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The Fate of the German Model

Peter A. Hall

There is a German model, although it is not uniquely German in all respects, nor is it something all countries should try to emulate. If it is neither entirely German nor a model for most countries, why should we speak of a German model? The answer turns on what this phrase implies about the operation of modern economies. All too often, economic analysis treats capitalist economies as if they should all operate in the same way. From that perspective, the distinctive institutional features of a national economy appear as deviations from an ideal configuration, which inhibit rather than enhance national performance until structural reform erases them. The American economy has often been held up as the closest approximation to such an ideal. Today the German economy is sometimes presented as the ideal to which its European neighbors should aspire.

What these views fail to acknowledge, however, is that successful economic performance can be delivered by more than one type of institutional configuration. The concept of the German model is useful precisely because it reminds us of this fact and indicates how economic performance is influenced by the organization of the political economy. The organization of the political economy is the institutional infrastructure supporting coordination among firms and other actors in spheres such as those of industrial relations, corporate governance, technology transfer, standard-setting, and skill formation. Of course, some institutions stand in the way of economic performance, but others are intrinsic to the efficiency of an economy; and there is convincing evidence that prosperity can flow from political economies that are organized quite differently (Hall and Soskice 2001; Amable 2003). The problem becomes one of establishing which institutions contribute to economic performance or well-being and how various institutions work together toward such ends.

This problem has been the defining intellectual challenge for comparative political economy since the 1960s and many scholars have made fruitful contributions to it. The French regulation school drew attention to the ways in which institutions in some spheres of the political economy can enhance the operation of institutions in other spheres (Boyer 1990). Industrial sociologists showed how production regimes depend, not only on the organization of the firm but also on institutions in its external environment (Sorge and Malcolm 1986; Streeck 1992). Studies of neo-corporatism have revealed how the organization of trade unions and employers condition the effectiveness with which countries manage inflation and unemployment (Schmitter and Lehmbruch 1979; Scharpf 1984; Katzenstein 1985).

My own approach to these problems is influenced by joint work with David Soskice on varieties of capitalism (Hall and Soskice 2001). We see firms as agents of adjustment in the political economy whose success depends on how effectively they coordinate with other actors, including employees, trade unions and other firms. The coordinating capacities of firms are conditioned by the institutional infrastructure of the political economy within which they operate; and we emphasize the distinction between coordination that is accomplished via competitive markets and coordination that is based on strategic interaction or collaboration among smaller groups of actors. We describe economies in which market coordination predominates as liberal market economies and those whose firms rely more heavily on strategic coordination as coordinated market economies. This distinction allows for sub-types as well as some national distinctiveness, so that “Western Europe” can be said to encompass social democratic economies in the Nordic world, continental coordinated economies elsewhere in northern Europe, liberal market economies in the UK or Ireland, and mixed market economies in southern Europe (Amable 2003; Hall and Gingerich 2009; Pontusson 2011).

Is there a German model?

Seen from this perspective, the German political economy displays some distinctive features constitutive of a German model of economic development. It is important to note that this model has both micro and macro dimensions, whose effects flow from how they operate in tandem.

At the micro level, the organization of German firms and the institutional environment in which they operate is important, especially in manufacturing. Many German firms have excellent capacities for making incremental improvements to their products and production processes, partly because works councils, backed by relatively strong trade unions, give the workforce some measure of job security and a voice in management decisions that makes it easier for firms to enlist their cooperation (Thelen 1991). As a result, many German producers have a reputation for high quality, which allows firms to compete on quality as well as price in markets for goods. These results also depend on a workforce with high levels of industry-specific skills, which are delivered by a system of vocational training, based on formal education and apprenticeships, built on collaboration between trade unions and employer associations that are well-organized at the sectoral level (Busemeyer and Trampusch 2012). Along with cross-shareholding among firms, those associations are conducive to collaborative research and development because they support corporate networks that allow firms to develop and monitor each other's reputations; and they shield firms from hostile takeovers that might threaten their close relationships with the workforce (Goyer 2012). The result is a form of stakeholder capitalism in which firms are responsive to the concerns of their employees and other firms as well as shareholders, and hence more resistant than their British or American counterparts to an exclusive focus on the price of the company's shares (cf. Gomory and Sylla 2013).

