

POLITICAL SCIENCE

"As the title suggests, this first-rate book covers a lot of ground. At the core is a pioneering analysis of the way national financial systems facilitate or hinder the conduct of industrial policy. A broader focus is on how the different relations of government and market in Japan, France, Germany, Britain, and the U.S. affect each country's ability to cope with changes in the international economy. All these financial systems are shown to be subject to new challenges—at different a good bit from one another. What they have in common, the author reminds us, is that they have provided the foundations for acceptable political systems which may also be called into question if they cannot cope with economic problems."

—FOREIGN AFFAIRS

"Governments, Markets, and Growth is an original and important contribution to the debate about industrial policy. Zysman holds out no panaceas for America. Rather, he helps us understand the nature of the institutional forces that set the stage for different kinds of policies. We are not likely to formulate an effective policy for this country until we have thought hard about the relationships between government, industry, and finance that Zysman explores in this path-breaking study."

—ROBERT HELBRONER, NORMAN THOMAS PROFESSOR OF ECONOMICS,  
NEW SCHOOL FOR SOCIAL RESEARCH

JOHN ZYSMAN is Professor of Political Science and Co-Director of the Berkeley Roundtable on the International Economy (BRIE) at the University of California, Berkeley. He is coauthor of *The Highest Stakes: The Economic Foundations of the Next Security System and Manufacturing Matters: The Myth of the Post-Industrial Economy*.

CORNELL STUDIES IN POLITICAL ECONOMY  
A series edited by Peter J. Katzenstein

Cornell Paperbacks

Cornell University Press  
www.cornellpress.cornell.edu

ISBN 778-0-401-7252-5  
90000  
9 780801 692325

ZYSMAN

Governments,  
Markets, and Growth

# Governments, Markets, and Growth

FINANCIAL SYSTEMS AND THE  
POLITICS OF INDUSTRIAL CHANGE

PASTA:	25
CÓPIAS:	22
R\$:	FRENTE
R\$:	FIN

JOHN ZYSMAN



## THE ARGUMENT

variation in the roles government plays in industrial markets. That variation, as we shall discover, depends on the relationship of a number of elements—political coalition, administrative structure, and the industrial tasks that confront the country. This discussion focuses on the system of money and credit. It considers how the structure of the financial system, the channels through which money and credit are allocated to competing uses, affects both corporate strategy and public policies for adjustment. Throughout the book the central proposition is that in advanced industrial countries the structure of the domestic financial systems helped shape the politics of industrial change in the postwar years. Financial systems influence both the leadership that state bureaucracies can exercise in the industrial economy and the nature of the conflicts about which goals governments should pursue.

The next chapter elaborates the tie between financial structures and the political and policy responses of government in the advanced countries to the task of adjusting their economies to the shifting conditions of the postwar years. The third and fourth chapters examine the politics of industry and economic growth in France and Britain, focusing on the effects that their very different financial systems have had on government policies and on the political conflicts that accompanied industrial change. The fifth chapter generalizes the argument in a succinct review of the American, West German, and Japanese experiences. The final chapter evaluates the argument linking variations in the financial system to the particularities of national political conflicts about industrial change and considers the relation of this variable to other elements of the political economy.

## CHAPTER TWO

# *Finance and the Politics of Industry*

## THE ARGUMENT

There are three distinct types of financial systems, each of which has different consequences for the political ties between banks, industry, and finance, as well as different implications for the process by which industrial change occurs. The three types are: (1) a system based on capital markets with resources allocated by prices established in competitive markets, (2) a credit-based system with critical prices administered by government, and (3) a credit-based system dominated by financial institutions. To distinguish between these three systems we focus on the process by which savings are transformed into investments and then allocated among competing users. Our emphasis is on the structural arrangements—the relations between the several markets and institutions through which funds flow—which shape this process in each country. Variations in macroeconomic policy as such do not concern us, for the administrative and political strategies used to alter the balance between consumption and investment are, in our view, more likely to reflect the structure of the existing financial system than to be forces for reshaping it. Similarly, we do not address the contention that certain financial systems are more amenable than others to policy manipulations that favor saving.<sup>1</sup> We are concerned, however, with the techniques by which governments pursue macroeconomic objectives, such as the control of the money supply or interest rates because these techniques help establish the routes by which savings are transformed and allocated to competing investors and are therefore part of the financial structure. For example, substantial national debt means constant governmental intervention in the bond

market to raise funds. Similarly, money-supply targets, much in vogue these days, can be pursued indirectly through interest rates or directly through quantitative limits on the lending of each financial institution.

This book focuses exclusively on domestic issues, not because I see the dramatic changes in the international monetary and banking systems as unimportant, but because I agree with Peter Kenen and Laura Tyson that one can isolate the dominant domestic structural elements that determine the domestic ramifications of an international economic development.<sup>2</sup> They have argued that though an international economic disturbance may be common to all countries, the structure of domestic institutions determines how the external disturbance is translated into a domestic disturbance in particular national economy. Moreover, the significance of these domestic institutions is not reduced by international developments that make countries more sensitive to changes that occur abroad. It is commonly argued that the increasingly elaborate international financial markets that link national economies ever more closely make it more difficult for governments to pursue autonomous economic policies. Domestic economic aggregates, such as the money supply and the interest rate, are more sensitive to developments in international markets than to government policy instruments. In this book, however, we are concerned with how resources are allocated through domestic financial channels, not with how economic aggregates are controlled. Thus, unless international developments undermine these differences in the domestic channels through which finance is obtained, the structure of the national financial system will be an autonomous influence on the political relations between business and government. In short, international financial developments that put common pressures on all countries have distinct national consequences that depend on the structure of the national financial system. Those consequences vary systematically with the type of domestic financial system.

In a given country the political implications of marketplace arrangements in the financial system can be understood by answering three questions:

1. Does one or several financial institutions exert discretionary power over financial flows, that is, influence who uses funds on what terms?
2. Is market power used selectively and intentionally to affect the decisions of firms or the organization of an industry? (The alternative is that any market power is used simply to achieve financial gain rather than to influence industrial behavior.)
3. Can government employ the financial system or institutions as an instrument in its dealings with the industrial economy? (It can do this

either by discriminating between firms or sectors in granting access to funds or by creating financial packages that can be used to bargain with companies.)

At issue is the ability of government to influence company choices through the medium of the financial system. It is a premise of this book that the answers to these questions lie in the structure of the financial system; that is, in the several types of financial markets and in the relative size and the detailed operations of those markets. To adopt for a moment a different language, the different market structures determine whether financial institutions exercise influence over companies through the mechanism of exit or through that of voice.<sup>3</sup> Influence through exit means that if you object to price or service you take your business elsewhere. Influence through voice means that you remain a client but lobby the management for changes. In capital market-based systems with elaborate secondary markets, entrance to and exit from different financial holdings are quite simple processes. The accumulation of the entrance and exit choices affects the price of different financial assets and thus the desirability of those assets and the allocation of funds between them. In credit-based systems with fewer arrangements for an easy exit, financial institutions are obliged to remain loyal to their customers. They will consequently use their position to make their voices heard in the affairs of client companies. In a credit-based financial system with administered prices, the voice of government will be heard along with that of the financial institutions; in a credit-based, bank-dominated system, the financial institutions will more often speak on their own.

We shall take a closer look at the detailed operations of the national financial systems when we consider the cases of individual countries. The discussion that follows is intended only to justify analytically the existence of the three types of financial systems mentioned above.

### *Financing Industry*

Financial systems serve to transform savings into investment and to allocate those funds among competing users.<sup>4</sup> In this chapter we will consider the types of markets that serve to perform this transformation and the way prices are set in those markets. Our central concern is to demonstrate how the company sector of the economy is financed.

The vocabulary of finance often adds mystery and confusion to the subject. To provide some basic vocabulary, we must distinguish, first, between financial agents and financial intermediaries and, second, between bank and non-bank financial institutions. Financial institutions,

grouped into markets by the type of service they provide, stand between the savers and investors, serving either as agent-brokers or as intermediaries in shifting the funds. In common parlance, broker and intermediary mean roughly the same thing, but in the specialized language of finance they represent quite different activities. Individual savers may give their money directly to final users, as when they buy a new stock or bond issue. In that case, the saver transforms his savings directly into investment and the financial institution merely facilitates the contact between the saver and the buyer of money. The financier may take a fee for his efforts, but he is an agent-broker, not a borrower or a lender; he is acting as a go-between. To give a simple example, if I personally lend money to my uncle's company, then he and I have transformed my savings into investment. As the company grows, my uncle may decide to seek a wider circle of investors. He may issue either shares or bonds to attract their savings. He may engage a broker to put him in contact with the investors, but the basic link is still directly between saver and investor.

Alternatively, a financial institution may hold money on deposit in the form of investments by savers, insurance payments, or borrowings from other institutions. When these funds are passed to the final user, the financial institution has acted—in the language of finance—as an intermediary. It has, acting on its own behalf, taken money from savers and lent it to users. "Financial intermediaries obviate the need for each group of savers to seek out and choose among the wide variety of capital users, and conversely for each group of capital users to seek out and choose among the wide variety of savers."<sup>5</sup> The institution profits from the margin between what the funds cost it and the price it can demand from the user. Thus, for example, when I put my money in a savings or a checking account, I am putting it in a bank or investment fund. Those institutions then place the money with the final users of *their* choosing; they stand between me, the saver, and the user. They act as intermediaries in transforming savings into investments. Although I have not given my money to my uncle, he may still get money from me by an indirect route. The financial institution may buy my uncle's stocks or bonds or it may make him a loan. The stock represents equity in my uncle's company, of which the institution has now become a part owner. Bonds represent a kind of arm's-length loan, a loan without close supervision. Clearly, bonds will be issued only by the best credit risks and only for their long-term investment purposes. For other firms there are bank loans, shorter-term grants of credit directly supervised by the lending institution. In both cases, however, the financial institution has be-

come an intermediary, and its activities are those of intermediation. (There are, of course, a multitude of services that financial institutions perform, such as brokering bills of sale to give producers funds before their customers pay and operating exchange markets to give international producers a guarantee as to the value of a deal. But for our purposes this broad distinction between agent and intermediary will suffice.) An agent-broker is a go-between who makes a profit for fees charged to the principals in a transaction. An intermediary, by contrast, buys and sells financial assets. For example, it buys deposits from savers with interest on savings accounts and then sells loans to users at a higher rate of interest. Its profit comes from the margin between the cost of its funds and the price at which it can sell them.

