INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/197

JAPAN

July 2015

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR JAPAN

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Japan, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 17, 2015 consideration of the staff report that concluded the Article IV consultation with Japan.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 17, 2015, following discussions that ended on May 21, 2015, 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 June 30, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Japan.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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July 23, 2015

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IMF Executive Board Concludes 2015 Article IV Consultation with Japan

On July 17, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Japan.

A modest economic recovery is underway. GDP is expected to grow at an above-potential pace this year (0.8 percent) buoyed by gradually strengthening private consumption on higher real wages and a gradual recovery of external demand. Inflation remains well below the Bank of Japan's 2 percent target partly due to commodity price developments, but will start to pick up toward the end of this year with the dissipation of the negative effects of falling oil prices and higher wage growth.

Ongoing structural reforms have improved long-term prospects modestly. Growth is projected to stabilize at around 0.7 percent over the medium term with improvements in productivity and capital formation and higher labor force participation offsetting headwinds from the diminishing labor force. On the back of the closing of the output gap, a tight labor market and renewed favorable wage-price dynamics, inflation is expected to increase gradually to about 1.5percent over the medium term under current policies. However, risks to this outlook are tilted to the downside with the most important risks stemming from weak domestic demand and incomplete policies, particularly with regard to the fiscal consolidation and structural reforms.

Abenomics needs to be reloaded so that policy shortcomings do not become a drag on growth and inflation. In addition to swift implementation of already announced reforms, further high-impact structural reforms are urgently needed to lift growth, facilitate fiscal consolidation, and unburden monetary policy. The next round of reforms should lift labor supply, reduce labor

[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.

market duality, continue agricultural and services sector deregulation and turn the financial sector into a driver of reforms.

A credible medium-term fiscal consolidation plan is needed to remove uncertainty about the direction of policies that may be holding back domestic demand. The medium-term fiscal reform plan should aim to put debt on a downward path, based on realistic economic assumptions, and specify structural revenue and expenditure measures upfront. The Bank of Japan needs to stand ready to ease further, provide stronger guidance to markets through enhanced communication, and put greater emphasis on achieving the 2 percent inflation target in a stable manner. However, further monetary easing without bolder structural reforms and a credible medium-term fiscal consolidation plan could lead to sluggish domestic demand and overreliance on yen depreciation to pursue domestic policy objectives, with possible adverse spillovers abroad.

Executive Board Assessment[2]

Executive Directors welcomed the improved medium-term outlook for growth and inflation. Directors commended the authorities for persistently pursuing the three-pronged economic strategy to lift growth, overcome entrenched deflation, and reduce public indebtedness. With risks tilted to the downside, Directors underscored that it would be essential to reinvigorate all elements of the government’s economic strategy, the success of which will also be beneficial for the global economy.

Directors emphasized the urgency of completing far-reaching structural reforms to address the challenge of population aging and achieve the ambitious growth objectives of the revitalization strategy. They welcomed the recent progress in improving corporate governance and raising female labor force participation. Directors encouraged further growth-enhancing reforms to increase labor supply, reduce labor market duality, and deregulate the agricultural and service sectors. Continued efforts are also needed to enhance the efficiency of resource allocation through the financial system.

Directors agreed that the fiscal consolidation strategy needs to strike a balance between making progress on deficit reduction and supporting growth and inflation momentum. They welcomed the recent announcement of a medium-term fiscal consolidation plan with specific primary deficit targets while acknowledging the need for flexibility to take account of economic and price developments. Directors noted that prudent economic assumptions, identification of concrete measures to put the debt-to-GDP ratio on a downward trajectory, and strong fiscal institutions would help impart credibility to the consolidation plan. Specifically, ongoing efforts

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

to raise the consumption tax and reform expenditures are crucial to this strategy.

Directors stressed that raising inflation in a stable manner remains an important— albeit challenging—priority. They were reassured by the authorities' readiness to take further monetary policy action as necessary, complemented with enhanced communication to guide markets. Directors encouraged the authorities to continue to improve monetary policy transmission, and to strengthen momentum for wage increases in the tripartite dialogue.

Directors agreed that the financial system remains sound and well capitalized. They supported initiatives to further enhance its resilience to risks, including from volatility in interest rates and liquidity in the government bond market. Directors saw scope for financial institutions to seek higher returns while improving their risk management tools. They emphasized the role of macroprudential policies in addressing financial stability risks in a low interest rate environment.

Directors took note of the staff's assessment that Japan's external position was broadly consistent with fundamentals in 2014 but that the yen has depreciated since then. Going forward, ambitious structural reforms to boost domestic demand and credible fiscal consolidation are critical to avoid overreliance on the depreciation of the yen. These efforts will ease the burden of monetary policy, as well as help avert negative spillovers from portfolio rebalancing by Japanese financial institutions.

Japan: Selected Economic Indicators, 2010–16

Nominal GDP: US$ 4,602 Billion (2014)
Population: 127 Million (2014)
GDP per capita: US$ 36,205 (2014)
Quota: SDR 15.6 Billion (2014)

	2010	2011	2012	2013	2014	2015	2016
						Proj.	
Growth (percent change) 1/							
Real GDP	4.7	-0.5	1.7	1.6	-0.1	0.8	1.2
Domestic demand	2.9	0.4	2.6	1.9	-0.1	0.7	1.1
Private consumption	2.8	0.3	2.3	2.1	-1.3	0.3	2.1
Gross Private Fixed Investment	-0.5	4.3	3.6	1.9	2.1	2.1	3.4
Government consumption	1.9	1.2	1.7	1.9	0.2	0.4	-1.6
Public investment	0.7	-8.2	2.7	8.0	3.8	-5.6	-10.0
Stockbuilding 2/	0.9	-0.2	0.2	-0.4	0.1	0.2	0.0
Net exports 2/	2.0	-0.8	-0.8	-0.2	0.3	0.3	0.2
Exports of goods and services 3/	24.8	-0.4	-0.2	1.2	8.4	7.7	5.5
Imports of goods and services 3/	11.1	5.9	5.3	3.1	7.4	6.4	5.3
Inflation (annual average)							
CPI 4/	-0.7	-0.3	0.0	0.4	2.7	0.7	0.6
GDP deflator	-2.2	-1.9	-0.9	-0.6	1.7	1.7	0.0
Unemployment rate (annual average)	5.0	4.6	4.3	4.0	3.6	3.7	3.7
Government (percent of GDP)							
General government							
Revenue	29.6	30.8	31.1	32.0	33.0	33.8	34.0
Expenditure	38.9	40.6	39.8	40.5	40.3	39.7	38.6
Overall Balance	-9.3	-9.8	-8.8	-8.5	-7.3	-5.9	-4.7
Primary balance	-8.6	-9.0	-7.9	-7.8	-6.7	-5.4	-4.2
Structural primary balance	-7.2	-7.6	-6.9	-7.5	-6.2	-5.0	-4.0
Public debt, gross	215.8	229.7	236.6	242.6	246.2	245.8	247.6
Macro-financial (percent change, end-perio, unless otherwise specified)							
Base money	16.7	22.2	19.3	60.3	36.7	29.1	22.5
Broad money	2.8	3.6	2.8	4.5	3.0	3.9	3.4
Credit to the private sector	-2.3	-2.9	2.6	6.7	1.4	2.3	2.7
Non-financial corporate debt in percent of GDP	187.7	191.4	196.4	225.1	237.8	235.7	237.6
Household debt in percent of disposable income	131.9	128.3	127.1	128.5	129.3	128.8	129.1
Interest rate							
Overnight call rate, uncollateralized (end-period)	0.1	0.1	0.1	0.1	0.1	…	…
Three-month CD rate (annual average)	0.3	0.3	0.3	0.2	0.2	…	…
Official discount rate (end-period)	0.3	0.3	0.3	0.3	0.0	-0.1	-0.1
10-year JGB yield (e.o.p.)	1.1	1.0	0.8	0.7	0.3	0.5	0.7
Balance of payments (in billions of US$)							
Current account balance	221.0	129.8	59.7	40.7	24.4	77.3	85.6
Percent of GDP	4.0	2.2	1.0	0.8	0.5	1.9	2.0
Trade balance	108.5	-4.5	-53.9	-90.0	-99.3	-39.7	-33.1
Percent of GDP	2.0	-0.1	-0.9	-1.8	-2.2	-1.0	-0.8
Exports of goods, f.o.b.	735.5	790.8	776.0	695.0	699.7	644.4	662.0
Imports of goods, f.o.b.	-626.9	-795.3	-829.9	-784.9	-798.9	684.0	-695.0
Oil imports (trade basis)	134.3	182.5	196.9	184.9	167.5	106.6	120.9
FDI, net (percent of GDP)	1.3	2.0	2.0	2.8	2.4	2.3	2.4
Terms of trade (percent change)	-3.3	-7.5	0.8	-2.9	-1.1	3.6	1.3
Change in reserves	44.3	177.3	-37.9	38.7	8.5	9.0	9.5
Total reserves minus gold (in billions of US$)	1061.5	1258.2	1227.2	1237.3	1231.0	…	…
Exchange rates (annual average)							
Yen/dollar rate	87.8	79.8	79.8	97.6	105.7	120.0	119.2
Yen/euro rate	116.5	111.0	102.6	129.6	140.5	133.8	133.7
Real effective exchange rate (ULC-based) 5/	109.8	118.5	119.7	96.7	88.8	…	…
Real effective exchange rate (CPI-based)	100.0	101.7	100.5	80.3	75.1	…	…

Sources: IMF, Competitiveness Indicators System; OECD, and IMF staff estimates and projections as of June 11, 2015.
1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ Contribution to GDP growth.
3/ For 2014 export and import growth rates are inflated because of changes in the compilation of BoP statistics (BPM6) implying a break in the series relative to previous years.
4/ Including the effects of consumption tax increases in 2014 and 2015.
5/ Based on normalized unit labor costs; 2005=100.

INTERNATIONAL MONETARY FUND

JAPAN

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

June 30, 2015

KEY ISSUES

Abenomics has lifted Japan out of the doldrums and needs to be reinforced to accomplish the desired "once in a lifetime" economic regime shift. Building on initial positive results, policies now need to embark on a sustained effort to meet the unprecedented challenges Japan is facing: ending an entrenched deflationary mindset, raising growth, restoring fiscal and debt sustainability, and maintaining financial stability in the face of adverse demographics.

Japan should be at the vanguard of structural reform. More vigorous efforts to raise labor supply and deregulate domestic markets, backed by further endeavors to raise wages and investment and designed to boost confidence and raise domestic demand, will be essential to lift growth, facilitate fiscal consolidation, and unburden monetary policy.

A credible medium-term fiscal consolidation plan is needed to remove uncertainty about the direction of policies that may be holding back domestic demand. The overarching goal should be to put debt on a downward path, through gradual but steady consolidation that does not derail growth and inflation momentum. It should be based on prudent economic assumptions and on concrete structural revenue and expenditure measures identified upfront.

More explicit monetary guidance would enhance inflation dynamics. Actual and expected inflation remain well below the Bank of Japan's (BoJ's) inflation target and monetary policy transmission remains weak. The BoJ needs to stand ready to undertake further easing and should provide stronger guidance to markets through enhanced communication. Absent deeper structural reforms, even with further easing, reaching two-percent inflation in a stable manner is likely to take longer than envisaged, suggesting that the BoJ should put greater emphasis on achieving the inflation target in a stable manner rather than within a specific time frame.

The financial sector should be a greater catalyst for growth, and guard against risks from unconventional policies. The soundness of the financial system allows more risk taking and consolidation, while remaining resilient to the likely higher volatility of asset prices, exchange rates and interest rates, and lower liquidity in the JGB market as quantitative easing proceeds.

While the 2014 external position was assessed to be broadly aligned with fundamentals, subsequent developments and incomplete policies raise the risk of negative spillovers. With the depreciation of the yen relative to its mid-2014 level, further monetary easing without bolder structural reforms and a credible medium-term fiscal consolidation plan could lead to sluggish domestic demand and overreliance on yen depreciation to pursue domestic policy objectives.

Approved By
Kalpana Kochhar and Tamim Bayoumi

Discussions took place in Tokyo from May 8–21, 2015. The staff team comprised K. Kochhar (head), L. Everaert, D. Botman, J. Kang, I. Saito (all APD), E. Jafarov (MCM), and G. Ganelli and N. Miake (all OAP). Messrs. Kajikawa and Hishikawa (OED) also participated in the discussions. Mr. Lipton held meetings with senior officials. S. Abebe and Y. Liu (all APD) assisted in this report's preparation. The mission was assisted by OAP staff.

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ANNEXES

BACKGROUND AND CONTEXT

1. **In late 2012, Japan launched "Abenomics," an economic revival plan to exit from decades-long deflation, low growth, and rising public debt.** The three-pronged strategy of aggressive monetary easing, flexible fiscal policy, and structural reforms promised to be a clear break from previous incremental efforts. So far, the pace of real GDP growth has remained similar to the post-bubble period at about 1 percent, and deflation risks remain. This is partly due to external shocks, including slower global growth and the collapse in commodity prices. In addition, the negative impact of the consumption tax rate hike in 2014 was bigger than expected as nominal wage growth fell short of inflation despite very tight labor market conditions. However, structural impediments have also played a role, including rigid wage dynamics due to labor market duality and the deeply entrenched deflationary mindset, while the effects of the sharp yen depreciation on exports and domestic investment have been weaker than expected due to a trend increase in production offshoring and headwinds from population aging.

2. **Abenomics needs to be reloaded so that policy shortcomings do not become a drag on growth and inflation.** With the exception of corporate governance and some progress on female labor force participation, structural reforms have not yet been in areas that could provide the biggest bang for the buck (Annex I). While there are concerns that structural reforms may be deflationary in the short term as they expand supply, a comprehensive package should bring forward demand and contribute to wage and price pressures. Fiscal policy needs to provide clear direction to reduce uncertainty for the private sector. And monetary policy should provide stronger guidance to markets.

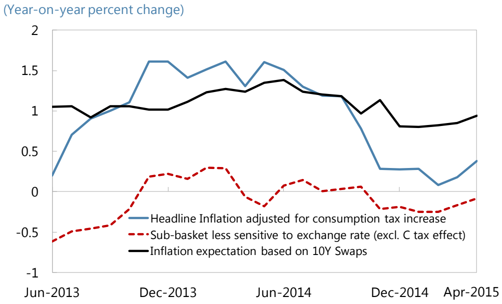
MODEST RECOVERY UNDERWAY

A. Recent Developments

3. **A modest recovery is underway as domestic demand has bottomed out** (Figure 1). GDP growth accelerated to 3.9 percent in 2015:Q1 (qoq, saar). The rebound in business investment is especially encouraging, but consumption remains sluggish and more than half of the reported quarterly growth stemmed from inventories. Leading indicators such as retail sales and industrial production suggest a continued modest recovery of domestic demand in 2015:Q2.

Headline and Inflation Expectations

(Year-on-year percent change)



Sources: CEIC; Bloomberg; and IMF staff estimates.

4. **Inflation expectations are still below the Bank of Japan's (BoJ's) inflation target and actual inflation has been pushed down by commodity price developments** (Figure 2). After rising to 1.5 percent in mid-2014, core inflation (excluding fresh food and the effects of the consumption tax increase) declined rapidly and has been close to zero since February 2015. Initially, the decline reflected the waning effects of yen

depreciation in 2013 and weak domestic demand. More recently, falling energy prices have added to disinflation. A CPI sub-index, with items less sensitive to the exchange rate, has been in deflationary territory since last October. Market-based measures of inflation expectations have declined since mid-2014 and recently stabilized at around 1 percent.

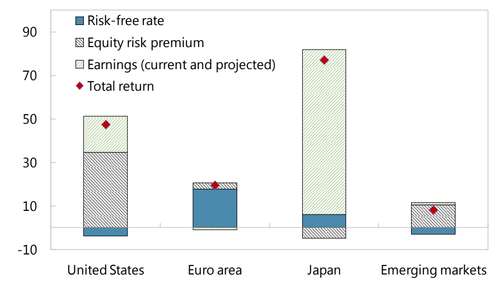
5. Loose monetary policy has improved financial conditions and fueled asset prices.

- Notwithstanding recent volatility, Japanese government bonds (JGBs) yields have remained near historic lows (Figure 3). Financing conditions for firms also continue to improve with both bank lending rates and corporate bond yields near historic lows. As of May, the real effective exchange rate (REER) had depreciated by 7 percent compared to the average of 2014.

- Stock prices have more than doubled since the launch of quantitative and qualitative monetary easing (QQE) by the BoJ, mainly driven by actual and expected earnings growth (Figure 4).[1] Fundamental drivers include increased profitability of large corporations on the back of yen depreciation, lower corporate income tax rates, recent corporate governance reforms, and buybacks by companies. The portfolio allocation shift by the Government Pension Investment Fund (GPIF) towards equities and other riskier assets and the BoJ's additional purchases of ETFs have also contributed to this outcome.

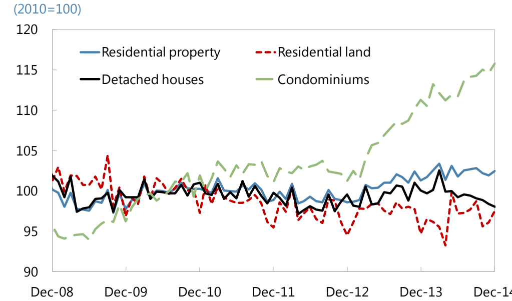
- Land and real estate prices have bottomed out in most market segments and condominium prices in metropolitan areas are rising again after a two-decade slump.

Decomposition of Equity Performance
(percent contribution from Dec 2012 - Feb 2015)



Sources: Haver Analytics; I/B/E/S; JPMorgan Chase & Co.; and IMF staff estimates.
Note: Based on a standard three-stage dividend discount model.

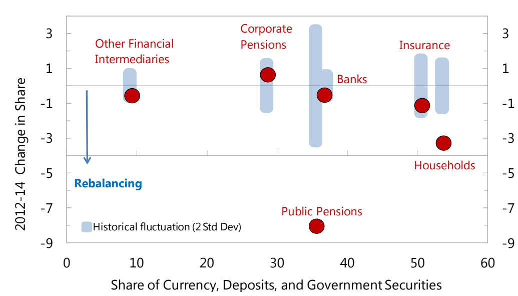
Japan: Residential Property Price Indices
(2010=100)



Source: Japan's Ministry of Land, Infrastructure, Transport, and Tourism.

6. Portfolio rebalancing is progressing but credit growth has remained subdued. Balance sheets reveal that most financial institutions have reduced their holdings of government bonds, but only public pension funds and households have materially rebalanced towards riskier assets. Banks have been shedding their JGBs and building up excess reserves although lending to the non manufacturing corporate sector, including small and medium-sized enterprises (SMEs) has seen a modest

Currency, Deposits & Government Bonds Holdings (2014Q4)
(In percent of total portfolio)



Sources: Bank of Japan Flow of Funds; Haver; and IMF Staff Estimates.

[1] See IMF Global Financial Stability Report (2015 April) for more details.

increase and overseas lending has picked up. In contrast, lending to the manufacturing sector has been broadly flat, owing to ample corporate cash balances, while household borrowing is continuing at its historic rate.

7. **Financial system soundness has continued to improve.** Banks are benefitting from the recovery, loan growth and higher equity market valuations. With low credit costs and declining loan loss provisioning, capital positions have strengthened and internationally-active banks remain on track to meet Basel III capital requirements. Although major Japanese banks are more leveraged compared to other G-SIFIs, credit risks are limited by large holdings of low-risk assets such as government bonds. With interest rate margins squeezed by competition, most banks have expanded non-interest income. Moreover, QQE has reduced interest rate risk primarily for major banks, while regional banks have been slow to shed their JGB holdings given more limited lending opportunities. Insurance companies have dealt with low interest rates by investing in instruments with longer maturities and high-yield assets and expanding overseas investments while reducing guaranteed rates on their savings-type products. They have maintained their solvency margin ratios at levels well above 200 percent—the regulatory threshold to take corrective actions. The GPIF has aligned its portfolio allocation targets to international practices.

Japan: Banks Capital Adequacy and Non-Performing Loans

	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15
Capital adequacy ratio						
Major banks						
Internationaly active banks	14.5	15.5	15.7	15.3	15.2	15.6
Domestic banks	12.8	12.4	13.1	14.3	14.3	14.0
Regional banks						
Internationaly active banks	11.3	13.2	14.1	14.3	14.3	14.4
Domestic banks 1/	11.4	11.3	11.1	11.3	11.0	11.0
NPL ratio						
Major banks	1.8	1.8	1.8	1.8	1.3	1.1
Regional banks	3.2	3.2	3.2	3.2	3.1	2.6

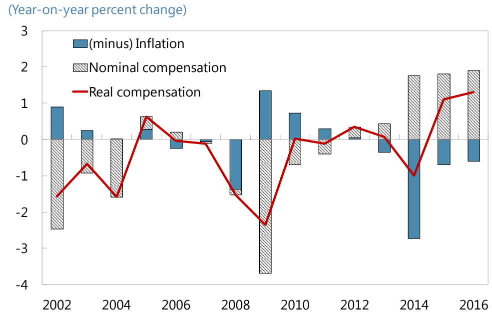
Source: Japanese authorities.

1/ Domestic banks have significant unrecognized gains in their balance sheet.

B. Outlook and Risks

8. **The economy is expected to recover moderately in 2015–16.** Following negative growth in 2014 (-0.1 percent), the economy is projected to grow by 0.8 and 1.2 percent in 2015 and 2016, respectively (Table 1).

Growth in Real Compensation
(Year-on-year percent change)



Sources: Haver Analytics; and IMF staff estimates.

Private consumption should gradually strengthen as real compensation is forecast to grow by 1 percent and 1.2 percent in 2015 and 2016, respectively, after declining by 0.6 percent last year. Higher nominal wage growth and lower headline inflation, helped by the oil windfall, will more than offset moderating employment growth. The higher real purchasing power will contribute to steady consumption growth this year and carry over into 2016, with these "base effects" accounting for half of 2016 GDP growth. Positive wealth effects from the stock price rally contribute in a limited way given the relatively small share of equity holdings by households.

- *Business investment* is projected to grow modestly, supported by lower production costs from declining oil prices, record-high corporate profits, ongoing corporate governance reforms, and the availability of credit. Lending is projected to grow slightly faster than GDP, as there are no lending constraints, but less than broad money, which is boosted by QQE (Table 2). The Tankan survey shows that the manufacturing sector still has excess capacity, implying that it will take time for investment to accelerate.

- *Net exports* are expected to continue to contribute moderately to growth in 2015–16. The pace of export growth is set to rise gradually in line with the recovery of external demand, while production offshoring remains a structural headwind (Box 1, Table 3). Import growth will gradually rise in line with stronger domestic demand, but dampened by the weaker yen.

- Despite a substantial improvement in the headline structural primary balance, the drag on growth from *fiscal consolidation* in 2015 and 2016 will be manageable at 0.2 and 0.7 percentage points, respectively (Table 4). The modest growth impact in 2015 is due to the fact that half of the fiscal improvement comes from last year's consumption tax rate increase (including from collection lags), whose adverse growth effects have already occurred. For 2016, the growth impact will be larger as a bigger share of the adjustment comes from declining government consumption and investment.

9. Under current policies, potential growth will rise to 0.6 percent over the medium term (Table 5). The rise in female labor force participation will partly offset the drag from population aging, which will nonetheless continue to be a structural headwind to investment. The recently implemented corporate governance reforms will help lift potential growth by reducing incentives for accumulating large cash buffers and by supporting investment, dividend payouts, and M&A activities over the medium term.

10. Inflation is expected to increase gradually under current policies. Although QQE is having positive effects, the effect on inflation has so far been limited as the expectations channel seems to be weak (Box 2), leaving yen depreciation as the key transmission channel. Several factors will put upward pressure on the price level in the near term, including the recovery of oil and commodity prices from their lows, the lagged effect of the recent episode of yen weakening, and the closing of the output gap. Continued tightening of the labor market could accelerate favorable wage-price dynamics. As a result, under current policies, staff expects inflation to rise gradually to 1½ percent over the medium term.

