August 2005
IMF Country Report No. 05/273

Japan: 2005 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Japan, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 26, 2005, with the officials of Japan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 26, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of July 26, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 29, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Japan

Approved by Daniel Citrin and Carlo Cottarelli

July 26, 2005

- **This report is based on discussions held in Tokyo during May 16–26, 2005.** The team comprised Messrs. Citrin (Head), Zanello, Kramer, Komori, Wolfson, and N'Diaye, Ms. Edison (all APD), and Messrs. McDonald (PDR) and Walker (ICM). Mr. Kitahara (Alternate Executive Director) also took part in discussions. Supporting information and analysis are provided in a companion *Selected Issues* paper.

- The team met with Bank of Japan Governor Fukui; Vice Minister of Finance for International Affairs Watanabe; and other senior officials at the Bank of Japan; Cabinet Office; Ministries of Finance; Internal Affairs and Communications; Health, Labor and Welfare; Agriculture, Forestry and Fisheries; Economy, Trade and Industry; and Foreign Affairs; the Financial Services Agency; the Industrial Revitalization Corporation of Japan; the Headquarters for Postal Privatization; and with business and financial sector representatives.

- **Japan maintains a floating exchange rate regime.** Published data indicate that the authorities last intervened in March 2004. The exchange system is free of restrictions on the making of current international transactions, with the exceptions of those notified to the Fund in accordance with Executive Board Decision 144-(52/51) (Annex I).

- **Data provided to the Fund are adequate for surveillance purposes, but some statistical shortcomings complicate analysis of economic and fiscal developments** (Annex II). The recent move to a chain-weighted methodology for national income accounts has improved the quality of economic statistics. However, consolidated fiscal data are published with a long lag. The authorities plan to participate in a data ROSC in September 2005.

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EXECUTIVE SUMMARY

Background

- Japan's economy is regaining forward momentum after a pause during the latter part of 2004. The external factors behind last year's soft patch appear to be waning and a number of economic indicators point to a revival in domestic demand. Mild deflation persists. Notwithstanding downside risks, near-term prospects are for a moderately paced expansion.
- Structural advances on many fronts have strengthened the economy's resilience. Firms have made additional progress in deleveraging and shedding excess capital and labor; banks have further reduced nonperforming loans; and labor markets have become more dynamic.
- Monetary policy continues to be highly accommodative. The Bank of Japan (BoJ) has left unchanged the target range for current account balances under its quantitative easing framework. Short-term interest rates remain at zero.
- Fiscal consolidation was achieved last fiscal year but the deficit remains large and the debt ratio on an unsustainable path. Prospective demands on the budget from an aging society add urgency to the need for consolidation.

Key Issues and Policy Discussions

- In spite of an improved near-term outlook, low trend growth and population aging pose risks to longer-term prospects. Accordingly, discussions focused on policies to bolster the underpinnings for stronger self-sustained growth.
- On monetary policy, the mission endorsed the BoJ's commitment to keep quantitative easing in place until deflation is eliminated. There was broad agreement that the transition to more normal monetary operations needs to be managed flexibly and clear communication remains key to guiding market expectations.
- Regarding fiscal policy, the mission and the authorities agreed that additional fiscal savings relative to the budget would be desirable in FY2005. For the medium term, the mission saw the need for a more ambitious—and better articulated—plan to stabilize the debt ratio by the early 2010s.
- Further structural and financial sector reforms are key to higher productivity and potential growth. There is scope to improve the soundness and efficiency of the financial system. Other priorities are to increase the flexibility of labor and product markets and promote greater competition in sheltered sectors. The mission presented illustrative model-based scenarios where modest productivity gains cushion the impact of fiscal consolidation on growth and the current account, with benefits from both domestic and global perspectives.

I. Introduction

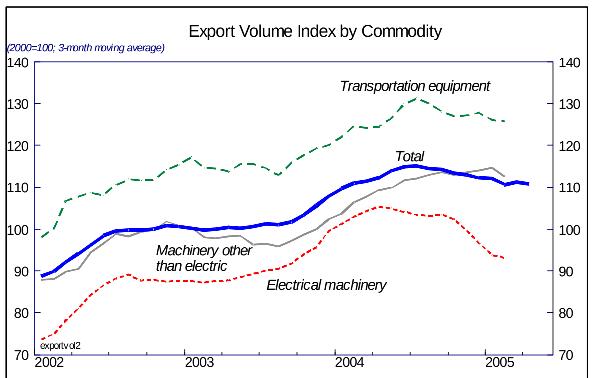
1. **Over the past few years, Japan has made progress in addressing deep-seated weaknesses.** Supportive policies and a cyclical upswing have facilitated structural adjustment on many fronts. Firms have whittled away at excess capacity and overemployment; corporate deleveraging has proceeded apace; labor markets have become more dynamic; and banks' balance sheets have improved significantly. While the legacies of the post-bubble years have not been fully shed—witness the persistence of deflation and the breadth of Japan's fiscal problems—underlying trends appear more favorable now than they have been for some time.

2. **With the immediate outlook brightening once again, policies need to take on longer-term challenges.** Recent data point to an improved near-term environment on the heels of a soft patch in 2004. Notwithstanding some risks, prospects are good for a moderately paced expansion over coming quarters. Looking beyond the cyclical recovery, however, there remains the need to bolster the underpinnings for stronger self-sustained growth. Policies need to address deflation, mounting fiscal imbalances, and low trend growth in the context of a declining labor force. Accordingly, the 2005 Article IV discussions focused on Japan's longer-term challenges, and the difficult policy choices they will require.

3. **Medium-term fiscal and structural reforms are indeed at the center of the public and political debate on economic issues.** Prime Minister Koizumi came to power in 2001 with an ambitious platform to revitalize the economy, shift resources from the public to the private sector, and further empower local government. Comprehensive reforms aimed at improving the allocation of resources and strengthening the fiscal structure are crucial to these goals. Several key initiatives are under way, notwithstanding some opposition, but the unfinished agenda remains large. The prime minister's term is scheduled to expire in 2006.

II. Economic and Policy Background

4. **Following buoyant growth in the latter half of 2003 and early 2004, GDP growth slowed unexpectedly in the second quarter of last year** (Table 1 and Figure 1). For 2004 as a whole, GDP rose 2.6 percent, compared with 4.5 percent projected at the time of the 2004 Article IV consultation last July.[1] About one-half of the shortfall reflected a shift to a chain-weighted methodology—



Source: Global Insight, Nomura Database.

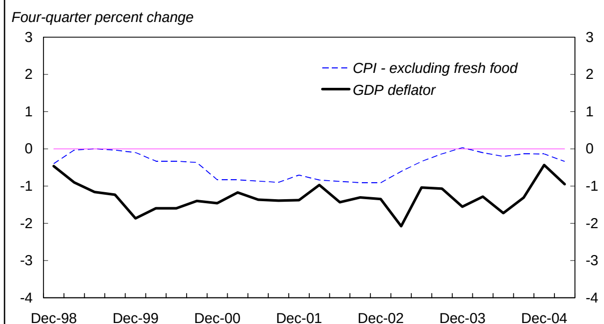
[1]These figures are based on quarterly GDP data. The official outturn based on annual data was 2.7 percent growth in 2004 (or 3.7 percent under the fixed-weight methodology).

growth on the old methodology was 3.6 percent. The rest was associated with an unanticipated fall in partner country demand, owing to a slowdown in the global IT market as well as higher oil prices, and weaker private domestic demand.

5. **Economic activity rebounded sharply in the first quarter of 2005.** First-quarter GDP growth amounted to 4.9 percent SAAR, in part reflecting temporary factors such as a bounce-back in private consumption following a weather-related weak previous quarter and some inventory buildup. Recent indicators such as industrial production, retail sales, and foreign machinery orders point to a continued expansion going forward, albeit at a more moderate pace than in the first quarter.

6. **Notwithstanding the recovery, mild deflation persists.** Core inflation (which excludes fresh food) was -0.2 percent y/y in April 2005, close to the estimated underlying rate of deflation net of temporary factors. Deflation as measured by the GDP deflator is more significant, but this may reflect a larger weight of IT goods whose prices are falling particularly rapidly. The persistence of deflation despite a narrowing output gap is difficult to explain; it may reflect weak domestic demand (until recently) and efforts by corporations to cut labor and other costs in the context of restructuring.

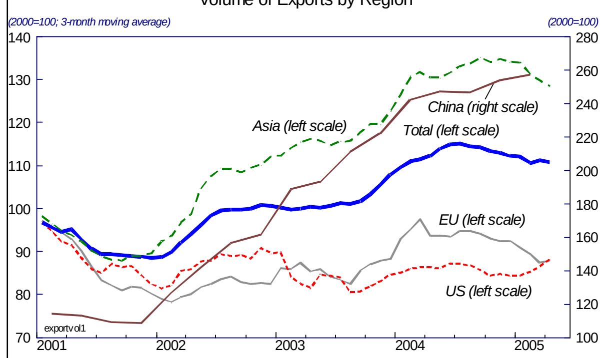
Inflation 1/



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

7. **Exports have been sluggish since mid-2004.** Exports to the European Union, the United States, and the rest of Asia all stalled during last year, although exports to the United States recovered in early 2005. In addition, exports to China have continued to expand steadily, albeit at a slower pace than in the earlier part of this decade. Indeed, China is an increasingly important trading partner, with its share of exports more than doubling since 2001 to 13 percent at present.

Volume of Exports by Region



Source: Global Insight, Nomura Database.

8. **Despite the export slowdown, the external balance continues to reach new highs** (Table 2 and Figure 4). The current account surplus was $172 billion (3.7 percent of GDP) in 2004. Export values were up some 20 percent in dollar terms for the year, partly because of carryover from strong export growth in late 2003. Imports remained robust through the year, reflecting higher energy prices as well as steady demand for consumer and IT-related goods. In addition, investment income benefited from buoyant performance of foreign subsidiaries

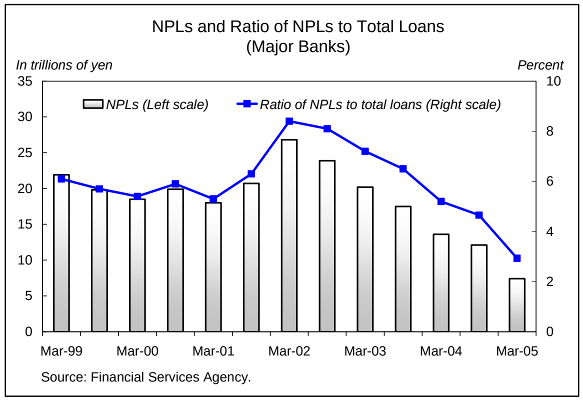
of Japanese companies and rising overseas portfolio holdings, boosting invisibles receipts. In the capital account, purchases of Japanese equities by foreigners picked up, while Japanese purchases of foreign bonds—particularly by investment trusts—remained large. Accumulation of official reserves slowed, as intervention ended in Spring 2004 after setting new records in 2003 and the first quarter of 2004 (Box 1). Foreign assets rose to 36 percent of GDP by end-2004, including official reserves of $834 billion. In the first quarter of 2005, the current account surplus rose further to $180 billion at annual rates. Export growth remained sluggish, and import demand weakened, while the balances on nonfactor services and investment income improved significantly.

9. **The yen has been broadly stable against the U.S. dollar and on a multilateral basis.** Over the past 12 months, the bilateral exchange rate vis-à-vis the dollar has been in a range of ¥102 to ¥115. Appreciation pressures emerged toward the end of 2004, driven largely by broad-based dollar weakness, but receded on expectations of faster tightening by the U.S. Federal Reserve. In effective terms, the nominal and real exchange rates have been little changed over the past 12 months. Unit labor cost pressures have been muted compared with those in partner countries, and moreover in light of Japan's already sizeable external surplus, competitiveness is not a concern at present. Indeed, staff estimates, prepared in the context of the periodic Coordinating Group on Exchange Rates exercise, suggest that the yen remains significantly undervalued from a medium-term perspective. In particular, under unchanged exchange rates, in the medium term the current account will likely exceed levels consistent with savings-investment fundamentals.

10. **Pressure on labor markets from job shedding is slowly abating** (Figure 2). The unemployment rate is at a six-year low, the ratio of job offers to applicants has continued to hover at post-bubble highs, and the Tankan corporate survey indicates declining labor market slack. Employment of regular workers is firming, as the past trend toward hiring temporary and contract workers begins to ebb. Thanks in part to the shift back toward regular workers (who are more highly paid), real wages have recently bottomed out, with positive implications for future income growth.

11. **Progress in corporate restructuring has continued.** Cash flow and profits remain buoyant, bankruptcies have fallen to a ten-year low, and leverage continues to decline (Box 2). Furthermore, the recovery in the corporate sector continues to broaden beyond large export-oriented manufacturers to include smaller enterprises and nonmanufacturers.

12. **Further advances also have been made in strengthening the banking system.** Tightened regulation of major banks under the Program for Financial Revival (PFR), together with corporate sector improvements, have reduced nonperforming loans (NPLs) and supported ratings upgrades (Box 3). Major



Source: Financial Services Agency.

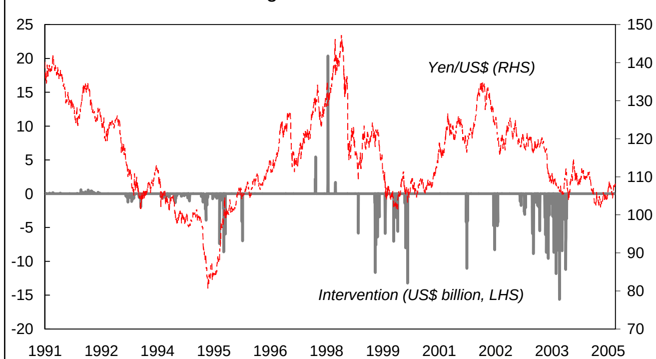
Box 1. Japan: Exchange Rate Policy and Intervention

In Japan, the Ministry of Finance (MoF) has the legal authority to conduct foreign exchange market interventions to achieve exchange rate stability. The Bank of Japan (BoJ) executes the interventions on behalf of the MoF, which decides the amounts and the method of intervention. In the case of foreign currency buying operations, yen funds are raised through sales of yen assets issued by the MoF (financing bills). Such interventions therefore are, in principle, sterilized: the pursuit of interventions on behalf of the MOF does not preclude the BoJ from achieving its domestic monetary objectives. Interventions could be “unsterilized” through expansionary open market operations.

Compared to the United States and the euro area, Japan stands out for its active use of foreign exchange market intervention as a policy instrument. Since 1991 the BoJ has intervened on behalf of the MoF on 340 days. By contrast, the Federal Reserve has intervened on 22 days over the same period, and the European Central Bank only on four days since its establishment in 1998. Most MoF interventions have been to limit a yen appreciation.

The frequency and size of interventions have varied through time. From early 1991 to mid-1995 interventions were generally small but frequent. From mid-1995 to end-2002, interventions became infrequent but large. Finally, in 2003 through March 2004, interventions were both large and very frequent. At the peak, they reached daily amounts in excess of \$10 billion. The cumulative amount of dollars purchased over this last period was about \$180 billion. No intervention has taken place since March 2004.

Exchange Rate and Intervention



Sources: Ministry of Finance and Bloomberg, LP.

There is evidence that intervention has had some impact on yen movements. Measuring the effectiveness of official intervention is difficult, since many interrelated factors affect the exchange rate at any time. This said, several researchers have concluded that Japanese intervention has had (at best) a modest and temporary impact on short-term movements in the yen/dollar exchange rate. In particular, one study found that intervention of about ¥2.5 trillion (or about \$250 billion) on average moved the yen/dollar exchange rate by ¥1 or so, or about 1 percent at the current exchange rate.[1] This impact may have been somewhat larger in the late 1990s, when foreign exchange intervention was often coordinated among major countries.

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[1]Ito, Takatoshi, “Interventions and the Japanese Economic Recovery,” paper presented at the University of Michigan Conference on Policy Options for Japan and the United States, October 2004.

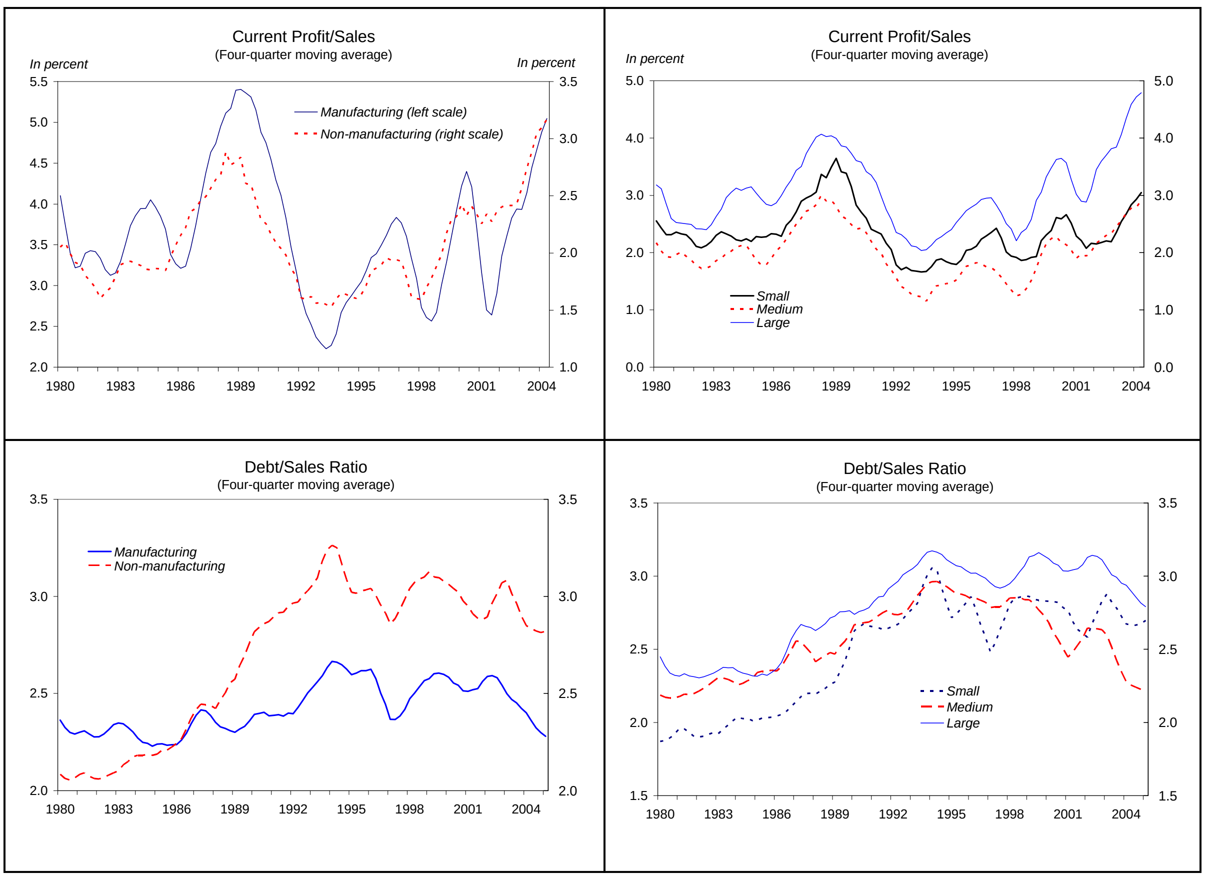
Box 2. Japan: Continued Improvements in Corporate Sector Health

Further progress has been made in addressing the corporate sector excesses of the 1990s. Firms have continued to trim labor costs from high levels, scale back fixed asset overhangs, and reduce debt. Meanwhile, recent years have seen a sharp fall in the debt of bankrupt companies, which is now about 1½ percent of GDP, not far above the 1980s average of about 1 percent of GDP. These improvements were facilitated by a variety of factors: enhanced regulatory pressure on banks to deal with nonperforming loans; enhancements to the framework for corporate sector restructuring; and a strengthening economic environment.

