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Recent Fundamental Reform of Public Financial System in Japan: Background and Remaining Problems

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ABSTRACT

Public financial system has played a crucial role in the Japanese economy. In this paper, we discuss the recent drastic reform of the public financial system in Japan. After describing the former system and the background that led to the 2001 reform, we examine the features and remaining problems of the new system. At the same time, we would like to mention issues of entire financial system in Japan, which seems to be a bottleneck for realizing an ideal public financial system.

JEL Classification: *H11, H54, H81*

Keywords: *Fiscal investment and loan program; Postal services; Credit enhancing*

I. INTRODUCTION

In general, the purpose of public financial activities is to offer services that private financial institutions cannot provide for various reasons. However, we ought to take account of the fact *that* aims that public agencies should pursue will change along with the development of the economy. Accordingly, the public financial system must be designed so as to correspond to such a transformation of social requirements. If the system becomes unable to accept such changes, then we have to reform the system to function effectively.

In recent years, unprecedented extensive reforms in the public financial system have been carried out in Japan. The purpose of the reforms was to reconstruct the system to meet the new economic demands. Although we can now observe the positive outcomes of these reforms, several bottlenecks still remain in terms of constructing an appropriate financial system for the Japanese economy.

This paper is divided into six sections. Section II is a review of the Japanese financial system before the reforms. Section III indicates the background or the necessity of the reforms. Section IV describes the contents of the fundamental reforms. Section V presents remaining problems for construction of a better financial system in Japan, and Section VI summarizes and concludes the paper.

II. PUBLIC FINANCIAL SYSTEM IN JAPAN BEFORE THE REFORMS

A. The Basic Framework of the FILP System before the Reforms

The public financial system in Japan has been recognized as the Fiscal Investment and Loan Program system (the FILP system).

Before the fundamental reforms in 2001, the FILP system took the form of a huge indirect-financial system. Namely, in the FILP system, each organization performed only a part of intermediation process, such as acceptance of deposits, fund management, and investment. This separation of the financial functions was quite unique because a private financial institution usually covers the entire intermediation process.

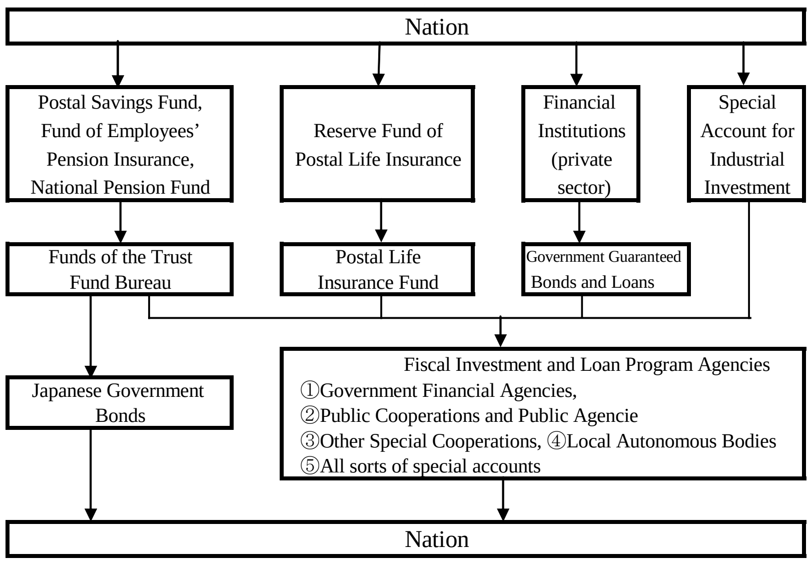
In the FILP system, financial institutions whose only function is accepting funds were called the Entrance Organizations. They included Postal Savings, Postal Life Insurance, Employees' Pension Insurance and the National Pension Fund. These accounted for 90 % of FILP funds in the last fiscal year of the old system (FY2000).

Institutions that played the role to invest the funds were called the Exit Organizations. Their formal name is "FILP agencies," which have been owned by the Government.

