

**FOR
AGENDA**

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INFORMATION

July 3, 2002

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Japan—Staff Report for the 2002 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2002 Article IV consultation with Japan, which is tentatively scheduled for discussion on **Wednesday, July 24, 2002**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Japan indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Ostry (ext. 37405) and Mr. Callen (ext. 38873) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Friday, July 12, 2002; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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JAPAN

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the
2002 Consultation with Japan

(In consultation with other departments)

Approved by Yusuke Horiguchi and Leslie Lipschitz

July 2, 2002

- This report is based on discussions held in Tokyo during April 4–12. The staff team comprised Messrs. Horiguchi (head), Ostry, Kalra, Kang, Baig, Nagaoka (all APD), Mr. Hayward (MAE), and Mr. Dell’Ariccia (RES). Mr. Toyama (Alternate Executive Director) attended the official meetings. Supporting information and analysis are provided in a companion *Selected Issues* paper. A small staff team will return to Tokyo in mid-July for an update on economic and policy developments.
- The team met with senior officials at the Cabinet Office (CAO); Ministries of: Public Management, Home Affairs, Posts and Telecommunications (MPHPT); Finance (MoF); Health, Labor and Welfare (MHLW); Agriculture, Forestry and Fisheries (MAFF); Economy, Trade and Industry (METI); Land, Infrastructure and Transport (MLIT); the Financial Services Agency (FSA); Bank of Japan (BoJ); Deposit Insurance Corporation (DIC); Resolution and Collection Corporation (RCC); and with business and financial sector representatives.
- Japan has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange system is free of restrictions on the making of current international payments and transactions apart from those notified under Decision 144 (see Annex I).
- Japan has subscribed to the Special Data Dissemination Standard.
- The principal author of this report is Mr. Ostry.

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I. INTRODUCTION

1. **At the time of last year's Article IV consultation, the Japanese economy was slowing in the context of weakening global activity.** Against this background, Directors expressed concern that the economy could re-enter a cycle of recession, rising bankruptcies, and a deteriorating banking system. They welcomed the Koizumi government's commitment to implement deep structural reforms to lay a foundation for healthy medium-term growth, and saw need for supportive macro policies to underpin activity in the near-term (Annex I).

2. **In the event, last year's downturn was more severe than expected, and Japan suffered its third—and deepest—recession of the past decade.** While the economy has since rebounded, sustained recovery is not assured. Strong activity in early 2002 has been narrowly-based on exports and public demand amid weak underlying private domestic demand.

3. **While external factors prompted last year's downturn, it is longstanding structural weaknesses that continue to impede self-sustained economic growth in Japan.** In particular, the failure to deal with the debt and capital overhangs from the bubble years or to embrace a regulatory regime that facilitates the economy's adjustment to globalization and technical change have undermined productivity and growth (Bayoumi and Collins, 2000).

4. **Continuing banking weaknesses magnify the risks from following a “muddle-through” strategy that leaves economic problems to fester.** While a modest cyclical recovery seems likely this year, the economy remains vulnerable to shocks, particularly if the rebound engenders policy complacency. Banks' deteriorating asset quality and exposure to the stock market heighten the risk of bank failures and a credit crunch. The potential impact of surging bankruptcies and unemployment on confidence and activity could be severe.

5. **The government of PM Koizumi has recognized the need to address Japan's fundamental economic problems.** A strategy was set out last year encompassing banking reform, fiscal consolidation, and deregulation, but it was less than fully fleshed out, and implementation has been slower and less complete than hoped, undermined by resistance from within the LDP and other interests. The recent “anti-deflation” packages affirmed the government's reform plans, but contained few new initiatives. Popular support of the PM has plunged, which may make it more difficult to secure Diet approval of reforms in the future.

6. **To address the decade-long slump and the current deflation, the staff sees no option but to move ahead forcefully with bank and corporate restructuring in the context of supportive macro policies designed to limit any short-term adverse impact on economic activity and deflation.** The staff's strategy has four interlinked pillars:

- *Deal decisively with financial sector weaknesses.* Loan classification standards need to be strengthened to ensure the deterioration in asset quality is recognized fully and promptly, and provisions against loan-losses raised to appropriate levels. To offset the impact on regulatory capital, viable banks will need to raise private capital or receive public funds subject to strong conditionality. Exit of nonviable banks and a scaled-down role of government financial intermediation are necessary to improve bank profitability. Steps are needed to strengthen supervision over life insurance firms.

- *Accelerate corporate restructuring.* Banks—which still provide the bulk of corporate financing in Japan—should take the lead in agreeing strong restructuring plans with their troubled-but-viable borrowers, while moving quickly to liquidate nonviable debtors and rapidly dispose of their assets. The RCC should do more to invigorate Japan’s distressed debt market. Regulatory reforms are needed to raise productivity and secure new investment and job opportunities as economic restructuring proceeds.
- *Set out a credible medium-term fiscal consolidation strategy.* Given the size of the fiscal imbalance, a credible strategy is needed to maintain investor confidence, and reforms that will facilitate consolidation need to be legislated promptly. However, in the near term, and to the extent that economic restructuring is vigorously pursued (possibly generating further headwinds against economic activity), the fiscal stance should remain broadly neutral so as not to endanger the fragile cyclical recovery.
- *Targeting monetary policy at securing an early end to deflation.* To date, the BoJ’s gradual quantitative easing has had a limited impact, deflationary pressures have not subsided, and recently the yen has strengthened. A bolder approach is needed—comprising a public commitment to end deflation within 12–18 months, backed by further quantitative easing. Such a policy may result in some yen weakening, but regional concerns should be limited if this takes place as part of an integrated policy package to restore healthy growth in Japan.

II. RECENT ECONOMIC AND POLICY DEVELOPMENTS

7. **In 2001, Japan experienced its third—and worst—recession of the past decade.** After a strong first quarter, real GDP fell for three successive quarters, with a drop of ½ percent on an annual basis, compared to 2¼ percent growth in 2000 (Table 1; Figure 1).

8. **The slump was largely attributable to the reversal of the engines of growth in 2000—business investment and net exports.** With the global IT downturn last year, profits, investment, and exports plunged, the latter leading to a sharp turnaround in the external sector’s contribution to growth (Figures 2 and 3). Private consumption remained anemic in the face of weak incomes and uncertain job prospects.

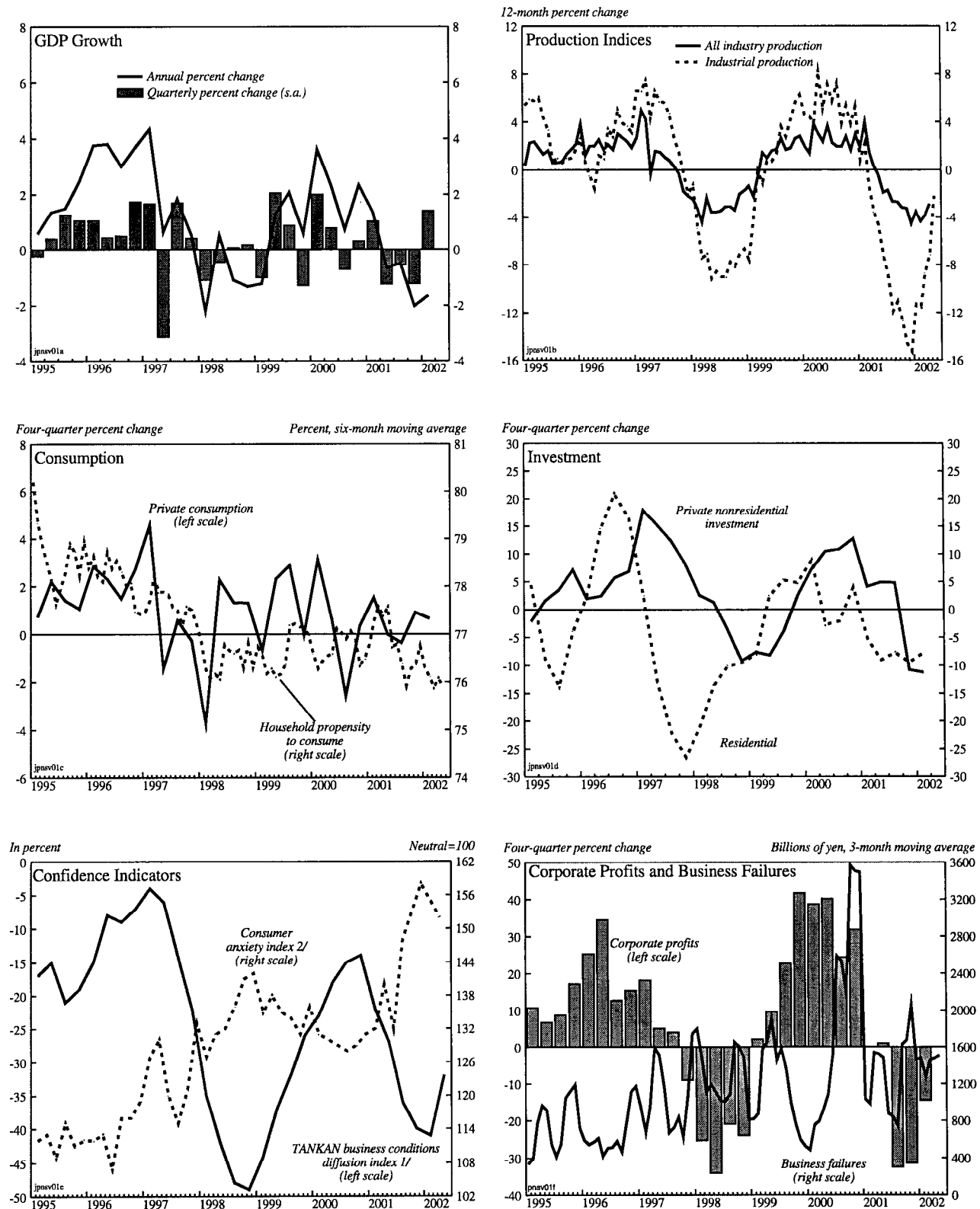
	2000	2001	2002 Proj.	2001 Qtr 2	2001 Qtr 3	2001 Qtr 4	2002 Qtr 1
Real GDP 1/	2.2	-0.5	-0.5	-1.2	-0.6	-1.2	1.4
Of which:							
Private final domestic demand	2.5	0.1	-1.7	-0.5	-0.8	-1.4	0.4
Private consumption	0.3	0.5	1.6	-1.1	-1.7	1.9	1.6
Residential investment	1.8	-7.8	-3.2	-6.4	1.0	-0.2	-2.3
Business fixed investment	10.3	0.6	-12.0	2.6	1.6	-12.0	-3.2
Government consumption	4.6	3.1	2.5	1.6	-0.3	0.4	1.2
Public investment	-9.8	-4.5	-2.7	-10.7	2.8	-2.4	4.1
Stockbuilding (contribution)	0.0	0.0	0.0	0.0	-0.1	0.0	0.0
Foreign balance (contribution)	0.5	-0.7	0.6	-0.3	0.1	-0.1	0.7

Sources: DRI-WEFA, Nomura database; and staff projections.

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

9. **The economy rebounded strongly in the first quarter of 2002.** Global recovery underpinned a large net export contribution, while special transitory factors—including unseasonably warm weather and anomalies in the small single-family spending survey—boosted household spending. Earlier fiscal stimulus measures boosted public demand, but business and residential investment continued to slump.

Figure 1. Japan: Selected Economic Indicators, 1995-2002

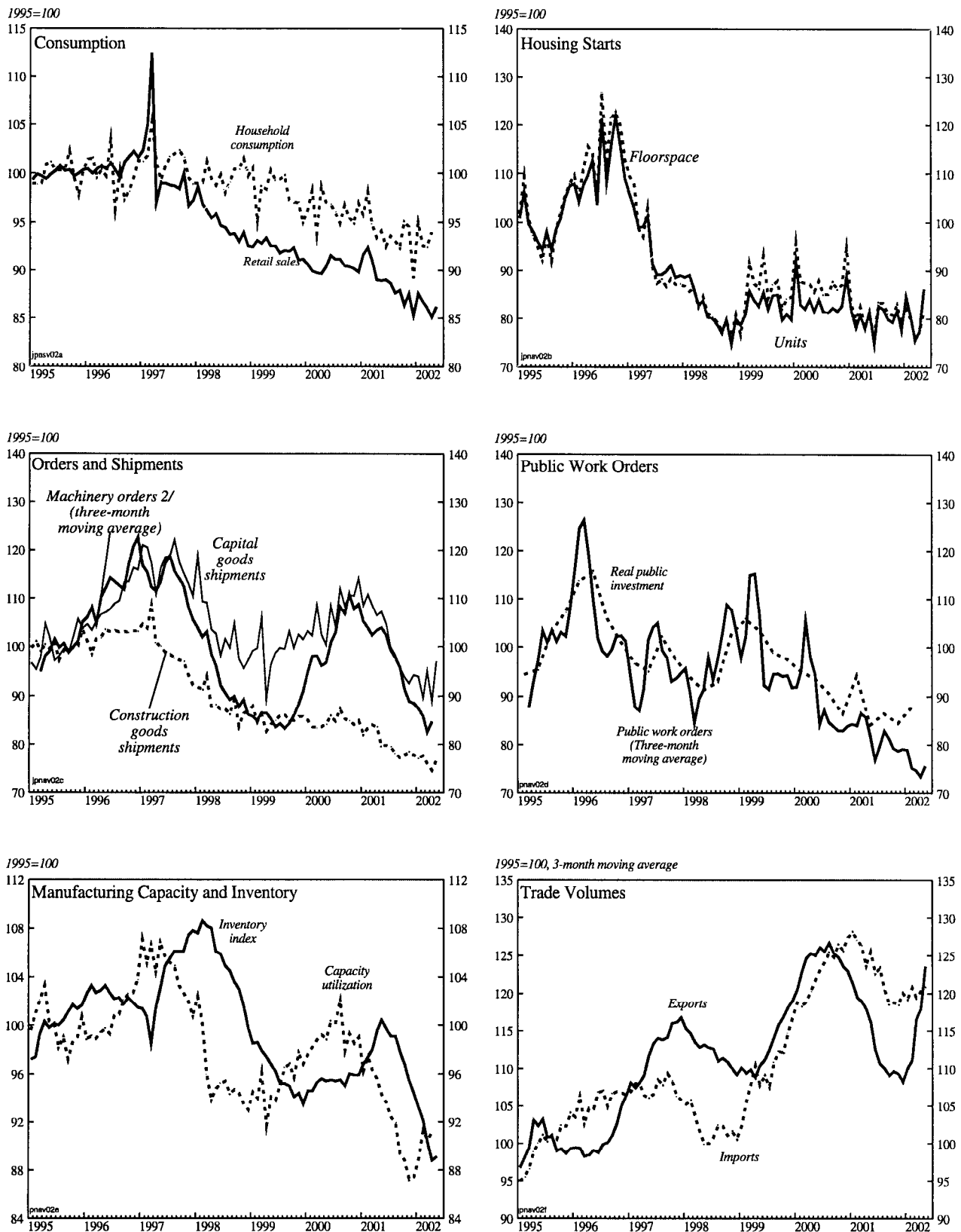


Sources: Nikkei Telecom; WEFA, Nomura Database; and Nippon Research Institute.

1/ "Favorable" minus "unfavorable".

2/ Higher number implies greater degree of consumer anxiety about future prospects.

Figure 2. Japan: Monthly Indicators of Real Activity, 1995-2002 1/



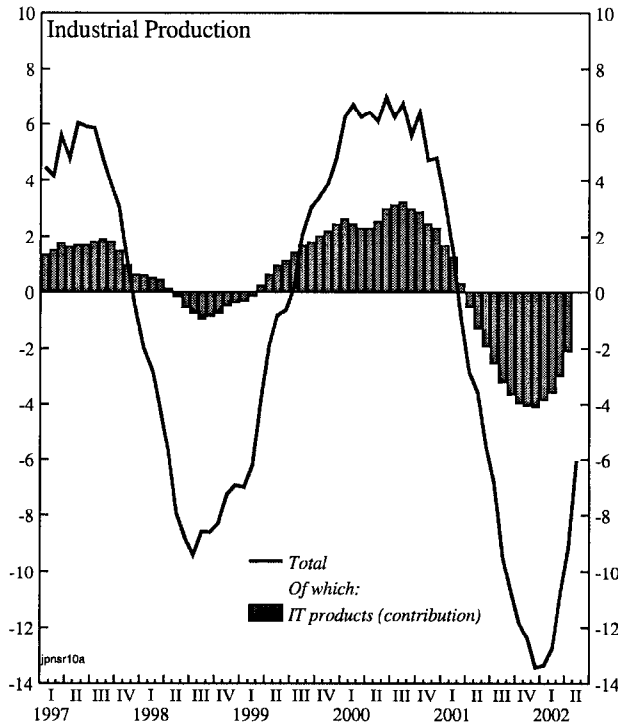
Source: DRI-WEFA, Nomura Database.

1/ Seasonally adjusted data.

