National Policy Responses to the Financial Crisis in Europe

The Politics of Adjustment in Coordinated and Social Market Economies

In Pontusson & Bermeo (2012) Coping with Crisis, Government Responses to the Great Recession

Case studies: EMU, Germany, France and Sweden

Chapters 1, 2, 4, 5 & 8

Week 8

Aidan Regan

Introduction

A central question guiding this class is how to explain the cross-national variation in policy responses to the Eurozone crisis in coordinated, social and liberal market economies in Europe. This week we will examine the European wide fiscal response, government responses in Germany and France, and conclude with an examination of Northern Europe. To begin with – what factors are likely to explain variation in government responses to an economic crisis?

Which would you accord more priority in shaping policy responses: political parties, organised interests, institutions, ideas, policy legacies, international bodies such as the EU?

Jonas Pontusson and Nancy Bermeo identify three major themes from their edited comparative study into the policy response to the great recession when compared with the long recession of the 1970’s: international institutions have failed to play an ameliorating role than anticipated, the menu of policy choices has narrowed considerably and changed in content, the core insights of VoC in comparative political economy hold less weight than might be expected.

The role of international institutions in the origins and management of the crisis

In the first quarter of 2009, twenty five out of the EU twenty seven member states statistically recorded negative GDP growth. The most important variable in identifying which countries were worst effected were those that experienced high capital inflows in the previous period of growth.

International financial interdependence was exposed as lacking two crucial components of economic governance (Soskice & Iverson, 2011): the inability to regulate high risk lending and a failure to regulate global trade imbalances. Cross-national capital flows fuelled speculative activities in countries with liberal financial markets: Ireland, UK and USA to name but three.

The major players on the global stage, according to Soskice and Iverson, continue to have divergent preferences on how to manage these two problems (trade imbalances and financial regulation) and can be traced to national models of capitalism. National responses to the crisis reflect the preferences of the dominant sectors of the economy. In CMEs this means defending policies that increase manufacturing exports (and trade surpluses), and in LMEs; an unwillingness to change rule that limit the comparative advantage of their financial sectors.

From a VoC perspective international coordination is a bargaining process between national governments representing their national models of capitalism. Domestic pressures explain national fiscal responses not international institutions. But does this perspective hold for the Eurozone?
In the Eurozone, the response of fiscally solvent countries certainly remains national (but conditioned against the EMU). This is not the case for Ireland and Southern Europe. In these countries the EU has assumed formidable powers of surveillance and acts as an unprecedented constraint. The capacity of the EU to coordinate a European wide fiscal response has been severely restricted by the minimal budget, institutional and legal constraints, and national interests. The German government, for example, have vetoed a general EU wide reduction of value-added taxes proposed by the EU Commission.

The general point to be observed is that the crisis has exposed a serious collective action, governance and coordination problem of the EU that on the one hand promotes interdependence but simultaneously national competition. But fiscal and monetary policy can clearly be no longer separated. The only policy coordinating capacity of the EU, it seems, is to impose austerity.

The outcome, according to Armingeon and Baccaro (2011) is a crisis of democracy, with unpredictable political consequences.

Comparing Responses: Cross-national and cross-temporal perspectives

In comparing policy responses this edited volume identifies three important factors: fiscal stimulus only occurred in countries that perceived at risk of default by financial markets, the size and composition differed considerably and related to national growth models, previous mechanisms such as devaluation, nationalisation and protectionism are not on the policy menu.

The US, UK and Japan pursued more expansive fiscal stimulus in the early stages of the crisis than the EU. But these countries do not rely as much on automatic stabilisers. VoC and comparisons based on national models under-estimated the differences in macroeconomic regimes. Countries also varied on the type of tax and spend packages introduced. Some prioritised income tax cuts (Spain), other consumption (UK), or payroll taxes (Germany).

