State and Finance in Economic Development: Analytical Issues Relevant to the East Asian 'Miracle'

Costas Lapavitsas*

The development successes of East Asia and South East Asia Have encouraged the emergence of a theoretical critique of the role of freely-operating markets in the process of development. Move recently, Stiglitz and Uy have brought together several of the current's analytical strands, at the same time drawing support from economic theory by relying on the literature on market failure, particularly that on asymmetric information. However, it is also necessary to identify some analytical and theoretical weakness that bedevil the current's intellectual output. The most fundamental problem is the absence of an analytical framework within which to analyze the interplay of economics, political, and social forces in the process of development. The main claim of this paper is that appropriate analytical principles for this task are to be found instead in the approach of radical political economy. (*JEL* Classifications: O10, O53)

I. Introduction

The development successes of East and South East Asia have encouraged the emergence of a theoretical critique of the role of freely-operating markets in the process of development, especially since the early 1980s. Characteristic works of that type are Chalmers Johnson (1982), Aoki (1988), Amsden (1989), Okimoto (1989), and Wade (1990). The modest rise in influence of this current of thought has been reflected in the well-known World Bank Report on East Asia (1993), the fascinating political genesis of

*Department of Economics, School of Oriental and African Studies, University of London.
[**Seoul Journal of Economics** 1997, Vol. 10, No. 4]

which has been chronicled by Wade (1996). Several of the current's adherents are political theorists, who often call themselves 'political economists' but share little common ground with the tradition of radical political economy. Moreover, their concerns and outlook tend to be very strongly US-inspired, something which decisively shapes many of their generalizations about economic practices in the 'West'.

More recently, two articles in the World Bank Observer (Stiglitz 1996; Stiglitz & Uy 1996) have brought together several of the current's analytical strands, at the same time drawing support from economic theory by relying on the literature on market failure, particularly that on asymmetric information. In answering the question 'To what can the remarkable success of the economies of East Asia be attributed?' these articles stress the significant and positive role of the state, and emphasize the beneficial impact of mild 'repression' on finance. In this respect, a more guarded position has been taken by Aoki *et al* (1997) – see also Teranishi (1996) – claiming that the success of policy activism in the process of development depends on the ability of governments to overcome co-ordination failures among private enterprises in the face continuously changing economies of scale and information about new technologies. If governments cannot ensure the credibility of their commitment to certain policies, government failure might also materialize.

Insofar as it criticizes the cruder and more ideologically driven arguments of neoliberal development economics, especially its hold on international organizations, this work is welcome. The prime purpose of this paper is to offer additional arguments seeking to strengthen its critical thrust. However, it is also necessary to identify some analytical and theoretical weaknesses that bedevil the current's intellectual output. The most fundamental problem is the absence of an analytical framework within which to analyze the interplay of economics, political, and social forces in the process of development, despite the clear appreciation of the importance of institutions. The economic literature on asymmetric information does not possess analytical concepts of sufficient breadth and accuracy to provide the necessary framework. The main claim of this paper is that appropriate analytical principles for this task are to be found instead in the approach of radical political economy. For radical political economy, there are limits to what the state can do in the development process set by the economic, social, and political relations within which the state operates. An important task of development economics is to identify these constantly changing limits.

Section II examines briefly the arguments by Stiglitz and Stiglitz and Uy with regard to state and finance in economic development. Section III provides support for the claim that radical political economy provides a better analytical framework for the role of the state in development by examining the key components of Japanese postwar development. The point here is that the underlying structures of the labour process and of private capital set limits to the activism of the Japanese state, often resulting in an antagonistic relationship with enterprises. At the same time, the Japanese state played a broad political and social role in establishing the aforementioned underlying structures. Section IV, by focusing more closely on the Japanese financial system and the reasons for its transformation in the course of the last two decades, adds more substance to the claim that there are limits to state activism set by the character of the economic, social and political relations within which the state operates.

II. The Recent Synthetic Presentation of the Critique.

For Stiglitz (1996), the importance of the experience of East Asia (meaning Hong Kong, Indonesia, Japan, the Republic of Korea, Malaysia, Singapore, Taiwan, and Thailand) lies in demonstrating the existence of a paradigm of economic development other than the one based on free markets and the (discredited) one based on government planning. In contrast to the last two, East Asian governments used and created markets. Theoretical scope for the East Asian paradigm is provided by market failure, typically associated with the presence of externalities, public goods, imperfect competition, and incomplete markets. Stiglitz, relying on a range of earlier theoretical work, for example, Greenwald and Stiglitz (1986), Stiglitz (1985, 1988), further stresses the significance of imperfect and asymmetric information for market failure, given especially the fact that development relies on the introduction of new technology, which amounts to the acquisition of new information. In this context, government interventions can actually improve upon the results generated by the free market.[1]

The overall role of government in East Asia, according to Stiglitz, was limited to: i) providing macroeconomic stability, ii) improving the operation of markets through regulation (financial markets, above all), iii) creating markets, iv) directing investment to enhance growth and stability, v) creating and atmosphere conducive to private investment and ensuring political stability. At the same time, governments were able to limit rent seeking and to secure adaptability by relying on performance based rewards and by creating a meritocratic civil service. Government interventions were organized around five major themes, briefly considered below: industrial policy, co-operation and competition, equality, export-led growth, and finance.

