

# Going to Extremes: Politics after Financial Crises, 1870-2014

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Goodbye financial crisis, hello political crash



## Motivation

- Slow recoveries from financial crises (Reinhart and Rogoff 2009; Jordà, Schularick, and Taylor 2013)
- Competing explanations: demand deficiency, debt overhang, slowing innovation, etc.
- What role for politics? Policy uncertainty (Baker, Bloom, and Davis 2013), fractionalization (Mian, Sufi, and Trebbi 2014), debtor-creditor conflict (Frieden 2015)
- Limited empirical evidence on the underlying channels

# The Questions

- Does the political landscape change systematically after financial crises?
- Does governing become more difficult, crisis resolution harder, and policy uncertainty more pronounced?

## What we do

- We turn to quantitative economic history to study rare crisis events and their political aftermath
- We code a new large dataset covering 800 general election results in 20 countries since 1870
- We then quantify the political after-effects of more than 100 financial crises

## What we find

### **1 Hard right turns:**

The political far right is the biggest beneficiary from financial crises.

### **2 Governing becomes more difficult:**

Crises are associated with shrinking government majorities, greater fractionalization, and increasing street protest.

### **3 The effects appear specific to the aftermath of financial crises:**

Not observable in either normal recessions or severe economic downturn without a financial crisis.

## Why is the reaction to financial crisis different?

- **The public may not see crises as “excusable” events:**  
Rather the result of policy failures, moral hazard and political favoritism: desire for accountability.
- **At the same time, policy responses to financial crises often have the opposite effects:**  
Dissatisfaction with bail-outs.
- **Crises produce financial winners and losers:**  
Wealth losses and conflict between creditors and debtors.
- **Order in unstable environment:**  
The appeal of authoritarianism and strong hands.

## Data

- Time period: 1870-2014
- Countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States
- Chronology of **systemic financial crises** building on Bordo et al. (2001), Reinhart and Rogoff (2009), Laeven and Valencia (2012), Jordà, Schularick and Taylor (2013)
- All macroeconomic data and business cycle coding come from the latest vintage of the Jordà, Schularick and Taylor (2016) dataset

# Political variables: voting and parliament

Variable	Description	Sources
<b>Government vote share</b>	Vote share of governing party or coalition in the most recent general elections to the national parliament (lower chamber)	Mackie and Rose (1974), Nohlen and Stöver (2010), Döring and Manow (2012) and country-specific sources
<b>Opposition vote share</b>	Combined vote share of all opposition parties, excluding independents, in the most recent general elections to the national parliament (lower chamber)	Mackie and Rose (1974), Nohlen and Stöver (2010), Döring and Manow (2012) and country-specific sources
<b>Far-right/ far-left vote share</b>	Combined vote share of all far-right (far-left) political parties with more than 0.1 % of total votes in the most recent general elections to the national parliament (lower chamber)	Bertelsmann Foundation (2009), Betz (1994), Capoccia (2012), de Bromhead, Eichengreen, and O'Rourke (2012), Minkenberg, (2001, 2008), Mudde (2000, 2005, 2007) and country-specific sources
<b>Fractionalization</b>	The probability that two representatives picked at random from among the parties in the legislature will be of different parties; range: [0;1]	Mackie and Rose (1974), Nohlen and Stöver (2010), Döring and Manow (2012) and country-specific sources
<b>Number of parties</b>	The number of parties elected into the legislative branch in the most recent general election to the national parliament (lower chamber)	Mackie and Rose (1974), Nohlen and Stöver (2010), Döring and Manow (2012) and country-specific sources

## Coding of far-right and far-left political parties

- For the interwar period, we use the list of extremist parties from de Bromhead, Eichengreen, and O'Rourke (2012)
- For the post-WW2 period, we use the “right-wing” and “communist/socialist” classifications in Döring and Manow (2012)
- We double-checked for name changes/ splinters/ mergers of parties
- We consulted additional country-specific sources

