THE END OF DIVERSITY?

PROSPECTS FOR GERMAN AND JAPANESE CAPITALISM

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The Re-Organization of Organized Capitalism: How the German and Japanese Models Are Shaping Their Own Transformations

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The German and Japanese models of capitalism are fundamentally transforming, yet they are neither collapsing nor converging to the liberal market model. Rather, they are "re-organizing," charting distinctive paths of adaptation. But which analytical perspective is most useful in describing and explaining the trajectory of institutional change? In this chapter, I contend that the best way to understand the transformation of German and Japanese capitalism is to focus on the preexisting institutions of the models themselves because these institutions powerfully condition patterns of change. I develop a simple model of institutional change and apply it to changes in two core components of the German and Japanese models: labor relations and financial systems.

The German and Japanese Models

For present purposes, I define the German and Japanese models as constellations of institutions (including political institutions, intermediate associations, financial systems, labor relations systems, and interfirm networks) linked together into distinct national systems of economic

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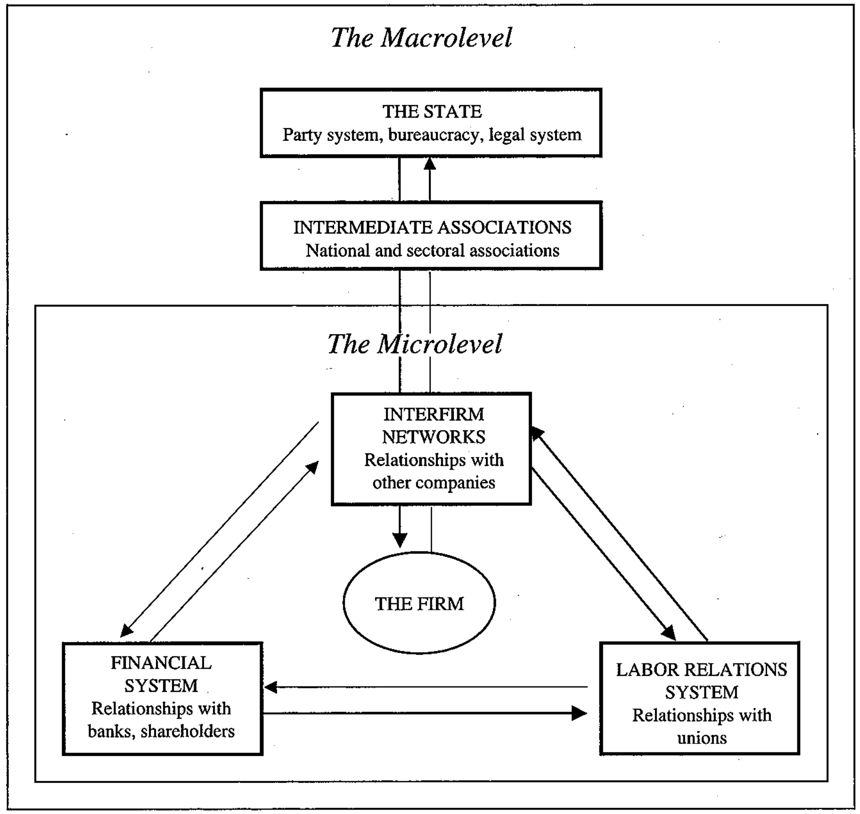

Figure 10.1 Simple Model of an Organized Market Economy

governance (see figure 10.1). Organized market economies (OMEs) such as Germany and Japan differ from liberal market economies (LMEs) in that they foster more long-term cooperative relationships between firms and labor, between firms and banks, and between different firms. And the state and intermediary associations play a critical role in establishing and maintaining the framework for this private-sector coordination. Although there is considerable variation across sectors and across firms within individual countries, OMEs remain sufficiently different from LMEs to make this a useful distinction. These governance structures affect everything from corporate strategy to public policy and economic performance (e.g., Albert 1993; Hollingsworth, Schmitter, and Streeck 1994; Kitschelt et al. 1999; Porter 1996).

The German and Japanese variants of the OME model also differ from one another. German firms, banks, and unions are more inclined to coordinate their activities at the sectoral level, whereas their Japanese counterparts coordinate through intersectoral groups (Soskice 1999, 106). Japan has denser interfirm networks, including horizontal industrial groups as well as supply and distribution chains. The German government merely facilitates private-sector coordination, whereas the Japanese government organizes and guides the private sector more directly. The German government has codified its economic model into law, whereas the Japanese model relies more on informal norms and standard practices.

The German and Japanese labor relations systems combine broad agreements on wage moderation in exchange for employment security with firm-level pacts that promote labor-management cooperation. In Germany, sectoral employer associations and unions negotiate collective bargains on wages and benefits. In Japan, a few leading firms negotiate settlements with their enterprise-based unions during the annual spring wage offensive (*shuntō*), and other firms then follow within a fairly narrow range of the leaders. These labor relations systems can benefit both sides: employers win moderation in wage demands, workers gain employment security, and both benefit from fewer labor disputes. In addition, firms avoid competing in wages or undermining labor-management cooperation through contentious negotiations at the firm level.

Both systems also feature systematic labor representation in the management process. German firms are legally required to represent labor through a system of codetermination, whereas Japanese companies typically incorporate labor despite the lack of a legal requirement to do so. Labor participation at the firm and plant level facilitates labor-management cooperation on the shop floor, a critical element in German and Japanese firms' ability to continuously raise productivity. Long-term cooperative relations between labor and management also give firms the incentive to invest in human resources. German firms typically do this through a distinctive dual (firm and school) vocational training system, whereas Japanese firms train their workers directly. In the political realm, German employer associations and unions are both represented in most important decision-making bodies, whereas Japanese business enjoys better access than labor to central ministries and the ruling party.

Germany and Japan both have credit-based financial systems in which banks have dominated the long-term financing of industry. The Japanese government has actively directed the allocation of credit through government financial institutions and private banks, whereas the German government has left the banks with greater freedom. In both countries, however, firms have developed long-term relationships with their primary banks, known as *Hausbanken* in Germany and main banks in Japan. The banks monitor firm performance and aid firms in distress. The firms, in turn, remain loyal clients—they conduct a large and stable share of their borrowing and transaction business with their lead bank. German banks exercise influence over industrial firms through ownership stakes, proxy votes, and direct representation on company boards, whereas Japanese banks are restricted to 5 percent ownership and rely more on industrial group ties and informal channels of influence.

The Forces for Change

Before we look at how Germany and Japan are responding to their respective predicaments, let us briefly review the common forces driving change in the two systems. First, the increase in trade and capital flows between nations is breaking down the relative insulation of the German and Japanese markets.[1] Manufacturers and financial institutions are less dependent on exclusive relationships with domestic business partners, because they can pursue other opportunities in international markets. Domestic markets are increasingly infiltrated by foreign companies that do not behave according to local norms, and domestic companies are exposed to new patterns of behavior as they move abroad. The growing mobility of capital and corporate activity not only undermines the ability of national authorities to control corporate behavior, but encourages the governments to reform regulations so as to prevent capital or corporate flight. Capital mobility also directly affects labor relations because it means firms can exit from long-term relations with labor partners by shifting to foreign suppliers or moving production abroad, whereas labor lacks a comparable exit option. Meanwhile, financial disintermediation disrupts bank-industry relations because firms rely less on their banks as they shift from borrowing to equity finance.

