Vulnerability to Adjustment and Crisis Politics in Eastern Europe and the Eurozone

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Abstract

National policy responses to the euro crisis and political difficulties in their implementation have varied considerably across the peripheral Eurozone member states. This paper argues that when countries are faced with balance-of-payments crises such as the euro crisis, variation in societies’ vulnerabilities to austerity and structural reforms, relative to the alternative of exchange-rate devaluation can explains these differences. It argues that political difficulties, delayed and mixed adjustment strategies, and use of external funds are particularly likely when the vulnerable to both of these crisis strategies is high. In contrast, decisive adjustment is more feasible and political difficulties much less pronounced when one type of vulnerability dominates both among the country as a whole and the government’s core constituency. Irrespective of the vulnerability profile and the policy response chosen, however, the government always tries to shelter its own core constituency from the negative consequences of the crisis. Empirically, the paper evaluates this argument by analyzing variation in crisis responses, crisis politics, and distributive outcomes to the global financial crisis of 2007-10 in eight Eastern European countries, including the Baltic states and Bulgaria, which successfully implemented internal devaluation. The paper concludes by discussing the implications of the Eastern European experience for crisis politics in the Eurozone crisis.
What explains variation in the success of the peripheral Eurozone member states in their fight against the euro crisis? Some countries have successfully implemented painful domestic reforms, whereas others have experienced significant political opposition to their crisis management and have made more limited progress in resolving their economic and structural problems. Ireland, for example, has successfully implemented reforms and concluded the financial assistance program in December 2013. In contrast, crisis politics has been highly contentious in Greece, where the implementation of the conditions attached to two sizeable bailout packages has been politically difficult, current account adjustment has mainly occurred through an implosion of domestic demand, and where strong radical parties on the right and the left of the political spectrum have emerged.

Existing research leaves us less puzzled by the political problems experienced by Greek policymakers than by the Irish success. Most research on the politics of adjustment emphasizes the difficulties associated with implementing painful and far-reaching domestic reforms, so-called internal adjustment (Nelson, 1990). Some work even implies that these difficulties are so large that democratic policymakers usually adjust through a devaluation of the currency rather than push through far-reaching internal reforms (Eichengreen, 1992; Simmons, 1994). It is therefore not surprising that very few democratic countries have ever successfully overcome balance-of-payments crises without devaluing their currency. This picture has changed only recently, when to the surprise of many observers, four Eastern European democracies - Bulgaria, Estonia, Latvia, and Lithuania – successfully resolved the severe balance of payments pressures that arose in the context of the global financial and economic crisis of 2007-10 through painful domestic reforms rather than a devaluation of their currencies.

These four successful episodes show that internal adjustment can be a feasible adjustment strategy for democratic countries experiencing balance-of-payments pressures. This is good news for those member states of the European Monetary Union (EMU) that accumulated large current account deficits in the first decade after the euro’s inception. EMU members have ruled out the option of external adjustment by design. Nonetheless, the Baltic and Bulgarian success stories, and the political difficulties faced by most EMU member states in replicating this success raise the question of when internal adjustment can turn into a viable option for democratic policymakers, despite the high economic, social, and political costs associated with this adjustment strategy.

1 See, for example (IMF, 2012).
2 The option still exists, but implies an exit from the eurozone which legally also requires exit from the European Union.
To answer this question, this paper first explores theoretically why policymakers respond differently to balance-of-payments problems and why crisis management is more controversial and politically difficult in some countries than in others. It argues that this variation is related to the vulnerability profiles of large parts of society and the government’s constituency. If one adjustment path clearly imposes more costs than the alternative, the government pursues the alternative. Adjustment occurs relatively swiftly, with limited political turmoil and with attenuated costs for the government’s core supporters. In contrast, when any crisis strategy is very costly in economic and social terms, crisis politics will be fraught with political conflict. Decisive action will be delayed and policymakers will seek to mitigate the need for adjustment by trying to involve other countries in the crisis resolution process. In this case, adjustment is politically difficult, even if the government strives to shelter its core constituency from the worst consequences of the crisis.

Empirically, the paper illustrates the argument by analyzing the variation in crisis responses, crisis politics, and distributive outcomes to the Global Financial Crisis of 2007-10 in eight Eastern European EU member states. Because these countries had not yet adopted the euro at the time of the crisis and hence had the full set of policy options at their disposal, they allow us to investigate under which circumstances countries succeed in their efforts to adjust internally, and under which circumstances crisis resolution is particularly difficult. The analysis shows that variation in vulnerability profiles is related to variation in policy responses, the use of (external) financing, and the level of political conflict in these countries. However, despite significant differences in adjustment strategies and crisis politics, the evidence also suggests that the government’s core constituency is systematically more sheltered from the consequences of the crisis than the opposition’s constituency or non-voters. The paper concludes with a discussion of the implications of the Eastern European experience for the eurozone member states.

1. **Argument**

Why do some governments undertake significant reforms when faced with balance-of-payments difficulties, while other governments seem paralyzed? Why do some implement far-reaching structural reforms while others rely more on an implosion of domestic demand? Why do some governments meet fierce resistance to their crisis management, while others can build on broad political and public consensus that reforms are needed? And what are the distributive consequences of the government’s crisis management within countries? I argue
that the answer to these questions is rooted in variation in countries’ and constituencies’ vulnerabilities to different types of crisis responses.

Balance of payments problems emerge when a country runs a current account deficit and the private capital inflows that have been financing this deficit dry up. In principle, there are three ways to address such problems (Webb, 1991). Countries can continue to finance the deficit using their foreign currency reserves or other (non-private) forms of foreign capital. Possible sources of such foreign funds range from capital provided by international organizations such as the International Monetary Fund (IMF) or other governments, to less visible transfers such as those recorded in EMU’s Target2 balances.

Since financing the deficit indefinitely is usually impossible, a substantial adjustment of economic policies aimed at a realignment of foreign and domestic prices is needed when the current account deficit reflects fundamental macroeconomic and structural problems. This can either be achieved through policies that raise relative prices in surplus countries, for example by permitting higher levels of inflation in these countries, or it can be achieved through policies that decrease relative prices in deficit countries.3 Because deficit countries are usually in a much weaker bargaining position, they tend to be forced to bear most of the adjustment burden (Stallings, 1992). As a result, deficit countries are faced with a choice between two main types of adjustment strategies: A reduction in relative prices can either be achieved through a depreciation or devaluation of the nominal exchange rate, a strategy called external adjustment, or through internal adjustment, also known as internal devaluation, in which domestic reforms (such as macroeconomic austerity and structural reforms) are undertaken to increase the economy’s competitiveness.4 Here, the goal is to deflate domestic prices through productivity gains and a reduction in domestic demand. Both strategies aim at making domestic products more competitive internationally and raising the price of imports, so that domestic expenditure is switched away from the consumption of internationally tradable goods and towards the production and export of such goods.

All three possible crisis management strategies – financing, external, and internal adjustment – have significant downsides. The financing strategy is only viable as long as funding can be procured, either in form of foreign currency reserves or in terms of international financial support.5 Moreover, if the problems are of a fundamental nature and

3 Of course, adjustment can also be achieved through a concerted effort in which both types of countries contribute to the necessary adjustment.
4 Elements of these adjustment strategies can also be combined.
5 Financing the deficit therefore is only an appropriate policy response to balance of payments difficulties caused by a temporary shock, but not when the current account deficit reflects more fundamental macroeconomic and structural problems.
the time bought by financing is not used to implement reforms, it results in a further deterioration of the balance of payments problems that will necessitate much more extensive adjustment later on.\textsuperscript{6} External adjustment reduces purchasing power and leads to more volatile exchange rates and rising debt service on foreign-currency denominated loans, although the depreciated exchange rate also tends to benefit the export-oriented sector (Frieden, 1991, 2014; Walter, 2008, 2013; Woodruff, 2005). In addition, external adjustment often precipitates inflation and exchange-rate volatility and creates contagion risk for states with similar problems. It should thus come as no surprise that devaluations have proven to be politically costly. Several studies show that voters are likely to punish policymakers who devalue the currency (e.g. Blomberg et al., 2005; Stein & Streb, 2004; Walter, 2009). Finally, internal adjustment is painful because it implies macroeconomic austerity (such as higher interest rates, public spending cuts, and tax increases) and structural reforms (such as measures designed to increase labor market flexibility or policies aimed at increasing competitiveness). In the short run, austerity typically leads to higher unemployment, lower wages, asset price deflation, and a recession, and structural reforms tend to threaten the interests of well-entrenched societal groups. As discussed above, some scholars suggest that overall, the political obstacles to implementing such policies are so large, that the likelihood of success of an internal adjustment strategy is very small in democratic countries (Eichengreen, 1992; Simmons, 1994).

