National Systems of Political Economy

MANY PROFESSIONAL economists and scholars of international political economy (IPE), including myself, have given insufficient attention to the importance of domestic economies to the ways in which the world economy functions. Economists regard national economies as dimensionless points, while scholars of IPE have focused almost exclusively on the international political and economic system. While it was never justifiable to neglect the role of domestic factors in the study of international political economy, it has become increasingly obvious that the role of domestic economies and the differences among those economies have become significant determinants of international economic affairs. Thus, study of the different types of national economies or "national systems of political economy" and their significance for the global economy has become an important aspect of the study of international political economy.[1]

Several developments in the 1980s increased awareness of the importance of the differences among national political economies. The miserable economic performance of the socialist economies and of most less developed countries led many observers to appreciate the superiority of the market system. The extraordinary economic success of Japan and of the industrializing economies of Pacific Asia prior to the 1997 financial crisis led revisionist scholars to declare and others to worry that the capitalist developmental state model provided the best route to economic success. International economic conflicts intensified and led to charges that one country or another was not "playing fair," and the increasing integration of various national economies with others possessing differing economic structures and business practices increased awareness of the significance of these differences. As economic interdependence has progressed, national differences have more frequently become the subject of international negotiations and a factor in the growing movement toward economic regionalism.

[1] The writings on comparative political economy are quite extensive. Examples include Peter A. Hall, *Governing the Economy: The Politics of State Intervention in Britain and France* (New York: Oxford University Press, 1986); and Gunter Heiduk, ed., *Technological Competition and Interdependence: The Search for Policy in the United States, West Germany, and Japan* (Seattle: University of Washington Press, 1990). A polemical but interesting work is Michel Albert, *Capitalism vs. Capitalism: How America's Obsession with Individual Achievement and Short-term Profit Has Led It to the Brink of Collapse* (New York: Four Walls Eight Windows, 1993).

In the 1980s and 1990s, there was some convergence among national economies, and the differences among them diminished in a number of important respects. Nevertheless, in the early years of the twenty-first century, fundamental differences among national economies remain important. This point is especially applicable to the American, German, and Japanese economies. These dominant economies not only influence the world economy, but they are also archetypes for many other economies. Whereas the American, British, and other "Anglo-Saxon" economies have much in common, the German economy shares many features with the corporatist-type economies of continental Europe, and the Japanese economy has, in certain respects, provided a model for the "developmental capitalist" economies of Pacific Asia.[2]

Differences among National Economies

While national systems of political economy differ from one another in many important respects, differences in the following areas are worthy of particular attention: (1) the primary purposes of the economic activity of the nation, (2) the role of the state in the economy, and (3) the structure of the corporate sector and private business practices. Although every modern economy must promote the welfare of its citizens, different societies vary in the emphasis given to particular objectives; those objectives, which range from promoting consumer welfare to pursuit of national power, strongly influence and are influenced by such other features of a national economy as the role of the state in the economy and the structure of that economy. As for the role of the state in the economy, market economies include the generally laissez-faire, noninterventionist stance of the United States as well as the Japanese state's central role in the overall management of the economy. And the mechanisms of corporate governance and private business practices also differ; the relatively fragmented American business structure and the Japanese system of tightly integrated industrial groupings (the *keiretsu*) contrast dramatically with one another. Very different national systems of politi-

[2] Peter Katzenstein, *Corporatism and Change: Austria, Switzerland, and the Politics of Industry* (Ithaca: Cornell University Press, 1984).

cal economy result from the variations in the basic components of economies.

The purpose of economic activity in a particular country largely determines the role of the state in that economy. In those liberal societies where the welfare of the consumer and the autonomy of the market are emphasized, the role of the state tends to be minimal. Although liberal societies obviously differ in the extent to which they do pursue social welfare goals, the predominant responsibility of the state in these societies is to correct market failures and provide public goods. On the other hand, in those societies where more communal or collective purposes prevail, the role of the state is much more intrusive and interventionist in the economy. Thus, the role of such states can range from providing what the Japanese call "administrative guidance" to maintaining a command economy like that of the former Soviet Union.

The system of corporate governance and private business practices constitutes another important component of a national political economy. American, German, and Japanese corporations have differing systems of corporate governance, and they organize their economic activities (production, marketing, etc.) in varying ways. For example, whereas shareholders (stockholders) have an important role in the governance of American business, banks have played a more important role in both Japan and Germany. In addition, regarding business practices, whereas the largest American firms frequently invest and produce abroad, Japanese firms prefer to invest and produce at home. The policies of each government have also shaped the nature of business enterprise and business behavior through regulatory, industrial, and other policies; furthermore, some national differences in corporate structure and business practices, as Alfred Chandler has demonstrated, have evolved largely in response to economic and technological forces.[3]

The American System of Market-Oriented Capitalism

The American system of political economy is founded on the premise that the primary purpose of economic activity is to benefit consumers while maximizing wealth creation; the distribution of that wealth is of secondary importance. Despite numerous exceptions, the American economy does approach the neoclassical model of a competitive market economy in which individuals are assumed to maximize their own private interests (utility), and business corporations are expected to maximize profits. The American model, like the neoclassical model, rests on the assumption that markets are competitive and that, where they are not competitive, competition should be promoted through antitrust and other policies. Almost any economic activity is permitted unless explicitly forbidden, and the economy is assumed to be open to the outside world unless specifically closed. Emphasis on consumerism and wealth creation results in a powerful proconsumption bias and insensitivity, at least when compared with the Japanese and German models, to the social welfare impact of economic activities. Although Americans pride themselves on their pragmatism, the American economy is based upon the abstract theory of economic science to a greater degree than is any other economy.[4]

At the same time, however, the American economy is appropriately characterized as a system of managerial capitalism.[5] As Adolf Berle and Gardner Means pointed out in their classic study of American corporations, the economy was profoundly transformed by the late-nineteenth-century emergence of huge corporations and the accompanying shift from a proprietary capitalism to one dominated by large, oligopolistic corporations.[6] Management was separated from ownership, and the corporate elite virtually became a law unto itself. Subsequently, with the New Deal of the 1930s, the power balance shifted noticeably away from big business when a strong regulatory bureaucracy was established and organized labor was empowered; in effect, the neoclassical laissez-faire ideal was diluted by the notion that the federal government had a responsibility to promote economic equity and social welfare. The economic ideal of a self-regulating economy was further undermined by passage of the Full Employment Act of 1946 and the subsequent acceptance of the Keynesian idea that the federal government has a responsibility to maintain full employment through use of macroeconomic (fiscal and monetary) policies. Al-

[3] Alfred D. Chandler, *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (Cambridge: MIT Press, 1970).

[4] Excellent studies of the American political economy include John L. Campbell, J. Rogers Hollingsworth, and Leon N. Lindberg, eds., *Governance of the American Economy* (New York: Cambridge University Press, 1991); Frederic L. Pryor, *Economic Evolution and Structure: The Impact of Complexity on the U.S. Economic System* (New York: Cambridge University Press, 1996); and James E. Alt and K. Alec Crystall, *Political Economics* (Berkeley: University of California Press, 1983).

[5] This characterization of the American economy is based on William Lazonick, *Business Organization and the Myth of the Market Economy* (New York: Cambridge University Press, 1991).

[6] Adolf A. Berle and Gardner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

though at the opening of the twenty-first century the federal government retains responsibility for full employment and social welfare, a significant retreat from this commitment began with the 1980 election of Ronald Reagan as President of the United States and the triumph of a more conservative economic ideology emphasizing free and unregulated markets.

Commitment to the welfare of individual consumers and the realities of corporate power have resulted in an unresolved tension between ideal and reality in American economic life. Whereas such consumer advocates as Ralph Nader want a strong role for the government in the economy to protect the consumer, American economists and many others react negatively to an activist government because of their belief that competition is the best protection for consumers except when there are market failures. In addition, there has been no persistent sense of business responsibility to society or to individual citizens. Japanese corporations have long been committed to the interests of their stakeholders, including labor and subcontractors, and German firms acknowledge their responsibility to society and are more accepting of the welfare state than are American firms. This explains why Japanese and German firms are much more reluctant to shift industrial production to other countries than are their American rivals. However, over time, the balance between the ideal and the reality of the American economy has shifted back and forth. In the 1980s, the election of Ronald Reagan as President and then his Administration's emphasis on the unfettered market diluted the welfare ideal of the earlier post–World War II era.

Economic Role of the State

The role of the American government in the economy is determined not only by the influence of the neoclassical model on American economic thinking but also by fundamental features of the American political system. Authority over the economy is divided among the executive, legislative, and judicial branches of the federal government and between the federal government and the fifty states. Whereas the Japanese Ministry of Finance has virtual monopoly power over the Japanese financial system, in the United States this responsibility is shared by the Treasury, the Federal Reserve, and several other powerful and independent federal agencies; furthermore, all of those agencies are strongly affected by actions of the legislative and judicial branches of government. In addition, the fifty states frequently contest the authority of the federal government over economic policy and implement important policies of their own.

Another restraining influence on the role of the American state in the economy is the tension between the private and public sectors. Not only does the adversarial relationship between government and business in the United States make cooperation very difficult, but their mutual suspicions are reflected in American politics. Whereas political conservatives reject, at least in principle, any strong role for the state in the economy, political liberals are fearful that private business interests will capture government programs in order to "feather their own nests," and this frequently produces political stalemate. At the same time, however, the fragmented structure of the American government and its many points of access make it easier for private interests to challenge government actions than it is in some other systems. These ideological, structural, and public versus private aspects of the American political economy have restricted greatly the capacity of the American government to develop a coherent and effective national economic strategy.

There is a major exception to the generally limited role of the American government in the economy in the area of macroeconomic policy-making. However, even in this area, the responsibility for macroeconomic policy, in actual practice, has been divided. The Congress and the executive branch are both responsible for fiscal policy, but control over monetary policy is vested in the Federal Reserve, and the "Fed" functions largely independently of the rest of the federal government. However, starting with the fiscal excesses of the Reagan Administration in the early 1980s and accumulation of an immense federal debt, the Congress and the executive branch deemphasized fiscal policy, and the Federal Reserve, with control over monetary policy, became the principal manager of the American economy.

The role of the federal government at the level of microeconomic policy is highly controversial. American society assumes that the government should establish a neutral environment for business and should not involve itself directly in business affairs. The primary responsibility of the government is believed to be the regulation of the economy, provision of public goods, and elimination of market failures. Notable examples are found in antitrust policies, regulation of pollution, and the safeguarding of public health. As Stephen G. Breyer and Richard B. Stewart point out in their authoritative text on administrative law and regulatory policy, the rationale for government intervention in the economy is to correct market failure as identified by economists. The unregulated market is treated as the norm, and advocates of government intervention must prove that such intervention is sometimes justifiable in order to achieve important public

objectives. Market failures that may justify an active government role in the economy include monopoly power, negative externalities, and inadequate consumer information.

Industrial policy represents the greatest difference between the United States and other economies, except for Great Britain, another Anglo-Saxon economy.[8] Industrial policy refers to deliberate efforts by a government to determine the structure of the economy through such devices as financial subsidies, trade protection, or government procurement. Industrial policy may take the form either of sectoral policies of benefit to particular industrial or economic sectors or policies that benefit particular firms; in this way such policies differ from macroeconomic and general policies designed to improve the overall performance of the economy, policies such as federal support for education and R & D. Although Japan has actively promoted sector-specific policies throughout the economy, the United States has employed these policies in just a few areas, notably in agriculture and national defense. Although firm-specific policies are generally frowned upon in the United States as examples of "pork barrel politics," government policies in support of Chrysler and Harley Davidson in years when they were threatened were considered successful firm-specific policies. However, as I shall note below, the United States in the 1980s took a major step toward establishing a national industrial policy.