In the old system, the Trust Fund Bureau (TFB) in the Ministry of Finance functioned as a fund manager. The Postal Savings, Employees' Pension Insurance and National Pension Fund were obliged to deposit all accepted funds with this Bureau, while the reserve fund of the Postal Life Insurance was managed by the Minister of Posts and Telecommunications in corporation with the FILP. The largest part of the TFB Fund was invested with FILP agencies and the remainder with Japanese government bonds (JGBs)[1].

Prior to the reforms, the entire FILP system could be illustrated as Figure 1.

Figure 1
Fiscal investment and loan (FILP) system before the large-scale reforms



Source: MOF Financial Bureau (2000).

The initial FILP system was established around 1955 and had been reportedly functioned well during the rapid growth period (i.e., from the 1950s to first half of the 1970s) in Japan. However, it was pointed out that the FILP system had a critical defect because it could not control how much the Entrance Organizations absorb funds. Thus there had been a potential tendency for the system to accept excessive funds, though this weakness had not stood out so much during the rapid growth period with vigorous fund demands.

B. Relationships between General Budget and the FILP Fund

Indeed, it is well known that there are sharp differences between the purposes of the general budget and the FILP funds[2]. But in practice, a close relationship between these funds existed.

With regard to the general budget's dependence on the FILP system, we should first of all mention the underwriting of government bonds by the TFB. Other complementary functions of the FILP for the general budget are as follows: compensatory lending to special account deficits (e.g. National Railway's debt); loans by FILP agencies (e.g. Housing Loan Corporation) as a measure to stimulate the economy during recessions; and price stabilizing operations, in other words, mass stock purchase using FILP funds in order to prevent a sharp decline in the stock market.

Concerning the flow of funds from the general budget to the FILP system, we should mention governmental subscriptions to FILP agencies and interest subsidies. General budget expenditure was necessary because the interest rates from borrowers to FILP agencies were often lower than those from FILP agencies to the TFB.

There was criticism that these complex twists of two kinds of funds had promoted increasing expansion of the public sector in Japan. Certainly, it was one factor that led to the reforms. In the next section, we would like to describe in detail the background that made the reforms inevitable.

III. BACKGROUND THAT LED TO THE REFORMS

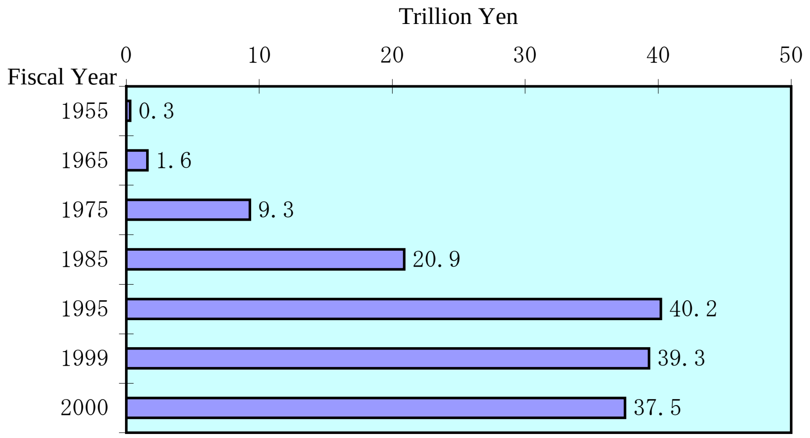
A. Criticism of the Ballooning Public Financial Sector

With the ending of high economic growth and the arrival of slow growth, a wide-ranging excess supply of funds came about in many Japanese industries. Furthermore, with the waves of financial deregulations since the second half of the 1970s, many corporations (mainly large enterprises) that had acquired their necessary capital mainly from city or regional banks came to diversify their financing means (e.g. issuing foreign bonds or equity finances). Therefore many private banks in Japan fell into operational difficulties. In particular, with the progression of interest rate deregulations, the difference between loan rates and deposit rates at banks narrowed. In order to avoid further deterioration of management, lots of city and regional banks in Japan turned to the stock and real estate markets in search of profits. Regrettably, such "new" profit opportunities for private banks were to vanish along with the collapse of the financial "bubble" at the beginning of the 1990s.

