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

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Puzzle and Research Question

• **Puzzle:**
  – Despite similar problems, there has been considerable variation in crisis responses and crisis politics in recent BOP crises.

• **Research Question:**
  – When democratic governments face balance-of-payments problems, what explains variation in
    • policy responses
    • crisis politics
    • distributive outcomes?
Governments design policy response considering the vulnerability to internal and external adjustment of
– the overall economy
  • General adjustment strategy
– their own constituency
  • Specific policy design within the chosen adjustment strategy

Vulnerability to Internal Adjustment
(austerity and structural reforms)

Vulnerability to External Adjustment
(exchange rate depreciation)
## Hypotheses

<table>
<thead>
<tr>
<th>Vulnerability profile</th>
<th>(I) Internal high, external low</th>
<th>(II) Internal high, external high</th>
<th>(III) Internal low, external high</th>
<th>(IV) Internal low, external low</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><img src="image1" alt="Diagram" /></td>
<td><img src="image2" alt="Diagram" /></td>
<td><img src="image3" alt="Diagram" /></td>
<td><img src="image4" alt="Diagram" /></td>
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</tbody>
</table>

### Policy Response

<table>
<thead>
<tr>
<th>(I) Internal high, external low</th>
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<th>(III) Internal low, external high</th>
<th>(IV) Internal low, external low</th>
</tr>
</thead>
<tbody>
<tr>
<td>• External adjustment</td>
<td>• Mixed adjustment</td>
<td>• Internal adjustment</td>
<td>• Mixed adjustment</td>
</tr>
<tr>
<td>• Decisive action, little financing</td>
<td>• Delay, financing</td>
<td>• Decisive action, less reliance on (ext.) financing</td>
<td>• Decisive action, no financing</td>
</tr>
</tbody>
</table>

### Crisis Politics

<table>
<thead>
<tr>
<th>(I) Internal high, external low</th>
<th>(II) Internal high, external high</th>
<th>(III) Internal low, external high</th>
<th>(IV) Internal low, external low</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Low levels of political conflict and turmoil</td>
<td>• Highly politicized</td>
<td>• Low levels of political conflict and turmoil</td>
<td>• Low levels of political conflict and turmoil</td>
</tr>
<tr>
<td>• Serious political conflict and turmoil</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Distributive Outcome

Government’s constituency harmed least
Research Design

Comparative case study

– Crisis responses in eight new Eastern-European-EU member states to the global financial crisis (2008-10)
  • Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania
  • Similar problems (current account deficits, speculative pressure) but variation in vulnerability profiles and policy responses.

– Analysis
  • Step 1: Classification of countries by vulnerability profile
  • Step 2: Qualitative analysis of
    – Step 2a) policy responses
    – Step 2b) crisis politics
  • Step 3: Quantitative analysis of individual-level effects of crisis / crisis management
Step 1: Variation in Vulnerability Profiles

Vulnerability to internal adjustment-index of
- unemployment
- wage rigidity
- fiscal deficit
- regulatory burden

Vulnerability to external adjustment-index of
- external debt
- Forex denominated debt
- export orientation
- import-content of exports
- fixed XR regime-dummy

Graph showing the vulnerability of different countries to internal and external adjustment indices.
### Step 2: Policy Responses and Crisis Politics

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<th>Vulnerability profile</th>
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<th>(III) Internal low, external high</th>
<th>(IV) Internal low, external low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td></td>
<td>Hungary, Romania</td>
<td>Baltics, Bulgaria</td>
<td>Czech Republic</td>
</tr>
</tbody>
</table>

#### 2a) Policy Response
- Swift external adjustment.
- Very limited external support.
- Delay and mix of external and internal adjustment strategies
- Extensive internal and external financing.
- Rather swift internal adjustment.
- Some external support (esp. Latvia).
- Swift external adjustment.
- Very limited external support.

#### 2b) Crisis Politics
- Depreciation uncontroversial
- Government reelected.
- Crisis management very contentious politically
- Political turmoil
- Public protests.
- Broad public and political support for reforms.
- Electoral success for pro-reform parties.
- Depreciation uncontroversial.
- Political turmoil, but unrelated to crisis mgmt.
Step 3: Quantitative analysis of individual-level effects of crisis (management)

• Data
  – European Social Survey, October 2010
    • Poland
    • Hungary
    • Estonia
    • Czech Republic

• Dependent variables
  – Individual-level effect of crisis
    • “Please tell me to what extent each of the following has applied to you in the last three years:
      – I have had to manage on a lower household income
      – I have had to draw on my savings or get into debt to cover ordinary living expenses.”
    • Scale from 0 (not at all) to 6 (a great deal)
Independent variable: Constituencies

• Three types of respondents
  – Government voters
    • Feel closest to or voted for the parties predominantly in office during crisis.
  – Opposition voters
    • Feel closest to or voted for the parties predominantly in opposition during crisis.
  – Non-voters
    • Did not vote in the last elections.
Crisis outcomes by voter groups

