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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/98-1

10:15 a.m., November 21, 2018

1. Japan—2018 Article IV Consultation

Documents: SM/18/262 and Correction 1; and Supplement 1; SM/18/263; and Correction 1

Staff: Cashin, APD; Schneider, APD; Panth, SPR

Length: 1 hour, 18 minutes

Executive Board Attendance

C. Lagarde, Chairman

Executive Directors	Alternate Executive Directors
	I. Mannathoko (AE)
M. Raghani (AF)	
G. Lopetegui (AG)	
N. Ray (AP)	
A. Tombini (BR)	
Z. Jin (CC)	
L. Villar (CE)	
L. Levonian (CO)	
R. Kaya (EC)	
H. de Villeroché (FF)	
S. Meyer (GR)	
	M. Siriwardana (IN)
D. Fanizza (IT)	
M. Kaizuka (JA)	
	M. Daïri (MD)
H. Beblawi (MI)	
	R. Doornbosch (NE)
	K. Virolainen (NO)
	Z. Smirnova (RU), Temporary
M. Mouminah (SA)	
J. Agung (ST)	
P. Inderbinen (SZ)	
	T. Hemingway (UK), Temporary
	P. Pollard (US), Temporary

J. Lin, Secretary
O. Vongthieres, Summing Up Officer
M. Gislen, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: P. Cashin, M. Colacelli, F. Han, G. Hong, K. Kang, V. Le, K. Miyachi, T. Schneider, N. Westelius. European Central Bank: A. Meyler, R. Rueffer. Fiscal Affairs Department: A. Peralta Alva. Legal Department: C. El Khoury, C. Ogada. Research Department: C. Rebillard. Strategy, Policy, and Review Department: S. Panth. Western Hemisphere Department: E. Fernandez Corugedo.

Executive Director: A. Mozhin (RU). Alternate Executive Director: J. Di Tata (AG), V. Rashkovan (NE), H. Razafindramanana (AF), B. Saraiva (BR), P. Sun (CC), F. Sylla (AF). Senior Advisors to Executive Directors: Z. Abenoja (ST), B. Alhomaly (SA), M. Choueiri (MI), M.Gilliot (FF), Y.Liu (CC), G. Gasasira-Manzi (AE), R. Morales (AG), E. Rojas Ulo (AG), J. Shin (AP), G. Vasishtha (CO). Advisors to Executive Directors: F. Al Kohlany (MI), M. Bernatavicius (NO), E. Boukpessi (AF), P. Braeuer (GR), S. Buetzer (GR), X. Cai (CC), D. Crane (US), S. David (AP), O. Diakite (AF), J. Essuvi (AE), H. Mori (JA), M. Mulas (CE), P. Snisorenko (RU), K. Hennings (BR), K. Lok (CC).

1. JAPAN—2018 ARTICLE IV CONSULTATION

The staff representative submitted the following statement:

This statement contains information that has become available since the staff report was circulated to the Executive Board. This information does not alter the thrust of the staff appraisal.

On November 14, Japan's Cabinet Office released its preliminary estimate of real GDP growth for the third quarter (July–September) at -1.2 percent (annualized), down from 3.0 percent in the second quarter. The decline in GDP can be attributed largely to several natural disasters affecting Japan, including typhoons in the Osaka area, and an earthquake in Hokkaido. With protracted closures of several important shipment hubs, the typhoon disrupted supply chains, affecting both private investment and exports. Private consumption also contracted, due partly to a disaster-driven surge in fresh food prices. On December 10 the revised preliminary estimate for third quarter growth will be released. Headline CPI inflation continues to increase gradually, recording 1.2 percent (year-on-year) in September, supported by energy and food prices. However, price pressures from domestic demand remain subdued, with core CPI inflation (excluding fresh food and energy) remaining flat at 0.4 percent.

Responding to the string of natural disasters, Japan's Diet passed a supplementary budget on November 7. This supplementary budget amounts to ¥0.9 trillion (about 0.2 percent of GDP), most of which will be allocated for disaster recovery expenditure. Staff expects that the supplementary budget will have an effect next year, supporting 2019 growth.

After declining in the second quarter, the external current account (CA) surplus recovered in the third quarter, with a balance (about US$50 billion) equal to the average CA balance over the first half of 2018. The main driver was a larger income balance, due to lower income debits. Meanwhile the trade balance turned to deficit, mostly due to increased goods imports and lower exports—the latter caused by the typhoon-related closure of Kansai International Airport and the Hokkaido earthquake that together disrupted export and tourism receipts. The yen has appreciated (in real effective terms) by almost 2 percent as of September 2018, relative to end-2017. Since the beginning of 2018, equity markets have fallen by 4.2 percent, and the 10-year government bond yield has increased by 7 basis points to 0.11 percent.

Japan has expanded its trade agreements. On November 6, Japan's Cabinet submitted legislation to the Diet that would ratify a free trade agreement with the European Union, aiming to bring the pact into force by February 1, 2019. The agreement would create a bloc covering about 28 percent of global GDP. Further, on October 31, Australia became the sixth country, after Japan, Mexico, Singapore, New Zealand and Canada, to ratify the terms of the eleven- nation Comprehensive and Progressive Agreement for Trans-Pacific Partnership. As a result, the Agreement will come into force on December 30.

Mr. Kaizuka, Mr. Saito and Mr. Komura submitted the following statement:

We appreciate a set of excellent papers, including Selected Issues, based on fruitful policy discussions between staff led by the Managing Director herself and the Japanese authorities during the Article IV Consultation this year.

The 2018 Article IV Consultation focuses on the macroeconomic effects of demographic changes on the Japanese economy. The authorities recognize that an aging and shrinking population, which can be called "a national challenge," is the most important challenge for Japan. Thus, we highly appreciate that staff analyzes the effects in the staff reports, including Selected Issues which covers and digs into a wide range of topics related to demographic changes. While we cannot touch all of them in this statement, every valuable work by the team surely helps us to tackle the challenge.

The authorities will further accelerate various reforms to ease medium- and long-term constraints on economic growth from demographic changes under the current favorable environment created by Abenomics. The government of Japan (GOJ) shows their main policies in Basic Policy on Economic and Fiscal Management and Reform every year. As we elaborate on it in detail later, this year the Basic Policy on Economic and Fiscal Management and Reform 2018 (Basic Policy 2018) centered on demographic changes and specified a set of reform agenda with the subtitle of "Realizing Sustainable Economic Growth by Overcoming the Decreasing Birth Rate and Aging Population." As this Basic Policy 2018 clearly shows, we broadly share staff's recommendations, including mutually-supported policies, and steady implementation of structural reforms, especially labor market reforms, to boost productivity and raise potential growth under demographic changes.

Recent Developments, Outlook, and Risks

The Japanese economy has improved moderately but on a continuous basis over a long period. The fruits of the economic recovery have been brought to a full range of society. The authorities have conducted Abenomics which consists of “three arrows,” aggressive monetary policy, flexible fiscal policy, and growth strategy including structural reform. Abenomics over the past six years has significantly improved the Japanese economy. The economy has expanded moderately but on a continuous basis over a long period, which would be the second longest since World War II. Against this backdrop, the fruits of the economic expansion have been brought to a full range of society. Corporate profits have achieved a historical record high. Expansion in the corporate sector has spread to the household sector as improvements in employment and income conditions clearly demonstrate. For example, the active job openings-to-applicants ratio has reached a 44-year record-high level and have exceeded one in every prefecture for two years, and the unemployment rate hit a record 25-year low, 2.3 percent. Labor force participation rate of female (15-64 years old) and older workers have increased and reached at 69.4 percent and 23.5 percent, respectively.

The economy continues on an expanding trend. The (first preliminary) quarterly estimates of real growth rate for July – September 2018 marked -0.3 percent (quarter-to-quarter). The negative figures are attributed to a temporary drop of private consumption and decline in exports by the several natural disasters in this period. Thus, the GOJ considers that the economy continues on a steadily growing trend.

The authorities will keep monitoring risks for the Japanese economy. In particular, external risks, including trade tensions, developments of the Chinese economy, vulnerabilities in Emerging Markets, and geopolitical tensions, call for continued attention. In addition, as we mention below, the authorities well recognize the importance of taking all possible measures to contain demand fluctuations caused by the consumption tax rate hike from 8 percent to 10 percent to stabilize the economy.

Policy Mix

We share the staff’s view on the importance of mutually-supportive policies. Abenomics has brought in certain fruits mentioned above by conducting mutually-supportive monetary policy, fiscal policy, and structural reforms. The authorities will strengthen and accelerate Abenomics, including growth strategy and structural reforms, taking into consideration complementarities and synergies among policies.

Growth Strategy and Structural Reforms

Growth strategy, including structural reforms, is the central part of Abenomics. The GOJ has speedily implemented many structural reforms, including “bedrock regulation” reforms. Staff assesses that gaps remain and implementation has been slow while the GOJ has appropriately specified reform areas. The GOJ has conducted a wide range of important reforms, including the “work-style reform,” greater labor participation of female and older workers, acceptance of highly-skilled foreign professionals, corporate governance reforms, and trade liberalization and FDI promotion under the current administration. Thus, the GOJ does not think implementation has been slow while it will further accelerate structural reforms going forward.

At the same time, structural reforms are still halfway. The GOJ will further promote structural reforms to boost productivity and raise potential growth for mitigating constraints on economic growth from demographic changes. Furthermore, the fruits of the economic recovery have been brought to a full range of society. The Box.3 quantifies macroeconomic effects of demographic changes on the economy and examines whether and how structural reforms can mitigate those effects. The results clearly illustrate the importance of full implementation of structural reforms, especially labor market reforms. As we mentioned above, the GOJ specified a set of reform agenda in the Basic Policy 2018 with the subtitle of “Realizing Sustainable Economic Growth by Overcoming the Decreasing Birth Rate and Aging Population” as well as the Growth Strategy 2018 in this June. While we explain the specific reform agenda in the next three paragraphs, their basic concept is the followings: Under the adverse demographic changes, reforms to strengthen the supply side are the most critical to raise potential growth by reducing constraints on economic growth. On the labor force, the GOJ will promote investment in human resources by greater labor participation of female and older workers and free early childhood education (“human resources development revolution”). On the productivity, the GOJ will take measures to enhance productivity, including promotion of AI and robots which the Selected Issues mentions, and strengthening corporate-governance (“realization and expansion of Supply System Innovation”). The work-style reform remains essential. Moreover, it is imperative to spread the fruits of economic growth from urban to rural, and from large companies to SMEs.

In particular, as staff gives them a top priority, labor market reforms are critically important. The GOJ will implement necessary reforms steadily. First and foremost, the GOJ continues to promote the “work-style reform.” The Work Style Reform Bills have been enacted in this June. Those bills include several clauses to rectify problems of work-style and labor market in Japan, including the establishment of a limit on overtime work with introduction of penalty in case of breach and the elimination of the irrational gap of the working conditions between regular and non-regular workers ("equal pay for equal work"). The GOJ will ensure effective implementation of the bills, for example, by developing a guideline and takes note the staff's other recommendations, such as strengthening a training to non-regular workers and introducing job descriptions, which would complement the bills. The GOJ will make continuous efforts to enhance labor supply of female and older workers based on the Basic Policy 2018.

The GOJ will continue to implement product market and corporate reforms, which are staff's second priority. As we mentioned above, the GOJ will take measures to enhance productivity. Specifically, their priority areas include promoting the use of new technologies, such as AI, robots, and IoT, supporting smooth business successions, developing a guidance for corporate governance, and promoting the Regulatory Sandboxes System.

The GOJ will further promote open and rule-based, multilateral trade and investment system, which is in line with staff's third priority. Keeping and improving the trade system based on free and fair rules are the source of growth for the global economy. As Japan achieved rapid economic growth through free trade after WWII, the GOJ commits to take a leading role to promote free and fair rules of trade and investment. In this regard, by proceeding with negotiations in mega agreements, including TPP11, Japan-EU EPA, and RECEP, the GOJ contributes to expand open and rule-based market in the global economy. TPP11 is scheduled to enter in force in this December, and Japan and EU reached an agreement in principle for Japan-EU EPA in this July.

Fiscal Policy

The GOJ firmly maintains the basic principle "without economic revitalization, there can be no fiscal consolidation," under the New Plan to Advance Economic and Fiscal Revitalization formulated in this June. The GOJ will accelerate and expand the three pillars reform, overcoming deflation and revitalizing the economy, expenditure reforms, and revenue reforms.

For fiscal consolidation, the GOJ aimed to achieve the primary surplus of the central and local governments by FY 2020 and steady reduction on the debt to GDP ratio under the Plan to Advance Economic and Fiscal Revitalization developed in 2015. On the expenditures side, the GOJ formulated budgets in line with the benchmarks for general expenditures as set in the plan. On the revenue side, it is expected that central and local tax revenue for FY 2018 would record at high levels. However, improvements of the primary balance have been delayed compared to the initial assumptions because of a more moderate growth of tax revenues, as well as the impact of the postponement of the consumption tax rate from 8 percent to 10 percent. In addition, the GOJ decided to change the use of revenues from the consumption tax rate hike to preserve stable financial resources for the “human resources development revolution” mentioned above. Against this backdrop, it became difficult to achieve the target of the primary surplus by FY 2020. Also, while the rise in the public debt to GDP ratio has been moderate, it has not yet reached the point of steady reduction.

Therefore, based on the developments mentioned above, the GOJ now aims for the primary surplus of the central and local governments by FY 2025 which would be more realistic while firmly maintaining the aim to achieve steady reduction on the debt to GDP ratio under the New Plan to Advance Economic and Fiscal Revitalization formulated in this June. To achieve the new fiscal consolidation target, the GOJ considers it imperative to put social security reforms as a center of consideration. In this vein, staff emphasizes the importance of specification of fiscal consolidation measures to enhance the credibility of the target. In this regard, the GOJ will comprehensively review progress focusing mainly on the social security reforms in FY 2020 and specify policy measures in social security, including modalities to balance between benefits and burdens. It should be noted that the GOJ will start to take actions, including scheduling and implementation of reforms, within FY 2019–FY 2021. Related to this point, we appreciate staff’s helpful work on the financing options for age-related expenditures and reform options for health care system.

Regarding the credibility of the fiscal consolidation target, we agree with staff on the importance of realistic macro-fiscal projections. However, the current framework can deliver them via the Council on Economic and Fiscal Policy (CEFP) and the Fiscal System Council (FSC) without making an independent fiscal institution. Following input from CEFP, the GOJ revised Economic and Fiscal Projections for Medium to Long Term Analysis in this January with more realistic assumptions based on the previous economic performances.

The consumption tax rate is scheduled to be increased from 8 percent to 10 percent on October 1, 2019 as stipulated by law. Based on our previous experience with the 3 percent consumption tax rate increase in 2014, we will mobilize a wide range of measures and make every effort to contain demand fluctuations before and after the tax rate increase, along with supports for low-income households. To this end, the GOJ will take temporal and special measures in the initial budgets for FY 2019 and FY 2020. The consumption tax rate hike is necessary to preserve stable financing sources for establishing a social security system for all generations. The GOJ has already announced the introduction of reduced tax rate, the enhanced relief of long-term care insurance premiums for the low-income elderly, and the provision of supporting benefits for pensioners to ease low-income households' burden, as well as the provision of greater supports for child-rearing generations by modifying use of the revenues generated by the consumption tax rate hike. Furthermore, while the upcoming hike is 2 percent which is smaller than the last one, the GOJ will take adequate measures to contain demand fluctuation before and after the tax increase. Related to this point, the GOJ will take tax and budgetary measures to create advantages for purchases of consumer durable goods, including automobiles and housing, after October 1, 2019. The staff report pointed out that mitigating measures are yet to be fully specified. The GOJ will take temporary and special measures in the initial budgets for FY 2019 and FY 2020. Because the GOJ usually decides the Draft of initial budget in December each year, the GOJ will specify and show specific mitigating measures for FY 2019 soon. In addition, while staff mentions that our growth projections do not provide guidance on the size of mitigating measures to offset the impacts of consumption tax rate increases, specific size and items of mitigating measures will be determined in the process of formulating budgets. Finally, as staff recommends, the GOJ will clearly communicate with public on the necessity of the consumption tax rate hike and mitigating measures.

Monetary Policy

With a view to persistently continuing with powerful monetary easing, the Bank of Japan decided to strengthen its commitment to achieving the price stability target by introducing forward guidance for policy rates, and to enhance the sustainability of “Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control” in this July. Specifically, as a forward guidance for policy rates, the BOJ publicly made clear to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019. In addition, the BOJ decided to conduct market operations and asset purchases in a more flexible manner in order to enhance the sustainability of QQE with Yield Curve Control. For example, while the target level of the long-term yields was maintained at around zero percent, the BOJ made it clear that the actual yields might move upward and downward to some extent mainly depending on developments in economic activity and prices. The policy is in line with staff's recommendation that monetary policy should remain accommodative while putting a premium on policy sustainability. In fact, since the policy decision was made, the degree of market functioning has improved with the BOJ conducting JGB purchases in a flexible manner.

The BOJ will continue with QQE with Yield Curve Control, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. The BOJ will examine the risks considered most relevant to the conduct of monetary policy and conduct its policy in an appropriate manner, taking account of developments in economic activity and prices as well as financial conditions.

Financial Sector

We welcome that staff finds that Japan' financial sector remains stable. The authorities will closely monitor financial risks while continuously improving supervisory approaches. Related to this point, we would like to emphasize that progress in implementation of FSAP recommendations including on macroprudential policies and resolution has been made. Although staff mentions that "implementation of other main FSAP recommendations – particularly on macroprudential policies and resolution – is incomplete" in paragraph 5, we reiterate that progress in macroprudential policies and resolution has been made based on the FSAP recommendations as mentioned in paragraph 28. For example, the authorities have expanded the coverage of their intensive monitoring of stress testing exercise to some D-SIBs and other large banks in addition to Japanese G-SIBs (three megabanks) for systemic risk assessment and expanded the scope of the requirements on Total Loss Absorbing Capacity (TLAC) requirement to one D-SIB.

As staff appropriately points out, financial institutions, especially regional financial institutions, need to improve their financial services considering changes in its surrounding environment. The environment has been significantly changing due to acceleration of digitalization, demographic changes, and prolonged low-interest rate. Financial institutions should improve their financial services suited to these changes. To support their efforts, the JFSA set the priorities such as responding to the acceleration of digitalization, promoting long-term personal asset building, vitalizing capital market and securing market integrity and transparency, and securing effective financial intermediation and financial stability. For regional financial institutions, the JFSA has formed and sent experts teams to local finance bureau to better capture regional economies through deep dialogues with regional financial institutions and to improve financial intermediation function.

External Sector

Reducing excess global imbalances is critical to sustain the global economic growth. It is important for the Fund to continuously refine EBA methodology, which is a multilateral monitoring tool to assess individual countries' CA balances. In this regard, we welcome efforts on EBA methodological update this year.

We agree with staff's assessment that the 2017 CA balance and the projected 2018 CA balance are broadly in line with fundamentals and desired polies, as well as related policy recommendations. As we have mentioned above, the authorities will promote fiscal consolidation as well as structural reforms, including labor market reforms. We welcome the fact that staff does not apply the adjustor related to increased energy imports due to shut downs of nuclear power reactors for the preliminary 2018 CA external assessment. Also, we highly appreciate candid and close dialogue between staff and the authorities for the Article IV Consultation as well as the EBA methodological update.

The authorities are still concerned about REER assessment using the CA gap calculated from the EBA methodology. First of all, exchange rates are determined by capital transactions rather than trade balance. Given the sensitiveness of capital transactions to interest rate differentials, it is extremely difficult to identify the appropriate level of REER. Linking CA assessment with REER assessment automatically causes a more fundamental problem especially in a country where income balance dominates in CA balances. Furthermore, developments of global value chains have also weakened the linkage between trade balance and REER.

Being mindful of these limitations, the Fund should not pursue to identify the appropriate level of REER for free-floating currencies, especially in the case of income balances dominating in CA balances, like Japanese yen. Instead of identifying the appropriate level of REER, we consider that the EBA should be used to identify the appropriate level of CA, find out structural problems which contribute to CA gaps, and recommend structural policies to solve them. We would like to continue discussions on this point.

Supply-Side of Corruption

The GOJ acknowledges the importance of supply-side issues to address corruption. Therefore, they decided to volunteer to have its legal and institutional framework assessed in the Article IV Consultation. Japan becomes the first case of this initiative, together with the United Kingdom which was discussed earlier this week. The OECD Phase 3 recommendations in the OECD Working Group on Bribery pointed out several points regarding enforcement of foreign bribery offences. The GOJ has steadily implemented the above recommendations as the staff report shows.

Mr. Virolainen, Mr. Rashkovan. Mr. Bernatavicius, and Mr. Cools submitted the following joint statement:

We thank staff for the insightful set of papers and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their helpful buff statement. We agree with staff's analysis that continued implementation of the third arrow of Abenomics is paramount. The ongoing broad monetary stance constitutes the right moment to pursue structural reforms, especially in the labor market. We share staff's concerns about the impact of ageing on fiscal sustainability.

Fiscal

We encourage the authorities to continue steadfast fiscal consolidation and invite them to structurally address increases in social security expenditure. We support the shift to consumption taxation combined with mitigating measures. Moreover, we appreciate the attention to distributional effects in the report and invite the authorities to strengthen the independence of Japan's fiscal bodies.

We welcome the shift towards consumption taxation, combined with mitigating measures to support the near-term growth momentum. Staff recommends the automobile acquisition tax to be lifted as part of the mitigating measures. However, without other compensatory measures, this could have negative environmental spill-overs. Has staff reflected on the environmental effects of this recommendation? Also, can staff more broadly elaborate on potential behavioral changes pursued by the tax shift towards consumption taxation?

We welcome the overall attention of the report to distributional effects. We specifically recommend the proposed measures to address income inequality and include safeguards for low-income households into the necessary reform measures to contain healthcare spending. While we agree that a unitary VAT rate is preferable as far as possible, we do invite staff to be mindful of distributional concerns that might warrant different VAT rates.

Regarding Japan's fiscal decision-making framework, we share staff's concern about overly optimistic assumptions on growth outlook, TFP growth, and budget projections. While we agree with staff on the importance of independent fiscal councils, we wonder whether this goal cannot be achieved within the current institutional set-up of Japan's budget decision-making framework, as suggested by the authorities. Could strengthening the existing two councils not have the same effect as creating a new fiscal council? Could staff elaborate on that?

Structural Reforms

On the labor market, we support staff's recommendations to strengthen the income policies and labor market reforms to reduce impediments to higher wage growth. We appreciate the authorities' efforts to diversify the labor supply, such as the equal pay legislation and the revision of the spousal tax deduction. That said, we would welcome further implementation efforts by the authorities, as outlined in the staff report. Finally, in light of Japan's significant demographic headwinds, additional measures to strengthen the supply of labor are warranted, and we invite the authorities to continue investing in childcare facilities, to abolish firms' rights to set the mandatory retirement age, and to ease restrictions for foreign workers.

We encourage the authorities to continue their product market reforms to boost productivity and investment, including measures addressed to the SME sector and a deeper corporate governance reform.

