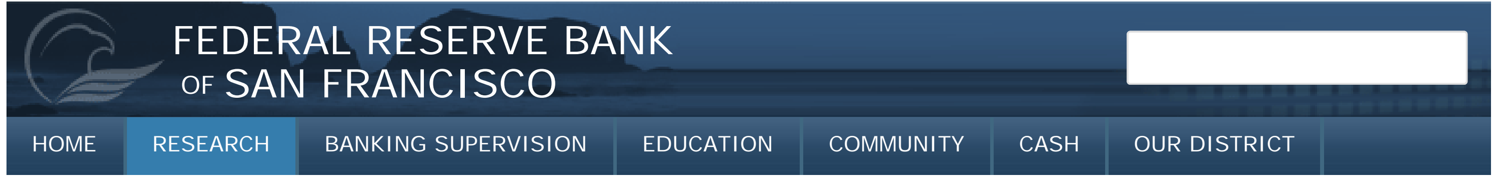

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Japan's New Prime Minister and the Postal Savings System

Thomas F. Cargill and Naoyuki Yoshino

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On April 26, 2001, Junichiro Koizumi was elected Prime Minister of Japan by the Parliament, winning a popular mandate to reform the ruling Liberal Democratic Party (LDP) and lead the country out of a decade of economic and financial distress. Koizumi is known as a maverick—a title of honor he will richly deserve if his proposal to privatize Japan's Postal Savings System (PSS) succeeds: It would represent the most significant and difficult structural change in Japanese finance in the postwar period. The PSS accounts for 34% of household deposits and currently holds about $2.2 trillion in deposits, making it the largest financial institution in the world. The PSS also sells life insurance, which represents about 30% of the Japanese market. Postal deposits, postal life insurance premiums, and other sources of funds support an extensive system of government intermediation finance and programs referred to as the Fiscal Investment and Loan Program (FILP) that target sectors of the economy. The FILP budget is large, equaling 10% to 11% of GDP.

This *Economic Letter* discusses the economics and politics of the PSS from both a historical and a forward-looking perspective. How Japan deals with the PSS and its associated institutions will reveal much about whether Japan is capable of developing a modern financial system that can return the economy to sustained growth and that can meet the challenge of a rapidly changing population.

Japan's Postal Savings System

The PSS was established in 1875, reached maturity in the early 1950s, and existed up to April 1, 2001. It was an official part of the FILP, which is managed by the Ministry of Finance. The nearly 25,000 post offices transferred the majority of deposits and a portion of life insurance premiums to the Ministry's Trust Fund Bureau, which combined these funds with funds from other sources (national welfare and pension premiums and government bonds) and distributed them to government banks and other FILP-financed entities. The FILP-financed entities provided subsidized funds to targeted sectors of the economy.

The PSS and FILP were an important and large part of the old, or pre-liberalization, financial regime. Moreover, two decades of financial liberalization did not lead to reforms in these institutions; indeed, they became more prominent, as Figure 1 shows. The single prominent period of relative decline in postal deposits to total deposits in the latter half of the 1980s reflected the shift of postal deposits to the rapidly rising stock market that was part of Japan's "bubble" economy.

The PSS and FILP avoided reform for four reasons. First, they provided significant advantages to the participants. Post offices relied almost exclusively on *teigaku* time deposits, which provided a no-penalty option to withdraw funds after six months to take advantage of interest rate movements. As a result, *teigaku* deposits offered a higher effective interest rate than any time deposit offered by private banks. Post offices were more convenient, as their numbers exceeded those of private bank branches in every prefecture for much of the postwar period. Funds obtained through the FILP were subsidized, and many borrowers would have been unable to obtain the same level of funding from the private banking system. Second, the FILP as part of the budgeting process was an instrument to maintain and enhance the political standing of the LDP, since local governments and many sectors of the economy were dependent to some degree on funds it provided. Third, the PSS and FILP were so large and pervasive that reform was a daunting process at a minimum and, thus, policymakers were willing to put PSS and FILP reform on the back burner. Fourth, the PSS and FILP were immensely popular in Japan, criticized only by a few academics, private banks, and on occasion, the Bank of Japan. The FILP increased its popularity in the 1990s as funds allocated to business and housing grew more rapidly than other FILP uses of funds, which mitigated the credit crunch at private banks.

Consensus for reform

Two factors motivated reform of the PSS and FILP. First was the economic and financial distress of the 1990s. In times of financial distress, the PSS complicated Japan's government deposit guarantee system and provided incentives to transfer private bank deposits to the PSS whenever the public became concerned about the condition of the banking system. In fact, the PSS in the early part of the 1990s encouraged disintermediation by advertising the safety of postal deposits over private bank deposits.

Second was growing concern over projected demographic trends in Japanese population, which are placing a premium on increasing the rate of return on Japan's high savings rate. Population is projected to start declining by 2008, and the dependency ratio (individuals 65 and over as a percent of the working age population) is projected to increase significantly. Increasing labor productivity through higher yield investment is the only practical offset to a decline in the standard of living (income per capita) that will occur under current conditions. Many would argue that much of Japan's high saving has been wasted because of an inefficient financial system and, more specifically, because of the large amount of funds collected by the PSS and allocated by government financial intermediation.

