A Study of the Investment of Japan's Public Pension Reserve Fund

- How Should the Government Behave as an Institutional Investor?

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July 2003

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Summary

Japanese public pension insurance programs have a reserve fund as large as 30% of GDP while they work on a pay-as-you-go basis. The funds were until 2001 automatically deposited with the Ministry of Finance to finance the investment in infrastructure and other public policies. In 2001, a major reform was implemented and instead of automatically depositing, the government has started market investment of the funds, thereby making the government the largest institutional investor who is responsible for the goal of maximizing the return of investment on behalf of the insured.

If the government has to pursue any other goal than above due to political pressures on their investment decisions, a decline in the efficiency of the market and resource allocation would follow possibly leading to a lower level of future GDP. At the same time it has a goal of enhancing public interests often through intervening in the profit-maximizing behavior of the firms. However, the government may have a large stake in these firms as an institutional investor, which may give rise to “intermingling” of policy goals inside the government. Moreover, the government sends a signal to the public that, by earning a higher return on the investment, it will be able to reduce the burden of the future working generations to support the life style of the elderly. In the light of “zero-sum game” nature of the government investment, this may be a wrong signal since it could generate a false sense of optimism among the public. On the other hand, a larger fund and a higher rate of return on the investment thereof will secure a larger slice of the economic “pie”, i.e. future GDP, for the elderly without an often painful political process of increasing intergenerational transfer through raising the insurance premiums.

In countries such as the US and Canada, independence of the investment body is often advocated as a solution to the above issues. However, independence is only a partial solution.

Now is the time to start a policy debate with a wider range of viewpoints.
Introduction

In Japan, the public pension system operates on a pay-as-you-go basis. It is mandatory to join and one has to pay the pension insurance premiums. In a pure pay-as-you-go system, no pension reserve fund greater than a running balance accumulates over time because cash outflow drawn by beneficiaries approximately equals the cash inflow provided by the working generation. However, as is also the case in the US and Canada, the pattern of economic growth and demographic distribution in Japan have led to the accumulation of a large pension reserve fund equivalent to around 30% of GDP. The reserve fund, as a result of “Reform 2001” (explained below), will be in its entirety invested in the financial markets by an investment arm of the government called the “Government Pension Investment Fund” (GPIF).

When governments act as an institutional investor in the financial markets, it is necessary to carefully consider the following three points:

1. Is investment by the government damaging the function of the financial market?
2. Are conflicts of interests arising as the government acts as an investor?
3. Should the point 1. and/or 2. hold true, i.e. costs are incurred through a drop in market efficiency (and the risk thereof) or through conflict of interests (and the risk thereof); can the government institutional investment be justified?

The establishment of GPIF in 2001 was the outcome of an initiative to drastically reform the process known as the Fiscal Investment and Loan Program (FILP) in which the Japanese government acted as an intermediary between the public as savers and governmental entities which utilized both the pension fund and the postal savings fund to build infrastructure and implement industrial, social and other policies.

The financial intermediation structure built around FILP was initially effective and efficient in providing funds necessary for the development of social infrastructure and projects that could not otherwise have been financed. However, FILP came under criticism as it became apparent that the allocation of funds by the government was grossly sub-optimal. Preceding the revision of the financing framework, Japan had an opportunity to debate the above three critical points carefully and formulate sound policies, but unfortunately did not seize that chance.

Urgent measures were required to restructure FILP and it is therefore understandable that the less pressing issues not having an immediate and conspicuous negative impact, such as how to

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1 The Japanese public pension system works as an insurance program in which money collected from the working generation is in the form of insurance premiums rather than tax, as is the case with the US’s social security tax.
revise the framework for pension investment, were not debated as a matter of priority. However, such debate cannot be postponed indefinitely.

In this paper, I would like to draw together the arguments pertinent to that debate, and provide the basis for future discussion.

1. Characteristics of Public Pension Fund Investment of Japan

The New System (implemented in fiscal 2001)

In Japan, a large proportion of financial intermediation is carried out through the government related channels. The balance of Japan’s postal savings has reached approximately 230 trillion yen and the pension fund now stands at around 150 trillion yen. These numbers are to be compared with the actual deposits in domestically licensed banks standing at around 500 trillion yen or the nominal GDP that is also around 500 trillion yen.

