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Postal Savings in Japan and Mortgage Markets in the U.S.

Financial system redesign has become high political drama in Japan. In August 2005, Prime Minister Koizumi's plan to privatize Japan's huge postal savings and life insurance system (PSS) was defeated in the Lower House of the Diet. Koizumi then retaliated by dissolving the Lower House and calling a "snap" election for September 11, 2005, in hopes of getting members of the Liberal Democratic Party (LDP) more supportive of his program into the legislature. This was essentially a showdown—an open confrontation between the "new" and the "old" LDP in an effort by Koizumi to reduce the role of government. In the end, Koizumi and the more liberal wing of the LDP were victorious, increasing their majority position from 54% to 67%, and on October 14, 2005, Koizumi's privatization proposal became law with only minor changes. This victory has generated widespread optimism that serious structural reform will commence and that the Japanese economy has turned the corner after almost fifteen years of recession, deflation, and stagnation.

Japan is not alone, however, in confronting issues related to a large government presence in the financial system. For example, Greenspan (2004) as Fed Chairman testified about the potential for Fannie Mae and Freddie Mac, the two big government-sponsored mortgage institutions, to generate systemic risk in the U.S. financial system.

This *Letter* puts the recent events in Japan in context, describes the Koizumi proposal enacted in October, and discusses the PSS and Fannie Mae and Freddie Mac (hereafter Fannie and Freddie).

Why reform Japan's PSS?

The PSS, now called The Japan Post, is a government-owned corporation that uses 25,000 post offices to collect government-guaranteed savings deposits and to sell life insurance. The funds in turn are passed to the government by buying either Japanese government bonds or the debt of government agencies that fund infrastructure projects like bridges and housing. The PSS is big—it holds about ¥330 trillion in assets, which is roughly 65% of Japan's GDP.

Although there is some debate about whether, as a historical matter, the PSS has had a net positive impact on Japan's economic growth, it is widely recognized that, to meet the current and future requirements of the Japanese economy, the existing structure and size of the PSS must be reformed. The PSS enjoys government-conferred advantages that make it difficult for private banks and insurance companies, still seeking to recover from the "lost decade," to compete on an equal footing. For example, the PSS network provides a ready-made subsidized branch system, the PSS pays no significant taxes, nor does it pay deposit insurance, it has no capital requirements, and it faces a far lower regulatory burden. Many also argue that the presence of the PSS results in substantial misallocation of capital to projects of questionable social value and creates systemic risk in the financial system; since PSS investments in these projects are guaranteed by the government, Japanese taxpayers are exposed to large losses because of nonperforming assets and loans embedded in PSS, which are estimated in one study (Doi and Hoshi, 2003) to have been 16% of GDP in 2001. The presence of the PSS also encourages disintermediation from private bank deposits to postal savings in times of financial distress and generally complicates Japan's efforts to establish a stronger deposit insurance and supervisory system for private banks. Finally, the PSS, with 400,000 employees, representing 30% of all national government employees provides a strong grass roots system for the traditional element of the LDP, which, in turn, has been responsible for much questionable government spending.

Pacific Basin Notes *Pacific Basin Notes* appears on an occasional basis. It is prepared under the auspices of the Center for Pacific Basin Studies within the FRBSF's Economic Research Department.

Japan faces major demographic challenges from a significant decline in population and a relative decrease in the number of working-aged individuals. Simple national income accounting implies Japan's GDP per capita will decline unless these demographic changes are offset by increased productivity. A key way to achieve that increased productivity is to invest Japan's substantial financial resources in the most productive enterprises, a difficult task with so much inefficiency in the financial system. Hence, reform of PSS is part of the effort to raise the rate of return on Japan's substantial savings.

Koizumi's proposal

The Koizumi proposal enacted October 2005 consists of six bills with the following elements: (a) Effective April 1, 2007 (now October 1, 2007), the Japan Post would be divided into four separate companies controlled by a holding company (Japan Postal Services Holding Company), responsible for mail service, postal savings, postal life insurance, and the network of post offices. The government will initially hold all shares in the holding company. A Postal Services Privatization Committee, consisting of 5 members with 3-year terms of office, will be in charge of the privatization process and will verify progress with privatization every three years. (b) At the end of the transition period in October 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 mail service and network companies will continue to be wholly owned by the holding company. (c) At the end of the transition period 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 utilize 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. (i) The postal savings corporation will be required to contribute to the deposit insurance system.

