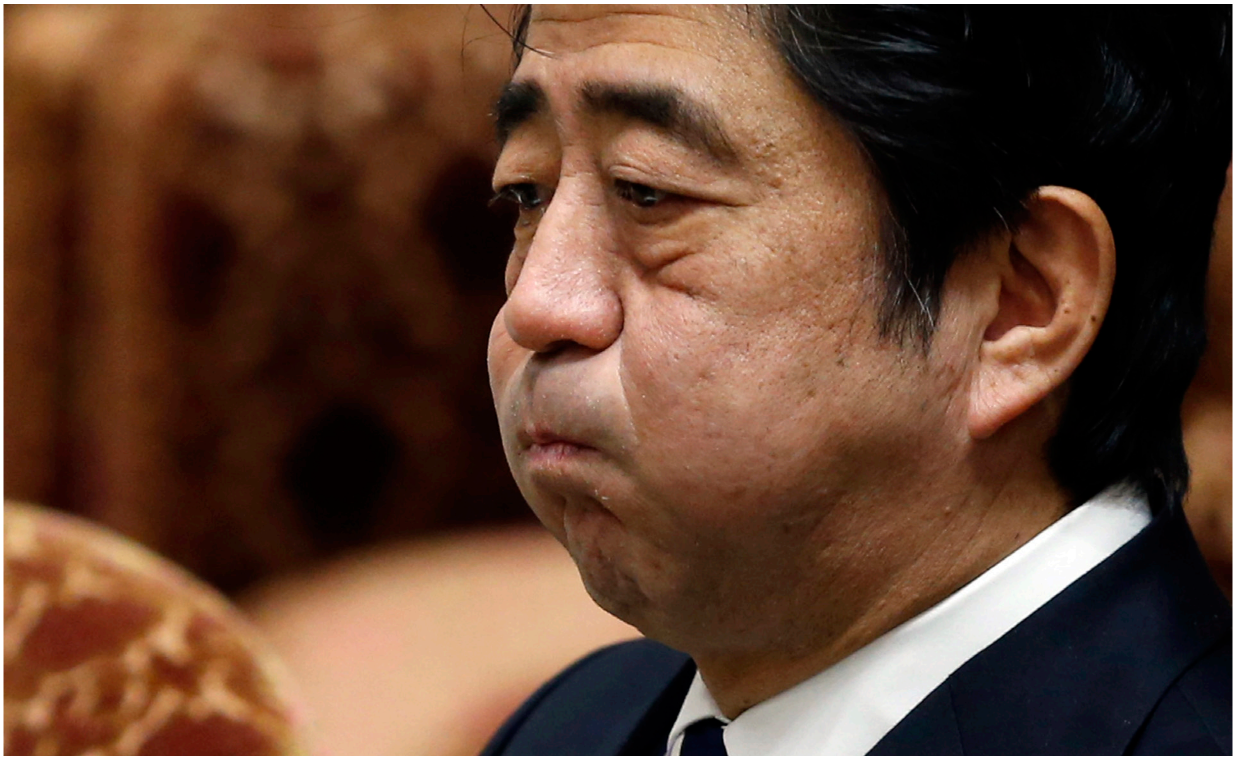

The deeper agenda behind 'Abenomics'

BY LEIKA KIHARA, TAIGA URANAKA, LINDA SIEG, YUKO YOSHIKAWA, TETSUSHI KAJIMOTO, TOMASZ JANOWSKI AND YOKO KUBOTA

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Kuroda's calculus: how the Bank of Japan staged its big bang

Central bank chief Haruhiko Kuroda wanted unanimous support from his board for a radical monetary plan to pull Japan out of the economic doldrums

BY LEIKA KIHARA

April 30 Tokyo

From the moment he assumed the job in March, Bank of Japan Governor Haruhiko Kuroda had a number in mind: 9. The number had nothing to do with the scale of the bank's stimulus plan, which the market had been buzzing about. It was a vote target.

The central bank's policies are determined in votes by its nine-member board, chaired by the governor. And Kuroda wanted all eight of his colleagues to back his controversial plan to jolt Japan out of its long slump by flooding markets with cheap money.

Only weeks before Kuroda joined, the board had voted 8 to 1 against a plan for bold monetary easing. Now, vocally backed by a new prime minister, Kuroda knew the arithmetic had moved in his favor. He was joining the board with two new deputies. They plus two sympathetic veterans on the board gave the new governor a 5-4 edge. But Kuroda wanted unanimous support.

His recipe was radical: double Japan's money supply in two years, and promise to ignite 2 percent inflation in two years, reversing nearly two decades of falling prices. Investors doubted the cautious BOJ had the stomach; Kuroda calculated that a 9-0 victory would show the BOJ now meant business.

In a two-week whirlwind of meetings, according to people with knowledge of those deliberations, Kuroda won over the four holdouts on the policy board for the biggest attack on stagnation by any central bank in recent years. The campaign kicked off at a secret weekend retreat in downtown Tokyo, inside a former BOJ dormitory.

On April 4, the board gave him his 9-0 win. The degree to which Kuroda delivered on his promise, and the extent of his support, stunned financial markets. The impact was exactly according to script: The yen went into a precipitous slide, Tokyo stocks extended a five-month rally, and government-bond yields fell to record lows.

The dramatic vote swing highlighted both the power of Kuroda's nerdy charisma and the influence of a group of senior BOJ officials who had agitated behind the scenes for a more aggressive policy for months. It is far too early to know whether Kuroda will conquer deflation, but the story of how he won his first battle suggests the new governor has galvanized internal support for the long fight ahead. This account is based on interviews with more than a

> Shirakawa was dragged into accepting Abe's call to double the bank's inflation target to 2 percent — even though prices were still falling, and the BOJ's own forecasts showed inflation wouldn't exceed even 1 percent for the next two years.

dozen central bank insiders before, during and after Kuroda's first days at the central bank.

