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IMF Staff Country Report No. 00/98

Japan: Staff Report for the 2000 Article IV Consultation

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with Japan, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 30, 2000,** with the officials of Japan on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 12, 2000**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;
- a staff statement **of August 4, 2000**, updating information on recent economic developments;
- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the August 4, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project. To assist the IMF in evaluating the pilot project for release of Article IV staff reports, reader comments are invited prior to October 5, 2000, and may be sent by e-mail to Pilotproject@imf.org.

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JAPAN

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the
2000 Consultation with Japan

Approved by Yusuke Horiguchi and Leslie Lipschitz

July 12, 2000

- This report is based on discussions held in Tokyo during May 15–30. The staff team comprised Messrs. Collyns (head), Ostry, Morsink, Mühleisen, Nagaoka (all APD), Mr. Hayward (MAE), and Mr. Faruqee (RES). Mr. Yoshimura (Executive Director) and Mr. Toyama (Alternate Executive Director) also took part in the discussions. A small staff team will return to Tokyo in late July for an update on economic and policy developments.

- The staff team met with senior officials at the Ministries of Finance, Home Affairs, International Trade and Industry, Labor, Posts and Telecommunications, as well as the Bank of Japan, the Economic Planning Agency, the Financial Supervisory Agency, the Financial Revitalization Commission, and the Tokyo Prefecture; and with business and financial sector representatives.

- The First Deputy Managing Director visited Tokyo over May 29–30 to participate in the concluding sessions and meetings with Finance Minister Miyazawa, BoJ Governor Hayami, FRC Minister Tanigaki, senior officials, and private sector representatives.

- The principal author of this report is Mr. Ostry. Supporting information and analysis are provided in two companion reports on *Recent Economic and Policy Developments* and *Selected Issues*.

- Japan has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange system is free of restrictions on the making of current international payments and transactions apart from those notified under Decision 144 (see Annex I).

- Japan has subscribed to the Special Data Dissemination Standard, using a flexibility option on the timeliness of dissemination of data on general government operations, as well as a flexibility option for the periodicity and timeliness of the data for central government operations.

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I. Introduction

1. **A fragile economic recovery finally appears to be underway in Japan.** Notwithstanding the technical recession experienced in the second half of 1999 and the surge in GDP in the first quarter of 2000, a range of other indicators suggest that economic activity has been growing modestly since the beginning of last year, underpinned by a pickup in corporate profitability that, in combination with improving confidence, is boosting business investment. The turnaround in investment is heavily concentrated in high-tech sectors, however, with "old Japan" still saddled with sizable excess capital. And, notwithstanding the surge in the first quarter, the underlying trend of spending is much less robust, reflecting the continuing negative impact of corporate restructuring on household incomes.

2. **The emergence of recovery has shifted the policy debate in Tokyo to the question of when and how to roll back the exceptional macroeconomic policy measures put in place over the past two years to stabilize the economy.** On the monetary side, the Bank of Japan (BoJ) has for some months now signaled its desire to move away from the exceptional zero-interest rate policy once conditions allow, and markets have generally taken this to imply that a change could occur well before year-end. As to fiscal policy, with the deficit approaching double-digit levels in relation to GDP and public indebtedness—already very high by G-7 standards—on a steeply rising trajectory, political pressure to begin tackling consolidation is intensifying, and the public appetite for further deficit spending has diminished. There are also concerns that the present degree of macroeconomic support may be slowing urgently-needed economic restructuring. For example, access to cheap funding may be encouraging corporates to postpone needed downsizing, while government credit guarantee programs and high levels of questionable public works spending prop up economically nonviable enterprises and the bloated construction sector.

3. **The staff shares the concern that economic restructuring needs to be accelerated, but sees this goal as best being met by intensifying structural reform efforts rather than by withdrawing macroeconomic policy support while the recovery remains fragile.**[1] Curtailing fiscal stimulus prematurely carries risks—highlighted for example by the experience of the latter half of 1999—of precipitating another downturn, while the case for firming the monetary policy stance in the near future is not compelling, given the size of the output gap and continued deflationary risks. However, to ensure a lasting recovery, the momentum of structural reforms must also be sustained and even accelerated. Priorities are to address remaining financial sector weaknesses, encourage thorough-going economic restructuring in the corporate sector more generally, and lay the basis for the eventually-needed shift toward fiscal consolidation. The need to reduce global imbalances among the major industrial countries further underscores the importance of securing a strong and enduring economic recovery in Japan.

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[1] This advice is consistent with that offered by Directors at the conclusion of the 1999 Article IV consultation (SUR/99/98, August 11, 1999); see Annex I.

II. Recent Economic and Policy Developments

4. **Japanese economic growth fell markedly during the 1990s in comparison to previous decades, while the volatility of output increased.** The deterioration in performance reflected mainly a prolonged slump in business investment, as corporates began to unwind the excess capital stock created during the bubble years of the late 1980s. It also reflected slow adjustment to the ongoing process of globalization and technological change, as Japan lagged in shifting to innovation and productivity improvements (rather than capital accumulation and exports) as the main engines of growth. The increase in output volatility reflected in part stop-go fiscal policies, which gave rise to unprecedentedly sharp movements in public investment.

Japan: Average Growth Rates
(In percent)

	1980s		1990s	
	Average growth rate	Standard deviation	Average Growth rate	Standard deviation
Real GDP	4.0	1.2	1.3	2.3
Of Which:				
Private consumption	3.7	1.3	1.5	1.6
Nonresidential investment	8.1	5.4	-0.3	8.5
Residential investment	4.0	9.6	-2.7	11.6
Public investment	0.9	5.2	5.0	10.7

Sources: Nikkei Telecom and WEFA.

5. **Growth turned negative in early 1997, and GDP fell by 4 percent in the five quarters through end-1998—the most severe recession of any major industrial country in the post-war period.** The downturn was initiated by a sharp fall in household spending after the April 1997 consumption tax hike, cuts in public investment, and the closure of three financial institutions in late 1997. Business investment was particularly hard-hit, reflecting the sharp cuts in bank lending associated with the financial crisis and the strengthening of bank regulation. Household spending also fell, as the financial crisis undermined confidence and unemployment mounted. The Asia crisis compounded the recessionary momentum.

6. **In the first half of 1999, growth turned sharply positive.** GDP expanded by 3½ percent (annual rate), driven by a rebound in confidence and fiscal stimulus measures. Consumption increased strongly, as precautionary savings built up

Japan: Growth of Real GDP by Component (at 1990 prices)
(Percent change from the previous period)

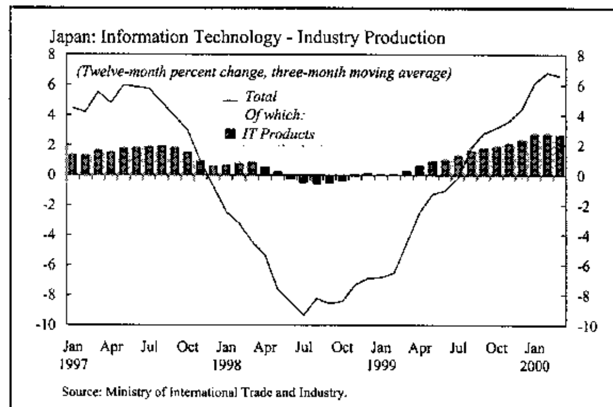
	1999		2000			
				Projections		
	H1	H2	Q1	Q2	Q3	Q4
Real GDP	1.8	-1.3	2.4	0.7	-0.1	0.3
Of which:						
Private consumption	1.4	-0.5	1.8	-0.2	0.1	0.1
Business fixed investment	-1.6	-1.1	4.2	0.3	0.5	1.8
Public investment	13.9	-9.7	-7.5	9.9	-3.0	-3.7
Foreign balance (contribution)	-0.4	0.1	0.9	-0.1	-0.1	0.1

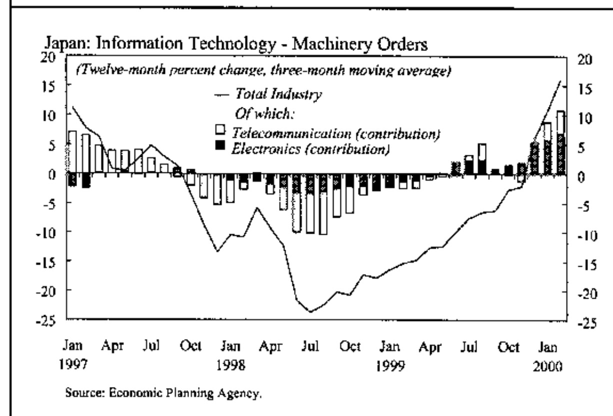
Sources: Nikkei Telecom; WEFA; and staff projections.

during 1998 were unwound, progress was made in tackling systemic threats in the banking sector, and tax cuts supported disposable income. Technical factors were also likely at work, however, including the spillover of the traditional end-1998 bonus payment until early 1999. Public investment surged as a result of two public works packages in 1998, while residential investment benefited from the introduction of temporary tax credits and interest rate subsidies to stimulate the moribund housing market.

7. **The national accounts suggest that the economy contracted again in the second half of 1999, although the extent of the decline may be exaggerated by distortions in the data.** The main proximate causes were renewed weakness in private consumption and a sharp contraction in public investment. However, with declines in real take-home pay and uncertain employment prospects weighing on household spending for most of the year, it is questionable whether the profile of consumption was so different between the two halves of the year—a doubt reinforced by other indicators such as retail sales and consumer confidence. The silver lining in the economic picture for the second half was a surge in business investment in the fourth quarter (14 percent at an annual rate, nearly offsetting the sharp contraction in the third quarter), as profitability recovered and sentiment improved.

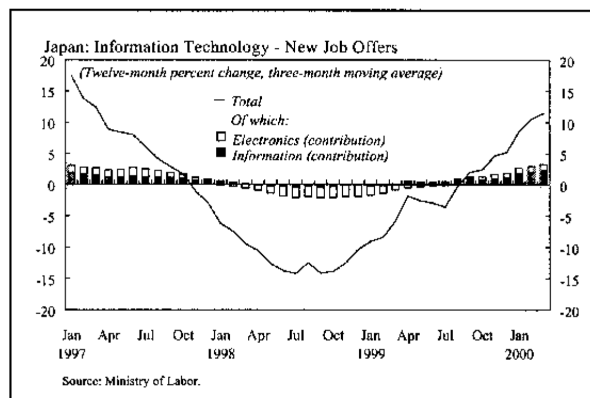
8. **Output appears once again to have surged in the first quarter of 2000.** The first quarter results—announced after the consultation mission—suggest growth of 10 percent at an annual rate, with strong contributions from private consumption, business investment, and net exports. However, the confluence of a number of temporary factors—including the delay in the end-1999 bonus payment and weaknesses in the EPA's seasonal adjustment (which, for example, does not take into account the leap-year effect), as well as the unwinding of the pre-Y2K buildup of import stocks—seems to have accounted for about half the first quarter surge. The decline in public investment likely reflects both increasing financial constraints at local governments and delays in the impact of last November's supplementary budget.





9. **The recent pickup in activity appears heavily concentrated in high-tech sectors.** According to the EPA, survey results suggest that between one-third and one-half of the recent pickup in industrial production has been contributed by IT sectors, and perhaps as much as two-thirds of machinery orders—a key indicator of business investment—has come from the electronics and telecommunications sectors combined. New job offers also are increasingly

coming from IT-related sectors and, to a lesser degree, the electronics sector. The growth of the new economy is apparent from other indicators as well, including the number of mobile phone subscribers, which has quintupled over the past five years (about the same growth rate as in the United States), and the rapid spread of E-commerce.

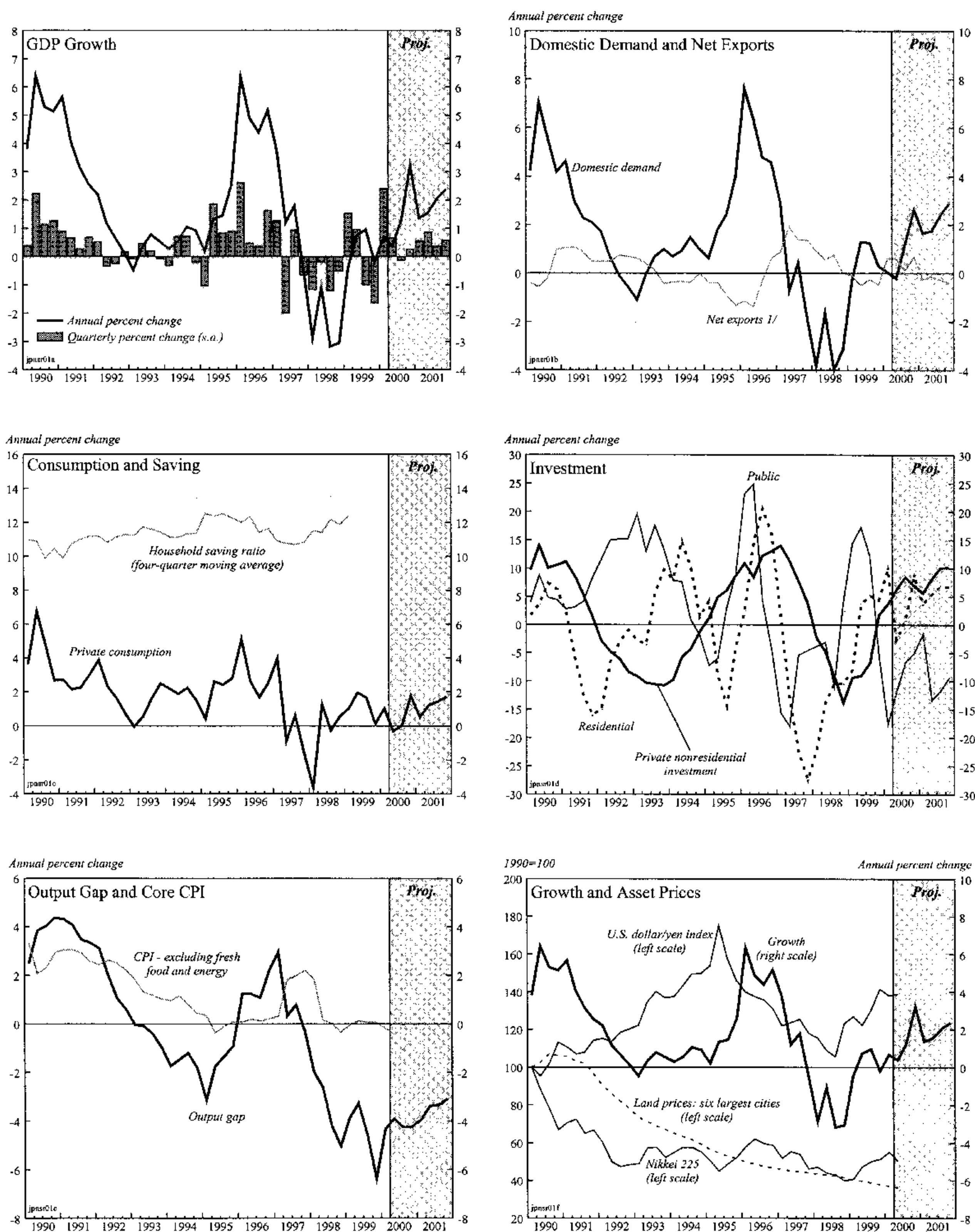


10. **The current account surplus narrowed in 1999, mainly due to higher imports following the sharp contraction in the previous year, but widened again in the first quarter of 2000**. Export volumes grew modestly in 1999 overall, dampened by the appreciation of the yen, although the strength of the Asian recovery has contributed to an uptrend since mid-1999. Import values rebounded strongly in 1999, however, reflecting not only the effect of higher oil prices, but also the impact on volumes of the pickup in domestic demand relative to the previous year, and a pre-Y2K buildup of import stocks. In the first quarter of 2000, export volumes continued to improve, while imports fell back as the pre-Y2K buildup of stocks was unwound (Figures 1, 2; Table 1). As to the capital account, net outflows fell sharply in 1999, reflecting both the reversal of the substantial short-term bank outflows that occurred in 1998 amid the looming banking crisis, as well as increased foreign purchases of equities as the economy turned around.

11. **The recession-cum-stagnation in 1997–99 widened the output gap and continued to put downward pressure on wages and prices** (Figure 3). Estimates of the gap are necessarily uncertain at this stage (in part due to difficulties in adequately capturing capital obsolescence), but its rising trend during 1998–99 is not in doubt, and the staff's estimate—4 percent of potential GDP in early 2000—is well within the range of other analysts' figures.[2] Other measures of excess capacity—including the unemployment rate, survey estimates of excess labor and capital, and data on capacity utilization—are also consistent with this picture. While a deflationary spiral has been avoided, consumer price inflation declined to about zero for most of 1999 and has been slightly negative in 2000 to date (compared to an average 2½ percent annual increase in the core CPI in the 1980s). The GDP deflator has been declining by 1–2 percent annually, although wholesale prices have recently been boosted by rising petroleum prices. In the labor market, the unevenness of the recovery—with certain sectors experiencing strong growth while others undergo restructuring—has implied a combination of rising overtime and job offers while earnings have continued to be weak and unemployment has remained on an uptrend.

[2] See T. Bayoumi, "Where Are We Now and Where Are We Going? Estimating the Output Gap and Growth of Potential Output in Japan," in Bayoumi and Collyns, *Post Bubble Blues—How Japan Responded to the Asset Price Collapse* (IMF, 2000).

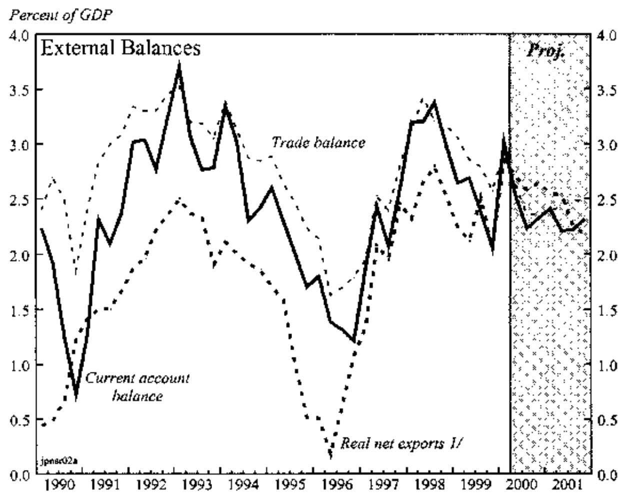
Figure 1. Japan: Selected Real Economic Indicators, 1990-2001

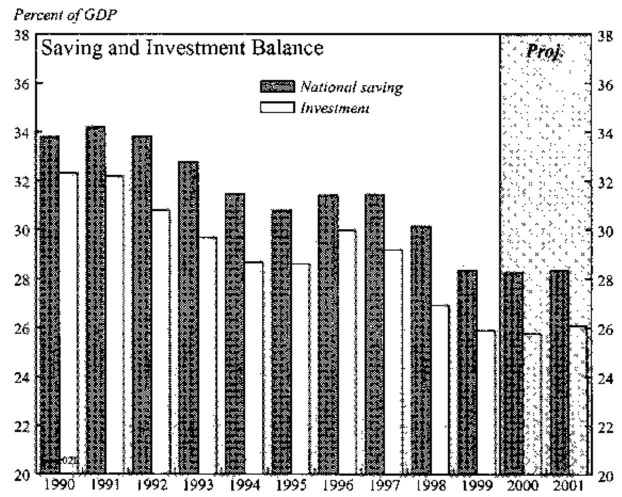


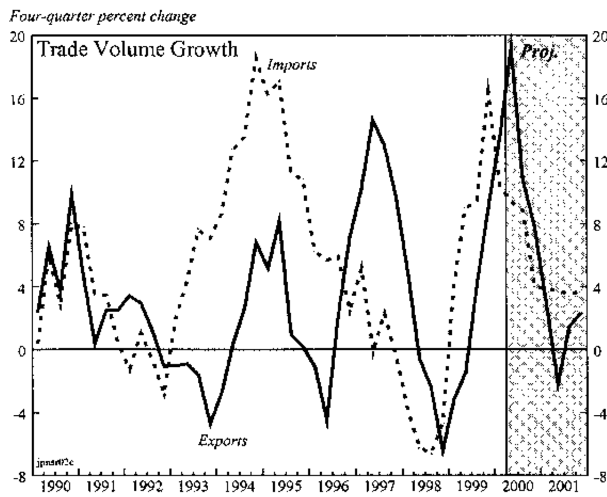
Sources: Nikkei Telecom; and staff estimates.

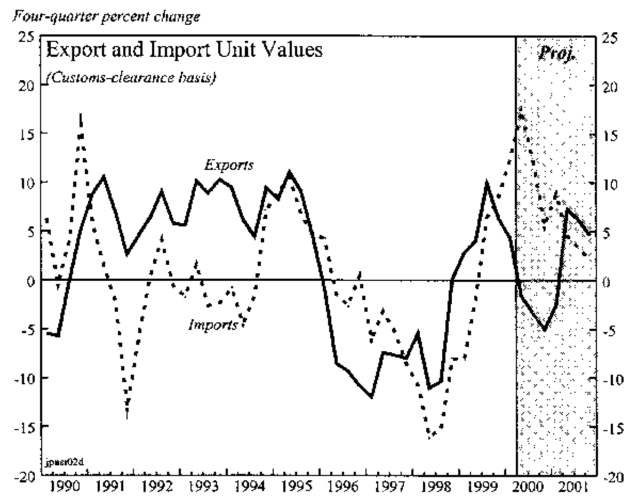
1/ Contribution to GDP growth.

