# Japan: Outlook change to A+/Negative

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**Update on Japan, April 2020, Frankfurt**

## Table of contents

# Japan: Outlook change to A+/Negative

## Executive summary

### ➢ Japan: A+/Negative captures rising fiscal and growth challenges

- Credit rating on a gradual downward path, particularly since the financial crisis
- Japanese workforce to significantly decline over next 30 years, challenging public finance and growth outlooks

### ➢ The Covid-19 pandemic will weaken the already struggling public finances

- Public finances gradually but constantly deteriorated over past 30 years; BoJ heavily buying JGBs since 2012
- Comprehensive and supportive countermeasures against Covid-19 crisis have been implemented
- While needed, they are likely to permanently and materially impact Japan's fiscal consolidation efforts

### ➢ Low-inflation, slow-growth economy challenges debt reduction over medium-term

- Sluggish GDP growth has characterized the last three decades
- Under Abe administration, Japan has a achieved small, but sustained economic expansion
- However, Abenomics undershoots inflation targets while BoJ's balances dramatically inflated

### ➢ Inherent credit strengths support Japan's sovereign rating

- Japan benefits from a wealthy and diversified economy
- Large domestic investor base, the role of the yen as reserve currency and large external position

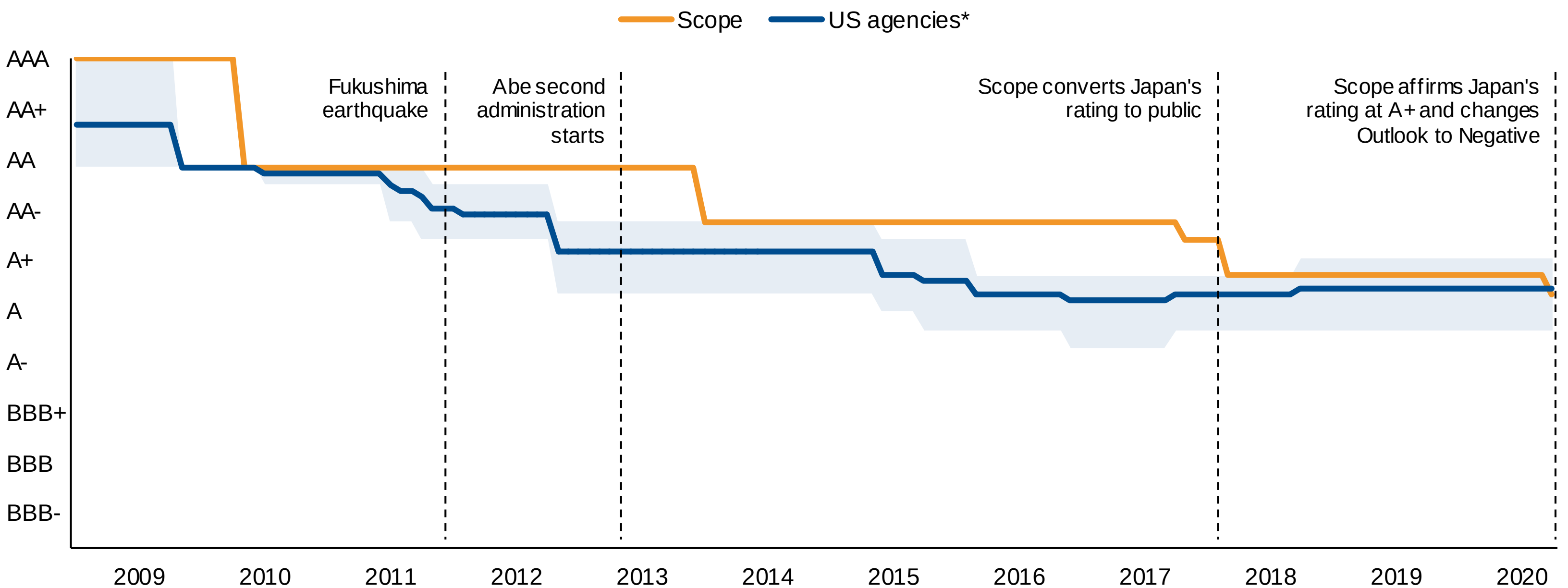
# Japan: Outlook change to A+/Negative

Context: Rating history, demographic headwinds and Covid-19 shock

## ➢ Balancing fundamental developments with rating stability

- On 24 April Scope revised Japan's Outlook on it's A+ rating to Negative from Stable

### Scope's rating history on Japan vis-a`-vis US competitors




N.BS: US agencies represents the average rating of S&P, Moody´s and Fitch.
Source: Reuters, Scope Ratings GmbH

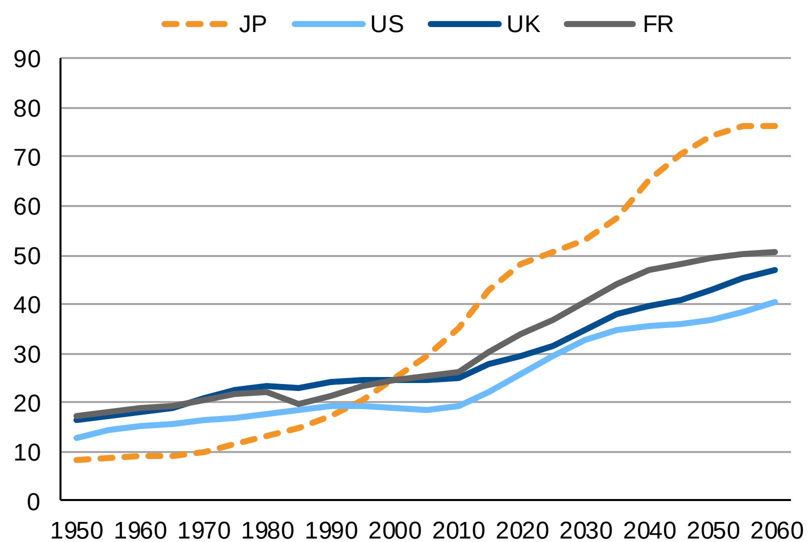
## ➢ Japan's creditworthiness on gradual decline since the financial crisis

