FOR AGENDA

SM/08/204
Correction 2

July 18, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Japan—Staff Report for the 2008 Article IV Consultation**

The attached correction to SM/08/204 (6/30/08) has been provided by the staff:

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 20, para. 18, bullet 2, lines 2–4: for "However, such intervention would need to be coordinated with other major countries and even this may not ensure that it would be effective."
read "In general, such intervention is more likely to be effective if coordinated with other major countries."

Questions may be referred to Mr. Gordon (ext. 37557) and Mr. N'Diaye (ext. 39751) in APD.

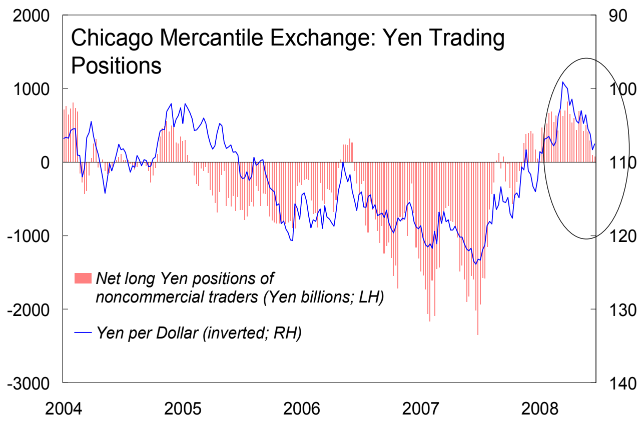
This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

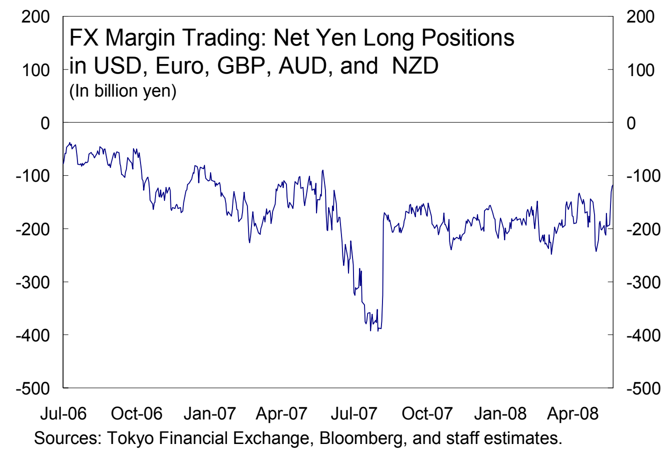
Figure 5. Japan: Exchange Rate and Capital Flows

The yen appreciated significantly against the U.S. dollar as noncommercial traders liquidated their short yen positions …



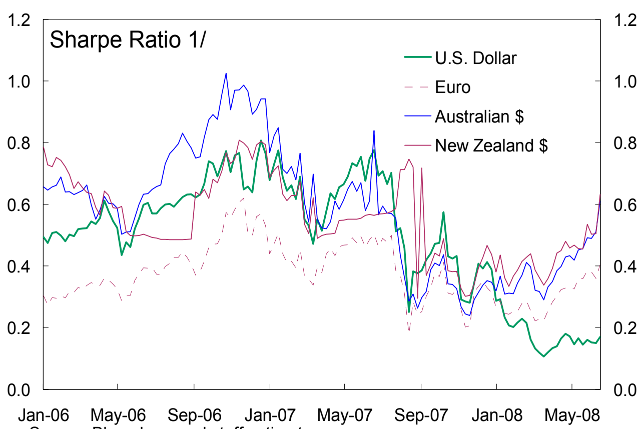
Sources: Bloomberg and staff calculations.

… and carry trades by FX margin investors came off their peak last summer …



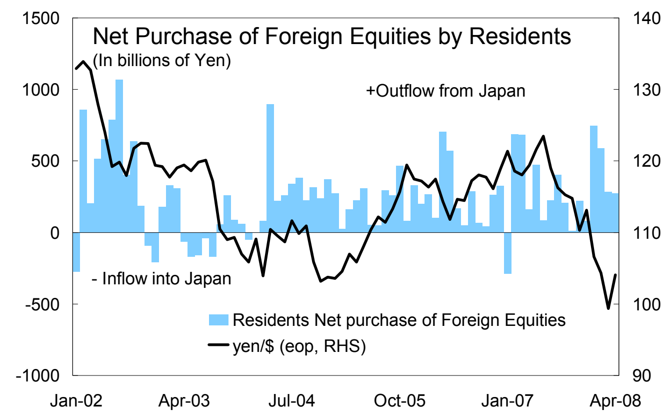
Sources: Tokyo Financial Exchange, Bloomberg, and staff estimates.

