Japan
Rating Report

A
NEGATIVE OUTLOOK

Credit strengths

- Wealthy, competitive and diversified economy
- Good funding flexibility and market access
- Strong 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 economy with solid fundamentals: Japan benefits from its high wealth levels as well as its diversified and competitive economy, supported by economic 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 due to the yen's safe-haven status, a very large domestic investor base and continued support from Bank of Japan policies underpins the government's, mitigating risks from weak fiscal fundamentals and very high public debt.

Robust external position: Japan's status as the world's leading external creditor reflects 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: 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%	aaa	JPY [+1]	-2/3	A
Public Finance Risk		20%	b-		-1/3	
External Economic Risk		10%	aaa		+2/3	
Financial Stability Risk		10%	bbb+		-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 Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Negative Outlook reflects Scope's view that risks to the ratings are titled to the downside.

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 stabilize debt and deliver on budgetary targets
- Growth outlook deteriorates substantially
- Unexpected shift in monetary policies threatens funding flexibility or 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

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

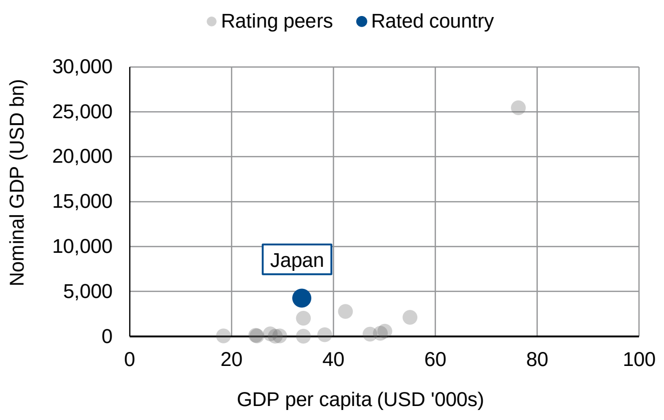
Domestic Economic Risks

- **Growth outlook:** The Japanese economy experienced modest growth of 1.0% in 2022 following 2.1% in 2021. A weaker external environment and the impact of the cost-of-living crisis weigh on near-term growth. Still, private consumption and investment rebounded along with the recovery of inbound tourism. We expect these factors to remain the main growth drivers in 2023, with real GDP growth expected at 1.2%. The government announced a 5.2% of GDP fiscal package in October 2022, as part of the "New Form of Capitalism", with subsidies to households and corporates as well as investments in science, start-ups, and digital transformation. The effectiveness of this package remains to be seen, however while long-term challenges related to an ageing population and low productivity growth remain. We expect economic growth to converge to Japan’s low potential of 0.4% in the medium term.
- **Inflation and monetary policy:** After a long period of deflationary pressures, Japan's headline CPI began to pick up in 2022, reaching a peak of 4.3% in January 2023. The rise was primarily driven by higher import prices, in particular energy and food prices and yen depreciation. Despite this, household inflation expectations remain low. Inflation is projected to peak in the first half of 2023 and gradually fall below 2% by the end of 2024, as the effects of higher import prices and a weaker yen wane. The BoJ widened the band around the 10-year JGB yield target from 0.25% to 0.50% while the short-term policy rate remains at -0.1%. The BoJ continues to maintain a very accommodating policy, with approximately JPY 580trn of Japanese government securities in their balance sheet.
- **Labour markets:** Japan’s labour market remains tight, with the unemployment rate at 2.6% in February 2023, which should further decrease to around 2.3% for 2023-2028. Furthermore, the number of employed individuals is on a steady downward trajectory. We expect labour shortages to persist and worsen in coming years as Japan's working age population is forecast to shrink by one fourth through 2050 according to the United Nations. The ratio of new job openings to new job seekers stood at 2.33 in October 2022, on par with the 1990s bubble period. An increasing number of companies are pointing to labour shortages as a hindrance to output growth, particularly in the industrial, financial services, and public sectors.

