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CAPITALISM'S GLOBAL FINANCIAL CRISIS: RE-VISITING THE STATE AND INDUSTRIAL POLICY

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Abstract: The bankruptcy and merger of three major American investment banks, Bear Stearns, Lehmann Brothers, and Merrill Lynch, in 2008 have shocked the United States government to undertake dramatic market intervention and a \$700 billion U.S. dollar bailout that resembles “industrial policy” in many other countries. Many global policymakers have discussed the end of laissez faire capitalism in the 21st century; others will blame investment bankers and financial institutions for their greed and lack of ethics as the root causes of the first global financial crisis of the 21st century.

Critics of market intervention, often called industrial policy in many countries, point out to two potential weaknesses: governments may have less knowledge than markets on how to pick winners, and industrial policy creates possibilities of corruption and rent seeking. Our conceptual paper introduces the idea that industrial policy helps to overcome three key aspects of “institutional infrastructure” in all countries of the world. These three institutional infrastructures are financial, knowledge, and physical.

Keywords: Capitalism; corporate governance; institutions; industrial policy; social learning; institutional infrastructure

Introduction

The bankruptcy and merger of three major American investment banks in 2008, Bear Stearns, Lehmann Brothers and Merrill Lynch have forced the United States to undertake a \$700 billion dollar bailout. This type of dramatic market intervention and regulation has often been categorized as industrial policy in many countries of the world. There is a growing consensus among social science researchers, that institutions are the foundations of economic development and growth (North, 1990, 2005; Ostrom, 2005). How did global financial institutions fail in the 21st century?

The purpose of this conceptual paper is to advocate a greater integration among the more institutional and microeconomic levels of the firm and industrial policy, which tend to be analyzed at more macroeconomic levels. We believe that three types of institutional infrastructure are fundamental to national economic success: financial infrastructure, physical infrastructure, knowledge and internet infrastructure. These three types of institutional infrastructure, financial, physical and knowledge infrastructures at a global level seem to be inadequately integrated to face the globalization of financial capital and internet communication of the 21st century.

In this paper, we advocate that a country's industrial policy can help to develop these institutional infrastructures which are fundamental to economic development and growth in any country in the 21st century. Multinational corporations and financial organizations can, in turn, contribute to the development of such institutional infrastructure. To do so, multinational corporations and financial organizations must invest not just in a specific product or sector but in several sectors that help to accelerate agglomeration economies (Rodriguez-Clare, 2004; Hausmann & Rodrik, 2004; Sabel, 2004). For example, a new technology or a new type of service can help to create such agglomeration economies (Krugman, 1991) in a national economy.

This conceptual paper is set out as follows. First, we analyze the recent history of industrial policy in different regions of the world and the implications for global economic welfare. Second, we define the three types of institutional infrastructure that are fundamental to economic development and growth: financial, knowledge and physical infrastructure. Third, we analyze the potential collaboration among foreign multinational corporations, local multinational corporations, and national governments in developing such institutional infrastructure, and we analyze the implications for analyzing the global financial crisis of the 21st century.

Institutions and Industrial Policy

The term "industrial policy" has both negative and positive connotations (Lall, 2002, 2004). Critics of industrial policy have two major objections. First, governments do not have more knowledge than businesses or financial markets, and, thus, government cannot pick winners or losers effectively in a national economy. Second, industrial policy breeds corruption and rent seeking through cronyism--relations between government, financial markets, and business. The critics, thus, see industrial policy as being against market forces, liberalization, and free trade, all factors that are seen to be fundamental to economic and business success. Neoclassical economics and market forces and free trade are seen as being superior to such collaboration among government, business, and other actors in a national economy.

Supporters of industrial policy tend to focus on the experiences of East Asia since the 1960's, especially today's developed economies such as Japan, Korea, Taiwan, Singapore (Amsden, 1989; Wade, 1990). In these countries, a long-term collaboration among government, business, and banking has produced high levels of economic development and global competitiveness (Lall, 2002; Mathews, 2003); in some sense, these economic models relied less on global stock markets. Other regions, such as South America, appear to not have followed such overall or extensive industrial policies as East Asia. However, in-depth analysis of Latin America's globally successful industries, such as steel and aircraft in Brazil, salmon and forestry in Chile, and motor vehicles and computers in Mexico, all seem to point out to successful industrial policy and the picking of winners in particular industries (Ferranti, 2002; Agosin, 1999; Bardhan & Roemer, 1992; Jarvis, 1994).

