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GERMANY: A GLOBAL MIRACLE AND A EUROPEAN CHALLENGE

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Abstract:

The excellent performance of the German economy over the past decade has drawn increasing interest across Europe for the kind of structural reforms that have relaunched the German model. Through those reforms, in fact, Germany has become one of the countries that benefit most from global economic integration. As such, Germany has become a reference model for the possibility of a thriving Europe in the global age. However, the same factors that have contributed to the German "global miracle" - the accumulation of savings and gains in competitiveness - are also a "European problem". In fact they contributed to originate the euro crisis and represent elements of danger to the future survival of the euro area. Since the economic success of Germany has translated also into political influence, the other European countries are required to align their economic and social models to the German one. But can they do it? Are structural reforms all that are required? This study shows that the German success depended only in part on the vast array of structural reforms undertaken by German governments in the twenty-first century. Much of the transformation took place much earlier. Moreover, it was the consequence of business initiatives by private actors - large-sized firms and banks that were increasingly oriented to cut their investments at home and thrive in the global market - more than the choices made by public policy actors. As such, the peculiarities of the German success story cannot be easily reproduced in other countries. The survival of the euro area and its future design depend on making the inevitable differences among countries compatible in a spirit of integration.

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INTRODUCTION

In 1994, five years after the fall of the Berlin Wall, the Germans feared that the unification of the two Germanys had failed. In 1997 the term "*Reformstau*" (the reform deadlock) had been elected as the "word of the year"[2]. In 1999 and 2000 the weekly magazine The Economist called Germany "the sick man of Europe"[3]. In 2003 the German economy was back in recession.

Until 2004, Germany was struggling in a spiral of a seemingly unstoppable decline, without precedent for its length. Since 2004, Germany has emerged from its economic sluggishness with a performance that, considering the preceding fifteen years, appears to be exceptional. Today, people commonly interpret the rebirth of the German economy as a new *Wirtschaftswunder*, an economic miracle comparable to that of the postwar period and able to provide such a political prestige and diplomatic assertiveness to determine the fate of the political and institutional framework of the rest of Europe.

Over the past seven years, other European countries have had comparable growth rates, Sweden and Switzerland in particular. France has been growing at higher rates if one takes into account a longer period, but probably as a result of the fiscal stimulus induced by a structural budget deficit which regularly exceeded the average of other euro area countries. But the German exception lies in having permanently transformed its economic model in line with the global challenge, showing that the opening of national economic systems can be an opportunity for prosperity. The transformation occurred by introducing more market elements in the economy. This has allowed the achievement of the traditional shared goals of German society - starting with full employment - which have always characterized the *Sozialmarktwirtschaft*, the social market economy.

However this has been possible only at the cost of giving up the traditional goal of egalitarianism, both within the German society and in the economic relations with the European partners. Income divergence has increased. The labor market has become dual. Seven million workers, many of them foreigners or migrants, have become dependent on extremely low salaries. Balance of payments disequilibria, and their re-distributional effects within the euro area have been regarded as irrelevant.

In order to defend at least some parts of the social market model, German governments since the early 1990s have accompanied the economy's internationalization process initiated by companies and major financial institutions. The common political analysis behind this is that a population of 1.15 percent of the world, which currently produces more than 5 percent of global GDP[4], can maintain its standard of living only by tying its growth to that of countries bringing 6 billion people out of relative poverty.

For this reason, the entire German production system had to and was able to strengthen its export orientation, while facing the major geopolitical changes that have directly involved the country: the German reunification, the European monetary unification, Eastern Europe opening to international trade and, finally, the entrance into the markets of large areas of the world up to the full development phase of globalization.

The German experience has been proposed by Chancellor Angela Merkel as a reference model for the entire euro area: "To be competitive in the world is not a requirement for Germany, but for the entire euro area, a group of countries which accounts for 7 percent of the world population but produces more than 20 percent of global GDP"[5]. Inevitably, it becomes important to understand whether the features of the German economic miracle are identifiable and replicable as a historical process of reform. The indications of this analysis are that the process of transformation of the German economy was born long before becoming a political project, under the impulse of a group of industrial and financial actors subject to the pressure of global competition. Only later, an intensive set of government-led economic reform programs accompanied the transformation of production, allowing the entire economy to benefit from their acquired competitive success. Therefore, the possibility of replicating the German success must lie not only in the process of political reform, but in a double and parallel evolution of the production structure and regulatory framework consistent with a long-term project. More importantly, Germany has deliberately forged its fiscal and labor policies as to ensure a very high net savings surplus. This strategy has drained resources from the rest of the euro area in two ways: The first via lower imports and the second through a huge amount of capital incomes flowing back from the countries of the euro area that had received huge German financial investments. I estimate this effect at a yearly 0.75 percent of German GDP and at an equivalent yearly amount subtracted from the euro area periphery for ten years. Given the incapability of the countries receiving the flows of capitals to put them to good use, the German strategy has aggravated the imbalances within Europe and — among other causes — seems to have contributed dramatically to the origins of the euro crisis.

1. A LONG METAMORPHOSIS WITH CONSEQUENCES FOR THE EURO AREA

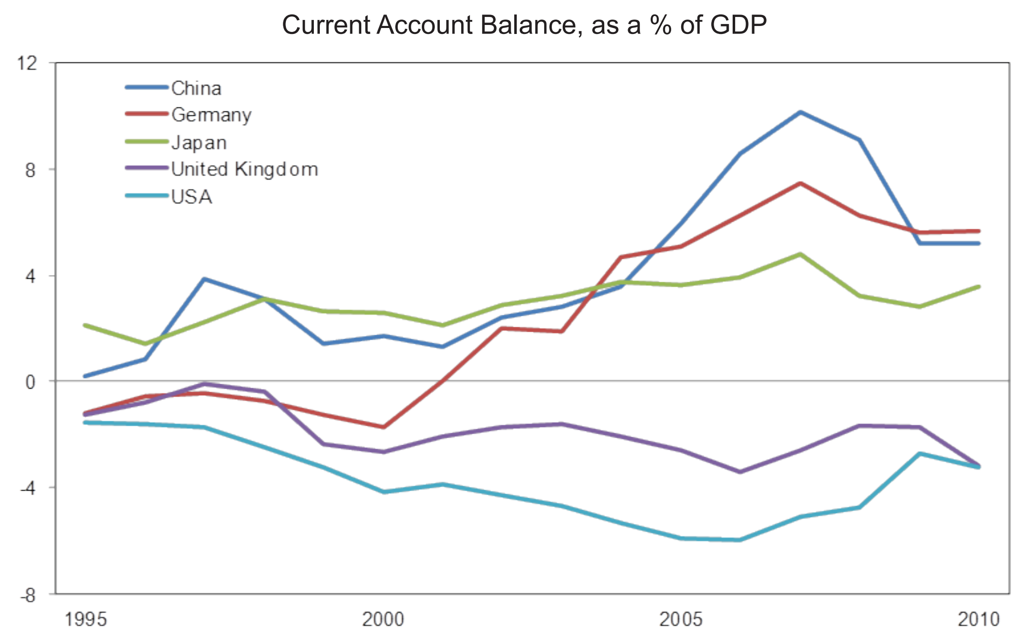
The macroeconomic data indicate that the breakthrough year was 2004. After a long period of stagnation, at the end of 2004 the German economy began to pick up again and in 2005-2008 growth nearly averaged 3 percent per year until the outbreak of the global financial crisis. Its openness to global trade (the weight of exports to GDP is close to 50 percent) accentuated the 2009 recession (-5.1 percent), but also allowed for a rapid recovery in the next two years: +3.6 percent in 2010 and +3.0 percent in 2011, except for the end of the year, when it indeed suffered from the consequences of the slowdown in global demand and the instability caused by the euro crisis. During 2012, growth prospects were revised down significantly as a consequence of the deterioration of the European economy; however Germany performed significantly better than all other larger countries in the euro area. This remarkable performance (with a 5.3 percent annualized rate of growth in the first quarter of 2011) fostered the belief that since 2004, Germany's potential growth rate has structurally increased from just over zero to three percentage points. The data on the level of the potential growth of the German economy, estimated by the International Monetary Fund (IMF) to be between 1.25 and 1.50 percent[6], do not indicate an acceleration of this type. In contrast, the assumptions on the workforce trend are affected by the sharp population decline and the level of investment in Germany remaining very low. From the pre-crisis level, one of the lowest in the euro area with respect to GDP, investment fell by 15 percent during 2009-2010, and seems unlikely to recover. This indicates that German firms do not believe that future domestic production is justified by expectations of above-average growth. Contrasting estimates come from the calculation of Germany's potential growth, which seems to fall significantly and remains well below the average for other euro area countries. If one limits one's analysis to the 2008 data in order to avoid distortions due to the global crisis, the OECD estimates that from 1992, the level of potential GDP increased at a rate of 2.3 percent in the euro area countries while it dropped to 1.4 percent[7] in Germany. It is therefore necessary to remain cautious when considering Germany's economic performance of the last six years, two of which were also marked by the global recession. However, there is no doubt that thanks to reforms introduced in its production system, the German economy, whose internal conditions were severely affected in the nineties, was able to hold up well.

The major parallel reforms of labor and capital markets in the period immediately prior to 2004 brought people to think that the political and economic reforms adopted in those months exercised a sort of cause and effect mechanism on the economic engine. This neoclassical interpretation of an automatic effect of a change in the incentive structure may, however, be misleading. Germany is a country that follows long processes, both because of the complex decision-making process, due to its federal structure, and the evident industrial predisposition of its economy, specialized in activities characterized by long production cycles undertaken by large economic groups, with necessarily complex evolutionary processes. The year 2004, in fact, represents the only year in which a long and complex process of disintegration and reconstruction of the German economy and society was completed. This process, which originated even before the German reunification, stimulated a series of responses from private and public German operators which should be evaluated for how they evolved, in order to understand their political impact, economic efficiency and social acceptability.

In summary, the change was catalyzed by the reaction of the country's major banks and companies to the loss of competitiveness caused by the wage and tax consequences of German reunification. The effects of the annexation of the *Neue Länder* depressed productivity in the German economy, which declined to reach a historic low in 1996. Around the mid-nineties, when the effect of the revaluation of the German mark vis-à-vis the other currencies in the European Monetary System - the Italian lira first of all – is added to this, companies and private banks accelerated the process of internal reform, allowing them to shift the focus of their activities abroad by the end of the nineties, in response to the rigidities of the domestic economy and expectations of falling domestic demand. Since the late 1990s, this process of economic "opening" also extends to the majority of medium-sized companies.

Thus, this process is added to other phenomena of great influence: both the structural and cyclical increases in world trade, the demand for investment and intermediate goods[8] in emerging economies, and the full exploitation of the favorable conditions provided by the European Monetary Union which, for the first time, eliminated the risk of exchange rate appreciation against the currencies of the European partners. Thanks to political will, the German model's reforms accelerated in the early 21st century and transferred the export benefits to the entire country through more profits and more jobs. Income growth was slow to come, but the increase in employment, stimulated by the commercial success of German products, was able to create a "new consensus" in public opinion, in favor of both the process of structural reform and a restrictive fiscal policy aimed at reducing internal

Figure 1: The Jump in the Foreign Account Surplus



Source: IMF.

costs. This is a new and unusual feature of the German public opinion, also resulting from increasing aversion to the solidarity taxes, which had become exorbitant after unification. The reduction of the budget deficit, combined with export success, produced an increasingly higher current account surplus in the country and, thus, an excess in savings (Figure 1). By definition, this is reflected in the export of capital, which is directed towards the highest-yielding foreign assets, with benefits for German savers (and a second-round effect that strengthened the foreign position's surplus) (Figure 2). This went on until the outbreak of the global crisis, at which time the increase in risk aversion produced the repatriation of capital.

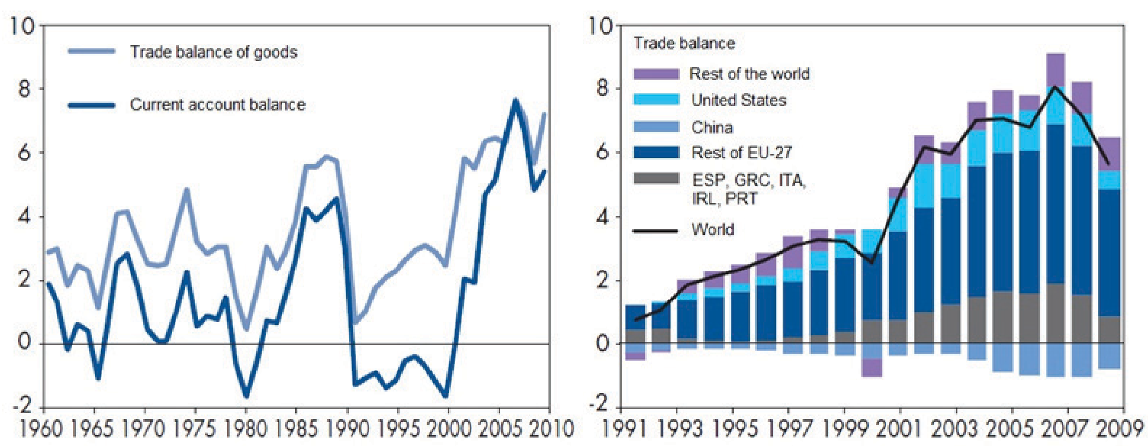
German competitiveness derives from the acquisition of comparative advantages in a rather large number of specialized categories of products. In capital goods, durable consumer goods and pharmaceutical products, German firms hold large shares of the world market.

Germany has thus increased exports to the rest of Europe, maintaining its traditional European subcontracting chains (supply chain), especially in non-euro Visegrad countries (Czech Republic, Hungary, Poland and Slovakia, the only euro area country). At the same time, German imports of consumer goods turned toward China's low-cost productions, pushing most of the rest of the euro area into a "competitive offside" position - that is, Germany put the rest of the euro area in direct competition with China - and, in fact, created the conditions for larger balance of payments imbalances within the euro area (Figure 3).

