28 October 2022

Sovereign and Public Sector

Japan
Rating Report

SCOPE A NEGATIVE OUTLOOK

Credit strengths

- Wealthy, competitive and diversified economy
- Good funding flexibility and market access
- Robust external position

Credit challenges

- Very high and rising public debt
- Weak demographics exacerbating fiscal and economic challenges
- Sustained ultra-loose monetary policy posing sustainability challenges

Rating rationale:

Wealthy, competitive and diversified economy: Japan benefits from a wealthy, diversified and competitive economy, supported by economic sophistication and the presence of innovative firms. All the above factors constitute critical drivers of Japan's resilience to shocks.

Strong funding flexibility and market access: Japan benefits from very strong funding flexibility and excellent market access due to the yen's safe-haven status. Continued support from the Bank of Japan's (BoJ) 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 consistent current account surpluses, high domestic savings and a sophisticated domestic banking system. Combined with low external debt and a reserve currency status, this significantly lowers vulnerability to external shocks.

Rating challenges: Japan faces significant structural challenges posed by a rapidly shrinking and ageing population, which i) exacerbates Japan's fiscal vulnerability 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 BoJ's highly accommodative monetary policy stance, which is critical for mitigating debt sustainability risks, faces sustainability challenges.

Japan's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	aa+	JPY [+1]	-2/3	A
Public Finance Risk		20%	b-		-1/3	
External Economic Risk		10%	aaa		+2/3	
Financial Stability Risk		10%	a-		-2/3	
ESG Risk	Environmental Factors	5%	ccc		-1/3	
	Social Factors	7.5%	b-		0	
	Governance Factors	12.5%	aaa		0	
Indicative outcome			**a+**		**-1**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment 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 Rating Methodology. Source: Scope Ratings.

Outlook and rating triggers

The Negative Outlook reflects our 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 budgetary targets
- Growth outlook deteriorates substantially
- Tangible weakening of the yen's reserve currency status

Ratings and Outlook

Foreign currency

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

Local currency

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

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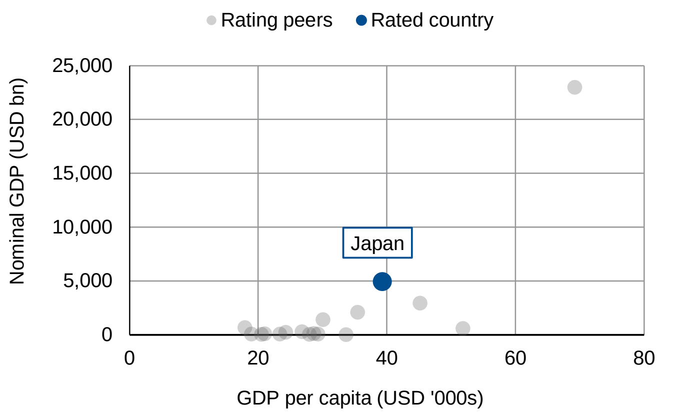
Domestic Economic Risks