First, nongovernmental organizations (Teegen, Doh & Vachani, 2004; Teegen & Doh, 2003) are seen increasingly as an institutional and fundamental actor in traditional relations between government and business and in global governance in the 21st century. The importance of such collaboration at a local level in developing countries, has also been extensively researched in numerous works by, Ostrom (2005). Second, the literature on institutional innovation in developed economies has shown the importance of institutional and social learning (Sabel, 2004; Henisz, 2000). New emerging industries in developed

economy settings, such as biotechnology and nanotechnology, benefit from interactive and social learning and collaboration among government, business and associations within a national economy.

Both these strands of recent literature on nongovernmental organizations and on institutional innovation in developed economies show the importance of knowledge infrastructure (Sabel, 2004; Moran & Ghoshal, 1999), global business ethics, and global governance in today's business environment. Emerging and developing countries, in turn, need to develop institutional infrastructures not only in knowledge sharing, but also in financial and physical infrastructures. The importance of social learning, and knowledge infrastructure for global competitiveness in the 21st century has added an additional constraint or urgent need for emerging and developing countries (Khanna & Rivkin, 2001; Hoskisson, et al., 2000; Lyles, et al., 2004).

The Washington Consensus Versus Industrial Policy

By the late 1980's, there was a convergence of views by the United States government, the World Bank, and the IMF towards the nature of economic development and growth. This was termed by John Williamson (1990) the "Washington Consensus." There were three key components of this approach very much in line with traditional static, neoclassical economics (Murrell, 1991): market forces as allocators of economic resources, openness to foreign direct investment, and free trade liberalization. Institutions were not a part of this economic paradigm, which was seen to suit all countries – the Washington Consensus also believed that emerging or developing countries would also benefit from economic and business success and growth if they followed the key beliefs of the Washington Consensus (Birdsall & de la Torre, 2001). In the late 1990's, this model was enriched with various other ideas, that broadly fall under, "good governance" (Stiglitz, 1998; Kuczynski & Williamson, 2003; Easterly, 2001; Lindauer & Pritchett, 2002).

In some sense, the Washington Consensus was closely in line with the robust economic success of the United States economy in the 1990's. The belief in a single model or paradigm for economic success is not new. In the 1970's, the model that was most widely discussed was Sweden and several other continental European countries (Lindbeck, 1997). In the 1980's, the model most widely discussed by researchers and policymakers was Japan's economic paradigm. In the 1990's, it was the United States model and the broader implications of the Washington Consensus for emerging and developing countries.

Three factors in the early 21st century helped weaken if not discredit the beliefs of the Washington Consensus approach to economic development and growth. First, various leading economists, such as the Nobel Laureate, Joseph Stiglitz, who became the Chief Economist to the World Bank, advocated the problems of imperfect information, asymmetric information, and market failures in developed economies, and, of course, with much greater implications for emerging or developing economies. Other economists from the World Bank, such as William Easterly (2001), also looked at the realities of the world, and pointed out that Latin American countries, which probably followed the model of the Washington Consensus most closely had achieved economic growth rates of 2% throughout the 1990's and even lower in the 1980's. In contrast, countries such as China, which seemed to be following an industrial policy, in direct contradiction to most of the tenets of the Washington Consensus, continued to achieve economic growth rates approaching 10% throughout the 1980's, 1990's and into the 21st century.

Second, numerous corporate scandals in the United States helped raise the question of, an universal system or a particular type of capitalism that was seen as a single solution to all countries. The

well-known corporate scandals in 1999, 2000 of major American corporations, such as Enron, Andersen, Worldcom, Tyco and many others, helped raise questions inside and outside the United States about the weaknesses of the U.S. governance model on which the Washington Consensus was broadly based. These have, in turn, been complimented by the financial crisis of 2007 and 2008 and the bankruptcy and merger of three major American investment banks: Bear Stearns, Lehmann Brothers, and Merrill Lynch.

Third, researchers from other social science disciplines began to emphasize the importance of “institutions” and institutional analysis in predicting economic development and growth (Kuczynski & Williamson, 2003). Comparative research in corporate finance, international business, and corporate governance showed the importance of, perhaps, two or three models of capitalism and national business systems, which have been proven to be economically successful and resilient over the last several decades.

