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# Japan: 2004 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with Japan, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 20, 2004**,** 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 6, 2004. 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 supplement of July 23, 2004 updating information on recent economic developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 28, 2004 discussion of the staff report that concluded the Article IV consultation.

The document listed below have been or will be separately released.

Selected Issues Paper

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

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.**

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INTERNATIONAL MONETARY FUND

JAPAN

**Staff Report for the 2004 Article IV Consultation**

Prepared by the Staff Representatives for the
2004 Consultation with Japan

(In consultation with other departments)

Approved by Daniel Citrin and John Hicklin

July 6, 2004

- This report is based on discussions held in Tokyo during May 7–20. The staff team comprised Messrs. Citrin (head), Lizondo, Kramer, Komori and Wolfson and Ms. Edison and Ms. Iakova (all APD), Mr. Stone (MFD), Mr. Hayward (outside consultant) and Mr. Schneider (PDR). Mr. Kitahara (Alternate Executive Director) also took part in discussions. Supporting information and analysis are provided in a companion *Selected Issues* paper.

- The team met with senior officials at the Cabinet Office (CAO); Ministries of Public Management, Home Affairs, Posts and Telecommunications (MPHPT); Finance (MoF); Health, Labor and Welfare (MHLW); Agriculture, Forestry and Fisheries (MAFF); Economy, Trade and Industry (METI); and Foreign Affairs (MoFA); the Financial Services Agency (FSA); the Bank of Japan (BoJ); the Deposit Insurance Corporation (DIC); the Industrial Revitalization Corporation of Japan (IRCJ); Development Bank of Japan (DBJ); Fair Trade Commission (FTC); Food Security Commission; Tokyo Metropolitan Government and with business and financial sector representatives.

- 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 transactions, apart from those notified under Decision 144-(52/51) and other restrictions imposed against the former Iraqi regime (see Annex I).

- Japan has subscribed to the Special Data Dissemination Standard.

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## EXECUTIVE SUMMARY

### Background

- **There are increasing signs that Japan's longstanding problems have eased**:
  - The recovery has gained pace and broadened, deflation is easing, and the near-term outlook is for a continued robust expansion and narrowing deflation (there remain downside risks to the outlook, mainly arising from external factors);
  - Monetary policy has been supportive, with short-term interest rates held at zero under the BoJ's quantitative easing policy. Exchange rate policy has sought to smooth short-term volatility and worked to avoid an undue tightening of monetary conditions;
  - Encouraged by policy measures, financial and corporate sector weaknesses are diminishing, as reflected in declining nonperforming loans and improved profits and deleveraging, respectively;
  - Fiscal deficits remain large, and public debt has grown rapidly. The authorities aim to achieve a primary surplus (excluding social security) by the early 2010s, and recently approved reforms will improve the pension system's finances.

### Key Issues and Policy Discussions

- **With agreement on the broad direction of policies, the staff favored expanding current reforms to secure a strong and durable medium term expansion**:
  - **Regarding monetary policy**, the mission agreed with the BoJ's policy of keeping short-term interest rates at zero until inflation turns positive. The mission proposed that the BoJ enhance its communications strategy to stabilize inflation expectations, including by quantifying a medium-term inflation objective. The BoJ sees this as one possible option for managing the transition to positive inflation;
  - **In the financial sector**, the mission proposed expanding on current reforms to more quickly resolve remaining weaknesses—especially for regional banks whose restructuring has lagged. The authorities preferred a more gradual approach;
  - **On fiscal policy**, with the economy stronger than initially envisaged, fiscal savings in FY2004 relative to the budget would be desirable. For the medium term, the mission advocated a specific target balance and measures to achieve it, to enhance the credibility of the government's plan. The authorities aim to further enhance credibility through concrete progress;
  - **Structural economic reforms** should be expanded to encourage job creation and raise productivity and potential economic growth. The priorities are to strengthen competition policy, increase labor market flexibility, and advance regulatory reforms. Further trade liberalization is also needed, particularly for agriculture.

# I. INTRODUCTION

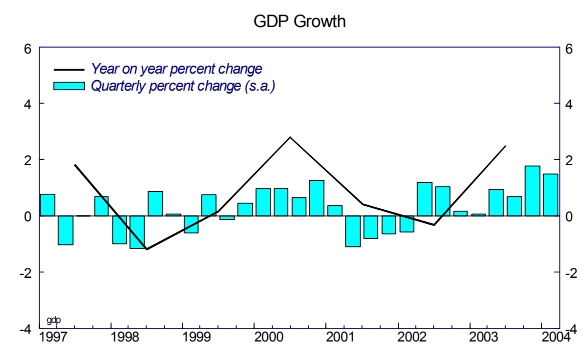
1. **There are clear indications that Japan's longstanding problems—sluggish economic activity, deflation, and financial and corporate sector weaknesses—have eased**. GDP has grown for eight consecutive quarters, picking up pace recently, and labor market conditions are improving. Also, deflationary pressures have diminished, against the backdrop of a narrowing output gap and supportive monetary policy. Meanwhile, progress has been made in addressing corporate and financial sector problems, helped by the economic expansion and encouraged by policy measures.

2. **Despite these favorable developments, weaknesses remain that could restrain growth over the medium term**. Deflation (though mild) persists; additional corporate and financial sector restructuring is needed; and public debt is high and rising. Moreover, accelerated deregulation and other structural reform efforts are needed to lay the basis for a strong and durable expansion over the medium term.

# II. SIGNS THAT JAPAN'S LONGTIME ECONOMIC PROBLEMS HAVE EASED

***The economic recovery is broadening***

3. **The present recovery has been surprisingly strong and is becoming increasingly broad based** (Box 1).[1] Indeed, output growth in 2003 was about twice the mid-year consensus forecast, and has picked up to an annual average rate of about 6¾ percent during the last two quarters. While index number problems in GDP data may cause them to overstate growth, data such as the all-industries index and business sentiment confirm that an economic upswing is firmly in place.[2] The stronger than expected recovery likely reflects both the fruits of past corporate and financial sector restructuring and higher than anticipated global growth.



Source: Global Insight, Nomura Database.

4. **The buoyant recovery initially reflected exports, but subsequently broadened to domestic demand**. Starting in early 2002, exports (especially to Asia) rebounded reflecting a

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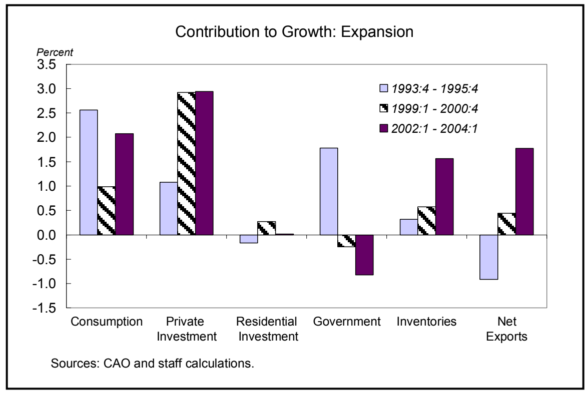
[1] See also the selected issues paper entitled "Key Features of the Japanese Business Cycle."

[2] Index number problems may cause an upward bias in measured GDP growth (and a corresponding downward bias in deflation as measured by the GDP deflator). Most estimates of the bias are around ¼ to ½ percent per annum. However, one oft-cited private study has suggested it may be higher, while rough STA estimates through 2002 are close to zero. The bias for 2003 can be more precisely estimated once the needed data are released in late 2004.

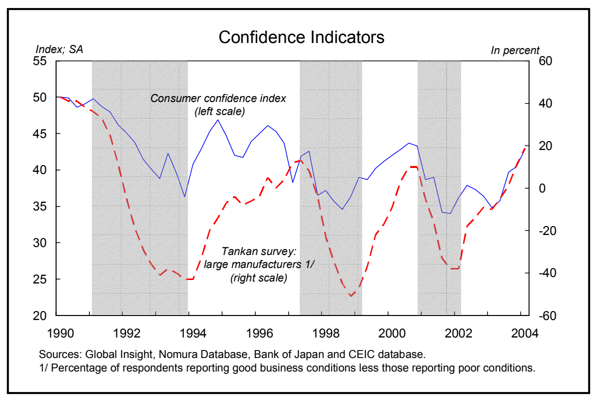
## Box 1: Is the Japanese Recovery for Real?

**This recovery is likely to be more durable than the previous recoveries during the 1990s, for three reasons:** [1]

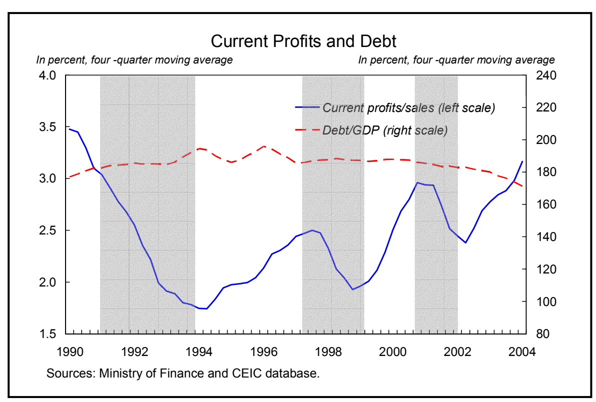
- **First, the current expansion is more broadly based than previous expansions, with a firmer basis in private domestic demand**. Strong investment is apt to be sustained going forward by robust corporate profits, improving business sentiment, and demand to upgrade Japan's aging capital stock. At the same time, consumption has begun to strengthen against the backdrop of rising consumer confidence and firming labor market conditions. Also, both investment and consumption have grown apace despite the headwinds of falling public spending.




- **Second, corporate restructuring has fostered structural gains in profitability, which should support investment going forward**. Firms have steadily pared back excess leverage and labor costs during this expansion. As a consequence, they are now better positioned to reap profits as demand grows, which is positive for the investment outlook.




- **Third, the corporate and financial sectors have become more resilient to shocks**. Firms have deleveraged while banks have shed nonperforming loans and equity holdings. As a result, these sectors have become less vulnerable to shocks that could trigger a sharp cutback in investment by firms or credit crunch by banks and thereby put the expansion at risk.

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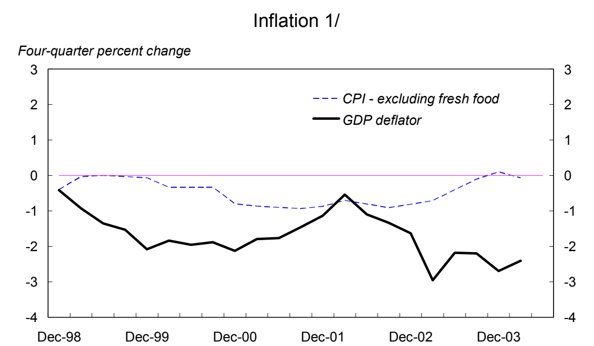
[1] The dates of these expansions are 1993Q4–1997Q2; 1999Q1–2000Q4; 2002Q1–2004Q1.

pickup in partner-country growth (especially China),[3] and the revitalization of export-oriented firms; accordingly, real net exports were a principal contributor to the accompanying turnaround in GDP growth. Subsequently, business fixed investment also began to grow briskly, fed by robust corporate cashflow and demand to replace aging capital. Most recently, consumption has shown strength, despite weakness in household income, while import growth has firmed.

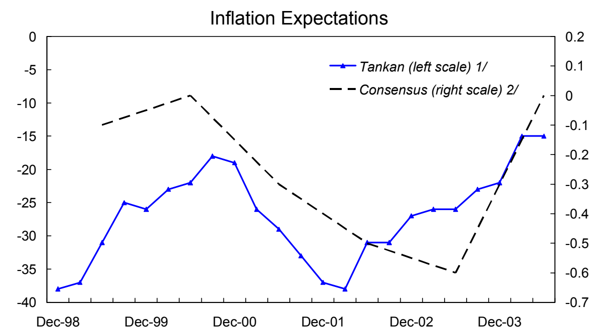
5. **The recovery has begun to lead to improvements in labor market conditions**. Employment, the labor force, and compensation, which had been declining since 2001, have stabilized, and the unemployment rate has fallen to 4.7 percent from the record-high 5.5 percent reached in early 2003. Also, job offers have risen both in absolute terms and in relation to the number of job seekers, while the fraction of firms reporting that they employ excess labor has decreased.

***Consumer price deflation has subsided to a mild rate***

6. **Reflecting both the expansion and one-off factors, CPI deflation has eased**. Since January 2003, the y/y fall in the core CPI (which excludes fresh food) has narrowed substantially owing to the declining output gap and temporary influences such as tax hikes and oil price increases. Net of transitory factors, the underlying trend shows that the core CPI is falling by 0.3 percent. Expected deflation has waned as well: current consensus forecasts are for a broadly flat CPI over 2004 and 2005.




Source: Global Insight, Nomura database.
1/ Seasonally adjusted.



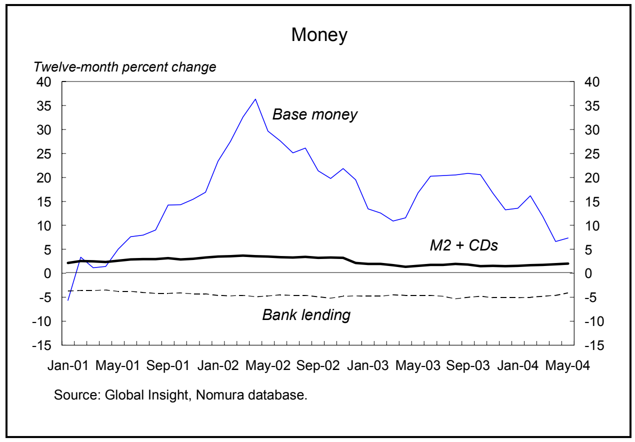

Sources: Bank of Japan and Consensus Economics Inc.
1/ Net percentage of large manufacturers that expect prices to rise (versus fall).
2/ Forecast as of June, for subsequent year CPI inflation.

7. **However, the GDP deflator has continued to fall more rapidly than the CPI**, declining by 2.6 percent y/y in the first quarter of 2004. The gap between changes in the deflator and in the CPI reflects two main factors. First, technological improvements have driven a rapid fall in the price of electrical machinery, which has a higher weight in GDP than in household consumption. Second, the CPI and GDP deflator are subject to opposing index number biases; the change in the CPI (a Laspeyres index) is biased upward, while the change in the GDP deflator (a Paasche index) is biased downward.

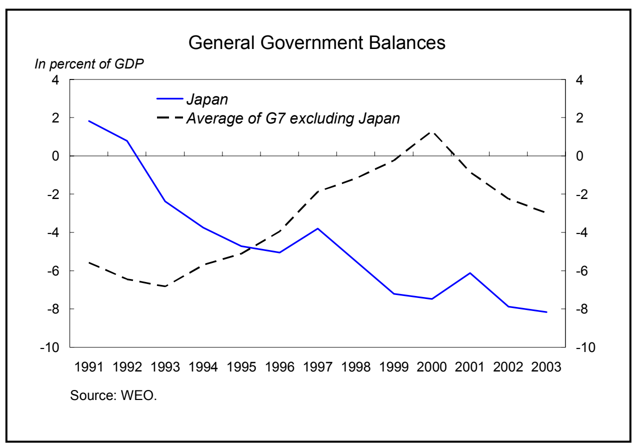
[3] Real exports to China increased by about 40 percent in 2003 (China accounts for about 12 percent of Japan's exports).

*Monetary policy is supportive; public debt is high and rising*

8. **Short-term interest rates remain at zero under the Bank of Japan's (BoJ's) quantitative easing policy**. Recent increases in the BoJ's operating target—current account balances, which are bank and nonbank accounts at the central bank—have supported growth in base money, kept short-term interest rates at zero, and ensured access to ample funding by banks.[4] Nevertheless, with banks weak and corporations deleveraging, bank lending continues to contract (partly reflecting loan writeoffs).




9. **During 2003 and into early 2004, periodic bouts of upward pressure on the yen threatened to unduly tighten monetary conditions** and thereby adversely affect Japan's recovery. Market concerns about adjustment in the major exchange rates focused on the large current account imbalances in the United States and Japan, the latter of which rose to a surplus of 3.2 percent of GDP in 2003 with sizeable increases in both the trade and nonfactor services balances. In response to upward pressure on the yen, the authorities intervened in record levels (¥20 trillion in 2003 and a further ¥15 trillion during January–March 2004).[5] However, in April 2004, both upward pressure on the yen and intervention ceased. Since June 2003, the yen/dollar exchange rate has fluctuated between ¥104 and ¥121, and on balance has appreciated by about 9 percent. On a multilateral basis, however, the yen has appreciated by less—3.5 percent and 2 percent in nominal and real effective terms respectively.[6]



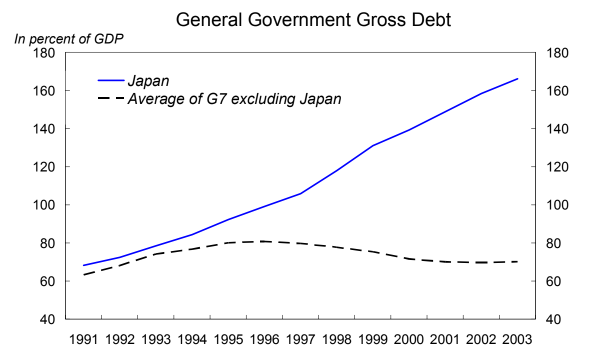

10. **Another large fiscal deficit was posted in FY2003, amounting to 7.9 percent of GDP (slightly lower than**

[4] Also, the BoJ has continued to purchase asset backed securities, with an aim to develop the market for these securities and thus strengthen the monetary policy transmission mechanism.

[5] The Ministry of Finance sets intervention policy and decides upon intervention operations, which the BoJ then conducts on behalf of the Ministry.

