



## Varieties of capitalism in light of the euro crisis

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### ABSTRACT

This article examines the implications of the euro crisis for theories of political economy associated with 'varieties of capitalism', considering how those theories help explain the origins of the crisis and how developments during it mandate revisions in such theories. Efforts to understand the crisis have extended these theories in four directions. They have inspired an emerging literature on growth models that integrates the demand side of the economy into theories once oriented to its supply side. They have led to more intensive investigation of the political economies of East Central Europe and Southern Europe. The crisis has drawn attention to the international dimensions of varieties of capitalism and to problems of adjustment, injecting an element of dynamism into varieties of capitalism analyses and underlining that adjustment is a political as well as an economic problem.


**KEYWORDS** Adjustment; capitalism; crisis; euro; macroeconomic; varieties.

The euro crisis began, at least in symbolic terms, on November 5, 2009, when a new prime minister announced that the Greek budget deficit would be 12.7 per cent of gross domestic product (GDP), more than three times the amount projected for that year by the outgoing government. This sparked a crisis of confidence in sovereign debt and European banks that forced Greece, Ireland, Portugal, Spain and Cyprus into torturous negotiations with the European Union, its central bank and the IMF, followed by bail-out programs that imposed various combinations of fiscal austerity and structural reform on them. Seven years later, the effects of the crisis are still palpable. The Greek economy has lost a quarter of its value; levels of unemployment are close to 20 per cent in parts of southern Europe; and economic activity in the eurozone as a whole has only now regained its level before the global financial crisis of 2008–2009, exacerbating a crisis of legitimacy that now afflicts the European Union (EU) from many angles.

Feverish attempts to identify the causes of and potential solutions to the crisis have inspired multiple literatures, including analyses in comparative

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political economy associated with varieties of capitalism. The objective of this contribution is to explore the implications of the crisis for such analyses. I will ask: what have theories about varieties of capitalism contributed to our understanding of the crisis? How has the crisis advanced our understanding of varieties of capitalism? And what has it revealed about the limits of that understanding? In keeping with the themes of this collection, my goal is to explore the implications of the crisis for these theories rather than to analyze the crisis itself in depth.

I will argue that varieties of capitalism (VofC) approaches are revealing about both the roots of the crisis and the response to it. Efforts to understand the crisis have also extended VofC theories in four directions. They have inspired scholars to reevaluate the relationship between varieties of capitalism and regimes of macroeconomic policy, giving rise to an emerging literature on growth models that integrates the demand side of the economy into theories once oriented primarily to its supply side. Second, they have led to more intensive investigation of the political economies of East Central Europe and southern Europe, advancing, in particular, understandings of Mediterranean market economies (MMEs).<sup>1</sup> Third, the crisis has drawn attention to the international dimensions of varieties of capitalism. Fourth, it has highlighted the extent to which countries face problems of adjustment generated by shocks exogenous or endogenous to the domestic political economy, thereby injecting an element of dynamism into VofC analyses and underlining the extent to which adjustment must be seen as a political as well as an economic problem.

At the same time, the euro crisis has brought some issues to the fore with which the VofC literature has yet to come fully to grips. Prominent among these is the politics of reform. Southern European countries are being called upon to alter the institutional structure of their political economies and the regulatory regimes supporting them, but we know relatively little about how coalitions will form around such efforts and which will prevail. Moreover, although VofC analysts have a good deal to say about why economic performance might be poor in the Mediterranean market economies of southern Europe, we need to know more than existing theories specify about how different types of capitalist economies might promote the skill formation and levels of innovation needed to prosper in an era of knowledge-based growth.

A number of factors converged to produce the euro crisis. The spark setting it off was official revelation of the Greek fiscal position, itself the product of a patronage-based political system that reduced tax revenue and swelled public spending. But structural problems had been intensifying for some time in the form of a large expansion of debt, much of it in the private sector, especially in the context of asset booms in Spain and Ireland, and growing current account imbalances in the eurozone, to which the spreads on sovereign debt became increasingly sensitive (De Grauwe and Ji 2013; Iversen and Soskice 2013).

Shifts in financial practices also made that debt more susceptible to speculation (Gabor and Ban 2012). Partly for these reasons, some have observed that the euro crisis was simply a European version of the more general financial crisis of 2008, while others maintain that it was inevitable in a monetary union that was not an optimal currency area (*cf.* Copelovitch *et al.* 2016).

However, the theories of monetary economics most widely advanced to explain the euro crisis are incomplete. Financial turmoil in the wake of a credit boom certainly played a major role. But such a perspective cannot explain why these booms and the subsequent crisis of confidence in sovereign debt were more pronounced in some countries than others. The emphasis of optimal-currency-area (OCA) theory on the lack of labor mobility and central fiscal stabilizers in Europe also does not get us very far (Kenen 1969; Krugman 2013; McKinnon 1963). It helps explain why the crisis was so severe, but tells us little about its origins, since they do not seem to lie in the asymmetry of exogenous economic shocks anticipated by that theory (Boltho and Carlin 2012). Moreover, Europe's Economic and Monetary Union (EMU) was not the only monetary union that failed to live up to the criteria conventionally specified for an optimal currency area (Matthijs and Blyth 2015; Schelkle 2016).

In this context, theories oriented to varieties of capitalism help to fill some important gaps. They help to explain why trade imbalances built up to become signals for speculation against sovereign debt and why asset booms leading to credit crises were more likely in some parts of Europe than others. In short, a variety-of-capitalism perspective identifies structural weaknesses in monetary union that go well beyond the evident inadequacies of the institutions managing it.