At the macro level, parallel sets of institutions and policies enhance the operation of these institutions at the micro level. Although weaker than they once were, in tandem with works councils, industry-wide trade unions are capable of coordinating with strong employer's associations on wage levels that encourage skill formation and restrain increases in unit labor costs. However, effective wage discipline also depends on supportive macroeconomic policies; and, in keeping with this, German governments have generally been reluctant to implement expansionary fiscal policies, lest they encourage higher wage settlements. For many years, the Bundesbank also policed this system by threatening to impose restrictive monetary policies in response to inflationary wage settlements (Streeck 1994; Hall and Franzese 1998; Carlin and Soskice 2009). Efforts to hold down the external value of the currency have also been central to promotion of the export sector, initially under Bretton Woods and then the European Monetary System (Kreile 1978). Since 1999, the European monetary union has also served this purpose, as the weaker economies in the eurozone hold down the euro exchange rate. The combination of these institutions and policies at the micro and macro levels of the German political economy have given rise to distinctive patterns of economic performance, marked by a large manufacturing sector and levels of exports that now comprise almost half of German GDP.

Of course, over the years, German policies have fluctuated around these norms and the institutions of the German political economy have undergone various changes. The universal banks that once exercised considerable influence over the industrial sector pulled back from it during the 1990s in order to expand their international business (Höpner and Krempe 2004; Deeg 2010). Trade union membership has recently declined, along with collective bargaining coverage, and works councils have become correspondingly more important in wage negotiations (Silvia

2013). Partly in response to initiatives from the EU, various realms of the German economy have been liberalized, and in this some see the collapse of collaborative capitalism (Streeck 1999). In my view, however, the basic features of the German political economy continue to distinguish it from many others, including its Anglo-American counterparts.

What has changed, however, is the structure of the German labor market, largely although not exclusively, as a result of the reforms of the Schröder government in the early 2000s. At that time, the Achilles heel of the German economy was its limited capacity to create jobs, especially in services (Iversen and Wren 1998). Most of those who were employed had good jobs, but overall levels of employment in Germany were low by cross-national standards. Germany was sometimes said to have an economy that provided "welfare without work" (Scharpf 2000). By reforming social insurance to lower the reservation wage, discouraging early retirement, and making part-time work more feasible, a series of reforms in the 2000s vastly expanded a secondary labor market of part-time jobs, often occupied by women, and employment in services. The resulting dualism is a double-edged sword (Palier and Thelen 2010). On the one hand, it has helped Germany to one of the lowest unemployment rates in Europe. On the other hand, many more German jobs are now precarious, lacking in social benefits, and low-paid. In this respect, Germany now resembles Japan, another coordinated market economy that has long had a set of dual labor markets.

Is the model a success?

Should we deem the German model a success? There are always trade-offs relating to what a particular political economy can deliver, and much depends on the criteria used to make this judgment. On national income per capita, the most familiar indicator of economic success, Germany ranked ninth in Europe in 2012 and well above the OECD average. It provides employment for 73 percent of the adult population, among the highest levels in Europe. As already noted, however, that achievement has come at the cost of rising levels of inequality (Thelen 2014). Workers in the core manufacturing sector continue to benefit far more substantially from this economic model than those on its periphery; and increasing inequality has aroused resentment among Germans, who now report lower average levels of satisfaction with their lives than people in most other European countries (OECD 2013; Alesina *et al.* 2004). However, after taxes and transfers, inequality in disposable household income has not risen as much in Germany as in Sweden or Finland since the mid-1990s, and it still stands significantly below the EU average (OECD 2014: 65). In short, Germany is now a less egalitarian society than it once was and its rates of poverty have edged upward, but there are many people elsewhere in Europe who would trade their life circumstances for those of the average German.

Can the model be sustained?

Is this model sustainable? In the long run, there is no doubt that it faces some formidable challenges. A low birth rate will eventually reduce the size of Germany's labor force and its potential rate of growth, unless higher levels of immigration swell the population. But immigration is not politically popular and immigrants rarely come with the high levels of certified skills on which the manufacturing sector depends. Thus, while a palliative, immigration is unlikely to be high enough to assure the growth prospects of the economy.

Second, levels of investment, on which the future growth of any economy depends, have been low over recent decades in both the private and public sectors. Partly for this reason, the rate of growth of productivity has been slow since 2000. Paradoxically, the problem in the private sector is linked to the success of German firms in lowering the rate of growth of unit labor costs. When labor is expensive, firms are more motivated to engage in labor-saving investment (Manow and Seils 2000). In the public sector, the problem is linked to the expansion of social programs, which consume resources that might otherwise be spent on capital investment, especially when governments are wary of deficit spending (Schäfer and Streeck 2013). Social programs are politically difficult to cut back because they are often seen as entitlements, while capital budgets can usually be pruned below the public radar screen.

