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July 30, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Japan—Staff Report for the 2003 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2003 Article IV consultation with Japan, which is tentatively scheduled for discussion on **Wednesday, August 20, 2003**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Japan indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Lizondo (ext. 38650) and Mr. Kramer (ext. 38491) 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 Thursday, August 7, 2003; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the
2003 Consultation with Japan

(In consultation with other departments)

Approved by David Burton and Leslie Lipschitz

July 29, 2003

- This report is based on discussions held in Tokyo during May 22–June 4. The staff team comprised Messrs. Burton (head), Lizondo, Kramer, Baig, Komori, Ms. Iakova (all APD), Mr. Hayward (MFD), Mr. Kim (RES) and Mr. Yang (PDR). Mr. Yagi (Executive Director) and Mr. Kitahara (Alternate Executive Director) also took part in discussions. Supporting information and analysis are provided in a companion *Selected Issues* paper. A small staff team will return to Tokyo in early August 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); and Foreign Affairs (MoFA); the Financial Services Agency (FSA); the Bank of Japan (BoJ); the Deposit Insurance Corporation (DIC); the Resolution and Collection Corporation (RCC); the Industrial Revitalization Corporation of Japan (IRCJ); and with business and financial sector representatives.

- The First Deputy Managing Director joined the mission during June 3–4 and met with the Bank of Japan Governor, the Finance Minister, the State Minister in Charge of Industrial Revitalization, the Cabinet Secretariat Advisor, and other senior officials.

- 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.

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Executive Summary

Background

- In 2002, the Japanese economy recovered from the deepest recession in four decades but the recovery subsequently stalled, and deflation remains entrenched. The near term outlook is for broadly flat output in 2003 and a gradual recovery in 2004.
- Monetary policy remains focused on maintaining financial stability, mainly by providing ample liquidity to banks. More rapid base money growth has not fed into broad money growth or stemmed the decline in lending. Fiscal policy was expansionary in FY2002, feeding rapid growth in already-high public debt.
- Since mid-2002, the yen has weakened modestly in effective terms, while stock prices and long-term yields recently touched long-term lows before rebounding. Banks have reduced bad loans but these remain high, while profits are weak, and the quality of capital is still poor. Corporate restructuring has made some headway.

Policy Discussions

The staff and the authorities broadly agreed on the nature and magnitude of Japan's economic challenges, but views differed on the need for more decisive actions. The authorities recognize the need to revitalize the corporate and financial sectors, tackle deflation, and address fiscal imbalances, but they are concerned that bolder actions might harm the economy in the short term.

The mission recommended: (i) broadening and bringing forward financial sector reforms, in line with FSAP advice, (ii) accelerating corporate restructuring, (iii) attacking deflation with more aggressive quantitative easing (purchasing a wider range of assets) with clear public communication, and (iv) implementing a framework for medium-term fiscal consolidation.

- Officials were concerned that more ambitious financial sector reforms could lead to excessive short-run economic costs and undue government involvement in intermediation. The mission saw near-term economic costs as lower than the medium-term benefits of reduced vulnerability and stronger growth, and noted that transitional public ownership could be used to strengthen bank governance.
- It was agreed that the government-sponsored IRCJ could play an effective role in promoting corporate restructuring, but the mission stressed that it would need to operate free of political interference and suggested that restructuring could be usefully complemented by regulatory and labor-market reforms to create new investment and job opportunities.
- On monetary policy, quantitative easing so far had helped preserve financial stability and may have prevented deflation from worsening, but the authorities saw risks in more aggressive easing, including to the BoJ balance sheet. The mission acknowledged these risks but viewed them as outweighed by the potential benefits of defeating deflation, and saw the risks to the BoJ balance sheet as manageable. It was agreed that foreign asset purchases could activate the exchange-rate channel for monetary policy and thereby help to end deflation, but the authorities expressed reservations about the efficacy of such operations. In any case, the international repercussions would need to be taken into account. The authorities saw current policy as a stronger commitment than inflation targeting, but the mission considered that setting a medium-term inflation target would strengthen perceptions of the commitment to end deflation.
- On fiscal policy, it was agreed that substantial medium-term consolidation was needed to stabilize government debt; thus discussions centered on the desirable pace and form of adjustment. The mission considered that defining an ambitious program of specific measures up front would enhance the credibility of the adjustment effort and reduce the risk that concerns about debt sustainability would result in sharp increases in real interest rates. The authorities saw benefits in remaining flexible on the details of measures, and stressed the need to avoid adverse effects on growth. The envisaged FY2003 stance was seen as broadly appropriate, but the mission suggested that significant progress toward consolidation in FY2004 would signal commitment to medium-term sustainability.

GLOSSARY

ABS	Asset backed securities
AML/CFT	Anti-money laundering and combating the financing of terrorism
BoJ	Bank of Japan
CGER	Coordinating Group on Exchange Rate Arrangements
CGPI	Corporate goods price index
CPI	Consumer price index
DCF	Discounted cash flow
DTAs	Deferred tax assets
ESRI	Economic and Social Research Institute
ETFs	Exchange traded funds
FIES	Family Income and Expenditure Survey
FILP	Fiscal Investment and Loan Program
FSA	Financial Services Agency
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FTA	Free Trade Agreement
GFI	Government financial institution
GFS	Government Financial Statistics
GSP	Generalized System of Preferences
JICPA	Japanese Institute of Certified Public Accountants
JGBs	Japanese government bonds
IRCJ	Industrial Revitalization Corporation of Japan
LDCs	Least developed countries
MoF	Ministry of Finance
NPLs	Nonperforming loans
ODA	Overseas development assistance
PFR	Program for Financial Revival
ROSC	Report on the Observance of Standards and Codes
RCC	Resolution and Collection Corporation
SARS	Severe Acute Respiratory Syndrome
SDDS	Special Data Dissemination Standard
SME	Small-and-medium-sized enterprises
SNA	System of National Accounts
WEO	World Economic Outlook
WPI	Wholesale price index

I. Recent Economic and Policy Developments

1. **At the time of the 2002 Article IV consultation (concluded in July), the Japanese economy was recovering from its deepest recession in four decades**. By that time, Japan had already experienced ten years of sluggish growth and several years of deflation. Executive Directors welcomed the economy's improvement but noted that there were still considerable downside risks to economic activity. Directors also commended the government's commitment to press ahead with structural reforms and build on the progress achieved in its first year in office.

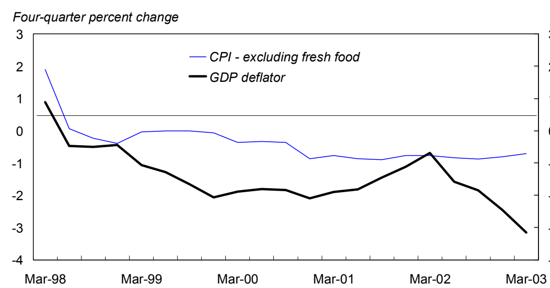
2. **The cyclical recovery in 2002 included a strong pickup in activity in the second quarter followed by a gradual slowdown during the rest of the year**. For 2002 as a whole, real GDP grew by only 0.1 percent, owing to the low base for the recovery that resulted from the sharp fall in output during the previous year (Figure 1; Table 1).

3. **The recovery appears to have stalled in 2003**. GDP grew by only 0.1 percent in the first quarter, and monthly indicators point to continued sluggish activity in the second quarter. Exports and the external balance, past sources of strength, have declined as partner-country growth has slowed. Industrial production has leveled off, household expenditure and retail sales have been broadly flat, and the cyclical rebound in business fixed investment and profitability seems to have lost momentum (Figure 2).

4. **Labor market weaknesses persist** (Figure 3). The unemployment rate remains near its record-high 5.5 percent. Moreover, employment, the labor force, and monthly earnings (real and nominal) have all been on downward trends since around mid-2001.

5. **Amid persistent economic slack, deflation continues**. The staff's production-function-based output gap widened from 1.9 percent to 2.8 percent of potential GDP in 2002, reflecting below-potential growth. The GDP deflator fell in 2002 for a fifth consecutive year, by 1.7 percent. In the first quarter of 2003, the deflator declined by 3.2 percent (y/y), partly reflecting a steep fall in civil servant bonuses (which subtracted an estimated 0.6 percent from the deflator). The core CPI (excluding fresh food) has also decreased (y/y) virtually every month for the past four years. The rate of decline bottomed out in early 2002 and stood at 0.4 percent in June 2003, with the easing in deflation partly reflecting the effects of a one-time increase in medical insurance co-payments. Meanwhile, expectations of deflation remain entrenched, with the July consensus forecast predicting CPI deflation of 0.5 percent in 2003 and 0.6 percent in 2004.

Japan: Inflation, 1998-2003 1/

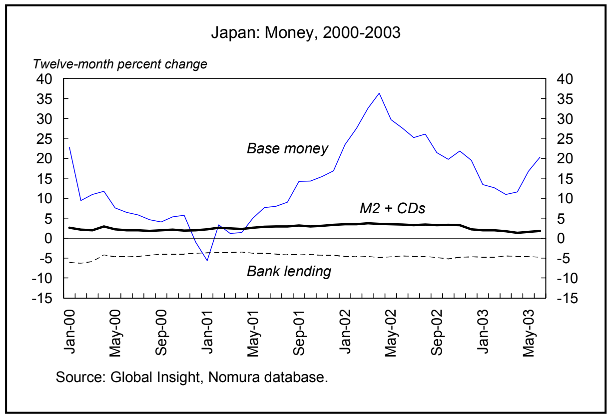


Source: Global Insight, Nomura database.
1/ Seasonally adjusted.

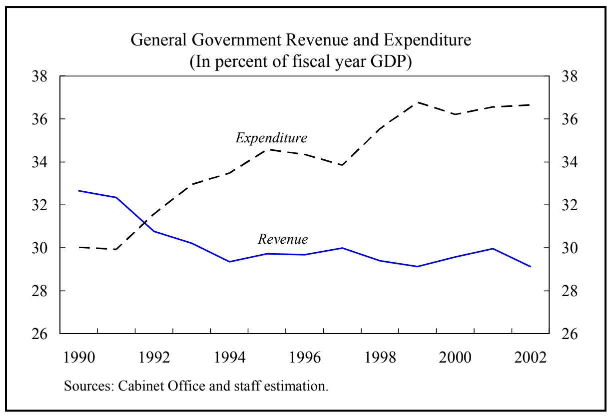
6. **Monetary policy has remained focused on maintaining financial stability**, primarily by providing liquidity to ensure that banks could meet their funding needs without difficulties. Over the past 12 months the Bank of Japan (BoJ) raised the target for current account balances on several occasions, periodically injected liquidity (pushing current

account balances well above the target ahead of the end-March 2003 book-closing), expanded the range of collateral eligible for operations, and removed the maturity ceiling on Lombard loans. The BoJ has also helped banks reduce their equity risk with its program to buy banks' shareholdings for a total of ¥3 trillion through September 2003 (with a possible one-year extension). A program of outright purchases of asset-backed securities, up to ¥1 trillion through March 2006, is set to commence at end-July 2003.

7. **Growth in base money has not fed into broad monetary aggregates or arrested the continuous decline in bank lending,** although short-term interest rates have been kept at virtually zero (Figures 4 and 5; Table 2). With persistent economic weaknesses and bank balance sheet problems limiting loan demand and banks' willingness to lend, bank loans continued declining by about 5 percent a year (including loan write-offs), while y/y growth in M2+CDs slowed to about 1½ percent.



8. **Fiscal policy was expansionary in FY2002**. On a cyclically-adjusted (structural) basis, the estimated general government deficit widened by about 1 percent of GDP to 6.5 percent of GDP (Table 3). Unadjusted, the deficit rose to 7.5 percent of GDP, mainly reflecting a fall in revenue. Continued fiscal deficits have fed rapidly growing government debt, with end-2002 gross and net debt estimated at 158 and 72 percent of GDP respectively.[1]



9. **In the external sector, the favorable trade performance in 2002 raised the current account surplus by about ¾ percent of GDP to 2.8 percent of GDP** (Table 4 and Figure 6). Export volume rose strongly in 2002 reflecting a sharp pickup in demand from Asian partner countries (notably China) and the United States, although volume growth slowed in the second half of the year. Imports, particularly from China, picked up during the year. As in recent years, the main financial counterparts of the current account surplus included net portfolio outflows, outward foreign direct investment, and acquisition of reserve assets. As of end-2002, Japan's net foreign assets amounted to US$1.4 trillion (35 percent of GDP) and international reserves were US$461 billion (excluding gold; Table 5).

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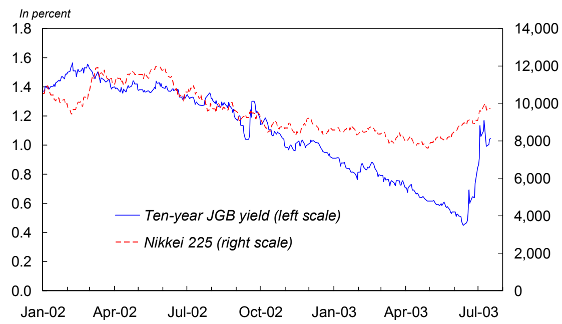
[1] The difference between gross and net debt partly reflects assets of the social security system.

10. **Compared to June 2002, the yen is broadly unchanged against the U.S. dollar but is modestly weaker in nominal and real effective terms** (see Figure 6). In the second half of 2002, the yen/dollar rate ranged between ¥116 and ¥125 amid heightened geopolitical uncertainty and concerns about the pace and sustainability of recovery in the major economies. In the first half of 2003, the yen came under pressure to strengthen against the dollar, as the dollar weakened against the euro. This pressure prompted the authorities to intervene in foreign exchange markets on a number of occasions over this period, in the total amount of some ¥7 trillion. In the event, for most of 2003 to date the yen/dollar rate has moved in a range of ±¥2 around ¥119. The yen has weakened significantly against the euro, however, contributing to depreciation in real and nominal effective terms.

11. **Long-term government bond yields hit record lows but subsequently rebounded sharply**. The decline in yields in the face of high and rising government debt partly reflected heavy buying of Japanese Government Bonds (JGBs) by financial institutions owing to ample liquidity, weak loan demand, increased risk aversion, and banks' efforts to cut risk-weighted assets. The BoJ has also made outright purchases of JGBs, amounting to ¥1.2 trillion per month since October 2002. Starting in June 2003, long-term yields more than doubled over a few weeks to slightly below the levels attained a year earlier. The rebound in JGB yields, which occurred in the context of a less pronounced global pickup in long-term interest rates, may have reflected financial market considerations such as portfolio rebalancing from bonds to equities, profit-taking, and investor concerns that yields had fallen too far. It may also have reflected an improvement in the economic outlook, although data continued to imply an outlook of broadly flat growth and persistent deflation.

Stock Market and Government Bond Yield



Source: Bloomberg.

12. **Stock prices have also recently recovered from long-term lows**. Stock prices have fallen during most of the past 12 months, partly reflecting concerns about selling pressures from banks and pension funds. In early 2003, the Nikkei index declined broadly in line with other mature markets, but from already low levels, and in April bottomed out at 21-year lows. On the heels of rallies in overseas markets, the Nikkei subsequently rebounded largely driven by foreign buying. As of mid-July 2003, the Nikkei was up about 14 percent for the year but was still about 5 percent lower than a year earlier. Japan's long-term market slide has had significant negative repercussions for the corporate and banking sectors and aggregate wealth. Between May 2002 and May 2003, Japan's market capitalization declined by about 25 percent, to about 40 percent of its 1989 peak.

13. **Banks' end-FY2002 results revealed some progress in dealing with their problems**. Major banks' average ratio of NPLs to credit declined from 8.4 percent to 7.2 percent during the fiscal year, in an environment of more stringent regulation and in line with the authorities' target to halve the ratio by end-FY2004. Major banks also cut equity market exposure. The ten largest regional banks managed to pare credit costs and increase

return on equity to positive (but still low) levels, and also cut back equity exposures and slightly reduced the share of problem loans in total loans. Also, the fiscal year end passed without evident funding difficulties among major or regional banks.[2]

14. **However, banks' financial difficulties persisted**. In FY2002, major banks' losses from equity holdings together with credit costs (including ¥4.9 trillion in costs resulting from NPL disposal) resulted in net losses of ¥4.4 trillion (0.9 percent of GDP). The major banks' average capital ratio declined—extending the ongoing fall since 1999—while the quality of banks' capital remained poor, with deferred tax assets (DTAs) accounting for a large share of Tier-1 capital.[3] In May, auditors for Resona—the fifth largest banking group—required the bank to significantly reduce its DTAs based on the auditors' reduced estimate of its future profitability. With this adjustment, Resona's capital fell short of regulatory requirements, and the government subsequently announced that it would purchase ¥2 trillion in shares in the bank. Capital adequacy ratios for other major banks remained above regulatory minimums, partly because some banks raised capital in the market. However, this capital was seen as overly expensive by the market, and this, along with the dilution effect, led to a fall in bank equity prices when the deals were announced.

15. **Meanwhile, life insurers faced continued pressures from their equity exposures and high guaranteed rates on existing policies**. In FY2002, the ten major life insurers posted current profits of just ¥350 billion, as their base profits were mostly offset by capital losses on securities. Solvency margins declined somewhat on average, although each company's margin remained above the regulatory minimum. Legislation to allow insurers to reduce guaranteed yields on existing policies (to no lower than a minimum level to be determined later), subject to government and shareholder approval, was passed by the Diet in July.

