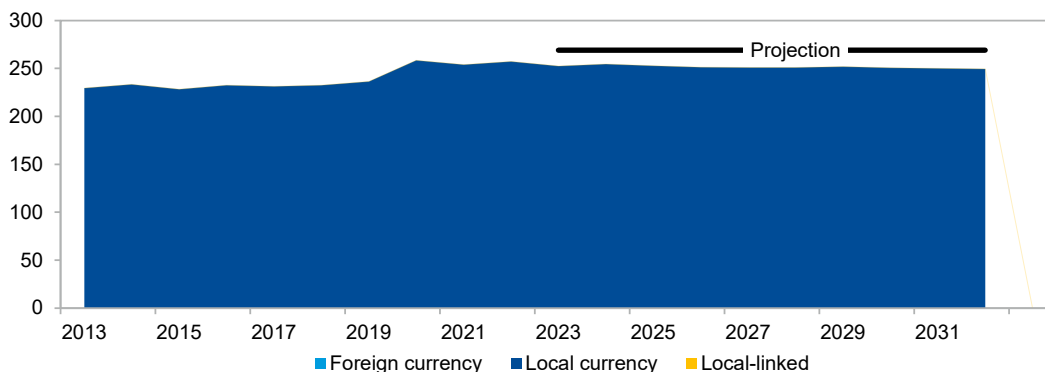
Horizon	Mechanical signal	Final assessment	Comments
<b>Overall</b>	...	<b>Moderate</b>	Staff's assessment of the overall risk of sovereign stress is moderate against mechanical signals of high risk in the medium-term mechanical signals. The overall risk of sovereign stress is moderate, reflecting Japan's domestic investor base, home bias, and public debt with long maturity and denominated in local currency.
<b>Near term 1/</b>	...	...	...
<b>Medium term</b>	<b>High</b>	<b>Moderate</b>	Staff's assessment of medium-term risk of sovereign stress is moderate against a mechanical signal of high. The latter is driven by an elevated debt level at the end of the projection horizon and large average gross financing needs under the baseline. Risks are mitigated by the large domestic investor base and the debt profile.
Fanchart	<b>High</b>	...	
GFN	<b>High</b>	...	
Stress test	FX rate	...	
<b>Long term</b>	...	<b>Moderate</b>	Long-term risks are moderate as aging-related expenditures on health and social security slowly feed into debt dynamics.
<b>Sustainability assessment 2/</b>	Not required for surveillance countries	Not required for surveillance countries	Not required
<b>Debt stabilization in the baseline</b>			No
<b>DSA summary assessment</b>			
<p>Commentary: Japan is at a moderate overall risk of sovereign stress. Under current policies, debt is projected to decrease over the medium due to favourable growth and real interest rate dynamics but increase in the long term driven by a less favourable interest growth-differential and by age-related spending pressures. The primary deficit is projected to remain high in 2023-24, following the November 2023 fiscal package, and decline to its pre-COVID-19 level in 2025 as measures supporting the recovery are phased out. Age-related spending pressures weigh on the primary deficit in the long term. Although sovereign stress risks according to mechanical signals are high, they are mitigated by a large domestic investor base and a favorable debt profile.</p>			
<p>Source: Fund staff.</p> <p>Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.</p> <p>1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.</p> <p>2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.</p>			

Figure 2. Japan: Debt Coverage and Disclosures

										Comments									
1. Debt coverage in the DSA: 1/										CG	GG	NFPS	CPS	Other					
1a. If central government, are non-central government entities insignificant?										n.a.									
2. Subsectors included in the chosen coverage in (1) above:																			
Subsectors captured in the baseline										Inclusion									
CPS	NFPS	GG: expected	CG	1	Budgetary central government	Yes					Not applicable								
				2	Extra budgetary funds (EBFs)	No													
				3	Social security funds (SSFs)	Yes													
				4	State governments	Yes													
				5	Local governments	Yes													
				6	Public nonfinancial corporations	No													
				7	Central bank	No													
				8	Other public financial corporations	No													
3. Instrument coverage:										Currency & deposits	Loans	Debt securities	Oth. acct. payable 2/	IPSGSs 3/					
4. Accounting principles:										Basis of recording		Valuation of debt stock							
										Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/					
5. Debt consolidation across sectors:										Consolidated		Non-consolidated							
Color code: <span style="color: green;">■</span> chosen coverage <span style="color: red;">■</span> Missing from recommended coverage <span style="color: gray;">■</span> Not applicable																			
Reporting on Intra-Government Debt Holdings																			
Issuer										Holder	Budget. central govt	Extra-budget. funds (EBFs)	Social security funds (SSFs)	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS	NFPS	GG: expected	CG	1	Budget. central govt						0								
				2	Extra-budget. funds						0								
				3	Social security funds						0								
				4	State govt.						0								
				5	Local govt.						0								
				6	Nonfin pub. corp.						0								
				7	Central bank						0								
				8	Oth. pub. fin. corp						0								
Total										0	0	0	0	0	0	0	0	0	
1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.																			
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.																			
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.																			
4/ Includes accrual recording, commitment basis, due for payment, etc.																			
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).																			
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.																			
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.																			
Commentary: Debt coverage is general government. While gross debt is the main indicator, net debt is also important in Japan, given the large financial assets held by the government. It should be noted, however, that not all the financial assets are available to meet debt obligations. The holdings include, for example, social security assets for future obligations.																			

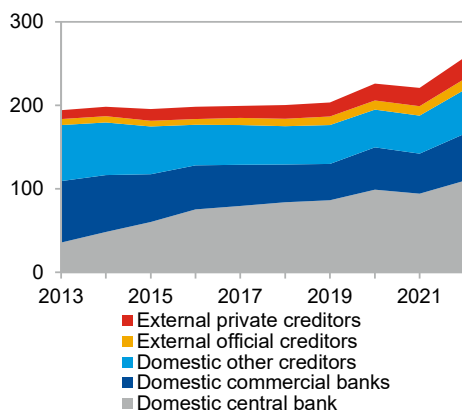
**Figure 3. Japan: Public Debt Structure Indicators**

**Debt by Currency (Percent of GDP)**



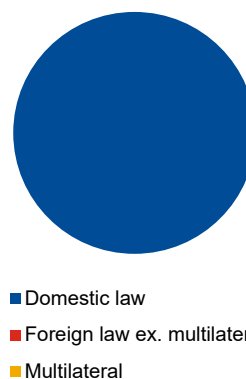
Note: The perimeter shown is consolidated public sector.

**Public Debt by Holder (Percent of GDP)**



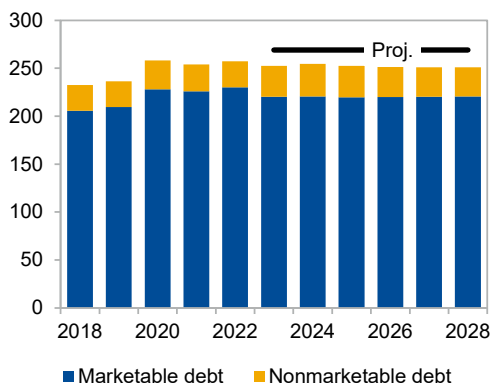
Note: The perimeter shown is general government.

**Public Debt by Governing Law, 2022 (Percent)**



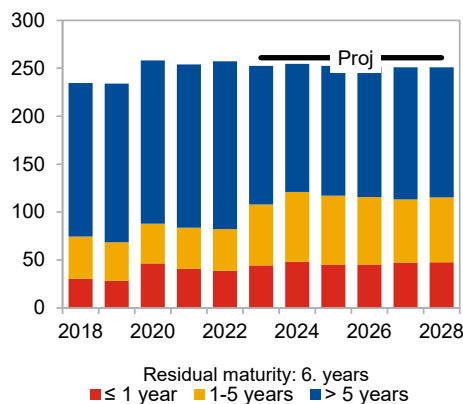
Note: The perimeter shown is general government.

**Debt by Instruments (Percent of GDP)**



Note: The perimeter shown is general government.

**Public Debt by Maturity (Percent of GDP)**



Note: The perimeter shown is general government.

