

Japan: Making the Most of Current Tailwinds

September 2017

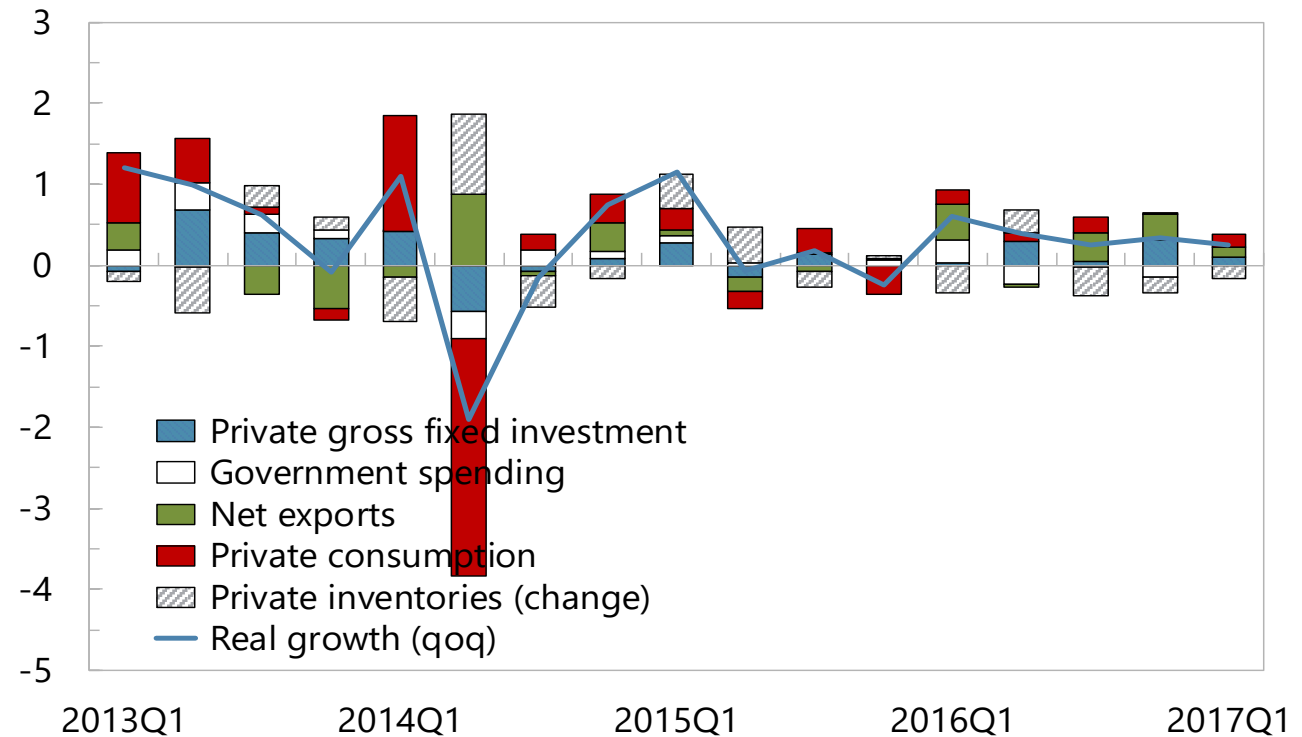
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Japan's economy is in a relatively good place ...

- Revised national accounts indicate more robust performance during 2013-2015
- Real GDP growth above potential the past one and a half years
- Consumption growth positive after contracting for two years
- Private investment stronger due to residential investment
- Net exports have been picking up since mid 2016

Contributions to QoQ Real Growth (SA)

(In percent)

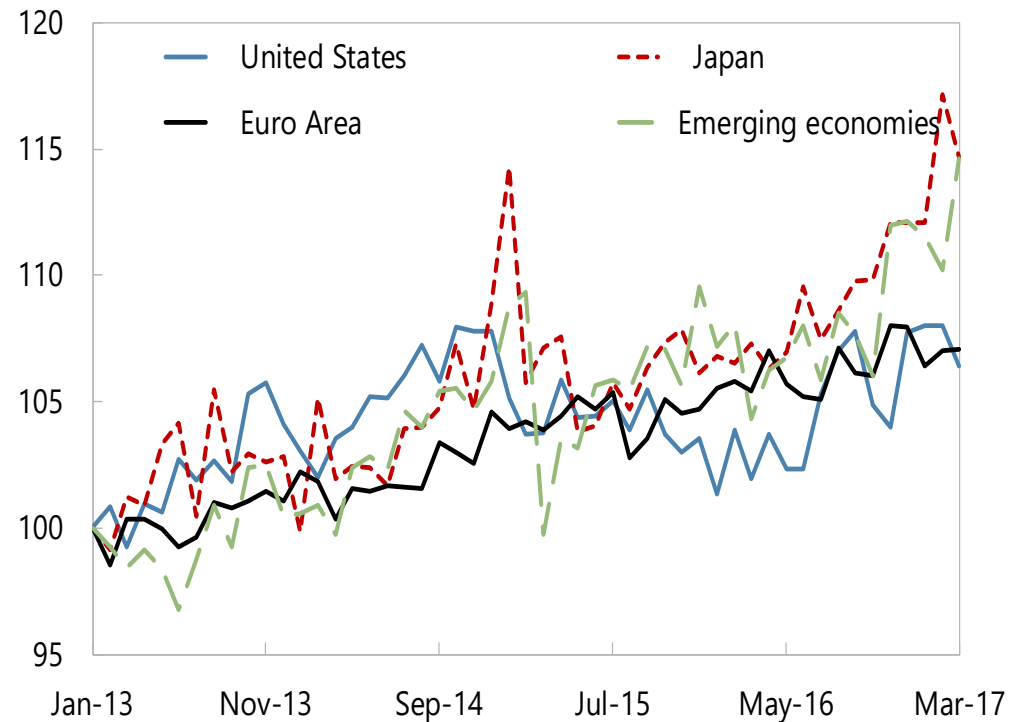


Source: Haver Analytics.

... driven by a supportive external environment ...