Second, the U.S. government, other national governments, and international organizations such as the World Trade Organization (WTO) and the European Union (EU) are promoting further market liberalization and regulatory harmonization. Third, both countries have experienced a long-term appreciation of their currencies, especially in the late 1980s and early 1990s, increasing pressure on corporations to cut costs to compete in international markets. Fourth, technological change and related marketplace developments are forcing German and Japanese ministries, associations, and companies to adapt. New products and production techniques have emerged that do not play to traditional German or Japanese strengths, and the growing importance of the service sector challenges countries such as Germany and Japan that have their primary strength in manufacturing (see the essay by Kozo Yamamura in this volume). Com-

1. For evidence of internationalization, see Milner and Keohane (1996).

pounded with internationalization, technological change increases the costs of dualistic economic systems, in which a highly competitive export sector, primarily in manufacturing, is combined with an uncompetitive sheltered sector, primarily in services.

Finally, Germany and Japan have experienced a decline in economic performance, with slower growth, declining export competitiveness, and high (in Germany) and rising (in Japan) unemployment. This has generated enormous political pressure for economic reform. In particular, slow economic growth and government budget constraints have encouraged political leaders to promote deregulation, privatization, and other reforms that promise to improve economic performance without increasing spending (Vogel 1996, 39–41).

Germany and Japan also face pressures unique to their particular circumstances. Germany has confronted the daunting challenge of reunification with the former East Germany, which not only strains the country's financial resources but also entails the incorporation of a region with a completely different institutional legacy. Germany must cope with integration into the EU, which mandates market liberalization and regulatory harmonization and imposes stiff requirements for fiscal policy. Japan faces greater political change, with the end of Liberal Democratic Party (LDP) hegemony, the introduction of a new electoral system, and the ongoing realignment of political parties. And Japan suffers a far more serious economic crisis, with a prolonged recession and a full-fledged financial crisis.

Understanding Institutional Change

The various schools of new institutionalism have been more successful in explaining why institutions persist than how they change. The new institutional economics (NIE) stresses the equilibrium nature of governance systems, the new institutionalism in sociology identifies normative and cognitive constraints on change, and the historical institutionalism in political science highlights path dependency. Nevertheless, some work offers insights into the process of institutional change as well (e.g., Boyer and Hollingsworth 1997; Knight 1992; North 1990). Here I outline one perspective on institutional change and apply it to Germany and Japan. Toward the end of the chapter, I suggest how it might be refined by incorporating further insights from political science and sociology (see Hall and Taylor 1996, especially 938–42, on calculus versus cultural approaches).

Incentives and Constraints

Building on the new institutional economics and the varieties of capitalism literature, let us view the German and Japanese (hereafter G-J) models of capitalism as systems of incentives and constraints (Aoki 1988; North 1990; Soskice 1999; Williamson 1985). That is, actors within these systems (firms, banks, and unions) use institutions such as the *Hausbank* (main bank) system, collective bargaining, and interfirm networks to reduce transaction costs. They then incorporate these institutions into their cost-benefit calculus as they adapt to new circumstances. Corporations will only abandon their stable partners, such as unions, banks, or other corporations, when the efficiency gains from doing so outweigh the cost of forgoing future benefits from cooperation with these partners. And in most cases, the marginal increase in efficiency will not justify the large fixed cost of exit from these relationships. This perspective not only helps to explain why the G-J models are slow to change, but it also helps to explain when and how they do change.

This model assumes for now that firms make rational cost-benefit calculations about corporate adjustments or their positions on government reform policies, but it incorporates insights from work in institutional economics to provide a broader and more realistic picture of this calculus. We could describe this in terms of broadening circles of rationality. In the first circle, a manager simply calculates the estimated costs of financing with the firm's main bank versus the costs with a competing financial institution. If the competitor is less costly, he abandons the main bank. In the second circle, however, he weighs the potential cost savings from switching against damage to the long-term cooperative relationship with the main bank, including preferential services and the insurance the bank provides in the form of a commitment to assist the firm in a crisis. And in the third circle, he further broadens the calculus to include possible costs beyond the main-bank relationship, such as damage to the firm's reputation or strains in relationships with workers, other business partners, intermediary associations, or the government. As the circle of rationality expands, the chances that a firm will exit from relationships diminishes. Because G-J firms rely so heavily on long-term relations with workers, banks, and other firms to maximize their performance, they are almost certain to broaden their calculus beyond the first circle and quite likely beyond the second.

In this view, institutional change occurs when an exogenous shock pushes actors to reassess the balance between the costs and benefits of the status quo.[2] Institutional change is a function of the level of the shock and

2. North (1990) describes this in terms of a shift in relative prices or preferences.

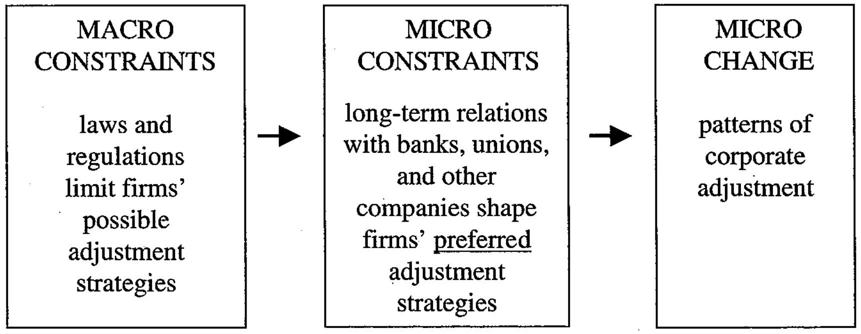

Figure 10.2 Microlevel: Factors Shaping Patterns of Corporate Adjustment

the incentives and constraints built into the existing system. This means that even when the shock is big enough to impose change, preexisting institutions still shape the substance of change. For our purposes, the forces for change make up the exogenous shock and the G-J models themselves constitute the incentives and constraints that shape the response to this shock.

In practice, the task of analyzing institutional change is made all the more difficult because it operates simultaneously at many different levels of a given political-economic system. That is, German and Japanese firms are renegotiating agreements with their workers, banks, and business partners; industry associations and union federations are reorganizing and redefining their missions; and the governments are revising regulatory procedures and passing reform legislation—all at the same time. To make the situation even more complex, adjustments at one level have ramifications for further adjustments at other levels. In order to make sense of this analytically, I simplify the picture somewhat and focus on adjustments at two levels: the firm and the government.

