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Contested Capitalism: Financial Politics and Implications for China

Richard Carney

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ABSTRACT

As China's economy grows and matures, is it developing institutional patterns that resemble those of other wealthy countries? I offer an innovative theory that deduces the structure of nations' capitalist institutions based on distributive welfare gains to those actors representing an economy's main factors of production (land, labor, and capital), using the structure of a nation's financial institutions as a proxy for its capitalist institutions. Based on statistical and qualitative evidence across countries and time, I then draw implications for China. I find that China resembles continental European capitalism far more than Anglo-American capitalism, and that it is likely to remain this way for the foreseeable future.

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After completing his PhD at the University of California, San Diego, Richard Carney received the Jean Monnet/Vincent Wright postdoctoral fellowship at the European University Institute in Florence, Italy. While there, he published several articles on politics and financial development, as well as a book chapter on European financial integration. Subsequently, he taught at the Graduate School of International Studies, University of Denver. Currently, he is an Assistant Professor in the S. Rajaratnam School of International Studies, Nanyang Technological University in Singapore, where he is working on a book examining the historical origins of capitalism in OECD countries in order to make projections about the future of capitalism in China.

Contested Capitalism: Financial Politics and Implications for China

What explains the varieties of capitalism observed around the world? For example, why do the economies of the US and UK exhibit such a strong reliance on impersonal markets, while the economies of other countries, such as Germany and Japan, exhibit a greater reliance on long-lasting relationships among economic actors? And why do capitalist systems change, sometimes dramatically and quickly? For instance, before World War II, the Japanese and French economies looked very similar to that of the contemporary United States; after the war, however, they changed dramatically. By examining what has happened to these established capitalist systems, can we draw lessons for China?

To predict how capitalist systems change requires that we first identify the fundamental characteristics that differentiate them from one another. In *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, Hall and Soskice (2001), drawing on the work of Oliver Williamson (1983), point to asset specificity as a critical attribute. Where assets are specific to the goods and services that are produced, relationships tend to dominate the manner in which actors organize their economic activity. They call this kind of capitalist system a Coordinated Market Economy (CME). Countries falling into this category include many of the continental European nations, such as Austria, Belgium, Denmark, Finland, Germany, Norway, Sweden, and Switzerland, as well as Japan. Where assets are more general -- that is, they can more easily be switched from producing one kind of good or service to another -- arms-length interactions predominate. This type of capitalist system is called a Liberal Market Economy (LME), and it is found in the UK, US, Ireland, Canada, Australia, and New Zealand.

Within these two categories, several features of political economies complement one another, including education and training, innovation, employment, wages, fiscal and monetary policy, corporate governance and the structure of the financial system. As one moves toward the CME end of the spectrum, education and training tends to be more specialized and geared towards the particular industries into which students will become employed, innovations tend to occur incrementally and primarily within well-established industries, employment and wages are more stable, fiscal policy is more redistributive, monetary policy has more of an inflationary bias to promote higher employment, corporate governance tends to be more concentrated in the hands of a few owners, and the financial system relies more heavily on banks. In general, there is more of an emphasis on the long-run among CMEs, and a clear bias towards labor's policy preferences. In LMEs, a shorter time horizon pervades business decisions, and labor's preferences are not as frequently translated into policy or economic outcomes.

However, Hall and Soskice acknowledge that several countries do not fit neatly onto their LME-CME continuum. They place these political economies into a third category: Mediterranean Capitalism. They are distinguished by their large agrarian sectors and recent histories of extensive state intervention, as in Italy, France, Spain, Portugal, Greece, and Turkey (Hall and Soskice, 2001: 21).

Based upon their characterization of these different capitalist systems, Hall and Soskice identify three key attributes that distinguish capitalist economies from one another: asset specificity, the size of the agrarian sector, and the level of state intervention in the economy. With these attributes in hand to focus and clarify our analysis, the question remains: What explains the varieties of capitalism observed around the world?

I argue that political battles among actors representing the key factors of production – land, labor, and capital – lead to specific types of capitalist systems. The coalitions that form among these actors, and who wins the political battles that ensue, is the critical determining factor for the structure of the capitalist system. My argument differs from those who consider coalitional conflicts among managers, owners, and labor (Gourevitch and Shinn, 2005), the effects of decentralized politics (Verdier, 2003), those who emphasize social welfare politics (Roe, 2003), or legal system effects (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998) and those who focus on the consequences of development in combination with international trade and capital flows (Rajan and Zingales, 2003).

The paper is organized into the following sections: (2) finance as a proxy for capitalism; (3) theory: actors, coalitions, and outcomes; (4) historical patterns; (5) cases: France and Japan; and (6) lessons for China.

2. Finance as a Proxy for Capitalism

Because capitalist systems are complex, the analysis would be more tractable if it were possible to focus on a single sphere of the political economy that could serve as a useful indicator for the structure of the broader capitalist system. By what criteria should we choose this sphere? First, it would have to vary along the three key dimensions identified by Hall and Soskice: asset specificity, government intervention, and the size of the agrarian sector. Second, it would be helpful if data were available across countries and time. These two qualifications make the financial system particularly attractive.

The first key dimension, asset specificity, gets reflected quite well in the structure of the financial system. With a greater reliance on general assets, and arm's-length interactions, we would expect securities markets to be more important. This conjecture matches reality quite well. Hall and Soskice illustrate that clustering occurs among LMEs and CMEs with reference to stock market capitalization; LMEs tend to have a higher market capitalization than CMEs (Hall and Soskice, 2001: 19).

Government intervention in the economy also gets straightforwardly reflected in the structure of the financial system by the extent of government ownership of the nation's banks. Indeed, development economists point to government ownership of banks as a, if not *the*, critical mechanism by which government intervention in the economy takes place.[1]

The importance of the agrarian sector also gets reflected in the structure of the banking system, primarily through the scope of agricultural banking. A larger agrarian sector generally requires a greater number of local credit institutions, so the number of these, and the size of financing directed to the agricultural sector reflects its importance. The kind of local credit institutions that serve farmers' financing needs usually take the form of branch banking, unit banks, or government-run agricultural credit offices. One could argue that larger farms may act more like corporations, especially when considering modern agribusiness in the United States. However, when contemporary political and economic institutions were established, farms were small. Even up through the transformation of the American economy into its modern market-oriented form in the 1920s and 30s, farms were still small. Thus, it is appropriate to consider the prevalence of local, agricultural banking as an indicator of the importance of the agrarian economy in examining the origins of contemporary capitalist institutions.

