Japan
Rating Report

SCOPE A STABLE OUTLOOK

Credit strengths

- Wealthy, competitive and diversified economy
- Very strong funding flexibility and excellent market access
- Robust external position

Credit challenges

- Very elevated public debt levels
- Fiscal pressures due to ageing population
- Low and decreasing growth potential, exacerbated by demographic decline

Rating rationale:

Wealthy, competitive and diversified economy: Japan benefits from its high wealth levels as well as its diversified and competitive economy, supported by high levels of sophistication and the presence of highly innovative firms. This is a critical factor underpinning Japan's resilience to shocks.

Strong funding flexibility and excellent market access: Japan benefits from very strong funding flexibility and excellent market access due to the yen's safe-haven status plus a highly favourable government debt profile. A large, savings-rich domestic investor base combined with continued support from Bank of Japan policies limit near- to medium-run debt refinancing risk, despite very elevated gross financing needs.

Robust external position: Japan's status as the world's leading external creditor reflects large and consistent current account surpluses, high domestic savings, and a sophisticated domestic banking system. This, combined with low external debt levels and reserve currency status significantly lower vulnerability to external shocks and risks associated with external debt sustainability.

Rating challenges include: the country's significant structural challenges posed by a rapidly shrinking and ageing population, which i) exacerbates Japan's fiscal vulnerabilities due to rising pension and healthcare-related costs and a reduction in the tax base and ii) constrains the country's already low growth potential.

Japan's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aa		-1/3	A
Public Finance Risk		25%	b+		-1/3	
External Economic Risk		10%	aaa		+1/3	
Financial Stability Risk		10%	aa-		-2/3	
ESG Risk	Environmental Risk	5%	b		-1/3	
	Social Risk	5%	bbb		0	
	Governance Risk	10%	aaa		0	
Overall outcome		a		**+1**	**-1**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

Positive rating-change drivers

- Fiscal consolidation places public debt on a firm downward trajectory
- Structural reform strengthens growth outlook

Negative rating-change drivers

- Growth prospects deteriorate, significantly damaging fiscal dynamics
- Financial system risks increase meaningfully, weighing on macro-stability
- Material weakening in the external position

Ratings and Outlook

Foreign and local currency

Long-term issuer rating	A/Stable
Senior unsecured debt	A/Stable
Short-term issuer rating	S-1/Stable

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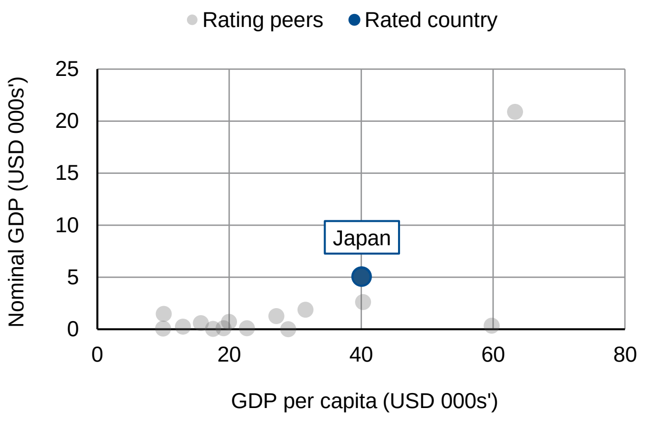
Domestic Economic Risks

- **Growth outlook:** The Covid-19 pandemic led to a contraction of Japan's GDP of 4.6% in 2020 in real terms. We project the Japanese economy to recover and grow by 2.4% in 2021, followed by 4.5% in 2022 as restrictions ease, global demand picks up and the large JPY 55.7trn fiscal stimulus package is implemented. Thereafter, we forecast a gradual convergence to the country's medium term low growth potential of 0.5%.
- **Inflation and monetary policy**: Short-term deflationary pressures persist with -0.2% inflation expected for 2021 and a projected increase to 0.8% over 2022-26, well below the 2% target. We expect the Bank of Japan to pursue its current accommodative policies of a negative short-term policy interest rate of -0.1% and purchases of sovereign debt, exchange-traded funds, Japan real estate investment trusts, as well as corporate bonds.
- **Labour market:** Labour markets have been affected but show signs of resilience relative to peers. The unemployment rate has only moderately increased from 2.4% in 2019 to 2.8% in 2020, well below levels observed in peer countries and is expected to average at 2.4% over 2021-26. Nevertheless, Japan's labour market is still dominated by an inefficient wage setting system based on seniority which hinders new talent to be promoted to executive ranks.

