

# **Domestic Structures, Foreign Economic Policies and Global Economic Order: Implications from the Rise of Large Emerging Economies**

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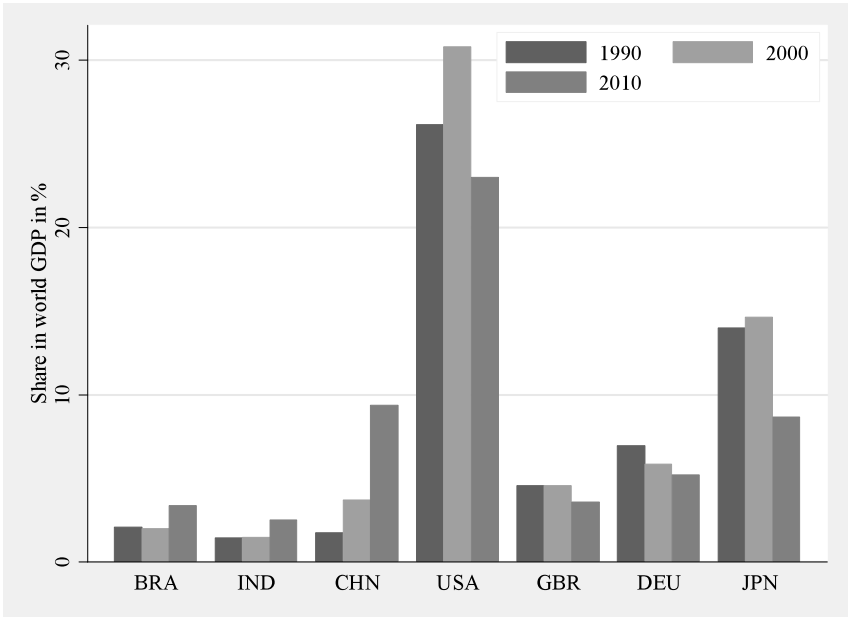
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An online edition of the final version will be available on SAGE Online First by about October or November 2014.

**Abstract:** The rise of the large emerging economies of Brazil, India and China can be counted among the most important contemporary structural changes in the global political economy. This article attempts to determine whether these countries have a common institutional model for governing their economies and addresses the implications of these commonalities for global economic institutions. The approach consists of three major steps: firstly, a general ideal type for encompassing capitalism in these large emerging economies is constructed, and dubbed 'state-permeated market economy'. Secondly, we compare these countries empirically, with regard to the features highlighted by the ideal type and in contrast to other varieties of capitalism. Finally, we extrapolate some long-term implications for the global economic order, based on the assumption that foreign economic policies will be informed by domestic institutional structures. Based on these three steps we conclude that a further deepening of the liberal global order is unlikely.

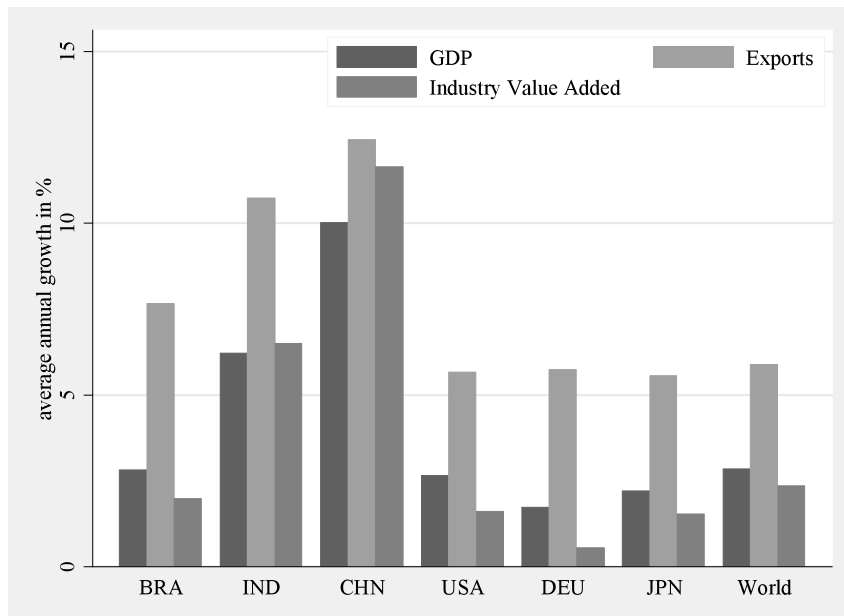
**Introduction**

The rise of Brazil, India and China, accelerated by the Great Recession, can easily be counted among the most important contemporary structural changes in the global political economy. This development is not only relevant for business analysts and economists, but also for political scientists and international relations scholars. It poses the question which implications this rise may have for global politics. This observation is even more striking if we ignore yearly or quarterly GDP figures, and examine long-term developments. Between 1990 and 2010, the share of World GDP by Brazil, India and China (BIC) doubled, whereas the shares of all the major established economies (USA, Great Britain, Germany and Japan) decreased (Figure 1).



**Figure 1.** Shifting shares of global wealth, Share in World GDP in %, 1990-2010. Source: World Bank Database.

As Figure 2 shows, growth stagnated for many parts of the world economy, including the USA and Europe, while emerging economies were able to boost their economic performance.



**Figure 2.** Industrial and trade growth compared, Average Growth of GDP, Exports and Industry Value Added, 1980 – 2010.

Source: World Bank Database.

Recent financial turbulences following the ‘tapering’ of the Quantitative Easing’ by the US Fed hardly affects the long term prospects of the largest emerging economies. According to the 2013 Global Manufacturing Competitiveness Index, a survey of more than 500 CEOs of global manufacturing firms, China will remain the top destination for manufacturing. Interestingly, it is predicted that India and Brazil will overtake Germany and the US (currently ranked 2<sup>nd</sup> and 3<sup>rd</sup> respectively) over the next five years. Similarly, the recent Global Development Horizons report projects that by 2030, China and India combined will account for 38 per cent of global gross investment and for almost half of global manufacturing investment (World Bank, 2013). These figures demonstrate that the increasing prominence of large emerging economies is not only a trend propagated by Goldman Sachs (‘BRICS’), but a more fundamental long-term shift in economic power. China in particular has gained impressively in economic importance over the last decades.

The concern of this article is to analyse the domestic economic architecture of Brazil, India, and China in order to understand possible implications of their rise for established global economic institutions. The point of departure of our argument is the obvious correspondence between the policy outlook of global economic institutions and the domestic economic principles of the leading economic powers, culminating in the (Post-) Washington Consensus during the heyday of US hegemony. One can imagine that, in the long run, the features of the Chinese economy will affect the institutions of the global economic order, by replacing Anglo-Saxon liberal capitalism with state-led Sino-capitalism as general lead model (McNally, 2012). However, for the foreseeable future, China alone is neither willing, nor powerful enough to challenge the liberal economic order (Lieberthal and Wang, 2012; Chong 2013). A more relevant contender thus might be an ensemble of large emerging economies from the South that share a similar trajectory of development, also comprising Brazil and India. We

may assume that common economic institutions within this grouping are a more likely potential alternative to the liberal US model than the Chinese model alone.<sup>i</sup>

To explore this issue, a 'second image' (Waltz 1959) perspective is applied. This perspective, especially in the version developed by Peter Katzenstein, maintains that domestic structures are crucial for explaining a state's international policy preferences (Katzenstein 1976, 1977, 1978).<sup>ii</sup> By inquiring into the "externalization of domestic structures" (Katzenstein, 1976), this perspective is well-suited for the combination of comparative and international approaches within Political Economy. It is particularly useful because the strong domestic orientations of large emerging economies and their specific state-society configurations require analytical instruments that are able to incorporate domestic features in the analysis of foreign economic policy preferences (Gray and Murphy 2013).<sup>iii</sup> The article thus develops a Political Economy approach for answering a question that so far has primarily been addressed from conventional International Relations perspectives, i.e. within Realist, Liberal or Constructivist reasoning about the role of 'rising powers' in the global political order (e.g. Legro, 2005; Johnston, 2007; Ikenberry, 2008; Alexandroff and Cooper, 2010; Kirshner 2010; Schirm, 2010; Schweller, 2011; Kahler, 2013; Scott and Wilkinson, 2013).