3. Theory: Actors, Coalitions, and Outcomes

Which actors should be considered to determine the structure of the capitalist system? Because of their fundamental importance to the structure of any nation's economy, their political power during industrialized nations' institutional birth and evolution, and because they have strong interests in the structure of the financial system (and the broader capitalist system), actors representing land, labor, and capital emerge as clear candidates. So, what are the preferences of these actors with regard to the three financial system attributes -- asset

[1] Gerschenkron (1962), Hawtrey (1926), Lewis (1950), Myrdal (1968), Garvy (1977), Kornai (1979), Shleifer and Vishny (1994), Shleifer (1998), and La Porta, Lopez-de-Silanes, and Shleifer (2002).

specificity (market-bank orientation), government intervention via banks, and agrarian banking – that proxy for the broader capitalist system?

Land (farmers): With regard to asset specificity, farmers prefer an economy with a greater emphasis on specific assets; in other words, a relationship-based economy. Long-term economic arrangements are important to them for coping with uncertain crop yields from one season to the next. Farmers, across most countries during the twentieth century, have usually been too small to seek financing from capital markets, and so they have tended to rely on local banks, either in the form of branches of large, networked banks, or in the form of unit banks (i.e., small, local banks without ties to a larger, national banking network). This relationship to the local bank, or agricultural credit bureau, is critical to their survival and success. Hence, they likewise have a clear preference for small, local, agrarian banks. They have also tended to favor government intervention in order to divert money away from industrializing sectors (where a higher return is likely).

Labor (workers): For reasons of employment stability, an economy centered around specific assets would be more favorable to labor (Aoki, 1994). With regard to corporate finance, concentrated ownership encourages the long-term employment stability that labor seeks. Concentrated ownership may occur via banks, as in Germany and Japan for many decades following World War II, or through a majority of shares being held in the hands of a few owners. Unlike farmers, however, labor tends to favor a more centralized financial system which facilitates the financing of urban industries. But like farmers, labor also favors government intervention in the economy, primarily via banks, in order to provide financing to industry during downturns in the economy to avert layoffs. Labor may also favor government intervention when labor controls government, and can thereby offer specific financing incentives to industries and firms to ensure that they act in the interests of workers. If banks are not a viable option for influencing industry (i.e., securities markets are more dominant), labor still favors government intervention to minimize layoffs, as frequently occurs with mergers and acquisitions. In this regard, they favor 'managed markets'.

Capital (Owners): Owners of firms face two basic external financing choices: issuing securities or taking a loan. The recent literature on corporate finance focuses on a continuum of financing instruments defined according to the elasticity of their cost with respect to problems of asymmetric information (Myers 1984; Myers and Majluf 1984; Diamond 1991). As firms mature, they ascend this 'pecking order' of finance. Firms just starting out may be forced to rely exclusively on retained earnings and the wealth of insiders. After a successful beginning, the firm can begin to rely on bank loans. The bank spends resources to monitor the firm, and protects itself against adverse selection problems by holding a debt claim on the firm. As the firm matures and develops a track record, its financing will change. Informed intermediaries will be willing to take equity positions in the firm, which will reduce the leverage of the firm and its exposure to financial distress, and provide a positive signal to outside investors. Outside finance through securities may initially take the form of closely held senior instruments (e.g., private placements). Later, firms will graduate to issuing bonds and preferred and common stock on the open market to outsiders, using underwriters as a means for providing credible signals of the firm's value to outsiders.

At the same time, firms favor minimal government intervention since this reduces inefficiencies in the allocation of capital, and lowers the costs of obtaining financing (e.g., via taxes and regulations). Firms will likewise favor low levels of agrarian financing so that capital gets allocated to industrializing (modernizing) sectors of the economy.

Land (N), Labor (L), and Capital (K) do not necessarily form coalitions in favor of specific financial system outcomes; rather, they form political power-sharing coalitions from which financial and capitalist structures emerge. Table 1 illustrates the coalitions and outcomes.

Table 1: Coalitions and Financial/Capitalist System Outcomes

Cleavage	Winner	Financial System Outcome	Corresponding Capitalist System	Example
Rural vs. Urban				
N vs. L & K_L	N	Decentralized agrarian banking; government intervention with industrialization.	Agrarian CME	Early 19th Century U.S.
	L & K_L	Concentrated banking or managed markets with some government intervention.	Classic CME	Germany post-WWII
Class Conflict				
K_L vs. N & L	K_L	Concentrated ownership capital markets; minimal government intervention.	Owner-Oriented LME	France pre-WWII, Japan pre-WWII
	N & L	Concentrated banking for industrial finance and decentralized agrarian banking; government intervention.	Mediterranean	France post-WWII
Voice vs. Property				
L vs. N & K_L	L	Concentrated banking; government intervention.	Statist CME	Austria post-WWII
	N & K_L	Decentralized banking with diffuse ownership capital markets; minimal government intervention in industrial finance; gov. intervention for agrarian financing.	Classic LME	Contemp. U.S.
Social Contract	N, L, K_L	Concentrated banking with extensive branches; some government intervention; managed markets may also emerge, with more bias to farmers than the urban outcome.	Inclusive CME	Japan post-WWII

1) Rural vs. Urban Politics

i) Farmers: Small, rural banks are likely to dominate when farmers wield political power. This is the first stage from which industrialization begins. As industrialization proceeds, the important question regards whether they will form a coalition with capital or labor. But of potentially greater importance is that democratic political institutions may be created when farmers wield vast political power, as in the early nineteenth century U.S. The political institutions allowed farmers to preserve their power despite a fall in their economic importance and population size. Accordingly, political authority regarding the structure of the financial system was turned over to the subnational level. Consequently, banking remained fragmented, and agrarian financing was disproportionately high.

ii) Labor and Capital Coalition: This coalition is the classic one that leads to a coordinated market economy in which a banking-oriented financial system emerges, like that found in Germany. In this case, concentrated ownership via banks permits greater employment stability for labor. At the same time, bank lending will generally be more centralized to cater to urban industries. Government intervention is also likely, albeit in a more indirect manner than that found when labor alone, or labor and farmers, exercise political control.

