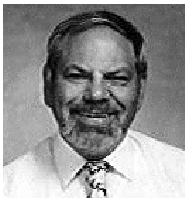
Japan's postal savings showdown

Controversial plans to privatise Japan's vast postal savings system have triggered a political crisis. Thomas F. Cargill and Hal S. Scott examine what is at stake in Japan's snap general election.

Financial system redesign is seldom high political drama, but Japan is the exception. After four years of effort, Junichiro Koizumi, Japan's prime minister, proposed to privatise the postal savings system (PSS), one of the most important elements of the old financial regime. As of 2005, postal savings and life insurance totalled about Y330 trillion, equivalent to about 65% of Japanese GDP. The proposal narrowly passed the lower house by 5 votes on July 5 2005, but lost by 125 to 108 in the upper house on August 8 2005. Koizumi then dissolved the lower house calling for a general election on September 11 2005. The situation has all the elements of a Hollywood showdown between the good guys and the bad guys reminiscent of Gary Cooper in "High Noon" – intense political pressure on both sides of the debate with at least one suicide in the Diet, the fall of a government, and an open confrontation between the "new" and the "old" political forces and the economic institutions which they support.

This article provides a context for understanding recent events in Japan that we believe will be useful whatever the outcome of the upcoming election. We begin with a



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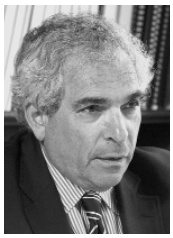

brief overview of the PSS, assess its cost to the Japanese economy, outline the Koizumi proposal, discuss the politics of postal savings reform and evaluate whether the Koizumi proposal goes far enough.

Cheque's in the post

The PSS consists of a system of postal savings and life insurance used to support government banks, corporations and enterprises through a fiscal investment budget determined in tandem with the general government budget (Cargill and Yoshino, 2003). Traditionally, funds in the PSS were transferred to the trust fund bureau of the Ministry of Finance, which in turn distributed the funds to the government entities. Postal savings were the single most important source of funds. After a reform in April 2001, entities previously dependent on the trust fund bureau now raise their own funds in the form of agency securities or participate in special bonds issued by the Ministry of Finance, which are indistinguishable from general government debt. The majority (80%) of postal savings are now invested in "safe" assets such as government bonds, agency securities and local government bonds, almost all backed by government guarantees. On April 1 2003, the PSS was reorganised as a government corporation called Japan Post, managed by a board of directors under the regulatory authority of the government and responsible for mail service, postal savings, and postal life insurance.

The PSS has played an important role in the Japanese financial system and economy. From the start of industrialisation, the PSS, with its extensive branch system of almost 25,000 post offices, brought banking services to rural areas of Japan ignored by the wholesale-oriented Japanese banks. The rebuilding of Japan's infrastructure in the 1950s and 1960s also benefited from the use of PSS funds. During the 1990s bank crisis, postal savings offered an option for Japanese savers who might otherwise have kept funds in cash or sent them abroad and government bank loans ameliorated some of the credit crunch for small business and housing. These benefits came with significant costs and it is debatable as to whether the system had a net positive impact on economic growth, especially considering the political influence on fiscal investment spending. The PSS in fact permitted non-competitive firms, such as in the steel industry, to continue operation and supported public-works projects with low or negative returns. The rapid growth of the Japanese economy for many decades can be attributed to factors other than PSS support, and rapid economic growth masked the inherent inefficiency of the PSS system. Irrespective of this debate, the current and future requirements of the Japanese economy no longer justify the existing size and structure of the PSS. Not only are the current benefits questionable, there is growing evidence the PSS imposes significant costs on the economy.

The PSS:
- limits competition in banking and life insurance markets;
- limits the development of money and capital markets;
- limits development of an explicit deposit insurance system;
- increases systemic risk and moral hazard because the government guarantees postal savings and the assets purchased with postal savings;
- distorts the tax system since taxpayers subsidise non-transparent risks;
- misallocates capital with adverse impacts on economic growth; and
- contributes to political corruption.