Financial Sector

We welcome that Japan's financial sector, overall, remains stable. However, some pockets of vulnerability are clearly visible. We agree with the need to implement the 2017 FSAP recommendations, including those aimed at strengthening credit management. In addition, we commend the JFSA's new supervisory framework as a step in the right direction to keep pace with the activities of financial institutions. We concur with staff that the JFSA should keep a close eye on the business models of Japan's regional banks, as low inflation and demographic headwinds are pushing these banks towards increased risk-taking.

Assessment of Corruption

We welcome staff's assessment of efforts in tackling the supply-side corruption and the decision taken by the authorities to volunteer. This assessment, and the assessments before that in the case of UK's Article IV, are positive steps for staff to gain more knowledge and experience of these issues. We took positive note of staff also drawing on other international bodies such as the OECD, to avoid duplication of work.

Ms. Riach and Mr. Hemingway submitted the following statement:

We thank staff for a comprehensive set of papers and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their informative buff. We welcome the balance in staff papers between the near-term outlook and the long-term, structural challenges facing Japan and agree that tackling them requires a mutually supportive policy package.

We note the divergence in views on the near-term growth and inflation outlook, in part due to underlying differences in the assessment of potential growth. We thank staff for the clear explanation of the difference estimates (Annex I). We would find similar analysis useful in other cases where staff and the authorities disagree on key parts of the forecast.

Notwithstanding this difference, we welcome the broad agreement that structural reform to raise productivity will be key in the coming years. We are grateful to staff for being clear in their prioritization of these reforms and agree that labour market reforms should be the top priority. We also welcome the buff setting out the reform agenda being pursued by the authorities in each area. We were pleased both the staff report and buff highlight the authorities' continued commitment to open and rules-based, multilateral trade and investment system. We also recognise the progress on key labour market reforms. However, we were unclear whether staff expect these reforms will be sufficient to tackle the duality in the labour market set out in the Selected Issues Paper and the need for 'work-style reforms' the buff identifies. Staff comments would be appreciated. We broadly agree with the staff recommendations on monetary, fiscal and financial sector policies. However, we would welcome further staff comments on the interaction between the proposals, particularly the impact of the fiscal policy stance on the likelihood of hitting the inflation target and the impact of monetary policy on balance sheets across the Japanese economy.

Staff analysis makes it clear that the ‘long-term’ is already affecting the Japanese economy and we welcome the priority placed on ageing and technology change in the papers. Ageing and a shrinking population is already affecting the labour force. We thank staff for their Selected Issues Paper exploring the consequences of different policy reactions to the pressure demographic change will place on the public finances, noting that all approaches have costs. We are also pleased that staff present complementary analysis on potential efficiency gains in the health sector since Japan, like other governments facing demographic headwinds, will undoubtedly require a combination of measures to contain age-related spending and raise additional revenues to pay for it.

In addition, we welcome the focus on new technology in the staff papers, including analysis of previous automation and the emphasis placed on the potential for greater adoption of fintech in Japan. Given Japan’s early adoption of robots in the production process, its experience has relevance to policy makers elsewhere that are considering the potential impact of automation. The Selected Issues Paper presented some very striking results for the positive impact robots have had on productivity, as well interesting findings regarding the labour market outcomes. Staff also present theoretically based findings for the negative impact on the labour share and on inequality. Noting estimates showing the average impact on wages was insignificant, have staff applied their empirical model to wages of particular groups (e.g. women, the low-skilled)?

Finally, we acknowledge the importance of supply-side issues to address corruption. We welcome the Japan volunteering to include these issues in their Article IV consultation. We hope this initiative contributes to further Fund’s engagement on governance across the membership.

Mr. Beblawi and Ms. Choueiri submitted the following statement:

We thank staff for the well-written reports and Messrs. Kaizuka, Saito, and Komura for their helpful buff statement. Driven by external and domestic demand, and despite recent natural disasters, Japan’s economy continues an expanding trend. Headline and core inflation have gained momentum on account of higher energy and food prices, but remain below Bank of Japan’s (BoJ’s) target. Discussions appropriately focused on the macroeconomic effects of Japan’s demographics, with a striking graph on population decline on page 8. Abenomics had a positive impact, easing financial conditions, reducing the fiscal deficit, and raising employment and female labor force participation. We agree with staff’s view that mutually-supportive, reinvigorated, and credible policies would bring Abenomics to full strength and would help to boost productivity and raise potential growth.

We concur with staff that near-term fiscal and income policies supported by a well-specified medium-term consolidation plan would help to support the BoJ's inflation efforts and ensure debt sustainability. In this connection, we support a neutral fiscal stance in 2019 and 2020 to mitigate the impact of the planned consumption tax increase in October 2019. Staff's work indicates that the fiscal stance would otherwise be contractionary by 0.7 and 0.6 percent of GDP, respectively, in the coming two years. Nevertheless, the consumption tax increase will bring in much needed revenue. We see merit in the mitigating measures articulated in the Selected Issues Paper. These include addressing concerns over durable consumption, including automobiles and housing, as well as considering a tax rebate or transfer program to reduce the burden on households at the lower end of the income distribution. We note from the buff statement that specific measures will be determined in the process of formulating budgets for both years. Can staff comment on the potential impact of the additional spending for the Human Resource Development Revolution that is envisaged by the authorities?

The delayed target date for a primary surplus of the central and local government from FY20 to FY 2025 is understandable and more realistic, in view of the recent setbacks due to natural disasters and the need to preserve growth momentum. The authorities and staff agree that a well-specified fiscal framework—relying on realistic assessments of the economic outlook and budget projections and setting out fiscal consolidation measures—is needed in the medium and long term. This will help to reduce policy uncertainty, address demographic challenges, and mitigate debt sustainability risks. We would be grateful for staff's views on the need for an independent fiscal institution given that two councils currently provide advice on fiscal policy, the Council on Economic and Fiscal Policy and the Fiscal System Council, as argued by the authorities.

We appreciate the authorities' commitment to an ambitious structural reform agenda and welcome the considerable progress made since our last discussion, although staff assess implementation to have been slow. Labor market legislation was passed by the Diet in June, progress was made on enhancing labor supply—women and older workers' participation rates, as well as foreign labor, are increasing—and revisions and guidelines for the corporate governance code were completed recently. Moreover, trade reforms have also accelerated, with the free trade agreement with the European Union and the Comprehensive and Progressive Agreement for Trans-Pacific

Partnership. Staff's work indicates, however, that gaps in the structural reforms agenda remain and credible reforms could boost real GDP by as much as 15 percent in 40 years, while incomplete reforms could deliver significantly lower effects on growth. Accordingly, building on progress to date, further efforts are needed on labor market reforms, including training and career opportunities, labor supply, products and corporate reforms, and trade liberalization and FDI promotion. We appreciate staff's prioritization of structural reforms in terms of their output and inflation impact (¶4 and ¶20) and encourage such prioritization in other Article IV consultations.

Japan's banking sector remains well-capitalized and liquid. Staff notes, however, that low interest rates and demographic headwinds are undercutting profitability and encouraging risk taking by some financial institutions. We, therefore, agree with the need to enhance risk management; strengthen financial oversight, while adjusting business models; and strengthen crisis management and resolution, as recommended in the 2017 FSAP. The Japanese Financial Services Agency's (JFSA) new supervisory framework is a step in the right direction towards a full risk-based approach, and its monitoring of regional banks' risk management capacity is appropriate. Considering the finding that Japan remains a heavily cash-based society with relatively low Fintech penetration, we welcome the authorities' agreement with staff that more could be done to facilitate the use of Fintech, and that continued efforts to strengthen crypto-asset oversight are needed.

The authorities and staff also concur that beyond the short term, a well-specified medium-term fiscal consolidation plan and bolder and credible structural reforms that support growth and domestic demand are needed to maintain external balance. Staff's work in Box 3 indicates that full implementation of the recommended structural reforms would lead to a decline in the external current account surplus by over 1 percent of GDP in the medium term. We note, however, that the authorities continue to have concerns over the REER assessment. They disagree with the assumed link between the current account and the REER used for the assessment, given the prominent role of the income balance in Japan's current account. Staff's comments on the authorities' concerns would be appreciated.

While recognizing the potential disruptive impact from a significant buildup and later unwinding of carry trade positions, the authorities did not so far observe a significant build-up of carry trade positions due to the widening differential between global and domestic interest rates. Nonetheless, the potential spillovers from such a scenario warrant close monitoring. We welcome Japan's commitment to take a leadership role in advancing multilateralism and free trade and investment, which can help to mitigate inward spillovers from a rise in protectionism. We also welcome the authorities' volunteering for an assessment of the legal and institutional framework for addressing supply-side corruption issues.

Mr. Ray and Mr. Shin submitted the following statement:

We thank staff for their comprehensive set of papers including some insightful analysis in the SIP and Mr. Kaizuka, Mr. Saito and Mr. Komura for their useful buff statement. Japan continues to grow above potential, but with stubbornly low inflation. While Japan's economy has coped remarkably well with the demographic headwinds to date, intensifying pressures suggest a need for a reinvigorated structural reform effort. We broadly agree with the staff assessment and have the following comments for emphasis and clarification.

Japan's economy has performed relatively well on many indicators. With an aging and shrinking population, it might be appropriate to give greater prominence to indicators such as real GNI per capita growth, productivity growth and the unemployment rate, on all of which Japan has performed well recently. As described in the buff, Japan's corporate profits are at a historical high and the labor market is strong, with very low unemployment accompanied by higher female and elderly participation.

Japan's high public debt burden remains a key vulnerability. We agree with staff that a sharpened focus should be placed on a credible and sustained fiscal consolidation. While staff recommend avoiding near-term fiscal tightening and instead making plans for gradual consolidation starting from 2021, we do not see much room to postpone fiscal consolidation. Given that by 2021 the external environment could be less favorable and the domestic economy might be suffering from a post-Olympics slump and a pick-up in the pace of aging, we would welcome staff's clarification of the basis for the starting point. As shown in the past episodes of Denmark and Ireland, some high debt countries experienced so-called 'expansionary fiscal consolidation.' Does staff envisage any possibility of this effect for Japan? While we agree with staff on the need for unbiased and realistic projections of economic parameters, we do not see why this could not be achieved by strengthening the existing institutional framework as suggested by the authorities.

The side effects of the BoJ's quantitative easing warrant close monitoring, especially as monetary accommodation is reduced elsewhere. We appreciate staff's highlighting the implications of asset purchases for the functioning of the JGB an ETF markets, as well as assessing recent efforts by the authorities to improve market functioning. We suggest that staff could also consider how asset purchases could be unwound in the future and canvas potential risks. Staff's view would be welcome.

Intensifying structural reform momentum should be a priority. Japan faces some challenging choices given its demographic pressures. Obtaining public confidence for a credible reform plan and its consistent implementation are necessary to maximize the policy effect. Do staff have views on how the authorities can do that?

Mr. Tombini, Mr. Saraiva and Ms. Hennings submitted the following statement:

We thank the staff for the reports as well as Mr. Kaizuka, Mr. Saito and Mr. Komura for their comprehensive and detailed statement. While the Japanese economy is growing above potential, the outlook remains clouded by the challenges posed by demographics – the aging and shrinking of population. We welcome staff's approach, as demographics impinges on the macroeconomic dynamics, affecting the external balance, constraining fiscal and monetary policies, as well as presenting risks to the financial sector. We agree with the staff that credible, strong and encompassing measures should be immediately taken to tackle such complex challenges and help boost productivity and growth.

Mounting demographic headwinds in Japan add urgency for fiscal consolidation. After six years of Abenomics, economic activity has shown some dynamism and the fiscal deficit has been reduced. That notwithstanding, fiscal consolidation has not proceeded as planned, heightening concerns about the level and the trajectory of the public debt, which is deemed unsustainable under the current policies. The staff presented very useful studies and alternative policies to cope with the fiscal pressure stemming from the rapidly aging population, given the high cost of the social security and health systems. Any delay in confronting these challenges raises uncertainty and the macroeconomic costs. Along these lines, the expected negative impact of the increase of the VAT rate on growth and investment should not further postpone the forthcoming hike, while mitigating measures should be taken to dampen such effects.

Measures to tackle gender and intergenerational factors shaping the labor market should contribute significantly to boost productivity and growth, while reducing income inequality. The duality in the labor market prevents the wages to respond freely to market conditions, negatively affecting both regulated and non-regulated workers. Female, elderly and foreign workers are mostly concentrated in the non-regulated group, where the part-time, lower-income and low-skilled jobs are. The scarcity of workers and the mismatch in qualification can be reduced by providing education and training for these groups, as well as by improving the conditions for women to work and have children – what would also have beneficial demographic effects. Accordingly, while we welcome the recent approval of a new legislation that should help reduce inequality in payments and stimulate female participation in the labor force, we encourage the authorities to make further progress in taxation and social security to align incentives toward more evenhandedness among the different groups of workers. Could staff discuss which measures could be taken to improve female labor force participation?

Monetary policy stance should continue strongly accommodative for a longer time, notwithstanding the financial risks entailed by such a prolonged period of low rates and excess liquidity. Interest rate is being kept close to zero for years and the Bank of Japan announced its commitment to keep short- and long-term policy rates low for an extended period. Such forward guidance is sensible in a context of entrenched low-inflation expectations, forthcoming adoption of a VAT hike and deflationary structural factors. However, a prolonged period of quantitative easing and very low interest rates could cause distortions in the financial markets that may further complicate normalization in the future. Japan's fight against deflationary pressures has lingered for the last few decades, with no clear outlook for a positive ending based only on macroeconomic policy tools. Having said that, most structural measures proposed by staff to improve labor market dynamics, while enhancing monetary policy transmission in the medium term, could conceivably result in some slack in the labor market in the near term. Could staff elaborate more on how the envisaged reforms are expected to sustain a higher level of inflation in their immediate aftermath?

The banking sector in general is liquid and well capitalized, however some challenges need to be addressed. One example is the regional banks. They are spread in the Japanese territory and are very close to the population outside the big urban centers, what makes them more sensitive to the demographic risks and to the performance of SMEs. Besides, their business model needs to be updated and the use of digital technology enhanced to become more attractive to the youth and find new economic opportunities. On a related note, we encourage the authorities to strengthen the financial sector supervision and proceed with the implementation of the FSAP recommendations.

We appreciate the inclusion of a section in the staff report on corruption, with a focus on the supply side. Despite the progress in raising awareness and furthering inter-agency coordination, the OECD assessment of the implementation of the Anti-Bribery Convention in Japan called the attention to the need to improve the enforcement of foreign bribery laws. We encourage the Japanese authorities to step up detection, investigation and prosecution of foreign bribery cases and to establish a legal framework for confiscating the proceeds of bribery.

Mr. Kaya and Mr. Stradal submitted the following statement:

We thank staff for a well-written and insightful set of papers and Messrs. Kaizuka, Saito, and Komura for their helpful buff statement. We welcome the focus on the macroeconomic effects of demographic changes as they present a daunting challenge for the Japanese economy and society in the medium to long term. We commend the authorities for their continued reform efforts and concur with staff that steadfast implementation of all three mutually reinforcing arrows of Abenomics is key for escaping the near-deflationary environment, as well as enhancing potential growth. We welcome Japan’s commitment to free trade demonstrated inter alia by the recent ratification of the CPTPP and by the recent submission of the trade agreement with the EU to the parliament for ratification.

The fiscal outlook remains a grave concern and we note that staff assess Japan’s public debt unsustainable under current policies. The expected hike in the consumption tax rate in 2019 will be a delicate balancing act between sustaining economic growth in the short term and staying the course of fiscal consolidation. We concur with staff that a credible and gradual medium-term consolidation plan, based on realistic growth assumptions with detailed expenditure and revenue measures, remains necessary to ensure fiscal sustainability and manage the financial costs of the demographic transition. Containing healthcare spending and reforming the generous social security system will play key roles in this process and should be dealt with urgently.

Continued monetary accommodation is appropriate as sustaining a moderate inflation has proved elusive over the past decade. Having said that, we concur with staff that examining and mitigating side effects stemming from a long period of low rates and central bank asset purchases is warranted. We welcome the discussion of the interplay between demographic changes and the natural rate of interest in Box 4. The finding that Japan’s natural rate has likely fallen into negative territory is another demonstration of the uniquely difficult macroeconomic environment and further reinforces the criticality of structural reforms.

Further improvements to the Bank of Japan's (BoJ) communication framework are essential for enhancing its credibility and shaping effectively the inflation expectations. The quantitative guidance on Japanese Government Bond purchases should be dropped as it clashes with the level guidance on their yields. The relationship between the yield guidance and the inflation target should in turn be clarified. In addition, the systematic overshooting of the BoJ's Board inflation forecasts should be addressed as it undermines the credibility of the inflation targeting framework.

We take positive note of the sufficient capitalization and liquidity of the banking sector in general. However, a long period of low interest rates, coupled with unfavorable demographic trends, poses a considerable challenge for the Japanese financial system. Potential risks arising in the financial sector, such as excessive risk-taking and the impact of low interest rates on profitability should be closely monitored and carefully assessed against financial institutions' risk management capacity. This is particularly relevant for regional banks that seem to be more exposed to these challenges.

Progress on structural reforms has been uneven. Continued vigorous structural reform efforts are essential to enhance potential growth by increasing labor supply, productivity, and private investments. We agree with staff that labor market reforms should be prioritized to eliminate the labor market duality and facilitate wage growth. The recently adopted "equal pay for equal work" legislation is a welcome step in the right direction. There is also ample scope to further deregulate professional services, lower the barriers to entry into some industries, and strengthen corporate governance.

We welcome the staff's assessment of low level of corruption, while encouraging the authorities to step up the enforcement of foreign bribery laws. We note that the assessment by design relies heavily on the OECD findings. Paragraph 40 lists the recent developments in response to the Phase 3 recommendations. Can staff assess their effectiveness?

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for their comprehensive set of reports on Japan and Mr. Kaizuka, Mr. Saito and Mr. Komura for their insightful buff statement.

The Japanese economy has been improving moderately, supported by the three arrows of ‘Abenomics’, which has lifted the economy out of deflation while delivering a series of meaningful reforms. Fiscal and primary deficits have been halved, current account surplus remains high and employment has improved steadily with significant increase in female labor force participation. We note that fruits of the economic recovery have been very widely distributed. However, inflation remains well below the 2 percent target of Bank of Japan (BOJ) and a durable exit from deflation is yet to be achieved. Overall, risks to the outlook are tilted to the downside with intensifying demographic headwinds, structural impediments to growth and high public debt. Hence, the prospect of postponing broad policy decisions seems to be diminishing. Against this backdrop, we concur with staff for reinforcing “three arrows” by implementing mutually-supportive, reinvigorated, and credible policies to bring ‘Abenomics’ to full strength, boost productivity and raise potential growth. We broadly agree with staff’s assessment and policy advice and would like to make following remarks for emphasis.

We note that the demographic challenge has now arrived on Japan’s doorstep. The rapid ageing and depopulation, coupled with the decline in working-age population and soaring old-age dependency ratio, raise difficult issues, which could depress productivity and growth, thus undermining both macroeconomic and fiscal prospects. Hence, it is reassuring that authorities have brought this critical issue to the forefront of the policy making by recognizing this as a “national challenge” in the buff Statement and giving top priority to address it, including through the “Basic Policy 2018” as well as the “Growth Strategy 2018”. Could staff comment on the possibility of having a vicious cycle of low fertility and low spending that could weaken the growth momentum and how policy reforms would address such a situation?

The most important priority for Japan seems to achieve robust growth, which would mainly depend on the productivity improvement as the primary catalyst for value addition and economic momentum, given the shrinking labor force. Therefore, structural reforms are essential to address supply-side issues and expand potential output to stimulate growth. We welcome the structural reforms so far implemented and note that the underlying strategy in the third of the “three arrows” of Abenomics is to improve those further, which should aim at restructuring the Japanese economy into a shape befitting its level of maturity.

In the above context, we commend the passing of Work Style Reform Legislation by the Diet in June 2018 aimed at boosting productivity. These reforms should be implemented vigorously with supporting measures to ensure desired outcomes. Meanwhile, we note the progress in reforms to increase the acceptance of highly-skilled foreign professionals. Could staff comment on the plans to further open-up labor market to foreign workers? We also note the plans to promote automation, AI and robots to increase productivity as highlighted in SI paper, which are in line with the ongoing fourth industrial revolution. This is being appropriately complemented by product market and corporate reforms.

We concur with staff that a well-specified fiscal framework is essential to anchor the medium and long-term debt trajectories. We welcome the authorities' commitment to expenditure related adjustments while putting social security reforms at the center of consideration to maintain a balance between benefits and burdens to address distributional effects of adjustments. The planned consumption tax increase in October 2019 will be important in generating much needed revenue to finance additional pressure emanating from demographic headwinds. In this regard, we share staff's view on the need for properly communicating the timing and content of mitigating measures to reduce policy uncertainty and minimize adverse impacts on the consumption and growth momentum.

Monetary policy continues to be accommodative and should be actively coordinated with fiscal policy and supported by structural reforms. We support staff's advice on clear forward guidance and further strengthening of monetary policy framework to anchor inflation expectations and preserve policy credibility. Moreover, we note the authorities' view that firms' preference to invest in labour saving technology, rather than raising prices and wages, has partly affected the sluggish inflation despite a steadily improving labor market and a positive output gap. Could staff comment on the impact of technological developments on inflation in Japan? Also, we wonder whether the inflation target of 2 percent as a metric for monetary expansion is excessive. Should BOJ scale this down? What implications might this have for monetary policy and other macro policies?

The financial sector remains stable but further strengthening will help safeguard financial stability. In this context, we associate ourselves with staff on the need for implementing the remaining FSAP recommendations. It is reassuring that BOJ is closely monitoring financial sector side-effects of prolonged monetary easing to improve market functioning and sustain accommodative monetary policy.

On the external sector, we note the authorities' agreement with staff's assessment, expressed in buff Statement that the 2017 CA balance and the projected 2018 CA balance are broadly in line with fundamentals and desired policies. However, they are still concerned about the REER assessment using the CA gap calculated from the EBA methodology. In this context, the authorities' call for further discussions, indicated in the buff Statement, on using the EBA to identify appropriate level of CA, identify structural problems which contribute to CA gaps, and recommend structural policies to solve them warrants specific attention.

We welcome Japan's expansion of trade agreements and commend the commitment of Government of Japan (GOJ) to continue moving ahead with multilateral efforts to advance a free, fair and rules-based trading system. The ratifying of a free trade agreement with the EU alone will pave the way to create a bloc covering about 28 percent of global GDP. In addition to the obvious benefits to the partners of the agreements, these could have significant implications for the rest of the world as well. Staff comments are welcome on the likely impact of Japan's recent trade agreements on EMDCs and LICs and possible enhancement of regional supply chains in the present turbulent global trade environment.