[6] Staff estimates (prepared in the context of the periodic Coordinating Group on Exchange Rates (CGER) exercises) imply that the yen remains substantially undervalued from a medium-run perspective.

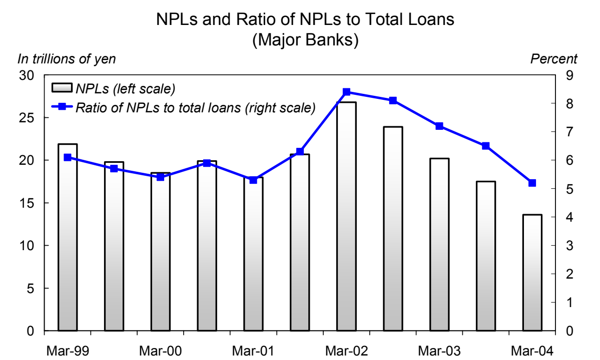
**in FY2002)**. On a cyclically-adjusted structural basis (including social security but excluding bank support) the fiscal stance was unchanged with a deficit broadly stable at around 6½ percent of GDP. A decade of high deficits has fed rapid growth in public debt, which at end-2003 stood at 166 percent of GDP on a gross basis (80 percent on a net basis)—the highest among advanced countries by a substantial margin.



Source: WEO.

***Financial and corporate sector weaknesses are diminishing***

11. **Financial institutions made headway in strengthening their financial conditions**, but some banking sector weaknesses persist and regional banks have lagged behind.[7] During FY2003 (the year ending March 2004), major banks cut bad loans, reduced deferred tax assets (DTAs) and equity holdings and lifted their capital adequacy ratios amid the economic recovery, the stock market rebound, and tighter regulation under the Program for Financial Revival (PFR).[8] The economic expansion and the equity market rally also boosted profits. The performance of major insurance companies improved, as profits and solvency margins rose.[9] However, bad loans remained high for one major bank, which, based on the inspection results by the Financial Services Agency (FSA) and discussions with auditors, significantly increased provisions and marked down earnings; DTAs, which have value only if the bank earns profits, still accounted for a substantial part of regulatory capital; core operating profits remained weak; and financial strength ratings, which abstract from government support, stayed low. Meanwhile, regional banks—which account for 40 percent of bank lending, but are subject to less demanding regulation than major banks (and are not covered by the PFR)



Source: Financial Services Agency.

[7] See the selected issues paper entitled "Recent Financial Sector Developments and Policies."

[8] Also, banks increased their bond holdings, raising their exposure to capital losses from rising long-term interest rates. However, if higher rates were accompanied by stronger growth, attendant gains in credit quality and stock prices would likely offset these losses.

[9] Insurance companies in Japan must satisfy a minimum solvency margin, which is the ratio of available capital and surplus to a measure of risks (insurance risk, interest rate risk, asset management risk and operational risk).

—made less headway in reducing bad loans. During the latter part of 2003 a large regional bank failed and was nationalized through share acquisition, suggesting that weaknesses remain among these banks.

**Current Major Bank Ratings**[1]

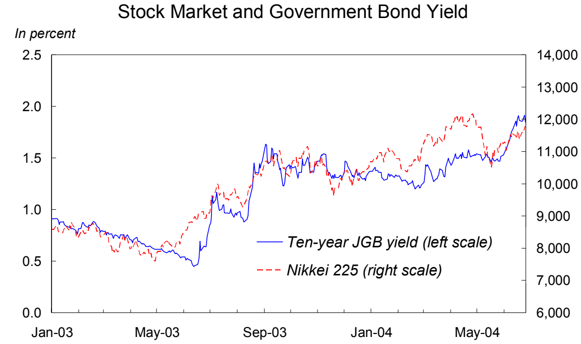
| Bank | L-T | Individual |
|---|---|---|
| Bank of Tokyo Mitsubishi | A- | C/D |
| Mitsubishi Trust | A- | D |
| Mizuho | BBB+ | E |
| Sumitomo Mitsui | BBB+ | E |
| UFJ | BBB+ | E |
| Resona Bank | - | E |
| Sumitomo Trust | BBB+ | D |
| Chuo Mitsui Trust | BBB- | E |
| Shinsei Bank | BBB | C/D |
| Aozora Bank | BBB- | C/D |
| *Memorandum: Foreign Bank Ratings* | | |
| Citibank | AA+ | A |
| Deutsche Bank | AA- | B/C |
| HSBC | AA | A/B |
| UBS | AA+ | A/B |

Source: Fitch Ratings.

[1]L-T=long term rating. Individual=rating if bank could not rely on external support; E denotes a bank with very serious problems.

12. **The corporate sector has made substantial progress in restructuring.**[10] Partly reflecting bank pressure on borrowers and facilitated by improvements to the legal infrastructure for corporate restructuring, aggregate profit indicators have improved during recent years; indeed, the profit/sales ratio has returned to bubble-era peaks. In the current cycle, profits gains were initially driven by labor cost cuts and strong external demand and were led at first by large export-oriented manufacturers but have recently broadened to SMEs and nonmanufacturers. Nevertheless, debt levels remain high and aggregate ROA is still low by historical standards, suggesting that further deleveraging and shedding of unproductive assets is needed.

13. **The economic recovery has sparked a rebound in stock prices and long-term interest rates**. Since their lows attained in 2003, the Nikkei has gained about 50 percent and ten-year JGB yields have risen from about 0.45 percent to about 1.8 percent. While average land prices have continued to fall, the rate of decline seems to have eased in a few major urban areas.



Source: Bloomberg.

***The near-term outlook is favorable, although growth will likely moderate in the medium term***

14. **Looking ahead, the near-term baseline outlook is for a continued expansion with mild deflation**. Assuming that the external environment remains supportive, the robust expansion is likely to continue over the near term, thanks to firmer support in domestic demand and reduced financial and corporate sector vulnerabilities (see Box 1). Staff's current projections are for GDP growth of about 4½ percent in 2004 and 2½ percent in 2005. As the remaining economic slack diminishes, deflationary pressures are likely to ease further, and

[10] See the selected issues paper entitled "Recovery of Japanese Firms".

y/y CPI deflation would ebb to about zero during 2005 (the staff's estimate of the output gap is about 2¼ percentage points as of end-2003).

Japan: Growth of Real GDP by Component (at 1995 prices)
(Percent change from the previous period)

| | 2003 | | | | 2004 | 2004 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Qtr 1 | Qtr 2 | Qtr 3 | Qtr 4 | Proj. | Qtr 1 | Qtr 2 | Qtr 3 | Qtr 4 |
| Real GDP 1/ | 0.1 | 0.9 | 0.7 | 1.8 | 4.5 | 1.5 | 0.7 | 0.7 | 0.7 |
| *Of which*: | | | | | | | | | |
| Private final domestic demand | 0.4 | 1.2 | 0.6 | 2.2 | 4.9 | 1.1 | 1.1 | 0.9 | 0.8 |
| Private consumption | -0.1 | 0.2 | 0.6 | 1.0 | 3.2 | 1.0 | 0.8 | 0.6 | 0.5 |
| Residential investment | -1.2 | -0.2 | 3.2 | -0.9 | 2.0 | 0.6 | 0.4 | 0.4 | 0.4 |
| Business fixed investment | 2.3 | 4.7 | 0.0 | 6.7 | 11.1 | 1.7 | 2.0 | 1.8 | 1.8 |
| Government consumption | 0.3 | -0.2 | 0.6 | 0.4 | 1.5 | 0.4 | 0.4 | 0.4 | 0.4 |
| Public investment | -2.3 | -4.0 | -5.4 | -1.3 | -10.2 | -2.9 | -1.7 | -2.1 | -2.1 |
| Stockbuilding (contribution) | -0.1 | 0.0 | 0.2 | -0.2 | 0.2 | 0.5 | -0.2 | -0.1 | 0.0 |
| Foreign balance (contribution) | 0.0 | 0.3 | 0.2 | 0.4 | 0.9 | 0.2 | 0.1 | 0.2 | 0.1 |

Sources: Global Insight, Nomura database; and staff projections.

1/ Annual growth rates and contributions are calculated from seasonally adjusted data.

15. **There are both downside and upside risks to the near-term outlook**. The *downside risks* stem mainly from external factors that could adversely affect Japan both directly and through knock-on effects on its partner countries. These risks include a sharp rise in long-term U.S. interest rates that could spark global portfolio rebalancing and volatility in international capital markets; a slowdown in China that could dampen its demand for Japan's exports;[11] a supply shock in oil markets that could foster a sustained oil price increase and thus reduce partner country growth;[12] and geopolitical shocks that could trigger a deterioration in business and consumer confidence. There are *upside risks* as well: consumption and business fixed investment could show further surprising strength, for instance if labor markets conditions and corporate profits improve more rapidly than anticipated.

16. **Over the medium term, growth is envisaged to slow to around potential,** estimated by staff at 1.7 percent per year. This estimate assumes that productivity growth continues at around current rates. However, additional structural economic reforms—such as further deregulation of labor and product markets—and continued progress in financial and

[11] Staff estimates that a 10 percentage point fall relative to baseline in China's *imports for domestic use,* caused by slowing Chinese domestic demand, would reduce Japan's GDP by about ½ percentage point.

[12] Staff estimates that a sustained 10 percent rise in oil prices could reduce Japan's GDP by up to ½ percentage point over the long term (near-term effects would be considerably smaller).

corporate sector restructuring could boost productivity, raise Japan's economic potential and foster more rapid job creation over the medium term.

## III. Policy Discussions

17. **During recent years, policies have moved broadly in line with past staff advice in key areas**. In the monetary policy area, various steps have been taken to counter deflation; bank regulation has been tightened; the framework for corporate revitalization has been improved; and on the fiscal front, the personal income tax base has been broadened, cuts in public works spending have continued, and elements of a medium-term fiscal consolidation strategy have been formulated. However, policy measures have generally been more moderate than those advocated by staff, mainly reflecting officials' concerns that bolder actions might harm the economy in the near term.

18. **Further progress in addressing Japan's economic problems would convey benefits both domestically and internationally**. Continued efforts to reduce domestic vulnerabilities and revitalize the economy and financial system would strengthen Japan's growth in the medium term. In turn, putting Japan on a firmer and more robust growth path would help to support the global expansion and strengthen its resilience to shocks. Also, stronger growth could reduce Japan's current account surplus, and thus limit both global pressures for protectionism and the risk of disorderly adjustments among major currencies.

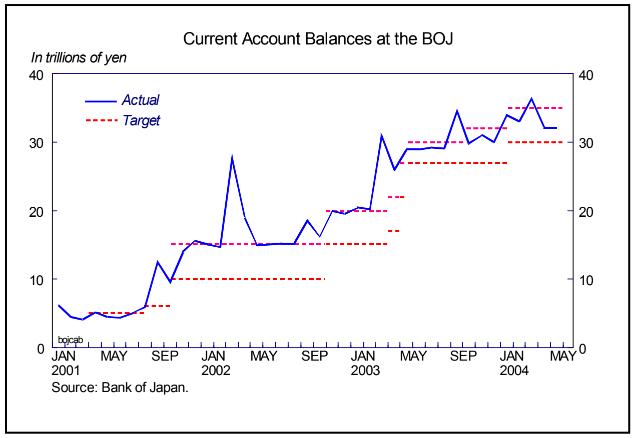
19. **The 2004 discussions took place against the backdrop of an improved economic outlook and progress in addressing Japan's structural problems**. The mission and the authorities agreed that Japan's near-term prospects had brightened considerably in the past year and that the risks to the outlook had become more balanced. In addition, progress had been observed in reducing financial and corporate sector weaknesses, although it was acknowledged that more needed to be done. In areas where progress has been less marked—notably fiscal consolidation and structural reforms—a consensus nevertheless existed on the key problems to be tackled, and it was also agreed that the main elements of a reform program had been sketched out.

20. **With agreement on the broad direction of future policies, the consultation discussions centered on the desirable speed and modalities of reforms**. The mission considered that the policy priorities going forward were to build on the existing reform program in order to resolve remaining weaknesses and secure a strong and durable medium-term expansion. While the authorities generally agreed on the policy requirements and priorities, in several areas they preferred to maintain their existing approach to allow more time for their current policies to work or to fully consider all options.

### *Monetary policy: committing to end deflation, then stabilizing inflation expectations*

21. **The BoJ has recently taken steps to clarify and demonstrate its commitment to maintain zero short-term interest rates as long as deflation persists**. In October 2003, the BoJ clarified its commitment by announcing two *necessary* conditions for ending quantitative easing—that core CPI growth be nonnegative for a few months, and that a majority of Policy Board members forecast positive core CPI inflation—while stressing that

even if these conditions obtained, it might maintain its present policy. Also, in October 2003 and January 2004, the BoJ raised its current-account balance target, which helped reassure markets that the current framework will be kept in place until deflation ends.




22. **The authorities and the mission agreed that in view of persistent (albeit milder) deflation, the current monetary policy stance and strategy should be maintained until inflation is positive**. With the economy strengthening, deflation waning, and liquidity ample, the case for additional increases in the current-account target had weakened substantially. However, if markets became concerned that quantitative easing might end too early, additional increases in the current account target could signal further the BoJ's resolve to maintain the framework until deflation was decisively subdued.

23. **The mission suggested that as the onset of inflation drew nearer, the BoJ could enhance its communication strategy to stabilize inflation expectations**. For example, the BoJ could quantify its inflation objective, setting it high enough to limit the risk of returning to deflation, account for upward bias in CPI inflation, and facilitate relative price adjustments in the presence of downward price rigidities. Also, to mitigate the risk to the BoJ's reputation if inflation temporarily strayed from the objective, it should be clearly specified as the BoJ's view on a desirable medium-term inflation rate, rather than as a binding target that it was committed to achieve within a specified time period. In addition, the BoJ could consider issuing more detailed discussion of its views on monetary policy and the inflation outlook in periodic reports.

24. **BoJ officials noted that they were weighing options for managing the transition to positive inflation and for the appropriate medium term monetary framework**. Regarding the immediate future, BoJ officials saw the present quantitative easing approach as a more effective policy commitment than inflation targeting, as their current approach was based on actual inflation—an objective concept—rather than (subjective) expected inflation. Looking beyond the transition period, they viewed inflation targeting as one option and highlighted specific implementation issues. If an inflation objective were to be announced, BoJ officials agreed that the objective should be understood as applying over the medium to long term to allow due flexibility to respond to short-term shocks. They also were investigating ways to convey the inflation forecast of the policy board in an effective manner while taking into account the fact that policy board members had diverse forecasts.

25. **As for exchange rate policy, the authorities emphasized that their continued approach was to aim to smooth excessive short-term volatility in the yen**. They regarded the interventions during 2003 and early 2004 as "extraordinary measures to deal with extraordinary circumstances," and as having successfully smoothed sharp short-term fluctuations in the currency. More recently, with pressures on the yen/dollar exchange rate having become more balanced, there was less need for such extraordinary measures. In this

connection, the mission agreed with the authorities that past sizeable interventions had kept upward pressure on the yen from leading to an undue tightening of monetary conditions. It also concurred that if such pressures reemerged, to the extent that they threatened to stall the recovery and heighten deflationary pressures, further intervention could be warranted.

***Financial and corporate sectors: completing the task of revitalization***

26. **The authorities' strategy to resolve remaining banking weaknesses comprised continued enhanced regulation of major banks and measures to promote restructuring of regional banks and their borrowers**. For the major banks, they would continue to implement the PFR's regulatory measures, such as forward-looking provisioning for selected loans, with the aim of reducing these banks' bad loan ratios to around 4 percent by end-March 2005 and strengthening the banks before insurance coverage was scaled back on interest-bearing demand deposits on April 1, 2005. For the regional banks, an Action Program for Enhancement of Relationship Banking Functions encouraged such banks to help borrowers restructure their operations, with the objective that loans to these borrowers could be upgraded. Also, a new facility would offer regional banks precautionary capital injections to support restructuring and strengthening of their operations (available in principle to any bank but intended for regional banks; the measure passed the Diet in June 2004). Injections would be provided only to viable banks that were indispensable for regional economies, with management accountable for implementing a restructuring plan.

27. **The mission welcomed these measures and encouraged the authorities to expand on these reforms to more quickly resolve remaining banking sector weaknesses**. It acknowledged that strengthened regulation had helped to foster a marked improvement in major banks' financial conditions, and noted that these banks were broadly on track to achieve the NPL targets set under the PFR and that there were no signs of strains in the run-up to the cutback in deposit insurance coverage. Nevertheless, significant weaknesses remained among the major banks, and regional banks had made less progress in reducing bad loans. Building on existing reforms would help to expeditiously resolve these problems so that banks could lend and thus help to sustain the expansion. In particular, the mission favored (in line with the 2003 FSAP):

- *To further improve recognition of and provisioning for problem loans,* encourage banks to make more extensive use of forward-looking provisioning, and allow provisions required by the FSA to be recognized as a cost for tax purposes;

- *To strengthen bank capital,* phase in limits on DTAs in bank capital, and raise the capital adequacy requirement for *all* domestic banks to 8 percent;

- *To enhance the environment for profitability*, front load and flesh out plans to reduce competition from Japan Post and government financial institutions (GFIs), including by more rapidly phasing out their preferences, and clarifying the timetable for shrinking their operations;

- *To improve bank governance*, urge banks to enhance the roles of outside directors and auditors, and exercise government ownership rights in any major bank that does not meet the end-March 2005 NPL target to make improvements in its management;

- *To encourage more rapid strengthening and restructuring of regional banks,* subject them to measures that have succeeded with major banks under the PFR, such as special inspections, enhanced disclosure about DTAs, and targets for NPL reductions. Also, use the capital injection facility, with appropriate conditionality, to facilitate consolidation.

