Policy-making in the Time of Crisis:

What determine the 2008-2009 Economic Stimulus Packages
in France and Germany?

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ABSTRACT

This thesis attempts to draw patterns of economic policymaking in the time of crisis. It analyzes within the context of the global economic crisis and explains how state capacities (both institutional and financial capacities) influence the size and composition of the economic stimulus packages. It utilizes political variables to explain the similarities and differences between the French and the German 2008-2009 packages. Media content analysis suggests that the prospect of fiscal consolidation post-crisis, institutional settings under the EMU and spillover effects of fiscal measure may be the main reasons for slow and timid fiscal responses by some EU countries.

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INTRODUCTION

The global financial and economic crisis that started in 2008 has become a hot research topic among economists and policymakers. Debates have been focused on identifying the root causes and lessons learned for long-term policy implications. (IMF 2009a, IMF 2009b). The extent of economic effects of the crisis has also been intensively analyzed to find appropriate policy responses (European Commission 2009; Lee 2009). While discussing agendas for appropriate reforms, governments around the world have implemented policies that aim at stabilizing macroeconomic and mitigating the impact on the vulnerable members of the society (OECD 2009a; United Nations 2009).

Short-term measures to improve financial intermediation and boost demands include the use of expansionary monetary and fiscal policies. While the effectiveness of monetary policies is in question due to credit crunch phenomenon and financial market malfunction, fiscal policies deem the most effective re-stabilizing tools. A widespread impact on the society, as a result of the interconnectedness between the financial and the real sector of economy, provides further justification for additional fiscal impulse to strengthen the effectiveness of existing economic policies. As a consequence, many governments have introduced economic stimulus packages with considerable variation in the size and composition across countries, as well as the timing of the announcement (Horton and Ivanova 2009; Saha and Weizsaecker 2008, 2009a and b; Spilimbergo et al (2008); Zhang et al. 2009).

Literature on economic policies amid the global crisis assesses the initial impact of fiscal measures on economic activities (OECD 2009a; Padoan 2009). The main purpose of such studies is to recommend, technically, the elements of stimulus packages that may be effective. It provides the analysis in the area of positive public economics which concerns technical aspect of policy i.e. the effects of tax and expenditure policies on individual and firm behaviors (Drazen 2000). However, the main challenge in economic policymaking especially during the time of crisis is to achieve the right balance between several competing governmental priorities – notably in the size and duration of interventions versus fiscal sustainability in the long-run (Spilimbergo et al 2008). Thus, the questions of how stimulus packages are chosen and what objective governments emphasize on cannot be neglected. They belong to the subject matter of normative public economics.

There are some literatures (Murillo and Foulon 2006) which study the core focus of this normative approach to policymaking in the time of crisis i.e. tracing the intricacies of government's decision-making in response to crises. For what we know; crisis containment strategies are difficult to design and implement in the midst of an actual turmoil when conflict of interests in the society is at its peak. The unexpected circumstances and unscheduled events that present themselves in the recent global economic crisis provide interesting research opportunity to study patterns of policymaking.

METHODOLOGY:

This thesis attempts to fill the lacuna by incorporating the analysis in the field of political economy to a better understanding of crisis-management. It seeks to determine how political nature of decision-making interacts with the unprecedented phenomenon; described the global crisis, to influence resource allocation among heterogeneity of interests in the society. In the context of the global financial and economic crisis, this thesis asks specific questions of what determine the size and composition of fiscal stimulus packages, as well as the timing of the announcement. Given different degrees of severity of the crisis across countries which have already provided partial explanation to the differences in fiscal measures; the thesis focuses on a case comparison of two largest economies of the eurozone – France and Germany.

In the beginning of 2009 the two largest advanced economies of the eurozone experienced the deepest recession since the World War II. They managed to escape a prolonged recession, but threats are still imminent. Public debts and government deficits in both countries are way higher than EMU fiscal rules while unemployment rates are approaching double digits. The governments have been implementing economic stimulus packages with a mix of tax cuts and new expenditures to boost up demands in the economies. Despite the commonalities in their macroeconomic settings and the effects of the crisis, we find that the composition and size of the French and the German stimulus packages (as % of 2008 GDP) as well as the timing of announcement demonstrate discernable patterns. In light of this information, our empirical part of the thesis contributes by identifying factors that explain differences in economic stimulus packages of the two countries.

The thesis relies on a few secondary literatures and has little engagement with theoretical debates. This is because it analyzes an ongoing phenomenon on the aspect which lacks prior theoretical examination from relevant field of studies. However, toolkits from development studies aid our conceptualization of frameworks for policy-making and decision-making in the time of crisis of this nature. Ongoing research studies conducted by international organizations and think thanks also provide essential information that captures the characteristics of economic stimulus packages in both countries. Case investigation into economic conditions relies on primary source of data extracted from the most updated World Economic Outlook Databases of the IMF, version April 2010 (cut off date for information is January 2010).

For empirical case analysis, we utilize a media content analysis together with comparative case analysis as two main research methods. We rely on LexisNexis Academic

Databases to extract information from major U.S. and world publications; notably Financial Times (London) archive and online archive, as well as the Economist (all sources are from September 2008 to December 2009). First, we summarize and analyze detailed messages containing information about French and German fiscal stimulus, as well as some relevant political issues. After identifying specific characteristics of information gathered, we then compare and contrast them in order to determine patterns of policymaking in France and Germany. A total of 39 articles from 66 newspapers and journals were analyzed.

The organization of the thesis is as followed; it starts off by discussing the Role of Crisis in Policy-making (Chapter 1) while highlighting a unique nature of the global economic crisis – unprecedented in its implications. Chapter 2 explores Characteristics of Economic Stimulus Packages before focusing on fiscal packages in France and Germany (Chapter 3). It determines Broad Patterns in Designing Economic Stimulus Packages (Chapter 4) prior to Explaining the Case of France and Germany in Chapter 5. Conclusion chapter summarizes the main findings of the thesis and provides policy recommendations.

CHAPTER 1:

The Role of Crisis in Policy-making

Economic Policy-Making and the Past Crises:

The view that economic crisis creates a necessary condition for change in policy has become a new conventional wisdom on reform, despite criticism attacking its tautological nature (Tommasi and Velasco 1996 cited in Drazen 2000)[1]. Following from that, existing literature on the effects of economic crises on policymaking thus focus mainly on policy reform via policy change and policy learning. While the former represents the conventional view of conflict-oriented theory, the latter emphasizes the role of knowledge in the policy process (Bennett and Howlett 1992; Sabatier 1988; and Hall 1988, 1989). Such field of studies has inspired frameworks of policy transfer (Dolowitz & Marsh 2000) and lesson-drawing for policy improvement (Rose 1988, 1991). Particularly on economic policy-making, studies have been conducted to observe policy reactions to crises[2] during the Great Depression in 1930s (Hall 1989) and other emerging market crises during 1980s and1990s. They have provided important lessons that need to be learned in order to prevent repeated policy mistake. Those valuable lessons have contributed to technical dimension and broad approach to economic policymaking at the domestic and global level. The Great Depression shifted the focus of economic policies to a fashionable demand-side one with government spending representing the core approach. Lessons from other emerging crises include the limitations of a fixed exchange rate regime, greater awareness of external shocks and the vulnerabilities of large international capital flows (Grenville 2007), risks associated with problems of inefficient intermediation and poor risk management, un-sustainability of current

[1] See more in Nelson (1990); Williamson (1994)

[2] Read more analysis on some well-known cases including 'Korea in 1997, Japan in the 1990s, the Nordic countries in the early 1990s,…, and the U.S. during the Savings and Loans crisis in the 1980s' in IMF 2008)

account deficits, excessive international reserves, weak domestic banking systems and the like.

Crisis management strategies drawn from those lessons are part of the process of deciding *technically* what policies to implement. According to the concept of political economy, actual policies are different from those policy options defined under technical and informational context – and especially without political constraint (Drazen 2000). Since those who are familiar with this type of analysis are mostly economists, less attention has been paid to study political factors that either contribute to the crises or shape the controversial politics of adjustment[3]. Even among some economists, they also agree saying that 'political pressures to rescue powerful interest are often too difficult for the authorities to resist' (Demirgüç-Kunt, Aslı and Servén, Luis 2009, 4).

What do existing literatures say about the normative economics of policy choice that are drawn up to manage those crises? Some observations have been made in the studies of Haggard (2000) on how the incumbent governments of Asian economies designed and implemented crisis measures and structural reforms following the Asian financial crisis of 1997. The central arguments presented in his book point out to the impact of close business-government relations that created moral hazard and complicated adjustment process after the crisis. Due to less developed financial systems in the region at the time, policy configurations emphasized institutional reforms including financial and corporate restructuring policies in attempt to induce accountability and transparency in the financial systems as well as to control corruption associated with business-government relations.

[3] See, however, Haggard (2000)

Apart from the longer-term policy measures derived through studies and consensuses regarding the root causes of the crisis, many[4] have regarded the role of international donors as an important factor causing a more immediate policy adoption during the time of crisis. One political factor and main institutional constraint that heavily influenced domestic shorter-term crisis measures during the 1980s and 1990s crises is the IMF's prescription. This one-size-fit-all policy package advocated for overly restrictive monetary and fiscal policies as well as ambitious structural adjustment programs. IMF's functions as 'primary official international lender of final resort' (Mussa 2006 p. 2) imply that member countries who face economic difficulties and are unable to obtain additional credit elsewhere may seek multilateral support in the context of IMF program. However, those countries would be subject to conditionality and close monitoring of IMF – causing alteration in sovereignty inevitably. Thus, pattern in crisis policy-making usually involved discussion regarding the drawbacks of Washington Consensus stabilization policies and market-based reforms (Stiglitz 2003).

Past crises have contributed to economic policymaking by introducing or advocating new policy paradigms as alternatives viable against the status quo (Hall 1993). It opens window of opportunity for reform and adoption of new program by helping to tip political balance (Wood 2006) by means of watering down resistance from various interest groups and stakeholders and thus overcome existing ideological skepticism (Drazen 2000).

Such line of arguments; however, have limited implications in explaining what influence government's reaction to the global financial and economic crisis that broke out in 2008. To determine why that is the case, we proceed to examine a distinctive and complex nature of recent global financial and economic crisis.