The Microlevel: Corporate Adjustment

At the firm (micro)level, the forces for change translate primarily into increased pressure to cut costs. But as G-J firms strive to cut costs, they are constrained from laying off workers, abandoning their main banks, and cutting off stable suppliers by the logic of the G-J models themselves (see figure 10.2 and table 10.1). Their options for adjustment are limited by legal and regulatory constraints, such as laws governing the dismissal of workers. Moreover, their preferred strategies for adjustment within these legal constraints are shaped by their preexisting relations with workers, banks, and other firms. That is, they are situated within a network of long-term

Table 10.1 How German and Japanese Models Shape Their Own Transformations

	Characteristics	Outcomes
Microlevel (corporate adjustment)	Firms are constrained by long-term relationships with workers, banks, other firms	Firms strive to adapt within the existing institutional structure
	Firms are constrained by their own internal governance structures	Firms try to leverage the advantages of existing institutions
Macrolevel (policy reform)	Industry demands for liberal reform are modified by internal governance structures and long-term relationships with workers, banks, other firms	Governments promote liberal reforms cautiously, consulting and often compensating groups opposed to reform
	Industry associations and political parties aggregate demands in a manner that further modifies pressure for liberal reform	Governments design reforms to preserve valued institutions
Micro-macro interaction	Corporate adjustments alter firm preferences regarding further policy reform	
	Policy reforms facilitate or constrain further corporate adjustments	

relationships with these partners from which they benefit, so when they face new challenges they are likely to go to considerable lengths to adjust without abandoning these partners. They are likely to renegotiate with these partners (to exercise voice) rather than to break with them (exit), and they are likely to leverage the benefits of these long-term relationships and perhaps even reinforce these ties in order to ride out their problems (Hirschman 1970). In short, G-J firms respond to new challenges neither by clinging to the status quo nor by converging to Anglo-American practices but rather by charting their own distinctive patterns of adjustment.

The Macrolevel: Policy Reform

At the national (macro)level, the G-J governments are also constrained from moving toward the liberal market model (figure 10.3). Just as firms' preferred business strategies reflect the incentives and constraints of the G-J models, so do their preferences on policy reform. I build here on the basic insight of the historical institutionalist school that suggests that institutions shape actors' preferences (Steinmo, Thelen, and Longstreth 1992; see also Hall 1999; Pierson 2000). In this case, I contend that there is a micro logic to macro preferences—industry policy preferences reflect the institutions of German and Japanese capitalism, such as labor relations and financial systems. Many firms derive comparative institutional

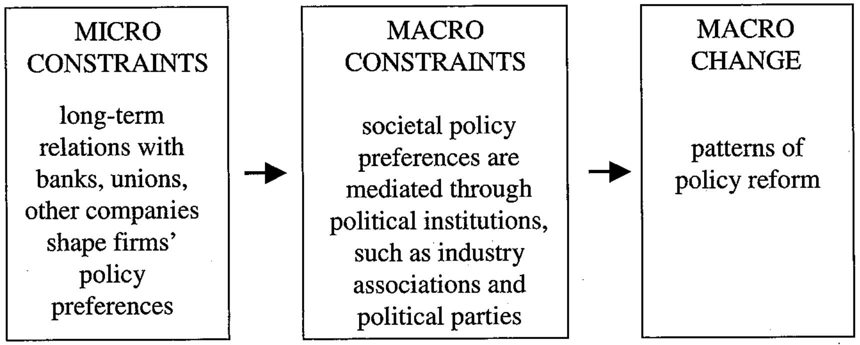

Figure 10.3 Macrolevel: Factors Shaping Patterns of Policy Reform

advantage from these institutions, so they have to weigh the expected efficiency gains from policy reforms against the possible costs of undermining these institutions (Soskice 1999).

Jeffrey Frieden and Ronald Rogowski (1996) offer a useful model for deducing societal preferences regarding liberal economic reform, focusing especially on sectoral cleavages. According to standard economic analysis, economic liberalization should reduce prices and expand choices for consumers, lower costs for producers, and boost economic growth. It not only improves efficiency in the short run, but also can bring more dynamic long-term benefits by stimulating business activity and innovation. Protection has both a distributive cost, in that it punishes consumers in favor of producers, and a social welfare cost, in that it distorts the allocation of resources within the economy. The higher the level of protection and regulation, the greater the potential benefits from reform. Frieden and Rogowski suggest that internationalization should intensify domestic groups' preference for liberalization. They focus primarily on the liberalization of international trade and financial transactions, but they note that the argument applies to domestic structural barriers as well. As international trade and capital flows expand, the gap between domestic prices of protected goods and world market prices widens, meaning that the welfare costs of protection (and hence the potential benefits of liberalization) increase. Moreover, they hypothesize that internationalization should increase conflict among sectors, specifically among those relatively competitive on world markets, which favor liberalization, and those relatively uncompetitive, which demand protection. They expect internationalization to strengthen the hand of those groups favoring liberalization at the expense of those opposing it.

In contrast, I argue that in Germany and Japan even the competitive sectors do not fully support liberal reform. The institutional context of

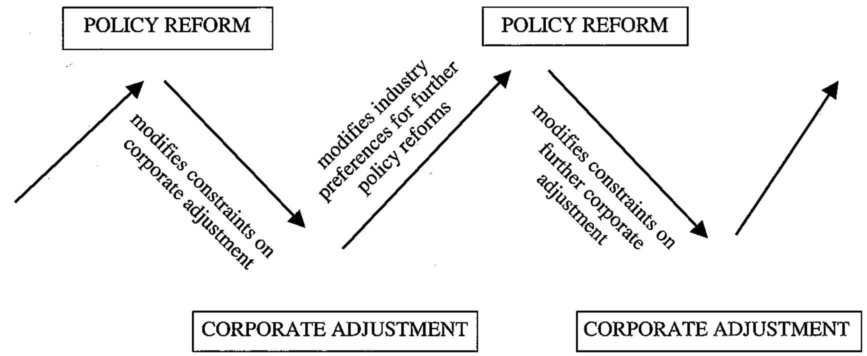

Figure 10.4 Micro-Macro Interaction

German and Japanese capitalism modifies industry preferences—fewer firms advocate reform than we would otherwise expect, and those firms that do advocate it are more ambivalent than we would otherwise expect. Moreover, these preferences are aggregated in the political (macrolevel) arena in a manner that further moderates demands for liberal reform. The major industry associations and political parties represent both the advocates and opponents of reform, so they are not likely to push for the all-out victory of one side but, rather, to arrange delicate compromises between the two. And if anything, they tend to favor the potential losers from liberal reform. As a result, when contemplating liberalization, German and Japanese government leaders are likely to move cautiously; to package delicate compromises, including considerable compensation for those who might be disadvantaged by the reforms; and to design reform to preserve the core institutions of the G-J models as much as possible (Vogel 2001).

Micro-Macro Interaction

Thus the G-J models themselves generate relatively predictable patterns of corporate adjustment and government reform. But the actual trajectory of change over the longer term is complicated by the fact that the two levels interact. As governments enact policy reforms, these reforms create new opportunities and constraints for further corporate adjustment. And as firms adjust to new challenges, these adjustments may modify the firms' policy preferences and thereby affect future policy reforms (figure 10.4).

Patterns of Corporate Adjustment

Let us now turn to examples from developments in labor relations and finance to illustrate how our model might play out: how preexisting institutions shape corporate adjustment, how preexisting institutions shape policy reform, and how corporate adjustment and policy reform interact.

Labor Relations

German and Japanese firms have responded to increased pressure to cut costs in remarkably predictable ways given the enormous diversity across sectors and companies in the two countries. Unlike their U.S. and British counterparts, they make considerable efforts to reduce costs without laying off workers. German and Japanese firms accomplish this in somewhat different ways, however, reflecting the institutional differences between the two countries.