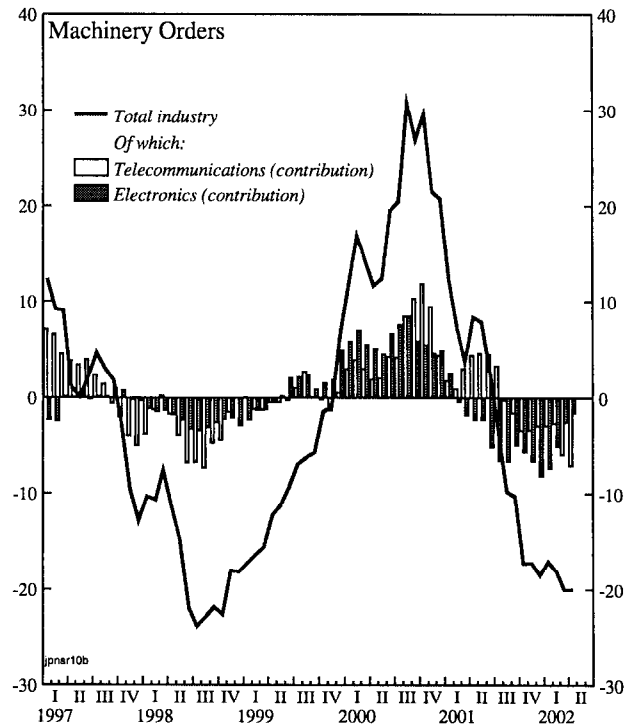
2/ Excluding ships and public utilities.

Figure 3. Japan: Information Technology Indicators, 1997-2002

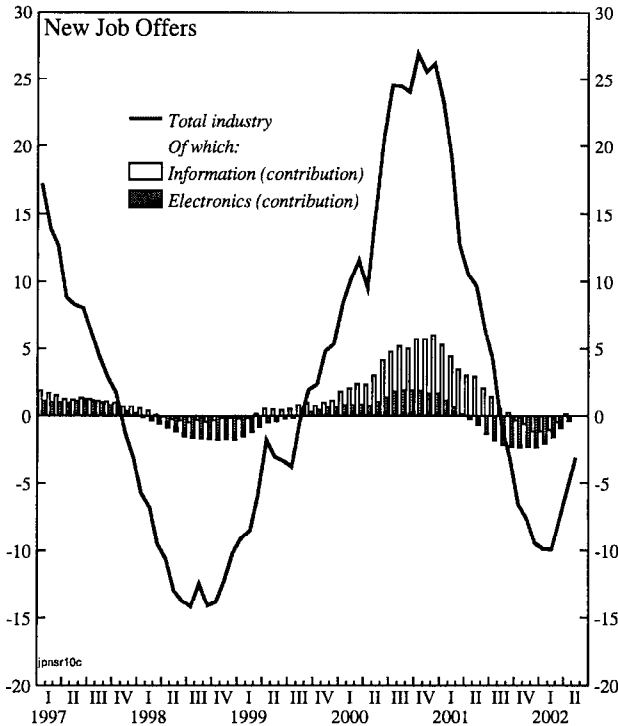
Twelve-month percent change; three-month moving average



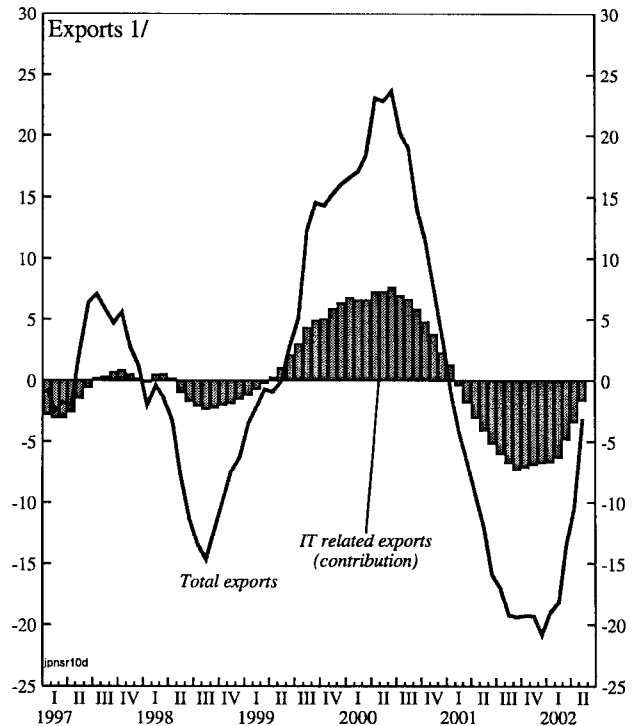
Twelve-month percent change; three-month moving average



Twelve-month percent change; three-month moving average



Twelve-month percent change; three-month moving average



Sources: Ministry of Economy, Trade and Industry; Cabinet Office; Ministry of Finance; and Japan Tariff Association.

1/ Customs clearance basis; in U.S. dollar terms.

10. **The quarterly national accounts remain highly volatile, however, and staff have had to rely on other indicators to assess developments.** Data on private consumption are particularly poor, being based on volatile small-sample surveys (Annex II). A major overhaul in the methodology will be introduced shortly to try and address some of the statistical weaknesses, and this could have implications for GDP estimates back to 2000. The all-industries production index—the best output-based measure of activity—paints a bleaker, and likely more realistic, picture of the economy in 2001, and suggests a more modest pace of recovery in the first quarter of 2002 than do the national accounts.

11. **Despite the recent rebound, the degree of slack in the economy is likely still greater now than during the 1998 recession.** Capacity utilization rates in manufacturing are near post-bubble lows, while the staff's production-function based estimate of the output gap stood at 3½ percent of potential GDP in early 2002.

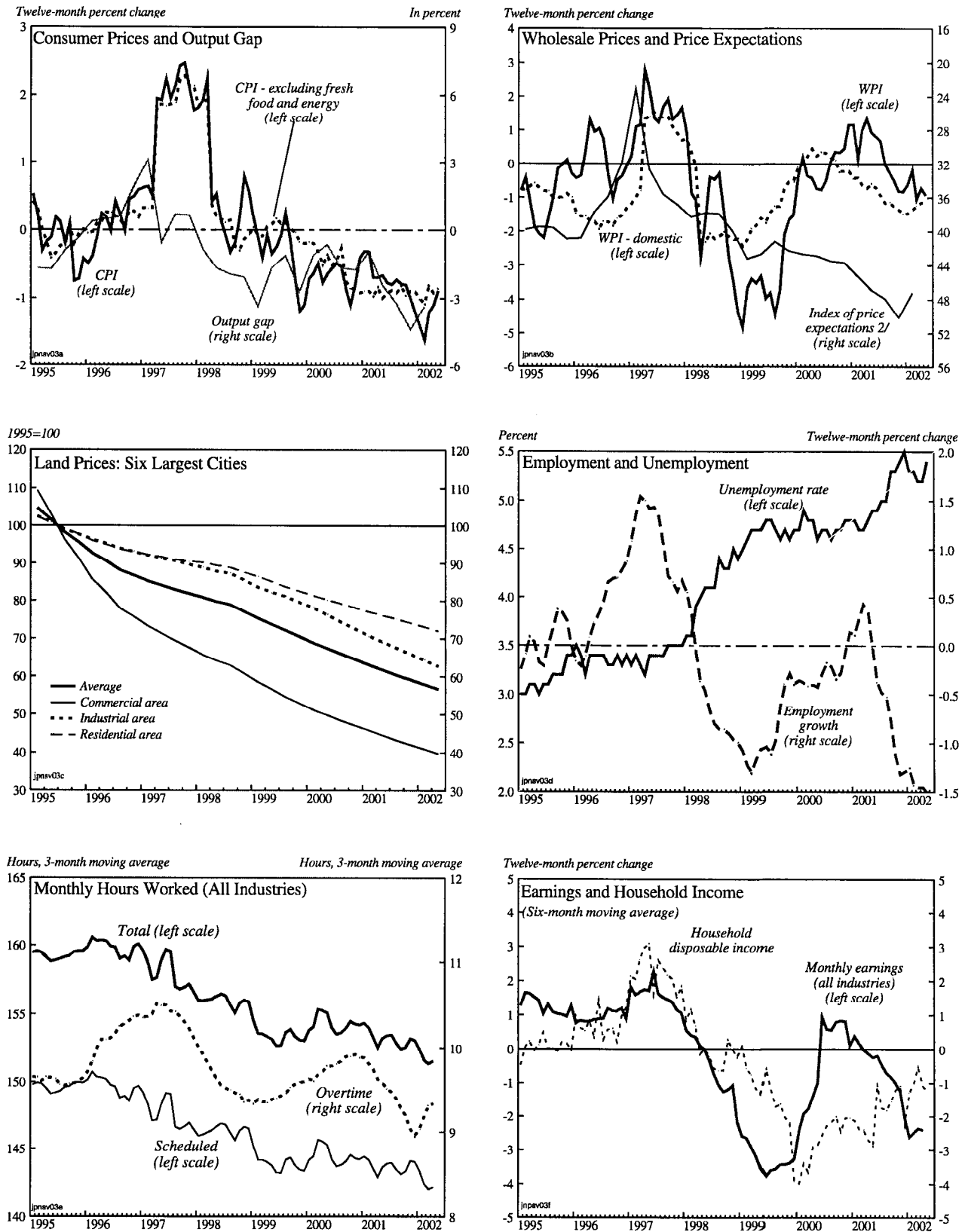
12. **Firms have responded to this slack by cutting jobs, and the unemployment rate has risen to a near-record high.** Labor market adjustment has been much more rapid than in the 1998–1999 recession, as 2 percent of the workforce have been retrenched, and the unemployment rate has risen from 4.7 to 5.4 percent (Figure 4). Total earnings declined by 1½ percent over the past year, partly due to a sharp decline in overtime pay.

13. **Deflation persists, magnifying real debt burdens.** In terms of the core CPI (which excludes fresh food and energy), deflation remains at 1 percent. While relative price declines for telecommunications, household goods, and clothing may reflect structural change—e.g., telecoms deregulation and increased imports from Asia—ongoing deflation in the general price level is likely due to weak demand and the output gap. Land prices have also continued to fall, and surveyed expectations point to ongoing deflation. Reflecting these trends, nominal GDP has fallen by 2½ percent in the past year, magnifying corporate debt burdens and contributing to a surge in bankruptcies to their highest level since 1984.

14. **Following last year's narrowing, the current account surplus widened strongly in the first quarter of 2002.** The trade surplus—which had narrowed sharply during 2001 as the global slowdown took its toll on exports—widened as export volumes recovered and imports declined. Strong profits from overseas subsidiaries of Japanese companies (recorded in the statistics with a lag) and a decline in payments overseas also boosted the investment income surplus. In the financial account, outward direct investment has increased as companies have sought to improve competitiveness by relocating operations overseas.

15. **Equity prices, which spiraled downwards last year amid the deterioration in the economy, rebounded during March–May 2002, but followed world markets down in June.** In contrast to other major stock market indices, the Nikkei and Topix did not rebound from their September lows through February, with both indices falling by one-half from their cyclical peaks in March 2000, as bank stocks weighed heavily on the market (Figure 5). As well as the sharp deterioration in the earnings outlook, structural factors—including the continued unwinding of cross shareholdings between banks and corporates—impacted the market. The stock market's rally in March coincided with a tightening of short-selling regulations on equities, but improved foreign sentiment toward Japanese stocks amid the

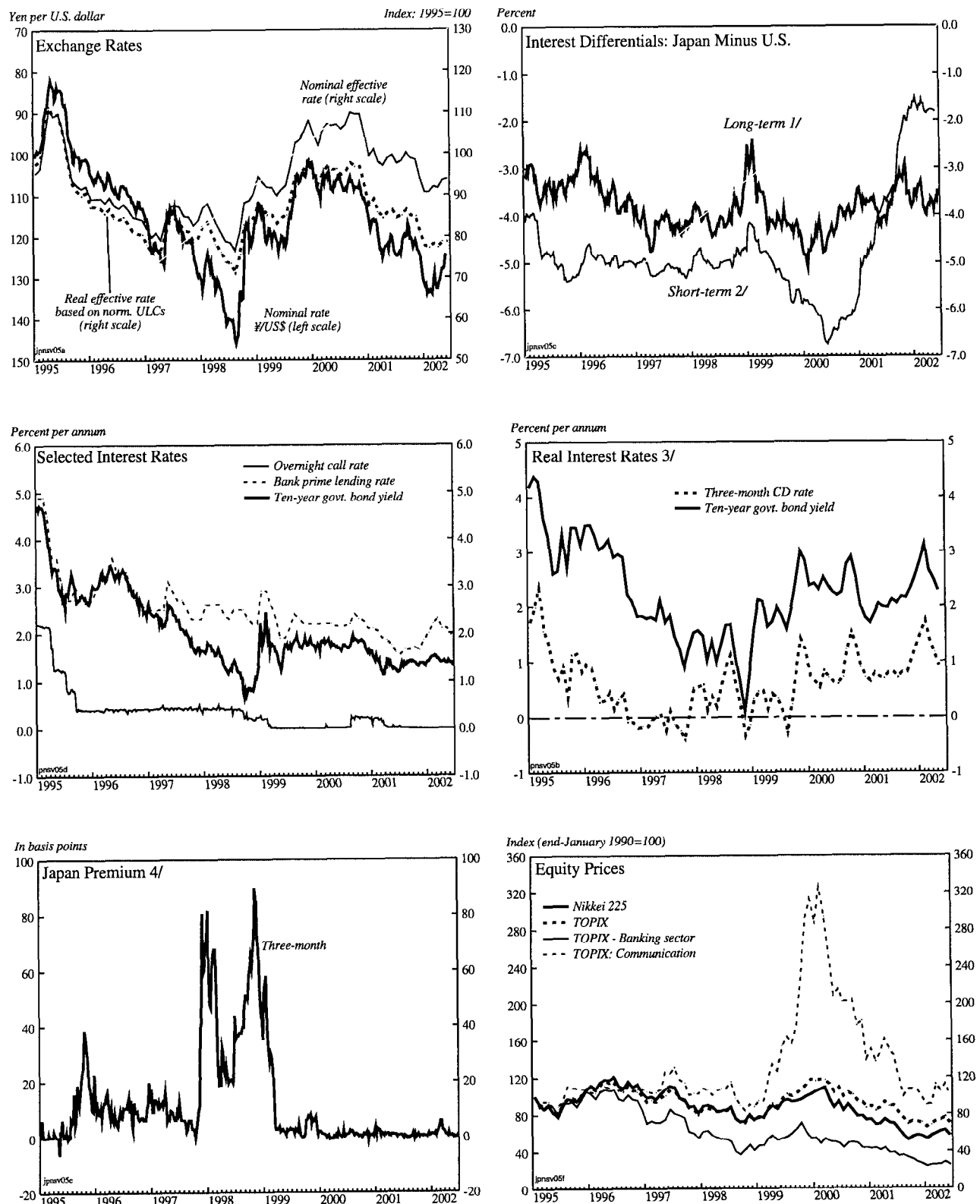
Figure 4. Japan: Price and Labor Market Indicators, 1995-2002 1/



Source: DRI-WEFA, Nomura Database.

1/ Seasonally adjusted data except for land prices, household income, and monthly earnings.
2/ Those expecting prices to decline (from consumer sentiment survey).

Figure 5. Japan: Financial Indicators, 1995-2002



Sources: IMF, Information Notice System; Nikkei Telecom; Bank of Japan; WEFA; and Bloomberg, LP.

1/ Ten-year government bond yield.

2/ Three-month CD rate.

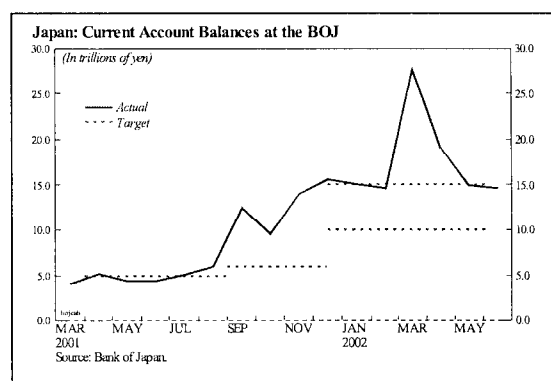
3/ Deflated by CPI adjusted for changes in indirect taxes and administered prices.

4/ Average U.S. dollar LIBOR of Fuji Bank, Bank of Tokyo-Mitsubishi, and Norinchukin bank minus the LIBOR fix from 1/21/1999; previously, Sumitomo Bank was included in the average.

strengthening of the global economy sustained the rebound. The Nikkei and Topix dropped 10–15 percent from their recent peaks during June, broadly in line with other major indices.

16. **The yen was under downward pressure for most of the past year, but reversed course from March 2002.** Following its downtrend in the first half of 2001, the yen briefly rallied in the wake of the September 11 terrorist attacks. Subsequently, Japan's currency weakened sharply against the U.S. dollar through early March 2002. From then on, and despite significant intervention to stem its rise, the yen has strengthened, especially against the U.S. dollar which has weakened in world markets. This said, the yen remains 5–10 percent depreciated in nominal and real effective terms (CPI and ULC basis) relative to average levels in 2001, and 10–20 percent below 2000 levels.

17. **Since the introduction of its quantitative framework in March 2001, the BoJ has gradually raised its operating target for current account balances** (bank and nonbank reserves at the BoJ). The BoJ first increased the target in August, and then again in December. In the runup to the removal of the blanket deposit guarantee in March, moreover, the BoJ allowed current account balances to exceed the target, and it stepped up its outright JGB purchases (*rinban* operations) to ¥1 trillion a month from February. Notwithstanding the impact on base money—which saw year-on-year growth of 30 percent in May 2002—broad money and bank lending have not responded.