The second important distinction is between a non-bank financial institution and a bank. This distinction, though often blurred in practice, is quite simple in principle: a bank creates money and a non-bank financial institution does not. A non-bank financial institution invests money that it collects either in exchange for a service it performs or by borrowing. Thus insurance companies collect funds in exchange for the service of protecting their clients against specified risks. Investment companies collect money to perform the service of managing those funds to the profit of their clients. Lastly, a long-term lending institution may obtain funds by borrowing them in the bond or money markets. However they obtain the funds, the amount of money a non-bank financial institution invests equals the amount it has collected or borrowed.

A bank is different. It takes in deposits and lends out more money than it takes in, creating money in the process. A bank may take in a deposit of \$100, but if it maintains a reserve of 20 percent it will lend out \$500. It is a simple process and John K. Galbraith is right to say that for something so important, a greater mystery would be only decent.<sup>6</sup> Any institution that creates money is "bank-like." Thus a savings and loan association is like a bank, even though its operations have been restricted. The reserves against which bank loans are made serve two purposes. First, they are a prudent protection, a guarantee that claims will not exceed the funds on hand. In the ordinary course of business there will be periods of heavy withdrawal—for rural banks, the planting season is such a period—that strain reserves. Second, reserves provide a means by which government can regulate the amount of money banks lend. Government increases in reserve ratios force a reduction in total bank lending. One bank may find additional reserves to maintain its existing loans, but it must get them somewhere else in the financial markets. Thus, government manipulation

of reserve ratios will affect the volume of lending in the system as a whole.

All three types of financial systems have agents and intermediaries as well as bank and non-bank financial institutions. What makes the financial systems different is the relative importance of two types of financial markets; capital markets and loan markets. Capital markets and loan markets are alternative sources of funds for all companies. A third market, the money market, is a source of short-term funds for large firms and financial institutions.

In capital markets the financial assets sold are securities with more than one year to maturity. The principal "goods" are corporate stocks and bonds, mortgages, and government securities, each sold within a primary or secondary submarket. New issues of stocks, bonds, and the like are considered the primary capital market, for they signify the creation of new investment funds and their allocation to specific uses. Most of the buying and selling of capital-market assets, however, takes place in secondary markets. These markets, such as the stock market in the United States and the *bourse* in France, permit the exchange of financial assets. They do not create new investments but instead shift the ownership of existing financial assets. The secondary market permits initial investors to dispose of their investments in order either to take profits or to adjust their portfolio of holdings. Thus it permits long-term investments to be made without the investor tying his money up for the life of the bond—or in perpetuity in the case of stocks. Secondary markets also establish a price for financial assets issued by different companies and governments, thereby setting the terms on which additional money can be raised. James Stone has deftly described the theoretical assumption that capital markets establish a price for the financial assets of companies: "The market accomplishes its job through the assignment of prices. When it does its job correctly it juggles stock prices up and down in such a manner that every available dollar of new investment is channeled to that proposed project with the highest rate of return. Simplicity is the market's virtue."<sup>8</sup>

Elaborate secondary capital markets, some argue, are needed to attract initial investment in new securities issues. They propose that a large number of buyers and sellers of existing capital assets, as well as the institutions that link them (which together constitute a developed secondary market) are a prerequisite for active primary markets. The large secondary market solves particular problems. For example, a large number of buyers and sellers means that any seller is likely to find a buyer and, consequently, that routine price fluctuations are apt

to be less extreme than they would be in a small market. Small secondary markets, then, could be thought to expose investors to a risk of market fluctuations, but at first glance, the French case would seem to disprove this argument. Although there is a limited secondary market in France, the primary market has raised substantial new investment in recent years. On closer inspection, however, we see that the French system has some special features. First, much of the new investment is money directed from parapublic lending institutions to parapublic firms. Thus the new investments are implicitly directed and insured by the government. Second, government management of price fluctuations in the secondary market creates a stability not normally possible with a narrow or limited market. The French case suggests, then, that a managed market may substitute for an elaborate and extensive secondary market as a means to attract investment in new securities issues.

Loan markets are an alternative of sorts to capital markets. We are concerned here with the market for business loans, not with consumer and home finance, which compete with companies for available funds. Business loans can be made either by banks that draw their funds from deposits or by specialized lending institutions that draw their funds from the bond side of the equity market or from the money market. Company lending can be divided roughly into short-term and medium-term loans. In all countries short-term loans are commonly used to finance stocks, carry outstanding billings, and the like. Such loans are in principle self-liquidating; for example, when stocks are sold the money lent to buy the stocks is paid back. Medium- and long-term lending is more significant in Japan, France, and Germany than in the United States and Britain. Very simply, where capital markets emerged to finance industrial development, bank lending has been traditionally limited to short-term purposes. Where the capital markets were neither adequate nor reliable sources of development funds, banks or specialized institutions filled the gap with loans.

The third type of market is a money market. Though not central to this story, let us examine it quickly. In this market, credit instruments with maturities of less than one year are traded. The retail market for money is the branch deposit system for savings and checking accounts with which we are all familiar. The wholesale market is an institutional interfirm or interbank market. Most activity in these wholesale markets is conducted by intermediaries. Institutions may borrow money in these markets, lending it to final users, or they may place excess funds as investments with still other institutions. The money market allows institutions to nourish their short-term needs for cash and to invest excess funds without affecting their liquidity.

Thus far we have focused on the supply of investment funds and the forms these funds can take. Let us consider for a moment the problem of the demand for funds or, more precisely, the form in which a company will choose to seek those funds. The choice of instrument for obtaining outside funds will depend on the price of money in different forms, the company's own preference for debt or equity, and the market's preference for the balance between debt investment and equity investment in the company. If it has a long-term project, it will not want money to be withdrawn halfway through the project and will therefore sell either equity (a share of the company), or a bond (an arm's-length, long-term loan). If the company needs money in the short run to pay its suppliers while waiting for payment itself it will borrow from the bank. This, at any rate, is the story as British and often American textbooks tell it. Long-term money comes from capital markets and short-term money comes from bank loans.

What happens, however, if a company wants to invest in a new factory and cannot sell stock or issue bonds? If the firm is small it may not be sufficiently well known to attract anonymous investors. Or perhaps there are not many investors prepared to buy anyone's bonds and stock that year: most of them may be small and thus inclined to put their money into deposit institutions or banks. In this case, the firm may try to borrow money from the bank or deposit institutions on a long-term basis.

Long-term borrowing, however, is quite different from a short-term loan relationship. For the borrower it means a long-term relationship with an institution that undoubtedly will want to interfere in his business as a condition for permitting the continued use of its money. For the bank as well, the problems of long-term lending are qualitatively different. Any loan is a gamble on the future solvency of the client, but a long-term loan involves a new kind of risk. Obviously, a long-term loan on the business of the client cannot in reality be secured by any physical assets. Moreover, a bank gets the bulk of the money it uses from funds deposited for a short term at the going interest rate. If it lends a firm money for five years, during that period, the depositors may withdraw their funds at which point the bank's reserves drop and it must reduce its loans: in an extreme case it might not be able to pay claims presented to it. Another, potentially more serious problem may occur should interest rates change in unexpected ways. If the short-term rates go down and the bank has lent long, its margin of profit increases, but if the rates go up, its profit margins are cut or it loses money. To encourage the transformation of short-term savings into long-term lending, governments have often absorbed part of this risk

of interest-rate fluctuation. As we shall see, this policy provides a lever for government to direct the flow of funds toward ends of its own choosing.

Long-term borrowing from banks or institutions exchanges the impersonal arm's-length dealings of capital markets for the personal institutional ties of banks or lending institutions. Indeed, the greater a corporation's dependence on debt as a basic element in its business strategy, the greater the influence of those institutions that provide it with credit. Many French and Japanese companies operate with a very high debt-to-equity ratio; that is, they use a high proportion of borrowed money. Such arrangements can permit a high return on capital because the company has less of its own money invested, but heavy debt can also make companies vulnerable to economic downturns. Very simply, debt represents fixed charges that must be repaid, regardless of business conditions, whereas returns to investors can be restrained by not declaring a stock dividend. One would predict, therefore, that in countries where companies operate with heavy debt firms will periodically find themselves extremely vulnerable to and dependent upon their banks and their governments. Companies tend to turn to bank financing when the growth rates they choose to pursue exceed the capital they can obtain from retained earnings and securities issues. This is why credit-based systems tend to be tied to late and rapid growth; investigation will show that in late-developing countries the state has helped to organize the provision of financial resources.

A system in which capital markets are the central means of corporate finance is thus very different from one in which loans or credits predominate. A financial system based on capital markets is weighted toward exit as a means of exercising influence. There is a tendency for banks to specialize in short-term lending rather than longer-term loans and to stay clear of the capital markets, leaving other financial institutions to specialize in capital-market operations. Relations between financial institutions and companies rest primarily on an arm's-length capital-market basis or on limited short-term lending arrangements. Where there are well-developed secondary markets for securities investment, financial institutions tend to manage portfolios of stocks, spreading their risks across companies rather than investing in the future of specific companies that they nurture through hard times. The often derided emphasis on stock-market values characteristic of American and British companies leads to a short-term focus on dividends and on capital return and is thus part of this same pattern. Even though large investment institutions have come to dominate capital markets in the United States and Britain, they have not changed the

## THE ARGUMENT

arm's-length bias of the two systems. The elaborate secondary markets allow investors an exit route.