[4] Such as Evans (2009)'s studies on post-war reconstruction which provides implications of how one considers the legitimacy of externally-promoted policy change

The 2008 Global Financial and Economic Crisis:

In the summer of 2007, the meltdown in the U.S. structured securitization instruments disrupted its existing growth model facilitated by consumption and boom in the housing market. Several months after sub-prime crisis unfolded itself, the impact has spread swiftly across the highly integrated financial system of advanced economies through extraordinary growth of cross broader transactions[5]. By 2008 the world began to experience the impact of the collapse in the global financial system from 'a deterioration of credit quality, a drop in valuations of structured credit products, to a lack of market liquidity accompanying a broad deleveraging in the financial system'(IMF 2008, 18)[6] – a credit crunch phenomenon. With the domestic demand in the U.S. being affected, the economies of other advanced nations as well as emerging market economies also felt the impact as tensions in the U.S. spilled over. These second round effects have created negative feedback loops affecting the real sector worldwide.

To the surprises of many; the applications from other crises seem to be limited due to a unique nature of full-blown economic crisis featuring a break down of capitalism (Diamond and Liddle 2010). The unprecedented nature and effects of the 2008 global financial and economic crisis have buffeted policymakers around the world.

'Never before in modern times has so much of the world been simultaneously hit by a confluence of economic and financial turmoil such as we are now living through.' said the U.S. Treasury Secretary Timothy Geithner in remarks to the Economic Club of Washington[7].

In addition to traditional monetary tools, ad hoc measures have been implemented including financial sector support operations e.g. liquidity injection, purchases of toxic assets, and

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[5] Drawn from speech given by Graham Watson, leader of the ALDE Group, European Parliament

[6] See IMF's Global Financial Stability Report: April 2008

[7]See details in http://www.cleveland.com/business/index.ssf/2009/04/geithner_says_crisis_unprecede.html

bailouts insolvent banks. Some[8] even discuss nationalizing the entire banking systems. In many situations policies are found to work less well than had been anticipated, resulting in different or even more complicated effects. Apart from some obvious economic policy implications, lessons drawn from previous crises seem to be applicable only to a longer-term adjustment process. This has left an important issue on what determine shorter-term crisis strategies without proper theoretical examination, and thus creates a significant gap regarding the studies of policy-making in the time of economic crisis.

Despite a lack of theoretical framework on immediate crisis management strategies – especially ones that are applicable to public finances – policymakers have drawn some useful implications from previous crises. IMF Staff Position Note (Spilimbergo et al. 2008) on fiscal policy in the time of crisis suggests that sustainability of any fiscal action requires that problems in the financial sector be the first in governments' list of priority – preceding the solution to the macroeconomic crisis[9]. Moreover, immediate and sizable supports to financial sector followed by fiscal stimulus packages; with composition that addresses the specific features of the crisis, are crucial in order to minimize adverse impact on macroeconomic conditions[10]. Thus, technically speaking, the necessary features of short-term crisis measures consist of elements aiming to first fix the financial system and then stimulate aggregate demands (ibid).

While mushrooming literatures attempt to identify the root causes of the current crisis and immediate policy responses, none – to the best of my knowledge – has conducted studies on how political constraints influence policy-making amid the actual turmoil. Political

[8] Including Paul Krugman and Nouriel Roubini

[9] Lessons drawn from the bursting of Japanese asset bubble in 1990s and the Savings and Loans crisis in the US (Spilimbergo et al. 2008)

[10] Lessons drawn from Korean in 1997 and the Nordic crises in the early 1990s (ibid)

economy of fiscal stimulus deserve closer investigation – for past crises saw less eminent role of governments in implementing large stimulus as the only viable policy response. Discussing what factor motivates a series of unprecedented initiatives to rescue the financial sector[11] is beyond the scope of this thesis; however, for less could be said about political motivations than technical applications necessary to fixing the system. We therefore are interested in studying the second element of such policy package i.e. government measures to stimulate demands as it generates fruitful discussion on political factors that influence government decision-making. To contribute to existing research gap pertaining in the studies of this crisis, the following chapter proceeds to draw the patterns of fiscal stimulus efforts that are evident around the world.

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[11] '[e.g.] providing extensive liquidity, giving assurances to bank depositors and creditors that include blanket guarantees, structuring bail-out programs that include taking large ownership stakes in financial institutions, …, establishing programs for direct provision of credit to non-financial institutions' (World Bank 2009)]

CHAPTER 2

Characteristics of Economic Stimulus Package

Concerns over economic slowdown in the U.S. since early 2008 had sparked discussion among leading economists and world leaders especially those of advanced industrial countries for possible economic stimulus packages. Because financial turmoil has its deep roots embedded in the U.S., early initiations of such policy responses could be observed from this side of the Atlantic.

Initiation and Composition of Economic Stimulus Package:

The season of fiscal initiatives started after a contraction in the US manufacturing and equities slumped in mid January 2008[12]. Following such imminent sign of widespread economic slump, the White House under George W. Bush administration gained a bipartisan mood to use economic stimulus package to address such unstable economic conditions (Bryant and Mahmudova 2008). Debates over features of fiscal package contrasted the effectiveness of tax cuts with that of the spending measures. Research and lessons drawn from past recessions had convinced the U.S. House Budget Committee for increases in unemployment insurance benefits, state fiscal relief, food stamp payments, and targeted tax rebate as temporary measures (CBPP 2008). Apparently, this type of measures has been supported by Democrats while Republicans are usually pushing for a different set of measures emphasizing on tax cuts. But both parties were willing to compromise thanks to a sense of urgency perceived by both parties. Features of U.S. stimulus packages therefore consist of

[12] Refer to the Institute for Supply Management's non-manufacturing business activity index – the ISM index – in http://www.ism.ws

both tax measures as well as spending ones[13]. Otherwise, its stimulus would have suffered additional (decision) lags as a result of power struggle and partisan gridlock as evident during the past years of U.S. politics.

The spreading of financial and economic crisis from the U.S. to other parts of the world sparks unprecedentedly comprehensive policy responses in major advanced and emerging economies (Padoan 2009). By the first week of February 2008, equities markets around the world felt spillovers from economic recession in the U.S. where negative growth was evident for two consecutive quarters. Despite such threat, the Group of Seven leading economies (G7) had yet to response to the U.S. concerns over contagion effects. Having a wait-and-see attitude before drawing any lesson, they refused to take steps to strengthen their demand's components notwithstanding signs of deteriorating activity in the crucial service sector of the euro zone (Chris Giles 2008). They agreed; however, to further discussion on potential fiscal measures at the international Monetary Fund (IMF) meeting in the following quarter.

When the Bank of International Settlements (BIS) warned central bankers of the most serious economic crisis since the Second World War[14], the UK urged international community especially the G7 to ease strains in financial markets by demanding prudential regulation and disclosures from banks and financial institutions. The report from the Financial Stability Forum (FSF); which revealed the root causes of the crisis, helps to lower degree of uncertainties that surrounded the crisis[15]. It seems to generate confidence among policymakers wishing to follow the UK lead. In the context of this crisis, we may have just

[13] see more details on the composition of U.S. stimulus packages in UNDP 2009; ADBI 2009; www.usbudgetwatch.org/stimulus

[14] Letter from Malcolm Knight, General Manager at the Bank of International Settlements

[15] Summary of FRS report of April 2008 discussing the causes of the crisis is available at http://www.bankofengland.co.uk/publications/fsr/2008/fsrsum0804.pdf

witnessed stronger roles played by the group of policy entrepreneurs who are policymakers and institutions in the global financial regulatory system. Given the unknown consequence of 'do nothing'; FSF policy recommendations towards tighter capital standards and tougher supervision (Economist 2008b) on banks and financial institutions were well-received among major political leaders.

Despite the *technocratic* characteristics, such policy options failed to be ranked high on governments' agenda as political climates at the time had not opened the window for reforms but preferred 'quick' measures to halt economic deterioration at home. We then witnessed the Group of Seven finance ministers announced that they would rather monitor and respond in ways that are consistent with their domestic circumstances[16].

While further bailout measures had been implemented to stabilize the financial systems, short-term crisis containment strategies emphasize more on monetary stimulus and expansionary measures i.e. injecting liquidity into the system and slashing interest rates to counteract the credit crisis. But banks still did not lend to each other and growth prospects show no sign of improvement. As a consequence, governments started to cast doubt over the effectiveness of traditional monetary policy and its transmission mechanism to fix financial crisis. By the end of 2008, the needs for 'demand stimulating policy' become unavoidable as credit crisis spread from the financial sector and deeply embedded itself in a recession of the real economies around the world (The Irish Times 2008). Evidence of looming fiscal stimulus measures was then realized across advanced industrialized economies, and research has started to conduct studies on the size and composition of fiscal stimuli[17].

As for Europe; the European Council agreed on EU-wide economic stimulus of €200 billion in which 85 percent was contributed according to national plans. Although European

[16] Statement of G-7 Finance Ministers and Central Bank Governors on April 11, 2008 in http://www.mof.go.jp/english/if/g7_080411.htm

[17] See UNDP 2009; ADBI 2009; IMF 2009

fiscal policy response came later than other regions, it is notable that the ECB was the first major central bank to use monetary stimulus via liquidity injection to its banking system after the sub-prime crisis spread in the summer of 2007 (EC 2009, 65). Scope of the EU proposal for national stimulus is flexible in terms of the required composition which allows for differential impact of the recession in different countries (Saha and Weizsaecker 2009b; The Irish Times 2008). For 2009, the largest fiscal stimulus package - in comparison to the country's GDP - was implemented by Spain, followed by Austria and the UK. For 2010, Germany and Poland represent comparatively large fiscal stimulus packages (EC 2009). The geography and timing of the member states' stimuli reveals France and the United Kingdom were giving a lead while Germany had been heavily criticized for its contrariness in terms of timid cooperation reflecting in the size and timing of its responses in 2008-2009. Take the view of the region as a whole, 'the overall fiscal stimulus, including the effects of automatic stabilizers, amounts to 5% of GDP in the EU' (EC 2009, ii)[18].

