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March 30, 2022

**Statement by Mr. Stephan and Ms. Khademi on Japan
(Preliminary)
Executive Board Meeting
April 1, 2022**

We thank staff for their comprehensive and insightful set of reports and Mr. Tanaka, Ms. Kashima, Mr. Naka, and Ms. Ogihara for their helpful Buff statement. We broadly concur with staff's assessment.

Economic Outlook and Risks

Japan has weathered the pandemic with mixed results so far. On the one hand, cases have been contained well below most peers, even without having to resort to large-scale lockdowns. On the other hand, although substantial macroeconomic support measures were taken, economic activity has recovered only moderately from its initial pandemic-related contraction. However, staff now projects robust growth over this year and the next, also supported by the release of pent-up consumption demand. *Could staff elaborate on the catch-up effects experienced after previous waves? What role does foregone consumption in services play in this regard?* At the same time, the country appears fairly insulated from inflationary pressures weighing on the economic outlook in other major economies. As the pandemic-related reaction has further stretched the limits of macroeconomic policies, the critical role of structural reforms to unlock the country's substantial productivity reserves becomes even more pronounced.

Fiscal Policy

Decisive consolidation is necessary to transition to a more sustainable fiscal position. We echo Staff's call for rebuilding fiscal buffers and ensuring debt sustainability over the medium to long term. While we agree that the debt rollover and issuance risks are low in the near term, we expect debt sustainability risks to increase with higher global interest rates and unfavorable demographic trends. We see particular merit in installing an adequately tight and binding medium-term fiscal framework along staff's suggestions. We especially second staff's call for more realistic fiscal projections – ideally made by an independent institution. We recognize the authorities' continued

commitment to achieving a neutral primary balance by 2025. To not lose track of this target, we agree with Staff that fiscal adjustment will require measures both on the expenditure (e.g. containing age related expenditures) and revenue side (e.g. increasing tax revenues).

Monetary Policy

We broadly concur with Staff's view that the Bank of Japan's accommodative monetary policy stance remains appropriate to support reflation efforts, in view of the Staff's projections pointing to inflation remaining below the central bank's 2% inflation target. Allowing for more fluctuation around the Yield Curve Control (YCC) target and increasing flexibility in ETF purchases have widened monetary leeway and improved market functioning. Still, the bank's dominant role in financial markets as well as the detrimental effect of the low interest environment on bank profitability – amongst other factors – pose challenges for financial stability. *Could staff share their view on the potential need for write-downs in the banking sector on the expanded lending from Covid-19 programs?* Moreover, we encourage the authorities to continue to improve the macroprudential framework, including the systemic risk assessment and toolkit.

We take note of staff's recommendation to consider reducing the policy rate further into negative territory. As we recall, the introduction of negative interest rates in 2016 led to a pronounced decline and flattening of large parts of the yield curve, ultimately pressing the Bank of Japan to intervene by once again reviewing the monetary framework and introducing YCC after only a few months. *How does staff judge the potential for unintended consequences (for example due to the widening international interest rate differential) of a further reduced policy rate under current circumstances?*

Structural Reforms

Reinvigorating the structural reform drive will be key to brace for the challenges ahead. Not least with a view to the demographic projections, boosting labor supply and unlocking productivity reserves are of primary importance. As recommended by staff, measures to strengthen female and elderly labor force participation should go hand in hand with efforts to increase the quality of employment and reducing labor market duality. Closing digitalization gaps will provide additional momentum for productivity growth. We welcome the authorities' reinforced commitments to reduce carbon emissions. As staff, we see merit in strengthening price signals, which would also increase efficiency.