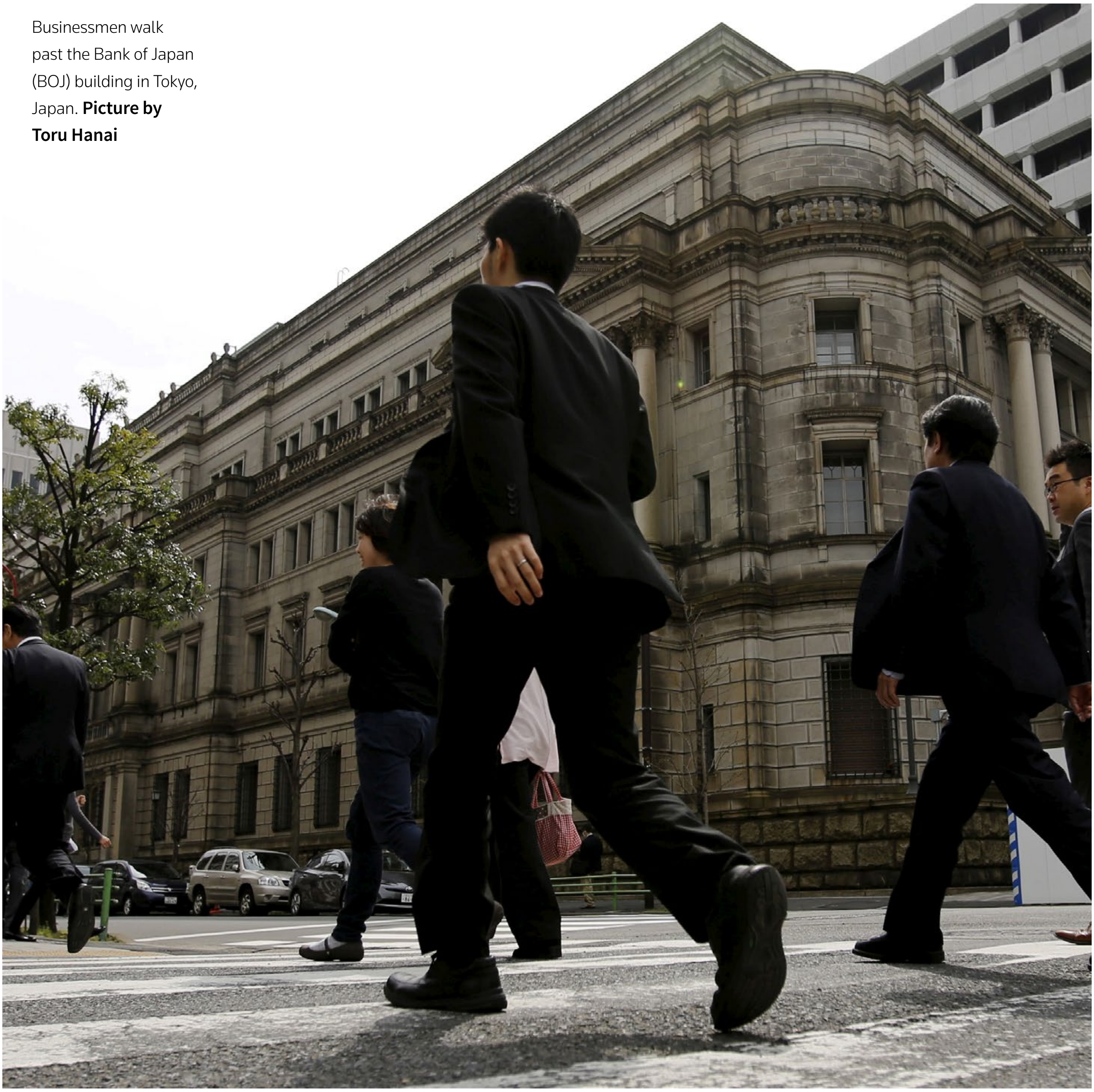

Businessmen walk past the Bank of Japan (BOJ) building in Tokyo, Japan. **Picture by Toru Hanai**

BOJ loses its mojo

BY LEIKA KIHARA AND MINAMI FUNAKOSHI

FEBRUARY 5 — OCTOBER 28 TOKYO

BOJ board among those surprised by negative interest rate plan

BY LEIKA KIHARA

FEBRUARY 5 TOKYO

Just days before the Bank of Japan stunned financial markets with its radical adoption of negative interest rates, members of the central bank's own policy board had also been taken by surprise by the move.