The rationale or justification for industrial policy and associated interventionist activities is that some industrial sectors are more important than others for the overall economy. The industries selected are believed to create jobs of higher quality, like those in manufacturing, to produce technological or other spillovers (externalities) for the overall economy, and to have a high "value-added." These industries are frequently associated with national defense or are believed to produce a highly beneficial effect on the rest of the economy; the computer industry and other high-tech sectors provide examples of such industries. In general, however, the only justification for an industrial policy considered legitimate in the United States is to overcome a

[7] Stephen G. Breyer and Richard B. Stewart, *Administrative Law and Regulatory Policy* (Boston: Little, Brown, 1979).

[8] The literature on industrial policy is quite extensive. A good place to survey the subject is M. Donald Hancock, John Logue, and Bernt Schiller, eds., *Managing Modern Capitalism: Industrial Renewal and Workplace Democracy in the United States and Western Europe* (New York: Greenwood Press, 1991). An excellent and wide-ranging discussion of the subject is Keith Cowling and Roger Sugden, eds., *Current Issues in Industrial Economic Strategy* (New York: Manchester University Press, 1992).

market failure. In practice, most American economists, public officials, and business leaders are strongly opposed to industrial policy. Their principal objection is that governments are incapable of picking winners; many argue that politicians will support particular industries for political ("pork barrel") reasons rather than for sound economic reasons.[9] American economists argue that the structure and distribution of industries in the United States should be left entirely to the market. This belief is supported by the assumption that all industries are created equal and that there are no strategic sectors. Nevertheless, despite the arguments against having an industrial policy in America, such policies have developed in the areas of agriculture, national security, and research and development.

Corporate Governance and Private Business Practices

The American system of corporate governance and industrial structure parallels its political system. The governance and organization of American business are characterized by fragmentation and an overall lack of policy coordination. Indeed, the strong American antitrust and competition policies are intended to prevent concentration of corporate power and direction. American business is much more constrained in its ability to share business information, to pool technological and other resources, and to develop joint strategies than are its rivals. Many observers have charged that such restrictions disadvantage American firms in global competition.

Control of American business is also much more dispersed than in Japan and Germany. Although American firms are much more responsive to shareholder concerns then are German and Japanese firms, the largest shareholders in many of America's large corporations may own just 1 or 2 percent of the stock. In Japan, ownership of 70 percent or more of the stock frequently resides in a cooperative business grouping called a *keiretsu*. Also, industry and finance are more completely separated from one another in the United States, and in some instances this has meant higher capital costs than those enjoyed by foreign rivals. This also contributes to frequent conflicts between industry and finance, and these conflicts have been detrimental to national policy-making. At the national level, the National Association of Manufacturers, Chamber of Commerce, and other business organizations have no role commensurate with that of either the *kei-*

[9] A valuable and representative critique of industrial policy is Gene M. Grossman, "Promoting New Industrial Activities: A Survey of Recent Arguments and Evidence" (Princeton: Woodrow Wilson School, 1989).

representing Japanese big business) or the Federation of German Industries. Both the Japanese and German organizations can speak with a single strong voice and frequently do act on behalf of major business interests.

A fundamentally different conception of the corporation and its role in society underlies many of these contrasts between *shareholder* (stockholder) American capitalism and Japanese/German *stakeholder* capitalism. In the American system of shareholder capitalism, a firm's fundamental purpose is to make profits for its investors or shareholders; in principle, the firm has minimal obligations to employees and/or to the communities in which its production facilities are located. Moreover, in the United States, a business corporation is regarded as a commodity that is bought and sold like any other commodity without regard for the social consequences of such transactions; waves of leveraged buyouts and corporate takeovers in the 1980s and 1990s were extreme examples of this mentality. In both Japan and Germany, on the other hand, the corporation is assumed to have a major responsibility toward its stakeholders (workers, subcontractors, etc.), and the interests of shareholders are given much less attention than in the American system; instead, firms are expected to promote larger social objectives. Japanese firms are expected to increase the power and independence of the Japanese nation and to promote social harmony; Germany also places a high premium on social welfare. American law is designed to ensure neutrality and fair play in the competitive market for corporate control. In Japan and Germany, profitability has been assigned less importance than economic stability. Moreover, German and Japanese policies are intended to limit hostile and foreign takeovers, and to control what Carl Kester has called "the global contest for corporate control."[10]

The Japanese System of Developmental Capitalism

G. C. Allen, the distinguished British authority on Japanese economic history, tells a story that provides an important insight into Japanese economic psychology. At the end of World War II, American occupation officials advised the Japanese that they should follow the theory of comparative advantage and hence concentrate on labor-intensive products in rebuilding their economy. Japan's economic and political elite, however, had quite different ideas and would have nothing to do with what they considered an American effort to relegate Japan to the low end of the economic and technological spectrum. Instead, the Japanese Ministry of International Trade and Industry (MITI) and other agencies of the Japanese economic high command set their sights on making vanquished Japan into the economic and technological equal, and perhaps even the superior, of the West. At the opening of the twenty-first century, this objective has remained the driving force of Japanese society.[11]

In the Japanese scheme of things, the economy is subordinate to the social and political objectives of society. As the distinguished Japanese economist Ryutaro Komiya has written, ever since the Meiji Restoration (1868), Japan's overriding goals have been "making the economy self-sufficient" and "catching up with the West."[12] In the pre–World War II years this ambition meant building a strong army and becoming an industrial power. Since its disastrous defeat in World War II, however, Japan has abandoned militarism and has focused on becoming a powerful industrial and technological nation, while also promoting internal social harmony among the Japanese people. There has been a concerted effort by the Japanese state to guide the evolution and functioning of their economy in order to pursue these sociopolitical objectives.[13]

These political goals have resulted in a national economic policy for Japan best characterized as neomercantilism; it involves state assistance, regulation, and protection of specific industrial sectors in order to increase their international competitiveness and attain the "commanding heights" of the global economy. This economic objective of achieving industrial and technological equality with other countries arose from Japan's experience as a late developer and also from its strong sense of economic and political vulnerability. Another very important source of this powerful economic drive is the Japanese

[10] W. Carl Kester, *Japanese Takeovers: The Global Contest for Corporate Control* (Boston: Harvard Business School Press, 1991).

[11] Among the many important studies of the Japanese economy, several should be mentioned: Yasusuke Murakami, *An Anticlassical Political-Economic Analysis: A Vision for the Next Century*, ed. and trans. Kozo Yamamura (Stanford: Stanford University Press, 1996), is a brilliant interpretation of the distinctive nature of the Japanese economy; Takatoshi Ito, *The Japanese Economy* (Cambridge: MIT Press, 1992), is a very useful survey and analysis of the Japanese economy; Bai Gao, *Economic Ideology and Japanese Industrial Policy: Developmentalism from 1931 to 1965* (Cambridge: Cambridge University Press, 1997), is an outstanding history and evaluation of Japanese industrial policy.

[12] Ryutaro Komiya, *Industrial Policy in Japan* (Orlando, Fla.: Academic Press, 1988).

[13] Richard J. Samuels, *"Rich Nation, Strong Army": National Security and the Technological Transformation of Japan* (Ithaca: Cornell University Press, 1994).

in the superiority of their culture, and in their manifest destiny to become a great power.

Many terms have been used to characterize the distinctive nature of the Japanese system of political economy: Shinto capitalism, developmental state capitalism, tribal capitalism, collective capitalism, welfare corporatism, competitive communism, network capitalism, companyism, producer capitalism, stakeholder capitalism, strategic capitalism, and, perhaps most famously or infamously, "Japan, Inc." Each of these labels connotes particularly important elements of the Japanese economic system, such as its overwhelming emphasis on economic development, the key role of large corporations in the organization of the economy and society, subordination of the individual to the group, primacy of the producer over the consumer, and the close cooperation among government, business, and labor. I believe that the term "developmental state capitalism" best captures the essence of the system, because this characterization conveys the idea that the state must play a central role in national economic development and in the competition with the West.

Despite the imperative of competition, the Japanese frequently subordinate pursuit of economic efficiency to social equity and domestic harmony.[14] Many aspects of the Japanese economy that puzzle foreigners are a consequence of a powerful commitment to domestic harmony; and "over-regulation" of the Japanese economy is motivated in part by a desire to protect the weak and defenseless. For example, the large redundant staffs in Japanese retail stores developed from an effort to employ many individuals who would otherwise be unemployed and discontented. This situation is also a major reason for the low level of productivity in nonmanufacturing sectors, and it accounts in part for Japan's resistance to foreign direct investment by more efficient foreign firms. The Japanese system of lifetime employment has also been utilized as a means to promote social peace; Japanese firms, unlike their American rivals, are very reluctant to "downsize" and lay off thousands of employees. At the opening of the twenty-first century, however, Japan's economic problems are causing this situation to change. Nevertheless, the commitments to political independence and social harmony are major factors in the Japanese state's determination to maintain firm control over the economy.

Economic Role of the State

Ever since the 1868 Meiji Restoration, the Japanese state has assumed the central role in the economy. Following Japan's defeat in World War II, the ruling tripartite alliance of government bureaucracies, the governing Liberal Democratic Party (LPD), and big business began to pursue vigorously the goal of catching up with the West. To this end, the elite pursued rapid industrialization through a strategy employing trade protection, export-led growth, and other policies. The Japanese people have supported this extensive interventionist role of the state and believe that the state has a legitimate and important economic function in promoting economic growth and international competitiveness. The government bureaucracy and the private sector, with the former frequently taking the lead, have consistently worked together for the collective good of Japanese society.

To attain the goal of rapid industrialization, the Japanese state supported, or even created, certain social characteristics, including an industrious and highly educated workforce. In many ways, the Japanese state created today's Japanese society.[15] Japan's postal savings institution fostered an extraordinarily high savings rate. Because of strict capital controls for much of the postwar era, the postal service was able, while paying depositors just a minimal rate of interest, to make these savings available for loans to Japanese firms; such financial assistance significantly reduced the cost of capital and contributed importantly to the rapid industrialization of the country and to international competitiveness. The Japanese state has also unfortunately played an important role in supporting social, political, and legal aspects of Japanese society that made it inhospitable to foreign direct investment and to the importation and consumption of foreign goods.[16] Fortunately, since the mid-1990s, this situation has been changing.

The unusual independence and power of the government bureaucracy accompanied by bureaucratic fragmentation within the government provide yet another distinctive aspect of the Japanese state that sets it apart. The economic and other bureaucracies of the government are virtually independent fiefdoms. With few major exceptions, each bureaucracy represents a particular segment of Japanese society and believes that it has a responsibility to promote the interests of that group. There are frequent disputes among agencies over policy and jurisdictional responsibility; these have increased as new technologies and economic developments have spread across the traditional functions of government agencies. Chalmers Johnson has made the

[14] Frank Upham, *Law and Social Change in Postwar Japan* (Cambridge: Harvard University Press, 1987).

[15] The central role of the Japanese state in the formation of the Japanese economy and economic psychology has been demonstrated by Sheldon Garon, *Molding Japanese Minds: The State in Everyday Life* (Princeton: Princeton University Press, 1997).

[16] Edward J. Lincoln, *Japan's Unequal Trade* (Washington, D.C.: Brookings Institution, 1990).

point that the three major economic agencies responsible for foreign affairs frequently have differing foreign economic policies that conflict with those of the other agencies. Although bureaucratic struggles exist in every country, Japan does not have a powerful executive and therefore has no easy way to resolve such conflicts. In addition, the strong belief of the Japanese in consensus decision-making permits and even encourages stalemate and indecision. Indeed, during much of the postwar period the weak executive branch was of little consequence because of the agreement within the Japanese political elite on the path that all should follow. By the late 1990s, however, it became clear that the weakness of the Japanese executive had become a serious obstacle to Japan's ability to deal with its difficult economic and financial problems.