Balance-of-payments problems thus confront policymakers with a list of unattractive options. Which of these are they likely to choose, and how easy is it to implement these options? Building on previous research (Frieden, 1991; Haggard & Kaufman, 1992; Walter, 2013), I argue that societal vulnerabilities to internal and external adjustment strategies affect the policy responses of national policymakers to balance-of-payments problems, crisis politics, and crisis outcomes. For that purpose, I assume that policymakers care about the state of the overall economy in an effort to design policies that maximize their reelection chances by targeting the median voter (Downs, 1957). At the same time, policymakers also care about ideology and the well-being of their specific constituencies, so that they design economic policies with these (partisan) interests in mind (Boix, 1998; Garrett, 1998; Hibbs, 1977). When faced with balance of payments problems, governments therefore consider both the potential effects of each adjustment strategy on the country as a whole and the specific consequences of these strategies for their particular constituencies (Bearce, 2003). While the

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\textsuperscript{6}To avoid such a situation, official foreign funds are usually only provided under strict conditionality, which means that the recipient country is forced to implement reforms in return for access to foreign funds (for examples from the IMF see, for example, Dreher & Vaubel, 2004; Stone, 2008).
type of strategy will be mainly influenced by the effects on the country overall, the specific design of these policies will be influenced by constituency concerns. To learn about the potential consequences of various crisis strategies, policymakers will rely on many different sources of information, including the strong voices of affected interest groups. But within the policy option that crystallizes from these more general considerations, it is the more narrow electoral interests of parties that influence the precise design of the specific anti-crisis policy package.

The choice is easiest for policymakers when the vulnerabilities of their constituents align with those of the overall economy. For example, because leftist parties have a tendency to prefer external over internal adjustment, because their constituents tend to be hurt by restrictive macroeconomic policies (Bearce, 2003; Oatley, 1997), leftist governments governing economies with a high vulnerability to internal, but low vulnerability for external adjustment, are the most likely to devalue, and vice versa for conservative governments. At the same time, these policy decisions are likely to generate little political conflict. In contrast, left governments may still pursue more internally-oriented adjustment policies if the economy as a whole is highly vulnerable to devaluation. Likewise, rightist governments can be expected to devalue when the economy overall is highly vulnerable to austerity. However, even though the general direction of the adjustment path will be determined by a country’s overall vulnerabilities, the specific policy design will then be shaped by the interests and ideological leanings of the political parties in government. For example, structural reforms will be designed in ways that benefit and spare the government’s core constituencies, tax increases and spending cuts will mainly be borne by non-voters and the opposition parties’ core constituencies, and the government may implement specific policies designed to offset the negative impact of a devaluation on its constituents. As a result, policymakers buffer the potentially negative effects of their policy choices on their constituencies.

Figure 1 summarizes the implications of this argument. When the country overall is significantly more vulnerable to one type of adjustment strategy than to another, then policymakers are likely to implement the policy to which it is less exposed in a swift and decisive manner. There are two possible cases in this scenario. First, when the country is very vulnerable to austerity and structural reforms, but less vulnerable to external adjustment, a rather quick depreciation of the exchange rate and a low reliance on (external) financing is likely to be the preferred adjustment strategy (quadrant I). For example, in a country characterized by a large and export-oriented manufacturing sector and inflexible labor

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7 For a related argument see Bodea (2010).
8 Such as, for example, programs designed to support those owing foreign currency denominated debt.
markets, external adjustment should be the preferred strategy. This should be easier to implement for left-leaning governments, because their constituents tend to be more vulnerable to unemployment and expenditure cuts than those of conservative governments. While the latter can also be expected to adjust externally in this environment, they are more likely to combine these strategies with policies that buffer the negative effects of devaluation for their constituents, who therefore should emerge as the group least harmed by the crisis. In terms of politics, because policymakers implement policies that are clearly preferred to the alternative by the median voter, the policy process should be characterized by relatively low levels of opposition and political conflict.

**Figure 1: Vulnerability Profiles and Crisis Politics – Hypotheses**

In a second case (quadrant III), the country overall is much more vulnerable to depreciation than to internal adjustment, for example because the private sector holds high levels of foreign-currency denominated debt and relies heavily on imports, while labor markets are quite flexible. In this case governments are more likely to pursue internal reforms, designed in favorable terms for the government’s core constituency. Because internal adjustment can be carried out in far more varieties than external adjustment, this strategy is particularly amenable to particularist interests. This should result in distinct partisan differences in the specific reforms implemented (and not implemented). For example, agrarian parties might design structural reforms that only pertain to the industrial, but not the
agrarian sector, whereas leftist parties might implement austerity policies in a progressive manner. In contrast to the first scenario, however, governments pursuing internal adjustment are likely to combine this strategy with some temporary financing to bridge the time until the reforms start to bite. This is because domestic reforms do not depress domestic prices as quickly as a devaluation of the currency. External financing should hence be regarded as a way to smooth, rather than avoid, adjustment. Moreover, there should be a rather broad political consensus about the choice of the internal adjustment strategy, although I expect more distributive domestic conflict about the specific design of the necessary reforms. Once more, I expect the government’s constituents to be hit less hard by the government’s crisis management than the constituencies of opposition parties or non-voters.

Policymakers face a much more difficult situation when the overall economy is very vulnerable to both internal and external adjustment (quadrant II). When a country has a large non-tradable sector, inflexible labor markets, high levels of unemployment and widespread foreign-currency debt, for example, both types of adjustment are going to have painful consequences. This creates severe political difficulties to implementing far-reaching reforms and policymakers therefore have strong incentives to delay adjustment and to finance the current account deficit instead. Moreover, once adjustment becomes unavoidable (either because of donor conditionality or because of market pressure), policymakers are likely to implement a mix of external and internal adjustment measures. Given the high costs associated with adjustment, there should be considerable political conflict both within government and the public about the general crisis response and the design of specific adjustment policies. Reflecting government’s wish to protect their core constituents, the latter once more should be tilted towards the benefit of the governments’ constituency.

Finally, the situation is much easier for policymakers when vulnerabilities to both types of adjustment are low (quadrant IV). In this case, the issue is not likely to generate a lot of attention, which leaves policymakers a lot of leeway in deciding how to respond to the crisis. Financing, and hence delayed adjustment is unlikely under these circumstances, and the opposition to adjustment will be low.

2. Empirical Evidence: Crisis Management in Eastern Europe

To assess how well this argument can explain national variation in crisis responses and crisis politics, this section conducts a comparative case study of eight new EU member states

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9 Because adjustment is painful, they are also likely to try to keep the conditions attached to the required external financing to a minimum level both in the negotiations and during the implementation process, and compliance with conditionality is likely to be more spotty.
in Central and Eastern Europe that experienced balance-of-payments pressures in the wake of the global financial crisis (2008-2010): Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania. These countries were hit hard by the global financial crisis (EBRD, 2009; 2010). Most of them had boomed in the years following EU accession and in the process had accumulated large current account deficits. When the collapse of Lehman Brothers sent shock waves around the world in the fall of 2008, all of these economies experienced balance-of-payments pressures. Because they had not yet adopted the euro when the crisis hit the region, they were able to choose between internal and external adjustment. The resulting policy responses and crisis politics varied considerably. Some countries followed internal adjustment strategies, others mainly external strategies, and some chose more mixed strategies. Some countries relied heavily on external financing support by the IMF, the EU, and other sources, while others implemented their anti-crisis strategies without major external funding. Some acted swiftly, some only after considerable delay. Finally, the crisis management was not very contentious in some countries, while others experienced severe political conflicts.

The experiences of these countries are particularly interesting because the vulnerability profiles of the national economies and governments’ constituencies also varied considerably. They are also particularly instructive for understanding crisis politics in the euro crisis. Not only did four of these countries successfully embark on the internal adjustment path later also chosen by the Eurozone crisis countries, but like the EMU crisis countries, they equally operated within the larger setting of the European Union, even if freed from the restrictions of a common currency.

