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Redistributive Cooperation: Market Failure, Wealth Transfers, and the Basle Accord

Thomas Oatley and Robert Nabors

Theories of international institutions have focused almost exclusively on considerations of efficiency. Ethan Kapstein's treatment of the 1987 Basle Accord is representative.¹ In December 1987, policymakers belonging to the Group of Ten (G-10) signed a far-reaching agreement on international financial regulation: the Basle Accord on the International Convergence of Capital Measures and Capital Standards. Under the terms of this agreement, G-10 policymakers implemented uniform risk-based capital requirements on commercial banks. The origins of the Basle Accord, according to Kapstein, lay in the consequences of international financial integration. International financial integration, by raising systemic risk and eroding regulators' capacity to ensure the soundness of national banking systems, generated a market failure evidenced by the debt crisis. Commercial banks had accepted a riskier portfolio of loans than society considered optimal and were now unwilling to bear the full costs of this lending behavior. Financial market failure created a demand for international regulation to which policymakers responded by supplying the Basle Accord. "To the extent that the payments system had the character of a public good, it was reasonable to ask every state to contribute to its maintenance. . . . Bank supervisors responded to the need for greater oversight by negotiating the Basle Accord."² In short, the presence of a financial market failure revealed by the debt crisis induced policymakers to create mutually beneficial international regulations.

Although we single out Kapstein for criticism, we do so because his work is typical rather than unique. Kapstein's account of the Basle Accord is based on standard theories of international cooperation, according to which policymakers create international institutions to realize joint gains.³ With an explanatory framework lifted from the transactions costs and market failure literature, Robert Keohane illustrated

We thank Timothy McKeown, Michael Munger, Peter Van Doren, two anonymous referees, and the editors of *International Organization* for helpful comments. Rachel Brewster contributed valuable research assistance.

1. Kapstein 1989, 1991, 1994.

2. Kapstein 1989, 331–32.

3. See, for example, Keohane 1984; Martin 1992; Milner 1992; and Oye 1986.

how information asymmetries, transactions costs, and ex post enforcement problems can prevent governments from entering into mutually beneficial agreements, and how international institutions, by mitigating each of these problems, enable them to realize mutual benefits.⁴ While Stephen Krasner and Geoffrey Garrett have added distributive considerations to the basic model, the recognition that politicians must also agree how to distribute the resulting welfare gains among them only slightly complicates the central problem of realizing mutual benefits.⁵ Scholars have taken this institutionalist logic one step further, developing a demand-driven functional argument in which governments identify potential joint gains and create international institutions to provide the conditions necessary to realize them. As Keohane notes, “regimes are developed . . . because actors in world politics believe that with such arrangements they will be able to make mutually beneficial agreements that would otherwise be difficult or impossible to attain.”⁶ Kapstein’s explanation of the Basle Accord, therefore, is a fairly straightforward application of theories of international cooperation: international financial regulation is simply another instance of politicians building an international institution to facilitate the creation and distribution of gains from trade.

This article challenges Kapstein’s account of international capital adequacy regulation, and by extension the joint gains emphasis and functional logic of the theories of cooperation on which it is based, by suggesting that the Basle Accord is an instance of redistributive cooperation: the creation of an international institution that intentionally reduces at least one other government’s welfare compared to the status quo. We develop this argument in three sections. First, we present a model based on positive theories of regulation in which domestic politics create incentives to propose redistributive international institutions. Second, we show how governments can achieve international redistribution within the confines of voluntary international agreements. Third, we apply the model to the Basle Accord and draw two conclusions. First, the creation of the Basle Accord does not correspond to a functional joint gains logic. The U.S. proposal for capital adequacy regulations was not motivated by concern about international financial stability, but by a need to satisfy competing interest group and voter pressures. Nor was a generalized concern about the stability of the international financial system evident in the Basle Committee, the forum in which the Basle Accord was negotiated. Thus, linkages between joint gains and the Basle Accord are tenuous at best. Second, the Basle Accord does correspond to a redistributive logic. The U.S. proposal sought to transfer income from Japanese commercial banks to compensate American commercial banks for the costs of regulation demanded by voters. Moreover, international capital adequacy regulations were instituted only through U.S. policymakers’ use of financial market power. The Basle Accord, therefore, corresponds more to a redistributive than to a joint gains logic. Because governments sometimes propose and create redistributive international in-

4. Keohane 1984.

5. See Krasner 1991; and Garrett 1992. Knight 1992 provides a more general treatment.

6. See Keohane 1984, 88; and Martin 1993.

stitutions, we need to reconsider the functional logic on which theories of cooperation are based.

Domestic Politics and the Incentive to Propose Redistributive International Institutions

Theories of cooperation argue that politicians create international institutions to resolve the information, transactions cost, and enforcement problems that complicate international bargaining in order to reach mutually beneficial agreements. This section suggests that politicians propose international institutions to resolve domestic political dilemmas and that the international institutions they propose sometimes will be intentionally redistributive. We develop these two claims by extending positive theories of regulation into an open economy context. Positive theories of regulation were constructed as approaches that treated regulation as welfare-maximizing corrections of market failures began to show weaknesses.⁷ Early theories of regulation, sometimes called the consumer protection approach and sometimes referred to as normative theories of regulation, abstracted from political processes to examine the policy options available to omniscient social planners maximizing aggregate social welfare when confronted by monopolistic industrial structures, externalities, and information asymmetries. Like theories of international institutions, the causal logic behind normative theories was crudely functionalist. "The existence of market failure is sufficient to generate a demand for regulation. . . . Then, in a crude reversal of Says' law, the demand is supplied costlessly by the political process."⁸ This approach was increasingly criticized, however, as empirical studies began to provide evidence that regulation failed to work as normative theories suggested it should. Rather than eliminate market failures, evidence suggested that regulation created them in markets where none had existed previously and failed to correct them in those markets in which they did exist.⁹ In other words, no necessary relationship existed between regulation and market failures; regulation was more likely to redistribute wealth than it was to create it.

