2011 Article IV Consultation with Japan

Concluding Statement of the IMF Mission

June 7, 2011

JAPAN'S ROAD TO RECOVERY

The Great East Japan earthquake has brought Japan's nascent recovery to a halt. The Japanese authorities have responded swiftly to stabilize markets and activity has begun to recover. The outlook, however, remains uncertain due to lingering supply disruptions and weak sentiment. Against this backdrop, fiscal policy should aim to quickly address supply side constraints while committing to a credible medium-term strategy to bring down the high level of public debt. Additional easing by the Bank of Japan and an acceleration of structural reforms would support a robust recovery. This statement summarizes the staff's findings, including economic spillovers from Japan to the rest of the world, which will be more fully discussed in the forthcoming IMF Article IV staff report.[1]

I. Outlook and Risks

1. **The economy continues to face headwinds from the shock of the earthquake but is set to recover strongly in the second half of this calendar year.** Supply disruptions, electricity shortfalls, and weak demand are likely to hold back economic activity for some time. However, over the summer the economy is expected to recover sharply as supply conditions normalize and reconstruction spending picks up. The recovery will continue in 2012 as the resumption of exports lifts domestic demand and reconstruction spending continues. On this basis, we forecast GDP growth to slow to -0.7 percent in 2011 before rising to 2.9 percent in 2012 (see Table 1 overleaf).[2] Headline inflation is expected to be around zero percent in 2011 and 2012. Underlying inflation—excluding food and energy—is, however, projected to remain negative as a result of the still wide output gap.

[1] The 2011 IMF Article IV Staff Report will feature a *Spillover Report,* which is part of a broader effort by the IMF to evaluate the impact of economic developments and policies in systemically important countries on the rest of the world. Similar reports are being prepared for China, the Euro Area, the United Kingdom, and the United States.

[2] The mission will update its growth projections prior to the Article IV Board meeting in July on the basis of updated national accounts estimates and other indicators.

2. Spillovers to other countries from supply disruptions are expected to be short-lived. The earthquake was felt globally, and especially in Asia, as shortages of many high-tech inputs from Japan slowed overseas production, particularly of automobiles and electronics. With industrial production showing signs of turning around, exports will likely pick up soon, limiting the risk of a sustained disruption to regional production networks.

Table 1 **Japan: Near-Term Projections**

	2010	2011	2012
	(Calendar Year, Growth Rate)		
Real GDP	4.0	-0.7	2.9
Total domestic demand	2.2	0.0	2.5
Net exports (contribution)	1.8	-0.7	0.4
CPI inflation (average) 1/	-0.7	0.1	0.0
Current account balance (in percent of GDP)	3.6	2.5	2.9
General government balance	-9.6	-10.5	-9.1
Gross debt (in percent of GDP)	220.4	233.7	236.2
Net debt (in percent of GDP)	117.6	131.1	137.8

Source: *IMF staff estimates*.
1/ Projections do not include an estimate of the CPI base-year change scheduled for August 2011.

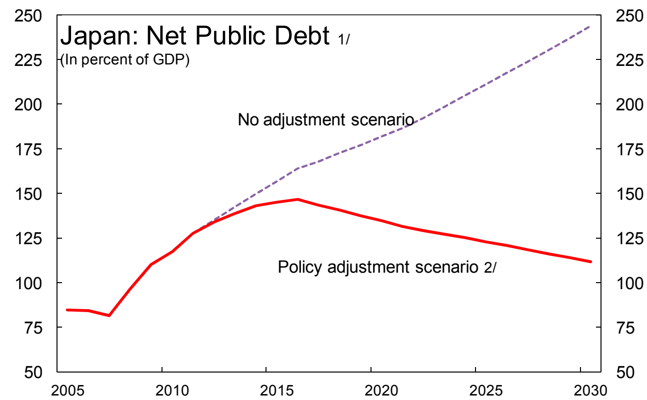
3. Uncertainty surrounding the outlook is unusually large with the recovery depending on how quickly supply bottlenecks ease and private demand turns around. Risks to the outlook are biased downwards because delays in resolving supply disruptions and rebuilding electricity capacity could hold back private consumption and investment. External risks stem primarily from a slowdown of growth in the advanced economies. If these risks materialize, larger upfront fiscal spending and monetary easing combined with a more ambitious medium-term fiscal strategy may be needed. On the upside, a faster easing of supply constraints could accelerate the recovery in exports and investment.