Before revision in fiscal 2001, the entire balance of both the pension and postal funds were automatically deposited with the Ministry of Finance’s Trust Fund Bureau, and was subsequently provided to governmental entities through FILP. FILP covered investment and loans to the government entities such as the Government Housing Loan Corporation (responsible for concessionary rate home loans), the Japan Highway Public Corporation (highway construction) and a few government related banking institutions, for example the Development Bank of Japan. This means that the scale of FILP was not determined by policy related financing needs and tended to swell. In other words, FILP continued to receive funds passively irrespective of the need or lack thereof for financing. In order to resolve this fundamental problem, the way in which the pension and postal funds are invested was radically reformed in 2001 (referred to henceforth as “Reform 2001”). Rather than automatically being deposited with the Trust Fund Bureau, the Ministry of Public Management, Home Affairs, Posts and Telecommunications and the Ministry of Health, Labor and Welfare (MHLW) have begun independently to invest the postal and pension funds respectively in the financial markets.

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2 The Japanese government had for a long time been investing a large fund in equity and other private financial instruments even before Reform 2001 (for a more detailed explanation, see 4. (1)).
**Before “Reform 2001”**

- public pension reserve fund
- postal savings

Automatic depositing

Trust Fund Bureau

FILP

governmental entities

**After “Reform 2001”**

- public pension reserve fund
- postal savings

- financial markets

- bonds

- government

- stocks, bonds

- firms

- bonds

- FILP

governmental entities

### Government as “by-far-the-largest” Institutional Investor

Currently, the public pension program reserve fund is approximately 150 trillion yen, the bulk of which is still invested in the pre-Reform 2001 structure because funds are deposited with the Trust Fund Bureau with a seven year maturity and approximately one seventh is redeemed every year to be invested in the market by GPIF.

It is instructive to compare the presence of GPIF in the financial markets with the total investment in securities by life insurance companies in Japan of 110 trillion yen (as of March 2003). When all the funds are redeemed in fiscal 2008, the government will be “by-far-the-largest” institutional investor.

Investment by GPIF will be in line with the “Basic Portfolio” as determined by MHLW. The current “Basic portfolio” is shown below.

### “Basic Portfolio” (%)

<table>
<thead>
<tr>
<th>domestic bonds</th>
<th>domestic stocks</th>
<th>foreign bonds</th>
<th>foreign stocks</th>
<th>short term assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>68±8</td>
<td>12±6</td>
<td>7±5</td>
<td>8±5</td>
<td>5</td>
</tr>
</tbody>
</table>

(MHLW)

To implement the “Basic Portfolio”, GPIF employs fund management firms to direct the majority of the fund, whilst in-house managers invest a small fraction. Fund managers determine

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3 As of the end of March 2001, 147 trillion yen.
individual assets to buy and sell. As of the end of December 2002, GPIF manages 30.1 trillion yen, 7.2 trillion yen of which is invested in domestic stocks. The proportion invested in domestic stocks of 24% is significantly higher than that dictated by the Basic Portfolio because GPIF succeeded the former Pension Welfare Service Public Corporation in 2001 which maintained a portfolio with a higher domestic stock investment ratio. As more of the deposited funds are redeemed, GPIF will manage those funds and in 2008 will ultimately manage the entire fund as the shift to the Basic Portfolio is completed.

When the Basic Portfolio is realized, and assuming that the total reserve fund remains around the same level, GPIF will hold about 18 trillion yen in domestic stocks, i.e. (approximately 150 trillion yen) x 0.12 \approx 18 trillion yen, allowing for a deviation of \pm 6\% of the total fund. This compares to a current total capitalization of about 280 trillion yen for the first section of the Tokyo Stock Exchange (TSE) given a TOPIX value of around 800 and Nikkei Index of around 9,000. This means that about 6 per cent of TSE, depending on the level of the stock prices, will be under the control of the government, and in many firms the largest shareholder’s stake is less than 10 per cent. Fund managers will exercise voting rights in line with guidance from GPIF, which is designed to best serve shareholders’ interests.

(3) Lower Degree of Independence of GPIF

GPIF is not as independent as similar governmental investment body such as Canada Pension Plan Investment Board (CPPIB). GPIF is closely supervised by MHLW, and the President and the Internal Inspectors are appointed by the Minister. MHLW has to work as far as possible to be a guardian defending investment decision by GPIF from political interference although it should be noted that MHLW itself is not necessarily free from a bias.