In the face of mounting evidence that regulation failed to correct and often created market failures, economists began to search for alternative models of regulatory politics.¹⁰ In undertaking this search, economists moved decisively away from a focus on social planners concerned about aggregate social welfare. In place of the expectation that regulation corrects market failures, economists substituted the empirical observation that by creating barriers to entry and otherwise constraining the operation of competitive markets, regulation enables economic actors to earn above-normal returns from economic activity. In place of the assumption that politicians produce regulation to maximize aggregate social welfare, positive theories of regula-

7. Viscusi, Vernon, and Harrington 1995.

8. Peltzman 1989.

9. *Ibid.*

10. See Stigler 1971; Peltzman 1976; and Becker 1983.

tion assumed that politicians produce regulation to maximize their probability of reelection. In the basic model, politicians need votes to achieve and maintain political power, and a well-financed and well-organized campaign is needed to attract votes. Politicians attract votes and campaign contributions in exchange for regulatory policy. Unfortunately for the politician, there is a trade-off between efforts to maximize one's number of votes and efforts to maximize one's campaign contributions. Regulation extended to producers in exchange for campaign contributions imposes costs (deadweight losses) on society, causing those who bear the costs of these regulations to vote for another candidate. Removing regulation that provides rents to producers will increase votes but will also cause producers to contribute to candidates that promise to reimpose the regulation. Given this trade-off, politicians maximize utility by equating the marginal campaign contribution from regulation with the marginal loss in votes caused by the resulting transfers. The result is a market in which producer and consumer groups compete for wealth transfers.

The market for regulation "distribute[s] more of the good to those whose effective demand is highest."¹¹ Effective demand is a function of organization and wealth. "Groups must organize to lobby and provide campaign contributions, and voters must have enough information to vote 'right' on election day."¹² A group's ability to organize is constrained by the costs of organization and information. Voters must spend money to learn a proposed regulation's impact on their wealth and candidate positions regarding the legislation. Any wealth gains from voting "right" must offset these costs, and since each voter is likely to suffer a small wealth loss and has only a small probability of affecting the electoral outcome, few have an incentive to invest the necessary resources. Organization is also costly, and these costs increase as the size of the group increases. Because information and organization require resources, smaller, more compact groups will be better able to prevail in the market for regulation than larger, more disparate groups. Thus positive theories of regulation lead us to expect regulation to transfer wealth from large disparate groups (consumers as voters) to small compact groups (producer interests) but at a rate tightly constrained by politicians' need to remain responsive to voter demands.

Although developed in a closed-economy context, this model can be extended to show how rational politicians operating in an open economy can have an electoral incentive to propose a redistributive international institution. To do so we assume that the political system is resting at a regulatory equilibrium and consider the impact of a "revenue shock," that is, an exogenously given need to raise additional revenue. We equate an increase in taxation with a reduction in the rents provided by the regulation and therefore as functionally equivalent to a reduction in regulatory benefits to producers or to an increase in the costs imposed on voters or both. In a closed economy the need to raise additional revenue creates a political dilemma a politician will find difficult to resolve without losing voter and producer support. A tax on income will obviously cost votes, whereas a tax on producers will cost votes and

11. Peltzman 1976, 212.

12. Peltzman 1989, 8.

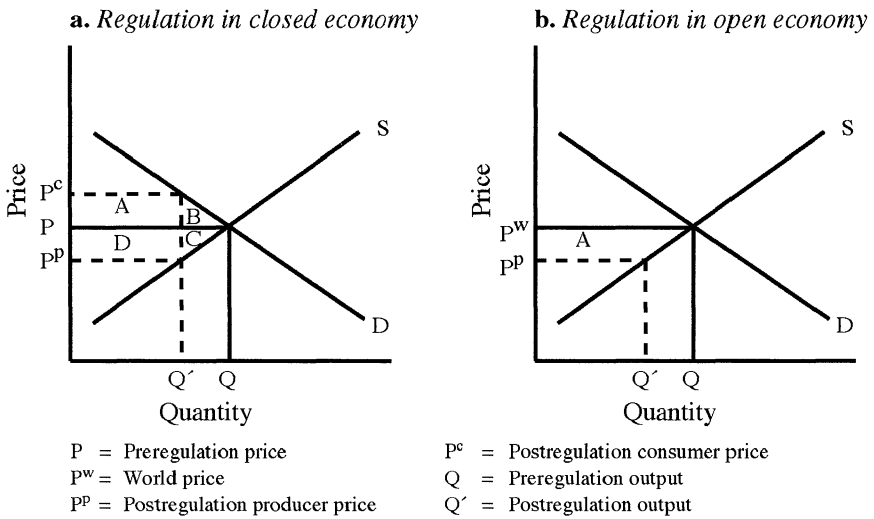


FIGURE 1. Welfare effects of regulation

campaign contributions. Standard welfare analysis of the effects of a transactions tax can illustrate this point (Figure 1a). Given the initial price, P , a tax will drive a wedge between the price consumers pay (P^C) and the price producers receive (P^P). Because the price consumers pay increases, there is a loss in consumer surplus ($A + B$). Because the price producers receive decreases, there is a loss of producer surplus ($D + C$). Domestic production will fall as a result, from Q to Q' . A portion of the loss in consumer and producer surplus is transferred to the government ($A + D$), and a portion of this loss disappears; that is, the tax creates a deadweight loss equal to the loss of producer and consumer surplus minus the tax revenue to the government ($ABCD - AD = BC$). In short, because the tax imposes costs on both producers and consumers, taxes are politically damaging instruments: campaign contributions and votes both fall.