World Exports

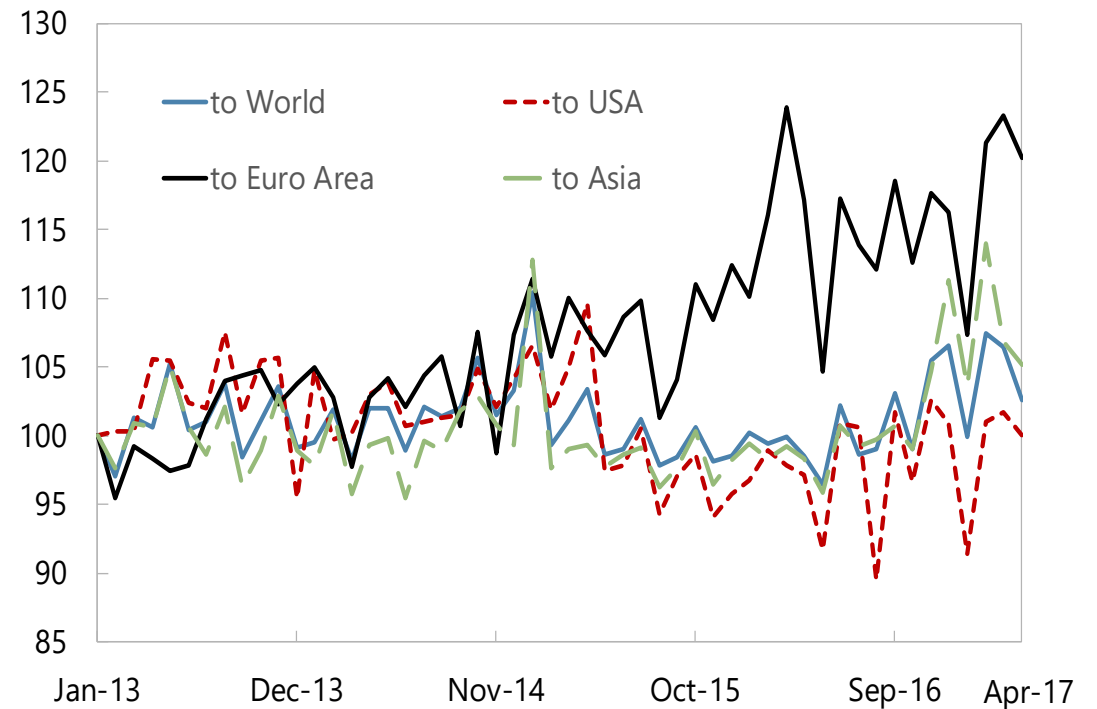
(Jan.2013=100; SA; Volumes)



Source: CPB World Trade Monitor.

Real Exports by Destination

(Jan. 2013=100; SA)

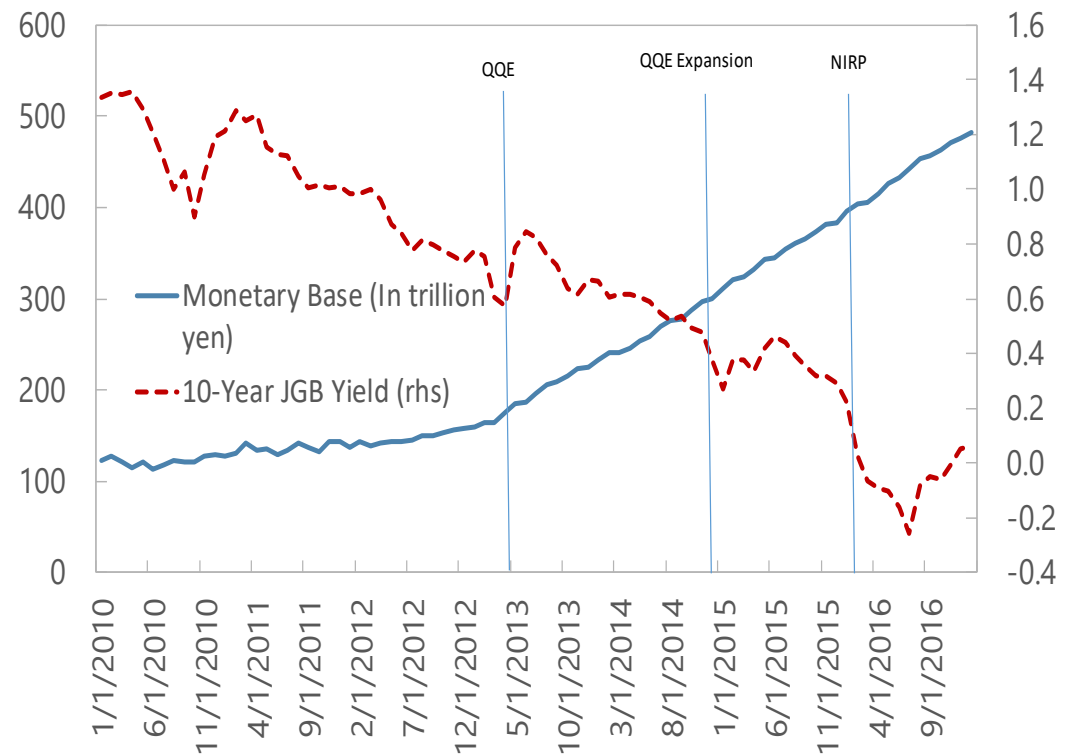


Source: Haver Analytics.

...and fiscal and monetary support

- **Two percent increase in consumption tax rate postponed from April 2017 to October 2019**
- **Supplementary fiscal package approved in August 2016**
- **Bank of Japan introduced “QQE with Yield Curve Control” in September 2016**

10-Year JGB and Monetary Base Expansion

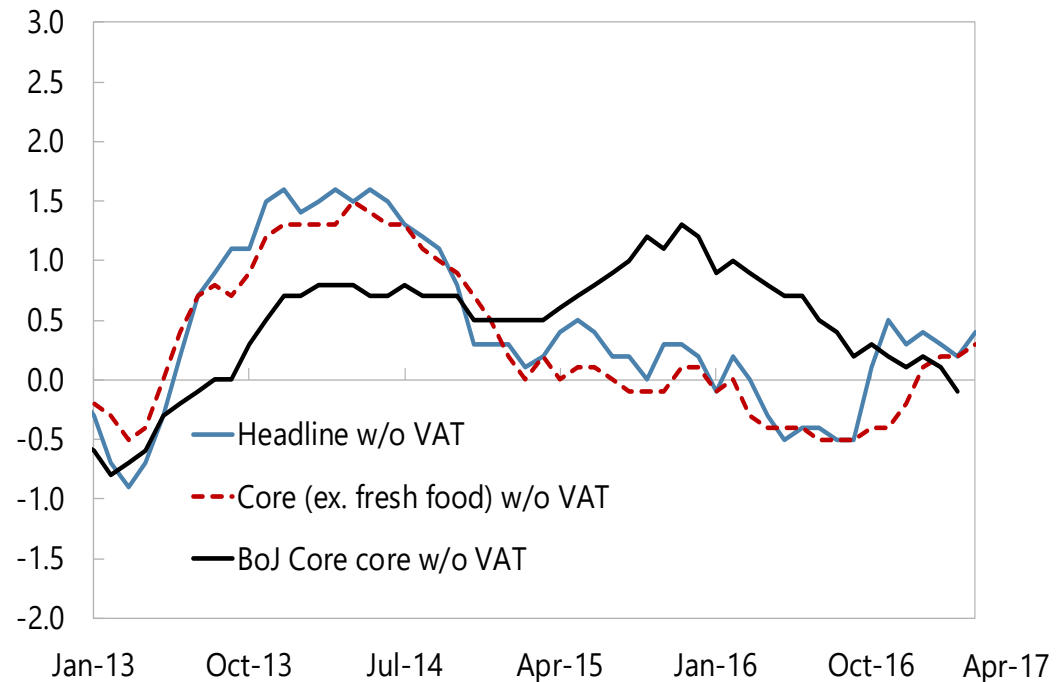


Source: Haver Analytics.

But inflation and wage growth remain stubbornly low....