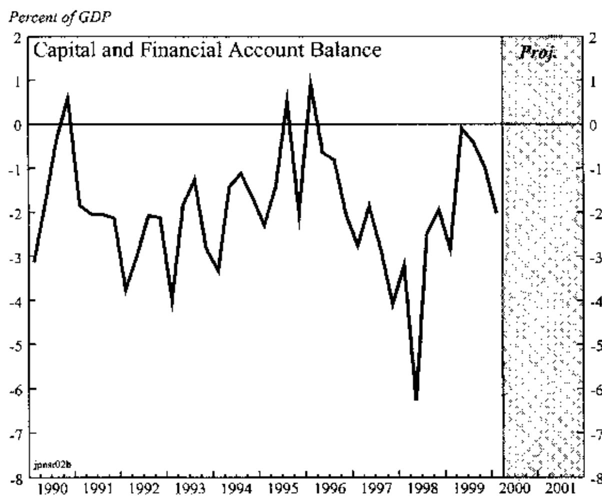
Figure 2. Japan:External Sector Indicators, 1990-2001 1/

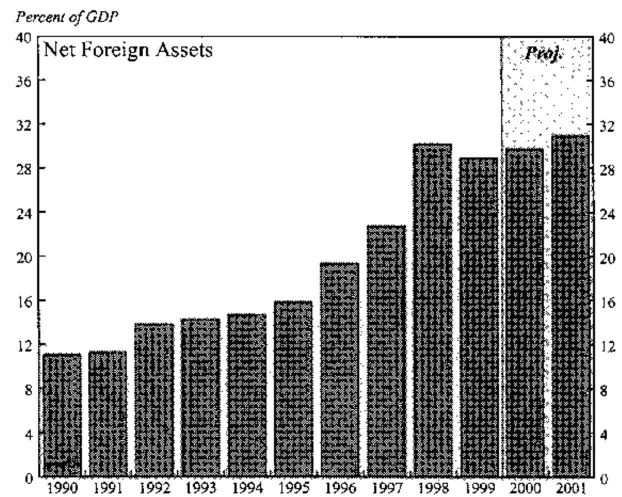








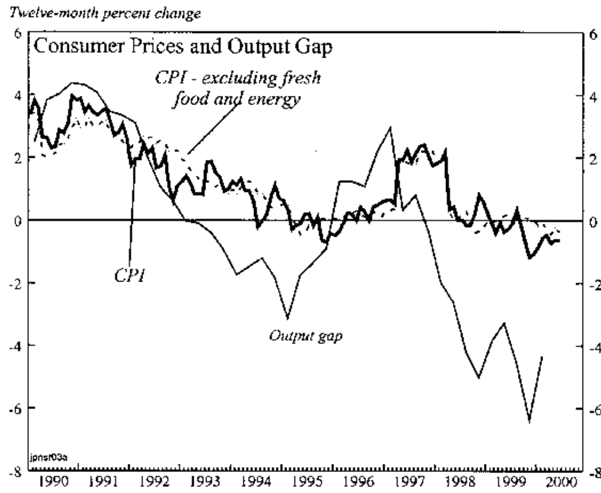


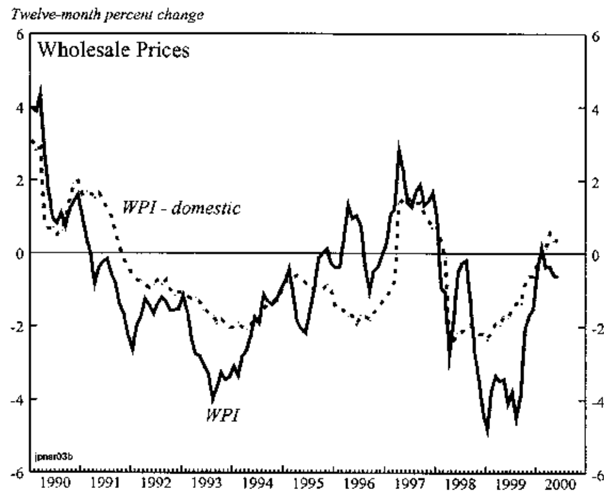


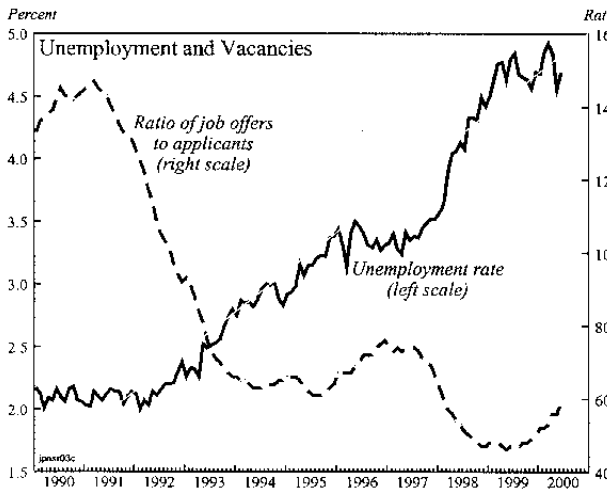
Sources: Nikkei Telecom; WEFA; and staff estimates and projections.

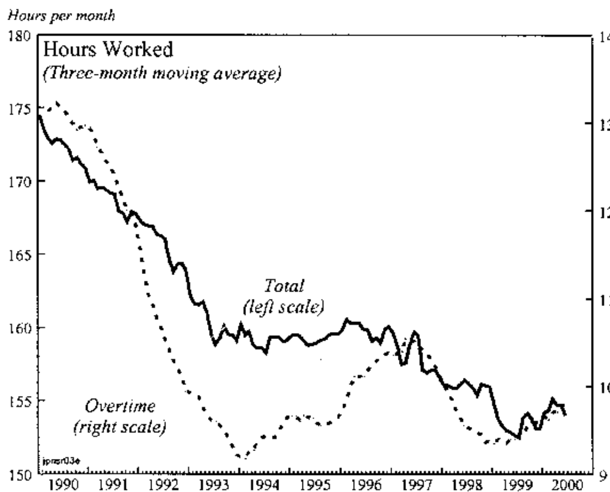
1/ Real net exports of goods and services on a national accounts basis.

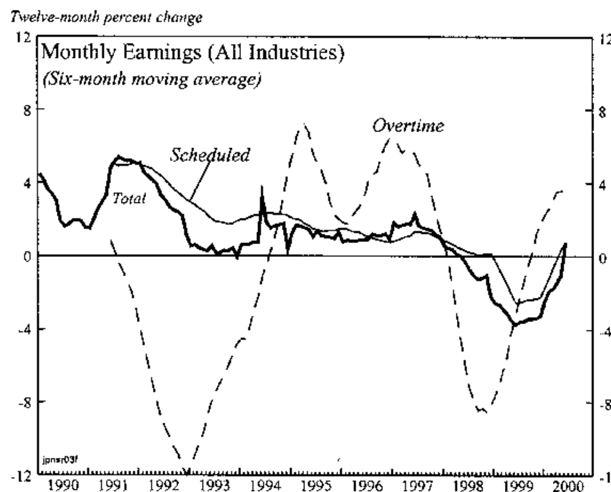
Figure 3. Japan: Indicators of Prices and Labor Market Conditions, 1990-2000 1/









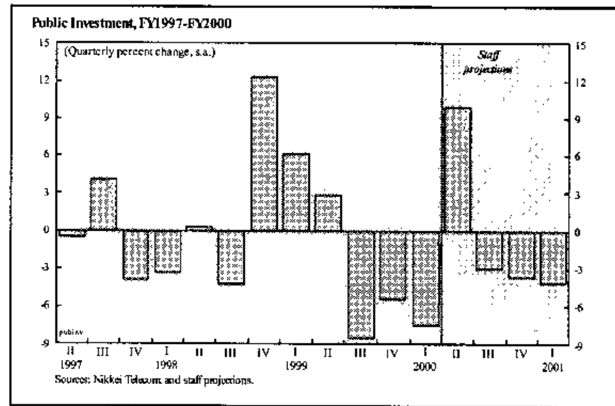


Sources: Nikkei Telecom; and WEFA.

1/ Seasonally adjusted data.

12. **The yen and stock prices strengthened markedly through early 2000 but have weakened since.** While the yen depreciated in the first half of 1999 amid further monetary policy easing and official expressions of concern about its level, from midyear it shifted course in the context of increasing confidence that a recovery of activity was getting underway. Upward pressures drove the yen to a high of almost ¥100/dollar at year-end despite significant intervention last summer, possibly fuelled in part by market perceptions that the BOJ was unwilling to ease monetary policy further (Figure 4). The yen declined slightly in early 2000, aided by further exchange market intervention which, on this occasion, came amid growing perceptions of a widening gap between short-term economic prospects in the United States and Japan, and was therefore more effective. Equity prices surged between early 1999 and March 2000—due mainly to rises in "new Japan" (high-tech) stocks while "old Japan" (including bank) stocks languished (Figure 5). Equity markets have since fallen back, likely reflecting not only the global downturn in high-tech stocks, but also recognition that corporate restructuring in Japan is likely to be a drawn-out process, transitional effects associated with changes in the composition of the Nikkei index, and the unwinding of cross-shareholdings.

13. **Following the premature move toward fiscal consolidation in FY1997, fiscal policy has been used to support growth, though the overall effectiveness may have been undercut by partial implementation at the local level and lack of transparency.**[3] The main vehicle for countercyclical fiscal policy has been a series of supplementary budgets designed to shore up public works spending, cut taxes, and increase credit guarantees for bank loans to SMEs. These packages are estimated to have raised the general government's structural deficit by a cumulative 2 percent of GDP in FY1998 and FY1999 (Figure 6; Table 2), although intensifying financial constraints at local governments, the opaqueness and stop-go nature of the supplementary budget procedure, and mounting levels of public debt, have all likely contributed to reducing fiscal multipliers in Japan.[4] The budget for FY2000, together with the stimulus package announced last November (which included 1½ percent of GDP in "real water" measures), should help to maintain the fiscal stance broadly unchanged during the current fiscal year. However, absent a further significant supplementary budget, public investment could again fall off sharply in the second half of this fiscal year, as it did in 1999.

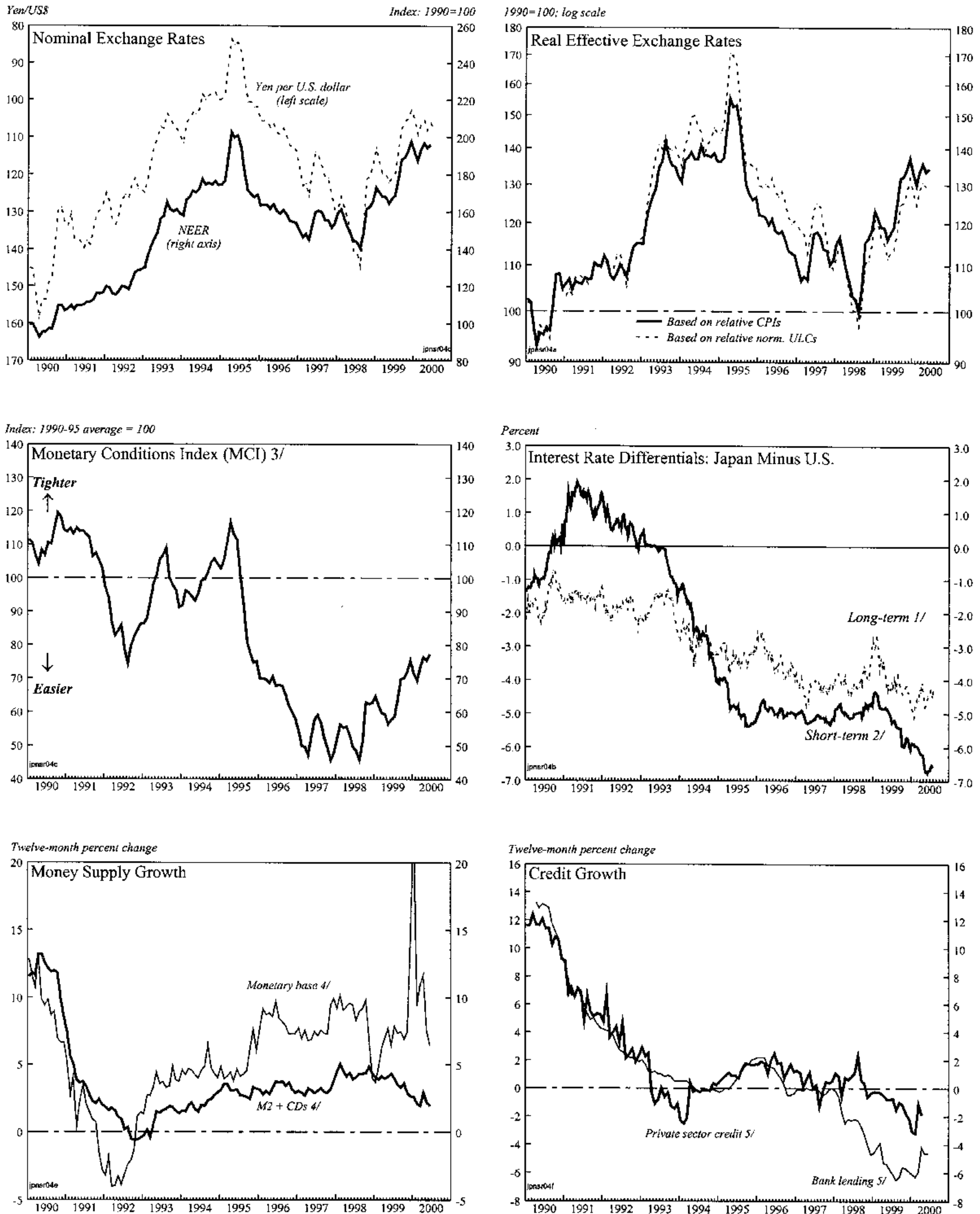


14. **While the monetary stance has remained unchanged since the reduction in short-term interest rates to their floor in early 1999, the BoJ has in recent months**

[3] The fiscal year runs from April to March.

[4] See Martin Mühleisen, "Effectiveness of Fiscal Stimulus" in *Post Bubble Blues.*

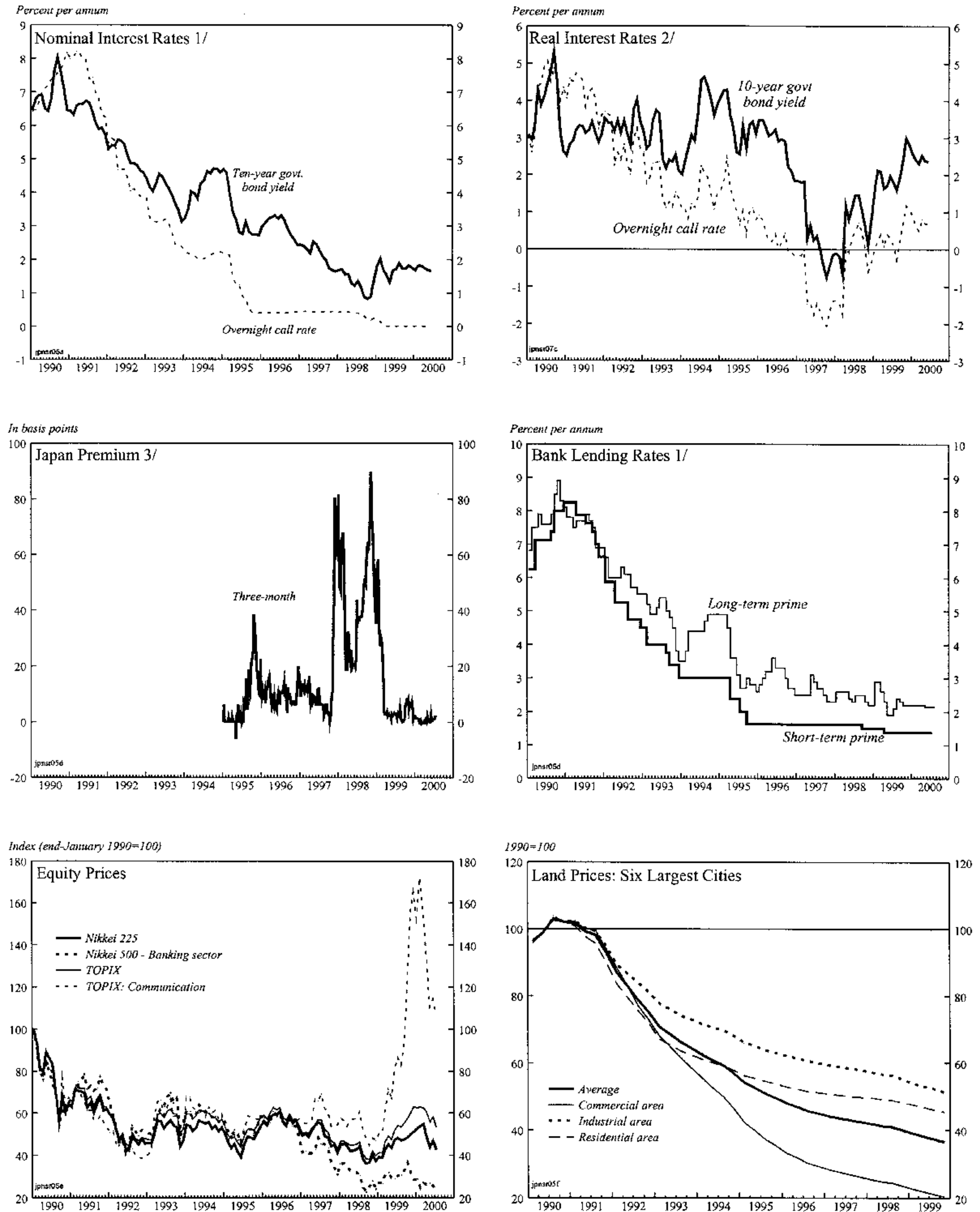
Figure 4. Japan: Monetary and Exchange Rate Indicators, 1990-2000



Sources: IMF, Information Notice System; Nikkei Telecom; WEFA; and staff estimates.

1/ Ten-year government bond yield.
2/ Three-month CD rate.
3/ An increase indicates a tightening of monetary conditions. The MCI is a weighted average of changes in the real interest rate and the real effective exchange rate.
4/ Period average.
5/ End-period.

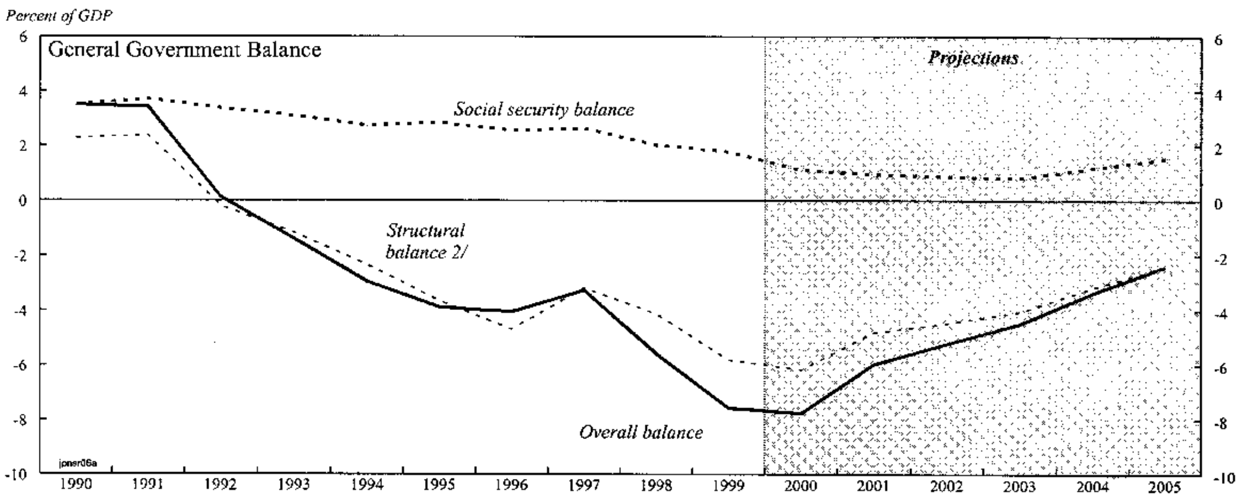
Figure 5. Japan: Selected Financial Indicators, 1990-2000

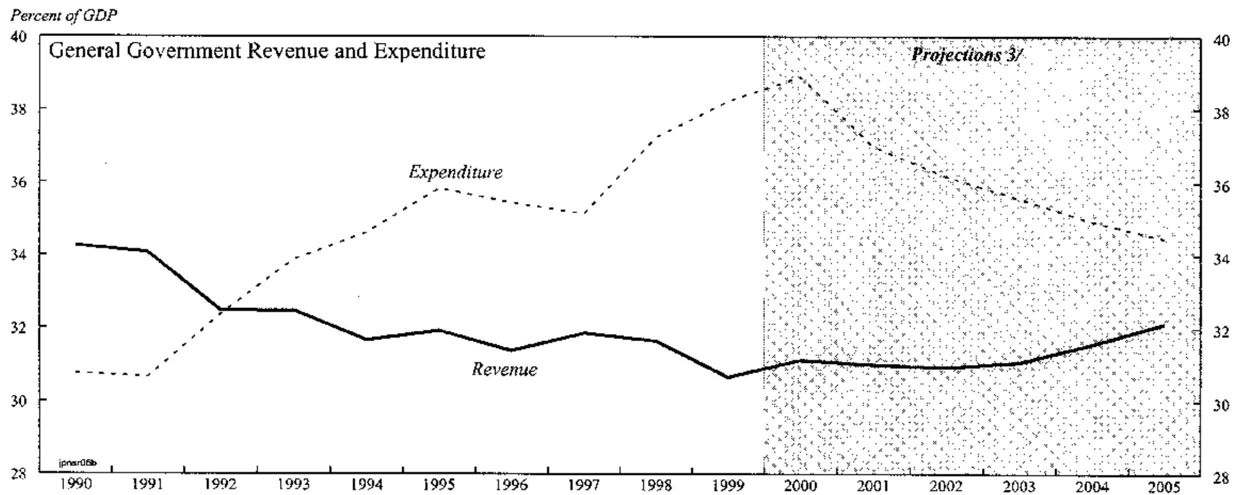


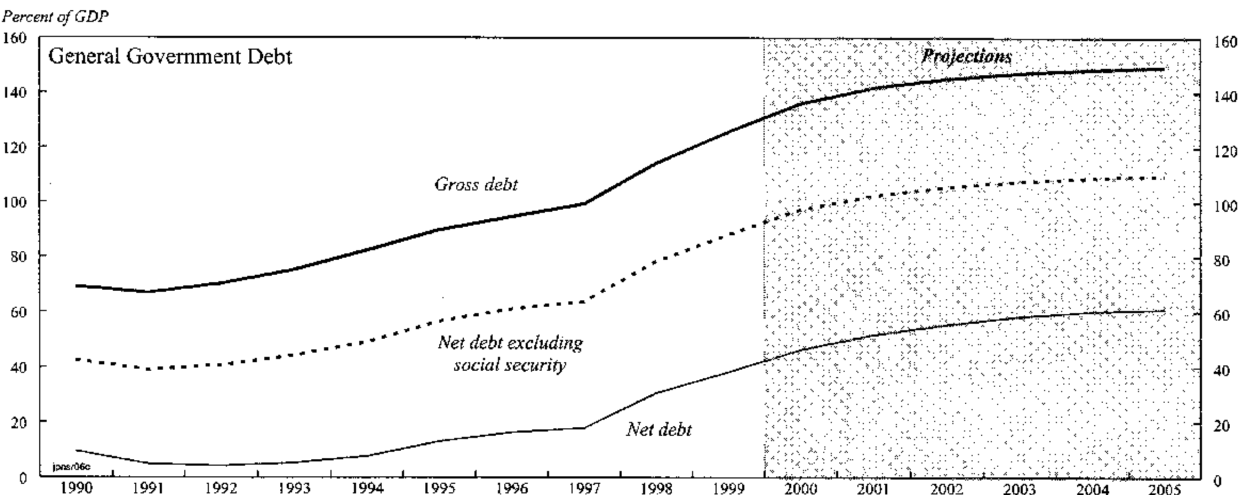
Sources: Nikkei Telecom; Bank of Japan; WEFA; and Bloomberg, LP.