An open economy changes this result in an important way. In an open economy the domestic price of tradable goods and services is given by the world price (P^W), and therefore producers cannot increase domestic prices in response to the tax (Figure 1b). The tax will still drive a wedge between the price producers receive (P^P) and the price consumers pay, which in the open economy remains the world price. Because domestic prices cannot increase, however, all costs will fall on producers—note that in the open economy case the loss of producer surplus is large (A) and consumer surplus is relatively unaffected. Domestic production will fall from Q to Q' , but because the gap can be made up through imports ($Q - Q'$), domestic consumption remains close to the pretax level at the pretax price. There will be some reduction in consumer surplus; as domestic output falls, so too does domestic income, shifting the demand curve toward the left, and this income effect reduces consumer surplus. This

loss is highly concentrated, however, falling disproportionately on those employed in the sector being taxed.¹³ Thus in an open economy a tax on producers will transfer income from domestic to foreign producers without imposing costs on consumers who do not receive income from the taxed sector. Therefore, our first conclusion is that in an open economy politicians can impose a tax on producers without imposing any direct costs on voters.

Politicians can also avoid the loss of campaign contributions that results from this tax if they can use international regulation to compensate domestic producers. If domestic producers are at a competitive disadvantage compared to foreign firms prior to the tax (because of domestic regulation or for other reasons), the revenue lost by domestic producers as a result of the domestic tax can be offset by using international regulation to impose a tax on foreign producers. For the foreign producer, the effect of an international agreement along these lines is equivalent to the domestic story told in Figure 1b, but now the foreign producer bears the brunt of the tax. An international regulation will cause foreign producer surplus to fall, and income will be transferred back to domestic producers. In sum, whereas a tax costs votes and campaign finance in the closed economy, in an open economy a politician can impose the domestic tax on producers to avoid a loss of votes and then use international regulation to tax foreign firms to compensate domestic producers. A redistributive international institution allows politicians to avoid losing votes or campaign contributions.

Although the preceding discussion emphasized how domestic politics can create incentives to propose redistributive international institutions, the model is more general. Domestic political dilemmas can also create incentives to propose welfare-improving international institutions. Consider a bilateral trade agreement. Politicians wanting to increase their vote might believe that a domestic tariff reduction, by raising domestic real income, will attract votes. A unilateral tariff reduction will eliminate rents in some sectors, however, and will therefore erode campaign contributions. To avoid this reduction in campaign contributions, politicians must provide some benefit to the producer. A bilateral trade agreement that reduces a foreign tariff gives the domestic producer access to a new market and will therefore transfer wealth from foreign to domestic producers (and to foreign consumers). Although the resulting bilateral agreement will redistribute from the foreign to the domestic producer, because the twin tariff reductions also reduce deadweight losses, the agreement is welfare improving.

The more general point, therefore, is that international cooperation in this model is attractive due to the private goods it creates, not the public goods. Although public goods are not irrelevant, they effect political choice through their effects on private wealth. Thus international cooperation might be politically attractive even if it creates public “bads.” Whether international institutions will be redistributive or welfare improving depends on whether “the private objectives of those with the bargain-

13. This is conditional on the assumption that these individuals have sector-specific human capital, and that, therefore, relocation will be costly. See Wallerstein 1987.

ing strength to alter institutions produce institutional solutions that turn out to be or evolve into socially efficient ones.”¹⁴

Achieving International Redistribution

The claim that politicians construct international institutions to transfer wealth from foreign to domestic producers appears to coexist uneasily with a central tenet of the international cooperation literature: cooperative agreements are voluntary agreements. Because they are voluntary, cooperative agreements are constrained by the Pareto condition—only those agreements that make all actors better off will be concluded. Since transfers by definition make someone worse off, they appear to be ruled out. Thus the Pareto condition might lead us to suggest that even if politicians sometimes have an incentive to propose redistributive institutions, the redistributive institutions they propose will not be created.

“Cooperative” international redistribution is impossible, however, only if two stringent conditions are met: unanimity is the choice rule and no actor has the ability to manipulate the choice set, that is, the set of alternatives from which the outcome is selected. If either of these conditions is missing, politicians can construct an international institution that transfers wealth. The implication of moving from unanimity to majority rule is obvious: the majority can redistribute wealth from the minority. Although majority rule is not the dominant decision rule in international politics, it does characterize some organizations—the International Monetary Fund (IMF) and World Bank, for example, take decisions by weighted majority, as does the European Union on many issues. Thus the politics of institution building in these bodies can be redistributive.

Less obvious, however, is the recognition that if one actor can define the choice set, redistribution is possible even under unanimity rule. The logic is similar to agenda-setting power in the public choice literature. Because majority rule voting can generate cycles, instances in which no single outcome defeats all other alternatives in pair-wise voting, “an individual who can control the agenda of pair-wise votes can lead the committee to any outcome in the issue space he desires.”¹⁵ Agenda-setting power arises because outcomes are sensitive to the way agenda setters frame the choices others must make, and this logic is fully applicable to unanimity rule situations. Under unanimity rule, an actor can manipulate other governments’ choices by excluding the status quo from among the feasible alternatives and including only redistributive outcomes among them. With the status quo no longer a relevant choice, foreign politicians must choose among costly outcomes and will choose the least costly—the powerful actor’s desired regulation—even though it entails a negative wealth transfer. Thus, by having the power to define choice sets, politicians can use international regulation to transfer wealth from foreign to domestic producers.

14. North 1991, 16.

15. Mueller 1989, 88.

To summarize, the model argues that politicians propose international institutions as maximizing responses to interest group and voter pressure. The need to satisfy voter demands without imposing costs on domestic producers leads politicians to initiate international regulation that satisfies voter demands and transfers wealth from foreign producers to compensate domestic firms for the costs of the regulation. An international institution is created if the proposing politician can eliminate the status quo from other politicians' choice sets, forcing them to choose between redistributive options.