2.1 Vulnerability Profiles

The argument suggests that the differences in Eastern European crisis management and crisis politics should be related to variation in national vulnerability profiles. To substantiate this claim, this section classifies the eight countries under study with respect to their aggregate vulnerabilities to external and internal adjustment. Based on this analysis, the subsequent sections will analyze how the resulting variation in vulnerability profiles is associated with variation in policy responses, crisis politics, and reform outcomes.

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10 Slovenia and the Slovak Republic are not included because they had joined (Slovenia) or been accepted (Slovak Republic) into the eurozone by the summer of 2008. I focus on this time period because growth had returned to all countries in the sample by mid-2010 (even though some countries experienced renewed problems as a consequence of the eurozone crisis later on).
I construct two indices to gauge the overall vulnerability of each national economy to external and internal adjustment. External adjustment is particularly painful for countries with high levels of external and foreign-currency denominated debt and a high reliance on imported intermediate goods, but beneficial for countries with a strong export-oriented sector. Moreover, it is a particularly costly strategy for countries that have committed themselves to a fixed exchange rate, in the case of Eastern Europe those countries that have pursued EMU-membership as a near-term goal.\footnote{For these countries, external adjustment would imply a violation of one of the four convergence criteria for their planned entry into EMU, which would make near-term euro accession impossible. In addition, an exit from these fixed exchange rate regimes would carry significant contagion risks across the region.} I therefore measure aggregate vulnerability to external adjustment as an unweighted additive index of four standardized indicators on vulnerability to external adjustment, plus a dummy variable indicating whether a country was in the European Exchange Rate Mechanism II at the time of the crisis. The following variables are included: a country’s share of foreign currency lending as a percentage of all lending to non-banks in 2007 (M. Brown et al., 2009), a country’s net external debt in percent of GDP in 2007 (European Commission, 2014), the import content of exports in 2007, i.e., the contribution that imports make in the production of exports of goods and services (OECD, 2014), and exports in percent of GDP in 2007 (Schwab & Porter, 2008).\footnote{I use an inverted scale for exports (exports minus one) because a lower prevalence of exports implies a higher vulnerability to external adjustment. The sum is then divided by 1 to arrive at an index running from -1 (no vulnerability to external adjustment) to 1 (very high vulnerability to external adjustment).}

Internal adjustment becomes more costly when austerity is implemented in an already weak macroeconomic environment and when the economic structures that structural reforms intend to liberalize are deeply entrenched. I use four variables to capture these two dimensions of vulnerability to internal adjustment for the year 2007. Two variables, the national unemployment rate (European Commission, 2014: table 3.15) and the pre-crisis fiscal deficit in percent of GDP (Eurostat, 2014) measure the macroeconomic setting. Higher unemployment rates and fiscal deficits imply that austerity is more painful. Second, the level of wage rigidity (Schwab & Porter, 2008)\footnote{This variable is a survey-based measure of the perceived flexibility of wage determination I use an inverted scale, in which higher values denote less flexibility.} and the regulatory burden (Schwab & Porter, 2008), measure the vulnerability of national labor markets to internal adjustment and how entrenched economic structures are in a country.\footnote{I use an inverted scale, where higher values denote a higher regulatory burden.} In countries with high levels of wage rigidity, internal adjustment tends to depress wages through an increase in unemployment rather than to lower wages, which tends to be particularly painful in countries with already high levels of unemployment. In countries with a high regulatory burden, certain interests...
tend to have a lot at stake in terms of structural reforms. I again construct an unweighted additive index based on these four standardized variables.

Figure 2 shows the vulnerability profiles of the eight Eastern European economies on the basis of these two indices. It shows that all four quadrants are occupied by at least one country. Quadrant I, on the upper left, contains Poland, a country with a low vulnerability to external adjustment rooted in a low exposure of Polish firms and households to foreign-currency debt, the flexible and appreciated exchange rate, well-contained inflation and the fact that that euro adoption was not an immediate priority. In contrast, high unemployment, a rather strained fiscal situation, and mainly domestic currency-denominated debt tied to domestic interest rates reduced the country’s vulnerability to internal adjustment. Given this vulnerability profile, the argument predicts that Poland should pursue predominantly external adjustment in a swift and relatively uncontested manner and with little recourse to external funding.

Figure 2: Vulnerability Profiles in eight Eastern European countries

Romania and Hungary occupy quadrant II, putting these countries in the uncomfortable position of being highly vulnerable to both external and internal adjustment. This vulnerability is based mainly on their high levels of foreign-currency denominated borrowing coupled with a strained fiscal position (especially in Hungary) and an overheated economy (especially in Romania). Overall, this suggests that a combination of exchange-rate depreciation and internal adjustment measures should be the outcome of a politically contested, highly conflictual, and delayed process characterized by significant financing.
through foreign reserves and external funding sources. As before, however, the core constituency of the governing parties should emerge as the group least harmed by the crisis.

The biggest cluster of countries occupies quadrant III and consists of Bulgaria and the Baltic republics of Estonia, Latvia, and Lithuania. These countries exhibited a low to moderate vulnerability to internal adjustment, but a very high vulnerability to external adjustment. The latter was rooted in the very high level of foreign-currency denominated borrowing by private households and firms (between 56.5% in Bulgaria and almost 90% of all bank loans in Latvia in 2009 (ECB, 2011: S17)), a high reliance on imported intermediate goods, and large potential problems associated with exiting from the fixed exchange rate regime and/or ERM II. Such an exit meant not only jeopardizing the near-term goal of euro adoption (which for the Baltic states also had a geopolitical dimension in terms of deepening the ties with the West in light of geopolitical challenges posed by Russia), but also carried large contagion risks across the other fixed exchange-rate regimes and was strongly opposed by EU officials. In contrast, rather flexible labor markets, especially in the Baltics (Purfield & Rosenberg, 2010), and relatively low levels of government debt and unemployment meant vulnerability to internal adjustment was comparatively low. Overall, this suggests speedy internal adjustment as preferred adjustment strategy, with a limited reliance on external funding, and low levels of political conflict about the crisis management.

Finally, the Czech Republic, located in quadrant IV, was not very vulnerable to either external or internal adjustment. This was rooted in the country’s strong export-orientation and the low level of external debt and foreign-currency lending as well as relatively low levels of unemployment and rather flexible economic structures, even if its fiscal situation was a somewhat more strained. Given that vulnerability to external adjustment was lower than that to internal adjustment, I would expect Czech policymakers to prioritize external adjustment and to implement it rather swiftly and without any financing, and the issue not be neither salient nor the subject of political conflict.

2.2 Managing the Crisis in Eastern Europe

The previous section showed that although all new EU member states in Eastern Europe exhibited current account deficits at the outset of the crisis, their aggregate vulnerabilities to external and internal adjustment varied considerably. This suggests that these countries should vary significantly with regard to the types of policy responses chosen, their reliance on (external) financing, and the contentiousness of the national crisis management. Despite these different expected policy trajectories, however, the argument also predicts that in all countries,
the core constituencies of the government should emerge as the group least harmed by the crisis. This section examines each of these hypotheses.

2.2.1 Policy Responses, Timing, and Reliance on Financing

Although, all eight countries studied here experienced balance-of-payments pressures in 2008, figure 2 shows that their policy responses to this crisis differed substantially. As expected, the choice of adjustment strategy corresponds with the countries’ respective vulnerability profiles. Countries typically chose the adjustment path to which they were less vulnerable in the aggregate, or chose mixed strategies when vulnerability to both types of adjustment were high.

Poland and the Czech Republic let their exchange rates depreciate immediately when pressures emerged. Between August 2008 and February 2009, the Polish Zloty depreciated by 32% and the Czech Koruna by 15%. In addition, rather than implementing contractionary internal adjustment, these countries initially pursued expansionary fiscal and monetary policies. This was particularly pronounced in the Czech Republic, where imbalances were less severe than in other Eastern European economies. Poland additionally sought access to a precautionary IMF program, which gave Poland the option – ultimately not used – to draw on IMF funds quickly if strong speculative pressure should emerge. Although both countries benefited from accelerated access to structural and cohesion funds from the EU, the Czech and Polish response to the crisis can thus be characterized as external adjustment with very limited recourse to financing. This crisis response is in line with expectations for countries located in quadrants I and to a lesser extent quadrant IV, that is countries with a low vulnerability to a depreciation of their currencies.