# Japan: Outlook change to A+/Negative

Context: Rating history, demographic headwinds and Covid-19 shock

## Old-age dependency ratio

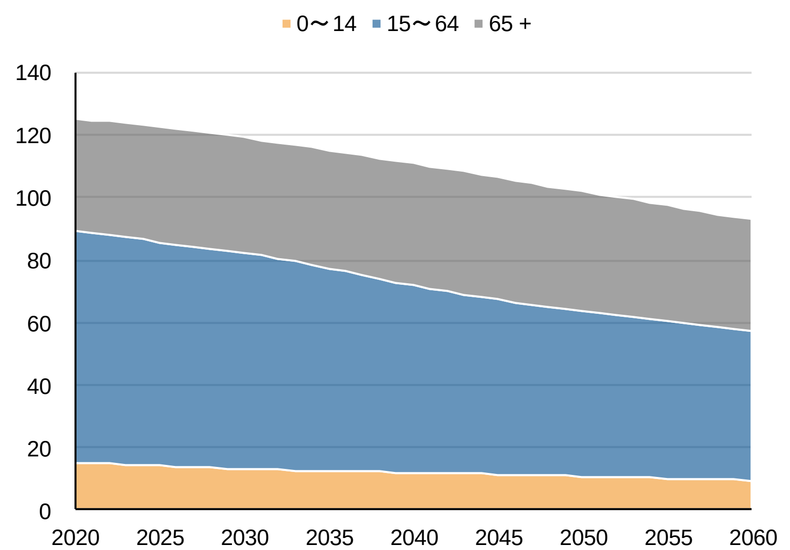
%




Source: UN, Scope Ratings GmbH

## Total population

Millions




Source: National sources, Scope Ratings GmbH

### ➢ Japanese workforce expected to significantly decline in the next forty years

- Japan has the oldest population in the world with a median age of 48 years and 29% of citizens aged 65+
- By 2060, the working age population will shrink by one third and the old-age dependency ratio will reach 76%
- Participation rates of women, the elderly as well as foreign workers are rising but more progress is needed