The recent earthquake and the typhoon has highlighted the risks and significant implications that natural disasters pose to the Japanese economy, although the recovery is very fast. We noted, somewhat surprisingly, the considerable impact these events have had on the supply chains, private consumption, tourism and exports, as described in the Statement by the IMF Staff Representative on Japan. While positively noting the emergency measures put forward by the GOJ to respond to recent natural disaster events, we observe the need for further measures aimed at disaster prevention and mitigation as well as building national resilience of foundation to the Japanese economy and ensure safety of the people. Could staff comment on the medium-term plans to ensure national resilience to natural disasters in Japan?

With these remarks, we wish authorities and the people of Japan all the very best in their future endeavors.

Mr. Di Tata and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the comprehensive report and the interesting Selected Issues Papers, and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their insightful buff statement, including the presentation of the authorities' views on Japan’s macroeconomic policies and structural reforms and their concerns on the external sector assessment.

Japan’s policy mix has allowed the economy to maintain growth above potential in 2018, but inflation remains well below the Bank of Japan (BoJ)’s 2 percent target and wage growth is weak. Underlying growth is expected to remain moderately robust but would slow closer to potential growth over the medium term. At the same time, macro-financial vulnerabilities, the need for medium-term fiscal consolidation, and relatively limited monetary space make the economy vulnerable to adverse shocks, including weaker global growth, trade or geopolitical tensions, and a tightening of global financial conditions.

The report focuses on Japan’s long-term demographic problem due to its rapidly aging and declining population, which constitutes a serious challenge to the country’s long-term growth prospects. This phenomenon permeates the whole spectrum of socio-economic variables and is a top priority for policy action. Against this backdrop, we agree with the report on the need to reinvigorate the three arrows of Abenomics: monetary stimulus, flexible fiscal policy, and a growth strategy that prioritizes structural reforms. Clearly, it is of utmost importance to strengthen the public’s credibility on mutually supportive policies and reforms. Generating credibility and reducing policy uncertainty are the main priorities.

Fiscal policy should aim at avoiding near-term fiscal tightening while strengthening the long-term fiscal framework to ensure debt sustainability. Although we support the authorities’ plan to postpone the primary surplus target from FY 2020 to FY 2025, we concur with staff on the need to specify a clear medium- and long-term path of fiscal consolidation based on realistic projections. In this regard, we are encouraged to learn that the authorities plan to conduct a comprehensive review of the social security system by FY 2020, focusing on social security reforms to balance benefits and burdens. More generally, could staff elaborate on the feasibility of adopting the gradual approach proposed in the report that envisages an annual consolidation of about 0.5 percent of GDP in the structural fiscal balance starting from FY 2021? In particular, what are the authorities’ views regarding gradual and steady increases in the consumption tax rate beyond 10 percent, as well as about the reforms proposed by staff to put the healthcare system on a sounder footing? On a related issue, we welcome the authorities’ plans to contain demand fluctuations by including specific measures to mitigate the impact of the 2019 consumption tax increase in the initial budgets for FY 2019 and FY 2020, as well as to reduce uncertainty by clearly communicating to the public the necessity of the tax increase and mitigating measures.

In view of the limited progress of monetary policy to generate inflationary pressures, we agree with staff and the authorities on the need to maintain the accommodative stance of monetary policy for a prolonged period and to make such stance more sustainable. In this connection, we welcome that the BoJ has made clear its intention to maintain the current low levels of short- and long-term interest rates for an extended period and has taken steps to mitigate side effects from prolonged monetary easing, including those related to ETF purchases. However, further efforts are needed to improve coordination and make the functioning of the JGB market more flexible. At the same time, we agree with staff on the importance of strengthening the monetary framework and further improving market communications to enhance policy predictability. Could staff elaborate on the BoJ's position regarding moving closer to full-fledged inflation targeting? On a related matter, could staff discuss the authorities' intentions with respect to the recommendations to strengthen income policies and raise administered prices to support reflation efforts?

As noted in the report, the overall banking sector remains well capitalized and liquid. However, some financial institutions have taken excessive risks. We agree with staff that these institutions (in particular regional banks) need to improve credit risk management. We welcome the steps underway in this area and encourage the authorities to continue with their efforts to fully implement the 2017 FSAP recommendations, including those related to the macro prudential and resolution frameworks. Could staff elaborate on its recommendation to make loan-loss provisioning more forward looking? Also, what specific measures are being considered to increase cyber resilience and crypto-asset exchanges?

Both staff and the authorities agree with the preliminary external assessment that the projected 2018 CA balance is in line with fundamentals and desirable policies, and that credible structural reforms and a medium-term fiscal consolidation plan are needed to maintain external balance going forward. We believe, however, that the concerns expressed by the authorities about the REER assessment and the EBA methodology warrant further discussion. Could staff elaborate on the methodological issues raised by the authorities?

In addition to the need for a well-specified medium and long-term fiscal consolidation plan, staff rightly emphasizes the importance of moving ahead with a reinvigorated structural reform agenda to enhance productivity, labor supply, and investment. In this regard, we are encouraged by the buff statement's assertion that the growth strategy, including structural reforms, constitutes the central part of Abenomics. Regarding labor market reforms, we welcome the recent passage of Work Style legislation, as well as the authorities' commitment to ensure its effective implementation, strengthen training of non-regular workers, and continue with efforts to enhance labor supply of female and older workers. We also take note of the authorities' plans for product market and corporate reforms, which include promoting the use of new technologies and developing guidance for corporate governance. Could staff elaborate on the prospects for deregulation and for developing alternative sources of SME financing? Could it also comment on the reasons behind corporations' large cash holdings? We welcome Japan's support for a multilateral free and open trading system, including recent progress on the free trade agreement with the EU and the Trans-Pacific Partnership.

We congratulate the authorities for volunteering to participate in the Fund's initiative to assess efforts to address the supply side of corruption, as well as on the steps underway to implement the OECD Phase 3 recommendations to strengthen the legal framework against foreign bribery.

With these comments, we wish the people of Japan every success in their future endeavors.

Mr. Mozhin, Mr. Palei and Mr. Snisorenko submitted the following statement:

We thank staff for a set of comprehensive papers on Japan and Messrs. Kaizuka, Saito, and Komura for their informative buff statement. A set of policies known as Abenomics over the past six years has aimed at easing financial conditions, gradually reducing fiscal deficit, and raising economic growth. Despite the recent stronger growth, inflation remains well below target, while the public debt path appears to be unsustainable and risks in the financial sector continue to build up. In this context, reinvigoration and strong coordination of the key reforms would help alleviate demographic pressures. Strengthening communication strategies would be helpful in many policy areas.

We agree with staff that near-term fiscal tightening on the basis of currently scheduled 2019 consumption tax rate increase should be avoided. The analysis of the Japanese and international experience provided in Chapter 1 of the Selected Issues paper (SIP) suggests that the Japanese government should carefully design and clearly communicate mitigating measures to attenuate the impact of the consumption tax rate increase. The effects on durable consumption and housing deserve special attention.

In the medium to long term, a stronger fiscal framework with well-articulated specific consolidation measures is needed to cope with demographic challenges. More specificity is likely to help in restoring policy credibility and putting public debt on a sustainable path. Chapter 2 of the SIP provides valuable insights on the costs of aging in Japan. According to the analysis, the least distortive way to finance these costs is to further increase the consumption tax (to 15 percent). Of course, revenue mobilization should be complemented by a broad set of structural reforms, including a comprehensive healthcare and long-term care reform. In this regard, we also welcome the analysis provided in Chapter 7 of the SIP of the options for the healthcare reform and the associated potential fiscal savings.

While monetary policy stance remains appropriate, the efficiency of monetary policy transmission mechanism is still low. Structural rigidities and backward-looking inflation expectations hampered the authorities' efforts to reflate the economy, while the side effects of the prolonged accommodative stance are building up. Massive JGB and ETF purchases created significant distortions of liquidity and pricing mechanisms in the respective markets. Low interest rates environment makes the yen prone to the appreciation shocks that could be caused by the "flight to safety" effect, as described in Chapter 6 of the SIP. At the same time, large and sharp appreciations run the risk of lowering actual and expected inflation. We encourage the authorities to closely monitor these effects. Staff's elaboration on other important side effects of prolonged monetary easing would be welcome. We agree with staff that further improvements in the Bank of Japan's communication framework, such as moving it closer to full-fledged inflation targeting, are likely to enhance policy predictability and generate public support for achieving the inflation target. In staff's opinion, are there any downside risks to the policy of even greater transparency?

Closer coordination between the Bank of Japan and the government may help in reaching the 2 percent inflation. Despite the sharp drop in unemployment in recent years wage growth remains below the three percent target, weakening the authorities' efforts to reflate the economy. The analysis provided in the Chapter 5 of the SIP shows that the main factors of subdued wage inflation are the downward pressure exerted by dual labor market effects and wage rigidities. As staff have already suggested on prior occasions, a more aggressive incomes policy in the short term may enhance the effect of demand stimulus on wage growth and could eventually lead to higher inflation.

Low interest rates environment also poses risks to the financial sector. Despite overall soundness of the banking sector, there are signs of the excessive risk accumulation, particularly in the regional banks. For instance, the real estate loans-to-GDP ratio has reached a historic high, while the housing market is considered somewhat overvalued. Could staff elaborate on the analysis of the real estate prices? We agree with staff that the authorities should facilitate the improvement of the credit risk management and adaptation of business models by the regional banks to demographic trends. We note the progress made on the 2017 FSAP recommendations, while there is still room to improve macroprudential policies as well as crisis management and resolution.

A more ambitious structural agenda leads staff to a more optimistic growth scenario. Staff believe that, if additional structural reforms are successfully implemented, economic gains will help in coping with demographic pressures in Japan and reinforce the effects of fiscal and monetary policies. We agree with staff that labor market reforms should remain among the authorities' policy priorities. The progress on the labor market reforms has been mixed. New labor market legislation (the "Work Style Reform") was passed by the Diet in June. At the same time, more should be done for enhancing labor supply, including deregulation and elimination of disincentives to regular work.

With these remarks, we wish the Japanese authorities success in their endeavors.

Mr. Mahlinza, Ms. Gasasira-Manzi and Mr. Essuvi submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Kaizuka, Mr. Saito and Mr. Komura for their insightful buff statement.

Economic conditions in Japan have improved with the economy continuing to expand moderately. Unemployment has reached a record low and the labor participation rate has improved. However, risks to the outlook have shifted to the downside, with the planned increase in consumption tax scheduled for October 2019 likely to lead to volatility in private consumption and investment, demographic headwinds and high public debt. While moderate growth is expected over the medium-term, structural reforms to leverage productivity gains, lift long-run growth, stabilize government debt, and improve the monetary policy transmission mechanism remain imperative. Against this background, we concur with staff that the current favorable conditions present an opportunity to push forward with the authorities' ambitious structural reform agenda, and we wish to offer the following comments.

Under current policies, short-term fiscal measures and fiscal consolidation are key to supporting near-term reflation and placing public debt on a sustainable path. With the delay in the implementation of the Fiscal Revitalization Plan, the operationalization of the new consumption tax could undermine the Bank of Japan's (BOJ) monetary policy objective to bring inflation to the targeted level, and the growth momentum. in this respect, specific measures to mitigate the adverse impacts of the tax and to support durable consumption are warranted. We, therefore, welcome the authorities' intention to include specific measures in the draft budget expected in December 2018, as mentioned in the buff statement. Further, the rising concerns about the medium-term fiscal sustainability could weaken confidence in policy effectiveness and the future performance of the economy. In this regard, a credible medium-term fiscal consolidation plan will help to reduce policy uncertainty and to put public debt on a sustainable path.

The accommodative monetary policy stance remains appropriate. Despite the growth recovery, inflation continues to remain below the BOJ target. Given the need to maintain an accommodative stance, the BOJ has to pay close attention to the costs and risks of the prolonged monetary easing. In this regard, there is need to continue efforts to strengthen the monetary framework and make the stimulus program sustainable, without destabilizing the banking system. Structural reforms remain important to support monetary policy in bringing inflation to target. Going forward, we concur that the BOJ should strengthen its communication framework to better anchor inflation expectations.

An enhanced management and supervisory framework is crucial to safeguard financial stability. While the banking system remains liquid and well-capitalized, its profitability continues to be affected by the prolonged accommodative monetary policy, which might induce banks to make riskier investment decisions. In this context, we welcome authorities' progress on the implementation of the 2017 Financial System Assessment Program (FSAP) recommendations, including, encouraging banks to evolve risk management practices in line with new business activities. Going forward, we encourage authorities to strengthen supervision of the banking system and to continue monitoring the business governance, profit trend and risk management, specifically on banking groups.

Moving ahead with multilateral efforts can help mitigate inward spillovers and strengthen the external position. Preserving and broadening the gains of global trade integration requires countries to work together. In this context, we commend the Japanese authorities for their leading role in advancing multilateralism and their commitment to promoting an open and rules-based multilateral trade and investment system. Furthermore, while the current account and the exchange rate are projected to be consistent with fundamentals, implementing fiscal consolidation measures and structural reforms to support growth and domestic demand remains imperative. Finally, we would encourage staff to continue engaging with the authorities on the Real Effective Exchange Rate (REER) assessment and the External Balance Assessment (EBA) methodology. Staff comments on the differences in views with the authorities regarding the EBA methodology are welcome.

Structural reforms should address the demographic headwinds, labor market rigidities and support investment. In this regard, we support authorities' efforts in implementing measures under the "The Action Plan for the Realization of Work Style Reform" and agree that mitigating structural rigidities in the labor market, by stimulating greater labor participation by women, older workers, and foreign workers could partly offset Japan's demographics challenges. Further, to boost investment and productivity, it is crucial to support business succession of firms with high growth potential. This could be achieved through incentivizing alternative sources of Small and Medium-Sized Enterprises (SMEs) financing, supporting SMEs Research and Development (R&D), and continuing the deregulation process, by lowering barriers to entry and removing incumbents' protections in some industries. Finally, we welcome the Japanese authorities' participation in addressing supply-side corruption issues as well as the implementation of the OECD recommendations as mentioned in the buff statement.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

Growth in Japan has been above potential over the past few years and the unemployment rate is at a 25-year low. In order to sustain and improve growth prospects, and to durably improve wage growth and inflation outcomes, the authorities should reinvigorate their structural reform agenda, as well as implement a credible medium-term fiscal consolidation framework. We thank staff for their report and offer the following comments.

Fiscal Policy

The authorities' decision to delay achieving a primary surplus from FY2020 until FY2025 is more realistic and welcomed. However, a credible fiscal consolidation plan is paramount, and we strongly agree with staff that the authorities are still using overly optimistic economic scenarios and budget projections for their base case. More structural fiscal changes will be needed so that Japan can build sufficient fiscal space to respond to shocks. On the consumption tax increase, staff rightly notes that the authorities will need to communicate clearly the details of mitigating measures and other fiscal policies. Does staff have a sense of whether the measures to offset the October consumption tax increase to be included in the December draft FY2019 budget will be sufficient to avoid a sharp drop in consumption?

Given Japan's demographics and limited fiscal space, we are particularly focused on the social security review which will be finalized by FY2020. We encourage the authorities to clearly define the parameters of this review, given its importance in achieving a sustainable fiscal outlook.

Monetary Policy

We agree with staff that the BoJ's recent measures to enhance the sustainability of the accommodative monetary policy stance were appropriate. We endorse staff's recommendations to improve market communication and strengthen the monetary policy framework by publishing BoJ staff baseline forecasts and underlying policy assumptions. Such a communication strategy could be helpful for alleviating risks that have built up in the financial sector.

External Sector

We appreciate Messrs. Kaizuka, Saito, and Komura's discussion in the buff statement of the Japanese authorities' views on the external sector assessment. We agree that in economies with market determined exchange rates, the main focus should be on the deviation of the current account balance from its norm, and policies to correct the deviation. In such economies, any indication of an under or overvaluation of the exchange rate does not require policy action to adjust the exchange rate but to address the underlying causes of the imbalance.

Financial Sector

Financial sector side effects from monetary policy warrant close monitoring and macro-financial vulnerabilities are likely to increase over the medium term. Additionally, demographic headwinds are a key problem for

Japanese banks, especially regional ones. We would have welcomed additional staff analysis on how consolidation of regional banks could improve efficiency and profitability in the sector. Shinkin banks, similar to U.S. community banks or credit unions, in particular may warrant special coverage given risk management and profitability issues compared to regional peers.

Japan could benefit from increased fintech penetration, and we welcome recommendations for the authorities to encourage regional banks to consider adoption of fintech practices by establishing clearer regulations and promoting cyber resilience, as well as reducing regulatory reporting costs for small start-up participants. Could staff provide a view on how the JFSA's proposed functions-based approach might better fit the evolving world of fintech?

Structural Reforms

Finally, Japan has made progress on structural reforms over the past several years, but there is need for a reinvigorated approach supported by ambitious policies. Staff has helpfully prioritized how the authorities should tackle their reform plans. We agree that further labor market reforms, including training, contract revision, and addressing pay gaps are crucial and could have positive impacts on productivity. Could staff opine on these reforms' impact on potential output?

Mr. Raghani and Mr. Alle submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Kaizuka, Mr. Saito and Mr. Komura for their insightful buff statement.

We commend the Japanese authorities for the achievements under Abenomics, which has notably reduced the fiscal deficit, eased financial conditions, and raised employment and female labor force participation. The strong fundamentals have helped weather the impact of recent natural disasters and growth is projected to stay above potential at 1.1 percent in 2018. Going forward, the authorities will be faced with the challenges of consolidating the fiscal stance to curb public debt without curtailing domestic demand and overall growth. Moreover, further structural reforms are needed to lift bottlenecks to growth, address the effects of population aging and mitigate risks related to the global outlook. We share the staff's assessment and would like to emphasize a few points.

The authorities' fiscal plan should carefully balance consolidation objectives and actions to support growth momentum. We welcome the steps taken to unveil the "New Plan to Advance Economic and Fiscal Revitalization" and take good note of the primary surplus target being postponed from FY2020 to a more realistic FY2025. The consumption tax hike envisaged in October 2019 is a good step to enhance revenue, strengthen the current fiscal space and make strides towards achieving the fiscal surplus target. Yet, we concur with staff that measures should be taken to mitigate the impact of this tax increase on growth. We understand that the authorities will formulate by December, additional measures to mitigate the impact from the 2019 planned consumption tax rate increase. Can staff confirm whether the authorities intend to consider their recommendations, notably addressing concerns over durable consumption or setting a time-bound and well-targeted tax rebate or transfer program for low-income households? We take good note of the authorities' decision to communicate clearly to the public, the timing and content of the mitigating measures to reduce uncertainty and hence alleviate potential adverse effects.

We note that staff recommend gradual and steady increases in the consumption tax rate, up to at least 15 percent, to finance growing social security costs and reduce debt sustainability risks. Though we understand that consumption tax is the preferred financing option, we recall from past Article IV discussions that property tax, asset tax and personal income tax reforms were once contemplated. Could staff elaborate on why these options are not considered anymore? Isn't there a risk to heavily rely on the consumption tax for enhancing revenue?

We welcome the review of the social security system to be concluded in FY 2020 as a favorable undertaking to cut expenditures and further advancing fiscal consolidation for ensuring debt sustainability. The authorities should be encouraged to follow through the review with a concrete implementation plan. In particular, reforms to put social security on a sustainable path should pay due regard to intergenerational equity.

The continuation of the accommodative monetary stance and a stable financial sector serve well the authorities' growth and fiscal objectives. We welcome the BOJ's decisive actions in July to keep short and long-term interest rates low amid uncertainties and speculations, as well as the various improvements brought to the monetary policy framework. Going forward, efforts should be stepped up to improve communication to the public so as to enhance policy predictability for achieving the inflation target. We take good note that the financial sector remains stable, with the overall banking system being well-capitalized and liquid. Yet, the authorities should keep a close eye on banks' high risk taking, particularly regarding lending to SMEs and the real estate sector. The new forward-looking and dynamic supervisory framework of the Japanese Financial Services Agency (JFSA) should be used to the fullest to address risks and vulnerabilities in the financial sector, including low profitability, lending to vulnerable firms and the sustainability of regional banks' business models.

Challenges related to demographic headwinds and long-term growth warrant deep and comprehensive structural reforms. We commend the authorities for the recent passage of the labor market legislation, measures to enhance labor supply, the completion of revisions and guidelines for the corporate governance code and trade reforms, notably the Japan-EU trade agreement and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). They should implement forcefully the labor market legislation and make progress on eliminating the social security system's disincentives to regular work and on deregulation.

We welcome the authorities' efforts to tackle supply-side of corruption by implementing the OECD Anti-Bribery Convention. They should focus on areas highlighted by the OECD Working Group, including detecting, investigating and prosecuting foreign bribery cases; and establishing a legal basis for confiscating the proceeds of bribing foreign public officials and criminalizing the laundering of the proceeds of foreign bribery.

We take note of Staff assessment that Japan's 2018 external position is projected to be broadly consistent with fundamentals and desirable policies. The authorities are encouraged to press ahead with their macro-structural agenda for maintaining external balance going forward. We welcome the authorities' commitment to multilateralism and look forward to their planned efforts to advance a free, fair and rules-based trading system.

Mr. Meyer and Mr. Buetzer submitted the following statement:

We thank staff for the comprehensive report and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their insightful buff. We broadly concur with staff's assessment and recommendations.

Before offering our comments on the staff report we would like to express our appreciation for Japan's long-standing strong commitment to multilateralism in general and the IMF in particular, including the provision of substantial funding to the Fund and its TA/CB activities.

Recent economic growth in Japan has been broad-based, driven by external and domestic demand and supported by the expansionary fiscal and monetary stance. On a per capita basis economic growth has been even more favourable. However, wage growth remains muted, despite tight labor market conditions, contributing to inflation still being well below the two-percent target. We welcome the important structural reforms that have been undertaken in the context of Abenomics, while others, in particular pertaining to the labor market, are still outstanding as also acknowledged in the buff.

Structural Reforms

The prolonged reliance on expansionary monetary and fiscal policy inevitably raises questions pertaining to sustainability and cannot substitute for structural reforms that are needed to raise actual and potential growth over the medium to long term. Against the backdrop of a rapidly shrinking and aging population, we share staff's view that the thorough implementation of structural reforms, in particular regarding labor and product markets as well as the corporate sector, is essential to regain self-sustaining economic growth in Japan and to offset some of the adverse effects stemming from demographic change. There appears to be scope to further strengthen income policies, including by using tax and wage policies as well as targeted social transfers. Continued deregulation in product and service markets and improving career opportunities for non-regular workers via contract reform would contribute to enhancing dynamism in the economy.

Given the unfavorable demographics, we are very supportive of the authorities' efforts to expand the country's labor supply and actions to boost productivity. The current tax and social security system still favors irregular and part-time work of spouses and elderly, causing higher social security spending, and reduced labor force participation. We therefore support reforms aimed at ameliorating this situation, such as raising the retirement age, eliminating disincentives in the tax and social security system to full-time and regular work, and promoting female labor force participation, including through improved access to childcare and nursing facilities.

In this vein, we are also looking forward to exploring ways and learning from best practices to address the challenges posed by demographic change in the context of Japan's upcoming G20 presidency.