1/ End of period.
2/ Nominal rates deflated by the CPI.
3/ Average U.S. dollar LIBOR of Fuji Bank, Bank of Tokyo, and Norinchukin bank minus the LIBOR fix from 1/21/1999; previously, Sumitomo Bank was included in the average.

Figure 6. Japan: Summary of Fiscal Indicators, FY 1990-2005 1/



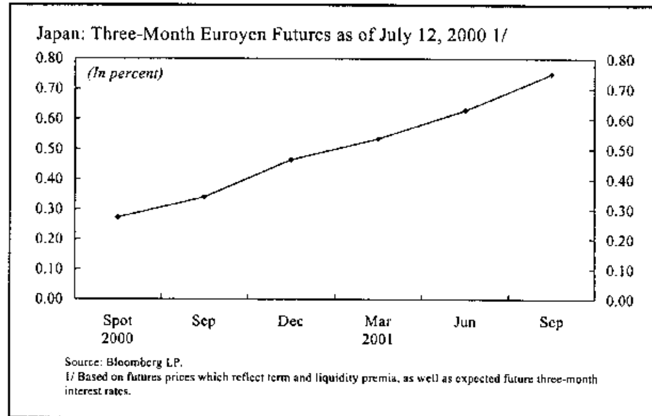




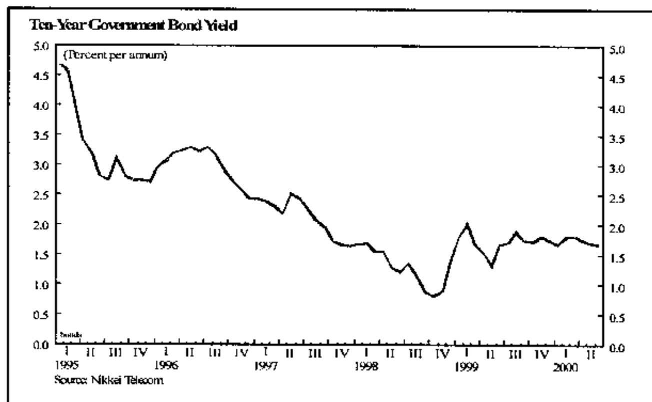
Sources: Ministry of Finance; Economic Planning Agency; and staff estimates and projections.

1/ The fiscal year is from April to March.
2/ Including social security; excluding bank support.
3/ Based on implementation of the 1994 pension reform and tax reform plans, the FY 1997 budget, and the public investment plan for 1995-2004.

increasingly signaled that the conditions for raising short-term interest rates by a small amount are falling into place. Following the reduction in the overnight call rate to about zero in March 1999, the BoJ announced in April that the zero rate policy would be maintained until deflationary concerns were dispelled. Short-term nominal rates have indeed been maintained close to their floor since that time, including during the Y2K period, when the BoJ's aggressive liquidity injections largely succeeded in containing upward interest rate pressures. Even with short-term nominal interest rates at their floor, however, real rates have remained positive, bank lending has continued to decline, and an appreciating yen since mid-1999 has implied a significant firming of monetary conditions (Figures 4 and 5). Nevertheless, with the gradual improvement in economic prospects, the BoJ has increasingly signaled—and markets have come to expect—that some firming of the policy stance is likely well before the end of the year.



15. **Long-term government bond yields have been relatively stable over the past year, but renewed volatility is certainly possible.** Following the surge in late 1998, yields have remained in the 1½–2 percent range, as banks have willingly absorbed increasing government bond issues. The BoJ's announced readiness to enter into repurchase operations with the Trust Fund Bureau may also have helped stabilize the market ahead of the maturing of a large volume of 10-year postal saving deposits.[5] Nevertheless, risks of sharply higher yields remain, reflecting uncertainty about the future course of macro policies and changing demand for JGBs arising from potential withdrawals from the postal savings system.[6]



[5] ¥106 trillion in 10-year deposits are due to mature in FY2000–FY2001, which could imply—to the extent that they are not renewed or maintained—a significant reduction in demand for government securities from this source.

[6] This said, experience during April–June suggests a redeposit rate of funds eligible for rollover of about 75 percent, although outflows could well pick up as interest rates move higher.

16. **While concerns about systemic risk in the banking sector have receded, bank restructuring is still at an early stage, and the financial position of the life insurance sector has continued to weaken.**

- Under the framework established in late-1998, **substantial progress has been made in stabilizing the banking system**: the major banks have been recapitalized, with capital adequacy ratios increasing to an average of 11¾ percent in March 2000; the two banks nationalized in late-1998 have been or are about to be reprivatized; and four mega-mergers have been announced, with two breaking *keiretsu* ties. This progress has been reflected in the behavior of the Japan premium which, apart from a brief rise during the Y2K period, has remained close to zero since March 1999.

- While systemic threats appear to have dissipated for now, concerns that **major banks do not yet have in place credible plans to restore core profitability** are reflected in the weakness of Japanese bank stock prices. The bulk of the bad loan problem may have been recognized by cumulative loan loss charges of over ¥50 trillion (10 percent of GDP) since 1990, but many analysts still feel that the full extent of the post-bubble deterioration of loan quality has not been recognized while warning that corporate restructuring is expected to lead to a further decrease in underlying asset quality. Moreover, banks could also be vulnerable to capital losses on their equity holdings and rising stock of JGBs.[7]

- Beyond the major banks, **while a number of regional banks have made progress in raising their capital over the past year, weaknesses among the credit cooperatives are only now beginning to be addressed.** Although only seven regional banks have received public capital injections, and another five were intervened over the past 18 months, a significant number have nevertheless succeeded in raising capital from the market over the same period.[8] However, some regional banks continue to have regulatory capital below the Basel 8 percent international standard and weaknesses among the credit cooperatives remain very serious.[9] The FSA—under whose jurisdiction the credit cooperatives now fall—will be undertaking

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[7] According to market analysts, a 100 bps rise in JGB yields—as occurred between October 1998 and January 1999—would lead to a valuation loss at major banks of about ¥1.1 trillion (about one-third of operating profits or less than 5 percent of Tier-1 capital). By comparison, a 1,000 point fall in the Nikkei stock price index would reduce the market value of banks' equity holdings by about ¥2.2 trillion. Most major banks (as well as one of the nationalized banks) now report equity holdings on a cost basis (requiring that "hidden reserves" not be included in regulatory capital) but will mark to market from April 2001.

[8] Two of the five intervened regional banks, as well as one of the nationalized banks, have been sold to non-Japanese investors.

[9] Japanese deposit-taking institutions with exclusively domestic operations are only required to observe a minimum capital ratio of 4 percent.

intensified inspections of these institutions through March 2001. The delay in reintroducing partial deposit insurance announced last December—from April 2001 to April 2002, except for settlement deposits, where the deadline is a year later—was largely related to concerns about the significant weaknesses in the credit cooperative sector.

- The **financial strength of the life insurance sector has deteriorated further** over the past year, as returns on assets fell short of guaranteed returns paid on policies. Following the implementation of stricter disclosure standards in April 1999, the FSA began in May 1999 on-site inspections of life insurers and tightened regulations on the adequacy of policy reserves, the calculation of solvency margin ratios, and triggers for prompt corrective action procedures. The FSA has intervened in two mid-sized insurers since inspections began. Earlier this year, the government-guaranteed borrowing limit of the Life Insurance Policyholders Protection Corporation was increased by ¥500 billion, while in May 2000, legislation was passed to facilitate strengthening of the sector, including by providing for conversion from mutual associations to limited corporations and allowing troubled life insurers to lower future guaranteed rates of return on policies as part of reorganization proceedings.

17. **Beyond the financial sector, the authorities have made significant progress in their legislative agenda to foster corporate restructuring, but progress on regulatory reform more generally has been less impressive.**

- **A number of measures to encourage corporate restructuring have been legislated over the past year**, including passage of the Industrial Revitalization Law (IRL) (August 1999)—which includes tax incentives for capacity cuts, low interest loans and loan guarantees to encourage new businesses—and changes in the Commercial Code to facilitate corporate spin-offs (May 2000). In addition, the Civil Rehabilitation Law (CRL)—which provides more flexible corporate reorganization procedures closer to U.S. style Chapter 11—was legislated with effect from April 2000. **Reforms to encourage labor mobility**—including through the introduction of portable defined contribution pension plans—have been proposed and are likely to be reintroduced into the Diet in the coming months.

- **Reforms to accounting standards are moving ahead**, with the introduction of consolidated financial accounting in FY1999 and the phasing in of marking-to-market in FY2000–01. These reforms are increasing incentives to strengthen returns on assets, improve corporate governance, and unwind cross-shareholdings.

- **Most remaining "Big Bang" financial reforms came into effect in October 1999**, including full liberalization of brokerage commissions, allowing commercial bank subsidiaries to deal in shares, and allowing banks to issue long-term debt. Remaining reforms—relating for example to the removal of barriers on the entry of banks into the insurance business—are planned to be completed by October 2000.

- **While the authorities have moved to expand the coverage of their deregulation program and plan to shift the emphasis of regulation from prior intervention to retroactive supervision, implementation is proceeding slowly in other areas.**

  - In addition to expanding the coverage of the official deregulation plan, important steps have been taken over the past year to improve competition in the utilities and transportation sectors, which are expected to reduce costs for long-distance telephone services, mobile phone service, air transportation and inter-city buses.

  - Nevertheless, progress in allowing private-sector entry in local telephone services and setting network access charges based on lowest foreign rates has been slow. Lack of competition in the power sector continues to result in Japan having the highest industrial electricity prices of any major industrial country, despite recent steps to allow independent power producers to supply electricity to large customers. While supply-demand regulations have been eliminated for domestic airlines and inter-city buses, deregulation for taxis and local bus services has not yet taken place.

  - Progress in modernizing the agricultural sector—*inter alia* by permitting corporations to own agricultural land—has also been slow.

  - On the labor market, while the authorities have passed a revised law governing the use of temporary ("dispatched") workers, the new law is still quite restrictive, for example in the limits it places on the maximum work period for such workers and the range of sectors.

III. ECONOMIC OUTLOOK

18. **Despite positive recent signs, the staff expects the recovery to remain underpowered and uneven in 2000–01, and subject to significant downside risks.** The baseline projection is for growth of about 1½ percent in 2000 and 1¾ percent in 2001, broadly in line with the private consensus forecast. However, achieving this outcome is by no means assured, given that a sustained recovery in private demand has not yet been established and corporate restructuring will continue to dampen both business investment and household expenditures for some time to come. In these circumstances, confidence could still be undercut by a "triple-dip" in activity after midyear—still possible following the surge in output that likely took place in the first half of 2000 (repeating the pattern of 1999), particularly if fiscal stimulus wanes and the monetary stance is firmed. The decline in stock prices since March is a reminder that confidence is still fragile and provides further headwind against a sustainable recovery in private demand. Other downside risks arise outside Japan, including that of a sharp recession in the United States. In more detail:

- Consistent with survey indicators of investment intentions and the general strength of recent indicators on capital goods shipments and machinery orders, the recovery will continue to be led by a pickup in **business investment**, underpinned by improving corporate profitability and business confidence, as well as strong IT spending

(Figure 7). **Residential investment**, which posted strong growth in the first quarter, should also pick up gradually through the year.

- **Private consumption** is expected to remain anemic for some time, as corporate restructuring continues to dampen take-home pay and unemployment is reduced only slowly, while the temporary boost from special factors in the first quarter is unwound. A sustained increase hinges on household income growth, which is unlikely before the end-year bonus payment at the earliest. Stagnant retail sales data are also consistent with only a modest uptrend in household spending (Figure 8).

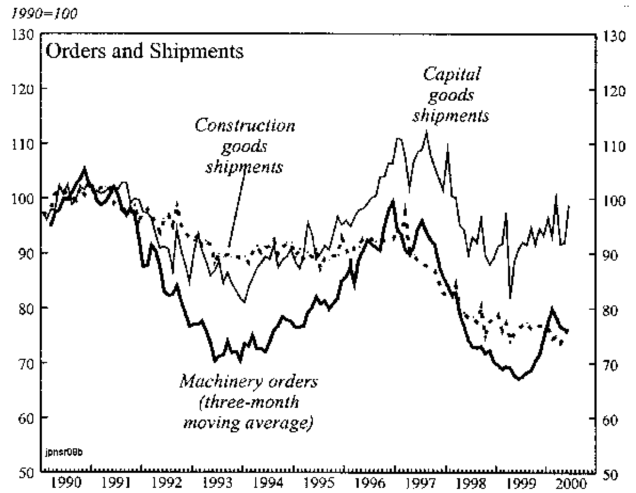
- The **fiscal stance** should be about neutral in 2000 as a whole, although an expected drop in public investment later this year would imply a withdrawal of stimulus in the second half of FY2000 and in FY2001. Following three consecutive quarters of contraction, public investment is expected to have surged in the second quarter of 2000 due to the impact of the November 1999 supplementary budget, but would then fall back again over the subsequent three quarters. For FY2001, an initial budget of about the same size as in FY2000 and a "typical" supplementary budget of about ¥1 trillion in late 2000 are assumed. This would result in a reduction in the structural deficit of about ½ percent of GDP in FY2001, and a contractionary impact on aggregate demand of nearly 1 percent of GDP, given the size of estimated multipliers.

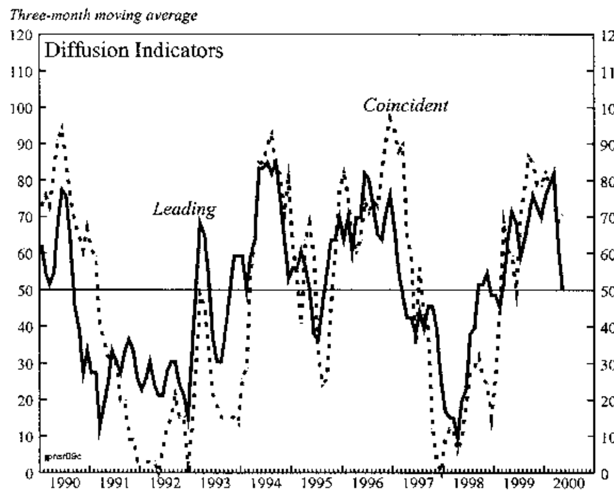
- The **foreign balance**'s contribution to growth would be about neutral in the near term, as stronger partner-country growth more or less offsets the lagged effects of earlier yen strengthening, although the very strong first quarter results will imply a modest positive contribution for the year as a whole. The current account surplus is projected to remain about constant in relation to GDP, as recent strength in export volumes offsets the impact of higher oil prices on import values.

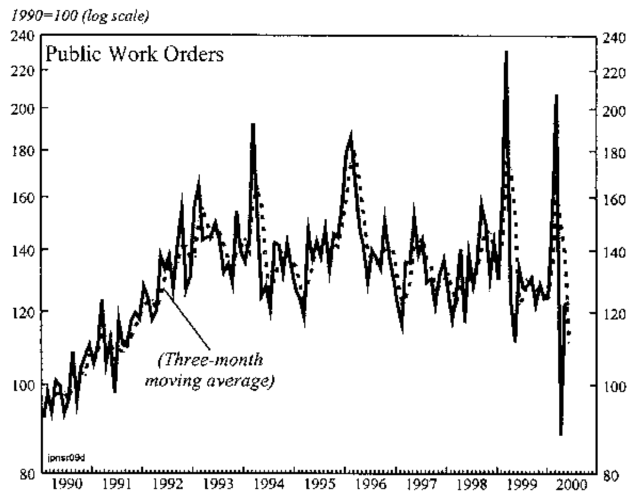
- Consistent with the significant degree of economic slack and slight year-on-year declines in the core CPI in early 2000, the staff is projecting consumer price **inflation** of about zero this year, and a further decline in the GDP deflator of about 1 percent.

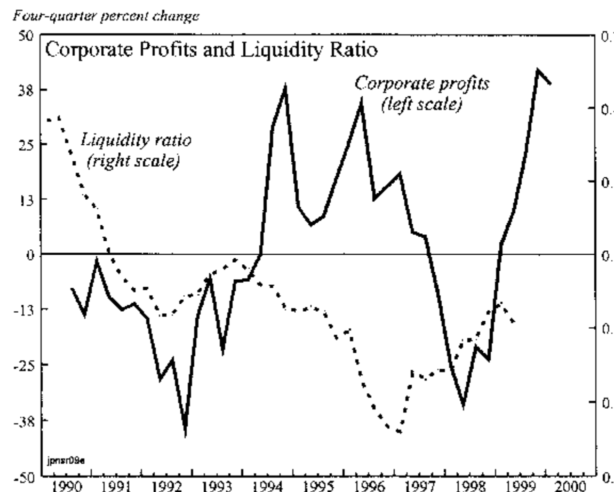
19. **Uncertainty about the size of the output gap and potential growth rate at present makes the medium-term path of the economy difficult to gauge**. Potential growth may be depressed in the near term because of dislocations associated with structural change; the staff's estimate of the output gap has already been revised down for similar reasons. Even with these revisions, however, a sizable output gap is likely to remain for most of the projection period through 2005, so that upward demand-led pressures on wages and prices would seem remote. Another area of uncertainty relates to the timing and modalities of fiscal consolidation. In preparing its medium-term baseline forecast, the staff has assumed that the process would begin gradually in 2001, and would reduce the structural balance (excluding bank support) by about ½ percent of GDP per year through 2005. While this is a somewhat slower pace of adjustment than envisaged in the now-suspended Fiscal Structural Reform Act—and does not stabilize net debt (excluding social security) within the forecast horizon—a much faster pace would likely imply downside risks for growth.