Profitability has continued to rise on a broad basis. Firms of all sizes, in both manufacturing and nonmanufacturing industries, have enjoyed a sharp pickup in profitability. Indeed, it is notable that this trend continued through the 2004 soft patch, suggesting that structural as well as cyclical factors have been at play. For all categories of firms, the ratio of current profits to sales is the highest since the late 1980s; indeed, for large companies and nonmanufacturers, it exceeds the late-1980s peak.

In addition, corporate deleveraging has continued apace. Debt/sales ratios have recently declined for both large and small firms in manufacturing and nonmanufacturing sectors alike. By and large, leverage by this measure has fallen to around levels last seen more than a decade ago. However, small firms' leverage remains around the 1990s average.

All in all, the picture is one of a corporate sector that is in better health than in a number of years. In some sectors, Japanese firms are in the best shape since the bubble period by some measures.



Source: Minisitry of Finance.

Box 3. Japan: Update on the Banking System

The financial condition of the banking system has continued to improve. Nonperforming loans (NPLs) have declined sharply, with the NPL ratio at major banks falling from more than 8 percent in FY2001 to below 3 percent. Capital quality improved, with the capital adequacy ratio rising to 11.6 percent, and the share of deferred tax assets in capital declining. The improvement at regional banks has been more gradual, however.

Banking system profitability has increased, but remains low by international standards. Owing to reduced credit costs, major banks earned a combined net income of ¥575 billion in FY2004, following losses in the previous three years. Nonetheless, underlying profitability (excluding credit costs and gains on bond and stock holdings) remains low. Compared with their industrial country peers, Japanese banks earn narrow net interest margins and low noninterest revenues.

Banks are now less vulnerable to market shocks. Banks have taken steps to reduce their equity holdings, which are now below the level of Tier 1 capital. However, bond holdings have increased slightly.

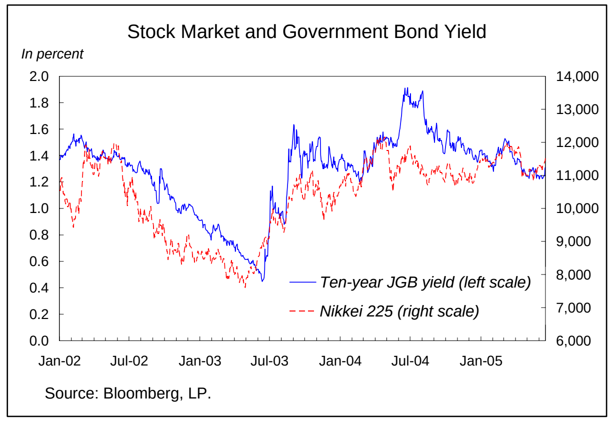
Heightened supervisory efforts have contributed to the improvement in the banking system. Ongoing corporate restructuring efforts and the improved economic outlook have helped reduce the overhang of bad debts. Policy efforts have also played a central role, notably through the 2002 Program for Financial Revival. Policies have been broadly in line with staff recommendations, including in the 2003 Financial Sector Stability Assessment. The priorities have included:

- *Improve recognition and provisioning of bad loans*. The Financial Services Agency (FSA) has broadened the application of forward-looking discounted cash flow analysis in assessing loan quality. Heightened scrutiny of loan books through special inspections of select borrowers has led to better bad loan recognition and more appropriate provisioning.
- *Strengthen bank capital*. The FSA has requested greater scrutiny of deferred tax assets by auditors, and is considering rules to limit the share of DTAs in regulatory capital.
- *Recapitalize banks subject to strict conditions*. Legislation allowing regional banks to apply for public capital injections was adopted in 2004. No applications have been made yet, although the scheme could be used to support planned regional bank mergers.
- *Reduce the role of government financial institutions (GFIs)*. The authorities are in the process of deciding the basic framework for GFI reform, with a view to cutting outstanding GFI loans in half. A blueprint for the privatization of Japan Post—by far the largest GFI—is currently before the Diet.

Going forward, policies need to shift toward promoting the revitalization of the banking system. A key priority is to raise core profitability in the banking system. Planned measures to expand the range of products that banks can offer will be helpful. In addition, reduced reliance on real estate collateral and improved risk management systems will help prevent a return of the bad loan problem, and help prepare Japanese banks for the adoption of Basel II. The FSA has adopted a new Program for Further Financial Reform to guide future financial sector reforms along these lines, and is in the process of elaborating more detailed policies.

banks more than met the PFR's goal of halving the NPL ratio to around 4 percent by the program's expiration in March 2005. The pace of decline in bank lending has slowed and, according to the Tankan survey, borrowers perceive an increased willingness to lend. In addition, the blanket guarantee on bank deposits was lifted at end-March, with no signs of strain.[2] Regional banks, which have been subject to a less rigorous action plan than major banks, have also made progress, albeit more slowly, in cutting bad loans. Nonetheless, the process of revitalizing the banking system has further to go. The quality of bank capital is weakened by deferred tax assets (DTAs), which have fallen steadily but still account for about a fourth of major banks' Tier 1 capital.[3] Core profitability remains low, leaving banks vulnerable to shocks and ill-positioned to perform effective financial intermediation.

13. **Asset market developments have been relatively uneventful** (Figure 3). The Nikkei has been broadly flat over the past year. The ten-year JGB yield declined in the summer of 2004 as economic data disappointed, and has remained low. There are indications that land prices may be bottoming out, with clear signs of revival in central Tokyo.



14. **Monetary policy remains highly accommodative** (Table 3). The Bank of Japan (BoJ) has provided significant liquidity under its quantitative easing framework, keeping current account balances at a high level and short-term interest rates at zero.[4] It has repeatedly stressed that the policy will remain in place until deflation is defeated. In May, the BoJ decided to allow temporary undershooting of its target range for current account balances in the face of seasonal volatility in the demand for liquidity. The move was generally perceived by markets as a technical step and not as a fundamental policy shift.[5]

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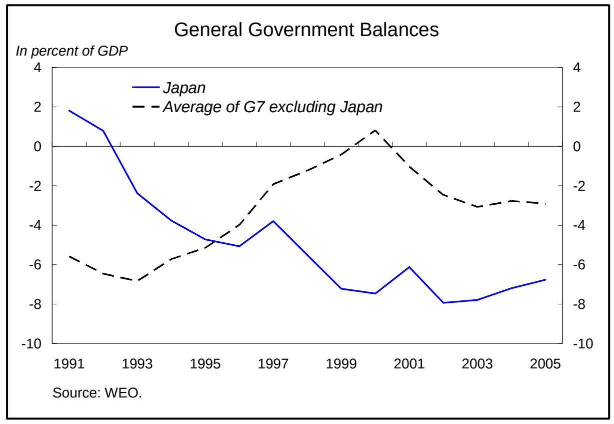
[2]The blanket guarantee was originally to be replaced with a more limited scheme in March 2001, but the change was twice delayed on concerns that the banking system remained too weak.

[3]DTAs are credits against future taxes, which have value only if the bank earns profits.

[4]The quantitative easing framework was put in place in March 2001. The target for current accounts (bank and nonbank accounts at the central bank) was last raised in January 2004.

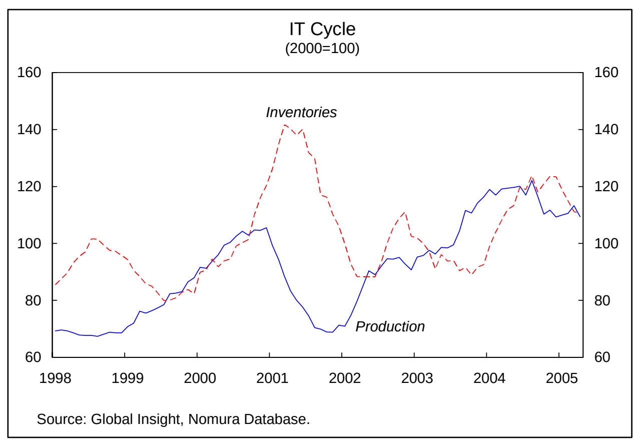
[5]Recent fund-supplying auctions have been undersubscribed, as the demand for liquidity has declined.

15. **Fiscal consolidation was achieved in FY2004 (ending March 2005), but the deficit remains large** (Table 4 and Figure 5). The general government deficit is estimated to have narrowed by 0.6 percent of GDP to 6.9 percent of GDP, although the structural deficit declined by only 0.3 percent of GDP. About half of the decline in the general government deficit reflected stronger-than-expected revenues and some expenditure savings achieved in the supplementary budget.[6] A decade of high deficits has fed rapid growth in gross public debt to 170 percent of GDP, by far the highest among advanced countries. Net debt is around 80 percent of GDP.



III. Macroeconomic Outlook and Risks

16. **There are signs that the factors underlying Japan's soft patch are waning.** The mid-2004 slowdown in world growth appears to be bottoming out, while inventory and production adjustments in the IT sector are advancing. Other data point to a revival of private consumption and investment and more resilient domestic demand going forward. Reflecting these factors, as well as base effects from the 2004 soft patch, annual average growth is projected at 1.8 percent in 2005 (2½ percent on a q4/q4 basis), somewhat above potential and broadly in line with private and official views. Growth in 2006 is projected at 1.7 percent. As economic slack is taken up, deflation is expected to ease, with consumer prices finally bottoming out during 2006.



17. **Nonetheless, risks remain biased to the downside.** Global growth could weaken, especially if new spikes in oil prices occur.[7] In addition, renewed upward pressure on the yen

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[6]The supplementary budget incorporated higher revenue projections as well as spending for reconstruction in regions affected by earthquakes, partly offset by reduced expenditures in other areas. Overall, the supplementary budget targeted savings of ¥1½ trillion.

[7]Japan has become more energy efficient over time. Since 1980, oil imports have declined from 5 percent to 1¼ percent of GDP. Japan's oil utilization per dollar of real GDP is the lowest among advanced economies. According to staff estimates, shocks that could reduce

(continued)

could dampen external demand and exacerbate deflation. On the domestic side, risks appear more balanced: the outlooks for consumption and business investment hinge mainly on the buoyancy of confidence and the prospects for wages and profits growth, which staff gauge as roughly equally likely to exceed or fall short of expectations.

18. **Over the medium term, with the output gap now having narrowed, growth is envisaged to slow to potential, with population aging and fiscal consolidation shaping the economic landscape.** In the staff's baseline projections, growth moderates to potential, estimated at 1.5 percent, by 2008 (Box 4). Relatively low potential growth reflects muted total factor productivity, as well as a continued decline in the working-age population. Population aging also pushes down the household savings rate, contributing to a steady decline in the private savings-investment balance (with corporate savings and investment essentially stable).[8] However, a rising public savings-investment balance offsets this trend, with the effect that the current account balance is broadly unchanged over the medium term.

Japan: Medium-Term Projections, 2004-10
(Percentage change from the previous period, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010
Real GDP 1/	2.6	1.8	1.7	1.6	1.5	1.5	1.5
Total domestic demand	1.9	1.9	1.6	1.5	1.4	1.4	1.4
Net exports (contribution)	0.8	-0.1	0.2	0.1	0.1	0.1	0.1
Unemployment rate (percent)	4.7	4.4	4.2	4.0	4.0	4.0	4.0
CPI inflation	0.0	-0.4	-0.1	0.6	1.2	1.5	1.9
Savings-investment balances 2/							
Private	7.7	7.2	6.7	6.6	6.6	6.5	6.3
Public	-4.1	-3.7	-3.2	-3.0	-3.0	-2.9	-2.6
Foreign saving 2/	3.7	3.5	3.5	3.5	3.6	3.7	3.7

Sources: Global Insight, Nomura database; and Fund staff estimates.
1/ Annual growth rates and contributions are calculated from seasonally adjusted data.
2/ In percent of GDP.

IV. POLICY DISCUSSIONS

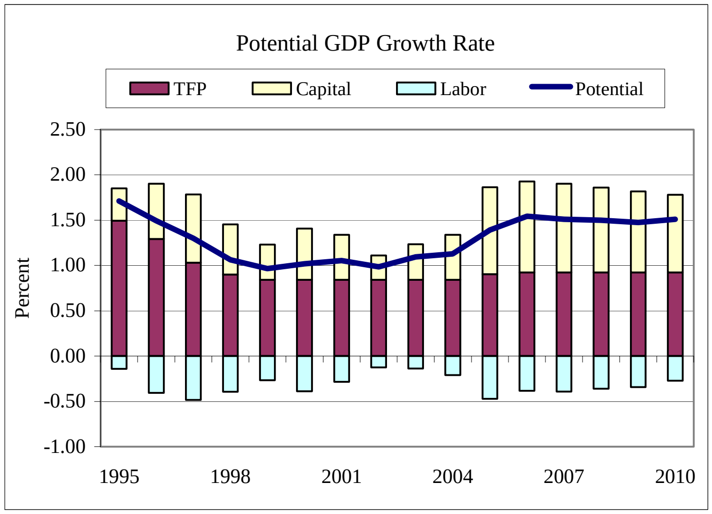
19. **The discussions focused on policies to lay the foundation for a resilient, lasting expansion.** Near-term economic prospects have improved and structural reforms have advanced, bolstering the economy's resilience. In addition, a start has been made on fiscal

Japan's growth by 0.1 percent include: a ¼ percentage point fall in the U.S. growth rate; a 10 percent increase in oil prices; and a 5 percent appreciation of the yen.

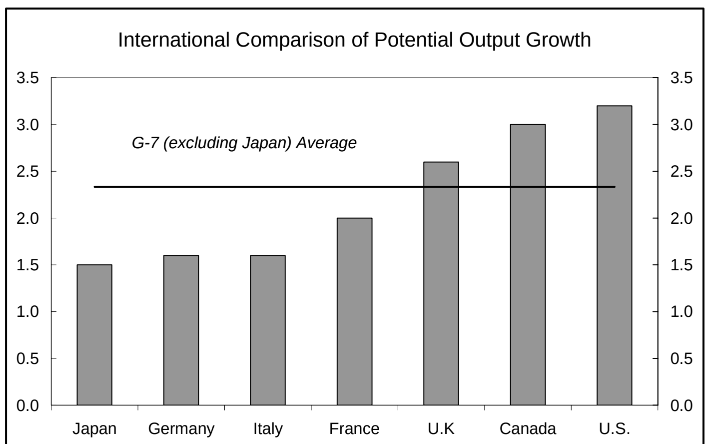
[8] The *Selected Issues* paper discusses the impact of population aging on household savings.

Box 4. Japan's Potential Output Growth

The staff estimates Japan's potential output growth at 1.5 percent. The estimate is based on a production function approach and uses the new chain-linked GDP data. It can be decomposed into contributions from total factor productivity (TFP) growth (1 percent), capital input growth (about ¾ percent), and labor input growth (about -¼ percent). As ongoing corporate restructuring proceeds—and obsolete capital is either scrapped or replaced—net investment is projected to pick up, leading to an increased contribution of capital over the longer term. This increased contribution, however, is partly offset by a prospective decline in the labor force, the net result of a decline in the working-age population, and some gains in the participation ratio.



Japan's potential output growth is low relative to other G-7 countries. According to the OECD, Japan lags its counterparts by nearly 1 percentage point. While this in part reflects the decline in the working-age population, much of this difference stems from lower TFP growth. To improve its growth prospects in the medium term, Japan should take steps to boost productivity. In addition, measures to increase labor force participation would be desirable.



Source: OECD.

[1] Based on the 1995 fixed-weight GDP aggregate, the previous staff estimate for potential growth was 1.7 percent.

consolidation, and elements of a strategy to stabilize the debt over the medium term are in place. However, with modest underlying growth and mounting demographic pressures, the outlook remains vulnerable. Thus, the discussions focused on measures to boost productivity and rein in fiscal imbalances. There was agreement that monetary policy should continue to be geared to defeating deflation; fiscal policy should stabilize the debt while making room for growing budgetary demands from an aging society; and structural policies should further pursue the benefits of greater competition and flexibility in factor and product markets.

20. **During recent consultations, the staff and the authorities have agreed on the main policy priorities** (Box 5). In recent years, the broad thrust of policies has been in line with staff advice, including an expansionary monetary stance, fiscal consolidation, and tighter bank regulation. By and large, however, the authorities have preferred a more gradual approach than staff, partly out of concern that aggressive reforms could stifle economic activity, and partly owing to a preference for policy flexibility.

21. **The mission emphasized that putting Japan on a higher medium-term growth path would also help strengthen the world economy and reduce global imbalances.** Medium-term fiscal consolidation is an essential part of the required strategy. In the short run, fiscal consolidation could have a modest negative impact on growth, as well as raise national savings (thereby leading to a larger current account surplus). But in the longer run, putting the debt on a sustainable path is crucial to achieving a sustained expansion—in particular, by limiting the risk of higher real interest rates and a more burdensome future adjustment. The other essential element of the medium-term strategy is structural reform, which is necessary to mitigate the effects of population aging on potential growth and bolster Japan's productive capacity. In addition to making the global economy more resilient, more robust growth in domestic demand stemming from such reforms would help to reduce Japan's large current account surplus. In the context of concerted policy efforts in other countries to address external imbalances, this strategy could contribute to a smooth resolution of global imbalances, and thereby reduce the risk of a disorderly adjustment in currency markets.

22. **To illustrate the long-run gains from a comprehensive package of fiscal consolidation and structural reforms, the staff prepared indicative scenarios using the Fund's Global Economic Model.**[9] The analysis examines the effects of a policy package combining (a) a pickup in productivity of ½ percent per year—the simulated payoff from reforms—and (b) an additional ¼ percent of GDP per year in deficit reduction (as discussed below, this adjustment is estimated by staff to be necessary, over and above the authorities' intended path, to stabilize the debt over the medium term). In the simulations, a small upfront

[9]For details of the simulations, see the *Selected Issues* paper.

Box 5. Japan: Policy Dialogue

In recent years, the Japanese authorities and the Fund have agreed on the main policy priorities, but the authorities have generally favored more moderate steps than the Fund, partly out of concern for the risks that stronger actions might pose.[1] The staff has had a frank and open dialogue with the authorities.

Monetary policy

Fund recommendations: Maintain highly accommodative monetary conditions, including through increases in the quantitative target, and possibly through unsterilized intervention; enhance the communications strategy through an inflation objective and other measures.

Policy developments: In the past few years, monetary policy has been eased and sizeable interventions have been made, although the Bank of Japan (BoJ) eschewed more aggressive approaches owing to concerns about the risks to (for example) its balance sheet. On communications strategy, the BoJ views an inflation objective as an option and continues an active internal debate on the pros and cons of this and other approaches.

Fiscal policy

Fund recommendations: Employ both spending restraint and revenue enhancement to make progress toward medium-term fiscal sustainability; enhance the credibility of the authorities' consolidation plans by specifying a primary surplus target and measures to achieve it; in the near term, save any stronger-than-expected revenues and explore possible expenditure savings.

Policy developments: The structural deficit was reduced by about 1 percent of GDP over FY2001–04, reflecting both expenditure and revenue measures (and in FY2004, windfall revenues that were saved). However, the authorities have been reluctant to adopt a more specific medium-term plan, citing a need for flexibility (in the late 1990s, a fiscal program had to be abandoned soon after it was adopted, owing to the onset of a recession).