# List of far-right (R) and far-left (L) parties since 1919

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- CHE R Freedom Party of Switzerland, Geneva Citizens' Movement, National Front\*, Swiss Democrats, Swiss People's Party, Ticino League  
L Alternative Left, Autonomous Socialist Party, Communist Party of Switzerland\*, Progressive Organizations of Switzerland, Solidarity, Swiss Party of Labour
- DEU R Action Alliance of Independent Germans, Alternative for Germany, Civil Rights Movement Solidarity, Economic Reconstruction Union, Empowered Citizens, German Community, German National People's Party\*, German Party, German People's Union, German Right Party, Law and Order Offensive, National Democratic Party of Germany, National Socialist German Workers' Party\*, Organization of the National Collection, Patriots for Germany, Popular Vote, Pro Germany, Pro German Middle, Statt Party, The Offensive  
L Action Democratic Progress, Alliance of Germans, Collection to Action, Communist Party of Germany\*, German Communist Party, German Union for Peace, Marxist-Leninist Party of Germany, The Left
- DNK R Danish People's Party, National Socialist Worker's Party of Denmark\*, Progress Party  
L Communist Party of Denmark\*, Common Course, Left Socialists, Socialist People's Party, Unity List - The Red-Greens
- ESP R Falange Española\*, Basque Nationalists\*  
L Catalan Nationalists\*, Communist Party of Spain\*, Workers' Party of Marxist Unification\*, United Left
- FIN R Finns Party, Finish Rural Party, Patriotic People's Movement\*  
L Communist Worker's Party, Communist Party of Finland\*, Finnish People's Democratic League, Left Alliance
- FRA R Movement for France, National Front, National Republican Movement  
L French Communist Party\*, Left Front, Revolutionary Communist League, Worker's Struggle
- GBR R British National Party, Democratic Unionist Party, English Democrats, National Democratic Party, National Front, United Kingdom Independence Party  
L Communist Party of Great Britain\*, Green Party of England and Wales, Plaid Cymru, Respect Party, Scottish Socialist Party, Sinn Féin, Socialist Alternative, Socialist Labor Party
- GRC R Freethinkers' Party\*, Golden Dawn, Independent Greeks, National Democratic Union, National Political Union, Popular Independent Alignment, Popular Orthodox Rally  
L Coalition of the Radical Left, Communist Party of Greece\*, Communist Party of Greece (Interior), Democratic Left, Synaspismos, United Democratic Left

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## Financial crises

Australia	1893	1989						
Austria	<i>1873</i>	1924	<i>1929</i>	2008				
Belgium	<i>1870</i>	1885	1925	<i>1931</i>	<i>1939*</i>	2008		
Canada	1907	<i>1923</i>						
Denmark	1877	<i>1885</i>	1908	<i>1921</i>	1931	1987	2008	
Finland	1878	1900	<i>1921</i>	1931	1991			
France	1882	<i>1889</i>	1907	1930	2008			
Germany	<i>1873</i>	1891	<i>1901</i>	1907	1931	2008		
Greece	1931	1991	2008					
Ireland	2008							
Italy	1873	<i>1887</i>	<i>1893</i>	1907	<i>1921</i>	<i>1935*</i>	1990	2008
Japan	1882	1900	<i>1904*</i>	<i>1907</i>	<i>1913</i>	<i>1927</i>	1992	
Netherlands	1893	1907	<i>1921</i>	<i>1939*</i>	2008			
Norway	1899	<i>1922</i>	1931	1988				
Portugal	1890	<i>1920</i>	<i>1923*</i>	1931	2008			
Spain	1883	<i>1890</i>	<i>1913</i>	<i>1920</i>	<i>1924*</i>	<i>1931</i>	1978	2008
Sweden	1878	1907	<i>1922</i>	1931	1991	2008		
Switzerland	<i>1870</i>	<i>1910</i>	1931	1991	2008			
United Kingdom	1890	1974	<i>1984</i>	1991	2007			
United States	<i>1873</i>	1884	<i>1893</i>	1907	1929	1984	2007	

**Notes:** Financial crisis events from Bordo et al. (2001), Reinhart and Rogoff (2009b), Laeven and Valencia (2008; 2012), and Jordà, Schularick, and Taylor (2013). The table shows all financial crisis events in the 20 countries in our sample since 1870. \* = crises removed from the OLS regression. Italics = crises removed from the descriptive analysis.