The Anglo-Saxon model, on which the Washington Consensus is most closely based, was, increasingly, seen as just one type of system (Albert, 1991; Krugman, 1995) with strengths and weaknesses like other systems. Other systems with a more collective and Communitarian approach (Bowles & Gintis, 1996) were seen to be the norm in continental European countries, as well as the developed Asian economies of Japan, Korea, Taiwan, and Singapore. The contrast between the Washington Consensus and the newer lessons on institutions and economic development, are shown in the table below.

Table 1. *Washington consensus versus Industrial Policy and Institutional infrastructure*

Washington Consensus	Institutional Infrastructure
Free markets – market forces are superior to government second guessing the market	Develop the key three institutional infrastructures: financial, physical, knowledge infrastructures
Free trade and liberalizing trade in all sectors and industries of a national economy	A new industrial policy and partnership among government, local MNCs and foreign MNCs
Foreign direct investment and the encouragement any type of foreign direct investment	Government-local MNCs-foreign MNCs select and invest in multiple, related sectors, agglomeration
Good governance, legal structures to ensure the protection of property rights, and contract enforcement	Strategy for entry into global competition can differ across countries

Re-Visiting Industrial Policy

In this paper, we advocate a conceptual model of industrial policy that requires collaboration among national governments, local multinational corporations, and foreign multinational corporations. This three-way collaboration and knowledge sharing, we believe, is fundamental in today’s complex global business environment. Critics of traditional industrial policy between national governments and local multinational corporations used to point out that national governments cannot have complete knowledge or information in choosing winners or losers in complex global environments; supporters of traditional industry policy would respond that local multinational corporations, too, do not have sufficient knowledge to optimally choose the sectors and industries in which to make investments.

We believe that high uncertainty and continuous change is fundamental to today's global business environment. Thus, we believe that neither national governments, local multinational corporations, nor foreign multinational corporations acting alone have sufficient information or knowledge to choose winners or losers or to make optimal investment decisions in a complex global environment of, high uncertainty. A three-way collaborative knowledge and investment partnership among national governments, local multinational corporations, and foreign multinational corporations can help to minimize the costs of ineffective investment and business decisions. Thus, we are advocating a new industrial policy structure that involves a close partnership among national governments, local multinational corporations and foreign multinational corporations. This is shown in the Figure 1 below.

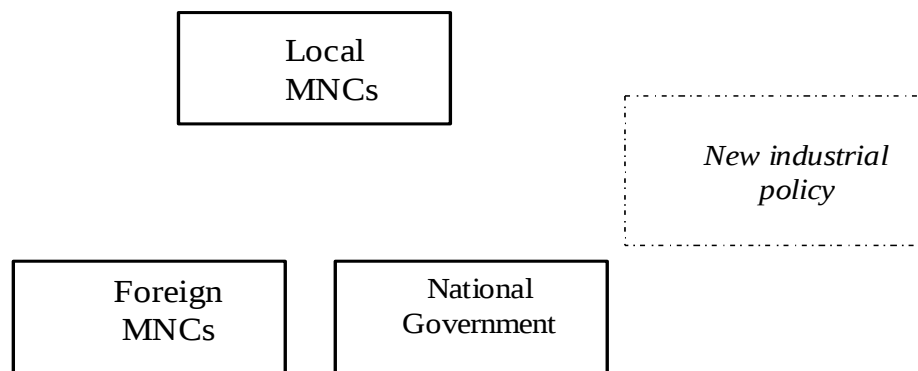


Figure 2. Three way partnership and a new industrial policy and global corporate governance: Government-Local MNCs-Foreign MNCs

Such a three-way, partnership-driven industrial policy is especially important in emerging and developing countries, where not only specific sectors, but several sectors or general industries need to be developed and sustained at the same time. Although the concept of a big push has existed in economic development at least since the 1940's based on works of researchers such as Rosenstein-Rodan (1948), Hirschmann (1958), Rostow (1965), Gerschenkron (1962), and formalized by Murphy, Shleifer and Vishny (1989), the actual international business or business level strategies of a big push national economic strategy have not been analyzed. The concept of a, big push has similarities to industrial policy within a single national setting in that governments need to work closely together with financial institutions, including, if necessary, a merger of banks, in order to jump start economic growth and overcome any financial crisis.