Financial and corporate sectors

Fund recommendations: Strengthen supervision and regulation to expeditiously resolve banking sector weaknesses (including in the context of the 2003 FSSA); take steps to improve the environment for bank profitability, in particular by leveling the playing field with public financial institutions.

Policy developments: The government's 2002 Program for Financial Revival fostered a significant improvement in the health of major banks, although the Fund favored bolder reforms. In addition, weaknesses remain in the financial system: regional banks continue to lag, and bank profitability remains low. Meanwhile, a government plan to privatize Japan Post could reduce competition from public financial institutions. The plan is now in the final stages of legislative deliberation.

Trade policy

Fund recommendations: Reduce high levels of agricultural protection to ameliorate the costs to Japanese consumers and developing countries; move forward with trade liberalization in a multilateral context.

Policy developments: The authorities have felt that agricultural liberalization should be gradual and take account of nontrade concerns such as food security and environmental protection. They have seen bilateral agreements as opportunities to move forward with objectives that made little progress in the Doha Round.

Structural reforms

Fund recommendations: Enhance labor market flexibility, advance regulatory reform, and accelerate public enterprise reforms.

Policy developments: The authorities have broadly agreed with these priorities. However, progress has been mixed, and much remains to be done.

[1]The PIN for the 2004 Article IV consultation is available on the web at www.imf.org/external/np/sec/pn/2004/pn0488.htm.

decline in GDP (about ¼ percent) is quickly followed by a rebound in growth to about ½ percent above the baseline, as the growth effects of higher productivity come to more than offset the impact of fiscal consolidation. The current account is broadly unchanged initially, but then rises modestly over time reflecting the boost to national savings from fiscal consolidation; however, the current account surplus increases by less than if fiscal consolidation were undertaken alone, as import demand picks up due to higher income. Government debt declines significantly, falling by 18 percent of GDP over the next ten years. The effects on other countries are minimal, as structural reforms offset the potential negative international spillovers from fiscal drag.

Japan: Effects of Structural and Fiscal Reforms
(Percentage deviation from baseline)

	2005	2010	2015
Japan			
Real GDP (level)	-0.2	0.7	2.5
Current account (percent of GDP)	-0.1	0.8	0.7
Government debt (percent of GDP)	0.3	-5.8	-17.8
United States			
Real GDP (level)	0.0	0.0	0.0
Current account (percent of GDP)	0.0	-0.2	-0.2
Euro area			
Real GDP (level)	0.0	0.0	0.0
Current account (percent of GDP)	0.0	0.0	0.0
Emerging Asia			
Real GDP (level)	0.0	-0.1	0.0
Current account (percent of GDP)	0.0	0.0	0.0
Rest of the world			
Real GDP (level)	0.0	0.0	0.0
Current account (percent of GDP)	0.0	0.0	0.0

Source: Fund staff estimates using Global Economic Model.

23. **A stronger pickup in productivity—corresponding to more vigorous structural reforms—would yield concomitantly larger benefits.** The assumed payoff from structural reforms of ½ percent per year is toward the cautious end of estimates in the literature, which range from ¼ to 2½ percent of GDP (see Annex IV). With a more optimistic one-percent per year pickup in productivity growth and the same fiscal effort as in the previous scenario, the current account surplus declines by about ½ percent of GDP in the near term. In addition, after ten years the level of debt is 24 percentage points of GDP lower than under the no-reform baseline—thus, structural reforms facilitate the task of stabilizing the debt.

Monetary policy: Defeating deflation and guiding market expectations

24. **The authorities and the mission agreed that the priority for monetary policy remained tackling deflation.** BoJ officials stressed the continued commitment to maintain the quantitative easing framework until actual inflation is nonnegative for a few months and a majority of Board members forecast positive inflation (on the basis of the year-on-year change in the core CPI). Even then, quantitative easing may stay in place if circumstances dictate. Accordingly, the BoJ has maintained the present level of the current account target since January 2004 to signal its commitment to easy monetary policy.

25. **That said, there has been increasing discussion in recent months about whether to lower the quantitative policy target.** On the one hand, with dwindling precautionary demand for liquidity, reducing the target would probably not push up short-term interest rates. In addition, the fund-supplying operations needed to maintain the target exacerbate distortions in financial markets and reduce the BoJ's operational flexibility by lengthening

the maturity of its operations.[10] On the other hand, markets could misread a reduction in the balance as signaling an intention to move toward an early tightening, and there remains a need to defeat deflation once and for all. On balance, the BoJ has decided to leave the target unchanged to signal unambiguously the monetary stance and its intentions.

26. **Looking further ahead, it was agreed that skillful communication will be essential to guide expectations as monetary conditions and operations normalize.**[11] BoJ officials noted their recent efforts in this regard, including more explicit public discussion of the considerations surrounding the conduct of monetary policy as well as a longer horizon for policy members' forecasts in the biannual Outlook Reports. The mission observed that open discourse by BoJ officials on the pros and cons of different policy options appears to have helped reassure markets of the intention to maintain easy monetary conditions for as long as necessary. This was evidenced by a smooth market response to the recent adjustment to monetary operations. Going forward, continued communication along these lines could lay the groundwork for eventual reductions in the quantitative target.

27. **More generally, there was a shared view that it is important to maintain flexibility in monetary operations and strategy during the transition back to inflation.** Monetary operations will need to shift back to using interest rates as a policy tool, as inflation reappears; however, the risks of remaining accommodative for too long are outweighed by the costs of a premature tightening. That said, it would be inappropriate to specify in advance a concrete strategy for future monetary operations, which would need to be tailored to evolving financial and economic conditions. With regard to strategy, the mission discussed whether more explicit elaboration of the BoJ's medium-term inflation objective, without a commitment to achieve it over any specific timeframe, could allow due flexibility while helping to anchor inflation expectations during the transition. BoJ officials acknowledged that this was one option for communicating policy objectives, but nevertheless emphasized the practical difficulties of identifying an appropriate numerical target, partly because of the measurement problems inherent to price indexes. They also expressed concerns that even a nonbinding objective would be interpreted by markets as a rigid target that the BoJ was obliged to achieve in the short term. Accordingly, introducing such an objective could adversely affect the BoJ's credibility if inflation did not quickly rise to the target. This was especially a concern in light of remaining weaknesses in the transmission mechanism. The team agreed that, given the stated commitment to maintain zero interest rates until inflation turned positive, the benefit of elaborating a medium-term inflation objective at present was unclear. Nevertheless, the mission encouraged the BoJ to keep the option open for the future.

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[10] Financial market distortions include downward pressure on bank profits due to very low spreads and reduced transactions in private money markets (with overnight interest rates near zero, money market dealing is unprofitable).

[11] For further analysis, see "A Post-Reflation Monetary Framework for Japan" (WP/05/73).

28. **The mission also discussed the possible use of unsterilized intervention to combat deflationary pressures if the yen strengthened.** In its view, smoothing operations could be warranted if market conditions turned disorderly. In addition, with the effectiveness of more conventional monetary policy tools hampered and the room for fiscal maneuver limited, unsterilized intervention would be an option if appreciation pressures threatened to stall the recovery or significantly worsen deflation. However, from both domestic and global standpoints, unsterilized intervention would be warranted only under extraordinary circumstances. The economy is better placed now than a year ago to cope with a stronger currency, while its external surplus has grown. Also, from a longer-term perspective, heightened competition in international markets has probably reduced pass through from exchange rates to final goods prices over time—implying that yen appreciation would put less downward pressure on Japanese domestic prices than it had in the past.[12]

29. **The authorities broadly concurred with this assessment, and stressed that Japan's exchange rate policy remained unchanged.** It remains grounded in the notion that exchange rates should reflect fundamentals, since excess volatility harms economic growth. Accordingly, the authorities considered that, in the event of disorderly fluctuations in the foreign exchange market, intervention could still be warranted.

Fiscal policy: Stabilizing the debt and making room for population aging

30. **Large fiscal imbalances and growing pressure on the budget from population aging create risks for medium-term growth.** Since 2000, net public debt has grown from 60 percent to 80 percent of GDP, and absent significant further fiscal measures, is set to rise further over the medium term. Avoiding an upward spiral in debt will require, among other measures, steps to contain pressures on public social security spending from population aging. Government projections show that under unchanged policies, such spending will double in nominal terms over the next two decades—an increase of 2.5 percentage points of GDP—reflecting higher healthcare outlays (comprising medical and long-term care). Addressing this situation will require difficult policy choices (Box 6).

31. **The authorities see a growing public consensus in Japan that the debt situation needs to be addressed.** A focal point for discussion is the Cabinet Office's medium-term analysis, which envisages achieving balance in the primary deficit excluding social security by the early 2010s. This path would stabilize the debt/GDP ratio and subsequently put it on a slightly declining path. In this context, it is also increasingly recognized among officials and

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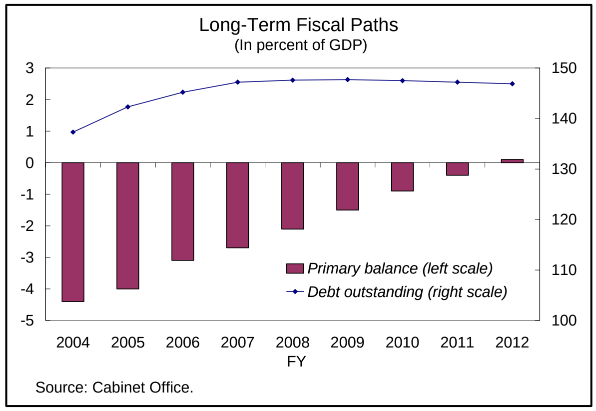
[12] Research has found that the pass through from dollar depreciation to U.S. import prices has declined significantly during the past ten years or so, possibly owing in part to increased competition from China and other new entrants. See Marazzi and others, "Exchange Rate Pass Through to U.S. Import Prices: Some New Evidence," International Finance Discussion Paper 883, U.S. Federal Reserve Board of Governors (April 2005).

Box 6. Japan's Longer-Term Fiscal Challenges and the Authorities' Plans

In January 2005, the Cabinet Office (CAO) released projections for the public finances excluding social security. The projections envisaged a primary surplus of 0.1 percent of GDP in FY2012 for the central and local government (a concept approximating the general government minus social security). This adjustment would stabilize the gross debt ratio from FY2007.[1] The projections assume progress in structural reforms that generate gains in productivity, as well as some fiscal efforts to restrain the deficit.



The interest rate path underlying the projections appears optimistic (the growth trajectory is in line with staff projections). In particular, the average real interest rate appears low, and the primary surplus for FY2012 would not stabilize the debt-to-GDP ratio under the staff's more conservative real interest rate assumption. According to the staff's analysis, stabilizing the debt in net terms (a somewhat different exercise than in the authorities' plan) would require a primary surplus excluding social security near 3 percent of GDP (see Annex III).

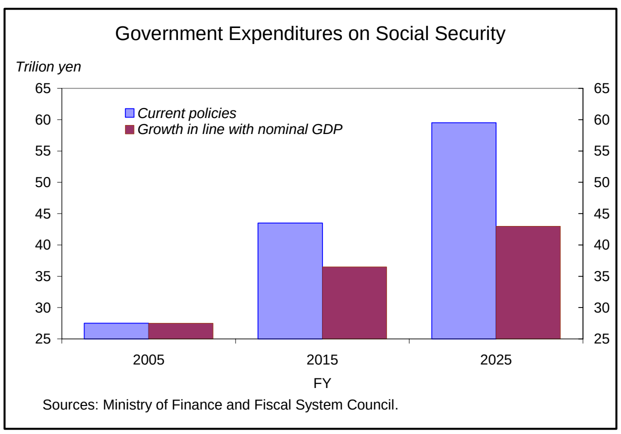
Macroeconomic Indicators
(Average, FY2006–FY2012)

	CAO	Staff
Real GDP	1.5	1.5
GDP deflator	1.8	0.8
Real interest rate	1.5	2.6

Sources: Cabinet Office; and Fund staff estimates.

A recent government report indicates that the public finances including social security will continue to deteriorate under current policies. In May 2005, the Fiscal System Council (an advisory group to the Finance Minister) simulated the implications of maintaining current revenue and expenditure policies:

- The primary deficit of the central government's general account (which is a focal point of Japan's fiscal system) would rise to ¥25 trillion in FY2015, from ¥16 trillion in FY2005.
- In addition, government expenditures on social security benefits (both inside and outside the general account) will rise to almost ¥60 trillion (8 percent of GDP) in FY2025 from ¥27½ trillion (5½ percent of GDP) in FY2005.



The authorities recognize that bold steps will be needed to address these challenges. The Fiscal System Council estimates that relying only on expenditure measures to fill the gap would result in a 30 percent across-the-board spending cut. Alternatively, assuming no other actions are taken, the consumption tax rate would need to be increased to 19 percent (from 5 percent). Fiscal adjustment is therefore likely to involve a mix of spending and revenue measures.

[1]The CAO projection is based on a debt concept consisting largely of central and local government bonds. The SNA definition of gross debt also includes social security liabilities and foreign exchange bonds (which raise the debt ratio by about 30 percentage points).

in the public at large that the adjustment—on the order of ½ percent per year in these projections—will require difficult measures on both revenue and expenditure sides.

32. **The mission supported the authorities' aims and recognized the significant efforts that would be required, but still saw a need for a more ambitious medium-term consolidation program.** In addition to social security reforms, a significant primary surplus excluding social security is likely to be needed to stabilize the debt, as real interest rates may be higher than in the authorities' projections (Box 6 and Annex III)—and indeed, could potentially exceed the staff's projections. Accordingly, a more ambitious objective might be needed—perhaps a primary surplus excluding social security of around 3 percent of GDP, implying an adjustment on the order of ¾ percent of GDP per year on average through the early 2010s (a cumulative adjustment of 7 percentage points of GDP).[13] Moreover, it will be desirable to reduce the debt over time, given its already high level—thus, any savings over and above that average should be used for that purpose. The authorities expressed reservations about the possible adverse macroeconomic effects of stronger deficit reduction, but the mission considered that the impact of an additional annual ¼ percentage point of GDP in fiscal withdrawal over the medium term would be manageable, given that the economy has become more resilient and that the fiscal multipliers are in all likelihood small (Box 7). The mission also discussed the question of whether fiscal rules could bolster the credibility of the authorities' plans, as they have in other countries. The authorities were skeptical about the usefulness of such rules, citing the experience in 1998 when a rigid fiscal program had to be abandoned shortly after its introduction in the face of faltering growth. In their view, the credibility of fiscal policy would hinge most of all on the steady implementation of deficit reduction. In any event, the mission and authorities agreed that implementation of fiscal consolidation would need to take due account of evolving economic circumstances.

Primary Balance Needed to Stabilize Debt

	General Government	Social Security	General Government Excluding Social Security
FY2004	-5.4	-1.2	-4.2
FY2013	1.0	-1.9	2.9
Change	6.4	-0.7	7.1

Source: Fund staff estimates.

33. **As for specific measures, the authorities view further reining in expenditures as a first priority.** Although the scope to trim discretionary spending is limited, such cuts are necessary to limit the size of tax hikes, streamline the public sector, and convince the public that all possible measures are being considered prior to raising taxes. With regard to more specific steps, the authorities are discussing expenditure measures in four areas:

[13] A one-percentage point increase in the long-run real interest rate, or a one-percentage point decline in the long-run real growth rate, would increase by roughly one percent of GDP the primary balance needed to stabilize the debt (see Annex III).

Box 7. How Much Does Fiscal Policy Affect Economic Activity in Japan?

Studies of fiscal policy effectiveness generally find that fiscal multipliers in Japan are modest.[1] Estimated multipliers are typically around unity or less in the short run, and often smaller in the long run. Broadly speaking, a ¥100 cut in expenditure is estimated to reduce GDP by around ¥100 to ¥125 in the short run, while a ¥100 increase in the tax burden is estimated to reduce GDP by about ¥25 to ¥50. Long-run multipliers are usually estimated to be even smaller. Calculation using the Global Economic Model, for example, shows a short-run fiscal multiplier of about 1 and a long-run multiplier of about zero.

However, the impact of future deficit reduction could be different than suggested by these estimates. The estimates depend on underlying economic assumptions (such as the sensitivity of investment to interest rates and the responsiveness of labor supply and savings to after-tax income) which are hard to measure. Also, fiscal multipliers may change with economic circumstances. Accordingly:

- The effects could be *larger* if past cuts to public investment eliminated unproductive spending, but future cuts impact core infrastructure, thereby lowering growth prospects. Also, the scope for an offsetting easing of monetary policy is more limited than in the past.

- The effects could be *smaller* if fiscal consolidation lowers the risk premium and real interest rates significantly. In addition, taxpayers might pay for expected future tax hikes by drawing down savings instead of cutting spending, limiting the impact on aggregate demand. Indeed, research finds that in OECD countries, a one-percentage-point of GDP increase in the deficit elicits a rise in private savings of one-third to one-half that size.

On balance, steady fiscal consolidation as advocated by staff in this report will probably dampen output somewhat over the medium term. With a multiplier of 0.5 to 1.0, additional annual deficit reduction of ¼ percentage point of GDP would reduce growth by 0.25 to 0.13 percent at the margin. To the extent that taxes bear part of the adjustment and have a smaller multiplier, the drag would be toward the lower end of this range. In addition, more decisive consolidation could yield an implicit payoff by forestalling a rise in real interest rates and a larger future adjustment. In some countries, fiscal consolidation has even been associated with output expansions, as it has *reduced* risk premia (see WEO, May 1995, Box 2). However, such an "expansionary fiscal contraction" seems unlikely in Japan, as risk premia and interest rates are already very low.

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[1] See, for example, the survey by Hemming and others (2002). "The Effectiveness of Fiscal Policy in Stimulating Economic Activity—A Review of the Literature," IMF Working Paper WP/02/208.

- *Social security:* The 2004 reforms to the pension system put its finances on a stable footing under current demographic assumptions, but healthcare expenditures are set to continue rising. The government is discussing measures for healthcare spending, with the aim to devise specific proposals by end-2005.

- *Local government finances:* Devolution of tax and spending responsibilities from central to local government in the context of "trinity reforms" has already achieved net savings, albeit modest (a cumulative cut in subsidies of 0.1 percent of GDP during FY2004–05). For FY2006 further tax devolution and subsidy reform is envisaged: the overall objective of the trinity reform is to shift the financing of ¥4 trillion worth of subsidies to local governments through the devolution of ¥3 trillion in tax authority over 2004–06. So far, subsidy reform has entailed broad agreement among the parties concerned to devolve spending of about ¥2½ trillion (of which ¥0.7 trillion is to take place in FY2006). The corresponding reallocation of the tax base (including from the national income tax to the local inhabitant tax) is to be decided in FY2006. Going forward, increasing local accountability and efficiency through reforms of the system of block grants (the Local Allocation Tax) could have larger effects over time.

- *The public sector wage bill:* In the regions, public servants' pay is somewhat above private-sector levels; in addition, scope might exist to reduce head count.

- *Public investment:* Since its 1995 peak, spending has been reduced from 6½ percent to a projected 3½ percent of GDP in 2005, but there was room for additional reductions (it remains slightly above the OECD average). The Cabinet Office's projections assume a 3 percent cut in FY2006.

