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Japan's failed response to the Basle Accord for capital adequacy standard: Beyond two-level games analysis

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1. Introduction

The Basle Accord at the Bank for International Settlements (BIS) for capital adequacy, concluded in 1988 for providing minimum standard of capital adequacy for international banks, has been considered as exemplary case for successful international cooperation in finance. On the other hand, implementing the Accord caused serious problem for Japanese banks after the crush of financial “bubble” in 1990s, which I describe below. If a “failure” is defined as an act leading to unwanted consequences for the actor, there must have been some failures in Japanese government's and/or Japanese banks' behavior. The purpose of this short essay is to explain how and why the policy failures came about.

2. Evolution of international convergence of capital standard

There is already a vast literature on the development of the Basle Accord. Therefore, here I just make a short description on the road to the Accord.

Until the 1970s, overseas activities of banks worldwide had been advanced. Nevertheless, the supervision on banking sector was exclusively controlled by domestic governments, and no formal institutions for coordinating national regulation of international banks. The collapses of the Herstatt Bank of Germany and the Franklin National Bank of the U.S. in 1974 and inadequate responses of national authorities made the international financial society realize the need for such institutions. The product of the concern was the “Basle Concordat” created by the Standing Committee on Banking Regulations and Supervisory Policies (“Cooke Committee,” named after the committee chair, Peter Cooke of the Bank of England) of BIS in 1975, which provided that primary responsibility for international banking supervision was given to the authorities of parent country while banks' foreign subsidiaries were to be governed by host country. The Concordat was revised in 1983 in order to remedy its technical deficiencies, but the revision was for clarifying who was in charge of supervising international

banks, not what regulations should be imposed on the banks. The “content” of banking supervision was still in the hands of domestic authorities (Dale, 1994 and Kapstein 1989, 1991) .

A change of tide came from the United States. As Latin American “debt crisis” hit international financial market in early the 1980s, the U.S. Government had to provide fund to the IMF by increasing IMF quota. In the U.S. Congress, however, American financial authorities (the Federal Reserve Board (FRB) , the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC)) were demanded by the Congresspeople to create new regulatory framework for banks before pouring taxpayers’ money to the IMF. The three authorities fixed a “joint program” for improving banking supervision which included regulation on banks’ capital adequacy in 1983. The U.S. banks criticized in congressional hearings that unilateral capital standard would diminish American banks’ competitiveness vis-_-vis foreign rivals such as Japanese and German banks. By the 1980s, Japanese banks, expanded presence in the international financial market with high leverage ratio. The U.S. banks also lobbied the Congresspeople to attack unilateral regulation. The Congresspeople thus faced a dilemma between bank soundness and American banks’ falling international competitiveness. According to Kapstein, “international convergence of capital-adequacy standards was put on the table by Congress rather than by the regulators” (Kapstein, 1991) in order to solve this dilemma. The International Lending Supervision Act of 1983 not only gave federal financial regulators power to set minimum capital ratio of banks and to order banks with insufficient capital but also encouraged foreign banking authorities to strengthen capital bases of international banks.

In March 1984, FRB Governor Paul Volcker made a presentation of congressional request for international capital standard at a BIS meeting in Basle. The presentation, however, only met cool response from other central bank governors. Meanwhile, the fall of Continental Illinois Bank in May 1984 drove the U.S. financial authority for tighter bank capital requirement, hence for international conversion of capital adequacy.

When Volcker suggested to the Bank of England (BOE) a bilateral agreement on bank capital standard in July 1986, BOE quickly consented. The two central banks announced for the agreement in January 1987. Nevertheless, American bankers criticized that the agreement lacked provisions for major portion of internal banking including Japan.

