Crisis Politics in Europe: Why Austerity Is Easier to Implement in Some Countries Than in Others

Stefanie Walter[1]

Abstract

When countries face balance-of-payments crises, their policy responses vary widely. This article argues that the choice between the two main options of *internal adjustment* (i.e., austerity and structural reforms) and *external adjustment* (i.e., exchange-rate devaluation) depends on how costly each of these strategies is for a country overall. Although the choice of adjustment strategy is thus structurally determined, the level of political conflict associated with crisis management depends on both the national vulnerability profile and partisan interests. Moreover, irrespective of the adjustment strategy, all governments design the specific reforms in ways that shelter their own voters. Empirically, this article uses qualitative case studies and survey data to examine the significant variation in crisis responses, crisis politics, and distributive outcomes of the 2008-2010 global financial crisis in eight Eastern European countries. The article concludes with a discussion of the implications of the Eastern European experience for crisis politics in the Eurozone crisis.

Keywords

economic policy, political economy, east European politics, politics of growth/development, euro crisis, financial crisis

[1]University of Zurich, Switzerland

Corresponding Author:
Stefanie Walter, University of Zurich, Affolternstrasse 56, 8050 Zurich, Switzerland.
Email: walter@ipz.uzh.ch

Across the Eurozone, crisis politics have varied widely. Some countries, such as Ireland, have successfully implemented painful domestic reforms. Others have experienced significant political difficulties in resolving their macroeconomic and structural problems. In Greece, for example, the implementation of austerity measures and structural reforms have been so politically contentious that it has brought the country to the verge of a Eurozone exit twice and has drawn many voters to radical parties on the right and the left of the political spectrum.

Existing research leaves us less puzzled by the political struggles in Greece than by the Irish success. Most research on the politics of past balance-of-payments (BOP) crises, such as the breakdown of the gold standard (Eichengreen, 1992; Simmons, 1994), the Latin American Debt Crisis (Frieden, 1991a; Nelson, 1990), or the Asian Financial Crisis (Pepinsky, 2009; Walter, 2013), emphasizes the political difficulties associated with implementing painful domestic reforms. The Eurozone crisis is the newest in this series of crises (Copelovitch, Frieden, & Walter, 2016; Gibson, Palivos, & Tavlas, 2014). It is an unusual crisis because membership in a currency union officially rules out the option of external adjustment. This presents Eurozone countries with a daunting task: History shows that democracies usually devalue their currencies during severe BOP crises, rather than "adjust internally" through austerity and structural reforms. Nonetheless, across the Eurozone all crisis countries have embarked on a course of internal adjustment: The wish to remain a member of the Eurozone deprives them of the option to devalue their exchange rate. What is puzzling is that some countries have had a much easier time implementing this strategy than others.

Marrying insights from comparative and international political economy research, this article argues that this variation can be understood in terms of national differences in the costs of internal adjustment relative to the costs of external adjustment. Differences in a country's cost structure, or "vulnerability profile," affect the choice of crisis strategy and the level of political conflict associated with crisis management. If one adjustment path (say Eurozone exit) clearly imposes more costs than the alternative (say internal adjustment), the government pursues the latter path swiftly and without major political difficulties. In contrast, when both crisis strategies are associated with high economic and social costs, crisis politics will be fraught with political conflict, delay, and attempts to involve other countries in the crisis resolution process. The choice of adjustment strategy is thus basically a technocratic choice; however, partisan considerations influence the specific policy design, as all governments try to protect their own voters from the consequences of the crisis.

To empirically test this argument, this article analyzes how another set of European countries responded to similar problems. It performs qualitative comparative case studies of how eight Eastern European EU member states outside the Eurozone varied with regard to crisis responses, crisis politics, and distributive outcomes during the Global Financial Crisis of 2008-2010. As EU members, these countries operated in a framework that is similar to those of Eurozone countries in many respects. But as EU countries outside the Eurozone, they still had the full set of policy options at their disposal. Nonetheless, four countries—Bulgaria, Estonia, Latvia, and Lithuania—still chose internal adjustment rather than a devaluation of their currencies, an approach that plunged these countries into deep recessions but nonetheless enjoyed wide popular support. In contrast, crisis resolution was much more difficult and contentious in Hungary and Romania where adjustment measures included elements of both internal reforms and exchange-rate devaluation. Finally, Poland and the Czech Republic devalued in response to the crisis, a strategy that was largely uncontroversial. The analysis shows that these differences in adjustment strategies and crisis politics were associated with variation in national vulnerability profiles. Despite these significant differences, the distributive outcomes of the crisis did not vary significantly across countries: Government voters systematically felt less affected from the consequences of the crisis than voters of the opposition or non-voters.

Looking at the Eastern European experience allows me to investigate under which circumstances countries succeed in their efforts to adjust internally, and under which circumstances crisis resolution is particularly difficult. Taking into consideration that not only the cost of external adjustment but also the willingness of other Eurozone members to provide financial support are significantly larger in the Eurozone, this analysis then allows me to draw inferences about the politics of crisis management in the Eurozone crisis. The last section of this article therefore concludes with a discussion of the implications of the Eastern European experience for the Eurozone crisis.

Argument

BOP crises have been a constant feature of the international economy and are often associated with other crises, most notably debt, banking, and currency crises. They all share the same core problem: The country is consuming more than it is producing, which is reflected in a current account deficit. When the private foreign capital that has been financing this consumption stops flowing in, the country experiences a BOP crisis.

In principle, there are three ways to address such a crisis (Webb, 1991). Countries can continue to *finance the current account deficit* using their

foreign-currency reserves or accessing other (non-private) forms of foreign capital. Although this is the appropriate policy response to BOP problems caused by temporary shocks, it does not solve BOP problems caused by fundamental macroeconomic and structural problems. In those cases, a substantial adjustment of economic policies aimed at a realignment of foreign and domestic prices is needed.[1]

Adjustment in these more serious cases can be achieved in two ways: First, a reduction in relative prices can result from a depreciation or devaluation of the nominal exchange rate, a strategy called *external adjustment*. Alternatively, macroeconomic austerity and structural reforms can reduce domestic demand and increase productivity, which also lowers relative prices.[2] This strategy is called *internal adjustment*, also known as *internal devaluation*. 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 toward 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 funds are available, either in form of foreign-currency reserves or in terms of international financial support. Moreover, if the time bought by financing is not used to implement reforms, the fundamental problems underlying the BOP problems tend to deteriorate, necessitating much more extensive adjustment later on.[3]

External adjustment implies a significant devaluation of the exchange rate. On the upside, this stimulates exports, and therefore particularly benefits countries with a strong export-oriented sector (Frieden, 1991b). But devaluation also reduces purchasing power, which hurts consumers and firms who heavily rely on imported intermediate goods (Frieden, 2014). It is also a particularly costly strategy for countries with high levels of net external and foreign-currency denominated debt, who see their debt burden rise as a consequence of devaluation (Walter, 2008, 2013; Woodruff, 2005). Moreover, devaluation often precipitates inflation and exchange-rate volatility and creates contagion risk for states with similar problems. Especially in fixed exchange-rate regimes, devaluing is often a politically costly choice, because it damages credibility and contradicts expectations of exchange-rate stability (e.g., Blomberg, Frieden, & Stein, 2005; Stein & Streb, 2004; Walter, 2009).

Finally, internal adjustment is painful because it implies austerity (brought about by higher interest rates, public spending cuts, and tax increases) and structural reforms (such as labor market reforms or policies aimed at increasing competitiveness). In the short run, this adjustment strategy typically leads to higher unemployment, lower wages, asset price deflation, and recession. It

is particularly costly when implemented in a macroeconomic environment that is weak to begin with, when the budget is already in deficit, and when the economic structures that structural reforms intend to liberalize are deeply entrenched. This creates huge political obstacles for democratically elected governments, and is therefore a strategy that these have found very difficult to implement (Eichengreen, 1992; Simmons, 1994).

BOP 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 this choice? I assume that policymakers care about the median voter and the state of the national economy (Downs, 1957). When faced with a BOP crisis, they therefore consider how the different options for policy adjustment will affect the country as a whole and choose the option under which the country's economy will suffer least. Echoing earlier research on distributive politics in times of crisis (Frieden, 1991b, 2015; Gourevitch, 1986; Haggard & Kaufman, 1992; Pepinsky, 2009; Walter, 2013), this suggests that policymakers decide on their preferred adjustment strategy by weighing the overall costs of internal adjustment against the costs of external adjustment. The country's choice of adjustment strategy is thus mainly structurally determined by its "*vulnerability profile* (Walter, 2013)—that is, the potential costs of external adjustment for the country relative to the potential costs of internal adjustment. Although this vulnerability profile tends to be endogenous to earlier policy choices, it presents an exogenous context within which governments have to address the crisis. Figure 1 summarizes the four different vulnerability profiles that a country can exhibit.