Inflation Indicators

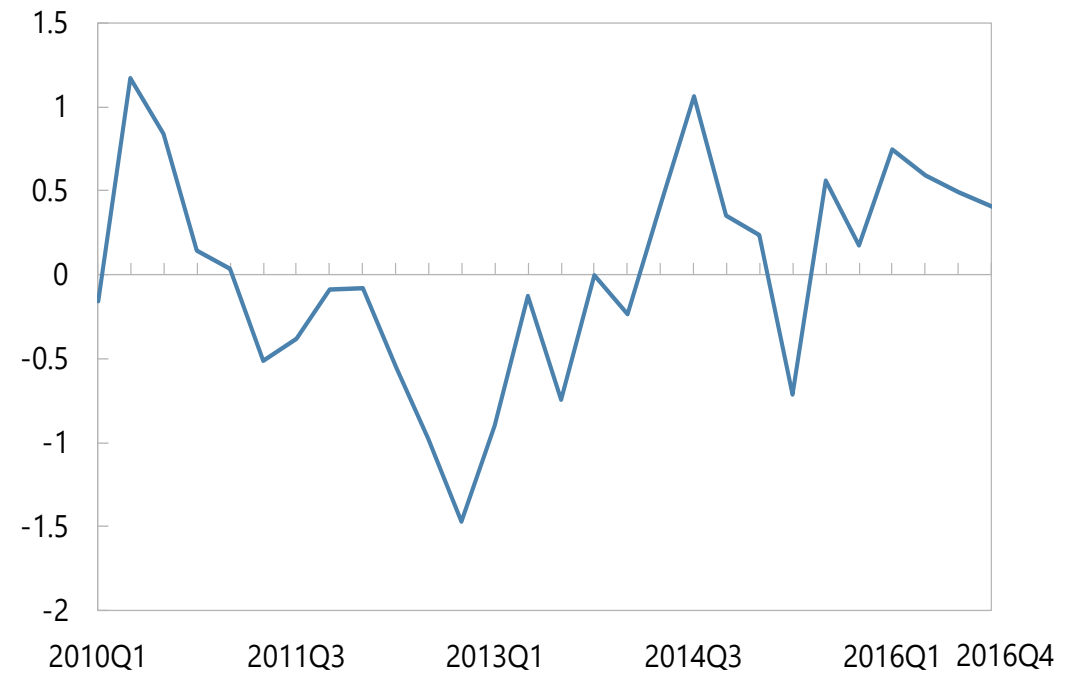
(YoY; in percent)



Sources: Haver Analytics; IMF staff estimates.

Total Cash Earnings

(per employee; YoY; in percent)

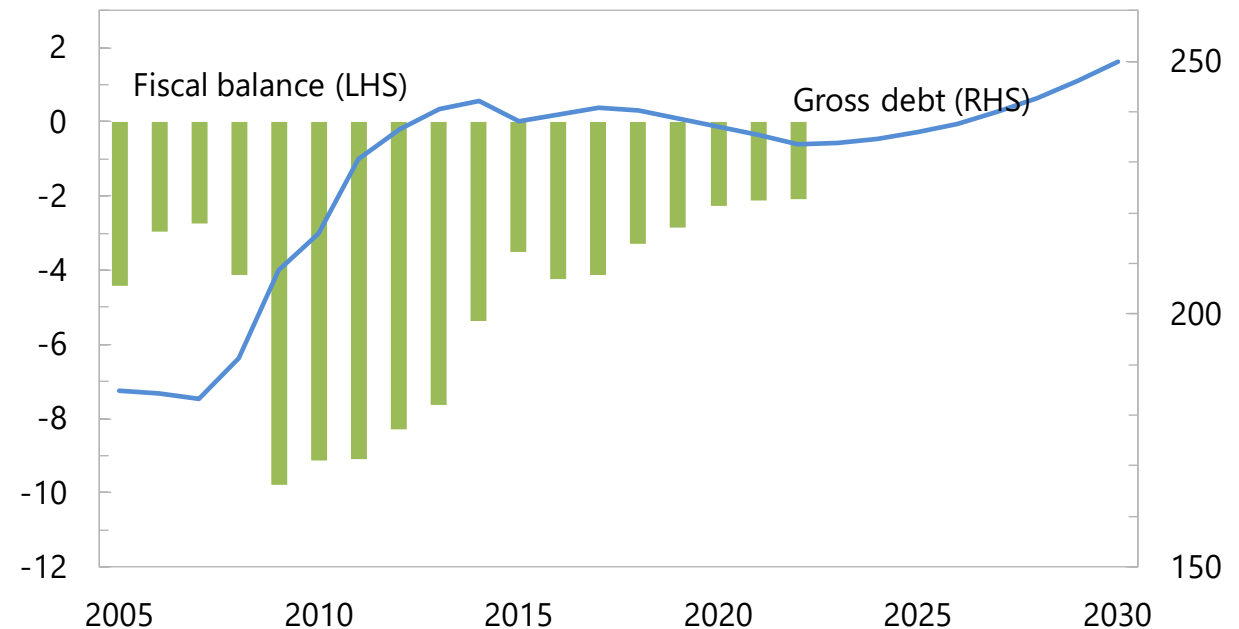


Sources: Haver Analytics; and IMF Staff calculations.

...and public debt is high

- **Public debt remains unsustainable under current policies**
- **Debt-to-GDP ratio projected to start rising after 2022**
- **Fiscal policy has been characterized by a stop-go approach and repeated supplementary budgets**

Japan: Gross Public Debt^{1/} and Fiscal Balance
(In percent of GDP)



Sources: Cabinet Office; and staff estimates and projections.

1/ Gross debt of the general government including the social security fund.

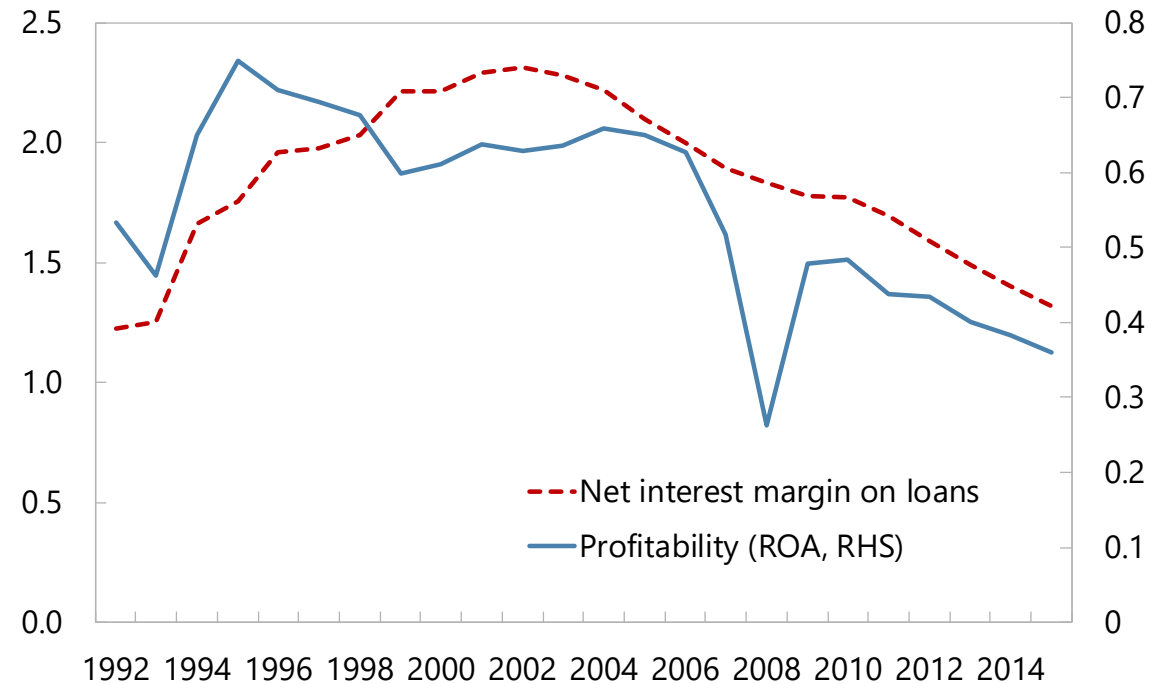
Withdrawal of fiscal stimulus and consumption tax increases to 10 percent in October 2019 are assumed.