## **Toward growth models**

In the course of developing this perspective on the euro crisis and preceding global financial crisis, scholars have extended VofC accounts in important ways. Some have developed deeper analyses of how wage-setting varies across the co-ordinated market economies of northern Europe and Mediterranean market economies of southern Europe (Hancké 2013a, 2013b; Johnston 2012, 2016; Johnston *et al.*, 2014), while others have delved more deeply into the relationship between the organization of production and macroeconomic policy regimes (Baccaro and Pontusson 2016; Hall 2012, 2014; Iversen *et al.* 2016; Iversen and Soskice 2012). Out of these analyses has emerged the important contention that countries with different varieties of capitalism tend to operate different growth models, understood as alternative approaches to securing economic growth, based on the ways in which the organization of the political economy encourages the production of certain

types of goods and limits or expands the number of instruments available for managing the economy.

The co-ordinated market economies (CMEs) of Northern Europe, including Austria, Belgium, Finland, Germany and the Netherlands, have generally relied on the expansion of exports in order to secure growth. In the first instance, that export-led growth model was made possible by the institutional infrastructure characteristic of CMEs, which supports high levels of co-ordination among producer groups, thereby facilitating co-ordinated wage bargaining, co-operation in vocational training schemes that confer high levels of skill and the incremental innovation favorable to medium- or high-technology production (Hall and Soskice 2001). Although the past three decades have seen a devolution of bargaining toward the firm level and flows of international capital have loosened relationships between firms and national banks, the institutions characteristic of these political economies remain well-suited for the promotion of high-value-added exports (Iversen *et al.* 2016; Iversen and Soskice 2012). In the German case, for instance, an effective system of skill formation and co-operative employer–employee relations, often underpinned by works councils, improves quality control and promotes incremental innovation. As a result, many of these countries have developed comparative advantages in medium- and high-technology products that have remained relatively impervious to competition from emerging economies such as China. Institutional capacities for the strategic co-ordination of wages are also important here because they give co-ordinated market economies an instrument for containing the labor costs linked to the competitiveness of exports (Hancké 2013a, 2013b; Höpner and Lutter 2014; Johnston *et al.* 2014).

However, the recent literature suggests that the successful operation of these export-led growth models also depends on a complementary set of macroeconomic policies (Carlin and Soskice 2008; Iversen 1999; Iversen *et al.* 2016; Iversen and Soskice 2012). Co-ordinated wage bargaining is facilitated by non-accommodating monetary policies oriented to a hard exchange rate which assures producers that exorbitant wage increases will not be accommodated through devaluation. Moreover, where the central bank faces a set of wage bargainers co-ordinated enough to internalize the effects of macroeconomic policy, it can effectively deter wage increases with threats to tighten monetary policy (Hall and Franzese 1998; Soskice and Iversen 2000). The complement to this monetary stance is a restrained fiscal policy, which is especially important in such contexts because it limits public-sector wage increases that might otherwise raise the real exchange rate and damage competitiveness (Hancké 2013a; Iversen *et al.* 2016; Johnston 2012).<sup>2</sup> Table 1 confirms that these political economies are especially reliant on exports.

**Table 1.** Export dependence by varieties of capitalism and growth models, 2007.

Co-ordinated market economies	Exports % GDP	Liberal market economies	Exports % GDP	Mediterranean market economies	Exports % GDP
<i>Nordic</i>		<i>Demand-Led</i>			
Denmark	52	UK	29	France	27
Finland	45	US	11	Greece	23
Norway	45	Australia	20	Italy	29
Sweden	51	Canada	37	Portugal	31
		New Zealand	29	Spain	26
<i>Continental</i>		<i>Export-Led</i>			
Austria	56	Ireland	79		
Belgium	81	Czech Rep	68		
Germany	46	Estonia	67		
Netherlands	73	Hungary	81		
Switzerland	51	Latvia	42		
		Poland	41		
		Slovenia	69		

Source: OECD, World Bank.

## Mediterranean market economies and other growth models

Among the countries of the new monetary union, however, were some with different varieties of capitalism (Amable 2003; Pontusson 2005b). These include the Mediterranean market economies of Southern Europe, encompassing Spain, Portugal, Greece and Italy.<sup>3</sup> Hall and Soskice (2001) suggested that these countries display a distinctive variety of capitalism, marked by some capacities for co-ordination in the sphere of corporate governance and limited capacities for strategic co-ordination in the sphere of labor relations, but said little more than to note that these political economies reflect a legacy of high levels of state intervention in the economy (see also Hall and Gingerich 2009; Schmidt 2002).

However, the prominent role played by these countries in the euro crisis has inspired more investigation, tending toward the conclusion that these political economies are not well-structured for operating the kind of export-led growth models seen in Northern Europe. Many of these studies conclude that these economies lack a key instrument for promoting export-led growth, namely, institutional capacities for the strategic co-ordination of wages, aside from periodic but short-lived social pacts (Hancké 2013a; Johnston and Regan 2016; Molina and Rhodes 2007). Although international competition induces wage moderation in the export sector, the sheltered sectors of these countries are prone to inflationary increases in wages that damage exports by raising the real exchange rate (Johnston *et al.* 2014). To some extent, this problem is rooted in trade unions that are relatively powerful but lack incentives to co-operate with each other on wages because they are divided into competing confederations.