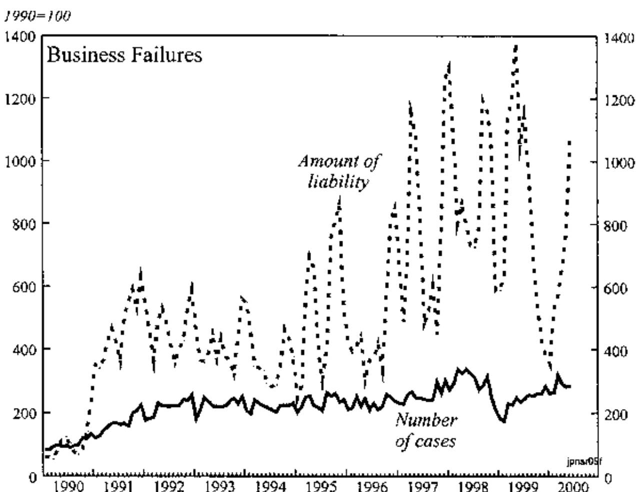
Figure 7. Japan: Indicators of Business Activity, 1990-2000 1/







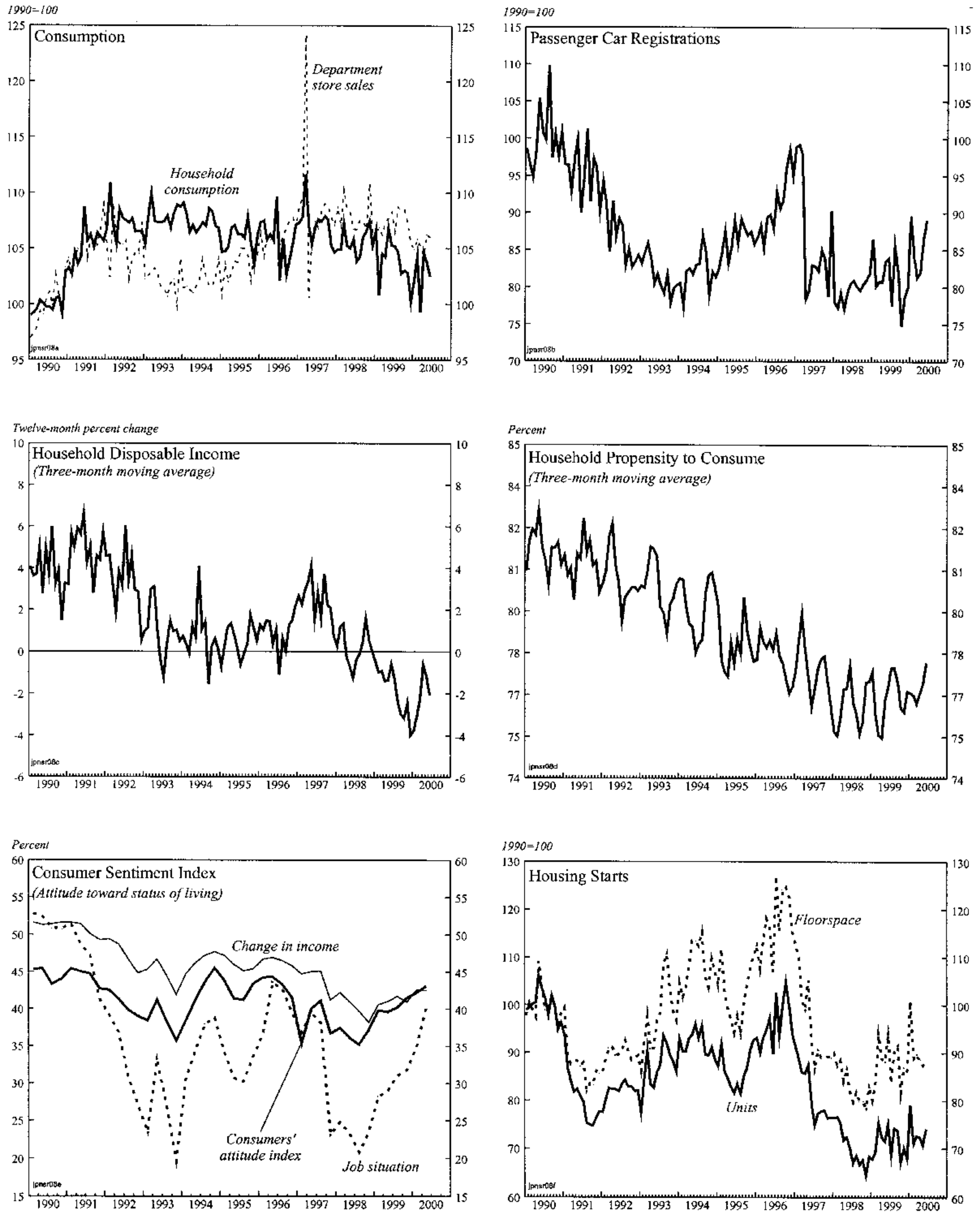




Source: Industrial Statistics Monthly.

1/ Seasonally adjusted data except for diffusion indicators.

Figure 8. Japan: Consumption Indicators, 1990-2000 1/



Sources: Nikkei Telecom; and WEFA.

1/ Seasonally adjusted data.

20. **A sustained recovery in Japan would contribute importantly to a gradual reduction in global saving-investment imbalances**. As envisaged in the medium-term baseline, a sustained recovery would be associated with a reduction in the current account surplus to around 1½ percent of GDP, thus facilitating a transition in the U.S. to a more balanced external position, as well as continuing to support the recovery of East Asian trading partners.[10] However, there remain risks that global imbalances may not unwind so smoothly. In addition to the domestic risks already noted, Japan's economy would be particularly susceptible to a sharp drop in equity prices and slowdown in activity in the U.S., which could affect Japan adversely through a range of channels: the effect on demand for Japan's exports (particularly hi-tech and capital goods) which could be amplified by repercussions through the entire Asia region; the indirect effect on Japanese equity valuations; and the possibility of sharp upward pressure on the yen as the dollar lost its luster. This external perspective underscores the need to move cautiously in unwinding supportive macroeconomic policies. Moreover, given that there is only limited scope available to offset a negative external shock through increased macroeconomic policy stimulus, it becomes even more critical to push through wide-ranging structural reforms to broaden and make more robust the current recovery phase.

IV. Policy Discussions

The discussions focused both on the strategy for macroeconomic policies in the period ahead and the priorities for accelerating bank and corporate restructuring.

A. Fiscal Policy

21. **MoF officials concurred with the mission's assessment that, on present policies, fiscal stimulus would likely fall off by the second half of FY2000**. While public works spending was expected to rise strongly in the second quarter of 2000 as the impact of last November's stimulus package came through, it would decline thereafter in the absence of another significant supplementary budget. However, the authorities pointed out that, as no decision had been made to frontload expenditure this year (in contrast to FY1999), the expected contraction would be less marked than was the case last year. They nevertheless acknowledged that a significant withdrawal of stimulus would be in prospect for FY2001 under the assumptions of a "neutral" initial budget and no supplementary this year.

22. **The mission emphasized the need for an early supplementary budget to mitigate the withdrawal of fiscal stimulus later this year and in FY2001**. The possibility of a policy-induced "triple-dip" beyond midyear underscored the importance of reaching an early decision. The staff noted that the risks of a downturn resulting from a premature withdrawal of stimulus were real—the second half of 1999 suggested that, with private demand fragile, fiscal policy could make the difference between technical recovery and technical recession, while the experience of 1997 suggested that, in combination with other factors, premature

[10] A surplus of around 1½ percent of GDP would be broadly consistent with the saving-investment norm used in the CGER framework.

consolidation could undermine economic recovery and confidence. In the same vein, public debt dynamics would likely be much less favorable if premature consolidation gave rise to a renewed downturn, not least because, without growth, policies aimed at advancing consolidation would not be sustainable. The mission recommended a package amounting to some ¥3 trillion in "real water" measures (½ percent of GDP), which would help to cushion the estimated withdrawal of stimulus in FY2001—at present estimated to be about 1 percent of GDP on the assumption of an initial budget for FY2001 of a similar size to FY2000.

23. **The authorities indicated that no decision on a supplementary budget would be taken before the autumn, but restated their intention to maintain fiscal support for the economy as long as necessary to ensure a sustained recovery**. They explained that the public appetite for further deficit spending had clearly diminished over the past year, reflecting valid concerns with the very high present level of the budget deficit, and the steeply rising trajectory of public debt—which was already very high by major industrial-country standards. Officials indicated that a decision for a supplementary budget would be taken in the early fall, taking into account indicators of the economy's strength through the summer—most importantly the second quarter GDP figures available in September—while reassuring the mission that, if warranted by underlying economic conditions, a further supplementary budget would be enacted.

24. **While the time for fiscal consolidation has not yet arrived, the mission stressed the importance of beginning now to prepare a medium-term fiscal strategy**. The team suggested that it could be helpful to initiate a public debate on the issues involved in order to start to develop the necessary consensus, thus raising public confidence in long-term growth prospects and reducing the risks of volatile financial market conditions. While long term bond yields have remained relatively stable over the past year, the chances of maintaining this favorable market environment would be enhanced by gaining broad public support for upcoming changes in the orientation of fiscal policy through improved disclosure of the conditions under which it would begin and the modalities for achieving it.[11] In practice, this would involve greater transparency about medium-term fiscal objectives in the budget, and discussion of how policy would respond to different risks.

25. **While recognizing the potential benefits of publicly developing a medium-term strategy, MoF officials indicated that reaching a consensus on the modalities and timeframe for fiscal consolidation would not be easy**. Recession had proved a powerful unifying force for fiscal policy, but there were widely divergent views on how best to achieve fiscal consolidation. Officials expressed concern that a public airing of the difficult issues involved in restoring a sustainable fiscal position could have a chilling effect on confidence and was therefore best left until the recovery was more robust.

[11] The absence of a credible medium-term fiscal strategy was mentioned by Fitch IBCA as one reason underpinning its decision to downgrade Japan's domestic-currency sovereign rating in late-June 2000.

26. **The mission emphasized the need for the medium-term fiscal strategy to be responsive to the evolution of economic and financial conditions, rather than follow a predetermined path of adjustment over a set period.** It recommended a gradual and flexible approach—with the aim of stabilizing the general government net debt/GDP ratio over the next decade, and then reducing it. As illustrated in Annex II, the amount of fiscal adjustment is sensitive to alternative assumptions about growth and interest rates. Under the baseline assumption in which the economy grows at a potential rate of about 2 percent from 2005, a reduction in the structural deficit (excluding bank support) by around 5½ percentage points of GDP over 10 years would stabilize the net general government debt ratio (excluding social security) at about 118 percent of GDP by 2010. However, the need for flexibility is underscored by the fact that the necessary cumulative fiscal adjustment for debt stabilization would rise by some 1¼ percentage points of GDP if steady-state growth converged to only 1 percent, and by 1 percentage point of GDP if the real JGB yield were to converge to 5 percent instead of the 3½ percent assumed in the WEO. The mission further cautioned that even after the net debt ratio had stabilized, further efforts would be needed to offset rising social security obligations and declining income tax revenues as demographic pressures intensified—the peak in the old-age dependency ratio only occurs around 2050 (Box 1).

27. **As to the modalities of consolidation, the mission noted that an appropriate strategy would likely involve a substantial scaling back of public works spending combined with revenue increases secured through a broadening of the personal income tax base and some rise in the consumption tax rate.** A further round of social security reforms would also likely be required, given the need to prepare for Japan's relatively unfavorable—by G-7 standards—demographic transition. This point is underlined by the fact that, under current policies, the budgetary contribution to meeting pension and health care costs is likely to increase by around 1½ percent of GDP over the next decade. Staff simulations suggest that—owing to the shrinking labor force and the adverse effects on growth of increases in social security contribution rates—a strong effort to restrain expenditure (especially on public works) would be needed to avoid a prolonged period of stagnation in response to consolidation, at the same time that base-broadening measures and indirect rate increases—where the growth costs are smaller than for increases in direct taxes—are stepped up.[12]

28. **The authorities agreed on the need for a gradual approach, but were not in a position to respond in detail to the mission's proposals.** They recognized that, given the likely magnitude of needed consolidation over the medium term, a broad-based approach—covering both expenditure reductions and revenue increases—would be needed. There was certainly scope to reduce the scale of public works spending once the recovery was established, while the agenda for future tax reform would be influenced by the forthcoming report of the Tax Reform Commission.

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[12] See the chapters by Mühleisen and Faruqee in the *Selected Issues* paper for further details.

Box 1. How Bad is Japan's Long-Term Fiscal Situation?

The rapid pace of population aging in Japan, together with the present size of the fiscal deficit, suggest that Japan will face more difficult fiscal challenges over the long term than other major industrial countries. Mainly owing to rising longevity, Japan already has the highest old age dependency ratio in the OECD, and this ratio will increase further as the population ages. Japan's social security system is only partly funded and receives substantial government transfers. Benefit payments will rise with an aging population, both on pensions and particularly on old-age medical care, which is highly subsidized. In an effort to rejuvenate the economy, Japan currently runs the largest fiscal deficit of any major industrial country, with a general government deficit of 9¼ percent of GDP (excluding the social security surplus). Even adjusting for Japan's weak cyclical position, the structural deficit remains far higher than the G-7 average.

Japan: Demographic and Fiscal Indicators

	Germany	U.S.	Japan
Retirement age dependency ratio[1]		(In percent)	
1995	30.8	21.4	35.3
2025	44.0	30.3	47.9
General government structural balance (1999)		(In percent of GDP)	
Including social security	0.4	0.5	-5.7
Excluding social security	0.7	-0.2	-8.1
General government debt (1999)		(In percent of GDP)	
Gross debt	61.1	64.1	125.4
Net debt	52.4	49.5	38.1
Net debt, excl. social security assets	53.1	59.1	87.9

Source: OECD; World Economic Outlook, 10/1999; staff estimates.
[1] Population over retirement age relative to working age population.

After almost a decade of using fiscal stimulus, general government debt now exceeds that of most other industrial countries. General government *gross debt* has been rising rapidly in recent years, to reach 125 percent of GDP in 1999, although *net debt* (at close to 40 percent of GDP) is still comparatively small by international standards. The difference—85 percent in government asset holdings—reflects the partly funded nature of the pension system, as well as the government's major role in financial intermediation:

- The pension system has accumulated assets worth 50 percent of GDP—which are almost exclusively invested through the FILP (see Box 2)—to fund benefit payments for future retirees. However, these assets are more than offset by future pension obligations. Indeed, projected net liabilities of the pension system—currently estimated at around 60 percent of GDP—are relatively large by major industrial-country standards, although they are estimated to have been reduced by about 30 percent of GDP as a result of recent reforms to the pension system.
- The remaining 35 percent of GDP in financial assets are held by the central and local governments. The exact breakdown of these holdings is difficult to determine, given the lack of information on them in the fiscal accounts, but a considerable part is likely to include foreign exchange reserves and investments in public sector enterprises. Some government agencies also hold government bonds that could in principle be directly offset against government liabilities.[1]

In view of the underfunded nature of the pension system, the staff most frequently uses the concept of *net debt excluding social security assets* which—at close to 90 percent of GDP—is significantly higher than in most other industrialized countries.

The general government's net obligations—including contingent liabilities—may be somewhat higher than suggested by these figures. The true value of government assets is difficult to estimate, partly because of lack of liquidity and the possibility that some of the investments may represent soft loans that may not be repaid.[2] While the default rate on loans by government financial institutions has so far been low (bad loans account for about 1–2 percent of the total loan portfolio), some large public infrastructure investments appear to generate significantly less than budgeted returns, which may imply significant contingent liabilities for the government (as was the case with the JNR Settlement Corporation). The government may also need to cover contingent liabilities arising from government guarantees. The total amount of outstanding government-guaranteed bonds and loans amounted to ¥50 trillion (10 percent of GDP) in March 1999, and the government may also be called on to cover losses related to ¥43 trillion in guarantees extended by regional credit guarantee agencies to cover bank loans to small and medium-sized enterprises.

The authorities have moved to reduce imbalances in the social security system, but further reforms are required to limit increases in future contribution rates. The **pension reform bill** approved by the Diet in March contained provisions to cut lifetime pension benefits by around 20 percent for future retirees, but the main earnings-related contribution rate would still have to rise to 25 percent of base wages by 2025 (from the current level of 17¼ percent) to preserve the solvency of the pension scheme. The need for future contribution increases could be higher, however, if the fertility rate does not recover as currently projected in the official population models.[3] The introduction of **nursing care insurance** from FY2000 and a **health care reform bill** (aiming at higher medical co-payments) currently under review by the Diet are both intended to limit increases in public spending on medical care, although the long-term impact on the public sector's obligations is far from clear. Under present policies, the staff estimates that public health expenditure would increase from 5 percent of GDP in 1997 to close to 8½ percent in 2025 which would be financed through a doubling of government subsidies (from 2 to 4 percent of GDP) and an increase in health insurance contribution rates from 8½ to 10½ percent of base wages.

[1] For example, non-profit corporations run by the Postal and Welfare Ministries use FILP funds for portfolio investments that mostly involve government bonds.
[2] See OECD, *Gross and Net Debt Measures in Japan*, 1998.
[3] See the paper by Mühleisen in this year's *Selected Issues* paper.

29. **The mission welcomed the passage of significant fiscal reform legislation in recent months, but expressed concern that a number of issues—some of which would help ease the transition to eventual fiscal consolidation—remained unresolved:**

- ***Public works spending***. The mission emphasized the need to step up efforts to apply cost-benefit analysis for project selection, improve the efficiency of bidding and procurement procedures, and accelerate the private sector's involvement in infrastructure provision, to set the stage for the substantial reduction in such spending that will be needed once consolidation moves forward. There would be a particular need—in the context of any forthcoming supplementary budget—to ensure that additional expenditures were directed at areas earning higher rates of return, for example by expanding public spending on technology infrastructure to support the new economy.

- ***FILP reform.*** Officials commented that the passage of FILP reform legislation in May—which phases out the intermediary role of the Trust Fund Bureau by FY2001 and envisages a greater role of private capital markets in financing investments of FILP agencies—was expected to improve the efficiency of FILP spending, while helping to reduce the role of the public sector in financial intermediation. The mission stressed that the favorable impact on resource allocation would be maximized by requiring FILP agencies to rely as much as possible on market financing, and accordingly strictly limiting the use of government guarantees of their borrowing.

- ***Tax reform***. In addition to reforms aimed at fostering an environment conducive to corporate restructuring discussed in paragraph 44, the mission stressed the importance of introducing taxpayer identification numbers (TINs) at an early stage in order to improve tax administration and lay the groundwork for later base-broadening measures. It also recommended efforts to address the vertical fiscal imbalance between the central and local governments—underscored by the Tokyo Prefecture's recent decision to impose a 3 percent tax on the gross operating profits of major banks in Tokyo—particularly the need to move away from reliance on highly cyclical tax bases, once recovery was underway.

- ***Social security reform***. Officials observed that the recent passage of pension reform legislation—involving reduced benefit levels and a gradual increase in the retirement age—would improve the solvency of the public pension system. Nevertheless, academic experts consulted by the mission suggested that further reforms would likely be required in the future to ensure the pension system's solvency and avoid an undesirable rise in contribution rates, *inter alia* because the underlying demographics were likely to be considerably worse than implied by official projections. On the health care side, the mission raised concerns regarding lack of progress on public health care reform—particularly as recent legislative proposals to modestly increase medical copayments were not passed in the recent Diet session—which was likely to further delay the much-needed containment of rises in the budgetary cost of public health care in Japan.

- ***Improvements in fiscal transparency***. Officials noted recent initiatives in this area, most notably through the intention to publish a consolidated central government balance sheet by this autumn and to introduce policy performance reviews at the Ministry-level. The mission stressed the need to accelerate more fundamental reforms, including regular publication of medium-term fiscal projections on a current services basis and more timely publication of consolidated fiscal accounts, in order to provide a more solid basis for assessing the macroeconomic implications of fiscal policy. The mission also recommended completion of a fiscal ROSC at the earliest opportunity, in order to help identify key priorities (see Box 2).[13] While recognizing the importance of these issues, the authorities did not commit to proceeding with a fiscal ROSC at this stage, preferring instead to wait until they had made more progress themselves in developing their strategy in this area.

B. Monetary Policy

30. **BoJ officials saw the conditions for abandoning the zero-interest rate policy as gradually falling into place**. They explained that the policy was an emergency measure that was justified when a deflationary spiral and financial crisis loomed, but that due weight had to be given to the damage—in terms of dulling incentives for economic restructuring and raising moral hazard—now that economic conditions had improved. They considered that the probability that deflationary risks had been dispelled was increasing over time, and that once this probability had become sufficiently high in the Policy Board's view, it would be appropriate to raise interest rates by a small amount.[14] Such a judgment would likely hinge on the emergence of a broad recovery in private demand (including consumption), which in turn would depend on a turnaround in household incomes. Financial markets well understood the BoJ's policy on this score, and had for some months now priced in a 25 or so basis point increase in the overnight call rate by the last quarter of 2000. Officials indicated that the decision of the Policy Board from that point would depend on their assessment of inflationary risks. If increasing demand pressures were forecast to compromise the BoJ's target of price stability, further rate rises would be likely. However, while the recovery remained anemic, the probability of inflationary pressure would remain low, and further rises in policy rates would be some way off in such circumstances.

31. **The mission stressed that the BoJ should proceed very cautiously in moving away from the zero-interest rate policy**. First, while economic indicators were gradually improving, the recovery remains fragile in the face of recent equity market weakness and recurrent upward pressures on the yen. Moreover, under the staff's baseline scenario, the output gap would take several years to close, suggesting that deflationary—rather than

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[13] The groundwork for this has already been laid, as the authorities and staff have discussed responses to the fiscal transparency questionnaire during the 1999 Article IV mission.

[14] In fact, analysis undertaken by BoJ staff suggested that once the impact of technological changes and imported commodity prices was stripped away, the contribution of weak demand factors to deflation was falling over time.

Box 2. Fiscal Transparency—Where Is The Problem and What Can Be Done?