Most of the nine board members were only told of the scheme in the week leading up to last Friday's rate review, according to interviews with more than a dozen officials familiar with the deliberations.

The startling speed and secrecy with which such a major policy shift was executed suggest its intent was more about delivering a shock to markets that would weaken the yen, than about maximising the stimulative impact of further easing.

That would be in keeping with the single-minded style of central bank Governor Haruhiko Kuroda, people who know him well or have worked with him say, but could risk entrenching divisions between BOJ policymakers.

"If you're a board member, you're told about the plan at the last minute," said a former board member, speaking on condition of anonymity. "It's hard to argue against it or draft a counter proposal when there's so little time left."

The BOJ declined to comment on the decision-making process.

Kuroda had been saying for months that taking rates below zero was not a timely option, a position he had repeated as recently as Jan. 21.

But the global market turbulence that greeted the start of 2016 had been threatening two planks of Prime Minister Shinzo Abe's reflationary agenda — rising asset prices and a cheap yen.

Before leaving for the annual World Economic Forum in Davos on Jan. 22, Kuroda instructed his staff to come up with options for further easing of the BOJ's already ultra-loose policy, and report back to him when he returned to Tokyo three days later.

Expanding the bank's massive asset purchasing programme, known as "quantitative and qualitative easing" (QQE), by 10-20 trillion yen ($83-$167 billion) was one option, sources said, though it was quickly ruled out as too weak to shock markets.

Something more arresting was needed, and few investors were predicting negative rates.

"The key was to show people that the BOJ will really do anything to achieve 2 percent inflation," said a BOJ official.

The complex plan, formulated by four top officials from the monetary affairs department, drew on studies of negative interest rate policies in Denmark, Switzerland and Sweden.

By charging interest on just a fraction of banks' deposits with the BOJ, they hoped to ease the pain on financial institutions and get around one of the big problems of twinning negative interest rates with QQE — that the central bank is force-feeding lenders cash it then penalises them for holding.

On his return, Kuroda gave the go-ahead, favouring the idea that combining negative rates and money-printing would dispel market views he was running out of ammunition.

RED LIGHTS FLASHING

At the BOJ's headquarters in Tokyo, monitoring signs alert staff with a flashing red light

> What's very important is to spring a surprise and to appear unwavering in your policy direction. That's how you get the maximum effect on markets.
>
> **Eisuke Sakakibara**
> Senior finance ministry official

to show when a board member has visitors in their rooms on the eighth floor.

In the days leading up to the Jan. 29 meeting, the lights for the three swing voters on the divided board glowed red for hours, as a handful of top officials lobbied furiously for the plan.

Kuroda could count on his two deputies to support him.

Three other board members — market economists Takehiro Sato, Takahide Kiuchi and former banker Koji Ishida — were known to be deeply suspicious of QQE's effectiveness and opposed to more easing.

The lobbying effort therefore focused on the remaining board members — academics Yutaka Harada and Sayuri Shirai, and former Toyota Motor Corp executive Yukitoshi Funo.

As Japanese stocks fell and the currency rose on safe-haven demand, the senior BOJ officials told waverers that failing to act could hurt business sentiment and discourage firms from raising wages, said sources familiar with the discussions.

Already worried about weak consumption, Harada consented.

But Shirai — once a strong advocate of QQE — has grown doubtful of Kuroda's argument that by aggressively printing money the BOJ can spur public expectations that prices will rise. It soon became clear she would vote against.

The fate of the plan thus rested with Funo, a newcomer to the board whose vote was hard to predict.

A week before the rate review, Funo had said he did not think additional stimulus was needed now. But the ex-Toyota man, hand-picked by the government in the hope he would support its radical "Abenomics" policies to beat deflation, also had no strong reason to block Kuroda.

"Funo really held the key to Friday's decision. Now we know he'll probably vote with Kuroda if the BOJ were to ease again," said one source familiar with the bank's thinking.

UNINTENDED CONSEQUENCES

When the board met, Kuroda likely read a statement to members huddled around a round table, sources who know how policy-setting meetings are organised said, arguing the bank needed to act to pre-empt risks from unstable global markets.

The dissenters then made their counter-arguments.

Ishida said that pushing down already low bond yields would do little for the economy, according to the views outlined in the policy statement released after the decision.

Shirai, whose term expires in March, said the scheme was too complicated and could confuse markets, and also worried it could be interpreted as exposing the limits of QQE.