Macroeconomic

Sweden increased public sector employment whilst Ireland and Southern Europe have cut it. Overall the policy response to the crisis, when compared to the 1970’s, was significantly less expansionary. Some describe the response to crisis as a shift from ‘social’ to ‘liberal’ Keynesianism.

The type of quantitative easing measures introduced (in the US) is not aimed at devaluing the dollar as such but bringing down long-term interest rates. Explicit devaluation has not been pursued anywhere in the advanced economies of the western world.

Fiscal

The countries that had the greatest latitude in crafting a response to crisis were those that used personal income taxes to build a budget surplus in good times.

Labour market

Perhaps one of the most striking features of the response to the great recession, when compared to previous crisis, is that governments have neither increased employment protection nor unemployment compensation. The opposite has occurred.

Industrial

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1 The Eurozone constraint is crucial here. Paul de Grauwe argues that member-states were priced out of bond markets because they were, in effect, given the absence of a fiscal government and central bank, issuing debt in a foreign currency.
Three differences stand out in the government responses when compared to previous crisis. First, there has been no direct role for the state in creating employment. Second, sectoral based interventions (such as car manufacturing) are designed to boost market competition. Third, by far the biggest beneficiary of state intervention is the financial sector.

**Explaining Policy Responses**

1. International institutions: EU, IMF, ECB, G20

2. Domestic factors: ideology and elite consensus, domestic political institutions, electoral considerations by politicians, budgetary position and policy legacies, pre-crisis tax policies, sectoral foundations of economic growth

**Updating Past Perspectives**

1. Business, institutions, varieties of capitalism (VoC)

The coordinating capacity of business is the key dimension in which capitalist political economies differ. National governments will strive to serve the interests of their dominant economic sectors. The crisis has provided an opportunity to ask more pertinent questions about intra and inter differences between CMEs and LMEs. It would appear that the domestic sheltered sectors (construction and housing) had a significantly more important impact on the politics of adjustment than exposed-export sectors. Furthermore, the crisis has illustrated that the fiscal-state capacity is more NB in explaining public policy than the coordinating capacities of the private sector.

2. Parties and Government Partisanship

In a crisis, and under conditions of scarcity, political parties expose their true colours and make policy choices that cater to the distributive interests of their core constituencies. But there are two dimensions to this explanatory framework in conditioning policy responses: partisan polarisation and government partisanship.

3. Organised Interests and Class Coalitions

The social actors that have figured most prominently in the political response to the crisis are not trade unions and employer associations but the financial sector and homeowners. As citizens of various income levels (half the poor own their home in Ireland) become owners of wealth, the maintenance of alliances and associations based on class has become significantly more difficult.

**Explaining cross-temporal variation**

The last point illustrates that the differences in crisis responses across time are rooted in these changed political landscapes. Politicians now face a completely differed set of incentives and constraints in crafting policy responses. The EMU is what we are particularly interested in.

There have been 4 major changes: organised labour has been weakened dramatically with the demise of manufacturing, the rise of finance has weakened the sectoral-specific coalitions of the past, new identities have emerged that cut across class identities (labour market dualisation and immigration being two particularly important factors). Political identities have fundamentally changed.

**Conclusion**
The absence of either radical policy innovation or dramatic institutional change is perhaps due to the fact that no new powerful social coalitions have emerged to take advantage of the crisis. Finance capital is implicitly supported by the constituent interests of home-owners (that have increased dramatically) who resist tax increases and state intervention more generally. This is the domestic coalition that is driving the policy response to crisis.

**Case Studies – the Eurozone Core**

There has not been a coordinated EU-wide fiscal response to the crisis other than prescribed austerity and stricter budgetary rules. Why? The evidence presented in this chapter points to a serious policy gap at EU level to enact a European wide response to crisis. The analysis on member-states highlights that austerity has largely contributed to a higher loss of output and employment. The difference in discretionary fiscal policy choices reflects regional structural differences on pre-crisis tax policies. Importantly it only focuses on the 2008-2009 period.