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Overview

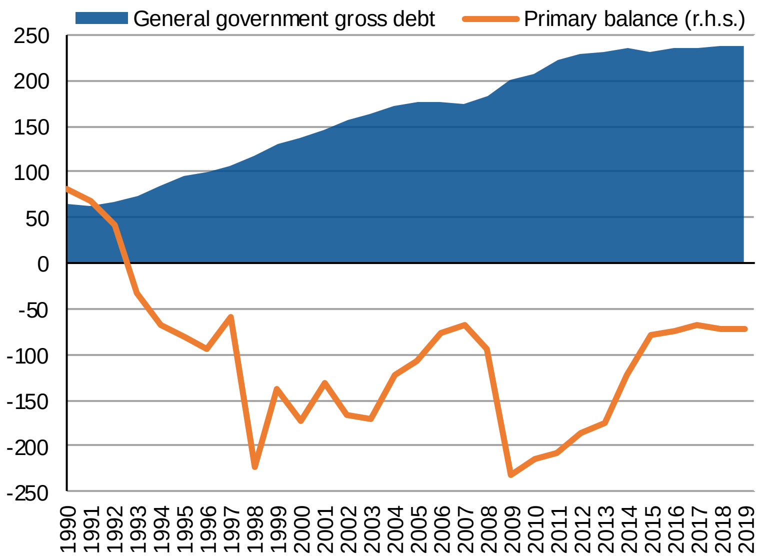
## Table of contents

# Japan: Outlook change to A+/Negative

Deteriorating fiscal outlook

## Primary balance and public debt

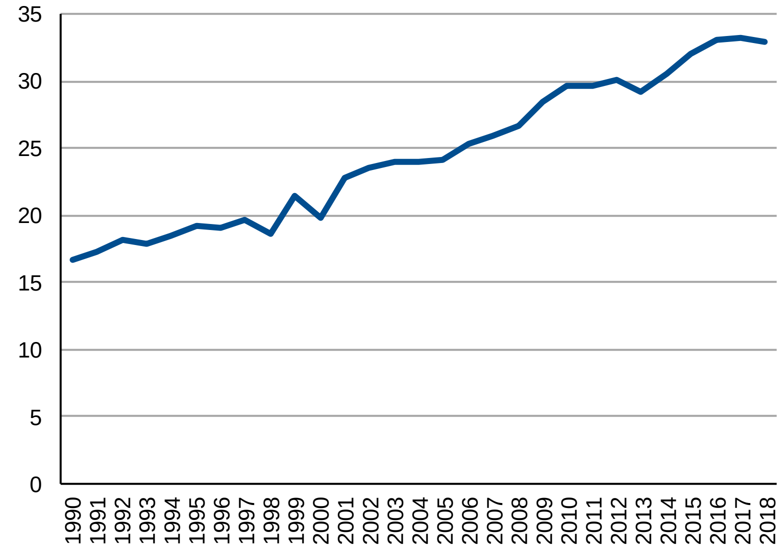
% of GDP




Source: IMF, Scope Ratings GmbH

## Social security expenditure

% of the total




Source: Ministry of Finance, Scope Ratings GmbH

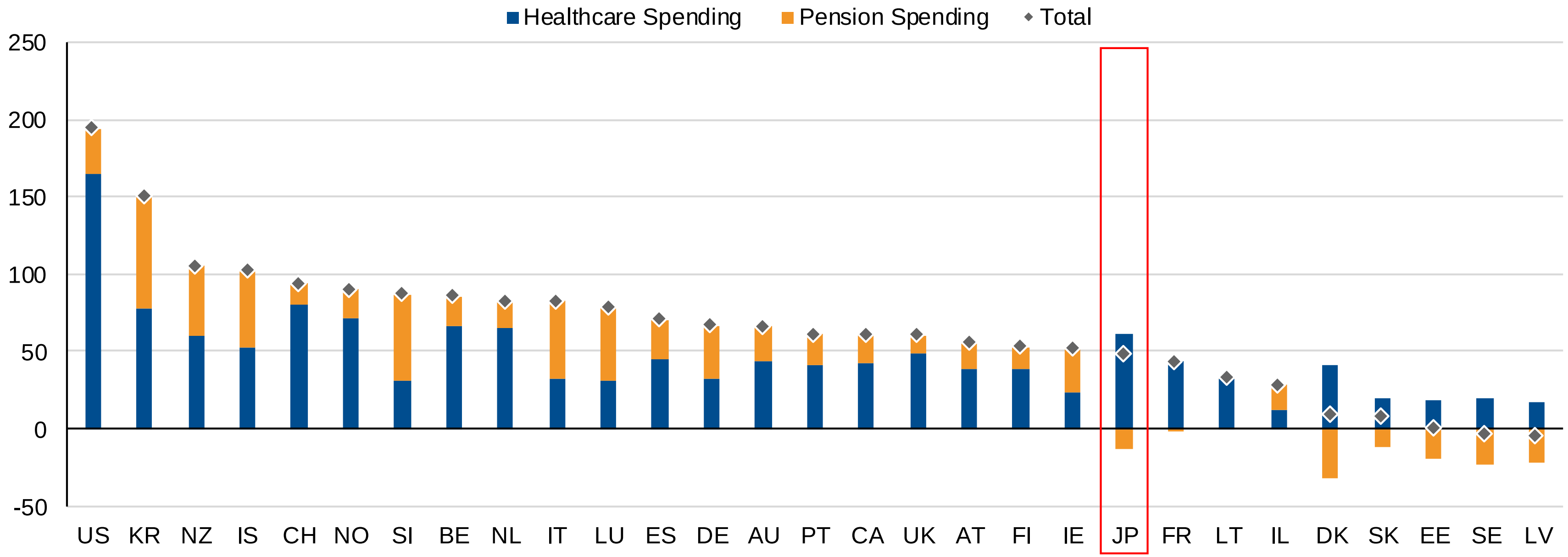
➢ **Public finances experienced a gradual but constant deterioration over the last 30 years**

- Government debt has increased from 64% in 1990 to 237% in 2019 due to sustained primary deficits
- The share of social security expenditure in total public spending has been increasing due to Japan's ageing society
- Budgetary pressures and fragile economic growth have constrained the government's ability to consolidate

# Japan: Outlook change to A+/Negative

Deteriorating fiscal outlook

**Net present value of ageing-related spending, 2019-50**
% of GDP




N.B. Pension projections rely on authorities' estimates when these are available; For NPV calculations, a discount rate of GDP growth + 1% is used for each economy.
Source: IMF, Scope Ratings GmbH

## ➢ Rising healthcare costs will weigh on public finances

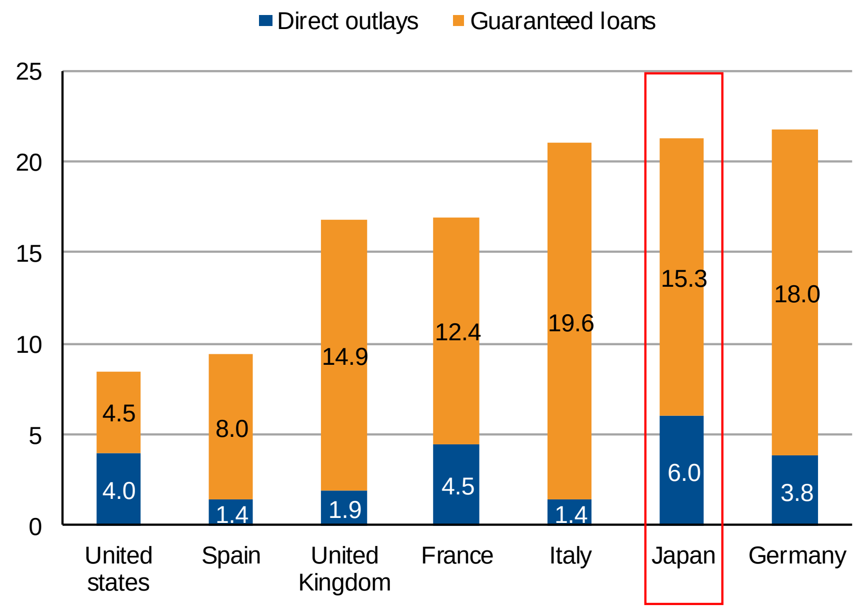
- Japan is among the advanced economies that face the largest rise in healthcare expenditure
- Rising structural expenditure pressures coupled with a shrinking tax base will gradually erode fiscal fundamentals

# Japan: Outlook change to A+/Negative

Deteriorating fiscal outlook

## Fiscal package comparison

% of GDP




Source: IMF, Scope Ratings GmbH

## ➢ Package composition:

| Direct outlays (6% of GDP): |
|---|
| Direct spending in healthcare, cash transfers, subsidies, tax exemptions |
| **Guaranteed loans (15.3% of GDP):** |
| Public guarantees on loans of firms belonging to the most affected sectors, government loans at 0% interest rate |