- **Growth outlook:** Following a 4.6% contraction in 2020, Japan's economy grew by 1.7% in 2021, a much flatter recovery than in most major advanced economies. The recent unwinding of all Covid-19 measures, the resumption of tourism flows, expected private investment growth and the release of household savings should support growth. However, the growth outlook faces downward pressure from weakening global demand and the rise in commodity prices linked to the Russia-Ukraine war. Consumer confidence is deteriorating, and real income suffers from inflation though business investment sentiment is positive. We expect real GDP growth of 1.7% in 2022 and 1.4% in 2023, followed by a gradual convergence to the country's medium-term low growth potential, which we estimate at 0.4%.
- **Inflation and monetary policy:** After exiting negative territory in 2021, consumer price inflation slowly reached 3% in August 2022, reflecting a deterioration of the terms of trade from higher import prices. The price increase is mainly driven by energy and water (15.6% YoY as at August 2022) and food (4.7%) prices, accounting together for 77% of the total price rise. Inflation should fall back under the BoJ's 2% target in 2023. The BoJ is maintaining its ultra-loose policy stance of keeping long-term yields at around 0% via yield curve control, unlimited government bond purchases and a policy rate at -0.1%. Recent pressures on long-term yields have led to record monthly BoJ bond purchases of over JPY 16trn in June 2022, versus the previous high of JPY 11trn in April 2016.
- **Labour markets:** Unemployment peaked at 3.1% in October 2020 and has since trended down to 2.5% in August 2022. We expect the unemployment rate to go down to 2.4% by 2023 and stabilise thereafter. The employment situation is picking up, but real income growth has remained negative due to rising prices. The government has committed to raise wages, facilitate labour mobility, and enhance human capital. Japan's economy is facing intense labour shortages from a rapidly aging and shrinking population. According to the UN, the working age population (aged 15-64 years old) decreased by 15% over 1990-2020 and is expected to decline further by 27% by 2050, exacerbating these challenges.

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

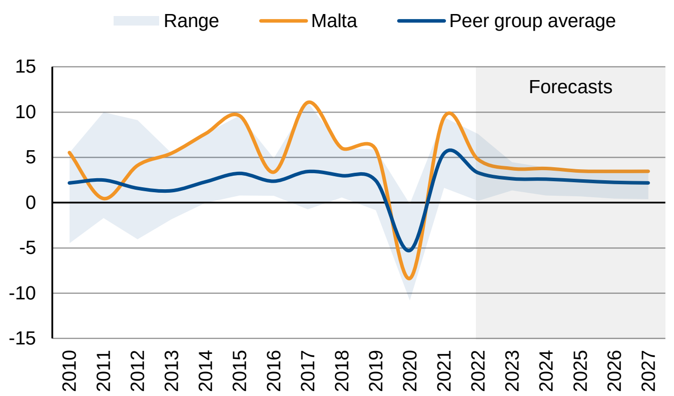
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Growth potential of the economy	Weak	-1/3	Low and declining growth potential
	Monetary policy framework	Neutral	0	BoJ is a sophisticated central bank; persistent accommodative policies have failed to reflate the economy;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