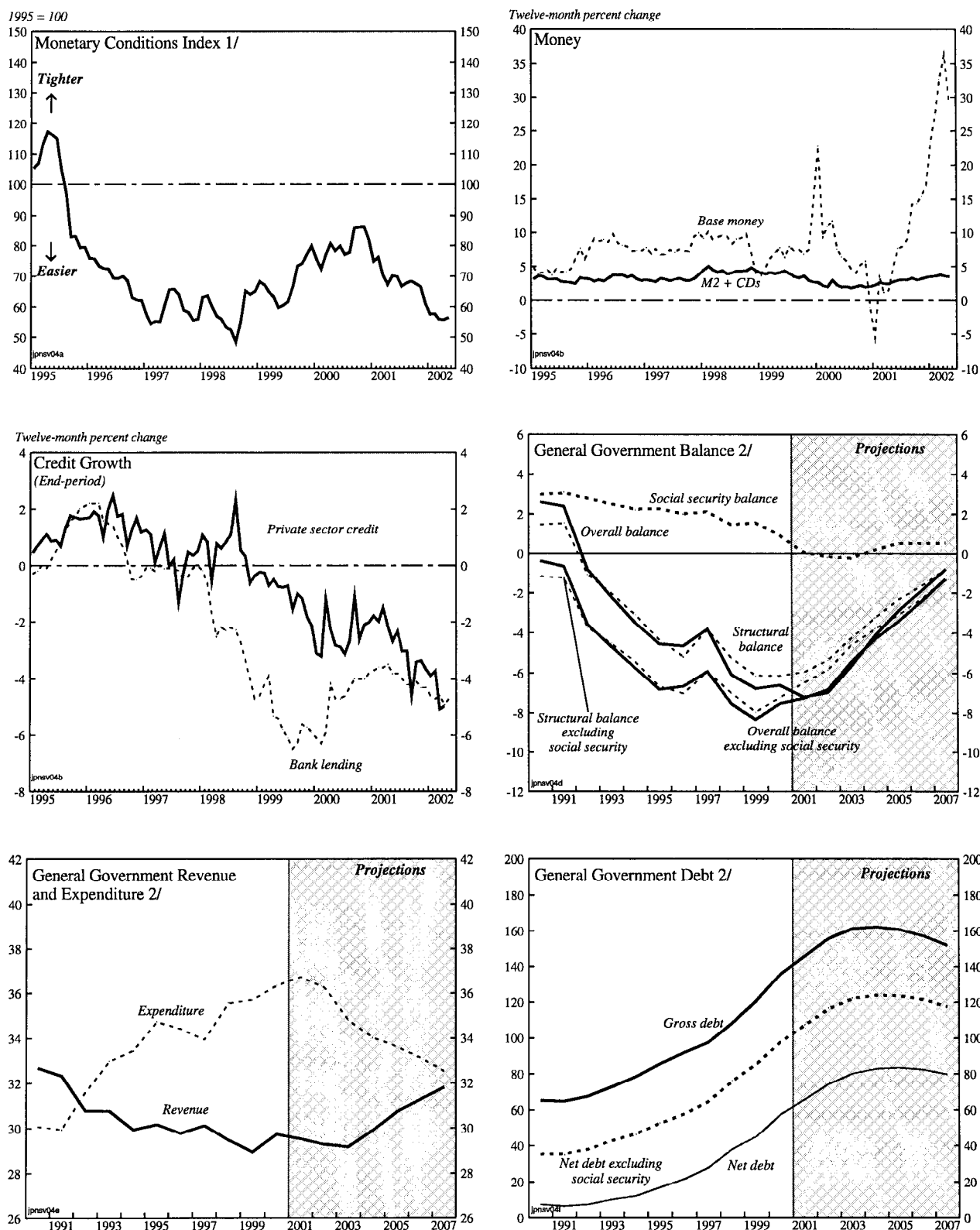


18. **Current policy is set to deliver a fiscal contraction in FY2002, following the expansionary stance in FY2001** (fiscal year runs from April 1 to March 31). To meet the PM's pledge to limit net JGB issues to ¥30 trillion, the FY2002 budget included spending cuts—on public works, public enterprise subsidies, and ODA—that will result in the first decline in discretionary spending in four years. These cuts, however, will be cushioned to some extent by two supplementary budgets in late FY2001, and the general government structural budget deficit is expected to decline by around ½ percent of GDP in FY2002. Gross government debt rose to around 146 percent of GDP at end-2001, and net debt (excluding social security assets) rose to 112 percent of GDP (Table 2 and Figure 6).

19. **JGB yields have fluctuated in a narrow range over the past year**, despite the downgrades of Japan's sovereign credit rating, mounting public debt, and concerns that another round of public funds may need to be injected into the banking system.¹ **Spreads for**

¹ S&P downgraded Japan's long-term sovereign credit ratings by one notch to AA- in April, 2002 and indicated the possibility of a further downgrade. Moody's downgraded Japan's sovereign rating by two notches to A2 in May, 2002, but indicated a stable outlook. Moody's now places Japan's rating below that of any other major industrial country, and level with the ratings of a number of emerging market economies.

Figure 6. Japan: Monetary and Fiscal Indicators, 1990-2007



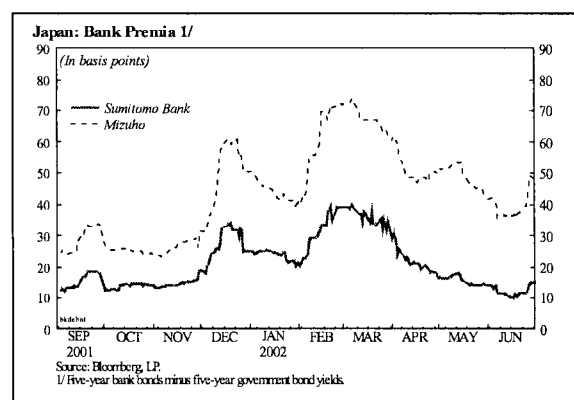
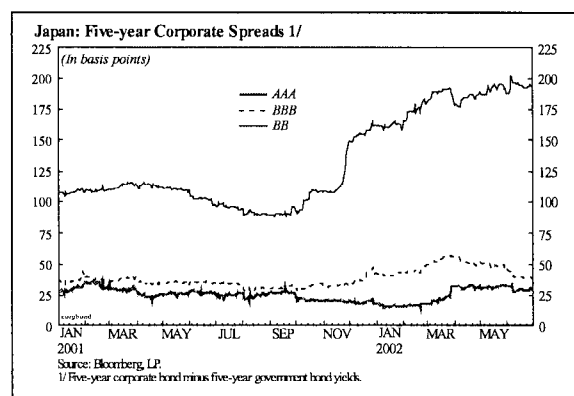
Sources: Ministry of Finance; Cabinet Office; WEFA, Nomura Database; and staff estimates and projections.

1/ The monetary conditions index is the weighted sum of short-term interest rates and the exchange rate, where the weights reflect the estimated impact of those variables on aggregate demand. Specifically, a 1 percentage point change in the overnight call rate receives the same weight as a 10 percent change in the nominal effective exchange rate.

2/ In percent of GDP; the fiscal year is from April to March.

lower-grade (BB rated) corporate borrowers, however, have widened to around 200 basis points, as bankruptcy risks have risen.

20. **The weak economy and falling equity prices have taken their toll on bank profits, and on market perceptions of banking risks.** Major banks' FY2001 loan-loss charges rose to ¥7.7 trillion, four times as large as projected at the start of the financial year. While operating profits did rise, with no gains on equity portfolios in contrast to previous years, net losses of ¥3.5 trillion were posted. Reflecting concerns about their financial health, spreads on bank debentures rose in early 2002 ahead of the removal of the blanket deposit guarantee, but have since narrowed. The Japan premium (the spread between U.S. dollar borrowing costs of Japanese banks and U.S. LIBOR), however, has not resurfaced, as Japanese banks have largely been absent from the market. Among smaller institutions, two regional banks and 49 credit cooperatives and *shinkin* banks have recently filed for bankruptcy.



21. **Life insurers' financial health weakened further in FY2001 due to falling equity prices and ongoing negative yield spreads.** Solvency margins at the ten major life insurers fell sharply in FY2001, although they all remained well above the 200 percent prescribed minimum. While policy cancellations slowed, the number of policies in force has continued to decline. In the nonlife insurance sector, Taisei Fire and Marine filed for bankruptcy after being hit by a large reinsurance claim following the September 11 terrorist attacks.

III. SHORT-TERM ECONOMIC OUTLOOK AND RISKS

22. **Even with the recent rebound, staff expect GDP to fall ½ percent in 2002 (annual average basis) and to expand only modestly in 2003, in line with the private consensus.**

- For **2002**, given the unsustainable rise in private consumption and public investment in the first quarter, the staff has factored in some reversal in GDP in April-June. Thereafter a gradual recovery in private domestic demand in the latter part of the year broadly offsets the sharp falloff in public investment as the earlier fiscal stimulus wears off. Business investment is not expected to recover before late-2002 given the present weakness in core machinery orders, while private consumption picks-up modestly, as employment prospects stabilize. While the export outlook remains favorable, the drop in imports in the first quarter is not sustainable, which would

suggest a tapering off of the external contribution to growth. Deflationary pressures are likely to persist given the still sizable output gap.

- For **2003**, if the global recovery gathers further momentum, business investment would begin to contribute to growth, and private consumption could pick up as stronger profits feed through to wage bonuses. On the other hand, the sizable fiscal contraction implicit in current policy—the structural budget deficit is expected to decline by nearly 1½ percent of GDP—would be a drag on growth.

23. The downside risks to this outlook are considerable, although a stronger global rebound would provide some offsetting upside potential to the outlook.

- **Banking risks.** A continued deterioration in asset quality augmented by a plunge in stock prices would undermine bank regulatory capital, and necessitate intervention in a number of banks. While prompt implementation of the public support framework should prevent a systemic meltdown, the potential impact on firms as bankruptcies surge, on consumers as employment and confidence decline, and on domestic and foreign investors, could see economic activity sharply weaker this year and next.
- **Fiscal risks and the JGB market.** Given the very high public debt level and the absence of a fully-fleshed out fiscal consolidation strategy, the JGB market remains vulnerable to a swing in investor sentiment, which could see a sharp spike in yields with implications for bank capital and business investment.

24. The growth path followed by the economy in coming years will depend very much on the approach taken to addressing bank and corporate weaknesses. Analysts estimate that disposal of the worst of banks' NPLs could result in employment losses of 300,000–500,000 (¾ percent of the labor force). If the deterioration in asset quality were fully recognized and consequent action taken by the banks, the employment loss could easily be 2–3 times that, with an impact on short-term GDP growth of 1–2 percentage points over 1–2 years. The payoff, however, would be a strengthening of economic and job prospects in the medium term in the context of faster potential growth, to perhaps 2–3 percent. With a return of confidence, moreover, domestic demand growth would reach a pace that would allow a gradual closing of the output gap, while a vigorous monetary policy—in the context of the integrated policy strategy outlined at the beginning of this staff report—would help to deliver an early end to deflation. In contrast, a “muddle-through” strategy to reform could perhaps alleviate some short-term output losses, but inevitably at the cost of weaker medium-term growth, high structural unemployment, and continuing deflation. Along such a path, the goal of reestablishing Japan as a locomotive of regional and global growth would remain elusive, and its economy would remain highly vulnerable to domestic and external shocks.

IV. POLICY DISCUSSIONS

25. The authorities expressed broad agreement with the integrated policy strategy advanced by staff, and concurred that sustained growth would remain elusive without deep structural reforms. They stressed that plans set out last year—including ridding banks of their worst NPLs and broadening the RCC's mandate to help bring this about and spur

corporate restructuring—remained centerpieces of their approach. On the macro side, steps had been taken to establish a credible fiscal consolidation strategy—including the JGB-issue cap and the target of restoring a primary surplus over the medium term—while the BoJ had continued to supply ample liquidity to maintain market stability and mitigate deflation.

26. **Nevertheless, as discussed below, the mission came away with the sense that implementation of reforms would be slower and less comprehensive than needed in its view for a speedy reinvigoration of Japan's economy.** There is a related concern that the cyclical rebound could itself give way to a slowing in the reform momentum. The discussions therefore focused on fleshing out the details of the integrated policy strategy outlined earlier, and offering concrete suggestions of how to strengthen the authorities' reform agenda in critical ways to lay a firmer foundation for medium-term growth while alleviating any near-term adverse impact on economic activity and deflationary pressures.

A. Financial Sector Issues

27. **Japan's banking system remains chronically weak.** Despite writeoffs of 16 percent of GDP over the past decade, NPLs have not come down, and there is a clear risk that more loans will turn sour in the future (Box 1). Weak profitability, meanwhile, continues to constrain banks' provisioning capacity. While measured capital ratios remain above BIS-minima, the weight of government preferred shares and deferred tax assets undermines capital quality. As well as the domestic implications, bank weaknesses have potential ramifications for international financial stability given banks' foreign securities holdings and lending and foreign investors' exposure to Japan (as discussed in the latest *Global Financial Stability Report*).

28. **The authorities explained that their strategy for dealing with bank weaknesses remained focused on strengthening loan classification, accelerating NPL disposals, and reducing equity price risk exposure.** Implementation was proceeding broadly as planned:

- Partly in response to the collapse of a major retailer (Mycal) last autumn, when banks were found to have overclassified (and underprovisioned) their exposures to the firm, the FSA embarked on a program of special inspections to assess the adequacy of loan classification and provisioning practices for large, highly-indebted borrowers. Banks' FY2001 financial statements incorporated the results of these inspections. The FSA also plans to introduce a *de facto* resident inspector system for major banking groups and to prepare a supplement to the inspection manual regarding loans to SMEs.
- Major banks have made significant progress in disposing of NPLs to bankrupt and near-bankrupt borrowers (BNBBs), as called for under the plan established in April 2001. Out of the ¥11.7 trillion of such loans at end-March 2001, banks disposed of around one-half in the following year through sales, collection, or liquidation, with the remainder left for disposal in the year to March 2003. In April 2002, the three-year disposal requirement for newly-classified NPLs to BNBBs was strengthened by encouraging banks to dispose of one-half within a year and 80 percent within two

Box 1: An Update of the Situation in the Financial Sector¹

Following two years of modest profits, major banks made a net loss of ¥3.5 trillion (equivalent to 9 percent of capital in FY01). While operating profits actually increased quite substantially—largely due to increased earnings from treasury operations—this was more than offset by a near doubling of credit costs to ¥7.7 trillion and losses on equity holdings of ¥1.6 trillion.

Japanese Major Bank Profitability		
	March 2001	March 2002
(In trillions of yen)		
Operating profits	3.4	4.1
Losses from NPL disposal	4.3	7.7
Profits/losses from stocks	1.4	-1.6
Net profit	0.1	-3.5
Source: FSA		

The weak economic environment and the strengthening of loan classification standards by the FSA resulted in a sharp increase in NPLs.

At end-March 2002, NPLs of major banks were ¥26.8 trillion (8.4 percent of outstanding loans), up from ¥20.7 trillion a year earlier. For all deposit-taking institutions, NPLs stood at ¥43 trillion and total loans to classified borrowers (“needs attention” and below) were ¥141 trillion at end-March 2001 (latest available data). Against these loans, institutions held ¥10 trillion of specific reserves, while ¥58 trillion were covered by “superior” collateral or guarantees. Many private analysts continue to believe that a forward-looking assessment of “gray-zone” loans (those classified as performing, but that require attention) would result in many being downgraded to nonperforming status.

NPLs of Japanese Financial Institutions				
	March 2000	March 2001	Sept. 2001	March 2002
(In trillions of yen)				
Deposit-taking Institutions	42.2	43.0	...	...
Banks	31.8	33.6	36.8	...
Major Banks ¹	20.4	20.0	22.5	26.8
Regional Banks	11.4	13.6	14.2	...
Cooperative institutions	10.4	9.4	...	...
Source: FSA				
¹ Includes Shinsei and Aozora banks through Sept. 2001.				

The capital position of major banks is under considerable pressure. While the regulatory capital ratio declined only modestly in the year to March 2002—from 10.9 percent to 10.4 percent (consolidated basis), and all major banks remained above the minimum—the quality of capital deteriorated. At end-March 2002, deferred tax assets and government preference shares accounted for almost all of Tier-1 capital, while other Tier-1 capital (largely common equity and retained earnings) had been almost wiped out. Were banks to provision their problem loans in line with analysts’ estimates, the capital of most banks would fall well below regulatory minima. Further, bank capital remains vulnerable to market risks.²

Major Bank Capital (March 2002)		
	¥ trillion	Percent ¹
Deferred tax assets	8.4	2.6
Minority interest	2.7	0.9
Public funds (pref. stocks)	6.0	1.8
Other Tier 1 capital	0.4	0.1
Total Tier 1 capital	17.5	5.4
Total capital	33.7	10.4
Memorandum items:		
Regional banks (Tier I) ²	11.5	9.9
Regional banks (Tier II) ²	2.9	8.0
Shinkin banks ³	5.9	10.0
Credit cooperatives ³	0.8	7.9
Source: FSA; Fitch IBCA		
¹ Percent of risk weighted assets.		
² As of September 2001.		
³ As of March 2001.		

The FSA has continued to make progress in addressing problems among the regional banks and other smaller deposit-taking institutions. Stepped-up inspections have resulted in improved credit quality assessments of borrowers, but NPLs remain high and the capital base generally weak. A further 51 of these institutions have recently filed for bankruptcy, including two second-tier regional banks.

¹ For further details, see Callen and Mühleisen, “Developments in the Banking and Life Insurance Sectors,” in the *Selected Issues* paper.

