

The Graying of Japan and ESG Credit Implications

Sovereigns

ESG Research

As Kroll Bond Rating Agency (KBRA) expands our global footprint and sovereign ratings, we continue to focus on analyzing structural issues that could develop into key contributions to credit risk analysis, including those related to environmental, social, and governance (ESG) factors. In the case of Japan, demographic trends are important social factors that shape the sovereign's credit metrics and public policy decisions. Demographic challenges, including the aging (graying) of its population, contribute to Japan's credit profile, alongside other important credit features such as reserve currency status and income level. This report highlights the relevance of ESG factors in sovereign credit analysis and supports our expanding research effort to improve transparency on the impact of ESG factors on credit quality.

Key Takeaways

- Population dynamics influence government credit ratings through their impacts on economic growth, political risk, and government finances.
- Japan's demographic puzzle involves low fertility rates, rising life expectancy, and its growing elderly population.
- Government policies are already targeting this ESG risk, although improvements in fertility rates have plateaued.
- Japan's adverse demographics is a standout even among other advanced economies with similar challenges.

Importance of Demographics to Sovereign Ratings

Social factors are generally an important underpinning of sovereign credit analysis, as they can reflect the strength of an issuer's tax base and ensure the smooth functioning of government activity. In particular, an evaluation of demographic and population trends is integral to sovereign analysis as this has a direct bearing on economic vibrancy, spending patterns, and fiscal health. Countries with declining populations often face swollen pension obligations, rising health care costs, and declining labor force participation rates, all of which translate into reduced fiscal flexibility and burden government finances.

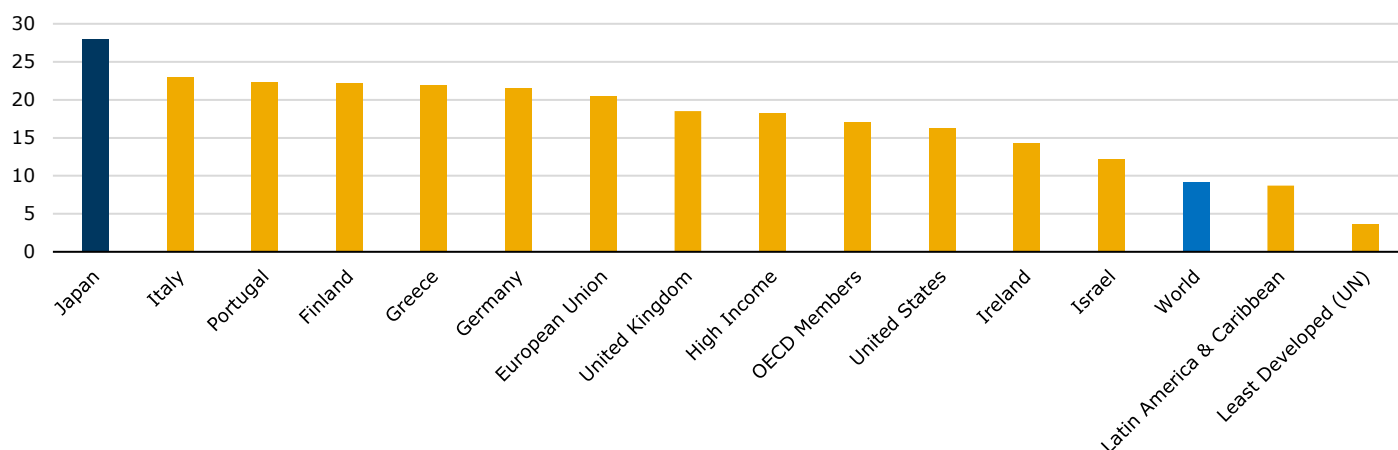
However, fast growing populations are not always constructive to a sovereign's credit profile. In several countries, rapid population growth is accompanied by few job opportunities and high unemployment; conditions which can give rise to political risk and exert pressure on fiscal policy. For these reasons and more, bespoke analysis of every credit factor (ESG and otherwise) is critical in determining the credit impact.

Aging Population Dynamics in Japan: A Graying Population

In 2019, Japan topped the global ranking of countries with the highest aging population (age 65 or older) at 28%, followed by Italy (23%), according to the World Bank. Japan's aging population is expected to rise to 30% by 2030 before rising to 38.4% by 2065.¹ Further, comparative statistics underscore that even among high-income countries, Japan's elderly population rate is high (see Figure 1).

¹ <http://www.ipss.go.jp/s-info/e/pssj/pssj2019.pdf>

Figure 1: Percentage of Population Age 65 and Above, 2019



Source: World Bank

The average life expectancy in Japan is 84 years, which is among the highest in the world. Meanwhile, the country's fertility rate has been on a decline, averaging 1.42 births per woman in 2018 after rising slightly for a few years.² In 2019, the estimated number of babies born hit a record low in the country, at 864,000 births.³ As a result, Japan's population is expected to decrease to around 88 million by 2065 from 124 million in 2018.⁴

Conduits for Negative Fiscal Impact

Japan's graying cohort and future population projections translate to an increasing social security burden. While this trend impacts spending, the government's revenue base is also affected by fewer young workers entering the labor market, meaning productivity and government revenue could falter. Moreover, reductions in the labor force will likely mean greater offshoring of production and lower productivity rates, which also negatively impact employment and tax mobilization.

Policy Solutions Slow the Adverse Trend

Japan has introduced targeted policies to combat these demographic challenges, including support toward increasing the number of women in the country's workforce. In 2013, the government introduced the "Womenomics" policy, which incentivizes businesses to hire and promote female employees. Evidence suggests that it is working, with the percentage of Japan's female working population in their prime working years (age 25 to 54) increasing to 80% in 2019 versus 73.6% in 2013.⁵ The government has also expanded childcare access throughout the country by creating free preschool education, making it easier for mothers to join the labor market. Japan has also attempted to increase the share of foreign workers by loosening its migrant labor laws and allowing up to 350,000 foreign workers to enter the country over a five-year period.⁶

² https://data.worldbank.org/indicator/SP.DYN.TFRT.IN?most_recent_value_desc=false

³ <https://www.reuters.com/article/us-japan-population-births-idUSKBN1YS0FX>

⁴ <http://www.ipss.go.jp/s-info/e/pssj/pssj2019.pdf>

⁵ <https://www.oecd.org/>

⁶ <https://www.migrationpolicy.org/article/japan-labor-migration-reforms-breaking-past>

Conclusion

Japan's demographic issues are important to its sovereign credit profile. While trends are worrisome, steps undertaken to mitigate the aging and shrinking of the population, could stem the credit impact, if successful. Japan's adverse demographics underscore the importance of ESG factors to sovereign risk analysis. KBRA endeavors to incorporate an analysis of all risk factors into its credit ratings and research, including ESG considerations.

Contacts

Joan Feldbaum-Vidra, Managing Director, Sovereigns
+1 (646) 731-2362
jfeldbaumvidra@kbra.com

Emilie Nadler, Associate, ESG
+1 (646) 731-3386
enadler@kbra.com

Andrea Torres Villanueva, Associate, ESG
+1 (646) 731-1238
andrea.torresvillanueva@kbra.com

William Cox, Global Head of Corporate, Financial,
and Government Ratings
+1 (646) 731-2472
wcox@kbra.com

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