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Other titles: Distributing the Pain: Societal Vulnerabilities and the Choice between Internal and External Adjustment

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**Distributing the Pain
Vulnerability to Adjustment and Crisis Politics
in Balance-of-Payments Crises**

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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 devaluation can explain these differences. It argues that political difficulties, delayed and mixed adjustment strategies, and use of external help are particularly likely when the economy is vulnerable to any policy adjustment. 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 as much as possible 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 comparing the vulnerability profiles and crisis politics in the peripheral Eurozone member states with those of the Eastern European countries.

What explains variation in the success of the peripheral Eurozone member states in their fight against the euro crisis? Some countries have successfully implemented drastic and painful domestic reforms, whereas others have experienced significant political opposition to their crisis management and have made more limited progress in resolving the underlying problems in their economies. Ireland, for example, has implemented far-reaching reforms and successfully 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, adjustment has mainly occurred through an implosion of domestic demand, and which has seen the emergence of strong radical parties on the right and the left of the political spectrum.

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; Bearce and Hallerberg 2011). It is therefore not surprising that virtually no democratic country has successfully overcome balance-of-payments crises without devaluing its currency. This picture has changed only recently with the global financial and economic crisis in 2007, which hit the Eastern European economies particularly hard. These countries had accumulated substantial current account deficits in the pre-crisis boom years, resulting in significant imbalances and need for substantial adjustment. To the surprise of many observers,¹ four of these democracies – Bulgaria, Estonia, Latvia, and Lithuania – successfully rebalanced their economies 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.² Nonetheless, the Baltic and Bulgarian success stories, and the political difficulties faced by most EMU member states

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.

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.

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. 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, countries where any policy adjustment is likely to be very costly will experience political conflict and policymakers will tend to delay adjustment and mix elements of external and internal strategies. In this case, adjustment is politically difficult, even if the government will strive 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 the eight Eastern European EU member states that had not yet adopted the euro at the time of the crisis. It 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 suggests that in each country studied, the government's core constituency systematically emerged as the group less harmed by the crisis than opposition voters or non-voters. This suggests that policymakers not only take the country's overall situation into account, but design crisis policies with special attention to the needs and vulnerabilities of their core 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 how does the government's fight against such a crisis affect the well-being of different societal groups? 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. There are three ways to address such problems. Countries can continue to *finance the deficit* using their foreign currency reserves or procuring 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. However, financing the deficit is the appropriate policy response only to a temporary shock. When the current account deficit reflects fundamental macroeconomic and structural problems, substantial adjustment of economic policies aimed at a realignment of foreign and domestic prices. This 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 monetary and fiscal tightening and structural reforms) are undertaken to increase the economy's competitiveness.³ 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 to be switched away from the consumption of internationally tradable goods and towards the production and export of such goods.

All three 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. Moreover, if the problems are of a fundamental nature and 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 a much more extensive adjustment later on.⁴ Although a depreciation of the exchange rate tends to benefit the export-oriented sector, *external adjustment* also reduces purchasing power and leads to more volatile exchange rates and rising debt service on foreign-currency denominated loans (Frieden 1991; Walter 2008, 2013). 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

³ Elements of these adjustment strategies can also be combined.

⁴ 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. Nonetheless, both the extent of these conditions and the compliance with conditionality vary significantly (for examples from the IMF see Dreher and Vaubel 2004; Dreher 2004; Stone 2008; Copelovitch 2010).