"MR. SPOCK"

Kuroda's central idea is a more determined version of the U.S. Federal Reserve's "quantitative easing," which involved pumping vast amounts of money into the American financial system. His plan calls for the BOJ to roughly double annual purchases of Japanese government bonds to a half-trillion dollars and double its purchase of riskier assets in two years.

The aim is to push down long-term interest rates, encourage companies and individuals to borrow, and induce investors to seek higher returns, in the equity markets for instance.

The 68-year-old Kuroda seems an unlikely change agent. A cerebral retired Ministry of Finance bureaucrat with a master's degree in economics from Oxford, he doesn't pound tables or raise his voice, say people who have worked with him. His analytical bent reminds one former associate of "a Japanese version of the Mr. Spock character" from Star Trek.

But Kuroda has been a relentless critic for 15 years or more of what he saw as the BOJ's lack of decisive action in the face of a stalled economy. That stance was what prompted the new prime minister, Shinzo Abe, to whisk him away from the top job at the Asian Development Bank.

Career BOJ officials got an inkling of what Kuroda had in mind on March 4, when he appeared at his first confirmation hearing in a cramped committee room at the lower house of parliament. Members of the BOJ's elite Monetary Affairs Department watched a closed-circuit video feed from the seventh floor of the central bank's headquarters to take stock of their incoming boss.

It was a month before the new BOJ board's first policy meeting. The bureaucrats had drawn up three scenarios, knowing time would be tight. The first was a relatively tame increase in asset purchases; the second was a bolder proposal to extend the duration of bonds the central bank would buy to five years or longer, up from three years.

By the time Kuroda finished his nearly three-hour session, it was clear both of those proposals were effectively dead. Wearing a dark suit and a black tie with silver stripes, Kuroda appeared subdued. But his tone was authoritative, and confirmed much of what the watching bureaucrats had suspected: Kuroda would come out swinging.

They realized he wanted the bank, over the next few weeks, to come around to the most radical of the set of options they had imagined: to buy bonds of all maturities and boost purchases of riskier assets, such as exchange-traded funds and real-estate investment trusts. The only question was whether the rest of the board would follow the incoming BOJ chief.

Three days later, the BOJ board met for its last policy review under the retiring governor, Masaaki Shirakawa. It stood pat on policy. Overnight interest rates — the bank's primary tool — were already essentially at zero. Shirakawa had been openly skeptical about how much more the central bank could do, especially if the government didn't match fresh monetary easing with structural reforms of the economy, such as cutting red tape and freeing up the labor market.

It was a stance that frustrated some senior BOJ officials, who like Kuroda, wanted a more radical approach. "What we had to change was the incremental approach to monetary policy," one said.

Shirakawa had been under intense pressure the past year to give ground. Abe rode to power in December's election on a campaign that focused on ending Japan's debilitating price declines and bashing the central bank. The vote turned into an unexpected referendum on the BOJ, and the BOJ lost.

In January, Shirakawa was dragged into accepting Abe's call to double the bank's inflation target to 2 percent — even though prices were still falling, and the BOJ's own forecasts showed inflation wouldn't exceed even 1 percent for the

> The board members may have thought they should vote as one to show their determination to achieve 2 percent inflation, or face threats of a revision to the BOJ Law.

next two years. Central bankers hate setting difficult goals: Failure can undermine their credibility with the public. Credibility, in turn, is everything. If a central bank can make people believe inflation is coming, for instance, that very expectation might spur people to buy things before they grow expensive — a self-fulfilling prophecy.

Shirakawa reluctantly engineered an enhanced, "opened-ended" round of quantitative easing, though he set it on timed release. The additional asset purchases would begin more than half a year after he left office.

At Shirakawa's last board meeting, on March 6 and 7, Sayuri Shirai, who had previously shared his caution, proposed starting the open-ended bond-buying immediately. Board member Ryuzo Miyao proposed committing the BOJ to maintaining zero interest rates until the 2 percent inflation target was "in sight."

But without a leader willing to catalyze the growing readiness for change, both dovish proposals were voted down 8-1.

PUSHING ON AN OPEN DOOR

More signs of movement came on March 12. The more conservative of the two nominees to be Kuroda's deputy governors, career BOJ civil servant Hiroshi Nakaso, said in his confirmation hearing the bank "shouldn't be bound to precedents and must think with a new mindset." Nakaso had always warned of the dangers of loading the BOJ's balance sheet with too much long-term debt. Now, he acknowledged the bank could have done more to beat deflation.

Nakaso was cast in the Shirakawa mold but he was a realist. He would accept the tide's turn toward "Abenomics," but would fight for the things the central bank most wanted to preserve. The first was the BOJ's statutory independence, granted in a 1998 law that critics — including, for a time, Abe himself — were threatening to rewrite. Also vital for Nakaso, who as a BOJ bureaucrat had engineered the end to a previous spell of quantitative easing in 2006, was the need to work on an exit strategy for Kuroda's reflation program.

Kuroda's other nominee for deputy, Kikuo Iwata, was, if anything, more committed than his new boss to radical reflationary tactics. The academic economist had branded the BOJ as "The Guardians of Deflation" in a book last year. He now was pushing for the unorthodox idea of targeting not just the size of the BOJ's balance sheet for expansion, but also a measure of Japan's entire money supply.

Kuroda would make no formal contact with the protocol-sensitive BOJ before his March 20 inauguration. But staffers were already hard at work anticipating policies he might want.