# Strategy

- Start with historical narrative and core stylized facts
- Event study (FE Panel): post-crisis deviation from long-run country-specific average
- Dynamic local projections (Jordà 2005): quantify the cumulative change in political variables relative to the pre-crisis level

## Empirical strategy

- Event study regressions

$$Y_{it} = \alpha + \beta * post_{it} + \mu_i + \varepsilon_{it}$$

where  $post_{it} = \{\tau_i + 1, \dots, \tau_i + 5\}$ ;  $\tau_i = \text{crisis event}$

## Empirical strategy II

### Local projections

$$\underbrace{\Delta_h y_{it+h}^k}_{\text{outcome}} = \underbrace{\theta_F^k d_{it}^F}_{\text{conditional post-crisis path}} + \underbrace{\sum_{l=0}^L \Gamma_{h,l}^k Y_{it-l}}_{\text{controls (demeaned)}} + \underbrace{\alpha_i^k}_{\text{fixed effects (demeaned)}} + \underbrace{u_{h,it}^k}_{\text{error term}}$$

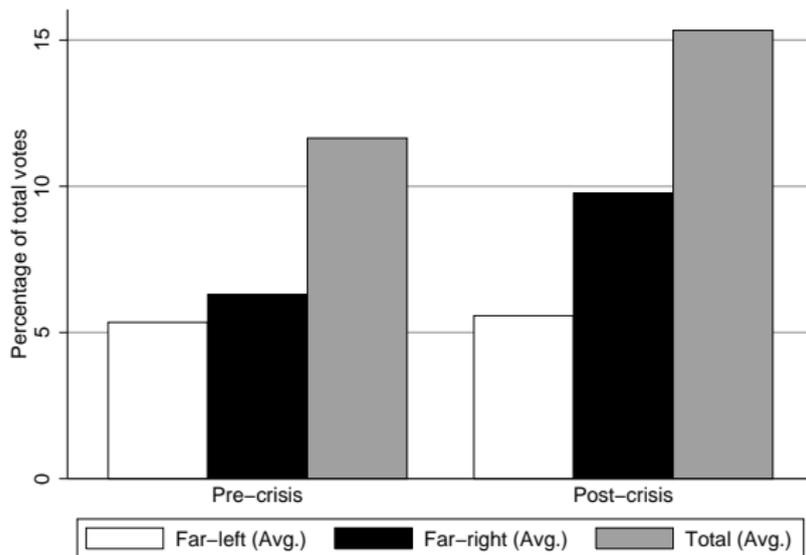
where  $\underbrace{k = 1, \dots, K}_{\text{variables}}; \underbrace{h = 1, \dots, H}_{\text{horizons}}; \underbrace{l = 1, \dots, L}_{\text{lags}}$

Electoral outcomes

## Hard right turns

- Rise of right-wing and fascist parties in the 1920s/1930s crises: Mussolini's Fascist Alliance, German NSDAP, Rexists (Belgium), Patriotic People's Movement (Finland), Falange (Spain), National Front (Switzerland)...
- 1990s financial crises: Danish Progress Party, Norwegian Progress Party, New Democracy (Sweden), Swiss People's Party, North League party (Italy)...
- 2007-08 crisis: UKIP, Party for Freedom (Netherlands), Front National (France), True Finns, Sweden Democrats, Alternative for Germany, The Donald...