Blocking competition

The government-conferred advantages of the PSS retard reforms designed to increase the competitiveness of Japanese banks and insurance companies. It is difficult to see how Japanese banks and life insurance companies can recover from the "lost decade" of the 1990s and achieve long-run sustainability if they are required to compete with the PSS. Postal savings of up to Y10m are guaranteed by the government with no cost to the depositor or PSS, whereas private banks are required to pay a premium for deposit insurance to obtain the same guarantee. In practice, savers in the postal savings system exceed the Y10m limit through the use of multiple accounts. Life insurance policies are guaranteed by the government, whereas private life insurance is guaranteed only by the assets behind the policies. The 25,000 post offices that provide a ready-made branch system are subsidised by the government. Postal savings and life insurance operations, unlike their private competitors, pay no significant taxes and have no capital requirements, and generally face a far lower regulatory burden. Overall, subsidies are substantial and cannot be easily overcome by private institutions. As a result, the PSS can offer services and products at prices that cannot be met by the private sector. This is most clearly illustrated by the fact that the majority of postal savings are held in the form of *Teigaku* ten-year time deposits, which provide a no-penalty option to withdraw funds after six months to take advantage of interest rate movements. The inherent interest rate risk is significant and few private banks would be capable of offering such a deposit on a large-scale basis.

The dominant role of postal deposits in household portfolios limits wider participation in the government bond market. Almost half of all government bonds are held by private financial institutions but approximately 30% are held by the postal savings and postal life insurance system, 15%

are held by the Bank of Japan with the remainder held by individuals and foreigners (Okina, 2003). The small percentage of bonds held by the public is due directly to the fact the public already holds large amounts of government debt in the form of postal savings.

Market distortions

Postal savings distorts Japan's deposit insurance reform in two ways. First, they encourage disintermediation from private bank deposits to postal savings in times of financial distress. This potential exists despite the deposit insurance limit of Y10m because postal savings are direct government debt, while deposit insurance in Japan is relatively new and in the early 1990s was incapable of providing the Y10m guarantee beyond only a small number of depository institutions. Such potential disintermediation would be better dealt with by a stronger deposit insurance system and better supervisory system for private banks. Second, in the absence of financial stress, the PSS establishes a dual system of deposit guarantees in Japan with postal savings and deposits of the large banks perceived as guaranteed by the government. In contrast, the deposit guarantee is more uncertain for the large number of small credit cooperatives and banks, and places them at a competitive disadvantage.

The ready access of funds to government banks, corporations and enterprises provided by the PSS constitutes an implicit government guarantee of the assets supported by these funds. There is increasing evidence that this implicit guarantee has become large and exposes the public to a large tax burden. Doi and Hoshi (2001) estimated that non-performing loans embedded in the government banks and assets held by government enterprises and corporations are equal to about 16% of GDP. This credit risk is directly subsidised by the public in a manner that distorts the tax burden on the Japanese citizen.

Misallocation of capital is generally adverse in any economy. Its negative effect is particularly serious for Japan. Japan's population is projected to decline while the dependency ratio is projected to increase significantly. Simple national income accounting indicates Japan will experience a decline in the standard of living (GDP per person) in the absence of an increase in labour productivity. As long as the PSS absorbs a large part of the flow of funds and allocates those funds to low or even negative-return uses, Japan will not likely be able to deal with the economic impact of a declining and aging population. Japan possess sufficient savings to deal with these issues, but lacks a financial infrastructure to allocate those savings efficiently.

Pork barrel politics

The PSS has been a major element in the dominance of the Liberal Democratic Party (LDP) and pork-barrel politics since the 1950s.

The some 25,000 post offices, often staffed by LDP supporters who openly campaign for LDP members during elections, provide a strong grass-roots support system. In turn the LDP delivers the pork. The complete postal services system, including PSS, has 280,000 full-time and 120,000 part-time employees, together representing 30% of all national government employees. Postal savings and life insurance premiums are used to pay for paved river beds, flood control projects, under-utilised highways and roads, and under-utilised but beautiful single-spanned bridges and so on. These wasteful projects are testaments to the role of the PSS in maintaining LDP power. The influence goes even further when one considers the post-retirement plans of LDP members in the context of the widespread system in Japan of *Amakudari*, or "descent from heaven," reward system, in which party members may retire from office to a position in the PSS.