A. Industrial Policy

East Asian governments promoted engineering and science education, discouraged the allocation of capital to real estate, encouraged exports, adopted technology development programmes, and advanced explicit and implicit (through credit) subsidies to industry. Governments often took steps to encourage the inflow of foreign investment.[2] Several explanations are offered regarding the reasons for adopting these policies: to replace weak and non-existent markets (such as capital markets), to obtain technological and marketing spillovers that the free market would necessarily miss, to take advantage of increasing returns to scale when capital markets are underdeveloped, to make good co-ordination failures by the price mechanism (for instance, in the manufacturing of intermediate goods).

With Japan in mind, Stiglitz (1996) claims that these policies were effective. Mistakes were made in directing policy, but that was inevitable since risks have to be taken for development. The key to success was that the government did not impose its will on industrialists and others, nor did it attempt 'micro-management' of sectors and companies. Rather, broad industrial strategies were adopted which primarily addressed market failure rather than

[1]This argument is essentially the same as Wade's (1990) distinction between market-supporting and market-supplanting policies.

[2]A rather surprising claim for Japan where policy toward inward foreign investment has been cool and often downright hostile.

strictly 'picking winners'. East Asian governments actually undertook an entrepreneurial role, 'combining technological and marketing knowledge, a vision of the future, a willingness to take risks, and an ability to raise capital'.

B. Co-operation and Competition

Again with Japan in mind, it is claimed that East Asian authorities recognize that the business sector has superior information about investment decisions, but broaden the information base by organizing formal and informal councils involving rival firms and government bodies. Truthful behaviour is secured by ensuring co-operation advantages for firms (impossible under freely competitive conditions), and is fostered by government control over the supply of state-related contracts, credits, and licenses. Co-operative behaviour is also strengthened within firms by the instigation of life-time employment and seniority wages. Finally, co-operative behaviour is strengthened in the capital market and the banking sector through long-term arrangements between banks and companies, buttressed by interlocking shareholding. At the same time, co-operation is combined with competition, the latter being promoted by workers' struggle for seniority within firms and by government-managed contests among firms for access to foreign exchange and capital.

C. Growth with Equality

The traditional expectation that intensive capital accumulation necessary for growth also entails the exacerbation of inequality has not been borne out in East Asia. Policies to promote equality appear to have helped the growth process as they have encouraged workers to work harder. Such policies include high and increasing wages, limitations on real estate speculation, improving education, and the advance of rural credit (particularly to women).

D. Export-Oriented Growth

East Asian governments focus on promoting exports in several ways: by providing infrastructure, such as ports, airports, transportation, and telecommunication; by giving exporters preferential access to credit; by providing information to firms about suitable new export markets; by enhancing the reputation of their country's exports through campaigns to establish 'branding' abroad. Moreover, export success affords government an objective criterion to award credit and foreign exchange licenses. Exports provide a broader information base on which to judge a firm's performance than profits, since the latter might simply reflect imperfect domestic competition. Exports, moreover, also capture the technological and commercial learning accumulated by a firm as it trades abroad.

E. *Finance*

East Asian governments intervene heavily in the sphere of finance to make markets and institutions function better as well as to equalize private and social returns to investment. Stiglitz and Uy (1996) identify the following five main areas of regulation. First, savings promotion through the creation of postal saving systems, as in Japan, and provident pensions funds, as in Singapore and Malaysia. For Stiglitz and Uy, the pension funds have not displaced private savings but appear to have raised the national saving rate, and they supplied annuities that the free market is unlikely to have provided because of high risks. Moreover, limitations on the availability of consumer credit, particularly for housing, appear also to have increased savings. Mild financial repression ('restraint') may also have increased saving because it encouraged firms to accumulate out of profits in order to win export and credit privileges.

Second, extensive bank prudential monitoring, including capital adequacy requirements, collateral requirements, lending restrictions for real estate and other speculation, constant direct supervision by the authorities, and prudential behaviour leads given by government banks, appears to have strengthened the guarantees against bank failure. However, the most important element of such regulation is the protection of banks from competition. Entry into the banking sector has been tightly controlled, securing bank profits, preventing competition from foreign-owned banks, and allowing banks to enjoy economies of scale.

Third, development banks and financial markets have been created to fill credit gaps. Long-term credit banks (public and private) can monitor borrowers more closely than capital markets. Long-term lending is very important in volume terms for equipment investment in certain key industries but, more importantly, it acts as a signal for increased commercial lending. The particular success of East Asian development banks is due to their being shielded from the political process, their competent and honest administration, and the tight controls on the types of their lending. Finally, governments-created bond markets provided benchmark rates for private long-term lending (benchmarks for risk).

Fourth, mild restraint on finance and credit allocation has enhanced growth. Contrary to financial liberalization arguments, freely-operating banks tend to ration their credit on risk grounds, a problem that can be overcome by financial restraint. The empirical evidence linking high real interest rates to growth is faulty because it does not differentiate between large and moderate repression, nor does it identify the separate influence of bad macroeconomic policies and lack of investment opportunities on interest rates.