Loan-based systems of corporate finance are of necessity premised on the exercise of influence by voice. Since such systems have more restricted capital markets and, in particular, a limited secondary capital market, it is harder for financial institutions to treat equity investments simply as a matter of financial portfolio balance. In a limited secondary market they may not be able to dispose of equity holdings without affecting the price of the stock. Exit is not easy and, as a result, these institutions are pressed into close monitoring of management and the exercise of voice. Limited secondary markets and the long-term loans characteristic of this system reinforce each other, militating toward intimacy between financial institutions and the companies whose equity they own and to whom they lend. Also, there is less institutional specialization. Indeed, the German "universal" banks, preeminent players in all financial markets, contrast sharply with the more specialized banks of the Anglo-American system. For "universal" banks equity investments and loans are alternative means of providing corporate finance.

The distinction between a capital-market system, with its emphasis on influence by exit, and a credit-based system, with its emphasis on influence by voice, can be observed in the lending and investment policies of financial institutions. The different relations between business and banks are defined by the criteria institutions use in deciding whether to grant loans and in determining how to deal with companies in trouble and with "bad" loans. In deciding whether to grant a loan, a bank can either assess risk on the basis of historic performances and securable assets or make that assessment on the basis of future prospects and projected cash flows. To pose the distinction at its most extreme: application of the first criterion makes a financier into a pawnbroker who takes company assets as security (which, as we shall see, is how American bankers often view their English cousins); application of the second criterion makes the investor a venture capitalist, betting on corporate futures and taking an equity position in a company as part of his stake (on a large scale this has often been the role of the German universal banks). The treatment of "bad" loans is a second criterion for defining the relations between businesses and banks. When faced with a business loan that is in default, a bank can either sell the company's assets or help the company work its way out of trouble, trading out of the situation by reorganizing the management and corporate strategy of the company in difficulty. Again, the pawnbroker simply sells out or exits from his position, whereas the venture capitalist has from the

## *Finance and the Politics of Industry*

beginning intended to exercise his voice in the form of management advice as a means of protecting his investment position.

The existence of these two different systems is evident in a comparison of the French and American security markets (see Table 2.1). France has a credit-based system in which security, or capital, markets are of secondary importance. In America, the capital markets are crucial to corporate finance, one corollary of which is the great importance of investing institutions. Individual savings are funneled through investing institutions into capital markets to a greater extent in the United States. Finally, in France long-term credit institutions with limited deposit bases (note the liabilities) lend extensively to companies (note the claims). They funnel funds from savings institutions into loans.

We next distinguish financial systems by the way prices are set in the three types of financial markets—capital markets, loan markets, and money markets. The textbook notion of financial markets is that prices are set by the efforts of lenders to get the highest return (given their tolerance for risk) and the efforts of users to get the cheapest money for their different projects. In this perfect market, savers are offered a variety of investment options tailored to meet individual preferences for the balance between risk and return; users of money can choose between many sources of funds offered on terms suited to their different purposes. The flow of funds through different institutions and the price for borrowing money (interest rates) shift with the mixes of supply and demand for different instruments. In that sense stock and bond markets and bank loans represent different ways of doing the same thing. Both the suppliers and the users of funds are price takers, not price setters: neither has the ability to determine the prices by the volumes of funds placed or taken up. Thus unfettered markets are one possible mechanism for setting prices.

Not all markets are perfect, however; financial institutions may exert market power and shape the terms on which money is bought and sold. An institution may be dominant in a single financial market; that is, it may have power over prices in the bond or stock market but not in the bank lending market. Or one institution may have a position of influence in several different markets, thereby influencing prices in all markets and the movement of money through the financial system as a whole. For example, the French Caisse des Dépôts et Consignations, a public depository, has a powerful position in the bond and stock market as well as in the wholesale money market. The German universal banks are able to take positions in all types of markets, even though no single bank is dominant in any one of them. Thus institution-dominated markets are a second potential mechanism for setting prices. Efforts by buyers and sellers to

Table 2.1. Credit-based and capital market-based financial systems: the examples of France and United States, end 1975

Country	Securities markets as percent of Gross Domestic Product		Share (in claims and liabilities) with nonfinancial sector (percent)			
	Bonds	Equities	Investing institutions		Long-term credit institutions	
			Liabilities	Claims	Liabilities	Claims
France	16	11	11.3	9.3	8.2	32.9
United States	57	45	32.3	31.2	5.5	7.9

NOTE: Liabilities represent deposits; claims indicate loans.

SOURCE: Figures taken from Appendixes 1A to 9A, Dimitri Vittas, ed., *Banking Systems Abroad* (London: Inter-Bank Research Organisation, 1978).

strike the best deal still determine prices and flows, but some players have the power to dominate the markets and influence prices.

Market power arguably has different consequences in capital market-based and lending-based financial systems. In capital market-based systems, concentration of financial institutions within any given financial market need not in itself overturn the arm's-length character of the system because easy exit is still possible.\* Since most bank lending is short term, market power over the prices of loans does not automatically translate into an ability to manipulate company choices through access to a loan window. As long as banks are kept out of capital markets, investment institutions that have never had intimate ties to company management will tend to maintain a portfolio approach to investment. Market concentration that means that a few institutions control most of the business in a sector may bias prices and allow a few investors to determine allocation priorities, but whatever problems concentration may pose, it does not automatically imply detailed influence in corporate management. In fact, although institutional investors have come to dominate securities markets in Britain and the United States, the concentration is not so great that single institutions are able to shape those markets systematically. In a lending-based system that already rests on institutional ties, a financial institution's market power translates more directly into influence on its clients. This is not, of course, to imply that financiers and bankers in America and Britain have no influence in corporate affairs, but rather to point out that their influence is different from that of their Japanese, German, and French counterparts. Yet we must not overdraw the argument that the channels of finance structure power relations in the economy. In the United States, for example, legal limits on banking power are critical to the structure of the financial markets.

A third possible mechanism is that government will simply establish prices in these several markets. Prices, even if administratively set, can serve as devices that help allocate goods and services. That is, if prices are not free to move in response to the supply or the demand for funds, the result will undoubtedly be disequilibrium—an imbalance of supply and demand. Low prices (interest) may encourage more users but discourage savers, thus reducing supply. If supplies of funds are short, some additional mechanism will be required to discriminate among users who collectively demand more money than is available at a given interest rate. Controlled prices imply some administrative mech-

\*Concentration is a technical economic measure of the organization of an industry. A highly concentrated industry is one in which a few firms control a substantial portion of production (or of purchases).

anism that chooses whose demands will be met, thus allocating resources. It is important to point out that administered pricing in essential markets may be very difficult to dismantle; the attempt to move from an administered price to a free price may create market disorder and political resistance.

In short, the different pricing mechanisms create three different types of institutional ties between finance and industry. Allocation of funds by price in perfect markets is thoroughly impersonal. Allocation of funds in markets dominated by financial actors gives those with market power the ability to make discretionary choices about whom to lend to and on what terms; thus discretion will more quickly translate into influence inside corporations. Lastly, where prices are administratively set by government, the likelihood is disequilibrium in which the supply and demand for money is balanced by administrative discretion. The crucial issue is who exercises the discretion when markets are in disequilibrium.

The final step in this brief sketch of financial systems is to consider the various ways in which governments operate in financial markets. First and most obviously, governments manage the creation of money to achieve either interest rate or money-supply targets. These objectives are pursued through arm's-length techniques, such as manipulating the level of reserves a bank must hold, or through more direct means, such as establishing quantitative limits on what each bank can lend. Second, governments manage and regulate financial systems to assure overall stability and the solvency of the individual institutions. To this end, central banks serve as lenders of last resort to assure that temporary mismatches of funds or illiquidity in the system does not set off a crisis. In Britain and the United States the central bank's role is essentially to act as a marginal stabilizer, whereas in France and Japan the central bank facilitates the creation of money by providing extensive access to their own funds and thus influence the allocation of funds. (For our initial discussion it does not matter whether the central bank, which has the most immediate responsibility, is actually under the thumb of the government, as in France, or independent, as in Germany and the United States.) Third, in managing the financial system governments may establish rules that implicitly favor one type of institution over another. Such biases may amount to subsidies to certain borrowers or lenders; if the biases are imposed by rules concerned not with resource allocation but with the conditions of competition—as, for example, in the rules governing savings and loan associations in the United States—then the logic that markets set prices will not be altered.

Fourth, the government is a substantial borrower and lender in many markets. In countries with a substantial national debt, such as the

United States and Britain, government securities are an important part of both the bond market and the money market. In countries where either the government or public agencies collect savings, these same institutions may be substantial lenders. This is the case in France, where specialized deposit institutions collect 30 percent of the nation's savings and then place them in bond or money markets. Fifth, the government may help banks manage the risks of transforming short-term borrowing into long-term loans. One device is to rediscount long-term financial paper at the central bank—in other words, to permit certain types of long-term loans to be converted into liquid assets, thereby reducing the bank's risk in borrowing short and lending long. When such a device is used, the government can influence the availability of credit to different users by choosing to favor loans to certain industries or firms.

It may seem difficult to distinguish between governments in terms of how they operate in financial markets, since, to one degree or another, all governments do all these things—manage the money supply, manage the stability of the system, borrow and lend, set interest rates, and facilitate bank lending. In fact, however, we can make such distinctions by asking two related questions. First, does a government place its emphasis on managing the aggregates of the system, such as the money supply, or does it attempt to manipulate the allocation of resources? Second, does it attempt to achieve its objectives—both aggregate and specific—by direct quantitative administration or by market manipulation?