As previously noted, when a German or Japanese firm considers laying off workers, it does not simply weigh the benefit of reducing operating expenses versus the cost of shrinking the workforce. It also must consider how this decision might impair its ability to mobilize the remaining workers to enhance productivity, to recruit new workers in the future, and to project a positive image in the business community. It is also likely to encounter more substantial legal and regulatory barriers to laying off workers than its U.S. counterpart. Moreover, the G-J models themselves provide troubled corporations with other options: they can rely on their close cooperative relationship with workers to raise productivity or call on their lead bank to help obtain more credit or reduce financing costs.

In both countries, corporations have focused first on raising productivity and lowering nonlabor costs. They have leveraged their relationships with workers to enhance productivity, they have simplified the production process, and they have pressured suppliers to reduce costs. When they have sought to reduce labor costs, they have done so through a predictable series of steps, with layoffs as the last step in the chain. In Germany, for example, companies worked with the unions to shorten work hours and to design early retirement plans. With this strategy exhausted, they moved on to more creative solutions that build on one of the strengths of the German system, the ability of management and labor to negotiate solutions that benefit both sides. For example, many employers agreed to preserve job security or to forgo plans to move production abroad in exchange for greater flexibility in working hours. Some firms have devised elaborate schemes in which they pay workers constant wages over a year, but the workers' actual hours vary considerably so as to better match production cycles.

Meanwhile, the peak employer and labor organizations have agreed to allow greater flexibility in collective bargains. Specifically they have established clauses allowing companies that meet certain hardship criteria to diverge from the bargains. Employers and unions are working on a longer-term compromise solution that would preserve collective bargaining but permit more leeway at the plant level. This approach naturally builds on the strengths of the German system: peak organizations able to negotiate broad agreements combined with good working relations between management and labor at the plant level. The system is coming under increasing stress, however, because a growing number of employers are not abiding by the agreements or are defecting from their associations altogether. But even firms covered by the bargains often use these agreements as a reference point in determining wages and benefits (see the essay by Kathleen Thelen and Ikuo Kume in this volume).

Large Japanese corporations are also striving to cut labor costs without laying off workers. They accomplish this primarily by reducing new hires and offering early retirement, not by opting for the German solution of cutting working hours. Japanese firms also tend to reduce management salaries and bonuses before cutting blue-collar wages and to reduce workforces more rapidly overseas than at home. Japanese firms enjoy some built-in flexibility because they can shed temporary and/or part-time workers without threatening lifetime employment for the core workforce and they can shift the burden of adjustment to suppliers outside the system of long-term employment guarantees. Beyond this, large Japanese firms have developed a distinctively Japanese method of reducing labor costs by putting their corporate networks to a new use. In the past, they have used these networks as channels for reemploying workers after retirement. Now they are extending this practice as a means of coping with excess labor. In fact, some companies have diversified with precisely this goal in mind—to create subsidiaries and affiliates that can serve as employment networks.[3]

Finance

As German and Japanese firms seek to reduce costs and bolster profits, they naturally look to lowering financing costs. In Germany, large firms have markedly decreased their reliance on loans as a source of funding since the 1980s, shifting more to equity markets and self-financing (Deeg 1993). And as they shift to equity financing, they become more dependent on outside investors, often including foreign investors. Meanwhile, many small and medium-size enterprises still depend on loans and rely on a close working relationship with their *Hausbanken* as much as ever.

But even large corporations have not simply severed their long-term relationships with their banks. German banks are universal banks (i.e., they

3. Hirokuni Tabata (1996) offers a fascinating case study of how Japanese auto unions have worked with management to reduce costs and increase productivity.

can provide the full range of financial services, including banking and brokerage), so they can adapt to their clients' changing needs by transforming from providers of loans to underwriters of debt (Roe 1993). Although underwriting implies less oversight and control than lending, it does leave the banks with a continuing role in meeting these corporations' financial needs. Moreover, the banks have many other channels of influence over industrial corporations, including substantial shareholding positions, representation on supervisory boards, and proxy voting rights. Many banks have been decreasing their ownership stakes in client firms, but they appear to be decreasing their largest stakes while increasing other shares, leaving the overall level of ownership relatively steady (Deeg 1993). They are not only reluctant to sell off shares of companies with which they have long-term business relationships, but they are also deterred from doing so by the possibility that they might drive share prices down if they sell too much at one time. Likewise, banks have not substantially reduced their positions on corporate supervisory boards or given up their proxy voting rights (see the essay by Gregory Jackson in this volume).

Rather than abandon one another (exit), German corporations and banks have been more likely to manipulate the changing business environment by renegotiating the terms of their relationships (voice). The banks have retained substantial equity shares in long-term business partners, but have pressed these firms to increase profitability. The corporations still give the bulk of their banking business to their long-term banking partners, but demand lower costs and better service in exchange. Meanwhile, banks are trying to reduce the financial burden of bailing out client corporations in trouble, but they have not abandoned this role. Bankers argue that they serve their own enlightened self-interest in doing so in many cases—they may lose more by allowing a firm to fail than by bailing it out because its failure could spread to affect other corporate clients. Banks have become more stingy in funneling cash into rescue operations, but they remain critical intermediaries in most mergers, acquisitions, and other forms of corporate restructuring.

Likewise, German corporations' well-publicized newfound attention to shareholder value has gone further in rhetoric than in reality. A few prominent firms have set targets for profitability, created departments for investor relations, adopted international standards of accounting, and otherwise sought to make themselves more attractive to international investors (Marsh 1996). Even so, most German companies have a substantial proportion of their shares in stable hands and relatively little in foreign hands. This means they can continue business as usual without being punished too brutally by fickle international investors. And of course German firms are constrained from making some of the moves that would most

please their shareholders—such as shedding excess workers—by the constraints of the labor-relations system.

Japanese companies have also moved away from reliance on bank loans, but they too are renegotiating their relationships with their main banks rather than abandoning them. As in Germany, smaller corporations remain heavily reliant on banks. In fact, the banks are trying to strengthen their ties with medium-size firms in order to compensate for business lost from the larger corporations. Japanese banks are not universal banks, and therefore disintermediation has posed a greater threat to their business than in Germany. Not surprisingly, they lobbied to enter the securities business, gaining the right to underwrite debt through separate subsidiaries in 1992. They have since leveraged their main-bank relationships to seize a substantial share of the corporate bond market.

Japanese corporations still give much of their banking business to their traditional main banks, and the banks retain ownership shares in these corporations. Japanese bankers describe an elaborate ritual in which the banks and their main-bank clients renegotiate the terms of the relationship. The guiding principles are twofold: prior consultation and reciprocity. If a bank wants to sell shares of a corporation, it consults the corporation first. As a result, it can expect to lose a proportionate share of the corporation's banking business. Likewise, a corporation that shifts some of its banking business to other financial institutions can expect that the bank will divest some shares. In either case, the bank does not divest all of its shares and the corporation does not completely drop the main bank, so the long-term relationship continues. When banks vie for underwriting business, a similar logic applies. The banks expect their favored clients to give them the largest share of this business, but the client companies do so on the condition that the banks offer terms, expertise, and a menu of financial instruments nearly comparable to the top securities firms. And the companies continue to pressure the banks to enhance their services.