² For major banks, the FSA estimates that a 100 point drop in the TOPIX is estimated to reduce Tier-1 capital by ¥1–1.5 trillion (about ¼ percentage point of the Tier-1 capital ratio), while a 1 percentage point rise in interest rates reduces Tier-1 capital by ¥0.8 trillion. Private analysts estimate that the impact is doubled if swap positions are included.

years. An amendment to the Financial Reconstruction Law has also been passed to allow the RCC to purchase banks' NPLs at "fair value" and to rehabilitate companies.²

- Banks have also made progress in reducing their exposure to equity price risk through sales to the market and to the Bank Shareholding Purchase Corporation (BSPC), which began operations in February 2002. The goal remains to reduce banks' equity portfolios to within their Tier-1 capital by September 2004, although banks with very large holdings will qualify for 1–2 year extensions beyond this deadline.

29. **FSA officials considered that the special inspections had forced banks to deal aggressively with the bulk of their problem loans.** They pointed out that the inspections had resulted in the downgrades of 71 out of 149 corporate borrowers examined (¥7.5 trillion out of a total ¥12.9 trillion in credit), especially in the construction, real estate, retail, and nonbank financial sectors. They noted that, while the inspections had primarily been carried out at main banks, because other banks had exposure to the same borrowers, the exercise had in effect reviewed double this amount of loans. Banks' forecasts for FY02 were consistent with the view that the worst of the NPL problem was over, as credit costs were projected to fall sharply, and profits to recover.

30. **The mission welcomed the efforts to strengthen classification and provisioning practices in the context of the special inspections, but cautioned that concerns still remain about whether the true scale of the NPL problem has now been recognized.** The doubts center on the fact that the special inspections focused only on large borrowers with exposures greater than ¥10 billion, which represent only 4 percent of major banks' loans, and totally excluded loans to potentially-weak SMEs (about 60 percent of the total).³ Two related issues are the speed with which non-main banks will downgrade loans in line with main banks, and whether banks will attempt to pace their recognition of problem loans so as to maintain capital comfortably above BIS-minima.

31. **A more forward-looking approach to classification and provisioning is needed systemwide.** While the Mycal failure suggested that large, highly-indebted borrowers have been misclassified—thus justifying the focus of the special inspections on such borrowers—the results indicate the need for a more comprehensive assessment to ensure that all loans are appropriately classified.⁴ A key issue relates to gray-zone loans—loans that are performing (in no small measure because near-zero interest rates allow firms with barely positive cash

² Previously the RCC was prevented from making losses on its purchases, and paid very low prices (4 percent of book value), giving few incentives for banks to sell loans to the RCC.

³ Based on its own on-site inspections of 97 banks and credit associations last year, the BoJ recommended reclassifying loans to 1900 borrowers, 9 percent of firms examined.

⁴ Japan's participation in the FSAP, which staff very much welcome, will help shed light on a range of issues related to financial stability, including the adequacy of loan classification and provisioning practices. The FSSA is expected to be available with the 2003 Consultation.

flow to remain current on debt service) but are at clear risk of down-migration. Absent regulatory pressure or a strong capital base, banks lack incentives to be aggressive with such claims, especially if higher recovery values are possible down the road. Such loans may be to firms in weak sectors like construction and retail, as the special inspections suggest, but also to SMEs. Another issue relates to land collateral, which in the absence of a liquid real estate market, may continue to be overvalued by banks. Admittedly, staff lack the information to come to a conclusion on such issues, but the inspections' results raise questions about current practices. FSA officials responded that the establishment of the resident inspector system will ensure that banks appropriately classify loans to all their borrowers on an ongoing basis.

32. **The mission welcomed progress made with bad loan disposal at the major banks, but stressed the need to establish a timetable for disposal at all institutions.** Because the majors account for only about half of all loans and NPLs of deposit-taking institutions, a policy that establishes a disposal timeframe for the majors alone will miss a large part of the problem. The wisdom of requiring disposal only in the case of loans to BNBBs, rather than to all classified NPLs (including “special attention” loans), is also questionable. The authorities responded that the approach favored by staff could have undesirable consequences for local economies that depend on a single institution, but that to the degree there were borrowers in common between major and smaller banks, loans extended by the smaller institutions would also be covered by the rapid disposal requirement. In addition, smaller banks are under pressure from the market to follow the same practices as the major banks.

33. **The mission stressed that the review of classification and provisioning practices it was calling for could result in bank capital ratios falling below regulatory minima.** If this were the case and banks continued to face difficulty in raising significant funds from the market, there would be no alternative to a public funds infusion in systemic banks, subject to strong conditionality to limit moral hazard. The ¥15 trillion available in the DIC's Crisis Management Account to counter systemic risks would need to be invoked in such case, although if the dimension of the problem proved larger, more funds would need to be made available. An alternative approach—spreading NPL recognition over a number of years to allow provisions to be paid from operating profits with no impact on capital—would preserve an aura of stability but would postpone resolution of the fundamental problems. These include high levels of excess corporate leverage and capacity, deflation, and continued access to credit for firms that should exit at the expense of dynamic companies. For non-systemic banks that fail to meet capital requirements, “prompt corrective action” would need to be invoked, including orderly exit of nonviable banks.

34. **The authorities disagreed on the need for public capital injections in present circumstances, believing that the bulk of NPLs had been recognized following the special inspections, and there was therefore little likelihood of bank capital falling below regulatory minima.** They noted that even after the special inspections, capital ratios of most major banks were in the 10–12 percent range, and regional banks' were in the 7–11 percent range. Further, they felt that the best way to build capital was for banks to improve their profitability or to tap the markets, rather than rely on public funds. Their main objections to another round of public capital injections in the absence of systemic risk were the potential for moral hazard, the dilution of private shareholder value, and the potential for government interference in the operation of commercial banks.

35. **With respect to equity market risk, the mission stressed the need to avoid using the Bank Shareholding Purchase Corporation (BSPC) as a warehouse for illiquid stocks.** Staff continue to have reservations about channeling sales of banks' equity holdings to the BSPC rather than directly to the market, given the potential for non-market sales to distort corporate decisions and delay corporate restructuring. The mission therefore welcomed the intention to limit public funds at risk in the BSPC and to use the Corporation more as a safety net than as a principal channel for unloading banks' equities.

36. **There was agreement on the need to lay a stronger basis for banks to boost their profitability, including by leveling the playing field with public financial intermediaries.**

- While banks have taken steps to cut costs, more efforts are needed to increase lending margins (by appropriately pricing credit risk) and boost fee income, while curtailing low-yielding corporate lending. There is also a need to exploit synergies from the major bank mergers and strengthen the disclosure and corporate governance frameworks so bank managers face appropriate pressures to raise rates of return.
- Staff welcomed legislative proposals to force the corporatized Postal Services Agency to make corporate-tax equivalent payments from next year, and suggested that it should also pay deposit insurance premia and provide a return on capital. Removing these advantages should, over time, bring about a welcome downsizing of the postal savings system itself, which remains much larger than can be justified by the social objective of providing banking services in remote rural areas.
- As to the GFIs, a number of them—including the Government Housing Loan Corporation (GHLC) and the institutions lending to SMEs—do not pay a market rate for funds and are thus able to undercut commercial banks in their lending terms. The mission welcomed reform proposals for the GHLC, but stressed that efforts are needed to encourage GFIs to source more funds from capital markets—building on recent Fiscal Investment and Loan Program (FILP) reforms—and to speed efforts toward down-sizing and selective privatization. Combined with a downsized postal savings system, such GFI reforms would also help to level the playing field with private banks.

37. **The mission supported the authorities' decision to go ahead with the phased withdrawal of the blanket deposit guarantee, but conditioned that support on using the time ahead of full removal in April 2003 to address remaining bank weaknesses.** With no large banking deposits explicitly insured from next April, there would be potential for contagion from weaker institutions if systemic confidence is in doubt at that time. The potential for deposit movement, moreover, is significant—current deposits in excess of the ¥10 million insured amount are around ¥100 trillion (20 percent of GDP), and there are already signs from deposit movements leading up to this year's change that large depositors (including some local governments) will not hesitate to take their funds out of weaker institutions. This underscores the critical need for rapid progress in dealing with weaknesses in banks' balance sheets and ensuring that viable institutions are well capitalized.

38. **Notwithstanding the problem of negative yield spreads, the authorities were not overly concerned about potential problems in the life insurance sector.** They pointed out

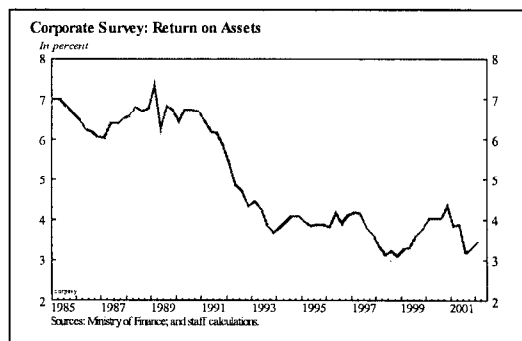
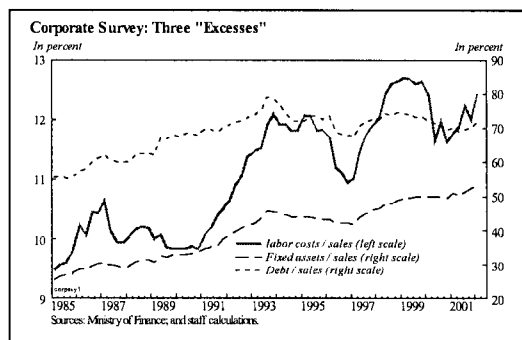
that, because of favorable mortality trends, life insurers as a group had succeeded in posting profits of about ¥2 trillion in FY2001. The mission noted that some private analysts continue to have doubts whether the solvency standards—though strengthened last year—are stringent enough to give early warning of looming difficulties, and were also concerned by the growing practice of double-gearing whereby banks loaned funds to insurers which in turn purchased banks' subordinated debt—risking a cascading effect if either actor experienced difficulty. The mission also noted the absence of a clear solution to the problem of negative yield spreads, and thus welcomed revisions to the bankruptcy law for insurers which allowed them to reduce guaranteed yields in the context of reorganization proceedings.

B. Corporate Restructuring and Structural Reforms

39. **Progress with corporate restructuring has been disappointing.** Continued unwillingness to restructure or liquidate companies is adding to excess capacity and deflationary pressures, and harming the operations of healthier companies. Corporate rates of return remain low, and little headway has been made in reducing the still significant excesses of capital, debt, and employment. Concerns about the impact of restructuring on unemployment may also be slowing down the process—the government's approval of Dai-ichi's restructuring plan under the Industrial Revitalization Law may reflect a desire to limit job losses relative to what could ensue under a court-led restructuring plan.

40. **The authorities considered that a strong corporate restructuring framework was now in place, based on:**

- **Formal, court-led, rehabilitation.** This is expected to remain the predominant channel, and has the advantage of mandating the level of debt reduction and loss recognition, and applying strict enforcement mechanisms. Introduction of the Civil Rehabilitation Law (CRL) in April 2000 eased procedures for debtor-in-possession reorganization (à la U.S. Chapter 11) and expedited approvals of restructuring plans.
- **Informal out-of-court debt workouts, including under recently established private sector guidelines.** New guidelines have been set out, aimed at firms whose value would erode quickly if legal procedures were followed. Only four companies, however, have applied to use the guidelines so far.
- **Workout and disposal of NPLs by the RCC.** Under new legislation, the RCC has three options to dispose of the loans it acquires from banks: outright sale; securitization; or operational and financial restructuring of the company. To aid in the



rehabilitation of troubled companies, the RCC will establish deleveraging funds with the Development Bank of Japan and the private sector to participate in debt-equity swaps. Banks can also continue to sell assets to private restructuring funds.

41. **The mission stressed the importance of banks using this framework proactively to bring about strong corporate restructuring.** With the bulk of firms' excess leverage owed to banks, progress will require banks taking the lead in agreeing restructuring plans with their potentially-viable debtors, pushing nonviable firms into liquidation, and disposing of unwanted loans to third parties (private investors or the RCC). But banks will lack the capacity and incentives to move forcefully unless they have adequately recognized and provisioned against their problem assets. This underscores the need for continued regulatory pressure on banks in dealing not only with the worst of their problem loans (where there may be little option other than liquidation of the debtor), but also with a broad range of gray-zone loans, where the bulk of companies with a real chance of a turnaround are likely to be found.

42. **While welcoming the recent strengthening of the RCC's mandate, the mission stressed the need to develop Japan's distressed debt market where the RCC could play a lead role.** The RCC had made a good start in early 2002 in participating in NPL auctions and raising prices paid on NPLs toward market levels, but purchases remain small, especially in relation to the ¥12 trillion of funds it has available (which could allow the RCC to buy loans with a face value in excess of ¥100 trillion based on recent discounts), and the value of loans banks need to dispose of to restore health to their balance sheets. The mission urged that the mandate of the RCC—including value, pricing, and timeframe of its purchases—be clarified further and stressed that its comparative advantage is likely to reside in accelerating its purchases and subsequent resale of NPLs, rather than in direct involvement in corporate rehabilitation where it lacks expertise (Box 2). By securitizing banks' NPLs, and creating pricing benchmarks and standards for such transactions, the RCC could play a helpful role in expanding the distressed debt market in Japan (similar to the RTC in the U.S. in the 1980s).

43. **There was agreement on the need for structural reforms to ease the transitional costs from corporate restructuring and generate new investment and job opportunities.**

- **Labor mobility and the social safety net.** Staff welcomed some recent initiatives, including expanded job training programs and the modest improvement in the safety net. Nevertheless, there remains a case in the staff's view for more public spending on active labor market policies—the level of such spending in Japan is significantly below the OECD average—and for temporarily extending the duration of the jobless benefit in a period of structural change. The mission encouraged the authorities to liberalize rules governing private job placement and dispatching agencies (which remain limited in the professions they can handle and duration of the contract), and to review job protection legislation to ensure it does not hamper needed labor shedding.
- **Regulation.** Japan's approach to regulatory reform has been piecemeal rather than strategic, and the current (964-item) program is no exception. The mission endorsed the direction of the Regulatory Reform Council's recommendations—including the focus on deregulating the health- and child-care sectors, and urban rejuvenation—but urged a review of rules requiring local government approval of large retail stores and

Box 2: The RCC and the Market for Distressed Debt

The Resolution and Collection Corporation (RCC) is a government-owned agency mandated with collecting bad loans from failed housing loan companies, banks, and credit cooperatives. The RCC is financed by bonds issued by the Deposit Insurance Corporation (DIC) and is entrusted with special investigative powers that allow it to tackle difficult cases, such as real estate tied to organized crime. It has primarily served as a “catch all” for banks which have been unable to collect or sell bad loans on their own. Its portfolio consists mainly of real estate used as collateral on defaulted loans and, to a lesser extent, ordinary loans. Since its inception, the RCC has played only a minor role in reducing bank NPLs, having so far purchased only ¥1.3 trillion in distressed assets (face value) at an average discount of 96 percent.

In December 2001, the RCC was given broader powers to purchase NPLs and promote corporate restructuring. Previously, because the RCC could not post losses when it disposed of its assets, it demanded steep discounts and thus was not an attractive option for banks. Under the new Financial Reconstruction Law, the RCC was given more flexibility to purchase NPLs at “fair market” value and to participate directly in NPL auctions. In September 2001, the RCC was granted a trust business license to securitize nonperforming assets and issued its first asset-backed security of ¥40 billion in real estate assets. Under the new law, the RCC has also taken steps to rehabilitate troubled borrowers by initiating restructuring programs for 12 companies and announcing plans to examine 110 more.¹

However, the price at which the RCC purchases NPLs and its role in corporate restructuring remain unclear. Although purchases at a higher-than-market price, e.g., net book value, would make it more attractive for banks to sell to the RCC, it would reward banks that have made less progress in recognizing loan losses and encourage inadequate provisioning. “Backdoor” recapitalization also hides the true cost and may undermine the commercial goal of the RCC. Market valuation promotes transparency and creates the right incentives for banks to restructure loans or to seek out bankruptcy or liquidation procedures. To encourage banks to part with their distressed assets, the RCC could include profit sharing arrangements in the sales contracts to allow banks to benefit from any upside potential.

The RCC could play a useful role in purchasing distressed assets from banks and transferring them quickly to the private sector where the chances for recovery are higher. A market for distressed debt with both active foreign and domestic players already exists in Japan but is limited in supply. Like AMC's in other countries, the RCC can facilitate the transfer of these assets by purchasing company debt from various creditors and repackaging them for quick sales either through auction or as a securitized asset. The RCC should also look to dispose of its assets quickly, using a strategy that takes into account the cost of its capital and depreciation of its assets. Also by establishing benchmark prices and standards for securitized transactions, the RCC can help expand the market for securitization, similar to what the RTC did in the U.S. in the 1980s.

Proper provisioning and recognition of losses is crucial for ensuring that banks have the right incentives to dispose of their NPLs. Underprovisioning still remains the biggest obstacle for banks to sell their distressed assets. This applies particularly to loans classified as “requiring special attention” where debtor companies may still be a going concern.

The RCC's portfolio of mainly real estate collateral and its limited resources and experience suggest it should focus on asset disposal and leave the lead role in corporate restructuring to the private sector. The RCC could support the restructuring of viable but distressed firms through joint ventures with professional workout specialists where the RCC takes a minority position. Equity partnerships would help improve recovery prospects by bringing in outside expertise and leveraging the interests of private investors. However, having the RCC as the lead agent for restructuring runs the risk of distorting commercial decisions and inviting political interference, ultimately leading to the warehousing assets, slower restructuring, and further losses.

