

# CareEdge Global assigns Long Term Foreign Currency Rating of AA- (Unsolicited) to State of Japan

## Credit Profile

Japan's credit profile derives strength from its strong external position which gains on the back of Yen's reserve currency status, persistent current account surplus, positive net international investment position (NIIP), and robust foreign exchange reserves. Additionally, strong assessment in terms of institutions and quality of governance support its overall credit profile. While Japan's large, diverse, and highly competitive economy are its key strengths in terms of economic structure, the country faces challenges from weak growth prospects and an ageing population. Furthermore, Japan's credit profile faces challenges from its high gross general government debt.

## Strengths

- Large, high-income, diverse, and competitive economy
- Large and developed financial system
- Yen's Reserve Currency Status
- Persistent current account surplus and highly positive NIIP

## Weaknesses

- Weak economic growth profile
- High gross general government debt
- High external debt

## Key Monitorables

- Bank of Japan's exit from the negative interest rate policy and its impact on debt affordability
- Impact of ageing population on growth prospects and government finances

## Key Rating Drivers

### Economic Structure & Resilience

Japan's economic profile is characterized by a large, high-income, diverse, and competitive economy. However, the economy has a weak growth profile. Real GDP growth rebounded to 1.9% in 2023 following 1% growth in 2022. However, growth is projected to decelerate to 0.9% in 2024 with fading support from one-off factors such as uptick in tourism witnessed in 2023. Going ahead, GDP growth is projected to remain subdued averaging at 0.8% over the next five years. Japan's growth prospects are weakened by challenges from an ageing demographic profile and a declining population.

### Fiscal Strength

Japan's fiscal assessment is characterized by its historically high levels of gross general government (GG) debt. The debt shot up above 250% of GDP following the fiscal support in response to the Covid-19 pandemic and repercussions of the Russia-Ukraine war. Japan's gross GG debt remains the highest

amongst other major sovereigns at 252.4% of GDP (2023). This is higher compared to the pre-pandemic average of 232% of GDP seen during 2015-19. The GG debt to GDP is projected to remain largely unchanged over the next five years. Moreover, Japan's committed expenditure in the form of spending towards salaries, pensions, net social benefits, and subsidies is high at 34.4% of the total expenditure (2022). Going ahead, the fiscal costs associated with an ageing population could pose a further challenge for the government's debt burden. However, a large quantum of the government debt is financed domestically, hence mitigating the external vulnerabilities.

Despite Japan's high debt burden, its debt affordability remains healthy with low interest payments as a percentage of revenue. The Bank of Japan's (BoJ) ultra-accommodative monetary policy has remained supportive of the comfortable debt payment scenario. The recent exit of BoJ from the negative interest rate policy and its impact on debt affordability remain monitorable going forward.

### External Position & Linkages

Japan's strong external position derives benefits from its persistent current account surplus, positive NIIP, robust foreign exchange reserves, and Yen's reserve currency status. Japan has a track record of maintaining a healthy current account surplus, which averaged at 3.1% of GDP in the last five years. The current account surplus is projected to remain healthy at ~3.5% of GDP over the next five years. The main driver of Japan's current account surplus is the primary income balance which gains on account of its large overseas investments. This is also reflected in Japan's strongly positive NIIP at 78.8% of GDP in 2023. Japan's foreign exchange reserves are strong, sufficient to cover around 15 months of imports (August 2024).

Japan's external debt is high at 105.8% of GDP (2023). The risk from high external debt is partially mitigated by the current account surplus and strong foreign exchange reserves. As a result, Japan's external funding ratio (calculated as a ratio of current account payments and short-term external debt by residual maturity to current account receipts and FDI net inflows) is estimated to be comfortable at 3.85 (2023) compared to the similar rated peers.

### Monetary & Financial Stability

Japan follows a free-floating exchange rate regime and Yen's reserve currency status is a key strength for its monetary assessment. A large and developed financial system as well as a lower proportion of bank non-performing loans to gross loans bode well for the assessment of this pillar.

The Central Bank in the past has struggled with long periods of very low inflation despite an ultra-accommodative monetary policy. However, CPI inflation has been ruling above the central bank's 2% target since April 2022. Furthermore, the higher inflationary expectations and strong wage growth have also bolstered confidence that the BoJ's 2% inflation target can be sustainably achieved.

On the monetary policy front, Bank of Japan hiked the short-term policy rate for the first time since February 2007 ending its eight year-long negative interest rate policy at the March 2024 monetary policy meeting. The BoJ opted for a second-rate hike in its July 2024 meeting, taking the short-term interest rate to 0.25% from the earlier range of 0 to 0.1% set in March 2024. It also undertook some other steps aimed at monetary

policy normalization such as abolition of yield curve control framework.