Macro-financial challenges persist

- **Chronic pressures from low interest rates and demographic headwinds, especially for regional financial institutions and life insurers, are creating new channels of risks**
 - **Search for yield has led to expansion of overseas and real-estate lending, contributing to higher FX liquidity risk and moderately overvalued condominium prices**
 - **Low profitability of regional financial institutions could lead to a bunching of solvency problems in the medium to long term**
- **Sovereign-financial linkages remain close**

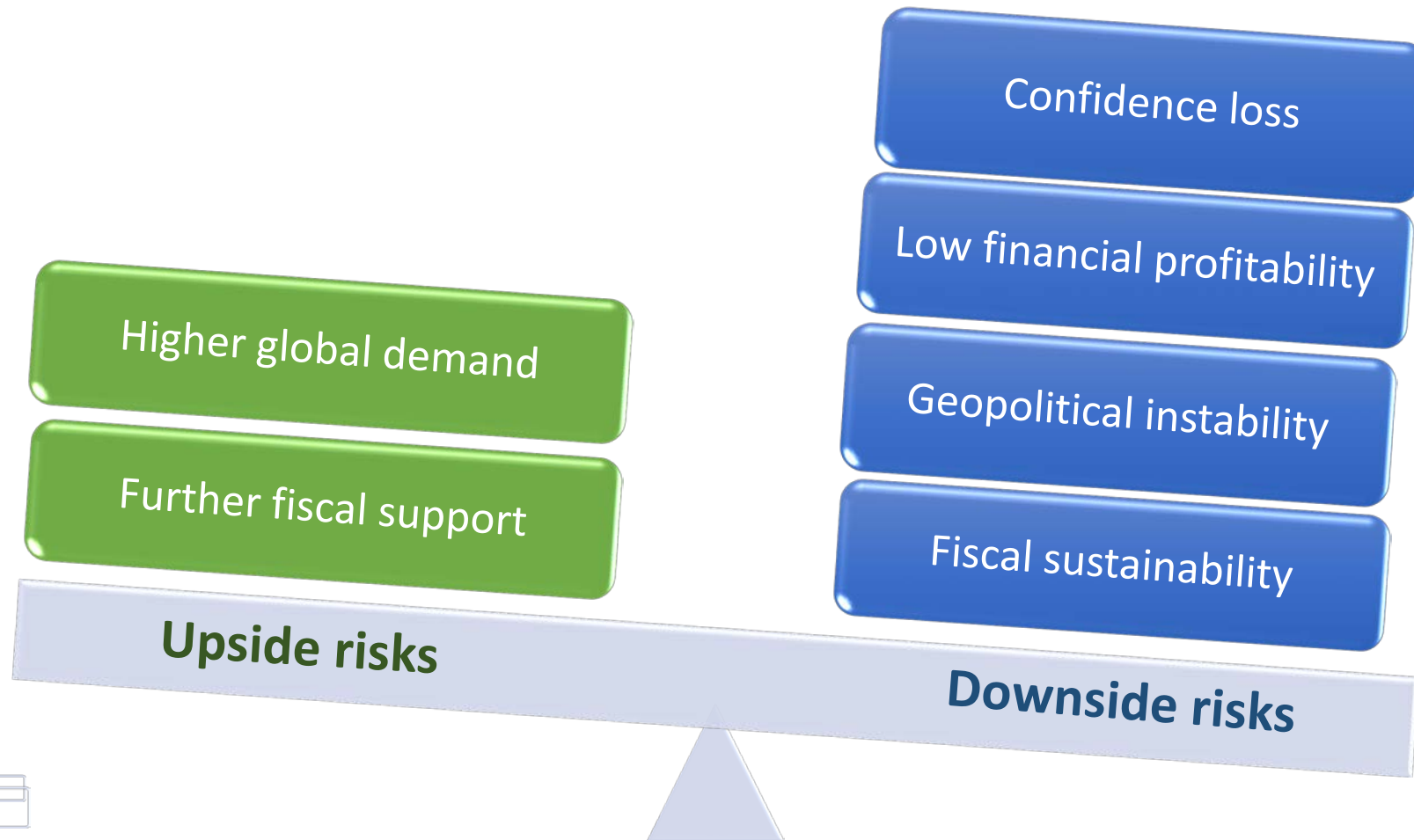
Profitability and Net Interest Rate Margins

(In percent)



Sources: Fitch Connect; and IMF staff calculations.

Risks to the outlook are tilted to the downside



Economic policy implications

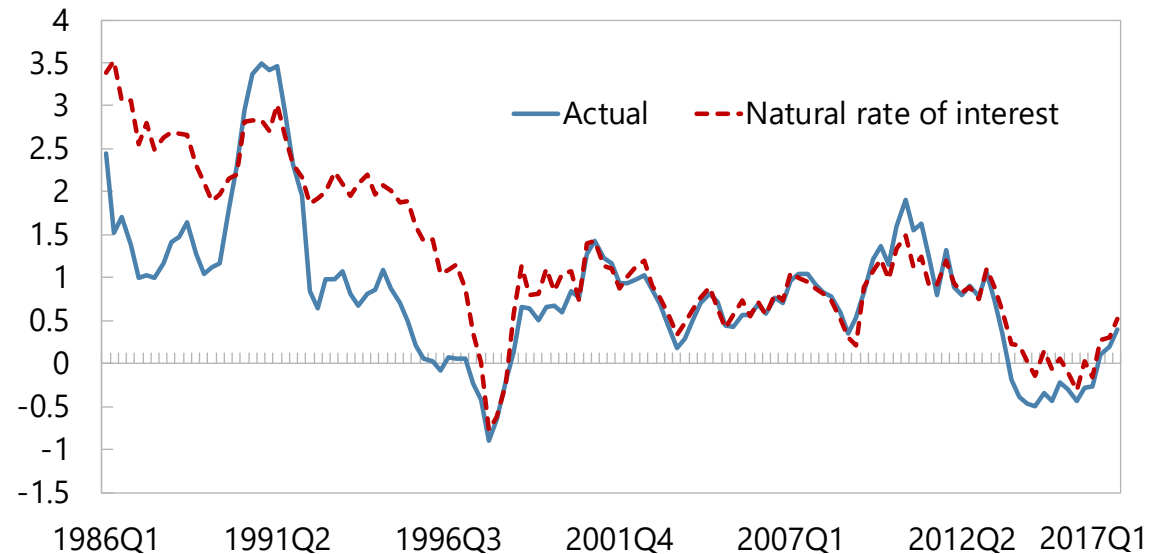
Making the Most of Current Tailwinds: A Mutually Reinforcing Strategy

Monetary policy needs to stay the course ...

