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Japan Passes Again on Fundamental Financial Reform

Japan's Prime Minister Koizumi came to power in April 2001, promising to deal aggressively with the problems that underlay the country's economic and political instability. Since then, his reform efforts have met increasing resistance, the economy and financial system have yet to improve, and his public support has fallen.

This *Economic Letter* focuses on two aspects of those reform efforts: reducing Japan's extensive system of government financial intermediation and reducing government deposit guarantees. While these two reforms are widely understood to be critical to Japan's efforts to modernize its financial system, it is less well understood that they are interdependent: so long as government financial intermediation remains a large part of the Japanese economy, the potential benefits from deposit insurance reform will remain limited, exposing the private banking system to even more stress. Koizumi promised major reforms in both areas, but continued economic and financial distress in Japan and a lack of consensus to change indicate that Japan again will fail to enact fundamental financial reform this year.

The PSS and FILP: Reform and reaction

The Postal Savings System (PSS) and the Fiscal Investment and Loan Program (FILP) constitute Japan's system of government financial intermediation. The PSS holds deposits of ¥240 trillion, making it the world's largest financial institution; it also sells life insurance, accounting for about 30% of the Japanese market. Until 1998, the PSS was officially part of FILP. FILP, which is managed by the Ministry of Finance (MoF), essentially finances government banks that provide subsidized loans to targeted sectors of the economy and a wide range of other government entities. Much of the money for these loans has come from transfers from the PSS through the Trust Fund Bureau of the MoF to FILP. The FILP budget is about 10% of Japan's GDP.

Legislation passed in 1998 set April 2002 as the beginning of a changed relationship between the PSS and FILP. At that time, the PSS and FILP budgets were separated. The PSS was no longer required to transfer funds to the Trust Fund Bureau. The FILP entities were required to raise funds either by selling their own obligations (that is, FILP-agency securities with or without a government guarantee) in the open market or by participating in FILP bonds issued by the government. At present, only a small number of FILP entities sell FILP-agency securities with their main funding coming from FILP bonds; however, the goal is that the FILP entities eventually will obtain a major part of their funding through FILP-agency securities. The PSS now allocates 80% of its portfolio to "safe" assets such as government bonds, FILP bonds, and FILP-agency securities. Some argue the new arrangement may not be much different from the old one. The PSS now supports FILP entities by purchasing bonds, whereas in the past, the PSS supported FILP entities through the Trust Fund Bureau.

In the spring of 2002, Koizumi introduced legislation to begin privatizing the PSS. This followed his announcement in December 2001 that he would begin dismantling several government banks, including the large and popular Government Home Loan Corporation. Koizumi, however, has been unable to garner any broad public support for change, and indeed, his plans have met stiff resistance. It now appears likely the PSS will remain a government bank and no further meaningful reform of the FILP entities will occur this year.

Where is the resistance to reform coming from? Various observers have cited several opponent groups. One is the Liberal Democratic Party. It relies on the PSS both to maintain power by mobilizing votes at the local level and to maintain the *amakudari*, or "descending from heaven," reward

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system, in which party members may retire from office to a position in the PSS. Another is the regulatory agencies that deal with the PSS; reform would reduce regulatory power as well as eliminate an important part of the *amakudari* system for government bureaucrats. A third is small businesses and the household sector; several government banks expanded loans to small businesses and households significantly in the 1990s, and the household sector is earning a relatively high real return on PSS deposits—which many regard as safer than private bank deposits—because of declining prices. Finally, private banks, long supporters of privatizing the PSS, have become less vocal as they increasingly establish relationships with the PSS via cash dispensers and transfer arrangements. Okina (2000) documents the PSS's efforts to integrate itself into Japan's payment system by these means. As these interactions between the PSS and private banks grow, private banks may be less supportive of privatizing the PSS than before.

With regard to FILP, even if politicians were willing to dismantle a major part of it, they might be constrained by a reluctance to reveal to the public the magnitude of its nonperforming loan problem. Doi and Hoshi (2002) estimate that as much as 68% of the outstanding loans to FILP recipients (about 9% of GDP) are nonperforming. This estimate has been challenged; but even if it is overstated by as much as 50%, it still represents a serious problem that has not been acknowledged. And, combined with the nonperforming loan problem in the private depository industry, which is estimated at about 12% of GDP, Japan's nonperforming loan problem is immense and, under current policies, not likely to decline.

Deposit insurance reform

Japan established the Deposit Insurance Corporation (DIC) in 1971 not as a safety net for the banking system but as a counter to critics of the MoF's decision to permit increased branch banking. In fact, until the late 1980s, the DIC had only a very small staff, no independent regulatory powers, no program to conduct bank examinations, and insufficient reserves to resolve even a medium-sized bank failure with its ¥10 million deposit insurance limit. As a result, Japan's financial safety net continued to rely on an implicit guarantee by the government to protect all deposits. The financial distress of the first half of the 1990s revealed the weakness of deposit insurance and the implicit complete deposit guarantee in Japan. The failures of several small credit cooperatives rendered the DIC insolvent, and the public became concerned about the safety of private banks in general and the ability of the government to protect all deposits. A much smaller government insurance corporation for small and specialized depository institutions also became insolvent in the early 1990s.