In simple terms, the main aim of this article is to assess the potential for a 'State Capitalist Consensus' (instead of a 'Beijing Consensus') replacing the '(Post-) Washington Consensus' and how foreign economic strategies of large emerging economies are actually paving the way for such a process. For the case selection we include the most prominent and economically successful cases, China and India, while also showing that 'state capitalism' is not an exclusively Asian phenomenon, by taking in Brazil. Due to their comparably small domestic markets and the fact they are hardly 'emerging', we are not looking into other large non-OECD economies such as South Africa and Russia.<sup>iv</sup>

In order to speak of 'BIC'-capitalism as a potential challenger of the established economic order, however, it still bears the question whether there are sufficient similarities among large emerging economies. At first glance, this idea seems to be negated by the very different economic profiles of the three countries, which are dominated by agriculture and mining (Brazil), software and business services (India) and manufacturing (China) (Barbosa and Jenkins, 2012). However, except for trade issues, these specializations are of limited importance for the institutions of the global economic order. More important are the various institutions that are governing the economy in Brazil, India and China. It is thus imperative to determine whether these countries have some kind of common institutional model. For this purpose, the Comparative Capitalisms approach, which stresses the importance of institutional spheres and their mutual complementarities for the evolution of distinctive models of capitalism, is followed. Inspired by the landmark study by Hall and Soskice on 'Varieties of Capitalism' (Hall and Soskice, 2001), considerable theoretical development and innovation occurred in this field over the last decade. The two original models coordinated market economies (CME) and liberal market economies (LME) have recently been complemented by a third model of dependent market economies (DME) (Nölke and Vliegenthart, 2009)<sup>v</sup> and a model of state-led market economies.<sup>vi</sup> We thus contribute to a CC/BRICS research program that is currently burgeoning, also within emerging countries such as Brazil, India and South Africa (Becker, 2013; Boschi and Santana, 2012; Bresser-Pereira, 2012; Conde and Delgado,

2009; Ebenau, 2012; Kennedy, 2011; Mazumdar, 2010; Musacchio and Lazzarini, 2014; Padayachee, 2013; Schmalz and Ebenau, 2012; Schneider, 2013; Witt and Redding, 2014). In the context of this debate, we refer to the field of ‘Comparative Capitalisms’ (Jackson and Deeg, 2006), which includes the ‘Varieties of Capitalism’-approach, but goes beyond its national LME-CME dichotomy. National systems of capitalism cannot be understood without their transnational 'embeddedness'. This necessitates an approach which combines concepts from Comparative and International Political Economy, contributing to overcoming the artificial split within the Political Economy tradition. Finally, in contrast to the earlier ‘Varieties of Capitalism’ (VoC) research program, we also seek to overcome the narrow preoccupation with micro-economic efficiency. Our approach includes issues like the role of the state, of (large) domestic markets and of power relations. Yet, despite the analytical value of different approaches to capitalist diversity (Amable, 2003; Coates, 2006; Jackson and Deeg, 2006), we follow some the heuristics of the VoC-approach because it allows for a rigorous comparison with other types of capitalism on the ground of a clearly defined set of institutions.

Our argument proceeds in three major steps: first, we construct an ideal type of state capitalism in large emerging economies which we call ‘state-permeated market economy’ (SME). Second, we empirically compare Brazil, India and China with regard to the elements of the model, but also against a set of countries that serve as emblematic cases of alternative forms of capitalism (CME, DME and LME). Importantly, we do not assume that the ideal type and the empirical situation of a given country are necessarily identical: countries may differ from the ideal type and they may also move more closely to or more distant from the type over time (Becker, 2013). In fact, we observe China as being the most typical case of an SME, while the elements of the ideal type are slightly less pronounced in India and Brazil. Third, the empirical properties of the large emerging economies are compared to the relevant current features of global economic institutions. . Here we are demonstrating that state-permeated capitalism as a model of global economic order is indeed different from the liberal model that is informing the established international economic institutions. From this perspective, a further deepening of the current US-led global liberal order (Breen 2012; van Apeldoorn and de Graaff 2014) is highly unlikely.

### **State-permeated capitalism: the ideal type**

Our model of state capitalism is based on the observation that the state in the BICs, driven by a strong pro-business support for national development, is more important than in established OECD economies (Kohli 2004). Yet, in opposition to those who do not distinguish contemporary state capitalism from older varieties (see Bremmer, 2010; Economist 2012), this article maintains that the state, in large emerging economies, is not an all-powerful, centralised, steering bureaucracy (as in the classical developmental state model) (Boschi, 2011; Wade, 1990). Rather, its activity is based on close cooperation between various state and domestic business coalitions at the national and sub-national level which gives rise to the notion of a rather fragmented, yet dynamic state-*permeated* market economy. This model is coordinated by reciprocal mechanisms of loyalty and trust between individual members of these (competition-driven) state-business coalitions, based on informal personal relations, family ties, and shared social (elite) backgrounds. In this common feature, SMEs differ not

only from older, bureaucratic state capitalisms, but also from other economic models, which are coordinated by the market and formal contracts (LMEs), formalised networks and associations (CMEs), or hierarchies within multinational enterprises (DMEs).

Furthermore, the model of state-permeated market economies is considered to be typical for *large* emerging economies. Undoubtedly, the practitioners of this new form of capitalism are deeply immersed in the international trading system and global production networks. However, due to the large size and dynamics of their domestic markets, emerging economy governments have a good negotiation position vis-a-vis foreign investors and governments and are able to practice a selective opening of their economies. Therefore, large emerging economies are marked by the dominance of national capital – not of foreign multinationals – in marked contrast to dependent market economies in East Central Europe or to other emerging economies such as Mexico or South Africa (Nölke and Vliegenthart, 2009; Schneider, 2013).

The following model is based both on deductive reasoning and on inductive studies on emerging economies. Moreover, it is assumed that these countries are internally too large and heterogeneous to fit into one model for the whole economy. Therefore, the focus is on large companies and on the industrialised sectors of these economies (and e.g. not on the rural subsistence economy). The model aims to transfer the insights of studies on the relation between state and economy in developing countries into a model that is comparable to other types of capitalism. Hence, it draws on the analyses of the state-society-relationship in developing countries (Migdal 2001), of the role of the state in the economic order (Amsden, 1989; Wade, 1990; Boyer, 2005), and in fostering industrial development (Haggard, 1990; Evans, 1995; Kohli, 2004). By this, we are better able to analyse the impact of the state in the economy beyond a general assertion that the ‘state matters’. The model departs from the five central institutional spheres which were established by the Comparative Capitalism research program: corporate governance (understood as the ability for corporate control); corporate finance (the means by which companies raise funds for investments); labour relations; education and training<sup>vii</sup>; and the transfer of innovations. We enlarge this program through the examination of the role of the state across all spheres as well as the importance of domestic markets and ways of international economic integration. Together, these issues constitute the set of domestic structures that large emerging economies eventually seek to externalise. We therefore stick to the analytical distinction between the domestic and the international level in economic policy-making, as put forward by numerous scholars (Katzenstein, 1976, 1977; Gourevitch, 1978; Milner, 1997; Simmons, 1994), but do not assert that the externalization of domestic structures is primarily one of domestic policy-making. Instead, our explanatory model for the formation of external strategies by economic actors follows the assumption that these actors seek to avoid the establishment of powerful global institutions that might destroy crucial domestic institutional complementarities, based on considerations developed in historical institutionalism (Fioretos 2001, 2011).

*Corporate governance:* In SMEs, most major companies in SMEs are dominated by national capital, and not by transnational financial investors. They are usually controlled by well-connected families or the state. This is in contrast to liberal market economies (where the largest companies are dominated by minority shareholders and transnational financial

investors), coordinated market economies (where the largest companies are dominated by block-holders such as families, other companies or banks) and dependent market economies (where the largest companies are dominated by multinational enterprises).

*Corporate finance:* Enterprises in SMEs are relatively independent from short-term volatilities on global capital markets as well as from profit expectations by international investors. They mainly raise investments through internal savings and loans by national banks. Furthermore, they enjoy preferential support by the state, receiving for instance cheap credit or tax reductions. Although banks are central creditors in SMEs and CMEs, SMEs differ in that domestic banks and capital markets are controlled by the state and in that the state controls the inflow of foreign capital in these countries. The institutional characteristics of both enterprises as well as financial systems in emerging countries create a system of incentives in which the market for corporate control plays a minor role. This is in stark contrast to LMEs (where major corporations tend to be oriented to global capital markets) and it also differs from DMEs (where investment funds are primarily allocated from the parent branches of multinational enterprises).