28. **With broad agreement on the main priorities, the main differences of view between the authorities and the mission surrounded the timing and possible adverse effects of additional measures**. In particular, the FSA considered that progress had been made by regional banks in implementing the Action Program, which took into account the difficult conditions in regional economies, and thought that it should be allowed more time to work. Also, in their view, raising the capital adequacy requirement for all banks could adversely affect the lending attitude of regional banks. They agreed that expanded use of forward-looking provisioning was desirable, and noted that some banks were applying such practices more broadly on a voluntary basis; that said, they believed that banks were adequately provisioned for distressed loans. Also, the government was considering ways to deal with excessive DTAs in bank capital; any new rule would need to be phased in over time and be accompanied by liberalized tax-deductibility of provisions (which the FSA may propose again in 2004). As for GFIs, discussion would resume in 2005 on how to halve the sector's balance sheet as a proportion of GDP; the intention was that the GFIs should operate in areas where private sector institutions would not operate, rather than competing with them.

29. **The mission agreed that existing regional weaknesses should be taken into account but nevertheless saw a need to deal more decisively with banks' remaining problems**. In particular, a uniform capital adequacy ratio and enhanced regulation for regional banks would need to be introduced gradually over time, in light of the weaknesses in regional economies and institutions. That said, plans to phase in such measures could be developed soon. Also, since heightened regulation had worked well in fostering an improvement in the situation of major banks, it could also be effective in encouraging regional banks to restructure and in ensuring that they are equally strong as major banks. Together with the mission's other suggested steps, this could bring about an early strengthening of the overall banking system.

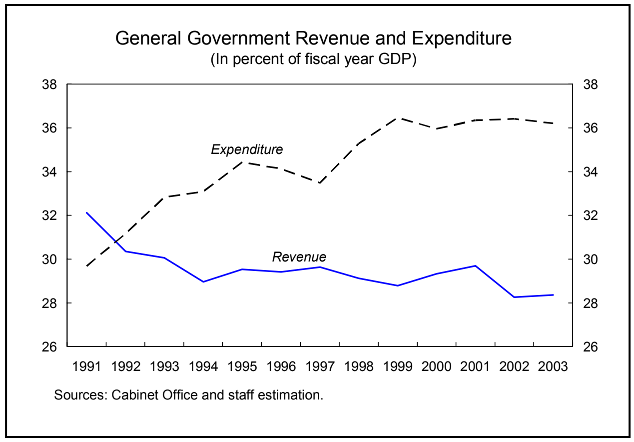
30. **Officials observed that corporate restructuring was progressing, with the Industrial Revitalization Corporation of Japan (IRCJ) coordinating a handful of cases**. The IRCJ, an official organization created in 2003, had some mechanisms such as tax incentives to facilitate restructurings, and had also succeeded in coordinating large numbers of creditors (over 100 in one case) and getting them to accept a pro rata haircut. As of early June 2004, the IRCJ was involved in 17 cases (others were in the pipeline). The mission considered that the IRCJ could appropriately continue to facilitate market-based restructuring, particularly in instances where it could help to coordinate creditors.

31. **The mission observed that a strengthened banking system would facilitate further corporate restructuring,** by allowing banks to more easily shoulder the losses involved in dealing with weak borrowers. In addition, revisions to the Commercial Code to ensure that outside directors are fully independent from corporate management could

improve incentives for corporations to restructure both financially and operationally. The mission acknowledged the continued official efforts to promote mergers and acquisition activity, which had helped to foster revitalization.

***Fiscal policy: stabilizing public debt over the medium term***

32. **Reflecting their concerns about the fiscal situation, the authorities have put in place a strategy aimed at medium-term fiscal adjustment to stabilize public debt**.




- Regarding the *general government excluding social security*, the authorities aimed to achieve a primary surplus by the early 2010s (staff projects a deficit of 3.6 percent of GDP in FY2004). To this end, they intended to keep government expenditure at or below its current level as a percent of GDP through FY2006. Subsequently, they would continue limiting expenditure but would also introduce revenue-enhancing measures.[13]

- Regarding the *social security system*, the government customarily reviewed the pension and medical insurance schemes periodically and proposed reforms to the Diet. A pension reform that strengthened the system's finances passed the Diet in June 2004 (Box 2).[14] The reform featured gradual increases in contributions and government transfers and reductions in pension benefits, which together would significantly reduce the system's long-term deficit.

33. **The mission and the authorities broadly agreed that the stronger economy meant that a tighter fiscal stance was warranted from a near-term perspective**. With growth much higher than initially envisaged, achieving additional fiscal savings in FY2004 relative to the budget would be desirable. As the budget implied a constant cyclically-adjusted deficit, the mission recommended that any stronger than expected revenues should be saved and in addition the scope for expenditure savings should be explored. The authorities agreed on revenues. However, they considered that it was too early in the fiscal year (which began only in April) to consider expenditure measures. Also, it was not yet clear that the recovery was sufficiently robust to step up discretionary spending cuts. However,

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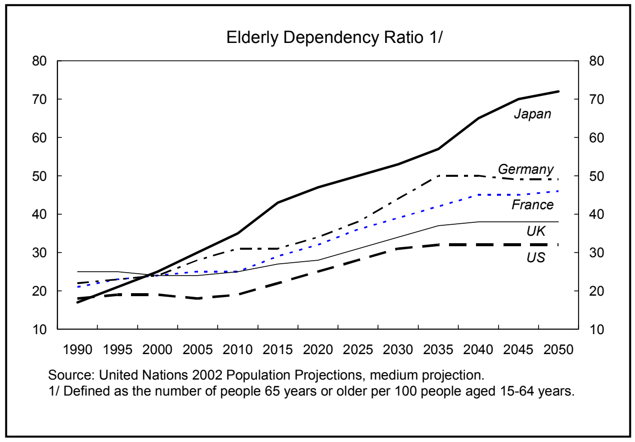
[13] The government was also contemplating reforms of the fiscal relationship between the central and local governments, which would aim to both decentralize decision-making and achieve fiscal consolidation at the local and central government levels. See the selected issues paper entitled "Reform of Local Government Finances."

[14] See the selected issues paper entitled "Pension Reform Issues in Japan."

## Box 2. Public Pension Reform in Japan

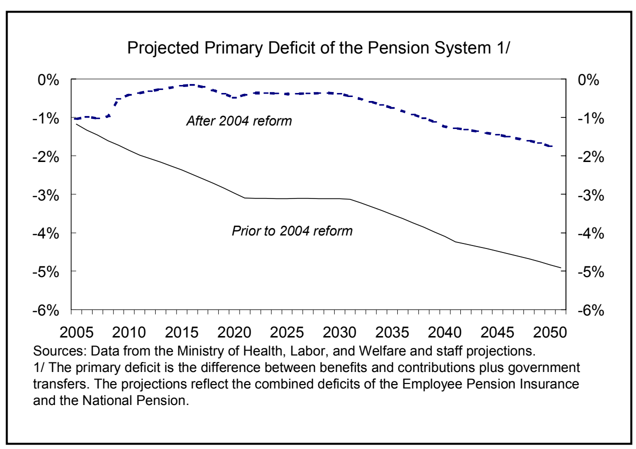



**Japan's demographic trends present a serious challenge to its long-term fiscal sustainability**. Japan has the most rapidly aging population among advanced countries. The elderly dependency ratio is expected to increase from about 30 percent currently to more than 70 percent in 2050. Social security expenditure (including on pensions, health, and welfare) has been the fastest growing component of public expenditure and is set to continue outpacing GDP growth in the future.

**Japan has a defined-benefit public pension system with comprehensive coverage, supplemented by various private pension plans**. The public system includes the National Pension (NP), which covers all people and pays flat-rate benefits; Employee Pension Insurance (EPI), which covers private sector employees and pays wage-related benefits; and mutual pension schemes, which cover public sector employees and have structures similar to that of the EPI.

**The 2004 public pension reform recently passed by the Diet features the following changes**:

- Contribution rates would be gradually raised through 2017: by 27 percent in real terms for the NP, and from 13.58 percent of salary to 18.3 percent for the EPI;
- Pension benefits would be gradually reduced (by not fully indexing them to the CPI), but the reductions would stop once the EPI benefits for a typical family fall to 50.2 percent of average salary (the current level is 59.3 percent);
- Government transfers to the NP would increase gradually from one-third to one-half of total benefit payments between 2004 and 2009;
- The reserves of the pension system would fall to the level of annual benefit expenditure by 2100 (currently the reserves are five times annual benefit expenditure).




**The reform would improve the finances of the pension system**. Staff projections suggest that with the reform the primary deficit of the public pension system would be 2 percent of GDP in 2050, compared to 5 percent of GDP in the absence of reform.

**However, the proposed reform has been criticized on several grounds**: (i) it relies heavily on increases in contribution rates and government transfers, both of which are likely to affect negatively economic growth (the latter because—other things constant—it would require higher taxes); (ii) it does not include an automatic mechanism to lower benefits or increase contributions in case that current assumptions regarding economic growth and the evolution of other key variables turn out to be too optimistic; and (iii) it deepens intergenerational inequality as the younger generations would bear most of the burden of the reform.

spending measures might be contemplated later in the year, provided that the recovery proved strong enough.

34. **Regarding the medium term, the discussion focused on the best way to undertake the sizeable adjustment that would be needed**. The mission considered that an adjustment of 6.9 percent of GDP in the primary balance excluding social security would be needed to stabilize public debt relative to GDP by 2013 (corresponding to the authorities' target period—the early 2010s—for attaining a primary surplus excluding social security). Even after this large adjustment, debt would remain very high—110 percent of GDP. The consolidation effort would most likely need to comprise a mix of spending cuts and revenue-boosting measures, which could include:

Primary Balance Adjustment

| | General govt. | General govt. excluding social security | Social security |
|---|---|---|---|
| FY2004 | -4.9 | -3.6 | -1.3 |
| FY2013 | 1.4 | 3.3 | -1.9 |
| Adjustment | 6.3 | 6.9 | -0.6 |

Source: Fund Staff estimates.

Primary Balance (Excluding Social Security) Required to Stabilize Net Debt [1]

| Real interest rate/ real GDP growth rate | 2 | 3 | 4 |
|---|---|---|---|
| 0.7 | 3.3 | 4.4 | 5.5 |
| 1.7 | 2.2 | 3.3 | 4.4 |
| 2.7 | 1.2 | 2.2 | 3.3 |

Source: Fund Staff estimates.
[1] In percent of GDP; debt stabilized at 110 percent of GDP; social security primary deficit in 2013 is estimated at 1.9 percent of GDP.

- *Further cuts in capital expenditure*, which is high (5½ percent of GDP in 2003, compared with an average of 3 percent in other G-7 countries) and includes some inefficient public works spending;

- *Additional measures to broaden the personal income tax base* by further reducing or eliminating various allowances and exemptions;

- *An increase in the consumption tax rate,* introduced gradually over several years to avoid an undue adverse impact on consumption and confidence. The consumption tax rate is low compared with rates in most other advanced economies, and staff estimated that each 1 percentage point increase would yield 0.5 percent of GDP;

- *Social security reforms* to address the major medium-term fiscal challenges posed by population aging. In addition to the recently approved pension reform, these could include strengthened enforcement of pension contributions and reforms of the medical and long-term care systems to contain rapidly growing costs. Future pension reviews should duly consider both the system's long-term finances and adverse effects on growth when weighing contribution hikes against benefit cuts.

Also, in view of the size of the needed adjustment, measures to enhance the plan's credibility by specifying a primary surplus target and measures to achieve it could help to prevent a rise in real interest rates.

35. **The authorities agreed that a sizeable adjustment was needed, and would aim to further enhance credibility through concrete future progress**. On tax reforms, the ruling parties had

recently outlined some possible measures, including reforms of the consumption tax by around 2007, but the timing and modalities required further discussion. However, the authorities were reluctant to adopt specific targets and measures in view of the unsuccessful experience with a detailed and rigid medium-term fiscal adjustment program in 1998, which had to be abandoned soon after its introduction. The mission agreed that any more specific consolidation plan should have due flexibility to adapt to economic fluctuations, by providing that shortfalls relative to the goal could occur during slowdowns and be made up when growth revives. Also, it concurred that early steps to rein in fiscal imbalances could also help to signal the commitment to medium-term consolidation.

***Trade and structural reforms: expanding opportunities domestically and internationally***

36. **The Koizumi administration has embarked on a broad-based program of structural reforms,** with a view to encouraging job creation and raising productivity and potential economic growth (Box 3).[15] The program spans deregulation of product and labor markets, strengthened competition policy, and reforms of key public enterprises. In each of these areas, progress has been made or proposals have been drafted.

37. **The mission noted the progress to date and encouraged the government to accelerate its program for structural reforms**. In view of the prospective rapid aging of the Japanese population (see Box 2), such reforms are critical to enhancing prospects for Japan's economic vitality and prosperity in the years ahead. Priority areas include:

- *Regulatory reforms to improve resource allocation*, notably by pressing ahead with special structural reform zones; removing barriers to entry in sectors such as health care, agriculture, and education; and permanently reducing capital requirements to start new firms;

- *Strengthening competition policy to facilitate market entry and exit*, including by enhancing the resources and power of the Fair Trade Commission and increasing sanctions for anti-competitive practices;

- *Increasing labor market flexibility*, in particular by further clarifying conditions for dismissing workers; further relaxing restrictions on fixed-term contracts, temporary workers, and private job-placement firms; improving the effectiveness of public job training programs; and raising contribution limits for portable corporate pensions;

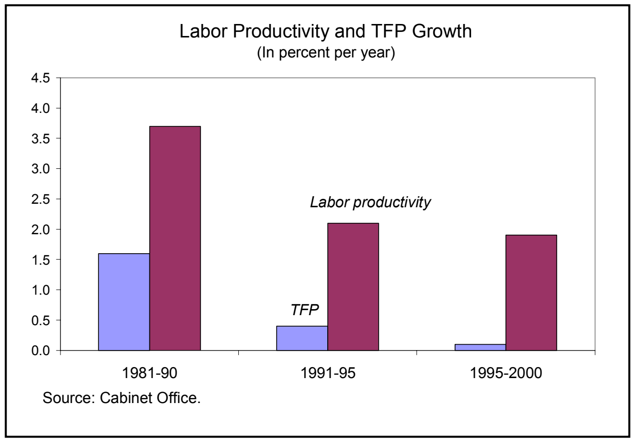
- *Further progress in public enterprise reforms*, notably of the highway and postal corporations, through plans that would raise the efficiency of these enterprises, reduce distortions in related private markets, and realize fiscal savings.

38. **The mission reviewed trade policy, especially the increased reliance on bilateral agreements**. Officials viewed the preliminary Economic Partnership Agreement (EPA) with Mexico as a key development, as it included a number of commitments on agriculture. This

[15] See the selected issues paper entitled "Structural Reforms and Productivity Growth."

## Box 3. Japan: Structural Reforms

**The government's structural reform agenda aims to reverse the secular decline in growth and productivity**. Real GDP growth declined from an average of 4 percent in the 1980s to 1½ percent in the 1990s. Estimates by the Cabinet Office suggest that average labor productivity growth declined from 3¾ percent to 2 percent over this same period, while total factor productivity growth (based on a Cobb-Douglas production function) declined from 1.6 percent to 0.2 percent (Figure). The slowdown in productivity is generally attributed to rigidities that inhibited a rapid and efficient reallocation of economic resources.




**Consequently, structural reforms have been geared towards enhancing private sector activity and employment**. The current framework for reforms was set out in the Council on Economic and Financial Policy's *Outline of Basic Policies for Macroeconomic Management and Structural Reform* in 2001, and is updated annually. The framework is wide-ranging, covering fiscal and monetary policies, financial sector reforms under the Program for Financial Revival, trade policy, and other structural reforms.

**The main elements of the structural reform agenda include the following**:

- *Enhancing labor market flexibility*. Restrictions on the use of temporary workers have been relaxed by allowing such workers to be hired on fixed-term contracts of up to three years (up from one), and rules governing worker dismissal have been clarified. Pension portability has been increased through the introduction of defined-contribution plans, although these are subject to a low contribution limit and have yet to be widely adopted. The scope for private job placement services has increased, but the services currently account for only 1 percent of new hires.

- *Advancing regulatory reform*. The Council for Regulatory Reform, a group of private-sector experts, was established at the Cabinet Office in 2001 to guide regulatory reform. Its focus has been on removing obstacles to private sector involvement in social sectors (e.g., healthcare and education) and establishing "special structural reform zones" that relax business regulation at a local level on a pilot basis. In FY2003, the first year of the program, over 300 special zones were approved. It is expected that successful reforms will be extended nation-wide.

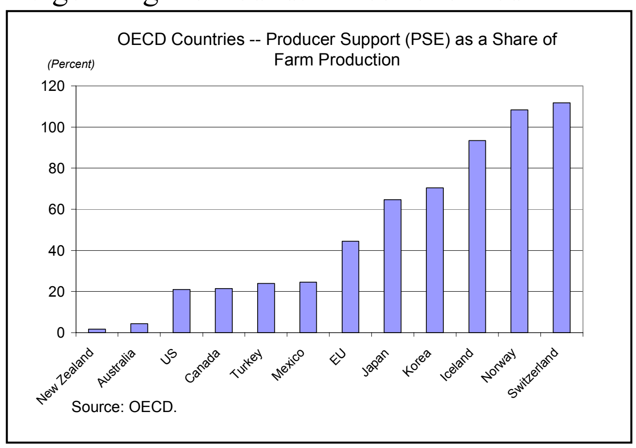
- *Strengthening competition policy*. The Fair Trade Commission (FTC) has had mixed success in addressing anticompetitive activities. Many companies have been exempted from the Antimonopoly Act, and the FTC often relies on formal warnings, while fines for anticompetitive practices have been infrequent and small. In recent years, steps have been taken to strengthen the independence of the FTC and increase its resources. More generally, competition has been encouraged by temporarily reducing the minimum capital required to start a new business.