At the end of the meeting, which lasted a fairly typical four hours, Kuroda's proposal passed by a 5-4 vote.

Top bank officials were relieved to see the yen weaken after the announcement.

"It's typical Kuroda style," said Eisuke Sakakibara, who as a senior finance ministry official worked with Kuroda to contain sharp yen swings in the late 1990s.

"What's very important is to spring a surprise and to appear unwavering in your policy direction. That's how you get the maximum effect on markets."

But work on the plan was done so hastily that some operational details were not hammered out in time for the decision.

Critics say Kuroda has failed to explain why combining QQE and negative rates would spur public expectations of future price rises.

Some policymakers also worry of unintended consequences.

Banks may keep cash holdings to a bare minimum to avoid being penalised, which would expose them to the risk of a sudden liquidity squeeze, some of them say.

"There could be accidents, where money gets clogged," said one official. "Nobody really knows what could happen." Ⓡ

Reporting by **Leika Kihara**; Additional reporting by **Sumio Ito**, **Yoshifumi Takemoto** and **Tetsushi Kajimoto**; Editing by **Alex Richardson**.

Under government pressure, BOJ mulling specific steps for easing

BY LEIKA KIHARA AND MINAMI FUNAKOSHI

JULY 29 TOKYO

The Bank of Japan, under pressure from the government, is considering specific steps for expanding monetary stimulus on Friday to address signs of weakness in inflation, people familiar with the central bank's thinking said.

By timing its action with the government's big fiscal spending package, the bank would aim to maximise the boost of its measures on the world's third-biggest economy, which is struggling to escape decades of deflation, the sources said.

The Ministry of Finance is lobbying hard for the BOJ to ease policy further and has prepared a statement it will publish in the event that the BOJ eases.

"We welcome the BOJ's decision and will deploy all necessary policy steps including a scheduled big stimulus package," says a draft statement seen by Reuters.

It is uncertain whether the MOF has drafted the statement because there is a high chance the BOJ will ease policy or only because it is standard practice to prepare one as a precaution in case the central bank shifts policy.

But the fact a draft statement is being prepared suggests the government is keen for the BOJ to ease on Friday.

Economy Minister Nobuteru Ishihara piled fresh pressure on the BOJ, telling reporters on Friday that he hoped the bank will "continue to do its utmost" to achieve its inflation target.

Core consumer prices in June suffered the biggest annual decline since the BOJ embarked on its aggressive stimulus drive in 2013, data showed on Friday.

Some board members may dissent to BOJ Governor Haruhiko Kuroda's proposal for easing due to wariness over the rising costs and diminishing returns of an already massive stimulus programme.

BOJ IN BIND

Pressure for BOJ action intensified with Japan's economy minister calling on the bank to work with the government to spur growth in the wake of Prime Minister Shinzo Abe's announcement of a bigger-than-expected 28 trillion yen ($266 billion) stimulus package on Wednesday.

Worried about their dwindling policy options, many BOJ officials prefer to not ease now. Some have openly voiced doubts over the feasibility of expanding an already massive stimulus programme that has failed to boost inflation.

But analysts say the BOJ has little choice but to ease, with markets almost fully pricing in action and Abe having put the ball into the bank's court by unveiling his big spending plan days before its policy meeting.

"Abe's announcement is a squeeze play on the BOJ. The BOJ has to move now. It is

> Unless the BOJ does something really big, it can't go above the already high expectations.
>
> **Hiroshi Shiraishi**
> BNP Paribas economist

unavoidable," said Hiroaki Muto, an economist at Tokai Tokyo Research Center.

Even if the BOJ were to act, it is unlikely to please market players betting on radical steps such as "helicopter money," or direct central bank underwriting of public debt.

That means the BOJ will likely use its existing policy framework that combines negative interest rates with the huge asset-buying programme adopted in 2013.

The BOJ is now buying roughly 110 to 120 trillion yen of government bonds a year to meet a pledge to expand the total amount of its JGB holdings at an annual pace of 80 trillion yen.

Expanding bond purchases further would be a challenge as the BOJ already holds one-third of Japan's entire government bond market.

Still, a sizable increase in bond purchases, combined with an expansion of risky assets like exchange-traded funds (ETF), would be the most likely option if the BOJ wants to shock markets by scale, the sources say.

The option of deepening negative rates from the current minus 0.1 percent is less preferred, as the policy, decided on January, has proven unpopular among the public, they say.

Some analysts aren't quite sure what could happen given Kuroda's history of springing surprises.