Policymakers in the Baltic states and Bulgaria successfully tackled their severe balance-of-payments problems very differently. They implemented policies aimed at an “internal devaluation” of domestic prices while keeping their exchange rates unchanged, as predicted for countries with a high vulnerability to external and a lower vulnerability to internal adjustment. These countries implemented painful domestic reforms such as wage and expenditure cuts, substantial reductions in public sector employment, and some tax increases (for a more detailed discussion, see Aslund, 2010; Bukovskis, 2014; Kattel & Raudla, 2013; 15

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15 The precautionary flexible credit line (FCL), which Poland agreed with the IMF in April 2009, is a new type of IMF program that is available only to countries with strong economic fundamentals and policy track records. It gives policymakers the flexibility to draw on the specified fund at any time within a pre-specified window, but is precautionary insofar as it is intended to provide a shield against speculative pressure and therefore does not necessarily involve a disbursement of funds.
Because internal adjustment takes more time to affect domestic prices than external adjustment it is not surprising that all four countries combined their adjustment policies with a financing component to counteract the strong pressure on their currencies and banking sectors. Financing came from internal (especially in Estonia) and external sources. All four countries used external funds from the EU, which were granted mainly through an easier access to structural and cohesion funds, and the Baltic countries additionally received substantial bilateral support from the Nordic countries, whose banking sectors were heavily exposed to these economies. But only one country (Latvia) turned to the IMF to receive large-scale balance of payments support in the form of a regular stand-by-agreement. In all four countries the internal adjustment strategy was successful, but also caused a collapse in growth and massive increases in unemployment. Between 2007 and 2010, unemployment increased by almost one half in Bulgaria, doubled in Latvia, more than doubled in Estonia, and tripled in Lithuania.

Finally, in Hungary and Romania, policymakers showed more reluctance to adjust and therefore relied more on combinations of falling exchange rates, some austerity, and some structural reforms, coupled with significant current account financing. When their currencies came under increasing pressure in 2008, both national central banks raised interest rates and intervened on the foreign exchange market with foreign reserve sales to slow down the depreciation of their currencies. But as depreciation accelerated in the early fall of 2008 despite these efforts, both countries sought help from the international community, most notably the IMF and the EU. Hungary concluded an US$ 25 billion package with the IMF, the EU and others in October 2008, in return for which it agreed to pursue substantial fiscal consolidation and structural reform. At the same time, it continued to follow a mixed adjustment strategy by letting the currency depreciate further. Following a similar path, Romania also received a US$ 27 billion package from the IMF, the EU, and others in March 2009. Both countries bore painful consequences of their fight against the crisis. Economic growth turned negative, unemployment and the proportion of non-performing loans increased, and wages fell, albeit to a lesser extent than in the Baltic states. Given the high levels of vulnerability to both internal and external adjustment in these countries, the mix of depreciation, financing, and internal adjustment squares with the predictions of this paper’s argument for countries located in quadrant II.

Policymakers explained their policy choice mainly with reference to four issues: the high level of foreign-currency borrowing, the high contagion risk associated with a devaluation of one of the fixed currencies, the unclear effect of devaluation on exports, and the high level of labor market flexibility (Walter, 2013: 207-8). This suggests that they were acutely aware of the significant direct and indirect vulnerabilities of the economy more generally and their constituencies in particular.
2.2.2 Crisis Politics

Eastern European countries not only varied with regard to their policy responses to the crisis, but also with regard to the severity of political conflicts associated with these different crisis management strategies. The argument predicts that crisis politics should be less contentious in countries that exhibit a low vulnerability to at least one type of adjustment strategy (i.e., countries located in quadrants I, III, and particularly IV), whereas crisis management should be highly conflict-prone in countries in which vulnerability to any adjustment is high (quadrant II).

In Poland (quadrant I), the choice of the external adjustment path was uncontroversial. Generally, the depreciating currency in general was not a salient issue, although the export industry viewed the depreciation of the currency as a welcome reversal of the exchange-rate appreciation experienced in the pre-crisis months. As a centrist government, whose largest political challengers were situated at the right of the political spectrum, this strategy was also broadly in line with the interests of the government’s constituency. The uncontroversial nature of the crisis management was reflected in the high level of public support for the centrist coalition government under Prime Minister Donald Tusk, which remained comfortably high throughout the crisis (CBOS Public Opinion, 2011; Tworzecki, 2012). The coalition partners did well in all elections, including the presidential elections in July 2010, and local elections in November 2010 and the parliamentary elections in October 2011, and Poland was one of the few countries in the region where more conservative challengers did not replace the incumbent government during the crisis (see table 1).

In the Baltic republics and Bulgaria (quadrant III), the decision to maintain exchange rate stability at the price of serious internal adjustment likewise enjoyed strong popular and political support despite the very painful consequences of this adjustment strategy (Bukovskis, 2014; EIU, 2009; Kattel & Raudla, 2013; Kuokstis & Vilpisauskas, 2010). Even in Latvia, the hardest-hit of these countries, an opinion poll conducted at the peak of the crisis in August 2009 showed that almost two-thirds of respondents wanted their currency’s peg to the euro to remain unchanged (Aslund, 2010: 35). This is not to say that the path of internal adjustment was politically easy. In January 2009, riots erupted in the Latvian and Lithuanian capitals in the aftermath of initially peaceful demonstrations against austerity measures and the government more generally. In most countries, the coalition partners in government fought over the specific austerity and structural reform measures in an effort to spare their own voters the worst pain, even if the strategy itself was never substantively questioned. There
were also occasional discussions about the merits of defending the currency board arrangements in light of the enormous cost this strategy was imposing on the domestic economies. Nonetheless, although external adjustment was discussed as a distinct policy option in international policy circles\textsuperscript{17} and initially was the IMF’s preferred policy response for Latvia (IMF, 2009; Lütz & Kranke, 2013), this option was ruled out, or not even considered, by most domestic analysts (Kuokstis & Vilpisauskas, 2010). And although political tremors did affect all four countries and changes in the government occurred, in each case, more reform-minded parties and politicians were voted into office (see table 1). Their core constituents were the better-off, but they were also more likely to hold foreign-currency debt, which increased their support for internal, rather than external, adjustment. There was of course debate about the specific design of internal adjustment measures. In Estonia, for example, the Social Democrats left the government when their more right-leaning coalition partners proposed reforms that squarely hurt the Social Democrats’ core constituency (Raudla & Kattel, 2011). But given the immense pain internal adjustment generated in the form of a massive increase in unemployment, higher taxes, and significant cuts in wages and public expenditure, conventional political economy approaches would lead us to expect much more far-reaching political difficulties, protests, and election outcomes (e.g., Eichengreen, 1992; Pacek, 1994; Remmer, 1991; Simmons, 1994). Even though this broad consensus about the strategy of internal devaluation also stemmed in part from geopolitical concerns regarding the “Russian Bear” and the wish to tie the country ever more closely to the West through EMU membership (especially in the Baltics), the Baltic “patience culture,” and the weakly developed civil society (Kattel & Raudla, 2013; Kuokstis, 2013), this consensus seems to have been facilitated by the rather uniform vulnerability profile amongst voters and the governments’ constituencies.

In the Czech Republic (quadrant IV), the choice of the external adjustment path was uncontroversial as well. Nonetheless, Czech politics was turbulent in the years surrounding the global financial crisis. The inherently unstable coalition government fell in a vote of no confidence in March 2009 and was replaced by a technocratic caretaker government, and two new parties entered the political scene. Notably, however, this instability had characterized Czech politics even before the crisis and was not directly related to the decision to let the exchange rate depreciate. In fact, the depreciation of the koruna played no role in the political debate, which was dominated by other issues, such as the ratification of the Lisbon Treaty, the location of an American anti-missile radar in Czech territory, and questions about church

\textsuperscript{17} Examples include Nouriel Roubini (Financial Times, 10 June 2009), Kenneth Rogoff (Bloomberg, 29 June 2009), or Paul Krugman (New York Times Blog, 23 December 2008)
property (Linek & Lacina, 2010). Only the salience of fiscal policy increased over time (Stegmaier & Vlachová, 2011). Moreover, throughout the crisis years, one party, the conservative Civic Democratic Party (ODS), continuously participated in or supported the respective governments and was also able to hold on to the presidency. The Czech case thus shows that domestic politics is likely to be rather unaffected by balance-of-payments adjustment when vulnerability to both internal and external adjustment among influential societal groups is low.