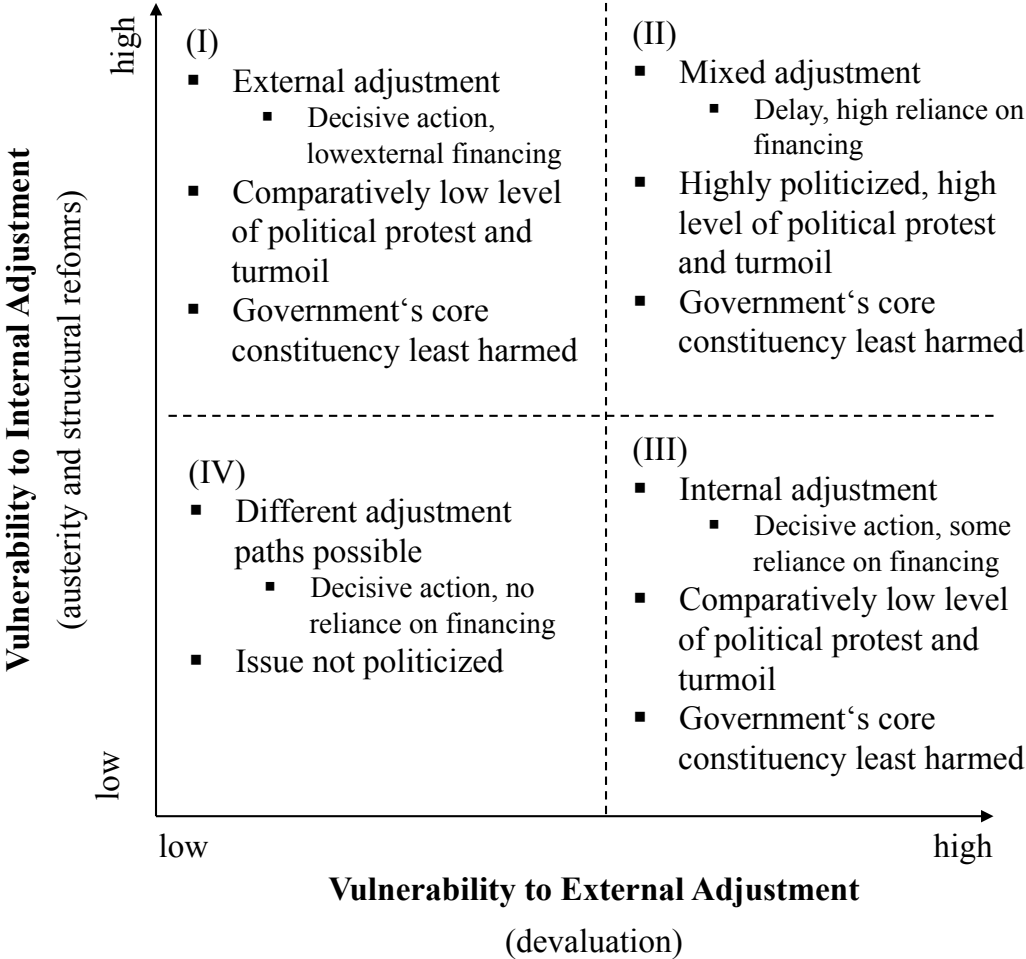
that devaluations have proven to be politically costly as well. Several studies show that voters are likely to punish policymakers who devalue the currency (e.g. Frieden and Stein 2001; Stein and Streb 2004; Blomberg et al. 2005; Walter 2009). Finally, *internal adjustment* is painful because it implies 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. Structural reforms threaten the beneficiaries of the status quo: By abolishing subsidies and removing barriers to competition, such reforms destroy rents for these groups (for a related argument, see Hall 2012). As discussed above, some scholars suggest that overall, the political obstacles to implementing internal adjustment are so large, that the likelihood of success of such policies 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; Walter 2013; Walter and Willett 2012), I argue that a country's vulnerabilities to internal and external adjustment strategies affect both the policy responses of national policymakers to balance-of-payments problems and crisis politics. Assuming that policymakers care both about their constituencies and the overall economy, this suggests that governments are going consider both the aggregate effects of different adjustment strategies on the country as a whole and the specific consequences of these strategies for their constituencies (Bearce 2003). Taking the economy's overall vulnerabilities into account allows policymakers to design policies that maximize their reelection chances by targeting the median voter (Downs 1957). At the same time, as members of political parties, policymakers also care about ideology and the well-being of their specific constituencies, so that they design economic policies with these interests in mind (Hibbs 1977; Boix 1998; Garrett 1998). This implies that although the general direction of the adjustment path will be determined by a country's overall vulnerabilities, the specific policy design will be shaped by the interests and ideological leanings of the political parties in government.

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 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. Nonetheless, in such an environment the latter can also be expected to implement external adjustment, but they are more likely to combine these strategies with productivity-enhancing policies and measures that buffer the negative effects of devaluation for their constituents.⁵

Figure 1: Vulnerability Profiles and Crisis Politics – Hypotheses



In the second case (quadrant II), the country overall is much more vulnerable to depreciation than to internal adjustment. An example would be a country in which the private sector holds high levels of foreign-currency denominated debt and relies heavily on imports,

⁵ Such as, for example, programs designed to support those owing foreign currency denominated debt.

while the economy is characterized by a sound fiscal position and a flexible economy. In this case governments are more likely to pursue a predominantly internal adjustment strategy, particularly when the necessary internal reforms can be designed in such a way that the core constituencies of the government can be spared. Conservative parties have an advantage in this respect. Because they represent the better-off, these parties should be more willing to implement internal adjustment strategies that lower inflation, decrease unit labor costs and increase productivity. When other parties operate in such a setting, they are likely to implement internal adjustment as well, but to design reforms that limit the negative impact on their constituencies. For example, agrarian parties can be expected to design structural reforms that do not affect farmers. Leftist parties should implement austerity policies in a less regressive manner and should be more willing to combine internal adjustment with a depreciation of the currency. Moreover, because domestic reforms do not depress domestic prices as quickly as a devaluation of the currency, governments pursuing this adjustment path are more likely to seek temporary and limited external funding to finance the current account deficit until the reforms bite. External financing should hence be regarded as a way to smooth, rather than avoid, adjustment. Negotiations about conditionality for such international support should therefore also be less conflictual and compliance should be better in these countries.

Because policymakers implement policies that are clearly preferred to the alternative by the median voter, the policy process in both scenarios I and III should be characterized by lower levels of opposition and less tumultuous political environment than in countries where policymakers impose significant costs on society. And because policymakers design the adjustment strategies in ways that spare their own voters to the largest extent possible, the constituencies of the respective governing parties should be hit less hard by crisis and the government's adjustment program than the constituencies of opposition parties or non-voters.