16. **Corporate profits rebounded in FY2002, although some of the recovery momentum waned by early 2003**. Current corporate profits rose for five consecutive quarters through the fourth quarter of 2002, reflecting cost-cutting among larger companies (SME profits remained weak). However, in the first quarter of 2003 profits fell by 3.1 percent (q/q, seasonally adjusted) as manufacturers' profits contracted owing to weaknesses in export dependent segments such as transport equipment and machinery.

II. Short-Term Economic Outlook and Risks

17. **The staff projects growth of 1.1 percent in 2003 and 0.8 percent in 2004**, broadly in line with the July private consensus forecast. The projection for 2003 reflects carry over effects from strong growth in 2002. Output is projected to be broadly flat during 2003 (roughly in line with official views about the near term outlook), reflecting the staff's

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[2] The blanket guarantee on demand deposits scheduled to expire at end-FY2002 was extended to end-FY2004 owing to concern for the health of the banking system.

[3] DTAs—credits against taxes on future income—are usable only to the extent that the bank makes profits, and are not available to meet losses if the bank fails. In March 2003, major banks' DTAs accounted for 58 percent of Tier-1 capital, up from 48 percent in March 2002.

judgment that declining household incomes will dampen private consumption, uncertain sales prospects will restrain investment, and that slower growth in partner-country demand will limit the contribution from net exports.[4] In 2004, growth is expected to recover gradually, led by net exports spurred by a modest uptick in partner country demand, with feed-through effects to profits, incomes, investment and consumption. Deflation is expected to persist, reflecting the continued sizeable output gap and entrenched deflationary expectations.

Projected Growth of Real GDP by Component (at 1995 prices)
(Percent change from the previous period)

	2003				2004			
	Qtr 1 Actual	Qtr 2	Qtr 3	Qtr 4	Qtr 1	Qtr 2	Qtr 3	Qtr 4
Real GDP 1/	0.1	0.0	0.0	0.0	0.2	0.3	0.3	0.4
Of which :								
Private final domestic demand	0.2	-0.1	-0.1	0.0	0.1	0.1	0.2	0.3
Private consumption	0.2	0.0	0.0	0.0	0.1	0.1	0.2	0.3
Residential investment	-1.2	-1.0	-1.0	-1.0	-1.0	-0.5	0.0	0.5
Business fixed investment	0.7	0.1	0.1	0.2	0.2	0.3	0.4	0.5
Government consumption	0.6	0.2	0.2	0.3	0.4	0.5	0.5	0.5
Public investment	-3.2	1.0	0.7	0.3	-0.7	-1.2	-1.2	-1.2
Stockbuilding (contribution)	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance (contribution)	-0.1	0.0	0.0	0.1	0.2	0.2	0.2	0.2

Sources: Global Insight, Nomura database; and staff projections.

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

18. **The outturn could be better than projected, but the risks are mainly weighted to the downside**. Upside risks include stronger than expected private domestic demand, for example, if households reduced their savings rates even further, or if there is an end to the adjustment of inventories, which have been on a declining trend since mid-2001 and are now at an historical low. Regarding downside risks, partner country growth could be lower than anticipated; households might cut spending in light of the weak labor markets and uncertain outlook; and finally, turbulence in domestic financial markets could occur and aggravate corporate and financial sector fragilities, triggering a rapid cutback in bank lending and dampening investment.

III. Policy Discussions

19. **The staff and the authorities broadly agreed on the nature and magnitude of the challenges facing Japan's economy, but there were differences of view about the need for more decisive actions to address these problems**. In recent Article IV consultations, the staff has emphasized the need to revitalize the corporate and financial sectors, tackle deflation, put the fiscal balance on a sustainable medium-term footing, and undertake regulatory reforms to facilitate the reallocation of resources. The authorities have shared this view and increasingly have taken steps toward addressing these issues: they have fashioned a framework for corporate restructuring, strengthened bank supervision and regulation, adopted more aggressive monetary policies, moved to reduce and allocate more efficiently public works spending, and started to deregulate important sectors. But mainly because of concerns that bold actions might harm the economy in the short term, many reforms have been watered down, delayed, or only partially implemented. In the staff's view, while

[4] SARS is seen as having had a negligible effect on Japan's GDP during the recent period.

progress had been made, stronger actions in several areas were needed for Japan to tackle successfully the serious economic difficulties it still faced.

20. **The mission acknowledged that accelerated reforms could entail significant short-term economic costs**, possibly including a sharp rise in bankruptcies and a further increase in unemployment, but viewed these risks as outweighed by the medium-term benefits of reduced vulnerability and higher potential growth (Box 1).[5] The 1990s illustrated the costs of a continued go-slow approach: unsteady growth, punctuated by bouts of financial instability and recessions; fiscal imbalances leading to a buildup of debt toward unsustainable levels; and an economic performance that substantially trailed that of other major countries. The alternative would be to more decisively address financial and corporate sector fragilities, deflation, and fiscal imbalances to attain a stronger and more resilient medium-term growth path. In view of Japan's economic importance, both regionally and globally, stronger economic performance in Japan would benefit other countries as well.

21. **Against this backdrop, staff continued to recommend a strategy based on four interlinked pillars**:

- *In line with the FSAP's recommendations, broadening and bringing forward financial sector reforms,* building on the authorities' recent program;
- *Accelerating corporate restructuring,* and implementing complementary reforms to create new investment and job opportunities and improve the business environment;
- *Launching a more aggressive, coordinated attack on deflation* with quantitative easing through purchases of a wider array of assets paired with a clear communication strategy;
- *Developing and implementing a framework for medium-term fiscal consolidation*, with a significant start toward that goal in FY2004 to signal commitment to medium-term fiscal sustainability.

22. **The mission emphasized that these policies complemented one another and would therefore be most effective if implemented together**. While each of the policies above would lead to some improvement over the present situation, it is their simultaneous adoption that would likely result in a sustainable revitalization of the economy. For instance, monetary policy would be more effective in ending deflation if banks' balance-sheet problems were resolved. In turn, a durable strengthening of the banking system could only be achieved if viable but heavily-indebted corporations were restructured. Also, ensuring fiscal sustainability would be critical for the ultimate goal of putting Japan on a path of strong and sustained growth over the medium-term.

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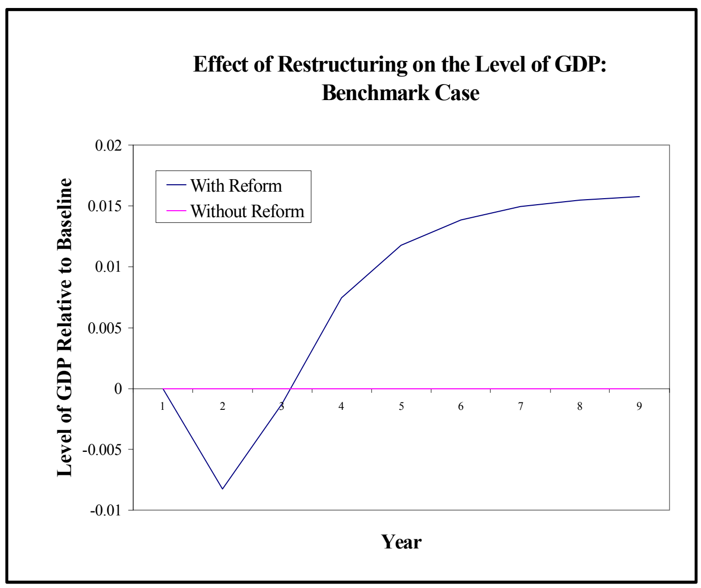
[5] See the *Selected Issues* chapter entitled "Macro-Effects of Corporate Restructuring in Japan" by Se-Jik Kim.

Box 1. Macro-Effects of Corporate Restructuring

Restructuring—the reallocation of capital and labor across firms—entails both short-term costs and medium-term benefits. Costs arise in part because firm- or industry-specific capital and skills are lost. For instance, researchers have estimated these costs to be equivalent to about 72 percent of value for capital and 13 percent of income for workers. Costs also occur because output is lost during the time it takes to reallocate resources. A year typically passes between the time a firm shuts down and the time it sells its capital, while around 30 percent of laid-off Japanese workers remain unemployed for at least a year. Benefits from restructuring arise because capital and labor are reallocated to more productive uses.

An illustrative scenario, based on supply side simulations, suggests that for Japan the medium-term benefits from restructuring may significantly outweigh the short-term costs. The simulation had four steps. (i) Estimate total factor productivity A_i for each of 1,555 Japanese firms, based on Cobb Douglas production functions ($y_i = A_i \; l_i^{1-\alpha} \; k_i^{\alpha}$), with industry-specific capital and labor coefficients (α); (ii) Identify the least-productive firms, defined as those with the lowest value of A_i, starting with the least productive and adding firms until those representing five percent of debt outstanding are cumulated; (iii) Calculate the gross drop in the level of output from closing the least productive firms; (iv) Calculate the increase in the level of output from reallocating capital and labor released by these firms across all the remaining firms in proportion to their existing capital and labor. The reallocation occurs gradually over time—after the first year, one-half of the stock of "unemployed" capital and labor is assumed to be reemployed each year. The simulation assumes that 72 percent of restructured capital is permanently lost, that 30 percent of restructured workers' human capital is permanently lost, and that 25 percent of restructured workers become permanently unemployed.

Adding up the costs and payoffs in the simulation, restructuring reduces the *level* of output by 0.8 percent in the first year and about 0.1 percent in the second year. The initial effect reflects the fact that the least-productive firms contribute about 0.8 percent to output. **From the third year on, the level of output exceeds its initial level, converging to a level 1.5 percent above its initial level**. This payoff reflects the fact that the average restructured firm is substantially less productive than the other firms. Sensitivity analysis indicates that the overall conclusions remain valid under a range of alternative assumptions.



Two additional factors need to be considered in interpreting these results. First, the analysis focuses on the supply side, and thus implicitly assumes that demand for the additional output would be forthcoming. This underscores the importance of aggressive monetary policy aimed at eliminating deflation and fostering demand. Second, although the simulation uses conservative assumptions, the actual short-run costs of restructuring could be higher than these simulations suggest. For example, the restructuring simulation implies a sharp increase in unemployment, which could have social or economic costs that are not measured in this exercise. Accordingly, to limit the costs of restructuring it is important that an adequate social safety net is in place.

A. Financial Sector Issues

23. **Financial sector restructuring has progressed under the Program for Financial Revival (PFR)**. Unveiled in October 2002, the PFR incorporated regulatory changes to accelerate bank restructuring, special facilities to support banks and thus ensure financial stability, and steps to revitalize the corporate sector.[6] The PFR had prompted banks to increase provisioning, reduce NPLs, and raise new capital (although the capital had been costly, and in some cases was provided by customers and by other financial institutions, increasing cross-shareholding). In addition, the Resona rescue had proceeded smoothly, without any disruption in financial markets, showing the effectiveness of the safety net in dealing with weak banks; also, needed improvements to Resona's management and governance were in train.

24. **Notwithstanding this progress, the financial system has significant remaining problems** (Box 2). The mission observed that low profitability made it difficult for banks to provision sufficiently against their still-high problem loans. Low profits were mainly due to the weak economy, but also reflected competition from government financial institutions and problems in bank management that could be traced to shortcomings in corporate governance. Also, bank capital had limited capacity to absorb losses, with Tier-1 capital relying heavily on deferred tax assets (DTAs). In addition, financial institutions remained vulnerable to a further decline in equity prices, an economic downturn, or a rise in long-term interest rates.

25. **The authorities explained that their strategy for dealing with banking system weaknesses involved measures to encourage prompt disposal of NPLs and financial system strengthening**. These measures included enhanced supervision (notably through the use of discounted cash flow methodology for provisioning on some loans and the latest round of special inspections); the introduction of new guidelines for the conversion of publicly held preferred shares into common shares; and targets for the major banks to halve the NPL ratio to 4 percent by March 2005 and to reduce equity exposures to the level of Tier-1 capital. Major banks' FY2002 results indicated that they were on track to achieve the NPL target, and that their equity holdings had declined from 150 percent to 100 percent of Tier-1 capital on average.

26. **The mission welcomed these efforts, but considered that a more comprehensive and accelerated approach was needed** to avoid the risk of a prolonged period of pressure on banks in which an ongoing cutback in credit would restrain economic growth. Such an approach would combine strengthened regulation with targeted use of public funds as needed to recapitalize weak but systemically important banks, in line with FSAP advice. A stronger capital base would allow banks to take the losses involved in restructuring weak borrowers,

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[6] Key measures are: (i) new inspections of major banks' loan classification and provisioning; (ii) introducing discounted cash flow (DCF) methodology for provisioning loans to large "need special attention" borrowers; (iii) harmonizing loan classification for large borrowers across banks; (iv) disclosing the gaps between major banks' self-assessment of problem loans and supervisory assessment; and (v) external auditing of capital adequacy, starting in FY2003.

Box 2. Summary of the Financial Sector Stability Assessment Report

The FSSA notes that, notwithstanding important steps to address financial sector problems taken in recent years years, Japan's financial system remains weak and vulnerable. The banks' capital positions and earnings are weak; nonperforming loans, although declining, remain high; the system is exposed to sizable market and credit risks; and, looking ahead, losses are expected to continue in the absence of reform. Accordingly, financial sector weaknesses, if not squarely resolved, would persist and continue to restrain economic growth.

The main conclusions and recommendations from the FSSA include the following:

- For the **banking system**, provisioning levels for certain loans should be strengthened including by requiring banks to use more forward looking expected loss estimates. Banks' capital positions should be enhanced by introducing rules to limit the use of deferred tax assets for purposes of calculating capital adequacy. Those banks that are unable to raise sufficient capital in the market and whose failure would pose a significant threat to the financial system should be recapitalized to at least 8 percent while other nonviable banks should be wound down or merged to promote consolidation of the system. It would also be useful that banks adopt corporate governance guidelines consistent with the Basel Committee guidelines, and that the criteria for recognizing losses for tax purposes be aligned to those accepted under Japanese accounting standards. Also, the significant involvement of the public sector in financial intermediation has held back the profitability of the banking system, and thus it would be advisable for the **government financial institutions** and the **Postal Services Agencies** to downsize gradually their operations. In addition, **public guarantees** of bank lending distort the credit market and should be avoided.
- Regarding nonbank financial institutions, shrinking profit margins and portfolio losses have weakened the capital bases of **life insurers**, which are of systemic importance given their large size and cross-shareholdings with other sectors of the economy. To ensure a more accurate assessment of their financial conditions, life insurers and their actuaries should establish appropriate policy reserves taking into account current investment returns, while supervisors should take steps to tighten their solvency standards. **Pension liabilities** are only partially funded, and the high level of premium nonpayment in the national system suggest the need for enhanced efforts to restore confidence in the system. The **corporate sector's** high leverage and dependence upon bank financing means that its weaknesses have more serious potential implications for the health of the banking system than in other countries. Further improvements in corporate governance and strengthened banks could facilitate corporate restructuring.
- In terms of **supervision**, the system has been strengthened with the creation of the Financial Services Agency (FSA) but more needs to be done. The FSA should continue to build and train an integrated and skilled modern staff and to recruit more skilled professionals, especially actuaries. Reforms are needed to give the FSA full operational autonomy and to facilitate routine exchange of information with the BoJ and other regulatory bodies. **Safety net arrangements** are broadly appropriate. Since 1998 a number of reforms have strengthened the efficiency and safety of the **payment, clearing and settlement arrangements**. Overall, the level of **transparency of monetary and financial policies** was in line with international good practices. Finally, a preliminary and partial assessment of the **AML/CFT** framework noted improvements in recent years and revealed no major issues.

thereby improving the prospects for achieving the urgently-needed revitalization of the financial and corporate sectors and the restoration of economic growth.

27. **The recommended strategy built on the existing framework of the PFR along four main lines**. First, to improve recognition and resolution of problem loans, apply forward-looking assessments for all distressed loans, and extend these reforms to regional and smaller banks. Second, to facilitate provisioning, allow specific provisions required by the Financial Services Agency (FSA) to be recognized as a cost for tax purposes. Third, to ensure that the banking system was adequately capitalized, continue to apply rigorously the prompt corrective action framework to banks whose capital ratios fell below the regulatory limit; and provide public funds to systemically important banks (if needed) and convert any publicly-owned preferred shares into common shares. In addition, so that capital would better reflect resources available to meet losses, introduce rules to limit the use of DTAs in regulatory capital. Fourth, to improve prospects for bank profitability, enhance banks' corporate governance, remove the requirement that banks receiving public funds commit to additional SME lending, and reduce the extent to which government financial institutions compete with private banks.

28. **The authorities considered that the approach recommended by staff involved excessive risks and costs**. In particular, accelerated reforms could adversely affect the economy. Also, allowing banks' specific loan-loss provisions to be recognized as a cost for tax purposes could cause a loss in tax revenue that they could not afford from a fiscal perspective (and could be seen as favoring banks over other types of firms). The mission acknowledged that bolder actions could involve near-term risks and costs, but saw them as outweighed by the medium-term benefits of reduced vulnerability and stronger growth.