11. Risks to this growth and inflation outlook are tilted to the downside (Annex II).

- *Near term*. The economic recovery could stall on weakness in domestic demand. Wage growth following the spring *Shunto* (annual synchronized wage bargaining) round and spending of the oil windfall could disappoint. Smaller wage growth would imply larger multipliers from the fiscal adjustment in the pipeline, resulting in more depressed demand. Declining JGB market liquidity could spark volatility in government bond yields, possibly triggered by global developments, and cause gyrations in the stock market and the exchange rate, undermining consumer and business sentiment. Other external risks include lower-than-expected growth in China and the U.S. and safe-haven appreciation.

- *Medium term*. Weak domestic demand and incomplete fiscal and structural reform policies, could result in either stagnation or stagflation. Without swift progress in structural reforms, headwinds from population aging and production offshoring could undermine domestic demand. If, on the other hand, continued aggressive monetary easing and further yen depreciation raise inflation, expectations of monetary policy normalization could arise at a time when potential growth is low and fiscal deficits are large. In both cases, doubts about long-term fiscal sustainability could lead to a jump in the sovereign risk premium, forcing abrupt further fiscal adjustment with adverse feedback to the financial system and the real economy. This could compound low profitability of the banking system and trigger excessive volatility in the JGB and currency markets.

Authorities' Views

12. The authorities were confident that growth would accelerate. They expected the recovery to continue on the basis of robust domestic demand in the near term. The increase in base wages and total compensation following this year's collective wage bargaining round is expected to underpin private consumption, while easy financial conditions and high profits would support the nascent recovery in corporate capital expenditure. In a "revitalization" scenario under which the authorities were designing their medium-term fiscal consolidation plan, they expected real GDP growth to rise to about 2 percent over the medium term through steady implementation of the three arrows' strategies for the revitalization of the Japanese economy.

13. The BoJ was determined to achieve its 2 percent inflation target "around" the first half of FY2016. The BoJ noted that inflation could become negative and remain subdued throughout the summer of 2015, but would pick up strongly toward the end of this year with the dissipation of the negative effects of falling oil prices, higher wage growth, a further rise in medium- to long-term inflation expectations, and the positive output gap. While acknowledging that the evolution of wage-price dynamics was uncertain in the context of an unprecedented effort to dislodge a deeply entrenched deflationary mindset, the BoJ noted that the introduction of the price stability target and QQE had shifted trend inflation away from zero percent after 15 years at that level.[2]

[2] See Kaihatsu and Nakajima (BoJ Working Paper Series No. 15-E-3).

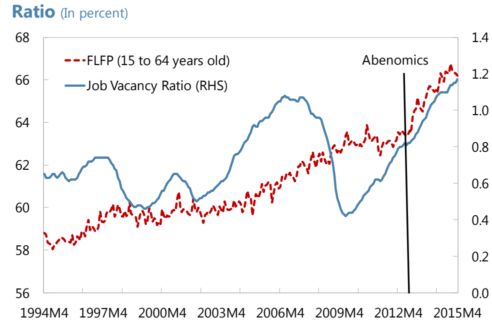
GROWTH REFORMS VITAL TO ABENOMICS' SUCCESS

14. Japan should be at the vanguard of structural reform. The economy faces the formidable challenge of a rapidly shrinking labor force which needs to be countered by higher labor force participation and faster productivity growth. Despite some progress in a number of areas, the impact of reforms has yet to substantially materialize and potential growth remains far below what is required to realize the "revitalization" scenario. While swift implementation of already announced reforms is essential, it should be accompanied by further substantial reforms to boost confidence and contribute to higher domestic demand.

Policy Issues and Staff's Views

15. Structural reforms are progressing in a number of areas. Female labor force participation, which had been rising gradually since the mid-2000s on tightening labor market conditions, got a further boost with Abenomics, possibly as a result of increased availability of child-care facilities and cash transfers to families with children. Significant progress has been made in corporate governance reforms which are expected to unlock large corporate cash positions. Measures taken so far include the Stewardship Code inducing greater institutional investor activism; the amendment of the Companies Act and the adoption of Corporate Governance Code requiring listed companies to appoint outside directors on a "comply or explain" basis; and the launching of the JPX-Nikkei Index 400 comprising only profitable firms with good corporate governance and disclosure. Deregulation in designated special economic zones (SEZs) is under discussion at the local government level. Even so, these measures may not suffice to counter the headwinds on labor supply from adverse demographics.

Female Labor Force Participation Rate and Job Vacancy Ratio (In percent)

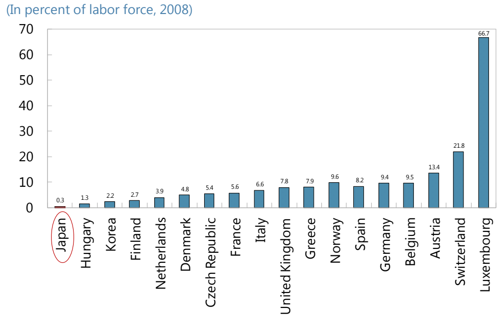


Source: Haver Analytics.

16. Further high-impact reforms are urgently needed.

- *Labor market reform:* Building on encouraging progress, female labor force participation can be boosted further by eliminating tax-induced disincentives to work and raising the availability of child-care facilities through deregulation. Drawing more aggressively than planned on foreign labor by relaxing immigration restrictions in sectors with labor shortages[3] as well as incentivizing older workers to remain in the workforce would help address labor shortages that hamper investment. New hiring should

Stock of Foreign Labor Force
(In percent of labor force, 2008)



Source: International Migration Outlook 2010.

[3] See Ganelli and Miake (IMF WP, forthcoming).

take place under contracts that balance job security and flexibility to reduce labor market duality and raise horizontal mobility, contributing to higher productivity and wage growth. The authorities should move quickly to clarify the legal and regulatory environment surrounding these "intermediate" contracts. At the minimum, these reforms should counter the declining labor force, but in the medium-term they need to boost potential growth above current levels.

- *Corporate governance reform:* Governance reforms should be strengthened to unlock renewed dynamism in product markets. Next steps should include more ambitious requirements for independent directors, greater transparency of beneficial ownership, as well as other measures to reduce incentives to hoard cash such as introducing regulatory limits to discourage excessive cross-shareholdings, removing bottlenecks which prevent takeovers, and introducing pre-packaged reorganization plans for bankruptcy procedures.

- *Deregulation:* The conclusion of the Trans-Pacific Partnership (TPP) trade agreement could provide a boost to activity, but only if it leads to deregulation of agriculture and domestic services sectors and elimination of most tariffs and non-tariff and investment barriers in Japan. Deregulation in SEZs should be expedited with a view to rolling out these reforms nation-wide as soon as possible as it would raise productivity and provide investment opportunities, including inward foreign direct investment.

17. The financial sector should help drive more efficient resource allocation. It should take advantage of the recent corporate governance reforms to unwind cross-shareholdings, foster consolidation in the enterprise sector, and promote exit of unviable enterprises. The authorities should phase out financial sector support schemes for SMEs that do not invest or hire workers and promote the expansion of securitization and the provision of risk capital. The supervisory agency's guidance to move from collateral to risk-based lending and its efforts to promote better risk management should help. Private-sector led consolidation in the financial system, in particular among regional banks, would also be beneficial. Given the substantial changes to the portfolio allocation of the GPIF, it will be important to strengthen its governance structure. To further promote portfolio rebalancing of households to riskier investment through tax-exempt individual savings accounts, consideration should be given to extending the 5-year term limit and gradually raising the maximum contribution limit.

18. As part of the tripartite dialogue, the authorities are rightly calling for higher wage increases. The labor market is very tight with the unemployment rate at historic lows and participation rising. With booming profits, corporations have the opportunity to establish favorable wage-price dynamics. Ongoing wage increases are a good start, and their momentum should be further strengthened by raising all administratively controlled wages and prices, calling for a supplementary wage round, the conversion of some of the seemingly permanent bonuses into base wages, and a stronger-than-usual winter bonus round. Higher-than-usual minimum wage increases and strengthening tax incentives for firms that raise wages should be considered.

Authorities' Views

19. The authorities emphasized significant progress with ongoing reforms, such as corporate governance. They noted that enhancement of corporate governance was leading to a historic shift in Japan's corporate culture, which should result in a much more dynamic corporate sector. The authorities felt that their "comply or explain" approach would be effective in a Japanese context. The "*Seiroshi*" tripartite dialogue among the government, corporate sector, and labor, in which PM Abe actively participates, led to large wage hikes for two consecutive years by encouraging large companies enjoying record high profitability to grant generous wage increases and higher contract prices to their suppliers. In addition, the authorities emphasized progress on other structural reforms such as labor market reforms and deregulation: 25 related bills have been submitted to the Diet, with the final stage reforms in the energy sector being approved on June 17, 2015, adding to the 44 bills which have already been passed (Annex I).

20. The authorities highlighted that the FY2015 tax reform aimed to support growth. The statutory corporate tax rate was cut by 2.5 and 0.8 percentage points in FY2015 and FY2016, respectively, reducing it by a cumulative 3.3 percentage points by FY2016. To finance the CIT-rate reduction, encourage companies to make more active efforts to improve their profitability and develop new technologies, and induce companies to record corporate income, the deduction limitation for loss carried forward was modified. It is being lowered from 80 to 65 percent in FY2015 and to 50 percent in FY2017. The pro-forma standard taxation (based on value added and capital base of corporations) will be expanded from ¼ to ½ of local enterprise tax revenue between FY2014–16. These changes should reduce the tax burden on companies with "profit-earning power" and allow a broader sharing of the tax burden. The authorities eased requirements to qualify for tax incentives for wage hikes.

BALANCED FISCAL ADJUSTMENT

21. The authorities recently announced a medium-term fiscal consolidation plan. Following the halving of the primary deficit of the national and local governments between FY2010 and FY2015, they intend to achieve a primary surplus by FY2020 under the "revitalization" scenario. The consumption tax rate increase to 10 percent in April 2017, is a key measure, together with a further 1½ percent of structural adjustment over 2018–20 to be identified at a later stage.

Policy Issues and Staff's Views

22. Sound principles need to underpin the fiscal consolidation plan to secure its credibility. Low and stable JGB yields should not be taken for granted as shifts in investor sentiment could happen abruptly. A concrete and credible medium-term plan based on the following principles would remove uncertainties about fiscal intentions, which could be hampering domestic demand, and create space to respond to downside risks:

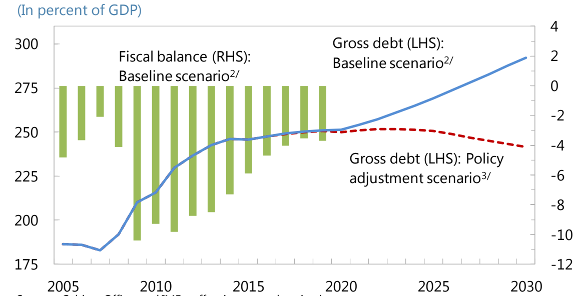
- Use of prudent and realistic economic assumptions;

- Adoption of a long-term goal of putting debt on a downward path;
- Specification of adjustment in terms of structural fiscal balance; and
- Upfront identification of specific structural revenue and expenditure measures.

23. Stronger fiscal institutions will be necessary to impart credibility to such a plan. Continuous large deficits, the record high level of public debt, the use of optimistic growth assumptions, and the uncertainty introduced by recurrent recourse to supplementary budgets suggest large benefits from anchoring fiscal discipline in a more credible medium-term budget framework. As the fiscal adjustment will span at least a decade, such a framework should include rules to curb expenditures, limits on the use of supplementary budgets, and publication of independent assessments of the outlook and budget projections by the Fiscal System Council. This would prevent procyclical policies, remove a source of volatility, and establish clear visibility about the direction of policies.

24. The announced medium-term plan provides a useful anchor to guide fiscal policy. Planned adjustment in 2015 and 2016—mainly withdrawal of past stimuli and waning reconstruction spending—is appropriate in striking a balance between reducing fiscal risks and maintaining growth momentum. However, in 2017, on the basis of current staff projections, mitigating measures of about 0.3 percent of GDP need to be introduced in order not to jeopardize growth and inflation momentum at the time of the next consumption tax rate hike. But this scenario will not stabilize debt. Further adjustment by 1½ percent during 2018–20 strikes the right balance between supporting growth and progress with fiscal consolidation. However, the reliance on optimistic growth assumption under a "revitalization" scenario, risks harming confidence in the authorities' plans as it limits the amount of structural adjustment needed to achieve the FY2020 target.

Japan: Gross Public Debt[1/] and Fiscal Balance
(In percent of GDP)



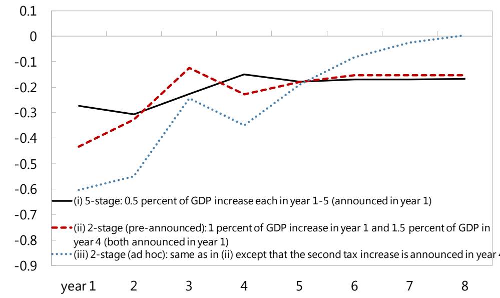
Sources: Cabinet Office; and IMF staff estimates and projections.
1/ Gross debt of the general government including the social security fund.
2/ Withdrawal of fiscal stimulus and consumption tax increases to 10 percent in 2017 are assumed.
3/ Assumes a stimulus of 0.3 percent of GDP in FY2017 and an additional adjustment of 6 percent of GDP in the structural primary balance (0.75 percent of GDP each between 2019 and 2026) with a multiplier of 0.5.

25. Further balanced consolidation will be necessary to place the public debt-to-GDP ratio on a downward trajectory (Annex III). The recent decline in the fiscal deficit through containment of spending and higher consumption tax revenue (Figure 5) and the similar measures planned for 2016–20 will temporarily stabilize the debt-to-GDP ratio at about 250 percent before it accelerates again under current policies To put debt on a downward path in the long run, staff sees the need for a further adjustment in the structural primary balance by 4½ percent of GDP. This adjustment scenario should be balanced in two ways: to maintain growth momentum its pace should be measured, at about ¾ percent of GDP per year; and, it should comprise both expenditure and revenue measures, including further increase, in the consumption tax rate beyond 10 percent.

On the expenditure side, entitlement reforms to contain social security spending growth will be crucial.[4]

26. The consumption tax rate increase should be implemented with a single rate structure. Equity concerns that the higher consumption tax could harm low-income households should be addressed through the existing cash transfers—targeting of which could be improved once the new tax identification numbers are introduced—instead of reducing rates on essential items, as this would hurt efficiency, increase compliance and administrative costs, and result in permanent revenue losses. An upfront credible commitment of further gradual consumption tax rate increases at a moderate pace over the long run would help smooth any negative confidence effects.

Consumption Tax Hike: Deviation in Growth from Baseline
(In percentage point)



Source: IMF staff estimates.

Authorities' Views

27. The authorities emphasized that they aim to achieve both economic revitalization and fiscal consolidation and firmly maintain the target to achieve a primary surplus of the central and local governments by FY2020. The authorities noted that they are likely to achieve the interim target of halving their primary deficit of the central and local governments to GDP ratio by FY2015 from the ratio in FY2010, which demonstrates their capability to deliver on their commitments. In order to achieve FY2020 target, they will proceed with the following three measures: (i) overcoming deflation and revitalizing economy through steady implementation of three arrows of strategies, (ii) reforming expenditures, and (iii) revenue measures. They underscored the importance of firmly maintaining a visible anchor (FY2020 target) to guide fiscal policy while acknowledging that more efforts will be needed after achieving a primary surplus to put debt firmly on a downward trajectory.

28. With regard to the expenditure reform, the authorities emphasized that concrete and credible measures would be essential. They were considering constraining the increase of expenditure as done under the current Abe administration. Social security and local government finance are the key policy areas of the reform, with a need for emphasis on effective and concrete measures for social security reform. They noted that the expenditure reform would not jeopardize the economy because its essence was to constrain expenditure growth rather than implement across-the-board cuts. In addition, they noted that further progress in structural reform would be essential to accelerating the closure of the output gap and emphasized the role of structural reforms, e.g., deregulation, to promote private investment. Meanwhile, public investment is being implemented in a focused and efficient manner taking into account depopulation trends. Transfers should be carefully examined and well-targeted in order to maintain cost effectiveness. The

[4] For a full list of measures, see 2014 Staff Report (page 16).

authorities agreed that the next consumption tax rate increase would be an important contribution to restoring fiscal sustainability.

CONTINUING SUPPORTIVE MONETARY POLICY

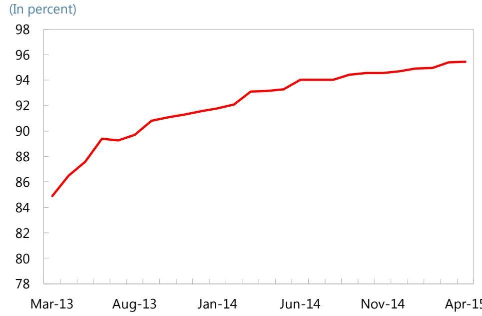
29. In response to falling inflation and inflation expectations, monetary policy was eased further in October 2014. In a bold step, surprising markets, the BoJ expanded its QQE framework by increasing net purchases of JGBs to 80 trillion yen annually, extending the average maturity of JGBs purchases to about 7–10 years, and tripling its purchases of private assets (ETFs and J-REITs).[5] Mainly because of the sharp fall in oil prices, in April 2015, the BoJ delayed the timing for achieving the 2 percent inflation target to around the first half of FY2016 while continuing to emphasize that it will continue QQE until the 2 percent inflation target is achieved in a stable manner.

Policy Issues and Staff's Views

30. Despite some progress, lifting inflation is taking longer than expected. Policy actions thus far have raised underlying inflation and eased financial conditions through reduced real interest rates, a depreciated yen, and a booming equity market. Credit has started to pick up and land and real estate price growth has turned positive, underpinning a nascent revival of construction activity. The output gap is closing and wage pressures are gradually rising. However, the transmission to inflation is taking longer than expected, in part because of the effect of lower energy prices, the deep entrenchment of the deflationary mindset, and structural impediments to stronger wage-price dynamics.

31. Weak monetary policy transmission creates a policy conundrum. As intended, the BoJ's balance sheet has more than doubled since the beginning of QQE. However, given weak credit growth there has been a large build-up of excess reserves. Tepid demand is the key bottleneck to credit growth as indicated by loan officer surveys, while weak credit assessment capacity at banks may play a secondary role. More confidence in the outlook for domestic demand would strengthen investment, suggesting that structural reforms could strengthen monetary policy transmission. Service sector reforms as well as policies to invigorate the labor market would be most beneficial.

Excess / Total Reserves
(In percent)



Source: Haver Analytics.

[5] In January 2015, the BoJ extended the Loan Support Program by one year to the end of March 2016 and raised the ceiling of the Growth Support Funding Facility by 1 trillion yen to 2 trillion yen per financial institution and from 7 to 10 trillion yen overall while opening both facilities to non-BoJ deposit account holders.

32. The BoJ needs to stand ready to ease further, provide stronger guidance to markets through enhanced communication, and put greater emphasis on achieving the 2 percent inflation target in a stable manner.

- *Additional easing*: Reflecting the weak and delayed transmission, further easing should take the form of increased asset purchases and lengthening their duration. This would further lower the long end of the yield curve and strengthen the commitment to low interest rates "for as long as it takes," while accelerating portfolio rebalancing by institutional investors. At the same time, further fiscal and structural reforms remain imperative to unburden monetary policy and, together with macroprudential policies, mitigate financial stability risks.

- *Enhancing communication to guide markets*: The BoJ should communicate more clearly the drivers that underpin its forecasts, including the output gap and wage-price dynamics and the factors that are believed to raise inflation expectations. In addition, the BoJ could clarify the indicators used to assess whether inflation is on track and spell out the criteria for judging whether its target has been sustainably achieved. Similarly, clarifying the conditions that would trigger additional actions would be helpful as this would help guide expectations when there is a need to adjust the asset-purchase program and facilitate preparations for an eventual exit. In this context, the publication of the oil price assumption underlying its forecast and studies of the effectiveness of its QQE and progress of the regime shift it is trying to engineer is highly welcome.

- *Reaffirming the BoJ's commitment to achieve the 2 percent inflation target in a stable manner*: To strengthen this commitment, the BoJ should reiterate that it remains open to all further avenues of easing when and if appropriate by: raising the amount of purchases of assets, lengthening their duration, broadening their range, and lowering the deposit rate on excess reserves and the policy rate.

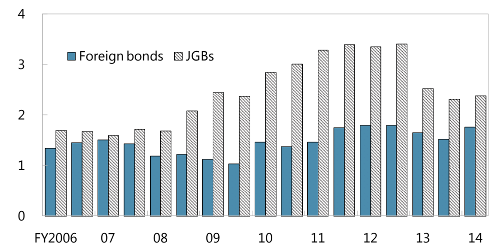
Authorities' Views

33. The BoJ stressed that its monetary framework is clear and working well. It emphasized that reaching 2 percent inflation in a stable manner is the primary objective and that use of a timeframe of achieving the price stability target at the earliest possible time with a time horizon of about two years emphasized their commitment and contributed to engineering a regime shift. BoJ officials assessed that underlying inflation has been improving significantly, although the firmness is currently masked by the temporary negative impact of the sharp decline in oil prices. Hence they saw no need for further easing at this point, but they repeated that the BoJ stands ready to ease further, with all options on the table, if underlying inflation momentum falters.

SAFEGUARDING FINANCIAL STABILITY

34. Despite the improvement in financial sector soundness, medium-term vulnerabilities are expected to rise. The low interest rate environment and large excess reserve balances are reducing profitability. With major banks expanding abroad, securing stable funding in all foreign currencies will be essential.[6] Total interest rate risk has declined. Interest rate risks on foreign bonds have become comparable to those on JGBs as banks have extended the maturity of their foreign bonds. Interest rate exposure remains high for regional banks, reflecting the longer maturity of their JGB assets and higher share of corporate bond holdings.

Interest Rate Risk among Major Banks
(In trillion yen, as of Sept. 2014) 1/

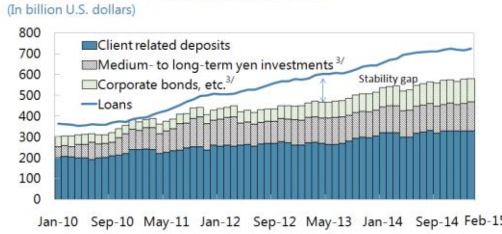


Source: Bank of Japan.
1/ Impact of a 100 basis points increase across all maturities. Only duration is considered for foreign bonds while convexity and higher order terms are considered as well for JGBs.

35. As QQE is maintained, liquidity in the JGB market may diminish, raising risks of volatility. Given the importance of the JGB market, spillovers to other financial market segments are likely. So far, traditional liquidity indicators of the JGB futures market such as the bid-ask spread and the daily price range to transaction volume ratio show that the JGB market has been functioning normally, though other indicators show some decline in liquidity (Box 3, Figure 6).[7] Liquidity of the JGB market could suffer more as the BoJ's share of JGBs increases further, especially in specific maturity segments. In this context, the doubling of the BoJ's securities lending facility is a welcome backstop to JGB market liquidity, while its cost and access criteria should remain under review to ensure its effective use. Continuing consultations with market participants and close monitoring of liquidity will be essential.

36. Financial sector policies should guard against risks from unconventional policies. Financial institutions need to continue to be tested for their resilience to higher volatility of asset prices, exchange rates and interest rates, and lower liquidity in markets. Banks look well capitalized, but their risk management needs to be further strengthened and business models adapted to raise profitability in the medium term (Figure 7, Table 6). Banks lending in foreign currency should secure robust funding sources to manage their gaps between illiquid loans and stable funding, which have recently stabilized. Regional banks, accounting for 36 percent of total bank assets, are more

"Stability Gap 1/" Among Major Banks 2/
(In billion U.S. dollars)



Source: Bank of Japan.
1/ The gap between the amount of illiquid loans and stable funding.
2/ Covers major bases (operations) of internationally active banks.
3/ "Corporate bonds, etc." and "Medium- to long-term yen investments" indicate funding maturing in over 3-months until March 2012 and funding maturing in over 1-year from April 2012.

