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Going to extremes: Politics after financial crises, 1870–2014

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ABSTRACT

Partisan conflict and policy uncertainty are frequently invoked as factors contributing to slow post-crisis recoveries. Recent events in Europe provide ample evidence that the political aftershocks of financial crises can be severe. In this paper we study the political fall-out from systemic financial crises over the past 140 years. We construct a new long-run dataset covering 20 advanced economies and more than 800 general elections. Our key finding is that policy uncertainty rises strongly after financial crises as government majorities shrink and polarization rises. After a crisis, voters seem to be particularly attracted to the political rhetoric of the extreme right, which often attributes blame to minorities or foreigners. On average, far-right parties increase their vote share by 30% after a financial crisis. Importantly, we do not observe similar political dynamics in normal recessions or after severe macroeconomic shocks that are not financial in nature.

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1. Introduction

With the catastrophe of the 1930s in mind, the fear of political radicalization in the wake of economic and financial disasters looms large in public discourse. Recent events in the Eurozone support such concerns. Since 2008, two-party systems that were stable for decades were swept away in the wake of the economic and financial turmoil. New political forces have since entered parliament and gained ground, while others have disappeared from the political map. In many countries, parties on the extreme right such as Front National in France or Golden Dawn in Greece have scored major electoral successes. Populist or openly Eurosceptic parties such as the Five Star Movement in Italy, Podemos, the party of True Finns, the UK Independence Party, or the Alternative for Germany have been surprise winners in recent elections.

Increasing fractionalization and polarization of parliaments makes crisis resolution more difficult, reduces the chances of serious reform and leads to political conflict at a time when decisive political action may be needed most. A number of authors have linked political gridlock to slow recoveries from financial crises. Frieden (2015) and Mian et al. (2014) as well as Lo and Rogoff (2015) argued that dysfunctional politics contribute to the now well documented phenomenon of slow recoveries from financial crises (Jordà et al., 2013, 2016b).[1] These ideas complement an important body of work in

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[1] Polarization and fractionalization may also have longer-term repercussions on the political economy. For example, Alesina and Tabellini (1990) and Azzimonti (2011) predict that more polarized political systems produce economic inefficiencies, higher debt, and lower growth. Alt and Lassen (2006), Lindqvist and Östling (2010), Azzimonti and Talbert (2014) and Azzimonti (2015) provide empirical evidence supporting this view.

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macroeconomics in recent years that has studied policy uncertainty and its economic effects in more depth (Bloom et al., 2007, 2012; Bloom, 2009; Bachmann et al., 2013; Baker et al., 2013). An important insight resulting from this literature is that measured policy uncertainty is particularly high after financial crises. However, with few exceptions, there is limited empirical evidence on the underlying channels.[2]

What has history to say about the political after-effects of financial crises in modern democracies? Can we, over the long-run of modern history, identify systematic shifts in voting behavior after financial crises? And if so, in which direction? Does the extreme left or the extreme right gain, or both? To answer these questions, we examined the political aftermath of all major financial crises in advanced economies since the late 19th century. We also assembled the most ambitious and comprehensive historical dataset of election results and parliamentary composition to date, covering 20 countries and spanning 140 years with more than 800 elections between 1870 and 2014.

Our first key finding is that financial crises are followed by important changes in voter behavior that in turn, contribute to high levels of policy uncertainty. Political polarization increases after financial crises throughout the 19th and 20th century. Moreover, political parties on the far right appear to be the biggest political beneficiaries of a financial crash. On average, far-right parties have seen an increase in their vote shares of about 30% relative to their pre-crisis level in the five years following a systemic financial crisis. These findings echo a recent study by de Bromhead et al. (2012), who focus on the electoral consequences of crises in the 1920s and 1930s. We show that the gains of far-right parties were not limited to the interwar period: In recent decades, far-right parties, including populist parties of the so-called "New Right", also saw broad-based electoral gains. After financial crises, voters seem to be systematically lured by the political rhetoric of the far right, with its frequently nationalistic or xenophobic tendencies. Moreover, we identify an important asymmetry in the political response to crises: on average, the far left did not profit equally from episodes of financial instability.[3]

Our second main insight is that governing becomes more difficult after financial crises, irrespective of which parties are in power. In particular, *after* World War II, crises are associated with shrinking government majorities, a strengthening of opposition and greater political fractionalization. This in turn is associated with a higher probability of government crises and changes in the executive branch. We thus confirm the finding of Mian et al. (2014) that political fractionalization increases in the aftermath of financial crises after 1980. However, using the depth of our historical dataset we can show that these effects have become stronger over time. Third, we document that street protests increase dramatically in the aftermath of financial crises. Riots, strikes and demonstrations can be seen as an additional proxy for political constraints on governing. Passarelli and Tabellini (2013) have recently demonstrated how social unrest may negatively impact policy-making in democracies.

Generally, our study suggests that policy-making and the implementation of reforms become substantially more difficult in the aftermath of a financial crisis. These results are robust to controlling for macroeconomic and financial conditions as well as political factors such as electoral systems, voter turnout, suffrage and different government systems.

On the methodological side, we use the statistical toolkit of local projections (LPs) pioneered in Jordà (2005) and project the path of political variables over a five and ten year horizon following the beginning of a financial crisis recession. As in Jordà et al. (2013, 2016a, 2016b), we compare the political aftermath of crisis recessions to the aftermath of (non-financial) recessions. Benchmarking normal vs. financial recessions allows for cleaner identification of the effects of financial crises than comparing financial crises spells to a counterfactual of all other years. We find that the political effects of financial crises are particularly more pronounced than those of normal recessions that tend to have little or no effects on political variables.

A potential concern with these findings is that financial recessions could be deeper than normal recessions and as a result the observed effects are due to the severity of the recession and not to the financial crisis. In the spirit of Barro and Ursúa (2008), we then compare financial crisis recessions to other severe macroeconomic "disasters" that do not involve a financial crash. We find that the effects are much more pronounced in financial crises and conclude that financial crashes stand out since their political after-effects are particularly disruptive.

What explains the more severe political fall-out after financial crises? One possibility is that non-financial downturns are seen as "excusable" events, triggered by exogenous shocks, while financial crises may be perceived as endogenous and "inexcusable" – the result of policy failures, moral hazard and favoritism. The electorate may blame politics for financial crashes because the perception is that they could have been avoided. Moreover, financial crises may provoke unprecedented policy reactions and uncertainty about their consequences, which in turn reduces confidence in the political leadership. Financial crises may also have social repercussions that are not observable after non-financial recessions. For example, it is possible that the disputes between creditors and debtors are more severe or that inequality rises more strongly (e.g., Bordo and Meissner, 2011). Lastly, financial crises involve unpopular bailouts for the financial sector (e.g., Broz, 2005), which increases political discontent.

On the data side, a core contribution of this paper is the compilation of a rich new dataset that will benefit future research in the field. Our newly compiled data covers the near universe of systemic financial crises and general elections in 20 advanced economies since 1870. Since financial crises are rare events, many researchers in this field have opted to go

[2] An exception here are Baker et al. (2014) who show that political polarization was an important driver for the increase in US policy uncertainty since the 1960s.

[3] This finding somewhat contradicts Giuliano and Spilimbergo (2014) who link recession experiences to distrust in institutions, leading to more right voting, as well as to more support of government intervention/redistribution, resulting in more left voting.

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