2) Class Conflict

i) Capital: When owners of capital -- owners of large firms in particular -- control politics, they are likely to press for the development of securities markets and to retain controlling blocks in corporations (e.g., pre-WWII France and Japan). Government intervention will be minimal, and agrarian financing will be low. Banks will be universal with branches in rural areas to draw deposits out of the interior.

ii) Farmers and Labor: This populist coalition leads to a combination of centralized commercial banking to finance industrial development and local agricultural banking, with heavy government involvement in both. What is particularly interesting about this case is the difficult transition that occurs as capital owners become more influential. Because institutions were originally designed according to the preferences of labor and farmers, they do not easily accommodate capital owners' growing influence. Consequently, growing pains occur for the political economy as its institutions adjust. Also notable of this capitalist outcome is the heavy government intervention in economy since both actors favor it.

3) Voice vs. Property

i) Labor: When labor wields exclusive political power, a centralized, government-controlled banking system emerges. Labor seeks to control the financial system through nationalized, government-run banks in order to direct lending to specific firms and industries in exchange for high and stable employment.

ii) Farmers and Capital Coalition: When farmers exercise political power in democratic governments, they implement a decentralized banking structure, which may precede the advent of capital's political power and economic importance. Once capital forms a coalition with farmers, capital requires the creation of centralized capital markets to finance industry since the banking system will likely remain decentralized. As part of farmers' general antipathy towards oligarchic capital, they seek to prevent the emergence of concentrated banking and large corporations, which creates political pressure for diffuse ownership. The U.S. offers a clear example of the financial structure resulting from this power-sharing coalition (e.g., Roe, 1994).

4) Social Contract

This occurs when labor, capital, and farmers come to a three-way compromise on the structure of the financial system. This is more likely to occur when a foreign power imposes its will on these actors, and thereby forces a compromise among them. The clearest example of this is American influence on post-WWII Japan. If it were not for American involvement, a labor-farmer outcome would have been likely, but US pressure forced a capital-labor-farmer compromise. However, this capitalist form may arise independently of American foreign pressure, as in other Asian countries (e.g., South Korea). For example, globalization places pressure on smaller states to form a social contract like that found among many small European countries (Katzenstein, 1985). As capital gains increasing leverage via globalization, a transition may occur from a mixture of banking and market reliance to a greater reliance on markets, though in a more managed form than LME countries.

4. Historical Patterns

Before delving into an analysis of whether the theory accurately describes the causal mechanisms that lead to different capitalist styles, it is useful to observe some of the broad patterns of capitalism that countries have exhibited over time. Accordingly, I illustrate patterns across time and space for the financial system variables that proxy for the capitalist system, where data are available: bank-market orientation for asset specificity and government ownership of banks and state control of the economy for government's economic intervention. Agrarian financing is examined in the case studies. I then look at correlations between these financial system variables and the independent variables.

A) Financial Systems Across Time and Space

Hall and Soskice (2001) use stock market capitalization relative to GDP as their indicator for a nation's reliance on markets relative to relationship-based forms of financing (i.e., bank lending). This is a good measure, but it needs to be treated with caution. Stock markets are known for occasional bubbles which can last for several years and may occur across countries, making it a potentially unreliable measure if examining only one point in time for a particular country. In the long-run (over decades), stock markets tend to settle around an equilibrium price level (e.g., 10% increase per annum for the NYSE), making it preferable to measure a country's reliance on stock markets across long periods of time to gauge a country's overall reliance on markets.

At the same time, looking exclusively at stock markets only captures one half of the asset specificity variable. It would be preferable to have a measure for a nation's reliance on banks as well, such as bank deposits relative to GDP (as used by Rajan and Zingales, 2003).

Table two shows the average reliance on stock markets during the pre-World War II period in comparison to the post-World War II era across countries. It is clear that there have been considerable changes across countries between these two periods. The ordering of countries in the postwar period, however, raises some questions with regard to the utility of the stock market capitalization measure as a reliable indicator for the LME-CME orientation of a country since some countries seem out of place, such as Switzerland (being too LME), and the USA (being too CME).

Table 2. Stock Market Capitalization to GDP, Pre-WWII and Post-WWII

	High (LME)														Low (CME)
avg. 1913-1938	UK 1.2	JAP 1.17	BEL 1.15	CAN .87	FRA .76	AUT .76	NET .65	AUS .6	SWI .58	USA .57	SWE .39	GER .32	DEN .26	ITA .22	NOR .19
avg. 1950-1999	SWI 1.53	UK 1.15	CAN 1.14	AUS .72	NET .69	USA .69	JAP .59	SWE .47	NOR .36	FRA .34	BEL .34	DEN .31	GER .27	ITA .25	AUT .12

Source: Rajan and Zingales, 2003.

Table three illustrates the ratio of stock market capitalization to bank deposits. Compared to the stock market capitalization table, the country orderings seem more in line with the LME-CME expectations: the USA is appropriately LME for the post-war period; Switzerland remains on the LME side, but less so than before. Like table one, we see movement of countries along the LME-CME continuum from the pre- to the post-WWII era, notably Japan, France, Switzerland, and Belgium.

Table 3. Ratio of Stock Market Capitalization to Bank Deposits, Pre-WWII and Post-WWII

	High (LME)														Low (CME)
avg. 1913-1938	CAN 4.8	JAP 4.23	UK 4.1	BEL 2.09	NET 1.98	FRA 1.78	USA 1.57	AUS 1.39	GER 0.95	ITA 0.89	AUT 0.68	SWI 0.62	SWE 0.56	DEN 0.49	NOR 0.27
avg. 1950-1999	UK 3.8	USA 3.31	CAN 2.87	SWI 2.46	AUS 1.63	NET 1.61	JAP 1.41	SWE 1.13	GER 0.99	NOR 0.86	FRA 0.83	DEN 0.72	BEL 0.7	ITA 0.66	AUT 0.24

Source: Rajan and Zingales, 2003.

Table 4a illustrates government ownership of banks during the postwar period, in 1970 before privatization waves began, and in 1995. What is notable about these data is the stability of countries relative to one another in 1970 and 1995, again suggesting that underlying institutional rigidities constrain the extent of change along the LME-CME continuum. Data are not available for the prewar period. Table 4b offers an additional measure of state intervention in the economy, which shows a fairly similar country ordering.