While the UK was busy arguing whether to implement further stimulus package for fear of uncertainty over its effectiveness following the unexpected tax giveaways measure in May 2008 (Chris Giles 2008), the world saw Taiwan, South Korea, Japan, and even so in China take swift actions to unveil plans to boost their economies. Early attempts of East Asian governments to stimulate the economies in the second quarter of 2008 aimed to offset soaring prices, boost consumer confidence and calming investors (Kathrin Hille 2008; Song Jung-a 2008; Michiyo Nakamoto 2008). Japan's first package; however, was criticized not only for too little to generate significant impact on its growth but also misguided in the ways that could cause unnecessary fiscal burdens. Not to mention a high possibility that such measures would suffer from policy lags. Japanese urgent move onto demand stimulus policy had thus been regarded by the public as 'an attempt by the ruling LDP [Liberal Democratic Party] to

[18] Information as of September 2009

boost its public supports [amid looming election] than to stimulate real consumption or investment' (Michiyo Nakamoto 2008 p. 3). While the Japanese government faced criticism over its policy lacking substantial extra outlays, the UK took cautions over measures such as unfunded tax cuts for fear of 'Ricardian equivalence' effects[19] (Chris Giles 2008). Together with differing policy stance between Democrats and Republicans in the U.S. as mentioned earlier, debates over desirable features of fiscal stimulus packages have intensified.

Amid uncertainties regarding the characteristics of desirable stimulus, policy experts had advocated – having drawn from past lessons – for fiscal measures that are timely, targeted, and temporary (CBPP 2008). The Managing Director of the IMF further called for a sizable fiscal response at the global level with varying magnitude depending on crisis impact on aggregate demands (Spilimbergo et al. 2008). Studies undertaken by IMF staffs advocated for additional specifications of lasting, diversified, contingent, and collective stimulus policy (ibid). While it may be too soon to make policy conclusions or provide any assessment, consensus may have been reached in regards to appropriate composition. With a traditional view that spending has larger fiscal multiplier effect, many policymakers believe that economic stimulus should target investment spending than cut tax. However, given the current context characterized by macroeconomic conditions and phenomena not experienced in past decades, many have argued that policy configuration based on estimates of fiscal multipliers – or other existing economic models – may provide less reliable prediction of which instruments would be effective.

Research by Asian Development Bank Institute on the size and composition of fiscal packages in thirty one OECD members points out to significant cross country variations reflecting different national preferences and fiscal spaces available for maneuvering (Padoan

[19] suggesting that such policy has no effect on spending because the public expects future tax rises, and thus increase their savings instead of spend additional income

2009)[20]. Studies conducted by United Nations Development Programme (cut-off date in September 2009) look closely at 49 discretionary measures of fiscal stimulus packages worldwide (Zhang et al. 2009). It shows that more than USD653 billion out of USD2.4 trillion of the total fiscal stimulus around the world – one out of four percent of world's GDP in 2008 – go to social protection components[21]. This suggests that adverse impact of the crisis has triggered governments' supports to deter further poverty and vulnerability. It also marks evidence of grater role of governments in the area of social policy to mitigate the hardships of households, families and communities. Public expectation for such state's function has complicated policy-making task even further by increasing the number of stakeholders involved in a search for appropriate strategies.

[20] See more analysis on the size and composition of OECD members' fiscal packages e.g. cumulative impact over the period 2008–2010 on fiscal balances, Timing of packages, Relationships with the degree of openness, Impact on growth and fiscal sustainability, in (ADBI 2009)

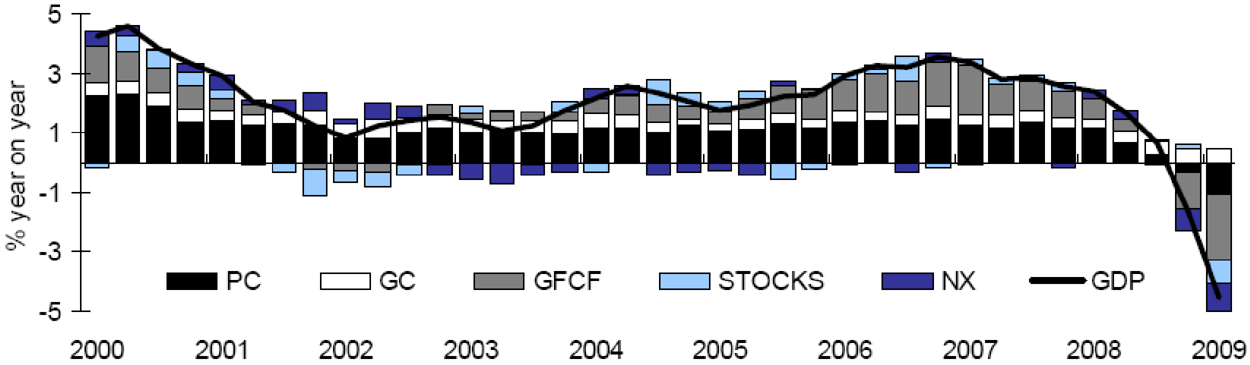
[21] Refer to 'measures taken in the areas of public education, health, housing, labor market policies, social services, both contributory social insurance programs and noncontributory safety net (social assistance) programs' (UNDP 2009, 4)

CHAPTER 3

Economic Stimulus Packages in France and Germany

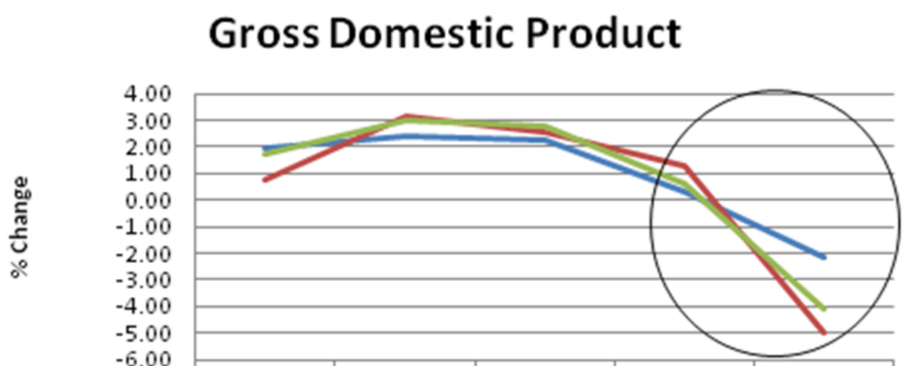
Financial crisis severely affected the euro zone countries especially its two largest economies – France and Germany – from the third quarter of 2008 onwards. According to the analysis of the European Commission (EC 2009), the effects of the crisis have been transmitted to Europe via three channels i.e. the connections within the financial system which lead to a large contraction in economic activity, the wealth and confidence effects on demand components, and the global trade channel which suffers from the unavailability of trade finance and activity previously stimulated by the force of globalization and global supply chains. The below diagram depicts deteriorating growth rates in the EU and composition of demand shocks. It points to the adverse impact of significant shrinkage in Gross Fixed Capital Formation (GFCF) in machinery, equipment and construction which characterize major industries in German and French economies. Not to mention a continuous declining in Net Export (NE); which is the main driving force of growth in many EU countries.

Quarterly Growth Rates in the EU



Source: European Commission 2009

Having faced the deepest recession since the World War II, France's Gross Domestic Products (GDP) shrank more than 2% in the first quarter of 2009 while Germany contracted almost 5% at the peak of the crisis before managing to creep out of negative growth zone in the second and third quarters of 2009. Such knock-on effects from the financial turmoil and global recession have worsened the purchasing power of consumers. Transmission mechanisms to such social impact include channels such as reductions in public and private transfers, changes in assets, limited accessibility to goods & services, and losses of job. As depicted in the diagram, unemployment in both countries was projected to reach double digits in 2010. Thus, social impact of the crisis seems to be more severe and prolonged than expected during the onset of the crisis.



	2005	2006	2007	2008	2009
France	1.94	2.42	2.26	0.32	-2.19
Germany	0.73	3.18	2.52	1.25	-4.97
Euro area	1.70	2.98	2.77	0.65	-4.09

	2005	2006	2007	2008	2009
France	9.30	9.25	8.33	7.88	9.39
Germany	9.14	8.10	8.33	7.24	7.44
Euro area	8.97	8.37	7.49	7.55	9.41

Source: World Economic Outlook Databases April 2010, IMF

In response to the adverse impact of global crisis, the two governments announced their first fiscal stimulus in November 2008. Features of policy package were designed to accommodate the severity and complexity of global crisis as reflected in the above macroeconomic indicators. We examine in more details their announced policy packages in supports of the proposal endorsed by the European Council under the European Economic Recovery Plan (EERP). As fiscal stimulus is an on-going phenomenon contingent upon the state of economic recovery, the cut-off date for information gathered in this thesis is 22 April 2009 – inline with one of our main secondary sources; Saha and Weizsaecker (2008. 2009a, 2009b). Their most recent research captures the characteristics of 2008 to end 2009 stimulus packages in the EU member countries. It is notable that the measures included in their analysis were the ones adopted after September 2008 and expected to take effects by end of 2009. Such effects are categorized under additional spending disbursed, foregone tax revenue, and extra credit and economically similar measures (5).

The Size of the Stimulus Package for 2009

Country	GDP current price, as of 2009	Tax cuts & fiscal expenditures		Extra credit & similar measures	
	€ bn	€ bn	% of GDP2008	€ bn	% of GDP2008
Germany	**2,407.200**	**39.30**	**1.50%**	**70.30**	**2.80%**
France	**1,921.252**	**16.90**	**0.90%**	**41.50**	**2.10%**
United Kingdom	1,777.240	22.60	1.40%	23.30	1.40%
Italy	1,520.870	-0.30	0.00%	0.00	0.00%
Spain	1,051.151	12.30	1.10%	54.30	4.90%
Netherlands	570.633	6.10	1.00%	0.30	0.10%
Belgium	337.737	1.20	0.40%	2.10	0.60%
Sweden	329.988	3.80	1.30%	8.80	3.00%
Austria	274.182	3.90	1.40%	2.50	0.90%
Denmark	251.700	0.00	0.00%	0.00	0.00%
Greece	237.494	0.00	0.00%	23.00	0.90%
Poland	163.595	1.60	0.50%	5.00	1.60%
Ireland	163.542	0.00	0.00%	0.00	0.00%
13 largest EU economies		107.60	0.94%	231.20	2.00%
Imputed EU-27 total		120.30	0.94%	258.60	2.00%
European Commission Package		9.30	0.07%	15.50	0.10%
Imputed grand total		**129.60**	**1.01%**	**274.10**	**2.10%**

Source: Saha and Weizsaecker 2009; World Economic Outlook Database (IMF), April 2010; Author's own computations

As of second quarter of 2009, German and French stimulus packages stood at 109.63 and 58.40 billion Euros respectively. Stimulus from these two countries make up of more than 168 billion Euros or more than 43 percent of the imputed grand total of the European stimulus. Together with Spain and the UK who unveiled another 112.50 billion Euros, the four largest economies generates almost 70 percent of the whole pact. However, there is no clear evidence that the size of GDP signals how large the stimulus would be. Greece, for example, is the 11th largest economy in the Euro zone but its stimulus package was ranked the fifth in terms of size. On the contrary, policy response of the fourth largest economy; Italy, aims instead at marginal fiscal consolidation. Problems associated with the Southern European governments' budget deficit over-run suggest that one factor which influences the size of fiscal stimulus may be related to the size of government budget deficits. Analyzing the size of fiscal space should provide more convincing explanation to the varying scale of stimulus package than looking only at the size of the economy. We examine those figures in the following chapter.

