Policy Challenges and the Reform of Postal Savings in Japan

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ABSTRACT

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This paper discusses the current policy challenges to the existence of Japan's postal saving system, the main repository for Japan's household savings.

Some critics have erroneously conflated the investment function of mobilized funds that occurred under the government's managed by the Ministry of Finance, with the collection mechanism managed separately by the Ministry of Posts.

Critically reviewed are the efficacy and wisdom of the search for market-oriented investment policies in view of the public's real fears for the safety of their savings; current proposals to privatize, not only the postal savings system but also the post delivery system itself and the potential loss of essential services to rural populations.

ACKNOWLEDGEMENTS

The author would like to thank Naoyuki Yoshino and Toake Endoh for their contributions to earlier drafts of this paper. The author would also like to thank the members of the Japan Economic Seminar for their comments on an earlier version of this paper presented at its November 2002 meeting in Washington, D.C. In particular, the author would like to thank Patricia Kuwayama for her comments as discussant and to Kazuo Sato for his extensive written comments following the JES meeting.

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by Mark J. Scher[1]

I. Introduction

Japan's postal savings system *(yubin-chokin,* popularly called *yu-cho)* with 240 trillion yen [July 2002] is not merely the world's largest postal savings system in volume of deposits, but is also the world's largest financial institution, with more individual and household savings deposits than all of Japan's commercial banks combined. As *yu-cho's* deposit base has steadily increased over the past decade, largely as a result of the public's fears over the uncertainty of the commercial banking sector, there have been repeated calls from *yu-cho's* critics for it to be privatized, if not entirely abolished. Japan took its first steps of reform in April 2001 when *yu-cho* was reorganized to give it autonomy over its investment policy and to achieve a partial "market solution" for the investment of postal savings funds. At the same time the intermediation of postal savings funds was partially delinked from the policy-based objectives of a key government loan program. With more changes on the horizon, *yu-cho*, which had been a government department, in April 2003 became a separate, government-owned public corporation, an event which may change the entire postal savings system.

Privatization of *yu-cho* is being fiercely advocated not only by banking industry critics but also by important members of government reform advisory committees. These include leading academic figures, who have put forth substantive recommendations for *yu-cho's* privatization, and government

[1] Mark J. Scher initiated and coordinated the Postal Savings for Development project with Keio University, Tokyo on behalf of the United Nations Department of Economic and Social Affairs where he was an Economic Affairs Officer in the Finance and Development Branch. The views and interpretations in this paper are his own.

policymakers, including Prime Minister Koizumi, who has made market liberalization of all postal services one of his chief policy objectives. [Koizumi interview, *Financial Times* 13 May 2002]

This paper will examine from a public policy perspective the issues related to the privatization of Japan's postal savings system and assess to what extent, if at all, privatization is likely to improve on government-run postal savings. It will also examine the social and economic effects of privatization and/or termination of Japan's postal savings system within the context of the competition in Japan's financial sector for savings funds, and the possible effects on *yu-cho's* organizational strategy of a changing regulatory framework, market liberalization, and privatization. Postal savings in Japan has had a profound effect as a means for social growth and economic development. It still continues to serve this purpose by delivering financial services, often otherwise unavailable, to all segments of the population without discrimination, most notably the poor, as well as middle-income, pensioners, rural and low-population areas. Nevertheless, just as several European countries have privatized their systems, some important large business and financial organizations, such as Keidanren (Federation of Economic Organizations) and Zenginkyo (Japan Bankers Association), are advocating the same course for Japan.

II. Postal Savings and Japan's Development

A. Origins - Inculcating Values of Thrift

Since its origins in the 19th century, Japan's postal savings system has played a significant role in economic growth. It has done so by serving as a collector of domestic savings and a provider of financial services for middle-income and poor people, and at the same time by serving as a means to build the nation’s capital resources. When Japan's postal savings system was introduced in the 1875, saving was not socially condoned according to the prevalent effete moral attitudes of the feudal aristocracy of the late Edo period of the 19th century. A popular saying of this elite time admonished "trying to get one *sen* (cent) to last from one day to the next was shameful." At that time, there were no savings banks or commercial banks in Japan for personal savings, either in the cities or the rural areas. Household saved in cash or kind to meet emergencies or special events. Despite such conditions, Maejima Hisoka, who had founded of Japan's national postal system in 1871, at the beginning of Japan's modern period, the Meiji Era (1868-1912), introduced a postal savings system in Japan which he based upon his own first-hand observations of the British postal savings system. Maejima had been greatly impressed with the positive role he perceived the postal saving system to be playing in English society. Through his efforts, including the organization of school children's savings programs to inculcate thrift, post office branches for the first time began accepting deposits at 18 locations in downtown Tokyo and at one office in Yokohama in May 1875. The number of post offices taking savings deposits rapidly expanded to rural regions soon thereafter, aided by the fact that Maejima had previously charged all village headman throughout Japan to establish local post offices and to serve as postmasters in their villages. This step created an extensive nationwide network of post offices within a year or two of the institution of a national postal system. Japan was the fourth country to establish postal savings and the first in an Asian economy.

Japan's postal savings system was initiated at a time when Japan was moving out of centuries of feudalism and isolation. Unequal treaties had been earlier imposed by naval forces, granting Britain, France and the United States extraterritorial rights which also restricted Japan's rights to collect custom's duties to 5 per cent. By comparison, the United States' own tariffs were 45 per cent and the main source of revenue for the U.S. Government, as were Great Britain's tariffs during its Industrial

Revolution. Japan's Meiji era leaders were acutely aware of the political dismemberment of China by the same Western imperialist powers. Elimination of the unequal treaties and restoring Japan's economic sovereignty was their prime concern.

The Government's leaders had also taken note of the foreign indebtedness' of the Ottoman and Chinese empires to European bankers. The Japanese Government decided to turn to mobilizing is domestic savings for building its industries, railroads, shipping and communications, and most significantly and not least, its military. Japan was thus able to forswear almost all foreign borrowings for its military and infrastructure development for the next 20 years (until the advent of the Russo-Japanese War). It can be said that the establishment of a postal savings system at such a critical juncture in its history provided Japan with a significant resource in its future economic and social development.[2]

The postal savings stamp deposit forms and promotional posters of the late Meiji and Taisho eras (1900-1925) document the appeals used by the post office to encourage individuals to save, both for their personal future prosperity and for the prosperity and development of the nation. One of the postal savings system's unique attributes, and the probable basis for its early mass appeal, was the fact that at one time it accepted deposits as small as one-half a *sen* (1 yen = 100 *sen*).