¹ See Kang, “The RCC and the Market for Distressed Debt in Japan,” in the *Selected Issues* paper.

limiting the size of housing developments. The mission stressed the need for stronger enforcement by the Fair Trade Commission of competition policy, including in the construction sector. While welcoming progress made in reducing entry barriers in the telecom and power sectors, the mission stressed the need to lower costs which are high by international standards. In view of Japan's low rate of business formation, the mission advised streamlining the complex approvals process for business startups.

- **Real estate market.** The mission stressed the need for reforms to revitalize the real estate market. Zoning regulations and laws on rentals and land-leases in particular should be further liberalized, and tax distortions that create disincentives to realizing capital gains on real estate removed. Despite its potential short-term negative impact on prices, the accelerated disposal of land collateral—both by the RCC and banks—is also needed to make the market more liquid and help it find a bottom.
- **Corporate governance.** Slow progress in boosting corporate rates of return reflects not only banks' failure to exert discipline on firms, but also shortcomings in corporate governance, especially the excessive role of "inside" directors, and lack of contested takeovers. The mission thus welcomed the recent revision of the Commercial Code allowing firms to adopt management structures with a majority of outside directors, which should help to better align shareholders' and directors' interests.

C. Fiscal Policy

44. **The authorities were satisfied with the fiscal stance achieved by the FY2002 budget and the two supplementary packages of FY2001.** They explained that, owing to the need for fiscal consolidation in the medium term and public dissatisfaction with old-style fiscal pump-priming measures (particularly rural public works projects), the ¥30 trillion limit on JGB issuance for the current year had been an appropriate mechanism for maintaining market confidence. On the other hand, they well recognized that the economy was undergoing a period of structural adjustment and, in such circumstances, it would be inappropriate to move aggressively with consolidation in the near term. For this reason, the government had pushed hard to pass two supplementary budgets in late-FY2001. More fundamentally, however, the authorities consider that the change in the composition of spending in both the annual and supplementary budgets—away from pork-barrel rural public works projects toward priority areas such as the social safety net, urban rejuvenation, and IT—would not only help to promote structural adjustment but would tend to have a stronger short-term demand impact than traditional spending on public works.

45. **The mission responded that, under the scenario in which policies were pushing hard to spur bank and corporate restructuring, the near-term fiscal stance should not amplify already strong headwinds to growth.** Staff therefore had concerns that the support provided by last year's supplementary budgets would fade by the second half of this year and into FY2003, and that fiscal policy would begin to withdraw stimulus when what appears to

be a fragile cyclical recovery was still in its early stages.⁵ In the context of the staff's overall policy strategy, the team thus advised that the authorities frame the FY03 initial budget to achieve a broadly neutral fiscal stance, and that a supplementary budget focused on measures to promote economic restructuring be passed to mitigate the likely withdrawal of stimulus later this year. Regarding the composition of spending, the mission strongly supported the reorientation underway, but remained unconvinced that the reorientation itself would suffice to counteract the macroeconomic impact of a drop in the structural deficit this year.

46. There was agreement on the need for fiscal reforms to strengthen the credibility of the commitment to medium-term consolidation and lower risks of a JGB yield spike.

- **Spending reform.** Despite some welcome reallocation of spending in the FY2002 budget away from public works and subsidies to public enterprises, public investment remains excessive. As priorities, the mission recommended the full de-earmarking of road-related tax revenues and a more thorough cost-benefit analysis of public works projects. The resources so freed up could be used to support a strengthened social safety net, improved nursing and child care, and better-crafted job training programs.
- **Tax reform.** The mission welcomed the government's commitment to include a comprehensive tax reform in the FY2003 budget, and stressed that such an overhaul should seek to broaden the personal and corporate income tax bases, which would also help ease the transition to fiscal consolidation down the road. Since the mission, the government has published an outline of a tax reform plan, including base-broadening measures and fully-funded reductions in effective corporate rates; further details are expected to be announced in coming months. To facilitate such base broadening and improve tax administration, staff stressed the need to overcome political resistance to the introduction of taxpayer identification numbers (TINs). While welcoming the introduction of consolidated corporate taxation from FY02, the mission urged the authorities to reconsider their decision to impose a tax surcharge on firms filing on a consolidated basis, as this was likely to severely hamper takeup of the new regime, and so delay the favorable impact on corporate restructuring.
- **Social security reform.** The mission welcomed the recent submission of the Medical Insurance Reform Bill, but noted it will have only a small effect on stemming rising costs. With the budgetary contribution to the medical insurance system due to rise from one third to one half within five years, the mission stressed the need to overcome resistance by vested interests to curbs on the growth of the system's total medical expenses. With respect to pensions, the mission noted that another round of reforms, building on measures introduced two years ago, will be needed to address the still sizable unfunded liabilities of the system.

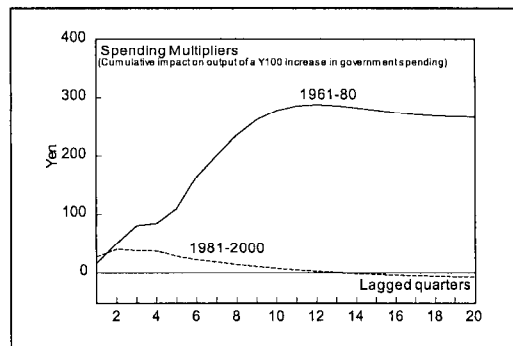
⁵ While the evidence is mixed, analytical work undertaken by the staff suggests that fiscal policy remains an effective countercyclical policy tool (Box 3).

Box 3: The Effectiveness of Fiscal Policy

The empirical evidence on the size of fiscal multipliers in Japan does not reach a clear conclusion. On one hand, a recent survey by Hemming, *et al* (2002) concludes that fiscal multipliers in industrial countries are small, OECD (2000) suggests that fiscal multipliers in Japan declined significantly during the 1990s, and Bayoumi (2000) obtains short-term spending and revenue multipliers in Japan of 0.65 and 0.2, respectively, for 1981–98. In contrast, Kuttner and Posen (2001) obtain large tax and aggregate spending multipliers for Japan, and suggest that fiscal policy remained quite effective in countering recessions. Indeed, that study went further by noting that the “real water” content of the stimulus packages of the 1990s was actually small, and that with a more aggressive fiscal policy, recessions might actually have been avoidable.

Against the background of this lack of consensus on the size of fiscal multipliers, the staff attempted some quantification of its own.¹ Dynamic fiscal

multipliers were estimated using a structural VAR framework. The results found multipliers broadly centered around $\frac{1}{2}$ in the short run. For the sample period 1981–2000, spending multipliers (represented as the impact at lagged quarters of a ¥100 increase in government spending on the output gap, see figure) estimated from a VAR including government spending, revenue, the real interest and exchange rates, and the output gap, peaked after 2 quarters at about ¥40, and were effectively zero after three years. Compared to the sample period 1961–1980, these multipliers were similar over short horizons.



However, over longer horizons, the multipliers appear to have declined substantially compared to large positive multipliers in the earlier period. As regards **tax multipliers**, a tax cut of ¥100 is estimated to lead to an increase in output of about ¥40–50 in the short term but the effect wears off to ¥30 after 20 quarters.

Lower fiscal multipliers for both government consumption and investment spending contributed to the decline in the aggregative spending multiplier. For the period 1981–2000, consumption and investment spending multipliers were about 0.45 and 0.65, respectively, after two quarters. Over longer horizons, however, both multipliers declined and the consumption multiplier was smaller. The decline in the consumption multiplier is likely attributable to a shift in spending, especially for provision of health services to an ageing population, where a number of inefficiencies exist (see OECD, 2001). These inefficiencies are related to the fee-for-service system which generates a high number of outpatient consultations per capita per year (more than twice the OECD average) and high drug consumption (third highest among 25 OECD countries for which data are available). As regards the investment multiplier, the VARs suggest that while government investment “crowded in” private investment during 1961–80, the standard “crowding out” was more prominent during 1981–2000. These results complement other explanations which ascribe the decline in investment multipliers to a shift in public investment to agriculture and road construction. The estimated return to public capital in these sectors is low compared to tertiary sector industries and in large urban-based prefectures where complementarities between public and private investment are higher (Yoshino, 2000).

The implications of this analysis for the conduct of fiscal policy are:

- Fiscal policy continues to be an effective instrument for countercyclical demand management. Although the multipliers are smaller, government spending increases and tax cuts can help support aggregate demand in the short run.
- Improving the composition of government expenditure could boost the effectiveness of fiscal policy. Shifting government investment to sectors and geographical locations where its rate of return is higher could increase its effectiveness. Similarly, multipliers for consumption spending can be raised by switching the composition of expenditure. While pressures for higher social security spending are likely to persist for the foreseeable future, the impact on output could be enhanced through improved efficiency, especially in the health sector.

¹ See Kalra, “Fiscal Policy: An Evaluation of its Effectiveness,” in the *Selected Issues* paper.

Public enterprise reform. The mission welcomed last December's reform plan, which calls for abolishing or privatizing about a fifth of Japan's 263 special public corporations; apart from the efficiency gains, any associated revenues could be used to pay down government debt. However, staff expressed concern that the process of restructuring these firms was very drawn out (until March 2006), and that the reform plan did not spell out in any detail the future of four road-related corporations that are in urgent need of reform. It also stressed the need to bring GFIs that compete with commercial banks into the plan—the premise being that only GFIs that fulfill, at reasonable cost, an explicit social objective should remain in the public sector. While welcoming efforts underway to encourage GFIs and other FILP agencies to source their capital from the market, staff stressed the need to take the process further—only 7 percent of FILP agencies' financing will come from market sources in FY02—in order to ensure that their activities are increasingly subject to a market test.

47. **Apart from these reforms, the mission stressed that the government's credibility to consolidation would be helped by comprehensively spelling out its strategy.** Staff calculations indicate that measures of around $\frac{3}{4}$ percent of GDP per annum would be needed to stabilize the debt ratio by 2007, and then only at the very high level of 134 percent of GDP (see Annex III for a range of alternative scenarios). Further measures would then be needed to reduce the debt ratio and leave room for demographic pressures (Faruquee and Mühleisen, 2001). A permanent fiscal responsibility law could provide an appropriate vehicle to spell out a medium-term debt target and the broad objectives of tax, expenditure, and social security policies, including with respect to: public works spending; tax base broadening; the consumption tax rate; and parametric changes in the pension and health care systems.

48. **Last year's fiscal ROSC noted a number of shortcomings in fiscal transparency in Japan** (IMF Country Report 01/156). Actions are needed to: improve indicators of the fiscal stance; reduce recourse to supplementary budgets; formulate annual budgets in a medium-term context; and improve the transparency of public financial intermediation.

D. Monetary Policy

49. **The mission welcomed the BoJ's efforts over the past year to expand liquidity in the system and thereby help to maintain market stability.** Officials considered that the very rapid growth rates of base money—especially in the runup to the end of the financial year in March—had helped to avert a possible liquidity crunch and spike in interest rates, which in turn would have further exacerbated deflationary pressures in the economy.

50. **BoJ officials did not see a strong case for further policy easing at this point.** The “hard fact” in their view was that the significant easing that had taken place so far had failed to produce the long-sought-after end to deflation. While monetary policy could theoretically continue to operate even once short-term interest rates hit their floor, lack of success to date meant either that lags were longer than the time that had elapsed so far or the transmission channels were weak. In the first case, a wait-and-see attitude was appropriate to see the payoff from past actions, while in the second, the conclusion was that monetary policy had essentially run its course. The consensus within the BoJ was that—short of broadening monetary operations to include purchases of equities and real estate (which was not on the

table at present)—there was little chance that additional purchases of orthodox instruments like JGBs could succeed in eliminating deflation within a 12–18 month horizon.

51. **The mission responded that it was too soon to conclude that monetary policy had run its course.** Deflationary episodes from Sweden and the U.S. in the 1930s suggested that more aggressive and sustained actions than had yet been undertaken by the BoJ were needed to secure an end to entrenched deflation; empirical evidence from Japan, moreover, indicated that quantitative easing has a significant impact on prices even with short-term interest rates at their floor (Box 4). While bank weaknesses were clearly undercutting the effectiveness of monetary policy, the credit channel does not appear to have been fully short circuited (Box 5; Bayoumi and Morsink, 2000). That channel aside, further BoJ purchases of JGBs could still reduce long-term interest rates—yields remain some 60 basis points above historic lows—while portfolio rebalancing would be expected to affect the entire range of asset prices, including for equities and foreign exchange. The issue in the staff’s view thus boiled down to an assessment of risks: staff saw the benefits of potential success from an all-out effort to arrest deflation as outweighing the costs, while the BoJ saw the cost of potential failure—if instruments were ineffective as it believed—as potentially very damaging to its credibility.

52. **The mission stressed that a public commitment by the BoJ to end deflation within 12–18 months would help to enhance monetary policy’s effectiveness.** Greater transparency would help guide the Policy Board’s decisions, provide a benchmark against which to judge such decisions, and help to anchor the public’s expectations. There is, moreover, ample room for the BoJ to back up such a target with further JGB purchases within the present limit it has set, increases (without legal implication) in that limit, and purchases of other assets such as high-quality corporate paper.⁶ While there is no guarantee of success, the mission argued that the current approach—committing to maintain the present framework until deflation ended—is overly cautious, especially set against the deflationary psychology in the economy and the pernicious impact of deflation on real debt burdens. Beyond the next 12–18 months, the mission suggested that a modest positive inflation target (2–3 percent) would help to guard against the risk of again being constrained by the zero bound on nominal interest rates (Hunt and Laxton, 2001), a move BoJ officials indicated could be considered once more normal economic conditions had been restored in Japan.

53. **The recent strengthening of the yen, were it sustained, would bolster the case for further monetary easing in staff’s view.** Senior MoF officials during the mission saw recent yen movements as broadly reflecting fundamentals. Staff noted that, while the yen was somewhat undervalued in relation to the CGER framework’s medium-run equilibrium, such weakness was helpful from a cyclical standpoint; indeed, the significant depreciation since 2000 had boosted competitiveness and underpinned the recent export recovery. Since the mission, however, the yen has appreciated by about 10 percent against the dollar. In the staff’s view, the potential impact on deflation and activity strengthened the case for further

⁶ The BoJ’s limit is that JGB holdings not exceed currency in circulation. Based on recent data, that would leave room to buy about an additional ¥15 trillion of JGBs (4 percent of the outstanding stock). The BoJ may unilaterally choose to set a different (or no) limit, however.

Box 4: Monetary Policy in a Deflationary Environment

Since March 2001, the BoJ has carried out significant quantitative easing resulting in a tripling of current account balances (bank and non-bank reserves) held at the central bank. As a result, base money was up 30 percent (y/y) in May. However, bank lending continues to decline, broad money growth remains stagnant at 3–4 percent, and deflationary pressures show few signs of abating. Under these circumstances, has monetary policy essentially run its course in Japan? Lessons from deflationary episodes in other countries and empirical analysis for Japan suggest that it is premature to write-off the ability of monetary policy to influence demand and prices.

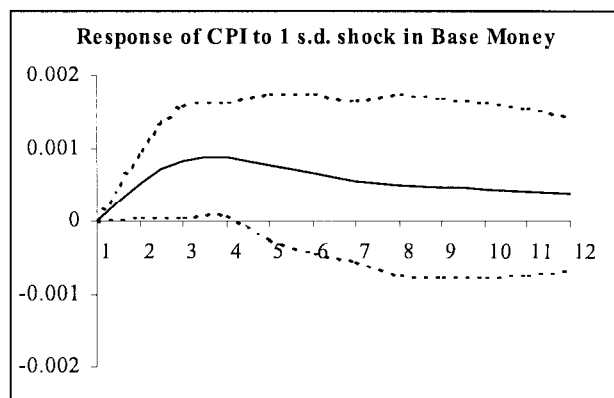
The experiences from Sweden and the U.S. in the 1930s underscore the importance of decisive monetary easing in lifting the economy out of a deflationary spiral:

- Starting from late-1931, the monetary authority of **Sweden** aggressively lowered the discount rate and carried out operations in the foreign exchange market, expanding base money by 92 percent over the subsequent five years. Moreover, the krona exchange rate was effectively devalued and then pegged to the British pound from 1933 onward. The monetary program was combined with a series of measures to boost the real economy and address the financial sector and, by the mid-1930s, Sweden was able to come out of economic stagnation and deflation (Berg and Jonung, 1998).
- The Federal Reserve of the **United States** pursued an aggressive monetary policy to lift the economy out of the Great Depression. Following the departure from the Gold Standard in 1933, holding down the discount rate and keeping inflows unsterilized boosted base money by 60 percent in three years. In a number of seminal research papers, Bernanke (1983, 1995, and 2000) stresses that reflation was a leading component of the U.S. economic revival. However, he points out that the New Deal's rehabilitation of the financial system was also a prerequisite for recovery.

The BoJ's policy actions so far fall short of the level of easing seen in Sweden and the U.S. in the 1930s. While ultra low interest rates in recent years and quantitative easing since March 2001 resulted in base money expanding by a cumulative 44 percent between 1999–May 2002, this is considerably less than in Sweden and the U.S. There would thus appear to be potential for additional quantitative easing.

