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The Transition of Finance, Postal Savings, and Government Financial Intermediation

1.1. INTRODUCTION

The Postal Savings System (PSS) and the Fiscal Investment and Loan Program (FILP) are major components of the Japanese economy measured by their size relative to both the economy and the financial system, and together they support a pervasive system of government financial intermediation. The PSS and the FILP also play an important role in Japanese politics, since they are an integral part of the budgeting process. Although extensively discussed and debated within Japan, the PSS and FILP are not familiar to many outside observers. In fact, it would not be an exaggeration to say that, in general, the PSS and FILP are among the least-understood elements of postwar Japanese finance. The outside public became aware of some aspects of Japan's extensive system of government financial intermediation when Junichiro Koizumi was elected prime minister by the Diet on 26 April 2001. Koizumi won a popular mandate to reform the Liberal Democratic Party (LDP) and lead the country out of a decade of economic and financial distress. His mandate was reaffirmed in July 2001 when the LDP won a majority of the seats in the Upper House of Representatives. One of Koizumi's campaign promises was to privatize the PSS, and widespread news accounts of his reform package, which included the privatization proposal, probably represent the first time in postwar Japan that the outside community became aware of the PSS.

Koizumi's plan to privatize the PSS, if successful, would be the most significant institutional change in Japanese finance since the early 1950s. News accounts of Koizumi's program and his continuing popular support as of late 2001, however, grossly understate the difficult task ahead. The PSS and FILP are based on the administrative and credit-allocation role of the government in the flow of funds that characterized the old or preliberalization financial regime, and despite over two decades of financial liberalization, the PSS and FILP are larger and more pervasive at the start of the new century than at any time in the postwar period.

Reform of the PSS and FILP, however, commenced in 1998, and many of the changes became effective on 1 April 2001. Although incomplete, the reforms have the potential to significantly alter the role of government financial intermediation in Japan; however, those who formerly benefited from the PSS and FILP can still limit the effectiveness of the reforms and end up with a system not much different from what existed previously. This is an outcome one cannot dismiss, given Japan's past record of incomplete financial liberalization. Nonetheless, serious reform has commenced, and Prime Minister Koizumi has for the first time provided political leadership to a program of reform. Even the most ardent supporters of PSS and FILP reform, however, recognize the difficulty of significantly reforming these institutions, nor do they believe that reform of the PSS and FILP is the most urgent item on Japan's agenda for reversing over a decade of economic and financial distress. Nonetheless, Japan needs to address the issues raised by the PSS and FILP if recovery and stable economic growth are to be achieved. To understand the motivation for reform, we need to discuss the role of the PSS and FILP in Japan's financial system and the issues raised by that role. A knowledge of the PSS and FILP is therefore a necessary part of understanding postwar Japanese finance and assessing the ability of Japan to establish a modern financial system that will be on a par with the financial systems of the United Kingdom and the United States as envisaged by the November 1996 "Big Bang" announcement, which remains the operating guideline for financial liberalization.

This chapter places reform of the PSS and FILP in the context of the broader transition of the Japanese economy and financial system, provides an institutional outline of the FILP system, discusses the reforms that commenced in 1998, discusses the underlying motivation for reform, discusses the political changes initiated by Koizumi and how they impact reform, and outlines the remainder of the book.

1.2. THE TRANSITION OF THE JAPANESE ECONOMY AND FINANCIAL SYSTEM: OVERVIEW

Economic, financial, and political events in Japan during the past several decades have been remarkable. Table 1.1 presents selected macroeconomic performance measures for much of the postwar period. The 1975–85 period is the high point of Japanese economic, financial, and political stability in the postwar period. Economic and financial development from 1950 to 1975 was impressive, with the exception of the early 1970s when Japan experienced oil-price shocks, the so-called Nixon shock, high rates of inflation, and the collapse of the fixed exchange-rate system. Economic stability was achieved by 1975, however, and a decade of impressive development ensued during which Japan emerged as a major industrial power and achieved a level of economic and financial

Table 1.1. *Indicators of macroeconomic performance in Japan, 1955–99*

Fiscal year	WPI growth	CPI growth	HPM growth	M2CD growth	Nominal GNP growth	Real GDP growth	$/yen exchange rate	Nikkei 225 stock price	Land price, six large cities	Interban rate call rate	Discount rate	Unemployment rate	Individual savings rate
1955							360	390.68	0.7	6.77	6.78	2.60	11.9
1956		5.1	0.94		12.1	6.4	360	519.84	0.9	7.44	7.31	2.20	12.9
1957		6.31	8.62		14.5	7.5	360	522.95	1.1	11.39	8.32	1.90	12.6
1958	2.33	0	11.62		7.0	7.3	360	618.58	1.3	9.04	7.57	2.20	12.3
1959	0.23	5.94	3.82		17.2	11.2	360	890.17	1.7	8.38	7.06	2.00	13.7
1960	1.14	6.9	11.89	22.91	19.9	12.2	360	1,247.61	2.7	8.31	7.01	1.50	14.5
1961	−1.69	8.47	16.31	17.11	20.9	11.7	360	1,547.08	4	8.46	7.01	1.40	15.9
1962	2.17	2.97	22.87	24.60	10.6	7.5	360	1,417.05	4.9	8.64	7.01	1.30	15.6
1963	0.00	6.86	16.37	20.61	17.4	10.4	360	1,385.10	5.7	7.56	5.89	1.20	14.9
1964	0.22	5.74	17.25	15.72	15.8	9.5	360	1,252.95	6.4	10.07	6.49	1.10	15.4
1965	1.29	4.47	15.61	18.49	11.1	6.2	360	1,268.07	6.6	6.33	5.56	1.30	15.8
1966	2.98	5.81	12.46	15.74	17.6	11.0	360	1,472.09	6.8	5.87	5.48	1.30	15.0
1967	1.86	5.49	13.98	14.93	17.0	11.0	360	1,379.59	7.4	6.85	5.77	1.20	14.1
1968	0.81	4.93	16.40	15.41	18.3	12.4	360	1,662.69	8.3	7.79	5.97	1.10	16.9
1969	3.02	5.74	16.18	18.20	18.4	12.0	360	2,099.38	9.7	7.95	6.08	1.10	17.1
1970	2.15	6.91	17.99	18.00	15.8	8.2	360	2,147.56	11.4	8.02	6.09	1.20	17.7
1971	−0.76	5.98	18.58	24.04	10.2	5.0	335	2,569.34	12.9	5.87	5.23	1.30	17.8
1972	4.05	5.38	15.95	23.18	16.6	9.1	297	4,304.36	16	4.74	4.37	1.30	18.2
1973	21.67	15.92	18.17	26.53	20.9	5.1	274	4,591.43	20.3	8.88	6.94	1.30	20.4
1974	20.09	20.93	26.92	22.69	18.4	−0.5	293	4,177.54	19.8	12.74	9	1.50	23.2
1975	2.28	10.2	20.25	11.92	10.2	4.0	290	4,374.51	19.1	9.23	7.36	1.90	22.8
1976	6.07	9.59	13.59	13.10	12.4	3.8	292	4,759.95	19.5	6.93	6.47	2.00	23.2
1977	1.99	6.94	11.08	15.11	11.0	4.5	257	5,061.21	20	5.14	4.59	2.10	21.8
1978	−0.57	3.81	9.11	11.38	9.9	5.4	201	5,775.63	21.2	4.28	3.5	2.20	20.8
1979	8.76	4.76	9.81	11.75	8.0	5.1	230	6,420.81	23.8	7.04	5.5	2.00	18.2