Fifth, credit is directed to chosen groups, firms, and activities (such as those with high technological potential), as well as on largely social grounds, for example, to small farmers, small and medium enterprises, and ethnic groups. Stiglitz and Uy, however, claim that the overall assessment of the effect of credit direction in Japan and Korea is difficult: some risk-taking was necessary, no-one knows what would have happened in the absence of the schemes, and private lending was not simply displaced. Nevertheless, the programmes did not fail wholesale because they were not very large relative to total credit provided and they were part of an overall package of development measures.

In conclusion, these synthetic essays claim that several aspects of the East Asian experience can be replicated elsewhere, including industrialized countries, given that the interventions were fundamentally driven by the need to correct market failures. Governments can use and create markets to promote the generation of savings, more efficient resource allocation, equality, the accumulation of physical and human capital, investment, and, ultimately, higher growth. Neither paper explains why East Asian governments should have been uniquely able to adopt such policies successfully, though they both hint strongly that the reason must be sought in the organizational and incentive structure of the public sector, and in 'political economy' more generally, by which they appear to mean the interaction between politics and economics, particularly in the realm of the state.

III. The Role of the State in Post-war Japanese Economic Development: Some Analytical Considerations

It is a very welcome aspect of this approach to development that it emphasizes industrial policy, the regulation of the credit system, the promotion of scientific and engineering training, the policy of encouraging companies to export to the world market, the tendency to strengthen co-operation, and so on. However, the same cannot be said of the theory of market failure as a foundation for the analysis of the role of the state in East Asia. The main claim of this section is that the theoretical starting point of market failure leads to both the underestimation and overestimation of the role of the state in the development process.

Theoretical stress on market failure ascribes to the role of the state in development a kind of generality, which it does not inherently possess. Many of the conclusions of the critique regarding the state are drawn from the Japanese experience. However, patterns of development in East Asia have been as markedly different as those in Europe: the absurdity of attributing the path of capitalist development of Germany, Italy, and Greece to some presumed common role of the state is more apparent to many than that of doing so for Japan, the Philippines, and Singapore. In contrast, from the perspective of radical political economy, though the state does have an important role to play in capitalist development, that role can be neither the starting point nor the common denominator of the analysis of the development process.[3]

The analysis of Japanese success in development should commence with the material realities of production itself, namely the characteristics of the labour process (above all, how work is undertaken in Japan) including the availability of technology. In this respect, the main features of the labour market and the

[3]One remarkable aspect of the emphasis of the critical literature on the role of the state in Japanese development is how different it is from the various analyses offered by Japanese economists. It is probably correct to say that none of the major currents of Japanese economic thinking, Marxist, neoclassical, Keynesian, or otherwise, attributes to the Japanese state a particularly benign role in the country's development. That is not to say that these currents have not been aware of the importance of the state's role. Yet, if the recent literature is correct, one would have expected considerable support for its claims among Japanese economists themselves.

structure of private capital in the country also have to be examined. To start with the material conditions of production is not to argue that growth occurs as more of the factors of production accrue to the country: qualitative transformations are inevitably wrought to the economy when the above elements are combined in the process of social production. Nor is it to imply that the state plays an auxiliary role in the process of development. It is, rather, to recognize that production is the foundation of a society's economic order, partly autonomous from conscious economic interventions by the state and ultimately determinant of the policies, which the state puts in place. In that respect, the critical literature overestimates the role of the state in economic development. On the other hand, however, the state plays a vital role in establishing the broad social conditions that make capitalist production possible, and in that respect, the critical literature underestimates the role of the state.[4] To provide some insight into these complex issues, we shall briefly consider the interaction between the labour process, the structure of private capital, and the state in Japan.

A. The Labour Process

The labour process in post-war Japan has been, and still is, characterized by three fundamental conditions: life-time employment, seniority wages, and company unionism. These conditions do not apply uniformly across the labour force, being more applicable to large companies and less so to small and medium companies, and 'life-time' usually meaning to the age of fifty-five. Nevertheless, and the validity of this point has been once again demonstrated during the deep recession of the 1990's, 'life-time' does mean that companies are reluctant to make workers redundant when a recession materializes.[5] Instead, workers are seconded to smaller companies, overtime is cut, recruitment is reduced, and lower profits caused by higher employment costs are tolerated more than in the US or Britain. The other side of the coin, however, is

[4]In that respect too, there has been an Asian 'miracle', contrary to the claims of Krugman (1994).

[5]Though how peculiar seniority wages and life-time employment are to Japan should be interpreted with care. There are several developed capitalist countries whose practices resemble Japan in this respect, Koike (1988, ch 1, 2).

undoubted loyalty and commitment on the part of the worker, that translates into lower turnover rates of employment, willingness to accept frequent changes of job description and geographical posting despite the heavy personal and family costs involved, and preparedness to undertake substantial amounts of unpaid overtime.[6]

Seniority wages entail the movement of workers up the hierarchy ladder in cohorts determined by age, but do not also imply equality regarding promotion to managerial posts. On the contrary, within each cohort fierce competition takes place among workers for the few higher posts, encouraged by the company. Far from deadening initiative and leading to indifference, Japanese seniority wages appear to promote incessant contests among workers.

