From Developmental to Regulatory State? Japan's New Financial Regulatory System

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ABSTRACT

Recent financial reforms in Japan and elsewhere in Asia represent, for various authors, a fundamental shift in financial governance and in state-business relations in the region. The old 'developmental' state in East Asia has supposedly made way for a neoliberal, 'regulatory' state, with its emphases on agency independence and the non-discretionary enforcement of rules. I show in this paper that this interpretation exaggerates the extent of the transformation in the important case of Japan. Although the outward institutional forms of economic governance in Japan, as with many Asian developing countries, has changed dramatically since the mid-1990s, discretion still remains at the core of economic and financial policy. In the area of Japanese banking regulation and supervision, I show how this highly discretionary application and enforcement has been consistent with domestic political pressures. The result is a substantial divergence between superficial convergence upon international regulatory standards and underlying behaviour. I also give reasons why globalization does not mean that this hybrid regulatory model is unsustainable.

Key words: **Japan, regulation, compliance, developmental state, neoliberalism, international standards, convergence.**

Draft version: 16 February 2006.

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From Developmental to Regulatory State? Japan's New Financial Regulatory System[1]

Since the end of the bubble era, banking sector problems and associated reform proposals have been at the heart of Japanese politics, including the election of September 2005. Japan's ongoing financial problems gained international attention as the 1990s wore on because many suggested they were contributing to deflation and undermining economic recovery at home and abroad. Increasingly, a consensus emerged that Japan's pre-1990s financial regulatory framework was substantially to blame for the rampant lending of the bubble era and the proliferation of non-performing loans in the 1990s. Within Japan and abroad, proposals for tightening the bank regulatory and supervisory framework were made, though reformers have faced considerable domestic political and bureaucratic opposition along the way.

The deepening of Japan's banking sector crisis from 1997 led to a series of reforms that aimed to bring Japan's regulatory framework into conformity with 'international best practice standards.' These were embodied in the international 'standards and codes' negotiated within various international economic organizations and promoted by the International Monetary Fund (IMF), World Bank and the newly created and G-7 dominated Financial Stability Forum (FSF) (see Eichengreen 2002; Goldstein 2001; Schneider 2003). Elsewhere in East Asia, financial crisis also pointed to failures in existing financial regulatory systems. Although Japan's own economic crisis was less dramatic than in Indonesia, Korea and Thailand, its protracted nature

[1] I am grateful to Hyoung-kyu Chey and two anonymous reviewers for helpful comments on an earlier draft. None are responsible for remaining errors. Thanks are also due to the Japan Foundation Endowment Committee for funding a research trip to Tokyo.

and the apparent inability of its government to prevent continued deterioration suggested that Japan must also import western financial regulatory standards. Not only significant parts of Japan's financial and corporate sectors, but its whole political-economic system seemed bankrupt (Kerr 2001).

The financial reforms adopted since then in Japan and elsewhere in Asia have been characterized as a fundamental shift in financial governance and in state-business relations (Amyx 2000, 2003, 2004). In East Asia generally, some authors have suggested a broad convergence upon the policies and institutions of a neoliberal, 'regulatory' state model under the pressures of globalization (Jayasuriya 2005; Pirie 2005).[2] Gone, apparently, is the old symbiotic relationship between government and business and the highly discretionary policy intervention that was the hallmark of Japan's system of 'administrative guidance' or of Korean developmentalism.[3] In its place, we are told, is a neoliberal regulatory state epitomized by the delegation of core policy responsibilities to autonomous regulatory agencies. Discretionary economic governance is thus replaced with fixed rule, 'depoliticized' governance, whether in monetary policy or in financial supervision. As Amyx (2004: 197) puts it, in the Japanese case a fundamental 'paradigm shift' in Japan's approach to regulation occurred in the late 1990s, 'away from the relational system of regulation characterized by informality, opacity, and bureaucratic discretion toward a more arms-length, rules-based system of regulation characterized by increasingly transparent and formal interactions between government regulators and financial institutions.'

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[2] Others claim that globalization is producing convergence upon a neoliberal 'competition' state (Soederberg, Menz and Cerny 2005). In what follows, I use the interchangeable term 'regulatory state.'

[3] On the developmental state see, among many other works, Johnson 1982 and Woo-Cumings 1999.

However, have the major East Asian states really become so westernized in their approach to economic and financial regulation? I argue in this paper that although these authors correctly identify the direction of reform, they risk exaggerating the transformation that has to date occurred in Japan (and by implication elsewhere in East Asia). I do not claim that nothing has changed, but there is less change than meets the eye. In particular, low agency independence and regulatory discretion remains at the core of economic and financial policy. Japan's new financial regulatory framework appears much more rules-based, but these rules have been substantially bent in practice to achieve political and bureaucratic objectives.

Of course, for all states there is a gap between the image or rhetoric of regulation and its reality. Even in the neoliberal heartland, discretionary policy interventions that depart from fixed rules do occur, such as in the UK regulator's recent decision to relax solvency requirements for life insurers, or the US Federal Reserve's facilitating role in the rescue of Long Term Capital Management in September 1998.[4] Clearly, 'developmental' and 'regulatory' states are ideal types and within these broad-brush categories there is much variation in practice.[5] However, the degree of regulatory discretion in Japan remains much deeper and more systematic compared to the major Anglo-Saxon countries and the gap between the appearance of imported 'western' regulatory frameworks and the reality of regulation is much

[4] LTCM was not 'bailed out' by the Federal Reserve, as is often claimed, but the Fed played an important role in facilitating a private creditor-led rescue.

[5] Woo-Cumings 1999b stresses how Chalmers Johnson, the founder of the concept of the developmental state concept in Asia, applied it only to Japan, South Korea and Taiwan and distinguished it from the 'predatory' or 'patrimonial' states of South-East Asia. The 'varieties of capitalism' literature has long insisted on fundamental differences between different models of western capitalism (Esping-Anderson 1990; Hall and Soskice 2001).

greater. Thus, underneath the appearance of convergence upon regulatory neoliberalism lies considerable continuity in Japanese regulatory policy. I argue that this continuity stems from a persistent, symbiotic relationship between government and business. Although this relationship is not as close or as productive as in the past, it is unlikely to disappear soon.