Banks continue to play a role in corporate restructuring, yet they are much less capable of providing funds given the current financial crisis. When banks do intervene to help firms in crisis, they do so in accord with the principles of reciprocity previously described. That is, they gauge their commitment to a firm in terms of the level of cross-ownership and the firm's loyalty as a banking customer. As the financial crisis has deepened, many firms are actually reinforcing their ties with their main banks. As their bond ratings have deterioriated, they have been forced to shift back from equity financing to borrowing. And although the banks' ability to bail out the firms may have diminished, the firms' reliance on the banks' generosity has only increased.

Patterns of Policy Reform

German and Japanese firms' choices are limited not only by informal constraints, such as commitments to long-term relationships, but also by the formal laws and regulations that underlie the G-J models. So any substantial transformation of the models requires policy reform. As Peter Gourevitch (1996) has noted, the microinstitutions of capitalism rest on macro (political) foundations, and thus major reforms to these institutions must survive the political process. Yet just as the microinstitutions of the models themselves affect firms' preferred strategies for adjustment, these institutions also shape firm preferences about policy reform.

Labor Market Reform

Given the cost pressures they face, we expect German and Japanese employers to favor labor deregulation, which should give them access to a wider pool of workers at a lower cost. Commentators in both countries now blame rigid labor markets for high labor costs, decreasing competitiveness, and high unemployment. Politically, therefore, we expect the battle over labor deregulation to pit firms, employer federations, and the conservative parties against workers, union federations, and the parties of the left. Yet in both countries firms have been ambivalent about labor market reforms, fearing that these reforms might undermine the advantages of the German and Japanese labor relations systems.[4] Moreover, firm preferences have been aggregated through employer federations and political parties that represent opponents as well as advocates of reform.

In Germany, economists, journalists, and other opinion leaders have called for the abolition of the collective bargaining system altogether. But most firms feel that they benefit from the present system and prefer to preserve it while introducing modest reforms to allow more flexibility. German companies are wary of abandoning the collective bargaining system because they fear that shifting wage and benefit negotiations to the plant level will undermine the cooperative atmosphere on the shop floor. In addition, labor market reforms could force companies to compete for workers on the basis of wages, dilute their incentive to invest in human resources, and otherwise erode their productivity advantage (see Soskice 1999; Thelen 1999b). Meanwhile, the employer associations and the trade unions strongly support the system; after all, they have a huge institutional stake in preserving it. The conservative government under Chancellor Helmut Kohl did not attempt to reform the collective bargaining system, but did take several smaller steps (Thelen 1999b). In 1996, the government reduced legally mandated sick-pay allowances from 100 to 80 percent of salary. This created a major uproar, with unions arguing that companies would be violating their labor contracts if they implemented the change. Interestingly enough, Kohl himself encouraged companies with such provisions in their contracts to maintain this commitment, whereas Freie Demokratische Partei (FDP) leaders were alone in pressing companies to take advantage of the new law (*Financial Times*, 30 September 1996, p. 2). As it turns out, the vast majority of German companies have simply continued to pay the 100 percent rate. Then, in the autumn 1997, the government enacted two additional measures: one easing requirements for terminating workers and the other allowing more flexibility in short-term (one- to two-month) contracts. The Sozialdemokratische Partei Deutschlands (SPD)-Green government has since reversed all three of these measures.

In Japan, employers have not proposed any wholesale change in the employment system but instead only piecemeal reforms coupled with more active adjustment polices and new protections for workers. The government has moved forward with modest deregulation measures in the context of a governmentwide deregulation movement that began in the 1980s and has accelerated since 1993. In 1997, the government removed some special protections for female workers, such as those governing overtime and nighttime work. Then in September 1998, it revised portions of the Labor Standards Law to give employers more flexibility with employment contracts and overtime pay, but it coupled this with increased regulation of termination notices, working conditions, and overtime hours. And in July 1999, it revised the Worker Dispatching Law and the Employment Security Law to give employers greater freedom in dispatching workers, to allow private companies to provide employment placement services, and to increase legal protection for job seekers. Nevertheless, the Japanese legal system still gives employers considerable flexibility in managing human resources within the firm by transferring employees to subsidiaries or increasing work time, for example, while sharply constraining their ability to hire and fire workers. In particular, the Japanese courts have developed a case law doctrine that deters employees from dismissing workers (Yamakawa 1999).

Financial Reform

Here again, we expect firms to advocate financial and corporate governance reforms designed to make equity markets operate more efficiently because this will reduce financing costs and stimulate financial innovation.

4. The logic of the present argument also applies to welfare reform. That is, we expect most firms to favor reforms to reduce mandatory spending on employee benefits and otherwise lower the overall tax burden. But German and Japanese firms are more ambivalent than we might normally expect because many feel that welfare provisions help to sustain productivity pacts on the shop floor (see Manow 1999).

But German and Japanese firms derive distinct advantages from their existing financial systems. Many German and Japanese managers value their freedom to hide profits and losses or to manipulate reporting to smooth out earnings over time, so they are reluctant to embrace financial reforms that would bring stricter requirements for information disclosure. Others worry that further financial liberalization might undermine the advantages of close working relations with their banks. They count on these banks for preferential access to credit at special rates, a wide range of free services such as providing information and brokering business alliances, and for assistance in the event of a financial crisis. Despite the firms' reservations, however, Germany and Japan have both moved forward with substantial financial reforms in the face of powerful forces for change.

Germany lagged behind other advanced industrial countries in financial liberalization, especially with respect to securities markets. The big banks supported measures to promote new financial instruments and to centralize equity trading activity in Frankfurt, whereas the smaller financial institutions and the *Länder* opposed these. Meanwhile, the Bundesbank opposed the introduction of money-market instruments for fear these might affect monetary policy. And when the Bundesbank finally did permit these instruments, it did so in a manner such that the banks could dominate the new products (Vitols 1997). Nevertheless, the German government pushed through substantial reforms in the 1990s in response to political pressure from the large banks; increasing competition from other financial centers, especially London; and EU directives on financial services. In 1994, the government passed an omnibus financial reform bill that reorganized the stock exchange; created a new regulatory agency, the Supervisory Office for Securities; set criminal penalties for insider trading; and established the legal foundation for the introduction of money-market funds (Story 1996; Vogel 1996).

In Japan, some of the biggest banks favored more rapid liberalization in the 1980s and early 1990s, but they moderated their demands for reform because they recognized that rapid reform could threaten other financial institutions with whom they have strong long-term working relationships. They also realized that articulating demands too strenuously could undermine their relationship with the Ministry of Finance. The ministry moved very deliberately, packaging elaborate political compromises among the various groups within the financial sector (city banks, securities houses, insurance companies, regional banks, credit associations, and cooperatives) (Vogel 1996, 93–117). With the financial crisis and the widespread loss of faith in the ministry, however, the political pressure for further reform increased substantially.