In January 1987, Gerald Corrigan, the president of Federal Reserve Bank of New York, visited Japan in order to solicit Japanese financial authority for accepting capital standard for international banks. Japanese Ministry of Finance (MOF) demanded that 70% of banks' "hidden reserves," be included in equity. The "hidden reserves" refers to the balance between book values and market prices of corporate shares and real estate held by Japanese banks. Because MOF guided banks to employ lower of cost or market accounting method, and because Japanese stock and land prices had been rising for nearly four decades, the hidden reserves of Japanese banks had become enormous. MOF insisted that the hidden assets were functioning as a shock absorber of bank management, hence, should be added to capital. Regulators of the U.S. and Britain opposed to such inclusion, pointing out volatility of share prices.

The Cooke Committee of BIS started to create international capital adequacy standard in May 1997. In June, FRB again discussed with MOF, but they failed in reaching an agreement. However, at a meeting of BIS in late June, the U.S. officials suddenly became soft on the issue, and announced that they would agree to incorporate hidden reserves in equity. By September, the U.S., Britain, and Japan had come to an agreement that 45% of the hidden reserves be added to base capital, and that the new standard be implemented from FY 1992 (Kapstein, 1991) .

At the Cooke Committee later the year, the members eventually accept the trilateral agreement. On December 10, the BIS announced that the G10 central bankers had agreed on converged capital adequacy standard for international banks. The agreement, with some revisions, was released in July 1988 by the Committee as the International Convergence of Capital Measurement and Capital Standards. The Basle Accord states that: i) Banks conducting international business are required to maintain more than 8% of capital based on risk-asset ratio; ii) Off-balance items are included in the risk-asset; iii) Tire I capital includes equity and reserve fund, and Tire II capital includes loan loss reserve, subordinated bond and 45% of unrealized capital gain. The amount of Tire II capital cannot exceed that of Tire I capital. The Accords clarified its objectives as for strengthening stability of international banking system and for diminishing competitive inequality among international banks.

3. Two-level games and the Basle Accord

Successful conclusion of the Basle Accord described above fits well for Robert Putnam's "two-level game" theory.¹ According to Putnam, a state's representative (chief negotiator) at an international negotiation is forced to play two games simultaneously. In the Level-I Game, the negotiators try to reach a tentative agreement (or, non-agreement) with her/his foreign counterparts; in the Level-II Game, discussions are made among domestic constituents about whether to ratify the agreement (Putnam, 1993, p. 438). Putnam defines concept of "win-set" as a set of Level-I agreements that "win" necessary support from players in the Level-II game. In other words, any Level-I accords outside the win-set are rejected by domestic constituents. As a result, chief negotiators take their domestic win-sets into consideration at international negotiation. An international agreement is successful (i.e., wins ratification) only when it is within the realm where negotiating countries' win-sets overlap.

The essence of the two-level games theory is that it focuses on each negotiating countries' domestic politics as a critical factor that determine the outcome of international deals. It thus diverges from neo-realist or neo-liberal conception of the world politics in which states are assumed as unitary actors.

As Kapstein wrote, the story of Basle Accord started from American domestic politics. As American banking sector became weak in early 1980s, the U.S. financial authorities (FRB, OCC, Treasury, etc.) wanted to impose minimum capital standard to the banks. This attempt met opposition from American banks and American Congresspeople that such a unilateral regulation would place the U.S. financial intermediaries on competitive disadvantage vis-à-vis foreign rivals, notably Japanese banks. Thus, the U.S. authority faced a dilemma between bank soundness and international competitiveness of American banking industry. The only solution for the dilemma was to impose the standard globally, i.e., to converge bank regulation policy internationally for creating a "level playing field" for banks worldwide. British banking authority (BOE) jumped onto American bandwagon, since the bank capital regulation of the U.S. was consistent with that of Britain, and alliance with the U.S. would let Britain play a leading role in European financial reforms. The two nations soon made a bilateral agreement.