Denmark, Estonia, Ireland and Latvia entered a recession in the final quarter of 2007. In 2008 it broadened into a European wide recession. In 2009 it swept into a sovereign debt crisis. In 2010 most countries exited recession. This has since reversed and a double dip has occurred. The evidence would clearly indicate that the impact of coordinated austerity has been severely under-estimated. It has increased economic contraction and hence unemployment.

**The EU’s 2008 Recovery Plan**

In December 2008 the EU Council adopted the Commissions plan to implement a fiscal recovery plan of €200bn or 1.5 percent of GDP between 2009 and 2010. 85 percent would come from member-states budget. The US at the same time approved a €700bn+ package. It soon emerged the crisis and contraction was much higher than European policy makers anticipated. Despite pressure from the US they did not change strategy. By 2012 they went full circle and adopted increased coordinated austerity measures. Cameron (2011) identifies two factors behind the EU austere response:

1. The EU has no fiscal capacity
2. The EU cannot issue debt
3. The EU resources come from member-states who must abide by the growth and stability pact (GSP)
4. There is no ‘E’ in the EMU

Additional domestic factors that constrained active fiscal stimulus responses include: higher debt-GDP ratios (Germany, France, Italy and Greece are all 60 +), most are open economies and feared the benefits of a domestic stimulus would leak abroad through spending on imports. This is despite the fact that the Eurozone is a semi closed trading economy.

**Fiscal Responses of the Member-States**

The only countries to adopt discretionary fiscal measures to stimulate the economy (i.e. not automatic stabilisers) were countries that did not have housing bubble and stable sizeable budgetary surpluses. This is because (in line with VoC) forms of revenue that are income-elastic. Because their tax-spend to GDP ratios are much larger automatic stabilisers have a stronger effect.
The clustering of countries tends to reflect the social democratic, conservative and liberal welfare state regimes we discussed in the first three weeks.

The Impact of Fiscal Policy on Recovery

Cameron’s (2011) regression analysis suggests that contrary to macroeconomic theoretic expectations, countries that introduced tax reductions recovered from the recession earlier. He also concludes that the EU response to crisis has exacerbated the divide between north and south of Europe.

This in turn can be traced to divergent attributes to fiscal capacity (revenue generating structures) and welfare state traditions.

French and German Responses to the Eurozone Crisis

Building on the theoretical framework outlined above this chapter asks a pertinent question in comparative political economy: why did two centre-right governments in the Eurozone favour different responses to a common shock?

Politics needs policy, so it is in the realm of politics (as opposed to functional economic arguments that we can expect to observe variation). Schelke (2012) argues that it is a combination of electoral and interest group politics that matters most.

It also draws our attention to the mismatch between what government’s say they do and what they actually do; the public presentation of policies must speak to constituencies and pivotal groups of voters by conveying competence in solving problems or communicating a credible ideological stance.

The EU response tries to be ideologically indifferent by appealing to rational problem solving rather than distributive conflict management. National governments cannot do this – they have to frame their response against electoral considerations.

The presentation of crisis management

How did the French and German government initially frame the response to the international financial crisis?

- Strong leadership role for the EU - politics
- Crisis management and debt breaks - technocracy

Domestically, France played up politics and state intervention whilst Germany played it down. In practice Germany was much more interventionist, introducing three stimulus packages and actively supporting new Kurzarbeit schemes. Support for the second stimulus was backed in parliament on the condition of constitutionally enshrining a new debt break – something Germany went on to prescribe for the entire Eurozone.

Flagship programs of intervention

A single stimulus package was introduced in France and the end of 2008 – and managed under a new ministry created by Sarkozy. It included a one off payment of €200 to those on benefits.

Germany introduced two stimulus packages in 2008 and 2009 – to give relief to citizens and firms, in the form of lower taxes, reduced social security contributions and short term work programs. The latter could be done by the federal employment minister and did not need parliamentary approval. The employment
agency paid 60 percent of the net wage lost due to short term work. It is estimated to have saved 500,000 full time jobs.