II. FINANCING RECONSTRUCTION AND CHARTING A PATH FOR FISCAL REFORM

4. The immediate priority for fiscal policy is to repair damaged infrastructure and facilitate a swift recovery. The fiscal cost of reconstruction could range between 2–4 percent of GDP, spread over several years. The government has moved quickly to pass its first supplementary budget of around 0.8 percent of GDP to address immediate needs. Timely passage of a second, sizeable supplementary budget, which is well targeted and focused on revitalizing the affected regions, would help address downside risks and catalyze private spending.

5. At the same time, new tax measures are needed to limit bond issuance and strengthen the commitment to fiscal reforms. While other tax measures could also be considered, we recommend a moderate increase in the consumption tax, from 5 percent to 7-8 percent, starting in 2012 when a cyclical recovery is underway.[3] As the new revenue would support reconstruction, the net impact of this tax increase and spending on growth is unclear but would likely be moderate. The alternative, relying mainly on debt financing would add to fiscal risks stemming from an already high level of public debt, which at over 220 percent of GDP in gross terms is the highest among advanced economies.

6. Bringing down public debt over the medium term will require a sustained and significant adjustment of the primary balance. The government's fiscal strategy last year committed to halving the primary deficit in percent of GDP by FY2015 and reducing the debt ratio starting in FY2021 at the latest. We welcome the strategy and the recent proposal of the tax and social security reform commission to raise the consumption tax and reform social security. But in our view more needs to be done to put the net debt-to-GDP ratio on a downward path earlier by the middle of this decade. This would reduce the risk of a more severe adjustment resulting from a loss of confidence in public finances. Based on IMF staff estimates, stabilizing and bringing down the net debt ratio by 2016 and reducing it around 135 percent of GDP by 2020 would require a reduction of the primary structural balance by 10 percent of GDP over a 10 year horizon.



Source: Cabinet Office and staff estimations.
1/ Net debt of the general government including the social security fund.
2/ Policy adjustment scenario assumes a 10 percent of GDP improvement (7.5 percent of GDP relative to no adjustment scenario) of the structural primary balance between 2010-2020.

7. Given the limited scope for cutting expenditure, fiscal adjustment would need to rely mainly on new revenue sources and limits on spending growth (Table 2). The main elements could include:

- *Comprehensive tax reform.* The key revenue measure would be a gradual increase in the consumption tax to 15 percent over several years, yielding 5 percent of GDP. To promote domestic investment, the corporate income tax rate, currently at 40 percent, could be lowered to 35 percent with revenue losses offset by reforms of personal income tax that reduce allowances and base exemptions.
- *Expenditure reform.* Freezing central government contributions to the public pension system in nominal terms, including by raising the pension retirement age, could yield ½ percent of GDP in savings. The remainder (4.5 percent of GDP) could come mainly from freezing nonsocial security spending in nominal terms and introducing an income cap on social transfers. To facilitate these reforms, we support the government's efforts to introduce a taxpayer identification system to allow a more effective targeting of social transfers.

[3] Introducing a "solidarity" tax would also be in line with experience in other countries following large disasters, such as Chile after its earthquake in 2010 and Australia following major floods in 2011.

8. Adopting an explicit fiscal rule could help sustain fiscal consolidation. In 2010, the government introduced a "pay-as-you go" budget rule that requires new expenditures be funded through offsetting savings or higher revenue. To further strengthen the commitment to cap public debt, the government could adopt an explicit fiscal rule that targets a primary surplus consistent with its debt reduction plan. The framework should be based on prudent economic assumptions and permit temporary deviations from its target only under narrowly defined conditions.

Table 2 Possible Options for Reducing the Primary Deficit by 10 percent of GDP over 10 Years
(In percent of GDP)

		Consumption Tax Rate 1/ (In percent, currently at 5 pct)		
		14	**15**	**18**
Revenue from consumption tax		4.5	5.0	6.5
	Assumed impact over 10 years			
Withdrawal of fiscal stimulus	1.0	✔	✔	✔
Modest increase in personal income tax through broadening the base	0.5	✔	✔	✔
Freeze non social security spending in nominal terms (excluding interest payment)	2.5	✔	✔	✔
Limit annual nominal growth in non pension social security spending at 1-1.5 percent	1.0	✔	✔	
Freeze central government contributions to the public pension system in nominal terms, including through raising pension retirement age	0.5	✔	✔	
Corporate tax cut (by 5 percentage points)	-0.5		✔	✔
Total savings		10.0	10.0	10.0

1/ To be adjusted gradually over a 10-year period.

9. Lengthening the maturity of public debt would help limit rollover risks and keep funding costs low. The government has progressively lengthened the average maturity of public debt (including short-term financing bills) to 5–6 years, close to levels in other advanced economies. However, given the large debt stock, annual financing requirements are high at about 55 percent of GDP.[4] To lower rollover risk and lock in favorably low interest rates, we recommend a faster pace of extending maturities, such as by shifting from short-term financing bills to longer-term debt.