German exports were at the same time largely protected from competition with Asian products, of which they were complementary. Euro area products were

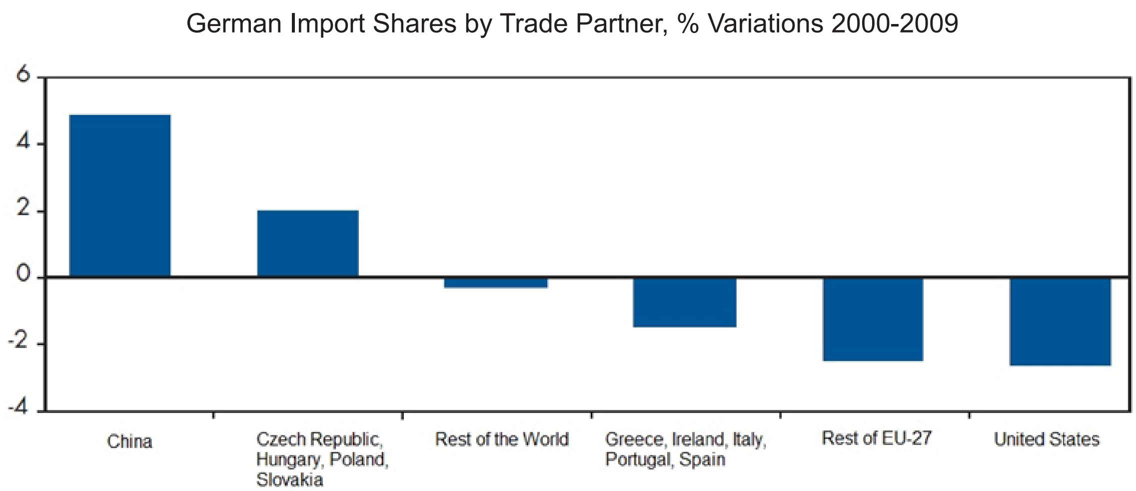
Figure 2: Current Account Dominated by the Trade Balance with Europe

Germany, Balance of Payments, as a % of GDP



Source: IMF.

Figure 3: The share of imports from China increases in the year 2000



Source: IMF.

instead directly exposed to competition from low-wage Asian countries. Hence large foreign balance deficits were created within the euro area which could no longer be financed after the increase in risk aversion determined by the global financial crisis of 2008.

Germany's structural reforms, which also started in the first half of the 1990s, initially helped sustain the recovery led, for the most part, by exports and investment, sometimes even at the expense of private consumption, hampered by wage moderation and budgetary constraints. Later, reforms would help to repatriate the benefits of the German financial and industrial transformation in the form of higher employment and more jobs with higher technological content and higher wages.

The completion of this process increased the consensus in public opinion in favor of "reforms" and "sacrifices" aimed at increasing productivity. This continues to facilitate the implementation of supply side reform policies and, symmetrically, makes it more difficult to convince the Germans to assist their fellow euro partner countries, seen as laggards in the process of reform and sacrifice[9], two words that have closer connotations to religion than to political culture.

Based on the policy agendas of government and opposition, the German reform process will proceed in three main directions: investment in education, investment in information and communication technology and the commitment to the reduction of the tax burden on households and businesses.

2. THE GERMAN REUNIFICATION AND THE END OF THE MODELL DEUTSCHLAND

The German reunification after the fall of the Berlin Wall on November 9, 1989, is one of those events profound enough to be considered a moment of transformation in the history of a country and a continent. In a sense, however, German reunification contributed to the transformation of the economy and politics of Germany by making latent problems worse and delaying reforms which were already underway. German unification was achieved in some ways by including the protection of the social and political status quo in Western Germany as one of its primary objectives. The result however was the opposite, forcing the *Modell Deutschland*[10] to change radically because of its un-sustainability.

The unification was, in fact, achieved by transferring the very institutional structures to the former German Democratic Republic which, in the late eighties, were already considered dysfunctional in West Germany. The possibility of taking advantage of the reconstruction of the eastern regions to transform Western institutions as well - the system of federalism with its highly unbalanced regional guarantees; consultation on economic policy through a neo-corporatist system of mediation between the interests of unions and employers' associations; a system of corporate governance strongly characterized by cross-shareholdings among the largest industrial and financial groups - was immediately and deliberately rejected by Chancellor Helmut Kohl. He feared that a revision of the Western model would alienate the support for the unification by both the citizens of the old *Länder* and the Parliament, which was blocked by the main opposition party, the Social Democratic Party, to which many Unions representatives belonged. Thus, the unification, which formally brought five new regions into an existing state (and did not consist of the confluence of two states into a new state), turned into a celebration of the *Modell Deutschland*. Ultimately, the unification caused the postponement of the necessary reforms of the old *Modell* and, although unwittingly, doomed it.

The post-war German political economy consisted of a unique configuration of institutional mechanisms to coordinate capital, labor and public authority. Some crucial elements evolved only after World War II. Federalism, an independent central bank, a strong constitutional court and an antitrust authority were all imported in Germany by the Western Allies after 1945. The aim was to bring stability to a country that had been highly unstable in the past and had caused enormous pain throughout Europe and the world. Stability, continuity and smooth incremental changes became institutional features of the German political economy. The economy had to be managed around modest cyclical swings. Full employment was the main goal and income distribution was to be compressed around high means[11]. Stable prices and economic conditions encouraged *long-termism* in business activities and this in turn made possible that corporate leaders were engineers or product experts who had risen through the ranks of the firm. Competition was rather subdued, whereby firms were competing on the product market while cooperating in the acquisition of inputs and in innovation or foreign trade, generally through local or sectoral business associations. In some sectors, competition was simply avoided, as in the health care, transports and shipping, insurance and agriculture sectors. As an issue of stability, the politically divided unions of the Weimar Republic were reorganized as industrial unions (*Einheitsgewerkschaften*). Coordinated wage bargaining and the long-term nature of labor contracts granted peace in industrial relations and anchored the moderate real wage increases to the level of productivity. After the war, the sectoral bargaining system became well established and a stable division of labor emerged between the bargaining autonomy (*Tarifautonomie*) of the social partners, unions and employers, on the one hand, and government social policy, on the other. The relevance of the unions was also acknowledged in their role in the administration of the social security system (*Selbstverwaltung*). Finally, co-determination (*Mitbestimmung*) at company level, one of the hallmarks of German capitalism, was the consequence of the British effort to politically neutralize the German coal and steel industry. This occurred after the American government vetoed its nationalization,[12] but rapidly established itself after two landmark pieces of legislation in 1972 and 1976. In 1976 the Federal Constitutional Court dismissed a suit against the Mitbestimmung Act, pointing out that managers have to protect interests that are not necessarily those represented by the owners of the firm. All those institutes put German unions at the center of political power in the framework of the "*Konzertierte Aktion*", or concerted action.

Signs of malfunction in the German social model were already evident in the 1980s, when conventional manufacturing, where Germany's institutions of corporate governance, long-term employment and co-operative industrial relations provided a comparative advantage, were no longer growing fast as opposed to high technology sectors and business and commercial services, where more fluid industrial relations are required. In only twenty years, unemployment increased from 0.7 million in 1980 to almost 4 million[13]. Half a million jobs were lost within a year in the manufacturing sector in 1992/1993 in the recession following the boom of the unification. Inevitably, the importance of intermediation of unions and employers' associations in regulating relations between capital and labor began to spontaneously decline in reaction to the excessive rigidity of bilateral agreements. In the metal-mechanical sector, the number of small and medium-sized enterprises belonging to employers' associations had already dropped in the early 1980s, as had the number of union members, which had peaked in the seventies. In the late eighties, the Kohl government introduced the first elements of flexibility in the economy, starting from the supply side, and planned to reduce the excessive tax burden on firms and households. Also in the late eighties, the social partners were called upon to renegotiate old-age pensions, the most important instruments in absorbing the unemployed as part of business restructuring. The process of tax and welfare system reform came to a stop at the moment of reunification.

From the point of view of the social model, the unification was, in fact, made by simply extending to East Germany the collective bargaining system, the intermediary organizations and the entire social security system existing in the West. For the representative organizations of the German social model - trade unions and business associations - this transposition represented a quantitative extension of their consensus base, which obviously strengthened their resistance to change.

The goal of protecting the interests of Western Germany was evident in all features of unification. The decision to maintain an unrealistic exchange rate was taken with the objective of avoiding a westward migration of the former German Democratic Republic population. The application of western labor contracts to the new regions is the consequence of an agreement between trade unions and employers to prevent the creation of a low-wage enclave in the East that could exert strong competitive pressure on Western businesses and jobs. The local currency appreciated overnight by 400 percent, rendering all East German business activity instantly uncompetitive. Productivity levels in the East were estimated at only about 30 percent of western levels, but Chancellor Kohl did not resist the temptation to promise wage equalization within five years, just before the federal election in December 1990. The two primary elements of cost competitiveness, the exchange rate and the wage level, produced an immediate decline in economic activity and exceptionally high unemployment rates in the new *Länder*.

The social institutions of West Germany included the use of social protection funds in order to reduce friction in the case of economic restructuring, thus effectively absorbing excess labor through the institution of early retirement. In order to secure western Germans' consent for reunification, Chancellor Kohl promised to repay the costs without raising taxes. This inevitably meant that the social costs of restructuring the new *Länder* were attributed to the social security funds. In an integrated welfare system, the burdens generated by the crisis in which the Eastern economy fell were immediately passed on to Western wage levels, making labor cost too expensive in the West as well and producing unemployment not only in the East but throughout Germany. Transfers and new debts amounted to 75-100 billion euro per year and the cumulative total net financial transfers from the west reached 700 billion euro between 1990 and 2000. Much of the transfers wound up in subsidizing unproductive sectors or an over-staffed public sector. The German public debt escalated from 41.5 percent of GDP in 1991 to 61.5 percent in 1997. The accumulation of all these expenses made German payroll taxes rise from 35 percent in 1990 to 42 percent in 2002[14]. Automatically, the more labor was taken out of the market, the higher the cost of labor became, forcing further cuts in employment.

The worsening conditions of production throughout the country had almost immediate consequences on the institutional framework of *Modell Deutschland* and on the consensus which it had enjoyed among the citizenship. Thus, from both sides, the companies' and the workers', the channels of collective representation dried up.

The most obvious example is provided by what happened in the metallurgical sector. In March 1991, again with the aim to avoid a breakdown in the Western contractual model, the *IG Metall* trade union and the *Gesamtmetall* sector's employers' federation agreed to increase Eastern salaries from 65 percent of Western salaries to 100 percent in just three years. The agreement was devastating for Eastern production and provoked protests from the *Gesamtmetall* industrial confederation's Eastern associates which, after *IG Metall's* refusal to renegotiate the 1991 agreement, imposed the unilateral termination of the agreement in the spring of 1993. The May 1993 strike called by *IG Metall* represented a stinging defeat for the entrepreneurs' association, which had seen an ever-increasing number of dropouts among its members. The phenomenon started in the East and took hold in the West as well.[15]

The importance of what had happened to *IG Metall* and *Gesamtmetall* was due to the fact that, in a negotiation system devoid of inter-sectoral contracts and, formally, based on regional negotiations, the metal-mechanical sector's union and employers were recognized as wage leaders. That is, they were contractors whose agreement would dictate the content of other negotiations between the two social sides, even at the small business level through factory councils (*Betriebsräte*).

A system by which a leading sector can determine the wage trend for the rest of the economy had meant that until the early nineties, while worldwide wage differentials between different work positions increased, they decreased in Germany. The abandonment of collective representation by firms in a very severe economic environment and firms' offers of work contracts to employees outside the centralized negotiation scheme inevitably caused an increase in the number of workers who did not join the union or created altogether new independent professional or quasi-employee work positions (*Scheinselbständig*).

Thus, paradoxically, Germany's historical road toward egalitarianism stopped right at the time when there was the strongest effort to make incomes uniform between two different countries that had united. A cultural transformation inverted the priority in the relationship between the two main criteria of the political language, social justice and freedom, and accompanied this economically-rooted phenomenon. Demographic surveys confirm, in fact, a shift in the preferences of Western citizens from the traditional priority of egalitarianism toward that of individual freedom. What triggered the change was the transformation of the concept of solidarity as a result of the reunification. If Max Weber had defined solidarity as a two-way process (solidarity is given on the expectation of it being reciprocated, and therefore in order to receive solidarity in the future), the German reunification, as seen from the West, is only unidirectional. From the assistance provided to the new *Länder* citizens, Western citizens did not expect to be repaid over a foreseeable period. The term solidarity, which was unwisely used to baptize an extremely burdensome additional income tax destined to finance the Eastern reconstruction (*Soli-zuschlag*), took on a completely different meaning than when it referred to the reduction of inequalities in a homogeneous and self-referential social environment, as it was understood in the old Federal Republic. In the eyes of the public, the refusal of solidarity extended from macro welfare policies to microeconomic interventions. From 1996 onward, in fact, two-thirds of the Germans opposed bailouts of distressed companies with public money. Public assistance was a taboo that had remained untouchable from the fifties to the eighties. Since the 1990s, instead, the percentage of the public opposed to bailouts grew suddenly and remained constantly high, independent of the subject to be saved, be it Mannesmann or Opel or, finally and significantly, Greece.

Thus, the major consequence of German reunification was, paradoxically, the disintegration of *Modell Deutschland*. According to data provided by *Betriebspanel*[16], the share of Western workers affected by collective sector agreements fell regularly since 1995, from 53 percent to 37 percent in 2006 (Streeck, 2009[17]). Between 1990 and 2000, the unions lost four million members, taking into account the new workers added by the unification. The abandonment of Union labor agreements was particularly numerous in the Eastern regions. According to *Gesamtmetall*, the business association, only one out of five workers in the metal-mechanical sector was unionized in 2005 in the East.

The large migrations of the nineties, with the arrival of young people with very low skills into the German labor market accompanied a lower degree of national wage agreements and automatically resulted in a growing inequality between average or medium-high and the lowest wages. Union membership among those under 25 percent dropped to about 10 percent of the total. Income diversity was evident because young workers were often non-unionized and recent immigrants, in a country whose degree of social mobility is among the lowest in the OECD. Unions were engaged in defending the rights of their members who were rarely employed in lower wage activities, in which little or nonunionized immigrants were instead employed. The result was an increase in inequality tolerated by the trade unions. According to some calculations, in some regions, particularly in the East, wage dispersion - historically low in Germany compared to the OECD average - is higher than the one registered in the United States.

As mentioned, firms in the nineties began to leave trade associations as well. Moreover, those who remained increasingly tended not to apply contractual sectoral labor agreements. Indeed, this process had started in 1984, well before reunification, in what was perhaps the greatest moment in union conflict in modern German history. A very dramatic series of union protests and general strikes, led by *IG Metall*, gradually led to a reduction in working time to 35 hours per week. During the negotiations, however, union leaders made concessions which, at the time, seemed acceptable, but were actually bound to make extensive changes in the German labor market. In particular, trade unions, interested in reducing working hours, lost control of the link between wage increases and productivity. And, most significantly, entrepreneurs were able to use very diversified and increasingly sophisticated working schemes that would allow them to recover the productivity margins even with a reduction in working schedules. Thus, a company-designed system of labor contracts was created, which found perhaps its fullest expression in the Volkswagen group - whose largest shareholder was in the *Land* of Lower Saxony (the governor of which was, in the nineties, the future Chancellor Gerhard Schröder). After reunification, it had already adopted about 170 different organizational models for work schedules. The personnel director of the Wolfsburg group was Peter Hartz, who would later be called upon by Chancellor Schröder to lead the commission in charge of reforming the labor market.

