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Deregulation and privatization in the Japanese financial sector and its effects on competition

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Abstract

In this thesis I am studying the institutional reforms that have been made in the Japanese financial system, from the beginning of the 80s but mostly between the years 1990-2000, and the privatization of the Japan Post, started in 2007. In the highly regulated Japanese financial system, the government divided the banks and other financial institutions into functional and regional categories such as city banks, regional banks, long-term credit banks, and securities companies etc, and restricted entry of companies of another category. Government banks also competed with private banks. Deposit rates were fixed according to government regulations. The government was giving banks protection and did not allow any bank to go bankrupt. The background of how the financial system regulations have changed is how the economy has developed in Japan during the years. Especially the financial crises of the 90s accelerated the reforms. The Postal Saving Bank (PSS) within the Japan Post is a government owned bank that offer deposit services to the Japanese public. The deposit balance of the Postal Savings was in 2004 equal to the deposits at Japan's four largest private banks together. The PSS used its funds to put into a government program called Fiscal Investment and Loan Program, FILP, where it is used to finance different government investment. Because of the PSS being of such large size compared to the privatized banks, the privatization has raised fears that it would dominate the market after becoming private and therefore hurt competition and private banks. My purpose with the study was to describe the Japanese financial system and how deregulation of the financial sector and privatization of the PSS affected competition on the bank market. My main question was how institutional reform in the form of deregulation and privatization has given/will give a more competitive bank market? This was divided into three questions to easier be able to find an answer on the main question. Q1: Has the deregulations of the financial sector given a more competitive bank market? Q2: Will the privatization of the PSS give a more competitive bank market? Q3: Is the FILP system compatible with free competition on the bank market? The findings show that competition increased on the bank market since the government removed all functional and regional barriers on the market, removing artificial barriers of entry for financial companies. The fact that lending margins has decreased after the deregulations is one sign of increased competition. For the privatization of the PSS the pattern is mostly the same. The privatization will mean the abolition of subsidies from the government to the PSS. The large size of the PSS is mainly because of very generous terms on its products which are likely only possible because of government subsidies. After a privatization the deposits at the PSS could be expected to fall making the competition more equal. Also the banks situation is improving. For the FILP, reforms have made it less problematic for competition but the problem of government banks competing with private banks still remain.

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1. Introduction

1.1 Background

After the WWII-defeat and the American occupation that followed, the Japanese bank sector has been strictly regulated. The Americans designed the Japanese financial system with the American, at that time, tightly regulated financial system as a model. In the context of war and economic crises this model was thought to create stability for reindustrialization and increased living standards for the Japanese people. In the early financial regime and main corporate structure of large conglomerates, companies got their main funding from banks, private or government owned. Private consumers were seen as a source of funding for the banks, not consumers of credit. But economic reality changed the conditions for having a regulated financial system. (Yoshino and Cargill, 2003) When companies easier could get access to funds on international capital markets, then the environment changed in favor of a deregulated financial sector and then first US, but also later Japan made a series of deregulations. The model was to create the same kind of environment as the “big bang reform” of British financial markets that revived London’s status as a financial centre. (Flath, 2005) One part of the system however stayed virtually unchanged throughout the years. The Japan Post consist of many different sections and two of them, the Postal Savings (or the PSS as it will be referred to from now), and the Postal Life Insurance Company, are providers of financial services to the general public. The PSS was created in 1875 to raise money to various government investment programs and projects, as well as to provide deposit services throughout the country. The money raised by PSS was transferred to the Trust Fund at the Ministry of Finance. The funds were then put into a program called Fiscal Investments and Loan Program, or FILP and were used to finance different government investments. This program has been criticized however to invest money in unprofitable projects, being non-transparent and give the bureaucracy too much power without democratic control. After the 90s when the Japanese economy went through crisis after crisis, the pressure for reform became greater. Also the PSS was criticized for competing unfairly with private banks and even to disturb monetary policy (Yoshino and Cargill, 2003). As the significance of the PSS grew as the balance of deposits increased, the criticism became even louder. In 2005 the PSS had deposits equal to the deposits of the four major private banks (JCER, 2005). The Koizumi administration was the first government to make a serious attempt to do something about this and announced that it would privatize the Japan Post in 2003. This created debate and the bill was rejected

once in the parliament leading to Koizumi announcing an extra election putting all his political credibility at stake in order to succeed with this reform.

In this thesis I will study the deregulations of the financial sector and the privatization of the PSS. In order to understand the context of these reforms one must start with the environment changes. For both the deregulations of the bank sector and the privatization of the Japan Post it is the development of the Japanese economy that has had the largest influence on the agenda. Especially the economic troubles during the 90s were important to explain why the reforms took place so therefore it is natural to start from there.

The Japanese economy was one of the most successful economies in the world in the years between 1950 and 1990. After a double bubble-burst of both stock and property prices in 1989 the economy never really returned to its former strength. The 90's has even been referred to as the "lost decade" because of low economic growth, persistent bank troubles due to a bad loan problem and failing financial institutions despite a record level of easy monetary policy (Yoshikawa, 2001). The problems in the 90s can be divided into three main stages.

The recession from 1992 through 1994 with an average annual growth of 0.6%

A recovery in 1995 through 1996 with average annual growth of 5.1%

A slump from the second quarter of 1997 through the end of 1999 with negative growth (Yoshikawa, 2001, p. 10)

What caused the long period of low growth is debated. Yoshikawa (2001) blames a long-term shortage of demand. However supply-side arguments gained more acceptance as the recession continued, urging Japanese companies to scrap their excess capacity. Sato (1999) blames the aging of the Japanese society, and low fertility rates as a part of the problems. Also the shift from an industry-based economy to a service-based one started later in Japan compared to US and Western Europe.

However, the main reason to the lower growth during the 90's was reduced private investment. From 1988 to 1993 the growth rate declined with 5.9% and the fall in investment was responsible for 70% of that reduction (Yoshikawa, 2001, p 14). In the recovery of 1995-1996 investment accounted for 3.7 percentage points of the increase in growth of 4.8 percentage points (Yoshikawa, 2001, p 15). Also the investment fell sharply as the economy slumped in 1997. Yoshikawa further argues that the slump of investment of the early 90's was not due to the credit crunch but simply a result of a needed adjustment of

capital stock that had been forgotten during the bubble era of over-investments. For non-manufacturing industries as finance and real estate the reduction in investment was, apart from a stock reduction, a result of the credit crunch. These sectors had been previously stabilizers of the private investment, in relation to manufacturing, but after the bubble burst investment in these sectors collapsed. (Yoshikawa, 2001, pp. 21-25) Private consumption was also to blame for some of the decline in growth although it has been quite stable and contributed positively to the growth every year except for 1998. When the recession of the early 90's changed into a recovery the government got somewhat overconfident about the strength of the economy. This led to a major policy error in 1997 when the government raised the sales tax from 3% to 5% in order to reduce the budget deficit but created a slump in demand causing a new recession in 1997 (or at least contributing to the recession). The general consensus in Japan before the 1997 recession was that the recession of the early 90's was only a cyclical adjustment and that the economy would return to previous growth figures (Sato, 1999, p.86). These arguments however, became unsatisfactory when trying to explain the second recession. However, this belief might have influenced the Government to make an incorrect analysis of the market indicators as they thought the growth from 1995 could sustain the rise in consumption tax. The second recession of the 90's that followed caused the bankruptcy of the Hokkaido Takushoku Bank, and Yamaichi Securities, two large financial corporations and greatly hurt the public confidence in the bank sector and the rest of the financial sector. Also two other banks had to be nationalized in order to avoid bankruptcy (Yoshino & Cargill, 2003).

1.2 Problem discussion

What makes a study of Japan's deregulations of the bank sector necessary? In order to answer the question, it must be looked at from different perspectives. First one must find an interesting aspect of deregulation worth studying, and then find a suitable question for the study. Thirdly, the reasons for studying Japan must be clear and justifiable. What can we learn from the Japanese experience?

In the problem discussion and problem selection it is explained why Japanese deregulations in the bank sector are interesting and important. In order to find an interesting question for the study I will also go through the different components of deregulation and select the most interesting and suitable approach.

1.2.1 Why Japan?

When a major event happens somewhere many questions will arise that are suitable for a study like this. The privatization of the Japan Post is an event like this. In addition to the good timing there are some major points why a study of Japan in general and these reforms in particular are interesting. One reason is the fact that Japan is the world's second largest economy and that they stood as a model for many other East and South East Asian nations' development ambitions. In order to avoid policy mistakes the South East Asian nations should study Japan closely. In the west most countries have done these institutional changes already and it has given us crucial information on how these changes affect the world and their respective societies. If the Japanese society and financial system was exactly the same as in other nations there would be little reason to study Japan as the findings from other countries could be applied to Japan straight away. However, there are some major differences between the Japanese deregulations and the ones in Europe and United States. Just as in United States the Japanese bank sector was divided into regions with no access to other regions for individual banks. But in United States they did not allow free branching and the deregulations were made step by step and occurred at different times in different states. Another major difference between Japan and the West is the large size of the PSS. When the privatization of the PSS will become a reality, a very large competitor will join the market. With such large size there is most likely an apparent risk that they will get substantial power over the market with a possibly negative effect on competition. When the bank sector became free in United States banks were usually single branch banks and thus with no such impact on the market of the individual firm (Kroznier and Strahan, 1999). These major differences make it worth studying the Japanese deregulation and privatization.

1.2.2 The PSS and the FILP system

One important aspect when making this kind of study is to relate the changes of the banks to changes in the environment. To understand how the Japanese deregulations/ privatization affected the bank sector the bank sector must be put in a bigger context of the financial system. What is the role of Japanese banks and how are they connected to the rest of the financial system? One important difference between the western financial system and the Japanese system is the presence of the so called FILP system. Since the PSS is the main source of funds for the FILP system it is important to relate the PSS to the changes of this system. The FILP system however, stayed virtually unchanged for a long time when it was reformed in 2000. The authorities receiving funding from this system employs a lot of

bureaucrats probably with influence on the political agenda. Compared to many other countries, bureaucrats in Japan are known to have a great deal of power over politics. The FILP system is also argued by Yoshino and Cargill (2003) to be the least understood element of Japanese finance. Therefore it is interesting to see how this system works and how it affects the bank market.

1.2.3 Selecting an approach on the phenomena of deregulation and privatization

When studying existing research about deregulation and privatization I have observed three major ways to look at the phenomenon. One might start to look at what forces are making deregulation/privatization occur. Since the goal of deregulation/privatization is to increase competition one can also focus on different issues affecting how much competition deregulation/privatization can achieve. Thirdly, there are of course many aspects of on how the economy is affected by a deregulation or privatization.

So what forces can affect deregulation to occur at a certain time? Since deregulation is a politically initiated process either the result of outside pressure or the personal opinion of politicians, a deregulation will be preceded by a political decision as the opposite, regulation, is a result of political forces. The ideological impact on policy design is discussed among others by Appel (2000) and Horwitz (1986). The main pattern is that deregulation is favored by a conservative or (neo-) liberal tradition and regulation is favored by a socialist or social democratic tradition. But in the past war and economic crises were usually the reasons to regulate markets (Horwitz, 1986). In cases when deregulation/privatization is not on the initiative of politicians for ideological reasons, other reasons like inter-industry rivalry or strength of consumers or company financial stability in the sector might put pressure on politicians to make a change. This approach, testing for what factors drives deregulation, is among other discussed by Kroszner and Strahan (1999). They find support for a theory that the presence of strong interest groups like bank-dependent small companies will put pressure on politicians in favor of a deregulation.

Questions that might come from the political perspective might be whether it is ideology or pragmatism that drives the politicians in charge. How large impact has other forces? Who oppose the reform and what influence do they have on the political process? Is it a risk (or chance depending on political views) that the reforms will be reversed?

A deregulation or privatization or both will affect competition on the bank market. When new companies are allowed to enter the market the established companies will be put under pressure. Therefore there will be resistance from these. They might try to use monopolistic methods to prevent the newcomers from getting established on the market. Alternatively the established companies previously shielded from competition had lost their competitiveness and might be very weak competitors for the entering companies. If the bank market was divided into regions, as it was in Japan, and regulations stopped new banks from entering, then there is a great risk that this is the case. When regional markets eventually are opened up for competition, multinationals and large national banks might take over using their size and financial strength. But the opposite might also be true as local banks have knowledge about the local markets that give them favors in the competition.

One very interesting aspects of competition is the fear of a market turning into an oligopoly or monopoly with one or few dominating companies when the government no longer has control. Then banks can merge freely which will add up to the fear of an oligopoly. If this happens the dominating companies will get power over the market and can get margins that highly exceed the marginal cost of their operations. This means they can overprice their products without loosing market shares (Angelini and Cetorelli (2003).

There are also reasons to look whether deregulations and increased competition have created more choices for consumers in terms of products and services.

The bank sector affects the overall economy like all other sectors through profits, products offered and to what price and also employment opportunities. In addition to this the bank sector has a unique impact on the economy as it is the creditor to other sectors and therefore should channel funding to a number new and existing growing companies. What happens if the bank sector is strictly regulated and the government uses it to channel funds to unproductive sectors is discussed by Yoshino and Cargill (2002). They also discuss the case when government channels funds to productive sectors that could not get funding from private banks. Depending on whether it succeed with the task to provide funding where it gives the best result the economy can perform well or badly. This is very much a question in Japan given the very problematic economic situation of the 90s with all the different government programs trying to revive the economy and the problems of the bank sector (Yoshino and Cargill, 2003), (Ito, Patrick, and Weinstein, 2005), (JCER, 2004). Another perspective is to estimate how deregulation/privatization affects companies' efficiency (Tirtiroglu et al. 2005). Other issues related to privatization can be how the transfer of assets affects wealth distribution in a society (Vickers and Yarrow, 1991).

1.3 Problem formulation

Given the different aspects of deregulation and privatization discussed in the problem discussion and the special conditions in Japan I have made the choice to look at how competition is affected by the deregulation and the privatization of the PSS. Since there might be some differences between how the reforms were carried out in the West and in Japan it would be interesting to see how the Japanese bank market will be affected. Also the very problematic situation for the banks might affect how the competition will work in the future. The private banks have been severely affected by the bank crisis of 1997 and it is not known if they can tackle the great threat a privatized Postal Savings might pose in the future. Also the Japanese financial system seems complex and might affect competition in many ways and maybe in ways in contrary to what the government wishes to achieve with a privatization. Previous studies have looked at an isolated part of the financial system; how the FILP system should be reformed, or how the banks will tackle their problems etc., but there is little study, as far as I have seen, that puts all this into a the context of the large financial system and government programs like the FILP system. Therefore I thought it would be appropriate to make this kind of study.

On the basis of this the following main problem has been formulated. Has institutional change in terms of deregulation and privatization given/will give a more competitive market for bank services in Japan?

This main problem will be divided on three questions to better investigate and find an answer to the problem.

Q1: Has deregulation of the bank sector led to a more competitive bank market?

Q2: Will the privatization of the Postal Savings Bank lead to a more competitive market for bank services?

Q3: Is the construction of the FILP system compatible with free competition in the bank sector?

1.4 Purpose

The purpose of this study is to describe the complex Japanese financial system including the FILP system and point out important changes of the regulatory environment and find out how these changes affected competition in the market for bank services.

1.5 Limitations

The topic selected is covering many aspects but to avoid the study getting to large there are some limitations chosen.

Firstly, this study is of a descriptive nature and therefore I will not try to quantify any effect of competition on company profit margins, productivity or any effects on the general economy. The purpose means I am more interested in the environment that the Japanese financial system makes up and how this has affected the conditions for free competition in the bank sector.

The second limitation is that I am not analyzing the life insurance market. Even if the deregulations also cover the insurance industry and that the privatization also means that the Postal Life Insurance will be privatized, I have made the choice not to analyze this in order to limit the size of the study. However, it is possible that the same logics apply to this market and that the findings of this study thus are applicable on the insurance sector as well.

The problem selected involves some definition problems. To exactly define what is free competition would be quite hard. To be able to get around this problem I am looking at the change of environment and trying to see whether the conditions for free competition got better or worse. In order to do this the problem will be looked at from two perspectives. First there is the aspect of government treatment of companies on the market. If there are some preferential treatment of a single or a few companies this is not compatible with free competition. The government should have a non-discriminatory approach on their regulations. Secondly there is the problem related to the power of the different companies. If a single or a few companies can dominate the market and use their size to keep competitors out in order to capture excess profits this is thought to hurt competition. What the signs on such domination are will be described in the theory chapter.