- **Bank of Japan faces an uphill battle due to the public's deflationary mindset and a low natural real rate of interest**
- **Japan's monetary policy is expected to lag behind other advanced economies in terms of normalization**
- **A stable long-term benchmark yield combined with income policies and labor market reforms should help reflation**

Japan: Natural Rate of Interest

(In percent)



Sources: Bank of Japan; Haver Analytics; and Fund staff estimates.

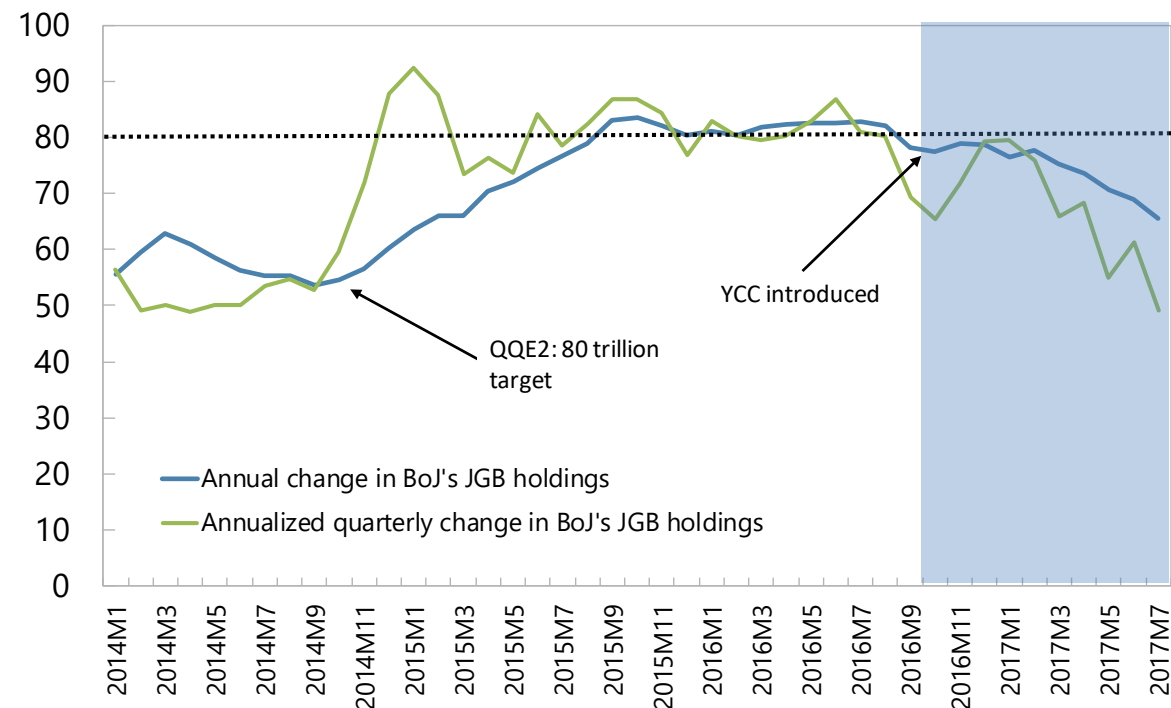
Note: The blue line is the actual real discount rate deflated by the inflation expectations estimated from an MA(4) model, and the red line marks the mean posterior estimates of the natural rate of interest from a Bayesian time-varying parameter vector autoregression (TVP-VAR) model following Lubik and Matthes (2015).

...and ensure credibility of the new framework

Strengthening communication should help bolster credibility and lift inflation expectations

- **Gradually phase out references to quantitative JGB targets to prevent confusion with interest target**
- **Publish BoJ staff forecast to generate better policy understanding and predictability**

Annual Change in Outstanding JGBs and BoJ Holdings, 2010-2017
(Trillion Yen)



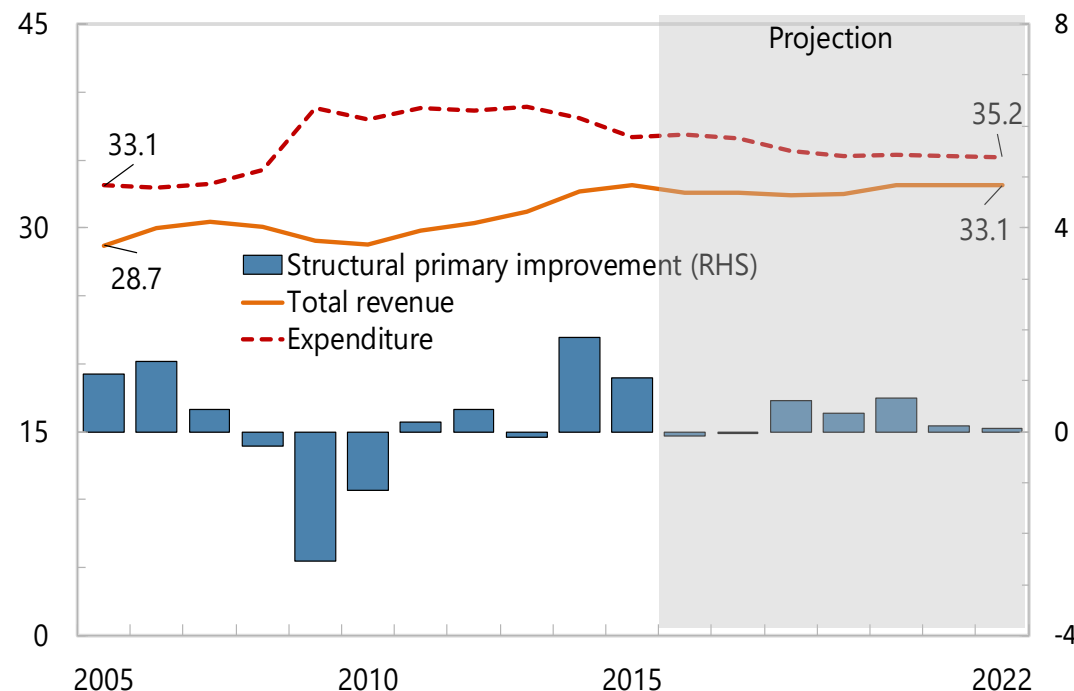
Source: Haver

Fiscal policy should preserve near-term growth...