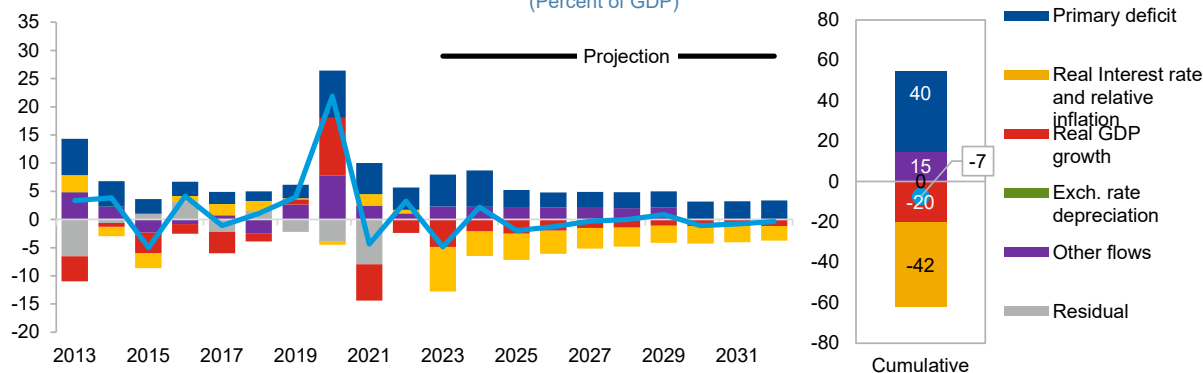
Commentary: Domestic creditors held more than 90 percent of public debt in 2021. The Bank of Japan increased significantly over the last decade from 12 percent in 2012 to 43 percent in 2022. All public debt is governed by domestic law. Debt is mostly long term, with an average residual maturity above 8 years.

**Figure 4. Japan: Baseline Scenario**

(Percent of GDP unless indicated otherwise)

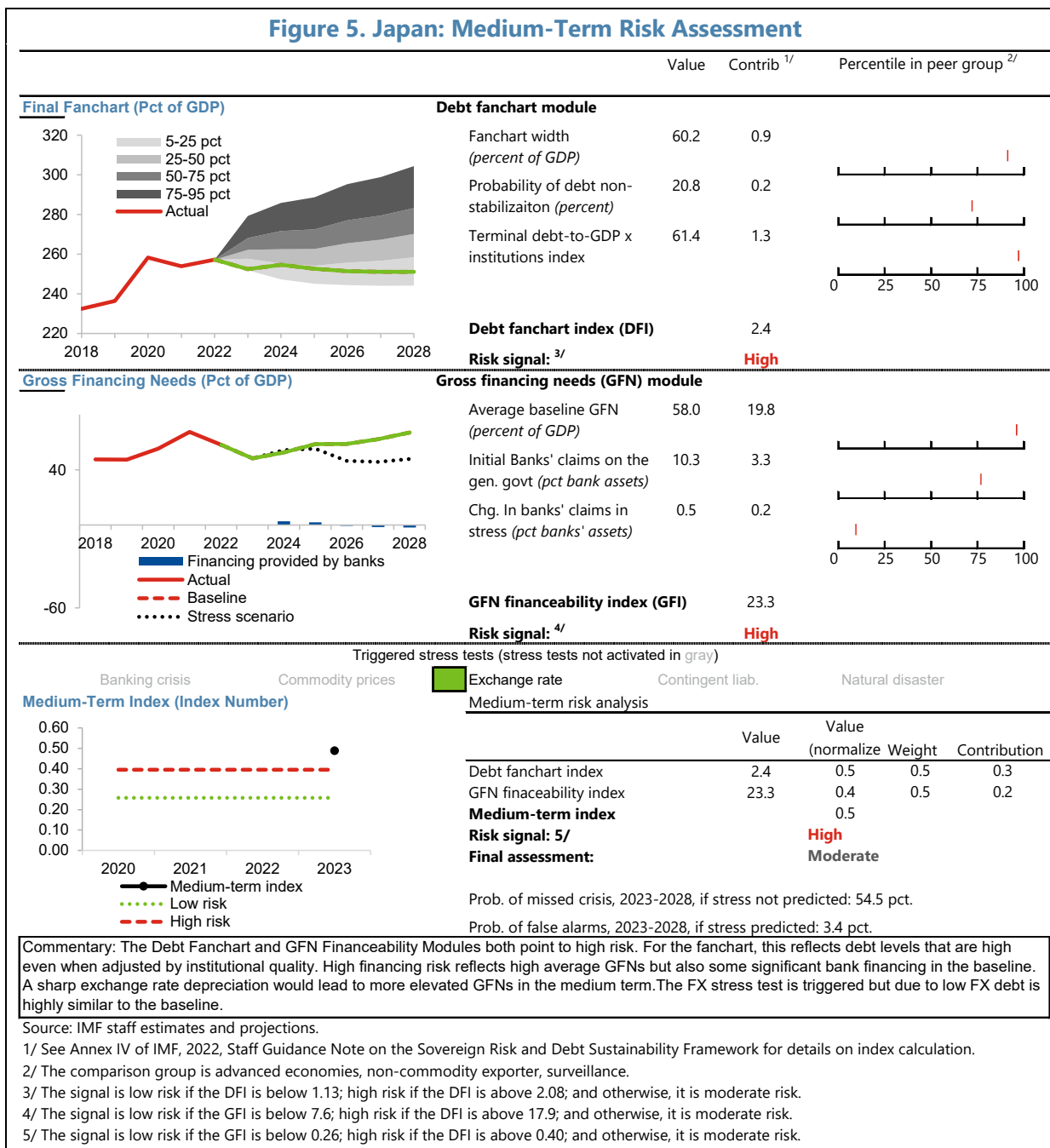
	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	257.2	252.4	254.6	252.6	251.3	251.0	251.0	251.9	250.8	250.0	249.6
Change in public debt	3.3	-4.8	2.2	-1.9	-1.3	-0.3	0.0	0.9	-1.1	-0.8	-0.4
Contribution of identified flows	3.3	-4.8	2.2	-1.9	-1.3	-0.3	0.0	0.9	-1.1	-0.8	-0.4
Primary deficit	3.9	5.6	6.4	3.0	2.7	2.8	2.8	2.9	3.2	3.2	3.4
Noninterest revenues	36.5	35.4	34.7	35.5	35.5	35.5	35.6	35.6	35.6	35.6	35.6
Noninterest expenditures	40.5	41.0	41.1	38.5	38.2	38.3	38.4	38.5	38.8	38.8	39.0
Automatic debt dynamics	-1.7	-12.8	-6.5	-7.2	-6.1	-5.2	-4.8	-4.1	-4.3	-4.1	-3.7
Real interest rate and relative inflation	0.7	-7.9	-4.4	-4.6	-4.1	-3.7	-3.4	-3.0	-3.1	-2.9	-2.6
Real interest rate	0.7	-7.9	-4.4	-4.6	-4.1	-3.7	-3.4	-3.0	-3.1	-2.9	-2.6
Relative inflation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-2.4	-4.9	-2.1	-2.5	-2.0	-1.5	-1.4	-1.1	-1.2	-1.2	-1.2
Real exchange rate	0.0	...	...	...	...	...	...	...	...	...	...
Other identified flows	1.1	2.3	2.3	2.2	2.1	2.1	2.0	2.1	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	0.0
(minus) Interest Revenues	-1.1	-1.1	-1.1	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Other transactions	2.2	3.4	3.3	3.2	3.1	3.0	2.9	3.0	0.9	0.9	0.9
Contribution of residual	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	58.3	48.4	52.7	58.7	58.9	62.3	67.0	67.3	66.6	69.8	71.7
of which: debt service	55.4	43.9	47.3	56.7	57.1	60.5	65.1	65.4	64.3	67.5	69.3
Local currency	55.4	43.9	47.3	56.7	57.1	60.5	65.1	65.4	64.3	67.5	69.3
Foreign currency	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memo:											
Real GDP growth (percent)	1.0	1.9	0.9	1.0	0.8	0.6	0.6	0.4	0.5	0.5	0.5
Inflation (GDP deflator; percent)	0.3	3.8	2.3	2.3	2.1	2.0	2.0	2.0	2.1	2.1	2.1
Nominal GDP growth (percent)	1.3	5.7	3.1	3.4	3.0	2.6	2.6	2.4	2.6	2.6	2.6
Effective interest rate (percent)	0.6	0.5	0.5	0.5	0.5	0.5	0.6	0.7	0.8	0.9	1.1