*Labour relations:* In the SME model, state institutions arrange for the preservation of a low wage regime. Labour relations are characterised by the strong segmentation and segregation of the labour force into a comparatively highly paid and well protected segment, a less well paid and barely protected segment and an informal sector, often in addition to segmentation between regions and industrial sectors. This labour regime is supported by a continuous supply of cheap rural labour power and state preservation of low wages, often through the selective non-enforcement of labour regulations which often only sound comprehensive on paper. Industrial relations are regulated at the firm level, which is very different from the sector-corporatist CME model. The SME model therefore shows some parallels to LMEs and DMEs, which also feature firm level regulation, yet it is still quite different, due to lower wages, limited worker protection and a large informal sector.

*Innovation:* SMEs have relatively weak, state-tolerated patent rights systems that simplify reverse engineering and support technological catch-up. Furthermore, original technological innovations in SMEs take place through state support in selected sectors for technological upgrading as well as through spin-offs from public research. This can be juxtaposed to LMEs (where innovations are mostly spread via markets), CMEs (where innovation is frequently based on inter-company cooperation and associations), and to DMEs, (where innovation is based on intra-firm transfer in multinational corporations). In contrast to the SMEs, the other three types share the importance of a strong regime for intellectual property rights protection.

*Domestic market and international integration:* The relatively stable, steady growth of SMEs is not least based on the existence of large domestic markets. They are of major significance for the growth of industries, for domestic companies successfully orienting towards them, and for a national interest in protecting this beneficial internal setup. In comparison to higher degrees of openness in LMEs, CMEs and DMEs, SMEs rather use a policy of selective and phased integration into the global economy. Because of the sheer size of their economies, and their lucrative investment climates (which make them attractive markets for multinational corporations from OECD countries), SMEs become strong negotiation partners in bi- and multilateral decision making processes, more so than other emerging countries (see van

Tulder, 2010). Therefore, state managers do not necessarily have to cater the demands of foreign multinationals. In this way, they strive for a selective opening (for purposes such as technological modernization through foreign multinationals). Additionally, the large and protected domestic markets serve as a stepping stone for the international expansion of large SME companies. Moreover, public and private demand allows for a certain degree of isolation from fluctuations on global markets, and may also enable growth strategies based on internal demand. Large domestic markets therefore allow for a high degree of independence from external economic pressures – which should become visible in their policy stance towards global economic institutions. Table 1 summarizes the SME model in contrast to other varieties of capitalism.

**Table 1.** The main varieties of capitalism.

<i>Variety of capitalism/ institutions</i>	<i>Liberal Market Economy (LME)</i>	<i>Coordinated Market Economy (CME)</i>	<i>Dependent Market Economy (DME)</i>	<i>State-permeated Market Economy (SME)</i>
<i>Coordination mechanism</i>	Competitive markets and formal contracts	Interfirm networks and association	Dependent on intrafirm hierarchies in multinational corporations	Interpersonal reciprocity, loyalty and private-public alliances
<i>Corporate governance</i>	Outsider control: minority shareholders	Insider control: concentrated shareholders	Control by headquarters of multinational corporations	Control by national capital, not by transnational investors
<i>Corporate finance</i>	Domestic and international capital markets	Domestic bank lending and internally generated funds	Foreign direct investments and foreign-owned banks	Family capital and state-owned banks, low foreign finance
<i>Labor relations</i>	Pluralist, market based, few collective agreements	Corporatist, rather consensual, sectoral or national-wide agreements	Appeasement of skilled labor, company based agreements	Low wage regime, selective enforcement of worker rights
<i>Transfer of innovation</i>	Market and formal contracts	Inter company co-operations and business associations	Intra-firm transfer within multinational corporations	Technological catch-up through reverse engineering and state-led innovation
<i>Domestic market and international integration</i>	Linked to liberalized global economy, expansion via financial markets	Not constitutive for export-based growth model, mainly exports	Very open for imports, dependent on external actors	Large domestic markets, selective internationalization

To conclude, the SME model shows a clear juxtaposition to other established CC models. It presents an alternative conception of the state that can be compared to other capitalist



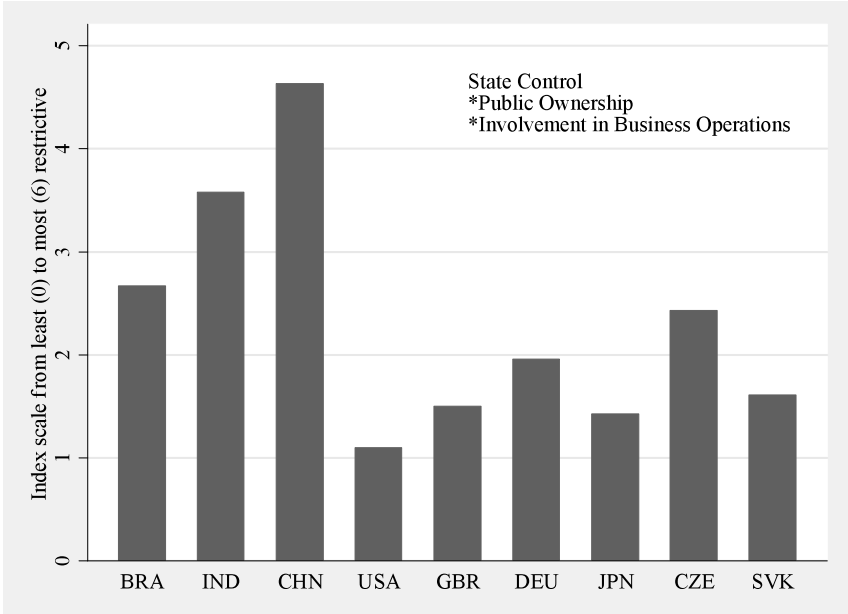
varieties (see Amable, 2003; Boyer, 2005; Whitley, 2005; Schmidt, 2009). In simple terms, SMEs are less dependent than DMEs, less liberal than LMEs and less coordinated than CMEs. Given that DMEs have almost no potential to challenge existing global institutions, and CMEs tended to converge to the liberal ‘rules of the game’ during the 1990s and 2000s, SMEs are the only candidates to put liberal hegemony into question.

**Empirical findings: state-permeated capitalism in comparison to other varieties of capitalism**

In the following, we assess how Brazil, India and China fit to the SME ideal type. Additionally, these countries are compared to other countries whose political economies resemble the other three established types of capitalism (CME, LME and DME). Therefore, the questions guiding this section are: how do the BICs compare to the SME ideal type? Do the BICs share commonalities with the other three types? Are some of them closer to the SME ideal type than others? In order to answer these questions, a rather general and static ‘snapshot’, based on descriptive statistics and qualitative research, is used. The basis is a comparison of LME/CME/DME/SME, where the three BIC countries represent SMEs, and of two other most significant countries for each comparative type: the USA and Great Britain for LMEs; Germany and Japan for CMEs; and the Czech Republic and Slovakia for the DME variety.

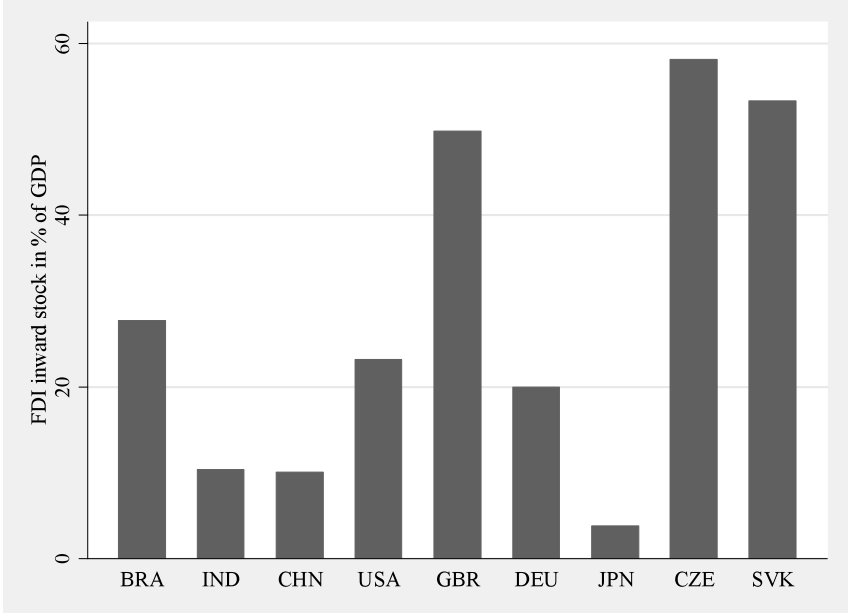
*Corporate governance*

According to our model, large companies in SMEs are dominated by national capital, in particular the state and well-connected families. A typical feature is state control of major corporations, in terms of public ownership and various forms of state involvement in business operations. We thus observe strong state control in all BICs (Figure 3).