Table 1.1. *(Cont.)*

Fiscal year	WPI growth	CPI growth	HPM growth	M2CD growth	Nominal GNP growth	Real GDP growth	$/yen exchange rate	Nikkei 225 stock price	Land price, six large cities	Interban rate call rate	Discount rate	Unemployment rate	Individual savings rate
1980	12.50	7.52	11.65	11.85	8.9	2.6	217	6,999.03	26.1	10.76	8.1	2.10	17.9
1981	0.20	4.1	7.01	8.90	6.2	2.8	220	7,599.12	27.9	6.96	6.02	2.20	18.4
1982	0.30	2.55	3.99	9.20	4.9	3.2	235	7,531.08	29.4	6.94	5.5	2.50	16.7
1983	−0.70	1.92	6.85	7.40	4.6	2.4	232	9,322.97	30.9	6.28	5.32	2.70	16.11984
0.30	2.11	5.40	7.80	6.9	4.0	251	11,060.72	33	9.06	5	2.70	15.8	
1985	−1.70	1.95	4.08	8.40	6.6	4.2	201	12,934.89	36.8	4.56	4.89	2.60	15.6
1986	−5.20	0	6.12	8.70	4.5	3.2	160	18,032.35	45.5	4.28	3.27	2.80	15.6
1987	−1.70	0.46	7.40	10.40	5.0	5.1	122	24,194.71	59.7	3.39	2.5	2.80	13.8
1988	−0.60	0.79	10.31	11.20	7.1	6.3	126	28,865.17	72.8	4.13	2.5	2.40	13.0
1989	2.70	2.81	10.77	9.90	7.5	4.9	143	34,967.53	93.7	4.38	3.53	2.20	12.9
1990	1.30	3.17	11.09	11.70	8.1	5.5	136	26,872.30	104.1	6.66	5.69	2.10	12.1
1991	0.40	2.9	1.94	3.60	5.3	2.5	125	23,350.00	92.5	8.34	5.31	2.10	13.2
1992	−1.00	1.5	2.24	0.60	1.8	0.4	125	17,188.86	71.4	5.56	3.29	2.20	13.1
1993	−1.80	1.2	3.66	1.10	0.9	0.4	112	19,640.87	63.2	3.91	2.11	2.50	13.4
1994	−1.40	0.5	4.85	2.10	1.0	1.1	99	19,508.51	54.7	2.44	1.75	2.90	13.3
1995	−1.00	−0.3	5.28	3.00	2.0	2.5	103	19,868.15	48.6	2.28	1	3.20	13.7
1996	−1.50	0.4	9.03	3.30	2.6	3.4	116	19,361.35	44.9	0.44	0.5	3.40	13.4
1997	1.00	2	8.20	3.10	1.0	0.2	130	15,258.74	42.6	0.47	0.5	3.40	12.7
1998	−2.10	0.2	9.20	4.00	−1.1	−0.6	115	13,842.17	39.5	0.32	0.5	4.10	13.2
1999	−1.00	−0.5	6.00	3.60	−0.2	1.4	102	18,934.34	36.1	0.05	0.5	4.70	13.7
2000	0.00	−0.5	7.40	2.10	−0.5	0.9	114	13,785.69	N/A	0.2	0.5	4.70	N/A

Sources: National Income Account Statistics, Economic Planning Agency, various issues; Bank of Japan, Economic Statistics, Annual various issues; Bank of Japan, ***Handbook of Main Statistics***, Ju 01; Kinyu (Finance) Federation of Bankers Association; *House and Loan* Monthly Magazine, The Government Housing Loan Corporation.

development that attracted world attention. During this period, Japan managed a transition toward more open and competitive economic and financial institutions while at the same time achieving a high degree of macroeconomic stability in the face of oil-price shocks in 1979 and 1980. This performance stood in contrast to the financial disruptions and macroeconomic instability experienced by most other developed countries, such as the United States. Japan's economic institutions, especially its financial system, were increasingly viewed as a model by policymakers in both developed and developing countries.

In the late 1980s, however, Japan experienced a period of equity and land-price inflation in the context of rapid real GDP growth and price stability, now referred to as Japan's "bubble economy" period. Asset-price inflation exposed the economy to serious risk, and the eventual asset-price collapse set the stage for a decade of economic and financial distress that now can be referred to as Japan's "lost decade" in terms of economic and financial development. Economic growth for the first two-thirds of the 1990s was essentially zero, negative starting in the fourth quarter of 1997 through 1998, and again negative starting in 2000. After almost a decade of dealing with troubled financial institutions, many of Japan's financial institutions in 2000 were either market insolvent or close to market insolvent. The government was required to resort to extraordinary means to deal with troubled financial institutions and nonperforming loans, even to the extent of nationalizing two large banks—the Long Term Credit Bank and the Nippon Credit Bank—in 1998, which were subsequently sold to the private sector in 1999.

The "collapse of the bubble economy" was initiated by the Bank of Japan's decision to raise the discount rate in May 1989 because of concerns about CPI and WPI inflation and, especially, about asset inflation in the equity and real-estate markets. The subsequent collapse of equity and land prices revealed fundamental weaknesses in Japan's economic and financial institutions, and a series of policy failures on the part of the Ministry of Finance, Bank of Japan, and government in general generated stagnant or declining real GDP, a gradual decline in the price level, and near-collapse of the financial system.

Four causes of the prolonged economic and financial distress can be identified. First, failure to resolve the nonperforming loan problem and the close relationship between equity prices and bank capital deteriorated bank balance sheets and generated a bank credit crunch, especially after 1997 when Hokkaido Takushoku Bank and Yamaichi Securities Company failed in November 1997. This outcome is generally attributed to the fact that Japan had pursued an incomplete and flawed financial liberalization process that exposed the system to shocks such as a sudden collapse of asset prices. Second, the Bank of Japan made a series of policy mistakes. The Bank accommodated asset inflation after 1986, thereby ensuring that a soft landing would be difficult to achieve; then, once asset prices collapsed after 1990, the Bank waited too long to shift to easy monetary policy. After 1997, the Bank initiated an insufficiently aggressive policy and permitted a slow and gradual decline in the price level. Third, fiscal policymakers also made a series of policy mistakes. The decision to raise the consumption tax in 1997 is generally regarded as one of the causes of the sharp decline in economic growth in the fourth quarter of 1997, and subsequent fiscal actions were insufficient and/or directed to unproductive uses to stimulate the economy. Fourth, the Asian Financial Crisis that started in the summer of 1997 in Thailand and spread to Indonesia and South Korea by the end of the year did not cause Japan's economic and financial distress nor did Japan's depressed economy cause the Asian Financial Crisis; however, the extreme economic and financial distress in East Asia in 1997 and 1998 did adversely affect Japan through various financial and trade channels.

The economic and financial distress of the 1990s provided clear evidence that Japan needed to reform its economic and financial institutions. An official policy of liberalization had been in place since the late 1970s, but the 1990s revealed that Japan had not yet achieved the degree of liberalization required to modernize the economic and financial system. By the late 1990s, it became evident to the majority of policymakers that a new economic and financial regime would be required to support economic and financial development in the new century.

The economic and financial distress of the 1990s also had far-reaching political consequences. The longstanding dominance of the LDP ended in August 1993 when it lost the majority of the Lower House. Although the party regained power in the Lower House in October 1996, the LDP was more fractionalized than previously. Dissatisfaction with the failure of the LDP to resolve the continuing economic and financial distress and a series of scandals at the Ministry of Finance and the Bank of Japan, however, led to the LDP's loss in the Upper House elections in July 1998, and as a result, Prime Minister Ryutaro Hashimoto resigned. Prime Minister Keizo Obuchi, Hashimoto's successor, brought some stability; however, health considerations led to his replacement by Prime Minister Yoshiro Mori. Mori failed to provide effective leadership, and by early 2001 he had less than a 10-percent popularity rating. In April 2001, Koizumi became the new prime minister and leader of the LDP, promising radical reform to reverse Japan's stagnant and declining economic growth. Overall, by the end of the decade, Japan's stable political structure no longer existed. Japanese politics became more fractionalized, thereby increasing the potential for closer interaction between economic and political institutions.

Japan's economic and financial distress in the 1990s is unprecedented among the industrial economies in the postwar period. The distress followed a postwar record of stability and growth impressive by any standard, and it has been deep and widespread, reaching crisis proportions in late 1997 when Japan came close to a deflationary spiral and the financial system was on the verge of insolvency. Japan's macroeconomic performance brought comparisons with the 1930s and regenerated debates about monetary policy, deflation, and liquidity traps that had been absent for the previous four decades.[1]

In response, institutional and attitudinal reform has been unprecedented in postwar Japan. The "new" Bank of Japan was established in 1997 with enhanced legal independence from the Ministry of Finance, in contrast to the "old" Bank of Japan, which formerly operated under the direction of the Ministry of Finance. The "new" financial regulatory and supervisory regime was established in the second half of the 1990s by a series of institutional changes. The role of the Ministry of Finance was reduced, the Deposit Insurance Corporation was restructured and expanded, the Financial Supervisory Agency and Financial Reconstruction Commission were established,[2] and new guidelines, referred to as Prompt Corrective Action, were adopted for dealing with troubled financial institutions. The "new" financial regulatory and supervisory regime emphasizes transparency, prompt action to resolve the problems of troubled financial institutions, and a willingness to impose penalties on troubled financial institutions, in contrast to the "old" regime that emphasized nontransparency, mutual support, and a policy that did not permit the failure of financial institutions and markets. The "new" attitude emphasizes market principles and accepts risk and bankruptcy as a normal part of the economic process, as opposed to the "old" attitude that emphasized the minimization of risk and bankruptcy.

These changes are designed to establish a fundamentally different monetary and financial regime than what previously existed in postwar Japan. In the new regime, market forces rather than government direction will play the dominant role in the allocation of credit. In the new regime, an acceptance of risk and bankruptcy, rather than mutual support and minimizing risk and bankruptcy, will be a normal part of the economic development process. As part of the reform effort, attention was finally directly toward the PSS and the FILP, starting in 1998. The PSS and FILP had previously avoided any meaningful reform, despite their incompatibility with a modern market-oriented financial system.

[1] Comparisons between Bank of Japan Policy in the 1990s and policies followed in the 1930s by Japan, Sweden, and the United States are presented in Cargill (2001). Mikitani and Posen (2000) compare Japan's economic and financial distress with that experienced by the United States in the 1980s.

[2] The Financial Supervisory Agency and the Financial Reconstruction Commission were combined into a new institution named the Financial Services Agency, effective from January 2001.