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[6] Some Japanese banks have access to host central bank facilities, while the BoJ provides collateralized FX lending to domestic banks. In terms of supervision, Memoranda of Understanding are in place between Japan and most host and home country authorities.

[7] See Kurosaki et al. (BoJ Working Paper Series No. 15-E-2) for more details.

challenged from lack of regional diversification, longer duration of assets, and higher share of corporate bond holdings. Their capital standards need strengthening, including by reassessing the treatment of unrealized losses in capital. Insurance companies need to enhance profitability to work through the legacy of guaranteed return products. While there are no immediate concerns, macroprudential policies should be readied in case exuberant equity market developments and riskier lending (including abroad) threaten financial stability.

Authorities' Views

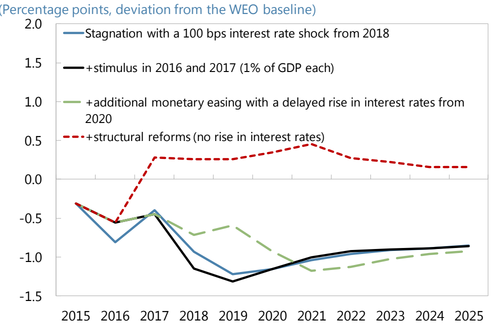
37. The FSA noted that financial sector health has further improved. Internationally-active banks have ample capital and liquidity to meet Basel III capital requirements as well as the liquidity coverage ratio (LCR). Various risks such as foreign funding risk and interest rate risk are being closely watched in light of banks' business and market developments. The FSA did not see any immediate risks from booming asset markets and is focusing supervisory efforts on improving risk management. As for the Japan Post Bank (JPB), the application for new lending businesses is being examined to ensure that these new services will be provided in a sound and efficient manner, in accordance with the Banking Act. Similarly, it is being verified whether the implementation of new services would impede competition between JPB and other financial institutions, and the appropriate provision of the services, in accordance with the Postal Services Privatization Act.

POLICIES UNDER DOWNSIDE SCENARIOS

38. Accelerating structural reforms is the only effective policy lever to address downside risks and maintain confidence in Abenomics. Demand-side policies in response to downside risks will depend on the nature of the risks. Specifically, the fiscal policy response would need to be contingent on the behavior of the sovereign risk premium and monetary policy on inflation developments and the stability of financial markets, with macroprudential policies stepping in as needed. Should Abenomics fail to reinvigorate domestic demand or adverse external shocks occur, the resulting weaker outlook could sap investment and confidence and abort the nascent favorable wage-price dynamics.

- The resulting stagnation scenario would cast doubt on fiscal sustainability, leading to higher sovereign and corporate risk premiums, though only when the BoJ reaches the limits of its QQE program.[8] Fiscal policy could attempt to revive demand but the stimulus would need to be very large to push growth back to the baseline. Further concomitant easing by the BoJ could at least delay the rise in risk premia, but in the end an adverse feedback loop

Growth under Various Scenarios
(Percentage points, deviation from the WEO baseline)

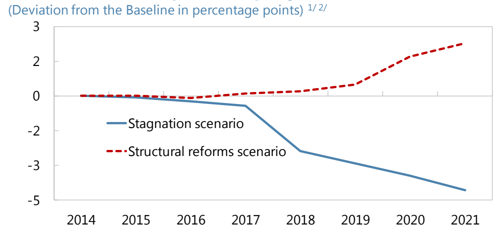


Source: IMF staff estimates.

[8] Simulations were conducted with the IMF's GIMF model and a Japan-specific satellite model of the banking system.

including the financial system would likely take hold. In contrast, accelerating structural reforms would be the only effective and sustainable policy lever, with higher productivity growth and labor and product market deregulation boosting demand and preventing the rise in risk premia, allowing growth to be 1 percentage point above the baseline.

Domestic Banks' Capital Adequacy
(Deviation from the Baseline in percentage points) 1/ 2/



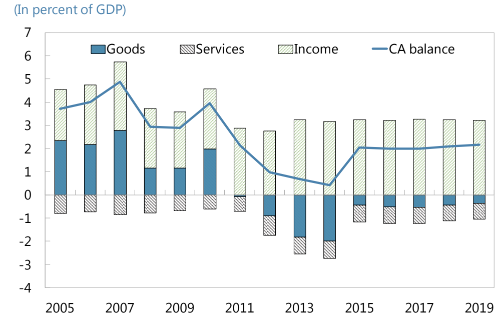
Sources: Japanese Bankers Association; and IMF staff estimates.
1/ Only credit risks and interest rate risks were estimated using unconsolidated balance sheets, the former by using the relationships between non-performing assets and GDP growth and interest rates; the latter by applying the duration analysis to all bond holdings for all banks.
2/ Macroeconomic assumption were taken from the GIMF simulation.

- Stagnation with rising risk premia would induce immediate mark-to-market losses on banks from their significant government bond holdings. Retail and wholesale funding costs would rise, compounding losses from equity holdings. Using the input from the GIMF scenarios, stress tests suggest a significant adverse impact on capital adequacy. Moreover, weaker activity and tighter financing conditions are likely to boost non-performing loans. Conversely, the structural reform scenario would have a positive effect on capital levels over the medium term from better earnings and lower credit risk.

EXTERNAL POSITION AND SPILLOVERS

39. The current account surplus continued its secular decline in 2014, falling to 0.5 percent of GDP. The yen's real effective depreciation in 2014 failed to arrest the decline in Japan's trade balance, though it helped the tourism balance. Exports started to pick up in the second half of 2014 supported by gradual economic recovery overseas, but were outpaced by import growth on rising import penetration in electronics and smartphones. A rising income balance surplus from higher interest income on overseas investment moderated the impact. With the sharp fall in oil and commodity prices, the goods trade balance turned to surplus in 2015:Q1 for the first time since 2011:Q1 before the Great East Japan Earthquake.

Current Account
(In percent of GDP)



Sources: Haver Analytics; and IMF staff projections.

A. External Sector Assessment

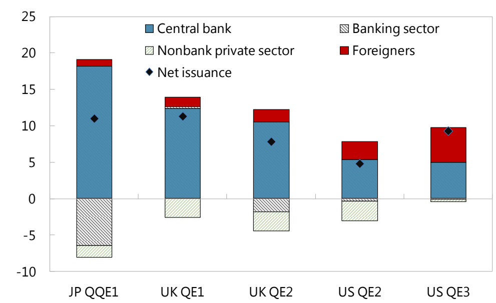
40. Taking last year's trade developments into account, Japan's external position and its real effective exchange rate in 2014 were assessed to be broadly consistent with fundamentals and desirable policies (Annex IV). The assessment takes into account structural shifts (e.g., production offshoring) as well as temporary factors (e.g., impact of nuclear power shutdowns) affecting the trade balance.

Subsequently, terms of trade effects and the REER depreciation suggest a strengthening of the external position under current policies. The reduction in the oil import bill has improved the trade balance and the REER depreciated by 7 percent through May 2015 relative to its 2014 average. This has moved the REER toward a moderately weaker level than would be consistent with its fundamentals suggested in the 2014 assessments. The weakening of the yen has been beneficial, given the current stage of the economic cycle and the need to address low inflation and reduce deflation risks. However, sustained easing by the BoJ while others tighten, combined with the lack of bolder structural reforms and the absence of a credible and specific medium-term fiscal consolidation plan could strengthen the external position.

B. Spillovers

41. Continued portfolio rebalancing may induce sizable capital outflows. Japanese banks' claims over other countries show strong connection to Asian countries (more than 20 percent of GDP for some countries) and global financial centers while receiving significant inflows from banks in the U.S., the U.K., and France. Under current policy settings overseas bank lending is likely to continue. In addition, the JGB maturity extension under QQE is expected to lead to more portfolio rebalancing at life insurers and pension funds. An illustrative portfolio rebalancing scenario suggests that Japanese financial institutions could shed 165 trillion yen of JGBs by end-2017 (110 trillion yen by banks and 55 trillion yen by nonbanks), which could result in significant portfolio outflows amounting to 42 trillion yen ($350 billion).[9] Under the current allocation ratios, 80 percent of these flows would go towards advanced economy bonds, 14 percent into emerging market bonds, and 6 percent into global equities.

Change in Government Bond Holdings During QE Episodes
(Percent of GDP)



Source: Global Financial Stability Report, April 2015.

42. Without further strengthening of fiscal and structural policies, the balance of spillovers may turn negative. The BoJ's QE announcements have contributed to favorable financial conditions in EM Asia through lowering government borrowing costs, boosting equity prices, and loosening credit conditions with a decline in corporate bond spreads.[10] In addition, increased portfolio outflows and continued expansion of overseas' bank lending and foreign direct investment are positive spillovers from Japan, though they may add to vulnerabilities in some neighboring countries. However, further weakening of the exchange rate has dampened imports while raising Japan's corporate competitiveness in global goods markets. Without bolder structural reforms and credible fiscal consolidation, domestic demand could remain sluggish, and any further monetary easing could lead to overreliance on yen depreciation in the pursuit of domestic policy objectives, with adverse effects on direct competitors.

Authorities' Views

43. The authorities expressed understanding of the 2014 external assessment but saw any assessment for 2015 as premature. Although acknowledging the need to better understand the implications of recent large movements in the major currencies, they argued that it is not possible to

[9] See IMF Global Financial Stability Report (2015 April) for more details.

[10] See Rafiq (2015) for more details.

make an assessment of the external position for 2015 based on REER developments to date or on the 2015 current account forecast given large uncertainty about developments over the remainder of the year.

44. The authorities reiterated that successful launching of all three arrows of Abenomics will have positive spillovers to global economy. They noted that spillovers had been benign so far and that potential capital outflows could help ease financing conditions of EMs in the region. They also added that spillovers through the trade channel would be more limited than in past episodes of large depreciations due to structural factors, including from the offshoring of production. They also agreed that completing all three arrows is important to avoid overburdening of monetary policy.

STAFF APPRAISAL

45. A modest recovery is underway and inflation is expected to rise gradually over the medium term. Rising real income due to wage growth and favorable terms of trade effects should support private consumption while external demand and yen depreciation will underpin exports. Investment is likely to respond with a lag, helped by the availability of credit and a sound financial system. Risks to the outlook are tilted to the downside, stemming from weaker-than-expected domestic demand, incomplete policies, possible shocks to the sovereign risk premium, low medium-term profitability of the financial system, and slower-than-expected growth abroad.

46. All arrows of Abenomics need to be strengthened to lift Japan out of its entrenched deflationary mindset. Building on initial positive results, policies now need to embark on a sustained effort to meet the unprecedented challenges Japan is facing, by lifting growth and restoring fiscal sustainability against adverse demographics, while maintaining financial stability.

47. Japan should be at the vanguard of structural reform. While swift implementation of already announced reforms is essential, it should be accompanied by further high-impact reforms to provide a robust long-term outlook and underpin near-term demand. The next round of structural reforms should lift labor supply, reduce labor market duality, continue with agricultural and services sector deregulation and turn the financial sector into a driver of reforms.

48. Credible and balanced fiscal consolidation, to avoid jeopardizing growth and inflation momentum, will support confidence and private consumption. The medium-term fiscal reform plan should aim to put debt on a downward path, based on realistic economic assumptions, and specific structural revenue and expenditure measures should be identified upfront. It should be bolstered by stronger fiscal institutions and aim for a pace of adjustment that strikes the right balance between reversing the debt dynamics and safeguarding growth momentum.

49. More explicit monetary guidance would enhance inflation dynamics. With a persistent difference between market expectations and the BoJ's inflation target and timeframe as well as still low inflation, the BoJ needs to stand ready for further easing, provide stronger guidance to markets through enhanced communication, and put greater emphasis on achieving the 2 percent inflation target in a stable manner. In their role as partner in tripartite discussions and in light of unprecedented corporate profits, the authorities should continue to emphasize the need for adequate wage growth.

50. Ensuring that the financial sector remains resilient to economic and policy risks will be essential. Internationally-active banks have ample capital and liquidity to meet current and prospective regulatory requirements while supporting more risk taking, while other banks are sufficiently capitalized. Exposure to domestic and foreign interest rate risk and funding risk of overseas operations are the main concerns.

51. While the 2014 external position was assessed to be broadly consistent with fundamentals, subsequent developments and incomplete policies raise the risk of negative spillovers. With further the depreciation of the yen relative to the mid-2014 level, further monetary easing without bolder structural reforms and credible fiscal consolidation could lead to sluggish domestic demand and overreliance on depreciation of the yen in the pursuit of domestic policy objectives.

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

Box 1. What Explains Japan's Export Sluggishness?[1]

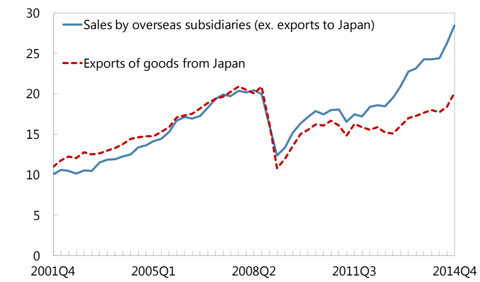
Solid external demand growth and the large yen depreciation since late 2012 have failed to trigger a firm export recovery. *Offshoring,* a substitution of production at the source of overseas demand for exports, seems to be the main culprit. *A compositional shift in foreign demand* towards less import-sensitive items and a leveling-off of trade growth due to *the maturing of Asia's supply chain* also contributed. Since these factors constitute structural headwinds to exports, they are likely to be only partially compensated by a weaker yen. Successful implementation of structural reforms in Japan could rekindle a virtuous cycle of private investment and more dynamic exports.

Japanese firms' offshoring seems to be the main driver behind the sluggish recovery of exports.

- Over the last two decades, Japanese firms have expanded abroad to exploit labor cost differentials and rising demand in host countries. The pace of offshoring accelerated since the global financial crisis, partly due to large yen appreciation and uncertainty about energy supply after the 2011 earthquake. As a result, overseas investment now accounts for about 25 percent of total manufacturing investment, while domestic production capacity declined by about 4 percent since 2011. In 2014, exports by Japanese overseas subsidiaries (to countries excluding Japan) exceeded exports from Japan by more than 40 percent.
- A standard Armington export model augmented with the ratio of overseas to total investment captures the largely flat export performance of Japan after the global financial crisis (in both additive and multiplicative specifications, with partner country growth and the real effective exchange rate).

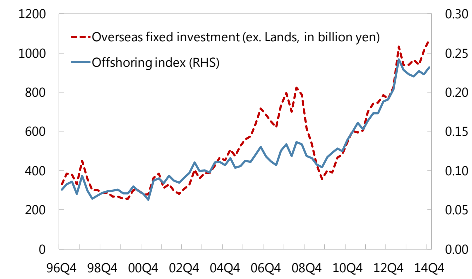
Other factors have also contributed to slowing export growth in recent years. Import intensity-adjusted demand, which takes into account the fact that different component of expenditure have different import contents, exhibited a slower recovery during and after the crisis compared to a conventional measure of aggregate demand. In addition, with deepening of global supply chains, more Japanese firms that used to export intermediate goods have expanded abroad and some intermediate good supplies are now sourced from local suppliers in host countries. This explains the broad decline in Japanese value-added embedded in other countries' gross exports since mid-2000s.

Exports vs. Sales of Overseas Subsidiaries
(In trillion yen)



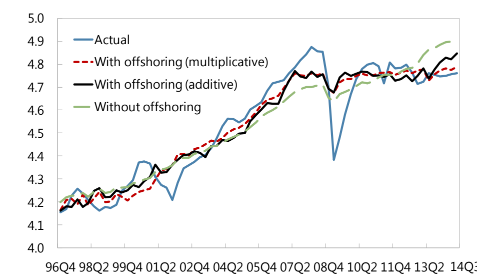
Sources: Ministry of Economy, Trade & Industry; IMF staff estimates.

Investment by Manufacturing Sector 1/



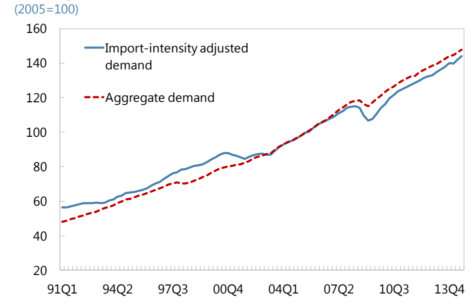
Source: Haver Analytics.
1/ Investment flow.

Real exports
(In logs)



Sources: Haver analytics; IMF staff projections.

Trading Partner's Demand
(2005=100)



Sources: Haver Analytics; and IMF staff calculations.

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[1] Prepared by Joong Shik Kang (APD).

Box 2. Drivers of Inflation in Japan[1]

Inflation forecasts for Japan are highly uncertain. Inflation developments will depend critically on whether the Philips curve will become steeper and shift upward, which in turn depends on the credibility of the Bank of Japan and the extent to which higher actual or expected inflation feeds into nominal wages and other price-setting behavior. Furthermore, estimates of inflation expectations are hampered by a consistent upward bias for survey-based measures and limited liquidity for market-based indicators.

An expectations-augmented Philips curve confirms that the Philips curve is relatively flat in Japan and that nominal earnings growth is an important determinant of actual inflation. The estimation assumes that inflation expectations would gradually become less adaptive and more forward-looking and therefore increasingly drive actual inflation.[2] However, despite rising inflation expectations in 2014, neither wage growth nor portfolio rebalancing accelerated substantially. Furthermore, as actual inflation declined in the wake of faltering aggregate demand after the consumption-tax hike and waning exchange rate effects, inflation expectations reversed. This suggests that inflation expectations may not be an important driver of actual inflation, at least not until actual and expected inflation are nearer to the BoJ's target level.

An alternative model—separating adaptive and forward-looking inflation expectations—suggests substantial inflation persistence. Kaihatsu and Nakajima (2015) estimate trend inflation and the slope of the Phillips curve within a hybrid, regime-switching model. They show that trend inflation has risen since the launch of QQE, whereas the slope of the Philips curve has remained broadly unchanged during the past decade. They hypothesize that this regime change reflects the rise in medium- to long-term inflation expectations since January 2013. Alternatively, column (d) in Table 1 shows a specification based on monthly data, which captures the true data-generating process well by including wage growth and the exchange rate. Columns (c), (e), and (f) show alternative specifications with a shorter lag on the exchange rate or the inclusion of crude oil prices, which is insignificant. Inflation expectations are generally insignificant and have the wrong sign, with inflation dynamics characterized by substantial persistence. These results support the view that inflation expectations are lagging rather than leading actual inflation and that the transition to more forward-looking inflation formation has not yet occurred. Instead, the increase in inflation during the past two years largely reflects the weakening yen and higher total earnings growth, which, given the dynamics in the inflation process, has had a persistent impact, but should not be interpreted as a permanent upward shift in trend inflation.

Expectations-Augmented Phillips Curve Estimates for Japan

	GMM	GMM	GMM	GMM	GMM	GMM
	(a)	(b)	(c)	(d)	(e)	(f)
	1981:q2-2014:q3	1991:q1-2014:q3	2006:m1-2014:m11	2006:m1-2014:m11	2005:m10-2014:m11	2006:m1-2014:m11
Lagged inflation			**1.062**	**1.095**	**1.137**	**1.044**
			0.099	*0.103*	*0.085*	*0.121*
Twice lagged inflation			**-0.285**	**-0.297**	**-0.298**	**-0.251**
			0.084	*0.082*	*0.079*	*0.010*
Expected Inflation*	**0.750**	**0.606**	**-0.065**	-0.038	-0.038	**-0.059**
	0.065	*0.115*	*0.038*	*0.038*	*0.038*	*0.040*
Output Gap	**0.200**					
	0.070					
Crude Oil Price (year on year)	**0.017**	0.002				0.001
	0.010	*0.005*				*0.001*
Post-2008:Q4 dummy	**-0.204**	0.005				
	0.502	*0.320*				
Output Gap*Post-2008:Q4 dummy	-0.074	**0.132**				
	0.134	*0.073*				
Nominal earnings growth		**0.137**	**0.048**	**0.050**	**0.057**	**0.033**
		0.039	*0.017*	*0.015*	*0.018*	*0.014*
Exchange rate appreciation (-3)					**-0.007**	
					0.003	
Exchange rate appreciation (-6)			**-0.014**	**-0.011**		**-0.014**
			0.004	*0.004*		*0.005*
2008-09 dummy			0.048			
			0.070			
Dummy March-June 2011 and 2012			0.009			
			0.039			
Number of observations	134	95	107	107	110	107
Adjusted R-squared	0.73	0.73	0.93	0.93	0.92	0.93
P-value (Hansen's J-statistic) for test of instrumental validity	0.26	0.70	0.08	0.20	0.12	0.17

Dependent Variable: Headline CPI Inflation, y/y percent change
Expected Inflation: until 2009Q1, lagged four quarter moving average of core inflation; from 2009Q2: inflation implied by average of 5-year breakevens, 3-5 years and 8-10 years inflation swaps, and 10-year expectations from Nikkei Quick Survey and Conscensus Forecasts. Except for monthly estimation that uses the average of Nikkei Quick Survey, 10-year inflation swaps, and conscensus forecasts when available.
Output Gap and Crude Oil Price (year on year) are entered as one-period lagged values
White's HAC standard errors in italics below point estimates

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[1] Prepared by Dennis Botman and Malhar Nabar (both APD).

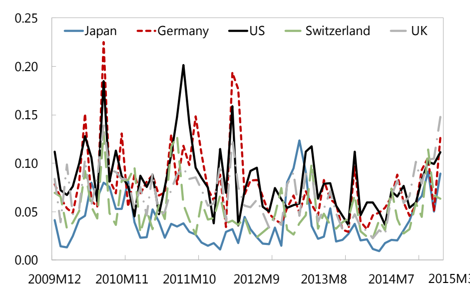
[2] This was formalized by constructing an explanatory variable that consisted of the lagged dependent variable until 2009:Q1 and expected inflation from 2009:Q2 onwards (column (a), Table 1).

Box 3. Volatility in the JGB Market[1]

Following the BOJ's QQE, the volatility of the JGB market has increased. Cross-country comparisons suggest that both common and country-specific factors have contributed to the increased volatility in government bond yields in Japan.

- JGB yields correlate well with the yields of the government bonds of the US and other advanced economies. In particular, the volatility in the Swiss government market in January-February and the German bund market in April affected the volatility of the JGB yields. This is in part because JGBs are, to some extent, considered safe-haven assets and a similar asset class.

Volatility of 10-year Bond Yields



Sources: Bloomberg; and IMF staff calculations.

- Regarding domestic factors, a combination of very low interest rates and limited liquidity in the secondary market for JGBs has contributed to the increased volatility in the JGB market. In particular, QQE affects the supply of and demand for JGBs by design, and some investors have reportedly withdrawn from the market given the very low interest rates. Similar, but less pronounced than other QE sovereigns, the JGB market went through a significant gyration (mini-"tantrum") in early 2015 with the 10-year JGB yield sharply falling and then doubling within less than a month.

There are indications that liquidity in the JGB market has been declining. Although traditional indicators suggest that the JGB market continues to function normally, the volume of limit orders at the best-ask price, the impact of a unit volume of transactions on the market price in the JGB futures market, the divergence in quotes offered by dealers in the JGB cash market, and the lending fee of JGBs in the SC repo market—all suggest that liquidity in the JGB market has been declining (Figure 7). A BOJ survey revealed that 75 percent of Japanese bond dealers included said bond market functioning had worsened, but more than 60 percent said they were not experiencing "a lot of trouble" in fulfilling orders.

Some structural factors may have contributed to the reduced liquidity in the market. Recent and envisaged regulatory reforms affecting the size of the balance sheet and risk management practices may have reduced the capacity of market makers to conduct operations with JGBs. The share of more volatile overseas investors in the total stock of tradable JGBs has increased. This would suggest that the volatility of the JGB market in the future will remain above historical levels.