- **Limited funding risks and low borrowing costs provide some near term fiscal space**
- **Near-term fiscal policy should be coordinated with monetary and incomes policies to support demand**
- **Fiscal support should promote and complement structural reforms and income policies**

General Government Fiscal Balance

(In percent of GDP)



Sources: WEO database; and IMF staff estimates.

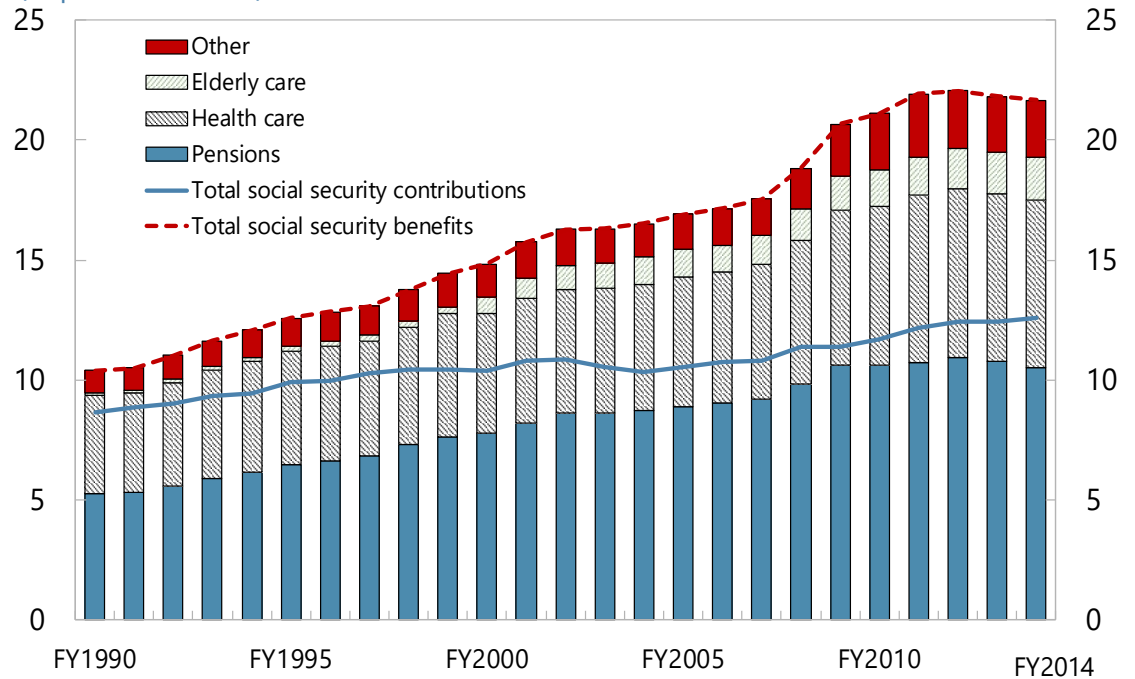
...within a credible medium-term framework

The FY2018 Interim Fiscal Review will be an opportunity to strengthen the fiscal framework:

- Gradual pre-announced increases in the consumption tax
- Social security spending curbs through fundamental reforms
- Institutional arrangements to anchor policies and expectations

Social Security Benefits and Contributions

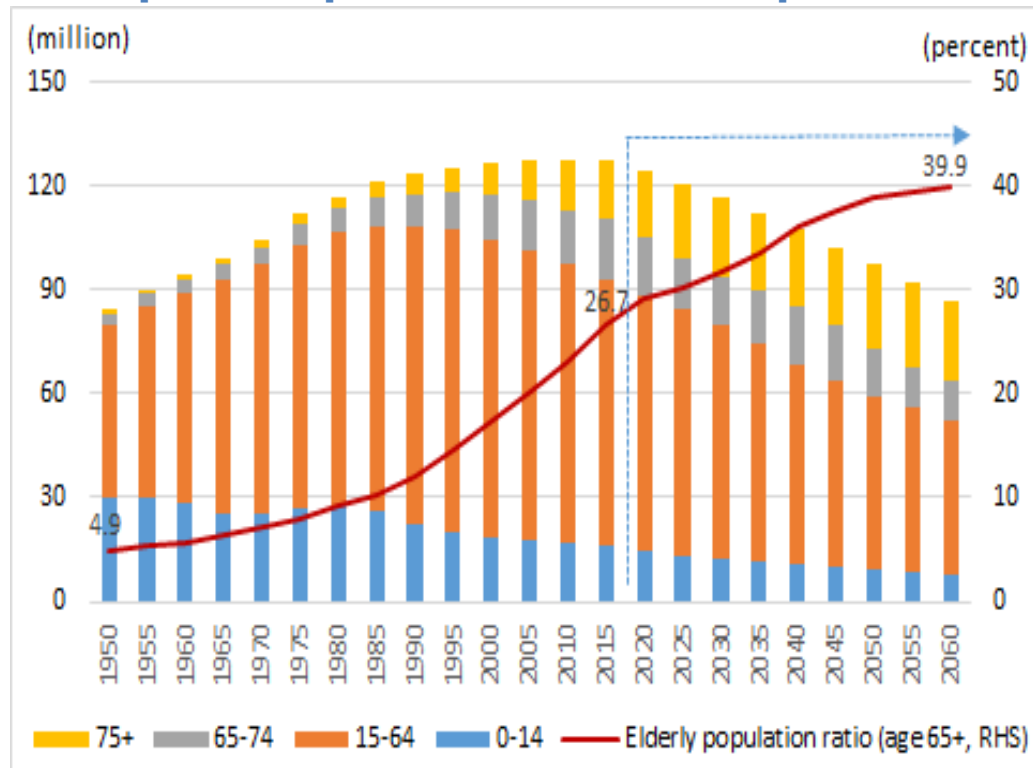
(In percent of GDP)



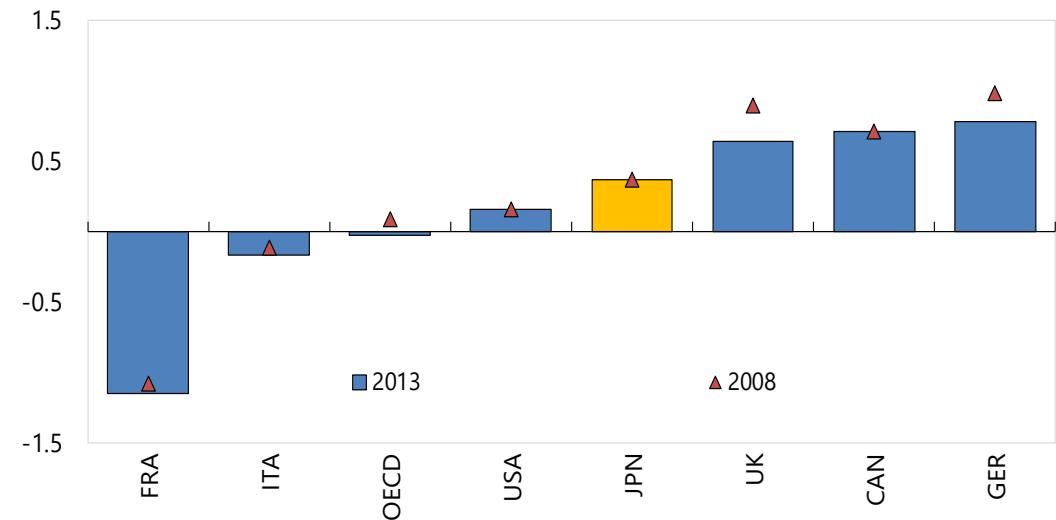
Sources: National Institute of Population and Social Security Research.