Another distinctive feature of Japanese society is that many "public" responsibilities have been assumed by the private sector. For example, private corporations carry a major responsibility for the social welfare of a substantial portion of the Japanese population. Whereas the American government delegates regulatory authority to quasi-autonomous public agencies, Japan delegates much of the responsibility for policing business activities to private business associations. This has been a highly pragmatic practice based on the close ties and mutual trust between private business and government. There is a particularly interesting example of this practice in the delegation of public functions in the privatizing of "law and order." One reason for the low level of street crime in Japan is that the *yakuza* (the Japanese Mafia) police the streets in exchange for police toleration of their businesses.

This practice of self-regulation and self-policing by business and other private associations is intended to provide social stability and ensure fairness. However, it does result in special treatment of particular groups, seemingly arbitrary decisions, and discriminatory behavior; this practice of self-regulation is also directly counter to the American concept of universal rules that apply equally to everyone regardless of status. Cultural differences in the definition of "fairness" have been a major source of American-Japanese economic tension that has, on occasion, erupted into open conflict. The Japanese practice of private associations assuming essentially public responsibilities has raised significant problems in the integration of Japan into the world economy. For cultural and other reasons, the Japanese find it virtually impossible to incorporate outsiders into the self-regulating associations that set the rules governing competitive behavior and other aspects of the conduct of business in Japan, while foreign companies seeking entry into the Japanese market naturally regard the practice of self-regulation as discriminatory. The self-policing system, with its emphasis on "fairness" and on tailor-made rules enforced in self-regulatory associations, may conflict with the rules embodied in the World Trade Organization (WTO) and is thus an immense hurdle to be cleared to open the Japanese market and internationalize Japan more completely.

Industrial policy has been the most controversial aspect of the Japanese political economy.[17] As I have already noted, industrial policy refers to deliberate efforts of a government to guide and shape the overall structure of the economy. In the early postwar decades, the Japanese provided government support for favored industries, especially for high-tech industries, through trade protection, generous subsidies, and other means. The government also supported creation of cartels to help declining industries and to eliminate "excessive competition."[18] Through subsidies, provision of low-cost financing, and especially "administrative guidance" by bureaucrats, the Japanese state plays a major role in the economy.[19]

The effectiveness of Japanese industrial policy has been very controversial and a matter of intense debate. On one side are revisionist scholars and proponents of the developmental state who attribute Japan's success to its unique economic system and the government's powerful role in the economy. The opposing position is held by American and some Japanese economists, who emphasize Japan's market-conforming economic strategy.

Chalmers Johnson's *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (1982), in which he credits Japan's Ministry of Trade and Investment (MITI) with having orchestrated postwar economic and technological success, is the most outstanding statement of the revisionist or developmental state position.[20] Accord-

[17] A useful and sympathetic treatment of Japanese industrial policy is Miyohei Shinohara, *Industrial Growth, Trade, and Dynamic Patterns in the Japanese Economy* (Tokyo: University of Tokyo Press, 1982). A wide-ranging discussion of Japanese industrial policy from several different perspectives is Hugh Patrick, ed., with the assistance of Larry Meissner, *Japan's High-Technology Industries: Lessons and Limitations of Industrial Policy* (Seattle: University of Washington Press, 1986).

[18] Jeffrey R. Bernstein, "Japanese Capitalism," in Thomas K. McCraw, ed., *Creating Modern Capitalism: How Entrepreneurs, Companies, and Countries Triumphed in Three Industrial Revolutions* (Cambridge: Harvard University Press, 1997).

[19] For a discussion of administrative guidance, consult Bernstein, "Japanese Capitalism," 479

[20] Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford: Stanford University Press, 1982).

ing to Johnson, Japan is a capitalist developmental state rather than an American-style capitalist regulatory state. He credits MITI and other Japanese bureaucracies for Japan's outstanding postwar economic success. MITI and other agencies employed such techniques as import protection, government subsidies, and low-cost financing to promote rapid industrialization and development of the high-tech sectors. In the opinion of Johnson and other revisionists, the most important instrument of Japan's successful industrial policy was the device of administrative guidance, which was utilized to encourage and sometimes pressure private firms to invest in those industrial and high-tech sectors characterized by high value-added and favored by the government. In addition, Japan's export success has been due to its neomercantilist strategy of export-led economic growth.

On the other side of the debate, many American and some Japanese economists argue that Japanese economic success has been due to the fact that Japan pursued market-conforming economic policies and thus got the economic fundamentals correct.[21] They call attention to Japan's high savings and investment rate, superior management and entrepreneurship, and excellent system of education as bearing the primary responsibilities for Japan's success. In addition, the Ministry of Finance (MOF) has pursued stable and prudent macroeconomic policies. Explaining Japan's export success, many note that Japan, as a resource-poor and capital-skilled, labor-rich economy, has had a comparative advantage in manufacturing and industrial innovation.[22] According to this position, Japan's industrial policy had very little to do with its economic success and has even wasted resources.[23] Notable examples of failure are found in MITI's efforts to promote fifth-generation computers and a petrochemical industry. A more infamous example is provided by MITI's effort to prevent Honda from becoming an automobile producer, because MITI believed that Japan could not support another automobile company!

There is considerable evidence on both sides of this debate, but the outcome remains inconclusive because there is no counterfactual

[21] Hugh Patrick, *Asia's New Giant: How Japan's Economy Works* (Washington, D.C.: Brookings Institution, 1976); and Edward F. Denison and William K. Chung, *How Japan's Economy Grew So Fast: The Sources of Postwar Expansion* (Washington, D.C.: Brookings Institution, 1976).

[22] Gene M. Grossman, "Explaining Japan's Innovation and Trade: A Model of Quality Competition and Dynamic Comparative Advantage," *Bank of Japan, Monetary and Economic Studies* 8, no. 2 (September 1990): 75–100.

[23] A valuable assessment is provided by Daniel I. Okimoto, *Between MITI and the Market: Japanese Industrial Policy for High Technology* (Stanford: Stanford University Press, 1989).

experience to indicate whether Japan would have been more or less successful without government intervention.[24] Certainly, as critics charge, MITI made many mistakes and wasted resources. Yet several comments can be made in support of Japan's industrial policy. The government's support and protection of private firms in favored industrial sectors has been central to Japan's industrial policy. MITI and other Japanese economic bureaucracies' supportive policies were very important in enabling Japanese firms to close the technological gap with American and other Western high-tech industries. For example, Japanese competition (antitrust) policy encouraged the formation of the *keiretsu*, and by almost all accounts the *keiretsu* have been very important to Japan's industrial efficiency and international competitiveness.

In the early postwar years, the Japanese government selected a small number of powerful firms to be protected from both domestic and, especially, foreign competition; these protected firms were given tax credits and subsidies that enabled them to develop rapidly.[25] The government also supported technological developments through promotion of cooperative research programs and other means. Once the technology was fully developed, the government strongly encouraged domestic (but not foreign) competition to increase the firms' efficiency. This government support encouraged corporate strategies that emphasized profit-making at home and increased market share abroad. It is a mistake to assume, as some neoclassical economists do, that one can make a clear distinction between government policy and private initiatives in Japan.

The extensive use of "infant industry" protection has provided another key factor in the success produced by Japan's industrial policy.[26] Although it is undoubtedly correct, as American economists argue, that Japan and other governments have been largely unsuccessful in picking winners—that is, in selecting viable new industries—Japan has been very successful in protecting and supporting those sectors whose economic significance has been proved already in the United

[24] This point is made by Ryutaro Komiya, "Planning in Japan," in Morris Bornstein, ed., *Economic Planning: East and West* (Cambridge, Mass.: Ballinger, 1975). Moreover, as Komiya, one of Japan's most distinguished postwar international economists, points out elsewhere, Japan's industrial policy and its goals have changed considerably over the course of the postwar era: Komiya, "Industrial Policy in Japan," *Japanese Economics Studies* (summer 1986): 53–80.

[25] Ryuzo Sato, Rama Ramachandran, and Shunichi Tsutsui, "Protectionism and Growth of Japanese Competitiveness," in Dominick Salvatore, ed., *Protectionism and World Welfare* (New York: Cambridge University Press, 1993), Chapter 13.

[26] Ito, *The Japanese Economy*.

States and elsewhere: automobiles, consumer electronics, and scientific instruments.[27] Among the policies Japan has used to promote these infant industries have been the following:

(1) Taxation, financial, and other policies that encouraged extraordinarily high savings and investment rates.
(2) Fiscal and other policies that kept consumer prices high, corporate earnings up, and discouraged consumption, especially of foreign goods.
(3) Strategic trade policies and import restrictions that protected infant Japanese industries against both imported goods and establishment of subsidiaries of foreign firms.
(4) Government support for basic industries, such as steel, and for generic technology, like materials research.
(5) Competition (antitrust) and other policies favorable to the *keiretsu* and to interfirm cooperation.

Japanese industrial policy was most successful in the early postwar years when Japan was rebuilding its war-torn economy. However, as Japan closed the technology gap with the West and its firms became more powerful in their own right, Japan's industrial policy became considerably less significant in the development of the economy. Yet the population and the government continued to believe that the state should play a central or at least an important supportive role in the continuing industrial evolution of the economy.

Corporate Governance and Private Business Practices

The Japanese corporate system of industrial organization differs in several important respects from that of other industrialized economies.[28] Although its distinctive features have been undergoing important changes due to the maturing of the Japanese economy and to the economic stagnation in the late 1990s, fundamental differences remain between the Japanese and Western economic systems.[29] Three

[27] An excellent example of Japanese industrial policy has been the government's promotion of the Japanese automobile industries. During my several stays in Japan, I was impressed by the flawless condition of Japanese cars. A major reason, I was informed by Frank Upham, a New York University expert on Japanese law, was a set of government policies with respect to auto insurance and inspections that created strong incentives for Japanese consumers to purchase new cars. Then the consumers' replaced cars were shipped abroad to Southeast Asia and, in the 1990s, to Russia.

[28] Ryutaro Komiya, *The Japanese Economy: Trade, Industry, and Government* (Tokyo: University of Tokyo Press, 1990), Part II.

[29] Paul R. Krugman, *Trade with Japan: Has the Door Opened Wider?* (Chicago: University of Chicago Press, 1991).

of the most important differences are in the systems of industrial relations, of corporate finance, and of industrial organization. Although these elements are closely tied to one another and reinforce one another, it is useful to consider them independently.

The Japanese system of industrial relations has been characterized by a dual labor market. The core workers in Japan's large and highly competitive corporations such as Sony and Toyota, have enjoyed lifetime employment, have been paid on the basis of seniority, and have been considered stakeholders to whom Japanese firms have a social responsibility. Although the system has been strongly criticized and is being eroded by Japan's economic problems, one advantage of this system has been that, because lifetime workers are considered long-term assets, Japanese firms have a strong incentive to invest in laborers' skills. However, a major disadvantage of lifetime employment has been that it restricts the flexibility of Japanese firms and makes it difficult to reward younger and more valuable workers; it has also been nearly impossible to fire incompetent or redundant workers. On the other hand, the majority of workers, especially women and workers in smaller firms, have little job security and do not receive an equivalent share of the benefits of the system.