Comparison of French and German Stimulus

by spending category for each update[22]

<table>
<tr><th rowspan="3">Category of Measures</th><th colspan="4">Germany</th><th colspan="4">France</th></tr>
<tr><th colspan="3">Billion Euros</th><th rowspan="2">April 2009 packages as % of GDP_{2008}</th><th colspan="3">Billion Euros</th><th rowspan="2">April 2009 packages as % of GDP_{2008}</th></tr>
<tr><th>December 2008 Update</th><th>January 2009 Update</th><th>April 2009 Update</th><th>December 2008 Update</th><th>January 2009 Update</th><th>April 2009 Update</th></tr>
<tr><td>Additional fiscal spending:</td><td>14.81</td><td>35.83</td><td>39.33</td><td>1.55%</td><td>14.30</td><td>14.30</td><td>16.9</td><td>0.8%</td></tr>
<tr><td>Additional credit and similar measures</td><td>21.80</td><td>70.30</td><td>70.30</td><td>2.76%</td><td>52.70</td><td>41.45</td><td>41.45</td><td>2.08%</td></tr>
<tr><td>Total</td><td>36.61</td><td>106.13</td><td>109.63</td><td>4.31%</td><td>67.00</td><td>55.75</td><td>58.35</td><td>2.88%</td></tr>
</table>

Source: Saha and Weizsaecker 2009 and Author's own computations

The above table represents an attempt to compare the total German packages for 2009 to that of the French government. It reflects different patterns and emphasis on each category as the magnitude of severity of the crisis revealed itself over a five month time horizon. 'April 2009 update' column in the table indicates the most recent updates of stimulus packages for each category[23]. Following public announcements of additional stimulus package and other amendments in early 2009, we saw a large surge in the size of German stimulus as a result of its second package – Konjunkturpaket II – announced in January 2009 followed a first (modest) package of measures in November in 2008. We also see changes in the composition, and thus the size, of the French stimulus as a result of its new social package worth around 26 billion Euros announced in February 2009. What can be quite noticeable from analyzing

[22] Incorporate information from previous two versions of estimates made in December 2008 and January 2009

[23] They are not; however, to be summed up with the December and January version of estimates

newspapers and articles is the intense irritation in the French government – as well as those of the UK, the U.S. and Japan – at German's reluctance to launch larger stimulus packages. Although German officials responded by pointing to some thirty plus billion euro package it first launched in 2008, economists argued that, over 2 year period, it is worth only a third of its numerical figures (Hall 2008). This makes us realize that fiscal stimulus package can be a political matter as much as an economic one. The release of additional stimulus or amendment to existing package demonstrates discernable pattern that may constitute political explanation, and thus deserves closer investigation.

Stimulus packages as % of 2008 GDP of each country not only vary in size but also in their composition. Notice that German packages utilize all available spending measures while French package relies very little on tax revenue measures[24]. For in-depth analysis of factor(s) influencing the design of these stimulus packages, it is necessary to look beyond the above headline figures and not only the size of aggregated measures. This is because the size of stimulus packages signals only the available fiscal room for policy maneuver. The following tables entail composition of stimulus packages announced by each government.

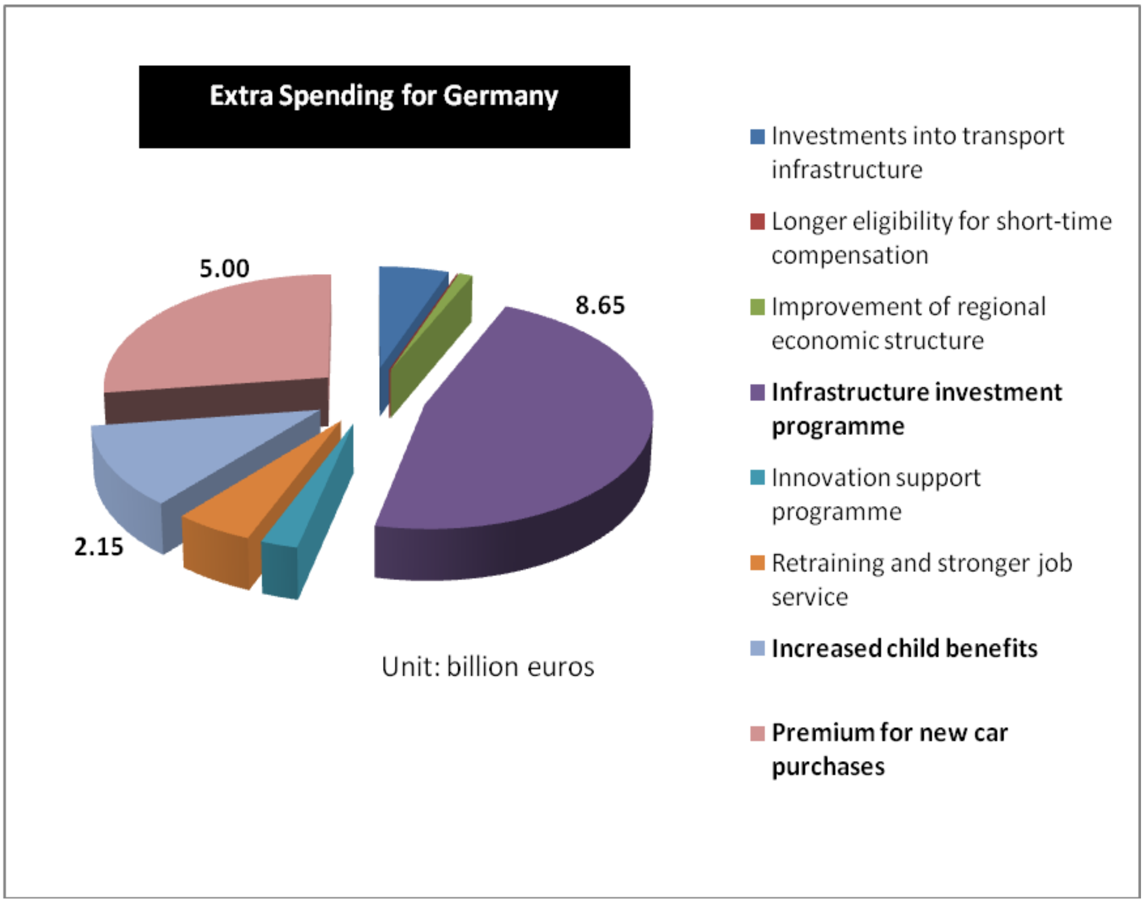
Composition of German Stimulus Packages:

Measure	**Billion Euros**
Tax Cuts	**20.94**
Degressive depreciation deduction	1.94
Higher tax-free allowances for companies	0.24
Suspension of car tax on new vehicles including an extended car tax holiday	0.44
Tax deductibility of professional commute	5.00

[24] According to the studies, 'additional fiscal spending [– both on and off budget –] and foregone tax revenues [tax cuts] are treated as commensurate' (Saha and Weizsaecker 2009, 5)

Package for tax burden reduction, stabilization of social security contributions and investment in families	6.00
Income tax cut	2.90
Reduction in health insurance contributions	3.00
State payment of 50% social insurance for short-time workers	1.25
Reform of car tax	0.17
Extra spending	**18.40**
Investments into transport infrastructure	1.00
Longer eligibility for short-time compensation	0.00
Improvement of regional economic structure	0.20
Infrastructure investment programme	8.65
Innovation support programme	0.45
Retraining and stronger job service	0.95
Increased child benefits	2.15
Premium for new car purchases	5.00
Extra credit + similar measures	**70.30**
CO2-friendly renovations of houses	2.80
Additional credit for SMEs	15.00
Credit for infrastructure investment by municipalities in structurally disadvantaged regions	1.50
Corporate innovation and energy efficiency credit	1.00
Additional guarantees and credit lines for larger enterprises	50.00