Table 4a. Government Ownership of Banks (% of total ownership), 1970 and 1995

1970	UK 0	USA 0	JAP 0.07	NET 0.08	DEN 0.098	CAN 0.11	SWE 0.21	AUS 0.21	SWI 0.25	BEL 0.4	GER 0.52	NOR 0.55	AUT 0.71	FRA 0.74	ITA 0.76
1995	UK 0	USA 0	JAP 0	CAN 0	DEN 0.09	NET 0.09	AUS 0.12	SWI 0.13	FRA 0.17	SWE 0.23	BEL 0.28	ITA 0.36	GER 0.36	NOR 0.44	AUT 0.5

Source: La Porta, Lopez-de-Silanes, and Shleifer (2002).

Table 4b. State Control

UK 0.55	USA 0.85	AUS 1.26	CAN 1.29	JAP 1.29	SWE 1.51	GER 1.76	SWI 2.08	AUT 2.11	NET 2.28	DEN 2.46	FRA 2.63	BEL 2.78	NOR 3.19	ITA 3.95

Source: Nicoletti et al, 1999, p. 74. Ranking described as capturing "public ownership" (in turn taking into account the "size" and "scope" of the public sector, "control of public enterprises by legislative bodies," and "special voting rights") and "(state) involvement in business operation" (in turn including "price controls" and "use of command and control regulations").

B) Correlations

According to the argument, the structure of modern capitalist institutions is broadly determined as a result of political battles among actors representing an economy's factors of production. For this reason, we must look at the power of these actors at the point in time when they struck these institutional bargains. For some countries – particularly the Scandinavian ones – these bargains were struck at the beginning of the twentieth century. For most continental European countries, however, political battles were fought after World War II, and new institutions were created (e.g., France, Germany, Austria, Italy, and Japan). And still other countries' political institutions have been intact since the nineteenth century or earlier, such as the UK, US, Canada, and Australia. But many of the contemporary capitalist institutions in these countries were not crafted until the late nineteenth or early twentieth century, although political institutions biased the outcome. Thus, it is important that we are sensitive to the period of time when actors fought political battles over nations' capitalist institutions. In other words, the theory predicts that today's capitalist institutions were determined by the political bargains struck in the late 1940s for some countries (e.g., France, Germany, Japan), and during the pre-WWII period for other countries (e.g., Scandinavian and Anglo-American countries).

How do we measure actors' power? For left-wing political power, I use a measure compiled by Franzese (2002), which takes the average ideological value assigned to political parties by multiple expert studies, and is then weighted according to the number of cabinet posts held by each party.[2] I extend this measure to the pre-World War II period. This variable allows us to place countries on a left-right wing political spectrum which then also accounts for the political orientation towards labor or capital.

Farmers' power can be difficult to measure accurately, as seen when they exercise more political influence than their fraction of the population ought to allow them (e.g., American, French, and Japanese farmers preventing agricultural agreements in the WTO

[2] The expert studies include Laver and Hunt (1992), Laver and Schofield (1990), Dodd (1976), Castles and Mair (1984), Laver and Budge (1992), Sani and Sartori (1983), Morgan (1976), Inglehardt and Klingemann (1987), Mavgordatos (1984), Bruneau and MacCleod (1986), Blair (1984), Kerr (1987), Taylor and Laver (1973), Browne and Dreijmanis (1982), and de Swaan (1973). Multiple expert studies are used to minimize the bias/subjectivity caused by relying on only one or a couple.

rounds). This is largely due to institutional rules that grant them a minimum number of representatives which are often sufficient to veto changes to the status quo (this institutional bias usually occurs with an increasing level of malapportionment over time). However, a more accurate assessment of their political influence *is* frequently possible based on population figures if we look back to when contemporary political and capitalist institutions were created -- immediately following World War II in the cases of Japan and France, or the pre-WWII period for Scandinavian countries. For some countries (e.g., the Anglo-American ones), agricultural population figures remain inaccurate, however, they are less inaccurate during the early twentieth century than later.

The control variables include level of industrialization as measured by the logarithm of per capita GDP (used by Rajan and Zingales, 2003), civil legal codes (used by La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998), and state centralization (used by Verdier, 2003). Left-wing power is also used by Roe (2003) and Gourevitch and Shinn (2005).

The evidence suggests that there is a weak correlation between left-wing power and market-bank orientation during the pre-World War II period, as illustrated in table five. The evidence, however, is not consistent with farmer power correlating with the market-bank measure. However, this result should be viewed with some skepticism since many countries during this period did not have political institutions that granted farmers (and labor) the political power that they deserved according to their actual constituency size since, in many cases, the upper house could easily veto initiatives from the lower house. For this reason, the farmer power measure in particular may offer an inaccurate measure of their actual power. The post-WWII measure offers a more accurate assessment of their power since many countries' political institutions granted farmers political power that corresponded more closely to their actual constituency size. The prewar left-wing measure, however, looks at the partisanship of the cabinet, as opposed to a measure that captures their fraction of the voting population, and it is therefore more accurate.

Examination of the scatterplots reveals that Canada may be biasing the farmer power outcome; rerunning the regression without Canada does, in fact, produce a statistically significant correlation at the 5% level.

Table 5.
Politics and Pre-WWII Market-Bank Orientation

	Market-Bank Orientation, 1913-1938 average	
Independent Variables	1	2
Left Power Prewar	-0.46* (0.23)	-1.4*** (0.07)
Farmer Power Prewar	-0.03 (0.04)	-0.1*** (0.004)
Log (per capita GDP)		-0.48 (0.26)
State Centralization		2.1*** (0.16)
French civil		2.7*** (0.2)
German civil		1.57** (0.16)
Scandinavian Civil		6*** (0.4)
Constant	4.4*** (1.2)	7.9** (1.2)
Adjusted R^2	0.31	0.98
N	12	10

Note for all correlations: *** statistically significant at the 1% level; ** statistically significant at the 5% level; * statistically significant at the 10% level. Standard errors in parentheses.

A better assessment of the correlation between farmer power and the market-bank orientation of the financial system is evident from the post-WWII data since farmers' power is more accurately measured by their constituency size. Here, both left and farmer power correlate with the market-bank orientation, and maintain a statistically significant correlation with the inclusion of the control variables. For this post-WWII sample, left and farmer power are measured as close to the point in time when contemporary capitalist institutions were created. For example, left and farmer power remain the same as for the pre-WWII measure for Scandinavian countries, whereas these measures are updated to 1950 for Japan and most of the continental European countries (France, Italy, Germany, Austria). The Anglo-American countries likewise remain the same as the pre-WWII measures.