Policymakers face a much more difficult situation when the country is very vulnerable to both internal and external adjustment (quadrant II). For example, when a country has a large non-tradable sector, inflexible labor markets, high levels of unemployment and widespread foreign-currency debt, both types of adjustment are going to have painful consequences. This creates severe political difficulties to implementing serious reforms and policymakers therefore have strong incentives to delay adjustment and to finance the current account deficit instead. 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. Moreover, once adjustment becomes unavoidable (either because of

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 how specific adjustment policies and reforms should be designed. As a result, crisis politics in such settings is expected to be characterized by political conflict, government instability, and hot debates about the appropriate policy response to the crisis. Nonetheless, the specific design of the anti-crisis policy package once more should be tilted towards the benefit of the governments' constituency.

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. A financing, and hence a delayed adjustment is unlikely under these circumstances, because financing involves costs 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 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 particularly hard by the global financial crisis (EBRD 2009; 2010; Connolly 2012; Myant and Drahokupil 2012). Most of them had boomed in the years following EU accession and had accumulated large current account deficits in the process. When the collapse of Lehman Brothers sent shock waves around the world in the fall of 2008, all of these economies experienced serious balance-of-payments pressures. Because they had not yet adopted the euro when the crisis hit the region, they had a certain leeway in choosing between internal and external adjustment – and policy responses and crisis politics indeed varied considerably.⁶ 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

⁶ 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).

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 in the aggregate society and among governments' constituencies varied considerably. And they are particularly instructive for understanding crisis politics in the eurocrisis because like the EMU crisis countries, they equally operated within the larger setting of the European Union, although freed from the restrictions of a common currency.

2.1 Vulnerability Profiles in Eastern Europe

My 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 all eight countries with respect to their aggregate vulnerabilities to external and internal adjustment. Based on this analysis, the subsequent section will analyze how variation in vulnerability profiles was associated with variation in policy responses, crisis politics, and reform outcomes.

To measure each country's aggregate vulnerability to external and internal adjustment, respectively, I construct two indices. External adjustment tends to be 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. Aggregate vulnerability to external adjustment is therefore measured as an unweighted additive index of four standardized indicators on vulnerability to external adjustment and a dummy variable indicating whether a country was in the European Exchange Rate Mechanism II (ERM 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 (Brown et al. 2009), 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 and Porter 2008).⁷ I also add a dummy variable for ERM II membership (the Baltics) or a currency board (Bulgaria), because devaluation tends to have significant negative political and economic ramifications in regimes with fixed exchange rate regimes that go beyond those vulnerabilities

⁷ I use an inverted scale for exports (exports minus one) because a lower prevalence of exports implies a higher vulnerability to external adjustment.

measured by the other indicators in the index. For example, for countries in ERM II, 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.

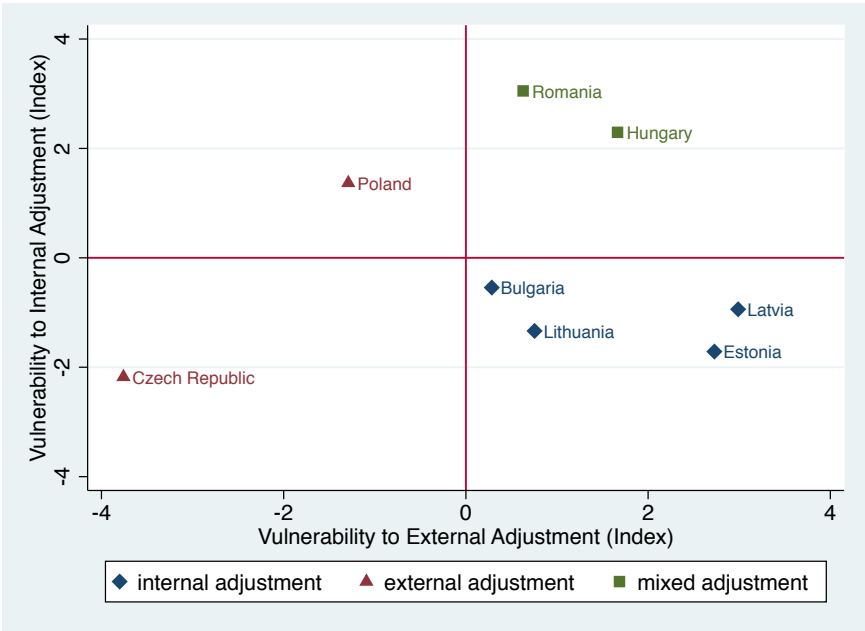
Internal adjustment becomes the more costly the higher the costs of austere macroeconomic policies and the more entrenched the economic structures are that structural reforms intend to liberalize. I use four variables that capture various dimensions of vulnerability to internal adjustment for the year 2007. The first two variables, the national unemployment rate (European Commission 2014: table 3.15), and the level of wage rigidity (Schwab and Porter 2008),⁸ measure the vulnerability of national labor markets to internal adjustment. 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. The third variable records the pre-crisis fiscal deficit in percent of GDP (Eurostat 2014), because higher fiscal deficits imply higher budget cuts and stronger tax increases. The final indicator is the regulatory burden (Schwab and Porter 2008), which is used as a measure of how entrenched economic structures are in a country.⁹ I construct an unweighted additive index based on these four standardized variables.

Figure 2 shows the vulnerability profiles of 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 made the Polish median voter and the centrist Polish government's constituency very vulnerable 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.

⁸ 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.

⁹ I use an inverted scale, where higher values denote a higher regulatory burden.