**Figure 3.** Levels of state control in BIC economies, 2008.  
Source: OECD, Product Market Regulation Database.

Foreign ownership of companies, in contrast, is much less relevant (Figure 4). This contrast is most obvious when comparing SMEs to DMEs, but also noticeable with regard to LMEs and CMEs (with the exception of Japan). However, empirical results point to a stark contrast with China and India on the one side, and Brazil on the other; with Brazil being more open to foreign ownership.



**Figure 4.** Levels of foreign ownership, FDI Inward Stock as percent of GDP, 2011. Source: UNCTAD, World Investment Report.

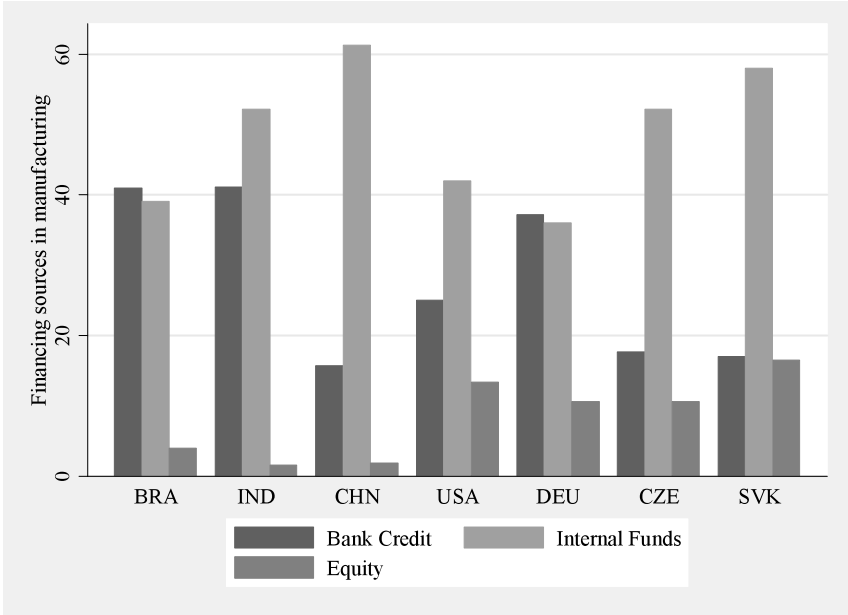
China is paradigmatic for state control of major corporations. However, in opposition to older versions of state capitalism and developmental states, there is neither a classical top-down control, nor is there a single guiding enterprise model (such as Chaebols and Keiretsu in South Korea and Japan respectively). New forms of profit-oriented and competition-driven state-controlled enterprises such as China Mobile have emerged, which are mostly listed, and are yet dominated by state block-holders. Nonetheless, private firms and public-private hybrids such as Huawei, Lenovo or Geely have also been able to play a significant role in development. These days, such non-state national firms are also seen as ‘national champions’ by state managers (Naughton, 2007). With some notable exceptions (for instance in the IT industry, which is deeply integrated into global production networks), most industrial sectors are dominated by national (state-controlled, hybrid and private) capital, and not by foreign multinationals.

Major Indian companies are typically also not dominated by dispersed shareholders or the organised forces of global capital markets (for example mutual funds, pension funds, investment banks and hedge funds), but are controlled by family-led business groups (mainly in manufacturing and services) or the state (predominantly in the primary sector). Family ownership can be counted among the “distinguishing features” of Indian multinational corporations (Allen et al., 2006: 31). Even after the wave of privatization in the early 1990s, over 70% of the largest Indian enterprises are family-owned (Dutta, 1997: 9).

Most large Brazilian companies are exchange listed, but are usually dominated by family shareholdings or other block-holders (see the data in Valor, 2012). In addition, the Brazilian state keeps substantial shareholdings, particularly in the case of former public enterprises that have been privatised (such as Embraer). Direct state intervention, however, remains the exception - more important are indirect channels, in particular via institutions such as the national development bank BNDES (Banco Nacional de Desenvolvimento Econômico e Social). In nearly all cases, major Brazilian companies are fairly independent from short-term fluctuations on the financial markets. There is no open market for the control of companies but rather an 'insider' dominated mode of corporate control,. Completely dispersed shareholding is very rare, and minority shareholders tend to be disadvantaged by dominating shareholders. As such, the recent 'Corporate Governance' movement met considerable resistance in Brazil (Grün, 2010), even if the dominant role of family capitalism has been modernised (Abu-El-Haj, 2007: 106). Thus, major SME companies tend to share state and family control.

*Corporate Finance*

In contrast to LMEs, CMEs and DMEs, global capital markets play no significant role in funding new investments in the BICs (for the manufacturing sector, see Figure 5). Instead, firms primarily use internal funds and bank credit for their operations. Due to the prevailing corporate governance structures in Brazil, China and India, the use of internal funds is directly controlled by the owning families or state institutions. This facilitates autonomous business strategies which would be less possible if firms were to rely on (foreign) shareholders.



**Figure 5.** Sources for financing investments in manufacturing in percent, 2007 – 2011. Source: World Bank Enterprise Surveys, China National Bureau of Statistics, US Census (no comprehensive data for Great Britain and Japan available).

However, unlike in CMEs, banks are often not privately held, but in the hands of the state. Approximately half of the national banking assets (and even up to 75% in the case of India)

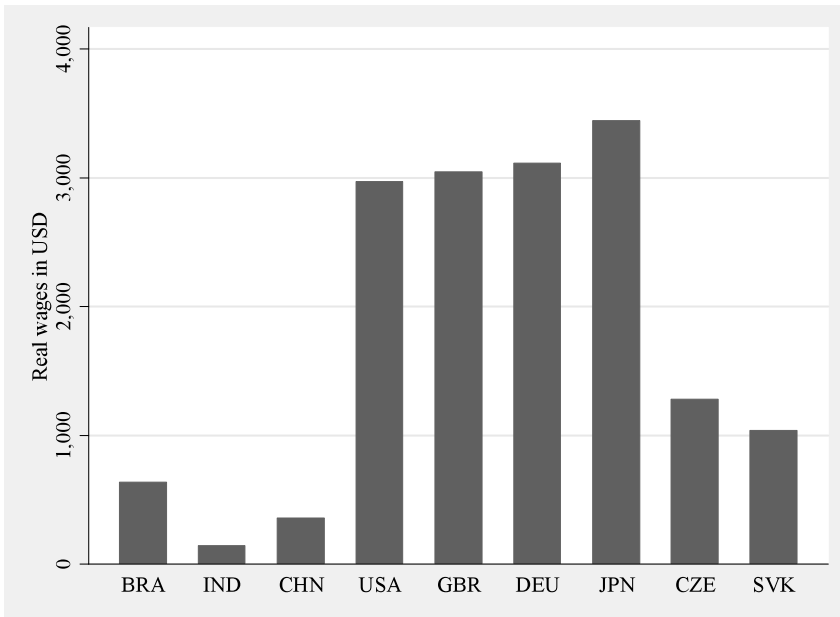
are held by the state. While in DMEs and emerging countries such as Mexico foreign banks account for more than 75% of the domestic banking sector, they play a minor role in SMEs. In Brazil, about 20% of the total banking assets are foreign-owned, while the rates for China and India are even lower (Deutsche Bank Research, 2011). Most 'private' banks are indeed listed on local stock markets but their shares are held by public bodies. Thus, most bank loans to BICs enterprises are in fact state credit lines.