1.3. THE PSS AND THE FILP

The transition from the old to the new financial regime has resulted in fundamental changes[3] in Japan's private financial institutions, financial regulatory institutions, and the Bank of Japan. The PSS and FILP, however, have largely avoided being part of the financial transition toward more open and competitive markets. The PSS and FILP are special features of Japanese finance and, although frequently discussed within Japan, they have received little attention outside of Japan.[4] Private banks and some academics frequently voiced criticism of the PSS and FILP because, in their view, these institutions unfairly competed with private banks and were incompatible with financial liberalization; however, these criticisms received little support from regulatory authorities (with, perhaps, the exception of the Bank of Japan), the public, or the business sector.

The PSS and FILP in many ways represent an essential and large element of the old financial regime currently in transition. As such, the way that reform of the PSS and FILP evolves in the coming years will provide insight into whether Japan can achieve a modern financial system and break with the past. Reform of the PSS and the FILP will represent a major challenge for regulatory authorities for two reasons. First, the PSS and FILP until 1998 for all practical purposes avoided any reform, and second, these institutions represent a major and pervasive part of the old financial regime with widespread public and political support.

The reforms initiated in 1998 are potentially significant and have already generated sufficient institutional change to the degree that we can distinguish between the "old" and "new" FILP system. The New FILP system started on 1 April 2001.

1.3.1. *The Old PSS and FILP*

The PSS was established in 1875 as part of the postal services system and has since then been a prominent feature of Japanese finance. The role of the PSS in Japan's financial system in the 1990s is as large, if not larger, than it has ever been since its establishment. The PSS is Japan's largest financial institution, holding 34 percent of household deposits. The PSS also sells life insurance and accounts for about 30 percent of the life-insurance market. The financial resources of the PSS, measured in terms of deposits of 255 trillion yen as of

[3] These changes are discussed in Blomstrom *et al*. (2001); Cargill *et al*. (1997, 1998, 2000); Hoshi and Kashyap (2001), and Hoshi and Patrick (2000).

[4] There are a limited number of discussions of Japan's PSS and FILP in English. The following is a selected list of references: Alexander (2002); Anderson (1990); Calder (1990); Cargill (1993); Cargill *et al*. (1997, 2000); Cargill and Royama (1988); Cargill and Yoshino (1998, 2000); *Economist* (1998); Elixman (1992); Kuwayama (2000); Ministry of Finance (2000); Ogura and Yoshino (1998); Patrick (1967); Sakakibara (1991); Okina (2000); [*Strom* (1997)] Suzuki (1987); Yoshino (1993) and United Nations (1993).

31 March 2000, or 2.32 trillion dollars (110 yen to the dollar), make it larger than any other private or public financial institution in the world.

The quantitative size of the PSS, however, does not fully convey the role of the PSS in Japan, nor can the PSS be fully appreciated without considering its role in the larger FILP. The FILP is an integral component of the old financial regime, which assigned an important role to government regulation and administration of the flow of funds to support industrial policy, compensate unproductive enterprises or sectors left behind in the economic development process, and minimize risk and bankruptcy. The PSS is the most important component of the FILP, which together represent a set of multidimensional and complex policies for transferring funds from the public to designated sectors of the economy.

The FILP is not so much an institution or government agency as a process of decision making concurrent with the formulation of the national budget that directs financial resources under the government's control to targeted sectors of the economy. The PSS, the related institutions, and the decision-making process of allocating government financial intermediation are collectively referred to as the FILP system.

Table 1.2 illustrates the flow of funds through the FILP system for amounts outstanding as of 31 March 2000, which is the end of the fiscal year in Japan. The process started with household postal deposits of 255 trillion yen, national welfare and pension premium payments of 140 trillion yen, other premium payments of 48 trillion yen, and life-insurance premium payments of 112 trillion yen. The first three items total 443 trillion yen and were deposited directly into the Trust Fund Bureau of the Ministry of Finance. The life-insurance premiums of 112 trillion yen were transferred to the Postal Life Insurance Reserve Fund.

The Trust Fund Bureau purchased 115 trillion yen of government bonds, leaving 328 trillion yen to fund the FILP. The Postal Life Insurance Reserve Fund retained 62 trillion yen for its own portfolio management and transferred 60 trillion yen to the Postal Life Insurance Fund, which in turn was used to fund the FILP. The Trust Fund Bureau and Postal Life Insurance Fund together provided 388 trillion yen to be distributed through the FILP system; however, the FILP also received funds from other sources. The FILP received an additional 26 trillion yen from purchases of government bonds by private financial institutions (22 trillion yen) and the Industrial Investment Special Account Fund (4 trillion yen), which increased total FILP funding to 414 trillion yen. The 414 trillion yen were then distributed to a total of forty-eight FILP-financed entities consisting of special accounts, government financial institutions, government corporations and enterprises, special firms, and local governments (counted as one entity).

Not all of the forty-eight FILP-financed entities indicated in Table 1.2 received funds from the Trust Fund Bureau in fiscal 2000. Some of the entities are financed by non-Trust Fund Bureau funds, such as postal life-insurance funds or

Table 1.2. *Outline of the old PSS and the FILP system, fiscal 2000 (in trillion yen)*

	Trillion yen	
Households provide funds to the FILP system in the form of		
Postal deposits	255	
National welfare and pension premiums	140	
Other premiums	48	
Postal life-insurance premiums	112	
Total household-provided funds		555
Distributed to the following accounts		
Trust Fund Bureau of the Ministry of Finance		443
Postal deposits	255	
National welfare and pension premiums	140	
Other premiums	48	
Postal Life-Insurance Reserve Fund		112
Postal life-insurance premiums	112	
Distribution of Trust Fund Bureau and the Postal Life Insurance Reserve Fund		
Of the 443 trillion yen received by the Trust Fund Bureau, the Trust Fund uses 115 trillion yen to purchase government bonds, etc., and the remaining 328 trillion yen are provided to the FILP (FILP-financed entities).		
Of the 112 trillion yen provided to the Postal Life Insurance Reserve Fund, 60 trillion yen are provided to the Postal Life Insurance Fund, which in turn are provided to the FILP (FILP-financed entities).		
The sources of funding of the FILP for FILP-financed entities are		
Trust Fund Bureau	328	
Postal Life-Insurance Fund	60	
Industrial Investment Special Account Fund	3	
Government Bonds purchased by private financial institutions	22	
Total FILP funding		414
Distribution of FILP funding to FILP-financed entities		
Government banks or financial institutions (8)	145	
Government Housing Loan Corporation		
Japan Finance Corporation for Small Business		
Development Bank of Japan		
National Life Finance Corporation		
Agriculture, Forestry, and Fisheries Finance Corporation of Japan		
Japan Finance Corporation for Municipal Enterprises		
Okinawa Development Finance Corporation		
Japan Bank for International Cooperation		
Quasi-government corporations (27)	110	
Urban Development Corporation		
Pension Welfare Service Public Corporation		

Table 1.2. *(Cont.)*

	Trillion yen
Japan Environment Corporation	
Teito Rapid Transit Authority	
Japan Regional Development Corporation	
Japan Sewage Works Agency	
Social Welfare and Medical Service Corporation	
Organization for Pharmaceutical Safety and Research	
Promotion and Mutual Aid Corporation for Private Schools of Japan	
Japan Scholarship Foundation	
Japan Green Resources Corporation	
Bio-oriented Technology Research Advancement Institution	
Japan Highway Public Corporation	
Metropolitan Expressway Public Corporation	
Hanshin Expressway Public Corporation	
Honshu-Shikoku Bridge Authority	
Japan Railway Construction Public Corporation	
New Tokyo International Airport Authority	
Corporation for Advanced Transport and Technology	
Water Resources Development Public Corporation	
Fund for the Promotion and Development of the Amami Islands	
Metal Mining Agency of Japan	
Japan National Oil Corporation	
Japan Science and Technology Corporation	
Information-Technology Promotion Agency, Japan	
Japan Key Technology Center	
Postal Life Insurance Welfare Corporation	
Special accounts (7)	73
Lending Urban Development Funds	
Consolidation of Specific National Property	
National Hospital	
National School	
Government-Operated Land Improvement Project	
Airport Development	
Postal Savings Special Account	
Local governments	83
Special firms (5)	3
Kansai International Airport Co., Ltd	
Central Japan International Airport Co., Ltd.	
Electric Power Development Co., Ltd	
Shoko Chukin Bank	
Organization for Promoting Urban Development	

Source: Ministry of Finance (2000, pp. 6, 40–1).

funds from the special account for industrial investment. In some cases, the entities had FILP loans outstanding and did not receive new FILP funds. Of the eight FILP-financed government banks, seven received funding from the Trust Fund. Of the twenty-seven FILP-financed quasi-government corporations, twenty received funding from the Trust Fund. The local governments, the seven special accounts, and one of the five special firms received funds from the Trust Fund. Special firms are those in which the government has no equity interest but which are supported by public funding.