Overview of Scope's qualitative assessments for Japan's *Domestic Economic Risks*

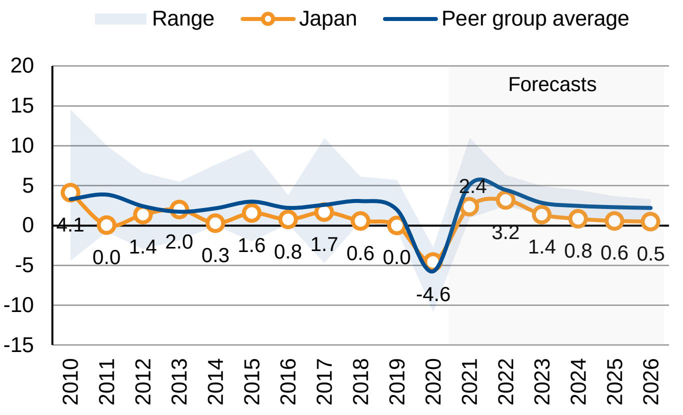
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Growth potential of the economy	Weak	-1/3	Low and declining growth potential
	Monetary policy framework	Neutral	0	BoJ is a sophisticated central bank; persistent accommodative policies have failed to reflate the economy; price stability and financial stability objectives are increasingly conflicting
	Macro-economic stability and sustainability	Neutral	0	Large, competitive and diversified economy with robust labour markets; shrinking workforce presents sustainability challenges

Nominal GDP and GDP per capita, USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

Public Finance Risks

- **Fiscal outlook:** Japan's primary deficit worsened substantially in 2020 to 9.5% of GDP and is expected to remain elevated as the government's extensive fiscal stimulus plan is rolled out. We forecast the primary balance to average -5.3% of GDP over 2021-26.

  Even though Covid-related expenditure will eventually decline, age-related expenditure and a shrinking tax base will weigh on the fiscal outlook in the medium- and long-term because of adverse demographics.

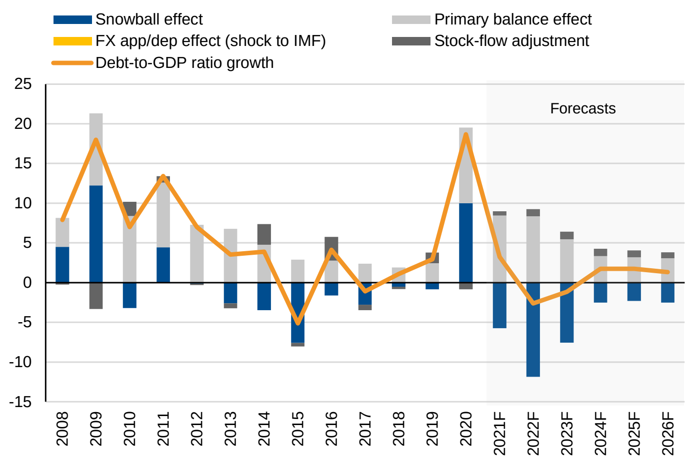
- **Debt trajectory:** Japan's debt is estimated to reach 257% of GDP by the end of the year, the highest among developed nations. We then project the debt ratio to decline slightly in 2022-23 as the economy recovers and return to an increasing trajectory thereafter. We expect debt-to-GDP to reach 259% by 2026 given moderate growth expectations and wide fiscal deficits.

- **Market access:** Japan's government is benefiting from excellent support of the Bank of Japan, whose accommodative monetary policy is expected to be maintained in coming years. The central bank has removed its self-imposed ceiling on Japanese Government Bonds (JGBs) purchases in 2020. The bank will continue with its extensive bond purchases to achieve the zero-percent yield target for 10-year JGBs to accommodate public finance. As of 10 November 2021, the JGB 10-year bond yield is at 0.06% and public debt has an average maturity of around nine years. Refinancing risks are very low also due to a large domestic investor base (86.8% of total public debt), of which the central bank makes up a large share (44% of the total).

