Japan: Making the Most of Current Tailwinds

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

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

**Contributions to QoQ Real Growth (SA)**
(In percent)

[Diagram showing contributions to QoQ real growth with categories including private gross fixed investment, government spending, net exports, private consumption, private inventories (change), and real growth (qoq)].

Source: Haver Analytics.
... driven by a supportive external environment ...

**World Exports**
(Jan.2013=100; SA; Volumes)

- United States
- Euro Area
- Emerging economies

Source: CPB World Trade Monitor.

**Real Exports by Destination**
(Jan. 2013=100; SA)

- to World
- to USA
- to Euro Area
- to Asia

Source: Haver Analytics.
...and fiscal and monetary support

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

Source: Haver Analytics.
But inflation and wage growth remain stubbornly low....

**Inflation Indicators**
(YoY; in percent)

**Total Cash Earnings**
(per employee; YoY; in percent)

Sources: Haver Analytics; IMF staff estimates.

Sources: Haver Analytics; and IMF Staff calculations.
...and public debt is high

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

**Japan: Gross Public Debt\(^1\) and Fiscal Balance**

(In percent of GDP)

Sources: Cabinet Office; and staff estimates and projections.

1/ Gross debt of the general government including the social security fund.
Withdrawal of fiscal stimulus and consumption tax increases to 10 percent in October 2019 are assumed.
Chronic pressures from low interest rates and demographic headwinds, especially for regional financial institutions and life insurers, are creating new channels of risks

- Search for yield has led to expansion of overseas and real-estate lending, contributing to higher FX liquidity risk and moderately overvalued condominium prices
- Low profitability of regional financial institutions could lead to a bunching of solvency problems in the medium to long term

- Sovereign-financial linkages remain close

**Profitability and Net Interest Rate Margins**

(In percent)

Sources: Fitch Connect; and IMF staff calculations.
Risks to the outlook are tilted to the downside

Upside risks:
- Higher global demand
- Further fiscal support

Downside risks:
- Confidence loss
- Low financial profitability
- Geopolitical instability
- Fiscal sustainability
Economic policy implications

Making the Most of Current Tailwinds: A Mutually Reinforcing Strategy
Monetary policy needs to stay the course ...

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

Sources: Bank of Japan; Haver Analytics; and Fund staff estimates.
Note: The blue line is the actual real discount rate deflated by the inflation expectations estimated from an MA(4) model, and the red line marks the mean posterior estimates of the natural rate of interest from a Bayesian time-varying parameter vector autoregression (TVP-VAR) model following Lubik and Matthes (2015).
Strengthening communication should help bolster credibility and lift inflation expectations

- Gradually phase out references to quantitative JGB targets to prevent confusion with interest target
- Publish BoJ staff forecast to generate better policy understanding and predictability
Fiscal policy should preserve near-term growth...

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

**General Government Fiscal Balance**
(In percent of GDP)

Sources: WEO database; and IMF staff estimates.
The FY2018 Interim Fiscal Review will be an opportunity to strengthen the fiscal framework:

- Gradual pre-announced increases in the consumption tax
- Social security spending curbs through fundamental reforms
- Institutional arrangements to anchor policies and expectations
Structural reforms are central to making Abenomics work

Japan’s Population and its Composition

Difference in Employment Protection: Regular vs Temporary

Source: OECD, Employment Protection Database.
Note: Difference in index for protection of regular employment and index for protection of temporary employment. Each index is a scale 0-6 from least to most restrictive.
First priority: Labor market reform

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

1. Establish clear legal framework for “intermediate” labor contracts
2. Accelerate “equal-pay for equal-work” initiative, together with job descriptions
3. Support worker mobility across firms
Second priority: Reforms to increase private investment

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

Sources: OECD Product Market Regulation Database; and Koske (et al) 2013 update.
Third priority: Diversification and enhancement of labor supply

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

Source: Ministry of Internal Affairs and Communications.
Enhanced financial sector policies to boost the productivity of SMEs

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

Source: OECD 2015.

### SME Productivity in Manufacturing

(Value added Per person, Index 250=100 in 2014; Size = number of employees)
Steps to safeguard financial stability against emerging risks and longer-term pressures ...

**Supervision and governance**
- Move to full risk-based prudential supervision
- Better tailor capital requirements according to individual bank risk profiles
- Further strengthen corporate governance across the whole banking and insurance sectors
- Implement an economic-value-based solvency regime for insurance sector

**Macroprudential framework**
- Clarify mandate of the Council for Cooperation on Financial Stability
- Broaden systemic risk assessment to non-systemic important banks
- Develop tools for the housing sector

**Crisis management and resolution framework**
- Strengthen and clarify resolution framework
- Improve crisis preparedness, prompt corrective actions
- Improve institutional framework and inter-agency coordination
- Tighten preconditions for use of public funds
Engage with bank boards and senior management to ensure impact of population dynamics on future viability is understood

Facilitate transition of regional banks to augmented fee-based income, reduced costs, and consolidation

Consolidation alone is unlikely to be sufficient to address the challenges

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**Demographic Impact on the Annual Loan-Deposit Ratio**

(Percentage points)

Sources: IMF Staff Calculations
Abenomics has improved economic conditions and engendered structural reforms but has not yet achieved a durable exit from deflation.

The current favorable economic environment is an opportunity to accelerate reforms:

- Coordinated demand and income policies to boost inflation and put the economy on a durable growth path
- Further strengthening the monetary and fiscal policy frameworks to bolster credibility and reduce long-term risks
- Enhanced financial sector policies to contain financial stability risks
Thank you!

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