Before 1987, all postal deposits were transferred to the Trust Fund Bureau; however, starting in 1987 the Ministry of Posts and Telecommunications[5] was permitted to manage a percentage of postal funds that varied from year to year but which gradually increased to about 20 percent in fiscal 2000. As of 31 March 2000, the portfolio managed by the Ministry of Posts and Telecommunications was 58.9 trillion yen and consisted of government bonds (47.3 percent), local government bonds (15.9 percent), public institution bonds (4.5 percent), private bonds and bank debentures (6.2 percent), and foreign bonds (7.9 percent). The remaining 18.1 percent were invested with private financial institutions.

There are four important issues regarding the FILP system as outlined. First, the FILP budget, like the PSS, is large by any reasonable standard; for example, Figure 1.1 illustrates the FILP budget in flow terms as a percentage of GDP from 1953 to 1998. In 1998, the FILP budget represented 10.9 percent of GDP. Also note that the FILP budget continued to increase relative to the economy over time despite an official policy of financial liberalization that commenced in the 1970s.

Second, the PSS is the most important contributor to the FILP system. In 2000, postal deposits accounted for 62 percent of the amount budgeted for FILP-financed entities and represented 58 percent of the Trust Fund Bureau Account. As the FILP budget has increased relative to GNP, postal deposits continued to increase relative to total deposits, as illustrated in Figure 1.2. Likewise, postal life insurance became an increasingly important source of funds to the FILP and, like postal deposits, postal life insurance has increased relative to total life-insurance sales (Figure 1.3). The relative growth of postal deposits and postal life insurance, like the relative growth of the FILP budget to GNP, are contradictions to an official policy of financial liberalization.

Third, the FILP system is wide ranging in terms of projects and activities funded. It supports transportation, education, electricity, housing, roads, bridges, and small and medium-sized businesses. As a result, the FILP system is

[5] As of January 2001, the Ministry of Posts and Telecommunications was reorganized and renamed the Ministry of Public Management, Home Affairs, Posts, and Telecommunications. This was part of the general reorganization of the Japanese cabinet and bureaucracy initiated in the late 1990s. The Ministry of Finance was renamed the Ministry of the Treasury in Japanese to reflect the reduced role it plays in financial regulation and supervision; however, the English name remains unchanged.

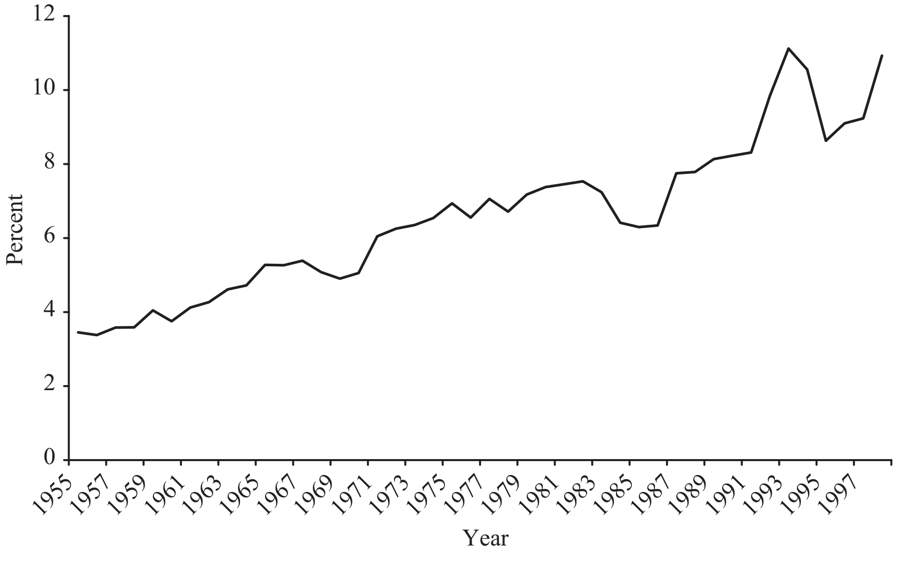

Figure 1.1. *FILP budget as percentage of GNP.*

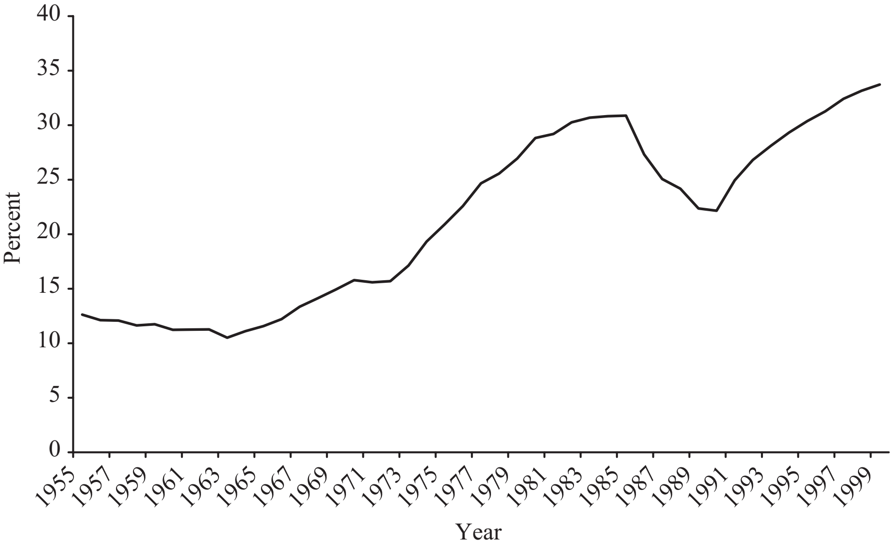

Figure 1.2. *Postal savings as percentage of total deposits.*

pervasive in the Japanese economy with few aspects of economic life in Japan not under some influence of the FILP system.

Fourth, the FILP budget is determined in tandem with the national budget (discussed in more detail in Chapter 2); consequently, the FILP system plays

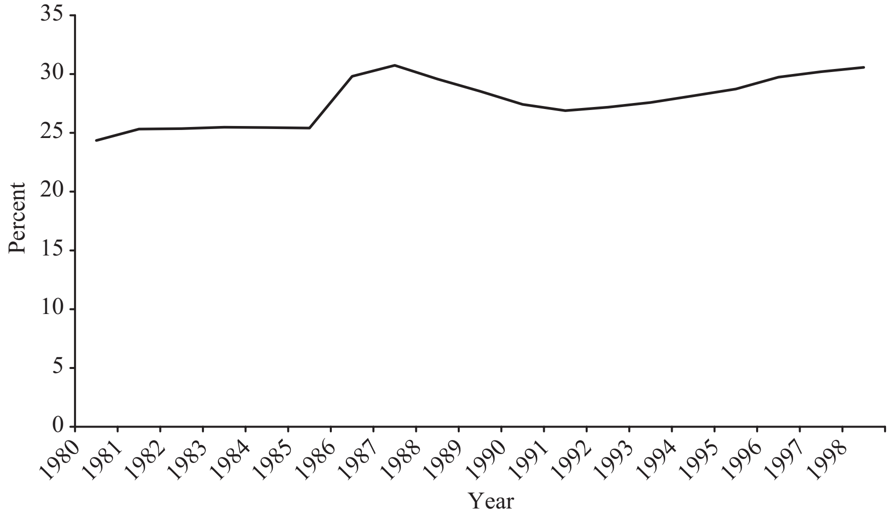

Figure 1.3. *Postal life insurance as percentage of total life insurance 1980–98.*

an important role in Japan's political institutions, since the distribution of the funds plays a key role in maintaining and enhancing political power.

1.3.2. *The New PSS and FILP*

The outline in Table 1.2 is a reasonable description through 31 March 2001, of Japan's FILP system; however, the reforms commenced in 1998 fundamentally changed the flow of funds through the FILP system starting 1 April 2001. 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 1 April 2001, postal deposits, postal life-insurance premiums, national welfare and pension premiums, and so on, were no longer provided to special accounts or government banks through the Trust Fund Bureau. FILP-financed entities previously dependent on the Trust Fund Bureau must now 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 to be treated equally with Japan Government Bonds (JGBs).

As part of an effort to require FILP entities to raise funds in the private market and achieve a greater degree of transparency, all thirty-three FILP entities that previously obtained funding from the Trust Fund Bureau will be required after fiscal 2001 to disclose a policy or subsidy cost analysis consisting of estimates of the present value of future subsidies of each FILP entity. This disclosure is designed to bring about the greater transparency needed to raise capital in the private market. In fiscal 2001, twenty FILP entities planned to raise a small part of their funding (1.1 trillion yen) through nonguaranteed agency bonds. In early 2001, four entities issued agency bonds that received high ratings by Moody's, S&P, and Rating and Investment Information, Inc. The agency bonds issued by the Government Housing Loan Corporation (mortgage-backed securities), Japan Highway Public Corporation, New Tokyo International Airport Authority, and Water Resource Development Public Corporation have been rated at Aa2 (Moody's) or better, largely because they are viewed as having the implicit guarantee of the government.