Whereas American firms tend to obtain the largest portion of their capital from the huge American stock market, Japanese firms rely on retained earnings and, most importantly, on an affiliated bank. Bank loans have generally been guaranteed by the government, either directly or at least implicitly. The Japanese banking system, including the government-run postal savings system, tight capital controls, and government macroeconomic policies have enabled Japanese firms to enjoy very low capital costs. As Kent Calder has shown, this financial system has been a crucial component in what he calls "Japan's strategic capitalism."[30]

Whereas American firms emphasize safeguarding both profitability and the interests of shareholders, Japanese firms have considered their primary responsibility to be toward a firm's stakeholders, and stakeholders include employees and subcontractors. American firms seek to maximize profits; Japanese firms have attempted to maximize sales and corporate growth. Differences like these led Alan Blinder, former member of the Federal Reserve, to question whether or not the Japanese economy was really capitalist![31]

[30] Kent E. Calder, *Strategic Capitalism: Private Business and Public Purpose in Japanese Finance* (Princeton: Princeton University Press, 1993).

[31] Alan S. Blinder, "More Like Them?" *American Prospect* 8 (winter 1992): 53.

The *keiretsu*, a business grouping or conglomerate whose members are bound together by the mutual trust and long-term relationships among a number of major firms, their suppliers, and their distribution networks, is a particularly important component of the Japanese corporate system.[32] At the heart of every ***keiretsu*** is a major bank (referred to in Japan as the main bank system) that supplies credit and plays a key role in the ***keiretsu***'s economic strategy. Informal ties among member firms are reinforced by overlapping memberships on governing boards, mutual stock ownership, and other mechanisms. The purpose of these structures is to serve the interests of stakeholders rather than shareholders. There are horizontal ***keiretsu***, enterprise groups such as Mitsui, Mitsubishi, and Sumitomo, that are composed of a few dozen members and include a large bank, manufacturing firms, and a distribution network along with other elements.[33] In addition, there are vertical ***keiretsu*** composed of a parent manufacturing company and a large network of long-standing subcontractors and suppliers of services. The approximately two dozen vertical ***keiretsu*** include leading Japanese manufacturing corporations in the automotive and consumer electronics industries, such as Toyota and Matsushita. Together, the vertical and horizontal ***keiretsu*** control much of Japanese business.

Dominant firms in a ***keiretsu*** may exploit and/or promote the strengths of their junior partners. For example, the parent firms work with their extensive stable of long-term and trusted subcontractors to increase the latter's technological capabilities and to improve the quality of the components supplied to the parent. The parent even shares exclusive information with its affiliates, and this greatly enhances the overall efficiency of the ***keiretsu***. The extensive presence of the ***keiretsu*** in the Japanese economy thus has profound consequences for the nature of Japanese domestic and international economic competition and for the dynamics of the Japanese economy. Market share rather than profit maximization has been the principal driving force in Japanese corporate strategy; a large market share increases economies of scale and benefits the firm's stakeholders. Even

[32] Kester, *Japanese Takeovers*.

[33] The six or so horizontal ***keiretsu*** are the direct descendants of the prewar ***zaibatsu*** that the Occupation sought to destroy and thought they had. The principal characteristics of these groupings is that the members in each grouping hold one another's shares and have interlocking directorates. The presidents of member firms meet frequently to formulate strategy and decide upon joint policies. The members of the group also cooperate in financial matters, R & D activities, and marketing. Together, these six industrial groupings have a powerful presence in the Japanese economy.

though the Japanese economy is highly regulated, compartmentalized, and overprotected, this market is in fact extraordinarily competitive. For example, Japan has a number of automobile companies, whereas the United States has only three. Competition in Japan does tend to be oligopolistic and Schumpeterian; that is, it is based on technological innovation and is quality-driven rather than based on price competition; consumer prices are kept high by government policies to increase the profits of the corporate sector.

In his book on the governance of Japanese corporations, Carl Kester makes a convincing argument that the ***keiretsu*** is a highly efficient and rational mechanism for organizing economic activities, and its distinctive characteristics make it a formidable competitor in world markets.[34] Mutual trust, for example, substantially reduces transaction costs. Information exchange within the ***keiretsu*** decreases uncertainties and is conducive to innovative activities. Intragroup cross-shareholding protects members against hostile takeovers and significantly reduces the cost of capital.[35] The system is a mutual assistance society, and when a member firm gets into trouble, other members come to its rescue.

Corporate leadership's independence from outside shareholders permits the firm, unlike American management, to pursue a corporate strategy based on maximizing market share rather than short-term-profit maximization. As Ronald Dore has argued, the ***keiretsu*** contributes greatly to Japan's remarkable capacity to adjust to economic, technological, and other changes.[36] Certainly, no other country was as successful as Japan in adjusting to the two oil price rises of 1973–1974 and 1979–1980. Despite the troubles of the Japanese economy in the 1990s, the ***keiretsu*** has proved to be a successful innovator of new products and production techniques because of its immense internal resources and long-term perspective. The ***keiretsu*** mechanism has effectively joined the financial and other advantages of the large firm with the flexibility and innovative capabilities of the small firm.

Although (or perhaps because) the ***keiretsu*** is a highly effective means of industrial organization, it has been deeply resented by non-Japanese. One reason for this resentment is that the ***keiretsu*** is a closed system that excludes all outsiders. The term "outsider" includes not only non-Japanese firms, but any Japanese firm that is not

[34] Kester, *Japanese Takeovers*.

[35] Robert Zielinski and Nigel Holloway, ***Unequal Equities: Power and Risk in Japan's Stock Market*** (New York: Kodansha International, 1991).

[36] Ronald P. Dore, ***Flexible Rigidities: Industrial Policy and Structural Adjustment in the Japanese Economy*** (London: Athlone, 1986).

a member of the alliance of stakeholders who share the monopolistic rents generated by this oligopolistic form of business organization. The exclusive nature of the *keiretsu* system has significantly limited foreign firms' access to the Japanese market. The *keiretsu* also makes it extremely difficult for foreign firms to "take over" Japanese firms and gives Japanese firms a huge advantage in corporate expansion. Whereas the *keiretsu* firms can easily purchase a non-Japanese firm in order to acquire its technology or to gain market access, it has frequently been difficult for non-Japanese firms to purchase Japanese firms for the same purposes. Furthermore, the *keiretsu*'s control of distribution channels effectively shuts non-Japanese firms out of some Japanese markets. Although the situation is changing as this is written, non-Japanese still regard the *keiretsu* as a significant barrier to trade and foreign direct investment, while the Japanese, on the other hand, regard the *keiretsu* as a key element in their economic success. The problem of differential or asymmetrical access has been a major cause of conflict between Japan and its trading partners.

The German System of "Social Market" Capitalism

The German economy has some characteristics similar to the American and some to the Japanese systems of political economy, but it is quite different from both in other ways.[37] On the one hand, Germany, like Japan, emphasizes exports and national savings and investment more than consumption.[38] However, Germany permits the market to function with considerable freedom; indeed, most states in Western Europe are significantly less interventionist than Japan. Furthermore, except for the medium-sized business sector (*Mittelstand*), the nongovernmental sector of the German economy is highly oligopolistic and is dominated by alliances between major corporations and large private banks. The German system of political economy attempts to balance social concerns and market efficiency.[39] The German state

[37] This section draws from Philip Glouchevitch, *Juggernaut: The German Way of Business: Why It Is Transforming Europe—and the World* (New York: Simon and Schuster, 1992).

[38] Gunter Heiduk and Kozo Yamamura, eds., *Technological Competition and Interdependence: The Search for Policy in the United States, West Germany, and Japan* (Seattle: University of Washington Press, and Tokyo: University of Tokyo Press, 1990).

[39] The German system is representative of classical liberalism that emphasizes a free market and a strong welfare-oriented state. See Razeen Sally, *Classical Liberalism and International Economic Order: Studies in Theory and Intellectual History* (New York: Routledge, 1998).

and the private sector provide a highly developed system of social welfare.

The German national system of political economy is representative of the "corporatist" or "welfare state capitalism" of continental Europe, in which capital, organized labor, and government cooperate in management of the economy. This corporatist version of capitalism is characterized by greater representation of labor and the larger society in the governance of corporate affairs than in Anglo-Saxon shareholder capitalism.[40] Although the continental economies differ from one another in many respects, in all of them the state plays a strategic role in the economy. It is significant, especially in Germany, that major banks are vital to the provision of capital to industry. While, in many European countries, employee councils have some responsibility for running the company, in Germany labor has a particularly important role in corporate governance. Indeed, the "law of codetermination" mandates equal representation of employees and management on supervisory boards. Although the power of labor on these boards can be easily overstated, the system is a significant factor in Germany's postwar history of relatively smooth labor relations.

Ever since Chancellor Otto von Bismarck took the first important steps toward the modern welfare state in the late nineteenth century, the German state has assumed a major role in providing public welfare for every citizen. This national commitment to advance the overall welfare of the German people has rested on the extraordinary efficiency of German industry. In the modern era, pairing industrial efficiency with public welfare has been made manifest in the concept of the "social market." Germany emphasizes the values of domestic harmony and community. Worker benefits include a greatly reduced workweek, unemployment insurance, health care, and lengthy vacations. By one reckoning, the cost of benefits is equal to about 80 percent of a worker's take-home pay. The nation's high rate of productivity growth has enabled the German nation to provide these generous social welfare benefits, but these especially generous welfare programs have imposed a large burden on German business.

Economic Role of the State

The most important contribution of the German state to the economic success of their economy has been indirect. During the postwar era, the German federal government and the governments of the individual *Lander* (states) have created a stable and favorable environ-

[40] Katzenstein, *Corporatism and Change.*

[illegible] private enterprise. Their laws and regulations have successfully encouraged a high savings rate, rapid capital accumulation, and economic growth. Germany has a highly developed system of codified law that reduces uncertainty and creates a stable business climate; the American common law tradition guides U.S. business, and the Japanese bureaucracy relies on administrative guidance.

At the core of the German system of political economy is their central bank, or Bundesbank. The Bundesbank's crucial role in the postwar German economy has been compared to that of the German General Staff in an earlier German domination of the Continent. Movement toward the European Economic and Monetary Union has further increased the powerful impact of the Bundesbank. Although the Bundesbank lacks the formal independence of the American Federal Reserve, its actual independence and pervasive influence over the German economy have rested on the belief of the German public that the Bundesbank is the "defender of the mark" (euro) and the staunch opponent of dreaded inflation. Indeed, the Bundesbank did create the stable macroeconomic environment and low interest rates that have provided vital support to the postwar competitive success of German industry.

The role of the German state in the microeconomic aspects of the economy has been modest. The Germans, for example, have not had an activist industrial policy although, like other advanced industrial countries, the government has spent heavily on research and development. The German government, however, has not intervened significantly in the economy to shape its structure except in the support it has given through subsidies and protection to such dying industries as coal and shipbuilding and the state-owned businesses such as Lufthansa and the Bundespost (mail and telecommunications). However, since the early 1990s, these sectors have increasingly been privatized. On the whole, the German economy is closer to the American market-oriented system than to the Japanese system of collective capitalism.

Corporate Governance and Private Business Practices

The German system of corporate governance and industrial structure has noteworthy parallels to the Japanese system. As in Japan, powerful national organizations such as the Bundesverband der Deutschen Industrie and the Deutscher Industrie-und Handelstag represent the interests of business in national affairs, and labor is also well organized at the national level. IG. Metall, an organization that represents the auto and metal workers as well as other industries, can speak for

German labor in a way that the American Federation of Labor/Congress of Industrial Organizations cannot for American workers. Japanese organized labor, on the other hand, is fragmented into company unions and has almost no influence on either company or national affairs. The system of codetermination at the level of the firm has made German labor a partner, albeit a junior partner, in corporate governance.