Table 6.
Politics and Post-WWII Market-Bank Orientation

	Market-Bank Orientation, 1950-1999 average	
Independent Variables	1	2
Left Power Postwar	-0.37*** (0.13)	-0.5** (0.2)
Farmer Power Postwar	-0.043** (0.02)	-0.05* (0.02)
Log (per capita GDP)		1.9 (4.7)
State Centralization		-2.3 (2.2)
French civil		0.2 (1)
German civil		-0.7 (0.5)
Scandinavian Civil		0.6 (1)
Constant	4.4*** (0.7)	-1.5 (22)
Adjusted R^2	0.52	0.68
N	15	15

The scatterplot for left power shows that Japan is a clear outlier. The case study will reveal that its placement at such a far right-wing extreme is problematic since the left exercised considerable power in the years immediately after the war, when bargains over capitalist institutions were struck.

Because institutional complementarities preserve the relative spatial location of countries, we should expect to see the correlation hold up across time. As mentioned above, looking at only one point in time may be problematic since equities markets may exhibit temporary fluctuations that depart from their long-term behavior. The tests across decades in table seven offer some confidence for the robustness of the left power and farmer power correlations, suggesting that institutional rigidities keep countries locked into a steady spatial arrangement relative to one another which is determined by the political bargain struck at the time of their creation. 1950 fails to produce a statistically significant correlation, however, one could argue that financial systems were still underdeveloped in 1950, and therefore did not have time to reflect the underlying political bargain so soon after the war. 1999 also fails to produce a statistically significant correlation, but one could argue that the equity bubble affected some countries more than others, and thereby distorted the long-run market-bank orientation of countries relative to one another. With regard to government ownership of banks, left-wing power offers a stronger correlation, which is consistent with existing arguments. Whether farmers have had any meaningful influence will be examined in the case studies.

Table 7. Robustness Across Time

Independent Variables	1950	1960	1970	1980	1990	1999
Left Power Post WWII	-0.19 (0.14)	-0.42*** (0.1)	-0.6** (0.2)	-0.15 (0.12)	-0.49*** (0.15)	-0.3 (0.36)
Farmer Power Post WWII	-0.02 (0.02)	-0.035* (0.017)	-0.09** (0.037)	-0.04** (0.02)	0.004 (0.02)	-0.07 (0.05)
Adjusted R^2	0.07	0.62	0.49	0.29	0.39	0.06
N	12	13	15	15	15	15

Table 8. Politics and Government Intervention

	Gov Ownership Banks 1970	Gov Ownership Banks 1995	State Control
Left Power Post WWII	0.07* (0.04)	0.06** (0.025)	0.36*** (0.11)
Farmer Power Post WWII	0.006 (0.006)	0.001 (0.004)	0.02 (0.018)
Constant	-0.17 (0.24)	-0.097 (0.14)	-0.09 (0.67)
Adjusted R^2	0.16	0.24	0.42
N	15	15	15

5. Cases

To draw implications for China, I briefly consider two country cases: pre- and post-WWII Japan and France. These cases are useful because they illustrate the consequences for the capitalist system when a crisis occurs that grants more power to labor and farmers—two of China's largest groups that currently lack political representation, but which could dramatically alter China's political economy if they were to gain political power.

A) Japan, Pre-WWII: Owner-Oriented LME

Japan's pre-war financial system was highly dependent on equity finance, which began with a privatization wave in 1880. Not until wartime financing occurred (beginning in 1937 with the Sino-Japanese war), did the financial system begin to change into a more concentrated, and bank dependent one (Hoshi and Kashyap, 2001).

With regard to the banking system, most of the financing went to industry, rather than agriculture. Throughout the prewar period, small farmers generally faced a capital shortage and had to pay high loan rates; around 9.2% in 1929, compared with large firms' bond yields of 5.5-6%. Small firms also had very high borrowing costs relative to large firms during the interwar period -- around 15% for short-term industrial loans in Tokyo in 1930.[3] Lockwood (1954) attributes these high costs to a scarcity of capital, since it was being directed toward the larger enterprises. Thus, Japan's financial system in the pre-war era is characterized by a high reliance on securities markets, low levels of government intervention, and weak agricultural financing.

Japan's politics exhibited strong links between the rapidly growing business sector and government officials, with rural *elites* also wielding political influence. Political institutions entrenched power in the hands of the oligarchs who surrounded the emperor (the

[3] See Lockwood, 1954, 289.

Genrō and the Privy Council) with some political power accorded to the upper house of the Diet (the House of Peers). These institutions kept policymaking out of the hands of popular influence (e.g., labor and small farmers), and thereby cemented the power of the elite – particularly the business elite and the wealthy bushido leaders. Consequently, they determined domestic economic policy, and ensured that owner-oriented markets dominated the structure of the financial system, with little government intervention. And, because such a small proportion of agrarian interests wielded any significant political influence, agricultural financing remained relatively low.

In the prewar period, labor had almost no influence on the financing decisions of large firms, nor on the financial system more broadly. Although labor gained some concessions during the interwar period, when it was strongest, the most significant pieces of legislation which would have legally protected labor unions, the Labor Union Bills of 1926 and 1927, were never passed by the Diet.

B) Japan, Post-WWII: Inclusive CME

When the war with China began in 1938, a series of laws were passed to put the allocation and control of finance firmly under government control, resembling similar actions performed by other countries during WWII (e.g., France, Germany, and Italy). To this end, banks were consolidated. The 424 ordinary banks at the end of 1936 were consolidated to just 61 in 1945 with four major zaibatsu banks controlling almost half of the capital of Japan's financial institutions.[4]

By the end of the war, bank-firm relationships were solidified and assigned banks dominated firms' external financing needs; capital raised on securities markets (bond markets in particular since the stock exchange had been closed) fell to a trickle. Hoshi and Kashyap

[4] See Adams, 1964, 128-59; and Hoshi and Kashyap, ch. 3.

(2001) find that the relations formalized by the munitions companies system of WWII (where a bank is assigned to a particular firm) lasted into the postwar period.

It is important to note that although banks dominated financing during the war, this did not mean that Japan's postwar financial system would remain banking-oriented. In both the US and UK, banks were heavily relied upon during the war, and yet markets came to dominate shortly after the war ended. The political situation in Japan following the war was critical to allowing and even encouraging the continuance of the wartime bank-firm relations.

Farmers: Following the war, several institutional mechanisms vaulted farmers to a politically powerful position, including the electoral system, universal male suffrage, the executive-legislative balance, and malapportionment.