34. **The staff stressed that revenue measures would likely need to comprise a significant part of the medium-term adjustment.** For FY2006, steps could include streamlining the income tax system and broadening the tax base (the number of exemptions has risen dramatically over past decades). For FY2007 and beyond, the consumption tax could be raised, which would yield about ½ percent of GDP in revenue for each percentage point increase in the tax rate. The rise might be implemented in modest increments so as to limit the drag on economic activity. Because the prime minister had vowed not to increase the tax during his term, a hike is unlikely before 2007.

35. **While comprehensive expenditure and tax reforms are being formulated, the authorities are taking measures to restrain the deficit.** In the FY2005 budget, a past cut in income taxes has been partly rolled back, with effect from January 2006. In addition, many areas of discretionary spending in the general account of the central government have been trimmed relative to FY2004 initial budget levels—with

Central Government General Account

	FY 2004		FY2005
	Initial Budget	Revised 1/	Projected 2/
	(In percent of GDP)		
Central Government General Account			
Revenue	9.0	10.0	9.4
General expenditure	9.5	10.1	9.3
Other expenditures 3/	6.7	7.1	6.8
Bond issuance	7.2	7.2	6.7
General Government (Fund staff estimates)			
Balance		-6.9	-6.7
Primary balance (excluding social security)		-4.2	-3.8

Source: Ministry of Finance.
1/ After supplementary budget/estimated outturn.
2/ Approved budget for central government general account.
3/ Debt service and transfers to local governments.

cuts of 2 to 7 percent in education, investment, and other general expenditures—although nondiscretionary spending has grown.[14] Overall, these measures bring about a projected improvement in the gap between general account revenues and general expenditures of 0.2 percent of GDP (comparing the projected FY2005 outturn with the revised FY2004 budget). With the primary deficit of the social security system unchanged and the local government balance improving by 0.2 percent of GDP on the back of buoyant revenues, this translates into a projected reduction of 0.4 percent of GDP in the general government primary deficit (staff estimates).[15]

36. **Regarding the near-term fiscal position, the mission encouraged the authorities to make significant further headway in deficit reduction.** The staff projects that the primary deficit will decline over FY2005 and FY2006 based on existing measures and a continued expansion. However, the structural balance is projected to decline only slightly in FY2005, and staff therefore expressed the view that further savings would be desirable. The mission and the authorities agreed that in FY2005 any tax windfall should be saved, and that there is no need for expansionary measures in this year's supplementary budget, assuming the expansion continues as envisaged. Looking to FY2006, the mission encouraged the authorities to make additional significant progress in the context of the forthcoming budget, reducing the primary deficit excluding social security by ¾ percent of GDP or more. The mission deemed this adjustment feasible based on existing and prospective policy measures, namely the further rollback of past income tax cuts, measures to broaden the income tax base, and continued cuts in discretionary spending (including public investment).

37. **The mission expressed the hope that the authorities would achieve fiscal consolidation without further impinging on development assistance, with every effort to raise it toward the UN target.** Net ODA disbursement was around 0.2 percent of GNI in FY2004, slightly reduced from FY2003 and below the UN target of 0.7 percent. The authorities noted that the reduction in net ODA during recent years reflects heavy loan repayments; gross ODA has risen for the past four years. In addition, a significant part of development assistance, including lending activities, is financed off-budget.

Financial system: Shifting from stabilization to revitalization

38. **Strengthened regulation, along with the economic recovery, has stabilized the financial system.** The main balance-sheet weaknesses stemming from the bubble period—

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[14] The general account is the basis for the central government budget. It includes most central government revenues and some spending, with (for example) social security premia included in "special accounts."

[15] The staff's macroeconomic estimates compare the estimated outturn for FY2004 (final data are not yet available) with the projected outturn for FY2005. In formulating the budget, the authorities' analysis focuses on the difference between the current year's and prior year's initial budgets.

high NPLs, excessive market risk exposures, and weak capital—have been reduced to manageable levels for the major banks. In addition, regional banks have made slower, yet steady, progress in dealing with NPLs. Thanks to the attendant improved confidence in banking system stability, the end-March rollback in deposit insurance coverage went smoothly.

39. **Accordingly, financial sector policies are shifting emphasis to revitalization.** The Program for Further Financial Reform (PFFR) announced in 2004 proposes a wide range of policy measures to improve the soundness and efficiency of Japan's financial system, in line with the longer-run trend toward liberalization and internationalization of capital markets (Box 8).[16] For example, banks will be allowed to offer a wider range of products, which could support core profitability.[17] The PFFR incorporates an enhanced focus on risk management, including proposals to encourage banks to rely less on real estate collateral and guarantees. In addition, the program aims to enhance investor protection through a comprehensive Investment Services Law covering the full range of financial services (banking, securities, and insurance). It also includes insurance industry measures, such as a review of the solvency margin standard and strengthened policy holder protection.

40. **The mission encouraged the authorities to implement the PFFR and sustain efforts to strengthen balance sheets.** Enhanced risk management along with stronger profitability would make the banking system more efficient and robust. This would allow the banks to better support medium-term growth, including by avoiding a reemergence of past balance-sheet problems. Meanwhile, however, some balance-sheet weaknesses remain: NPLs are high at regional banks, and DTAs are a significant part of regulatory capital. The mission thus encouraged the authorities to continue with tightened regulation and supervision—especially for regional banks. The authorities broadly shared this view, noting that a proposal to phase in limits on DTAs in bank capital is under consideration. More generally, the authorities' aim is to pay continued attention to balance-sheet weaknesses, while increasing emphasis on forward-looking issues under the PFFR. For the regional banks, in light of factors including the more limited risk management capabilities of these banks, the authorities will continue with the Action Program for Enhancement of Relationship Banking plan, under which banks played a more active role in debt workouts with problem borrowers.

41. **It was agreed that the planned privatization of Japan Post could help level the playing field for private financial institutions.** Japan Post includes massive savings and

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[16]Financial sector reforms since the 1997–98 "big bang" have included the winding up of registration requirements on foreign exchange transactions in 1998, pension reforms in 2000 and 2001, and opening up bank window sales channels for various investment products. Following these measures, institutional investors have gradually shifted portfolios toward foreign assets (see the *Selected Issues* paper chapter on home bias).

[17]The *Selected Issues* paper analyzes factors affecting bank profitability in Japan.

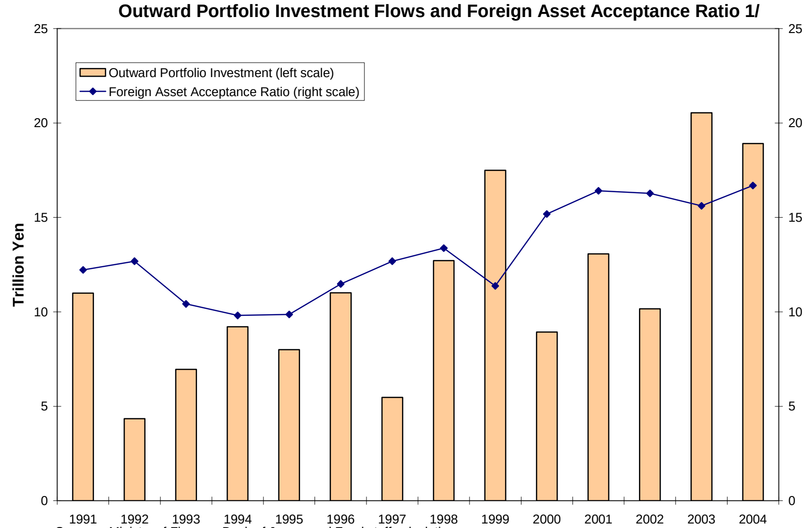
Box 8. Is Japan's Home Bias Disappearing?

Historically, Japanese investors have shown a strong preference for domestic assets—or "home bias." Reflected in a low ratio of holdings of foreign assets to total assets, home bias is present in many countries. However, it has been particularly pronounced in Japan, due in part to a combination of regulatory restrictions, administrative guidance, and aversion to currency risk.

However, investment in foreign assets has picked up. In the past decade, Japan has reduced or eliminated many administrative and regulatory sources of home bias. The remaining structural impediments to acquiring foreign assets do not appear out of the norm for an advanced country. Investors have responded to these changes, as well as low domestic interest rates and relative yen stability, by increasing purchases of foreign portfolio assets. Indeed, such purchases reached a record rate in 2003 and a near-record in 2004—almost double the average pace of 2000–02—and continued at a strong pace in the first quarter of 2005. Correspondingly, the share of foreign assets in Japanese portfolios is rising.

This adjustment could have further to go. It takes time to build up new sales channels or introduce new portfolio management practices. Accordingly, flows may respond fully to the new regulatory environment only with a delay of a few years. If outward flows continue at current rates, home bias should fall further, both in the aggregate and for several classes of institutional investors (see the *Selected Issues* paper).

Outward Portfolio Investment Flows and Foreign Asset Acceptance Ratio 1/



Sources: Ministry of Finance; Bank of Japan; and Fund staff calculations.
1/ Foreign asset acceptance ratio computed as (domestic holdings of foreign assets/total domestic asset holdings)/(foreign market capitalization/world market capitalization).

With other factors at play, the macroeconomic implications of a continued reduction in home bias are not clear. Capital outflows associated with declining home bias would be expected to put downward pressure on the exchange rate. However, there have been countervailing trends on the financial account, including a surge in foreign purchases of Japanese equities in 2003 and 2004. This may be due to reduced home bias on the part of foreign investors, as documented in the April 2005 *World Economic Outlook*. Moreover, the financial liberalization that contributed to the rise in Japanese appetite for foreign assets has also helped to raise the attractiveness of Japanese assets to foreign investors.

insurance arms, with postal savings deposits of ¥214 trillion and life insurance policies in force of ¥119 trillion (equivalent to almost one-half and one-fourth of GDP, respectively) in FY2004. In addition to a huge balance sheet and explicit government guarantees, the institution enjoys exemptions from deposit insurance premia and certain taxes. Bills submitted to the Diet in early 2005 provide for Japan Post to be subdivided into four entities (mail services, postal deposits, insurance, and over-the-counter services) and privatized over 2007–17 under a holding company structure. The holding company would be partly government-owned after 2017 but the deposit-taking and insurance arms would be fully divested. Some observers have expressed concerns about certain features in the draft bills—notably the provision to allow the holding company to buy back shares in the savings and life insurance arms after they were privatized—but by and large the draft legislation was viewed as appropriate. The mission underscored the importance of taking timely steps ahead of full privatization to ensure fair competition with private institutions, including by phasing out exemptions from deposit insurance premia and taxes as stipulated in the draft bills. The mission also saw merit in scaling back and consolidating the activities of other government financial institutions, as is under consideration, which could both make room for private lending and reduce fiscal risks.

Structural reforms: Boosting Japan's medium-term prospects

42. **The government has been pursuing a range of structural reforms to lift productivity.** For example, conditions have been eased for the use of temporary workers and job placement services; the penalties for anti-competitive behavior have been increased; and regulations have been relaxed in a number of localities on a pilot basis, under the "Special Zones for Structural Reform" initiative. Notwithstanding these steps, the authorities consider that much remains to be done in a wide range of areas. A recent government-sponsored report "Japan's 21st Century Vision" appropriately highlights the importance of improving productivity and reaping the benefits of globalization in order to avoid deteriorating living standards.

43. **In spite of these efforts, unresolved structural rigidities continue to hamper underlying growth.** The efficient allocation of resources remains saddled by market distortions, excessive and often unclear regulation, and a weak anti-trust framework. Against this background, productivity growth has tended to decline over time.

44. **The mission supported the authorities' aims to address these rigidities and encouraged them to pursue a comprehensive agenda, including** (see Annex IV for details):

- *Further improving flexibility and participation in labor markets*. Key measures would include clarifying the conditions for dismissing workers, and implementing more family-friendly policies to encourage women to enter (or reenter) the labor force.

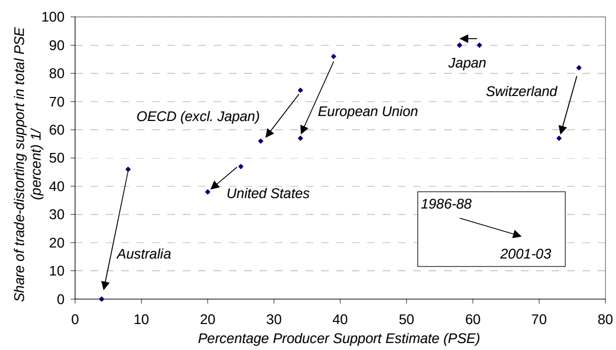
- *Enhancing competition in product markets*. The Fair Trade Commission could further stiffen its financial penalties for anti-trust violations, which remain low by international standards. Also, regulation could be relaxed further, for example by allowing more private-sector involvement in health and education at a national level (in line with "Special Zones" initiatives).

- *Encouraging inward foreign direct investment*. A key measure is to allow share-for-share swaps, along the lines of recent revisions to the Commercial Code (their entry into force has been delayed). These revisions, along with clearer rules regarding takeover defenses, would also facilitate domestic corporate restructuring.

45. **The authorities agreed that reforms are needed on a broad front, and hoped that barriers to more rapid progress would ease in coming years.** In that connection, the 21st Century Vision report has been helpful in highlighting the need for action. Nevertheless, vested interests continue to oppose liberalization measures in a number of areas such as medical care, and building a public consensus would take time. However, the authorities intend to move steadily ahead with their reform agenda, continuing to develop and implement structural measures with the aims to revitalize the economy and foster a larger role for the private sector in economic activity.

46. **The mission also highlighted the agricultural sector as particularly in need of reform.**[18] High protection for agriculture contrasts markedly with the liberal trade policies for most other sectors. Staff urged the authorities to reduce overall farm support and to better target assistance, lowering import barriers while raising direct payments to farmers—as in most other OECD countries. Ambitious agricultural reform would improve productivity and enhance growth prospects for the overall economy. It would also open up market access for developing countries, particularly if complemented by reforms in other developed countries in the context of the WTO Doha Round. The authorities broadly agreed and noted that the Agricultural Basic Plan adopted by the Cabinet in March 2005 encourages the use of income support to producers and provides a framework that could support ambitious reform in this direction. However, the details will depend on further internal debate and on the Doha Round outcome. Legislative proposals will be submitted in early 2006.

Selected Countries: Overall Farm Support and Trade-Distorting Support, 1986-88 to 2001-03



Source: OECD.
1/ Share of PSE due to trade or market price support measures or to payments based on output and input use (percent).

47. **Trade liberalization more generally would help spur productivity gains.** The mission urged Japan to play a leadership role in the Doha negotiations. In line with this objective, the authorities support ambitious outcomes in areas such as textiles, clothing and

[18] The *Selected Issues* paper details policies regarding the agricultural sector.

footwear, and forestry and fisheries, where Japan retains pockets of high protection. Their interests in the Doha Round include trade facilitation, promoting South-South trade, reducing industrial product tariffs (especially in advanced developing countries), and tightening WTO rules on anti-dumping. This agenda could benefit Japan while strengthening the multilateral system and providing security and new market access for developing countries. The authorities reaffirmed that the multilateral system remains Japan's top trade priority. Although the rapidly expanding network of regional trade agreements diverts attention and resources from this priority, officials do not see scope to slow negotiations on such arrangements during the remainder of the Doha Round.[19]

V. Staff Appraisal

48. **Continued progress has been made in resolving the legacies of the bubble years.** The financial system has been stabilized, the corporate sector is more resilient, and labor markets have begun to revive. Moreover, a start has been made on fiscal consolidation, and elements of a medium-term strategy to address fiscal imbalances are in place. As a result of this progress, the economy appears to be better positioned to sustain an expansion than it has been in a number of years.

49. **Nevertheless, further efforts are needed to deal with the risks to medium-term prospects posed by low trend growth and mounting demographic pressures.** Population aging is pushing up social spending, a trend that will only worsen in time. In addition, as illustrated by last year's soft patch, modest underlying growth makes the outlook vulnerable to shocks. In this situation, building on efforts so far with fiscal and structural reforms will help to secure a robust medium-term expansion.

50. **The necessary fiscal and structural reforms will be difficult, but will pay dividends for Japan and the world.** Significant fiscal consolidation will not be easy, given the sizeable cuts in discretionary spending already made. Moreover, structural reforms will continue to face resistance from vested interests. Nevertheless, a push to accelerate fiscal and structural adjustment would be timely in light of the growing public consensus in favor of reform, which itself is due in part to the increasing evidence (notably in the financial system) that past reforms are bearing fruit. Accelerated reforms would benefit not only Japan but the world, both by raising global growth and—by bolstering domestic demand—helping to resolve global imbalances.

51. **As for monetary policy, the priority remains conquering deflation.** With continued deflationary pressures and uncertainties about the outlook, the accommodative

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[19] A free trade agreement with Singapore took effect in 2002, and one with Mexico in April 2005. In addition, negotiations with most individual ASEAN countries are well advanced and negotiations on a comprehensive agreement with ASEAN are under way. An agreement with Korea may be reached as early as this year, while discussions with India, Chile, Australia, and Switzerland are at early stages.

stance of policy is appropriate. In line with the BoJ's commitment, quantitative easing should be sustained until deflation—and deflation expectations—are eliminated. The current account target could probably be reduced without tightening monetary conditions, in view of reduced liquidity demand. Nevertheless, maintaining the present level is appropriate for the time being, as it signals unambiguously the BoJ's commitment to maintain easy monetary conditions. Indeed, given the high costs if deflation worsened, it would be preferable to err on the side of being accommodative.

52. **Clear communication has helped to guide market expectations, and will play a crucial role as monetary operations and conditions normalize over time.** Recent more explicit communication with markets and more open discussion of policy options have paid off in connection with the recent smooth introduction of a more flexible operational directive. Going forward, further effective communication can pave the way for future reductions in the quantitative target for current account balances and, over time, a shift back to using interest rates as a policy tool. It will be important to take a flexible approach as the end of deflation draws nearer, with close attention to financial market stability, the economic environment, and the strength of the monetary transmission mechanism. In this connection, announcing an inflation objective may not provide benefits at present, but it could be a useful element of a post-deflation monetary framework.

53. **Fiscal policy faces daunting medium-term challenges.** Achieving the authorities' objective of primary balance excluding social security by early in the next decade would lead to a large decline in the deficit and require a strong effort. However, a significant primary surplus will be needed to stabilize the debt, given the likely future level of real interest rates. The more ambitious adjustment required is achievable, with the economy now more resilient thanks to progress in addressing structural weaknesses. That said, the authorities' plan to achieve medium-term consolidation should have due flexibility to adapt to economic circumstances. Measures would need to be taken to both curtail spending and raise revenues. On the expenditure side, there is some scope to continue reducing public investment, and early steps to deal with rising healthcare spending are needed. On the revenue side, there is room to broaden the tax base, and plans to raise the consumption tax could be put in place soon.

54. **Further progress in dealing with fiscal imbalances is desirable in the near term.** Welcome consolidation was achieved in FY2004. The authorities are taking a range of measures and further deficit reduction is likely in the coming fiscal years. However, for FY2005 the structural deficit is estimated to decline only slightly. At a minimum, any windfall revenues should be saved. In FY2006, policy should aim to reduce the primary deficit excluding social security by ¾ percent of GDP or more. Such an adjustment should be feasible on the basis of planned and prospective policy changes.