Similarly, although there are relatively high levels of cross-shareholding in these countries, business associations lack the capacity to impose wage restraint or to operate collaborative training programs on a large scale; and recent research suggests that relationships between business and the state there are typically based on clientelistic relations with individual firms (Evans 2015; Featherstone 2011; Hassel 2014).

However, it is important to note that several other features of these political economies also limit their capacities to mount export-led growth strategies. With limited capacities for skill formation, their firms tend to be more heavily oriented than those of Northern Europe toward the production of low-technology goods or services, which compete on price rather than quality, and are thus more vulnerable to rising competition from emerging economies. Limited structural capacities for incremental innovation exacerbate this problem. In short, although a good deal of attention has been focused on the impact of limited wage co-ordination, many features of the broader structure of these economies militate against export-led growth strategies; and one of the challenges facing analysts of varieties of capitalism is to delineate these more fully (cf. Storm and Naastepad 2015).

In light of these observations, Hall (2012, 2014) argues that the governments of Mediterranean market economies are more inclined to pursue demand-led growth, namely, economic growth based on the expansion of consumer demand, an approach also characteristic of liberal market economies (Iversen and Soskice 2012). This growth model may also be especially suitable for economies in which small and medium-sized businesses are responsible for a large portion of economic activity (Gambarotto and Solari 2015). Its macroeconomic corollary is broadly accommodating monetary and fiscal policies designed to push up levels of domestic demand.<sup>4</sup> Table 2 suggests that the role played by domestic demand is greater than that of exports in a representative group of liberal and Mediterranean market economies (see also Table 1; Hope and Soskice [2016]; cf. Picot [2015]).

**Table 2.** The contribution of domestic demand and the external balance to GDP growth 2000–08.

	Export-led CME		Demand-led LME		Resource-led LME		Demand-led MME	
	Germany	Japan	UK	US	Australia	Canada	France	Italy
Real GDP growth	1.46	1.22	2.21	2.08	3.20	2.28	1.61	0.73
Contribution of domestic demand	0.83	0.75	2.43	2.15	4.69	3.46	2.12	0.82
Contribution of the external sector	0.63	0.46	-0.23	-0.07	-1.37	-1.16	-0.51	-0.08
Growth in net exports as a share of GDP	5.6	1.24	-2.83	-4.88	-1.43	3.50	-0.49	-0.09

Note: The cells indicate average annual percentages for the years of the trade cycle running from the low point of GDP in the early 2000s to 2008.

Source: Hein and Mundt (2012).

In liberal market economies where trade unions are relatively weak, it is often possible to operate a demand-led growth strategy without much inflation; but, where unions are stronger, as in most Mediterranean market economies, an accommodating macroeconomic stance is often accompanied by moderate but significant levels of inflation. On the one hand, inflation serves this growth model because it provides a further stimulus to consumption (and disincentive to saving). On the other hand, it erodes the international competitiveness of a nation’s products. Therefore, another economic instrument of importance for countries operating demand-led growth strategies is the capacity to alter the exchange rate and, prior to the run-up to monetary union (when aspiring members were constrained by a hard currency policy), Mediterranean market economies tended to rely more heavily than co-ordinated market economies on periodic devaluations to offset the effects of inflation on the competitiveness of their national products (see [Table 3](#)).

Of course, devaluation offsets the effects of inflation on national competitiveness only if nominal wages do not immediately adjust; and there is appropriate skepticism in the literature about whether it is a useful instrument of adjustment, especially in Europe, where nominal wages are often flexible and real wages rigid (Bean 1992). In the years prior to EMU, however, devaluation seems to have worked relatively well for Europe’s Mediterranean market economies. Devaluation was often followed by a relatively persistent decline in unit labor costs (see Höpner and Spielau [2015]; Petrini [2013]; and the Online Appendix).

Based on these observations, it should be apparent how variations in European capitalism contributed to the euro crisis. It was difficult to operate both types of growth models successfully within a single monetary union. For the co-ordinated market economies of Northern Europe, monetary union offered a relatively propitious environment. Fears that German wage co-ordination

**Table 3.** Nominal exchange rate changes and average inflation rates, 1980s and 1990s.

	Average annual change in the nominal exchange rate		Average annual change in inflation	
	1980s	1990–98	1980s	1990–98
Austria	2.41	1.40	3.84	2.61
Belgium	−0.56	1.33	4.90	2.26
Finland	1.43	−1.27	7.32	2.24
Germany	2.89	2.00	2.90	2.73
Netherlands	1.84	1.32	3.00	2.60
Export-led average	1.60	0.96	4.39	2.49
Greece	−11.67	−4.83	19.50	12.05
Italy	−2.41	−1.45	11.20	4.38
Portugal	−8.83	−0.87	17.35	6.59
Spain	−2.34	−1.57	10.26	4.44
Demand-led average	−6.31	−2.18	14.58	6.87

Source: Johnston and Regan (2016) from the AMECO database.