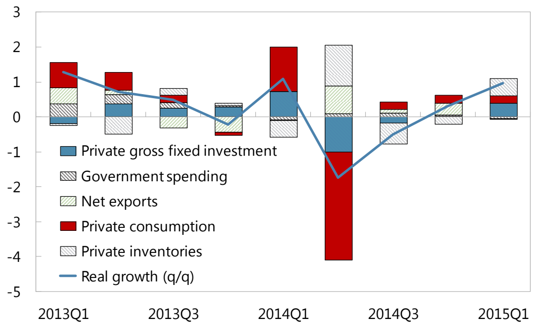
The authorities are prepared to mitigate shocks and financial stability risks emanating from the JGB market. The repo, money and derivatives markets, as well as well as structured finance rely heavily on a well-functioning JGB market, given that the corporate bond market is small and less liquid. JGB yields are widely used as benchmarks. To guard against risks, the BoJ and MoF have stepped up their regular consultations with market participants, the MoF is conducting liquidity enhancing auctions, and the BoJ has doubled the size of its securities lending facility.

[1] Prepared by Etibar Jafarov (MCM).

Figure 1. Japan: Economic Developments and Outlook

Growth is gradually rebounding…

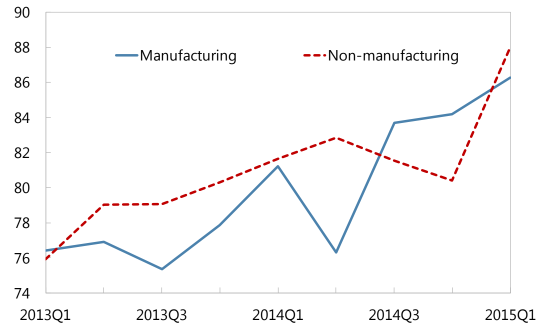
Contributions to QoQ Growth
(In percent, SA)



Source: Haver Analytics.

…with a sharp uptick in non-manufacturing investment.

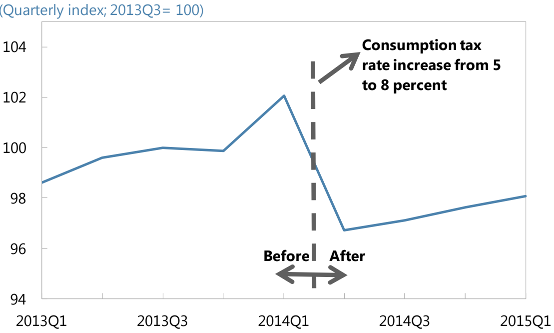
Capital Investment
(SA, 2005=100)



Source: Haver Analytics.

But private consumption remains subdued…

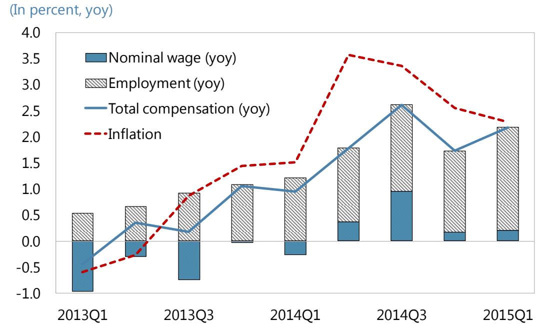
Private Consumption before and after the Tax Increase
(Quarterly index; 2013Q3= 100)



Source: Haver Analytics.

…as real compensation growth fell despite very tight labor market conditions.

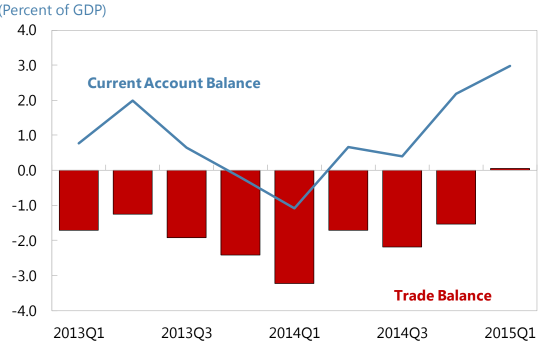
Total Compensation and Inflation
(In percent, yoy)



Sources: Ministry of Intenal Affairs and Communications, Ministry of Health, Labour & Welfare; and IMF staff calculations.

The trade balance remained in deficit until recently…

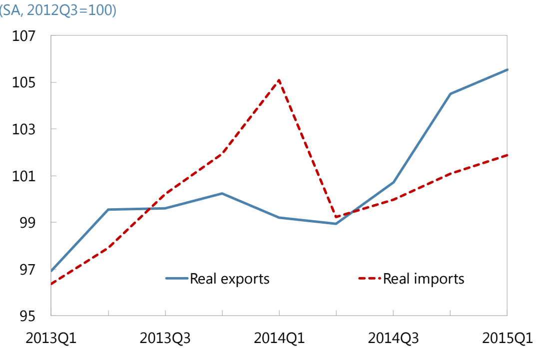
Japan: External Balance
(Percent of GDP)



Source: Haver Analytics.

…but exports are on the rebound supported by rising external demand and the weaker yen.

Real Exports and Imports
(SA, 2012Q3=100)

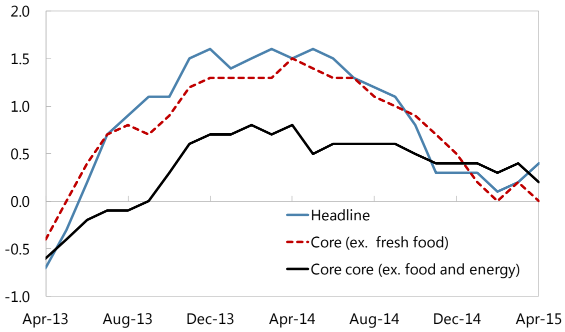


Source: Haver analytics.

Figure 2. Japan: Inflation and Inflation Expectations

Inflation declined rapidly to close to zero…

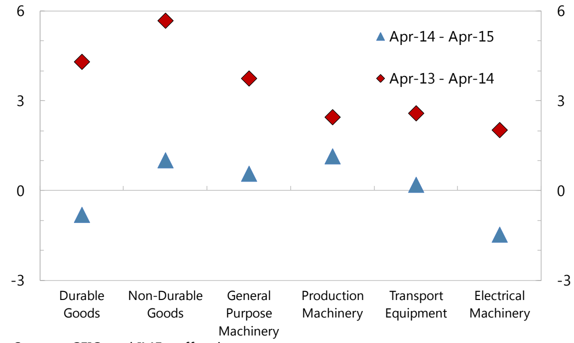
Inflation
(y/y, percent, without consumption tax)



Source: Haver Analytics.

…with some consumer goods and capital input prices falling since mid-2014.

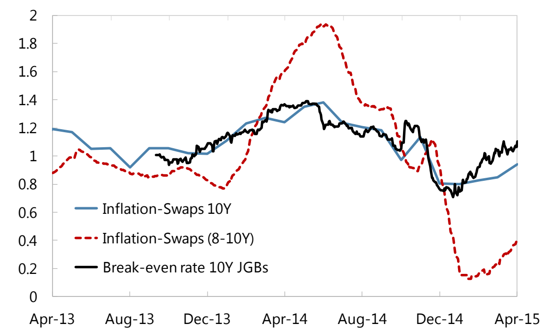
Consumer Goods Prices and Capital Goods Prices
(In percent change)



Sources: CEIC; and IMF staff estimates.

Inflation expectations have fallen since mid-2014, stabilizing at around 1 percent.

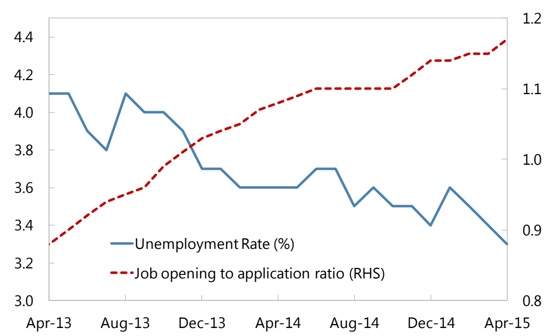
Long Term Inflation Expectations
(In annual percentage points)



Sources: Bloomberg; Quick Survey; Consensus Forecasts; and IMF estimates.

The labor market remains tight, with the unemployment rate at a 17-year low…

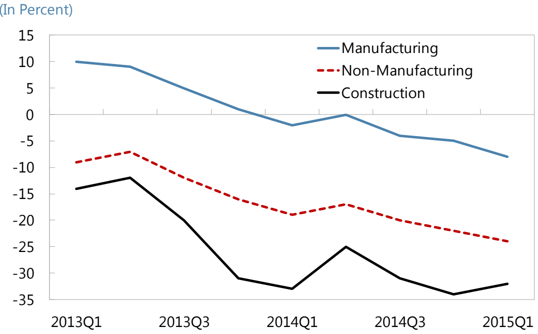
Labor Market



Source: Haver Analytics.

…with particularly acute labor shortages in the construction and the services sectors.

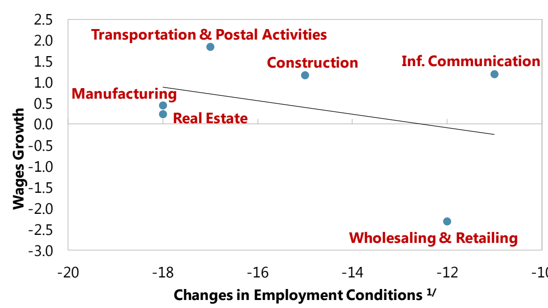
Employment Conditions by Industries [1/]
(In Percent)



Source: Haver Analytics.
1/ Diffusion index. More negative indicates more tightening.

Tight labor market conditions have fed through to higher wages over the last two years.

Changes in Employment Conditions and Wages Growth
(2013Q1-2015Q1)

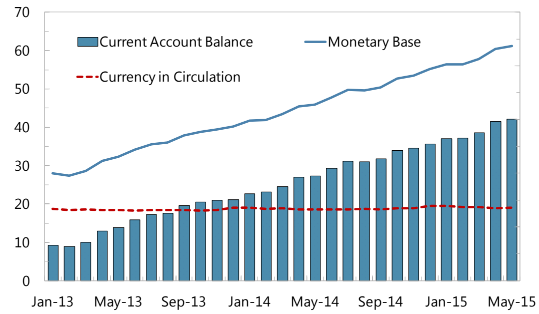


Source: Haver Analytics.
1/ Diffusion index. More negative indicates more tightening.

Figure 3. Japan: Monetary Policy Transmission

QQE has led to a rapid expansion of the monetary base…

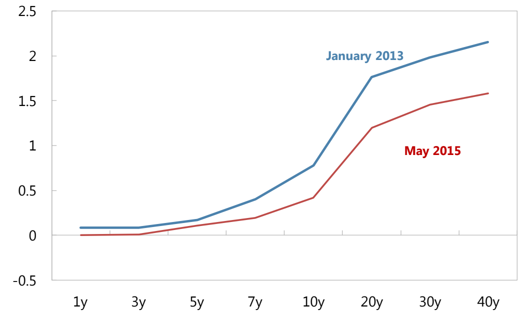
Japan: Monetary Base and Components
(In percent of GDP)



Source: Haver Analytics.

…and the yield curve flattened.

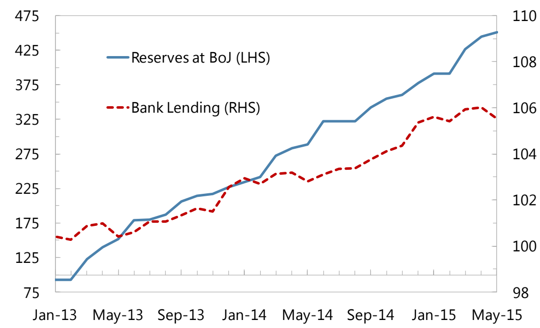
JGB Yield Curve
(In percent)



Source: Haver Analytics.

But bank lending growth has been modest.

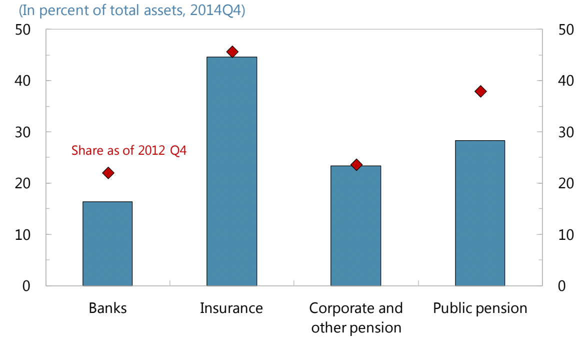
Banks Lending and Reserves
(Index, Dec-2012 = 100)



Source: Haver Analytics.

Portfolio rebalancing away from JGB holdings is progressing, initially by banks…

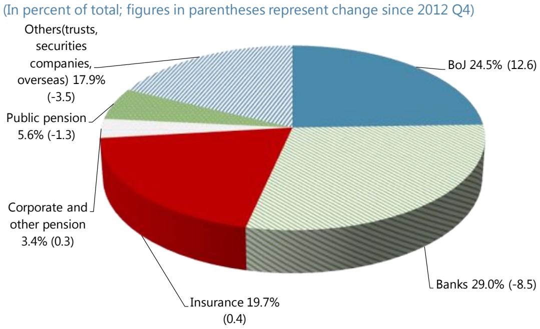
Overall-Portfolio Central-Government Securities Share
(In percent of total assets, 2014Q4)



Sources: Haver Analytics; and IMF staff calculations.

…and more recently by public pension funds and other financial institutions.

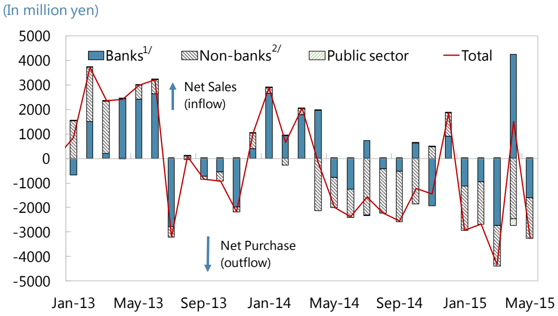
JGB Holders Composition (2014 Q4)
(In percent of total; figures in parentheses represent change since 2012 Q4)



Sources: Haver Analytics; and IMF staff calculations.

Non-banks have increased their overseas investment.

Foreign asset purchase/sales by Japanese residents
(In million yen)

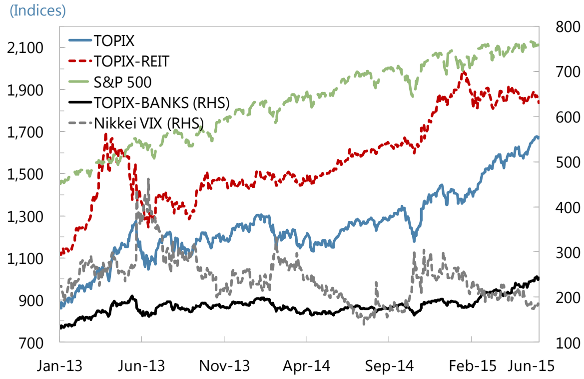


Sources: CEIC database; and IMF staff calculations.
1/ Banking accounts of banks and trust banks.
2/ Includes trust accounts of banks and trust banks.

Figure 4. Japan: Financial Markets Developments

Additional BoJ easing, GIPF portfolio reallocation and governance reforms are boosting equities…

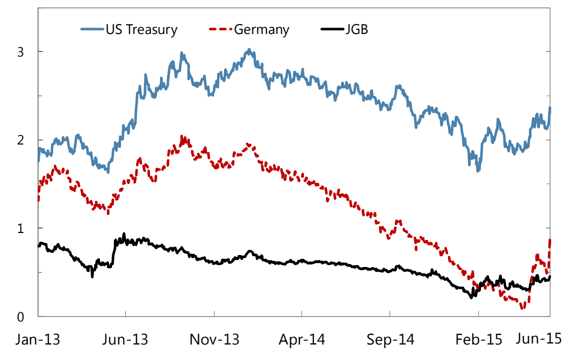
Equity Markets
(Indices)



Source: Bloomberg.

…and sovereign bond yields remain near historic lows.

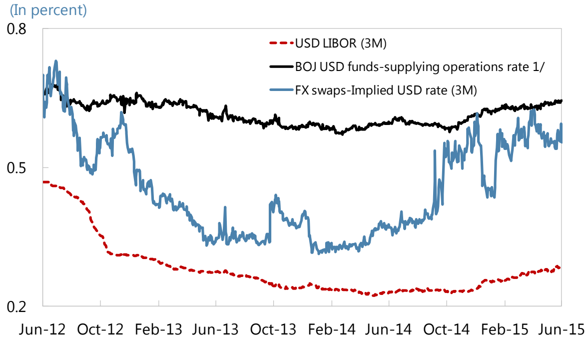
10-Year Sovereign Bond Yields
(In Percent)



Source: Bloomberg.

Dollar funding costs remain stable…

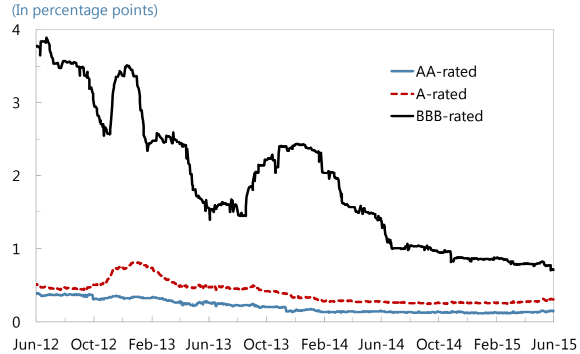
USD Funding Cost in Japan
(In percent)



Sources: Bloomberg; and IMF staff estimates.
1/ OIS rate + 50 bps afterwards.

…and financial conditions for firms highly accommodative.

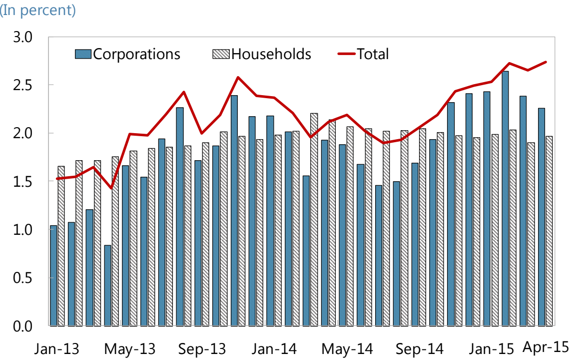
Corporate-Government Bonds Spreads (5Y)
(In percentage points)



Source: Bloomberg.

Banks continue to expand domestic lending modestly…

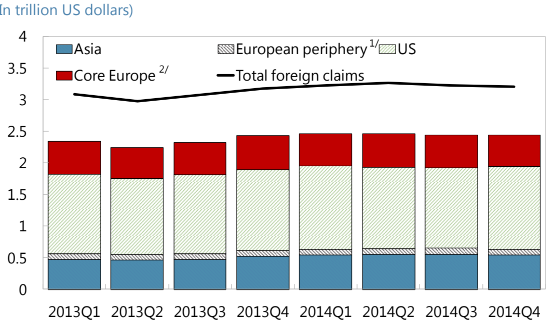
Japan: YoY Growth in Bank Lending
(In percent)



Source: Haver Analytics.

…while raising overseas activities, especially in Asia.

Consolidated Foreign Claims for Japanese Banks
(In trillion US dollars)



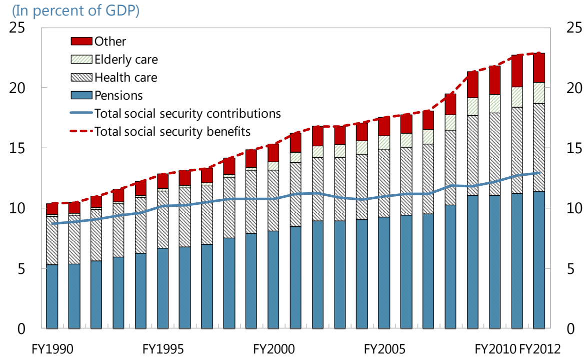
Source: BIS.
1/ Includes Greece, Ireland, Italy, Portugal, and Spain.
2/ Includes Germany, France, UK, and Switzerland.

Figure 5. Japan: Fiscal Developments and Sustainability

The gap between social security spending and contributions is expanding…

Social Security Benefits and Contributions

(In percent of GDP)

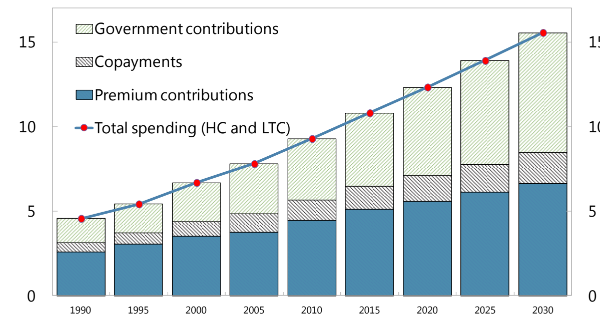


Sources: National Institute of Population and Social Security Research

…mainly due to rising health spending.

Financing of Health Care and Long-Term Care

(Percent of GDP)



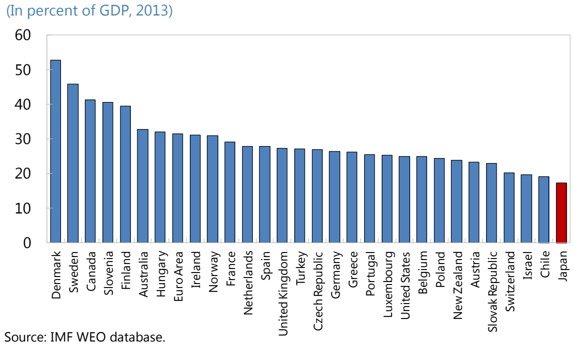
Source: "Health Spending in Japan: Macro-Fiscal Implications and Reform Options," Kashiwase, Nozaki, and Saito (2014).

Note: Excess cost growth of 1 percent is assumed for 2011-30.

Non-social security primary spending is low.

OECD: Spending excluding Social Security and Interest 1/ 2/

(In percent of GDP, 2013)



Source: IMF WEO database.

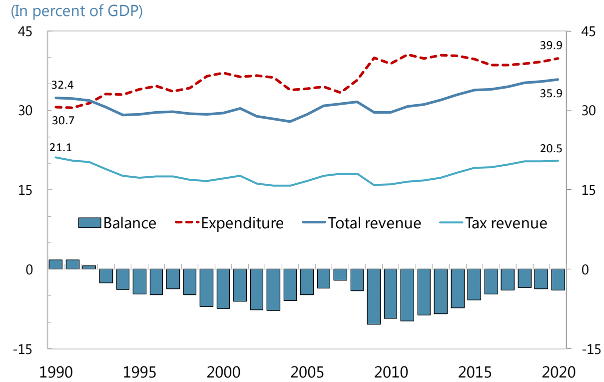
1/ OECD countries with missing data (e.g., Italy) are not reported here.

2/ General government basis.

Fiscal deficits are set to continue.

General Government Fiscal Balance

(In percent of GDP)



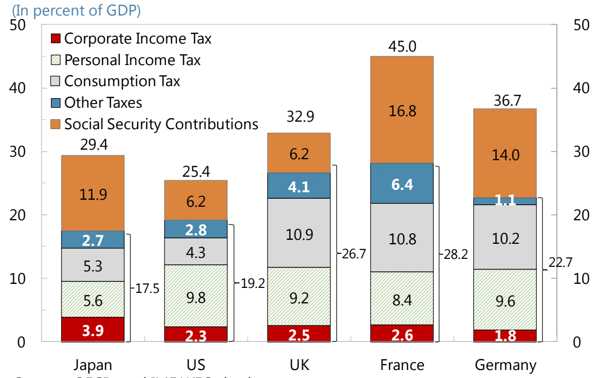
Sources: IMF WEO database; and IMF staff estimates.

Revenues are comparatively low.

But corporate income tax rates remain above average.