Overview of Scope's qualitative assessments for Japan's *Public Finance Risks*

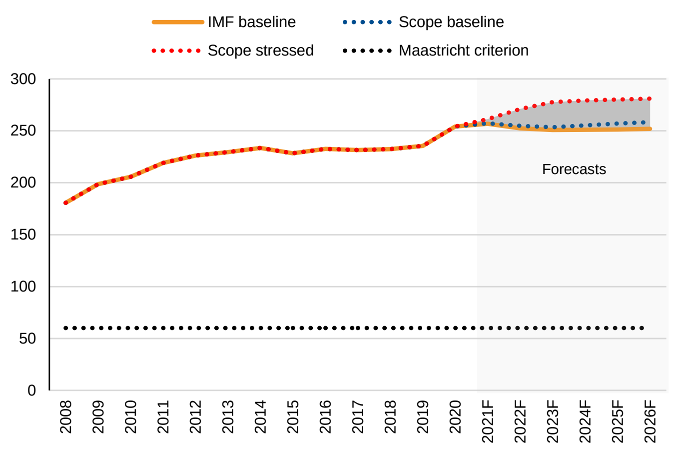
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b+	Fiscal policy framework	Weak	-1/3	Persistent fiscal deficits exacerbated by ageing population; lack of credible medium-term consolidation plan
	Debt sustainability	Weak	-1/3	Very high and rising debt levels pose sustainability challenges
	Debt profile and market access	Strong	+1/3	Strong market access, smooth redemption profile and large domestic investor base, in line with peers

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

External Economic Risks

- **Current account:** The current account balance remained robust throughout the pandemic and is expected to stay at 3.5% in 2021 due to the large primary income flows, which have proven to be resilient to short-term external shocks. Japan's current account balance is significantly stronger than peer's and is expected to average 3.2% over 2022-2026.

  The current account has increasingly become insulated from changes in the trade balance as the primary income now accounts for most of positive net balances (given a large creditor position). Substantial foreign investments greatly support current account stability, which was confirmed during the Covid-19 crisis.

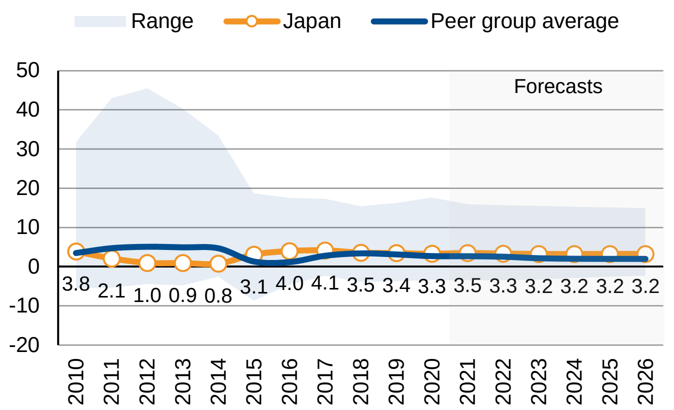
- **External position:** Japan's external position benefits from its large net creditor position with the net international investment position remaining at a high level of 68.2% of GDP in 2020.

- **Resilience to shocks:** External economic risks are mitigated by the Yen's reserve currency status and is supported by a robust external position. The country's large foreign exchange reserves, which totalled USD 1.4trn at year-end 2020, the second largest after China, further bolster resilience to short-term shocks.

Overview of Scope's qualitative assessments for Japan's *External Economic Risks*

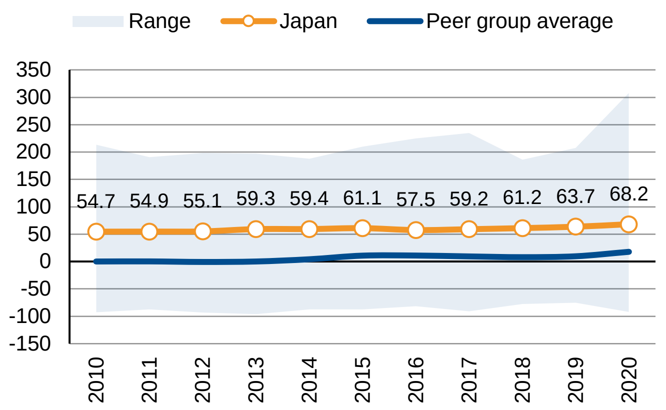
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Current account resilience	Strong	+1/3	Robust track record of current account surpluses supported by diversified export base and large external creditor position
	External debt structure	Neutral	0	Moderate external debt levels; large share of short-term liabilities
	Resilience to short-term shocks	Neutral	0	Reserve currency status, large FX reserves and robust external-creditor position

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

Financial Stability Risks

- **Banking sector:** The Japanese banking sector demonstrated its resilience during the Covid-19 pandemic. The banking sector's tier 1 ratio was at 14.6% in Q1 2021, well above minimum requirements, and the system wide NPL ratio did not worsen materially during the crisis, only increasing from 1.1% in Q1 2019 to 1.2% in Q1 2021.