Company unionism, finally, though a somewhat unfortunate term since it has misleading overtones of open collaboration with management, corruption, and coercion, is a further important plank of the labour process. It secures relative peace in times of recession-induced rationalization, it generally results at wage increases below productivity rises, and it constantly works with management to defuse problems before these reach critical dimensions.

The development of this system is related to the scarcity of specialized labour in the immediate post-war conditions, since firms derive benefits from locking-in labour skills while offering relative security of employment. The peculiarities of the Japanese labour process could deliver flexibility of work practices despite their apparent rigidity, thus allowing corporations to meet the requirements of changing demand and to intensify work in order to achieve higher productivity. It also made it possible for corporations rapidly and smoothly to introduce new technologies from abroad, a key feature of the high growth period of the 1950s. Equally, the system came into being in conditions characterized by an abundance of unskilled labour-power: roughly 50% of the Japanese workforce lived on the land in 1950 compared to less than 6% at present. More than ten million workers moved into the major urban centres in the 1960s. While Japanese employment practices enabled companies to train and hold on to skilled personnel, rapid growth rested on the availability of cheap labour-power, (Itoh 1990, ch 6).

[6]The classic discussion of this process in English is Dore (1986).

B. The Structure of Private Capital

Japanese capital, as is well-known, is characterized by a strongly oligopolistic structure, based on the so-called 'keiretsu'. These conglomerates, often containing a bank and a general trading company, usually include significant numbers of relatively autonomous companies bound together through interlocking shareholding as well as a myriad of other trading, financial, employment, and simply informational links. The connections extend to large numbers of smaller companies, which might not necessarily belong to the keiretsu but expect to do long-term business with some of its companies. Even the hundreds of thousands of small and medium firms that do not belong to a keiretsu adopt trading practices among them that are often reminiscent of the long-term practices of keiretsu-related firms. Yet, the firms of the keiretsu are also locked in competition with each other in the domestic market, and with foreign firms in the international markets. In the domestic market, size and market share rather than profitability appears to be the prevalent criterion. Companies meticulously monitor the pecking order of firms in each industry, and steps are continuously taken to prevent demotion.

The implication of the existence of long-term relations among firms is that larger firms can often dictate terms to their suppliers about delivery times and methods of payment. This is ultimately the foundation of the well-known 'just-in-time' system, whereby firms keep low inventories relying on the prompt delivery of supplies at specified times. As long as the relationships among firms are stable and extensive, the leading firm saves the costs of inventories and the suppliers expect to do steady business. During recession-induced restructuring the smaller firms of the keiretsu also act as convenient posting places for the redundant workers of the larger firms, allowing the latter to reduce their labour costs without firing workers. Japanese industry, moreover, and particulaly the keiretsu, have a special relationship with the banks and the credit system generally that has important implications for their ability to invest in plant and equipment as well as undergo recession-induced restructuring.

These structural ingredients of Japan's success in the post-war period are not directly creations of the state, and they critically influence what the state can do. It is important also to remember that rapid growth took place in the context of the remarkable post-war growth of world trade. Japan has not been immune to the changed conditions of capitalist accumulation in the post-1973 world, its rates of growth have become progressively lower and a profound crisis of accumulation has materialized in the 1990s.[7] If one does not start with the material conditions of production (supplemented with the characteristics credit system, as will be done below) but instead with the role of the state in assuaging market failure, it is very hard to analyze the slow-down of the Japanese economy and stagnation during the 1990s.

C. The Japanese State

The post-war Japanese state has played a significant role in broadly shaping the above conditions. As far as the labour process is concerned, company unionism was firmly established only after the purge of the communists at the beginning of the Cold War, the intense strike activity of the early 1960s, and the general unrest of the early 1970s. The state lend vital support to the management of large corporations during the main bouts of industrial struggle, but also brokered the compromises between unions and employers which gradually led to the emergence of Japanese employment practices (Kawanishi 1992). The state also underwrote and tacitly guaranteed life-time employment for workers in large firms, significantly contributing to the atmosphere of relative employment security that still characterizes Japan.

The state also allowed the post-war structure of Japanese private capital to materialize. The US Occupation Authority had considerable success in dissolving the pre-war zaibatsu, the oligopolistic concentrations of capital, which dominated the Japanese economy during the first half of this century and supported Japanese militarism. However, soon after the end of the Occupation, the Japanese state gave its assent and actively promoted the construction of the keiretsu that presently dominate Japanese industry and economy. In subsequent years, the Japanese state has also pro-

[7]There appears to be a structural break in the development of Japanese capitalism in the mid-1970s that has given rise to a variety of theories among radical political economists. An influential view is that Japan has entered a 'post-Fordist' period of accumulation (Kenny and Florida 1988; Kato and Steven 1993; Peck and Miyamachi 1994)

moted the emergence of outright cartels in several industries, particularly recession cartels, and has acted as arbiter of disputes regarding the pecking order of firms within industries.