- *Accelerating public enterprise reform*. The emphasis has been on privatizing the highway and postal corporations. The four highway corporations are to be transformed into six private corporations which would enter into long-term contracts to build and manage highways. The privatization of Japan Post is set to begin in 2007, although the modalities have yet to be determined.

**The benefits of accelerating reforms in these areas are difficult to quantify, but could be significant**. A number of studies in the 1990s suggested that structural reforms could boost the level of output by around 6 percent. A more recent study by the OECD, based on explicit assumptions about the scope for reducing price-cost margins in a number of sectors, estimated that comprehensive regulatory reforms could reduce producer prices by 5–7 percent and raise labor productivity and output levels by 5–6 percent.

new degree of flexibility could prove essential for prospective EPAs with Malaysia, Thailand, the Philippines, Republic of Korea and ASEAN. The staff noted that while steps toward a more liberal trade environment were welcome, broad-based liberalization through the WTO framework would bring more substantial benefits and would demonstrate support for the world trading system at a critical juncture. Staff also highlighted the risk of trade diversion, and the need to avoid creating a multiplicity of trade rules that could complicate trade administration. The authorities emphasized that the WTO and the Doha Development Agenda remained the centerpieces of Japan's trade policy and that their recent pursuit of bilateral agreements did not represent a shift away from support for the multilateral trading system. Instead, it represented in part a response to regional trade agreements by other countries, which in recent years had reduced Japanese firms' competitiveness in key markets. Furthermore, the comprehensive nature of EPAs created an opportunity for Japan to pursue objectives that had made little progress in the Doha Round.

39. **The authorities regarded the outcome of the WTO Ministerial in Cancun as reflecting a deep-seated lack of consensus**—principally on agriculture and the so-called Singapore Issues. The mission suggested that Japan, along with other major industrialized countries, should play a leadership role in reinvigorating the Round. It also reiterated concerns that Japan's continued high agricultural support unduly burdened Japanese consumers.[16] The authorities remained hopeful that a multilateral consensus in this area could be achieved soon, but argued that non-trade concerns (such as environmental protection, food security, and rural employment) should be taken into account. They also emphasized that, international criticism notwithstanding, Japan is one of the world's largest net importers of agricultural products. The mission nevertheless urged the authorities to consider means of addressing non-trade concerns that were more cost effective and distorted trade less.




40. **The mission welcomed the expanded product coverage for tariff- and quota-free imports from least developed countries (LDCs)** under Japan's Generalized System of Preferences (GSP). It emphasized the importance of further lowering barriers to LDC exports, as Japan's imports from LDCs in 2003 accounted for only about 0.5 percent of its total import bill. The mission noted that expanded LDC trade opportunities will be critical for contributing to the Millennium Development Goals.

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[16] Japan ranks high among OECD countries in terms of the ratio of producer support to farm output. Also, domestic producer prices in Japan are on average more than twice world agricultural market prices.

*Other areas*

41. **The authorities were reviewing the methodology for compiling national-accounts statistics** and were considering a shift to a chain-weighted methodology to improve the accuracy of the associated price and volume measures. The mission welcomed the aim to improve the national accounts statistics and noted the authorities' intention to conduct a data ROSC starting in mid-2005.

42. **A fiscal ROSC update completed in June 2004 welcomed the progress achieved in improving transparency and identified areas where further efforts were needed**.[17] Consistent with the original ROSC's recommendations, reforms of the Fiscal Investment and Loan Program (FILP) initiated in 2001 significantly reduced its size, the government has announced a medium term fiscal target to indicate the desired direction of fiscal policy, and the use of supplementary budgets has been minimized. Further efforts could be directed at providing timely information on the consolidated general government balance, better integrating the medium term framework with the budget process, and analyzing the financial implications of the FILP program.

43. **An AML/CFT ROSC completed in June 2004** (IMF Country Report No. 04/187) noted that important progress has been made towards achieving a high level of compliance with the FATF Recommendations and that a comprehensive legal and institutional framework is in place. Some weaknesses, however, were noted in international cooperation and in staffing resources for financial supervision (including of Japan Post) and for the financial intelligence unit.

44. **The authorities noted that, notwithstanding a cut in ODA, Japan remained the second largest provider of such assistance**. Also, Japan's ODA was becoming more focused, targeted and prioritized, with a view to promoting infrastructure development in Asia and Africa. The mission observed that Japan's ODA was currently equivalent to 0.2 percent of GNI, virtually the same as the weighted average in G-7 countries, and encouraged the authorities to raise ODA closer towards the UN target of 0.7 percent of GNI.

## IV. Staff Appraisal

45. **The economic recovery, in tandem with policy measures, has fostered progress in dealing with Japan's longstanding economic problems**. Deflationary pressures have eased, against the backdrop of a narrowing output gap and supportive monetary policy; and financial and corporate sector restructuring have continued, encouraged by enhancements to bank regulation and the framework for corporate revitalization. This progress bodes well for a continued expansion in the near term, although there remain risks to the outlook, stemming mainly from the external environment.

46. **Looking ahead, decisively resolving remaining problems would help to sustain the expansion over the medium term**. Existing corporate and financial sector weaknesses and the high and rising public debt are apt to pose vulnerabilities and restrain growth over the medium term if not fully addressed. Accordingly, policies should aim to encourage continued

[17] The authorities have consented to publication of the fiscal ROSC update.

and broader restructuring in the corporate and financial sectors, stabilize the public debt over the medium term, and in addition unlock Japan's untapped economic potential through structural reforms. These steps would mainly involve building on the administration's current policy program.

47. **The current monetary policy stance and strategy are appropriate for the present deflationary environment and should be maintained until inflation is firmly positive**. Recent increases in the current-account target and steps to spell out necessary conditions for ending the quantitative easing framework have usefully clarified and demonstrated the commitment to maintain zero-short term interest rates until deflation ends. While liquidity is now ample, further increases in the current account target could be considered, if needed, as a way of further signaling to markets the commitment to maintain the quantitative easing framework as long as necessary. Also, with exchange rate risks now more balanced, large-scale currency market interventions by the authorities no longer seem necessary to prevent an undue tightening of monetary conditions. However, such interventions could be used if significant upward pressures on the yen reemerged, to the extent that they threatened to stall the recovery and heighten deflationary pressures.

48. **As the onset of inflation draws nearer, enhancements to the BoJ's communications strategy could help to stabilize inflation expectations**. This could include quantifying the BoJ's inflation objective, although to mitigate reputational risks and afford flexibility such an objective should be clearly specified as a desirable medium-term inflation rate rather than a binding target to be reached in a fixed period. Also, the BoJ could publish more details of its views on monetary policy and the inflation outlook.

49. **In the financial sector, the economic recovery and strengthened regulation have fostered progress in resolving balance-sheet problems**. Thanks in part to the Program for Financial Revival, major banks have reduced NPLs and DTAs and are on track to attain the NPL ratio target of about 4 percent by end-March 2005. Also, there are no signs of strain in the run-up to the cutback in deposit insurance coverage, and it would be desirable to reduce deposit insurance coverage on April 1, 2005 as currently planned. However, weaknesses remain that are apt to restrain growth over the medium term if not addressed: one major bank is very weak, regional banks have made less progress in reducing NPLs, core profits remain low, and DTAs are still a significant share of regulatory capital.

50. **Expanded bank reforms could build on this progress to put banks in a better position to lend and thus to help support the recovery**. Building on policy efforts to date, which have played a key role in pushing banks to address their difficulties, would help to ensure continued and broader progress in resolving the banking system's problems. For major banks, measures to further improve recognition of and provisioning for problem loans, strengthen bank capital, and bolster bank governance would be key. For the regional banks, measures similar to those that have worked well for major banks would encourage them to catch up in reducing NPLs, and holding them to the same rigorous minimum capital standard as major banks would ensure that they are equally strong. However, these steps for regional banks should be introduced gradually over time, in light of the weaknesses among these banks and regional economies. Also, the new capital injection facility could be used, with appropriate conditionality, to facilitate consolidation among the numerous regional

institutions. For all banks, implementing soon plans to scale back government financial institutions in areas where they compete with private institutions would enhance the environment for profitability.

51. **A strengthened banking system would also facilitate additional corporate restructuring,** because banks would be more easily able to take the losses involved in restructuring weak borrowers. Revisions to the Commercial Code to ensure that outside directors are fully independent from corporate management could improve incentives for corporations to restructure. Also, the IRCJ can appropriately continue to facilitate market-based restructuring, particularly in cases where it has an advantage in coordinating creditors.

52. **The staff shares the authorities' concern about the fiscal situation**. Public debt is already at very high levels, and population aging will pose major fiscal challenges over the medium term. In this connection, staff regards the official goal to achieve a primary surplus (excluding social security) by the early 2010s and the recent adoption of public pension reforms as steps in the right direction. In light of the need to begin fiscal consolidation and the favorable economic environment, achieving savings in FY2004 relative to the budget would be desirable. In particular, it would be useful to explore the scope for expenditure savings this year, which (together with any stronger than expected revenues) should be used to reduce the deficit.

53. **In the medium term, a sizeable adjustment will be needed to stabilize the debt even at a very high level**. Staff considers that options for consolidation could include further social security reforms (in addition to the recently adopted pension measures, reforms of the medical and long-term care elements), further cutting capital spending and broadening the personal income tax base, and (in the medium term) raising the consumption tax. Early consolidation steps could bolster the credibility of the government's medium-term fiscal plan and thereby reduce the risk of a harmful rise in real interest rates. Credibility could also be enhanced by adopting a specific medium term primary surplus target and explicit measures to achieve it, although this more specific plan would need due flexibility to adapt to short term economic fluctuations.

54. **Accelerating the government's structural reform program would raise potential growth**. Front-loaded regulatory reforms, measures to strengthen competition policy and further increase labor market flexibility, and public enterprise reforms would help to unlock Japan's economic potential. In view of rapid population aging, such steps would be key for enhancing Japan's economic prospects in coming years.

55. **On trade policy**, market opening under the preliminary EPA between Japan and Mexico is welcome but multilateral liberalization under the WTO framework should remain the centerpiece of Japan's trade policy regime. In this context, it will be crucial for the authorities to work with other industrial countries to ensure achievement of the Doha Round's development objectives; flexibility on agriculture will be essential in this regard. In this connection, the high level of agricultural support remains a concern, and more cost-effective and less distortionary means of addressing non-trade concerns might be sought. However, the expansion of coverage for LDC exports under Japan's generalized system of

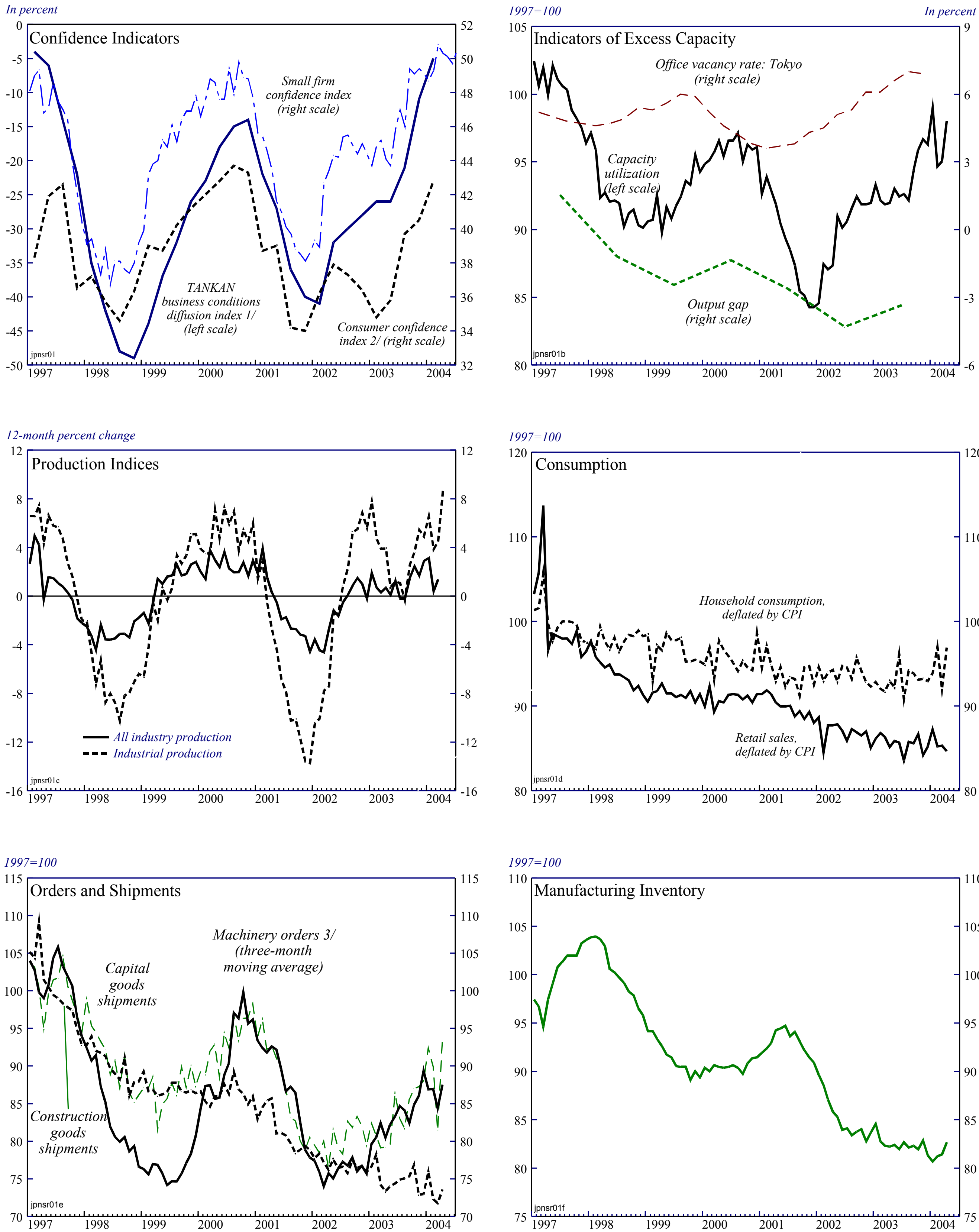
preferences in 2003 is commendable, and the authorities should work to make further progress in this area.

56. **The review of the national accounts methodology is welcome**. The staff encourages the authorities to make needed improvements to the national accounts data and notes the intention to conduct a data ROSC starting in mid-2005. Also, reducing the publications lag for fiscal statistics would ease analysis in this critically important area.

57. **The staff encourages the authorities to raise ODA toward the UN target of 0.7 percent of GNI**. ODA is presently about the same as the average in G-7 countries.

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

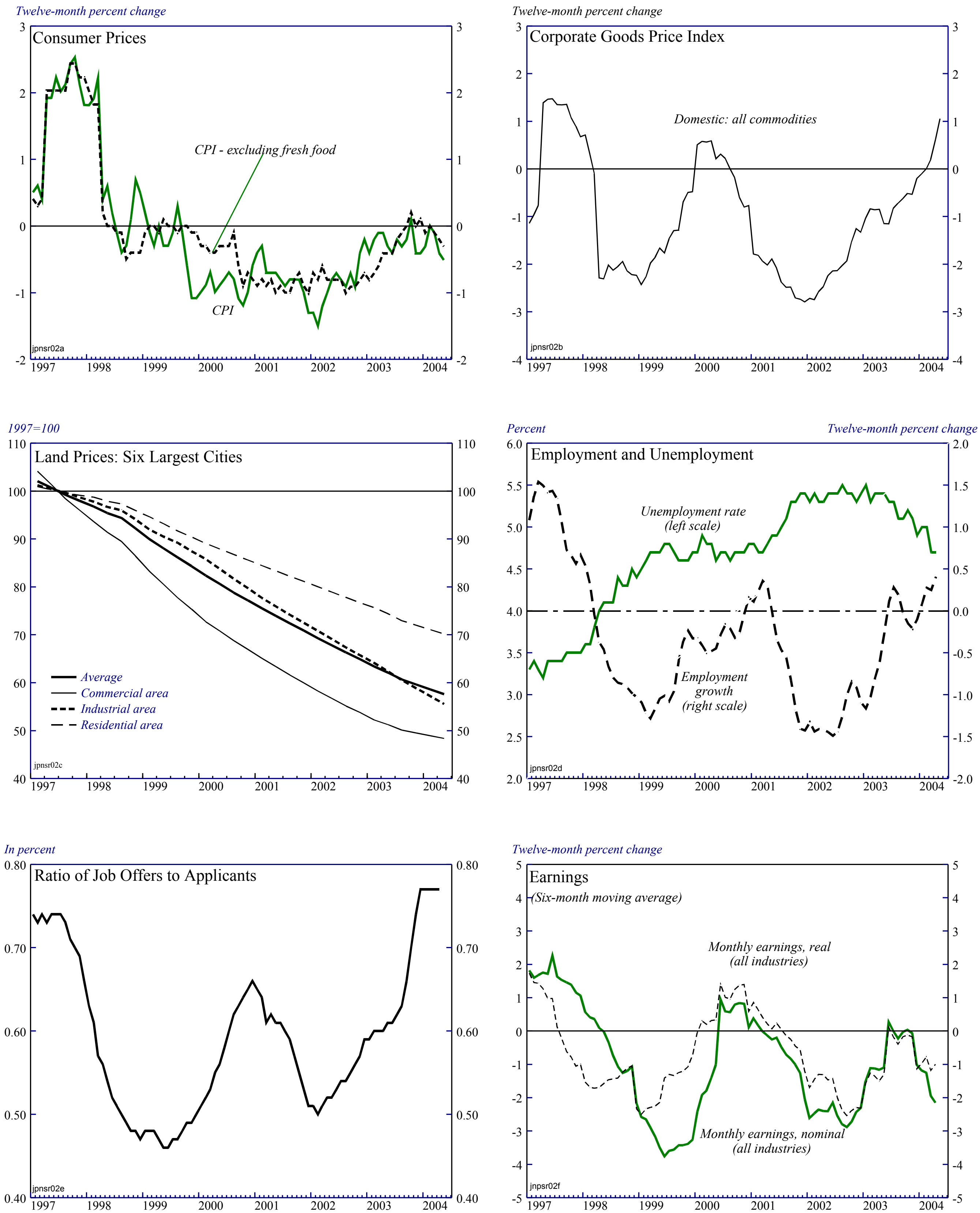
Figure 1. Japan: Selected Economic Indicators, 1997-2004




Source: Global Insight, Nomura Database; and CEIC Database.