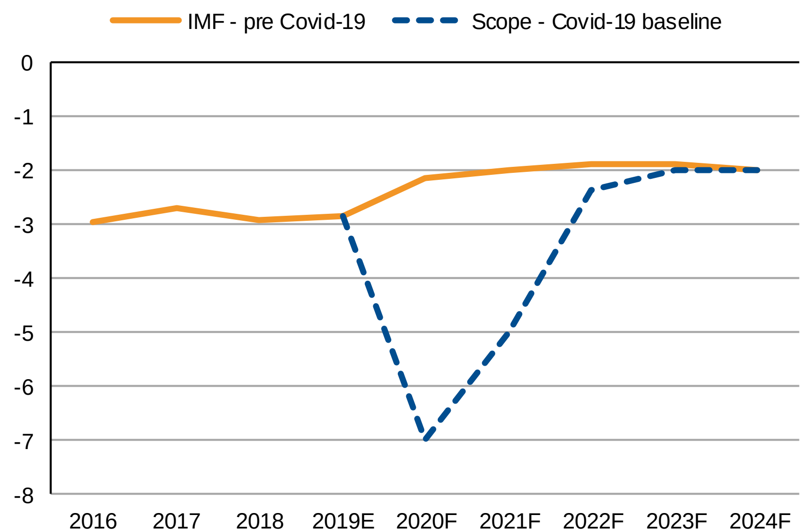
## ➢ The government has announced a massive fiscal support package

- Successive fiscal support packages have been announced since December 2019
- In total, JPY 118 trillion, of which JPY 33.9 trillion (6% of GDP) in direct outlays have been announced
- This will provide much-needed support to the economy although timing is key

# Japan: Outlook change to A+/Negative

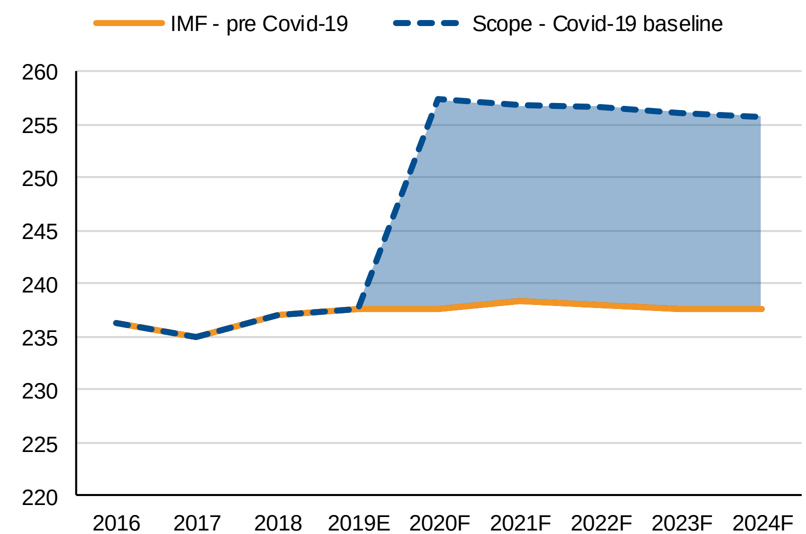
Deteriorating fiscal outlook

## Primary balance
% of GDP




Source: IMF, Scope Ratings GmbH

## General government debt
% of GDP




Source: IMF, Scope Ratings GmbH

➢ **…which however will adversely impact on consolidation attempts**

| Scenario | Time Period | Real GDP growth (%) | Primary bal. (% of GDP) | Real eff. int. rate (%) | Debt end period (% of GDP) |
|---|---|---|---|---|---|
| **History** | 2014-2019 | 1.0 | -3.2 | -0.6 | 237.7 |
| **IMF Baseline** | 2020-2024 | 0.5 | -2.0 | -0.4 | 237.6 |
| **Covid-19 baseline** | | -0.3 | -3.7 | -0.2 | 255.8 |

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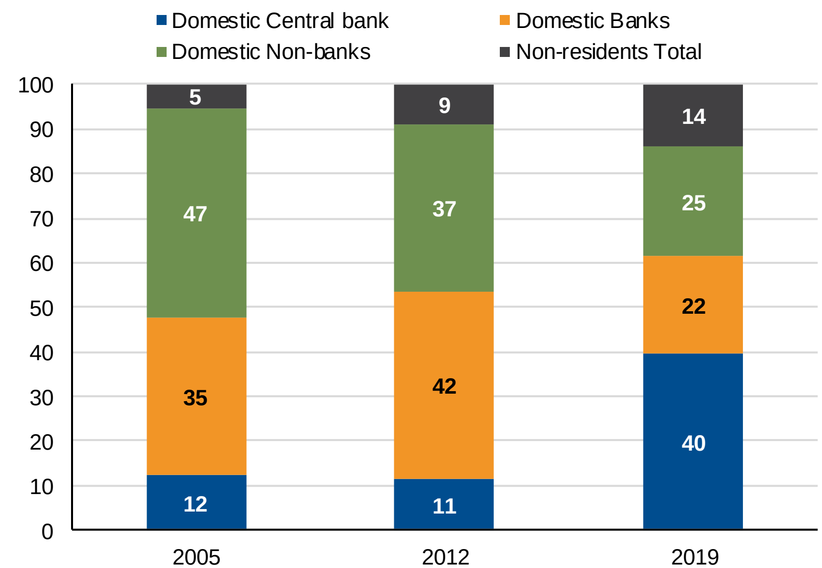
Deteriorating fiscal outlook