  Long-standing banking sector vulnerabilities relate to the persistent low interest rate environment which has pressured banks' interest margins and forced them to engage in riskier activities without securing commensurate returns. Longer-term, these search for yield behaviors could lead to a build-up of financial system risks.

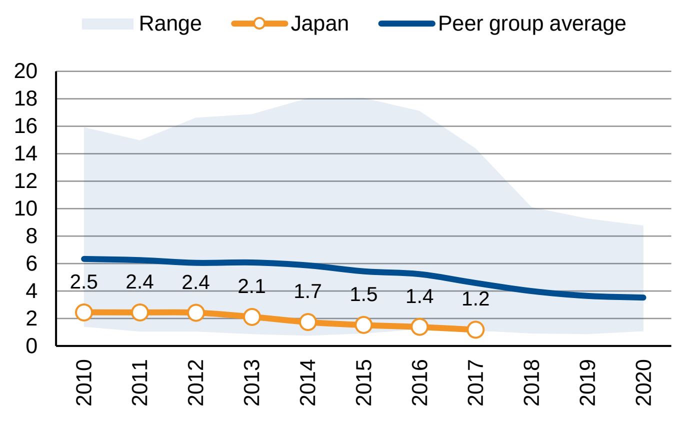
- **Private debt:** Leverage in the private sector has increased by 20pps of GDP relative to pre Covid-19 levels but is not excessive and remains in line with peers. Risks associated with household debt are mitigated by households' large financial assets which outweigh their liabilities.

- **Financial system resilience:** The Bank of Japan's macro stress test concluded that the financial system is likely to remain robust to a recession in real economy due to a resurgence of Covid-19 or an adjustment in global financial markets triggered by a rise in the US long-term interest rate. However, a situation in which global financial markets experience a substantial and rapid adjustment, comparable to that during the Great Financial Crisis, could trigger a substantial deterioration of the banking system's financial soundness.

Overview of Scope's qualitative assessments for Japan's *Financial Stability Risks*

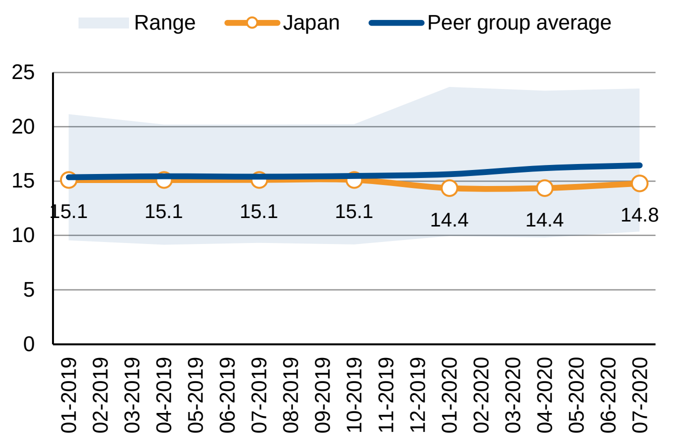
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Banking sector performance	Weak	-1/3	Profitability pressures lead to increased risk-taking without commensurate returns
	Banking sector oversight	Neutral	0	Strong oversight frameworks under the Bank of Japan and Financial Services Agency
	Financial imbalances	Weak	-1/3	High household debt; prolonged accommodative monetary policies pose long-term financial stability risks