B. The State Harnesses Savings for Development

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[2] The history of Japan's economic and financial development in the 1870s offers some interesting parallels to problems confronting developing economies today. With unfettered and untaxed access to Japan's domestic markets, foreign traders and mercantile banks also took advantage of the disparities between foreign and Japan's fixed gold and silver exchange rates and were able to completely drain Japan's gold reserves, not unlike the 1997 Asian financial crisis which also drained the reserves of several Southeast Asian countries that hopelessly tried to defend their currency's overvalued fixed exchange rates. Faced with runaway inflation from the Government's issue of inconvertible notes that in turn bankrupted the Government's efforts to collect taxes, Japan's banking system collapsed. This was then followed by an ill-fated experiment in adopting an American-style national bank system. Some 153 newly formed banks issued their own banknotes, further exacerbating inflation, with taxpayers again passing the depreciated banknotes at face value for payment of taxes. The public, than, as now, had no confidence in the banking system. Against this historical background, with the banking system in a complete collapse, the new Minister of Finance, Masayoshi Matsukata took charge in 1881, overturning previous monetary policy.

In 1885, Meiji Finance Minister Matsukata brought postal savings funds under the control of the Ministry of Finance and directed their use towards the national goals of building its industrial, transportation, military infrastructure and carrying out anti-inflationary policy. Already by 1883, as the success of the system grew, the cumulative total of these small savings deposits had reached nine per cent of Japan's ordinary bank deposits, and by 1897 postal savings were nearly 13 per cent of ordinary bank deposits. Taxation riots following the Russo-Japanese War (1905) further strengthened the government commitment to mobilize savings to serve its financing needs. Campaigns to increase postal savings deposits and promote thrift resulted in postal savings deposits increasing 390 per cent from 1905 to 1914, compared to a 120 per cent increase in ordinary bank deposits during the same period. Postal savings depositors increased from 12 per cent to 23 per cent of the population.

Postal savings deposit campaigns were later initiated at various times to remedy specific problems. For example, during the inflation following the First World War, a campaign was launched to encourage savings to stem spending and absorb the excess liquidity which had resulted from the war, postal savings represented 13 per cent of total commercial banking deposits. In 1919, postal savings deposits became the largest resource of direct government financing, as direct taxation had proved unreliable and counterproductive, sparking periodic riots and agrarian tax rebellions.

As the Japanese economy developed, the postal savings system was able to respond to the changing circumstances. Some of the issues, besides inflation, that the postal savings system helped the government confront included providing pump-priming private sector support to new and developing industries, development and modernization of infrastructure, pumping up the economy during recessions, and at times stabilizing capital markets and providing non-inflationary funding of government deficits. Postal savings deposits grew especially during deflationary periods, 1881-1887, 1925-31, and 1990-1992. Historically, however, its foremost goal has been to sustain economic development.

C. The Early Modern Period and the Development of Savings Banks

The development of the Japanese banking system coincided with the early growth of the postal savings system. In 1880, five years after the establishment of postal saving, Japan's first private savings bank, the Tokyo Savings Bank was established, and by 1890, when the Savings Bank Act was passed to protect small savers there were 23 savings banks. Both the number of savings banks and the volume of deposits rapidly grew, doubling every four years or less. By 1920-21 the number of saving banks and their branches reached their zenith, with 2,128 savings bank branches holding 95 per cent of all bank deposits (including all private/ordinary banks). Alarmed at the deteriorated condition of the commercial bank sector, the Government moved to reverse this trend through the Savings Bank Act of 1921, which converted 77 per cent of the saving banks into commercial banks. Postal savings, a non-bank institution, continued to grow and in 1937 it had on deposit nearly one-third of the amount of deposits in commercial banks. Although the government had repeatedly sought to consolidate the savings banks, it was not until 1943 that the Ministry of Finance ordered almost all of them closed and the personal savings they held transferred into commercial banks to intermediate funds to munitions industries for financing the war effort.[3] Postal savings, however, was left intact. By the end of the war only five savings banks remained, which were ultimately merged with or converted to commercial banks in 1949. At this point, individual and household savings became a large component and foundation of the profits of the main bank system [see: Scher 1997, 1998].

Today, besides the postal system the only remaining non-bank savings deposit takers are the *shinkin* (non-profit financial cooperatives) which has some 40 per cent of the volume of deposits by

[3] Some trace the origins of the Japan's main bank system to the wartime period. However, the system's origins were evinced in the dedicated financing of their industrial conglomerates by the zaibatsu-owned group's commercial banks, which were in turn prefigured by the earlier zaibatsu-group accounting houses of the seventeenth century,

individuals compared to the postal savings system. Viewed from the perspective of total deposits raised by all of Japan's deposit-taking institutions, 1,202 trillion yen, postal savings share of 20.8 per cent slightly exceeds the 20.6 percent total share of Japan's seven existing city banks. Regional and Second-Tier Regional banks make up another 19.8 per cent share.[4] However, from the perspective of small, individual and household savings, at the end of March 2000, there were 260 trillion yen in personal savings on deposit in the postal savings system, representing 36 percent of all personal savings on deposit in Japan, and nearly equal to the combined personal/household savings deposited among all private sector commercial institutions. (The balance of small savings is mainly in *Shinkin*, non-profit financial cooperatives, and mutual credit cooperatives). Deposits of individuals/households represent 54.9 per cent of total deposits in City banks, 67.0 per cent of Regional Banks, 69.6 per cent of Second-Tier Regional banks, 75.3 per cent of Shinkin banks, and 99.6 per cent of postal savings deposits. [*Economic Statistics*, Bank of Japan 31 March 2000]

D. Fiscal Investment Loan Program: from Postwar Development to Structural Readjustment

Starting in the postwar period and until the end of March 2001, postal savings funds deposited into the Ministry of Finance's Trust Fund Bureau were in turn lent to the Fiscal Investment Loan Program (FILP) *(zaisei toyushi* -- the so-called "*zaito* system"), also managed by the Ministry of Finance. Major recipients of FILP funding during the 1950s through the early 1980s included policy-based financial institutions such as the Japan Development Bank (JDB), which allocated funds for industrial development to meet national and regional development goals. In the 1950s, FILP provided

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such as those owned by Sumitomo and Mitsui. See Scher: 1997; 1998.