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

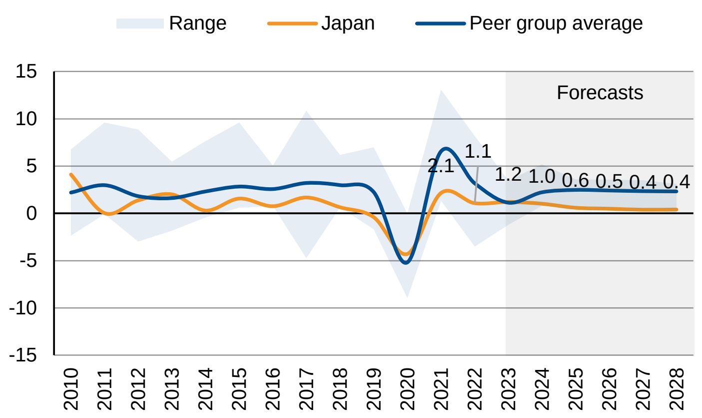
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Weak	-1/3	Low and declining growth potential
	Monetary policy framework	Neutral	0	BoJ is a sophisticated central bank; persistent accommodative policies have failed to reflate the economy; 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

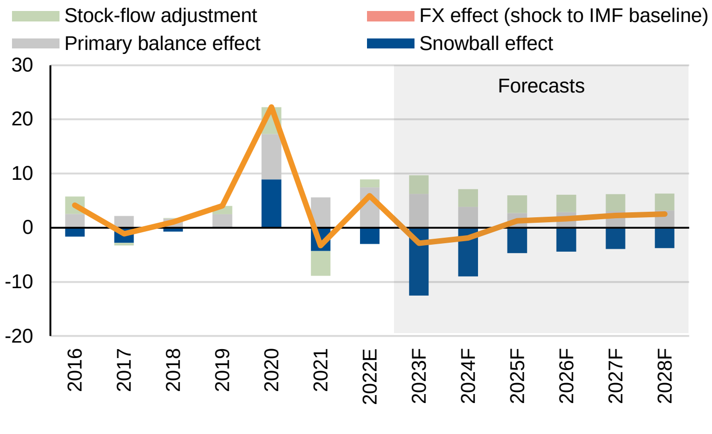
Public Finance Risks

- **Fiscal outlook:** Japan's primary deficit increased to 7.5% of GDP in 2022 from 5.6% of GDP in 2021, as the government implemented several fiscal packages to support the economy. The government remains committed to reflating the economy through pro-active fiscal policies. However, the recurring need to provide fiscal support amid flagging growth and rising costs of ageing exacerbate fiscal vulnerabilities. The recently stimulus package is too large, not sufficiently targeted and will further reduction Japan's fiscal space with uncertain benefits for the economy, as highlighted by the IMF. With the costs of population ageing, a shrinking tax base, rising expenditure pressures in other areas such as defence, we deem it unlikely that Japan will be able to achieve meaningful budget consolidation in the long term. We forecast the primary deficit to remain high at above 6% of GDP in 2023, then narrow to around 3% of GDP in 2028 as the Covid-19 and cost-of-living fiscal support is withdrawn.
- **Debt trajectory:** We estimate that Japan's debt-to-GDP ratio increased to 261% in 2022 from 255% in 2021. Although we anticipate a moderate decline in debt to 258% in 2023 thanks to high inflation, we expect it to resume an upward trajectory and reach 264% by 2028. The uncertain economic environment and Japan's low growth prospects could prompt additional fiscal stimulus, resulting in faster debt accumulation, however. Additionally, in a more stressed scenario with a combined macro-fiscal shock and assuming Japan's financing costs align with those of other major advanced economies, the country's debt and interest payment burden would enter a rapidly rising path.
- **Debt profile and market access:** Japan's debt profile remains favourable, with an average maturity of 9 years and 6 months for outstanding debt, while market access is supported by the yen's status as a reserve currency. The country also benefits from the highly accommodative stance of the Bank of Japan, which includes large-scale purchases of government bonds to maintain the 10-year yield at around 0%. The 10-year JGB yield was slightly less than 0.5% on 17 April 2023. The Bank of Japan widened the 10-year government bond yield's upper policy limit from 0.25% to +/- 0.5%. The Bank of Japan held 46.3% of Japanese government bonds and T-bills, while other domestic investors held 39.8%.

