German Economic Performance:
Disentangling the Role of Supply-side Reforms, Macroeconomic Policy and Coordinated Economy Institutions

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Abstract

Debate about Germany’s poor economic performance over the past decade and a half focuses on supply-side weaknesses and the need for more vigorous reforms to make low-skill labour markets more flexible. We question this diagnosis using three lines of argument. First, effective restructuring of the supply-side in the core advanced industries has been carried out by the private sector using institutions of the coordinated economy, including unions, works councils and blockholder owners. Second, implementation of orthodox labour market and welfare state reforms has created a flexible labour market at the lower end and an associated increase in inequality. Third, low growth and high unemployment in Germany are largely accounted for by persistent weakness of domestic aggregate demand, rather than by failure to reform the supply side. To explain these developments, we identify the external pressures on companies in the context of increased global competition, the continuing value of the institutions of the coordinated market economy to the private sector and the constraints imposed on the use of stabilizing macroeconomic policy by these institutions. Finally, we suggest how changes in political coalitions permitted the implementation of orthodox labour market reforms in a consensus political system.

JEL: E65, J50, P52

Key words: economic performance; economic reform; varieties of capitalism; collective bargaining; corporate governance; Germany; United Kingdom; Scandinavia

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1 This paper draws on a body of related research including Carlin and Soskice (2007a, b), which has been presented to different audiences. This version has been prepared for the conference ‘The Nordic Model: Solutions for Continental Europe’s Problems?’ Center for European Studies, Harvard, 9th – 10th May, 2008. Useful comments on an earlier related paper were received at the CEPR-ECB-Bank of Italy Conference on ‘Globalisation, EMU and the Reshaping of European Economies’ at the EUI Florence in June 2007. We have benefited from excellent research assistance provided by James Cloyne and Etienne Hans and from useful discussions about these questions with Andrea Boltho, Andrew Glyn, Bob Hancke and Matthew Harding.
For the decade and a half following German unification, Germany’s economic performance was poor. Throughout this period, debate has focused on the role of labour market rigidities and the need for reforms, with the objective of creating labour market flexibility in line with Anglo-American norms. However, the contours of German performance pose some puzzles for this interpretation. In particular, effective restructuring of the supply-side in the core advanced industries has been carried out by the private sector using institutions of Germany’s coordinated economy model, including unions, works councils and blockholder owners. This indicates the continuing value of the institutions of the coordinated economy to the private sector in the face of external pressures of increased global competition. Second, orthodox labour market and welfare state reforms were implemented and created labour market flexibility at the lower end with an associated increase in wage dispersion. The combination of these two supply-side developments has sharpened the separation of the labour market in the advanced sector of the economy from the ‘outsider’ labour market. Third, the presence in Germany of low GDP growth and high unemployment together with low real wage growth (relative to productivity) points toward the role of persistent domestic aggregate demand weakness and is harder to reconcile with a purely supply-side causal mechanism. Moreover, implementation of reforms to make the labour market more flexible may have interacted with the behaviour of workers with specific skills to increase precautionary saving and contributed to depressed domestic demand.

Nevertheless, our alternative hypothesis itself raises puzzles. The first is economic: how can aggregate demand shocks account for unemployment outcomes that persist for over a decade? The second and third are political economic: if persistent weakness of domestic demand was at the core of Germany’s poor performance, what accounts for the absence of stabilizing macroeconomic policy? And finally, how did a consensus political system as is characteristic of a coordinated economy secure support for labour market reforms that are associated with increased inequality and the polarization of the labour market?

A central problem with assigning an independent role to aggregate demand weakness in accounting for German economic performance is highlighted by the standard New Keynesian macroeconomic model. In this model, aggregate demand shocks have a short run effect on employment and output because of the failure of wages and prices to adjust immediately: in the face of a negative shock, wage and price inflation does not fall rapidly enough to restore the initial constant inflation equilibrium. Nominal stickiness creates a role for the policy maker in stabilizing the economy by adjusting the real interest rate. The policy maker is normally the central bank but in principle, the fiscal authority could achieve the same result. In this model, a negative aggregate demand shock therefore produces a temporary rise in unemployment and fall in inflation followed by restoration of the pre-existing constant inflation equilibrium. Thus the observation of persistently high and rising unemployment alongside modest and stable inflation suggests deterioration on the supply side with no independent role for aggregate demand. However, extending the macroeconomic model to the open economy introduces a new channel through which aggregate demand shocks can produce persistent effects on unemployment. In an open economy model in which countries produce differentiated goods, a country-specific aggregate demand shock leads to a change in the real
consumption wage (as home inflation diverges from import inflation). Because real wages decline, the economy can remain at a higher constant inflation unemployment rate following a negative demand shock. Similarly if the aggregate demand shock is positive, home wage and price inflation rises relative to import inflation and real wages increase, allowing for a new lower constant inflation unemployment rate to be sustained. The open economy channel provides a way of reconciling Germany’s depressed real wage growth with the weakness in growth and employment in the context of negative demand shocks.

The political puzzles arise from one of the core hypotheses of the Varieties of Capitalism (VoC) literature (exemplified by Hall and Soskice, 2001), which links institutions of the production sector of the economy to the nature of the welfare state and the political system. In the VoC literature, Germany is characterized as a coordinated market economy in which supportive private sector institutions play a central role in solving coordination problems faced by firms and employees. The activities in which firms are engaged and, by extension, the specialization of the German economy are deemed to require long-term investment and the commitment to relationships entailed by this. When standard mechanisms dependent on publicly verifiable information cannot be used, networks and institutions compensate for the associated costs and facilitate the transfer of information. Hall and Soskice point to the role of networks and institutions in the five defining features of the German coordinated economy relating to: corporate governance and the financial system; within-firm incentive structures; the industrial relations system at industry and company level; the education and training system; and inter-company relationships that facilitate technology transfer.

Strong complementarities are posited among the coordinated economy institutions: the heavy reliance of firms on deep firm- and sector-specific skills creates a role for wage-setters outside the firm (unions) so as to curtail the power of skilled insiders to ‘hold-up’ the firm with excessive wage demands. In turn, if workers are to invest in these co-specific assets, the welfare state has to provide adequate insurance in the event of job loss due to company failure. This brings in the nature of the political system since the long-term character of the investments requires that institutional change be difficult and require wide agreement. Thus a consensus political system complements the other coordinated economy institutions.

The complementarities between institutions suggest that at the economy-wide level, the presence of large but non-encompassing wage-setters requires a non-discretionary macroeconomic framework in order to create incentives for wage restraint. This may help to explain the absence of a stabilizing fiscal response in Germany in the face of persistently weak domestic aggregate demand especially in the post-2000 period: recovery from the end of 2004 rested entirely on the strength of external demand. But the VoC framework faces a challenge in accounting for the introduction in Germany of wide-ranging reforms of the welfare state weakening protective labour market institutions. The specific characteristics of German partisanship and union structure have been proposed as ways of accounting for the inegalitarian character of the reforms implemented.
In Section 1, we focus on the evolution of the supply side in Germany looking both at how the private sector used the institutions of the coordinated economy to undertake restructuring, and at supply-side reforms that focused on standard measures to increase the cost of job loss. Both sets of supply-side developments would be expected to weaken real wages relative to productivity and to reduce equilibrium unemployment. In Section 2, we compare the extended growth recession in Germany with the long recession-free boom in the UK. This allows us to illustrate how contrasting patterns of aggregate demand – positive shocks in the UK case and negative ones in the German case – are consistent with the divergent outcomes in unemployment and real wages observed. The role of the open economy channel is reflected in real exchange rate appreciation in the UK and real depreciation in Germany. In Section 3, we turn to the political economic arguments, looking first at why German institutions may be especially ill-suited to the use of discretionary fiscal policy and second, at how changes in political coalitions in Germany made possible the implementation in a consensus political system of reforms that weaken protective labour market institutions.