Naturally, the two nations' next target for soliciting was Japan, the last of big-3 financial market. As always, the U.S. authority pressed Japan hard to accept

American demands. Japanese MOF, on the other hand, knew that its domestic constituents, Japanese banks, would not obey unless some measures were taken for securing Japanese banking sector access to international capital market. For MOF officials, inclusion of banks' "hidden reserves" into equity in calculating capital ratio was the answer to solve the two-level games they faced. Japan insisted on such inclusion, and finally, the U.S. and the U.K. conceded.

The rest was an easy game. With big-3 capital markets on board, other countries had no choice but to accept. Therefore, within months from the trilateral agreement, the Basle Capital Adequacy Accord was concluded in 1988. In the process to the Accord, the U.S. and British authorities achieved to impose capital standard to banks and to create more equal standing for banks worldwide. Japan also got what it wanted: assured path to international financial market. If the story ends here, it was a happy ending.

4. Japanese banks after the Basle Accord

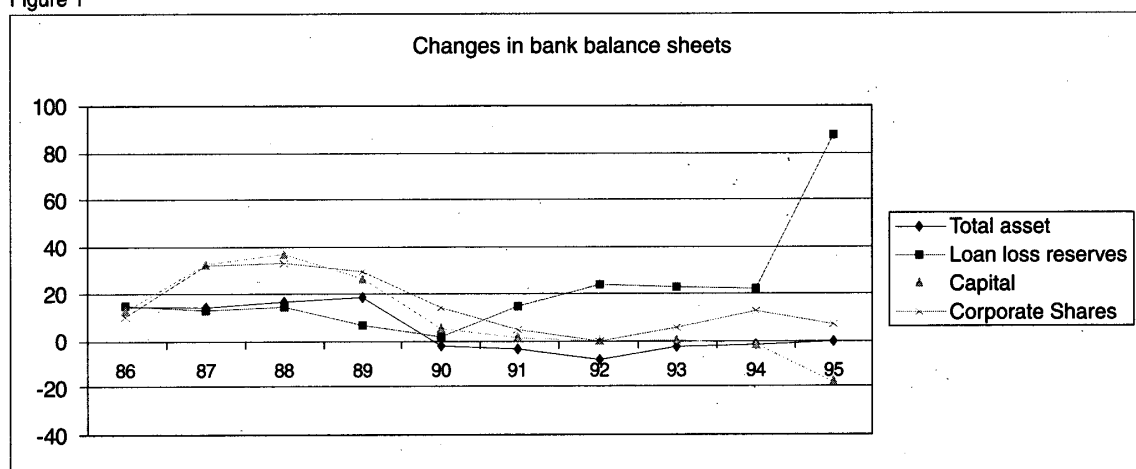
Quite unfortunately for MOF and Japanese banks, this was not the end of the story. The implementation of the Basle Accord caused several critical problems for Japanese banks and Japanese economy.²

First, after the Accord, banks became exposed to capital market fluctuation. This was caused by banks' vigorous efforts for capital increase via cross-shareholding. Even before the trilateral agreement, Japanese banks moved aggressively for preparation. Until 1986, Japanese banks' capital increase had been hundreds of million yen per year. In 1987, however, the amount jumped to 2.5 trillion yen. During three fiscal years from FY 1988 to FY 1990, banks increased equity by 30% a year while the asset grew 13-20%, as is shown in Figure 1. The booming capital market enabled banks to issue new stocks in the market. The rapid growth of equity was achieved through cross-sharing of capital with other firms, notably with insurance companies. Figure 1 shows that during that period, banks also increased the amount of their held corporate shares by 30% annually. The point is that Japanese banks bought corporate shares at high prices then. This made the bank assets vulnerable to the stock market.

Second, credit crunch. After the peak (Nikkei Average 38,915 yen) at the end of 1989, Japanese stock prices went down. In August 1992, the Nikkei Average fell to 14,309 yen. As the unrealized gain vanished without being

realized, and as issuance of new shares was discouraged by weak capital market, banks had to rely on issuing subordinated bonds for maintaining their capital adequacy ratios. Because subordinated bonds enter in Tire II capital (which cannot exceed Tire I capital), and because interest for subordinated bonds is higher, this method had a limitation. As a result, banks were forced to decrease the denominator of capital ratio, the asset.