2. Theoretical framework

This theory chapter will describe some aspects of deregulation and privatization by giving examples from previous research. It has the objection of comparing these examples with the empirical findings and thus achieve better understanding and be able to draw conclusions regarding our problem. These studies given as examples include experiences from America and other countries. Firstly it is appropriate to point out that this is a study that will encompass two similar concepts both deregulation and privatization. The difference is that deregulation is looking at the juridical framework based on a political ideology compared to privatization which is concerning the control of production assets. Even so, both privatization and deregulation are most often embraced by the same kind of political views. Therefore it is appropriate to start with the political perspective.

2.1 The political perspective on deregulation

Starting with ideological views on deregulation Robert B. Horwitz (1986) are describing two major views of deregulation. Firstly there is the conservative (or classical liberal) view that deregulation is a “coming to senses” of a great bureaucratic state that gradually dismantles its own control in favor of more efficient governing of the private sector coming from the market itself. The other view coming from liberal (or socialist/social democratic) politicians is that deregulation is a “betrayal of the public interest” leading to declining democratic influence over services of great social importance (Horwitz, 1986).

To be able to understand deregulation it is important, he argues, to first study the phenomenon of regulation. He describes regulation as the hallmark of the modern interventionist state. In the views of the left it is the result of democratic reform and triumph of the interest of the people against different corporate special interests and also a way of correcting perceived market failures. To explain various failures of the government intervention the left blames mostly institutional shortcomings such as bad administration and hiring the wrong people or the possibility that the regulatory agencies despite their public interest objectives have been taken over by the private interest that they were thought to regulate. This is called the capture theory (Horvitz, 1986). According to the conservative view regulation is a way for companies within the system to get privileges by creating artificial cartels and raise the barriers of entry for presumptive competitors. In many ways conservatives identify the same problems with interests of regulation authorities but instead of seeing it as a result of individuals they blame the whole system of

regulation as they think that despite good intentions from authorities these will inevitably end up in a situation when they destroy the efficiency of the market. Thus conservatives view the problem as structural and therefore deregulation is the only solution to the problem.

The reasons for regulations can also be viewed through the theories of private-interest and public-interest respectively (Kroszner and Strahan, 1999). The private-interest theory of regulation means that well-organized interest groups will put pressure on legislators to regulate markets and therefore give them the possibilities of capturing rents through less competition at the expense of others who are not as well organized. An example can be laborers compared to consumers, or large corporations compared to small companies. The public-interest theory sees regulation as a way of correcting market failures and maximizing social welfare. This perspective however has some problems with explaining some regulations in certain sectors where reduced competition has unquestionably affected welfare in a bad direction (Kroszner and Strahan, 1999).

2.2 Types of regulations and the reasons to regulate

There are differences in the type of regulation depending of the nature and scope of the regulation. The order of introduced types of regulations can be described and understood in the context of the development of the modern western state. Historically, regulation of the economy came in waves depending on the problem the economy was facing at the time. So did the regulations that evolved during the late 19th century in America. Until then the regulations were usually restricted to those activities that directly involved the federal government such as land grant programs, shipping subsidies, tariffs etc. The regulations controlling economic activity were restricted to the judge-made private law and tort (Horwitz, 1986). These laws served as limiting risk by limiting the responsibility of injury and granting the right to freely set up contracts. This favored risk taking and capitalist economic development by creating a structured economic environment.

But as time changed the rise of new problems undermined the existence of an economy with just the existing laws, according to Horwitz. The rise of the large national corporation as well as rising social conflict put pressure on the government to introduce new regulations. As the previous regulations can be seen as a framework, the new regulations can be described as more detailed aiming at influencing the behavior of individuals and corporations. These laws Horwitz calls administrative laws. For the US this was the first time a national administrative structure was established. Before this the US had been built

on the regulations from courts and local control rather than federal regulation. This might be a sign that regulation is an element of a more centralistic political tradition. These administrative laws kept growing in the 20th century but the nature of the regulations changed with the climate of the political debate. During the Progressive Era regulatory bodies were introduced and were designed to ease the pressure from the way that the large firms changed the society. One of these was dealing with competition issues like the antitrust division under the Department of Justice. During the New Deal era the objectives were to create stable conditions for companies and therefore the government created strong price and entry controls with the result that these selected industries were cartelized. For this purpose New Deal Agencies like the Civil Aeronautics Board regulation of the airline industry. These kinds of laws can be named “producer protection”. During the 60’s and the 70’s the perspective changed. Now the regulations were designed to protect consumers’ interests functioning as social regulations. For this purpose agencies like the Environment Protection Agency and Occupational Safety and Health Administration were established (Horwitz, 1986).

In short regulation, as Horwitz describes it, can be seen as a stable system of mutual compromises. The background to the desire for stability was the depression and the New deal sought to give stability to troubled basic services like airlines, railroads, trucking, banking, and radio broadcasting that, according to Horwitz, at that time suffered from too much competition. Regulations decided the number of companies and the price level on the market which it created stable market shares and profits and therefore protecting established firms. These regulations also favored heavy unionization within the protected industries creating stability for workers. For consumers these basic services became available for everybody regardless location. Therefore regulation can be seen as a compromise, in order to achieve stability. The service available for everybody meant a cross-subsidization meaning that people in high cost areas did not need to pay more than those people in low-cost areas even if those areas had better market conditions and therefore lower production costs. This might come with the price of less efficiency. When deregulation started, the most important change was the easing of entry controls. The objectives behind the deregulation were to enhance competition and efficiency as well as to encourage technological innovation (Horwitz, 1986).

2.3 Deregulation of the bank market in the US

Since the deregulations were carried out in the US before many other countries and also since there are many studies covering the American experience it might be appropriate to

use US as an example. The fact that Japan's financial regulations were created by the US with US as a model is another reason. Kroszner and Strahan (1999) explain how the American regulations and the following deregulations of the bank sector were done. In the regulated American bank market, or markets since every state was an independent market, the states received license fees from banks. Since the states did not receive any fees from banks originating from other states, they simply banned all out-of-state banks. This created banks that became beneficiaries of economic rent due to the reduced competition. The states also prohibited banks from having branches by introducing "unit banking" laws. In addition to state regulations, the Douglas amendment to the Bank Holding Company Act from 1956 banned all acquisitions of banks in other states if there were not an explicit permission from the states. Before 1979 no states allowed interstate branching and most of the state restricted intrastate branching (Kroszner and Strahan, 1999). Therefore most banks were single-office branch banks in the US prior to deregulation.

Deregulation of the banking sector started with intrastate deregulations in the 70s. In the beginning the states preferred to keep the scope of their deregulations quite narrow. For a state with a unit-bank law the deregulation were often done in three steps, described by Kroszner and Strahan (1999). First most states allowed so called **multi-bank holding companies**, or **MBHC**. This arrangement allowed banks to own more than one bank but had to operate them as independent companies. This had the implications that the banks could not form a network of branches with back-office integration and a depositor could not access her deposit at another branch. Thus, all offices had to be run independently and could not get any economies of scale and every office had to meet the regulations of capital requirements. The next step was to allow these multi-bank holding companies to integrate into a network of branches of the same bank by allowing branching through mergers and acquisitions. A third step is to allow unrestricted intrastate branching. Maine was the first state to open up for acquisitions from other states' banks in 1975 (Kroszner and Strahan, 1999, p. 1440). Many states entered **regional or national reciprocal arrangements, RR or NR**, (mutual agreement between states), granting banks from states within the arrangement the right to branch and acquire banks under the MBHC structure. Since the deregulation progressed differently in the states there came to be a various combinations of regulations each representing a certain degree of market openness described by Tirtiroglu et al (2005, pp. 344). A **national non-reciprocity, NN state** allows all U.S commercial banks to enter the state's bank market. For a **national reciprocity state**, only banks that originate from states within the reciprocity program could enter the market. **Regional non-reciprocity states, RN**, require only the bank to be originating from a certain region whereas **regional reciprocity states, RR**, have both location and reciprocity requirements.

The interstate branching restrictions that remained were eventually phased out by the Riegle-Neal Interstate Banking and Efficiency act of 1994, granting all banks free branching throughout the US.

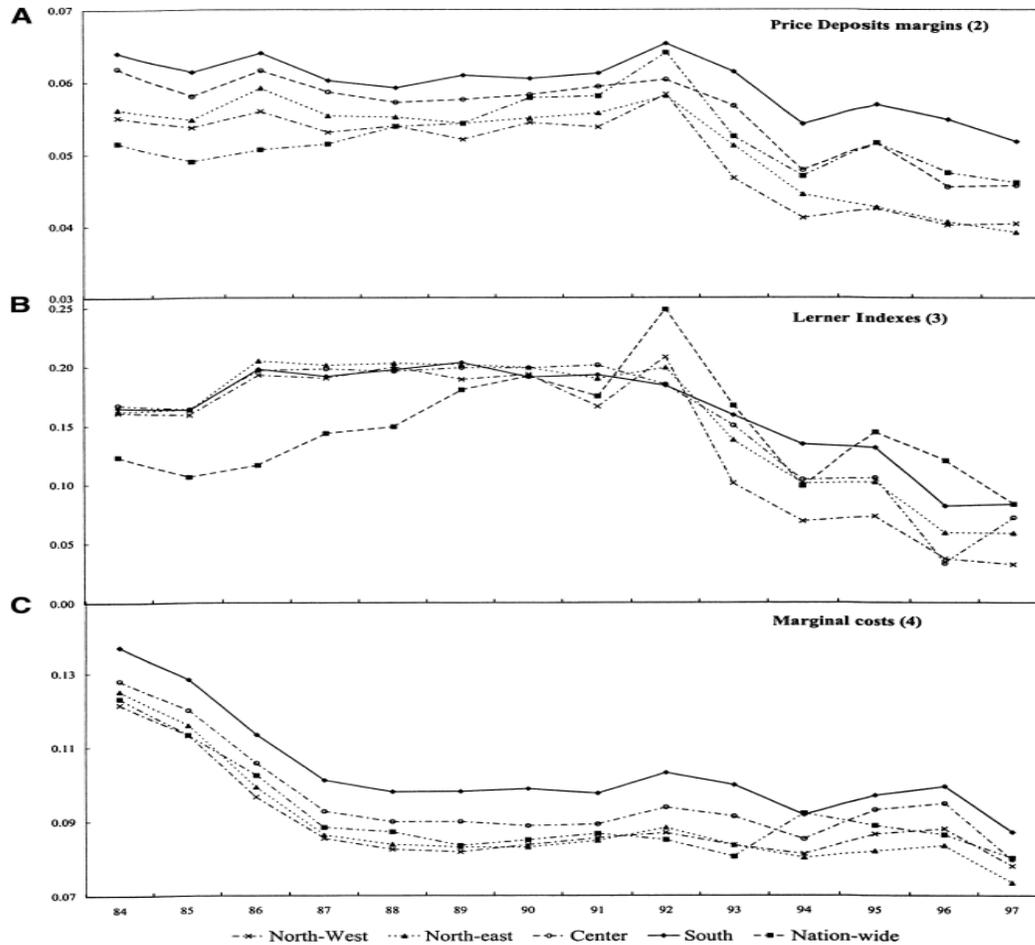
2.4 Fear of increased market power and concentration in deregulated markets

The greatest fear for deregulation of a certain market is that the new freedom of companies to merge and take over a competitor might lead to a concentration in companies on the market, reduced competition and giving greater power over the market to the existing companies. If this is the case, the banks' prices and profit margins should increase, hurting the interests of consumers. Angellini and Cetorelli (2003) addressed this problem and performed a study on the Italian bank markets after the deregulations covering the years 1984-1997. The European Union, as in its efforts to create a single market, has given Europe's banks the right to freely branch all over Europe reducing the barriers of entry. Angellini and Cetorelli (2003) argue that Italy is a good representative for the general picture since its banking market is one of Europe's largest; also the country is unusually rich in data of bank's balance sheets. Moreover, Italy has followed the general trend in Europe after deregulation has been implemented. The trends include reduction in staff costs, increased number of branches and an increase in the percentage of assets held by foreigners, seen as a sign of greater openness.

The study focuses on three questions. Firstly they study the Lerner indexes over the period. Lerner index is a measure of the companies' ability to charge prices greater than the marginal cost on the market and thus a measure of the firms' market power. Secondly, they examine whether mergers or acquisitions have given banks greater long-run market power compared to the rest of the banking system. Thirdly, they looked at **cooperative credit banks (CCB)** because they might get extra market power given their "niche position" in the banking sector.

According to the findings of the study for commercial banks marginal costs have been falling substantially even if margins were almost constant until the beginning of the 90's. After that the margins declined making the Lerner Indexes fall. These changes can be seen in graph 2.1 below.

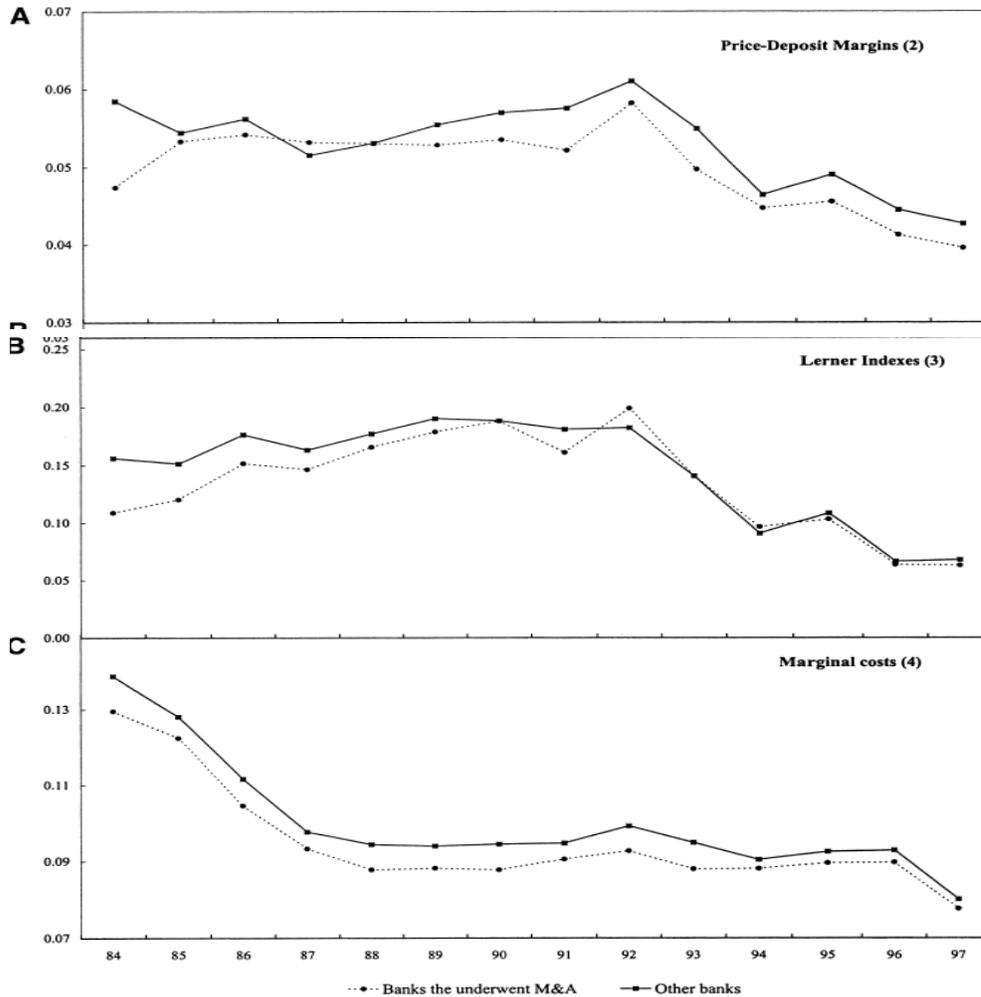
Graph 2.1 Marginal costs, Price deposits margins and Lerner indexes Italian banks 1984-1997