The directors of Canada’s CPPIB are selected through a process designed to avoid political bias or the appearance thereof. This is not the case for GPIF. Furthermore, GPIF needs to obtain formal approval from MHLW for its annual budget.

2. Two Impacts of the Reform

The reform and transition to the new system will have two impacts.

Firstly, the government will become more of a player/investor in the financial markets and ultimately become “by-far-the-largest” institutional investor, thereby attaining the status of “partial owner of Corporate Japan”.

Secondly, despite the “pay-as-you-go” nature of the Japan’s public pension system, the government has conveyed to the public that, with the government earning greater investment return in the markets, the burden to be born by the working generation to support the lifestyle of future retirees will be reduced. This may lead people to believe that the government has some untapped
resources for future pension benefits.

(1) Impact of the Government Being the Largest Institutional Investor

(a) Conflict with Political Interests

In the United States and Canada, how to invest the public pension fund such as the Social Security Trust Fund of the US was widely discussed in mid 1990s and one focus of the debate was on the desirability of investment in equity and other private financial instruments.

Opponents of such investment highlighted the risk by referring to “social investment”, decisions which are made to encourage or discourage investment in specific interests rather than to maximize investment return. Examples of “social investment” might include disproportionately large investment in certain ethnic interests, or restraint on investment in companies with extensive operation in countries with human rights problems.

Three problems will arise due to “social investment”.

Consider the example of “social investment”, in which the funds are directed to small and high-risk businesses in a distressed community whereas the government cannot charge the rate of return consistent with the risk. In other words, the government invests in a high-risk and middle return borrower.

Firstly, the balance between risk and return will be unfavorably skewed thus conflicting with the interests of the generation contributing to the pension system.

The second issue is related to the process of the decision-making. If community investment is justified as a public policy then that investment should be determined through the same process of decision-making and of evaluation as other social policies. “Social investment” could be an important exception to the orthodox process. It is non-elected officials who make investment decisions and social investment via the pension reserve fund could leave these officials in a position of excessive power. “Social investment” would mean that money belonging to the pension program is de facto spent to subsidize social policies or to finance the governmental financial activities to enhance social policy objectives, thereby bypassing the usual budgetary and legislative processes.

The third issue is potential damage to the function of financial markets. If the government is smart and plays in the market solely to maximize return, resource allocation by the financial markets will remain efficient. However, “social investment”, through which the funds are allocated for a goal other than maximizing the return, distorts resource allocation, and will have a negative impact on efficiency meaning future capital stocks will be less productive, conflicting with the interests of the future generation.

The problem as above of bypassing the due process of policy decision-making and
distorting market function may arise in a much broader fashion and on a greater scale when driven by various political interests. The government becoming a partial owner of Corporate Japan will have an unpredictable impact on the corporate governance structure. Politicians might exert undue influence on corporate strategy as a result of equity investment by the government, which will pose conceptual as well as practical challenges.

Solutions proposed to address these issues in the US and Canada included, (1) investing exclusively based on indices in order to avoid difficulties in selecting between individual stocks and (2) investment to be carried out by an independent entity in order to insulate investment decisions from political pressure. The conclusions reached following debate differed between the United States and Canada. The United States chose not to start equity investment. Canada established a body (CPPIB), whose investment is not exclusively index-based, designed to begin equity investment independently, thereby alleviating the problems associated with social investment and lower efficiency.

(b) Conflict with Other Functions of Government

The second central issue is that of potential conflict of interests between the objective of maximizing return on investment, a relatively new aim for the government, and other long existing functions of government.

Government intervenes for various policy purposes in the profit maximizing behavior of firms. Should the government be a major shareholder in a particular firm, conflicts will arise between the need for intervention and the needs of pension contributors. Such conflicts could occur across a whole range of areas, five examples of which are outlined below.

(Example 1: Medicine pricing)

The Japanese government determines medicine prices to be covered by medical insurance programs. The government may well be, through investment of the pension reserve fund, a large shareholder of a pharmaceutical company, which wants to see an increase in the price of medicines. At the same time, the government is required to control medical expenditures by setting appropriate price levels. The government must play a difficult double role.

(Example 2: Protection of workers)

The government is responsible for the implementation of labor laws to protect workers. If the government is a large shareholder of a company involved in a labor dispute, and is called upon for arbitration, will the labor union trust the government to be an honest broker?