29. **In addition, officials preferred that the issue of DTAs be addressed through the auditing process rather than through regulatory means**. The Japanese Institute of Certified Public Accountants (JICPA) had issued guidance requiring auditors to ensure that any DTA appearing in the balance sheet was based on a reasonable and conservative estimate of future profitability. Rather than limit the extent to which audited DTAs could be used to satisfy regulatory capital requirements, the FSA had instead formally requested auditors of financial institutions to observe the JICPA guidelines rigorously (this was the basis for the action of Resona's auditors). Officials viewed this approach as in line with their efforts to promote more accurate assessments of banks' balance sheets. In the context of discussing the FSAP, however, staff noted that in other countries regulators often allow audited DTAs to be used to meet only a small part of regulatory capital requirements. Such policies reflected a view that regulatory capital requirements—which aim to ensure that banks are financially sound—warranted a stricter treatment of DTAs than accounting requirements.

30. **The authorities also raised concerns that the strategy recommended by the mission could make the government the largest shareholder in a number of banks**, resulting in excessive government involvement in financial intermediation. In this connection, the mission noted that a transitional period of government ownership could be used to foster strengthened bank governance. As part of this approach, it would be crucial for the government to use its leverage to put in place an effective and transparent governance structure to give bank management a clear mandate to restructure the bank's operations in

preparation for its reprivatization, to protect managers from outside interference, and to hold them accountable for their performances. The mission viewed the Resona case as providing an opportunity for the authorities to demonstrate their resolve to implement such an approach.[7] Regarding the government's aim to limit its role in financial intermediation, the authorities noted that they intended to scale back the activities of public financial institutions in areas where they competed with private institutions, although they did not consider that such activities had a major impact on bank profitability.

31. **The mission also urged the authorities to take further steps to address problems in life insurance companies**, which continued to experience pressure on their solvency margins from negative spreads on investment returns and equity market losses. Moreover, they remained vulnerable to a further deterioration in financial markets. The mission recommended that regulation be strengthened, in particular by improving the basis for calculating solvency requirements, and introducing limits on single exposures and on outright positions in derivative markets. FSA officials, however, considered that the present solvency calculations adequately reflected life insurers' financial conditions. Regarding position limits, they preferred to rely instead on supervisory assessments of risk management systems.

B. Corporate Restructuring and Structural Reform

32. **Corporate restructuring has made headway, albeit limited and uneven**. In recent years, debt/equity ratios for nonfinancial corporations had come down, while profitability had risen, especially for large companies. Also, some banks had recently created subsidiaries to handle nonperforming loans, and the local distressed debt market had continued to develop, both of which would facilitate restructuring. Nevertheless, many companies continued to suffer from high leverage, low profitability, and excess capacity.[8] Also, progress in restructuring had not been uniform across sectors, and seemed to have been particularly slow among SMEs and in the construction and retail sectors.

33. **Two main factors appeared to be responsible for the limited progress to date**.[9] First, and as the mission emphasized in the discussion of financial sector issues, banks lacked the provisions and capital needed to be able to take the losses involved in restructuring weak borrowers. Thus, more rapid progress to strengthen the banking system was key to faster corporate restructuring. Second, it seems to be difficult to coordinate creditors on debt restructuring plans under Japan's main bank system, partly reflecting information asymmetries between main banks and other creditors.

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[7] As part of the injection of public funds, Resona Group will adopt a committee-style corporate governance system with a majority of outside directors, a move aimed at improving its governance.

[8] See the *Selected Issues* chapter entitled "Health and Vulnerability of the Corporate Sector in Japan" by Ken Kang.

[9] The legal framework for corporate restructuring (including the insolvency system and the out-of-court workout guidelines) is not seen as an impediment, following improvements in recent years.

34. **The authorities indicated that the newly-created Industrial Revitalization Corporation of Japan (IRCJ) would play a key role in facilitating corporate restructuring**, mainly by helping to address the coordination problem.[10] The IRCJ, by purchasing and bundling bank claims on troubled firms, would facilitate implementation of a restructuring plan in cooperation with the main bank, and sometimes with an outside sponsor. Also, banks and corporations involved in IRCJ-led restructurings could benefit from tax incentives—easing of conditions for restructuring-related tax deductions—designed to encourage them to cooperate. To limit the risk of direct political interference, the IRCJ had strict compliance requirements to promptly disclose contacts by politicians.

35. **The mission agreed that the IRCJ could play an effective role, but stressed that it would need to operate free from political interference** with decisions governed strictly on the basis of firms' economic viability. The requirements that the IRCJ consult with ministries on individual restructuring plans and pay attention to employment stability could potentially be used to keep nonviable firms afloat. To mitigate this risk, the mission recommended that the period between the purchase and sale of loans should be kept as short as possible. The IRCJ's accountability would also be enhanced by strict rules to make transparent its operations and progress in recovering public funds.

36. **The mission suggested that corporate restructuring could be complemented by reforms to create new investment and job opportunities and improve the business environment**. For example, stronger efforts were needed to improve competition in the markets for medical services, social welfare services, education and agriculture. The mission welcomed the special structural reforms zones initiative as an initial step that could show the benefits of regulatory reform and pave the way for its application at a national level. Nevertheless, reforms to clarify conditions for dismissing workers and deregulate labor contracts would be useful to help facilitate reallocation of labor.[11] Finally, the mission considered that progress in adopting international accounting standards should continue, and any pressure to undo prior improvements in the accounting framework should be staunchly resisted.

C. Monetary Policy

37. **The BoJ's quantitative easing policy had helped preserve financial stability and may have prevented deflation from worsening**. By accommodating periodic increases in the demand for liquidity following shocks and maintaining short term rates at zero, the policy had kept funding difficulties from emerging in the banking system despite domestic and external disturbances (Box 3). Moreover, the deflation rate had been broadly stable in the

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[10] The IRCJ, a state-funded institution, will buy loans for two years and is to dispose of loans within three years of purchase. Its main function will be to purchase "need special attention" loans corresponding to troubled but viable borrowers. The Resolution and Collection Corporation (RCC), meanwhile, would focus on bankrupt and near bankrupt borrowers.

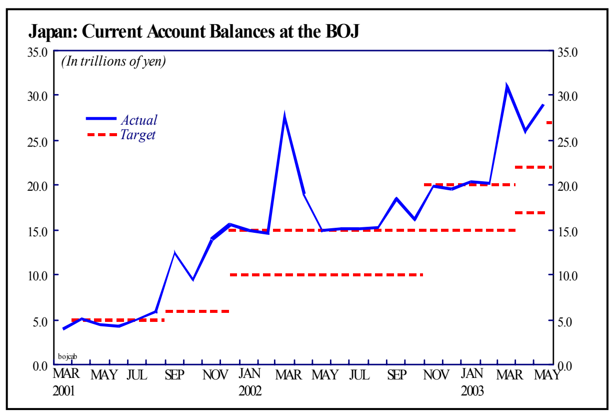
[11] See the *Selected Issues* chapter entitled "Structural Changes in Japan's Labor Market" by Takuo Komori.

Box 3. The Bank of Japan's Quantitative Easing Framework

On March 19, 2001, the Bank of Japan (BoJ) adopted **quantitative easing** as a new framework for monetary policy. This framework has three main components:

- **A target for current account balances held by financial institutions at the BoJ**: This target is adjusted by the BoJ in response to developments that are perceived to affect demand for liquidity. When facing a surge in demand, the BoJ would be ready to inject liquidity above the target if needed to preserve financial market stability. The main objective of this policy is to prevent the emergence of liquidity shortages that could have systemic adverse consequences on the financial system and thus reinforce deflationary pressures. Another objective would be to potentially stimulate economic activity through the long-term interest-rate channel.
- **Increased outright purchases of long-term Japanese Government Bonds (JGBs)**: The BoJ would increase its outright purchases of JGBs when deemed necessary for the smooth provision of funds to meet the target for current account balances. (The BoJ however also has a self-imposed limit on JGB holdings, which is equal to the outstanding stock of banknotes issued. The limit has been set up to make clear that the BoJ's purchases of JGBs are aimed at providing liquidity, rather than supporting government bond prices or monetizing fiscal deficits.)
- **Policy commitment based on the CPI**: The BoJ commits to maintain the current framework for money market operations until the CPI (excluding fresh food, on a nationwide basis) records a year-on-year increase of zero percent or more on a sustainable basis. By providing assurances that an ample provision of liquidity will be maintained for a prolonged period, this commitment seeks to lower long-term interest rates by "borrowing" from the effects of future monetary easing.

Since quantitative easing was introduced, the target for current account balances has been raised several times, always in response to potentially adverse developments. From an initial level of ¥5 trillion, the target was increased in a number of steps to ¥27–30 trillion as of end-May 2003 (over this period monthly outright purchases of JGBs increased from ¥0.4 trillion to ¥1.2 trillion). Changes in the target responded to domestic developments (such as weakening of economic activity, steep decline in stock prices, and the Resona bank rescue) as well as external developments (such as global uncertainties following the events of September 11, 2001, and concerns about the impact of SARS). Sizeable provision of liquidity beyond the target was undertaken in March–April 2002 (in advance of end-FY2001 book-closing and the transition to partial deposit insurance, and after computer trouble emerged at Mizuho Bank) and in March–April 2003 (amid a sharp decline in stock prices—particularly bank stocks—around end-FY2002, and with an adjustment to reflect the establishment of Japan Post).



Quantitative easing has kept short-term interest rates at zero, and has led to high—though unsteady—growth in base money. From about 1 percent in March 2001, base money growth (year-on-year) increased substantially, to peak at 36 percent in April 2002; it subsequently declined and stood at 20 percent in June 2003. On a cumulative basis over the whole period, base money grew by 56 percent, but broader monetary aggregates did not respond to the liquidity injection, with M2+CDs growing by only 6.6 percent.

Quantitative easing has also increased the BoJ's holdings of JGBs. These holdings grew from ¥46.7 trillion (81 percent of banknotes) in April 2001, to ¥60.4 trillion (86 percent of banknotes) in June 2003.

face of a large and persistent output gap, implying that quantitative easing may have had some effect on the price level.

38. **Nevertheless, the mission considered that a more decisive and proactive monetary policy strategy to end deflation was warranted, given the costs of deflation and the risk that it might intensify**. Entrenched deflation and deflationary expectations were imposing large economic costs by keeping real interest rates higher than desirable given the weak economy and by inhibiting financial and corporate sector restructuring.[12] Moreover, the mission saw a significant risk that a shock could send the economy into a deflationary spiral.

39. **While acknowledging the difficulties of conducting monetary policy with interest rates at zero and a weak banking system, the mission felt that a strategy comprising two main elements could be effective**. The first element was more aggressive quantitative easing implemented by purchasing a wider array of assets, with the aim of allowing monetary policy to act through asset prices as well as through the now weak liquidity channel. In particular, continued sizeable purchases of JGBs could hold down or even reduce long-term interest rates (albeit from already low levels). Also, foreign asset purchases could bring the exchange rate channel into play, influencing the price level directly through import prices, by stimulating net exports, and through inflation expectations.[13] Finally, purchases of equities through exchange traded funds (ETFs) could reinforce economic activity through wealth effects and by boosting the value of shares on corporate and financial institution balance sheets. The second element of the strategy was clear communication to the public of this bolder approach to enhance the effectiveness of monetary policy by influencing inflation expectations, with a commitment to end deflation within a limited time frame and establishment of a medium term inflation target.

40. **The authorities considered that quantitative easing already involved adverse side effects, and thus preferred to work on improving the transmission mechanism rather than undertaking more aggressive easing**. Zero interest rates already entailed negative side effects such as reduced market discipline, compressed credit spreads, and pressure on bank profits. Such costs were a necessary price to pay for maintaining financial stability and preventing deflation from worsening, but the situation nevertheless made the BoJ cautious about raising further the target for liquidity provision. Accordingly, the BoJ's preferred approach was to make better use of the already ample liquidity in the financial system by working to strengthen the transmission mechanism. In this connection, the BoJ's current plans for outright purchases of asset-backed securities (ABS) would eventually foster deepening of securities markets and reduce reliance on the weak banking system for financial intermediation, thereby improving the transmission channels for monetary policy.

[12] See the *Selected Issues* chapter entitled "Japan's Experience with Deflation and Associated Costs" by Taimur Baig.

[13] Although the yen has remained somewhat undervalued relative to the CGER framework's medium-run equilibrium, yen weakness could nevertheless be helpful from a cyclical perspective.

41. **Concerning the proposal to buy a wider set of assets, the authorities acknowledged that aggressive purchases could raise asset prices but emphasized the attendant risks**. They stressed that asset prices would respond to such purchases only when market participants believed that the central bank was determined to purchase the assets without limit.[14] Such purchases, however, would imply that the BoJ would be ready to incur significant costs, which would ultimately be borne by taxpayers. It was unclear to the BoJ whether it was appropriate for a central bank to engage in such quasi-fiscal operations. Moreover, large purchases of assets could distort the market mechanism, without necessarily improving the transmission channels of monetary policy.

42. **As regards buying foreign assets, in particular, officials acknowledged that this could bring the exchange rate channel into play, and that depreciation could in principle help to reverse deflation, but expressed several reservations**. First, given the relatively small share of trade in the Japanese economy, a sizeable depreciation would be needed to have a significant impact on deflation. Second, it was questionable, especially in light of recent experience with interventions, whether the injection of liquidity through purchases of foreign assets could result in a significant impact on the yen. Third, and crucially important, given the yen's role in the global financial system, the possible international repercussions had to be taken into account; in this connection, it was stressed that agreement among major countries would be needed, particularly if a significant fall in the yen were involved.[15]

43. **Regarding inflation targeting, BoJ officials viewed their current announced policy as embodying a stronger commitment to ending deflation than conventional inflation targeting**. Under the BoJ's current approach, interest rates would be kept at zero until actual inflation became positive, whereas with conventional inflation targeting, policy would be tightened based on projected inflation—which could be too early. Furthermore, officials considered that setting an inflation target would accomplish little if the BoJ lacked measures that could effectively achieve the target. That said, the BoJ acknowledged that inflation targeting was potentially useful for increasing monetary policy transparency, and indicated that they would continue to consider the possibility of adopting it.

44. **The mission viewed the possible negative side effects and distortions from more aggressive quantitative easing as outweighed by the benefits of decisively tackling deflation**. Ending deflation would alleviate the aforementioned problems associated with the current zero rate environment by fostering a pickup in interest rates and spreads, and could also benefit the financial system through a stronger economy and a rebound in equity and land prices. In the meantime, while efforts to strengthen the monetary policy transmission

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[14] As a practical matter, outstanding ETFs were presently too small to buy in large quantities. However, the mission's view was that the market for these assets could expand rapidly if the BoJ announced it would start buying them.

[15] Officials also noted—and the mission acknowledged—that monetary expansion through foreign asset purchases would require appropriate coordination between the BoJ and the Ministry of Finance, given the latter's responsibility for exchange rate policy.

mechanism through purchases of ABS were useful and welcome, they were unlikely to have a major near-term impact on deflation.[16]

45. **The staff acknowledged that its recommended bolder approach might entail risks to the BoJ's balance sheet, but saw these risks as manageable**. In particular, they could be handled through institutional loss-sharing arrangements with the government. For instance, the BoJ could swap (with the government) its holdings of fixed-rate bonds for floating-rate bonds to limit the capital losses that could arise from a sizeable increase in long-term interest rates.[17] At the same time, the risks were not entirely on the downside: an end to deflation could yield gains on some assets on the BoJ's balance sheet through an attendant pickup in stock prices and a depreciation of the yen.

46. **The mission recognized the difficulties with injecting liquidity through purchases of foreign assets, but, given the lack of effective alternatives, felt that this mechanism deserved consideration**. While the mission emphasized that it was not advocating targeting the exchange rate, unsterilized intervention could activate the exchange rate channel for monetary policy.[18] Normally part of the transmission mechanism, with interest rates at the zero bound and bank lending unresponsive to increased liquidity this channel was not working. The mission acknowledged that the implications for the global economy were very important and would need to be taken into account, particularly in light of Japan's high current account surplus. However, the mission noted—and the authorities agreed—that the impact on partner-country growth could well be positive in the medium term as Japan began to escape from deflation and recover.[19]

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[16] As noted above, under current plans BoJ outstanding purchases of ABS would be limited to a total of ¥1 trillion—equivalent to around 1 percent of the monetary base—and purchases would take place through end-March 2006, roughly a three-year period.

[17] Starting in FY2004, the BoJ will value JGBs at amortized cost (in line with practice for valuation of bond holdings at other central banks, including the U.S. Federal Reserve), adjusting the value by a fixed amount each period so that it gradually converges to par at maturity. As a result, changes in the market prices of these bonds would no longer affect its balance sheet unless the bonds are sold before maturity (in the past 30 years, the BoJ has always held its JGBs to maturity).

[18] That recent large-scale interventions had stabilized the yen against the dollar during a period of dollar weakness suggested that unsterilized intervention could be effective in influencing the exchange rate.