10. Delays in fiscal reform could have some spillover effects to other countries. The capacity of the market to absorb debt will gradually decline as private savings fall due to population aging.[5] If Japanese government bond (JGB) yields were to rise rapidly, Japanese banks including Japan Post, which hold almost 40 percent of outstanding JGBs, could experience sizeable losses and may change the composition of their asset portfolios. In addition, increases in JGB yields as a result of delays in fiscal reform, may lead to higher interest rates elsewhere, especially in some economies where government debt is already high.

III. MONETARY POLICY OPTIONS TO END DEFLATION

11. The Bank of Japan (BoJ) has substantially expanded its policy toolkit. In October 2010, the BoJ under its new comprehensive monetary easing policy (i) adopted a "virtually zero interest rate" policy, (ii) committed to maintain zero interest rates until the BoJ judges, on the basis of its "understanding of medium- to long-term price stability" that price stability is in sight[6], and (iii) introduced a new purchase program for various financial assets, covering corporate bonds, commercial paper, exchange-traded funds (ETFs), and real estate investment trusts (REITs) in addition to government securities. Following the earthquake, the BoJ expanded the size of its asset purchase program by ¥5 trillion yen and introduced a new ¥1 trillion loan program to support lending activities of financial institutions in the affected regions. The asset purchase program has helped reduce interest rates and boosted equity prices.

12. The BoJ's communication of the special factors driving inflation has helped clarify its policy stance. We welcome the Bank of Japan's statements in its reports explaining that the rise in headline inflation has been partly due to the rise in international commodity prices. The BoJ could further strengthen communication by regularly reporting the outlook for different inflation indices and explain their influence on monetary policy setting. In the current environment, where underlying inflation pressures are very subdued, we would suggest the BoJ give high weight to measures of inflation that exclude food and energy.

---

[4] The financing requirement is calculated as the sum of the estimated overall deficit of the general government (about 10 percent of GDP) and the principal value of short term financing bills and JGBs maturing in 2011 (45 percent of GDP).

[5] Kiichi Tokuoka (2010) "The Outlook for Financing Japan's Public Debt", IMF Working Paper 10/19.

[6] This commitment is conditional on the absence of problems when examining risk factors, such as an accumulation of financial imbalances.

13. Despite the pick-up in headline inflation, deflationary pressures are likely to persist. Excluding food and energy, core inflation has averaged -1 percent since 2009. Although the impact of the earthquake on inflation is unclear, the sharp fall in demand and heightened uncertainty about the outlook could add to deflationary pressures. In addition, the rebasing of the inflation index in August 2011, which is estimated by some market analysts to reduce the price level by around 0.5 percentage points, could push headline inflation back into negative territory and weaken inflation expectations.

14. The BoJ could guard against deflation risks through:

- *Further monetary easing.* To further reduce term premia on yields, the BoJ could increase the share of longer maturity JGBs (with remaining maturities of 3 years and above) in its portfolio. The BoJ could also expand its special loan facility to "support the foundations of growth" to include reconstruction projects in the affected regions.
- *Additional purchases of private assets.* To stimulate activity, the BoJ could accelerate and expand its purchases of corporate bonds, commercial paper, and ETFs. It could also broaden this program by purchasing securitized SME loans to ease financing constraints and foster a new market for lending to smaller firms.

15. Monetary easing has had little effect on the yen exchange rate. Since the global crisis, interest differentials between major currencies have narrowed and reduced incentives for yen funded carry trades. Going forward, however, as Japan is likely to maintain an accommodative monetary stance for longer than other advanced economies the yen could weaken and affect other economies via trade and financial channels.

IV. FINANCIAL POLICIES TO SAFEGUARD STABILITY

16. Japan's financial system has weathered well the initial shock of the earthquake. Swift and decisive action by the Bank of Japan and the Financial Services Agency have helped maintain financial stability. Major banks have largely been unaffected because of their small exposure to the hardest-hit regions and domestic insurers are expected to have sufficient reserves to meet disaster claims. A few regional and *shinkin* banks have sizeable exposures to the affected areas and could face large losses, but given their small size do not pose systemic risks.

17. Financial markets have reacted negatively to uncertainty about the financial situation of the Tokyo Electric Power Company (TEPCO) and its possible implications for creditors and shareholders. To minimize spillovers to the rest of the financial system, any rehabilitation plan for TEPCO should follow applicable laws on the treatment of claims on TEPCO.