**Contribution to Change in Public Debt**  
(Percent of GDP)

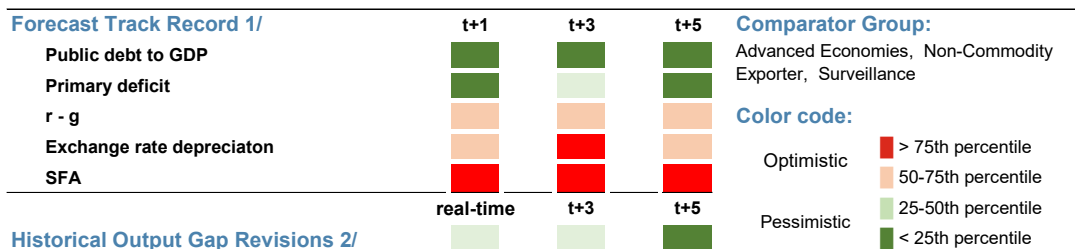


Commentary: Public debt will fall over the medium term following strong growth in 2023 and negative real interest rates but continue to rise after 2028 reflecting a primary deficit that is larger than the debt stabilizing level by 1.4 percentage points on average over the next two decades.

Figure 5. Japan: Medium-Term Risk Assessment



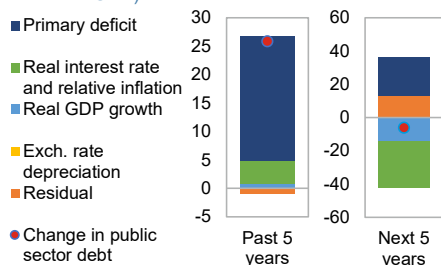
**Figure 6. Japan: Realism of Baseline Assumptions**



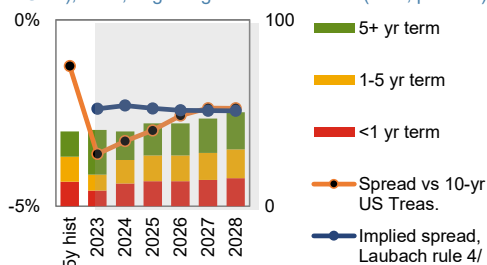
**Historical Output Gap Revisions 2/**

**Public Debt Creating Flows**

(Percent of GDP)

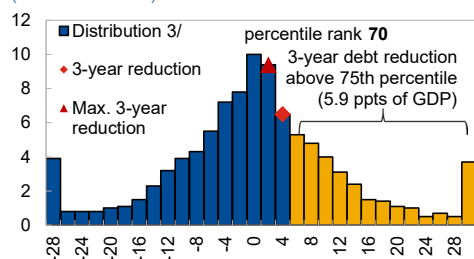


**Bond Issuances** (Bars, Debt Issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))



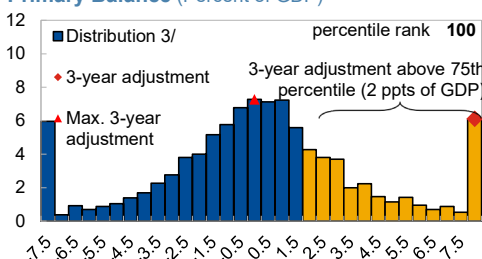
**3-Year Debt Reduction**

(Percent of GDP)



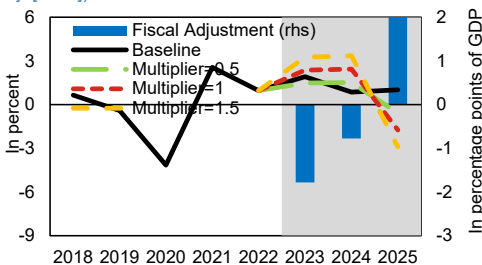
**3-Year Adjustment in Cyclically-Adjusted**

**Primary Balance** (Percent of GDP)



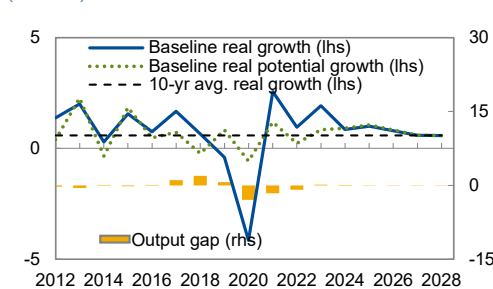
**Fiscal Adjustment and Possible Growth Paths**

(Lines, Real Growth Using Multiplier [LHS]; Bars, Fiscal Adj. [RHS])



**Real GDP Growth**

(Percent)



**Commentary:** The realism analysis shows a large median forecast error for medium-term primary deficit and public debt projections suggesting a pessimistic bias. However, this is explained by the unwinding of exceptional support measures after the pandemic and sharp rise in inflation following the war in Ukraine and global supply chain disruptions.

Source : IMF Staff.

1/ Projections made in the October and April WEO vintage.

2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates)

3/ Data cover annual observations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.



**Figure 7. Japan: Triggered Modules**

Large amortizations

Pensions  
Health

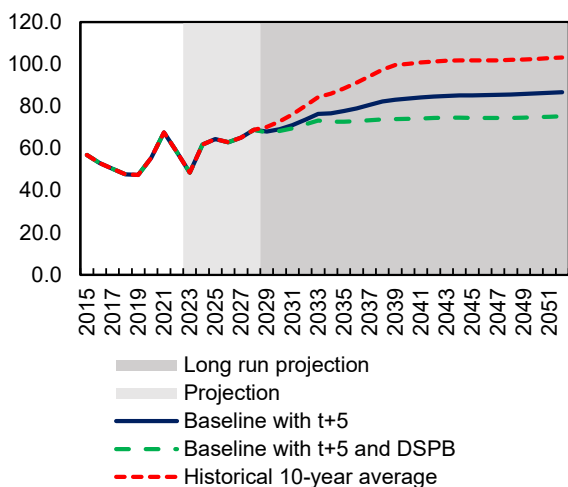
Climate change: Adaptation  
Climate change: Mitigation

Natural Resources

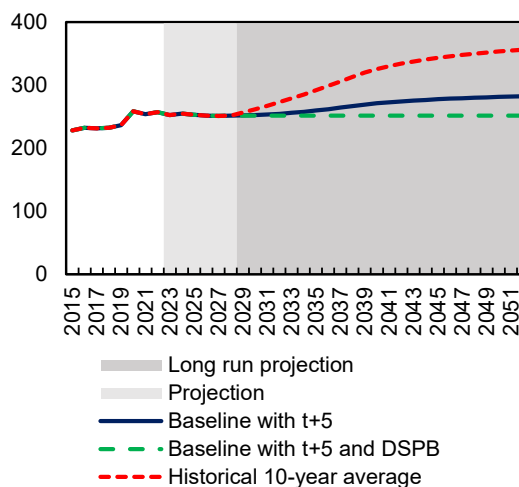
**Long-Term Risk Assessment: Large Amortization**

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio	■
	Amortization-to-GDP ratio	■
	Amortization	■
Medium-term extrapolation with debt stabilizing primary balance	GFN-to-GDP ratio	■
	Amortization-to-GDP ratio	■
	Amortization	■
Historical average assumptions	GFN-to-GDP ratio	■
	Amortization-to-GDP ratio	■
	Amortization	■
Overall Risk Indication		■

**GFN-to-GDP ratio**



**Total Public Debt-to-GDP Ratio**

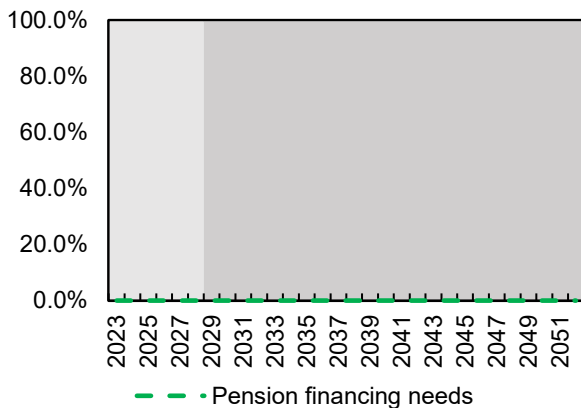


Commentary: Due to the high level of debt to GDP and thus the large levels of amortisation and roll over this entails, longer term risks are significantly affected by large amortisations. This is especially relevant as interest rates on debt rise to levels not seen in the past two decades.