[4] The balance of funds raised 18.5 per cent are deposited in private sector trust banks, long-term credit banks, and foreign-owned banks, and 19.6 per cent in government-owned policy-based financial institutions that specialize in

funding for the reconstruction of the electric power, coal mining, ocean shipping, and iron and steel industries. In the late 1950s to the early 1960s, the emphasis shifted to catching up with advanced countries in the synthetic fiber, oil refinery, nuclear power generation, machinery, and electronic industries. By the late 1960s and into the early 1970s, FILP's policy emphasis was re-directed towards social welfare and environmental considerations in urban and residential land development, pollution prevention, welfare facilities, private railroads, and further development of new technology. In the late 1970s and early 1980s, energy policy received priority from FILP with lending for energy conservation and the development of alternative energy sources.

Other public policy-based institutions which received FILP funds during the postwar period included: the Japan Import-Export Bank; regional development finance institutions, such as the Hokkaido-Tohoku Development Corporation and the Okinawa Development Finance Corporation; the Japan Finance Corporation for Small Businesses and the People's Finance Corporation, which provide loans for small and medium-sized firms; and the Housing Loan Corporation for housing finance. By the 1990s, however, JDB and other policy-based institution were no longer a major recipient of FILP funds.

The character of the FILP program changed in the early 1990s in response to the economic crisis following the collapse of the bubble economy. FILP's key mission was re-directed towards promoting structural adjustment of industry and maintaining employment through the funding of infrastructure and other construction projects aimed at providing economic stimuli to ailing sectors of the economy, the chief beneficiaries of what has come to be called "Japan's second budget." Whatever the policy intention, political trade-offs were involved in the FILP system. During the 1990s, the overwhelming majority of FILP funds for developmental purposes were no longer channeled through the

lending to small and medium size businesses, agriculture, forestry, and fisheries [Zenginkyo, 2001].

JDB or other government-owned banks and policy-based financial institutions. Instead they were directly parceled out to designated quasi-governmental companies such as the Japan Highway Company and other politically well-connected recipients of local infrastructure development funds, particularly those tied to the construction and real estate industries interests, which were also key borrowers responsible for the non-performing bank loans that still plague the banking industry. Political considerations were also never far from such an investment/disbursement system that favored rural provincial areas rather than urban industrial centers.

III. Reform of FILP and its Relation to Postal Savings

The 1990s economic crisis accelerated the movement for reform of Japan's financial system, the so-called "Big Bang," which was modeled after the UK market liberalization reforms of the same name. There was already a growing demand that financial markets be liberalized, half-heartedly begun in the 1980s, to respond to new domestic and international monetary and structural environments. The State-led development model of postwar Japan came under criticism as incompatible with a liberalized financial system. Among the policies criticized were what some critics termed "government intermediation," referring specifically to the use of postal savings funds by the FILP. Nevertheless, following the burst of the bubble economy in 1989 and the ensuing domestic banking crisis, the Government's need for State-directed credits to small businesses and housing lending overrode market liberalization concerns when the commercial banks ceased to lend. This further enhanced the FILP's role as a policy instrument in revitalizing the economy.

Some economists and financial industry critics have questioned the continued need for and the efficiency of FILP types of development-lending practices in the presence of a developed capital market. Others have seen the disbursement function of FILP as the underlying cause of fiscal inefficiency and have argued that the disbursement function should be kept separate from the collection function of the postal savings system. Critics have emphasized a political rationale to what they term to be "government intermediation" of the postal savings funds to FILP to finance "*Tokushu Hojin*" – various governmental and quasi-governmental financial institutions and infrastructure agencies which finance housing, highways, and small businesses. The majority of these enterprises have been criticized not only for being inefficient and debt-ridden but also for undertaking unnecessary investment, as exemplified by bridges and rural highways that lead to nowhere and government-financed nearly-vacant resort facilities. Often justified as public works projects to create jobs to sustain the ailing economy, their political raison d'être is, however, feeding pork-barrel projects for politicians' local districts and employment opportunities for higher-level retired bureaucrats. In 2002, the largest recipients of FILP disbursements were to local governments (28%), Government Housing Loan Program (19%), National Life Finance Corporation (13%), Japan Highway Public Corporation (8%), Japan Finance Corporation for Municipal Enterprises (6%), and the Japan Finance Corporation for Small Businesses (5%).

Indignant public outcry challenging the misuse of funds had become a staple of the press and a new term, "MoF-bashing," became a mainstay of public debate. Taxpayer outcry had its effect: the FILP program was reformed, and its direct financial ties to the postal savings funds through the Trust Funds Bureau of MoF were severed. However, FILP is still quite relevant to *yu-cho* since the postal savings funds and other postal administrated funds are expected to be major investors in the bond issues of FILP and its related agencies through 2006. In 2001, 76 per cent of FILP bonds, some 33.3 trillion yen, were purchased by either postal savings (41%), postal pension plan reserves (27%), or postal life insurance funds (8%).

Another outcome of the reform program was that after several years of lobbying, the Postal Savings Bureau was finally granted the authority to invest the funds it collects in the financial markets on its own, thereby bypassing the MoF/Trust Fund Bureau in the designated-finance FILP system. In April 2001, the reorganized Postal Savings Agency was given discretion over the investment of collected funds, thereby opening itself to market risk.

A. The Fundamental Reform Law and the Changing Role of the FILP

FILP related programs are now required to meet the following criteria to qualify for support:

1. Individual FILP institutions will be assessed by an independent policy assessment organization.

2. Each FILP operation will be either terminated or privatized unless its necessity as an activity of the government is convincingly proven.

3. Each FILP institution will utilize the private capital market to raise funds for the operations it supports.

4. If the FILP institution's activity is deemed necessary for policy purposes, its funding will be covered by bonds issued by the relevant sponsoring agency.