In 1995, the government attempted to restore public confidence in the banking system and reduce the "Japan Premium" (i.e., the premium Japanese banks had to pay to purchase funds in the London market). It reorganized, enlarged, and expanded the DIC's powers and adopted Prompt Correct Action in dealing with troubled institutions. The intention was to make the DIC the primary safety net for private deposits (like the FDIC in the United States) and to eliminate the complete, but implied, government deposit guarantee that had been in place since the early 1950s.

The MoF declared a "transition" period for implementing these reforms during which all deposits would have explicit government guarantees. The transition ran to March 31, 2001, by which time the government was confident the economic and financial distress would be resolved. Indeed, in 1996 the government was optimistic enough to announce the Big Bang—that is, the goal of making Japan's financial system equal in terms of competition, fairness, and transparency with London and New York by 2001.

Needless to say, the Japanese economy and financial system did not improve and, in fact, deteriorated during the remainder of the 1990s. As a result, the government extended the removal of the explicit complete guarantee by one year and phased in its removal over two years. Since April 1, 2002, time deposits have been insured up to only ¥10 million, while other deposits are completely covered until April 1, 2003. Recent actions by Koizumi and the government indicate the complete deposit guarantees may not be removed on transaction-type deposits next year.

The PSS and deposit insurance—the cart before the horse

So long as the PSS is a government bank, it complicates Japan's deposit insurance reform in two ways. First, it encourages disintermediation of funds from private bank deposits to PSS deposits in times of financial distress; second, in the absence of financial stress, the PSS will likely establish a dual system of deposit guarantees in Japan.

Disintermediation. During periods in the 1990s, when people were concerned about the financial stability of the private banking system, they transferred funds from private depository institutions into the PSS. Why did this happen, considering that private bank deposits were insured up to ¥10 million and PSS deposits were limited to ¥10 million? Because PSS deposits were perceived by the public as direct government debt, and therefore fully guaranteed, while the DIC was perceived to be incapable of providing the ¥10 million guarantee beyond only a small number of depository institutions.

U.S. history itself has an episode when a postal saving system led to disintermediation. This happened in the early 1930s, when the financial system was in distress. O'Hara and Easley (1979) and Kuwayama (2000) document how bank failures encouraged disintermediation of funds from private banks to the U.S. postal system, which served to increase the stress on private banks.

While the U.S. version of the PSS has long since disappeared, Japan's PSS remains a large part of the country's flow of funds. Hence, its role as a government bank remains a potential problem as Japan moves toward a U.S.-style deposit insurance system.

Dual system of government deposit guarantees. Even in a more stable economic and financial environment, Japan will not likely establish a meaningful deposit insurance system as long as the PSS remains a government bank, because in that form it leads to a dual system of deposit guarantees. One part of the system is the PSS and very large banks. PSS deposits are regarded as government debt, so holders of those deposits are not concerned about the underlying financial condition of the DIC or of any separate government insurance agency to fulfill the deposit insurance limit. Though PSS deposits are limited to ¥10 million—the same level as the insurance limit on private deposits—the two types of deposits are not likely to be viewed as equivalent by the typical Japanese deposit holder, especially given the experience of deposit insurance in Japan and the lack of credibility in the government. At the same time, the very large banks in Japan operate with a complete deposit guarantee, irrespective of deposit insurance. This feature of Japanese finance is known as "too big to fail," and while the government may declare large banks insolvent (like Japan Long Term Credit Bank, and Nippon Credit Bank in late 1998), depositors anticipate their deposits will be protected beyond the deposit insurance limit.

The other part of the system is the large number of small credit cooperatives and small banks, whose deposit guarantee status is less certain. In the view of the typical deposit holder, postal deposits will be considered safer than the deposits of the smaller depository institutions. This complicates the government deposit guarantee system and puts smaller private depository institutions at a competitive disadvantage compared to the large private banks and the PSS.

A prerequisite to deposit insurance reform

There are many arguments for privatizing the PSS. Few have recognized so far, however, that one of the most important arguments is that privatizing the PSS is a critical prerequisite in reforming deposit insurance. Japan, unfortunately, appears unable at this time to meaningfully reform the PSS. In spite of this, Japan has continued to reform deposit insurance until recently without much consideration for the complications created by a government bank. But even this effort appears to have stalled in recent months.

Prime Minister Koizumi came to power on an optimistic note, but the past year has shown that good intentions are insufficient to reform Japan's troubled financial system.

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