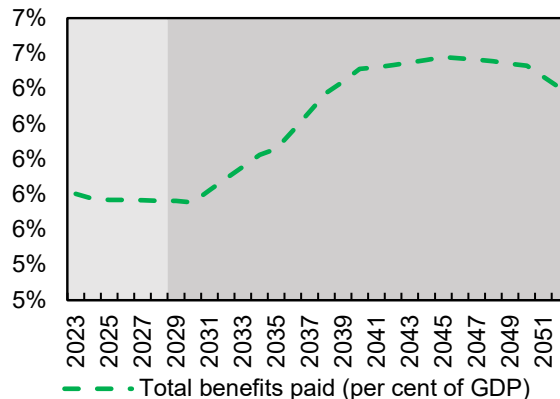
**Figure 8. Japan: Demographics: Pensions**

Permanent adjustment needed in the pension system to keep pension assets positive for:	30 years	50 years	Until 2100
(pp of GDP per year)	0.0%	0.0%	0.0%

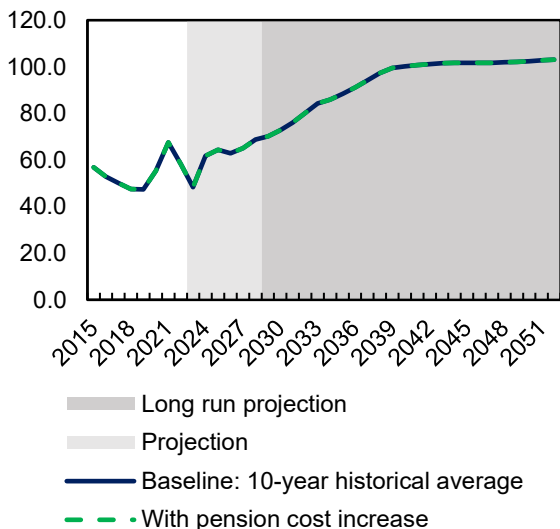
**Pension Financing Needs**



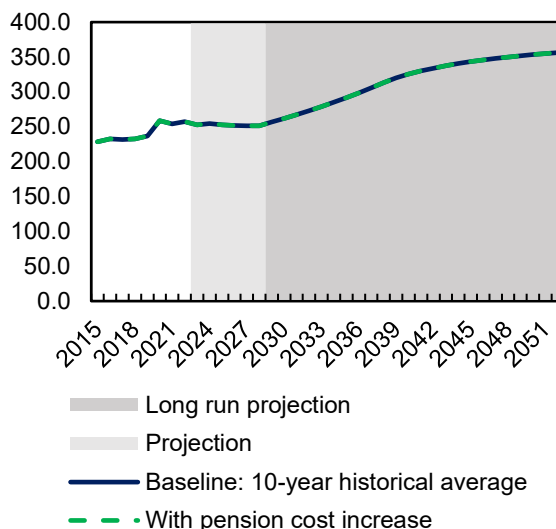
**Total Benefits Paid**



**GFN-to-GDP Ratio**



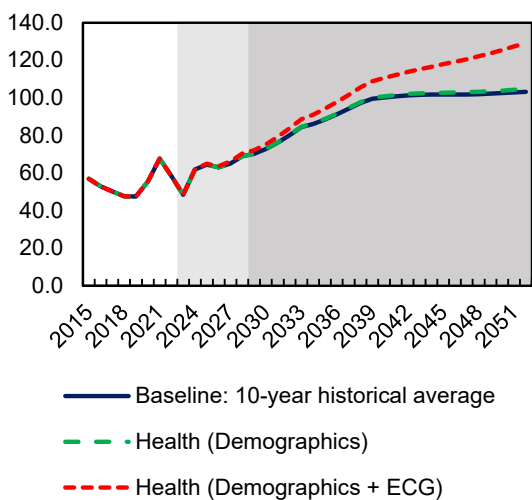
**Total Public Debt-to-GDP Ratio**



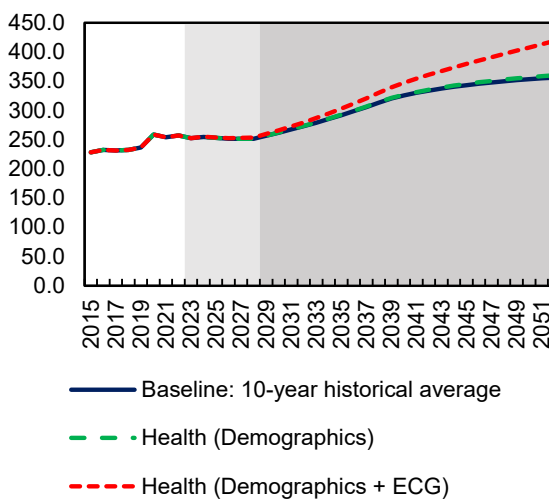
Commentary: Japan faces significant long-term pressures from an aging population however those pressures are greatly reduced ameliorated by significant pension system assets of 38 percent of GDP in 2023 and automatic adjustment of pension benefits following the 2004 pension reforms which ensure that the pension system remains fully funded.

Figure 9. Japan: Demographics: Health

GFN-to-GDP ratio



Total Public Debt-to-GDP Ratio



Commentary: Japan's demographics are set push up already high GFN in the long term, which rising above 100 percent of GDP by 2038. Should additional excess cost growth (ECG) occur at the standard 1.4 percent, GFN would be about 25 pp higher by 2052.

## Annex IV. Distributional Impacts of Climate Mitigation Policy in Japan<sup>1</sup>

**1. The IMF-World Bank Climate Policy Assessment Tool (CPAT) was used to simulate the consumption incidence effects for Japanese households of an economy-wide carbon tax.**<sup>2</sup> The tax is assumed to apply to all greenhouse gas (GHG) emissions<sup>3</sup> and gradually rise (in equal annual increments) starting from 2026 (first rate increase) to reach US\$ 75/ton carbon dioxide equivalent (CO<sub>2</sub>e) in 2030.<sup>4</sup>

**2. Distributional effects are expressed in terms of the variation in household consumption (gain if positive; loss if negative) at different parts of the consumption distribution.** Specifically, the variation in consumption for household consumption deciles  $d = \{1, 2, 3, 4, 5, 6, 7, 8, 9, 10\}$  from changes in end-user prices due to the carbon tax was estimated as:

$$(A) \quad \sum_g \pi_t^{dg} \cdot \rho_t^{dg}$$

where  $g$  stands for the main categories of goods/services consumed by households,  $\pi_t^{dg}$  is the share of decile  $d$ 's total consumption spent on good/service  $g$  at time  $t$  (here, year 2030), and  $\rho_t^{dg}$  is the relative price change for good/service  $g$ . Calculating (A) in terms of each energy (non-energy) product yields an estimate of the loss in household consumption from higher household energy (non-energy) bills or the "direct" ("indirect") household consumption incidence effect.

**3. Household budget shares were calculated using 2017 Japan Household Panel Survey (JHPS/KHPS) microdata.** Price changes for energy products were directly obtained from CPAT (Figure V.1b), while those of other consumer goods/services (due to higher energy input prices) were calculated as the sum-product of: i) each sector's input intensity in each energy product

<sup>1</sup> Prepared by Victor Mylonas (FAD External Expert).

<sup>2</sup> Results are aggregated at the population-weighted per capita consumption decile level. Positive (negative) incidence "effects" represent gains (losses) in percent of total household consumption. All incidence "effects" are scaled by household consumption decile (and consumption item)-specific price elasticities of demand based on [USDA](#) data. This implicitly adjusts the estimated incidence effects for household behavioral responses to higher energy/non-energy prices resulting from the carbon tax (accounting for substitution to/away from given consumption items, but not substitution across specific consumption items). For details on the methodology, see: Black S., Parry, I., Mylonas, V., Vernon, N., & Zhunussova, K. (2023). "[The IMF-World Bank Climate Policy Assessment Tool \(CPAT\): A Model to Help Countries Mitigate Climate Change](#)." IMF Working Papers, 2023/128.