General Government Tax and SS Revenue, 2013

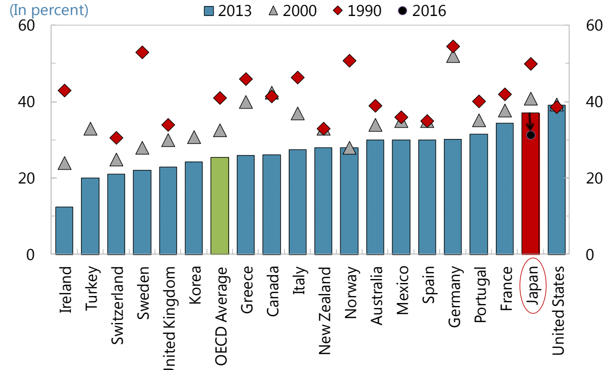
(In percent of GDP)



Sources: OECD; and IMF WEO database.

CIT Statutory Rate: Selected OECD Economies

(In percent) ■ 2013 ▲ 2000 ◆ 1990 ● 2016



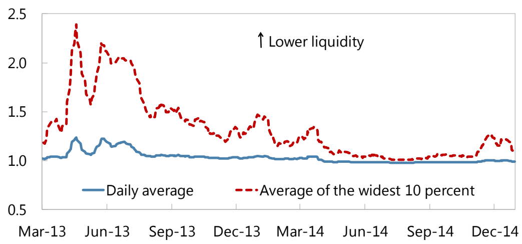
Source: OECD.

Figure 6. Volatility in the JGB Market

Bid-ask spreads are very tight…

Bid-ask Spreads

(Daily Average and Average of the Widest 10 percent, JPY cents) 1/

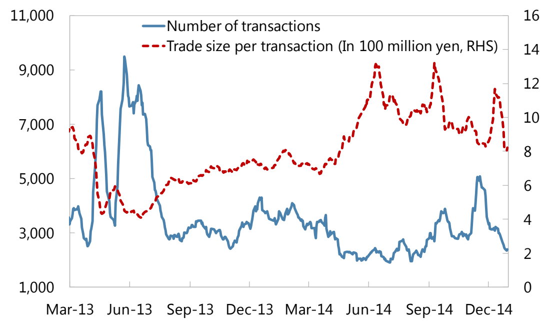


Source: Nikkei Inc., "NEEDS."
1/ "Daily average" is the average of the bid-ask spread data with a 1-minute frequency within each business day. "Average of the widest 10 percent" is the average of the widest 10 percent of that data. A 10-day backward moving average is then applied to both time-series.

…trade size appears normal…

Transaction Volume and Trade Size 1/

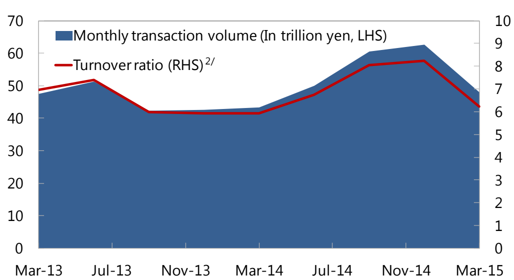
(Number of transactions)



Source: Nikkei Inc., "NEEDS."
1/ 10-day backward moving average.

…and inter-dealer transaction volumes have remained broadly stable.

Inter-dealer Transaction Volume 1/

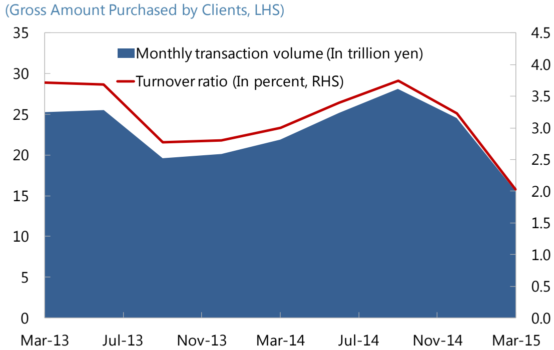


Sources: Japan Securities Dealers Association; and Ministry of Finance.
1/ Treasury Discount Bills, etc. are excluded from transaction volume.
2/ "Turnover ratio" is calculated by dividing the transaction volume by the outstanding amount.

However, dealer-to-client transaction volumes have declined…

Dealer-to-client Monthly Transaction Volume

(Gross Amount Purchased by Clients, LHS)

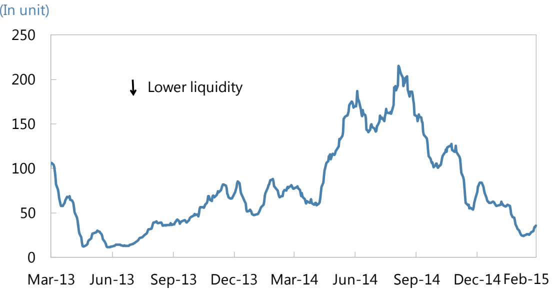


Sources: Japan Securities Dealers Association; and Ministry of Finance.

…volumes of limit orders at the best-ask price have fallen…

Volume of Limit Orders at the Best-ask Price 1/

(In unit)

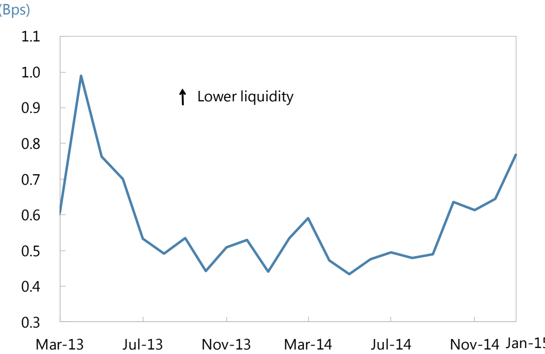


Source: Nikkei Inc., "NEEDS."
1/ Figures are calculated by taking the median of the volume of limit orders at the best-ask price with a 1-minute frequency within each business day, and then applying a 10-day backward moving average.

…and best-worst quote spreads have widened.

Best-worst Quote Spreads Average

(Bps)

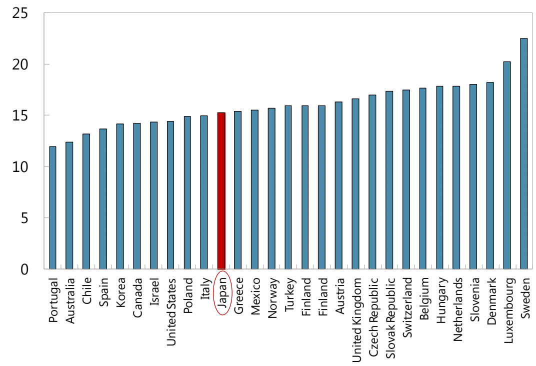


Source: Yensai.com.

Figure 7. Japan and Other OECD Countries: Selected FSIs [1/]

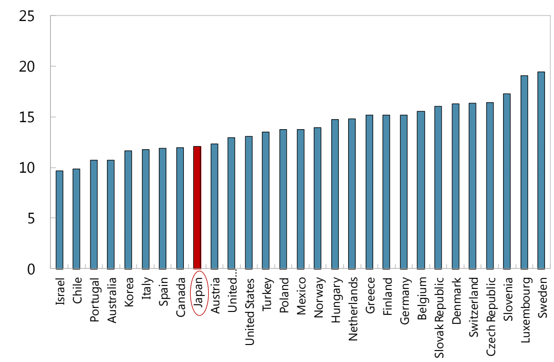
Japanese banks are well capitalized…

Regulatory Capital to Risk-Weighted Assets



…including in terms of Tier 1 capital…

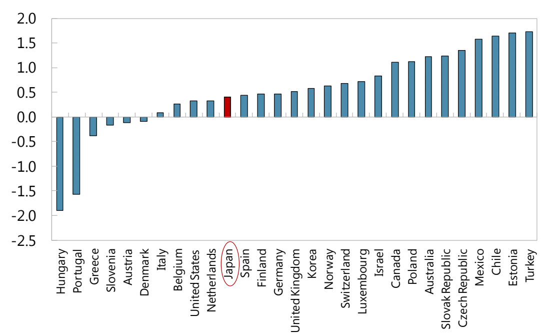
Regulatory Tier 1 Capital to Risk-Weighted Assets



…and remain profitable despite very low interest rates.

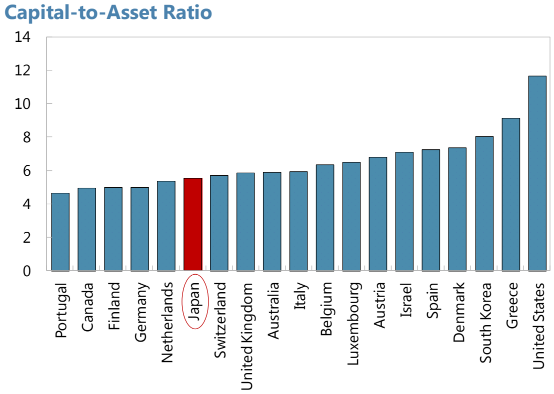
Return on Assets

(ROA)



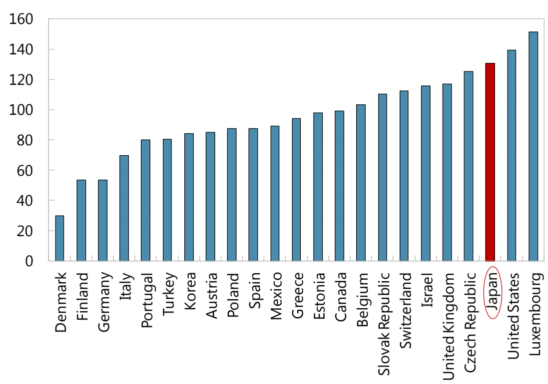
But appear more leveraged than peers.

Capital-to-Asset Ratio



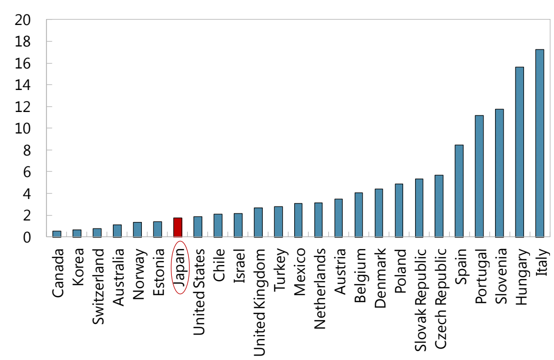
Loans are financed mostly by deposits…

Customer Deposits to Total Non-interbank Loans



…and non-performing loans are low.

Non-performing Loans to Total Gross Loans



Sources: IMF FSI database; and Mizuho Securities.

1/ Cross-country comparisons should be interpreted with some caution due to differences in accounting, regulatory requirements, and the business environment. 2014 or the latest available.

Table 1. Japan: Selected Economic Indicators, 2010–16

Nominal GDP: US$ 4,602 Billion (2014)
Population: 127 Million (2014)
GDP per capita: US$ 36,205 (2014)
Quota: SDR 15.6 Billion (2014)

	2010	2011	2012	2013	2014	2015	2016
						Proj.	
Growth (percent change) 1/							
Real GDP	4.7	-0.5	1.7	1.6	-0.1	0.8	1.2
Domestic demand	2.9	0.4	2.6	1.9	-0.1	0.7	1.1
Private consumption	2.8	0.3	2.3	2.1	-1.3	0.3	2.1
Gross Private Fixed Investment	-0.5	4.3	3.6	1.9	2.1	2.1	3.4
Government consumption	1.9	1.2	1.7	1.9	0.2	0.4	-1.6
Public investment	0.7	-8.2	2.7	8.0	3.8	-5.6	-10.0
Stockbuilding 2/	0.9	-0.2	0.2	-0.4	0.1	0.2	0.0
Net exports 2/	2.0	-0.8	-0.8	-0.2	0.3	0.3	0.2
Exports of goods and services 3/	24.8	-0.4	-0.2	1.2	8.4	7.7	5.5
Imports of goods and services 3/	11.1	5.9	5.3	3.1	7.4	6.4	5.3
Inflation (annual average)							
CPI 4/	-0.7	-0.3	0.0	0.4	2.7	0.7	0.6
GDP deflator	-2.2	-1.9	-0.9	-0.6	1.7	1.7	0.0
Unemployment rate (annual average)	5.0	4.6	4.3	4.0	3.6	3.7	3.7
Government (percent of GDP)							
General government							
Revenue	29.6	30.8	31.1	32.0	33.0	33.8	34.0
Expenditure	38.9	40.6	39.8	40.5	40.3	39.7	38.6
Overall Balance	-9.3	-9.8	-8.8	-8.5	-7.3	-5.9	-4.7
Primary balance	-8.6	-9.0	-7.9	-7.8	-6.7	-5.4	-4.2
Structural primary balance	-7.2	-7.6	-6.9	-7.5	-6.2	-5.0	-4.0
Public debt, gross	215.8	229.7	236.6	242.6	246.2	245.8	247.6
Macro-financial (percent change, end-perio, unless otherwise specified)							
Base money	16.7	22.2	19.3	60.3	36.7	29.1	22.5
Broad money	2.8	3.6	2.8	4.5	3.0	3.9	3.4
Credit to the private sector	-2.3	-2.9	2.6	6.7	1.4	2.3	2.7
Non-financial corporate debt in percent of GDP	187.7	191.4	196.4	225.1	237.8	235.7	237.6
Household debt in percent of disposable income	131.9	128.3	127.1	128.5	129.3	128.8	129.1
Interest rate							
Overnight call rate, uncollateralized (end-period)	0.1	0.1	0.1	0.1	0.1	...	...
Three-month CD rate (annual average)	0.3	0.3	0.3	0.2	0.2	...	...
Official discount rate (end-period)	0.3	0.3	0.3	0.3	0.0	-0.1	-0.1
10-year JGB yield (e.o.p.)	1.1	1.0	0.8	0.7	0.3	0.5	0.7
Balance of payments (in billions of US$)							
Current account balance	221.0	129.8	59.7	40.7	24.4	77.3	85.6
Percent of GDP	4.0	2.2	1.0	0.8	0.5	1.9	2.0
Trade balance	108.5	-4.5	-53.9	-90.0	-99.3	-39.7	-33.1
Percent of GDP	2.0	-0.1	-0.9	-1.8	-2.2	-1.0	-0.8
Exports of goods, f.o.b.	735.5	790.8	776.0	695.0	699.7	644.4	662.0
Imports of goods, f.o.b.	-626.9	-795.3	-829.9	-784.9	-798.9	-684.0	-695.0
Oil imports (trade basis)	134.3	182.5	196.9	184.9	167.5	106.6	120.9
FDI, net (percent of GDP)	1.3	2.0	2.0	2.8	2.4	2.3	2.4
Terms of trade (percent change)	-3.3	-7.5	0.8	-2.9	-1.1	3.6	1.3
Change in reserves	44.3	177.3	-37.9	38.7	8.5	9.0	9.5
Total reserves minus gold (in billions of US$)	1061.5	1258.2	1227.2	1237.3	1231.0	...	...
Exchange rates (annual average)							
Yen/dollar rate	87.8	79.8	79.8	97.6	105.7	120.0	119.2
Yen/euro rate	116.5	111.0	102.6	129.6	140.5	133.8	133.7
Real effective exchange rate (ULC-based) 5/	109.8	118.5	119.7	96.7	88.8	...	...
Real effective exchange rate (CPI-based)	100.0	101.7	100.5	80.3	75.1	...	...

Sources: IMF, Competitiveness Indicators System; OECD, and IMF staff estimates and projections as of June 11, 2015.
1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ Contribution to GDP growth.
3/ For 2014 export and import growth rates are inflated because of changes in the compilation of BoP statistics (BPM6) implying a break in the series relative to previous years.
4/ Including the effects of consumption tax increases in 2014 and 2015.
5/ Based on normalized unit labor costs; 2005=100.

Table 2. Japan: Monetary Authorities' Accounts and Monetary Survey, 2010–16

	2010	2011	2012	2013	2014	2015	2016
						Projections	
			(In trillions of yens)				
Monetary authorities							
Net foreign assets (NFA)	5	4	6	5	4	4	4
Net domestic assets (NDA)	104	121	132	197	272	352	432
Net domestic credit	113	130	143	211	291	372	452
Net credit to non-financial public sector	65	77	96	159	224	304	384
Credit to the private sector	2	6	9	12	14	14	14
Net credit to financial corporations	46	48	39	40	54	54	54
Other items net	-9	-9	-11	-14	-19	-19	-19
Monetary base	110	125	138	202	276	356	436
Monetary survey (depository corporations)							
NFA	83	90	101	132	148	147	149
NDA	1,015	1,037	1,050	1,064	1,083	1,126	1,166
Net domestic credit	1,077	1,088	1,125	1,166	1,214	1,262	1,307
Net credit to nonfinancial public sector	438	464	482	525	559	594	624
Credit to the private sector	504	501	517	541	551	564	579
Net credit to other financial institutions	136	123	126	100	104	104	104
Other items net	-63	-51	-75	-102	-131	-136	-141
Broad money	1,091	1,122	1,146	1,190	1,225	1,272	1,315
Currency in circulation	78	80	83	85	88	91	94
Current deposits	435	461	478	506	532	571	605
Other deposits	577	581	586	598	605	611	617
			(In percent of GDP)				
Credit to the private sector	104	106	109	113	113	112	113
Net credit to other financial institutions	28	26	26	21	21	21	20
Credit to the private sector from depository corporations	104	106	109	113	113	112	113
Corporate debt (includes loans and securities other than shares)	188	191	196	225	238	236	238
Household debt in percent of net disposable income	132	128	127	129	129	129	129
			(Y-o-y growth in percent)				
Base money	16.7	22.2	19.3	60.3	36.7	29.1	22.5
Broad money	2.8	3.6	2.8	4.5	3.0	3.9	3.4
Credit to the private sector from depository corporations	-1.0	-0.6	3.1	4.8	1.8	2.3	2.7
Credit to the corporate sector from depository corporations for fixed investments 1/	-1.3	1.2	1.0	2.7	1.8	2.3	3.3
Housing loans 2/	2.5	2.0	2.2	2.3	1.8	2.5	3.3
Credit to the private sector from all financial institutions	-2.3	-2.9	2.6	6.7	1.4	2.3	2.7
Memorandum items:							
Velocity of broad money	0.45	0.43	0.42	0.41	0.41	0.40	0.40
Money multiplier	10.0	9.0	8.3	5.9	4.4	3.6	3.0
Loan-to-deposit ratio (percent) 3/	63.1	59.8	60.4	58.0	56.9	56.4	56.5
Leverage ratio (capital to assets)	4.4	4.7	4.7	5.5	5.5	5.5	5.5
CAR (percent of RWA)	13.3	13.8	14.2	15.2	15.6	15.8	15.9
CET1 ratio (percent of RWA)	10.7	11.3	11.7	12.1	12.4	12.6	12.7
Return on equity (percent)	5.5	6.9	6.5	7.6	8.4	9.1	9.8
Return on assets (percent)	0.2	0.3	0.3	0.3	0.4	0.5	0.6
Gross impaired assets (percent of total loans)	2.5	2.4	2.4	2.3	1.9	1.8	1.8

Sources: Bank of Japan; and IMF staff estimations and projections.

1/ Projections were made using the correlation between lending and investments in the 2008-14 period.

2/ Projections were made using the correlation between lending and investments in the 2004-14 period.

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

Table 3. Japan: External Sector Summary, 2010–16

	2010	2011	2012	2013	2014	2015	2016
						Projections	
Balance of payments				*(In billions of U.S. dollars)*			
Current account balance	221	130	60	41	24	77	86
Trade balance (goods)	109	-4	-54	-90	-99	-40	-33
Exports of goods	735	791	776	695	700	644	662
Imports of goods	-627	-795	-830	-785	-799	-684	-695
Services balance	-30.3	-35.0	-47.8	-35.7	-29.2	-26.1	-26.9
Income balance	155.1	183.1	175.6	176.4	171.9	156.1	158.6
Credits	201.9	233.9	229.6	232.9	234.3	211.3	217.8
Debits	-46.8	-50.8	-54.0	-56.5	-62.5	-55.2	-59.2
Current net transfers	-12.4	-13.8	-14.2	-10.0	-19.0	-13.0	-13.0
Capital account	-5.0	0.5	-1.0	-7.7	-1.9	-3.1	-3.1
Financial account	259.2	175.5	47.2	-67.7	18.3	70.1	77.9
Direct investment, net	72.5	117.8	117.5	139.4	110.9	95.5	100.6
Portfolio investment, net	147.9	-162.9	28.8	-280.6	-42.9	-3.8	6.4
Other investment, net	-5.5	43.4	-61.1	34.8	-58.2	-30.5	-38.6
Reserve assets	44.3	177.3	-37.9	38.7	8.5	9.0	9.5
Errors and omissions, net	31.2	28.1	-4.8	-42.6	28.6	0.0	0.0
				(In percent of GDP)			
Current account balance	4.0	2.2	1.0	0.8	0.5	1.9	2.0
Trade balance (goods)	2.0	-0.1	-0.9	-1.8	-2.2	-1.0	-0.8
Exports of goods	13.4	13.4	13.0	14.1	15.2	15.5	15.6
Imports of goods	-11.4	-13.4	-13.9	-16.0	-17.4	-16.4	-16.4
Services balance	-0.6	-0.6	-0.8	-0.7	-0.6	-0.6	-0.6
Income balance	2.8	3.1	2.9	3.6	3.7	3.7	3.7
Global assumptions							
Exchange Rate (¥/US$)	87.8	79.8	79.8	97.6	105.7	120.0	119.2
(Percent change)	-6.2	-9.1	0.0	22.3	8.3	13.5	-0.6
Oil prices (US$/barrel)	79.0	104.0	105.0	104.1	96.2	58.9	64.2
(Percent change)	27.9	31.6	1.0	-0.9	-7.5	-38.8	9.1
Memorandum items :							
Nominal GDP (US$ billion)	5,498	5,914	5,956	4,921	4,602	4167	4243
Net foreign assets (NFA)/GDP, US$ basis	57.1	57.8	58.1	62.9	66.1	72.8	71.2
Return on NFA (in percent), US$ basis	4.9	5.4	5.1	5.7	5.7	5.2	5.2
Net export contribution to growth	2.0	-0.8	-0.8	-0.2	0.3	0.3	0.2

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

Table 4. Japan: General Government Operations, 2010–16

	2010	2011	2012	2013	2014	2015	2016
					Est.	Proj.	
Total revenue	29.6	30.8	31.1	32.0	33.0	33.8	34.0
Taxes 1/	16.0	16.6	16.8	17.3	18.3	19.2	19.3
Social security contributions	11.8	12.5	12.8	13.0	13.2	13.3	13.4
Grants	13.5	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	1.7	1.7	1.6	1.7	1.5	1.3	1.2
o/w interest income	1.5	1.4	1.3	1.5	1.3	1.1	1.0
Total expenditure	38.9	40.6	39.8	40.5	40.3	39.7	38.6
Expense	34.9	36.1	36.1	36.2	36.3	36.0	35.3
Compensation of employees	6.1	6.3	6.1	5.9	...	...	...
Use of goods and services	3.7	3.8	3.8	4.0	...	...	...
Consumption of fixed capital	3.0	3.0	3.0	3.0	3.0	2.9	2.8
Interest	2.0	2.1	2.1	2.1	1.8	1.5	1.4
Grants	0.1	0.1	0.1	0.2	...	...	...
Social security benefits	19.7	20.5	20.6	20.8	21.0	20.7	20.7
Other expense	0.3	0.2	0.3	0.2	...	...	...
Net acquisition of nonfinancial assets	1.0	1.5	0.8	1.3	1.0	0.9	0.5
Acquisitions of nonfinancial assets	3.9	4.5	3.8	4.3	3.9	3.7	3.3
o/w public investment	3.3	3.1	3.2	3.5	3.6	3.4	3.0
o/w land acquisition	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Consumption of fixed capital	-3.0	-3.0	-3.0	-3.0	-3.0	-2.9	-2.8
Net lending/borrowing (overall balance)	-9.3	-9.8	-8.8	-8.5	-7.3	-5.9	-4.7
Excluding social security fund	-8.2	-9.0	-8.0	-8.0	-6.9	-5.5	-4.4
Primary balance	-8.6	-9.0	-7.9	-7.8	-6.7	-5.4	-4.2
Structural balance	-7.8	-8.4	-7.8	-8.2	-6.9	-5.6	-4.6
Structural primary balance	-7.2	-7.6	-6.9	-7.5	-6.2	-5.0	-4.0
Financing	9.3	9.8	8.8	8.5	7.3	5.9	4.7
Net issuance of debt securities	10.2	8.7	7.4	8.2	...	...	...
Other	-0.9	1.2	1.4	0.3	...	...	...
Stock positions 2/							
Debt							
Gross 3/	215.8	231.6	238.0	243.1	246.2	245.8	247.6
Net	113.1	127.2	129.0	122.9	126.1	125.9	127.9
Net worth	6.5	-3.6	-8.0	0.1	...	...	...
Nonfinancial assets	119.6	120.6	119.0	122.3	...	...	...
Fixed assets (excluding land)	93.5	95.1	93.8	97.4	...	...	...
Land	25.7	25.1	24.7	24.4	...	...	...
Other	0.4	0.4	0.5	0.5	...	...	...
Net financial worth	-113.1	-124.3	-127.1	-122.3	...	...	...
Financial assets	102.8	102.0	107.3	119.6	...	...	...
Currency and deposits	16.5	16.1	15.9	16.5	...	...	...
Loans	6.7	6.7	7.1	7.5	...	...	...
Securities other than shares	26.4	25.6	25.4	23.8	...	...	...
Shares and other equities	23.9	22.9	24.8	31.9	...	...	...
o/w shares	9.4	8.6	10.4	17.4	...	...	...
Financial derivatives	0.0	0.0	0.0	0.0	...	...	...
Other financial assets	29.3	30.8	34.1	39.9	...	...	...
Liabilities	215.8	226.3	234.4	241.8	...	...	...
Loans	34.6	34.0	33.8	34.0	...	...	...
Securities other than shares	170.1	181.8	189.7	197.5	...	...	...
Equities	4.9	5.0	5.0	5.0	...	...	...
Financial derivatives	0.0	0.0	0.0	0.0	...	...	...
Other liabilities	6.2	5.5	5.8	5.3	...	...	...
Memorandum item:							
Nominal GDP (CY, trillion yen)	482.7	471.6	475.3	480.1	487.6	499.9	505.8

Sources: Japan Cabinet Office; IMF staff estimates and projections.
1/ Including fines.
2/ Market value basis.
3/ Nonconsolidated basis.