5. The FILP institution will focus on guaranteeing and refinancing through market mechanisms such as securitization.[5]

B. Intermediation of Postal Savings Funds: The search for a market-oriented solution

One result of the Reform Law and changes, with respect to the intermediation of funds to the FILP, has been that the MoF Trust Fund Bureau was deprived of direct access to the postal savings funds. Now, Governmental Financial Institutions and Agencies (GFIA) have to issue their own bonds (agency bonds), participate in issuance of Trust Fund bonds to finance their own lending, or issue Government-guaranteed bonds. Among these three classes of financial instruments, FILP bonds are the major source of funding for the new FILP system. In the case of agency bonds, each GFIA has to obtain a credit rating to issue bonds whose yield properly reflects its investment risk. MoF's willingness to require all GFIAs to issue their own bonds, instead of piggybacking on Government bonds, in which GFIA's rating is not questioned.[6]

While markets foresaw a Darwinian evolution in the FILP bond system, problems have been alleged in the credit rating process. It is said that rating agencies evaluate the solvency of the GFIAs based on a GFIA's "closeness" to the government. The closer a GFIA is perceived to be to the government, the better the rating it receives [Cargill and Yoshino, 2002]. If such practices really dictate the ratings and the ratings determine the yield, than the yield of a FILP bond will not truly reflect its risk based upon financial fundamentals. For a genuinely free and fair market, FILP-related bonds must be rated based on the same rating criteria applied to private corporate bond issuers.

MoF sharply reduced the 2002 budget for FILP by 18 per cent from the previous year to 26.8 trillion yen [*Asahi Shimbun*, 19 December 2001], expecting the GFIAs to fill the gap by issuing their own bonds in the market, totaling 2.7 trillion yen, albeit all with Government-guarantees and therefore without credible risk. This was a 270 per cent increase in GFIA bonds over the previous year. As of November 2002, 14 out of 33 FILP agencies have issued their own agency bonds. In what seems to

[5] See the government website: http://www.kantei.go.jp/foreign/senryaku/chap3.html
[6] Shigeru Itose, "Keizai Koramu" No.10, 6 December 2001, http://www.tv-tokyo.co.jp/nms/column/itose/itose1205.html

be a variation of Gresham's Law, of "bad money driving out the good from circulation," the weaker-rated, high interest guaranteed bonds work to exclude better-rated bonds from the market, a case of "junk bonds" driving out good bonds.

New accounting rules will be also applied to FILP projects. Each government entity will disclose its “policy cost” (i.e., State subsidies) and show the discounted present value of the project to be financed. In this way, it is expected that an accurate estimate can be made of future demand for a given public project and the future profitability of the project [Yoshino and Nakada, 2002].

This appears to be a good prescription for the financial health of postal savings and other purchasers of the bonds. It is especially significant for postal savings because, even though the postal deposit funds were officially severed from the controlling hand of the MoF in April 2002, the Postal Savings Bureau is expected to continue to finance FILP in the form of direct purchase of FILP bonds, and those issued by GFIAs, until the end of fiscal year 2006. As the major buyer of FILP bonds, *yu-cho* needs to be informed of the risks of the bonds and the solvency of GFIA bond issuers.

IV. Commercial Banks versus Postal Savings

Besides reproaching postal savings as the prime channel for financing highly political FILP projects, the postal savings system has been attacked for its savings mobilization function itself. Envying for many years the huge amount of deposits the postal savings system continued to garner, Japan’s private banking sector has called for the system's privatization, if not the abolishment of postal savings.

In March 1998 postal savings represented a 36 per cent share of all household deposits, exceeding the combined household deposits in Japan's City banks (banks with a national franchise), making the Japanese postal savings system the largest financial institution in the world. Since the Japanese banking crisis began in 1990, there has been a flight to safety by individual/household customers at commercial banks. The contraction of commercial bank deposits and marked increases in the size and number of depositors in postal savings accounts reflects the crisis of public confidence in Japan's banking system. This trend is likely to increase as the Government intends to reduce the ceiling on government guarantees on bank deposits in April 2003, further fueling the rise of postal savings deposits. While it thus remains popular with the Japanese public, we should examine the charges that have been leveled by *yu-cho's* critics.

A. Does postal savings have an unfair competitive advantage?

Critics from the banking industry have complained of the unfair advantages given the postal savings system by its exemption as a Government-owned institution from national and local taxes of all types and from the requirement to insure its customers' accounts with payments to the Deposit Insurance Corporation. *Yu-cho* is also exempt from Bank of Japan's reserve requirements and the payment of dividends that private banks make to their shareholders. On the other hand, the chronic losses experienced by banks over the last decade have also resulted in the banks' not paying taxes and issuing only minimal or no dividend payments to their shareholders. Furthermore, the huge portfolio of non-performing loans held by the banks is in stark contrast to *Yu-cho's* investment portfolio of Government-guaranteed bonds which obviates the need for deposit insurance.

The banks' main argument, and some economists' as well, is that *yu-cho's* success in mobilizing deposits deprives the banks of these funds for intermediation. If this argument is to be considered, we should first ask what in fact are banks doing with their funds? In 1999, 8.4 trillion yen (US$ 80 billion) in public funds were spent in recapitalizing the commercial banks so as to provide them with adequate capital reserves to resume their lending to small- and medium-sized enterprises (SME). Instead, banks have chosen to purchase Japanese Government Bonds with their funds rather than lend to SMEs, thus violating the spirit and intent of the Government's bank recapitalization program. Meanwhile, for the SMEs, publicly owned policy-based finance companies that are funded, in part, by postal savings deposits must fill the needs left by the commercial banks' lending gap. This role reversal, where postal savings must indirectly take up the bank's role as a supplier of credit to SMEs, highlights a key policy failure in resolving Japan's long-ongoing banking crisis.

B. Attractiveness and Cost of Savings Products

Postal savings has captured a substantial part of the retail market with its *teigaku chokin*, a 10-year time deposit with an early withdrawal option. Although the private banking sector has the right to issue the same product, virtually no banks do. Indeed, since the 1980s a level playing field has existed for both the type and features of financial products, including tax exemptions, that postal savings offers.

A case can also be made that the postal savings system helps keep the private sector honest, and that even with the competitive pressure from the postal savings system, private sector banking has shown little innovation on its own and made few efforts to provide competitively priced retail banking services and products for the general public (see table below). Government even aids the private banking sector by restricting *yu-cho* from making any comparison to banks in their advertising, and by restricting postal savings interest rates to the levels of commercial banks' offerings.