It is also important to remember that the Japanese state has been rather small in terms of its claim on the annual flow of output, certainly when compared to several European and even the US state (Minami 1986, ch 10). Low unemployment, the comparative smallness of welfare provision in health and education, and the official restriction of military spending to less than 1% of GNP, have kept the state quite small for most of the post-war period. It is only in recent years, with the explosion of Keynesian demand management aiming at ameliorating the worst of the recessions of the 1970s, 1980s, and 1990s, that the state's claim onto annual output has grown considerably and its finances are facing a crisis (Itoh 1990, ch 8).

The point is, however, that in all these respects there is nothing qualitatively different between the Japanese state and other developed capitalist states. Historically, the capitalist state has always been closely involved with the construction of the essential conditions for capitalist accumulation, particularly those pertaining to the constitution of the labour process and the structure of industry. Labour laws, interventions in strikes and other activities, the regulation of competition and the formation of monopolies and oligopolies, have characterized the US state, the British state, the German state, and so on. We should not allow the historical peculiarities and the specificity of the interventions by each of these states to obscure the essential similarity of their role. There is little historical foundation for the belief that the conditions for capitalist production emerge naturally and spontaneously. Rather, the state plays a necessary role in creating and maintaining these conditions.

To approach the above on the basis of the theory of market failure is to fall prey to the inherent naturalism of mainstream economics: the state interferes with the operations of the capitalist economy only when markets cannot perform their normal role of allocating resources and maximizing efficiency for reasons which are specific to particular circumstances. Yet, interventions in the field of capital-labour relations, allowing the re-establishment of keiretsu, and minimizing the costs of welfare provision, are essentially political and social interventions, which allow markets to be established. These activities evidently have a profound economic content that cannot be captured by market failure.

At the same time, the interventions of the Japanese state are decisively circumscribed by the conditions of capitalist accumulation that it has itself helped to establish. The Japanese state, as already mentioned, plays an active role the industry-level and economy-level councils at which the strategic direction of particular Japanese industries in the world market is discussed and broadly decided upon, and in which the pecking order of corporations in the domestic market is monitored. Yet the state cannot exercise despotic control over these councils, and at critical moments in the past it has had to relent to pressure from the corporations themselves. One of the most celebrated instances of this was the failed attempt by the Ministry of Traded and Industry to rationalize the motor industry and to promote petrochemicals in the 1960s. Thus, the relationship between Japanese private capital and its state is fraught with disagreement, conflict, and dissent. The existence of keiretsu, which liaise with each other at regular intervals, sets limits to the development policies the state bureaucracy might wish to adopt. Market failure does not help analyze the opposition put up by the capitals that bear the brunt of the development policies of the state, particularly if some of these capitals stand to gain in the longer run.

Analogously, the guarantee of life-time employment and absence of mass unemployment, implicit to the arrangements of the labour process outlined above, severely circumscribe the policy options of the state when industrial rationalization is at issue. Recessions, or plain declines in world demand for particular products, that in principle require plant closure and firing of workers, generate enormous pressure on the Japanese state because it has less freedom than states to advocate 'normal' rationalization measures. That is one important factor behind the extraordinary length of the 1990s recession.

Nevertheless, the Japanese state does appear to play a leadership role relative to private capital that is quite different from that, say, of the British and the US states. To understand that peculiarity, however, more is needed that market failure, above all, an appreciation of late development, i.e., the emergence of national capitalism in a world market already dominated by established capitalist economic powers. From the perspective of radical political economy, a late-comer country must rely on the power of the state to marshal and direct its resources in order to succeed in gaining a niche in the world division of labour. After the Meiji restoration of 1868, the Japanese state consciously played this role, supporting the emergence of private capital and, in the early days of capitalist development in Japan, even creating nationalized industries and subsequently transferring them to private individuals. In that profound sense, Japanese capital is the product of the Japanese state.

The institutional structures erected by the Japanese state to guide private capital, comprising ministries, planning agencies, councils, financial corporations, has exhibited considerable stability throughout the present century. The ideology of 'catching-up with the West' further facilitated the disciplining influence exercised by the state on private capital. It is misleading to adopt terms derived from the experience of the US, usually stressing the 'outside', 'intrusive' role of the state relative to capital, in order to analyze the relationship of the Japanese state to Japanese capital. Rather, the Japanese state has naturally led Japanese capital in the struggle to 'catch up'. The successive campaigns of the post-war era, typified by the various plans, indicating the broad aims of economic development in each period and ensuring confidence for private capital, are an instance of this role. The same position of natural leadership enabled the state to control and to organize the allocation of credit and export licenses among private capitals. The framework for the latter was provided by the aims of the national plans and the regular meetings between state and capital representatives in which the pecking order and the performance of companies was scrutinized. Approached in this manner, it is evident that leading role of the Japanese state could not but change as Japan 'caught up' and entered a period of low growth and pronounced accumulation crises. Better to appreciate this change in the role of the state we need to turn briefly to the financial system.