[19] Past studies suggest that depreciation caused by monetary easing would have broadly neutral or positive medium-term effects on activity in other countries owing to the accompanying pickup in Japanese growth (Chapter 12, *Japan's Lost Decade*, IMF, 2003). Also, McCallum (*Economic Quarterly,* Federal Reserve Bank of Richmond, Winter 2003) argues that monetary expansion through purchases of foreign currency assets would *increase* Japan's net imports by boosting domestic real income. Simulations of yen depreciation in the Oxford Economic Model show a modest negative effect on the East Asian region in the short run, followed by a positive effect as Japan's growth picks up (*World Economic Outlook*,

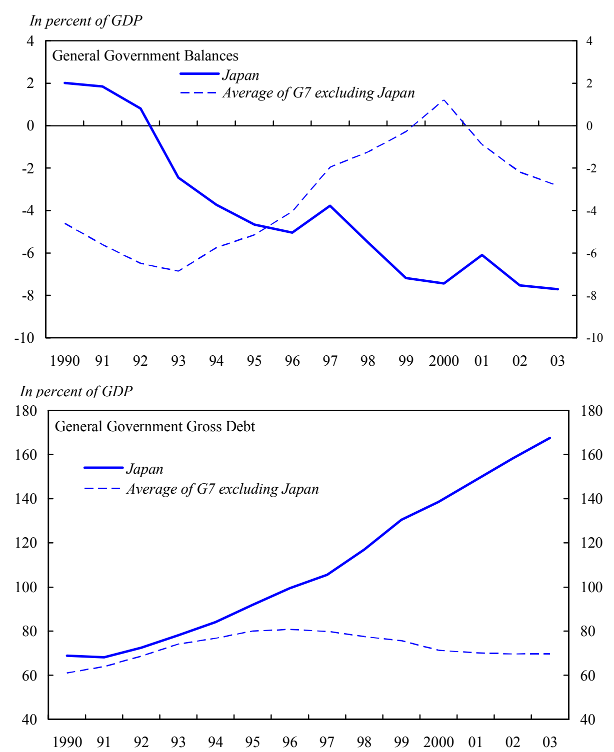
(continued)

47. **As regards inflation targeting, the mission argued that its adoption could help anchor medium-term inflation expectations**. While the BoJ had clearly stated its intention to maintain zero short-term interest rates until deflation ended, it was clear that deflationary expectations remained entrenched. An explicit inflation target would strengthen perceptions about the BoJ's commitment to end deflation, guide inflation expectations and help to manage any risk that inflation would overshoot a desirable range. That said, it was agreed that merely announcing an inflation target would be unlikely to affect deflation or deflationary expectations. However, in the context of the more aggressive quantitative easing strategy outlined above, an inflation target could help to reverse deflationary expectations.

D. Fiscal Policy

48. **The authorities and the mission agreed that substantial medium-term fiscal consolidation was needed to stabilize the public debt**. High fiscal deficits had led to rapid growth in both gross and net debt, with gross debt now above 150 percent of GDP, by far the highest level among advanced economies. In the absence of fiscal adjustment, with fiscal deficits currently above 7 percent of GDP and growing social security expenditure arising from an aging population, both gross and net debt were expected to continue growing rapidly relative to GDP over coming years. The mission expressed concerns that this trend would eventually precipitate an increase in real long-term interest rates, with adverse effects on growth. The authorities broadly agreed with this assessment, and thus the discussions focused on the desirable pace and form of medium-term adjustment.

General Government Balance and Gross Debt, 1990-2003



Source: WEO.

49. **The authorities viewed their medium-term framework as setting out the general direction for fiscal consolidation and as providing some specific measures**. The framework comprised pension reform and a goal to achieve primary balance excluding social security by the early 2010s. They saw pension reform as a high priority, to be taken up in the

October 2001, Box 1.4). If yen depreciation raised expected inflation and lowered real interest rates, the attendant boost to domestic demand could largely offset the effect of real depreciation on net exports (Meredith, "Escaping Japan's Liquidity Trap", 2002).

context of the forthcoming review of the system to be finalized by end-2003. Nevertheless, they noted that concrete plans that ensured the medium term viability of the system could take time to develop given existing differences of view on the issue. To achieve the goal of primary balance excluding social security,[20] they envisioned making spending cuts in the near term, followed by tax increases beginning in a few years. The authorities viewed their medium-term target as anchoring fiscal policy while remaining flexible (by not committing to specific measures) and avoiding being unduly ambitious in light of the weak economic environment. Also, they cautioned that it could be difficult to muster public support for bold measures given concerns over the weak economy.

50. **The mission agreed that the fiscal deficit should not be reduced too abruptly, but stressed that a detailed and ambitious medium-term program was urgently needed**. While recognizing the considerable difficulties in embarking on a medium-term adjustment program in present circumstances, further delays would only require a more painful and disruptive adjustment down the road. Also, defining specific measures up front would enhance the program's credibility and reduce the risk that concerns about debt sustainability would result in sharp increases in real interest rates. Regarding the medium term, the mission considered that stabilizing the debt to GDP ratio (even at a level of around 100 percent of GDP on a net basis) would require: (i) a major reform of the social security system that eliminated net liabilities in present value terms; and (ii) a substantial adjustment in the accounts of the rest of the general government (that would likely need to go beyond the official goal of reaching primary balance by the early 2010s).[21] It was important to address these two components together, as increased dependence by the social security system on transfers from the budget would imply the need for stronger adjustment in the rest of the general government.

51. **A program to achieve these objectives would need to include the following elements**:

- *Adjustment to social security benefits and contributions.* Given the magnitude of the needed adjustment, both benefit reductions and revenue measures would likely be required. However, substantial reliance on revenue measures in the pension reform may result in too heavy a tax burden on future generations with negative effects on growth. The mission welcomed recent changes in the medical insurance system, but noted that additional efforts would be required to contain growing costs in this area.

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[20] This would require an adjustment equivalent to 4.5 percent of GDP with respect to 2002.

[21] A debt sustainability exercise indicates that stabilizing net debt by the early 2010s is likely to require an adjustment equivalent to 6.5 percent of GDP at the level of the primary balance of the general government (excluding social security), assuming in addition a reform of the pension system that strengthens the social security primary balance by 2 percent of GDP with respect to the baseline scenario (Box 4). See also the *Selected Issues* chapter entitled "Assessing the Long-Term Fiscal Position of Japan" by Dora Iakova.

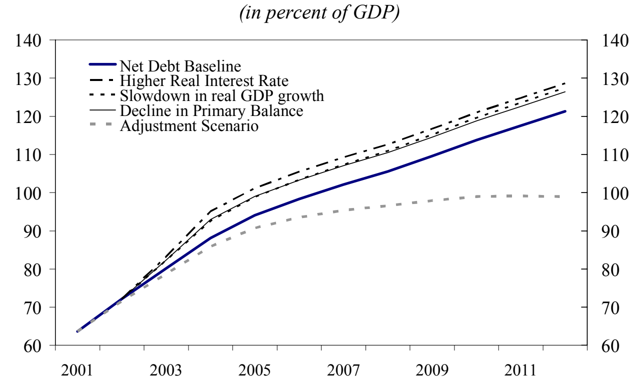
Box 4. Public Debt Sustainability

This box presents a standard analysis of public debt sustainability in Japan, including the results of stress-tests. The point of departure is end-2002, with gross debt at 158 percent of GDP and net debt at 72 percent of GDP. Table 6 contains the full sustainability template.

The baseline scenario is broadly based on the authorities' announced fiscal policies. The main assumption is that the government attains its medium-term goal of eliminating by the early 2010s the primary deficit of the general government excluding social security (the cyclically-adjusted primary deficit was about 4.5 percent of GDP in 2002). The social security system is assumed to remain unchanged, with contribution rates at current levels and benefits (per person) changing in line with the latest reforms. The paths for real GDP, the GDP deflator, and real interest rates are consistent with the current WEO projections until 2008. After 2008, real GDP growth and GDP deflator growth are assumed to be 1 percent each, and the long-term real interest rate is assumed to be 3 percent.

Under the baseline scenario, the public debt-to-GDP ratios would increase by about 50 percentage points over the next ten years, and would continue increasing thereafter. Gross and net debt respectively would reach 207 and 121 percent of GDP by 2012 (assuming no change in government assets). The increase in debt is driven by both growing interest payments and rising pension and medical expenditures related to the rapid aging of the population. Debt may accumulate even more rapidly than projected in the baseline scenario if the government needs to meet any contingent liabilities, such as bank recapitalization or defaults on guaranteed loans. These are difficult to quantify with any precision, however; for example, the fiscal costs of bank recapitalization would depend on the extent to which private sector capital would be involved.

Sensitivity of Net Public Debt
(in percent of GDP)



Various stress tests illustrate the sensitivity of the projection to different shocks. The figure shows the path for net public debt under alternative assumptions for the real interest rate, real growth, and the primary balance. The individual shocks—effective in 2003 and 2004—are equal to two standard deviations from the ten-year average for each variable (the interest-rate scenario does not include possible quasi-fiscal costs related to adverse effects on the banking system). Of course, under these adverse shocks net public debt grows even more rapidly than under the baseline scenario.

Stabilizing the debt-to-GDP ratio over the ten year horizon—even at very high levels—would require substantial consolidation beyond that included in the baseline. For instance, the figure shows an adjustment scenario that stabilizes net public debt at about 100 percent of GDP by the early 2010s. This scenario assumes: (i) a pension reform (a gradual doubling of pension contribution rates that would make the pension system actuarially solvent), which by the early 2010s would strengthen the social security primary balance by 2 percent of GDP with respect to the baseline; and (ii) an adjustment of 6.5 percent of GDP at the level of the primary balance of the central and local governments (compared to an adjustment of 4.5 percent of GDP in the baseline). The resulting ratio of net debt to GDP—while stable—would still be very high by international standards, and thus it may be desirable to target a lower level of debt, which would require additional consolidation. Given the size of the needed adjustment, it is critical to define and start implementing an ambitious medium-term program that includes a major reform of the pension and medical care systems.

- *Public expenditure reduction.* With the level of public investment relative to GDP still twice the average level in other G-7 countries despite recent declines, current steps to cut inefficient public works and improve bidding practices were welcome and should continue. Further reduction in ear-marking of revenues would contribute to these efforts.

- *Tax reform.* Tax revenue in relation to GDP remained low relative to other advanced economies. Room existed to broaden the personal income tax base and to increase the consumption tax rate. Introducing taxpayer identification numbers would improve tax administration.

52. **Regarding the short term, it was agreed that the envisaged stance of FY2003 fiscal policy—a small reduction in the structural fiscal deficit—was appropriate given the weak economy**.[22] This stance struck a suitable balance between making a significant start toward the medium-term goal of fiscal consolidation and the need to avoid exacerbating the current weaknesses in the economy. Given the small size of the fiscal multipliers, the envisaged modest start toward fiscal consolidation would have negligible effects on output. The mission suggested that, in the event that an acceleration of banking and corporate sector reforms led to higher unemployment, automatic stabilizers should be allowed to work (the authorities saw the existing social safety net arrangements as adequate to deal with a possible rise in unemployment).[23] However, discretionary expenditure should be kept within the budgeted amount, to prevent a significant divergence from a path of fiscal consolidation. Looking to FY2004, the anticipated pickup in economic activity could support significant progress towards consolidation, which would signal the government's commitment to medium-term fiscal sustainability.

53. **The staff's proposed approaches regarding the financial sector and monetary policy may entail some immediate fiscal costs—which are difficult to quantify—but their medium-term fiscal effects are likely to be positive**. On the financial sector, capital injections will have fiscal costs that would depend on an array of factors including the accurately assessed value of bank assets, whether private funds would be utilized in the recapitalization, and the extent to which public funds would be recovered at a later stage through dividend payments and reprivatization. The alternative of postponing needed bank recapitalization and other revitalization measures, however, is likely to result in continued deterioration in the banking system and delay of the economic recovery, thereby raising the ultimate fiscal costs. On monetary policy, potential BoJs balance sheet losses (other than those resulting from a drop in JGB prices, as these losses would be offset by equivalent gains for the government as issuer of JGBs) must be weighed against the favorable fiscal effects that would result from a successful attack on deflation. These effects would arise from

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[22] The structural balance excludes bank support (which for Resona is 0.4 percent of GDP in 2003).

[23] For discussion of the safety net see the *Selected Issues* paper entitled "Employment Insurance and the Social Safety Net" by Takuo Komori.

stronger economic growth and lower ex-post real interest rates paid on outstanding government debt.

54. **The mission suggested updating the 2001 fiscal transparency ROSC in the period through the 2004 consultation**. The ROSC identified the need to provide more timely information on the overall stance of fiscal policy, examine fiscal policy in a longer-term context, and clarify the role of public financial intermediation. The mission's informal review suggested limited progress in these areas.[24]

E. Other Issues

55. **Regarding trade, Japan's policies in the industrial sector are generally liberal, but the mission saw its import regime for agricultural products as highly restrictive**, which continued to impose high costs on Japanese consumers and on developing countries. Japan continued to maintain quotas on a number of imports, but had made limited use of trade remedies.[25] There had been domestic pressure for imposing import restrictions on certain textile products, but the authorities had so far refrained from taking such actions.

Measures of Agricultural Support, 2002

	Japan	EU	USA	OECD
Producer support estimate (percent)[1]	59	36	18	31
Nominal protection coefficient (ratio)[2]	2.04	1.42	1.10	1.37
Total support estimate (percent of GDP)[3]	1.4	1.3	0.9	1.2

Source: "Agricultural Policies in OECD Countries: Monitoring and Evaluation 2003," OECD, 2003.

[1] Annual monetary value of gross transfers from consumers and taxpayers to producers as percent of gross farm receipts.
[2] Ratio of the average price paid by consumers to the border price.
[3] Annual monetary value of all gross transfers from taxpayers and consumers arising from policies supporting agriculture.

56. **The mission suggested that Japan, together with other major industrial countries, should play a leadership role in bringing about a successful conclusion of the Doha Round trade negotiations**. In this regard, agriculture was central and the mission recommended ambitious liberalization. The authorities felt that agricultural liberalization should be gradual and that nontrade concerns (such as food security, farm income protection, and environmental protection) should be addressed. The mission noted that these nontrade objectives could be more effectively tackled through policies directly targeted to those objectives than through trade protection.

57. **The authorities reiterated that Japan remained committed to the multilateral trade system despite its recent push for regional and bilateral free trade agreements**

[24] For instance, the government introduced medium-term guidelines for the primary balance and expenditure limits, but these are nonbinding and lack details on supporting policies. Also, the consolidated fiscal position of the general government is not included in the budget documentation.

[25] It had in place only one antidumping measure, and its first safeguard measure was introduced in 2001 on three agricultural imports from China.

(FTAs). The mission cautioned on the trade diversion effect of FTAs and emphasized that they should be comprehensive in product coverage (e.g., include agriculture). The authorities said that Japan's FTAs would limit the discriminatory effects on the country of proliferating FTAs in Europe and the Americas, and help them advance their agenda on issues that had faced resistance in entering the Doha Round agenda, such as international investment rules.

58. **The mission welcomed the recent expansion of product coverage for least developed countries (LDCs) under Japan's generalized system of preferences (GSP) and encouraged the authorities to make further progress in this area**. In April 2003, Japan added 198 tariff lines of agricultural and fishery products to the list of products whose imports from LDCs are subject to duty- and quota-free entry. Nevertheless, most agricultural and fishery products remained excluded from such entry, and there were ceilings on GSPs for some industrial products.

59. **The mission welcomed Japan's continued commitment to overseas development assistance (ODA)**. Japan remains the second largest ODA provider in absolute terms, and in 2002 its ODA was equivalent to 0.23 percent of GNI compared with a weighted average of 0.19 percent in G-7 countries.

60. **The authorities noted a number of recent steps to improve the legal framework for anti-money laundering and combating the financing of terrorism** (AML/CFT). During the past year, measures had been taken to freeze funds and other financial assets of a number of individuals and entities related to terrorist organizations. Also, the "Foreign Exchange Inspection Manual," including checklists for internal controls and compliance with relevant laws, had been established by the Ministry of Finance, and since January 2003 inspections had been made based on the manual. A preliminary and partial review of the legal and institutional framework for AML/CFT (conducted prior to the mission) found it to be broadly appropriate, and the authorities have agreed to an AML/CFT ROSC to be conducted as a follow-up to the FSAP.

61. **The mission encouraged the authorities to renew their efforts to enhance the quality of economic statistics, especially in the areas of national accounts and fiscal statistics**. For example, quarterly GDP data remain subject to frequent revisions, whereas annual national accounts data are only available with a lag of nine months, limiting their usefulness for current analysis. In addition, further efforts could be made to improve the quality of consumption surveys. Also, data on the fiscal operations of the general government could be released on a more timely and comprehensive basis. In this context, the mission noted that undertaking a data ROSC in the period through the next Article IV consultation would be useful.

IV. Staff Appraisal

62. **Progress has been made in addressing the major economic challenges facing Japan**. Banks have reduced nonperforming loans, prompted by the tighter regulation of the Program for Financial Revival, and the banking system safety net effectively prevented disruptions after the rescue of a major bank. Corporations have continued to cut excess leverage and raise profits. Supportive monetary policy has helped maintain financial stability

and may have kept deflation from worsening in the face of persistent economic slack. Public works spending has been reduced and efforts made to allocate it more efficiently, and the need for fiscal consolidation is increasingly being recognized.

