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American Capitalism and Global Convergence: After the Bubble

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The American Decade and Its Aftermath

The 1990s were America's decade, economically speaking. The United States experienced the longest expansion in its postwar history, becoming the engine of growth for the global economy and the pace-setter for economic performance in other industrialized nations. Our unemployment rate fell to a level (4 percent) that was not only the lowest among the major industrialized nations but that had previously been thought to be attainable only at the cost of accelerating inflation. Yet the U.S. inflation rate remained comfortably under control. Meanwhile, Western Europe struggled with slow growth and persistently high unemployment while Japan, whose economic system had been increasingly hailed as a model for others to emulate during the 1980s, became mired in a prolonged and seemingly intractable slough of economic stagnation.

The last decade of the twentieth century began against the dramatic backdrop of the fall of the Berlin Wall and the demise of the Soviet Union, developments that led Francis Fukayama to declare not only the global triumph of capitalism but also, in hindsight somewhat prematurely, the "end of history".[1] By the end of the decade the United States' impressive macroeconomic performance, together with strong pressures for "system convergence" exerted by the global integration of markets, suggested that it was not just capitalism in general but American (or Anglo-Saxon) style capitalism in particular that would dominate the global economy as the 21st century began.

Much has changed, however, since the beginning of the new millenium. The American economy slowed sharply in mid-2000 and the unemployment rate reversed direction, reaching six percent early in 2003. The collapse of the US stock market and the demise of many of the brightest shooting stars of the New Economy, interacting with a number of high-profile corporate scandals, undermined confidence both at home and abroad. The U.S. current-account deficit rose to a proportion of GDP unprecedented in the postwar era, sharply worsening our position as an international debtor.

The strengthening of forces opposed to globalization, which in the minds of many was equated with Americanization, was symbolized by the 1999 debacle in Seattle, when efforts to set the agenda for a new round of multilateral trade negotiations collapsed. The terrorist attacks of September 11, 2001 have led the United States to take a variety of actions that appear inconsistent with its role as the leader of an open world economy and a major supporter of international institutions. And the pace of economic globalization, as reflected in the expansion of both trade and foreign investment in relation to global output, has slowed, although it is too early to tell whether this reflects a trend or is merely a cyclical phenomenon.

What do these developments imply for the future of system convergence and the competition among different types of capitalism: the Anglo-Saxon investor capitalism that exists in its most undiluted form in the United States; the social-market capitalism, epitomized by Germany, that prevails to some extent in most of the other large countries of continental Western Europe as well; and the producer-oriented or mercantilist capitalism that provided such an impressive engine of growth for the Japanese economy throughout much of the postwar era?

Three Varieties of Capitalism

These different varieties of capitalism are defined primarily by the nature of relationships between corporations and their major stakeholders, particularly with employees and their communities on the one hand and shareholders and their agents on the other, as well as by the way interactions among firms and between firms and governments are organized. In so-called liberal or Anglo-Saxon style market economies, epitomized by the United States, such relationships are generally characterized by formal contracting, arms-length transactions, and market-mediated competition. More organic forms of capitalism, represented in different variants by Germany and Japan, depend much more heavily on non-market relationships, defined by law or custom, to shape the organization of their economies.

At the beginning of the 1970s, American firms and the executives who managed them enjoyed an enviable situation. The industrialized nations of Western Europe and Japan had not yet converged on US levels of income, productivity, and technological advancement; the countries behind the Iron Curtain were effectively out of the market; and today's newcomers to the club of economically advanced nations had not yet attained that status. Lacking significant competition, most large American firms enjoyed substantial market power, both at home and abroad, and the high profit margins that accompanied it.

In such circumstances, the men who led these firms could keep all their major stakeholders satisfied: consumers with reasonable prices and a wide variety of products to chose from; employees with secure jobs, steadily rising wages and generous benefits, and shareholders with generally rising share prices and steady dividends. As a result, the job of chief executive, once attained, tended to be a lifetime sinecure, and its holder generally enjoyed a degree of autonomy in the management of the firm that gave birth to the phrase "managerial capitalism".

There were large differences, however, among the various types of capitalism in the organization of relationships between corporations and those who provided their financing during these early postwar decades. In the United States, shareholders of large companies were widely fragmented; with relatively few exceptions, no one entity owned a significant share of the stock. As a result, shareholders tended to be passive owners; the separation of ownership from control had been noted as a defining characteristic of American capitalism by Berle and Means as far back as 1932.[2] Despite the fact that US law, repeatedly tested in the courts, made it clear that the primary function of a corporation was to maximize the return to its shareholders, the reality was that if said shareholders didn't like the way a firm was being managed, their only effective option was to sell their shares.

In Germany and Japan, in contrast, banks provided a large share of the external financing for corporations, both as creditors and as holders of large blocks of stock. German banks were well represented on the supervisory boards that elect and oversee the managing boards of large corporations, while banks in Japan frequently sent their own executives to "assist" the management of a company when financial difficulties threatened its ability to service or repay loans. And Japanese firms were—and often still are—bound together in large groups (called *keiretsu)* with supplier and customer firms, links that were cemented by cross-holding of each others' shares; large German firms were also characterized by a high proportion of cross-shareholding.

In labor relations, as in corporate governance, the regimes in these three countries appeared on the surface to be widely divergent at the start of the 1970s. Labor unions were relatively weak in the United States (they have since become weaker still, except in the public sector) and, with the exception of a few industries in which pattern-bargaining prevailed, tended to engage in collective bargaining on a decentralized, company-by-company basis. Unionization was more widespread in Japan, but Japanese unions are company unions, more committed to the interests of their firm than to those of the union movement as a whole. In bargaining, their major concern is with working conditions and job security rather than wages and, like their counterparts in the United States, they have not sought to participate in the management of the firm.