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. Foreign-currency denominated borrowing had been very common in these countries, creating high vulnerabilities to devaluation among households and the private sector. At the same time, a strained fiscal position with high levels of public debt (especially in Hungary) and an overheated economy (especially in Romania) made them vulnerable to internal adjustment as well. Hungary’s leftist government, which mainly represented “cosmopolitan, post-communist and anti-clerical“ voters (Bértoa 2014: 24), faced constituents who were vulnerable to fiscal tightening. Because Romania went through a rather unstable political time when the crisis hit, with changing government coalitions that oscillated between center-right and center-left orientations, the constituency of these governments frequently changed, although it was concentrated in the middle of the political spectrum. Overall, this suggests that both exchange-rate depreciation and internal adjustment measures should constitute important elements of the adjustment strategy eventually implemented (with a higher reliance on external adjustment in Romania than Hungary), but also that crisis management should be very contentious and characterized by delay and recourse to external sources of financing. As before, however, the main 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 Estonia, Latvia, and Lithuania. These countries exhibited a low to moderate vulnerability to internal adjustment, but a very high vulnerability to external adjustment. The

high vulnerability to external adjustment 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)), the high reliance on imported intermediate goods, and the potential problems associated with exiting from the fixed exchange rate regime and/or ERM II were large. Such an exit meant not only jeopardizing the near-term goal of euro adoption (which 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 and Rosenberg 2010) and relatively low levels of government debt and unemployment meant that although internal adjustment was bound to inflict pain on most people, this pain was much lower than the potential pain of external adjustment. In terms of constituency vulnerabilities, with the exception of Bulgaria, all countries were governed by (center-)right parties. Their core constituents were the better-off, but were also more likely to hold foreign-currency debt, making them in general more vulnerable to external than to internal adjustment. 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 is located in quadrant IV, indicating a low aggregate vulnerability to both external and internal adjustment. The country's strong export-orientation and the low level of external debt and foreign-currency lending limited its vulnerability to depreciation. In terms of vulnerability to internal adjustment, the Czech Republic mainly benefitted from relatively low unemployment and rather flexible economic structures, although its fiscal situation was a little more strained. Given that vulnerability to external adjustment was lower than that to internal adjustment, we would expect Czech policymakers to prioritize external adjustment and to implement it rather swiftly, but reliance on external funds should be limited and the issue not to be strongly politicized.

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 Eastern European countries experienced severe balance-of-payments pressures in 2008, their policy responses to this crisis differed substantially. Figure 2 shows that countries typically pursued one of three types of policy responses: external adjustment (Poland and the Czech Republic), internal adjustment (Bulgaria and the Baltic states) and more mixed strategies (Romania and Hungary). Figure 2 also shows that 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.

More specifically, Poland and the Czech Republic adjusted externally in a rather swift manner and with little recourse to financing. Policymakers let exchange rates depreciate immediately when pressures emerged. Moreover, rather than implementing contractionary internal adjustment, they initially pursued expansionary fiscal and monetary policies. This was particularly pronounced in the Czech Republic, where the low vulnerability to adjustment was also rooted in the fact that imbalances were less pronounced than in other Eastern European economies. As a result, between August 2008 and February 2009, the Polish Zloty lost 32% and the Czech Koruna 15% of their August 2008 values. In Poland, this strategy was supported by a precautionary IMF program, which gave Poland the option – ultimately not used – to draw on IMF funds quickly if strong speculative pressure should emerge.¹⁰ Although both countries benefited from accelerated access to structural and cohesion funds from the EU, the principal Czech and Polish response to the balance of payments pressures was thus quick external adjustment with very limited financing. This behavior is in line with expectations for countries located in quadrants I and IV in figures 1 and 2, that is countries with a low vulnerability to a depreciation of their currencies.

Policymakers in the Baltic states and Bulgaria chose a different adjustment path in response to the global financial crisis. Policymakers in these countries successfully tackled

¹⁰ 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.

their severe balance-of-payments problems through policies aimed at an “internal devaluation” of domestic prices, most notably fiscal austerity and nominal wage adjustment, while keeping their exchange rates unchanged. The 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; Purfield and Rosenberg 2010; Kattel and Raudla 2013).¹¹ Because internal adjustment takes more time to affect domestic prices than external adjustment it is not surprising that all countries combined their adjustment path with a financing component to meet 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. The Baltic countries additionally received substantial bilateral support from the Nordic countries, especially from Sweden and Norway, 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. Taken together, the chosen path of internal adjustment policies successfully staved off speculative pressure, brought down price levels, and led to a significant reduction in the current account deficit. However, these measures 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. Overall, the policy responses chosen by these four countries correspond well with the predictions for countries with a high vulnerability to external and a lower vulnerability to internal adjustment (quadrant III in figures 1 and 2).