In fiscal year 2001, 43.9 trillion yen of FILP bonds were issued by the Ministry of Finance, with the majority issued at five- and ten-year maturities. These FILP bonds are government debt used to finance Trust Fund distributions to various entities. The FILP bonds are indistinguishable from construction and deficit-financing bonds. At the time bonds are sold, the Ministry of Finance indicates amounts that represent FILP bonds, construction bonds, and deficit-financing bonds; however, there is no further designation, and all three types of bonds are regarded as general government debt or JGBs.

Thus in fiscal 2001, nonguaranteed agency bonds represented only a small fraction of the total funding by the Trust Fund Bureau. The intent of the reforms, however, is to increase the agency bond offerings to provide the major source of financing for FILP entities.

The new process of funding FILP entities through general FILP bonds or agency bonds 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. In this new system, the 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 (formerly the Ministry of Posts and Telecommunications) announced a strategy to manage postal deposits. The portfolio "in principle" should consist of 80 percent in "safe" assets (government bonds, etc.), 5 percent in foreign bonds, 5 percent in foreign equities, 5 percent in domestic equities, and the remaining 5 percent in money-market instruments. The plan to hold 80 percent of postal deposits in government bonds and other safe assets essentially turns a major part of the PSS into a "narrow" bank. On 1 April 2003, the PSS will become a separate public corporation collecting funds through postal deposits and allocating those funds according to its own portfolio decision-making process.

Figure 1.4 contrasts the old with the new PSS and FILP systems. Under the old system, postal savings and pension reserves were transferred to the Trust Fund Bureau of the Ministry of Finance, though some of the funds were retained for discretionary management. The Trust Fund Bureau in turn distributed the funds to the various FILP entities. Under the new system, these funds

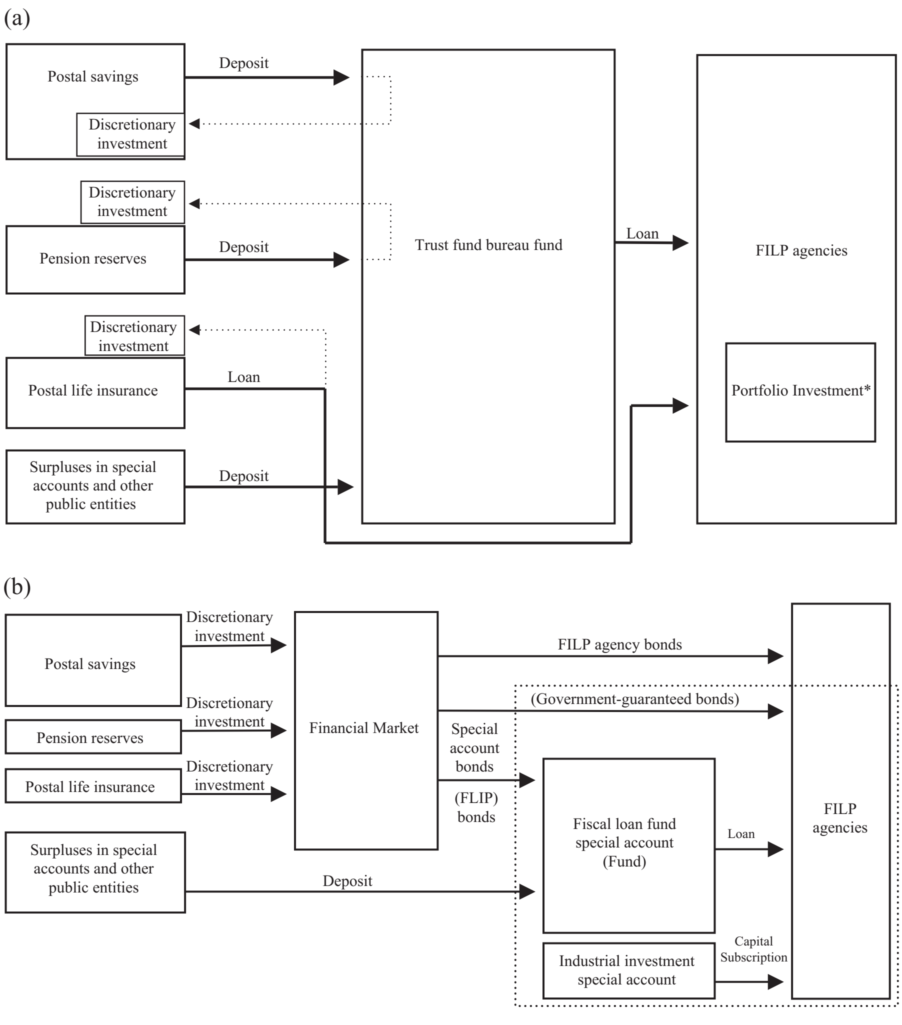

Figure 1.4. *(a) Pre 1 April 2001 and (b) post 31 March 2001 FILP system.*

are placed directly into the financial market through the purchase of FILP agency bonds (guaranteed and nonguaranteed) issued by the FILP-entities and the purchase of FILP bonds issued by the Ministry of Finance. The Trust Fund Bureau will cease to exist. The FILP entities will henceforth obtain funding from the financial system or directly from the Fiscal Loan Fund Special Account (Fund) in the form of loans. The Fund will be supported primarily by FILP bonds.

The reforms of the PSS and FILP are potentially important; however, the fact remains that the PSS and the FILP have avoided meaningful reform for over two decades of official financial liberalization policy in Japan. As a result, there is reason to be cautious about whether this is real reform. Even if these turn out to be significant reforms, the PSS remains as a government bank. However, as a prerequisite to making an assessment of the 1998 reforms and subsequent administrative decisions, it will be useful to first discuss the role of the PSS and the FILP in Japan's policy of financial liberalization during the past two decades.

1.4. THE PSS, THE FILP SYSTEM, AND FINANCIAL LIBERALIZATION: 1976–89

Japan initiated a policy of financial liberalization in 1976 when the Ministry of Finance officially recognized the *gensaki* market, a market in repurchase agreements based on government bonds that had been unofficially in operation since the mid-1960s. The transition appeared to progress smoothly for the next ten years as a large number of incremental changes were made that increased the role of competitive forces (Cargill and Royama, 1988, 1992; Feldman, 1986). Although the structural changes made during this period were substantial when compared to the financial system in 1975, the financial supervision and regulatory framework remained wedded to the old financial regime.[6] This is especially true of the PSS and the FILP system.

The PSS and FILP resisted meaningful reform during the first decade of financial liberalization through 1985, and despite an official policy of liberalization, the PSS and FILP increased their relative role in the economy (Figures 1.1–1.3). The large and increasing role of the PSS and FILP system was at odds with the official policy of liberalization; however, this was not a major concern to regulatory authorities for three reasons.

First, financial liberalization was not enthusiastically pursued in Japan despite an official policy of liberalization. Some significant accomplishments occurred through the 1980s, but financial liberalization can be characterized more as rhetoric than as substance. Despite interest-rate liberalization, development of money and capital markets, and internationalization of the yen, the Japanese financial system remained dependent on a bank-finance model with pervasive deposit guarantees, nontransparency, and a mutual-support system designed to limit risk and bankruptcy.[7] As a result, there was little enthusiasm on the part of regulatory authorities to reform either the PSS or the FILP system, which together represented a major and widely supported role of government in the financial intermediation process.

Second, financial liberalization in Japan was mainly a response to internal and external pressure in which various groups saw liberalization as a way to

[6] The old financial regime is summarized by Cargill (1999), which in turn draws from a number of well-known studies cited in that work.

[7] Lincoln (2001) provides an interesting discussion of the reasons reform has been so slow in Japan.

reestablish lost markets (domestic banks), expand markets (foreign financial institutions and domestic securities companies), enhance profit via portfolio management (domestic corporations), or deal with trade-balance issues (mainly the United States). Only the domestic banks expressed concern with the FILP system, along with some academics, and, on occasion, the Bank of Japan. Their complaints, however, found no support among regulatory authorities, politicians, or the public; hence, there was no internal pressure for reform, and the fact that the FILP system was not directly associated with trade-imbalance disputes with the United States and was often not well understood outside of Japan meant that there was little external pressure for reform from the United States.

Third, the slow and incremental approach to financial liberalization through the 1980s appeared successful in terms of balancing the desire to adhere to the old financial regime while giving in to pressure to liberalize specific components of the financial system. That is, judged by Japan's macroeconomic performance, the gradual and incremental approach to liberalization appeared successful.

Japan avoided financial disruptions like the collapse of the S&L industry in the United States in the 1980s or the inflation and disinflation experienced by most industrial countries in the wake of the oil-price increases in 1979 and 1980. As a result, Japanese regulatory authorities saw little benefit to reforming the PSS or the FILP or to departing from the slow liberalization process that for all practical purposes left unchanged many of the core elements of the Japanese financial system. This reluctance to change under any circumstance is a characteristic of Japanese society in general and has often been identified as a separate set of factors from economic considerations that account for the slow pace of financial liberalization in Japan (Lincoln, forthcoming).