## The tragedy of the left



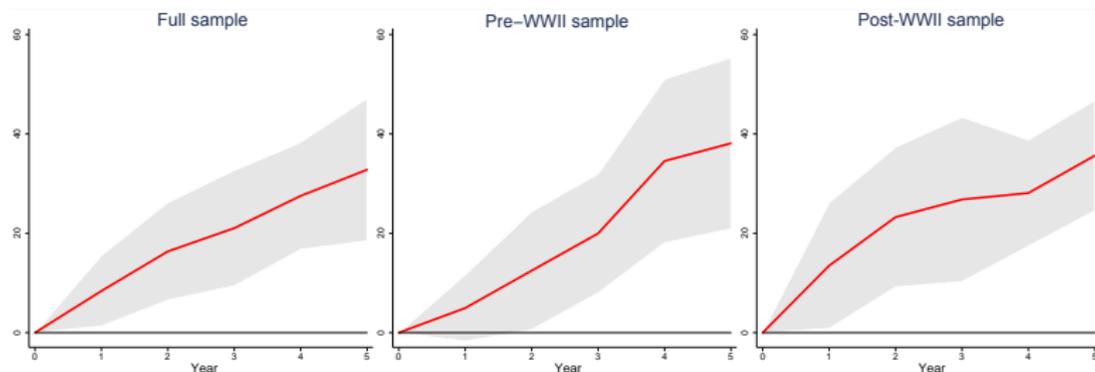
**Notes:** The figure shows average vote shares of far-left (white columns) and far-right (black columns) political parties. The grey columns represent the sum of the two. The left panel refers to average vote shares in the five years before the start of a financial crisis and the right panel shows average shares in the five years after. The differences are statistically significant at the 5% level, except for the far-left vote share, which does not significantly increase in the post-crisis period. All crises from 1919 to 2014. Years that are simultaneously pre-crisis and post-crisis years, years in which financial crisis erupts and World War II years are excluded.

## Event study

	(a) Full sample	(b) Pre-WWII	(c) Post-WWII
Far-right vote share			
Post-crisis	4.212* (2.161)	3.288 (3.376)	3.770*** (1.089)
$R^2$	0.023	0.012	0.056
Observations	1611	390	1221
Far-left vote share			
Post-crisis	-1.580 (0.978)	-0.001 (0.335)	0.437 (1.025)
$R^2$	0.015	0.000	0.001
Observations	1611	390	1221

**Notes:** This table compares the post-crisis levels of far-right and far-left vote shares to their average level. The time window for post crisis is five years. Regressions controlled for country fixed effects, the growth rate of real GDP per capita and the CPI inflation rate (not reported). Robust standard errors (clustered by country) are shown in parentheses. Panel (a) cover the years 1919-2014, with World War II being excluded, panel (b) 1919-1938, panel (c) 1950-2014. \*\*\* Significant at .01 \*\* significant at .05 \* significant at .1. Coefficient for far-right vote shares in the (b) Pre-WWII sample is 4.665 (statistically significant at the 5% level) once country fixed effects are removed.

## Local projection: right wing vote shares



**Notes:** Each path shows local projections of the cumulative change in 100 times the logged variable relative to peak for years 1-5 of the recession/recovery period. The red line refers to the average path in financial crisis recessions and the shaded region is a 90% confidence interval. The controls are contemporaneous and 1-year lagged values of the growth rate of real GDP per capita and the CPI inflation rate at peak. The left panel cover the years 1919-2014, with World War II being excluded, the middle panel 1919-1938, and the right panel 1950-2014. The dependent variable is the combined vote share of all electorally successful far-right political parties in the most recent general election.