Three Institutional Infrastructures

In developed, large-income economies, infrastructure is largely taken for granted. In this paper, we introduce our idea of "institutional infrastructures" because they represent one of the greatest differences between developed and emerging or developing economies (Uhlenbruck, et al., 2003; Whitley & Csaban, 1998; Meyer, 2001; Lyles & Baird, 1994). We also use the term "institutional infrastructure" to describe infrastructure that is well grounded and existing in a national economy on a long-term basis, reflecting a commitment by governments and local multinational corporations. In turn, the differences in institutional infrastructures influence the attractiveness of other resources, such as talented, global managers, which, in turn, increasingly help to determine the location and joint venture decisions of multinational corporations.

We define institutional infrastructure as being comprised of financial, physical, and knowledge:

Institutional infrastructure is defined as a national economy's long term commitment to 3 key types of infrastructures. In turn, these three key infrastructures are embedded in local institutions – including informal traditions, norms, and social conventions especially towards the global economy, foreign direct investment and multinational corporations.

This is shown in the figure below.

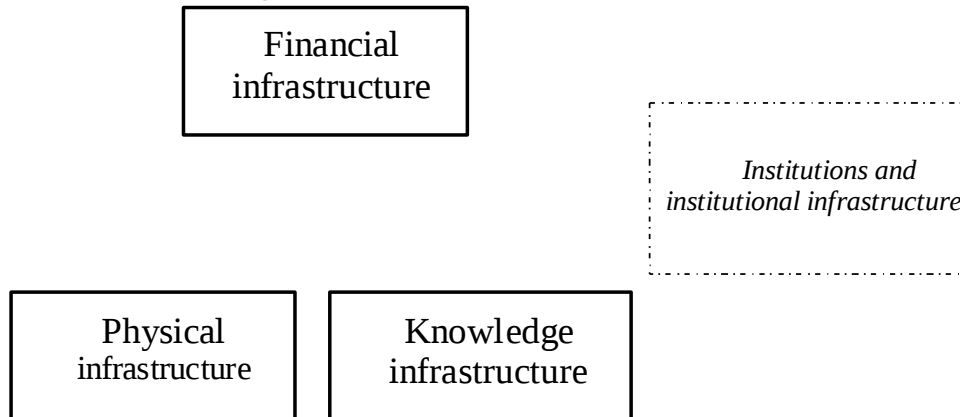


Figure 3. Industrial Policy and Institutional infrastructure–financial, physical, knowledge

Financial Infrastructure

In the growing literature on comparative corporate governance and finance, there have been extensive discussions about the differences between the more stock-market-driven financial institutions in Anglo-Saxon countries versus the more bank-driven financial institutions in continental Europe, and the developed Asian economies, such as Japan and Korea. The conclusions of this research in international business, comparative corporate governance, and corporate finance is that both financial institutions of a stock market-based business system and the financial institutions of a bank-based business system have their relative strengths and weaknesses (Beck & Levine, 2002; Levine, 2005).

A general conclusion from these various strands of research is that a national economy's financial institutions are part of a greater picture included other types of institutions (Haggard, 2003; Vamvakidis, 2002). The existing literature, however, has not sufficiently researched the interdependence between a national economy's financial institutions and other types of institutions (Trinidad, 2003). The need for a more interconnected view of financial institutions has become more evident even in developed economies, as the dramatic changes of the global internet, digital technologies and knowledge based societies, create a new type of dynamic and interdependence between financial and other types of institutions.

Thus, the academic and policy debate in developed economies is about the relative strengths of stock market versus bank-driven financial institutions and the occasional fine tuning that is required between both, since in developed economies, both stock market and bank-driven financial institutions, co-exist. In emerging or developing countries, recent by various authors such as Levine (1997, 2005), Beck and Levine (2002) and LaPorta, et al (1997) have shown that there is a generally shortage of financial capital and the supporting financial institutions. Thus, emerging or developing countries will welcome, either

stock market or bank driven financial institutions. We believe that in emerging or developing countries, this is a fundamental need for, “institutional infrastructure”, including, financial infrastructure. In emerging or developing countries, such financial infrastructure can only be developed through a long term commitment by national government, local multinational corporations and increasingly foreign multinational corporations and global institutions, such as the World Bank and the IMF.

A clear example of developing institutional infrastructure, such as financial infrastructure in a new industrial policy context is the case of, China. China continues its liberalization of its financial services, taking a first major step with the extremely successful stock market listings done in 2005 and 2006 of its 4 largest national banks: China Construction Bank; Bank of China; Industrial and Commercial Bank of China; Bank of Communications. The strategy for this development of financial infrastructure is a three-way partnership among the Chinese government, foreign financial multinational corporations, and local multinationals, or the major Chinese banks.