In response, Prime Minister Ryūtarō Hashimoto proposed a Big Bang reform in which the government would liberalize foreign exchange restrictions; open up the mutual fund, pension, and trust markets; deregulate brokerage commissions; allow banks, securities houses, and insurance companies to enter one another's lines of business through holding companies; and delegate some of the Ministry of Finance's supervisory duties to a new finance agency. Even so, the Big Bang does not represent a complete break with past patterns of financial regulation because the government is phasing in these measures gradually and paying special attention to their impact on domestic financial institutions. Moreover, the government has gained leverage over the financial sector as a result of the banking crisis. It is playing a major role in allocating funds to banks in crisis, monitoring troubled banks' behavior, and orchestrating the reorganization of the financial sector.

Germany and Japan both have large public-sector components of their financial systems, representing approximately one-half of total savings, that strongly resist reform. In Germany, the public-sector regional banks and cooperatives are highly popular and politically powerful at both the regional and the national levels. Despite pleas for reform from the private banks, conservative politicians have resisted reforms that would threaten this sector. Meanwhile, government officials and public bank executives are working together to increase economies of scale through business tie-ups and mergers within the network of public banks. Likewise, the Japanese bureaucracy has allied with powerful LDP politicians to fight back calls for reforming the postal savings system. Prime Minister Jun'ichirō Koizumi finally began to push through his long-anticipated reform program in 2002.

The German and Japanese governments have both made progress on corporate governance reform as well, but have compromised on the terms of those reforms that have gone through and have yet to address many other regulations that impede a more decisive move toward shareholder capitalism. In Germany, politicians debated major reform legislation for over a year before reaching a compromise in November 1997. The bill abolishes enhanced and maximum voting rights (special voting rights not accorded to all shareholders); restricts banks from exercising proxy voting rights in firms in which they have a greater than 5 percent ownership share; requires banks to report transfers of their own personnel to firms in which they have a greater than 5 percent stake; allows firms to buy back up to 10 percent of their own shares; reduces restrictions on shareholders' ability to receive compensation for management misconduct; and increases the duties of supervisory boards, especially with respect to coordination with auditors. In announcing these measures, Economics Minister Günther Rexrodt was careful to stress that the legislation would not undermine the positive role of banks in providing capital to growing industrial firms and supporting firms in times of crisis (*Business Law Europe,* 12

November 1997, p. 8). The government considered but ultimately rejected proposals to impose legal restrictions on bank share ownership. In addition, Labor Minister Norbert Blüm blocked proposals to reduce the size of supervisory boards due to powerful resistance from unions that feared this might undercut their influence.

In Japan, the authorities have gradually phased in a shift toward market value–based accounting. But many firms have resisted these reforms because they fear this will make it more difficult to manipulate return on equity figures, to smooth out earnings over time, to ignore contingent or unfunded liabilities, or to camouflage the cross-subsidization of business operations (Shinn 1999). The Ministry of Finance and the Financial Services Agency have also been reluctant to move too far for fear they might lose the ability to supervise and restructure the financial sector in a discretionary and discreet fashion. Meanwhile, both the Federation of Economic Organizations (Keidanren) and the LDP have proposed measures to allow corporations to restructure their cross-shareholdings without causing the stock market to collapse or allowing outside shareholders to buy up the shares. Yet these measures violate the very purpose of market-oriented corporate governance reform—to facilitate stock market adjustments and corporate contests for control (10–11).

Micro-Macro Interaction

Let us now turn to concrete examples of how these two levels of adjustment interact, beginning with some stylized facts from postwar Japanese history and then moving on to speculation about how current changes might evolve in the future. As noted in figure 10.4, policy reforms alter the incentives for and constraints on corporate adjustment; and corporate adjustments in turn shift industry preferences regarding further policy reforms. For example, when the Japanese government relaxed capital controls in the 1960s, this prompted Japanese firms to dramatically increase their cross-shareholdings, creating what is considered to be a primary feature of the Japanese model. In doing so, Japanese firms helped to preserve features of the Japanese system—such as industrial policy, administrative guidance, and interfirm collaboration—that function best in a market protected from foreign capital. And they were only able to accomplish this in the context of close government-industry collaboration, relatively weak antitrust regulation, and well-organized interfirm networks.

Then in the 1970s, when the Japanese government moved forward with trade liberalization, some industries replaced tariffs and quotas with private-sector substitutes, including preferential procurement practices, exclusive dealerships, and cartels. Kodak argued this point in its WTO case against Fuji Film, contending that the Ministry of International Trade and Industry (MITI) had worked with Fuji to establish exclusive dealer networks that effectively shut out foreign suppliers (Dewey Ballantine 1995; Johnson 1982; Tilton 1996).

Then in 1985, the G-5 governments launched a substantial appreciation of the yen with the Plaza Accord. Many Japanese firms responded by shifting manufacturing activity to southeast Asia so as to reduce production costs. But rather than abandoning their favored suppliers, large manufacturers moved abroad in tandem with their suppliers, extending national supply networks into the Asian region (Hatch and Yamamura 1996). In each of these cases, the Japanese model transformed, yet did not converge with, a liberal market model. In fact, the government and industry interacted to produce an adjustment of the model (institutional change) conditioned by the incentives and constraints of the model itself.

I contend that this has been happening once again since the 1990s. Germany and Japan have made little progress in labor-market reforms (macrolevel), meaning that the governments have not substantially expanded opportunities for private-sector adjustment (microlevel). So the two levels of change are not interacting in a way that is likely to dramatically accelerate the rate of change. In fact, we could even argue that feedback mechanisms are reducing the prospects for radical change in Germany. That is, as firms gain more flexibility in applying collective agreements and those firms most dissatisfied with the system simply defect, the firms left within the employer associations are even less likely to press for major reform. In finance, however, the two governments have enacted reforms in accounting, pension systems, and other areas that are spurring more substantial changes at the firm level. As German and Japanese corporations adjust to more international regulatory standards and deeper ties with foreign institutions, they are likely to become more favorably disposed toward future financial reforms.

Looking to the future, Japan's decision to lift the ban on holding companies could profoundly affect the long-term evolution of the Japanese model. Most countries already have holding companies, but this new option could solve Japan-specific problems in distinctive ways. For example, the holding company option will help companies to extend their practice of using interfirm links and diversification in managing labor costs without layoffs. They will be able to develop multiple tiers of wages and benefits for permanent employees and to reallocate workers across firms within the holding company structure. Likewise, holding companies may be able to develop a functional substitute for venture capital by funneling investments into virtually autonomous subsidiaries with new forms of organization and structures of compensation designed to foster innovation. Japanese firms may be able to develop a new approach to mergers and acquisitions in which two firms integrate gradually within a holding company rather than fusing more abruptly. This could alleviate the problem of distinctive corporate cultures and ingrown resistance to mergers, which is especially acute in Japan. Commentators joke about merged banks that have twin branches across the street from one another because neither partner will shut down its branch or about executives who identify with one partner firm and not the other decades after a merger. Of course, companies that slow down the process of integration will also forestall the efficiency benefits from merging, but this may be a price they are willing to pay.

By looking at the interaction effects in this way, we begin to see both the strengths and the limits of the model presented here. By focusing on institutions, we can go quite far in explaining the distinctive German and Japanese patterns of corporate adjustment and policy reform over the short to medium term. We can also show how adjustments at one time reshape the possibilities and constraints for change at a later time. But we cannot predict the long-term evolution of these institutions because micro and macro adjustments interact and cumulate over time. I argue that this does not imply a failure of the model but simply reminds us of the inherent limits of social-scientific models in explaining complex interactions over time.