In sum, then, national financial systems vary in three ways. The first dimension is the importance of different markets in shifting resources from savings to investment. Here we distinguish fundamentally between capital market-based systems and credit-based systems. The second dimension is the way prices are set in these markets. We have seen that the possibilities are competitive prices, institution-dominated prices, and government-fixed prices. The third dimension is the roles played by government in the financial system. Within the third dimension, national systems may be distinguished by whether government gives priority to controlling monetary aggregates or to allocating resources between competing uses, and whether it pursues either of those goals administratively or by manipulating market conditions. These three dimensions serve to distinguish three types of financial systems.

### *Three Models of Finance*

The three financial models outlined here highlight the relationship between specific features of a financial system and political outcomes.<sup>9</sup>

Although the details of a particular financial system do not match any one of these three models precisely, its important structural characteristics must. We do not attempt to demonstrate that these are the only possible systems. There do, however, appear to be a limited number of possible arrangements, certainly empirically and perhaps theoretically. The role of government, the significant markets, the mechanisms by which prices are fixed, and the links between finance and industry seem interconnected. Each grouping forms a system. The logic of eliminating possibilities simply is not worth the effort since all we really need to do is establish that the systems are distinct from each other in politically significant ways.

The first model is a capital market-based system in which security issues—stocks and bonds—are the predominant source of long-term industrial funds. In such a system the central function of bank lending is to serve short-term purposes. In each distinct market prices are set in plausibly competitive conditions, a situation that implies a wide variety of capital and money-market instruments and a large number of specialized financial institutions. As a result, the saver and the investor meet across the divide of competitive markets, most often with the help of intermediary institutions. Since there is an active stock and bond market in which firms can raise long-term funds, they do not need to pass through the commercial banks to reach the capital markets and are not dependent on bank credit for long-term projects. The opposite side of this proposition is that, whether by historical circumstances or legal prohibition, financial institutions do not act as owner-managers and do not hold substantial shares of the stock of any particular firms. In such a system the central bank is concerned primarily with the control of monetary aggregates, be they money supply figures or interest rates. Only secondarily, if at all, is it concerned with the allocation of resources between competing uses. Though it may seek to control critical aggregates or a few central prices, it leaves the rest of the prices and aggregates to move on their own. The central bank and the commercial banks stand at arm's length from each other and neither the volume nor the allocation of bank lending is directly determined by the central bank. The central bank may act as a lender of last resort but it does so only in a very limited way. When the central bank does intervene in a capital market-based system, it does so by buying and selling to bring about market conditions that produce the outcomes it favors; it does not attempt to impose these conditions by administrative fiat. *This model places banks, firms, and governments in distinct spheres from which they venture forth to meet as autonomous bargaining partners.*

The market arrangements described by this first model tend to limit

both the influence of financial institutions on (nonfinancial) firms and the influence of governments on the details of the lending activities of banks. They certainly limit government capacity to direct flows through capital markets, with two distinct consequences: first, government will not have natural handles in the market system by which it can selectively influence the allocation decisions of financial institutions; second, financial institutions will not routinely have influence inside corporations. Government intervention in corporate affairs will require specific legislative authorization and will operate outside routine market operations. Consequently, individual interventions by government may be broadly opposed by the financial community, not only because of the objectives of any specific intervention but also because of the threat that interventionist policies pose to the integrity of market arrangements. The market principle, as much as any particular purpose of government, is at issue in the political efforts to gain specific authorization for government action in industrial or financial affairs. Britain and the United States fit this first model.

The second model is a credit-based system in which market interrelations are dominated by government-administered prices. The stock and bond market is not easily accessible to private borrowers, though it is often used by the government as a means of raising money for its projects. Given the weakness of the capital markets, firms must turn to lending institutions, both specialized lenders and banks, for the funds they need. Indeed, banks may serve as crucial access routes to the capital market and general purpose banks may end up owning or voting much of the stock of important companies. Credit is at the core of the system of corporate finance, however, and the banking system's ability to extend industrial credit is therefore critical. Government chooses to underpin bank lending and to facilitate money creation. Finally, government sets the prices in important markets in order to shape the economy's priorities. Since prices are administratively fixed there is an inherent tendency for markets to be in disequilibrium; that is, at the established prices there are too many borrowers or lenders. The balance *must* then be achieved by administrative action that discriminates in favor of some users and against others. Some administrative rule must be substituted for the free play of prices in the market. The issue in this system is not whether government intervenes to affect the allocation of financial resources; the question is who controls the process and how.

To summarize the second model, credit extended by institutions becomes a linchpin in the system of industrial finance and government is drawn in to bolster the system and to make the administrative choices

about allocation. It appears that government's role is to compensate for weaknesses in an existing private financial system. Historically, the state intervenes to accomplish particular purposes and the resulting financial structure institutionalizes its discretionary influence in the financial market. The political implication is that the state's entanglement with industry becomes part and parcel of the financial system. *The borderline between public and private blurs, not simply because of political arrangements, but because of the very structure of the financial markets.* The arrangements between bureaucracy and finance which blur this borderline can occur in widely different state structures. Thus, for example, the Italian financial system is more similar to the French than to any other, but the discretion it generates is diffused among warring factions in the Italian polity, whereas in the French system discretion is concentrated in the hands of the central executive.

The third model is also a credit-based system, but one in which a limited number of financial institutions dominate the system without themselves being dependent on state assistance. Markets, not administrative actions, determine prices, but the movement of prices in the markets reflects this concentration of financial power. Evidence comparing German and British stock exchange operations, for example, convincingly demonstrates that banks exercise market power over price movements in Germany but not in Britain.<sup>10</sup> In this model the state pursues aggregate instead of allocative objectives, and it does so through market operations instead of administrative techniques. As a result, the financial institutions have influence in the affairs of companies through their market power in lending and their domination of access to securities markets. *Government does not have the apparatus to dictate allocative choices to the financial institutions and consequently it has no independent instruments in the financial system with which to influence companies. Banks, however, can serve as policy allies for government, on terms negotiated between the government and finance.*

Both the second and third models are solutions to late development, whereas the first is tied to an earlier industrial transformation. The market differences themselves become important elements, though, in shaping the responses of all countries to their present economic problems.

The position taken here is that the three models are distinguished by structural differences and that the relations that describe the operation of the system—the differing importance of securities and lending markets, the mechanisms that establish prices, and the objectives and techniques of government management—are fundamentally distinct in each model. An alternative argument holds that one general model of a “financial system” can be used to predict the behavior of any national

case, that one need only vary the quantities in the markets of each system to make predictions for any particular case. Formalizing the issue, we can say that the choice is between (1) a set of models, each of which rests on a different set of equations that expresses the behavior of each financial system, and (2) a single set of equations in which we vary the quantities in each national case to predict system outcomes. The existing literature is not much help in testing the proposition that there are several structurally distinct financial systems. There is an extensive institutional literature, but it focuses on the peculiarities of each system's institutions, not on the distinctions in the workings of their financial markets. Another body of literature assumes that a common financial model is adequate and does not test the converse. Some writings that produce evidence of structural differences do not ask the questions that could define those differences. Jacques Melitz's recent study of exchange-rate systems, however, offers strong support for the structural line argued here.<sup>11</sup>

Melitz claims that in general economists have had great success in using identical structural equations to describe the different national markets. He contends that commodity markets as well as production, consumption, and investment functions are quite similar. He is even willing to accept that wage and price equations are similar in different national cases, once one allows for variations in the openness of national economies. He takes a different position about finance, however. Though his central concern is money-supply issues rather than industrial finance, his argument directly supports the analysis offered here. Melitz distinguishes two models in his analysis, categorizing Japan and France as one type and the United States and Britain as a second. (The German case, which is the basis of our third model, is not discussed.) Melitz argues: “It is not surprising, therefore, that many efforts could be made to use a uniform model of the money-supply process for all nations, typically patterned after the United States. I believe, nonetheless, that such efforts are in vain. History and policy condition financial structures more than industrial ones. Whatever the reason, financial environments differ internationally in critical ways.”<sup>12</sup>

In the United States and Great Britain the capital markets are very large, corporations rely heavily upon these markets for finance, and the commercial banks face major competition at home from other financial intermediaries. In the cases of France and Japan, however, the commercial banks dominate financing on the capital market and face virtually no competition at home from other financial institutions. Consequently, any analysis of the United States or Great Britain must em-

## THE ARGUMENT

phasize the bond market, whose role is perhaps as large as or larger than that of the market for commercial bank loans. Indeed, in Great Britain the government's ability to finance deficits through bond issues is probably the most important element in the money-supply process. In the cases of France and Japan, however, any model of the money-supply process which does not put primary emphasis on the market for commercial bank credit will be misleading. At least in France, the bond market can virtually be ignored.

To cite another basic point of contrast: British commercial banks cannot borrow directly from the central bank; U.S. banks can do so to a small, but significant extent; and French and Japanese banks can do so to an enormous extent. If we omit the extreme case of Great Britain and compare the United States with France and Japan, we still find that the appropriate treatment of borrowed reserves in these cases is not the same. In the United States, borrowed reserves can be viewed essentially as a portfolio choice made by bankers according to opportunity costs. In France and Japan, however, borrowed reserves are so basic to bank operations that their level cannot be dissociated from the aggregate quantity of bank credit. That is, reserves borrowed from the central bank must be seen as a percentage of the total credit distribution. Finally, in France, for example, the central bank has only a limited portfolio of capital-market assets, such as government bonds. Thus, any references to open market operations in which the government influences interest rates by buying and selling its own financial paper cannot even make sense. Melitz summarizes the issue well:

My view then is that to use an identical schema in order to model the money-supply process in the United States, Great Britain, France, and other nations, is simply to indulge in all sorts of fiction, fictions which are important enough to defeat the very purpose of the modelling of the money-supply process. . . . It becomes impossible, subsequently, to infer the relationship between policy instruments and the quantity of money. Essential money scenarios and their consequences cannot be worked out. Even if a U.S. set of structural equations provided excellent econometric estimates for France, the estimates still would have no value, since we could not interpret the equations in accordance with the hypotheses; hence we could not base any explanations or policy conclusions upon the estimates.<sup>13</sup>

In short, the crux of Melitz's argument is that structural variations have quite different consequences for economic outcomes. For example, similar levels of demand for money do not result in similar prices or money-supply figures in different models. The same logic

holds for our problem. That is, structural differences strengthen the case that political actors must adapt their strategies for managing the economy to the constraints imposed by their particular national financial system.