But democratic policymakers also follow different partisan ideologies and care about the well-being of their voters (Bearce, 2003; Garrett, 1998; Hibbs, 1977). Although the country's vulnerability profile determines the general choice of adjustment strategy, it is the more narrow electoral interests of parties that influence the precise design of the specific anti-crisis policy package within the confines of the general adjustment strategy. Governments will design this policy package in a way that shields the government's voters as much as possible from the potentially negative effects of adjustment, leaving societal groups mainly represented by the opposition and non-voters to bear the brunt of adjustment. For example, structural reforms will be designed in ways that benefit or spare the government's core voters; tax increases and spending cuts will mainly be borne by non-voters and the oppositions' main voter groups, and the government may implement specific policies designed to offset the negative impact of a devaluation on its constituents.

The country's vulnerability profile thus determines the government's choices about the general adjustment strategy, whereas the specific policy
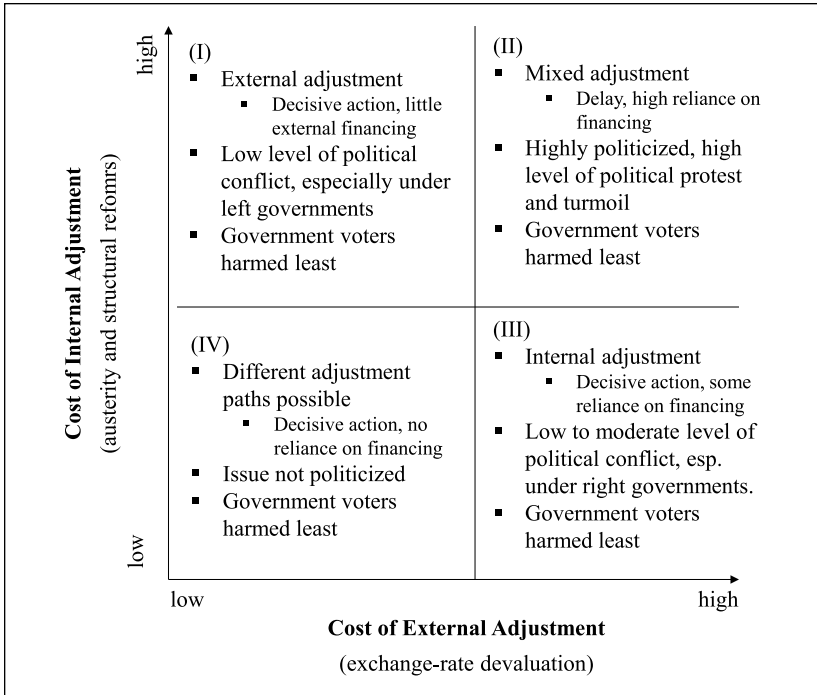
Figure 1. Vulnerability profiles, adjustment strategy, crisis politics, and distributive outcomes—Hypotheses.

design, the level of political conflict surrounding crisis politics and the distributive outcome of the crisis are influenced by partisan considerations as well.

Choice of Adjustment Strategy

How does a country's vulnerability profile determine the choice of adjustment strategy?

This choice is clear-cut when one type of adjustment strategy is significantly more costly than another, because this creates strong incentives to implement the less costly strategy in a swift and decisive manner. Two vulnerability profiles fit this scenario. The first one (Vulnerability Profile I in Figure 1) contains countries for which austerity and structural reforms are very costly, whereas the potential costs of external adjustment are comparatively low. An example is a country characterized by high unemployment and inflexible labor markets, and a large export-oriented sector. These countries

typically respond to BOP pressures with a swift devaluation of the exchange rate and without much financing. In the second case (Vulnerability Profile III), the potential costs of devaluation are significantly higher than those of internal adjustment, for example, because the private sector holds high levels of foreign-currency denominated debt and relies heavily on imports, whereas labor markets are flexible. Here, governments are likely to opt for internal adjustment, while maintaining exchange-rate stability. Because domestic prices decrease more slowly with this strategy, some temporary financing to bridge the time until the reforms start to bite is likely, but such financing will be regarded as a way to smoothen, rather than avoid, adjustment.

Policymakers face a much more difficult situation when both internal and external adjustments are very costly (Vulnerability Profile II)—for example, when a country has high levels of unemployment, rigid economic structures, and widespread foreign-currency denominated debt. This vulnerability profile creates strong incentives to delay adjustment and finance the current account deficit instead. Avoiding adjustment altogether is possible as long as countries can draw on their reserves, but gets more difficult as soon as financing from external sources, such as the International Monetary Fund (IMF), is needed. Because external assistance to help the country to resolve its BOP problems is typically granted so that a larger international financial crisis can be avoided, such financing is usually subject to conditionality requiring the government to adjust. This puts policymakers in Profile II countries in an uncomfortable situation. As a result, negotiations about the conditions attached to external financial support are likely to be difficult, and compliance with conditionality is likely to be spotty. Once adjustment becomes unavoidable (either because of donor conditionality and/or market pressure), policymakers are likely to mix elements of external and internal adjustment.

Responding to BOP pressures is easiest for countries with a vulnerability profile IV. Given the low cost of adjustment, policymakers have a lot of leeway in choosing their response. Financing and delay are less likely under these circumstances. Unfortunately, countries with severe BOP problems are unlikely to find themselves in this category.

Crisis Politics and Distributive Outcomes

The argument, that the vulnerability profile determines the choice of adjustment strategy, suggests that this choice is more or less depoliticized. But in many instances, crisis politics is highly contentious. So when and where does politics enter?

Both a country's vulnerability profile and the government's partisan interests influence the level of political conflict associated with crisis management.

Political conflict will be particularly high in countries with a vulnerability profile II, as any policy adjustment will cause widespread pain in these countries. In countries exhibiting any of the other three vulnerability profiles, crisis politics will be less conflictual. This is especially the case when there is a clear preference both within the country overall and among the government's partisan constituency for one specific type of adjustment. When national vulnerabilities and the preferences of the government's core voters diverge, crisis management will be more contentious.

Partisan preferences depend on the vulnerability profiles of a party's core voters. Vulnerability profiles for individuals, special interests, or political parties. They denote how costly devaluation will be for the individual or (voter) group, relative to the costs of internal adjustment (Walter, 2013). Partisan vulnerability profiles vary both across countries and across political parties, aligning some parties more strongly with the national vulnerability profile than others. For example, left parties usually represent voters who tend to be hurt more by austerity than devaluation, whereas the reverse tends to hold for conservative parties (Bearce, 2003; Oatley, 1997). Political parties whose voters on average exhibit a vulnerability profile similar to the national vulnerability profile face no trade-offs between their partisan and national interest: Both point to the same adjustment path. Governments comprised of such parties will be able to implement their crisis policies without major problems. In contrast, government parties whose voters are vulnerable to the adjustment path suggested by the national vulnerability profile face a more difficult situation. The concern about the national economy pushes these governments to implement policies that stand in conflict with their partisan interests. Crisis politics are bound to be more conflictual in these situations.

What does this imply for the level of political conflict associated with responding to a BOP crisis and the distributive consequences of it? Let us consider these questions for each vulnerability profile (the hypotheses are summarized in Figure 1).

Devaluation will be easiest to implement for left governments governing a "Profile I" country, because their voters tend to be more vulnerable to unemployment and expenditure cuts than exchange-rate adjustment. Governments whose voters' vulnerability profiles do not align with the national profile, will also adjust externally in this environment, but this choice will be more contentious. As a result, these governments are likely to combine external adjustment with policies that buffer the negative effects of devaluation for their constituents. For example conservative governments may additionally design programs supporting holders of foreign-currency denominated debt.[4] Regardless of which party governs, government voters should therefore be harmed least by the crisis.

Similarly, there will be a broad political consensus in Profile III countries that internal adjustment is preferable to devaluation. But because internal adjustment can be carried out in far more varieties than external adjustment, it is more susceptible to particularist interests and political conflict over specific policy design. Crisis management is therefore likely to be more contentious than in countries pursuing devaluation. In addition, austerity should be easier to implement for conservative parties than left parties. But all governments are likely to design the adjustment package in ways that spare their own voters the most. For example, agrarian parties might design structural reforms that only pertain to the industrial, but not the agrarian sector, whereas leftist parties might introduce new progressive taxes. As a result, government voters again will on average be hit less hard by crisis than opposition voters or non-voters.