Labor relations in Germany stood in sharp contrast to those just described. They were (and still are) embedded in a highly centralized corporatist system, involving joint economic management by the 'social partners"—employers, workers, and government—at the national or regional level and strong employee representation in management at the level of the firm. Employees held half the seats on the supervisory boards of large corporations, and some of those employee seats were held by union representatives. Collective bargaining was centralized at the industry level, and the wages that emerged from this bargaining process became effectively minimum wages, applying to nonunion workers as well as union members in a particular industry.

Although the corporatist organization of labor relations was more or less unique to Germany, virtually all the large countries of continental Western Europe had (and continue to have) much stronger labor protection laws—making it harder to fire workers or close plants—and more generous unemployment insurance and welfare benefits than have ever existed in the United States. In Japan, employment security was based less on legislation than on custom and a large body of case law but, in practice, the prevalence of lifetime employment in large firms and seniority-based compensation made Japanese labor markets the most rigid of all.

Despite significant differences in the structure of relationships between firms and their sources of financing, the leaders of German and Japanese firms, like their Anglo-Saxon counterparts, enjoyed substantial managerial autonomy. In Japan, executives were initially hired right after graduation from university and promoted steadily up through the ranks, largely on the basis of seniority, thus creating self-perpetuating corporate bureaucracies. The rules were less rigid in Germany, but the results were not very different. Despite much greater concentration of ownership than was typical in the United States, investors and creditors in both Japan and Germany tended to keep hands off as long as a firm's financial results were satisfactory, and to show considerable forbearance even when financial difficulties arose. But the laws, institutions, and customs of these nations, unlike those in the United States, made it clear that firms and those who supervised and managed them had responsibilities not merely to shareholders but also to other "stakeholders", that is, groups such as employees, creditors, customers, suppliers, and host communities, whose welfare was closely tied to the firm's performance.

In labor relations, too, the actual, on-the-ground relationships between companies and their employees were more similar at the beginning of the 1970s than the substantial differences in laws and formal institutions would seem to imply. In the United States, the social contract, as most Americans understood it at the time, had four major characteristics: *permanence* in the employer-employee relationship; *entitlement*, not only to a job but to steady pay advancement and generous benefits; *paternalism*, in the form of a shared view of employees as part of a company "family"; and *hierarchy*, such that lines of authority and levels of status were clearly defined within the firm and carried over into the outside world.[3] Although there were significant differences in some respects—wage and income disparities, for example, were already much wider in the United States than in the other countries, and on-the-job training played a less important role there—the four key words italicized here could have applied equally to all three countries and the three forms of capitalism they epitomize.

Global Winds of Change

All of the industrialized nations faced strong pressures for economic change during the last quarter of the twentieth century, in the form of a global slowdown in growth, increased economic and financial turbulence, and intensified competition. The global economy was severely buffeted by the 1971-73 demise of the Bretton Woods system of exchange-rate management and the resulting sharp increase in the volatility of exchange rates. The ensuing oil shocks of 1973 and 1979 dramatically disrupted patterns of economic activity in industrial nations and caused severe debt problems in developing countries. Growth slowed in virtually every industrial nation, and inflation and unemployment worsened.

In this much more uncertain and volatile economic environment, more gradual but equally significant structural developments were increasing the intensity of competition both within and across national borders. The most obvious of these was the deepening integration of markets produced by trade liberalization, pursued successively under the expanding multilateral umbrellas of the Organization for Economic Cooperation and Development (OECD), the General Agreement on Tariffs and Trade (GATT), and the World Trade Organization (WTO). Over time, the scope of the liberalizing agenda broadened from focusing on tariffs and quotas to include domestic legal and regulatory requirements relating to standards for both products and the processes by which they are produced, services, and intellectual property.

Along with trade liberalization, domestic privatization and-or economic deregulation in all three of our representative nations expanded the domain of the private sector and opened up new opportunities for market competition, even as new forms of social regulation imposed constraints on firms in such areas as worker and product safety, protection of investors and pensioners, and the quality of the environment. Finally, rapid advances in information and communications technology drastically altered methods of production, stretching supply chains in an increasing number of industries virtually across the globe. These advances also created whole new industries and increased the tradability of many services long thought to be confined by their very nature to operating within a single domestic market.

These developments have interacted to reinforce each other: technological progress has made transportation and telecommunications more effective facilitators of international trade and investment than ever before, while trade liberalization and economic deregulation have stimulated the pace of technological advance by intensifying competitive pressures and speeding up the international diffusion of technology. Furthermore, the convergence of the European and Japanese economies toward US levels of income, productivity and technological advancement, combined with the other changes just described, have stimulated virtually all large firms in the leading industrial countries to become multinational in scope. This expansion of foreign direct investment (FDI) means that, at home, firms find themselves competing not only with imports but also with the domestically-produced output of firms headquartered abroad. At the same time, firms increasingly serve foreign markets not only through exports but also through sales from subsidiaries located in other countries.

These changes have intensified competitive pressures in all the markets in which firms operate: pressures "from below" in markets for goods and services and pressures "from above" in the markets for financial assets and corporate control. Such pressures were felt earlier and more intensely in the United States than in Germany and Japan, where a variety of structural and institutional buffers softened and delayed their impact. In the 1950s and 1960s, the United States was the world's only economic superpower, and its large firms were dominant in international markets. But, as Germany and Japan played rapid catch-up, these American firms were more suddenly and sharply exposed to international product-market competition . In Germany and Japan, furthermore, the impact of global competition was attenuated by a variety of government subsidies, both explicit and covert, and in the latter by opaque but widespread barriers to imports and inward FDI as well.

Intensification of the product-market competition faced by American firms produced a sharp expansion of the choices available to customers and a dramatic shift in power from producers to consumers. This loss of market power was reflected in a decline in concentration ratios, which measure the degree to which a small number of firms dominate a market. Much more dramatic, however, was the steady decade-by-decade decline in the profit margins of US firms. The economic slowdown and increased economic and financial volatility that struck in the early 1970s contributed to this profit-margin decline, as did the overconfidence of US corporations, born of their earlier dominance in both domestic and foreign markets. But intensified competition, exacerbated by the huge appreciation of the US dollar in the 1980s, which put American producers of tradable goods at a disadvantage both at home and abroad, was a major factor.