Comparison of Convenience: Postal Savings vs. Banks (as of January 2001)

		Postal savings	Bank (Bank of Tokyo Mitsubishi)
Annual interest	Regular	0.12%	0.10%
	CD	0.15%	0.15%
Transaction fee	Teller	Y140	Y315—840
	Internet		Y0—367
ATM fees (weekend and nighttime)		No fee at post office ATMs	Y105
No. of office branches		24,768*	316*
No. of ATMs		25,184*	3,873*

Source: *Shukan Daiamondo*, 2/20/2001

Note: *= March 31, 2000 Annual Reports: Postal Savings Bureau; Tokyo-Mitsubishi Bank

Indeed, the programs and plans offered by the postal service have materially improved the quality of financial services available to the general public. The post office has long offered products such as life insurance (since 1916) and pension plans (both managed separately from postal savings), and payment services (giro, since 1906; money orders, 1875), although it is only in recent years that Japan's private sector institutions have begun to compete in the cross-selling of products such as insurance and pension plans. Postal savings maintains a nationwide network of automatic teller machines that can be used to make deposits, withdrawals, credit card payments, or to pay utility bills or transfer payments to anywhere in Japan without the fees exacted by banks.

Banks are only now beginning to compete in these areas in response to consumer pressures. The number of postal savings ATMs also overwhelms those of any single private bank, with 25,184 machines (March 2000). This number is 6.5 times as many as those of Bank of Tokyo Mitsubishi, one of Japan's Big Four banks. Postal offices' ATMs are more depositor-friendly than those of banks, charging no transaction fee for after 6 p.m. and weekend use. The postal savings ATM outlets continue to expand, with tie-ups to several private-sector financial institutions adding 2,152 ATMs as of December 2000. Recently some City banks have begun to charge depositors a minimum account fee, while postal savings depositors can keep a minimal balance, even as low as 10 yen, without any account maintenance charges.

C. Accessibility of Locations

The success of the postal savings system can be chiefly attributed to the fast and consumer friendly ease of counter service (average wait time 2 minutes 40 seconds), and the fact that Japan's widely dispersed 24,737 post offices function as collection points for its savings system, far outstripping the 16,000 branches of all 110 banks, savings and loans, and other financial institutions in Japan. In fact, Japanese people on average live within 1.1 kilometers from a post office, while bank branches are typically found clustered in the cities' commercial business districts. Of the 3,235 cities and municipalities that have post offices, 567, i.e. some 18 per cent, are without banks. The wide-based infrastructure of post offices offers tremendous economies of scale, especially in reaching out to rural areas where there would be little profit margin for a stand-alone institution such as a bank.

D. Cross-selling and Cross-subsidization

Cross-selling of financial products has become a commonplace strategy in recent years in the global financial sector and has provided the motivation for many of the mega-mergers in the banking, securities, trust and insurance industries as a result of the market liberalization in financial services that has taken hold in most developed countries. As discussed in Scher [2001], similar cross-selling opportunities have also taken place in the private sector express package delivery services which have reconfigured and market themselves as fully integrated logistic services, not only delivering parcels, but also including warehousing, product fulfillment, and financial service components such as billing, and factoring as newly formed logistics services. Despite the prevalence of cross-selling practices in the private sector, when government-owned institutions, such as the post, makes use of its facilities for multi-service activities, the charges of anti-competitive cross-subsidization are heard from the private sector.

Some critics of *yu-cho* have argued that revenues from postal operations subsidize the postal savings system; however, the Ministry of Post's own cost analysis shows there is no such subsidy. As discussed earlier in Scher [2001], postal financial services provide a substantial portion of the post's revenue and typically supports mail delivery, which operates at a loss. In fact, without the multiple use of the existing infrastructure, the Japanese postal system would find it difficult to sustain mail delivery operations in many rural areas if left on its own. Postal savings officials also counter criticisms of a supposed competitive advantage by pointing to the costs they must bear in providing postal, savings and life insurance services in rural areas to fulfill their official mandate to serve all markets, rural or urban whether profitable or not.

E. Market Strategies

The commercial banks rely chiefly on the employee accounts of their client firms for individual and household savings. These employee accounts have historically been part of a package of rewards to the main bank, in which such accounts provide cross-subsidization of the bank-firm relationship. These accounts are the mainstay of a bank's deposit base under Japan's so-called "main bank system" whereby corporate finance in Japan has been largely mediated by the banking sector, especially within groupings of affiliated companies.[7] With captive employee accounts, as their prime source for retail banking fees such as bill payments, ATM transactions and other profitable services including consumer lending, the City banks have had no incentive to improve retail client services and products since these employee accounts are an expected component of the bank's commercial relationships with its corporate clients.

In contrast, the popularity of postal savings is due in large measure to the capabilities of postal savings, from the tremendous economies of scale provided by the post office network to reach out to rural areas and urban/suburban neighborhoods where there would be little profit margin for a stand-alone institution such as a bank. In addition, the popularity of the postal savings products and services is another crucial aspect in its ability to mobilize savings.

The ongoing shift of household deposits out of the employee accounts into postal savings has become a significant loss to the commercial banks and thus a factor in the declining efficacy of the corporate lending system and weakening of the so-called main bank relationship. This tendency is likely to continue in the face of corporate downsizing and layoffs, which have fueled employee distrust in the corporate system in general, and the profound fear by depositors of the lack of safety and security of the banking system in particular.

V. Postal Reform and the Future of *Yu-cho*

[7] See Mark J. Scher, *Japanese Interfirm Networks and Their Main Banks*, London and New York: Macmillan Press Ltd/St. Martin's Press (USA and Canada), 1997.

A. The Creation of a Postal Corporation in 2003

In December 1997, then Prime Minister Ryuichi Hashimoto's final report on proposed ministerial reform, *The Fundamental Reform of the Central Government Ministries and Agencies Law* (*Chuo shocho to kaikaku kihon ho*), defined the future shape of the postal organizations. The current Postal Agency will be incorporated in April 2003 as an independent public enterprise to be known as the Postal Corporation. The new entity will continue to administer together postal services, postal savings, and postal life insurance businesses. The regulatory provision governing the Postal Corporation requires an annual financial audit by Financial Service Agency. Under the old rules, each one of the three postal businesses had what was called a "special budget" (*tokkai*), which was independent of the general accounts and operated within a special, regulation-free framework. [*Shukan Daiamondo*, 20 January 2001, pp.32-33] Even though opaque accounting frameworks are hardly unique among government agencies, the new accounting rules, which we discuss later in more detail, are expected to eliminate the obscurity of the postal accounting system, render the corporation subject to an independent audit by an external authority, and improve its accountability and transparency, thus eliminating the very points upon which many privatization advocates hang their arguments.