1/ "Favorable" minus "unfavorable". There is a break in the series at December 2003.
2/ Higher number implies greater degree of consumer confidence about future prospects.
3/ Excluding ships and public utilities.

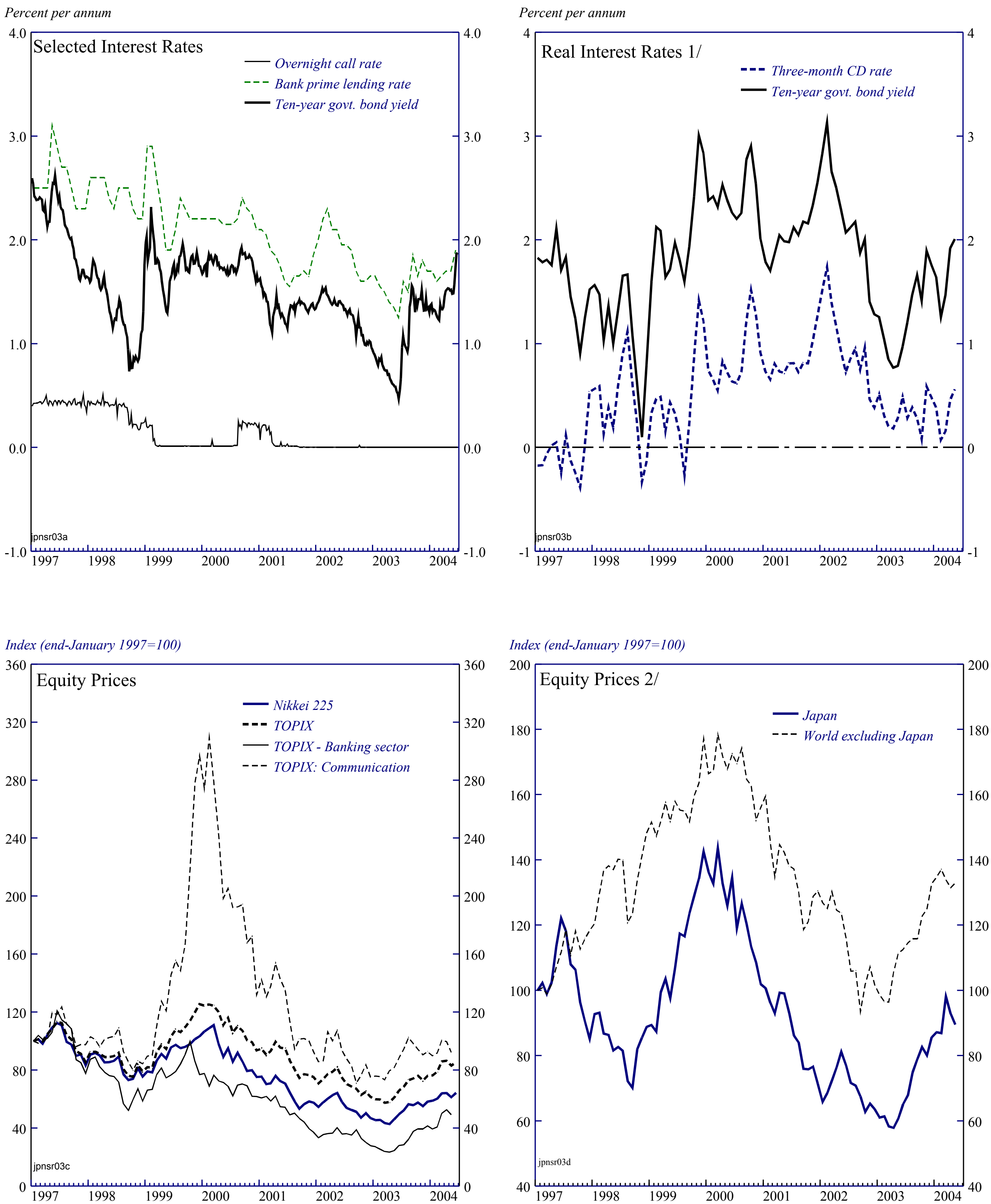
Figure 2. Japan: Price and Labor Market Indicators, 1997-2004 1/




Source: Global Insight, Nomura Database.

1/ Seasonally adjusted data except for land prices and monthly earnings.

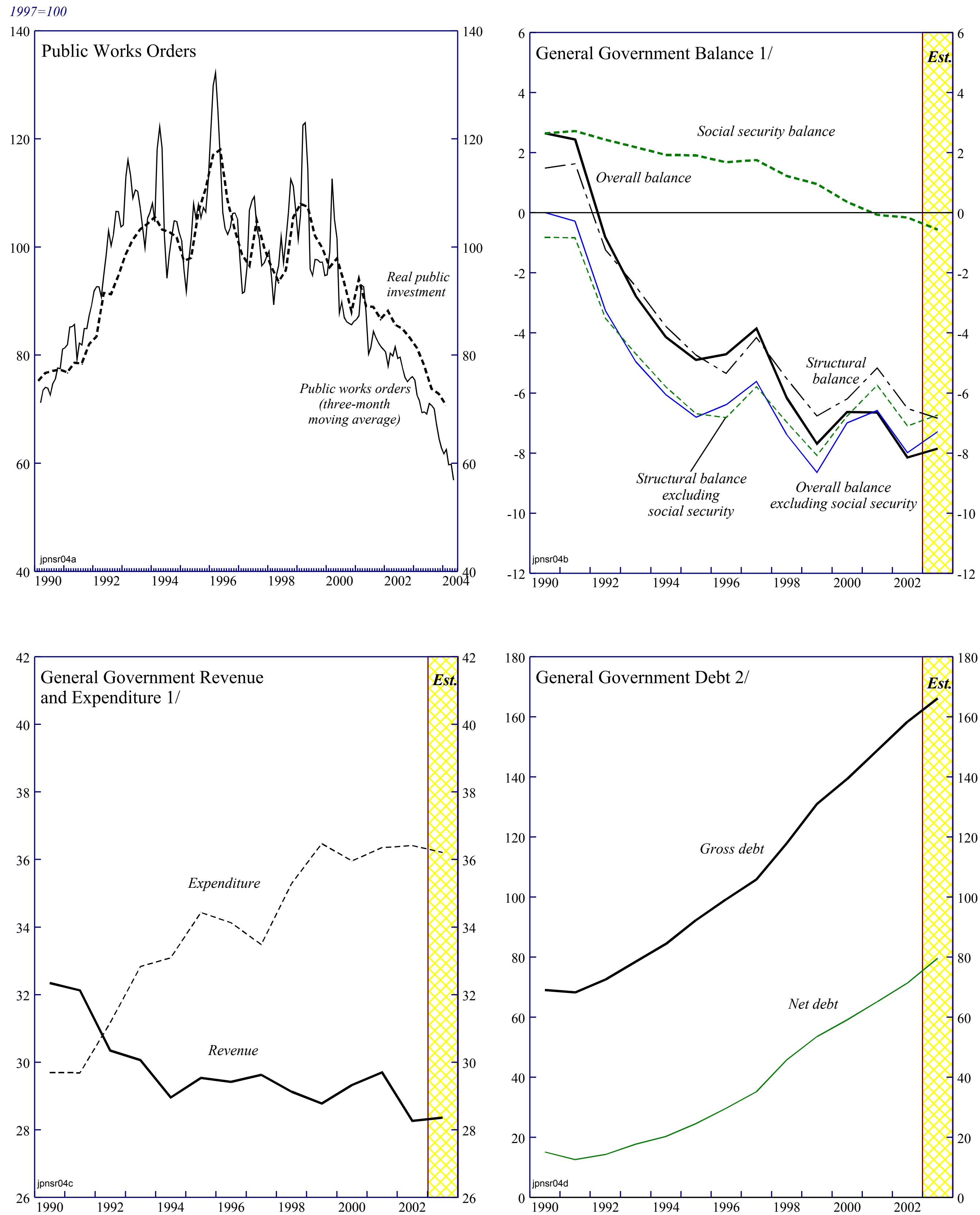
Figure 3. Japan: Financial Indicators, 1997-2004




Sources: Global Insight, Nomura Database; CEIC Database; Bloomberg, LP; and staff calculations.

1/ Deflated by CPI adjusted for changes in indirect taxes and administered prices.
2/ Morgan Stanley Index.

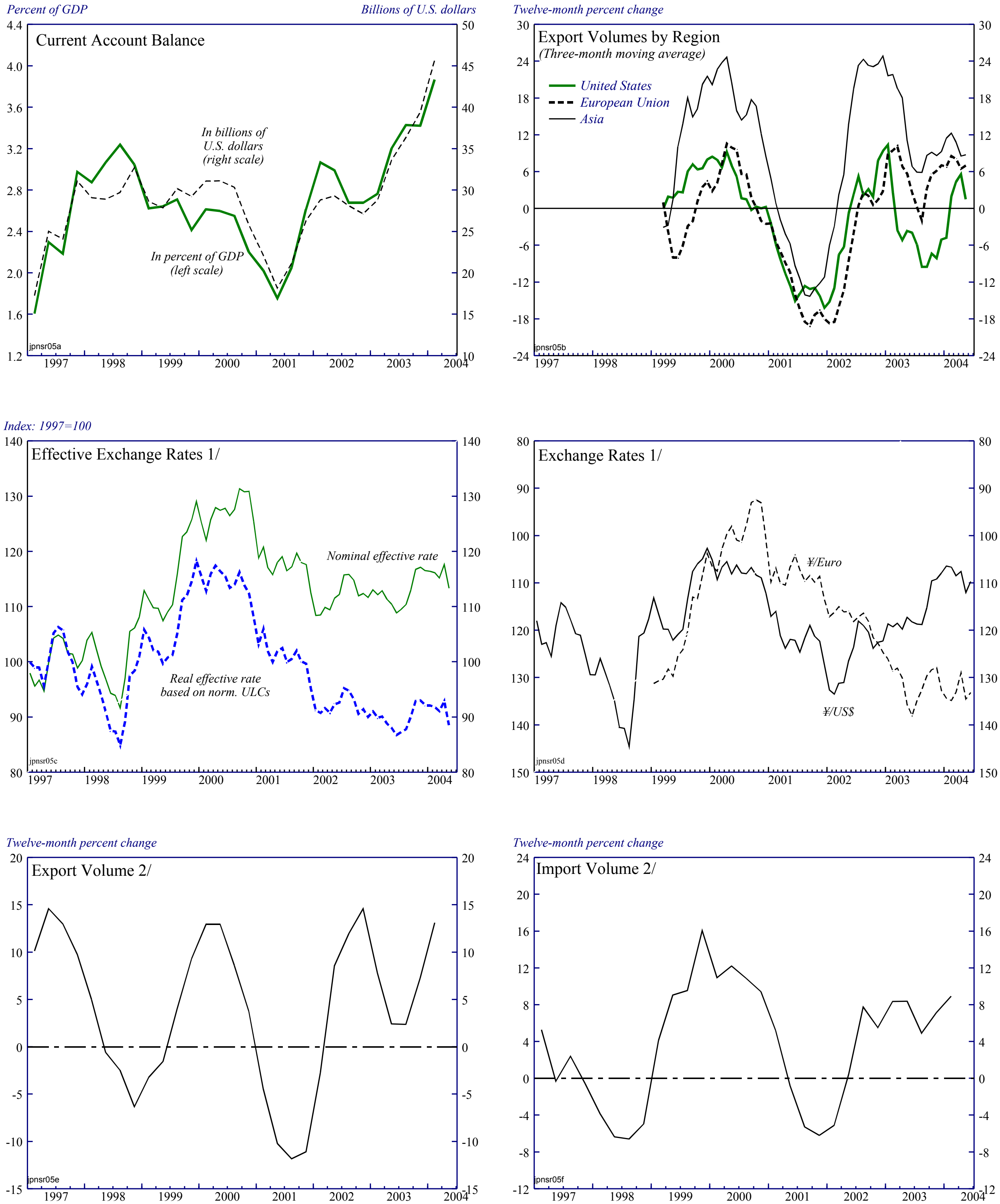
Figure 4. Japan: Fiscal Indicators, 1990-2004




Sources: Cabinet Office; Global Insight, Nomura Database; and staff estimates and projections.

1/ In percent of fiscal year basis GDP; the fiscal year is from April to March.
2/ In percent of GDP, calendar years.

Figure 5. Japan: External Sector Developments, 1997-2004




Source: Global Insight, Nomura Database.

1/ Increase implies appreciation.
2/ Customs-clearance data.

## Table 1. Japan: Selected Economic Indicators, 1997-2005

Nominal GDP: US$4,302 billion (2003)
Population: 127.6 million (2003)
GDP per capita: US$33,722 (2003)
Quota: SDR 13,312.8 million

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | Proj. 2004 | | Proj. 2005 |
|---|---|---|---|---|---|---|---|---|---|---|
| Growth (percent change) 1/ | | | | | | | | | | |
| Real GDP | 1.8 | -1.2 | 0.2 | 2.8 | 0.4 | -0.3 | 2.5 | 4.5 | | 2.4 |
| Domestic demand | 0.8 | -1.5 | 0.3 | 2.3 | 1.2 | -1.0 | 1.8 | 3.7 | | 2.0 |
| Private consumption | 1.0 | 0.0 | 0.2 | 0.8 | 1.8 | 0.9 | 0.8 | 3.2 | | 1.8 |
| Residential investment | -11.7 | -14.5 | -0.1 | 0.7 | -5.3 | -4.2 | -0.8 | 2.0 | | 2.0 |
| Business investment | 11.1 | -2.3 | -3.9 | 9.7 | 0.9 | -7.1 | 9.6 | 11.1 | | 6.2 |
| Government consumption | 1.0 | 2.0 | 4.6 | 4.9 | 3.0 | 2.4 | 1.0 | 1.5 | | 1.1 |
| Public investment | -10.5 | -2.2 | 6.7 | -10.0 | -4.5 | -4.7 | -10.5 | -10.2 | | -7.5 |
| Stockbuilding 2/ | -0.1 | -0.6 | -0.4 | 0.3 | 0.0 | -0.2 | 0.3 | 0.2 | | -0.1 |
| Net exports 2/ | 1.0 | 0.3 | -0.1 | 0.5 | -0.7 | 0.7 | 0.7 | 0.9 | | 0.5 |
| Exports of goods and services | 11.5 | -2.4 | 1.4 | 12.5 | -6.1 | 7.9 | 10.1 | 13.4 | | 7.6 |
| Imports of goods and services | 1.0 | -6.6 | 3.3 | 9.3 | 0.2 | 1.9 | 5.0 | 8.2 | | 5.1 |
| Saving-Investment (percent of GDP) | | | | | | | | | | |
| Gross national saving | 30.9 | 29.8 | 28.6 | 28.8 | 27.8 | 26.7 | 27.2 | 27.7 | | 27.8 |
| Gross domestic investment | 28.7 | 26.8 | 26.0 | 26.3 | 25.7 | 23.9 | 24.0 | 24.4 | | 24.5 |
| Inflation (annual average) | | | | | | | | | | |
| CPI (SA) 3/ | 1.7 | 0.6 | -0.3 | -0.9 | -0.8 | -0.9 | -0.2 | -0.1 | | 0.0 |
| GDP deflator | 0.3 | -0.1 | -1.5 | -2.0 | -1.5 | -1.2 | -2.5 | -2.2 | | -1.1 |
| Unemployment rate (annual average) | 3.4 | 4.1 | 4.7 | 4.7 | 5.0 | 5.4 | 5.3 | 4.7 | | 4.4 |
| Government (percent of GDP, fiscal year basis) | | | | | | | | | | |
| General government | | | | | | | | | | |
| Revenue | 29.6 | 29.1 | 28.8 | 29.3 | 29.7 | 28.3 | 28.4 | 28.5 | | 28.8 |
| Expenditure | 33.5 | 35.3 | 36.5 | 36.0 | 36.4 | 36.4 | 36.2 | 35.2 | | 35.0 |
| Balance | -3.9 | -6.2 | -7.7 | -6.6 | -6.7 | -8.1 | -7.9 | -6.7 | | -6.1 |
| Balance excluding social security | -5.6 | -7.4 | -8.6 | -7.0 | -6.6 | -8.0 | -7.3 | -6.2 | | -5.6 |
| Structural balance 4/ | -4.2 | -5.3 | -6.1 | -5.5 | -5.0 | -6.5 | -6.5 | -6.5 | | -6.1 |
| Money and credit (percent change, end-period) | | | | | | | | | | |
| Base money | 9.9 | 4.0 | 14.2 | -1.1 | 16.9 | 19.5 | 13.2 | 7.4 | 7/ | ... |
| M2 plus CDs (period average) 5/ | 3.1 | 4.4 | 3.7 | 2.1 | 2.8 | 3.3 | 1.7 | 2.0 | 7/ | ... |
| Domestic credit 5/ | 1.3 | 0.7 | -0.3 | 2.3 | 1.4 | -1.6 | 3.9 | 4.4 | 8/ | ... |
| Bank lending 5/ | 0.0 | -4.7 | -5.9 | -3.8 | -4.3 | -4.8 | -5.1 | -4.1 | 7/ | ... |
| Interest rate | | | | | | | | | | |
| Three-month CD rate (annual average) | 0.5 | 0.6 | 0.1 | 0.2 | 0.09 | 0.07 | 0.09 | 0.05 | 9/ | ... |
| Official discount rate (end-period) | 0.5 | 0.5 | 0.5 | 0.5 | 0.10 | 0.10 | 0.10 | 0.10 | 9/ | ... |
| Balance of payments (in billions of US$) | | | | | | | | | | |
| Exports, f.o.b. | 409.2 | 374.4 | 403.9 | 459.6 | 383.5 | 395.7 | 449.2 | 525.2 | | 567.1 |
| Imports, f.o.b. | 307.8 | 251.6 | 280.5 | 342.8 | 313.3 | 301.8 | 342.8 | 396.1 | | 427.1 |
| Current account balance | 96.6 | 119.1 | 114.5 | 119.6 | 87.8 | 112.6 | 136.2 | 149.3 | | 156.7 |
| Percent of GDP | 2.2 | 3.0 | 2.6 | 2.5 | 2.1 | 2.8 | 3.2 | 3.2 | | 3.3 |
| Terms of trade (percent change) | -3.9 | 6.7 | 4.6 | -5.0 | -1.0 | 1.0 | 1.7 | -0.9 | | -0.2 |
| Change in reserves | 6.9 | -7.4 | 77.3 | 49.3 | 41.1 | 46.7 | 188.1 | ... | | ... |
| Total reserves minus gold (in billions of US$) | 219.6 | 215.5 | 286.9 | 354.9 | 395.2 | 461.2 | 663.3 | 807.2 | 7/ | ... |
| Exchange rates (annual average) | | | | | | | | | | |
| Yen/dollar rate | 121.0 | 130.9 | 113.9 | 107.8 | 121.5 | 125.4 | 115.9 | 107.6 | 9/ | |
| Real effective exchange rate 6/ | 119.5 | 109.9 | 127.2 | 136.6 | 120.8 | 110.0 | 107.3 | 105.8 | 7/ | ... |

Sources: Global Insight, Nomura database; IMF, Competitiveness Indicators System; and staff estimates and projections as of June 30, 2004.