The union itself calculated that in 1998, one out of five firms, among those belonging to business associations, occasionally or systematically, did not apply each category's contractual labor agreements. About 80 percent of eastern enterprises ignored the wage settlements. The unions began to tolerate firm-specific wages and working time agreements and so-called "opening and hardship clauses" were introduced in collective agreements to improve factor flexibility. When, in 1999, the union recognized the un-sustainability of a too-rigid bargaining system and accepted the possibility of "derogation clauses", which delegated even fundamental contract components to company-level bargaining, the percentage of firms that made use of derogated clauses increased from 22 percent to 74 percent in just five years. A further factor contributing to the erosion of the traditional model of industrial relations was the conflict that emerged between larger firms and their smaller sized domestic suppliers. In order to cut costs, larger groups imposed price reductions to their supplier, piling pressure on them to change and restructure. Small and medium sized enterprises became allergic to the old-regime, which aimed mainly at preserving peace in the industrial relations of the larger firms. This was expressed in the neo-liberal rhetoric of the BDI, the employers association, and in the Liberal Party, traditionally opposed to high levels of taxation.

Evidently, the key mechanism of the German economic transformation was the tax and wage burden produced by the German reunification. The exit from the collective bargaining system of a growing number of companies - or at least their application of derogated agreements - represented the first step. The second step in the business response was the outright abandonment of the country. The two were obviously linked, not so much by a timeline sequence as by a causal linkage: contractual flexibility increased with the opportunity to relocate.

3. VERY STRONG INTERNATIONALIZATION

In the nineties, all the conditions described above increased the difficulty in developing manufacturing activities in Germany. At the same time, more opportunities arose, from both the supply and the demand side, to produce abroad. This shifted the center of firms' interests from the German economy - whose growth prospects were considered depressed for years to come - to the global market, where Germany had succeeded very convincingly with its nearby Eastern neighbors, once the economies of Eastern Europe had changed from command to market economies. A widespread interpretation is such that German firms went abroad in search of more convenient production conditions. Hans-Werner Sinn, the charismatic economist who heads Munich's Institute for Economic Information and Research IFO (*Institut für Wirtschaftsforschung*), has used Marx's "investment strike" image to describe employers' refusal to support wage and bureaucracy costs of the German productive system. However, the production shift from Germany to foreign markets has taken on an entirely uncommon dimension in the recent history of major developed economies.

In 1995 the degree of openness of the German economy – i.e. the sum of import and export values of goods and services relative to GDP - was lower than France's, and also, albeit slightly, than Italy's. Including intra-European trade, between 1991 and 2008, it increased from 52 percent to over 90 percent and became by far the highest of all the G7 countries, surpassing France and Italy by well over 50 percent and was nearly three times higher than America and Japan.

Again, it is necessary to take a step back in historical reconstruction in order to understand the German industrial transformation. What mostly contributed to significantly increase the competitive pressure on German firms was European legislation in the realization of the EU Single Market. For Germany, this meant the end of a network of strict rules that had had the scope of protecting domestic producers by setting standards for goods and services traded in the German market. The harmonization with the European standards of the rules that had raised non-tariff barriers against the entry of European producers in the German market, quickly changed the competitive environment in what was the largest European market. Inevitably, German companies stopped modeling their production mainly - though not exclusively - on the home market and began to produce standard goods and services that were indifferently targeted for marketing in Germany, as well as throughout Europe and worldwide. Even before then, Germany was the world's leading exporter of manufactured goods and this strategic shift increased its competitiveness and helped it to maintain its leadership until 2009, when, thanks to the recession, it was overtaken by China. The increased weight of foreign trade on German GDP coincided with the new wave of globalization and this reduced the German share of trade with its euro area partners. Between 1991 and 2006, the share on the total of German exports towards the euro area was down significantly from 52 percent to 42 percent, despite the completion of the single market and the disappearance of the exchange rate risk within the monetary union, and favored greater integration and higher intra-area trading. The share of imports from the rest of the eurozone went down to a similar extent, from 48 percent to 38 percent of the total. However, although the relative weight of the euro area had shrunk, trade volumes doubled since the early 1990s. This meant that the change in shares came from a greater increase in trade with other regions of the world. And, in fact, it was the increase in trade with the new world economic areas that was, in particular, higher than that with the other euro area countries. In a first phase, from 1991 to 2003, the countries of Eastern Europe were those to record a very significant increase in the interchange, which rose from 3-4 percent to 10-12 percent of the total. Since 2003, however, the effect of China and the emerging countries began to be felt: the latter were taking over as the driving force of trade passing from 20 percent of the total in 2000 to 26-27 percent in 2008 (IMF, 2011c[18]).

All this gives the idea of the impressive effort made by German firms to move into international markets. The importance of the international activity - exports rose from 21 percent of GDP in 1970 to 47 percent in 2008 - brought about a change in economic culture that affected both firm management and the attention to global economic developments.

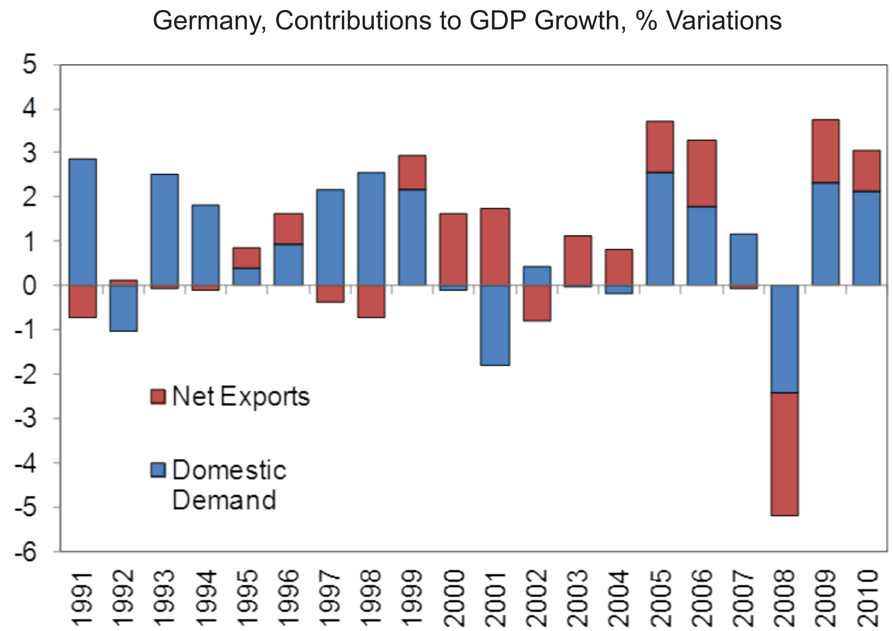
The change also affected policy choices regarding Germany's international role. In 1999 the European single currency was founded and, in the same year, the German army participated for the first time in an international military mission. In the following year, the citizenship law was enacted and abandoned the blood right criterion, (*jus sanguinis*) as the distinction for being German, and territory right (*jus soli*) was adopted. Moreover, new immigration policies brought about the arrival within the German borders of millions of people seeking asylum, including 500 thousand refugees from ex-Yugoslavia.

The growing importance of Germany's international activity was directly reflected in its GDP performance. While in the 1990s, foreign trade contribution to German economic growth was close to zero, starting in 1999, about 80 percent of it came from net exports (Figures 4 and 5). Since 2000, exports have grown by 7 percent in real terms per year. From that same year, Germany began to regain shares of world trade and this demonstrates that the recovery of competitiveness had begun in the second half of the 1990s.

It is, however, necessary to consider a further structural feature of the German economy in order to understand the degree of transformation linked to its export orientation: that is, the presence of a significant number of large industrial groups. During the 1990s, groups such as Daimler, Siemens, Hoechst, BASF, BMW, Volkswagen and others became, in all respects, global groups. As early as the 1980s, large companies started to develop into "machines for high productivity growth"[19] through the insertion of capital-intensive, labor-saving technology and subcontracting with components manufacturers situated in low-wage countries. The new geopolitical landscape after 1989 offered a great opportunity primarily, through the opening or the acquisition of production plants in the neighboring countries of Eastern Europe. In some cases, the new plants— for example, those in Poland or the Czech Republic— were geographically closer to the parent company than other plants in Germany. Although part of the investments in Eastern Europe was driven by market seeking considerations, the most critical part belonged to the kind of vertical investment aimed at the restructuring of the existing groups and driven by differences in factor prices. As proven by statistical correlations on employment, lower costs of Eastern European affiliates helped German firms to lower overall productions costs and to stay competitive.

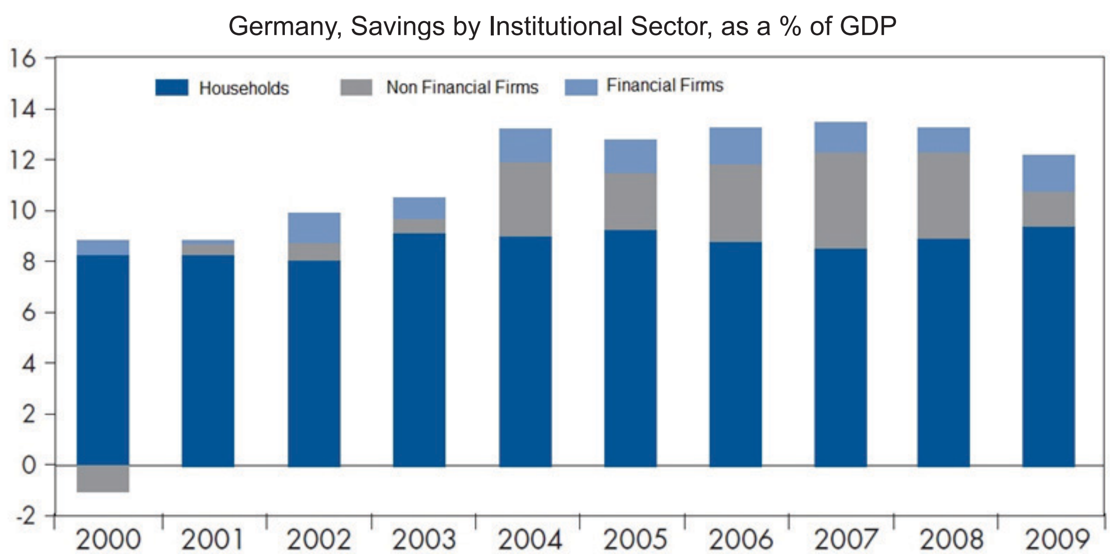
The availability of good infrastructures enabled the industrial groups to organize production not by commodity type or single products, but by stages of production of the same product. It was the beginning, on a continental scale, of the segmentation process of the value-added chain and the organization of the international division of labor which, on a global scale,

Figure 4: Net Export Leads Growth



Source: Eurostat.

Figure 5: Savings by Non-Financial Institutions Has Increased



Source: Carlo Bastasin (Brookings Institution) "Waltzing with the Elephant: The Painful but Inevitable Convergence of Germany and the Euro-Periphery" -http://www.brookings.edu/papers/2010/1220_german_economy_bastasin.aspx. Data from 2010 annual report (Herbstgutachten) of the Wise Men Commettee (Sachverstandigenrat).

characterized the first decade of the year 2000, resulting from improvements in communication technology as well. Due to their size and unique talent for rational organization, the great German industrial groups were able to place themselves in the center of production chains of intermediate goods, optimizing costs and production plants. In making this transformation, Germany gave further evidence of its ability to act as a single system. The transport and infrastructure network in fact expanded and adapted to the economy's interests. Its central geographical position in Europe was used extensively with the construction of new ports and airports. With respect to south of the Alps, even land routes had a much greater development. Finally, trade promotions were fully exploited; for example, 15 of the 20 largest world's trade or industrial sectors' fairs were held in Germany (Sinn, 2006[20]).

After leading-edge large enterprises, the association of firms integrated in vertical production chains also allow smaller-sized firms to benefit from international trade supported by both widespread public offices and the financial system (Barba Navaretti and others, 2010, Table 1). In this way, internationalization spread like an epidemic. In fact, according to a report produced by the *Institut der deutschen Wirtschaft* in Cologne in 2002, as early as 2000, almost 60 percent of firms considered medium-size in Germany, that is, with 1,000-5,000 employees, had established their plants outside the European Union[21]. In 2002, Germany was the largest direct investor in Eastern Europe for amounts that were not only greater than those of the United States, but also the sum of France and the United Kingdom together. The number of employees of German firms in Eastern Europe had already then reached the same number of those whom they were employing in the United States (*Deutsche Bundesbank*, 2004[22]).

Sinn notoriously compares the new German industrial model to a bazaar: from the mid-1990s to the middle of the first decade of 2000, the import content of intermediate products increased by 64 percent in real terms and this would explain nine-tenths of lower German manufacturing output. Only one tenth of this is related to the simple shift of production abroad (Sinn, 2006). Already at the beginning of the year 2000, the import content of German exports exceeded 50 percent. Sinn describes the German economy as a "siphon" for the flow of goods from Slovakia to America passing through the German sta-

Table 1: Smaller-Sized Firms Have Access to Foreign Markets
(% Shares of Exports to Total Sales)

Size Class	Austria	France	Germany	Hungary	Italy	Spain	United Kingdom
10-19	26,2	23,0	25.9	30.2	30.4	21.4	26.2
20-49	33,3	27,0	28,1	43,6	34,2	24,5	27,8
50-249	55,9	33,0	33,9	53,2	42,2	33,3	33,2
250 and more	64,7	41,2	37,8	66,6	52,6	40,6	34,2
Total Sample	40,4	28,5	30,0	44,8	34,6	25,9	29,1

Source: Efige.

tistical office. For every euro of export, 53 cents were paid for import. What is not considered in this kind of analysis, however, is that the import itself frequently came from the same German-owned companies (often belonging to production chains parallel to that of the acquiring firm). Thus, it would be too simplistic to describe Germany as a bazaar or siphon, that is, a mere place of mediation, through which goods transit and are produced elsewhere.

German exports were growing for two main reasons: the ability of firms to hook into the global demand, particularly in emerging countries, and the ability to exploit the regional division of labor in the production of goods. These two factors explained about 60 percent of the faster growth of German exports than that of other industrial countries since 2000 (Joutz and Danninger, 2007[23]).

For businesses, once borders opened, organizational parameters changed as well. Working on the system of internal prices, in fact, the major industrial groups were able to obtain arbitrations that impacted Germany at the level of the domestic workforce (and their wages). However, the degree of dependence on public authority changed as well because, again by operating on internal flows, firms were able to optimize the tax burden.