Monetary Policy

Since the risks and side-effects of continued monetary easing could over time outweigh the expected benefits, we are somewhat more cautious than staff and the authorities regarding the appropriateness of a prolonged accommodative monetary policy stance. With a balance sheet of over 550 trillion yen in November 2018, the exit will be challenging. We therefore share staff's assessment that the BoJ has rightly put more emphasis on limiting potentially negative side-effects of its accommodative monetary stance and that market communication should be further improved. Effective market communication will gain even more importance, once the reflation momentum in the economy strengthens and the price stability objective is within reach.

Fiscal Policy

The high level of debt and the risks to debt sustainability remain a concern. We take note that the authorities have postponed the target to reach a balanced primary budget from the fiscal year of 2020 to a more realistic 2025. However, we concur with staff that under current and envisaged policies under the New Plan to Advance Economic and Fiscal Revitalization even this target – which relies on relatively optimistic growth assumptions – appears challenging. Against this background and given that Japan suffers primarily from structural problems, fiscal stimuli do not seem advisable at the current juncture. Rather, we support the view that a well-specified consolidation plan and fiscal framework would reduce policy uncertainty, help to achieve debt sustainability, and have positive effects on economic activity. Generally speaking, a credible medium-term fiscal strategy is inevitable to regain public confidence in the ability to manage the costs of the aging society.

We welcome that the authorities have reaffirmed their commitment to the planned consumption tax hike from 8 percent to 10 percent in October 2019. The increase is a first step towards a robust fiscal framework in the medium- and long-term. Mitigating measures should be specified to dampen potential adverse impacts. To make the tax hike effective, however, we believe that those mitigating measures shall not turn into permanent subsidies and are reassured by the buff that these are indeed intended to be temporary. As proposed by staff, a pre-announced path of gradual consumption tax hikes beyond 10 percent would reduce prevalent uncertainty over the course of fiscal policy.

Financial Sector

With regards to the financial sector, we agree with staff that the macroprudential framework should be further strengthened and macroprudential measures should be well established before detrimental developments occur. Although there may be no immediate concerns about financial stability, the extensive use of unconventional monetary policies may render macroprudential measures necessary in the future. As staff points out, the Japanese Financial Services Authority (JFSA) has taken necessary steps in adopting a fully risk-based supervisory approach. However, low profitability and the build-up of credit risk still contribute to medium-term vulnerabilities.

The authorities should also remain vigilant against challenges that result from ongoing demographic changes and the sustained low interest rate environment. Encouraging financial institutions to step-up efforts in improving their risk management capacity, as well as to further adjust their business models, including by potentially streamlining costs, diversifying income sources, and consolidation would be helpful in this regard.

Lastly, we are very appreciative of the country's voluntary participation in having its legal and institutional framework assessed in the context of the OECD's efforts to tackle bribery. In this vein, we fully support the efforts of the authorities to better organize resources to detect and enforce cases of bribery, in line with the OECD Anti-Bribery Convention.

Mr. Agung and Mr. Abenoja submitted the following statement:

We thank staff for a comprehensive and interesting set of reports, and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their insightful buff statement. We commend the authorities for their efforts in pursuing growth-oriented policies while safeguarding macroeconomic stability. The Japanese economy continues to expand at a moderate pace supported by both domestic and external demand. Inflation has gained momentum, albeit, below target. However, downside risks to growth remain, alongside the need to raise productivity and ensure debt sustainability amid the "national challenge" of aging and shrinking population. In response, the BoJ has explicitly committed to keeping interest rates low for an extended period while fiscal authorities have stretched the timeline for attaining fiscal primary surplus to support growth and reflation objectives. The structural issues make it imperative to invigorate on-going efforts to implement the wide-ranging set of structural reforms as envisioned in the multi-pillar Abenomics program. We concur with the broad thrust of staff appraisal and offer the following comments for emphasis.

We welcome the authorities' steadfast commitment in pursuing a medium-term fiscal consolidation program. We note positively that the increase in consumption tax will be imposed in 2019, accompanied by additional mitigating measures to be formulated by the end of this year. We are encouraged by the authorities' clear communication of the necessity of the consumption tax adjustment and the specific efforts to alleviate its negative impact. We share staff's view that a well-specified long-term fiscal consolidation program is required to address concerns on policy uncertainty, demographic challenges and debt sustainability risks. In this regard, staff specifically cited well-informed macroeconomic projections, concrete consolidation measures and an independent fiscal unit as key elements in enhancing the fiscal framework. We are pleased that the authorities view these initiatives as consistent with their new fiscal plan and feasible under the existing framework and institutions. Staff comments are welcome on the merit of exploring how current institutions can be strengthened to further improve the discipline and rigor of the policy framework.

We further agree with staff recommendation for a gradual approach in the implementation of the fiscal consolidation plan. This approach would help preserve near-term growth momentum while ensuring that safety nets are in place and socio-economic spending remains adequate. The report discusses specific measures (see pp. 11-12) that can be considered as part of the package of fiscal adjustment. To complement the estimation of the impact of these measures, it may also be useful for staff to discuss some prioritization, synergy and sequencing issues that should be considered by the authorities when assessing the efficacy of these various measures.

Monetary policy should continue to adopt an accommodative stance complemented by reforms to further improve the monetary policy framework. We welcome BoJ's recent emphasis on making its accommodative policy stance sustainable and the shift to a more patient approach in achieving its inflation target. Inflation has stubbornly remained below target despite the accommodative monetary policy due to the backward-looking nature of inflation expectations and adverse demographic trends that have partly muted the transmission of monetary policy. The staff report contains interesting results from various studies (see Box 1 p. 28) suggesting that the long experience of deflation has embedded low inflation into the public psyche to the extent that it may have had deep-rooted impact on expectations formation among the young segment of the consumer population and on the price-setting behavior of firms. Could staff expand on the possible monetary and nonmonetary measures that could promote forward-looking elements in expectations formation?

Staff has recommended the publication of BoJ staff's baseline forecasts together with the underlying policy assumptions as a way of enhancing the public's understanding of the rationale behind its monetary policy actions. We note the authorities concerns regarding this suggestion, highlighting that the release of staff forecasts alongside the already published board members' forecasts could be a source of market confusion. We share the view that this proposal should be evaluated more carefully. A deeper analysis on important factors including market behavior is necessary in gauging the readiness of an economy to adopt such a practice.

Financial sector policies should continue to be geared towards addressing the possible build-up of systemic risks. We welcome the latest staff assessment that the banking system continues to be well capitalized and liquid. We appreciate the analysis highlighting the risks to the financial sector arising from the prolonged period of low interest rates and Japan's demographic challenges. In this vein, we welcome the progress made in implementing the 2017 FSAP recommendations and the authorities' continued vigilance in monitoring financial risks closely.

The wide-ranging set of structural reforms is a crucial element in helping lift long-term growth, anchor inflation expectations closer to target and stabilize public debt at sustainable levels. We welcome the progress made by the authorities in pursuing broad-based reforms. However, both the authorities and staff recognize that there are opportunities to further deepen the reform agenda and intensify implementation. We look forward to the authorities' efforts to evaluate the impact of earlier reforms and formulate possible follow-through initiatives to boost labor supply, deregulate markets and improve corporate governance. To this end, staff has presented a ranking of reform initiatives based on their impact on economic activity and inflation. Could staff briefly clarify the possible sequencing of these reforms based, among others, on their prerequisites and the synergies across these measures to help ensure an orderly reform process.

We welcome staff assessment that the current account position in 2018 for Japan is projected to be broadly in line with fundamentals and desirable policies. While the authorities agreed with the results of the external position assessment, they highlighted possible weaknesses in the methodology. In particular, the assumed link between the CA and the REER underpinning the framework may not capture the important role of the income balance in

Japan's CA. We therefore encourage staff to continue to do further research in refining its external assessment framework to incorporate country-specific features including those cited by the authorities.

Lastly, we are encouraged by the authorities' commitment to take a leading role in multilateral efforts to promote a "free, fair and rules-based trading system." The potential escalation of trade tensions will have spillovers not only to Japan but also to emerging market economies.

Mr. Inderbinen and Mr. Danenov submitted the following statement:

We thank staff for the insightful set of papers and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their helpful buff statement. Japan's economic outlook remains positive, but inflation remains low and downside risks have increased, reflecting trends in the global outlook and trade. Also, demographic pressures are intensifying, which calls for a more determined structural reform effort. We broadly agree with the staff assessment and have the following comments for emphasis.

Continued fiscal consolidation remains crucial to ensure debt sustainability. Given its large debt stock, Japan remains vulnerable to changes in market risk perception. The authorities should pursue a clear and credible consolidation strategy in order to rebuild resilience and to put debt on a sustainable path. The envisaged strengthening of the revenue base by raising the consumption tax rate is welcome.

Monetary policy should remain accommodative, supported by growth-enhancing structural reforms. Japan's core inflation continues to be very low and inflation expectations remain backward-looking. Against this background, the Bank of Japan's policy stance should remain accommodative, while mitigating side-effects from prolonged monetary easing. In order to lift inflation expectations in a durable manner, as well as to improve policy predictability and maintain credibility, we encourage the BoJ to consider efforts to improve transparency of the monetary policy framework. As staff suggest, this could entail moving to a full-fledged inflation targeting regime by publishing BoJ's baseline forecast together with underlying policy assumptions.

Monitoring side effects of monetary policy on the financial sector is important. These side effects will most likely intensify when BoJ eventually starts the normalization of monetary policy. For instance, given the commercial banks' significant holdings of investment trust instruments, any reduction of BoJ’s holdings may negatively impact banks’ profitability. Against this background, we would like to ask the staff what concrete micro- and macro-prudential measures the authorities might take to minimize side effects.

Further labor market reforms are needed to address demographic headwinds. The shrinking population is challenging Japan’s economy in several areas, including the labor and housing markets. The shrinking workforce offsets productivity gains and, as fewer young people support a growing number of retirees, the pressure on pension and health care systems is rising. The ongoing efforts to boost labor supply are welcome. We encourage the authorities to implement additional measures to increase female labor market participation and to promote the inclusion of older and foreign workers into the workforce.

To stimulate productivity growth, product market reforms should continue. Japan has already achieved notable progress in its macroeconomic reform agenda. In order to further speed up competition-enhancing reforms in product markets, we support staff’s recommended measures, such as the reduction of entry and exit barriers. We also encourage the authorities to consider stepping up support for R&D investment and incentivizing alternative sources of SME financing. Higher productivity to lift potential growth would seem especially important to compensate for the demographic trends and to support fiscal consolidation.

Ms. Levonian, Ms. McKiernan and Ms. Vasishtha submitted the following statement:

We thank staff for a comprehensive report, including the insightful and detailed Selected Issues paper, and Messrs. Kaizuka, Saito, and Komura for their constructive buff statement.

The Japanese economy continues to grow above potential, although inflation and wage growth remain sluggish. The authorities’ new fiscal plan is aimed at making the fiscal consolidation path more realistic. Structural reforms are progressing, including enhancing labor force participation of women and older workers, corporate governance reforms, and trade liberalization.

The staff’s outlook calls for underlying growth to remain solid even in the face of the planned 2 percentage point increase in the consumption tax rate in October 2019. While the VAT rate increase will bring in much-needed revenue, it is expected to result in volatility in private consumption and investment, and constrain domestic demand and overall growth through 2020.

A “reinvigorated” structural reform package is necessary for unleashing the full potential of Abenomics and dealing with the demographic headwinds facing Japan. As such, the Article IV report appropriately focuses on the macroeconomic effects of Japan’s demographic trends. The rapidly aging population and shrinking labor force are negatively affecting growth and productivity. In addition, labor market rigidities, such as preference for job security over higher wages, lack of mobility across firms, and unequal pay between nonregular and regular workers, are a drag on productivity growth and limit the pass-through of higher demand into real wages and prices. The participation rate of women in the labor force is still low – albeit rising – and the integration of foreign workers is limited. It is important for the authorities to stay committed to the reinvigorated reform agenda which should boost productivity, labor supply and investment, ultimately supporting reflation.

Fiscal Policy

In their “New Plan to Advance Economic and Fiscal Revitalization” announced in June, the authorities have postponed the primary surplus target from FY2020 to a more realistic FY2025. But limited progress has been made in strengthening the fiscal framework as the fiscal plan rests on relatively optimistic growth assumptions. The current framework also lacks a long-term plan to address the increases in social security expenditures and ensure debt sustainability. We support staff’s view that specification of consolidation measures and use of more realistic macroeconomic projections will enhance the credibility of the primary surplus target.

On the planned VAT rate hike, we welcome the authorities’ emphasis on formulating additional mitigating measures by December and on clear communication. We agree with staff that near-term fiscal tightening should be avoided in order to make the planned VAT rate hike successful.

Financial Sector Policies

A prolonged accommodative monetary policy stance and demographic headwinds are contributing to lower bank profitability and encouraging risk taking, as corroborated by the recent stress testing by the Bank of Japan (BoJ). While the overall financial system has remained stable, we agree with the staff recommendations to strengthen financial sector policies to contain the build-up of systemic risks. In line with the 2017 FSAP assessment, the Japanese

Financial Services Agency (JFSA) is moving towards an enhanced, more forward-looking supervisory framework and examining the sustainability of regional bank's business models.

We welcome Japan's role in supporting a multilateral rules-based trading system, as demonstrated, for instance, by the recent progress in advancing the Japan-EU Trade Agreement and the CPTPP. We concur with the authorities' views on the potentially significant adverse effects from a rise in more inward-looking and protectionist policies globally. We remain strongly supportive of the authorities' plans to press ahead with multilateral efforts to advance a free, fair, and rules-based trading system.

Finally, we appreciate the rich set of topics explored by staff in the Selected Issues paper. For instance, the work on the macroeconomic implications of automation demonstrates the staff's efforts to "mainstream" into surveillance its analysis of issues that cut across several dimensions, namely labor markets, demographics, and technological advances impacting the future of work. We urge staff to continue to push ahead with such efforts in future analysis as well.

Mr. Mouminah, Mr. Alkhareif and Mr. Alhomaly submitted the following statement:

We thank staff for an informative set of reports and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their insightful buff statement.

We consider the focus of the 2018 Article IV Consultation on demographic challenges to be appropriate and commend the authorities for the progress made in implementing ambitious reforms and the plan to accelerate them in the period ahead. Going forward, the adopted Abenomics, which contains policy mix of monetary easing, flexible fiscal policy, and growth-enhancing reforms, has created a favorable macroeconomic environment that offers an opportunity to accelerate reforms and further strengthen policies to raise productivity and potential growth.

Our overall assessment of developments and prospects in Japan is positive. Nevertheless, aging and shrinking population continue to be the main challenge facing the economy. Similarly, the still low inflation environment would necessitate further remedial actions that go beyond the monetary policy.

On the fiscal front, we agree on the need for a gradual consolidation over the medium-term to put public debt to GDP ratio on a declining path and address fiscal risks, while maintaining a neutral fiscal stance in the near-term to underpin growth momentum. In this respect, the authorities' adjusted fiscal plan to postpone the primary surplus target from FY2020 to FY2025 is a step in the right direction. On the same note, the envisaged increase in consumption tax from 8 percent to 10 percent next year would help secure stable financing for social security costs, but would also necessitate mitigating measures to offset the possible impact on demand. To this end, we are encouraged to note from the buff statement the announced measures to reduce tax rate for food and non-alcoholic drink and enhance social spending to better target the most vulnerable segments of the population and support child-rearing. We also welcome the authorities' intention to clearly communicate with the public on the importance of the consumption tax rate hike and look forward to the introduction of specific measures to fully contain potential economic and social impacts from the planned increase in the tax rate.

On macro-structural issues, we see the need for comprehensive and ambitious reforms to boost productivity and investment while addressing labor market challenges. In this vein, we are encouraged by the implementation of wide-ranging reforms in the areas of labor market, corporate governance, and trade and foreign direct investment promotion, and look forward to further accelerating structural reforms in the period ahead. We take note of the divergent views between the authorities and staff on the pace of implementing structural reforms. Could staff elaborate why do they assess the implementation to be slow, given the important reforms that already took place, as illustrated in the buff statement?

With a view to complement the planned fiscal policy and macro-structural reforms, we agree with staff that monetary policy should remain accommodative for a prolonged period, while taking into consideration the importance of safeguarding financial stability.

Finally, we are comforted to note that the financial sector remains stable, with adequate levels of capitalization and liquidity. That said, the emerging challenges from low interest rate and shrinking population are affecting financial institutions' performance and increasing their risk appetite. Therefore, priority should be given to strengthening financial policy, including by further enhancing the supervisory framework. In this regard, we take positive note of the progress made in strengthening macroprudential and resolution frameworks, in line with FSAP recommendations.

With these remarks, we wish the authorities further success.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their insightful set of documents and Mr. Kaizuka, Mr. Saito, and Mr. Komura's for their informative buff statement. The gradual increase in inflation as well as the continuous expanding trend over the recent years confirm that the Abenomics' three arrows strategy remains adequate and consistent even though downside risks, including external, need to be addressed and measures taken to put the public debt on a downward trajectory. Against this background, we concur with staff that thorough implementation of the planned structural reforms including labor market, product market, corporate reforms and trade liberalization would help boost investment and enhance Japan's productivity as well as real growth, which is particularly needed in the context of a rapidly aging population.

Economic Outlook

The Japanese economy continues to grow above potential and inflation remains low. While we note that the authorities have a more upbeat projection than staff, the latter's projections appear reasonable. With a 0.1 percent rise in September 2018 and a decrease since the start of 2018, we might have been even more cautious in assessing core inflation as having "gained momentum". The risk of sharper-than-expected impact of the rise of the VAT in 2019 should be balanced as reduced rates will apply on a range of products (food, alcoholic beverages, etc.) and the authorities are better prepared with fiscal and monetary policy buffers ready to be deployed. Conversely, more emphasis could have been put on the risk of a disorderly rebalancing in China, where a more rapid slow down than anticipated would have a significant impact on Japanese real GDP growth through trade channel and financial contagion. Deterioration of the external outlook and trade tensions would also have important consequences on the export-led Japanese economy but may also trigger "safe haven" mechanism on the Yen amid heightened global uncertainty, leading to a sharp appreciation.

Fiscal Policy

We fully concur with staff that fiscal consolidation should proceed in a gradual manner anchored by a credible medium-term fiscal framework. We take note of the postponement to FY 2025 of the objective of reaching a positive primary surplus as a consequence of the delayed hike of the VAT and of the channeling of additional resources to support enhanced labor force participation, notably among women, as stated in Mr. Kaizuka, Mr. Saito, and Mr. Komura's buff statement. Along with temporary measured on durable consumption goods and on households' tax burden, fiscal consolidation should be careful undergone in the near-term in order to alleviate the adverse macroeconomic impact from the planned October 2019 VAT rate increase. We are however surprised by the significant impact of fiscal policies (end of stimulus and VAT hike) for 2019 in staff's estimates (-0.6pp) since the negative effect should be concentrated in Q42019 and mostly affecting 2020 while 2019 GDP growth should benefit from the frontloading of consumption and investment spending prior to the VAT hike. We would be pleased to have staff's comments.

Monetary Policy

We share the view that monetary policy should remain accommodative and forward-looking. We take positive note that, after its September 2016 "inflation-overshooting commitment" to reach its price stability target of 2 percent in a stable manner, BOJ has committed in July 2018 to "maintain the current extremely low levels of short and long-term interest rates for an extended period of time". While we note staff's recommendation to further enhance the forward guidance framework, the authorities have already acted on that front and academic literature has shown that expectations are mostly backward-looking, limiting the reach of forward guidance announcements. Facing concerns overs Japanese government bonds (JGB) market functioning, the introduction of yield-curve control (YCC) has allowed the BOJ to drastically reduce the amount of assets purchased. We also acknowledge the efforts made to mitigate tensions on the ETF market and sovereign yields. The BOJ announced in July 2018 that purchases of ETF will vary "depending on market conditions" which may translate into a similar downsizing of these asset purchase programs. The greater flexibility on its 0 percent target on the 10-year yield (from+/-0.1pp to +/-0.2pp) has also alleviated pressures stemming from the global rise in sovereign yields. Finally removing the quantitative target on JGBs purchases of ¥ 80 trillion per year should have little effect as the BOJ seems to have already started to reduce its JGBs purchases. Could staff elaborate on this aspect?

Structural Reforms to Boost Productivity

The third arrow's results of Abenomics have overall fallen short of the mark and more could be done to remove structural rigidities in labor and corporate markets that dampen productivity growth and hinder pass-through of demand stimulus to real wages and prices. Wage growth remains weak despite tight labor market conditions. We fully agree with staff's recommendations that labor market reforms are crucial and should be prioritized as they would have the largest growth and inflation impact. Labor supply should be fostered through enhanced women's participation, increased childcare and nursing facilities and a reduction of the gender wage gap. In this respect the "spouse deduction" translates into a low-salary trap for women should be removed. Older workers and foreign workers' participation should also be encouraged and disincentives in the tax and social security system to full-time and regular work removed. We agree that training and career opportunities for non-regular workers (fixed-term contracts, part-time and temporary workers) should be bolstered as their rise share in total employment has had some downward pressures on wages as the average difference regarding regulars is high.

In line with staff, we welcome the Labor market legislation passed by the Diet in June 2018 but nevertheless express concerns about its effectiveness and the way the authorities will enforce it remains unclear. We wonder for instance how they will be able to spot fraud on whether firms abide by their "equal pay for equal work"- related obligations among the population of regular and non-regular workers and accordingly to the employees' effective work carried out and skills. Staff comments on this would be welcome. Corporate reform is also needed to make the SMEs' fabric more efficient and competitive. In that sense, we agree with staff that exit of non-viable SNEs and entry of firms with potential should be increased as the entry/exit ratio of SMEs in Japan is particularly low with a low rate of entrepreneurs. We believe that on the entry side, Japan should promote entrepreneurship by lowering the risks associated with this career and softening the regime of personal bankruptcies. On the exit side, incentives for alternative sources of SME financing and reduction in coverage of the credit guarantee system should be promoted to replace a financial system based on personal guarantees and public subsidies/guarantees.

On population ageing, we fully agree with the set of structural reforms as advocated in the report as the fast shrinking in Japan's population will undoubtedly pose major risks to labor market and output, leading to a massive drag on real output. Figures are edifying as under current policies real GDP would decline by over 25 percent in 40 years. As regards the "credibility" of reforms, we note that the calibration used in GIMF model could be further detailed and justified, namely on agents' expectations but do not really get the idea behind this wording. Staff's explanation on the "credible" implementation of structural reforms would be valuable. Additionally, we take note of staff's recommendation, in the dedicated selected issues paper, to finance the rising age-related spending through a rise in the consumption tax revenues. While we thank staff for the effort to compare the potential impacts of different revenue-measures to deal with this challenge, the scope of this SIP raises question and we wonder whether a broader approach should have been preferred. First, and as well detailed in the report and the buff statement, rising TFP and labor force participation (notably through women labor force participation or immigration) appears as a priority to tackle the rapid aging of the population. A strategy focusing mostly on rising the saving rate (be it through private or public saving) would contribute to increase the current account surplus, which is already projected to be above the EBA norm in the coming years. Second, the impact of the recommended consumption tax hike might be significant on domestic consumption, as well as on the distribution of incomes. In this regard, the selected issues paper dedicated to inequality in Japan points to the fact that the tax and transfers system has limited the rise in income inequality over the recent years. In this regard, we are not sure to understand what staff meant with the following sentence: “Because labor income taxes are progressive, partly financing the cost of aging through this way has more negative effects on individual with higher productivity” and whether this assertion is consistent with staff’s recent work on tax progressivity. Staff comments are welcome.