55. **As for the financial system, the emphasis of policies is appropriately changing from stabilization to revitalization.** The banks are healthier, and major banks' balance-sheet problems are largely resolved. The smooth transition to partial deposit insurance is evidence of solid public confidence in banking system stability. Continued supervisory scrutiny is needed, though, to address remaining balance-sheet weaknesses—particularly NPLs at regional banks. Looking ahead, improving risk management and enhancing the

environment for bank profitability are key to ensuring more effective financial intermediation and avoiding the reemergence of balance-sheet problems. In this connection, the steps envisioned in the PFFR, as well as privatization of Japan Post, are appropriate. Formulation and implementation of measures—in the case of Japan Post, particularly those to level the playing field with private institutions—should proceed without delay.

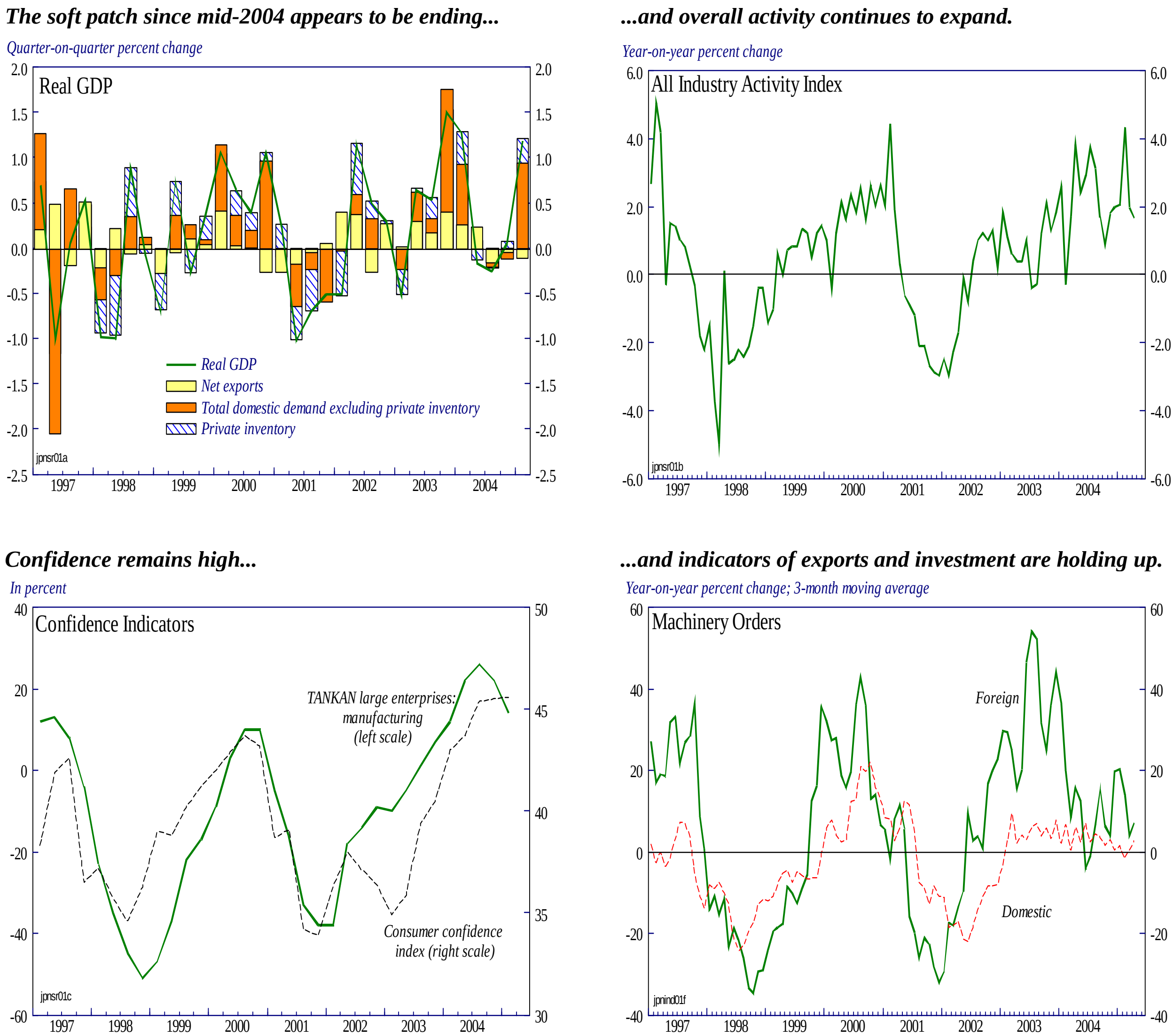
56. **More broadly, structural reforms to liberalize factor and product markets can improve underlying growth.** Increased labor force participation can help to offset the impact of a declining working-age population. Deregulation, particularly to allow the private sector a larger role in areas traditionally dominated by the government, can also help to boost long-run growth. The agricultural sector can particularly benefit from reform, given the high protection and low efficiency. Reducing import barriers and moving toward direct payments to farmers would bolster productivity and enhance growth prospects.

57. **Further trade liberalization would be beneficial for both Japan and developing countries.** The authorities' continued support for the multilateral trading system is welcome. Indeed, Japan should play a leadership role in helping to bring about a successful conclusion to the Doha negotiations. Concentrating on multilateral liberalization, with ambitious measures regarding agricultural imports, would enhance opportunities for developing countries and yield sizeable benefits for Japanese consumers.

58. **Japan has made commendable efforts to maintain ODA notwithstanding budgetary pressures.** Going forward, the authorities are encouraged to do their utmost to raise development assistance toward the UN recommended target.

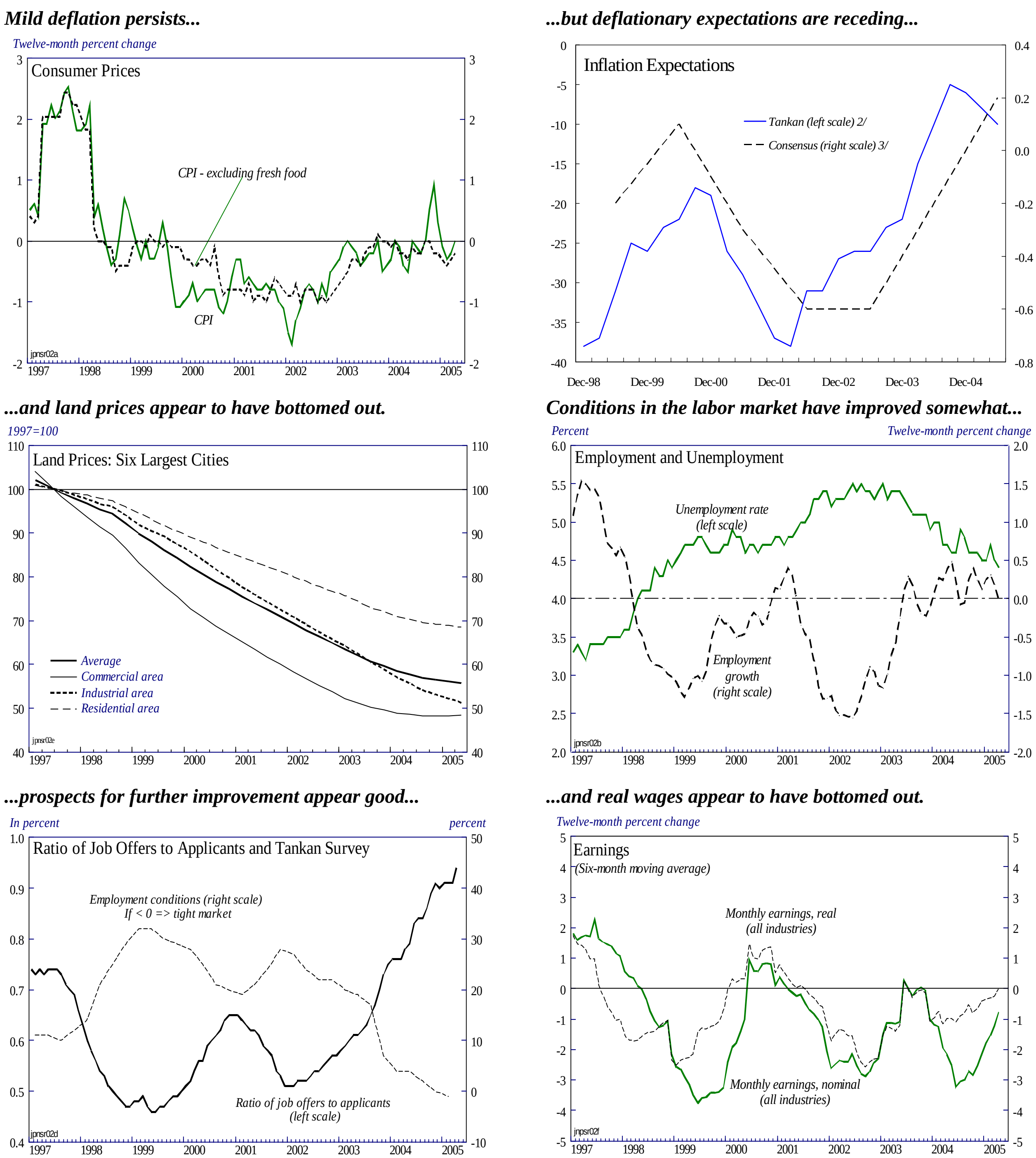
59. **It is recommended that the next Article IV consultation take place on the 12-month cycle.**

Figure 1. Japan: Selected Economic Indicators, 1997-2005



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

Figure 2. Japan: Price and Labor Market Indicators, 1997-2005 1/



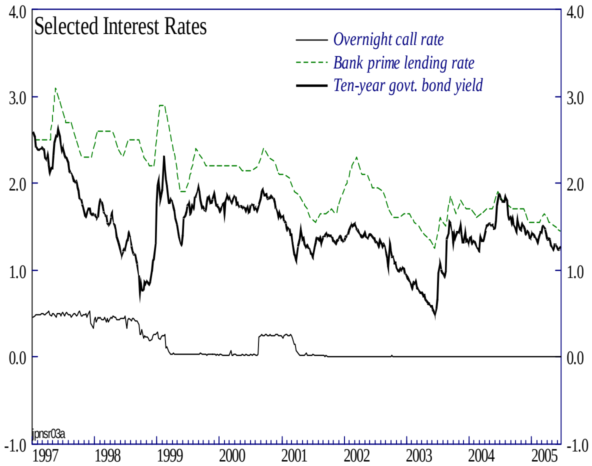
Sources: Global Insight, Nomura database; Bank of Japan; and Consensus Economics Inc.

1/ Seasonally adjusted data except for land prices and monthly earnings.
2/ Net percentage of large manufacturers that expect prices to rise (versus fall).
3/ Forecast as of May, for subsequent year CPI inflation.

Figure 3. Japan: Financial Indicators, 1997-2005

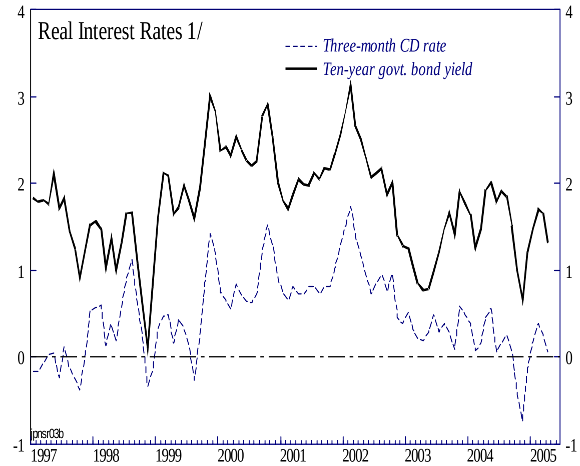
Nominal interest rates are low...

Percent per annum



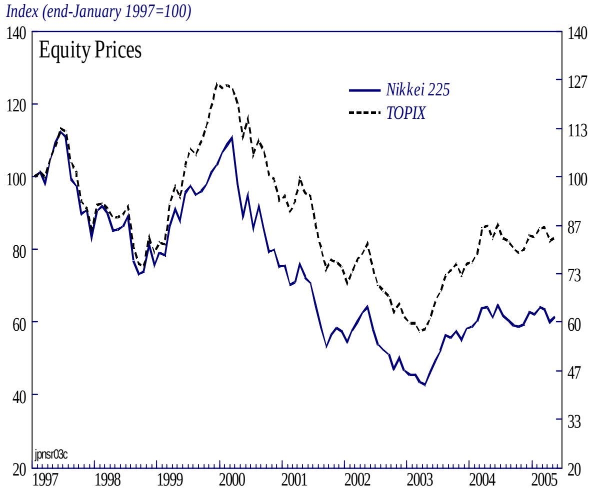
...and real interest rates remain well contained.

Percent per annum



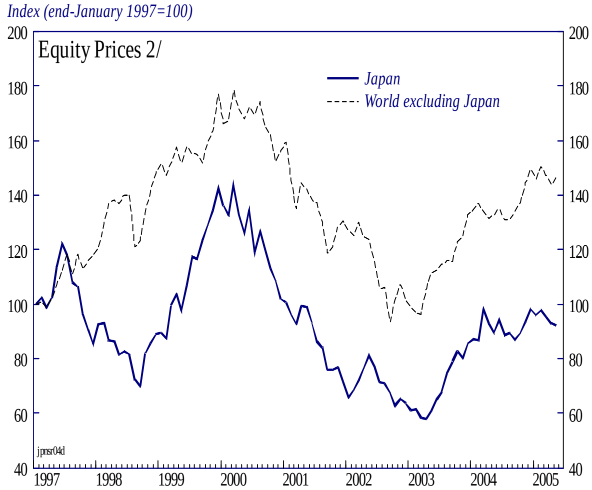
Equity markets have moved sideways...

Index (end-January 1997=100)



...broadly mirroring developments in global markets.

Index (end-January 1997=100)

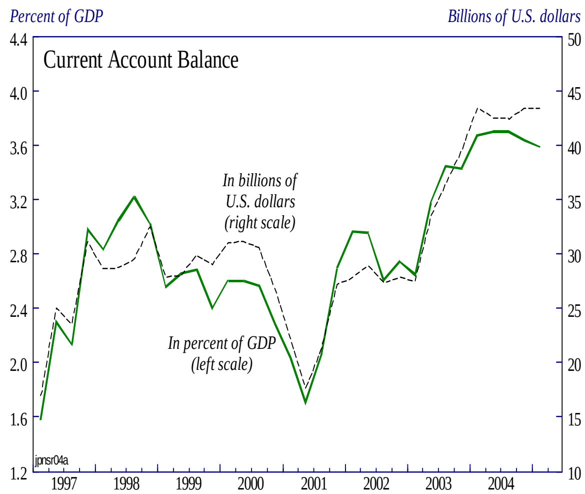


Sources: Global Insight, Nomura database; CEIC database; Bloomberg, LP; and Fund staff calculations.

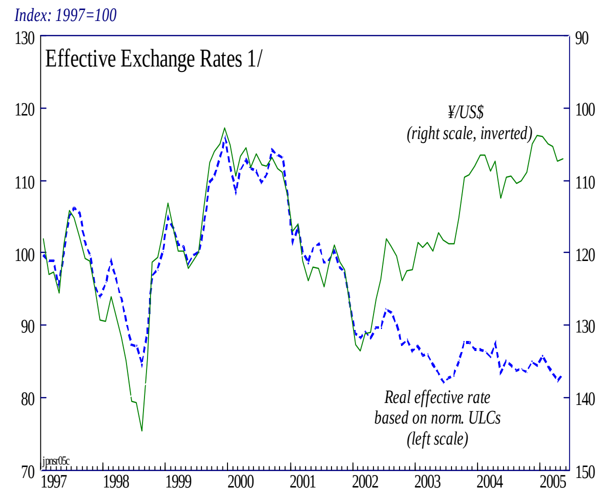
1/ Deflated by CPI adjusted for changes in indirect taxes and administered prices.
2/ Morgan Stanley Index.

Figure 4. Japan: External Sector Developments, 1997-2005

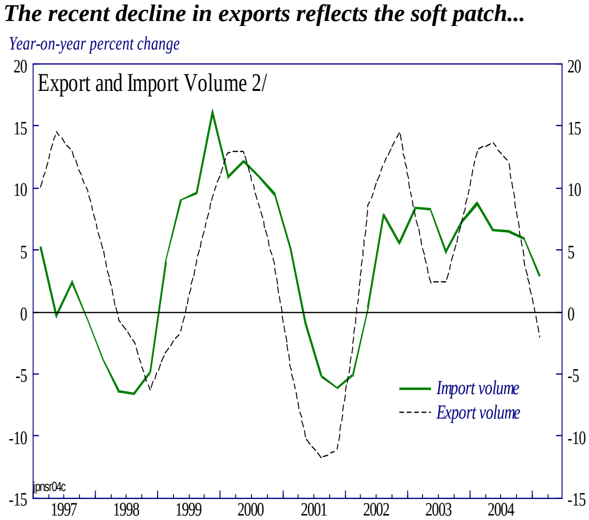
The current account balance continues to rise...



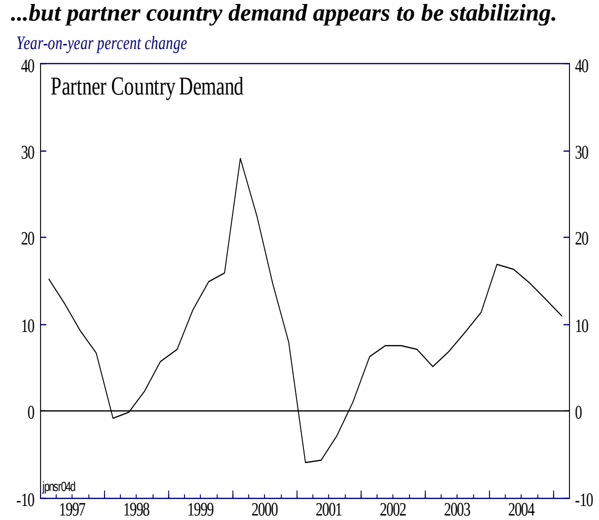
...while the real exchange rate is broadly unchanged.



The recent decline in exports reflects the soft patch...



...but partner country demand appears to be stabilizing.

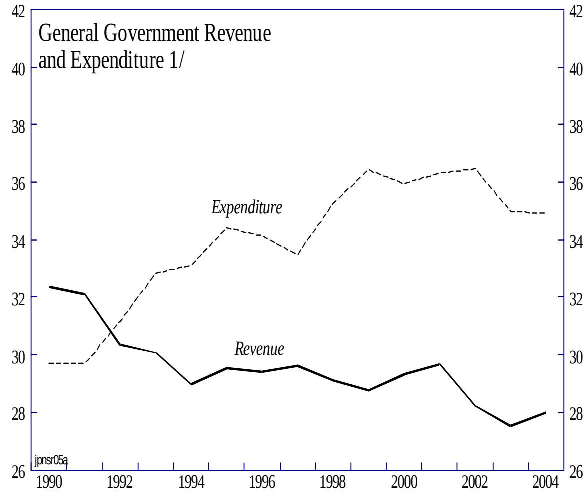


Source: Global Insight, Nomura database.

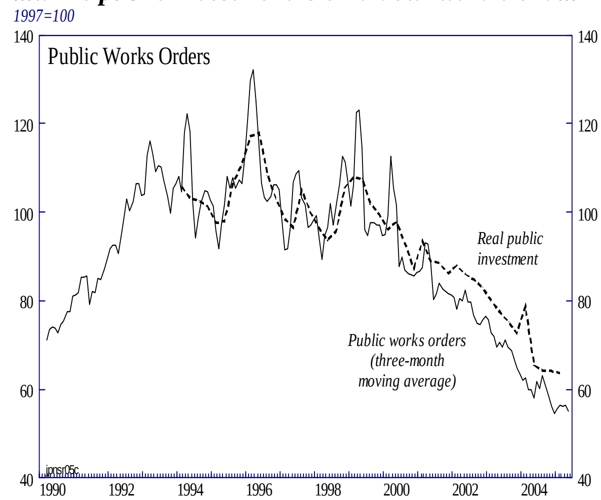
1/ Increase implies appreciation.
2/ Customs-clearance data.