These are just two examples that in Japan fall to the responsibility of the Minister of Health,
Labor and Welfare, who is at the same time in charge of investment of the pension reserve fund. Problems will also arise outside the jurisdiction of the MHLW, for instance in banking supervision.

(Example 3: Banking supervision)

Suppose a bank is in a trouble and its shareholders’ equity is diminished. A rational strategy for its shareholders is to gamble in high-risk-high-return transactions defying the charge of “moral hazard” because the shareholders have little to lose if the transactions go sour, but a lot to gain if they are lucky. The depositors and the government as the safety-net provider bear the risk. Banking supervision would prevent the bank from gambling to protect the depositors and the safety net, thus losing a chance to maximize the return to best serve the pension contributors. The government will be faced with a difficult choice between prevention of the gamble and maximizing the rate of return on investment.

Macro economic policy may well be in conflict with the government’s mandate to maximize return.

(Example 4: Policies in support of stock prices)

When the economy is expected to enter a mid to long-term downturn, it may be a rational judgment for the government in its capacity as an institutional investor to reduce the allocation of funds in domestic stocks. However, a downturn may well be a time when the government needs to support the stock market to maintain confidence in the economy. The government will be in a difficult position between the effectiveness of its own macro policy and its responsibility as institutional investor.

(Example 5: Exchange rate policy)

From time to time exchange rates stay away from a level consistent with the long-term economic fundamentals, and the government’s exchange rate authority (Ministry of Finance) intervenes to awaken the intoxicated market. This action will be based on the judgment that the current rate is not in line with the economic fundamentals. However, it is not unlikely that the MHLW/GPIF has an alternative view on the exchange rate and wishes to change the allocation of the fund in the opposite direction to that of the market intervention. It is possible that while the Ministry of Finance is selling the dollar to offset capital outflow, the MHLW/GPIF is buying the dollar to increase foreign assets in the portfolio.

This will confuse the market and erode the awakening impact of the intervention and therefore the effectiveness of exchange rate policy.

Conflicts as illustrated by the above examples will not be entirely solved by making the
entity responsible for investment decisions independent, i.e. attempting to shield it from political pressure.

The government, as an institutional investor, joins the investment game as a player, and at the same time, as “playing-referee”, intervenes in the profit maximizing behavior by firms to protect the public interests through implementing such policies as environment, food safety, anti-monopoly policies and so on. There is potential for a lack of coordination in these dual-roles, which would lead to a subsequent general loss of confidence in the effectiveness of government policy. The public may suspect that there is some intermingling of interests inside the government ultimately resulting in poor policy. Lack of confidence in policy often leads to a greater risk premium, less overall investment and therefore a smaller future national income.

It should be noted that loss of confidence in policy and in the integrity of the financial markets and resulting higher risk premiums would be significant costs associated with investing pension reserve funds in the private sector.

(2) Disproportionate expectation on the investment return

The Japanese government has repeatedly said that if it earns a higher yield from its investments, the burden on the future working generation for premium payments will be reduced. This is correct in the sense that the burden of “the payments of premium of the pension insurance” will be reduced. However, the Government’s statement should not be interpreted as meaning “if the government earns a higher yield from its investment, it will become easier to provide the future elderly with resources to support their lifestyle while also maintaining a higher standard of living for the future working generation”. If misinterpreted in such a way, it may foster a counterproductive and false sense of optimism.

For future national income of any given level, it is simple arithmetic that there cannot be sufficient resources to provide the future elderly with ample benefits without lowering the standard of living of the working generation.

For the future working generation to support the lifestyle of the elderly while realizing themselves a higher standard of living, future national income needs to be greater. This can be brought about in any or all of the following ways (i) increasing working capital stock in the future via increased levels of saving by today’s generation, (ii) increasing labor input such as by lifting the age of retirement, (iii) increasing productivity through technological innovation and/or making resource allocation more efficient. Performance (i.e. rate of return) of investment by the government of the pension reserve funds will determine the share to be taken by the pension program. If the government is a smart investor, more resources will flow into the coffers of the pension program thereby reducing pension premiums to be paid by the working generation. However, as national income is finite, the more the government takes for the pension program, the less will be left for
Consider an extreme case for illustration. Suppose the pension program owns all the capital and the income allocation is such that capital takes 80% and labor 20%. In such a situation, there will be almost no need to collect pension premium or tax from the working generation because 80% of the national income is secured for pension benefits, while probably the standard of living for the working generation will be very low. A higher rate of return on the government investment is not necessarily the interest of the working generation.