1. The supply side in Germany: private sector restructuring and government reforms

In spite of the emphasis on supply-side failure in much analysis of Germany’s economic woes, there is evidence of robust restructuring in the core advanced sector of the economy and of the effects of labour market reforms in the ‘outsider’ labour market.

Supply-side restructuring – the private sector and coordinated economy institutions

We suggest that the very different type of labour market and skill organisation in Germany in comparison to the UK and the US has played an important part in the conduct of private sector-led restructuring of the past decade in Germany and may also help account for cross-country differences in consumption behaviour that came to the fore. Of central importance in the argument is the vocational training system in which companies play a leading role, and in which young workers acquire relatively deep skills specific to a sector and to a considerable extent to a firm. By contrast, the UK and the US place far more emphasis on general education and training. The depth of skills across the German work-force is illustrated by cross-country estimates of labour quality at industry level for the year 2000 comparing Germany, the US, the UK and France. They show Germany ranked first in all but 12 of the 68 industries (Mason, 2007).

A striking development over the post-unification period is the extent to which the German economy has become increasingly characterized by two separate labour systems: one in the core advanced sector of the economy and the other ‘outsider’ labour system, which has been the focus of government labour market reforms. The restructuring of the economy connected to the core labour system has been extensive and successful. Moreover, this has been carried out by private sector agents (unions, employers’ associations, firms, works councils) without a significant role for the government. Restructuring has entailed increased consensus-based decision making in firms with works council chairs playing a greater role in co-management (e.g. Höpner 2003). Works councils have played an important role in the advanced service sector companies (e.g. banking, insurance) that are less unionized. The median (i.e. skilled) employee interest
has become increasingly aligned with the firm’s. Whilst industry unions still play a major role in coordinated wage bargaining and vocational training, both have become more oriented to company needs (Thelen, 2007, Addison, Schnabel, Wagner 2007). Industry unions are more dominated than in the past by major works council chairs.

Key changes since the early 1990s included the collapse of coordinated bargaining in East Germany, where the attempt to reproduce the core German model largely failed. In West Germany smaller firms tended to leave the formal wage-setting system but small firm associations emerged to shadow coordinated wage bargaining since the reasons for not wanting internal firm-level wage-setting prevail. Union membership density (as a percentage of employees) fell from 32% in 1980 to 23% in 2004 (in West Germany; 18% in East Germany). However, although coverage declined as well, in 2004 it was still the case that 68% of employees in West Germany and 53% in East were covered by collective agreements and that for about one-half of those not covered, the sectoral agreement was the point of reference for wage-setting (Addison, Schnabel, Wagner 2007). There was also a shift in a range of tariff-related bargaining areas from union to company works council level (e.g. part-time working for older workers) negotiated with the unions and with input from works councils. Average job tenure appears not to have fallen, which suggests that companies have focused on internal restructuring and the flexible redeployment of workers facilitated by the new occupational profiles and flexible working times negotiated with unions (Bosch and Kalina, 2008).

In a coordinated economy, blockholder owners play a role both in allowing long-run relationships between workers and the firm to be sustained and in facilitating the monitoring of performance within the firm. Neither worker nor manager performance in these activities is easily evaluated in external markets and skilled workers need mechanisms to ensure that their investments in acquiring new competences will not be undermined by radical changes in asset use. In the face of financial globalization over the past decade and a half, it was increasingly in the interest of stakeholders to have access to global rates of return but it was not in the interests of institutional investors to change effective management systems. Rather, management and works councils chairs were able to make use of institutional investors when they needed to apply pressure for the restructuring of companies.

Although the available data is fragmentary, a number of sources of evidence – on ownership, the presence of different kinds of institutional investors and the nature of changes in corporate governance at company level – support the hypothesis that under the pressure of the global integration of financial markets, Germany developed differently along these dimensions than Italy or France, and remains very distinct from the UK (Carlin, 2007). One indicator of the continued importance of blockholders is that the proportion of market capitalization owned by non-financial companies increased in Germany from 37% in 1996 to 43% in 2004 and the share owned by financial institutions

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[2] In Italy, control structures adapted to far-reaching changes in regulation in a way that reproduced pre-existing control patterns (e.g. pyramids were replaced by shareholder coalitions) and protected incumbents from the growing threat of international competition. Corporate sector performance was poor. In France, there is evidence of transition toward a different institutional cluster: changes in regulation led to the replacement of blockholder arrangements by the greater engagement of activist institutional investors, including those from abroad (Carlin, 2007).
declined from 21% to 15%. An analysis of voting blocks in German listed firms showed stability in the core companies and core sectors of the economy, with a modest move toward somewhat smaller blockholder stakes in firms (mainly in ‘new economy’ sectors) present in 2003 but not in 1997. In Germany like France, changes in governance standards toward greater transparency led to greater engagement of foreign and domestic institutional investors. However in Germany, such involvement appears to have been of a more passive kind: investors who were largely content with existing management and control arrangements sought to take advantage of opportunities for portfolio diversification, rather than taking stakes to gain active control. Goyer (2006, 2007) argued that foreign pension funds acquired small stakes in large firms in both France and Germany as part of their diversification strategies but that a clear difference in preference for stakes in French versus German firms could be observed in the case of mutual and hedge funds. The argument is that the latter favoured investment in France over Germany because of the greater unilateral control by top management in French firms, where works council involvement is absent. The changes in corporate governance and the functioning of the block-holder system in Germany fit the broader picture of restructuring from ‘below’ or ‘inside’, with government reforms having only a limited effect on how the core economy functions.

Reflecting the success of private sector restructuring was the behaviour of profitability in German industry and the performance of the tradeables sector. The profitability of German firms improved and this is illustrated in the national accounts data where the net profit share staged a very impressive recovery (Fig. 1). The deep disruption to the private sector of the German economy caused by unification was overcome. The recovery since the mid 1990s contrasts with that in the 1980s. In the earlier episode, profitability was rebuilt in non-manufacturing industry with only a limited recovery in manufacturing. However, by 2005, the net profit share in German manufacturing was back to levels recorded by West German manufacturing in the early 1970s.

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3 The corresponding figures for France are a fall in the share held by non-financial companies from 29% to 16% and a rise in the share held by financial institutions from 25% to 40% (Carlin, 2007).
The success of restructuring from the mid 1990s is reflected in German export performance. During the period when China, India and the former communist countries of Central and Eastern Europe and the former Soviet Union entered world markets, the export performance of most OECD countries deteriorated. They lost market share to the new entrants. Germany’s performance was counter to this trend: as Fig. 2 shows, Germany’s export performance in goods and services improved over the decade to 2006 (See Fig. 2).4

4 A similar picture emerges from alternative measures – e.g. the change in exports less imports. In an econometric analysis of the determinants of export performance 2001-2004 in France, Germany, Italy and Spain, the authors conclude that ‘Germany’s relatively vibrant recent export performance is consistent with its comparative strength on price and cost competitiveness and global demand for its products’ (Allard et al. 2005, p. 4). In contrast to the other countries there is also a positive growth of exports, unexplained by the traditional determinants of domestic and foreign demand and cost and price competitiveness. This is consistent with the positive trend in export market share controlling for cost competitiveness for Germany identified by Carlin, Glyn and Van Reenen (2001) for the earlier period, 1970-1992.
Supply-side restructuring – government labour market & welfare state reforms

The long period of high unemployment in Germany, which we argue in the next section was largely an aggregate demand phenomenon, prompted welfare state and labour market reforms of the traditional kind (beginning in the mid 1990s and culminating in the extensive Hartz reforms from 2003 onwards). Table 1 reports OECD data on the intensity of labour market and welfare state reforms undertaken, benchmarked against the OECD recommendations: Germany ranked fourth highest of thirty OECD countries in this measure of reform effort for the 1994-2004 period. The reform intensity of the UK during this period is shown for comparative purposes.
Table 1. The intensity of OECD-recommended labour market and welfare state reforms undertaken between 1994 and 2004

A.

