Abenomics: Third arrow in question

The recent election win by Shinzo Abe is likely to provide further impetus for the Japanese government's package of economic reforms termed "Abenomics". Takeshi Kanamaru, Portfolio Manager with the Japanese Fixed Income Investment team from Manulife Asset Management shares his views on the likely impact of the "third arrow" of Abenomics.

Following the Liberal Democratic Party's landslide victory in a December 2014 snap election that was widely viewed as a referendum on Abenomics, it can be argued that Prime Minister Shinzo Abe now has a mandate to accelerate implementation of the economic growth strategy – including the much-anticipated third arrow of structural reform. However, market estimation on the chances of success for the third arrow are rather low.

This is because there is a general perception, particularly in the media, that the first and second arrows (monetary and fiscal policy easing) have primarily benefitted large corporations or wealthy individuals and that Abenomics has not provided much real benefit to the ordinary taxpayer. Abenomics may have even harmed them to some degree, due to higher import prices as a result of a weaker Japanese yen and the April 2014 consumption tax hike.

Review of Abe's growth strategy

Economic and structural reform has been the central premise of Abe's growth strategy in the two years since he came to power. However, the pace of implementation of these reforms has been mixed. Abe was able to implement some policy changes immediately after gaining power, while others have taken longer to be put into effect.

Figure 1 highlights the major components of Abenomics and their current status. As illustrated, there has been some measure of progress for each component and some of the proposals are close to implementation. Included in the latter group are corporate tax cuts and rebalancing the Government Pension Investment Fund's (GPIF) asset allocation to increase its equity exposure, both of which have attracted a lot of attention in the markets.

The rest of the growth strategy, however, is a long way from implementation and this is why it is argued that the third arrow's reforms are not moving fast enough. Such slow progress is unsurprising though, as many of the proposed reforms raise potential conflicts of interest. This is particularly true when dealing with proposed policy reforms, which are likely to face fierce resistance from the parties whose interests may be negatively affected.

For example, the Ministry of Finance is unlikely to agree to a reduction in the corporate tax rate unless they can secure an alternative source of tax revenue in return, meaning that a series of long-lasting negotiations are inevitable. Similarly, agricultural cooperative associations – cooperatives that are backed by the nation's rural communities and that have strong political influence – are also unlikely to relinquish their authority or allow privatisation. Finally, the US and Japan have been unable to reach a compromise over the inclusion of certain trade items in the proposed Trans-Pacific Partnership (TPP) free trade agreement, including pork and beef exports from the US and car exports from Japan.

Figure 1: Major initiatives under Abenomics

Category	Policy change	Current status
Pensions	GPIF asset allocation	Guideline changed (equity exposure > 50%).
Corporate	Improved corporate governance	Newly introduced stewardship code accepted by 157 institutional investors. Corporate governance code drafted.
	Lowering the corporate tax rate to around 20% over several years	Effective rate to be lowered to 32.11% in FY2015 and to 31.33% in FY2016.
Deregulation and innovation	National strategic special zones	Established general policy. Selected 11 zones in total. Necessary legislation expected to pass in FY2015.
	Robot revolution	Committee formed. Established general policy.
Labour force	Higher participation by women	Number of female employees increased by 840,000 over past two years. Aim to increase number of kindergartens. Aim to increase the percentage of female managers to 30% by 2020.
	Foreign employment	Relaxation of requirements under discussion.
	Improving working style	Introduction of white-collar overtime exemption under discussion.
Trade and industry	Trans-Pacific Partnership	Pending due to disagreement between US and Japan over certain trade items.
	Agricultural industry reform	Reforming agricultural cooperative associations.
	Electricity	Retail deregulation planned in 2016. Industry overhaul planned in 2020.
	Healthcare	Deregulation of medical treatment and introduction of “mixed billing” for patients under discussion.
	Tourism	Foreign tourists visiting Japan reached a record 13.4 million in 2014. Relaxation of visa requirements for some ASEAN countries.

Source: Prime Minister of Japan and His Cabinet, Manulife Asset Management, 2015.

Impact of third arrow on growth

Unlike with the first two arrows, it is difficult to predict the potential contribution of the third arrow to economic growth. In addition, the success of an individual strategy may not necessarily lead to an increase in gross domestic product. The timeframe required to achieve visible results is also likely to be longer, while the media and markets are likely to demand more immediate results. Thus, for policymakers, implementation of third arrow reforms will be the most challenging. However, even after taking these challenges into account, it is fair to say that Abenomics has so far been unable to provide the market with sufficient positive surprises along the way, which is vital for the success of the overall growth strategy itself.

What should we expect in the months ahead?

Our base-case scenario is that we will see slow but steady progress in the implementation of the third arrow going forward. For example, a lower corporate tax rate, albeit a marginal decrease, will be implemented this fiscal year, higher infrastructure expenditure is planned for the Tokyo Olympics in 2020 and further passing of third-arrow-related legislation is expected. On the wage front, strong corporate earnings growth is likely to support wage growth of over 2% in 2015, similar to or even higher than the increase seen in 2014.

Wage growth on an inflation-adjusted basis, which fell deep into negative territory in 2014, is likely to come back sharply into positive territory from April onwards due to lower oil prices and the removal of base-effect from last year's consumption tax hike. While the latter effect is a mere technical phenomenon, the data may be well received by the market.

More importantly, the overall macroeconomic environment is also likely to be supportive, as a number of economic indicators are finally suggesting that the Japanese economy has started to recover from the slump caused by the tax hike last year. Indeed, we believe that the macro economy is crucial to the success of the third arrow as evidenced last year, when the economic slump cast a shadow over not only the economic and inflationary outlook, but also the success of the third arrow. The second half of last year was probably the bottom in terms of sentiment for Abenomics and we expect to see a gradual reversal in sentiment due to a pickup in economic growth.

However, any drastic changes to the growth strategy, particularly those that markets are eager to see, are unlikely to occur and we are likely to continue to hear negative sentiment on Abenomics going forward. From a market perspective, we expect Abenomics to have a neutral impact, as the overall macroeconomic environment is likely to be in better shape than last year. In short, how Abenomics and the third arrow will be assessed will be conditional on the macro economy. With a stronger-than-expected recovery, investors may have a better perception of the growth strategy than otherwise.

Risks ahead

We view the second consumption tax increase planned for April 2017 (delayed from October 2015) as the biggest risk ahead. While the delay itself was helpful for economic growth and supportive of Abenomics, it is likely that the tax hike will have a negative impact on the economy in 2017, resulting in lower economic growth and a setback for Abenomics similar to what we saw in 2014.