The larger the share that is given to the capital stock the government owns, the less that can be given to labor and capital stock belonging to the private sector. In other words, the government competes with workers and private sector investors for a larger slice of the economic “pie” whose size is given for any given amount of capital and labor employed in the production process.

In 1999, Alan Greenspan, the Chairman of the Federal Reserve Board, in his testimony before a committee in the US House of Representatives, referred to the investment of the Social Security Trust Fund in equities as “largely a zero-sum game”.

**On investing the social security trust fund in equities** (excerpt)

Testimony of Chairman Alan Greenspan
Before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, U.S. House of Representatives
March 3, 1999

“the transfer of social security assets from U.S. Treasuries to equities would not, in itself, have any effect on national saving. Thus, the underlying economic assets in the economy would be unchanged, as would the total income generated by those assets. Any increase in returns realized by social security must be offset by a reduction in returns earned on private portfolios, which represent, to a large extent, funds held for retirement. Investing social security assets in equities is, then, *largely a zero-sum game*. To a first approximation, aggregate retirement resources--from both social security and private funds--do not change.”

Making the public believe that the government will, without disproportionate cost, be able to somehow create wealth out of investment will dispel sense of urgency required to build a political consensus on how much intergenerational transfer the government should make in an aging society.

The message the government as operator of the pay-as-you-go pension program should convey is that greater future national income will assure greater intergenerational transfer.

An important reservation that should be noted, especially in a country like Japan where investors’ risk appetite is limited, is that if overseas investment delivers higher yield then future “national” product (but not future domestic product) will be greater and it will be possible to pay higher pension benefits without reducing the standard of living of the future working generation. If
the rate of return is greater overseas than at home, the government could work as investment channel, and could do so efficiently because investing in large volumes economizes transaction costs.

3. What Cost to Compare with What Benefit

(1) Cost to be Recognized

As discussed above, we need to recognize that the costs of the government investing pension reserve fund in private financial instruments are twofold.

The first cost is what may be termed as “efficiency cost”, a loss of economic efficiency through politically biased investment decisions or loss of confidence resulting in a rise in risk premium.

The second cost is “consensus cost”, due to confusion over the impact of the return on investment by the government on the sustainability of the pension program. Consensus cost will possibly lead to a loss of sense of urgency, and will be dearer in an environment with a rapidly aging population and continued economic sluggishness where it is even more necessary to make difficult economic decisions or “bite the bullet”. This is particularly true for Japan.

“Investment fees” payable to fund managers in the private sector obviously represent another cost to be regarded as an additional burden.

(2) Benefit to be Considered

What are the benefits to be compared with these costs?

Because, as Chairman Greenspan says, investment by the government is “largely a zero-sum game”, a higher return per se will not be a benefit in that it provides additional wealth to the future generations as a whole. However, a higher return and a greater reserve fund do provide more “liquidity” to the pension program.

Liquidity is important because it buys time for building political consensus and reduces uncertainty that future benefit payments will be disrupted due to lack of time for the political process.

It is critically important to distinguish between private pension funds and a public pay-as-you-go pension program in terms of the role to be played by fund investment. A larger return on investment in a private pension fund means more wealth belonging to the fund, i.e. the “pie” is enlarged. On the other hand, a larger return on investment in a public pension program will give the government more claims over future resources secured for pension benefits without going through the political process of consensus building for higher insurance premiums in the case of Japan or social security tax in the United States. While a higher return on investment by the government does not enlarge the ‘pie’ of future national income, it does make it easier for the
government to secure a bigger slice of the ‘pie’ for pensioners.

4. What Should Be Debated?

(1) Missing Debate

It is remarkable that the debate preceding “Reform 2001” in Japan almost entirely bypassed rigorous consideration of costs (efficiency cost and consensus cost) and benefits (enhanced liquidity) of government investment as analyzed in this paper. It was a priori assumed that investment would provide additional resources to the pension program thereby making it easier to support the future elderly, and consequently the debate focused on asset allocation, applying the theory of financial engineering to the investment, building safeguards against insider trading and the fiduciary duty of the fund managers.