Figure 1



Source: *Financial Statements of All Banks*, Japanese Bankers' Association, various years

Third, delay in banks' writing-off of bad loans. After the crush of asset "bubble," Japanese banks found difficulty in maintaining 4% of Tier I capital ratio. Given asymmetry of information of loan conditions between banks and other parties, banks had an incentive to hide damages on loans by not writing-off loans that actually went bad. Although Loan Loss Reserves was counted as the Tier II capital in the Basle rule, the total amount of the Tier II capital could not surpass the Tier I. This incentive was one of reasons why Japanese banks postponed writing-off their bad assets.³

5. Banks' responses to negotiation results

It seems clear that the two-level games analysis is insufficient to address the problems Japanese financial system has been facing after the successful conclusion of the Basle Accord. After all, the theory stops when it explains

success or failure of some international cooperation.⁴ Therefore, our analysis has to go beyond Putnam's conception of the world politics.

At the negotiation with FRB and BOE, MOF had three options: i) to reject international accord for capital adequacy; ii) to accept the accord as it; and, iii) to negotiate for the inclusion of unrealized capital gain to equity. Before analyzing the consequences of each option, we make simple assumption on Japanese banking sector.

A Japanese bank A receives deposits from depositors and lends loans. The bank, as other Japanese banks, is allowed to accumulate capital from the market through issuing its shares, and to hold corporate shares (e.g., through cross-shareholding with other firms). The authority forces bank A to enter the value of corporate shares in the lower of the cost or market value method. Suppose that bank A acquired quantity s_0 of corporate shares when the stock price was fairly low (at q_0). Hence, bank A's balance sheet is:

(BS₀)

The credit side: Loans $\{L_0\}$, Corporate Shares $\{s_0q_0\}$

The debit side: Deposits $\{D\}$, Equity $\{E_0 (= L_0 + s_0q_0 - D)\}$

Throughout this analysis, the D is held constant.

Since risk weights of L and S are both 100% in the Basle Accord Standard, bank A's initial "Cooke ratio" (C_0) is

$$C_0 = E / (L + S) = (L + s_0q_0 - D) / (L + s_0q_0) \quad (1)$$

At this initial stage (period T_0), as in the case of real Japanese banks, C_0 is lower than 8%. Now, let us see how banks will react to each of MOF's three choices.

A) Banks' behavior after the Accord

After international negotiation for bank supervision is concluded (or broken down), banks will react to the changed policy environment. Banks behavior at this stage (period T_1) will be as follows.

i) rejecting accord

If no international agreement was made, the U.S. and Britain would impose the capital adequacy standard bilaterally; i.e., the two countries would force foreign banks below the capital standard go out of their territories. In this case, Japanese banks which wanted to remain in the U.S. or Britain had to increase capital by themselves via issuing E1 of new shares. Fortunately for the bank A, now the stock prices are high at q1. If the authority prohibits cross-shareholding to the banks, A also sells a substantial portion of its held corporate shares in the market, and enters 45% of capital gain (after paying 55% corporate tax) in equity in the balance sheet. Since holding corporate shares has little meaning in meeting Cooke ratio, the bank may sell a part (s0') of its held corporate shares at higher prices in order to increase its equity (after paying 55% of income tax thereon). If the authority forbids further cross-shareholding, all the acquired money is lent as loans. The bank will issue new shares and sell held corporate shares so as to make its Cooke ratio C1 become 8%. That is:

$$\begin{aligned} C1 &= (E+E1) / \{L + E1 + s0'q0 + (s0 - s0')q0\} \\ &= \{L + E1 + (s0 - s0')q0 - D\} / (L + E1 + s0q0) = 0.08 \end{aligned} \quad (2)$$

The bank's balance sheet will be:

(BS1-a)

The credit side: Loan $\{L + E1 + s0'q0\}$, Corporate shares $\{(s0-s0')q0\}$

The debt side: Deposit $\{D\}$, Equity $\{L + E1 + s0q0 - D\}$

Alternatively, if the authority allows the bank for cross-shareholding, the bank can increase equity partly through the mutual holding of new shares with other firms. Suppose that the stock price of the bank's counterpart of mutual shareholding is q1. If the bank acquires s1 of the firms shares, the bank's balance sheet is:

(BS1-b)

The credit side: Loan $\{L+E1+s0' q0-s1q1\}$, Corporate shares $\{(s0-s0')q0 + s1q1\}$

The debt side: Deposit $\{D\}$, Equity $\{L + E1 + s0q0 - D\}$

Please note that now part of corporate shares are entered in the B/S at higher stock price, q_1 .

In each case, if the bank fails to increase capital, it has to abandon its operation in the U.S. and/or in the U.K.

ii) Accepting the Accord as it is

If Japanese banking authority accepts the Capital Adequacy Standard offered by American and British counterparts as it is, Japanese banks behave similarly as the case i) above. In this case, however, a Japanese bank failing to meet the Cooke ratio has to abandon not only operation in the U.S. and U.K., but also any international business. Therefore, more Japanese banks will try to increase capital in the market.

iii) Accepting the Accord including unrealized capital gain as equity

If Japanese authority negotiates tough, and succeeds in making the U.S. and British authorities accept to include 45% of banks' unrealized capital gains in corporate shares held by the banks, the banks enjoy more options than the two cases above. As the unrealized capital gain is enormous, Japanese banks now can meet the Standard only by making its equity 4% of their risk-weighted assets. The banks will not sell its held corporate shares until it becomes apparent that no more capital gains are likely. Since the inclusion of "hidden assets" pre-supposes corporate share holding by banks, it might be illogical for the authority to restrict such shareholding. (Please recall that Japanese authority has a reputation in avoiding such logical inconsistency.) Then, a Japanese bank will increase capital as much as $E_2 (> E_1$ in the case i) and ii) above). The bank's balance sheet will be:

(BS1-c)

The credit side: Loan $\{L - s_2q_1\}$, Corporate shares $\{s_0q_0 + s_2q_1\}$

The debt side: Deposit $\{D\}$, Equity $\{L + s_0q_0 - D + E_2\}$

B) Bank behavior at changes in stock market

Now we have three alternate bank balance sheets, BS1-a, BS1-b and BS1-c. Suppose with probability p , the stock prices at period T2 will fall from q_1 to the initial level q_0 , and with probability $(1-p)$, the capital market will remain high at q_1 .

Even share prices fall down to q_0 , bank A with BS1-a maintains sufficient capital level to meet the Basle Standard. Since all assets in BS1-a are evaluated conservatively (i.e., at q_0), BS1-a suffers no damages, either. As a result, bank A stays in a good condition at adverse economic environment.

Bank A with BS1-b also keeps its base capital for clearing 8% of Cooke Ratio. Nevertheless, since some portion of corporate shares in BS1-b is evaluated at the "bubble price level" q_1 , bank A has to suffer some "hidden loss," which hampers the bank's ability in credit-making.

The fortune of bank A with BS1-c is the most miserable. At lower stock prices, all "hidden reserves" of bank A vanish in the air. The bank cannot meet the Capital Adequacy level unless it reduces the balance sheet. In our simple model, reduction of balance sheet is attained only through decreasing loans. At the same time, bank A also face the problem of unrealized loss due to lower stock prices.

Please note that the above three policy choices (plus the one we omitted from our analysis) correspond with combinations of two kinds of regulations: accounting principle and regulation on banks' shareholding. On one hand, there are two systems of accounting: cost (or, lower of cost or market value) accounting method and market value accounting. On the other hand, banking authority may allow or forbid banks to hold corporate shares.