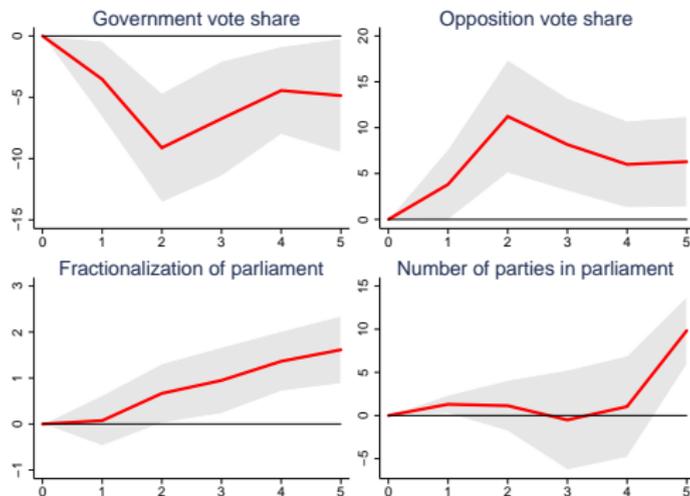
Increasing fragmentation

## Government vote share

	(a) Full sample	(b) Pre-WWII	(c) Post-WWII
<b>Government vote share</b>			
Post-crisis	-2.275 (1.556)	-0.133 (1.741)	<b>-4.377***</b> (1.372)
$R^2$	0.006	0.000	0.022
Observations	1865	636	1229
<b>Opposition vote share</b>			
Post-crisis	1.623 (1.498)	-0.456 (1.760)	<b>3.523**</b> (1.434)
$R^2$	0.003	0.000	0.013
Observations	1865	636	1229
<b>Fractionalization of parliament</b>			
Post-crisis	0.011 (0.020)	0.007 (0.013)	<b>0.063**</b> (0.023)
$R^2$	0.001	0.000	0.029
Observations	2241	969	1272
<b>No. of parties in parliament</b>			
Post-crisis	0.325 (0.489)	0.371 (0.271)	<b>1.110***</b> (0.340)
$R^2$	0.002	0.004	0.026
Observations	2241	969	1272

**Notes:** This table compares the post-crisis levels of the parliamentary variables to their average level. The time window for post crisis is five years. Robust standard errors (clustered by country) are shown in parentheses. Regressions controlled for country fixed effects, real GDP per capita growth rate and CPI inflation rate (not reported). Panel (a) covers 1870-2014, panel (b) 1870-1938, and panel (c) 1950-2014. Years of global war (1914-1918 and 1939-1949) are excluded. \*\*\* Significant at .01 \*\* significant at .05 \* significant at .1.

## Time path: fragmentation



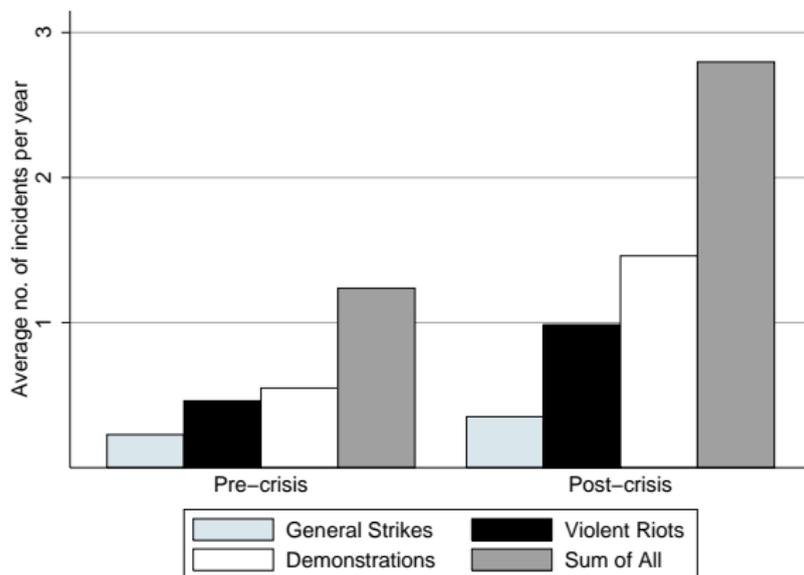
**Notes:** Each path shows local projections of the cumulative change in 100 times the logged variable relative to peak for years 1-5 of the recession/recovery period. The red line refers to the average path in financial crisis recessions and the shaded region is a 90% confidence interval. The controls are contemporaneous and 1-year lagged values of the growth rate of real GDP per capita and the CPI inflation rate at peak. Post-WWII sample: 1950-2014.

## From fragmentation to post-crisis instability

	Major Government crises (Fixed effects OLS)	Executive turnover (Fixed effects logit)
Government vote	-0.0216* (0.0116)	-0.0701*** (0.0207)
$R^2$	0.301	-
Observations	235	249
Opposition vote	0.0213* (0.0116)	0.0670*** (0.0195)
$R^2$	0.302	-
Observations	235	249
Fractionalization	2.1268*** (0.6783)	3.7292** (1.4695)
$R^2$	0.315	-
Observations	252	380
No. of parties	0.0653** (0.0258)	0.0711 (0.0735))
$R^2$	0.229	-
Observations	252	380