This argument could be applied to many East Asian countries,[6] but Japanese financial regulation is a pivotal case. Over 1997-9, the Japanese government undertook three important steps explicitly designed to bring about conformity between Japanese financial regulation and international best practice standards. First, after a series of bank failures demonstrated the inadequacy of the existing deposit insurance fund, the recapitalization of major banks using public funds was undertaken in February 1998 and again in March 1999 (Nakaso 2001, 6-16). Second, as a quid pro quo for this public recapitalization, banks were required to adhere to stricter capitalization and, most crucially, loan accounting rules. The authorities claimed that these rules were in conformity with those in the US, the now accepted best practice benchmark.[7] Third, in June 1997 the government legislated for a new, integrated financial regulatory agency (FSA) independent of the Ministry of Finance (MOF), the agency formerly responsible for the country's regulation and supervision.

The rest of this paper asks whether there is now conformity between Japanese regulatory practice and international best practice standards, and whether this reflects the emergence of a neoliberal regulatory state in Japan. My method is as follows. I assess Japanese compliance with the core set of international bank supervisory

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[6] See Walter, forthcoming.

[7] FSA, 'About the Financial Services Agency', p.14, available at: http://www.fsa.go.jp/info/infoe/pamphlet_e.pdf, accessed 5 November 2003.

standards, in particular the Basle Core Principles for Banking Supervision (BCP).[8] I focus on banking regulation and supervision because Japan's financial system remains dominated by banks rather than by capital markets (IMF 2003a, 28), and because this has been the most important focus of the convergence efforts of the Japanese government since 1997. Japan participated in the negotiation of the Basle standards over 1996-7, then intended primarily as a benchmark for regulatory reform in the major emerging market countries. Nevertheless, by the late 1990s the BCP had also become one of the key benchmarks for Japanese regulators too, given the perceived and openly admitted weaknesses of their existing regulatory framework. In some areas, where the BCP lack specificity, Japanese reformers have looked primarily to the US and UK for regulatory detail and so I also employ relevant regulatory benchmarks from these countries where appropriate.

The paper is structured as follows. Section 1 briefly discusses some definitions and justifies the method adopted here. Section 2 explores how Japan's deepening crisis led to formal compliance with international best practice standards and shows that a powerful coalition of private sector and political interests prevented substantive compliance with these standards. A concluding section draws out the implications of the argument.

1. COMPLIANCE WITH INTERNATIONAL STANDARDS: PRELIMINARY ISSUES

Policy standards, according to the FSF, 'set out what are widely accepted as good principles, practices, or guidelines in a given [policy] area.'[9] Twelve sets of

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[8] See BCBS 1997.

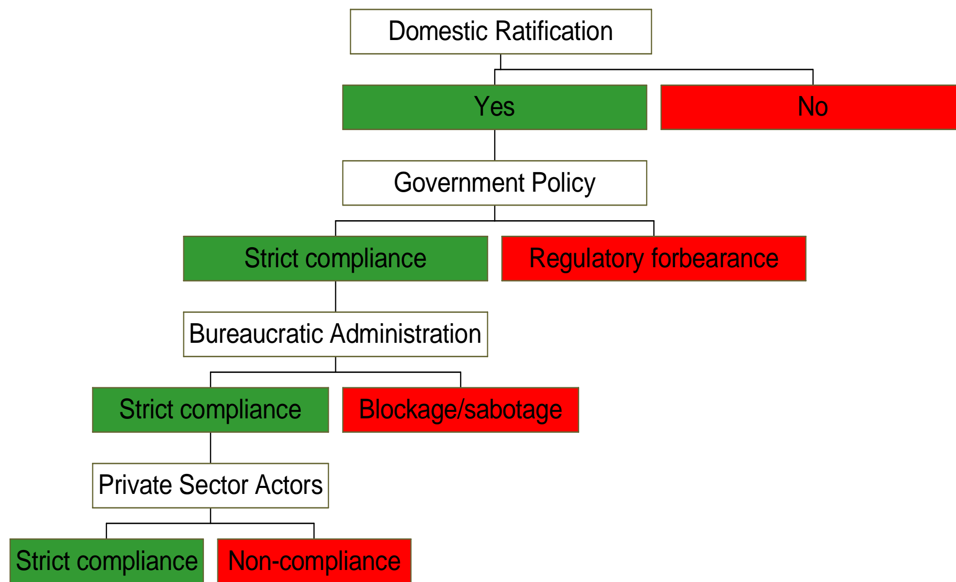
[9] FSF, 'What are Standards?,' http://www.fsforum.org/compendium/what_are_standards.html, accessed 22 April 22, 2003.

international standards and codes have been negotiated, mostly since the mid-1990s, in the areas of macroeconomic policy and data transparency, institutional and market infrastructure, and financial regulation and supervision. In the latter two there are standards relating to international accounting and corporate governance, banking, securities and insurance supervision, money laundering and terrorist financing, and a range of other areas.[10] All of these standards are voluntary, though the IMF and World Bank now encourage all member states to adopt them and to have their compliance independently assessed. Many developed and developing countries, including Japan, have done so in recent years.

We can distinguish between formal and substantive compliance with international standards (Raustiala and Slaughter 2002, 539). *Formal compliance* occurs when organizations take the necessary steps to ensure that legislation and institutions are consistent with international standards. *Substantive compliance* occurs when the actual behaviour of all relevant actors conforms to international standards. Substantive compliance may occur without formal adoption if actors comply voluntarily with a given standard, though formal adoption is often an important precondition of substantive compliance. Compliance can be essentially superficial if it is formal but not substantive: I term this 'mock compliance.' The sources of mock compliance are potentially multiple, as illustrated in figure 1.

[10] See http://www.fsforum.org/compendium/key_standards_for_sound_financial_system.html (accessed September 7, 2005) for a description of the standards and standard-setting organizations.

Figure 1: The 'Compliance Chain': Four Sources of Compliance Failure



‘Ratification failure’ occurs when proposed reforms fail to be adopted by a legislature due to organized political opposition (cf. Putnam 1988; Milner 1997). ‘Regulatory forbearance’ occurs when the government itself intentionally refrains from strictly enforcing new standards, systematically or on an *ad hoc* basis. ‘Administrative failure’ occurs when implementing bureaucracies obstruct compliance, due to weak enforcement, low capacity, or corruption. ‘Private sector compliance failure’ occurs when market actors pursue strategies that ignore or negate the effects of new standards. These four kinds of compliance failure are not mutually exclusive; a political system might conceivably suffer from all at once, though mock compliance can only occur if ratification succeeds. In practice, it may be difficult to discern where the main source of compliance failure is located (e.g.: is compliance by a well intentioned government blocked by obstructionist forces in the bureaucracy or the private sector, or is the government itself quietly facilitating non-compliance by under-providing enforcement?). As we shall see, a major difficulty for researchers is that none of the major actors involved may have strong incentives to reveal substantive non-compliance.