<sup>3</sup> According to CPAT, (energy-related) CO<sub>2</sub> emissions represent approximately 90 percent of Japan's total 2020 GHG emissions (excluding Land Use, Land-Use Change and Forestry (LULUCF) emissions), with F-gases, methane (CH<sub>4</sub>), and nitrogen (N<sub>2</sub>) accounting for the remaining 5, 3, and 2 percent respectively. Energy-related CO<sub>2</sub> emissions are generated from the combustion of coal (47 percent), natural gas (24 percent), diesel (12 percent), gasoline (11 percent), kerosene (3 percent), liquefied petroleum gas/LPG (2 percent), and jet fuel (1 percent). The largest CO<sub>2</sub>-emitting sector is power generation (43 percent), followed by transport (19 percent), industry (14.5 percent), buildings (12 percent), and non-power transformation (11.5 percent).

<sup>4</sup> This is the global average rate that is approximately in line with meeting the objectives of the Paris Agreement (Black et. al., 2021) and a benchmark for high-income countries (Chateau et. al., 2022). All estimates are presented relative to a Business-As-Usual (BAU) scenario (assuming the absence of new, or ramp-up of existing, climate mitigation policies).

(sourced from the Global Trade Analysis Project ([GTAP](#)) database); and ii) the price increase of the respective energy product (assuming full passthrough from firms to households<sup>5</sup>).

**4. In 2030, the modeled carbon tax is expected to reduce GHG emissions by 17.6 percent relative to BAU.** This amounts to 81 percent of Japan’s Nationally Determined Contribution (NDC) requirement (Figure V.1a). Abatement consistent with fully meeting the NDC would likely require complementary policies. The simulated carbon tax would raise substantial revenues of around 1 percent of GDP, which could, in turn, help enhance fiscal space in Japan. Without use (“recycling”) of any of these revenues for compensation, Japanese households are, on average, expected to lose around over 2 percent of their total consumption (Figure V.1c). Most of these consumption losses are attributed to higher electricity bills<sup>6</sup> (“direct effect”) as opposed to higher bills for other energy-intensive (non-fuel) goods and services such as food, clothing, etc. (“indirect effect”). This holds roughly across all deciles.

**5. The carbon tax is only moderately regressive (Figure V.1c).** More precisely, mean losses for deciles 2 and 3 are roughly 20 percent higher than those of deciles 8 and 9. This could be due to the relatively large share of direct energy (particularly electricity and natural gas) consumption in poorer households’ overall budgets. This result underscores issues related to compensation mechanisms that may potentially be extended to boost the redistributive capacity of and ensure some buy-in for the carbon tax (or other, similar policies).

**6. Compensating households by using (“recycling”) a portion of the revenues raised via the carbon tax could substantially offset their initial consumption losses (Figure V.1d).** Assuming half of the modeled carbon tax revenues (around 0.5 percent of GDP) are recycled into new, targeted cash transfers to the bottom 20 percent of the consumption distribution (with the rest being allocated to, e.g., the general budget)<sup>7</sup> could result in substantial gains for this part of the population. More precisely, deciles 1-2 could enjoy net increases in consumption of over 15 percent, on average. In simulating these (new) targeted cash transfers, the available revenues were used as a proxy for the gross (monetary) household gain from revenue recycling. Specifically, recycled revenues were divided by the population of the targeted deciles (i.e., deciles 1-2, assuming no

<sup>5</sup> Or flat supply curves at the domestic level. Although this assumption would generally be a reasonable approximation for the estimation of (first order) household consumption incidence effects, some of the carbon tax incidence may be passed back to firms in the form of lower producer prices (assuming upward-sloping supply curves), particularly in energy intensive trade exposed (EITE) industries. To the extent that imperfect carbon tax incidence passthrough impacts industry profits, some of the incidence could be borne by capital owners (via lower returns to capital) or labor (via lower wages). The estimation of these incidence effects is, hence, relatively more complicated (Fullerton and Heutel, 2011) and outside the scope of this Annex.

<sup>6</sup> This pattern is largely driven by the high household budget share for electricity (e.g., due to substantial heat pump purchases) of around 5.5 percent of total household consumption, on average across all deciles.

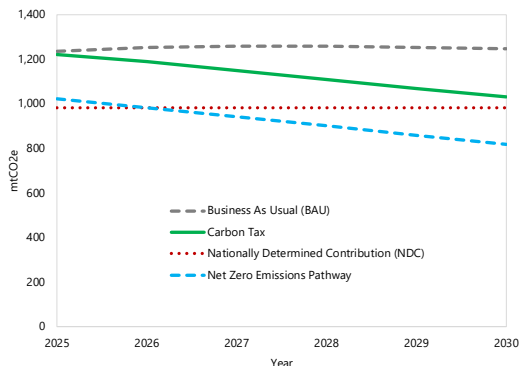
<sup>7</sup> This modeling scenario was chosen to provide illustrative evidence of the impacts of carbon tax revenue recycling for the purposes of this Annex. In practice, the case for overcompensating low-income households through carbon tax revenue recycling would have to be well substantiated, since it may come at an opportunity cost in terms of diverting revenues from potentially more productive purposes (e.g., cutting distortionary taxes). Additionally, if there is a strong case for redistribution in Japan, it would possibly be more efficient to achieve this through adjustments to the entire tax-benefit system rather than through climate mitigation policy per se.

leakage or under-coverage) and, subsequently, expressed in percent of decile-specific household per-capita consumption.

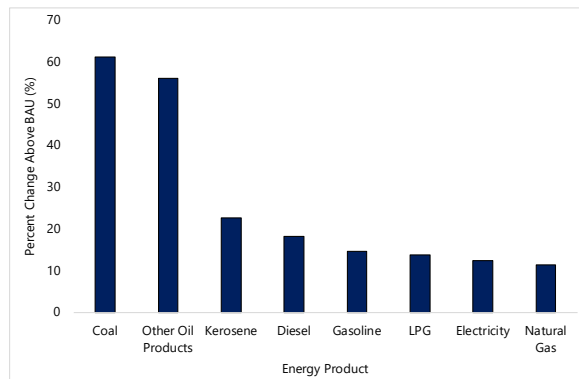
**7. Recycling carbon tax revenues into the modeled targeted cash transfers could help reduce consumption inequality.** The redistributive nature of the aforementioned transfers is reflected in a decrease in the household consumption-based Gini coefficient of approximately 3 percent (Figure V.1e), which is consistent with the findings under Figure V.1c that shows relative (net) gains for the bottom 2 (and losses for the top 8) deciles. In addition to reducing consumption inequality, the revenues recycled would more than offset the initially negative impact of the carbon tax on real GDP growth, hence attenuating potential equity-efficiency tradeoffs that may arise from proceeding with climate mitigation via carbon pricing (Figure V.1f).

### Figure V.1. Japan: Incidence Effects of a Simulated Carbon Tax (for Real 2021 US\$ 75 Carbon Tax/Ton CO<sub>2</sub>e on GHG Emissions in Year 2030)

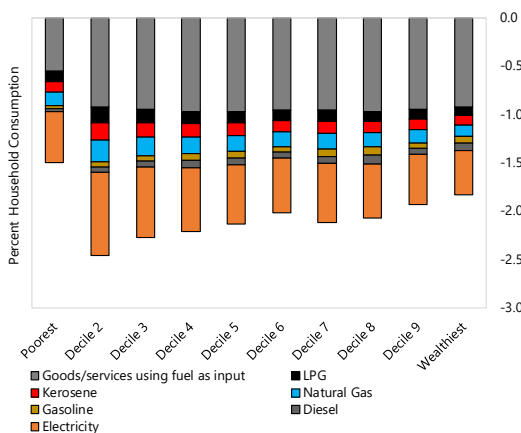
**Figure V.1a. Emissions Pathways by Scenario, 2025-2030**  
(Metric Tons of Carbon Dioxide Equivalent, mtCO<sub>2</sub>e)