German industrial organization has certain noteworthy features. One element is the prominent role played in the economy by medium-sized, privately owned firms, called the *Mittelstand.* Despite the international prominence given to Germany's large corporations, such as Siemens or Daimler-Benz, the *Mittelstand* constitute an important reason for German economic success. They are major exporters and are especially strong as suppliers of such intermediate goods as chemicals and machine tools. The second major component in German success is the publicly owned corporations whose shares are traded freely on the German stock market. Nevertheless, corporations such as these are much less important in the German economy than in the American economy. In fact, in the 1990s, there were only about six hundred fifty German companies listed on the stock market, and only about one hundred twenty were actively traded. The firms that are most important in the overall structure and governance of the German economy are the bank-linked corporations.

The integration of finance and industry has been a noteworthy feature of corporate governance in Germany. Although more informal than the Japanese *keiretsu*, long-term bank-corporate ties are a crucial element in the system. The major universal banks (i.e., those that perform all financial services) such as the Deutsche Bank and the Commerzbank are worthy of particular attention. Representatives of these banks and of the large German multinational corporations sit on one another's boards of supervisors. In important ways the system of cross-ownership and interlocking boards resembles the Japanese *keiretsu* with their integration of financial, industrial, and distribution activities; the system facilitates the sharing of vital information, provision of less expensive investment capital, and coordination of economic planning. Also, like the *keiretsu*, the system emphasizes long-term relationships based on negotiated prices and supply arrangements among corporations. However, German participants in these arrangements seek to advance the interests of their particular firm rather than those of the whole organizational alliance. It is important to note that as the German economy has globalized, the linkages between banks and industry have weakened.

Banking-industry ties have reduced conflict between industrial and financial interests over economic policy. Because of their pervasive financial power and their linkage with key industries, the major German banks play a central role in the governance of industry and in overall strategic planning for the German economy. While the German corporate world, like the Japanese, is closed, the German economy itself is open, and the German legal system and codified administrative procedures ensure that foreign businesses will be treated in a legally fair manner.

The powerful influence of German universal banks over the economy is primarily a function of the considerable freedom the banks enjoy to enter a great variety of business activities. Under the system of universal banking, German banks can participate in almost every conceivable financial activity, from commercial to investment to merchant banking. Until the 1990s, American commercial and investment banking, on the other hand, was restricted by the Glass-Steagal Act of the early 1930s. In this system, different activities have been conducted by different types of institutions, while German universal banks have had a hand in almost every facet of German financial and business affairs. For example, industrial financing is supplied principally through bank loans rather than through issuance of stock or commercial paper. The banks also own large portions of German companies, and the supervisory boards of German industry are frequently dominated by bankers. Industrial firms prize their ties with the banks because, in addition to ensuring lower cost capital, this arrangement has provided security against hostile takeovers and interfering shareholders.

The strategic role of banks and the close links between banks and industry in the German economy are largely the result of Germany's experience as a late industrializer. As Alexander Gerschenkron, and Thorstein Veblen before him, pointed out, the timing of industrialization is a key factor in determining the mechanism of capital accumulation and the overall structure of a nation's industrial system.[41] In contrast to Great Britain and the United States, where capital was initially accumulated largely in the hands of individual entrepreneurs, in Germany and other continental European countries there was relatively little capital in the hands of individuals. In these circumstances, the banks became the principal means of amassing sufficiently huge amounts of investment capital to expedite industrialization and catch up with the industrial leaders. This historic linkage between finance and industry has continued in both Germany and Japan.

[41] Alexander Gerschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays* (Cambridge: Belknap Press of Harvard University Press, 1962); and Thorstein Veblen, *Imperial Germany and the Industrial Revolution* (New York: Macmillan, 1915).

The most influential of the major German universal banks is, without question, the Deutsche Bank (DB). The DB's pivotal position in the German economy may be gauged by its holdings in the nation's major corporations; it has a substantial stake in Daimler-Benz, Germany's largest corporation, and it also has substantial holdings in Germany's leading insurance company (Allianz), its largest reinsurance company (Munich Re), and its major department store chain (Karstadt). The list of blue-chip companies in which DB has a large stake could easily be lengthened. In addition, members of the upper management of DB are on the supervisory boards of over one hundred fifty German corporations.

German government policies have supported and reinforced the position of Germany's major private banks in corporate governance. Corporate law has empowered banks by giving considerable rights to minority shareholders. For example, corporate law has required that 75 percent of the shareholders in a public corporation must approve any change in the corporation's capitalization and hence in the governing structure of a firm. This means that a bank with only a 26 percent share can block change. Since, in certain circumstances, the banks can also vote the shares of their account holders, this provides banks with considerable influence over corporate affairs.

The governing structure of German industry is affected by the German government's tolerance of the concentration of economic power, by horizontal cooperation, and by the linkages between finance and industry. Despite the fact that the American Occupation after World War II attempted to wipe out the German cartel tradition and to promote an antitrust mentality, this mentality remains relatively weak in Germany. The decision of the German government to permit Daimler-Benz to acquire Messerschmitt-Bölkow-Blohm, Germany's largest defense and aerospace firm, is an example of German tolerance of the concentration of economic power. (Subsequently, Daimler-Benz eliminated its interests in Messerschmitt-Bölkow-Blohm.)

German management is less restricted by shareholder concerns about annual returns on their investments than is American management. Freedom from outside scrutiny has unfortunately sometimes protected the incompetent, but it has enabled German management to pursue long-term plans. This situation began to change in the late 1990s, but previously, management independence had been greatly

system of dual boards. In Germany, there is both a supervisory board, comparable to the American board of directors, and a management board, composed of the chief executive and top management. While, in theory, the supervisory board is the superior body, in actual practice the management board, which is full-time and functions on the basis of consensus, is frequently dominant. This empowerment of management strengthens management's ability to make long-term strategic decisions.

The structure and governance of German industry is also significantly influenced by the negative German attitude toward corporate takeovers. The methods used to prevent hostile takeovers are legion: for instance, companies may simply stay private, stock may be distributed to increase resistance, blocking minorities may be employed, German corporate law can be utilized to discourage takeovers, and voting rights can be restricted. Whereas in the United States, corporate takeovers are defended as a blunt but effective means to guarantee high performance and to demonstrate the ultimate responsibility of management to the shareholders, in Germany takeovers have been regarded as destabilizing and destructive of important long-term business relationships. A number of American executives discovered this, to their chagrin, when they attempted to gain control of the Deutsche Bank. This attitude has made corporate takeovers and struggles over corporate governance rare in Germany, and German banks have seldom sold their stakes in German corporations. This situation, however, began to change in the late 1990s.

Significance of National Differences

This chapter has analyzed and compared the three national systems of political economy dominant at the beginning of the twenty-first century. The American system incorporates neoclassical precepts regarding the organization and functioning of an economy intended to maximize consumer satisfaction and facilitate adjustment to change. Many other countries consider the social costs of such an economy to be too high because of their impact on poverty and on those who lose through economic developments. The Japanese system places a high priority on social harmony and national power, but its critics consider that system to be inflexible, mercantilistic, and unresponsive to the concerns of other societies. The German emphasis on the social market has many of the virtues and vices of both the American and Japanese systems. Although each of these economies was experiencing important changes at the turn of the century, they remained distinctly

different from one another, and their fundamental differences are significant for the nature and dynamics of the world economy.

The significance of the differences among national economies became more and more apparent in the late 1960s and 1970s as a consequence of the increasing interdependence of national economies. As economies became more integrated with one another, the domestic and international spheres became more closely linked to one another, and national policy makers became more and more concerned about the domestic economic structures and private economic practices of other societies that might affect the welfare of their own citizens and nations. As these national differences have become more significant, several questions have arisen: (1) Is one national system superior to the others, and should it therefore be the model for other economies? (2) Do national systems of political economy compete with one another in a "Darwinian struggle" for survival and dominance? and (3) Are systems of political economy converging?

Is One System Superior to the Others?

At one time or another during the postwar era, one or another national economy has been declared superior. In the 1970s, the German system of the Social Market was assigned credit for the postwar German "economic miracle"; as one enthusiastic writer stated, West Germany had become a juggernaut and a challenge to all other economies. In the 1980s, attention shifted to Japan, which was then enjoying a huge trade surplus and a rapid rate of economic growth; at that time, the Japanese system of state-led capitalism or developmental state capitalism became the envy of the rest of the world and the model to be emulated. Both Germany's and Japan's stakeholder capitalist systems were judged superior to America's shareholder (stockholder) capitalism, in part because the former were believed to free corporate leaders from short-term shareholder demands for higher dividends and thus to enable them to take a long-term view in their investment and other decisions. When Japan plunged into a serious financial crisis and recession in the 1990s, the prize for best performance went to the United States, whose economy was booming throughout much of the decade; American public officials, economists, and commentators announced that America's shareholder and free-market capitalism had proved superior to all others. The outstanding success of the American economy, many argued, was due to the fact that in the 1980s and 1990s the United States had created a novel type of economy based on a "New Economic Paradigm." The

... of the world, Americans proclaimed, should adopt their model of deregulation, open markets, and minimal government intervention in the economy.

The claim that one economy is superior to others is difficult to assess. Nations differ greatly in their standards of judgment. Should one apply such criteria as the rate of economic growth, the extent of economic equality and social well-being, or perhaps what some have called a "misery index"? National values obviously differ on these matters. The French, for example, reject what they consider to be the ruthlessness of America's emphasis on the market and its insufficient attention to the problems of income inequality and economic insecurity. Many American observers, on the other hand, believe that the overly protective nature of the French state is largely responsible for France's economic troubles, especially its very high rate of unemployment. In short, an economic system strongly reflects the values of the society in which it is embedded and must be judged, at least to some extent, in terms of those values. The Japanese *keiretsu*, for example, would certainly be incompatible with American opposition to concentrations of economic power.

The most objective measures of national economic performance are an economy's rates of economic and productivity growth. However, even these measures have limitations. Productivity, particularly in those service industries that increasingly characterize the American and Western European economies, is difficult to measure. Another difficulty is that when an economy is beyond a certain level of economic development, its performance at any particular moment is more a function of the phase of the business cycle than of the economy's inherent features. Although economists and governments do not yet know how to manage an economy to avoid the business cycle, a government's use of macroeconomic policy obviously significantly influences national economic performance.

Despite the difficulties of the endeavor, the effort to determine whether particular economic arrangements are superior to others has engaged many scholars. Karl Marx, Joseph Schumpeter, and Alexander Gerschenkron have been among these scholars. One theme of these early writers as well as more recent commentators is that the stage or timing of economic development determines the nature and appropriateness of an economic system. Each stage in the evolution of technology and other aspects of capital accumulation is said to require a different form of economic and sociotechnological organization. Gerschenkron, for example, argued that the method of capital accumulation (by business enterprise, banking system, or state) was

determined by the timing of economic development. Whereas Great Britain and the United States, as early industrializers, relied on capital accumulation by entrepreneurs and by shareholders, Germany and Japan as late starters emphasized accumulation by powerful banks, and the USSR and China as late, late developing countries depended on state-led capital accumulation.

A similar theme has been set forth by business economist Alfred Chandler (1977) and other scholars.[42] Each stage in the development of technology, this position argues, requires new and appropriate institutional arrangements. In fact, national institutional and societal restructuring is frequently necessary to take advantage of new technologies.[43] For example, it could be argued that the open and free-wheeling American economy is appropriate for the age of the Internet. Whether it is correct or not, this argument suggests that flexible and adaptable economic and other institutions are desirable. Another formulation of the evolving institutional requirements for economic success has been set forth by Robert Wade in his argument that, whereas the Japanese and East Asian economic model of state-led industrialization and capital accumulation is appropriate for economic takeoff, the American system of maximizing returns through the optimum allocation of the existing capital stock and national savings may be better suited to maintaining economic stability in an industrialized economy.[44]

Another approach to understanding superiority has been taken by Jeffrey Hart in his book *Rival Capitalists: International Competitiveness in the United States, Japan, and Western Europe* (1992). He argues that "variations in state-societal arrangements" determine the success and international competitiveness of national economies.[45] And Peter Katzenstein has made a strong case for the superior performance of corporatist small West European countries.[46] Although these ideas provide useful insights into the relationship of national

[42] Alfred D. Chandler Jr., *The Visible Hand: The Managerial Revolution in American Business* (Cambridge: Belknap Press of Harvard University Press, 1977).