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

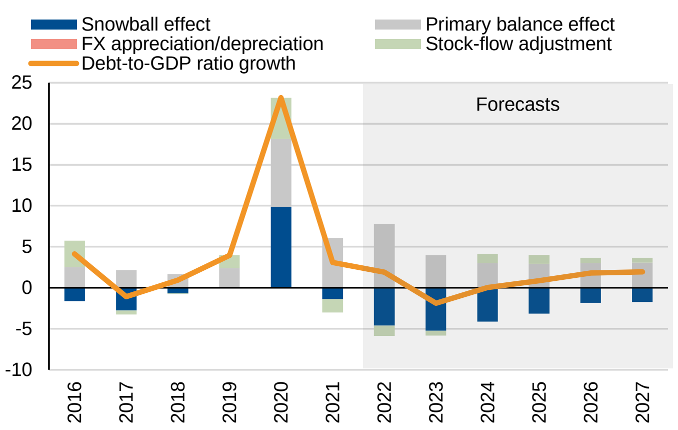
Public Finance Risks

- **Fiscal outlook:** Japan's budgetary position deteriorated considerably during the Covid-19 pandemic and has been recovering unevenly compared to other advanced economies. Its budget deficit stood at 6.7% of GDP in 2021, down from 9% of GDP in 2020. The government is implementing stimulus packages to recover from the Covid-19 crisis, including the latest one announced in December 2021 (JPY 79trn, 14.5% of GDP) and a package to counter soaring commodity prices (JPY 2.7trn, 0.5% of GDP). The government will unveil a second supplementary budget in November 2022 to further tackle rising prices and support the recovery. We expect the budget deficit to remain high at above 8% of GDP in 2022 and around 4% of GDP in 2023. Population ageing prevents meaningful budget consolidation in the long term with deficits expected at around 3% of GDP on average until 2027. We expect the primary surplus target to eventually be pushed back further as a result.
- **Debt trajectory:** The debt-to-GDP ratio reached 263% in 2021, up from 259% in 2020. We expect debt to decline moderately in 2023 before returning to an upward trajectory and reaching 267% by 2027. However, debt could rise faster given the uncertain economic environment and Japan's flagging growth prospects, which are likely to prompt further fiscal stimulus. In addition, a more stressed scenario in which Japan's financing costs converge with those of other major advanced economies would put Japan's debt and gross financing needs on an explosive path, an important tail risk.
- **Debt profile and market access:** Japan has a favourable debt profile. The average maturity of debt stands at nine years and three months and only 16.3% of it is short term. Market access is supported by the yen's reserve currency status. Japan benefits immensely from the support of the BoJ, whose highly accommodative stance includes unlimited purchase of Japanese government bonds to maintain the 10-year yield at around 0%. The 10-year government bond yield is at the BoJ's upper policy limit of 0.25% while yields on long-term maturities are at their highest in years (40-year yield at 1.9% as of 24 October 2022). The BoJ held 44.3% of Japanese government bonds and treasury bills as of end-June 2022.

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

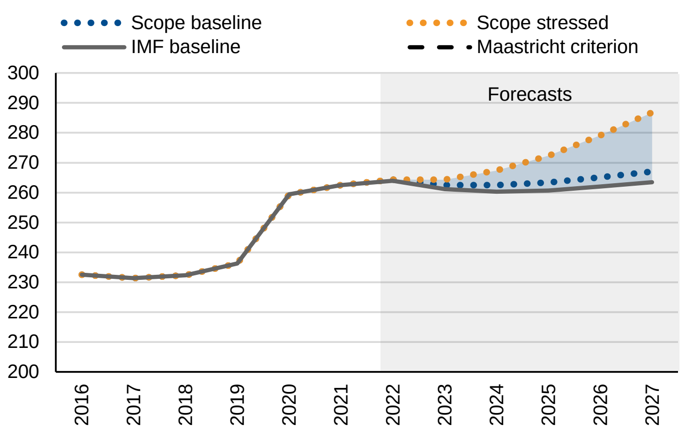
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Fiscal policy framework	Weak	-1/3	Persistent fiscal deficits exacerbated by ageing population; lack of credible medium-term consolidation plan
	Debt sustainability	Weak	-1/3	Very high and rising debt poses sustainability 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, pp of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