Figure 5. Japan: Fiscal Indicators, 1990-2005

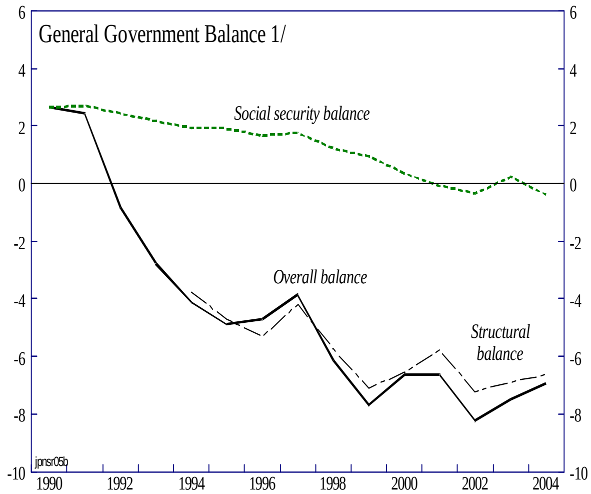
Revenues picked up in FY2004...



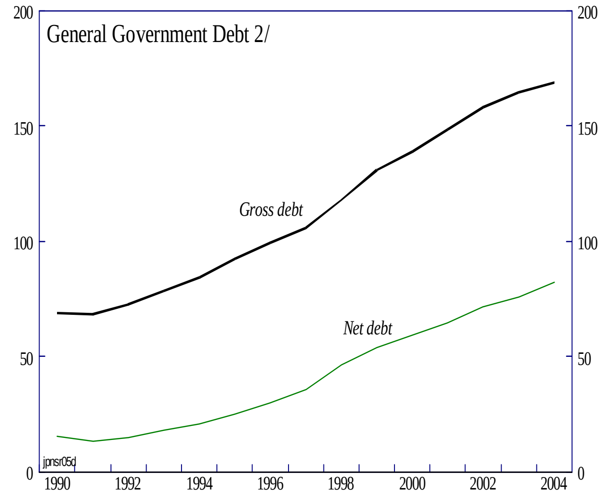
...while public investment is on a downward trend...



...contributing to the improvement in the overall balance...



...but public debt continues to rise.



Source: Cabinet Office; Global Insight, Nomura database; and staff estimates and projections.

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

Table 1. Japan: Selected Economic Indicators, 1999-2006

Nominal GDP: US$4,668 billion (2004)
Population: 127.6 million (2004)
GDP per capita: US$36,555 (2004)
Quota: SDR 13,312.8 million

							Proj.	
	1999	2000	2001	2002	2003	2004	2005	2006
Growth (percent change) 1/								
Real GDP	0.0	2.4	0.2	-0.3	1.4	2.6	1.8	1.7
Domestic demand	0.2	1.9	0.8	-0.9	0.8	1.9	1.9	1.6
Private consumption	0.0	0.5	1.1	0.5	0.2	1.5	1.2	1.5
Residential investment	-0.1	0.7	-5.3	-4.3	-1.1	2.2	0.3	1.4
Business investment	-4.3	8.8	0.6	-6.6	6.6	5.8	5.2	5.0
Government consumption	4.8	4.9	3.0	2.6	1.2	2.7	1.9	1.3
Public investment	6.5	-10.2	-4.6	-4.3	-10.6	-10.8	-3.9	-4.9
Stockbuilding 2/	-0.4	0.3	0.1	-0.2	0.2	0.2	0.2	-0.2
Net exports 2/	-0.2	0.5	-0.6	0.6	0.6	0.8	-0.1	0.2
Exports of goods and services	1.5	12.2	-6.0	7.2	9.1	14.5	3.5	5.1
Imports of goods and services	3.6	8.5	-0.7	1.2	3.8	8.9	5.2	4.9
Inflation (annual average)								
CPI (SA) 3/	-0.3	-0.9	-0.7	-1.0	-0.2	0.0	-0.4	-0.1
GDP deflator	-1.3	-1.5	-1.3	-1.3	-1.4	-1.2	-1.0	-0.5
Unemployment rate (annual average)	4.7	4.7	5.0	5.4	5.3	4.7	4.4	4.2
Government (percent of GDP, fiscal year basis)								
General government								
Revenue	28.8	29.3	29.7	28.2	27.5	28.0	28.4	29.1
Expenditure	36.4	35.9	36.3	36.5	35.0	34.9	35.1	35.2
Balance	-7.7	-6.6	-6.6	-8.2	-7.5	-6.9	-6.7	-6.2
Primary balance	-6.4	-5.3	-5.4	-6.9	-6.2	-5.4	-5.0	-4.2
Primary balance excluding social security	-5.8	-4.4	-4.1	-5.5	-5.5	-4.2	-3.8	-2.9
Structural balance 4/	-6.4	-5.9	-5.7	-7.0	-6.9	-6.6	-6.5	-6.1
Money and credit (percent change, end-period)								
Base money	14.2	-1.1	16.9	19.5	13.2	4.2	2.2 6/	...
M2 plus CDs (period average)	3.7	2.1	2.8	3.3	1.7	1.8	1.5 6/	...
Domestic credit	-0.3	2.3	1.4	-1.6	3.9	-0.9	-3.0 7/	...
Bank lending	-5.9	-3.8	-4.3	-4.8	-5.1	-3.2	-2.7 6/	...
Interest rate								
Three-month CD rate (annual average)	0.1	0.2	0.09	0.07	0.09	0.06	0.05 8/	...
Official discount rate (end-period)	0.5	0.5	0.10	0.10	0.10	0.10	0.10 8/	...
Balance of payments (in billions of US$)								
Exports, f.o.b.	403.9	459.6	383.5	395.7	449.2	539.1	580.2	619.7
Imports, f.o.b.	280.5	342.8	313.3	301.8	342.8	407.0	449.9	482.7
Oil imports (trade basis)	36.2	58.4	50.7	47.0	59.2	72.4	79.4	82.8
Current account balance	114.5	119.6	87.8	112.6	136.2	172.1	175.3	175.4
Percent of GDP	2.6	2.5	2.1	2.8	3.2	3.7	3.7	3.6
Terms of trade (percent change)	4.6	-5.0	-1.0	1.0	1.7	-2.2	4.5	0.8
Change in reserves	77.3	49.3	41.1	46.7	188.1	161.0	...	...
Total reserves minus gold (in billions of US$)	286.9	354.9	395.2	461.2	663.3	833.8	832.3 6/	...
Exchange rates (annual average)								
Yen/dollar rate	113.9	107.8	121.5	125.4	115.9	108.2	108.7 8/	...
Real effective exchange rate 5/	92.6	100.0	88.7	80.6	78.0	78.5	74.7 6/	...

Sources: Global Insight, Nomura database; IMF, Competitiveness Indicators System; and Fund staff estimates and projections as of June 20, 2005.

1/ Annual growth rates and contributions are calculated from seasonally adjusted data. The official outturn based on annual data for GDP growth in 2004 was 2.7 percent.
2/ Contribution to GDP growth.
3/ Annual growth rates are calculated from annual averages of monthly data.
4/ Including social security, excluding bank support.
5/ Based on normalized unit labor costs; 2000=100.
6/ May 2005.
7/ April 2005.
8/ June 23, 2005.

Table 2. Japan: Balance of Payments Summary, 1998-2005

	1998	1999	2000	2001	2002	2003	2004	Proj. 2005
Balance of payments								
Current balance	119.1	114.5	119.6	87.8	112.6	136.2	172.1	175.3
Trade balance	122.7	123.4	116.7	70.2	93.9	106.4	132.1	130.3
Exports	374.4	403.9	459.6	383.5	395.7	449.2	539.1	580.2
Imports	251.6	280.5	342.8	313.3	301.8	342.8	407.0	449.9
Invisibles	-3.6	-8.9	2.9	17.6	18.7	29.8	39.9	45.0
Nonfactor services	-49.5	-54.2	-47.7	-43.7	-42.2	-33.9	-37.9	-45.0
Investment income	54.6	57.4	60.4	69.3	65.9	71.3	85.8	98.6
Labor income	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.0
Net transfers	-8.8	-12.1	-9.8	-7.9	-4.9	-7.5	-7.9	-8.6
Capital account	-14.7	-16.5	-9.3	-2.9	-3.3	-4.0	-4.8	...
Financial account	-107.6	-115.8	-127.3	-88.6	-109.5	-115.5	-138.5	...
Direct investment, net	-21.3	-10.0	-23.4	-32.3	-23.0	-22.5	-23.3	...
Direct investment abroad	-24.5	-22.2	-31.6	-38.5	-32.0	-28.8	-31.1	...
Foreign direct investment in Japan	3.3	12.2	8.2	6.2	9.1	6.3	7.8	...
Portfolio investment, net	-40.9	-30.7	-35.1	-46.8	-105.8	-97.3	24.6	...
Other investment, net	-52.8	2.2	-19.5	31.5	66.0	192.4	21.1	...
Reserve assets	7.4	-77.3	-49.3	-41.1	-46.7	-188.1	-161.0	...
Errors and omissions, net	3.2	17.7	17.0	3.7	0.2	-16.8	-28.8	...
				(In percent of GDP)				
Memorandum items								
Net foreign assets	29.2	24.2	25.3	31.1	35.3	35.5	36.2	...
Current account balance	3.0	2.6	2.5	2.1	2.8	3.2	3.7	...
Trade balance	3.1	2.8	2.5	1.7	2.4	2.5	2.8	...
Invisibles	-0.1	-0.2	0.1	0.4	0.5	0.7	0.9	...

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

Table 3. Japan: Monetary Indicators, 1999–2005

	1999	2000	2001	2002	2003	2004	2004 Mar.	2004 Jun.	2004 Sept.	2004 Dec.	2005 Mar.	2005 May
(In trillions of yen)												
Base money 1/	68.7	68.0	79.4	94.9	107.5	112.0	108.1	107.3	108.5	112.0	110.3	111.3
M1 2/	213.2	230.6	250.1	319.2	345.4	359.3	354.9	358.7	359.5	368.4	371.2	377.3
M2 + CDs 2/	616.3	629.3	646.8	668.2	679.5	692.1	685.7	692.7	693.8	699.3	700.2	704.3
Bank lending 1/	478.4	460.5	440.6	419.7	398.1	385.5	397.4	386.6	387.4	385.5	385.8	378.0
(Year-on-year change, in percent)												
Base money 1/	14.2	-1.1	16.9	19.5	13.2	4.2	11.9	4.4	4.7	4.2	2.0	2.2
M1 2/	10.6	8.2	8.5	27.6	8.2	4.0	4.0	3.5	4.0	4.1	4.6	4.0
M2 + CDs 2/	3.7	2.1	2.8	3.3	1.7	1.8	1.7	1.7	2.0	2.0	2.1	1.5
Bank lending 1/	-5.9	-3.8	-4.3	-4.8	-5.1	-3.2	-4.8	-4.2	-3.1	-3.2	-2.9	-2.7
(In percent of GDP)												
Base money 1/	13.5	13.3	15.7	19.1	21.6	22.2	21.3	21.3	21.5	22.2	21.7	...
M1 2/	42.0	45.0	49.4	64.0	69.3	71.1	69.9	71.0	71.3	73.0	73.1	...
M2 + CDs 2/	121.3	122.9	127.8	134.1	136.4	137.0	135.1	137.2	137.6	138.5	137.9	...
Bank lending 1/	94.2	89.9	87.0	84.2	79.9	76.3	78.3	76.6	76.9	76.4	76.0	...

Source: Global Insight, Nomura Database.

1/ End of period.
2/ Period average.

Table 4. Japan: General Government Operations, 1999-2005 1/

(In percent of GDP)

	1999	2000	2001	2002	2003	2004 Est.	2005 Proj.
				(Fiscal year)			
Total revenue	28.8	29.3	29.7	28.2	27.5	28.0	28.4
Taxes and fines	16.6	17.3	17.2	15.9	15.5	16.0	16.2
Social security premiums	9.7	9.8	10.3	10.4	10.3	10.4	10.6
Property income	2.1	1.9	1.9	1.7	1.5	1.3	1.3
Total expenditure	36.4	35.9	36.3	36.5	35.0	34.9	35.1
Current	29.1	29.2	30.4	30.7	30.4	30.8	31.0
Consumption	11.1	11.1	11.5	11.7	11.6	11.7	11.5
(less) Depreciation	-2.3	-2.4	-2.5	-2.7	-2.7	-2.7	-2.8
Social security benefits	13.3	14.0	14.9	15.4	15.5	15.6	15.8
Other current	3.5	3.2	3.3	3.4	3.4	3.4	3.4
Interest paid	3.4	3.3	3.1	3.0	2.8	2.9	3.1
Capital	7.4	6.8	5.9	5.7	4.5	4.1	4.1
Investment	5.6	5.1	4.9	4.6	4.2	3.5	3.5
Land acquisition	0.8	0.8	0.7	0.6	0.6	0.5	0.5
Capital transfers	0.9	0.9	0.4	0.5	-0.2	0.2	0.2
Of which : Bank support	0.7	0.7	0.1	0.3	0.0	0.0	0.0
Balance	-7.7	-6.6	-6.6	-8.2	-7.5	-6.9	-6.7
Primary balance	-6.4	-5.3	-5.4	-6.9	-6.2	-5.4	-5.0
Excluding social security	-5.8	-4.4	-4.1	-5.5	-5.5	-4.2	-3.8
Structural balance (excluding bank support)	-6.4	-5.9	-5.7	-7.0	-6.9	-6.6	-6.5
				(Calendar year)			
Total revenue	28.8	29.1	30.0	28.7	28.2	27.8	28.3
Taxes and fines	16.6	17.1	17.6	16.2	15.7	15.8	16.2
Social security premiums	9.7	9.8	10.2	10.4	10.7	10.4	10.6
Property income	2.1	2.0	1.9	1.7	1.5	1.3	1.3
Total expenditure	36.0	36.5	36.1	36.6	36.0	35.0	35.1
Current	29.0	29.3	29.9	30.9	30.7	30.6	30.9
Consumption	11.1	11.1	11.4	11.8	11.7	11.6	11.5
(less) Depreciation	-2.2	-2.4	-2.5	-2.6	-2.7	-2.7	-2.8
Social security benefits	13.2	13.9	14.6	15.3	15.5	15.5	15.8
Other current	3.5	3.4	3.3	3.4	3.5	3.4	3.4
Interest paid	3.4	3.3	3.2	3.0	2.8	2.8	3.0
Capital	7.0	7.3	6.2	5.7	5.3	4.3	4.2
Investment	5.8	5.1	4.9	4.7	4.2	3.7	3.5
Land acquisition	0.9	0.8	0.7	0.7	0.6	0.5	0.5
Capital transfers	0.3	1.4	0.5	0.4	0.5	0.1	0.2
Of which : Bank support	0.1	1.2	0.3	0.2	0.1	0.0	0.0
Balance	-7.2	-7.5	-6.1	-7.9	-7.8	-7.2	-6.8
Primary balance	-5.8	-6.0	-4.7	-6.5	-6.4	-5.7	-5.1
Excluding social security	-5.4	-5.3	-3.7	-5.3	-5.6	-4.6	-3.9
Structural balance (excluding bank support)	-6.5	-6.1	-5.3	-6.7	-6.8	-6.8	-6.7
Debt (in percent of GDP, calendar year)							
Gross	130.9	139.1	148.8	158.3	164.6	169.2	174.3
Net	53.8	59.3	64.5	71.5	76.0	82.1	88.3
Memorandum items							
Nominal GDP (fiscal year, trillion yen)	508.3	513.7	501.6	497.6	501.5	505.3	510.4
Nominal GDP (calendar year, trillion yen)	507.9	512.2	506.3	498.4	498.2	505.3	509.1

Source: Fund staff estimates.

1/ Estimated from the National Income Accounts data. The fiscal year is April through March.

Table 5. Japan: Indicators of External and Financial Vulnerability, 1997-2005

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003	2004	2005 Latest
External indicators									
Real exports of goods and services (percent change)	11.4	-2.3	1.5	12.2	-6.0	7.2	9.1	14.5	...
Real imports of goods and services (percent change)	0.7	-6.7	3.6	8.5	-0.7	1.2	3.8	8.9	...
Terms of trade (percent change)	-3.9	6.7	4.6	-5.0	-1.0	1.0	1.7	-2.2	...
Current account balance	2.2	3.0	2.6	2.5	2.1	2.8	3.2	3.7	...
Capital and financial account balance	-2.7	-3.1	-1.1	-1.9	-1.4	-1.7	1.5	0.3	...
Of which :									
Inward portfolio investment	1.8	1.4	2.8	1.0	1.4	-0.5	1.9	4.2	...
Inward direct investment	0.1	0.1	0.3	0.2	0.1	0.2	0.1	0.2	...
Other investment liabilities (net)	-2.8	-1.4	0.1	-0.3	0.7	1.6	4.4	0.4	...
Total reserves minus gold (US$ billion)	219.6	214.8	286.9	354.9	395.2	461.2	663.3	833.8	832.3
In months of imports of goods and services	6.3	7.4	9.1	9.6	11.7	14.0	17.9	19.1	...
Broad money (M2 + CDs) to reserves ratio	2.1	2.1	1.9	1.6	1.3	1.1	0.9	0.8	0.8
Foreign assets of DMBs (US$ billion)	1064.0	833.2	682.5	787.8	768.4	724.2	689.2	795.2	...
Foreign liabilities of DMBs (US$ billion)	762.5	612.5	478.8	568.7	565.5	536.7	505.0	576.3	...
Net international investment position (US$ billion)	958.7	1,153.6	829.1	1,157.9	1,249.1	1,598.5	1,721.9	1,852.8	...
Of which :									
External loan liabilities	883.2	717.7	676.8	707.2	654.5	668.0	721.7	839.0	...
External public sector debt (gross) 1/	229.6	244.0	208.7	271.7	232.8	189.1	205.6	319.0	...
External loan liabilities to exports ratio	1.9	1.7	1.5	1.4	1.5	1.5	1.4	1.4	...
External interest payments to exports (in percent) 2/	7.4	7.2	4.5	3.9	4.1	2.3	1.7	1.4	...
Nominal effective exchange rate (percent change)	-4.2	0.3	15.2	10.2	-7.7	-4.9	0.7	2.3	0.8
Financial market indicators									
General government gross debt	105.8	117.8	131.1	139.3	148.8	158.4	164.7	169.2	...
Interest rates (percent, end-year)									
3-month Gensaki rate	0.23	0.14	0.07	0.32	0.01	0.003	0.001	0.001	0.001
3-month Gensaki rate, real	-1.59	-0.45	1.15	0.72	1.21	0.31	0.41	-0.20	0.00
3-month interest rate spread vis-à-vis U.S.	-4.93	-4.28	-5.16	-5.51	-1.71	-1.19	-0.89	-2.20	-2.87
Stock market index (TOPIX, percent change, end-year) 3/	-20.1	-7.5	58.4	-25.5	-19.6	-18.3	23.8	10.2	0.4
Banking sector risk indicators									
Total loans to assets (in percent)	50.9	49.9	47.3	44.3	39.6	38.2	34.6	32.6	...
Total loans to deposits (in percent)	107.0	105.1	98.9	97.8	93.4	87.3	81.9	78.8	...
Share of real estate sector in total lending (in percent)	14.2	14.2	14.5	14.9	14.9	14.6	13.8	14.3	...
Share of nonperforming loans in total loans									
(In percent, end-fiscal year) 4/	5.5	6.1	5.4	5.3	8.4	7.2	5.2	2.9	...
Risk-weighted capital ratio (in percent, end-fiscal year) 4/	9.5	11.6	11.8	11.7	10.8	9.4	11.2	11.6	...