Empirical analysis is also suggestive of a potentially favorable impact of additional easing.¹ A monetary model (including reduced-form VAR equations with private demand, prices, interest rates, base money, bank loans, and stock prices) was estimated using quarterly data from 1980 to present. The results reveal a statistically significant transmission mechanism, even after controlling for interest rates to account for the prevailing zero-bound, with prices responding to a base money shock with a cumulative elasticity of 0.04 within four quarters, i.e. a 25 percent base money shock boosts prices by 1 percent.

The VAR estimates also reinforce previous empirical results on the need to strengthen the banking sector to fully leverage monetary policy's effectiveness. Both bank loans and an index of bank strength are found to be statistically significant determinants of demand, similar to Morsink and Bayoumi (2000). These variables however do not substantially weaken the link between base money and prices, i.e. the existence of banking sector weakness does not short-circuit the transmission between increases in base money and other macroeconomic variables.



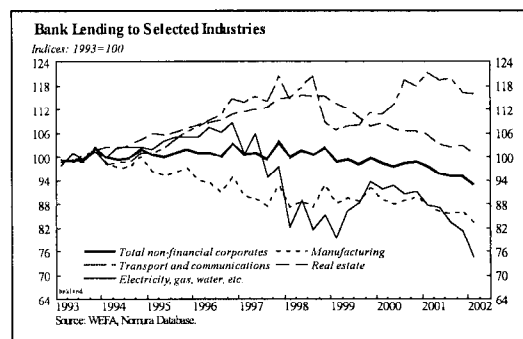
¹ See Baig, "Monetary Policy Effectiveness in a Deflationary Environment," in the *Selected Issues* paper.

Box 5: Banks and Credit in Japan

The Japanese economy remains heavily reliant on bank intermediation. Despite the financial reforms that began in the early 1990s, depository corporations have seen their market share in the financial system fall only slightly from about 58 percent to just below 52 percent. Instead, there have been significant changes in the relative weight of different depository institutions; with banks losing market share to the Postal Savings System partly because of differential regulation and perceived riskiness.

Bank lending, however, has fallen during the 1990s, and has become more focused on local governments and individuals, and less on corporates. Loans to corporates declined by about 13 percent in nominal terms between 1993 and 2001, while loans to local governments more than doubled over the same period.¹ These compositional changes reflect substantial write-offs of existing loans, decreased demand for funds originating in the corporate sector, and increased demand for funds from the government.

There has also been significant variability in bank lending across different industrial sectors (see figure). Outstanding loans to firms operating in traditional sectors such as manufacturing, trading, and construction contracted considerably, while lending to firms in “new” industries such as transport and communications expanded significantly. In addition, even in sectors that witnessed an overall contraction in bank lending, the evolution of outstanding loans has not been uniform. For example, loans to utility companies increased in the first part of 1990s, decreased sharply after 1995, and then increased again at the end of the decade.



Firms' bank dependence has declined over the past decade, but substantial variability exists across sectors and categories of firms. Comprehensive survey data from the Ministry of Finance suggests that overall bank dependence, measured as the ratio of bank debt to total assets, has declined from 36.2 to 31.4 over the past ten years. However, bank debt still represents about 76 percent of total corporate debt, down only 3 percentage points, indicating that deleveraging, rather than the recourse to alternative sources of finance, played the main role. In addition, large and medium firms reduced bank dependence more than small enterprises, and non-manufacturing firms reduced it more than manufacturing firms. Differences in borrowing patterns across firms of different size can be explained by the differential access to alternative sources of credit, as confirmed by the sharper decrease in the percentage of bank debt over total debt for large and medium enterprises. Differences across sectors can be explained by the fact that during the 1980s, manufacturing firms had reduced significantly their reliance on bank lending (with bank-debt to assets ratios declining from 32 percent to 16 percent), while bank dependence in the non-manufacturing sector had either increased or remained stable.

Statistical evidence suggests that weaknesses in both the corporate and the banking sectors have been associated with the recent decline in aggregate bank credit.² The analysis is based on finely disaggregated data from the *Tankan* survey and recent banking statistics, and reveals further sectoral heterogeneity. It finds that a slow (or negative) rate of bank credit growth has been associated on the corporate side with a high initial degree of bank dependence and high levels of initial leverage; and on the banking side with a higher initial NPL ratio and a lower initial loan loss reserve ratio.

¹ See Dell'Ariccia "Banks and Credit in Japan" in the *Selected Issues* paper.

monetary easing, which is likely to be a more effective response to yen appreciation than sterilized intervention.

54. Staff discussed with the authorities the likely impact on the yen of implementing the integrated policy package discussed above—including further monetary easing.

There was agreement that, while some short-term weakening of the yen could result, the regional impact was likely to be more manageable than during the Asian crisis, given the greater flexibility of exchange rates and healthier external debt and reserve positions (Callen and McKibbin, 2001). Further, if the weakening of the yen resulted from the implementation of a policy package to restore healthy growth in Japan, this would benefit the rest of the world over the medium term. Staff thus stressed that regional and multilateral concerns should not undercut monetary policy efforts to secure an early end to deflation in Japan.

E. Other Issues

55. The mission stressed the need to address weaknesses in national accounts and fiscal statistics that hamper the monitoring of economic developments. It noted the frequent and large revisions in the quarterly national accounts, and stressed the need to improve the quality of private consumption data, for which preliminary estimates are based on small-sample household surveys. Another priority remains to improve the fiscal data, especially the timeliness and comprehensiveness of measures of the fiscal stance. The authorities responded that a number of improvements had already been made, including the move to *SN493*, the expansion of the household spending survey, and the intention to reduce the time lag in releasing preliminary national accounts data. Faster release of comprehensive fiscal data continued to be hampered by the difficulties of collecting and collating data from the more than 3,000 independent prefectures and municipalities in Japan (Annex II).

56. The authorities reiterated Japan's commitment to multilateral liberalization within the WTO framework, but noted that Japan was also seeking to strengthen regional cooperation through bilateral free-trade agreements. As far as the Doha round was concerned, Japan attached particular importance to the inclusion of anti-dumping, FDI, and trade-environment issues in the Round. Officials consider that China's accession to the WTO will have substantial net benefits to Japan by helping secure new markets, although there were concerns in some quarters about the potential for manufacturing companies to shift operations from Japan to China (so-called "hollowing-out" worries). The authorities were pleased with the final Japan–Singapore Economic Partnership Agreement signed in January, and indicated that preliminary negotiations were underway with Mexico and Korea on possible bilateral FTAs. Officials stressed that Japan expanded its preferential treatment for market access by LDCs in April 2001, with a new augmented list of products eligible for duty- and quota-free access and an increase in the number of eligible LDCs from 42 to 46, although no further measures had been taken recently.

57. The mission urged more progress in reducing agricultural protection, which remains high. While import barriers for industrial products are relatively low, simple average applied tariff rates for agricultural products in Japan are much higher than in the U.S. (and slightly higher than in the E.U.); agricultural producers also benefit from high, production-distorting, domestic support subsidies. The authorities replied that a desire to

raise Japan's low food self-sufficiency rate lay behind high rates of agricultural protection, to which staff responded that reforms that boost the low productivity levels in the agricultural sector would be a more effective way of addressing these concerns. In this context, while staff welcomed Japan's efforts to broaden LDC market access for industrial products, it urged faster progress in securing their access for agricultural products as well.

58. **The authorities explained Japan's efforts to upgrade its anti-money laundering and terrorist financing legislation.** To ratify and implement UN Security Council resolution 1373 and the International Convention for the Suppression of the Financing of Terrorism, the authorities have submitted legislation to: criminalize the financing of terrorist activities; strengthen customer identification requirements for financial institutions; and expedite the authorities' ability to freeze the assets of suspected terrorist organizations. On the anti-bribery initiative, Japan has broadened the definition of public officials covered under legislation to further strengthen its implementation of the OECD's convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

59. **The mission welcomed Japan's ongoing commitment to ODA.** Reflecting its difficult fiscal situation, in 2001 Japan became the world's second largest ODA provider in absolute terms (equivalent to 0.23 percent of GDP in 2001), from first position previously. While Japan's ODA will be reduced by 10 percent in FY02, the authorities explained that the impact would be contained by improving the effectiveness of ODA and focusing on recipient countries' core needs. Staff further welcomed Japan's efforts to advance regional financial cooperation through bilateral swap arrangements that are complementary to IMF facilities.

V. STAFF APPRAISAL

60. **Policymakers in Tokyo face critical choices at this juncture between a bold strategy to finally break the back of Japan's structural economic problems and a muddle-through approach that leaves them to continue to fester.** Notwithstanding some positive results, the policy actions taken during the first year of PM Koizumi's government—including strengthening bank loan classification practices, giving the RCC a bigger role in the NPL disposal process, and providing macro policy support to combat the recession—have fallen short of the integrated strategy needed to lay a firm foundation for healthy growth. To be sure, implementing such a strategy will not be easy, as vital interests will inevitably be adversely affected, and there may even be a temptation—now that the global rebound is expected to pull Japan from recession and temporarily mask the symptoms of its deep-seated problems—toward policy complacency. However, it is clear to everyone how costly and risky the alternative strategy is likely to be, both in terms of prolonging Japan's decade of stagnation, and because of the mounting vulnerabilities from the bank, corporate, and fiscal sectors, both for Japan and the rest of the world.

61. **The integrated policy strategy being recommended by the staff has four pillars:** decisively addressing banking weaknesses; accelerating corporate restructuring; avoiding a premature fiscal contraction while laying out a credible medium-term consolidation strategy; and following a monetary policy that promotes an early end to deflation. These pillars are interlinked, not least because supportive macro policies will be needed to mitigate the headwinds to growth and prices in the near term from vigorous restructuring. Of course, it is

also clear that, without vigorous restructuring, supportive macro policies alone will not lead Japan's economy out of its decade-long slump in any sustainable way.

62. Resolution of the problems in the banking sector is a prerequisite for restoring and sustaining healthy growth. The staff considers that the strategy announced last year needs to be strengthened to accelerate the process of bank restructuring. Time is of the essence given the final phase of the transition to partial deposit insurance next April and the potential for contagion from weaker banks if systemic confidence is in doubt at that time.

- *Loan classification and provisioning practices need further strengthening.* While staff very much welcome the more forward-looking approach to loan classification and provisioning pursued in the FSA's special inspections, it sees an urgent need to extend the application of such an approach systemwide—to regional and smaller banks, and to SMEs—with an appropriate emphasis on gray-zone loans. It is also essential that land collateral on banks' books accurately reflects market conditions. The results of the FSAP should help shed light on these issues, among others.
- *Should the rigorous review of loan classification and provisioning practices staff is calling for result in capital falling below BIS-minima, the public support framework should be used proactively to put capital in systemically-important banks, subject to strong conditionality to limit moral hazard.* The present support framework will need to be augmented if the costs seem likely to exceed the presently-available ¥15 trillion.
- *All deposit-taking institutions should face a timetable for NPL disposal.* The lack of a deadline for smaller banks runs the risk that the NPL problem will linger excessively.
- *The BSPC should not be used to warehouse illiquid stocks.* The staff would continue to view direct sales to the market and rapid repackaging of BSPC-acquired shares into ETFs as the primary disposition for banks' excessive holdings of equity.
- *Banks need to restore their profitability to healthy levels.* In addition to dealing with the NPL problem, other critical steps include: stronger regulatory pressure on banks to develop viable business improvement plans (including shifting away from low-yielding corporate lending to fee-income and other markets such as consumer loans); improved governance and disclosure rules to ensure that markets are in a position to exert appropriate discipline on bank managers; and a downsizing of public financial intermediaries, particularly where these compete unfairly with private banks.

63. The authorities should remain vigilant to the potential risks associated with double-gearing between banks and insurance companies. This practice risks a cascading effect if either actor experiences difficulty. Supervisors need to remain vigilant about potential financial difficulties of life insurers, and to ensure that the reorganization procedures are used when needed to avoid systemic problems.

64. The goal of accelerating corporate restructuring requires that banks proactively use the existing framework. Since banks own the bulk of corporate excess leverage, it is they which must take the lead in agreeing restructuring plans with their potentially-viable

debtors, push nonviable firms into liquidation, and dispose of unwanted loans to third parties. A strong approach in turn requires that banks have recognized the true value of loans on their books, which again underscores the need for rigorous regulatory pressure as discussed above.

65. The RCC should play a lead role in developing Japan's distressed debt market. For this, it needs a clear mandate as far as value, pricing, and timeframe for its purchases are concerned. In staff's view, the RCC should be given latitude to rapidly step up its purchases of distressed debt over the next year, with a view to quickly reselling the NPLs so acquired rather than becoming involved in operational restructuring of distressed firms. This should allow the RCC to play a useful role in expanding Japan's distressed debt market, especially by securitizing NPLs and creating pricing benchmarks and standards for such transactions.

66. Structural reforms are needed to ease the transitional costs from corporate restructuring and generate new investment and job opportunities.

- *Employment and social safety net.* To boost employment and protect the unemployed, regulations governing private employment placement and dispatching agencies should be liberalized further, public funding for retraining programs should be raised, and the social safety net should be improved by lengthening the maximum duration of unemployment benefits, at least for the next few years. At the same time, however, to support the needed reallocation of labor, employment protection legislation needs to be liberalized to facilitate labor shedding.
- *Regulation.* Regulations that limit the size of housing developments and require large retail stores to obtain local government approval need review. Stronger enforcement of competition policy is needed, including in sectors such as construction. While entry barriers are being reduced in the telecoms and power sectors, more progress is needed to reduce costs which remain high by international standards. Streamlining the approvals process for business start-ups would help to spur business formation.
- *Real estate market.* Zoning regulations and laws on rentals and land leases should be liberalized further, and land transaction taxes should be reduced. Despite its potential negative short-term impact on prices, accelerated disposal of land collateral by the RCC and banks is needed to make the market more liquid and help it find a bottom.
- *Corporate governance.* The recent Commercial Code revision allowing firms to adopt managements with a majority of outside directors should help to better align manager and shareholder interests in firms that take up this governance model.

67. A key role of fiscal policy in the context of the staff's comprehensive policy strategy is to achieve a broadly neutral stance in the near term. Implementation of the integrated policy strategy is likely to intensify headwinds against the fragile recovery, and that makes the likely withdrawal of fiscal stimulus from later this year—once the impact of last year's supplementary budgets fades—undesirable. Staff would thus recommend that the initial budget for FY2003 aim to achieve a neutral fiscal stance on an annual basis, while a small supplementary budget—focused on measures to encourage economic restructuring—be legislated to counteract any fiscal contraction that seems likely in the latter half of FY2002.

68. **Even more important is the implementation of a range of fiscal reforms to strengthen the credibility of the commitment to medium-term consolidation and lower risks of a JGB yield spike.** On the **spending** side, the priorities are the full de-earmarking of road-related tax revenues and a more thorough cost-benefit analysis of public works projects to free resources for better training programs, a stronger safety net, and improved nursing and childcare. On the **tax** side, staff is strongly supportive of current proposals to overhaul the tax system with a view to broadening bases of personal and corporate income taxes; introduction of taxpayer ID numbers and an early review of the tax surcharge on firms filing on a consolidated basis are other priorities. Regarding **social security**, there is need to revisit the issue of curbing the growth of total medical expenses by the health care system, and also to reduce unfunded pension liabilities through another round of pension reforms. Finally, on the public enterprises, there is a need to move faster than currently-proposed with privatizing or abolishing a number of special public corporations (including the road-related corporations), ensuring that GFIs remaining in the public sector fulfill an explicit social objective at reasonable cost, and increasing the share of market financing for GFIs in the FILP.

69. **Apart from these reforms, the government needs to comprehensively spell out its medium-term fiscal consolidation strategy.** A permanent fiscal responsibility law could provide an appropriate vehicle for committing to a medium-term debt target, and the broad objectives of tax, expenditure, and social security policies. While the illustrative scenarios prepared by staff suggest that fiscal adjustment of $\frac{1}{2}$ – $\frac{3}{4}$ percent of GDP per year can stabilize the public debt ratio over a 5–10 year horizon, further adjustment would be needed beyond that timeframe given the still high level of public debt and Japan's adverse demographics.

70. **The BoJ should aim monetary policy to achieve an end to deflation over the next 12–18 months.** While the expansion of liquidity over the past year has helped to maintain market stability, it is unlikely to succeed in eliminating deflation any time soon, as confirmed by the Policy Board's own forecasts. More therefore needs to be done. This should include a public commitment on the timeframe for ending deflation, and further quantitative easing, including stepped-up purchases of government bonds and other high-quality assets as needed. Once deflation has been eliminated, the BoJ should adopt a modest positive inflation target to minimize the risk of again being constrained by the zero bound on nominal interest rates.

71. **The yen's recent appreciation is a concern, as it could undermine a still fragile export-led recovery.** This strengthens the case for further monetary easing as part of the staff's integrated policy strategy, which could weaken the yen in the near term. Any short-term cost to the region and other economies of a weaker yen would need to be set against the benefit from a more vigorous Japanese economy in the medium term. Because regional economies are generally better able now than a few years ago to cope with yen volatility, not least due to their greater exchange rate flexibility, staff do not consider that regional or multilateral concerns should undercut efforts to secure an early end to deflation in Japan.

72. **Weaknesses in national accounts and fiscal statistics should be addressed.** The priorities are to improve the quality of surveys underpinning the quarterly consumption data, and to upgrade the timeliness and comprehensiveness of measures of the fiscal stance.

73. **Protection of the agricultural sector should be reduced, and LDC market access, especially for agricultural products, improved.** While staff welcome the expansion of LDC market access for industrial products, more progress is needed to secure their access for agricultural products. Staff would also stress the likely gains for consumers and productive efficiency of reductions in rates of agricultural protection.