An example of the effects concerning labor remuneration within the country is demonstrated by the estimate of the domestic value creation per unit of exported goods, which was constantly declining during the middle decade between 1995 and 2006, dropping from 69.0 percent to 56.4 percent.[24] Nevertheless, the overall contribution of value creation through exports to total value creation rose sharply over the same period, thanks to the exceptional increase in trade volumes, which rose from 17.9 percent in 1995 to 27.8 percent in 2006. In addition, labor specialization on both ends of the supply chain created a demand for higher paid jobs in fields such as engineering, marketing and design. Due to this upgrading in the domestic labor, economic integration did not turn into mere factor price equalization and thus, the pure replacement of jobs with similar lower-paid jobs abroad was avoided.

This was a decisive result in order to reconcile the transfer of domestic activities abroad with the acceptance of such transfers by the workers and the public. The consensus of German citizens for industry restructuring had been sought by companies' top managers as well as politicians themselves through a large and persistent debate about the *Standort*, Germany as the place of production. The debate was primarily led by the government coalition parties—the Christian Democratic Union (CDU) and the Liberal Party (FDP)—with a strong drive by the latter, then considered the German party closest to a pro-market Anglo-Saxon culture. The media repeatedly took up and re-launched the theme of the debate and the public opinion, acknowledging the economic difficulties, shared the *Standort* issues - essentially a critique of the conditions in which German industry was operating with regard to the supply side.

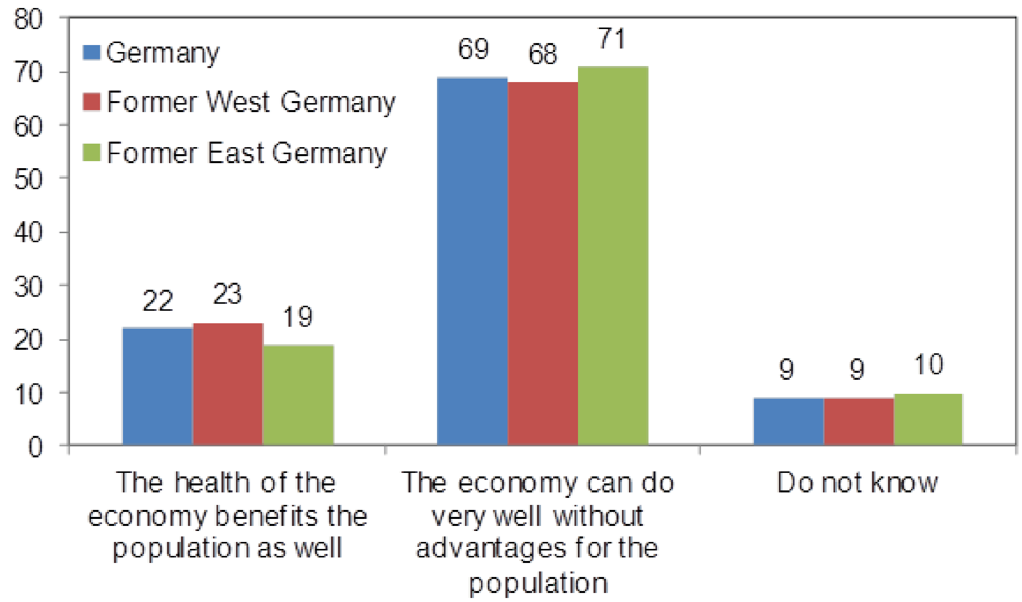
The *Standort* theme reemerged at the beginning of the year 2000, this time thanks to the Social Democratic government, in conjunction with globalization analysis. In this way the theme of the country's global competitiveness became part of citizenship's common language. The acknowledgement by citizens of the country's competitive lag was accelerated by the traumatic discovery that they themselves were part of the delay, since the level of education of Germans was surprisingly low compared to that of other countries with advanced economies. The 2000 PISA (*Program* *for International Students Assessment*, an initiative of the OECD) test results, published at the end of 2001, revealed, in fact, that, the performance of German schools was at the bottom of the ranking of the 32 countries surveyed. The debate within the country, which loves to define itself as the "country of thinkers and poets", was initially more angry and shocked than productive. German media talked extensively about the PISA-shock. In 2003, when the results of the next test came out, Germany was still only in 18th place among the surveyed countries. After heavy controversy (instrumentally, the bad outcomes were being blamed on the basis of wrong methodological procedures) the shock provoked by the successive test, in 2006, produced a political response. Both the Grand Coalition (2005-2009) and the subsequent center-right government launched programs to improve the educational system with the *Bildungsinitiative* (Education-Initiative) and allocated significant resources of the state budget for school and higher education, for example by opening universities' academic programs and management to competition and by identifying some elite colleges. Chancellor Merkel had made the "Education Initiative" the primary political issue before the outbreak of the European crisis at the 2008 Dresden Summit on Education. Even today, the objectives of investing 3 percent of the overall public budget (federal and state governments) in research and technological development and of allocating an additional 7 percent to the school and university system have been confirmed[25].

In the effort to build political consensus for reforms, the dialectical device used was that "there is no alternative". This had been the message of Chancellor Kohl on the occasion of the German reunification and had also been the key argument for his successor, Schröder. The completion of the message on the absence of alternatives finally arrived with the Grand Coalition that, by definition, admits no alternative. The communication mechanism is such as to occupy the political discussion with the country's interest as the central theme, rather than interests within the country. On closer inspection, this was a political development which was also dictated by the opening of the global economy.

However, the transformation of the German economy was not accompanied by true consensus of public opinion; at least until the employment statistics did not become positive again[26] . In the meantime, however, public opinion tended to move away from conventional political references, as we shall see below (Figure 6).

Figure 6: Economic Performance and Consequences for the Population.

What were the Germans thinking in 2008?
(% of answers to a survey published by *Institut für Demoskopie Allensbach*)



Source: Institut für Demoskopie Allensbach.

4. THE LARGE GROUPS AND THE TRANSFORMATION OF DEUTSCHLAND AG

Once the process of firms' transformation was identified as the engine of change in the German model, it was necessary to go into the mechanisms that set in motion this transformation.

Since the war, the German economic system has been characterized by a system of intertwined shareholding controls between industry and finance, which offered protection from foreign investors, from nationalization requests in period of crisis and, finally, from the pressure of minority shareholders. The task of financial assistance was typically performed by a *Hausbank*, a home bank, which, through its system of long-term and low-cost financing, enabled firms' management to repay their loans on the basis of a contained and constant stream of income. In the same way, corporate profits were expected to grow steadily in the long-term. In the business function, stability represented a necessary framework for productive investment with very long cycles, like those in chemicals, pharmaceuticals, or in aviation. It also represented, however, the suitable social framework to guarantee a constant distribution of produced income to the workforce which, in the aftermath of the war, in the absence of income guarantees, could still be attracted by the socialist alternative offered beyond the eastern borders by the German Democratic Republic. The social relations system inevitably incorporated strong elements of homogeneity, of which centralized wage negotiations were seen as an element of protection of individual firms from the risk of labor disputes.

The transformation of the system of cooperative capitalism began in the eighties with the strategic decision by Deutsche Bank, the largest German financial institution, to phase out its role as a "house bank", differentiating the financing criteria among the various companies belonging to the sphere of influence of the bank. The reorientation of the Deutsche Bank from commercial to investment bank began in the eighties under the leadership of the then Chairman of the Board Alfred Herrhausen[27], who was also regarded as a man able to influence Chancellor Kohl. In 1984 the bank moved the headquarters of its capital market operations from Frankfurt to London. In 1989, almost coinciding with the death of Herrhausen, it acquired the British brokerage house Morgan Grenfell. During the same year perhaps the most sensational case of conflict took place between the new role to which the bank aspired and its traditional role of "home bank". The contradiction, in fact, exploded when the Italian company Pirelli made a bid for the Continental Group. The acquisition failed because of a change in strategy by Deutsche Bank itself. After having supported the transaction, Deutsche Bank realized that the companies it assisted as a "house bank" denounced the institution's behavior as contrary to the protective spirit hitherto observed, and threatened to abandon it in favor of competing institutions. Deutsche Bank precipitously reversed its position which seemed to freeze the institution's ambition to compete with the big Anglo-Saxon investment banks.

However, the profitability benchmark of American financial institutions operating in investment banking was an obvious incentive for Deutsche Bank to abandon its traditional semi-public role. The change took shape mainly in the second half of the nineties. In 1996, 29 out of 100 presidents of the supervisory boards of major German companies were Deutsche Bank's managers; in just two years the number dropped to 17. In the previous years the institute had adopted international accounting systems, at that time different than those applied in Germany. Concepts common to the German banking system, such as 'hidden reserves' or long-term profitability could no longer find their place. Inevitably, businesses served by Deutsche Bank were affected by the new accounting method for financial reporting. Some of them had to adopt the same accounting systems at the same time as the conventional ones, from which different and more stringent profitability criteria emerged. However, the shift of Deutsche Bank's business activity from traditional credit to investment forced a much deeper change: as the Continental case had proved, the role of investment bankers could not be reconciled with the direct control of large shareholdings in companies. Deutsche Bank should have abandoned it, thus renouncing its central role in the system of German financial and industrial power. Equity holdings sales were, however, hampered by a heavily penalizing tax legislation regarding capital gains arising from the sale of business equity. Since the first half of the nineties, Deutsche Bank had repeatedly reminded the German governments of the need to reform the tax system. In the absence of feedback, in the second half of the nineties, Deutsche Bank publicly discussed the possibility of moving its headquarters from Frankfurt to London.

As Deutsche, other commercial banks wanted to end the old regime of "long-term, subsidized loans" as they needed to increase their profitability in the wake of financial harmonization in Europe. The bursting of the tech bubble after the year 2000 exposed the fundamental weakness in the core lending business and moved banks to look for a different model. Although the share of loans within the total liabilities of the corporate sector stood at close to 40 percent from 2002 to 2004, compared with around 15 percent for the United States, new factors were leading the banks to get closer to the capital markets. Among them were technological change, the globalization of financial markets and the adoption of a common currency and common rules in the euro area.

The government's necessity to adapt the German financial market to the privatization program that had become necessary after reunification eventually converged with the objectives of Deutsche Bank. Since the early nineties the Kohl government proceeded towards a very gradual reform of the financial market with the objective of strengthening the rights of minority shareholders and the structure of the financial market itself. The goal was indeed to create a hybrid system which, absorbing some Anglo-Saxon features, would not weaken too much the control of the firms by the insiders, namely the German shareholders.

The reform of the financial market came about in several different stages, the first of which was in 1994 with the prohibition of insider trading, that is, the use of privileged information. Then in 1995, there was the creation of the federal securities surveillance office[28] and the approval of the Securities Trading Act which established the compulsory disclosure of equity interests by those shareholders who had significant voting rights. In 1998 the law safeguarding competition was strengthened and the use of *International Accounting Standards* (IAS) or the *American Generally Accepted Accounting Principles* (GAAP) was sanctioned. The law to reinforce control and transparency (Kon-TraG) is considered a milestone in the reform of corporate governance since it improved the control functions of the supervisory board on management. But perhaps the most important element was the cancellation of two typical instruments of German capitalism: the limitation on voting rights and the issuance of shares with multiple voting rights. Both tools allowed insider managers to strengthen their control over the company's property. In addition, shareholders' rights were no longer dependent on the stability of property control, but became - together with the dividends - the central feature of enterprise. Emblematic of the attitude change was the public debate held in the country on the transition from the creation of stakeholder value to that of shareholder value.

Even before accepting the codification of a new cultural orientation for business activities, German entrepreneurs and managers began to worry about low capitalization of firms. Because of this, companies could easily become the target of hostile takeovers once that the safety net of the 'home bank' was missing. The volume of foreign direct investment in Germany, in fact, quintupled in just four years between 1996 and 2000, when it reached €500 billion.[29]

After the aborted takeover of Continental by Pirelli, in the wake of Deutsche Bank's turncoat, the most significant cases of German companies raising the interest of foreign investors were those of Thyssen-Krupp and Mannesmann, which had to defend themselves against hostile takeovers without the support of German banks. The decisive event was the hostile takeover by the British mobile phone group, Vodafone, of one of the major German industrial group, Mannesmann, which had itself entered the telephone services production. Deutsche Bank in that case actually supported the takeover, even though it had a representative on the supervisory board of the target company. The takeover took place, although with many difficulties, but at least it did not fail as had happened, instead, with the oldest German construction group Philip Holzmann, protected by the Government from a hostile bid by an Asian investor. However, controversies regarding the closed nature of the German capitalist system meant that the boom in foreign direct investments wore off instantly. The balance of foreign direct investments (FDI) actually turned negative with the greater participation of German investors abroad. The volume of German direct investment abroad in fact exploded from 100 billion in 1991 and two hundred billion in 1996 to about 900 billion in 2010.[30]

As Juergen Beyer and Martin Hoepner described[31], the takeover battle between Thyssen and Krupp rose to historical relevance because it became the stage of a spectacular struggle inside the management board of Deutsche Bank in which investment bankers finally prevailed over the traditionalist bankers. That battle transformed the strategy of the larger German banks, made them dismantle ties with industrial companies to avoi conflict of interest, and eventually changed face to the whole European capitalism. A new breed of managers inspired by financial experiences took over on the old shool of engineers and technicians at the top layers of German corporations. Rolf Breuer at Deutsche Bank, Paul Achleitner at Allianz, Gerhard Cromme at Thyssen-Krupp, Heinrich von Pierer at Siemens, Juergen Schrempp at Daimler Benz and other top managers at VEBA (now e.on) and Hoechst (now Aventis) transformed the role of entrepreneurs and revolutionized the character of German organized and corporatist capitalism. Finally a number of spectacular scandals or corporate crises, among them Metallgesellschaft, Schneider, Bremer-Vulkan or Kloeckner, convinced the government that German corporate governance had to change.

In 2000, the first government led by Chancellor Schröder passed what is considered the crucial reform of the German financial system: the abolition of the tax on capital gains arising from the repeal of interweaving in stock participation. The company "network" of cross shareholdings of major industrial companies, banks and insurers has been a major feature of the German economy for a very long time. The emergence of the network can be traced back to the period of industrialization around the second half of the 19th century. Ties between banks and their industrial clients became the core of the system. At that time the German government openly favored the organization of cartels. Even though the network was seen as a characteristic of Germany in the Third Reich, it was not really dismantled until after World War II. The government actually urged the banks to assist companies directly in their reconstruction and development, so banks functioned as financially stable and strong hands holding shares of their clients in their portfolios.