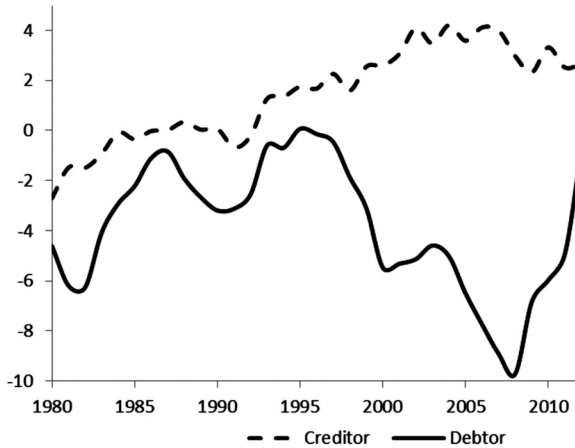
might suffer with the disappearance of the Bundesbank soon proved unfounded, as the independent European Central Bank committed itself to a non-accommodating monetary policy; and, even if it was occasionally breached, the Stability and Growth Pact encouraged fiscal restraint (*cf.* Hall and Franzese 1998). Moreover, the neighboring markets for these countries exports were rendered more secure because the member states could no longer depreciate their exchange rates against one another.

In the first instance, entry into monetary union also fed demand-led growth in the Mediterranean market economies of Southern Europe, notably by lowering interest rates and expanding the volume of available credit, as confidence effects led European financial institutions to recycle the funds generated by growing northern trade surpluses into them with seeming disregard for the accompanying risks (Blyth 2013). As a result, most of these economies grew relatively rapidly during the first decade of the new currency.<sup>5</sup> But partly because their governments lost the exchange-rate instrument formerly used to offset the effects of inflation on competitiveness, their intra-EU exports grew more slowly than those of their northern neighbors, while their imports increased rapidly. At the same time, inflation reduced real interest rates in the South and fueled asset booms in Spain and Ireland that would eventually burst.

No doubt, the authorities should have acted earlier to dampen down these booms, but, because they could no longer operate an independent monetary policy, that became difficult (Johnston and Regan 2016). Doing so via fiscal policy alone would have required policies so austere as to be at odds with any aspiration to demand-led growth, and efforts to put the brakes on lending by the southern banks were short-lived because that put them at a disadvantage *vis-à-vis* their foreign competitors (Carlin 2013; Schelkle 2017). As a result of export-led surpluses in the North and debt-fueled deficits in the South, substantial imbalances on the current account built up inside the eurozone, ultimately serving as a signal for speculation against sovereign debt, after the European Central Bank indicated it would reduce the liquidity it provided to national central banks (see Figure 1).

Experience under the euro also confirms the observations of VofC theorists that it is not easy to alter the institutional infrastructure of a political economy (Hall and Soskice 2001; Thelen 2004; Yamamura and Streeck 2001). In the early 1990s, some suggested that competition under a single currency would force institutional change or new growth models on the member states (*cf.* Krugman 2013). Such hopes had been fueled by the success with which aspiring entrants managed to contain inflation and sustain their exchange rates during the late 1990s in order to qualify for entry. But the social pacts negotiated for that purpose proved only temporary expedients made possible by the presence of a strong external constraint in the form of the Maastricht criteria (Avdagic *et al.* 2011; Featherstone 2004). Capacities for export-led growth





**Figure 1.** Current account imbalances in the eurozone 1980–2012 (% GDP).

Note: Creditors include Austria, Belgium, Finland, France, Germany and the Netherlands. Debtors include Greece, Ireland, Italy, Portugal and Spain. Source: Johnston and Regan (2016) and AMECO database.

depend on durable structures for strategic co-ordination among producer groups that emerge only out of a long process of prior historical development.

Of course, Ireland also became a debtor country amidst the euro crisis. To some extent that can be traced to its structure as a liberal market economy and corresponding propensity for demand-led growth. But inspection of the Irish case also reveals the emergence of another kind of growth model. There was certainly a substantial expansion of consumer demand in Ireland during the early 2000s. But Ireland also pioneered what might be described as a ‘liberal export model’ paralleling an approach subsequently adopted in economies of East Central Europe that Bohle and Greskovits (2012) describe as the ‘neoliberal’. These countries remain liberal market economies in the sense that their firms co-ordinate their endeavors largely through competitive markets.<sup>6</sup> But, in order to secure economic growth, they depend especially heavily on low corporate taxes to attract foreign direct investment, much of it oriented to assembly for export into the global value chains that are becoming important features of the international economy (Nolke and Vliegenthart 2009). Although there is some variation here, notably between the ‘embedded liberalism’ of the Viségrad countries and the ‘neoliberalism’ of the Baltic states, low tax rates tend to imply relatively low levels of social spending, which also encourages such investment by holding down the reservation wage (Bohle and Greskovits 2012).

The key role that exports play in such political economies is evident in Table 1; and several features of this growth model became especially significant in the wake of the global financial crisis. Many of these countries recovered rapidly partly because the flexible labor markets in these liberal market

economies meant that the elasticity of wages with respect to unemployment was high, rendering domestic deflation effective for reducing unit labor costs. At the same time, because their economic growth was more dependent on exports than domestic demand, when their trading partners recovered, these economies could move back toward higher levels of growth even in the context of domestic deflation (Aslund 2011; Kuokštis 2015; cf. Mabbett and Schelkle 2015; Reagan 2014). By contrast, because the Mediterranean market economies of Southern Europe are more dependent on domestic demand for growth, the deflation forced on them by the bail-out programs of the EU, while designed to lower unit labor costs and make their products more competitive, takes a greater toll on aggregate rates of growth.