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

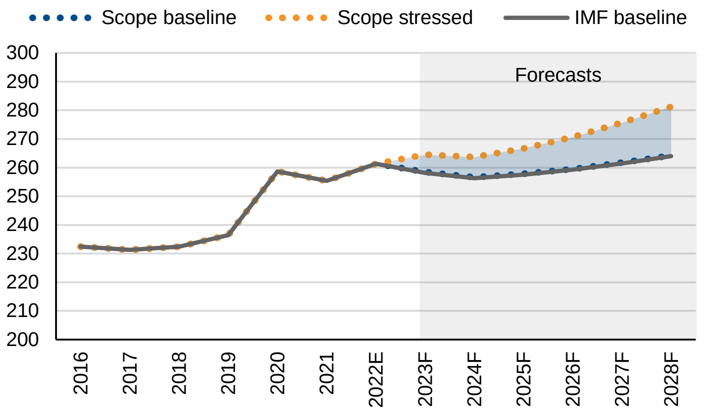
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Fiscal policy framework	Weak	-1/3	Persistent fiscal deficits exacerbated by ageing population; lack of credible medium-term consolidation plan
	Debt sustainability	Weak	-1/3	Very high and rising debt poses sustainability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



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

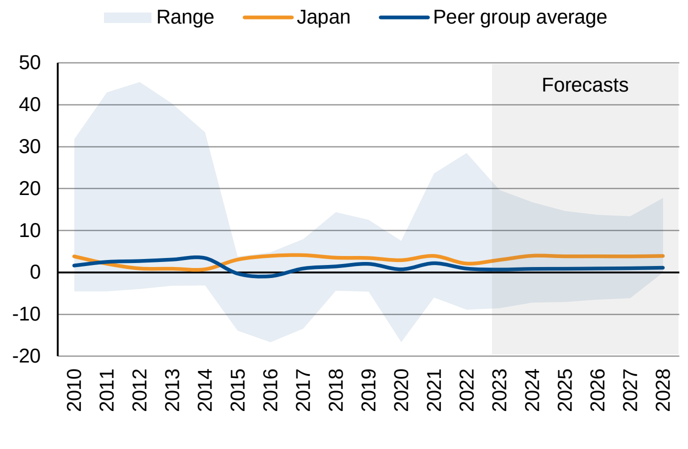
External Economic Risks

- **Current account:** Japan has maintained a consistent record of generating current account surpluses, averaging 3.6% of GDP between 2015-19. The current account surplus decreased to 1.9% of GDP in 2022 from 3.9% in 2021 driven primarily by a deterioration in the trade balance from higher commodity import prices and weaker export performance. We expect the current account balance to benefit from recovering goods and services exports, bouncing back to an average of 3.7% of GDP over 2023-28, thanks to a wide primary income surplus arising from Japan's large positive net international investment position and high net returns.
- **External position:** Japan's external position remains strong due to its large net creditor position, with the country holding the world's largest stock of net foreign assets. Japan's net international investment position (NIIP) stood at 75% of GDP as of December 2022, in line with 2021 levels. The NIIP is estimated to have generated a net annual investment income of 7.3% of GDP in 2022. Gross external debt amounted to 102% of GDP as of December 2022, with 40% of liabilities being central bank and government debt.
- **Resilience to shocks:** Despite the yen's reserve currency status, large foreign exchange reserves, and Japan's robust external position, authorities had to intervene in 2022 to support the yen's value against the US dollar, which had deteriorated significantly due to monetary policy shifts in advanced economies. The support provided in September and October amounted to approximately USD 63bn. Official reserves declined to USD 1.3trn by the end of March 2023, but they remain among the largest in the world. However, the yen's reserve currency status may be at risk in the long term due growing sustainability challenges around the Bank of Japan's policy stance vis-a-vis 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 for Japan's *External Economic Risks*

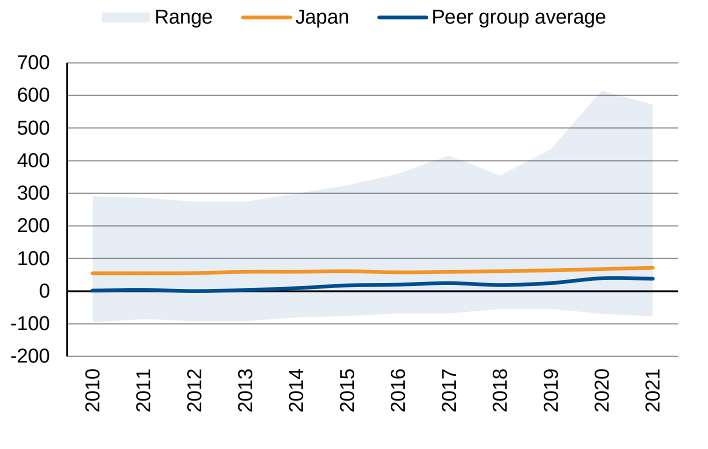
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Current account resilience	Strong	+1/3	Record of current account surpluses supported by diversified export base and large external creditor position
	External debt structure	Neutral	0	Moderate external debt; large share 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 (NIIP), % of GDP