[43] Carlotta Perez argues that an economy's institutions must be tuned to the dominant technologies of an era. See "Structural Change and Assimilation of New Technologies in the Economic and Social Systems," *Futures—The Journal of Forecasting and Planning* 15, no. 5 (October 1983): 357–75.

[44] Robert Wade, "The Asian Debt-and-Development Crisis of 1997: Causes and Consequences," *World Development* 26, no. 8 (August 1998): 1535–53.

[45] Jeffrey A. Hart, *Rival Capitalists: International Competitiveness in the United States, Japan, and Western Europe* (Ithaca: Cornell University Press, 1992).

[46] Peter Katzenstein, *Small States in World Markets: Industrial Policy in Europe* (Ithaca: Cornell University Press, 1985).

systems and economic success, economic performance is ultimately a function of many factors and cannot be completely explained by any particular institutional arrangement. Moreover, as the contributors to Suzanne Berger and Ronald Dore's edited book, *National Diversity and Global Capitalism: Domestic Institutions and the Pressures for National Convergence* (1996), amply demonstrate, different societies use different institutional arrangements to perform the same economic functions.[47] Although an economy may borrow "best practice" techniques and institutions from one another, as happened when the United States and others adopted Japan's system of lean production, there is no one-to-one correspondence across national economies between structure and function.

It is certain that some economic systems have failed miserably, notably the command economies of the former Soviet bloc, and this suggests that there are some minimal requirements for economic success. Nathan Rosenberg and L. E. Birdzell demonstrate, in *How the West Got Rich* (1986), that government policies and socioeconomic institutions must facilitate efficient, flexible, and innovative economic behavior.[48] Whether through an unfettered market mechanism or some form of state interventionism, a society must create incentives that encourage entrepreneurship, innovation, accumulation, and efficient use of the basic factors of production (especially through investment in capital and skilled labor). Society must also reward innovative activities and support the economy's ability to adjust to economic, technological, and other changes. However, such objectives as these can be fulfilled by differing economic institutions and practices.

The outstanding performance of the American economy in the 1990s and the dismal failure of many other economies convinced most Americans, as well as many others, that the American economy should be the model for the rest of the world. Throughout most of the decade, the United States enjoyed a high rate of economic growth, low unemployment, and low inflation, while Western Europe had a low rate of economic growth and a very high rate of unemployment. After the collapse of its bubble economy in the early 1990s, Japan entered a serious financial crisis and, somewhat later, a recession. Although the other Pacific Asian economies posted spectacular rates of

[47] Suzanne Berger and Ronald Dore, eds., *National Diversity and Global Capitalism: Domestic Institutions and the Pressures for National Convergence* (Ithaca: Cornell University Press, 1996).

[48] Nathan Rosenberg and L. E. Birdzell Jr., *How the West Got Rich: The Economic Transformation of the Industrial World* (New York: Basic Books, 1986).

economic growth throughout most of the 1990s, they were hit by a severe financial crisis and recession in the fall of 1997. The economic pace slackened in China, and the Russian economy was a disaster. Thus, for a period in the late 1990s, the United States was an economic oasis in a global economic desert.

American officials, business leaders, and popular commentators attributed the prolonged success of the American economy to fundamental changes that had occurred in the 1980s and the 1990s. Proponents of the "New American Economy" argued that the American economy had been transformed by several factors: deregulation, increased openness to the global economy, downsizing and restructuring of American corporations in the 1980s, and rapid technological advances (especially in the computer and information technologies) that increased national productivity. The globalization or openness of the American economy to imports kept prices down, decreased inflationary pressures, and hence permitted the Federal Reserve to pursue expansionary economic policies. Deregulation of the American economy made it better suited than its Japanese and European competitors to take advantage of the digital revolution. Some alleged that the productivity and international competitiveness of the American economy have significantly increased and surpassed the rest of the world. Many even proclaimed that the American economy had transcended the boom-and-bust business cycles of the past.

There is no dispute about the overall success of the American economy in the 1990s. Excellent management of the economy by the Federal Reserve as well as an upswing in the business cycle certainly played an important part in this success. However, it has not yet been demonstrated that the United States has created a superior economic model; indeed, good luck has played a role in American success. For example, the victory over inflation and consequent low interest rates can be attributed in large part to the fact that the rest of the world economy was in recession in the 1990s. Moreover, the American economy benefited greatly from a huge inflow of foreign capital that buoyed the stock market; indeed, by the late 1990s, America's national foreign debt had reached approximately $1 trillion. Economic expansion was also funded by the virtual elimination of personal savings and a huge buildup of consumer and corporate debt. Rapid economic expansion was accompanied by increasing income inequalities, job insecurity, and serious social problems. Despite the impressive achievements of the American economy in the 1990s, one must remember that it is dangerous to argue that the American or any other economic model is and will be, for all time, superior to others.

Do Nations Compete with One Another?[9]

The Clinton Administration assumed power believing that pursuit of a "competitiveness strategy" would restore the international competitiveness of the American economy. The United States, as the President told the American people, is "like a big corporation competing in the global marketplace." Clinton raised the competitiveness issue in response to America's huge trade deficit and to growing concern about the deindustrialization of the economy. The immense trade deficit with Japan alarmed the Administration and convinced many that the United States had become noncompetitive with Japan, especially in high-tech industries. The newly elected President created the National Economic Council in response to these concerns and charged it to develop a national strategy to deal with such problems.

About the same time, many West European leaders also began to express concern about the international competitiveness of Western Europe. In June 1993, Jacques Delors, then president of the European Commission, stated that the European economy's most basic problem was loss of international competitiveness. The fundamental reason for high unemployment, he proclaimed, was that Europeans were no longer competitive with the Americans and the Japanese, and the solution should be to increase competitiveness in high-tech industries. Other West Europeans have also spoken of the intense global economic struggle. Many political leaders and the general public began to believe that the economic well-being and even the political survival of Western Europe was at stake in this international struggle. Although both European and American concerns moderated in the late 1990s, concern over competitiveness continued to be very much alive.

The idea that nations qua nations are engaged in a zero-sum competition for market share and economic superiority is anathema to every mainstream economist. It was economist Paul Krugman who, in an article in the *Foreign Affairs* journal (1994), launched the attack on the Clinton Administration's competitiveness strategy and even on the very idea of national competitiveness.[10] Krugman previously had been a principal author of the theory of strategic trade and thus had inadvertently contributed to the intellectual rationale supporting the Administration's policies. In a series of books and articles, Krugman

[9] The question of whether national differences lead to economic and political conflicts is discussed in my book, *The Challenge of Global Capitalism: The World Economy in the 21st Century* (Princeton: Princeton University Press, 2000), Chapter 8.

[10] Paul R. Krugman, "Competitiveness: A Dangerous Obsession," *Foreign Affairs* 73, no. 2 (March/April 1994): 28–44.

subsequently moderated his former enthusiasm for strategic trade and argued that international economic competition takes place between individual business firms and not between national economies. Krugman and other American economists have noted, moreover, that since imports comprise just a small fraction of the American economy, the principal competitors for most American firms are other American firms. And interfirm competition is beneficial, because it rewards efficient producers, benefits the consumer, and leads to maximization of world wealth.

Whereas some individuals and governments believe that nations are engaged in a win-or-lose economic struggle, economists argue that free trade and international competition benefit everyone; indeed, according to the theory of comparative advantage, every nation has a comparative advantage in something and can therefore be a winner. The mercantilist or geoeconomics position of the Clinton Administration that emerged from belief in the win-or-lose struggle, Krugman correctly warned, would produce ill-conceived and reckless policies, including wasteful industrial policies and confrontational trade policies. Moreover, he warned that emphasis on competitiveness diverted attention from such fundamental problems as America's low savings rate and the declining skill level of an alarmingly large portion of the American workforce. Indeed, in the 1990s the United States found it necessary to import large numbers of engineers and scientists to staff its growing information economy.

As Krugman has pointed out, the most appropriate measure of an economy's performance is its productivity and not its balance of trade or of international payments.[11] The national level of productivity and the rate of productivity growth not only constitute the true measure of an economy's performance but also determine a nation's long-term well-being. For this reason, Krugman and other economists have no objection to the term "international competitiveness," provided that such thinking refers to national productivity and gives rise to improved government policies to increase national savings and investment in capital goods and in skilled labor.

It should be pointed out, however, that economic policies designed to increase a nation's rate of productivity growth do not necessarily have any effect on a nation's balance of foreign trade and international payments, although many noneconomists believe that there is a direct causal relationship. The trade balance and payments balance of an economy are determined principally by its savings/investment

[11] Productivity is a measure of the ratio of national output to national input.

... macroeconomic (fiscal and monetary) policies. Furthermore, the productivity growth of one economy does not necessarily harm other economies and may even raise the economic welfare of others. For example, increased productivity of one economy can improve the economic welfare of its trading partners by making the former's exports less expensive. As a case in point, no one could deny that the high rate of productivity growth of the Japanese automotive and electronics industries has benefited American consumers enormously and has forced American firms to increase their own productivity and competitiveness in price and quality.

Although nations may not compete with one another in a narrow economic sense, nations can be said to compete in a broader sense; that is, in their ability to manage their economic affairs effectively. At particular times, certain national economies are obviously superior in their ability to fashion and implement policies that promote economic and productivity growth. Beneficial economic policies encourage savings, investment, and education, and also facilitate rapid adjustment of the private sector to economic and technological change. Swedish economist Gunnar Eliasson stated that competitiveness can be defined as a nation's ability to renew itself. In this sense, competitiveness is ultimately the ability of a society to transform itself continuously in response to economic, political, and technological changes. The state and its policies must play a central role in transformation and adjustment; markets alone will not succeed. The state must address such issues as market failures and the provision of such public goods as R & D. Eliasson believes that competitiveness depends on the economy's flexibility both to adjust relative prices and to modify industrial structures by scrapping obsolete economic activities and thus releasing labor and capital to facilitate the development of viable new businesses. The capacity of an economy to transform itself is a crucial characteristic in the global struggle to determine which nations will develop a comparative advantage in those industries and economic activities most important to economic welfare and national power.[52]

The concept of the "competitive state" emerges from ideas expressed by Eliasson and incorporates Krugman's argument that it is firms and not states that compete. The competitive state concept also incorporates the fact that firms are increasingly mobile as they seek the most attractive locations in the global economy.[53] Moreover, it recognizes that governments cannot pick winners and that the choice of technologies must be left up to the private sector. According to this concept, however, governments should be active and should not leave matters to the market alone. As Vincent Cable has pointed out, a "competing nation" attempts to strengthen the position of its firms in the global economy and attract foreign investment through creation of a pool of highly educated, flexible workers, an efficient physical infrastructure, sound economic policies, and an attractive quality of life.[54] Such a competition strategy has been employed effectively by Singapore and has been adopted by Britain, Ireland, and other countries; Germany is also moving in this direction. However, another significant example of a successful competitive state is the United States. In 1980, for example, responding to fears of deindustrialization, the Congress passed the Bayh-Dole Act that, for the first time, permitted universities to patent the results of federally funded research and to license those results to private firms.[55] Subsequent legislation has strengthened this corporate-university alliance as a key element in America's competitive strategy in the area of high-tech industries. Many observers, however, do fear this could prove harmful to the universities over the long term.