Source: Angellini and Cetorelli, 2003, p. 664-665

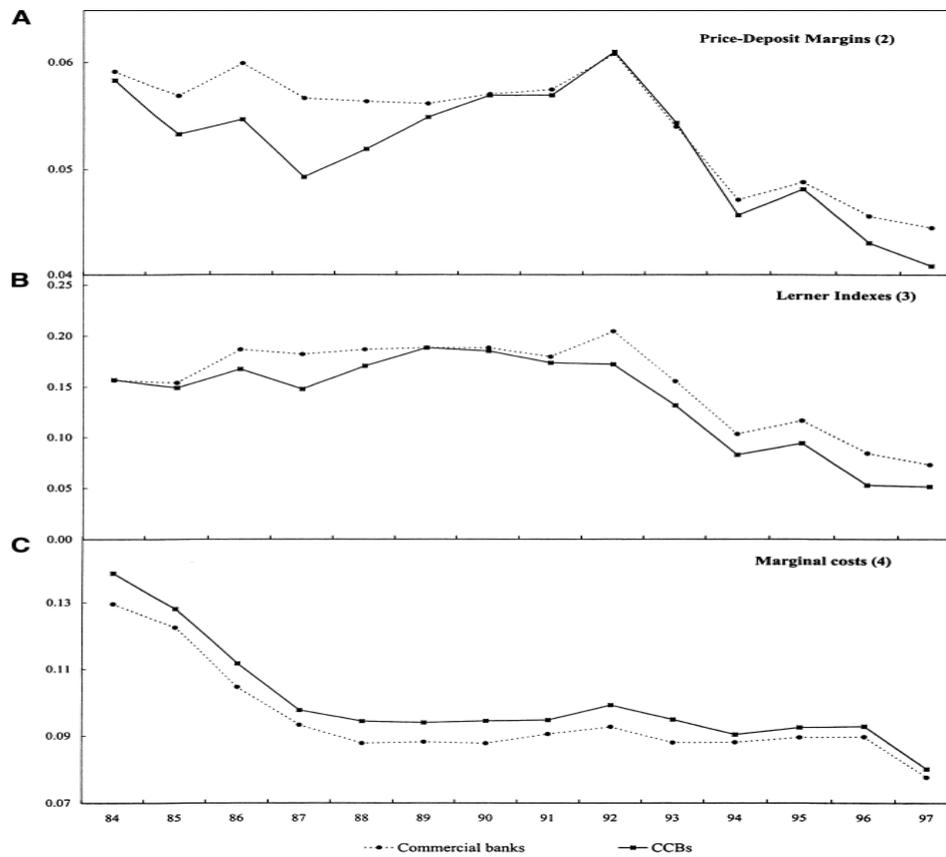
When checking whether banks that underwent a **merger or acquisition, M&A** (graph 2.2) gained power over the market compared to those banks that did not, the result showed that this was not the case. Generally those merger and acquisitions banks had lesser market power than the others. This implies that the reason for M&A is to keep up with the competition on the market and to preempt the actions from foreign banks that might enter on the domestic market. The other interesting perspective is that M&As did not make the Lerner indexes go up when the concentration increased.

Table 2.2 Marginal costs, Price deposits margins and Lerner indexes, banks that underwent M&As and other banks respectively 1984-1997



For cooperative credit banks the Lerner indexes were systematically lower than the commercial banks contrary to their expected favors of their own niche. The reason for the lower Lerner indexes is their higher marginal costs.

Table 2.3 Marginal costs, Price deposits margins and Lerner indexes, Commercial banks and Credit Cooperative Banks, CCBs, respectively 1984-1997



According to the findings of this study there were certain factors affecting the Lerner indexes (Angellini and Cetorelli, 2003, p. 677-679). The effects of GDP-growth can be expected to be positive as the margins are not under pressure in times of a good economy. This was also the result of the study but the figures were not significant. For inflation the relation is negative. Higher inflation will lead to smaller margins and the coefficient in the study was significant. Monetary policy can also affect the profit margins. In times of monetary tightening, with increased interest rates as a result, because of the fact that the interest tend to rise less on bank liabilities than on the banks assets, there will be a positive effect on the margins of banks. These effects could also be seen in the results of the study with figures that were significant but the magnitude of these effects seemed to be small. When examining the effects of market structure three different regressors were used; branches per capita, number of banks in a market, and the Herfindahl concentration index. For these the expected coefficients are negative, negative, and positive respectively. As the result showed, the impact of branches per capita was negative as expected. In contrast, for the other two the pattern was the opposite (Angellini and Cetorelli, 2003). Their

explanation for this is that in the context of possibly increased competition and establishment of foreign banks in a certain market the banks on the market choose a strategy to consolidate and restructure their operations leading to greater efficiency. A part of the gains from this they pass over to consumers and thus creating greater competition on the market and decreasing the risk of new entrants. According to this mergers and market concentration will not harm consumers, which is also consistent with their findings of the impact of mergers and acquisitions on the Lerner indexes.

2.7 Privatization

When the phenomenon of deregulation is related to the juridical framework, privatization is related to the control over productive assets in the economy. The political perspective on this is somewhat analog to the perspectives on deregulation since both phenomena are having the aim of increasing competition and efficiency in an economy.

2.7.1 Boundary between private and public sectors

Often the debate about privatization is how to find an appropriate boundary between public and private sectors (Vickers and Yarrow, 1991). To be able to find this optimal boundary there are some important considerations. If a privatization is not likely to lead to anything positive the privatization might not be necessary.

Are privatized companies more efficient?

From the Vickers and Yarrow study, two major forces affecting the efficiency of a firm can be observed. The first comes from ownership itself; the other force is the force coming from the competitive market. If privatization leads to a greater competition, this force will be stronger. It is possible however, that competition can be just as strong, or even stronger in a market where there is a major government owned company. But if private ownership leads to better management of the company a privatization can be appropriate. The question is therefore whether ownership matters for the “efficiency of enterprise performance” (Vickers and Yarrow, 1991, p. 111-112).

Monitoring managers

One major task for an owner is to supervise and control managers. This is the well-known agent problem. Change of owners will affect the methods for doing this. Therefore there is

a connection between privatization and the management of an enterprise. Ownership can be seen to interact with competition. On some markets competition alone is enough; in other the owner must use its power to control managers. In a competitive market the market will serve as a control function, which will make sure that the managers do what they should. In businesses with monopoly or in companies with substantial market power there is less or no pressure from the market. In these cases Vickers and Yarrow argue that it is to a greater degree appropriate with public ownership or with public control measures. But public control can also create problems due to the indirect relationship between the managers, politicians and bureaucrats and the people. Vickers and Yarrow argues that the performance of state owned companies are not the most important thing that people considers when they cast their votes apart from some close-downs of factories etc. Therefore there may not be any effective control on managers not to give themselves a lot of favors. In private firms there is a clear contract between the shareholders and the managers that might prevent some of the bad behavior (Vickers and Yarrow, 1991). This is not necessarily the case as seen in the Skandia incident in Sweden.

The threat of takeover is another factor that is discussed whether it is effective or not Vickers and Yarrow argues, in the context of multi-bank holding companies in the US, that removing the threat of takeover will lead to worse performance of the bank. Another aspect is the threat of bankruptcy, where the monitoring effectiveness is clearer compared to the threat of takeover. For government owned companies staff and managers can usually be confident that the government will not let the company go bankrupt therefore making it possible for them to grant themselves generous compensation as there always is tax money ready to help if there is a problem. Labor union can take advantage of this when bargaining for a higher pay.

Competition

Competition has the role of disciplining managers and staff but can also be used as a way of comparing firms by cost structure, prices, share price and other performance comparisons etc. that could lead to better management. When there is no competition due to legal barriers that restrict entry, subsidies or trade protection etc, competition can be achieved, as previously discussed, through deregulation. Another way can be to contract out services that used to be restricted to government agencies or firms. An implication of this described by Vickers and Yarrow (p. 116), is that if the government need to engage in a lot of monitoring, enforcing or bargaining measures after the services had been contracted out one

might end up in a situation when the government just as well could have produced the services itself.

So is competition in itself enough to make companies efficient? There are many views whether it is competition only that creates more efficient firms making the question about who owns the assets of less interest or if ownership do matter. The result from a study of the Canadian rail industry showed that ownership was less important but other studies showed that private firms were more efficient (Horwitz, 1986).

2.7.2 Different methods of privatization

Depending on the function of the market of a firm that will be privatized the methods of privatization can differ. When analyzing privatization Vickers and Yarrow identify three categories: 1) The transfer of public sector enterprises to the private market on competitive product markets free from any larger market failures. In this category the privatized firms have no or little market power. 2) The privatization of monopolies. In this category the company has total or very much market power. It is important to make a difference between so called “natural monopolies” such as roads, electricity and gas infrastructure where the possibilities of competition are limited and artificial monopolies that exist just because of national or regional regulations. 3) Contracting out of public finances services previously run by public companies or institutions. Contracting out is not a transmission of physical assets but is the sale of a service contract to a private operator. Depending on the special issues for each of these categories a privatization could be done in different ways in order to get the best results.

How to transfer the assets of a firm to the private sector is as well as whom to sell to an important issue when a privatization is about to be done. Vickers and Yarrow names the following categories of possible buyers: individual shareholders, managers, other employees, banks, mutual funds, corporations, domestic residents, foreigners.

There are different methods of how to transfer the assets to privatization such as selling assets either in one piece or to split it up in parts and sell either straight to a buyer or over the stock market. It is also possible to distribute the assets to the citizens for free via voucher systems. In the Czech Republic mass privatization program all citizens were granted equal shares for free without any special privileges for any groups (Appel, 2000). In 1979, the state government of British Columbia, Canada gave every citizen five shares of the privatized Resources Investment Corporation (Horvitz, 1991, p. 121). There are also

examples, perhaps not so good ones, where despite good intentions the companies end up in the hands on privileged groups as when former Soviet assets were handed out to the so called “Oligarchs”. This happened despite the fact that the Soviet privatization plan was designed just like the Czech program (Appel, 2000).

The issue of distributing shares for free has also been debated just recently in Sweden. The new centre-right government has plans of privatizing a substantial amount of government owned assets. It seems as the policy chosen is to sell to the highest bid (E24, 2006-10-24). This strategy has been criticized, (Kristianstadsbladet, 2006-10-26), by those who want to use privatization as a way of creating an ownership society. A broader ownership of stocks can be a way of reducing income inequalities as well as getting people to be more enthusiastic of both privatizations and the market economy in general.

2.7.3 Some additional issues to consider before and after a privatization

A privatization might if not conducted in the right way leave a bitter taste for the government and the general public. There are especially some issues that the government has to consider.

Government intervention

Even if a public enterprise is privatized there is no guarantee that there will be no more subsidies from the government or other government intervention. Government owned companies sometimes are in a bad shape because of mismanagement or they have been for a long time subsidized to cover for losses. One other explanation important to consider is that government owned companies usually are used to redistribute the costs of a service or product equally over the country even if it is more expensive to offer in certain parts of the country or to certain citizens (Horwitz, 1986). After a privatization, these kinds of activities usually become less manageable. The government can then use subsidies and taxes to maintain this kind of pricing structure (Vickers and Yarrow, 1991). One example of that are the Swedish government’s subsidies to certain air routes in the northern part of the country. A problem when privatizing firms with a certain amount of market power is the risk of abuse. When there is no competition and no control from the government a private company might overcharge the customers. The solution to this problem is government regulation in the form of a price cap. The risk with government regulations like this could be that a privatized firm might do some new investments and when the investments are sunk the government will introduce a price cap too low in order to grant the

company the adequate compensation for its investments resulting in underinvestment (Vickers and Yarrow, 1991). Chile is an example of problems with privatization strategy. In the second privatization wave the government's objective was to raise money to cover for large budget deficits. Therefore firms were auctioned out to the highest bid. The privatized firms were also highly levered, and the time of privatization was also the time of substantial deregulation efforts and trade reforms that put the companies under competitive pressure with the result that many firms failed and had to be put back under government supervision. The lesson learnt from this is that it is advisable to make the deregulation reforms first in order to get a competitive market, then when the market conditions are stable the state owned assets can be privatized (Vickers and Yarrow, 1991, p. 126-127).

Political issues and effects on distribution

When privatization is implemented there might be great distributional effects influencing the political debate. As discussed earlier, firms with market power will most often use that power to capture rents at the expense of consumers. There are also distributional effects when a privatized firm stops subsidizing consumers in high cost areas as showed earlier. The greatest effects, however according to Horwitz (1986), are related to pricing of the assets that are going to be privatized. A good example of this is the privatizations in former Soviet Union where a lot of assets were given for free to a few persons. If the assets are under-priced it will be a transfer of wealth from the general public to the buyers. It will be attractive for Governments to price the assets in a favorable way for the buyer since it is reducing the risk of leaving the assets unsold. Also since the perceived loss of the public is lesser than the perceived gain of the buyers there small risk from the Governments point of view get punished for such measures. However this kind of privatization can be very costly for the public economy especially if the assets go abroad (Horwitz, 1986, 120).

3. Methodology

This chapter will present in what way the study will be conducted, from the process of selecting the topic and study approach, through data collection and discussion of the validity and reliability of data and finally how to analyze the results.

3.1 Selection of topic for the study

The choice of this topic relates to my exchange studies in Japan. At the time there was one major event that was the center of political debate, the privatization of the Japanese Post. Since the bill had just been approved after an extra election it felt natural to study how and why this major change came to be. The privatization however was not possible to isolate to a single issue since it was related to so many other aspects of the Japanese financial system. Since the measure to privatize was not the first institutional change in Japan during the last three decades it would be more interesting to put the privatization into a larger picture of earlier deregulations and analyze competition on the bank market as a whole.

3.1.1 Research approach

After selecting a topic it is important to find an optimal study approach. According to Patel & Davidsson (1994) there are three major approaches. The choice of approach is usually related to how much already existing knowledge there is about the field of study. **Explorative** studies seek to find as much information as possible about a certain area or phenomenon, and have a general approach to the topic. This approach is suitable for research in a field where little research has been made in the past and where knowledge is limited. Often the objectives are to find ideas of future study.

In case we have a lot of knowledge of a certain area and some models have been designed, a **descriptive approach** can be suitable. The researcher then limits herself to describe a certain part of a phenomenon and creates a more detailed and deep study.

The third approach is a **hypothesis testing approach**, which starts with existing theories and forms one or many assumptions or hypotheses which are tested in reality in order to find if they are true or not.

In this study I have chosen to use a combination of the explorative and the descriptive approach. At the beginning I took a start with just privatization as the topic, then continued to study the Japanese financial system and lastly I started to read other research articles covering different aspects of deregulation and privatization. Doing the study in this order can be seen as an explorative way of researching, even if the general knowledge of privatization or the Japanese financial system is not limited as was the case usually in explorative studies. After this initial study I formed the problem and limited my approach to certain areas of this issue. In this way my approach changed in favor of a more descriptive approach.

3.2 Method of data collection

When doing a study like this, one must also choose what method to use when collecting, describing and analyzing data. This can be made in either a quantitative or qualitative way. These two methods can be seen as having the same purpose, to give better understanding about society and describe the behavior or relation of individuals, groups and institutions (Holme & Solvang, 1997). But the differences are how this is done. Quantitative methods seek to describe a specific phenomenon by looking at it from outside and trying to quantify it into figures. Quantitative studies try to take information from the surrounding world and make it into figures and numbers and use it as inputs for statistical analyses (Holme & Solvang, 1997). This method is more interested in average figures with the goal of applying these figures as representatives for the whole population from where a sample is analyzed.

Qualitative studies in contrast, are interested in creating understanding for a certain phenomenon. This method is according to Merriam (1998) more flexible and the samples used for research are nonrandom and the findings can be more rich and descriptive. Qualitative research has a goal of more understanding whereas quantitative research has the goal of making precise numerical estimations (Merriam, 1998). Holme & Solvang (1997) writes that one should choose qualitative method if one wants to:

- get a full perspective or a thoroughly understanding
- make hypotheses or create a framework for comparison
- understand social processes

In this thesis the purpose involves understanding of the phenomenon of institutional changes and its impact on competition. Hence, a qualitative study was the most suitable in

my opinion. To understand this phenomenon, describing these changes and put them into a bigger picture of the Japanese financial system as a whole including the FILP system and then trying to find the impact on competition, requires a certain amount of flexibility to choose what to study in the middle of the work process and the possibility to make a deeper analysis of certain parts. As described in the limitation section, my aim is not to quantify any impact on the economy in general nor quantify the impact on productivity in the bank sector. Therefore a qualitative method is the most natural choice. As with all methods or models, there are of course a few shortcomings, which will be discussed later in this methodology chapter.