Market Failure, Redistribution, and the Creation of the Basle Accord

The creation of the Basle Accord corresponds more to a redistributive rent-seeking than to a market-failure logic. International capital adequacy standards reached the international agenda not as an optimal economic response to the debt crisis, but as a U.S. congressional response to competing demands from voters and bankers. Moreover, banking data and bargaining positions of G-10 politicians within the Basle Committee suggest that there was no Pareto improvement to be realized from harmonized international capital adequacy standards. This conclusion poses a puzzle: if international capital adequacy regulations did not provide joint gains, why did the G-10 implement the Basle Accord?

Domestic Politics and the Origin of the Basle Accord

Kapstein argues that the Basle Accord was an efficient response to international market failure. Clearly, banks had engaged in unsound lending practices. The debt crisis, for the developed world, was caused by too many loans to too few high-risk borrowers. By 1982, Mexico alone owed U.S. banks \$23 billion, estimated to be about 46 percent of the capital of America's seventeen largest banks. Once Brazilian and Argentinean loans are added, "the nine largest U.S. banks had lent more than 140 percent of their capital to these three countries."¹⁶ Exposure among the dozen largest American banks in the five most indebted Latin American countries ranged from a low of 82.7 percent to a high of 262.8 percent, with most banks falling between 140 and 180 percent. In short, the lack of prudential oversight by American regulators had allowed U.S. money center banks to engage in unsound lending practices, the consequences of which threatened the stability of the U.S. financial system.

Commercial bank weakness, however, was insufficient to generate a demand for international regulation. U.S. regulators initially sought to address the financial consequences of the debt crisis not by tightening the regulatory framework governing international lending, but instead through a transfer of wealth from voters to commercial banks and a transfer of risk from commercial banks to voters. Both would be

16. Reinicke 1995, 142.

achieved through the IMF. The IMF would be granted additional capital with which to provide developing country debtors new credits with which to service their loans, a process that would transfer ownership of a portion of developing country debt from commercial banks to the public sector. Through this process, “society as a whole,” rather than the commercial banks, would bear the risk of default by less-developed countries (LDCs). Implementing this strategy required an increase of IMF resources, and thus in early 1983 IMF members agreed to a 47 percent increase in IMF resources. The U.S. share of this increase was approximately \$8.4 billion, and its provision required congressional approval.

Calls for stricter financial regulation emerged only after the Reagan administration submitted the IMF quota increase to Congress, and initially these calls focused on domestic regulation. Congress was “scarcely a hotbed of support for the IMF.”¹⁷ The United States was engulfed in its deepest recession since the 1930s. Industrial production was declining, unemployment had risen to 10.8 percent, and the federal budget deficit in fiscal 1982 reached a record \$110.7 billion. Within such an environment, voters were not enthusiastic supporters of the proposed \$8.4 billion transfer to money center banks. Senator Joseph Biden reported being confronted at town meetings by taxpayers opposed to using their money to bail out the banks, and his colleague Senator Larry Pressler reported that the IMF funding issue had been raised by citizens in each of the twenty-five town meetings he held. Senator Claiborne Pell also stated that his constituents were asking tough questions regarding the IMF issue, “[questions] that I find hard to answer.”¹⁸ In open hearings, over a dozen members of Congress related to Secretary of State George Schultz that they had faced pressure from constituents opposed to the IMF quota increase. An August 1983 Louis Harris and Associates poll summarized voter sentiment, reporting that 77 percent of those surveyed opposed increasing IMF funds.

Such public sentiment was not conducive to congressional support for the IMF quota increase. As Ferdinand St. Germain, chair of the House Banking Committee stated, “at a time when millions stand in unemployment lines and thousands of small businesses are filing bankruptcy petitions, the idea of an international bailout for adventurous U.S. bankers may not be the most popular idea on the legislative agenda.”¹⁹ Senator William Proxmire was even more blunt: “If you’re going to lend \$9 billion to anybody, why not provide it to home builders or automobile buyers.”²⁰ The need to satisfy voter concern led Congress to search for a legislative linkage that would reduce voter costs—as Senator Jake Garn put it, “the price of an \$8.4 billion increase in the IMF authorization . . . is going to be legislation so that lawmakers can go home and report that we did not bail out the big banks.”²¹

The legislation Congress initially considered was to tighten domestic financial regulation, and in particular to impose and enforce capital adequacy standards uni-

17. Kapstein 1994, 92.

18. *Congressional Quarterly*, 19 February 1983, 371.

19. U.S. House 1982, 2.

20. U.S. Senate 1983, 3.

21. Reinicke 1995, 146.

formly on all U.S. commercial banks. Capital adequacy regulation held two advantages. First, and more obvious, forcing commercial banks to raise new capital would visibly demonstrate that taxpayers would not bear the full costs of the debt crisis. Second, but no less important, there was a broad congressional consensus that U.S. regulatory authorities were partially responsible for the debt crisis; as Senator Proxmire queried, “where were our regulators when all this debt was piling up? They did everything but regulate.”²² Regulatory authorities came under scrutiny for having failed to enforce commercial bank compliance with uniform capital standards introduced in 1979. The Federal Reserve had not enforced these standards for the large commercial banks because it believed that their easy access to international capital markets and more diversified lending portfolios made higher capital reserves unnecessary. According to Federal Reserve Chair Paul Volcker, nothing was wrong with the framework introduced in 1979, and he urged Congress not to “overreact with excessive regulations.”²³ Determined, however, to find some way to make banks bear at least some costs of the debt crisis to satisfy voter concern, Congress pushed forward with capital adequacy in spite of Volcker’s plea for caution.