In spite of difficulties faced by private banks, suspicion and criticism began to surface that public financial institutions, postal services and FILP agencies, which were supported by the government, had over-expanded their activities even after the end of rapid growth and had started to squeeze profit opportunities from the private institutions. Certainly, Figure 2 shows the ballooning of the FILP[3].

For example, a researcher at a private financial institution insists that it is necessary to leave such mature fields as large-scale corporate finances and housing loans to the private financial institutions, because the private sector now can provide these services[4].

Figure 2
Transition of the scale of fiscal investment and loan program



Source: MOF Financial Bureau (2000).

B. A Structural Defect in the FILP System

As mentioned in endnote 1, FILP funds are managed through parliamentary deliberations based on a FILP plan issued by the government every fiscal year. However, the amount of accepted Postal Saving deposits or the number of contracts for Postal Life Insurance had not been adjusted along with the program. With regard to funding, each post office was obliged to accept as many deposits and insurance contracts as possible, and the Postal Savings Fund deposited the accumulated funds with the Trust Fund Bureau. A large part of the Postal Life Insurance Fund was also controlled in partnership with the FILP.

These postal services started before the First World War in order to accumulate funds for the government, which used some of the funds for military purposes. They restarted in the post World War II period, serving a new role as the main suppliers of capital. However, even after the transition to slow growth, postal services did not review their role from the viewpoint of the entire FILP system, or for the entire financial system in Japan. Therefore revisionists of the Japanese public financial system thought that the unlimited supply of funds from postal services had led to inefficient FILP agencies and costly public projects, which were unbalanced with outputs values (or benefits).

Another criticism concerning the structural defects of the FILP system is related to interest rate risks. The FILP agencies have not been admitted to make advance repayments to the Fund Trust Bureau. Thus, during times of low interest, if a borrower from the FILP agency wants to repay a loan made during a higher interest period, it becomes necessary for the agency to reinvest the repaid funds at a lower interest rate.

Accordingly the FILP agency tends to face a negative spread (a higher borrowing rate and a lower lending rate). This fact is the main reason why interest subsidies should be necessary[5].

C. Negative Effects on Productivity and Capital Market

Public financial organizations had previously been expected to discover new sunrise industries and supply them with the necessary funds for growth. Recently, however, doubts surfaced over this function. The measures, such as interest subsidies and preferential taxation through the FILP, do not encourage pioneer businesses or strategic industries. Instead, these measures have rather been used to help declining industries but have failed to improve their productivity.

An ordinal revisionist for the public financial system would insist that we should primarily make the most of the finding function of capital markets to nurture pioneer enterprises or venture corporations. But in Japan, abundant and government-guaranteed FILP funds were swept against capital markets, so that, in general, managers of private corporations didn't have any incentives to utilize capital markets to raise the necessary funds. As a result, the development of the long-term financing function of capital markets in Japan didn't progress significantly, and it was difficult for emerging firms to find finance and grow. Thus, it is natural for such a revisionist to conclude that we have to reduce the role of the FILP in funding long-term and risky projects[6].

D. Criticism for Insufficient Disclosures of FILP Agencies and Postal Services

Lastly, we need to refer to the insufficient disclosure of the FILP system. For example, Hashimoto (1996) stated that "although individual Entrance and Exit Organizations have disclosed their own information to some extent, a disclosure of the entire FILP system as a giant financial intermediation is not enough," and indicated "the check function of the Diet on the FILP is incomplete because it discusses only the FILP plan every fiscal year while leaving unscheduled management of the FILP fund to the officials."[7]

Furthermore, Imai (1996) mentioned that the disclosure report of the MOF (1995) had not shown financial statements of the individual FILP agencies while it had partially disclosed the financial condition of the Trust Fund Bureau[8]. Combining these two opinions, we can conclude that the disclosures of the FILP were unsatisfactory both for the entire and individual levels.