IV. The Financial System and Japanese Development

Finance and the role of the state in the financial system deserve a special place in the analysis of development for a variety of reasons. Several technical aspects of finance are *sine qua non* for capitalist development, including an efficient payments mechanism that also regularly clears commercial debt, an efficient mechanism for the transmission of money domestically and abroad, and the capacity to safeguard and monitor the accumulations of money that inevitably arise in the course of production and trade. Equally important are, first, the regular advance of commercial (or trade) credit to facilitate the sale of output without the immediate intervention of money, thus speeding the turnover of capital, and second, the mobilization of spare money funds for investment.

To a very significant extent, a capitalist economy spontaneously creates a financial system.[8] Firms engaging in commercial activities, particularly with foreign firms, naturally advance commercial credit to each other and create complicated chains of credit relations sustaining production. The same holds for the discounting of commercial credit by the holders of temporarily stagnant funds. The more that commercial credit grows, and the more that spare funds become available among merchants and industrial capitalists, the more scope there is for a banking system that systematically collects spare money across society, transforms it into loanable money capital, and lends it to functioning capitalists. To the degree to which such loanable money capital is also lent among banks, a money market emerges, dominated by the central bank, the bank of banks. In its spontaneously emerging form, a capitalist credit system tends to lend to functioning capitalists for rather short periods and for what is usually called 'working capital'. This is apparent in the practice of bill discounting, or the advance of short-term loans and overdrafts, characteristic of British and US banks. The provision of longer-term capital, on the other hand, particularly that associated with large investment in fixed capital, requires the emergence of a capital market. Loanable money capital can that seek its eventual users directly, avoiding the intermediation of banks. Thus, a characteristic distinction emerges between indirect finance, based on the banks, and direct finance, based on the capital market.

In the context of late development, particularly if the requirements for fixed capital are large, the financial system need not necessarily emerge in its spontaneous form. Insofar as the spare resources of the country need to marshalled and directed to

[8]These issues are more fully discussed in Itoh & Lapavitsas (1998, ch 4).

particular areas of accumulation, it is arguable that the capital market (direct finance) is not the most appropriate institutional mechanism for doing so. Its inherent freedom in allocating capital might result in funds being directed to areas with low social returns; the emphasis on dividends to satisfy shareholders might not allow for patience with low returns during an initial period of learning and experimenting with new industrial processes (Stiglitz 1985). The possibility of speculative booms in share prices, often fed by credit, might also militate against the suitability of direct finance for development.

In practice, late developers, though they have often made room for a capital market, tend to satisfy the financial needs of accumulation through the banking system. The Japanese financial system could be characterized as bank-based from its inception, though the expression should be understood broadly. In the post-war period, finance was structured to provide long-term funds to industry, partly through specialized long-term institutions and partly through commercial banks. The key mechanism in ensuring this was privileged access to long-term debentures for some institutions, granted by the state (Nihon Ginko Kinyukenkyujo 1996, ch 5). However, judging by comparative evidence from other financial systems, the Japanese system does not particularly stand out among others in terms of sources of funds for industry. The implication is that it is difficult to categorize it as bank-based purely on that basis (Corbett and Jenkinson 1996). Equally important in this respect is the close, non-market, connection between banks and private industry, underpinned by interlocking shareholdings that are typically not traded. Firms, large, medium sized, and sometimes small, tend to have a 'main bank' which, though it might not necessarily be the only lender, is the bank that will stand by the firm if a recession materializes. This amounts to tolerating the non-payment of interest, advancing fresh credits, dispatching personnel to offer advise on restructuring, and bending the ear of customers and suppliers. When the firm recovers, the bank recoups its costs and probably makes extra profits.[9] The presence of a 'main bank' appears to have made a significant difference to the ability of Japanese firms to invest and take risks.

[9]An issue thoroughly examined in Aoki & Patrick (1994). See also Horiuchi and Yoshino, eds. (1992)

The state has played an important role in shaping the post-war financial system of Japan. The Ministry of Finance (MoF) has exercised tight prudential control over banks, relying on controls over the award of banking licenses and permits for opening new branches. It has offered to banks an implicit guarantee against bankruptcy throughout this period and regulated the domestic pecking order among banks. Much of the financial power of the MoF comes from its control over a substantial part of the funds of the Postal Savings System (PSS). The Bank of Japan (BoJ), on the other hand, has also exercised a strong prudential influence over the banks for much of the post-war period through its 'window guidance', i.e., the rather direct encouragement to lend (or not) for particular purposes. Not least of the BoJ's activities during the high growth period has been the practice of 'overloan', i.e., encouraging the banks to lend for industrial investment beyond the point commercially justified by their liabilities and reserves. The BoJ regularly made good the shortfall by advancing its own soft loans to banks.

The Japanese financial system, during much of the post-war period, has also been characterized by state controls in the form of financial 'repression'. Controls took three forms: first, low interest rates to promote industrial investment, second, rigid functional specialization among institutions (commercial banks engaged in industrial lending, long-term banks in longer-term lending, trust banks in long-term deposit taking, agricultural banks in lending to farmers, and so on), and third, effective isolation of the financial system from the international markets through foreign exchange controls. In this context, the activities of the banks were tightly circumscribed, their profit margins were thin as interest rates were controlled, and risk was substantially reduced. As a result banks tended to compete primarily through the expansion of market share, though even that was closely monitored by the authorities.