Street protests

## People take to the streets



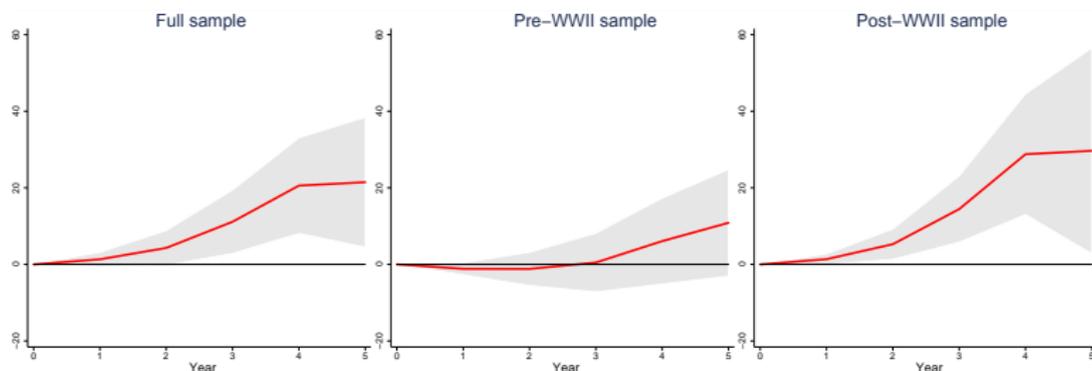
**Notes:** The figure shows the average number of street protest incidents per year, including the number of general strikes (light blue columns), violent riots (black columns), anti-government demonstrations (white columns) and the sum of the three (grey columns). The bars in the left-hand side panel refer to pre-crisis averages (five years) and the bars in the right-hand side panel to post-crisis averages (five years). All crises from 1919 to 2014. Years that are simultaneously pre-crisis and post-crisis years, years in which a financial crisis erupts and World War II years are excluded. Except for the number of general strikes, the differences are statistically significant at the 5% level.

# Strikes, riots, demonstrations

	(a) Full sample	(b) Pre-WWII	(c) Post-WWII
General strikes			
Post-crisis	0.058* (0.031)	0.037 (0.023)	0.104*** (0.034)
$R^2$	0.048	0.048	0.104
Obs.	1623	396	1227
Violent riots			
Post-crisis	0.072** (0.033)	0.140* (0.075)	0.052 (0.048)
$R^2$	0.014	0.135	0.014
Obs.	1623	396	1227
Anti-government demonstrations			
Post-crisis	0.084*** (0.026)	0.075 (0.048)	0.148** (0.060)
$R^2$	0.016	0.083	0.026
Obs.	1623	396	1227
Street protests			
Post-crisis	0.115** (0.045)	0.159** (0.070)	0.159** (0.071)
$R^2$	0.020	0.127	0.025
Obs.	1623	396	1227

**Notes:** This table compares the post-crisis levels of the number of street protests events per year (% deviation from trend) to their average level. The time window for post crisis is five years. Robust standard errors (clustered by country) are shown in parentheses. Table 12 shows the crises that are included. Regressions controlled for GDP per capita growth rate and CPI inflation rate (not reported). The left panels cover the years 1919-2012, excluding World War II (1939-1949), the middle panels 1919-1938, and the right panels 1950-2012. \*\*\* Significant at .01. \*\* Significant at .05. \* Significant at .1.