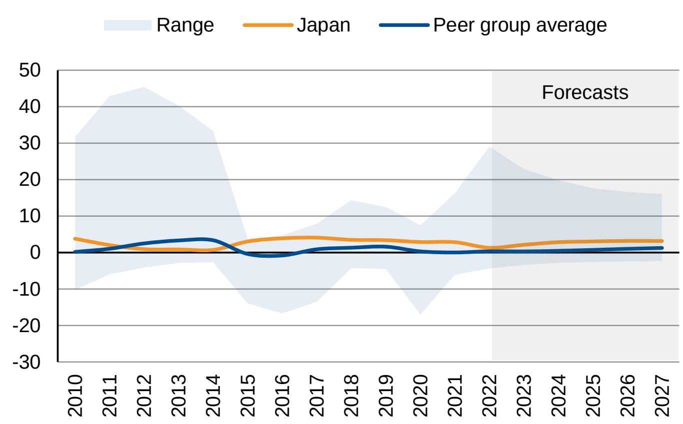
External Economic Risks

- **Current account:** Japan has a record of consistent current account surpluses. Its current account has increasingly become insulated from changes in the trade balance as primary income now accounts for most of positive net balances given Japan's large creditor position. In June 2022, the year-to-date current account balance stood at 1.7% of GDP. However, the steep rise in import prices coupled with a large yen depreciation led Japan's current account balance to go negative in July and August 2022 for the first time since 2014, at JPY -629bn and JPY -530bn respectively. This reflects a marked deterioration in the goods and services trade balance, which has only been partly offset by rising primary income.
- **External position:** Japan's external position benefits from its large net creditor position. The net international investment position reached a record high at 82% of GDP as of June 2022, up from 76% in 2021 due to the appreciation of foreign assets in yen terms. Gross foreign debt stood at 109% of GDP as of Q2 2022 (94% in Q2 2021), of which 37% relates to the public sector. Short-term external debt accounted for a large share, at 71% of the total while equity and direct investment accounted for one-third of external debt. The IMF considers that Japan's external position is broadly in line with medium-term fundamentals and desirable policies.
- **Resilience to shocks:** External economic risks are limited due to a robust external position and the yen's reserve currency status. The country's large foreign exchange reserves further support resilience. The yen has depreciated by almost 30% against the dollar since January 2022. The BoJ responded with a USD 20bn foreign exchange intervention in September 2022, the first since 2011, though the yen has since kept declining. This, coupled with the global devaluation of Japanese-owned foreign bonds, have led Japan's foreign reserves to drop by a record USD 54bn in September 2022 to USD 1.24tn, the lowest since 2017. In the long term, the yen's reserve currency status could erode given the contrast between the BoJ's policy stance and that of other major central banks, yen volatility, low yields and the growing share of debt absorbed by the central bank.

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

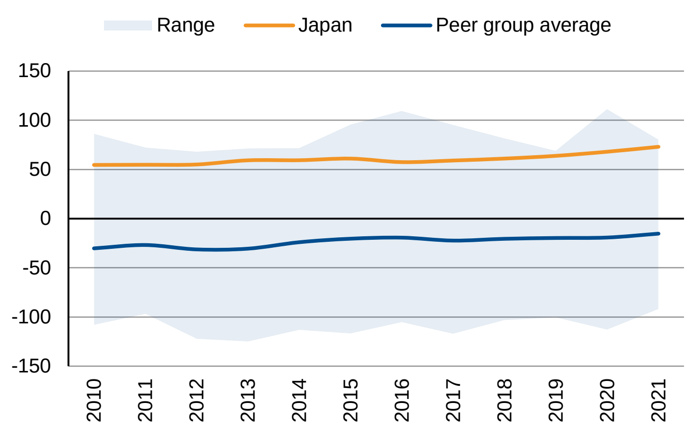
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Current account resilience	Strong	+1/3	Record of current account surpluses supported by diversified export base and large external creditor position
	External debt structure	Neutral	0	Moderate external debt; large share of short-term liabilities
	Resilience to short-term external 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

Net international investment position, % of GDP



Source: IMF, Scope Ratings

Financial Stability Risks

- **Banking sector:** The profitability of Japanese banks improved in 2021 thanks to substantial income from securities and fees and commissions in international operations. Financial soundness indicators are robust with low non-performing loans (1.2% of total loans in March 2021), sound capitalisation (tier 1 ratio of 15%). Stress testing by the BoJ showed that Japan's financial system is likely to remain highly robust even in the event of a resurgence of Covid-19 and a simultaneous rise in US long-term interest rates. A rapid and substantial adjustment in global financial markets could erode banks' financial soundness and put downward pressure on the real economy, however. Long-term pressures due to persistently low interest rates and demographic decline are likely to further erode profitability, incentivise risk-taking behaviour and lead to a build-up of financial risks, as highlighted by the IMF.