Refining the Model

Before summarizing the patterns of institutional change, let us look briefly at two ways we might enhance the model presented thus far.

A More Political Perspective

The model outlined so far is inherently political because it suggests that corporate adjustments are subject to legal and regulatory constraints and that changes in these constraints must survive the political process. It emphasizes how institutions shape societal preferences, but also suggests that intermediate associations and political parties play an important role in aggregating these preferences. Nonetheless, we could easily imagine a perspective that would bring politics much more to the forefront, and Herbert Kitschelt (in his essay in this volume) suggests just how this might be done.

For present purposes, we might simply add that the German and Japanese political systems both have built-in propensities toward immobilism. In Germany, the weakness of coalition government makes it hard for a ruling coalition to impose change, and the federal structure of government makes it difficult for the central government agencies to impose change on the *Länder* (Webber 1992). In Japan, the bureaucracy-led process of packaging political bargains can be painfully slow and prone to elaborate compromises. Likewise, the LDP route in policy formulation leans toward solutions that reflect a delicate balance among multiple constituent groups (Stockwin et al. 1988).[5] The Japanese government faces less formidable obstacles than its German counterpart in passing reform legislation, but is more prone to building in compromises and concessions before legislation reaches the Diet. And bureaucrats are often less than zealous in implementing liberal reforms.

Moreover, the two systems both rest on a power structure in which multiple groups are given privileged status. This means that to the extent that change takes place through the political process, the primary beneficiaries of the status quo are well represented and thus have a substantial say in the terms of change. In Germany, labor has a privileged status at every level of the political structure (national, *Länder*, sectoral, and firm), and thus it can try to shape decisions that do not destroy those institutions it values. In Japan, the sheltered sectors of the economy, such as agriculture and small business, have privileged relations with the LDP and/or the bureaucracy, so they too have a substantial say in determining the mode of adaptation. Thus although both governments must package reforms that are sensitive to the demands of the protected sectors of the economy, the German government must be especially sensitive to labor, whereas the Japanese government caters more to farmers and small businesses.

Even so, I argue that the microinstitutions that shape industry preferences are even more important in shaping the distinctive patterns of reform in the two countries than the macroinstitutions that mediate these preferences (see figure 10.3). Opinion leaders such as the president of the Federation of German Industries (Bundesverband der Deutschen Industrie, BDI), Hans-Olaf Henkel, and Liberal Party leader, Ichirō Ozawa, have proposed constitutional changes to break the reform logjam in their respective countries. But even with constitutional changes, it is hard to imagine how a democratic government in either country could push through reforms that societal actors do not want.

A More Sociological Perspective

We could also argue that the model developed here is too rationalistic—it views the German and Japanese models as systems of incentives and constraints rather than systems of norms. From a more sociological perspective, we might suggest that actors facing new circumstances do not rationally calculate costs and benefits as much as they fall back on preexist-

5. On the bureaucracy-led process, see F. Schwartz (1993); Vogel (1994).

ing norms and routines (Powell and Dimaggio 1991). The two perspectives, the economic and the sociological, overlap with one another up to a point. That is, systems of incentives and constraints reflect underlying norms, and formal incentives and constraints (such as laws or regulations) can reshape norms over time. For example, we could explain a G-J firm's reluctance to lay off workers either way; that is, the firm may be calculating the cost savings against the potential damage to its cooperative relationship with the remaining workers or its ability to recruit workers in the future, or it may simply be adhering to prevailing social norms of acceptable firm behavior.

Although the two perspectives are consistent with one another up to a point, there are real differences. I prefer the economic perspective for my present purposes because it is more useful in moving beyond an explanation of why institutions are slow to change toward an explanation of the substantive patterns of change. Nonetheless, I readily concede that a rationalist logic misses the ways normative factors affect the trajectory of change. Specifically, a deeper appreciation of these factors might alter our expectations about patterns of change in three ways.

First, a sociological perspective leads us to expect an even slower process of institutional change. The economic perspective implies that firm managers are reluctant to cut off a stable supplier because this will entail a substantial cost in terms of the loss of the long-term cooperative relationship. But once they determine that the efficiency benefits outweigh these long-term costs, then presumably they act decisively. The sociological perspective suggests, however, that firm managers may not respond even to very clear shifts in economic payoffs due to normative commitments. They might hesitate because they view certain actions as inappropriate or because they fear societal disapproval. One Japanese manager recalls an internal debate in which several board members proposed that the firm cut off a stable supplier in favor of a lower-cost foreign supplier—the board member with closest personal relationships with the domestic supplier's managers successfully fought off the proposal because he felt he could not betray these partners (interview, February 1997, Tokyo).

Second, a sociological approach might help us to understand the consistency in corporate adjustment strategies within each country across diverse sectors. That is, the economic approach leads us to expect substantial variation across sectors because the economic rationale for stable employment, for example, varies considerably by sector, depending on the level of training required and the nature of the work. Yet German and Japanese firms trying to cut labor costs have followed remarkably similar patterns of adjustment across diverse sectors. This suggests that firms are not simply rationally choosing the best strategy, but instead are imitating one another and minimizing dissent by not diverging too far from standard practice.

Third, a sociological approach suggests a perspective on the mechanisms of change that focuses more on the diffusion of norms than on a shift in incentives. Specifically, it predicts more rapid change when foreign firms or domestic opinion leaders disseminate new ideas widely enough to alter the prevailing discourse about corporate adjustment or policy reform, thereby shifting actors' judgments about what constitutes an appropriate response. It provides insight about the tipping points, at which isolated incidents of defection might cumulate into broader institutional change, suggesting that the key lies not in rational calculus but in legitimacy. This helps to explain why certain changes may be slow to take hold but then may diffuse very rapidly. Thus, many German companies suddenly embraced shareholder value in the early 1990s, and many Japanese companies abruptly shifted toward merit-based wage systems in the late 1990s.

The Comparative Context

At this point, I propose three tentative conclusions about patterns of institutional change in Germany and Japan that can be further tested against evidence in future research: Germany and Japan have not converged to the Anglo-American model, they have each responded differently, and they have both moved further in finance than in labor relations.

Germany and Japan versus the Liberal Market Economics

Despite popular cries of the end of German and Japanese capitalism, these two economies have preserved many of their distinctive features. Compared to the United States and Britain, they continue to maintain greater cooperation amarg labor and management, closer ties between banks and industry, denser networks of relationships among firms, and closer coordination between government and industry. But have Germany and Japan moved closer to the liberal market model? If we view the liberal market model in static terms, then Germany and Japan have indeed moved in the direction of more competitive market systems. If we compare them to the moving targets of the United States and Britain, however, they may not have narrowed the gap at all.[6] If anything, U.S. and U.K. firms have been moving further toward the LME ideal: reducing costs, maximiz-

6. Using a statistical index, James Gwartney and Robert Lawson (1997) find that economic freedom did not rise at all in Germany from 1990 to 1995, actually fell in Japan, and rose substantially in the United States and Britain. Then from 1995 to 2000, economic freedom fell in both Germany and Japan, remained stable in the United States, and rose in the United Kingdom (O'Driscoll, Holmes, and Kirkpatrick 1999).

ing short-term profits, relying more on equity markets for finance, and increasingly participating in markets for corporate control. Whereas Germany and Japan have been cautiously moving ahead with liberal policy reforms, the United States and Britain have been surging forward more boldly. In labor markets, for example, the United States and Britain have aggressively deregulated, but Germany and Japan have not (Golden, Wallerstein, and Lange 1999; Soskice 1999). As Desmond King and Stewart Wood (1999) demonstrate, the micrologic of industry policy preferences in the LMEs is strikingly different from that of the OMEs. Because firms in the LMEs compete more on the basis of cost than quality, they strongly advocate market liberalization and other policies designed to lower costs.