Convergence, Harmonization, or Mutual Recognition?

There are several possible solutions to problems engendered by national differences that have created obstacles to the smooth functioning and full development of the global economy. Differences could be eradicated or moderated either through the functioning of the market, as neoclassical ***convergence*** theory suggests, or through political negotiations to achieve ***harmonization*** of national practices. The convergence position requires patience, as it posits that national systems will converge through the operation of markets in which, over time, economic forces will cause nations to modify their economic structures and business practices. Harmonization, on the other hand, is based on international negotiations and reciprocity leading to elimi-

[52] Gunnar Eliasson, *The Knowledge Base of an Industrial Economy* (Stockholm: Industrial Institute for Economic and Social Research; distributed by Almqvist and Wiksell International, 1988).

[53] The implications of this fact are developed by Robert Reich, *The Work of Nations: Preparing Ourselves for 21st Century Capitalism* (New York: Knopf, 1991).

[54] Vincent Cable, "The Diminished Nation-State: A Study in the Loss of Economic Power," in *What Future for the State? Daedalus* 124, no. 2 (spring 1995): 48–50.

[55] This development and its potential dangers is discussed by Eyal Press and Jennifer Washburn, "The Kept University," *Atlantic Monthly* 285, no. 3 (March 2000): 39–54.

nation of national differences; the negotiations between Japan and the United States over the Structural Impediments Initiative (SII) in the late 1980s is a prime example. Both methods of accommodation are slow, and the latter can be very confrontational. Still a third way to deal with national differences is by application of the principle of ***mutual recognition***, in which nations agree to honor one another's economic and business practices. Indeed, mutual recognition has been central within the movement toward European and, to a lesser extent, North American regionalism.

Convergence

According to neoclassical convergence theory, economic interdependence will ultimately lead to a convergence in economic performance among national economies as rates of economic growth, productivity levels, and national incomes move toward one another. Many writers even argue that economic globalization necessarily forces convergence of the structural features of an economy and of private economic practices and that, therefore, national differences will disappear. These persons argue that intensification of global economic competition, expansion of trade and foreign direct investment, and interpenetration of national societies necessitate that societies adopt similar domestic institutions and economic practices. As other countries close the economic and technological gap with the more developed economies, the role of the market will become more central in each economy; then the policy prescriptions of neoclassical economics—economic openness, noninterventionism, and the like—will increasingly guide the economic activities of that society. Many American economists and public officials argue that the superior performance of the American economy in the 1990s and the weaknesses of the once-envied Japanese and other Pacific Asian economies have made the American economy and the free market the model for the world. Some observers even proclaim that the convergence process leads the world toward individualism and political democracy.

The neoclassical position assumes that national variations in economic performance are a function either of a catching-up process or of a country's failure to manage its economy according to the policy prescriptions of neoclassical economics. In this view, the outstanding economic success of Japan and the East Asian Newly Industrializing Countries (NICs) was caused by their having had the advantage of backwardness and their ability to apply the experience and technology of the more advanced economies when they mobilized national resources to expedite economic growth. Then, as countries develop,

they will inevitably converge toward the neoclassical model of a market economy. As these countries draw close to the more industrialized countries, their growth rates will slacken, and they will eventually settle down as more "normal" countries with more typical normal growth rates.

Since the end of World War II, there has indeed been convergence in economic performance among the more advanced economies. Convergence in productivity levels and other economic indicators has taken place between the United States and the other industrialized economies largely as a consequence of trade liberalization. However, the gap between rich and poor countries has actually widened except in the case of the East Asian and a few other industrializing economies. Some explain that most poor countries have failed to catch up because convergence can work only when political, social, and economic institutions are conducive to economic development and are supportive of inward flows of capital and technology; these conditions did exist in East Asia. The East Asian experience indicates that convergence between developed and less developed countries is not automatic, but, as Robert Barro has pointed out, requires an appropriate social and political infrastructure.[16]

Another possible reason why so many less developed countries have failed to catch up with the developed economies is supplied by the new growth theory. In that theory, an initial advantage of one country over another in human capital can and usually will result in a permanent difference in income level between the countries. This happens particularly when the differences in human capital are very large. Developed countries rich in human capital can sustain a much higher level of economic output than can less developed countries with a low level of human capital; thus, the former will be able to maintain a decisive lead indefinitely by generating more new savings and investment than the less developed economy can generate. Thus, even though poor countries may be gaining in wealth, the gap between them and the rich will continue.

If convergence in economic performance has been weak and uneven, what about convergence in economic institutions and business practices? With economic globalization, is the world gravitating toward the American free market model? It is certain that the increasing integration of national economies has encouraged societies to adopt particular institutions and practices proven especially successful else-

[16] Robert J. Barro, *Economic Growth and Convergence*, Occasional Papers No. 46 (San Francisco: International Center for Economic Growth, 1994).

... the Japanese technique of lean production to the United States, Great Britain, and elsewhere exemplifies this phenomenon. But this does not necessarily lead to the conclusion that economic globalization has been homogenizing domestic economies. The only significant examination that I have found of whether or not institutional convergence has really occurred is in Berger and Dore's edited volume, *National Diversity and Global Capitalism*, mentioned earlier. In a number of case studies, the contributors to this excellent volume (all of whom are experts on one or another of the economies examined) seek to determine whether or not convergence of institutions and domestic practices has been occurring; the volume reaches the following conclusions:

(1) Despite some convergence in macroeconomic performance, very little convergence has taken place at the level of national institutions. National institutions tend to be "sticky" or, in the language of economics, "inelastic." Societal changes are usually very costly, strongly resisted, and exceedingly slow.
(2) Differing but equally effective systems of corporate and other institutions within national societies limit the need for convergence to achieve particular objectives.
(3) External pressures may require a response or outcome, but the character of the response is largely determined by domestic factors and is not limited to a unique or single response.
(4) Convergence of national institutions has been subject to international negotiations; it can seldom be identified as an automatic consequence of globalization.
(5) The domestic effects of globalization are largely determined by states themselves.

Despite this impressive study, evidence suggests that important changes in economic behavior and structure have been taking place in a number of countries and that these changes tend primarily toward the American model of shareholder capitalism. The two most notable examples of this development are Germany and Japan. Yet, one should not jump to the conclusion, at least not yet, that the German and Japanese economies are shedding their distinctive features.

The German system of stakeholder capitalism came under severe pressure in the 1990s. The unification of Germany in 1989 imposed a very high and continuing financial burden on the German economy; Germany has been required to pump substantial funds into the backward economy of the former East Germany. In addition, German industry has had to deal with high labor costs (both wages and welfare

benefits) and with the costly effort to create a unified European currency. The tension between the costs of the overly generous German welfare state and the need for greater economic efficiency has constituted a serious problem and has encouraged German firms to establish production facilities in Eastern Europe, the United States, and elsewhere. Moreover, Germany for many years has had to contend with a chronic high rate of unemployment (over 10 percent). Most importantly, Germany has become increasingly aware that fundamental reforms are necessary if it is to meet the combined challenges of economic globalization, European economic integration, and the increasing importance of the Internet and information economy. The growing pressure to internationalize production and to significantly increase the capital available to German industry to further the development of high-tech industries has placed a severe strain on the German "Social Market" economy.

One of the central tasks of reforming and restructuring the German economy to bring it into the information age entails elimination, or at least significant weakening, of the close bank-industry alliances; these powerful alliances are held together by webs of cross-holdings and interlocking directorates. This system has a number of major negative consequences; it has tied up large amounts of capital in traditional industries and discouraged individual entrepreneurship. In order to transform itself into a high-tech information economy, Germany requires large amounts of capital to invest in new industries; such a need prompted the unprecedented decision of Daimler-Benz to list DaimlerChrysler on the New York Stock Exchange, a move that required the company to break with tradition and to open its books to outsiders. Similar remarkable changes are taking place in Germany itself in response to the growth of a shareholder mentality that is creating a more vigorous and innovative German economic system.

Several events in early 2000 signaled that a significant change in the bank-industry alliance was taking place. The first development was the bid of the British firm Vodafone AirTouch to acquire the German firm Mannesmann A.G. The initial reaction of the German government was to denounce the threatened hostile takeover as "anti-German" and contrary to German culture. Germany has always had a strong preference that German firms merge with other national firms and has opposed hostile takeovers. The intense opposition to hostile and cross-boundary mergers has been due to a corporate culture that favors consensus and the interests of such stakeholders as labor. In the past, a German bank would have stepped in and used its own capital to save the threatened German firm. When, in this

feature of German economic culture was changing.

Another and even more important example of the profound change taking place in the German economy early in the year 2000 was the proposed merger of Deutsche and Dresdner banks engineered by the powerful insurance conglomerate Allianz A.G. Although the merger effort eventually failed, it did signal an important change in German economic culture. Such an initiative would have dismantled a key component of the bank-industrial system and led to the loss of many thousands of jobs, an event unheard of in Germany. This development in turn would have led to a major restructuring of a key segment of the German economy. Efforts to restructure German industry have been greatly facilitated by a new tax law that allows corporations to sell off their holdings and investments without paying capital gains taxes. The purpose of these sell-offs is to enable German banks and corporations to eliminate burdensome holdings and pave the way for the same type of corporate mergers, acquisitions, and takeovers as in the United States and elsewhere. As a result, Germany will be able to accelerate development of a more entrepreneurial and high-tech economy appropriate for the world of the Internet and information economy.

These developments will undoubtedly transform Germany and make it more of a "competing state." As German investors are demanding greater transparency in the management of German business and a much higher rate of return on their investments, the shift from stakeholder to shareholder capitalism will accelerate. Equity culture is spreading fast in Germany and the rest of Europe, and the number of shareholders is rapidly increasing. Yet, it is highly unlikely that the German "social market" economy will be wholly abandoned in favor of the American-style free-market economy. Although welfare programs will be trimmed in the interest of greater efficiency and flexibility, the welfare state is too ingrained in German mentality to be abandoned. In addition, the practice of codetermination has given German labor a powerful voice in German firms, and German unions have become so important in the overall economy that a Thatcher-Reagan type of conservative ideology is unlikely ever to sweep that country.

In Japan, the issue of institutional change has also become urgent. Throughout the 1990s, the Japanese system of political economy suffered one serious setback after another. In the early 1990s, major problems arose with the collapse of the inflated "bubble" economy and resulted in a severe banking crisis; Japan's banks found themselves with a huge burden of underperforming or bad loans. Subsequently, in the late 1990s, the East Asian economic crisis greatly aggravated Japan's economic slowdown and financial problems. In 1998, Japan lunged into its deepest recession since the end of World War II; moreover, in contrast to past crises, Japan's export-led growth strategy has been unable to reinvigorate the economy and, as these lines are written in the early spring of 2000, recession continues. At a more fundamental level, Japan's rapidly aging population, the overcapacity and low profitability of many export industries, and the overall low level of productivity outside the export sector portend severe economic troubles in the decades ahead.

These accumulating difficulties have caused many Japanese to accept the idea that a radical deregulation and restructuring of the Japanese political economy has become necessary. For example, Japan's Economic Planning Agency (EPA) published a report in 1995, *Toward the Revival of a Dynamic Economy*, in which it warned that Japan must either reform its economy or face long-term economic decline. Essential to any significant reform would be a shift from an export-led to a domestic-led growth strategy, opening of the economy to greatly increased amounts of manufactured imports and to foreign direct investment, and extensive deregulation of the economy. Such steps, some argue, would lead to a significant revival of the economy, increase overall productivity growth, and enable Japan to become more of a leader in the world economy. However, powerful resistance from the Japanese bureaucracy and from entrenched private interests, and the seeming indifference of the Japanese people, lead to doubt about the ability or willingness of Japanese political leaders to make truly significant reforms in the economy.