Source: Saha and Weizsaecker 2009



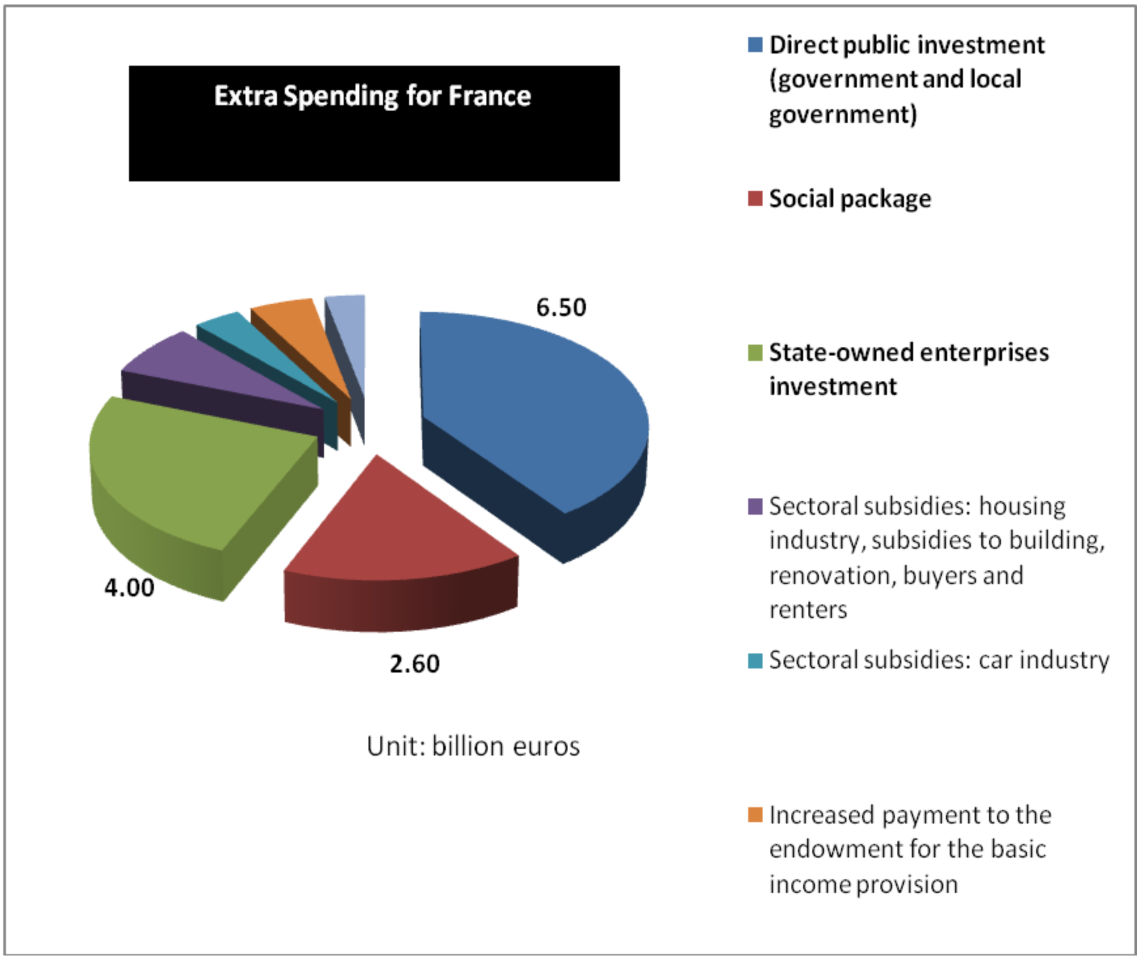
Source: Author's own computations

From the above information, German package represents a mix of policies attempting to boost domestic spending. These measures include tax and health insurance reduction to support households, infrastructure spending to prop up construction industry, scrappage program providing $2,500 per unit environmental premium to stimulate the automobile industry while removing inefficient/ high emissions vehicles (Campbell 2009). Social security contributions make up the largest measure in tax cuts category while infrastructure investment accounts for almost half of the extra spending measures as detected in the above diagram. The biggest portion (50 percent) of the whole hundred-billion-euro stimulus is set up as additional guarantees and credit lines to rescue large enterprises

Composition of French Stimulus Packages:

Measure	Billion Euros
Tax cuts	**0.70**
Reduced obligation to contribute to social insurance conditional on new hiring, for very small firms	0.70
Extra Spending	**16.20**
Direct public investment (government and local government)	6.50
Sectoral subsidies: housing industry, subsidies to building, renovation, buyers and renters	1.20
Sectoral subsidies: car industry	0.60
Increased payment to the endowment for the basic income provision	0.80
Employment policies	0.50
State-owned enterprises investment	4.00
Social package	2.60
Extra Credit + Similar Measures	**44.70**
Credit for PPP projects	8.00
Loans and guaranteed loans to SMEs	22.00
Loans to social housing construction	4.50
Faster implementation of research tax credit and profit tax reimbursement	5.60
Change of VAT reimbursement mechanism	3.60
Higher down-payments on public procurement projects	1.00

Source: Saha and Weizsaecker 2009



Source: Author's own computations

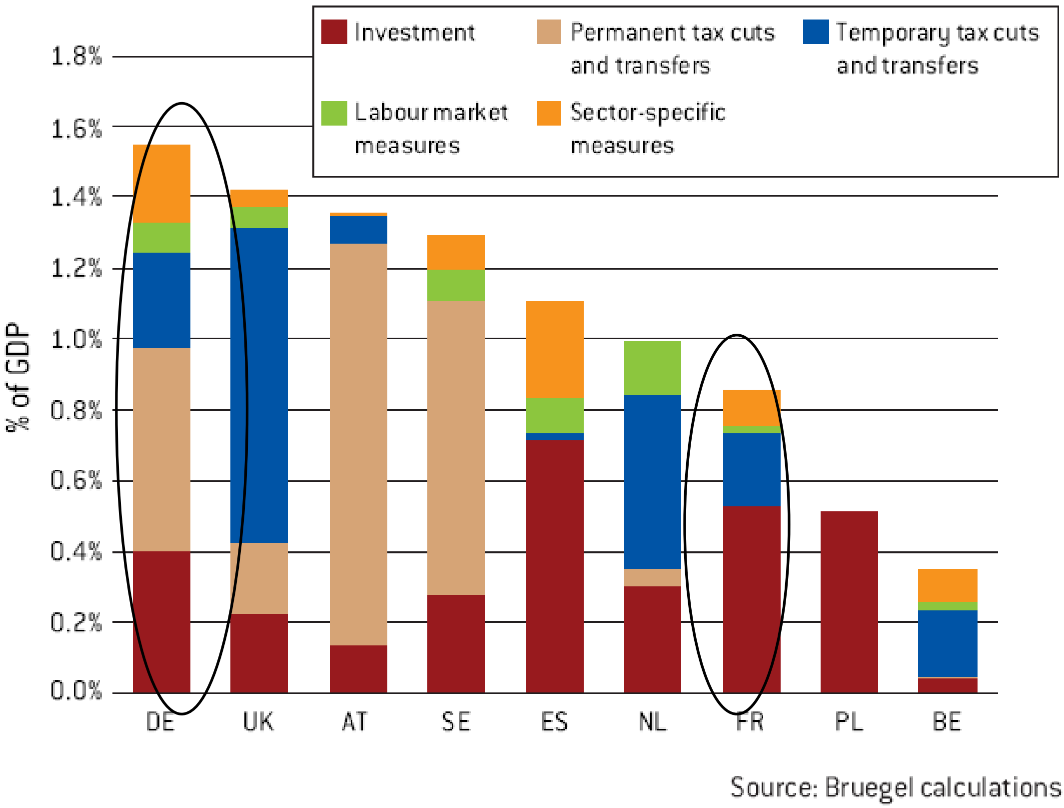
When President Nicolas Sarkozy unveiled a 26 billion euro stimulus plan in December 2008[25], France found herself among one of the leading EU countries to offer state supports in boosting its economy. In addition to a 26 billion euro plan, the government also sets aside sizable extra credits and loans to its SMEs sector. This version of stimulus costs roughly 2.8 percent of its GDP and heavily emphasizes on investment into infrastructure projects, sustainable development, higher education and military industries (The New York Times 2008). According to the diagram, large amount of extra spending goes to targeted aids including subsidies to the automotive industry – scrappage scheme with similar characteristics to that of the German. The main difference is a penny-pinching support in the form of tax cuts

[25] Read more details about the announcement in (Gauthier-Villars 2009)

which is worth less than a billion euro. It may be foreseeable; however, that the French package would lack tax measure given the fact that Germany had already launched sizable tax cuts months earlier. As hinted by Ms Merkel that EU stimulus would entail 'a common response with different instrument' (Hall 2008); coordinated tax cuts should not be part of the European stimulus.

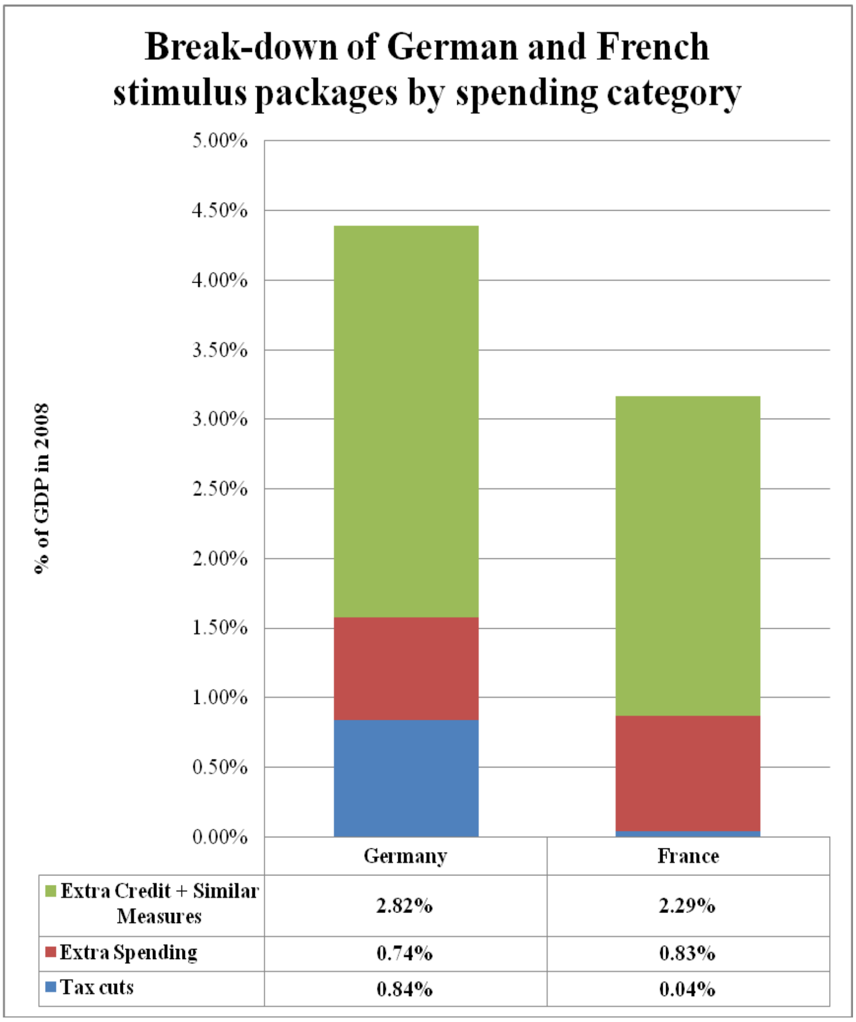
Break-down of French and German stimulus packages by spending category[26]

: As of December 2008



[26] Due to different methodologies used to categorize spending measures between the December and the April version of estimates, graphical illustrations may not be appropriate for direct comparison.