## Investor base

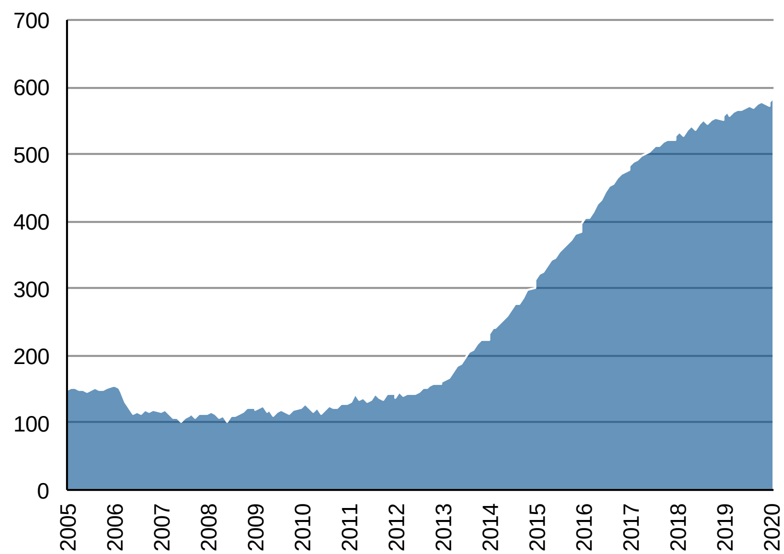
% of Japanese public debt




Source: IMF, Scope Ratings GmbH

## Bank of Japan's total assets

JPY trillions




Source: BoJ, Scope Ratings GmbH

### ➢ Large-scale purchases by BoJ displace traditional private sector investor base

- Since 2012, the Bank of Japan has increased its share of Japanese government debt holdings from 11% to 40%
- Aggressive BoJ policies have displaced the traditional investor base of domestic banks and non-banks
- Is the BoJ's balance sheet expansion, now at over JPY 600 trillion and above 100% of GDP, sustainable?

## Table of contents

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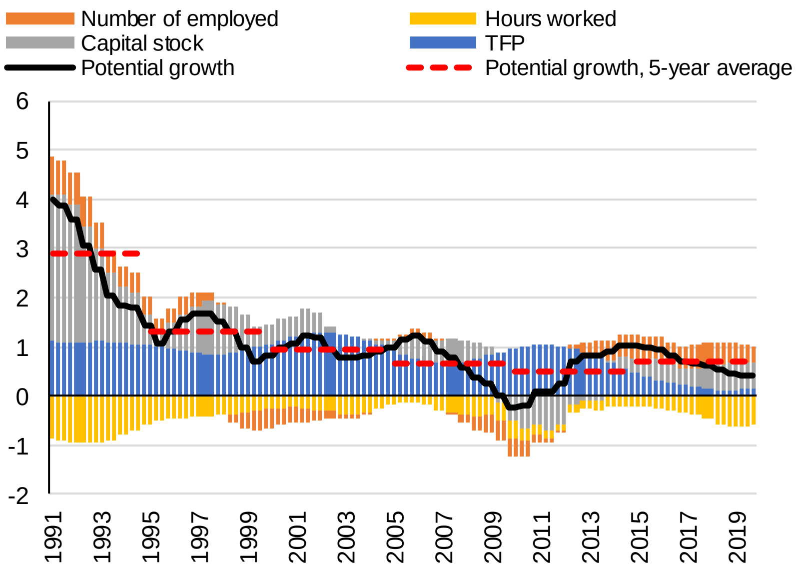
Low growth potential

## Potential GDP growth

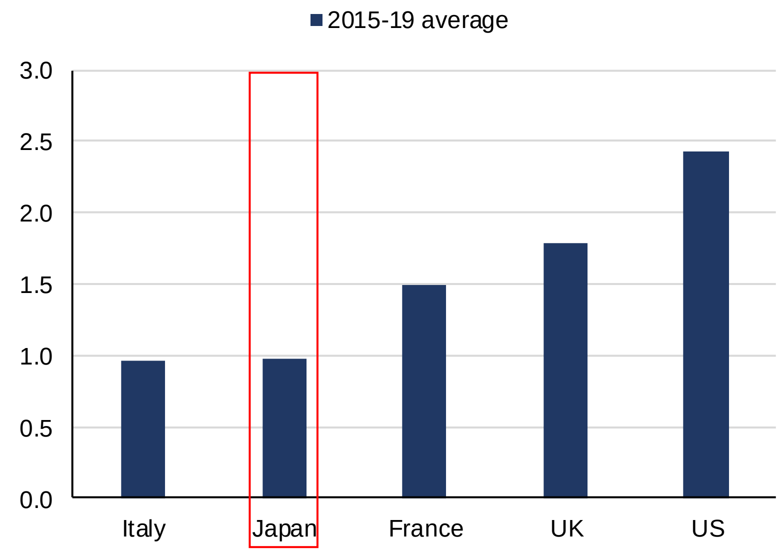
%




N.B. TFP: Total Factor Productivity
Source: Bank of Japan, Scope Ratings GmbH

## Real GDP growth

%




Source: IMF, Scope Ratings GmbH

## ➢ Japan has experienced sluggish GDP growth over the last three decades

- Since 1990, Japan has experienced a decline in potential growth due to declining productivity growth and hours worked
- Despite highly accommodative monetary and fiscal policies, Japan lags behind peers in terms of real growth
- Mounting demographic pressures will weigh on Japan’s already low growth potential (estimated at 0.3-0.4%)