It should be stressed that none of these arguments suggest that the presence of different varieties of capitalism within the monetary union was the sole cause of the euro crisis. At least three other factors made that crisis more likely. In proximate terms, even more important was the financial ‘confidence effect’ that followed the entry of Southern Europe into monetary union, which saw a vast expansion of lending and borrowing across Europe. Debt-fueled expenditure in the sheltered sectors of the southern countries rendered them susceptible to the crisis of confidence that erupted in 2010 (Blyth 2013; Frieden and Walter 2017; Jones 2016). A second factor was the inadequacy of the institutions devised to accompany the monetary union, marked by a paucity of capacities for sharing risks across the member states (Schelkle 2017). A common banking union with supervisory teeth might have been able to dampen down asset booms and render the European banking system more robust, while a central bank capable of purchasing sovereign debt might have staved off the initial crisis of confidence. Moreover, national governments made plenty of policy mistakes, most notable in the case of Greece; and the halting response of the EU itself, linked to inadequate institutions for coping with a crisis, made it worse (Sandbu 2015).

However, VofC analyses indicate that the long-term economic strains underlying the crisis were rooted, not in the asymmetric economic shocks anticipated by OCA theory, but in the institutional asymmetries of different varieties of capitalism yoked together in a single monetary union. Those asymmetries encouraged governments to follow divergent growth strategies that contributed to rising imbalances on the current account, while the exigencies associated with a common currency and monetary policy limited their capacities to correct those imbalances or to off-set the pernicious side-effects of such strategies.

## **International dimensions**

Both within Europe and across the globe, the economic crises of 2008–2010 have drawn attention to the ways in which different varieties of capitalism

interact on an international plane. Indeed, Iversen and Soskice (2012) argue that the international interdependence of co-ordinated and liberal market economies provided a structural basis for emerging global imbalances. By virtue of their institutional capacities for export-led growth, many co-ordinated market economies tend to run surpluses on their current account, while liberal market economies focused on demand-led growth often run trade deficits. Recycling of the surpluses of co-ordinated market economies into investment in liberal or Mediterranean market economies, in turn, allows the latter to sustain the trade deficits induced by demand-led growth models. This tendency is especially pronounced in countries with large and internationally important financial sectors, such as the United States (US) and the United Kingdom (UK), whose financial sectors press governments for the lighter regulation that feeds debt-financed demand (Kalinoski 2013). Moreover, the key role that these two countries play in international financial transactions encourages off-setting inflows of capital that allow them to run trade deficits for considerable periods of time, bolstered in the American case by a reserve currency (Carlin and Soskice 2015; Iversen and Soskice 2012; cf. Gabor and Ban 2012). Thus, at the international level, some liberal and co-ordinated market economies maintain a symbiotic relationship.<sup>7</sup>

The co-ordinated and Mediterranean market economies of the eurozone stand in a similarly asymmetric relationship to each other, albeit one that is more pathological than symbiotic because Mediterranean market economies have greater difficulty than liberal market economies containing inflation and unit labor costs. As inflation renders their products increasingly uncompetitive, there is a risk that the inflows of capital necessary to sustain imbalances in trade will dwindle, leading to the kind of credit crisis seen in 2010. However, persistent trade imbalances are surely present in other monetary unions as, for instance, between the American states. Thus, one of the intriguing issues still unresolved in political economy asks: what kind of institutional arrangements, if any, ranging from a full banking union to more fluid transnational equity markets, might make persistent imbalances of this sort feasible in the eurozone (Hall 2015a; Schelkle 2017)?

The euro crisis has also drawn attention to the distinctive effects that developments in the international economy have on different varieties of capitalism, often as a result of the latter's inherent comparative institutional advantages (Fioretos 2011; Nolke 2016). In the early 2000s, for instance, a number of international developments intensified the trade imbalances apparent between Northern and Southern Europe (DeVillie and Vermeiren 2016). As I have noted, by virtue of how their production is organized, many of the co-ordinated market economies of Northern Europe are adept at producing high-quality goods of high value. In the German case, that

includes capital goods. By contrast, based on lower levels of skills, the Mediterranean market economies of Southern Europe have tended to specialize in agricultural products, some types of services such as shipping and tourism, and the production of medium-quality consumer goods at relatively low cost (Hausmann and Hidalgo 2014).

Thus, rapid economic development in the emerging economies of China, Russia, Brazil and India provided important new markets for capital goods and high-quality products from Northern Europe at the same time as it posed significant new competition in the low-cost production characteristic of many firms in Southern Europe. A parallel dynamic played out on the European continent following the transition to democracy in East Central Europe. All of a sudden, the economies of Southern Europe faced formidable new competitors in sectors where they formerly had advantages in low-cost production. The Viségrad nations secured especially key positions within the value chains supplying German industry that might otherwise have gone to Southern Europe (Dustmann *et al.* 2014). As this experience indicates, there is room for more investigation into the ways in which broader developments in the international economy affect distinctive varieties of capitalism.

### **Adjustment as an economic and political problem**

The euro crisis has underlined the value of approaching the problems of contemporary political economies as problems of adjustment – to events that are endogenous as well as exogenous to the domestic economy. Entry into the single currency was an institutional shock that called for adjustment within the member states, and the sovereign debt crisis of 2010 was another such shock mandating further adjustment. This focus directs our attention to the range of instruments available for economic adjustment, and VofC approaches make some distinctive contributions to such analyses. In particular, they see firms, as well as governments, as important agents of adjustment and the institutionalized relationships in which firms are embedded as central components of a country's capacities for economic adjustment.