Structural reforms are central to making Abenomics work

Japan's Population and its Composition



Difference in Employment Protection: Regular vs Temporary



Source: OECD, Employment Protection Database.

Note: Difference in index for protection of regular employment and index for protection of temporary employment. Each index is a scale 0-6 from least to most restrictive.

First priority: Labor market reform

Top priority within structural reforms is to boost wages and increase productivity

1. Establish clear legal framework for “intermediate” labor contracts

- 2. Accelerate “equal- pay for equal-work” initiative, together with job descriptions

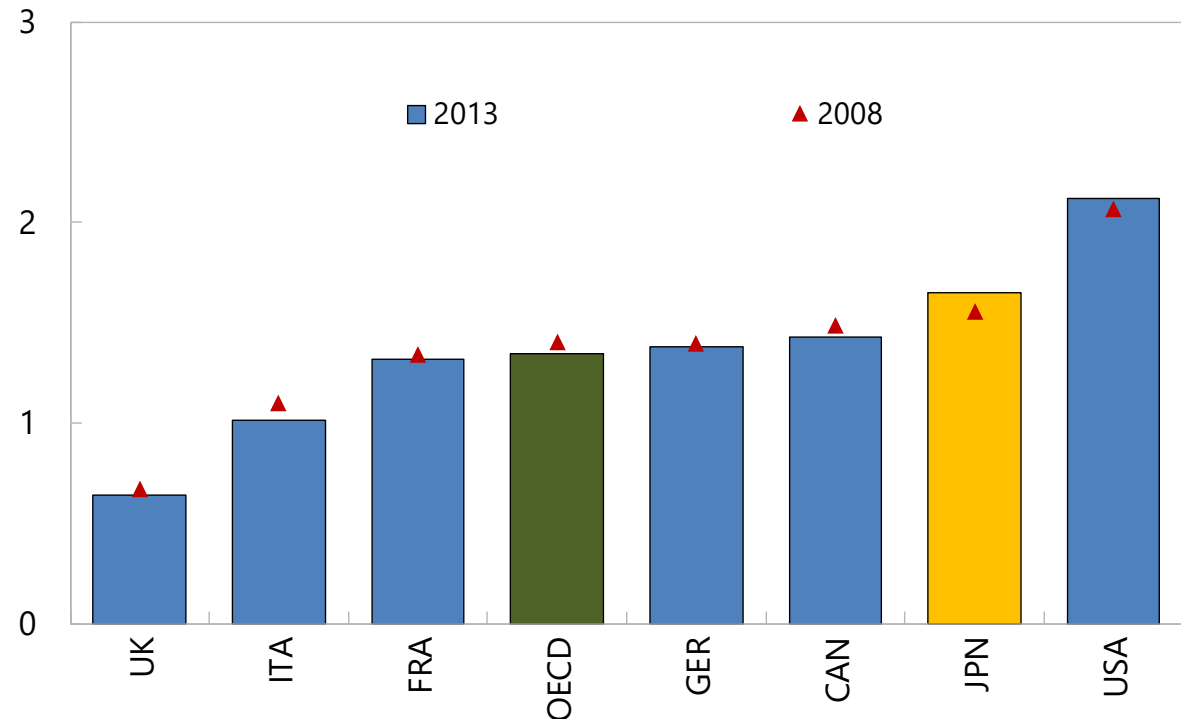
- 3. Support worker mobility across firms

Second priority: Reforms to increase private investment

- **Deregulation of industries (i.e. telecoms, gas, professional services)**
- **Further corporate governance reform**
- **Scaling back government guarantees for SMEs**
- **Reduction in policy uncertainty and enhanced policy frameworks**
- **Trade and FDI promotion**

Regulatory Protection of Incumbents

(Index scale of 0-6 from least to most restrictive)



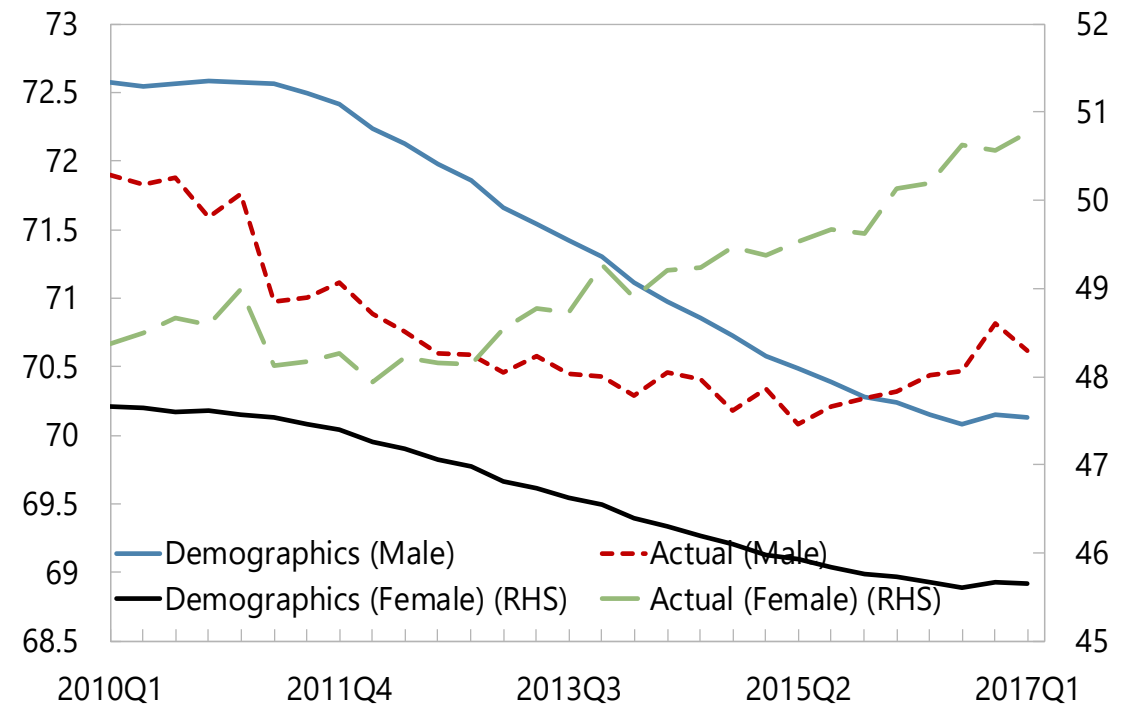
Sources: OECD Product Market Regulation Database; and Koske (et al) 2013 update.

