

BELEAGUED BANKER: Bank of Japan Governor Masaaki Shirakawa, due to step down in April, has been grilled in parliament 29 times this year, over the central bank's ineffectual responses to falling prices.

REUTERS/YURIKO NAKAO

Central bank executives are preparing a radical plan to pull Japan out of its deflation doldrums.

The Bank of Japan's 'big bang'

BY LEIKA KIHARA
TOKYO, NOVEMBER 30, 2012

Bank of Japan Governor Masaaki Shirakawa was feeling the heat in February when he was summoned to parliament five times to explain what he planned to do to get Japan out of its deflation doldrums.

Shirakawa tried to defend his cautious approach to easing monetary policy, but his tremulous voice

was often drowned out by jeers from the benches. "We need a new governor," one MP shouted during one session. Some angry lawmakers even questioned whether the Bank of Japan should retain its independence from the government.

Shirakawa had been opposed to another round of policy easing, though most members of his policy

board were actually arguing for it at that time, according to sources familiar with the bank's internal discussions.

The threat from lawmakers to withdraw the BOJ's charter granting its independence was what changed his mind, the sources said. So the central bank surprised the markets in February by setting an inflation target for the first time of 1 percent and announcing a \$122 billion increase in its asset-buying programme.

Those five days of intense grilling and the ones that have followed have been among the most intense ever faced by a Japanese central bank governor. Shirakawa has been summoned 29 times so far in 2012, a decade-long record. And the pressure is having a big impact: it was the catalyst for a radical rethink in central bank policy. The full effect of that pivot is expected after April when Shirakawa is due to step down, according to more than a dozen interviews with those involved in the process.

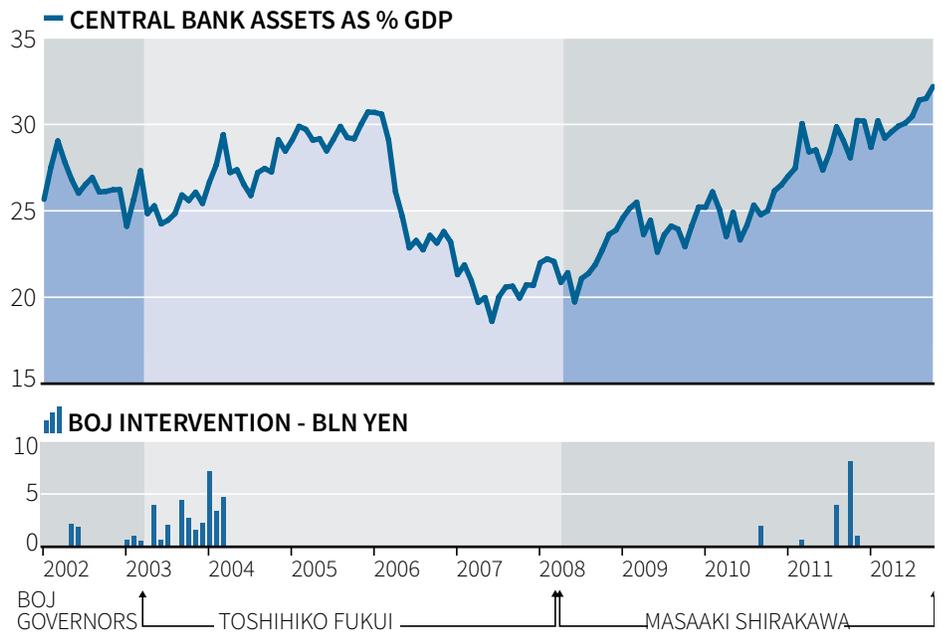
"The central bank, as an institution, was under threat and people there were getting pretty desperate, feeling that something had to be done," said a former BOJ official who remains in touch with central bank executives.