In an earlier era, mainstream accounts of economic adjustment focused primarily on the tools of fiscal and monetary policy, encompassing changes to the exchange rate in open economies. With particular vehemence in the wake of the euro crisis, economists have seen regulatory reforms, designed to make markets in products or labor more intensely competitive, as another tool for accomplishing some immediate economic adjustment and for altering the long-term capacities of an economy for adjustment to shocks. However, building on a prior literature about neo-corporatism, VofC analyses expand these conceptions of the instruments available for adjustment to include the institutional capacities of various economic actors for

strategic co-ordination (Schmitter and Lehbruch 1979). Among these, institutional capacities for wage co-ordination were especially relevant in the run-up to the euro crisis, but the relevant range of capacities include those that make possible various kinds of skill formation and innovation central to the long-term growth prospects of a country.

Analyses of the euro crisis suggest that, in some cases, various instruments can serve as *substitutes* for one another. Under some conditions, for instance, depreciation of the nominal exchange rate can be used as a substitute for domestic deflation to hold down the real exchange rate, setting up a familiar choice between 'external' and 'internal' adjustment. However, the recent literature on growth models indicates that some instruments may also be *complements* to others: it is easier to co-ordinate wages, for example, in the context of non-accommodating macroeconomic policy (Iversen 1999). In short, the euro crisis has drawn attention to the prominence of adjustment problems in the political economy, and one of the contributions of the VofC literature has been to show that the organization of the political economy conditions both the types of adjustment problems that arise and the range of instruments available for addressing them.

At the same time, the recent VofC literature emphasizes that there are also political dimensions to any adjustment process. The ability of a country to accomplish particular economic goals depends as much on what is politically feasible as on what is economically desirable (Bohle and Greskovits 2012). Although understanding of such issues is still underdeveloped, the VofC literature points to at least three ways in which the political dimensions of adjustment may be construed.

The first might be termed a 'coalitional perspective' which stresses that governments can act only if they can form coalitions among voters and producer groups around the economic strategies associated with adjustment. Walter's (2016) analysis of adjustment in East Central Europe provides an illustration. Asking whether governments relied on external or internal adjustment in the wake of the global financial crisis, she finds that the outcome was driven not only by national economic conditions such as existing levels of debt, inflation and unemployment, but also by the extent to which the costs of alternative strategies would be borne by constituents of the governing parties – a factor likely to be influenced, in turn, by the character of electoral rules (Iversen and Soskice 2006).

Iversen and Soskice (2012) develop a coalitional argument to explain why many governments have responded to contemporary economic shocks by retaining, rather than changing, the macroeconomic regimes central to their export-led or demand-led growth models, despite considerable international pressures for change. In this respect, they go well beyond earlier accounts that focus on what is 'efficient' for each political economy. In co-ordinated market economies such as Germany, for instance, they expect political

resistance to proposals to reduce the trade surplus via a more accommodating fiscal policy because the latter would threaten the demand for (and wages of) skilled workers in the export sector (as domestic consumption becomes a larger share of economic activity), unless cutbacks in vocational training reduce the supply of skilled workers; but they argue that such cutbacks will be resisted by employers in the export sector lest they raise that sector's wage bill and by low-skill workers who fear that such initiatives would increase their numbers, putting downward pressure on their wages.

Thus, both of the major parties in Germany resist an approach to adjustment widely mooted by others in Europe because such a change in policy would incur opposition from employers, who are an important constituency for the Christian Democratic party, and low-skilled workers, whose support the Social Democratic party is seeking to retain in stiff competition with parties to its left. Such core constituencies have considerable influence within the type of parties typically found in countries with electoral systems based on proportional representation. This is one way of explaining why Germany has resisted so stoutly calls for it to move beyond balanced budgets to fiscal expansion.

Conversely, Iversen and Soskice argue that, even if it would be desirable for liberal market economies to step back from demand-led growth strategies, there will be political resistance there to more restrictive macroeconomic policies because increases in interest rates and efforts to balance the budget will tend to make the crucial median voter in what are usually majoritarian political systems worse off. Of course, electoral outcomes turn on many factors, but this is an important move in the recent literature on varieties of capitalism to explain policy, not only on efficiency grounds, but with regard to the political coalitions likely to form around specific policy options.

Similar considerations help explain the halting response to the crisis by a diverse set of member states and why movement toward a 'fiscal union' is resisted in many parts in Europe, even though some experts believe such a union is crucial to the survival of the euro. Fiscal union itself is simply an institutional shell: the real issue is what kind of policies it would adopt. However, as the VofC literature notes, substantial groups of producers in Northern Europe are likely to favor the relatively austere fiscal stance that is complementary to co-ordinated wage bargaining, while support for a vigorous counter-cyclical policy is likely to be stronger in Southern Europe, where economic growth has been more dependent on domestic demand. The roots of the contemporary stalemate turn, not only on issues about what new European institutions should be created, but on controversy about what those institutions should do, linked to the ways in which different varieties of capitalism affect the interests of producer coalitions in each country.

However, there are many reasons why voters are currently resistant to giving more powers to EU institutions, not least a populist electoral politics

that has seen the rise of radical right parties opposed to transnational transfers, any augmentation of EU powers and sometimes to the euro itself in Northern and Eastern Europe, alongside radical left parties in Southern Europe seeking an end to economic austerity. This is an important political phenomenon with which the VofC literature has yet to come to grips. A literature initially oriented to explaining why there is more than one path to growth and where each path finds political support has tended to focus on those who gain from specific growth strategies rather than those who may lose from them. Designed to explain how different nations prosper in the context of globalization, it has had less to say about the revolt against globalization now enveloping the developed world.