IV. FUNDAMENTAL REFORM IN 2001

A. The Overall Abolition of Deposit Requirements

The fundamental reforms in 2001 consisted of several pillars. The first pillar was to eliminate the obligation to deposit all funds of the Postal Saving and Pension Reserves with the Trust Fund Bureau. From new acceptances in fiscal year 2001, these funds have come to be invested voluntarily with various sorts of securities through financial markets. The main reason for eliminating the deposit requirements is reportedly that revisionists intended to dam a stream of abundant money from Postal Services to the FILP in order to ease the unification and reorganization of inefficient and oversized FILP agencies.

At the same time, the organizational reform of the Postal Services began. Together with the Postal Service, Postal Savings and Postal Life Insurance had been managed by the Ministry of Posts and Telecommunications before fiscal year 2001. Between 2001 FY and 2002 FY, these businesses were taken over by the Postal Services Agency, which was an outside bureau of the Ministry of Internal Affairs and Communications (MIAC). Since 2003 FY, they have been managed by the Japan Post, which was a public agency [9].

B. The FILP Agency Bonds

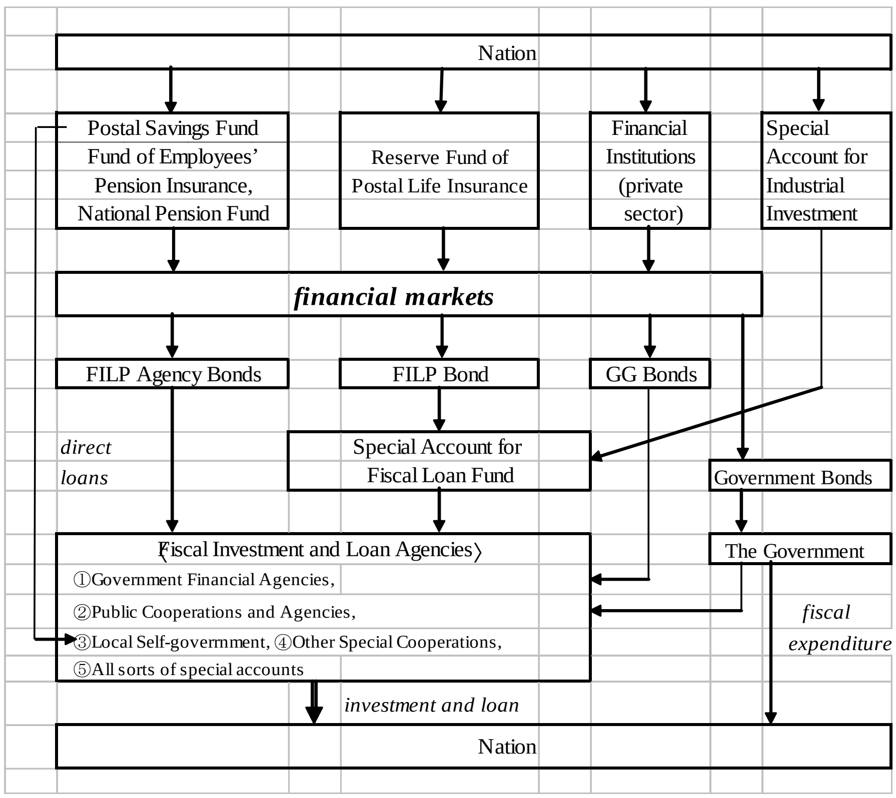
The second pillar of the fundamental reform was that FILP agencies became basically obliged to raise their necessary funds through financial markets. In principle, each agency has to issue its own FILP agency bonds. Because of no government guarantee, the interest rate of a FILP agency bond should rise if financial conditions and/or management of the issuer deteriorate. Accordingly, each agency comes to be required to rationalize and improve its financial condition and/or activities to keep its interest rate adequately low. In addition, unless its information disclosure is sufficient, the risk premium of a FILP agency bond would rise due to asymmetric information. Thus, disclosures from FILP agencies may be anticipated to advance.

