

Japan

Rating Review Annex



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% | bb | | -2/3 | | |
| ESG Risk | Environmental Factors | 5% | | cc | | -1/3 |
| | Social Factors | 7.5% | | b- | | 0 |
| | Governance Factors | 12.5% | | aaa | | 0 |
| Indicative outcome | | | | a+ | | |
| 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 Stable Outlook reflects our view that risks to the ratings are balanced.

Positive rating-change drivers

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



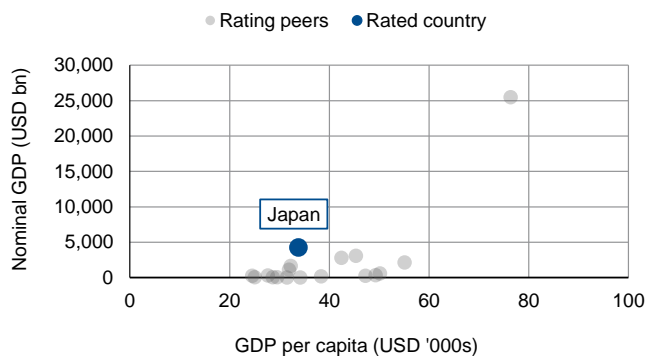
Bloomberg: RESP SCOP

Domestic Economic Risk

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

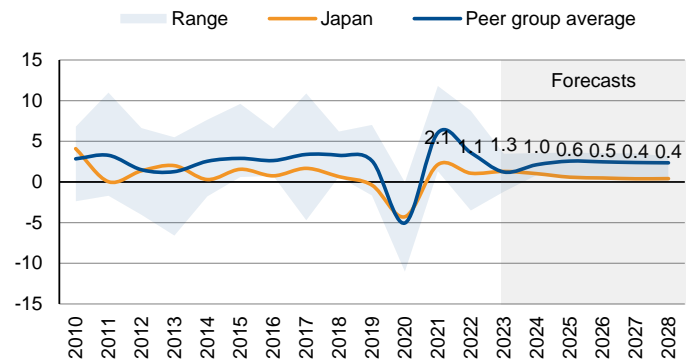
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|-----------------------|---|------------|------------------|---|
| aaa | Growth potential of the economy | Weak | -1/3 | Low and declining growth potential |
| | Monetary policy framework | Neutral | 0 | BoJ 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



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

Real GDP growth, %



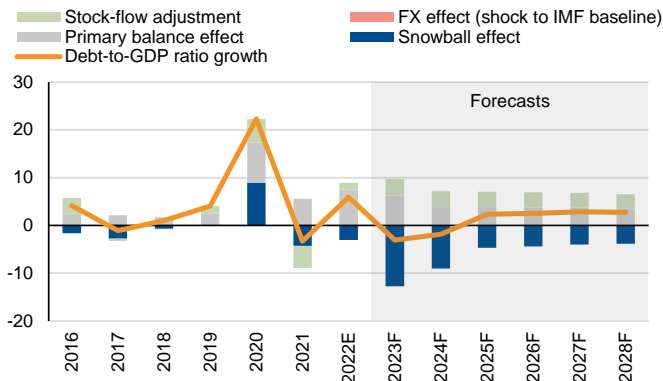
Source: IMF WEO, Scope Ratings forecasts

Public Finance Risk

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

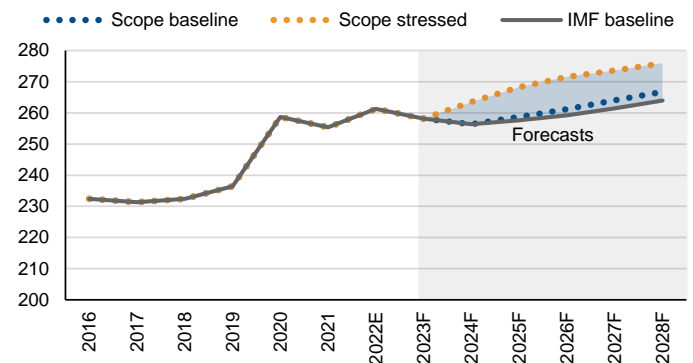
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|-----------------------|--------------------------------|------------|------------------|--|
| b- | Fiscal policy framework | Weak | -1/3 | Persistent fiscal deficits exacerbated by ageing population; lack of 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



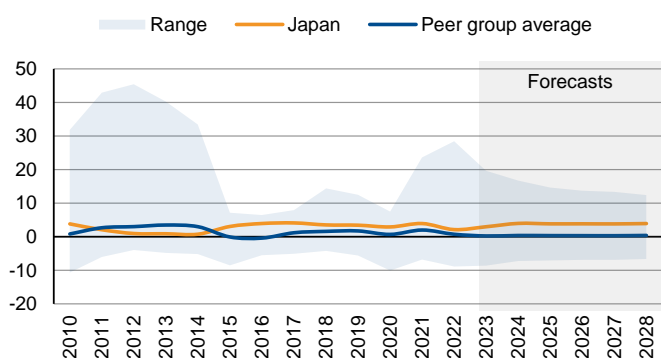
Source: IMF WEO, Scope Ratings forecasts