Critics have argued for some time that VofC analyses need to pay more attention to the ways in which capitalism creates losers as well as winners, and the populist politics of the contemporary era have brought such issues to the fore (Coates 2005; Thelen 2014). Their point is that the purpose of economic policy is not simply to secure prosperity but also to resolve endemic social conflict over the distribution of resources; and exploring how that conflict plays out in different varieties of capitalism offers an important new research agenda (Hall and Thelen 2008; Pontusson 2005a). As I see it, one of the core issues here is to develop better understandings of how cross-national variations in the organization of the political economy condition the types of political conflicts that will arise and the social coalitions that form around them. Baccaro and Pontusson (2016) argue that, in order to do so, analysts of comparative capitalism need to move away from the emphasis of the VofC literature on the supply side of the economy to pay more attention to its demand side (*cf.* Hope and Soskice 2016). However, they contend that policy turns less on the institutional structure of the political economy than on the presence of powerful social blocs. At the heart of such debates lies the issue of whether cross-national variations in policy are better explained by variations in the institutionally conditioned interests of key social groups or by variations in their power (*cf.* Swenson 1991).

Other analysts argue that, in order to understand these processes, we need to move beyond an emphasis on manufacturing to consider the issues that economic growth based on services and technological change raises for different types of capitalism. With this in mind, Beramendi *et al.* (2015) posit that the key problem facing governments is to find a balance between public spending on consumption and investment; and they develop a coalitional analysis to explain such choices by associating different occupational groups with corresponding preferences over consumption and investment. Although it is not entirely clear how these choices might be conditioned by different types of capitalism, this effort to reformulate the policy problem offers a stimulating impetus for further research (*cf.* Hall 2016).

In broader terms, this literature reminds us that governments have to approach issues of adjustment, not only as matters of how to render the economy more efficient, but as issues about how best to contain social conflict. That, in turn, draws our attention to the ways in which the institutional features of a political economy might condition the economic costs and political feasibility of any particular course of adjustment. In the years prior to the euro, for instance, many countries resorted to devaluation to restore the competitiveness of their national products in the face of inflation, not because it was the most efficient way to cope with inflation, but because it was more politically feasible than negotiating an incomes policy or a protracted exercise in internal deflation. Just how costly each of these options would be was conditioned by the organization of the industrial relations arena (Hall and Franzese 1998).

In much the same way, the euro crisis has drawn our attention to the extent to which national capacities for adjustment turn not simply on the trajectory of a country's *economic* development, but on the character of its *political* development. Iversen and Soskice (2009) suggest that the economic and political institutions of a nation might co-evolve to generate political arrangements that reinforce specific varieties of capitalism. However, the euro crisis reveals a darker side to such relationships. The case of Greece is an especially salient reminder of how much the structure of the state influences the economic strategies adopted by governments. Several scholars have argued that the Greek approach to economic adjustment in the first decade of the euro was deeply conditioned by weaknesses in its political executive and by the limitations of a patronage-based political system (Featherstone 2011; Trantidis 2015). Factors that made it difficult for the Greek state to raise revenue or control expenditure allowed public sector deficits and debt to balloon out of control.

Hassel (2014) advances a parallel argument about the political economies of Southern Europe. She suggests that the legacy of state intervention common to these Mediterranean market economies inspires a distinctive pattern of adjustment in which firms and producer groups turn to the state for protection in the face of economic challenges rather than change their practices. In her view, the other members of the eurozone have been insistent on structural reform in these economies precisely in order to break longstanding relationships of this character between producers and the state.

Similarly, Bohle and Greskovits (2012) note that the ability of states in East Central Europe to weather the global financial crisis of 2008–2009 depended as much on the capacities of their political systems as on their economic situations, conditioned by political experience since the transition to capitalism. Party systems that threw up few alternatives to neoliberal strategies and had experienced previous crises linked to the transition facilitated the political



acceptance of deep budget cuts in the Baltic countries, when they were not elsewhere. In short, as scholars think more deeply about the ways in which varieties of capitalism condition national capacities for adjustment, they would do well to consider not only the organization of the economy, but also the organization of the state and the nature of structural relations between producer groups and the state (cf. Culpepper 2016).

### **A lingering question: what now for Southern Europe?**

One of the peculiarities of the euro crisis is that the costs of adjustment in the wake of what was essentially a debt crisis have been imposed almost entirely on the debtor nations, leaving them in a deeply disadvantageous position (Frieden and Walter 2017). Moreover, the adjustment programs pressed on them by the creditor countries have focused heavily on lowering unit labor costs, as if this were the only prerequisite for economic growth. Thus, one of the most important questions still on the European agenda is: how can the political economies of Southern Europe prosper again in its wake?

That will turn on the institutions and policies adopted for the eurozone as a whole; but it is also a question about how Mediterranean market economies might most effectively be reformed. Until recently, the European Commission and other member states appear to have embraced a particular answer. In a series of memoranda accompanying the five bail-out programs it has sponsored, the EU has insisted, not only on cuts to budget deficits, but also on extensive structural reforms designed to reduce the role of the state in the economy and render markets in labor and goods more intensely competitive. In effect, the EU seems to be trying to turn Mediterranean market economies into liberal market economies, with an emphasis on reducing the cost of labor and its products.