63. **Nevertheless, serious and interrelated problems remain, and sustained economic revival and an end to deflation are not yet in prospect**. The near-term outlook is for a broadly flat economy and persistent deflation, with the risks mainly weighted to the downside. In the near term and beyond, financial and corporate sector weaknesses, if not squarely resolved, will continue to restrain economic growth. In addition, deflation would continue to exacerbate corporate and financial sector fragilities and curtail growth, while unemployment would stay high. Furthermore, the economy remains vulnerable to domestic and external shocks that could both worsen deflation and trigger an economic downturn. Also, the current unsustainable fiscal policies would at some stage raise Japan's public debt to levels that could put upward pressure on real interest rates, with serious adverse effects on economic growth and the financial system.

64. **A comprehensive and bolder program is urgently needed to address imbalances and weaknesses, end deflation, and restore sustainable robust growth**. Bolder actions could have temporary adverse effects on the economy, especially as a result of faster corporate restructuring. But these short-term costs are outweighed by the medium-term benefits of higher potential growth, and of reduced vulnerability to a serious deterioration in the economic situation that could prove difficult to reverse. Indeed, given the high and rising public debt, a further prolonged period of delay is not a viable option.

65. **The staff's recommended policy strategy comprises four interlinked pillars designed to resolve financial and corporate sector weaknesses, end deflation, and rein in fiscal imbalances**. First, broadening and accelerating financial sector reforms, building on the Program for Financial Revival. Second, facilitating faster corporate restructuring and implementing complementary reforms. Third, attacking deflation more aggressively through BoJ purchases of a wider range of assets, combined with a clear communication strategy. And fourth, developing and implementing a framework for medium-term fiscal consolidation. In combination, these policies can put Japan firmly on a stronger and more robust medium-term growth path.

66. **Financial sector restructuring has made headway under the Program for Financial Revival (PFR), but significant problems remain in the financial system**. The PFR's measures to strengthen the regulatory framework have prompted banks to increase provisions, cut NPLs, and raise new capital. However, banks' low profitability and the poor quality of their capital—reflecting heavy reliance on DTAs—still inhibit dealing with problem loans, which remain high. Meanwhile, life insurers continue to face financial pressure and are vulnerable to a further deterioration in financial markets.

67. **A more comprehensive and accelerated approach, building on the existing framework of the PFR, is needed to decisively resolve these problems**. Such an approach, along the lines of the FSAP recommendations, would have four main elements: first, improving the recognition and resolution of problem loans by applying recent measures to a wider set of loans and institutions; second, facilitating FSA-mandated provisioning by

allowing it to be recognized as a cost for tax purposes; third, strengthening bank capital by introducing rules to limit the use of DTAs in capital, continuing to apply prompt corrective action, and selectively using public funds to capitalize systemically important banks if needed; and fourth, improving prospects for profitability by enhancing banks' corporate governance, removing the requirement that banks that receive public funds commit to lend more to SMEs, and reducing GFI competition with private banks. In addition, steps are needed to address problems in life insurers, including by strengthening regulation.

68. **A durable resolution of the banks' problems will also require further progress in corporate sector restructuring**. The limited progress so far in revitalizing Japan's corporate sector reflects both banks' lack of provisions and capital to take the necessary losses involved in restructuring—underscoring the importance of strengthening banks' balance sheets—and the difficulty of coordinating creditors. In the latter connection, the newly-created IRCJ has the potential to facilitate restructuring by addressing the coordination problem. However, it will be important to ensure that the requirements for the IRCJ to consult with ministries on individual restructuring plans and to pay attention to employment stability are not used to keep nonviable firms afloat. Keeping the period between the purchase and sale of loans as short as possible, and employing strict transparency about its operations and progress in recovering public funds, would help to mitigate this risk. In addition, reforms to create new investment and job opportunities and improve the business environment usefully complement measures to facilitate corporate restructuring.

69. **Monetary policy easing has maintained financial stability and forestalled a worsening of deflation, but more aggressive actions will be needed to end deflation**. Recent steps to improve the transmission mechanism through ABS purchases are welcome, but will have little near-term impact on deflation. Meanwhile, deflation continues to be costly for Japan's economy, as it elevates real interest rates and inhibits the necessary financial and corporate restructuring, and the risk remains that a shock could cause deflation to intensify.

70. **A more decisive and proactive monetary policy approach in the staff's view needs to involve purchases of a wider array of assets paired with a clear communication strategy**. More aggressive quantitative easing through purchases of a wider array of assets could act to reflate the economy through asset price channels as well as through the now weak liquidity channel. Any attendant risks to the BoJ balance sheet could be managed through loss-sharing arrangements with the government. To the extent that this approach involved purchases of foreign currency assets, with the potential to lead to a significant depreciation in the yen, the international repercussions would need to be taken into account. In addition, clear public communication of this strategy, including committing to end deflation in a limited period of time and establishing a medium-term inflation target, would make monetary policy more effective by influencing deflationary expectations.

71. **On the fiscal front, a major challenge is to put the public debt on a sustainable trajectory**. Under current policies, and with looming demographic pressures, already high public debt is set to continue growing rapidly in the future. Absent a substantial medium term adjustment, this situation poses a significant risk of an increase in real long-term interest rates that would adversely affect growth and potentially damage the financial system.

72. **The authorities recognize this challenge, but a program of specific measures needs to be quickly put in place**. On the social security system, a major reform is necessary to eliminate net liabilities in present value terms. This will require adjustments in pension contributions and benefits, and further measures to address the growing costs of the medical insurance system. For the rest of the general government, the official goal of achieving primary balance by the early 2010s is welcome, although a more ambitious target may be necessary to stabilize the debt to GDP ratio. Also, a specific plan to achieve this goal would help to strengthen credibility. On the expenditure side, steps to streamline and increase the efficiency of public works should continue, as public investment in relation to GDP remains high by G-7 standards. Regarding revenue, there is room to broaden the personal income tax base and to increase the consumption tax rate. In addition, introducing taxpayer identification numbers would help to improve tax administration.

73. **For FY2003, the envisaged small cut in the structural deficit (excluding support to banks) is broadly appropriate given the weakness in the economy**. If accelerated corporate and financial restructuring were to cause unemployment to rise, automatic stabilizers should be allowed to operate. Looking to FY2004, the expected growth pickup would facilitate a significant start toward consolidation, which would be appropriate to indicate the government's commitment to its goal of medium-term fiscal sustainability.

74. **Renewed efforts are warranted to enhance fiscal transparency and the quality and availability of economic statistics—both areas where progress has been limited**. In this context, the staff urges the authorities to update the fiscal transparency ROSC undertaken in 2001 and to conduct a data ROSC in the period through the next Article IV consultation.

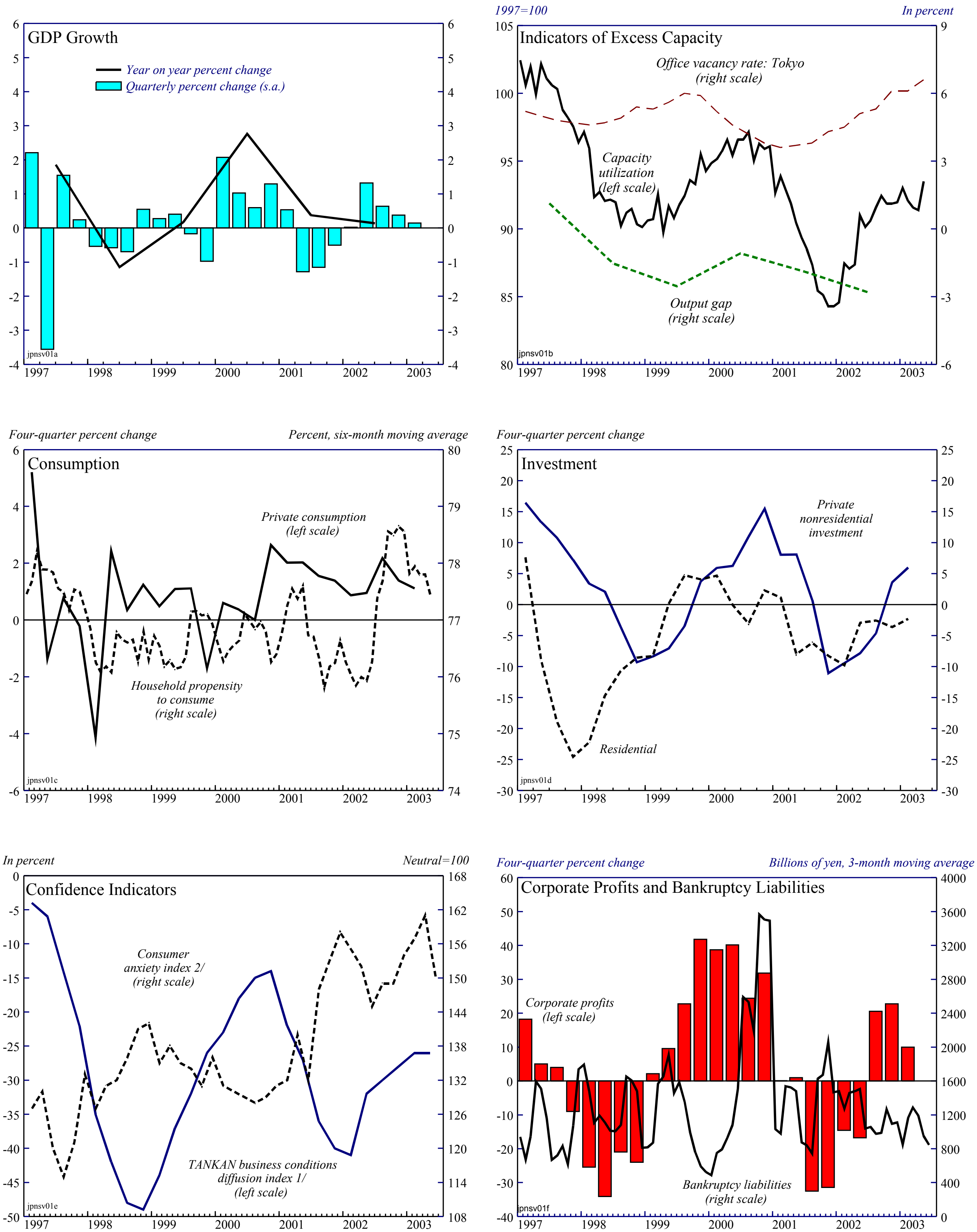
75. **Regarding trade policy, Japan along with other major industrial countries should play a leadership role in moving the Doha Round negotiations forward**, all the more so at this critical juncture in the lead up to the September WTO Ministerial in Cancun. In this regard, Japan should commit to ambitious reductions in its agricultural support, which is costly to Japan and its trading partners. In light of their recent push for preferential trade arrangements, the authorities' continued commitment to the multilateral system is encouraging. However, preferential trade arrangements should cover all sectors. The recent expansion of duty- and quota-free access for imports from LDCs is welcome. Further steps in this direction should aim at extending such access to all imports from LDCs, and removing GSP ceilings and import quotas.

76. **Japan's continued commitment to overseas development assistance (ODA) is commendable**. Japan remains the second largest ODA provider in absolute terms, and relative to GNI exceeds the average for other G-7 countries. Its ongoing demonstration of leadership in this important area is welcome.

77. **Recent steps have improved the legal framework for AML/CFT**. A preliminary review suggests that the legal and institutional framework is broadly appropriate, and the authorities have agreed to an AML/CFT ROSC.

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

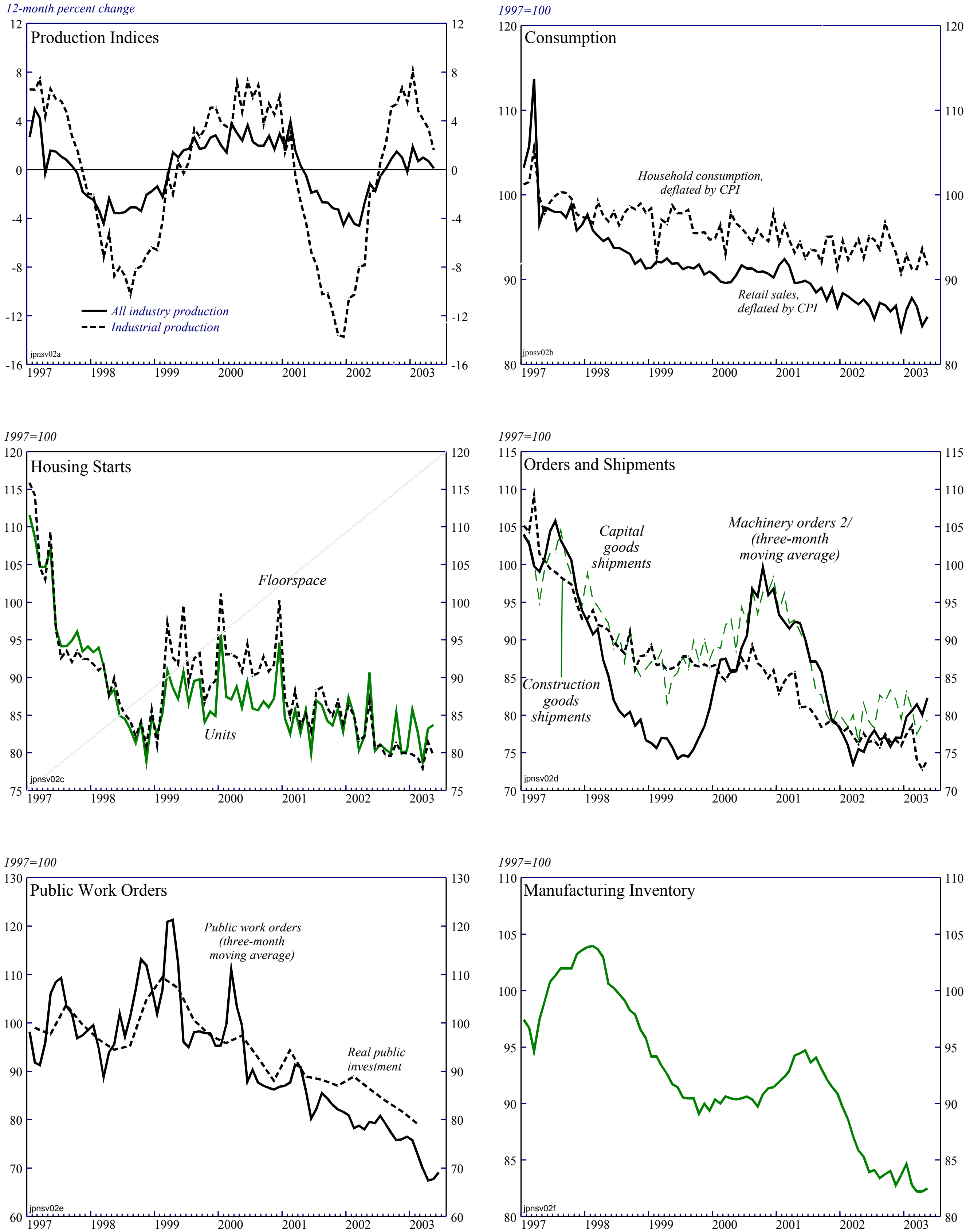
Figure 1. Japan: Selected Economic Indicators, 1997-2003



Sources: Global Insight, Nomura Database; and CEIC Database.

1/ "Favorable" minus "unfavorable".
2/ Higher number implies greater degree of consumer anxiety about future prospects.