Not only does this allow the state a certain 'grip' on national companies, it also gives the companies a strategic advantage due to lower interest rates, longer credit maturities and few conditions for creditworthiness (in contrast to global credit markets) (Masiero and Zalaf Caseiro, 2012). Here, development banks (or commercial banks acting similar to development banks) play a crucial role. Through favourable and large credit lines, they are able to create incentives for investment according to states' development policies. BNDES, for instance, lends out approximately 7,5% of the Brazilian GDP and disburses four times more loans than the World Bank (Lazzarini et al., 2012, 32; Santana, 2007). Between 70 and 80% of BNDES loans go to large enterprises (BNDES, 2012: 35). The objective behind development bank lending is therefore not to provide credit for those firms that face constraints on the private credit market, but to boost investments of already profitable firms (Lazzarini et al., 2012). In all BICs, large firms are able to secure additional bank credit for investment next to their internally generated funds, enabling them to undertake larger investments which, in turn, support the concentration of business in large emerging economies.

The state further restricts the free flow of capital (especially foreign capital) through regulatory measures, such as capital controls (Brazil), limits to financial products to be traded (Brazil and India) or limits to the tradability of firm shares. Two thirds of all shares on Chinese stock exchanges are non-tradable, and are mostly held by the state (Allen et al., 2010: 155). Hence, Chinese stock markets are designed to raise additional capital for a few large firms that are not fully "private" as they are still controlled by state blockholders (Yeung, 2004: 194). In contrast to LMEs, CMEs and DMEs, state regulation of the credit sector in SMEs thus limits the influence of foreign capital and thereby maintains the concentration of capital, especially within domestic national fractions.

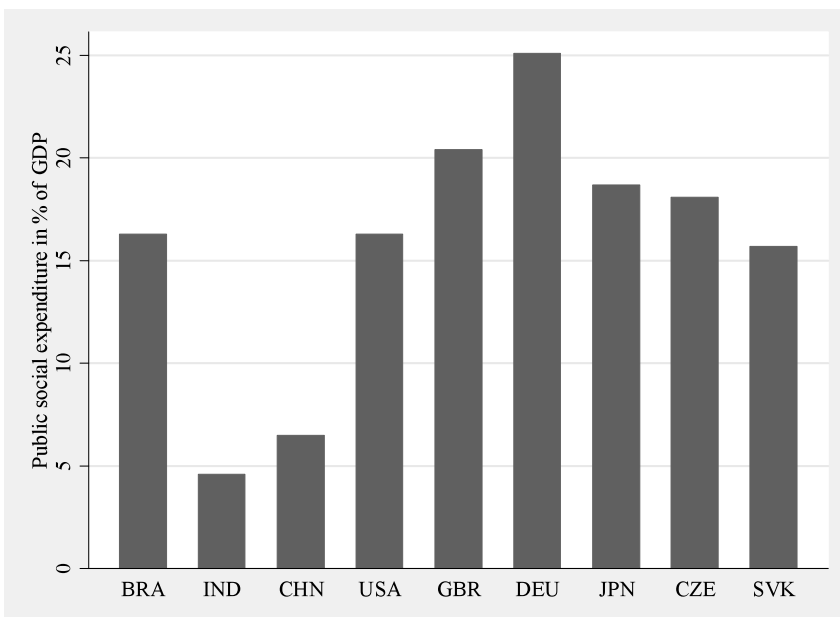
### *Labour relations*

In the SME model, state institutions in Brazil, India and China arrange for the maintenance of a low wage regime. Even if extreme poverty has significantly decreased, interviewees from Economics departments in Chinese universities state that "low wages" accounted for almost "50 percent of overall GDP growth during the reform era" (Interview, 8 January 2013), compared to other factors such as state steering capacities, foreign investment and/or the benefits of international integration. In comparison to LMEs, CMEs and also DMEs, the average wages for workers in the SMEs remain much lower (Figure 6).



**Figure 6.** Real average wages across types of capitalism, 2009 (except for India, 2008).  
Source: International Labor Organization, KILM Database.

The fact that wages are regulated mainly at the firm level results in a lack of collective and cross-sector regulation of labour and social standards, as well as low organizational and bargaining powers of workers. This is underlined by a decrease in the wage share. Low public social expenditures also contribute to the preservation of the low wage regime (with the exception of Brazil – see Figure 7) (see Frazier 2011). In addition high volume production based on cheap labour creates a profitable investment climate. On top of this, government’s attempts to individuate industrial disputes help to keep labour unrest at bay (Butollo and ten Brink 2012).



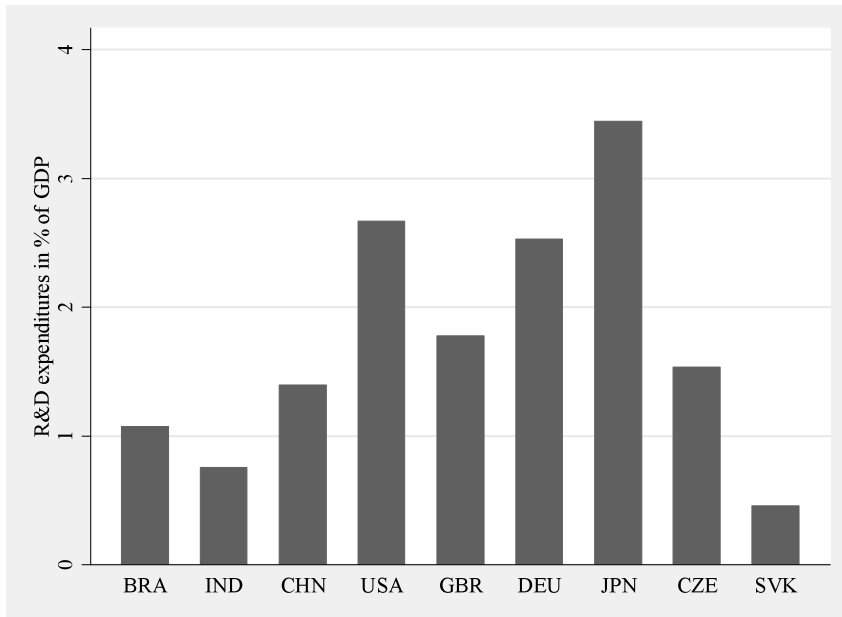
**Figure 7.** Levels of public social expenditure, in % of GDP.  
Source: OECD 2010; OECD 2013. All values for the year 2007, except Brazil (2005), India (2006-2007) and China (2008).

Importantly, the size and the heterogeneity of the BICs allow employers to exploit the inequalities of diverging regional conditions of accumulation, regional working systems and different industrial sectors. A key factor for this 'success story' thus proves to be the segmentation and segregation of the labour force. First, huge *differences between industrial sectors* prevailed over the 2000s. Second, enormous *differences within sectors* exist. Regarding China, close cooperation between management and both the state and party-led trade unions is common in industrial sectors with increasing wage demand. State regulations and their selective implementation thereby contribute to keeping labour costs relatively low. On top of this segmented wage organization (with space for small labour elites) comes the geographical segregation of urban and migrant workers, which provides the Chinese companies with cheap labour. The household registration system (*hukou*), which ties an individual's social benefits to a particular place, "is obviously central to the current system of sustaining super low-cost Chinese labour in the international market" (Chan and Buckingham, 2008: 604).

A strong segmentation and segregation of the workforce can also be identified in India with its history of caste discrimination and huge internal heterogeneity. The majority of the Indian working class still has no formal contract, and thus a weak implementation of existing labour standards prevailed over the 2000s, also in the booming IT services sector (Kohli, 2012: 148). Surprisingly, even after some reform policies of the Lula government, Brazil's system of labour relations can still be called a low wage regime. There are huge regional gaps in terms of wages and working conditions. Brazil's own internal 'migrant workers' from the Northeast are employed in the industrialized areas such as the Southern state of São Paulo (and they are often being racially discriminated against).

### *Innovation*

Compared to CMEs and LMEs, research and development expenditures are more limited in the BICs, but higher than in DMEs (Figure 8). China, scoring the highest among the BICs, spends about 1.46% of its annual GDP on research and development. All LMEs and CMEs spend more on research and development and so far, both DMEs and SMEs are not significant centres of research and innovation. In DMEs, new products and technologies are usually brought in by foreign multinational corporations. By contrast, SMEs have found a competitive niche in the technological reinvention of imported products, which they are able to reproduce at a much lower cost.