<table>
<thead>
<tr>
<th></th>
<th>Overall score</th>
<th>Rank (out of 30 OECD countries)</th>
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<tbody>
<tr>
<td>Germany</td>
<td>23.9</td>
<td>4</td>
</tr>
<tr>
<td>UK</td>
<td>16.7</td>
<td>11</td>
</tr>
</tbody>
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B.

<table>
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<tr>
<th></th>
<th>EPL</th>
<th>Unemp. Benefits</th>
<th>Working time flexibility</th>
<th>Early Retirement</th>
<th>Wage formation &amp; industrial relations</th>
<th>ALMP</th>
<th>Taxes &amp; social security</th>
</tr>
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<tbody>
<tr>
<td>Germany</td>
<td>16.7</td>
<td>19.2</td>
<td>16.7</td>
<td>25.0</td>
<td>9.1</td>
<td>57.7</td>
<td>12.5</td>
</tr>
<tr>
<td>UK</td>
<td>-10.0</td>
<td>11.5</td>
<td>0.0</td>
<td>25.0</td>
<td>-9.1</td>
<td>50.0</td>
<td>56.3</td>
</tr>
</tbody>
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Source: Brandt, Burniaux and Duval (2005). Table 8, p. 56.
Notes: The score relates to the number of actions taken. Measures introduced contrary to the recommendations of the OECD Jobs Study are scored with a negative number. The score relates to the number of actions taken. EPL – employment protection legislation; ALMP – Active Labour Market Policies. More detail is available in the Appendix of Carlin and Soskice (2007b), which is reproduced below.

Evidence from a number of data sources confirms that the incidence of low-paid work in Germany began to increase in the mid 1990s (Bosch and Kalina, 2008). For example, among full-time workers incidence began to rise from 1995 in West Germany (after declining from 1980-1993). By 2003, 17.3% of full-time employees in West Germany and nearly one-fifth in East Germany received less than two-thirds of West (resp. East) German median earnings. Internationally comparative data in a 6-country study show the incidence of low pay\(^5\) in 2005 varying widely from 8.5% in Denmark and 11.17% in France to 17.6% in the Netherlands, 21.7% in the UK, 22.0% in Germany, and 25% in the US (Mason, Mayhew and Osborne, 2008\(^6\)). In the light of the two-track restructuring of the labour market that has occurred over this period, variation across industries in Germany is interesting: comparing 1995 with 2003, the incidence of low paid work remained roughly constant in manufacturing and in retail, wholesale, business and professional services whereas it increased in utilities, construction and household and personal services (Bosch and Kalina, 2008).

One effect has been to leave particular groups such as the low skilled, immigrants and East Germans outside the generous German welfare state, whilst employees in the core

\(^5\) ‘Low pay’ is defined as gross hourly earnings below two-thirds of the median hourly wage for all employees.

\(^6\) Updated to 2005 by Geoff Mason. If East and West Germany are treated together, the low pay incidence is 22.7%.
labour system are still relatively protected. Inequality at the bottom of the wage distribution has increased as collective bargaining ceased to cover them (Dustmann, Ludsteck and Schönberg, 2007). At the same time it appears that the children of those in the outsider labour market are likely to be increasingly excluded from the vocational training system, an outcome reinforced by the worsening performance of children in the lowest secondary school track (Bosch and Kalina, 2008). This may reflect the diminished motivational role for children in the lower tail of the ability distribution that was previously played by the existence of a more or less continuous ladder of apprenticeships by quality and where lower tier apprenticeships led to semi-skilled jobs (Soskice, 1994).

Although primarily directed at freeing up the outsider labour market, it is plausible that the government reform programme affected the behaviour of workers in the core export-oriented labour system. Employees with specific skills can be expected to react with particular concern to a slowdown in growth, a rise in unemployment and the threat from welfare state reforms to unemployment benefits and pensions. For workers with specific skills it will generally be harder to find appropriate re-employment if they lose their jobs. Moreover, there is a negative externality in a labour market dominated by specific skills. If most of the work force has long-term employment, the number of vacancies within a given category of employment is likely to be limited; and companies may anyway seek to fill vacancies via apprenticeships. Thus mid-career labour markets for many categories may be quite ‘illiquid’. The most obvious comparative example of this is with life-time employment in Japan: in the relevant categories, mid-career labour markets do not exist, short of accepting a position in a subsidiary company.

In Germany as in Japan, illiquidity of mid-career labour markets applies more to the relatively highly skilled – since firms have already invested more in them and, since it pays companies to invest more in them, they have longer tenure. Less skilled workers, but still with apprenticeship certificates, face more open occupational labour markets – which are what portable qualifications should equip them to do. Given serious concerns about unemployment and with governmental pressure for welfare state reform in unemployment benefits and pensions, those with specific skills who remain employed – in fact the great majority – respond by building up precautionary and life-cycle savings. Iversen’s (2005) analysis of the guarantor-insurance role of the welfare state for those with deep specific skills in a coordinated economy explains why this substantial proportion of the workforce should feel insecure as its welfare state benefits start to be questioned. Many employees factor in the possibility of involuntary early retirement or part-time work from their mid-50s should economic conditions become difficult – both schemes depend on welfare state provision. By contrast to liberal market economies such as the UK or US where a workforce with more general skills could imagine at a similar age responding to economic difficulty by finding alternative employment, labour markets for older workers do not exist on any substantial scale in Germany.

To summarise, our hypothesis is that the specificity of skills in the advanced sector in Germany, aggravated by uncertainty about the future of the protective welfare state due at least in part to government reform programmes introduced or announced over the past decade, amplified adverse aggregate demand shocks by further dampening household consumption growth. This effect is likely to have been reinforced by the fact that the German labour market and welfare state are characterized by provisions that encourage
single earner households. The difficulty for women with children to enter and reenter the labour market depresses women’s participation. The dramatic growth in the prevalence of marginal part-time jobs has taken place in the context of a tax and benefit regime in which spouses acquire access to social security via their husband and face a very high marginal tax rate if they exceed a limited number of hours of work. By reducing the incentive for fuller engagement in the labour market by women and by providing derived entitlements to social security, this structure undermines the development of a potentially important insurance mechanism for families with risk-averse male workers who have specific skills.

The German reform path did not entail the adoption of family policies that could potentially have improved the resilience of consumption. Recent cross-country data for 20 OECD countries in 2003 (left hand panel of Fig. 3) illustrates a positive – although not significant – correlation between the female employment rate and fertility. The correlation in 1980 was weakly negative. Data in both panels highlights that the Nordic countries have increased (or maintained very high) employment rates and increased fertility rates since 1980. Germany has both a low female employment rate and low fertility, with the incidence of low paid work concentrated amongst women.

Figure 3. Fertility and female employment rates: cross-country comparisons

![Graph showing cross-country relation between fertility and the female employment rate, 2003](image)

![Graph showing change in fertility rate and change in female employment rate, 1980-2003](image)

Source: OECD data.