Indeed, as the experience of government-sponsored enterprises (GSEs) in the United States has shown, it is easy to anticipate that FILP agencies would be unable to obtain sufficient funds by issuing only their own non-guaranteed FILP agency bonds, especially in the initial stage of the new system. Thus, in order to maintain the management of the agencies that might not be evaluated by the market but would still be necessary from a political viewpoint, other means of raising funds were required. In the case of GSEs, insufficient capital is covered by loans from the Federal Government through the Federal Financing Bank. In the case of the Japanese FILP, the Fiscal Loan Fund (FLF) should cover any insufficient funds of the agencies. The FLF raises necessary funds through the market by issuing FILP bonds, which is a kind of Japanese Government bond, and loans the funds to the agencies[10]. The new system, which includes other financing routes for FILP agencies, is illustrated as Figure 3.

C. Introduction of Policy Cost Analysis

The third pillar of the fundamental reform was the introduction of policy cost analysis. The purposes of the introduction are firstly to show the degree of future public burdens in carrying out such a project, secondly to promote rationalization when each FILP agency plans projects, and thirdly to improve project transparency. The policy cost analysis was introduced before fundamental reforms started (i.e., from fiscal year 1999). In the first year, only five agencies disclosed their results of the cost analyses, followed by 14 agencies in 2000 and 30 in 2001.

Figure 3
The public financial system in Japan after reforms in 2001



Source: MOF Financial Bureau (2000), Nishigaki (2002, 2003).
(Note) "GG bond" means Governmental Guaranteed bonds.

The FILP report (2002) interprets the meaning of "the policy cost" as a differential between the total amount (discounted present value; DPV) of subsidies and the total amount (DPV) of payment to government by FILP agencies[11]. This concept can be expressed in the following formula:

$$\begin{aligned}&\text{Policy cost (DPV)} = \text{Total amount of government subsidies, etc. (DPV)}\\&\quad - \text{Total amount of payments to state coffers, etc. by FILP agencies (DPV)}\end{aligned} \tag{1}$$

The usage of the analysis is thought in general as follows. Firstly, a decision-maker of the concerned project compares the DPV of policy costs calculated by the formula (1) with the DPV of benefits expected to be gained from the projects, and sorts out such projects that satisfy the next inequality:

$$\text{DPV of benefits} > \text{DPV of policy cost} \quad (2)$$

Projects that don't satisfy this inequality are to be abolished. Secondly, projects that not only satisfy the inequity but also produce profits are to be referred to private organizations. And thirdly, such projects that satisfy the inequity (2) and do not produce profits are reserved for the FILP agencies. Finally, the FILP agencies choose a project that has largest net benefits among potential projects (DPV of benefits - DPV of policy cost).

V. REMAINING PROBLEMS FOR FURTHER REFORM

A. Need to improve heavy dependence of FILP agencies on FILP bonds

Now, let us consider the remaining problems with the public financial reforms in Japan. If FILP agency bonds have been the central financing measure of FILP agencies, it would be inevitable for many FILP agencies to be unable to obtain sufficient funds in the markets. It is not because they are inefficient but because public organizations are intrinsically obliged to operate on, or to finance, projects that cannot be expected to produce profits or to work with businesses that are accompanied with heavy risks that ordinal private companies are not willing to take on. Furthermore, their loans tend to be long-term and their interest rates are set fixed and lower than market levels. Therefore, in the case of Japan, the majority of FILP agencies have inevitably become heavily dependant on loans from the Fiscal Loan Fund.

With regard to this point, the MOF emphasizes that "those funds … are truly required by FILP agencies as they carry out projects"; that "funds raised for the FILP carry market interest rates"; and that "the prevailing yield curve of JGBs in the market is used to calculate interest rates on loans to the FLIP agencies after adjusting the maturity of the loan."[12]

Needless to say, for a true introduction of market principles, the FLF or the MOF has to make its best efforts to reduce the volume of FILP bonds issued and to increase the share of bonds issued by the FILP agencies. In fact, individual FILP agencies in general have tried to issue more FILP agency bonds, and the ratio of issuing FILP agency bonds over the size of their businesses has increased since FY 2001 (See Table 1). We can guess that the introduction of policy cost analysis and greater transparency have contributed to these improvements to some extent. We might anticipate further headway in this respect in the future.