The 63-year-old Shirakawa, a University of Chicago-trained economist, insists monetary policy can have only a limited impact in the battle against persistent deflation that has come to define two decades of Japan's economic stagnation. Pumping unlimited amounts of cash into the banking system or underwriting government debt, the solutions pushed by his critics, could thrust Japan into a financial crisis, he says.

But the terms of the debate are already changing within the BOJ's nine-member policy board, where Shirakawa is now outflanked by newcomers who pushed

Ballooning balance sheet

Japan sells yen, expands balance sheet to revive growth



– unsuccessfully for now – for a bolder commitment to an ultra-easy policy last month, minutes released by the board in November showed.

Members of the BOJ's elite monetary affairs department have been drawing up plans for a bolder set of policy options since late last year, people with knowledge of those discussions say.

One unifying concern, many of those interviewed say, is a belief that in order to keep lawmakers from undermining its legal independence the BOJ needs to step into uncharted territory by running an ultra-loose policy for years to come.

Masaaki Kanno, a former BOJ official and now chief economist at JPMorgan Securities in Japan, said Shirakawa will go down in history as the last "normal" governor of the central bank.

"Shirakawa is unpopular because he tells the hard truth people don't want to hear," Kanno said. "He may not necessarily be the best cheerleader, but then, do we really

want the central bank governor to be just a good cheerleader?"

Shirakawa has also become a lightning rod. With a series of headline-grabbing comments that jolted financial markets, Shinzo Abe, the former prime minister whose Liberal Democratic Party (LDP) is favoured to return to power after a nationwide election on Dec. 16, has made BOJ bashing a centrepiece of his campaign.

Abe has called on the BOJ to set an inflation target of at least 2 percent – doubling its current target – and to commit to open-ended monetary easing. Short-term interest rates should be set below zero, he has said, and the central bank should stand ready to buy all the bonds needed to finance public works investment from the market – an extreme step economists warn is dangerously close to "monetising" debt, or directly underwriting debt from the government.

If needed, Abe also says, the 1998 law that granted the BOJ its long-sought independence should be rewritten.

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Bank of Japan at a turning point?:
<http://link.reuters.com/gut34t>



CHIEF CRITIC: Shinzo Abe, the former prime minister whose LDP is favoured to return to power after Dec. 16 elections, has made BOJ bashing a centerpiece of his campaign. **REUTERS/TORU HANAI**

Proposals to rewrite the law governing the BOJ first came from a number of junior Democratic Party lawmakers who formed an “Anti-Deflation League” in 2010. Initially seen as a fringe initiative without real chance of succeeding, their ideas gradually drew allies from other parties and has become a cross-party movement, winning endorsements from party heavyweights such as Abe.

As a 130-year-old institution, the BOJ is proud of its traditions and of having been on the right side of Japan’s modern history. Visitors to the bank’s hulking Meiji-era headquarters are told how the central bank had the foresight to buy one of Japan’s first elevators – and a vault that withstood the bombing of Tokyo by the U.S. military.

They are sometimes shown a portrait of Korekiyo Takahashi, a former BOJ governor and later prime minister, who stands as something of a martyr for economic policy. Known as Japan’s Keynes, Takahashi advocated fiscal expansion and an abandonment of the gold standard and is credited with pulling the economy out of the Great Depression. He was assassinated in 1936 by military officers

who blamed him for cuts in arms spending.

The BOJ’s legal independence came only in 1998 after officials had argued for decades for more autonomy. The bank’s previous charter, based on the Reichsbank of Nazi Germany, was enacted as part of Japan’s World War Two-era mobilization.