In Hungary and Romania, policymakers showed more reluctance to adjust and therefore relied more on combining external and internal adjustment measures with current account financing through foreign reserve sales and external support from the international community. When the global financial crisis hit these economies, the currencies in both countries came under increasing pressure. Both central banks raised interest rates and intervened on the foreign exchange market with foreign reserve sales to slow down the depreciation of their currencies. When intervention proved insufficient and depreciation accelerated in the early fall of 2008 despite efforts to finance the deficit rather than substantially adjust economic policies, both countries sought external sources of funding

¹¹ 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.

mainly from the IMF and the EU. Hungary concluded an agreement with the IMF, the EU and others in October 2008. In return for the US\$ 25 billion package, it agreed to implement internal adjustment measures, most notably fiscal consolidation aimed at reducing Hungary's large fiscal deficits and high level of public debt. At the same time, it continued to pursue a mixed adjustment strategy by letting the currency depreciate further. Romania endured a longer decline of its currency before turning to the IMF in March 2009, but then equally committed itself to an austerity program designed to stabilize the currency and to rebalance the economy. In return, it received US\$ 27 billion financing support from the IMF, the EU, the World Bank, and the EBRD. The fiscal consolidation measures and structural reforms implemented in both countries were painful. 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. In both countries, the high level of foreign-currency denominated debt emerged as "a key concern" during the crisis and a major topic of political and public debate (e.g., EBRD 2010), alongside with concerns about public finances and the domestic economic situation.¹² Given the high levels of vulnerability to both internal and external adjustment in these countries, the mix of depreciation, foreign exchange intervention and the conclusion of the IMF/EU rescue packages, which required the implementation of internal adjustment measures such as fiscal retrenchment and structural reforms squares with the predictions of this paper's argument for countries located in quadrant II of figures 1 and 2.

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. This section shows that the experience of the eight countries examined here squares with the argument's prediction that crisis management should be most conflict-prone in contexts in which vulnerability to any adjustment is high (quadrant II). In contrast, crisis politics should be less contentious in countries that exhibit a low vulnerability to at least one type of adjustment strategy (quadrants I, III, and particularly IV).

In Poland (quadrant I), the choice of the external adjustment path was quite uncontroversial. Especially the export industry viewed the depreciation of the currency as a welcome reversal of the exchange-rate appreciation experienced in the pre-crisis months, although the depreciating currency in general did not receive a lot of public attention. The

¹² In both countries, the governments also introduced measures to discourage foreign currency borrowing and the Hungarian government created several policy instruments designed to support debt-laden households holding foreign currency denominated debt.

uncontroversial nature of the crisis management was also 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 (Tworzecki 2012; CBOS Public Opinion 2011). 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 II), 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 (Kuokstis and Vilpisauskas 2010; EIU 2009; Kattel and Raudla 2013). Even in Latvia, the hardest-hit of these countries, almost two-thirds of respondents of an opinion poll conducted in August 2009, at the peak of the crisis, said that they 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 capitals of both Latvia and Lithuania 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 internal adjustment 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 circles¹³ and initially was the IMF's preferred policy response for Latvia (IMF 2009; Lütz and Kranke 2013), this option was ruled out, or not even considered, by most domestic analysts (Kuokstis and Vilpisauskas 2010). In light of the extent of adjustment necessary and the immense pain imposed on the domestic populations in the course of its implementation in the form of a massive increase in unemployment, higher taxes, and significant cuts in wages and public expenditure, however, crisis politics were surprisingly uncontentious. Nevertheless, political tremors did affect all four countries and changes in the government occurred, although in each case, more reform-minded parties and politicians were voted into office (see table 1). For example, in Estonia the Social Democrats left the government when their more right-leaning coalition partners proposed reforms that squarely hurt their core constituency (Raudla and Kattel 2011). But given the size of reforms and the harshness of their

¹³ 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)

consequences for the domestic economies, conventional political economy approaches would lead us to expect much more far-reaching difficulties, protests, and election outcomes (e.g., Remmer 1991; Pacek 1994; Eichengreen 1992; Simmons 1994). Although 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 and Raudla 2013), this consensus seems to have been facilitated by the rather uniform vulnerability profile amongst voters and the governments’ constituencies.

In a similar vein, the choice of the external adjustment path was uncontroversial in the Czech Republic as well. Nonetheless, Czech politics was muddled and unstable in the years surrounding the global financial crisis. Notably, however, this instability had characterized Czech politics even before the crisis hit and was not directly related to the decision to let the economy adjust externally. In fact, the depreciation of the koruna played no role in the political debate, which was dominated by other issues. In 2008, the year in which all of Eastern Europe was heavily mired in financial crisis, the four most important issues in Czech politics were the ratification of the Lisbon Treaty, a treaty between the Czech Republic and the United States on the location of an American anti-missile radar in Czech territory, questions about church property, and, only fourth, the reduction of the welfare state (Linek and Lacina 2010). However, although the Czech government had implemented reforms that were far less painful than those of the other Eastern European countries and additionally implemented some stimulus measures to soften the impact of the global financial crisis, unemployment eventually increased in the wake of the global financial crisis and domestic economic conditions and the growing fiscal deficit became increasingly salient (Stegmaier and Vlachová 2011). The political environment was quite turbulent in this period: 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. Nonetheless, throughout the crisis years, one party, the 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 any adjustment among influential societal groups is low.

Table 1: Government composition, 2007-2010

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

Data source: ParlGov database {www.parl.gov.org, \ Döring, 2013 #1900}. 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 presided over the strong speculative pressure on the forint in the fall of 2008, to which it responded with a mix of depreciation, financing and some internal adjustment. These measures and their painful consequences were unpopular and the Socialist Prime Minister Ferenc Gyurcsány resigned in March 2009 amidst public protests and strikes, worsening

economic conditions, and a falling currency.¹⁴ 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. 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 in November 2008, at the height of the crisis. 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 and 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 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.