With discretionary fiscal policy a key element of the government's strategy to revive the economy, efforts are urgently needed to raise the level of fiscal transparency in Japan. In present circumstances, lack of transparency has likely contributed to reducing the effectiveness of fiscal policy in securing economic recovery, as well as raising concerns about the sustainability of the fiscal position. The main issues are:[1]

- **Important fiscal information is presented with a significant time lag and not in a format that lends itself easily to macroeconomic analysis.** The authorities report consolidated fiscal accounts for general government with a 12-month lag, which is related to a delay in data reporting by some 3,200 local authorities (which implement the bulk of public works spending). The information is provided only in the context of the national income accounts, in a classification that is not compatible with GFS standards.
- **The budget process suffers from a confusing distinction between initial and supplementary budgets.** Discretionary counter-cylical fiscal policy has largely been implemented through large supplementary budgets which in practice has implied volatile quarterly swings in public works spending—c.f. the decline in output caused by the sharp fall in public works spending in the second half of 1999. The diminished role of initial budgets also creates uncertainty about the immediate path of fiscal policy. For example, while the government indicated that it plans to maintain a "neutral" budget in FY2001, the fiscal stance in FY2001 will depend crucially on decisions yet to be made on the FY2000 supplementary budget.
- **The absence of a clear medium-term fiscal policy framework invites speculation about future public deficit and debt levels**, and may contribute to instability in bond and foreign exchange markets. Although the authorities regularly publish a five-year fiscal forecast, this is based on a linear extrapolation of recent trends rather than a detailed assessment of factors likely affecting revenue and expenditure in the future or indications about the authorities' future fiscal plans. Perceptions of a rising fiscal imbalance, combined with concerns over the future of social security, have probably led to increasing Ricardian offsets (through higher private saving), reducing the effectiveness of the government's stimulus policies.
- **The extensive use of the Fiscal Investment and Loan Program (FILP) as a quasi-fiscal tool leads to rising concerns over the quality of the public asset portfolio.** The FILP channels funds from the social security system and the postal savings system largely into government securities, special accounts and government financial and nonfinancial enterprises. The perception that a substantial share of FILP lending may not be justified on economic grounds has fostered expectations that returns from such investments will be insufficient to service existing debt. Although the default rate on current FILP assets remains low, the value of the government's contingent liabilities is difficult to assess, as FILP agencies have thus far been shielded from market scrutiny.

What should be done? The authorities are working to improve transparency in some areas. Recent legislation has put in place a framework that would require a number of FILP agencies to seek market financing without public guarantees. Increased reliance on market financing is likely to encourage the dissemination of more information on these agencies' profitability and spending plans. The Ministry of Finance has also begun to work on a consolidated central government balance sheet with results expected for this autumn. While these efforts are welcome, they need to be supplemented with steps in the following areas:

- Budget planning should be put in the context of **five-year rolling forecasts based on current policies,** with initial budgets designed to cover the full fiscal year. Initial budgets should aim at incorporating the measures needed to secure the desired policy stance, allowing the use of mid-year supplementary budgets to be drastically curtailed. In addition, budgets should be presented on an outlays basis as well as an appropriations basis to facilitate analysis of their macroeconomic impact.
- The system of central and local government fiscal accounts needs to be overhauled, taking advantage of advances in information technology with the aim of **reducing the role of special accounts** and allowing **faster compilation of consolidated accounts.**
- Using sampling methods, information on local governments should be used to compile timely **general government consolidated accounts on** a preliminary basis within 3 months of the end of the fiscal year. Similarly, information from the social security system and public enterprise accounts should be used to provide a **timely overview of overall public sector operations.**

[1] For more details on fiscal transparency, see chapter by M. Mühleisen in *Japan: Economic and Policy Developments Paper* (SM/99/181), especially pp. 49–52.

inflationary—pressures would likely be of concern for some time to come. Indeed, deflation as measured by the core CPI (which excludes perishable food and energy) had intensified during the first four months of 2000, while the 12-month change in monthly earnings was still negative, suggesting that inflationary pressures from this source were some way off. In such circumstances, much greater weight should be placed on the risks associated with moving to tighten too early and possibly precipitating a damaging fall back into recession, than on the limited inflationary risks implied by moving to tighten a few months too late. Second, given the pressures for fiscal consolidation, there is a strong case for a near-term policy mix that delays—rather than brings forward—the shift to positive interest rates. Third, while there may be costs to maintaining the zero-interest rate policy, the fact that firms expect this policy to be abandoned in the future and that interest rates remain significantly positive in real terms, would tend to mitigate the disincentive effects on economic restructuring. And fourth, there is a danger that even a small move away from the zero-interest rate policy could be misinterpreted by markets—for example if it were seen to signal an increased likelihood of further tightening in the future—and thereby risk undercutting the recovery. In light of these considerations, the staff recommended that a firming of the policy stance await a sustained period of above-potential growth and a broad-based recovery of private demand.

32. **BoJ officials acknowledged some of the mission's concerns—especially the need to take account of the future course of fiscal policy and for the initial move away from zero interest rates to be communicated to markets very carefully—but cautioned that the output gap might be smaller than many observers (and staff) thought**. They suggested that the need to shift resources across sectors in response to globalization could reduce potential output at least in the short term, and pointed out that excess capacity indicators suggested that the output gap was already narrowing. In view of the uncertainties involved in assessing the output gap, officials were concerned that waiting for a sustained period of growth above conventional estimates of potential before moving away from the zero interest rate policy might put monetary policy behind the curve, and so lead to inflationary pressures down the road. An appropriate, forward-looking policy, in their view, would be to act sooner by a small amount and thereby avoid the risk of having to take more aggressive and destabilizing actions in the future. The mission emphasized that its estimate of the output gap—about 4 percent of GDP at present—was in line with private sector estimates and that, while potential growth was indeed likely to be depressed by restructuring in the near term, even so it would still take some considerable time to close the output gap. Although capacity utilization indicators had indeed been increasing recently, this was from an extremely low base, and a broad range of indicators (including the unemployment rate, and corporate surveys) continued to indicate the existence of substantial slack in the economy.

33. **The mission underscored the importance of taking additional steps to ease the monetary policy stance in the event that downside risks to the economic outlook materialized**. Steps to provide additional monetary stimulus would be critical in the face of events that could undercut the recovery, including upward pressures on the yen unjustified by the strength of the economy or a sharp recession in the United States. Although the conventional short-term interest rate channel was exhausted, economic theory suggested that quantitative easing through purchases of longer-dated government securities and foreign

exchange would be expected to have an impact on interest rates further up the yield curve and on the exchange rate (Box 3). BoJ officials responded that they did not see a need for additional measures at this time, but that they would be prepared to act decisively in the event of an intensification of deflationary pressures.

34. **Officials are giving increased emphasis to ways to ensure clear communication with markets, but are cautious with respect to adoption of a full-fledged inflation targeting framework, as advocated by the staff.** On steps to improve transparency of monetary policy, officials responded that the BoJ already published a monthly economic assessment and the minutes of the Policy Board Meetings, and they explained that a study was in the process of being finalized which would cover, *inter alia*, price stability measurement, inflation targeting, and the tradeoffs in publishing inflation forecasts. Officials explained that one problem with publication was that performance of the BoJ's internal price forecasting models had deteriorated recently. The mission noted that publishing inflation forecasts could help to reduce market uncertainties about the BoJ's view of the future course of inflation, even if this view had wide standard errors. This was particularly important given the lack of a track record of decision-making by the Policy Board. On inflation targeting, the staff favored a target that was broadly consistent with the BoJ's mandate to pursue price stability, but nevertheless somewhat above zero, given estimated measurement bias in CPI inflation in Japan of about 1 percent a year. Greater transparency about the price goal would be especially helpful in current circumstances, to counteract deflationary expectations. BoJ officials responded that they remained open to the idea of an inflation targeting framework, but only once more normal growth and price conditions had been reestablished, given the limited scope for using the instruments of monetary policy at this point.

35. **Regarding exchange rate policy, the authorities considered that foreign exchange intervention had had some success in mitigating unwarranted upward pressures on the yen, and they were committed to further action should such pressures recur, although they did not target a particular level of the exchange rate.** A rough indication of the BoJ's net purchases of foreign exchange can be obtained from the change in official reserves as reported in the balance of payments, which was about $80 billion in 1999. The mission supported this approach, referring to recent work by the staff providing some evidence that such actions had been somewhat effective in the past (Box 4), although it cautioned that a substantial and lasting effect would likely depend on a supportive monetary policy. While the exchange rate appeared to be broadly aligned with medium-term fundamentals according to the CGER framework, its current trading range (¥105–110/dollar) was unhelpful from a cyclical perspective and the mission cautioned that a significant rise from current levels risked undercutting a still fragile recovery.

C. Financial Sector Issues

36. **While stressing that progress in strengthening banks' balance sheets had allayed concerns about financial instability, officials agreed with the mission on the importance of firmly implementing the strengthened regulatory framework to ensure banking system soundness and allow a smooth transition to limited deposit insurance in April 2002.** The mission emphasized that key challenges in the period ahead would be to transform the major banks into healthy, competitive institutions that could earn internationally

Box 3. Options for Further Monetary Policy Easing—The Recent Literature

Options for further monetary easing once the overnight call rate is zero have been addressed by several recent academic papers. Most papers agree that additional monetary operations in short-term government securities on which interest rates are already close to zero would have little effect at the margin. The main alternatives suggested are the adoption of an explicit inflation targeting regime, the extension of monetary operations up the yield curve, and increased purchases of foreign exchange.

Bernanke (2000) takes the view that an explicit inflation target would help to clarify further the BOJ's policy stance and that the target should be set fairly high (3–4 percent). Building on Krugman (1998), which was discussed in last year's Article IV papers, Bernanke noted that "cheap talk" could affect expectations if there was no conflict between the announcement and the central bank's incentives, helping to serve as an equilibrium selection device. He added that the effect on the term structure of the announcement by the BOJ in April 1999 of a sustained zero-interest-rate policy was a good example of the potential power of announcement effects. However, Okina (1999) argued that there are important difficulties with setting and achieving an inflation target. On setting a target, he pointed to the sometimes divergent movements of different price indices, especially at low inflation rates, and to biases and measurement errors in any given price index. On achieving the target, he noted that since the central bank cannot explicitly show how the desired inflation rate will be achieved (see below), announcing a target would not necessarily affect inflation expectations. The central bank's credibility would be damaged by making the announcement and then failing to achieve the target. This would be particularly the case for a target—such as 3–4 percent—that was not fully credible as an objective once conditions returned to a more normal situation.

Meltzer (1999) and Goodfriend (1999) consider that monetary policy remains effective as long as the central bank can buy (or sell) any asset that does not have a zero yield. Goodfriend pointed out that monetary transmission would occur through portfolio rebalancing and the credit channel, though the magnitudes of such effects would be uncertain. Okina (1999) responded that, while such policies could be effective in raising inflation, they would have damaging side effects. First, if the BOJ increased its purchases of government securities, it would be difficult to stop providing this additional financing to the government. Indeed, such purchases would be equivalent to underwriting government debt, which is prohibited by the Fiscal Law. Second, the likely rise in nominal long-term interest rates would cause a capital loss to the BOJ (which by law stays with the BOJ), which in turn would erode confidence in the central bank and hence the economy. However, Bernanke (2000) noted that paper losses to the BOJ's portfolio would have no effect on its operating budget or on overall government finances, since the BOJ's losses would be precisely offset by the fiscal authority's gains. Goodfriend (1999) agreed with Okina that the BOJ's balance sheet was relevant to the credibility of monetary policy, but suggested that the fiscal authority could agree to indemnify the central bank against capital losses (as under the old BOJ law).

McCallum (1999) and Svensson (2000) suggest that monetary policy also retains effectiveness through the foreign exchange market. McCallum noted that there would be no economic limit to the depreciation of the exchange rate that could be engineered by central bank purchases of foreign exchange, since the central bank has an unlimited supply of domestic currency at its disposal. Svensson proposed a specific mechanism to escape the liquidity trap, consisting of a price level target path, a devaluation of the currency and an exchange rate peg, which would be replaced by price-level or inflation targeting once the price-level objective had been reached. This would jump-start the economy by a real depreciation of the domestic currency, increased inflation expectations and lower short and long real interest rates. Okina (1999) expressed concern that large-scale purchases of foreign exchange by the Japanese authorities could provoke opposition from its major trading partners and be criticized as a beggar-thy-neighbor policy.

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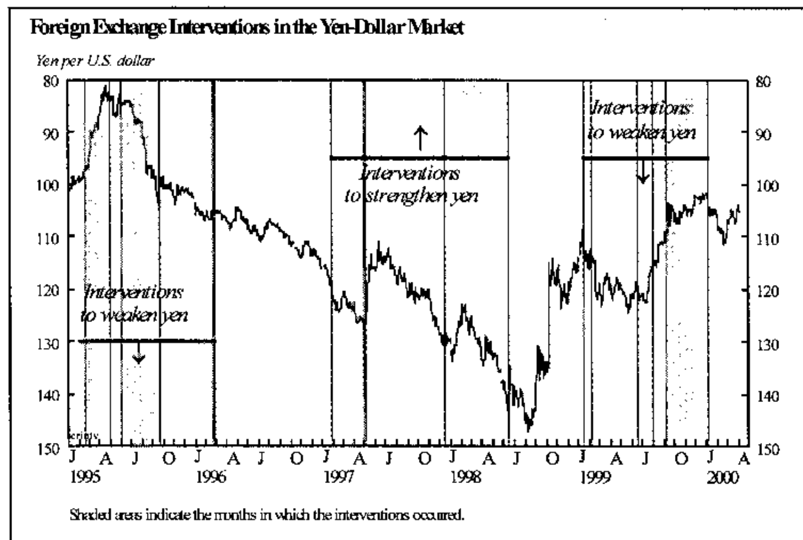
Box 4. Has Intervention in the Yen-Dollar Market been Effective?

The Japanese authorities have intervened much more frequently in the foreign exchange market than most other industrial countries. News reports suggest that there were about 40 instances of unilateral interventions by the Bank of Japan (BOJ) during the past five years. With short-term interest rates near zero, and other policy options limited, foreign exchange interventions have taken on added importance as an instrument to potentially alter monetary conditions and affect aggregate demand. The discussion in Box 3 suggests that foreign exchange interventions could *in principle* alter the foreign exchange value of the yen, and thus have an impact on monetary conditions and economic activity. The main question is therefore empirical, namely: are interventions effective in practice in changing the exchange rate?

How does intervention work in Japan? Foreign exchange interventions are both authorized and funded by the Ministry of Finance, although the BoJ implements the actual intervention operations in the foreign exchange market. Like the Federal Reserve in the United States, the BoJ routinely sterilizes its foreign exchange interventions, in the sense that, in practice, the BoJ calibrates its money market operations so that the foreign exchange interventions do not alter the desired level of liquidity in the overnight market—which has for sometime now effectively been a target for the level of excess reserves. The foreign exchange interventions carried out during 1995–99 have, at different times, aimed at both strengthening and weakening the yen. Unilateral interventions have outnumbered coordinated interventions in this period, and interventions to weaken the yen have predominated over interventions to strengthen it.



Econometric estimations indicate that interventions in the yen-dollar market have been at least partially effective.[1] Interventions to curb both yen appreciation and yen depreciation have had sustained, though relatively small, effects on the level of the exchange rate. Coordinated interventions have a higher probability of success than unilateral interventions, and when successful, move the exchange rate in the desired direction by a larger margin—at times, about thrice as large—than unilateral interventions do. Contrary to conventional wisdom, sterilized interventions have mattered in the yen-dollar market.

The success of sterilized interventions appears related to the fact that they provide signals about economic fundamentals to the market. Sterilized interventions can have an impact on the exchange rate either by altering the currency composition of the assets held by the private sector—the portfolio balance effect—or by providing the market with signals about the central bank's assessment of economic fundamentals or the future course of monetary policy. They can also change the exchange rate by altering sentiment when bandwagon effects result in currency misalignments. However, since the typical size of an intervention in the yen-dollar market is a small fraction of the daily foreign exchange turnover, the success of sterilized interventions hinge crucially on the credibility of the signals that it provides markets.

[1] See Ramana Ramaswamy and Hossein Samiei, "The Yen-Dollar Rate: Have Interventions Mattered?" in WP/00/95 (June 2000).

comparable rates of return; address remaining deep-seated weaknesses among the credit cooperatives and some regional institutions; continue to strengthen the regulatory and supervisory framework; and adopt a number of structural reforms aimed at scaling back the still pervasive role of the public sector in financial intermediation.[15]

37. **The authorities emphasized the strides made by major banks to strengthen their balance sheets and the potential gains from the mergers now being planned. The mission shared private analysts' concerns that boosting core profitability at the major banks was likely to proceed slowly**. The main issue related not so much to reducing costs—Japanese major banks compare quite well with those in other large industrial countries in terms of branch or staff numbers—but rather the need to improve income prospects through a better mix of business lines, especially reducing the proportion of assets still taken up by low-yielding, big-company lending, and the development of new activities opened up by the big-bang reforms. The planned mergers had potential for reaping returns to scale particularly in applications of new technology, but the process of combining different corporate structures seemed likely to be slow, possibly diverting from aggressive efforts at business development. While the main burden of reorganization must lie with the banks themselves, the mission recommended that the authorities use the regulatory leverage from recent public capital injections to exert more pressure on banks to strengthen their earnings base.

38. **Responding to the mission's concerns about the still weak situation of the smaller deposit-taking institutions, officials noted that many regional banks had made progress in raising capital over the past year, while acknowledging that weaknesses remained among the credit cooperatives**. FSA officials considered that most regional banks had now succeeded in raising provisions to appropriate levels, and that a large number of them had been successful in securing significant capital increases over the past year without recourse to public money. As a result, the average capital ratio of first-tier regional banks was 10 percent and that of second-tier regional banks was 8 percent as of March 2000. The FSA's examinations of credit cooperatives that were now underway were likely to reveal a number of insolvent institutions, however. The mission noted that there were still a number of regional banks with capital adequacy well below 8 percent as well as many weak credit cooperatives: while these smaller institutions did not have the systemic importance of major banks, failures could nevertheless have strong contagion effects once limited deposit insurance was reintroduced. To limit such risks, the authorities and mission agreed on the need to rigorously apply the regulatory framework to intervene in insolvent institutions, encourage the orderly exit of weak institutions such as through their absorption by stronger ones, and use targeted public capital injections to catalyze meaningful restructuring without jeopardizing credit supply in local areas.

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[15] The mission discussed with the authorities the possible timing of a Financial System Stability Assessment (FSSA). The authorities indicated that they could consider an FSSA in the second half of 2001, following completion of administrative changes affecting the organization of financial sector supervision scheduled for early 2001.

39. **While bank regulators appear to be making headway in raising supervisory standards, resources are limited and the framework still has gaps.** The authorities maintain that provisioning levels have now been raised sufficiently to cover loan losses related to bad loans from the bubble period, although private analysts considered that recognition and provisioning against impaired assets still had some way to go. Nevertheless, FSA officials recognize that sustained supervisory pressure will be needed to ensure full recognition and provisioning against any further deterioration in asset quality which could occur in view of continued corporate restructuring. In response to the mission's recommendation to gradually raise the capital adequacy standard for all deposit-taking institutions to 8 percent, the authorities indicated their intention to monitor progress in restoring the smaller institutions to health, given the risks of a credit crunch in some areas if the standard were raised in present circumstances. In view of the importance of frequent, sophisticated, and comprehensive monitoring of all financial institutions—including the large and complex banking organizations created in the wake of recent mega-mergers—the mission stressed the need for continued increases in the FSA's supervisory resources, and to ensure the agency's independence in the context of the new organizational structure to be introduced in 2001.

40. **Officials indicated that the inspection of life insurers, which the FSA had largely completed, revealed asset quality problems similar to those of the banks.** While the FSA has tightened regulations on the adequacy of policy reserves, the calculation of solvency margin ratios, and triggers for prompt corrective action procedures, the mission stressed the need for firm implementation of the strengthened regulatory framework in order to secure an improvement in the underlying net worth of life insurers. Recently-passed legislation providing more flexibility for insurers to reduce future guaranteed rates of return on policies in the context of comprehensive reorganization plans and to raise capital should help to facilitate restructuring in this sector.

41. **The mission discussed a number of other systemic reforms to strengthen the soundness of the financial system.**

- ***Reform of deposit insurance.*** Officials clearly recognized the need to adhere to the present deadline for reintroducing partial deposit insurance in order to avoid further dilution of incentives for restructuring. While welcoming the new procedures—including accelerated purchase and assumption methods—in the recently-enacted deposit insurance reform legislation, the mission stressed that their effectiveness would depend on early intervention, flexible application, and ensuring that uninsured creditors and shareholders bear appropriate losses when institutions fail.

- ***More active loan disposition.*** The authorities explained that the Resolution and Collection Corporation (RCC) was required to dispose of assets acquired from banks within five years of purchase. The mission recommended the need for more aggressive action to recover value from nonperforming assets, including through foreclosure and asset sales, in order to promote restructuring and the reallocation of productive assets.

- ***Eliminating preferential status of postal savings system***. The mission noted the importance of gradually reducing the size of the postal saving system in Japan—the largest financial institution in the world—by leveling the playing field between it and private banks in competing for funds through elimination of tax and other advantages enjoyed by the postal savings system. Not only would this help reduce the role of the public sector in financial intermediation, it would also provide a more conducive environment for banks to raise their core profitability. Officials responded that the recently enacted reforms would imply that the postal savings system would be run on more commercial lines, but that the regulatory advantages it enjoyed were offset by the costs of providing basic financial infrastructure, particularly in rural areas where private financial institutions did not operate.