Much of the financial policy success during this period was attributable to Bank of Japan policy (Cargill, 1986, 1990; Cargill and Hutchison, 1988). The Bank of Japan from 1975 to 1985 achieved a record of economic stability that brought world attention to Japanese monetary policy and led some observers to regard the Bank of Japan as a "model central bank." In hindsight, the macroeconomic stability established by the Bank of Japan covered up fundamental weaknesses created by adherence to elements of the old financial regime, while at the same time liberalization policies were increasing the role of market forces in the Japanese financial system. It was only a matter of time before a problem would arise.

1.5. FINANCIAL DISTRESS IN THE 1990, THE PSS, AND THE FILP

The economic and financial distress of the 1990s originated during the second half of the 1980s when increasing equity and land prices generated the bubble economy. Banks and other financial institutions, long protected by extensive deposit guarantees and limited competition, expanded credit without sufficient regard to economic fundamentals, thereby generating a speculative bubble in land and equity prices. Bank of Japan policy contributed to the credit expansion and subsequent asset inflation by pursuing easy monetary policy in an effort to restrain appreciation of the yen to offset the negative effect of an appreciating yen on economic growth (Cargill *et al*., 1997; Ueda, 2000; Yoshino and Yoshimora, 1995). Regulations introduced in 1988 allowing unrealized capital gains on bank holdings of equities to count as Tier II capital in satisfying BIS capital requirements ensured a close relationship between increasing equity prices and bank lending.

The collapse of asset prices, initiated by Bank of Japan policy to raise interest rates starting May 1989, deteriorated bank balance sheets, increased nonperforming loans, and reduced spending. The resulting economic and financial distress, however, was not unique to Japan. Many countries experienced financial distress and banking problems in the late 1980s and early 1990s (*Economist*, 1997; Borio *et al*., 1994; Hutchison and McDill, 1999; Lindgren *et al*., 1996). Japan's economic and financial distress, however, was deeper and longer lasting than that experienced by any other industrial country and continued through the end of 2000.

Part of the distress can be traced to an unwillingness on the part of government policymakers to depart from attitudes and policies embedded in the old financial regime that had served Japan so well for so many years, and part can be traced to inappropriate fiscal and monetary policies. The collapse of asset prices in 1990 and 1991 exposed the fundamental weaknesses of the old regime and especially weaknesses in the government's ability to manage the resulting financial distress. The slow and inadequate government response can be traced to attitudes embedded in the old financial regime that preferred policies of delay, forgiveness, and forbearance covered up by a general lack of transparency in the financial system. The policy was also based on the belief that asset deflation would not be long lasting, and thus forgiveness and forbearance were viewed as short-run solutions. Nonetheless, the emphasis of the old regime on limiting risk and bankruptcy in a nontransparent manner ensured that forgiveness and forbearance would be the preferred policy even in the longer run. As a result, Japan's economy stagnated in the first half of the 1990s with essentially zero real GDP growth, the financial system deteriorated as nonperforming loans accumulated, a number of small depository institutions failed, and the resources of the Deposit Insurance Corporation were exhausted by 1994.

The financial distress in the first half of the 1990s raised new concerns about the PSS and ultimately the entire FILP system. It became increasingly clear that the PSS complicated Japan's government deposit-guarantee system in the context of financial liberalization, in general, and financial distress, in particular.

The disintermediation of private-bank deposits to the PSS exposed private banks to liquidity risk. Disintermediation resulted from an explicit government guarantee of postal deposits up to 10 million yen, household concern about the condition of the banking system, and concern over the failure of several small banks and credit cooperatives in the first half of the 1990s.

The PSS in the early part of the 1990s encouraged this disintermediation by informing the public that postal deposits were safer than bank deposits. The claim appeared credible as, for the first time in postwar Japan, small depository institutions failed and the Deposit Insurance Corporation became market insolvent by 1994, as was Japan's smaller deposit-insurance agency for small financial institutions (Cargill *et al.*, 1996). In 1993, however, post offices were officially directed to stop advertising the problems of private banks and to stop appealing to depositors' fears about the stability of the banking system as a means to attract deposits to the PSS. In 1994, an agreement was reached between the regulatory authorities that the PSS would set deposit rates "close to" private-bank deposit rates[8] in an effort to reduce disintermediation. The majority of postal deposits (about 80 percent) are in the form of *teigaku* deposits. These are ten-year time deposits with an option to withdraw the funds after six months without penalty. The 1994 agreement did not eliminate the potential for disintermediation. The *teigaku* time deposit was superior to any deposit offered by private institutions because of its favorable interest-rate risk feature and postal deposits were viewed as a direct obligation of the government, whereas private-bank deposits were viewed as private-bank obligations insured only by an agency of the government.

The general situation deteriorated in 1995 and forced the government to depart from its passive policies of the early 1990s. The *jusen* or housing-loan industry was declared insolvent and liquidated, the Deposit Insurance Corporation was reorganized and recapitalized, the Resolution and Collection Bank was established to assume the assets of failed credit cooperatives, and the government announced a complete guarantee of all private-bank deposits, to expire on 1 April 2001. The economy appeared to improve in late 1995, and recovery in 1996 appeared to be at hand. Although land prices continued to fall, equity prices slowly improved in 1996.

The direct action of the government in dealing with the financial distress in 1995 and 1996, combined with the apparent economic recovery, generated a sense of cautious optimism that Japan had turned the corner. The Hashimoto

[8] The 1994 agreement specified two conditions depending on whether interest rates were increasing or decreasing. Increasing interest rates: in this case, the postal rate (*teigaku* deposit) is "normally" set at 0.95 of the bank rate. Decreasing interest rates: in this case, the postal rate (*teigaku* deposit) is "normally" set at 0.5 percent less than the ten-year government bond rate; however, the postal rate can range from 0.5 to 1.0 percent less than the government bond rate.

government regained control of the Lower House in October 1996 on a pledge to reform and deregulate the economy. Prime Minister Hashimoto in November 1996 announced the Big Bang financial reform, so-named after similar reforms were announced in Great Britain a decade earlier. The Big Bang was intended as a plan of action to make Japan's financial system fair, open, transparent, and competitive by 2001.

The objective of the Big Bang proposal was nothing less than to render Japan's financial system equal to any financial system in the world in terms of efficiency and stability. The new financial regime envisaged by the Big Bang announcement differed significantly from the old regime, and many observers doubted whether Japan was ready to embark on such an ambitious agenda that would fundamentally change the structure of the financial and real sector. Financial reform had been on the table for almost two decades at the time of the Big Bang announcement. Japanese regulatory authorities during this period had found it difficult to depart from the essential elements of the old regime for two reasons. First, the old regime had provided Japan's financial infrastructure for over a hundred years and especially had contributed to Japan's postwar economic successes. The financial regime served as a base model for other Asian economies in the postwar period, and thus the "Asian miracle" added further credibility to the Japanese financial regime's ability to support rapid and sustained economic growth. Second, transition to the new financial regime involved many winners but also created many losers who had benefited from the old regime. The slow and incomplete pace of liberalization in Japan can partly be explained by the fact that those who have benefited the most from the old financial regime are still in power and at the same time are likely to experience the greatest loss. The winners, however, are widely dispersed, not always clearly identified, and—most important—lack political power.

One would have thought that the PSS and FILP would be part of the Big Bang announcement, given their prominent role in the financial system and their clear conflict with the type of market-oriented financial system envisaged by the Big Bang announcement. Their omission from the announcement suggested an official reluctance to deal with one of the most important and complex constraints interfering with financial modernization. In fact, during this period the PSS was being held up by Japan as a model for other Asian countries (*Wall Street Journal*, 1997).

In the spring of 1997, a flurry of legislation was passed to begin implementation of the Big Bang objectives. The Bank of Japan Law was revised to give the Bank of Japan legal independence from the Ministry of Finance. The Financial Supervisory Agency was established to consolidate regulatory and supervisory responsibility over the financial system and thereby to reduce the role of the Ministry of Finance. Foreign-exchange laws were completely liberalized so that a special license was no longer needed to conduct foreign-exchange transactions.

There were no proposals in the Big Bang announcement, however, to deal with the PSS or the FILP, other than some minor comments regarding accounting for government corporations (Cargill *et al*., 1998). Like the elephant in the room for all to see, however, everyone in Japan knew that these institutions would soon be on the agenda for structural reform. The PSS and the FILP, in fact, had increased their relative importance in the financial system during the past two decades despite an official policy of liberalization, and it was not until 1994 that the PSS was subjected to any significant reform.[9] In 1994, the PSS and the Ministry of Finance reached an agreement that the PSS would set competitive interest rates on time deposits in order to reduce the disintermediation of funds from private banks. There were no reforms of the FILP system.

Financial distress and economic recovery in 1996 and 1997 turned to financial panic and economic decline in late 1997. The failures of Hokkaido Takushoku Bank and Yamaichi Securities Company, combined with the financial and economic distress spreading through much of Asia in the summer of 1997, shocked observers both within and outside of Japan. In response, in early 1998 the government committed 30 trillion yen in public funds raised by bond sales to protect depositors and recapitalize banks. By October 1998, a total of 60 trillion yen in public funds was committed to deal with the troubled financial system. The Long Term Credit Bank and the Nippon Credit Bank were nationalized in late 1998, and new institutions were set up to liquidate the loans of failed institutions. More aggressive policies were adopted to deal with the financial crisis, such as forcing banks to be more transparent about the extent of their nonperforming loans and requiring them to produce realistic resolution plans as a precondition to receiving public injections of capital. However, negative real GDP growth in 1998 and low growth in 1999 and 2000, combined with fiscal and monetary policy failures, complicated the situation.