: As of April 2009



Source: Saha and Weizsaecker, April 2009 and Author's own computations

In sum; despite the commonalities between France and Germany in terms of macroeconomic settings and the effects of the crisis, differences in the timing of announcement, composition and scale of measures are quite detectable. In order to provide fruitful explanation of such differences in the realm of political economy, we need to focus on the dynamics of policymaking in each country over a time horizon – bearing in mine the initial policy plans made during earlier period. This is where we now turn.

CHAPTER 4

Broad Patterns in Designing Economic Stimulus Packages

A generalized fiscal policy response to the 2008 global economic crisis around the world lends itself to the packages initiated in the context of the advanced economies where effects of the fall in private sector demand are replaced by public sector expenditure. Economic model of rational decision-making under imperfect information setting which account for the effects of surprise and urgency (Congleton 2005) proves to provide partial explanation to policy reactions described in the previous chapter. He suggests that urgency and surprises (or uncertainties) are essential elements that influence crisis management. Take the U.S. as our first and foremost observation. Given the political history of the previous year characterized by a divided government with Democrats' control of the Senate and Republicans held control of the House of Representatives; academics opined[27] that stimulus proposals provided no assurance that the Senate would approve the bills.

However, the sense of urgency and severity of recession had somehow created a mood in Washington for 'action, bold, and speedy' (the Economist 2008a). Couples with uncertainties over the full impact of the crisis; both Democrats and Republicans had compromised and finalized the composition of stimulus packages. Such evidences of national unity, which surprised many people, may be understandable given proper consideration in the realm of rational and political behavior. In the context of the current crisis, there is a 'high propensity for making policy errors' (Congleton 2005) due to the environment that characterizes imperfect information. This may have triggered consensus-building form of decision-making in both parties for fear of getting blamed for severe economic downturns and

[27] prior to U.S. Congress's endorsement of its first stimulus package in January 2008

failing businesses in the face of their 2008 election. This have resulted in, as I shall argue, the 'politically desirable' features of stimulus packages implemented by both administrations[28], though less could be said back then about the effectiveness of those measures in preventing full-scale crisis.

As economic stimulus go international, the wait-and-see attitude seems to explain the timing of the stimulus in most countries especially those who are less integrated with troubled financial markets of the U.S. and the European. Since crisis proved even more complicated and difficult to anticipated, policy decision-making also requires the contributions from the epistemic communities[29] (Hall 1993), mainly from economists and financial supervisors, for their technical analysis and policy advice. As discussed in the previous chapter, policy reactions from governments of major economies came only after comprehensive discussions over the causes of the crisis at the international forums. As a consequence of high degree of uncertainties surrounding the crisis, affirmation by a group of experts is needed to anchor political commitment for further steps towards policy implementation.

Following clearer signs of widespread economic deterioration and policy recommendation from international community – i.e. policy parameter perceived to be appropriate for this crisis – we have witnessed greater political influences in the designing of economic policies. At the domestic level, politicians now have a powerful excuse to maneuver their traditional policy tools towards spending more of public resources. Benefits then include double dividend of stimulating growth and gaining political supports – as evident in the attempts of the U.S. and Japan. At the international level, the spillover effect of expansionary stimulus implies greater roles of large economies with sufficient fiscal spaces to contribute to global recovery. However, experts have argued that such characteristics of

[28] This describes stimulus packages announced in 2008 and 2009 by The Bush and Obama administrations.

[29] More on central bankers as the epistemic communities in (__)

stimulus policy viable in the context of open economies may be discouraging to countries with high degree of trade openness (Spilimbergo et al. 2008). There are some concerns that such policy packages would not be effective to boost domestic demand but result in deteriorating trade balance instead[30]. Thus, analysis made in the context of political economy – weighing between effectiveness of fiscal efforts of individual countries and collective ones – provide important implication for cooperation efforts to combat the crisis at the international level (ibid).

General patterns of crisis policymaking also unveil another cross-national concern regarding the sustainability of public finances following a big loosening of structural fiscal policy, and thus making the pursuit of such policy a costly course of action. Institutional constraints in the context of medium-term fiscal sustainability; which has become applicable to many countries, can explain why such pattern can be observed. In violation of such fiscal practices, there is a high possibility for adverse effects on financial markets once a country demonstrates sign(s) of unsustainable debt situation (Spilimbergo et al. 2008). The case of Greece's fiscal crisis in 2010 has triggered not only the risk of sovereign default but also the instability of fixed exchange rate system – the euro[31]. The threatening consequence of unsound public finances may deter not only the effectiveness of stimulus announced but also the prospect of fiscal consolidations in the future.

[30] In line with lessons drawn from France during 1975 and 1981 when transfers to household and private sectors saw big surge in imports, fuelled inflation and wrecked public finances. (Hall 2009)

[31] Read more about Greece's fiscal crisis in CNN (2010)

CHAPTER 5

Explaining the Case of France and Germany

Framework for investigating cross-country patterns of policymaking in the time of crisis can be drawn from the contribution of Grindle and Thomas (1991). They argue that the modality for such decision-making depends on the nature and the context of problem which in turn determines particular reform strategies. There are four aspects of the crisis which determine the pattern of national and bureaucratic responses; be they the degree of threat to regime stability, the degree of dependence on technical solution, the degree of it spillover effects, and the continuity of the problem as a crisis[32]. This framework needs to be examined on a case-by-case basis, and thus makes the analysis country-specific which is suitable to our empirical cases. Fritzen (2008) adopts this framework in a cross-country comparison of crisis decision-making by Southeast Asia governments, and studies how crisis types interact with the characteristics of country's governance to shape policy decision-making. The cost-benefit analysis associated with each aspect of the crisis forms the basis for identifying winners and losers, as well as the distribution of losses and benefits of policy strategies (World Bank 2008).

Another useful framework pioneered in Grindle's 1996 book discusses three categories of state capacities which provide strategic approach to crisis management. It allows us to investigate how state capacities shape policy configurations across countries. Such analysis can provide important implication for effective decision-making, as well as desirable governance[33]. The first capacity is related to political and leadership capacities of individual

[32] Conceptualized in Fritzen (2008)

[33] It is notable that the concept of governance covers all aspects of policy-making for it refers to 'the exercise of political authority and the use of institutional resources to *manage society's problems* (author's own emphasis)

or of the whole political system including party system. This refers to capacities to set agenda and to direct attention (of the public and relevant political actors) to a problem ‘in a manner that shape how crisis is perceived’ (Fritzen 2008, 70)[34]. Second capacity belongs to existing bureaucratic and process capacity in managing high-quality decision-making processes amid the actual turmoil and executing decision(s) taken professionally[35]. Effective crisis management therefore relies on well-functioning institution(s) with adequate resources to implement the agreed strategies in a timely manner. The last capacity is related to (political) supports from the public including various interest groups and grateful constituents. The degree to which they are willing to cooperate with the government on a particular policy matters dramatically as it signals smooth implementation. Such aspects of state capacity are important not only to explain variations in policy options from one country to another but also to provide necessary conditions for effective policy implementation. The analysis of stakeholders and institutional impact on decision-making ; a toolkit developed by Grindle (1996)[36], facilitate us a great deal in examining the importance of the Economic and Monetary Union (EMU) as well as other political constraints external to national politics in the designing of policy response.

The above political economy models of analysis are crucial to our investigation into the impetus and motivation of political agents in choosing among various policy options – including the timing, the size, and the composition of stimulus package. Focusing on the context of the crisis, the following discussion examines how governments of France and

and affairs, or the use of institutions, structures of authority and even collaboration to allocate resources and coordinate or control activity in society or the economy’ (ILO 2006, 72).

[34] the ability to provide appropriate problem definition which is country-specific

[35] ibid

[36] See (Nash et al. 2006)

Germany[37] identify problems associated with the global crisis, and analyzes – using cost/benefit analysis – how such perceptions lead to certain policy direction(s). Such problem definitions are then analyzed in conjunction with state capacities and institutional constraints to determine similarities and differences in the patterns and characteristics of actual policies implemented.

Degree to which a crisis threatens regime stability:

Threat to regime stability can be an indirect consequence of economic and social impact of the crisis. They can be expressed in terms of political uprising or unsatisfactory election results e.g. higher chance of incumbents losing the next election. The severity and likelihood of such threat can be analyzed in accordance to the degree of adverse impact of the crisis[38]. The impact of the crisis determines the extent to which citizens shift their political supports by mean of voting for opposition parties, or create significant political changes. Thus, political cost to incumbents can be measured in terms of reduction in economic growth and business sentiment, declining purchasing powers, as well as rising unemployment. Negative consequences of such economic hardship and widening inequality could potentially cause political instability and social unrest. When regime and incumbents are threatened by the consequences of the crisis, strategic approach for decision-making then suggests that the political calculus of senior officials is needed (Fritzen 2008).

Following such arguments, government's response to the crisis should therefore be contingent upon leader's perception of the severity of the crisis. Base on cost/benefits analysis, government who acknowledges looming threats of prolonged and severe recession tends to react immediately and forcefully in order to minimize or avoid the worst consequences associated with such unpleasant phenomenon – and therefore prevents large-

[37] it also includes some other countries in the discussion for better illustration

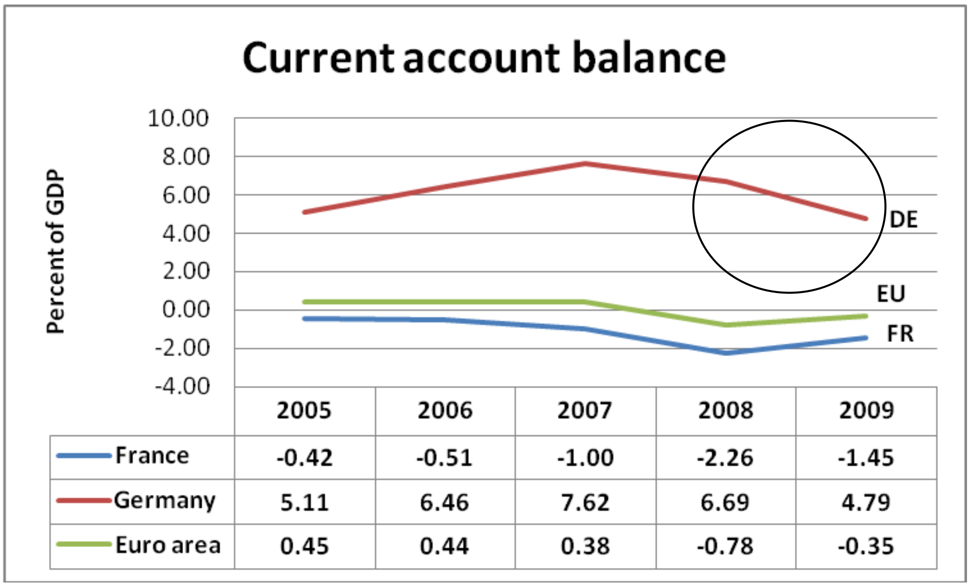
[38] which has received widespread media interest and scholarly publications, fortunately

scale impact and political instability. Such line of arguments may help explain variations in the timing, size, as well as emphasis of stimulus packages. Governments facing looming elections such as the U.S. and Japan in 2008 had reacted swiftly by announcing stimulus policies partially in attempt to re-gain public supports before the elections. On the other hand, the German government led by Angela Merkel not only show sign of reluctant but also announced relatively small stimulus package in 2008 despite its large current account surplus and healthy public finances[39]. Germany was heavily criticized[40] for its timid effort in boosting its demands (and that of its neighbors).