Generally, U.S. banks are prohibited from holding equity shares by the Glass-Steagal Act. Although U.S. Bank Holding Company Act permits bank holding companies to invest in up to 5% of the shares of a single company, "but in practice they hold only a negligible amount of stock" (Scott and Iwahara, 1994, p. 32).

Japanese Antitrust Law has permitted Japanese banks to own up to 5% of shares of a company. Nevertheless, there has been no restriction on the sum of corporate shares held by banks. As we know, Japanese banks hold large amount of stock of their borrowers and members of their "keiretsu." The total book value of stock in Japanese banks' balance sheets remains some 4-5% of their assets. As of FY1992, the revaluation reserves of Japanese banks amounted to 1.49% of total risk assets, while that of U.S. banks was as small as 0.08% (Scott and Iwahara, 1994, p. 37).

Regarding to accounting method, most nations including the U.S. had been employed historical cost or lower of historical cost or market value accounting on banks' held securities. However, after banking sector problem in 1980s, American authorities on accounting method moved for market-value accounting. In 1993,

the Financial Accounting Standards Board (FASB) released "Accounting for Certain Investments in Debt and Equity Securities (FAS115)" which introduced market value accounting method in banks' held securities. FAS115 was to be adopted by SEC from December 1993.

In Japan, the authority stuck to conservative lower of historical cost or market value method except a short digression at falling stock prices in 1992. Nevertheless, the inclusion of revaluation reserves into capital in the Basle Standard had the same effect for Japanese banks as employing market-value accounting method (Okina, 1993, p. 113, Sawabe, 1994, p. 59, Itose, 1996, p. 178). Even in the FAS115 of the U.S., securities held until maturity are evaluated on historical cost method. Therefore, the Basle Standard forced Japanese banks to live with extremely market-oriented accounting standard.

German financial authority's response to the Basle Accord gives an interesting example here. Like Japanese bank, German universal banks hold huge quantity of corporate shares. Since German banks also employ conservative accounting method, the banks, again like Japanese counterparts, held enormous undisclosed reserves." In the negotiation for international capital adequacy level, however, German authority even opposed to the inclusion of unrealized capital gains into numerator of capital ratio (Sawabe, 1994, p. 53).

Table below plots the above three countries position in the accounting method (historical cost vs. market value accounting) and corporate share holding of banks.

Table 1. Accounting methods and corporate share holding of banks

Because the volatility of corporate share prices is quite high, and stock market is beyond the control of banks (and MOF), the lower-right position, where Japan has been located since the Basle Accord, is highly risky for bank soundness.

		<i>Accounting method</i>	
		Historical cost	Market value
Banks' corporate share holding	Prohibited		The U.S (after FAS115)
	Allowed	Germany, Japan (before Basle Accord)	Japan (after Basle Accord)

6. Reconsidering MOF's strategy

Now get back to the negotiation table where MOF was negotiating for international bank regulation. As we saw above, MOF had three choices at the negotiation: i) rejecting policy coordination, ii) accepting the accord without modification, and iii) negotiating for including unrealized capital gain to equity. MOF employed the third strategy and negotiated hard for the inclusion of "hidden reserves" into the numerator. And, the above analysis shows that the third way was the most destructive among the three not only for Japanese banks but also for Japanese economy as a whole. Then, why did MOF choose the worst strategy?

An answer easily comes to our minds. MOF tried to include banks' unrealized revaluation gains into capital because MOF (somehow) believed that Japanese stock prices would never fall. In our analysis, if Japanese authority's subjective belief on the probability that stock prices will fall is fairly low, the authority will choose iii) , the easiest path for meeting capital standard. This theory seems convincing, and most analyses on this issue employ this explanation (for example, Zushi, 1992 and Higashitani, 1999) . Actually, in a paper written at the conclusion of the Basle Accord, Tadao Senno, then advisor of MOF Banking Bureau the chief negotiator on the issue, wrote absolutely nothing about the possibility of such capital market downfall (Senno, 1988) .