External Economic Risk

Overview of Scope's qualitative assessments for Japan's External Economic Risk

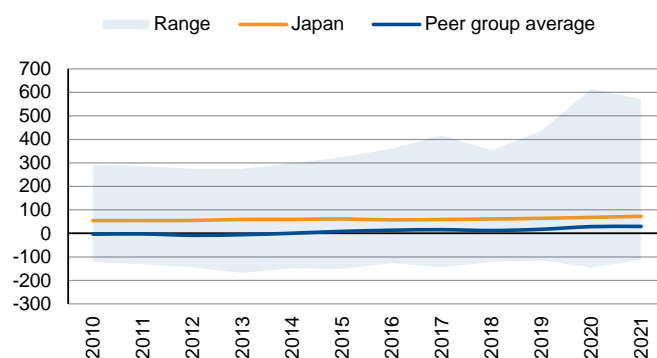
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|-----------------------|--|------------|------------------|---|
| aaa | Current account resilience | Strong | +1/3 | Record of current account surpluses supported by diversified export base and large external 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



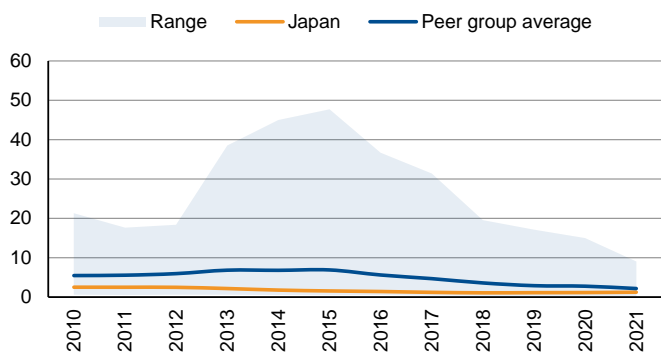
Source: IMF, Scope Ratings

Financial Stability Risk

Overview of Scope's qualitative assessments for Japan's Financial Stability Risk

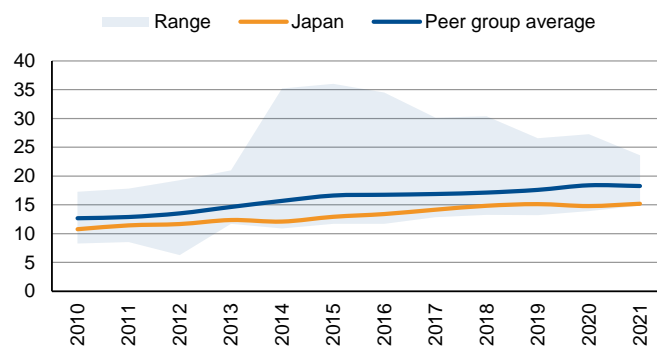
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|-----------------------|----------------------------|------------|------------------|--|
| bb | Banking sector performance | Weak | -1/3 | Profitability pressures lead to increased risk-taking without commensurate 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 (NPLs), % of total loans



Source: World Bank, Scope Ratings

Tier 1 capital, % of risk-weighted assets



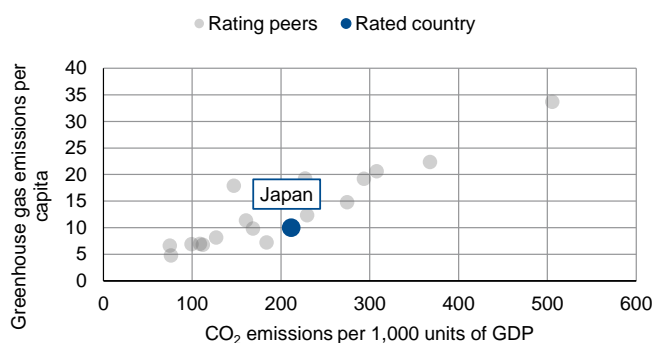
Source: IMF, Scope Ratings

ESG Risk

Overview of Scope's qualitative assessments for Japan's ESG Risk

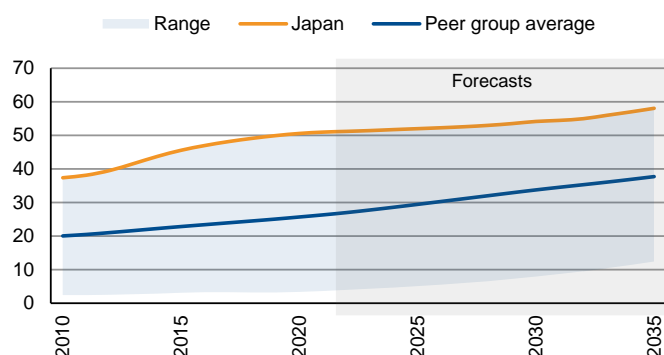
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|-----------------------|-----------------------|------------|------------------|---|
| bbb | Environmental factors | Weak | -1/3 | High exposure to natural disaster, and resource risks; insufficient policy respond on social care systems; deteriorating social conditions of the elderly |
| | 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 capita, mtCO₂e