D. Structural Reforms and Corporate Restructuring

42. **The general perception in Tokyo is that recent structural reforms, together with a stronger banking system and financial sector innovations, are contributing to increased corporate restructuring efforts, although the process probably still remains in its initial stages.**[16]

- Announcements of corporate restructuring plans have picked up over the past year, with the number in the second half of 1999 about double year-earlier levels, including a significant number of government-approved restructuring plans benefiting from tax and other incentives provided under the Industrial Revitalization Law. The new accounting standards also appear to be exerting a positive influence on the process, including by encouraging consolidation and streamlining of industrial groups and the unwinding of cross-shareholdings.

- Bankruptcies have continued at high levels, despite the onset of recovery, as the major banks have been more aggressive in dealing with bad loans prior to mergers, and the breathing space provided by credit guarantees offered only limited respite. The new Chapter 11-style Civil Rehabilitation Law, which came into effect in April, has already prompted a surge of applications, which are running about twice the rate under the previous procedure.

- M&A activity has picked up sharply, including Renault's acquisition of a controlling stake in Nissan motors, Merrill Lynch's purchase of Yamaichi Securities' operations, and U.K. Cable and Wireless' acquisition of International Digital Communications. The first attempt at a hostile takeover in Japan's history also took place last year, perhaps indicating a shift in corporate culture.

- As well as plans to downsize employment, a number of major companies have begun to introduce incentive-based compensation structures to replace seniority-based

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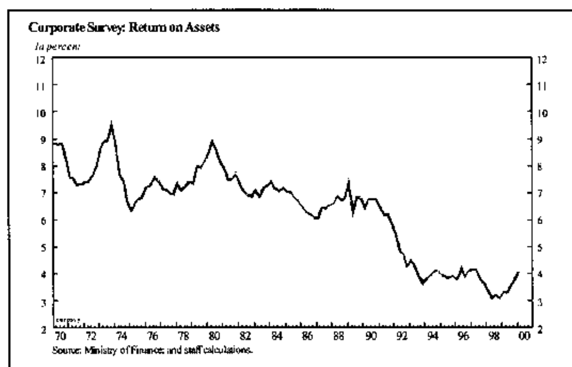
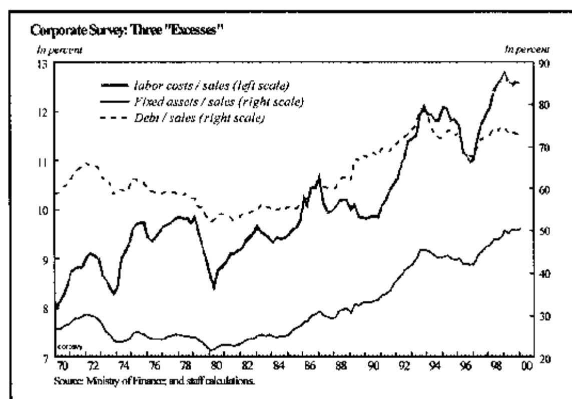
[16] See also this year's International Capital Markets report.

structures, following regulatory changes in April 1997 that allow the use of employee stock options.

43. **Progress with restructuring and the cyclical pickup in activity are helping to raise corporate profitability, but the process of durably raising returns on assets is still at an early stage.** Corporate profitability has staged a strong recovery over the past year—rising nearly 30 percent over the past four quarters—although cyclical, as well as structural, factors are likely behind this impressive performance. While higher profits have translated into some increase in the returns on assets in the corporate sector over the past year, considerably more restructuring will be needed to reestablish levels prevailing in the 1970s or 1980s, including through scrapping and upgrading of unproductive physical assets.[17] Moreover, corporate data suggest that profit gains have so far been mainly related to more efficient use of inputs—squeezing suppliers—rather than making much of a dent in unwinding the "three excesses" of labor, capital, and debt from the bubble period. Some deleveraging of corporate balance sheets has taken place over the past year, however, with the ratio of corporate financial liabilities to net worth falling from 350 percent in 1998 to 320 percent in 1999, mainly reflecting progress in the SME sector.





44. **To build on this progress, the mission recommended a number of further reforms to accelerate corporate restructuring which—in combination with the rehabilitation of the financial system—would help to secure the basis for sustained market-led growth.**

- First, to encourage a more rational corporate structure in Japan, the mission emphasized that recent reforms of the Commercial Code to facilitate mergers and spinoffs be followed by a range of other reforms, including removal of tax impediments to such transactions, as well as the early introduction of consolidated corporate taxation. The authorities explained that they were now giving priority to examining appropriate tax changes to complement the recent passage of amendments

[17] Staff estimates of the excess capital stock, which are based on extrapolating the trend from the 1970s and 1980s in the capital/output ratio, suggest an excess capital stock on the order of 8 percent of GDP at present, broadly consistent with official and market estimates.

to the Commercial Code dealing with corporate spinoffs. Subsequently, they would tackle the issue of consolidated corporate taxation. The latter would adversely affect tax revenue, however, and needed to be carefully considered given the size of the present budgetary shortfall.

- Second, while welcoming the authorities' efforts to expand worker retraining programs and liberalize restrictions on job placement services, the mission recommended a number of additional steps—including the early introduction of favorable tax treatment for portable defined-contribution pension schemes to encourage labor mobility and improve the functioning of the mid-career labor market. The authorities expected that legislation on the tax treatment of private portable defined contribution pension schemes would be passed in the next Diet session. Private analysts suggested the need for legislation to facilitate labor shedding, but officials expressed concern about the impact on employment while the recovery remained fragile.

- Third, to further enhance corporate governance, the mission suggested strengthening the role of external auditors and outside directors on corporate boards, rigorously implementing the new accounting standards, and requiring pension fund trustees to maximize returns on assets.

- Fourth, to further enhance the framework for corporate restructuring, the mission stressed the need to establish more permanent and broadly-available incentives for corporate restructuring, building on the temporary—through 2003—and limited incentives provided in the Industrial Revitalization Law. Efforts to expand the still small number of qualified attorneys specializing in bankruptcy law would also be well rewarded. Officials were broadly satisfied with the number of applications received to date for restructuring within the IRL framework, as well as the surge in applications for reorganization under the CRL. Efforts to facilitate an increase in the supply of qualified lawyers and accountants were also in train.

- And fifth, to help set the stage for an expansion of the "knowledge-based economy" and increase competition generally, the mission advised a broad reduction in barriers to entry in the telecommunications sector, timely implementation of plans for sectoral reforms in the transportation, agriculture, and power sectors, and follow through on the intention to shift the basis of regulation from prior approval to retroactive assessment. The authorities responded that further progress on these areas was expected over the next year, including reducing electricity tariffs to internationally comparable levels by FY2001, significant reductions in telecommunications network access charges, and a gradual phasing out of price supports on agricultural products.

E. Other Issues

45. **Continuing weaknesses in economic data complicate the monitoring of developments and formulation of macroeconomic policies.** The mission stressed the need to address longstanding problems related to the absence of timely consolidated fiscal data

and the quality and timeliness of national income accounts, especially through the preparation of an action plan that would include specific measures and deadlines for resolving the more serious deficiencies (Annex III). Officials explained that the weaknesses in the national accounts data related mainly to the quarterly figures, and noted that this was due to the use of partial survey data for household spending and business investment, rather than the more comprehensive surveys that were available at an annual frequency. The authorities were taking steps to remedy these deficiencies, by broadening coverage of the household survey and making improvements to seasonal adjustment methodology.

46. **The authorities indicated their strong commitment to multilateral trade liberalization in the WTO framework**. They assessed that the benefits for Japan lay not only in improving industrial competitiveness, but also in promoting regulatory reform. In their view, the new trade round should adopt a comprehensive approach, including the liberalization of customs, investment, and services. At the same time, they cautioned that due consideration be given to the economic cost of anti-dumping measures. In response to the staff's calls for further liberalization of trade in agricultural products, the authorities reiterated familiar concerns related to food security, while stressing that significant liberalization had already taken place over an extended period.[18] Along with other members of the Quad group, Japan has proposed to improve duty-free access of least-developed country exports to their domestic markets."

47. **The mission welcomed the authorities' recent efforts to increase ODA, which rebounded strongly in 1998–99**. Japan remains the largest provider of ODA, and this level rose to 0.35 percent of GDP in 1999, largely as a result of increased support to Asian countries in the context of the new Miyazawa Initiative. Moreover, Japan ranks very highly—second only to Luxembourg based on 1998 data—in terms of the proportion of *untied* bilateral ODA grants and loans. The mission also welcomed Japan's commitment to provide full debt relief to the HIPC in line with the Cologne Summit agreement. It encouraged the authorities to maintain Japan's high level of ODA, as well as greater efforts to augment resources for least developed countries and for social objectives.

V. Staff Appraisal

48. **The macroeconomic policy support and structural reforms implemented over the past 2½ years have helped to bring about the economic recovery that finally appears to be underway in Japan, but the recent pickup remains fragile and subject to downside risks.** While the GDP data have moved erratically since the end of 1998, the picture from a variety of other indicators is that of a moderate economic recovery. However, while business investment has turned around, the lynchpin of a sustained economic recovery—a durable rise in household incomes and spending—does not yet appear to be in place. Moreover, while the reallocation of capital and labor to more productive activities is now under way, uncertainties

[18] For example, the self-sufficiency rate on grain products has fallen from 82 percent in 1960 to 28 percent in 1997.

related to the process of corporate restructuring will continue to pose risks to the outlook for some time to come.

49. **While it is essential to maintain supportive macroeconomic policies until the recovery becomes more robust and assured, it is equally important to develop a credible medium-term fiscal consolidation strategy and to persevere with structural reforms**. An early move to firm the stance of macroeconomic policies would not materially advance corporate restructuring, but would pose significant risks for the course of the recovery. Rather, to promote economic restructuring, the authorities should firmly apply the improved regulatory framework to ensure that a strong banking system and developing capital markets exert appropriate discipline on firms, while continuing to remove tax and other impediments to corporate reorganization and accelerating efforts to promote competition and deregulation on a broad front.

50. **Fiscal policy remains critical to stabilizing the economy**. Recent experience in Japan clearly illustrates the risks for growth—and ultimately public sector debt dynamics—of implementing fiscal consolidation prematurely, not least because without growth, policies aimed at advancing consolidation are not sustainable. To cushion the expected withdrawal of fiscal stimulus in the latter part of FY2000 and FY2001, a significant supplementary budget will need to be implemented in a timely fashion.

51. **Initiating a public process to obtain consensus on a credible strategy for eventual fiscal consolidation would help to raise confidence in long-term growth prospects and reduce the risks of volatile financial market conditions.** Such a strategy would lower the deficit gradually over a 5–10 year period, and would be responsive to the evolution of the economy rather than follow a predetermined adjustment path over a set period. The aim would be to stabilize and eventually reduce the general government net debt to GDP ratio. The plan would include a substantial scaling back of public works spending, while revenue increases would be secured through a broadening of the personal income tax base and a rise in the consumption tax rate.

52. **Progress with a number of structural fiscal reforms would help lay the groundwork for such a strategy**:

- *Public works and FILP reform*. To improve the quality of public works spending, further efforts are needed to apply cost-benefit analysis for project selection, improve the efficiency of bidding and procurement procedures, and accelerate private sector involvement in infrastructure provision. In the context of any forthcoming supplementary budget, new spending should be directed at areas earning higher rates of return. FILP agencies should be required to rely to the greatest possible extent on market financing of their operations, with strictly limited use of government guarantees.

- *Tax reform*. Early introduction of taxpayer identification numbers would help to improve tax administration and set the stage for eventual measures to broaden the personal income tax base. In addition, there is a pressing need for reforms that would

secure a more stable revenue source for local authorities. Tax reforms are also needed to foster corporate restructuring, as discussed below.

- *Social security reform*. While significant progress has been made in improving the solvency of the public pension system, a commensurate effort is still needed to put the public health care system on a sound financial footing. Early passage of the medical reform bill would provide an important first step. Over the medium term, further cuts in lifetime pension benefits and increases in the retirement age are likely to be needed to stem the rise in contribution rates over the next few decades.

- *Fiscal transparency*. A strong effort is needed to upgrade fiscal transparency to improve public understanding and provide a stronger basis for the assessment of the macroeconomic implications of fiscal policy. The most pressing objectives would seem to be publication of more timely consolidated fiscal data and rolling multiyear projections of the main fiscal aggregates on a current services basis.

53. **In the staff's view, the conditions for abandoning the zero interest rate policy are not nearly in hand**. A range of indicators suggest that a still significant degree of economic slack remains in Japan, with the prospect that deflationary pressures are likely to persist for some time. While the assessment of the degree of slack is an uncertain exercise in current circumstances, the potential costs of a premature tightening that could push the economy back into recession outweigh the risks of waiting too long to move to a less accommodative stance. Indeed, a tightening of the policy stance should wait until a broad-based recovery of private demand has been secured and a sustained period of above-potential growth has significantly narrowed the output gap. Moreover, timely action would be needed to provide further monetary stimulus in the face of events that could undercut the recovery, including upward pressures on the yen unjustified by the strength of the economy or a sharp recession in the United States.

54. **While regular publication of the BoJ monthly report and minutes of the meetings of the Monetary Policy Board are welcome, greater transparency about the policy framework would further enhance the effectiveness of monetary policy**. In view of the current exceptional circumstances and lack of a track record of decision-making by the Policy Board, communication to markets about the BoJ's economic projections and policy intentions is critically important, since any uncertainty could have an adverse impact on term premia and contribute to macroeconomic volatility and deflationary expectations more generally. Particular care will be needed in handling an initial move to positive interest rates, as this could be misread by markets and compromise the still fragile recovery. Early adoption of an inflation targeting framework, including identification of the price goal and regular publication of the BoJ's inflation forecast, would help to limit such risks and to shield the BoJ from possible criticism that bold measures in support of the target compromised its independence.

55. **A premature appreciation of the yen not justified by improving fundamentals remains a concern**. While the yen is broadly aligned with medium-term fundamentals at present, its current value is not helpful from a cyclical perspective, and a further significant

rise would risk undercutting the fragile recovery. Recent experience suggests that sterilized intervention may be partially effective in securing the authorities' exchange rate objectives, although a substantial and lasting impact is likely to depend on a supportive monetary policy.

56. **Important progress has been made over the past two years in strengthening major banks' balance sheets and allaying concerns about financial instability, but much remains to be accomplished to ensure the soundness of the financial system and allow a smooth transition to limited deposit insurance in April 2002:**

- While the four mergers among major banks that have been announced since August 1999 hold the promise of accelerating the pace of restructuring, their plans to increase core profitability do not seem sufficiently ambitious to achieve internationally comparable returns on equity. The authorities should encourage major banks to further strengthen their earnings base, through reviews of banks' restructuring plans and regulatory pressure.

- While the regional banks have succeeded in raising capital over the past year, a number still have capital adequacy below 8 percent and little progress has been made in addressing problems in credit cooperatives. In the period ahead, the authorities should be rigorous in using the regulatory framework to intervene in insolvent institutions, encourage the absorption of weak institutions by stronger ones, and use targeted public capital injections to catalyze meaningful restructuring without jeopardizing credit supply in local areas.

- Application of the strengthened regulatory and supervisory framework has helped to significantly improve bad loan recognition, but sustained supervisory pressure will be needed to ensure full recognition and provisioning against impaired assets. More stringent capital requirements—including a gradual increase in the minimum capital adequacy ratio to 8 percent for all deposit-taking institutions, including those with domestic operations only, and limitations on the use of deferred tax assets, would help to ensure that financial institutions have a reasonable buffer to absorb adverse shocks. To allow the new Financial Services Agency to fulfill its mandate, its supervisory resources must continue to be increased.

- Further postponement of the deadline for the reintroduction of partial deposit insurance would seriously undermine incentives for restructuring. The new procedures in the recently-enacted deposit insurance reform legislation are welcome, although their effectiveness will depend on early intervention, flexible application to maximize value, and making uninsured creditors as well as shareholders of failing institutions bear appropriate losses.

- The new framework for dealing with weaknesses in the life insurance sector should be firmly implemented in order to secure a durable improvement in the underlying net worth of life insurers.

- Leveling the playing field between the Postal Savings System and private banks in competing for funds would tend to reduce over time the role of the public sector in financial intermediation, as well as provide a conducive environment for banks to raise their core profitability.

57. **Recent structural reforms have improved the environment for corporate restructuring, but the momentum for such reforms needs to be maintained to secure the basis for sustained market-led growth.**

- *The framework for corporate restructuring* should be further enhanced by the early introduction of consolidated corporate taxation, the flexible implementation of the new Chapter 11-style bankruptcy legislation, and the establishment of more permanent and broadly-available incentives for restructuring, building on the Industrial Revitalization Law.

- *Labor mobility* should be improved by introducing portable defined-contribution pension schemes, and further expanding worker retraining programs to ease transitional costs on workers.

- *Corporate governance* should be enhanced by rigorously implementing the new accounting standards, requiring pension fund trustees to maximize returns on assets, and strengthening the role of external auditors and directors on corporate boards.

- *Further regulatory reform* is needed, including follow through on the intention to shift the basis of regulation from prior administrative approval to retroactive assessment of compliance with clear rules. A broad reduction of barriers to entry in the telecommunications sector, including a lowering of network access charges, would help set the stage for an expansion of the "knowledge-based economy."

58. **Continuing weaknesses in economic statistics, especially in national accounts and fiscal data, complicate the monitoring of developments and the formulation of macroeconomic policies**. Further efforts are needed to publish more timely, comprehensive, and accurate estimates of quarterly GDP. For fiscal data, the priorities are to improve consolidation, valuation methods, and timeliness.

59. **Japan remains the world's largest provider of ODA, and efforts to increase ODA further in 1999 have been welcome**. Initiatives taken over the past year to provide financial support to Asian countries, despite Japan's own economic difficulties, have played an effective role in supporting the strong economic recovery in the region. Japan's debt relief to the HIPCs will also play an important role in international efforts to alleviate poverty.

60. **It is proposed that the next Article IV consultation with Japan take place on the standard 12-month consultation cycle.**

Table 1. Japan: Selected Economic Indicators, 1993-2001

Nominal GDP: US$4,347 billion (1999)
Population: 126.6 million (1999)
GDP per capita: US$34,334 (1999)
Quota: SDR 8,241.5 million

	1993	1994	1995	1996	1997	1998	1999	Staff Projection 2000	Staff Projection 2001
Growth (percent change)									
Real GDP	0.3	0.6	1.5	5.0	1.6	-2.5	0.2	1.4	1.8
Domestic demand	0.1	1.0	2.3	5.7	0.2	-3.1	0.5	1.0	2.2
Private consumption	1.2	1.9	2.1	2.9	0.5	-0.5	1.2	0.6	1.2
Residential investment	2.4	8.5	-6.5	13.6	-16.2	-14.4	1.4	3.7	5.6
Business investment	-10.2	-5.3	5.2	11.3	9.0	-7.6	-5.9	6.2	8.5
Government consumption	2.4	2.4	3.3	1.9	1.5	1.5	1.3	1.3	1.8
Government investment	15.7	2.8	0.6	9.2	-10.4	-3.0	7.8	-9.8	-9.2
Stockbuilding 1/	-0.1	-0.2	0.2	0.4	0.1	-0.6	0.1	0.1	0.3
Net exports 1/	0.2	-0.3	-0.8	-0.5	1.4	0.5	-0.3	0.5	-0.3
Exports of goods and services	1.3	4.6	5.4	6.3	11.6	-2.5	1.9	9.3	3.2
Imports of goods and services	-0.3	8.9	14.2	11.9	0.5	-7.6	5.3	6.8	6.1
Saving-Investment (percent of GDP)									
Gross national saving	32.7	31.5	30.7	31.5	31.4	29.9	28.6	29.0	29.1
Gross domestic investment	29.7	28.7	28.6	30.0	29.1	26.7	26.1	26.2	26.6
Inflation (percent change)									
CPI	1.2	0.7	-0.1	0.1	1.7	0.6	-0.3	-0.2	0.5
GDP deflator	0.6	0.2	-0.6	-1.4	0.3	0.3	-0.9	-1.1	0.4
Unemployment rate (percent)	2.5	2.9	3.1	3.3	3.4	4.1	4.7	5.0	5.3
Government (percent of GDP)									
General government									
Revenue (percent change)	-2.5	0.8	0.7	2.4	1.6	-2.1	-3.5	1.6	2.2
Expenditure (percent change)	7.0	2.9	4.6	4.2	-0.9	1.6	4.4	3.4	-2.7
Balance	-1.6	-2.3	-3.6	-4.2	-3.3	-4.7	-7.4	-8.2	-6.3
Balance excluding social security	-4.8	-5.1	-6.5	-6.8	-5.9	-6.8	-9.2	-9.5	-7.3
Structural balance 2/	-1.5	-1.8	-3.1	-4.7	-3.7	-3.4	-5.4	-5.3	-4.9
Money and credit (percent change, end-period)									
M2 plus CDs	1.4	2.9	3.2	2.9	3.8	3.9	2.6	1.9 4/	...
Broad liquidity	2.9	3.7	4.1	3.5	3.3	3.1	2.4	2.9 4/	...
Domestic credit	0.8	-0.4	1.8	1.4	1.3	2.6	2.9	4.4 5/	...
Bank lending	0.5	-0.2	2.1	-0.4	0.0	-4.7	-5.9	-4.6 4/	...
Interest rate									
Three-month CD rate (annual average)	2.8	2.1	1.1	0.5	0.5	0.6	0.1	0.04 4/	...
Official discount rate (end-period)	1.8	1.8	0.5	0.5	0.5	0.5	0.5	0.5 4/	...
Balance of payments (in billions of US$)									
Exports, f.o.b.	352.9	386.0	429.4	400.2	409.2	374.4	403.9	451.5	475.8
Imports, f.o.b.	213.3	241.5	297.2	316.7	307.8	251.6	280.5	332.7	358.3
Current account balance	132.0	130.6	111.4	65.8	94.1	121.0	106.8	116.9	109.7
Percent of GDP	3.1	2.8	2.2	1.4	2.2	3.2	2.5	2.5	2.3
Terms of trade (percent change)	10.4	7.1	0.5	-6.9	-3.9	6.7	4.7	-12.0	-0.8
Change in reserves	27.7	25.4	58.7	36.8	6.9	-7.4	77.3	...	...
Total reserves minus gold (in billions of US$)	98.5	125.9	183.2	216.6	219.6	215.5	286.9	337.9 4/	...
Exchange rates (annual average)									
Yen/dollar rate	111.2	102.2	94.1	108.8	121.0	130.9	113.9	107.4 6/	...
Real effective exchange rate 3/	134.9	143.5	149.5	126.7	117.7	107.3	119.8	129.5 4/	...

