Japan
Rating Report

A NEGATIVE OUTLOOK

Credit strengths

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

Credit challenges

- Very elevated and rising public debt
- Weak demographics, which exacerbate fiscal and economic challenges
- Sustained ultraloose monetary policies pose sustainability challenges

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 driver of 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. Continued support from Bank of Japan policies underpins the government's financing capacity despite adverse fiscal fundamentals and very high public debt.

Robust external position: Japan's status as the world's leading external creditor reflects large and 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. The Bank of Japan's highly accommodative monetary policy stance, which is critical for reducing debt sustainability risks, is increasingly diverging from that of other major central banks.

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%	aaa		-2/3	
Public Finance Risk		25%	b+		-1/3	
External Economic Risk		10%	aaa		+2/3	
Financial Stability Risk		10%	bbb+		-2/3	A
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 Negative Outlook reflects Scope's view that risks to the ratings are tilted to the downside over the next 12 to 18 months.

Positive rating-change drivers

- A credible fiscal consolidation strategy is established with tangible results
- Material improvement in the growth outlook

Negative rating-change drivers

- Failure to stabilise debt and deliver on budgetary targets
- Increase in financial system risks, weighing on macro-stability
- Unexpected weakening in the yen's reserve currency status

Ratings and Outlook

Foreign and local currency

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

Lead Analyst

Thibault Vasse
+33 1 86 26 24 55
t.vasse@scoperatings.com

Team Leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389-0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

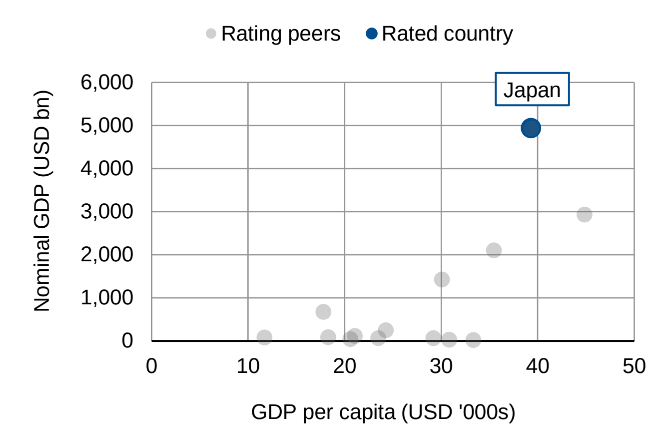
Domestic Economic Risks

- **Growth outlook:** The Japanese economy is recovering unevenly from the pandemic despite strong policy support and high vaccination levels. Following a contraction of 4.5% in 2020, real GDP growth is estimated to have grown by 1.6% in 2021, well below expectations. A weakening of global growth due to knock-on effects of the war in Ukraine and the erosion of consumer and business confidence is weighing on the country's growth outlook. We project the Japanese economy grow by 2% in 2022, followed by 1.7% in 2023. Thereafter, we forecast a gradual convergence to the country's medium term low growth potential of 0.4%. The government's structural reform agenda and associated investments can support growth potential, but it remains to be seen whether it will be sufficient to meet the considerable challenge of population ageing and demographic decline.
- **Inflation and monetary policy**: Inflation has risen gradually during 2021, due to rising commodity prices but remains well below the 2% inflation target, at 1.2% in March 2022. Core inflation has been negative over the past year, averaging -0.8% in the twelve months to March 2022, reflecting continued deflationary pressures in the economy. Against a worldwide tightening of monetary policy stances, the Bank of Japan has maintained its ultraloose policy stance by keeping long-term yields low via yield curve control and unlimited government bond purchases, in line with its price stability mandate. Japan's monetary policy stance thus stands in contrast to that of other major economies.
- **Labour market:** Unemployment peaked at 3.1% in October 2020 and has since trended down to reach 2.6% in March 2022. We expect the unemployment rate to go down to 2.5% by 2023 and stabilise thereafter. The employment and income situation has remained relatively weak overall, although improvement has been seen in some parts. Japan's economy is still facing intense pressures from a rapidly aging and shrinking population. According to UN data, the working age population has decreased by 14% over the 1990-2020 period and is expected to decline by 28% by 2050. This will exacerbate existing labour shortages.

