Is There a Successful “German Model”?

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Brigitte Unger sent me a list of questions and asked for very brief responses. So here they are, even though one of my points took a little more space.

Has Germany been economically successful since the 2000s?

To the question of whether Germany has been economically successful since the 2000s I have two different answers:

The first answer is “No”: From 2001 to 2005 Germany was the “sick man of Europe”. German GDP per capita declined from 2001 to 2003, and unemployment increased from 7.9 percent in 2001 to 11.3 percent in 2005.The initial decline can be explained as a consequence of Germany entering the monetary union: the Bundesbank could no longer fight the German recession through an expansionary monetary policy. On the contrary, since Germany had the lowest rate of inflation in the eurozone, the average-oriented monetary policy of the ECB was too tight for Germany, further depressing, rather than stimulating, consumer demand and investment. At the same time, the government's capacity for fiscal reflation was severely constrained by the Stability Pact (on which the previous German government had insisted). As a consequence of rising social expenditures and a fall of tax revenues from 37.2 percent of GDP in 2000 to 34.8 percent in 2005; Germany violated the pact's 3-percent deficit limit from 2001 to 2005.

The second answer is "Yes": After 2005 Germany became economically successful. From 2005 to 2012, GDP per capita increased by 12 percentage points, and unemployment declined from 11.3 to 5.5 percent of the labour force. And while GDP fell steeply from 2008 to 2009 as a consequence of the international financial crisis, unemployment increased only slightly and continued to decline in 2010. At the same time, the German balance of current accounts, which had still been negative in 2000 and which became positive as a consequence of falling domestic demand in the recession, continued to rise after 2005 and amounted to a surplus of 7.4 percent of GDP in 2007.

Germany's recent economic and employment success is generally attributed to three beneficial policy choices: union wage restraint, the Schröder government's "Hartz" reforms of 2005, and the expansion of short-time wage subsidies in 2009. All three explanations have empirical support. Unit labour costs in manufacturing had begun to decline with the onset of the recession, falling by more than

12 percentage points between 2002 and 2007 which did reduce domestic demand but improved the cost-competitiveness of German exports. And while economy-wide unit labour costs increased on average in the eurozone after 2000, they remained stable in Germany and even decreased by 5 percentage points between 2005 and 2007. The latter effect may indeed be associated with the "Hartz" reforms which had reduced the reservation wage of the unemployed and liberalized the rules of atypical employment. The intended effect was a significant expansion of low-wage employment[1] – which was also associated with a rise in poverty and social inequality.[2] And there is no question that the expansion of short-time subsidies in 2009 helped to stabilize the jobs of the core labour force and allowed firms to benefit fully from the quick recovery of international demand in 2010.

Is there a "German model"?

On this question, I defer to the work of Wolfgang Streeck and his collaborators. In his seminal paper on "German Capitalism: Does It Exist? Can It Survive?" Streeck (1995) has summarized the economic, institutional, cultural and political characteristics of the German political economy and its beneficial social effects to explain how and why, at the end of the 1980s, Germany could be seen as "the internationally most successful of the major economies" – which managed to combine high wages with comparatively little inequality.

The main thrust of Streeck's paper is, however, pessimistic: considering the challenges of German reunification and, above all, the deregulatory and liberalizing impacts of economic Europeanization and globalization, the German model was unlikely to survive. Its "parochial" socio-economic structures and mechanisms could not be exported, and they were bound to erode under the pressures of economic and regulatory competition and ever-increasing capital mobility. These expectations were further explored and confirmed by the work of Streeck's associates and students examining the erosion of collective-bargaining agreements (Hassel 1999; Rehder 2003), the effects of liberalized capital markets and the dominance of shareholder-value orientations on corporate governance and industrial relations (Höpner 2003), the impact of European competition rules on the industrial-policy functions of public banks (Seikel 2013) or of European rules guaranteeing the free movement of capital on the institutions of German co-determination (Werner 2013). In a comprehensive review of such changes, Streeck (2009) did indeed conclude that the 1989 model of German capitalism that he had described was rapidly eroding, and that its beneficial socio-economic functions and distributional effects could no longer be maintained.

Yet if that is so, one may indeed wonder why, in 2014, Germany should once more be seen, at least by its neighbours and by European authorities, as the model of a highly successful economy. One presently popular explanation focuses on the liberalizing German "reforms" in the mid-2000s. And it is indeed true that some of the non-liberal characteristics of Streeck's German model were weakened or abolished over the past two decades. But liberal economies have not been generally more successful in recent years, and liberalizing reforms have not primarily affected the industrial core of the German economy. Thus Germany has not been transformed from having been the most typical "coordinated market economy" into a perfect "liberal market economy" (Hall/Soskice 2001). In short, liberalization by itself does not seem to explain the present success of the German economy.