Physical Infrastructure

By physical infrastructure, we include not only the creation of basic foundations in transportation industries, such as shipping ports, railways, and airports, but also the deeper institutional connections to the national economy. Physical infrastructure that is appropriate for a national economy, in turn, is interconnected (Olson, 1992) to the type of sectors or industries that are globally competitive in that national economy (Dasgupta, Marglin & Sen, 1972). In turn, this depends on the industrial policy decisions towards particular industries, sectors as decided by knowledge sharing among national governments, foreign multinational corporations and local multinational corporations.

If physical infrastructure development needs to match a national economy's focused sectors and industries, how can emerging and developing countries choose which sectors and industries to enter during various phases of national development (Olson, 1982, 1992; Nelson, 2004), as well as the complex changes in the global business environment? This is a fundamental problem for any emerging and developing country undertaking industrial policy.

Imbs and Wacziarg's (2003) large cross section of countries' data have shown regularity in terms of industry concentration or diversification during different phases of a country's national economic development. Those countries that have successfully moved from emerging or developing country levels to a more developed or OECD level of national incomes go through a more diversified process of industries and sectors, until they reach a developed economy or OECD level of national income. Once they reach this high level of developed economy income levels, their economies become more concentrated over time (Hausmann & Rodrik, 2004; Klinger & Lederman, 2004).

If we broadly divide the world's economies into developing reflecting the lowest levels of incomes, emerging as reflecting the next tier and developing as the final OECD mature economies, then there are phases and a dynamic path that a national economy must go through that requires investment into and diversification, which, in turn, may require successful industrial policy to help choose the particular target industries and sectors for such diversification in the national economy. For those national economies that have made the successful transition and taken the dynamic path from developing to emerging to developed economic levels, there is thus a “turn around” from focused or concentrated simple economies to diversified complex economies to concentrated complex economies.

“In fact, our result is an extremely robust feature of the data. The estimated turnaround point occurs quite late in the development process and at a surprisingly robust level of income per capita. Thus, increased sectoral specialization, although a significant development, applies only to high-income countries. Countries diversify over most of their development path.” (Imbs & Wacziarg, 2003, p. 64)

The implication of this empirical research on a wide cross section of countries is that diversification on a national economy level needs to happen for countries to achieve successful economic development. However, such diversification is a complex issue and, in turn, requires the choosing of winners and losers (Krueger, 1974) in the correct sectors and industries across a national economy.

Physical infrastructure, then, is no longer about transportation, railways, and shipping ports. Physical infrastructure must help reflect a national economy's chosen diversification strategy into various industries and sectors. Such diversification must also take into account the nature of the global business environments, which industries are most competitive, which industries are new and emerging, and the potential interaction with multinational corporations that are market leaders in their industries from various countries.

The best examples of institutional infrastructure in terms of physical infrastructure can be seen from the successful cases of Latin American industries – especially Chile, Brazil, and Mexico (Rodriguez-Clare, 2004; Agosin, 1999; Ocampo, 2003). Chile has experienced great economic and business success in the salmon and forest industries (Clapp, 1995). Brazil's greatest successes have been in steel and aircraft. Mexico has at least two global industries and multinational corporations in car components and personal computers (Melo, 2001).

These successful economics and international business cases from Latin America, of Chile, Brazil and Mexico have been based on a close three-way partnership among the government, foreign multinational corporations, and local multinational corporations. In the famous case of the salmon industry in Chile, the Fundacion Chile, a government agency, worked with major local companies in partnership with multinational corporations from Norway and Scotland. This three-way partnership adapted to the Chilean business environment a technology that had been developed by Norwegian and Scottish multinational corporations. Before this development, Chile had never exported salmon before. In 2006, Chile is one of the world's biggest exporters of salmon.

Knowledge Infrastructure

Among the three institutional infrastructure advocated in this paper, knowledge infrastructure is an issue discussed throughout the world in developed, emerging, and developing countries. Knowledge-based infrastructure is seen as being fundamental to knowledge-based societies (Steensma & Lyles, 2000; Inkpen & Beamish, 1997), especially an ambition of the world's developed, high-income countries. The commercialization of the global internet in the mid-1990's, of course, is a fundamentally new driver that has been added to the issue of knowledge infrastructure. The global internet and the emergence of digital technologies as the foundation of all technology and communications have created an urgent need to develop knowledge infrastructure in national economies. In such national development, we believe that

equal if not initial development of the more rural sectors is important for the preservation of local knowledge (Ostrom, 2005) as well a more overall, balanced approach to national business and economic development.