Banking Sector

We share staff’s analysis that while the banking sector is well capitalized and liquid, some source of vulnerabilities deserves a close attention from the authorities. The low interest rate environment may translate to a “search for yield” behaviors and a bid up in the prices of risky assets. The impact of declining demography on banking sector is to be stressed in this respect. On anti-monopoly legislation, we commend the authorities for their recent move to provide the Japan Fair Trade Commission with more power in the examination of mergers of regional entities. Could staff share its view on this aspect? Finally, demography is raising the critical issue for banks to match supply and demand by adapting the range of financial products to a new ageing population. Could staff elaborate on the necessity for banks to adapt to a new consumer market?

Supply-Side of Corruption

We commend the authorities in their willing to have volunteered to be part of this assessment. We salute the improvement in implementing the OECD Anti-Bribery Convention that will provide them with adequate policies and intervention resources to detect, investigate and prosecute foreign bribery cases. Going forward, we encourage the authorities to pursue their efforts to establish a legal basis for confiscating the proceeds of foreign bribery and ensure a stronger role of the Ministry of Economy, Trade and Industry in the effective implementation of the Convention.

Mr. Jin and Ms. Liu submitted the following statement:

We thank staff for the comprehensive report and the interesting Selected Issues paper, as well as Messrs. Kaizuka, Saito, and Komura for their informative buff statement. Supported by domestic and external demand, the Japanese economy is growing above potential. Unemployment rate is low, and labor force participation of women and older workers have increased. Nevertheless, downside risks have increased both internally and externally. Japan's public debt remains high, and inflation is well below the Bank of Japan's 2 percent target. Rapid aging and shrinking population also pose significant challenges to economic growth and debt sustainability. We broadly agree with staff's assessment and would like to make the following comments.

We share staff's view that a gradual medium-term fiscal consolidation is needed to ensure debt sustainability. As presented in the DSA, Japan's public debt is unsustainable under current policies, and aging-related government spending will increase significantly in the long-term, while its tax base will shrink due to depopulation. Japan's fiscal challenges will intensify due to demographic pressures. In this regard, an increase of consumption tax rate by two-percentage point in October 2019 should have positive effect on the fiscal profile. However, taking into account Japan's experience in 2014, during which the consumption tax rate hike led to a record decline in household consumption and sharp economic contraction, we agree with staff's suggestion that well-targeted mitigating measures and clear communication are needed to reduce adverse macroeconomic impacts. In this respect, as highlighted in the buff statement by Mr. Kaizuka and his team, we take positive note of the authorities' efforts in mobilizing a wide range of measures to contain demand fluctuation along with support for low income households. Staff recommended that the consumption tax rate needs to be raised well beyond 10 percent. We wonder what the authorities' view is, and welcome staff's comments.

The effectiveness of monetary policy requires better coordination between fiscal and income policies and should be supported by structural reforms. Japan has been adopting an extensive monetary easing policy for several years, and recently the BOJ made it clear that it would maintain the current interest rate levels for an extended period of time. Even so, inflation and inflation expectations are yet to reach their optimal level. The effectiveness of monetary policy has been weakening due to lack of fiscal and income policy support as well as needed reforms such as labor market reform. We see higher wages as critical to spur inflation. Therefore, strengthening the needed reforms and policy coordination are crucial for boosting real wage increase and durable reflation. Meanwhile, side-effects from prolonged monetary easing should be mitigated, supported by clear communication.

We are puzzled by the yen's appreciation against the U.S. dollar from time to time, against the backdrop of the monetary policy normalization in major advanced economies and rising global interest rates. The report attributed the yen's appreciation to safe haven effects, interest rate differentials, and carry trade reversals. But appreciation of the yen could have further intensified Japan's deflation and made the inflation target more difficult to achieve. Staff comments are welcome. Compared to other currencies, is the yen relatively safer?

We share the concern about macroeconomic challenges associated with rapid aging and declining population. Japan is not alone in facing demographic changes, and Japan's experience could be useful for other member countries. In this regard, we look forward to the Fund's upcoming work on Demographics to help member countries address challenges, drawing on related experiences, including macroeconomic implications on growth and fiscal sustainability, and the design of welfare and healthcare systems that can appropriately contain aging-related government expenditure.

We welcome the topics of the SIP which are relevant, interesting, and helpful. As presented in the SIP on "Macroeconomic Implications of Automation", we note that Japan has introduced quite a few initiatives, including Society 5.0 to support automation and AI technology development in coping with demographic challenges. Significant progress has been made, especially in the utilization and dissemination of robots. We are impressed that Japan has accounted for 52 percent of global robot production. As the SIP pointed out, Japan's demographic trends makes it a unique laboratory to understand the opportunities and challenges of automation. While automation brings Japan great benefits, the possible negative impacts on the service sector should be carefully monitored given the predominant share of the service sector in the economy. Training and education should be provided to those negatively affected by automation, particularly women and low-skilled labors.

We commend the authorities for taking a positive role in supporting a multilateral free and open trade system. Japan has long been participating in regional and global financial cooperation to promote regional economic integration. We encourage the Japanese authorities to make more efforts to strengthen regional economic integration.

Lastly, we appreciate Japan's voluntary participation in the supply side of corruption assessment. This is not because Japan is perfect in this area, but the starting point is rather to identify and solve the problems existing in the supply side of corruption. Such an attitude deserves respect.

Mr. Hurtado submitted the following statement:

We thank staff for their comprehensive report and Messrs. Kaizuka, Saito, and Komura for their informative buff statement. We agree with the main thrust of the report and would like to highlight certain aspects and pose a few questions on specific matters.

The Japanese economy is at a point in which economic policy requires to achieve a delicate balance. While policy has to be supportive in the short term, it needs to be underpinned by a well-thought-out medium-term consolidation plan, as staff put it. This, together with credible macro structural reforms, are necessary conditions to foster growth and stabilize public debt.

We encourage progress on structural reforms and agree that they are critical for the Japanese economy to recover its dynamism in face of demographic headwinds.

For years, important structural reforms in various areas have been necessary for the economy to recover growth dynamics. We note and agree with staff on the importance of labor reforms to increase productivity and labor supply, product and corporate reforms for productivity and investment, as well as trade liberalization and FDI promotion. Staff advise to prioritize by classifying these as first, second and third "tier" reforms. Could staff clarify what that ordering means, is it a suggested sequencing? Along these lines, we note that continued deregulation will increase productivity and investment by reducing barriers to entry -and exit-, removing incumbents' protections and deregulating professional services. Can staff please expand on what industries or sectors are most in need of these policies?

We note that there are two councils -one of them with external members- that provide advice on fiscal policies. However, these advisory bodies serve the prime minister and the finance minister, so they do not seem independent. Can staff comment on this point?

Although the financial system remains stable, staff consider that several risks are being taken that may destabilize it, meanwhile, the authorities do not see excessive risk taking at this time. Is this because although there is substantial risk taking by some institutions, it has not become systemic?

Finally, we welcome the authorities' cooperation and their acknowledgement of the relevance of the IMF initiative to assess efforts to address issues related to the supply side of corruption and their willingness to be part of the assessment.

Mr. Fanizza and Ms. Collura submitted the following statement:

We thank staff for a good set of papers, and Mr. Kaizuka, Mr. Saito and Mr. Komura for the informative buff. We concur with staff on the need for mutually supportive policies to lift growth and inflation in order to face the impact of aging and lower the public debt-to-GDP ratio. We share the staff's appraisal and offer the following comments for emphasis.

Structural reforms are critical to boost productivity, labor supply and investment. In this regard, the relevant Selected Issues Paper analyzes the impact of structural factors on wage-price dynamics well. Higher wage growth and more private investment would help channel the high corporate savings to the domestic market, helping to address the saving- investment imbalance.

Staff make a distinction between credible implementation of structural reforms and a not- fully-believed path of reforms. We agree that credibility is an essential requirement of any successful policy. We find the three-tier reform agenda suggested by staff to the Japanese authorities reasonable. However, we do not fully understand the metric that staff use to judge whether a reform path is credible.

We agree with staff that at the current juncture a near-term fiscal tightening should be avoided and encourage the authorities to proceed in the identification of mitigating measures to attenuate the adverse impact on demand of the planned consumption tax rate increase. We find it reasonable to postpone to FY 2025 a primary surplus target and we concur on the need to keep an accommodative monetary stance to achieve the inflation target. We believe the way for Japan to lower the high debt-to-GDP ratio goes mainly through raising growth and inflation.

Finally, we welcome that Japan has volunteered to include the supply-side issues of corruption in their Article IV consultation and we express appreciation for staff's approach which mostly relies on the OECD assessment, thus avoiding duplication, while providing the authorities with the space for illustrating progress in their actions.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for well-articulated and well-written papers, and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their informative buff statement. We agree with the thrust of the staff appraisal and focus on a few key issues.

Japan's underlying growth fundamentals are strong, but a fast aging and shrinking population is posing serious long-term fiscal, growth, productivity and equity challenges that need to be addressed by accelerating structural reforms in a number of areas. With its anchored position in the global supply chain, the Japanese economy is also facing heavy external headwinds from weakening global growth and escalating global trade conflicts and geopolitical tensions that are likely to adversely impact investment and growth, with potential negative spillovers in financial markets. In the face of serious threats of retreat from globalization, Japan's continued strong commitment to open trade and its global leadership in advancing multilateralism are commendable. More generally, the authorities strong track record of sound policies and reforms under Abenomics, as highlighted by Mr. Kaizuka, Mr. Saito, and Mr. Komura, provides confidence that they will make significant inroads toward meeting these challenges.

Near-term macroeconomic and incomes policies should remain supportive in view of modest growth and stubbornly sluggish price and wage dynamics. We support staff recommendation of a neutral fiscal stance in the next two years, particularly since the planned increase in the consumption tax may require mitigating measures to contain its impact on domestic demand and growth. Beyond that, a gradual consolidation from 2021 seems appropriate, and targeting a primary surplus by 2025 seems more realistic. Over the longer run, gradual, yet sustained, increases in primary surpluses are central to addressing the strong demographic pressures and stabilizing the debt dynamics.

Accommodative monetary policy should remain for longer than expected earlier in view of the limited success in fueling inflation and raising inflation expectations. In this connection, we support staff recommendation for the Bank of Japan (BoJ) to move closer to full-fledged inflation targeting to lift inflation expectations and strengthen the monetary framework to improve monetary transmission mechanism and policy signaling. BoJ's eventual monetary policy normalization is likely to lag behind those of other major central banks. An easy monetary policy in the face of global financial tightening carries risks that should not be overlooked. The rapid rise of real estate loans and holdings of investment trusts with heavy exposure to volatile foreign equity markets merits close monitoring. We welcome the authorities' indication that they are making continued progress in addressing financial risks, including by implementing FSAP recommendations.

Structural reforms in support of macroeconomic policies are essential to meeting the long-term challenges of lifting productivity, investment and growth, and adapting to demographic pressures. Reforms would also strengthen the link between policies and outcomes, particularly as regards the impact of stimulus policies on domestic demand and on wages and prices. Staff correctly identifies the urgent need for reforms to address labor market rigidities, including: eliminating disincentives to regular full-time work; increasing labor force mobility; closing the gender wage-gap; and encouraging labor market participation, especially of women and older workers. The authorities' intention to facilitate immigration of skilled workers to address shortages goes in the right direction, and we encourage staff to monitor developments in this area.

Staff categorizes labor market reforms as "first tier" reforms, given their potential output and inflation impact. In our view, reforms in all three tiers should move in parallel with equal commitment and urgency for full impact. In this regard, we agree with staff, as well as with Mr. Kaizuka, Mr. Saito, and Mr. Komura, on the importance of mutually-supportive policies.

We commend the authorities for volunteering to be part of Fund initiative to assess supply-side issues of corruption, and are encouraged in particular by their response to Phase 3 recommendations by strengthening the anti-bribery legal framework and enforcement. So far, the discourse on bribery in Fund staff reports has been largely on the demand side and supply-side corruption has been assessed less frequently. We encourage other advanced economies to follow in the footsteps of Japan and volunteer for similar assessment, which should strengthen membership support for Fund work on governance and corruption.

With these remarks, we wish the authorities continued success.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their Report and Issues Papers and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their buff Statement.

We agree with Staff that growth is expected to remain overall solid, albeit risks are on the downside. The impact of natural disasters is likely to be temporary, while activity is expected to benefit from continued accommodative monetary policy. Some near-term volatility is expected due to the planned increase in the consumption tax rate that is part of the medium-term fiscal consolidation plan. More concerning, however, is that the balance of risks has shifted to the downside in line with the global outlook. While external risks associated in particular to heightened trade uncertainty have yet to make a visible impact on the data, they are the key downside risks over the near term. At the same time, macro-financial vulnerabilities and fiscal sustainability concerns are expected to weigh on growth, amid limited monetary policy space. More specifically, we note that limited progress has been achieved in strengthening the fiscal framework and further credible and realistic medium-term consolidation plans remain necessary to ensure fiscal sustainability and manage the financial costs of the demographic transition.

We take note of staff's assessment that maintaining an accommodative monetary policy stance remains appropriate to achieve the price stability objective, against a backdrop of limited upward momentum in priced and wages in spite of tightening labor markets and recent supportive growth developments. At the same time, we concur with Staff's view that examining and mitigating side effects stemming from a long period of very accommodative monetary policy is warranted. Importantly, stepped-up efforts on structural policies could tackle existing bottlenecks in the economy and improve the effectiveness of monetary policy in supporting the reflation momentum.

We agree with Staff that progress on structural reforms has been uneven, while there is still ample room and significant need to raise productivity, labor supply, and private investment. In this context, it is essential to thoroughly implement recently adopted labor market reforms and further strengthen income policies via continued deregulation in product and services markets, improved career opportunities for non-regular workers via contract reform, minimum wage and other wage policies, and targeted social transfers.

We broadly share Staff's assessment of the current account balance being consistent with medium-term fundamentals. Whereas trade in goods and services are broadly balanced, the persistent current account surplus is mainly driven by the income balance related to Japan's sizeable and positive international investment position.

We broadly concur with Staff that the financial sector remains stable, however, significant challenges to financial stability remain. A long period of low interest rates, coupled with unfavorable demographic trends, poses a considerable challenge for the Japanese financial system. As such, financial sector policies should be enhanced in order to contain the potential build-up of systemic risks and safeguard financial stability. At the same time, potential risks arising in the financial sector (e.g. excessive risk-taking and impact of low interest rates on profitability) should be closely monitored and carefully assessed against financial institutions' risk management capacity. For instance, financial institutions (particularly regional banks) should be encouraged to step-up efforts in improving their risk management capacity, as well as to further adjust their business models to the demographic challenge, including by potentially streamlining costs, diversifying income sources, and consolidation.

The Chairman made the following statement:

I had the pleasure of visiting Japan when the mission concluded its work and to have bilateral meetings with the authorities, including Prime Minister Abe, who had just completed the formation of his government after the elections. I would argue that Japan has massively benefited from the three arrows of Abenomics over the course of the last few years, and if we look at the current situation, the growth has risen above potential. The recovery continues. The unemployment is at rock bottom and has fallen to a 25-year low; and despite this performance, Japan is still facing the inevitable situation of an aging society, added to which it has suffered massive natural disasters, particularly in the last 12 months, which has had an impact on the growth of the country and more so than in many years.

The main challenge, as concluded by the Article IV consultation, is for the authorities to arrive at that policy mix that will continue to support growth and reflation; prepare for the demographic changes and the related security, welfare, and social security benefits that are expected by the population; while at the same time maintaining debt sustainability and financial stability.

Mr. Kaizuka made the following statement:

I thank the Chairman for making herself available in Tokyo during the Article IV mission. She had a bilateral meeting with Finance Minister Aso and Prime Minister Abe, and he was extremely happy after the landslide victory in the election of the Liberal Democratic Party (LDP) leaders, meaning that he will be the longest-lasting Prime Minister in the country.

I thank the Japan team led by Mr. Brekk, who is now back in Tokyo, Mr. Cashin, Mr. Schneider and the rest of the team. I thank them for the candid discussion, which are successfully concluded. I also thank Directors for meeting on the eve of Thanksgiving. I should have prepared a turkey, but I am not a very good cook; so instead I prepared a lengthy buff statement, and the Japan team has come up with the selected issues paper which contained seven outstanding, interesting topics. I reiterate the importance and the necessity of the selected issues papers, which we discussed seriously.

Ms. Levonian made the following statement:

We thank the staff for a comprehensive report and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their constructive buff statement. We have issued a gray statement, so I will highlight two points. First, we welcome the staff's rich and insightful analysis in the selected issues paper. I will mention in particular the work on the macroeconomic implications of automation, which helpfully draws together issues of labor shortages, population aging, technological innovation, and inclusion, and the implications of these for future policy.

The second issue I want to raise is gender equality. It is encouraging to see that the female labor participation rate has increased in recent years. We agree with the staff that this could be facilitated further by efforts to provide greater access to childcare and nursing facilities, as well as reducing the gender wage gap. There is a natural experiment in Canada; one of our provinces, Quebec, provides much more childcare facilities and much more generous maternity and paternity leave. There is a much higher female participation rate in Quebec than in the rest of the country, and studies have shown that there is a link between the policies and the result, and so we welcome authorities' plan to promote greater female labor force participation and wish them well in their efforts to invest in human capital.

Ms. Pollard made the following statement:

I thank the staff for their well-written report and echo Mr. Kaizuka's comments on the selected issues paper, which we found particularly important and interesting. I also want to thank Mr. Kaizuka, Mr. Saito, and Mr. Komura for their thoughtful buff statement, which we greatly appreciated. I also would like to echo the comments of Ms. Levonian on the importance of increasing female labor force participation.

I would like to add one point that we did not cover in our gray statement, and that is to commend Japan for volunteering to be part of the assessment of supply-side corruption and have this included in their Article IV report. This is an important workstream and a good addition to Article IV consultations, and we welcome the authorities' commitment to implementing the OECD Phase III recommendations. While more work is still needed, the authorities' action plan is a welcome step forward.

Mr. Virolainen made the following statement:

I thank the staff for the comprehensive and insightful reports. I share my colleagues' appreciation for the impressive set of selected issues papers, which were timely and interesting.

I issued a joint gray statement with Mr. Rashkovan, but I would like to offer brief additional remarks on three topics. First, I would like to commend the authorities for the progress made with the implementation of the third arrow of Abenomics, especially in the labor market. Female labor force participation has shown a significant increase in recent years. However, as much of the increase represents non-regular and part-time work, this has had the unfortunate side effect of also contributing to one of the widest gender wage gaps among the advanced economies. With Japan's population falling at an increasing pace, more efforts will be needed to further boost labor supply.

Second, I agree with staff that Japan's fiscal framework needs to be further enhanced, and I share the staff's concern about the overly optimistic assumptions regarding growth. I would also like to recall that in the previous 2017 Article IV consultation, the staff recommended to start gradual fiscal consolidation in 2019. This year, the staff recommends maintaining a neutral fiscal stance in 2019 and 2020 and starting a gradual adjustment only in 2021. In light of the fact that the Japanese economy still grows above potential and the output gap will be closed by next year, could the staff elaborate on the reasons for changing the recommendation of the timing of fiscal consolidation?

Third, given the limited progress in stimulating inflation, I agree with the staff that the Bank of Japan needs to stand ready to maintain the accommodative stance for a prolonged time period; however, I underline the critical importance of mitigating the potentially harmful side effects from prolonged easing. I also share the staff's view on the need to further improve monetary policy communication, specifically the relationship between forward guidance on the long-term interest rate target, and the inflation target needs to be further clarified to avoid misinterpretations.

To conclude, I want to reiterate the point we made in our gray statement that we welcome that the Japanese authorities volunteered to the staff's assessment of the legal and institutional framework to tackle issues related to the supply-side of corruption.

Mr. Meyer made the following statement:

We thank the staff for the report and broadly concur with its appraisal despite having a somewhat different take on the monetary policy stance. We also thank Mr. Kaizuka, Mr. Saito, and Mr. Komura for their insightful buff statement and the continued commitment to multilateralism and structural reforms, as described in this buff statement. We also commend the authorities for achieving broad-based growth. If we look at it in per capita terms, then it is even more impressive. Japan might not only have the longest-serving prime minister, but maybe also the longest-lasting recovery at the moment. However, against the backdrop of a rapidly aging population, structural reforms that raise actual and potential growth over the medium- to long term are of the essence to offset some of the adverse effects stemming from demographic change, as also underscored by many other Directors. In particular, we are very supportive of the authorities' efforts to expand the country's labor supply and actions to boost productivity, and there are a number of good elements for how to achieve this in the report, which are supported by the authorities. In this vein, we are also looking forward to exploring ways and learning from best practices to address the challenges posed by demographic change in the context of Japan's upcoming G20 presidency.

As regards monetary policy, we are somewhat more cautious than the staff and the authorities regarding the appropriateness of a prolonged accommodative monetary policy stance, which requires vigilance against associated risks and side effects. The report goes into some detail on mitigating efforts, but it is important that we do not just mention that. It is more a description of the problems. We have to act on those, and we have to understand those problems, and I would encourage the staff in this case, but more generally, to go into more details. The report states that in Japan, the public sector, the central bank, is one of the largest shareholders of listed companies, and this is the context in which the balance sheet is still expanding. We are not even discussing how we would keep the balance sheet unchanged or unwind the balance sheet. It just shows that there will problems for years in terms of how to move to a more normal situation.

Lastly, we reiterate the importance of a credible fiscal consolidation plan, as also emphasized by Ms. Pollard, Mr. Mozhin, Mr. Kaya, Mr. Tombini, and others in their gray statements. It is central to have a step-by-step increase in the consumption tax rate and decide on the path forward now and offset it if necessary by measures that should be temporary, as is being discussed for the current tax hike.

Mr. Jin made the following statement:

We thank the staff for the comprehensive set of papers, their candid policy recommendations, and Mr. Kaizuka and his colleagues for a robust buff statement. We have issued a gray statement, and I would like to limit my comments to the following.

It is good to see that the Japanese economy has improved, and underlying growth is expected to remain solid. Due to stable economic growth and depopulation, Japan's per capita GDP actually grew by 1.9 percent, higher than Germany's 1.8 percent and the United States' 1.5 percent in 2017. This is quite remarkable. Nevertheless, Japan faces increasing uncertainties surrounding the global economy arising from the tightening financial conditions and the trade tensions. The domestic policy agenda will also continue to face challenges, especially from rapid aging and depopulation.