Again there were three scenarios. But in a sign of how rapidly the game was changing, even the most modest plan — increasing annual Japanese government bond purchases by 30 trillion yen ($300 billion) — was far more radical than the Shirakawa era, when a big increase was 10 trillion yen. Even that wouldn't be enough for Kuroda, who would also reject a 40-trillion yen plan. He insisted on the biggest option — boosting debt purchases by 50 trillion yen ($500 billion) a year.

Kuroda now had on his side his two deputies and willing accomplices in board members Miyao and Shirai, the former academics who had proposed policy tweaks at the previous meeting. That gave him a 5-4 majority for his big-bang plan.

At that point, Kuroda decided to gather the new board for the first time at a weekend retreat at Hikawa-ryo, a former BOJ residence near the Syrian embassy, people familiar with the deliberations told Reuters about this previously undisclosed meeting. The getaway is the central bank's place of choice when privacy is paramount.

Obscured behind earthen walls, Hikawa-ryo appears to be an oasis of solitude from outside its wooden gate. Inside, Kuroda's focus that weekend was to hear out the doubts of the four BOJ board members who were not yet in the reflationist camp.

One of them was former Nomura Securities economist Takahide Kiuchi, who worried about

> The board was largely agreed on the need for bolder action — even if they were divided on how to do it.

the risks of giving the government a blank check to issue new debt. During its long slump, Japan has run up the largest ratio of debt to economic output of any advanced economy, some 200 percent — double the ratio of the United States and exceeding even the 170 percent of Greece.

In the discussions, Kuroda took care not to appear to be imposing his will in steering the debate, listening carefully and with a reassuring smile to what everyone had to say. "He's a good listener," one BOJ official said.

As he used the retreat to launch his push for a unanimous vote, Kuroda also let it be known he was unwilling to delay the big decision, even if that meant splitting the board vote, according to officials with knowledge of the deliberations.

The board was largely agreed on the need for bolder action — even if they were divided on how to do it, the officials said. Kuroda was helped by the fact that board members were under extraordinary pressure not to appear to be resisting the will of the Japanese people, who had given Abe a strong electoral mandate. Lawmakers had repeatedly warned they would overhaul the bank's legal charter if board didn't wage all-out war on deflation.

"The board members may have thought they should vote as one to show their determination to achieve 2 percent inflation, or face threats of a revision to the BOJ Law," said prominent BOJ watcher Izuru Kato, chief economist at Totan Research.

Moreover, a consensus was beginning to form, and bucking a consensus in Japan takes guts, said Miyako Suda, a former BOJ board member who sometimes voted against boosting bond purchases in the past. "It's tough, particularly if you're voting against monetary easing. People like it when central banks ease policy, so you need courage to vote against it," she told Reuters.

Two of the four unconvinced board members — former market economist Takehiro Sato and banker-turned-policymaker Koji Ishida — to some extent had already supported Kuroda's calls for radical monetary expansion and a departure from Shirakawa's incremental approach.

But Sato was deeply suspicious about incoming Deputy Governor Iwata's calls to target the monetary base — the sum of Japan's cash in circulation plus deposits that commercial banks hold with the BOJ. Sato argued this would essentially be a reversion to the bank's quantitative easing of 2001-2006, an episode that had failed to end deflation.

The other doubter, Ishida, thought more time was needed to deliberate on the potential consequences of such a momentous overhaul of BOJ policy.

A third board member, Yoshihisa Morimoto, a former electric-power executive, wasn't opposed to further easing, but he balked at the sheer size of the package. He questioned whether the BOJ really needed to do so much in a single go.

Kiuchi, the former Nomura economist and debt hawk, worried that loading up the BOJ's balance sheet with so much long-term debt would complicate an eventual exit from an ultra-easy policy. He wanted the BOJ to issue guidance to the market that its massive bond-buying would not mean the bank was monetizing government debt — printing money to repay it.

The retreat ended without the unanimous endorsement of his plan that Kuroda was seeking.

'DOUBLE FOR EVERYTHING'

In the two days leading up to the landmark April 3-4 policy meeting, Kuroda began working the library-quiet eighth floor of the BOJ headquarters, where board members have their offices.

A habitual organization man from his decades at the Finance Ministry and his eight years heading the Asian Development Bank, Kuroda met each board member in his or her office. He sought to allay their remaining concerns, while insisting the bank needed to send a "simple, clear" message with its decision, according to the officials with knowledge of those talks.

He knew the importance of presentation.

> They are burning markets to the ground, reducing them to ashes.

Shirakawa had tended to diminish the impact of his 14 easing decisions by talking down their significance in professorial tones. Kuroda had long experience influencing financial markets from his days leading Japan's currency policy at the Finance Ministry, where he was regularly ambushed by reporters for comment on possible yen-selling interventions.

Presented with carefully calibrated proposals on how much the BOJ would need to boost money supply to achieve the desired level of inflation, Kuroda asked his staff to go big on the numbers. "Can we make it double for everything?" he asked.

By the time he faced the media to announce the policy, he had a simple chart with four bullet points, each with the number 2 highlighted in red: 2 percent inflation in two years; a doubling of the monetary base; and at least a two-fold increase in the BOJ's bond holdings and average maturity.

He later said nothing was "magical" about the number 2, but repeatedly said at his news conference he wanted the new policy to be "easy to understand".

Kuroda got almost everything he wanted. The only hint of dissent was board member Kiuchi's lone — and unsuccessful — plea to water down the BOJ's commitment to hitting its inflation target in two years.

"All the board members talked about this and came to the conclusion that instead of taking incremental steps, the BOJ would decide on all the necessary steps this time," Kuroda told a news conference. Sporting a red tie, he was animated, accenting his points with frequent smiles and hand gestures. "We had that kind of discussion, and I was able to garner everyone's support."