Going ahead, attainment of the 2% inflation target in a sustainable manner while effectively managing the monetary policy divergence between BoJ and other Central Banks remain the key challenges for the monetary policy.

### **Institutions & Quality of Governance**

Japan's assessment of this pillar gains on the back of strong performance in aspects of government effectiveness, rule of law and regulatory quality in the Worldwide Governance Indicators. However, geopolitical risks in the form of regional tensions with China & North Korea pose a challenge for Japan.

Japan is set to witness a change in political leadership following the recent stepping down of Prime Minister Fumio Kishida. The governing Liberal Democratic Party's (LDP) leadership contest scheduled for end-September will yield Japan its next Prime Minister. Overall, we expect broad policy continuity to prevail especially given the dominance of the LDP in Japan's political landscape.

Japan – Select Indicators									
	Unit	2018	2019	2020	2021	2022	2023	2024 F	2025 F
<b>Economic Indicators</b>									
Nominal GDP	USD Billion	5040.9	5118.0	5055.6	5034.6	4256.4	4212.9	4110.5	4310.4
GDP Per Capita (Constant-PPP)	USD	41758.0	41680.5	40070.0	41207.5	41713.5	42703.3	43270.2	43922.0
Real GDP Growth	%	0.6	-0.4	-4.1	2.6	1.0	1.9	0.9	1.0
GFCF/GDP	%	25.3	25.5	25.5	25.5	26.0	26.1	-	-
Gross Domestic Savings/GDP	%	25.7	25.5	25.0	25.2	22.8	-	-	-
Exports (G&S)/GDP	%	18.4	17.7	15.7	18.3	21.7	21.9	-	-
Working-Age (15-64) Population (% Share in Total)	%	58.9	58.6	58.5	58.4	58.5	58.5	58.4	58.4
Old-Age (65+) Population (% Share in Total)	%	28.9	29.3	29.6	29.8	29.9	30.1	30.2	30.4
<b>Fiscal Indicators – General Government</b>									
Fiscal Balance/GDP	%	-2.5	-3.0	-9.1	-6.1	-4.4	-5.8	-6.5	-3.2
Revenue/GDP	%	34.3	34.2	35.5	36.4	37.6	36.5	35.8	36.5
Expenditure/GDP	%	36.7	37.3	44.5	42.5	41.9	42.2	42.3	39.7
GG Gross Debt/GDP	%	232.4	236.4	258.3	253.9	257.2	252.4	254.6	252.6
GG External Debt (by Creditor)/GG Gross Debt	%	13.1	13.7	14.0	15.4	15.2	14.1	-	-
Interest/Revenue	%	4.9	4.7	4.5	4.1	3.9	4.1	-	-
<b>External Indicators</b>									
Current Account Balance/GDP	%	3.5	3.4	3.0	3.9	2.0	3.4	3.5	3.5
FDI, Net Inflows/GDP	%	0.5	0.8	1.2	0.7	1.1	0.5	-	-
Outstanding FII Liabilities/GDP	%	62.9	71.0	81.3	82.0	81.1	84.6	-	-
NIIP/GDP	%	61.1	63.9	68.6	72.7	74.4	78.8	-	-
Foreign Exchange Reserves	USD Billion	1265.3	1323.1	1387.9	1415.7	1222.6	1290.4	-	-
Import Cover	Months	16.4	17.4	20.8	18.0	13.6	15.6	-	-
External Debt/GDP	%	79.6	82.9	95.4	92.1	103.1	105.8	-	-
<b>Monetary and Financial Indicators</b>									
CPI Inflation	%	1.0	0.5	0.0	-0.2	2.5	3.3	2.2	2.1
Exchange Rate (Average)	LC per USD	110.5	109.0	106.7	109.9	131.6	140.6	-	-
Non-Performing Loans/Total Gross Loans	%	1.1	1.1	1.1	1.2	1.2	1.2	-	-
Private debt, loans and debt securities/GDP	%	159.5	164.5	183.5	184.4	186.1	-	-	-

Sources: International Monetary Fund, World Bank, Bank for International Settlements, National Sources, CareEdge Global

Note: F - Forecast; PPP – Purchasing Power Parity; GFCF – Gross Fixed Capital Formation; Exports (G&S) – Exports of Goods and Services; GG – General Government; FDI – Foreign Direct Investment; FII – Foreign Institutional Investment; NIIP – Net International Investment Position; Data refers to fiscal/calendar year and actual/estimate as reported by the source; Where general government data is unavailable, central government data is used; Latest available data for 2023

## Rating History

Instrument	Type	Rating	Date
Issuer Rating	Long Term Foreign Currency (Unsolicited)	AA-	October 3, 2024

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## Criteria Applied

CareEdge Sovereign Rating Methodology

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CIN-U66190GJ2024PLC151103