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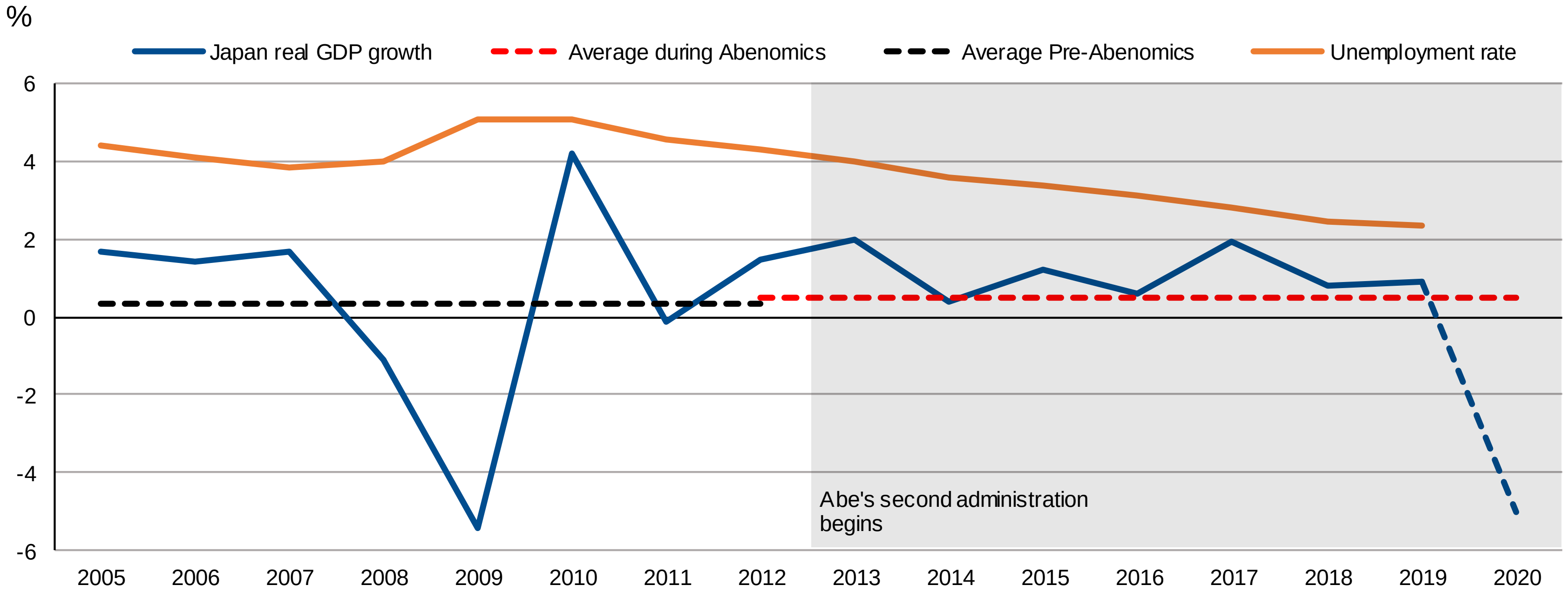
Low growth potential

## Real GDP growth and unemployment rate




Source: Ministry of Internal Affairs and Communications, IMF, Scope Ratings GmbH

## ➢ Despite an ambitious ‘Abenomics’ reflation initiative, growth has yet to pick up

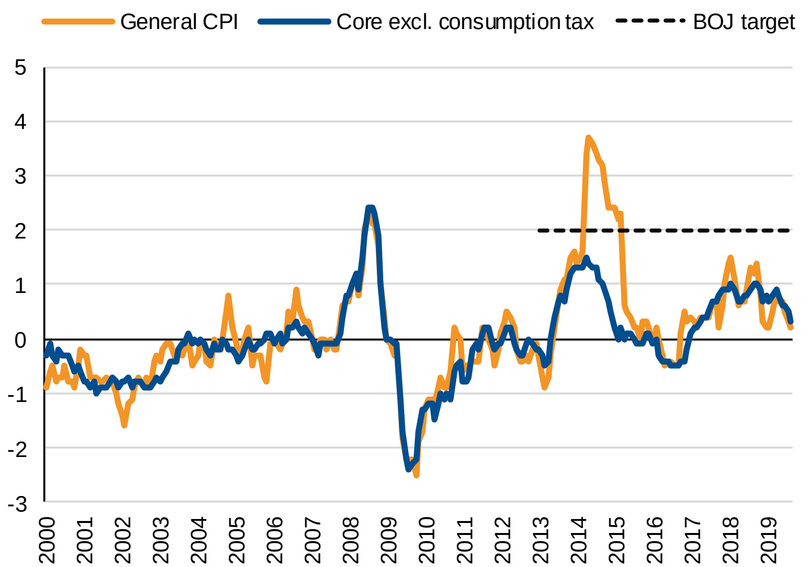
- Average GDP growth has been 1.17% since 2012 excl. 2020, above potential, due to fiscal and monetary stimulus
- This stimulus combined with an ambitious structural reform programme reduced unemployment to record lows
- However, real growth under Abenomics has hardly picked up, reflecting structural macroeconomic pressures
- Including the decline of -5% growth in 2020, average economic growth will essentially be flat despite all efforts

# Japan: Outlook change to A+/Negative

Low growth potential

## Inflation

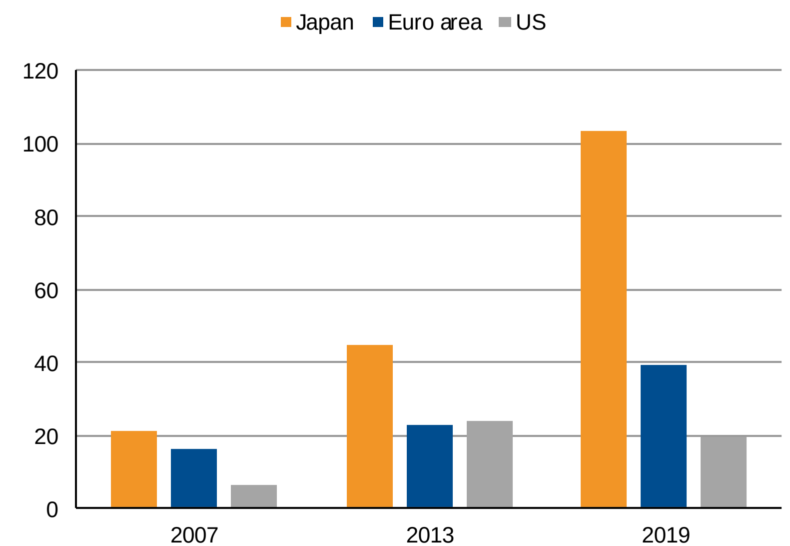
%




N.B. Core inflation includes all items less fresh food
Source: Bank of Japan, Scope Ratings GmbH