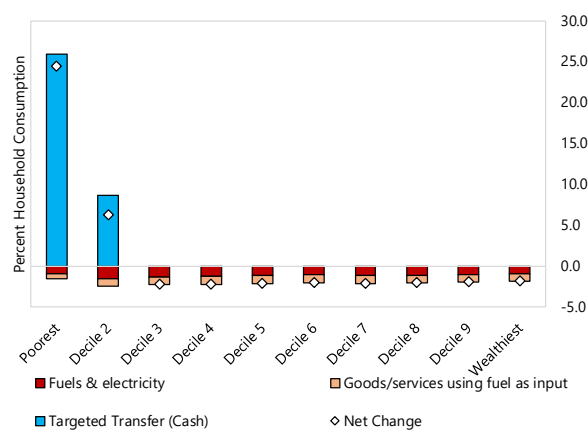
**Figure V.1b. Household Energy Price Impacts by Product**  
(% Change Relative To BAU)



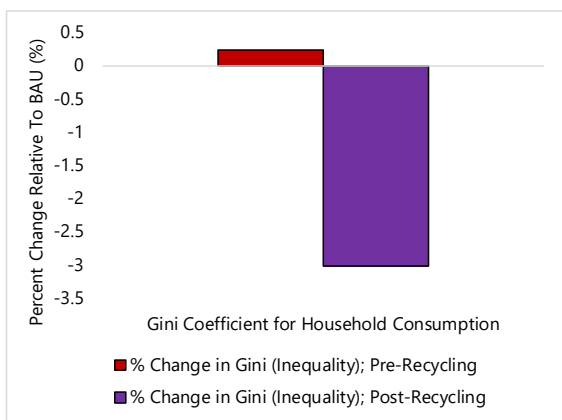
**Figure V.1c. Direct vs. Indirect Effect**  
(% Household Consumption, Pre-Revenue Recycling)



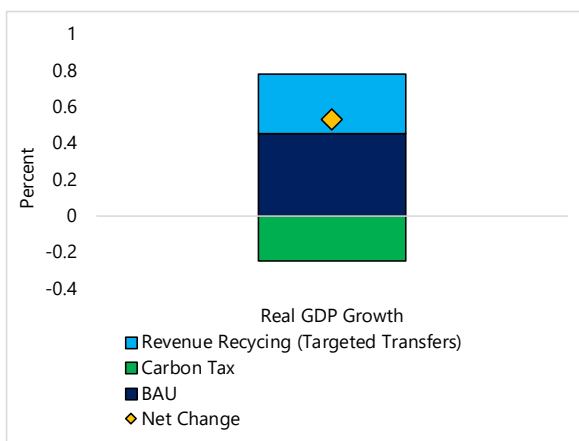
**Figure V.1d. (Net Change in) Direct vs. Indirect Effect**  
(% Household Consumption, Post-Revenue Recycling)



**Figure V.1e. Impact on Inequality (Consumption Gini)**  
(% Change, Pre- Vs. Post-Revenue Recycling)



**Figure V.1f. Impact on Real GDP Growth**  
(%, Post-Revenue Recycling)





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Schoder, C. (2023). "Regime-Dependent Environmental Tax Multipliers: Evidence from 75 Countries." *Journal of Environmental Economics and Policy*, 12(2), 124-167.

## Annex V. Supply-Side of Corruption<sup>1</sup>

**1. In Japan's Phase 4 evaluation, the OECD noted that Japan had made certain progress to improve its framework for detecting and investigating foreign bribery.** Efforts include the measures to engage with the private sector by the Ministry of Economy, Trade and Industry (METI) to raise awareness of foreign bribery offence, amend laws to allow the confiscation of the proceeds of foreign bribery and criminalize the laundering of such proceeds (2017), introduce the Agreement Procedure (2018) to improve Japan's ability to investigate and resolve cases of designated offenses including foreign bribery, and debar companies engaged in foreign bribery by Japan's agency for official development assistance. The authorities also reported that the Consumer Affairs Agency (CAA) revised the Whistleblower Protection Act in 2020, which became effective in June 2022, and adopted guidelines based on the Act to request enterprises to establish a whistleblowing system to properly handle internal reports from employees. Pursuant to the revised Act, the CAA can take actions against a non-compliant enterprise, such as giving guidance or requiring reports on its compliance status. In addition, the scope of whistleblowers that are eligible for protection under the Act was expanded to include officers and former workers who were employed within one year prior to the date of the whistleblowing report. In 2021, the Supreme Public Prosecutors Office issued guidance to address enforcement of foreign bribery, though its impact and application remain to be evaluated. The authorities further reported that Japan amended the Unfair Competition Prevention Act (UCA) in June 2023 to address the priority recommendations of the OECD Phase 4 evaluation. The amendments to the UCA include increasing the statutory maximum fines for natural and legal persons convicted of foreign bribery to the highest level in Japan's legislation, extending the statute of limitations to the longest level compared to other similar offences, and ensuring that Japan can assert jurisdiction over a corporation having its principal office in Japan even when the offence is committed abroad without regard to the nationality of the employee who commits the offence.

**2. Japan should take additional steps to fight foreign bribery, taking into account the size and export-oriented nature of its economy and the high-risk regions and sectors in which its companies operate.** While acknowledging some positive steps, the OECD Working Group on Bribery in International Business Transactions (WGB) is concerned that Japan has not fully implemented the majority of its Phase 4 recommendations. With regard to the low level of investigations and convictions, it is recommended that Japan, among others, urgently take measures to achieve stronger enforcement of its anti-bribery legislation, strengthen international cooperation, ensure sufficient resources and specialization to investigate and prosecute foreign bribery cases, enhance incentives for self-reporting and the use of coercive investigative measures, pro-actively investigate foreign bribery cases and improve evidence gathering, and reduce undue executive influence. The authorities are encouraged to take additional measures to address these issues and other OECD WGB Phase 4 recommendations, including on refining the Agreement Procedure, increasing enforcement against legal persons, raising judicial awareness, adopting tax measures to improve detection and the effectiveness of sanctions, and addressing corruption risks in official development assistance.

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<sup>1</sup> Information relating to supply-side corruption in this annex draws on the WGB's Phase 4 Report of Japan (June 2019) and the two-year follow-up report (October 2021). The IMF staff and Japan have provided additional views and information whose accuracy have not been verified by the WGB or the OECD Secretariat, and which do not prejudice the WGB's monitoring of the implementation of the OECD Anti-Bribery Convention.



# JAPAN

April 15, 2024

## STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department (In consultation with other departments)

### CONTENTS

FUND RELATIONS	2
STATISTICAL ISSUES	4

## FUND RELATIONS

(As of February 29, 2024)

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

### General Resources Account:

	SDR Million	Percent Quota
Quota	30,820.50	100.00
IMF's Holdings of Currency (Holdings Rate)	22,747.81	73.81
Reserve Tranche Position	8,089.59	26.25
Lending to the Fund		
New Arrangements to Borrow	320.78	

### SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	41,825.03	100.00
Holdings	42,568.43	101.78

**Outstanding Purchases and Loans:** None

### Latest Financial Arrangements:

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

### Overdue Obligations and Projected Payments to Fund <sup>1</sup>

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

	Forthcoming				
	2023	2024	2025	2026	2027
Principal					
<b>Charges/Interest</b>	<b>0.53</b>	<b>0.53</b>	<b>0.53</b>	<b>0.53</b>	<b>0.53</b>
<b>Total</b>	<b>0.53</b>	<b>0.53</b>	<b>0.53</b>	<b>0.53</b>	<b>0.53</b>

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

**Exchange Arrangements:**

Japan's exchange rate arrangement is a free-floating. Since October 2022, Japan has not conducted foreign exchange intervention. The Ministry of Finance publishes foreign exchange intervention information on its website. Japan has accepted the obligations under Article VIII, Sections 2(a), 3 and 4, and maintains an exchange system that is free of multiple currency practices and of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions imposed solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144–(52/51).

