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Economic Outlook

Japan Moves toward Sustainable Recovery

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Japan's stock market, one of the world's strongest this year, is up about 20 percent since spring. It is doing remarkably well for a country whose nominal GDP is still below its 1997 level. By contrast, the U.S. stock market has been drifting lower all year. The S&P 500 Index is down about 4 percent in the last five months, even more when the high-flying energy sector is excluded. This is the case despite U.S. nominal GDP having grown by a cumulative 46 percent since 1997. Clearly, stock markets are looking ahead and seeing a brighter future for Japan than for the United States.

The Japanese stock market's rise is tied to the steady progress made over the last several years in improving the operation of the country's capital markets while removing the regulatory burdens facing its corporations. The recent, dramatic victory of Prime Minister Junichiro Koizumi on privatization of Japan's huge postal savings system represents a key step forward for Japanese capital markets and for their ability to abet efficient deployment into productive uses of Japan's formidable $7 trillion total pool of savings.

Japan's banking system is now in a position, thanks to the disposal of bad loans, to serve as a viable financial intermediary in the event that domestic demand revives on a sustainable basis and deflation is brought to an end. There are signs that inflation expectations are stabilizing around zero and may move higher over the coming year, allowing the Bank of Japan to move away from its zero interest rate policy. As ever, caution is warranted lest premature removal of monetary accommodation cause a drop in demand growth as it did in the 2000, when the Bank of Japan last tried to move away from zero interest rates.

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Postal system privatization is a dynamic new force that will help to ensure sustainable growth in Japan's economy, even as extreme monetary accommodation is removed. For decades, the country's postal savings system, with its monopoly on retail financial service branches at every post office, made it difficult for banks to compete for deposits. Beyond that, the system has accumulated over $3 trillion worth of assets (about 30 percent of Japanese households' savings) and has "invested" the funds in a manner that has not been designed to maximize growth or rates of return. Rather, it has been employed wastefully to satisfy the financing demands of the Japanese government and to fund questionable public works projects, including the famous "bridges to nowhere." Redeployment of Japan's substantial savings, including those invested in the postal savings system's large share of the government's outstanding bonds, will help Japan's economic recovery continue.

Post Offices Now Offer Mutual Fund Shares

There has been substantial grumbling about the slow pace of Japan's postal privatization, even after passage of Prime Minister Koizumi's privatization law. This is understandable in view of the nominal 2017 completion date of privatization. However, the most important aspect of postal privatization is already underway. Since October 1, it has been possible for Japanese savers to buy shares in mutual funds directly at their post office windows. Three institutions—Goldman Sachs, Daiwa Securities, and Nomura Securities—were the winners in the first round of bidding to initiate mutual fund outlets in Japan's post offices.

Part of the bidding process was a presentation to the Japanese government of plans to train postal officials to advise their depositors on the benefits of alternative mutual fund investments. These are the same postal officials who, in the past, have mopped up literally trillions of dollars of assets from Japanese households for use by the government to purchase government bonds or to finance shaky public works projects. Now, the post office, the key financial institution in the postwar period for most Japanese households, is being mobilized to help attract Japanese savings into productive uses in the private sector.

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The simple fact that Japanese households can now buy mutual funds at their post offices may not sound very impressive to most American investors, who are accustomed to a wide range of savings outlets including, literally, hundreds of mutual funds. Yet, in Japan, where outlets for savings have been monopolized for years by the government, this is truly a big step. Anyone who doubts the significance of the transition to mutual fund offerings at the post office need only take a look at the long faces of the unsuccessful bidders in the initial round of selecting the firms permitted to offer their funds at post offices. Major names like Fidelity, Mizuho, and Shinsei Bank were all eagerly seeking a presence in the post office and will be aggressive bidders in the next round of allocating slots.

Japan's 24,000 post office branches have long constituted a dream opportunity for any financial institution seeking direct point-of-sale access to the nation's legendary savers. As already noted, but worth repeating, for most of the period since World War II, Japan's post offices have monopolized the access of Japanese households to financial markets. The system is popular because in the past, with government subsidies, the post office has been able to offer attractive deposit options such as the 6 to 8 percent coupon ten-year bonds offered in the early 1990s, before Japan's deflation really set in. Banks and brokerage houses just could not compete with the postal system offerings, except during the bubble years of the 1980s in Japan's stock market.