By contrast, many actors have strong incentives to signal positive compliance intentions. This is true for the Japanese government and regulatory authorities since 1997 and for the major Japanese banks, all of whom have wished to restore their battered reputations. Japan’s membership of the Basle Committee for Banking Supervision (BCBS), which had responsibility for negotiating standards in this area, meant that Japanese negotiators participated in the standard-setting process from the beginning. As Japan’s own financial crisis worsened from 1997 and the sense of deep-seated failings in its existing regulatory framework grew, the government committed itself to the adoption of and compliance with Basle and other international benchmark

standards. As Eisuke Sakakibara, one of Japan's lead negotiators on international financial issues through the 1990s remarked: 'after the crisis, who could disagree with the need to implement best practice regulation?'[11] The creation of a new independent financial services agency along British lines, with a substantially revised supervisory rulebook, was the key development. By April 2001, the ruling Liberal Democratic Party (LDP), visibly split on the issue of regulatory reform, had elected a new Prime Minister, Junichiro Koizumi, vocally committed to radical economic reform and the eradication of lax regulation of Japan's financial sector in particular. Facing much domestic and international criticism, in 2003 the government claimed substantive compliance with Basle standards and essential equivalence with key US bank regulatory benchmarks.[12]

2. JAPANESE COMPLIANCE WITH INTERNATIONAL BANKING REGULATION STANDARDS

Since 1945, Japan has acquired a generally good reputation in terms of compliance with international rules, standards and norms. Its status as a core member of the G-7 and of international standard-setting bodies, including the BCBS, favours compliance. Other attributes that favour compliance include Japan's high level of development and wealth, its deep institutional and human resource capacity, its long-internationalized banking sector, its effective legal system and relatively low levels of corruption.[13] Even so, I argue in this section that Japan's compliance with key international bank regulatory standards continued to be poor despite the regulatory

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[11] Interview, Tokyo, 18 June 2002.

[12] See footnote 7.

[13] Of Asian countries, only Singapore scores consistently higher in corruption control indices (see e.g. Transparency International 2004, 284-6).

innovations of 1997-9. This prompted growing pressure on Japan from the IMF and the US Treasury, which culminated in 2001 with Japan's agreement to undertake an independent assessment of its compliance with international standards. Above all, it was hoped this would resolve what the Japanese head of the IMF's Asia and Pacific Department termed the 'considerable uncertainty about the size of [Japan's] bad loan problem and the adequacy of banks' provisions against these loans.'[14] The mission began in 2002 and its report was published in September 2003 (IMF 2003a).

It is impossible to assess here compliance with all 25 of the BCP (let alone all relevant international benchmarks). Instead, I focus on two key areas: the independence of regulators (Principle 1) and standards relating to capital adequacy, loan classification and provisioning (Principles 6 & 8, supplemented by US regulatory benchmarks). The first is crucial because the BCBS sees agency independence as a basic institutional prerequisite of effective supervision, and because this is central to the concept of the neoliberal regulatory state. The second set contains essential aspects of the regime in the area of risk management and capitalization and hence are supposed to be key triggers for regulatory intervention of a non-discretionary kind. Assessing this area in some detail helps to discern the extent to which Japan has shifted from a highly discretionary towards a relatively fixed rule bank regulatory regime.

2.1 Independence of financial regulatory agencies

BCP 1 states that regulatory agencies should have 'operational independence to pursue [their objectives] free from political pressure' (BCBS 1997, 13). Before

[14] See IMF 2003e: 16; Yusuke Horiguchi, Director, Asia and Pacific Department, IMF 'Crisis Prevention: Time for Japan to Act', 20 September 2001, available at: http://www.imf.org/external/np/vc/2001/092001.htm, accessed 17 November 2003.

1998, this was not true in Japan. Banking supervision was the primary responsibility of the Banking Bureau of the MOF, though the Bank of Japan (BOJ) also undertook bank inspections. Lax regulation was ubiquitous. The prioritization of growth and, in the MOF, tax collection, meant prudential issues were a low priority. The 'convoy system' ensured that when banks got into difficulty, the MOF and/or stronger banks would bail them out (Nakaso 2001, 2-3). After the bursting of the asset price bubble in 1990, the general assumption was that any small bank failures would be absorbed by the deposit insurance system, but that larger banks were not seriously threatened as asset prices and the economy were expected to recover quickly (Nakaso 2001, 3). The MOF, with the connivance of the ruling LDP, opted for a forbearance policy (Amyx 2004, ch.7). By the mid-1990s, with recovery still elusive, this policy continued because a shift to stricter regulation might lead to a collapse of confidence in the financial system. A full deposit guarantee was proclaimed in 1996, but the deposit insurance system's funds were insufficient to cope with the collapse of several large banks. Accordingly, the MOF desperately needed to prevent large bank failures.

Other factors also favoured generalized regulatory forbearance and administrative blockage as the financial sector's problems deepened. A stock exchange rule that firms would be de-listed if they posted losses for three consecutive years prompted banks and regulators to collude on loan classification and provisioning (Kanaya and Woo 2000, 26-7). The system of *amakudari*, or 'descent from heaven', in which retired MOF and BOJ officials often took up positions in banks they had formerly supervised, compromised the independence of regulators (Horiuchi and Shimizu 1998; Kanaya and Woo 2000, 26). Finally, over 1997-8, senior

officials at the MOF and BOJ were arrested on charges of explicit corruption, including accepting bribes from banks.[15]

A series of financial scandals and failures weakened the authority of the MOF and enabled pro-compliance reformers to push through legislation in June 1997 to establish an integrated financial regulator, the Financial Supervisory Agency (FSA), which began operations in June 1998. The primary objectives were to remove control of financial sector regulation from the MOF and to converge upon international best practice standards.[16] At the beginning of 2001, the FSA became an external agency of the Cabinet Office, with a Minister and Vice-Minister for Financial Services responsible for all matters under the FSA's jurisdiction.

Does the FSA herald a fundamental turning point in financial supervision in Japan? The FSA itself argues that its operational independence is assured because the Prime Minister formally delegates authority for bank supervision, inspection and the granting of banking licenses to the FSA Commissioner, who is in charge of day-to-day operations.

The IMF, to the considerable annoyance of Japanese officials, argued that the FSA is too open to both industry and political pressure (IMF 2001, 25; 2003a, 10, 38, 76). Since all significant reports on individual banks (which are not published) are

[15] Executives from Sanwa Bank and IBJ were also prosecuted (interview, senior bank analyst, Tokyo, 18 June 2002).