Third priority: Diversification and enhancement of labor supply

- **Boost female and older-worker labor force participation and utilize foreign labor**
- **Reward worker productivity - over seniority and long hours**
- **Remove tax and social security disincentives to full-time/regular work**
- **Increase childcare and nursing facilities**

Labor Force Participation Rate

(In percent)



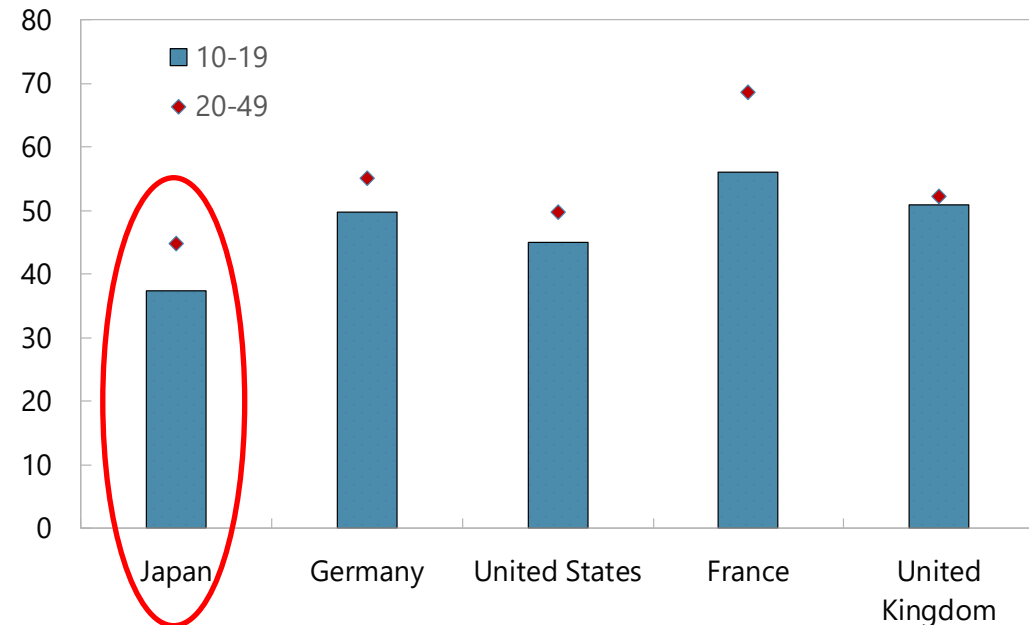
Source: Ministry of Internal Affairs and Communications.

Enhanced financial sector policies to boost the productivity of SMEs

- **Productivity of Japanese SMEs is relatively low**
- **Lending to SMEs based largely on fixed-asset collateral or personal guarantees**
- **Financial sector policies should promote risk-based lending to increase efficiency**
 - **Upgrading banks' credit risk assessment capacity**
 - **Lowering the coverage of public credit guarantees**
 - **Improving SME reporting standards**

SME Productivity in Manufacturing

(Value added Per person, Index 250= 100 in 2014 ; Size = number of employees)



Source: OECD 2015.

Steps to safeguard financial stability against emerging risks and longer-term pressures ...

Supervision and governance

Move to full risk-based prudential supervision

Better tailor capital requirements according to individual bank risk profiles

Further strengthen corporate governance across the whole banking and insurance sectors

Implement an economic-value-based solvency regime for insurance sector

Macroprudential framework

Clarify mandate of the Council for Cooperation on Financial Stability

Broaden systemic risk assessment to non-systemic important banks

Develop tools for the housing sector

Crisis management and resolution framework

Strengthen and clarify resolution framework

Improve crisis preparedness, prompt corrective actions

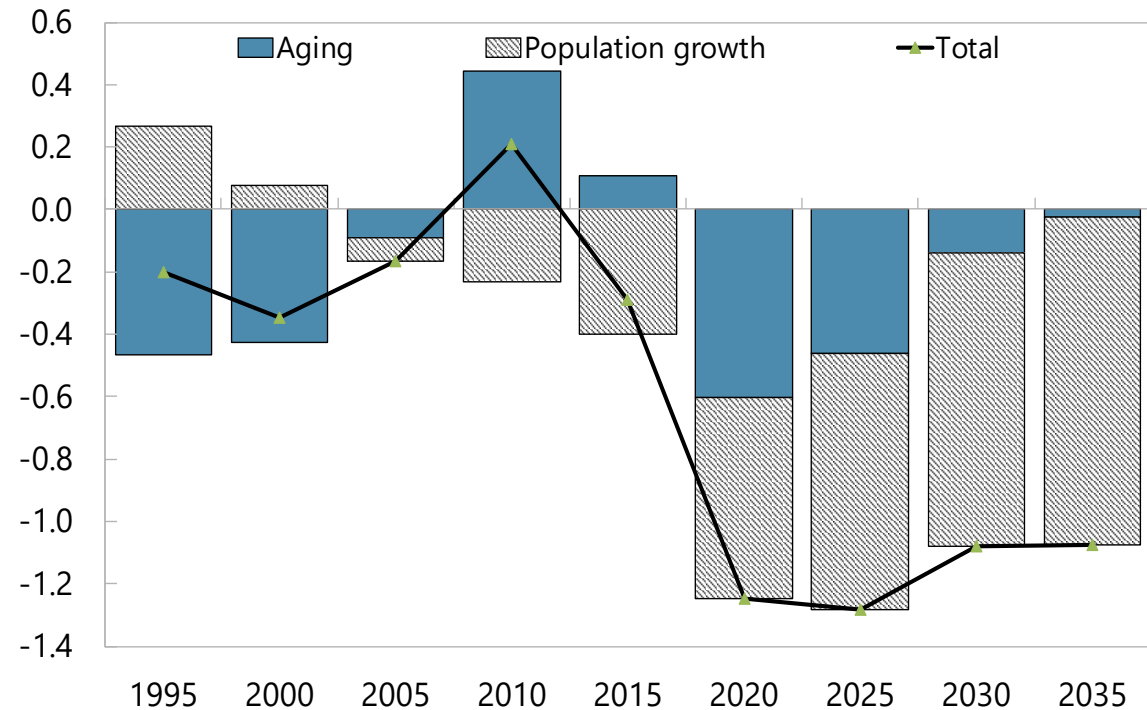
Improve institutional framework and inter-agency coordination

Tighten preconditions for use of public funds

... including by engaging with financial institutions on the implications of demographic trends

- **Engage with bank boards and senior management to ensure impact of population dynamics on future viability is understood**
- **Facilitate transition of regional banks to augmented fee-based income, reduced costs, and consolidation**
 - **Consolidation alone is unlikely to be sufficient to address the challenges**

Demographic Impact on the Annual Loan-Deposit Ratio
(Percentage points)



Sources: IMF Staff Calculations

All told....

- **Abenomics has improved economic conditions and engendered structural reforms but has not yet achieved a durable exit from deflation**
- **The current favorable economic environment is an opportunity to accelerate reforms:**
 - **Coordinated demand and income policies to boost inflation and put the economy on a durable growth path**
 - **Further strengthening the monetary and fiscal policy frameworks to bolster credibility and reduce long-term risks**
 - **Enhanced financial sector policies to contain financial stability risks**



Thank you !

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