Candidate-centered electoral systems such as Japan's multi-member district single nontransferable vote system (MMD-SNTV) create incentives for politicians to develop a loyal group of supporters (personal vote coalitions) by wooing them with pork in exchange for votes (Cowhey and McCubbins, 1995: 44). In Japan, farmers and small business have benefited considerably as the key members of these local vote coalitions.

But the influence of farmers and small firms became a political reality only because Japan's postwar institutions granted significantly more power to the lower house than during the prewar era. Land redistribution vaulted farmers to a very politically powerful position following the war, and they subsequently comprised nearly half of the total electorate in 1950.

With such an overwhelming proportion of the electorate, agricultural interests had sufficient power to elect Diet members outright and to propose and pass legislation. As the rural population declined, agriculture still retained considerable negative political power (i.e., the ability to ensure electoral failure if votes are redirected away from a candidate and to veto unfavorable policies), which was sustained by increasing malapportionment of electoral districts begun with the 1947 electoral law (Wada, 1996: 11).

Labor: The labor movement surged immediately after the war, as shown in figure one. Nosaka Sanzo, a leading Communist, published "An Appeal to the Japanese People" which served as the basis for the Emancipation League (formerly the Anti-War League), founded in 1944. The League's program was couched in moderate language so as to appeal to a wide audience, but among its key policy prescriptions, it advocated "maintaining and strengthening state control over banks" (Colbert, 1952: 64). The program served as the ideological basis for a large segment of the postwar labor movement. The more moderate Socialists, in 1946, proposed a system of state control of key industries (Colbert, 1952: 88), as well as the establishment of a Supreme Economic Council to determine general economic policies, subsidiary councils for each industry, and at each level of planning or supervision trade-union representatives, as well as representatives of business and government would participate. The long-term financial program of the Socialist Party called for the socialization of all banks and insurance companies, entailing the establishment of a Banking Control Committee to be headed by the Finance Minister and to be responsible for the utilization of funds. Additionally, it proposed that half of each banks' managers would be selected from among its employees (Colbert, 1952: 90). The resemblance to France's postwar Socialist policies is striking.

At first, American General Headquarters (GHQ) actively promoted labor unions, but as the Cold War began and the communist threat increased, GHQ modified its policies. The implementation of the Dodge Plan led to firings and layoffs on a large scale, causing the elimination of a large sector of the militant left, and to the reorganization and strengthening of oligopoly capital. Although the Dodge program involved expanding big industry and therefore employment in big industry, the reorganization was used carefully to weed out militant workers and to weaken the union movement. To retain the loyalty of the remaining workers, managers offered remaining employees lifetime employment. At the same time, the Japanese main bank system developed strongly after World War II.[5] The main banks' ownership of stock in industrial firms expanded, making them main bank stockholder-creditors. They monitored firms, and acted as firms' main source of external financing for several decades after the war. Although this banking-oriented financial system remained out of the control of labor, it neatly matched their initiative for financing arrangements that would offer employment stability. Lifetime employment and the main bank system acted as stable complements, even if one did not induce the other.

C) France, Pre-WWII: Owner-Oriented LME

Like pre-war Japan, France's Third Republic political institutions also privileged the wealthy elite and excluded the populace from exercising real political influence. The financial system likewise exhibited a strong reliance on markets, with little government intervention, and low levels of agrarian financing.

Prior to the 1930s, France relied heavily on capital markets as the conduit by which money flowed from savers to borrowers with self-financing becoming more common during the 1930s.[6] Table 9 shows the decline in stock and bond issues for corporations beginning in the 1930s, and its persistence to the end of the sample in 1964.

[5] Hoshi (1995) shows that post-war main bank relations grew directly out of the authoritative wartime allocation of defense companies to particular banks.
[6] Bank financing also experienced a change from a reliance on private banking in the 1920s to public banking in the 1930s (Gueslin, 1992: 85).

Table 9: French Corporations' Stock and Bond Issues, 1900-1964
(percent of gross domestic product)

Year	Stocks	Bonds	Total
1900	2.0	1.8	3.8
1913	2.6	2.9	5.5
1924	3.3	1.2	4.5
1929	5.7	2.6	8.3
1930	3.4	4.4	7.8
1938	0.6	0.3	0.9
1949	0.6	0.3	0.9
1954	0.6	0.8	1.4
1959	1.7	1.4	3.1
1962	1.4	1.2	2.6
1964	1.2	1.0	2.2

Source: Carré, Dubois, and Malinvaud (1975, 334)

Additionally, there was little government intervention in the economy, and agrarian financing likewise remained very low but this changed considerably after the war.

France's pre-WWII government was dominated by the parliament, comprised of the Chamber of Deputies and the Senate, with the Senate having the clear upper hand. The Senate was designed to insulate the political system from the universal suffrage of the Chamber of Deputies. Senators were elected indirectly by mayors and councilors of departmental and arrondissement assemblies, ensuring that they were elected only by the privileged. Wealthy landowners were over-represented in the Senate, and big business also wielded considerable influence through their direct financial contributions to Senators and through the growing number of wealthy industrialists. Labor, small business and small farmers had almost no influence in the upper house. Rather, their votes were important to the election of Deputies.

Interests: The most important feature of the Third Republic's agricultural economy was the rapid industrialization movement. From the mid-nineteenth century up to the 1930s, the national supply of credit went increasingly to firms participating in the industrial revolution

(Gueslin, 1978, 29-44).[7] Consequently, farmers faced rising borrowing costs. And in terms of France's overall financial system, agricultural credit constituted a small fraction of total enterprise financing.

Prior to World War I, unions and left-wing political movements had sporadic, but mostly negligible influence on firms and government. At the end of World War I, labor activity and union membership surged. On December 16, 1918 the Confederation of Workers (Confédération General du Travail: CGT) issued a statement of the changes it sought in its Minimum Program, which formed the major themes of the interwar years. With regard to the economy, this document primarily focuses on the objective of *dirigisme*. That is, "The working classes must manage the national effort" of reorganizing the economy by exercising "permanent" control over all branches of production.[8] The Program advocated nationalization of key industries, which was to be implemented not by the state alone, but by mixed public corporations, "administered by the qualified representatives of producers and consumers" (Lorwin, 1954: 52-53).