The BOJ will take into account the boost to growth from Abe's stimulus package, which means any cut to its inflation forecasts will be small, sources have told Reuters. That makes it hard for the bank to justify acting now.

"It's like trying to read Kuroda's mind — to be honest, we can't say we're very confident (about our predictions) and I think other analysts are the same," said BNP Paribas economist Hiroshi Shiraishi, who sees a 60 percent chance of easing.

"Unless the BOJ does something really big, it can't go above the already high expectations. But if it does do something really big, there's a chance the side-effects and future costs will be really big." ®

Additional reporting by **Takaya Yamaguchi** and **Sumio Ito**; Editing by **William Mallard** and **James Dalgleish**.

BOJ studying options to steepen bond yield curve

BY LEIKA KIHARA

SEPTEMBER 9 TOKYO

The Bank of Japan is studying several options to steepen the bond yield curve, say sources familiar with its thinking, as authorities desperately seek out policy tools to revive an economy that has failed to emerge from stagnation despite years of massive stimulus.

BOJ officials have become increasingly wary of the costs of a flattening yield curve, such as hurting bank profits, especially as its controversial decision to adopt negative rates in January has made matters worse.

Bank bureaucrats are brain-storming ways to cut short- to medium-term bond yields, which affect corporate borrowing costs the most, while pushing up super-long yields from undesirably low levels, the sources said on condition of anonymity.

The options might be debated at this month's rate review as part of measures to fine-tune its massive stimulus programme, they said.

The challenge for the BOJ would be to come up with ways to lift long-term yields, without giving markets the impression it is withdrawing stimulus.

Among ideas being floated is to make the BOJ's bond buying more flexible and offering markets clearer guidance on the future path of policy, the sources said.

"With negative rates now added to the policy framework, the BOJ can combine its tools in numerous variations," said one of the sources familiar with its thinking. "Offering forward guidance could also be very effective."

More radical ideas, such as switching its policy target to interest rates from base money, remain on the table. But there is no consensus within the nine-member board yet on what the most appropriate step would be.

FORWARD GUIDANCE AN OPTION

Japan's yield curve flattened markedly after the BOJ adopted negative rates, surprising policymakers who did not expect super-long yields to fall so much in response to a step aimed at reducing short-term rates.

Many analysts expect the BOJ to ease at its Sept. 20-21 rate review, when it conducts a comprehensive assessment of its policies that will examine why three years of heavy money printing has failed to accelerate inflation to its target.

The assessment will also look at ways to mitigate the rising costs of its stimulus programme that combines negative rates with a huge asset-buying programme.

A flat yield curve benefits companies borrowing money for long-term investment. But it hurts bank profits and household sentiment by making pension investment difficult

> It would be hard to justify buying foreign bonds when there are many domestic assets still available for the BOJ to buy.
>
> Sources

— costs Governor Haruhiko Kuroda recently acknowledged.

"One thing we could consider as a policy option is ways to change the shape of the yield curve," BOJ board member Makoto Sakurai told Reuters, a view shared by at least two other members of the board.

Several ideas to fix this are being discussed internally.

One is to slow the pace of long-term bond purchases but offset the monetary tightening effect by deepening negative rates, the sources said. This would allow the BOJ to argue that taken together, it is loosening policy.

But with January's negative rate decision having proved deeply unpopular among the public, opponents of this idea worry that deepening negative rates now could be counter-productive.

Another idea is for the BOJ to set a timeframe for how long it will keep buying government bonds at the current pace, and leave open the possibility of tapering purchases after that.

By offering such guidance, the BOJ could lower yields for up to 10-years while lifting the long end of the curve by spurring market expectations of future tapering, the sources said.

What options will be chosen depends largely on how the board members weigh the pros and cons of each step, they said.

Many BOJ officials dismiss the idea of buying foreign bonds, arguing that doing so to weaken the yen would infringe on the finance ministry's jurisdiction over currency intervention.

The BOJ could technically buy foreign bonds from domestic financial institutions and describe the step as aimed at supplying yen liquidity, not weakening the yen. But the amount of foreign bonds held by domestic banks is probably too small to have a sizable impact on the economy, the sources said.

"It would be hard to justify buying foreign bonds when there are many domestic assets still available for the BOJ to buy," said one of the sources. Ⓡ

Additional reporting by **Yoshifumi Takemoto** and **Sumio Ito**; Editing by **Shri Navaratnam**

Less QQE, more YCC? With new framework, BOJ braces for long-term battle

BY LEIKA KIHARA

SEPTEMBER 21 TOKYO

Running out of tools to battle external headwinds, the Bank of Japan has opted to set a yield curve control — an idea it has long discussed internally as a future option, but which was considered controversial and technically challenging.