But there wasn't time to forge agreement on everything. The bank failed to set a new measure to show it wasn't simply printing money to repay the national debt. It could agree only to suspend the previous limit, which the new policies broke. And the policy board left operational details undecided — to the consternation of the banks that would be on the receiving end of the BOJ's fire hose of liquidity.

BANKS BLINDSIDED

The BOJ's decision to deluge financial markets with cash sent the benchmark Nikkei Stock Average to a near five-year high. The yen went to a four-year low to around 100 to the dollar. The 10-year bond yield hit a record low 0.315 percent before rebounding.

Major banks were blindsided, in part because they hadn't been consulted on the market implications of the central bank's massive asset purchases. In the past, the BOJ had worked out details of its asset-buying operations after sounding out the banks in detail to cushion the potential market impact. The central bank skipped that process this time because of Kuroda's urgency in getting his big bang plan approved at his first board meeting.

When the BOJ summoned executives of major banks for a meeting on April 11, the bond market was in gyrations. Some bankers complained the BOJ was on the verge of crowding them out of the 900-trillion-yen JGB market, making it harder for banks to buy the bonds they have relied on during a decade of slow growth as a safe-haven substitute for loans.

"It's actually scorched-earth tactics," said Hideo Kumano, a former BOJ official who is now chief economist at Dai-Ichi Life Research Institute in Tokyo. "They are burning markets to the ground, reducing them to ashes."

BOJ officials were shaken by the financial industry's criticism, acknowledging that the rush to get the plan out had left the market in the dark about the operational details of the $500 billion in annual bond purchases. But there was no going back.

"Basically, we're coming up with the specifics as we go along," one senior central bank official said. Ⓡ

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The agenda behind 'Abenomics'

Premier Shinzo Abe is riding high on his popular recovery program. But the true aim of him and his backers is to remake Japan's pacifist post-war order

BY LINDA SIEG, YUKO YOSHIKAWA AND TETSUSHI KAJIMOTO

May 24 Tokyo

When ill health and political gridlock forced Shinzo Abe to quit after one dismal year as Japan's prime minister, his pride was dented and his self-confidence battered.

One thing, however, was intact: his commitment to a controversial conservative agenda centered on rewriting Japan's constitution. Conservatives see the 1947 pacifist charter, never once altered, as embodying a liberal social order imposed by the U.S. Occupation after Japan's defeat in World War Two.

"What worries me most now is that because of my resigning, the conservative ideals that the Abe administration raised will fade," Abe wrote in the magazine Bungei Shunju after abruptly quitting in September 2007. "From now on, I want to sacrifice myself as one lawmaker to make true conservatism take root in Japan."

Less than six years after his humiliating departure, Abe, 58, is back in office for a rare second term. He is riding a wave of popularity spurred mainly by voters' hopes that his prescription for fixing the economy will end two decades of stagnation. The policy, known as "Abenomics", is a mix of monetary easing, stimulative spending and growth-inducingsteps including deregulation in sectors such as energy.

But interviews with some two dozen allies and insiders show "Abenomics" was a late addition to his platform.

Abe's unlikely comeback was engineered by a corps of politicians who called themselves the "True Conservatives," many of whom share his commitment to loosening constitutional constraints on the military and restoring traditional values such as group harmony and pride in Japanese culture and history.

While the cultural-political agenda is what drove them, Abe and his backers also came to realize that voters cared most about the economy, so this time, they made it the top priority.

"Mr. Abe in his first term put more priority on revising the constitution than on the economy," said Yoichi Takahashi, a former finance ministry official who is an adviser to Abe. "Even now, I think that is the case. But I think he realized that in terms of order of priority, he had to work on the economy first."

Ahead of a July upper house election that his Liberal Democratic Party (LDP) looks set to win, Abe is again floating the conservative political agenda, including constitutional revision, that

> He wants to achieve what he left undone — to break free of the ‘post-war regime.’

drew his core supporters even as he tries to steer a more pragmatic course.

Revising the constitution, though, ranks far down the list of public priorities, polls indicate, and voters are sharply divided over whether to alter the document’s signature passage, the war-renouncing Article 9, to legitimize the military.

Some Abe allies worry that a hasty push for constitutional changes could upset voters who want the focus to stay firmly on the economy — repeating a mistake seen as a key factor in Abe’s first failed attempt to govern.

“He wants to achieve what he left undone — to break free of the ‘post-war regime’,” said Koichi Hagiuda, a lawmaker and special aide to Abe. “What is most symbolic of that is the constitution that was drafted in one short week under (U.S. General Douglas) MacArthur’s Occupation.”

But Hagiuda added: “He has no intention to rush”.

Japan’s security ally, the United States, would likely welcome an easing of the constitution’s constraints on Japan’s military. But Washington worries that Abe’s efforts to strike a less apologetic tone on wartime history will further strain ties with China and South Korea, who suffered under Japan’s occupation and colonization before and during World War Two.

Abe has declined requests for interviews.

HOPE OF REBIRTH

Months after resigning in September 2007, Abe visited Kumano Shrine deep in the mountains of western Japan, known since ancient times as a place of healing and resurrection. Few thought then he would be politically reborn as one of the country’s most popular leaders.

“It is said that if you make a pilgrimage there, you will be restored to life,” said one government source close to Abe. “I said, ‘Let’s go there and you will surely come back.’”

“I urged him many times ... to take some action aimed at becoming prime minister again. But he kept saying, ‘No, no. It’s too soon. The public will not forgive the way I resigned.’”

Yet Abe never abandoned hope of political redemption, his closest advisors from those times say.

“He definitely wanted to be prime minister again,” said Hidenao Nakagawa, who had served as the LDP’s No. 2 official during Abe’s first term. “And those around him encouraged him and told him ‘Your time will come.’”