After World War I, the Confédération Générale du Patronat Français (CGPF) was formed to represent the interests of big business to government, in reaction to the growing political influence of labor. Duchemin was the president of the CGPF from 1926 to 1936, and in his book he outlined the philosophy of the CGPF which entailed an overriding commitment to economic liberalism (Duchemin, 1940). Big business sought to ensure that the 'classical laws' of laissez-faire governed the structure of the French economy. This equated to ensuring that access to capital remained free from any government imposed restrictions or manipulation, such as regulations affecting access to securities markets, as well as control over lending arrangements through various credit granting facilities (i.e., banks). While Duchemin articulated the interests of big business only after labor became a real

[7] Gueslin's book, *Les Origines du Crédit Agricole (1840-1914)*, offers a very thorough account of the formation of the Crédit Agricole.
[8] Minimum Program of the CGT.

political threat, he was merely expressing the sentiments that business leaders shared for many decades prior to the formation of the CGPF.

D) France, Post-WWII: Mediterranean Capitalism

Socialists and Conservatives had different visions for postwar France. Heading the Socialist Program was André Philip, who pressed for structural reforms within six months of the landings since the fervor for change would peak with the beginning of the new republic. He proposed comprehensive planning (and Keynesian countercyclical policies) to sustain full employment and economic development. In a planned economy, he argued, certain producers were so important that they had to be nationalized so that the state could effectively control investment.[9] Additionally, he proposed the creation of a National Economic Ministry as "a coordinating organ," whose primary purpose was to plan the national economy according to socialist guidelines.

The conservative neoliberal perspective was articulated best with Courtin's Program, which envisaged a "return to the market, economic freedom, and free trade" that prevailed during the Third Republic (Kuisel, 1981: 171). Ultimately, labor in alliance with farmers, would win the political battle by a wide margin and France would bolster industrial and agrarian banks, and promote high levels of government intervention.

Politics: In the immediate postwar environment, popular opinion accused big business of aiding the downfall of the French Republic. This anti-business sentiment pervaded the first years of the liberation. Labor (and farmers), by contrast, was seen as opposing the Germans, and was celebrated as defenders of the French Republic. A popular election held in October 1945 confirmed the leftward swing that had taken place in the electorate, and so the left

[9] André Philip's report was published by the Parti Socialiste, Pour la Rénovation de la République, and entitled *Les Reformes de Structure*.

overwhelmingly dominated the policymaking process in the new Constituent Assembly.[10]

One of the first items on the agenda was the nationalization of banks since credit was a critical element for reconstructing and managing the economy. The banking act that was eventually passed on December 2nd 1945 nationalized the four largest deposit banks (or commercial banks: these held around half of all banks' assets and were the only banks with nationwide branch networks) and extended minor regulations over private investment banks.[11] All representatives from the left and center voted for it.[12] The law structured French finance for the postwar period and gave the government greater influence over the course of postwar economic development by placing the volume and allocation of credit firmly under its control.

Farmers: With the new provisional government, small farmers now enjoyed political influence more closely reflecting their proportion of the population; there was no longer a Senate to block their legislative initiatives. So, between 1950 and 1963, Crédit Agricole medium and long-term loans rose from 630 million francs to 13 billion francs (INSEE, 1986). This expansion continued as the bank financed, with considerable government subsidy, the technical and infrastructural modernization of the countryside. The Crédit Agricole considerably increased its services to farmers in comparison to the prewar period, in addition to offering low rates of interest and increasing the availability of credit, corresponding to

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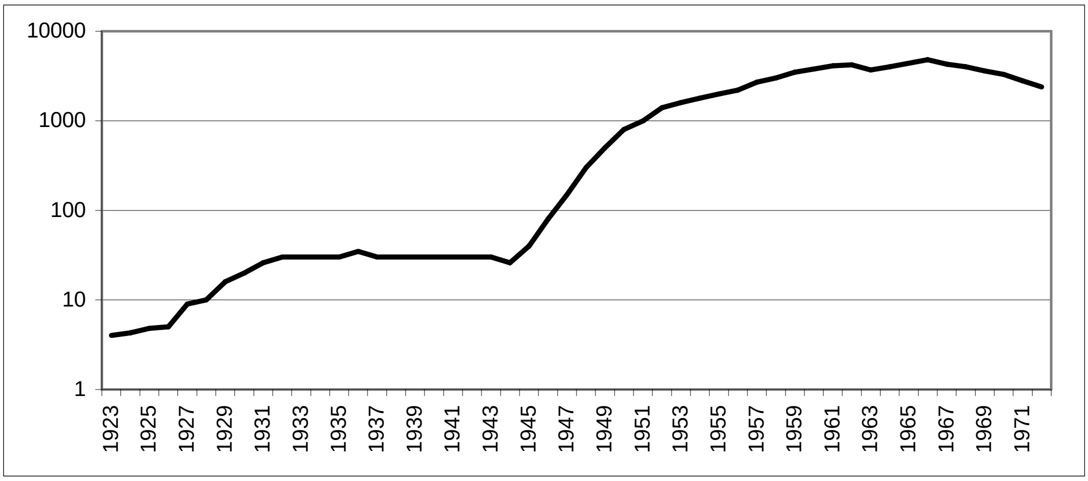
[10] An interim legislature preceding the ratification of a new constitution and the election of the National Assembly in October 1946.

[11] For information on the formulation and effect of this banking legislation, see Alhadeff's six chapters on French banking in *Competition and Controls in Banking* (1968), Wilson's *French Banking Structure and Credit Policy* (1957), the France chapter by Henry Germain-Martin in Beckhart's *Banking Systems* (1954) and Dupont's *Les Contrôle des Banques et la Direction du Crédit en France* (1952).

[12] 461 out of 494 representatives from mainland France voted for the law; 442 from the left and center, and 19 from the right; 33 on the right voted against.

farmers' far greater political power.[13] The government likewise increased substantially the level of funds directed to the agricultural sector.

Figure 1: Value of Advances from the State to the Crédit Agricole (1923-1972)
in million of Francs (logarithmic scale)



Source: adapted from Gueslin, André. 1984. Histoire des Crédit Agricoles, p. 322.

6. Implications for China

If the evidence presented convincingly demonstrates that labor, farmers, and capital interact with one another to affect the structure of the national financial system, then what might some of the implications be for China? To answer this question, it is useful to first describe some of the main features of China's financial system and to then consider how actors could affect the government's attempts to modernize it.