Third, energy costs are now considerably higher in Germany than in some competing countries, such as the United States which is extracting oil and gas using new techniques of hydraulic fracturing. In addition, the aggressive stance of Russia has called into question the security of Germany's energy supplies which are highly dependent on that country. Although Germany is exploiting new sources of renewable energy, the closing of its nuclear plants also puts pressure on its energy prices. Since energy prices affect the cost of German exports, these developments pose long-term problems that cannot be ignored.

Finally, some analysts argue that the norms which encourage German firms to cooperate with one another, thereby enhancing collaboration and public goods, have eroded under intense pressure from foreign competition and liberalizing reforms that have removed some of the institutional constraints underpinning those norms (Streeck 2009). If this is the case, the capacities for strategic coordination at the center of the German model may be threatened.

Challenges such as these mean that we cannot take the continued success of the German model for granted. In order to prosper, the country will have to cope with them, and that may require some adjustments in German institutions and policies. Based on historical experience, however, I am cautiously optimistic that Germany can rise to these challenges without a radical change in the structure of its political economy. After all, Germany has met such challenges in the past. Reunification was a remarkable accomplishment. Concerted action made it possible to incorporate the eastern states (*Länder*) into a reunified Germany without dismantling the overall German model. Of course, reunification involved some alterations to that model, but, as already noted, all national models undergo changes over time Hall (2007). In this case, the process was marked by some mistakes, real sacrifices and some suffering, but it demonstrated the striking adjustment capacities of the German model.

Those capacities are rooted in the organization of the German political economy, which provides producer groups and governments with considerable capabilities for concerted action. Concertation is not always a smooth operation: producer groups sometimes move only under pressure from governments. Some arrangements provide the actors with considerable room for maneuver under broad guidelines, and firms have recently been defecting from some agreements in search of flexibility (Thelen and van Wijnbergen 2003). But the capacity of the system to provide such flexibility is not necessarily a weakness: in some respects, it contributes to the long-term resilience of German institutions.

Can the model be exported?

In the short to medium term, the most serious challenges facing Germany stem from the on-going crisis in the eurozone. In the wake of that crisis, levels of unemployment have soared and rates of growth plummeted in the countries on the periphery of western Europe most affected by the crisis. The Greek economy is now 25 percent smaller than it was in 2008. But stagnant growth across the eurozone threatens deflation across Europe, and Germany's rate of economic growth is projected to reach only 1.3 percent in 2014. One of the most pressing problems facing Germany is how to restore growth in Europe, an issue with political as well as economic dimensions.

However, the possible responses turn on the nature of the crisis facing Europe. Many factors converged to produce this crisis, including fiscal imprudence in Greece, loose financial regulation, and the inflationary effects of cheap credit flows inspired by the inception of the euro. However, the crisis also has roots in institutional asymmetries within the eurozone (Hall 2014). EMU brought together a set of political economies organized in quite different ways, and the type of growth strategy a country can pursue is conditioned by the organization of its political economy. But EMU proved more propitious for some growth strategies than for others.

To put it simply and leave aside some national variations, EMU can be said to have joined together two types of political economies – coordinated market economies in northern Europe, including Germany, the Netherlands, Belgium, Finland and Austria, and mixed market economies in southern Europe, including Spain, Portugal, Italy and Greece. The coordinated market economies had institutional structures conducive to export-oriented growth strategies. Effective systems of wage coordination restrained the rate of growth of unit labor costs, while para-public systems of skill formation encouraged high value-added production and incremental innovation, which allowed firms to compete on quality as well as price. As a result, these countries were well-equipped to compete in the new monetary union; and EMU provided a favorable context for their export-led growth strategies. It prevented their principal trading partners from devaluing their currencies to enhance the relative competitiveness of their own products, and, by holding down the external exchange rate, it enhanced the attractiveness of exports from the eurozone in other markets. Not surprisingly, Germany soon built up large balance of payments surpluses inside the eurozone.

By contrast, the structure of the political economies in the mixed market economies of southern Europe was not conducive to export-led growth strategies. Wage coordination to hold down the price of exports was difficult because their trade unions were relatively powerful but organized to compete for the allegiance of the workforce rather than to collaborate (Hancké 2013). Employer associations were less deeply institutionalized than in northern Europe and ill-equipped to operate collaborative vocational training schemes. As a result, the workforce was less skilled and the continuous innovation and high levels of quality control that enhance the attractiveness of exports were more difficult to achieve.