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

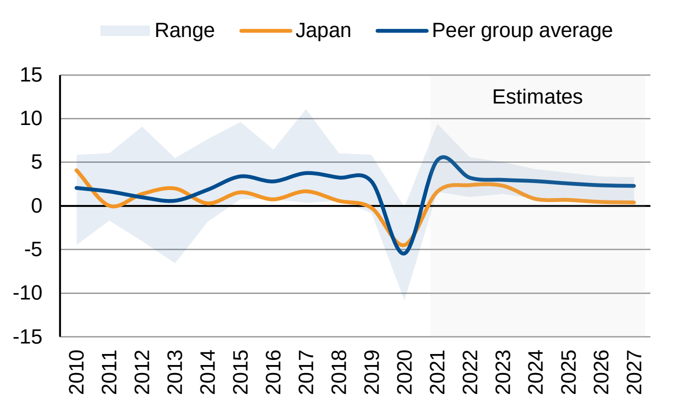
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Weak	-1/3	Low and declining growth potential
	Monetary policy framework	Neutral	0	BoJ is a sophisticated central bank; persistent accommodative policies have failed to reflate the economy;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

Nominal GDP and GDP per capita, USD thousands



Source: IMF WEO, Scope Ratings GmbH

Real GDP growth, %



Source: IMF WEO, Scope Ratings GmbH

Public Finance Risks

Fiscal outlook: Japan's primary deficit worsened substantially in 2020 to 9.1% of GDP and has remained elevated at 7.6% of GDP in 2021 as the government continues to provide substantial fiscal support to the economy. We expect the government to maintain a loose fiscal stance in response to an uneven economic recovery from the crisis. Medium- to long-term fiscal pressures due to population ageing and a shrinking tax base weigh substantially on Japan's fiscal outlook. This, combined with weak economic prospects raises concerns about the government's ability to deliver on its budgetary targets of achieving a balanced primary budget by 2025. A coherent fiscal consolidation strategy underpinned by credible economic assumptions is needed to address the country's rising public finance imbalances.

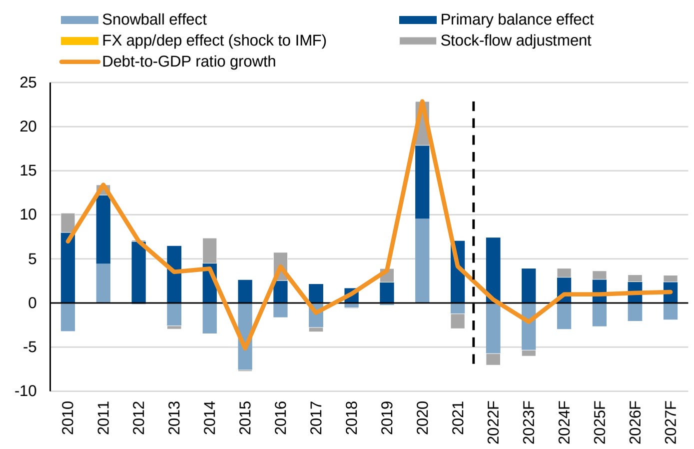
- **Debt trajectory:** We foresee Japan's debt to reach 261% of GDP in 2022, the highest among developed nations. We then project the debt ratio to decline slightly in 2023 as the economy recovers and return to a firmly increasing trajectory thereafter. We expect debt-to-GDP to reach 266% by 2027 given moderate growth expectations and wide fiscal deficits. Japan's debt level and trajectory has deteriorated beyond expectations, reflecting structural fiscal pressures and the uneven economic recovery. Importantly, debt sustainability hinges on the low interest rates. Japan's debt and gross financing needs would enter an explosive path if interest rates were to rise materially, as highlighted by the IMF.

- **Debt profile and market access:** Japan's government is benefiting from excellent support of the Bank of Japan, whose accommodative monetary policy, which includes a zero-percent yield target for the 10-year bond, is expected to be maintained in coming years. The JGB 10-year bond yield stood at 0.25% as of April 2022. Refinancing risks are very low also due to a large domestic investor base (86% of total public debt), of which the central bank makes up a large and growing share (43% of the total) while foreign investors held 14% of outstanding public debt (5.2% of which are held by the official sector). A long maturity of debt of 9 years and 3 months also mitigates refinancing risks.