Abe’s time had appeared to come when the scion of a wealthy political family took office in 2006 at the age of 52, Japan’s youngest post-war premier. Abe was dedicated to conservative ideals imbibed at the knee of his grandfather, former Prime Minister Nobusuke Kishi, and encapsulated in Abe’s 2006 book, “Toward a Beautiful Country.”

A wartime cabinet minister, Kishi was imprisoned but never tried as a war criminal after World War Two. He was premier from 1957 to 1960, but had to resign without achieving his goal of revising the pacifist constitution due to a public furor over a U.S.-Japan security pact that he rammed through parliament.

Just 12 months after taking over as heir to charismatic Prime Minister Junichiro Koizumi, however, Abe stunned the political world by quitting. His term was marred by scandals in his cabinet, a public outcry over lost pension records and a huge election loss that created a deadlock in parliament. He also suffered a severe worsening of his chronic ulcerative colitis, for which he was hospitalized after quitting.

“TRUE CONSERVATIVES”

Soon after his resignation, Abe and other LDP conservatives set up the True Conservatives Association. Its goals were to protect tradition and culture, revise the “post-war regime”, protect national interests and earn international respect.

Central to the group’s world view is a belief that the constitution, drafted by U.S. Occupation officials in February 1946, not only restricted

> After we lost power, we thought that if we did not create a true conservative core, our time in opposition would drag out.

Japan's right to defend itself but also eroded traditional mores by emphasizing individualism and citizens' rights over social harmony and duty to the state.

The association included close allies such as Yoshihide Suga, a former minister in Abe's first cabinet. It formed the core of Abe's support when many LDP powerbrokers thought his future was on the back bench.

"Politically savvy people did not think that he could come back as prime minister," said Michael Green, Japan chair at the Washington-based Center for Strategic & International Studies, whose ties to Abe go back to his stint at the U.S. National Security Council from 2001 to 2005. "The people who pushed his comeback and remained fiercely loyal were not the most influential."

A group of conservative business executives known as the Four Seasons Association provided moral support and advice. Members included Central Japan Railway Co's Yoshiyuki Kasai and Fujifilm Holdings Corp's Shigetaka Komori.

"Mr. Kasai and Mr. Komori thought they needed to nurture a future prime minister from among younger politicians," said former economics minister Kaoru Yosano, who first introduced Kasai to Abe before he first became premier. "After he resigned, they disbanded, but contact and friendship remained on a personal basis. Mr. Kasai and the others were in full agreement that he should have a second chance."

Kasai, 72, is an outspoken critic of China and during the first Abe cabinet served on an advisory panel on teaching of patriotism in Japanese schools. He declined to be interviewed. Komori, 73, is credited with saving Fujifilm from the fate of failed imaging rival Kodak.

Their backing stemmed from agreement with Abe's conservative agenda rather than specific economic policies.

"The constitution puts individual rights too far out in front," said Komori, who with Kasai later became core members of a more recent corporate-executive support group for Abe, the Cherry Blossom Association. "Mr. Abe is extremely sensitive to the merits of restoring that sort of Japanese spirit. I was in great agreement with that," he told Reuters.

RETURN TO THE STAGE

Abe met periodically with a quartet of former cabinet-minister comrades — Suga, Yasuhisa Shiozaki and Yoshimi Watanabe — who called themselves the Abbey Road Group — a pun on Abe's name and the iconic cover of the 1969 Beatles album.

Suga had been working towards Abe's return from the time he quit. His reasons, say some who know him, were as much personal as ideological. "He was a bosom friend," said one political source.

The campaign to bring back Abe gathered momentum in 2009 even as public support for the LDP slid under yet another unpopular prime minister, pushing the long-ruling party towards the opposition for the first time since it was briefly ousted in 1993-1994.

Abe began to emerge from the shadows, traveling to Washington in April 2009 to speak at the Brookings Institution, where he expressed concern about China's military build-up and touted "innovation" as the cure for Japan's economic ills.

His public appearances sparked speculation he was considering another bid for the premiership, a possibility he left open in an interview with Reuters in May of that year.

"I want to receive the judgment of the people in the election, obtain the voters' trust and work towards my next goal," he said then.

Indeed, Abe's close allies say the August 2009 general election, which ousted the LDP after ruling Japan for most of the past half-century, marked a turning point.

Abe went to unusual lengths to ensure he not only kept his own seat in that poll — never really in doubt — but also resoundingly defeated his Democratic Party rival. He pounded the pavement, called on voters at their homes, shook

> The study group advocated revising the BOJ law, and we felt it would be laughed at by world leaders.

hands at shopping alleys — rare activities for former prime ministers with safe seats.

"That was the time I felt that this man definitely intends to try (for the premiership) again," said the government source close to Abe. "He wanted to win by a landslide. I think his intention was to settle the account with the past that way."

Abe did win by a landslide, but the LDP was trounced by the novice Democratic Party of Japan. Now in the opposition, Abe took over leadership of the True Conservatives Association.

"After we lost power, we thought that if we did not create a true conservative core, our time in opposition would drag out," said Seiichi Eto, a founding member of the group and now a special aide to the prime minister. "From that time, we carried out activities like a political party."

PENSIONS AND POCKETBOOKS

While Abe and his allies remained committed to their conservative agenda, the failure of his first administration had taught them one scarring lesson: Voters care more about pensions and pocketbooks than changing the constitution and reviving patriotic education.

The program of drastic monetary easing that became central to "Abenomics" took root in Abe's agenda after the triple disasters of March 11, 2011 — a mammoth earthquake, tsunami and nuclear crisis.

In June of that year, senior LDP member Kozo Yamamoto set up a group calling for a 20 trillion yen ($200 billion) reconstruction program to be funded by debt purchased by the Bank of Japan.