Notes: The female employment rate is employment as a percentage of the population aged 15-64

Variations in arrangements exist across the Nordic countries to promote labour market participation and fertility – e.g. in Finland, generous allowances are paid to women who have children and decide to remain at home while the children are very young. Their jobs are held open for them. In Sweden, families with young children have generous maternity and paternity leave, both parents tend to remain in employment and make use of high quality child-care (e.g. Hoem, 2005). Both arrangements have been associated with a revival of fertility rates along with continued high employment rates for women. Such policies presumably help to maintain the growth of household expenditure by reducing
the household income risk as compared with the single bread-winner paradigm in Germany. For example, in the sharp post 1990 recession in Finland, families appear to have responded to the weakness of the labour market by shifting the timing of family formation: women received generous out-of-work benefits whilst looking after young children at home.\footnote{For more details including a comparison with Sweden, see Vikat (2004).}

We can sum up the argument in this section by noting that government reforms (broadly in line with the advice of the OECD and the consensus amongst German economists) had the effect of reinforcing the outsider labour system with some unintended consequences. These include increased segregation between the two labour systems, increased poverty (Förster and Miranda d’Ercole, 2005) and inequality. Rising precautionary savings contributing to Germany’s persistently weak domestic aggregate demand (European Commission 2006, p. 200) are likely to have been driven by growing insecurity of core labour market workers as a consequence of the labour market and welfare state reforms. Meanwhile, the core labour system was characterized by continuity combined with effective restructuring by private agents. Incremental organizational innovation consistent with the essential characteristics of the German version of a coordinated economy was undertaken in the face of external pressures from global product and financial markets.

2. Aggregate demand and persistent unemployment

According to standard New Keynesian macroeconomic models, a sustained fall in unemployment without inflationary consequences must reflect supply-side improvements either via reforms or as a consequence of unanticipated positive productivity shocks. Conversely, persistently rising unemployment without continuously falling inflation suggests a worsening of supply-side conditions. In such models, aggregate demand plays a passive role in accounting for longer term changes in unemployment. Since only supply-side determined equilibrium unemployment is sustainable, fluctuations in aggregate demand either account for temporary deviations of the economy from the equilibrium or track the path of the economy to a new equilibrium following a supply side shift. For example, if supply side conditions have deteriorated but the downward adjustment of private sector aggregate demand is sluggish, the macroeconomic policy reaction functions will respond to the upward pressure on inflation and signal the necessary policy change to ensure stabilization of aggregate demand around a new higher unemployment equilibrium. Equally, if there are exogenous shocks to aggregate demand (e.g. from the rest of the world) this may require policy intervention to dampen or stimulate activity.

There is a sharp contrast between British and German economic performance in the period following the unification shock in Germany and the UK’s exit from the Exchange Rate Mechanism. The British economy grew on average by more than one percentage point per year faster than Germany, its unemployment rate declined more or less continuously and its public debt shrank. German unemployment and public debt rose. The standard macroeconomic framework suggests that these differences reflect supply-side phenomena. However, Section 1 presented a prima facie case for the presence of
supply-side improvements in Germany over this period: restructuring by the private sector of the export-oriented part of the economy encapsulated by the recovery of profitability together with the implementation of prescribed supply-side reforms. Indeed, applying the results of widely cited cross-country empirical studies of the determinants of cross-country unemployment performance to Germany (e.g. the panel data analysis of Bassanini and Duval, 2006) predicts that German unemployment should have fallen, not risen over this period. The Bassanini-Duval results predict a fall in unemployment in Germany of 1.6% points from 1993-2003 due to supply-side changes, when unemployment increased by 1.4% points; for the UK, one-half of the actual fall (5.5% points) was predicted by supply-side changes.\(^8\)

One response to the ostensible failure of the New Keynesian model to explain the performance of the UK and Germany, is to extend the model to allow for long-lasting aggregate demand effects. This can be done by opening the economy and allowing changes in the real exchange rate to persist (explained in detail in Carlin and Soskice 2006; Carlin and Soskice, 2007a,b). Central to the standard model is a negative relationship between the unemployment rate and the real consumption wage reflecting the behaviour of wage-setters. From the perspective of wage-setters, a lower unemployment rate is consistent with stable inflation only when the real wage is higher (given the disutility of work). However, from the perspective of price-setters, a higher real wage is not compatible with lower unemployment: assuming constant productivity, price-setters require an unchanged real wage to deliver their required profit margin. Hence the constant inflation rate of unemployment in the closed economy is completely pinned down by supply side conditions. In an open economy, however, the resources to make a higher real consumption real wage at lower unemployment compatible with an unchanged real product wage are potentially available from abroad through an appreciation of the real exchange rate. This lowers the real cost of imported goods and thereby boosts real consumption wages.

The final step in the argument is to connect shifts in aggregate demand to changes in the real exchange rate and the real wage. The open economy model assumes that firms produce differentiated goods that are sold in imperfectly competitive markets. A higher level of aggregate demand raises domestic output and prices and produces a real exchange rate appreciation. This reduces the real cost of imports and allows a higher real wage to prevail at higher output and lower unemployment. Hence shifts in aggregate demand, if they are persistent, can move the economy to new constant inflation unemployment rates. In the case of a positive aggregate demand shock, the closed economy mechanism through which rising inflation at lower unemployment leads the central bank to raise the interest rate and induce contraction back to the original unemployment rate is circumvented in the open economy by the fact that real consumption wages can rise. Conversely, if there is a period of sustained weakness in aggregate demand, unemployment rises but inflation ceases to fall once real consumption wages.

\(^8\) Using the base-line linear regression in Bassanini and Duval (2006) and ignoring the variables with insignificant coefficients (union density and employment protection legislation). The evolution of the supply-side variables in the regression is reproduced below in the Appendix.
wages have fallen to a level consistent with wage-setters’ behaviour at higher unemployment. There is a real depreciation, lower real consumption wages and higher unemployment.

Fig. 4 presents data for the UK and Germany for the period from 1993. The left hand chart shows unemployment and inflation performance: the limited difference between the countries in inflation performance and the contrast in unemployment are clear. The right hand chart provides data on labour productivity and real wage growth. After 1995, real wage growth in the two countries diverges dramatically: rising in the UK and falling in Germany. Productivity growth differences are much more muted: German productivity growth is always above real wage growth, whereas the opposite is the case for the UK from 1996.

Figure 4. Comparative data for Germany and the UK: Unemployment, Inflation, Real Wage and Productivity Growth

Source: OECD Economic Outlook Database, 82.
Notes: Unemployment is the OECD standardized rate (%); Inflation is CPI (% p.a.); Real wage growth is compensation per employee in the private sector deflated by the CPI (% p.a.); Productivity is labour productivity (employment basis) (% p.a.). Inflation, real wage and productivity growth series are 3-year moving averages.

We turn now to examine whether the evolution of real exchange rates was consistent with shifts in aggregate demand in these economies having played a major role in accounting for the behaviour of unemployment. In the case of Germany, the left hand panel of Fig. 5 shows higher unemployment associated with a depreciating real exchange rate, as would be the case in the face of negative aggregate demand shocks. By contrast, a boom in aggregate demand in the UK is consistent with the pattern in the right hand panel: falling unemployment and an appreciating real exchange rate. A movement from the south-east to the north-west in the chart is consistent with stronger aggregate demand (at a given
real exchange rate) permitting a lower unemployment rate to be maintained because of the associated rise in the real wage. An important difference between the UK and Germany is that the sterling exchange rate was floating throughout. Hence part of the British adjustment took place rapidly through nominal appreciation around 1997 whereas real exchange rate adjustment in the German case (depreciation) took place in a more protracted fashion via domestic wage restraint (Fig. 4).

Figure 5. Unemployment and the Real Exchange Rate, Germany and the UK, 1995-2006

Source: OECD Economic Outlook Database 82.
Notes: The real exchange rate is an index of relative unit labour costs in manufacturing; 2000=100; a rise in the index shows a real appreciation. The unemployment rate is the OECD standardized unemployment rate.