Table 5. Japan: Medium-Term Projections, 2013–20

	2013	2014	2015	2016	2017	2018	2019	2020
			Projections					
			(Percent change)					
Real GDP	1.6	-0.1	0.8	1.2	0.4	0.7	0.7	0.7
Total domestic demand	1.9	-0.1	0.7	1.1	0.2	0.5	0.5	0.5
Net exports (contribution)	-0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Unemployment rate (percent)	4.0	3.6	3.7	3.7	3.8	3.7	3.7	3.7
Headline CPI inflation (average)	0.4	2.7	0.7	0.6	1.6	1.1	1.2	1.5
memo item: without planned consumption tax increases	0.4	1.2	0.5	0.9	0.7	0.9	1.2	1.5
Output gap (in percent of potential output)	-1.2	-1.7	-1.3	-0.5	-0.5	-0.3	-0.1	0.0
			(In percent of GDP)					
Overall fiscal balance	-8.5	-7.3	-5.9	-4.7	-4.0	-3.5	-3.7	-4.0
Primary balance	-7.8	-6.7	-5.4	-4.2	-3.5	-3.0	-3.0	-3.0
General government debt								
Gross	243.1	246.2	245.8	247.6	249.1	250.1	251.0	251.3
Net	122.9	126.1	125.9	127.9	129.5	130.5	131.4	131.7
External current account balance	0.8	0.5	1.9	2.0	2.0	2.1	2.2	2.3
National savings	22.0	22.4	23.5	23.5	23.8	23.9	24.0	24.2
Private	22.4	21.4	21.4	20.6	20.4	20.1	20.4	20.9
Public	-0.5	0.9	2.1	2.9	3.4	3.8	3.6	3.3
National investment	21.1	21.9	21.7	21.5	21.8	21.8	21.8	21.9
Private	16.3	16.8	17.0	17.3	17.9	18.0	18.1	18.1
Public	4.8	5.1	4.7	4.2	3.9	3.8	3.7	3.7

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

Table 6. Japan: Financial Soundness Indicators (FSI)

	2010	2011	2012	2013	2014
			(In percent)		
Capital adequacy					
Regulatory capital to risk-weighted assets	13.3	13.8	14.2	15.2	15.6
Regulatory tier 1 capital to risk-weighted assets 1/	9.9	10.7	11.3	11.7	12.1
Non-performing loans net of provisions to capital 1/	22.7	22.2	21.4	19.2	14.3
Asset quality					
Non-performing loans to total gross loans	2.5	2.4	2.4	2.3	1.9
Sectoral distribution of total loans: 1/					
Residents					
Deposit-takers	6.4	6.3	6.9	7.1	5.1
Other financial corporations	10.0	9.3	9.5	9.2	8.9
General government	7.2	7.8	8.1	8.3	8.6
Nonfinancial corporations	36.4	35.7	35.1	34.2	33.8
Other domestic sectors	34.7	34.8	34.3	33.6	34.1
Nonresidents	5.2	6.0	6.2	7.5	9.4
Earnings and profitability					
Return on assets (ROA)	0.2	0.3	0.3	0.3	0.4
Return on equity (ROE)	5.5	6.9	6.5	7.6	8.4
Interest margin to gross income 1/	73.9	70.5	69.2	66.0	63.4
Non-interest expenses to gross income 1/	63.2	62.6	63.3	61.9	60.6
Personnel expenses to non-interest expenses 1/	...	...	...	44.2	44.8
Liquidity					
Liquid assets to total assets (Liquid asset ratio) 1/	21.6	23.2	24.4	23.6	21.1
Non-interbank loans-to-customer-deposits 1/	77	75	75	75	76
Other					
Capital-to-total assets	4.4	4.7	4.7	5.5	5.5
Spread between reference lending and deposit rates 1/2/	156	153	147	140	130
Trading income to total income 1/	...	...	...	9.7	8.6
Gross derviative assets/capital ratio 1/	70.7	61.4	54.2	51.2	46.4
Gross derviative liability/capital ratio 1/	65.3	56.6	52.0	50.5	47.7

Source: Japanese authorities; and IMF staff estimates.

1/ Data for these series are for Q1 of each year until 2014. For 2014, data for Q3 are used.

2/ Basis points.

Annex I. Status of Structural Reforms

Abenomics' third arrow: key measures and status

Policy area	Key measures planned by the authorities and status	IMF assessment and advice	Size of impact if comprehensive reform consistent with IMF advice is implemented
Labor market			
Female Labor Participation	Increase childcare facilities capacity by 200 thousand by FY2017 (implementation ongoing; 43 thousand children were on the nurseries' waiting list as of Oct 2014). Raise childcare leave benefits (implemented in FY2014). Removal of tax and social security disincentives for working spouses (under discussion but no progress observed yet). A bill requiring large companies to prepare plans to promote women will be re-submitted to the Diet, after not passing last year.	FLP has risen substantially during the past two years, in part due to "Womenomics". However, more needs to be done to increase the availability of child care. Specifically, regulatory impediments for privately provided childcare facilities and for caregivers should be relaxed and tax and social security distortions to FLP should be eliminated.	An increase in the FLP rate to the G-7 average--combined with a rise in old age labor force participation--could raise potential growth by 0.25 percent per year (Source: 2013 Art. IV Report).
Immigration	Relaxation of the current points-based preferential immigration system of highly-skilled professionals (implemented as of Dec 2013). Extending trainee program period from 3 to 5 years for foreign workers (decided). Use SEZs to encourage use of foreign human resources (decided).	Pending bills and decisions will not materially raise foreign labor. Reforms should move beyond the trainee program by introducing guest workers programs, and loosening entry requirements in sectors with labor shortages using a sector- and skill-based approach. Allow certain industries to enter in direct agreements with the government to fill labor shortages. Establish a qualification framework for recognition of skills. See Ganelli and Miake (Forthcoming, IMF WP) for more details.	Immigration equivalent to a rise of Japan's labor force by 1 percent distributed over a decade could increase potential growth by 0.1-0.2 percent per year (2013 Art. IV).
Labor market duality	Expand subsidies for job mobility (decided from FY2015 budget). Discussion underway to ease non-regular work rules (Bills related to dispatched workers and fixed-term workers submitted to the current Diet). Relax the conditionality for dismissal in SEZs (decided).	Reforms introduced so far are bypassing contract reform that would significantly reduce duality and raise productivity by clarifying the legal framework for limited regular contracts. Contract reform should also encourage greater horizontal labor mobility.	A substantial reduction in labor market duality would increase productivity, potential growth and wages, although the precise magnitude is difficult to quantify (Aoyagi and Ganelli IMF WP 13/202).
Deregulation			
Special Economic Zones (SEZ)	Six areas were designated on March 28, 2014--including Tokyo and Osaka--accounting for about 40 percent of GDP. Expected deregulation includes easing restrictions on land use and medical practices, agriculture reform, labor reform and creation of new businesses. SEZs are expected to propose specific measures--to be vetted by a national committee--in the near future.	Initial plans surprised on the upside in terms of the scale of designated areas. SEZs could become a laboratory for reforms to be implemented at the national level, but detailed measures under discussion at the local government level have been slow to progress.	Unlikely to have a significant growth effect in the short term, but could be more substantial once rolled out at the national level.
Agricultural reforms	Land banks to increase farm size established. Private companies are allowed to join agricultural enterprises, but the shareholding is limited to 25% (private companies requested for relaxing the regulation to allow a majority holding, but the discussion will restart after 2019). Review of rice production adjustments ongoing (*gentan* system to end by FY2018). Farmers' income subsidies are not abolished although they have shrunk. Japan Agriculture group approved a plan to abolish the Central union of Agricultural Cooperatives. Discussions are ongoing on reforming the public rice price setting system (gaisankin).	Measures taken so far have been steps in the right direction, but fall short of fully deregulating agriculture, including the elimination of subsidy support and allowing majority holdings of private companies in agricultural enterprises, which would raise productivity and competition.	Full deregulation in agriculture could boost productivity by up to 30 percent although the sector is small in percent of GDP (IMF estimates).
Electricity reform	First fundamental reform in 60 years to be completed by 2020, including (i) a gradual opening of grid; (ii) liberalization of the retail electricity sector; and (iii) legal separation between electricity generators and distributors and abolish retail price regulation. Legislation passed.		Likely to have a modest impact on potential growth by reducing production costs.
Business sector			
Corporate governance	Japan's Stewardship code for institutional investors introduced in February 2014. Companies Act amended in June 2014 to encourage appointment of outside directors. Corporate governance code (requiring at least two outside directors on "comply or explain" basis) became effective in June 2015.	Significant progress has been made, but more should still be done to materially affect corporate behavior. The corporate governance code could be more ambitious in its requirements for outside directors and other measures aimed at reducing incentives to hold cash (e.g. regulatory limits on cross shareholdings; removing bottlenecks which prevent takeovers; and introducing pre-packaged reorganization plans for bankruptcy procedures).	Raising shareholders' rights could result in unlocking excessive corporate savings. The economic impact is difficult to quantify but likely to be substantial (see Aoyagi and Ganelli, WP 2014) especially in combination with other reforms that reduce incentives for large cash balances stemming from precautionary demand, transactions costs, and taxation (see Sher, WP 2014).
Corporate income tax reform	Reduction of corporate tax rate (from 34.62 to 32.11 percent). Government internal discussions ongoing about elimination/reduction of existing tax incentives.	CIT reform is desirable as part of a comprehensive medium-term fiscal consolidation package.	CIT rate cut is likely to be good for investment and growth, but not self-financing, so compensatory measures will need to be identified (see de Mooij and Saito, WP 2014).
Trade			
Trans Pacific Partnership	Started participating in negotiations of the ambitious 12-nation free trade plan in July 2013. More negotiating to do after multi-lateral talks failed in Singapore in February 2014. Japan-US remain apart on the issue of tariff reduction/elimination of Japan's "sacred" agricultural products. Final decision is expected to be made by July 2015.	The decision to join the TPP negotiations was welcome and should be used as an opportunity to deregulate protected sectors.	Japan would stand to gain considerably from an agreement, provided it is a comprehensive deal that leads to widespread tariff reductions and deregulation (about 0.1-0.2 higher growth p.a., see Peterson Institute)
Financial Sector			
Financial sector reform	GPIF to shift away from JGBs towards riskier assets (decided in June 2013). GPIF governance reform was proposed but to a more limited extent than the market expected, due to the resistance from the Government. New stock market index including only profitable companies (launched in January 2014). Tax-free investment accounts (NISA) to encourage shifting household savings away from cash (launched in January 2014).	Substantial progress has been made to facilitate portfolio rebalancing, but GPIF governance needs to be strengthened. Reforms should now focus on stimulating the provision of risk capital and phasing out the full credit guarantees to SMEs, which should stimulate firm entry and exit.	Financial sector reforms that raise risk capital and induce a restructuring of the SME sector could lift potential growth by about 0.2 percentage points (Source: 2013-14 Art. IV Reports).
Wage Policy			
Policies to encourage wage increases	Tripartite Commission (employers, labor unions and government) agreed on wage hike. Tax incentives for increasing wages introduced in 2013.	Tax incentives could be expanded and better targeted. A higher than usual increase in the minimum wage could be considered to raise base wages. Tripartite bargaining should take place more often to stimulate wage-price dynamics.	If successful in stimulating wage growth, the economic impact would be substantial, both on short term growth and inflation dynamics.
Source: staff estimates	Degree of progress of reforms: Significant	Medium progress	Limited progress

Annex II. Risk Assessment Matrix[1]

Overall Level of Concern		
	Likelihood (Over next 1–3 years)	**Impact and Policy Response**
➢ **Successful reflation following comprehensive reforms**	**Low/Medium** Aggressive monetary policy easing and a credible medium-term fiscal and growth strategy could lead to a virtuous cycle of high growth and positive inflation.	**High** Increased inflation expectations would help lowering expected real rates and thereby stimulate activity as well as leading to sustained 2-percent inflation. It would improve debt dynamics, minimizing the negative effect of consolidation on growth. *Policy response:* The BoJ should prepare a credible exit strategy and the government should save any fiscal over-performance.
➢ **Persistently low energy prices**	**Medium** Supply factors may reverse only gradually and partially, and/or weaker-than-expected aggregate global demand may keep energy prices lower than currently expected under the WEO baseline.	**High** As a net oil importer (windfall gain of 1.6 percent of 2015 GDP), Japan will benefit from higher real incomes of consumers and lower production costs, but inflation and inflation expectations could be further reduced. *Policy response:* The BoJ should strengthen communication by clarifying the indicators used to assess whether inflation is on track and spell out the criteria for judging whether the BoJ's target has been sustainably achieved.
➢ **Protracted period of slower growth in Euro Area and Japan**	**High** Weak demand and persistently low inflation from a failure to fully address crisis legacies and appropriately calibrate macro polices, leading to "new mediocre" rate of growth.	**High** Negative output gap will increase and growth potential could be adversely affected via low investment, lower labor supply, and inadequate supply-side reforms, complicating efforts to restore public debt sustainability. *Policy response*: Despite limited policy space, the government should deploy additional measures on all policy fronts in order to restore growth and inflation momentum and maintain confidence in Abenomics.
➢ **Bond market stress from a reassessment of sovereign risk in Japan**	**Medium** Abenomics falters, resulting in an eventual return of depressed domestic demand and deflation and leading to bond market stress (stagnation). Alternatively, the BoJ succeeds with raising inflation, but growth would remain sluggish leading to a higher sovereign risk premium (stagflation).	**High** The DSA and risk scenarios presented in Box 5 show that in both cases, the sovereign risk premium would rise, worsening public debt dynamics substantially, albeit gradually as the average maturity is about 6.5 years. In addition, such a shock could have a material effect on the financial sector. *Policy response:* The authorities should prepare a credible and concrete fiscal adjustment plan to restore credibility while implementing ambitious structural reform to raise growth potential. The BoJ should calibrate QQE depending on market developments.
➢ **Sharp growth slowdown and financial risks in China over the medium term**	**Medium** Insufficient progress with reforms could lead to a continued buildup of vulnerabilities, which would results in a significant slowdown in growth over the medium term.	**Medium** The recovery of exports would stall not only due to close trade links but also due to potential yen appreciation on safe-haven effects. *Policy response*: If the authorities commit to a credible fiscal consolidation plan by passing concrete measures, the near-term fiscal withdrawal could be made more gradual. Ambitious structural reforms are important to boost domestic demand and the pace of BoJ asset purchases could be accelerated.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non mutually exclusive risks may interact and materialize jointly.

Annex III. Debt Sustainability Analysis

Japan's public debt is unsustainable under current policies. Although the gross debt-to-GDP ratio is projected to rise only marginally during the WEO projection period due to an improving primary balance and a favorable differential between interest and growth rates compared to past values, complementary analysis up to 2030 (paragraph 24) shows that the rise in the debt ratio will accelerate after 2020, reaching around 290 percent of GDP in 2030. The debt outlook is vulnerable to various shocks especially when financial sector shocks cause spillovers to growth, the deficit, and the interest rate. Persistent shocks to growth and inflation could also have a significant impact in the long run. Moreover, larger public health spending is an important downside risk. While all the debt profile indicators are below early warning benchmarks, Japan's extremely high financing needs point to vulnerabilities to changes in market perceptions.

Baseline and Realism of Projections

- **Assumptions.** The analysis is based on the following key macroeconomic projections and policy assumptions (Table 5): potential growth will rise from the current 0.4 percent to 0.6 percent by 2020 assuming moderate gains from currently approved structural policies, with actual growth being somewhat volatile in part due to fiscal policy. The output gap closes by end 2016 and growth will remain at potential beyond 2020. Monetary policy is assumed to remain accommodative during the entire projection period, with CPI inflation converging to around 1.5 percent over the medium term. Fiscal policy assumes the rise in the consumption tax rate from 8 to 10 percent in April 2017, without offsetting measures, such as additional stimulus or multiple rates. It also assumes the gradual waning of past stimulus and reconstruction spending, with no further adjustment in the baseline after 2018. As no hikes in risk premia are assumed in the baseline, long-term interest rates are projected to only gradually pick up, in tandem with rising inflation, to around 3 percent on new long-term bond issuances, but because of the average maturity of government bonds of around 6.5 years (including financing bills), the nominal effective interest rate on public debt is lower and rises gradually to 1.0 percent in 2020, implying a favorable interest-growth differential of -0.5 with a nominal GDP growth rate of 1.5 percent. As a result, after the second stage of the consumption tax hike, although the primary deficit will remain around 3 percent of GDP, the overall fiscal deficit will start rising in the outer years due to gradually rising interest payments.
- **Financing Needs.** Japan's gross financing need (defined as the public sector deficit, plus all maturing debt) was 56 percent of GDP in 2014, the highest among the advanced economies. Despite the decline in the primary deficit in the next few years, the gross financing needs will remain exceptionally large above 50 percent of GDP in 2020. Although the government intends to lengthen the average maturity of JGBs, without specific plans, a similar maturity structure to the one in 2014 is assumed throughout the projection period.
- **Debt Profile.** The debt financing conditions are helped in the medium-term by a number of factors. The 10-year bond yield has been at a record low and its spread against the US is negative at around 190 basis points. The external financing requirement, incorporating the

current account surplus, is well below the lower threshold at 10 percent of GDP. This reflects the fact that foreign holdings of JGBs are quite low at 8 percent. In addition, there are no direct risks related to exchange rates as no debt is denominated in foreign currencies, which is also assumed for the future.

- **Net Debt.** Given the large financial assets held by the government, net debt is an important indicator for Japan. It should be noted, however, that not all the financial assets are available for debt repayment or easy to liquidate as, for example, they include assets for future pension payments. The financial-assets-to-GDP ratio is assumed to be stable at around 120 percent.

- **Realism of Baseline Assumptions.**
  - Past assumptions on real growth[1] have been neither too optimistic nor pessimistic compared to peer countries. Although past projections of the GDP deflator were on the optimistic side, the difference with actual values is small.
  - Past assumptions on the primary balance have been neither too optimistic nor pessimistic. Recent underperformance is due to the response to the global financial crisis and the 2011 earthquake. The size of Japan's 3-year adjustment on a cyclically adjusted primary balance (CAPB) basis is in the top quartile of the historical experience for high-debt market access countries, but the CAPB level is in the lowest quartile due to the large deficit. Staff believes that the pace of fiscal consolidation in 2015–18 of around 0.5–1.0 percent of GDP per annum is appropriate, balancing the high deficit and debt on one hand, with the need to end deflation and revive growth on the other.
  - Underlying growth without fiscal adjustment would be even more above potential for the projection period, but this is due to a strengthening of the private-sector recovery on the back of supportive monetary policy and declining oil prices. For the fiscal consolidation in the baseline, the overall fiscal multiplier is assumed to be 0.5, which is lower than the default value of 1. The reasons for this include that about half of the fiscal consolidation is assumed to come from revenue measures (mainly the consumption tax increase to 10 percent with a multiplier of around 0.7), that there are partly offsetting rate reductions in more distortionary taxes such as the corporate income tax, and that some expenditure reductions take place in areas with relatively lower multipliers such as pension spending.

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[1] Optimistic growth projections for 2011 are mainly due to the earthquake.