[16] Initially, the FSA was established under the auspices of and subordinated to the Financial Reconstruction Commission (FRC), responsible for rehabilitating and improving supervision of the financial sector. In July 2000, the Financial Supervisory Agency was renamed the Financial Services Agency and combined with the Financial Planning Bureau of the MOF. In January 2001, the FSA assumed all the duties of the FRC, which was abolished (IMF 2003a, 6, 37).

referred to the Minister, there is considerable scope for government interference. The rules for dealing with under-capitalized banks remain ambiguous, despite the adoption of a supposedly non-discretionary 'prompt corrective action' (PCA) framework for intervention in 1998. The main trigger point for closing banks is a capital adequacy ratio (CAR) of 2% or below (1% for 'domestic' banks, as explained later), but there is room for discretion in the Banking Act.[17] Nor is the FSA financially independent: its funding comes directly from the government budget rather than from charges on the financial industry.

Behind the scenes, LDP politicians and the MOF continued to wield considerable influence, ensuring that the FRC/FSA did not depart radically from the existing policy strategy. As Amyx (2000, 2003, 2004) argues, 'network state' linkages between the LDP and Diet, private banks, and government agencies created established routes for information transmission, communication and negotiation. In such circumstances, it was difficult for the new regulator to exert its potential independence. In early 2000, the head of the FRC himself said openly that he favoured leniency in bank inspections, in other words the discretionary non-application of the new rules, though this ill-judged comment led to his demise.[18] One prominent Japanese bank analyst also claimed that sources in the FSA told him that a 'very senior' MOF official asked the FSA to postpone special bank inspections until

[17] Interview, Financial Services Agency, Tokyo, 20 June 2002.

[18] His successor caused similar dismay when, in an apparent shift of FRC policy, he suggested that regulators be lenient on small financial institutions and that banks should avoid unwinding their cross-shareholdings since this might put further downward pressure on the stock market ('Japanese Cabinet minister resigns over financial scandal', *CNN.com*, 30 July 2000).

March 2002.[19] The first Financial Services Minister, Hakuo Yanagisawa, once also a (reformist) head of the FRC and reappointed in the 2001 Koizumi government, was widely seen to have caved in to LDP stalwarts in clinging to the official line that no further public funds should be used to resolve the banking sector's problems. Yanagisawa was sacked by Koizumi in September 2002 and replaced by Heizo Takenaka, who favoured more radical reforms (Tett 2004, 265). However, Takenaka lacked support in key LDP constituencies. Hideyuki Aizawa, head of the LDP's powerful anti-deflation and tax committees until November 2003 and of the LDP's 'finance tribe,' was a key source of resistance to a real policy shift.[20]

A month after Yanagisawa's sacking, the now independent BOJ itself sided with the FSA's critics. The BOJ, which retains the right to inspect banks, implicitly criticized the FSA for leniency in arguing that 'through its on-site examination of off-site monitoring, [the BOJ] intends to encourage major banks, in particular, to strengthen their own efforts toward more appropriate provisioning' (BOJ 2002, 2). This was indicative of the growing conflict within the government and LDP over the issue; some senior FSA officials may have quietly supported the BOJ's critique, though as government employees FSA officers are unable openly to criticize official policy.[21]

Capacity constraints are also significant at the FSA, reducing its ability to toughen its inspection regime.[22] In 2000, the number of FSA bank inspection staff

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[19] Interview, senior Japanese bank analyst, Tokyo, June 2002.

[20] 'Friendless: Financial Reform in Japan', *The Economist*, 15 November 2003.

[21] Interview, senior BOJ official, March 2004.

[22] Author interviews, Tokyo, 19 June 2002; IMF 2003a, 38.

was fewer than the number of bank examiners in the US state of Michigan.[23] Supervision and inspection of regional banks, which are weaker than the city banks, is in practice delegated to local branches of the MOF. Given Japan's vast wealth and human capital resources, such capacity constraints are largely politically determined.

2.2 Rules on capital adequacy, loan classification and provisioning

A central part of the BCP and related Basle standards are those on bank capitalization, loan classification and loan loss provisioning. The capitalization standard, BCP no.6, is comprised of the familiar 'Basle I' rules on minimum risk-weighted capital.[24] The loan classification and provisioning standard, BCP no.8, was clarified in a later Basle document (BCBS 1999). Furthermore, there was explicit acceptance by Japanese and other Asian authorities by the late 1990s that the US system of loan classification and provisioning represented international best practice. Below, I assess Japanese compliance with international benchmarks in these two related areas.

2.2.1 Capital adequacy

From 1992, the minimum CAR for Japanese banks *with international operations* ('BIS banks') was 8% of risk-weighted assets, consistent with Basle I. From the beginning, however, the MOF gave banks the choice to be regulated as 'domestic banks,' for which the minimum CAR was only 4%. Although not strictly inconsistent with Basle I, this and other less stringent regulations[25] applied to

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[23] Stephen Lange Ranzini, 'Japan Needs Many More Bank Examiners', letter to the editor, *Financial Times,* 7 August 2001.

[24] See BCBS 1988 for an explanation of the components of Tier 1 and 2 capital (Tier 1 or 'core' capital must make up at least half of the 8% minimum) and for risk weightings of different assets.

[25] E.g. see FSA 1999, 51-2.

domestic banks gave weak banks an incentive to sell their (often small) international operations and revert to 'domestic' status. This well-used compliance escape route persists under the FSA regime. From 1993 to 2003, the number of Japanese banks adhering to BIS standards fell from 90 of 151 in total (60%) to only 17 of 134 in total (13%).[26] The exodus accelerated from 1998 when the FSA introduced a PCA regime for dealing with under-capitalized banks.

Moreover, although major Japanese banks formally met the 8% Basle minimum CAR, this greatly exaggerated their true financial strength (IMF 2003a, 39). As of March 2003, by which time the Japanese authorities were claiming approximate equivalence with US bank capitalization rules, the proportion of common equity and retained earnings in the Tier 1 capital of major banks was actually negative, with deferred tax assets (DTAs), public funds and other preferred shares/securities making up the bulk of core capital (table 1). For two of the top seven banks, DTAs made up all of Tier 1 capital (Fitch Ratings 2003, 17). This was very problematic because DTAs are past tax losses carried forward, arising from differences between tax accounting and financial disclosure rules. Their use as capital assumed the resumption of substantial taxable profits in the future, but this was highly uncertain at the time. In Japan, DTAs can be carried forward for up to five years, as opposed to only one year (or a maximum of 10% of Tier 1 capital) in the US, the only other major country in which DTAs are important. Moreover, since DTAs are not immediately available to cushion large losses, there is a strong case for sharply constraining if not eliminating

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[26] I am grateful to Hyoung-kyu Chey for these figures, calculated from the annual 'Analysis of Financial Statements of All Banks,' Japanese Bankers Association. As of March 1999, average CARs of domestic banks were 6.7%, compared to 11% for BIS banks. Since then, domestic bank average CARs have hovered around 8-9% (BOJ 2004).

their use as core capital (IMF 2003a, 8, 18). Adopting the US rule or eliminating their use entirely would have reduced all major Japanese banks' Tier 1 capital below the regulatory minimum, requiring either further large public recapitalizations or outright nationalizations (Fitch Ratings 2003, 2).[27] However, as long as banks met the formal regulatory minimum, they could be sure to avoid such a fate and the government could avoid being forced to act.