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

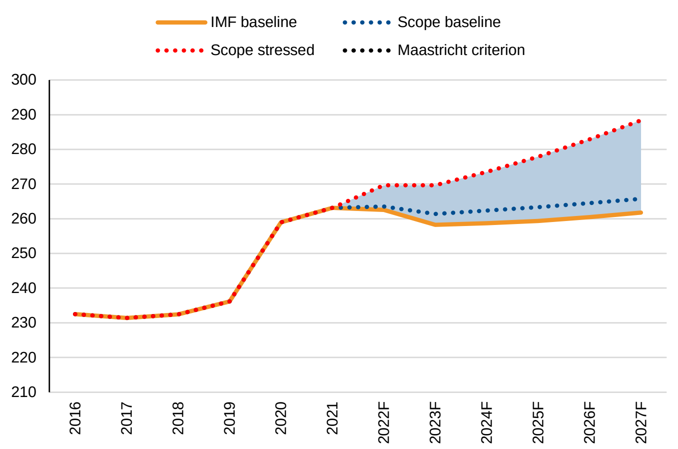
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b+	Fiscal policy framework	Weak	-1/3	Persistent fiscal deficits exacerbated by ageing population; lack of credible medium-term consolidation plan
	Debt sustainability	Weak	-1/3	Very high and rising debt levels pose sustainability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

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

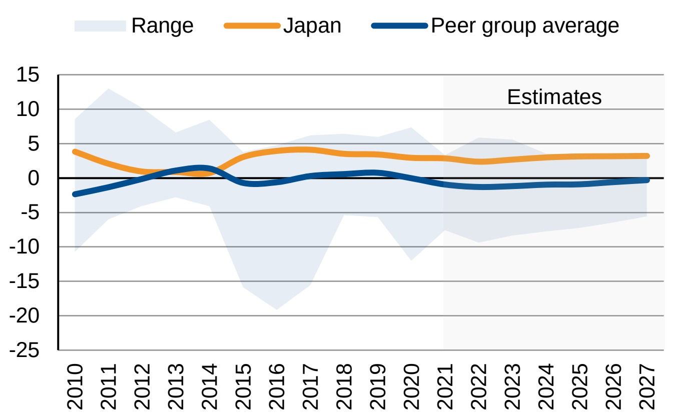
External Economic Risks

- **Current account:** Japan has a good record of consistent current account surpluses. 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). The current account balance remained robust throughout the pandemic, at 3.0% of GDP in 2020 and 2.9% of GDP in 2021 due to large primary income flows. It is expected to decrease to 2.4% of GDP in 2022 and then average at 3.2% of GDP over 2022-2026. Exports recovered strongly in 2021 at around 11.7% of GDP even though recent supply chain disruptions and surging raw material prices cause by high crude oil prices pose a threat to Japan's car exports, which is one of the most prominent industries of the economy.
- **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 77% of GDP as of December 2021, up from 66% in end-2020. Gross foreign debt at 98% of GDP as of end-2021 (93% end-2020), of which 37% from the public sector. Short-term external debt accounts for a large share, at 68% of the total as of Q4 2021.
- **Resilience to shocks:** External economic risks are limited due to a robust external position and by the Yen's reserve currency status. Resilience is further bolstered by the country's large foreign exchange reserves which totalled USD 1.2trn in March 2022, the second largest after China. The yen's reserve currency status could be eroded given the current moves in monetary policies around the world in contrast with the Bank of Japan accommodation, yen devaluation and low yields and the growing share of debt being financed by the central bank. However, we note that there are no material signs that confidence in the currency has dropped to date.