Crisis management will be most contested and conflictual in Profile II countries. Because both external and internal adjustments are bound to be painful, policymakers have no good choices to make. Political conflict both about the general crisis response and the design of specific policies will be rife, leading to political protests and turmoil. Governments will design reform packages that once more try to shelter their own voters as much as possible from the repercussions of the crisis, with left governments relying somewhat more on external and right governments more on internal adjustment measures. Nonetheless, this is likely to be more difficult than in the other cases.

Finally, because adjustment is not associated with large costs, responding to BOP pressures is going to be a largely depoliticized issue in Profile IV countries, although the specific policy design will once more reflect the partisan interests of the government.

Empirical Evidence: Crisis Management in Eastern Europe

To what extent can this argument explain national variation in crisis responses, crisis politics, and distributive outcomes? In particular, can it explain why some democracies choose to implement painful domestic reforms, even though this has proven to be a very difficult undertaking in past crises? To empirically assess the argument proposed above, this section conducts a comparative case study of the only crisis episode so far in which a considerable number of democracies successfully implemented internal adjustment. It focuses on eight new EU member states in Central and Eastern Europe that experienced BOP pressures in the wake of the global financial crisis (2008-2010): Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Romania.

This group of countries lends itself well to a comparative case study analysis: The region had boomed in the years following EU accession and all eight countries exhibited current account deficits in the run-up to the crisis. When the collapse of Lehman Brothers sent shock waves around the world in the fall of 2008, the region was hit particularly hard (European Bank for Reconstruction and Development [EBRD], 2010). All eight countries faced BOP pressures in the wake of the global financial crisis. As members of the European Union, these countries also shared a broad regulatory framework and had access to EU funds that could to some extent be used to cover external financing needs. But because they had not yet adopted the euro when the crisis hit, these countries were much less constrained in their choice between internal and external adjustments than the countries in the Eurozone.

Despite these similarities, the eight countries pursued a diverse set of strategies in response to the crisis. Some countries adjusted internally, others relied mainly on external adjustment, and some chose more mixed strategies. Certain countries relied heavily on external financing support, whereas others implemented their anti-crisis strategies without major external funding. Some acted swiftly, some only after considerable delay. Crisis politics varied considerably as well, being fraught with severe political conflicts in some countries, whereas crisis management was not very contentious in others.

The argument suggests that the differences in Eastern European crisis management and crisis politics should be related to variation in national vulnerability profiles. To test this claim, I first identify each country's vulnerability profile based on an estimation of the potential costs of external and internal adjustment and then analyze whether variation in cost profiles is associated with variation in policy responses, crisis politics, and reform outcomes.

Vulnerability Profiles

To classify countries by their vulnerability profile, I use principal components analysis (PCA) to construct two indices that gauge the potential cost of external and internal adjustments for each country. PCA is a method that reduces the information contained in several variables by calculating "components" that capture as much variation from the original variables as possible, taking into account the correlation between these variables. Each principal component can be interpreted as a common underlying dimension of the original data. Based on a sample comprising the eight Eastern European countries studied in this article and all European Monetary Union (EMU) countries that recorded a current account deficit in 2007,[5] I conduct two separate PCAs for two sets of variables associated with the costs of external

adjustment and internal adjustment, respectively. I then use the first principal component from each analysis as a measure of the potential cost of adjustment. Details on the analysis and the operationalization are presented in the online appendix.

The variables used in each PCA analysis reflect the theoretical expectations about the factors driving the cost of each adjustment strategy and take the values for the year 2007, that is, the year before the global financial crisis took its toll in Europe. External adjustment is particularly costly for countries owing net external and foreign-currency debt, struggling with inflationary pressures, and following a fixed exchange-rate regime, and is less costly for countries with a large export-oriented sector. These factors are operationalized by the following variables (Table 1): net external debt in percent of gross domestic product (GDP), the Net International Investment Position in percent of GDP (both European Commission, 2014), the foreign-currency exposure of the non-financial sector (based on Bank for International Settlements [BIS], 2015; Brown, Peter, & Wehrmüller, 2009),[6] the size of the export sector in percent of GDP and the inflation rate (both Eurostat, 2015). Because having a fixed exchange-rate regime did not load strongly on the first dimension and had a negative loading, I chose not to include it in the index so as to have a clearly interpretable measure of external adjustment costs. Instead, I will address the variation in exchange-rate regimes when interpreting the results. I use the predicted values of the first principle component, which explains 49.3% of the variation in the data, as my measure for the potential costs of external adjustment.

Internal adjustment is costly when it is implemented in a weak macroeconomic and fiscal environment and when economic structures are rigid and deeply entrenched. To capture these aspects, I include the unemployment rate, the size of the government budget deficit (both Eurostat, 2015), general government sector debt in percent of GDP (European Commission, 2014), and a measure of the rigidity of employment (World Bank, 2007) in my analysis. Once more, I use the predicted values from the first principal component, which captures 52.1% of the variation in the data, as my measure for the potential costs of internal adjustment.

Figure 2 shows the vulnerability profiles of the eight Eastern European economies on the basis of these two indices. The size of markers varies, with larger circles representing larger current account deficits (Eurostat, 2015) and hence a higher need for adjustment. Bulgaria, where the current account deficit in 2007 amounted to 25.2% of GDP, and Latvia (22.4%) exhibit the biggest current account deficits, whereas deficits are much smaller for the Czech Republic (4.3%) and Poland (6.2%).

Table 1. Variable Values: Vulnerability to Internal and External Adjustments.

	Net external debt	Foreign-currency exposure of non-financial sector	NIIP	Exports/ GDP	Inflation rate	Unemployment rate	Government sector debt	Government surplus/deficit	Rigidity of employment	Current account balance 2007	Exchange-rate regime
Bulgaria	32.7	48.2[b]	−81.1	53.3	7.6	6.9	17.2	1.1	29.0	−25.2	Currency board[a]
Czech Republic	−7.3	13.9	−38.7	66.6	3.0	5.3	27.9	−0.7	31.0	−4.3	Managed float
Estonia	35.0	79.2	−72.0	63.2	6.7	4.6	3.7	2.5	58.0	−15.9	Currency board[a]
Hungary	50.9	55.7	−105.1	78.6	7.9	7.4	67.0	−5.1	30.0	−7.3	Flexible
Latvia	49.6	86.1	−74.7	38.5	10.1	6.1	9.0	−0.6	43.0	−22.4	Fixed[a]
Lithuania	29.6	50.0	−55.8	50.4	5.8	4.3	16.8	−0.8	48.0	−14.4	Currency board[a]
Poland	20.7	24.6	−50.1	38.8	2.6	9.6	45.0	−1.9	37.0	−6.2	Flexible
Romania	20.9	58.9	−47.1	29.1	4.9	6.4	12.8	−2.9	66.0	−13.4	Managed float
Cyprus	−19.8	40.4[b]	11.7	53.8	2.2	3.9	58.8	3.3	24.0[c]	−11.7	Currency union
France	10.8	44.8	−1.5	27.1	1.6	8.0	64.2	−2.5	56.0	−1.0	Currency union
Greece	69.3	10.9	−96.1	22.5	3.0	8.4	107.2	−6.5[d]	55.0	−14.6	Currency union
Ireland	−212.0	30.7	−19.5	77.5	2.9	4.7	24.9	0.3	17.0	−5.3	Currency union
Italy	41.4	29.8	−24.5	27.4	2.0	6.1	103.3	−1.5	38.0	−1.3	Currency union
Malta	−85.6	40.4[b]	17.7	129.5	0.7	6.5	60.7	−2.3	42.7[e]	−6.2	Currency union
Portugal	64.0	30.4	−87.9	31.0	2.4	9.1	68.4	−3.0	48.0	−10.1	Currency union
Slovenia	20.4	21.9	−21.8	67.6	3.8	4.9	23.1	−0.1	63.0	−4.2	Currency union
Spain	68.5	22.3	−78.1	25.7	2.8	8.2	36.3	2.0	56.0	−10.0	Currency union
M	11.12	40.48	−48.51	51.8	4.12	6.49	43.9	−1.1	43.63	−10.21	
SD	68.71	21.12	37.67	27.46	2.62	1.75	31.57	2.58	14.33	6.87	