Germany versus Japan

Shifting to the comparison between Germany and Japan, we find substantial differences as well as similarities. Germany has moved further toward the liberal market model than Japan, especially in finance. Although a full explanation for this divergence is beyond the scope of this essay, I suggest that four factors are salient. First, in Germany the EU gives greater urgency to corporate adaptation as firms fight off new competitors in their home markets and move into foreign markets. The EU serves as a political force driving liberalization and regulatory harmonization that is sometimes able to supersede the normal logic of German domestic politics. Second, German politics is more infiltrated by international interests and views than Japanese politics. Foreign firms have a stronger presence in Germany than Japan and play a greater role in advocating reform. Third, the German bureaucracy has not shaped the substance of reform nearly as much as has its Japanese counterpart. Japanese officials have been especially zealous in designing reforms so as not to undermine their own regulatory discretion, a critical source of leverage over industry. And finally, Japanese firms are linked to banks, other firms, and government agencies in even denser networks of interrelationships than their German counterparts, making them more reluctant to undermine these ties or to support reforms that might jeopardize them.

Furthermore, the logic of the argument presented here suggests that we should find considerable differences between Germany and Japan, reflecting differences in the structure of the two economies. As noted at the outset, both systems are organized, but in different ways. The German labor market is organized through a massive array of national, regional, and plant-level associations, whereas the Japanese labor market relies more on private-sector networks. So German firms have used their corporatist institutions to renegotiate bargains with labor, whereas Japanese firms have leveraged their dense corporate networks to reallocate workers without

laying them off. Likewise, the German labor relations system is more codified into law. This means that German firms have less freedom in a legal sense to adjust their practices than their Japan counterparts, but it also means that the German government has a greater ability to impose changes in these practices through legislation.

Differences in economic governance at the sectoral level also influence patterns of reform. For example, Japan's separation of commercial and investment banking made the process of financial reform more contentious and protracted than it was in Germany. Because Japanese commercial banks could not enter the securities business prior to 1992, they had very different views from German universal banks on financial reform. They wanted to slow down the liberalization of securities markets until they could fully participate in these markets. Meanwhile, securities firms fought to prevent banks from invading their turf.

Labor versus Finance

Not surprisingly, Germany and Japan have moved furthest in those areas in which market pressures are the greatest and in which the reform debate has not become highly politicized. They have enacted substantial financial and corporate governance reforms, although they are more tightly constrained with labor and welfare reform. In addition, Germany and Japan have made substantial reforms in more technical areas that have not become as politicized, such as accounting. The German government was able to move forward with a major corporate governance reform bill with relatively little political resistance. Likewise, the Japanese government almost pushed through its new holding company bill without the labor unions or opposition parties even taking notice. At the eleventh hour, however, Japanese Trade Union Confederation (Rengō) officials suddenly realized the ramifications of this bill and mobilized to win a delay. As financial and corporate governance reforms continue, this will create more leeway in corporate adjustments, contributing to greater feedback effects between policy reform and corporate adjustment (micro-macro interaction) and greater institutional change overall.

If reform is in fact moving more quickly in finance and corporate governance than in labor, this then raises the question of how tightly the different parts of the German and Japanese systems are linked. For example, we could argue that the German or Japanese labor-relations systems are linked to their financial systems (Aoki 1994a). Firms are only able to make long-term commitments to their workers because the financial system shields them from shareholder demands for short-term profits, but patient capital in turn relies on stable labor relations. If this is true, then we should find that shocks to one side reverberate to the other. Will more competitive financial markets and tougher information disclosure requirements force German and Japanese firms to shift from stakeholder to shareholder governance? And if so, does this mean that these firms will have to abandon or loosen their long-term commitments to their workers? Changes in finance in the late 1990s have put additional pressure on companies to reduce costs and raise returns, but they have not forced German and Japanese firms to abandon the core features of their respective labor-relations systems. That is, financial developments have created new challenges in German and Japanese labor relations, but have not been so powerful as to dictate the nature of the response to these challenges.

Whither Germany and Japan?

Thus far I have described and explained patterns of corporate adjustment and policy reform in Germany and Japan. But what *should* Germany and Japan be doing? If we take institutional legacies seriously, as this chapter suggests we should, this could lead us to either of two radically different conclusions. First, we could argue that Germany and Japan are doing just what they should be doing—searching for the right mix of continuity and change. They are making incremental adjustments to refine their models, building on their strengths when possible, and avoiding radical moves toward the liberal market model that would be doomed to fail in the absence of complementary institutions. Jonah Levy (1999) tells a delightful tale about how French leaders tried to shift the institutions of *dirigisme* from the national to the local and the EU level and to replace state sponsorship of industry through selective credit allocation with the cultivation of German-style industrial banks. But for the most part, he argues, they failed because they could not find the necessary complementary institutions at either of these levels. Likewise, we could argue that British attempts to develop an industrial policy in the 1960s and 1970s were destined to fail because Britain lacked the close working relationship between government and industry necessary for such a policy to work (Vogel 1996). We might conjecture, then, that German and Japanese attempts to create a U.S.-style venture capital market cannot succeed because Germany and Japan lack the unique institutional infrastructure of Silicon Valley. German reformers might be better served to adapt handicraft production to the needs of the twenty-first century, and Japanese reformers might be better off trying to use partnerships between government and special research-oriented subsidiaries of large companies to promote innovative research.

Alternatively, however, we might argue that Germany and Japan may be proceeding along the wrong path—failing to adjust to a fundamental shift in the dominant production paradigm from flexible manufacturing to a new paradigm centered on global finance and information technology. They may have mastered the challenges of the late twentieth century so well that they have failed to prepare for the new challenges of the twenty-first century. In this view, Germany and Japan share the fate of seventeenth-century Spain, nineteenth-century Britain, and perhaps the mid-twentieth-century United States—they were so successful that they naturally built on existing strengths rather than shifting resources toward a new paradigm that would eventually supersede the one they had mastered (see Landes 1999).

So which is it: right mix or wrong path? We cannot know at this point; the answer depends on technological and societal shifts yet to come (see the essay by Kozo Yamamura in this volume). We know how Germany and Japan are adjusting to new challenges, but we cannot evaluate the long-term results of these patterns based on a few good or bad quarters of growth or a jump or blip in the stock market. German and Japanese business and political leaders clearly recognize the weaknesses of their respective economic models, and they will continue to strive to adapt them to a changing world. But they will do so by reorganizing rather than dismantling the institutions that have brought them so much success.