**Figure 8.** Public expenditures on R&D, in percent of GDP, 2007.

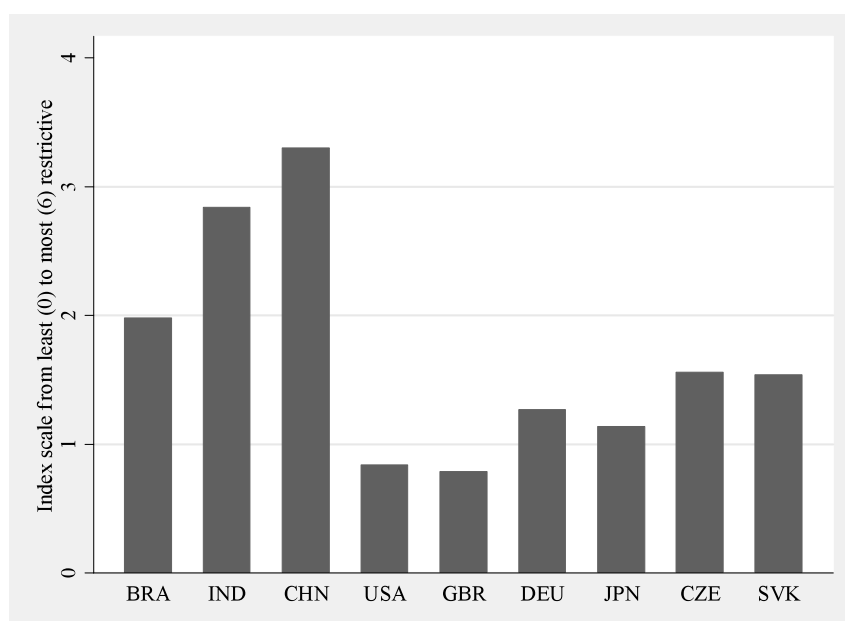
Source: World Bank.

Traditionally, SME companies rely on various forms of interaction with CME and LME companies (such as joint ventures) and a weak patent rights system for their technological catch-up. They profit from existing technology and the transfer of innovation through trade and foreign direct investment, mainly from industrialised countries (Goedhuys and Veugelers, 2012: 517; Szirmai, 2012: 407). China, the key SME, has built its production system and its successful economic growth path on the imitation of imported products, leading to conflicts about the protection of intellectual property rights (Liu and Liu, 2009: 152-158; Plechero, 2012: 44-45). Similarly, Indian enterprises use reverse engineering to create competitive domestic firms, especially in the automotive and pharmaceutical industries. Only recently India has begun to support foreign research collaboration among firms, as well as research and development investment by foreign firms in India and abroad (Joseph and Abrol, 2009: 113-129).

Brazilian firms are also traditionally hesitant to invest into research and development activities. 1.7% of Brazilian companies focus on innovation, while more than 77% situate their competitive advantage in a low-cost, but also low-productivity environment (Arbix, 2008: 5). These companies have traditionally been content with providing goods for the domestic market which, similarly to India, is protected by relatively huge tariffs, which today are still on average above 30% (WTO, 2012). Innovation policies are limited to public companies, while private firms are able to evade investments on technological development (Condé and Godinho, 2009: 20; Kattel and Primi, 2012: 274-5). Similar to India, it is only recently that the Brazilian state has taken on a more active role in supporting collaboration between universities and enterprises through research and development and direct subsidies, mainly led by the Brazilian innovation agency FINEP.

### *Domestic market and international integration*

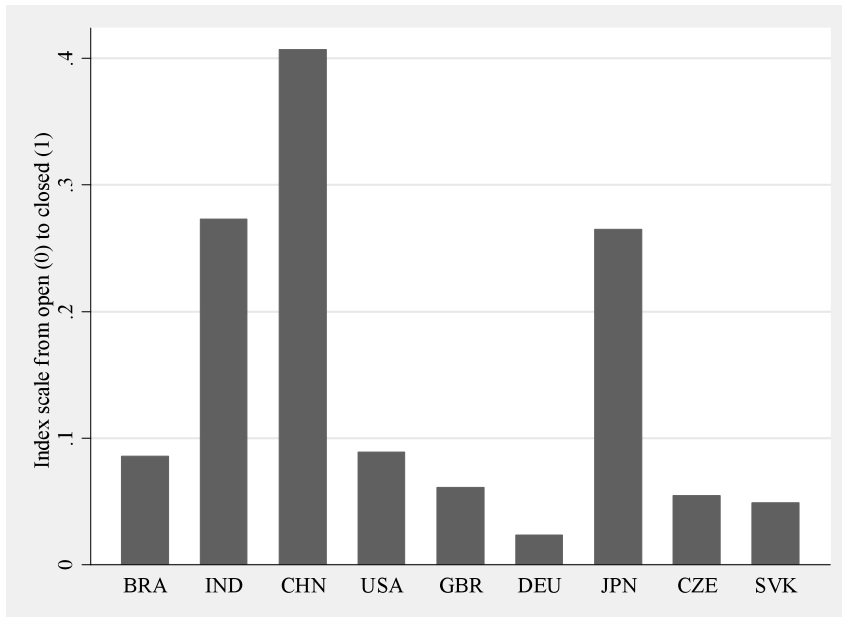
In contrast to widespread assumptions that emphasise the role of exports in the rise of emerging economies, the size of BIC domestic markets is of major significance for their growth dynamics. Accordingly, BIC exports represent only about a quarter of industrial output since the 2000s. While Brazil, India and China have undoubtedly profited tremendously from opening their economies to foreign direct investments (FDI), their internal markets are still far more protected than in LME/CME/DME, in order to support national domestic firms. One obvious indicator is the product market regulation score as compiled by the OECD (Figure 9). According to this indicator, product market regulation in all three countries is more restrictive than in all other countries chosen for comparison.



**Figure 9.** Regulation levels of national product markets, Product Market Regulation Scores, 2008.  
Source: OECD, Product Market Regulation Database.

However, a closer look at the more particular issue of inward FDI regulation shows the familiar picture of China and India standing somewhat apart from Brazil, which is more open (Figure 10).



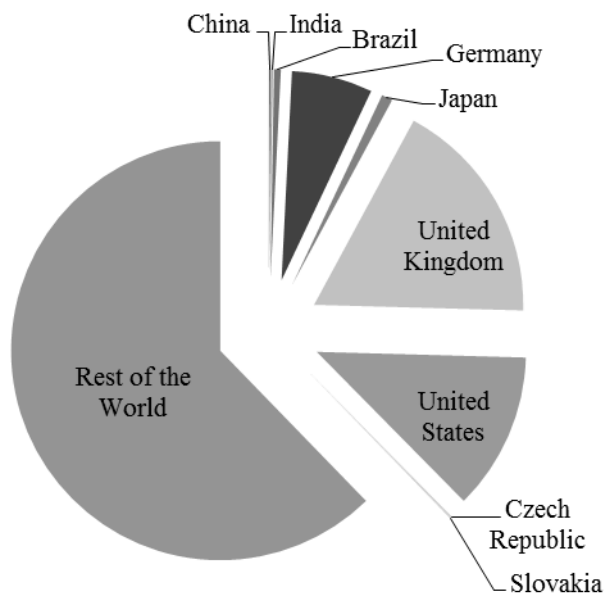


**Figure 10.** Barriers to incoming FDI, FDI regulatory Restrictiveness Index, 2012.

Source: OCED, FDI Regulatory Restrictiveness Database.

In spite of its very large, absolute inward FDI stock, China is by far the most restrictive country regarding inward FDI. India follows suit, as number four in the FDI Regulatory Restrictiveness ranking. The high rate of FDI restrictiveness corresponds with the overall low level of FDI stock (see Figure 4). Hence, the low rate of foreign ownership in emerging economies is not primarily due to economic factors (such as a rough investment climate or limited access to capital) but also due to the barriers to foreign capital erected by the state. This is part of a strategy to protect national firms from foreign takeover and to facilitate their going out strategies at the same time. It is furthermore a necessary precondition to enable selective imports of foreign technology to modernise the industrial sector without losing control over the national business structure (Brandt and Thun, 2010; NBS, 2011). Support by the state and public policies such as financial support schemes and investment regulations are crucial factors contributing to the rise of Indian multinational corporations. Thus, the Indian state has been the major player in creating, shaping, and fostering the growth of today's Indian multinational corporations, based on close collaboration with major capitalists (Gupta, 2006). Similarly, Brazilian companies are profiting from their "thick ties between the traditional oligarchy and the state" (Phillips, 2004: 55. At the same time, Brazil is subject to a policy of purposeful diversification of economic structures, on the basis of state led import substitution and targeted protection of individual economic sectors. However, compared to the US or Western Europe, the internationalization of Brazilian capital is relatively limited (Phillips, 2004: 194).