In my view, what is missing in most discussions on the German success is a focus on the interaction between the domestic model and its international monetary environment. To discuss this effect, however, I need to answer a question that has not been asked:

Has the German model come to depend on undervalued exchange rates?

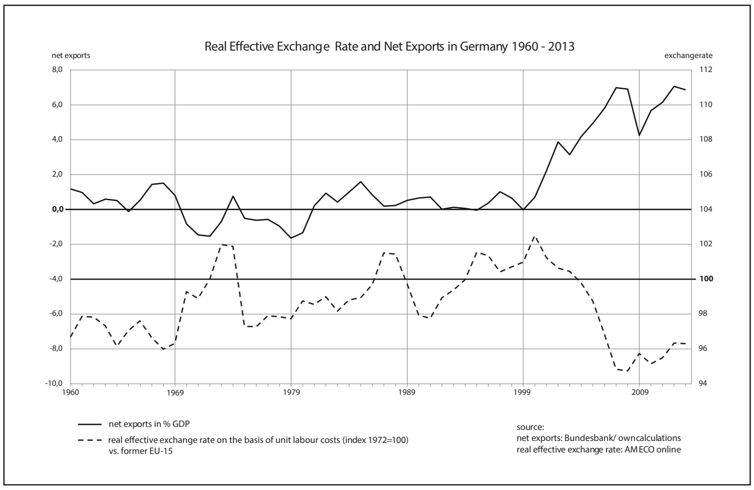
There is of course no question that Germany's success is related to its international *economic* environment. Even if it could never be described as a "small open economy" (Katzenstein 1985), its industry has long been export-oriented, emphasizing up-market consumer and investment goods (Streeck 1991). Hence German exports have recently benefited from the industrialization of former socialist and Third-World economies after the fall of the Berlin Wall. But other countries used to have internationally successful industries as well which, however, have withered away in the general deindustrialization of advanced industrial economies. In my view, it was its particular relationship to international *monetary and currency regimes* that has allowed Germany to buck this trend, and to increase its reliance on export-led growth and employment to such an extent that the share of exports in GDP rose from less than 10 percent in the 1960s to almost 50 percent in 2012.[3]

The present pattern has its roots in the late 1940s and early 1950s, when West Germany and its industrial base were in ruins and mass unemployment was extreme. For German industrial unions, therefore, jobs and profit-financed economic reconstruction (plus co-determination) were initially more important than wage increases. Moreover, the new D-Mark, which in 1948 had replaced the hyper-inflated *Reichsmark* at a discount of 10:1, was as yet untested; and after an initial devaluation of almost 30 percent,[4] the future Bundesbank was determined to establish and defend its external and internal stability without compromise.

Under the Bretton-Woods regime of fixed exchange rates, this combination of devaluation, wage restraint and stability-oriented monetary policy paid off when German industrial exports benefited from the rise of inflation in the United States during the Korea boom of 1950-51. More generally, the asymmetry of Bretton-Woods rules (which Keynes had argued against) favored stability-oriented national regimes. It allowed member states to ask for a devaluation of the dollar exchange rate if persistent current-account deficits resulted in a balance-of-payments crisis. But it did not oblige countries with a surplus to raise the nominal exchange rate – which then allowed them to benefit from the export subsidy of an undervalued real effective exchange rate (Bordo 1993, 55).

In general, of course, rising wages and prices would soon eliminate this comparative advantage. Not so in Germany, even though rapidly falling unemployment and rising real wages corrected the extreme distributional imbalance between capital and labour in the 1950s, German unions continued to realize that at least in export-oriented industries wage policy was not only about incomes but also about jobs. And in the domestic economy, the Bundesbank's hard-money policy continued to constrain inflationary wage rises that could have destroyed the competitive advantage of an undervalued currency. As a result, the real-effective exchange rate of the D-Mark remained undervalued against European competitors, and German net exports remained in surplus throughout the 1960s (Figure 1). As a side effect, the rising gold and dollar reserves of the Bundesbank allowed Germany to be among the first countries to liberalize capital mobility and currency exchange.

Figure 1: Real effective exchange rates and net exports



The value of real undervaluation was well understood by German industry and unions who jointly protested against even marginal exchange-rate adjustments at the end of the 1960s, when the undervaluation of the D-Mark had increased to such an extent that the Bundesbank was forced to re-introduce currency-exchange controls in its fight against "imported inflation" (cf. Germann 2014). Their fears proved more than justified when the Bretton-Woods regime finally collapsed, and was then replaced by floating exchange rates. Then the D-Mark/dollar exchange rates, which had been at the ratio of 4:1 from 1961 until 1968, fell by a third to 2.65:1 in 1973 and declined even to 1.83 in 1979. And while fluctuations of the real effective exchange rate against Germany's European competitors were not quite as extreme, the steady surplus of net exports had come to an end in the 1970s.