Japan: Public DSA Risk Assessment

Heat Map

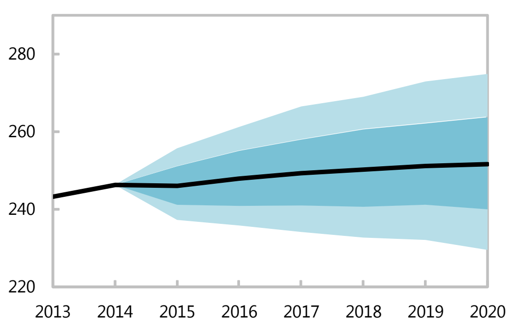
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing neec	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

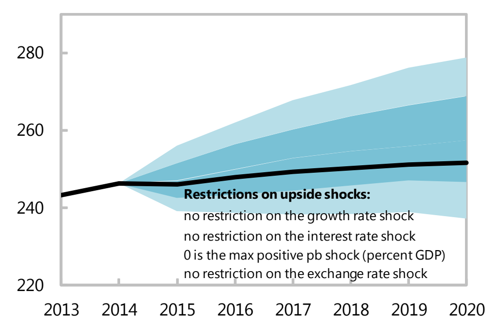
(in percent of GDP)

Baseline Percentiles: 10th-25th 25th-75th 75th-90th

Symmetric Distribution



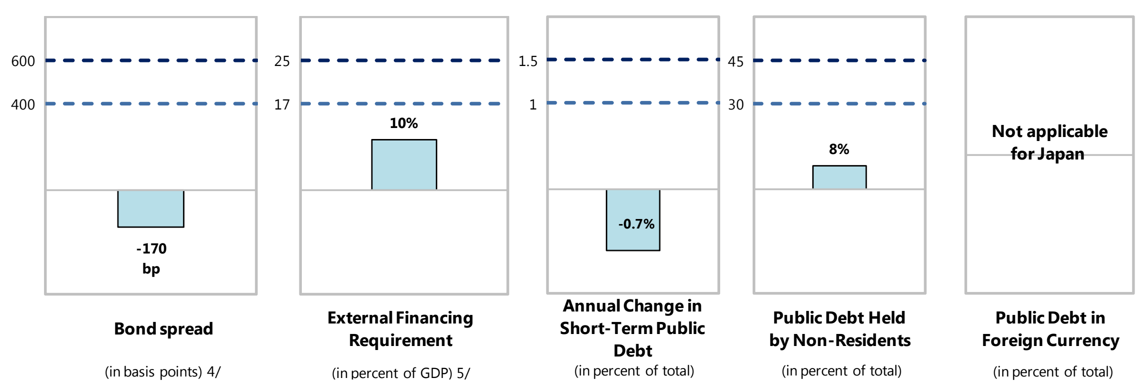
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)

Japan -- Lower early warning ·-- Upper early warning



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

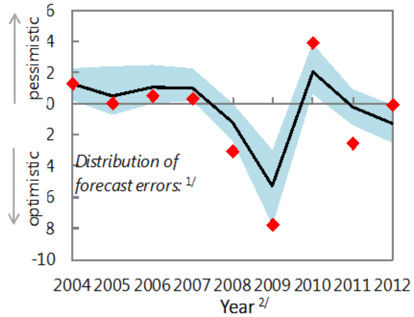
4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 17-Mar-15 through 15-Jun-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

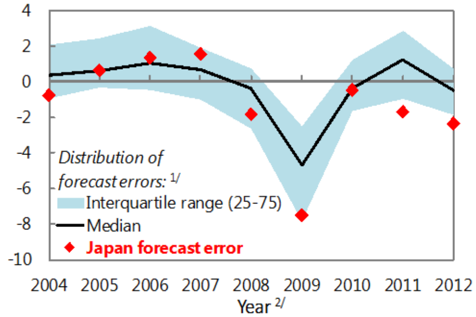
Japan: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

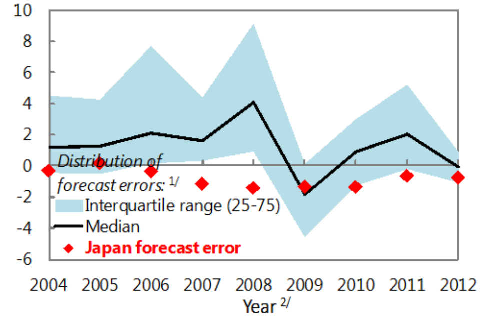
Real GDP Growth
(in percent, actual-projection)
Japan median forecast error, 2004-2012: 0.03
Has a percentile rank of: 43%



Primary Balance
(in percent of GDP, actual-projection)
Japan median forecast error, 2004-2012: -0.76
Has a percentile rank of: 34%

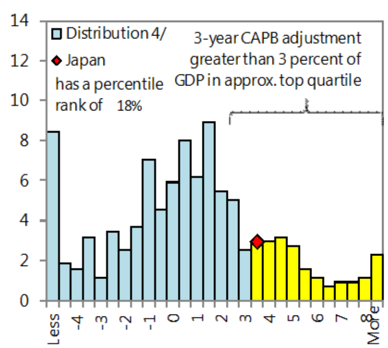


Inflation (Deflator)
(in percent, actual-projection)
Japan median forecast error, 2004-2012: -0.73
Has a percentile rank of: 6%

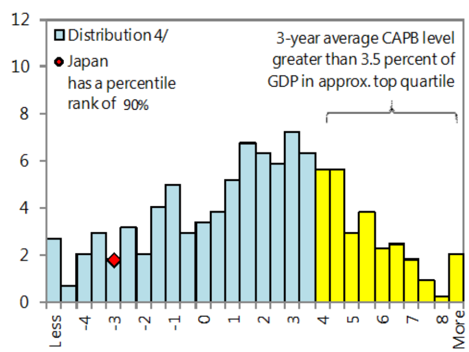


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

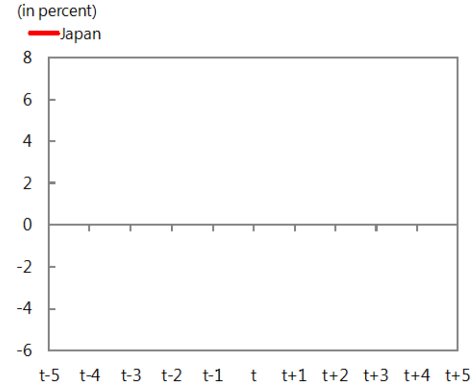


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Japan.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Japan: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

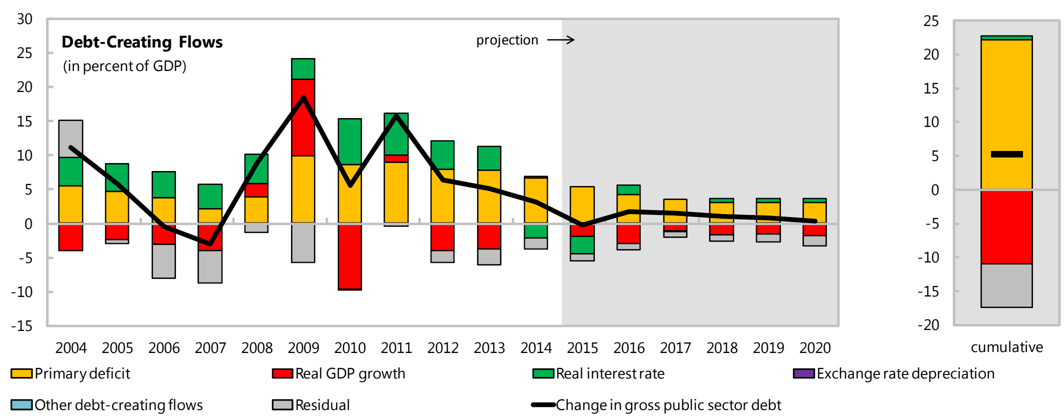
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	202.6	243.1	246.2	246.0	247.8	249.3	250.3	251.1	251.5
Public gross financing needs		55.9	55.8	53.1	53.0	52.5	51.9	50.8	51.7
Net public debt	99.6	122.9	126.1	126.1	128.1	129.7	130.7	131.5	131.8
Real GDP growth (in percent)	0.8	1.6	-0.1	0.8	1.2	0.4	0.7	0.7	0.7
Inflation (GDP deflator, in percent)	-1.3	-0.6	1.7	1.7	0.0	0.6	0.3	0.5	0.8
Nominal GDP growth (in percent)	-0.5	1.0	1.6	2.5	1.2	1.0	1.0	1.1	1.5
Effective interest rate (in percent) [4/]	1.0	0.9	0.7	0.6	0.6	0.6	0.6	0.7	1.0

As of June 15, 2015		
Sovereign Spreads		
Spread (bp) 3/		-186
5Y CDS (bp)		42
Ratings	Foreign	Local
Moody's	A1	A1
S&Ps	AA-u	AA-u
Fitch	A	A

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	7.6	5.1	3.1	-0.2	1.8	1.5	1.0	0.9	0.3	5.3	
Identified debt-creating flows	9.2	7.5	4.7	0.8	2.7	2.3	2.0	2.0	1.9	11.7	
Primary deficit	6.2	7.8	6.7	5.4	4.2	3.5	3.0	3.0	3.0	22.1	-1.2
Primary (noninterest) revenue and grants	28.7	30.6	31.8	32.8	33.0	33.6	34.3	34.3	34.4	202.5	
Primary (noninterest) expenditure	34.8	38.4	38.5	38.2	37.2	37.2	37.3	37.3	37.4	224.6	
Automatic debt dynamics [5/]	3.0	-0.3	-1.9	-4.5	-1.5	-1.2	-1.0	-1.0	-1.2	-10.4	
Interest rate/growth differential [6/]	3.0	-0.3	-1.9	-4.5	-1.5	-1.2	-1.0	-1.0	-1.2	-10.4	
Of which: real interest rate	4.5	3.4	-2.2	-2.6	1.5	-0.1	0.6	0.6	0.6	0.6	
Of which: real GDP growth	-1.4	-3.7	0.2	-1.9	-2.9	-1.1	-1.7	-1.6	-1.8	-11.0	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-1.6	-2.4	-1.6	-1.0	-0.9	-0.9	-0.9	-1.2	-1.5	-6.4	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

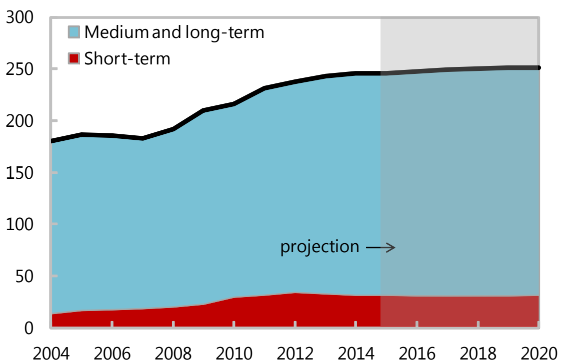
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

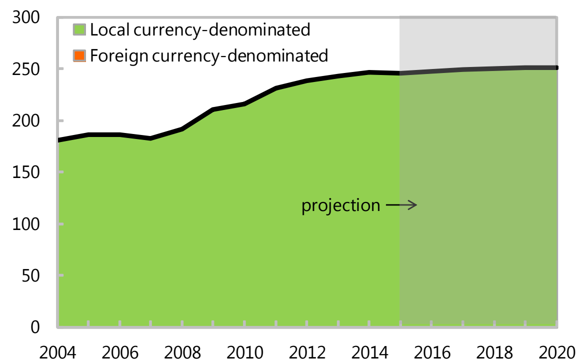
Japan: Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



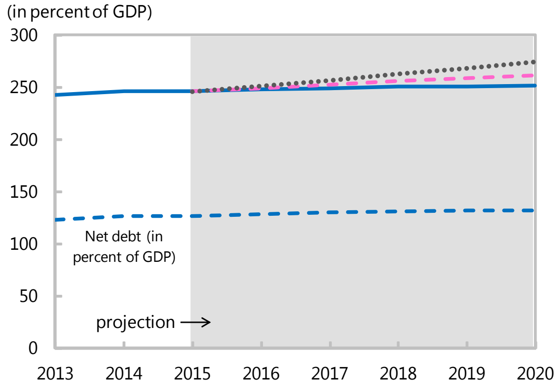
By Currency
(in percent of GDP)



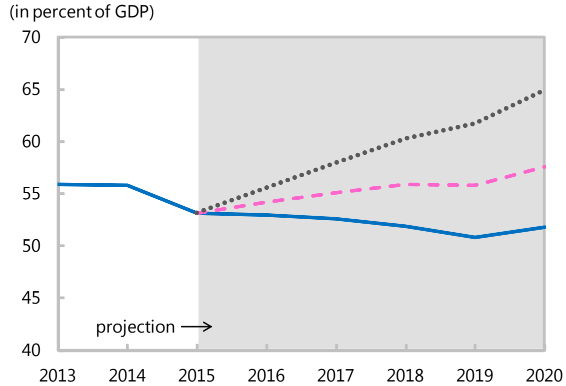
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.8	1.2	0.4	0.7	0.7	0.7
Inflation	1.7	0.0	0.6	0.3	0.5	0.8
Primary Balance	-5.4	-4.2	-3.5	-3.0	-3.0	-3.0
Effective interest rate	0.6	0.6	0.6	0.6	0.7	1.0
Constant Primary Balance Scenario						
Real GDP growth	0.8	1.2	0.4	0.7	0.7	0.7
Inflation	1.7	0.0	0.6	0.3	0.5	0.8
Primary Balance	-5.4	-5.4	-5.4	-5.4	-5.4	-5.4
Effective interest rate	0.6	0.6	0.6	0.6	0.7	1.0

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.8	0.6	0.6	0.6	0.6	0.6
Inflation	1.7	0.0	0.6	0.3	0.5	0.8
Primary Balance	-5.4	-6.4	-6.4	-6.4	-6.4	-6.4
Effective interest rate	0.6	0.6	1.0	1.2	1.4	1.8

Source: IMF staff.

Shocks and Stress Tests

- *Fan chart.* The fan chart, which incorporates feedback effects between macroeconomic variables and relies on historical data to calibrate shocks, illustrates additional risks around the baseline. For example, under the worst quartile case, the debt-to-GDP ratio could reach around 260 percent of GDP in 2020, more than 10 percentage points higher than in the baseline. In addition, when the possibility of positive primary balance shock is ruled out considering recent experience, the debt-to-GDP ratio could be even higher by 5 percent of GDP in 2020.

- *Primary balance shock.* The impact is estimated to be modest. The improvement in the primary balance underperforms by half of the 10-year historical standard deviation of changes in the primary balance, compared to the baseline. Additional borrowing cost of 25 basis points per 1 percent of GDP worsening of the deficit is assumed. The gross debt-to-GDP ratio will be higher by around 3 percent of GDP in 2020 than the baseline.

- *Growth shock.* The impact on the debt ratio is the second largest among the shock scenarios. Real output growth rates are lower by a half of the 10-year historical standard deviation of changes in growth, compared to the baseline, for 2 years starting in 2016. As a result, the primary balance deteriorates, leading to higher interest rates as in the primary balance shock scenario. Also, a decline in inflation is assumed at a rate of 0.25 percentage point per 1 point decrease in growth. The impact is relatively large, bringing the debt ratio to around 260 percent of GDP, around 10 percentage points higher relative to the baseline.

- *Interest rate shock.* The effect becomes larger with the passage of time. A spike in JGB yields is an important medium-term tail risk. A shock of 200 basis points is assumed to happen in 2015 and stay for the rest of the period. Although increasing only gradually due to the average maturity of around 6.5 years, the effective interest rate is higher by around 1 percentage point in 2020 than the baseline, with the debt ratio higher by around 5 points. The difference with the baseline does not look very large, but the impact will accelerate as the interest rate hike becomes fully reflected. In addition, such a shock could have a material effect on the financial sector with possible knock-on effects on the debt ratio and could lead to distress in the financial sector (see next shock).

- *Interest rate and contingent liability shock.* The impact is by far the largest among the scenarios. A one-time capital injection equivalent to 2.5 percent of banking sector assets (approximately 10 percent of regional banks assets) will increase government spending by around 3.0 percent of GDP. The interest rate is assumed to rise by 25bps for each percentage point increase in the primary deficit. This is also combined with the real GDP growth shock. As a result, the debt ratio will increase to around 275 percent of GDP in 2020, more than 20 percentage points higher than in the baseline.

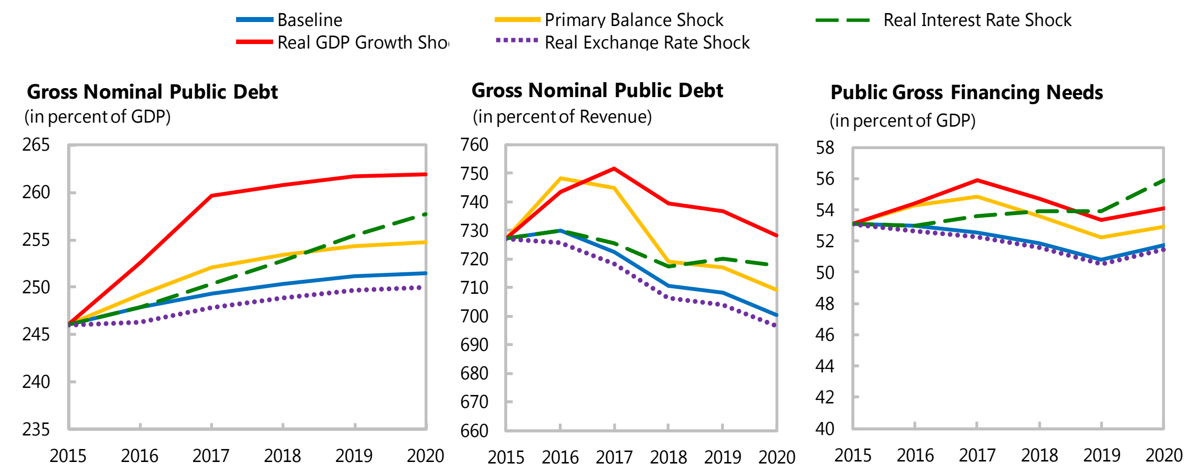
Longer-term Projections and Risks. Despite the relatively stable fiscal outlook in the medium term, the gross and net debt-to-GDP ratios are projected to start increasing faster after 2020 and reach around 290 percent and 170 percent of GDP by 2030, respectively. This increase is a reflection of a gradual rise in the interest rate-growth differential towards the historical average of 1.[2] Long-term projections are sensitive to macroeconomic and policy assumptions.

One important downside risk is a larger increase in public health spending than assumed in the baseline (Kashiwase, Nozaki, and Saito 2014). Maintaining the same macroeconomic assumptions as in the baseline, this would imply a debt ratio of 305 percent of GDP by 2030, about 15 percentage points higher than in the baseline. Other risks include a less favorable interest rate-growth differential due to disappointing growth or interest rate hikes upon BoJ exit or both, and changes in the investor base towards foreign sources of funding that will demand higher risk premia.

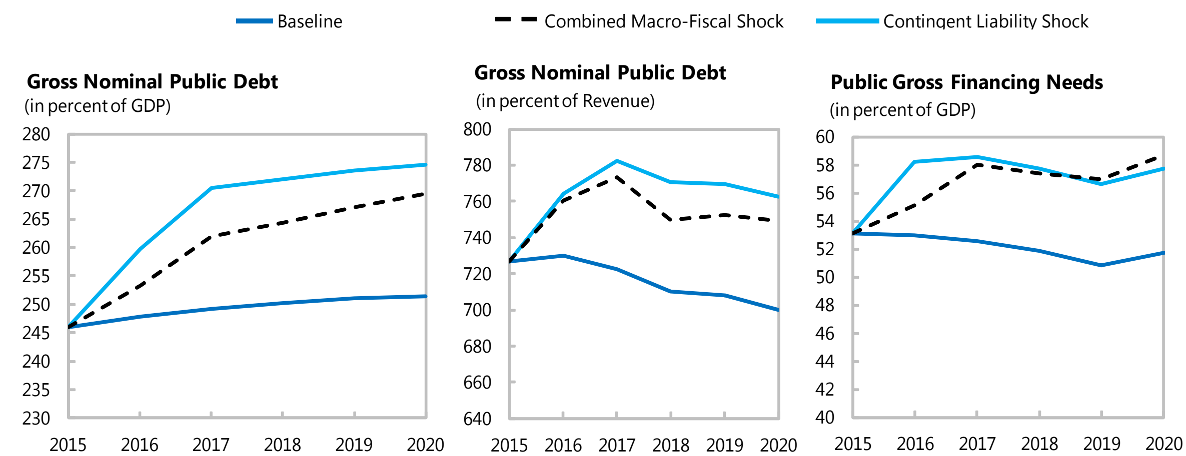
[2] The differential is currently lower than the historical average, estimated at around -0.8 in 2014, partly reflecting exceptional monetary easing.

Japan: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2015	2016	2017	2018	2019	2020
Primary Balance Shock						
Real GDP growth	0.8	1.2	0.4	0.7	0.7	0.7
Inflation	1.7	0.0	0.6	0.3	0.5	0.8
Primary balance	-5.4	-5.5	-4.9	-3.0	-3.0	-3.0
Effective interest rate	0.6	0.6	0.6	0.7	0.8	1.0
Real Interest Rate Shock						
Real GDP growth	0.8	1.2	0.4	0.7	0.7	0.7
Inflation	1.7	0.0	0.6	0.3	0.5	0.8
Primary balance	-5.4	-4.2	-3.5	-3.0	-3.0	-3.0
Effective interest rate	0.6	0.6	1.0	1.2	1.4	1.8
Combined Shock						
Real GDP growth	0.8	-0.1	-0.9	0.7	0.7	0.7
Inflation	1.7	-0.4	0.3	0.3	0.5	0.8
Primary balance	-5.4	-5.5	-5.5	-3.0	-3.0	-3.0
Effective interest rate	0.6	0.6	1.0	1.2	1.5	1.8

	2015	2016	2017	2018	2019	2020
Real GDP Growth Shock						
Real GDP growth	0.8	-0.1	-0.9	0.7	0.7	0.7
Inflation	1.7	-0.4	0.3	0.3	0.5	0.8
Primary balance	-5.4	-4.8	-4.8	-3.0	-3.0	-3.0
Effective interest rate	0.6	0.6	0.6	0.7	0.8	1.0
Real Exchange Rate Shock						
Real GDP growth	0.8	1.2	0.4	0.7	0.7	0.7
Inflation	1.7	0.6	0.6	0.3	0.5	0.8
Primary balance	-5.4	-4.2	-3.5	-3.0	-3.0	-3.0
Effective interest rate	0.6	0.6	0.6	0.6	0.7	1.0
Contingent Liability Shock						
Real GDP growth	0.8	-1.5	-2.3	0.7	0.7	0.7
Inflation	1.7	-0.7	-0.1	0.3	0.5	0.8
Primary balance	-5.4	-7.7	-3.5	-3.0	-3.0	-3.0
Effective interest rate	0.6	0.6	0.8	0.9	1.1	1.4

Source: IMF staff.

Annex IV. Assessment of Japan's External Sector

	Japan	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The net international investment position (NIIP) position has nearly doubled in the last ten years to close to 70 percent of GDP in 2013 (assets: 166 percent; liabilities: 98 percent) . In the medium term it is projected to rise toward 75 percent with higher current account (CA) surpluses, before stabilizing as valuation effects are offset by dis-saving as the population ages. **Assessment**. Vulnerabilities are limited (equity and direct investment comprise a rising share of liabilities, now at 35 percent of total). Assets are diversified geographically and by risk classes. The NIIP generates annual investment income at 3-3 ½ percent of GDP, keeping the current account balance positive despite the rising trade deficit.	**Overall Assessment**: *The 2014 external position was broadly consistent with medium-term fundamentals and desirable policies.* As of May 2015, the key developments relative to 2014 are the reduction in the oil import bill, the REER depreciation, and some pickup in exports. The REER depreciation compared to the average of 2014 has been beneficial, given the current stage of the economic cycle and the need to address low inflation and reduce deflation risks. At the same time the REER has moved toward a moderately weaker level than would be consistent with its fundamentals suggested in the 2014 assessment. Together with these developments, sustained easing by the BoJ while others tighten, combined with the lack of bolder structural reform and the absence of a credible and specific medium-term fiscal consolidation plan could strengthen the external position. **Potential policy responses**: Forceful structural reforms are needed to raise growth as well as lift prices. These include measures to boost labor supply, reduce labor market duality, enhance risk capital provision, and accelerate agricultural and services sector deregulation. Fiscal consolidation should proceed anchored by a concrete plan to achieve the medium-term target, and its conduct attuned to economic conditions and prospects. These 'desirable' policies are expected to support growth, boost domestic demand, imports and prices, without overreliance on depreciation of the yen, and help prevent the external position from moving out of line with fundamentals over the medium term.
Current account	**Background**. The 2014 CA surplus fell to 0.5 percent of GDP. Export volumes grew 0.6 percent y/y (4 ¾ percent in value) in the face of continued headwinds - rising share of offshoring, loss of market share, limited pass-through of the depreciation to lower export prices, and low global investment. Nonetheless, exports picked up in Q4 2014 supported by gradual economic recovery overseas and delayed J-curve effects. Despite weak domestic demand and the REER depreciation, import volumes grew 0.7 percent (5 ¾ percent in value), with rising import penetration in electronics and smartphones. **Assessment.** - EBA estimates the 2014 cyclically-adjusted CA at 0.6 percent of GDP. Staff adjust the estimate for temporary factors (delayed effects of depreciation, elevated energy imports with the nuclear power plant shutdown, regional tensions), to get an underlying, cyclically-adjusted CA of 2-2 ¼ percent of GDP. - EBA estimates the 2014 CA norm at 3.1 percent of GDP. Staff adjust the estimate to account for factors not captured by EBA - structurally lower export competitiveness and permanently higher domestic demand and imports under complete Abenomics - to get a norm of 1 ¼ to 2 percent of GDP. - The underlying CA in 2014 is therefore assessed to be 0-1 percent of GDP larger than the norm, broadly consistent with desirable policies and medium-term fundamentals. (*See notes, below.)* The 2015 surplus is expected to rise to 2 percent of GDP under the current policy mix on lower oil prices (the oil balance deficit improves from – 3.6 percent of GDP in 2014 to -2.5 percent projected in 2015) and a pick-up in export growth.	
Real exchange rate	**Background**. The real effective exchange rate (REER) depreciated 5 ¾ percent between 2013 and 2014 (a further 7 percent through May 2015 (relative to the 2014 average), mainly on account of the nominal depreciation fueled by further widening of interest rate differentials relative to the U.S. (10y JGB yields stayed suppressed below 60 bps for most of 2014 in anticipation of further BoJ easing, and eventually dipped as low as 30 bps after the BoJ accelerated its QQE program in October). **Assessment**. The EBA REER Level model estimates the 2014 average REER to be 21 percent weaker (EBA Index REER model: 26 percent weaker) than the level consistent with fundamentals and desirable policies, mainly from a large unexplained residual. The model does not include fiscal policy and so the estimated policy gap is close to zero. Other Japan-specific factors that affect the REER – JGB-UST spread, portfolio rebalancing, speculative short positions against the yen, and the shock requiring higher energy imports - are also not included. Because of these missing factors, the EBA REER model is not used in Japan's assessment. Instead, using the staff-assessed CA gap range as reference, staff assess a 2014 REER gap midpoint of -5 percent with an indicative range of 0 to - 10 percent.	
Capital and financial accounts: flows and policy measures	**Background**. There has been a pick-up in portfolio outflows as institutional investors have begun to diversify overseas. Net short yen positions have eased from their extreme highs of last year, but continue to be an important driver of exchange rate movements. **Assessment**. Vulnerabilities are limited (inward investment tends to be equity-based and home bias of Japanese investors remains strong). So far there have been no large spillovers from QQE to domestic financial conditions in other economies in the region and elsewhere (interest rates, credit growth). If outflows from Japan accelerate, they could provide an offset to any tightening in domestic financial conditions regional economies face with normalization of policy rates in other advanced economies.	
FX intervention and reserves level	**Background**. Reserves are about 25 percent of GDP, on legacy accumulation. There has been no FX intervention in recent years. **Assessment**. The exchange rate is free floating. Interventions are isolated (last in 2011) to reduce short-term volatility and disorderly exchange rate movements.	