Neither was the independence of GPIF fully discussed. In the current framework MHLW determines the basic portfolio, i.e. asset allocation, and GPIF implements it. GPIF is not an independent entity like Canada’s CPPIB, and the MHLW needs to play the role of the guardian for the GPIF against the political pressure. However, the supervisory responsibility of the MHLW might become the channel of the political pressure. It was fortunate that it was stipulated that in making investment decisions the interests of those who pay pension insurance premiums should be given priority, although the staff of MHLW and GPIF are not given any institutional protection as a defense against political pressure.

It is to be noted that it is an important exception to market economy that the government is an institutional investor who seeks to maximize the return. In searching for a reason for the lack of rigorous discussion in Japan required to allow the exception as above, one must think of historical inertia. From 1986, the former Pension Welfare Service Public Corporation began market investment with funds borrowed from the Trust Fund Bureau. Postal Life Insurance (Kampo) for decades has been investing the funds in public bonds as well as in private financial instruments including stocks and corporate bonds. With this historical background, it is no surprise that it was a tough challenge to deny the justification of the existing institutional framework.

“Reform 2001” was an extremely important action that abolished the automatic depositing with the Trust Fund Bureau, and it is well understandable that a swift action was the priority at that time. The reform allowed a fundamental change to the way money flew through the government that automatically channeled a huge sum of money into FILP, and created an enormous degree of freedom.

One might argue that Japan for decades has been living with the government as a huge institutional investor without a serious problem. Efficiency cost could have been negligible.
However, there are a few important contradictory arguments to be made.

Firstly, there have been from time to time media reports in Japan that ruling party politicians suggested to MHLW that it support the stock market with the fund but that MHLW refused to do so on the grounds that the fund should be invested solely for the benefit of the insured. There may have been already a negative impact of political pressure, if not one has been detected.

Secondly, political pressure will be greater when the government has to sell assets to pay pension benefits (drawing down the reserve) rather than when the government buys assets and increases the reserve. In Japan the fund has been consistently increasing. It will be more acutely necessary to sell the assets when the economy is in recession with falling wages and when money-flow into the pension program is shrinking. Then political problems may arise if the government wants to sell stocks prompting lower stock prices, sell bonds thereby increasing long-term interest rates, or sell foreign currency assets resulting in a higher yen. In this regard, the real test is yet to come.

Thirdly, it will be more difficult to correct the misallocation of resources by market mechanism when the economy is in deflation because the downward rigidity of prices will decelerate the reallocation of resources. Under the inflationary environment hitherto, the efficiency cost of investment by the government may have been smaller. Now that we are in a deflationary environment, we need to be more careful not to create an institutional structure that will give rise to a misallocation of resources.

(2) What Should be Debated

A higher return on investment of a private pension fund directly leads to expansion of the “pie” and the goal of supporting the life of the elderly will be achieved. However, in a pay-as-you-go public pension program, a higher return on investment does not entail a larger “pie”. Understanding of this relationship should be shared among participants in the debate. It should be made clear that future national income is the key factor in determining the standard of living for both retirees and contributors, and that it is in their interest to maximize future national income through the efficient allocation of resources.

On this basis, the impact of efficiency cost and consensus cost should be compared with the benefit of enhanced liquidity.

(a) “Efficiency Cost” and Independence of the Investment Body

“Efficiency cost” depends on how far the investment decisions are distorted away from the goal of maximizing the return, and, by making the investment body independent, will be alleviated. Under the current situation in Japan, it is not a meaningful alternative to stop
purchasing stocks, or even less so to liquidate the existing stock portfolio. A solution that can be placed on the policy-debate arena will be to give GPIF a substantially higher degree of independence. In Canada, CPPIB that is highly independent has been in operation, and its institutional structure can be at least partially modeled after. However, independence of CPPIB is made possible at least partly by carefully dividing the power of the government on nomination of the board members between the federal government and the government of the provinces. This is a country-specific framework based on the fact that Canada is a federal state, and it cannot be a panacea to simply copy this structure for Japan, which is not a federal state. Moreover, CPPIB has not experienced yet drawing down the fund and it is yet to be seen how independence works to cope with the impact of selling the assets on the market.

Independence reduces “efficiency cost” primarily through shielding investment decisions from political pressures to prevent social investment and excessive intervention by the government in corporate management. Additionally, it will also work to reduce the negative impact from the conflict between the goal of maximizing the return and other goals of the government. This will be made possible so far as it is a view widely shared among people and in the financial market that the investment body is de facto outside the government and that if other parts of the government pursue the goal other than maximizing the return people do not perceive that the government is split.