However, having faced a tight election in September 2009, Merkel's centre-right coalition government changed their stance in light of the severity of the crisis, and decided to draw up strategic policies to prop up the economy and secure their political supports. According to Federal Statistics Office, economic data shows that German exports dropped for a fourth consecutive month in January 2009 - more than 20 percent down compare to January 2008 - which pulled down German industrial production by more than 7 percent. While companies reduced investment and household spending remained flat, there had been a significant deterioration in labor market conditions. The below diagram illustrates a decline in German current account surplus, surpasses its 2005 level, as a result of a sharp drop in export and small change in import.

[39] Indicators to fiscal prudence which allow room for policy maneuver

[40] See The Economist (2008_November) for more details



Source: World Economic Outlook Database (IMF), April 2010

The government therefore made the announcement of the second stimulus package – a huge wave of emergency spending, biggest in its history, as government officials claimed. It also spent more than 1.5 billion Euros a few months later in rescuing carmakers, the Opel marquee (a manufacturing company with four large plants), in order to secure thousands of jobs (Financial Times 2009). Given potential political cost and sense of urgency; the government has powerful reasons to provide additional supports to its automotive industry which employs more than 745,000 people (Invest in Germany 2008) – almost 2 percent of its labor force. It is not surprising that the government announced not only large but also sector-targeted stimulus package to counter-act the impact of recession, and thus deter any political threat.

In the context of parliamentary system as in Germany, party politics plays a crucial role in shaping the elements of policy package. Economists opine that the second stimulus package represents 'the work of the grand coalition' (Benoit 2009) between the Christian Democratic Union (CDU), The Christian Social Union (CSU) and the Social Democratic Party of Germany (SPD). Policy package characterizes a fine balance covering all relevant areas as an effort to please the coalition's various camps; from consumption- boosting measures (of low-tax conservatives), long-term investments (of public-spending advocates), sector-specific measures (of economic-nationalists) (ibid), to 20 percent of the whole package for revenue measures (of tax-cutting activism). Such a comprehensive combination – which includes bigger-than-expected tax measures as a concussion to the CSU – was criticized by experts that the political considerations may have blunted its effectiveness in addition to the usual problem of policy lags.

In France, the president Nicolas Sarkozy, faced the threat of a widespread anti-government protest movement by striking workers and public sector workers including students for lacking measures to support household consumption in his economic stimulus plans (Hall 2009). Facing tough political challenge, Mr Sarkozy exercised his political leadership by going on national television in defense of his investment-led stimulus package while attempting to persuade the public that he can live up to his promises of providing greater prosperity for French citizens. Adverse impact of the crisis along with the public outcry over their leader being dogmatic in excluding household sector from state relieves had caused his approval ratings to fall five percentage points in February 2009, according to a French polling agency (Gauthier-Villars 2009). Unless he manages to prop up stronger public supports, Mr. Sarkozy could face a rising political resistance coming from the New Anti-Capitalist Party (NPA) which has emerged as a leading opposition to the new president, according to media analysis (ibid). This may be the reason why we see the latest version of French stimulus covers €2.6 bn of social package; in below table – added only a few months after the first proposal in December 2008 – as an attempt to mitigate social impact due to shortage in tax relieves. But his main goal could be to shore up declining political supports.

Labour market and social protection measures in France and Germany's Stimulus

Category of Measures	France	Germany
Improving job placement and investing in re-training	×	×
Reinforcing activation	×	×
Supporting household purchasing power	×	×
Supporting employment by cutting labour costs	×	×
Encouraging flexible working-time	×	×
Mitigating the impact of financial crisis on individuals	×	
Maintaining/reinforcing social protection	×	
Enhancing education and life-long learning		×
Others	×	

Source: European Commission, the information included up to 31 March 2009

Under such threatening circumstances, strategic approach to crisis policy-making and management requires political and leadership capacities. The above discussions have demonstrated that the threat of the crisis and how it was perceived by (the group of) decision-makers determine the pattern of policy-making and the content of policy responses in ways that suit existing political systems. The more accurate analysis of the impact of the crisis, the more appropriate policy reaction, and the greater the influence in shaping public reaction. Party politics matters as much as political leadership of an individual leader. However, one observation into types of democratic institutions suggests that presidential system may achieve timely decision-making given stronger presence of the nerve center for policy decision-making dynamics. As oppose to consensus democracy where the power of head of government (or chancellor in the case of Germany) is fused with the power of the majority group in the parliament; policy-making thus requires times to allow coalition parties to make compromises and other negotiations.

Such analysis therefore suggests that; the higher the greater the adverse impact of the crisis, the higher the political cost to incumbents. Patterns in policy decision-making would depend on the characteristics of political institutions that exist – which in turn influence the timing and composition of policy package.

Degree to which a crisis requires technical solution:

High level of technical complexity associated with identifying problems and implementing policy solution implies that the effectiveness of decision-making would be influenced largely by the bureaucratic capacities that exist in the system (Fritzen 2006, 69). Under such context – which characterizes the global crisis – bureaucratic quality is likely to determine the cost of pursuing a particular policy direction. This requires us to explore the nature of global crisis, and evaluate how much the analysis relies on technical expertise before the root causes and possible solutions can be identified. For the advanced industrialized countries like France and Germany, bureaucracy can be regarded as being rule-governed, transparent, and conformable with norms of professionalism and honest behavior (Evans and Rauch 1999). Such qualities enable predictability and calculability of decisions (Weber 1988 p. 321) which help lower transaction costs, and thus encourage effective decision-making process. Such effectiveness should then add to speeding up the time required to make policy decision with possible minimum error.

In our comparative cases, France and Germany share the same market and regulatory institutions under Economic and Monetary Union (EMU). Transaction cost involved in making policy decision cannot differ significantly between the two countries. Theoretically, with capable bureaucrats evident in both countries, we should observe predictable, perhaps less controversial and timely policy decisions from both governments. However, this is not the case as the differences in policy packages in both countries – especially the size and the timing – are quite detectable. It may be possible to suggest that effectiveness in decision-making may not be so relevant in the context of this crisis. This brings us to another conclusion that; by comparing France and Germany, bureaucratic capability cannot explain variation in policy-making for crisis of such nature.

One potential explanation for German government's reluctance to launching fresh measures may be regarded as resulting from the uncertainties surrounding the effectiveness of its initial stimulus package. Such ambiguities and policy puzzles are rooted in the multifaceted economic and political geographies of globalization – making an assessment of any measure a daunting task as policy outcome could go undetectable. It also explains, to a large extent, any delayed decision-making of the EU countries as evident when the German chancellor warned others against acting with 'haste' (Hall 2008).

Ms. Merkel was retraining further fiscal maneuver not only to wait for the existing measures to work its way through the economy, but also to be able to respond *strategically*[41] to the package due to be announced by the U.S. government in the coming month (Hall et al. 2008). Such reaction has unveiled the (positive) externalities or spillover effects associated with economic stimulus, and thus making the designing of policy response even more complicated[42]. Research of ADBI suggests that 'the degree of economic openness [measured by imports/(GDP – imports)%]...magnifies the spillover effect of fiscal stimulus...'(Padoan 2009, 3). Therefore, a *big-enough* stimulus in the U.S. would benefit the world, and boost up German exports automatically without its [German] government having to toss around billions and risks future debt crisis. Governments of large economies with available fiscal space – including Germany – have been under pressures to take greater responsibility to ensure the effectiveness of (global) stimulus. On this point, French government certainly faces less criticism given its unfavorable fiscal prudence than the German. We are not to suggest

[41] Author's own emphasis

[42] 'the greater the spillover effect, the more outcomes will be shaped by the effectiveness of regional forms of cooperation and by differentials in power between states' (Fritzen 2008, 69)

that French policymakers and politicians do not have to assume such responsibility. After all, problem has become global crisis with unique nature and complexity, and therefore requires international cooperation efforts to address its impact.

Slow and timid government response may earn it plenty of criticism for having politicians who were 'oblivious of the seriousness of the crisis' (Surowiecki 2009) due to the effect of uncertainties. But we could also attribute such reluctance to a high technical complexity of the issues at hand, as well as the dynamics of international politics.

The above arguments emphasize how important it is to have a well-functioning state with adequate resources (both institutional and financial capacities) to deal with the crisis. On this point, France and Germany may posit some differences; notably economic and political ideology and fiscal capacity to administer the crisis.

Economic and Political Ideology:

The same economic crisis may mean different thing to different people. Patterns of economic policymaking depend largely on state administrations. The fact that policies of the French are closer to measures adopted by the German than the British[43] signals the differences between 'Anglo-Saxon' versus 'European Social' models of European economies. But given similar economic fundamentals between France and Germany, any other dissimilarity in the pattern and content of stimulus should therefore reflect different political tastes and desired goals.

As pointed out by some analysts[44], Germany's caution over big stimulus reflects an important attitude toward concepts such as debt and inflation. The government believes that ballooning deficits and public debt deters the functioning of national automatic stabilizers and

[43] refers to a cut in VAT which is ruled out by both German and French governments

[44] See more in (Surowiecki 2009)

triggers insolvency. Economist suggests that expansionary policies could lead to inflation as extra spending overheats the economy. But for the Germans, their concern over inflation stems from the legacy of hyperinflation episode in 1923 when prices rose more than seventy-five billion percent in one year (Surowiecki 2009; The Economist 2009). We therefore witness a dominant role of Germany advocating for various institutional frameworks to deter excessive public spending among EMU members in order to preserve the price stability goal.