Sources: Nikkei Telecom; and staff estimates and projections as of July 12, 2000.

1/ Contribution to GDP growth.
2/ Including social security, excluding bank support.
3/ Based on normalized unit labor costs; 1990=100.
4/ June 2000.
5/ April 2000.
6/ July 12, 2000.

Table 2. Japan: General Government Operations

(In percent of GDP)

	FY1998	FY1999 Est.	FY2000 Proj.	FY2001 Proj.	CY1998	CY1999 Est.	CY2000 Proj.	CY2001 Proj.
General government balance	-5.6	-7.6	-7.7	-6.0	-4.7	-7.4	-8.2	-6.3
Excluding social security	-7.6	-9.3	-8.8	-6.9	-6.8	-9.2	-9.4	-7.3
Of which:								
Taxes and fines	17.9	16.9	17.4	17.4	17.8	16.9	17.3	17.4
Consumption	10.2	10.3	10.4	10.1	10.2	10.3	10.3	10.3
Investment	6.0	5.7	5.5	4.8	5.8	6.1	5.5	4.9
Support for banks	0.2	0.7	0.8	0.0	0.0	0.3	1.4	0.1
Change in structural balance (Including social security, excluding support for banks)	-0.7	-1.2	-0.3	0.6	0.3	-2.0	0.1	0.4
Impact on aggregate demand	0.0	0.4	0.3	-0.8	-0.6	1.1	-0.2	-0.6

Source: Staff estimates, based on the following assumptions:

Growth : Real GDP growth is projected to be 1.5 percent in CY2000. Each percentage point increase in growth raises the general government balance by about 0.3 percentage points of GDP.

Stimulus Packages : The projections take account of the FY1999 supplementary budgets and the FY2000 initial budget. The ¥18 trillion stimulus package announced in November 1999 includes additional public investment of ¥6.8 trillion (headline figure) through FY2000, most of which would take place in the first two quarters of FY2000. Local governments are projected to largely offset their share in the stimulus package with cuts in own-account expenditures elsewhere. A "typical" supplementary budget of ¥1 trillion is included in the calculations for FY2000.

Support for Banks : Under Japanese fiscal accounting, the budgetary impact of capital made available to the DIC for dealing with bank closures occurs at the time the money is spent. In addition to the funds spent in 1998-99 to resolve the failures of Hokkaido Takushoku, LTCB, and a number of regional banks, it is assumed that unwinding the nationalization of NCB and other smaller banks will require DIC funds of ¥4 trillion in FY2000.

Impact of Aggregate Demand : These calculations assume that changes in the structural component of taxes and transfers have an elasticity of ½ while changes in consumption and investment spending have an elasticity of 1.2. Interest tax revenue on maturing postal saving deposits (estimated at roughly ¥3.5 trillion in both FY2000 and FY2001) is assumed to have zero elasticity. Net lending and capital transfers, including land acquisition and depositor protection, have a multiplier of zero. The calculations include the impact of changes in the social security balance and changes in public enterprise investment.

Table 3. Japan: Indicators of External and Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1995	1996	1997	1998	1999
External indicators					
Real exports of goods and services (percent change)	5.4	6.3	11.6	-2.5	1.9
Real imports of goods and services (percent change)	14.2	11.9	0.5	-7.6	5.3
Terms of trade (percent change)	0.5	-6.9	-3.9	6.7	4.7
Current account balance	2.2	1.4	2.2	3.2	2.5
Capital and financial account balance	-1.3	-0.6	-2.9	-3.2	-1.0
Of which :					
Inward portfolio investment	-1.7	-2.5	-1.7	-3.0	-3.9
Inward direct investment	-0.4	-0.5	-0.6	-0.6	-0.5
Other investment liabilities (net)	-0.1	0.8	-2.9	-1.4	0.1
Official reserves (US$ billion)	182.8	217.9	220.8	215.9	288.1
In months of imports of goods and services	5.4	6.0	6.4	7.4	9.1
Broad money (M2 + CDs) to reserves ratio	3.1	2.3	2.1	2.1	1.9
Foreign assets of DMBs (US$ billion)	1169.5	960.7	1064.0	833.2	682.5
Foreign liabilities of DMBs (US$ billion)	803.0	736.0	762.5	612.5	478.8
Net international investment position (US$ billion)	817.6	891.0	958.7	1153.6	1260.6
Of which :					
External loan liabilities	1039.3	950.1	969.9	805.9	708.9
External public sector debt (gross) 1/	161.0	156.0	216.6	217.6	208.3
External loan liabilities to exports ratio	2.2	2.1	2.1	1.9	1.6
External interest payments to exports (in percent) 2/	25.7	8.3	7.4	7.1	4.5
Nominal effective exchange rate (percent change)	6.7	-12.7	-4.2	0.3	15.2
Financial market indicators					
General government gross debt	89.7	94.4	99.2	114.2	125.6
Interest rates (percent)					
3-month Gensaki rate	0.23	0.25	0.23	0.14	0.07
3-month Gensaki rate, real	0.32	0.12	-1.47	-0.51	0.40
3-month interest rate spread vis-à-vis U.S.	-5.29	-4.78	-4.84	-4.68	-4.59
Stock market index (TOPIX, percent change, end-year)	1.2	-6.8	-20.1	-7.5	58.4
Banking sector risk indicators					
Total loans to assets (in percent)	53.3	52.8	51.4	49.9	48.1
Total loans to deposits (in percent)	108.6	107.6	106.8	105.4	100.1
Share of real estate sector in total lending (in percent)	13.6	13.7	14.0	14.2	14.5
Share of non-performing loans in total loans (in percent, end-fiscal year) 3/ 4/	6.6	4.9	5.5	8.5	7.8
Risk-weighted capital ratio (in percent, end-fiscal year) 4/	9.1	9.0	9.5	11.6	11.8

Sources: Nikkei Telecom; WEFA; IMF, International Financial Statistics; Fitch IBCA; and staff estimates.

1/ Public sector debt securities and other loan liabilities.
2/ Other investment income, debit.
3/ The definition of non-performing loans was broadened in FY97 and again in FY98.
4/ Major banks.

JAPAN—FUND RELATIONS
(As of June 30, 2000)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	13,312.80	100.0
Fund holdings of currency	9,259.40	69.6
Reserve position in Fund	4,053.64	30.4
Operational budget transfers (net)	-31.00	

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	891.69	100.0
Holdings	1,869.40	209.6

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

Japan maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions maintained against Iraq and Libya, pursuant to UN Security Council Resolutions 661 and 748. These restrictions were notified to the Fund (EBD/90/261) in accordance with Executive Board Decision No. 144-(52/51). Restrictions against former members of the Federal Republic of Yugoslavia (Serbia/Montenegro) have been lifted.

VIII. **Article IV Consultation**:

The Executive Board discussed the Staff Report for the 1999 Article IV Consultation (SM/99/165) and concluded the consultation on August 4, 1999. In the Summing Up, Directors endorsed the Government's evolving economic strategy, which was giving increasing emphasis to promoting restructuring efforts while maintaining vital macroeconomic support. Notwithstanding the longer-term need for fiscal consolidation, most Directors suggested that a supportive fiscal stance be maintained until a recovery in private demand was well in hand. Directors commended the Bank of Japan's commitment to maintaining the zero interest rate policy until deflationary concerns were dispelled.

Sensitivity of Fiscal Consolidation Requirements to Changes in Growth and Interest Rates

This annex presents a sensitivity analysis of the amount of fiscal adjustment required to achieve debt stabilization. For given growth and interest rate assumptions, the primary deficit necessary to stabilize the debt-to-GDP ratio in the year t is given by the following formula:

$$b_t^p = (r_t - g_t)/(1+g_t)\ d_t$$

where b^p is the target for the primary balance in percent of GDP, d is the steady-state debt-to-GDP ratio, and r and g are the steady-state values for the nominal interest rate paid on government debt and the nominal growth rate, respectively. The amount of fiscal measures necessary to stabilize the debt-to-GDP ratio (the "required adjustment") can then be calculated as the difference between the value of b^p and the current cyclically-adjusted primary balance (estimated at -4½ percent of GDP in FY2000). The purpose of this note is to determine how this required adjustment changes under different assumptions for r and g, based on a simulation of the debt path over the next decade.

As discussed in Box 1, the appropriate proxies for b^p and d are the net debt and primary balance for the general government *excluding social security*, respectively. The interest paid on government debt is an implied interest rate that reflects past debt contracted at different maturities and interest rates. As interest rates have generally been declining in recent years, the current value of r is higher (at roughly 3½ percent) than the current yield on 10-year JGBs (1¾ percent). With an average debt maturity of about 5-6 years, future changes in JGB yields will affect the average interest rate only gradually—a fact that is taken into account in the following calculations.

The results of the sensitivity analysis are presented in the table below. The table shows the required fiscal adjustment (in terms of reduction in the structural primary deficit) to achieve debt stabilization by 2010, given combinations of real growth rates and real JGB yields in that year.[1] For simplicity, it is assumed that growth and interest rates on new debt increase in a linear fashion to their steady-state values by 2005, while the adjustment in the structural balance is assumed to be linear over the full 10-year period, except for FY2001 when large support measures for failed banks expire.[2]

The results highlight the importance of growth for fiscal consolidation. The staff's current baseline forecast corresponds to the scenario in which growth converges to a medium-term

[1] Inflation is assumed to be flat at 1 percent a year throughout.

[2] Variations in the paths of interest rates and growth towards their endpoints have only small effects on the required adjustment.

potential of about 2 percent, and real JGB yields rise to 3½ percent by 2005. In this case, fiscal adjustment of 5½ percent of GDP—sufficient to generate a structural primary surplus of 1 percent of GDP—would stabilize net debt (excluding social security assets) at 118 percent of GDP, compared to an estimated 97 percent of GDP in 2000 (Annex Table 1). The required fiscal adjustment would be 1¼ percent of GDP smaller, however, were the potential growth rate to increase to 3 percent, and it would be higher by the same amount if the growth rate fell to 1 percent. Variations in JGB yields also change the required fiscal adjustment. For example, if real interest rates remained at present levels of around 2 percent, the required adjustment would be 1 percent of GDP smaller than in the baseline scenario.

Finally, what would be the payoff for public debt of faster consolidation? A simulation using the same underlying growth and interest rate path as in the WEO scenario—an admittedly implausible assumption given the short-term impact of consolidation on growth—suggests that to stabilize the net debt ratio by 2005, the required improvement in the structural primary balance would be 5 percent of GDP over 5 years, compared to the WEO baseline of 5½ percent of GDP over 10 years. Faster adjustment would also result in a lower (stable) net debt ratio of 108 percent of GDP.

Adjustment in Primary Structural Balance of General Government (Excluding Social Security) Needed to Achieve Debt Stabilization by 2010

(In percent of GDP)

		Steady-state real JGB yield				
		2.0	3.0	3.5	4.0	5.0
Steady-	0.5	6.5	7.2	7.5	7.8	8.5
State	1	5.9	6.5	6.8	7.2	7.8
Real	2	4.6	5.3	**5.6**	6.0	6.6
GDP growth	3	3.5	4.2	4.5	4.8	5.4
Rate	4	2.5	3.1	3.4	3.7	4.3

Source: Staff calculations.

Note: Table shows fiscal adjustment required by FY2010 under a gradual consolidation process, starting from a structural primary deficit of 4.6 percent of GDP in FY2000. GDP growth and JGB yields are assumed to increase linearly to their steady-state values by 2005 and remain constant for the remainder of the projection period.

Annex Table 1. Japan: Baseline Scenario for Medium-Term Debt Consolidation

General government excluding social security	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
					(in trillions of yen)						
Balance	-44.2	-36.5	-35.2	-33.9	-32.8	-31.9	-30.7	-29.3	-27.6	-25.6	-23.4
Primary	-28.3	-20.2	-17.9	-15.4	-12.8	-10.0	-7.1	-3.9	-0.6	2.9	6.7
Net interest payments	-15.9	-16.3	-17.3	-18.5	-20.0	-21.8	-23.6	-25.3	-27.0	-28.6	-30.1
Debt	484.8	521.3	556.4	590.4	623.2	655.1	685.7	715.0	742.6	768.3	791.6
					(in percent of GDP)						
Balance	-8.9	-7.1	-6.7	-6.3	-5.9	-5.5	-5.2	-4.8	-4.4	-4.0	-3.5
Primary	-5.7	-3.9	-3.4	-2.8	-2.3	-1.7	-1.2	-0.6	-0.1	0.5	1.0
Net interest payments	-3.2	-3.2	-3.3	-3.4	-3.6	-3.8	-4.0	-4.1	-4.3	-4.4	-4.5
Structural balance	-7.8	-6.3	-6.0	-5.8	-5.6	-5.5	-5.2	-4.8	-4.4	-4.0	-3.5
Structural primary balance	-4.6	-3.1	-2.7	-2.4	-2.0	-1.7	-1.2	-0.6	-0.1	0.5	1.0
Net debt (ex. soc. sec.)	97.2	101.7	105.6	108.8	111.6	113.9	115.7	117.1	118.1	118.6	118.6
Memorandum items:					(in percent)						
Implied interest rate	3.5	3.3	3.3	3.3	3.4	3.5	3.6	3.7	3.8	3.8	3.9
JGB yield	1.8	2.3	2.9	3.4	4.0	4.5	4.5	4.5	4.5	4.5	4.5
In real terms	2.0	1.3	1.9	2.4	3.0	3.5	3.5	3.5	3.5	3.5	3.5
Nominal GDP growth	1.1	2.8	2.8	2.9	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Real growth	1.7	1.8	1.8	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Deflator	-0.6	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Nominal GDP (Y trn)	498.7	512.6	527.1	542.4	558.5	575.3	592.7	610.6	629.0	648.0	667.6

Source: Staff calculations.

JAPAN—DATA ISSUES

1. Japan has subscribed to the Special Data Dissemination Standard (SDDS).

2. **National accounts**

The Economic Planning Agency (EPA) published in March 2000 a paper on the methodology used to calculate quarterly national accounts (an English version will be available shortly). The EPA is currently improving national accounts statistics to the SNA93 standard, revising the benchmark year to 1995, and making efforts to improve seasonal adjustment. The EPA recently established a committee to study possible improvements to GDP data, which will review the experience with releasing flash estimates, examine seasonal adjustment methods, and consider how to better record spending on computer software in investment data and spending by single-person households in consumption data. The EPA and the Management and Coordination Agency recently established a working group to study possible improvements to the household survey. Remaining issues include:

- Preliminary estimates of Japan's quarterly GDP data are released by the EPA about 2½ months following the end of the relevant quarter—similar to many industrial countries, but slower than the U.S., U.K. and that planned for the E.U.[1] More complete annual national accounts data are only available with a lag of about one year, severely limiting their usefulness for current analysis.[2]

- The publication date for the preliminary estimates of quarterly GDP is set only one week in advance of the data release. In turn, this reflects the lack of fixed publication dates for the major underlying data.

- The GDP data on some key components of demand are available only with the release of the annual data, including the breakdown of trade flows into goods and services, of business investment into structures and equipment, and of private consumption into durables and nondurables.

- There are no preliminary estimates for the income side of the national income accounts (with the exception of household employment income). This is in part because estimates for profits are based on an imputed quarterly pattern for annual data.

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[1] The EPA has started releasing "flash" estimates at the same time as the preliminary estimates, so the public can be made aware of the differences in results.

[2] The annual data are available in hard copy and electronically (on the internet) after a delay of about nine months; however, the Annual Report on National Accounts, which contains the comprehensive data together with detailed references, is published with a lag of about one year.

- The procedures used to seasonally adjust the quarterly GDP data do not fully account for leap year, trading-day, and other shift factors. This problem has contributed to sharp swings in quarterly GDP growth in recent quarters.

- The EPA relies on other agencies and organizations to compile the underlying source data used to construct the national accounts, and it faces coordination problems with data providers in influencing the design of surveys and administrative collections to serve national accounts purposes.

3. **Fiscal**

- Fiscal accounts typically distinguish between general (or ordinary) accounts for core government functions, and special accounts, some of which are partly financed through borrowing from the FILP. Information on the central government general account is readily available, but published consolidated accounts—which incorporate special accounts—are insufficient to calculate a consolidated deficit as borrowing is included in revenues.

- There exist more than 3,000 independent prefectures and municipalities, the finances of which are only partly consolidated with a delay of about two years.

- Data on general government operations—including disaggregation by major government sector—are available only with the release of the annual national accounts data, implying a lag of up to 15 months in assessing overall government operations.[3]

- Public assets and liabilities are reported based on their book values, which may be significantly different from market values. Although the Ministry of Finance has begun work on a consolidated balance sheet for the central government and some affiliated agencies, including an assessment of contingent liabilities (which is expected to be completed this autumn), a full assessment of the public sector's net worth (including the FILP) is still outstanding.

- The authorities have not reported any fiscal data for publication in the *GFS Yearbook* since 1994. Thus, the 1999 edition of the *GFS Yearbook* include data for the consolidated central government and local governments through 1993 and 1989, respectively.

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[3] Comprehensive fiscal data of the general government sector are particularly important in Japan, given the importance of special accounts, local government operations, the Fiscal Investment Loan Program, and other items that are not included in the general account of the central government.

4. **External trade**

- While monthly data on merchandise trade and the balance of payments are released on a timely basis, there is no predetermined schedule for their release.

5. **Household spending and labor market activity**

- The definition of employment and labor force participation in the labor force survey differ from standardized OECD definitions, which may lead to an understatement of the unemployment rate.

- Concerns about the quality of survey data on household consumption spending, reflecting declining response rates and possible sampling biases, have increased over the past year.

6. **Monetary and financial sector**

- The data on monetary and credit aggregates are generally satisfactory, although Japan has chosen to make use of the "extensive branch banking network" flexibility of the DDS and will continue to disseminate banking sector data with a 5–6 week timeliness rather than the 4 weeks called for by the Standard.

- The need to improve disclosure of asset quality and balance sheet data for financial institutions is discussed in the main text.

7. **Recommendations for data improvements**

- improving the timeliness and periodicity of the fiscal data (particularly given the importance of monitoring fiscal consolidation efforts on a comprehensive basis);

- publishing more timely estimates of quarterly GDP data;

- providing greater detail on the quarterly components of spending and national income;

- setting fixed release dates, including for key inputs into the national accounts, the national accounts, and external trade;

- improving the seasonal adjustment of the national accounts and other important economic data;

- bringing Japan's definition of labor market activity into line with OECD standardized definitions;

- moving Japan's data production to a single, independent agency staffed with professional statisticians.

Japan: Core Statistical Indicators

(As of June 30, 2000)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of latest observation	6/30/00	5/00	5/00	6/20/00	5/00	6/30/00	5/00	5/00	4/00	1998	2000:Q1	End-1999
Date received	6/30/00	6/00	6/00	6/20/00	6/00	6/30/00	6/00	6/00	5/00	2/00	6/00	5/00
Frequency of Data	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A
Frequency of Reporting	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A
Source of data	C	C	C	C	C	C	C	C	C	C	C	C
Mode of Reporting	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality	Unre-stricted	Unre-stricted	Unre-Stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted
Frequency of publication	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A

Statement by the IMF Staff Representative
August 4, 2000

1. **This statement provides an update of information that has become available since the release of the staff report** (SM/00/164, 7/13/00). It covers recent monthly data, the Sogo bankruptcy, monetary policy developments, financial market developments, and fiscal policy plans. This information does not alter the thrust of the staff appraisal.

2. **Recent data are consistent with the staff's view that the recovery remains fragile and subject to downside risks**. While monthly household expenditure data are generally consistent with a slight rise in private consumption in the second quarter, a firm uptrend has yet to be established. The unemployment rate remains high—with an uptick to 4.7 percent in June—and survey results suggest that summer 2000 bonuses (which are typically paid in June and July) were 1–2 percent lower than in 1999, although data for June show a small year-on-year increase. The June *Tankan* survey showed continued improvements in business confidence, but it also confirmed corporate perceptions of significant excess capacity and ongoing deflation, and recent indicators—including declines in capital goods production and shipments in the second quarter—underscore the potential for a slowdown in business investment. Private domestic demand may also be affected by the sharp drop in equity prices since the Sogo bankruptcy in mid-July (see below). On the supply side, industrial production grew by about 1½ percent in the second quarter, while the all-industry index (the closest supply-side proxy of GDP) was roughly unchanged in both April and May. On balance, these data are consistent with the staff's current forecast for real GDP growth in calendar 2000 of 1.4 percent, which is in line with the consensus. The consumer price index posted a year-on-year decline of 0.7 percent in June (in line with previous months) while the core CPI, which excludes perishable food and energy, fell by 0.4 percent year-on-year.