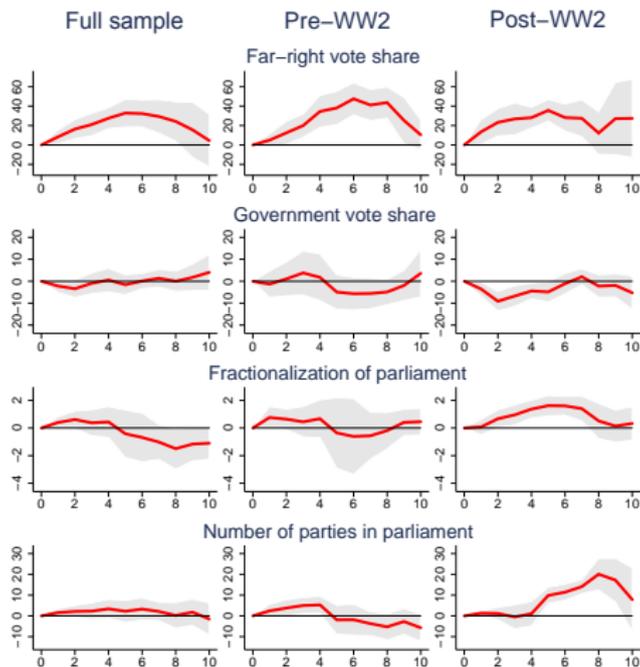
## Time path: street protests



**Notes:** Each path shows local projections of the cumulative change in 100 times the logged variable relative to peak for years 1-5 of the recession/recovery period. The red line refers to the average path in financial crisis recessions and the shaded region is a 90% confidence interval. The controls are contemporaneous and 1-year lagged values of the growth rate of real GDP per capita and the CPI inflation rate at peak. The left panel cover the years 1919-2012, with World War II being excluded, the middle panel 1919-1938, and the right panel 1950-2012. The dependent variable is the percentage deviation from trend in the combined number of street protests (general strikes, violent riots and anti-government demonstrations) per year.

How long does it take for politics to normalize?

# A decade of instability



**Notes:** Each path shows local projections of the cumulative change in the political variables relative to peak for years 1–10 of the recession/recovery period. The red line refers to the average path in financial crisis recessions and the shaded region is a 90% confidence interval. The controls are contemporaneous and 1-year lagged values of the growth rate of GDP per capita and the CPI inflation rate at peak.

Are financial crises different?

## Crises and other (severe) recessions

- How does the political fall-out from crises compare to normal recessions and severe (non-financial) macroeconomic slumps?
- Benchmark 1: all normal recessions without financial crisis
- Benchmark 2: sub-sample of particularly severe non-financial recessions, “macro-disasters”
  - Definition: annualized peak-to-trough percentage decrease of real p.c. GDP more severe than the average financial recession

## Crises and recessions: example United States

Financial crisis 1873, 1884, 1893, 1907, 1929, 1984, 2007

1873	1875	1882	1887	1889	1892	1895	1901	1906
1909	1913	1916	1918	1926	1929	1937	1944	1948
1953	1957	1969	1973	1979	1981	1990	2000	2007

Financial recession

Normal recession

Macro disaster

## Severe non-financial recessions

Australia	1881	1889	1896	1926	1981			
Austria	1912	1915	1943					
Belgium	1913	1916	1942					
Canada	1877	1884	1913	1917	1928	1944	1953	1981
Denmark	1877	1884	1914	1916	1939	1944	1953	1981
Finland	1890	1913	1916	1938	2008	2011		
France	1892	1909	1912	1920	1939	1942	2012	
Germany	1879	1913	1922	1943				
Greece	1973	1885	1888	1894	1896	1899	1911	1918
	1921	1926	1935	1939	1973	1986		
Ireland	none							
Italy	1918	1939	1974	2010				
Japan	1880	1887	1890	1895	1898	1919	1929	1940
	1973	2007						
Netherlands	1873	1913						
Norway	1873	1916	1939	1941				
Portugal	1916	1927	1934	1939	1973			
Spain	1873	1877	1894	1909	1935			
Sweden	1916	1939						
Switzerland	1875	1890	1893	1916	1920	1939	1957	1974
United Kingdom	1907	1918	1925	1929	1943			
United States	1895	1913	1918	1937	1944	1957	1981	

**Notes:** Non-financial macro-economic disasters are defined as normal recessions where the yearly real p.c. GDP percentage loss is higher than the average in financial crisis recessions.