Junichiro Koizumi, then Health and Welfare Minister in the Hashimoto cabinet and an adamant postal reformer, reluctantly endorsed the 1997 proposals, although they fell far short of his ultimate goals of privatization of the posts, with the following conditions:[8]

1) Mandatory deposit of postal savings funds with the Trust Fund Bureau (TFB) under management of the Ministry of Finance (MoF) will be abolished and the savings and life insurance funds will be independently managed (as discussed later, in more detail).

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[8] Koizumi obtained the support of the Mori faction in exchange for approving the Postal Corporation initiative when Koizumi ran for LDP chairman in April 2001. From Ushio Shioda, "Focus Seiji" in *Shukan Toyo Keizai*, 26 January 2002, pp.104-105.

2) The postal delivery business will be deregulated and private companies can enter the market. This is more controversial.

First class mail delivery in urban business areas, a profitable monopoly of the Postal Agency is the main target of deregulation. The scope of deregulating this sector is still under discussion. While Koizumi pushes for full, unconditional deregulation, the Ministry of Public Management, Home Affairs, Posts and Telecommunications (MPT) attempts to maintain some regulatory control through the partial deregulation of the posts by weight of the mail. The MPT is concerned that a full deregulation of the market may destroy the existing "universal service" principle, which guarantees the impartial delivery across the nation with equal service quality at the flat rate. Once the free market principle rules the industry, postal service companies – whether a privatized Postal Corporation or a parcel delivery firm like Yamato – are likely to stop service or raise fees to unprofitable areas. Such was the case in Finland and Sweden [See Scher, 2001].

Japan's postal delivery already suffers from severe loss of market through regulatory evasion.[9] For example, far from enjoying a monopoly position in the market, advertising circulars and utility bills bypass the postal system and are routinely deposited by independent carriers directly into the letterboxes of households and businesses. Non-priority mail (advertising, etc.) accounts for only 12 per cent by volume of the Japanese post office business compared to the U.S. Postal services 48 per cent, in the U.K., 69 per cent, and in France, 74 per cent. Japan also has the lowest average post deliveries per capita among the major industrialized countries, at 206 pieces per annum, compared to France 447, Netherlands 442, UK 336, and U.S. 734. The loss of these revenues is partially compensated for by

[9] Liberalization typically brings new entrants into markets; thereby causing loss of market share in formerly highly regulated service industries, especially banking, but also in telecommunications, electric power generation and other utilities that are obligated to provide the public with certain basic, if not universal services, as does the posts.

Japan's high postal rates.[10] Prime Minister Koizumi's proposed introduction of competing private-sector postal delivery companies to cherry-pick the market even further will likely result in making the postal system's urban deliveries unprofitable as well.[11] Koizumi has already met partial defeat of his agenda when the Japanese parliamentary committee recently required any new entrants to the mail delivery market to provide as many letter collection boxes throughout Japan as the postal system provides, some 175,570, thus making it a non-starter. [*Financial Times*, 4 July 2002].

In spite of strong political pressure within his own party opposing privatization, Koizumi has not given up his postal privatization stance. Yet, after more than a year and half from his entering the Prime Minister's office, Koizumi's personal advisory group, which consists mainly of intellectuals and policymakers, that has been studying and discussing a postal privatization strategy has yet to make public any specific plans.

Nevertheless, business groups, including the *Keizai Doyukai*, have proposed a privatization blueprint to create a post bank, separate from the postal service. The proposed post bank would first be 100 per cent government-owned, with its financial products sharply reduced to only postal savings and life insurance; privatization would follow as soon as possible. Some private think tanks have suggested a hybrid approach, breaking up the privatized postal savings entity into prefectures and turning them over to the severely ailing regional banks. Since a straightforward privatization of the Postal Corporation, which dominates in the three postal-related businesses, would not remove the threat of monopoly to other private competitors, it is argued by the business sector that the postal savings and postal life insurance businesses should be privatized and partitioned. The business groups complaint about the size and scope of the post's "monopoly" seems disingenuous when private sector financial

[10] The high rate of mail delivery in the U.S. stems from the U.S. Postal Service rigorously enforcing it legal control of exclusive access to letterboxes for advertising, as well as all other mail. This factor keeps U.S. First Class postal rates the lowest of all industrialized countries, and less than half of Japan's letter rate.

mega-groups have been formed in recent years between commercial banks, securities firms, trust banks, and insurance companies, such as the Mizuho Group (centered around IBJ, DKB, Fuji Banks), UFJ Group (Sanwa and Tokai Banks), Tokyo-Mitsubishi Bank Group, and Sumitomo-Sakura Bank Group.

B. Funds management and the privatization question

Some of the rationales for privatization of the postal system pertain to its financial activities per se:

1) The Postal Corporation lacks the ability to independently manage the enormous amount of funds on deposit, 255 trillion yen in the Postal Savings and another 112 trillion yen in the Postal Life Insurance. A failure in funds management would be a costly liability which would ultimately be borne by the taxpayers.

2) The funds are so large that they may distort the market. Of particular concern are the so-called PKO (price keeping operations) in equity markets, i.e., government intervention which buoys the stock market. The existence of PKO is frequently referred to in financial circles and the press, yet is flatly denied by postal savings officials.

3) The Postal Corporation deprives markets of business opportunities by "monopolizing" retail savings, a chief complaint of private sector financial institutions.

1. Is postal savings to blame for bad FILP performance?

The above points highlight a significant conceptual problem in the public debates over postal savings reform, namely the failure to distinguish between the function of the postal savings system (i.e., savings collection) with that of fund management. In particular, privatization advocates tend to focus on

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[11] See *Financial Times* 13 May 2002 interview with Prime Minister Koizumi.

the past mismanagement of the funds as a major reason for liquidating the entire postal savings system. In a press interview last year, Mr. Koizumi argued:

> "Why do we need a privatization of the three postal businesses? The answer is simple. A downsizing of public employment, an elimination and/or reorganization of the GFIAs, and a reform of the FILP system. All these reforms, which are the focal point of administrative and financial reforms, are in essence linked to a postal reform… The financial source of the GFIAs is postal savings and postal insurance. We cannot make progress in rationalization of the GFIAs and reduction of public service workers unless we privatize the postal businesses and sever this flow of funds." [*Shukan Daiamondo*, 20 January 2001 p.46]

Savings collection and fund management, however, are independent functions, and had until 31 March 2001 been administered by different ministries. Management of the funds is guided by the investment practice of the fund managers and the institutional channels give discretionary access to the funds. Past investment and financing losses are more properly attributed to the Ministry of Finance, whose Trust Fund Bureau (TFB) had abused the fund by financing fruitless Government-sponsored projects and/or investing postal pension plan funds in volatile financial market operations. This confusion over the domains of responsibility and authority among government institutions is a misconstruction that harms serious consideration and discussion of institutional reforms of the postal savings system.