The congressional push for stricter regulation generated opposition from the commercial banks. As the vice chairman of Chase Manhattan Bank told a congressional committee, “a tighter web of administrative controls around the foreign lending of banks . . . would be unwise, unnecessary, and counterproductive. . . . [T]he fundamental situation of banks is sound.”²⁴ Bank opposition was based on their recognition that tighter capital standards, by reducing commercial bank profitability, would accentuate two trends that had been eroding U.S. commercial bank business. On the one hand, U.S. commercial banks were facing increasing competition from foreign, particularly Japanese, commercial banks. During the high-growth period of international finance between 1960 and 1980, U.S. banks accounted for 30 percent of total international banking business, nearly a 10 percent larger market share than rival institutions from Japan. By 1985, however, the market share of U.S. commercial banks had fallen to 23 percent, whereas Japanese banks had climbed to 26 percent.²⁵ Moreover, cross-national differences in existing capital adequacy regulations were seen by American bankers as directly contributing to their competitive difficulties. In a Group of Thirty survey of commercial banks administered in late 1981, U.S. bankers specifically pointed to existing capital adequacy standards as a factor that contributed to their competitive disadvantage vis-à-vis Japanese and European commercial banks.²⁶

U.S. commercial banks were also facing strong competition from other financial institutions as a result of securitization. Borrowers were increasingly bypassing commercial banks, raising capital instead through bond and equity issues that U.S. commercial banks were legally barred from underwriting. Between 1960 and 1981, “com-

22. Quoted in Reinicke 1995, 144.

23. *Ibid.*

24. *Ibid.*

25. Bryant 1987, 35–36.

26. Group of Thirty 1982.

mercial banks' share of the market for short- and intermediate-term commercial lending declined from 83 percent to 60 percent."²⁷ Similarly, the share of assets of American financial institutions held by commercial banks dropped from 57 to 38 percent between 1946 and 1980. The same trend was evident in international markets, where between 1981 and 1983 the percentage of all international financial market activity provided by syndicated commercial bank loans fell from just less than 75 percent to approximately 40 percent as borrowers relied more heavily on international bond issues and Euro-note facilities.²⁸ In short, U.S. commercial banks were losing their traditional business to foreign commercial banks and to foreign and domestic investment banks and nonbank banks. Unilaterally imposed capital adequacy standards such as those being contemplated by Congress would further weaken their competitive position.

Congressional debate thus made clear that transfers to commercial banks would alienate voters, whereas satisfying voters by implementing stricter capital adequacy requirements would alienate commercial banks and cost campaign contributions. The need to respond to both groups led Congress to link stricter capital standards in the United States with an international agreement on uniform capital standards. Higher domestic capital requirements, by forcing U.S. commercial banks to raise new capital, would satisfy voter demands, whereas international regulation would shift the relative competitiveness of American, European, and Japanese banks, thereby transferring income from foreign commercial banks that would compensate U.S. commercial banks for the costs of the domestic regulation. This linkage was laid out in the International Lending Supervision Act (ILSA). Passed by Congress on 30 November 1983, ILSA directed regulatory agencies to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions" and to "encourage . . . other major banking countries to work toward maintaining, and where appropriate strengthening, the capital bases of banking institutions involved in international lending."²⁹ Pursuant to this, Congress instructed U.S. regulatory authorities to use the Basle Committee to establish an international agreement on uniform capital standards.

Thus, even if we accept the premise that the debt crisis revealed an international financial market failure, this was not sufficient to generate a demand for international regulation. Rather than seek new regulation, U.S. regulatory authorities initially sought to address commercial bank weakness by using the IMF to transfer LDC loans from commercial banks to the public sector and opposed congressional demands for a stricter regulatory regime. Capital adequacy was placed on the international agenda by a U.S. Congress responding to voter unwillingness to bear the costs of bank lending practices and commercial banks' unwillingness to bear the competitive costs of stricter domestic regulations. An international agreement on capital adequacy offered American politicians a way to satisfy both demands; the voters would get regu-

27. Reinicke 1995, 57.

28. *Ibid.*, 45.

29. ILSA 1983, 1280–81.

lation, and commercial banks would be compensated by reducing the regulatory advantage enjoyed by foreign commercial banks.

Looking for International Market Failure

Though domestic politics in the United States pushed capital adequacy onto the international agenda, the Basle Accord might still have been a Pareto-improving correction of an international market failure. In this section we assess whether in fact it was. We use objective banking data on extant bank capital–asset ratios and exposure to LDC borrowers to assess the soundness of G-10 commercial banks and the extent to which an economic market failure was present. We then examine the bargaining positions of key G-10 governments (Japan, France, and Germany) to assess the extent to which policymakers believed harmonized capital regulations would be beneficial. The evidence fails to show either an objectively compelling financial stability rationale for international capital adequacy regulations or a belief by G-10 policymakers that joint gains could in fact be realized from such an initiative. In other words, harmonized capital adequacy regulations did not provide joint gains.