B. Obstacles to Credit Enhancing Instruments in Japan

Additionally, Table 1 suggests two factors for the increase in the ratio of FILP agency bonds issuance over the size of their businesses. One factor is the rise of FILP agency bond issues, and the other is the decrease in size of agency businesses themselves.

Table 1
Change in the size/ratio of issuing FILP agency bonds (Billion Yen (%))

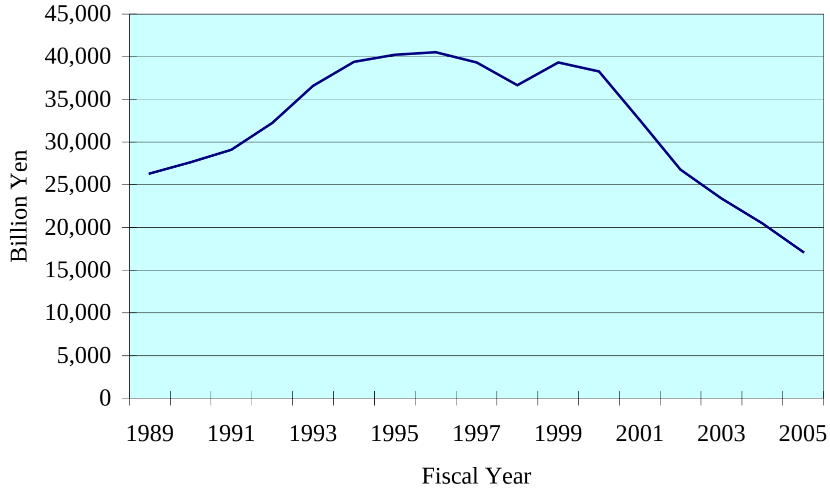
Agency (Note*)	2001FY	2002FY	2003FY	2004FY	2005FY
Government Housing Loan Corporation	200.0(1.9)	600.0(7.4)	850.0(14.3)	1,500.0(30.5)	2,760.0(68.3)
Japan Financial Co. for Municipal Enterprises	100.0(5.1)	220.0(11.6)	300.0(16.9)	400.0(24.8)	400.0(26.1)
National Life finance Corporation	…	200.0(5.4)	240.0(6.5)	240.0(6.5)	240.0(6.8)
Japan financial Co. for Small and Medium Enterprises	…	200.0(10.5)	200.0(10.5)	240.0(12.6)	240.0(13.1)
Okinawa Development Finance Corporation	…	10.0(4.6)	20.0(9.9)	20.0(10.5)	30.0(16.6)
Agriculture Forestry and Fisher Finance Co.	15.0(2.9)	22.0(4.7)	22.0(4.8)	23.0(5.1)	23.0(5.3)
Development Bank of Japan	100.0(6.3)	200.0(16.7)	240.0(20.4)	240.0(20.4)	240.0(20.5)
Japan Bank for International Cooperation	100.0(4.5)	200.0(10.5)	240.0(12.8)	240.0(13.0)	260.0(14.3)
Urban Renaissance Agency	*40.0(3.1)	*63.0(6.0)	100.0(11.1)	134.0(16.2)	240.0(35.9)
Japan Water Agency	10.0(9.2)	13.0(13.3)	13.0(12.3)	15.0(18.9)	15.0(18.9)
Japan Railway Construction, Transport and Technology Agency	*16.0(3.1)	*50.0(8.7)	65.0(13.5)	65.0(16.9)	86.0(…)
Japan Fund for Global Environment	…	6.0(23.5)	5.0(98.0)	7.0(125.0)	5.0(454.5)
Welfare and Medical Service Agency	10.0(1.7)	20.0(3.3)	40.0(6.2)	60.0(8.5)	119.0(16.9)
National Hospital Organization	…	…	…	…	3.0(8.0)
Promotion and Mutual Aid Co. for Private Schools of Japan	6.0(6.3)	6.0(7.0)	6.0(7.8)	7.0(11.7)	7.0(11.7)
Center for National University Finance and Management	…	…	…	…	5.0(7.6)
Japan Student Services Organization	10.0(4.1)	56.0(19.0)	56.0(16.4)	76.0(17.6)	110.0(22.5)
Japan Green Resources Agency	…	4.0(6.0)	4.7(7.7)	6.5(11.3)	6.5(12.2)
Japan Highway Public Corporation	150.0(8.3)	400.0(26.9)	510.0(35.4)	530.0(39.9)	300.0(29.8)
Metropolitan Expressway Public Corporation	10.0(3.6)	30.0(11.5)	50.0(20.0)	70.0(28.5)	32.0(24.7)
Hanshin Expressway Public Corporation	10.0(5.8)	20.0(13.9)	35.0(24.7)	45.0(38.9)	30.0(46.7)
Honshu-Shikoku Bridge Authority	…	…	…	10.0(113.6)	23.1(471.4)
Japan Expressway Possessed Debt Repayment Organization	…	…	…	…	234.9(…)
Organization for Small & Medium Enterprises and Regional Innovation, JAPAN	…	…	10.0(80.6)	16.0(262.3)	…
Central Cooperative Bank for Commerce and Industry	224.9(11.7)	283.2(15.3)	331.9(17.9)	380.4(20.6)	413.5(23.0)
Narita International Airport Corporation	50.0(59.2)	35.0(57.0)	41.3(41.9)	79.7(102.2)	56.3(63.8)
Kansai International Airport Corporation	…	…	…	…	1.3(1.3)
Teito Rapid Transit Authority	43.9(87.5)	69.0(96.4)	…	…	…
Total (Note**)	1,105.8(3.4)	2,707.2(10.1)	3,379.9(14.4)	4,404.6(21.5)	5,880.6(34.3)