As these developments in markets for goods and services were creating new pressures from below, developments in US asset markets, including the rapid growth of pension funds, mutual funds, and other institutional investors were generating equally intense pressures from above. Around the middle of the 1970s, the sharp separation of ownership and control that had characterized American-style capitalism for at least half a century began to erode. The proportion of the shares of the nation's thousand largest publicly-held companies held by such large institutional investors rose from just over 15 percent in the mid-1960s to nearly 60 percent in 2000. As their ownership of corporate America grew, these investors exercised their new power in a variety of ways. In particular, they played a major role in the development of a market for corporate control that emerged in response to the profit-erosion and resulting collapse of stock prices in the 1970s.

Frustrated by these developments and empowered by economic deregulation and a more relaxed anti-trust environment, financial innovators sought new ways of wringing improved financial performance from companies that had grown complacent and unfocused. The result was an unprecedented wave of mergers, breakups, hostile takeovers, and leveraged buyouts in the 1980s. Mergers and acquisitions of publicly-traded companies more than doubled between 1980 and 1988 and then, after a pause, tripled again between 1990 and 1998. Executives of companies with disappointing earnings or sagging stock prices, and even of companies that were doing well, felt their positions threatened along with the very survival of their firms.

The threats these executives perceived were real. Whereas only 4 percent of the Fortune 500 companies had turned over annually during the 1960s and 1970s, by the 1980s that annual rate of turnover had doubled. In fact, fully one-third of the Fortune 500 in 1980 no longer existed as independent entities in 1990. And the job security of the chief executives of such companies, a position long thought of as a virtually bullet-proof sinecure once it was achieved, was shattered by a boardroom revolution. This startling development, precipitated by the pressure exerted on boards of directors by dissatisfied institutional shareholders, resulted in the abrupt departure in 1992-93 of the chief executives of such venerable firms as American Express, General Motors, Sears, and Westinghouse. The chief executives of other large, well-known firms met with similar fates, or lost their positions to mergers or takeovers, in the years that followed.

American corporate managers' sensitivity to shareholder dissatisfaction is reflected not only in increased turnover in top management but, even more directly, in their compensation, as a growing share of their pay has come in forms, such as stock and stock options, contingent on their firm's financial performance and, above all, on the price of its shares. Senior executives have responded, unsurprisingly, with an intensified focus on the bottom line. Furthermore, both the analysts whose opinions have such a magnified impact on share prices and the institutional investors, themselves (particularly in the case of mutual funds) locked in fierce competition for money to manage, stress quarterly results above all else. In response, corporate managers have felt increasing pressure to focus their energies on short-term results rather than on the long-term profitability and viability of their firms. In extreme cases, these developments produced the earnings manipulation and outright fraud that, combined with the explosion of executive compensation, have so undermined public trust in business since they came to light.

Perhaps nowhere has the combined impact of pressures from below and from above had a greater impact than on US labor markets and on the implicit contract between firms and their workers. Whereas at the beginning of the 1970s such relationships had strong similarities in all three countries, despite major differences in structure and institutions, thirty years later the United States was unique in the flexibility and fluidity of these relationships as regards both employment and compensation. Employment relationships, once assumed to embody a reciprocal lifetime commitment, are more likely to be regarded today as contingent and, very often, temporary. A job, benefits, and pay increases based on seniority are no longer regarded as automatic entitlements. Instead, the emphasis is on pay for performance (both the individual's and the firm's) and individual responsibility for one's own future in the workplace. And dispersion in earnings, both within and between categories of workers, has expanded dramatically.

As executives focused increasingly on cost-cutting as the quickest way to enhance efficiency and profitability, corporate layoffs and downsizings reached unprecedented levels in 1992-95, even though the American economy was expanding and the overall unemployment rate was falling. In addition, the heightened risk of job-loss spread to categories that had previously been relatively immune, including older, more educated, and white-collar workers and middle managers. Utilization of temporary employees and contract business services expanded rapidly. And, whereas in the past such employment was associated almost entirely with low-paid, low-skilled occupations, the fastest-growing subcategory of such workers was now in the professional-technical group, including doctors, lawyers, engineers, accountants, and even business executives employed on an "as needed" basis.

While these developments were gaining momentum in the United States, the old social contract remained essentially unchanged in Germany and Japan. This is partly because such changes were easier to make in the US, where union strength was steadily shrinking and the legal system imposed few constraints on laying off workers or closing plants. In Germany, and most other continental countries, unions are more powerful and strong labor-protection laws make it very costly to close plants and dismiss workers. And in Japan, the social cohesion that underpins an implicit lifetime contract between large firms and their employees is deeply embedded in every aspect of the society.

In addition, differences among the three countries in the way companies are financed meant that the capital-market pressures from above that impinged so sharply on firms in the United States were virtually absent in Germany and Japan until relatively recently. Whereas American companies have increasingly had to compete for funding in impersonal securities markets, in the other two nations large blocks of stock are firmly held by banks, which are also major creditors, and by other corporations. Furthermore, the motives underlying these holdings are different from those of institutional investors in the United States. Rather than emphasizing short-term profitability, portfolio values, and rates of return, the focus is on longer-term prospects and ongoing viability. Indeed, such holdings are often intended to cement long-term business relationships: creditor-debtor relationships in the case of banks and supplier-customer relationships in the case of firms.