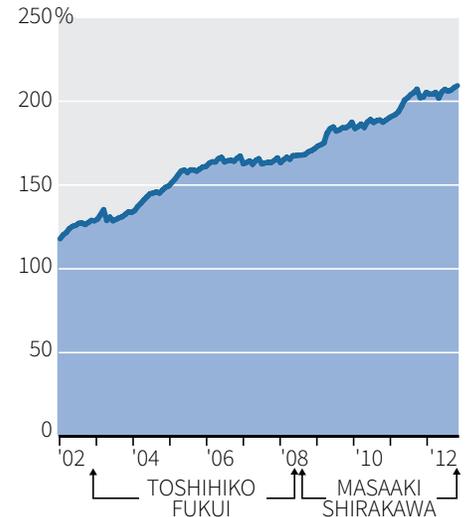
Its independence was granted in part because of a string of financial scandals and the fallout from the collapse of Japan’s asset bubble in 1991. The charter states the BOJ’s objective is to pursue “price stability.” But Japan’s long bout of falling prices, which began back in mid-1998, has actually destabilised the economy, undermining the central bank’s ability to claim the intellectual high ground. Somewhat like Germany’s central bankers, whose collective memory is seared by hyper-inflation nearly a century ago, Bank of Japan officials were shaped by past bouts of asset bubbles and price inflation – an impulse they found hard to abandon.

In December 2011, a group of the most senior bureaucrats from the Monetary Affairs Department decided it was time for bold

Heavy debt

Public debt has soared under Japan’s last two central bank governors.

DEBT TO GDP



action that would impress both lawmakers and markets alike, with an objective of fighting deflation more forcefully. They were worried that the old approach – doling out monetary stimulus in measured doses at times of heightened market stress, usually coinciding with yen rallies – was no longer working.

Although final policy decisions are made by the BOJ’s nine-member board, the bank’s Monetary Affairs Department hammers out policy options. Nearly all of the 50 or so members of the predominately male group were recruited from the University of Tokyo with degrees in law or economics. All have done stints with other departments at the BOJ before being called in to serve in the inner sanctum of policy.

“It’s a very close-knit society. Most of us have known each other for a long time,” one member said.

Many officials in the current team had their first stint at the bank in the late 1990s when Japan was struggling with a banking crisis that forced the BOJ to cut interest rates to zero.

“Dealing with inflation isn’t really on

BOJ THE BANK OF JAPAN'S 'BIG BANG'

the minds of the younger generation. They seem to doubt whether Japan may ever see inflation driven by economic strength," said a person in regular contact with central bank officials.

Some inside this circle advocate a shock to the system with a "big-bang" increase in government bond buying to the tune of 100 trillion yen (\$1.22 trillion) in one go, instead of the much-criticized baby-step approach of incremental increases, people familiar with the discussions say.

Another idea being floated would have the BOJ buy foreign bonds, a step intended in part to drive down the value of the yen and ease pressure on exporters such as Toyota Motor <7203.T> and beleaguered consumer electronic giants like Sony <6758.T> and Panasonic <6752.T>. Carrying out the latter step would require creating a new fund to give the BOJ legal cover, those familiar with the discussions say.

The emerging shift in central bank strategy carries risks: the BOJ would be expanding its balance sheet at a time when Japan's public debt is already off the charts because of the ballooning costs of providing healthcare and pensions to its rapidly ageing population.

If it goes too far, some worry, it could trigger a loss of confidence and a debt crisis.

But among the firebreaks against runaway price increases is a banking sector that keeps pouring money into government bonds, rather than lending it out, and individuals who continue to save against uncertainty, rather than splurging. The same factors could give the BOJ more room to buy government bonds aggressively without igniting panic-inducing price increases, or so the argument goes.

"ALWAYS SUNSET"

Those who have worked for the soft-spoken Shirakawa describe him as a workaholic and a perfectionist. His few pleasures outside work include listening to the music of the Beatles and catching an occasional movie. A recent favourite: "Always Sunset on Third Street," a 2005 drama that captures Tokyo on the cusp of economic boom in 1958.

“It will certainly have an effect on who will be chosen as governor.”