Source; http://www.mof.go.jp/jouhou/zaitou/zaitou.htm

(Note)* In fiscal year 2003, large amounts of reconstitutions and integration among FILP agencies were executed. The names of agencies mentioned in the Table are those of the inherited beings. In the case of integration, we present the sum of amounts in all integrated agencies as before 2003 FY.

** A share concerning an individual agency indicates the ratio of issuing FILP agency bonds over the size of its business, while the total of those shares indicates the ratio of total issuing FILP agency bonds over the size of the total amount of the FILP plan in each fiscal year.

Figure 4
Change in the size of FILP



Note: The planned and actual sizes of FILP are different. Here, planned values are used in this Figure.

As shown in Figure 4, the size of the FILP has been reduced rapidly since the beginning of new century. Thus, we may incline to wonder whether truly necessary projects have been closed forcibly or irrationally because of strong pressure from revisionists who have maintained the harmfulness of a ballooning FILP. However, we cannot deny another possibility that such rapid reduction indicates that huge unnecessary funds had been invested and loaned before. At this moment, we had better avert a premature judgment on this question.

However, we want to note that the net benefits depend on the methods by which public organizations offer financial services. Thus in Japan, the following rules should be applied.

If net benefit of a project was negative, but at the same time we could anticipate adequately high DPV of benefit from the project or we could expect a social intensive request for the project, then we should attempt to converse the method of the project from direct loans to any kind of credit enhancing (e.g. credit guarantee).

The main purpose of this method conversion is to reduce policy costs through decreasing the total amount of government subsidies. In comparison with direct loans, credit-enhancing instruments need negligible funds to offer these services. In the case of the United States or Germany, this conversion has been dramatically achieved from the 1980s, although negative opinions against the effects of credit enhancing existed[13].