At this point, policymakers in Japan realized that adherence to policies of delay, forbearance, forgiveness, and nontransparency had failed. These policies rooted in the old financial regime had prolonged and intensified the financial distress. After 1997, policymakers could no longer claim that financial distress was confined to the smaller and less important part of the financial system. The failure of Hokkaido Takushoku Bank and Yamaichi Securities Company indicated that financial distress had spread to the very core of Japan's financial system. Only significant structural reform, accompanied by large amounts of public funding, could solve the problem. By early 1998, there was general

[9] Tax reform in 1986 reduced a significant advantage of postal over bank deposits. However, this reform was not specifically directed at the PSS. It will be discussed in Chapter 2.

consensus that serious public funding would be needed to recapitalize the banking system and resolve the nonperforming loan problem. This was a significant turning point. Regulatory authorities by 1998 realized that only an extensive institutional redesign of Japan's financial institutions would provide the basis for achieving the goals of the 1996 Big Bang proposal, which remains the operating outline for financial reform in Japan. At this point, policymakers were willing to consider reform of the PSS and FILP.

1.6. PRODUCTIVITY, AGING, AND THE FILP SYSTEM

The economic and financial distress of the 1990s and the recognition that the old financial regime could no longer be sustained provided the incentive, for the first time in the postwar period, for regulatory authorities seriously to consider reforming the PSS and the FILP. However, another and more long-term issue began to emerge in the 1990s that provided additional incentive to consider reform. Japan's population growth is slowing dramatically, and population is projected to decline significantly by 2050.[10] Table 1.3 presents Ministry of Welfare[11] population estimates through 2010. Not only is population projected to decline starting in the first decade of the twenty-first century, but the percentage of persons aged 65 and older is projected to increase significantly. Japan's population is expected to age faster than the population of any other industrial country. These demographic changes require that savings be channeled to the most productive uses possible in order to increase productivity if Japan is to maintain the current standard of living for its population.

Japan has one of the highest and most stable savings rates in the world, although the household-sector savings rate declined after 1975 from the high levels in the previous decade (Table 1.1). Many would argue that much of this saving has not been utilized productively because of an inefficient financial system and, more specifically, because of the large amount of funds allocated by government financial intermediation for domestic purposes. Many observers argue that the rate of return on FILP-financed activities is low and in some cases negative. Japan will pay a high price in terms of reduced productivity if institutions are not soon changed to channel funds to higher rate-of-return uses.

Feldman (1996) provides a simple framework to emphasize this point. Based on a production function identity that expresses output as the product of productivity (output per worker) and the number of workers, the standard of living measured as output per capita can be expressed as:

$$Y/P = [\sum s_j(Y_j/L_j)](1-u)(W/A)(1-d) \tag{1.1}$$

[10] Takayama (1998) presents a comprehensive overview of Japan's population changes.
[11] The Ministry of Welfare as of January 2001 is now the Ministry of Health, Labor, and Welfare.

Table 1.3. *Population and aging in Japan*

Year	Population (millions)	Persons 65 or older
2000	126,919	16.7
2005	127,684	19.6
2010	127,623	22.0
2020	124,133	26.9
2030	117,149	28.0
2040	108,964	31.0
2050	100,496	32.3

Source: Ministry of Welfare Website.

where Y represents output, P represents population, s_j represents the allocation of working labor in the jth sector, (Y_j/L_j) represents labor productivity in the jth sector, Y_j represents output in the jth sector, L_j represents working labor in the jth sector, W represents the labor force, A represents the working-age population, d represents the dependency ratio (non-working age population to population), and u represents the unemployment rate. Feldman and others emphasize the fact that Japan faces a difficult future given projected demographic trends. The increase in the dependency ratio, d, will reduce the standard of living, other things held constant. The only way this can be offset is if labor productivity is increased, the unemployment rate is lowered, or the participation rate is increased. There are constraints on how much offset can be expected from a decline in the unemployment rate or an increase in the participation rate, both of which are expected to improve in the near future, but not sufficiently enough to offset the increase in the dependency ratio. The major issue is labor productivity, and it is this factor that raises concern about the role of government financial intermediation.

Thus, aside from the efforts to reform Japan's financial system that emerged from the economic and financial distress of the 1990s, the near-term demographic changes provide an additional incentive to modernize the financial system to ensure that Japan's high savings are put to the most productive uses.

1.7. CONTINUED GROWTH OF THE PSS AND ENHANCED ROLE OF POSTAL DEPOSITS IN JAPAN'S PAYMENTS SYSTEM

PSS officials have shown little inclination to slow their growing role in the financial system, and its scheduled public corporation status in 2003 provides the PSS with incentive to establish itself as a government provider of financial services. Okina (2000) provides a detailed documentation of the new services offered by the PSS and the increasing willingness of private financial institutions to enter into formal relationships with the PSS to handle transactions between individuals and between individuals and businesses. In 1985, the PSS established cash dispensers (CDs) and automatic-teller machines (ATMs) outside the premises of the post office. In 1989, automated transfer service accounts were established linked to ordinary savings accounts and remittance functions. In the 1990s, the postal savings network was opened to private financial institutions with 1,823 members as of year-end 1999; it also established international remittance services and began discussions with private institutions to establish Internet banking services, inter-institutional remittance services, and debit cards. Whereas the majority of these relationships are being established with smaller depository institutions (regional banks, credit cooperatives, and other cooperatives), the PSS is also establishing relationships with several city banks, trust banks, long-term credit banks, securities companies, and life-insurance companies. Table 1.4 lists the CD and ATM tie-ups between the PSS and various private financial institutions as of 31 December 1999. The PSS is also in the process of establishing payment services not only with private financial institutions, but with nonfinancial business firms such as NTT Data and All Nippon Airways.

These developments are problematical, aside from the increased competition with private financial institutions. The increased role of the PSS in the payments system provides a strong argument that the PSS should be formally incorporated into the official settlement system operated by the Bank of Japan. This will be necessary to improve efficiency in the settlement of outstanding balances and, more important, to ensure that the Bank of Japan has oversight over the settlement process to maintain financial stability. At the same time, incorporation of the PSS into the formal Bank of Japan settlement system enhances the economic and political power of the PSS. Private financial institutions, especially banks, have been vocal critics of the PSS; however, the various relationships being established between the PSS and private financial institutions will either turn private financial institutions into reluctant supports of the PSS or, at a minimum, into silent critics of the PSS.

These developments suggest that the window of opportunity to deal with the PSS problem and to modernize Japan's financial system is not large.

1.8. CONSENSUS FOR REFORM

Thus, by the late 1990s there was sufficient consensus that reform of the PSS and the FILP be placed on the reform agenda. To recapitulate, four factors generated the consensus. First, financial distress in the first part of the 1990s

Table 1.4. *Applications for CD and ATM tie-ups from private financial institutions (as of 31 December 1999)*

Type of institutions	Number of institutions	Major applicants
City banks	3	Daiwa, Tokai, Asahi
Trust banks	7	Sumitomo, Mitsui, Chuo, Yasuda, Toyo, Mitsubishi, Orix
Foreign banks	3	CityBank, Bank of Brazil, Banco do Estado de SaÕ Paolo S.A. (Banespa)
Regional banks	16	Hokuetsu, Musashino, Okinawa, Ryukyu, Tokyo Tomin, etc.
Regional banks II	50	Niigata Chuo, Chubu, Tokyo Sowa, Kagawa, etc.
Long-term credit banks	3	Long-Term Credit Bank of Japan (now Shinsei Bank), Industrial Bank of Japan, Nippon Credit Bank
Shoko chukin banks	1	
Shinkin banks	316	
Labor credit associations	41	
Credit cooperatives	145	
Credit federations of agricultural cooperatives	29	
Agricultural cooperatives	1,000	
Credit federations of fishery cooperatives	1	
Fisheries cooperatives	115	
Securities companies	15	Daiwa, Nomura, Nikko, etc.
Security-investment trust companies	3	
Life-insurance companies	12	
Non-life-insurance companies	4	
Charge companies	52	
Bank-affiliated card companies	7	
Total	1,823	

Note: Each private financial institution holds postal savings accounts and makes payments using cash and checks.

Source: Okina (2000, p. 16).

revealed the potential instability that the PSS presented to the financial system by encouraging disintermediation of funds from private banks to the PSS and by complicating the government deposit-guarantee system. Second, political consensus was growing that Japan needed a major overhaul of its economic institutions. The PSS and FILP together were the elephant in the room that had been ignored, and the elephant could no longer be ignored if Japan wanted to achieve a credible financial reform process. Third, the projected decline in population and increase in the dependency ratio (nonworking-age population as a percentage of the population) will lower the standard of living under current conditions. Increasing labor productivity through higher yield investment is the only practical offset to a decline in the standard of living that will occur under current conditions. Fourth, the increasing role of the PSS in the payments system and the potential that the PSS will become an important part of the payment system imply that reform will encounter significant resistance.