In other words, German export industries had good reason to dislike volatile exchange rates, not only because of increased transaction costs but also because they eliminated the export subsidies of an undervalued real effective exchange rate. For the Bundesbank, by contrast, floating rates eliminated the need to use its monetary tools to stabilize an unrealistic fixed exchange rate, and exchange controls to fight imported inflation. Instead, it could now concentrate on restoring price stability in Germany. Ignoring the steep rise of unemployment caused by the oil-price crisis of 1973-74, the bank continued its restrictive monetary policy to fight cost-push inflation. At the same time, the unions were made to understand that wage increases above the line defined by the bank would be punished by an even more restrictive monetary policy and additional job losses

(Scharpf 1991, chapter 7). In effect, therefore, inflation rates in Germany were far below those in competing European economies – which in spite of currency fluctuations again reduced real exchange rates in industrial markets, whereas the export balance suffered from the steep rise of oil prices.

Right after the demise of Bretton-Woods, the social-liberal German government had started efforts to restore currency coordination at least in Europe. Initial agreements on a joint float of European currencies against the dollar (the "snake in the tunnel") soon disintegrated, however, as governments tried to cope with the oil-price crisis. But in 1979, Helmut Schmidt and Giscard d'Estaing were able to agree on the creation of a "European Monetary System" (EMS). It was meant to replicate the Bretton-Woods regime, except that individual currencies were pegged to a currency "basket", the ECU, rather than to a national currency. And there was also no equivalent to the International Monetary Fund (IMF) as lender of the last resort. In practice, however, the D-Mark was the largest currency in the basket – which also meant that the monetary policy of the Bundesbank had the largest influence on the course of the ECU. Hence central banks trying to keep their currencies within allowable margins needed to mirror its stability-oriented policies – which, however, continued to focus on conditions of the German economy, rather than those of the EMS area (Marsh 2009).

In general, the EMS was once more beneficial for German export industries. Currency fluctuations were reduced and upward revaluation was dampened by the deadweight of less stability-oriented EMS economies. As a consequence, real effective undervaluation of the D-Mark continued[5] and net-export surpluses reappeared. For Germany and countries with a similar stability orientation, like Austria or the Netherlands, the EMS was a near-optimal regime while other member states could use it as a "stability anchor" that helped to reduce inflationary dynamics without eliminating the possibility of devaluation or even exit as a last resort.

But devaluations were politically costly, and avoiding them by having to mirror the Bundesbank's monetary policy could damage the national economy if it was out of sync with conditions in Germany. In France and elsewhere, therefore, the Bundesbank's hegemonic role was increasingly resented. But instead of supporting proposals for EMS reform, the French government and the Delors Commission opted for a fully centralized and irrevocable European Monetary Union (EMU). Germany, which had been quite satisfied with the EMS, finally agreed as well to demonstrate that it was fully committed to European integration even after German unification. In order to allay fears of inflation, however, it insisted on tough conditions of admission in the Maastricht Treaty and on an additional Stability Pact to constrain public-sector deficits and debt.

The rest is history (Scharpf 2011; DeGrauwe 2012; Höpner/Lutter 2014).

What matters here is the fact that with the run-up to the monetary union the fluctuations of European interest rates were progressively reduced, and in 1999 they were completely eliminated. For the former soft-currency economies, that created a massive boost to credit-financed domestic demand, whereas for Germany, which in the turbulent years after reunification had been running current-account deficits and which had entered the monetary union at too high an exchange rate, the challenges resembled those of the early postwar years: Unemployment was high and rising, average-oriented ECB monetary policy was too tight for low-inflation Germany, and the Stability Pact ruled out fiscal reflation. And since the exchange rate was also fixed, the responses resembled those that had been successful in the 1950s: Jobs in industry were once more defended through union wage restraint.

In the corporatist literature it is generally assumed that the capacity to use wage-setting as an instrument of economic policy depends on the organizational power and economic sophistication of large, centralized and cohesive industrial unions (Scharpf 1991; Calmfors 1993; Höpner/Lutter 2014). That is indeed plausible when wage restraint is supposed to constrain inflation in tight labour markets. Under the threat of massive job losses, however, decentralized concession bargaining may be equally or more effective. In Germany, at any rate, industrial unions were urged to accept opening clauses that allowed works councils to negotiate cost-reducing agreements at plant-level (Hassel 1999; 2012; Rehder 2003). As a consequence, effective wage increases were below collective-bargaining agreements, and unit labour costs in manufacturing did not merely stagnate but actually declined after entry into the EMU.[6] And whereas in the EMS real undervaluation had been limited by the nominal devaluations of other member states, that corrective mechanism was now eliminated. Hence the overall weakness of eurozone economies also limited the impact of German surpluses on the exchange rate of the euro.

