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THE OUTLOOK FOR ABENOMICS' THIRD ARROW

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Abenomics has aimed to break free of deflation through a bold monetary policy (the first arrow) and a flexible fiscal policy (the second arrow), and attention in Japan and abroad is now turning toward its third arrow. To set the Japanese economy firmly on the path to recovery, private-sector demand must be steadily expanded in terms of consumption, investment and exports and competitiveness improved to boost the potential growth rate.

Some overseas investors are skeptical of this third arrow. Prime Minister Abe has declared his determination to break through the solid bedrock that is Japan's regulatory regime, but reforming bedrock-like regulations is no simple matter. Deregulation is well known to be politically difficult not only in Japan but in all developed industrialized nations, and the ability of the Abe administration to see this through will be put to the test.

Many people believe the third arrow to be “a growth strategy,” but it must be pointed out that this is incorrect; the third arrow of Abenomics is “a growth strategy to stimulate private-sector investment”. If it were simply a growth strategy, supply-side policies would come to mind: pursuing regulatory reform and opening markets to more efficiently allocate resources and encourage innovation. Adding “to stimulate private-sector investment” includes demand-side policies as well.

An important point in understanding the Japanese economy at present is that balance sheet adjustments in the private sector are over. During the “lost two decades” following the bursting of the economic bubble, households, companies and financial institutions all suffered from overloaded balance sheets.

However, households, companies, and financial institutions substantially improved their asset quality during this 20-year adjustment. Put simply, there is an abundance of funds available for investment, in sharp contrast to the situation in the US and Europe, which suffered in the adjustments that took place after the Lehman Shock and the euro crisis.

How will these private-sector funds be mobilized to stimulate investment? This is a key aspect of Abenomics’ third arrow. A breakout from deflation is crucial because of the difficulty of stimulating private-sector investment as long as deflation continues.

Looking at the reforms that the Abe administration has tackled, there are sectors emerging in which large-scale investment can be anticipated. One typical example is reform of the electrical power system. Large-scale investments in new power plants and retail business can be expected if electric power generation and transmission are further segregated and if retail sales are liberalized. Significant developments can already be seen within the purview of

Tokyo Electric Power Company as it is compelled to undertake extensive reforms.

Japan's hosting of the Olympics and Paralympics will also provide major opportunities for private-sector investment. Many companies have begun to think seriously about what they will do leading up to the 2020 Olympics, and the government is no doubt aware of the importance of encouraging the private sector's latent willingness to invest.

The import of demand-side measures has been noted, but it is by no means the case that supply-side reforms are inconsequential. In fact, the market is closely monitoring whether Japan will begin these reforms in earnest. The key point here will be where these reform efforts are directed.

Drilling head-on into the bedrock of Japan's regulatory regime will take time. There should be weak points in this bedrock, however, and it is important to seek out these points for reform. For instance, revamping the labor market is vital, but poses many politically difficult problems. Hopes are thus converging on approaches that zero in on promoting active roles for women, as a narrower focus enables more intensive reforms. Limited space precludes an in-depth examination of these "pressure points" for reform, but corporate tax reform and TPP negotiations are among the more prominent.

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