Although they can be regarded only as providing indirect evidence, the ex post patterns of aggregate demand in the UK and Germany are consistent with demand shocks playing an independent role in the evolution of unemployment in the two countries. Fig. 6 shows the ex post accounting contributions to the growth of real GDP of household consumption and housing; private investment; government consumption and investment; and net exports.
Figure 6. Comparison between Germany and the UK in contributions to growth of aggregate demand, 1993-2005 (3 year moving average)

Source: OECD National Accounts Database June 2006
Notes: Contributions to the growth of constant price GDP (3 year moving average). The contributions do not add up to GDP growth because of the omission of stock-building, a statistical discrepancy and the treatment of government investment in housing. Data for 2006 are OECD forecasts.

The superior growth performance of the UK throughout is illustrated in the top chart. In the early years, British net exports and investment benefited briefly from the post-ERM depreciation of the pound. However, this was soon replaced by a boom in private consumption and housing, which contributed about 2% p.a. to GDP growth throughout the period. In the second half, the growth of demand was sustained by strong public spending. This pattern contrasts sharply with the German one, where the contribution of private consumption and housing expenditure and government spending declined throughout the period. Growth in the 2000s was virtually entirely dependent on net exports. These contrasting patterns are more difficult to reconcile with a hypothesis highlighting supply-side problems in Germany: in that case, a given level of aggregate demand would be associated with upward inflationary pressure and a tendency toward a deterioration rather than improvement of net exports.

Table 2 compares the pattern of employment creation in the two economies. Job creation was far superior in the UK – the ratio of employment to the population of working age
increased by seven percentage points in the UK and by only two in Germany. But where
were these new jobs created? The run-down of manufacturing and mining employment in
the UK and its success in business services and finance are well-known. Table 2 shows
that the contraction of employment in the ‘goods’ producing sectors was indeed slightly
less in Germany than the UK; more surprising is the fact that employment in business
services increased by just as much (3 percentage points) in Germany as in the UK. The
real differences lie elsewhere – in construction, government employment, and
distribution, where job creation in the UK was respectively 2.2, 1 and 0.8 percentage
points higher. The employment patterns correspond closely to the differences in the
structure of aggregate demand between the two economies.

Table 2. The industry composition of changes in the employment rate, 1995-2003

<table>
<thead>
<tr>
<th>Industry</th>
<th>Germany</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Agriculture, forestry &amp; fishing</td>
<td>-0.4</td>
<td>-0.3</td>
</tr>
<tr>
<td>2 Mining and energy</td>
<td>-0.3</td>
<td>-0.2</td>
</tr>
<tr>
<td>3 Manufacturing</td>
<td>-1.3</td>
<td>-1.5</td>
</tr>
<tr>
<td>4 Construction</td>
<td>-1.7</td>
<td>0.5</td>
</tr>
<tr>
<td>5 Distribution</td>
<td>0.9</td>
<td>1.7</td>
</tr>
<tr>
<td>6 Transport &amp; communications</td>
<td>-0.1</td>
<td>0.5</td>
</tr>
<tr>
<td>7 Finance, business services</td>
<td>3.1</td>
<td>3.0</td>
</tr>
<tr>
<td>8 Public administration, health, education</td>
<td>1.2</td>
<td>2.2</td>
</tr>
<tr>
<td>9 Other services</td>
<td>0.7</td>
<td>1.0</td>
</tr>
<tr>
<td>10 Total</td>
<td>2.0</td>
<td>7.0</td>
</tr>
</tbody>
</table>

Source: Calculated from Groningen Growth and Development Centre, 60-Industry Database, October 2005,
Notes: The table shows the absolute change in employment 1995-2003 divided by the 2003 population of
working age.

As argued in Section 1, the interaction between the government’s reform programme and
the specific characteristics of the German labour market may have played a role in the
contrasting behaviour of aggregate demand in the two countries. The prospect of labour
market reforms that increase the cost of job loss is likely to have a greater effect in
boosting savings than, for example, in the UK. The left panel of Fig. 7 shows the
evolution of the household savings ratio (as a percentage of disposable income) over the
period in both countries. The pattern for Germany is a shallow U-shape, with the trough
at the turn of the century. By contrast, there was a dramatic fall in the UK savings rate
beginning around 1997. Unlike the US, where there was a sharp improvement in
productivity growth from the mid 1990s (often attributed to the role of information
technology), productivity growth in the UK remained stable and does not appear to offer
an explanation for the decline of the savings rate. The role of house prices appears more
relevant. Indeed, an important structural difference between the two economies over this
period that is linked to consumption and savings behaviour is the evolution of house
prices.9 As the right panel of Fig. 7 indicates, house price trends in Germany and the UK

9 For cross-country empirical evidence demonstrating that there is a strong contemporaneous relationship
between consumption and housing market wealth, see Case, Quigley and Schiller, 2005. Their study also
have been opposite in the past decade. Since 1995, real house prices in the UK have risen by an annual rate of more than 8% whereas they have fallen by more than 2% p.a. in Germany (partly due to the unwinding of the unification construction boom). This difference helped sustain domestic aggregate demand in the UK and depress it in Germany.

Figure 7. Household savings ratio and real house price changes, UK and Germany

Source: The household savings ratio comes from OECD National Accounts database; the house price data is from OECD Economic Outlook 79, p. 18.

Longer-term issues
Does this argument mean that the equilibrium level of unemployment in an open economy is not uniquely determined by the supply-side but driven by the combined mechanism of aggregate demand and real exchange rate adjustment? The answer is yes in the medium term, but not in the longer term. In a globally integrated economy in which firms and their owners can choose where they make investments, employment can only be maintained at a given rate in the long run if the real risk-adjusted rate of return on new fixed (non-housing) investment (call it \( r \)) is equal to the corresponding world rate of

reports that the impact of changes in housing wealth on consumption is larger and more important than of changes in stock market wealth.

The OECD estimated the overvaluation of house prices in the UK in 2004 at 32.8% (using the price to rent ratio, which was most recently at its 35 year average in 2000) and undervaluation in Germany in 2004 at 25.8% (also relative to 2000 – although the price to rent ratio has been declining there since the 1980s). (OECD, 2005. Economic Outlook 78 p. 136).

In their modelling exercise (of eurozone countries) using a simulated dynamic stochastic general equilibrium model, ad hoc demand shocks have to be introduced to match the data for Germany. The authors note that “no particular shock is given to the labour market. The demand shocks, especially housing and corporate investment are sufficient to generate a decline in the employment rate of the same order of magnitude as observed in the data” (European Commission, 2006, p. 203).
return \( r^* \). With a number of simplifying assumptions \( r \) is inversely related to the real wage \( w \), so that there is some real wage \( w^* \) at which \( r = r^* \).

Fig. 8 shows two quite different ways in which international flows of capital can work.\(^{12}\) In the left-hand panel, we have a situation like that of Maquiladoras-type foreign direct investment (FDI) in a Mexican region: plants and machinery can be quickly put together, and just as quickly dismantled; and product markets at which output can be sold at world market prices absorb whatever is produced. In the right hand panel an advanced economy is portrayed in which fixed investments, once made, can only be sold or broken up at a significant loss; in addition investments are – within limits – specific to the differentiated products that the company in question produces. The real wage \( w \) is measured on the vertical axis and unemployment \( U \) on the horizontal; and the vertical dashed lines are used to refer either to levels of capital stock \( K \) or to the level of aggregate demand needed to maintain a given level of unemployment. Both \( K \) and aggregate demand decline from left to right.