Yamamoto invited Abe to head the group. It later morphed into an association urging the central bank to set a 4 percent inflation target — considered an extreme notion to which the BOJ was staunchly opposed. Abe accepted the role, and through his association with the group and its mentors such as Yale University professor Koichi Hamada, became a convert.

Some of Abe's closest allies, such as Shiozaki, an ex-central bank official in the Abbey Road group, at first opposed adopting what they considered extreme economic views. They particularly objected to a threat to gut the central bank's independence by revising its legal charter if it refused to embark on radical monetary easing.

"What Mr. Yamamoto was saying was a heretical view," one government source said. "The study group advocated revising the BOJ law, and we felt it would be laughed at by world leaders."

By March 2012, however, it was clear Abe supported a bolder monetary policy. Business supporters pushed him to rein in the strong yen, which was battering exporters and pushing output offshore. A big bout of monetary easing might do just that.

Two months later, Abe impressed business executives at an exclusive gathering with his economic analysis. He whipped out color charts comparing the monetary base - cash in circulation plus deposits at the central bank - under the BOJ, the European Central Bank and the Federal Reserve.

He used the prop to put the blame for persistent deflation squarely on Japan's central bank. "I was stunned that he started by talking about the monetary base and deflation," said one source who attended the meeting.

ABE REDUX

In the spring of 2012, Abe's allies prepared for a run at the LDP presidency. Much of the groundwork was laid by the True Conservatives Association, now renamed Sosei Japan (Japan Rebirth). Education reform and revising the constitution topped the list of policies, but the proto-platform also called for a 3 percent inflation target.

Speculation about an Abe comeback grew in April, when he met outspoken Osaka Mayor Toru Hashimoto, who hoped to woo Abe to the new right-leaning Japan Restoration Party he was planning to set up. Abe rejected the overture.

> For all the change in style, those close to Abe say his ultimate goal remains unchanged.

"He told me around last May that he would not join the Japan Restoration Party and wanted to seek a second chance from the LDP," said Watanabe of the Abbey Road quartet, recalling a late night chat in a bar in Tokyo's Roppongi nightspot.

His allies gave Abe conflicting advice over whether he should run in a September vote for leadership of the LDP. Some said it was too soon, others that he should grab the chance.

Ahead of Japan's mid-August summer Obon holidays, when spirits of ancestors are honored, Suga and another close ally visited Abe in his office for another appeal. They told him his chances of victory over two front-runners were at least 50-50. Abe promised to consult his wife, Akie.

He declared his candidacy on Sept. 12, 2012 — five years to the day after quitting — and won the leadership race in a rare second round run-off. Campaigning on pledges to revive Japan's economy and diplomacy, Abe then led his party to a landslide December election win.

Back in office, the prime minister and his inner circle — many from his first attempt to govern — have applied lessons learned from that early failure, when the government message was more cacophony than harmony.

Allies credit Suga, 64, now in the key post of chief cabinet secretary, with running the tight government ship that eluded Abe the first time.

Unlike during his first term, cabinet ministers rarely speak out of turn. Abe is kept front and center in the media through interviews, news conferences and Facebook postings. Abe spends considerable effort wooing media executives but shuns the brief daily stand-up Q&A sessions with reporters that tripped him up the first time.

For all the change in style, those close to Abe say his ultimate goal remains unchanged.

"He intends to be in office for four or five years and in the end, he wants to revise Article 9 of the constitution," said another government source. The pacifist clause, if taken literally, bans Japan from maintaining a military, but has been stretched to allow armed forces now bigger than Britain's.

This time Abe is pushing first for procedural changes to the constitution's Article 96 to lower the hurdle for revisions. Currently, Article 96 requires that amendments be approved by two-thirds of the members of each house of parliament, followed by a majority of voters in a public referendum. The LDP wants to change that to a simple majority in parliament, followed by the public vote.

Critics say such an amendment would leave the constitution vulnerable to easily shifting political winds.

One recent Sunday, the media-savvy Abe made what looked to some like a pitch for the revision at the ballpark. After giving two popular Japanese baseball greats — including former New York Yankees star Hideki Matsui — a national award, Abe got a present of his own — a jersey with the number 96. He donned the shirt and strode onto the field at Tokyo Dome stadium before 46,000 fans and live TV cameras.

Asked later if the number referred to the proposed change in the charter, Abe replied with a smile: "The uniform is because I am Japan's 96th prime minister."

Fixes typo in date in paragraph 45

Additional reporting by **Taiga Uranaka**
Editing by **Bill Tarrant**

Japan's shrinking shinkin: small banks left behind by Abenomics

BY TAIGA URANAKA

September 6 Wakkanai, Japan

First the commercial fisheries began shutting down in this hardscrabble corner of Japan's northern coast. Then tourism fizzled.

Now, the small-town bank that serves Wakkanai, at the tip of Hokkaido, is grappling with a problem common throughout Japan's financial system: to survive years of deflation it has had to stray far from its core mission of making loans, and the easy investment income it has come to rely on is looking shaky.

"There's no demand for productive loans," says Masatoshi Masuda, president of the town's Wakkanai Shinkin bank.

Japan's big banks are starting to feel some benefit from "Abenomics" — the radical policy mix of massive monetary easing, fiscal stimulus and growth-orientated reforms pursued by Prime Minister Shinzo Abe since his return to power last year.

But economic revival feels a long way off in places like Wakkanai, and the country's smaller lenders, unable to make loans to multinational companies or overseas, risk being left behind to face either consolidation or closure.

"We don't feel any impact of Abenomics here," said Katsumi Ogawa, an official at the Wakkanai Chamber of Commerce.