Note. Values refer to the year 2007. NIIP = net international investment position; GDP = gross domestic product.
a. European Exchange Rate Mechanism (ERM) II member. b. Data for Malta and Cyprus are imputed as average value of European Monetary Union (EMU) countries. c. 2009 data. d. Data taken from World Development Indicators. e. Imputed as mean of the variable.
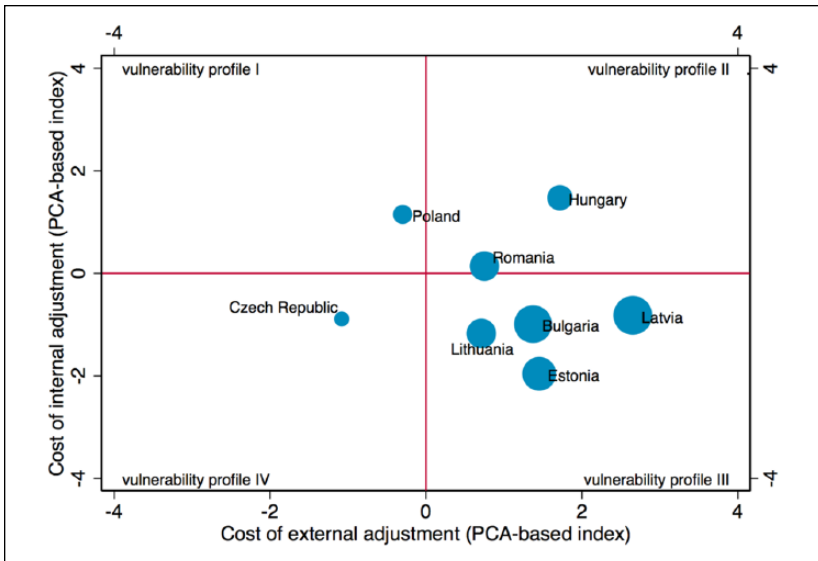
852

Figure 2. Vulnerability profiles of eight Eastern European countries.
Size of markers correspond to the 3-year average of the current account deficit (2005-2007).
Indices are constructed as predicted values of PCAs and based on 2007 values (see text and
online appendix). PCA = principal components analysis.

The graph shows that each vulnerability profile is represented by at least
one country case. Poland exhibits a vulnerability profile I. High unemploy-
ment and a strained fiscal situation were bound to make internal adjustment
more painful than a depreciation of the currency in an environment of low
external and foreign-currency debt, well-contained inflation expectations,
and a flexible exchange-rate regime. Romania and Hungary both have a vul-
nerability profile II, putting these countries in the uncomfortable position of
facing high costs associated with both external and internal adjustment. This
was mainly based on their high levels of foreign-currency denominated bor-
rowing coupled with a strained fiscal position. The biggest cluster of coun-
tries exhibits the unusual vulnerability profile III and consists of Bulgaria,
Estonia, Latvia, and Lithuania. These countries were very vulnerable to
exchange-rate devaluation. Not only had private borrowing abroad and in
foreign currency been very high (European Central Bank, 2011) in these
countries. External adjustment also meant giving up their fixed exchange-rate
regimes in the form of currency boards and/or membership in the ERM II
mechanism, which would put the near-term goal of euro adoption in jeopardy

(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) and carried large contagion risks across the other fixed exchange-rate regimes. At the same time, rather flexible labor markets (Purfield & Rosenberg, 2010) and a sound fiscal situation reduced the potential costs of internal adjustment in these countries. Finally, due to a strong export orientation, low level of external and foreign-currency denominated debt, and rather flexible economic structures, the Czech Republic exhibited a vulnerability profile IV, suggesting that relatively low potential costs of both external and internal adjustments.

Managing the Crisis in Eastern Europe: Policy Responses, Response Speed, and Reliance on Financing

Was this variation in vulnerability profiles associated with variation in national policy responses? Table 2 shows that although all eight countries experienced BOP pressure in the wake of the global financial crisis, their reactions to this pressure differed substantially. Poland (Profile I) and the Czech Republic (Profile IV) let their exchange rates depreciate immediately when their currencies came under pressure in the late summer of 2008 and initially even pursued expansionary fiscal and monetary policies, rather than austerity policies. 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.[7] Although both countries benefited from accelerated access to structural and cohesion funds from the European Union, the crisis response undertaken by the Czech and Polish governments can thus be characterized as swift external adjustment with very limited recourse to financing.

In Hungary and Romania (Profile II), policymakers showed more reluctance to adjust. When their currencies came under pressure in 2008, both national central banks raised interest rates and intervened on the foreign exchange market to counter this pressure. But when depreciation nonetheless accelerated, both countries sought help from the international community, most notably the IMF and the European Union. Hungary concluded a US$25 billion package with the IMF, the European Union, and others in October 2008, and Romania followed with a US$27 billion package in March 2009. In return for these funds, both countries agreed to pursue substantial fiscal consolidation and structural reforms. Both countries thus combined elements of external and internal adjustments and the crisis trajectory was painful: Unemployment and the proportion of non-performing loans increased, wages fell, and real GDP fell by almost 7% in 2009.

Table 2. Overview About Government Composition and Policy Responses, 2008-2010.

Country	Vulnerability profile	Government ideology (left (1)-right (10) score)	Policy response
Poland	I	Center-right (5.99)	External adjustment Currency depreciation up to 43%, no austerity, no recession. Precautionary IMF program (not used).
Hungary	II	Leftist (2.98) April 09: Technocratic government, supported by Socialist party May 10: Rightist (6.66)	Mixed adjustment Currency depreciation up to 31%, fiscal consolidation through public sector wage, pension, and other spending cuts. Support for holders of foreign-currency mortgages. Unemployment increased by 50%. Significant foreign-currency interventions, Stand-By Agreement with the IMF.
Romania	II	Center-right (6.04) December 08: Center-left (4.33) December 09: Center-right (5.49, later 5.30)	Mixed adjustment Currency depreciation up to 22%, fiscal consolidation through public sector wage cuts and other spending reductions. Unemployment increased moderately. Significant foreign-currency interventions, Stand-By Agreement with the IMF.
Estonia	III	Rightist (7.47, later 8.12)	Internal adjustment No depreciation, large fiscal adjustment, significant cuts in public sector wages, labor market flexibilization. Unemployment more than tripled. Bilateral financial support from Nordic countries.

(continued)

855

Table 2. (continued)

Country	Vulnerability profile	Government ideology (left (1)-right (10) score)	Policy response
Latvia	III	Rightist (6.99, later 6.58)	Internal adjustment Almost no depreciation, large fiscal consolidation, large cuts in public sector wages and employment. Unemployment tripled. Stand-By Agreement with IMF, bilateral financial support from Nordic countries.
Lithuania	III	Center-right (5.46)	Internal adjustment No depreciation, large fiscal consolidation, significant cuts in public sector wages, labor market flexibilization. Unemployment quadrupled. Bilateral financial support from Nordic countries
Bulgaria	III	Center-left (4.08)	Internal adjustment No depreciation, fiscal consolidation through expenditure cuts and tax increases. Unemployment increased by 50%
Czech Republic	IV	July 09: Rightist (7.33) Rightist (6.97) May 09: Caretaker government July 10: Rightist (7.07)	External adjustment Currency depreciation up to 21%, no domestic austerity, later some fiscal consolidation. Unemployment increased moderately.

Sources. Aslund (2010); Myant, Drahokoupil, and Lesay (2013); and Walter (2013). Ideology score based on ParlGov database (Döring & Manow, 2013), calculated as weighted mean of all cabinet parties.
IMF = International Monetary Fund.

Policymakers in the Baltic states and Bulgaria (Profile III) chose a very different path to address their large current account imbalances. They speedily implemented far-reaching and painful domestic reforms such as wage reductions, cuts in public employment and other expenditure cuts, as well as tax increases aimed at an "internal devaluation" of prices, while keeping exchange rates unchanged (for a more detailed discussion, see Aslund, 2010; Kattel & Raudla, 2013). In all four countries the internal adjustment strategy was successful, but also caused a collapse in growth and massive increases in unemployment. All four countries combined their adjustment policies with a financing component to counteract the strong pressure on their currencies and banking sectors. They all used their foreign-currency reserves and external funds from the European Union, which were granted mainly through an easier access to structural and cohesion funds. In addition, the Baltic countries received 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 BOP support in the form of a regular stand-by agreement.

The analysis thus supports the hypothesis that the type of vulnerability profile determines the choice of adjustment strategy and the reliance on financing.

Crisis politics. Eastern European countries not only responded differently to the crisis but also differed with regard to the severity of political conflicts associated with crisis politics.