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

Japan underwent an assessment of its AML/CFT framework against the AML/CFT standard by the Financial Action Task Force (FATF) and the Asia/Pacific Group (APG) in 2021. The assessment found significant improvements since the 2008 evaluation, including amendments to the AML/CFT legislative framework which introduced the obligation to identify and verify beneficial ownership information of legal persons, the extension of the scope of customer due diligence (CDD) measures, including with regards to politically exposed persons (PEPs), and the adoption of enforceable guidelines for financial institutions (FIs) by financial supervisors. Nevertheless, significant deficiencies were identified, including technical gaps affecting the reporting of suspicious transactions by Designated Non-Financial Businesses and Professions (DNFBPs), the dissuasiveness of sanctions for ML offenses, and the implementation of UN-imposed targeted financial sanctions. Japan's AML/CFT regime was found to be only moderately effective in eight of the 11 areas reviewed, including ML investigation and prosecution, confiscation of proceeds of crime, AML/CFT supervision of FIs and DNFBPs, and transparency of legal persons. Two follow-up reports published by the FATF in 2022 and 2023 noted that the country had taken several actions to strengthen its AML/CFT framework further and revised upward the ratings on six recommendations. Japan will continue to be monitored by the FATF on its progress under the enhanced follow-up framework, with the expectation that most, if not all, technical deficiencies will be addressed by end-2024.

**Article IV Consultation:**

The 2023 Article IV consultation discussions were held between January 11 and 26, 2023; the Executive Board discussed the Staff Report (IMF Country Report No. 23/127) and concluded the consultation on March 30, 2023. The concluding statement, staff report, selected issues paper, and press release were all published.

**FSAP:**

A mandatory financial stability assessment was conducted in time for the 2024 Article IV consultation, pursuant to Decision No. 14736-(10/92), 15495-(13/111), 16849-(20/77). The Financial System Stability Assessment (FSSA) report for the 2024 assessment has been published and is available on the IMF website.

**Technical Assistance:** None

**Resident Representatives:** None

## STATISTICAL ISSUES

### I. Assessment of Data Adequacy for Surveillance

**General:** Japan's economic and financial sector databases are generally comprehensive and high quality. Data provision is adequate for surveillance.

**National Accounts:** The Cabinet Office (CAO) of Japan compiles and publishes national accounts statistics. The actual compilation is conducted by the Department of National Accounts (DNA) at the Economic and Social Research Institute (ESRI), an affiliated institution in the organization chart of the CAO. The data are compiled in accordance with the System of National Accounts 2008. Since 2016, Japan has followed the 2008 SNA as a general framework for compiling the national accounts statistics. The deviations from 2008 SNA are limited and described in detail in an appendix to *the Compiling Standard of SNA in Japan*. The latest benchmarks and input-output tables were compiled for the year 2015 and were scheduled to be updated on a quinquennially basis.

**Price Statistics:** The data for the Consumer Price Index (CPI) is compiled by the Consumer Statistics Division of the Statistics Bureau of Japan in accordance with the Consumer Price Index Manual. The Producer Price Index (PPI) data is assembled by the Price Statistics Division of the Bank of Japan (BOJ) in accordance with the Producer Price Index Manual.

**Government Finance Statistics:** The data for general government operations is compiled by the ESRI of the CAO, following the 2008 SNA. The data for the general government gross debt is compiled by the ESRI of the CAO, in close collaboration with the BOJ, following the Government Finance Statistics Manual (GFSM) 2014 and the 2008 SNA. Japan started reporting quarterly General Government Gross Debt data in April 2018. It also started disseminating quarterly General Government Operations in line with SDDS Plus requirements in 2021.

**Monetary and Financial Statistics:** Japan reports monetary and financial statistics (MFS) to the IMF's Statistics Department for dissemination on a regular basis based on the standardized report form (SRF) for the central bank, other depository corporations (ODCs), and the other financial corporations (OFCs) with sufficient granularity. The compilation methodologies are broadly in line with the Monetary and Financial Statistics Manual and Compilation Guide (MFSMCG). Japan reports data on some key series of the Financial Access Survey (FAS), including series on SMEs and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

**Financial Soundness Indicators:** Japan disseminates data on financial soundness indicators (FSIs) quarterly in line with the SDDS Plus standard. Semi-annual submission to IMF includes 12 core indicators and 6 additional indicators for deposit takers as well as additional FSI for the real estate sector.

**External Sector Statistics:** Japan's Ministry of Finance (MOF) and the Bank of Japan (BOJ) compile the balance of payments (BOP), merchandise trade, international investment position (IIP), external debt statistics, and the template for international reserves and foreign currency liquidity. They also participate in the IMF's Coordinated Direct Investment Survey (CDIS), Coordinated Portfolio Investment Survey (CPIS) providing core and some encouraged items. These datasets are based on the latest statistical standard (BPM6) and consistent with each other.

**II. Data Standards and Quality**

Since April 18, 2016, Japan has adhered to the IMF's Special Data Dissemination Standard (SDDS) Plus and it meets the SDDS Plus specifications for the coverage, periodicity, and timeliness of data. Japan is also progressing in the implementation of the G-20 Data Gaps Initiative (DGI-3) recommendations.

The last mission on the Observance of Standards and Codes (data ROSC) took place in 2005 with a report published in March 2006 (available at <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Japan-Report-on-the-Observance-of-Standards-and-Codes-ROSC-Data-Module-19054>).

**Table 1. Japan: Table of Common Indicators Required for Surveillance**  
(As of March 29, 2024)

	Date of latest observation	Date received	Frequency of data 6/	Frequency of reporting 6/	Frequency of publication 6/
National Accounts	2023Q4	Mar. 11, 2024	Q	Q	Q
Consumer Price Index	Feb. 2024	Mar. 22, 2024	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Feb. 2024	Mar. 6, 2024	M	M	M
Reserve/Base Money 1/	Feb. 2024	Mar. 3, 2024	M	M	M
Broad Money 1/	Feb. 2024	Mar. 3, 2024	M	M	M
Central Bank Balance Sheet	Feb. 2024	Mar. 4, 2024	M	M	M
Consolidated Balance Sheet of the Banking System	Jan. 2024	Mar. 3, 2024	M	M	M
Interest Rates 2/	Mar. 29, 2024	Mar. 29, 2024	D	D	D
Exchange Rates	Mar. 29, 2024	Mar. 29, 2024	D	D	D
Revenue, Expenditure, Balance and Composition of Financing 3/ – General Government 4/	2023Q1	Jan. 24, 2024	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/ – Central Government	2023Q4	Mar. 22, 2024	Q	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt 5/	2023Q4	Feb. 9, 2024	Q	Q	Q
External Current Account Balance	Jan. 2024	Mar. 8, 2024	M	M	M
International Investment Position	2023Q4	Mar. 8, 2024	Q	Q	Q
Exports and Imports of Goods and Services	Jan. 2024	Feb. 28, 2024	M	M	M
Gross External Debt	2023Q4	Mar. 7, 2024	Q	Q	Q
<p>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).</p>					



**Statement by Jun Mizuguchi, Executive Director for Japan,  
Shuntaro Hara, Alternate Executive Director, and Motofumi Umemura, Senior Advisor to  
the Executive Director, Keigo Ando, Advisor to the Executive Director, and Yui Matsui,  
Advisor to the Executive Director  
May 6, 2024**

On behalf of Japan's authorities, we welcome the productive policy discussions held from January to February and in mid-March 2024, and thank staff for their valuable policy advice in their reports. We broadly share the staff's views on Japan's economy, albeit with some reservations. On the staff analysis and recommendations, we would like to emphasize the following specific points.

### **Recent Economic Developments and Outlook**

**Japan's economy is recovering at a moderate pace, although the recovery recently appears to be pausing.** Despite an improvement in consumer confidence, pick-up in private consumption appears to be pausing, amid weak automobile sales due to production suspension in some companies. Business investment continues to strengthen, while export growth appears to be on halt. Consumer prices have been rising moderately, as the employment situation improves.

**According to the "Outlook for Economic Activity and Prices" published by the Bank of Japan (BOJ) in April 2024, Japan's economy is expected to continue growing at a pace above its potential growth rate.** However, its growth projection for FY 2024 is lower than that projected by staff, due in part to base effects. Private consumption is projected to increase moderately, reflecting the rise in wage growth and improvement in consumer sentiment. The preliminary wage settlements from the annual spring wage negotiations registered a notable 5.2 percent increase in nominal terms, the highest in three decades. On consumer prices, the BOJ projects core inflation to be in the range of 2.5 to 3.0 percent (y/y) in FY 2024, gradually falling to around 2 percent in FY 2025 and 2026 (y/y). Underlying inflation, which is still somewhat below 2 percent, is expected to increase gradually on the back of an improving output gap and rising medium- to long-term inflation expectations as a virtuous cycle between wages and prices is expected to intensify.