Several features of the privatization of the PSS leave some observers wondering if it amounts to being "privatized" in name only. The privatized PSS will continue to be a large player in Japan's financial system, and, because of the special relationship to the government, it will continue to enjoy implicit government guarantees. The postal savings and life insurance companies can continue to use the post office network and will receive licenses enabling them to conduct a full range of business activities, domestically and internationally. With continued government ownership of the holding company, new obligations will enjoy a perceived implicit government guarantee. While the new system will be taxed and pay deposit insurance, it is not clear how or at what level capital asset requirements will be imposed. Finally, there is a general vagueness about what the new system will look like after a 10-year process, and this long transition is susceptible to political tinkering, especially once Koizumi steps down at the end of 2006.

On the positive side, however, are three major accomplishments. First, the declassification of a large number of government workers to private status sets the stage for other reforms. Second, now that it has begun, the process of privatization is unlikely to be reversed—this is a major attitudinal change, especially considering that this significant element of Japan's financial system has been in place since 1875. Third, Koizumi's victory in the "snap" election showed politicians that liberalization and privatization policies will be rewarded by the public.

What can be learned from Fannie Mae and Freddie Mac?

As Japan moves toward a privatized PSS, it may be instructive to consider the privatized Fannie Mae and Freddie Mac in the U.S., to anticipate issues that might arise in the future. Like the PSS, Fannie and Freddie are large institutions—they hold assets worth nearly $4 trillion, representing about 30% of U.S. GDP and they either hold or assume the credit risk of about three-quarters of U.S. residential mortgages. Like the PSS, Fannie and Freddie enjoy competitive advantages over private sector competitors by borrowing with implicit government guarantees. As a result they increase systemic risk by assuming significant interest rate risk, and they misallocate resources by directing most of their subsidy to shareholders rather than homeowners. Like the PSS, these institutions have strong grass roots support among homeowners and the home industry.

Also like the PSS, Fannie and Freddie have arguably played an important positive role in the U.S. financial system. Their original function was to create a secondary market in residential mortgages, and in this regard they were highly successful. The secondary market allowed depository institutions, especially savings and loans, to reduce interest rate and prepayment risk. Fannie and Freddie purchased these mortgages with funds raised by selling mortgaged-back securities (MBS) to those better able to manage the interest rate and prepayment risks. Fannie and Freddie assumed the credit risk of the mortgages because they guaranteed only that interest and principal would be paid. Even though now privately owned, Fannie and Freddie have a special relationship with the government that in turn was part of a social contract with the public dating back to the Homestead Act of 1863 to support residential housing.

Like the PSS, the original rationale of Fannie and Freddie is increasingly difficult to support in light of the potential problems they generate. Securitization is now a major part of the private market, and, in the absence of Fannie and Freddie, private market securitization providers would surely emerge. Furthermore, in an effort to generate higher earnings, Fannie and Freddie have significantly increased borrowing from the markets to finance purchases of mortgages held in their own portfolios as well as MBS that they previously issued. This portfolio activity generates interest rate and payment risk in addition to credit risk for Fannie and Freddie. Those institutions have been able to borrow at rates only slightly above government security rates, because their debt is perceived as implicitly guaranteed by the government, even though it is only their assets that are so guaranteed. Given this perception, the public is likely correct that the government would go to great lengths, including using taxpayer funds, to "save" the mortgage market and support the American dream of homeownership.

Concluding comment

Japan has started a process to privatize the largest and longest-lived element of its old financial regime. There are many limitations of the Koizumi proposal and much could change during the long transition period; however, one should not understate the significance of recent events in Japan from a public policy perspective. There is broad public support for modernizing Japan's economic institutions. At the same time, even a privatized PSS with a special relationship to government will continue to generate issues—one need only consider the issues that have arisen in the U.S. regarding its own government-sponsored enterprises, Fannie Mae and Freddie Mac.

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