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Sarkozy's stage

By Ben Hall in Paris

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Nicolas Sarkozy made his name in French politics when, in 1993, he defused a human bomb. Then the young mayor of Neuilly, a chic Parisian suburb, he walked calmly into a nursery school to negotiate the release of children taken hostage by a man strapped with explosives.

Fifteen years on and, faced with a financial and economic cataclysm, the French president has once again proved his strength in a crisis.

At the beginning of this year, distracted by his love life and the stardom of his office, Mr Sarkozy seemed uninterested in running his country. His approval ratings hit record lows. Few in foreign capitals held high expectations for France's rotating six-month presidency of the European Union.

But as Mr Sarkozy's assured stint at the EU's helm draws to a close, he looks like a man transformed. "I tried to shake up Europe but it was Europe that changed me," the president told the European parliament in Strasbourg last week.

The financial crisis has restored his gravitas and sense of purpose. Although exasperating to many European leaders, his hyperactive style and disdain for protocol have become assets amid the whirlwind of this autumn. A blizzard of domestic initiatives to cushion France from a brutal slowdown and his handling of the EU presidency have won him back the respect of the French public - if not their affections.

In the 18 months since he assumed office, Mr Sarkozy has driven through many changes, some unthinkable only a few years ago. He has kept his programme to modernise the French economy on the road, avoiding all-out confrontation with his trade union opponents. But it is hard to point to a single reform that will transform France's economic prospects or radically re-draw the lines of the state.

A recent decision to delay an important reform of the high school system because of fears of violent protests is being seen as the first real retreat of his presidency and a worrying sign of a return to the political paralysis of his predecessor, Jacques Chirac. Many commentators believe Mr Sarkozy will sacrifice his reform drive to provide succour to a nation frightened by the economic crisis.

But others are more optimistic, noting that the president's €26bn ($36bn, £25bn) stimulus package finally marks the outlines of a clear, consistent strategy. "The contours of his economic policy now appear more coherent," says Alain Lambert, a former centre-right budget minister and critic of Mr Sarkozy's record. "For the first time in a long time, we are prioritising investment, supply-side reforms and removing administrative barriers to growth."

Mr Sarkozy entered the Elysée promising to pare back the state, cut public spending and balance the budget, having argued that France was living beyond its means. But at the same time, the president was eager to fulfil his campaign promise of boosting the purchasing power of French consumers. One of his first acts after taking office was to rush through a package of tax cuts worth up to €14bn in a full year. The cuts - a combination of tax-free overtime, mortgage interest relief and inheritance tax reductions - further increased the deficit but did little to support demand or improve the economy's underlying performance.

The ambiguity at the heart of his economic policy - between subsidising demand and freeing up supply - appeared to leave even Mr Sarkozy confused. When asked in January what he intended to do next for purchasing power, having already cut taxes and widened the deficit, he snapped: "What do you expect of me? That I empty the coffers that are already empty?"

The stimulus package marks a turning point in Mr Sarkozy's presidency because it breaks with a 25-year French tradition of using government borrowing to bolster consumer spending. Some Elysée officials highlight the irony in France's decision to stimulate the supply side of its economy just as the traditionally more orthodox US and UK rediscover the merits of Keynesian demand management.

Although the stimulus - which in terms of budgetary cost amounts to only €15bn - will raise the public deficit to 3.9 per cent of gross domestic product in 2009, Mr Sarkozy has focused his fiscal firepower on a one-off boost to investment, particularly in housing, energy and transport infrastructure, universities and research. Only about €1bn of the total is earmarked for consumption, in the form of a bonus payment to poor families and incentives to buy low-emission cars.

To the stimulus, he added two important deregulatory measures: onerous rules governing public procurement are to be pared back to EU minimum standards and urban planning rules are to be relaxed. Mr Sarkozy rejected a UK-style general cut in value-added- tax, arguing it would simply encourage consumption of imported goods, add further downward pressure to prices and do nothing to improve the underlying strength of the economy.

The president's advisers say he is determined to avoid the mistakes of his predecessors. Two previous attempts to reflate demand through deficit spending - by Jacques Chirac, then prime minister, in 1975 and President François Mitterrand in 1981 - provided a temporary fillip to the economy but stoked inflation, sucked in imports from Germany and Japan and set France on a quarter-century path of persistent public deficits. France has not balanced its budget since 1980.

Even some of Mr Sarkozy's staunchest critics, who have accused him of repeating the mistakes of socialist governments, acknowledge a change of direction. "We salute as an achievement that he is not repeating his earlier errors," says Jean Peyrelevade, a banker and vice-president of the opposition Democratic Movement party.

Yet if Mr Sarkozy has found some consistency, it is still not a quality easily associated with a mercurial leader who cares little for economic theory and whose only dogma is pragmatism.

The French president loves to blur political boundaries, confusing opponents while softening his own sharp rightwing edges in the eyes of the public. "It is not a question of knowing whether I am a free-market liberal or not, whether I have rediscovered Keynes or abandoned Milton Friedman," he said in a speech last month. "It is a question of being pragmatic faced with an economic situation the likes of which we have never seen before."