The effects on the reorganization of German capitalism and the dismantling of the cross-shareholding system were immediate. Already in the same year, Deutsche Bank, which until then was the pivot of the German capitalist system, even more than Allianz, Dresdner Bank and Muenchener Rueck, was no longer in a central position with respect to the system (Figure 7). The share of cross-shareholding in the capital of the first one hundred German companies declined from 16 percent to 9 percent between 1996 and 2002. Among the same hundred major companies the cases of capital intertwining, 143 in 1996, had fallen to 67 in 2002.

The shift to a less bank-based system had consequences on the whole economic system. Notoriously a larger role of capital markets in corporate government changes the structure of the incentives of most actors and increases their risk attitude. In fact, both banks and capital markets risk losing all their credit if the borrower defaults, but on the upside the situation is different: the payout of a bank is capped by the level of interest rate applied, while a shareholder has potentially unlimited profits after all outstanding interest rate payments have been made. Consequently banks tend to be more risk-averse, while capital investors need to look for higher dividends. Inevitably, firms that are financed by equity investors need to generate higher returns and to restructure and use their capital more efficiently.

Companies can achieve a higher return on capital through innovation or a more efficient use of capital, or cutting costs, increasing their productivity. German companies found the obvious strategy in allocating capital more efficiently while cutting costs. Investment at home was cut back significantly in order to improve the average profitability of the existing capital stock, and the average return on investment was increased by cutting back industrial projects with a lower rate of return. At the same time, productions were moved across the borders in search for lower cost of the productive factors, mainly lower salaries.

Although this process of delocalization should have encouraged increased investments in technological innovation at home, the statistics show that the productivity growth of German companies remained based mainly on improvements in existing technologies. The main factor seems to have been total factor productivity and the excellent capacities in organizing the new global supply chains around the traditional productions. A rebalancing process was then rekindled once in Germany the higher cost of capital, lower employment and lower remuneration conjured to make work more productive at home. But this long process needed further change in the structure of German capitalism.

It would be a mistake to conceive the change in corporate culture as only a shift to finance. It is a more elusive phenomenon that has to do with a ruthless drive for competitiveness. A test case is Volkswagen that was in dire condition in 1993 when Ferdinand Piech took over as chief executive. Production was inefficient and quality poor. In 2011 it became the world's largest car producer and posted profits for a record €18.9 billion. The changes in corporate governance were formally relevant, but did not change the VW unorthodoxy of being a family owned firm with a blocking stake of a Regional State and a powerful labor force. VW's oddity became clear in 2005 when Horst Neumann, became labor director. Neumann was a former official of IG Metall, the union whose membership amounts at 90 percent of the group's German workforce. The previous labor director, Peter Hartz, had resigned for a scandal alleged to involve prostitutes for unions' delegates.

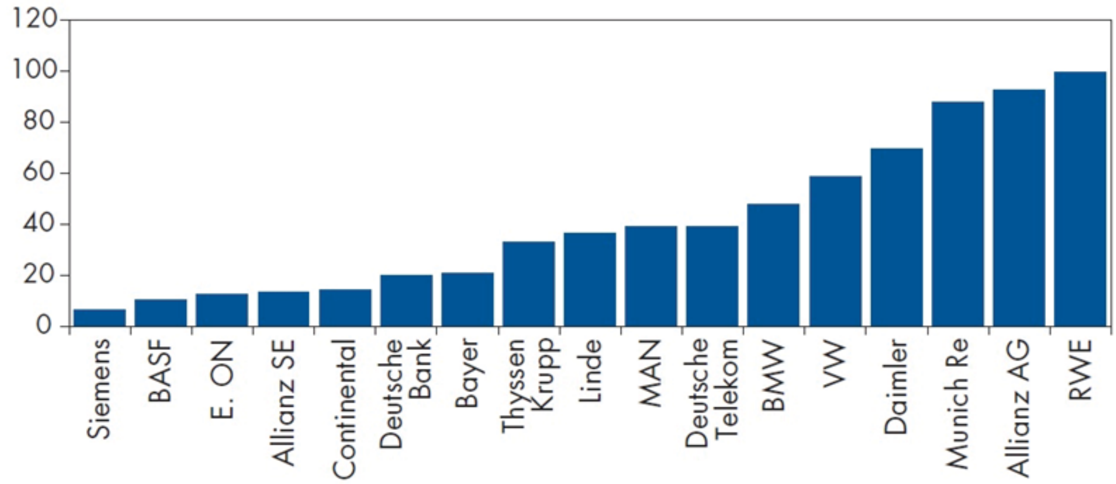
The state of corporate governance was actually so poor that in 2006 Gerhard Cromme, the father of the Germany's new corporate governance code, abandoned the VW supervisory board expressing criticism, On May 2005 an action against the Federal Republic of Germany was brought before the European Court of Justice against the derogations in the VW-Gesetz or company law. Under the VW Gesetz any shareholders cannot exercise more than 20 percent of the firm's voting rights, de facto making a takeover impossible. The explanation of this protection goes back to a 1959 contract (Staatsvertrag) under which the workers and the trade unions, in return for relinquishing their claim to a right of ownership over the company, secured the assurance of protection against any large shareholder which may gain control of the company. It was a faithful design of German corporatism. In 2007 the Court sanctioned Berlin for allowing forms of protection preventing other European investors to take stakes in the company. Porsche's family – Piech – reacted launching a Porsche takeover bid on VW to prevent that "VW is dismantled by hedge funds and sold in pieces on the stok market". The rhetoric of Germany opening to the "anglo-saxon" capitalism was evidently a stretch. Furthermore, as to finance, Piech, grandson of Ferdinand Porsche, was more of an engineering freak than a financial wizard. VW concentrated on saving costs through parts-sharing between models, reducing the number of platforms and introducing innovation. But cost cutting benefitted primarily from the opportunity of outsourcing productions in lower cost countries. Between 2002 and 2007 the share of gross value added by imports from countries with low labor costs quadrupled from 7 percent to 28 percent. As the top foreign investor in Eastern Europe, Volkswagen leveraged on its three subsidiaries – Skoda Auto of the Czech Republic, Audi Hungaria and Volkswagen Slovakia, that were able to share platforms and components with the German parent company.

A different criterium has driven the restructuring of Siemens. The engineering group had organized its activities in a global value chain with its R&D and engineering activity located in Europe and the U.S., procurement and logistics located in South East Asia, its assembly activity located in Eastern Europe, and its marketing activity organized on the local market or via the Internet.

In 2001, the German parliament introduced new legislation regarding takeovers, the WpÜG law which replaced the self-regulatory codes, with elements of laws common in other countries. As a result of the controversies raised by the not-so-exemplary defense of German groups from foreign takeovers, in 2002 the German code on corporate governance was introduced, successively amended in 2008. The new regime has been under scrutiny many times by the European Commission as insufficiently fair towards foreign investors. The conservation of the dual structure of corporate control, with a governing and a supervisory board, had continued to make it more difficult for a foreign investor to take control of German firms. This was true even when cross-holdings no longer represented an insurmountable system of protection in which the management would not adopt

Figure 7: High Concentration of Own Capital, Especially in the Insurance Sector

(Germany, % of Stock Not Dispersed in the Market, 2006)



Source: World Bank, IMF and Hoppenstedt.

those defensive measures which were often criticized by European authorities. Finally, the requirement of a totalitarian public tender to control more than 30 percent of the stock made the acquisition of large groups particularly burdensome.

Since the end of 2004, a significant number of German companies have adopted the corporate form of the European Company (EC), which offers higher margins of flexibility in internal controls. In particular, it gives the possibility of having a single board, with fewer members and varying participation (but usually inferior) of workers' representatives, compared to the traditional supervisory board (Table 2).

The effects of the evolving role of businesses and the system of corporate governance on the mentality of German managers is impressively demonstrated by the decrease in the percentage of chief executive officers for the top 50 private German companies who came from the public sector. It was 33.3 percent in 1980, 25.0 percent in 1990, but had fallen to 9.3 percent in 2005. In essence, the German manager abandoned the role of "public officer" who guaranteed the firm's stability (Streeck 2006).

The industrial case that most significantly shows this change in mentality was probably that of Daimler-Benz (today Daimler), the country's most representative industrial group, with a role comparable to that of the Deutsche Bank to which it was linked by capital intertwining. Until 1995, the group was headed by Edzard Reuter, a member of the Social Democratic Party (son of a former SPD Berlin mayor), whose strategy was to build an integrated technology group which included other German electronic or mechanical companies (including AEG, which thus was saved from bankruptcy). Diversification was sec-

Table 2: Since 2004 Eight German Firms With More Than 2000 Employees Have Chosen the Social Form of the European Company			
SE	**Employment**	**Board Structure**	**Labor Participation in Supervisory Board**
Allianz	177.000	Two-tier	6 out of 12
Conrad Electronic	2.314	One-tier	Not applicable
Donata Holding	3.922	One-tier	Not applicable
Fresenius	100.000	Two-tier	6 out of 12
Man Diesel	6.625	Two-tier	5 out of 10
PCC	3.756	One-tier	Not applicable
Porsche Holding	11.500	Two-tier	6 out of 12
Surteco	2.109	Two-tier	3 out of 9

Source: ETUI-REHS.

ondary with respect to the idea of creating a national technology center. From 1996 the leadership of the Stuttgart group went instead to Jürgen Schrempp, whose strategy was completely different. Schrempp built an automotive group whose center of gravity was no longer German but global, through the acquisition of Chrysler and Mitsubishi, aiming at creating a "Welt AG", a World company. Under this strategy, Schrempp immediately sold the aviation and electronics business and quoted the group in the New York Stock Exchange, merging with Chrysler. A change in Daimler's corporate culture was probably inevitable. In 1994, Daimler-Benz had disgraced itself by publishing two completely different balance sheets, one saying that the company had earned 600 billion DM under German standard accounting methods (HGB), the other indicating a loss of nearly 2 billion DM under the U.S.-GAAP accounting method. Nevertheless the change was extreme. While Reuter had refused to use a particular stratagem for reducing taxes (the procedure was called "Schuett aus; hol zurueck") arguing that large groups of the size of Daimler-Benz had an obligation to social responsibility, Schrempp had no qualms in using all the strategies available for tax-avoidance. He actually announced that he would not pay "one more pfennig to German tax authorities" for the rest of the century. A more severe break from the traditional semi-public role of the large German groups cannot be found.

5. THE POLICY RESPONSE

The process of industrial transformation was only partially reflected in politics. Contrary to what has become common to sustain, the greatest contribution of politics to the reform of the German industrial landscape in the nineties was not a new vision of capital and labor relations but it came from the need to regain control of the public budget after the significant impact of reunification. The public debt to GDP ratio had already doubled during the 1974-1984 decade. The change in economic policy under the first Chancellor Kohl governments had stopped growing until 1990. In the following 15 years, however, the debt to GDP ratio exceeded the 60 percent threshold set by the accession criteria to the European single currency.

In practice, the biggest factor in changing the industrial landscape was the process of privatization of state-controlled companies, which began with the complex sale of former East Germany's *Kombinats* through the public company *Treuhandanstalt*. Through German unification, more than 8,000 nationalized firms with 4.1 million workers had to be converted into private firms in a market economy. Eventually, the privatization methods of the *Treuhandanstalt* produced gigantic losses, which increased the need to reduce state deficits and indirectly paved the way for privatization in the West.

The European Union played a key role, which required the harmonization of a large number of German administrative regulations - there was talk, then, of about 150,000 binding DIN[32] provisions - representing the same number of barriers to the free movement of goods and services. The revision of the DIN standards represented a threat to public companies' profitability in particular, and constituted a strong incentive for the transformation of public property into private property and public employment into private employment.[33] In the late 1980s the European Commission and the European Court of Justice enforced measures to enhance market integration and competition in several activities where the state was dominant. Among these were telecommunication, postal services, air and rail transport, and energy and water supply.

In the early nineties, both the federal and the regional governments started selling off a large number of public properties, which produced about €73 billion of revenue for the public budget between 1995 and 2005. According to the 2006 *Finanzbericht* annual report of the German Finance Ministry, without privatizations, the German public debt would have been 20 percent higher. In 2011, therefore, the German debt to GDP ratio would have likely exceeded 100 percent.

Beyond the financial effects, however, the privatization process extending to large-sized companies - such as railways, postal services and the telecommunications monopoly group - had other and perhaps more profound consequences. First, in order to sell public companies, it was necessary to update the German law regarding capital markets, making them more efficient and strengthening the rights of small shareholders. In the past, these had been sacrificed for the intertwined interests of major shareholders. As we have seen, to this purpose, the Kohl government made three successive reforms of the financial market (*Finanzmarktforderungsgesetz*). The large German financial and industrial groups embraced, rather than hindered, this process. They were indeed aware of the need to adopt a new culture based on the belief that the shareholder's values are directly in line with the goal of increasing the value of his or her assets and resisting the process of global mergers and acquisitions. The latter was making German companies the object of hostile interest from foreign investors.

The second change brought about by the privatization of state monopolies, primarily post offices, railways and telecommunications, was the transformation of hundreds of thousands of jobs for civil servants to normal employment contracts.[34] The privatization of these companies led to many job losses (although, according to some studies on the privatization of Deutsche Telekom, these reductions were more than offset by the creation of jobs from companies which entered the markets which were no longer monopolistic) and the creation of new jobs with much lower pay, greater commitment and less protection.

The privatization of public services also created a multitude of new businesses operating in outsourcing, forced to compete with each other and freed from preexisting category contracts. They extended the application of very flexible labor contracts which had been, until then, entirely unknown in German industrial relations. The traditional egalitarianism of the German labor market rapidly imploded into a two-tier system, in which the one with fewer guarantees has become totally decentralized, to the point that labor relations were conducted on an individual basis.

Another effect of the privatization process is related to the strong use of public communication to favor the quotation in the stock market of very large companies. The Deutsche Telekom operation was perhaps the one with the greatest impact among European privatizations. The extraordinary effort made in the Telekom public relations campaign had to do with the failure of the first German privatization program from 1959 to 1965, which had injected huge doses of skepticism among German savers about equity investments. After the Telekom campaign, the language of stock exchange investment had become familiar in Germany through what was called a "*Volksaktie*", the stock market equivalent of the Volkswagen Beetle. Millions of German citizens became acquainted with the stock market during an operation which, moreover, would leave them bitterly disappointed in its financial outcome. The change in the German people's mass behavior became evident through their massive participation in the high-tech boom, which was also destined to leave scars behind, both in terms of investors' loss of pride and their lightened portfolios. Despite the massive privatization program, at the beginning of the 21st century, Germany was still in a state of economic impoverishment. The level of private investment with respect to GDP was the lowest of the entire euro area. Unemployment remained high in a context, moreover, of low labor participation of the working-age population. The slow growth weighed heavily on the public budget which had to meet the Maastricht constraints. It is within this framework that a major policy shift took place, although less one-sided than how it was perceived abroad: a series of reforms in the welfare system and the labor market that modified the country's supply conditions.

