The $3 Trillion Stamp

Sam S. Park – October 2005

Japan's Hope for a Miracle Man

Junichiro Koizumi first stepped into office as Japan's Prime Minister in 2001. We all recognize the amazing growth that Japan had witnessed throughout the 1980s. However, what goes up must come down, and the Japanese economy fell hard. Japan went through a decade of economic stagnation and has not really come out of that slump. The Japanese government has tried one fiscal stimulus after another with little success.[1]

Japan can blame the credit induced bubble for the slump it has been experiencing. The Japanese authorities tend to favor a zero interest rate policy. This may benefit borrowers, but extremely easy credit does not necessarily mean good things for the economy. Let's put things into perspective. Here in the U.S., many homebuyers have seen some attractively low mortgage rates, which have fueled the red-hot housing market. And that's when the 10-year Treasuries hovered above 4 percent. Imagine if those borrowing costs were close to nothing (as was the case in Japan), everyone (who could) would buy property and thus drive up prices, creating an unmanageable bubble.

When the bubble popped, prices fell hard, and the Japanese central bank (Bank of Japan) was left with their pants down because they couldn't lower interest rates to correct the deflationary pressures. How can you go lower than practically zero? The Japanese people witnessed this downfall as its central bank's hands were handcuffed, which prevented it from engineering solutions. So the government decides to stimulate the economy by increasing its fiscal deficits by funding certain "chosen" public projects. Seriously, who were they kidding?

The Japanese government's appetite for a quick fix had plagued its economy. Japan currently runs the world's largest debt of 795.8 trillion yen (approximately $7 trillion assuming 114 yen/dollar), of which nearly 20 percent of that is funded by the Japanese Postal Savings System (PSS or *yucho*).[2] This means that 44 percent of the 350 trillion yen (over $3 trillion) of Japan's PSS assets go towards funding the Japanese government's fiscal stimulus efforts.[3] So how does Japan's PSS provide over a trillion dollars to its government? A review of the privatization of the *yucho* will answer this and shed some light as to what will happen in the years to come. We believe this privatization will have implications to the U.S.

Japan's Postal Savings System

Japan's Postal Savings System served its country by funding much of the growth that Japan went through in the 80s. The PSS also has been blamed for much of the inefficiencies in the Japanese economy. As mentioned, the *yucho* holds over $3 trillion worth of assets, making it the largest financial institution in the world. One may wonder how a postal service could accumulate such a large amount of assets.

The postal system in Japan has been accepting savings deposits for well over a century. The PSS has such a presence in Japan that the Post Savings account for 20 percent of all financial assets

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[1] http://www.econ.ucla.edu/workingpapers/wp811.pdf
[2] Ministry of Finance Japan - http://www.mof.go.jp/english/gbb/e1706.htm
[3] http://www.japantimes.co.jp/cgi-bin/geted.pl5?eo20050831ro.htm

held by Japanese households.[4] Japanese citizens can send letters, deposit money, and buy insurance at any of the PSS 25,000 branch offices. Four units make up the PSS: over-the-counter service (Post Office Company), mail delivery (Mail Service Company), savings (Postal Savings Bank), and insurance (Postal Insurance Company). Just to make sure we're on the same page, the mail delivery unit is far from being the cash cow of the *yucho*. The term "Postal" in PSS can seem deceiving for those who do not understand the different components of the entity. Your perceptions will change as you continue reading this report.

The postal savings concept is not a unique concept. The United Kingdom first applied this concept, and even the U.S. had implemented a postal savings system back in the early 1900s. However, this system could not last in the U.S. because of the competition from the private banks. The crucial influence that allowed the Japanese version to thrive has been coming from the government. The Japanese structural system seems to favor a cross-holding relationship.

The best way to put this in perspective is like saying, "I scratch your back; you scratch mine." And that's what has been going on in Japan, allowing the creation of such a huge financial institution. The PSS was the funding source for inefficient public projects. The Japanese government provided benefits to the depositors in the form of interest tax exemptions and deposit guarantees.

Although these benefits have been somewhat lessened over the recent years, such government subsidies have allowed the PSS to offer better rates than the competing private banks. The funny thing, as a person who is used to rates in the U.S., is that the *yucho* has been offering annual rates below one percent since 1995.[5] The Japanese people however have remained very conservative and preferred safety above all else. Can you blame them after having gone through such a wild rise and fall in its economy? Asset prices plummeted, and private banks full of non-performing loans failed because of troubled businesses and the lack of government support.

The government backing has allowed the PSS to build the amount of assets it has over the years. Much of the *yucho's* deposits get channeled to the Fiscal Investment and Loan Program (FILP), an entity managed by Japan's Ministry of Finance.[6] Accusations have surfaced as the Japanese public has been pointing fingers at certain officials for inefficient misuse of these funds. The Japanese government has been investing the nation's money in transportation, military and social programs. Such programs have been blamed for the inefficient use of the nation's funds.

Since Japan's PSS provides a large chunk of financing for the central government, control over Japan's Postal Service is extremely vital for the Japanese government. This is probably why the privatization of the PSS has been a long and heated battle for Prime Minister Koizumi, who based his reform campaign on this privatization. It's no surprise that the Prime Minister's privatization opposition (Democratic and Social Democratic parties, including some of his own Liberal Democratic Party) fought hard to oppose this bill that finally passed October 14th of 2005.

A Privatized Postal Savings

Koizumi's stated purpose for privatizing the PSS focuses on creating an efficient use of these deposit funds. The privatization, in theory, would take away the government's control of the money, and in effect, the funds would be allocated to more efficient investments. Back when the

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[4] Yucho - http://www.japanpost.jp/top/disclosure/e2003/cyokin/1/1-1-1.html#04
[5] Yucho - http://www.yu-cho.japanpost.jp/cgi-bin/rateautchg.cgi?6
[6] Federal Reserve Bank of San Francisco - http://www.frbsf.org/publications/economics/letter/2001/el2001-15.html

Japanese government decided to apply the zero interest rate policy and use fiscal stimulus to pick up the dismal economy, the country's decision makers seemed to have neglected the importance of efficient and proper management of the nation's money.

Does this privatization have all the answers to Japan's mounting problems? Probably not. Once the decade-long privatizing process begins in 2007, the funds will be allocated towards investments with best and safest returns. As I pointed out, much of the *yucho's* deposits have been used to fund Japan's government projects, which came in the form of Japanese Government Bonds (JGB or *zaito*) purchases. These bonds offered relatively low returns to *zaito* bondholders, and hardly represent best potential investment returns.

We believe these funds will find their way into foreign government bonds with attractive returns. U.S. Treasuries offer one of the best and safest returns that fit the criteria. Among various 10-year government bonds, U.S. offers the highest rate of almost 4.5 percent, compared to Japan's plus 1.5 percent. American authorities will compete for the piece of the *yucho* pie to help fund our own deficits.

This is a two-way street in that Japan (like China) will need to fund American spending behavior to continue buying Japanese products. The Bank of Japan currently holds about $800 billion in U.S. Treasuries. Since 44 percent of the yucho's $3 trillion has been used to purchase JGBs, this puts about $1.3 trillion worth of deposits at risk to the Japanese government. We believe this privatization will continue to support U.S. Treasury purchases.

As for Japan, this search for best returns will increase the need to raise the ridiculously low interest rates on the JGB. Certainly, there may be some efficiency created as the Japanese government will be forced to act more wisely. However, it appears the Japanese economy will have a tough climb out of the deep hole during this process. It appears that the Japanese economy will face a bumpy ride no matter what. On the bright side, the privatization will probably provide a more stable economy in the long term.

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