[27] Other aspects of bank Tier 1 capital also cause concern. Large amounts of banks' preferred shares and subordinated debt are owned by insurance companies who are often bank borrowers and are themselves chronically weak. This suggests that Tier 1 capital at banks and insurance companies is effectively double-counted (Fukao 2002; interviews, FSA, Tokyo, 20 June 2002).

Table 1: Major Japanese Banks: Tier 1 Capital 2002-3

	Yen trillion, March 2003	% of Risk-Weighted Assets	Yen trillion, March 2002	% of Risk-Weighted Assets
Deferred Tax Assets	8.1	2.9	8.3	2.6
Public Funds	6.0	2.1	6.0	1.9
Other Preferred Shares/Securities*	4.9	1.8	2.9	0.9
Other Tier 1 Capital*	-5.0	-1.8	0.0	0.1
Total Tier 1 Capital	14.0	5.0	17.4	5.4
Total Capital	26.3	9.4	33.7	10.5

Source: Fitch Ratings 2003, 6.

* 2003 figures are estimates

It is easy to see why the government refused to adopt the stricter US rule on treatment of DTAs, but it underlined the still large degree of discretion in how Japan applied international benchmark standards. The DTA issue in fact became a lightning rod in the struggle between reformers and their opponents. In October 2002, the newly appointed head of the FSA, Takenaka, suggested that Japan should adopt the US rule from 31 March 2004. However, this proposal was blocked due to heavy opposition from banks and from within the LDP itself.[28] The Koizumi government compromised by allowing the FSA 'to study' the regulatory treatment of DTAs.

The Takenaka faction within the FSA was not wholly defeated, however. The FSA instructed banks' external auditors to assess more rigorously the real value of DTAs (FSA 2002, 11). This had some effect, but it also demonstrated the danger of regulatory tightening. The government rescue of Japan's fifth-largest bank, Resona, was launched in May 2003 after its CAR collapsed from the 6.5% the bank had announced in March 2003 to 2.1% two months later (Resona was classified as a domestic bank). This fall was largely due to the downward revaluation of Resona's DTAs by its external auditor. In October 2003, the FSA announced that it would ask banks to provide five-year profit forecasts at the end of November 2003, as a further check on the use of DTAs.[29] Nevertheless, it is not clear that all auditors have been as strict as Resona's.[30] Eventually, in September 2005, with bank profits recovering, the

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[28] 'Takenaka receives no-confidence motion,' *FT.com,* 23 October 2002.

[29] FSA, 'Request for Improvement of Disclosure on Deferred Tax Assets', 31 October 2003, available at: http://www.fsa.go.jp/news/newse/e20031031-1.html, accessed 17 November 2003.

[30] 'Japanese banks warned over deferred tax assets', *FT.com*, 5 November 2003. In November 2003, the government's Financial System Crisis Committee also declared insolvent and nationalized Ashikaga Bank, a regional bank, whose auditors had baulked at allowing the bank to include its DTAs

FSA moved to phase in some restrictions on the use of DTAs, but only for the major banking groups (Fitch Ratings 2006: 4). During the crisis years, Japan's DTA rule was clearly discretionary and facilitated mock compliance with international capitalization standards. Without it, most of Japan's major banks would have required further recapitalization with public funds or outright nationalization.

2.2.2 Loan classification and provisioning

The quality of bank capital also depends substantially upon the stringency of loan classification and provisioning against NPLs. Lax classification of bad loans and under-provisioning inflates banks' profits and hence Tier 1 capital. In Japan, the rules have changed considerably in recent years and require considerable effort to decipher. There are three overlapping definitions of non-performing loans (NPLs): risk management loans (RMLs) based on article 21 of the March 1998 Banking Law and as required by the Japanese Bankers' Association (Zenginkyo), the FSA's 'classified assets' based on the October 1998 Financial Reconstruction Law (FRL), and self-assessments by banks, introduced in April 1998 (BOJ 2001, 105-110) (see table 2). There is much overlap between the various definitions but not complete correspondence across the different categories.

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as capital. An FSA inspection assessed its DTAs at 146% of Tier 1 capital; their exclusion resulted in a CAR of –3.7% ('Japan Faces Up To Banking Reality', *FT.com*, 1 December 2003).

Table 2: Comparison of NPL Definitions in Japan Since 1998

	Classification of Risk Management Loans	**Classification Based on the FRL**	**Classification for Bank Self-Assessment**
Purpose	Disclosure under Banking Law	Disclosure under FRL	Procedure for determining write-offs and provisions
Coverage	All loans	Securities loaned, foreign exchange, accrued interest, temporary payment, claims to guarantee	All assets
N.B.	Includes portions covered by collateral/provisions	Includes portions covered by collateral/provisions	Categorization of assets reflects status of collateral/provisions
	Loans to borrowers in legal bankruptcy	Assets for which borrowers are bankrupt/effectively bankrupt under the self-assessment framework	Bankrupt/effectively bankrupt borrowers
	Past due loans (>6 months) not in legal bankruptcy	'Doubtful' or risk assets (borrowers in danger of bankruptcy under the self-assessment framework)	Borrowers in danger of bankruptcy
	Past due loans: 3-6 months	Assets requiring special attention (past due 3 months and restructured loans)	Borrowers that need attention (overdue loans, poor cash flow, restructured loans, etc)
	Restructured loans		
	Normal loans	Sound assets	Normal borrowers

Source: FSA (http://www.fsa.go.jp/news/newse/e20030207-1/r01.pdf); BOJ 2001, 107-8.
Note: the different categories do not necessarily correspond across the three definitions.

