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March 20, 2023

**Statement by Ms. Marcussen and Mr. Slettvag on Japan
(Preliminary)
Executive Board Meeting
March 22, 2023**

We thank staff for the insightful report and for the topical Selected Issues Papers. We also thank Mr. Mizuguchi, Ms. Kashima, and Ms. Ogihara for their helpful BUFF statement and discussions. We welcome that the recovery in the Japanese economy has firmed, driven by strong domestic demand. Inflation has reached multi-decade highs, with more wide-spread price increases in recent months. In this environment, we support staff's call for more targeted fiscal support alongside steps from the BOJ to further increase flexibility in longer term yields. Structural reforms should play a more significant role in promoting sustainable and inclusive growth and we welcome the recent policy package focusing on green and digital transformation, measures to address risks associated with the ageing population, and reforms in the labor market. We broadly agree with the staff appraisal and offer the following comments for emphasis.

Amid a tight labor market, rising inflation, and fiscal vulnerabilities, the authorities should stand ready to withdraw fiscal policy support more quickly. We note that the primary deficit for FY 2023 remains elevated at 6.2 percent and agree with staff that the projected fiscal support risks aggravating fiscal vulnerabilities and adding to inflation with limited impact on output. Moreover, we share staff's concern that frequent use of supplementary budgets risks undermining fiscal discipline and should be limited to responses to large and unexpected shocks.

Medium-term fiscal consolidation, underpinned by a credible framework, is needed to put public debt on a downward path. As noted in the BUFF statement, Japan's fiscal position has become "unprecedentedly severe" following the pandemic, and we note from the

DSA that the public debt is expected to remain on an upward path under current policies. While debt vulnerabilities are mitigated by long average maturity and a large domestic investor base, we share staff's concerns that rising debt levels may erode fiscal buffers and expose Japan to a range of shocks. In this regard, we welcome the efforts to contain costs related to health and long-term care, while stressing the need for protecting the most vulnerable. Given Japan's relatively low tax revenues, we urge the authorities to accelerate efforts to increase government revenue in line with staff's advice.

We agree with staff that risks to inflation are two sided, with the upside likely most prominent in the short term. Considering the history of very low inflation in Japan, and the fact that inflation so far has been driven predominantly by cost-push factors, we understand the authorities' focus on downside risks to price developments. At the same time, with inflation rising to the highest level in more than 40 years and the share of price-increasing items rising steadily, we agree with staff's recommendation to consider upside risks to inflation that could challenge the status quo. How wage growth responds to unprecedented cost-of-living pressures is key in this regard, and we welcome staff's useful analysis in the SIP III. While the passthrough from inflation to overall wages has been limited so far, we note that wages have tended to respond to core inflation with a one-year lag, indicating that the most significant pass through may be ahead of us. *Could staff provide an update on the ongoing wage negotiations for spring 2023?*

Strong pressures against the ceiling of the 10-year JGB yield target have required the BOJ to undertake record JGB purchases with wide ranging side effects. Against this backdrop, **we agree with staff on the benefits of pursuing further flexibility in longer term yields to better manage inflation risks and address side effects.** Moreover, we thank staff for the alternative scenario on sustained inflationary pressures which, together with the SIP IV on the JGB yield curve and macro financial stability, provide timely insights into the potential effects of a policy normalization from the BOJ. *Could staff elaborate on degree of duration risk and the ability of Japanese banks to absorb (short term) negative impacts on bond valuations?*

Japan's upgraded target for emissions reduction by 2030 is commendable and will require determined action to promote the green transition. To this end, we welcome the new policy initiatives laid out in the BUFF statement to accelerate decarbonization efforts in the private sector, and encourage the authorities to accelerate work on expanding the carbon pricing framework. We agree with staff that the distributional consequences of the transition need to be well-managed to protect vulnerable parts of society and maintain support for mitigation measures. As shown in SIP VI, early efforts will also be needed to align corporate strategies with national level emission reduction targets to reduce the risk of disorderly

adjustment. Finally, in addition to large investments in renewable energy, achieving Japan's ambitious emission goals will likely require concrete policies to reduce reliance on fossil fuels, in particular to phase out the use of coal.