¹⁴ 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.

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 2010.¹⁵ 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 (vulnerability type I), the centrist governments followed a path of external adjustment, the leftist government in Hungary (vulnerability type II) mixed external and internal adjustment elements and combined this with extensive use of financing, Estonia's rightist government (vulnerability type III) pursued internal adjustment, and the center(-right) government in the Czech Republic (vulnerability type 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).¹⁶

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.¹⁷ I

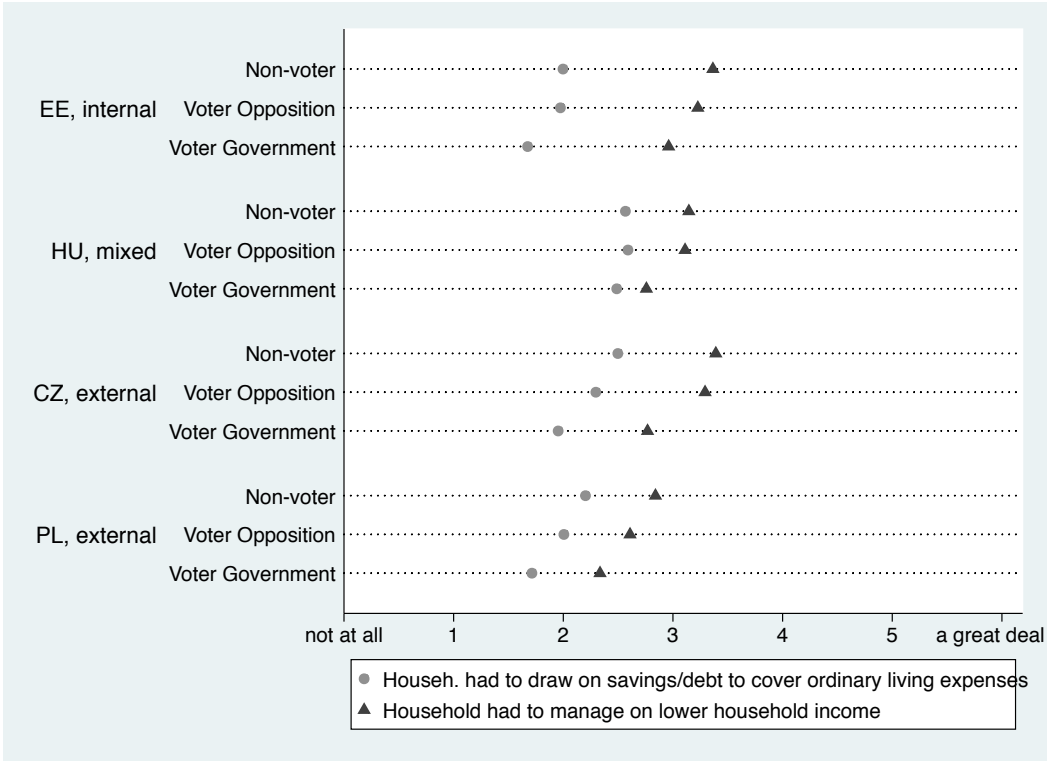
¹⁵ www.europeansocialsurvey.org

¹⁶ Results are robust to using to alternative indicators, respondents rating of the statement „I have had to cut back on holidays or new household equipment“ (Q10) and whether the respondent is currently unemployed. Since unemployment and a cut-back in holidays/equipment are likely to be more prevalent among poorer households, I prefer the other two measures.

¹⁷ 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

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 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., Wlezien et al. 1997; Evans and Andersen 2006; Gerber and Huber 2010).¹⁸ Individuals who voted for a political party that was not in government during most of the crisis is 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



Note: Weighted mean values for each voter group. Data are weighted by the design weight. Government voters are identified as voters of the parties that were in government during the crisis. Data are from the European Social Survey 2010 (survey 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 and are therefore not counted as additional government parties. d) Civic Platform and Polish Peasants’ Party in Poland (PL).

¹⁸ 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.

government voters and all other respondents is statistically significant at the 1%-level in all countries but Hungary.¹⁹ 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 orientation. 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 further 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.²⁰ 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.²¹ 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).²² 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).²³ 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

¹⁹ 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. 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.

²⁰ Age: question F3, gender, question F2, education level question F15.

²¹ 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.

²² Question F39

²³ Question F32.

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.²⁴

Table 2 shows the results of OLS regression analyses of respondents' assessments about the crisis effects on their household on these different groups (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 own voters.²⁵ 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

²⁴ Questions F17a, F1 (family is defined as a household with children), F14, respectively.

²⁵ A similar pattern with regard to rural voters, though less substantially and statistically significant, can be observed in Estonia and the Czech Republic.