In all three countries, the organization of labor markets and capital markets are complementary. In the United States, a firm must maintain its profitability through thick and thin because it is profitability, and the associated share price, that sustains its access to capital and ability to resist takeover. At the same time, fluid labor markets make it easy to lay off workers, while the fact that US capital markets make it relatively easy to transfer financial resources from contracting enterprises to expanding ones helps to sustain the demand for labor and thus total employment. In Germany and Japan, by contrast, access to patient capital that does not insist on current profitability enables firms to focus on longer-term considerations, such as growth and market share, and to maintain their employment commitments even in the face of downturns in demand. At the same time, the very rigidity of these commitments pressures firms to concentrate on growth and maintenance or expansion of market share. Thus, the differing characteristics of each of the three styles of capitalism reinforce and sustain each other.

Pressures for Convergence

During the 1990s, the changes just described came together to produce what has come to be known as American or Anglo-Saxon shareholder capitalism. But, just as the defining characteristics of the three styles of capitalism had become most sharply differentiated, the pressures that had transformed economic relationships in the United States were beginning to impinge on Japan and Germany, along with most other large nations in Western Europe, as well.

The pressures both from below and from above that transformed the behavior of large, publicly-held American firms during the 1970s and 1980s did not strike firms in Germany and Japan with full force until somewhat later. But the defining events that characterized these nations' economies during the 1990s also began to strip away the insulation that had hitherto protected their large firms from the kinds of changes in relationships with major stakeholders that had transformed American companies and sharpened the distinctions between American- style capitalism and the variants represented by these other two nations.

The rapid growth of FDI flows from industrialized nations into a number of developing or emerging-market countries, of which China has become the most prominent, and the associated entry of this latter group of nations into global competition in product markets, naturally intensified competition for all participants in these markets. But it was the impact of the European Union's single-market initiative (often called EC 92) at the beginning of the decade and the completion of the European Monetary Union (EMU) at the decade's end that brought these product-market pressures home to bear in Germany, at the same time that the shock of German reunification was making greater demands on the economic resources of the former West Germany. Similarly, the decade-long recession that has burdened the Japanese economy ever since the bursting of its asset-market bubble at the beginning of the 1990s has had a comparable impact there.

One of the major purposes of Europe's single-market initiative was, in fact, to increase the productivity and efficiency of member nations' firms by eliminating physical, fiscal, and regulatory barriers to competition across national borders that are internal to the EU as a whole. This liberalization process has affected the markets for both goods and services but has been particularly important for the latter, where a variety of barriers to market access had been particularly important in limiting inter-country competition. The move by 12 of the EU member countries to join together in the EMU and adopt a single currency (the Euro) in place of their national currencies has expanded the scope for such competition even further by making it harder for companies and their distributors to charge different prices in different EU markets. The liberalization of so-called gray-market trade—the sale of brand-name goods in countries where manufacturers have not authorized such sales—is operating in the same direction, most particularly in the automobile industry.

Large Japanese firms had felt some competitive pressures from below as a result of the global growth slowdown and the entry of their own products into global competition during the 1970s and 1980s. But, because of the insulating factors mentioned earlier, it was not until prolonged recession at home and the appreciation of the yen vis a vis the dollar, which reduced the price-competitiveness of their products abroad, that these pressures came into their own as forces for change.

In addition, not only were Japan and Germany, like other industrialized nations, pressured to alter their relations with their workers by broadened and deepened goods-market competition but, in these two cases in particular, the impact was magnified by causation running in the opposite direction as well. That is, the very rigidity of their own labor markets led firms in these countries to invest in production facilities in other nations when cost pressures became intense. German firms have invested in the Czech Republic, Hungary, and other Central European countries in order to reduce their labor costs; Japanese firms have done the same in other Asian countries. Despite the rhetoric of Pat Buchanan and Ross Perot it is these countries, rather than the United States, that have felt the brunt of the “great sucking sound”, the pull of lower labor costs in emerging-market countries. Whereas capital formation has held up well in the United States, which has continued to attract large amounts of FDI from abroad (including Germany and Japan), business investment has been a significant source of weakness in these latter nations.

Particular constraints on the effective use of monetary and fiscal policy have also made it especially difficult for Germany and Japan to combat the high and persistent unemployment that has resulted from the economic developments of the 1990s. Membership in the EMU required Germany, along with all other member nations, to abandon any independent monetary policy. Monetary policy is now implemented on behalf of the entire group by the European Central bank (ECB), and its decisions are geared to average conditions in EMU countries rather than being suited to the needs of Germany, where inflation is lowest, growth slowest, and unemployment highest.

At the same time, Germany’s resort to expansionary fiscal policy has been significantly constrained by the requirements of the EMU’s Growth and Stability Pact, which requires member nations to hold fiscal deficits to no more than 3 percent of GDP, with the threat of very large fines for violations. In fact, however, both Germany and France are currently in violation of the Pact, with Germany widely expected to be in that position for a third consecutive year. No fine has yet been imposed on a violator; on the contrary, the continuation of the Pact in its present form is a matter of ongoing discussion within the EU.

There are no such institutional constraints on the use of monetary and fiscal policy in Japan. There the problem is rather that such policies have so far proved utterly ineffective. Japanese interest rates are already effectively zero and the fiscal deficit is an unprecedented 10 percent of GDP, yet stagnation continues. Although there are further measures that might be more effective—such as using monetary policy to target a positive rate of inflation or exercising fiscal expansion in the form of permanent tax cuts rather than dollops of government spending on unneeded infrastructure projects—the authorities have so far been unwilling to take such measures. And this prolonged situation has enhanced the pressure on Japan’s private sector.

The economic difficulties of the 1990’s also brought about increased pressures from above on German and Japanese firms, changes in capital markets similar to those that had radically altered American firms’ relationships to their creditors and shareholders during the 1970s and 1980s. In both nations, and in much of the rest of continental Western Europe as well, the rapid increase in international capital mobility and the internationalization of the financial services industry that had been developing for some time provided the underpinnings essential for such developments in capital markets. And these increases have been dramatic: cross-border transactions in bonds and equities, which equaled some four percent of US gross domestic product (GDP) in 1975 had ballooned to more than 150 percent in 1996. The equivalent shares for Germany are 5 percent in 1975 and nearly 200 percent in 1996, and for Japan, 1.5 percent and more than 80 percent, respectively; similar trends are apparent in other leading industrial countries as well.