## Far-right votes

(a) Full sample	Year 1	Year 2	Year 3	Year 4	Year 5
Financial recession	8.47*	15.90**	21.27***	27.85***	33.10***
	(4.34)	(5.97)	(6.95)	(6.38)	(8.70)
Normal recession	5.53	8.19**	10.14***	7.36**	8.72*
	(3.27)	(3.35)	(3.37)	(3.22)	(4.31)
Non-financial macro disaster	1.20	0.85	4.73	2.10	14.83
	(2.34)	(3.29)	(7.22)	(8.08)	(13.51)
Ho: Financial = normal; p-value	0.66	0.32	0.19	0.01	0.02
Ho: Financial = disaster; p-value	0.12	0.03	0.11	0.00	0.23
$R^2$	0.037	0.067	0.091	0.115	0.120
Observations	1539	1515	1491	1467	143
(b) Post-WWII sample	Year 1	Year 2	Year 3	Year 4	Year 5
Financial recession	13.77*	23.86**	27.76**	29.03***	35.57***
	(7.70)	(8.56)	(10.08)	(6.78)	(6.99)
Normal recession	6.18	9.21**	12.48**	9.34**	11.05*
	(3.23)	(3.96)	(4.77)	(4.33)	(5.39)
Non-financial macro disaster	0.35	0.15	8.41	7.96	31.95
	(2.15)	(4.17)	(13.30)	(13.92)	(24.45)
Ho: Financial = normal; p-value	0.38	0.12	0.13	0.01	0.00
Ho: Financial = disaster; p-value	0.10	0.01	0.22	0.16	0.86
$R^2$	0.056	0.103	0.141	0.167	0.187
Observations	1174	1154	1134	1114	1094

## Other political variables (post-WWII)

	Year 1	Year 2	Year 3	Year 4	Year 5
<b>Government vote share</b>					
Financial recession	<b>-3.54*</b> (1.89)	<b>-9.13***</b> (2.68)	<b>-6.86**</b> (2.85)	<b>-4.40*</b> (2.21)	<b>-4.84</b> (2.84)
Normal recession	-0.91 (1.62)	-0.17 (1.62)	-0.54 (1.41)	-0.02 (1.24)	0.24 (1.31)
Non-financial macro disaster	-1.30 (1.53)	-0.00 (2.74)	8.98* (4.98)	2.82 (1.63)	3.73 (3.87)
Ho: Financial = normal; p-value	0.37	0.02	0.02	0.11	0.16
Ho: Financial = disaster; p-value	0.43	0.06	0.01	0.01	0.07
<b>Fractionalization of parliament</b>					
Financial recession	<b>0.02</b> (0.33)	<b>0.70*</b> (0.37)	<b>0.95**</b> (0.41)	<b>1.36***</b> (0.39)	<b>1.610***</b> (0.44)
Normal recession	-0.33 (0.31)	-0.13 (0.39)	0.33 (0.45)	0.10 (0.42)	-0.29 (0.55)
Non-financial macro disaster	-0.53 (0.47)	2.15 (3.15)	2.00 (3.29)	2.47 (3.19)	1.65 (3.81)
Ho: Financial = normal; p-value	0.37	0.06	0.36	0.05	0.02
Ho: Financial = disaster; p-value	0.25	0.64	0.75	0.73	0.99
<b>Street protests (% deviation from trend)</b>					
Financial recession	<b>1.37</b> (0.86)	<b>5.30**</b> (2.45)	<b>14.72**</b> (5.47)	<b>28.96***</b> (9.77)	<b>30.04*</b> (16.39)
Normal recession	2.20*** (0.69)	2.71** (1.28)	0.96 (2.03)	-0.03 (2.40)	-1.52 (2.60)
Non-financial macro disaster	3.95* (2.19)	7.78 (5.19)	6.99 (5.73)	4.53 (6.74)	4.20 (9.71)
Ho: Financial = normal; p-value	0.50	0.42	0.04	0.01	0.08
Ho: Financial = disaster; p-value	0.34	0.71	0.40	0.08	0.19

## Conclusions

## Financial crises have political after-effects

### **1 Hard right turns:**

The political far right is the biggest beneficiary from financial crises.

### **2 Governing becomes more difficult:**

Crises are associated with shrinking government majorities, greater fractionalization, and increasing street protest.

### **3 The effects are specific to the aftermath of financial crises:**

Not observable in either normal recessions or non-financial macro-disasters.

# Implications

**1 Slump politics are different.**

The political economy of financial crises poses particular challenges and puts a strain on effective governance when it is needed most.

**2 The danger that politics go off track is real.**

Fragility of democracies not only a 1930s story.

**3 Preventing financial crises means reducing the probability of a political disaster.**

Regulators carry a large responsibility for political stability.

The End

## Appendix