## Finance and the Politics of Industry

### *The State as Economic Player*

We have distinguished three financial models. Let us pursue a bit further the political and policy implications of different financial arrangements, focusing on the distinctive possibility for state action implicit in the credit-based, administered-price system. We begin by distinguishing several different roles that government may play in the industrial economy.

As suggested earlier, the government can be an economic regulator, an economic administrator, or an economic player.<sup>14</sup> As a *regulator*, it is an umpire refereeing the behavior of others in the hope that if they follow a particular set of rules, a certain set of outcomes will occur. Controls on mergers and on securities issues are examples of such rules. As an *administrator*, the government executes certain operations based on a specific assignment or task, applying particular decision criteria and following set procedures. As a *player*, it pursues specific outcomes on a case-by-case basis, assembling packages of incentives which can be used to persuade or coerce. It discriminates among firms and applies administrative rules and regulations to accomplish particular objectives. All governments have discretion over the application of rules and regulations but only a few of them use discretion systematically to initiate and shape particular industrial outcomes. American antitrust legislation is intended to assure a "competitive" market, but it does not provide the government with a means of forcing particular companies to undertake government defined industrial objectives. By contrast, the Japanese ability to control selectively the flow of goods, capital, and technology allows government to influence the affairs of particular firms and the structure of sectors.

To be a player in the market a government bureaucracy must be able to make its administrative or regulatory decisions contingent on particular actions taken by the firms it administers or regulates. Those actions may have little relation to the general authority on which the bureaucracy's power rests. For example, the Japanese Ministry of International Trade and Industry (MITI) monitored technology imports to strengthen the nation's bargaining power and reduce the purchase price of those technologies. Since it could deny access to needed know-how, it could also influence investment and organization deci-

sions, and in trade negotiations it was even able to force "voluntary" export restraints. Finally, some policies may require the coordination of diverse bits of discretion spread throughout the bureaucracy. The ability to discriminate, to make decisions contingent on actions often unrelated to the particular choice at hand, and to coordinate policies depends upon the internal organization of the bureaucracy and the channels of its outside influence as well as the ideologies of the bureaucrats themselves.

The concept of the state as marketplace player is quite distinct from the concept of public ownership. The distinction between public and private ownership does not identify the degree of control the government executive will have on a corporation's affairs. In a study of U.S. public utilities, for example, Marc Roberts found that internal organization, recruitment and promotion policies, and the need for outside capital, rather than any characteristic of ownership, accounted for differences in company behavior.<sup>15</sup> If the state is a passive stockholder, a public coupon clipper, its influence in public corporations may be minimal. It may find itself a regulator or an administrator, with a relationship to public companies that is similar to its relationship to private companies. The right to appoint top management may provide moments when the government can exert its influence, but the case of Enrico Mattei and the Italian Energy Corporation suggests that state-appointed managers may in fact become autonomous power brokers.<sup>16</sup> For our purposes, the impact of nationalization depends on the character of the relations between the state and public companies. The problem of control and direction remains after nationalization, even if the means used to control public enterprise may be a bit different from the means used to control the private firm.

The central argument of this book is that discretion in the provision of industrial finance—in the selective allocation of credit—is necessary for the state to enter continuously into the industrial life of private companies and to influence their strategies in the way that a rival or partner would. Even with public companies, the financial instruments for selectively allocating credit provide government a refined set of tools to supplement the appointment of management or the imposition of broadly defined government policy directives. Selective credit allocation is the single discretion necessary to all state-led industrial strategies.

There are two reasons why credit allocation is a particularly effective instrument of industrial policy. First, credit allocation is critical in industrial policy simply because specific business decisions are hard to control or influence through administrative or regulatory rules. Those same decisions may, however, be influenced by negotiation in which

the payment for services rendered is unambiguously calculated in monetary terms. Discretionary influence in industrial finance permits the government to deal within the framework of business decisions and to affect the balance sheet directly. It becomes a player in the market. Second, credit allocation is a universal tool, one that eliminates the need to find specific authority to influence specific decisions or to control an agency that has formal authority over a specific policy instrument. It should be noted that taxation is not as flexible as credit allocation. Taxes can be used to target categories of action but they are difficult to manipulate toward specific industrial ends. Unless the principles of rational administration are violated, taxes cannot be bargained. Moreover, taxes operate to increase profits from gross earnings; they tend to follow rather than to lead new activities.

The universality of finance enables a single agency to exert influence across a range of issues without having to develop regulatory or administrative apparatus for each specific case. When discretionary control over finance derives from the operation of the financial system itself rather than from a specifically created and specialized agency, there are several bureaucratic consequences. First, this multipurpose policy tool is outside the direct control of the legislature. Funds are obtained by manipulating the economy's financial flows not by making budgetary allocations. Second, that control is likely to be in the hands of the minister of finance or the central bank. Discretionary control of the flow of industrial credit in the financial system can thus give economic ministries with general responsibilities a tool to form alliances with an ever-changing combination of industrial sectors and government agencies that represent industrial interests. This special glue for coordinating industrial policy is most likely to belong to the ministry that is best able to assemble bits of policy for changing objectives and that is most insulated against specific pressures from industrial constituents. As we shall see, in the French case control of finance facilitated a victory by those who sought to promote the development of French industry.

The player state must possess or control institutions that provide it with discretion in the affairs of firms and with financial discretion in particular. Unless it has direct influence in the allocation of credit by the financial system, it must either make the financial institutions its allies or confront them as political opponents to its interventionist strategies. Any government can provide funds to the sectors or companies it wants to support. The question is how public its efforts to do so become and how much special authority the particular intervention demands. (In the United States the Lockheed case involved a large-

scale bailout linking government and banks, but it provoked widespread political opposition, chiefly because it required special legislation.) If, as a routine matter, the selective provision of finance can be used as an instrument of policy, the government can continuously intervene in industrial affairs as a private bargaining party without special authority.

### *Market Structures and State Capacities*

We have argued thus far that the arrangement of financial markets, like the structure of the state administrative apparatus, affects the "capacity" of social groups and the political executive to act in pursuit of their goals. In considering the effect of the marketplace, we have viewed the financial market as a system—as the aggregate of its pieces. Structural arguments are commonplace in politics, and the subfield of economics known as industrial organization explores market structures as constraints on the behavior of the firm.<sup>17</sup> Here we are concerned to determine how market structures act as constraints on politics. The structural approach holds that a structure creates an enduring set of penalties and rewards that mold action independent of the motivation or purposes of the actors. The constraints of the situation or the channels of action determine which choices are expensive and which are cheap. A structural approach makes several types of claims.

First, within a particular financial market structure there will be regularity in the *form* of policy, in how policy is formulated and implemented, whatever the objectives. In the case of France, therefore, one might suggest that although the instruments of a centralized state are put to quite different ends by the Left and the Right, there are common elements in their approaches to policy and government simply because they face the same institutional constraints and options. A related proposition is that since financial market structure limits the repertoire of policy strategies, a particular government is apt to find some problems more intractable than others. This statement presumes, of course, that there is a limited number of ways of attacking certain problems and that some structures simply preclude finding workable solutions to particular problems. I have shown in *Political Strategies for Industrial Order* (Berkeley, 1977) how very similar policies succeeded in some French industries but not in others. Although the policies looked very much alike, the outcomes were different because the required solutions varied. In the cases where the French accomplished some reasonable version of their original purposes, the solutions required by the problem matched the policies that were applied. The structural

argument suggests that particular institutional structures that create or conversely circumscribe capacities for state action will establish patterns of distinctive national competence and weakness.

Second, because structure constrains strategy, those who pursue new economic goals or try new approaches to policy must often reform or rearrange economic institutions and the links between them and the state. If new strategies or new problems require expanded capacities, it may be necessary to make structural changes in the economy. The required institutional reforms involve much more than redesigning organizations to achieve greater effectiveness, however. Since the arrangements between and within organizations establish positions of privilege, reform means dislodging incumbents from their strongholds. When these incumbents represent specific groups in the society, as they often do, "institutional reform" entails a political change in the social balance of power; it becomes a political conflict. To reform the banking system, for example, is to change the possibilities for financial institutions to lend or invest, and thus the possibilities for financiers to profit. Since it is often possible to foresee which groups will benefit and which will suffer, the politics of institutional change can take a very predictable form. In such a case, the structure will not simply set down regularities in policy but will create predictable kinds of political battles. The *how* of policy and politics will affect *who* will be allies and enemies, as well as the tactics used in their fights. The economic structure does not "create" politics, but by delimiting some of the possible issues and alliances, it can establish the channels through which political fights flow.

Implicit in this discussion is a simple model in which different institutional structures respond differently to the same stimulus. The argument is more complex than this model suggests, however. Stated somewhat differently, the problem is to assess the relation between policy content and policy form, not just that between structure and outcome. For example, one might hypothesize that national differences in industrial policy exist because the purposes that societies wish to achieve are different. Next, one might hypothesize that even when those purposes are the same, they will be achieved differently and with different degrees of success because structures differ. Finally, and more powerfully, one might hypothesize that the purposes pursued as well as the strategies chosen are affected by the relative costs of achieving different goals. The structural argument suggests that the form of policymaking affects the purposes pursued; structure affects not only outcome but also the goals themselves. Simply stated, what is attempted and achieved is affected by how it must be done.