As far as data in Japan show, most credit enhancement activities by public agencies are only at the beginning stage. There is a possibility that these activities would prevail hereafter, but there are several obstacles to diffuse. Firstly, we have to point out the low capacity of private financial institutions in Japan regarding screening and monitoring borrowers, as shown in the lengthy delays in reducing the amount of bad debts during the 1990s. Accordingly, there exist real fears that private institutions would extend huge bad loans, and the Government should suffer large losses because the Government guarantees these loans.

Secondly, we cannot help but have suspicions over the nation's future ability to pay back its debts. The liabilities of the Japanese government are going to exceed the amount of GDP within fiscal year 2005. The nation's excessive outstanding debts would prevent the effects of credit enhancing because people doubt the government ability to perform as a last resort.

Eliminating these obstacles is necessary to further improve the public financial system in Japan.

VI. SUMMARY AND CONCLUSION

In this paper, we have described the public financial system in Japan; its initial form, its problems and reasons for reform, contents of the fundamental reform, and remaining issues. Particularly, former public financial system was inefficient because it was not disciplined by market mechanism. Therefore, the main feature of the 2001 reform was to make public agencies being subject to market pressures by requiring them to raise their necessary funds through financial markets. In addition, policy cost analysis was introduced in order to rationalize the planning of projects of each public agency.

The results of the reforms now sharply emerged as shown in Table 1 and Figure 4. However, these reforms are not enough at the individual agency level. Moreover, although we believe that changing the main measures of the public financial service from direct loans to credit enhancing instruments is necessary in order to improve the efficiencies of public financial system, the reform in this regard has not yet progressed sufficiently. Particularly, the low capacity of private banks for screening and monitoring and too much outstanding national debt are serious bottlenecks for strengthening the credit enhancing function of the public financial system in Japan. Therefore, we conclude that the reform of the public financial system will not be completed unless we advance it together with reinforcing the economy.

ENDNOTES

1. With regard to the decision process of the FILP, there is no large difference between the previous system and the present one. The Financial Bureau of the MOF goes on to draw up the FILP plan, keeping pace with the budgetary process of the general account every fiscal year. At the end of August each year, the authorities of the FILP agencies propose their request to the Financial Bureau at the same time as the budget request from ministries to the Budget Bureau. From September to December, while the general budget assessment continues, FILP requests are examined and screened, and both are adjusted with each other. In December, based on the Cabinet Council's decision, both the general budget and

FILP plan are submitted in bulk as a MOF draft to the Cabinet. After fine adjustments inside the government, the government draft is submitted to the Diet and passed after parliamentary discussions.

2. In the case of the general budget, the objects of expenditure are restricted to such matters that no returns can ever be anticipated, and the budget has to be used completely within a single fiscal year. In contrast, in the case of the FILP fund, the objects of expenditure have to be limited to profitable projects and businesses such as construction of highways, or confined to matters that are expected to be paid back such as housing loans, because the sources of the FILP fund are all obliged to repay the money. In addition, there are various maturities in fiscal investments and loans, from a single month to 35 years.
3. However, there is a different contention that public funds had made up for the decrease of loans by private banks to industries and have prevented further decline into recession. See Inoue and others (1999).
4. Imai (1996), p.14.
5. Of course, there might be another reason that has led to inefficient public agencies making losses. But Yoshino (1994) reported empirical evidence that government financial agencies had the lowest rate of expense in all kinds of financial intermediaries in Japan.
6. See Iwata (1998), pp.261-262.
7. Hashimoto (1996), p.24.
8. Imai (1996), p.14.
9. Concerning the details of arguments over the reform of postal services in Japan, please see Yamori and Nishigaki (2005).
10. Another relief method for FILP agencies with insufficient funding is to issue government guaranteed (GG) bonds. However, issuing GG bonds is restricted to agencies that face difficulties in issuing FILP agency bonds without government guarantees.
11. See http://www.mof.go.jp/zaito/zaito2002e/za02e-03.html.
12. For example, see http://www.mof.go.jp/zaito/English/Za2003-01-03.html.
13. For example, see Williamson (1994), pp.523-544.

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