### Table 1: Government composition, 2007-2010

<table>
<thead>
<tr>
<th>Country</th>
<th>Start date</th>
<th>Cabinet name</th>
<th>Left-right score</th>
<th>Cabinet parties</th>
<th>Cabinet type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>2007-11-16</td>
<td>Tusk II</td>
<td>5.99</td>
<td>PO, PSL</td>
<td>minimum winning cabinet</td>
</tr>
<tr>
<td>Hungary</td>
<td>2006-06-09</td>
<td>Gyurcsány II</td>
<td>2.98</td>
<td>MSZP, SzDSz</td>
<td>minimum winning cabinet</td>
</tr>
<tr>
<td></td>
<td>2008-05-02</td>
<td>Gyurcsány III</td>
<td>2.87</td>
<td>MSZP</td>
<td>minority cabinet</td>
</tr>
<tr>
<td></td>
<td>2009-04-14</td>
<td>Bajnai</td>
<td>2.87</td>
<td>MSZP</td>
<td>minority cabinet</td>
</tr>
<tr>
<td></td>
<td>2010-05-29</td>
<td>Orban II</td>
<td>6.66</td>
<td>Fidesz, KDNP</td>
<td>surplus majority coalition</td>
</tr>
<tr>
<td>Romania</td>
<td>2007-04-05</td>
<td>Popescu-Tariceanu III</td>
<td>6.04</td>
<td>PNL</td>
<td>minority cabinet</td>
</tr>
<tr>
<td></td>
<td>2008-12-22</td>
<td>Boc I</td>
<td>4.33</td>
<td>PD-L, PSD</td>
<td>minimum winning cabinet</td>
</tr>
<tr>
<td></td>
<td>2009-12-23</td>
<td>Boc II</td>
<td>5.49</td>
<td>PD-L, UDMR</td>
<td>minority cabinet</td>
</tr>
<tr>
<td></td>
<td>2010-05-19</td>
<td>Boc III</td>
<td>5.30</td>
<td>PD-L, UDMR, UNPR</td>
<td>minority cabinet</td>
</tr>
<tr>
<td>Estonia</td>
<td>2007-04-05</td>
<td>Ansip II</td>
<td>7.47</td>
<td>Ere, IRL, SDE</td>
<td>minimum winning cabinet</td>
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<tr>
<td></td>
<td>2009-05-21</td>
<td>Ansip III</td>
<td>8.12</td>
<td>Ere, IRL</td>
<td>minority cabinet</td>
</tr>
<tr>
<td></td>
<td>2011-04-05</td>
<td>Ansip IV</td>
<td>8.14</td>
<td>Ere, IRL</td>
<td>minimum winning cabinet</td>
</tr>
<tr>
<td>Latvia</td>
<td>2007-12-20</td>
<td>Godmanis II</td>
<td>6.99</td>
<td>TP, ZZS, LPP/LC, TB/LNNK</td>
<td>minimum winning cabinet</td>
</tr>
<tr>
<td></td>
<td>2009-02-26</td>
<td>Dombrovskis I</td>
<td>6.98</td>
<td>TP, ZZS, JL, PS, TB/LNNK</td>
<td>surplus majority coalition</td>
</tr>
<tr>
<td></td>
<td>2010-03-17</td>
<td>Dombrovskis II</td>
<td>6.58</td>
<td>ZZS, JL, PS, TB/LNNK</td>
<td>minority cabinet</td>
</tr>
<tr>
<td></td>
<td>2010-11-03</td>
<td>Dombrovskis III</td>
<td>6.51</td>
<td>V, ZZS</td>
<td>minimum winning cabinet</td>
</tr>
<tr>
<td>Lithuania</td>
<td>2006-07-18</td>
<td>Kirkilas I</td>
<td>5.46</td>
<td>LSDP, LiCS, PDP, LVLS, TS-LKD, TPP, LRLS, LiCS</td>
<td>minority cabinet</td>
</tr>
<tr>
<td></td>
<td>2008-11-27</td>
<td>Kubilius II</td>
<td>7.84</td>
<td>TS-LKD, TPP, LRLS, LiCS</td>
<td>minimum winning cabinet</td>
</tr>
<tr>
<td></td>
<td>2010-09-21</td>
<td>Kubilius III</td>
<td>7.63</td>
<td>TS-LKD, LiCS- TPP, LRLS</td>
<td>minimum winning cabinet</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>2005-08-17</td>
<td>Stanishev</td>
<td>4.08</td>
<td>KzB, NDSV, DPS</td>
<td>surplus majority coalition</td>
</tr>
<tr>
<td></td>
<td>2009-07-27</td>
<td>Borisov</td>
<td>7.33</td>
<td>GERB</td>
<td>minority cabinet</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>2007-01-09</td>
<td>Topolanek II</td>
<td>6.97</td>
<td>ODS, KDU/CSL, SZ</td>
<td>minority cabinet</td>
</tr>
<tr>
<td></td>
<td>2009-04-09</td>
<td>Fischer</td>
<td>5.26</td>
<td>none (supported by ODS, CSSD, SZ)</td>
<td>caretaker government</td>
</tr>
<tr>
<td></td>
<td>2010-06-28</td>
<td>Necas I</td>
<td>7.07</td>
<td>ODS, TOP09, VV</td>
<td>minimum winning cabinet</td>
</tr>
</tbody>
</table>

Data source: ParlGov database ([www.parlgov.org](http://www.parlgov.org), Döring & Manow, 2013). Ideological (left-right) orientation of the government is the weighted mean of all respective cabinet parties.

In contrast, the incumbent governments in Hungary and Romania, the two countries
where vulnerabilities to both internal and external adjustment were high (quadrant II), faced significant political problems and electoral challenges. Although these political difficulties were not solely related to the economic crisis but also to corruption charges, crisis management proved highly controversial. In Hungary, the Socialist minority government, which mainly represented “cosmopolitan, post-communist and anti-clerical” voters (Bértoca, 2014: 24), presided over the strong speculative pressure on the forint in the fall of 2008. Its policy response, the mix of depreciation, financing and some internal adjustment, was unpopular and the Socialist Prime Minister Ferenc Gyurcsány resigned in March 2009 amidst public protests and strikes, worsening economic conditions, and a falling currency.\(^{18}\) His government was replaced by a more technocratic government, which implemented deeper spending cuts and more far-reaching structural reforms in an attempt to ease pressure on the currency, whose depreciation was causing major problems for many Hungarians with foreign-currency loans.\(^{19}\) In the wake of these policies, unemployment and inflation increased further, heightening discontent with the government and creating an antagonistic political atmosphere (Varnagy, 2010). The incumbent Socialists lost about two thirds of their seats in parliament in the next regular elections in April 2010, whereas the main opposition party, the rightist Fidesz, won a landslide victory and a new extreme right party (Jobbik) emerged as a player on the political scene. In Romania, the incumbent center-right coalition government was resoundingly defeated in elections held at the height of the crisis in November 2008. After some difficult negotiations, a new center-left coalition government formed, but conflicts about how to address the economic crisis arose quickly between the coalition partners. The conclusion of the IMF program in March 2009 committed the governing parties to internal adjustment measures, but these were only implemented in a half-hearted manner (Stan & Zaharia, 2010). The divergent policy stances of both parties led to increasing tensions within the government, which culminated in its breakdown in October 2009 amidst major protests against the government’s austerity measures. The new center-right government implemented more austere adjustment measures (Aslund, 2010) but continued to face political difficulties: in June 2010 it narrowly escaped a vote of no-confidence concerning its proposal to cut public sector wages and pensions and in October a general strike with 800'000 participants paralyzed the country. The difficult political environment led to significant delays in the highly contentious crisis management. Overall, the experiences of Hungary and Romania thus

\(^{18}\) He had been in a difficult position ever since his open admission that he had lied to the public about the need for fiscal retrenchment in order to be elected had been leaked to the public.

\(^{19}\) In addition, the governments introduced measures to discourage foreign currency borrowing and created several policy instruments designed to support debt-laden households holding such debt.
highlight the political difficulties associated with implementing macroeconomic adjustment in countries in which voters exhibit high vulnerabilities to both external and internal adjustment.