We welcome the authorities' wide range of structural reform efforts, including the recent passage of the Work Style Reform legislation. Some positive impact has been made in this respect, as demonstrated by the increasing labor force participation, especially among women and older people.

Some structural issues warrant further analysis. For example, as shown on the chart on selected trade policy and FDI indicators in the staff report, Japan's agricultural subsidy is quite high. What is the current level of Japan's agricultural subsidy? How does this level compare to that in the United States, Europe, and the emerging market economies, and what are the authorities' cost and benefits considerations? What external and internal effects arise from these subsidies?

Another question is how would the North American Free Trade Agreement (NAFTA) rules of origin affect the Japanese automobile sector? What is the possibility that tariffs will be imposed on Japan, and what will be the associated impact on the Japanese economy? We wish success to the authorities in their endeavors.

Mr. Tombini made the following statement:

I want to thank Mr. Kaizuka, Mr. Saito, and Mr. Komura for their detailed buff statement and the staff for the comprehensive reports. We have issued a gray statement, so I just want to make a few points. The first relates to the fact that Japan has made remarkable progress in improving the health and increasing the life expectancy of its population. Such an achievement, however, comes with a cost. The fiscal burden of the pension and the health systems of Japan's aging population is a critical issue that should be tackled without delay. Any postponement increases future cost of adjustment. Therefore, I welcome the authorities' awareness of this issue and encourage them to address it without delay.

Second, I acknowledge the formidable challenge faced by the Bank of Japan and the need to proceed with an accommodative monetary policy stance. In addition to protracted deflationary pressures and entrenched low inflation expectations, there are the potential knock-on effects of the increase in the VAT rate next year to be considered. That being said, the staff notes that despite improvement in liquidity indicators after the adoption of the yield curve control, there are signs of possible market malfunctioning and perhaps exhaustion of these policies. For a different reason than Mr. Meyer, I would also like the staff to elaborate on these problems that Japan is facing with implementation of monetary policy at this juncture and whether there was discussion on policy alternatives to continue to support the economy in addressing this negative implication of current policies.

Finally, I want to welcome Japan's leadership in advancing with the multilateral agenda, in particular its advocacy for a free, fair, and rules-based trading system. I encourage the Japanese authorities to heighten the efforts to tackle the supply side of corruption.

Mr. Beblawi made the following statement:

We thank staff for the well-written reports and the answers to our questions. We issued a gray statement in which we welcomed the focus of the discussions on the macroeconomic effects of Japan's demographics. Going forward, mutually supportive, reinvigorated, and credible policies would bring Abenomics to full strength and would help boost productivity and raise potential growth. The authorities expressed concerns regarding the methodology used for the Real Effective Exchange Rate (REER) Assessment as they questioned the assumed link between the REER and the current account. We note that staff agrees that the trade elasticity is relatively low in Japan, and we welcome their readiness to carry out additional work on the relationship between income account and REER. We appreciate the staff's prioritization of structural reforms in terms of their output and inflation impact and encourage such prioritization in other Article IV consultations.

Finally, we welcome Japan's commitment to take a leadership role in advancing multilateralism, free trade, and investment. We also welcome the authorities' volunteering for an assessment of the legal and institutional framework for addressing supply-side corruption issues. With these comments, I wish the Japanese authorities continued success.

Mr. Di Tata made the following statement:

We issued a gray statement, but I would like to make some comments on an issue that I find fascinating, particularly in the case of Japan, and the issue is inflation expectations and credibility.

We in South America are used to discussing disinflation rather than reflation. Specifically, we are used to cases where the central bank tightens its monetary policy to reduce inflation. In those cases, we usually go through a situation in which the effective rate of inflation remains above the actual rate of inflation in the initial period of the disinflation process owing to insufficient credibility on the new policy. Because of this expectation and disequilibrium and other factors, such as wage and price rigidities, disinflation is usually accompanied by output losses and unemployment rate above the natural rate.

In the case of Japan, the situation is completely different. Despite the Bank of Japan's accommodative monetary stance, expected inflation is lagging actual inflation, which is still low but has been rising. As a result, Japan is on the other side of the Phillips curve, with output above and employment below the natural rate.

How can we get out of this situation of expectation disequilibrium? Here the policy prescription seems to be simple but at the same time powerful. In both cases, the policy prescription is one of sticking to the policy until people are convinced of its credibility. This implies that in the disinflation case, the central bank should persevere with its tighter monetary policy, while in the reflation case, the Bank of Japan should maintain a policy of sustained monetary accumulation. In both cases, the authorities need to convince people that they will not abandon their policies.

Box 1 of the staff report seeks to provide an explanation of why inflation expectations in Japan are low. We will focus on two arguments presented by the staff. First, the staff shows a positive correlation between age and inflation expectations in Japan, with the younger generation having lower inflation expectations than older cohorts. The explanation provided by the staff is that people form backward-looking expectations. Older people have higher inflation expectations than younger people due to the latter's limited exposure to inflation. We would argue that from a theoretical perspective, a more plausible assumption is that both the young and the old form expectations rationally and that the expected inflation might be low because of credibility concerns about the continuation of an accommodative monetary policy, but we understand that the issue raised by the staff reflects an empirical relationship. However, even if we were to admit the possibility of backward-looking expectations, it should be recognized that Japan has experienced deflation or low inflation from the mid-1990s, which makes it hard to believe that older people could give significant weight to inflation and the experience that occurred a long time ago.

Finally, the second issue raised by staff is product downsizing. The argument is that with intense competition and low inflation expectation, Japanese firms search for ways to respond to rising costs by not raising prices through product downsizing. That is the practice of substituting similar products with a reduction in size and/or weight. First, if this is the case, the CPI needs to be revised, because over time it is measuring different baskets of product and underestimating actual inflation. Second, it is hard to see how this issue could affect people's expectations as people presumably take this factor into account when forming their expectations. Any comment by the staff on these issues would be welcome.

Mr. Agung made the following statement:

I join other Directors in thanking the staff for a comprehensive analytical report and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their insightful buff statement.

The Japanese authorities have identified aging and a shrinking population as the national challenge. The analysis of both the authorities and the staff clearly saw the potential significant adverse impact of the aging population on the long-term growth, inflation dynamics, and public debt sustainability. This would require a delicate balancing of macroeconomic policies in the near-term and, equally important, steadfast commitment to a broad set of mutually reinforcing structural reforms. We fully appreciate the progress of the reform process, as discussed in the buff statement, and look forward to hearing future updates.

We issued a gray statement, and I would like to highlight a few key additional points. First, the impact of structural reform is highly dependent on the perceived efficacy of the reform package. We have known for some time that the reform can result in multiple equilibria ranging from desirable steady states, if they are seen as credible, to unfavorable outcomes if they are deemed less credible. This is similar to the observation of Mr. Fanizza and Mr. de Villeroché. It is important to have a clear understanding of whether the reform path and its implementation are sufficiently credible.

Second, the widespread application of technology, particularly automation and artificial intelligence (AI), can be useful in overcoming some of the labor constraints and declining productivity challenges posed by the aging society. However, automation can also have negative consequences on the low-skilled segment of the labor sector. We encourage the staff to continue its work in monitoring and evaluating the crosscutting impact of technological advances as part of its surveillance activities.

Finally, we reiterate our appreciation of the authorities' continued commitment to promoting a multilateral free and open trade system, as well as their voluntary participation in the legal and institutional assessment along the context of OECD and the Bribery Convention.

Mr. Kaya made the following statement:

We join other Directors in thanking the staff for the excellent set of reports and their answers to technical questions and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their comprehensive buff statement.

Japan continues to grow above its potential, but inflation remains stubbornly low. This constellation has become commonplace in many advanced economies in the recent decade, and there is much to learn from Japan's experience in this respect. We commend the staff for taking a longer-term perspective in this year's Article IV consultation and for focusing on the impact of demographic change on economic performance. Japan is at the forefront of a development that to some extent awaits most advanced economies in the years to come.

We agree with Mr. Ray and Mr. Jin that the per capita growth could feature more prominently in the report given the changing population, and on that metric, Japan performs strongly. Nevertheless, the demographic pressures will intensify further and will affect fiscal and monetary policy alike.

The third arrow of Abenomics, namely deep structural reforms, is essential and inevitable. We agree with the staff's prioritization, which assigns the labor market reforms the highest urgency. Continued deregulation in product and service markets should complement them. The very high debt burden exposes Japan to a range of fiscal risks, as stated in the Debt Sustainability Analysis (DSA). The authorities should design and implement a credible consolidation strategy based on realistic assumptions. Containing the health care spending as well as the general social security spending should be the key elements alongside the gradual and steady consumption tax increases. Monetary policy should remain accommodative, but the staff rightly points to the need to monitor its side effects.

The Bank of Japan conducted by far the most aggressive balance sheet expansion of all the major central banks, and as pointed out by Mr. Meyer, the exit will be unprecedented and challenging. We fully agree with the staff that communication should be improved to better shape the expectations of the market participants and thereby improve the monetary transmission.

Finally, we welcome the progress on implementing last year's Financial Sector Assessment Program (FSAP) recommendations and encourage the authorities to further strengthen financial oversight, including enhanced risk management capacity. This pertains mostly to the regional banks, whose profits are hardest hit by the shrinking and aging client base in combination with the low-yield environment, and therefore are involved in more aggressive search for yield.

Mr. Inderbinen made the following statement:

We thank the staff for the report and the selected issues papers and also for the responses they provided to our questions.

In our gray statement, we note that Japan's economic outlook remains positive—as also emphasized in the helpful buff statement by Mr. Kaizuka, Mr. Saito, and Mr. Komura—but that inflation remains low, and the downside risks have increased and also point to increasing demographic pressures. Against this background, we recommend continued fiscal consolidation, which we believe remains crucial, particularly also given the clear findings of the DSA that the staff has conducted.

We would strongly agree with what Mr. Tombini, Mr. Ray, and others have said in terms of the costs of delayed consolidation. We also find that what Mr. Meyer and Mr. Buetzer wrote in their gray statement is very pertinent to the structural issues of adverse demographics and issues of low productivity growth, that these should not be answered primarily through continued fiscal stimulus.

We take good note of the authorities' goal to reach primary surplus by the 2025 financial year. We also take good note of the mitigation measures that are envisaged to counteract the effects of the further increase in the consumption tax. We believe that against this background, it might be valuable to make a distinction on when concrete measures of consolidation are taken and when a commitment to a credible consolidation plan is made; and we would emphasize that the commitment should be made as soon as possible and that determining when concrete measures are taken will depend on the conjunctural situation of the country. We welcome the concrete measures that will be taken from FY2019 onward.

My second remark relates to the financial sector, and here we welcome the new supervisory framework of the Japan Financial Services Agency (JFSA). We also welcome the stepped-up supervision of the regional banks as outlined in the buff statement, and also acknowledge the important progress that has been achieved already since the 2017 FSAP.

We would note in closing that there are some big-ticket items that remain from the 2017 FSAP. One is enhancing the independence of the Bank of Japan and the JFSA, and also issues like the statutory power of the JFSA to set bank-specific capital requirements based on risk profiles, and we believe this would be important in particular also given the challenges faced by the regional banks currently.

Ms. Mannathoko made the following statement:

We have issued a gray statement, so I wanted to comment on the real long-term challenge that Japan faces. In the background papers, I noticed there were some simulations done on the macroeconomic implications of automation with a declining labor force—essentially the long-term strategy is robotics automation, taking advantage of the capital intensity and using that to employ the younger generation. I was wondering if the staff could talk about future work in this area. The assumption is that automation will occur alongside a declining labor force because the population is aging; however, we also note that there is displacement, so as automation rises, the non-workers will increase. If one takes it through to the end, the simulation rate implies a future economy where there is a workforce of young people who are very skilled, well educated, and very wealthy, and then a larger, broader population of the displaced workers and retirees. That suggests that the GDP challenge is addressed; but it would be interesting to see work in terms of what the social welfare system will look like, and what kind of job program will exist for displaced workers which informs reskilling.

Mr. Siriwardana made the following statement:

We join the other Directors in thanking the staff for the well-written reports and an equally good set of selected issues papers. We thank Mr. Kaizuka, Mr. Saito, and Mr. Komura for the insightful buff statement. We also thank the staff for responding to the questions in our detailed gray statement. I will limit my comments to the following four points for emphasis.

First, like other Directors, we observe that more needs to be done to solidify the recent expansion and ensure Japan's continued economic prosperity and well-being against the backdrop of a shrinking labor force and high government debt. This mainly entails the full implementation of structural reforms such as labor market reforms and measures to improve productivity to raise the potential growth by reducing constraints on economic growth.

On the labor market, we note the critical importance of effectively implementing recent legislation for labor market reforms and support the envisaged policies to ensure labor supply and higher wage growth, as alluded to by Ms. Levonian. We welcome the increasing numbers of female and older workers, as well as foreign workers. In this regard, we agree with the staff on the need to provide childcare and nursing care facilities and reduce the gender wage gap to improve female labor force participation.

On the productivity, further measures in automation, AI, and provision of robots will help improve productivity in the future. It will also serve as a partial solution to deal with the rapidly shrinking labor force.

As a country that already has an impressive level of technical development, Japan may also be the first to grapple with a threat to the human workforce posed by automation in the fourth industrial revolution. Hence, Japan's unique experience with these two interesting forces will provide important lessons on domestic employment and income growth. We would expect the staff's comments on this.

Second, we observe that rural Japan is likely to be hit hardest by the shrinking population. We also note that poorer and older prefectures have shown higher inequality as well. Hence, like Mr. Rashkovan, Mr. Virolainen, and others, we support having safeguards in necessary reform measures, and reforming health care spending and the general social security system to protect low-income households and disadvantaged groups while addressing intergenerational and regional inequality, as they have distributional effects.

Related to this, we would like to hear more from the staff on the recent recommendations by the Fiscal System Council in Japan to go ahead with the proposed consumption tax hike in next October, taking all steps to prevent a downturn while also avoiding fiscal expansion due to offsetting measures.

Third, with regard to the concerns expressed by the Japanese authorities on the REER assessment and the EBA methodology, like Mr. Beblawi, we would welcome the staff's comment in response to our questions about actual work on the relationship between the income account and the REER.

Finally, we agree with Mr. Mahlinza that preserving and broadening the gains of global trade integration requires countries to work together. In that vein, we commend the Japanese authorities for their commitment to move ahead with multilateral efforts to advance a free, fair, and rules-based trading system amidst the present turbulent global trade environment.

Mr. Raghani made the following statement:

We also thank the staff for the reports and answers to our questions. We also acknowledge the insightful buff statement by Mr. Kaizuka, Mr. Saito, and Mr. Komura. We agree, and I would like to emphasize two points.

We commend the Japanese authorities for their resolve in implementing the three pillars of their economic policy over the past years and for the related achievement amid shocks linked to natural disasters. Going forward, we understand that fiscal policy will be central in their strategy as they strive to cope with demographic headwinds and related effects. We stressed in our gray statement the need to carefully balance fiscal consolidation and actions to support the growth momentum. In this regard, we learned from the staff’s written responses to questions that the increase in consumption tax has had a larger-than-expected negative impact on growth when first implemented in 2014. We would, therefore, recommend that the authorities consider mitigating measures to support growth, as well as additional revenue measures in their package in preparation for next December.

Second, on structural reforms, we see the recently adopted labor market legislation as a good step to enhance labor supply. Going forward, and considering Japan’s significant challenges linked to aging and shrinking population, we share the point made by Mr. Virolainen, Ms. Levonian, and Ms. Pollard that the authorities should continue investing in childcare facilities to further boost female labor force participation. With that, we wish the Japanese authorities every success in their endeavors.

Mr. Mouminah made the following statement:

We join other Directors in thanking the staff for the extensive report and the comprehensive answers, and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their detailed buff statement.

We issued a detailed gray statement, so I will be brief. We commend the authorities of Japan for the progress made in implementing the comprehensive reforms and the plan to accelerate them in the period ahead. We consider that the staff has rightly focused this year on the demographic challenge, which continues to be the main challenge facing the economy. Similarly, the still-low inflation environment would necessitate further remedial actions that go beyond monetary policy.

Against this background, we agree with Mr. Kaizuka that the adopted policy mix of Abenomics has created a favorable macroeconomic environment to accelerate the reforms and further strengthen the policies to boost productivity and growth.

We also note that much of the policy advice to boost growth amid adverse structural issues have already been identified under the authorities' reforms and growth strategies. Therefore, the priority is to ensure the implementation of the identified fiscal, monetary, and financial policies, while also accelerating the implementation of the wide-ranging reforms, particularly in the labor market. With these remarks, we wish the authorities continued success.

Mr. Ray made the following statement:

Like others, we thank the staff for an interesting set of papers and Mr. Kaizuka, Mr. Saito, and Mr. Komura for an excellent buff statement. I want to make three points.

First, I support Mr. Jin's view that Japan's performance in recent years has been quite remarkable in many ways, particularly when one looks at it in per capita terms. We would, as we said in the gray statement, probably look at GNI rather than GDP, particularly in Japan's case, but it is quite remarkable, especially when one thinks about what has happened to Japan's terms-of-trade in recent times.

Typically, we think about terms-of-trade shocks for commodity exporters, but the last time I looked at it, Japan's terms-of-trade just mirrored Australia's, and so the size of the terms-of-trade shock for Japan has been as big as for an economy such as Australia's, and it shows that there is an underlying flexibility in Japan that many people might not realize.

On demography, it is not exactly an exogenous thing, and there is a public-choice question here, and I do wonder whether the staff could assist the Japanese authorities to think about that public-choice question with some analysis about what Japan might be able to do to change some of its future demography and the economic benefits of doing so. I also wanted to comment on the Bank of Japan's communication. We are not convinced that publishing a staff forecast would greatly improve the bank's communication given that it already publishes the board's forecasts, and those forecasts are presumably informed by the staff. Having two sets of forecasts could confuse matters. On the other hand, if the bank gradually phased out references to quantitative targets, that could possibly help with its communication.

Mr. de Villeroché made the following statement:

I thank the staff for this very good set of documents, and Mr. Kaizuka, Mr. Saito, and Mr. Komura for their informative buff statement. I would like to add the following comments to our gray statement.

We concur with the staff that Japan's strategy remains adequate and consistent even though downside risks, including external, need to be addressed and measures need to be taken to put the public debt on a downward trajectory.

In terms of fiscal policy, we believe that the fiscal consolidation should proceed in a gradual manner, anchored by a credible medium-term fiscal framework; and we take note that the objective of reaching a positive primary surplus by FY2025 was postponed due to a delayed hike of the VAT and the need to generate additional resources to support and enhance the labor force participation.

On the monetary policy side, monetary policy should remain accommodative and forward-looking. While we note the staff's recommendation to further enhance the forward guidance framework, the authorities have already acted on that front, and the literature has shown that expectations are mostly backward-looking, limiting the reach of forward guidance, so we thank the staff for the answer in this aspect. I do not want to elaborate now on the importance of structural reforms, and we need to enhance medium-term productivity.

On the nexus between population aging and global imbalances, it is necessary to ensure good articulation between the different recommendations made to the authorities and to fully draw on the different aspects of the staff's macroeconomic diagnostic. In the case of Japan—an advanced economy with a persistent current account surplus and a relatively low level of domestic investment due to cash-holding phenomenon and a persistent low inflation level—we would be cautious about recommending measures that would rely mostly on higher aggregate savings, since it could create or exacerbate other imbalances.

We fully agree with the set of structural reforms to enhance participation, notably of women, raising productivity. However, we wonder whether the recommendation of the SIP to rely mostly on the hike of the consumption tax has been sufficiently thought through, including in the context of rising income inequalities in Japan and the potential impact on consumption. In past Article IV consultations, we had recommendations on property taxes and the increase on the personal income tax, and we think this should be considered as well.

Lastly, I would like to praise Japan for its commitment to multilateralism. It is welcome in these days.

The staff representative from the Strategy, Policy, and Review Department (Mr. Cashin), in response to questions and comments from Executive Directors, made the following statement: [1]

First, on the monetary policy accommodation question, we spent a lot of time and staff resources looking at Japan's monetary policy accommodation, the side effects of those policies, and the consequences for the economy if and when monetary policy normalization occurs. Some of the major side effects that we saw were: looking at the functioning of the Japanese Government Bond (JGB) markets, particularly given the dominance of Bank of Japan purchases; also the functioning of exchange-traded funds (ETF) markets given the large purchases in that market. So, both ourselves and the Bank of Japan are certainly looking at both of those markets as key signals of increasing side effects.

The other main side effect which we did focus on—we made visits to various regions of Japan as well to talk to the regional banks—is the low interest rate policy of the Bank of Japan and combining that with the effects of demographics, which definitely has consequences for the profitability of the regional banks. While we do not see any of those side effects at present as being a systemic risk, we are paying increasing attention to them, because as long as the accommodative monetary policies remain, those consequences will increase, particularly when they are placed alongside the adverse demographic factors (an aging and shrinking population) that are operating in Japan.

There were several questions about inflation expectations that quite correctly pointed out that this is a key feature of Japanese macroeconomics. We have done some supplementary analysis of Japan inflation expectations formation, and to be perfectly frank, it is a very strange beast. According to our analysis, Japan has the most backward-looking inflation expectations formation of any advanced economy, indeed of any emerging market economy. Basically Japan as a country is number one for backward-looking expectations, and what we tried to do in the Box contained in the staff report

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

was unlock some of the reasons for that. In the process we looked at the age cohort, because basically now there are people reaching the age of 20-25 years, and they have never seen positive inflation, so that is where the age of the cohort distribution is quite illuminating. But Executive Directors are quite correct that this product downsizing adaptation—we think it is mostly a consequence of excessive competition among the retail sector in particular—is also contributing to the great reluctance of firms to raise retail prices for any reason at all. The last chart in the Box showed the distribution of Japanese commodities that have a zero rate of increase in consumer prices, which in the case of Japan is firmly anchored around zero with the mode of its distribution, whereas other economies such as the United States are anchored at about the 3 to 3.5 percent range for price increases. Those zero-price-increase commodities are much more common in Japan and many other economies rather than the United States.

Japan has done a good job at anchoring inflation expectations, but unfortunately they are firmly anchored at about 1 percent, below the target rate of 2 percent CPI headline inflation, and the authorities' ongoing efforts have concentrated on trying to raise those expectations.

There was a question about demography and some of the assumptions we used in some of our analyses. We have two forthcoming Working Papers, and we had a few Boxes in the staff report looking at this issue, and Mr. Ray is correct that we took the official demographic projections from the authorities into both of those analyses, which looked at the effect of structural reforms on the economy and also on the social security and health financing dimensions. We will return to analyzing demographic factors in the future, and certainly demographics is an endogenous process, so we can then look at what effects public policies might have on, for example, increasing birth rates and some of those other factors (such as fertility) which would definitely help Japan push back against the aging and shrinking of its population.