Before 1998, Japanese standards were very lax in this area relative to US standards, but they were gradually tightened over time. Before financial year 1995 (FY1995),[31] RML definitions included only loans to borrowers in legal bankruptcy and six-month overdue loans.[32] The much stricter US standard for classifying NPLs, which has since become the global benchmark, was 90 days overdue. 'Evergreening' of loans, whereby new loans are given to borrowers suffering repayment difficulties, was common in Japan because such 'restructured' loans could be classified as normal immediately upon the resumption of repayments (Kanaya and Woo 2000, 12-14). In FY1995, restructured loans were added to the RML definition, but only if the interest rate was reduced to below the BOJ discount rate, by then only 0.5% (Jackson and Lodge 2000, 111). In FY1997, the definition was further tightened to include loans overdue three months or more and *all* restructured loans. From December 1998, banks were required to measure NPLs on a consolidated basis; previously, weak consolidation rules had enabled banks to hide NPLs in partially owned related companies (Kanaya and Woo 2000, 14).

Banks are required under the third definition of NPLs to estimate required provisions against bad loans and write-offs. Under this system, banks first classify borrowers and then classify loans into four further categories that overlap with the FRL definitions (see table 3 for details). The value of attached collateral is subtracted from required provisions (BOJ 2001, 107-9).[33] Required provisioning rates are

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[31] In Japan, the financial reporting year ends in March the following calendar year.

[32] For regional banks, not even overdue loans were included.

[33] In Japan and East Asia generally, lending against collateral is normal practice. Ordinary collateral is subject to a 'haircut' for provisioning purposes (30% for real estate and equities) (FSA 1999, 24).

determined from historical credit cost (defaults), using guidelines issued by the Japanese Institute of Certified Public Accountants (JICPA) (column 3, table 3).

Table 3: Bank Self-Assessments and Provisioning Rules

Classification	Definition	Required Provision
Category I	Normal 'unclassified' loans and those loans with superior collateral, plus the portion of loans provisioned for in Category II-IV loans	Historic credit loss ratio (≈1%)
Category II ('Grey area loans')	Loans in need of monitoring and those with ordinary collateral such as real estate	Historic credit loss ratio (≈5-7%; 15% for 'special attention borrowers')*
Category III	Loans for which recovery is extremely doubtful, net of collateral/guarantees	Historic credit loss ratio (≈70%; 100% for effectively bankrupt Category III borrowers)
Category IV	Loans to bankrupt and effectively bankrupt firms, net of collateral/guarantees	Written off by the end of each financial year, but retained on the balance sheet at zero value

Source: BOJ 2001, 2003.

* Since March 2002, large banks have been required to apply the DCF method for provisioning for large borrowers needing 'special attention'.

By 1999, therefore, Japan was more or less formally compliant with international best practice as regards loan classification and provisioning, albeit in a somewhat confusing manner (Fukao 2002, 3). However, because this regulatory tightening produced higher provisions and further bank losses, some banks simply continued to hide NPLs and hence to block substantive compliance. This was graphically illustrated in the fraudulent accounting practices of the now defunct LTCB and NCB, both of which officially had CARs over 8% right up until their collapse (Kanaya and Woo 2000, 22). The BOJ and others were also concerned that collateral was being systematically over-valued, since write-downs of real estate values did not keep up with declining property prices.[34]

Given all this, the gap between official and private sector estimates of total NPLs differed enormously, mainly because of concerns about misclassification of category II loans, which made up the bulk of published NPLs. Official estimates of total NPLs were 35 trillion yen in March 2003, about 8% of total loans, though many private sector estimates were in the region of 20-30%. The latter estimate was even given, apparently inadvertently, in a response by an FSA official to a question put in the Diet in 2001.[35] A common private sector view was that the government's desire to avoid bank runs and further injections of public funds into weak banks led the FSA to determine the maximum limits of new NPL recognition and provisioning by working backwards from current bank operating profits.[36] This view was encouraged by the fact that each new FSA bank inspection seemed to uncover previously hidden NPLs,

[34] Interviews, senior bank analyst and BOJ, Tokyo, 18 June 2002.

[35] Interview, senior bank analyst, Tokyo, 19 June 2002.

[36] 'Delays Called Threat to Japan's Bank System', *Asian Wall Street Journal*, 19 June 2002.

and by a series of high profile corporate bankruptcies that also exposed borrower misclassification.

The deeper problem was that the backward-looking definitions of NPLs were highly misleading in a deflationary environment. With deflation, the constant emergence of new NPLs weakened the credibility of the whole reporting framework.[37] Japan's extremely low interest rates meant that many 'zombie companies' could service their loans. Banks, which have been extraordinarily unprofitable since 1992, had powerful incentives to count these loans as performing and to hope that a recovery in property prices would resolve many of them.[38] The BOJ argued openly in October 2002 for the introduction of a forward-looking method of loan accounting and provisioning (via a discounted cash flow (DCF) methodology) (BOJ 2002), which the FSA had publicly resisted. The government subsequently instructed large banks to apply DCF methodology in provisioning for large 'special attention' borrowers (those with credits over Yen 10 billion).[39] However, this method was not required across the board, reflecting the political concern within the LDP to protect the weaker regional banks and highly leveraged firms in the construction, retail, and small and medium enterprise (SME) sector generally.[40] Once again, the

[37] Interview, BOJ, Tokyo, 18 June 2002.

[38] Interviews, Tokyo, 19 June 2002. Average corporate borrowing rates fell from 6.8% in 1991 to 2% by 2002 (IMF 2003b, 6).

[39] In February 2003, JICPA published guidelines on DCF-based provisioning based on the US standard (SFAS 114), and the FSA made appropriate changes to its inspection manual (BOJ 2003, 26).

[40] The SME sector, historically close to the LDP, provides the bulk of employment in Japan and was suffering greatly from the credit squeeze from the late 1990s due to its heavy dependence upon bank loans (Pempel 1998: 165).

discretionary and partial adoption of international standards by the government substantially moderated the real extent of Japanese regulatory convergence.

3. CONCLUSION: FORMAL COMPLIANCE AND REGULATORY DISCRETION

In key areas of banking regulation, we have seen clear evidence of mock compliance with international standards in Japan since the late 1990s. Although Japan appeared to converge upon neoliberal regulatory model in this crucial area, the discretionary application of the new rules by both regulators and the banks themselves meant that the degree of real convergence was often low. The supposedly independent FSA was permitted to tighten the rules only gradually, partially, and reactively, and never so much as to jeopardize the stability of the still fragile post-1999 financial system and economy or to require a further massive public bailout of failing banks. Senior bankers themselves were very keen to avoid this outcome to maintain their jobs and their operational independence from government.