Partly because they were ill-equipped to operate export-led growth strategies, the southern European nations tended to adopt demand-led growth strategies, which relied on expansionary macroeconomic policies and generous industrial or manpower subsidies to increase employment, notably in services. Because expansionary policies are inflationary, however, prior to EMU many of these countries relied on periodic devaluations to maintain their external competitiveness. For such countries, entry into monetary union posed serious challenges. Unable to shift to export-led growth strategies and encouraged by flows of cheap credit from the north, they continued to pursue demand-led growth, only to find their current account deficits ballooning because they could no longer use devaluation to depress their unit labor costs and restore their competitiveness. In the end, these imbalances in the current account were as important as government deficits to eroding confidence in sovereign debt within the eurozone.

What can Germany do to restore rates of growth in Europe? Although some have argued for dismantling the monetary union, the immediate costs of doing that would be enormous for Germany and the other member states (McKinsey Germany 2012). Other analysts have suggested that reflation in Germany should be used to address the problem. However, although some reflation may be desirable in the short term, the spillovers from German reflation would not be high enough for this step to have a major impact on growth in southern Europe; and, as I have noted, fiscal expansion over a prolonged period is incompatible with the German model, since it threatens the wage coordination on which exports are based (Ivanova and Weber 2011).

In this context, some observers have suggested that the solution lies in forcing the southern European countries to adopt the German model. According to that view, they can prosper by becoming more like Germany but my analysis suggests that this vision is entirely unrealistic. The countries of southern Europe can be forced to adopt balanced budgets, a measure that the fiscal compact of the EU is now pressing on them. However, the success of the German model depends as much on its micro as its macro dimensions, namely, on the organizational structure of its political economy; and it is unreasonable to think that can be emulated in southern Europe. The structure of a political economy cannot be changed overnight. It is based on the organization of producer groups and capacities for cooperation that develop only over decades out of hard-won experience (Streeck and Yamamura 2001; Thelen 2004). To impose contractionary fiscal policies on countries that lack the institutional infrastructure for export-led growth, thereby preventing them from pursuing demand-led growth, is a counsel of misery, based on a fundamental misunderstanding of how the Germany economy works.

The alternative approach implicit to some extent in the EU's enthusiasm for "structural reform" is to espouse radical deregulation of labor and product markets in the countries of southern Europe with a view to turning them into liberal market economies, like the U.S. and U.K. which rely largely on market mechanisms for economic adjustment. There is more promise in this approach. The Anglo-American economies can secure reasonable rates of growth, but it comes at the cost of relatively high levels of socioeconomic inequality which are unappealing to many Europeans. Moreover, because they are not well-suited to export-led growth, liberal market economies tend to depend on demand-led growth strategies of precisely the sort that the EU is now denying to southern Europe. There is a real risk that the countries of southern Europe may end up with deregulated economies joined to deflationary policies that doom them to low rates of growth and high current account deficits for many years to come.

What then should Germany do? There are no easy answers to this question, and the dilemmas are as much political as economic. The German government is caught in a pincer. On one side, the states of southern Europe, including France and Italy, are urging that they be allowed more room for fiscal reflation, ideally accompanied by expansion in Germany. They argue correctly that there is more than economic growth at stake. Hanging in the balance is the credibility of the claim that European Union advances the prosperity of all, rather than only some, of its member states, an issue currently fueling the rise of the radical right in many of them. On the other side of this pincer are those in Germany who believe, based on German experience, that fiscal rectitude is a necessary condition for economic prosperity, and who argue, with some reason, that German taxpayers should not foot the bill for economic problems occurring elsewhere in Europe.

Faced with this dilemma, the German government is likely to do what German governments almost always do, namely steer a middle way between Scylla and Charybdis. The governing coalition will likely tolerate some relaxation of austerity elsewhere in Europe and look for ways to expand public investment at home, in greater measure if economic conditions continue to deteriorate. Whether such steps will be enough to raise levels of growth and stave off populist electoral forces elsewhere in Europe remains to be seen. However, it will certainly not be enough to resolve the endemic problems of operating a currency shared by countries with very different political economies. That will ultimately require institutional reforms, which are underway, but for which few in Europe have the requisite political enthusiasm.

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