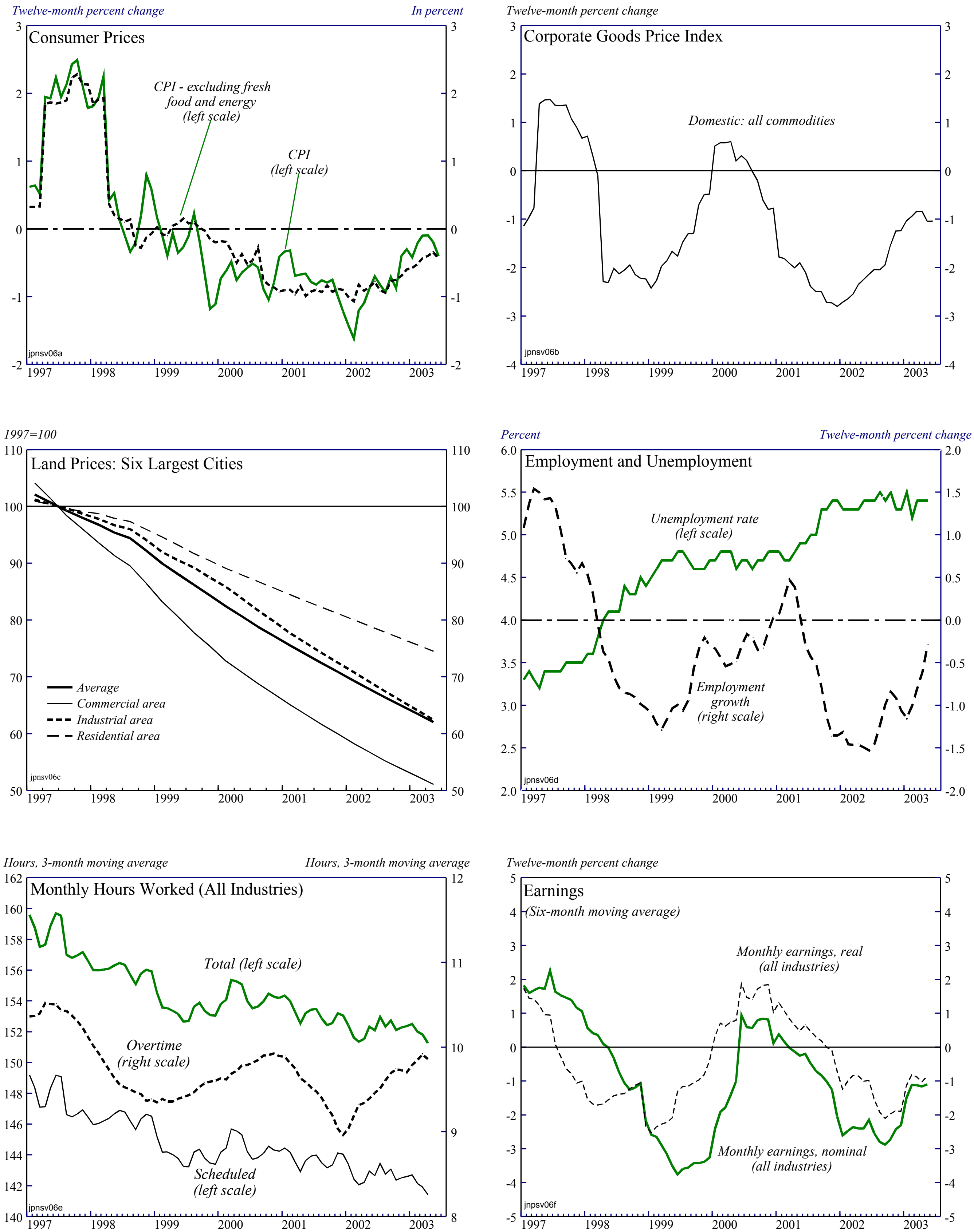
Figure 2. Japan: Monthly Indicators of Real Activity, 1997-2003 1/



Source: Global Insight, Nomura Database.

1/ Seasonally adjusted data.
2/ Excluding ships and public utilities.

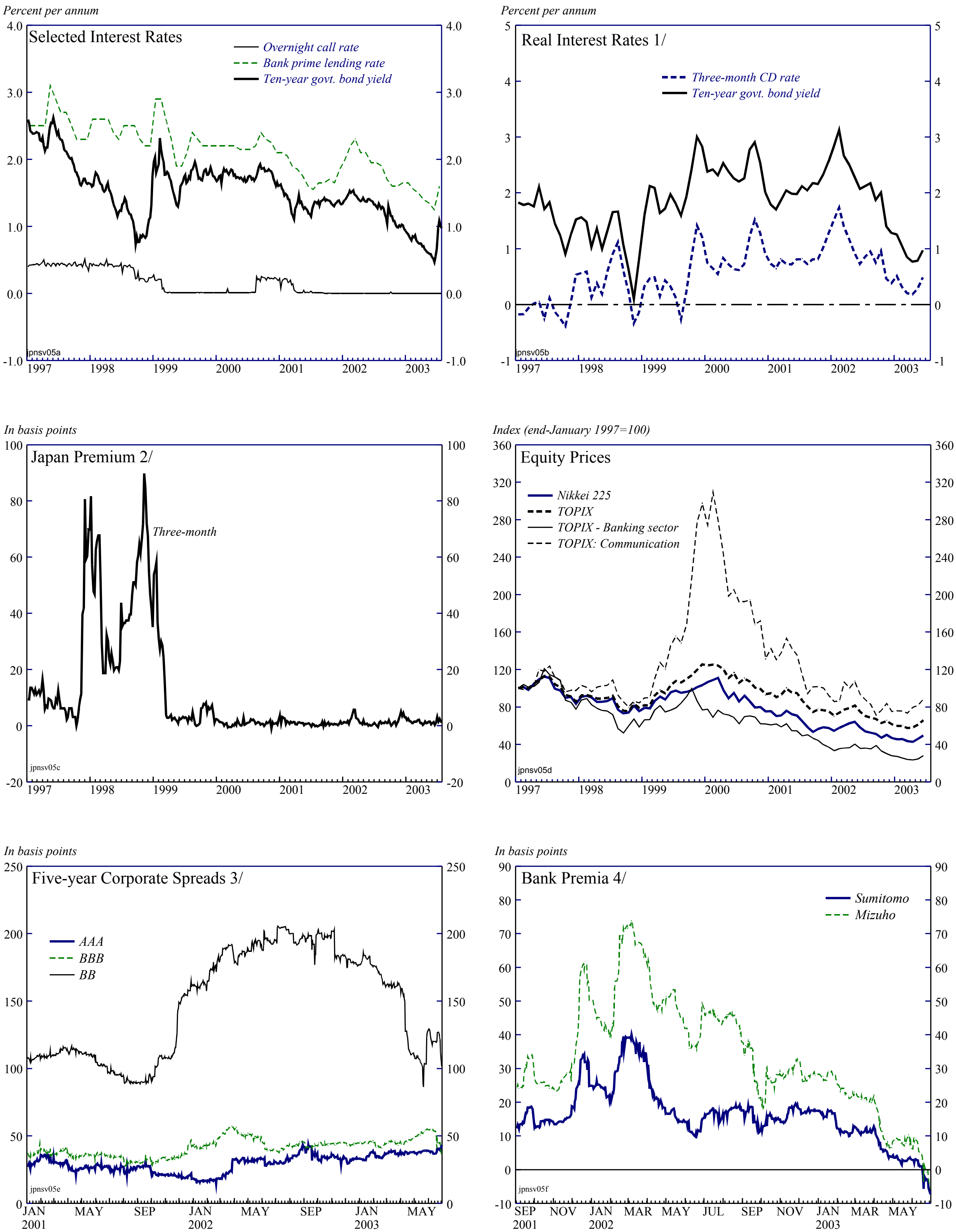
Figure 3. Japan: Price and Labor Market Indicators, 1997-2003 1/



Source: Global Insight, Nomura Database.

1/ Seasonally adjusted data except for land prices, household income, and monthly earnings.

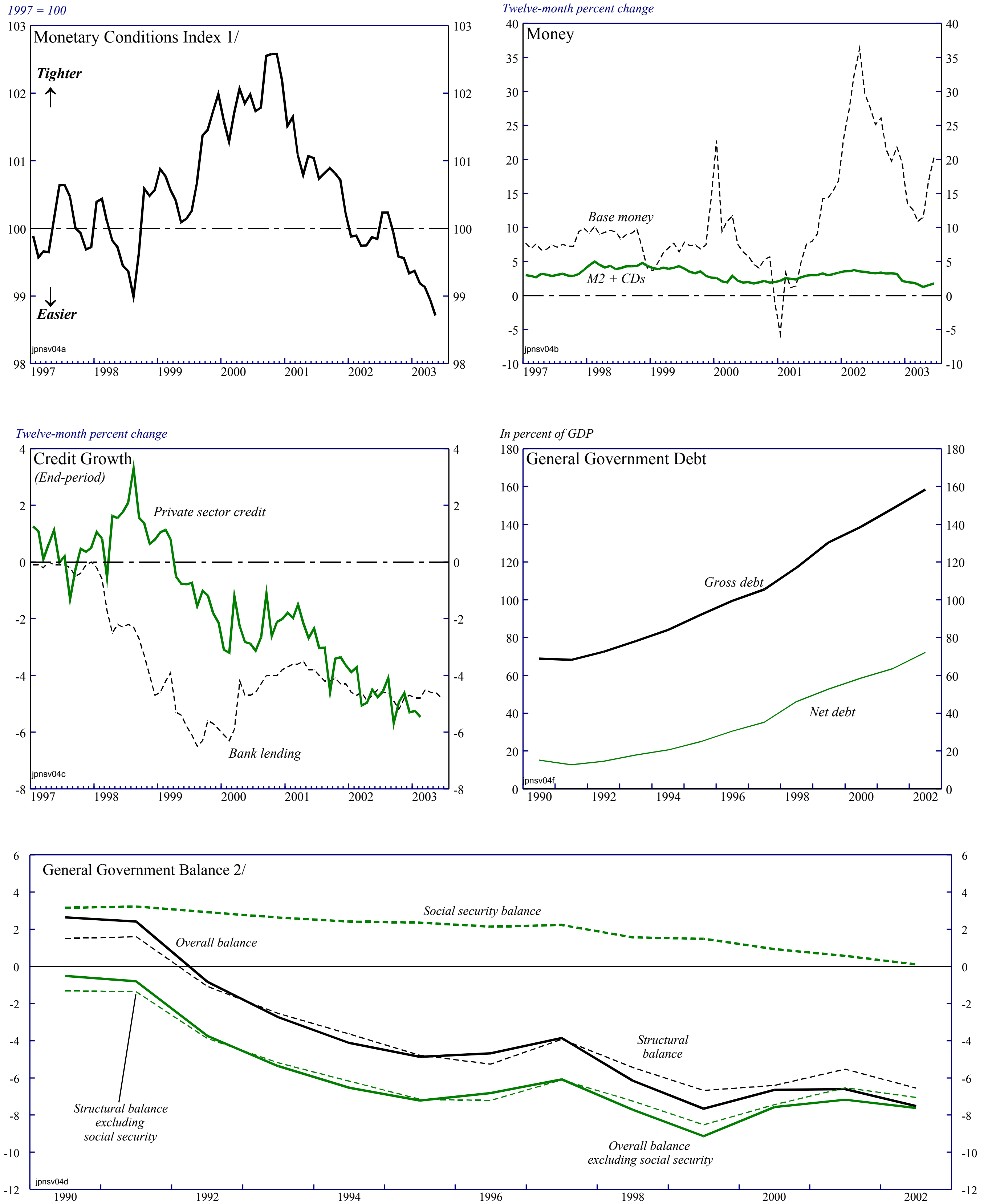
Figure 4. Japan: Financial Indicators, 1997-2003



Sources: Global Insight, Nomura Database; CEIC Database; Bloomberg, LP; and staff calculations.

1/ Deflated by CPI adjusted for changes in indirect taxes and administered prices.
2/ Premium paid by Japanese banks to borrow dollars in London interbank market (average rate for Bank of Tokyo-Mitsubishi and Norinchukin Bank compared to London fixing rate from 3/18/02; previously, Fuji Bank was included in the average).
3/ Five-year corporate bonds minus five-year government bond yields.
4/ Five-year bank bonds minus five-year government bond yields.

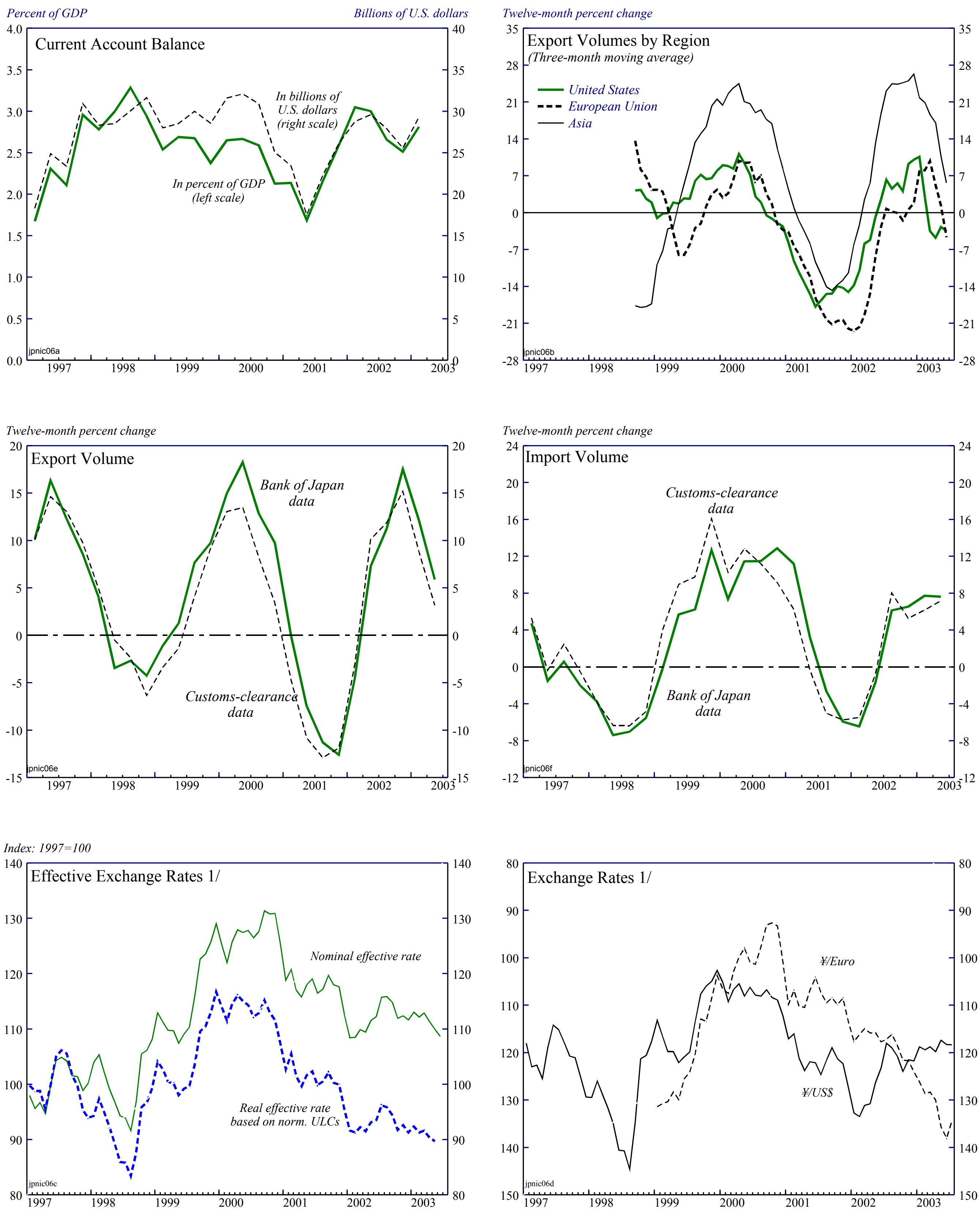
Figure 5. Japan: Monetary and Fiscal Indicators, 1990-2003



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

1/ The monetary conditions index is the weighted sum of the short-term real interest rate and the real effective exchange rate, where the weights reflect the estimated impact of those variables on aggregate demand. Specifically, a 100 basis point change in the overnight call rate (in real terms) receives the same weight as a 10 percent change in the real effective exchange rate.
2/ In percent of fiscal year basis GDP; the fiscal year is from April to March.

Figure 6. Japan: External Sector Developments, 1997-2003



Source: Global Insight, Nomura Database.

1/ Increase implies appreciation.