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

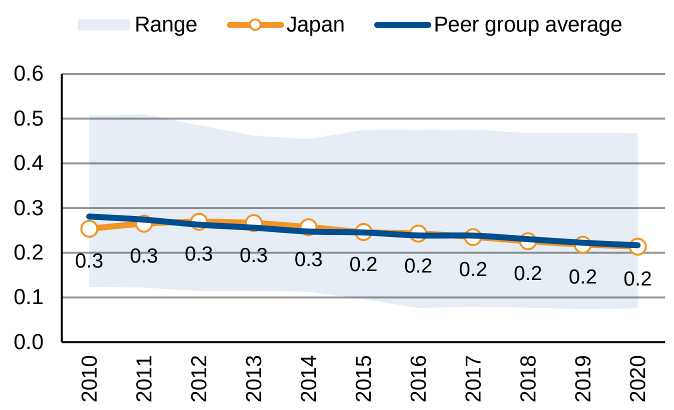
ESG Risks

- **Environment:** Japan ranks lowest among all rated countries on Scope's natural risk index and is likely to become increasingly exposed to natural disasters and extreme weather conditions due to climate change as these events becoming more frequent and severe. Japan is one of the most carbon intensive countries (0.22 CO² per GDP) and is a net importer of fossil fuels including coal (27.2% of the energy mix) and oil (37.9%). The government aims to achieve carbon neutrality by 2050 by raising the share of renewable energies in their energy mix to 36%-38% and to cut targets for coal use by 2030 to tackle climate change. More clarity on how the government plans to phase out fossil fuels is needed.
- **Social**: A rapidly ageing population, as captured by the highest old age dependency ratio in Scope's sovereign rating universe indicates that the pension and healthcare system will undergo more pressure in the future while shortages in the labor market will pose a threat to the economy. Gender inequality is also substantial in Japan due to the significant gender wage gap of 22.5% which is the third largest among OECD members.
- **Governance:** Fumio Kishida, who became Prime Minister in October 2021 after Suga's resignation in September, won a strong majority with his Liberal Democratic Party in last month's election. Besides his stimulus package and the ambition to redistribute wealth more broadly, Kishida is expected to take a more critical foreign policy stance towards China. Growing vulnerabilities within the Liberal Democratic Party may lead to renewed political uncertainty and leave Japan's vulnerabilities unaddressed, further weighing on credit quality. Elections in Japan's upper house are planned for 2022. Still, Japan's institutional framework is strong with high degrees of governance quality.

Overview of Scope's qualitative assessments for Japan's *ESG Risks*

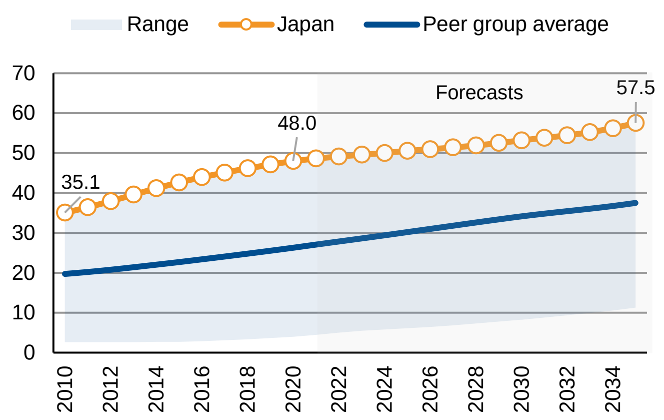
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Environmental risks	Weak	-1/3	High exposure to natural disaster, transition, and resource risks; insufficient policy response in the past though mitigation efforts are accelerating
	Social risks	Neutral	0	Low inequality, strong healthcare and educational systems; adverse demographics likely to put pressure on social care systems; persistent gender inequalities
	Institutional and political risks	Neutral	0	High quality democratic institutions and stable political environment; declining popularity of ruling LDP party