The staff representative from the Asia and Pacific Department (Mr. Schneider), in response to questions and comments from Executive Directors, made the following statement:

I will pick up on three questions. One was on the staff's advice with respect to fiscal policy and fiscal consolidation, in particular whether or not there has been a shift. The answer is that the present is a year later than the previous staff report and we are not operating in a vacuum. The government has several times reaffirmed its commitment to raise the consumption tax rate by 2 percentage points in October 2019, and that is a credible commitment. In that context, when we were talking about the path for fiscal consolidation and what the staff's recommendation is, the discussion has shifted somewhat because now there is a firm commitment, and the emphasis was on making this next consumption tax rate increase a success in what is still a somewhat unsettled macroeconomic environment. The government certainly wants to make it more of a success than the last consumption tax rate increase in 2014, where there was a massive amount of volatility in consumption and investment.

The focus of the Japan Article IV discussions was how to make the increase in the consumption tax rate a successful increase with lower volatility in domestic demand; and in that context, the staff was recommending measures to support a neutral fiscal stance in 2019 and 2020. The essence of the staff's advice regarding the course of fiscal consolidation beyond 2020 was the second part of the discussion, because we are clear that an increase in the consumption tax rate to 10 percent will not be sufficient to meet expenditure needs, particularly growing expenditures related to health care and pensions. In that sense, our advice has not changed in recent times. We still see gradual increases in the consumption tax rate of a small degree—say a half a percentage point at regular intervals—as a more optimal way to increase revenue over the medium term.

On the question on agricultural subsidies, the chart associated with paragraph 35 in the staff report shows that agricultural support in Japan, in particular the producer support equivalent, is relatively high. The chart on the left panel compares Japan with the G20 advanced economies' average and with the G20 average industry support. This chart also confirms that Japan's agricultural support is relatively high, at least for 2015 and 2016. But this is the only sectoral area measured where Japan's trade and FDI regimes show relatively less openness than the OECD average. In that sense it is important to take into context that there are ongoing efforts certainly within the CPTPP to advance agricultural sector reforms, which the staff supports.

Lastly, with respect to the work that we did on automation and the potential income redistributional consequences, that is true; those consequences do exist. We wanted to look at Japan outside of the G20 however. Most of the work that has been done on the consequences of automation had amalgamated or aggregated advanced economies, and certainly the recent G20 work has done this. We felt that conditions in Japan, given its population dynamics and a shrinking workforce, were essentially very different from most OECD countries, and we did get rather different results. However the thread of the distributional consequences of automation is consistent through all the work, and Japan is not excluded from that. The policy recommendations that we are looking at focus on what will be done with education, what will be done with the social safety net, and what policies are optimal in this context to make automation labor-augmenting rather than labor-replacing. Labor-replacing automation is a concern, and it is certainly an area where Japan team intends to do more work.

Mr. Kaizuka made the following concluding statement:

I thank Directors for this rich discussion. I thank them for the valuable comments and the inputs. I will duly convey these to my authorities, which could be fully utilized in shaping our future policy options.

I would like to pick up some of our discussed points and share our thoughts and policy responses. I have five items to raise: the economic outlook, structural reform, fiscal policy, monetary policy, and the external sector.

On economic outlook, the Japanese economy is on a steady growth path. The recent third-quarter GDP figures marked a negative 0.3 percent on a quarter-to-quarter basis, but this negative figure is largely attributed to the series of natural disasters which happened during this period. There are certain positive recent indicators which confirm the steady growing path of the economy. For example, machinery orders for the third quarter, one of the leading indicators, showed a 0.9 percent increase on a quarter-to-quarter basis, resulting in the expansion over five consecutive quarters.

On the policy front, in order to proceed with the reconstruction work after the disasters, the government of Japan formulated a first supplementary budget amounting to ¥1 trillion, which is about 0.2 percent of the GDP, which was already approved by the Diet. Furthermore, Prime Minister Abe issued an order to formulate a second supplementary budget on Tuesday which would include expenditure on enhancing resilience to natural disasters, as well as strengthening the agricultural sector as the TPP or CPTPP will enter into force in December. While the size of the budget will be determined in the coming weeks, these measures will make the path of the economy firm in the coming year.

Structural reform is the central part of Abenomics. Let me highlight some of the reform agenda. The labor market reform is a top priority agenda for the current administration. The work-style reform legislation is a critical step to tackling with the problem of the Japanese labor market, including the labor market duality and overtime work. We are now making efforts to ensure effective implementation of this legislation, for example, by developing a guideline for the implementation. Labor market reform is a continuous process. The government has recently submitted another legislation to create a new status of residents to accept the foreign workers who have a certain level of professional and technical skills. The legislation is now being discussed in the current Diet. We will continue this challenging journey.

I would like to emphasize our effort to promote an open and rules-based monetary trading and investment system, which many Directors positively noted. The negotiation completed for the CPTPP and the Japan-EU Economic Partnership Agreement is in the final stage. These agreements will contribute to not only lowering the tariff, but also to facilitating domestic deregulation and ensuring the proper rules. For example, the CPTPP has included clauses to adapt certain regulations restricting the establishment of a business entity in participating countries and also rules to prohibit the participating countries from requiring investors of the other participating countries to transfer particular technologies. I hope our experience in these areas may contribute to the discussion on trade, which is going to the Board soon.

The staff recommends to further deregulate several industries and professional services. The staff's written answers pointed out that engineering and accounting services have relatively restrictive regulation in professional services in Japan. We look forward to having more granular policy discussion in the next Article IV consultation, as we did not have sufficient time to have these micro-level discussions while the mission team was in Tokyo this time.

On the fiscal side, we firmly maintain our principle that without economic revitalization, there can be no fiscal consolidation. Under this principle, we now aim to achieve the primary balance surplus by FY2025 instead of FY2020. Given the severe demographic changes, we need to put social security reform at the center of our goal to achieve the first fiscal target. In this regard, as many Directors noted, we will conduct a comprehensive review of the social security system in 2020, facing the demographic challenges, which could contribute to the discussion on the demographic changes in our presidency of the G20.

On the possible mitigation measures to contain demand fluctuation before and after the tax consumption rate hike scheduled in October next year, although the complete set of measures can only be available when the FY2019 budget and tax reform negotiation are completed by the end of next month, I would like to share with some of the current discussions.

The government is discussing specific measures for creating advantage of durable goods, including automobiles and housing, after October 1, 2019. The government is also discussing a complete redesign of a consumption point reward system scheme to support private consumption and SMEs. Furthermore, while enabling SMEs to pass consumption tax to their business partners, the government is also developing a guideline to allow firms to set prices flexibly according to demand fluctuations.

On fiscal, there is a discussion on the possible creation of independent fiscal institutions. Here the important point is not whether to create a new institution, but how to make our economic projection more realistic. We will work closely with the Fund for this objective by fully utilizing two existing councils.

On monetary policy, in order to achieve the price stability target of 2 percent, we believe it is necessary to persistently continue with the current powerful monetary easing. The Bank of Japan decided at the July 2018 monetary policy meeting to enhance the sustainability of the policy, as we mentioned in the buff statement. As it has been taking time to achieve the price stability target of 2 percent, it has become necessary to persistently continue with powerful monetary easing while considering positive effects and also the side effects of monetary policy in a balanced manner.

Last but not least, on the External Sector Assessment, we echo Mr. de Villeroché and others who were encouraged that the staff agrees that trade elasticity is relatively low in Japan and additional work on the relationship between the income account and REER is needed. We appreciate the staff's intensive effort regarding an update of an EBA methodology and we look forward to further discussion on this particular subject.

The Chairman noted that Japan is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors broadly agreed with the thrust of the staff appraisal. They welcomed Japan's remarkable economic growth performance, especially in per capita terms, and the prospect of continued above-potential growth in the near term. Directors nevertheless noted that inflation remains below target and that downside risks have risen, notably from the upcoming consumption tax rate increase and deteriorating global conditions. Moreover, intensifying demographic headwinds continue to pose challenges. Directors emphasized the need to reinvigorate the policies of “Abenomics” to achieve sustained high growth, durable reflation, and public debt sustainability.

Directors generally underscored the importance of maintaining a neutral fiscal stance to support near-term growth and reflation. They welcomed the authorities’ plan to implement temporary measures to alleviate the adverse impact of the scheduled increase in the consumption tax rate, accompanied by clear communication to the public. For the medium term, Directors saw merit in developing a well-specified fiscal framework, based on realistic assumptions, to reduce policy uncertainty and anchor a gradual consolidation path toward debt sustainability while addressing demographic challenges. While an independent fiscal institution could be helpful in this regard, some Directors saw scope to achieve these objectives within the existing institutional arrangements.

Directors welcomed the authorities’ ambitious structural reform agenda aimed at lifting potential growth. They stressed the importance of strong government commitment to mutually-supportive reforms, with priority given to labor market reforms to enhance labor supply including from female, older, and foreign workers. Directors recommended further efforts to eliminate tax and social security disincentives to full-time and regular work, reduce the gender wage gap, and increase the availability of childcare and nursing facilities. They also encouraged the authorities to further deregulate product and services markets, facilitate entry and exit of firms, promote small- and medium-sized enterprises, and deepen corporate governance reform.

Directors agreed that monetary policy should remain accommodative, possibly for an extended period to successfully reflate the economy, while carefully monitoring and mitigating side-effects. They stressed that effective communication and forward guidance would help reduce market volatility and guide inflation expectations.

Directors recognized the challenges facing the financial sector, especially from demographic pressures and low interest rates. They welcomed the progress made in implementing the 2017 FSAP recommendations, in particular, the new more forward-looking supervisory framework. Directors highlighted the importance of enhancing risk management, financial oversight, and the macroprudential framework. They welcomed the authorities’ close engagement with regional financial institutions to help adapt their business models to demographic trends. Directors also saw priority in facilitating financial institutions’ use of Fintech and strengthening crypto-asset oversight.

Directors took note of the staff’s assessment that Japan’s 2018 external position and real exchange rate are projected to be broadly consistent with fundamentals and desirable policies. They agreed that a credible fiscal consolidation plan combined with bolder structural reforms are needed to maintain external balance over the medium term. Directors also noted that advancing multilateralism would help mitigate inward spillovers from heightened trade tensions, and appreciated Japan’s leadership role on this front.

Directors commended the authorities for volunteering to participate in the Fund’s initiative to assess efforts to address supply-side of corruption in Japan’s Article IV consultation. They looked forward to continued progress in enforcing foreign bribery laws.

It is expected that the next Article IV consultation with Japan will be held on the standard 12-month cycle.

APPROVAL: April 8, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Real Sector

1. Could staff comment on the possibility of having a vicious cycle of low fertility and low spending that could weaken the growth momentum and how policy reforms would address such a situation?

- There are several channels through which adverse demographic trends could hamper Japan's growth momentum. Investment by firms would be discouraged due to the shrinking size of demand. Households—with increased financial burdens related to age-related social security costs—may also be incentivized to save for precautionary reasons.

- To address these challenges, staff stresses the importance of a credible and well-specified fiscal framework including the reforms to health care and structural reforms to boost growth and productivity. A credible fiscal framework will reduce policy uncertainty and prevent excessive precautionary savings. It should be accompanied by social security reform, mainly in health care sector, to contain total spending, generate fiscal savings, and improve efficiency, while preserving public welfare. Credible structural reforms which prioritizes labor market reforms focusing on investment in human capital and increasing labor supply, would also boost wages and sustain growth momentum and productivity.

2. Could staff comment on the plans to further open-up labor market to foreign workers?

- Japan's share of foreign workers is relatively low but has been increasing in recent years. Most labor inflows go to manufacturing, hotels/restaurants, and wholesale/retail. In June 2018 the Cabinet decided to create a new status of residence to allow foreign workers into the country to ease labor shortages and, if the relevant act is amended, starting in April 2019, Japan will accept foreign workers who have a certain level of professional and technical skill.

3. Could staff comment on the impact of technological developments on inflation in Japan?

- Japanese firms face severe labor shortages, with declining population amid strong economic performance. Instead of offering higher wages to attract workers, many firms have instead begun to invest in labor-saving technologies. This has partly contributed to private non-residential investment growth which may have translated into positive price pressures. However, absent sufficient increase in nominal wages, this has had only a limited impact on inflation.

4. ***Could staff comment on the medium-term plans to ensure national resilience to natural disasters in Japan?***

- The authorities adopted the "Fundamental Plan for the National Resilience" in 2014 with a view to address potential vulnerabilities to large scale natural disasters. This covers various aspects, including the government function, public infrastructure, and financial markets. The authorities formulate the concrete action plan every year to take necessary steps in accordance with the "Fundamental Plan." In addition, given the recent severe natural disasters, Prime Minister Abe announced on November 20 that the government will formulate another supplementary budget to further accelerate expenditure on disaster resilience.

5. ***We agree that further labor market reforms, including training, contract revision, and addressing pay gaps are crucial and could have positive impacts on productivity. Could staff opine on these reforms' impact on potential output?***

- Staff estimate that the implementation of the overall proposed reform program will boost potential growth by up to 0.5 percentage points, with labor market reforms contributing over half of the improvement (further details in the forthcoming IMF Working Paper *Macroeconomic Effects of Japan's Demographics: Can Structural Reforms Reverse Them?*).

Fiscal

6. ***Staff recommends the automobile acquisition tax to be lifted as part of the mitigating measures. Has staff reflected on the environmental effects of this recommendation?***

- The government's environmental objectives will continue to be met by replacing this automobile acquisition tax with an environmental excise in October 2019 (see 2018 Selected Issues Paper "The Impact of Consumption Tax Increases and Their Policy Implications for Japan" footnote 15). This is a 'package'— replacing the automobile acquisition tax with an environmental excise in 2019, at the same time as the consumption tax increase. The measure, which is intended to revamp the environmental aim of automobile taxation, will encourage consumers to purchase environmentally friendly vehicles as they are then eligible for a tax reduction on the environmental excise.

7. Can staff more broadly elaborate on potential behavioral changes pursued by the tax shift towards consumption taxation?

- In the near-term, consumption is likely to rise prior to the tax hike but then contract, causing some demand fluctuations in 2019–20. However, given that the authorities have not fully specified their medium-term consolidation plan (including the views on consumption tax rate increases beyond 10 percent), staff does not expect substantial changes in household behavior beyond the near-term. If a credible medium-term fiscal framework (together with much-needed structural reforms) successfully reduces policy uncertainty, it could potentially unlock some portion of precautionary savings.

8. Does staff have a sense of whether the measures to offset the October consumption tax increase to be included in the December draft FY2019 budget will be sufficient to avoid a sharp drop in consumption?

9. We understand that the authorities will formulate by December, additional measures to mitigate the impact from the 2019 planned consumption tax rate increase. Can staff confirm whether the authorities intend to consider their recommendations, notably addressing concerns over durable consumption or setting a time-bound and well-targeted tax rebate or transfer program for low-income households?

- Details regarding the authorities' mitigating measures will not be available until December 2018. However, the authorities have expressed their strong commitment to take all possible measures to mitigate the impact of the planned consumption tax increase. They have also emphasized the need for addressing demand fluctuations, in particular for durable consumption.

10. Could staff elaborate on the feasibility of adopting the gradual approach proposed in the report that envisages an annual consolidation of about 0.5 percent of GDP in the structural fiscal balance starting from FY 2021? What are the authorities' views regarding gradual and steady increases in the consumption tax rate beyond 10 percent, as well as about the reforms proposed by staff to put the healthcare system on a sounder footing?

11. Staff recommended that the consumption tax rate needs to be raised well beyond 10 percent. We wonder what the authorities' view is, and welcome staff's comments.

- The authorities have not committed to any further increases in the consumption tax beyond the two-percentage point increase slated for 2019. In general, the authorities noted that a gradual approach could have merits in terms of smoothing the economic impact but highlighted larger compliance costs for firms and the administrative burden for the tax authorities.

- Staff is cognizant of the potential political challenges of increasing the consumption tax over multiple consecutive years. On the other hand, the 2014 consumption tax hike had a larger than expected negative effect on growth—contributing to the decision to postpone the next rate increase from 2015 to 2017, and then to 2019. Staff is of the view that a more gradual path of consumption tax hikes would cause less economic fluctuation and thus increase the chances that they are implemented as initially planned.

- Staff understands that healthcare reform is one of the authorities' top reform priorities. We expect that the planned comprehensive review on the social security systems by FY 2020 will specify measures to curb healthcare outlays.

12. We are surprised by the significant impact of fiscal policies (end of stimulus and VAT hike) for 2019 in staff's estimates (-0.6pp) since the negative effect should be concentrated in Q42019 and mostly affecting 2020 while 2019 GDP growth should benefit from the frontloading of consumption and investment spending prior to the VAT hike. We would be pleased to have staff's comments.

- As mentioned in the Staff Report, the contractionary fiscal stance in 2019 and 2020 (defined by changes in structural primary balance) mainly reflects the withdrawal of the 2018 supplementary budget (for 2019) and the consumption tax increase (for 2019Q4 and 2020). Despite this contractionary fiscal stance, underlying growth is expected to remain solid, with the 2019 growth projected to be 0.9 percent.

- As mentioned in the Staff Statement, the authorities announced a supplementary budget for disaster recovery expenditure. Furthermore, on November 20, Prime Minister Abe announced that the government will formulate another supplementary budget for accelerating disaster prevention and enhancing the competitiveness of agricultural sector. While details are yet to be seen for the latter, these measures will at least partly offset the contractionary fiscal stance.

- Additional mitigating measures for the 2019 consumption tax increase (to be announced in December) are expected to take effect in 2019Q4 and 2020.

13. Though we understand that consumption tax is the preferred financing option, we recall from past Article IV discussions that property tax, asset tax and personal income tax reforms were once contemplated. Could staff elaborate on why these

options are not considered anymore? Isn't there a risk to heavily rely on the consumption tax for enhancing revenue?

- While not discussed in detail, we are of the view that these measures are still valid options to bolster revenue (as mentioned in text chart in page 11), albeit the potential revenue increases would be small compared to what could be achieved through the consumption tax. For more details, please refer to 2017 Japan Selected Issues Paper *Tax Policy Challenges of an Ageing/Declining Population*.

14. Could strengthening the existing two councils not have the same effect as creating a new fiscal council? Could staff elaborate on that?

15. We would be grateful for staff's views on the need for an independent fiscal institution given that two councils currently provide advice on fiscal policy, the Council on Economic and Fiscal Policy and the Fiscal System Council, as argued by the authorities.

16. We are pleased that the authorities view these initiatives as consistent with their new fiscal plan and feasible under the existing framework and institutions. Staff comments are welcome on the merit of exploring how current institutions can be strengthened to further improve the discipline and rigor of the policy framework.

17. We note that there are two councils -one of them with external members- that provide advice on fiscal policies. However, these advisory bodies serve the prime minister and the finance minister, so they do not seem independent. Can staff comment on this point?

- The ultimate objective of staff recommendations is to strengthen the fiscal framework by (i) relying on more independent and realistic assessments of the economic outlook and budget projections; (ii) specifying fiscal consolidation measures; and (iii) limiting the use of supplementary budgets. At the same time, the effectiveness of independent fiscal institutions (IFIs) hinge on their ownership, and the broadest possible consensus. In this regard, staff does not rule out the possibility of achieving the objective through strengthening the existing institutions. Should the authorities pursue this option, staff recommends that these councils start from intensively reviewing the authorities' macro-fiscal projections based on the historical performance while taking into account demographic headwinds. This review could involve external experts.

- More broadly, staff is of the view that an independent fiscal institution (IFI) could play an important role given that progress toward the objectives noted above has been slow. Neither of two existing institutions meets the main attributes described in the OECD Principles for IFIs: independence and non-partisanship; mandate; resources;

relationship with the legislature. With these attributes, an IFI could prepare a medium-term macro-fiscal baseline (no policy change) projection that would serve as the backdrop for evaluating the realism of (i) the government's projection that incorporates the envisaged policy measures and (ii) the annual budget bill and its consistency with the target.

18. Can staff comment on the potential impact of the additional spending for the Human Resource Development Revolution that is envisaged by the authorities?

- The "Human Resource Development Revolution" policy package will redirect some of the revenue raised by the consumption tax rate increase to childcare and pre-school, education, and long-term care. In the near-term, this will mitigate the impact of the consumption tax hike by reducing households' net tax burden (estimated to be about 0.3-0.4 percent of GDP, which we have incorporated into our baseline). The additional spending could also have positive long-run impacts by promoting female labor force participation and raising the fertility rate.

19. While staff recommend avoiding near-term fiscal tightening and instead making plans for gradual consolidation starting from 2021, we do not see much room to postpone fiscal consolidation. Given that by 2021 the external environment could be less favorable, and the domestic economy might be suffering from a post-Olympics slump and a pick-up in the pace of aging, we would welcome staff's clarification of the basis for the starting point.

- Staff believes that a comprehensive and coordinated policy package is needed to help sustain growth, raise inflation, and address medium term challenges—including fiscal consolidation and raising potential growth. In this context, staff believes near-term fiscal policy should avoid premature tightening to support BOJ's reflation efforts and implementation of structural reforms. At the same time, it is critical to make the planned consumption tax hike successful through temporary mitigating measures, especially given the challenging political economy of consumption tax increases in Japan. Although staff is aware of the cost of postponing adjustments, this can be offset by adopting a credible fiscal framework and accelerating much-needed structural reforms.

20. As shown in the past episodes of Denmark and Ireland, some high debt countries experienced so-called 'expansionary fiscal consolidation.' Does staff envisage any possibility of this effect for Japan?

- Staff has not examined this issue closely. However, the 2016 Japan Selected Issues Paper, *Fading Ricardian Equivalence in Ageing Japan,* argued that more households are now more myopic and liquidity constrained in Japan partly due to aging, suggesting a higher fiscal multiplier in the near-term. However, if a credible medium-term fiscal framework (together with much-needed structural reforms) successfully reduces policy uncertainty, it could potentially unlock some portion of private savings, delivering positive impacts even in the near-term.

21. The report discusses specific measures (see pp. 11-12) that can be considered as part of the package of fiscal adjustment. To complement the estimation of the impact of these measures, it may also be useful for staff to discuss some prioritization, synergy and sequencing issues that should be considered by the authorities when assessing the efficacy of these various measures.

- It is important that a credible medium-term fiscal consolidation plan lays out specific measures in a comprehensive manner. Staff sees healthcare reform and gradual increases in the consumption tax rate as imperative building blocks. On the expenditure side, healthcare reform is the most urgent initiatives as per capita spending on healthcare increases rapidly with aging, and as the baby boomer generation will start crossing the 75-years-of-age threshold by 2025. Anchoring healthcare spending is also important to reduce policy uncertainty on additional financing needs. In this context of financing, staff views that gradual increases in the consumption tax rate would be the preferred option. Other potential options (listed in the text chart in page 11) should be implemented gradually taking into account the overall pace of fiscal consolidation as well as political buy-in.

Monetary

22. We broadly agree with the staff recommendations on monetary, fiscal and financial sector policies. However, we would welcome further staff comments on the interaction between the proposals, particularly the impact of the fiscal policy stance on the likelihood of hitting the inflation target and the impact of monetary policy on balance sheets across the Japanese economy.