The decision announced on Wednesday was a compromise to ensure there was something for everyone in a fragmented nine-member board — except for two outliers deemed impossible to convince — said people familiar with the BOJ's thinking.

It also suggested that Governor Haruhiko Kuroda no longer had the ammunition to deploy another "bazooka" stimulus and so was shifting the policy framework from shock therapy to one better suited for a long battle against deflation, they said.

"This is clearly a change to prepare for a long-term battle to hit the price target," one source said on condition of anonymity. "It's a modification to make the BOJ's policy framework more sustainable."

The main purpose of the policy overhaul was to abandon the base money target — a symbol of Kuroda's signature "quantitative and qualitative easing" (QQE) programme — in a face-saving way that does not give markets the impression it was withdrawing stimulus.

The target, under which the BOJ pledged to print money at an annual pace of 80 trillion yen, was forcing it to gobble up bonds at an unsustainable pace even as it failed to accelerate inflation to a 2 percent target.

"The idea of conducting a comprehensive assessment was really about ditching the base money target," said another source. "It's tricky, but do-able."

Abandoning the base money target would make the BOJ's bond buying more flexible and open up new options, including setting a long-term interest rate target.

Setting a yield curve target has been among the preferred options for BOJ bureaucrats drafting monetary policy. Supporters say it's an easier step than forcefully crushing yields by buying huge amounts of bonds.

The challenge was to decide which zone of the curve to target, and explain what the desirable yield curve would look like.

After much debate, the bank opted to target 10-year bond yields because of its domestic benchmark status. Instead of setting an explicit cap across the curve, the BOJ would push down short- to medium-term borrowing costs while allowing for a natural rise in super-long yields.

That would address some concerns held by BOJ officials, and shared by Prime Minister Shinzo Abe's administration, over what they saw as an excessive flattening of the bond yield

> If he (Kuroda) sees benefits in changing things, he'll do so without hesitation.
>
> Official

curve that could squeeze financial institutions' already thin margins.

"The BOJ was gradually shifting its focus on the interest rate element of its stimulus," said a third source. "Among the options, topping up bond buying was now the lowest on the list."

CONVINCING THE REFLATIONISTS

Kuroda initially preached the benefits of expanding base money, but gradually backed away and sided with those wanting to overhaul the huge asset-buying programme.

A former top currency diplomat, Kuroda's priority was to halt unwelcome yen gains that would hurt Japan's export reliant economy, sources say. With the BOJ's bond buying reaching its limits, guiding yields lower through direct rate targets appeared a more preferable approach.

Policymakers who work for Kuroda say he is a pragmatist open to new ideas and willing to be flexible on policy. "If he sees benefits in changing things, he'll do so without hesitation," said one official. "He doesn't like making excuses."

In a speech two weeks ago, Kuroda emphasised how the BOJ's policies were pushing down real interest rates. He did not mention the base money target.

In a departure from his earlier approach, he told reporters on Wednesday: "In the short-term, there isn't a clear link between the base money target and inflation expectations."

The challenge was to convince Deputy Governor Kikuo Iwata, a former academic who introduced the idea of setting the base money target, and has insisted that expanding base money was effective in heightening inflation expectations.

Two more board members favoured focusing on the effect of expanding base money in pushing up prices and spurring public expectations that inflation will accelerate. But those backing heavy money printing didn't insist on keeping the base money target, as long as the BOJ kept up the pace of printing money and buying assets, the sources said.

In a likely compromise, the BOJ pledged to keep buying bonds at the current pace even after abandoning the target, and leave base money expansion among future easing options.

Kuroda could count on the support of Hiroshi Nakaso, the other deputy governor, and two other swing voters appeared to have no strong views on ditching the base money target, as long as the bank's ultra-easy policy was in place.

Former market economists Takehiro Sato and Takahide Kiuchi, consistent dissenters to recent easing proposals, were sidelined from the start. As expected, they voted against the shift, warning it would hurt financial intermediation.

While Kuroda sought to dispel market concerns he was running out of policy ammunition, he acknowledged the BOJ was buying bonds in huge amounts, and could slow the pace of purchases.

"With the new framework, the BOJ probably won't use its easing tools so frequently," said a source. "It will probably use it only in the event of a severe yen spike." R

Reporting by **Leika Kihara**; Editing by **Ian Geoghegan**.