As in the case of increased pressures in product markets, however, the particular economic conditions in these countries during the 1990s created a climate for changes from which their institutions had previously insulated them. In Germany, the creation of the EU single market and the advent of the EMU has stimulated a rapidly-developing bond-market and a concomitant reduction in the still-dominant role of banks in the financing of German firms. The development of such a large multi-nation market has attracted the interest of foreign, primarily American, institutional investors interested in geographically diversifying their holdings. It has also stimulated a growth of mergers and acquisitions activity in the EU akin to that which first accelerated in the United States during the 1980s.

At the same time, on the demand side, German firms seeking financing either to compete more effectively in an integrated EU market or to invest abroad are providing willing customers for these new sources of funding. These shifts away from dependence on banks as the major source of business financing are being facilitated by a reduction in the punitive levels of capital gains taxes previously imposed on sales of corporate shareholdings, as well as by the developing cross-country integration of European stock markets and movement toward diversification of pension funds.

American institutional investors have, not surprisingly, brought their bottom-line focus on short-term returns to shareholders with them into the European marketplace. In addition, they have led by example, as domestic pension funds, mutual funds, and other intermediaries have begun to emulate the shareholder activism of their American counterparts. This shift away from the patient capital provided by banks committed to long-term relations with their customer firms toward much more demanding sources of funding has been forcing firms to pay more attention to good governance, efficiency, and profitability.

All these developments in capital markets have been facilitated and reinforced by legislative and regulatory moves, at both the national and the EU levels, to tighten accounting standards, criminalize insider dealing, dismantle restrictive voting structures, and legitimize takeovers. And privatization of formerly state-owned firms in Germany, France, and other European nations is also forcing managements and boards to pay more attention to profitability and shareholder returns.

In Japan, once again, the liberalization and deregulation of capital markets, prolonged recession, and the precarious situation of domestic financial institutions are major agents of change. Depressed stock prices and declining dividends are forcing many companies to reduce cross-holdings of shares, and the importance of the "main banks" that had been the principal suppliers of credit to non-financial corporations has declined. This is because the precariousness of their own balance sheets has made them severely restrain new lending and forced firms to rely much more heavily on direct access to capital markets both at home and abroad.

Similarly, the importance of cross-shareholding ties between large companies and their suppliers and customers through *keiretsu* groups has been declining as the prolonged recession has encouraged diversification of such business relationships. Indeed, a number of large Japanese firms, among which Nissan and Mazda are perhaps the most prominent, have been forced to accept what was previously unthinkable: controlling ownership by a foreign investor, accompanied by a new management focus on the bottom line. In addition to the pressure for bottom-line results exerted by institutional shareholders in general, pension funds and the individuals who depend on them now or in the future are increasingly seeking better returns as the only way to alleviate a looming crisis created by Japan's rapidly-aging population and the inadequacy of government-provided pensions.

It is not only the pressures of globalization, both from below and from above, that are pushing industrialized nations with their own indigenous forms of capitalism in the direction of the Anglo-Saxon variety. There are some macroeconomic incentives for such moves as well. In particular, the fact that income and output have grown faster in the Anglo-Saxon countries than in other industrialized nations in recent years suggests that the flexible, investor-oriented capitalism characteristic of these countries, and most particularly of the United States, is especially well-suited to the encouragement of economic growth in an era of rapid change.

In fact, at least two such links are highly plausible. One is the fact that unemployment rates are lower, and labor-force participation rates higher, in the United States than in most of the EU countries, and the average hours worked per year by American workers are the highest among large industrialized nations. While some of these differences in labor-force utilization may reflect different tastes for work versus leisure, the large "wedge" between gross wages and take-home pay and the generous benefits available to the unemployed and to non-participants in the labor force, both characteristic of social-market capitalism, surely play a significant role.

Although the introduction of more flexible work practices and more part-time workers in the EU have accelerated the growth of both labor-force participation and hours worked, they have not yet caught up to U.S. levels. Japan, whose labor force participation rates and hours worked, (as well as take-home pay as a percentage of gross wages) are roughly comparable to U.S. levels, nonetheless experienced significant declines in both over the stagnation decade of the 1990s, a situation that shows no signs of reversing.

The second factor contributing to economic growth is increases in productivity. Here, again, the United States has outpaced both the EU and Japan since 1995. Part of the explanation is doubtless cyclical, associated with the rapid expansion of the U.S. economy over most of that period. But some of the reasons appear to be structural, and associated with the flexibility and market-responsiveness of American economic institutions. American firms are born and die with a rapidity engendered by a Darwinian competition for the survival of the fittest: the average age of the firms listed on the New York Stock Exchange in the mid-1990s was 14 years, as contrasted with 55 years for firms on the pan-German exchanges. And the shares of less-than-10-year-old companies listed on the Stock Exchange was about 40 percent, compared to less than one percent in Japan.[4] Taking a longer-range view, Italy's then-prime minister Prodi noted in 1998 that "of the 25 biggest firms in the USA at present, 19 did not exist or were virtually negligible before 1960…while none of the 25 major European firms are new, all having been on the scene for over 30 years."[5]

The availability of equity capital, particularly venture capital, the rapidity of firm turnover, and the ease of layoffs and high labor mobility characteristic of the US economy all make this form of economic organization particularly well-suited to the radical innovation characteristic of high-risk, fast-moving, research-intensive technology sectors like biotechnology and software, and those involving the provision of complex, system-based products such as telecommunications and defense systems. And it is in just such sectors that the United States has a comparative advantage with respect to both Germany and Japan. The latter countries, with their more stable, more risk-averse, less fluid and adaptable labor and capital markets, excel in sectors like consumer goods, transportation, and machine tools.[6] These industries are characterized by the sort of incremental innovation to which their economic institutions are particularly well-suited. But in today's economic environment, it is radical innovation that underpins rapid productivity growth. In particular, the slowdown in European and Japanese productivity growth during the latter half of the 1990s, as contrasted with its pickup in the United States, is due in large part to a US advantage in the production and diffusion of information and communications technology.