**On risks to growth, as staff highlights in the report, external and domestic risks remain.** There are uncertainties around how the risk of prolonged tight monetary policy on the back of global inflationary pressure as well as deepening geopolitical tensions could play out and affect Japan's economy and prices. On the domestic side, firms' wage- and price-setting behavior, which could exert either upward or downward pressure on prices, is highly uncertain.

### **Fiscal Policy**

**The government aims to achieve sustainable growth led by private demand as well as the virtuous cycle of growth and distribution.** To achieve this goal, the government formulated the FY 2023 Comprehensive Economic Measures and the FY 2024 budget that address Japan's

domestic and external challenges. They include key policy measures, which are critical to ensure sustainable growth amid various economic challenges. The FY 2023 supplementary budget to implement the Economic Measures prioritized measures to mitigate negative impacts from high prices, including temporary energy subsidies, and to achieve sustainable and structural wage increases, such as the facilitation of wage increases by small and medium-sized enterprises. Supplementary budgets, including in FY 2023, have been formulated only in the case that immediate needs exist. The FY 2024 budget reinforced efforts to achieve wage increases that surpass the price hike, and to increase children-related and defense spending. The government has also been working to secure stable revenue sources to advance its policy priorities, including children-related policies and defense buildups, following its existing plan. Additionally, it plans to promote GX investment, for which spending will be financed through carbon pricing. One-time income and local residential tax cuts will be put in place in June 2024. These tax cuts play a crucial role in easing the burden on households amid higher prices and contributing to changing the public “deflationary mindset.” On fuel subsidies, they remain temporary measure to address the non-negligible impacts of high prices on the economy, and the government is considering their exit strategies. Electricity and gas subsidies were reduced in early May and will expire at the end of May. With regard to state funds, to secure transparency and verify their performance, the government reviewed all state funds and set a termination point and a quantitative goal, where appropriate, in April 2024.

**With the general government debt-to-GDP ratio projected to reach 252.4 percent in 2023, Japan is in a difficult fiscal environment, and we agree with staff that further fiscal consolidation efforts are warranted.** To this end, the government will continue to work to normalize the budget spending structure from the expansionary fiscal stance during the pandemic, ensure that temporary spending does not continue beyond what is necessary, and further rationalize spending. The government remains committed to achieving the fiscal target of a primary surplus of the central and local governments in FY 2025. On medium-term economic and fiscal policy framework, the government reviewed the progress of the integrated policy and fiscal reforms in March 2024.

### **Monetary Policy**

**The BOJ normalized its monetary policy framework.** In the March monetary policy meeting, taking into consideration of the improving inflation outlook, the BOJ opted to discontinue its large-scale monetary easing measures, including the negative interest rate policy and the yield curve control. Instead, the BOJ introduced a new framework, guiding the short-term interest rate as a prime policy tool with the policy target continuing to be the attainment of 2 percent inflation in a sustainable manner. For the time being, the BOJ continues its purchases of Japanese government

bonds (JGBs) with broadly the same amount as before, and remains prepared to respond swiftly to any rapid increase in long-term interest rates by increasing its purchases of JGBs.

**Towards the March monetary policy meeting, the BOJ's external communication was carefully crafted to ensure the external stakeholders that the change in policy framework is not in any way a discontinuation of its accommodative monetary policy stance.** The BOJ will continue to place the utmost importance on clear and effective communication with market participants to ensure that its approach is widely and properly understood.

**The BOJ will continue to conduct data-driven monetary policy, supplemented by anecdotal information,** to cautiously assess the effects of recent policy changes on the economy and inflation. It will take a closer look at the trends in wages, and subsequent sales prices and service prices, not only among large enterprises but also among small and medium enterprises, which are key to maintaining the virtuous circle between wages and prices. The BOJ will consider further adjustments as deemed appropriate. As for JGB purchases, the BOJ will begin to reduce at an unspecified time in the future, although the extent of the reduction remains undetermined. It will also take time to consider what to do with the ETFs it holds.

## **Financial Sector**

**We welcome staff's view under this year's FSAP that Japan's financial system has remained resilient to a series of recent shocks.** The analyses by the government and the BOJ also suggest that Japan's financial system has sufficient buffers to withstand stress. We welcome staff's assessment that highlights progress on financial regulation and supervision, expansion of crisis preparedness, resilience of the ELA framework, and enhanced interagency coordination. We thank staff for their valuable suggestions to strengthen our financial stability and regulatory frameworks, given the evolving nature of the vulnerabilities and risks in the financial system. We also broadly agree on the sources of vulnerabilities underlying the financial system, albeit with nuanced views on some of them, including from real estate markets. Taking into account the staff's recommendations, the government and the BOJ will continue to strengthen their efforts to ensure the resilience of Japan's financial system.

## **External Sector**

**The yen depreciation has been rapid and one-sided since the beginning of 2024, among other factors, with speculative trading behind such moves. The government is paying close attention to these developments with serious concern.** The government remains committed to a flexible exchange rate regime while reiterating that excess volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability. Should a market

turn disorderly, the government would take appropriate actions in line with the international agreements including in G20, G7 and the IMFC.

### **Alternative Scenario**

**Japan has maintained market confidence in fiscal sustainability for a long time, even during the period of global crises, including the pandemic.** We welcome staff’s analysis that points out the potential risk of a crisis caused by deterioration in market confidence, and broadly agree that strong fiscal discipline and near-term fiscal consolidation efforts would be warranted. That said, we note that the probability that the assumptions actually materialize appears very low, and their propagation channels under the risk scenario are uncertain.

### **Growth Strategy and Structural Reforms**

**In June 2023, the government revised its strategy, the “Grand Design and Action Plan for a New Form of Capitalism,” to accelerate efforts to solve social challenges and achieve economic growth through public and private cooperation.** The strategy aims to address structural challenges facing Japan, including through promoting wage increases by boosting investment in human capital, implementing labor market reforms, increasing investment in GX and DX, and improving the business environment for start-ups.

**The government is strongly committed to promoting a significant change in the current trend of a declining birthrate as well as female leadership.** In line with the “Future Strategy for Children” formulated in December 2023, the government is working to strengthen economic support for households with children and to promote wage increases among the young. It also advocates co-parenting and addresses dualism in labor market, including by facilitation of parental leave. The promotion of co-parenting, together with other measures to narrow the gender wage gap and support women’s active participation in the labor market, could also improve women’s representation in senior leadership.

**Reducing inequality is an important priority for the government, and it will continue to implement a wide range of labor market reforms, including by raising the minimum wage, addressing the wage gap between regular and non-regular workers, and increasing support for improving workers’ qualification through re-skilling.** In order to make the analysis more comprehensive, we urge the Fund to work on a more detailed analysis of the impact of capital gains on inequality in Japan to capture the full picture and provide useful policy advice.

**On climate, green transition efforts have been steadily advancing to achieve the goal of reducing greenhouse gas emissions by 46% before 2030 and achieving net-zero by 2050.** The government is advancing decarbonization initiatives for GX, including promoting energy efficiency improvement and making renewable energy the main source of electricity, based on the

premise of ensuring a stable energy supply. In addition, Japan Climate Transition Bonds have been issued in 2024 to strengthen support for GX investments. Carbon pricing will be introduced with a necessary transition period, taking into account the impact of its implementation on the economy.

**Increasing investment in DX and promoting start-up support are key to enhance growth potential.** The government is working to facilitate an environment that supports DX investment in various sectors, including small and medium-sized enterprises, medical care, and the public sector. As for start-ups, based on the “Startup Development Five-Year Plan” developed in November 2022, the government is advancing efforts to improve the business environment to increase investment in start-ups.

**Japan highly values the importance of multilateral cooperation and continues to support the rules-based multilateral trading system with WTO at its core.** In this context, the government will promote international rules and norms to facilitate trade and strengthen economic resilience. As such, Japan will also make its efforts to make its global supply chain more resilient, sustainable, and reliable.

### **Conclusion**

Our authorities highly value their close collaboration with the Article IV team and the FSAP team, and IMF Management and staff in a broader context, and look forward to continuing to work with them on addressing domestic and international macroeconomic challenges.