2.2.3 Policy Outcomes: The distributional effects of crisis management

The previous two sections have shown that the variation in adjustment paths and crisis politics among the new EU member states in Eastern Europe in the context of the global financial crisis are related to differences in vulnerability profiles, particularly on the aggregate level. This section now turns to the policy outcomes and engages in a more fine-grained analysis of the distributional effects of crisis management within these countries.

Although my argument predicts that differences in aggregate vulnerability profiles influence the choice of adjustment strategy, it also suggests that all governments design these policies in ways that privilege their own constituencies. Empirically, this implies that across all countries, the governments’ core constituencies should be least negatively affected by the crisis, irrespective of the general type of adjustment path. To test this hypothesis, I use data from the fifth round of the European Social Survey (ESS), which was conducted in 21 European countries in October 2010.20 The survey covers four of the countries analyzed in this paper, and these vary with regard to vulnerability profiles, adjustment strategies and government ideology: In Poland (quadrant I), the centrist governments followed a path of external adjustment, the leftist government in Hungary (quadrant II) mixed external and internal adjustment elements and engaged heavily in financing, Estonia’s rightist government (quadrant III) pursued internal adjustment, and the center(-right) government in the Czech Republic (quadrant IV) predominantly relied on external adjustment.

The survey included a battery of questions on the effects of the global financial crisis, two of which are particularly well suited to investigating the overall effect of the government’s crisis management on individuals. These questions focus on the change in respondents’ personal economic situation over the past three (crisis) years. Both questions ask respondents to rate on a 0 (not at all) to 6 (a great deal) scale whether they “have had to manage on a lower household income” (question Q8) and whether they “have had to draw on [their] savings or get into debt to cover ordinary living expenses” (question Q9).21

To identify voters belonging to the respective governments’ main constituencies, I grouped each respondent into one of three categories: government voters, opposition voters,
or non-voters. Based on information on which party they felt closest to (or if this information is not available, which party they had voted for in the last election) and whether they had voted at all in the last election, I classified respondents as government voters, if they had voted to or felt close to those parties that were in government during most of the crisis. I chose those parties rather than those in office at the time of the survey, because I am interested in the consequences of crisis management. In two countries (Hungary and the Czech Republic), the government had changed a few months before the survey was taken. This is fortunate, because it allows me to discriminate between the effect of being in the (former) government’s camp and potential cognitive biases which let voters view the situation more favorably when “their” party is in power (e.g., Evans & Andersen, 2006; Gerber & Huber, 2010; Wlezien et al., 1997). Individuals who voted for a political party that was not in government during most of the crisis are coded as opposition voters, and respondents who did not vote in the last election are coded as non-voters.

Figure 3: Impact of the crisis on households, by voter group

These parties are: a) the Estonian Reform Party, Union of Pro Patria, Social Democratic Party (which left the government in May 2009) in Estonia (EE), b) the Hungarian Socialist Party (in office between May 2008 and May 2010) in Hungary (HU), c) Civic Democrats, Christian Democratic Union, and Greens who formed a center-right government between January 2007 and March 2009 in the Czech Republic (CZ). Between April 2009 and June 2010, a technocratic, nonpartisan government was in charge, with the support of Civic Democrats (ODS), Social Democrats (CSSD), Greens (SZ), who did not, however, participate in the government and are therefore not counted as additional government parties. d) Civic Platform and Polish Peasants’ Party in Poland (PL).

The main results hold (but are weaker, as expected) when the new government parties that ruled in Hungary and the Czech Republic from June 2010 onwards are additionally included as governing parties.
Note: Weighted mean values for each voter group. Government voters are identified as voters of the parties that were in government during the crisis. Data are from the European Social Survey 2010 (conducted in October 2010).

Figure 3 shows that in all countries, voters in the government camp fared better than voters in the opposition camp and non-voters. The figure displays the weighted means of the two measures of respondents’ assessment of the changes in their personal economic situation over the past three years for each subgroup of respondents. The difference between government voters and all other respondents is statistically significant at the 1%-level in all countries but Hungary. This means that in each country, the government’s constituency was less affected by the crisis than all other groups – irrespective of the country’s vulnerability profile, adjustment path, or the government’s partisan ideology. Likewise, non-voters were the most negatively affected. From the viewpoint of a vote-maximizing government, this behavior makes sense: while at least some voters from the opposing camp can potentially turn into allies, non-voters are not even part of the wider constituency. As such, they are most vulnerable politically, and the evidence shows that this group bore the largest pain during the crisis.

To examine this result in more detail, I investigate which specific groups reported more or less serious effects of the crisis. I use the question about changes in the household income as dependent variable, but results are robust to using the savings/debt question instead. In addition to basic demographic information (age, gender, education level), I identified a number of groups that represent potentially relevant constituencies for political parties. First, I distinguish respondents based on income, because left parties generally represent voters with lower incomes and conservative parties typically represent the better-off. Income is measured as an ordinal measure that reports the difference between a respondent’s income class and the median income class per country and ranges from -5 to +5, with higher values indicating that the respondent is better off than the median respondent. Higher-income voters should report less problems in countries governed by (center-)right governments at the time of the crisis, here Estonia, and to a lesser extent the Czech Republic and Poland. Since left-leaning parties often have closer ties to trade unions, I also control for union membership, expecting that union members should be better off in countries with left governments (here in Hungary).

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24 This might be related to the significant vote losses of the Hungarian Socialist Party over the course of the crisis, which are also reflected in the ESS survey. In this data this formerly largest party only records a voter share of 13.8%, suggesting that a substantial portion of former MSZP voters are not counted as government voters in the analysis.

25 Age: question F3, gender, question F2, education level question F15.

26 The variable is based on question F41. Unfortunately, the ESS survey does not include any information about respondent’s financial situation, especially foreign-currency denominated debt.

27 Question F39
Second, I look at different types of employers, focusing on whether the respondent works in the public sector, in a state-owned enterprise (SOE), is self-employed, or works in the private sector (the base category). Given that the structural reforms associated with internal adjustment are often targeted towards the public sector and SOEs, this would suggest that respondents working in these areas should be particularly strongly hit in Estonia (internal adjustment) and Hungary (mixed adjustment). Finally, I look at several sociodemographic groups – pensioners, families, and people living in rural areas – some of which represent clearly defined constituencies of smaller coalition parties in the countries under study.

Table 2 shows the results of OLS regression analyses of respondents’ assessments about the crisis effects on their household (models (a)). Positive values denote that a group was more negatively affected, while negative values imply that the respective group was less negatively affected. Because I am not only interested in the distributive effects across society, but particularly interested in the distributive effects across different constituencies, I compare these results to analyses of the composition of the government’s constituency. For this purpose, for each country the second column in table 3 (models (b)) shows the results of logit models that examine to what extent each of these groups is associated with a higher probability of belonging to the government’s constituency (measured as above in terms of whether a respondent voted for one of the governing parties).

The results show some interesting communalities and differences across countries. In all countries, the crisis had a regressive effect, with poorer respondents reporting more negative effects of the crisis than richer respondents. However, this effect was least pronounced in Hungary, which in contrast to the other three countries had a leftist government during much of the crisis. In the other three countries, wealthier individuals are more likely to be part of the government constituency, and also less likely to have a lower household income as a result of the crisis. Families were significantly hit harder by the crisis than other households in all four countries. This effect is particularly large in Poland, which is a country in which families are less likely to be part of the government constituency, and in Hungary. In contrast, respondents living in rural areas in Poland report significantly less serious repercussions of the crisis. Because the agrarian “Polish Peasants party” participated as the junior partner in the Polish government, this squares with the prediction that governments try to design their policies in ways that attenuate the effects of a crisis on their

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28 Question F32.
29 Questions F17a, F1 (family is defined as a household with children), F14, respectively.
own voters. Likewise, in Estonia older people are more likely to vote for the government parties, and pensioners report less severe consequences of the crisis.