#### THE ARGUMENT

To summarize, this argument makes two claims about the influence of financial systems on politics. First, the structure of the national financial system affects the capacity of the national political executive to intervene in the industrial economy. Second, since the financial system is a constraint on action and an influence on the power relations in the economy, it is an element shaping the arena for industrial and economic politics. National variations in the arena for industrial politics, then, help account for differences in the nature of the conflicts and alliances that emerge. This second claim is quite limited and should not be exaggerated. It contends only that financial systems are an intervening variable or a parameter in the political equation.

#### TESTING THE ARGUMENT

The three models of financial system imply different degrees and different forms of executive discretion in industrial affairs. In the first model, the capital market-based system with allocation by competitive price, government aspirations to intervene at either the sectoral or the firm level are blocked or, at the very least, any interventionist efforts provoke public political controversy. In the second model—a credit-based, price-administered financial system—executive discretion in the allocation of credit, the discretion required for interventionist or promotional strategies, is extensive. In the third model—a credit-based financial system dominated by large institutions with influence in industry—banks can act as allies of the government in an industrial crisis but government discrimination between sectors is not automatically provided; the government gains discretion at second hand, exercising it through a negotiated partnership with coequals.

Two hypotheses, suggested by this argument, are explored in this book. The first is that credit-based financial systems with state-administered prices will facilitate intervention and ease the political problems of mustering support for state-led industrial promotion. In a state-administered financial system, in fact, the bureaucracy can hardly avoid exercising specific influence in credit allocation. Executive action based on discretion in financial markets is less subject to public scrutiny or political interference than intervention based on any administrative allocation or legislative program would be. Governmental mechanisms for exerting discretion in the allocation of the money flow through financial markets, even when their influence is exercised only on the margins, establish a private executive instrument of public intervention.

The second hypothesis is that in a system characterized by financial allocation according to market-established prices, an elaborated capital market, and limited industrial dependence on long-term debts, the state will encounter financial institutions as rivals defending the existing organization of the financial system and will confront financial markets as barriers to state influence in industry. The struggle to establish interventionist instruments or state-led industrial promotion can easily degenerate into a conflict over the sanctity of markets.

We take two approaches to the problem of testing these hypotheses. The first approach is to argue from case studies of France and Britain, examples that permit us to consider in historical detail how the structure of the financial system shaped political conflict about industrial change. The second approach adds the Japanese, German, and American experiences to those of France and Britain and correlates more formally the financial system and the process of industrial adjustment.

#### *Interventionist Policies in Britain and France: A First Test*

The British and French efforts to adjust to a changed world economy support the line of argument developed here: their different experiences with interventionist strategies cannot be explained without considering the role of their different financial systems.

The French system of intervention rests on its state-dominated, credit-based financial system with administered prices. Credit is allocated as much by quantity and administrative rule as by price. Indeed, the financial system embodies so much discretion that the state bureaucrats are virtually obliged to exercise it. These financial arrangements affect not only the form that policy takes—that is, how the state achieves its purposes—but also significantly influence the character and the outcomes of political conflicts about the purposes of state intervention. Institutional arrangements contain political biases that favor some groups and penalize others, and their influence can be analyzed. Financial weapons were crucial in the postwar fight to alter the relation of the state bureaucracy to the business community. The Trésor in the Ministry of Finance was the bureaucratic stronghold that gave those fighting for economic modernization the leverage they needed to win their battle against traditional industrialists. The reforms the modernizers made in the financial system consolidated their power and strengthened the policy instruments they could devise in the years that followed. The reformed financial system became for the state executive both an instrument of economic policy and a device

for constructing specific political alliances. The financial system served to amplify the political resources of those favoring rapid industrialization and it later influenced the fight between the modern, growth-oriented alliance and the traditional preservationist segment of industry.

In the British case the financial system, with its elaborate securities market that allocates resources by price, proved an obstacle to a government effort in the 1960s to establish an interventionist apparatus to promote industrial adjustment and redevelopment. State bureaucrats and politicians had to go around the private financial system in order to use money grants as a means of industrial intervention. The financial system's autonomy from the executive also influenced the character of postwar Labour party economic strategies and the nature of the government's response to Britain's declining industrial position. Despite Labour's hope of reforming capitalism, the government had neither the instruments to do so nor a conception of how to manipulate the industrial economy. Physical controls, which proved unworkable, were seen as the only alternative to a reluctant endorsement of the market system. Even nationalization did not alter the fundamentally arm's-length relations between government and the now-public companies. As a result, the first postwar Labour government led the return to a neoliberal economic normalcy. The need to construct new institutions that paralleled or challenged the private financial system contributed to a conflict over the distribution of gain from industrial growth. This distributional conflict in turn undermined a common desire for more rapid growth and gave the appearance of pluralistic paralysis. The lack of a state capacity to exert industrial leadership and the character of the fights required to create such a capacity shaped the political terms in which economic decline was confronted.

The British political battle rested in part on the effort to imitate the French style of indicative planning and intervention. Could the British government have developed promotional policies that would not have challenged the institutional underpinnings of the nation's economy? Were its tactics of intervention what made financial structure seem so important a barrier? Could one argue that other, less troublesome strategies for exerting industrial leadership could have been found? The German case, we shall argue later, does not provide a counterexample—state promotion of industry by arm's-length leadership—because the structure and direction of German industry required virtually no change during the boom. If we cannot prove that the British had to attempt interventionist policies, we can certainly argue that there were both political and technical constraints on the range of policies the British state could choose. Only when the tension of failed develop-

ment becomes great enough will political pressures suffice to break the institutional arrangements born of the political fights that accompanied past growth. If the old structures fail, then a new political victory must occur to imbue the new institutions with direction and purpose. The arrangements in the British financial market made it all the harder for either Conservatives or Labour to achieve that political victory.

Such historical reconstructions have the advantage of highlighting the role of a favored explanation—here, the role of finance—but that very advantage also points up the limited utility of case analysis. There is a risk that the reconstruction will overplay the importance of the favored explanation and underplay that of its competitors. Certainly the case-study approach does not permit any means of weighing competing explanations. Put more baldly, historical reconstruction allows the author to order facts at will, perhaps making a plausible case but hardly permitting a test for the argument. We shall confront this limitation by widening our focus and adopting a different technique in our second approach.

#### *The Politics of Industrial Adjustment in Five Countries: A Second Test*

The politics of industrial adjustment provides a second device for exploring the political consequences of different financial market structures. The French-British cases do not require much formal comparison. The financial systems in the two countries are demonstrably different and our historical reconstruction illuminates their impact on industrial politics. It is easier to demonstrate how a credit-based financial system facilitated state policy in France than to demonstrate how, indirectly, a capital market-based system undermined state industrial leadership in Britain. In the French case, we can demonstrate that finance was used to implement policy, whether or not an alternative technique was possible. In other words, we can show that one interventionist state used financial instruments as a principal mechanism of policy, demonstrating the policy problems such a choice resolved and the political advantages it offered. What our case study cannot show is that an interventionist or promotional state *must* use such mechanisms, and that any other approach will founder politically or technically. The contention that British financial institutions acted as a limit on state action requires a more complicated line of argument. Here we must contend that the conflict that occurred resulted at least in part from efforts to lift the limits on state action.

A single case, or even two, cannot demonstrate the generality of the

argument that financial markets structure the terms of the politics of industry. Accordingly, in Chapter 5 we shall present three more cases: Japan, Germany, and the United States. With the resulting set of five countries we shall try to establish a correlation between the type of financial system and the approach to adjustment. This larger enables us can also more effectively to isolate the financial system from other characteristics of the countries. Though the number of cases is still too small to do more than simply reinforce the argument emerging here, its plausibility can be greatly strengthened by expanding the set.

A government's various policies for industry, if taken as a set, represent a political settlement among different social groups and sectors about the terms of industrial change. The issues in that settlement are not only the immediate economic gains and losses from market changes, but also positions of power and privilege in the market and in policymaking. For example, industrial management may in fact make higher wage payments in order to gain or to maintain control over the organization of production. Union leaders may accept wage restraint in exchange for policy influence. The United Auto Workers did just that when they accepted a position on Chrysler's Board of Directors in exchange for wage restraint; so did the British unions in the later 1970s when they accepted influence in policymaking as part of a government strategy of income policies. The political decision to press firms to adjust price signals in order to preserve jobs or maintain production, is ultimately a decision about who will pay for the costs of industrial change, about who will gain and who will be protected.

To explain the techniques of state policy and the political settlement that policy embodies, we must first ask: (1) who predominates in politics, those seeking opportunity and profit in market changes or those seeking insulation from the market; and (2) does the dominant group require government support or aid for its plans, and what help is the state capable of providing. Any attempt to answer these questions must consider both the formation of the "secondary majorities" that influence policy in a particular sector and the inclinations of the governing coalitions that constrain the outcomes in the individual policy arenas. Since we have argued that industrial change takes place at the level of the firm, we will begin with the formation of "secondary majorities" in industry. Initially, we might posit that the political objectives in a particular sector, the types of conflicts, and the pattern of policy which emerges reflect the ability to use finance in a selective way.

To proceed systematically we need a more explicit statement of the outcome to be explained—the process of industrial adjustment. The analytic problem is not so much what weight should be attributed to markets,

institutions, or political actors as explanations of policy; the essential problem is how they interrelate. Our task is to fit finance into an interpretation of the state's capacity for managing industrial adjustment.

#### *The Process of Adjustment: The Outcome to Be Explained*

We shall first view the problem of industrial adjustment from the top, from the vantage of the political executive and its capacities for action. Then we shall start again from the bottom, considering the problem from the vantage of the firm, to explore what the state may be asked to do and how the direction of policy is determined. We shall conclude this analysis by proposing that there are three model solutions to the political-technical problems of adjustment, each tied to a different arrangement in the financial system. Each model turns on capacities for action and mechanisms for determining the direction of policy.