The Bismarckian welfare system has the feature of being funded through social security contributions and of being oriented towards maintaining the status quo, rather than preventing poverty. Obviously, high contribution rates interact with unemployment and start a downward spiral. At the beginning of 2000, the Federal Labor Office's annual budget was €50 billion, almost double the cumulative budget of all German universities, from which, in theory, one should expect a decisive contribution to the formation of the German labor force (Streeck and Trampusch, 2005[35]).

In order to modify the German welfare system, it was necessary to address all four pillars on which it was based: the pension system, unemployment protection, health insurance and long-term care (*Pflegeversicherung*). The period of the greatest expansion of the welfare system was between 1970 and early 1980, when an integrated system between the welfare state, collective bargaining and the federal budget was established. But once again, reunification changed the accounting balances, expanding the benefits of the social security system to the East, in the absence of contribution funds, where citizens of the new *Länder* were rapidly excluded from the labor market (and therefore in need of unemployment benefits) or put into early retirement. Five years after reunification, the last Kohl government introduced the fourth element of the welfare system, the *Pflegeversicherung*, ensuring that assistance to the sick who were not self-sufficient would be able to almost entirely finance itself. It would not weigh upon social contributions except for 1 percent of the salary. However, a year later, in 1996, total social contributions exceeded, for the first time, the magic threshold of 40 percent of average gross wage, and in July of the same year the contribution for *Pflegeversicherung* increased by 1.7 percent. Thus, between 1990 and 1998, social security contributions rose from 35.5 percent to 42.1 percent of gross wages. Regarding this increase, only half could be directly attributable to the German reunification.[36]

Since the 1970s, German governments had used creative accounting to distribute new expenditures among the various budgets of the social security system. Thus, for example, pension contributions, which did not exist for the unemployed in East Germany were included in the budget of the unemployment fund rather than in the budget of the pension system (Streeck and Trampusch, 2005). The aim was indeed to maintain, until possible, social contributions from the pension insurance below 20 percent. But it did not go on for too long, since the threshold was breached in 1997, despite an ad hoc increase in the value-added tax from 15 percent to 16 percent. One of the consequences of the intertwining between the budgets of various funds in the social security system was that if one wanted to reform the system, it would have been necessary to intervene on all budgets. In 1997, toward the end of his fourth term as chancellor, Kohl, under pressure from the increasingly rapid growth of social contributions, decided to break with the traditional premise on which the pension system was based, namely the protection of the worker's income. With the goal of stabilizing social security contributions[37], he introduced a demographic factor that, in the government's proposal, would reduce the ratio between pension and salary from 70 percent in 1999 to 64 percent in 2030. Kohl pushed through the reform in a climate of strong conflict which seemed to affect the old Chancellor's capacity to carry out the other reforms which, since 1995, had become central in German debate. The September 1998 elections marked Kohl's defeat. The leadership of the country was taken over by a red-green coalition, social-democrats and environmentalists, led by Gerhard Schröder, Foreign Minister Joschka Fischer and, above all, finance minister, Oskar Lafontaine.

Schröder had presented himself as a man of change, who wanted Germany to start moving ahead again. But the German political system is no friend of rapid reform. In the first full year of government, i.e. in 1999, seven regional elections were held in addition to the vote for the European parliament. Since the first regional vote in Hesse, the new red-green coalition lost the Land leadership and the majority in the Bundesrat, the upper chamber where the *Länder's* representatives sit.

Above all, it took the new government six months to choose between the more radical line of Lafontaine, supported by a high proportion of the Social Democratic Party, and that of the "new center", preferred by Schröder and vaguely inspired by Tony Blair. Apparently the choice was obvious. Lafontaine was in fact promoting a redistribution of income to workers in a time when businesses were already in huge trouble. In fact, Lafontaine was opposed to a reduction in wages, knowing that, in a Bismarck system, it would have automatically resulted in a reduction of social benefits as well: lower wages mean lower social security contributions and therefore a cut in pensions and unemployment benefits, further worsening the condition of workers. It's no coincidence that the first provision taken by the Schröder-Lafontaine government was the abolition of the demographic factor mentioned above and cuts to disability pensions. The measure was called "law for social insurance correction and for the safety of workers' rights." The way to reduce social security contributions for pension costs was to reduce them by decree and to recover the resources needed to finance the pension system by taxing self-employed workers who were actually considered para-subordinate workers. Finally, in the spring of 1999, the obligation to pay pension contributions was introduced for low-income jobs (630 marks per month) as well, a measure which again increased labor market rigidities. In a context where the *IG Metall* Union was calling for the reduction of the retirement age to 60 years (*Rente mit 60*), the Schröder government studied ways of reducing social security contributions that actually moved the burden on the federal budget and eventually translated into an increase in taxation. In March 1999 the political contradictions within the new government were already evident. Lafontaine had to resign on March 11, 1999 and Schröder's victory inevitably led to the beginning of a process of structural reforms that went beyond the short-term objective of reducing the budget deficit.

The first test came with the proposal by Labor Minister Walter Riester in June 1999 - opposed by the party base and the unions - to set a ceiling on social security contributions (22 percent of gross salary) and establish a "third pillar" for the pension system, namely a system of private insurance (to which employees would contribute 1 percent of their salary), supported by tax deductions. Against expectations, the reform was implemented in 2001 and introduced both a private component and the goal of reducing the pension-to-wage ratio to 67 percent of net income by 2030. Despite the ineffectiveness of his actions in his first mandate, Chancellor Schröder was reelected in 2002 and had to immediately focus on the pension issue again with a rather confusing series of measures that forced him to increase the public budget. In May 2003, the federal subsidy for the pension system reached a full €54 billion.[38] It is in that year that both Germany and France were able to prevail on the European Commission, prompting it to revoke the prescribed excessive deficit procedure against them. As it's known, the consequences of that decision led to a systematic violation of the Stability Pact on the part of the eurozone countries.

If the legislation on the European single market had changed the international orientation of German manufacturing, what was actually decisive in the first decade after 2000 were the very same constraints on public finance - the Maastricht criteria - that Germany had wanted as a guarantee to join the single currency. The limitations on the deficit – which, as mentioned, had been already violated in 2003 - implied a constraint to the continuation of the status quo in public policy and thus a stimulus to reform the economy. In 2004, it became evident that the policies followed up to that time were not sustainable. They aimed at preserving the economic and social structure of the country while limiting growth capacity and maintaining a precarious budget balance. An assessment by the government itself estimated that, if policies were left unchanged, pensions would have required continuous transfers of funds from the federal budget and would absorb up to half of the budget in 2050. The pressure of welfare spending on the public budget was unsustainable. In 1989, the share of the federal budget absorbed by social spending was 17 percent, but it had already doubled in 2004. The use of public money with the aim of defusing social conflicts between capital and labor had crippled the federal government's spending ability. It had created acute distributional conflicts over available resources, even among social partners (in particular, small businesses complained of the privileges of big businesses in the use of old age pensions).

In 1995, Helmut Kohl tried to resolve these conflicts through the establishment of an Alliance for Labor, in which the government sat at the same table with businesses and unions, with the aim to reduce unemployment and prevent public finance balances from running out of control. The union protests were vehement, especially as the deadline for the 1998 federal elections was approaching. In fact, the Alliance failed. The new red-green government began by calling an Alliance for Labor in the form of a tripartite meeting. The shift in the balance among the social partners took place in mid-1999, when *IG Metall* found that, in its request for a further reduction in weekly working hours, it did not have the support from its members and replaced this goal (compatible, according to the union, with the objective of reducing unemployment) with that of reducing the retirement age from 65 to 60 years. The request was completely unacceptable for the government and the union and for the first time, it offered, in return for the request, the reduction of wages (Figure 8).

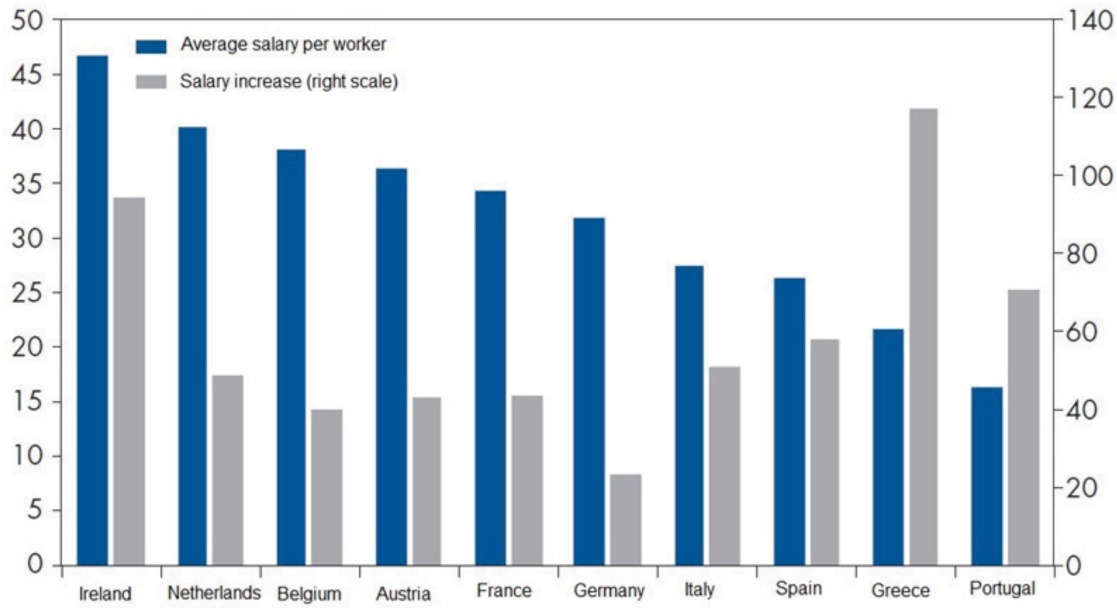
It is the failure of the two Alliances for Labor that brought about a fundamental change in the German government's philosophy of social policy. For both issues, pensions and the labor market, technical committees were, in fact, established, which eliminated the social partners' principle of self-government and transferred to the government the final decision on the basis of analytical considerations made by the committees (Streeck , 2009[39]).

A technical committee was appointed in 2003 with the task of submitting decisive proposals with regard to pensions. A new law on pension reform was thus approved in 2004 by reintroducing the Kohl government's demographic factor with a different name, however, to take into account the sustainability factor. Among the technical committee's proposals was the reduction of the gross wage-to-pension rate from 48 percent to 40 percent, a ceiling to the social security's rate of contribution which should not exceed 22 percent of gross salary and finally a gradual increase in the retirement age from 65 to 67 years by 2035.

In the spring of 2002, the government modified the Federal Labor Agency, the state-controlled agency that runs the government's labor policy programs, diluting the presence of the social partners. The same thing happened within a technical committee which was entrusted with the task of preparing the labor market reform in which (quite an unusual event indeed) there was the symbolic presence of unions and business associations. Finally, in 2003 and 2004 the Parliament approved the so-called "Hartz reforms", named after the former personnel director of the Volkswagen Group who had been appointed to lead the 15 member government committee called *Kommission für moderne Dienstleistungen am Arbeitsmarkt*.

Figure 8: Since 1995 the Average Salary has Increased Less Than in Competitors' Countries

Thousands of Euro at 2009 Prices and % Variations 2005-2009



Source: IMF and OECD.

The Hartz Committee was established on February 22, 2002 and produced thirteen intervention units that were divided into four successive reform programs (Hartz I-IV), which were finally included in Agenda 2010, the overall reform plan of the German economy that Chancellor Schröder requested. The first step - the Hartz I package – included the creation of personnel service agencies (PSA), the strengthening of the link between education and first employment and the institution of subsistence allowances paid by the Federal Labor Agency. The second package - Hartz II - formalized new forms of employment with low salaries, the *Minijob* and *Midijob*, with lower-than-normal tax and social security contributions. With it, the creation of small businesses was also facilitated by a public subsidy (Ich-AG). Finally, assistance centers for job seekers were increased. The third package - Hartz III – became operational in January 2004 and completely reorganized employment centers which took the name of *Agentur für Arbeit* (formerly *Arbeitsamt* or *Bundesanstalt für Arbeit*). Finally, the Hartz IV was approved by the *Bundestag* in December 2003 and by the *Bundesrat* on July 9, 2004 and became effective in January 2005. This fourth reform package was considered the most important because it changed the unemployment and social benefits system, reducing them significantly. In 2010, the *Regelsatz*, which is the social subsidy, was about €370 per month, to which "appropriate" costs for housing and health care were added.

Previously, the employment subsidy had a duration of 12-36 months, depending on the applicant's age and work history. This subsidy used to cover approximately 60-67 percent of net pay and was followed by a *Arbeitslosenhilfe*, an unemployment allowance amounting to 53-57 percent of net work salary. In some cases, through other forms of assistance, an unemployed person was even able to collect more income than when he was working and of course the incentive to re-enter the labor market was negative, with the consequence of creating a wide range of the long term unemployed. The Hartz IV package reduced the full unemployment benefit (*Arbeitlosengeld* I) to 12 months, allowing for an extension to 18 months only, for workers who were more than 55 years of age. The additional allowance (*Arbeitlosengeld* II) depended on family income, personal wealth and availability of a life insurance. The income threshold that allowed access to such subsidy was particularly restrictive and reduced the number of eligible earners, to whom social security contributions and health insurance were also paid.

In order to receive the benefits, the unemployed person had to sign a legal agreement whereby the person agreed to accept any kind of job the labor agency was able to offer, without violating the person's constitutional rights. If he or she refused, he or she lost his or her right to the subsidy. One of the elements which structurally changed the subsidies' administration was the fusion of the federal agency for assistance to the unemployed with the local authorities who dealt with social assistance. In this way, it was possible to closely follow the requests for assistance on a case by case basis. Each labor agent was able to follow no more than 75 people without jobs, if they were younger than 25 years, or 150 if older, instead of the previous 400.

Union protests intensified, but had no effect on the government's decisions. The Chancellor's loss of popularity, however, was significant, prompting him to call new elections one year in advance of the natural end of the legislature, which was in 2005. Despite the electoral defeat, Schröder's policy survived. In 2006, the Minister of Labour of the CDU-SPD (a large coalition that was formed after the election), the Social Democrat Franz Müntefering, passed a new pension reform that raised the retirement age from 65 to 67 years, permanently reducing the Unions' influence on the government's general policy and asserting the government's unilateralism in political decisions.