CO2 emissions per GDP, mtCO2e



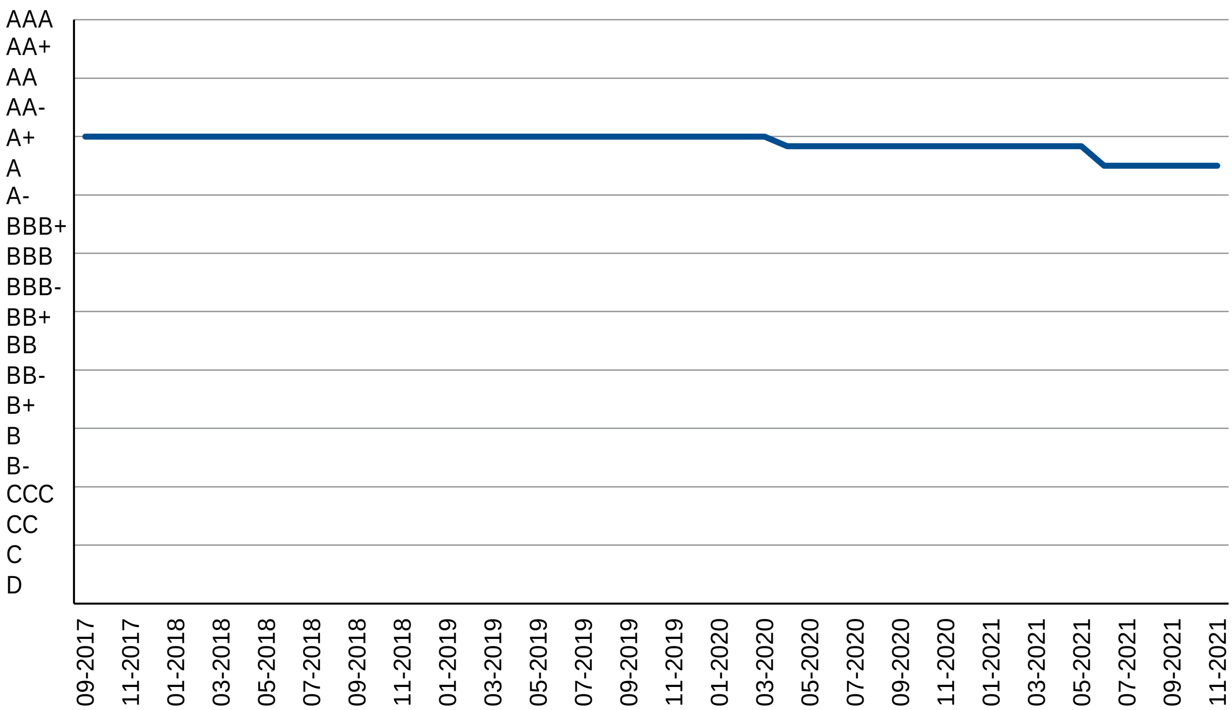
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard.

Peer group*
Bulgaria
France
Italy
Latvia
Malta
Poland
Russia
Slovakia
Spain
United States

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	39.4	38.9	39.8	40.7	40.1	40.7	43.1
Nominal GDP, USD bn	5003.7	4930.8	5036.9	5135.9	5045.1	5103.1	5383.7
Real growth, %[1]	0.8	1.7	0.6	0.0	-4.6	2.4	4.7
CPI inflation, %	-0.1	0.5	1.0	0.5	0.0	-0.2	0.5
Unemployment rate, %[1]	3.1	2.8	2.4	2.4	2.8	2.8	2.4
Public Finance Risk							
Public debt, % of GDP[1]	232.5	231.4	232.5	235.4	254.1	257.4	254.7
Interest payment, % of government revenue	3.2	2.8	2.3	2.0	2.1	1.6	0.9
Primary balance, % of GDP[1]	-2.8	-2.4	-1.9	-2.4	-9.5	-8.4	-8.4
External Economic Risk							
Current account balance, % of GDP	4.0	4.1	3.5	3.4	3.3	3.5	3.3
Total reserves, months of imports	17.0	16.3	14.7	15.4	18.5		
NIIP, % of GDP	57.5	59.2	61.2	63.7	68.2		
Financial Stability Risk							
NPL ratio, % of total loans	1.4	1.2	-	-	-	-	-
Tier 1 ratio, % of risk weighted assets	13.4	14.2	14.8	15.1	14.8	14.6	-
Credit to private sector, % of GDP	162.1	167.6	167.2	173.9	194.6	-	-
ESG Risk							
CO^2 per EUR 1,000 of GDP, $mtCO^2e$	243.0	235.2	225.5	218.1	213.5	-	-
Income quintile share ratio (S80/S20), x	-	-	-	-	-	-	-
Labour force participation rate, %	77.0	77.8	79.1	79.8	-	-	-
Old age dependency ratio, %	44.0	45.1	46.2	47.1	48.0	48.6	49.2
Composite governance indicator[2]	1.4	1.4	1.3	1.3	1.1	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 22 November 2021	17.9

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