Whither Convergence? Current Developments

The received wisdom in most discussion of the pressures for system convergence as a result of deepening economic integration is that these pressures are making it increasingly difficult and costly for nations to resist moving toward the American or Anglo-Saxon style of capitalism. Certainly, this is the view popularized by Thomas Friedman in his description of the policies required by what he has termed the Golden Straightjacket.[7] As summarized by Dani Rodrik, these policies are "tight money, small government, low taxes, flexible labor legislation, deregulation, privatization, and openness all around,"[8] for which the U.S. represents the model. Similarly, Sylvia Ostry argues that "[A] confluence of unrelated events. . .are accelerating the global reach of investor capitalism and deepening the push for convergence to an 'Anglo Saxon' corporate governance model in which the stockholder is king".[9]

Ongoing developments in other large industrialized nations support this view. Not only in Germany but also in other large continental European nations, the protected labor markets and related welfare-state benefits associated with social-market capitalism have come under increasing pressure from global competition, budgetary strains, and persistently high levels of unemployment. In France, Germany, and several smaller European nations, firms are downsizing and restructuring in the face of considerable political and popular opposition. At the same time, the importance of both part-time and temporary employment has increased, particularly where restrictions on such atypical arrangements have been relaxed.

Government measures to reduce unemployment benefits, ease job protection, and permit further decentralization of collective bargaining in Germany and to introduce pension reform in France and Italy have met with strong union objections and actual or threatened demonstrations and strikes. Although in the past these governments have tended to capitulate in the face of such pressures, this time they appear to be holding firm and it is the unions that are making unprecedented concessions.

In Japan, where the ties that bind firms and their employees have traditionally been strongest, change has accelerated under the pressure of prolonged economic stagnation Among the unprecedented measures resorted to by a growing number of large firms are short-term employment contracts, layoffs and encouragement of "voluntary" early retirement, and the substitution of performance-based pay for earnings based strictly on seniority. A 1997 survey found that slightly more than 20 percent of Japanese firms were using performance-based rather than seniority-based annual salary systems, up from 15 percent two years earlier and less than 10 percent in 1980.[10] In Japan, unlike the United States, these changes in compensation have fallen more heavily on white-collar than on blue-collar workers.

Pressures to adhere to the sorts of policies just described have been generated not only by the increasing globalization of private markets for goods, services, and capital, but have been reinforced, in the case of emerging-market countries, by such multinational institutions as the International Monetary Fund and the World Bank. They have done so through their insistence that current or would-be borrowers adapt their policies to what has come to be called the "Washington consensus". This set of prescriptions essentially extended the requirements imposed by private capital markets, into the sphere of public borrowing and lending as well. Just in the last year or so, however, the lessons learned from recent currency crises, together with heavy pressure from international NGOs, are causing these organizations to rethink certain aspects of these prescriptions, in particular the requirement for early liberalization of capital markets, by taking into account the strength and level of development of financial institutions in particular countries.

Changing relations between firms and their shareholders, increasing the pressures from above described earlier in the U.S. context, are also pushing both German and Japanese firms toward American-style changes in corporate governance, stressing transparency and accountability on the part of firms and their managers. And, as in the United States, the revelation of home-grown corporate scandals in these as well as other industrialized countries has reinforced these pressures and accelerated responses to them.

One dramatic piece of evidence of these developments is that the American boardroom revolution of the 1990s has now gone global. A study of the world's 2500 largest listed companies by the consulting firm Booz Allen Hamilton revealed that the number of chief executives dismissed worldwide rose sharply in 2002, increasing from 2.3 percent in 2001 to 3.9 percent in 2002, as compared with only 1 percent in 1995. In Europe, the rate of performance-related turnover edged up to 3.7 percent from 3.6 percent in 2001, while in Japan it jumped from 0.3 percent to 3 percent over the same year. In North America, the percentage was 4.2 percent in 2002, up from 2.7 percent in 2001 but down from 5.2 percent in 2000, a decline due at least in part to the drop in corporate merger activity. That board and shareholder impatience with poor financial performance underlay these dismissals worldwide is underscored by the fact companies where chief executives were dismissed generated total shareholder returns 6.2 percentage points lower than companies whose CEOs retired voluntarily.[11]

Similar pressures from both regulators and institutional shareholders are pushing German and Japanese firms in the direction of higher standards of corporate accountability and a greater stress on the governance role of truly independent "outside" directors. In the United States, long regarded as the "gold standard" for corporate governance, such requirements have been significantly tightened by the Sarbanes-Oxley legislation and the new listing rules of the New York Stock Exchange, both promulgated in response to the wave of corporate scandals that began to surface with the collapse of Enron in 2001. Germany, for example, is already tightening the corporate governance code originally promulgated in 2001, while EU regulators in Brussels are planning to require all listed EU companies to issue quarterly financial reports, long required in the United States.

Such moves are less far along in Japan, where financial secrecy and shareholder passivity have long been hallmarks of its form of capitalism. But prolonged recession and severely weakened corporate balance sheets have brought Japan to a reluctant acceptance of foreign takeovers of domestic firms, and new managements have frequently brought with them an American-style focus on shareholder returns. New pressures are arising from domestic sources as well: the Pension Fund Association, one of Japan's largest conglomerations of pension assets, has instituted rules declaring that it would vote against the re-election of management or payment of their retirement compensation if the company suffered three straight years of losses with no dividend pay-outs. And Sony, one of Japan's largest and most visible firms, announced in January of 2003 that it planned to abandon its traditional "insider" governance system in favor of one that clearly separates the roles of management and supervision, putting the latter under the purview of a board and board committees with a majority of independent directors. Sony is one of 34 Japanese companies listed on the New York Stock Exchange, and others in that group are expected to follow its lead.