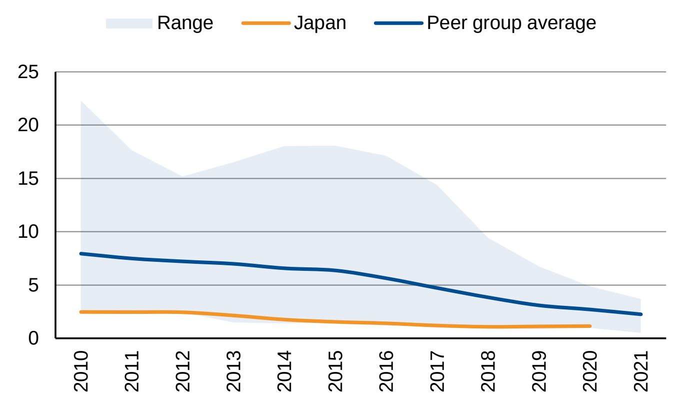
- **Private debt:** Leverage in the private sector has continued to increase but is not excessive compared to other major advanced economies. The Bank of International Settlements estimates that total credit to non-financial corporates reached 117% of GDP in Q1 2022, from 102% of GDP at end-2019. Household debt-to-GDP increased to 69% from 63% over the same period. Risks associated with private debt are mitigated by households' large financial assets and firms' large precautionary cash holdings. While many large firms have ample liquidity and sound financial positions, small- and medium-sized enterprises in face-to-face services continue to struggle to repay debt.

- **Financial imbalances:** Sustained accommodative policies by the BoJ 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 placed Japan in a dominant position in important asset markets. A prolonged highly accommodative monetary policy stance raises risks of distortions to markets and inflated asset prices.

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

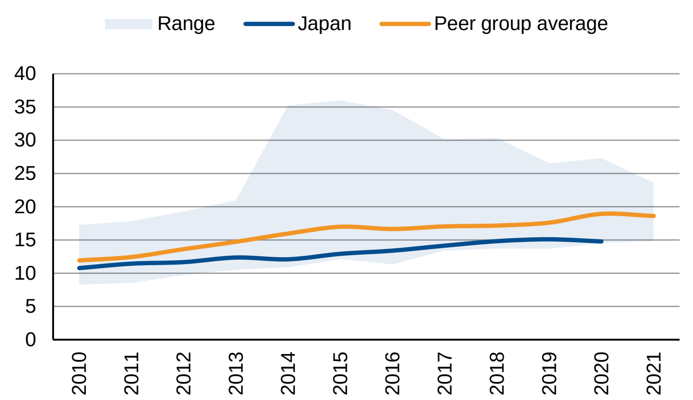
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Banking sector performance	Weak	-1/3	Profitability pressures lead to increased risk-taking without commensurate returns
	Banking sector oversight	Neutral	0	Strong oversight frameworks under the BoJ and Financial Services Agency
	Financial imbalances	Weak	-1/3	Prolonged ultra-accommodative monetary policies pose long-term financial stability risks