In line with expectations (see Figure 1) for countries with a vulnerability profile I, the choice of the external adjustment path was uncontroversial in Poland (Myant, Drahokoupil, & Lesay, 2013). The depreciating currency was not much discussed and the export industry even welcomed it (Bernaciak, 2013). From a partisan perspective, the implementation of counter-cyclical Keynesian policies coupled with exchange-rate adjustment may seem puzzling for a centrist government. However, considering that the government's largest political challengers were situated at the right of the political spectrum, this strategy appears more in line with the government's partisan interests. The uncontroversial nature of the crisis management is 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). Both government parties did well in all elections, including the presidential elections in July 2010, 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.

Crisis politics in Hungary and Romania were much more conflictual. As expected for countries with a vulnerability profile II, crisis management in both countries proved highly controversial and incumbents faced significant political problems and electoral challenges (although these political difficulties were not solely related to the economic crisis but also to corruption charges, especially in Romania). In Hungary, the Socialist minority government, which mainly represented "cosmopolitan, post-communist and anti-clerical" voters (Bértoa, 2014, p. 24), held office when the forint came under strong speculative pressure in the fall of 2008. During this episode economic conditions substantially worsened. The government's policy response, a mix of depreciation, an IMF program, and some internal adjustment, was unpopular and the Socialist Prime Minister Ferenc Gyurcsány resigned in March 2009 amid public protests and strikes. 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, while also creating several policy instruments designed to support households holding foreign-currency debt. But as unemployment and inflation continued to increase, discontent with the government rose especially among poorer voters (Varnagy, 2010). In the next regular elections in April 2010, the incumbent Socialists lost about two thirds of their seats in parliament, 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 an early peak of the crisis in November 2008. After difficult negotiations, a new center-left coalition government formed, but conflicts regarding how to address the economic crisis quickly arose between the coalition partners. Although the IMF program committed the governing parties to internal adjustment measures, these were implemented in a half-hearted manner (Stan & Zaharia, 2010). The divergent policy stances of both parties led to increasing tensions within the government, culminating in its breakdown in October 2009 amid major protests against the government's austerity measures. In line with conservative voters' interests, the new center-right government subsequently implemented more austerity (Aslund, 2010). But political difficulties continued: In June 2010, the government narrowly escaped a vote of no confidence over 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 crisis resolution. The experiences of Hungary and Romania thus highlight the political difficulties associated with adjustment in countries with a vulnerability profile II.

In the Baltic republics and Bulgaria (vulnerability profile III), the choice of internal adjustment and the decision to maintain exchange-rate stability enjoyed strong popular and political support, even though the consequences of this policy response were harsh (Bukovskis, 2014; Kattel & Raudla, 2013; Kuokstis & Vilpisauskas, 2010). Even in Latvia, the hardest hit of the four 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). Although external adjustment was discussed as a distinct policy option in international policy circles[8] and was initially the IMF's preferred policy response for Latvia (International Monetary Fund [IMF], 2009; Lütz & Kranke, 2014), this option was ruled out, or not even considered, by most domestic analysts (Kuokstis & Vilpisauskas, 2010). And although political tremors affected all four countries and changes in the government occurred in each case, more reform-minded parties and politicians were voted into office (Table 2). As these were more right-leaning parties, many of their voters were the better-off, but were also more likely to hold foreign-currency debt, which increased their support for internal, rather than external, adjustment. This is not to say that the path of internal adjustment was politically easy. In January 2009, riots erupted in the capitals of Latvia and Lithuania, following demonstrations against austerity measures and the government more generally. In most countries, the coalition partners in government fought over specific austerity and structural reform measures. In Estonia, the Social Democrats left office when their more right-leaning coalition partners proposed reforms that squarely hurt the Social Democrats' core voters (Raudla & Kattel, 2011). But whereas the specific design of the internal adjustment measures were debated, the strategy itself was never substantively questioned. This broad overall support for internal adjustment and comparatively modest political difficulties are unusual. Given the pain internal adjustment generated through the massive increase in unemployment (it more than tripled in the Baltics), 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). Although this broad consensus about the strategy of internal devaluation also partly stemmed from geopolitical concerns about Russia 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 vulnerability profile that clearly led to a preference of internal over external adjustment.

Finally, in the Czech Republic (Profile IV), the choice of the external adjustment path was uncontroversial. Nonetheless, Czech politics were turbulent in the years surrounding the global financial crisis. The inherently unstable coalition and scandal-ridden 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 of Czech politics had begun before the crisis and was not directly related to the decision to let the exchange rate depreciate (Aslund, 2010). 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 property (Linek & Lacina, 2010). Only the salience of fiscal policy increased over time (Stegmaier & Vlachová, 2011). The Czech case thus shows that domestic politics is likely to be rather unaffected by BOP adjustment when vulnerability to both internal and external adjustments among influential societal groups is low.

Policy outcomes: The distributional effects of crisis management. The analysis so far has shown that, in line with my argument, different vulnerability profiles were associated with variation in policy responses and political conflict in Eastern Europe, whereas governments' partisan ideology was unrelated to the general choice of adjustment path. But I have additionally argued that partisan interests should affect the specific policy design and the distributive outcomes of the crisis. A closer look at the cases supports this expectation. For example, in Estonia, the government coalition had originally also included the Social Democratic party, but this coalition broke apart over a conflict about the specific reforms included in a new austerity package: Whereas the Social Democrats pushed for an increase in the income tax to finance higher unemployment benefits, its more conservative coalition partners refused to increase spending on unemployment benefits. The Social Democrats ultimately left the government and the conservative minority government pushed through the package in June 2009 with the help of the Green party, whose support was won by increasing environmental fees and taxes (Raudla & Kattel, 2011). Among others, this package curbed unemployment benefits and increased value-added tax (VAT), measures that clearly hurt the poorer part of the population, who no longer had strong advocates in the government coalition. In Poland and the Czech Republic, overseeing the depreciation of the national currencies was facilitated for the (center-)rightist governments by the fact that it was strongly supported by the export sectors in both countries. Moreover, the governments complemented this external adjustment with policies specifically targeted at particularly important voter

groups, such as entrepreneurs. For example, new tax deductions for small and medium-sized enterprises were implemented in Poland and business taxes and social insurance contributions were reduced in the Czech Republic (Myant et al., 2013). In Hungary, the ruling Socialists had complied with IMF conditionality, restructuring the tax system and changes to the pension system, but shied away from proposing substantive cuts in government spending. The government also compensated public sector employees for bonuses that had been cut as a consequence of the IMF program (Economist Intelligence Unit, 2009). Similar examples can be found in the other countries examined in this article.

To test the hypothesis that incumbent policymakers design specific policies in ways that privilege their own voters in a more systematic manner, I use data from the fifth round of the European Social Survey (ESS) from October 2010.[9] The survey covers four of the countries analyzed in this article. These countries vary with regard to vulnerability profiles, choice of adjustment strategy, and government ideology and include Poland (Profile I, external adjustment, centrist government), Hungary (Profile II, mixed adjustment and financing, left government), Estonia (Profile III, internal adjustment, rightist government), and the Czech Republic (Profile IV, external adjustment, rightist/technocratic government). The survey includes a battery of questions on the effects of the global financial crisis, two of which I use to investigate the distributive effect of the government's crisis management on individuals. These 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" and whether they "have had to draw on [their] savings or get into debt to cover ordinary living expenses" over the past 3 (crisis) years.[10]

I then assign each respondent into one of three categories: *government voters*, *opposition voters*, or *non-voters*. For this purpose, I first identify the political parties that were in government during most of the crisis period. Governments were stable throughout the crisis in Poland (Civic Platform and the Polish Peasants' Party) and Estonia (Estonian Reform Party and Union of Pro Patria[11]), where government parties were still in place when the ESS poll was conducted. In Hungary and the Czech Republic, however, the government composition changed throughout the crisis. I code the Socialist Party (in office between May 2008 and May 2010) as governing party in Hungary. The Czech Republic had a technocratic, non-partisan government between April 2009 and June 2010. I code those parties who supported this government as government parties: Civic Democrats, the Social Democrats, and the Greens. In a second step, I code respondents' answers about on which party they feel closest to (Question B20a), or, if this information is not available, which party they had voted for in the last election (Question B12) and whether
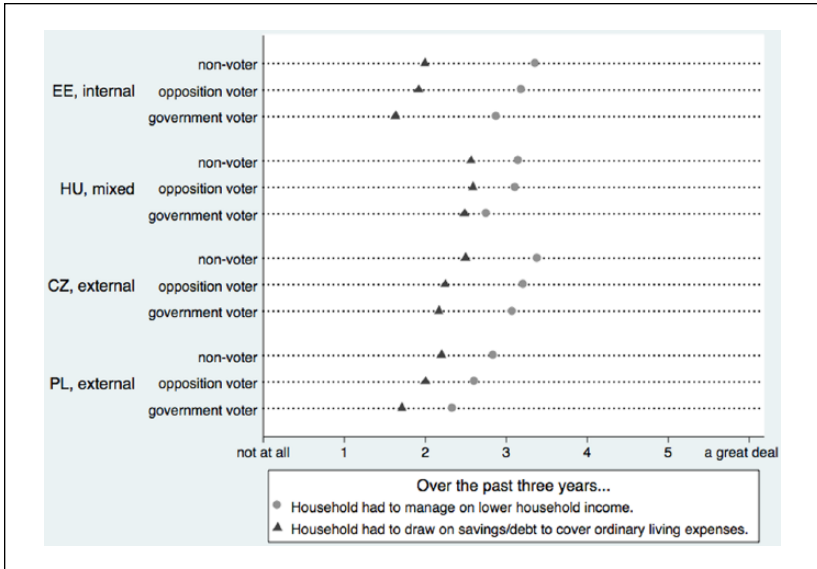
Figure 3. Impact of the crisis on households, by voter group.
Weighted mean values for each voter group. Government voters are identified as voters of the parties that were in government during most of the crisis. Data are from the European Social Survey 2010 (conducted in October 2010). EE = Estonia; HU = Hungary; CZ = Czech Republic; PL = Poland.