Table 2 also shows some unexpected findings. For example, given that Estonia implemented internal adjustment, it is surprising to see that government and public sector employees as well as workers in state-owned enterprises were in fact less severely hit by the crisis than respondents working in the private sector, a pattern that is repeated to some extent in mixed-adjustment pursuing Hungary. One could speculate that these groups enjoyed better

### Table 2: Different constituencies and the impact of the crisis and vote choice

<table>
<thead>
<tr>
<th></th>
<th>Estonia</th>
<th></th>
<th>Hungary</th>
<th></th>
<th>Czech Republic</th>
<th></th>
<th>Poland</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(a)</td>
<td>(b)</td>
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<td>(b)</td>
<td>(a)</td>
<td>(b)</td>
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<tr>
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<td>vote</td>
<td>income</td>
<td>vote</td>
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<td>vote</td>
<td>income</td>
<td>vote</td>
</tr>
<tr>
<td></td>
<td>OLS</td>
<td>(logit)</td>
<td>OLS</td>
<td>(logit)</td>
<td>OLS</td>
<td>(logit)</td>
<td>OLS</td>
<td>(logit)</td>
</tr>
<tr>
<td>Income</td>
<td>-0.251***</td>
<td>0.181***</td>
<td>-0.174***</td>
<td>0.007</td>
<td>-0.318***</td>
<td>0.115***</td>
<td>-0.269***</td>
<td>0.105***</td>
</tr>
<tr>
<td></td>
<td>(0.02)</td>
<td>(0.03)</td>
<td>(0.03)</td>
<td>(0.03)</td>
<td>(0.02)</td>
<td>(0.04)</td>
<td>(0.02)</td>
<td>(0.03)</td>
</tr>
<tr>
<td>Union member</td>
<td>0.022</td>
<td>0.069</td>
<td>0.036</td>
<td>0.168</td>
<td>-0.252</td>
<td>-0.174</td>
<td>0.419*</td>
<td>-0.025</td>
</tr>
<tr>
<td></td>
<td>(0.29)</td>
<td>(0.32)</td>
<td>(0.21)</td>
<td>(0.25)</td>
<td>(0.19)</td>
<td>(0.35)</td>
<td>(0.23)</td>
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<tr>
<td>Public sector</td>
<td>-0.463***</td>
<td>0.175</td>
<td>-0.060</td>
<td>0.325</td>
<td>0.006</td>
<td>0.517**</td>
<td>-0.185</td>
<td>0.036</td>
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<td>(0.17)</td>
<td>(0.18)</td>
<td>(0.20)</td>
<td>(0.12)</td>
<td>(0.20)</td>
<td>(0.17)</td>
<td>(0.19)</td>
</tr>
<tr>
<td>State-owned</td>
<td>-0.367**</td>
<td>-0.410*</td>
<td>-0.443**</td>
<td>0.016</td>
<td>-0.088</td>
<td>0.312</td>
<td>-0.216</td>
<td>-0.104</td>
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<tr>
<td>enterprise</td>
<td>(0.17)</td>
<td>(0.22)</td>
<td>(0.19)</td>
<td>(0.22)</td>
<td>(0.16)</td>
<td>(0.25)</td>
<td>(0.18)</td>
<td>(0.21)</td>
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<tr>
<td>Self-employed</td>
<td>-0.163</td>
<td>0.891*</td>
<td>0.163</td>
<td>-0.272</td>
<td>0.014</td>
<td>0.587**</td>
<td>0.240</td>
<td>0.535*</td>
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<tr>
<td></td>
<td>(0.34)</td>
<td>(0.46)</td>
<td>(0.28)</td>
<td>(0.36)</td>
<td>(0.24)</td>
<td>(0.29)</td>
<td>(0.21)</td>
<td>(0.28)</td>
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<tr>
<td>Retired</td>
<td>-0.558***</td>
<td>-0.324</td>
<td>-0.628***</td>
<td>0.013</td>
<td>-0.227</td>
<td>-0.194</td>
<td>-0.154</td>
<td>-0.206</td>
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<td>(0.23)</td>
<td>(0.22)</td>
<td>(0.27)</td>
<td>(0.18)</td>
<td>(0.25)</td>
<td>(0.19)</td>
<td>(0.22)</td>
</tr>
<tr>
<td>Children</td>
<td>0.339***</td>
<td>0.186</td>
<td>0.792***</td>
<td>-0.051</td>
<td>0.496***</td>
<td>0.111</td>
<td>0.654***</td>
<td>-0.244*</td>
</tr>
<tr>
<td></td>
<td>(0.11)</td>
<td>(0.14)</td>
<td>(0.14)</td>
<td>(0.16)</td>
<td>(0.12)</td>
<td>(0.17)</td>
<td>(0.12)</td>
<td>(0.14)</td>
</tr>
<tr>
<td>Rural</td>
<td>-0.016</td>
<td>0.650***</td>
<td>0.092</td>
<td>0.018</td>
<td>-0.084</td>
<td>0.333*</td>
<td>-0.298**</td>
<td>-0.124</td>
</tr>
<tr>
<td></td>
<td>(0.11)</td>
<td>(0.14)</td>
<td>(0.14)</td>
<td>(0.16)</td>
<td>(0.11)</td>
<td>(0.17)</td>
<td>(0.12)</td>
<td>(0.14)</td>
</tr>
<tr>
<td>Age</td>
<td>-0.004</td>
<td>0.019***</td>
<td>0.005</td>
<td>0.009</td>
<td>0.002</td>
<td>0.006</td>
<td>-0.002</td>
<td>0.003</td>
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<td>0.335**</td>
<td>-0.003</td>
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<td>-0.136</td>
<td>0.059</td>
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<td>(0.11)</td>
<td>(0.14)</td>
<td>(0.13)</td>
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<td>-0.126*</td>
<td>-0.024</td>
<td>-0.139**</td>
<td>0.343***</td>
<td>0.006</td>
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</tr>
<tr>
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<td>(0.05)</td>
<td>(0.06)</td>
<td>(0.07)</td>
<td>(0.08)</td>
<td>(0.07)</td>
<td>(0.10)</td>
<td>(0.05)</td>
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</tr>
<tr>
<td>Constant</td>
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<td>-2.825***</td>
<td>3.149***</td>
<td>-1.741***</td>
<td>3.738***</td>
<td>-3.021***</td>
<td>2.613***</td>
<td>-0.524</td>
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<td>(0.35)</td>
<td>(0.36)</td>
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<td>(0.26)</td>
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<td>N</td>
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<td>R2</td>
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<td>0.092</td>
<td>0.145</td>
<td>0.139</td>
<td>0.0496</td>
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<td>Adj. R2</td>
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<td>0.084</td>
<td>0.0484</td>
<td>0.116</td>
<td>0.0496</td>
<td>0.116</td>
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</table>

30 A similar pattern with regard to rural voters, though less substantially and statistically significant, can be observed in Estonia and the Czech Republic.
|------------|--------|--------|--------|--------|-------|--------|-------|--------|-------|--------|-------|--------|-------|--------|-------|--------|-------|--------|-------|

Values in parentheses are standard errors. Data are weighted by the design weight. Dependent variables: Assessment of the statement “I have had to manage on a lower household income in the past three years”, with higher values denoting more consent to the statement. Government voter is a dummy variable that takes the value of 1 if the respondents feel closest to one of the party in government during most of the crisis (see footnote 17).

structural access to the decision-making arena, which might have allowed them to influence the policy design in their favor. In contrast, possibly as a reflection of the more indiscriminate effects of external adjustment, in the Czech Republic and Poland there are no differences between respondents that are self-employed or working in the private or public sector – even though some of these groups are more likely to belong the respective governments’ constituencies.

Overall, this final part of the analysis shows that the negative effects of the crisis and the policy responses pursued by the national governments did have clear distributive consequences. Some groups were hit harder than others, and despite all the differences across the four countries, the group that emerged least harmed in each of the countries consistently was the group that had voted for the parties in government during the crisis.

2.3 Conclusion: Crisis and Adjustment in Eastern Europe

The Eastern European experience during the recent global financial crisis shows that when balance-of-payments problems emerged, differences in national vulnerability profiles were associated with different crisis responses and variation in the level of political conflict. When vulnerability to one type of adjustment strategy clearly dominated, adjustment occurred more swiftly and with less recourse to financing, and there was less political conflict about the appropriate crisis management. In contrast, where important parts of society exhibited a high level of vulnerability to both possible types of adjustment, crisis management was very difficult. Here, the question how the crisis should best be addressed was politicized and very controversial, which is why the policy response was frequently characterized by financing and delay, a mix of both externally and internally oriented adjustment measures, and conflictive crisis politics. However, a similar pattern emerged across all countries: Even though a majority of respondents felt that their situation had at least somewhat deteriorated in the course of the crisis, voters of the governing parties were privileged: they were on average least negatively affected by the crisis. These results suggest that governments tried to implement those policies that were least painful to the economy at large and their constituencies in particular. Overall, the analysis thus suggests that differences in
vulnerability profiles can influence crisis politics in countries affected by balance of payments crises.