More broadly, firms in fast-moving, highly innovative industries, in whatever country they are located, are increasingly cognizant of the advantages of listing on one of the U.S. stock exchanges, thus gaining access to sources of equity capital that would not otherwise be open to them. The number of foreign companies listed on the two major US stock markets (Nasdaq and the New York Stock Exchange) increased from roughly 170 in 1990 to over 750 in 2000. There are now more non-US companies listed on these two exchanges than there are German firms on the Deutsche Borse. And one of the requirements of such a listing is adherence to most if not all of the characteristics of the American model of corporate governance.

Although the major moves toward convergence of corporate governance practices have been in the direction of those prevailing in the United States, some developments are narrowing the governance gap from the opposite direction as well. Institutional investors have been increasingly vocal in their demand that American firms distinguish the supervisory and management roles more definitively by separating the role of board chairman from that of chief executive officer (CEO). Although relatively few publicly traded firms in the U.S. have so far separated these functions, a much larger number is creating or formalizing the role of "lead" or "presiding" director, whose job it is to share agenda-setting for board meetings with the CEO and to preside over periodic evaluations of the performance of the board, its committees, and the chief executive. In Germany, this separation of functions is already provided by means of a two-tier board system, consisting of an eponymous management board and a supervisory board that appoints the members of the management board and participates in strategic decisions. In Great

Britain, the other major practitioner of Anglo-Saxon style capitalism, most large firms have both a chief executive and a non-executive board chairman.

During the 1990s the compensation of American chief executives exploded upward, vastly enlarging not only the gap between the pay of the average CEO and that of the average U.S. worker (estimates suggest that this percentage gap increased ten-fold between the early 1980s and the end of the 1990's), but also between American chief executives and their counterparts in other industrialized nations as well. The whole issue of executive pay has become the focus of severe scrutiny and criticism in the wake of the various corporate scandals, and such compensation may be starting to level off. This is particularly true for the fastest growing component of executive compensation, stock options, as an increasing number of firms recognize that rising standards of good corporate governance require them to include such options in their expense accounting, thus reducing reported earnings. But it is in the United Kingdom that shareholders have so far had the most impact, in several cases passing (non-binding) resolutions to reduce the compensation of chief executives when firms have attempted to emulate U.S. pay levels.

The pace and nature of convergence in principles of corporate governance will be significantly affected by the pending harmonization of global accounting standards. At present, a struggle for the hearts and minds of the International Accounting Standards Board (IASB) is being waged in the search for a compromise between the broad "principles-based" philosophy that prevails in Europe and the much more detailed "rules-based" approach that underlies America's generally accepted accounting principles (GAAP). Just how things will settle out by 2005, when all publicly- traded firms within the EU will be required to conform to IASB rules, is as yet unclear, although the recent rash of accounting-related scandals in the United States has certainly unseated GAAP from its gold-standard throne.

Whereas convergence continues to be primarily, although not exclusively, toward U.S.-style capitalism in the arenas of labor and capital markets and corporate governance, the picture is more complex as regards relationships between companies and their customers. In some instances, particularly in Germany, the loosening of product-market regulations governing retail pricing, store-opening hours, and related matters, represent baby steps in the direction of American-style economic deregulation. As regards traded goods and services, however, it is the rules and standards of the European Union, whose "social market capitalism" is characterized by stronger and more pervasive economic and social regulation than prevails in the more laissez-faire United States, that are extending their reach in the global economy.

The major conduit for this extended reach is EU regulations affecting both the characteristics of goods and services that are internationally traded and the processes by which they are produced. That is because, where protection of consumers or of the environment is involved, EU requirements are generally more stringent than those of the United States or of most other nations. This stringency is grounded in the EU's strong adherence to the precautionary principle which holds that, in cases where there is uncertainty regarding the possibility of harm, rules and standards should err on the side of caution.

The EU has not always prevailed when specific applications of the precautionary principle have been submitted to the WTO's dispute-settlement procedures, whose sanction is necessary for a provision to be incorporated into the formal body of supranational law. But its record in creating de facto global law is more impressive. The EU's 15 nations together constitute the world's second-largest market—the United States remains the largest—and non-EU companies that compete in the global marketplace, or hope to do so, are increasingly designing and manufacturing all their products to conform to EU requirements. That is because customizing products to meet different rules and standards in different countries would vastly increase complexity and expense; uniformity requires that the most rigorous regulations and standards will prevail.

Thus it is that Fisher-Price toys, Carrier air conditioners, Toyota (as well as other makers') cars and SUVs, and Procter and Gamble's dishwasher detergents all have been, or soon will be, adapted to meet EU safety, environmental, and recycling rules. And, as regulatory harmonization across the EU proceeds, more and more products, wherever they are made and wherever they are sold, will, in practical terms, be subject to the EU's requirements. The same is true of the processes involved in international commerce. Over the past two years, for example, nearly 200 U.S. companies, producing a broad range of goods and services, have signed "voluntary" agreements to abide by EU privacy rules, which affect the transfer and use of online data about individuals and thus have an impact on virtually every firm that has workers, suppliers, or customers within its borders. Microsoft, which does not yield easily to regulatory intervention, has agreed to make "radical" changes in its online authentication system to satisfy these rules.

Perhaps the greatest impact of EU application of the precautionary principle is on farmers, primarily but not exclusively American, who make use of biotechnology in producing genetically modified crops. Because of stringent EU restrictions and labeling requirements on genetically altered foods or ingredients, multinational food processors are increasingly refusing to buy them on the grounds that they are likely to cause marketing problems in Europe.