Here I want to question the utility of this conventional wisdom. In essence, this line of explanation asserts that MOF officials were irrational (more exactly, stupid) in believing that Japanese share prices would never fall. Nevertheless, this argument tells little about the causes of MOF's stupid behavior and hence what to be done to avoid such stupidity. Alternatively, here I assume that actors in international negotiation including MOF are rational, and that if one fails, he/she has a good reason to fail.

For a rational negotiator, it is apparent that asset booms come and go and stock prices go up and down. Although German universal banks also hold corporate shares and retain substantial hidden reserves, German financial authority never insisted and still has not allowed German banks to include those reserves into capital in calculating the Cooke Ratio. In Basle, foreign negotiators repeatedly raised concern on such inclusion that it was too risky. The same concern was heard inside MOF.

On the assumption that MOF officials were rational, I infer that MOF's subjective p was not negligible, i.e., MOF knew that Japanese stock prices might go down. For rational MOF, it was a gamble to insist on inclusion of hidden reserves to equity, which might threaten Japanese financial system if capital market slumped. Then, why MOF made such a gamble?

We can find a clue to solve the problem in Putnam's original paper, which suggests the possibility that the chief negotiator has her/his specific self-interests. "Empirically, the preferences of chief negotiator may well diverge from those of his constituents" (Putnam, 1993, p. 456) . Putnam raises motives of the chief negotiator: i) enhancing the negotiator's standing in the Level II game; ii) shifting the balance of power at Level II in favor of domestic policies that she/he prefers for exogenous reasons, or, achieving the negotiator's favored policies which he/she cannot realize without "foreign pressure," and, iii) to pursue her/his own conception of national interest in the international context. I think these motives are not exhaustive, but in this preliminary study, it may be useful to formulate our argument in line with Putnam's three motives.

i) Enhancing MOF's power in Japanese domestic politics

As we saw, U.S. Congresspeople played a pivotal role in making American policy agenda on international banking supervision standard. In a democratic polity, elected politicians are supposed to play at least some roles in policy-making. In Japanese Level-II game, however, neither chief negotiator (MOF) nor its constituents (banks) are elected from people. Then, where are Japanese chosen few in the Level-II game?

In theory, central ministries are accountable to ministers who are accountable to the Cabinet which is accountable to the Diet whose members are elected from Japanese people. In reality of Japanese politics, however, Japanese bureaucracy is fairly "insulated" from this democratic system of governance.⁵ Especially in the field of financial administration, MOF had monopolized the governing power throughout Japanese postwar history.⁶

This does not mean that MOF was free from politicians' intervention. Japanese laws, like laws of other democracies, provide that all laws have to pass the Diet, and that cabinet members (most of whom are also Dietpeople) have the power in controlling their ministries. Meanwhile, since the politicians' primal concern is winning election, and since their resources for policy research and policy making are limited, politicians (especially those of the party in power) have an

incentive to leave troublesome policy issues to bureaucracy, so long as bureaucrats are doing well. The only time politicians are interested in intricate policy issues is when they are lobbied with political donation.

Japanese banks will obey MOF's rules to the extent that MOF is benefiting banks and that MOF had considerable carrots and sticks for the banks. If MOF's behavior threatens banks' interest, banks will oppose to such a move, or, will lobby politicians.

Thus, MOF's power lies in the balance between politicians and banks. In other words, MOF is in the center of domestic two-level game in which MOF has to satisfy both politicians and banks. If MOF loses this game, MOF loses its authority.