Sources: Global Insight, Nomura Database; IMF, International Financial Statistics; Fitch IBCA; and Fund staff estimates.

1/ Public sector debt securities and other loan liabilities.
2/ Other investment income, debit.
3/ Twelve-month percent change for the latest figure.
4/ Major banks. Capital ratio is on a nonconsolidated basis.

JAPAN—FUND RELATIONS
(As of April 30, 2005)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	13,312.80	100.00
Fund holdings of currency	9,399.82	70.61
Reserve position in Fund	3,913.96	29.40

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	891.69	100.00
Holdings	1,805.26	202.45

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

Japan maintains a floating exchange rate regime. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, with the exceptions of restrictions maintained against the Taliban, Al-Qaeda, the former Iraqi regime, and others, pursuant to UN Security Council Resolutions 1267, 1333, 1390, 1373, 1483, and 1532. These restrictions were notified to the Fund (EBD/02/52 and EBD/04/111) in accordance with Executive Board Decision No. 144–(52/51).

VIII. **Article IV Consultation**:

The 2004 Article IV consultation discussions were held during May 7–20 2004; the Executive Board discussed the Staff Report (IMF Country Report No. 04/224) and concluded the consultation on July 28, 2004. Executive Directors welcomed signs that the Japanese economy is emerging from its long period of slump, with support from a range of policy measures. At the same time, Directors noted that financial and corporate sector weaknesses remain, mild deflation persists, and the public debt is very high, which could restrain growth over the medium term. Against this background, Directors considered that policies should build on the existing reform program in order to resolve remaining weaknesses promptly, boost Japan's economic potential, and thereby sustain expansion over the longer term. The staff report, staff supplement, selected issues paper, and PIN were all published.

JAPAN—STATISTICAL ISSUES

1. Japan subscribed to the Special Data Dissemination Standard (SDDS) on July 3, 1996 and met the SDDS specifications for the coverage, periodicity, and timeliness of data and for dissemination of advance release calendars on June 9, 2000. Economic and financial data provided to the Fund are considered adequate for surveillance purposes. The Japanese authorities have agreed to participate in the data module for a Report on the Observance of Standards and Codes (data ROSC) scheduled to take place in September 12–28, 2005. This will involve detailed assessments of their country's practices with regard to the following data headings.

2. **National accounts**

- The Japanese National Accounts were revised in 2000 by the Economic and Social Research Institute (ESRI) to reflect the *1993 System of National Accounts (1993 SNA).* The data revision involved, among other things, the inclusion of spending on computer software in investment expenditure and depreciation on social capital in government consumption, and revision of the benchmark year to 1995. Improved seasonal adjustment methods were also introduced to take account of leap year and other shift factors. The data revisions, from 1980 onwards, are described in ESRI's publication *System of National Accounts 1993 in Japan* (April 2001).

- Preliminary estimates of Japan's quarterly GDP data are released by the ESRI. Starting with data from the second quarter of 2002, it introduced a new method that combines supply and demand side indicators to improve the accuracy of the estimates. In particular, additional supply side indicators are combined with the previously-used demand side indicators, thereby reducing the statistical discrepancy between estimates of GDP measured from the production and expenditure sides. ESRI also now releases the estimate about 1½ months after the end of the quarter, approximately a month earlier than before. At the same time, more frequent backward revisions and concurrent seasonal adjustment methods were introduced. More complete annual national accounts data are only available with a lag of nine months to one year.[1]

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

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

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

- The Family Income and Expenditure Survey (FIES) has been subject to volatility, particularly in “lumpy” expenditure items such as consumer durables. Some steps were taken in January 2002 to improve the quality of the data, including a modest expansion of the sample size to about 9,000 households and reclassification of survey items to better reflect expenditures on IT products. In addition, a new survey on durable goods expenditures, covering about 30,000 households, was introduced in October 2001, and has been incorporated in GDP estimates since December 2004.

- The GDP data on some key components of demand are available only with the release of the annual data, including the breakdown of trade flows into goods and services, of business investment into structures and equipment, and of private consumption into durables and nondurables.

- Preliminary estimates for the income side of the national accounts (with the exception of household employment income (or compensation of employees)) are not provided, in part because estimates for profits are based on an imputed quarterly pattern for annual data.

- A chain-linked price index number formula (following *1993 SNA* recommendations) was adopted for use in the estimation of real GDP, beginning with the third quarter of 2004.

The ESRI relies on other agencies and organizations to compile the underlying source data used to construct the national accounts, and faces coordination problems with data providers in influencing the design of surveys and administrative collections to serve national accounts purposes.

The Statistics Bureau is responsible for the compilation of the consumer price index (CPI) and the Bank of Japan (BoJ) is responsible for the wholesale price index (WPI). The WPI has been renamed as the corporate goods price index (CGPI) to better reflect its characteristics.

- The CPI has its weights updated every five years. However, the Statistical Bureau also compiles a chained CPI with weights updated every year and a “mid-period” index. The latter index has been shown to provide a good approximation to a “superlative” index which makes use of current and base period weights and is theoretically desirable. Estimates for 1995 to 2000 found the chained estimates to be lower than the fixed base “official” index and the “mid-period” index to be in turn lower than the chained index, though the differences were not substantial.

- The Bank of Japan (BoJ) revised its CGPI by updating the base year from 1995 to 2000, updating commodities that constitute the index and increasing the number of sample prices for the index compilation. The BoJ produces both chained and fixed base estimates. For February 1995, for example, for all commodities, the former fell to 94.4 (2000=100) while the latter was 96.5 (BoJ website).

The compilation of chained indexes accords with recommendations in the 2004 CPI and PPI Manuals.

3. **Fiscal**

- Fiscal accounts distinguish between general (or ordinary) accounts for core government functions, and special accounts, some of which are partly financed through borrowing from the Fiscal Investment and Loan Program (FILP). Information on the central government general account is readily available, but published consolidated accounts—which incorporate special accounts—are insufficient to calculate a consolidated deficit.

- There exist more than 2,000 independent prefectures and municipalities, the finances of which are only partly consolidated with a delay of about one year. The most recent data for local public finances are published with a lag of six months and final data with a lag of nine months.

- Data on general government operations—including disaggregation by major government sector—are available with the release of the annual national accounts data.

- The government has published its annual balance sheet since October 2000. Estimates from FY1998 to FY2002 are now available. However, the relationship with the flow data is unclear because the balance sheet consolidates the FILP whereas flow data do not.

- The authorities have not reported fiscal data for publication in the *GFS Yearbook* since 1994 and STA attempts to initiate reporting have been unsuccessful. As a result, the Japan country page has been dropped from the *GFS Yearbook*. No fiscal data are reported for publication in *IFS*.

4. **External sector**

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

5. **Monetary and financial sector**

- There are some weaknesses in the monetary and financial data submitted to STA. For example, other (private) nonfinancial corporations, other (nonbank) financial corporations, and individuals and households are all aggregated as a single category (private sector). Timeliness of data could also be improved. Depository corporations (DC) data are disseminated six to eight business days after the end of the reference month for money stocks and total credit. However, DC data on the external position, as well as the breakdown of credit to the government and to the private sector, are usually disseminated six to ten weeks after the end of the reference month. Only data on money stocks and total credit meet the one-month SDDS timeliness requirement for Analytical Accounts of the Banking sector.

6. **Recommendations for data improvements**

In the short term, there is a need to:

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

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

Over the longer term, efforts should be directed to:

- moving data production (other than monetary and financial statistics) to a single, independent agency.

JAPAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of June 22, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	5/2/05	5/2/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	3/05	4/05	M	M	M
Reserve/Base Money	4/05	6/05	M	M	M
Broad Money	4/05	6/05	M	M	M
Central Bank Balance Sheet	4/20/05	4/22/05	Every 10 days	Every 10 days	Every 10 days
Consolidated Balance Sheet of the Banking System	4/05	6/05	M	M	M
Interest Rates[2]	5/2/05	5/2/05	D	D	D
Consumer Price Index	3/05	4/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2003	1/05	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2004	11/04	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/05	3/05	Q	Q	Q
External Current Account Balance	2/05	4/05	M	M	M
Exports and Imports of Goods and Services	2/05	4/05	M	M	M
GDP/GNP	2005 Q1	6/05	Q	Q	Q
Gross External Debt	End-Dec. 2004	3/05	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

JAPAN—PUBLIC DEBT SUSTAINABILITY

1. **The staff has updated its assessment of Japan's medium-term debt sustainability, on the basis of the government's announced fiscal goals.** (The macroeconomic assumptions are based on the latest WEO submission.) The central goal of the authorities' plan is the achievement of a primary surplus (excluding social security) by the early 2010s, compared with a deficit estimated at 4.2 percent in FY2004. The baseline scenario assumes that fiscal consolidation is achieved through both revenue measures and expenditure reductions (the specific reforms underlying the government's plan have not yet been identified). Projections for social security incorporate reforms introduced in 2004 which are expected to slow the growth in pension spending. Nonetheless, the social security system will continue to run a deficit (estimated at 1.9 percent of GDP by FY2013).

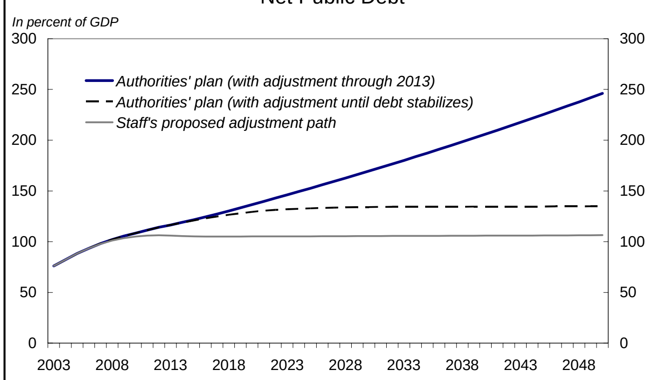
2. **Under this scenario, public debt will continue to grow rapidly.** By 2010, net debt will rise to almost 110 percent of GDP, up from 82 percent at end-2004. Debt would accumulate even more rapidly in the event that the government needs to meet contingent liabilities associated with bank recapitalizations or defaults on government-guaranteed loans. In addition, the debt dynamics are sensitive to shocks to interest rates and growth. A 100 basis point increase in the real interest rate or a decline in growth by 1 percentage point for would raise the debt-to-GDP ratio by 1 percentage point, with the effect growing rapidly if the shock persisted for more than one year.

Primary Balance (Excluding Social Security) Required to Stabilize Net Debt[1]

Real interest rate/ real GDP growth rate	2.0	2.5	3.0
1.0	2.9	3.4	3.9
1.5	2.4	2.9	3.4
2.0	1.9	2.4	2.9

Source: Fund staff estimates.
[1]In percent of GDP; debt stabilized at 105 percent of GDP; social security primary deficit in 2013 is estimated at 1.9 percent of GDP.

Net Public Debt



Source: Fund staff estimates.

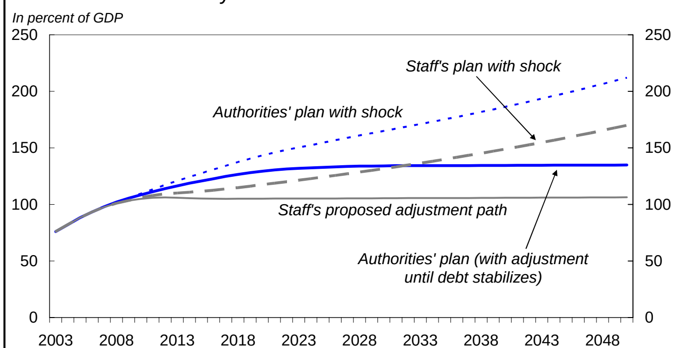
3. **Stabilizing the debt-to-GDP ratio would appear to require consolidation beyond that considered in the baseline scenario.** For example, stabilizing net debt at around 105 percent of GDP by 2013 would require achieving a general government primary surplus of 1.0 percent of GDP.[1] Reaching that surplus requires an adjustment of 6.4 percent in the general government primary balance and 7.1 percent in the primary balance excluding social security

[1]The estimation is based on a real potential growth rate of 1.5 percent and a long-term real interest rate of 2.5 percent (based on the GDP deflator).

(or about ¾ percent per year). The resulting net debt ratio would still be high by international standards and further consolidation may be desirable to reduce it.

4. **The more gradual consolidation envisaged under the government's plan would result in a higher level of debt.** Extending gradual consolidation beyond 2013 would eventually stabilize the debt, but at a level which could be some 30 percentage points higher as a ratio to GDP than in the staff's more rapid consolidation path. This higher debt stock would make the debt dynamics more vulnerable to interest rate shocks (assuming an unchanged path for the primary balance), particularly if the rise in interest rates were long-lived.

Sensitivity of Debt to Interest Rate Shock 1/



Source: Fund staff estimates.
1/ Permanent 100 basis point shock to real interest rate from 2010 and unchanged primary balance.

Japan: Public Sector Debt Sustainability Framework, 1999-2010

(In percent of GDP, unless otherwise indicated; calendar year basis)

	Actual													
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	2010
1 **Net general government debt**	53.8	59.3	64.5	71.5	76.0			**82.1**	**88.3**	**93.5**	**98.1**	**102.1**	**105.5**	**108.3**
Of which : Foreign currency-denominated	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Change in public sector debt	7.7	5.5	5.2	7.0	4.5			6.1	6.2	5.2	4.7	3.9	3.4	2.9
3 Identified debt-creating flows	7.8	7.0	6.8	8.9	7.8			6.1	6.2	5.2	4.7	3.9	3.4	2.9
4 Primary deficit	5.8	6.0	4.7	6.5	6.4			5.7	5.1	4.4	3.9	3.6	3.2	2.7
5 Revenue and grants	28.8	29.1	30.0	28.7	28.2			27.8	28.3	28.9	29.6	30.2	30.8	31.3
6 Primary (noninterest) expenditure	34.5	35.1	34.7	35.1	34.6			33.4	33.4	33.3	33.5	33.7	33.9	34.0
7 Automatic debt dynamics 1/	2.1	1.0	2.1	2.5	1.5			0.5	1.1	0.8	0.8	0.4	0.3	0.2
8 Contribution from interest rate/growth differential 2/	2.1	1.0	2.1	2.5	1.5			0.5	1.1	0.8	0.8	0.4	0.3	0.2
9 *Of which:* Contribution from real interest rate	2.1	2.3	2.2	2.3	2.5			2.4	2.5	2.3	2.2	1.8	1.8	1.8
10 *Of which:* Contribution from real GDP growth	0.0	-1.3	-0.1	0.2	-1.0			-2.0	-1.4	-1.5	-1.5	-1.4	-1.5	-1.6
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes	-0.2	-1.5	-1.6	-2.0	-3.3			0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net general government debt-to-revenue ratio 1/	186.7	203.8	215.3	249.6	269.4			295.7	311.8	323.2	331.9	338.2	342.7	345.6
Gross financing need 3/	23.5	25.8	26.5	30.3	32.0			32.8	34.5	35.8	37.3	38.5	39.6	40.3
Key macroeconomic and fiscal assumptions						10-Year Historical Average	10-Year Standard Deviation							
Real GDP growth (in percent)	0.0	2.4	0.2	-0.3	1.4	1.1	1.5	2.6	1.8	1.7	1.6	1.5	1.5	1.5
Average nominal interest rate on public debt (in percent) 4/	3.1	2.7	2.4	2.2	2.0	4.0	1.8	2.0	2.0	2.2	2.3	2.6	2.8	3.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.4	4.3	3.7	3.5	3.4	4.5	1.2	3.2	3.0	2.7	2.4	1.9	1.8	1.8
Inflation rate (GDP deflator, in percent)	-1.3	-1.5	-1.3	-1.3	-1.4	-0.9	0.7	-1.2	-1.0	-0.5	-0.1	0.7	1.0	1.2
Growth of real primary spending (deflated by GDP deflator, in percent)	4.5	4.0	-1.0	1.1	-0.2	2.0	2.7	-0.7	1.7	1.3	2.3	2.2	2.2	1.7
Primary deficit	5.8	6.0	4.7	6.5	6.4	4.6	1.5	5.7	5.1	4.4	3.9	3.6	3.2	2.7
A. Alternative scenarios														
A1. Key variables are at their historical averages in 2005-08 5/								**82.1**	**89.7**	**97.7**	**105.9**	**114.4**	**123.2**	**132.4**
B. Bound tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**82.1**	**91.5**	**100.6**	**105.3**	**109.3**	**112.7**	**115.6**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**82.1**	**92.6**	**103.9**	**111.2**	**117.7**	**123.8**	**129.3**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**82.1**	**90.8**	**99.2**	**104.0**	**107.9**	**111.4**	**114.2**
B4. Combination of 1-3 using one standard deviation shocks								**82.1**	**93.3**	**105.2**	**110.0**	**114.0**	**117.4**	**120.3**

Sources: Data from the Japanese authorities; and Fund staff estimates.

1/ Derived as $[(r - \pi(1+g) - g]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate.

2/ The real interest rate and real GDP growth contributions are derived from the numerator in footnote 1/.

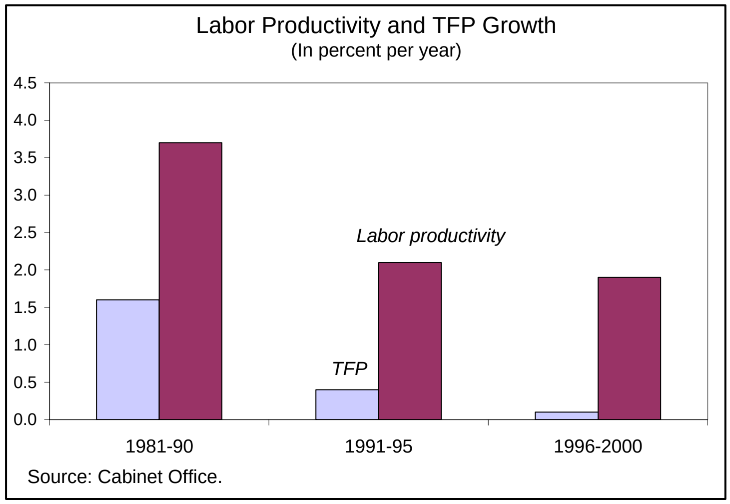
3/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

5/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

JAPAN—PRIORITIES FOR STRUCTURAL REFORM

1. **Unresolved structural rigidities explain much of Japan's low potential growth**. TFP has been basically flat over the last ten years. While this may reflect in part the ongoing adjustment to the excesses of the Bubble Years, structural factors have surely been at play. The reallocation of labor and capital out of exiting firms has been hampered by distortions in the labor and financial markets, excessive and often unclear regulation, a weak anti-trust framework, and—on occasions—outright government interference. As a result, labor productivity in sheltered sectors such as construction, food processing, agriculture, transportation, and communication has lagged that in countries where competitive forces have been less fettered. Impeded factor mobility across sectors and enterprises has weighed on average productivity in manufacturing as well.