3. **Sogo, a large department store chain, filed for court-led rehabilitation under the new Civil Rehabilitation Law on July 12**. Group debt amounts to ¥1.87 trillion, the largest ever for a nonfinancial firm filing for bankruptcy. This action follows the withdrawal of political support for a restructuring plan that included ¥97 billion ($900 million) in debt forgiveness by the government. Sogo's debt forgiveness plan required government approval because, under the terms of a loss-sharing agreement between the government and the now foreign-owned Shinsei Bank (formerly LTCB), the latter decided to sell its claims on Sogo to the Deposit Insurance Corporation. Initially, the government had supported the rescue plan, as had all 70 creditors that had been asked for debt forgiveness by Sogo. However, the public outcry against what was perceived as the bailing out of a mismanaged retailer (that had made poor real estate investments) eventually prompted Sogo to withdraw its request for debt forgiveness and to file instead for court-led rehabilitation. Sogo's bankruptcy will probably force creditors, including the government, to recognize significant losses up front, although major banks are believed to be largely covered by existing provisions. The end-result should be a stronger, more credible restructuring plan.

4. **At its last meeting on July 17, the Monetary Policy Board of the Bank of Japan (BOJ) decided to maintain the zero interest rate policy (ZIRP)**. In an unusual step, however, it issued a statement saying that, while the majority of the Policy Board thought that the economy was coming to the stage where deflationary pressures were dispelled (which was the condition for lifting the ZIRP), some members felt it was desirable to await further evidence on the firmness of the recovery, as well as to see how the Sogo bankruptcy would affect market developments and business sentiment. The next meeting of the Policy Board is on August 11.

5. **Since mid-July, the Nikkei stock market index has declined by over 7 percent to about 16,000, led by wholesale, retail, and bank stocks**. Following the Sogo episode, the decline seems to reflect in part concerns about a pickup in corporate failures among other heavily-indebted companies, and the resulting impact on banks. The yen has weakened to about ¥109/$, a depreciation of about 2 percent since mid-July, and somewhat less in nominal effective terms. The three-month interbank rate and the yield on the benchmark 10-year government bond are both roughly unchanged, at 0.3 percent and 1.7 percent, respectively.

6. **Recent monthly indicators confirm that local government financial constraints continue to undercut fiscal stimulus.** Monthly data indicate that about 40 percent of the public works spending in last November's supplementary budget had been executed by the end of the first quarter, suggesting that the drop in public investment in the national accounts in the first quarter was due more to lack of implementation at the local level than delays in executing the stimulus package itself. The authorities recently announced the release of a ¥500 billion (0.1 percent of GDP) contingency reserve from the FY2000 budget—mainly to boost public works—which is expected to have its largest effect in the third quarter of this year. In the spending guidelines for the FY2001 initial budget announced this week, the expenditure ceilings have been maintained at about the same level as in the initial FY2000 budget, although no contingency reserve for public works has been included. The outlook for public investment will also depend on the size of any possible supplementary budget—a decision on which is not expected before September.

7. **The Tax Commission, an advisory panel to the Prime Minister, recently published its report on medium-term tax reform issues**. Noting that Japan's income tax burden was smaller than that in other major industrial countries, the Commission cautioned against any further reduction in personal or corporate income tax rates, and noted that the high minimum threshold of taxable personal income in Japan should be reviewed. While not recommending an increase at this time, the Commission argued that, in view of the demographic changes underway, the consumption tax would likely become a more important source of revenue over the long term, given the need to provide a more stable revenue base and ensure a more equitable distribution of the tax burden across generations. To stabilize the tax revenue of local governments, the Commission stressed the importance of a broader base for the corporate income tax, such as a combination of profits, the wage bill, interest payments, and rent.

8. **Recently available results for the regional banks for the financial year ended March 2000 confirm that a number of them had capital adequacy ratios well below 8 percent of risk weighted assets**.[1] Specifically, 23 of the 55 second-tier regional banks had capital ratios below 8 percent, while 15 of these had capital ratios below 7 percent, and 4 had capital ratios below 6 percent. A number of first-tier regionals (8 out of 64) also had capital ratios below 8 percent, with five banks having capital ratios below 6 percent.

[1] In Japan, banks with exclusively domestic operations are required to observe a 4 percent minimum capital ratio.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/64
FOR IMMEDIATE RELEASE
August 11, 2000

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Japan

On August 4, 2000, the Executive Board concluded the Article IV consultation with JAPAN.[1]

Background

Japanese economic growth fell markedly during the 1990s in comparison to previous decades. The deterioration in performance reflected mainly a prolonged slump in business investment, as corporates began to unwind the excess capital stock created during the bubble years of the late 1980s. It also reflected slow adjustment to the ongoing process of globalization and technological change, as Japan lagged in shifting to innovation and productivity improvements (rather than capital accumulation and exports) as the main engines of growth. The volatility of output increased, reflecting in part stop-go fiscal policies, which gave rise to unprecedentedly sharp movements in public investment, and in addition wide swings in the value of the yen.

In 1997-98, Japan experienced the most severe recession of any major industrial country in the post-war period. The downturn was initiated by a sharp fall in household spending after the April 1997 consumption tax hike, cuts in public investment, and the closure of three financial institutions in late 1997. Business investment was particularly hard-hit, reflecting the sharp cuts in bank lending associated with the financial crisis and the strengthening of bank regulation. Household spending also fell, as the financial crisis undermined confidence and unemployment mounted. The Asia crisis compounded the recessionary momentum.

Economic growth, as shown in the national accounts, has been uneven over the past year and a half. In the first half of 1999, GDP expanded by 3½ percent (annual rate), driven by a rebound in confidence and fiscal stimulus measures. The economy contracted again in the second half of

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

1999, reflecting renewed weakness in private consumption and a sharp contraction in public investment, though business investment surged in the fourth quarter, as profitability recovered and sentiment improved. GDP figures for the first quarter of 2000 suggest growth of 10 percent at an annual rate, with strong contributions from private consumption, business investment, and net exports. However, the confluence of a number of temporary factors—including the delay in the end-1999 bonus payment, the leap-year effect, as well as the unwinding of the pre-Y2K buildup of import stocks—seems to have accounted for about half the first quarter rise of 2.4 percent. The recent pickup in activity appears heavily concentrated in "high-tech" sectors.

The current account surplus narrowed in 1999, mainly due to higher imports following the sharp contraction in the previous year, but widened again in the first quarter of 2000. Export volumes grew modestly in 1999 overall, dampened by the appreciation of the yen, although the strength of the Asian recovery has contributed to an uptrend since mid-1999. Import values rebounded strongly in 1999, however, reflecting not only the effect of higher oil prices, but also the impact on volumes of the pickup in domestic demand, and a pre-Y2K buildup of import stocks. In the first quarter of 2000, export volumes continued to improve, while imports fell back.

The recession-cum-stagnation in 1997–99 widened the output gap and continued to put downward pressure on wages and prices. While a deflationary spiral has been avoided, consumer price inflation declined to about zero for most of 1999 and has been slightly negative in 2000 to date (compared to an average 2½ percent annual increase in the core CPI in the 1980s), and the GDP deflator has been declining by 1–2 percent annually. The unevenness of the recovery—with certain sectors experiencing strong growth while others undergo restructuring—has implied a combination of rising overtime and job offers, while earnings have continued to be weak and unemployment has remained on an uptrend.

The yen and stock prices strengthened markedly through early 2000, but have weakened since. Notwithstanding significant intervention to weaken the yen in mid-1999, upward pressures persisted in the second half of 1999 and the yen reached a high of almost ¥100/dollar at year-end. The yen fell in early 2000, aided by further exchange market intervention, which—on this occasion—came amid growing perceptions of a widening gap between short-term economic prospects in the United States and Japan, and was therefore more effective. Equity prices surged between early 1999 and March 2000—due mainly to rises in "new Japan" (high-tech) stocks while "old Japan" (including banks) stocks languished. Equity markets have since fallen back, likely reflecting not only the global downturn in high-tech stocks, but also recognition that corporate restructuring in Japan is likely to be a drawn-out process.

Following the premature move toward fiscal consolidation in FY1997, fiscal policy has been used to support growth, though the overall effectiveness may have been undercut by partial implementation at the local level and lack of transparency. The main vehicle for countercyclical fiscal policy has been a series of supplementary budgets designed to shore up public works spending, cut taxes, and increase credit guarantees for bank loans to SMEs. The budget for FY2000, together with the stimulus package announced last November, should help to maintain the fiscal stance broadly unchanged during the current fiscal year. However, absent a further significant supplementary budget, public investment could again fall off sharply in the second half of this fiscal year, as it did in 1999.

While the monetary stance has remained unchanged since the reduction in short-term interest rates to their floor in early 1999, the BoJ has in recent months increasingly signaled that the conditions for raising short-term interest rates by a small amount are gradually falling into place. Even with short-term nominal interest rates at their floor, however, real rates have remained positive, bank lending has continued to decline, and an appreciating yen since mid-1999 has implied a significant firming of monetary conditions. Nevertheless, with the gradual improvement in economic prospects, the BoJ has increasingly signaled—and markets have come to expect—that some firming of the policy stance is likely before the end of the year.

While concerns about systemic risk in the banking sector have receded, bank restructuring is still at an early stage, and the financial position of the life insurance sector has continued to weaken. Under the framework established in late-1998, substantial progress has been made in stabilizing the banking system: the major banks have been recapitalized, the two banks nationalized in late-1998 have been or are about to be reprivatized, and four mega-mergers have been announced. However, concerns about major banks' asset quality and core profitability remain. While a number of regional banks have made progress in raising their capital over the past year, weaknesses among the credit cooperatives are only now beginning to be addressed. The delay in reintroducing partial deposit insurance announced last December was largely related to concerns about the significant weaknesses in the credit cooperative sector. Finally, the financial strength of the life insurance sector has deteriorated further over the past year, reflecting negative spreads.

Beyond the financial sector, the authorities have made significant progress in their legislative agenda to foster corporate restructuring, but progress on regulatory reform more generally has been less impressive. A number of measures to encourage corporate restructuring have been legislated over the past year, including enactment of the Industrial Revitalization Law and the Civil Rehabilitation Law, and changes in the Commercial Code. Reforms to accounting standards are moving ahead, with the introduction of consolidated financial accounting in FY1999 and the phasing in of marking-to-market in FY2000–01. Most remaining "Big Bang" financial reforms came into effect in October 1999. While the authorities have moved to expand the coverage of their deregulation program and plan to shift the emphasis of regulation from prior intervention to retroactive supervision, implementation is proceeding slowly in other areas.

Despite positive recent signs of an emerging recovery, the staff expects the recovery to remain underpowered and uneven in 2000–01, and subject to significant downside risks. The baseline projection is for growth of about 1½ percent in 2000 and 1¾ percent in 2001, broadly in line with the private consensus forecast. However, achieving this outcome is by no means assured, given that a sustained recovery in private demand has not yet been established and corporate restructuring will continue to dampen both business investment and household expenditures for some time to come. In these circumstances, confidence could still be undercut by a "triple-dip" in activity after midyear, possible following the surge in output that likely took place in the first half of 2000 (repeating the pattern of 1999), particularly if the monetary stance is firmed and fiscal stimulus wanes. The decline in stock prices since March is a reminder that confidence is still fragile and provides further headwind against a sustainable recovery in private demand. Other downside risks arise outside Japan, including that of a "hard landing" in the United States.

Executive Board Assessment

Executive Directors considered that the macroeconomic policy support and structural reforms implemented over the past 2½ years have been instrumental in bringing about the economic recovery that appears to be finally underway in Japan. However, the recent pickup remains fragile and subject to downside risks. While business investment has turned around, household demand remains lackluster. Moreover, while the reallocation of capital and labor to more productive activities is now underway, uncertainties related to the process of corporate restructuring will continue to pose risks to the outlook for some time.

Against this background, Directors urged the authorities to maintain supportive macroeconomic policies until the recovery becomes more robust, while pressing ahead with structural reforms to lay the foundation for sustained medium-term growth. Directors considered that an early move to firm the stance of macroeconomic policies would pose risks for the recovery. The preferred way to promote economic restructuring, Directors emphasized, is to apply firmly the strengthened regulatory framework to ensure that a sound banking system and efficient capital markets exert appropriate discipline on firms, while continuing to remove tax and other impediments to corporate reorganization and to accelerate efforts to promote competition and deregulation on a broad front.

While recognizing the need for medium-term fiscal consolidation, Directors stressed that withdrawal of fiscal stimulus should wait until the economic recovery is on a firmer footing. Recent experience in Japan clearly illustrates the risks for growth—and ultimately public sector debt dynamics—of implementing fiscal consolidation prematurely, that is while economic prospects remain fragile. To cushion the withdrawal of fiscal stimulus in the latter part of FY2000 and FY2001 expected under present policies, many Directors underscored the need for early implementation of a significant supplementary budget. Some Directors, however, cautioned that a further increase in public spending would provide little additional stimulus, and urged the authorities to give even greater emphasis to promoting the supply side of the economy. In any case, Directors emphasized that any further increase in public works spending should be combined with efforts to increase the overall efficiency of public spending. Some Directors also considered that additional public spending on active labor market policies would be desirable.

Directors recommended that the authorities initiate a public process to develop a consensus on a credible strategy for eventual fiscal consolidation aimed at stabilizing and eventually reducing the general government net debt-to-GDP ratio, thus helping to raise confidence in long-term growth prospects and reduce the risks of volatile financial market conditions. As the authorities recognize, such a strategy would need to be responsive to the evolution of the economy rather than follow a predetermined adjustment path over a set period. Directors suggested that key elements of such a strategy would include a substantial scaling back of public works spending, together with revenue increases secured through a broadening of the personal income tax base and a rise in the consumption tax rate, and further reforms in the social security system.

Directors welcomed the authorities' commitment to making sustained progress with structural reforms. Crucial to structural reforms in the fiscal area will be efforts to improve the quality of public works spending by applying cost-benefit analysis to project selection and improving the efficiency of bidding and procurement procedures, while accelerating private sector involvement in infrastructure provision. While welcoming the planned reforms to the Fiscal Investment and Loan Program (FILP), Directors considered that the benefits of the reforms would be maximized by requiring FILP agencies to rely to the greatest extent possible on market financing of their operations and strictly limiting the use of government guarantees. On tax reform, Directors noted that early introduction of taxpayer identification numbers would set the stage for measures to broaden the personal income tax base. Directors underscored the importance of improving fiscal transparency to provide a better basis for the assessment of the macroeconomic implications of fiscal policy. The most pressing objectives are the publication of more timely consolidated fiscal data and rolling multiyear projections of the main fiscal aggregates on a current services basis. The authorities were encouraged to complete a fiscal transparency ROSC module as soon as possible.

Directors welcomed the recent social security reforms aimed at improving the solvency of the public pension system. They stressed that a commensurate effort is still needed to put the public health care system on a sound financial footing, and that, over the medium term, further cuts in lifetime pension benefits and increases in the retirement age will be needed, given the longer-term pressure from population aging.

Directors cautioned against moving away from the "zero interest rate" policy at this time. They noted that, notwithstanding the inherent difficulty of assessing the degree of output slack under current circumstances, a range of indicators suggests that a still significant degree of economic slack remains in Japan, with the prospect that deflationary pressures are likely to persist for some time. While some Directors were sympathetic to the authorities' desire to reestablish a more normal monetary environment, Directors considered that, in present circumstances, the potential costs of premature tightening—which could push the economy back into recession—outweigh the risks of waiting to move to a less accommodative monetary policy stance. Directors suggested that timely action could yet be needed to provide further monetary stimulus in the face of events that could undercut the recovery, including upward pressures on the yen unjustified by the strength of the economy, or an economic slowdown in the United States. Some Directors noted that a more transparent monetary policy framework—including early adoption of an inflation targeting framework with identification of the price goal and regular publication of the Bank of Japan's inflation forecast—would further enhance the effectiveness of monetary policy.

Directors noted that, from a multilateral perspective, the yen appears at present to be broadly aligned with medium-term fundamentals. Directors were, nevertheless, concerned that a rapid appreciation of the yen, not justified by improving fundamentals, could yet undercut the recovery. Many Directors considered that the sterilized foreign exchange market intervention could at times be effective in mitigating unwarranted exchange rate pressures, although a substantial and lasting impact was likely to depend on a supportive monetary

policy. Other Directors raised questions about the effectiveness of intervention policy in general, and stressed that foreign exchange market intervention was not a substitute for sound and credible macroeconomic policies.

Directors welcomed the progress made over the past two years in strengthening major banks' balance sheets and allaying concerns about financial instability. However, much remains to be accomplished to ensure the soundness of the financial system and allow a smooth transition to limited deposit insurance in April 2002. The most pressing priorities are: to encourage major banks to strengthen their earnings base and achieve internationally comparable returns on equity; to implement rigorously the strengthened regulatory framework to address serious remaining weaknesses among smaller deposit-taking institutions (especially credit cooperatives); and to fill remaining gaps in the supervisory framework, including through a gradual increase in the minimum capital adequacy ratio to eight percent for all deposit-taking institutions. Directors believed that the effectiveness of the new procedures relating to deposit insurance will depend on the timeliness of interventions in financial institutions and their flexible application to maximize asset value, while ensuring that uninsured creditors as well as shareholders of failing institutions, bear the appropriate losses. Directors emphasized the need for firm implementation of the new framework for dealing with weaknesses in the life insurance sector. Some Directors suggested that leveling the playing field between the Postal Savings System and private banks in competing for funds would help to reduce over time the role of the public sector in financial intermediation. Directors welcomed the authorities' intention to consider undertaking a Financial Sector Stability Assessment in the second half of 2001.

Directors commended the authorities for the recent progress in the legislative agenda to improve the environment for corporate restructuring, but cautioned that the momentum for structural reforms must be maintained to secure the basis for sustained market-led growth. They considered that the framework for corporate restructuring should be further enhanced by the early introduction of consolidated corporate taxation, the pragmatic implementation of the new bankruptcy legislation, and the rigorous application of the new accounting standards. To encourage labor mobility, Directors recommended the early introduction of portable, defined-contribution pension schemes, and further expansion of worker retraining programs to ease transitional costs on workers. Directors also stressed the need to move ahead with broad-based regulatory reform.

Directors noted that continuing weaknesses in economic statistics, especially in national accounts and fiscal data, complicate the monitoring of developments, the formulation of macroeconomic policies, and the exercise of Fund surveillance. They encouraged further efforts by the authorities to publish more timely, comprehensive, and accurate estimates of quarterly GDP and to improve the timeliness of fiscal data.

Directors welcomed the authorities' efforts to increase ODA further in 1999 and Japan's commitment to liberalize access for least developed countries' exports. They considered that the initiatives taken over the past year to provide financial support to Asian countries, despite Japan's own economic difficulties, had played an important role in

supporting the strong economic recovery in the region. Japan's willingness to provide debt relief to the HIPCs will be a key element of international efforts to alleviate poverty.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Japan: Selected Economic Indicators

	1997	1998	1999	Proj. 2000	
	(Percent changes, unless otherwise noted)				
GDP	1.6	-2.5	0.2	1.4	
Private consumption	0.5	-0.5	1.2	0.6	
Nonresidential investment	9.0	-7.6	-5.9	6.2	
Residential investment	-16.2	-14.4	1.4	3.7	
Public investment	-10.4	-3.0	7.8	-9.8	
Public consumption	1.5	1.5	1.3	1.3	
Stockbuilding (contribution to growth)	0.1	-0.6	0.1	0.1	
Foreign balance (contribution to growth)	1.4	0.5	-0.3	0.5	
Exports of goods and services	11.6	-2.5	1.9	9.3	
Imports of goods and services	0.5	-7.6	5.3	6.8	
Inflation					
GDP deflator	0.3	0.3	-0.9	-1.1	
CPI	1.7	0.6	-0.3	-0.2	
Unemployment rate (period average, percent)	3.4	4.1	4.7	5.0	
Industrial production	4.1	-7.2	1.0	4.1	
Current account balance					
Billions of U.S. dollars	94.1	121.0	106.8	116.9	
Percent of GDP	2.2	3.2	2.5	2.5	
General government balances (percent of GDP)					
Balance including social security	-3.3	-4.7	-7.4	-8.2	
Balance excluding social security	-5.9	-6.8	-9.2	-9.5	
Structural balance 1/	-3.7	-3.4	-5.4	-5.3	
Money and credit (end period)					
M2 + CDs	3.8	3.9	2.6	1.9	2/
Bank lending	0.0	-4.7	-5.9	-4.6	2/
Exchange rates (period average)					
Yen/dollar rate	121.0	130.9	113.9	107.4	3/
Real effective exchange rate 4/	117.7	107.3	119.8	129.5	2/
Interest rates (period average)					
3-month CD	0.5	0.6	0.1	0.04	2/
10-year government bond	2.1	1.3	1.7	1.7	2/

Sources: Nikkei Telecom and IMF staff estimates.

1/ Including social security, excluding bank support.

2/ June 2000.

3/ July 12, 2000.

4/ Based on normalized unit labor costs; 1990 = 100.