Listening to his pronouncements in recent months, one could be forgiven for concluding that he has swung sharply to the left. Mr Sarkozy declared that "laisser faire capitalism is over", heralded with relish the return of the interventionist state, set up a new sovereign wealth fund to protect "strategic" French companies from foreign "predators", promised an expansion of publicly subsidised jobs and revived French ambitions for a eurozone "economic government" to rein in the European Central Bank.

He was even labelled a "socialist" by one centre-left member of the European parliament. The description did not seem to displease him.

Some analysts argue that Mr Sarkozy's fondness for an interventionist state also gives him political cover for his efforts to reform the French economy. "If the supply-side revolution is seen as a foreign influence on French affairs it has no chance of succeeding," says Gilles Moec, an economist at Bank of America. "Sarkozy needs to show public opinion that he is not submitting to Anglo-American dictats about the way the economy is being managed."

While the president's *dirigiste* initiatives are announced with great fanfare - often sending echoes of indignation across Europe - they are often accompanied by more discreet deregulatory measures or structural reforms.

Mr Sarkozy shocked his party when he said the government would fund a further 100,000 subsidised jobs next year, having rubbished the programme during his election campaign as a form of welfare dependency. But in the same speech, he proposed greater use of fixed-term contracts and temporary lay-offs and a relaxation of France's strict Sunday trading laws. A change to the law raising the maximum retirement age from 65 to 70 was quietly slipped into the welfare budget bill.

France is providing €360bn in bank debt guarantees and capital injections to stabilise its banking sector. But it has attached surprisingly few conditions in terms of curbing bonuses or the payment of dividends, and the interest rates are relatively generous. "Our bank support plan is the least interventionist in Europe," boasts a senior government official.

Mr Peyrelevade acknowledges that Mr Sarkozy has achieved many useful reforms, but argues that none of them attacked the two fundamental weaknesses of the French economy: the public sector deficit and the lack of competitiveness of its businesses.

It has become commonplace in France to argue that the economic crisis has derailed Mr Sarkozy's efforts to address these problems. But the opposite argument can also be made. Mr Sarkozy's stimulus package finally points the government in the direction it always wanted to go in by focusing resources on infrastructure, research and development and pursuing deregulation. It will increase the deficit by 0.75 per cent next year but only 0.1 per cent in 2010. France now intends to balance its budget by 2014.

However, Mr Sarkozy is likely to come under fresh pressure early next year to do more to stimulate consumption with a second stimulus package. At the same time, the president will have to convince doubters at home and elsewhere in Europe that he has a longer-term strategy for eliminating France's public deficit - something he has so far failed to do.

Charged with profligacy, Paris sees vice in Berlin's virtues

The financial and economic crisis has added fresh tensions to the strained relationship between President Nicolas Sarkozy and Angela Merkel, the German chancellor.

French frustration at Berlin's refusal to put in place a bigger economic stimulus stems from more than just a clash of opinions or leadership styles. It is also a reflection of the gulf in underlying performance between the eurozone's largest and second largest economies.

In recent years, while France has seen limp growth powered by public borrowing and a widening trade deficit caused by high labour costs, Germany has regained its exporting pre-eminence as its companies restored competitiveness by holding down wages. German contempt for France's inability to put its public finances in order is mirrored by French resentment at Germany's export-led model.

Senior figures in the French government complain that Germany has been holding down domestic demand at its neighbours' expense. "They have been running a competitive devaluation against us for years," says an influential voice in the Elysée.

The prospect of a second German stimulus package early next year on top of the - comparatively modest - €12bn announced last month may help ease friction. Berlin, like Paris, intends to stimulate investment rather than consumption.

The problem is that Paris would like Berlin to do the opposite but is in a weak position to demand it. After all, Mr Sarkozy has used the same arguments against a consumption-led stimulus as Ms Merkel: that using value-added-tax cuts to reduce prices at a time of disinflation, or even deflation, might simply encourage saving or suck in imports.

Increasing imports from the rest of Europe is, of course, precisely what France wants Germany to do. But it is hard for the profligate French to ask the Germans to discard virtue.

At the same time, Ms Merkel fears that a German fiscal expansion would be seen as a reward for French ill-discipline. "The Germans are the consumers of last resort," says Alain Lamoussoure, a member of the European parliament from Mr Sarkozy's centre-right UMP party. "But it should not be the French that tell them so."

Some in Mr Sarkozy's own party believe that by mapping out a more credible path to fiscal discipline - Paris has said it will balance its budget by 2014, but without providing a convincing explanation of how - France could offer Berlin some reassurance.

Alain Lambert, a UMP senator and former budget minister, says that France is not critical of German economic policy, but envious: "There is a sort of jealously that the Germans have carried out their structural reforms without social unrest and have ended up with an export performance that is completely different to ours."

Sarkozy scorecard

*Campaigned on pledges to reduce unemployment to 5 per cent by 2012, eliminate the public sector deficit and add a percentage point to the economy's potential growth rate

*Achievements so far include ending special pension privileges for 500,000 public sector workers and unravelling (but not scrapping) the 35-hour working week
*Challenges for 2009 include cushioning the impact of the recession, limiting unemployment to 8 per cent and ensuring the budget deficit does not much exceed 4 per cent of gross domestic product