This is not to say that the government was in the pocket of the banks. Continued government subsidies to public financial institutions, above all Japan Post, greatly limited private bank profitability and hence their ability to restore their balance sheets by themselves. Powerful elements within the LDP were rather primarily concerned to ensure that the new regulatory framework did not produce unwanted deep corporate sector restructuring, particularly of the vulnerable SME sector, which provides most of the country's employment. Government efforts to tighten the treatment of distressed borrowers generally avoided the SME sector entirely (including the FSA's special inspection regime). At the same time, the government's ability to use public funds was constrained by the growing fiscal deficit

and the deep public mistrust of the banks, zombie companies, and politicians themselves.[41]

All this suggests that arguments about the rise of a neoliberal regulatory state are greatly exaggerated in the case of Japan. When more stringent western-style regulations were imported, their real impact was much reduced by a combination of laxity in the details (e.g. the treatment of DTAs) and weak, uneven enforcement (e.g. NPL classification). Discretion, rather than the strict application of best practice rules, continued to be the overriding characteristic of government regulatory policy, suggesting considerable continuity with the past. This is not simply a minor variation on the theme of regulatory neoliberalism, but a fundamental departure from its core tenets (agency independence and non-discretionary application and enforcement).

This said, there is no doubt that even though Japan has avoided substantive convergence with western-style bank regulation, its institutional framework and formal regulations have changed dramatically since the early 1990s. The old 'developmental' policy framework, with its lack of attention to prudential regulation, has been discarded. Does this mean that, over time, Japan will eventually converge upon regulatory neoliberalism? On the argument presented here, if vigorous economic recovery takes hold, political resistance to substantive compliance may well diminish. Signs of banking sector recovery after 2003 have been accompanied by some tightening of bank regulation, notably in the FSA inspection regime. In May 2005, with NPLs having fallen significantly over the previous year, the FSA officially declared that Japan's bad loan crisis of 16 years was over.[42] As profits recover, banks will use DTAs to offset tax liabilities and thus to rebuild Tier 1 capital. Furthermore,

[41] Interviews, Mr Sakakibara and BOJ, June 2002.

[42] 'Japan's Bad-Loan Crisis is Over, Says Banking Regulator,' *FT.com*, 25 May 2005.

in the political arena, the recent Japanese elections were fought and won by Prime Minister Koizumi on a liberal reform agenda as much against the 'dinosaurs' in his own party as against the opposition parties, though it is too early to tell if this is a real political turning point.

These are plausible reasons why convergence *towards* regulatory neoliberalism may continue. However, against these we should remember that it is precisely the lax regulatory treatment of DTAs, which continues, and the less than wholly strict classification of NPLs in recent years that now allows banks to use their extensive DTAs to rebuild their BIS capital ratios. As of March 2005, DTAs still made up nearly 30% of the top six banks' Tier 1 capital and public funds made up another 28% (Fitch Ratings 2005, 12). Nor should we lose sight of the fact that as regulatory tightening occurred, notably in the introduction of the PCA regime in 1998, the vast majority of Japanese banks escaped the tighter rules by reverting to 'domestic bank' status. Government policy facilitated this private sector avoidance strategy.

Furthermore, only in trying times is the true extent of compliance tested; for this reason, the behaviour of the Japanese government and regulator since 1998 is highly revealing. By contrast, in the late 1980s, the Japanese authorities and banks were relaxed about compliance with Basle I rules because the size of banks' unrealized capital gains meant that formal compliance would be easy.[43] If the Japanese economy were to deteriorate further in the future, it seems likely that the authorities would opt for further forbearance and regulatory discretion if this were deemed necessary to promote financial and economic stability, given the political importance of the SME sector.

[43] Chey (forthcoming), ch.4.

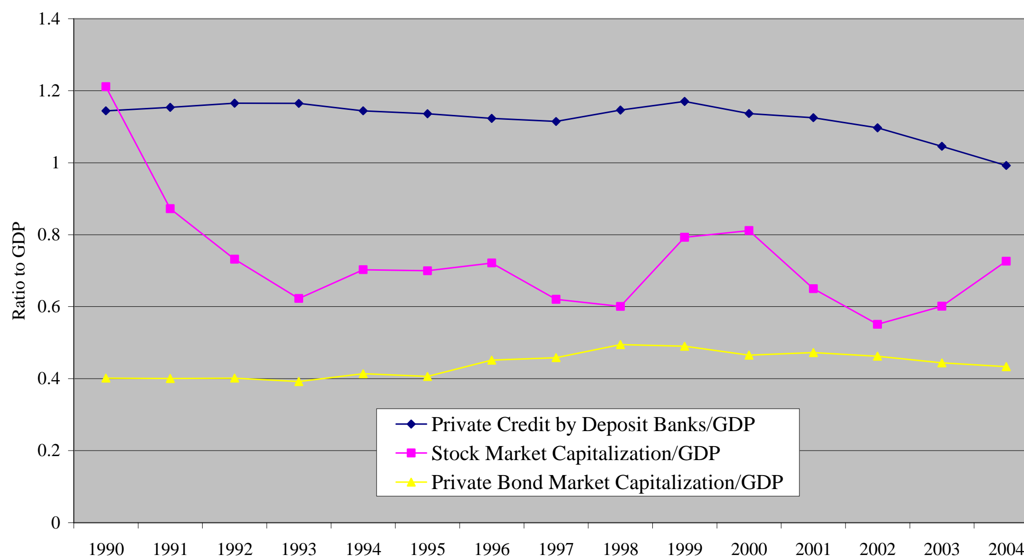
What of the argument that non-compliance in bank regulation is of limited relevance in a world increasingly dominated by capital markets? There are, surely, signs of the development of capital markets in Japan. Deposit bank assets as a percentage of total financial assets fell from 52% in 1980 to 43% in 1997.[44] Furthermore, as Vitols (2003) suggests, growing public sector debt, interest rate decontrol, and liberalization of securities markets (notably in the 'Big Bang' reforms of 1996) have reversed some of the factors that formerly inhibited the development of capital markets in postwar Japan. The recent privatization of the Post Office is likely to produce further change in Japan's financial sector in coming years.