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

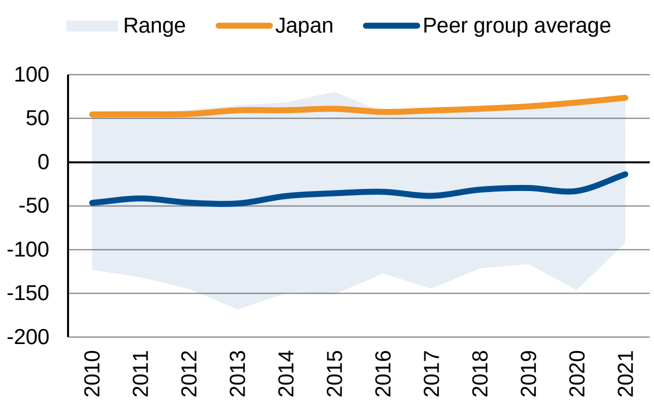
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Current account resilience	Strong	+1/3	Robust record of current account surpluses supported by diversified export base and large external creditor position
	External debt structure	Neutral	0	Moderate external debt levels;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

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF WEO, Scope Ratings GmbH

Financial Stability Risks

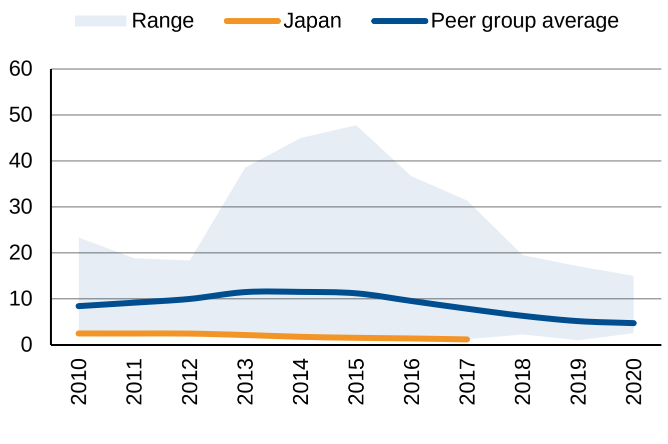
- **Banking sector:** The Japanese banking sector demonstrated its overall resilience during the Covid-19 pandemic. Profitability was hit in the beginning of 2020 and has since recovered though it remains below that of other major advanced economies. The banking system remains well-capitalised and liquid, and near-term vulnerabilities are contained. The Tier 1 ratio stayed above 14% throughout the pandemic, the NPL ratio was at 1.2% as of March 2021, lower than France (2.7%), and slightly above the US (1.0%). 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 relative to pre Covid-19 levels but is not excessive compared to other major advanced economies. The BIS estimates that total credit to non-financial corporate rose from 101% of GDP in 2019 to 115% of GDP in Q3 2021.Household debt-to-GDP increased from 63% to 67% over the same period. Risks associated with private debt are mitigated by households' large financial assets and large precautionary cash holdings of firms.
- **Financial imbalances:** Sustained accommodative policies by the Bank of Japan could lead to a build-up of financial system risks. The central bank's large-scale asset programmes that cover government and corporate bonds, exchange traded funds and real estate investment trust equities have resulted in a dominant position in important asset markets.

  According to the results of the last Bank of Japan macro stress testing of April 2022 Japan's financial system is likely to remain highly robust even in the case of a resurgence of COVID-19 and a simultaneous rise in U.S. long-term interest rates leading to an adjustment in the real economy and global financial markets. However, in the event of a substantial and rapid adjustment in global financial markets, a deterioration in financial institutions' financial soundness and the resultant impairment of the smooth functioning of financial intermediation could pose a risk of further downward pressure on the real economy.

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

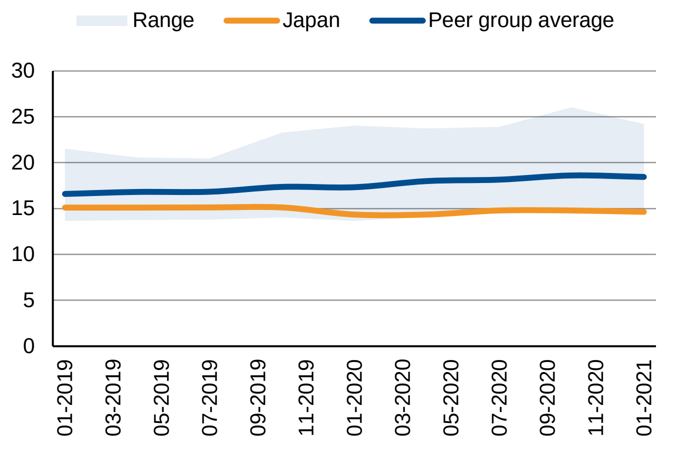
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Banking sector performance	Weak	-1/3	Profitability pressures lead to increased risk-taking without commensurate returns
	Banking sector oversight	Neutral	0	Strong oversight frameworks under the Bank of Japan and Financial Services Agency
	Financial imbalances	Weak	-1/3	Prolonged ultra-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