The change in mentality of politicians is one of the reforms' dynamic factors and is linked to the parallel loss of the unions' strength in representing citizens. While in previous decades, the two popular parties, which absorbed up to 90 percent of the electorate's votes in 1970-1980, were strongly influenced by 'social policymakers' (*Sozialpolitiker*), whose political lines, beyond the ideological differences, were actually mostly the same. Moreover, during the nineties, parties tended to break free from the interests of organized labor and capital. A relevant example is the composition of the *Ausschuss für Arbeit und Sozialordnung*, the *Bundestag's* permanent Committee for labor and social policies. Historically, the Committee was the body where policymakers, who had formerly belonged to unions or business associations, used to dictate social policies to the current labor minister based on their common interpretation of *Modell Deutschland*. In the nineties, instead, the parties were now represented in the committee by members who respond to the party's strategic interests, rather than organized social forces. Thus, on the one hand, the "common language" that had always brought close together Christian Democratic to Social Democratic policies was broken and, on the other hand, it encouraged competition among the social partners themselves, forcing them to look for new channels of political influence.

6. THE POLITICS OF SUPPLY-SIDE REFORMS

The vast consensus of the German population in the face of restrictive budgetary policies is not part of Germany's recent political history. Nor is it attributable to the German role in the eurozone's system of governance, in which the correct management of one's own public budget represents an insurance against the possibility of lax behavior by other countries and, ultimately, against the possibility of having to intervene to rescue those same countries.

The event that diverted collective preference in favor of strictly balanced budgets probably developed in the early eighties, when the policy of supporting the economy through the public deficit, implemented by Chancellor Helmut Schmidt, led to the fall of the government, with the exit from the coalition of the allied Liberal Party. It was the beginning of a four-time chancellorship of Helmut Kohl in coalition with the Liberals. The experience was traumatic, primarily for the Social Democratic Party, which until then had ideological ownership of the so-called Keynesian policies to support demand. The SPD had to wait 16 years to have a new opportunity to implement tax-and-spending policies by the finance minister, Oskar Lafontaine, but the experiment lasted only five months, from late September 1998 to March 1999, when Lafontaine resigned. His two successors, also Social Democrats, Hans Eichel, and Peer Steinbrück, adopted a line of fiscal rigor with the support of the party. Steinbrück's fiscal policy was calibrated to support the structural reforms of Agenda 2010. Thus, the only breach of the Maastricht criteria - which in fact had lasting consequences with the revision of the Stability and Growth Pact in 2005 and the weakening of the European Commission in its function as the European fiscal controller – coincided, in 2003, with the need to temporarily accommodate the Schröder government's structural reforms. Even in 2002-2005, however, the momentary loss of control over the budget balance contributed to a massive decline in popularity of the incumbent government. The result is that today, in the German parliament, only a small fringe, represented by the radical left, not surprisingly led by Oskar Lafontaine, is decidedly in favor of large public spending programs.

Even when conditions in the economic cycle clearly call for policies supporting demand, interventions through tax cuts are normally favored, rather than spending increases. In fact, there is a multi-party constituency favorable to lower taxes, which also tends to create competition among different political parties for the implementation of tax cuts. Because of its ideological imprint, the Liberal Party has traditionally been the most vocal about it. But recently it has been challenged, as the frontrunner of the tax cut, by the Bavarian Party (CSU). The latter reflects the opposition of its constituents to the continuous transfer of income to poorer regions through the *Finanzausgleich* system, which compensates for income differences between the states of the federal republic. As in the United States, German federal compensation movements between the different administrative areas remain unchanged, as some regions are in constant credit and other in perpetual debt.

A striking example of resistance to budget stimulus occurred in October-November 2008, whereby after the collapse of Lehman Brothers, Germany had been solicited by all advanced-economy countries to contribute to support global demand. Chancellor Merkel presented a first stimulus package of €50 billion at the end of November 2008, but had to back down under pressure from the Presidents of the *Länder* of her own party, who felt that their voters - 10 months from the federal vote - would react harshly. The package was rejected by the *Bundesrat* on November 5, 2008 and a later provision had to be re-proposed and scaled down to 16 billion. Just over a month following, however, a second, much more consistent package then had to be approved.

One of the main reasons for the loss of confidence by German citizens regarding the effectiveness of the fiscal stimulus is in large part due to the amount of time needed for its effects to be felt. The real economic situation as well as cumbersome decision-making (which may require both federal and local governments' approval), and finally, the planning and implementation processes delayed this collective awareness. Thus, the result is that, too often, stimuli tend to be pro-cyclic. This was the lesson learned between the 1970s and 1980s, but the same happened even after the German reunification.[40]

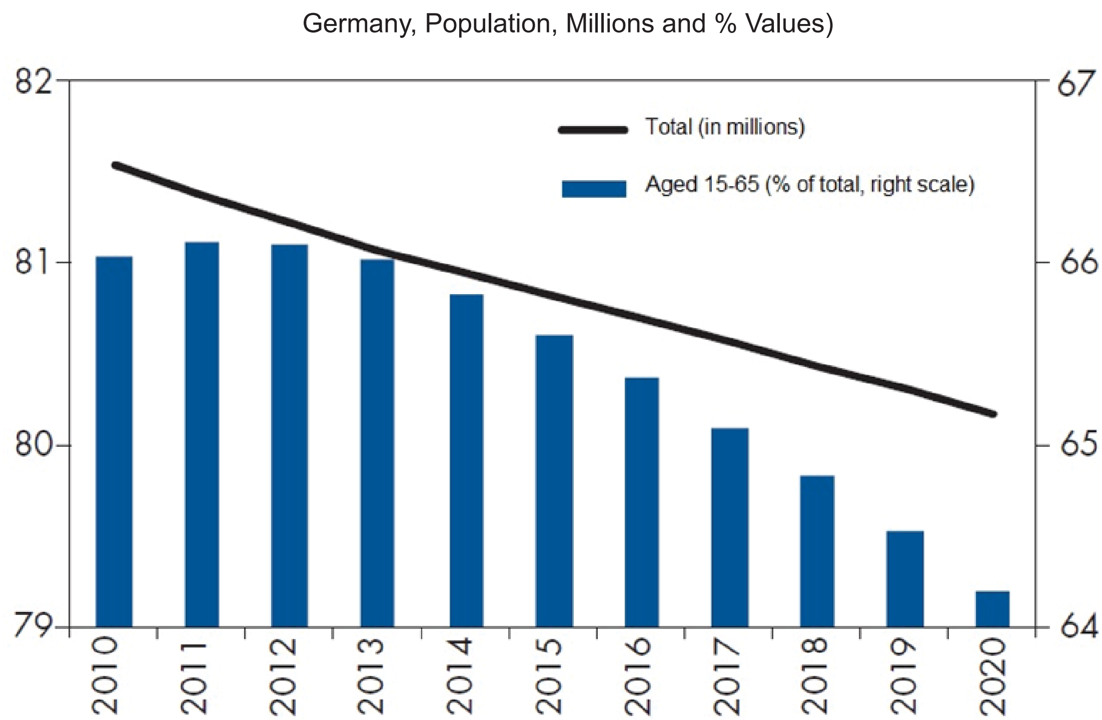
More reasons to distrust discretionary policies related to public spending increases arise from the strong effects of automatic stabilizers, which tend to offset about 50 percent of national income reductions with an increase in public support. In the recession that took place between 2001 and 2003, compared to an income loss of 2.5 percent, the automatic stabilizers determined an increase of 1.2 percent of GDP in the federal deficit, one third of which was entirely borne by the social security systems. Regardless of policy choices, the sentences of the German Constitutional Court constitute another factor in determining fiscal expenditures and in recent years have been more important, in quantitative terms, than the decisions by the government. They in fact have determined the level and nature of social spending as well as that of tax deductions, consistent with the constitutional rights of German citizens.

Furthermore, the degree of openness of the German economy and its relative size within the eurozone are bound to widely distribute the effects of a budget package abroad. With import and export shares that (taking into account the intra-European trade) almost reach the total value of GDP, a German stimulus is transmitted abroad for nearly half of it. An example was provided in 2009 by the car scrapping plan which benefited other European manufacturers of small cars, mainly French and Italian. Chancellor Merkel's commented that domestic production would have had more advantages if the government had financed Chinese consumers rather than German consumers.

The fact that the federal government budget is only 40 percent of the aggregate public sector budget - and even less in terms of public spending - means that the central government's actions to implement these programs depends to a very large extent on local authorities. However, especially after reunification, the country has become particularly heterogeneous and the Länder have very different economic - and therefore political – priorities, also due to the industrial specializations that characterize them.

A final, but powerful factor that acts in favor of discipline in the use of the public budgetand enhances the preference for structural reforms is demographics. The decline in the population, together with the increase in life expectancy (between 1980 and 2009 the increase was five years for males - to 78 - and four for females - to 82.5) makes the Germans one of the oldest populations in the world.[41] In 2030, the Federal Statistical Office expects that the share of the population over 65 will rise to 28 percent (compared to 20 percent in 2007, Figure 9). Deutsche Bank has developed a model of overlapping generations, according to which the working age population from 15-65 years will decrease from 66 percent to 59 percent of the total in 2030, resulting in a halving of the potential growth rate of the German economy.

Figure 9: The Population Will Diminish and Get Older



Source: IMF.

Obviously, one way to compensate for the decline of the labor factor in the production function is to increase capital intensity in service industries in particular. The supply-side reforms - which we normally refer to when we talk about structural reforms - are thus considered to be essential to maintaining the future income of the German population high. Of course, this strengthens the political consensus behind it.

The negative effect of tax subsidies allows counter-intuitive arguments to have a strong grip on the majority of the population, therefore greatly present in the public debate in Germany. Although in various forms, information and Parliamentary discussions always resort to rhetoric to emphasize the country's interest, often leaving little space to different opinions. The political arguments are therefore often technical and homogeneous. People know the details of the economy and budget problems. In large part this is due to a certain degree to ideological, and even more so, linguistic inhibition. German politics were, in fact, conditioned, for decades, by the tragic ideological mistakes of the thirties and forties and were reborn with the task of reconstructing the country - materially and morally at the same time.[42] Unfortunately, during the crisis in the euro area, the economic language has assumed the disturbing ideological character that was inhibited in the political discourse.

Finally, the ‘soft policy’ factors, including the intense talks between the head of government and the leading figures in business and finance, the respect for social partners’ participation in the decision-making process and a generalized favorable attitude towards social equality, are the usual constructive elements in German political development.

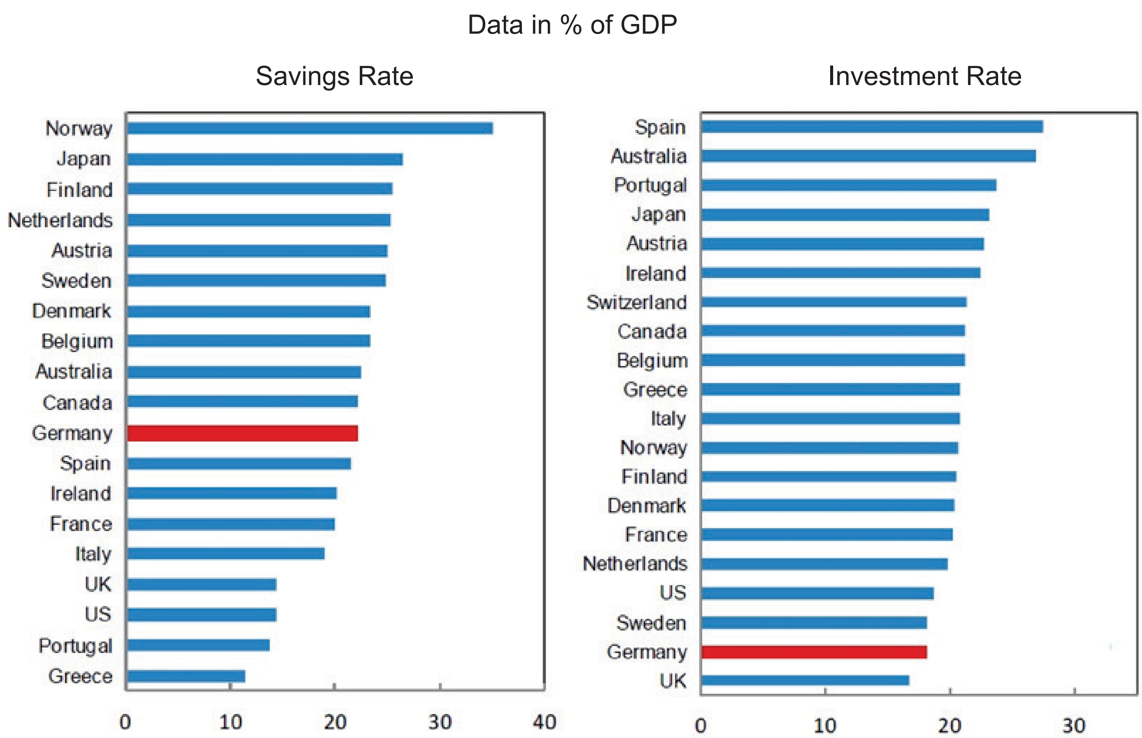
Which direction the German public discourse will take in the next years, after the consolidation of the “new economic miracle”, is still undetermined. It’s possible that the demographic decline in the German population will structurally change the process that started in the nineties regarding income redistribution from wages to profits. The generations that are close to retirement are, in fact, much more numerous than those who are entering working age. Over the next 20 years, the number of pensioners will increase by 50 percent, while new workers will fall by 20 percent. Having reached an unemployment rate of 5.5 percent in January 2012, the lowest since 1983 when it was calculated in West Germany alone, in fact, may change the relationship between demand and supply of labor and lead the major trade unions to demand annual pay increases of 6.5-7 percent. Probably, the level of unemployment reached is below the 'natural' rate and thus gives rise to wage increases above expected inflation.

In order for the distribution of income to once again be favorable to labor, necessary for maintaining German competitiveness, it is essential that the process of retraining the workforce through investment in education be successful. In the 2012 federal budget, for example, there was more than an 11 percent increase in education expenditures. This opens a potentially exciting new phase in economic policy in which the possibility for successful social policies depends on the “knowledge” content of work. That is, where the best quality of the individual citizen’s labor will truly result in an improvement in the entire society.

7. CONCLUSIONS

The German model of success is not exclusive. It was a response mechanism to the global context in which a high rate of net domestic savings – also achieved through sound budget policies and trade surpluses - was not invested in the country, but outside of it. All European countries with high growth - Norway, Finland, Holland, Sweden and Germany - are characterized by relatively high domestic savings, but by a low or, as in the case of Germany, very low level of capital accumulation at the local level (Figure 10). Excess savings was, in fact, reinvested abroad in search of yields that mature economies, with unfavorable demographics, cannot guarantee. Participation in the creation of global value, through trade and foreign investments, tends to strengthen the process with further accumulation of savings – trade balance surpluses - that is exported again, producing a new stream of capital income. This can create a spiral which can massively drain income from the neighboring countries with destabilizing effects that have previously appeared during the euro area crisis.

