The Economics of Japan's Postal Services Privatization

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Abstract: Japan's privatization of its postal services - which includes one of the largest financial institutions in the world - is exceptional for its huge size and complex structure. This essay examines the economic background of these features, as well historical development, competitive environment, and lessons. The effect on management incentives of a soft budget is key in understanding the system's problems when it was operated as a government agency. The analysis suggests the privatized components should achieve higher profitability and greater efficiency, including recovering from the soft-budget problem.
Introduction
Many privatization programs have been undertaken by developed and developing countries since the 1970s. In Japan, three state owned enterprises (SOE) - Japan National Railway (JNR), Nippon Telegraph and Telephone (NTT), and Japan Tobacco - were privatized in the mid 1980s.

Japan Postal Services Privatization was the hottest topic in Japanese politics in 2005. Now, I believe it is time to discuss the matter in an economics context. Among privatizations throughout the world, this one is exceptional for the huge size of the business volume and the complex structure of the reorganization. In this essay, I would like to show the economic background of these features.

First, I examine the economic nature of the products Japan Postal Services Enterprise (JPSE) has provided. I show that the markets for the products are very competitive.

Then, I review the development of business volume and the financial structure of JPSE. JPSE has significantly expanded its business volume since the 1960s, under the fiscal control of the Postal Services Special Account (PSSA).

Third, I analyze the management discipline of JPSE from the viewpoint of soft-budget-constraint (SBC) theory. I find the postal service business has been relatively efficient, but still suffering from an SBC problem. As for the financial businesses, I describe the financial commitment problem combined with the Fiscal Investment and Loan Program (FILP).

The essay concludes with my assessment of the effect and lessons of the privatization. If several conditions are satisfied, the privatization will bring market discipline to every entity of the privatized JPSE and successful results.

1 The Economic Nature of JPSE Products

JPSE products fall into two categories: postal services and financial services. This section reviews each group, including its competitive environment.
1.1 Postal Services

Postal Services involve transportation and communication. As regards the communication aspect, it is quite obvious that telecommunication services have several advantages compared to the post. In particular e-mail is far cheaper and faster than traditional mail. However, many communications, especially legal ones, still require original documents. But, even in this area, "electronic signatures" are becoming more acceptable.

The transportation aspect can be subdivided into freight and letters. As to freight, it is clear that the services of other firms are substitutes for the parcel delivery services of JPSE.

As for letters, the competition structure is not straightforward. JPSE has a universal service obligation, and also quasi-monopoly status. Other firms must satisfy minimum standards such as having their own nation-wide network in order to acquire permission to provide letter delivery services. So far, no firm has entered this market to challenge JPSE.

However, comparing the Japanese case with the US one, we find the environment in Japan more competitive. In Japan, the postal service does not have exclusive use of the mail drops of private residences, as is the case in the United States. That is, legally, only items with proper postage can be put in a residence mail drop in the United States. This is true even though the residence must provide and maintain the drop.

Newspaper delivery companies have been strong competitors for local postal service business in Japan. They can legally deliver commercial leaflets into private mail drops, and thereby skim demand for direct mail.

In Japan, a letter is defined as "a document that presents an idea of a sender or informs a fact to a specific receiver". Letters can be delivered only by the JPSE or other permitted entities, of which there currently are none. Items outside of this definition can be delivered by any freight company as parcels regardless of the weight or delivery condition. Such a definition of letters is not practical from a regulatory standpoint.

Some freight companies provide "mail transport" service for light-weight documents that are not covered by the definition of letter. This service is expanding as an alternative to the postal service.
In the United States, documents with a weight below a certain threshold and without any specific delivery conditions are defined as letters that must be handled only by the US Postal Service. "Specific delivery conditions" are the key needed for FedEx, United Parcel Service, and DHL to be able offer their various time-specific services.

The market for postal services in Japan is very competitive. Because JPSE has few institutional advantages, erosion by competitors is inevitable. Further, the JPSE has a universal service obligation that its competitors do not have. This means the overall operating environment for JPSE is very harsh. The volume of mail handled by JPSE, measured in units, has been falling - by 13.5% for letters and 7.4% for total items from fiscal 2001 to fiscal 2005 (the year ended March 2006). During this period, competitors' "mail transport" services increased volume by 165.9%, and had a 7.7% market share in fiscal 2005.

1.2 Financial Services

JPSE provides savings and life insurance services. The products are basically the same as deposits or life insurance policies provided by private banks and life insurers, but the government guaranteed the postal products before privatization.

As for savings service, the guarantee ought to have been irrelevant for depositors, because all deposits at Japanese banks have been perfectly protected by the government, and the upper limit for individual postal savings was equal to the amount of deposit insurance coverage for private banks. Besides, the deposit insurance budget has been financed mainly by the government budget.

In any case, the advantage for the postal savings business is not supposed to be very essential. It did not have to pay any deposit insurance premium. However, on the asset side, the level of credit risk was restricted. That is, there were limits on lending and investing activities that might have brought higher returns but higher risks. The foregone returns are presumed to have roughly corresponded to the foregone risks.

Private bankers have criticized teigaku - "fixed amount postal savings". These are a unique product that has accounted for most postal savings - some 90% in March 1985. Critics insisted teigaku had an economically irrational characteristic. Namely, depositors
enjoy a 10-year maturity with a guaranteed interest rate, compounded semi-annually, but can withdraw money without penalty after 6 months. This means that when rates fall, the depositor can simply leave the account in place, but if rates rise, the account can be closed without penalty and a new one opened. This was a common practice during periods of rising rates. In financial terms, depositors have a put option, with the postal savings system as the counter-party.

However, such characteristics can be achieved by private banks with option pricing techniques. Indeed, a shinkin bank in Tokyo offered a similar product in 1999. The critical point for depositors is the level of the option premium, rather than the option itself. (Shinkin specialize in financing small businesses. They are organized as non-profit cooperatives.)

Rather, the key point of the postal savings business is its abnormal structure as a financial enterprise. The business was a handicapped bank, which took deposits but was not able to extend loans. That is, postal savings did not have any information-creation function, which is the core competence of commercial banking.

This abnormal structure was related to the Fiscal Investment and Loan Program (FILP). Until April 2001, funds collected by government agencies, including the postal financial businesses and public pension system, became part of FILP. That is, the funds had to be passed on to the Fund Operation Special Account (FOSA) managed by the Trust Fund Bureau (TFB) within the Ministry of Finance (MOF). Under FILP, MOF then provided the funds to various public enterprises and local governments.

As for postal life insurance, the products are regulated under the basically same principles as other insurance policies. In general, life insurance policies in Japan are mixtures of saving vehicles and pure life insurance. For postal insurance policies, the saving elements are far larger than the pure life elements. Important characteristics of postal policies were a government guarantee, waiver of medical examination, and an upper limit on an individual policy amount.

The waiver of medical examination was an attractive feature for customers until the 1970s. However, it obliged the postal life insurance business to limit risk by constraining
the size of death benefits for an individual policy holder, and to give more weight to the saving element.

Postal life insurance policies as saving vehicles were guaranteed by the government. This was supposed to influence the competitiveness of the policies, as pay-outs by private insurers had been reduced in cases of bankruptcy. However, the period during which Japanese life insurers were in serious danger of bankruptcy was relatively limited, lasting from 1997 to 2001.

The upper limit of the postal policy amount for an individual policy holder was decided by negotiation between MOF and JPSE, considering the government guarantee in the saving element and the weak examination structure for the insurance element.

Since the 1990s pure insurance products such as medical insurance have became more promising as Japan moves to an aging society. The waiver of medical examination has thus become a handicap. As the postal life insurance business did not develop a close relationship with the medical industry, it has had difficulty developing a pure insurance product. The products the postal life insurance business can provide have been restricted not only because of state ownership, but also because of weak business capability.

Until 2001, the postal life insurance business had to pass funds to FOSA, with a little room independent investment decisions.

2 Development of JPSE

2.1 Volume Expansion

The most remarkable feature of JPSE is sheer size and growth, particularly of financial services. The incredible extent to which postal savings had expanded at its peak is especially outstanding. In the mid 1960s the system had 3 trillion yen in deposits, representing about 15% of Japanese household saving. By 2000 deposits had grown to 260 trillion yen, close to 40% of household saving. Postal life insurance also expanded: at the peak in 2002 its share of policies for Japanese individuals exceeded 30%, and total assets were 124 trillion yen.
Basic postal service has not shown such an extraordinary expansion, but it achieved steady growth. The number of delivered items increased from 10 billion in the 1960s to nearly 27 billion in fiscal 2001, though volume has declined since then. From the 1960s to the present, the number of post offices increased by one-third (from some 18,000 to 24,600), and the number of mailboxes increased about 40% (from 115,000 to 160,000).

2.2 Fiscal Control

Postal service was established in 1871, postal savings in 1875, and postal life insurance in 1916. From their founding, they were run by a government ministry that also operated the telephone and telegraph systems until the end of World War II. The telephone and telegraph systems were privatized in the 1980s after a period as a public corporation.

The fiscal management system of JPSE was established in 1951 and continued until privatization. Under this system, all revenues and expenditures from the postal service, postal savings, and postal life insurance businesses were recorded in the Postal Service Special Account (PSSA), which is outside the regular budget - General Account - of the government. The cash balances of the account were managed as a single entity. The system could borrow from the government, but it was not necessary to do so.

PSSA had two sub-accounts, Postal Savings Special Account and Postal Life Insurance Special Account. These were fund-management accounts where revenue such as interest payments made by F0SA, and payments such as withdrawals by depositors and insurance payments made to policy holders, were initially recorded.

The financial and regular postal businesses shared ordinary costs such as personnel expenses according to allocation rules. This cost-sharing by sub-accounts was recorded as transfers from them to PSSA. The balances of the postal saving business and postal life insurance business were merely details for reference in PSSA, so that mutual subsidizations were left to management discretion.

JPSE was transformed from being an agency of the Ministry of Post to a public corporation in 2003. However, the fiscal control system remained basically same.
2.3 Development of PSSA

The fiscal balances of PSSA from 1947 until 1951 were continuously in deficit because of hyper-inflation. Although JPSE raised postal rates every year, it could not keep pace with rising costs, and PSSA had to accept subsidies from the General Account of the government. From 1952 until 1960 PSSA did not accept subsidies, but had to borrow from FOSA under a redemption plan that included severe cost cuts. In 1961 this fiscal difficulty was removed. The government relieved JPSE of the need to repay its accumulated debts, and raised the interest rate for deposits made by JPSE in FOSA.

Subsequently, increases in personnel expenses meant that by the latter half of 1960s the postal service business had again fallen into deficit. During the 1970s the deficits were temporarily financed by funds collected by the postal saving business, and eventually covered by raises in postage rates. However, the situation entirely changed in 1981. The rate raise of that year reduced demand, and brought a decrease in revenue. This gave a strong incentive to undertake drastic restructuring. After several years of reform, the postal service business came back into surplus, and paid all accumulated debt in 1986.

The postal savings business continuously showed surplus until 1972. However, it operated at a deficit from 1973 until 1978 because of the sharp rise of interest rates. It recovered in 1980s, thanks to a relatively higher interest rate from FOSA.

In the 1990s the fiscal condition of PSSA had been getting worse over all. The postal service business showed deficits for 1998-2000 because of the recession. The savings business fell into the red as well, and the deficits were very large. The main reason was interest-rate mismatch.

Funds collected by the postal savings system were passed to FOSA for deposit contracts with a 7-year term and an interest rate at the level of the yield-at-issue of the contemporary 10-year government bond plus 20 basis points. Most savings deposits are in a product called teigaku. This has a nominal maturity of 10 years with a fixed interest rate in line with the yields for similar maturities of governmental bonds at the time the deposit was made. However, depositors can withdraw money without penalty after 6 months. This meant depositors can benefit from rising rates, but are protected from following rates.
The level of interest rates was very high in the last half of the 1980s, and then sharply declined in the beginning of the 1990s. Therefore, many depositors with teigaku from the late 1980s held the deposits to maturity, so that the interest payments by the postal savings business remained high. Meanwhile, in the early 1990s the interest revenue of the postal savings business declined as its deposit contracts with FOSA were renewed.

In the first half of the 2000s the fiscal condition of JPSE was getting better gradually, partly by the grace of the management effort of the newly established Japan Post Public Corporation.

The institutional framework of the Fiscal Investment and Loan Program (FILP) was totally reformed in 2001. As a result, postal savings are no longer deposited with FOSA, and outstanding deposits will have been repaid by the end of 2008. The postal financial businesses will no longer have an ensured spread between what they pay for funds and what it receives when investing those funds.

3 Management Discipline

3.1 Soft Budget Constraints

Privatization has been an interesting issue in economics. As a result, many scholars have built a vast literature on the subject. We find various arguments regarding market failure, incentive and agency problems, and the macroeconomic effects of privatization.

Arguments such as natural monopoly, externality, and public goods are not typically applicable to JPSE as a whole. This is because the markets for the products of JPSE are very competitive. The postal service might be classified as a quasi-public good, but postal financial services are not public by their nature. Besides, it was not claimed that postal services privatization would improve the public sectors' financial health. Therefore I want to concentrate my discussion on incentive and agency problems.

An important difference between a state-owned enterprise (SOE) and a private one is how financial distress is handled.
Under private ownership, an enterprise ordinarily is governed by shareholders, and the government's right to intervene is limited. In the case of financial difficulty, creditors have more voice. Depending on the viability of the enterprise, creditors decide whether the enterprise should be reorganized or liquidated.

Under state ownership, the government retains rights of intervention in everyday operations, regardless of the financial situation. In financial difficulty, the decision to reorganize or liquidate depends on whether the policy assignment of the SOE is judged to still be essential for the government. In the case of reorganization, fiscal supports such as capital injections or subsidies can be provided by the government.

Management incentive structures contrast accordingly. At least in Japanese large enterprises, the managers of a private enterprise ought to bear personal responsibility in the case of distress. In bankruptcy, for example, they are normally obliged to give up their positions, and sometimes to compensate the failed enterprise.

In the case of a distressed SOE, managers do not have to take such personal responsibility. They have duties regarding both policy assignment and fiscal health. If deficits are regarded as inevitable under a particular policy assignment, the losses are not blamed on lax management.

Soft-budget constraint (SBC) theory is fundamental to analyzing the behavior of SOE. It was originally developed for the analysis of a centralized economy, but SBC problems are present in market economies. Kornai characterizes SBC as having two major features, ex post renegotiation of firms' financial plans and a close administrative relationship between firms and the center.

I believe SBC theory is the key to understand Japan Postal Services Privatization. Describing the SBC problems of JPSE as deriving from the absence of a bankruptcy threat is an over-simplification, but perhaps a useful one. The concrete symptoms vary between the postal service business and the postal financial service business. I want to examine the management discipline of JPSE from this point of view.

3.2 Management Discipline in the Postal Service
In the 1970s the postal service business was distressed, having accumulated a deficit. JPSE had raised postage rates 18 times since 1945 in order to cover its ever-increasing expenses. However, the 1981 increase failed to improve the fiscal balance. Instead, it actually discouraged demand and reduced turnover. The market structure had entirely changed, as competition with telecommunication and private freight services had become very fierce.

This gave a serious shock to JPSE management. They sent a document to all post office managers saying “We have no other choice than to provide better services which meet the changing needs of customers. Otherwise we would become a bottom dog in the competitive market. We can see the miserable examples of Japan National Railway.” I believe this document was exceptionally arousing to the culture of the Japanese bureaucracy, where modest language is generally very preferred.

Indeed, JPSE management had a strong eagerness to perform a sweeping restructuring. The substances of the reforms are as follows.

- Switch the postal transport system from railway-oriented to truck-oriented.
- Start actively canvassing for postal services.
- Activate the postal parcel service by introducing new services, including hurusato kodutsumi (homeland packets) and yu-pack (postal standard freight service).

The outcome of these efforts was respectable. JPSE recovered from a cumulative deficit of 250 billion yen, and the budget became stable. The effort by JPSE should be given high marks as a government agency, showing a sharp contrast to Japan National Railways (JNR).

The key of the reform was the success of JPSE in persuading its labor union, which had been one of the most aggressive unions - along with the railway union - during the post-war period. The collapse of JNR and the way it was privatized might have given a strong incentive to employees of JPSE. JNR privatization included a division into seven regional enterprises, a strict business restructuring with abandonment of under-used local lines, and a drastic employment adjustment.

However, I must still point out symptoms of SBC in the behavior of JPSE in those days.
The first was the timing of the reform. The reform was started after three years of deficits. The accumulated deficit of 250 billion yen corresponded to one-third the turnover of the postal service business in that period. If JPSE had been a private enterprise, it would have suffered a cash shortage. The annual balance remained in the red until 1986, and it took six more years to settle the entire accumulated deficit. If JPSE had been private, it might have gone bankrupt before the reform showed significant effects.

The second symptom was the substances of the reform. The reform was reactive to the deficit, not proactive for future profit-making. The main contents of the reform were improvement in existing services. JPSE put the savings from the switch in the postal transportation system into the more-rapid delivery of standard mail, which made the advantage of the express service insignificant for customers. JPSE has developed neither a popular postal product, other than a new year's postcard, nor a menu of various services for local small post offices.

These problems might be partly attributable to institutional restrictions on the scope of business that could be undertaken as an SOE. However, I believe they were at least partly caused by the lack of market discipline in the postal service business. The postal service as operated by JPSE included the financial services businesses. There was no separate cost-accounting, let alone any profit and loss calculations, for various activities. As a result, profits from financial services off-set deficits in postal service business, but opaquely. There was no examination or monitoring by an external creditor.

If the postal service business had been a private enterprise, it could not have enjoyed a government guarantee. It would have had to give signals of financial soundness to creditors. The creditors would have examined and monitored the business, so that the management would have been obliged to keep the business profitable and the capital at an adequate level. In order to do that, it would have had to make business innovations constantly, and take prompt, proactive actions to avoid financial difficulty.

I believe that the JPSE postal service showed delayed and reactive action against the change of market structure because it was free from a hard budget constraint, and that the integration with financial service businesses brought remarkable SBC problems.
3.3 Management Discipline in the Postal Savings Service

The soft-budget constraint literature has not been limited to the public sector, including SOEs, but also addresses the banking sector. Market-discipline for the banking sector remains weak in Japan. In part this is because all deposits have been perfectly protected since the end of World War II. Especially until the 1980s, interest rates on deposits were strictly regulated by MOF, and the money market was rigidly controlled by Bank of Japan (BOJ). Banks have had no freedom to go bankrupt. In addition, corporate governance by shareholders did not function well until the end of the 1990s, as interlocking shareholdings was dominant in the Japanese capital market. Under these circumstances, an SBC problem in the standard context was not unique to the postal savings business.

We now examine the abnormal business structure of the postal savings business in order to consider the management discipline problem. The postal savings system collected funds nation-wide from depositors, but could not invest the funds itself. JPSE basically had to pass the funds to FOSA. Thus, the main revenue source was interest payments from FOSA.

The profit of the postal savings business mainly depended on the margin between the interest revenue from FOSA and the interest payments to depositors. The decision rules for the two rates were different. Revenue from FOSA was a compromise between the market and politics, mainly because this interest rate was also applied to funds collected by the public pension system. In contrast, the interest rates paid for postal savings were basically linked with market rates. Initially, these were fairly directly tied to the official discount rate of the BOJ. After rates were deregulated, the rates paid on private bank deposits were the benchmark.

In the decade after 1945, FOSA paid rates linked with the yield-at-issue of government bonds, while rates paid deposits were relatively high. JPSE suffered successive deficits.

The fiscal situation of JPSE was alleviated by measures taken in 1961. The Diet relieved JPSE of the obligation to repay its accumulated deficit. It also added 50 basis points to the interest rate being paid by FOSA. This was to compensate for the costs of the postal
savings business. This was an ex-post bailout for JPSE and an ex-ante guarantee of subsidies proportional to the business volume of the postal savings. I believe the SBC problem of JPSE was created by this measure.

In 1973 the balance of the postal savings business again went into the red as interest payments to depositors increased substantially. The tight monetary policy associated with the global oil crisis meant a vast increase in the interest rates paid to savers. The rate of teigaku deposits was a "floating rate" that in effect could only rise, as depositors had the option of receiving a higher rate if rates changed. On the other hand, the revenue from FOSA did not increase, as the yield-at-issue on government bonds was relatively stable. The unfavorable balance lasted until the overall downturn of interest rates, when FOSA reduced interest payments moderately.

From the 1980s, interest rates fluctuated far more radically than earlier. Therefore, in 1987 the Diet authorized MOF to set the FOSA deposit rate under a particular criterion, without the need of a specific amendment to the Fiscal Operation Act. Under this criterion, the rate had to be set in consideration of two elements. The first was linkage with market rates, such as the yield-at-issue of government bonds. The second was an assurance of the fiscal condition of postal savings business, postal life insurance business, and the public pension system. In practice, MOF set the rate for 7-year deposits paid by FOSA at the level of the yield-at-issue of 10-year government bond plus 20 basis points to cover JPSE's costs.

The background of this scheme had two important elements. First, the FOSA deposit rate was crucial for calculation of the public pension budget. This meant MOF had to take account of its impact when preparing the annual budget of the General Account. In particular, a lower FOSA rate might result in a larger subsidy to the public pension system. JPSE profited from this situation. Although such an excessive premium to the market rate can be covered only at the expense of the General Account in later years, MOF had enough to do to pass the current budget every year.

Second, liberalization of interest rates was still going on. At that time, Japan had long-term credit banks. They raised funds via bonds with yields-at-issue linked to the yields of government bonds. In turn, the lending rate of these special banks, called the "long-term prime rate", was set at the level of the banks' cost of funds (that is, the interest paid on their
bonds) plus a sufficient margin to afford sound administration. The long-term prime rate also was employed by government financial institutions (GFI) as a standard lending rate. This scheme was called the "interest rate hierarchy", and was managed by MOF to keep all participating entities sound and peaceful.

Actually, this hierarchy was already on the way to be broken up by market forces. Liberalization of deposit rates was completed in 1994. However, the budget authority was not fully aware of the market forces, so FOSA was segregated from the financial market principle to some extent. The FOSA deposit rate scheme remained basically the same until 2001, at which time the Fiscal Investment and Loan Program (FILP) was totally reformed.

3.4 The Effect of the Fiscal Investment and Loan Program

I believe the FOSA deposit-rate-setting system described above became fundamentally irrational in a free financial market, as it gave a high premium to financial products that did not have any additional risk. Under this system, it was quite natural for JPSE managements to swell the volume of postal savings. The larger volume brought JPSE proportionally more income, which could be distributed to its stake holders. Moreover, it was the only choice for JPSE, as an information-creation function was denied the postal savings business. Therefore it had extremely strong incentives to attract depositors with higher interest rates, and to engage in heavy canvassing activities through post offices.

At the same time, JPSE was an SOE that had to achieve both a policy assignment and the fiscal health of the enterprise. If deficits were regarded as inevitable under a particular policy assignment, JPSE would not be blamed. For JPSE, "encouragement of personal savings" was a policy assignment. Therefore, JPSE management felt secure in putting as many resources as possible into gathering personal depositors.

Indeed, JPSE has constantly tried to set the interest rates for postal savings as high as possible. This tendency was established in 1961 when the rescue measures were taken. From then on, JPSE has set the interest rates for postal savings higher than similar deposits of private banks.
JPSE negotiated with MOF very vigorously whenever regulated interest rates were revised during the 1970s. Every time, after tough and persistent negotiation, JPSE made postal savings more favorable to some extent. This continued during the 1980s as interest rates for private markets were liberalized. As a result, JPSE was able to maintain its advantages and increased the market share enormously. There was a term for it: "postal deposit shift".

The specific schemes show the extent to which JPSE would go to gain deposits. Thus, the calculation method of interest was manipulated in the 1990s. At the time, interest amounts smaller than 1 yen for a unit deposit were rounded up. Some employees of JPSE exploited this by dividing what could have been a single deposit into many deposits of the minimum amount in order to accrue rounded-up interest payments.

We can find a similar tendency in the postal life insurance business. JPSE made continuous efforts to set the assumed interest rate for policies higher than the private products. This could be regarded as one of the reasons for strong expansion of the postal life insurance business.

I believe the phenomenon discussed above is one of the distortions caused by FILP.

First, postal savings got into deficit because of the higher interest rates for postal savings deposits. Still, it was not a vital blow for JPSE management. The political reason was that the policy target of the business was "encouragement of personal savings", and the economic reason was that JPSE enjoyed a government guarantee and hence did not need to maintain capital adequacy, which other banks did.

Second, the higher interest rates for postal savings caused higher funding costs for FILP. This contradicted the policy target of the system, which should have given financial advantage to the public organizations borrowing funds. The contradiction was covered by dividend-free capital injection, subsidies, and loss-compensation for the public organizations from the government budget. The government was obliged to do so because any negative spread on the system's lending was the inevitable result of the government's own policy decisions.

Third, the FILP meant that the true burden of the government budget was obscured. Policy measures such as public works were often financed by borrowing from FILP, rather
than by explicit budget expenditure. Japanese taxpayers might well have had the illusion these policy measures would be free from any future tax burden.

Moreover, this phenomenon might have had a harmful effect on innovation in Japanese financial markets. In the process of interest-rate liberalization, "market-rate linkage rules" were established for the interest rates of postal savings. The rules discouraged the private sector from designing new financial products, as a fixed menu of products was presumed in the rules.

4 Expected Effects of Privatization

4.1 The Law Privatizing Postal Services

Postal services privatization took place on 1 October 2007. Under the law for the privatization of the postal services, Japan Post Public Corporation was abolished, and each of its businesses was taken over by one of four companies under Japan Post Holdings Company, a holding company. The four are Japan Post Network, Japan Post Service, Japan Post Bank, and Japan Post Insurance.

Japan Post Network is the entity that operates most post offices. Its main business is being an agent for the three other companies, but it can engage in any business by itself based on its own management decisions.

The government's share in Japan Post Holdings must be reduced to one-third as soon as possible. Japan Post Holdings is obliged by the law to dispose of all of its shares in Japan Post Bank and Japan Post Insurance no later than 30 September 2017. However, Japan Post Service and Japan Post Network will remain perpetually as subsidiaries of Japan Post Holdings.

As for the specific schedule of share disposals, Japan Post Holdings plans in principle to list its own shares and those of the two financial subsidiaries three to four years after privatization, and to sell all shares in the two subsidiaries within five years of the listing. Thus, the privatization might be completed by 2014 or 2015.
4.2 Management Discipline in the Postal Service and Network Companies

For the postal service and network companies, privatization has decisive effects on their managements.

Separation of the financial companies was the key to establishing management discipline. The Post Bank is to assess and monitor in the same way as a regular commercial bank when it lends to the other postal companies. This creates an incentive to evaluate the business plans of the postal companies from an external point of view.

The postal financial companies are regulated under the banking act or insurance business act. This means their lending to the postal service and network companies must follow the regulations regarding limits on exposure and the arm's length rule. These prudential rules are not solely supervisory rules. They are also administrative. They bring to the postal service and network companies hard budget constraints by limiting fund availability.

Because Japan Post Holdings will list its share, the business model of the two perpetual subsidiaries will be evaluated by potential shareholders of Holdings. In addition, the postal service and network companies might raise new funds from the financial market. The market discipline will penetrate the companies and let them be aware of the importance of capital adequacy as a signaling measure to the market. The financial markets will give them incentives to build a future-oriented business plan and to make proactive innovations in their products.

4.3 Management Discipline in the Postal Financial Companies

Even before privatization, abolishment of the system of passing all deposits received to FOSA had had a remarkable influence on the postal financial businesses. Because JPSE now has to invest in standard financial products such as Japanese government bonds, it is no longer assured a positive spread on the deposits it takes in. This has had led to restraint on the resources devoted to collecting funds from the public. As a result, the amount of postal
savings and postal life insurance has decreased steadily. In March 2008 postal savings deposits stood at 181 trillion yen, down almost 30% from the March 2000 peak of over 250 trillion yen.

The primary effect of privatization on the postal financial companies is from the loss of their government guarantee. This is particularly important for Japan Post Bank. The major part of its deposits (liabilities) is demandable after 6 months. Post Bank has a huge amount of long-term government bonds on the asset side. This term mis-match means the bank has two major risks.

First is interest-rate risk. Profits depend heavily on the yield curve and the tempo of interest rate change. Profits decline when the yield curve is flat or rates rise rapidly.

The second is liquidity risk. This is important from the viewpoint of management discipline. The bank has no debtor deposits or pool funds for commercial settlements. Most deposits are from individuals or small businesses and are effectively demandable. This means that as market conditions change, depositors can, and likely will, move funds to where they think they will earn more. But, on the asset side, the government bonds are substantially illiquid. The bank holds a large share of outstanding government bonds, and cannot liquidate quickly without having a large impact on the market. If it is known Post Bank wants to sell bonds urgently, the price would depreciate immediately and sharply. This risk is a very effective stimulant to Post Bank to establish determined discipline for risk and return management.

This risk structure is recognized by financial market participants. The bank must appeal to the market through the soundness of its management and adequate, credible disclosure of its financial condition. Capital adequacy is the key for Japan Post Bank, just like other banks, in order to retain the confidence of financial markets. Under this condition, the bank should not simply pursue expansion of its business volume, as the efficiency of the capital should be the most important target.

Ending capital ties with Japan Post Service and Japan Post Network is the most crucial requirement for the postal financial companies to acquire the confidence of financial markets. Generally, exclusion of non-financial business risk is the core concept for prudential regulation of banks and insurance companies. This separation is especially important for the
postal financial companies, as they have a common history with the postal service and network companies, and inertia from the past will be a serious concern of market participants.

4.4 Method of Privatization

Globally, not all privatization projects have been successful. Rather, we find many cases where economic society fell into difficulty, as in the Czech Republic, or privatized companies became fertile soil for corruption, as in Russia. Privatization of banks is especially complex and difficult. The experiences of Chile in the 1970s and Mexico in the 1990s demonstrate the need for coordination with the regulatory framework.

A World Bank Policy Research article by Kikeri and Nellis (2002) points out several factors for successful privatization that relate to the Japan postal services case.

> Commitment
Privatization requires a strong political commitment. In addition, the building of widespread public understanding is essential.

> Ownership and competition
Ownership change is needed to make competition effective. But competitive markets are also important if privatized enterprises are to perform well. Additionally, financial sector reform and a competitive and commercially oriented banking system are important.

> Transparency
Lack of transparency in the privatization process leads to allegations of - if not actual - corruption. This provides ammunition to opponents, which creates backlash from investors and the public at large. A public offering of shares is widely regarded as the most transparent method.

In the case of Japan's postal services, the institution-designing and political decision-making processes fully satisfied these conditions. Moreover, the markets for the products of JPSE are very competitive, and a broader reform of financial markets is on-going.
Therefore, the last necessary condition for a successful privatization of JPSE is the early listing and disposal of shares of Japan Post Holdings, Japan Post Bank, and Japan Post Insurance. This is important for the commitment condition, because the listing of shares is the most definite commitment to investors. Also, listing is important for the transparency condition, because it reduces room for "self-dealing" and other corruption by establishing disclosure and internal control systems.

In particular, shares of the financial companies have to be totally disposed of. Early listing and full disposal are critical for successful privatization.

4.5 Expected Performance of the Privatized Companies

JPSE has been managed as an SOE with a restricted business scope for a long period. Therefore, it is not so easy for the newly privatized companies to transform themselves into excellent private enterprises. This section examines the possibility of JPSE success.

According to empirical studies of privatizations throughout the world between 1980 and 1997 surveyed by Sceshinski and Lopes-Calva (2003), the following findings emerge.

> Important efficiency gains should be expected from the change in ownership structure in competitive sectors.
> Fully privatized firms should perform better than those that have been only partially privatized, under otherwise same conditions.
> Publicly owned enterprises in competitive environments have not performed better than private companies in the same circumstances in terms of profitability.

These results are applicable to Japan's postal services privatization because the new firms are doing businesses in very competitive environments and because they are to be fully privatized.

A study by D'Souza and Megginson (1999) that examines the success of share-issue privatization programs during 1990-96 yields other insights. The authors analyzed data from the prospectus for the privatization and post-privatization annual reports for 85 companies. The following empirical results are obtained.

> Profitability Change
Return on sales and return on assets increased significantly, while the changes in return on equity were not significant.

> Efficiency

Privatization yielded significantly higher real output per worker, regardless of industry or stage of national development.

> Output

Real sales increased significantly after privatization.

> Leverage

A significant decline in leverage for the full sample of privatized companies was documented.

From these studies, I believe we can expect good results from Japan's privatized postal companies. That is, they should achieve higher profitability and greater efficiency, which includes recovering from the soft-budget problem. In particular, the postal financial companies are to be expected to establish an adequate capital base and achieve profitability, albeit with a streamlined business volume.
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