2. **Estimates of the gains from removing structural impediments vary, but benefits are likely to be substantial**. Static gains (basically, one-time increases in productivity arising from a more efficient use of resources) are thought to range from about 2 percent of GDP (for trade reform) to about 8 percent of GDP (in the case of broad-based deregulation). Dynamic gains in the form of permanent increases in multifactor productivity growth are estimated in the range 0.3 to 2.4 percent of GDP depending on the breadth of reforms. Broadly, these estimates support the view that further structural reforms are key to raise the long-term growth potential.[1]

3. **A comprehensive reform agenda would entail the following priorities**:[2]

a. *Labor markets*. Greater flexibility in the labor market has facilitated corporate restructuring, but there remain obstacles to labor mobility. Furthermore, the market has become more dualistic, with a growing divide between "regular

[1]Estimates of the benefits from structural reforms are reviewed in IMF Country Report 04/247, p. 63.

[2]Details on Japan's structural hurdles are in many OECD studies, for example *Economic Policy Reforms: Going for Growth*, April 2005.

workers" and those on temporary or part-time contracts—who earn lower wages, are less able to upgrade their human capital, and largely fall through the social safety net. An additional issue for Japan is to support labor supply in the face of adverse demographic trends. In order to address these issues, essential steps include:

i. **Reducing employment protection for regular workers while shoring up the social insurance coverage for temporary workers.** This will address both equity and efficiency concerns, rebalancing the mix of regular and temporary workers at the margin. (Recent employment growth has largely been driven by temporary hires.)

ii. **Making corporate pensions portable** to enhance labor mobility.

iii. **Boosting the role of private job placement services**.

iv. **Encouraging labor force participation** through family-friendly policies to invite working age women to re-enter the labor force and discourage early retirement of all workers.

b. *Product markets*. Competitive forces are weak in many domestic markets because of timid enforcement of competition laws as well as low import penetration. Markups are high by international standards in the service sector and Japan's price level remains well above that in countries with a similar level of per capita income. Measures to address these problems include:

i. A **more vigorous enforcement of competition law** through stronger powers for the Fair Trade Commission and more effective sanctions. A new anti-monopoly law that goes some way in this direction was adopted in April 2005 and will take effect in January 2006.

ii. A **review of regulatory policies and procedures in many sectors**. Large-store regulations laws (which favor small-scale outlets) should be further relaxed to enhance the *retail sector*'s productivity. Independent sector regulators should be established to regulate *network industries* and limit the risk of regulatory capture. Universal service obligations should be subject to cost-benefit analysis—and financed by fiscal transfers. In the *postal sector*, these universal service obligations should be abolished for new entrants. There is scope for regulatory reform in the *energy sector* (electricity, gas) and in the *telecommunication sector* that would bring prices down to international levels. (For example, Japan is one of the largest consumer of natural gas. Liberalization of the sector could give important gains both for consumers and manufacture producers.) As for the *transportation sector*, according to the OECD, the cost of using Japan's harbors and airports is high by international standards.

c. *Inward FDI*. Japan's has the lowest inward FDI position as a ratio of GDP among OECD countries (about 2 percent versus more than 10 percent in the majority of OECD countries). This reflects the long period of economic stagnation but also barriers to entry for foreign firms. These barriers include limits on the use of foreign shares to acquire Japanese companies (which are scheduled to be removed) and relatively high effective taxation on inward FDI. Key steps to stimulate FDI inflows should include:

   i. **A shift to product market regulation that strengthens competition.**

   ii. **A removal of remaining barriers and implicit restrictions** on inward FDI, to increase foreign rivalry and the contestability of domestic markets.

d. *Agriculture*. Both domestic and trade policies maintain a high level of protection of this sector, evidenced inter alia by the very high prices of food and low sectoral productivity. The agenda for agricultural reform is intrinsically linked to an overhaul of commercial policies for the sector. Needed steps are:

   i. **Promote competition and large-scale operations** by allowing entry of corporations in the sector nation-wide (now it is possible only in a few agricultural "special zones.")

   ii. **Reduce agricultural protection**. Japan's trade policies for agriculture pursue goals that are very different from those for the manufacturing sector (which is generally more open than in the EU and the U.S.). There is a consistently high tariff wall: according to the WTO, the average unweighted tariff is about 16 percent but tariff dispersion is large. In 2001, overall support to producers (as reported by the OECD) accounted for about 1 percent of GDP or nearly 60 percent of agricultural value-added (compared to about 30 percent in the EU and 20 percent in the U.S.). The authorities accept in principle the need for changes in farm policies, but progress has been slow.

INTERNATIONAL MONETARY FUND

JAPAN

Staff Report for the 2005 Article IV Consultation

Supplementary Information

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Daniel Citrin and Michael T. Hadjimichael

July 26, 2005

1. **This supplement provides an update of economic developments since the release of the staff report.** The thrust of the staff appraisal remains unchanged.

2. **Data released over the last three weeks point to continued growth and strengthening domestic demand.** The June *Tankan* survey reports both improved business conditions during the second quarter and upgraded investment plans at both manufacturing and nonmanufacturing firms. Indicators of private consumption also remain on an upward trend, partly reflecting continued improvements in labor markets. Export growth, however, continues to be weak, partly as a result of reduced demand in the region, although exports to China picked up in June. Production-side data confirm improved prospects, although inventory decumulation in the IT sector and weak foreign machinery orders are holding back industrial activity. Consumer prices (excluding perishables), which have been declining slightly year-on-year, were unchanged in May, reflecting a rise in gasoline prices.

3. **Against this background, the authorities remain of the view that the expansion is on track.** In its latest monthly bulletin, the Bank of Japan notes that the economy continues to recover, notwithstanding ongoing adjustments in IT-related sectors, and the trend is expected to be maintained. The Cabinet Office reaches a similar assessment in its July report. The staff will review its growth projections following the release of second quarter GDP data in August. At this stage, recent data and the shift in the pattern of growth suggest that the near-term projections for the current account surplus in the staff report may be marked down.

4. **The authorities welcomed the revaluation of the Chinese renminbi**, **noting that a flexible Chinese currency would benefit not only China, but also Japan and the global economy.** The yen appreciated by over 1 percent against the dollar on the news, reversing part of its recent decline. The staff considers that, on balance, the impact of the revaluation on Japan's economy will be modest.

5. **In late June, two government advisory bodies released recommendations on economic reform.** The Tax Commission proposed revisions to income taxation, including streamlined deductions, a less generous treatment of retirement income, and an overhaul of income tax brackets. The Council on Economic and Fiscal Policy presented to the prime minister broad policy guidelines to inform the budget discussions for FY 2006. The guidelines call inter alia for capping some medical expenditures, rationalizing public work spending, reducing the number of public servants, and studying ways to liberalize the immigration of unskilled workers. These proposals will be developed in more detail in the months ahead.

6. **The lower house of the Diet approved the government's plan to privatize Japan Post by a very narrow majority**. The draft bill is now under consideration by the upper house which is expected to vote on it by mid-August. Much rides on this decision, as the prime minister could dissolve the lower house and call for early elections if the legislation, which he strongly supports, fails to be adopted.

INTERNATIONAL MONETARY FUND
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Washington, D. C. 20431 USA

Public Information Notice (PIN) No. 05/105
FOR IMMEDIATE RELEASE
August 8, 2005

IMF Executive Board Concludes 2005 Article IV Consultation with Japan

On July 29, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Japan.[1]

Background

GDP growth slowed unexpectedly in the second quarter of 2004, after several quarters of above trend growth. For the full year, GDP rose by 2.6 percent, well below expectations. A significant part of the shortfall reflected a shift to a chain-weighted methodology—growth on the old methodology was 3.6 percent. The rest was associated with an unanticipated fall in partner country demand, owing to a slowdown in the global IT market as well as higher oil prices, and weaker private domestic demand. During 2005, economic activity has rebounded, with unexpectedly strong GDP growth in the first quarter (4.9 percent SAAR), partly reflecting temporary factors. Recent indicators, notably on retail sales, investment plans, and employment growth portend a continued expansion going forward. Despite the acceleration in activity, mild underlying deflation persists. Financial markets developments have been uneventful, with the Nikkei broadly flat and bond yields somewhat lower compared with a year ago.

The yen has been broadly stable against the U.S. dollar and on a multilateral basis. Over the past 12 months, the bilateral exchange rate vis-à-vis the dollar has been in a range of

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

¥102 to ¥115. Appreciation pressures emerged toward the end of 2004, driven largely by broad-based dollar weakness, but receded on expectations of faster tightening by the U.S. Federal Reserve. In effective terms, the nominal and real exchange rates have been little changed over the past 12 months. Unit labor costs have been declining, while growing in partner countries; and, given Japan's already sizeable external surplus, competitiveness is not a concern at present.

Pressure on labor markets from job shedding is slowly abating. The unemployment rate is at a six-year low, the ratio of job offers to applicants has continued to hover at post-bubble highs, and corporate surveys indicate declining labor market slack. Employment of regular workers is firming, as the past trend toward hiring temporary and contract workers begins to ebb. Thanks in part to the shift back towards regular workers (who are more highly paid), real wages have recently bottomed out, with positive implications for future income growth.

Progress in corporate restructuring continues. Cash flow and profits remain buoyant, bankruptcies have fallen to a ten-year low, and leverage continues to decline. Furthermore, the recovery in the corporate sector continues to broaden beyond large export-oriented manufacturers to include smaller enterprises and nonmanufacturers.

Further progress has also been made in strengthening the banking system. Tightened regulation of major banks under the Program for Financial Revival (PFR), together with corporate sector improvements, have reduced nonperforming loans (NPLs) and supported ratings upgrades. Major banks more than met the PFR's goal of halving the NPL ratio to around 4 percent by the program's expiration in March 2005. The pace of decline in bank lending has slowed, and according to the Tankan survey, borrowers perceive an increased willingness to lend. In addition, a blanket guarantee on bank deposits was lifted at end-March, with no signs of strain. Nonetheless, the process of revitalizing the banking system has further to go, with the quality of bank capital weakened by deferred tax assets, core profitability still low, and regional banks lagging in cutting bad loans.

Monetary policy remains highly accommodative, with liquidity ample and short-term interest rates at zero under the quantitative easing framework. The Bank of Japan has repeatedly stressed that the policy will remain in place until deflation is defeated. In May, it decided to allow temporary undershooting of its target range for current account balances at the Bank in light of seasonal volatility in liquidity demand. The move was generally perceived by markets as a technical step and not as a fundamental policy shift.

Fiscal consolidation was achieved in FY2004 (ending March 2005), but the deficit remains large. The general government deficit is estimated to have narrowed by 0.6 percent of GDP to 6.9 percent of GDP. The structural balance improved by 0.3 percent of GDP. About half of the decline in the general government deficit reflected stronger-than-expected revenues and some expenditure savings achieved in the supplementary budget. A decade of high deficits has fed rapid growth in gross public debt to 170 percent of GDP, by far the highest among advanced countries. Net debt is around 80 percent of GDP.

The near-term macroeconomic outlook is improving. The slowdown in world growth appears to have bottomed out, with strong first quarter growth in most regions, while inventory and production adjustments in the IT sector are advancing and other data point to a revival of private consumption and investment. Accordingly, annual average growth of Japan's GDP is projected at about 1¾ percent in 2005 and 2006. As economic slack is taken up, deflationary pressures should ease, with consumer prices finally bottoming out in 2006. Risks remain biased to the downside, and include weakening global growth (especially if new spikes in oil prices occur), and renewed upward pressure on the yen. For the medium term, growth is anticipated to slow to potential, estimated at 1.5 percent. Relatively low potential growth reflects muted total factor productivity, as well as a continued decline in the working-age population.

Executive Board Assessment

Executive Directors welcomed the further signs of progress in resolving the legacies of the bubble years in Japan. The financial system has been stabilized, the corporate sector is more resilient, labor markets have become more dynamic, and fiscal consolidation is under way. As a result, the economy appears better positioned to sustain an expansion.

Nonetheless, Directors noted that low trend growth and rising demographic pressures pose risks to medium-term prospects. Population aging is pushing up social spending, and modest underlying growth leaves the economy susceptible to shocks. Against this background, further efforts will be needed to advance fiscal and structural reforms in order to strengthen the underpinnings for more robust self-sustained growth. Directors acknowledged that implementing such reforms will be difficult, but emphasized that they would strengthen the domestic economy and, together with concerted policy efforts in other countries to address external imbalances, contribute to making the global economy more resilient, thereby limiting the risk of a disorderly adjustment in currency markets.

Directors agreed that the priority for monetary policy remains to eliminate deflation. They welcomed the Bank of Japan's commitment to maintain an accommodative stance until both actual and expected inflation turn positive. Most Directors were of the view that, in the face of reduced liquidity demand, the target for current account balances could probably be reduced without tightening monetary conditions. Nonetheless, Directors agreed with the Bank of Japan that, in order to signal unambiguously the commitment to maintaining an easy monetary stance, keeping the target at its present level for the time being was appropriate.

Directors emphasized that continued clear communication of the authorities' monetary policy intentions will play a crucial role in promoting policy credibility and effectiveness as deflation ebbs and monetary operations shift back to using interest rates as a policy tool. Directors generally supported the Bank of Japan's preference for adopting a flexible approach in shifting to a new monetary policy framework, tailored to evolving financial and economic conditions. Some Directors supported the announcement of a quantified inflation objective to stabilize inflation expectations once deflation is incontestably defeated. Others noted that, in the current situation, the benefits of announcing an inflation target might be limited, in light of the uncertainties about the effectiveness of the monetary policy transmission mechanism.

Directors observed that the authorities base their exchange rate policy on the conviction that exchange rates should reflect economic fundamentals and that disorderly movements are not desirable for economic growth. They noted that the authorities had not intervened in the foreign exchange markets since early 2004. At the same time, given the primacy of protecting the objectives of eradicating deflation and supporting growth, a few Directors considered that intervention could be warranted as a last resort if appreciation pressures seriously threaten to lower the price level or risk the economic recovery, and taking into account the limited scope for more conventional monetary and fiscal policy. Most other Directors, however, pointed to the economy's improved ability to handle a stronger currency, and cautioned that intervention should only be used under extraordinary circumstances.

Directors welcomed the progress made in advancing fiscal consolidation in FY2004, but noted that the deficit remains large, the public debt is set to rise further, and the structural balance will decline only a little in the current fiscal year, despite steps to restrain nondiscretionary spending and raise revenues. They encouraged the authorities to save any potential tax windfall and to avoid any expansionary measures in this year's supplementary budget, assuming the expansion continues as envisaged.

Directors considered that stabilizing the public debt and making room for the fiscal costs of population aging will present challenges to fiscal policy in the medium term. They welcomed the authorities' objective of achieving primary balance excluding social security by early in the next decade. A number of Directors agreed that a steady and gradual reduction in the deficit is appropriate, to minimize any negative impact on the still-nascent economic recovery. Many other Directors, however, observed that a larger adjustment may be required to stabilize the debt, especially if real interest rates rise more than expected in the future. While such an adjustment would require difficult measures on both the revenue and expenditure sides, the adjustment should be manageable in light of the economy's improved resilience. Directors saw scope for further streamlining public investment and for civil service reform, as well as for comprehensive tax reforms, including an increase in the consumption tax. At the same time, they recommended that fiscal adjustment plans be given flexibility to adapt to changing economic circumstances.

Directors welcomed the progress made in resolving balance sheet problems in the banking system. They saw the smooth transition to partial deposit insurance as an important sign of public confidence in banking system stability. Looking ahead, Directors noted that the emphasis of financial sector policies is appropriately shifting toward revitalization, as highlighted in the new Program for Further Financial Reform. They welcomed the goals of the new program, and looked forward to prompt implementation of specific measures. The priorities include continued supervisory scrutiny to address remaining balance sheet weaknesses, particularly among the regional banks, and steps to improve risk management and enhance the environment for bank profitability. Directors also welcomed the planned privatization of Japan Post, the country's largest deposit-taker, which could help level the playing field for private financial institutions.

Directors stressed that structural reforms will be needed to mitigate the effects of population aging on potential growth and bolster Japan's productive capacity. Liberalizing factor and product markets will help strengthen underlying growth prospects, and in that vein, labor market flexibility should be increased further, product market competition enhanced, and inward foreign direct investment encouraged. Directors noted that reform of the agricultural sector could yield large benefits, given the sector's high protection and low efficiency. They encouraged the authorities to reduce import barriers and move toward direct payments to farmers.

Directors called on the authorities to make further trade liberalization a central element of their structural reform agenda, to the benefit of both Japan and developing countries. They welcomed Japan's continued support for the multilateral trading system, and encouraged the authorities to take a leadership role in helping to bring about a successful conclusion of the Doha Round negotiations.

Directors commended Japan's efforts to maintain official development assistance notwithstanding budget pressures. They encouraged the authorities to raise development assistance toward the UN recommended target.

Japan: Selected Economic Indicators

	2001	2002	2003	2004	Proj. 2005	
Real GDP 1/	0.2	-0.3	1.4	2.6	1.8	
Private consumption	1.1	0.5	0.2	1.5	1.2	
Nonresidential investment	0.6	-6.6	6.6	5.8	5.2	
Residential investment	-5.3	-4.3	-1.1	2.2	0.3	
Public investment	-4.6	-4.3	-10.6	-10.8	-3.9	
Public consumption	3.0	2.6	1.2	2.7	1.9	
Stockbuilding (contribution to growth)	0.1	-0.2	0.2	0.2	0.2	
Foreign balance (contribution to growth)	-0.6	0.6	0.6	0.8	-0.1	
Exports of goods and services	-6.0	7.2	9.1	14.5	3.5	
Imports of goods and services	-0.7	1.2	3.8	8.9	5.2	
Inflation						
GDP deflator	-1.3	-1.3	-1.4	-1.2	-1.0	
CPI	-0.7	-1.0	-0.2	0.0	-0.4	
Unemployment rate (period average, percent)	5.0	5.4	5.3	4.7	4.4	
Current account balance						
Billions of U.S. dollars	87.8	112.6	136.2	172.1	175.3	
Percent of GDP	2.1	2.8	3.2	3.7	3.7	
General government balances (percent of GDP, FY)						
Balance including social security	-6.6	-8.2	-7.5	-6.9	-6.7	
Balance excluding social security	-6.6	-7.9	-7.7	-6.6	-6.3	
Structural balance 2/	-5.7	-7.0	-6.9	-6.6	-6.5	
Money and credit (12-month growth rate; end period)						
Base money	16.9	19.5	13.2	4.2	2.2	3/
M2 + CDs (period average) 4/	2.8	3.3	1.7	1.8	1.5	3/
Bank lending 4/	-4.3	-4.8	-5.1	-3.2	-2.7	3/
Exchange and interest rates (period average)						
Yen/dollar rate	121.5	125.4	115.9	108.2	108.7	5/
Real effective exchange rate 6/	88.7	80.6	78.0	78.5	74.7	3/
3-month CD rate	0.09	0.07	0.09	0.06	0.05	5/
10-year government bond yield	1.33	1.28	1.00	1.51	1.23	5/

Sources: Global Insight, Nomura database and IMF staff estimates and projections.

1/ Annual growth rates and contributions are calculated from seasonally adjusted data. The official outturn based on annual data for GDP growth in 2004 was 2.7 percent.

2/ Including social security, excluding bank support.

3/ May 2005.

4/ From April 1998 onward, data reflect the inclusion of foreign banks, foreign trust banks and Shinkin banks in the monetary survey.

5/ June 23, 2005.

6/ Based on normalized unit labor costs; 2000 = 100.