	Japan (concluded)	Overall Assessment
Technical Background Notes	1/ Export elasticities are structurally lower because offshoring of production and a higher share of intermediate goods exports which makes Japanese exports less sensitive to yen fluctuations than in the past. 2/ The norm is positive because of high corporate saving in excess of domestic investment opportunities, low residential investment, and a sizable income account owing to the large NFA position and favorable return differential on assets relative to liabilities. 3/ The uncertainty in the CA gap results from (i) varying estimates of the impact of temporary factors weighing on the CA; (ii) hard-to-quantify implications of Abenomics policies for the norm; and (iii) uncertain effects of structural changes – higher offshoring, reduced competitiveness of some tradable sectors – on the trade balance.	

Annex V. Main Recommendations of the 2014 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal Policy:	
The second consumption tax rate increase in 2015 to 10 percent with a uniform rate should be confirmed.	The government postponed the next consumption tax rate increase from 8 to 10 percent from October 2015 to April 2017.
A post-2015 fiscal consolidation plan is urgently needed and should include further revenue measures and entitlement reforms such as: • Gradually increasing the consumption tax to at least 15 percent; • Broadening the personal income tax base; • Taking measures to contain pension and health care spending; • Reforming the spousal deduction from the personal income tax and threshold below which dependent spouses are exempted from paying social security contributions; and • Restructuring the currently untargeted wage deductions scheme.	The Diet approved new stimulus of about 0.8 percent of GDP, mainly consisting of cash transfers and public investment. In late June 2015, the government announced the medium-term fiscal consolidation plan to achieve a primary balance by FY2020, which identified additional measures of about 1½ percent of GDP, mostly through containing social security spending.
A corporate income tax cut schedule should be announced upfront, but phased in over time.	The government announced the reduction of the effective corporate income tax (CIT) rate by 3.3 percent over the next two years, together with base broadening measures including lowering the limit for loss carried forward and the increase of the ratio of pro-forma standard taxation.
Monetary Policy:	
The BoJ should act quickly if actual or expected inflation stagnates or growth disappoints.	In October 2014, the BoJ expanded its QQE framework further by increasing purchases of JGBs to 80 trillion yen annually, extending the average maturity of JGBs purchases to about 7–10 years, and tripling its purchases of private assets.
Communication should focus on achieving 2 percent inflation in a stable manner aided by a more transparent presentation of the BoJ's forecast and underlying assumptions.	The BoJ has published the oil price assumption underlying its forecast and studies of the effectiveness of its QQE and progress of the regime shift it is trying to engineer.
Financial Sector Policy:	
Strengthening capital standards for domestically oriented banks by including reassessing the treatment of unrealized losses in capital.	While consolidation of regional banks is being led by the private sector, the FSA is encouraging regional banks with low profitability and weak prospects for their local economies to change their business strategy in a forward-looking manner.
Mitigating foreign-exchange funding risks for banks with overseas activities by raising deposits overseas and by issuing long-term foreign-denominated debt.	The FSA is closely monitoring banks' liquidity risks, in particular in foreign currency, by changing the regulatory framework to raise the quality of capital and requiring banks' provisioning practices more forward looking.
Growth Strategy	
Raising labor supply by fully implementing plans to increase the availability of child care, gradually raising the retirement age, and relaxing immigration restrictions in areas with labor shortages.	The portfolio investment target of the GPIF was revised to increase investment in equities and foreign assets while reducing JGB holdings.
Enhancing risk capital provision by focusing on increasing credit to new growth projects and by revising GPIF's investment strategy.	The Stewardship code was introduced to induce greater institutional investor activism.
Implementing comprehensive corporate governance reform to strengthen firms' governance and potentially unlock corporate savings for more growth effective use.	The Companies Act was amended and the Corporate Governance Code was adopted to require listed companies to appoint outside directors on a "comply or explain" basis.
Deregulating agriculture and domestic services sectors to raise productivity and encourage inward foreign investment.	The JPX-Nikkei index comprising only profitable firms with good corporate governance and disclosure was launched.

INTERNATIONAL MONETARY FUND

JAPAN

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 30, 2015

Prepared By: Asia and Pacific Department (In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of May 31, 2015)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	15,628.50	100.00
Fund holdings of currency (Exchange Rate)	15,263.58	97.67
Reserve Tranche Position	365.45	2.34
Lending to the Fund		
New Arrangements to Borrow	6,549.35	

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	12,284.97	100.00
Holdings	13,041.12	106.16

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund[1]

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

	Forthcoming				
	2015	2016	2017	2018	2019
Principal					
Charges/Interest		**0.21**	**0.21**	**0.21**	**0.21**
Total		**0.21**	**0.21**	**0.21**	**0.21**

Exchange Rate Arrangement:

Japan maintains a free floating exchange rate regime. Since the 2014 Article IV consultation, Japan has not had foreign exchange intervention. The ministry of finance publishes foreign exchange intervention information on its website. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions imposed solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144–(52/51).

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

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

Japan underwent an assessment of its AML/CFT framework against the AML/CFT standard by the Financial Action Task Force (FATF) and the Asia/Pacific Group (APG) in 2008. Significant deficiencies were identified, notably with respect to customer due diligence (CDD) requirements, transparency of legal entities, the criminalization of terrorist financing and the freezing of terrorist assets. Since the 2014 Article IV mission, Japan has made significant progress in its commitment to strengthening its AML/CFT legal framework through the FATF standards, notably by enacting the Amendment Act on Prevention of Transfer of Criminal Proceeds, the Act to Amend the Terrorism Financing Act, and the Terrorist Assets Freezing Act. Japan will continue to be monitored by the FATF on its progress including the issuance of subsidiary legislations to implement the enacted Acts.

Article IV Consultation:

The 2014 Article IV consultation discussions were held during May 19–30, 2014; the Executive Board discussed the Staff Report (IMF Country Report No. 14/236) and concluded the consultation on July 23, 2014. The concluding statement, staff report, staff supplement, selected issues paper, and PIN were all published.

STATISTICAL ISSUES

Economic and financial data provided to the Fund are considered adequate for surveillance purposes. Japan subscribes to the Special Data Dissemination Standard (SDDS) and meets the SDDS specifications for the coverage, periodicity, and timeliness of data. The Japanese authorities hosted a data module mission for a Report on the Observance of Standards and Codes (data ROSC) in September 12–28, 2005. The Report on Observance of Standards and Codes - Data Module, Response by the Authorities, and Detailed Assessments Using the Data Quality Assessment Framework (DQAF) were published March 17, 2006 and are available at http://www.imf.org/external/pubs/ft/scr/2006/cr06115.pdf.

Japan: Table of Common Indicators Required for Surveillance (as of June 15, 2015)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	June 2015	June 2015	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/10/2015	6/12/2015	Every 10 days	Every 10 days	Every 10 days		
Reserve/Base Money	May 2015	June 2015	M	M	M	LO, LO, LO, LO	O, O, O, O, O
Broad Money	May 2015	June 2015	M	M	M		
International Investment Position	2015Q1	June 2015	Q	Q	Q		
Central Bank Balance Sheet	6/10/2015	6/12/2015	Every 10 days	Every 10 days	Every 10 days		
Consolidated Balance Sheet of the Banking System	April 2015	June 2015	M	M	M		
Interest Rates[2]	June 2015	June 2015	D	D	D		
Consumer Price Index	April 2015	May 2015	M	M	M	O, LO, O, O	O, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2013	January 2015	A	A	A	O, LNO, O, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2013	January 2015	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2015Q1	May 2015	Q	Q	Q		
External Current Account Balance	April 2015	June 2015	M	M	M	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	April 2015	June 2015	M	M	M		
GDP/GNP	2015Q1	June 2015	Q	Q	Q	O, O, O, O,	LO, LO, O, O, LNO
Gross External Debt	2015Q1	June 2015	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds and extra budgetary funds), local governments, and social security funds.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC or the Substantive Update (published on May 17, 2006, and based on the findings of the mission that took place during September 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data and its assessment, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

JAPAN

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

July 13, 2015

Prepared by Asia and Pacific Department

1. **This supplement contains information that has become available since the Staff Report was circulated to the Executive Board on July 2, 2015.** It does not alter the staff's broad assessment of policy issues and recommendations contained in the report.

2. **Data releases continue to be in line with staff projections.** Private consumption rebounded in May, with the real synthetic consumption index up by 0.6 percent (m/m), while consumer confidence edged up to 41.7 in June from 41.4 in May. In May, private machinery orders (excluding volatile items) rose (0.6 percent, m/m) while industrial production fell (2.1 percent, m/m). Core inflation (excluding fresh food) rose slightly to 0.1 percent (from 0.0 percent in April).

3. **On June 30, the government announced "Basic Policy on Economic and Fiscal Management and Reform 2015."** One of its main pillars is a 5-year fiscal consolidation strategy to achieve a primary surplus of the central and local governments by FY2020 and contains the following key components:

- A substantially higher nominal and real growth rate than in the staff's baseline WEO projections. Higher growth is expected to stem mainly from continued implementation of the current structural reform agenda;

- An interim benchmark in FY2018 of a primary deficit for the central and local governments of around 1 percent of GDP. Additional expenditure and revenue measures will be considered if needed to reach the FY2020 target;

- Containing expenditure growth, especially for social security spending, to the trend increase of the past 3 years (approximately 1.6 trillion yen for general expenditures of the central government), taking into consideration economic and price developments;

- Revenue neutral comprehensive tax reform with a focus on supporting low-income households and those with children, securing neutrality with regard to how people choose to work, and securing intra- and inter-generational fairness; and

- Acknowledging the need for flexibility to make sure that the economy will weather the next consumption tax hike scheduled in April 2017 but without specifying measures.

4. In its June 2015 policy meeting, the BoJ left its stance unchanged and announced a new communication framework to provide higher frequency and more detailed forecasts for Japan's economy and prices, which serve as the basis for policy decisions. The changes, which take effect from January 2016, are designed to enhance the transparency of the policy board's decision-making process and include:

- Preparing the Outlook for Economic Activity and Prices on a quarterly rather than a semi-annual basis;

- Releasing each board member's forecasts for growth and prices with a risk assessment;

- Issuing the "Summary of Opinions" in about a week after each monetary policy meeting, providing information about the policy board's debates; and

- Reducing the frequency of monetary policy meetings from around 14 to 8 times a year.

Statement by Mikio Kajikawa, Executive Director for Japan;
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1. We are grateful for the candid dialogue between staff and our authorities during this year's Article IV Consultation, and for the excellent set of papers. The authorities have strongly implemented the economic policy mix, namely the "three-arrows" of *Abenomics*, consisting of aggressive monetary easing, flexible fiscal policy, and structural reforms, in order to end a prolonged period of deflation, revitalize the Japanese economy and advance fiscal consolidation. In what follows, we will briefly explain our authorities' assessment of Japan's economic developments as well as their views and commitments in terms of macroeconomic policies and growth strategy.

Current Developments and Outlook for the Japanese Economy

2. The Japanese economy has continued to recover as a trend, albeit with more than expected fluctuations due to the front-loaded increase in demand prior to the consumption tax hike in April 2014 and the subsequent decline: the real GDP growth during the 1st quarter of 2015 recorded plus 3.9 percent (quarter-on-quarter growth on an annualized basis) and plus 9.4 percent in nominal terms, well above the expectations of market participants and economists, recorded positive growth for the second consecutive quarter. This is due to the resilient consecutive growth in private consumption and business investment.

3. The virtuous cycle from income increase to consumption and investment has been operating steadily in both the household and corporate sectors. For example, the corporate sector is now achieving a higher profitability and, indeed, the total net profit of listed companies at Tokyo Stock Exchange (TSE) hits the highest records as of March 2015. Against the background of the favorable corporate earnings, firms have maintained a proactive stance on investment, as suggested by the large upward revision of investment plan shown in the recent Tankan survey (Short-Term Economic Survey of Enterprises in Japan). The labor market continues to be tight: the unemployment rate has been approaching around 3.3 percent, breaking its bottom record for the first time in 18 years and the ratio of job openings-to-applications have reached the highest level in 23 years. Monthly wages have increased by 2.20 percent after this spring's annual wage negotiations, the highest level in 17 years.

4. Looking forward, consumption and business investment are expected to grow further with the tailwind of favorable business performance, decline in oil prices, and wage hike. The real GDP growth rate in FY2015 is expected to be 1.5 percent, the major contribution of which is stemming from the domestic demand.

Fiscal Policy

5. Fiscal consolidation has made major progress since Abenomics started. Thanks to revenue increase under the resilient economic performance, consumption tax rate hike to 8 percent, and reforms in the expenditure side, the FY2015 budget is projected to achieve the interim target of the halving of the primary deficit to GDP ratio by FY2015 from the ratio in FY2010 (from ▲6.6 percent to ▲3.3 percent). On the other hand, we would like to emphasis here that the government is paying due attention to strike a right balance between revitalizing the economy and fiscal consolidation: the consumption tax hike to 10 percent has been postponed to April 2017, and the FY2014 supplementary budget was formulated, taking into account the economic conditions; moreover, the size of the FY 2015 budget recorded the highest ever.

6. With regard to medium-term fiscal consolidation plan, "*the Plan to Advance Economic and Fiscal Revitalization*," has been formulated on June 30, with the following three pillars: "overcoming deflation and revitalizing the economy", "reforming expenditure measures" and "reforming revenue measures." In this plan, the government firmly maintains the original fiscal target which intends to achieve a primary surplus by FY2020 and put debt steadily on a downward trajectory thereafter. The government, cooperating with the ruling party, considers the plan as effective and concrete. Based on the plan, the government will further strengthen the measures which have been implemented over the past 3 years and make progress in revitalizing the economy and fiscal consolidation. Although staff points out that the fiscal outlook may rely on optimistic growth assumptions, the government will materialize the growth scenario in the plan by steadily revitalizing the economy for the next 5 years and, at the same time, the government will achieve the 2020 fiscal target of a primary surplus by making continued efforts of expenditure reform in line with the past developments.

7. The abovementioned plan stipulates that the progress of fiscal consolidation will be assessed in FY2018 against the interim benchmarks of achieving approximately 1 percent of the primary deficit to GDP ratio in FY2018, and intensive reforms will be implemented by then. For instance, on the expenditure side, the recent 3-year efforts to manage the expenditure size shall be continued toward FY2018, taking into account the total rise of expenditure being contained to 1.6 trillion yen from FY2013 to FY2015 and the economic and price development. (In the same manner, with regard to social security expenditures, the recent 3-year efforts to manage its size shall be continued toward FY2018, taking into account the outcome of economic reforms, the rise of its expenditure (approximately 1.5 trillion yen) being attributable to the population aging, and the economic and price development.) In assessing the progress of the reforms on both the expenditure and the revenue sides at the mid-term review in FY2018, additional measures in expenditure and revenue will be considered, if necessary, to achieve the FY2020 fiscal target, while maintaining the goal of overcoming deflation and economic revitalization.

8. On the revenue reform, the consumption tax hike to 10 percent will surely be implemented in April 2017 in order to sustain the social security system. In addition, the pro-growth corporate tax reform will be completed shortly. Furthermore, given the economic and social structural changes including population aging, the government will proceed with a comprehensive overhaul of the tax system in a prompt manner.

Monetary Policy

9. The quantitative and qualitative monetary easing (QQME), which the Bank of Japan introduced in April 2013 and expanded in October of last year, has been producing the intended effect: with a virtuous cycle from income to spending likely to maintain steadily in both the household and corporate sectors under the QQME, Japan's economy is expected to continue growing at a pace above its potential. The underlying trend in inflation has steadily been improving against the background of the improvement of output gap and the increase of inflation expectation. The BOJ expanded QQME in October 2014 since there is a risk in the short term that changing people's deflationary mindset will be delayed by the substantial decline in crude oil prices and somewhat weak developments in demand following the consumption tax hike. Looking at developments in inflation expectations thereafter, market-based indicators and various survey results have not declined despite the fall in crude oil prices.

10. Looking ahead, although staff emphasizes that it would take more time than expected to achieve the price stability target of 2 percent, the BOJ expects that the improvement in the output gap and an increase in inflation expectations are likely to continue, and thus the underlying trend in inflation is expected to steadily rise. Although the timing of the year-on-year rate of increase in the CPI reaching around 2 percent depends on developments in crude oil prices, this is projected to happen around the first half of fiscal 2016, assuming that crude oil prices will rise moderately from the recent level. The BOJ believe that this forecast is consistent with the commitment to achieving the price stability target at the earliest possible time, with a time horizon of about two years. That said, if there are changes in the underlying trend in inflation and it is deemed necessary to take action in order to achieve 2 percent inflation, the BOJ will make adjustments as appropriate without hesitation.

11. With regard to the communication strategy, staff insists that the BOJ needs to strengthen the strategy to anchor the market expectation. Actually, the BOJ decided at the monetary policy meeting (MPM) held in June to further enhance deliberations at the MPMs and the BOJ's communication on monetary policy: the BOJ will increase the frequency of publication of the outlook report from the current semiannual basis to a quarterly basis; each member's forecasts and risk assessments will be released; summary of opinions presented at each MPM will be released in about a week after the meeting. Those changes will take effect in January 2016.

Growth Strategy

12. The third arrow (growth strategy) is critically important to end a prolonged period of deflation and revitalize the Japanese economy and advance fiscal consolidation. Strengthening a virtuous cycle from favorable business performance to the increase in investment and wages, and hence consumption, is warranted to ensure self-sustaining growth led by private demand and materialize revenue increase. Necessary measures to make effective use of retained earnings, exceeding 60 percent of GDP, are already undertaken, including the corporate governance reforms, the coordination at the Trilateral Partnership Forum by representatives of employers, labor unions and political leaders, and the pro-growth corporate tax reform.

13. For example, regarding corporate governance, the authorities have been working to promote changes in corporates' behavior through corporate governance reforms. In June, the *Corporate Governance Code* was formally introduced and all listed companies are now asked, in comply-or-explain basis, to appoint at least two outside directors, and to disclose overall policy and voting criteria of cross-shareholding. The *Japan's Stewardship Code*, which encourages investors to fulfill their fiduciary duties for their clients, has been adopted by more than 190 institutional investors, including the Government Pension Investment Fund (GPIF), one of the largest pension funds in the world. We have already observed concrete fruits of these reforms through increase in ROE (raises from 5.8 percent in the 4Q of 2012 to 8.5 percent in the 1Q of 2015), share buy-backs, and capital investments.

14. Furthermore, the authorities established the abovementioned Trilateral Partnership Forum with the aim to strengthen momentum for wage increases. This framework has contributed to 2.20 percent average increase in monthly pay by Japanese companies in this spring wage negotiations, which was the highest in 17 years. The wage increase momentum is spreading among SMEs as well and is expected to be a large tailwind for a resilient recovery.

15. With regard to the corporate tax reform, the government will reduce the percentage level of effective corporate tax rates down to the twenties over several years, combined with broadening tax bases. The first phase of reductions is already in place: reducing the rate by 2.5 percent in FY2015 and by 0.78 percent in FY2016. The government facilitates companies through the reform to enhance their competitiveness and earnings by imposing more tax burden on underperformance companies while mitigating tax burden to favorable performance companies.

16. Another crucial issue facing Japan is declining labor force and, as staff rightly indicates, enhancing female labor force participation is crucial. Substantial resources in FY2015 budget has been allocated to the area including providing for sizable increase in child care facilities. As of the end of FY2014, additional childcare capacity for

approximately 0.2 million children was secured, and, on top of that, 0.2 million capacity will be added by the end of FY2017. We have already observed concrete fruits in this area as well; the number of employees has already increased by 0.9 million since Abenomic started and women's labor participation rate at ages 25-44 has increased from 70.9 percent to 74.3 percent for the last 2 years. More enterprises now adopt females as executive members or management level employees.

17. Regarding the tourism, with the tailwind of the deregulation of visa requirement in Asian countries and deregulation in Tokyo Haneda airport, the number of foreign tourists visited Japan hit a record of 13.4 million in 2014, and the pace from January to May in 2015 is increasing further by 44.9 percent compared to that in 2014. As a result, the travel balance has now turned to surplus. The government will make continued efforts to improve tourist environment to be ready to accept 20 million tourists from abroad in near future.

18. The government announced in June the revised version of *the Japan Revitalization Strategy*, an updated growth strategy, and the strategy will be kept evolving going forward. The strategy includes a wide range of agenda, but the government will surely implement the revised strategy in a prompt manner.

Financial Sector

As shown in the fact that all banks meet the safety and soundness concerns such as capital adequacy ratio, Japan's financial system remains, overall, sound and stable. The NPL ratio has been kept low and banks' net incomes remain high. In terms of interest rate risks, the Japanese banks have resilient enough to address risks stemming from higher interest rates, supported by their ample capital base. In this regard, my authorities continue to make efforts toward monitoring and assessing risks and strengthening stability of our financial system, taking into account the staff's views.

Spillovers

19. We take note of the staff's view that, without bolder structural reforms and credible fiscal consolidation, domestic demand could remain sluggish and the outward spillovers may turn negative. Our authorities continue to make efforts toward the implementation of all three arrows of Abenomics and boosting domestic demand. In this light, the goal of Abenomics is achieving a positive economic growth cycle through an increase in corporate performance, incomes, investments and, most importantly, consumption. It is expected that, in FY2015, economic growth is led by not external but domestic demand.

20. In terms of capital flows, it is worth noting that, after Abenomics has taken place, capital outflows to other countries are significantly increasing. For instance, on the back of the QQME, banks, insurance industry, and pension funds including the GPIF, have

rebalanced their portfolios and started to reallocate their investments to foreign assets. Japanese banks, in this context, have actively increased their foreign investments and loans, inter alia, for Asian countries, as their net foreign assets increased to 3.4 trillion USD as of the end-March this year, which is record high. Furthermore, foreign direct investments by the Japanese firms reached 12.8 trillion yen last year from 9.8 trillion yen in 2012, mainly toward North America and the ASEAN countries.

21. We have been implementing the fiscal consolidation and further consolidation efforts are clearly needed. We, however, would like to highlight here the positive side of our fiscal consolidation implemented in a different timing from other major economies; if Japan had implemented fiscal consolidation in parallel with the US and the euro area, the negative spillover would have been synchronized, resulted in larger impact on global economy as a whole. In other words, such differences in the timing of the consolidation efforts contribute to minimizing negative impact on the global economy and hence have positive spillover to support the global recovery momentum.