The French President Nicolas Sarkozy; on the other hand, has been heavily criticized (perhaps more from the outsiders) for showing his protectionist instincts. But it may be the character shared by the two leaders, unfortunately. This can easily be detected by looking at the content of stimulus packages of both governments as detailed in previous chapter. The major components are targeted aids to sectors like automotive and construction which hire a great number of local employees. Sarkozy's protectionist tone voices out louder than that of Ms Merkel whose anti-liberal position was watered down by various political camps in her coalition. As a president exercising his political leadership, Sarkozy made a bold statement in front of other EU leaders – causing furious reactions:

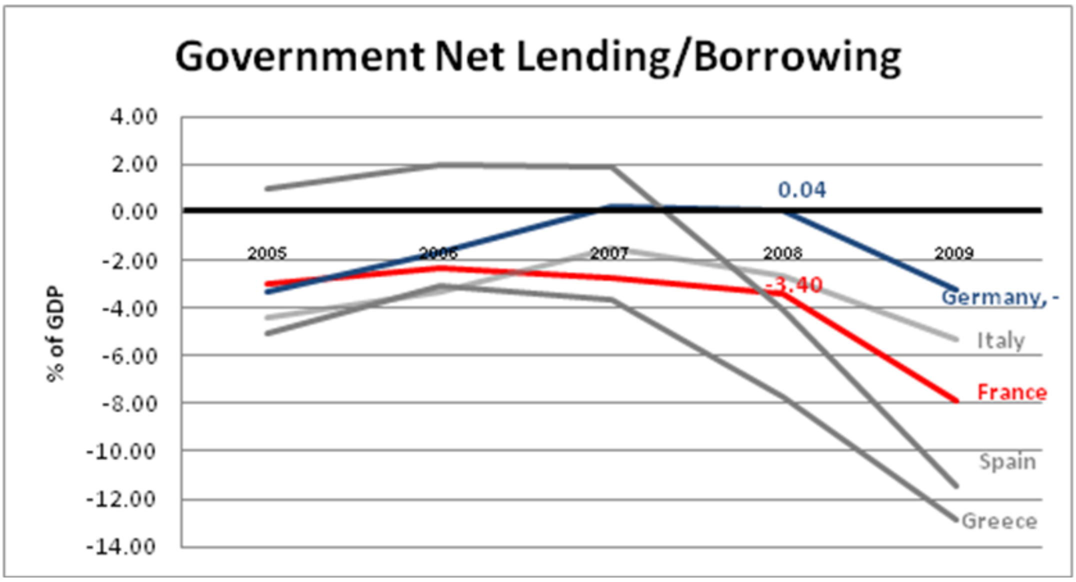
> *'We want to stop moving factories abroad, and perhaps we will bring them back. If we are to give financial assistance to the auto industry, we don't want to see another factory being moved to the Czech Republic.'*
>
> (Nicolas Sarkozy; cited in Muenchau 2009)

Sarkozy's conspicuous support for fresh stimulus plan in late 2008 makes a distinct difference between French and German ideologies – apart from their shared protectionism. The president had continuously urged countries to table their stimulus packages by playing a 'backseat role in coordinating the bloc's economic response' (Hall 2008) – which is in contrast to Ms Merkel's policy stance. But after realizing the affordability of his government and a looming threat from unsound fiscal position, Sarkozy's stance has shifted to stand beside Ms Merkel and resist fresh stimulus plans (The Economist 2009). This observation brings us to a second element of state capacities which determine how feasible it is to implement those ideologies.

Fiscal Capacity:

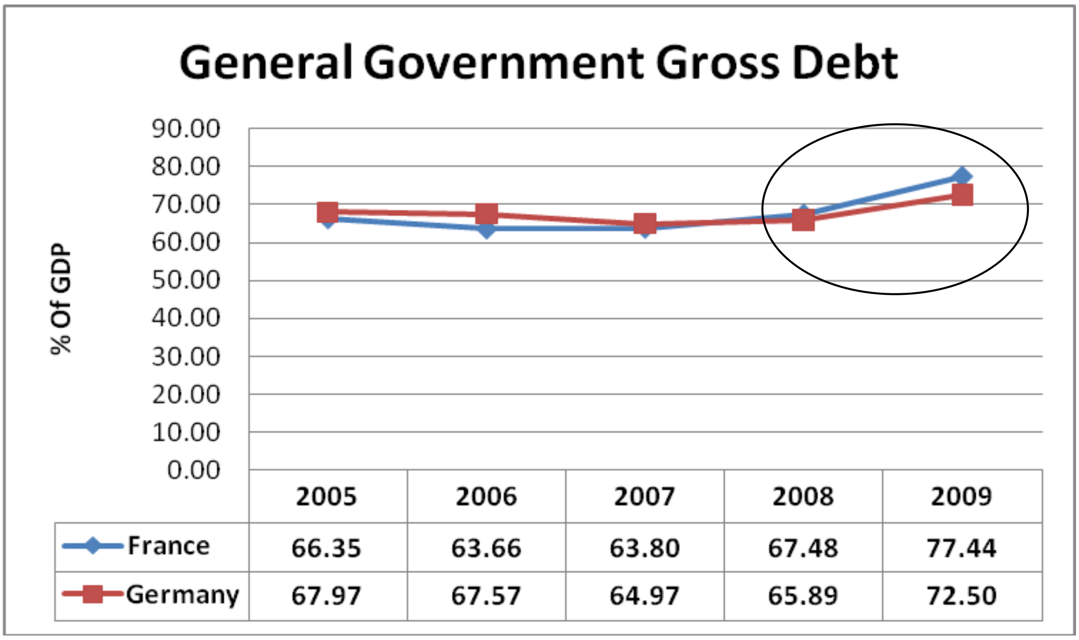
ADBI research[45] found that the size of stimulus packages increases with the soundness of the initial fiscal position. Empirical evidence in figure__ shows that Germany was making its way toward fiscal consolidation prior to drawing up its stimulus package in 2008 while France has always been running deficits. Along with evidence of a larger pile of French gross debt before the crisis hit Europe in 2008; this implies limited ability of its government to borrow more without worsen its fiscal prudence and long-term sustainability. Thus, the state of fiscal position seems to provide one explanation for a larger stimulus package in Germany which amounts to almost double that of the French. It also explains partially why Ms Merkel could afford to buy times to wait for the situation to present itself and signal clearer policy direction.

Government Fiscal Position:



* Government Budget Deficit as % of GDP

[45] Using different set of data than the work of Saha and Weizsaecker (2009)



Source: World Economic Outlook Database (IMF), April 2010; Author's own computations

The Impact of EMU Institutional Settings:

The unique characteristic of European stimuli is that they are drawn up under various institutional constraints of the Economic and Monetary Union (EMU) which sets a parameter over economic policies pursued by member countries. According to the Lisbon Treaty, all Member States shall uphold the shared principles of 'stable prices, sound public finances and monetary conditions and a sustainable balance of payments' (Lisbon Treaty – Article 119). To sustain a common currency regime, 'national policies must be adjusted consciously to support each other... [for] mutually agreed-on exchange rate... [in order to] improve collective and individual welfare' (Broz and Frieden 2001, 336). It is not an easy task to achieve such cooperation[46] among the 16 Member States with various economic backgrounds and national concerns – as evident in our empirical cases. The interdependencies among monetary policy conducted at the Community level and national policies imply that fiscal instruments e.g. fiscal stimulus package cannot be designed in ways that threaten the stability of a common

[46] Read more about fiscal policy coordination in (Korkman 2001)

currency – the euro. Therefore, any economic policymaking at the national level requires Member States' commitment to sound fiscal positions and budgetary disciplines[47].

According to the Commission's analysis, large fiscal stimulus is not recommended under the institutional context of EMU, not least to respect the obligations under the Treaty. More importantly, sizable government spending endangers the sustainability of public finances in the long-run due to difficulty with a necessary process of fiscal consolidation (EC 2009). Therefore, fiscal policymaking, both in France and Germany, has to take into account 'the paces of recovery, fiscal positions and debt levels, as well as the projected costs of ageing, external imbalances and risks in the financial sector' (EC 2009, ii)

Institutional constraints explain a large part of why the euro zone countries cannot and should not spend too much on their stimulus packages. It also explains why the government of Germany should continue its resistance and why the French president had to change his policy stance. Institutional setting of (EMU) therefore represents a common reason for crisis policy-making in both Eurozone's economic giants.

[47] Such **frameworks** are outlined in the preventative and corrective measures under the Stability and Growth Pact (**SGP**) and the Excessive Deficit Procedure (**EDP**). Lisbon Treaty, Title VIII

CONCLUSION

This thesis tracks political dynamics of two European governments - France and Germany - in managing their economies through a monsoon of the global economic crisis. The main contribution of this exercise is that it introduces political variables like party politics, democratic institutions, and other state capacities in the study of crisis policymaking. This is not an attempt to rule out the influence of technocrats in policy process. After all, the analysis reveals that economic arguments along with some technical analysis provide important explanations to the main difference between fiscal measures of the two countries: i.e. fiscal space determines the size of stimulus.

Common concerns for both leaders – which are reflected in the features of the economic stimulus – include the prospect of fiscal consolidation post-crisis, and the spillover effects. These concerns have resulted in similar policy stance reflecting in some elements of their stimulus. There is one other difference between the French and the German packages. It is the (German) reluctance toward announcing a big and fresh stimulus plan. This can be attributed to the effects of uncertainty and high complexities of the problem. But those factors cannot be any stronger than the institutional constraints under a common currency setting. Because once the French president realized a looming threat from surging debts and rising government deficits, he changed his policy stance without further ado. Besides, Member States of the EMU need not to be reminded of how importance it is to comply with the Treaty. They have Greece's fiscal crisis as a good example.

The media content analysis also makes some generalizable arguments outside the EMU context. That is; what matters more in directing the country toward a sustainable recovery is the clear policy preference of the incumbents. Together with their leadership skills that are capable of managing party politics and securing national unity in ways that are not counter-productive to long term development.

At the end of the day, politics always find its way(s) into the domain of policymaking. Especially when uncertainties can cloud out the prospect of making clear policy judgments. France and Germany, as well as others should keep reminding themselves of what constitutes a progress - and not regress – towards further integration of the European Community and the global economy as a whole. After all, that is what the two countries have long been fighting for.

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