#### *The Political Executive's View of the Economy.*

As it views the industrial economy, the political executive has four options:

1. to stay out of the market, letting price signals drive industrial change
2. to protect existing economic organization by limiting foreign access to its market and subsidizing declining firms and sectors
3. to compensate the losers in the processes of change, bribing them not to interfere
4. to intervene to promote or shape industrial change.

The executive's choice depends in part on its administrative capacities. The first three choices—hands-off liberalism, arm's-length preservationism, and compensation—do not require specialized administrative machinery or unique state capacities. A hands-off policy may involve a bit of compensation or subsidy to the losers but there is no need to organize market outcomes. Industrial preservationism can be achieved either by subsidy or by protection, since both act to mute market signals and relieve the need for change. Subsidy usually requires a direct budget outlay and protection can provoke international repercussions, but neither instrument is inherently complex to administer and in neither case does the government need its own view of how industry should develop. It will accept either the "view" of the market or the position forced on it by political pressure from the industry.

Purposive industrial intervention is much more difficult to implement both technically and politically. To promote or shape industrial change, a government must be able to do three things:

#### THE ARGUMENT

1. have its own view of where industry should be going, which should emerge from its own definition of public purposes and its own interpretation of industry dynamics
2. mobilize and allocate resources in pursuit of the outcomes defined by its view
3. link domestic and foreign economic policy.

A policy of positive promotion means that the state must help generate cash for investment, maintain cash flow for corporate health, promote markets to assure demand, and provide development funds. In sum, intervention to promote competitive development or to protect specific industries requires special and specific technical abilities—the capacities of the “player state” which we discussed earlier. When the state acts as a player it does more than umpire competition to assure that the market works properly, and it must do more than simply administer specific rules and regulations. To be a player, it must specify the objectives it seeks and assemble bits of policy to press toward its goals. To pursue specific industrial outcomes on a continuing and systematic basis, the state must have the capacity for discretion and discrimination. A state strategy of purposive development requires a distinct set of capacities, of which the capacity for action is only the first.

How a government establishes the *purposes* of its policy, the next question, is intertwined with its administrative capacity to act in industrial affairs. A first possibility is that the choice between policies that accept market outcomes and support price-driven change, those that seek to mute the market to preserve existing arrangements, and those that try to promote and direct, will be set by the market options of the firms in that industry. This hypothesis would suggest that an industry or firm in decline might turn to government for protection; that one in ascent might seek government support for its expanding efforts; and that a mature and profitable sector with stable markets and a solid competitive position might simply want the government out of its hair. Though this assessment is plausible as far as it goes, competitive position alone cannot account for national differences in the political strategies adopted by industry or in industry's demands on government. If production is declining, it is not inevitable that the industry will seek protection. Thus, the textile industry is seen as a declining sector in all the advanced countries but its political strategy and marketplace fate have differed from nation to nation. Governments have resolved differently the issue of which portion of the textile industry to protect from decline. In part, their choices have depended upon which firms have had the capacity to adjust to market competition by changing product and production. German firms have displayed greater capacity

#### *Finance and the Politics of Industry*

to adjust than French firms, which is one reason why the French government has had a greater concern with preserving employment and with preserving the traditional organization of production. In France natural fiber manufacturers (cotton and wool producers) sought protection from foreign imports, but they also won protection from *domestic* producers of artificial fibers. In Britain, modern capital-intensive and integrated firms have emerged in the face of cheap Commonwealth imports. By contrast, expanding steel and shipbuilding industries in Japan have been aided in their development by the state, whereas until recently prosperous German firms sought to keep all governments out of the steel industry. It must be emphasized that part of the differences in sectoral outcomes in different countries derives from relative corporate capacities. The firms that compose the several national industries are not the same—not in size, not in management strategy or ideology, and not in the resources available to them. Consequently they will need different things from government.

#### The Company Executive's View of the Economy.

A firm faced with changed market conditions can adopt one of three basic strategies. The first choice is to *exit* from its previous set of market activities, as when the United States Steel Corporation began to invest in unrelated industries instead of investing in the new steel plant and equipment required to keep it competitive in steel itself. The choice of exit may result from mistaken judgments or from acquiescence to ineluctable market forces. In exiting from one industry or product segment, a company may choose to enter another, taking a position of producer and directly accomplishing the intersectoral shift of capital adjustment involved. Alternatively, it may simply invest funds in purely financial assets and become a corporate rentier, allowing the financial system to accomplish the transfer of capital resources. Firms may exit from an existing activity without seeking protection if they have some alternative use for their resources, but organized labor will rarely exit voluntarily without some compensation. For an industry in decline, it is likely that some firms will have to exit and certainly some of the labor force will have to do so as well.

The second available strategy is for the firm to try to remain competitive within its industry by *adapting or adjusting* to the new market conditions. The corporate decision will depend on the changed elements in the competitive equation and the capacities of the firms in question. The adaptation may take the form of *new products*, such as IBM's development of a copier, or the improvement of existing products. The distinction is a slippery one. The integrated circuit and later

#### THE ARGUMENT

the microprocessor were fundamental innovations in electronics components. They made possible both the improvement of a range of existing products from autos to telephone-answering machines as well as such completely new products as the personal computer. The company's adaptation may also take the form of *process innovation* aimed at controlling production costs and thus lowering selling price or increasing profit margins. Process innovation, however, may mean job losses or a reorganization of work and a change in the labor-skill mix. Product and process adjustment are not easily separated. The process advantage of silicon microtechnology allowed Japanese producers to reduce the labor content of television manufacture dramatically while increasing the quality of the product offered. They had entered the American market with small television sets made possible by solid-state technology, a product technology that permitted production advantages. It is also important to note that when the American television firms were driven from the market for color television, their ability to enter the next round of product competition, and thus their long-run competitiveness, was fundamentally compromised. Product and process changes are both company tactics, but the strategic choices of which they are a part must be defined differently.

The redesign of the American automobile to meet demands for higher gas mileage and greater product reliability is a *defensive* effort by American auto companies to hold onto their current market share. IBM's computer series, the 1401, was an *offensive* effort intended to undermine the competitive position of its opponents. Offensive moves are intended to expand a market share or weaken an opponent, whereas defensive moves are intended to retain a market share or to respond to an opponent's initiative. Process and product adaptations are tactics in these strategies. These adjustment strategies may involve changes in the organization of the firm, such as divisionalization, or changes in the institutional environment in which the firm operates, such as a merger. The firm's third strategic choice is to mute the market conditions that are forcing change through a mix of approaches that range from protection against external competition and government subsidy to private conciliation with domestic rivals in the form of cartel. This third strategy aims to preserve the existing industrial organization and its terms of competition.

Since the firm may seek government assistance in any of these three strategies, we can usefully distinguish between the price governments pay to facilitate adjustment and the costs they incur by resisting decline, though the techniques of policy will be the same in each case. We can label payments to increase market incentives for adjustment as "trans-

#### Finance and the Politics of Industry

fer costs" and payments to maintain production that would not otherwise survive in market competition as "subsidies." Politically, of course, payments for adjustment blur into subsidies. Unless government intervention produces internationally competitive firms, it will tend to preserve ailing enterprise and government policy will degenerate from promotion into protection.

The weight of industry's demands on government will be greater if the sector speaks with a single voice. Each industry sector consists of many distinct segments, however, and within each segment the individual firms may have made different strategy choices. The politically articulated interests of the sector cannot in any simple way be derived from the market position of the industry or any of its segments. Its political interests must be understood as the product of a conflict *within* the industry about the appropriate market and political strategies.

#### The Transformation of Political Demands into Public Policy.

The political demands made by a firm or by an industry are obviously not processed into government policy automatically. If an industrial sector could capture and dominate the government agency that directly affects it, government policies might closely reflect the demands made by the strongest supplicants. Private capture of segments of the public policy machinery is certainly more typical of the United States than it is of France or Britain, for the U.S. bureaucracy is more open to direct private influence and each policy arena is more securely insulated from others. Even in the United States, however, the needs of one sector often have to be balanced against the demands of other industries. If, on behalf of American agriculture, the U.S. government insists that Japan open its market to American rice and oranges, it may have to limit demands that Japan open its markets to American electronic products. American demands that the Japanese restrict auto exports limit the American ability to insist that the Japanese change inter-firm arrangements in integrated circuit production. Consequently, whatever the needs or wishes of industry, we must look outside the industry to find an explanation for the policies finally adopted. Each industry might capture a component of the bureaucracy which speaks on its behalf and even provides for part of its policy needs. But there will be issues, such as trade, in which the needs of sectors are directly competitive and cannot be met simultaneously.

We must take this analysis further. If the state simply reproduced the demands of the strongest social groups or the winning political coalitions, the government would simply reflect the political balance in the society and policies for a given sector of the economy would be settled

by political competition within that sector or between sectors. In fact, however, government has powerful means of shaping the demands made upon it and the political executive can thus play an active role in determining the outcomes of the several conflicts. It can extend resources to the groups it favors—everything from privileged policy access and the right to administer state policy to selective access to credit. The technical capacity to pursue specific industrial objectives, discussed above, is also the basis of a capacity to shape the political terms of industrial change. The state can be as active in shaping the political competitions as it is in molding the marketplace.<sup>18</sup> Therefore, the political outcomes within each sector depend on state policy as much as they shape it.