2. How should funds be invested?

This leads to a critical question that needs to be addressed, how should the funds raised through the postal savings system be managed for better performance? The past poor performance of the postal savings funds has come from, among other things, mismanagement by FILP as mentioned above, the lack of transparency and accountability under accounting rules used for postal savings funds, and poor investment by the TFB in equities and land. We have already discussed how political considerations have wasted postal savings funds under the FILP program. The old accounting rules, which kept postal businesses untouched by external scrutiny, continued to cover-up the underperformance of investments. For example, the postal savings system was not obliged to report its financial statements based on market value (which was also the case until recently for commercial banks). Inadequate accounting and reporting frequently led to calls for a "market solution" for what was essentially a governance problem. Whether or not the market can provide any better governance mechanism or safety in preserving postal saving fund's assets we will examine next.

3. The mode of funds management and market risk

Under the new law, the Postal Administration Council, an advisory group to the Minister of Public Management, approves the portfolio structure of the postal savings fund. As of 2002 the fund is allocated as follows: 80 per cent of funds are in domestic bonds which are almost entirely invested in Japanese Government Bonds and other Government-guaranteed Securities; 10 per cent are divided equally into domestic and foreign securities, including some corporate bonds of foreign companies; 5 per cent in bonds of foreign governments and international organizations; 5 per cent are in the overnight interbank market. The basic composition of the portfolio has varied little in the past few years.

Since the government is prohibited from investing directly in stocks, the Postal Savings Bureau manages and invests the equity portion of the investment funds indirectly, through 15 or 16 private trust banks. The market keeps an eye on this type of investment because some analysts allege the funds are being used as the source of the government’s PKO operations. Responding to these concerns, the

MPT has pledged to "conduct a market-neutral fund management" [*Nikkei Shimbun*, 25 December 2001]. Nevertheless, the Postal Corporation will become a major market player with its 2-3 trillion yen in investments, which represent about 20 per cent of the 16 trillion yen traded through the market.

The MPT also expects that in the future when market demand by City banks for overnight interbank loans recover, that this demand will help to further diversify its portfolio structure to mitigate risks and better enable more stable investment returns. [*Nikkei Shimbun*, 11 February 2002]. Several asset liability management and portfolio diversification techniques are employed when 20 trillion yen are invested in equities together with life insurance in order to reduce exposure to volatile securities markets at home and overseas. The fundamental issue, however, is whether a market-vulnerable portfolio is desirable or necessary when Japanese Government bonds are a risk-free alternative.

Since postal savings has not publicly reported its investment performance to date, we do not know the specific performance of each class of investment or the amount of loss or gain associated with a specific class of investment. However, given the burst bubble and the stagnant Japanese equity market since then, coupled with the volatile U.S. and global markets, it is probable that postal investments have accumulated losses. As of the end of September 2001, unrealized losses in stock market investments were estimated to amount to some 6.6 trillion yen. [*Nikkei Shimbun*, 25 December 2001]. In a highly volatile market environment, it would therefore seem more prudent for postal fund managers to concentrate on low-risk investments, especially government bonds, which are virtually risk-free. Riskier investment requires fund management expertise and financial techniques, the very tools the postal savings system lacks. Moreover, poorer fund management may cost not only investment performance, but, more important, credibility and safety – two major advantages postal savings have over commercial banks. Postal savings depositors today do not expect higher returns but rather the safety and security of their deposits.

Even with a portfolio of only government and government-guaranteed securities, the postal savings system needs a viable internal risk management system, and especially for the existing portfolio strategy. Effective asset and liability management is essential to any financial institution entering into investment activities. The system helps to mitigate various kinds of risks inherent in financial markets and to take proper and quick action whenever risks come to a dangerous level. An improved internal control system needs to be the first step towards an accurate, market value-based accounting practice, which the current system lacks.

The savings fund intends to invest 10 per cent in stocks. Foreign denominated bonds for which 5 per cent of the fund will be allocated are subject to foreign exchange risk, and even sovereign-risk bonds are not risk free, as was recently seen in the Argentine debt default. The fund must also pay attention to solvency of its borrower banks in the call market. The exposure to volatile equity, bond, and call markets requires the postal savings fund managers to reinforce their risk management system and strategies.

An area that threatens consumer confidence in savings instruments is the postal savings system intention under its new business plan to sell a defined-contribution pension plan, a Japanese version of the U.S. 401K plan.[12] This type of product would require a sufficiently competent sales staff to explain the risks involved in this and other investment fund products to its customers. Until now, post offices have sold only principal-guaranteed products like time deposits and life insurance accounts.

[12] The stunning loss of retirement savings facing US defined pension plan holders' owing to the US stock market collapse and the attendant fraudulent reporting activities of companies whose stocks were held in their employee plans should give pause to Japanese public policymakers, as if the 1989 Japanese market's collapse should not have already given enough of a clear warning to policymakers of the public's concern over loosing their retirement savings.

VI. Conclusion

Depositors in fear of a financial meltdown continue to shift their assets from private banks, equity, and real estate into postal savings, and to a lesser extent to foreign currency accounts mainly at foreign-owned banks, and more recently into gold bullion. With seemingly no headway in resolving long-standing banking issues, the popular distrust in banks was at a high point. The bankruptcies of major and smaller banks, slow progress in writing off non-performing loans, the limitation on deposit guarantees on banks accounts to 10 million yen, originally slated for April 1, 2003, and further postponed, has further heightened the public's sense of insecurity about the banking industry. With the possible loss of deposit guarantees at banks, postal savings stands as a harbor of safety and trust for an apprehensive public. Although the maximum amount in a postal saving account is 10 million yen, one can deposit an unlimited amount in a non-interest-bearing arrangement. Even with no interest income, Japanese depositors find comfort in the safety provided by the postal savings system. Thus, postal savings are the most popular form of savings nowadays.