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

	Estonia		Hungary		Czech Republic		Poland	
	(a) Lower income (OLS)	(b) Governm. vote (logit)	(a) Lower income (OLS)	(b) Governm. vote (logit)	(a) Lower income (OLS)	(b) Governm. vote (logit)	(a) Lower income (OLS)	(b) Governm. vote (logit)
Income	-0.251*** (0.02)	0.181*** (0.03)	-0.174*** (0.03)	0.007 (0.03)	-0.318*** (0.02)	0.115*** (0.04)	-0.269*** (0.02)	0.105*** (0.03)
Union member	0.022 (0.29)	0.069 (0.32)	0.036 (0.21)	0.168 (0.25)	-0.252 (0.19)	-0.174 (0.35)	0.419* (0.23)	-0.025 (0.26)
Public sector	-0.463*** (0.14)	0.175 (0.17)	-0.060 (0.18)	0.325 (0.20)	0.006 (0.12)	0.517** (0.20)	-0.185 (0.17)	0.036 (0.19)
State-owned enterprise	-0.367** (0.17)	-0.410* (0.22)	-0.443** (0.19)	0.016 (0.22)	-0.088 (0.16)	0.312 (0.25)	-0.216 (0.18)	-0.104 (0.21)
Self-employed	-0.163 (0.34)	0.891* (0.46)	0.163 (0.28)	-0.272 (0.36)	0.014 (0.24)	0.587** (0.29)	0.240 (0.21)	0.535* (0.28)
Retired	-0.558*** (0.19)	-0.324 (0.23)	-0.628*** (0.22)	0.013 (0.27)	-0.227 (0.18)	-0.194 (0.25)	-0.154 (0.19)	-0.206 (0.22)
Children	0.339*** (0.11)	0.186 (0.14)	0.792*** (0.14)	-0.051 (0.16)	0.496*** (0.12)	0.111 (0.17)	0.654*** (0.12)	-0.244* (0.14)
Rural	-0.016 (0.11)	0.650*** (0.14)	0.092 (0.14)	0.018 (0.16)	-0.084 (0.11)	0.333* (0.17)	-0.298** (0.12)	-0.124 (0.14)
Age	-0.004 (0.00)	0.019*** (0.01)	0.005 (0.01)	0.009 (0.01)	0.002 (0.00)	0.006 (0.01)	-0.002 (0.00)	0.003 (0.01)
Female	0.161 (0.11)	0.335** (0.14)	-0.003 (0.13)	0.342** (0.15)	0.097 (0.10)	-0.136 (0.16)	0.059 (0.12)	0.175 (0.14)
Education level	0.044 (0.05)	0.420*** (0.06)	-0.126* (0.07)	-0.024 (0.08)	-0.139** (0.07)	0.343*** (0.10)	0.006 (0.05)	0.098 (0.07)
Constant	3.315*** (0.25)	-2.825*** (0.35)	3.149*** (0.36)	-1.741*** (0.42)	3.738*** (0.29)	-3.021*** (0.45)	2.613*** (0.26)	-0.524 (0.34)
N	1501	1132	1195	1019	1675	1256	1293	927
R2	0.104		0.092		0.145		0.124	
Adj. R2	0.098		0.084		0.139		0.116	
Pseudo R2		0.1120		0.0484		0.0496		0.0321
F	16.863		11.069		21.830		17.586	
Wald chi2		144.76		38.18		49.37		38.69

* p ≤ .1; ** p ≤ .05; *** p ≤ .01

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 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 to 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 any adjustment, the 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 and were 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 demonstrates that differences in vulnerability profiles can strongly 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.²⁶ 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. Nonetheless, there has been substantial variation in crisis politics in these countries as well, with some countries successfully implementing far-reaching 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 within a monetary union? To answer these questions, the final part of this paper briefly compares the situation in the main EMU deficit countries – Ireland, Italy, France, Greece, Portugal, and Spain – to the situation in the Eastern European countries in 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.