BOJ loses bark and bite under humbled Kuroda

BY LEIKA KIHARA

OCTOBER 28 TOKYO

As his term winds down, Bank of Japan Governor Haruhiko Kuroda has retreated from both the radical policies and rhetoric of his early tenure, suggesting there will be no further monetary easing except in response to a big external shock.

In a clear departure from his initial "shock and awe" tactics to jolt the nation from its deflationary mindset, he has even taken to flagging what little change lies ahead, trying predictability where surprise has failed.

This new approach will be on show next week, when the BOJ is set to keep policy unchanged despite an expected downgrade in forecasts that could show Kuroda won't hit his perpetually postponed 2 percent inflation target before his five-year term ends in April 2018.

"The days of trying to radically heighten inflation expectations with shock action are over," said a source familiar with the BOJ's thinking. "No more regime change."

Kuroda told parliament last week that while the BOJ might again stretch the timing for its inflation target, he saw no need to ease at the Oct. 31-Nov. 1 policy meeting.

"There may be some modification to our forecast that inflation will hit our 2 percent target during fiscal 2017," he said, the first time he has offered hints on upcoming projections.

Japan's core consumer prices fell for a seventh straight month in September as household spending slumped, data showed on Friday, reinforcing the view it will take some time for inflation to accelerate to its target.

In the past, the market has learned to expect the unexpected.

In 2013, when the BOJ deployed its massive asset-buying programme, dubbed "quantitative and qualitative easing" (QQE), his shock therapy boosted stocks and weakened the yen.

Further surprises came with an expansion of QQE in October 2014, and then the switch to negative rates early in 2016, which he had denied was an option just days before.

But the law of diminishing returns bought him less bang for each buck.

"When monetary policy options begin to wear out, the shock approach doesn't work any more," said Toshiro Mutoh, former BOJ deputy governor and now chairman of Daiwa Institute of Research.

"That's why the BOJ needs to avoid surprising markets and make its intentions more predictable through guidance."

OUT WITH THE NEW

When inflation gave up the ghost again after initially showing signs of life, the BOJ was

> Yield curve control is an untested policy, so there's uncertainty on how it works.
>
> **Toshiro Mutoh**
> Former BOJ deputy governor and now chairman of Daiwa Institute of Research

forced to revamp its policy framework last month to one better suited to a protracted battle against deflation.

Since then, Kuroda has been jettisoning nearly everything that made his BOJ unique.

He once derided his predecessor for blaming deflation on demographics and Japan's low growth potential, and in 2013 accepted sole responsibility for hitting 2 percent inflation. Now he says monetary policy alone cannot beat deflation and has called for government efforts to boost growth.

Gone are the fixed timeframes he set for hitting that price goal, along with his reassurances that he would do "whatever it takes" to beat deflation.

In a sign that the rising cost of his 80 trillion yen ($765 billion) a year bond buying could discourage further easing, the central bank said on Monday that some regional banks were struggling to earn profits as margins narrowed.

"It would probably take something very damaging to the economy, like a huge yen spike, for the BOJ to ease again," said Masaaki Kanno, a former BOJ official who is now chief Japan economist at JPMorgan Securities.

The BOJ's policy targeting the pace of money printing has been replaced by a complex "yield curve control" (YCC) with two targets — a short-term rate target of minus 0.1 percent and a 10-year bond yield target "around" zero percent.

"It doesn't look like Kuroda's style at all," another source said.

The new framework reflected the outcome of a comprehensive re-assessment of its policies the BOJ conducted last month, which included an unusually frank acknowledgement of what went wrong with Kuroda's monetary experiment.

The BOJ admitted there was no direct link between the pace of money printing and inflation expectations in the short run. It also said its stimulus programme wasn't powerful enough to weather headwinds and heighten inflation expectations.

The make-over could also have driven a wedge between him and some BOJ members who had hitherto formed his majority on a divided board.

Reflationist board member Yutaka Harada and Deputy Governor Kikuo Iwata have both sounded discordant notes in support of bond purchases despite the new framework, while Kuroda has said the pace of purchases could slow if the bank can hit its yield control target with less buying.

All of which strips Kuroda of the assurance he once projected.

"Yield curve control is an untested policy, so there's uncertainty on how it works," Mutoh of Daiwa Institute said.

"It's an enormous new challenge for the BOJ."

Reporting by **Leika Kihara**; Editing by **Will Waterman**.