18. The most significant risks to the banking sector are a sluggish recovery and a rise in market volatility. A delayed recovery could raise credit costs, especially on loans to heavily indebted SMEs, which are more vulnerable to a slowdown. Domestic banks also face market risk from their large holdings of equities, which account for over one-third of their tier-1 capital, and government bonds. Supervisors should continue to encourage banks to monitor closely these risks and proactively deal with distressed borrowers.

19. **Core profitability of Japanese banks remains low.** Preliminary FY2010 results for the major banks show that, despite improving credit costs, net interest margins remain very compressed while overall lending declined amid weak demand for funds. Reforms to promote more risk-based (as opposed to collateral-based) lending would help increase margins while consolidation or restructuring of weak regional banks, including through the use of public funds, would strengthen the banking sector. Privatization of Japan Post would also ensure a level playing field and broaden financial intermediation.

20. **Possible capital surcharges under the new Basel framework for global systemically important financial institutions (G-SIFIs) are under discussion and could have implications for Japanese financial institutions.**[7] While the outcome is still unknown, if classified as G-SIFIs, those Japanese financial institutions would have to meet the surcharge within the agreed timeline.

V. JAPAN'S GROWTH STRATEGY AFTER THE EARTHQUAKE

21. **Implementing the government's Growth Strategy through broad structural reforms would help sustain fiscal consolidation.**[8] The government last year set out an ambitious goal of doubling trend growth to 2 percent by the end of the decade. Notwithstanding the large but temporary shock, the earthquake provides an opportunity to broaden and accelerate reforms in several areas:

- *Boosting employment.* To cope with a shrinking labor force, Japan needs to expand employment opportunities for women, youth, and the elderly. Improving access to childcare by easing the approval process for new facilities and raising the mandatory retirement age could increase the share of women and elderly in the labor market. A new, more flexible labor contract that gradually increases employment protection would facilitate the employment of young workers and help narrow the gap between regular and nonregular workers.[9]

- *Raising productivity through regional integration.* Further trade liberalization, such as through the proposed Trans Pacific Partnership Agreement (TPP)[10], could open the door to new export markets and greater inward FDI. It would also act as a catalyst for regulatory reform of services and agriculture.[11]

---

[7] A Financial Sector Assessment Program (FSAP) Update in the coming year will provide an opportunity to explore the impact of new regulatory measures, as well as broader issues related to financial stability, the resolution framework for nonbanks, and policies to improve financial intermediation.

[8] Pelin Berkmen (2011) "The Impact of Fiscal Consolidation and Structural Reforms on Growth in Japan", IMF Working Paper 11/13.

[9] Masato Nakane and Chad Steinberg (2011) "To Fire or to Hoard: Japan's Labor Market Response to The Great Recession", IMF Working Paper 11/15.

[10] The Trans-Pacific Partnership is a multilateral free trade agreement between Brunei, Chile, New Zealand, and Singapore with ongoing negotiations to include Australia, Malaysia, Peru, the U.S., and Vietnam.

[11] Results from trade model analysis suggest that joining the TPP could raise annual export growth by between 1–4 percent over a decade and have beneficial growth spillovers to regional trading partners.

- *Promoting startups and restructuring SMEs.* To support business creation, the time limit on public credit guarantees should be shortened and some preference for guarantees be given to startups in new growth areas. Establishing asset management companies to purchase distressed loans would promote bank-led restructuring and reduce leverage in the SME sector.

VI. JAPAN'S CONTRIBUTION TO THE GLOBAL ECONOMY

22. As one of the largest and richest economies in the world, Japan is an important contributor to regional growth and stability. Japan accounts for nearly 9 percent of global GDP and about half of its international trade is conducted with regional neighbors. Its sophisticated manufacturing base contributes a large share of value added to regional production chains and Japanese final demand is an important and stable source of export demand for its Asian trading partners.

23. To maintain these positive spillovers in light of declining trend growth and rising public debt, fiscal and structural reforms are essential. Fiscal consolidation would have long-term benefits for its partners by reducing tail risks from a disruption in Japan's large sovereign debt market and freeing up domestic savings to help lower global interest rates. Speedy implementation of Japan's growth strategy would also support fiscal adjustment and strengthen global final demand.

24. Despite the adversity caused by the earthquake, Japan has enacted swiftly the law and budget to contribute to the replenishment of capital of the International Development Association (IDA) of the World Bank and other multinational development banks, as well as the quota increase of the IMF. This exemplifies Japan's strong commitment to international cooperation.

***

25. We are grateful to the authorities for their generous hospitality and very constructive discussions.