Although the BICs are selectively integrated into global product markets, they do not comprehensively engage with global financial markets. As a consequence, SMEs are independent from external credit (Figure 11).



**Figure 11.** Country shares of global outstanding international debt securities, 2010.  
Source: Bank for International Settlements.

Neither firms nor governments from SMEs (and DMEs) borrow to a significant degree on global security markets. While the capital needs of DMEs are met by high FDI inflows (Figure 4), SMEs neither depend on foreign capital nor on external debt but rather opt for a relative decoupling from global finance. By linking central bank policies (most notably the accumulation of currency reserves) with regulatory measures to inhibit the free flow of capital into the BICs, the state actively devotes itself to a stability-oriented strategy which supports the long-term orientation of the SME model.

To conclude, there are remarkable commonalities between all three countries. Certain features are visible throughout most institutional spheres, with state-permeation, a pro-business policy stance supportive of national development and large and dynamic domestic markets as the characteristic elements. While some of the characteristics in single institutional spheres are also present in other developing economies that are undertaking catch-up industrialization (e.g. a low wage regime), it is the concurrence of the characteristics in all institutional spheres taken together that makes for a dynamic form of state capitalism different from other emerging (and often dependent) market economies. As observers of the BICs are well aware of, this led to a dynamic economic development (in important parts of the urban economy) rather than to the production of patrimonial structures. It is the mutual complementarity of these features that allows for the establishment of a relatively stable growth regime. For instance, the closed control of companies by domestic capital complements the independence of the BICs from foreign financial capital. Similarly, a low wage, low skill regime and imported innovation foster the industrial concentration on relatively simple and medium-tech goods that can be sold on protected domestic markets. These domestic markets, in turn, are complementary to the dominant system of corporate finance because firms do not have to engage in giant investments in order to remain competitive on global markets. The empirical data shows evidence for most of the core elements of our SME model: strong state control;

company access to large domestic markets; protection against foreign capital and market fluctuations; segmented systems of (low cost) labour; yet limited, but increasing, innovation efforts. In a way, much of what has been written on Sino-capitalism is not exclusively Chinese but can be applied generally to this 'new type' of state capitalism that "contrasts sharply with liberal-democratic forms of capitalism, especially Anglo-American capitalism" (McNally, 2012: 757).

### **Domestic structures of state-permeated economies and foreign economic strategies**

The global capitalist system is experiencing the rapid and simultaneous rise of a continent sized capitalist power (China), a subcontinent sized power (India) and a regional power (Brazil). These countries feature institutions that are very different from those of Anglo-American liberal capitalism. How does this development affect the global economic order?

The question whether large emerging economies will challenge or will become integrated into the hegemonic liberal international economic and political system is among the most pressing questions of our times.. In the current International Relations debate (to put it in simple terms) this question mostly remains in a deadlocked, indissoluble state of contradictory theories. While many Realist scholars warn of a coming 'threat' (Mearsheimer, 2001: 362; Schweller, 2011, 287; Scott and Wilkinson, 2013), Liberal and Constructivist authors foresee a much more harmonious integration of China and other large emerging countries (Johnston, 2007; Ikenberry, 2008; Kahler, 2013). We argue that an answer to this question has to take the domestic level of emerging countries into account, in particular their domestic economic structures. This article maintains that a political economy approach opens up new perspectives on the implications of the rise of large emerging economies. What, then, has been determined so far?

In contrast to recent political economy studies that are following a country-by-country approach (Ban and Blyth, 2013; Becker, 2013) on large emerging markets, our study has avoided to be trapped by country-specific idiosyncrasies. From a Comparative Capitalism perspective, Brazil, India and China currently share important features, in spite of very different geographical locations and economic profiles. China and India are closer to the model of state-permeated market economies, whereas Brazil is somewhat more open to the liberal model. Yet, while China and India have never been liberal, Brazil is currently (after undergoing phases of liberalization during the 1990s) developing in a state-capitalist direction.

But if state capitalism is a decisive feature of the BICs, what would be the contours of their foreign economic strategies? Given the very recent rise of the BICs to economic prominence it seems to be too early to comprehensively answer these questions based on studies of existing political initiatives of the Brazilian, Indian or Chinese governments, either individually, as part of the BRICS group or other coalitions.<sup>viii</sup> In what follows, we develop a set of potential foreign economic strategies, based on the second-image reasoning by Peter Katzenstein that domestic structures are crucial for explaining a state's international policy preferences (see Katzenstein, 1976, 1977, 1978) and subsequent IPE approaches that investigated the domestic-international intersection (e.g. Fioretos 2001, 2011). In which ways could the BICs' domestic economic structures become "externalised" (Katzenstein, 1976: 2)?

For the support of our argument that the rise of large emerging economies might lead to an alternative global economic order, we present a range of *global institutional incompatibilities* and add brief empirical illustrations. It is a fact that the current economic order is largely modelled along the principles of the liberal model, the (post-) Washington consensus. How would an alternative economic order modelled along the state-permeated model look like? We proceed along the four different institutional dimensions established in the previous section and spell out the potential incompatibilities of the resulting foreign economic strategies with the norms and principles of existing global economic governance. In order to move beyond the purely hypothetical, we add a few illustrations about already existing (minor) conflicts. Our claim is not that this juxtaposition amounts to an alternative world economic order emerging in the near future. The latter would, inter alia, depend on the challengers' administrative capabilities for influencing global governance and on the counter-strategies of the incumbent powers (Kahler, 2013: 714). However, our perspective allows us to highlight more precisely where exactly preferences between challengers and incumbents are incompatible.

*Corporate governance:* Our discussion on corporate governance emphasises the importance of concentrated national (state/family) ownership, in contrast to the focus on the protection of minority shareholders in LMEs (and global economic institutions). In SMEs, the protection of minority shareholders is less prominent. Correspondingly, one can already observe an increasing number of disputes about international standards for corporate governance in regional trade agreements (Claar and Nölke 2013). Liberal international institutions not only insist on the existence of an open market for corporate control, but also on transparency for global investors in accounting, as stipulated by the London-based International Accounting Standards Board. Recently, conflicts between the latter and the governments of China and India have become more prominent (Ramanna 2013). Furthermore, the IMF framework on Reports on the Observance of Standards and Codes (ROSC), initially designed at the G7, includes the supervision of national corporate governance standards, following liberal OECD corporate governance principles.<sup>ix</sup> According to Baker, "they have become the principal international benchmarks for framing policy discourse in the area of corporate governance" (Baker, 2012: 390). Yet, this interference of the IMF into national regulation met with considerable resistance in the joint meetings of the IMF and World Bank as well as with the International Monetary and Financial Committee (IMFC) during the second half of the 2000s. Many emerging economies, most importantly Brazil and China, refuse to disclose information on corporate governance regulation according to these codes (Mosley, 2010).

*Corporate finance:* In this sphere, the picture is similar. Finance in large emerging economies is characterised by the dominance of national banks and other domestic-led channels of credit. The strong role of patient capital plays a crucial role for the medium-term stability of the BICs. As an external effect, they regularly erect hurdles against international capital mobility, in particular portfolio capital. Large emerging economies follow a defensive foreign economic strategy, when international pressures threaten the national financial system. Despite efforts for a New International Financial Architecture (Wade, 2007; Eichengreen, 2009; Germain, 2010), the crucial institutions of global finance remained essentially liberal.

Until very recently, capital controls constituted a breach with global economic regulatory norms, yet Brazil (as a more liberal SME) moved towards gradual controls from 2008 on.

More generally, the persistence of financial globalization collides with state-capitalist preferences to minimise risk and to preserve economic stability, as illustrated by the recent post-taper turbulences. Institutional incompatibilities thereby not only become visible in the area of capital account management, but also in banking regulation, as banks are central providers for corporate credit in emerging economies. The reforms of Basel III are mainly designed for large banks in developed countries and are based on very sophisticated regulations, although emerging economies already had to carry relatively high burdens of implementation under Basel II standards (Claessens et al., 2008). Unsurprisingly, the elaboration of Basel III provisions has been heavily attacked by Brazil and India (and other emerging countries) (Lall, 2012: 622-3). For now, emerging economies are cooperating with the Basel III framework, because the adoption of its standards is currently mostly a burden for Northern banks, not theirs. Moreover, the importance of national development banks in SMEs leads to tensions with the global liberal order. These banks do not only disburse loans out of commercial interests, but also in the national developmental interest. From a liberal perspective, prioritised lending by (development) banks is regarded as an ineligible subsidy and therefore stands in conflict with WTO rules. It does not take much imagination to foresee intensified conflicts on this issue, including punitive tariffs for countries that provide 'unfair' investment conditions for domestic firms.