The Financial System: China's stock market capitalization relative to GDP is 0.17 (17%).[14] When looking at table two, we see that China would fall at the CME end of the spectrum. The market capitalization over bank deposits measure, at 0.145, reinforces this placement. While it is common for developing countries to rely heavily on bank lending, China is far more heavily reliant on bank lending than most other Asian countries (nearly twice as high as any

[13] Carré, Dubois, and Malinvaud, 1975, 337.
[14] McKinsey report, "Putting China's Capital to Work: The Value of Financial System Reform." May, 2006.

other nation listed in a McKinsey report -- “Putting China’s Capital to Work: The Value of Financial System Reform”: May, 2006 -- which includes: Indonesia, Thailand, India, Philippines, Mexico, Japan, South Korea, Hong Kong, Singapore, Malaysia, and Chile).

The critical weakness in China’s financial system, according to the McKinsey study, is the heavy reliance on bank loans being directed to state-owned enterprises, largely to prevent massive layoffs, and because the equity and bond markets are incapable of offering a financing alternative. Because most of banks’ capital is lent to large, often state-owned companies, smaller firms and consumers get crowded out. This leads to a misallocation of capital, which, if corrected, could boost GDP by $62 billion a year. In addition, reforms that enable a larger share of funding to go to more productive enterprises would increase investment efficiency, raise GDP by up to $259 billion, or 13 percent a year, and bring higher returns for Chinese savers, thus enabling them to raise their living standards and consumption.

Political Impediments to Reform: The McKinsey study offers ten recommendations to improve the financial system, many of which involve deregulating banking and capital markets. A critical underlying difficulty with implementing the proposed reforms is the political will to do so. The study argues that although the reforms they recommend may cause some job losses as the least efficient companies shut down, they will also create the wealth that will provide the means to compensate displaced workers and create new jobs in more productive companies. However, this is an optimistic view that understates the political roadblocks to implementing these reforms when viewed from the perspective of other countries’ historical experiences. How might farmers, labor, and capital affect modernizing efforts?

Farmers: China's decentralized political structure grants considerable political power to local politicians. They have the ability to direct state funds (through policy banks) to local projects of their choosing. China's political and economic structure is so decentralized, that, in some ways, it can be best understood as a collection of independent provinces. Local leaders have significant influence both on companies and on the banking system that serves them. This decentralization has limited the effectiveness of China's financial system so far, and it also makes reform more difficult. As one might imagine, agriculture is an important player (Lardy, 1998: 90). The best country example to compare China to, in this regard, is the United States. American states did not begin permitting interstate bank branching until the 1970s. Japan, with more central political authority, but with its political system granting considerable power to local politicians (and their personal vote coalitions), and to farmers and small firms in particular, has also witnessed a considerable bias towards the countryside in terms of subsidized lending rates, and redistribution of capital to rural areas. Insofar as Chinese politicians rely on local groups (particularly businesses) to remain politically powerful, farmers will continue to play an important role in assuring that money gets diverted to rural areas, and they will prevent the efficiency enhancing regulatory reforms of the financial system, and the banking system in particular, that McKinsey recommends.

Labor: Although workers and farmers lack political representation in China's government, they exercise unusual political influence because of Chinese leaders' fears of popular upheaval. That is, Chinese officials placate these groups while at the same time slowly shifting the economy in a market-oriented direction, and integrating it into the global economy. Doing this necessarily means moving the economy away from agriculture towards industry, and allowing unsuccessful businesses to fail, and for their workers to lose their jobs. Because of the large numbers of noncompetitive state-owned enterprises, and the potentially huge job losses, Chinese leaders have good reasons to fear a political firestorm from such maneuvers. Local politics reinforces this political pressure: "branch managers sometimes face political pressure from local government leaders to continue to supply [state-owned enterprise] funding, because this keeps the largest employers in the area afloat, and it is in the interest of both the local government and the bank itself to protect local jobs" (McKinsey, 2006). At present, China's strategy seems to be to allow the economy to grow its way out of the problem, by creating enough jobs in competitive firms so that most workers do not oppose government efforts to wean companies off of state subsidized lending over time. But this strategy could be problematic since it crucially depends on maintaining high and stable levels of economic growth over a long period of time.

Capital: Competitive private-sector business would largely favor the reforms recommended by McKinsey. Reducing the transactions costs of obtaining financing and improving consumers' purchasing power is certainly in their interest. The present relationship of the Chinese government to the private sector is reminiscent of 1880s Japan, when securities markets became heavily relied upon as state-run industries were privatized. However, a critical difference is the existing volume of non-performing loans and the heavy dependence on non-competitive state-owned enterprises to maintain employment stability. Indeed, China's present market-oriented trajectory resembles that of many countries during the late nineteenth century, before true democratic reforms were instituted. However, because the Chinese can easily see the political power similar groups have in other countries, democratic reforms are likely to be pursued more aggressively in contemporary times than in late nineteenth and early twentieth centuries.

To keep China on its liberalizing trajectory, it must overcome the close linkages between politics and business, which leads to corruption. This has led to political reforms in other East Asian countries in the wake of economic crises (e.g., Korea after 1997), and is a serious worry for Chinese politicians. Making a smooth transition away from corruption could be difficult as long as nondemocratic institutions dominate, and local politicians continue to wield political influence over lending decisions.

Implications for the Capitalist System

Like the US from the late-nineteenth century to the 1920s and post-WWII Japan, could China evolve beyond its heavy dependence on bank lending without causing a political backlash? Its current political system certainly permits that possibility since its nondemocratic institutions do not require that its policies follow the wishes of labor and farmers. However, as has occurred in Korea (along with many other countries over time), economic prosperity creates a sufficiently large middle class that demands a political voice. When a crisis occurs, democratic changes to the structure of the political institutions usually follow. Because China's heavy reliance on bank lending is likely to continue for a long time (likely decades from looking at the historical experience of other countries), it seems more likely that an economic crisis would occur in the intervening time. Possibilities for an economic slowdown, and possibly a crisis, include: economic overheating, widening regional and rural-urban economic divides, banking sector fragility, environmental degradation, rampant corruption, the ageing population, and military conflict with Taiwan (Wu, 2006). If any of these situations occur, it could lead to democratic reforms that would allow labor and farmers to gain more political influence, thereby hardening the reliance on banks, and turning China towards a CME style of capitalism. This would give other nations in Asia a particular comparative advantage with regard to developing radical innovations if they develop LME capitalist institutions. But, so long as nations remain committed to open trade all nations will prosper, like the numerous CME countries in continental Europe.

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