On a simple interpretation of VofC analyses, that might appear to make sense: liberal market economies have generally performed better than Mediterranean market economies (Hall and Gingerich 2009). However, such a view rests on an overly superficial interpretation of theories about varieties of capitalism. The latter are not simply theories about wage determination; they focus on the institutional conditions supportive of many endeavors central to the success of firms, including their capacities for securing technology, skill formation and innovation. If structural reform concentrates primarily on reducing labor costs, it may simply encourage firms to cultivate low-wage forms of production that inhibit innovation or increases in productivity, ultimately delivering a poor standard of living (Lucidi and Kleinknecht 2010; Streeck 1991). In a world where low-cost producers face increasing competition from emerging economies, this does not appear to be a promising strategy.

Thus, the challenge facing the EU – and analysts of varieties of capitalism – is to develop fuller understandings of how economies based on a

Mediterranean market model, once supported by demand-led growth, can move from lower to higher-valued-added modes of production. To date, this problem has not been adequately addressed; and it is one where a focus on unit labor costs is potentially distracting. To tackle it, VofC analysts will also have to pay more attention to the ways in which contemporary capitalism is being transformed by the transition to services and the prospects for knowledge-based growth (Hall 2015b; Huo 2015; Soskice 2013; Tassej 2014; Wren 2013).

Although they are relevant to many political economies, issues of this sort are prominent in Southern Europe, where many countries are especially reliant on tourism and services such as banking in Spain or shipping in Greece. Moreover, with some variation, these economies tend to be laggards on the parameters associated with success in a knowledge economy, including skill formation, the scope of higher education, digital access, and the funding of research and development (Veugelers 2016). Although the EU has begun to acknowledge such issues in its proposals for 'Structural Reform 2.0', its insistence on budgetary cuts impedes progress in these realms, which require substantial levels of investment in public goods, such as education, digital infrastructure and research and development.

Moreover, Beramendi *et al.* (2015) suggest that political conditions in Southern Europe are not propitious for increasing such investment. They argue that the self-employed, who form a large proportion of the electorate in these countries, are unlikely to be supportive of public investment and that large segments of those electorates are addicted to consumption. However, their analysis is only a first-cut into this problem. Analysts of varieties of capitalism are beginning to consider how the operation of liberal and coordinated market economies is changing in the context of the services transition and technological advance (Busemeyer 2015; Iversen and Soskice 2015; Thelen 2014). In that context, we need to know more about what kinds of policies are likely to foster high value-added production in Southern Europe and how growth coalitions might form around those policies.

## Conclusion

In sum, efforts to understand the global financial crisis and ensuing euro crisis have taken theories about varieties of capitalism in more dynamic directions, which draw attention to issues of adjustment, and in more political directions, oriented to identifying the coalitional underpinnings behind economic strategies. The crisis has inspired important efforts to integrate the demand side into the analysis of the supply side emphasized by earlier theories about varieties of capitalism, yielding a rich new body of work on national growth models. This literature has been revealing about the structural roots of the euro crisis and the factors lying behind the responses to it. However, there

is much that remains controversial in these formulations, notably about how best to specify national growth models, and this literature has brought to the fore several issues that remain unresolved, including the key problem of how Southern Europe can best secure economic growth.

Notwithstanding the expectations of some, the integration of Europe has not yet brought about the disintegration of national varieties of capitalism. Despite changes in all political economies associated especially with liberalization, the co-ordinated market economies of northern Europe continue to operate quite differently from the liberal and Mediterranean market economies of Europe. But the opportunities provided by European integration have seen a number of countries experiment with alternative growth models, including most notably the liberal export models of Ireland and East Central Europe. For the Southern European countries that can no longer operate the demand-led growth models pursued prior to the crisis, however, economic experiments are ongoing. The danger, of course, is that some parts of Europe may end up with growth models without growth, which will ultimately threaten the very existence of the monetary union. In such respects, the euro crisis is far from over.

As European officials seek new routes to economic growth, however, they would do well to bear in mind the most basic tenets of the VofC perspective. Leaving aside the many debates about how to classify countries and distinguish growth models, virtually all who write from such a perspective argue that economic success is dependent not simply on the selection of correct policies, but on the shape of the institutional infrastructure of the political economy. Instead of seeking a single set of 'best practices' deemed applicable to all economies, these analysts maintain that there is more than one route to economic prosperity, and finding a successful national path requires adapting social and economic policies to the institutional conditions specific to each type of political economy. The sources of that lesson lie in European history and, at this moment of crisis, it would be ironic if European officials forget what the history of their own continent teaches.

## Notes

1. Other works often use the term 'mixed market economies' to describe these political economies.
2. Note that this tendency does not preclude episodes of fiscal expansion at some moments in time, for instance, in response to German reunification or in the immediate aftermath of the 2008–2009 financial crisis; and, as Baccaro and Pontusson (2016) note, institutional structures and macroeconomic policies may not always be tightly coupled. They argue, for instance, that there is more room for expansionary fiscal policy when the price elasticity of demand for exports is low.
3. Needless to say, there are some important differences among these countries not discussed here; and I leave aside the case of France, although it now bears a strong resemblance to the MMEs of Southern Europe.

4. Note that there are exceptions to this rule, as when the Thatcher government took an austere policy stance in the UK during the 1980s in order to weaken the trade union movement.
5. The notable exception is Italy, where growth has been stagnant for more than a decade.
6. It should be noted that this liberal export model did not preclude a serious social pact in Ireland or neocorporatist arrangements in Slovenia (Bohle and Greskovits 2012; Regan 2012).
7. There is a parallel symbiosis between the liberal American economy and the mercantilist policies of some emerging market economies such as that of China.

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