The problem with this argument is that Japan still has a highly bank-dominated financial system compared to the US and most other major developed countries. Although bank lending as a percentage of GDP declined somewhat over the 1990s (figure 2), it remains extraordinarily high by the standards of other G-7 countries, while private securities markets remain relatively underdeveloped. In 2001, the aggregate corporate sector debt-equity ratio of 175% was almost double that of the next-highest G-7 country, Germany (IMF 2003a, 28). In 2004, Japan's stock and bond markets were worth 73% and 43% of GDP respectively, compared to 132% and 112% for the US (Beck, Demirguc-Kunt and Levine 2006). Furthermore, Koizumi's privatization of the Post Office aims in part at restoring the profitability of the banking sector, which has also undergone substantial consolidation in recent years. Finally, although the assessment of compliance with global standards by Japan's securities sector is beyond the scope of this article, as in banking regulation, there are indications of improvement in recent years but also some evidence that Japan also

[44] The comparable figures for the US are 38% and 20% respectively (Beck, Demirguc-Kunt and Levine 2006).

lags other major developed countries in practice.[45] The aggressive new 'western-style' corporate tactics of Livedoor CEO, Takafumi Horie, sent similarly ambiguous signals, being met with deep resistance from within the Japanese business community and also (ironically) falling victim to new securities regulations.[46]

Figure 2: Japan's Financial Market Structure, 1990-2004



Source: Beck, Demirguc-Kunt and Levine 2006.

Vitols himself concludes that the current outcome in which there is a 'hybrid' mix of banking and capital markets is likely to persist in Japan, given the continued importance of the SME sector and the country's low levels of income inequality (which favours banking over capital markets). Amyx (2004: 260) also ultimately

[45] To give two examples, compliance with the OECD's Principles of Corporate Governance is qualified by the high incidence of ineffective corporate boards (IMF 2003a: 29), and the transparency and quality of Japanese accounting and auditing is generally seen to lag substantially that of other major developed countries (World Economic Forum 2003, 610).

[46] 'Editorial: Livedoor Scandal,' *Asahi Shimbun*, 19 January 2006.

reaches a similarly nuanced conclusion about the path dependence of the Japanese financial sector and its regulatory framework.

Is this hybrid halfway house between developmentalism and a highly discretionary regulatory state sustainable? Caution is required here since Japan is only one case (though preliminary evidence suggests that Japan is not exceptional – Walter, forthcoming). Even so, this case casts doubt on some general arguments that assume that a large gap between formal and substantive compliance with international standards is unsustainable. For example, Hall (2003), who investigates the Korean case, argues that new 'discursive practices generate narrative structures that have a constitutive effect on the subsequent discursive and economic practices of these actors' (Hall 2003, 73). The evidence presented here suggests that this postmodernist position exaggerates the constraining effects of new ideational narratives and underestimates the resourcefulness of groups opposed to compliance.[47] It simply fails to investigate the domestic politics of compliance and the potentially large and sustainable gap between words and deeds.

The Japanese evidence also implies limits to the argument that markets and hegemonic countries exercise structural power that will ensure convergence upon dominant international norms and standards (Gill 1995; Hansmann and Kraakman 2000; Soederberg 2003). Japan's economic size and importance means that it is not an ideal test of these claims, though its surprisingly weak position in the global political economy has long been recognized (Noland 2000; Wade 1996). Simmons (2001) argues that the degree of (formal) convergence upon international regulatory standards (set by the major countries) is determined by the market and political

[47] This empirical problem is also found in studies that focus only on formal compliance (e.g. Ho 2002; Oatley and Nabors 1998).

incentives for other countries to emulate these standards. If the adoption of international standards raises (lowers) the profitability of domestic firms, the incentives to emulate (diverge) will be strong. In the late 1990s, weak banks in Japan suffered a loss of deposits to larger and stronger banks and, for a time, a 'Japan premium' of up to 1% in additional borrowing costs emerged for Japanese banks in the international interbank market.[48] Self-evidently, despite the potentially high costs of adopting stricter bank regulatory standards, the Japanese authorities felt compelled to do so: the perceived costs for a major G-7 country of open defection from the Basle standards were too great.

However, as we have seen, the power of markets to ensure *substantive* compliance is limited for two main reasons. First, even if *formal* defection is costly, it can be very difficult for market actors to monitor substantive compliance when the private sector and regulatory authorities collude in masking the real situation. Second, even when sophisticated investors and creditors do have access to such information, they are still unlikely to shun non-compliant banks. This is because the Japanese government provided a credible blanket guarantee to all bank creditors that effectively put its creditworthiness behind its banks.[49] What is surprising, in other words, is how

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[48] After the failure of Hyogo bank in August 1995, interbank creditors charged Japanese banks a variable interest premium, which peaked at about 1% over 1998-9 (Ito and Harada 2003; Peek and Rosengren 2000).

[49] Hence, in October 2003, the weighted average Moody's 'stand alone' rating for Japanese banks was E+ (the second-lowest possible rating, compared to B for US and Singapore banks). However, the average standard deposit rating for Japanese banks, which takes into account the probability of public support, was A3, similar to other developed countries (Moody's Investor Services 2004, 20).

small the ‘Japan premium’ was.[50] Once again, discretionary government intervention in the financial sector effectively short-circuited most of the market pressure that would otherwise have been placed on Japanese banks to accept more stringent international standards. This is consistent with many other findings on the limits of market power in forcing policy convergence (e.g. Garrett 1998; Hall and Soskice 2001; Mosley 2003; Weiss 2003).

As for arguments about US hegemonic power, certainly it was largely American (and sometimes British) standards upon which Asian countries have formally converged. Japan, along with other Asian countries, has always found itself operating in the shadow of American hard and soft power. Japan’s membership of the Basle Committee also made it very difficult for Japan formally to defect from international banking standards. US regulators also obliged Japanese banks with US subsidiaries to comply with the minimum formal Basle requirements. However, the US authorities in practice accept ‘home state’ (Japanese) definitions of bank capital, helping to facilitate mock compliance in Japan even while US public diplomacy became openly critical.[51] The interdependence of financial markets means that the US

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[50] The Japan premium was largely related to uncertainty about the predictability of government support of weak banks (Peek and Rosengren 2000).

[51] ‘Host’ country regulators typically require subsidiaries of foreign-controlled banks to adhere to minimum local capital standards, but adopt a national treatment rule in accepting ‘home’ country definitions of capital (for US rules, see ‘Procedures to Become a Financial Holding Company and Guidance Regarding the Initial Monitoring of Acquisitions and the Commencement of New Activities by Financial Holding Companies’, Division of Banking Supervision and Regulation, US Federal Reserve, SR 00-1 (SUP), 8 February 2000, available at: http://www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0001.HTM#Footref6, accessed 17 February 2003).

has no interest in facilitating the collapse of another major country's financial sector. For this and the other reasons discussed above, the room for national discretion in the application of international regulatory standards is likely to remain considerable in the years ahead.

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