Nevertheless, Japan's national system of political economy has begun to change in a number of ways. The increased attention given to the Japanese consumer, the pervasive role of the Japanese state in the economy, and distinctive private business practices are changing. The system of lifetime employment and seniority-based pay is weakening because of recession and the increasing need in the information economy to reward the most valued younger workers; some firms have even been forced to lay off tens of thousands of workers. Under severe financial pressure, some *keiretsu* have begun to unravel as members have been forced to sell off their holdings in member firms. Corporate mergers and restructuring are still limited by Western standards, but are increasing; Renault's takeover of Nissan could never have occurred in the past. A significant increase in foreign direct investment and in the number of foreigners in the economy has taken

Throughout the economy, an increasing emphasis on return to equity has caused firms to decrease their former concern with market share. The pressure for profitability and reform will increase as pension funds demand greater returns to support the growing population of the aged. High wages, production costs, and an overvalued yen are forcing Japanese firms to produce more and more goods in overseas plants.

The core of the Japanese industrial economy is the "main bank system." In the early postwar years, this system was very effective in collecting national savings and funneling them to the industrial members of the *keiretsu*. However, this system resulted in overly close banking-industry ties and led to major inefficiencies, corruption, and other abuses. The main bank system that once pumped capital into *keiretsu* regardless of risk has failed; it was this system that led to the colossal misallocation of capital that culminated in Japan's bubble economy. Largely as a consequence of the collapse of the bubble and the ensuing financial crisis, the main bank system has been under strain and has been undergoing major reforms. In addition, financial reforms of the late 1990s have increased competition, especially from American and other financial institutions, and have been forcing Japanese banks to become more prudent lenders and more profit-oriented in their practices. Nevertheless, powerful banks and the Ministry of Finance can be expected to remain major forces in the Japanese financial system.

Despite these impressive changes in Japan's political economy, there has been no significant alteration in such fundamental aspects of the economy as the political domination of the country by a conservative political, business, and bureaucratic elite; Japan's neomercantilist export-led growth strategy has not changed nor has the closed nature of the *keiretsu* been altered. Fundamental change will succeed only when and if Japan moves decisively in the direction of a more market-oriented economy. Such a transformation would require greatly expanded deregulation of the economy, and the Japanese economy is still the most regulated among industrialized countries. The overregulation of the economy by government bureaucracies has stifled innovation, discouraged entrepreneurship, and caused gross inefficiencies. Deregulation of the economy would stimulate entrepreneurship and increase productivity; it would also be an important step toward opening the Japanese market to imports, and this would further increase overall efficiency.

Meaningful deregulation of the Japanese economy will be extremely difficult to achieve. The power of domestic interests that seek protection and the emphasis on social harmony and safeguarding the weak have contributed to overregulation. Reform and deregulation would entail closing thousands of firms and putting hundreds of thousands of Japanese out of work; therefore, it is almost a certainty that public and vested interests will remain overwhelmingly opposed to such action. Moreover, as deregulation would weaken the power of the Ministry of Finance and other powerful bureaucracies, these agencies would also oppose any drastic reforms. It is instructive to note that the Japanese have a quite different concept of deregulation than does the United States. Whereas Americans interpret "deregulation" to mean the elimination of rules and regulators, the Japanese word for deregulation (*kisei kanwa*) means "relaxation of regulation" and not elimination.[57] Even though the rules may be changed, the Japanese bureaucracy will still attempt to regulate the system. Nevertheless, the task of regulation has become increasingly difficult as Japanese firms have become more powerful and as success in catching up with Western technology has led to a diminished role for central planning and bureaucratic control. As the Japanese are well aware, they must become technological innovators, and this requires some drastic changes in their society.

Most American economists and public officials believe that the solution to Japan's economic problems is to transform Japan into an American-type of free-market economy. However, the Japanese, like other Asians and most continental Europeans, are fearful of the possible consequences of adopting completely the American shareholder system. Most Japanese and Europeans reject the "Anglo-Saxonization" of the economy as a threat to social peace and, in the case of the Japanese, to economic/political independence. Japanese society, they fear, would be torn apart by the ruthlessness considered typical of the American economy and its toleration of high levels of economic insecurity and a large number of losers. For these reasons, Japan strongly resists conversion to the American economic model. More importantly, changing Japan into a Western-style economy would entail a fundamental shift in the relationships between individuals and society; there would have to be much greater emphasis on individualism, and some of the tight social bonds that are so characteristic of Japanese society would have to be weakened. These hurdles mean

[57] Bernstein, "Japanese Capitalism," 484.

... become an American-type market economy.

Harmonization

Another possible solution to the problem posed by national differences is harmonization. Whereas the theory of economic convergence assumes that time and the market will lead to a blurring of national differences, the harmonization approach maintains that eradication of significant national differences should be an explicit goal of international negotiations. Many areas of government policies that lend themselves to harmonization already fall within the province of the World Trade Organization and other international institutions. The doctrine of national treatment embodied in the GATT/WTO, for example, prohibits discriminatory taxes and regulations to be applied to foreign firms. The Tokyo, Uruguay, and other GATT Rounds of trade negotiations have resolved many vexing issues that arise from cultural, historic, and government regulatory traditions. All these achievements, however, are only a small step toward a solution of the problem.

The first major effort toward negotiated harmonization of national differences was made in the Tokyo Round of trade negotiations; by the mid-1980s the concept of reciprocity, or more pointedly, "specific reciprocity," had become the principal mechanism employed to achieve greater harmonization among national systems of political economy. Under the GATT and, to a lesser extent, under the WTO system, general reciprocity had been the rule; nations would make broad concessions to trading partners in exchange for other broad concessions. Underlying this negotiating tactic was an assumption that, over time, concessions from one country to another would balance out, and everyone would benefit from a more open international economy. Rightly or wrongly, by the mid-1980s the United States and Western Europe believed that general reciprocity was working too slowly; the United States in particular believed that its trading partners (read especially Japan) had failed to carry out the agreements to which they had committed themselves. Therefore, in place of general reciprocity, the United States and Western Europe resorted to a policy of specific reciprocity under which these nations would not make any concessions and might even withdraw prior concessions if the other party did not fulfill its side of the agreement; this position was the rationale for the 1990s American policy of "managed trade" toward Japan, in which the United States demanded a percentage of the Japanese market in automobiles and other products in exchange

for Japanese access to the American market. Needless to say, Japan and other countries that have been the object of such treatment have deeply resented it and regard specific reciprocity as an unwarranted interference in their domestic affairs. Whatever the merits of specific reciprocity, it is one tool for dealing with the increasingly important clash between national systems of political economy and the threat that these national differences pose to maintenance of an open world economy.

The most contentious issues lie outside the jurisdiction of international organizations, and governments everywhere prefer that no international organization should have the authority to enact, enforce, or prescribe universal rules or regulations for conducting business. Every government prefers to leave such matters in its own hands. At the same time, however, every government (and certainly every business firm) would like those government regulations, economic structures, and private business practices that constrain the activities of its own firms in foreign markets to be eliminated. This objective of transforming the regulations and business practices of foreign governments has been aggressively pursued by the United States and, to a lesser extent, by Western Europe.

Competition policy is one critically important policy area that lies outside the jurisdiction of existing international institutions and that has become a source of increasing friction. Economists concerned with competition policy refer to restrictive business practices that pose an obstacle to economic growth, trade expansion, and other economic goals. Competition policy applies to those domestic economic policies and regulations that determine legal or legitimate forms of business behavior and practices; such policies have become significant points of contention between the United States and the developmental states of East Asia. The antitrust tradition that attempts to prevent collusive business practices and concentration of corporate power is the essence of competition policy in the United States, and it facilitates entry into the American economy by foreign firms. Japanese and South Korean competition policies, on the other hand, not only tolerate but actually encourage concentration of corporate power in the form of the *keiretsu* and the *chaebol*. Although both these institutions are troubled at the opening of the twenty-first century, it is unlikely that they will be dismantled in the name of increased openness and competition.

Can harmonization and the policy of specific reciprocity work rapidly and effectively enough to overcome the political problems raised by national differences? Successive American Administrations have

believed that the process of economic convergence and reliance on multilateral negotiations to overcome problems of policy, structural, and behavioral differences work much too slowly. Many reason that the United States and its more open and competitive economy suffer from efforts to pursue goals in this fashion. Thus, Americans have supported a policy of enforced harmonization, and where this tactic has failed, of protectionism. As has already been mentioned, the most notable or infamous example of this approach was the prolonged and acrimonious Structural Impediments Initiative (SII) negotiations between Japan and the United States. These negotiations, in which the United States sought to transform important aspects of the Japanese economy, achieved little and left a bitter residue in Japan.

Mutual Recognition

The most simple approach to the problem of national differences is mutual recognition. According to this principle, every nation should accept the legitimacy of the rules by which other nations manage their economies. For example, a multinational firm establishing a subsidiary in another economy should be free to behave as it does in its own economy. This approach has been adopted by the European Union. Except in a few basic areas such as health and national standards, the members of the Union have agreed to permit businesses to operate throughout Western Europe in accordance with the laws and regulations of their home country. Thus, the subsidiary of a German corporation doing business in France would be governed principally by German law; nevertheless, more and more business regulations are being formulated in Brussels.

The fundamental question, of course, is whether or not the principle of mutual recognition is applicable to other parts of the world. The principle is particularly well suited to Western Europe for a number of reasons. Continental Europe inherited the Roman and Napoleonic legal and administrative traditions, and, as Peter Katzenstein has pointed out, the nations of continental Europe share a concept of the limited state; that is, the state is regarded as an impartial and independent entity separate from society but responsible for creating a favorable and impartial environment for private business. Economic and cultural differences among the European nations are minor when compared to those in any other regions of the globe. Also, during the postwar era the processes of deregulation, privatization, and liberalization have reduced the role of the state in the economy and harmonized to a considerable degree the economic structures and business practices across the Continent. Both the historic traditions and other

developments in Western Europe have facilitated adoption of the principle of mutual recognition as an expeditious means to promote the economic unification of the Continent.

Needless to say, the conditions that exist in Western Europe do not exist anywhere else in the world. Within the North American Free Trade Agreement area, although the United States and Canada are very close in almost every aspect of national life, there is an enormous gap between these countries and Mexico in many respects; the principle of mutual recognition is hardly applicable to NAFTA or to relations between North and South America. The economic, cultural, and political diversity in the Asia/Pacific area is even more striking. The principle of mutual recognition cannot serve as a means toward the economic and political integration of that region and certainly cannot provide the basis for a resolution of differences between the West and these rising economic powers. At the heart of the problems is the fact that economic and political affairs are intimately joined to one another. It is therefore difficult to isolate the economy from the polity so that the former may function according to the principles of neoclassical economics. Moreover, if one incorporates religion as a vitally important element in many of these states, as it is in the Middle East, application of the principle of mutual recognition as a solution to the problem of national differences becomes totally out of the question.

Conclusion

In the early years following the end of the Cold War, there was a prevalent belief that the clash between capitalism and communism would be replaced by a clash between rival forms of capitalism. This belief, at least thus far, has been proved wrong. Yet it is obvious that increasing interdependence of national economies has made legal, policy, and structural differences among national societies both more important and frequently also a source of tension and occasional political conflict. Differing national systems of political economy constitute a serious obstacle to the movement toward an even more open multilateral global economy. Differences in such matters as competition policy, business practices, and corporate structures have become major concerns of international trade and other negotiations.