1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ Contribution to GDP growth.
3/ Annual growth rates are calculated from annual averages of monthly data.
4/ Including social security, excluding bank support.
5/ From April 1998 onward, data reflect the inclusion of foreign banks, foreign trust banks and Shinkin banks in the monetary survey.
6/ Based on normalized unit labor costs; 1990=100.
7/ May 2004.
8/ April 2004.
9/ June 25, 2004.

Table 2. Japan: Monetary Indicators, 1999–2004

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2003 Mar. | 2003 Jun. | 2003 Sept. | 2003 Dec. | 2004 Mar. | 2004 May |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | (In trillions of yen) | | | | | |
| Base money 1/ | 68.7 | 68.0 | 79.4 | 94.9 | 107.5 | 96.6 | 102.8 | 103.6 | 107.5 | 108.1 | 108.8 |
| M1 2/ | 213.2 | 230.6 | 250.1 | 319.2 | 345.5 | 341.2 | 346.6 | 345.6 | 354.0 | 354.9 | 363.0 |
| M2 + CDs 2/ | 616.3 | 629.3 | 646.8 | 668.2 | 679.6 | 674.2 | 681.0 | 680.2 | 685.8 | 685.8 | 694.0 |
| Bank lending 1/ | 478.4 | 460.4 | 440.5 | 419.6 | 398.1 | 417.3 | 403.7 | 399.9 | 398.1 | 397.5 | 389.0 |
| | | | | | | (Year-on-year change, in percent) | | | | | |
| Base money 1/ | 14.2 | -1.1 | 16.9 | 19.5 | 13.2 | 10.9 | 20.3 | 20.9 | 13.2 | 11.9 | 7.4 |
| M1 2/ | 10.6 | 8.2 | 8.5 | 27.6 | 8.2 | 14.4 | 4.7 | 5.7 | 4.1 | 4.0 | 4.2 |
| M2 + CDs 2/ | 3.7 | 2.1 | 2.8 | 3.3 | 1.7 | 1.7 | 1.8 | 1.8 | 1.5 | 1.7 | 2.0 |
| Bank lending 1/ | -5.9 | -3.8 | -4.3 | -4.8 | -5.1 | -4.5 | -4.6 | -5.0 | -5.1 | -4.8 | -4.1 |
| | | | | | | (In percent of GDP) | | | | | |
| Base money 1/ | 13.5 | 13.3 | 15.7 | 19.0 | 21.6 | 19.5 | 20.7 | 20.8 | 21.4 | 21.3 | ... |
| M1 2/ | 42.0 | 45.1 | 49.4 | 64.0 | 69.4 | 69.0 | 69.7 | 69.3 | 70.6 | 70.0 | ... |
| M2 + CDs 2/ | 121.4 | 123.0 | 127.8 | 134.0 | 136.4 | 136.3 | 136.9 | 136.5 | 136.7 | 135.3 | ... |
| Bank lending 1/ | 94.2 | 90.0 | 87.1 | 84.2 | 79.9 | 84.3 | 81.1 | 80.2 | 79.3 | 78.4 | ... |

Source: Global Insight, Nomura Database.

1/ End of period.
2/ Period average.

Table 3. Japan: General Government Operations, 1999-2004 1/

(In percent of GDP)

| | 1999 | 2000 | 2001 | 2002 | 2003 Est. | 2004 Proj. |
|---|---|---|---|---|---|---|
| | | | (Fiscal year) | | | |
| Total revenue | 28.8 | 29.3 | 29.7 | 28.3 | 28.4 | 28.5 |
| Taxes and fines | 16.6 | 17.3 | 17.2 | 15.9 | 16.2 | 16.3 |
| Social security premiums | 9.7 | 9.8 | 10.3 | 10.4 | 10.4 | 10.5 |
| Property income | 2.1 | 1.9 | 1.9 | 1.7 | 1.5 | 1.4 |
| Total expenditure | 36.5 | 36.0 | 36.4 | 36.4 | 36.2 | 35.2 |
| Current | 29.1 | 29.2 | 30.4 | 30.7 | 30.9 | 30.9 |
| Consumption | 11.1 | 11.1 | 11.5 | 11.7 | 11.5 | 11.4 |
| (less) Depreciation | -2.3 | -2.4 | -2.5 | -2.7 | -2.7 | -2.7 |
| Social security benefits | 13.3 | 14.0 | 14.9 | 15.3 | 15.6 | 15.7 |
| Other current | 3.5 | 3.2 | 3.3 | 3.4 | 3.3 | 3.3 |
| Interest paid | 3.4 | 3.3 | 3.1 | 3.0 | 3.1 | 3.2 |
| Capital | 7.4 | 6.8 | 5.9 | 5.7 | 5.3 | 4.3 |
| Investment | 5.6 | 5.1 | 4.9 | 4.6 | 3.9 | 3.4 |
| Land acquisition | 0.8 | 0.8 | 0.7 | 0.6 | 0.5 | 0.4 |
| Capital transfers | 0.9 | 0.9 | 0.4 | 0.5 | 0.8 | 0.4 |
| *Of which* : Bank support | 0.7 | 0.7 | 0.1 | 0.0 | 0.4 | 0.0 |
| Balance | -7.7 | -6.6 | -6.7 | -8.1 | -7.9 | -6.7 |
| Excluding social security | -8.6 | -7.0 | -6.6 | -8.0 | -7.3 | -6.2 |
| Excluding bank support | -7.0 | -5.9 | -6.5 | -8.1 | -7.5 | -6.7 |
| Primary balance 2/ | -5.7 | -4.6 | -5.2 | -6.8 | -5.8 | -4.9 |
| Structural balance (excluding support for banks) | -6.1 | -5.5 | -5.0 | -6.5 | -6.5 | -6.5 |
| Change in the structural balance | -0.8 | 0.6 | 0.5 | -1.5 | 0.1 | 0.0 |
| | | | (Calendar year) | | | |
| Total revenue | 28.8 | 29.1 | 30.0 | 28.7 | 28.4 | 28.5 |
| Taxes and fines | 16.6 | 17.1 | 17.6 | 16.2 | 16.2 | 16.3 |
| Social security premiums | 9.8 | 9.8 | 10.2 | 10.4 | 10.5 | 10.5 |
| Property income | 2.1 | 2.0 | 1.9 | 1.7 | 1.5 | 1.4 |
| Total expenditure | 36.0 | 36.6 | 36.1 | 36.6 | 36.6 | 35.3 |
| Current | 29.0 | 29.3 | 30.0 | 30.8 | 31.0 | 30.8 |
| Consumption | 11.1 | 11.1 | 11.4 | 11.8 | 11.6 | 11.4 |
| (less) Depreciation | -2.2 | -2.4 | -2.5 | -2.6 | -2.7 | -2.7 |
| Social security benefits | 13.2 | 13.9 | 14.6 | 15.3 | 15.6 | 15.7 |
| Other current | 3.5 | 3.4 | 3.3 | 3.4 | 3.3 | 3.3 |
| Interest paid | 3.4 | 3.3 | 3.2 | 3.0 | 3.1 | 3.2 |
| Capital | 7.0 | 7.3 | 6.2 | 5.7 | 5.5 | 4.4 |
| Investment | 5.8 | 5.1 | 4.9 | 4.7 | 4.1 | 3.6 |
| Land acquisition | 0.9 | 0.8 | 0.7 | 0.7 | 0.6 | 0.5 |
| Capital transfers | 0.3 | 1.4 | 0.5 | 0.4 | 0.8 | 0.4 |
| *Of which* : Bank support | 0.1 | 1.2 | 0.3 | 0.0 | 0.4 | 0.0 |
| Balance | -7.2 | -7.5 | -6.1 | -7.9 | -8.2 | -6.8 |
| Excluding bank support | -7.1 | -6.3 | -5.9 | -7.9 | -7.8 | -6.8 |
| Primary balance 2/ | -5.7 | -4.8 | -4.4 | -6.4 | -6.1 | -5.1 |
| Structural balance (excluding support for banks) | -6.2 | -5.7 | -4.8 | -6.2 | -6.5 | -6.5 |
| Change in the structural balance | -1.3 | 0.5 | 0.9 | -1.3 | -0.3 | -0.1 |
| Debt (In percent of GDP, calendar year) | | | | | | |
| Gross | 131.0 | 139.3 | 148.9 | 158.4 | 166.2 | 168.9 |
| Net | 53.5 | 59.1 | 65.1 | 71.4 | 79.6 | 84.8 |
| *Memorandum items* : | | | | | | |
| Nominal GDP (FY, trillion yen) | 507.9 | 513.4 | 501.3 | 497.8 | 501.1 | 510.7 |
| Nominal GDP (CY, trillion yen) | 507.7 | 511.7 | 506.0 | 498.5 | 498.1 | 508.9 |

Source: Staff estimates.

1/ Estimated from the National Income Accounts data. The fiscal year is April through March.
2/ The primary balance excludes bank support.

Table 4. Japan: Balance of Payments Summary, 1997-2004

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | Proj. 2004 |
|---|---|---|---|---|---|---|---|---|
| | (In billions of U.S. dollars) | | | | | | | |
| Balance of payments | | | | | | | | |
| Current balance | 96.6 | 119.1 | 114.5 | 119.6 | 87.8 | 112.6 | 136.2 | 149.3 |
| Trade balance | 101.5 | 122.7 | 123.4 | 116.7 | 70.2 | 93.9 | 106.4 | 129.1 |
| Exports | 409.2 | 374.4 | 403.9 | 459.6 | 383.5 | 395.7 | 449.2 | 525.2 |
| Imports | 307.8 | 251.6 | 280.5 | 342.8 | 313.3 | 301.8 | 342.8 | 396.1 |
| Invisibles | -4.9 | -3.6 | -8.9 | 2.9 | 17.6 | 18.7 | 29.8 | 20.2 |
| Nonfactor services | -54.2 | -49.5 | -54.2 | -47.7 | -43.7 | -42.2 | -33.9 | -45.3 |
| Investment income | 58.1 | 54.6 | 57.4 | 60.4 | 69.3 | 65.9 | 71.3 | 74.4 |
| Labor income | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | -0.1 | 0.0 |
| Net transfers | -8.8 | -8.8 | -12.1 | -9.8 | -7.9 | -4.9 | -7.5 | -8.9 |
| Capital and financial account balance | -130.4 | -122.3 | -132.3 | -136.6 | -91.5 | -112.8 | -119.5 | -118.0 |
| Capital account | -4.0 | -14.7 | -16.5 | -9.3 | -2.9 | -3.3 | -4.0 | -7.5 |
| Financial account | -126.4 | -107.6 | -115.8 | -127.3 | -88.6 | -109.5 | -115.5 | -110.6 |
| Direct investment, net | -22.9 | -21.3 | -10.0 | -23.4 | -32.3 | -23.0 | -22.5 | -34.3 |
| Direct investment abroad | -26.1 | -24.5 | -22.2 | -31.6 | -38.5 | -32.0 | -28.8 | -43.1 |
| Foreign direct investment in Japan | 3.2 | 3.3 | 12.2 | 8.2 | 6.2 | 9.1 | 6.3 | 8.9 |
| Portfolio investment, net | 30.0 | -40.9 | -30.7 | -35.1 | -46.8 | -105.8 | -97.3 | -79.6 |
| Other investment, net | -126.6 | -52.8 | 2.2 | -19.5 | 31.5 | 66.0 | 192.4 | 60.7 |
| Reserve assets | -6.9 | 7.4 | -77.3 | -49.3 | -41.1 | -46.7 | -188.1 | -57.4 |
| Errors and omissions, net | 33.9 | 3.2 | 17.7 | 17.0 | 3.7 | 0.2 | -16.8 | -31.3 |
| | (In percent of GDP) | | | | | | | |
| Net foreign assets | 22.2 | 29.2 | 24.2 | 25.3 | 31.1 | 35.3 | 35.5 | 36.0 |
| Current account balance | 2.2 | 3.0 | 2.6 | 2.5 | 2.1 | 2.8 | 3.2 | 3.2 |
| Trade balance | 2.4 | 3.1 | 2.8 | 2.5 | 1.7 | 2.4 | 2.5 | 2.8 |
| Invisibles | -0.1 | -0.1 | -0.2 | 0.1 | 0.4 | 0.5 | 0.7 | 0.4 |

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

Table 5. Japan: Indicators of External and Financial Vulnerability, 1996-2004

(In percent of GDP, unless otherwise indicated)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 Latest |
|---|---|---|---|---|---|---|---|---|---|
| External indicators | | | | | | | | | |
| Real exports of goods and services (percent change) | 6.4 | 11.5 | -2.4 | 1.4 | 12.5 | -6.1 | 7.9 | 10.1 | ... |
| Real imports of goods and services (percent change) | 13.2 | 1.0 | -6.6 | 3.3 | 9.3 | 0.2 | 1.9 | 5.0 | ... |
| Terms of trade (percent change) | -6.9 | -3.9 | 6.7 | 4.6 | -5.0 | -1.0 | 1.0 | 1.7 | ... |
| Current account balance | 1.4 | 2.2 | 3.0 | 2.6 | 2.5 | 2.1 | 2.8 | 3.2 | ... |
| Capital and financial account balance | -0.5 | -2.7 | -3.1 | -1.1 | -1.9 | -1.4 | -1.7 | 1.5 | ... |
| *Of which* : | | | | | | | | | |
| Inward portfolio investment | 1.4 | 1.8 | 1.4 | 2.8 | 1.0 | 1.4 | -0.5 | 1.9 | ... |
| Inward direct investment | 0.0 | 0.1 | 0.1 | 0.3 | 0.2 | 0.1 | 0.2 | 0.1 | ... |
| Other investment liabilities (net) | 0.8 | -2.8 | -1.4 | 0.1 | -0.3 | 0.7 | 1.6 | 4.4 | ... |
| Total reserves minus gold (US$ billion) | 216.6 | 219.6 | 215.5 | 286.9 | 354.9 | 395.2 | 461.2 | 663.3 | 807.2 |
| In months of imports of goods and services | 6.0 | 6.3 | 7.4 | 9.1 | 9.6 | 11.7 | 14.0 | 17.9 | ... |
| Broad money (M2 + CDs) to reserves ratio | 2.3 | 2.1 | 2.1 | 1.9 | 1.6 | 1.3 | 1.1 | 0.9 | 0.8 |
| Foreign assets of DMBs (US$ billion) | 960.7 | 1064.0 | 833.2 | 682.5 | 787.8 | 768.4 | 724.2 | ... | ... |
| Foreign liabilities of DMBs (US$ billion) | 736.0 | 762.5 | 612.5 | 478.8 | 568.7 | 565.5 | 536.7 | ... | ... |
| Net international investment position (US$ billion) | 891.0 | 958.7 | 1,153.6 | 829.1 | 1,157.9 | 1,249.1 | 1,598.5 | 1,721.9 | |
| *Of which* : | | | | | | | | | |
| External loan liabilities | 885.6 | 883.2 | 717.7 | 676.8 | 707.2 | 654.5 | 668.0 | 721.7 | ... |
| External public sector debt (gross) 1/ | 173.6 | 229.6 | 244.0 | 208.7 | 271.7 | 232.8 | 189.1 | 205.6 | ... |
| External loan liabilities to exports ratio | 1.9 | 1.9 | 1.7 | 1.5 | 1.4 | 1.5 | 1.5 | 1.4 | ... |
| External interest payments to exports (in percent) 2/ | 8.4 | 7.4 | 7.2 | 4.5 | 3.9 | 4.1 | 2.3 | 1.7 | ... |
| Nominal effective exchange rate (percent change) | -12.7 | -4.2 | 0.3 | 15.2 | 10.2 | -7.7 | -4.9 | 0.7 | 2.6 |
| Financial market indicators | | | | | | | | | |
| General government gross debt | 99.3 | 105.9 | 117.8 | 131.1 | 139.4 | 148.9 | 158.4 | 166.3 | ... |
| Interest rates (percent, end-year) | | | | | | | | | |
| 3-month Gensaki rate | 0.25 | 0.23 | 0.14 | 0.07 | 0.32 | 0.01 | 0.003 | 0.001 | 0.001 |
| 3-month Gensaki rate, real | -0.36 | -1.59 | -0.45 | 1.15 | 0.72 | 1.21 | 0.31 | 0.41 | 0.51 |
| 3-month interest rate spread vis-à-vis U.S. | -4.62 | -4.93 | -4.28 | -5.16 | -5.51 | -1.71 | -1.19 | -0.89 | -1.03 |
| Stock market index (TOPIX, percent change, end-year) 3/ | -6.8 | -20.1 | -7.5 | 58.4 | -25.5 | -19.6 | -18.3 | 23.8 | 36.1 |
| Banking sector risk indicators | | | | | | | | | |
| Total loans to assets (in percent) | 52.5 | 50.9 | 49.9 | 47.3 | 44.3 | 39.6 | 38.2 | 34.6 | ... |
| Total loans to deposits (in percent) | 107.6 | 107.0 | 105.1 | 98.9 | 97.8 | 93.4 | 87.3 | 81.9 | ... |
| Share of real estate sector in total lending (in percent) | 13.8 | 14.2 | 14.2 | 14.5 | 14.9 | 14.9 | 14.6 | 13.8 | ... |
| Share of non-performing loans in total loans (in percent, end-fiscal year) 4/ | 4.9 | 5.5 | 6.1 | 5.4 | 5.3 | 8.4 | 7.2 | 5.2 | ... |
| Risk-weighted capital ratio (in percent, end-fiscal year) 4/ | 9.0 | 9.5 | 11.6 | 11.8 | 11.7 | 10.4 | 10.2 | ... | ... |

Sources: Global Insight, Nomura Database; IMF, International Financial Statistics; Fitch IBCA; and staff estimates.