Figure 10: Savings in Line With the OECD but Level of Investments Low



Source: IMF.

However, what makes the German case exceptional is that this model has developed in a country with a strong industrial vocation. Among the countries that we mentioned, in fact, Germany is the only one in which the center of economic activity is not concentrated in services or commercial intermediation. Obviously, it's much more complex to internationalize industrial productions. It takes long-term programming and reliable infrastructure, two factors, however, that characterize German society. At the same time, in order to defend the competitiveness and the very existence of domestic production in the absence of capital investments, it is necessary to re-qualify domestic production in terms of quality, research and innovation.

The model corresponds to a clearly identified strategy, acknowledged at the political level and based on the primary data of the country's demographic development. A serious long-term socio-economic analysis thus provided the basis for its planning, followed by a long-term policy action which has not been substantially affected by changes in the ideological orientation of successive coalition governments since 1982.

Once the long term orientation was identified, the country was perceived as a "system" in which programming elements, prevailing in the fifties and sixties, were replaced by market factors: flexibility of production factors and incentives to increase productivity. Redistribution was ensured by the high level of social protection, which has been maintained and, obviously, by the rise in domestic savings enabled by increased business profitability. The elasticity of tax revenues to increased economic growth has proved, in fact, much higher than expected and has greatly facilitated containment of public deficits and the functioning of mechanisms for fiscal redistribution. This has helped to preserve the special nature of the German system as Sozialmarktwirtschaf and saving it from its expected extinction.

Finally, the sustainability of the strategy behind the "German miracle" has to be measured on the scale of its effects on the global economy and more specifically, on that of the European Monetary Union. One has to consider if the accumulation of domestic savings and the availability of an industrial firepower, which is unique on the European scale - ensuring export performances such as to grant a massive current account surplus - can be consistent with the global economic imbalances reflected in the balance of payments and in particular, with the integrity of the euro area. In fact, the emergence of huge imbalances in the current accounts of the different European countries has been a crucial feature of the crisis, once financial risk-aversion exploded in 2008 and made it impossible to finance the imbalances.

Starting in the mid-1990s, capital flows from the rest of the world entered the soon-to-be euro area through Germany and France and were increasingly funneled by financial intermediaries of those two countries to other countries of the euro area periphery (Greece, Ireland, Portugal, Spain and Italy), where financial assets generally granted higher yields. The rapid restructuring of German businesses and the restrictive fiscal policy have piled up larger net savings surpluses that also have been exported, often via London, to countries that were not always prepared to make good use of them. On the contrary, the massive capital inflows have created asset price bubbles in countries like Spain or Ireland, and excess demand in others. In a sort of financial version of Balassa-Samuelson, the whole price structure in the receiving countries has gone up, eroding competitiveness and creating larger current accounts imbalances, calling for more capital inflows in a negative feedback loop.

The reforms that had given a structural character to the German trade surplus have played an important role in this loop. However, it is hardly sensible to blame them for the disruptions in the euro area. In fact German capital exports were misused by the other countries. Moreover, the effect of the German industrial restructuring on the country's trade performance was enhanced by the coincidence with a few unprecedented changes in global trade; the opening of the Eastern European markets, the emergence of China as a fundamental economic actor, the appreciation of the euro due to the composition effect of the new currency in the portfolios of global investors, and finally, the increase of oil prices (+400 percent between 1999 and 2008). The new trade patterns created by those phenomena caused substantial asymmetries in the euro area.

Between 2000 and 2008, Germany's exports to Asia, Eastern Europe and the oil producing countries doubled to the equivalent of 10.6 percent of German GDP.[43] While Germany posted a positive trade balance with those countries, the rest of the euro area was in deficit, with Greece having a trade deficit of 6 percent of GDP with those countries alone. The overall increase of global trade in the last 15 years exalted the asymmetries in the euro area, given the different economic structure of the countries. While Greece was exporting 6.7 percent of its GDP in 2007-2008 and France 20 percent, Germany's exports amounted to 36.7 percent. Germany's industry found itself at the center of the new demand for machinery equipment coming from the new dynamic economies of the world. Those exports were often non price-sensitive so that Germany could easily absorb the revaluation of the euro, which instead pounded on the countries specialized in final goods and under the pressure of Chinese competition. The change in global trade patterns created asymmetric shocks and increased current account imbalances. No common policy response at the euro area level was available in the wake of those asymmetries. In fact, the responses were national and inconsistent with the yawning external imbalances.

Most of the peripheral countries did little to dampen the ebullient domestic demand and sat on their hands, watching their cost structure become less competitive, the more the euro appreciated, Germany did the opposite and the real effective rate appreciation of the euro was offset in Germany by the decline of its unit labor costs relative to its trading partners. This made it possible to bring the balance between German savings and investments from -1 percent in 1999 to +7.2 percent in 2008. As in the 1990s, when the DM appreciated, German weak domestic demand helped shift the economy towards the exporting sector. The current account surplus increased even more.

Integrated financial areas exacerbate those trends if capital flows are systematically accumulated in creditor countries and are not put at good use in the debtor countries. Theoretically, in the future, fiscal coordination may play a role in rebalancing current account disequilibria, for instance abating taxes in countries with higher trade surpluses. While economic governance coordination can impose structural reforms in the less competitive countries, this is the policy strategy adopted by the EU and by the euro countries.

The story of the German turnaround should suggest that the German way to thrive in a global economy cannot be easily replicated by other countries. First of all, the sequence of events in Germany in the Nineties reveals that it was not politics that determined the turnaround of banks and large groups into successful entities, but the other way around: after large German groups were able to surf on the mounting wave of global trade, politics ran behind them to change the framework of domestic political economy, making it possible to increase employment and bring back home the benefits of firms' globalization. Changing policies without leveraging on a dynamic industrial or financial sector, as it is the case in many euro area countries, would not do the trick to transform Greece or Spain into new industrial powerhouses. Second of all, there has not been a "German model" that could be replicated, since the major groups responsible for German global success have followed different strategies and have maintained substantial differences in their corporate governance. Finally, keeping pace with Germany would require the development of new productive capacities in other countries and their successful integration in global supply chains. Both goals could be interesting new fields for the reinvention of European industrial policy, common infrastructural programs and the completion of the Single Market.

Finally, one will have to accept that an economically integrated area, just like the European Union, cannot be uniform in all its regions. On the contrary, its strength depends on the comparative advantages born out of its specializations. In some regions, it will be possible to produce cars or software, while others may have comparative advantages in health systems, universities or agriculture, just like it happens in all federal countries: the U.S. is a major example. The opening of the service sectors throughout Europe – particularly in Germany – would be a prerequisite for a more equilibrated development of the European economy.

A reflection on the nature of the euro area economy as a whole is long overdue. Such a reflection calls first of all for a choice between identity and integration. It would be conceptually wrong and practically impossible to proceed along in the search of identity through a set of political reforms aimed at replicating the German success in all countries. Identity should be substituted by the concept of integration between different countries. As in all differentiated economic areas, marginal productivity will be different from region to region and, consistently, incomes will also be different. In such an environment, fiscal transfers are likely to be inevitable, just as they have been in the past decades. Accountability requires that fiscal transfers, the compatibility of social models, and the honest and fair regulation of the single market find a way to be democratically legitimized throughout the euro area. Differences, not uniformity, - integration, not identity - make a euro area political union inevitable.

ENDNOTES

1. This paper has been published in Italian in March 2012 for Confindustria "Come fare le riforme per crescere". Editore S.I.P.I. Roma
2. The choice is made by the Gesellschaft für deutsche Sprache in Wiesbaden.
3. See http://www.economist.com/node/209559; five years later the weekly English magazine used the same term for Italy.
4. See IMF (2011th). World Economic Outlook Database-September 2011, International Monetary Fund.
5. Angela Merkel, the introductory statement at the World Economic Forum in Davos, 26 January 2012.
6. See IMF (2011B). Germany's Impressive Recovery Presents Reform Opportunity - IMF Survey online - July 12, 2011 - http://www.imf.org/external/pubs/ft/survey/so/2011/CAR071211A.htm
7. See OECD (2008b). OECD Economic Surveys "Germany" Volume 2008/7 April 2008
8. Together, the two categories account for about three quarters of total German exports.
9. The cultural connotation is detectable in the response by Protestant Christian Democrat entrepreneurs, owners of small and medium-sized enterprises in the South of Germany, particularly hostile to sharing the single currency with Italy despite being the major beneficiaries of the absence of internal devaluation in the euro area.
10. The definition of "Modell Deutschland" has its origins in the social democratic electoral campaign of 1976. It was Chancellor Helmut Schmidt who believed that the definition would make visible to the world the country's technological success in a context of social attentiveness. The expression, however, was later extended to the concept of a negotiated and cooperative solution of problems relating to the restructuring of the economy within a neo-corporatist system of mediation between the interests of unions and business associations.
11. Herbert Kitschelt, Wolfgang Streeck: "Germany, beyond the stable state" Publisher Frank Cass,
12. Herbert Kitschelt, Wolfgang Streeck: "Germany, beyond the stable state" Publisher Frank Cass,
13. https://www.destatis.de/DE/ZahlenFakten/Indikatoren/Konjunkturindikatoren/Arbeitsmarkt/arb110.html
14. Statistisches Bundesamt "Statistisches Jahrbuch 1991-1997
15. Ten years later, IG Metall, convinced that it could replicate the 1993 victory, called a strike in the new Länder in order to make Eastern working hours equal to the West. The initiative failed because of the lack of support by Western factory representatives to their Eastern colleagues, concerned about a potential halt to production in a particularly critical situation, especially in the automobile industry. The failure was so clamorous that it opened internal conflicts in the union which lost representativeness and members.
16. Data refers to an annual panel of about sixteen thousand firms developed by the IAB, the research office of the Bundesagentur für Arbeit.
17. Wolfgang Streeck "Re-forming Capitalism" Oxford University Press 2009
18. 2011 International Monetary Fund July 2011 IMF Country Report No. 11/168. Germany: 2011 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Germany
19. Herbert Kitschelt, Wolfgang Streeck: "Germany, beyond the stable state" Publisher Frank Cass
20. Hans-Werner Sinn: "The pathological export boom and the bazaar effect, how to solve the German puzzle" - Cesifo Working Paper N. 178, Category 7: Trade Policy - April 2006.

21. Institut der deutschen Wirtschaft (2002), IW-Trends, Dokumentation 4.
22. Deutsche Bundesbank (2004), Kapitalverflechtung mit dem Ausland, Statistische Sonderveröffentlichung 10
23. IMF Working Paper European Department - "What Explains Germany's Rebounding Export Market Share?" Prepared by Stephan Danninger and Fred Joutz - February 2007
24. IMF Working Paper European Department - "What Explains Germany's Rebounding Export Market Share?" Prepared by Stephan Danninger and Fred Joutz - February 2007
25. Among other initiatives, the Merkel government launched the alliance for research "Industry-Science", a committee of experts composed of political, science and business representatives, with the aim of identifying both the purpose of research spending and the instruments to realize it.
26. As a "bridge" waiting for the benefits of foreign trade on employment to become concrete, the Social Democratic Party introduced legislation on the minimum wage which, however, took years to be partially applied.
27. Herrhausen was killed in a sophisticated attack for which no one was ever convicted. On his grave at the cemetery Waldfriedh of Bad Homburg, this epitaph is written: "We must say what we think, we must do what we say, we must also be what we do".
28. Integrated into the Bundesanstalt für Finanzdienstleistungsaufsicht in 2002.
29. http://www.bundesbank.de/Redaktion/DE/Downloads/Veroeffentlichungen/Monatsberichte/2006/2006_09_monatsbericht.pdf?__blob=publicationFile
30. http://www.bundesbank.de/Redaktion/DE/Downloads/Veroeffentlichungen/Monatsberichte/2011/2011_12_monatsbericht.pdf?__blob=publicationFile
31. Beyer, Hoepner: The Disintegration of Organised Capitalism: German Corporate Governance in the 1990s" in "Germany" part III ibidem
32. The DIN, the Deutsches Institut für Normung e.V., is a non-profit organization founded in Berlin in 1917. Since then it has offered to German stakeholders the platform for development standards for public and private economic activities. DIN defines itself as the recognized national institution – in agreement with the Federal Government of Germany - responsible for standards and represents German interests in European and international organizations: http://www.din.de.
33. Privatizations met strong resistance from the public and in Parliament forcing the German Government into difficult negotiations with European authorities, which in some cases led to significant delays. One of these, the postponement for some years of the abolition of state guarantees to Landesbank, has been a major factor behind the recent crisis in Europe. Regional public banks took advantage of this period of exemption to acquire, through leverage, about 300 billion in foreign securities, including the government bonds of countries in the euro periphery.
34. The *Beamten*, who had relatively strong rights, including the right not to be fired, as well as the certainty of a salary linked to the length of service.
35. Wolfgang Streeck e Christine Trampusch "Economic Reform and the Political Economy of the German Welfare State" - German Politics, Vol 4 N. 02 giugno 2005 pag 174-195
36. Wolfgang Streeck and Christine Trampusch "Economic Reform and the Political Economy of the German Welfare State" - German Politics, Vol 4 N. 02 giugno 2005 pag 174-195

37. The principle is called "einnahmeorientierte Ausgabenpolitik."

38. Wolfgang Streeck and Christine Trampusch "Economic Reform and the Political Economy of the German Welfare State" - German Politics, Vol 4 N. 02 giugno 2005 pag 174-195

39. Wolfgang Streeck "Re-forming Capitalism" Oxford University Press 2009

40. The fiscal stimulus in East German regions was done by supporting the construction sector and, despite a certain speed of its execution, required a 12-24 months of planning time and could not counter the first decline in demand due to the recession in the new Länders, the reasons for which we have explained above. The construction boom was followed by a slump that lasted for at least ten years and maintained average house prices stable, or even negative in real terms, until now (except in some specific markets).

41. Statistisches Bundesamt https://www.destatis.de/DE/ZahlenFakten/GesellschaftStaat/Bevoelkerung/Sterbefaelle/Tabellen/ModellrechnungLebenserwartung.html

42. Only recently, on the occasion of the European crisis, has a very controversial journalistic style spread throughout the country, which, in fact, distorted the reasons for the crisis.

43. As reported in "External Imbalances in the Euro Area", IMF Working paper by Ruo Chen, Gian-Maria Milesi-Ferretti and Thierry Tressel.

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