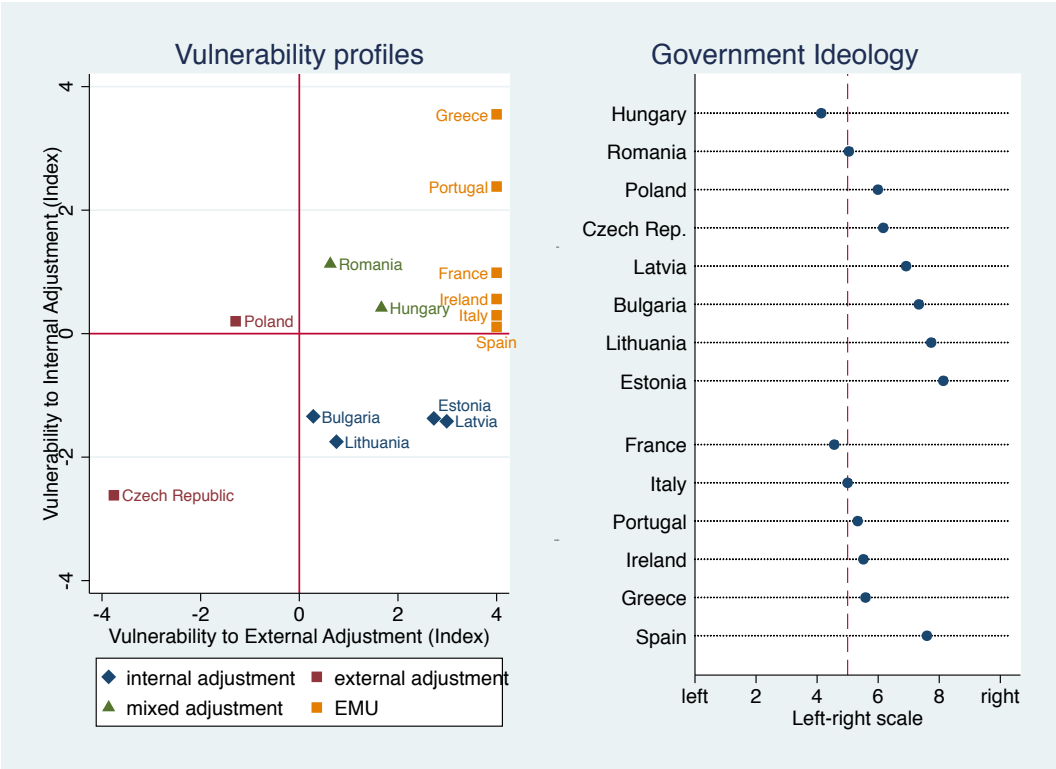
In terms of vulnerabilities, EMU member states are exceptional in that their vulnerability to external adjustment, i.e., euro exit, is exceedingly high. This high vulnerability not only results from the economic and political fallout that a euro exit would generate because of the potential loss of EU membership and the financial havoc this step would likely create across the eurozone. External adjustment in these economies would also imply the reintroduction of a national currency, creating substantial indirect foreign-currency risk in these countries.²⁷ The vast majority of debt in eurozone countries is denominated in euro, and the denomination of these debts would likely constitute one of the most contentious topics of negotiations concerning an exit from EMU. It is not unlikely that foreign debt in euro would remain denominated in euro, which would vastly increase the debt burden for individuals, firms, and banks in countries with a new, depreciating currency. For this reason, all euro-denominated external debt in the EMU deficit countries carries the risk of turning the substantial levels of external debt into foreign-currency denominated debt. All this makes all eurozone economies extremely vulnerable to a breakup of the monetary union, reflected in figure 4 as a uniform coding for all EMU member states as highly vulnerable to external adjustment. Whereas vulnerability to external adjustment does not significantly vary across EMU crisis countries, their vulnerability to internal adjustment does vary considerably – although it is high across the board. Reflecting inflexible labor markets, high unemployment

²⁶ An average current account deficit of 7.7%, compared with an average of 13.7% in the eight Eastern European countries.

²⁷ Moreover, most EMU crisis economies (with the exception of Ireland) are less export-oriented than most Eastern European states, hence further limiting the beneficial potential positive impact of a devaluation.

rates, and a strained fiscal situation, Greece and Portugal score highest, although Spain quickly joined these two countries after its housing bubble burst and the fiscal situation dramatically deteriorated in the wake of several bank rescues.²⁸ Ireland, France, and Italy show a somewhat lower vulnerability to internal adjustment going into the crisis, but nonetheless one that is significantly higher than that of the Eastern European countries that succeeded with their path of internal adjustment. Moreover, figure 4 shows that on average, 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.

Figure 4: Vulnerability profiles and government ideology in Eastern Europe and EMU deficit countries



Note: Index on external adjustment for Eastern European countries see figure 2. Vulnerability to internal adjustment is a additive index combining the variables unemployment, wage rigidity, fiscal deficit, and regulatory burden, standardized across all 13 countries in the sample (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 (based on ParlGov database, Döring and Manow 2013).

²⁸ Figure 4 is based on data for 2007 for all countries. If data for 2009 is used for the EMU crisis countries, vulnerability to internal adjustment is substantially higher, with Greece and Spain topping the list.

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 any adjustment – both in the aggregate and in terms of government constituencies. In contrast to the Baltic and Bulgarian experience, who managed to implement immense internal adjustment without major public opposition, this implies that implementing such a strategy should be much more difficult for EMU policymakers. The painful and drawn-out reform process in these countries and the strong reliance on external financing in the form of bailouts 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. This is indeed the case: 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 and Verney 2012; van Gent et al. 2013). Despite the large fallout from the crisis, however, we would also expect that well-entrenched groups and the core constituencies of the governing parties should be least 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 predictions for countries generated from this paper’s argument.

At the same time, the fact that these countries operate within a monetary union changes the situation in two key respects: First, whereas financing only tends to be a temporary option for most countries, the larger context of EMU and the EU more generally at least theoretically allows for more permanent forms of external financing through intra-EMU or intra-EU transfers. The discussions about fiscal union, an EU-wide unemployment benefits scheme, and “intra-EU solidarity” more generally attest to this possibility and it is likely that these discussions will intensify if the crisis persists. Second, deficit countries within a monetary union can try to lower their adjustment burden by convincing surplus countries to share carrying the burden, for example by accepting higher rates of inflation or a more active stimulation of domestic demand. So far, the deficit countries have not been very successful in inducing significant adjustment in surplus countries, although the ECB’s recent ultra-loose monetary policy can be interpreted as a first step in this direction. The significant financial interlinkages within the monetary union give deficit countries a certain clout and can explain why they have been rather successful in generating external financial help (although no debt relief and no adjustment) from surplus countries. Nonetheless, the fact that all EMU countries

share a rather problematic vulnerability profile does suggest that the reform process will continue to be a drawn-out, painful, and politically costly process.

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