In 1993, post offices were officially informed to cease appealing to the fears of the public to attract deposits. In 1994, an agreement was reached between the regulatory authorities that the PSS would set deposit rates "close to" private bank deposit rates in an effort to reduce disintermediation. These were not trivial reforms, but the most significant reform commenced June 1998.

The emergence of the "new" PSS and FILP

As part of the June 1998 Laws to Reform Central Government Ministries and Agencies, the formal relationship between the PSS and the FILP changed. Starting April 1, 2001, postal deposits, postal life insurance premiums, national welfare and pension premiums, and so on, are no longer provided to special accounts or government banks through the Trust Fund Bureau. The FILP-financed entities previously dependent on the Trust Fund Bureau must raise their own funds in the form of (a) FILP-agency bonds without a government guarantee, (b) FILP-agency bonds with a government guarantee, or (c) FILP bonds issued by the Ministry of Finance, which essentially represent general government debt. In fiscal year 2001, 20 entities previously financed by FILP will commence selling bonds without a government guarantee; this source of funds will provide only a small part of their funding, and the remainder will come from Ministry bonds. The other entities financed by FILP will continue to be supported by the government through the Ministry of Finance. The new process will be officially referred to in the budget as the Public Funding Mechanism; however, the term FILP will continue to be used to describe the process of allocating funds.

As a result, the new PSS is not required to transfer funds to the Ministry of Finance and for all practical purposes has become a stand-alone government bank. In June 2000, the Ministry of Public Management, Home Affairs, Posts, and Telecommunications announced a strategy to manage postal deposits. The portfolio "in principle" should consist of 80% in "safe" assets (government bonds, etc.), 5% in foreign bonds, 5% in foreign equities, and 5% in domestic equities, and the remaining 5% in money market instruments. The plan to hold 80% of postal deposits in government bonds and other safe assets essentially turns a major part of the PSS into a "narrow" bank.

Real reform?

One could view these reforms cynically and conclude that nothing has changed, especially since financial liberalization has been on the agenda in Japan for over 20 years. A formal model developed by Cargill and Yoshino (forthcoming) demonstrates that there is essentially no difference between the old and new FILP systems if the PSS purchases bonds used to raise funds for entities previously financed by FILP.

A more positive—and possibly more realistic—perspective emphasizes four potentially important elements of reform. First, the new system will be more transparent, and, because entities previously financed by FILP will obtain funds from the capital market directly or indirectly, their lending decisions and monitoring will be more market-sensitive. Second, even though the initial offering of agency-type securities is small for any one entity, they will still be market-sensitive and provide feedback information for future reforms. Third, the PSS system's uses of funds will become more market-sensitive. In the past, the PSS provided funds that were lent at fixed interest rates. In the new PSS, funds will be allocated to assets with market-determined interest rates. This may make it more difficult to rely on *teigaku* deposits and thus narrow the advantage postal deposits have over private bank deposits. Fourth, and most important, the separation of the PSS from the FILP changes the balance of political power. Combined, the PSS and FILP were a major economic and political presence with substantial influence; separated, their influence is reduced.

Practical and second-best solutions

Resolution of the problems of government financial intermediation in Japan must incorporate economic, institutional, and political dimensions, because the PSS and FILP are pervasive throughout Japanese economics and politics. While an efficiency argument can be made that Japan needs to reduce government financial intermediation and privatize the PSS, these changes need to be adopted slowly. Western advice often fails to consider the difficulty of shifting from a state-directed financial regime to a more market-oriented financial regime. The following examples represent some of the views that have been expressed in Japan as a means to reform the FILP and PSS.

Government banks and enterprises. Each government bank and enterprise should be evaluated in terms

of a cost-benefit framework with methods commonly employed to evaluate public projects. The objective is to place each entity into one of three categories: the entity should be abolished, the entity should raise a significant part of its funding in the capital market, or the functions of the entity should be supported in a different manner, for example, directly through the budget.

PSS. The first step might be to make the PSS a separate agency independent of the Post Office and the Ministry of Public Management, Home Affairs, Posts, and Telecommunications. Postal deposits would be invested in government bonds, and the PSS would have the authority to offer on a fee basis its considerable branching network to private banks, securities companies, insurance companies, and other financial institutions to sell financial products on their behalf to depositors. The extensive post office network can then be used to bring an improved mix of financial products to all areas of Japan. The second and more difficult step would be the ultimate privatization of the PSS. A large postal savings system, in the view of many observers, is inconsistent with financial liberalization.

Can Koizumi do it?

Most agree the PSS and FILP require significant reform if Japan is to achieve a modern financial structure. The 1998 reforms set the process in motion. But the process needs strong political leadership. It is too early to predict the degree to which Koizumi will act on his proposal to privatize the PSS, but if he is able to achieve political consensus on privatization, even without a specific timetable, he would dramatically change the direction of financial liberalization in Japan.

Thomas F. Cargill
Professor of Economics, University of Nevada,
and Visiting Scholar, FRBSF

Naoyuki Yoshino
Professor of Economics, Keio University, Tokyo

Reference

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