Both governments actively supported their automobile industries. France gave unconditional support to Peugeot and Renault on the condition they would not close down any factory in France. Eastern and Central European governments argued these companies would close factories in their country. The EU Commission intervened and it was rescinded.

Germany offered tax breaks to newly bought cars and provided subsidies to R & D advances. They offered €2500 to replace any car bought in the previous nine years. Germany never publicly stated it was stabilising production in the national interest – but this is clearly what occurred.

Crisis management and its outcome

The German legislature, contrary to public policy rhetoric, was much more active than the French administration, particularly on discretionary fiscal measures. France had one stimulus amounting to €27bn. Germany had three within thirteen months and worth €70bn. France passed one act to stabilise their financial system. Germany passed five. The success story of Germany is in employment stabilisation.

Crisis management and the EU

Battling through the first crisis

Germany achieved its preference for minimal coordination at EU level, particularly in relation to a Euro-investment strategy. France didn't get its political Europe. Germany might regret not pushing for greater coordination during this period.

Battling through the second crisis

When Greece went fiscally insolvent, ECOFIN demanded the democratically impossible. Non-market funding was made available with IMF support (resisted by France and encouraged by Germany) and a budgetary adjustment was imposed.

Prior to the establishment of the European Financial Stability Mechanism (EFSM), later the European Stability Mechanism (ESM) France demanded the ECB intervene directly and buy government bonds. This position was supported by southern European countries. Germany said no, and supported by the Dutch and Finish governments. Bi-lateral loans ruled the day.

The political economy of crisis management

The politicisation of the EU has not been accompanied by increasing the capacity for macroeconomic policymaking. The taboo between a strictly separated monetary and fiscal policy is now broken. It is not economics that has dominated the policy responses since 2008 but market panic. Market forces are irrationally pushing national governments into pro-cyclical tightening. The transnational dimension of the EU lacks the policy instruments to political resists this.

Politics and Policies in Two Economic Crises: The Nordic Countries

The core argument of Lindvall (2012) is that expansionary fiscal policies should be most difficult for parties to implement when the political economic institutions they affect are most contested: the labour market and welfare state. This explains the choices made in Nordic countries.

The great depression and the great recession
Both began in the US, as a financial crisis, and turned into a full blown macroeconomic crisis, that involved a sharp drop in aggregate demand and output.

Economic circumstances in the 1930s and 2008 were relatively similar (unemployment was much higher). Economic ideas were also similar: macroeconomist broadly favoured a fiscal stimulus. This reflects a long standing tradition of bringing in experts for sustained public policy planning in these countries. Centre-right political parties in the great recession adopted more expansionary policies than their centre-left counterparts in the great depression.

Despite having the largest automatic stabilisers in the EU, Sweden, Denmark, Finland and Norway also pursued the largest discretionary packages in the EU.

The January 2009 parliamentary approval of a stimulus package in Sweden included: infrastructure investments, increased spending on education and labour market policies, support for the automobile sector, and tax credits for home repairs. This was followed by a reduction in income taxes and increased funding for municipal government (to maintain employment in the public sector).

The only real difference between the conservatives and social democrats was that the latter were not supportive of tax cuts, a familiar left-right difference. The overall stimulus packages proposed by both were relatively similar. The policies proposed are low political salience issues in Sweden.

All discussion focused on their economic effects (problem solving) rather than their institutional or political effects. There are no real ideological conflicts over industrial relations, social policy and the role of the state in these countries.

Discussion: interests, ideas and institutions

Most governments in the advanced industrial economies adopted discretionary fiscal stimulus as an immediate response to the international crisis. This was soon rolled back in many countries. Why have we witnessed a quick return to austerity policies?

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2 This is the total opposite in Ireland. In pre and post crisis Ireland has had the most procyclical fiscal policy of member-states. Since the onset of the crisis, there has been no discussion or serious reform of its tax regime.