Generally, such small, local groupings or the larger communities play a role in the creation and maintenance national norms and social conventions. Nongovernmental organizations (Teegan & Doh, 2003; Teegan, Doh & Vachani, 2004), because of the power of the global internet to connect diverse and small groupings, play an increasingly fundamental connecting role between such local groupings, national governments, and local and foreign multinational corporations. Thus, in terms of the new industrial policy, we are advocating in this paper institutional infrastructure, such as knowledge infrastructure must combine the development of national level strategies on the internet and digital technologies, such as high speed broadband, along with the smaller, local groupings that, in turn, set the informal norms and social conventions that are also part of any successful national economic change.

Two examples from Asia help illustrate the importance of institutional infrastructure creation in knowledge infrastructure. The first example is that of high speed broadband institutional infrastructure development in Korea. In 2006, Korea continued to be the world's no. 1 broadband country, with 80% of homes in Korea's population of 50 million people, having high speed broadband approaching 20 megabytes in speed. This, in turn, has helped create various other linked sectors, such as internet games and animation.

High-speed broadband was first developed by the Australian telecom company, Telstra, in the mid-1990's. However, the Korean government, in collaboration with Telstra and local multinationals such as Korea Telecom and SK Telecom, were the first to commercialize the technology fully in the Korean market in the early 21st century. An interesting aspect of this three-way partnership among the Korean government, local multinational corporations, and a foreign multinational corporation was the emphasis on developing the high-speed broadband infrastructure in the relatively rural, agricultural, and lower-income regions of Korea before including the more cosmopolitan districts and major cities. We believe this approach helped to preserve the local knowledge, norms, and social conventions, in turn creating a more balanced national acceptance of the global internet and high-speed broadband technologies.

Another example in terms of local knowledge (Ostrom, 2005) development is from Taiwan. Taiwan was traditionally an exporter of sugar, but due to changing global competition and restructuring, sugar cane no longer became a viable export industry to Taiwan's farmers (New York Times, 2004; Taipei Times, 2004). The institutional infrastructure response has been a partnership among the Taiwanese government, local multinationals, and foreign multinationals to develop a globally competitive, orchid flower industry. This three-way partnership has created the knowledge infrastructure necessary to jump start such an industry. The three-way collaboration has created a genetics laboratory, quarantine site, shipping and packing areas, new roads, and privately owned greenhouses. It is too early to know whether Taiwan's orchid industry will be globally competitive, but by 2006, they had already achieved substantial export success; in turn, the development of such knowledge infrastructure in a rural region of Taiwan has been a positive alternative to subsidizing the depressed sugar cane export industry.

Conclusions and Future Research

The dramatic bankruptcy and merger of three major American investment banks, Bear Stearns, Lehmann Brothers and Merrill Lynch, in 2008, led to the dramatic government intervention and a \$700 billion U.S. dollar bailout by the United States government. Institutions are increasingly seen as fundamental to economic development and continued national economic success (North, 2005; Nelson, 2004; Ostrom, 2005). But what went wrong with global financial institutions in 2008?

This paper provided a conceptual analysis of the role of institutions in the three key components of institutional infrastructure: financial, physical and knowledge infrastructures. We introduced the idea of our three institutional infrastructures and how a new type of industrial policy is needed to successfully create and interconnect financial, physical, and knowledge infrastructures in a national economy.

We have advocated a new industrial policy framework that requires a three-way partnership among national governments, foreign multinational corporations, and local multinational corporations. Critics of traditional industrial policy believe that industrial policy can increase political corruption, as well as the fact that government doesn't have sufficient knowledge and information to correctly choose the winners and losers in a national economy. Douglass North (1994, 2005) has emphasized that uncertainty is a continuing reality of the global economy. We believe that in the 21st century's complex, global business environment, no single groups of actors, whether they be a national government, foreign multinational corporations or local multinational corporations can overcome the complexities of uncertainty and dynamic pace of change.

At least two areas warrant further research: First, a comparison of the connection and interdependence among the three institutional infrastructures in high-income, developed economies, and emerging and developing economies. Second, an empirical comparison of the role of these three institutional infrastructures in the United States versus other countries since the 2008 global financial crisis is needed.

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