LOTS OF CASH, NO TAKERS

Just like Tokyo's megabanks, Wakkanai Shinkin has plenty of cash. But very few in this port city of 38,000 want to borrow. Wakkanai Shinkin loans out only one-fifth of the $3.86 billion it holds in deposits.

Most of the rest has been ploughed into domestic bonds, a portfolio that makes its balance sheet look more like that of an investment club than a traditional lender.

It's an extreme case that illustrates just how badly warped Japan's banking system has become after a decade and a half of deflation. Facing weak demand for loans, banks have come to rely heavily on investment in bonds, including debt issued by the government — one of the few reliable borrowers.

As a result, hundreds of billions of dollars in savings from Japan's boom years have been cut off from potential investment by companies and entrepreneurs.

Lending at major banks has bounced back this year after more than three years of steady decline, but much of the demand is coming from housing and real-estate investment and to fund acquisitions overseas.

In remote, often depressed areas like northern Hokkaido, prospects for building a loan book can be particularly sparse.

The situation is especially severe for community-focused "shinkin" lenders, which resemble U.S. credit unions and are restricted by regulation to make loans only to local small

> We have to depend on fish and tourists but we're not getting as many tourists as we used to.

businesses and individuals.

"The prospects are grim for shinkin banks to reduce securities investment. There are limits to loan demand growth," said Nobutomo Watanabe, researcher at Norinchukin Research Institute, a Tokyo-based think tank.

FEWER FISH, FEWER VISITORS

The fisheries off Wakkanai, Japan's northernmost city that faces the Russian island of Sakhalin across the Soya Strait, once processed huge catches of Alaskan pollock, a staple of fish fillet sandwiches. But volume is one-seventh of what it was 40 years ago. The industry was hit hard by the Soviet Union's assertion of a 200 nautical-mile fishing zone in 1977.

The town also features twice-daily direct flights from Tokyo, but tourist numbers have dropped by nearly half over the past decade as visitors opted for other Hokkaido locations with easier access and better facilities.

"There is no business here," said Satsu Sato, 77, who runs a bar in Wakkanai that features cheap drinks and free karaoke. "We have to depend on fish and tourists but we're not getting as many tourists as we used to."

With few promising local borrowers, Wakkanai Shinkin was early among Japanese financial institutions to shift its money to Japanese government bonds (JGBs), as well as corporate bonds and other securities, where it could earn more reliable returns.

Over the past decade, shinkin lenders' total JGB holdings have risen nearly two-thirds to 10.6 trillion yen ($106.69 billion), while their corporate bond holdings also rose 50 percent to 16 trillion yen.

Shinkin lenders' average loan-to-deposit ratio is less than 50 percent, compared with more than 60 percent in 2002, according to Shinkin Central Bank Research Institute.

The bigger banks waded deeply into the bond market in 2008 as the financial crisis set in, riding a prolonged rise in JGB prices fuelled by easy monetary policies.

Japan's three megabanks — Mitsubishi UFJ Financial Group, Mizuho Financial Group and Sumitomo Mitsui Financial Group — earned 660 billion yen from JGB trading operations in the year to March 2013, more than seven times what they earned just five years earlier.

"It has been hard to make ends meet with banking profits alone," said Tetsu Komori, president of Sawara Shinkin bank in Chiba prefecture, northeast of Tokyo. He credits profits from securities investments with helping his bank clean up a soured loan portfolio after Japan's asset price bubble burst 20 years ago and helping it to weather the subsequent economic downturn.

THAT SHINKIN FEELING

Japan's dramatic monetary easing, including a bond-buying programme unleashed in April that puts the equivalent of 70 percent of all new JGB issuance with the central bank, has brought volatility to a market that had seemed a one-way bet.

The yield on the benchmark 10-year JGB fell to a record low 0.315 percent on April 5, the day after the Bank of Japan unveiled its radical plan to double the monetary base over two years in pursuit of a 2 percent inflation target.

But yields rebounded sharply in following weeks, making JGB investment suddenly appear far riskier to investors uncertain about how the central bank's surprise move will affect the market over the longer term.

"At the beginning of this financial year (in April), we bought only half the amount of JGBs we had planned," said a senior official at a shinkin lender near Tokyo.

"(Before) the JGB yields were stable, we did not have to do much. But now we are busy, looking for other investments," said the official, who spoke on condition his bank was not named because of the sensitivity of the matter.

Banks unloaded 20 percent of their 108 trillion yen in JGB holdings between end-May and end-June, Bank of Japan data shows.

That has made larger institutions more willing to lend. But it has not made companies more willing to borrow. Japanese corporations, excluding the financial sector, had a massive $2.3 trillion in cash on their books at the end of March.

The stakes are large. Japan's banks and shinkin lenders hold a combined 756.2 trillion yen ($7.71 trillion) in deposits, industry data shows, so a return to the lending ratios of more than a decade ago could make an extra three-quarters of a trillion dollars or more available for investment.

With prospects for new lending limited and the bond market gravy train under threat, the banks face pressure to consolidate.

Japan's big banks, plagued by a mammoth overhang of bad loans in the aftermath of the late-1980s asset price bubble, have already reorganised from 20 so-called city banks into just three megabanks.

Now, under Abenomics, consolidation is picking up among regional banks, which face problems similar to shinkin lenders in economically struggling regions.

Yachiyo Bank and Tokyo Tomin Bank, two small Tokyo-based banks, have begun talks on a merger next year, sources familiar with the matter have told Reuters.

The ranks of shinkin banks have thinned over the past decade and a half to 270 from 400, largely through mergers of institutions in heavily populated areas. But in Wakkanai, bank president Masuda sees no obvious merger partner.

Masuda says Wakkanai's portfolio reflects Japan's economic reality: the national and local governments need more money than private sector borrowers. "We are already have 50 percent of the local loan market," he said. "Simply, it's too high a share."