74. **Japan's ongoing commitment to ODA is commendable.** Japan's efforts to advance regional financial cooperation, including through bilateral swap arrangements which can be activated in conjunction with IMF facilities, is also welcome.

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

Table 1. Japan: Selected Economic Indicators, 1995-2003

Population: 127.1 million (2001)
GDP per capita: US\$32,631 (2001)
Quota: SDR 8,241.5 million

	1995	1996	1997	1998	1999	2000	2001	Proj.	
								2002	2003
Growth (percent change) 1/									
Real GDP	1.5	3.6	1.8	-1.0	0.7	2.2	-0.5	-0.5	1.1
Domestic demand	2.0	4.1	0.9	-1.4	0.8	1.8	0.2	-1.1	0.8
Private consumption	1.3	2.3	0.9	0.2	1.1	0.3	0.5	1.6	1.1
Residential investment	-5.8	13.4	-15.3	-14.0	0.9	1.8	-7.8	-3.2	2.1
Business investment	2.5	4.2	13.2	-2.3	-4.4	10.3	0.6	-12.0	3.8
Government consumption	4.3	2.8	1.3	1.9	4.5	4.6	3.1	2.5	2.1
Public investment	-0.3	9.0	-10.3	-2.7	6.5	-9.8	-4.5	-2.7	-11.4
Stockbuilding 2/	0.6	0.3	0.0	-0.6	-0.3	0.0	0.0	0.0	0.0
Net exports 2/	-0.5	-0.4	1.0	0.3	-0.1	0.5	-0.7	0.6	0.3
Exports of goods and services	4.1	6.4	11.3	-2.3	1.3	12.4	-6.5	5.0	8.2
Imports of goods and services	12.8	13.2	1.2	-6.8	3.0	9.6	-0.5	-0.9	7.0
Saving-Investment (percent of GDP)									
Gross national saving	30.2	30.6	30.9	29.8	28.4	28.5	27.6	26.3	25.6
Gross domestic investment	28.2	29.2	28.7	26.9	25.9	26.0	25.5	23.2	22.6
Inflation (annual average)									
CPI	-0.1	0.0	1.7	0.6	-0.3	-0.8	-0.7	-1.0	-0.4
GDP deflator	-0.3	-0.8	0.3	-0.1	-1.4	-1.9	-1.5	-1.4	-1.1
Unemployment rate (annual average)	3.2	3.4	3.4	4.1	4.7	4.7	5.0	5.4	5.5
Government (percent of GDP)									
General government									
Revenue	30.2	29.9	30.0	29.3	29.0	29.4	29.5	29.3	29.2
Expenditure	34.4	34.9	33.8	34.8	36.0	36.8	36.7	36.6	35.1
Balance	-4.2	-4.9	-3.7	-5.5	-7.0	-7.3	-7.1	-7.3	-5.9
Balance excluding social security	-6.5	-7.0	-5.8	-7.1	-8.5	-8.4	-7.4	-7.2	-5.7
Structural balance 3/	-3.8	-5.2	-4.1	-4.7	-6.0	-5.6	-6.0	-5.7	-4.4
Money and credit (percent change, end-period)									
Base money	6.1	7.3	9.9	4.0	14.2	-1.1	16.9	29.7 5/	...
M2 plus CDs	3.0	3.3	3.1	4.4	3.7	2.1	2.8	3.5 5/	...
Domestic credit	1.8	1.4	1.3	2.6	2.9	2.6	1.6	-2.4 6/	...
Bank lending	2.1	-0.4	0.0	-4.7	-5.9	-3.8	-4.3	-4.7 5/	...
Interest rate									
Three-month CD rate (annual average)	1.1	0.5	0.5	0.6	0.1	0.2	0.09	0.05 7/	...
Official discount rate (end-period)	0.5	0.5	0.5	0.5	0.5	0.5	0.10	0.10 7/	...
Balance of payments (in billions of US\$)									
Exports, f.o.b.	429.4	400.2	409.2	374.4	403.9	459.6	383.5	381.7	427.0
Imports, f.o.b.	297.2	316.7	307.8	251.6	280.5	342.8	313.3	284.0	307.8
Current account balance	111.4	65.7	96.6	119.1	114.5	119.6	87.8	119.6	125.8
Percent of GDP	2.1	1.4	2.2	3.0	2.5	2.5	2.1	3.1	3.1
Terms of trade (percent change)	-0.1	-6.9	-3.9	6.7	4.6	-5.0	0.3	1.2	-0.2
Change in reserves	58.7	36.8	6.9	-7.4	77.3	49.3	41.1	...	...
Total reserves minus gold (in billions of US\$)	181.6	216.6	219.6	214.8	286.9	354.9	395.2	411.6 5/	...
Exchange rates (annual average)									
Yen/dollar rate	94.1	108.8	121.0	130.9	113.9	107.8	121.5	119.8 7/	...
Real effective exchange rate 4/	146.4	125.1	119.5	111.6	127.0	136.5	120.8	110.4 5/	...

Sources: Nikkei Telecom; and staff estimates and projections as of June 26, 2002.

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

2/ Contribution to GDP growth.

3/ Including social security, excluding bank support.

4/ Based on normalized unit labor costs; 1990=100.

5/ May 2002.

6/ April 2002.

7/ July 1, 2002.

Table 2. Japan—General Government Operations 1/

(In percent of GDP)

	FY1998	FY1999	FY2000	FY2001 Est.	FY2002 Proj.	FY2003 Proj.	CY1998	CY1999	CY2000	CY2001 Est.	CY2002 Proj.	CY2003 Proj.
General government balance	-6.1	-6.8	-6.6	-7.2	-7.0	-5.6	-5.5	-7.0	-7.3	-7.1	-7.3	-5.9
Social security balance	1.5	1.6	0.9	0.1	-0.2	-0.2	1.6	1.5	1.1	0.2	-0.1	-0.2
General government excluding social security	-7.6	-8.3	-7.5	-7.3	-6.8	-5.4	-7.1	-8.5	-8.4	-7.4	-7.2	-5.7
Of which:												
Taxes and fines	16.9	16.4	17.3	17.3	17.0	17.0	16.8	16.5	17.0	17.3	17.1	17.0
Consumption	11.2	11.4	11.5	12.1	11.8	11.4	11.0	11.4	11.4	11.9	11.9	11.6
Investment	5.7	5.5	5.1	4.8	4.4	3.6	5.5	5.8	5.0	4.9	4.7	3.6
Support for banks	0.2	0.7	0.7	0.0	0.0	0.0	0.2	0.1	1.2	0.1	0.0	0.0
Structural balance												
(Including social security, excluding support for banks)	-5.0	-5.4	-5.4	-6.0	-5.4	-4.3	-4.7	-6.0	-5.6	-6.0	-5.7	-4.4
Change in structural balance												
(Including social security, excluding support for banks)	-1.2	-0.4	0.0	-0.5	0.6	1.1	-0.6	-1.3	0.4	-0.3	0.3	1.3
Memorandum items:												
Gross debt 2/	...	...	...	...	...	...	108.4	120.9	135.7	145.7	155.7	161.3
Net debt (excluding social security system) 2/	...	...	...	...	...	...	80.2	90.0	102.4	111.9	121.2	126.8

Source: Staff estimates, based on the following assumptions:

Growth: Real GDP growth is projected to be -0.5 percent in CY2002. Each percentage point increase in growth raises the general government balance by about 0.3 percentage points of GDP.
Stimulus Packages: The projections take account of the FY2000 supplementary budget and the FY2001 budget. For FY2002, the projection incorporates the initial budget, the first supplementary budget of November 2001 with a headline figure of ¥3 trillion, and a second supplementary budget of ¥4 trillion. Of this ¥4 trillion, ¥2.5 trillion is central government spending and ¥1.5 trillion is local government spending. The latter is financed by local government borrowing which will be redeemed by central government transfers.

Support for Banks: Under Japanese fiscal accounting, the budgetary impact of capital made available to the DIC for dealing with bank closures occurs at the time the money is spent.

1/ Estimated from revised National Income Accounts data, consistent with the SNA93 prepared by the Economic and Social Research Institute, Cabinet Office, released starting October 2000.

2/ The step up in debt for CY2000 reflects a revision of the flow-of-fund accounts. Local public corporations are included in the general government starting only in CY2000.

Table 3. Japan: Indicators of External and Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000	2001	2002 Latest
External indicators								
Real exports of goods and services (percent change)	4.1	6.5	11.2	-2.3	1.4	12.4	-6.6	-4.5
Real imports of goods and services (percent change)	12.8	13.2	1.2	-6.8	3.0	9.6	-0.6	-8.8
Terms of trade (percent change)	-0.1	-6.9	-3.9	6.7	4.6	-5.0	0.3	-2.3
Current account balance	2.1	1.4	2.2	3.0	2.5	2.5	2.1	3.5
Capital and financial account balance	-1.3	-0.5	-2.7	-3.0	-1.1	-1.9	-1.4	-3.0
Of which :								
Inward portfolio investment	1.0	1.4	1.8	1.4	2.8	1.0	1.5	-7.6
Inward direct investment	0.0	0.0	0.1	0.1	0.3	0.2	0.1	0.5
Other investment liabilities (net)	-0.1	0.8	-2.8	-1.4	0.1	-0.3	0.7	0.9
Official reserves (US\$ billion)	182.8	217.9	220.8	215.9	288.1	361.6	402.0	419.7
In months of imports of goods and services	5.4	6.0	6.4	7.4	9.1	9.8	11.9	13.6
Broad money (M2 + CDs) to reserves ratio	3.1	2.3	2.1	2.1	1.9	1.6	1.3	1.3
Foreign assets of DMBs (US\$ billion)	1169.5	960.7	1064.0	833.2	682.5	787.8	768.4	710.2
Foreign liabilities of DMBs (US\$ billion)	803.0	736.0	762.5	612.5	478.8	568.7	565.5	489.8
Net international investment position (US\$ billion)	817.6	891.0	958.7	1153.6	829.1	1157.9	1249.1	...
Of which :								
External loan liabilities	1039.3	885.6	883.2	717.7	676.8	707.2	654.5	...
External public sector debt (gross) 1/	161.0	173.6	229.6	244.0	208.7	271.7	232.8	...
External loan liabilities to exports ratio	2.2	1.9	1.9	1.7	1.5	1.4	1.5	...
External interest payments to exports (in percent) 2/	25.8	8.4	7.4	7.2	4.5	3.9	4.1	2.9
Nominal effective exchange rate (percent change)	6.7	-12.7	-4.2	0.3	15.2	10.2	-7.7	-5.8
Financial market indicators								
General government gross debt	85.4	91.8	97.5	108.5	121.0	135.8	145.9	155.7
Interest rates (percent, end-year)								
3-month Gensaki rate	0.23	0.25	0.23	0.14	0.07	0.32	0.01	0.002
3-month Gensaki rate, real	0.63	-0.36	-1.59	-0.45	1.15	0.72	1.21	0.90
3-month interest rate spread vis-à-vis U.S.	-4.93	-4.62	-4.93	-4.28	-5.16	-5.51	-1.71	-1.72
Stock market index (TOPIX, percent change, end-year)	1.2	-6.8	-20.1	-7.5	58.4	-25.5	-19.6	-0.7
Banking sector risk indicators								
Total loans to assets (in percent)	53.4	52.5	50.9	49.9	47.3	44.3	39.6	39.2
Total loans to deposits (in percent)	107.5	107.6	107.0	105.1	98.9	97.8	93.4	91.6
Share of real estate sector in total lending (in percent)	13.5	13.8	14.2	14.2	14.5	14.9	14.9	14.7
Share of non-performing loans in total loans								
(in percent, end-fiscal year) 3/	6.6	4.9	5.5	6.1	5.8	5.7	8.4	...
Risk-weighted capital ratio (in percent, end-fiscal year) 3/	9.1	9.0	9.5	11.6	11.8	11.7	10.8	...

Sources: DRI-WEFA, Nomura Database; IMF, International Financial Statistics; Fitch IBCA; and staff estimates.

1/ Public sector debt securities and other loan liabilities.

2/ Other investment income, debit.

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

JAPAN—FUND RELATIONS
(As of May 31, 2002)

I.	Membership Status:	Joined 8/13/52; Article VIII		
II.	General Resources Account:		SDR Million	% Quota
	Quota		13,312.80	100.0
	Fund holdings of currency		8,733.79	65.6
	Reserve position in Fund		4,579.42	34.4
	Financial Transaction Plan transfers (net)		174.00	
III.	SDR Department:		SDR Million	% Allocation
	Net cumulative allocation		891.69	100.0
	Holdings		1,863.65	209.0
IV.	Outstanding Purchases and Loans:		None	
V.	Financial Arrangements:		None	
VI.	Projected Obligations to Fund:		None	
VII.	Exchange Rate Arrangement:			

Japan maintains a floating exchange rate regime. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions maintained against Iraq and Libya, pursuant to UN Security Council Resolutions 661 and 748. These restrictions were notified to the Fund (EBD/90/261) in accordance with Executive Board Decision No. 144-(52/51).

VIII. Article IV Consultation:

The 2001 Article IV Consultation discussions were held during May 10–22, 2001; the Executive Board discussed the Staff Report (SM/01/221) and concluded the consultation on August 3, 2001. In the Summing Up, Directors stressed that Japan had little choice but to embark on the long delayed restructuring needed to achieve sustained growth in the medium term. While emphasizing that fiscal policy should remain responsive to changing economic circumstances, Directors noted that measures to improve the quality of government expenditure were essential. Directors welcomed the Bank of Japan's new monetary policy framework, but noted that further easing would be necessary to eliminate downward pressure on prices. Some Directors argued that the effectiveness of monetary policy would be enhanced if a timeframe for eliminating deflation were specified. The staff report, accompanying fiscal ROSC, and PIN were all published.

JAPAN—STATISTICAL ISSUES

1. Japan has subscribed to the Special Data Dissemination Standard (SDDS).
2. **National accounts**
 - The Japanese National Income Accounts were revised in 2000 by the Economic and Social Research Institute (ESRI, formerly the Economic Planning Agency or EPA) to reflect the *1993 System of National Accounts (SNA93)*. The data revision involved, among other things, the inclusion of spending on computer software in investment expenditure and depreciation on social capital in public consumption, and revision of the benchmark year to 1995. Improvements in the seasonal adjustment method were also introduced to take account of leap year, trading-day, and other shift factors. The data have been revised for only the period starting in 1980. The data revisions are described in ESRI's publication *System of National Accounts 1993 in Japan*, April 2001.
 - Preliminary estimates of Japan's quarterly GDP data are released by the ESRI. So far the estimate has been released about 2½ months after the end of the relevant quarter—similar to industrial countries, but slower than the U.S. and that planned for the E.U. Recently it was announced that a new method, combining supply and demand side indicators, will be introduced to improve the accuracy of the estimates and reduce the data release lag by 1 month. In particular, supply side indicators (including sales and shipment) would be combined with previously used demand side indicators (drawing from household expenditure survey data) to estimate consumption, potentially reducing the margin of error. More complete annual national accounts data are only available with a lag of nine months to one year, severely limiting their usefulness for current analysis.¹
 - Preliminary estimates of private consumption are currently based on volatile, small sample, household surveys. The Family Income and Expenditure Survey (FIES) has been subjected to volatility, particularly in “lumpy” expenditure items such as consumer durables. Survey response rates have also declined. Some steps were taken in January 2002 to improve the quality of the data, including a modest expansion of the sample size to about 9,000 households (from about 8,000) and reclassification of survey items to better reflect expenditures on IT products. Additionally, a new survey on durable goods expenditures, covering about 30,000 households, was introduced in October 2001.
 - The GDP data on some key components of demand are available only with the release of the annual data, including the breakdown of trade flows into goods and services, of business investment into structures and equipment, and of private consumption into durables and nondurables.

¹ The data are available in hard copy and electronic format after 9 months and one year, respectively.

- Preliminary estimates for the income side of the national accounts (with the exception of seasonally unadjusted household employment income) are not provided, in part because estimates for profits are based on an imputed quarterly pattern for annual data.
- The ESRI relies on other agencies and organizations to compile the underlying source data used to construct the national accounts, and faces coordination problems with data providers in influencing the design of surveys and administrative collections to serve national accounts purposes.
- The methodology used to construct preliminary GDP estimates is not well understood outside of the ESRI.

3. **Fiscal**

- Fiscal accounts distinguish between general (or ordinary) accounts for core government functions, and special accounts that are partly financed through borrowing from the Fiscal Investment and Loan Program (FILP). Information on the central government general account is readily available, but published consolidated accounts—which incorporate special accounts—are insufficient to calculate a consolidated deficit.
- There exist more than 3,000 independent prefectures and municipalities, the finances of which are only partly consolidated with a delay of about two years.
- Data on general government operations—including disaggregation by major government sector—are available with the release of the annual national accounts data.
- The government published its first balance sheet in October 2000. While the data on liabilities were largely as expected, the assessment of assets and contingent liabilities is likely to need considerable improvement, including through more comprehensive coverage of local governments, FILP agencies, and public corporations.
- The authorities have not reported fiscal data for publication in the *GFS Yearbook* since 1994. Thus, the *GFS 2001 Yearbook* includes data for the consolidated central government and local governments through 1993 and 1989, respectively. The central government data are preliminary or provisional for 1991–93.
- New estimates of the general government’s fiscal balances and debt have been prepared by staff using the revised national income accounts data. For 1990–98—the comparable historical period for which data were presented in the staff report for the 2001 Article IV Consultation discussions—the general government deficit is now estimated to be higher by 0.4–1.1 percent of GDP. This is consistent with the ESRI’s estimates which revised down the savings-investment balances of the general government sector by 0.3–1.0 percent of GDP for

1990–98. In addition, reflecting the shift of the employees’ pension funds—which have substantial financial assets—out of the general government sector, net debt (excluding social security) is now estimated to be 4½ percent of GDP higher at end-1998. Furthermore, local public corporations are now included in the general government starting in CY2000. This has resulted in a step up in general government debt for CY2000. The BoJ is in the process of revising the flow-of-funds data prior to CY2000 which would help provide a consistent data series for government debt.