3.3 Information used

Data used for a study can be either secondary data or primary data. Secondary data is data collected by someone else, for another studies usually with another purpose. Primary data is data collected straight from its source in the form of interviews or surveys. The information used for this study has been collected from many kinds of sources including textbooks, academic articles and reports as well as internet search, statistics and interviews. Hence, both primary and secondary data have been used.

This thesis is mostly based on analysis of secondary data. A problem for anyone trying to study something in Japan is the lack of relevant information in English. There are many reports and studies by Japanese scholars and research institutes but most of the information is in Japanese and if there is an English version this is usually just a summary of the Japanese version.

3.3.1 Literature

Because of the problem with finding adequate, relevant information in English the possibilities for an in-depth study will get somewhat limited if one is not completely familiar with the Japanese language. In this study I started with collecting information about the Japanese financial system from textbooks translated to English, written by Japanese scholars. Also articles in English from Japanese databases have been used. To validate and put this information into perspective, I then turned to articles with empirical studies from other countries' bank sectors to get some perspectives on the Japanese bank sector. In order to get a more theoretical understanding of the phenomenon of deregulation and privatization I used articles describing the in general terms the phenomenon and the forces behind it.

3.3.2 Interviews

Due to the problems with finding deep-digging information I have chosen to broaden the picture with the help of interviews. In total three people have been interviewed. Two of them work in the bank sector and the third is a famous professor in Finance and an expert of the Japan Post and the financial system of Japan.

3.3.3 Internet search

To get some wider information internet has also been searched, mostly in order to get some information from newspapers and to being up to date on the latest developments. Mostly used search words have been “privatization”, “Japan post privatization” or “Japanese finance”, “FILP system” etc.

3.3.4 Statistics

The qualitative nature of this study will limit the use of statistics but some information about the economic performance of Japan Post and the bank sector have been essential and also statistics on bank deposits and other savings have been used. The statistics come from Japanese databases and books mainly from the central bank of Japan and the Japanese Center for Economic Research.

3.4 Correlation between theory and empirical data

How the researcher chooses to relate empirical findings and the framework given by theory is affecting the analysis of the study. For a certain type of study a certain way of working can be preferable. There are according to Patel & Davidsson two major ways to relate theory and empirical data. A **deductive** way of researching will start with existing theories and based on them formulate a hypothesis. This hypothesis is later tested in reality. In this way the existing theories will decide what kind of empirical data will be collected, how to interpret this and how to relate it back to the theory. The other way is to work in an **inductive** way. Here the researcher is collecting data without first studying existing theories. Based on the empirical findings the researcher is trying to formulate new theories. The problem with this way of working is the risk of not knowing to what extent the new theories can be transferred to the general case, or if it can only be used for the special case that the research was based on (Patel & Davidsson, 1994).

By combining these two the research will be conducted in an **abductive** way. This is done by using empirical data and theory side by side. This way of doing research has been used in this study. My choice of studying the specific case of Japan made it problematic to first look at existing studies since these were trying to describe something different. Also they were done with a quantitative method making it hard to do a similar study. As my choice was not to give a general truth about the effects of deregulation and privatization but to study the impact of these forces in Japan, to first look at empirical data was natural. In contrast, just to look at the Japanese example would have given fewer perspectives and the risks of drawing the wrong conclusions would have been greater. Also, to know what to study about these phenomena would have been harder without comparing the empirical findings to existing studies from other countries.

3.5 Avoiding mistakes in research

Since a qualitative study method gives the researcher freedom and flexibility there are also many traps to fall into. The researcher can end up analyzing the wrong things or come to the wrong conclusions. In order to avoid these traps a reflection and discussion about what can cause the study to go wrong is much needed.

3.5.1 Validity

Validity involves the problems that the study are not describing what it was intended to describe, that the wrong things are analyzed. If so the conclusions will have less to do with the right picture. **Internal validity** means that the findings of a study capture the real picture and thus match reality (Merriam, 1998). The problem here is for the researcher to make a clear and careful study of the problem and that the analysis is logical. Patel & Davidsson, (1994), writes that we usually think that we are working in this way because we cannot see the shortcomings of our own work, but usually we will make some mistakes. Merriam (1998) gives a few strategies to correct these kinds of mistakes and increase internal validity. One way is **triangulation**, which means that the researcher uses information from multiple sources. **Member checks**, meaning that the data and its interpretation and results are confirmed with the source of information, are another way. It is also good to use **long-term observations** and repeated observations to increase validity. Discussing the findings with colleagues, (**peer checks**) can also be a way of looking at the problem from an alternative angle and will therefore increase the likeliness of the researcher making a thorough analysis.

Triangulation has been used in this study by using experiences from other countries (US and Italy) and to some extent comparing the results with Japan. The problem related to this is if there are some conditions in the two countries compared, that differ widely and thus affect the outcome of the respective study. If the researcher is not aware of these differences when making a comparison this comparison might be of less value for the analysis or lead the analysis wrong. Since I chose to study not only the latest reform (the privatization of the PSS) but to also look at previous deregulations, the observations are made throughout a longer period of time and will hopefully increase validity. I have also been able to confirm some of my thoughts and findings with Professor Yoshino, whose book and report I also used a lot in this study.

External validity relates to if the findings of the study can be generalized, and applied to other situations. In order to achieve external validity Merriam writes that this can be achieved by having internal validity. However, another method can be to give a good description of the findings so that the readers can draw their own conclusions about whether the findings can be applied on their case or not. According to Patel & Davidsson (1994) another good way to increase external validity is to compare our findings on some other criteria that represent what we want to measure. If there are signs that point in the same direction it should mean that the validity is good.

For this thesis it means that the method of using the studies of Italy and US as references can be useful in order to achieve higher external validity. Since they used quantitative methods and this study uses qualitative study, if this study will result in something that point in the same direction it must mean that the findings are more or less valid. But as previously discussed it is very important that we point out the different conditions of the specific country that might be found and limit the possibilities of a direct comparison.

3.5.2 Reliability

When validity means that we measure what we intended to measure, reliability describes how well we measure the results. This has the meaning that if we make the same study repeatedly, if we have good reliability we would get the same results. Also if many different researchers do the same study they should get the same results (Patel & Davidsson, 1994). In qualitative studies it is the researcher who observes and analyzes the results so the measure function is the researcher herself. Reliability is therefore related to the quality of the researchers work. To be able to increase the reliability on this study I have

tried to read through a lot of literature in order to get a lot of knowledge around the subject not only the studied phenomenon. To understand the Japanese society and culture is also important to understand the environment where the reforms occurred.

3.6 Disposition

To get a clearer picture of how this study was conducted I will explain what each part contains and my thoughts behind the selection of data.

3.6.1 Theoretical framework

In the theory part examples were given from articles and books about different aspects of deregulation and privatization both directly and indirectly related to my questions for this thesis. With this information I tried to provide the reader with knowledge about what issues there will be to consider when analyzing the results of my study. Firstly there is a description on how deregulation is seen and described in a theoretical way. We continue with describing some political and other forces both affecting when reforms occur, and how they are designed. To be able to validate the findings later from Japan some experience with similar reforms in the United States and Italy is described. Finally to better be able to analyze the privatization of the PSS a description of what issues are related to privatization ends this chapter.

3.6.2 Description of the Japanese financial system

In this results chapter the Japanese financial systems and the reforms that have been made in the past will be described. This is to put the deregulation of the bank market and the privatization in a historic and environmental context. Also the design of the Fiscal Investments and Loan Program (FILP system) will be presented and how it is related to the PSS and the financial system as a whole. Also changes in this system will be presented. This will affect how the competitive situation within the bank sector works and how it will work in the future.

3.6.3 The organization of the Japan Post, the outline of the privatization plan and the state of the PSS and the private banks

In this second results chapter I will present the basic structure of the Japan Post, describe how the privatization will be carried out as well as present some economic data important for future competition of the PSS and the private banks

3.6.3 Analysis

Question one

To find out whether the deregulations have led to a more competitive market or not I will analyze the deregulations to see if they are done thoroughly or if there are any government preferential treatment left. Also I will analyze economic data of banks lending margins and costs to see if there are any increases in profits which could be a sign of reduced competition and banks getting more pricing power over the market.

Question two

To be able to answer question two I do roughly the same kind of analysis as of question one. I will start to look whether there is any government preferential treatment that can be solved through a privatization and also see if there are complications from the privatization process that could make some preferential treatment to remain in the future. As the difference in size of the PSS and the private banks is great, the issue of market dominance will also be investigated. This involves predicting the future and to be able to do that I will look at historical data of economic performance and see which factors have influenced this performance. Based on that, some predictions of the competitive situation between the PSS and the banks in the future will be made. I will also try to find ways that the design of privatization can avoid any company getting dominant in the future.

Question three

In the last part of the analysis I will analyze the design of the FILP system and try to draw conclusions of whether it is compatible with a free competition in the bank sector or not. I have tried to look at the reforms of the FILP system and see whether there are elements left that might interfere with a free competition and also see whether the government with this system gives any part unfair favors.

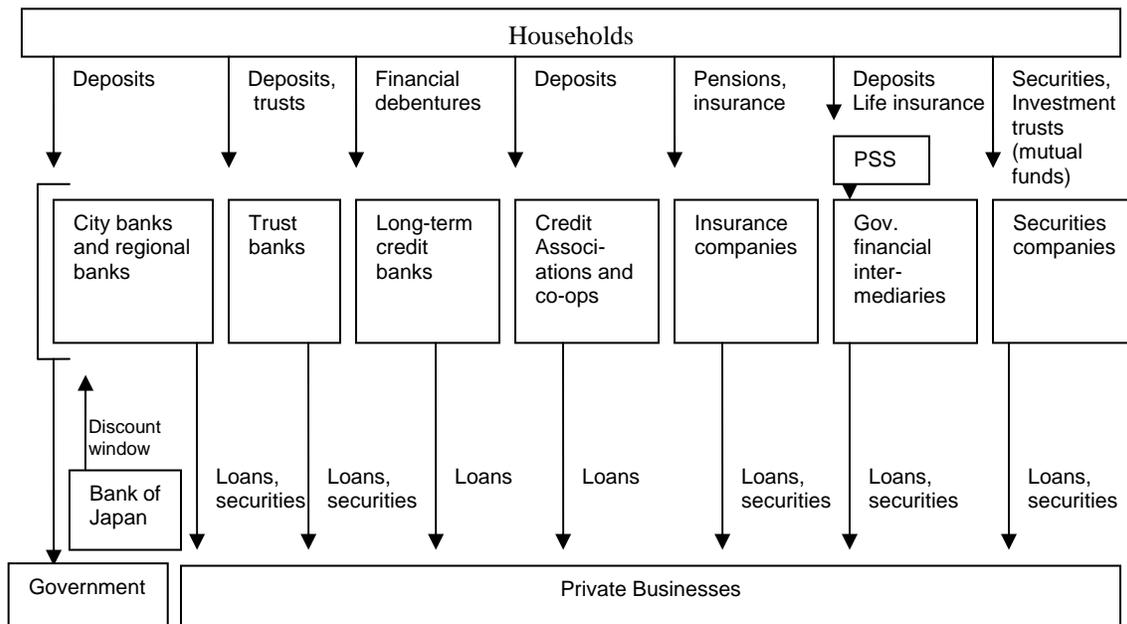
4. Description of the Japanese financial system

In order to gain understanding on what basis the reforms are made one must know how the Japanese financial system is constructed. This is also important in order to see what issues might affect the privatization of the PSS and the competition with private banks. Therefore I will give a description of this and put the private banks and the PSS into a broader context.

4.1 Financial intermediaries in Japan

To understand the how the financial system works it is important to have knowledge of which types of institutions are present in the Japanese financial system. Below, the flow of funds from households' savings to companies in the Japanese financial system is illustrated. This is a good overview on how the Japanese financial system works.

Table 4.1 Financial intermediation in Japan



Source: Flath, 2005, p. 261

Division of financial intermediaries such as banks, insurance companies and securities institutions into functional categories has been a prominent part of the Japanese financial system. Government regulations specified these categories and restricted companies in one

functional category to provide services characterized by another category. As an example were city banks not allowed to enter markets reserved for regional banks and long-term credit banks were not allowed to offer money deposit services etc. Banks have traditionally been the major source of funds for companies in Japan. The banks, under strict government supervision and regulation, became cartelized but with government protection of their funds. The fact that international financial market became more accessible during the 70's and 80's the system was gradually reformed and after 2001 all regulatory partitions between different financial intermediaries were eliminated in accordance with the "Big Bang" reform of 1996 (Flath, 2005, p.262). However, since these intermediaries are still mainly in same business as the regulations of the past specified, I will give a short explanation of each category and give example of single companies in these categories. As the regulations were lifted these banks were quick to start offering services previously reserved for others. Also since mergers were freely allowed the number of commercial banks has been reduced creating larger bank corporations.

4.1.1 Commercial banks

Commercial banks comprise four different types of banks: city banks, regional banks, trust banks, and long-term credit banks. **City banks** are banks with branches nationwide and sometimes worldwide. Before the Big Bang there were nine city banks. These banks mostly offer short-term loans (maturities of one year or less) to businesses. **Regional Banks** usually have branches in only one prefecture and lend their money to local small businesses. These banks also provide funds to city banks on the inter-bank market. Those banks that were previously mutuals between 1989 and 1992 have been converted to joint-stock companies are also referred to as regional banks. The difference between regional and city banks has been somewhat unclear as they engage in similar activities and the size of the largest regional banks are comparable to the smallest city banks. **Trust banks** offer trust deposits and issue long-term loans. These banks also manage corporate pension fund and therefore compete with insurance companies. They also accept ordinary bank deposits. In 1971 the trust banks were allowed to extend their services even providing consumer loans. Also one city bank, Daiwa, had always been allowed to offer trust deposits. The division between normal banks and trust banks is dating from the American occupation regulations and was motivated by restricting long term lending to those who are willing to take on long term liabilities. Three commercial banks were classified as **long-term credit banks**. These banks offered long-term loans to private companies maturing in five to seven years. The source of funds for these banks was mainly one-year or five-year debentures (bearer bonds) offered to the public and available in small

nominations like 10 000 yen (approx. SEK 650). In the early postwar years the activities of these banks were coordinated closely with the Japan Development bank which is a government bank. (Flath, 2005, p. 262-264)

4.1.2 Credit associations and co-ops

There are about 300 **credit associations** in Japan, also called shinkin. These are mutuals that regulations require to primarily lend money to their own members and only to small companies with less than 300 employees and capital below a certain limit. The National Federation of Credit Association functions as a central bank for these associations and invests the surplus funds of all credit associations of Japan. There are also **credit cooperatives** that are similar to the credit associations but tend to be smaller and less numerous. They also have a similar national federation. Labor credit associations are organized like the other credit associations but their members are mostly labor unions. They also provide government-assured housing mortgage to individuals. Apart from above mentioned associations there are about 1000 agricultural cooperatives and 500 fishery cooperatives. These cooperatives provide loans, deposit services and insurance to its members. The surplus funds of these are deposited with the prefectural credit federations of agricultural and fishery co-ops, where most of these funds were further funneled into the Central Depository for Agriculture and Forestry (Norin Chukin bank). This bank resembling of a long term credit bank were in the past obligated to invest its funds in low yielding government debt and loans to public utilities but was later allowed to invest in foreign securities. There are also a similar bank for small industry and commerce businesses called Shoko Chukin Ginko (Central Depository Bank for Commerce and Industry).

4.1.3 Insurance companies

Insurance companies in Japan are major lenders to private businesses and therefore important financial intermediaries. Just as banks the insurance companies have been organized into functional categories. These are life insurance companies and non-life insurance companies. Life insurance also manages corporate pension funds and these companies were not in the past allowed to offer casualty and property insurance. Non-life insurance companies were not allowed to offer life insurance. In Japan six out of the forty domestic life insurance companies are mutuals rather than joint-stock companies but all of these belong to the eight largest insurance firms. For non-life insurance twenty-six out of twenty-nine companies are mutuals (Flath, 2000, p. 265). Of the six large financial

Keiretsu (industry groups) five has an insurance company of their own. When stock prices collapsed in the bubble burst insurance companies were seriously hurt and in April 1997 Nissan Mutual were the first Japanese insurance company after WWII to file for bankruptcy. When comparing Japan to other countries, non-life insurance coverage in relation to GDP is less than any other developed nation but for life insurance the case is just the opposite (Flath, 2005).