We turn first to data on exposure of G-10 commercial banks to LDC borrowers and extant capital–asset ratios. The reason for considering this data is simple. Loans to developing countries were high-risk assets that carried a high probability of default. Losses of these assets would eat into banks' capital reserves—those who had small capital reserves compared to exposure would be most likely to fail, and the failure of large banks could initiate a global financial crisis. Thus evidence consistent with an international market failure would be a generalized pattern of high-risk loans and low capital reserves relative to assets. The data, presented in Tables 1 and 2, fail to suggest such a pattern. Data on LDC exposure (Table 1) illustrate a very uneven pattern. U.S. banks were most exposed, with the least vulnerable banks exposed at almost 100 percent of capital, and the most exposed at close to twice their capital. British and Japanese banks were much less exposed. The most exposed British bank had only 80 percent of its capital at risk, whereas the most exposed Japanese banks were at risk for just above 50 percent of their capital. Thus only U.S. banks were exposed above capitalization. Data on capital–asset ratios (Table 2) show that among the large banking countries, U.S. and British banks had the highest capital–asset ratios and were much more highly capitalized than were Japanese banks. The political importance of the high capital–asset ratios in the United States and the United Kingdom compared to Japan is addressed in the next section. Here it is sufficient to note that the pattern in capital–asset ratios appears consistent with underlying asset portfolios—American and British banks, being more exposed in risky LDCs, were carrying more capital than were less exposed Japanese and European banks. Based on this data, it is difficult to conclude that Japanese or British banks were so undercapitalized that they jeopardized the international financial system. The data do show an extreme weakness in U.S. commercial banks. One could argue that a collapse of the large U.S. commercial banks would cause a collapse of the U.S. financial system, and this in turn would threaten the international financial system. Such an argument,

TABLE 1. *LDC exposure of commercial banks, 1988*

<i>Country</i>	<i>Loans to LDCs, capitalization</i>
United States	93–199%
United Kingdom	27–82%
Japan	<55%

Source: De Carmoy 1990.

however, overlooks the more obvious point that American policymakers could have strengthened U.S. commercial banks through domestic legislation; correcting this weakness did not require international regulation.

Basle Committee bargaining positions do not suggest that G-10 policymakers believed that they confronted an international market failure. Not only did other G-10 policymakers not appear to believe that the lending behavior of their commercial banks required an international approach to capital adequacy, but many actively opposed the U.S. initiative. The U.S. proposal would require European and Japanese commercial banks to raise significant amounts of new capital, and raising and holding additional capital would reduce profitability. If G-10 policymakers expected the improvement in financial stability that would result from harmonized capital adequacy standards to be greater than the expected cost of new capital, one would expect them to welcome the American proposal and to move quickly to design and implement the proposed system. Yet the United States' request for international capital standards, put to the Basle Committee in 1983 by Volcker, was "greeted with a yawn."³⁰ Although "central bankers agreed . . . that capital levels should not be allowed to drop further," they did not agree that a single standard was necessary.³¹ In fact, by early 1986 G-10 central bankers had concluded that international agreement on capital adequacy standards was unlikely.³²

Just as U.S. preferences emerged from domestic pressures, "domestic regulatory authorities [in other G-10 countries] came under increasing pressure from their banking constituencies not to adopt any kind of regulation that would adversely affect the competitive position of their banking system."³³ Japanese and French regulators were the most vocal opponents of the U.S. initiative because the U.S. proposal would adversely affect French and Japanese commercial bank competitiveness. Capital-asset ratios in both countries were the lowest among the G-10 (see Table 2), and commercial banks in both countries had taken advantage of these less demanding requirements to gain international market share at the expense of British and Ameri-

30. Kapstein 1994, 108.

31. *Ibid.*, 276.

32. Reinicke 1995, 164.

33. *Ibid.*

TABLE 2. *Capital-asset ratios, 1981-87 (percentages)*

<i>Bank</i>	<i>1981</i>	<i>1982</i>	<i>1983</i>	<i>1984</i>	<i>1985</i>	<i>1986</i>	<i>1987</i>	<i>Mean</i>
Banque Nationale de Paris	0.42	1.34	1.53	1.51	1.98	3.15	3.17	1.87
Banque Bruxelles Lambert	1.81	1.49	1.68	1.55	1.61	2.10	2.04	1.75
Allgemeine Bank	2.37	2.52	2.75	2.67	2.91	3.51	3.96	2.96
Dresdner Bank	2.93	2.88	2.68	2.66	2.82	3.24	3.23	2.92
Deutsche Bank	3.10	3.27	3.24	3.33	3.99	3.93	4.06	3.56
Banca Nazionale del Lavoro	3.85	3.84	2.88	4.11	4.70	5.39	3.80	4.09
Barclays	4.66	4.68	4.56	3.53	5.07	4.71	4.83	5.01
Union des Banques Suisse	5.67	5.14	4.97	5.09	5.78	5.71	6.08	5.49
Bank of America	3.54	3.97	4.45	4.50	3.96	3.39	3.59	3.91
Citicorp	3.80	3.98	4.58	4.50	4.64	4.73	4.33	4.37
Chase Manhattan	4.77	4.26	4.75	4.93	5.25	5.37	3.31	4.66
Sumitomo	3.13	2.95	2.96	2.25	2.85	2.95	2.20	2.53
Dai Ichi Kangyo	3.26	2.86	2.63	2.51	2.38	2.38	1.79	2.54
Fuji	3.51	3.00	2.98	2.82	2.82	2.89	2.20	2.49

Source: De Carmoy 1990.

can banks.³⁴ Harmonized capital adequacy therefore represented a negative transfer of banking income. As one prominent Japanese banker noted, common capital adequacy regulations would mean “that Japanese banks would be paying a lot of additional taxes, and through these taxes their financial strength would deteriorate.”³⁵ German opposition derived less from a fear of losing an existing competitive advantage based on low capitalization than from what they believed to be a poor fit between the proposed regulation and the structure of the German banking system. The universal banks that dominated German finance, financial institutions engaged in both commercial and investment bank activities, had different capital requirements than did the commercial banks that dominated other G-10 financial systems. Imposing a unified standard, the German authorities argued, would seriously disadvantage German banks.³⁶ In short, while U.S. policymakers were seeking to eliminate existing regulation-induced competitive advantages, Japanese, French, and German regulators were seeking to preserve them. As a result, the U.S. proposal failed to offer joint gains.