Figure 8. Unique Long-Run Equilibrium Unemployment: the Role of Internationally Mobile Direct Investment Flows

In both cases \( w^* \) is the real wage that produces \( r^* \) with unemployment at \( U^* \).\(^{13}\) In the somewhat idealised flexible FDI world in the left hand panel, the medium run

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\(^{12}\) The model sketched here is a simplified version of one presented in Blanchard and Philippon (2003).

\(^{13}\) For simplicity, the level of productivity is normalized to unity throughout.
equilibrium at high unemployment (b) implies lower real wages and a higher rate of return, which produces a rapid switch of foreign direct investment by multinational companies to the region, restoring unemployment to $U^*$. Hence in this world – assuming structural conditions don’t change – the unemployment rate will be unique. The real wage change triggered by the initial demand shock produces a sufficiently rapid fixed investment response via international capital flows that the medium-run equilibrium at either high or low unemployment cannot persist.

But in the advanced countries, prolonged divergences can occur: assume an economy is in equilibrium at $U^*$ with $r = r^*$, $w = w^*$ and $K = K^*$. There is then an adverse aggregate demand shock and unemployment rises to $U_H$. Wages then fall relative to consumer prices until real exchange rate depreciation has reduced the real wage to $w_L$ and inflation has stabilised again. But investment does not respond to the new lower real wage for two reasons: first, there is spare capacity with the existing $K = K^*$, which is above $K(U_H)$, the lower capital stock now needed (right hand panel). And second, even if producers were to try and sell more, the decline in aggregate demand holds back demand for individual differentiated products. In fact in this advanced economy world, the profit rate on new investment depends on three factors: (i) as always, the real wage; but also (ii) spare capacity; and (iii) the marginal profit from selling more than is demanded at existing prices – which may well be negative as it involves cutting prices. So here, the economy can get stuck at low levels of activity for prolonged periods of time, as the capital stock slowly depreciates and squeezes out spare capacity. Even then recovery may be slow since it depends, at least to start with, solely on replacement investment.

The argument in this section is that strong British and weak German economic growth and unemployment outcomes in the period since the mid-1990s are not well accounted for by the conventional hypothesis of a strengthening supply-side in the UK and a weakening one in Germany. Moreover, Section 1 argued that supply-side improvements were introduced in Germany over this period. However, in the open economy the presumption that performance over a decade or more must reflect supply-side conditions is mitigated by the endogenous response of the real exchange rate to shifts in aggregate demand. A real appreciation in the case of a positive aggregate demand shock permits the real wage to rise and a higher level of employment to be supported and similarly, a real depreciation in the case of a negative shock reduces the real wage and eliminates falling inflation at higher unemployment.

We have shown that contrasting patterns of aggregate demand and real exchange rates in Germany and the UK are consistent with the hypothesis that aggregate demand changes were important in accounting for the performance outcomes. If anything, given the characteristics of its labour market, the implementation and announcement of supply-side reforms in Germany may have had the unintended consequence of raising precautionary savings in the core work-force as self-insurance substituted for expected lower state insurance reinforcing the depressed level of domestic aggregate demand. In the UK there is no core labour market where workers are involved with firms in making co-specific investments. Job turnover is higher in the UK and labour market reforms raising the cost of job loss do not affect the expectations of life-time income in the same way as in
Germany. It is also likely that whilst real wage restraint in Germany played some role in boosting net exports, its wider effects on aggregate demand in a large fairly closed economy reinforced the weakness of consumption by keeping real income growth low (European Commission, 2006, p. 200). We have also suggested why the response of investment to the restoration of profitability was sluggish.

3. Political economic puzzles

*Stabilizing fiscal policy and coordinated economy institutions*
If private sector demand shocks were an important source of the difference in macroeconomic performance between Germany and the UK, the question remains as to why stabilizing policy was not implemented in Germany. Macroeconomic policy was activist and stabilizing in the UK – making use of both monetary and fiscal policy instruments to sustain non-inflationary growth. By contrast in Germany, the ECB could react only partially to below target German inflation. This places more weight on the role of fiscal policy. In this section we argue that fiscal activism may have been constrained for political economy reasons – by the need to sustain incentives for wage restraint by the large wage-setters and by the exigencies of coalition government.

Evidence is emerging that countries divide into clear groups according to whether activist stabilizing fiscal policy is observed (e.g. OECD Economic Outlook 79, 2006). Countercyclical fiscal policy is observed in the ‘other OECD’ group, which includes the Anglo-American economies, and in the small Nordic economies with consensual wage-setting institutions. It is absent in the large continental economies with non-encompassing large wage-setters.

Figure 9. Variation in the Counter-cyclical Nature of Fiscal Policy by Country Group, 1981-2005.

Source: Data from OECD Economic Outlook 79, 2006, p. 32.
Notes: Each bar shows the contemporaneous correlation between changes in the cyclically adjusted primary balance and the output gap over the period 1981-2005 (Germany, 1991-2005). The sign has been changed for primary expenditure in the right hand panel so that a positive correlation indicates counter-cyclicality. Euro area excludes Finland, which is included in the Nordic group. Other OECD includes US, UK, Japan, Canada, Australia, South Korea, New Zealand and Switzerland.

From a political economy point of view there are two institutional situations that may lead to the creation of a conservative framework for the operation of fiscal policy ruling out the possibility of the use of discretionary fiscal policy (except perhaps in extreme circumstances, as eventually in Japan). The first situation is where there are a limited number of powerful wage bargainers who set the inflation rate and de facto the real exchange rate; we shall refer to this as the Small-N case. These powerful unions, usually in industrial sectors but also in the public sector, themselves represent a spectrum ranging from core highly skilled members in no danger of losing their jobs even with sizeable real wage increases to more substitutable employees in more marginally profitable companies or industries. If we assume these unions were acting independently (only partly true), and that the government was pursuing a discretionary fiscal policy to respond to increased unemployment, then each union is big enough to believe that an increase in unemployment as a result of its own actions will lead to some offsetting response by the government of the order of 1/N. By abandoning discretionary fiscal policy and therefore removing this possibility, the government sharpens the incentives for wage moderation.

This analysis appears relevant to Germany. The coordination of wage bargaining that we observe in Germany is an ex-post phenomenon reflecting the understanding of the major unions that any one of them is in a position to gain serious real wage increases and in turn that this would put pressure on other unions to be more aggressive. Given the fear of sharp conservative responses to inflation this has led to concerns across the major unions and produced the outcome of coordinated restraint.

Note that the prospect of discretionary fiscal policy has no effect when labour markets are flexible, or if there are a great many independent bargaining units, since no wage-setter believes that the tiny increase in unemployment resulting from its own wage bargain will change government expenditure. So neither the UK nor the US with flexible labour markets should fear the effect of discretionary fiscal policy. Equally, countries such as the Nordic ones with encompassing wage bargainers, or countries in which all the relevant wage bargainers sit around a table with the government and make a binding wage contract should be happy to conduct a flexible fiscal policy.14 In each of the latter cases, the macroeconomic implications of the wage bargain are internalized in the wage-setting process itself. By contrast in the German (or more generally, small-N case) where behaviour is non-cooperative, coordinated wage restraint is elicited by the presence of a non-accommodating macroeconomic framework. The classification (e.g. by the OECD) of Nordic countries and Germany as ‘high corporatism’ or ‘high coordination’ reflects two distinct sets of institutions, only the latter of which requires associated non-discretionary fiscal policy.