Additional reporting by **Guo Cheng**
Editing by **Edmund Klamann and Alex Richardson**

Abenomics scorecard: 'A' for early initiative, 'C' for follow-through

BY TOMASZ JANOWSKI AND YOKO KUBOTA

December 16 Tokyo/Daito, Japan

One year into Prime Minister Shinzo Abe's economic revival plan the message from Japan's industrial heartland and economists is clear: he has yet to act on his pledge to stage the nation's comeback as a global economic dynamo.

Abe's recipe of massive money printing, fiscal stimulus twinned with longer-run consolidation and pro-growth policies has already made it into economic vernacular as "Abenomics" and won praise for its initial "print and spend" stage.

But the longer it takes for Abe and his team to follow through with powerful incentives for businesses to take chances, innovate and grow, the bigger the risk that Japan will slide back into stagnation that has dogged it for the past two decades. And with more debt than ever.

The first two arrows of Abe's "three arrow" plan reversed crippling yen strength, buoyed market and business sentiment, got prices moving up after 15 years of deflation and set

> We just frown when we hear about Abenomics on the news over lunch. We're not feeling any effects of it.

Japan on course to outpace most of its peers for two years in a row.

Yet Abe swept to power on Dec. 16, 2012 promising much more, namely to defy the gravity pull of Japan's ageing and shrinking population with sweeping reforms to secure sustained, broad-based growth that has eluded Japan for two decades.

On that count Abenomics has barely left the starting blocs.

A trip to Japan's western manufacturing hub around Osaka shows there is a long way to go before the benefits of Abenomics start trickling further down from exporters, shareholders or high-end retailers.

"We just frown when we hear about Abenomics on the news over lunch. We're not feeling any effects of it," says Shigeru Yamada, 50, president and owner of Yamada Manufacturing in Daito in Osaka prefecture that is home to industrial groups such as Panasonic and Sharp and an ecosystem of smaller suppliers.

Yamada says his firm has replaced a 24-year-old metal folding machine with a new one, its first big investment in seven years, and will be receiving state assistance for that under a simplified government subsidy scheme. Beyond that, nothing has changed for the small family firm that employs 15 people and has won awards for perfecting its production process.

The company expects a loss this year and it has yet to see big manufacturers' optimism reflected in its order books, meaning no pay increases any time soon.

NEGLECTED ENGINES OF GROWTH

Small and mid-sized firms account for 70 percent of Japan's corporate jobs and 40 percent of the value of manufactured goods and parts, so growth will suffer for as long as many of those businesses struggle.

And Japan needs growth to maintain high living standards, cope with swelling ranks of pensioners and the world's biggest public debt burden worth nearly 2-1/2 years of its economic output that looms large over its financial system.

To that end, Abe's government targets real growth of 2 percent per year, more than double the average over the past two decades and more than double Japan's present potential — or the speed at which an economy can grow without excess inflation.

In economists' terms that potential can rise only as a result of an increase in capital, labour or greater productivity in using them.

The International Monetary Fund reckons 2 percent is possible provided Japan tackles all three with deregulation, tax and labour market reforms, bringing more women and elderly into the workforce and easing curbs on immigration.

"If everything that we are suggesting is introduced as a package then medium term potential growth could increase from around 1 percent to 2 percent," said Giovanni Ganelli, senior economist with the IMF Asia-Pacific office in Tokyo.

That is a big if.

Sceptics say demographic headwinds are so strong — the 18-24 age group is a third smaller than two decades ago — that nothing short of a miraculous burst of innovation will do, given significant immigration remains a political and social taboo.

But while Abe has been telling audiences from London's City to Wall Street that "Japan is back", at home many plans aimed at lifting the economy's metabolism have been watered down, delayed or shelved.

THE HARD YARDS

Asked what the Abe administration has done so far to benefit Japan in the long-run, most economists point to decisions to join talks on the U.S.-led Trans Pacific Partnership (TPP) free trade pact and to raise sales tax next April.

The TPP is expected to open some new markets for Japan but also bring more competition at home while the tax hike marks a first serious step to address the sorry state of public finances, a major source of uncertainty.

Corporations are afraid to go into new areas in Japan because once they hire people it is almost impossible to fire them.

The Bank of Japan's monetary stimulus can also help boost long-term growth if it succeeds in defeating deflation, economists say.

"The inflationary environment makes it easier for companies to invest, hire and produce," said Masahiro Kawai, head of the Asian Development Bank Institute in Tokyo.

Some economists also mention the government's efforts to shorten waiting lists at day-care centres to allow more women to return to the workforce, though many say much more is needed, including further changes in the tax code and corporate culture.

But the list of disappointments is far longer.

Nomura Securities economists estimate the government's growth strategy will add just over 0.3 percent to annual output by 2020 — not exactly the comeback Team Abe has been promising.

Scant progress in tackling labour market rigidities and a deep divide between well protected regular workers and a growing army of temporary and part-time staff tops the disappointment list.

Japan's labour productivity, at less than two-thirds of U.S. levels, offers ample room for improvement but companies must first feel more comfortable to hire and train staff.

"Corporations are afraid to go into new areas in Japan because once they hire people it is almost impossible to fire them," says Tomo Kinoshita, chief Japan economist at Nomura Securities.

Yet a proposal to test labour liberalisation in special economic zones got struck out from the final plan.

Decisions on two other items high on corporate wish lists have been pushed back: a cut in corporate tax, now one of the highest in the OECD, and social security reform.

"If anything there's re-regulation happening now," says Takuji Okubo, chief economist at Japan Macro Advisors. He says he learned it first-hand this year when he applied for a subsidy for start-ups as founder of his research boutique.

"The growth strategy is just a way to let the bureaucrats tell businesses how to spend the money."

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