The available evidence, therefore, fails to support a compelling argument for an international financial market failure being corrected by and joint gains being realized from harmonized capital adequacy regulations. Banking data does not suggest a compelling international financial stability rationale for capital adequacy regulations. Although U.S. commercial banks were weak, their strengthening did not require international regulation. Nor did G-10 policymakers’ bargaining positions indicate that they believed an international financial market failure had occurred. Rather

34. *The Banker*, May 1987, 55-59.

35. *American Banker*, 25 June 1987, 2.

36. Underhill 1991.

than quickly instituting international regulations, G-10 policymakers opposed and delayed the initiative because they recognized that the new rules would erode the competitive advantage of their commercial banks. Thus, rather than international market failure, the evidence suggests a lack of concern that existing regulation was inadequate—a lack of interest in, and a lack of mutual benefits from, the U.S. proposal for harmonized international capital adequacy regulations.

*Redefining the Choice Set: Financial Market Power
and the Basle Accord*

If harmonized capital adequacy regulations failed to offer joint gains, why did the G-10 agree to the Basle Accord? We suggest that the United States achieved a multilateral agreement by using financial market power. By concluding a stringent bilateral accord with Great Britain and threatening to apply the terms of this accord to foreign banks operating in the U.S. market, American policymakers effectively eliminated the regulatory status quo from G-10 policymakers' choice sets. Rather than a choice between a multilateral accord and the regulatory status quo ante, G-10 policymakers confronted a choice between a costly multilateral accord and an even more costly bilateral accord. Given these options, G-10 policymakers chose the multilateral accord.

In mid-1986 U.S. regulatory authorities, frustrated with the lack of movement in the Basle Committee, initiated discussions with the British government aimed at achieving a bilateral agreement on capital standards. The United Kingdom was an obvious partner. British regulators were revising domestic banking regulations in preparation for the "big bang" of financial deregulation, and a March 1986 Bank of England paper had presented proposals for new capital adequacy regulations. As in the United States, British regulators were pressured by British bankers not to undermine British commercial banks' competitive position. Denis Child, deputy chief executive of National Westminster Bank and chair of the British Bankers' Association, warned the Bank of England in mid-1986 that foreign banks were "working under less demanding regulations," and that the banking industry was concerned "that the Bank of England paper could, by accident rather than by design, place the British banks at a competitive disadvantage."³⁷ Competitive disadvantages were particularly acute in the area of capital ratios, because British authorities required British banks to maintain capital-asset ratios far higher than those prevailing in Japan (see Table 2). The Bank of England's proposals would have tightened these still further by requiring banks to hold capital to cover off-balance-sheet activities. Thus, like the U.S. government, British regulators had a clear interest in trying to pressure other G-10 countries to raise capital-asset ratios to compensate for the regulation they were imposing on British banks. A U.S.-U.K. partnership was quickly forged based on this common competitive interest, and negotiations that began in the second half of 1986 yielded a bilateral accord in January 1987. The bilateral accord provided a

37. *Financial Times*, 7 June 1986, 2.

common definition of capital, a common risk-weighted framework for relating capital to assets and off-balance-sheet items, and a common minimum capital requirement.³⁸

Rather than an abandonment of the attempt to achieve a multilateral accord, however, the bilateral accord represented a decisive attempt by the United States to eliminate the regulatory status quo from the Basle Committee's choice set and force a multilateral agreement. That the accord had such an impact was immediately recognized. Markus Lusser, vice chair of the governing board of the Swiss National Bank, noted the redefining nature of the bilateral accord: "Countries not prepared to join an agreement . . . could easily be put under pressure. It would be sufficient to bar their banks from using [these] financial centers or to subject them to special treatment there. If they wish to remain competitive internationally, the large banks . . . would quickly encourage their governments to cooperate internationally."³⁹ American regulators used the bilateral accord to drive home to G-10 regulatory authorities that their banks now faced a much more stringent regulatory environment in U.S. markets. In early 1987 Volcker announced that though the United States had not previously applied U.S. bank capital standards to foreign banking organizations seeking to expand in the United States, the bilateral accord provided a good base from which to begin to do so.⁴⁰ This threat became explicit in early 1987 when the Federal Reserve demanded data on capital structures in line with the capital definitions and requirements established in the bilateral accord from five Japanese banks owning subsidiaries in the United States.⁴¹

While wielding the stick of the bilateral accord with one hand, U.S. officials offered with the other hand the carrot of moderating the terms of the accord in exchange for a multilateral agreement. Gerald Corrigan, president of the New York Federal Reserve, traveled to Tokyo in January 1987 where he encouraged the Japanese government to align their capital requirements with those embodied in the bilateral accord, and he suggested soon after that the bilateral accord "is an approach which can easily be adapted to future developments."⁴² Volcker, testifying before Congress that summer, continued Corrigan's theme, suggesting that U.S. and British officials would hold off on the implementation of the bilateral accord because "we have a chance of getting a much broader agreement."⁴³ In short, U.S. policymakers used the bilateral accord to redefine G-10 policymakers' choice sets. Rather than a choice between a multilateral agreement and the regulatory status quo, G-10 policymakers now faced a choice between a stringent bilateral accord and a less stringent multilateral agreement.

38. U.S. House 1987, 437.

39. Speech delivered at Boppard am Rhein, 13 March 1987.

40. U.S. House 1987, 439.

41. Reinicke 1995, 172. The Japanese Ministry of Finance refused to provide the requested data. See *American Banker*, 10 March 1987, 1.

42. Reinicke 1995, 170.

43. U.S. House 1987.

The Japanese were the primary targets. In fact, the bilateral accord appears to have been designed specifically to leave the Japanese with little choice but to negotiate a multilateral accord. One suspects such a motive because one feature of the bilateral accord would be particularly costly for Japanese commercial banks. At the time, a large portion of Japanese banks' capital was held as unrealized capital gains on equities and real estate. In case of loan losses, some of these gains were realized and used to cover the loss. The bilateral accord excluded unrealized capital gains from its definition of core capital. Were Japanese authorities to refuse to negotiate a multilateral accord, Japanese banks operating in the U.S. and U.K. markets would therefore need to raise significant amounts of new capital. Japanese banks faced a choice between a regulatory regime in two of the world's largest markets that excluded an important source of their capital and the best alternative agreement Japanese regulators could gain from American authorities.