4.1.4 Securities companies

In Japan securities brokerage and underwriting were traditionally restricted to securities companies. These companies can be divided into categories depending on what kind of business they do. **Investment houses** do both brokerage and underwriting as well as trade in securities on their own accounts (dealing). The three largest, Nomura, Nikko, and Daiwa totally dominate the market. There are another 10 small companies that also do both brokerage and underwriting and also a couple of hundred small companies that only do brokerage (Flath, 2000, p. 267). The largest investment houses are linked to other companies called **investment trust companies** that offer “investment trust certificates” resembling of shares in mutual funds. Traditionally banks have been restricted from offer these services but recently the banks also were allowed to. In addition to the above mentioned companies there are also **securities finance companies** that lend money to finance houses to finance margin transaction of securities trade.

4.1.5 Government financial intermediaries

Apart from the PSS and Postal Life Insurance there are other government banks and financial institutions. There were in 2005 eight of these which were getting their investment funds from the FILP system described in the next section. **The Development bank of Japan** gives credit to large-scale investment in the private sector at below market interest rates often together in syndicates with private banks. The investments are selected on the basis of official policy not the prospects of profitability. **The Japan Bank for International Cooperation** gives import and export credits to Japanese firms as well as providing loans to joint ventures between Japanese and foreign companies and also loans to foreign companies when importing Japanese goods. The interest rates are below market rates. There are also the **Housing and Loan Corporation** providing housing loans, the **National Life Finance Corp**, and **Japan Finance Corp for Small Businesses**, both providing loans to small businesses, and **The Agriculture, Forestry, and Fisheries Finance Corporation** that provides loans to rural businesses. In addition to these there are

also a company called **Japan Finance Corp for Municipal Enterprises** which provides loans to municipal service providers. Finally there is the **Okinawa Development Finance Corporation**, aiming to help the Okinawa prefecture which is the least developed prefecture in Japan. Largest of these institutions is the Housing and Loan Corporation that has half of the loans outstanding of all government financial intermediaries. Together all these intermediaries have loans outstanding accounting for one-fourth of all loans in Japan and three-fourths of the loans of all city banks together (Flath, 2005).

4.2 The PSS, the FILP system and the Budget process

The Fiscal Investment and loan program is a major component of Japanese financial system and the centerpiece of the Japanese government's financial intermediation and therefore a key to understanding the Japanese economic situation. When analyzing the Postal Savings system it must be put into a broader perspective as it is and has been an integral part of the financial system since the PSS was introduced in 1875. PSS and FILP are elements of a state directed economy that is characteristic for most East Asian economies. Through this system government raise funds for different public projects and direct money to different private projects that are perceived strategically important for the national economy and competitiveness, persistent with the present industrial policy of the government. Although many claim that this system has served the country well in the past, most economic scholars agree that it is not compatible with the present dynamic financial system based on competition and a global market of capital. The Japanese government has put the reforms of the financial system as one of the most important measures and that was envisaged in the 1996 "Big Bang" reforms guidelines for a financial system with same strength as the ones of the UK and the US. We return to regulations of financial markets later. (Yoshino and Cargill, 2003)

4.2.1 Sources of funds

The FILP is more a process making institution than it is a government authority. Its budget is sometimes defined as a second national budget. It has been subject to a reform in 2001 giving bigger transparency and market adjustment. Before 1987 all funds raised by the PSS and the Postal Life insurance was transferred to the Trust Fund Bureau fund of the Ministry of Finance who in turn transferred its funds to the FILP. After 1987 the Ministry of Post and telecommunications, which is in charge of the Japan Post, was permitted to manage a certain percentage of the funds on its own. This percentage gradually increased to 20% in fiscal 2000. In the end of fiscal 2000 the PSS had funds amounting 58,9 trillion yen and

consisted of government bonds (47,3%), local government bonds (15,9 %), public institution bonds (4,5%), private bonds and bank debentures 6,2%, foreign bonds (7,9%), and 18,1% invested in private financial institutions (Yoshino & Cargill, 2003, p.12). As an example of the flow of funds I use the figures of fiscal 2000 provided by Yoshino & Cargill (2003, p.12). At first 443 trillion yen raised by, the PSS (255 trillion), welfare and pension premiums payments (140 trillion), and other premium payments of 48 trillion yen, were directly put into the Trust Fund Bureau of the Ministry of Finance. The trust fund used 115 trillion yen to buy government bonds and put the rest into the FILP system. The funds raised by the Postal Life Insurance (112 trillion yen) were transmitted to the *Postal Life Insurance Reserve Fund* which in turn put 60 trillion yen into the *Postal Life Insurance Fund* and kept 62 trillion for its own portfolio investments. The *Postal Life Insurance Fund* transmitted its 60 trillion yen to the FILP system and together with the funds from the Trust Bureau and some additional funds received from purchases of government bonds by private companies (22 trillion) and by the *Industrial Investment Special Account Fund* (4 trillion) the FILP ended up with total funds of 414 trillion yen.

When putting their money into the Trust fund the PSS received a fixed interest rate that equals the rate of a ten-year government bond plus a 0,2 % premium. The money was deposited on a seven-year-basis contract.

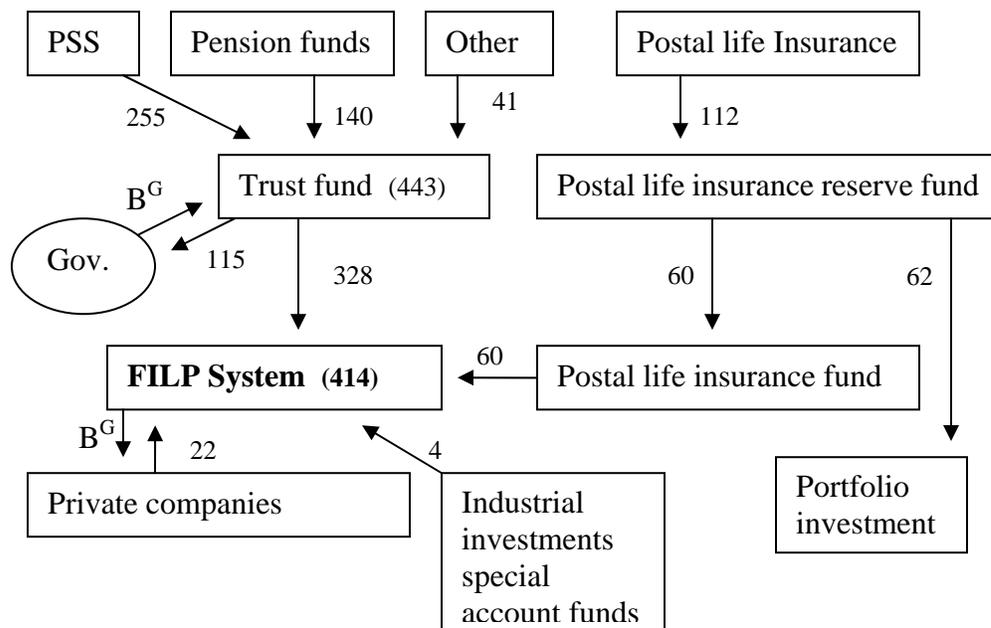


Figure 4.2 Year 2000 Flow of funds, old FILP system (trillion yen)

4.2.2 Uses of funds

The FILP uses its funds to finance twelve different categories of investments. Yoshino and Cargill divide these into six broader categories:

Strengthen key industries

a) Industry and technology

Trade/economic cooperation

b) Trade/economic cooperation

Regional development

c) Agriculture, forestry, and fisheries

d) National land development

e) Regional development

4. Infrastructure

f) Road construction

g) Transportation/communications

5. Modernization of low productivity sectors

h) Small and medium-sized business

6. Improvement in living standards

i) Housing

j) Living environment

k) Social welfare

l) Education

The way funds have been distributed among these six categories has changed over time. In the 1950's strengthening key industries was more important than it is today as these industries started to develop in a satisfactory way from the start. Regional development has also declined quite substantially over the years. For improvement in living standards the trend has been the opposite. Investment in housing has been the main driving force behind this, and now public funds account for 43,2% (1999) of the total loans provided for housing in Japan (Yoshino & Cargill, 2003, p. 57). 80% of the housing loans that is provided by the government are channeled through the Government Housing Loan Corporation. The rest is provided by regional government and other government enterprises. As in sources of funds, fiscal year of 2000 can serve as an example on how the investments funds are distributed to various government projects and institutions. Not all among the forty-eight institutions and corporations shown on the list got funding from the FILP system in 2000. Some entities got funding from other sources such as postal life-insurance funds or from the special account for industrial investment. Of eight government banks, seven received funding from the

FILP in the fiscal year of 2000. Special firms on the list are those firms that get funding straight from the FILP budget even if the government has no equity interest in them.

4.2.3 The new FILP

In 2001 the FILP system was reformed in order to strengthen the system through more transparency and a clearer focus on the investments creating value. As described before the funds of PSS were transferred to the Trust Fund and then invested into the FILP system. With the new system the PSS and Postal Life Insurance are supposed to invest their funds in the capital market and FILP-financed entities that previously relied on funding from the Trust Bureau now, have to raise their funding on the private market. They can raise funds by issuing: FILP-agency bonds without a government guarantee, FILP-agency bonds with a government guarantee, and FILP bonds issued by the Ministry of Finance. The FILP agency bonds are bonds that each individual FILP agency can decide to issue when they are in need of funds without needing to seek permission from the government. Also, they have to show that the money is used in a manner that will create profit in order to attract money on the financial market. With the old system all money was allocated according to the outcome of the FILP budget and was therefore the allocation was the result of politics rather than economic rationality. The new FILP agency bonds are thus different from the old system and are thought to grow in number in the future. The FILP bonds however can be seen as normal government bonds. The money raised from these is lent to the FILP Agencies according to the outcome of the FILP budget. Therefore same logics apply as with the old system for these bonds and the allocation of the capital raised from these. However, in order to enhance transparency thirty-three of the FILP-entities now had to make a subsidy cost analysis estimating the present value of future subsidies. This is thought to both make it easier to raise money on the financial markets but also give the government information needed to allocate the funds in a rational way. The implications for the PSS with the new system are that they now are free to put their money in the market at their own discretion. After the reform in 2001 existing funds within the Trust Fund (old FILP system) will gradually be repaid. By the end of the fiscal year of 2007 they will be fully repaid. At the end of fiscal 2004 the funds invested in other deposits than the old FILP system accounted for 63% of total assets or 134 trillion yen (Japan center for economic research, 2005). Most of these funds were invested in government bonds resulting in a lost premium of the 0,2 % received from the FILP.

4.3 Financial regime and the FILP, bank regulations and recent reforms

The Japanese financial regime is resting on a scheme that was created when Japan ended its international isolation in 1868. It was further developed in order to rebuild the Japanese economy after World War II with the aim of catching up with western economies in terms of GDP and living standards. It was characterized by a large extent of government guidance and control in order to build success in certain key industries. Bureaucrats therefore were given quite large power and influence over business and have been keeping this power since then, even if recent efforts have been made to down-scale government administration. Since private and government banks have been the most common way to finance new businesses in Japan they are very much a part of the Japanese administrative paradigm. PSS and FILP have been created as central parts of the old financial regime and their reformation is also a part of a larger effort to change the old financial and administrative paradigm. As a result, describing the both environment in which these institutions were created, and also how these institution developed within the system. It is of utmost importance for understanding the issues of reforming these institutions. (Yoshino & Cargill, 2003)

4.3.1 The Old Financial Regime and its liberalization

The old financial regime, not unique for Japan, had its golden era during the reindustrialization of the 50s and 60s and it was based on a large extent of government control. Cargill and Yoshino (2003) are giving examples of the elements of the old financial regime. They write that the financial system was viewed as an instrument of industrial policy. PSS was an integral part as it was seen as the provider of funds for the industry, and these funds should be channeled by the government. Therefore the encouragement of private saving was an important part of raising capital for the development of Japanese industry in accordance with the government's goals. The financial system was designed in way that limited households' access to the financial market as consumers of credit. As the government was seen as the conductor of the orchestra of reindustrialization the financial system was designed to give bureaucrats the power over managing the flows of capital. The financial system was therefore created with non-transparency as a goal to give politicians the major influence. The old financial regime relied on interest control to subsidize loans for targeted sectors and foreign financial institutions were banned or had only restricted access to the domestic market. There was also until 1980 restrictions of capital inflow and outflows (Sakakibara & Yoshino, 2001, p. 116). The central bank was controlled by the Ministry of Finance. The aim of these policies

was to ensure financial stability and minimizing risk and bankruptcy (Cargill & Yoshino, 2003, pp.71). These policies were giving large established corporations advantage over small ones. Small companies were supposed to get their capital from regional banks or government banks.

Even if the Japanese impressive growth figures in the 50s and 60s proved this old financial regime successful a set of new conditions made it incompatible with the environment of the 70s. Cargill and Yoshino blames the oil crisis and some policy mistakes of the central bank, who tried to hinder an appreciation of the yen, for a jump in inflation and an end to the period of high growth rates. The result was that the central bank were later given operational independence and the fixed exchange rate was abolished (Cargill & Yoshino, 2003, p. 73) Also companies access to international capital markets played a part in this.

4.3.2 Financial market regulations and deregulations

As mentioned before, where the banks a part of the government controlled financial intermediation and therefore subject to many regulations. Compared to most other countries Japan had and still has a very fragmented banking sector. It is as explained earlier due to the old bank regulations. In the context of the old financial regime and its liberalization I will present the major changes of banking regulation starting from after WWII based on (Smith, 2005, p. 292-293)

Occupation era

After the war US wanted to transform Japan to the ideal American society. Based on the US Banking Act of 1933 the banks of Japan were prohibited from underwriting securities as well as invest in securities themselves. After the occupation ended this was changed even if there were limitations for banks to own a larger amount than 10% of the stock of a single company. This was a part of Japan's new anti-monopoly law of 1953 and the limit was later in 1987 lowered to 5 % for banks and 7 % for insurance companies. At this time the segmentation regulations of the financial sector began. The right of securities brokerage became the exclusive right of investment houses. The banking sector was segmented into those specializing in long-term loans versus short-term loans and trust accounts (mutual funds) versus bank accounts. The insurance business was segmented into those companies specializing in life insurance versus those providing property or casualty insurance. The interest control law from 1948 gave the Ministry of Finance the right to control interest rates. The interest rates of bank accounts were suppressed but the loan rates

were left at market levels. In 1949 measures that isolated the Japanese financial market were introduced. The Foreign Exchange and Foreign Trade Control Law prohibited all international transactions that were not approved by the ministry. All transactions had to be approved on a case-by-case basis. Foreign companies were banned from issuing corporate bonds in Japan and Japanese companies were also banned from issuing foreign bonds of any kind. Japanese financial institutions were disallowed from having any foreign securities in their portfolios. Also, there were limits on the amount of loans Japanese banks could provide at overseas branches. As well as insulate Japanese financial market this also protected Japanese banks from foreign competition.

Deregulation begins

In 1981 the new Foreign exchange and Foreign Trade Control Law were adopted allowing all international transactions if not specifically prohibited. These measures started the end of the Government controlled cartelized Japanese banking system. In fact some restrictions for Japanese companies to engage in Euroloan syndicates or Eurobond underwriting syndicates were still present until 1984 but were thereafter phased out. With these new circumstances the suppression of issuing bond domestically became impossible and gradually more and more companies became eligible to issue domestic bonds without any collateral. By 1996 all corporations were allowed to issue bonds. Regulations on deposit rates were gradually relaxed and in 1994 all financial institutions could set their deposit rates at their own discretion.

Freeing the banks and insurance companies

In 1992 the Financial System Reform Act were introduced and it took effect in April 1993. This new law allowed banks, securities companies and insurance companies to merge and establish subsidiaries offering services that previously were reserved for others. Banks were allowed to offer loan and money trusts, as well as offering securities brokerage services by wholly owned subsidiaries. Since October 1996 Insurance companies offering life insurance could start to offer casualty and property insurance. Property and casualty insurance companies were also allowed to start offering life insurance through wholly owned subsidiaries.