Hideo Kumano

chief economist at Dai-ichi Life Research Institute

Shirakawa joined the BOJ in 1972, months before inflation began sharply rising to near 25 percent. The chaos of those months around the oil price shock was a formative experience for him, as was the "asset bubble" that formed in the late 1980s, people close to him say.

He was among the cadre of BOJ officials who masterminded the central bank's previous spell of quantitative easing, which involved pumping vast amounts of money into the financial system. That spell lasted for five years until 2006 and helped Japan emerge from a domestic banking crisis. But he remains wary of the risks of that policy.

Shirakawa declined to be interviewed for this story.

One worrying trend Shirakawa and others have cited to support their caution over easing monetary policy was that much of the money the BOJ has injected into the economy recently has simply been piling up in bank accounts, rather than feeding into the productive economy via bank loans. That poses the risk of inflating financial assets, if the account holders plough it into stocks.

Until the mid-1990s, cash and deposits held by companies and households were around 1.1 times the size of Japan's GDP.



NEW APPOINTEES: The most recent appointments to the central bank's nine-member policy board, Takahide Kiuchi (L) and Takehiro Sato, are both strong proponents of an easing policy to fight deflation. Takahide headshot is **REUTERS/ISSEI KATO**, Takehiro headshot is **REUTERS/YURIKO NAKAO**

BOJ THE BANK OF JAPAN'S 'BIG BANG'

They have now grown to 1.7 times GDP, the highest among major economies.

The real problem is that the economy has been running below its potential for years, according to a paper published in July by a team of BOJ researchers. They identified the yawning “output gap” as a key factor behind Japan’s long-running, mild deflation.

Market and consumer psychology was one reason for the weak output and falling prices, the study concluded. Japanese companies and consumers had come to expect prices would fall and were behaving accordingly, the study noted. In fact, inflation expectations had been in retreat since 1990 and plunged in 2008. The BOJ researchers believe expectations of falling prices could become dangerously self-fulfilling.

Advocates of an ultra-easy monetary policy argue that cycle could be broken by pumping a river of money into the system – economist Paul Krugman, a commentator Shirakawa is said to admire -- has urged the BOJ to do just that and “credibly commit to being irresponsible”.

“AMAMIYA MAGIC”

Masayoshi Amamiya was a key figure in the Monetary Affairs Department group that is overhauling BOJ policy. He oversaw the division until May this year when he was sent to head the bank’s Osaka branch, a step expected to set him up for an eventual stint on the bank’s policy board.

A 57-year-old fan of the music of Bartok and Prokofiev, who jokes he feels more comfortable talking about classical scores than monetary policy, won praise for bringing a newfound flexibility to BOJ policy since the previous round of quantitative easing. Admirers inside the bank refer to “Amamiya magic” for his skill at handling communication with lawmakers, and coming up with creative banking ideas.

Amamiya was at the centre of deliberations leading up to the BOJ’s surprise easing in February, when it announced an inflation target of 1 percent and raised its



BANK INDEPENDENCE: The 130-year-old Bank of Japan only won independence from the government in 1998. Lawmakers have threatened to revoke that charter over its failure to revive the stagnant economy **REUTERS/YURIKO NAKAO**

asset-buying target by 10 trillion (\$122 billion). Amamiya also helped make the case for a follow-up easing in April on the belief that, when necessary, the central bank must aim for a “shock” effect.

The most recent appointments to the policy board -- former economists Takehiro Sato and Takahide Kiuchi -- are also more strongly committed to an easing policy. Both warned on Oct. 30 that the central bank’s consumer price inflation forecasts were too optimistic. Their appointments came after the Diet turned down a nominee --- Ryutaro Kono, an economist at BNP

Paribas -- because lawmakers thought he would not be aggressive enough. Rarely if ever has a government nominee for a board member been rejected in parliament.

Kono’s rejection and the recent board appointments sent a clear message to the central bank that it needed to change, said Hideo Kumano, chief economist at Dai-Ichi Life Research Institute in Tokyo and a former central bank official. “It will certainly have an effect on who will be chosen as governor.”