they had voted at all in the last election (question B11). In a third step, I classify respondents as *government voters*, if they had voted to or felt close to those parties that were identified as government parties in step 1. 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 shows that in all countries, voters in the government camp fared better than voters in the opposition camp and non-voters. For both measures of the personal crisis impact, the figure displays the weighted means of respondents' assessment for each subgroup of respondents. The difference between government voters and all other respondents is statistically significant at least at the 95% level in all countries but Hungary.[12] This means that in each country, government voters felt less affected by the crisis than all other groups—irrespective of the country's vulnerability profile, adjustment path, or the government's partisan ideology. Compared with government voters, the average severity of problems reported by non-voters was between

17% and 28% and between 11% and 17% higher for opposition voters in Estonia and Poland, where governments did not change throughout the crisis.

In additional analyses (reported in Table A5 in the online appendix), I compare the determinants of respondents' assessments about the crisis effects on their household to the composition of the government's constituency. These analyses show that the crisis had a regressive effect, with poorer respondents reporting more negative effects of the crisis than richer respondents. This effect was least pronounced in Hungary, the only country with a leftist government during much of the crisis. In the other three countries, wealthier individuals were more likely to be part of the government constituency, and were also less likely to report a lower household income as a result of the crisis. In Poland, respondents living in rural areas also reported significantly less serious repercussions of the crisis, possibly because they were protected by the agrarian "Polish Peasants Party" who participated as the junior partner in the Polish government. Likewise, in Estonia, older people were more likely to vote for the government parties, and pensioners reported less severe consequences of the crisis. Families were hit significantly harder by the crisis than other households in all four countries, an effect that was particularly large in Poland, where families were significantly less likely to vote for the government parties. But there is also contradictory evidence. For example, in the Czech Republic and Poland respondents that were self-employed or working in the private or public sector reported similar effects of the crisis—even though some of these groups were more likely to belong the respective governments' constituencies.

Of course, these results have to be interpreted with caution. Much research shows that partisan cognitive biases can affect retrospective evaluations of economic outcomes, so that these findings might simply reflect the fact that respondents evaluate their economic experience more favorably when their preferred party has been in government (e.g., Evans & Andersen, 2006; Gerber & Huber, 2010; for a critique see Lewis-Beck, Nadeau, & Elias, 2008). Although this effect cannot be ruled out, three aspects reduce the risk that these evaluations merely reflect partisan loyalties in the four cases examined above. First, the questions about the personal economic experiences in the past 3 years were asked at a much later point in the (very long) questionnaire than the questions on electoral behavior and partisan preferences, a fact that should lessen the partisan bias of the response. Second, in Hungary, the government had changed a few months before the survey was conducted. A comparison of the responses of the supporters of the past versus the current government reveals that supporters of the current government were significantly more satisfied with the present state of the economy (question B25,

asked immediately after the party identification questions), whereas being a current government voter had no statistically significant effect on individual evaluations of the crisis effects on household income.[13] These effects were reversed for supporters of the Socialist party, which had governed during the crisis: Supporting the Socialists had no effect on satisfaction with the current economic situation, but these respondents reported significantly less negative effects of the crisis on their household. Finally, the fact that in most countries coalition governments navigated the crisis and the high levels of electoral volatility that characterizes Eastern European democracies (Tavits, 2008) suggests that the partisan bias might be less pronounced in these countries.

Overall, this final part of the analysis suggests 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.

Implications for the Eurozone Crisis

The analysis of the Eastern European experience shows that when BOP problems emerged in the region during the recent global financial crisis, 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. Despite these differences, however, voters of the governing parties were privileged, as governments protected their electorates from the worst pains of the crisis.

What lessons can we draw from the Eastern European experience for the deficit countries of the Eurozone, some of which have also been experiencing serious BOP problems during the euro crisis? As is well known, all EMU crisis countries have embarked on a path of internal adjustment. But this path has been easier politically for some countries than others.

Figure 4 compares the vulnerability profiles and the size of the current account deficits of EMU deficit countries to those of the Eastern European
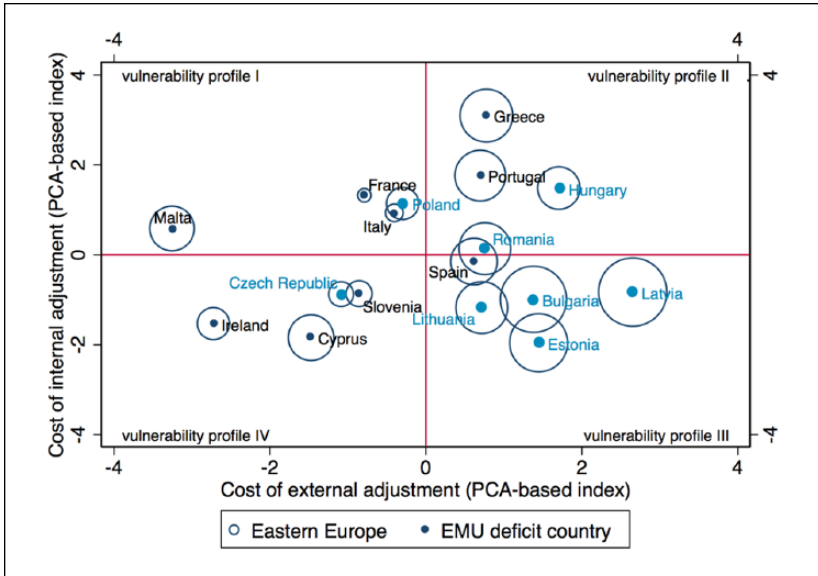
Figure 4. Vulnerability profiles of EMU deficit and Eastern European countries, 2007 values.
EMU = European Monetary Union; PCA = principal components analysis.

countries, using the methodology described above. It shows significant variation in the potential costs of internal and external adjustment. Internal adjustment is predicted to be particularly costly in Greece and Portugal, followed by France and Italy, who do, however, have much smaller current account deficits and have not been fully engulfed in the Eurozone crisis. Spain represents an intermediate case, largely because the analysis uses 2007 values (the potential costs of internal adjustment had risen considerably by 2009). Internal adjustment is least costly for Ireland and Cyprus, suggesting that internal adjustment should be implemented without major political difficulties in these countries. Overall, this ordering squares with the experience of these countries during the Eurozone crisis: Greece has outdone all other crisis countries in terms of political turmoil and conflict, but crisis politics have been contentious in Portugal and Spain as well. In contrast, internal adjustment has been less difficult to implement politically in Ireland and Cyprus.