1/ Public sector debt securities and other loan liabilities.

2/ Other investment income, debit.

3/ Twelve-month percent change for the latest figure.

4/ Major banks. Capital ratio is on a non-consolidated basis.

## JAPAN—FUND RELATIONS
(As of April 30, 2004)

I. **Membership Status**: Joined 8/13/52; Article VIII

| | | | |
|---|---|---|---|
| II. | **General Resources Account**: | **SDR Million** | **% Quota** |
| | Quota | 13,312.80 | 100.00 |
| | Fund holdings of currency | 8,312.97 | 62.44 |
| | Reserve position in Fund | 5,000.58 | 37.56 |
| III. | **SDR Department**: | **SDR Million** | **% Allocation** |
| | Net cumulative allocation | 891.69 | 100.00 |
| | Holdings | 1,842.56 | 206.64 |
| IV. | **Outstanding Purchases and Loans**: | None | |
| V. | **Financial Arrangements**: | None | |
| VI. | **Projected Obligations to Fund**: | None | |

VII. **Exchange Rate Arrangement**:

Japan maintains a floating exchange rate regime. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions maintained against Taliban, Al-Qaida, and other terrorists, pursuant to UN Security Council Resolutions 1267, 1333, 1390 and 1373. These restrictions were notified to the Fund (EBD/02/52) in accordance with Executive Board Decision No. 144–(52/51). Japan also maintains exchange restrictions against the former Iraqi regime that have not yet been notified to and approved by the Fund under the procedures of Decision 144–(52/51).

VIII. **Article IV Consultation**:

The 2003 Article IV Consultation discussions were held during May 22–June 4, 2003; the Executive Board discussed the Staff Report (IMF Country Report No. 03/281) and concluded the consultation on August 20, 2003. Executive Directors welcomed recent signs of improvement in the economic situation and outlook, and the progress in tackling the major economic challenges facing Japan. Nevertheless, Directors stressed that serious and interrelated problems remained, and agreed that a more comprehensive and integrated policy approach was needed to revitalize the corporate and financial sectors, tackle deflation, and address fiscal imbalances. The staff report, staff statement, FSSA and PIN were all published.

## JAPAN—STATISTICAL ISSUES

1. Japan subscribed to the Special Data Dissemination Standard (SDDS) on July 3, 1996 and met the SDDS specifications for the coverage, periodicity, and timeliness of data and for dissemination of advance release calendars on June 9, 2000. Economic and financial data provided to the Fund are considered adequate for surveillance purposes.

2. **National accounts**

- The Japanese National Accounts were revised in 2000 by the Economic and Social Research Institute (ESRI) to reflect the *1993 System of National Accounts (1993 SNA*). The data revision involved, among other things, the inclusion of spending on computer software in investment expenditure and depreciation on social capital in government consumption, and revision of the benchmark year to 1995. Improved seasonal adjustment methods were also introduced to take account of leap year and other shift factors. The data revisions, from 1980 onwards, are described in ESRI's publication *System of National Accounts 1993 in Japan* (April 2001).

- Preliminary estimates of Japan's quarterly GDP data are released by the ESRI. Starting with data from the second quarter of 2002, it introduced a new method that combines supply and demand side indicators to improve the accuracy of the estimates. In particular, additional supply side indicators are combined with the previously-used demand side indicators, which reduces the statistical discrepancy between estimates of GDP measured from the production and expenditure sides. ESRI also now releases the estimate about 1½ months after the end of the quarter, approximately a month earlier than before. At the same time, more frequent backward revisions and concurrent seasonal adjustment methods were introduced. More complete annual national accounts data are only available with a lag of nine months.

- The Bank of Japan (BoJ) revised its Wholesale Price Index (WPI) by updating the base year from 1995 to 2000, changing commodities released as index series, and increasing the number of sample prices for the index compilation. It also changed the name of the index from the WPI to the Corporate Goods Price Index (CGPI) to better reflect its characteristics.

- The industrial production series was improved in April 2003. The base year was updated from 1995 to 2000, with corresponding updates to components weights, and seasonal adjustment factors. One effect of these revisions is to increase the weight on the electrical machinery sector. In addition, revised seasonal adjustments may smooth the recent history of the series.

- In November 2002, methods for estimating pension fund output were improved, and part of expenditure on mobile telecommunication devices was reclassified to consumption because of wider dissemination of mobile phones to the public. These changes as well as other less significant changes were incorporated in National Income Accounts data back to 1980.

- The Family Income and Expenditure Survey (FIES) has been subject to volatility, particularly in “lumpy” expenditure items such as consumer durables. Some steps were taken in January 2002 to improve the quality of the data, including a modest expansion of the sample size to about 9,000 households and reclassification of survey items to better reflect expenditures on IT products. In addition, a new survey on durable goods expenditures, covering about 30,000 households, was introduced in October 2001.

- 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.

- Preliminary estimates for the income side of the national accounts (with the exception of compensation of employees) are not provided, in part because estimates for profits are based on an imputed quarterly pattern for annual data.

- The ESRI relies on other agencies and organizations to compile the underlying source data used to construct the national accounts, and coordinates with data providers on issues such as the design of surveys and administrative collections to serve national accounts purposes.

- The GDP deflator and corresponding volume series are re-based every five years. The current base year is 1995.

3. **Fiscal**

- Fiscal accounts distinguish between general (or ordinary) accounts for core government functions, and special accounts, some of which are partly financed through borrowing from the Fiscal Loan Fund which is the main part of the Fiscal Investment and Loan Program (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.

- There exist more than 3,000 independent prefectures and municipalities, the finances of which are consolidated with a delay of about one year.

- Data on general government operations—including disaggregation by major government sector—are available with the release of the annual national accounts data.

- The government has published its annual balance sheet since October 2000. Estimates from FY1998 to FY2001 are now available. However, the relationship with the national accounts flow data is unclear because the balance sheet consolidates the FILP whereas flow data do not.

- The authorities have not reported fiscal data for publication in the *GFS Yearbook* since 1994, and STA attempts to initiate reporting have been unsuccessful. As a result, the Japan country page has been dropped from the 2003 *GFS Yearbook*. No fiscal data are reported for publication in *IFS*.

4. **External sector**

- Monthly data on merchandise trade and the balance of payments are released on a timely basis.

- In the financial account of the balance of payments, the proceeds from the sale of loans during 1997–2000 may be overstated because the sales were not recorded at market prices. The BoJ recorded the corresponding large debit entries as capital transfers in the capital account.

5. **Monetary and financial sector**

- Banking sector data are disseminated 6–8 business days after the end of the reference month for money stocks and total credit. However, banking sector data on the external position, as well as on the breakdown of credit to government and to the private sector, are usually disseminated (as "The Monetary Survey" in the BoJ's *Financial and Economic Statistics Monthly*) 6–7 weeks after the end of the reference month. As only data on money stocks and total credit meet the one-month SDDS timeliness requirement for Analytical Accounts of the Banking sector (AAB), Japan is using a timeliness flexibility option for the other components of AAB on the grounds that they have an extensive branch banking system.

6. **Recommendations for data improvements**

*In the short term, there is need to*:

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

*Over the longer term, efforts should be directed to*:

- moving data production (other than monetary and financial statistics) to a single, independent agency staffed with professional statisticians.

- providing greater detail on the quarterly components of national accounts.

## Japan: Core Statistical Indicators

(As of June 8, 2004)

| | 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 | 6/8/04 | 5/04 | 5/04 | 5/31/04 | 5/04 | 6/8/04 | 4/04 | 4/04 | 3/04 | 2002 | 2004:Q1 | End-Dec. 2003 |
| Date received | 6/8/04 | 6/04 | 6/04 | 6/2/04 | 6/04 | 6/8/04 | 5/04 | 5/04 | 5/04 | 2/04 | 5/04 | 3/04 |
| Frequency of Data | D | M | M | Every 10 days | M | D | M | M | M | A | Q | Q |
| Frequency of Reporting | D | M | M | Every 10 days | M | D | M | M | M | A | Q | Q |
| 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 | Q |

## JAPAN—PUBLIC DEBT SUSTAINABILITY

1. **This annex analyzes public debt sustainability in Japan, centered on a baseline scenario broadly based on publicly announced medium term fiscal goals**.[1] The authorities aim to move from a primary deficit to a primary surplus in the accounts of the general government excluding social security by the early 2010s. For the purpose of this analysis, it is assumed that a primary balance of zero is achieved by 2013 through tax increases and capital expenditure reductions. Projections for the social security system incorporate the favorable impact of the 2004 pension reform, but nonetheless show rising deficits owing to rapidly increasing medical costs (health care contribution rates are assumed to remain fixed). These assumptions are consistent with a reduction in the overall primary deficit to about 3 percent by 2009.

2. **Under this scenario, the public debt will grow rapidly over the next 5 years**. By 2009, net debt will reach 106 percent of GDP (compared to 80 percent of GDP at end-2003).[2] Debt would accumulate even more rapidly than projected if the government needs to meet any contingent liabilities such as bank recapitalization or default on guaranteed loans. Standard stress tests illustrate the sensitivity of this projection to different shocks (see the attached table for the full sustainability template).

3. **Stabilizing the debt-to-GDP ratio would require substantial consolidation beyond that considered in the baseline**. For example, stabilizing net debt at 110 percent of GDP by 2013 (consistent with the government's medium term horizon) would require achieving a general government primary surplus of 1.4 percent of GDP.[3] Reaching that surplus requires an adjustment of 6.3 percent of GDP in the overall primary balance (6.9 percent of GDP in the primary balance excluding social security), compared with an adjustment of 3.6 percent in the baseline. The resulting ratio of net debt to GDP would be very high by international standards and further consolidation may be desirable to reduce it.

4. **There is an urgent need to address the fiscal challenges related to rapid population aging and high public indebtedness**. Consolidation at the local and central government levels would require significant efforts to control expenditure and increase revenue. The adjustment in social security should involve a reform of the health care system to address rapidly rising costs. The size of the needed adjustment underscores the importance of limiting reliance on revenue measures in further reforms of the social security system as the tax burden is already bound to increase significantly in the next two decades.

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[1] The paths for real GDP growth, GDP deflator growth, and real interest rates are consistent with the current WEO projections.

[2] Staff analysis of fiscal trends over 2003–2050 suggests that the accumulation of public debt is unsustainable in the long run as well unless substantial adjustments are implemented (see Chapter IV, Japan: Selected Issues, IMF Country Report 03/282, September 2003).

[3] This estimation assumes a real potential GDP growth of 1.7 percent and long-term real interest rate of 3 percent beyond 2009.

Japan: Public Sector Debt Sustainability Framework, 1998-2009
(In percent of GDP, unless otherwise indicated; calendar year basis)

| | Actual | | | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002 | | | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| | | | | | | | | **I. Baseline Projections** | | | | | | |
| 1 **Net general government debt** | 45.8 | 53.5 | 59.1 | 65.1 | 71.4 | | | **79.6** | **84.8** | **89.9** | **94.7** | **98.9** | **102.7** | **106.1** |
| *Of which* : foreign-currency denominated | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 2 Change in public sector debt | 10.6 | 7.7 | 5.6 | 6.0 | 6.3 | | | 8.2 | 5.1 | 5.1 | 4.8 | 4.2 | 3.8 | 3.4 |
| 3 Identified debt-creating flows | 11.2 | 7.8 | 7.1 | 6.8 | 8.9 | | | 8.2 | 5.1 | 5.1 | 4.8 | 4.2 | 3.8 | 3.4 |
| 4 Primary deficit | 4.1 | 5.8 | 6.0 | 4.7 | 6.4 | | | 6.5 | 5.1 | 4.4 | 4.1 | 3.8 | 3.5 | 3.2 |
| 5 Revenue and grants | 29.0 | 28.8 | 29.1 | 30.0 | 28.7 | | | 28.4 | 28.5 | 28.7 | 29.1 | 29.6 | 30.1 | 30.7 |
| 6 Primary (noninterest) expenditure | 33.1 | 34.6 | 35.1 | 34.7 | 35.1 | | | 35.0 | 33.5 | 33.2 | 33.2 | 33.4 | 33.6 | 33.9 |
| 7 Automatic debt dynamics 1/ | 1.9 | 2.1 | 1.1 | 2.1 | 2.4 | | | 1.7 | 0.0 | 0.7 | 0.8 | 0.4 | 0.3 | 0.2 |
| 8 Contribution from interest rate/growth differential 2/ | 1.9 | 2.1 | 1.1 | 2.1 | 2.4 | | | 1.7 | 0.0 | 0.7 | 0.8 | 0.4 | 0.3 | 0.2 |
| 9 Of which contribution from real interest rate | 1.5 | 2.2 | 2.5 | 2.4 | 2.2 | | | 3.5 | 3.5 | 2.7 | 2.3 | 2.0 | 1.9 | 1.9 |
| 10 Of which contribution from real GDP growth | 0.4 | -0.1 | -1.5 | -0.3 | 0.2 | | | -1.8 | -3.5 | -2.0 | -1.6 | -1.6 | -1.7 | -1.7 |
| 12 Other identified debt-creating flows | 5.2 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 13 Privatization receipts (negative) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 14 Recognition of implicit or contingent liabilities | 5.2 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 15 Other (specify, e.g. bank recapitalization) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 16 Residual, including asset changes | -0.7 | -0.1 | -1.5 | -0.7 | -2.6 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net general government debt-to-revenue ratio 1/ | 157.9 | 185.8 | 203.1 | 217.3 | 249.0 | | | 280.2 | 297.9 | 312.7 | 325.4 | 333.9 | 340.6 | 345.7 |
| **Gross financing need 3/** | 18.6 | 23.5 | 25.8 | 26.5 | 30.4 | | | 32.8 | 33.4 | 34.7 | 36.1 | 37.5 | 38.7 | 39.8 |
| **Key Macroeconomic and Fiscal Assumptions** | | | | | | 10-Year Historical Average | 10-Year Standard Deviation | | | | | | | |
| Real GDP growth (in percent) | -1.2 | 0.2 | 2.8 | 0.4 | -0.3 | 1.0 | 1.5 | 2.5 | 4.5 | 2.4 | 1.7 | 1.7 | 1.7 | 1.7 |
| Average nominal interest rate on public debt (in percent) 4/ | 4.0 | 3.2 | 2.8 | 2.4 | 2.2 | 4.6 | 2.1 | 2.3 | 2.2 | 2.2 | 2.2 | 2.4 | 2.6 | 2.8 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | 4.1 | 4.6 | 4.7 | 3.9 | 3.4 | 5.3 | 1.6 | 4.8 | 4.4 | 3.2 | 2.6 | 2.2 | 2.0 | 1.9 |
| Inflation rate (GDP deflator, in percent) | -0.1 | -1.5 | -2.0 | -1.5 | -1.2 | -0.7 | 0.9 | -2.5 | -2.2 | -1.1 | -0.4 | 0.2 | 0.6 | 0.9 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 1.8 | 4.7 | 4.5 | -0.8 | 0.9 | 2.8 | 2.7 | 2.0 | 0.3 | 1.3 | 1.7 | 2.6 | 2.4 | 2.5 |
| Primary deficit | 4.1 | 5.8 | 6.0 | 4.7 | 6.4 | 4.0 | 1.7 | 6.5 | 5.1 | 4.4 | 4.1 | 3.8 | 3.5 | 3.2 |
| | | | | | | | | **II. Stress Tests for Public Debt Ratio** | | | | | | |
| **A. Alternative Scenarios** | | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2004-08 5/ | | | | | | | | **79.6** | **87.1** | **94.8** | **102.9** | **111.2** | **119.9** | **128.9** |
| **B. Bound Tests** | | | | | | | | | | | | | | |
| B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005 | | | | | | | | **79.6** | **87.9** | **97.5** | **102.4** | **106.6** | **110.4** | **113.8** |
| B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005 | | | | | | | | **79.6** | **92.1** | **105.1** | **113.7** | **121.7** | **129.3** | **136.6** |
| B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005 | | | | | | | | **79.6** | **87.1** | **95.3** | **100.2** | **104.4** | **108.1** | **111.6** |
| B4. Combination of 1-3 using one standard deviation shocks | | | | | | | | **79.6** | **91.3** | **103.8** | **108.7** | **113.0** | **116.7** | **120.2** |
| B5. 10 percent of GDP increase in other debt-creating flows in 2004 | | | | | | | | **79.6** | **94.8** | **100.0** | **104.9** | **109.1** | **112.9** | **116.4** |

Source: Data from the authorities and IMF staff estimates.