The removal of all remaining barriers – the “Big Bang”

Under the Hashimoto administration the idea of final elimination of all partition regulation of the financial intermediaries markets were introduced in 1996. This was to be completed before 2001. In 1997 securities companies were allowed to offer “comprehensive accounts” providing their customers the possibility to write checks. From December 1998 banks were allowed to offer trust certificates (mutual funds) but only through subsidiaries. From July same year non-life insurance companies were free to set their own premium rates. Before that they had to follow the rates set by insurance industry rating bureaus that were government authorized cartels. For securities brokerage and underwriting, the banks were allowed to offer these services in 1999. At this time brokerage commissions were also deregulated. The Big Bang was completed in fiscal 2000 when all remaining regulatory barriers were removed.

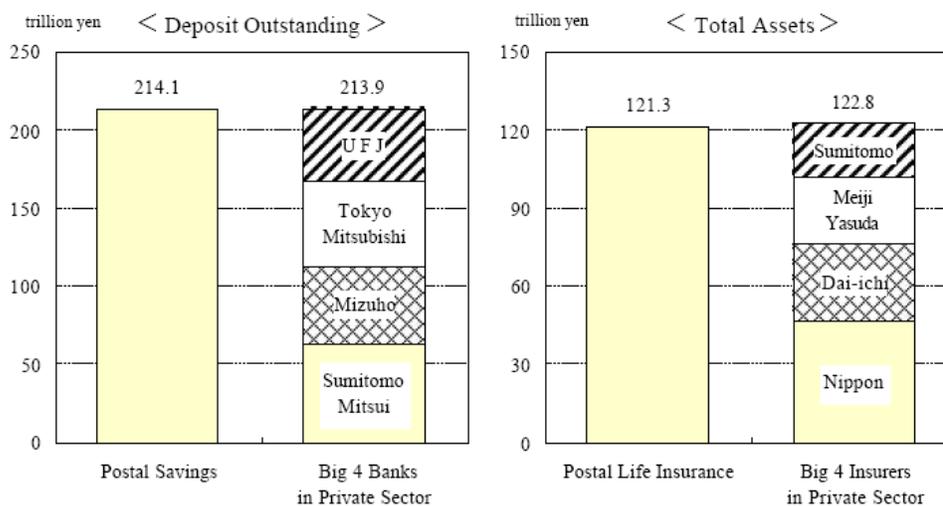
A series of measures to overcome the financial problems of the banking sector was also taken in the mid-late 90s. Among others the central bank was granted independence from the Ministry of Finance in 1997. Another regulatory and supervisory regime had gradually been introduced from the mid-90s. This includes the Ministry of Finance, reformation and expansion of the Deposit Insurance Corporation and the establishment of the Financial Supervisory Agency and the Financial Reconstruction Commission. Also, new guidelines called Prompt Corrective Action were introduced to deal with financial institutions in trouble (Cargill and Yoshino, 2003). Cargill and Yoshino also write that the financial regime went from emphasizing non-transparency, mutual support and unwillingness to permit failure of financial institutions to emphasizing transparency and willingness to impose penalties on troubled financial institutions.

5. The organization of the Japan Post, the outline of the privatization plan and the state of the PSS and the private banks

5.1 The Organization of the Japanese Post

The present shape of the Japanese Post's organism was created as late as April 1, 2003 when a new law, the Japan Post Law, was passed making the Japanese Post being run by the government as a public company rather than a government authority. The company consists of three businesses, Postal services, Postal Savings, and Postal Insurance Company (Kampo). The Ministry of Internal Affairs and Communications is the ministry that a responsible for overseeing the company in its new shape as well as before. The Japanese Post is a huge organization. It has as many offices as all branches of all private banks and credit unions together and manages assets worth 388 trillion yen (end of 2004) (JCER, 2005). At this time it had 24,678 offices around Japan and 261,937 employees. Also, the fact that Postal savings has assets equal to all assets of the four main private bank corporations and that its insurance company has assets equal to the four biggest private insurance companies, is another proof of its significance.

Graph 5.1 Assets of the PSS and the Postal Insurance compared to the four biggest banks and insurance companies, (trillion yen)



Source: JCER, 2005, p.1

5.1.1 The Mail delivery business

The business of mail delivery possess some special characteristics since it is object to an international convention who guarantees all citizens of the world the right, at least in theory, of adequate and equal service. This means that these services also must be offered to areas poorer or less densely populated regions where there is little chance for profitable operations. This also has the implication that the government must take an active part as no private company will volunteer to make losses just for charity. This problem however, might be of less significance in Japan compared to many other countries because of its dense population and few areas with little people. In many countries where these kinds of services have been privatized the government has given monopoly grants or provided financial support in order to make the private companies meet the universal needs of less fortunate ends of a country. (JCER 2005)

5.1.2 The Postal Savings business

This part of Japanese Post manage assets that consist of money that companies and the general public have put into the different accounts provided by the company. The value of these assets kept growing during the 90's and peaked in 1999 at 260 trillion yen (Japan center for economic research, 2005). After that the trend has been the opposite but even so the Postal Saving remains a massive financial institution. The way the company is obliged to manage its funds has been subject to change in the past. Other products that the Postal Savings are offering include money remittance services in the form of postal money orders or "postal giros" (Japan center for economic research, 2005) which is a direct transfer of money from one postal account to another or a transfer to a postal account. These services became popular at a time when the bank's infrastructure were not as developed. Even now when there are similar systems run by the banks in place this service still is very competitive since it takes advantage of the low handling costs and the fact that post offices are numerous and thus have a great reach throughout the country. (JCER, 2005)

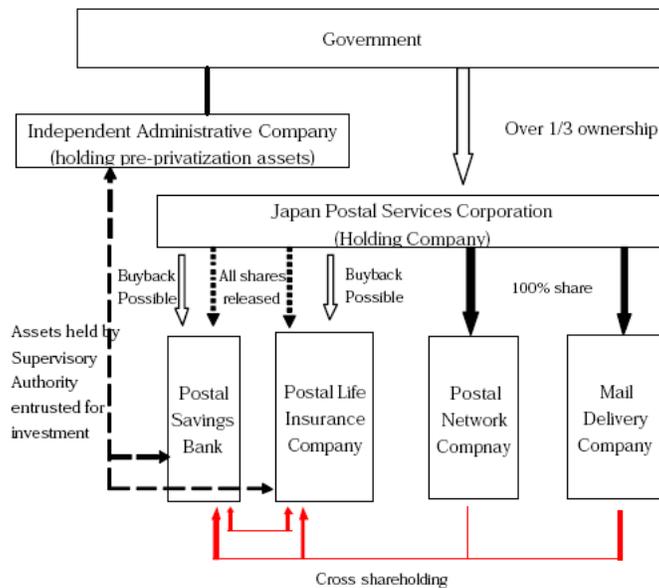
5.2 Outline of the planned Privatization process

In October 2005 the bill of privatization was passed after an extra election that followed the rejection of the first bill of privatization by the Diet, the Japanese Parliament. In October 2007 the new structure of Japan Post will be created. The reform will split up the current corporation into six new entities; a main holding company named Japan Postal Services Corporation (JPSC), a mail delivery company, a postal savings bank, a postal network

company, an insurance company and finally an independent administrative company to hold the assets of the postal savings and insurance company before the final stage of privatization. All staff will be employees of the new companies even though they will lose their status as civil servants and the privileges related.

The Postal Network Company will be in charge of the Post offices branches throughout the country that will continue to offer all services currently offered by the Japan Post, even after the Postal Savings and Postal Life Insurance are privatized. From 2007, when all the assets put into the trust fund are paid back and this new structure is created, there will be a transition period of 10 years for Postal Savings and Postal Life Insurance Companies. During these 10 years an independent administrative company will manage their common assets. These two companies' activities will be restricted in some areas and in order for them to enter into new business areas; permission from the government will be needed. This is done by an enactment to the Banking Law and the Insurance Business Law (Japanese Ministry of Finance, 2006). The initial business fields of these companies will be the same as the current business of the Japan Post. After the transition period, in 2017, the different companies of the Japan Post will do business under the general terms of the Banking/Insurance Business Law and other laws that apply to financial institutions, which means they are free to do business just like all companies in that sector. At this time shares of the Postal Savings Company and Postal Life Insurance Company will gradually be released for sale to the public on the stock market. According to the privatization law the government will be given the right to intervene in the privatization process depending on the development of the companies and the global financial markets. The government may buy back a percentage of the total shares. The government had to be willing to accept a change of its initial plan when the law was passed through the parliament granting the four privatized companies the right to cross-own shares. This has raised fears that the companies will cross-subsidize each other and the competition will not be fair even after a privatization. The government will keep its 100% of the stocks of the Mail Delivery Company and the Postal Network Company. However, a maximum of two thirds of the holding company will be privatized.

Graph 5.2 Overview of the privatization plan

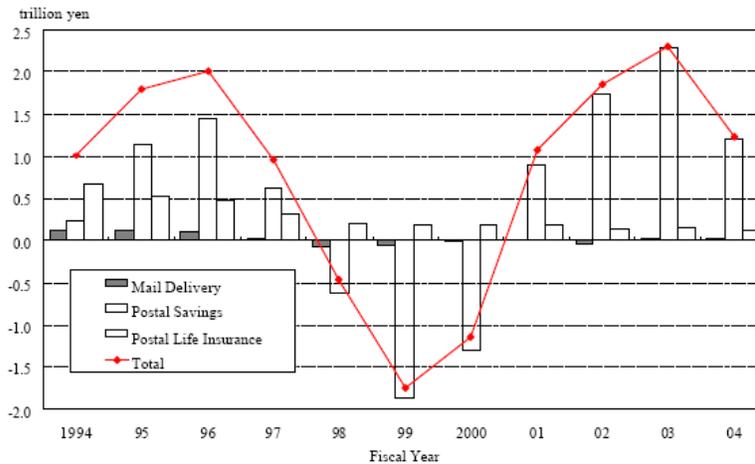


Source: JCER, 2005, p.13

5.3 The Economic state of Japan Post

The last decade the Japanese post had profits that fluctuated quite substantially. The main source of profit comes from the postal savings although this is also the source that has been changing the most over time. The mail delivery services have shown very little profit over time and the profit from insurance has fallen to a quite small amount. Although the fluctuations, in the recent years the profit has stayed above 1 trillion yen. During the recession of 1997 the PSS made huge losses when many of its accounts were canceled.

Graph 5.3 Net Income of Japan Post 1994-2004



Source: JCER, 2005, p. 2

One explanation of the poor performance of the PSS is the design of the company's most common product; the Teigaku plans. The Japan Center of Economic Research shows that both in times of rising or falling interest rates the company will face trouble. This is because of how the FILP system and the Teigaku plans are constructed. In times of rising rates, because of the fact that people can cancel their deposit after 6 months but before 10 years without any serious loss, cancellations are numerous. People are then demanding higher interest rates on their savings and they will therefore re-deposit their money at higher rates. But since the funds of Postal Savings are locked into the Trust Fund for seven years only earning a fixed low rate, it will result in a negative interest rate spread for the company. In times of falling interest rates on the other hand, people will keep their savings for the whole period of 10 years. The terms of the Trust Fund are only on a seven year basis forcing the Postal Savings to invest their funds at a lower interest rate for the remaining three years. This also results in negative interest spreads. All together this means that the company is sensitive for interest rates that fluctuate a lot and the Teigaku deposits with fixed rates is a risky product for the company to offer.

According to predictions made by the JCER, if the balance of deposits continues to fall, the PSS may not be able to stay in business if the subsidies disappear and if they continue to do business like today. In order to stay in business the PSS has the options of doing new business, increase fee income or increase their risk appetite on investments, or a combination. According to the simulation the PSS can by doing a combination of increasing fee income and risk appetite secure a positive profit with a deposit balance as low as 108 trillion yen, which is half of the balance today. (JCER, 2005).

Graph 5.4 Simulation of profitability at various deposit balances

	Case 1		Case 2		Case 3		Case 4	
	do no new business		increase fee income		increase risk appetite		Case2 & 3 simultaneously	
Net income(billion yen)	975	0	975	0	975	0	975	0
Deposit balance(trillion yen)	414	184	394	164	263	114	256	108

Source: JCER, 2005, p.12

It seems however that the prospects for earning higher fees will worsen in the future as a more fierce competition is the likely outcome in the future among companies offering financial services at the Japanese market. The American chamber of commerce writes in their White Paper of 2003 commenting the securities markets: “Competition in the sector continues to increase, as evidenced by the growing number of online and discount brokerages, greater latitude in the development and marketing of products, and continued pressure on commissions and margins”. Because of the deregulation of what services banks and financial institutions may offer, this logic is likely to apply also for other financial services than securities brokerage. So in order to increase fee income as increases in prices seems impossible the PSS must start offering new services (Japan Center of Economic Research, 2005)

5.4 The economic state of private banks

The banking sector had very hard times during the 90’s as the burden of bad loans was heavy to carry. In the study made by the Japan Center for Economic Research the bank sector was analyzed from the perspectives of profits, bad loans, capital adequacy rates and the conditions on the lending market. This study showed that the condition of banks improved substantially in the end of the period even if future threats very much remain.

Table 5.5 The profit structure of Japanese banks (All banks)

Fiscal Year	trillion yen													
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Lending Margin (A)	8.9	9.8	9.2	9.7	10.8	10.8	10.0	9.7	9.7	9.4	9.8	9.4	9.0	8.7
Other Revenue (B)	2.2	2.5	2.8	2.1	3.5	3.6	3.6	2.7	2.4	2.9	3.1	3.8	4.3	4.6
Gross Profit (C) = (A) + (B)	11.0	12.3	12.0	11.8	14.3	14.4	13.6	12.4	12.2	12.3	12.9	13.2	13.3	13.3
Operating Costs (d)	7.5	7.7	7.7	7.8	7.8	8.0	7.9	7.6	7.3	7.1	7.0	7.0	6.7	6.4
(Salaries and Wages)	3.8	3.9	3.9	3.9	3.9	3.9	3.8	3.6	3.5	3.4	3.2	3.2	3.1	2.8
Net Operating Profit before Loan Loss (E) = (C) - (d)	3.5	4.5	4.3	4.0	6.5	6.4	5.7	4.9	4.9	5.2	6.0	6.2	6.6	6.9
Loan Loss (f)	1.0	2.0	4.6	6.2	13.3	7.4	13.4	14.0	6.3	6.5	9.4	7.0	6.1	4.2
Net Operating Profit (G) = (E) - (f)	2.5	2.5	-0.4	-2.2	-6.8	-1.0	-7.8	-9.1	-1.4	-1.3	-3.4	-0.8	0.5	2.7
Realized Capital Gains (H)	0.7	0.0	2.0	3.2	4.4	1.1	3.6	1.4	3.8	1.4	-2.4	-4.1	0.6	-0.1
Net Profit (I) = (G) + (H)	3.3	2.5	1.7	1.0	-2.4	0.1	-4.1	-7.7	2.4	0.1	-5.8	-4.9	1.0	2.6
Asset	914	859	850	845	847	858	845	762	742	806	772	739	750	748
Outstanding Loans	537	542	539	539	554	563	536	492	476	474	465	435	423	414

Source: JCER, 2005, p. 16

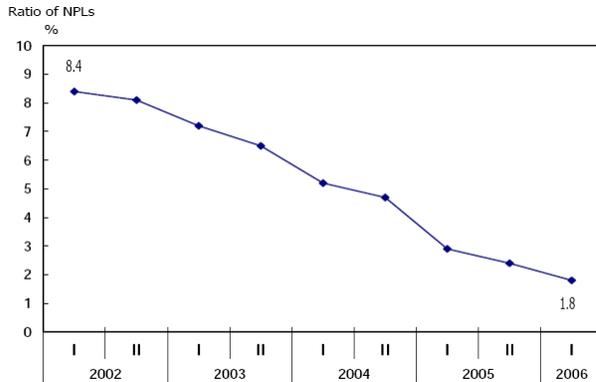
In the above chart the components that together make up the banks net profit. Looking at the net operating profit one can observe the hard times the Japanese banks had during the crisis beginning in 1997. What it also shows is that the situation improved in the end of the period. Lending margin has been declining even if it was compensated by larger income from other sources like fees for securities brokerage services and other services. But according to The American Chamber of Commerce this income is likely to decline because of improved competition in the financial services market leading to lower fees of these services. The most important factor leading to improved profit figures is the fact that the banks have been able to reduce the losses from bad loans. In the category Realized Capital Gains, the factor contributing negatively can be derived as bad loans. The reason is that these negative entries are losses on preferred stock that the banks bought in the past to support the companies receiving credits. Therefore these losses can also be referred to as losses from bad loans (JCER, 2005).