## Central banks' balance sheet

% of GDP




N:B: As of year-end
Source: BoJ, ECB, Fed, Scope Ratings GmbH

### ➢ Inflation remains very low despite BoJ's policies

- Inflation remains well below the Bank of Japan's 2% target, due to demographic pressures and low potential growth
- This is despite forceful monetary policy interventions, with the BoJ's balance sheet now exceeding 100% of GDP
- Low growth and low inflation, on top of persistent deficits, prevent any reduction in Japan's debt-to-GDP ratio

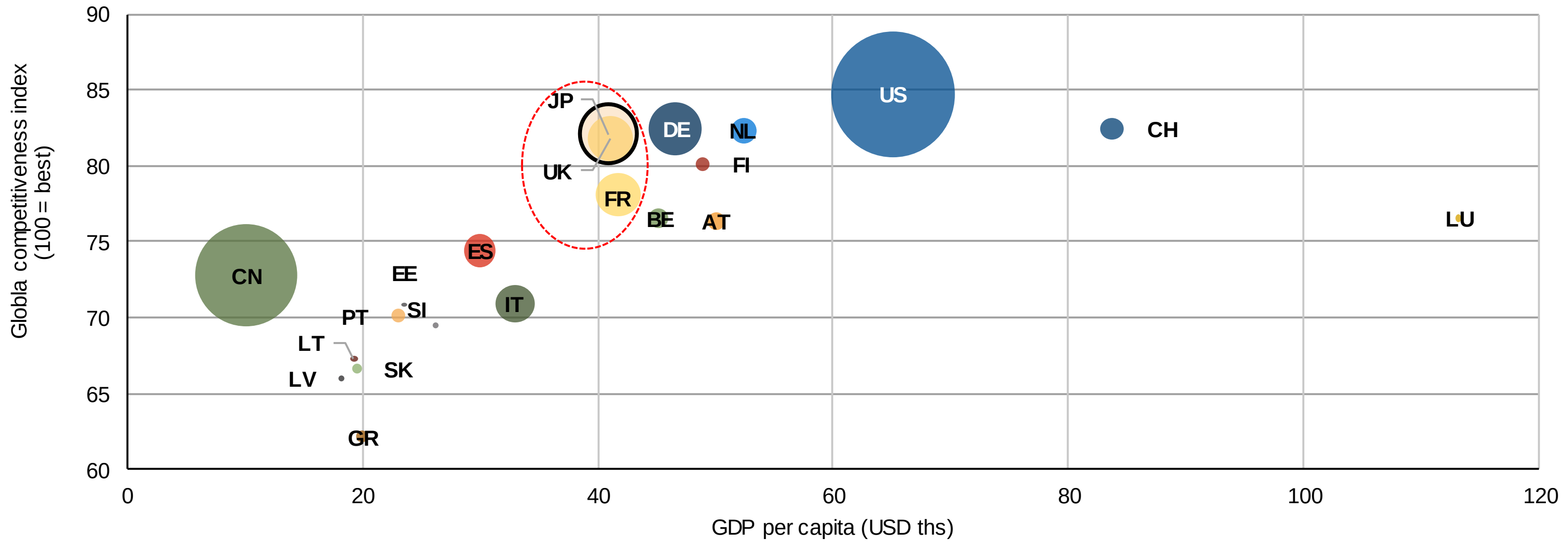
## Table of contents

# Japan: Outlook change to A+/Negative

Economy, funding flexibility, debt structure, external position

## A wealthy, diversified and competitive economy

GDP per capita (x axis), USD 000's; Global competitiveness Index (y axis); share in world GDP (bubble size)




N.B. The Global competitiveness index evaluates the determinants of productivity and economic efficiency of a country.
Source: World Economic Forum, IMF, Scope Ratings GmbH

## ➢ Japan has a large, wealthy, diversified and competitive economy

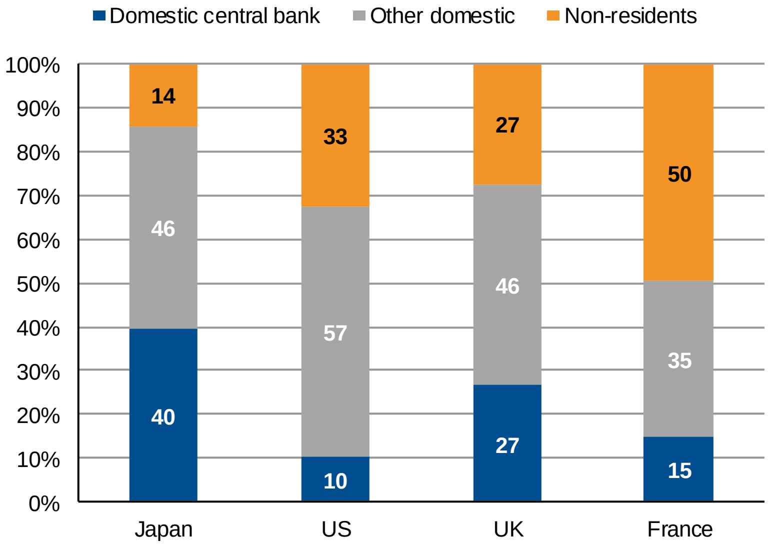
- Japan has a wealthy tax base, with the GDP per capita level in line with peers
- Its large market size, competitive market, excellent infrastructure and well-educated population are key strengths
- In the 2019 Global Competitiveness Index, Japan ranked 6$^{th}$