Source: IMF, Scope Ratings

Financial Stability Risks

- **Banking sector:** Japan's banking sector continued to exhibit resilience in 2022, boasting high capitalisation (Tier 1 ratio of 12.7% as of September 2022) and strong asset quality (NPL ratio of 1.2%). However, the common equity Tier 1 capital ratio of internationally active banks decreased by approximately 1pp on average from end-March to end-September 2022. Bank profitability improved slightly throughout the year, with return on assets reaching 0.3% as of December 2022, slightly up from 0.3% in December 2021. Elevated interest rate risks on banking books remain a concern, especially for smaller banks due to their higher and longer-tenor JGB holdings since the pandemic's onset. The Bank of Japan's macro stress test in October 2022 revealed that a significant adjustment in global financial markets could pose a risk to the functioning of financial intermediation.

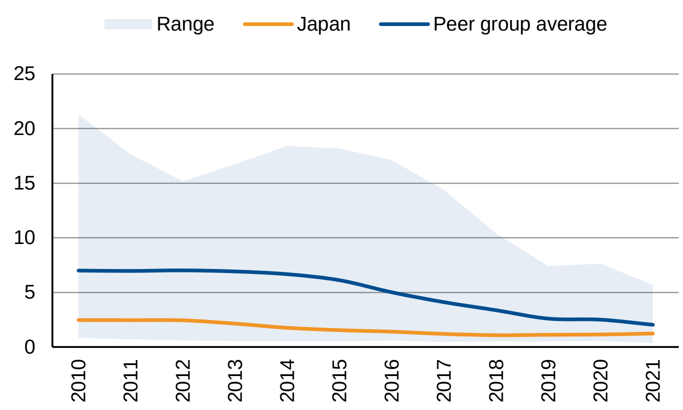
- **Private debt:** Private sector debt in Japan has increased, although it remains at a level comparable to other major advanced economies. This has largely been driven by an uptick in household and real estate loans. The Bank of International Settlements estimated that total credit to non-financial corporates had risen to 117% of GDP in Q3 2022, up from 102% at the end of 2019. Household debt-to-GDP has also increased from 63% to 68% over the same period. Japanese households' large financial assets provide an important buffer in cases of financial stress however. The recent escalation in energy and raw material prices could put more pressure on firms, although the credit risk for financial institutions remains relatively low.

- **Financial imbalances:** Prolonged accommodative policies by the Bank of Japan is leading to the long-term build-up of financial distortions and could result in an accumulation of risks in the financial system. The Bank of Japan's extensive asset purchase programmes that encompass government and corporate bonds, exchange-traded funds, and real estate investment trust equities have resulted in a dominant position for the central bank in critical asset markets, has impaired market and have supported search for yield behaviour. Sustained periods of highly accommodative monetary policy increase the likelihood of market distortions and inflated asset valuations, thereby raising the potential for risks. Any change to the Bank of Japan's policy stance could pose short to medium-term financial stability risks.

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

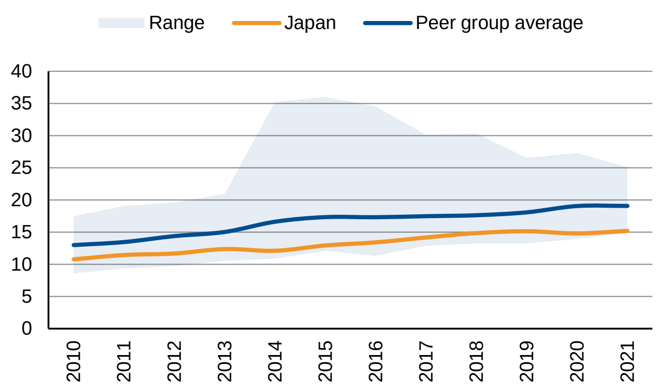
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Banking sector performance	Weak	-1/3	Profitability pressures lead to increased risk-taking without commensurate returns
	Banking sector oversight	Neutral	0	Strong oversight frameworks under the BoJ and Financial Services 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

