LONG-TERM RELATIONSHIPS: STATIC GAINS AND DYNAMIC INEFFICIENCIES

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Abstract
In the 1980s the Japanese 'keiretsu' system of interconnected business groups was praised as a model to emulate, but since then Japan has often been criticized for being less innovative than the United States. In this paper we connect the two views and argue that tight business relationships can create dynamic inefficiencies and reduce broad innovations. In particular, we consider the repeated interaction between final good producers and intermediate input suppliers, where the provision of the intermediate input is non-contractible. We build a cooperative equilibrium where producers can switch suppliers and start cooperation immediately with new suppliers. We first consider broad innovations: every period, one supplier has the opportunity to create a higher quality input that can be used by all producers. Since relationships are harder to break in the cooperative equilibrium the market size for potential innovators is smaller and the rate of innovation might be lower than in the non-cooperative equilibrium. We contrast this with a setting with relationship-specific innovations which we show are encouraged by the establishment of relational contracts. We illustrate the predictions of the model using the recent business history of the United States and Japan and further use patent data to show that U.S. patents are more general than Japanese and even more so in sectors using more differentiated inputs. (JEL: C73, K12, L14, O31, O43)

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