*Labour relations:* In large emerging economies, states claim discretion over the regulation of their workforce. Externally, they often reject international and transnational attempts to interfere into domestic labour relations. In this sphere, conflicts over the Western demand for common minimum labour standards and/or corporate social responsibility are already rife (for instance in US-China trade negotiations and nationalist sentiments such as 'Jobs for American workers'). Although Western multinationals also benefit from low wages in emerging economies, on the level of international politics, the structure of labour relations in SMEs may create serious conflicts with regard to the competitiveness of hubs of Western production, and attempts to protect the latter via labour standards.

*Innovation:* Reverse engineering for technological catch-up is crucial for economic development, resulting in weak patent rights systems within the BICs. The innovation strategy of state-permeated capitalism reflects the primacy of national development, thereby conflicting with the global intellectual property rights regime. The BICs insist on national jurisdiction, also at the risk of international conflict. The international transfer of innovation through copying and reinvention would be heavily contested, if liberal norms of intellectual property rights support the claims of Western companies for their exclusive use of new technology. When innovation policy and intellectual property rights became international issues, the loose regulatory stance of developing countries met with strong resistance from the North, most notably within the WTO TRIPS agreement (Hein and Moon, 2013). Its implementation by emerging economies remains sluggish and since the transition period for developing countries has ended, western countries will begin to push more aggressively for full adherence to TRIPS obligations. Thus, disputes between western and emerging economies over intellectual property rights likely will increase.

*Domestic market and international integration:* The existence of large domestic markets in the BICs leaves these countries in the comfortable situation that they can make use of current global trade regulations, while preventing a further deepening of the liberal order. Specifically, their high levels of product market regulation conflict with liberal principles of free trade. While the EU and the US mostly complain about the trade practices of Brazil, India and China before the WTO Dispute Settlement Body, currently almost 75% of all complaints by Brazil, India and China are in turn targeted against the EU and the US (Horn et al., 2011). However, the WTO regime not only suffers from tensions about free trade but more importantly stagnates because the topical deep integration agenda includes a range of issues (such as investment regulation and public procurement) over which emerging economies seek to preserve discretionary autonomy (Claar and Nölke 2013).

The same can be assumed regarding monetary politics. Since the state is able to control many macroeconomic parameters domestically, many sources of instability relate to the international economy. All BICs seek to stabilize their currencies, including the strategic accumulation of reserves, political control of the central bank and, especially for China, a strategy to use the currency beyond its national confines. McNally rightly argues, with regard to the Chinese interest in the internationalization of the Yuan that “the currency issue is perhaps the most fundamental point of contention in the economic relationship between China and the United States” (McNally, 2012: 758). Yet, the most likely road to the Yuan's internationalization can be found in Brazilian and Indian territories. It is the other emerging economies that are most interested in a stable trading currency next to the US Dollar, especially given increasing South-South trading volumes. If the BICs (and South Africa and Russia) paid their imports with local currencies (as agreed at the BRICS Summit in Durban 2013), more than 20% of world trade would no longer be denominated in US Dollars, another potential source of conflict.

### **Summary and implications for the global economic order**

Overall, the *institutional* configuration of state-permeated capitalism differs profoundly from liberal capitalism. Western firms depend on an open and market-based export and investment regime, which is why the established world economic order is still structured around the Washington Consensus, even in its more ‘inclusive’ Post-Washington version (Craig and Porter, 2005;). Many of its core premises, such as the “abolition of barriers impeding the entry of FDI”, “privatization of state enterprises” and the “abolition of regulations that impede the entry of new firms or restrict competition”, are crucial for the success of Western multinationals (Williamson, 2004: 196; Diniz, 2006). However, this institutional setup does not cater for the institutional context of firms in the BICs.. Therefore, the BICs will see little use in strengthening these institutions. Liberal global institutions are suboptimal for the growth needs of emerging economies but are often still used by the latter in the absence of better alternatives – which is why, for instance, China has accepted membership in the WTO, without, however, subscribing to the deep integration agenda.

If the alternative foreign economic strategies of the BICs consolidate into a set of common policies, a viable challenge to liberal hegemony comes from this common mode of state-

permeated capitalism, rather than from ‘Sino-capitalism’ alone. (1) Although we argue that Chinese capitalism shares similarities with other important non-Asian emerging economies, many features find no equivalent in other countries (such as the role of the party), making it hard to follow a pure “China model” (Dickson, 2011). (2) Following the Gramscian idea that hegemony is not only about material power but also about the ability to form consensus among the ruled, a challenge to liberal hegemony has to function as a “role model” (Gramsci, 1971). Because of the limited transferability of several Chinese institutions, a more general idea of a state-permeated capitalism is likely to find more resonance. In this, one must not underestimate the ‘soft power’ of, for example, the Brazilian way of life, or of democratic institutions in India (Leahy, 2013). (3) Finally, the Brazilian and Indian mode of developing new forms of state capitalism is proof for any economy which seeks to follow a non-liberal path of development, that such a strategy is not just possible, but also economically viable.

To conclude, this article demonstrates that the existence of a common institutional setup of state capitalism in Brazil, India and China is inherently incompatible with international economic institutions that function according to the liberal model. This abstract incompatibility was elucidated by highlighting how current foreign economic strategies of the BICs already lead to minor tensions, conflicts and deadlocks in world economic governance. Will these institutional incompatibilities become stronger? Which conflicts will matter; which will not? How will Western state managers try to come to grips with this? In any case, it seems likely that the much closer business-state relationship in large emerging markets will lead to a less liberal and more ‘mercantilist’ or neo-Listian global order. Such an international institutional configuration would allow countries to pursue their individual economic strategies with less attention to universal liberal principles. Undoubtedly, international economic cooperation will still be important, but this cooperation will rather take on a more bilateral, reciprocal nature, instead of relying mainly on multilateral or even supranational agreements.<sup>x</sup> If the Washington Consensus has been a program for universal liberal regulation, a State Capitalist Consensus, embodied in the common economic strategies of large emerging economies, would clearly put into question many of the former’s core principles.

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<sup>i</sup> This also takes the increasing institutionalization of the BRICS group into account, as witnessed at the 5<sup>th</sup> BRICS Summit in March 2013 in Durban.

<sup>ii</sup> Our subsequent analysis of the countries' international integration, however, acknowledges the transnationalisation of the global political economy over the last decades, thereby 'weakening' (in the sense proposed by Hobson (2000: 12)) a model that places explanatory power solely at the state level.

<sup>iii</sup> For a similar approach, albeit focusing on Western developed countries, see Fioretos (2001, 2011).

<sup>iv</sup> While South Africa has more similarities to the liberal model currently governing world markets, Russia can be perceived as a predominantly rent-seeking economy, with very limited economic development outside the natural resources sector (much more so than, say, Brazil) (see Kahler, 2013; Padayachee, 2013; Robinson, 2013).

<sup>v</sup> See also the model of hierarchical market economies (HME) as proposed for Latin-American capitalisms by Schneider (2013). Since both the DME and HME types stress the fundamental role of hierarchical coordination in the economy, we refrain from distinguishing both types for our analysis. Furthermore, Brazil plays an exceptional role within Latin America, making it hard to subsume it under a general type of Latin-American capitalism.

<sup>vi</sup> On different types of state-led capitalism see Boyer (2005), Schmidt (2009).

<sup>vii</sup> We will not include education and training in this study, because it is hardly regulated by global rules. In our SME model education and training complements the low wage regime with an education system in which the vast majority of the population receives only a secondary education and experiences only a low level of class mobility.

<sup>viii</sup> The latter is the approach pursued by Alexandroff and Cooper (2010), Ban and Blyth (2013), Kahler (2013) amongst others.

<sup>ix</sup> See <http://www.imf.org/external/NP/rosc/rosc.aspx> (accessed 20 February 2013).

<sup>x</sup> As indicated by the recent shift from multilateral to bilateral and regional free trade agreements.