14 Analogous results hold for monetary policy, see Soskice and Iversen (2000).
Second, the structure of governments may affect the incentives for running a discretionary fiscal policy (Hallerberg, Strauch and von Hagen, 2001). The basic argument is this: coalition government leads to a common pool problem if individual ministries with presumably different party preference functions can independently decide on expenditure while taxation is general. Expenditure will be too high with coalition government. Thus it will be in the interest of all the members of the coalition to work out a binding contract regarding how much each ministry (or party) should be allowed to spend. For the binding contract to work there needs to be a tough fiscal framework. This is likely to be at odds with a discretionary approach since there is a principal agent problem: whichever agent (say the Minister of Finance) is put in charge of the discretion will incite the concern of the principal (the other coalition members) that it is being used to the advantage of the Finance Minister’s party. Hence coalition governments will be nervous about discretionary fiscal policy.

Coalition versus single party government is largely a product of the electoral system. Majoritarian systems nearly always produce single party government; proportional representation systems nearly always produce coalitions (or, what are de facto the same, minority governments with agreed support from other parties).

German governments may have fought shy of discretionary fiscal policy because wage bargaining is carried out by a small number of powerful unions and because governments are nearly always coalitions. Historical experience of poor outcomes from the use of deficit financing in the Weimar period (McNeil 1988) and in the so-called Bonn locomotive episode of 1977-1982, when the US put strong pressure on the Schmidt government to engage in a fiscal expansion to stimulate growth and reduce global imbalances, is likely also to have played a role.

Consensual political systems and the nature of reforms
We noted earlier that coordinated economies have consensus political systems. They are characterised by proportional representation, coalition government, strong opposition committee rights and representative parties in which policy positions get negotiated out between different interests within the party. Thus different groups are well-entrenched politically in these systems, and it takes something like super majorities to bring about major changes in their droits acquis. These systems also normally produce centre-left coalitions – put crudely because centre parties can do better allying with left or centre-left parties and taking resources from higher income groups than they can allying with right of centre parties and taking resources from low income groups (Iversen and Soskice, 2006). So in principle low income groups are well-represented politically in coordinated economies, both because of the general protection of the political system against arbitrary or rapid change and because of the particular partisan colour of governments. The contrast with the lack of protection that the political system in the UK gives to low income groups is marked: a preponderance of centre-right governments, a leadership-dominated Labour Party necessarily focussed on the middle classes and its preoccupations – toughness on crime and good education for their children – to win plurality elections, and the almost complete absence of power of the opposition or other groups in parliament.
Given the features of consensus political systems, it remains to be explained how orthodox labour market and welfare state reforms that widen the income distribution gained political support in Germany and why alternative reforms along Nordic lines were not adopted. For example, the German authorities did not develop a serious, quasi compulsory cross-sectoral retraining programme to provide the skills for those made redundant in industry (typically the less skilled) to be reemployed in services. Part of the explanation rests on the fact that unions and employer associations in Germany are sectorally based and the powerful industry organisations have little incentive to invest in retraining for services. Lower income groups outside industry have limited union representation, and thus there has been less pressure for devoting resources to their adequate retraining. By contrast in Scandinavia and Finland, there is more effective cooperation within the union movement across sectors. Nor did German policy-makers reform the education system, where children are separated into three different schooling tracks at a young age. This makes the acquisition of social skills, including the ability to communicate easily across classes, harder to acquire subsequently. In Scandinavia, students are at common secondary schools and where tracking occurs, it is much later (at age 16 rather than at 10 in Germany). Another ‘Nordic’ reform route not taken in Germany relates to the reduction in the costs for women of moving between working at home and in the market. Among coordinated systems, across all of these dimensions, Germany is a thus a more fragmented society than those in Scandinavia and Finland.

The German political system fits the consensus description well, but it is exceptional among such systems in not having above average centre-left governments in the post second world war period. Manow and van Kersbergen explain this by arguing that a major Christian Democratic party with a strong social wing to counterbalance the interests of business has been more attractive to middle class voters than social democracy (Manow and van Kersbergen, 2007). The interests of low income groups were therefore represented in the social wing of the CDU, as indeed in the CSU, as well as in the Social Democratic party. Thus the political move to embrace flexible labour markets by weakening protective labour market institutions required an alliance shift that would, in effect, produce a super-majority that excluded low income workers and the unemployed.

Two broad sets of factors made this easier than it would have been in the Nordic countries: the relative fragmentation of unions and the nature of German political partisanship. Unions in Germany were divided both within and among themselves: works councils representing skilled workers had every interest in flexible low level service labour markets (even if not expressed openly) since it implied cheaper services and therefore increased the real income for their members, and it implied that their members would bear less of the cost of prolonged unemployment; unions directly representing low level service sector workers had much less weight than the major industrial unions; and the major industrial unions were split between the interests of powerful works councils and their own interest in catering for and protecting lower income workers in industry. And, pace Manow and van Kersbergen, faced with this major economic/distributional crisis, middle class voters in Germany were not pushed towards a centre-left solution that protected low income workers and the (typically low skilled) unemployed, because
Christian democracy was weighted towards the centre and thus potentially offered an alternative solution; this pushed the SPD equally towards the centre if it was to compete with the CDU, and the fragmentation within and across the unions made this possible. The coalitional realignment was sealed by the fracturing of the left of the SPD and the formation of the Left Party.

There is of course a question as to whether this shift in political coalitions – the fracturing of social democracy and the similar displacement of the influence of the social wing of Christian democracy – is permanent or a temporary consequence of the lengthy period of poor macro-economic performance. Strong forces within both major political groupings are contesting this general shift in policy.

4. Conclusions

In what ways is the original varieties of capitalism framework relevant to the analysis of the German economy today? Most institutions (vocational training, blockholder ownership, collective bargaining and codetermination, and technology transfer) are still in place, even if their functioning is more flexible and less encompassing than it was earlier. But two major and partially related changes are noticeable.

First, companies and their employees are less solidaristic than they were in relation to the wider organised business community and industry unions; they are more company-centred, or in Wolfgang Streeck’s phrase ‘betriebsegoistisch’. As Thelen (2007) has pointed out, this shift is reshaping the operation of the vocational training system. And, while corporate governance remains based on block shareholdings and capable of taking a long term perspective, financial globalization has had an influence, with the concomitant rise of foreign – typically minority – share-holders. Thus our analysis has suggested that the advanced sectors of the German economy have restructured using private sector coordinating institutions, which is far from inconsistent with the co-alignment of management and employee interests with the long-term profitability of the company. In these respects, we may be seeing a shift in the balance of power away from labour common to all coordinated market economies pushed by financial globalisation.

Second, Germany has developed somewhat differently from most other coordinated economies as far as the bottom end of the labour market is concerned. Here there has been a conscious effort by the German government to create a flexible market for low skilled workers along the lines advocated by the OECD in an effort to cope with rising unemployment among this group. While flexible labour markets exist to some extent at the bottom end of most countries classified as coordinated economies, the phenomenon is especially marked in Germany. This is reflected in a worsening of the income distribution and growing incidence of low-wage work. While inequality has not reached American or British levels it suggests that care is needed identifying coordinated economies with egalitarian outcomes.

What has caused this development? A major point of this paper is that one cannot analyse structural change in economies without bringing in macroeconomics. Macroeconomics was central to comparative political economy in the 1970s and 1980s. It was essential in
the analysis of the OPEC and other deflationary shocks of the 1970s, with sharp distinctions between corporatist and other economies in the nature of macroeconomic responses. Given the variety of macroeconomic shocks over the past decade and a half – from country-specific shocks such as German unification and its aftermath, and house-price based consumer booms, to the differential country impact of the formation of the eurozone and of the growth of the emerging economies – somewhat paradoxically, the macroeconomic dimension has dropped out of the comparative political economy repertoire (Iversen & Soskice, 2007).