Koizumi's reform agenda

The first few years of the Koizumi administration were disappointing in terms of major redesign of PSS. However, after the July 2004 elections and a cabinet reorganisation, Koizumi announced that privatisation of the PSS would be the main focus for the remainder of his administration, normally scheduled to end in late 2006. Koizumi appointed Heizo Takenaka, who had demonstrated an ability to deal with difficult financial issues as head of the Financial Services Agency, to take the lead role in the privatisation plan as minister of Japan Post.

In September 2004, the cabinet approved a privatisation plan for Japan Post that was introduced in the Diet as six bills this spring (see box on page 83). The plan was intensely debated with resistance from many politicians, including LDP members, labour unions and local governments.

Defeat in the Diet

Using every available political chip, Koizumi achieved a narrow legislative success on July 5 when the lower house passed the privatisation bills by five votes, 233 to 228. Many in the LDP continued to openly oppose Koizumi, with 37 LDP members voting against the bills with an additional 14 LDP no shows or abstentions.. The bills were intensely debated in the upper house through early August, but despite a threat by Koizumi to dissolve the lower house and call for a "snap" general election, the privatisation bills were defeated in the upper house on August 8 by 125 to 108. Koizumi dissolved the lower house upon the defeat and general elections are scheduled for September 11 2005. Koizumi has promised no less than the complete destruction of the LDP factions opposing his reform.

How to reform the PSS

Koizumi's reform plan, spelt out in six bills presented to the Diet in the spring, provides for the following:

(a) effective April 1 2007, Japan Post would be divided into four separate companies controlled by a holding company (Japan Postal Services Holding Company, JPSHC), responsible for mail service, postal savings, postal life insurance and the network of post offices. The government will initially hold all the shares in the holding company. A postal services privatisation committee (PSPC), consisting of five members with three-year terms of office, will be in charge of the privatisation process and will verify progress with privatisation every three years.

(b) By March 31 2017, the holding company will be required to sell all shares in the postal savings and postal life insurance companies; however, the holding company can immediately repurchase the shares. The buy-back provision, inserted as a compromise, casts doubt on the entire privatisation of PSS. The mail service and network companies will continue to be wholly owned by the holding company.

(c) By March 31 2017, the government will be required to sell shares in the holding company. However, the government will maintain at least a one-third share of the holding company.

(d) The postal office network company will be required to maintain universal postal service, maintain post offices, and be able to utilise post offices for financial services offered by the postal savings and postal life insurance companies.

(e) Existing postal savings and life insurance obligations will continue to be guaranteed by the government and the existing funds in these grandfathered accounts will be placed in government bonds.

(f) Japan Post employees will lose their status as government employees.

(g) The postal saving and insurance companies, as well as Japan Post the holding company, will be taxed as business corporations.

(h) The postal savings and insurance companies will be given licenses enabling them to conduct a full range of business activities, domestically and internationally. The pace at which they can make use of this authority will be determined by the PSPC.

(i) The postal savings corporation will be required to contribute to the deposit insurance system.

The PSS avoided meaningful reform in the past three decades despite an official policy of financial liberalisation. In fact, postal savings and life insurance increased their relative roles in the financial system. The August 8 defeat of the privatisation plan and the political fallout illustrate the extent of the resistance to institutional redesign.

Why has reform been so elusive? The reasons are straightforward. Postal savings are immensely popular with the average Japanese citizen as a convenient and safe financial asset that pays a higher effective interest rate than offered in the private sector, considering the value of the option to withdraw funds from a ten-year time deposit without penalty after six months. Loans supported by postal savings are likewise popular, especially those to small business and housing. The PSS is an important foundation for the LDP, both during their tenure as politicians and for their post-retirement careers. The PSS is large, pervasive and employs large numbers of government workers.

Little public support for reform

The bottom line is that while a strong case based on efficiency can be made for reform, up until now there has been little general support for reform outside of the private banks, the Bank of Japan on occasion, some academics, and the Koizumi government. During the heated debate in the lower and upper houses, surveys suggested the public was having a problem understanding why the postal savings system needed reform. One should not conclude from the public support Koizumi has in his confrontation with the LDP that the public supports a radical redesign of the PSS. The Japanese public knows a good thing when it sees it! Much like social security in the United States there is no sense of crisis among the public and hence it is difficult to overcome the political inertia to change the system. It remains to be seen whether Koizumi can convince the Japanese people that the implicit costs of the system outweigh the perceived benefits. A Koizumi election victory does not ensure the success of his reforms. The election is only for the lower house and the reforms were defeated in the upper house. While there will be increased pressure on upper house LDP recalcitrants if Koizumi wins, the success of PSS reform would still be in doubt if it continues to be opposed by the public.