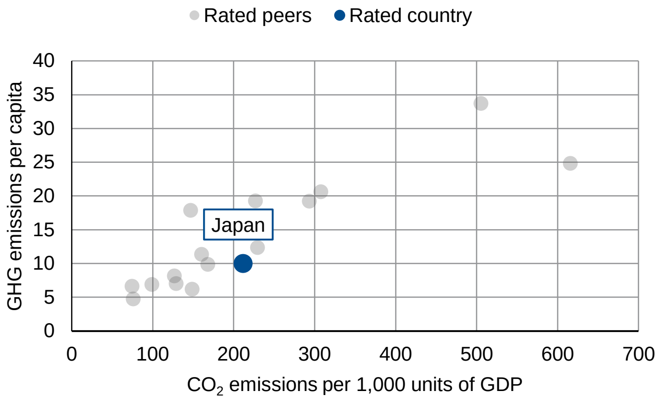
ESG Risks

- **Environment:** Japan is situated in the Pacific earthquake belt and the circum-Pacific zone, making it susceptible to natural disasters such as typhoons, earthquakes, tsunamis, floods, and cyclones. The climate experiences extreme temperature variations throughout the year and is influenced by monsoon circulation. Climate change will worsen the frequency and intensity of such disasters, posing greater risks for the country. Furthermore, Japan is highly dependent on fossil fuels, which account for 88% of its total power generation. This, coupled with its significant carbon emissions, exposes it to transition risks. The country aims to achieve net-zero greenhouse gas emissions by 2050, with an interim target of reducing emissions by 46% by 2030 relative to 2013 levels, though current policies remain inconsistent with the Paris agreement objective to limit global warming to 2°C, according to Climate Action Tracker.
- **Social:** Japan has the highest old-age dependency ratio among Scope's sovereign rating universe and will continue to rise rapidly as the population ages. This will put more pressure on pension and healthcare systems. To reduce the fiscal pressures of age-related costs, necessary reforms could pose social risks by reducing social benefits or requiring citizens to work more to sustain them. This could exacerbate the challenges that the elderly population faces, such as increasing poverty and social isolation. Nonetheless, the country's high level of social cohesion, along with its excellent health and education systems, remain core strengths.
- **Governance:** In October 2021, Fumio Kishida assumed the role of Prime Minister, and his Liberal Democratic Party won a substantial majority in the March 2022 general election. We anticipate that policy direction will remain largely unchanged in Japan. However, there are emerging weaknesses within the Liberal Democratic Party and declining public backing for the administration, which may result in renewed political instability and impede advances on crucial policy matters. Nonetheless, Japan has resilient democratic institutions and governance.

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

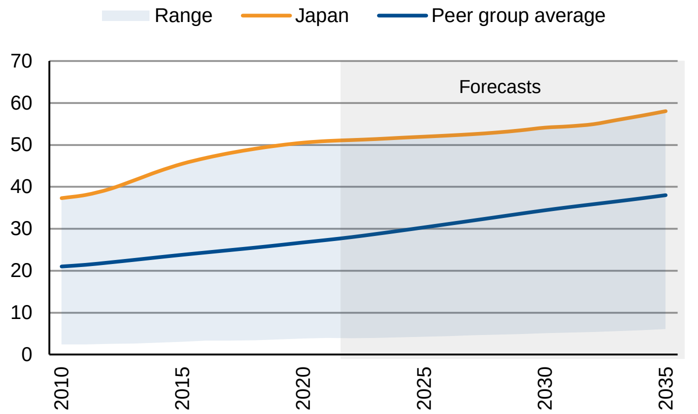
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental factors	Weak	-1/3	High exposure to natural disaster, transition, and resource risks; insufficient policy response in the past although mitigation efforts are accelerating
	Social factors	Neutral	0	Low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