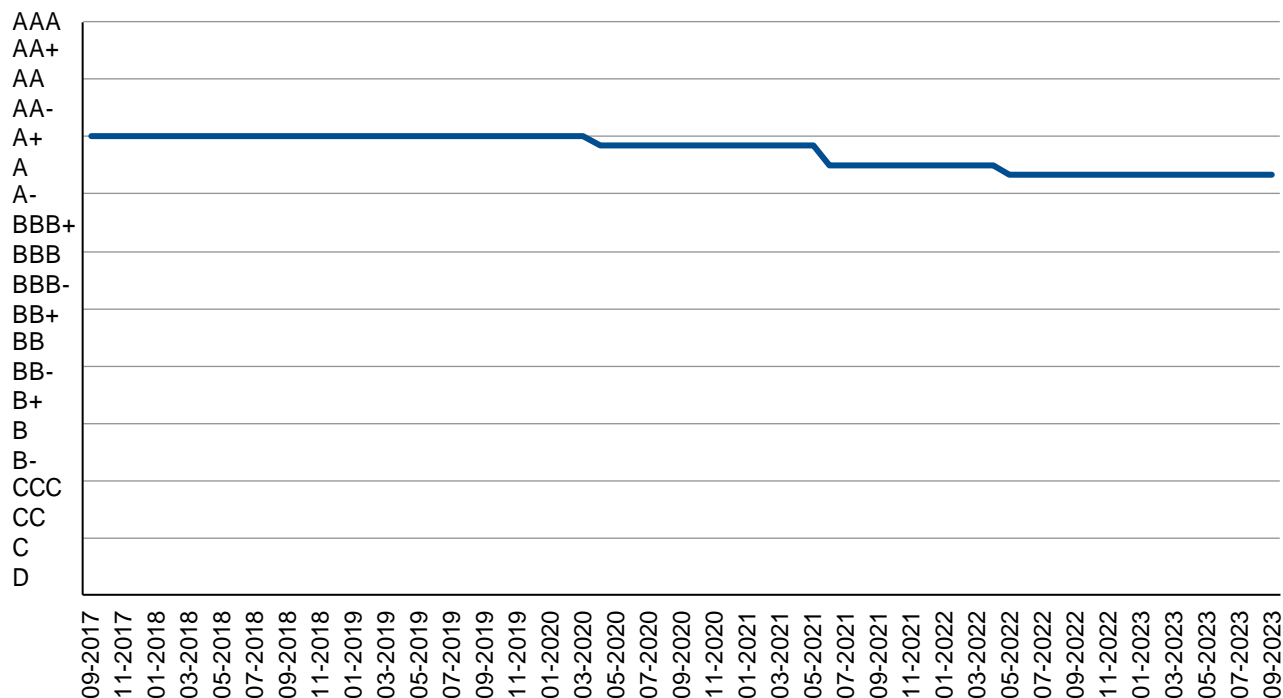
Source: European Commission, Scope Ratings

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 adjacent categories, with Scope's core variable scorecard embedding a methodological reserve-currency adjustment.

| Peer group* |
|----------------|
| Belgium |
| Cyprus |
| Czech Republic |
| Estonia |
| France |
| Lithuania |
| Malta |
| Portugal |
| Slovenia |
| United Kingdom |
| 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 | 2.6 |
| Public Finance | Public debt, % of GDP | IMF | 232.4 | 236.4 | 258.7 | 255.4 | 261.3 |
| | Net 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 | WB | 14.7 | 15.4 | 18.5 | 16.1 | 12.4 |
| | NIIP, % of GDP | IMF | 61.1 | 63.9 | 68.7 | 73.1 | 74.5 |
| 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 the private sector, % of GDP | WB | 166.8 | 174.8 | 193.2 | 194.1 | 195.6 |
| ESG | CO ₂ per EUR 1,000 of GDP, mtCO ₂ e | 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 | 79.5 | 80.2 | 80.3 | 80.6 | - |
| | 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 3 October 2023

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Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Frankfurt am Main

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

Phone +49 69 66 77 389 0

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Paris

10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 8295 8254

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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