Japan has a highly risk-averse culture, where safety and stability are the most crucial elements in people's savings decisions. While commercial banks underwent reorganization through mergers and acquisitions, with changes in ownership, bank names, and brands, postal savings maintained its original brand identity. The long-term penetration of the postal savings system in every locality helped to assure confidence, trust, and familiarity among people. Bank mergers and ownership changes confused and worried many ordinary Japanese who prize what is old, large, and stable, and are not used to the constantly changing "M&A culture." One cannot find a safer investment than postal savings in today's Japan.

Critics acknowledge an "evolutionary" process of financial reform, including a continuation of postal savings, as the "second best option," as opposed to radical change of the system [Cargill and Yoshino]. Any radical transformation in this huge savings system is viewed as too risky for a society undergoing critical structural changes, such as a decreasing working population, an increasing percentage of older people in the population, and a mounting public debt that now exceeds 140 per cent of annual GDP. As discussed earlier, the system needs to improve its accountability and transparency in its accounting and investment practices. It should also review its internal risk management system and its portfolio structure against market risks. On the other hand, the postal savings system cannot, indeed should not, take for granted its portfolio management capacity. Maintaining depositors' confidence in the system matters most.

Depositors' confidence

Many Japanese and foreign-owned financial institutions anticipated massive redemptions upon the maturity of the 10-year *teigaku* postal savings time deposits in FY1999 and FY2000, and began to introduce all sorts of attractive market-based financial products. Nevertheless, 84.9 per cent of the maturating deposits were rolled over into new certificates, and the remaining balance went into Ordinary Deposit postal savings accounts. The much-anticipated flow of funds to the commercial financial sector never materialized. Unlike savers in 1875 who had little choice but postal savings or those in the wartime who had to show patriotism in the form of postal savings, today's depositors *choose* to put their money into postal savings.

New products and services in a competitive environment

The postal savings system is anticipating a freer and more competitive financial market to come. In order to be an efficient and profitable market player, it is planning to launch new lines of financial service products. Among them are agency agreements for over-the-counter sales of financial products of commercial sector financial institutions. Using the existing postal network to assist sales activity, the system expects to receive commission fee revenues without using its own assets. The relationship of mutual benefit to commercial financial partners will enable a symbiosis of postal savings with private sector institutions. Other new financial services being introduced include an Internet payment settlements service, and, a grocery shopping/delivery service for the elderly reflecting the needs of the aging population. The postal savings system plans to offer what it calls "one-stop administrative service," which includes issuance of residence cards (scheduled for 2003), driver's licenses, and passports at every local post office.

The politics of privatization

When Maejima first established the Japanese postal service, he appointed prominent individuals in rural areas as local postmasters who, in turn, provided postal station facilities at little or no cost. Even today some 80 per cent of Japan's post offices buildings are privately owned by their postmasters, most having inherited their positions over many generations. Needless to say, these postmasters are a powerful force in regional and national politics, with ties to prominent factions within the ruling Liberal-Democratic Party. Together with the postal workers union, which is affiliated with the Socialist Party's trade union confederation, they have been able to foil PM Koizumi's plans to privatize the postal sector and banking industry efforts to marginalize or abolish Japan's postal savings system.

Postal savings as a catalyst for a better service in banking

Banks have been allowed for many years to offer the same products that postal savings offer their clients, but have not done so. Postal savings officials counter criticism of its supposed competitive advantage by pointing to the costs they must bear in providing postal, savings, and life insurance services in rural areas to fulfill their mandate. A good case can also be made that the existence of the postal savings system may raise the quality of private banking services available to the general public. The postal savings system has been a catalyst for keeping the private sector competitive and better qualified in the services offered. The consumer-oriented Japanese postal savings system offers products such as life insurance and a nationwide ATM network that can be used to make deposits, withdrawals, credit card payments, or to pay utility bills or transfer payments to anywhere in the country at lower fees than charged by banks. Since the 1980s its inexpensive international giro payment service has become very popular for sending overseas remittances. Banks, especially the large City banks have long taken their retail clients for granted. Banks now, have come to realize the profitability of the retail banking market, especially its income from transaction fees. In fact, banks' revenue from retail fees is larger than profits from corporate lending, especially in light of Japan's huge problem in non-performing bank loans. It is only recently that banks have begun to respond to the competitive pressures of the postal savings system. It would be instructive for banks to revisit their client strategies and to examine why the people prefer postal savings. The postal savings system's attributes of safety, accessibility and convenience of service, and the ease of comprehension and use of its financial products are a clear advantage of the system over banks. It is hoped that banks will get some clues from these attributes and use them to provide better and more competitive services and products in the future.

Important policy implications are at issue in the intermediation of *yu-cho's* funds that go well beyond the exposure to market risk. At issue is differentiating the intermediatory roles of savings institutions, such *yu-cho*, that were created for individual and household thrift, and charged with the prudent safeguarding of saver's deposits, as compared to the designated role of commercial banks of financing business enterprises with creditors' risk. A considerable amount of public funds have been spent in recent years by the Japanese Government to recapitalize the banks, some Yen 8.4 trillion (US$ 80 billion) in 1999, to provide the banks with adequate capitalization to resume financing small and medium-sized enterprises (SME). Rather than providing credits to SMEs, banks have instead invested their funds in the safety of Japanese Government Bonds (JGB). On the other hand, policymakers have moved to increase postal saving fund's investment-risk profile in equity markets instead of Government-guaranteed securities, thereby giving it greater risk exposure. By not addressing the wishes of postal savings depositors, who whose primary concern is safety, has led to a reversal of the primary roles of commercial banks with that of savings institutions. Government-owned policy-based finance companies must now provide small business loans, while commercial banks avoid credit risk by buying risk-free JGBs. With the huge amount of public debt that needs to be underwritten, some 140% of GDP, there is no reason not to provide postal saving depositors with the security they are seeking by investing in the safety of Government bonds. Commercial banks which rely on client companies' employee deposits as a cheap source of funds, on the other hand, have all but abandoned commercial lending and depend instead on fee income and government largesse. Unless banks that have accepted government injections of capital are proscribed from purchasing JGBs, there will be no way that the Japanese economy can recover based on its bank-centered financing regime.

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