- Fiscal policy should be supportive of BoJ's reflation efforts. Staff recommends a neutral stance in the near-term and fiscal consolidation over the medium term. To this end, a well specified medium-term fiscal framework will be key. Combining supportive fiscal policy, stronger income policies and sustained monetary accommodation should increase the likelihood of hitting the inflation target. Prolonged monetary policy easing could further encourage portfolio rebalancing of the private sector (away from Japanese Government Bonds (JGBs) to risky assets) and higher risk taking. So far, most of the rebalancing has occurred in financial institutions, while households have remained more conservative and corporates have built up substantial cash holdings.

23. ***We suggest that staff could also consider how asset purchases could be unwound in the future and canvas potential risks. Staff's view would be welcome.***

- Under the yield curve control (YCC) framework, JGB purchases by the BoJ are endogenously determined. So far, JGB purchases have continued but at a declining pace. The BoJ has not provided specifics on how asset purchases will be unwound once policy starts to normalize – emphasizing that it is too early to publicly discuss exit plans. Importantly, clear and effective communication will be essential to limit excess asset market volatility.

24. ***Also, we wonder whether the inflation target of 2 percent as a metric for monetary expansion is excessive. Should BOJ scale this down? What implications might this have for monetary policy and other macro policies?***

- Staff does not believe that the inflation target is set too high. Under staff's recommended policy package inflation should be able to reach the target within a reasonable timeframe. A lowering of the inflation target risk adversely affecting monetary policy credibility and reducing future policy space.

25. ***Could staff elaborate on the BoJ's position regarding moving closer to full-fledged inflation targeting?***

- It is staff's impression that the BoJ shares the view that transparency, accountability, and effective communication (pillars of inflation targeting) are key elements of a strong monetary policy framework. However, BoJ does not believe that publishing staff forecasts together with underlying policy assumptions would necessarily produce added benefits in the current environment. Instead, staff understands that the BoJ believes that its current framework provides enough information about the conduct and motives behind monetary policy (e.g., publication of Board members' projections, the Outlook for Economic Activity and Prices report, and speeches by BoJ officials).

26. ***On a related matter, could staff discuss the authorities' intentions with respect to the recommendations to strengthen income policies and raise administered prices to support reflation efforts?***

- Staff believes the authorities generally concur with staff's view on income policies and administrative prices. They have acknowledged that weak wage growth hampers reflation efforts and that income policies could play a role in lifting nominal wages. The authorities have raised minimum wages and implemented corporate tax incentives to encourage corporates to raise wages. Moreover, the BoJ has long pointed to limited price increases of administrative prices as a significant drag on inflation.

27. Large and sharp appreciations run the risk of lowering actual and expected inflation. We encourage the authorities to closely monitor these effects. Staff's elaboration on other important side effects of prolonged monetary easing would be welcome.

- Direct side effects from prolonged monetary easing relate to (i) continued JGB purchases and the impact on the functioning and liquidity conditions of the JGB market; and (ii) ETF purchases and possible equity price distortions and deterioration in corporate governance. Prolonged monetary easing also reinforces the chronic low interest rate environment stemming from demographic pressures (i.e., low real natural interest rate) and persistently low inflation expectations. Low interest rates, in turn, have resulted in declining profitability of financial institutions and increased search for yield. The situation is particularly pressing for regional financial institutions. However, while these side-effects do not currently constitute a systemic risk, they could become more acute over the medium-term if left unattended.

28. We agree with staff that further improvements in the Bank of Japan's communication framework, such as moving it closer to full-fledged inflation targeting, are likely to enhance policy predictability and generate public support for achieving the inflation target. In staff's opinion, are there any downside risks to the policy of even greater transparency?

- Increased transparency could be counterproductive if, for example, it reveals deficiencies in a central bank's ability to conduct monetary policy (e.g., due to lack of institutional, technical or human capacity). This is not the case for the BoJ. In staff's view, the BoJ has the resources and ability to implement full-fledged inflation targeting, similar to other major central banks. Doing so could help improve the public's understanding of monetary policy, increase predictability, and stem speculation of earlier-than-expected policy normalization.

29. Could staff expand on the possible monetary and nonmonetary measures that could promote forward-looking elements in expectations formation?

- The Japanese deflationary mindset constitutes a significant obstacle for the BoJ in its efforts to re-anchor inflation expectations at the 2 percent target. However, forward guidance combined with effective and credible communication (connecting underlying policy assumption with inflation projections) could help make expectations more forward-looking. It is also important to generate sustained upward movement in realized inflation. Strengthening income policies and raising administered prices, while ensuring that fiscal policy remains supportive, could help in this regard.

30. Finally removing the quantitative target on JGBs purchases of ¥ 80 trillion per year should have little effect as the BOJ seems to have already started to reduce its JGBs purchases. Could staff elaborate on this aspect?

- The quantitative target on JGB purchases is inconsistent with the YCC framework, as JGB purchases are endogenously determined. The current deviation of JGB purchases from the ¥ 80 trillion quantitative guidance complicates market communications and reinforces perceptions that the BoJ is engaging in "stealth tapering."

External Sector

31. We note, however, that the authorities continue to have concerns over the REER assessment. They disagree with the assumed link between the current account and the REER used for the assessment, given the prominent role of the income balance in Japan's current account. Staff's comments on the authorities' concerns would be appreciated.

32. We believe, however, that the concerns expressed by the authorities about the REER assessment and the EBA methodology warrant further discussion. Could staff elaborate on the methodological issues raised by the authorities?

33. Staff comments on the differences in views with the authorities regarding the EBA methodology are welcome.

- The authorities expressed concerns regarding the methodology used for the REER assessment as they question the assumed link between the REER and the current account. In particular, they stressed the weak relationship between the REER and the trade balance in Japan, and the lack of a relationship between the REER and the income account. Staff agree that the trade elasticity is relatively low in Japan and that additional work on the relationship between the income account and REER is needed.

34. Staff comments are welcome on the likely impact of Japan's recent trade agreements on EMDCs and LICs and possible enhancement of regional supply chains in the present turbulent global trade environment.

- As suggested by previous analyses of the Japan-EU trade agreement, Japan and the EU stand to gain from the agreement via boosted bilateral exports (*Trade Sustainability Impact Assessment of the Free Trade Agreement between the European Union and Japan*, European Commission, 2016). The Ifo Institute study "On the

Economics of an EU-Japan Free Trade Agreement" (Felbermayr et al 2017) estimates income gains for Japan of 0.23 percent of GDP every year after the enforcement of the agreement for a period of about 10 years, while the largest gains for EU members reach 0.11-0.19 percent of GDP.

- The Ifo Institute study mentioned above estimates relatively minor trade diversion effects (less than EUR 1.5 billion losses for China, Korea, and Taiwan), while some countries would win (small gains for Mexico and the US).

Financial Sector

35. Could staff elaborate on its recommendation to make loan-loss provisioning more forward looking?

- Loan-loss provisioning has been backward-looking and does not take into account possible future developments in the macroeconomic environment. Making loan-loss provisioning more forward-looking by, for example, using stress testing, could smooth out cyclical fluctuations from a medium- to long-term perspective.

36. Monitoring side effects of monetary policy on the financial sector is important. These side effects will most likely intensify when BoJ eventually starts the normalization of monetary policy. We would like to ask the staff what concrete micro and macro-prudential measures the authorities might take to minimize side effects.

- Investment trusts mainly invest in foreign bonds (41 percent), domestic equities (19 percent), and real estate funds (17 percent). The main direct impact on banks' holdings of investment trusts from normalization is through the BoJ's ETF holdings. The BoJ has been encouraging financial institutions to reduce shareholdings and control their exposures to the associated market risk within an appropriate range in terms of their business capacity. In general, strengthening the prudential frameworks should help mitigate potential side effects from normalization. As recommended by the 2017 FSAP, a full risk-based microprudential approach including more rigorous risk assessment and a risk tolerance framework could help keep pace with more sophisticated activities among financial institutions. Macroprudential measures including broadening the scope of systemic risk assessment and expanding the macroprudential toolkit could help prevent a build-up of systemic risk.

37. The real estate loans-to-GDP ratio has reached a historic high, while the housing market is considered somewhat overvalued. Could staff elaborate on the analysis of the real estate prices?

- An analysis of real estate prices was conducted by the IMF's 2017 Japan FSAP. In particular, an econometric analysis taking into account both demand and supply factors with city-level data shows that condominium prices in Tokyo and Osaka have started exceeding fundamental values by 15−20 percent since 2013. A similar regional analysis also indicates that condominium prices may be moderately overvalued by about 5−10 percent. These results should be interpreted with caution given data limitations and model uncertainty.

38. Also, what specific measures are being considered to increase cyber resilience and crypto-asset exchanges?

- Specific measures could include, for example, detailed cybersecurity requirements on the custody service provided to customers (such as clear rules on the storage of private keys). This would require further enhancing the JFSA's resources and expertise in cybersecurity. Moreover, crypto-asset exchanges should increase cybersecurity awareness and training efforts to increase resiliency amongst their staff. Incident response and continuity planning at crypto-asset exchanges are also important elements for successfully dealing with cyber-attacks.

39. Could staff provide a view on how the JFSA's proposed functions-based approach might better fit the evolving world of fintech?

- In light of the advancement of unbundling and rebundling of services driven by the development of IT and Fintech, the function-based regulatory framework applies the same rules to entities with the same functions and risks. This ensures a level playing field, helping prevent regulatory arbitrage.

40. On anti-monopoly legislation, we commend the authorities for their recent move to provide the Japan Fair Trade Commission with more power in the examination of mergers of regional entities. Could staff share its view on this aspect?

- Staff welcomes the government advisory panel's decision to consider creating a framework to make regional business integration possible or establishing transparent rules to enable decision-making with predictability. Clear guidelines on regional business consolidation (including regional bank consolidation) could help increase the transparency and predictability of the process under the antitrust law. However, consolidation alone is unlikely to be sufficient to address the demographic challenges. Regional financial institutions should continue to adapt their business models to prevailing demographic trends, including through revenue diversification, utilization of IT and Fintech, and consolidation.

41. Demography is raising the critical issue for banks to match supply and demand by adapting the range of financial products to a new ageing population. Could staff elaborate on the necessity for banks to adapt to a new consumer market?

- Banks, particularly regional ones, should adapt their business models to demographic trends. Aging may increase the demand for safe assets, as well as the demand for retirement-related and medical products and services. These could also include wealth management businesses, services for business continuity, and other consultation services. In this context, diversifying revenue sources towards fee-based income from services could help mitigate the demographic impact on banks.

42. For instance, given the commercial banks' significant holdings of investment trust instruments, any reduction of BoJ's holdings may negatively impact banks' profitability. Against this background, we would like to ask the staff what concrete micro- and macro-prudential measures the authorities might take to minimize side effects.

- See response to Question #36.

43. We share staff's analysis that while the banking sector is well capitalized and liquid, some source of vulnerabilities deserves a close attention from the authorities. The low interest rate environment may translate to a "search for yield" behaviors and a bid up in the prices of risky assets. The impact of declining demography on banking sector is to be stressed in this respect. On anti-monopoly legislation, we commend the authorities for their recent move to provide the Japan Fair Trade Commission with more power in the examination of mergers of regional entities. Could staff share its view on this aspect? Finally, demography is raising the critical issue for banks to match supply and demand by adapting the range of financial products to a new ageing population. Could staff elaborate on the necessity for banks to adapt to a new consumer market?

- See responses to #40 and #41.

44. Although the financial system remains stable, staff consider that several risks are being taken that may destabilize it, meanwhile, the authorities do not see excessive risk taking at this time. Is this because although there is substantial risk taking by some institutions, it has not become systemic?

- Low interest rates and demographic challenges have encouraged risk taking among financial institutions. Nevertheless, there has not been evidence of significant excess risk taking relative to banks' risk management capacity from a systemic perspective. However, the amount of risks taken by some financial institutions have exceeded their capital levels. In this context, financial institutions should enhance their risk management capacity to keep pace with the more sophisticated activities. The macroprudential framework should also be further strengthened to prevent a build-up of systemic risk.

Structural

45. We take note of the divergent views between the authorities and staff on the pace of implementing structural reforms. Could staff elaborate why do they assess the implementation to be slow, given the important reforms that already took place, as illustrated in the buff statement?

- Staff acknowledge that the authorities have advanced an important set of structural reforms but is of the view that the pace could be increased to counterbalance intensifying demographic challenges. While there has been recent accelerated progress in some reform areas (i.e. trade reforms), progress in some areas is taking more time. Reforms to address labor market duality are being implemented over several years. For example, the “equal pay for equal work” pillar of the recent legislation will be applied to large companies and temp-staff companies starting in April 2020, while it will be applied to non-temp-staff SMEs starting in April 2021. Similarly, the overtime cap will apply to SMEs starting in 2020. In addition, reforms centered on deregulation or corporate governance will be undertaken in a phased manner over several years, while efforts to eliminate disincentives to regular work stemming from the tax and social security system have been left out of the policy debate over the past year.

46. We also recognize the progress on key labor market reforms. However, we were unclear whether staff expect these reforms will be sufficient to tackle the duality in the labor market set out in the Selected Issues Paper and the need for ‘work-style reforms’ the buff identifies. Staff comments would be appreciated.

47. We wonder for instance how the authorities will be able to spot fraud on whether firms abide by their “equal pay for equal work”- related obligations among the population of regular and non-regular workers and accordingly to the employees’ effective work carried out and skills. Staff comments on this would be welcome.

- The above-mentioned labor market legislation passed by the Diet in June 2018 has three pillars: (i) overtime limit, (ii) equal pay for equal work, and (iii) white-collar exemption. As highlighted, its effectiveness in boosting productivity and wages will depend on implementation and courts’ interpretation. While some aspects of the legislation have the potential to boost wages and reduce structural bottlenecks in the labor market (depending on implementation that is partly linked to untested court mechanisms), other parts may not be as effective. In particular, to help the effectiveness of “equal pay for equal work,” job descriptions could be implemented together with a clear reporting framework that helps monitor compensation by categories.

48. ***As regards the “credibility” of reforms, we note that the calibration used in GIMF model could be further detailed and justified, namely on agents’ expectations but do not really get the idea behind this wording. Staff’s explanation on the “credible” implementation of structural reforms would be valuable.***

49. ***Obtaining public confidence for a credible reform plan and its consistent implementation are necessary to maximize the policy effect. Do staff have views on how the authorities can do that?***

- Staff did not model specific commitment devices to achieve credibility of structural reforms. However, this objective could be achieved by a mechanism that convincingly conveys to firms and households of the certainty of the reform program. Under this scenario, firms/households would bring forward consumption and investment decisions, thereby maximizing the impact on near-term growth, inflation, and debt stabilization. Reinvigorated, sustained, and ambitious reform efforts can be good signals to the public of government commitment to the reforms.

50. ***Could staff discuss which measures could be taken to improve female labor force participation?***

- Increasing the availability of childcare and nursing-care facilities can further promote female labor force participation. Reducing the gender wage gap is also critical to support opportunities for women in the labor market. In this regard, removal of social security and tax disincentives to full time and regular work will contribute to reducing the gender wage gap and improving female labor force participation. For example, the income threshold used to determine contributions to the social security system provides an incentive for workers to have a lower income. Other measures to promote female labor force participation include providing training and career opportunities to non-regular workers, reducing excessive overtime, and encouraging managerial practices that adequately reward productivity.

51. ***Most structural measures proposed by staff to improve labor market dynamics, while enhancing monetary policy transmission in the medium term, could conceivably result in some slack in the labor market in the near term. Could staff elaborate more on how the envisaged reforms are expected to sustain a higher level of inflation in their immediate aftermath?***

- Staff agrees that some of the proposed structural reforms may bring some slack in the labor market and deflationary pressures. However, staff estimates that under full credibility of the reform program, deflationary pressures would be avoided. Credibility of the reform program can help reflation efforts as the associated demand boost due to anticipation effects would exceed the contemporaneous supply boost from the reform program. Anticipation effects (due to a credible reform program) entail boosted investment and consumption by firms and households, due to higher expected capital returns and permanent income.

52. Staff has presented a ranking of reform initiatives based on their impact on economic activity and inflation. Could staff briefly clarify the possible sequencing of these reforms based, among others, on their prerequisites and the synergies across these measures to help ensure an orderly reform process.

53. For years, important structural reforms in various areas have been necessary for the economy to recover growth dynamics. We note and agree with staff on the importance of labor reforms to increase productivity and labor supply, product and corporate reforms for productivity and investment, as well as trade liberalization and FDI promotion. Staff advise to prioritize by classifying these as first, second and third "tier" reforms. Could staff clarify what that ordering means, is it a suggested sequencing?

- Staff recommendations for structural reforms prioritize reforms by their output and inflation effect. Therefore, if authorities are to sequence reforms in terms of their expected output and inflation gains, staff analysis provides insight into how they are to be sequenced though staff recommend reinvigorated policies that are mutually supportive. In addition, the authorities may have other considerations when deciding the specific reform sequence, including political economy factors or synergies between reforms. Synergies among policies within the coordinated reform agenda arise, for example, when reforms raise the return on investment and hence boost the capital stock and the real interest rate (i.e. product market reforms, corporate governance reforms), or when reforms lift labor supply – and potential growth in general – that also raises the return on investment and the natural real interest rate, making monetary policy accommodation more effective.

54. We note that the assessment by design relies heavily on the OECD findings. Paragraph 40 lists the recent developments in response to the Phase 3 recommendations. Paragraph 40 lists the recent developments in response to the Phase 3 recommendations (on corruption). Can staff assess their effectiveness?

- As part of the Fund's recently-adopted enhanced framework on governance and corruption vulnerabilities, Japan volunteered to have an assessment of its framework for dealing with bribery of foreign officials—the "supply-side" of corruption. Japan is the second G-7 country, following the United Kingdom, to undertake this exercise. Staff's approach relies mostly on the OECD Working Group on Bribery's assessment of Japan's implementation of the OECD Anti-Bribery Convention, particularly on enforcement of foreign bribery offences, and does allow the authorities to illustrate their progress in responding to the OECD Phase 3 report recommendations. The Government of Japan has made progress in implementing the recommendations, particularly through the development of an Action Plan as illustrated in the Staff Report. As part of that Plan, Japan is upgrading its legal and institutional framework to criminalize and prosecute the bribery of foreign public officials, but it is as yet too soon to evaluate its effectiveness. Staff will provide an update on the effectiveness of these measures in next year's Article IV based on the OECD June 2019 Phase 4 report.

55. ***We note that continued deregulation will increase productivity and investment by reducing barriers to entry -and exit-, removing incumbents' protections and deregulating professional services. Can staff please expand on what industries or sectors are most in need of these policies?***

56. ***Could staff elaborate on the prospects for deregulation and for developing alternative sources of SME financing?***

- Regarding deregulation prospects, OECD data point to room to improve (vis-a-vis G7 countries) in Japan's telecom and gas sectors. Among professional services, OECD data show that engineering and accounting services have relatively restrictive regulation in Japan and could therefore benefit from deregulation efforts.

- With SME lending based largely on fixed-asset collateral or personal guarantees, credit may not be channeled to the most productive firms. Staff recommends that alternative sources of SME financing are incentivized, including asset-based lending (ABL) and venture capital (VC). ABL has increased recently as a result of the efforts by government institutions. However, ABL based on movable assets (e.g., machines and inventory) and account receivables is less than 0.5 percent of total bank loans. Challenges include the ban on the transfer of credit in the civil code and the limited capacity of financial institutions in assessing the value and status of the movable assets. VC can play an important role but requires improving the environment for angel inventors who not only supply finance, but also provide mentoring and networking. Investment by pension funds in VC funds is limited in Japan compared to the U.S. and could be promoted along with their portfolio rebalancing targets. (see also the 2017 Japan Staff Report and 2017 Japan FSAP.)

57. ***Could staff comment on the reasons behind corporations' large cash holdings?***

- Japan's excessive corporate cash holdings are due to various characteristics of corporate governance and the legal framework, which reduces incentives for managers to use cash in an efficient way (e.g. to increase wages and investment). As emphasized in previous staff analysis (*Unstash the Cash. Corporate Governance Reform in Japan*, IMF WP 14/140 by Aoyagi and Ganelli), these characteristics include: relatively weak corporate governance; aversion to bankruptcies and lack of pre-packaged bankruptcy procedures (which encourages firms to accumulate cash as an insurance against having to file for bankruptcy); and high cross-shareholdings (which reduces the extent to which shareholders put pressure on managers to use cash efficiently). Moreover, the 2017 Japan Selected Issues paper on investment highlights channels holding back investment, and therefore contributing to high cash holdings. The channels include relatively low market competition and the role of regulation, beyond other channels including weak corporate governance, production offshoring, population ageing, and policy uncertainty. In addition, Japan's long history of deflation and deflationary mindset reduce the real and perceived cost of holding high amounts of its cash.

58. We are not sure to understand what staff meant with the following sentence: "Because labor income taxes are progressive, partly financing the cost of aging through this way has more negative effects on individual with higher productivity" and whether this assertion is consistent with staff's recent work on tax progressivity. Staff comments are welcome.

- The quoted sentence primarily focuses on the implication of financing the cost of aging through higher labor income taxes vis-à-vis higher consumption taxes.

- As discussed in the 2018 Japan Selected Issues Paper *Inequality in Japan: Generational, Gender, and Regional Considerations*, fiscal redistribution—mainly to the elderly—has helped maintain a relatively stable level of disposable income inequality. At the same time, when considering how to finance the cost of this fiscal redistribution to the elderly, intergenerational implications are also important. In this context, the 2018 Japan Selected Issues Paper "Financing the Cost of Japan's Demographic Transition" discussed potential implications of alternative financing options. Financing the cost of aging through the consumption tax has less distortive impact due to broader tax base including retirees. Relative to this option, financing the cost of aging through higher labor income taxes would increase the tax burden for current and future working age population, with stronger negative effects on higher productivity cohorts. This would lead to lower welfare for young workers and future generations.

- However, this analysis does not undermine the importance of progressive labor income taxes in fiscal redistribution (which is already in place in Japan) especially among the same generation.

59. Noting estimates showing the average impact on wages was insignificant, have staff applied their empirical model to wages of particular groups (e.g. women, the low-skilled)?

- Staff analysis does not include the impact of automation on wages of particular groups, mainly due to data constraints. Recent work by Hamaguchi and Kondo (2018) suggests that female workers and low-skilled workers in Japan are likely to be more negatively affected by automation than male and high-skilled counterparts, with lower wages and higher risks of automation.

Safe Haven

60. We are puzzled by the yen's appreciation against the U.S. dollar from time to time, against the backdrop of the monetary policy normalization in major advanced economies and rising global interest rates. The report attributed the yen's appreciation to safe haven effects, interest rate differentials, and carry trade reversals. But appreciation of the yen could have further intensified Japan's deflation and made the inflation target more difficult to achieve. Staff comments are welcome. Compared to other currencies, is the yen relatively safer?

- The yen tends to appreciate during episodes of heightened uncertainty. This is to some extent driven by safe haven effects, but carry trade reversal is an important amplifier. Given this, judging whether the yen is relatively "safer" than other currencies is difficult to assess, depending on the definition of "safe". The sometimes large and prolonged durations of yen appreciation do indeed intensity deflationary pressures and complicate the BoJ's efforts to relate the economy.