Whereas the ordering of countries along the internal adjustment cost dimension appears plausible, this is much less the case for the potential costs of external adjustment. Here, the analysis suggests that the EMU deficit countries are on average exposed to significantly lower costs associated with

external adjustment than the Eastern European countries. This is, of course, not true. In fact, because external adjustment would imply Eurozone exit and possibly the loss of EU membership, the costs associated with this strategy are exceptionally high for Eurozone members. 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.[14]

The comparison of these vulnerability profiles is nonetheless useful, because it highlights two important points. First, the exchange-rate regime plays a very important role in shaping the costs of external adjustment. The index used in Figure 4 does not include information on the exchange-rate regime, but solely focuses on economic variables, and therefore does not adequately capture this additional dimension. Although the wider economic and political costs associated with leaving a currency union are hard to quantify, it is safe to say that Eurozone member states would all shift to the right (higher costs of external adjustment) if these costs were taken into consideration. This implies that the Eurozone deficit countries are most likely to exhibit either Vulnerability Profile II (Greece, Portugal, France, Italy, and Malta) or III (Spain, Slovenia, Ireland, Cyprus). This may help explain why the reform process in the former set of countries has been so painful and drawn-out and why there has been a strong reliance on external financing in the form of bailouts, the European Stability Mechanism (ESM) and support from the European Central Bank (for a related argument, see Hall, 2012; Genovese, Schneider and Wassmann, 2016).[15]

Moreover, most of the Eurozone crisis countries have on average had much more centrist governments than those Eastern European countries that adjusted internally. Because implementing austerity policies is more difficult for these governments, especially in a Vulnerability Profile II context, it is not surprising that the euro crisis has been associated with political upheavals in these countries: In the course of the crisis, incumbents have been punished electorally, support for radical parties has increased and protest politics have become more prevalent in the wake of crisis (e.g., Bosco & Verney, 2012; van Gent, Mamadouh, & van der Wusten, 2013). Classifying Ireland and Cyprus as Profile III countries can also help explain why crisis politics have been much less difficult in these countries, although they have been more contentious than in the Eastern European countries with a similar vulnerability profile.

Second, the variation in the economic costs of external adjustment among Eurozone countries is interesting, because it suggests that the costs of euro exit—although indiscriminately high—are likely to vary across EMU member states. For example, the analysis of the Eastern European cases highlighted the importance of foreign-currency denominated debts. At first glance, this issue is of minor importance for EMU countries, because the vast

majority of debt in the Eurozone is denominated in euros. However, the introduction of a national currency would effectively turn this euro-denominated debt into foreign-currency debt, 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 surrounding an EMU exit. Governments would probably try to mandate the conversion of some of these loans into domestic currency, but this will be easier for some kinds of debt (such as loans from domestic banks) than others, and the prevalence of these debts differs significantly across countries (BIS, 2015).[16] Likewise, the size of the export sector varies significantly. For example, exports contribute to 77% of GDP in Ireland, but only 22% in Greece (Table 1). Although this variation in the potential costs of euro exit does not seem to matter much in light of the exceedingly high overall costs for EMU member states, it may become a salient issue in the future if some form of an EMU breakup turns into a political option (for historical precedents see Cohen, 1993).

The analysis of the Eastern European experience has an additional implication for Eurozone deficit countries. It suggests that well-entrenched groups and the core voter groups of the governing parties tend to be hurt least during BOP crises. The fact that less politically active groups (such as young people and the unemployed) have borne the brunt of adjustment in most EMU crisis countries, whereas structural reforms aimed at dismantling long-standing privileges of certain groups have stalled, suggests that this holds for the Eurozone as well (e.g. Fernández-Albertos and Kuo, 2016). But the Eurozone crisis also demonstrates that partisan concerns do not influence the choice of general adjustment strategy—irrespective of governments' partisan composition, all Eurozone governments have invariably opted for internal adjustment strategies.

Conclusion

Financial crises pose enormous challenges for policymakers and force them to make unpopular decisions. Often, governments do not survive such crises, although some governments manage to maintain popular support. This article has argued that despite the high salience of crisis politics, the fundamental choice between different crisis strategies is largely technocratic in nature. Rather than political preferences, it is a country's vulnerability profile that determines the general strategy with which policymakers address BOP crises. Although these vulnerabilities tend to be the product of earlier policy choices, they strongly constrain policymakers' options in the context of a crisis. Politics enters only where policymakers have discretion within the broad structures of the general adjustment strategy: in the design of specific policies and reforms that either buffer the effects of adjustment for the government's

core voter groups, or protect them from adjustment altogether. Here, crisis politics is most controversial when the stakes are high, that is, when all types of adjustment are costly.

The article thus highlights the constraints under which countries operate when they interact with the global economy. Large current account deficits have to be financed, and when private capital flows are no longer forthcoming for this purpose, countries are forced to adjust their policies. This often means that policymakers have to implement painful policies, and illustrates the extent to which global economic integration can curtail national democracy (Rodrik, 2011)—the inability of the Greek people to democratically decide that no further austerity (or euro exit) should be implemented in the July 2015 referendum is a case in point. Yet, at the same time, the article has shown that the behavior of political actors is resilient. On the microeconomic level, policymakers do manage to design specific reforms to the benefit of their voters even in highly constrained settings.

Notes

1. Adjustment can also be achieved by raising relative prices in countries with current account surpluses. But the weaker bargaining position of deficit countries means that they tend to bear most of the adjustment burden (Stallings, 1992).

2. Elements of these adjustment strategies can also be combined.
3. To avoid such a situation, official foreign funds are usually only provided under strict conditionality, which requires recipient countries to implement reforms in return for access to foreign funds.
4. Left governments are equally likely to implement specific policies in support of their constituency when voters are vulnerable to devaluation.
5. The sample includes Malta and Cyprus that had been admitted to join the Eurozone on January 1, 2008, in May 2007. I include the Eurozone countries both to have a broader set of comparable countries on which to base the analysis on and to be able to compare the vulnerability profiles of the European Monetary Union (EMU) deficit countries to the Eastern European countries.
6. Potential foreign-currency exposure in EMU countries is calculated as the share of non-financial private sector debt that does not come from domestic banks, assuming that it would be difficult to convert this debt into national currency debt in case of a Eurozone exit.
7. This new type of International Monetary Fund (IMF) program gives countries with strong economic fundamentals precautionary access to IMF funds as a shield against speculative pressure and ideally does not lead to any disbursements.
8. Examples include Kenneth Rogoff (Bloomberg, June 29, 2009) and Paul Krugman (New York Times Blog, December 23, 2008).
9. www.europeansocialsurvey.org
10. Questions G8 and G9, respectively.
11. The Social Democratic Party left the government coalition in May 2009 and is therefore not identified as a "government party."
12. In Hungary, the Hungarian Socialist Party became very unpopular over the course of the crisis. In the European Social Survey (ESS) data, only 14% of voters identify with this formerly largest party, suggesting that many former MSZP (Magyar Szocialista Párt [Hungarian Socialist Party]) voters are not counted as government voters in the analysis.
13. Results are available in the online appendix (Table A9).
14. This explains why the euro crisis countries have been able to draw on unprecedented amounts of external financing granted by other EMU members, see also Copelovitch and Enderlein (2014) and Jones, Kelemen and, Meunier (2016).
15. Which has been provided on an unprecedented scale by the other EMU members, who equally fear the costs associated with Eurozone breakup.
16. Moreover, by converting the debts into domestic currency, this may expose domestic banks to currency risk.

References

Aslund, A. (2010). *The last shall be the first: The eastern European financial crisis, 2008-10*. Washington, DC: The Peterson Institute.

Bank for International Settlements. (2015). *Long series on credit to the private non-financial sector*. Retrieved from http://www.bis.org/statistics/credtopriv.htm

Bearce, D. H. (2003). Societal preferences, partisan agents, and monetary policy outcomes. *International Organization*, *57*, 373-410.

Bernaciak, M. (2013). Social dialogue revival or "PR corporatism"? Negotiating anticrisis measures in Poland and Bulgaria. *Transfer: European Review of Labour and Research*, *19*, 239-251.

Bértoa, F. C. (2014). Party systems and cleavage structures revisited: A sociological explanation of party system institutionalization in East Central Europe. *Party Politics*, *20*, 16-36.

Blomberg, B., Frieden, J., & Stein, E. (2005). Sustaining fixed rates: The political economy of currency pegs in Latin America. *Journal of Applied Economics*, *VIII*, 203-225.

Bosco, A., & Verney, S. (2012). Electoral epidemic: The political cost of economic crisis in Southern Europe, 2010–11. *South European Society and Politics*, *17*, 129-154.

Brown, M., Peter, M., & Wehrmüller, S. (2009). *Swiss franc lending in Europe*. Zürich: Swiss National Bank.

Bukovskis, K. (Ed.). (2014). *The politics of economic sustainability: Baltic and Visegrad responses to the European economic crisis*. Riga: Latvian Institute of International Affairs.

CBOS Public Opinion. (2011, October). *Final evaluation of the government of Donald Tusk*. Warsaw, Poland: Polish Public Opinion Research Center.

Cohen, B. J. (1993). Beyond EMU: The problem of sustainability. *Economics & Politics*, *5*, 187-203. doi:10.1111/j.1468-0343.1993.tb00074.x

Copelovitch, M., & Enderlein, H. (2014). *Kicking the can down the road: The euro crisis and the political economy of Troika bailouts*. Madison: University of Wisconsin.