It is important to separate the 'repression' controls from the underlying structure of the financial system in order to understand the changes that have taken place in Japanese finance since the mid-1970s. Three factors led to the demise of 'repression' and to the profound transformation of Japanese finance, two of which are domestic.[10] First, the company sector found itself in possession of

[10]The structural transformation of Japanese finance is discussed in detail

increasingly substantial financial surpluses that encouraged coporations to by-pass banks and deal directly in the capital market, in their early form typified by the gensaki market. Second, the government emerged as a substantial borrower (in its attempt to avert the recession of the mid-1970s). In order to ensure the absorption of the enormously enlarged issues of bonds at acceptable prices, the authorities had to concede to banks the creation of a relatively freely operating secondary bond market. Finally, political pressure from abroad and the increasing tendency of Japanese financial institutions to compete internationally, led to the abolition of foreign exchange controls in 1980. The combined effect of these factors was completely to undermine 'repression' leading to substantial financial liberalization throughout the 1980s.

The story of the Japanese financial 'bubble' of the late 1980s, focusing on real estate and the capital market, is well-known and does not need retelling here. One point worth stressing, however, is that the 'bubble' was partly the result of liberalization as banks found themselves confronted by declining profitability (liberalized deposit rates having risen) and increasingly blurred demarcation lines of their activities. Banks wholeheartedly engaged in speculative practices, including even the Industrial Bank of Japan, usually mentioned as a pillar of respectability and a signal-giver to others. What is equally important for our purposes is that the changes occurring in the late 1970s and the 1980s seemed to indicate a shift in the underlying structure of the financial system toward a capital-market-based entity. In a paradoxical way, the stock exchange rose in importance in the Japanese economy because of the very factor that strongly characterizes the financial system as bank-based, namely interlocking shareholding. The shares held mutually as tokens of the long-term relationship between banks and corporations, which are typically not traded, provide the banks with hidden reserves: as long as stock prices were rising in the 1980s, strengthening reserves allowed the banks to continue feeding the bubble; falling stock prices in the 1990s, on the other hand, weaken the banks' reserves and prevent them from dealing with their bad debts as effectively as they might have done. The overall health of Japanese finance depends on a stock exchange in which less than half of the listed equity is actually traded.

in, Lapavitsas (1997).

Two aspects of these complex phenomena are important for the issue of state activism in economic development, and lend support to the general thesis of this article, namely that the economic interventions of the state have their limits set by the spontaneous evolution of the underlying economic relations. First, the Japanese financial system, while retaining several of its external forms, such as the distinction between City banks and Regional banks, is very different from the system that financed the rapid growth of the country. This change is best indicated by two phenomena: on the one hand, interest rates are largely set in free markets and, on the other, the functional specialization of institutions has become increasingly blurred, rendering the distinction between long-term and short-term finance devoid of much of its content. 'Marketization' began to characterize Japanese finance already from the early 1980s (Tachi and Royama 1986). That is not to say that the Japanese financial system has ceased to be bank-based and has become market-based. One remarkable feature of the protracted crisis of the 1990s is how little it seems to have affected the 'relational' aspect of Japanese banking: there is little evidence that the 'main bank' relationship is unravelling. It is to say, however, that a system that began life as a compact mechanism for the channelling of loanable funds to investment via intermediaries has spontaneously created room within itself for the direct lending of funds. That is also the deeper cause of the systemic crisis of Japanese finance in the 1990s. The critical literature discussed here began to extol the virtues of the Japanese financial system at the time when that system underwent profound change.

Second, the character of state interventions in the 'marketized' financial system has itself altered dramatically. The days of tight interest rate controls, of credit subsidies, of direction of credit through legislation or administrative guidance, and of guaranteeing a small but stable profitability for banks (hence encouraging them to go for market share) are irretrievably gone. Even the character of prudential regulation appears to be changing, turning from control of bank activities and rankings through regular meetings into a more formal regulation of risk. The Japanese state appears to have assumed the mantle of providing a 'safety net' for financial institutions and markets in the new conditions, relying on the relatively new Deposit Insurance Corporation at least as much as it does on the Ministry of Finance and the Bank of Japan.[11] Correspondingly, the activities of both the latter have began to change: the Ministry of Finance is due to devolve some of its supervisory role and the Bank of Japan, relying much more in open market operations than before, is due to acquire greater independence and concentrate on control of inflation.

In this respect too, the manner in which the crisis of the 1990s has been handled by the state indicates both the state's new role and the broader limits within which the state operates in the realm of finance. Unable to foster the rapid deflation of bad debts because of its commitment to low unemployment, implicit in the labour process arrangements, the Japanese state has adopted a piecemeal approach, dealing with the worst cases while hoping that aggregate demand expansion would lessen the magnitude of the problem as a whole. Given the transformation of finance, however, the state could countenance the bankruptcy of large financial institutions by 1997, a step unthinkable in the years of rapid growth. The Japanese state now appears to be treating financial institutions in a manner similar to other capitalist firms. It concerns itself primarily with maintaining orderly conditions in the financial markets and among banks.