Japanese banks responded to this threat with a four-pronged effort that suggested the bilateral accord was having its intended effect.⁴⁴ First, Japanese banks tried to get exempted from the accord's terms, using the Japanese Federation of Bankers Association to lobby the Bank of England and the Federal Reserve to request that part of their hidden reserves be included in the definition of capital. Second, Japanese banks began to reduce the extent to which they cut prices to gain market share in the U.S. market. According to some Japanese bankers, Ministry of Finance officials had cautioned them against aggressive pricing in response to Corrigan's January visit to Tokyo. Third, Japanese banks began to raise significant amounts of new capital, just less than \$11 billion by one estimate—a move some Japanese bankers admitted was an attempt to reduce U.S. pressure on formal capital adequacy requirements.⁴⁵ Finally, Japanese banks encouraged Japanese regulators to negotiate a multilateral agreement that incorporated hidden reserves, and by June 1987 Japanese officials had agreed in principle to the framework established by the U.S.-U.K. accord. By late September, Japanese, British, and American officials had agreed that commercial banks would be permitted to include 45 percent of their hidden reserves as part of their base capital, and the Japanese accepted a multilateral agreement on capital adequacy. Thus by early fall the bilateral accord had achieved its intended effect. By confronting Japanese banks with a highly unfavorable regulatory environment, U.S.

44. Direct pressure on capital adequacy was accompanied by U.S. and U.K. pressure on liberalization of Japanese financial markets. "The Japanese authorities . . . are anxious to convey the message that despite the technical difficulties involved, the issue can be settled without the risk of flaring up into yet another international confrontation over the scope and pace of the country's financial liberalization" (*Financial Times*, 4 March 1987, 33). It is interesting that in this same time period Japanese regulators allowed U.S. commercial banks to operate securities units in the Japanese market (*Financial Times*, 13 May 1987, 37). The extent to which there was an explicit linkage between this and the Basle Accord is unclear, as is the direction of the linkage; that is, the Japanese government may have allowed U.S. commercial banks to enter these markets in hopes that doing so would reduce pressure from the U.S. government on capital adequacy; the U.S. government may have used capital adequacy as a lever to force greater access to the Japanese market for American banks.

45. For lobbying efforts, see *Financial Times*, 4 March 1987. For reductions in price-based competition, see *American Banker*, 8 June 1987, 2. For efforts to raise capital, see *American Banker*, 25 August 1987, 2.

policymakers had forced them to raise new capital, to ease their aggressive pursuit of market share, and to pressure Japanese authorities to begin serious negotiations on a multilateral capital adequacy agreement.

Conclusion

The creation of the Basle Accord corresponds more to a rent-seeking than to a market failure logic. Rather than an optimal economic response to international financial weakness, the proposal for harmonized capital adequacy regulations emerged from congressional efforts to reconcile competing demands from U.S. commercial banks and voters. Voters were demanding that commercial banks bear the costs of the debt crisis, whereas bankers were demanding that they not be burdened with regulatory measures that would further limit their ability to compete against Japanese banks. Nor was international market failure evident once capital adequacy reached the G-10 agenda. There is no compelling evidence of widespread commercial bank weakness, nor did all G-10 policymakers believe that harmonized capital adequacy regulations would yield benefits relative to the regulatory status quo. Finally, the Basle Accord was created only after U.S. policymakers, acting in conjunction with the British government, had used financial market power to alter the choices other G-10 policymakers confronted. The Basle Accord suggests, therefore, that joint gains are not necessary to prompt policymakers to create international institutions. The Basle Accord is a case of redistributive cooperation.

The broader point is not that all (or even a large number of) international institutions are redistributive, but that thinking about redistributive cooperation requires us to go beyond the functionalist claim that policymakers create international institutions because the resultant reduction in information, transactions costs, and enforcement problems permit joint gains to be realized. We must develop explanations that focus on why governments seek the specific agreements they enforce through the international institutions they create. Creating such explanations requires models that explain why governments propose international institutions in one issue area rather than another, why they create international institutions at one time rather than earlier or later, and why, when they do propose an international institution, they propose one set of rules rather than another.

Developing answers to these questions shifts our attention to domestic politics; the model presented here suggests that governments create international institutions to maintain or expand their political support coalitions. Politicians propose new international institutions, or try to alter existing ones, when demands by members of their political support coalitions cannot be satisfied within the domestic political arena without alienating other members of this coalition, and when they have the capacity to shape international outcomes. The rules they propose will reflect the specific demands made by specific members of this electoral coalition. In short, thinking about redistributive cooperation encourages us to think about how domestic politics generate incentives for governments to create international institutions. Because there is

no a priori reason to expect the processes that generate welfare-improving international institutions to differ systematically from those that generate redistributive international institutions, the approach presented here has a general applicability: politicians create international institutions to maintain and extend electoral coalitions. Sometimes the international institutions they propose will be welfare improving, and sometimes they will be redistributive.

We suggest that analysts should abandon their sole reliance on the market failure analogy to explain why governments create international institutions and follow more closely the trajectory blazed by theories of regulation. In the regulation literature the initial depiction of regulation as a public good gave way to an approach that emphasizes the private goods that regulation creates. Assumptions about policymakers' motives in producing regulation were also altered. An initial treatment of policymakers as omniscient social planners maximizing aggregate social welfare was supplanted by the assumption of self-interested politicians maximizing political support. It is time for similar shifts to occur in studies of international institutions.

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