3. **Implications for Crisis Countries in the Eurozone**

What lessons can we draw from the Eastern European experience for the deficit countries of the eurozone, who have equally been experiencing substantial balance-of-payments problems during the euro crisis? At the outset of the crisis the extent of balance of payments problems in the EMU deficit economies were generally less pronounced than in the Eastern European economies.\(^3^1\) Although this should make the need for adjustment smaller, resolving the eurozone crisis has proven very difficult.

As members of a monetary union, for whom external adjustment is officially not an option, all EMU crisis countries have embarked on a path of internal adjustment. Despite this uniform choice of adjustment path, there has been substantial variation in crisis politics in these countries as well, with some countries successfully implementing significant domestic reforms, and others experiencing significant political opposition to their reform plans. To what extent does this variation reflect differences in vulnerability profiles? More generally, how is crisis management different for countries experiencing balance-of-payments crises within a monetary union? To answer these questions, the final part of this paper briefly compares the situation in several important EMU deficit countries – Cyprus, France, Greece, Ireland, Italy, Portugal, and Spain – to the situation in the Eastern European countries during the global financial crisis. I begin with a comparison of vulnerability profiles and government ideology, and then discuss the implications for policy responses, crisis politics, and distributive outcomes.

In terms of vulnerabilities, EMU member states are exceptional in that their vulnerability to external adjustment is exceedingly high. This is because in the context of EMU, such a strategy would imply an exit from the euro zone and, at least for the time being, the loss of EU membership. Such a step would likely cause financial havoc and a huge economic and political fallout both for the exiting country and the European Union as a whole.\(^3^2\) Although some form of a break-up of EMU is not inconceivable (for historical precedents see Cohen, 1993), this effectively means that the path of external adjustment is not

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\(^3^1\) An average current account deficit of 7.7%, compared with an average of 13.7% in the eight Eastern European countries.

\(^3^2\) For example, the reintroduction of a much depreciated national currency carries substantial indirect foreign-currency risk. The vast majority of debt in eurozone countries is denominated in euro, and the question whether these debts should be denominated in the new national currency or in euro would likely constitute one of the most contentious topics of negotiations concerning an exit from EMU, and would likely result in a huge increase in individuals’, firms’, and banks’ debt burden in countries with a new, depreciating currency.
perceived as an option for Eurozone crisis countries, leaving internal adjustment and financing as the two remaining strategies.

As we have seen, the ease with which internal adjustment can be implemented, is influenced the country’s overall vulnerability to adjustment and the government’s ability to design reforms in ways that spare its core constituency. Figure 4 shows some descriptive evidence on both counts. The left-hand panel displays the index for national vulnerability to internal adjustment discussed above calculated for 13 EMU and Eastern European countries and based on data from the year 2007. It shows that EMU crisis countries’ vulnerability to internal adjustment does vary, but does so on a rather high level. Reflecting particularly inflexible labor markets and a high regulatory burden, Greece, France and Italy top the list at the outset of the crisis, closely followed by Hungary, Poland, and Portugal. Ireland shows a below-average vulnerability to internal adjustment, but only Cyprus comes close to the values of those Eastern European economies that successfully implemented internal adjustment. Moreover, with respect to partisan politics, the right-hand panel shows that in ideological terms, the governments presiding over crisis management in the EMU countries tend much more towards the center of the political spectrum than the rather right-leaning governments in the Baltic states and Bulgaria. Internally-oriented reforms such as productivity-enhancing structural reforms, cuts in public spending, and tax increases tend to be unpopular policies amongst these governments’ voters. This suggests that internal adjustment should be politically more difficult for the policymakers in the deficit countries of the Eurozone than for those in the internally adjusting Eastern European states.

Figure 4: Vulnerability profiles and government ideology in Eastern Europe and EMU deficit countries
Notes: Vulnerability to internal adjustment is an additive index combining the variables unemployment, wage rigidity, fiscal deficit, and regulatory burden, standardized across all 13 countries in the sample, using 2007 values (data sources see above). Government ideology is measured as the average of the left-right score for each party in government, weighted by its cabinet seat share for the period 2008-2012 (Eastern Europe) and 2009-12 (EMU), based on information provided by the ParlGov database (based on ParlGov database, Döring & Manow, 2013).

Overall, this very rough analysis paints a rather depressing picture, because it suggests that the main EMU deficit countries exhibit the difficult vulnerability profile of high vulnerabilities to internal and external adjustment – both in the aggregate and in terms of government constituencies (for a related argument, see Hall, 2012). In contrast to the Baltic and Bulgarian experience, who managed to implement immense internal adjustment without major public opposition, this implies that EMU policymakers should have a much more difficult time in implementing such a strategy. The painful and drawn-out reform process in these countries and the strong reliance on external financing in the form of bailouts, the European Stability Mechanism (ESM) and growing Target2 balances attests to these difficulties. Moreover, this vulnerability profile suggests that political conflict and political instability are likely to be high, especially in Greece, Portugal, and Spain, where reforms are being forced through by Troika conditionality. Where external pressure to adjust internally has been weaker, such as in Italy and France, the reform progress can be expected to be slower, though also accompanied by political conflict. This expectation has largely been borne out: incumbents have been punished electorally, support for radical parties has increased and protest politics has become more prevalent in the wake of these crises (e.g.,
Bosco & Verney, 2012; van Gent et al., 2013) (Funke et al., 2014). Despite the large fallout from the crisis, however, the argument and evidence presented above also suggests that well-entrenched groups and the core constituencies of the governing parties should be less hurt by the crisis. The fact that less politically active groups (such as young people) have borne the brunt of adjustment in most countries, whereas structural reforms aimed at dismantling long-standing privileges of certain groups have stalled, are in line with this expectation.

Overall, then, the experience of the euro crisis squares with the pessimistic predictions for countries facing a high vulnerability to both internal and external adjustment. The fact that Eurozone deficit countries operate within a monetary union changes their situation in two key respects, however. Even without the option of external adjustment, two additional crisis strategies remain, at least theoretically, in addition to an internal adjustment by the deficit countries: internal adjustment by the surplus countries and a quasi-permanent financing of the deficit.

As discussed above, it is usually difficult for deficit countries to shift the burden of adjustment onto surplus countries, and the euro crisis has been no exception in this regard. EMU surplus countries such as Germany have proven rather reluctant to accept higher rates of inflation or to actively stimulate domestic demand, although the ECB’s recent loose monetary policy can be interpreted as a small step in this direction. Given the size of the needed adjustment and difficulties in pushing through the necessary reforms in deficit countries and the reluctance of surplus countries to contribute to sharing this burden, an escalation of the crisis is a distinct possibility. The significant financial inter-linkages within the monetary union mean that the costs of such an escalation would be huge for deficit and surplus countries alike, however. This gives deficit countries much more bargaining power vis-à-vis surplus countries than is usually the case (see also Copelovitch & Enderlein, 2014). Surplus countries who wish to avoid internal adjustment at home may therefore be more willing to contribute to a financing of the current account deficits in the peripheral countries through intra-EMU or intra-EU transfers, possibly even on a (quasi-) permanent scale. The discussions about fiscal union, an EU-wide unemployment benefits scheme, or “intra-EU solidarity” more generally attest to this possibility and it is likely that these discussions will intensify if the crisis persists. Given that this is quite unpopular among many Europeans, however, such financing carries the risk of that the Eurosceptic voices will continue to grow. Taken together,

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33 Of course, external adjustment in terms of a depreciation of the euro in general is also an option and the ECB has been actively working towards a weakening of the currency. A coordinated break-up of EMU has also been considered in policy circles and academic research (e.g., B. Brown, 2012; Crafts, 2014; Kawalec & Pytlarczyk, 2013; Watts et al., 2014).
then, the analysis in this paper suggests that the resolution of the euro crisis will continue to be a drawn-out, painful, and politically costly process.
References