4. External sector

- While monthly data on merchandise trade and the balance of payments are released on a timely basis, there is no predetermined schedule for their release.
- In the financial account of the balance of payments, the proceeds from the sale of loans during 1998–2000 may be overstated because the sales were not recorded at market prices. The BoJ recorded corresponding large debit entries as capital transfers in the capital account.

5. Labor market

- The definition of employment and labor force participation in the labor force survey differ from standardized OECD definitions, which may lead to an understatement of the unemployment rate.

6. Monetary and financial sector

- Banking sector data are disseminated 6–8 business days after the end of the reference month for money stocks and total credit. The breakdown of credit to government and credit to the private sector, which is published as the monetary survey in the Bank of Japan’s “*Financial and Economic Statistics Monthly*,” is disseminated normally 6–7 weeks after the end of the reference month. Data on the external position of the banking sector are also disseminated 6–7 weeks after the reference month. As only data on money stocks and total credit meet the one-month SDDS timeliness requirement for Analytical Accounts of the Banking sector (AAB), Japan is using a timeliness flexibility option for the other components of AAB on the grounds that they have an extensive branch banking system.

7. Recommendations for data improvements

In the short term, there is need to:

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

- provide greater detail on the quarterly components of spending and national income;
- set fixed release dates for key data, including the national accounts and external trade;
- improve the seasonal adjustment of the national accounts and other important economic data; and
- release more information on the methodology used to construct the national accounts from other economic indicators.

Over the longer term, efforts should be directed to:

- bringing the definition of labor market activity into line with OECD standardized definitions; and
- moving data production to a single, independent agency staffed with professional statisticians.

Japan: Core Statistical Indicators¹
(As of July 1, 2002)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of latest observation	7/1/02	5/02	5/02	6/20/02	5/02	7/1/02	5/02	4/02	3/02	2000	2002:Q1	End-2000
Date received	7/1/02	5/31/02	5/02	6/24/02	5/02	7/1/02	5/02	4/02	4/02	3/02	6/02	9/01
Frequency of Data	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A
Frequency of Reporting	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A
Source of data	B	B	B	B	B	B	B	B	B	F	N	B
Mode of Reporting	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted	Unre-stricted
Frequency of publication	D	M	M	Every 10 days	M	D	M	M	M	A	Q	A

¹ D: Daily; M: Monthly; Q: Quarterly; A: Annual; E: Electronic; B: Bank of Japan website; F: Ministry of Finance website; N: National Accounts website.

FISCAL MEASURES NEEDED TO STABILIZE PUBLIC DEBT

This annex presents a simple analysis of fiscal measures needed to stabilize the general government debt ratio. We use the accounting relationship between debt and budget deficits:

$$b_t^p = (r_t - g_t) / (1 + g_t) d_t$$

where b^p is the target for the primary balance in percent of GDP, d is the debt-to-GDP ratio, and r and g are the values for the nominal interest rate paid on government debt and the nominal GDP growth rate, respectively. The amount of fiscal consolidation necessary to stabilize the debt-to-GDP ratio (the “required adjustment”) can then be calculated as the difference between the value of b^p and the current cyclically-adjusted primary balance (estimated at around $-3\frac{3}{4}$ percent of GDP in FY2002). This annex also indicates the sensitivity of this measure to changes in r , g , and the horizon for achieving stabilization. These calculations are illustrative and do not touch on the desirable steady-state level of the debt ratio, which may well be lower than the stabilized-level reached at the end of the various scenarios.

The appropriate measure of public debt for Japan has been the subject of some debate.¹ In the following, net debt and the primary balance for the general government *excluding social security assets* are used as the measures of d and b^p , respectively.² As regards r , a measure of average interest costs derived from the interest paid on government debt, which reflects past debt contracted at different maturities and interest rates, is used. As interest rates on government bonds have generally been declining in recent years, the current value of r (roughly $2\frac{1}{2}$ percent) is higher than the current yield on 10-year JGBs ($1\frac{1}{2}$ percent). With an average debt maturity of about 4–5 years, the projected future changes in JGB yields affect the average interest rate only gradually—a fact that is taken into account in the following calculations.

The required fiscal adjustment—the reduction in the structural primary deficit needed to stabilize the debt ratio for various combinations of real growth rates and real JGB yields—is tabulated below, under two different stabilization horizons (5 and 10 years, respectively).³ For simplicity, it is assumed in both scenarios that growth and interest rates on new debt converge in a linear fashion to their steady-state values by 2007, and the adjustment in the structural balance is also assumed to be linear over the adjustment period.⁴

The staff’s current baseline forecast corresponds to a scenario in which real growth converges to a medium-term potential of about 2 percent, and real JGB yields stabilize at $2\frac{1}{2}$ percent by 2007. In this case, fiscal adjustment of $2\frac{1}{4}$ percent of GDP—sufficient to effectively eliminate the structural primary deficit by FY2007—would stabilize net debt (excluding social security assets) at 134 percent of GDP, compared to an estimated 122 percent of GDP in 2002 (Annex Table 1).⁵

¹ IMF Country Report 00/98.

² The assets of the social security system are more than offset by the projected future liabilities, although staff estimates suggest that the recent pension reforms reduced the projected net liabilities from 60 percent of GDP to about 30 percent of GDP.

³ Inflation is assumed to be flat at 1 percent a year throughout.

⁴ Variations in the paths of interest rates and growth towards their endpoints have only small effects on the required adjustment.

⁵ Debt stabilizes at a higher level than indicated in the staff report for the 2001 Article IV Consultation (Country Report No. 01/144) mainly because the starting debt level is higher. This, in turn, reflects the fiscal

The required fiscal adjustment would be smaller, however, were the potential growth rate to increase, and correspondingly higher if the growth rate were to fall. Variations in JGB yields also change the required fiscal adjustment. For example, if real interest rates fell to around 1 percent, the required adjustment would be ½ percent of GDP smaller than in the baseline scenario.

Adjustment in Primary Structural Balance of General Government (Excluding Social Security) Needed to Achieve Net Debt Stabilization by FY2007 (In percent of GDP)						
		Steady-state real JGB yield				
		1.0	2.0	3.0	4.0	5.0
Steady-state real GDP growth rate	0.5	3.8	4.1	4.3	4.5	4.8
	1	3.1	3.5	3.6	3.8	4.2
	2	1.8	2.2	2.3	2.5	2.9
	3	0.6	0.9	1.1	1.2	1.6
	4	-0.7	-0.3	-0.2	0.0	0.3
Source: Staff calculations.						
Note: Table shows adjustment required by FY2007 under a consolidation process, starting from a structural primary deficit of 2.8 percent of GDP in FY2002. GDP growth and JGB yields are assumed to increase linearly to their steady-state values by FY2007.						

A more gradual consolidation effort to stabilize net debt by 2012 scenario would require a somewhat larger cumulative shift in the structural balance, but spread out over a longer period. However, the slower adjustment under this scenario would lead to higher debt accumulation in the interim and stabilization of debt at a higher level of about 140 percent of GDP.

Adjustment in Primary Structural Balance of General Government (Excluding Social Security) Needed to Achieve Net Debt Stabilization by FY2012 (In percent of GDP)						
		Steady-state real JGB yield				
		1.0	2.0	3.0	4.0	5.0
Steady-state real GDP growth rate	0.5	3.8	4.6	5.0	5.4	6.2
	1	3.0	3.8	4.2	4.6	5.4
	2	1.7	2.4	2.8	3.2	4.0
	3	0.4	1.1	1.5	1.9	2.7
	4	-0.8	-0.1	0.3	0.7	1.4
Source: Staff calculations.						
Note: Table shows adjustment required by FY2012 under a consolidation process, starting from a structural primary deficit of 2.8 percent of GDP in FY2002. GDP growth and JGB yields are assumed to increase linearly to their steady-state values by FY2007, and remain constant for the remainder of the projection period.						

The above matrices provide information on the change in the structural primary balance needed to secure debt stabilization over a particular horizon. However, over that horizon, the

deficit in FY2001 and an upward revision of the debt stock due to a shift in the national income accounts to an SNA93 basis and the inclusion at end-2000 of local public corporations in the general government sector.

central and local governments' structural balance will deteriorate on a current policies basis because of transfers needed to sustain social security payments.

To take this into account, the revenues and expenditures of the social security system were projected under current policies. On the revenue side, the premium contributions reflect the decline in the working age population, while the rise in expenditures reflects the increase in the old age dependency ratio. The projections also reflect the prospective changes in contribution rates, benefits and retirement age due to pension reforms legislated in 2000. Budgetary transfers to the social security system are assumed to grow in line with expenditures, and the larger transfers from the central government—included in the reforms—help to maintain the assets of the social security system broadly unchanged as a share of GDP. The population projections used in this analysis are the official estimates by the Ministry of Health, Labor and Welfare.

In the baseline scenario, the budgetary transfers rise by 1½ percent of GDP by the end of the 5-year stabilization horizon. Together with the needed adjustment in the structural primary balance, the amount of fiscal measures needed to stabilize the debt ratio is, therefore, around 3¼ percent of GDP. Over the 10-year stabilization horizon, under continued demographic pressures, the transfers to the system rise by a little over 2½ percent of GDP,⁶ bringing the total amount of fiscal measures required to around 5¼ percent of GDP. These estimates, however, does not include the potential costs of government intervention in the financial sector.

Japan: Baseline Scenario for Medium-Term Debt Consolidation						
General Government excluding social security	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007
	(In trillions of yen)					
Balance	-33.7	-34.2	-27.9	-25.6	-23.4	-21.2
Primary	-18.9	-19.7	-12.7	-9.5	-6.2	-2.8
Net interest payments	-14.8	-14.5	-15.2	-16.1	-17.1	-18.4
Debt	599.1	633.3	661.2	686.8	710.2	731.4
	(In percent of GDP)					
Balance	-6.8	-6.9	-5.5	-4.9	-4.4	-3.9
Primary	-3.8	-3.2	-2.5	-1.8	-1.2	-0.5
Net interest payments	-3.0	-2.9	-3.0	-3.1	-3.2	-3.4
Structural balance	-5.8	-5.4	-5.0	-4.7	-4.3	-3.9
Structural primary balance	-2.8	-2.5	-2.0	-1.6	-1.0	-0.5
Net debt (excluding social security)	121.6	126.9	130.3	132.5	133.6	133.5
	(In percent)					
Memorandum items:						
Implied interest rate	2.5	2.4	2.4	2.4	2.5	2.6
JGB yield	1.5	1.9	2.3	2.7	3.1	3.5
In real terms	2.9	0.9	1.3	1.7	2.1	2.5
Nominal GDP growth	-1.6	1.3	1.7	2.2	2.6	3.0
Real growth	-0.2	0.3	0.7	1.1	1.6	2.0
Deflator	-1.5	1.0	1.0	1.0	1.0	1.0
Nominal GDP (¥ trillion)	492.6	498.9	507.4	518.3	531.7	547.8
Source: Staff calculations.						

⁶ The estimated transfers are lower than reported in Chand and Jaegar (1996) as they take into account the pension reforms in 2000.

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Japan

On July, 24, 2002, the Executive Board concluded the Article IV consultation with Japan.¹

Background

In 2001, Japan experienced its third—and worst—recession of the past decade. After a strong first quarter, real GDP fell for three successive quarters, with a drop of ½ percent on an annual basis compared to 2¼ percent growth in 2000. This slump was largely attributable to the reversal of the engines of growth in 2000—business investment and net exports. With the downturn in the global electronics market last year, profits, investment, and exports plunged, the latter leading to a sharp turnaround in the external sector's contribution to growth. At the same time, private consumption remained anemic in the face of weak incomes and uncertain job prospects.

The economy rebounded strongly in the first quarter of 2002. Global recovery underpinned a large net export contribution, while special transitory factors—including unseasonably warm weather and anomalies in the small single-family spending survey—boosted household spending. Earlier fiscal stimulus measures boosted public demand, but business and residential investment continued to slump.

Deflation persists, magnifying real debt burdens. In terms of the core CPI (which excludes fresh food and energy), deflation remains at 1 percent. While relative price declines for telecommunications, household goods, and clothing may reflect structural change—e.g., telecom deregulation and increased imports from Asia—deflation in the general price level reflected weak demand and the rising output gap. Land prices also continued to decline, and surveyed expectations point to ongoing deflation. Reflecting these trends, nominal GDP has

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the July, 24, 2002 Executive Board discussion based on the staff report.

fallen by 2½ percent in over the past year, magnifying corporate debt burdens, and contributing to a surge in bankruptcies to their highest level since 1984.

Following last year's narrowing, the current account surplus widened strongly in the first quarter of 2002. The trade surplus—which had narrowed sharply during 2001 as the global slowdown took its toll on exports—widened as export volumes recovered and imports declined. Strong profits from overseas subsidiaries of Japanese companies (recorded in the statistics with a lag) and a decline in payments overseas also boosted the investment income surplus. In the financial account, outward direct investment has increased as companies have sought to improve competitiveness by relocating operations overseas.

Equity prices, which spiraled downwards last year amid the deterioration in the economy, rebounded during March–May 2002, but followed world markets down in June. In contrast to other major stock market indices, the Nikkei and Topix did not rebound from their September lows through February, with both indices falling by one-half from their cyclical peaks in March 2000, as bank stocks weighed heavily on the market. As well as the sharp deterioration in the earnings outlook, structural factors impacted the market, including the continued unwinding of cross shareholdings between banks and corporates. The stock market's rally in March coincided with a tightening of short-selling regulations on equities, but improved foreign sentiment toward Japanese stocks amid the strengthening of the global economy sustained the rebound. The Nikkei and Topix, however, dropped 10–15 percent from their recent peaks during June, broadly in line with other major indices.

The yen was under downward pressure for most of the past year, but reversed course from March 2002. Following its downtrend in the first half of 2001, the yen briefly rallied in the wake of the post-September 11 terrorist attacks. Subsequently, it weakened sharply against the U.S. dollar through early March 2002. From then on, and despite significant intervention to stem its rise, the yen has strengthened, especially against the U.S. dollar which has weakened in world markets. This said, the yen remains 5–10 percent depreciated in nominal and real effective terms (CPI and ULC basis) relative to average levels in 2001, and 10–20 percent below levels in 2000.

Since the introduction of its quantitative framework in March 2001, the BoJ has gradually raised its operating target for current account balances (bank and nonbank reserves at the BoJ). The BoJ first increased the target in August, and then again in December. In the runup to the removal of the blanket deposit guarantee in March, moreover, the BoJ allowed current account balances to exceed the target, and it stepped up its outright JGB purchases (*rinban* operations) to ¥1 trillion a month from February. Notwithstanding the impact on base money—which saw year-on-year growth of 30 percent in May 2002—broad money and bank lending have not responded.

Current policy is set to deliver a fiscal contraction in FY2002, following the expansionary stance in FY2001 (fiscal year runs from April 1 to March 31). To meet the PM's pledge to limit net JGB issues to ¥30 trillion, the FY2002 budget included spending cuts—on public works, public enterprise subsidies, and ODA—that will result in the first decline in discretionary spending in four years. These cuts, however, will be cushioned to some extent by two supplementary

budgets in late FY2001, and the general government structural budget deficit is expected to decline by around ½ percent of GDP in FY2002. Gross government debt rose to around 146 percent of GDP at end-2001, and net debt (excluding social security assets) rose to 112 percent of GDP. JGB yields have fluctuated in a narrow range over the past year, despite the downgrades of Japan's sovereign credit rating, mounting public debt, and concerns that another round of public funds may need to be injected into the banking system.

The weak economy and falling equity prices have taken their toll on bank profits, and on market perceptions of banking risks. Major banks' loan-loss charges rose to ¥7.7 trillion in FY2001, four times as large as projected at the start of the financial year. Reflecting concerns about their financial health, spreads on bank debentures rose in early 2002 ahead of the removal of the blanket deposit guarantee, but have since narrowed. While operating profits did rise, with no gains on equity portfolios in contrast to previous years, net losses of ¥3.5 trillion were posted. The Japan premium (the spread between U.S. dollar borrowing costs of Japanese banks and U.S. LIBOR), however, has not resurfaced, as Japanese banks have been largely absent from the market. Life insurers' financial health weakened further in FY2001 due to falling equity prices and ongoing negative yield spreads.

Even with the strong growth in the first quarter of 2002, real GDP is nevertheless expected to decline by about ½ percent on an annual-average basis for 2002 as a whole. The sharp increases in private consumption and public investment in the first quarter are unlikely to be sustained during the rest of the year owing to the uncertain employment outlook and an expected withdrawal of the fiscal stimulus. Exports are likely to remain robust, but the external contribution to growth is expected to taper off as imports increase. A modest cyclical recovery in business investment is not expected before late-2002 given the existing weakness in core machinery orders. Deflationary pressures are expected to persist.

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