In May of 2003, the U.S. initiated legal action in the WTO against the EU for its refusal to approve some genetically modified (GM) crops, despite the fact that they have been approved by EU scientists, allegedly because of political sensitivity to European consumers' concerns about their possible health and environmental risks (concerns that have led to such crops being labeled "frankenfoods" by those suspicious of their potential effects). This illegal ban, the U.S. argues, is costing it some $300 billion a year in lost exports. The U.S. contends, furthermore, that the EU policy is undermining efforts to fight hunger in Africa, because African nations are avoiding growing food from better-yielding genetically modified seeds for fear that such crops would not be exportable to EU countries. In July 2003,, the EU was in the process of passing legislation imposing extremely strict and onerous labeling requirements on any food or animal feed product containing more than 0.9 percent GM components. This legislation will presumably end the moratorium but, in the view of producers of GM seeds and foods, is likely to leave the EU market still effectively closed to exports of such products.

Whither Convergence? Future Directions

Looking to the future, all three nations and the styles of capitalism they represent are searching for effective ways to combine the pressures for global convergence with national economic objectives appropriate to the social attitudes and institutions of their citizenry. For the United States, whose form of capitalism appears to be most consonant with the pressures created by global integration of markets, three challenges are paramount. One is to restore public trust in the economic virtues for which it has traditionally been recognized: transparency of financial information and accountability to the interests of shareholders. This trust was severely shaken, both at home and abroad, by the corporate scandals of recent years, and its restoration is currently a work-in-progress just begun.

The second challenge is to continue integrating the focus of American shareholder or investor capitalism with attention to the demands of other stakeholders as well, including customers, workers, host communities both at home and abroad, and the environment. That American business has already moved ahead in recognizing the competitive advantage—and therefore the benefit to shareholders—of such attention is recognized rhetorically in successive statements by the Business Roundtable, a group composed of the CEOs of 200 of the nation's largest and most influential companies. These statements have moved over a period of 20 years from regarding obligations to shareholders and to other stakeholders as competitive to seeing them as complementary.

Suiting action to words, a growing number of American firms have added "corporate responsibility officer" to their roster of high-level executives, incorporated such considerations as a factor in decisions regarding executive compensation, and are working to integrate social-responsibility awareness into their products and processes and into their strategic and business planning to increase profitability. An increasing number of companies see certification that they are adhering to the guidelines for corporate environmental responsibility known as ISO 14000, issued in 1997 by the non-governmental International Standards Organization, as a valued reputational symbol. And several voluntary codes of labor standards, generally promulgated on an industry-by-industry basis, are accumulating growing numbers of adherents and developing monitoring and certification processes. A prominent feature of these codes, developed under the pressure of public awareness create primarily by activist NGOs, is that they require signatory firms to take responsibility not only for their own labor practices but for those of their global suppliers as well.

Finally, although the tolerance for job insecurity and income inequality is likely to remain higher in the United States and other Anglo-Saxon countries than in other industrialized nations, the desire for some degree of personal and family security is universal. As expectations of long-term job security with a single firm have waned, the concept of employability security, in the form of measures that increase a person's probability of making a successful job transition, has gained prominence. But, because providing such security is by definition beyond the scope of an individual firm, its effective implementation is likely to require some form of partnership among firms, labor unions, and government at various levels. And this suggests that, although the corporatist "social partners" arrangements that characterize German capitalism would be totally unsuited to the United States, this country does need to continue and reinforce a number of pioneering efforts at cooperation among business, labor unions, and government to enhance workers' employability security even as the notion of lifetime employment with a single organization fades into obscurity.

For Germany and Japan, the overwhelming challenges are to reduce labor-market rigidity, make the availability of capital more dependent on market signals and less on traditional insider relationships, and to increase both the quantity and the quality of publicly available financial information. Both countries have started on a process of incremental adaptation, but both have a long way to go. As completion of the EU's single market increases competition in the markets for goods and services, and monetary union in the form of EMU accelerates the restructuring of financial markets, pressure on member-country firms both from below and from above to be more responsive to market signals are likely to increase. Japan's process of adaptation is slower and politically more difficult; to an outsider, it is difficult to tell whether the net result is two steps forward and one step backward or the reverse. And retrogression may become more pronounced when the prolonged recession finally ends.

For both these nations, and their respective forms of capitalism, the single greatest challenge will be to find measures of social protection that encourage rather than limit high levels of employment and labor-force participation and greater flexibility to adapt to changing market signals. Interestingly, one promising approach to such an integration of goals is currently being pioneered in the United States. As one of the political compromises required to pass the Trade Promotion Authority (TPA) legislation essential to the United States' effective participation in the current round of multilateral trade negotiations, the Bush Administration inserted a clause providing partial wage insurance for workers displaced by trade liberalization. This clause provides that, when a displaced worker (whose earnings lie below an upper limit) accepts a lower-paying job elsewhere, the government will replace a portion of his wage differential for a transitional period of several years.

The bottom line on global convergence after the bubble is that, despite the United States' fall from grace in a number of economic, social and political dimensions since the turn of the century, American or Anglo-Saxon investor capitalism continues to be the dominant model where capital markets and corporate governance are concerned. Various pressures continue to push the labor markets of industrial nations in that direction as well, although embedded social customs and institutions are likely to continue to play a more significant role in that arena.

Convergence pressures are operating in a different direction where firms' interactions with customers are concerned. Just as the "lean production" methods developed in the crucible of Japan's export-oriented capitalism became a global model for the factory floor in the 1980s and 90s, today it is the requirements imposed on products, services, and production processes by the stringent regulations of the EU's social-market capitalism that are increasingly dominating the global arena.

All three forms of capitalism are thus playing a role in global convergence, and all three are undergoing significant change in the process. In the case of both the German and the Japanese varieties, the movement, however hesitant and fraught with political and social pushback, is toward the greater transparency and adaptability of the American system. And American investor capitalism is itself evolving as its participants confront twin challenges: to restore the trust that has underlain its success and to integrate the adaptability and market-responsiveness of its rules and institutions with the broadened focus on corporate responsibility to multiple stakeholders that is increasingly perceived as a significant ingredient in global competitiveness and sustainable profitability.

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