Table 1. Japan: Selected Economic Indicators, 1995-2004

Nominal GDP: US$3,998 billion (2002)
Population: 127.4 million (2002)
GDP per capita: US$31,394 (2002)
Quota: SDR 13,312.8 million

									Proj.		
	1995	1996	1997	1998	1999	2000	2001	2002	2003		2004
Growth (percent change) 1/											
Real GDP	1.8	3.5	1.9	-1.1	0.2	2.8	0.4	0.1	1.1		0.8
Domestic demand	2.4	4.0	0.9	-1.5	0.3	2.3	1.1	-0.4	0.9		0.3
Private consumption	1.8	2.3	1.1	-0.1	0.2	0.9	1.7	1.3	0.5		0.4
Residential investment	-4.4	11.6	-11.7	-14.5	0.0	0.9	-5.4	-4.8	-3.4		-2.7
Business investment	2.7	4.7	11.8	-2.0	-4.0	9.7	1.1	-4.8	3.7		0.8
Government consumption	4.2	2.9	1.0	2.1	4.4	4.7	2.5	2.3	1.4		1.5
Public investment	-0.2	8.1	-10.8	-2.2	6.0	-9.8	-4.2	-4.9	-6.1		-1.7
Stockbuilding 2/	0.6	0.3	0.0	-0.6	-0.3	0.3	0.0	-0.4	0.3		-0.1
Net exports 2/	-0.5	-0.4	1.0	0.3	-0.1	0.5	-0.7	0.7	0.2		0.5
Exports of goods and services	4.1	6.4	11.3	-2.2	1.4	12.4	-6.1	8.1	5.9		7.7
Imports of goods and services	12.8	13.2	1.3	-6.8	3.0	9.4	0.1	2.0	4.7		4.9
Saving-Investment (percent of GDP)											
Gross national saving	30.1	30.5	30.8	29.7	28.4	28.7	27.7	26.5	26.1		25.9
Gross domestic investment	28.1	29.1	28.6	26.8	25.9	26.2	25.6	23.7	23.5		23.2
Inflation (annual average)											
CPI	-0.1	0.0	1.7	0.6	-0.3	-0.9	-0.7	-0.9	-0.4		-0.6
GDP deflator	-0.5	-0.8	0.3	-0.1	-1.5	-1.9	-1.6	-1.7	-1.9		-1.8
Unemployment rate (annual average)	3.2	3.4	3.4	4.1	4.7	4.7	5.0	5.4	5.5		5.6
Government (percent of GDP, calendar year basis)											
General government											
Revenue	29.6	29.8	29.9	29.3	29.1	29.4	30.2	29.3	29.0		28.9
Expenditure	34.3	34.8	33.7	34.8	36.3	36.8	36.3	36.8	36.7		36.1
Balance	-4.7	-5.0	-3.8	-5.5	-7.2	-7.4	-6.1	-7.5	-7.7		-7.1
Balance excluding social security	-7.0	-7.2	-6.0	-7.2	-8.7	-8.5	-6.3	-7.7	-7.8		-6.9
Structural balance 3/	-4.4	-5.4	-4.2	-4.8	-6.1	-5.8	-5.1	-6.5	-6.3		-6.0
Money and credit (percent change, end-period)											
Base money	6.1	7.3	9.9	4.0	14.2	-1.1	16.9	19.5	20.3	5/	...
M2 plus CDs (period average)	3.0	3.3	3.1	4.4	3.7	2.1	2.8	3.3	1.8	5/	...
Domestic credit	1.8	1.4	1.3	2.6	2.9	2.6	1.6	-2.1	-0.1	6/	...
Bank lending	2.1	-0.4	0.0	-4.7	-5.9	-3.8	-4.3	-4.7	-4.8	5/	...
Interest rate											
Three-month CD rate (annual average)	1.1	0.5	0.5	0.6	0.1	0.2	0.09	0.07	0.08	7/	...
Official discount rate (end-period)	0.5	0.5	0.5	0.5	0.5	0.5	0.10	0.10	0.10	7/	...
Balance of payments (in billions of US$)											
Exports, f.o.b.	429.4	400.2	409.2	374.4	403.9	459.6	383.5	396.2	434.1		459.6
Imports, f.o.b.	297.2	316.7	307.8	251.6	280.5	342.8	313.3	302.2	334.8		347.7
Current account balance	111.4	65.7	96.6	119.1	114.5	119.6	87.8	112.7	115.6		118.7
Percent of GDP	2.1	1.4	2.2	3.0	2.6	2.5	2.1	2.8	2.8		2.8
Terms of trade (percent change)	-0.1	-6.9	-3.9	6.7	4.6	-5.1	0.3	0.2	-3.3		-0.5
Change in reserves	58.7	36.8	6.9	-7.4	77.3	49.3	41.1	46.8	...		...
Total reserves minus gold (in billions of US$)	183.2	216.6	219.6	215.5	286.9	354.9	395.2	461.2	537.1	5/	...
Exchange rates (annual average)											
Yen/dollar rate	94.1	108.8	121.0	130.9	113.9	107.8	121.5	125.2	118.5	7/	...
Real effective exchange rate 4/	146.4	125.1	119.5	109.9	125.3	135.2	120.7	111.1	107.2	6/	...

Sources: Global Insight, Nomura database; and staff estimates and projections as of July 16, 2003.

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/ June 2003.
6/ May 2003.
7/ July 16, 2003.

Table 2. Japan: Monetary Survey, 1998–2003
(Percentage change over corresponding period of previous year, end-period)

					2002				2003
	1998	1999	2000	2001	Mar.	Jun.	Sept.	Dec.	Mar.
Monetary Survey									
Foreign assets (net)	-18.7	3.3	26.4	18.2	12.8	11.9	7.2	10.6	3.2
Domestic credit	2.6	2.9	2.6	1.6	0.5	-0.9	-1.1	-2.1	-1.4
Claims on government (net)	14.4	36.5	26.0	21.0	20.7	10.3	12.6	7.2	11.8
Of which: government bonds	17.6	44.4	26.3	16.8	11.1	8.1	11.5	10.3	12.6
Claims on local governments	11.0	4.3	-1.8	3.9	3.4	2.6	2.1	1.5	3.3
Of which: local government bonds	8.3	9.2	0.1	3.7	2.2	-2.0	-5.9	-6.7	-8.1
Claims on private sector	0.8	-2.1	-2.0	-3.7	-5.1	-4.8	-5.7	-5.3	-6.1
Lendings	1.1	-2.3	-2.2	-3.4	-3.9	-3.8	-5.2	-4.7	-4.8
Industrial bonds and stocks	-2.3	-0.8	-0.7	-6.3	-15.9	-13.7	-11.1	-11.1	-20.1
M2 + CDs	4.0	2.7	1.9	3.3	3.3	3.2	2.1	1.8	1.2
M1	5.0	11.7	3.5	13.7	30.6	29.8	25.3	23.5	5.7
Cash currency in circulation	3.0	9.4	4.3	7.6	12.7	10.0	10.0	7.0	4.1
Deposit money	5.6	12.5	3.2	15.7	35.8	35.6	29.7	28.6	6.1
Quasi-money + CDs	3.5	-2.1	0.9	-3.1	-14.0	-14.5	-13.4	-13.8	-3.2
Other items (net)	-12.3	4.5	15.5	0.5	-6.6	-12.6	-11.4	-14.6	-11.9
Accounts of Monetary Authorities									
Foreign assets (short-term, net)	-14.2	49.0	53.1	28.0	29.5	33.3	6.0	19.5	5.5
Claims on government	15.4	32.0	-11.3	61.8	72.7	22.2	17.6	18.7	11.0
Of which: government bonds	17.3	35.7	-12.4	68.1	80.1	23.6	18.5	19.8	11.5
Claims on deposit money banks	10.7	-4.5	-44.5	163.1	117.5	55.1	60.0	33.9	-0.6
Of which: lendings	-62.9	-3.5	-75.7	-30.3	-37.0	-21.3	7.6	-26.7	-45.5
Reserve money	3.6	39.3	-18.2	17.3	45.3	22.7	18.9	13.9	6.4
Cash currency issued	2.2	16.0	-2.8	8.4	14.7	11.0	11.7	8.9	4.5
Deposits from deposit money banks	29.0	360.5	-71.8	123.9	415.6	160.0	57.8	42.8	11.5
Government deposits	101.7	5.6	76.9	-2.5	-27.4	-13.4	-11.3	58.0	22.0
Accounts of Deposit Money Banks									
Cash and deposits with the Bank of Japan	7.2	201.4	-62.5	70.2	227.0	94.2	49.3	37.9	10.8
Foreign assets	-15.3	-28.7	9.2	10.0	-4.4	-6.7	3.1	-2.8	-0.9
Claims on government	20.8	35.4	55.8	3.0	-6.0	1.7	6.0	6.2	13.7
Of which: government bonds	17.8	51.1	52.8	-3.3	-13.5	-0.7	6.7	3.8	13.4
Claims on local governments	11.0	4.3	-1.8	3.9	3.4	2.6	2.1	1.5	3.3
Of which: local government bonds	8.3	9.2	0.1	3.7	2.2	-2.0	-5.9	-6.7	-8.1
Claims on private sector	0.8	-2.1	-2.0	-3.7	-5.1	-4.8	-5.7	-5.3	-6.1
Lendings	1.1	-2.3	-2.2	-3.4	-3.9	-3.8	-5.2	-4.7	-4.8
Industrial bonds and stocks	-2.3	-0.8	-0.7	-6.3	-15.9	-13.7	-11.1	-11.1	-20.1
Deposit money	5.6	12.5	3.2	15.7	35.8	35.6	29.7	28.6	6.1
Quasi-money + CDs	3.5	-2.1	0.9	-3.1	-14.0	-14.5	-13.4	-13.8	-3.2
Foreign liabilities	-13.1	-32.0	12.4	12.1	-3.1	-2.0	0.8	-2.1	-0.9
Credits from monetary authorities	10.7	-4.5	-44.5	163.1	117.5	55.1	60.0	33.9	-0.6
Bank debentures	-19.1	-0.4	-11.2	-12.6	-13.6	-16.4	-18.4	-19.8	-20.5
Unclassified liabilities (net)	-4.9	16.3	15.9	-31.0	-40.4	-42.5	-32.5	-31.9	-16.6

Source: Bank of Japan, *Financial and Economic Statistics Monthly.*

Table 3. Japan: General Government Operations, 1998–2003 1/

(In percent of GDP)

	1998	1999	2000	2001	2002 Est.	2003 Proj.
			(Fiscal year)			
Total revenue	29.4	29.1	29.6	30.0	29.1	28.9
Taxes and fines	16.9	16.6	17.2	17.1	16.6	16.2
Social security premiums	10.3	10.4	10.4	10.8	10.8	11.0
Property income	2.1	2.1	1.9	1.9	1.5	1.5
Total expenditure	35.5	36.8	36.2	36.6	36.6	36.7
Current	28.4	29.4	29.5	30.6	31.2	31.0
Consumption	11.1	11.5	11.5	11.8	11.9	11.6
(less) Depreciation	-2.1	-2.3	-2.4	-2.5	-2.5	-2.5
Social security benefits	12.7	13.3	14.0	14.9	15.2	15.5
Other current	3.3	3.5	3.2	3.3	3.3	3.2
Interest paid	3.4	3.4	3.2	3.1	3.2	3.2
Capital	7.1	7.4	6.8	5.9	5.5	5.7
Investment	5.7	5.6	5.0	4.8	4.5	4.4
Land acquisition	1.0	0.9	0.8	0.7	0.7	0.6
Capital transfers	0.5	0.9	0.9	0.4	0.3	0.6
Of which: Bank support	0.2	0.7	0.7	0.1	0.0	0.4
Balance	-6.1	-7.7	-6.6	-6.6	-7.5	-7.8
Excluding social security	-7.7	-9.1	-7.6	-7.2	-7.6	-7.9
Excluding bank support	-5.9	-6.9	-5.9	-6.5	-7.5	-7.4
Primary balance	-4.7	-6.2	-5.2	-5.2	-5.8	-6.0
Structural balance (excluding support for banks)	-5.2	-6.0	-5.7	-5.4	-6.5	-6.3
Change in the structural balance	-1.3	-0.8	0.3	0.3	-1.1	0.3
			(Calendar year)			
Total revenue	29.3	29.1	29.4	30.2	29.3	29.0
Taxes and fines	16.7	16.6	17.0	17.6	16.8	16.3
Social security premiums	10.3	10.4	10.4	10.7	10.8	11.0
Property income	2.1	2.1	2.0	1.9	1.6	1.5
Total expenditure	34.8	36.3	36.8	36.3	36.8	36.7
Current	27.9	29.3	29.5	30.2	31.1	31.0
Consumption	11.0	11.4	11.4	11.7	12.0	11.7
(less) Depreciation	-2.1	-2.2	-2.4	-2.5	-2.5	-2.5
Social security benefits	12.5	13.2	13.9	14.6	15.2	15.4
Other current	3.0	3.5	3.3	3.2	3.3	3.2
Interest paid	3.4	3.4	3.3	3.2	3.2	3.2
Capital	6.8	7.0	7.3	6.1	5.7	5.7
Investment	5.5	5.8	5.1	4.9	4.7	4.4
Land acquisition	0.9	0.9	0.8	0.7	0.7	0.6
Capital transfers	0.4	0.3	1.4	0.5	0.3	0.6
Of which: Bank support	0.2	0.1	1.2	0.3	0.0	0.4
Balance	-5.5	-7.2	-7.4	-6.1	-7.5	-7.7
Excluding bank support	-5.3	-7.1	-6.2	-5.8	-7.5	-7.3
Primary balance	-4.1	-5.7	-6.0	-4.7	-5.8	-6.0
Structural balance (excluding support for banks)	-4.8	-6.1	-5.8	-5.1	-6.5	-6.3
Change in the structural balance	-0.6	-1.4	0.3	0.7	-1.3	0.2
Debt (In percent of GDP, calendar year) 2/						
Gross	117.1	130.5	138.7	148.4	158.4	167.5
Net	46.2	52.8	58.6	63.7	72.2	80.5
Memorandum items:						
Nominal GDP (FY, trillion yen)	514.5	508.8	515.6	502.9	498.9	494.7
Nominal GDP (CY, trillion yen)	516.5	509.5	513.6	507.5	499.8	495.6

Source: Staff estimates, based on the following assumptions:
Stimulus Packages: The projections include the FY2002 supplementary budget, with public works spending of ¥1.5 trillion. A net tax cut of ¥1.8 trillion is assumed for FY2003 based on the budget. Tax revenue in FY2000 and FY2001 has been boosted by one-off increase in interest tax revenue from maturing postal saving deposits (estimated at ¥2.5 trillion for each year).

1/ Estimated from the National Income Accounts data. The fiscal year is April through March.
2/ The levels of gross and net debt were revised in the National Income Accounts data released in April 2003.

Table 4. Japan: Balance of Payments Summary, 1996-2003

	1996	1997	1998	1999	2000	2001	2002	Proj. 2003
	(In billions of U.S. dollars)							
Balance of payments								
Current balance	65.7	96.6	119.1	114.5	119.6	87.8	112.7	115.6
Trade balance	83.5	101.5	122.7	123.4	116.7	70.2	94.1	99.3
Exports	400.2	409.2	374.4	403.9	459.6	383.5	396.2	434.1
Imports	316.7	307.8	251.6	280.5	342.8	313.3	302.2	334.8
Invisibles	-17.7	-4.9	-3.6	-8.9	2.9	17.6	18.7	16.4
Nonfactor services	-62.3	-54.2	-49.5	-54.2	-47.7	-43.7	-42.2	-44.6
Investment income	53.5	58.1	54.6	57.4	60.4	69.3	65.9	70.7
Labor income	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0
Net transfers	-9.0	-8.8	-8.8	-12.1	-9.8	-7.9	-4.9	-9.7
Capital and financial account balance	-66.4	-130.4	-122.3	-132.3	-136.6	-91.5	-112.9	-115.6
Capital account	-3.3	-4.0	-14.7	-16.5	-9.3	-2.9	-3.3	-10.9
Financial account	-63.1	-126.4	-107.6	-115.8	-127.3	-88.6	-109.6	-104.7
Direct investment, net	-23.2	-22.9	-21.3	-10.0	-23.4	-32.3	-23.0	-32.8
Direct investment abroad	-23.4	-26.1	-24.5	-22.2	-31.6	-38.5	-32.1	-37.7
Foreign direct investment in Japan	0.2	3.2	3.3	12.2	8.2	6.2	9.1	4.9
Portfolio investment, net	-34.0	30.0	-40.9	-30.7	-35.1	-46.8	-105.7	-41.0
Other investment, net	30.9	-126.6	-52.8	2.2	-19.4	31.5	65.9	-10.8
Reserve assets	-36.8	-6.9	7.4	-77.3	-49.3	-41.1	-46.8	-20.1
Errors and omissions, net	0.7	33.9	3.2	17.7	17.0	3.7	0.2	0.0
	(In percent of GDP)							
Net foreign assets	18.9	22.2	29.1	24.1	25.2	31.1	35.2	36.2
Current account balance	1.4	2.2	3.0	2.6	2.5	2.1	2.8	2.8
Trade balance	1.8	2.3	3.1	2.8	2.4	1.7	2.4	2.4
Invisibles	-0.4	-0.1	-0.1	-0.2	0.1	0.4	0.5	0.4

Sources: Global Insight, Nomura database; and staff estimates.

Table 5. Japan: Indicators of External and Financial Vulnerability, 1995-2003

(In percent of GDP, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000	2001	2002	2003 Latest
External indicators									
Real exports of goods and services (percent change)	4.1	6.5	11.3	-2.3	1.5	12.4	-6.1	8.2	...
Real imports of goods and services (percent change)	12.8	13.2	1.2	-6.8	3.0	9.5	0.1	2.0	...
Terms of trade (percent change)	-0.1	-6.9	-3.9	6.7	4.6	-5.1	0.3	0.2	-1.2
Current account balance	2.1	1.4	2.2	3.0	2.6	2.5	2.1	2.8	...
Capital and financial account balance	-1.2	-0.5	-2.7	-3.0	-1.1	-1.9	-1.4	-1.7	...
Of which:									
Inward portfolio investment	1.0	1.4	1.8	1.4	2.8	1.0	1.4	-0.5	...
Inward direct investment	0.0	0.0	0.1	0.1	0.3	0.2	0.1	0.2	...
Other investment liabilities (net)	-0.1	0.8	-2.8	-1.4	0.1	-0.3	0.7	1.6	...
Total reserves minus gold (US$ billion)	183.2	216.6	219.6	215.5	286.9	354.9	395.2	461.2	537.1
In months of imports of goods and services	5.4	6.0	6.3	7.4	9.1	9.6	11.7	14.0	...
Broad money (M2 + CDs) to reserves ratio	3.1	2.3	2.1	2.1	1.9	1.6	1.3	1.1	1.1
Foreign assets of deposit money banks (US$ billion)	1169.5	960.7	1064.0	833.2	682.5	787.8	768.4	725.1	...
Foreign liabilities of deposit money banks (US$ billion)	803.0	736.0	762.5	612.5	478.8	568.7	565.5	537.4	...
Net international investment position (US$ billion)	817.6	891.0	958.7	1153.6	829.1	1157.9	1249.1	1598.5	...
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	2.3	...
Nominal effective exchange rate (percent change)	6.7	-12.7	-4.2	0.3	15.2	10.2	-7.7	-4.9	-3.2
Financial market indicators									
General government gross debt	91.9	99.4	105.6	117.1	130.6	138.7	148.4	158.3	...
Interest rates (percent, end-year)									
3-month Gensaki rate	0.23	0.25	0.23	0.14	0.07	0.32	0.01	0.00	0.00
3-month Gensaki rate, real	0.63	-0.36	-1.59	-0.45	1.15	0.72	1.21	0.31	-0.20
3-month interest rate spread vis-à-vis U.S.	-4.93	-4.62	-4.93	-4.28	-5.16	-5.51	-1.71	-1.19	-1.08
Stock market index (TOPIX, percent change, end-year) 3/	1.2	-6.8	-20.1	-7.5	58.4	-25.5	-19.6	-18.3	-3.6
Banking sector risk indicators									
Total loans to assets (in percent)	53.4	52.5	50.9	49.9	47.3	44.3	39.6	...	...
Total loans to deposits (in percent)	107.5	107.6	107.0	105.1	98.9	97.8	93.4	...	...
Share of real estate sector in total lending (in percent)	13.5	13.8	14.2	14.2	14.5	14.9	14.9	...	...
Share of non-performing loans in total loans (in percent, end-fiscal year) 4/	6.6	4.9	5.5	6.1	5.8	5.7	8.4	7.2	...
Risk-weighted capital ratio (in percent, end-fiscal year) 4/	9.1	9.0	9.5	11.6	11.8	11.7	10.8	10.0	...