Copelovitch, M., Frieden, J., & Walter, S. (2016). The political economy of the Euro crisis. *Comparative Political Studies*, *49*(7) 811-840.

Döring, H., & Manow, P. (2013). ParlGov—A new data infrastructure in comparative politics. *APSA -Comparative Politics Newsletter*, *23*(1), 17-19.

Downs, A. (1957). *An economic theory of democracy*. New York, NY: Harper & Row.

Economist Intelligence Unit. (2009, March). *Hungary* (Economist Intelligence Unit Country Report). London, England: Author.

Eichengreen, B. (1992). *Golden fetters: The gold standard and the great depression*. New York, NY: Oxford University Press.

European Bank for Reconstruction and Development. (2010). *Transition report 2009*. London, England: Author.

European Central Bank. (2011). *The international role of the euro*. Frankfurt, Germany: Author.

European Commission. (2014). *Statistical annex of alert mechanism report 2014*. Brussels, Belgium: Author.

Eurostat. (2015). *Statistics database*. Brussels, Belgium: European Commission–Eurostat.

Evans, G., & Andersen, R. (2006). The political conditioning of economic perceptions. *Journal of Politics*, *68*, 194-207.

Fernández-Albertos, J., & Kuo, A. (2016). Economic Hardship and Policy Preferences in the Eurozone periphery: Evidence from Spain. *Comparative Political Studies*, *49*(7) 874-906.

Frieden, J. (1991a). *Debt, development, and democracy*. Princeton, NJ: Princeton University Press.

Frieden, J. (1991b). Invested interests: The politics of national economic policies in a World of Global Finance. *International Organization*, *45*, 425-451.

Frieden, J. (2014). *Currency politics: The political economy of exchange rate policy*. Princeton, NJ: Princeton University Press.

Frieden, J. (2015). The political economy of adjustment and rebalancing. *Journal of International Money and Finance*, *52*, 4-14.

Garrett, G. (1998). *Partisan politics in the global economy*. New York, NY: Cambridge University Press.

Gerber, A. S., & Huber, G. A. (2010). Partisanship, political control, and economic assessments. *American Journal of Political Science*, *54*, 153-173.

Genovese, F., Schneider, G,. & Wassmann, P. (2016). The Eurotower Strikes Back: Crises, Adjustments, and Europe's Austerity Protests. *Comparative Political Studies*, *49*(7) 939-967.

Gibson, H. D., Palivos, T., & Tavlas, G. S. (2014). The crisis in the Euro area: An analytic overview. *Journal of Macroeconomics*, *39*, 233-239.

Gourevitch, P. (1986). *Politics in hard times: Comparative responses to international economic crises*. Ithaca NY: Cornell University Press.

Haggard, S., & Kaufman, R. R. (Eds.). (1992). *The politics of economic adjustment: International constraints, distributive conflicts, and the state*. Princeton, NJ: Princeton University Press.

Hall, P. (2012). The economics and politics of the euro crisis. *German Politics*, *21*, 355-371.

Hibbs, D. (1977). Political parties and macroeconomic policy. *American Political Science Review*, *71*, 1467-1487.

International Monetary Fund. (2009). *Republic of Latvia: Request for stand-by arrangement—Staff report; Staff supplement; Press release on the executive board discussion; and statement by the executive director for the Republic of Latvia*. Washington, DC: Author.

Jones, E., Kelemen, R.D., & Meunier, S. (2016). Failing Forward? The Euro crisis and the incomplete nature of European Integration. *Comparative Political studies*, *49*(7) 1010-1034.

Kattel, R., & Raudla, R. (2013). The Baltic Republics and the crisis of 2008–2011. *Europe-Asia Studies*, *65*, 426-449.

Kuokstis, V. (2013). *The political economy of internal adjustment in the Baltic States: Explaining responses to the crisis* (Doctoral dissertation). Vilnius University, Lithuania.

Kuokstis, V., & Vilpisauskas, R. (2010, September). *Economic adjustment to the crisis in the Baltic States in comparative perspective*. Paper presented at the 7th Pan_European International Relations Conference, Stockholm.

Lewis-Beck, M., Nadeau, R., & Elias, A. (2008). Economics, party, and the vote: Causality issues and panel data. *American Journal of Political Science*, *52*, 84-95.

Linek, L., & Lacina, T. (2010). Czech republic. *European Journal of Political Research*, *49*, 939-946.

Lütz, S., & Kranke, M. (2014). The European rescue of the Washington consensus? EU and IMF lending to central and eastern European countries. *Review of International Political Economy*, *21*, 310-338. doi:10.1080/09692290.2012.747104

Myant, M., Drahokoupil, J., & Lesay, I. (2013). The political economy of crisis management in East–Central European Countries. *Europe-Asia Studies*, *65*, 383-410.

Nelson, J. M. (Ed.). (1990). *Economic crisis and policy choice: The politics of adjustment in the third world*. Princeton, NJ: Princeton University Press.

Oatley, T. H. (1997). *Monetary politics: Exchange rate cooperation in the European Union*. Ann Arbor: University of Michigan Press.

Pacek, A. C. (1994). Macroeconomic conditions and electoral-politics in East-Central-Europe. *American Journal of Political Science*, *38*, 723-744. doi:10.2307/2111604

Pepinsky, T. B. (2009). *Economic crises and the breakdown of authoritarian regimes: Indonesia and Malaysia in comparative perspective* (1st ed.). Cambridge, UK: Cambridge University Press.

Purfield, C., & Rosenberg, C. (2010). *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008-09* (IMF Working Paper, WP/10/213). Washington, DC: International Monetary Fund

Raudla, R., & Kattel, R. (2011). Why did Estonia choose fiscal retrenchment after the 2008 crisis? *Journal of Public Policy*, *31*, 163-186.

Remmer, K. L. (1991). The political impact of economic crisis in Latin America in the 1980s. *The American Political Science Review*, *85*, 777-800.

Rodrik, D. (2011). *The globalization paradox: Democracy and the future of the world economy*. New York, NY: W. W. Norton.

Simmons, B. (1994). *Who adjusts? Domestic sources of foreign economic policy during the interwar years*. Princeton, NJ: Princeton University Press.

Stallings, B. (1992). International influence on economic policy: Debt, stabilization and structural reform. In S. Haggard & R. R. Kaufman (Eds.), *The politics of economic adjustment* (pp. 41-88). Princeton, NJ: Princeton University Press.

Stan, L., & Zaharia, R. (2010). Romania. *European Journal of Political Research*, *49*, 1139-1153.

Stegmaier, M., & Vlachová, K. (2011). The parliamentary election in the Czech Republic, May 2010. *Electoral Studies*, *30*, 223-244.

Stein, E., & Streb, J. (2004). Elections and the timing of devaluations. *Journal of International Economics*, *63*, 119-145.

Tavits, M. (2008). On the linkage between electoral volatility and party system instability in Central and Eastern Europe. *European Journal of Political Research*, *47*, 537-555.

Tworzecki, H. (2012). The polish parliamentary elections of October 2011. *Electoral Studies*, *31*, 617-621. doi:10.1016/j.electstud.2012.04.007

van Gent, W., Mamadouh, V., & van der Wusten, H. (2013). Political reactions to the euro crisis: Cross-national variations and rescaling issues in elections and popular protests. *Eurasian Geography and Economics*, *54*, 135-161.

Varnagy, R. (2010). Hungary. *European Journal of Political Research*, *49*, 1001-1008.

Walter, S. (2008). A new approach for determining exchange-rate level preferences. *International Organization*, *62*, 405-438.

Walter, S. (2009). The limits and rewards of political opportunism: How electoral timing affects the outcome of currency crises. *European Journal of Political Research*, *48*, 367-396.

Walter, S. (2013). *Financial crises and the politics of macroeconomic adjustment*. Cambridge, UK: Cambridge University Press.

Webb, M. C. (1991). International economic structures, government interests, and international coordination of macroeconomic adjustment policies. *International Organization*, *45*, 309-342.

Woodruff, D. M. (2005). Boom, gloom, doom: Balance sheets, monetary fragmentation, and the politics of financial crisis in Argentina and Russia. *Politics & Society*, *33*, 3-45.

The World Bank. (2007). *Doing business 2008*. Washington, DC: Author.

Author Biography

Stefanie Walter is professor for International Relations and Political Economy at the Department of Political Science at the University of Zurich. Her research in international and comparative political economy focuses on distributional conflict, political preferences, and economic policy outcomes. She is the author of *Financial Crises and the Politics of Macroeconomic Adjustments* (2013, Cambridge University Press).