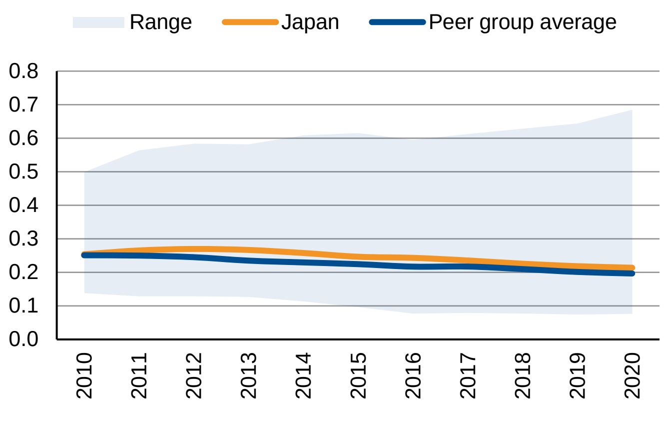
ESG Risks

- **Environment:** Japan is frequently exposed to natural disasters like tsunamis, floods, typhoons, earthquakes, and cyclones due to its location in the Pacific earthquake belt and the circum-Pacific zone. The climate is characterised by extreme temperature variations throughout the year and is influenced by the monsoon circulation. Japan is likely to become increasingly exposed to such risks due to climate change which could result in these events becoming more frequent and severe. Japan is a net importer of fossil fuels including coal (28% of the energy mix) and oil (37%). The government aims to achieve carbon neutrality by 2050 by raising the share of renewable energies in the 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. The needed reforms to reduce the fiscal pressures of age-related costs could pose social risks as Japanese citizens could face less generous social benefits or be required to work more to sustain them. This could exacerbate rising challenges that the elderly face, including rising poverty and social isolation. Still, the country benefits from high levels of social cohesion as well as high quality health and education systems.
- **Governance:** Fumio Kishida became Prime Minister in October 2021 and 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. It is a mature democracy with a stable government and robust checks and balances.

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

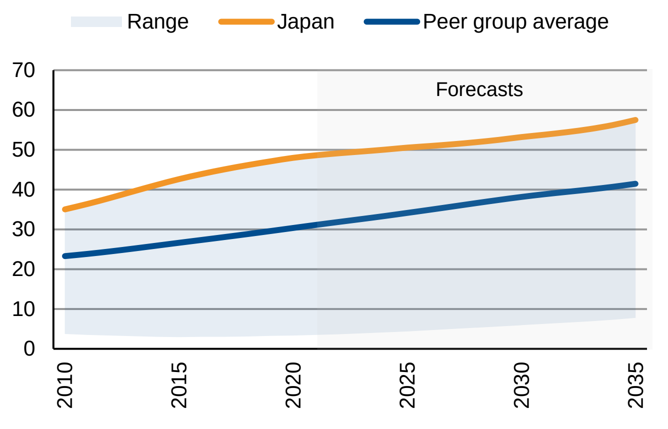
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Environmental risks	Weak	-1/3	High exposure to natural disaster, transition, and resource risks; insufficient policy response in the past though mitigation efforts are accelerating
	Social risks	Neutral	0	Low inequality, strong social systems; adverse demographics likely to put pressure on social care systems; social conditions for the elderly are deteriorating
	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