1/ Derived as $[(r - \pi(1+g) - g]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate.
2/ The real interest rate and real GDP growth contributions are derived from the numerator in footnote 1/.
3/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
4/ Derived as nominal interest expenditure divided by previous period debt stock.
5/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

INTERNATIONAL MONETARY FUND

JAPAN

**Staff Report for the 2004 Article IV Consultation**

**Supplementary Information**

Prepared by the Asia and Pacific Department
(in consultation with other departments)

Approved by Daniel Citrin and John Hicklin

July 23, 2004

1. **This supplement provides an update on economic, political, and financial market developments since the release of the staff report (7/7/04)**. The thrust of the staff appraisal remains unchanged.

2. **Recent indicators suggest that the economic recovery continues apace**. During the second quarter, the *Tankan* index of business conditions rose to its highest level in a decade, adding to indications that the current recovery is the strongest of the post-bubble era. Machinery orders have been on a solid uptrend, implying continued strength in private investment. While data on consumer demand are highly volatile, the balance of recent indicators point to further growth in private consumption. In particular, during May household spending rose 5.6 percent (y/y), and the unemployment rate fell further to 4.6 percent. Also, *Tankan* survey data indicate a further easing of deflationary pressures, although consumer price inflation remains slightly negative.

3. **Given the recent data, the near-term risks to the outlook may be tilted to the upside,** in particular with regard to business fixed investment and private consumption. Consistent with both the most recent indicators as well as data for the period since late 2003, the government has raised its forecast for FY2004 GDP growth to 3.5 percent up from 1.8 percent (released in January). In addition, a number of private-sector forecasters have been revising upwards their projections. The July consensus forecast for CY2004 is 4.2 percent, which is slightly below staff's forecast of 4.5 percent. The staff will review its forecast of annual growth for 2004 following the release of second quarter national accounts data in August.

4. **In the July 11 upper house elections, the ruling coalition retained a majority**. The Liberal Democratic Party (LDP) and its coalition partner the New Komeito Party now hold a combined 139 seats (of 242), the same as before the elections. The leading opposition Democratic Party of Japan (DPJ) gained a significant number of seats at the expense of other, smaller opposition parties, and now holds 82 seats, up from 70 previously. (Half of the seats

in the upper house are contested every three years.) The ruling coalition also controls the majority in the lower house.

5. **Following the elections, the discussion of pension reforms has regained momentum**. The DPJ has called for the repeal of the pension reform act, but the government has stated that it plans to implement it as scheduled.[1] The ruling coalition has, however, proposed to hold discussions with the DPJ on future pension reforms. Also, the government plans to establish a council—including business and labor representatives—to consider more fundamental reforms to the overall social security system of pensions, medical care, and long-term care.

6. **On July 14, two major banks announced plans to merge and form the largest bank in the world**. The merger would combine Mitsubishi Tokyo Financial Group (MTFG), which has the lowest ratio of nonperforming loans (NPL) to total loans among the major banks, with UFJ, which has a much higher ratio. Observers suggest that while the operational aspects of the merger could be complex and time-consuming, a successful strengthening of the merged bank's management culture and the realization of synergies across business lines would yield a strong and profitable bank. In addition, MTFG's strong capital position could allow UFJ to write off NPLs more quickly. Financial markets reacted favorably to the news, with bank stocks rising after the announcement.

[1] As noted in the staff report, the pension reform act passed in June stipulates a rise in premiums from 13.58 percent this year to 18.30 percent in 2017; this would entail annual premium increases of about 1/3 of a percentage point.

INTERNATIONAL MONETARY FUND
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International Monetary Fund
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Washington, D. C. 20431 USA

# IMF Concludes 2004 Article IV Consultation with Japan

On July 28, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Japan.[1]

## Background

There are clear indications that Japan's longstanding economic problems have eased. Growth is rebounding, deflation is diminishing, and progress is being made in addressing corporate and financial sector problems. Looking ahead, near term growth prospects are favorable, although weaknesses remain that could restrain growth over the medium term.

Japan's economic recovery continued in 2003 and into the first part of 2004. For 2003, GDP growth reached 2½ percent, double the mid-year consensus forecast, and continued at about 6 percent on an annualized basis in the first quarter of 2004. The recovery was initially driven by business fixed investment and net exports, with the current account surplus widening to 3¼ percent of GDP. More recently, private consumption also contributed as labor market conditions improved. Following steady declines since 2001, employment, the labor force, and compensation stabilized, while the unemployment rate fell to 4.6 percent in May, from the record high of 5½ percent reached in early 2003. Meanwhile, deflationary pressures have eased; core CPI deflation (excluding fresh food) narrowed, in part reflecting temporary factors, but the GDP deflator continued to decline at a pace of about 2½ percent.

[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.

Monetary policy has maintained short term interest rates at zero under the Bank of Japan's (BoJ's) quantitative easing framework. Increases in the BoJ's target for current account balances have also supported base money growth and promoted financial stability by ensuring banks access to ample funding. Recent steps to clarify the monetary framework—by announcing that quantitative easing will be maintained at least until core CPI growth is nonnegative for a few months and positive inflation is expected—have helped reassure markets that short-term interest rates will be kept at zero as long as deflation persists.

During 2003 and early 2004, the yen came under periodic pressure to strengthen against the dollar, as markets focused on global current account imbalances. This pressure prompted the authorities to intervene in record levels to avoid an undue tightening of monetary conditions, with total intervention amounting to ¥20 trillion in 2003, and a further ¥15 trillion in the first quarter of 2004. Both upward pressure on the yen and intervention have since ceased. Since June 2003, the yen/dollar rate has appreciated by about 9 percent, but with the yen's appreciation against the euro more modest, on a multilateral basis the yen has appreciated only moderately in nominal and real effective terms.

The government recorded another large fiscal deficit in FY2003—7.9 percent of GDP—slightly lower than the previous year. On a structural basis (including social security but excluding bank support), the fiscal stance was around 6½ percent of GDP, unchanged from the previous year. Sustained fiscal deficits have fed a rapid increase in public debt, estimated to stand at 166 percent of GDP on a gross basis (80 percent on a net basis) at end-2003, by far the highest among advanced economies.

The financial condition of the banking system improved in FY2003, particularly among major banks, but some weaknesses persist and regional banks have lagged behind. Nonperforming loans at major banks declined to about 5 percent of loans, in line with the authorities' target to reduce the ratio to about 4 percent by end-FY2004. Major banks also increased their profits and capital adequacy ratios, aided in part by the economic recovery and gains on their equity holdings. However, core profits and the quality of capital remained weak, and regional banks (which account for 40 percent of bank lending) made less headway in reducing nonperforming loans and strengthening their capital bases.

In the corporate sector, restructuring activity has expanded from large export-oriented manufacturers to include small-and medium-sized enterprises (SMEs) and nonmanufacturers. Although debt levels remain high, profit indicators have improved, driven at first by labor cost reductions and strong external demand, and more recently by buoyant sales. The improvement in corporate profits has contributed to a rebound in stock prices, with the Nikkei Index gaining about 50 percent and ten-year JGB yields rising about 130 basis points to 1.8 percent since the lows achieved in 2003.

The near-term economic outlook has improved over the past year. As the economic recovery broadens further, real GDP is projected to expand by 4½ percent in 2004 and 2½ percent in 2005, with CPI deflation ebbing to zero by the end of this period. However, this outlook could be threatened by external factors, including a potential sharp rise in global interest rates or a slowdown in key trading partners. Beyond the near term, growth is envisaged to slow to around potential, estimated by staff at around 1.7 percent per year. However, additional structural economic reforms and continued progress in financial and corporate sector restructuring could raise Japan's economic potential.

**Executive Board Assessment**

Directors welcomed signs that the Japanese economy is emerging from its long period of slump, with support from a range of policy measures. In particular, the recovery has strengthened and become more broadly based, while labor market conditions have improved. Meanwhile, deflationary pressures have eased, against the backdrop of a narrowing output gap and supportive monetary policy. Also, restructuring has continued in the financial and corporate sectors, encouraged by enhancements to bank regulation and the framework for corporate revitalization.

At the same time, Directors noted that financial and corporate sector weaknesses remain, mild deflation persists, and the public debt is very high, which could restrain growth over the medium term. In addition, several Directors acknowledged the existence of risks related to the external environment. Against this background, Directors considered that policies should build on the existing reform program in order to resolve remaining weaknesses promptly, boost Japan's economic potential and thereby sustain the expansion over the longer term. Key priorities include broader financial and corporate sector restructuring, medium-term fiscal consolidation, and continued structural reforms.

On monetary policy, Directors welcomed recent steps by the Bank of Japan to clarify and demonstrate its commitment to counter deflation by maintaining zero interest rates until both actual and expected inflation rates turned positive. Directors saw the current accommodative policy stance as appropriate and considered that further increases in the current account operating target could be used if needed to reinforce the policy commitment. Also, as the end of deflation draws nearer, enhancements to the Bank of Japan's communication strategy to provide a clear signal to markets about the future direction of monetary policy could help stabilize inflation expectations. While some Directors supported quantification of a medium-term inflation objective and an eventual shift to inflation targeting, a number of others considered such an objective premature at this point in time in light of the uncertainty in the monetary policy transmission mechanism.

Nearly all Directors observed that sizeable past interventions had kept upward pressure on the yen from resulting in an undue tightening of monetary conditions. With exchange rate risks now more balanced, such interventions were not seen as desirable. Many Directors considered that additional intervention could be warranted if significant upward pressures on the yen reemerged to the extent that they threatened to stall the recovery. Many other Directors, however, expressed concern that such actions could exacerbate global imbalances, and urged that the exchange rate be fully market-determined. Some Directors also asked for more analysis of exchange rate policies in future Article IV reports as called for in the conclusions to the last review of surveillance.

Directors noted that the economic recovery and enhanced financial regulation have fostered progress in resolving banks' balance-sheet problems. Major banks have cut nonperforming loans (NPLs) and are on track to attain the target of reducing NPLs as a share of loans to about 4 percent by end-March 2005. At the same time, deferred tax assets have fallen as a share of regulatory capital. In light of the progress in strengthening the banking system, Directors welcomed the planned reduction in deposit insurance coverage by the end of the fiscal year.

Nevertheless, weaknesses remain in the banking system, as reflected in low core profits and less progress in restructuring by regional banks. Directors thus welcomed the authorities' commitment to press ahead with bank reforms, and encouraged the authorities to expand on existing reforms to expeditiously resolve these weaknesses so that lending growth could resume and help support the recovery. For major banks, measures to improve further the recognition of, and provisioning for, problem loans, to strengthen bank capital, and to bolster bank governance would be key. Also, to improve prospects for bank profitability, competition of government financial institutions with private institutions should be scaled back. Regarding regional banks, Directors observed that measures similar to those employed for major banks could encourage more rapid restructuring. Also, the new capital injection facility could be used, with appropriate conditionality, to facilitate consolidation among regional banks.
Directors commended the Japanese authorities' high level of compliance with international standards to combat money laundering and terrorism financing, and encouraged them to address the remaining weaknesses identified.

Directors welcomed the notable headway in corporate restructuring, but also noted that corporate debt remains high and aggregate returns on assets are still low by historical standards. They considered that strengthening the banking system would facilitate additional corporate restructuring, and they agreed that the Industrial Revitalization Corporation of Japan could continue to coordinate creditors and facilitate market-based restructuring.

Regarding fiscal policy, Directors welcomed the authorities' strategy for achieving medium-term consolidation. They noted that the better-than-anticipated economic environment could facilitate an early start toward the authorities' goal to reach a primary surplus early in the next decade. In particular, it would be desirable to achieve savings relative to the budget in fiscal year 2004, if the recovery remains robust, by saving any stronger-than-expected revenues and seeking expenditure reductions.

Directors observed that a substantial medium-term fiscal adjustment will be needed to put the public debt on a sustainable trajectory. Accordingly, they welcomed the recently adopted pension reforms, while noting that further social security reforms will be needed in the medical and long-term care systems. In addition, most Directors saw scope to broaden the personal income tax base, increase the consumption tax rate over time, and further reduce public investment. Many Directors also considered that the credibility of the medium-term consolidation plan could be strengthened by defining a more specific goal for the primary balance and supporting measures to achieve it, while retaining due flexibility to adapt to short-term economic fluctuations. Some Directors called for further reform of local finances, including a reduction in transfers from the central government and greater tax autonomy, to encourage a more efficient allocation of resources and help improve the fiscal position at the subnational level.

Directors noted that Japan has embarked on a broad-based program of structural reforms. They considered that accelerated implementation of the reform program would help to raise Japan's long-term economic potential. In particular, front-loaded measures to improve labor market flexibility, relax business regulation and strengthen competition policy, and reform public enterprises could foster a more rapid and efficient reallocation of economic resources and thereby bolster medium-term productivity and growth.

On trade policy, Directors viewed the Japan-Mexico Economic Partnership Agreement as a step forward in further opening Japan's market, but stressed that multilateral liberalization should remain the centerpiece of Japan's trade policy regime. In this connection, they encouraged Japan to work with other major industrial countries towards implementation of the Doha Round's development objectives, especially in agriculture. Directors welcomed the expansion of coverage for LDC exports under Japan's generalized system of preferences, and encouraged the authorities to take additional steps in that direction.

Directors noted that Japan's official development assistance (ODA) was presently about the same as the G-7 average in percent of GNI. While recognizing that Japan remained the second largest provider of such assistance, they encouraged the authorities to raise ODA toward the UN target of 0.7 percent of GNI.

Directors welcomed the review of the methodology for compiling national accounts statistics, which aims at improving the accuracy of price and volume measures. Also, they noted the authorities' intention to conduct a data ROSC starting in mid-2005.

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**Japan: Selected Economic Indicators**

| | 2000 | 2001 | 2002 | 2003 | Proj. 2004 | |
|---|---|---|---|---|---|---|
| GDP 1/ | 2.8 | 0.4 | -0.3 | 2.5 | 4.5 | |
| Private consumption | 0.8 | 1.8 | 0.9 | 0.8 | 3.2 | |
| Nonresidential investment | 9.7 | 0.9 | -7.1 | 9.6 | 11.1 | |
| Residential investment | 0.7 | -5.3 | -4.2 | -0.8 | 2.0 | |
| Public investment | -10.0 | -4.5 | -4.7 | -10.5 | -10.2 | |
| Public consumption | 4.9 | 3.0 | 2.4 | 1.0 | 1.5 | |
| Stockbuilding (contribution to growth) | 0.3 | 0.0 | -0.2 | 0.3 | 0.2 | |
| Foreign balance (contribution to growth) | 0.5 | -0.7 | 0.7 | 0.7 | 0.9 | |
| Exports of goods and services | 12.5 | -6.1 | 7.9 | 10.1 | 13.4 | |
| Imports of goods and services | 9.3 | 0.2 | 1.9 | 5.0 | 8.2 | |
| Inflation | | | | | | |
| GDP deflator | -2.0 | -1.5 | -1.2 | -2.5 | -2.2 | |
| CPI | -0.9 | -0.8 | -0.9 | -0.2 | -0.1 | |
| Unemployment rate (period average, percent) | 4.7 | 5.0 | 5.4 | 5.3 | 4.7 | |
| Current account balance | | | | | | |
| Billions of U.S. dollars | 119.6 | 87.8 | 112.6 | 136.2 | 149.3 | |
| Percent of GDP | 2.5 | 2.1 | 2.8 | 3.2 | 3.2 | |
| General government balances (percent of GDP, FY) | | | | | | |
| Balance including social security | -6.6 | -6.7 | -8.1 | -7.9 | -6.7 | |
| Balance excluding social security | -7.0 | -6.6 | -8.0 | -7.3 | -6.2 | |
| Structural balance 2/ | -5.5 | -5.0 | -6.5 | -6.5 | -6.5 | |
| Money and credit (12-month growth rate; end period) | | | | | | |
| Base money | -1.1 | 16.9 | 19.5 | 13.2 | 4.4 | 3/ |
| M2 + CDs (period average) 4/ | 2.1 | 2.8 | 3.3 | 1.7 | 1.8 | 3/ |
| Bank lending 4/ | -3.8 | -4.3 | -4.8 | -5.1 | -4.2 | 3/ |
| Exchange and interest rates (period average) | | | | | | |
| Yen/dollar rate | 107.8 | 121.5 | 125.4 | 115.9 | 111.2 | 5/ |
| Real effective exchange rate 6/ | 136.6 | 120.8 | 110.0 | 107.3 | 108.0 | 3/ |
| 3-month CD rate | 0.20 | 0.09 | 0.07 | 0.09 | 0.05 | 5/ |
| 10-year government bond yield | 1.74 | 1.33 | 1.28 | 1.00 | 1.86 | 5/ |

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

1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ Including social security, excluding bank support.
3/ July 2004.
4/ From April 1998 onward, data reflect the inclusion of foreign banks, foreign trust banks and Shinkin banks in the monetary survey.
5/ July 30, 2004.
6/ Based on normalized unit labor costs; 1990 = 100.