To understand which sectoral demands prevail and the form they finally take, we must turn to the character of the coalitions that govern. If national coalitions are to delimit the range of policy across a set of sectors, policies must constrain choices within each sector or many of the same actors must be involved in the decisions in each industry. The consequence is that we cannot simply add up the expressed market needs of the different sectoral components of a coalition to discover the orientation of policy; any more than we could add up the position of different firms in a sector to discover its policy demands. Different coalitions presumably imply different policies and hence different industrial strategies for adjustment in several advanced nations, but these coalitions are not mechanical reflections of the economy. We can conclude from this discussion that mounting pressures in particular sectors will produce a national resistance to adjustment or growth only if they alter the composition of the governing coalition and the producer alliances on which industry routinely depends. Mancur Olson's proposal that we simply count up interest groups to estimate impediments to growth is both a futile and a pointless task.<sup>19</sup>

Struggles to formulate state policy for industry and the economy are, finally, struggles about how to allocate the costs and profits from industrial change. Unless there is a political settlement that distributes the gain and pain of growth, the distributional struggle will undermine the consensus to pursue growth. The question of the state's capacities to shape the political and marketplace outcomes in specific sectors and the question of the actual purposes it pursues join together here. The political settlement can simply be *left to the market* with the state giving some small compensation to those who complain the loudest. U.S. trade adjustment assistance to workers and communities damaged by imports fits this notion. The state may *impose* a distribution by consciously ma-

nipulating the market or the distributional outcome can be explicitly *negotiated* among the producer groups involved. Clearly, these are not exclusive alternatives: most negotiations contain some degree of threatened coercion and those who would coerce may employ negotiation from a position of strength as their vehicle. Nonetheless, each country may establish a different mechanism for achieving a settlement that embodies different combinations of markets, compensation, state-imposed distribution, and negotiation.

The politics of adjustment thus has three parts: (1) state capacities to act in the economy, which sets the range of possible policy strategies, (2) a political settlement that distributes the gains from change and in so doing establishes which market pressures will be resisted, and (3) a political process by which that distributional settlement is reached.

### *Three Models of Adjustment*

Even this cursory review of the technical and political roles of the state in industrial change suggests three models of the adjustment process. Each model embodies technical capacities for state action in industry, a political settlement allocating the costs of industrial change, and a political process by which the settlement is reached. The role of the financial system in each model of industrial change is different. The three models of change are: (1) state led, (2) company led, and (3) tripartite negotiated.

In the state-led model of development, the government bureaucracy attempts to orient the adjustment of the economy by explicitly influencing the position of particular sectors, even of individual companies, and by imposing the solutions on the weakest groups in the polity. The state seeks to select the terms on which sectors and companies confront the market, either by explicitly providing resources to favored groups or by creating conditions that will force the recalcitrant to adjust. The state is an economic player, usually pursuing some form of development. The aggressive promotion of industrial modernization which we find in Japan is not the only state-led possibility. A different balance emerged in France, where change was more contained. Finance acts as an instrument of such efforts, permitting bureaucrats to intervene in the affairs of particular firms and to allocate capital between competing uses. A state-led adjustment process politicizes and centralizes the process of industrial change. Those excluded from the circle of the favored are evident and can plausibly blame their plight more on political weakness than on economic failure. Consequently, the government-imposed balance of the costs and gains of change rests on the continued ability of

the executive and the political winners to exclude the losing groups from policymaking.

In the company-led model of industrial change, the basic choices are made by individual firms without outside interference, leaving the workers or communities who are displaced or damaged to fend for themselves or to seek compensation from the government. In this model the state does regulate and compensate but, fundamentally, the costs and gains of change are allocated through the market. Above all, the government does not have a view of the long-run development of the economy and of industry. The financial system is the vehicle that allocates resources among competing uses. Its autonomy from government isolates the government from the workings of the industrial economy.

The tripartite-bargaining strategy involves an explicit and continuing negotiation of the terms of industrial change by the predominant social partners. The bargaining base of the several partners rests both in the organization of the policy and in the organization of the market. In his study of the Netherlands, Arend Lijphart shows that bargains are explicitly worked out by elite representatives of the several political groupings, which incorporate the producer groups.<sup>20</sup> The organization of politics creates the basis of negotiation. The Swedish case, by contrast, is an instance in which labor market organization creates the basis of the national bargain.<sup>21</sup> In the German case, as we are so often told, finance plays a role in resolving the particulars of corporate crisis, with banks playing an almost parastatist role. The Swedish and German cases suggest that a powerful position in one market—labor, capital, or goods—provides the basis for entering into political bargains about the operations of other markets. In this third system of adjustment, financial institutions operate as potential government allies as a base for limited social bargaining.

Each of these ideal types suggests a basic political approach to resolving the controversies that accompany adjustment. The particular capacities of business and the organizational purposes of labor account for the specific thrust of policy within each model. Peter Katzenstein, in his interesting discussion of adjustment in small states, focuses on the capacities of business and the purposes of labor. He considers variation within the bargained-adjustment model and seeks to account for the several national outcomes within his set of small states.<sup>22</sup> Because the small states must remain open to the international market, their exports must be competitive abroad. Their domestic political arrangements must force them to bargain over the allocation of the burdens of change. Given these constraints on policy, the nature and strength of business and labor *do* become the central issues in accounting for the

particulars of policy. The small states represent only one type of adjustment, however. Since the countries we are considering present a wider variety of political approaches to adjustment and a greater range of market problems, we have focused on a prior step, establishing the several models of adjustment and differentiating the market problems they confront. Having distinguished these approaches to adjustment, we will later speculate on how variations in the position of business or labor affect the success of adjustment and the distribution and gain from it.

If we fit our countries to the three ideal types, we find that Japan and France can readily be categorized as state-led promotional types whereas the United States is a company-led regulatory type. Germany has many characteristics of the tripartite-bargaining type, in which there are often specific deals between finance, labor, government, and industry, but no overall explicit bargain. Sweden, whose centralized labor bargaining system has been so well depicted by Andrew Martin, is perhaps a better example of the bargained model.<sup>23</sup> Britain represents a case of failure to make any particular choice about an approach to adjustment: the political and industrial power of labor in that country has made it impossible to move without the unions' support, but the unions are not organized for the task of making detailed corporatist bargains and the companies are not prepared to accept them in that role. The tradition of private and often public company autonomy from government and finance lends the British case characteristics of company-led adjustment, whereas the state's effort to take the initiative is reminiscent of state-led adjustment.

#### *Finance and Adjustment: The Hypothesis*

Each of the three models of financial system has implications for the government's capacities to intervene in the market and for the types of political conflicts which emerge when the executive does act in the industrial economy. The proposition here is that each type of financial system is one of the defining components of a specific model of the process of adjustment. The financial marketplace, not just the arrangements of politics, sets the arena for the fights that accompany industrial change. Let us express the logic of the tie between the types of financial systems and adjustment processes in three propositions (see Chart 2.1). First, a credit-based, price-administered financial system is an instrument of state intervention which blurs the lines in the market between public and private sectors; it is part and parcel of a state-led model of adjustment. Second, financial systems with extensive and efficient capi-

## THE ARGUMENT

Chart 2.1. Financial systems and the adjustment process

Country	Financial system	Predicted adjustment	Actual adjustment
France	credit-based, price-administered	state-led	state-led
Japan	credit-based, price-administered	state-led	state-led
West Germany	credit-based, institution-dominated	tripartite-negotiated	tripartite-negotiated
Great Britain United States	capital market-based	company-led	unclear (Britain) company-led (U.S.)

tal markets both limit the channels of state action and generate opposition to intervention; they create institutional circumstances favorable to company-led adjustment. Third, institutional-led or bank-dominated capital markets create the conditions for negotiated adjustment.

The evidence to be presented in the case studies supports the hypothesis that types of financial systems are correlated to models of the adjustment process. With their credit-based, price-administered financial systems, France and Japan should have state-led adjustment processes. The United States and Britain, which have capital market-based systems with competitively determined prices, should have company-led growth. Germany, with an institution-dominated, credit-based system, should have elements of negotiation in the processes of change. Only the British case does not fit the predictions of this hypothesis, for reasons that should become clear. The reader will simply have to accept the country categorization developed in this preview, since the text that follows is a justification and interpretation of the schema. In the final chapter three alternative explanations of the relations between business and government are developed and evaluated: explanations built around the balance of political forces, the economic situations confronting a country which determine the choices open to its governments, and the structure of the state bureaucracy.

Since the proposition that the financial system structures the politics of industry can be denied, it can also be tested. In a theoretical argument that links the structure of finance to the process of adjustment, the proposed linkages can be examined by considering first the financial system and then the process of adjustment. A skeptic might argue that if the structure of finance is constructed by state bureaucrats, either to facilitate state strategies of intervention (as in France) or to prevent links between finance and industry (as in the United States), then the variations in the financial system and the process of adjust-

ment would have common political origins. There would be correlation but no causation; financial structures would be derivative of politics and not a real and independent influence on the politics of adjustment. The British and French case studies are crucial to our evaluation of this argument. When British bureaucrats confronted an entrenched market financial system, they were *not* able to turn it to their purposes of modernization. In France, conversely, the character of the financial system presented the political modernizers with valuable weapons.\*

\*We should acknowledge at the outset that this kind of analysis faces a "measurement" problem. To establish the plausibility of a relation between finance and the politics of adjustment, we have developed categories that distinguish types of finance and adjustment. Our national cases have then been assigned to these categories. In the case of the financial system, there are systemic characteristics (though not quantities) which enable us to assign a particular system to a specific category. In the case of the adjustment process, we depend on a qualitative characterization of the industrial politics of each country. This problem of measurement cannot be resolved within the scope of this study. Detailed and comparable evidence over a wide-enough range of industries to permit a formal five-nation comparison simply does not exist. Though a range of sector cases in these countries has been examined in the research presented here, any formal measures of them would simply represent a glorification of a still qualitative judgment. Only a detailed set of comparable sector studies—a book for each country—could truly permit a more explicit measure. It is therefore open to judgment whether the national cases examined here, based on evidence presented later in this text or available to others, fit the proposed characterization of adjustment. At issue is the existence of distinct national adjustment processes. We can alter the categories and still sustain the original argument. We cannot contend that all national adjustments proceed in similar fashion without abandoning this enterprise. In sum, the effort to correlate characteristics of finance, state structure, and economic situation to the national adjustment process provides evidence that is consistent with our proposition that financial systems structure the politics of industrial change. In fact the evidence points to the significance of the British and French cases, and makes their historical reconstruction of more general significance.