In effect, therefore, the monetary union allowed a dramatic fall of the real effective exchange rate after 2001 which then caused a steeper rise of German export surpluses than at any time since the end of the Second World-War (Figure 1).

Hence whatever was left of the German model that Streeck had described for 1989 has been supported and distorted by the perverse monetary regime of the EMU to such an extent that the share of exports in GDP, which had reached 25 percent at the end of the 1980s, continued to escalate to an incredible 50 percent of GDP in 2013.

And in present German and European debates, that is counted as "success".

Which theory underlies your argument?

In my view, no single general theory should be expected to explain the history of a specific and complex politico-economic configuration. If a plurality of theoretic perspectives were to be applied, it would include "Varieties of Capitalism" (Hall and Soskice 2001) which however needed to be complemented with an appreciation of the variety of macroeconomic regimes (Scharpf 1991) and with a political-economy variant of Peter Gourevitch's (1978) reminder of the influence of international regimes on domestic choices.

Can and should the German "success" be exported to other countries?

The German "success" does not have to be exported to some of the small open European economies inside the eurozone which are highly competitive in world-wide markets. But if some economies benefit from undervalued real exchange rates, others must suffer from real overvaluation, and if some achieve current-account surpluses, others must by necessity have corresponding external deficits. And in any case, not all European economies have industrial structures that would facilitate an export-led growth strategy (Wierts et al. 2013).

Is Germany's "success" sustainable?

Germany's success is sustainable as long as the monetary union does not collapse, and as long as the demand of BRIC economies for German investment goods and luxury cars remains strong enough to support the export-dependent German economy. And no, if either one of these conditions should fail.

What would you recommend Germany to do?

For Germany, leaving or dismantling the monetary union is economically and politically out of the question. But if the monetary union is to continue, Germany ought to contribute to reducing economic imbalances by reflating domestic demand and increasing imports.

In economic and political terms, however, Germany is now locked in its present position. If exports amount to fifty percent of GDP, the economy depends on them. Export industries and their unions dominate political debates in the media and in all political parties. And even though the government and the Bundesbank are presently recommending higher wage increases, not only employers but also industrial unions are unwilling to consider any action that might jeopardize sales and export-dependent jobs. And of course nobody has as yet suggested how the government could command private-sector wages to rise.

The public sector, however, could increase domestic demand through investments in the country's decaying public infrastructure and by expanding and improving under-financed public services in education and health care. But the present government has tied its hands by insisting on tough European rules on fiscal consolidation and balanced budgets for everybody, including the surplus economies. And the chancellor and her finance minister, who are still castigating Gerhard Schröder for exceeding the deficit limits of the Stability Pact in the recession of 2001-2005, are more likely to face another euro crisis than to confront the ridicule of European public opinion and the wrath of their own party for violating these rules. From a political-economy perspective, therefore, it is hard to see how Germany would soon accept the role of a good European citizen that everybody is asking it to play. And in terms of economic self-interest, it is hard to see why it should.

Notes

1. The share of low-wage earners with respect to hourly earnings rose from 17.4% in 2001 to 21.7 % in 2010. (Statistisches Bundesamt 2012, Niedriglohn und Beschäftigung 2010). https://www.destatis.de/DE/PresseService/Presse/Pressekonferenzen/2012/niedriglohn/begleitmaterial_PDF.pdf?__blob=publicationFile.
2. The share of population at risk of poverty or social exclusion increased from 18.4 % in 2005 to 20.1 in 2008. And the Gini-Coefficient rose from

26.1% to 30.2% in the same time span. (Source: European Union Statistics on Income and Living Conditions, SILC)

3. Exports in 1960: 8.9% in GDP, in 2012:49.7% in GDP. Source: Deutsche Bundesbank.
4. From 3.33 DM/US dollar to 4.20 DM/US dollar in September 1949 (Bidwell,1970)
5. After the Plaza Agreement of September 1985, however, the Bundesbank was asked to raise the nominal D-Mark rate to support the American economy – which was followed by a fall of German export surpluses.
6. When challenged on this point, industrial unions point to the principle of "solidaristic wage policy", explaining that their wage demands, though below productivity increases in manufacturing, were still in line with economy-wide productivity.

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