… as the risk-adjusted returns on carry currencies have declined.



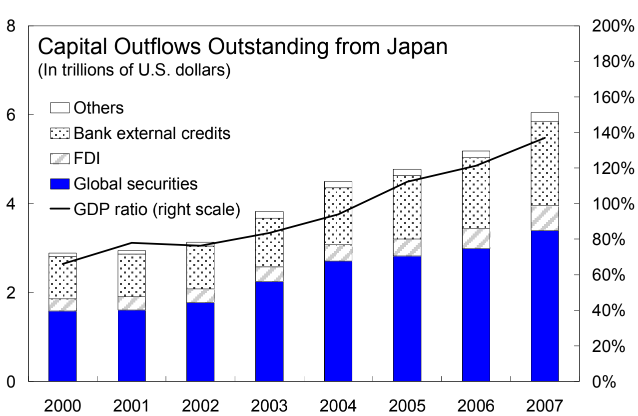
Source: Bloomberg and staff estimates.

However, structural outflows from Japan have continued …



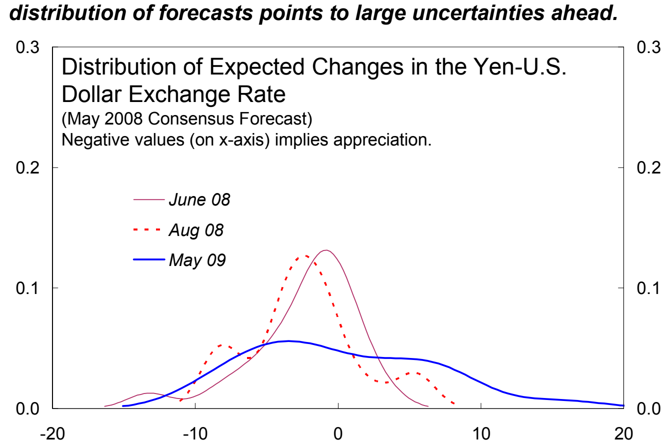
Source: Haver Analytics and staff estimates.

… confirming longer-term trends.



Sources: Ministry of Finance and the Bank of Japan.

The yen has weakened more recently, although the wide distribution of forecasts points to large uncertainties ahead.



Sources: Consensus Forecast and staff calculations.

1/ The Sharpe ratio (defined as the 1-month interest rate differential divided by implied volatility in bilateral exchange rate) is a measure of the risk adjusted return on yen carry trade.

15. **Nonetheless, monetary policy action might be required under the alternative scenarios.** In the case of a sharper than expected growth slowdown, the BoJ could ease, although with the policy rate already low at 50 basis points, its firepower would be limited. Alternatively, under the global inflation scenario, the BoJ might need to consider normalizing interest rates at a faster pace than warranted by domestic factors alone, especially if rising interest differentials were to lead to a weaker yen.

16. **Recent steps to enhance the communication strategy are welcome.** Given that firms have finally begun to pass through cost increases to consumers, guiding inflation expectations has become more challenging. The greater discussion of the risks to the outlook and of the views of the Policy Board Members on growth and CPI inflation in the BoJ's April Outlook should be useful in enhancing public understanding of the future conduct of monetary policy. In addition, in the staff's view the increased emphasis on the 1 percent median of the "understanding of price stability" could help anchor inflation expectations.

17. **The BoJ's liquidity management has kept money markets stable.** While liquidity pressures have been less pronounced than in other countries, the BoJ's more frequent and larger liquidity provisions have helped ensure market stability. That said, there may be scope to strengthen monitoring of the overall financial system by expanding information sharing between the BoJ and the Financial Services Agency (FSA) on activities of systemically important financial institutions outside the banking system, particularly regarding the liquidity positions of securities firms and the off-balance sheet exposures of nonbanks.

18. **The exchange rate should continue to be market determined.**

- *The exchange rate.* The yen is expected to appreciate in real effective terms over the longer term and the current account surplus to narrow. This adjustment would be facilitated by far-reaching structural reforms that promote a broad-based increase in productivity and the return to capital. Such reforms, which would reinvigorate domestic demand and capital inflows, should support a strengthening of the yen over time and a slower accumulation of net foreign assets as capital flows related to Japanese investors' international diversification of assets wane. Moreover, as the population ages, households' savings will fall and private investment will rise as firms substitute capital for labor, contributing to a narrowing of Japan's current account surplus.
- *Intervention.* In the event of excess volatility and disorderly movements in exchange rates, a case could be made for intervention. In general, such intervention is more likely to be effective if coordinated with other major countries.

The Authorities' Responses and Policy Intentions

19. **BoJ officials provided more background about current policy issues.**