**Estonia**
Type III, Internal adjustment  
Rightist government

**Hungary**
Type II, Mixed adjustment  
Leftist government

**Czech Republic**
Type IV, External adjustment  
Center(-right) government

**Poland**
Type I, External adjustment  
Center-right government

- **Estonia**
  - Respon. had to draw on savings/debt to cover ordinary living expenses
  - Respondent had to manage on lower household income

- **Hungary**
  - Respon. had to draw on savings/debt to cover ordinary living expenses
  - Respondent had to manage on lower household income

- **Czech Republic**
  - Respon. had to draw on savings/debt to cover ordinary living expenses
  - Respondent had to manage on lower household income

- **Poland**
  - Respon. had to draw on savings/debt to cover ordinary living expenses
  - Respondent had to manage on lower household income
## Government constituencies and crisis outcomes – disaggregated analysis –

<table>
<thead>
<tr>
<th></th>
<th>Estonia</th>
<th>Hungary</th>
<th>Czech Republic</th>
<th>Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>-0.251***</td>
<td>0.181***</td>
<td>-0.174***</td>
<td>0.007</td>
</tr>
<tr>
<td>(0.02)</td>
<td>(0.03)</td>
<td>(0.03)</td>
<td>(0.03)</td>
<td>(0.04)</td>
</tr>
<tr>
<td>Public sector</td>
<td>-0.463***</td>
<td>0.175</td>
<td>-0.060</td>
<td>0.325</td>
</tr>
<tr>
<td>(0.14)</td>
<td>(0.17)</td>
<td>(0.18)</td>
<td>(0.20)</td>
<td>(0.20)</td>
</tr>
<tr>
<td>State-owned enterprise</td>
<td>-0.367**</td>
<td>-0.410*</td>
<td>-0.443**</td>
<td>0.016</td>
</tr>
<tr>
<td>(0.17)</td>
<td>(0.22)</td>
<td>(0.19)</td>
<td>(0.22)</td>
<td>(0.22)</td>
</tr>
<tr>
<td>Self-employed</td>
<td>-0.163</td>
<td>0.891*</td>
<td>0.163</td>
<td>-0.272</td>
</tr>
<tr>
<td>(0.34)</td>
<td>(0.46)</td>
<td>(0.28)</td>
<td>(0.36)</td>
<td>(0.29)</td>
</tr>
<tr>
<td>Retired</td>
<td>-0.558***</td>
<td>-0.324</td>
<td>-0.628***</td>
<td>0.013</td>
</tr>
<tr>
<td>(0.19)</td>
<td>(0.23)</td>
<td>(0.22)</td>
<td>(0.27)</td>
<td>(0.25)</td>
</tr>
<tr>
<td>Children</td>
<td>0.339***</td>
<td>0.186</td>
<td>0.792***</td>
<td>-0.051</td>
</tr>
<tr>
<td>(0.11)</td>
<td>(0.14)</td>
<td>(0.14)</td>
<td>(0.16)</td>
<td>(0.17)</td>
</tr>
<tr>
<td>Rural</td>
<td>-0.016</td>
<td>0.650***</td>
<td>0.092</td>
<td>0.018</td>
</tr>
<tr>
<td>(0.11)</td>
<td>(0.14)</td>
<td>(0.14)</td>
<td>(0.16)</td>
<td>(0.17)</td>
</tr>
<tr>
<td>Age</td>
<td>-0.004</td>
<td>0.019***</td>
<td>0.005</td>
<td>0.009</td>
</tr>
<tr>
<td>(0.00)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
</tr>
<tr>
<td>+ additional controls</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>1501</td>
<td>1132</td>
<td>1195</td>
<td>1019</td>
</tr>
<tr>
<td>R2</td>
<td>0.104</td>
<td>0.092</td>
<td>0.145</td>
<td>0.145</td>
</tr>
<tr>
<td>Adj. R²/Pseudo R²</td>
<td>0.098</td>
<td>0.1120</td>
<td>0.084</td>
<td>0.0484</td>
</tr>
</tbody>
</table>

*p < .1; ** p < .05; *** p < .01

Additional control variables: union member, rural, female, education level. Values in parentheses are standard errors. Data are weighted.

OLS regression for effect (lower income in past 3 years), logit regression for government constituency.
Summary of findings

• Policy Responses
  – Aggregate vulnerability profiles influenced choice of adjustment strategy and implementation speed.

• Crisis Politics
  – Political difficulties were highest in countries with high vulnerability to both types of adjustment (type II).

• Distributive Outcomes
  – Government voters were harmed least during the crisis, irrespective of adjustment strategy and ideological orientation of government.
Vulnerability profiles of EMU deficit countries:

- Very high vulnerability to external adjustment across the board.
- Generally high vulnerability to internal adjustment.
- Prediction: delay, use of external financing, high level of conflict, gov constituency sheltered.
How is the euro crisis different?

• Strong financial integration with surplus countries
  – Possibility to share adjustment burden
    • See discussion about more domestic consumption and higher inflation in Germany.
    • Vulnerability to internal revaluation in surplus countries?
  – Better access to external financing
    • See discussions about Target2, EMU-wide transfer schemes, fiscal union, banking union etc.