Emissions per GDP and per capita, $mtCO_2e$



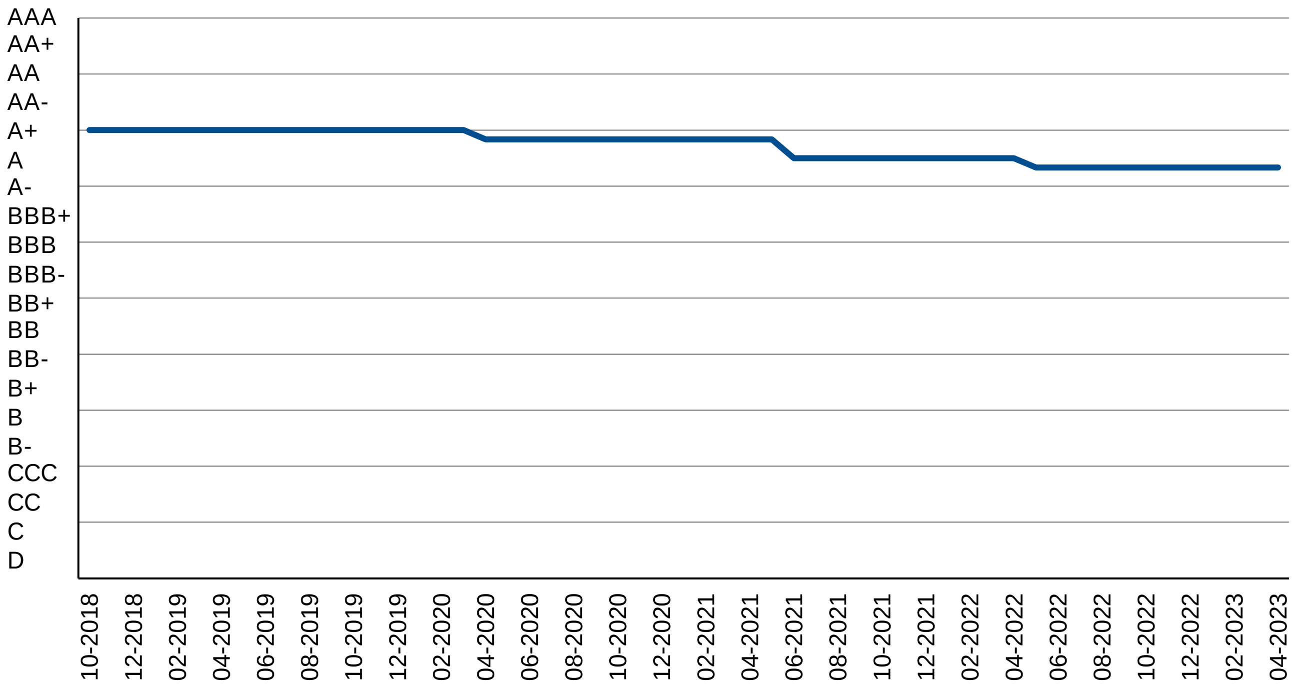
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history (foreign-currency long-term debt)



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 per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
Belgium
Croatia
Czech Republic
Estonia
France
Italy
Lithuania
Malta
Slovenia
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	2018	2019	2020	2021	2022
Domestic Economic	GDP per capita, USD '000s	IMF	39.9	40.5	40.1	39.9	33.8
	Nominal GDP, USD bn	IMF	5,040.9	5,118.0	5,048.8	5,005.5	4,233.5
	Real growth, %	IMF	0.6	-0.4	-4.3	2.1	1.1
	CPI inflation, %	IMF	1.0	0.5	0.0	-0.2	2.5
	Unemployment rate, %	WB	2.5	2.4	2.8	2.8	-
Public Finance	Public debt, % of GDP	IMF	232.4	236.4	258.7	255.4	261.3
	Interest payment, % of revenue	IMF	2.3	2.0	1.8	1.6	1.0
	Primary balance, % of GDP	IMF	-1.7	-2.4	-8.4	-5.6	-7.5
External Economic	Current account balance, % of GDP	IMF	3.5	3.4	2.9	3.9	2.1
	Total reserves, months of imports	IMF	14.7	15.4	18.6	16.2	-
	NIIP, % of GDP	IMF	61.1	63.9	67.8	71.9	74.8
Financial Stability	NPL ratio, % of total loans	IMF	1.1	1.1	1.1	1.2	-
	Tier 1 ratio, % of risk-weighted assets	IMF	14.9	15.1	14.3	14.6	13.8
	Credit to private sector, % of GDP	WB	166.9	174.6	193.5	-	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	222.7	216.3	209.2	211.7	-
	Income share of bottom 50%, %	WID	16.8	16.8	16.8	16.8	-
	Labour-force participation rate, %	WB	79.1	79.8	-	-	-
	Old-age dependency ratio, %	UN	49.1	49.9	50.6	51.0	51.2
	Composite governance indicators*	WB	1.3	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 (bps) as of 31 March 2023	25.6

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

10 avenue de Messine
F-75008 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 30 31 58 14

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer