Can the Government Deliver, On Time, Major Reform of Japan's Postal Service?

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The reawakening of Japan's economy following more than a decade of decline comes after a series of major economic reforms, but the biggest change may be yet to come.

Privatization of Japan's massive postal savings system, which holds savings and insurance assets valued at $3 trillion for 85% of Japan's population, is set to take place over the next 12 years. The proposal, overwhelmingly endorsed by voters in a September special election, will shift a mountain of assets from government control to private markets. Wharton faculty say the long timetable for carrying out the plan -- which stretches to 2017 -- may help blunt political opposition that is likely to continue, even after the process starts.

Olivia Mitchell, Wharton professor of insurance and risk management, predicts that postal savings reform will be another major step in unwinding the Japanese government's control over the nation's economy. By freeing money up for more private-sector investment, savers could reap better returns and businesses are likely to find more capital available for expansion and other financing needs.

"The Japanese postal service is one of the biggest financial institutions in the world; some people say it is *the* biggest," says Mitchell. "What's clear is that it is an institution with very far-reaching tentacles throughout Japanese society and the Japanese economy. So discussion of privatizing it bodes well for the modernization of financial markets in Japan."

The reform plan calls for Japan Post to be divided into four pieces: over-the-counter service, mail delivery, savings and insurance. The division would not take place until 2007 and even then, the four parts could remain owned by a holding company that would be 100% controlled by the government for another decade.

In 2017, according to the new law, the savings and insurance units would be released from government control and become private corporations through the sale of their assets on the stock market. The other two divisions would remain under control of the holding company, which by then is to be only one-third controlled by the government. In addition, the holding company would be allowed to buy back shares of the two financial service companies, and the other two units would be allowed to buy shares in the savings and insurance units.

In August, the legislation was voted down in the upper house of Japan's Diet. That prompted Prime Minister Junichiro Koizumi's landslide September victory in a special election in which postal system reform was the focal issue. After seeing strong public support for privatization, earlier opponents changed their votes and the measure became law. "This was a miracle in the political world," said Koizumi in a speech after the law passed. He has been pushing the idea of postal system privatization since 1979 when he served as a junior finance minister.

Financing Post-war Prosperity

The proposal, says Mitchell, will bring historic change to the system, which for more than 100 years collected savings door-to-door in Japan's crowded cities and rural villages alike. Savings amassed this way financed Japan's post-war economic rise, which culminated in its 1980s bubble economy.

"One of the interesting things the Japanese postal system has done is serve as a very efficient savings system," Mitchell points out. "It regularized the collection of small deposits every single week and enabled Japan to have one of the highest savings rates in the world. It's so easy; the postmaster comes around and just collects a few yen from the lady of the household."

The problem, says Mitchell, is that the money was often spent on politically motivated ventures. "Much of the money has gone into socially targeted investment projects the government deemed desirable," she says. "The claim is that the money has gone to build roads to nowhere and retirement communities out in the hills where no elderly people want to live. The money has done good in some instances, but the claim has been that much of this investment is not transparent. Nobody really knows in the light of day where the money is and whether it went to the right place."

The reforms will take a long time, Mitchell adds, but that is to be expected when it comes to restructuring a far-flung organization with 25,000 post office branches and 260,000 employees. "These employees have been strong political supporters of maintaining the system and opponents of the privatization. There will have to be a gradual approach to outsourcing what has been a primary bastion of the Japanese economy." Japanese society, she adds, places value on consensus. It will take time for all the stakeholders in the post office system to move together toward change.

According to Wharton finance professor Ayako Yasuda, the September election signaled a major shift in the political economy of Japan. "The Koizumi victory made it clear to everyone that the constituents that benefited from the old cooperation between political elite and interest groups lost. The constituents who won and supported Koizumi want Japanese firms and banks to be internationally competitive and accountable to shareholders."

The election was also rooted in generational change, she notes. "It arguably marked a tipping point in the demographic shift. The members of the younger generation know they will no longer benefit from the old regime, and for the first time they outnumbered the old guard."

Koizumi's mandate on postal reform may also give him additional power to continue to force change in other Japanese financial institutions, including the banking sector. "The political message here again is that credit allocation in the future will become more efficient in Japan, and banks who fail to see this sea change will fall behind others," Yasuda suggests. "I think this makes it easier for the surviving banks today to more aggressively transform themselves."

Meanwhile, Wharton adjunct management professor Adrian Tschoegl says the value of the postal savings system will be difficult to determine. "The biggest assets are holdings of government bonds which are the equivalent of treasury bonds, plus other bonds issued by various quasi-government and state-owned institutions. There's a question about what those are worth."

As a result, Tschoegl wonders whether outside investors will have much interest in buying a stake in the privatized system. "All the assets are government guaranteed, but that just means the government is on the hook for making good on any shortfall between the value of the assets and the value of the liabilities. What would someone pay for this portfolio? I just don't know how solvent they are."

Another problem is that the savings tend to be based in relatively short-term products while the assets are in long-term bonds. If interest rates rise, he says, that could trigger an interest rate mismatch. "There are a lot of quite thorny practical problems in the privatization that we are nowhere near knowing what to do about. Add in all the politics and the employees whose jobs are at stake, and I'm not sure that what we will see in 2017 is what is envisioned right now."

Changes in the Pension System

Preserving the assets in the postal reform system are critical. Many members of Japan's increasingly elderly population rely on them as the government and private pension systems have come under pressure during the long period of financial stress. Like the United States and Europe, Japan faces a growing elderly population, with fewer workers coming up to pay into state-run pension programs. By 2025, 28% of Japan's population is expected to be over 65 compared to 12% in the United States.

In 2004, the government announced that pension system contributions would rise every year until 2017, when they will stay at 18.3%. Now, the figure is 13.58% of a person's income. Benefits would be decreased to 50.2% of income from 59.3% over the same period. Corporate pensions, too, have been under stress as Japan, Inc. endured the long economic slump, according to Sarah McLellan, an equity analyst at Morgan Stanley in San Francisco and author of a 2004 working paper titled, *Corporate Pension Reform in Japan: Big Bang or Big Bust*, written for the Pension Research Council at Wharton.

To boost private pensions, the government introduced another financial reform in 2001 creating defined contribution (DC) retirement savings plans, similar to 401(k) programs in the United States. The plans met with limited success at first, but are beginning to increase, with 1,566 plans now in effect.

McLellan says the slow uptake was due mostly to low contribution limits, the equivalent of $4,000 for workers at companies without a pension program and $2,000 for those at a company with an alternative plan. "My view is that the introduction of DC plans will slow down and remain a vital part of increased employee self-responsibility for post-retirement savings, but will not take over the system."

She also notes that traditional defined benefit plans are not concentrated in declining or union-intense industries, like autos and airlines, so the incentive for firms to walk away from pension obligations in a restructuring is not an issue the way it is in the United States. Major U.S. firms, most notably airlines and steelmakers, have unloaded some pension obligations by filing for reorganization under bankruptcy laws.

While Japanese companies continue to struggle to reduce liabilities on their balance sheet, McLellan says most have already gone through the pain of marking down their expected return on pension assets and are adjusting to new pension accounting rules under the International Financial Reporting Standards. "As the working-age population continues to decline in Japan and companies seek new ways to attract and retain talent, pensions can assume an important role in employee recruitment, retention, and total compensation," McLellan suggests. "Increased pension options provide mechanisms to promote labor market efficiency and social welfare."

Slow, but Firm, Steps Forward

Changes in the pension system, along with the monumental postal savings reform, are part of continued efforts to make structural improvements in the Japanese economy. "It seems Japan has, for the last decade, slowly and steadily moved in the direction of financial system reform," says Mitchell. "I think anybody who understands the role of financial markets would agree they are moving in the right direction."

Reform, she adds, is never easy. "With reform, comes dislocation. Consequently, the government has tried to weigh the speed of reform against the pain of dislocation and has stepped gingerly. Now that Koizumi's recent reelection was such a resounding success, it's got to happen."