But these days are over. Now, as existing postal service deposit instruments come due, Japanese savers will be able to select from a broader range of outlets for their funds. Beyond that, the post office is no longer empowered to offer such unusually attractive terms, since the lengthy period of deflation and poor economic performance has meant far lower yields on postal service deposits.

Since the 1990 stock market crash, which was followed by years of deflation and poor, fee-laden service from shaky banks on deposits paying virtually no interest, Japanese households have accumulated trillions of dollars worth of cash held literally "under the mattress" or in what have become very low-yielding (below 0.5 percent annually) deposits at the post office. Over the last three years, cash and deposits (mostly cash) of Japanese households averaged about $7 trillion or about 54 percent of total personal financial assets of $13 trillion. Stock holdings in 2004, at about $700 billion, amounted to just 10 percent of the cash and deposits category and constituted only 5.4 percent of personal financial assets—up from a mere 3.8 percent in 2002.

A Boost to Stocks and Growth

Japanese, not to mention global financial markets and the Japanese economy, could be powerfully affected by the newfound ability of Japanese post offices to serve as a conduit for Japan's large pool of savings into effective use in financial markets. Global investors are already excited about the prospects for Japan's slimmed-down, well-managed large companies. Their purchases of Japanese stocks are largely responsible for the market's stellar performance this year. If Japanese savers decided to join global investors as stock buyers and move just 10 percent (or $700 billion) of their cash and deposits into stocks, the result would be higher stock prices and substantial wealth creation in Japan that would help to boost domestic demand—a necessary condition for economic recovery. Higher stock prices would, in turn, be based on strong fundamentals: a market capitalization of improved prospects for growth.

Japanese households, long deterred from stock markets by the perceived risks associated with the market crash of 1990, as well as by the subsequent market doldrums throughout the 1990s and for most of this decade, are now looking at improved fundamentals in the Japanese economy. Deflation has eased; foreign ownership in equities is rising. Foreigners are impressed by the unwinding of cross-shareholdings and the rise in dividend returns to over 4 percent. Improved labor incomes have boosted Japanese household confidence. The initial response of those households has been to invest heavily in foreign bond funds. Their next step, once they see a truly sustainable economic recovery in Japan—one that erases bad memories of the false starts over the past decade—will be to buy Japanese stocks.

Japanese policymakers appear to have reached the conclusion that the flow out of cash by households into foreign bonds can be partly (at least) diverted into Japanese stocks. This may be one of the reasons that Prime Minister Koizumi was so adamant about continuing postal system privatization. The future of the mutual fund outlets and post offices would have clearly been in doubt without the legislative approval of the full postal service privatization process.

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The redeployment of Japanese savings through the new mutual funds at the post office could initiate a virtuous cycle of growth. If the Nikkei 225 stock market index, as a result of a modest injection of the households' idle cash, rose by another 30 percent—say to 18,000—Japanese households would experience a wealth gain of about $210 billion on their current modest equity holdings. If just 5 percent of that wealth gain were spent, 0.2 percentage points would be added to GDP growth. That increase is significant in an economy where long-term sustainable growth is expected to be about 1.5 percent. It could, among other benefits, boost stock prices further.

Auction Off the Mutual Fund Windows

There is one more step financial reformers could take to improve the functioning of capital markets in Japan that is so critical to maintaining the momentum in Japan's recovery. The process of allocating access to the postal service as an outlet for mutual fund shares and other financial services should be made more transparent. Financial service providers should be able to bid openly for the right to offer financial services at Japan's post offices. The initial round of allocations was somewhat opaque. While private financial services firms seeking the post office franchise did include bids for the franchise in the package they offered for outlets in the post offices, other unspecified factors were involved in the final allocation.

A simple auction of these outlet franchises would be best. If enough private firms bid for and attain access to the post office as retail outlets, beyond recognizing substantial financial gains, the government's goals of liberalizing the financial services industry will be well served. A large number of financial outlets at the post office will generate competition among providers of financial services that will ensure the lowest cost and most effective access to such services for Japan's households.

Japan's economy is on the move, and while it will continue to have its ups and downs, Prime Minister Koizumi's postal service privatization drive will play a significant role in sustaining a higher level of performance for Japan's economy. The post office can play a key role in mobilizing Japan's substantial pool of savings into market-driven rather than government-directed utilization of the funds. The result will be improved resource allocation and faster growth in Japan.