# Japan: Outlook change to A+/Negative

Economy, funding flexibility, debt structure, external position

## Investor base

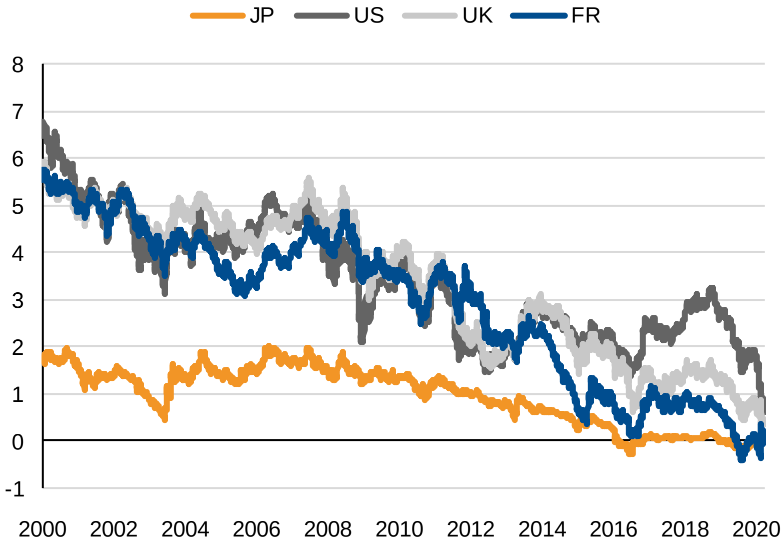
% of total




Source: IMF, Scope Ratings GmbH

## Yields

%




Source: FT, Scope Ratings GmbH

## ➢ Domestic investor base and yen's reserve currency status reduce refinancing risks

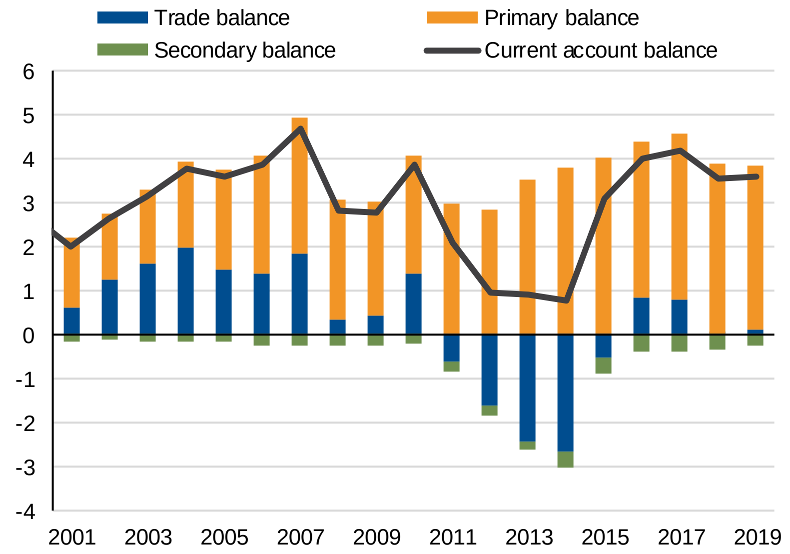
- Japan is capable of refinancing its debts mostly domestically, due to a large, savings-rich domestic investor base
- Large-scale purchases of government debt by the BoJ provides continuous demand for Japan's debt at low costs
- The yen's reserve currency status further supports demand and pushes down yields
- Therefore, Japan's cost of debt remains very low despite a very large debt stock

# Japan: Outlook change to A+/Negative

Economy, funding flexibility, debt structure, external position

## Current account balance

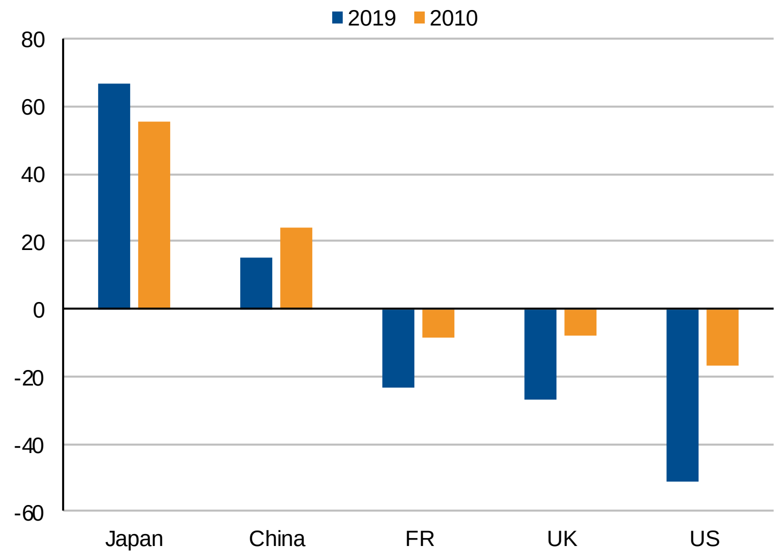
% of GDP




Source: IMF, Scope Ratings GmbH

## Net International Investment Position

% of GDP




Source: IMF, Scope Ratings GmbH

## ➢ A very robust external position is a key strength

- Japan continues to post sustained current account surpluses, underpinned by high foreign investment returns
- It is now the largest creditor nation in the world, with a net international investment position of 66.5% of GDP as of 2019
- Large primary income flows due to massive net foreign assets support the current account despite recent trade tensions

## Table of contents

# Japan: Outlook change to A+/Negative

Annexes

## Credit strengths

- ✓ Diversified economy
- ✓ Funding flexibility
- ✓ Favourable debt structure
- ✓ Strong external position

## Credit weaknesses

- ✓ Deteriorating fiscal outlook
- ✓ Low growth potential

## Positive rating-change drivers

- ↑ Medium-term fiscal consolidation
- ↑ Higher potential GDP growth

## Negative rating-change drivers

- ↓ Inability to consolidate public finances
- ↓ Inability to raise potential GDP growth

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