From this vintage point, we can explain MOF's rush for the Basle Accord. On the one hand, MOF wanted to "look good" to politicians by quickly concluding international negotiation and by acting as a leader of financial globalization. On the other hand, MOF wanted to keep banks satisfied, since otherwise the banks will reject to obey MOF. The Basle Accord, which created international capital standard for banks with banks' hidden reserves included as capital, was the "win-set" in not only international-domestic two-level game but also domestic two-level game in which MOF has to satisfy politicians and banks simultaneously.

ii) Achieving the MOF's favored policies which MOF cannot realize without "foreign pressure"

Before the U.S.-Britain bilateral agreement for setting unified bank regulation standard, MOF tried to impose its own minimum capital level onto Japanese banks in vain. Since as early as 1954, MOF had a guidance for banks that capital (including various reserves) be more than 10% of bank loans. This guidance remained unchanged well until the 1980s. Nevertheless, Japanese banks had been ignoring this guidance. In May 1986, MOF issued a memorandum "On Basic Issues Concerning Ordinary Banks' Business Operation" which stated:

a) banks should achieve capital-to-asset ratio (excluding hidden reserves) more than 4% by FY1990; and,

b) banks with foreign branches should achieve capital-to-asset ratio (including 70% of hidden reserves) more than 6%.

This guidance also met criticism from Japanese banks, and feasibility of the memorandum was questioned.

Please note that the agreed Basle Accord was quite consistent with the

memorandum above except the rate of hidden reserves included in the numerator. In the Accord, MOF could accomplish what it wanted but failed without foreign pressure.

iii) Pursuing MOF's own conception of national interest in the international context.

This line of explanation might be the most challenging and the most fascinating for those who are interested in Japanese bureaucratic politics. It is often ridiculed that MOF officials (somehow) believe they embody *raison d'etat* of Japan (somehow). This may be a weird idea for ordinary people, but the idea is not unusual in Japanese bureaucracy.

With the rise of Japan in mid-1980s as a global economic and financial power, MOF officials might dream of "world economic dominance" of Japan with MOF in its center, or something like that. Or, MOF might be determined to act as an agent for world harmonization and co-prosperity. Anyway, thus far we have too weak ground to support or reject either theories.

7. concluding remarks

In this short essay, I presented how successful conclusion of the Basle Capital Adequacy Accord for international banks had disastrous consequences for Japanese banks and Japanese economy. I also showed the case suggests the limit of Putnam's Two-Level Game theory whose only dependent variable is international cooperation and the need to incorporate domestic economic analysis into the framework. For the remaining puzzle of the Basle Accord, i.e., the reason why MOF chose such a risky choice, I only raised three hypothetical explanations following the clue in Putnam's paper. The proof or disproof of those explanations remains undone at this preliminary stage.

Endnotes

1. This is hardly a new discovery. Actually, Kapstein's classical works on this subject were written in line with the two-level games theory.
2. For Japanese banks' problems due to the Basle Accord after the crush of financial "bubble," see, for example, Higashitani, 1999.
3. According to Scott and Iwahara, "(e)arning (of Japanese banks) that would otherwise go to reserves can be held as earned surplus and counted as an unlimited

extent as Tier I capital. ... This advantage (of having more capital in the short run) may be one of the reasons that many Japanese banks, especially those with a sizable amount of nonperforming loans, do not want to increase reserves." (Scott and Iwahara, 1994, p. 31)

4. For example, Helen Milner's attempts to formalize Putnam's two-level games theory simplifies the theory to have just a single dependent variable: international cooperation or failures thereof (Milner, 1997). I think Milner's main contribution was to clarify the limits of Putnam's seemingly all-encompassing theory.

5. There is a huge literature on Japanese bureaucracy. I just raise most prominent examples of pros and cons of political independence enjoyed by Japanese bureaucrats such as Chalmers Johnson (1982), B. C. Koh (1989), and J. Mark Ramseyer and Frances McCall Rosenbluth (1993). Regarding state's insulation in East Asia, see World Bank (1993) and Evans (1995).

6. Frances Rosenbluth challenges this conventional wisdom by arguing that MOF's financial sector policy had been consistent with banks' and LDP politicians' interests in Rosenbluth (1989).

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