In 1993, post offices were officially directed to cease appealing to the fears of the public in order to attract deposits. In 1994, the regulatory authorities agreed 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 in June 1998.

1.9. THE FIRST SERIOUS EFFORT TO REFORM THE PSS AND THE FILP—1998

As a reflection of this greater willingness to depart from the old regime and of an emerging consensus that reform of the PSS and FILP could no longer be avoided, the PSS and the FILP were targeted for reform in 1998. The PSS or FILP were not regarded as a fundamental cause of the financial distress, and in fact the FILP played a counter-cyclical role by offsetting part of the private-bank credit crunch in the last part of the 1990s. However, the time had arrived for serious reform of the PSS and the FILP to transform the financial system into the one envisaged by the Big Bang announcement. Regulatory authorities recognized that unless meaningful reform of the PSS and FILP were attempted, Japan would be unable to make a creditable case to the international community that serious reform was in progress. Concerns about enhancing the productivity of the economy in the face of projected population changes provided further incentive to reform the PSS and FILP.

As part of the Laws to Reform Central Government Ministries and Agencies passed in June 1998, the structure of government budgeting was fundamentally changed. The process of reform initiated by the June 1998 legislation has the potential of significantly redesigning the role of government financial intermediation in Japan. This legislation was developed by the Ministry of Finance, which has responsibility for the Trust Fund Bureau and the FILP system; however, responsibility for the PSS resided with the Ministry of Posts and Telecommunications, so the June 1998 legislation only dealt with the FILP.

The June 1998 legislation and subsequent administrative decisions do not solve the PSS problem, nor do they address the larger role of government financial intermediation. The legislation essentially restructured government intermediation and set up a framework to make the sources and uses of funds more market sensitive. In fact, a cynic could argue that the changes are in form only, and not in substance, by pointing out that the PSS will now merely purchase bonds issued by government banks and/or bonds issued by the Ministry of Finance earmarked to fund entities previously financed by the FILP.

It is possible to view the changes in a positive manner, however, and to regard them as a meaningful step in the right direction, with the potential to modernize an important part of the Japanese financial system. These changes bring the issue of government financial intermediation to the forefront of policy discussion and establishes a framework that has the potential to generate additional fundamental reforms consistent with the Big Bang proposals. At a minimum, the reforms will provide more transparency to government financial intermediation and will render government financial intermediation more market sensitive, since many of the entities previously funded by the FILP will be required to rely partly on funds obtained in the capital market at market-determined rates. To assist in their greater reliance on market sources of funds, thirty-three FILP-financed entities that previously obtained funds from the Trust Fund Bureau are now required to provide public disclosure of a detailed analysis of the present value of their operations. With respect to the PSS, the closer link between uses and sources of funds in the PSS may also make it more difficult for the PSS to continue offering *teigaku* deposits.

Liberalization has been a major agenda item in Japan for over two decades, and although some progress has been achieved, essential elements of the old financial regime remained in place until the late 1990s. There were indications, however, in the late 1990s that Japanese regulatory authorities were in the process of making fundamental changes in the financial regime in a variety of areas. It would not be an exaggeration to view Japan's solution to the problems created by the PSS and FILP system as a fair indicator of whether the goals of the Big Bang will be realized. The PSS and FILP have been an integral part of the old regime, and reform of these key elements of the old regime will indicate just how willing Japan is to move to a new, more open, and competitive financial regime. Japan is indeed at the crossroads, and a review of the issues, politics, and economics of the PSS and FILP is needed for any assessment of the future of the Japanese financial system.

1.10. KOIZUMI AND THE PSS

On 26 April 2001, Junichiro Koizumi became Japan's new prime minister after winning a popular mandate on 24 April 2001, at the local LDP chapter level, to reform the ruling LDP and lead the country out of a decade of economic and financial distress. Koizumi is known as a radical and a maverick because of his position on privatizing the PSS as well as other positions on reforming Japan's depressed economy. He advocated a far more aggressive approach to resolving the nonperforming loan problem than had been attempted to date, by forcing banks to write off bad loans; he had criticized Japan's inefficient pension system; and he advocated the popular election of prime ministers. Prime Minister Koizumi came from the traditional LDP; however, his reform proposals, his grass-roots rather than party-boss support, and his resounding victory over the far more traditional LDP candidate, Ryutaro Hashimoto, who served as prime minister from late 1996 to July 1998, set him apart from the typical LDP politician. Hence, radical and maverick are well-deserved characterizations of Koizumi.

Prime Minister Koizumi must contend with the economic, financial, and political instability that have characterized Japan since the collapse of asset prices in the early 1990s, and his proposal to privatize the PSS would be the most significant structural change in Japan's financial system undertaken in the postwar period. The immediate problem as of late 2001 is to resolve the nonperforming loan problem and to adopt a more aggressive monetary policy to reverse the downward movement in the price level, but in terms of the long-run modernization of Japan's financial system to support sustained growth and deal with projected demographic trends, reform of the PSS and the FILP has high priority.

The reforms of 1998 and subsequent administrative decisions were significant steps toward modernizing Japan's financial system, but they lacked political leadership and were incomplete since they left the PSS as a government bank. Koizumi provides and adds a new dimension to the debate. Despite the significance of the 1998 reforms, the PSS remains a government bank, and liberalization of the PSS and FILP must ultimately entail privatizing the PSS as well as rendering the majority of FILP-funded entities dependent on market sources of funds.

The reality is that Koizumi, or any political leader advocating privatization of the PSS and further reform of the FILP, faces a daunting process. It is not by accident that the PSS and FILP have avoided reform until recently. First, they provide significant advantages to the participants. The *teigaku* time-deposit, which represents about 80 percent of postal deposits held by the public, provides a no-penalty option to withdraw funds after six months to take advantage of interest-rate movements; hence, the *teigaku* deposit offers a higher effective interest rate than any time-deposit offered by private banks. Post offices are more convenient than private banks, as their numbers exceeded those of private-bank branches in every prefecture for much of the postwar period. The PSS shows no interest in restraining growth and, in fact, has expanded its services and formed CD and ATM relationships with private financial institutions; for example, buses from Narita Airport to Tokyo advertise the availability of Visa services for cardholders at local post offices. According to Okina (2000), postal offices are devoting much effort to becoming "financial convenience stores." Funds obtained through the FILP were subsidized—a benefit to many borrowers who would have been unable to obtain 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. The PSS is also an important support system for the LDP and allows the LDP to reach virtually every area of Japan. Postal officials frequently play a role in the election process at the local level, since they in turn can depend on the LDP to support the PSS. According to the *New York Times* (2001), there was evidence that local postal authorities attempted to influence the April 2001 grass-roots voting in favor of Hashimoto, the LDP-designate to replace Mori. Third, the size and pervasiveness of the PSS and FILP rendered reform a difficult process even under the most favorable conditions, so policymakers were willing to put PSS and FILP reform on the back burner. Fourth, the PSS and FILP are 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. Fifth, financial liberalization was mainly a response to internal and external pressure from various groups who saw liberalization as a way to reestablish lost markets (domestic banks), expand markets (foreign financial institutions and domestic securities companies), enhance profit via portfolio management (domestic corporations),[12] or deal with trade-balance issues (mainly the United States). Their agenda did not focus on government financial intermediation. Thus, reform of the PSS and FILP is primarily an internally generated process and, until Koizumi, it lacked any political leadership. Sixth, the increasing role of postal deposits and the increasing relationship between the PSS and private financial institutions emphasized by Okina (2000) makes radical reform of the PSS more difficult and shortens the window of opportunity for reform. The increased role of the PSS in the payments system requires

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[12] The portfolio-management recommendations were developed by the Asset Management Council of the Ministry of Posts and Telecommunications, which were then formally announced by the Ministry.

that it become a formal component of the Bank of Japan settlement process; however, this will only strengthen the economic and political influence of the PSS.

1.11. OUTLINE OF THE REST OF THE BOOK

The remainder of the book is composed of the following four chapters. In Chapter 2, we discuss the historical evolution of the PSS and FILP, with emphasis placed on developments in the postwar period. Flow of funds and related statistical measures indicate that the PSS and FILP have been a major feature of Japanese finance and, despite an official policy of liberalization since 1976, the PSS and FILP increased their role in the economy. Chapter 3 develops a formal flow-of-funds model of the PSS and FILP to provide a representation of how the PSS and FILP interact with other elements of the financial regime. Comparative static results are derived to shed light on important policy issues that have been raised in the past with regard to the PSS and FILP, as well as to evaluate the 1998 reform effort. Chapter 4 presents empirical evidence on various aspects of the PSS and FILP in postwar finance and attempts to evaluate their impact on Japan's flow of funds and economy from several perspectives. Chapter 5 summarizes the main points of the study, reviews the report of the Asset Management Council of the Trust Fund Bureau that led to the June 1998 legislation, evaluates the reform process, and offers some recommendations for further reform.