We have argued that macroeconomic factors have played a key role in accounting for the differential impact of macroeconomic shocks on the German economy as compared with other coordinated economies. First, unlike other coordinated economies (with the notable exception of Japan), Germany is large. Wage restraint is therefore likely to have exacerbated the weakness of German aggregate demand because the adverse effect of real wage cuts on consumer spending may well have offset its beneficial effect via the external balance. Second, as we have argued, faced by a small number of powerful wage setters, the German fiscal authorities adopted a conservative rather than a discretionary fiscal stance. The government was not basically open to deals with unions over expenditure programmes. This contrasts not only with the discretionary fiscal stance adopted by liberal market economies with flexible labour markets such as the US and the UK (as illustrated in Section 2) but also with inter alia Nordic countries for whom ‘semi-committed’ collective understandings with the unions were easier. The outcome was procyclical fiscal policy in contrast with its counter-cyclical impact in the liberal and Nordic economies.

Thus initial negative shocks were magnified in one or both of two ways differently from other coordinated economies: wage restraint amplified the shock rather than dampening it; and fiscal policy tightened in order to hold down the deficit in public spending rather than allowing automatic stabilisers to work fully. In addition precautionary savings were built up at least ostensibly in response to the concerns about cutbacks in the welfare state generated by government policy. And we suggested as well how adverse aggregate demand was likely to hold back investment responses to lower real wages and higher profitability over a long period of time, and thus prevent flows of internationally mobile capital from boosting investment. Germany had to face a prolonged period of high unemployment and depressed growth with the associated heavy costs on the budget.

The analysis presented in this paper suggests that Germany remains a coordinated economy but, enabled by the reconfiguration of the underlying political coalition, a less egalitarian one. This has resulted from the combined impact of the restructuring carried out in the core economy by firms in conjunction with the institutions of the coordinated economy, the supply-side reforms introduced by the government and the long period of depressed growth.

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15 The analytics of this case are set out in detail in Carlin and Soskice, 2007b.
References


Vikat, A. (2004). Women’s labor force attachment and childbearing in Finland. Demographic Research Special Collection No. 3 (8), 175-211.

Appendix (reproduced from Carlin & Soskice, 2007b)

A. Details of labour market reforms implemented in line with OECD recommendations


Source: Annex 3 of Brandt, Burniaux and Duval (2005).

The following are taken directly from the above source.

EPL:
1994-1999: “Regular contracts” -- company size limit for dismissal protection lifted from 5 to 10, but this was reversed, score: 0, “Temporary contracts” -- maximum duration and permissible renewal frequency increased with a resulting change in the EPL-indicator of 1.5, score: +3; total score for 1994-1999 equals 3.
2000-2004: “Regular contracts” -- size limit for dismissal protection lifted from 5 to 10, this reform is not reflected in the EPL indicator, score: +1 “Temporary contracts” -- maximum age for restrictions on the renewability of fixed-term contracts decreased and the maximum duration for contracts through temporary work agencies eased further with a corresponding decrease of the EPL-indicator of 0.2, score: +1; total score for 2000-2004 equals 2.

Overall score for the 1994-2004 period equals 2.5; the overall score expressed as a percentage of the maximum score (=15, that is a total of 6 for a change in the EPL indicator bigger than 0.6 for both temporary and regular contracts plus 9 extra points) takes a value of 16.67 per cent.

Unemployment benefits:
1994-1999: work availability requirements were tightened, score: +1; eligibility conditions tightened, score: +1; concerning the benefit replacement rate, crediting of redundancy payments against unemployment benefits was introduced and reversed in 1999, score: 0.
2000-2004: wage base for benefit calculation extended resulting in an average increase of the replacement rate of 1.8 per cent, but in 2004, it was decided to reduce benefits sharply beginning in 2005, to capture the latter reform measure a score of +1 is assigned; benefit duration lowered: +1; work availability criteria tightened: +1.

Overall score for the 1994-2004 period: 2.5, as a percentage of the maximum score (=13): 19.2 per cent.

Work time flexibility:
1994-1999: 1 point in the category “Flexibility of working time arrangements” for the introduction of working time accounts.
2000-2004: employees obtain a right to unilaterally transform a full-time job into a part-time job, score: 0 because it is not clear that the possibility to transform full-time into part-time jobs without the employer’s consent eases constraints in a way that more job creation is to be expected.

Overall score for the 1994-2004 period: 0.5; as a percentage of the overall score (=3): 16.7 per cent.

Early retirement:
1994-1999: entry ages to different retirement schemes gradually increased, involving a drop in the average implicit tax of 1.7 percentage points, score: 1; introduction and subsequent suppression of reforms to the sick pay and the disability pension system, score: 0.
2000-2004: early retirement involves discounts and unemployment benefit pathway to early retirement is phased out progressively as the exemption of older workers from job search requirements expire, involving an average reduction in the implicit tax of 11.5 percentage point, score: +2.

Overall score for the 1994-2004 period: 1.5; as a percentage of the overall score (=6): 25 per cent.

Wage formation:
1994-1999: 1 point in “Wage determination” for an increase in plant-level agreements over the 1990s; 1 point in “Use of opt-out clauses”.
2000-2004: no action, score: 0.

Overall score for the 1994-2004 period: 1; as a percentage of the maximum (=13): 9.1 per cent.
Active Labour Market Policies:
1994-1999: evaluation efforts stepped up, score: +1; ALMPs were targeted more on the long term unemployed, the young and older workers, with some of these programmes being new, consequently 1 point was assigned in the category “Targeting of ALMPs” together with a point in the category “Extent of ALMPs”; ALMPs were re-oriented towards encouraging job search while inefficient job creation programmes were scaled down, for this measure a point was assigned in the category “Integration and restructuring of ALMP activities” and a point in the category “Extent of ALMPs” for enhancing the job search function of the PES (resulting in a total of 2 points in this category); one point was assigned in the category “Re-qualification via ALMPs” for abolishing re-qualification via training programmes.
2000-2004: evaluation efforts stepped up once more, score: +1; for profiling, corresponding to an enhancement of the job search function of the PES, for individual action plans to become mandatory in 2005 and for efforts to introduce early activation, a score of 4 is assigned in the category “Extent of ALMPs”; a supplementary point in “Targeting of ALMPs” is assigned for early activation of young jobseekers; in “Contestability of PES” 1 point for introducing the possibility to outsource placement to private agencies is assigned; in “Integration of job counselling, ALMPs and various benefit agencies”, 2 points are assigned for the centralisation of the responsibility for the long-term unemployment in one agency that will be introduced in 2005; a further point is assigned in the category “Re-qualification via ALMPs” for abolishing the possibility to re-qualify.
Overall score for the 1994-2004 period: 7.5; as a percentage of the maximum score (= 13): 57.7 per cent.

Taxes on labour income:
1994-1999: “Overall taxes on labour income” -- labour tax decreases along with some increases and some decreases in social charges with a resulting increase in the tax wedge by 0.8 per cent, score: -1; “Taxes for low income” -- increases in tax allowances and in the lowest tax rate, social charges for “Minijobs” introduced with a resulting decrease of the average of the three tax wedges of 1.1 per cent, score: +1.
2000-2004: “Reduction on taxes in labour income”: tax rate decreases across all income ranges with a resulting decrease in the tax wedge of 0.8 per cent, score: +1; increase of the earnings ceiling for “Minijobs” and rebates of social charges for income ranges just above that ceiling with a resulting decrease in the average of the three tax wedges for low income of 0.8 per cent, score: +1.
Overall score for the 1994-2004 period: 1, the overall score expressed as a percentage of the maximum score (=8): 12.5 per cent which is the reform intensity indicator.
B. Evolution of supply-side variables used in Bassini-Duval (2006)

Source: Bassanini Duval database 2006.