The non-performing loan problem

A major reason to the banks' bad performance in the 90s is losses from non-performing loans. According to the Financial Revitalization Law there are three categories of bad loans in Japan: loans that are "unrecoverable", "doubtful", and finally those in "need of special caution". The value of these three categories for all banks were in March 2005 17.9 trillion yen after been reduces by impressive 8.7 trillion yen in fiscal year of 2004 (Japan center for economic research, 2005). JCER explains this by the fact that the recovery of the economy significantly improved business conditions for the banks' borrowers, facilitating financial

reconstruction of many firms leading to healthier loans. In addition to that many loans had simply just been taken off balance sheets. The city banks were the ones that reduced the amount of bad loans fastest while the reduction has been very slow in regional banks. The chart below shows the significance of the reduction in bad loans as percentage of total loans outstanding.

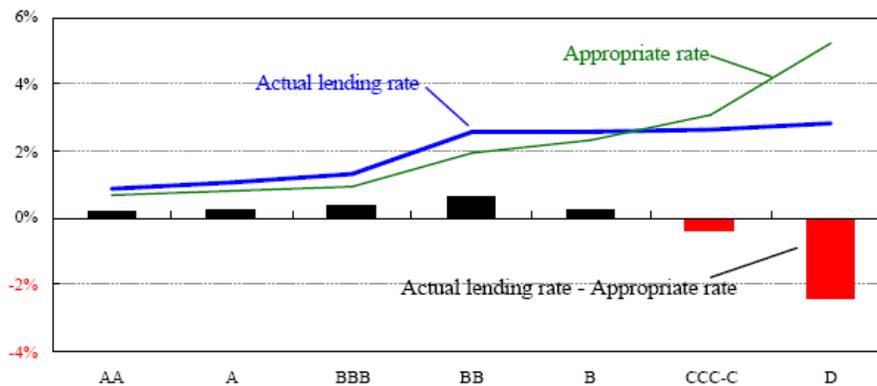
Graph 5.6 Ratio of non-performing loans to total loans (major banks)



(Source: Japan Ministry of Finance)

Another problem with outstanding loans is the banks' incapability of securing the appropriate interest spread for the actual risk group illustrated in the following graph.

Graph 5.7 Appropriate interest rate spread by risk category, all industries fiscal year 2004



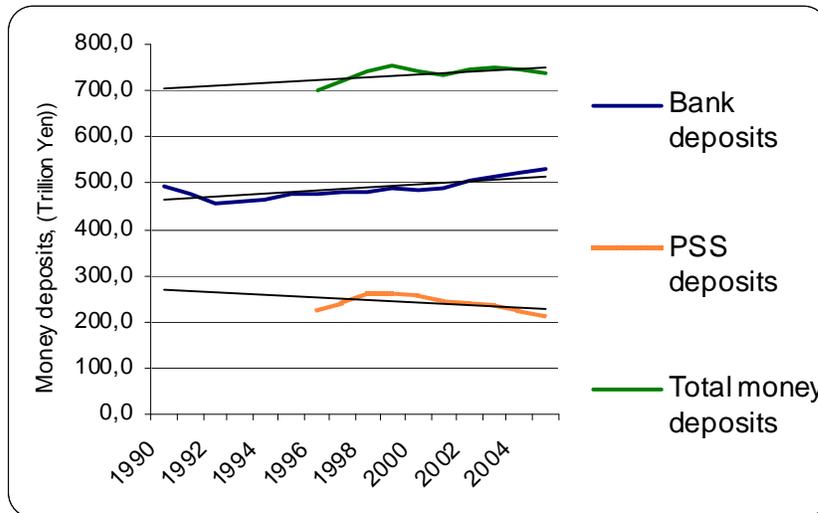
Source: JCER, 2005, p. 20

5.5 The PSS versus private banks

In section will compare some aspects of the PSS and private banks important for the competitive situation.

5.5.1 Deposit balance

Graph 5.8 trends in deposit balance PSS and private banks



Source: Bank of Japan Statistics, 2006

Comparing the amount of money deposited at the PSS at the end of 1996 with November 2005 there has been little change: a fall with 13,8 trillion yen. But in between of those years there were some larger changes. From 1996 to 1999 there was an increase from 223.8 trillion yen to 260.6 trillion yen, an increase with 36.7 trillion yen. From 1999 to November 2005 the amount of money deposits decreased gradually ending up at 210.1 trillion yen in 2005. The trend is a falling amount of deposits. For the private banks the general pattern has been the opposite. With a few years with a falling balance the money deposited at private banks have steadily increased. Especially the last two years after the banks have made huge efforts in reducing bad loans and also regained the general trust to a larger extent at least, the balance of money deposits has increased.

5.5.2 Government subsidization of Japan Post

The Japan post gets subsidies from the government, not directly but indirectly. The JCER shows that the Japan Post gets this in four major ways:

Firstly, they get subsidization of income through the funds they put into the FILP. Even if the terms for this program is based on a seven-year horizon the company has been getting interest equivalent to ten years plus the additional 0,2 % premium. This system was reformed in 2001 and the Postal Savings no longer put its funds into the Fiscal Program (FILP), but the company still has a significant balance entrusted in this program and therefore still receives interest income from it. Secondly, maybe most notably, the companies are exempt from paying many corporate taxes, stamp duties and fixed assets taxes. Thirdly, private banks are obliged to pay a 0.084 % fee of their deposit balance as insurance provided by the government to people to protect their savings from bank bankruptcies and the PSS is not. Fourthly, private life insurers have to become members of the Life Insurance Policyholders Protection Corporation and contribute annually to the “Policy Protection Fund” and to the “Administration Fund” managed by this corporation. The Japan Post Insurance company is exempt from making these contributions (Japan Center for Economic Research, 2005) The JCER estimated these hidden subsidies to be worth 1 trillion yen in fiscal year of 2004. Most of this comes from income subsidization of the funds put into the Trust Fund and therefore will gradually fall to zero in 2007.

5.5.3 Deposit insurance

Deposits at banks are protected up to 10 million yen by the Deposit Insurance Company, established in 1971. For deposits at the PSS they have an explicit government guarantee up to 10 million yen. For that reason they do not have to be a part of the Deposit Insurance Company and thus do not have to pay any insurance premiums for protection of deposits. The problem apart from the subsidy problem is that when the banks were hit with financial distress the people started to see deposits at the PSS as much safer. This is not strange as the financial crisis meant the failure of many financial institutions. As a consequence the Deposit Insurance Company’s resources were depleted in 1994, and became market insolvent. This was causing distrust of the general public in private banks and many people moved their savings to the PSS. This disintermediation of funds was exposing the banks to liquidity risk. (Yoshino and Cargill, 2003)

6. Analysis

This chapter will analyze the results on the basis of the three research questions.

6.1 Question one

Have the deregulations lead to a more competitive bank market?

6.1.1 Government preferential treatment

In broad terms the institutional changes affecting competition in the bank sector have been deregulations but also government policies towards risk and possible failures of individual financial companies. The most important deregulations as described earlier are the relaxation of deposit rate regulations, the right for financial companies to merge or acquire other banks as well as the abolition of regional and functional partition regulations of the bank market.

To separate banks on the basis of regional markets is a way of creating artificial protection for banks on these markets. This will mean that pressure from competition will be reduced and the possibilities of getting excess profits will increase. Less pressure might also mean the bank may run the operations inefficiently. Hence, this is a sort of unfair government treatment that is limiting competition. The fact that regional banks are having greater problems with bad loans and also the failure of Hokkaido Takushoku as well as many smaller depository institutions can be seen as evidence that these banks were being irresponsible with their lending. The problem with getting the appropriate interest spread is another sign of this. The regional banks seem to have been less careful not to lend money to unprofitable firms or projects, given their remaining bad loan problem, and protection from competition were most likely making this possible. Also, safety of the government not allowing failure most likely lead to these problems.

The partition regulations on functional basis are working in the same way. For example long-term credit banks or normal city banks, securities companies, or other, have their kind of niche protected from new entrants and that is naturally limiting competition. After these regulations were abolished banks income from other sources than lending increased which is a sign that the banks have been moving into new businesses. Thus the market has grown with more companies offering these services. One can guess that as stocks were only

accessible to the general public through special securities companies, stock ownership was not so common. After it has been accessible at normal banks it can be expected to spread to a broader category of people. Thus the competition in this field could be expected to increase through different internet brokers. Just as we have seen in Sweden the last 10 years.

When mergers and acquisitions were allowed many banks took advantage of this to merge into large financial groups. This has raised questions, as discussed earlier, about whether the banks sector could turn into an oligopoly with negative impact on competition. This will be discussed further in the next section. However, mergers and acquisitions could also be seen as a way for the government to treat companies differently. As some companies were of a certain size from the beginning, by not letting competitors merge into larger units they could probably continue to dominate smaller companies. Thus, mergers can be seen as a way of increasing competition. This pattern was observed in the study of the Italian bank market.

Before the deregulations, banks could not set the deposit interest rates at their own discretion. This can be seen as limiting competition as well. For some banks it might have been possible to set a higher rate to attract customers. This is also problematic since different banks have different risk profiles and having their rates regulated means that the government might favor one kind of risk profile over another. In this way it could be problematic for competition and will also mean less choice for consumers when all banks have the same rate.

Apart from direct regulations, government practices in dealing with risk and bankruptcy can affect competition. As discussed in the privatization part in the theory chapter, if companies get the security that governments will always step in to help there are no pressure on the company to run their operations efficiently. This problem can also be viewed from the perspective that the government is punishing companies that behave responsibly where they support banks that have provided loans in an irrational and irresponsible way. This is contrasted in the way the practices have been changed from the old financial regime to the new regime. The new practice is to let banks take their own risk and permit failure of banks if necessary. So in this way the changes have been made in favor of non-discriminatory regulations. Rather than to always try to avoid bank failure it seems like a better idea to make sure that the insurance of people's savings are reliable than to help troubled financial institutions. In the past this has been handled in a bad way with

the funds of the Deposit Insurance Corporation being depleted thus risking the trust in the bank system of the general public.

6.1.2 Risk of a dominating company or companies

When looking at the experiences from the Italian bank market, the risk that banks might increase their power over the market and capturing excess profits is not very large. However there are some aspects of the Japanese deregulations that might give a different result in Japan. At the time of deregulations, the Japanese banks were in the middle of a financial crisis and were having trouble with non-performing loans. This might have given some banks a lot of trouble while other banks might have been less affected. This might have the implication that some banks have a better opportunity to take advantage of the deregulation and therefore get a head start. If that happens that bank could use its strength to keep other competitors out of the business. To see whether there is any dominant bank in Japan, and whether banks in general could increase their pricing power over the market, the figures presented in the last chapter will be more closely looked at.

In order to find this I have as far as possible looked at the same indicators as the Italian study. If the effects of the deregulations of Japan were the same as in Italy it would mean that banks were not able to increase their operating margins in relation to the marginal cost on the market. As I have not been able to calculate the marginal costs I have simply looked at the operating costs of banks in table 5.5. These figures show that the lending margin has been declining since the regulations on bank rates were lifted in 1994 but this has been balanced by rising revenues from other sources. In 1999, banks were given the right of underwriting securities and that may have added up to the source of other revenues, which rose from 2.3 to 4.6 trillion yen between years 1999-2003. This increase was quite a lot but as said earlier these revenues might be put under pressure from new competitors according to the predictions of the American Chamber of Commerce. Operating costs has been declining. Since 1993 when banks were allowed to merge or take over other banks the operating costs has fallen from 7.7 to 6.4 trillion yen, a drop with 1.3 trillion yen. Most of this has been a reduction in expenses for wages; 1.1 trillion yen. If comparing the net operating profit before loan loss from the year 2000 when all deregulation had been completed to year 2003, the profits increased from 5.2 to 6.9, an increase with 1.7. Judging by these figures the banks seem to have increased their power over the market, but if looking at the figures more closely the whole increase of profits are related to larger revenues from other sources. These revenues we know are likely to be put under pressure

in the future, so the risk that banks might increase their power over the market is maybe not that great.

6.1.3 Summary of question one

When comparing the two perspectives there are signs of a bank market more open with increased competition. The government has abolished the partition laws and the regulated deposit interest rates. In addition to that the financial regime has changed in favor of a more non-discriminatory approach that would allow failure of individual banks if necessary. When analyzing the risk of the banks increasing their power over the market there are few signs of this since lending margin has went down after the deregulations. Even if the banks income from other sources than lending increased there are signs that increased competition will make this income fall in the future. So in general the deregulations favored a more competitive bank market.

6.2 Question two

Will the privatization of the PSS lead to a more competitive bank market?

6.2.1 Government preferential treatment

Japan Post is and has been getting preferential treatment by the Japanese Government that has implications since the Japan Post compete with private corporations in its major areas of both mail and parcel delivery, money remittance, bank services as well as insurance services. Even though these subsidies from the government are not direct subsidies, this way of subsidizing a single state-run company which is doing business in markets with a number of private competitors is not compatible with free competition. We saw before that the Japan Post offer money deposit services with very generous terms. In addition to the information that it also gets a substantial amount of state subsidies it looks like that these subsidies are used in order to offer these generous terms of their products and thus make it harder for other companies to compete. This is not only the case in the postal savings business but also very much in the life insurance business.

Another issue related to this is the design of the company after the privatization has been made. As told before the government changed the initial plan from banning the companies to cross-own shares in favor of allowing the same. This will raise questions about the new private companies' independence. As the mail services and the service outlet network

companies still will remain under state ownership there is a risk that the private companies can receive some indirect subsidies from the government in the form of capital transfers between the companies if they cross-own shares.

Another issue is how the chain of post offices will be owned by the network company after a privatization and all the four companies' products will be offered at these offices. If the postal savings company and the post insurance company not have to pay a fee for this service equal to market prices this will take the form of an indirect subsidy and must thus be monitored carefully by policy makers.

Another issue related to the questions whether the PSS stand free from the government or not, is the government protection of funds. In addition to the preferential treatment of not having to pay any fees for this protection they are seen as a safer place for savings just because they are a part of the government. The financial distress of the banks is the major explanation why. Even if the government removes all preferential treatment the PSS, if remaining government owned, will have an advantage of being seen as a safe haven for people's savings. This is because people will have the financial crisis and the failed Deposit Insurance Corporation fresh in mind and will view all deposits at the PSS as protected by the government.

6.2.2 Risk of a dominating company

If the market is dominated by one company there is risk that this company will abuse its power to keep competitors out as well as making excess profits. As we saw when analyzing question one there was little signs that the deregulations lead to this in the banking sector. But when we now start to look at the banks, not compared to one another but compared to the giant of the PSS the case might be different. The difference also from the analysis of question one is that analysis of the risk that PSS might end up in a dominant position would involve making predictions about the future. One cannot know exactly what power the company would get when it is free from government control. What one can do is to look at the historical economic performance of the PSS and its private bank competitors and try to find explanations to this performance and also how it is likely to develop in the future. If making a comparison between the performance and future opportunities for the PSS and the banks respectively one will get a picture of the relative strength of these. Then it will be easier to make predictions. Also to relate this to the expected conditions in the future, both in terms of regulatory issues that will matter for future performance but also and economic issues, one can hopefully be able to make more precise predictions.

The first thing to look at is the economic performance of the PSS. Although the PSS is protected and given a lot of favors by the government, the Japan Post has shown poor performance in terms of profits. The size here seems no guarantee for the company to show a good performance. Its profits have fluctuated a lot and in total averaged on a low level. One major explanation to that the PSS is/was making these losses is how the terms and conditions of their most important product, the teigaku deposits, are designed. In the result chapter we discussed how the PSS is sensitive to changes in interest rates. In 1997 when banks made huge losses, it led to a credit crunch. A credit crunch would lead to a reduced supply of loans, resulting in higher interest rates (Yoshikawa, 2002). Rising interest rates on the financial markets will make customers require a higher return on their deposits, making them renegotiate their teigaku plans. These demands made the PSS to make huge losses from 1998-2000. Also the banks made losses at this time but mainly because of their problems with bad loans and also likely because people distrusted the banks to handle their money. The distrust of the general public towards the private banks favored the growth of deposits at the PSS. Even so it is interesting to note is that in 1999 the PSS made their largest loss ever even though they had the largest amount of deposits ever. This illustrates more than anything that a high money deposit balance does not have to mean large profits. In this case it seems that an unfavorable product strategy is making the PSS make losses.