Even if Koizumi's privatisation proposal were enacted and implemented by its April 1 2017 timetable, it falls far short of reducing the size of the postal and life insurance system or enhancing the modernisation of Japan's financial system.

A private savings and life insurance entity on the scale of the current system with liabilities about 65% of GDP would establish anything but a level playing field with private financial institutions. The postal savings and life insurance companies remain the Godzillas of Japanese finance. We believe any serious reform of the system should impose ceilings on the expansion of the system – such as prohibitions on taking new deposits or issuing new insurance policies. Such limitations are a cornerstone of the Bush administration's proposal for dealing with Fannie Mae and Freddie Mac. In addition, the asset powers of these two institutions should be narrowly circumscribed to investing in safe assets, like government debt, rather than expanded as under Koizumi's proposal. This would avoid putting PSS into even more serious competition with its private counterparts. We would also recommend that PSS be fully subject to risk-based capital and that *Teigaku* time deposits be phased out. The viability of these deposits depends on an implicit government guarantee of PSS against the consequences of losses from interest rate risk. Finally, the system should be fully privatised in form, which requires complete divestiture by the government of any ownership interest in PSS. This would require eliminating government ownership of one-third of the shares of the new holding company, JPHSC, and eliminating authority for JPHSC to buy back any shares of PSS. Without this last change, there is no real privatisation. This point was well summarised by *The Japan Times* editorial of July 6 2005 which said that if the Koizumi proposal became law "…it is likely that Japan Post will be 'privatised' in name more than deed". This is similar to the situation in the United States where large government-sponsored financial firms like Fannie Mae and Freddie Mac that are private in form, continue to be perceived as enjoying government guarantees.

Putting a cap on growth

The key element of our proposal is caps on PSS growth, which, of course, over time will lead to the shrinkage of PSS. Even with the other reforms we suggest, such as capital requirements, PSS will continue to be perceived as backed by the government and thus will enjoy competitive advantages over the private sector in their cost of capital (Scott and Iwahara, 1994).

Shrinkage of the PSS system will also help address the costs to Japan of using PSS resources to fund wasteful infrastructure. As the resources of PSS shrink, such funds will no longer be available. Of course, the government agencies funding these projects could still issue guaranteed debt to the private sector but such debt would become more expensive since private investors with a market cost of funds (unlike PSS with a below market cost due to subsidies) would demand higher returns. Of course, an even better solution would be to prohibit agencies from issuing guaranteed debt to fund any off-budget projects. Shrinkage of PSS would also permit the private capital markets to more fully develop.

Even if the plan becomes law the potential exists for political tinkering at some point during the long transition – what the Diet creates it can later undo once the pressure for reform is removed. The political environment is likely to change significantly once Koizumi steps down in late 2006 (assuming he is re-elected) and there is indication the next government will be less reform oriented, especially if the Japanese economy improves. While an ongoing process – privatisation cannot be done overnight – can never be completely insulated from political change, it would help to put authority over the privatisation process into an independent agency composed of members with long terms, say 14 years, the term of members of the Federal Reserve Board. This contrasts with the proposal which vests management of the process in a government "committee" of five members with three-year terms. Japan's enduring problem is that other than for a short period in 1998 it does not see itself in crisis and a return to growth, even slow growth, will remove many incentives for reforming government financial intermediation.

Stiff resistance

Inability to reduce the role of the PSS is an indication of Japan's continuing reluctance, even given the "lost decade", to move toward modern financial and economic institutions. Irrespective of the outcome of the September 11 2005 election, the outlook is not optimistic. The fact that even a largely inadequate version of privatisation did not become law suggests the PSS will continue to resist reform. Politics will continue to trump efficiency until there is more basic reform of the political system. Perhaps a Koizumi election can lead to such political reform by destroying the old guard in the LDP and by educating the Japanese public as to why reform of PSS is necessary. One can always hope. After all, the good guys won in High Noon.

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