At the working level, the BOJ is preparing for a leadership change next spring when the terms of Shirakawa and both of his deputies expire. The bank has appointed 50-year-old Shinichi Uchida as head of the Monetary Affairs Department, making him the youngest of the bank’s 15 department heads and surprising many in an organisation where posts are almost universally assigned according to seniority.

Miyako Suda, who served on the BOJ board for a decade before leaving in March 2011, had been Shirakawa’s last dependable ally. Suda stood out as the only woman on

\$1.22 trillion

The amount of money central bank executives are considering for buying government bonds in a “big bang” war on deflation.

the policy board during her tenure, and because she was so open with her dissent.

Suda warned that too much easing might forestall more important economic reforms, such as deregulation and opening up Japanese markets to foreign competition. For Shirakawa, Suda also had been something of a soulmate and sounding board, someone who shared his core set of beliefs, people close to the policy board say.

BRING IN THE OUTSIDER

The pressure for a shakeup at the BOJ has mounted both from the LDP and key members of the ruling Democratic Party. The new generation of BOJ critics mostly started their careers during Japan's lost decades. They have witnessed how fiscal policy tools such as subsidies, tax breaks and massive public works failed to jolt the economy back to life.

As a matter of tradition the top BOJ job long rotated between career central bankers and finance ministry bureaucrats, though BOJ insiders have dominated the post for the past 15 years. Now lawmakers and finance ministry officials are putting on the pressure to bring in someone from outside to replace Shirakawa.

That favours candidates such as Toshiro Muto, 69, a former finance ministry bureaucrat who served as deputy governor from 2003 to 2008 and Kazumasa Iwata, 66, a former deputy governor who now sits on a government panel discussing ways to boost Japan's productivity. Both advocate a radical expansion of the BOJ bond-buying programme and both play down the threat of inflation or another market bubble.

"The effect of non-traditional policy may not be clear, but neither are the side-effects. The chance of Japan seeing inflation flare up soon is small," Muto told Reuters.

The BOJ's post-Shirakawa policies could have global reverberations. If the experiment with radical monetary expansion fails, it would strengthen the opponents of



TSUNAMI OF DEBT: The March 2011 quake and tsunami helped throw the country into recession and the recovery bill has added to the huge pile of government debt.. **REUTERS/HANDOUT**

quantitative easing policies that have been in vogue among central banks across the world. Foes warn of its diminishing returns and risks for long-term financial stability. Success in Japan would have the opposite effect, perhaps ushering in a new era of experimental central banking - with an additional side effect of realignment among major currencies, weakening the yen in a lasting manner.

There is no guarantee the BOJ will succeed. The last time price increases were over 2 percent was in 1992, just after the collapse of the bubble in property and stock prices. That was the end of the boom era when growth had averaged over 4 percent for nearly two decades.

Bolstered by a pioneering round of quantitative easing Shirakawa helped engineer as a working-level official, Japan's economy staggered back to average growth of 1.6 percent between 2002 and 2007.

But the 2008 global financial crisis sent Japan into recession as did the March 2011 earthquake and tsunami. Some members of the BOJ's policy board have warned the third recession since Shirakawa took the central bank's helm may have begun in the past quarter.

Some economists say Shirakawa did well guiding the economy through crisis,

though failing to win allies or communicate effectively with markets and lawmakers. Others are not so kind.

When asked to grade Shirakawa's nearly five-year tenure, economists at major Tokyo banks surveyed by Reuters at the end of September gave him a grade of 60 percent. Twelve of 16 said they expected him to leave when his term ends in April. Most rejected the need to change the BOJ law.

Yasutoshi Nishimura, 50, a LDP lawmaker who is expected to have a big say in the choice of the next BOJ chief, underscores the consensus. "The next governor should be someone who does not have the 'inflation fighter' DNA," Nishimura told Reuters.

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