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

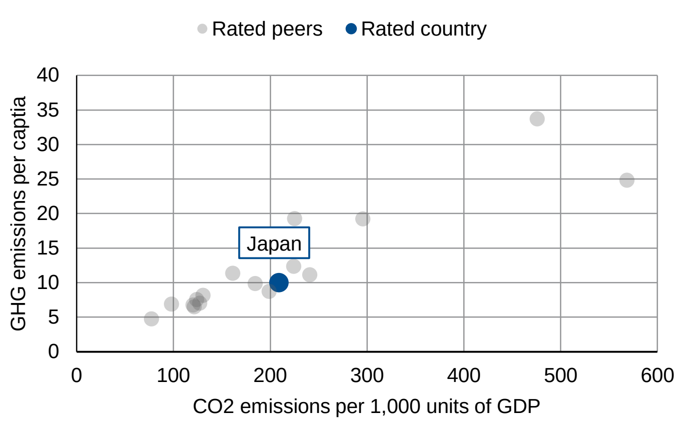
ESG Risks

- **Environment:** Due to its climate and geological conditions, Japan is particularly exposed to natural risks including typhoons, seasonal rains, earthquakes and volcanic eruptions. High population density and industrial facilities in limited flatlands can lead to escalating costs from natural hazards, though the country has developed resilient infrastructure to mitigate these risks. Japan's economy is very carbon intensive relative to other major advanced economies: its energy mix is import-dependent and fossil fuel-based (82% of the energy supply in 2020). Climate ambitions are accelerating with a new greenhouse gas emissions reduction target of 46% by 2030 compared to 2013 levels and a New Basic Energy Plan aimed at achieving a share of renewable energy of 36-38% by 2030. More progress is needed as current policies and actions are deemed insufficient to limit global warming to 2°C according to the Climate Action Tracker.
- **Social:** A rapidly ageing population, as captured by the highest old age dependency ratio in Scope's sovereign rating universe, indicates that the pressure on the pension and healthcare system will keep growing. The reforms needed 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 challenges that the elderly already face, including rising poverty and social isolation. Still, the country benefits from social cohesion as well as high-quality health and education systems.
- **Governance:** Fumio Kishida became Prime Minister in October 2021 and his Liberal Democratic Party secured a strong majority in the March 2022 general election. We expect broad policy continuity in the country. However, growing vulnerabilities within the Liberal Democratic Party and waning public support for the government may lead to renewed political uncertainty and hamper reform progress on important policy issues. Still, Japan's democratic institutions and governance are strong.

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

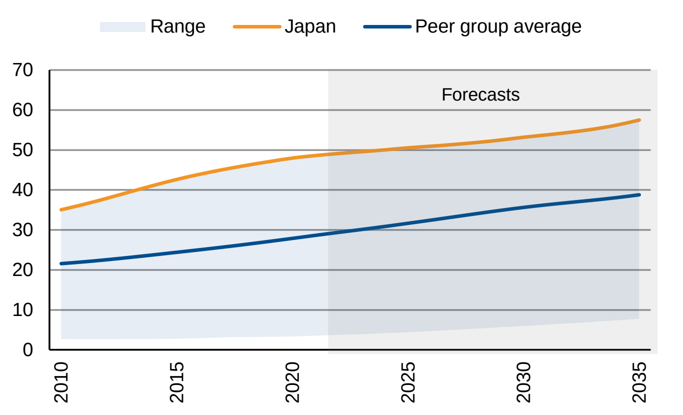
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental risks	Weak	-1/3	High exposure to natural disaster, transition, and resource risks; insufficient policy response in the past although mitigation efforts are accelerating
	Social risks	Neutral	0	Low inequality,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