Given the discussion above one can say that the PSS is offering products to its customer too favorable for the company's own good. By doing so it can of course attract a large number of customers and that explains its large market share of bank deposits. But this must only be possible with support from the government. The fact that the PSS do not need to pay any fees in order for the Government to insure its deposits and the exemption from tax, as well as the other subsidies described earlier, means that it is possible to offer good terms for customers at the expense of competitors. But after the privatization when these subsidies disappear it is likely that the company will end up in trouble if it does not find alternative sources of revenue. The Teigaku plan is not a sustainable product to rely on as shown above. The company must provide new services in order to survive. The PSS seems to have such large market share just because it is providing a favorable product for the customers but which is not sustainable in the long run. When needing to make these Teigaku plans less favorable for the customers in order to secure a positive interest spread the balance of deposits can be expected to shrink.

The JCER made predictions that by offering new services or increasing the risk appetite of its investments the PSS can increase its profits. If doing nothing the balance has to increase

a lot. Given the previous discussion this seems most unlikely. The problems of receiving new sources of income might also worsen, as predicted by the American Chamber of Commerce. The competition on the bank market has increased, as seen before, so there are more companies fighting for these revenues. Another problem for the PSS is that it is restricted by the government to move into new business without government approval in accordance with the privatization plan and Postal Law.

Another possible explanation to the bad performance of the PSS is bad management. We saw in the theoretical framework chapter that it is likely that private companies are more efficient than government owned companies. As government companies are protected from bankruptcy there are little pressure or incentives to keep their operations efficient and productive. Also as we discussed earlier postal services are considered a right of everyone. Therefore a national post company can always be sure that the government would not allow them to go out of business. This is likely to have a positive impact on the company's costs and thus a negative impact on profits. When splitting up the Japan Post into different companies, the Post Corporation will be independent and the PSS can no longer free ride on the common rights of postal service. Then it will be just one of many banks. Therefore the threat of bankruptcy would be more frightening and incentives for a better management are likely to be the result. Cutting costs is one way to increase profitability. After the Japan Post was turned from a government authority into a government owned corporation they have shown that it was possible to cut costs. This could mean that if becoming private it is possible to cut costs even more. It could also mean that all opportunities of cutting cost are already taken advantage of, even if it seems unlikely.

The banks on the other hand, have their own problems. Burdened by bad loans the recession beginning in 1997 was a tough time. But as shown earlier the banks have now been able to reduce the amount of bad loans and been very successful with that in the recent years. Thus, it seems that the banks have their problems mainly behind them. However, there has been a trend of declining amount of loans that will make the prospects of earning interest income worse if this trend is not reversed. Also the problem with getting an interest spread aligned with the borrowers actual credit risk is also an issue. The recession seems to have taken its toll on the bank customers' willingness to take on new loans. But with a recovering economy the demand for loans is likely to increase and that makes it likely that the private banks can look into the future with a bit more optimism than the PSS.

Even if the banks' problems seem a bit easier than the problems of the PSS it is not likely, it seems, that any part can capture a lot of market power. However if the banks situation

will continue to improve with a lower share of bad loans, their situation is likely to improve. Also they might get some efficiency gains from the recent mergers that have occurred in Japan the last few years. In the case of PSS, it seems more unpredictable if it is going in a positive or negative direction. It is likely though that the teigaku plans cannot continue to be designed as it is today. It also seems that the size of the PSS' deposits not necessarily means that they have a lot of power over the market. Also the PSS's deposits are shrinking and deposits at banks are rising.

When comparing the future prospects for the banks and the PSS it is not possible to say that any part has a great advantage over the other. The banks might not have to worry a lot about competition from the PSS. This was also the opinion of Aki Kinjo at Amro in Tokyo, and Takae Hirata at Swedbank in Tokyo. The expected more equal situation of the PSS and the banks has implications on one element of the privatization plan: the transition period. When the assets of the PSS is transferred to an independent company, just as mentioned before, there will be a transition period on 10 years before the shares are sold on the market. During this time the PSS is not allowed to move into new businesses without permission from the government. This seems unfortunate as the study by JCER showed that entering new businesses can be one way for the PSS to solve their problems. The transition period is used to control the PSS operations, most likely intended to protect the banks from the great size of the PSS. When looking closely on the PSS we have seen that such protection is maybe not needed. It might even be the case that the PSS is the weaker part. This means that it is maybe a good idea to shorten the transition period or let the PSS freely engage in more business as it was needed in order to increase profitability. What talk against this logics is the experiences from Chile discussed earlier. The lesson from those experiences is that deregulation should be done first and after the market has been stabilized a privatization can be made. Compared to the time of the bad loan problem at its worst stage the market could now maybe be seen as reasonably stable. Also during the transition period the government could intervene which can make the PSS to get a feeling of safety of getting help if ending up in trouble. To avoid this, the government must be very firm and declare that the end of the transition period is very sharp and that no help will be given after it ended.

6.2.3 Summary of question two

The PSS are getting subsidies from the government, incompatible with free competition on the bank market. They get an extra bonus when buying government bonds and are exempt from paying various taxes and also insurance premiums on protection of their funds. Even

with these subsidies the PSS is showing very poor results when looking at the company's profits. Among others a bad product strategy is to blame for this. In order to get new income the PSS need to find alternative sources of income or increase the risk on their investments. If not doing anything and the deposit balance is continuing to fall the company is likely to end up in trouble. The banks have had some tough times but have managed to write off a large amount of bad loans and have returned to profitability. Since the banks have seen their finances improve and the PSS is doing not that good, the size of the PSS looks less problematic compared to what one might expect at a first glance. When analyzing deeper and seeing the full picture it is not possible to see that any particular part would dominate the market after the privatization is completed. Therefore if the privatization is made so that the PSS stand free from the government without any remaining preferential treatment the bank sector would be fairer and more competitive. Also the fact that PSS is seen as safer because they are a part of the government is talking in favor of a privatization. In order to make sure that the PSS stand free from the government so that the PSS cannot be seen as safer than other banks, a privatization can be a good solution.

5.3 Question three

Is the FILP system compatible with free competition on the bank market?

As shown earlier, the reforms of the FILP system in 2001 changed the system from being completely isolated from market forces to use financial markets as a channel to its funding with help from the FILP agency bonds. However these bonds together with investments in private and foreign markets represent only a minor part of the investments made with the funds raised by the PSS. The rest is used to buy FILP-bonds and normal government bonds that can be used freely by the Ministry of Finance. So in reality not much has changed despite the latest reform. The question is whether this system provides the PSS with unfair competitive advantages. There are a few major points. As we could see, with the old system the PSS got a premium on deposits with the Trust Fund of 0,2 % which represents a government subsidy as this is not given to private banks when buying government bonds. But this premium is not longer given as the funds deposited with the trust fund will be fully repaid at the end of 2007. So with the new system this issue will not be a problem for competition.

Another problem still very much present is the presence of government banks. As shown before the FILP entities consist of eight government banks or other lenders, mainly which

offer housing loans to the general public or loans to small businesses. These banks offer loans at below market rates. Some of its customers are people or companies which cannot get loans from elsewhere but some have a choice between government banks and private banks. Yoshino and Cargill (2003) points out that “government banks that are the most dependent on FILP funds compete directly with private banks”. This is a problem for the FILP system and the private banks in the new financial environment.

As government banks compete with private banks offering below-market rates the competition from these are hurting private banks. Given the problems with non-performing loans and trouble in general for private banks this seems most unfortunate. As discussed in question one the government has recently changed their policies towards risk and bank failures. As it was before the government did not let any banks fail. But with the new policy the banks are standing alone and in that context any unfair competition from government banks seems much more problematic. With these logics the government is first taking some income from private banks by competing unfairly with them and then it refuses to help banks if they end up in trouble. To solve this problem the government needs to be consistent in its policies, to let banks fail but also stop competing with them when they are not failing.

The reason the PSS and the FILP system avoided the reforms have been its strong backup from politicians and bureaucrats. When looking at all 41 FILP entities and all the different funds within the FILP system it is possible to get a picture of all people needed for the management of the system. All these authorities and public corporations offer many top jobs for politicians and top bureaucrats. They offer funding to a wide range of unprofitable companies and they offer help to rural areas badly affected by global competition. This means that the losers from a reform of the FILP system are many. As the PSS is the main source of funding to the FILP system a privatization will most likely be perceived threatening by all these people. And with these kinds of reforms the winners might be more numerous but they are not concentrated to a certain region or company, and they might not see the benefits and they might lack political power. The resistance against reform from within the system can be seen as an indirect threat against competition in the bank sector since the FILP system itself is a threat towards competition through the government banks and the preferential treatment of the PSS. In order to disarm this resistance the government could try to reduce the number of bureaucrats and reduce spending on management functions.

6. Conclusion

The Japanese financial system was created after WWII with a great deal of government regulation, international protectionism, and bureaucratic control. The main goals were to establish stability and a good environment for reindustrialization and increased living standards. In this context regulations were understandable and did not seem to have any negative impact as the Japanese economy was one of the most successful in the world in the second half of the 20th century. Like the whole financial system the banks were under strict regulation and supervision. The government was in charge of much of the financial activities and directed funds to selected key industries. The role of banks was to raise money for investments in the private sector and savings were encouraged by the government. In order to achieve stable conditions for financial institutions they were divided into functional or regional categories and were given protection from failure. However, when the international capital markets became accessible in the 70s and when financial crises hit the Japanese economy, both in the late 70s and in the early 90s, reforms of the financial system came onto the political agenda. Beginning in the early 80s and especially during the 90s the banks system was gradually deregulated. However one bank avoided reform. The PSS has been a major part of the Japanese financial system as the source of funds that make the financial intermediation of the government possible come mainly from the PSS. Since Japan has a political environment with a great deal of power by bureaucrats who uses the FILP system and PSS to stay in power and to get a lot of career benefits, an action to privatize the PSS must be a very risky thing to suggest as a politician. But the reform was eventually passed through the parliament in 2006.

In this study I have tried to put the reforms of the banks, the PSS and FILP system into a bigger picture by describing how the financial system works and how the different financial institutions are interrelated. The reforms have been investigated and their impact on competition has been analyzed. The reforms have been done in a way of incorporating market forces in a larger extent in the financial system and encouraging competition as well as changing the policies towards risk and bank failures. But how did these affect competition?

Starting with the deregulation of the bank sector it happened gradually during quite a long period of time. The deregulations can be seen as a way of dismantling different barriers to competition. The government has ended the protection and barriers of entry by abolishing functional and regional regulations. This has most likely increased competition on the bank

market. Also the laws prohibiting mergers and acquisitions by banks have been abolished. When analyzing whether there has been any unhealthy market concentration with increased market power from the banks, there was little signs of any negative impact. The lending margin of banks has been reduced but the income from other sources increased after banks could move into other services. The competition for this income is likely to increase in the future leaving mostly positive signs for competition in the bank sector. The government has also changed their attitudes towards risk and bank failure in favor of letting banks fail if necessary. This has likely reduced the incentives of irresponsible lending and can be seen as a way of being more non-discriminatory toward private banks.

For the future privatization of the PSS the general pattern is that this can add up to competition in the bank sector if carried out in the right way. This is not obvious however given the fact that the PSS is a major financial institution with a size that could disturb competition on the market after a privatization. However this is probably not going to happen. The large amount of deposits at the PSS is the result of a product that has very generous terms and is economically unsustainable on a competitive market, especially in times of changing interest rates. This has caused the profits of the PSS to be very low over time and sometimes negative. The trend of banks deposits is also negative for the PSS. Their competitors, the private banks, however have a positive trend on deposits even if their economic performance is not the best at the moment. Since the middle of the 90's they have had major problem with non-performing loans and some banks even went bankrupt. Still the banks have problems with getting the appropriate interest spread of different creditor risk categories. City banks have done better than regional banks when trying to solve the bad loan problem. It seems as the situation of private banks will improve in the future. The future for the PSS might not be as positive. Altogether this means that since both private banks and the PSS have economical difficulties there seems not to be any apparent risk that the size of the PSS will mean they can dominate the market after becoming private. This is in line with the expectations of the study of the Italian bank market.

The most obvious conclusion related to the privatization and its impact on competition is the favors given to the PSS by the government. The PSS has lost the most important premium from the Trust Fund but some benefits still remain like tax exemptions etc. These subsidies can be seen as used to finance the generous terms of their products that attracts customers away from private banks. Even if it is possible to just stop giving the PSS these subsidies the connection to the government still remains. This will become a problem when people are making judgments about the security of their savings. The current bank troubles

and the fact that the bank's deposits insurance fund has been depleted once in the 90s makes people mistrust the banks. At the same time, deposits at the PSS are seen as protected by the government. Therefore the PSS always has an advantage which is incompatible with free competition in the bank market. This talks in favor of a privatization in order to get a more competitive market on more fair terms.

When it comes to the FILP system and its implications for competition on the bank market some things are disturbing competition. The presence of government banks are troublesome since they compete directly with private banks in providing loans to small businesses and the general public. If these banks would have provided loans to only those who cannot get access to normal bank loans it would have been less problematic. Therefore action must be taken to correct this problem. Given the changes in the government's attitude towards bank failures it is appropriate to stop competing unfairly with private banks if the government does not want to save banks from going bankrupt. In the old system the government was responsible for the banks not failing and was willing to step in to help if needed. Then the government banks competing with private banks were less of a problem.

Another problem with the FILP system is an indirect threat to competition coming from within the system. The bureaucracy that the FILP system represents might resist reforms and try to reverse the privatizations, and defend their own privileges. This can be seen as a way for special interests to disturb the democratic process and a waste of money.

Altogether the deregulation and privatizations have been good in order to create a more competitive bank market. There are just a few negative signs but many more positive. With the privatization of the PSS the government has a great opportunity to end the preferential treatment of the PSS and at the same time make the competition between the banks and the PSS work in a better way. There is however no reason for the government to stop monitoring the developments carefully in order to avoid any disappointments. There are also a few aspects to be considered as shown earlier in the analysis. The transition period is one aspect. As the transition period limits the freedom of the PSS, the banks can be seen as winners of the transitions period being as long as 10 years. With the problematic finances of the PSS in mind, a good idea is to shorten the transition period in order to give the PSS a bit more of much needed freedom. The need of the PSS moving into new areas of business is one reason to shorten the transition period. Also when considering the fact that the revenues from other services has increased within the private banks PSS could increase

competition by going after this revenue. Shortening the transition period would also mean that the risk of the privatization plan being changed or abandoned would decrease.

Another issue for the government to consider is how to assure the separation between government and the privatized companies. It is very important that the PSS will not get an indirect subsidy from the post office network company, by offering all PSS products at the post offices for less than market rent. Also the cross-owning of shares should not be used as a way of subsidizing the PSS.

In short my recommendations to the government would be:

- Continue the privatization but reduce the transition period to half and give the PSS freedom to move into new businesses.
- Monitor the relation between the Japanese Post and the PSS to avoid indirect subsidies in the form of money transfers between companies. If possible prohibit the cross-owning of shares within the Japan Post companies.
- Monitor the pricing strategy of the Postal Network Company to make sure they charge market rents for providing PSS's services at the post offices.
- Stop government banks from competing with private banks by start charging market interest rates or close down these banks.
- Reduce the bureaucracy of the FILP entities. Many entities could be closed down or merged with others. By doing this the government can also reduce the power of bureaucrats and therefore reduce the problems of private interests in the government sector as well as saving tax money.

Further studies

In this study I have both been looking at historical figures but also trying to make predictions about the future. Always when making predictions it is of course good to come back to the subject and see whether the predictions were right. When relating this to the deregulation of banks and the privatization of the PSS a study like the study of Italian banks could be made. After a few years, similar data about concentration, margins, and marginal costs could be collected and Lerner indexes could be calculated. Then it would be

possible to know how competition, market power and concentration have developed. That kind of study I would recommend.

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