Sources: Global Insight, 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/ Year on year percent change for the latest figure.

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

Table 6. Japan: Public Sector Debt Sustainability Framework, 1992-2007

(In percent of GDP, unless otherwise indicated)

	Actual										Projections					
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections																
1 Public sector debt 1/	14.5	17.9	20.5	24.8	30.5	35.3	46.2	52.8	58.6	63.7	**72.2**	**80.5**	**88.5**	**94.5**	**98.8**	**102.5**
2 Change in public sector debt	1.9	3.3	2.7	4.3	5.6	4.8	10.9	6.6	5.8	5.1	8.5	8.3	8.0	6.0	4.3	3.8
3 Identified debt-creating flows (4+7+12)	-1.1	2.3	3.5	4.4	4.4	3.1	11.2	7.8	7.0	6.8	8.5	8.3	8.0	6.0	4.3	3.8
4 Primary deficit	-1.9	1.3	2.5	3.4	3.7	2.5	4.1	5.7	6.0	4.7	5.8	6.0	5.3	4.4	4.1	4.0
5 Revenue and grants	31.8	30.4	29.6	29.6	29.8	29.9	29.3	29.1	29.4	30.2	29.3	29.0	28.9	29.2	29.5	29.9
6 Primary (noninterest) expenditure	29.9	31.6	32.1	33.0	33.5	32.4	33.4	34.8	35.4	34.9	35.1	34.9	34.2	33.6	33.6	33.9
7 Automatic debt dynamics 2/	0.8	1.1	1.0	1.0	0.7	0.7	1.9	2.1	1.0	2.1	2.7	2.4	2.7	1.5	0.2	-0.2
8 Contribution from interest rate/growth differential 3/	0.8	1.1	1.0	1.0	0.7	0.7	1.9	2.1	1.0	2.1	2.7	2.4	2.7	1.5	0.2	-0.2
9 *Of which:* contribution from real interest rate	0.9	1.1	1.2	1.4	1.5	1.2	1.5	2.2	2.5	2.4	2.7	3.2	3.3	2.9	2.0	1.7
10 *Of which:* contribution from real GDP growth	-0.1	-0.1	-0.2	-0.4	-0.8	-0.6	0.4	-0.1	-1.4	-0.2	-0.1	-0.8	-0.6	-1.3	-1.8	-1.9
11 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	5.23	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
12 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	5.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Residual, including asset changes (2-3)	3.0	1.0	-0.9	-0.1	1.3	1.7	-0.3	-1.2	-1.2	-1.7	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	45.7	58.8	69.4	83.8	102.3	117.9	157.8	181.4	199.3	210.5	246.5	277.7	306.0	323.3	334.2	342.7
Key Macroeconomic and Fiscal Assumptions																
Real GDP growth (in percent)	0.9	0.4	1.1	1.8	3.5	1.9	-1.1	0.2	2.8	0.4	0.1	1.1	0.8	1.5	2.0	2.0
Average nominal interest rate on public debt (in percent) 4/	9.1	8.2	6.8	6.4	5.5	4.4	4.0	3.1	2.8	2.4	2.6	2.4	2.3	2.2	2.3	2.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	7.4	7.7	6.7	6.9	6.2	4.1	4.1	4.6	4.7	4.0	4.2	4.4	4.1	3.2	2.2	1.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.4	11.5	12.1	-3.0	-11.4	-10.7	12.4	13.1	-11.1	-12.8	9.9	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	1.7	0.5	0.1	-0.5	-0.8	0.3	-0.1	-1.5	-1.9	-1.6	-1.6	-1.9	-1.8	-1.0	0.1	0.7
Growth of real primary spending (deflated by GDP deflator, in percent)	3.4	6.2	2.5	4.8	5.1	-1.7	1.9	4.5	4.4	-1.0	0.8	0.6	-1.4	-0.2	1.9	2.9
II. Stress Tests for Public Debt Ratio																
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-07											**72.2**	**78.6**	**85.4**	**92.4**	**99.6**	**107.2**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004											**72.2**	**83.6**	**95.5**	**101.6**	**105.9**	**109.7**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004											**72.2**	**82.7**	**93.0**	**99.3**	**103.8**	**107.7**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004											**72.2**	**82.4**	**93.0**	**99.0**	**103.3**	**107.1**
5. Combination of 2-4 using one standard deviation shocks											**72.2**	**83.1**	**94.8**	**100.2**	**103.8**	**106.9**
6. 10 percent of GDP increase in other debt-creating flows in 2003											**72.2**	**90.5**	**98.8**	**105.0**	**109.3**	**113.0**
Historical Statistics for Key Variables (past 10 years)							Historical Average		Standard Deviation				Average 2003-07		Average 2003-13	
Primary deficit							3.2		2.3				4.7		3.8	
Real GDP growth (in percent)							1.2		1.4				1.5		1.3	
Nominal interest rate (in percent)							5.3		2.3				2.3		2.7	
Real interest rate (in percent)							5.6		1.5				3.1		2.5	
Inflation rate (GDP deflator, in percent)							-0.4		1.1				-0.8		0.2	
Revenue to GDP ratio							29.9		0.8				29.3		30.3	

1/ General government, net debt.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ Derived as nominal interest expenditure divided by previous period debt stock.

JAPAN—FUND RELATIONS
(As of April 30, 2003)

I. **Membership Status**: Joined 8/13/52; Article VIII

II. **General Resources Account**:

	SDR Million	% Quota
Quota	13,312.80	100.00
Fund holdings of currency	7,769.16	58.36
Reserve position in Fund	5,544.90	41.65
Financial Transaction Plan transfers (net)	365.00	

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	891.69	100.00
Holdings	1,800.78	201.95

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 2002 Article IV Consultation discussions were held during April 4–12, 2002; the Executive Board discussed the Staff Report (SM/02/199) and concluded the consultation on July 24, 2002. In the Summing Up, Executive Directors expressed concern that the ongoing recovery was likely to prove short-lived unless Japan's deep-seated structural problems in the bank and corporate sectors were urgently and comprehensively addressed. They urged that complacency must be avoided at all costs, as this would only serve to prolong Japan's decade of stagnation, as well as heighten the vulnerabilities from the bank, corporate, and fiscal sectors. Directors therefore welcomed the government's reaffirmation of its commitment to press ahead with structural reforms, and to build on the progress that has been achieved during its first year in office. The staff report, staff statement, and PIN were all published.

JAPAN—STATISTICAL ISSUES

1. Japan subscribed to the Special Data Dissemination Standard (SDDS) on July 3, 1996 and met the SDDS specifications for the coverage, periodicity, and timeliness of data and for dissemination of advance release calendars on June 9, 2000.

2. **National accounts**

- The Japanese National Income Accounts were revised in 2000 by the Economic and Social Research Institute (ESRI) 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 government consumption, and revision of the benchmark year to 1995. Improvements in the seasonal adjustment method were also introduced to take account of leap year 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. Starting with data from the second quarter of 2002, it introduced a new method that combines supply and demand side indicators to improve the accuracy of the estimates. In particular, additional supply side indicators are combined with the previously-used demand side indicators, which reduces the statistical discrepancy between estimates of GDP measured from the production and expenditure sides. ESRI also now releases the estimate about 1½ months after the end of the quarter, approximately a month earlier than before. At the same time, more frequent backward revisions and concurrent seasonal adjustment methods were introduced. 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]

- The Bank of Japan (BoJ) revised its Wholesale Price Index (WPI) by updating the base year from 1995 to 2000, changing commodities released as index series, and increasing the number of sample prices for the index compilation. It also changed the name of the index from the WPI to the Corporate Goods Price Index (CGPI) to better reflect its characteristics.

- The industrial production series was improved in April 2003. The base year was updated from 1995 to 2000, with corresponding updates to components weights, and seasonal adjustment factors. One effect of these revisions is to increase the weight on the electrical machinery sector. In addition, revised seasonal adjustments may smooth the recent history of the series.

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

- In November 2002, methods for estimating pension fund output were improved, and part of expenditure on mobile telecommunication devices was reclassified to consumption because of wider dissemination of mobile phones to the public. These changes as well as other less significant changes were incorporated in National Income Accounts data back to 1990.

- The Family Income and Expenditure Survey (FIES) has been subject to volatility, particularly in “lumpy” expenditure items such as consumer durables. 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 and reclassification of survey items to better reflect expenditures on IT products. In addition, 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.

- Preliminary estimates for the income side of the national accounts (with the exception of 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.

3. **Fiscal**

- Fiscal accounts distinguish between general (or ordinary) accounts for core government functions, and special accounts, some of which 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 has published its annual balance sheet since October 2000. Estimates from FY1998 to FY2000 are now available. However, the relationship with the flow data is unclear because the balance sheet consolidates the FILP whereas flow data do not. In addition, the assessment of assets and contingent liabilities is likely to need considerable improvement, including through consolidation with local governments.

- The authorities have not reported fiscal data for publication in the *GFS Yearbook* since 1994. 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.

4. **External sector**

- Monthly data on merchandise trade and the balance of payments are released on a timely basis.

- In the financial account of the balance of payments, the proceeds from the sale of loans during 1997–2000 may be overstated because the sales were not recorded at market prices. The BoJ recorded the corresponding large debit entries as capital transfers in the capital account.

5. **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 BoJ's "*Financial and Economic Statistics Monthly*," is normally disseminated 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.

6. **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); and

- provide greater detail on the quarterly components of spending and national income.

Over the longer term, efforts should be directed to:

- moving data production to a single, independent agency staffed with professional statisticians.

Japan: Core Statistical Indicators

(As of July 2, 2003)

	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	7/2/03	5/03	5/03	6/30/03	5/03	7/2/03	5/03	5/03	4/03	2001	2003:Q1	End-2002
Date received	7/2/03	6/03	6/03	7/2/03	6/03	7/2/03	6/03	6/03	6/03	12/03	6/03	5/03
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	C	C	C	C	C	C	C	C	C	C	C	C
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

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IMF Concludes 2003 Article IV Consultation with Japan

On August 20, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Japan.[1]

Background

Japan experienced a cyclical recovery in 2002, which included a strong pickup in activity in the second quarter followed by a gradual slowdown during the rest of the year. For 2002 as a whole, real GDP grew by only 0.1 percent, owing to the low base for the recovery that resulted from the sharp fall in output during the previous year.

The recovery appears to have stalled in 2003. GDP grew by only 0.1 percent in the first quarter, and monthly indicators point to continued sluggish activity in recent months. Exports and the external balance, past sources of strength, have declined as partner-country growth has slowed. Industrial production has leveled off, household expenditure and retail sales have been broadly flat, and the cyclical rebound in business fixed investment and profitability seems to have lost momentum.

Labor market weaknesses persist. The unemployment rate remains near its record high, while employment, the labor force, and monthly earnings (real and nominal) have all been on downward trends since around mid-2001.

Amid persistent economic slack, deflation continues. The GDP deflator fell in 2002 for a fifth consecutive year, by 1¾ percent. The core CPI (excluding fresh food) has also decreased

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[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 August 20, 2003 Executive Board discussion based on the staff report.

year on year virtually every month for about the past four years. Meanwhile, expectations of deflation remain entrenched.

Monetary policy has remained focused on maintaining financial stability, primarily by providing liquidity to ensure that banks could meet their funding needs without difficulties. Over the past 12 months the Bank of Japan (BoJ) raised the target for current account balances on several occasions, periodically injected liquidity, expanded the range of collateral eligible for operations, and removed the maturity ceiling on Lombard loans. The BoJ has also helped banks reduce their equity risk with its program to buy banks' shareholdings for a total of ¥3 trillion through September 2003. A program of outright purchases of asset-backed securities, up to ¥1 trillion through March 2006, commenced at end-July 2003.

Growth in base money has not fed into broad monetary aggregates or arrested the continuous decline in bank lending, although short-term interest rates have been kept at virtually zero. With persistent economic weaknesses and bank balance sheet problems limiting loan demand and banks' willingness to lend, bank loans continued declining by about 5 percent a year.

Fiscal policy was expansionary in FY2002, as the general government structural deficit widened by about 1 percent of GDP to 6½ percent of GDP. Unadjusted, the deficit rose to 7½ percent of GDP, mainly reflecting a fall in revenue. Continued fiscal deficits have fed rapidly growing government debt, with end-2002 gross and net debt estimated at 158 and 72 percent of GDP respectively.

In the external sector, the favorable trade performance in 2002 raised the current account surplus by about ¾ percent of GDP to 2¾ percent of GDP. Export volume rose strongly, reflecting a sharp pickup in demand from Asian partner countries (notably China) and the United States, although volume growth slowed in the second half of the year. Imports recovered along with domestic income, partly reflecting a pickup in imports from China.

Compared to June 2002, the yen is broadly unchanged against the U.S. dollar but is modestly weaker in nominal and real effective terms. In the second half of 2002, the yen/dollar rate ranged between ¥116 and ¥125 amid heightened geopolitical uncertainty and concerns about the pace and sustainability of recovery in the major economies. In the first half of 2003, the yen came under pressure to strengthen against the dollar, as the dollar weakened against the euro. This pressure prompted the authorities to intervene on a number of occasions over this period, in the total amount of some ¥7 trillion. In the event, for most of 2003 to date the yen/dollar rate has moved in a range of ±¥2 around ¥119. The yen has weakened significantly against the euro, however, contributing to depreciation in real and nominal effective terms.

Long-term government bond yields hit record lows in June 2003 but subsequently rebounded. The decline in yields in the face of high and rising government debt partly reflected heavy buying of Japanese Government Bonds (JGBs) by financial institutions amid ample liquidity, weak loan demand, increased risk aversion, and banks' efforts to cut risk-weighted assets. The BoJ has also made outright purchases of JGBs, amounting to ¥1.2 trillion per month since October 2002. Starting in late June 2003, long-term yields rebounded to slightly below the levels attained a year earlier. The rise in JGB yields, which occurred in the context of a less pronounced global pickup in long-term interest rates, may have reflected financial market considerations such as portfolio rebalancing from bonds to equities, profit-taking, and investor concerns that yields had fallen too far. Alternatively, it may have reflected a perceived improvement in economic prospects, although data continued to imply an outlook of broadly flat growth and persistent deflation.

Stock prices have also recently recovered from long-term lows. During most of the past 12 months, stock prices have fallen amid concerns about selling pressures from banks and pension funds. In early 2003, the Nikkei index declined broadly in line with other mature markets, but from already low levels, and in April bottomed out at 21-year lows. On the heels of rallies in overseas markets, the Nikkei subsequently rebounded largely driven by foreign buying. As of mid-July 2003, the Nikkei was up about 14 percent for the year but was still about 5 percent lower than a year earlier. Japan's long-term market slide has had significant negative repercussions for the corporate and banking sectors. Between May 2002 and May 2003, Japan's market capitalization declined by about 25 percent, to about 40 percent of its 1989 peak.

Financial institutions' end-FY2002 results revealed some progress in dealing with their problems, but their financial difficulties persisted. Major banks' average ratio of NPLs to credit declined from 8½ percent to 7¼ percent during the fiscal year, in line with the authorities' target to halve the ratio by end-FY2004. However, major banks' losses from equity holdings together with credit costs resulted in net losses of ¥4.4 trillion. Meanwhile, life insurers faced continued pressures from their equity exposures and high guaranteed rates on existing policies.

Real GDP is expected to grow by 1.1 percent in 2003, reflecting carry over effects from strong growth in 2002. Output is projected to be broadly flat during the year, with declining household incomes dampening private consumption, uncertain sales prospects restraining investment, and slower growth in partner countries limiting exports. The outturn could be better than expected, but the risks are mainly weighted to the downside. The upside risks include stronger than expected private domestic demand, for example, if households reduced their savings rates even further. Also, an end to the adjustment of inventories, which have been on a declining trend since mid-2001 and are now at an historical low, would contribute positively to growth. Regarding downside risks, partner country growth could be lower than anticipated; households might cut spending in light of the weak labor markets and uncertain outlook; and finally, turbulence in domestic financial markets could occur and aggravate corporate and financial sector fragilities, triggering a cutback in bank lending and dampening investment.

Executive Board Assessment