Emissions per GDP and per capita, $mtCO_2e$



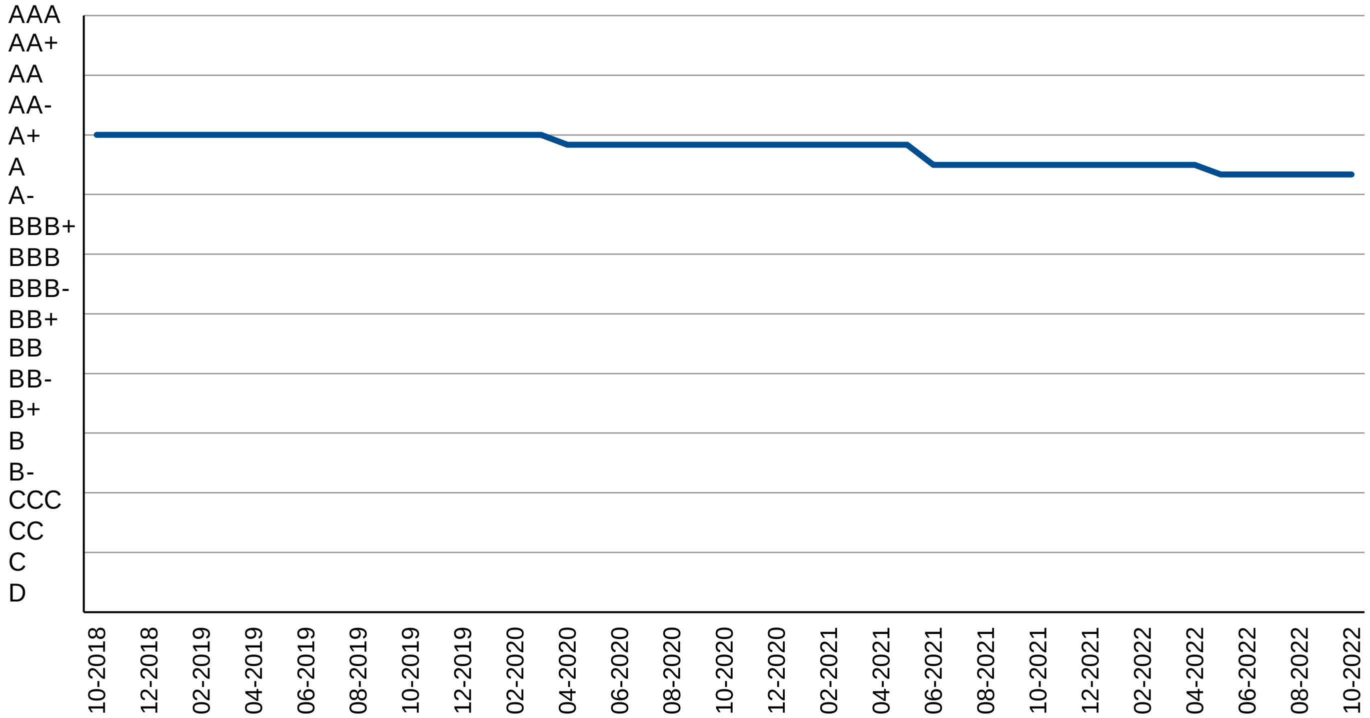
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories as per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Belgium
Czech Republic
Estonia
France
Italy
Latvia
Lithuania
Malta
Poland
Portugal
Slovakia
Slovenia
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 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	GDP per capita, USD '000s	IMF	38,903	39,850	40,566	39,981	39,301
	Nominal GDP, USD bn	IMF	4,930.8	5,040.9	5,120.3	5,031.6	4,932.6
	Real growth, %	IMF	1.7	0.6	-0.4	-4.6	1.7
	CPI inflation, %	IMF	0.5	1.0	0.5	0.0	-0.2
	Unemployment rate, %	WB	2.8	2.4	2.4	2.8	2.8
Public Finance	Public debt, % of GDP	IMF	231.4	232.3	236.3	259.4	262.5
	Interest payment, % of revenue	IMF	2.8	2.3	2.0	1.8	1.6
	Primary balance, % of GDP	IMF	-2.2	-1.7	-2.4	-8.3	-6.1
External Economic	Current account balance, % of GDP	IMF	4.1	3.5	3.4	2.9	2.9
	Total reserves, months of imports	IMF	16.3	14.7	15.4	18.5	16.2
	Net international investment position, % of GDP	IMF	59.2	61.1	63.9	68.0	73.0
Financial Stability	NPL ratio, % of total loans	IMF	1.2	1.1	1.1	1.1	-
	Tier 1 ratio, % of RWA	IMF	13.5	14.9	15.1	14.4	14.6
	Credit to private sector, % of GDP	WB	166.9	166.9	174.3	192.8	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	231.4	222.7	216.3	209.2	211.7
	Income share of bottom 50%, %	WID	16.8	16.8	16.8	16.8	16.8
	Labour-force participation rate, %	WB	77.8	79.1	79.8	-	-
	Old-age dependency ratio, %	UN	45.1	46.2	47.1	48.0	48.6
	Composite governance indicators*	WB	1.4	1.3	1.3	1.3	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bp) as of 21 October 2022	29.7

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