The source of the reserve fund is insurance premium collected by the government, and the investment of the fund is obviously the responsibility of the government. There will be some legitimate concern that, if the investment body is independent, the government will not be able to fulfill this responsibility. A similar concern is often expressed in the context of the independence of a central bank. The argument that the government will not be able to implement a fully coordinated set of economic policies if the central bank is made independent has been repeated many times. The debate between this argument and the one in favor of central bank independence followed a path that differs from country to country, and the central banks are independent to varied degrees in a country-specific manner. The reason for making a central bank independent is to better maintain price stability, which is a very extensively shared idea. On the other hand, the rationale for independence of investment body to reduce efficiency cost has not acquired a similar status to that of central bank independence. The argument for independence of investment body will have to start with defining the rationale.

In 2002, the Bank of Japan started a purchase of stocks held by commercial banks exceeding their Tier I capital to reduce market risk pertaining to the shareholdings of these institutions as an initiative toward financial system stability. The Bank is significantly

\[\text{The Bank of Japan started purchasing the stocks in 2002, and as of the end of June 2003, the purchase has reached 1.49 trillion yen. The Bank has set the limit of the total purchase at three trillion yen.}\]
independent of the government and the decision of the purchase is not likely to be influenced by political pressures. Moreover, the rationale of the Bank’s action is, as in the Bank’s statement, “to enhance financial institutions’ efforts to reduce their shareholdings” and “to ensure financial system stability as well as laying the foundation for financial institutions to steadfastly deal with the non-performing loan problem”. Maximizing the return on stock purchase is never the goal for the Bank. Still, the stock purchase by the Bank was regarded as a very exceptional policy and drew many arguments. This is a sound treatment of such an emergency measure, while a similar debate is conspicuously lacking in the context of the investment of reserve fund of public pension programs.

(b) “Consensus Cost” and “Enhanced Liquidity”

The consensus cost and the advantage of enhanced liquidity have been little focused. This reflects a fact that people do not have a macro economic viewpoint, as a basis of pension policy debate, that the key to the financial soundness of a public pension program lies in enlarging the “pie”, or that equity investment by the government is largely a zero-sum game.

The framework of a discussion on how best to manage the investment of a public pension fund is, in many cases, not much different from that of a private sector fund, which illustrates the lack of a macro economic viewpoint among the participants in the discussion. Once it is decided that the reserve fund is invested in financial markets to maximize the return, it is matter of course to pursue the best portfolio. Otherwise, there will be a distortion of the market or efficiency cost.

However, if the macro economic viewpoint is not added to the policy debate, we will not be able to follow the royal road to a sound financial basis of the pension (i.e. enlarging the “pie” and consolidation of intergenerational consensus building). Then, in order to quickly obtain the resources to cover benefits, the pressure could build up for a higher return, resulting in a risky investment strategy and erosion of people’s confidence in the pension program, which is the worst scenario.

To secure a calm climate for discussion, it will be of a vital importance to share a macro economic viewpoint.

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5 The Bank of Japan says in “New Initiative Toward Financial System Stability”, September 18, 2002, “3. For the management of financial institutions to pursue this approach, market risk pertaining to the shareholdings of these institutions has become a significant destabilizing factor. Thus, reducing such risk is an urgent task from the viewpoint of ensuring financial system stability as well as laying the foundation for financial institutions to steadfastly deal with the non-performing loan problem. Based on such recognition, the Bank has decided to explore possible policy measures to enhance financial institutions' efforts to reduce their shareholdings. The Bank will endeavor to submit proposals as soon as possible.”
Concluding Remarks

In this paper, the necessary viewpoint and the key concepts for an effective policy debate are summarized.

The funds that were automatically deposited with the Ministry of Finance are being redeemed and the size of the investment in the market by the government will grow by around five times in the coming years, while higher yielding bonds are redeemed every year. At the same time, the performance of the investment by GPIF has been disappointing due to a prolonged decline in the stock prices. This situation could well generate a criticism against the framework of the investment of the pension reserve fund and make it more compelling to start a full-dress discussion on the nature of the investment by the government and pros and cons thereof.

After all the funds are redeemed from the Ministry of Finance in 2008, when the economy experiences downturn and the insurance premium of the year falls short of the benefit payments, the government will be faced with a new challenge of drawing down the reserve fund in a timely manner.

Now is the time to start a policy debate with a wider range of viewpoints.

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