V. Conclusion

The motivation for this paper was provided by the critique of mainstream economics that rests on the East Asian development experience and utilizes the literature on market failure and asymmetric information. It is claimed here that, welcomes as it is, this critique does not approach the relationship between industry, finance, and the state in an appropriate analytical manner because of the theoretical foundations provided by market failure. On the one hand, it underestimates the role of the state because it does not analyse the state's influence on the social and political relations necessary for economic development. On the other hand, it overestimates the role of the state because it does not discuss the manner in which the underlying structures of the economy characterize the economic interventions of the state.

(Received August, 1997; Revised December, 1997)

[11]An account of some of these changes can be found in Itoh(1995, ch 6)

References

Amsden, A. *Asia's Next Giant.* New York: Oxford University Press, 1989.

Aoki, M. *Information, Incentives, and Bargaining in the Japanese Economy.* Cambridge: Cambridge University Press, 1988.

_________, and Patrick, H. (eds.). *The Japanese Main Bank System.* New York: Oxford University Press, 1994.

_________, Kim, Hyung-Ki, and Okuno-Fujiwara, M. (eds.). *The Role of Government in East Asian Economic Development: A Comparative Institutional Analysis.* Oxford: Clarendon Press, 1997.

Corbett, J. and Jenkinson, T. "The Financing of Industry, 1970-1989: An International Comparison." *Journal of the Japanese and International Economies* 10 (No. 1 1996).

Dore, R. *Flexible Rigidities.* London: The Athlone Press, 1986.

Greenwald, B., and Stiglitz, J. "Externalities in Economies with Imperfect Information and Incomplete Markets." *Quarterly Journal of Economics* 101 (May 1986).

Horiuchi, A., and Yoshino, N. (eds.). *Gendai Nihon no Kinyu Bunseki.* Tokyo: Daigaku Shuppansha, 1992.

Itoh, M. *The World Economic Crisis and Japanese Capitalism.* London: Macmillan, 1990.

_________, and Lapavitsas, C. *Political Economy of Money and Finance.* London: Macmillan, 1998.

Itoh, O. *Nihongatakinyu no Rekishiteki Kozo.* Tokyo: Daigaku Shuppansha, 1995.

Johnson Chalmers, H. *MITI and the Japanese Miracle.* Palo Alto: Stanford University Press, 1982.

Kato T., and Steven, R. "Is Japanese Capitalism Post-Fordist?" In *Is Japanese Management Post-Fordism.* Kato and Steven (eds.), Tokyo: Mado-sha, 1993.

Kawanishi, H. *Enterprise Unionism in Japan.* London and New York: Kegan Paul International, 1992.

Kenny, M., and Florida, R. "Beyond Mass Production: Production and the Labour Process in Japan." *Politics and Society* 16 (No. 1 1988).

Koike, K. *Understanding Industrial Relations in Modern Japan.* London: Macmillan, 1988.

Krugman, P. "The Myth of Asia's miracle." *Foreign Affairs* 73 (No. 6

1994)

Lapavitsas, C. "Transition and Crisis in the Japanese Financial System: An Analytical Overview." *Capital and Class* 62 (1997).

Minami, R. *The Economic Development of Japan.* London: Macmillan, 1986.

Nihon Ginko Kenkyujo. *Wagakuni no Kinyu Seido. Tokyo,* 1986.

Okimoto, D. *Between MITI and the Market.* Palo Alto: Stanford University Press, 1989.

Peck, J., and Miyamachi, Y. "Regulating Japan? Regulation Theory versus the Japanese Experience." *Environment and Planning D: Society and Space* 12 (1994).

Stiglitz, J. "Credit Markets and Control of Capital." *Journal of Money, Banking, and Credit* 17 (No. 1 1985).

________. "Technological Change, Sunk Costs, and Competition." In Martin Neil Bailey and Clifford Winston (eds.), *Brookings Papers on Economic Activity* 3. Washington, DC: Brookings, 1988.

________. "Some Lessons from the East Asian Miracle." *World Bank Observer* 11 (No 2 1996).

Stiglitz, J., and Uy, M. "Financial Markets, Public Policy, and the East Asian Miracle." *World Bank Observer* 11 (No 2 1996).

Tachi, Y., and Royama, S. *Nihon no Kinyu Atarashii Mikata.* Tokyo: Daigaku Shuppansha, 1987

Wade, R. *Governing the Market: Economic Theory and the Role of the Government in East Asian Industrialization.* Princeton: Princeton University Press, 1990.

________. "Japan, the World Bank, and the Art of Paradigm Maintenance: The East Asian Miracle in Political Perspective." *New Left Review* No. 217 (May/June 1996).

Teranishi, J. "Market failures and Government Failures: A Conceptual Framework and Japan's Experience." Background paper for the conference on 'Market and Government: Foes or Friends?', Institute of Economic Research, Hitotsubashi University, February 1996.

World Bank. *The East Asian Miracle: Economic Growth and Public Policy.* New York: Oxford University Press, 1993.