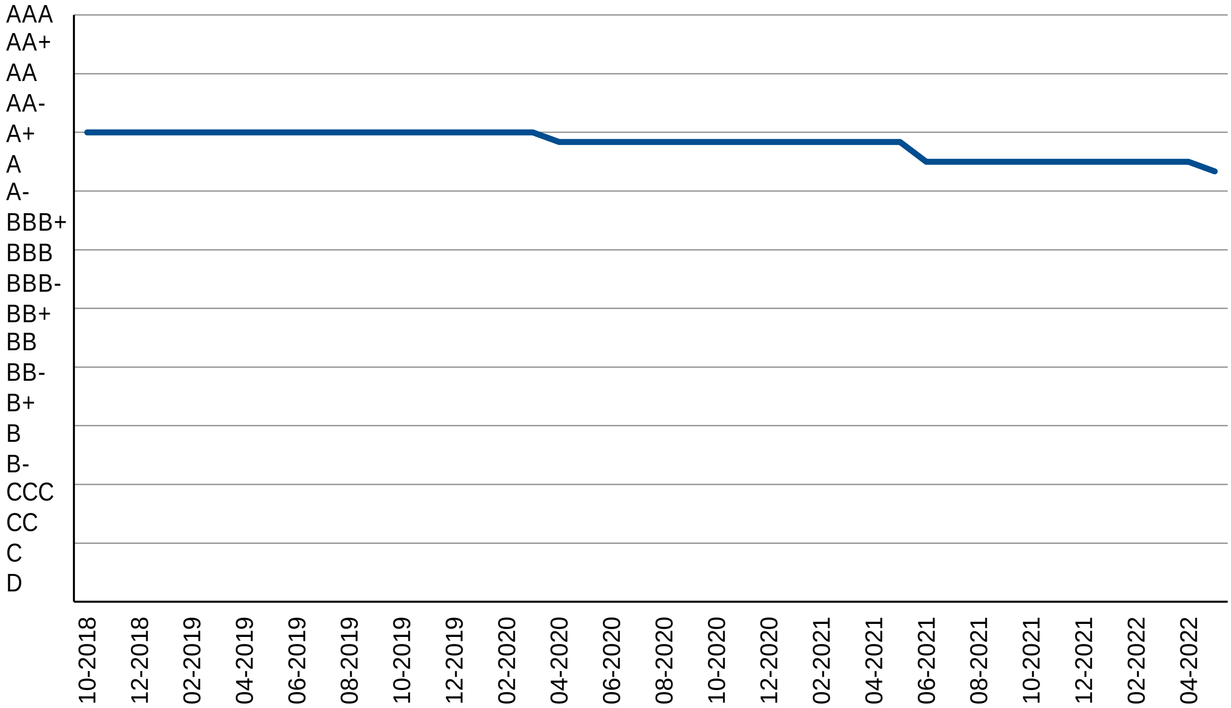
Source: European Commission, Scope Ratings GmbH

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
Cyprus
France
Italy
Latvia
Lithuania
Malta
Poland
Portugal
Slovakia
Slovenia
Spain

*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	2021	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD 000s'	39.4	38.9	39.8	40.6	40.0	39.3	39.2	42.5
Nominal GDP, USD bn	5003.7	4930.8	5037.8	5123.3	5040.1	4937.4	4912.1	5291.4
Real growth, %[1]	0.8	1.7	0.6	-0.2	-4.5	1.6	2.0	1.7
CPI inflation, %	-0.1	0.5	1.0	0.5	0.0	-0.3	1.0	0.8
Unemployment rate, %[1]	3.1	2.8	2.4	2.4	2.8	2.8	2.6	2.5
Public Finance Risk								
Public debt, % of GDP[1]	232.5	231.4	232.5	236.1	259.0	263.1	263.5	261.4
Interest payment, % of government revenue	3.2	2.8	2.3	2.0	1.8	1.6	1.2	0.5
Primary balance, % of GDP[1]	-2.5	-2.2	-1.7	-2.4	-8.3	-7.0	-7.4	-3.9
External Economic Risk								
Current account balance, % of GDP	4.0	4.1	3.5	3.4	3.0	2.9	2.4	2.7
Total reserves, months of imports	17.0	16.3	14.7	15.4	18.6	-	-	-
NIIP, % of GDP	57.5	59.2	61.1	63.8	68.3	73.7	-	-
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	161.5	166.9	166.9	173.5	192.1	-	-	-
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	49.6
Composite governance indicator[2]	1.4	1.4	1.3	1.3	1.3	-	-	-

[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 3 May 2022	18.5

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer