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Countries in distress: transformation, transnationalization, and crisis in Hungary and Latvia

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With the outbreak of the global financial crisis, the vulnerability of democratic capitalism in East-Central Europe has come once again to the fore. Almost all new EU member states have accumulated major economic imbalances, and have been experiencing steep recessions. The crisis in the region is not only economic. Surging protests and the increasing appeal of political illiberalism attest to the end of the “political economy of patience” (Claus Offe) which characterized the first decade of post-socialism. The paper seeks to understand what has made the region’s democratic capitalist project so vulnerable. It takes its cue from an early body of literature which has pointed to the problems involved in simultaneously introducing capitalism and democracy. Contrary to the “breakdown thesis” which was a part and parcel of this literature, the paper argues that repeatedly, temporary solutions to the dilemma of simultaneity were found. Based on the Hungarian and Latvian examples, the paper shows how at first domestic resources – generous welfare policies in Hungary and appeals to sentiments of national solidarity in Latvia - allowed to reconcile democracy with market reforms. From the second half of the 1990s onwards, EU-accession and deeper transnational integration helped to secure the democratic capitalist project. By the late 2000s the full exposure to the risks of an increasingly instable global order has however become a major source of trouble for the two countries.

The process of transformation toward democratic capitalism in East–Central Europe has given rise to a number of competing interpretations.¹ The early literature focused almost entirely on domestic variables in order to explain progress and setbacks on the region’s road toward Western-type political and economic systems. More recently, a rapidly growing literature has placed emphasis on the role of transnational actors, stressing their pervasive impact on post-communist transformations. Competing interpretations of the internal and external factors of regime transformation are also closely linked with divergent assessments of the chances that the democratic capitalist project will succeed. The early literature was mostly pessimistic about the outcome of the ‘dual’ or even ‘triple’ transformation to capitalism, democracy, and nation-states, as it judged the reform agenda was too loaded and full of contradictory requirements. In contrast, approaches focusing on transnational influences took a much more optimistic stance, arguing that such influences helped to stabilize the democratic capitalist project in the region.

Recent developments, however, should give us pause. In the wake of the dramatic financial and economic downturn at the end of the first decade of the new millennium, the fragility of post-communist democratic market societies returned with a vengeance. Although leaving socialism and heading toward transnational integration appeared to be the solution in the 1990s, by the late 2000s full exposure to the risks of an increasingly unstable global order had become part of the region’s problems. Almost all new European Union (EU) member states have accumulated major economic imbalances and have experienced very steep recessions. Three countries - Hungary, Latvia, and Romania - had to turn to the International Monetary Fund (IMF) in order to defend their currencies and keep their economies afloat. The current crisis in East–Central Europe is not only economic. Surging protests and the increasing appeal of political illiberalism attest to the end of the happy marriage between transnationalization and successful transformation.

Motivated by the current calamities of democratic capitalism in the region, this paper seeks to contribute to the debate about domestic and transnational factors in post-communist transformation. Comparing the Hungarian and Latvian experiences, it argues that although those with pessimistic views were right in pointing to the dilemmas of the dual or triple transformations, they underestimated the possibilities for political actors to find temporary solutions to these dilemmas. At first, domestic resources - such as generous welfare policies or appeals to sentiments of national solidarity - made it possible to reconcile democracy with market reforms. In a second phase, from the second half of the 1990s onwards, EU accession and deeper transnational integration helped to secure the democratic capitalist project. Proponents of an optimistic view, however, have underestimated the dilemmas inherent in this latter solution. The current crisis has brought the drawbacks of deep transnationalization to the fore.

Comparing Hungary and Latvia allows a teasing of out of the similarities and differences between pathways toward democratic capitalism and forms of transnationalization in the region. Hungary was considered a forerunner in the transformation, while Latvia lagged behind during the first years. Hungary faced only a dual transformation, while Latvia went through a triple transformation to nation-state, democracy, and market economy. Hungary's transnational integration comprises both its industrial and service sectors and has given rise to increasing international competitiveness, while Latvia's transnational economic integration is concentrated on services. Despite their differences, however, both countries had to turn to the IMF in the recent crisis.

The paper is structured as follows. The first section briefly revisits the theoretical debate as a starting point for developing a refined analytical framework of the dynamics of transformation and transnational integration, then proceeds to show how different solutions to the 'dilemmas of simultaneity' (Offe 1991) were applied across cases and over time. The second section shows that Hungary mitigated the social costs of the transition to a market economy through welfare policies, whereas Latvia - a newly independent state - used identity politics to instill tolerance for social hardship in its society. However, these domestic resources were insufficient to create solid support for democratic capitalism and showed signs of exhaustion already during the 1990s. The next section argues transnational actors and markets increasingly came to the rescue of the fragile capitalist democracies. The EU's decision to start entry negotiations offered an external anchor for reforms and made the countries much more attractive for transnational capital flows, which were abundant in the 2000s. The tolerance of international markets and institutions for great economic imbalances allowed governments in both countries to grant their population a broader share of the new system's wealth. The fourth section traces the varied routes to economic and political instability in both countries. The final section concludes.

Challenges of transformation, transnationalization, and temporary remedies

After the breakdown of communism, a number of scholars forcefully made the case for the incompatibility of simultaneous economic and political transformations (Dahrendorf 1990; Offe 1991; Przeworski 1991). These scholars argued that although the agendas of creating capitalist market economies and democratic societies were inextricably linked, they were also mutually contradictory. In their analysis, creating a market society is a political project, which requires popular legitimacy in order to succeed. However, the social dislocation inevitably brought about by marketization creates masses of dissatisfied voters who can use their newly gained democratic rights to undermine that legitimacy, and obstruct further reforms. In addition, many East-Central European countries not only had to cope with the challenges of simultaneously introducing democracy and the market, but they also had to build up new nation-states. Most of them thus had to traverse a process in three stages that in Western Europe 'were mastered over a centuries-long sequence' (Offe 1991: 873). The early literature saw a real danger that the double or triple transformation would either result in economic

backsliding to ‘third ways’ between socialism and capitalism or give rise to authoritarian temptations and upsurges of nationalism and xenophobia

A decade into the transformation, however, most students of East–Central European transformation concluded that ‘the breakdown literature has failed’ (Greskovits 1998: 4). In order to explain successful transformation, scholars turned away from the role of domestic actors to that of foreign advisers, international financial organizations, the EU, and transnational corporations (for an overview see Jacoby 2006). According to these scholars, it was the prospect of EU membership especially that was crucial for stabilizing the region’s development paths (Schimmelfennig/Sedelmeier 2005; Vachudova 2006). EU accession has bestowed the transformation with greater legitimacy, as it offered a concrete option for Eastern European societies to return to the West. It also lengthened the time horizons of political actors who otherwise might have backslid on some of the reforms in light of waning popular support. In some cases, EU accession tipped the balance in favor of pro-market and pro-democratic forces. In addition, accession conditions aimed at achieving conformity with the EU’s laws, regulations and norms have strengthened governance effectiveness in the region. Finally, the EU’s decision to start entry negotiations also impressed a seal of approval on previously undertaken reforms and served as a guarantee for further reform efforts. As such, it increased the region’s credibility for transnational market actors. From the second half of the 1990s onward, transnational capital flows kept pouring into the region, greatly assisting economic development. The major contention of Europeanization and transnationalization literature is succinctly summarized by Orenstein et al. (2008: 6): ‘At first ignored, transnational actors turned out to be the dark matter that held the various aspects of postcommunist transition together in Central and Eastern Europe.’

The divergent interpretations present two puzzles. First, neither the dilemma of simultaneity thesis nor the transnationalization thesis can account for the initial success of democratic capitalism in the region. Although occasional lapses into authoritarian temptation and some backsliding in economic reforms occurred in the first seven or so years of the transformation, it is nevertheless remarkable that despite a ‘transformational recession’ (Kornai 1993) comparable to the Great Depression of 1929–33 for its extraordinary depth and length, no wholesale attack on the project of democratic capitalism was launched. Furthermore, East–Central Europe made progress in creating a market order remarkably quickly. For proponents of the dilemma of simultaneity thesis, this outcome was unexpected. But the transnationalization literature cannot account for the initial success of transformation either. International financial institutions and foreign advisers were mostly engaged in propagating radical economic reforms, thus contributing to the stress on the new democracies, rather than seeking to engage these countries in a democratic process. The EU itself, far from embracing the newly democratic countries, was initially very hesitant in its attitude toward the region. It is only from the second half of the 1990s onwards that it developed into a ‘causal behemoth’ of transnational influence in post-communist politics (Vachudova 2008).

The transnationalization thesis faces a second puzzle. If transnationalization is indeed the ‘dark matter’ allowing for the East–Central European success, how to explain that soon after EU accession, elements of this success seem to be coming apart? Liberal democracies have been challenged by the rise of populist parties and extreme political forces. The capitalist project has experienced a significant setback with the global economic crisis. To qualify as the dark matter that holds democracy and capitalism together in East–Central Europe, transnationalization - and its beneficial influences - should surely stretch beyond the short period of EU accession.

Although neither the dilemma of simultaneity nor the transnationalization thesis can thus fully account for the successes and calamities of the democratic capitalist project, it is not so much because these approaches are wrong, but because they are incomplete. In the remainder of this section I will present the building blocks of a solution to the puzzles through drawing on and combining both sets of literature. The starting point is the vulnerability of the capitalist democratic project in East–Central Europe, as analyzed by the dilemma of simultaneity literature. In fact, this vulnerability is not specific to Eastern Europe. The very history of the

‘short 20th century’ (Hobsbawm 1994) is a powerful reminder that combining capitalism and mass democracy is a challenging agenda, not only for countries that have to introduce both simultaneously. At the same time, the second half of the 20th century has also given ample evidence for *temporary* solutions that successfully mediated these tensions. Keynesianism, consumerism, or welfarism are but some examples of such temporary solutions (Crouch 2008).

The experience of the West thus implies that by drawing on economic or ideological resources that bring stability and security to an important share of the population, capitalism and mass democracy can be reconciled. While the task is more challenging in East–Central Europe, I do not see any *a priori* reason why politicians in this region should not attempt to draw on similar resources. At the same time, however, as Crouch (2008: 475) reminds us, ‘The tension can never be “resolved” as it is endemic to the only successful form of political economy that we know; it has to be managed, by a series of regimes that will always in the end wear out and need to be replaced by something else.’ Thus, the problems stemming from the dilemma of simultaneity can be solved for a certain period of time, but ultimately fundamental tensions tend to come to the fore again and new solutions have to be found.

Politicians in East–Central Europe at first relied on domestic resources to temporarily cope with the dilemma of simultaneity. However, these resources started to wear out quickly. It was against this background that transnationalization lengthened the life span of initial solutions and offered additional resources to cope with the tensions underlying the economic and political processes, exactly as argued in the transnationalization literature. Deep integration, however, also presents no more than a partial and temporary solution to the problems inherent in the capitalist–democratic project, rather than stabilizing it *ad infinitum*.

Coping with the dilemma of simultaneity

Any attempt to reconcile the tensions inherent in the simultaneous introduction of capitalist market economies and mass democracy has to find ways to successfully mediate between ‘the insecurity and uncertainty created by the requirements of the market to adapt to shocks, and the need for democratic politics to respond to citizens’ demands for security and predictability in their lives’ (Crouch 2008: 476). Which resources could reformers in East–Central Europe rely upon in order to mediate the tensions? Political elites have drawn on the legacies of socialist welfare states or revitalized ideological traditions that were oppressed under the communist regimes, such as nationalism, or combined both (Bohle/Greskovits 2007: 2009; see also Greskovits 2008). While welfare states directly mitigate the social dislocations of transformation by building in protective devices, nationalism gives people a sense of identity, belonging, and pride, which can to some extent compensate for material losses and insecurity (e.g., see Ringmar 2005, 101).

The Hungarian welfarist social contract

Hungarian political elites resorted overwhelmingly to a welfarist social contract in order to cope with the dilemma of simultaneity. In this, they drew on the legacy of ‘goulash communism’, a set of policies introduced by the communist leader Janos Kadar after the revolt of 1956 in order to appease the citizenry. Goulash communism showed a far greater concern for the material well-being of the citizens than communist regimes in neighboring countries. It combined economic reforms with moderate consumerism and social protection and also loosened somewhat the restrictions on individual freedoms (Greskovits 2008, 277).

Post-communist attempts to deviate from the inherited patterns of social appeasement were short-lived. The first democratic government led by Jozsef Antall attempted a radical shift away from the past by cutting subsidies and simultaneously raising the charges on fuel. Confronted with fierce resistance, the conservative government backpedaled, and henceforth committed itself to ‘dividing and pacifying’ opposition to market reforms by relatively

generous welfare provisions. Access to disability and early retirement benefits was liberalized, and unemployment and family benefits as well as encompassing schemes of public health care and education were continued. The welfare packages also had the effect that the better-off and more vocal parts of the population could exit from the labor market under more advantageous conditions than less resourceful workers (Vanhuysse 2006).

Yet 'goulash post-communism' (Kornai 1996), while capable of generating some consent and legitimacy for market reforms, was soon seen as an impediment to the effectiveness of the new economic system. Major macroeconomic imbalances and a fear of losing international competitiveness motivated the second post-communist government, formed by a coalition of the Socialist Party and the Free Democrats, to launch a major austerity program. The Bokros package - named after its architect Lajos Bokros - was successful in improving Hungary's external balance by facilitating a shift toward export-oriented re-industrialization. On the other hand, the shock it administered 'proved to be a lasting nightmare for the Hungarians, produced loss of trust in the Socialists' and Liberals' sensitivity on issues on social welfare, and reinforced the welfarist opportunity structure of political life' (Greskovits 2008: 282). After the Bokros package, popular satisfaction with democracy and the market economy reached a historical low (see Table 1).

The Latvian nationalist social contract

Latvian political elites had to face the challenges of a 'triple transition', as they had to re-build their nation-state while introducing democracy and capitalism. The 'dark matter' that held the early transition together was a nationalist social contract. Successive governments in Latvia relied on a nationalizing project rather than welfare policies in their attempts to generate support from citizens.² One very important symbol of national independence, with crucial implications for social welfare, was the (re)introduction of Latvia's own currency, the lats, shortly after independence. As Gilbert and Helleiner (1999) argue, national currencies are a major device to bind state and nation and play an important role in building national identities. Latvia opted for a strong currency. It pegged the lats against an external anchor, and the Latvian Central Bank's policy has successfully mimicked the currency board arrangements of its two Baltic neighbors (Knöbl et al. 2002, 20). As a corollary of the choice of currency regime, Latvia's political elite accorded great importance to macroeconomic stability. Successive governments tried to control public expenditure, thereby limiting the resources for compensatory social policies. Although the social costs of transformation were much higher than in Hungary, social benefits remained low (see Table 1). Latvia was also the first country in the region to embark on radical welfare state reforms. The resulting dislocation put disproportionate burden on Latvia's large Russian-speaking minority.

The nationalizing project also severely limited the minority population's access to the democratic polity. Due to Latvia's restrictive citizenship law and slow progress in naturalization, an important share of the Russian-speaking population was denied citizenship rights. As late as 2006, 18 per cent of the Latvian resident population were non-citizens (Organization for Security and Co-operation in Europe, Office for Democratic Institutions and Human Rights 2007). This had repercussions on the emerging party system and political competition, as it effectively wiped out the electoral basis for a major left-wing party.

The nationalizing project was in the final account only half successful in generating support from Latvian citizens for the new political and economic system (see Table 1). Already by the mid-1990s, nationalism as a mass ideology had lost much of its appeal. Teachers and doctors went on strike for higher wages, and Latvian politicians were increasingly confronted with the social grievances of the population, while having only limited resources at their hands to offer relief (Dreifelds 1996; Smith-Sivertsen 2004). In sum, toward the second half of the 1990s, the first set of solutions to the challenges of the double or triple transitions had reached its limits.

Table 1: Social, political and economic variables, 1997-1999

	Social indicators (1999)			Satisfaction with democratic capitalism (1997)		External vulnerabilities (1999)	
	Real wages (1989 = 100)	Unemployment (% of labor force)	Social protection spending (% of GDP)	Satisfaction with market economy (% of respondents)	Satisfaction with democracy (% of respondents)	External debt (% of exports)	Current account (% of GDP)
Hungary	81	6.9	20.7	6 %	30	101.5	- 7.8
Latvia	66.2	14	17.2	0 %	24	131.1	- 9.0

Sources: Column 1: Transmonee database 2004, Column 2: AMECO Database, Column 3: Eurostat, Column 4 and 5 Central and Eastern Eurobarometer 1997, Questions: (Annex 71) Do you personally feel that the creation of a market economy is right or wrong for your country's future? (Annex 72) On the whole, are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the way democracy is developing/working in your country?, Column 5 and 6: EBRD Transition Report 2007

Transnationalization and privatization of social contracts

From this point onward, transnational actors and markets increasingly came to the rescue of the democratic capitalist project in East–Central Europe. In particular, the EU's decision to start accession negotiations had crucial impacts on the development prospects of the region. Most importantly, it offered an external anchor for further reforms. The criteria animating the accession process were comprehensive and included political and economic requirements that pushed the candidates further down the road toward democratic capitalism. Compliance was ensured through a number of instruments that put the members-to-be under constant surveillance of the European Commission.

The EU's devotion to push the agenda of democratic capitalism further - as well as its heavy-handed top-down approach which sidelined domestic politics in most crucial decisions over public policy - could have easily reinforced the frustration of the region's population over the course their countries had taken after the breakdown of communism. However, a number of compensatory effects contributed to turning the process of EU accession into a stabilizing device for the new regimes, at least initially. First, the prospect of membership bestowed additional legitimacy on the new regimes. 'Returning to Europe' was the main objective of the East–Central European societies and leaders alike. Europe was seen as a place abundant in all those properties that their region lacked in the late 1980s and before: an efficient economy, generous public welfare provisions, political freedom, and national sovereignty. Second, accession conditions aimed at achieving conformity with the EU's laws, regulations, and norms strengthened governance effectiveness in the region. This coincided with periods of higher catch-up growth in many countries. Both processes taken together helped to increase the new regimes' 'output legitimacy' (Scharpf 1999). Finally, the accession process made the region very attractive for transnational capital flows, which were becoming abundant in the 2000s. The ensuing debt economy allowed for the pursuit of domestic policies of mass appeasement.

Transnationalizing Hungary's welfarist social contract

Hungary belonged to the first wave of Central–East European countries that started entry negotiations with the EU in 1997. By this time, the country fulfilled the political criteria for membership, and the Commission considered its economic reforms to be going into the right direction. The Hungarian accession strategy focused on reinforcing the economic reform path, strengthening Hungary's overall regulatory framework, and assuring its adoption of the

acquis communautaire. All major political actors agreed on the goal of joining the EU. Arguably, therefore, the major impact of EU accession on the viability of the capitalist–democratic project in Hungary was indirect: under the protective umbrella of EU candidate status, Hungary could attract massive transnational capital flows. Foreign direct investment contributed to re-industrialization, job creation, and growing international competitiveness, while the external financing of public and private debt provided the resources for the welfarist social contract.

After the shock of the Bokros package, neither of the two major Hungarian parties dared to challenge this contract. The conservative Fidesz –MDF government coalition (1998–2002) pursued a number of policies with the aim of boosting domestic output and consumption. One important policy measure was a program for generously subsidized housing loans, coupled with hefty personal income tax exemptions, through which the government sought to appeal to the middle and upper-middle classes (Greskovits 2006). According to estimates, total housing subsidies reached about 1.5 per cent of GDP (Rozsavolgyi/Kovacs 2005).

After the conservative coalition marginally lost the 2002 elections, the left-liberal coalition led by the Hungarian Socialist Party continued the welfare effort by additionally focusing on public sector employees and pensioners. Confronted with the increasing budgetary costs of the housing subsidies program, the government decided to cut the subsidies sharply in 2003–04. At this moment, transnational banks stepped in to allow the Hungarian middle class to continue its recently acquired consumer habits. Employing a practice created in Austria, Hungary's mainly Austrian-owned banks offered foreign exchange-denominated mortgage loans – mostly in Swiss francs – to their private customers. By the end of 2007 roughly 50 per cent of mortgage and personal loans in Hungary were denominated in Swiss francs, and between 2006–07 80 per cent of all new home loans and 50 per cent of small business credits and personal loans were in this currency (Hugh 2008a).

The significance of foreign currency consumer credits and mortgage lending has to be seen against the background of the policy of the National Bank. Preparing for Eurozone entry, it pursued a policy of high interest rates to fight inflation and the growing fiscal deficit. This made borrowing in Hungarian forint almost prohibitive. The much lower interest rates of the Swiss franc-denominated credits and the ensuing house price rises sheltered middle-class consumers from the impact of the restrictive domestic monetary policy and simultaneously extended available credit.

The move into private foreign currency-denominated lending can be called a transnational form of privatized Keynesianism, a term coined by Crouch (2008) to refer to the shift from counter-cyclical state policies to secure income and employment in times of recession to the growth of private credit markets for poor and middle-income groups, which compensate for stagnating salaries and job insecurity and bolster consumer confidence. The specificity added to privatized Keynesianism in Hungary was that the credit and mortgage boom relied on foreign rather than domestic currencies, thus privatizing the exchange risk and placing it on the consumers. Yet, both consumers and financiers seemed to bank on Hungary's eventual entry into the Eurozone, which would put an end to exchange rate risks.³

Middle-class-oriented policies as well as public and private forms of consumer subsidization allowed the country to experience a period of somewhat greater political stability and satisfaction with the new system. Despite high electoral volatility and repeated wholesale alternations of government and opposition, the Hungarian political system overall proved to be among the more stable ones in Eastern Europe (Toka 2004). For the first time in the history of post-communist Hungary, an incumbent government coalition was re-elected in 2006. Overall satisfaction with democracy increased over the 2000s as compared to the 1990s (see Table 2), and popular protests against market reforms subsided after 1995, only to take off again in 2004 (Greskovits and Varhalmi 2009). It is important to note, however, that 'overall political stability in Hungary probably benefited from the fact that the major issue of economic transformation became a matter of partisan controversy only to a limited extent' (Toka 2004: 321). The convergence of the major political parties on issues of economic reforms, integration with Western Europe and welfare policies implies that socioeconomic

cleavages - however weak they might have been - were not articulated in the existing party system. This was not a problem as long as enough (external) resources were available to keep the economy afloat and guarantee basic security, as well as access to housing and consumption, to a broad share of the population. But as will be shown below, it also set the stage for political destabilization in hard times.

Transnational privatized Keynesianism in Latvia

Latvia was excluded from the first wave of countries that started entry negotiations with the EU on two grounds. The European Commission found Latvia's policies towards the Russian-speaking minority wanting and urged the country to accelerate the naturalization process and to ensure greater equality of non-citizens in their access to professions and political participation. In addition, the Latvian economy was not considered sufficiently prepared for EU membership (European Commission 1997). Nonetheless, entry negotiations with Latvia started a year after those with Hungary. Latvia's accession agenda was more challenging than Hungary's, as the Commission kept pushing the country toward greater political and economic reforms. However, political conditionality was only weakly enforced, which allowed Latvia to enter the EU without having made major changes to its discriminatory regime against the Russophone population (Hughes 2005). In contrast, the economic and administrative agenda of the EU in Latvia had a beneficial effect on government effectiveness (Kaufmann et al. 2003). To a greater degree than in Hungary, EU accession indirectly constituted a major stabilizing device, as the prospect of EU membership encouraged massive transnational capital flows that allowed Latvian citizens to finance their welfare through increasing indebtedness (see Table 2).

Latvian governments continued to rely mostly on market forces to secure citizens' living standards. During the 2000s governments stayed committed to prudent fiscal policies and were reluctant to stretch fiscal limits by increasing social spending, minimum wages, and public sector salaries. However, the high rates of catching-up growth - more than 8 per cent on average between 2000 and 2006 - made it easier to reconcile pension and wage growth with fairly balanced budgets. Growth also brought down unemployment. Moreover, in contrast to Hungarians, Latvians made use of the newly acquired right to exit when their country joined the EU. In 2006, six to eight per cent of the labor force was working abroad (Hugh 2007). As a consequence, labor markets tightened, leading to exceptional wage growth (see Table 2).

Amid fast growth and abundant transnational credit, Latvian governments relied on privatized Keynesianism even more strongly than Hungary's did, in an attempt to further promote middle-class living standards. The European Commission had encouraged Latvia to open its banking sector to foreign investors, as this promised the easiest way to achieve more efficient allocation of capital, and improve the quality of financial services. In May 2002, Swedish Hansabanka, the major foreign investor, submitted a proposal to facilitate mortgage lending, which was embraced by Andris Berzins' center-right government (Swedbank 2002; Leitner 2007). As a consequence, residential construction took off and housing prices soared. On average, between December 2001 and 2006 the price of a square meter in a standard-type block house in Riga increased by 42 per cent annually. By 2006, more than 70 per cent of the construction loans were issued in a foreign currency (Latio Real Estate 2007). Housing prices in the Baltic states exhibited growth rates 'unseen in the industrial world' (Egert/Mihaljek 2007: 4).⁴ Mortgage loans, as well as consumer and firm credits, were mostly issued in Euros.

In political terms, Latvian democracy has long been among the least stable in East-Central Europe. As discussed above, it started off as a highly exclusionist regime, and naturalization has been slow. Electoral volatility and party fragmentation have been notoriously high, and while political elites have not changed all that much, political parties were not there to stay. New start-up parties emerged at every election, and more-established ones disappeared as rapidly (Kreuzer and Pettai 2003). Still, some signs of stability found their way into this highly volatile environment. Mirroring developments in Hungary, in 2006 an incumbent

government coalition was re-elected for the first time. Consistent with patterns in Latvia's political economy, this silver lining of stability amid political instability was achieved against the background of a mass exit from politics. Voter turnout decreased significantly, from almost 89 per cent in the early 1990s to 71 percent in 2002 and just above 60 per cent in 2006.

Table 2: Social, political and economic indicators, 2006

	Social indicators				Satisfaction with democratic capitalism		External vulnerabilities	
	Real wages 2006 (2000 =100)	Unemployment (% of labor force)	Social Spending (% of GDP)	Mortgage loans (% of GDP)	Trust in the economic situation (% of respondents)	Satisfaction with democracy (% of respondents)	External debt (% of exports)	Current account (% of GDP)
Hungary	135.6	7.5	22.3	13.9	26	45	121.4	- 8.4
Latvia	159.5	6.8	12.2	28.9	19	41	271.8	-21.1

Sources: Column 1: AMECO database, deflator: private consumption, Column 3: Eurostat, Column 4: EBRD structural indicators. Column 6-7 Eurobarometer 65, 2006, Questions QC1: How would you judge the situation of the national economy? QA34a: On the whole, are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the way democracy works in your country? (fieldwork from spring, thus before the Hungarian adjustment package), Column 7 and 8: EBRD Transition Report 2007

The exhaustion of privatized social contracts

From the second half of the 2000s onwards, the resources that EU accession and the transnational credit boom had offered to Hungarian and Latvian political actors to mediate the social costs of marketization started to wane. A number of developments conspired to reach this effect. Even after accession, EU pressure for further reforms did not weaken. Almost immediately after enlargement, the EU started to scrutinize its new members on their economic convergence with the Maastricht criteria. This led to increasing tensions within the prevailing social contracts. In addition, both countries had relied to an unusual degree on transnational markets to finance their public and private social contracts (see Table 2). With export competitiveness declining, and external debts and current account deficits soaring, access to transnational finance slowly tightened. The outbreak of the global financial crisis in the fall of 2008 finally pulled the rug from under the existing social contracts.

Hungary's road to economic crisis and political destabilization

Although its fundamental macroeconomic and financial imbalances were by no means worse than those of Latvia, it was Hungary that first felt increasing pressures. Its twin fiscal and current account deficit as well as its persistent exchange rate instability brought it on the radar screen of several transnational actors at the same time. Almost immediately after enlargement, the EU started an excessive deficit procedure against Hungary. The socialist-liberal government submitted a first convergence program in 2005, which was rejected by the European Council. Complying with the Council's request for a new program, the recently re-elected socialist-liberal coalition in 2006 took a radical departure from 'goulash post-communism'. Shortly after his re-election, Prime Minister Ferenc Gyurcsany (2006) delivered his infamous speech in Balatonöszöd to the Socialist Party members of the National Assembly, where he suggested that only 'divine providence, the abundance of cash in the world economy, and hundreds of tricks, which you obviously don't need to know about, [had] helped' the government to survive and be re-elected, but that the time had now come to finally stop lying and bring the house in order. The austerity package presented by Gyurcsany

envisaged short-term measures to redress the budget deficit, as well as long-term structural reforms of the public sector, health care, and pension systems (Toth and Neumann 2006).

While the Gyurcsany package started to redress some of the domestic and external imbalances, it had negative repercussions on growth, real wages, and consumption. The shock was not yet digested when Hungary became one of the hot spots of the global financial crisis. In October 2008, its currency and stock markets started to plunge and credits dried up. In order to boost confidence in the forint and to get access to foreign currency liquidity, the Hungarian government had to rely on a coordinated rescue package crafted by the IMF and the EU. The conditions attached to the package prescribed the country yet another hefty dose of austerity. The agreement with the IMF stipulates a reduction of the primary spending to GDP ratio to 40 percent in 2011. In 2006, the ratio still stood at 49 percent. This adjustment, if realized, is among the largest in Eastern Europe.

What have been the political repercussions of the increasing problems of capitalism? Far from being a resource for solving these problems, Hungarian democracy has suffered as well. The devastating defeat of the Socialist and Liberal Parties in the Spring 2010 elections bear witness to that. The defeat was preceded by a dramatic withdrawal of the Socialist Party from civil society. It had severed its remaining ties to the trade unions, and tied its fate increasingly to a narrow circle of domestic and transnational actors eager to continue harsh economic reforms. This became especially clear with the replacement of Prime Minister Ferenc Gyurcsany by Gordon Bajnai in March 2009, whose cabinet is made up by a number of 'experts' with close connections to transnational corporations.

While the Socialists (and their previous junior partner, the Liberal Party) had 'evacuated' the 'traditional world of party democracy – a zone of engagement in which citizens interact with their political leaders' (Mair 2006, 33), the then opposition party Fidesz has skillfully moved into that zone. Since its electoral defeat in 2002, it has successfully concentrated on bringing a host of local grassroots protest movements and organizations under the party's auspices. The current success of Fidesz is based on nationalist–populist mobilization. For some, Fidesz right-wing outlook has however not gone far enough. Ever since the European parliamentary elections in June 2009, the breakthrough of a far right addition to the Hungarian party landscape, Jobbik, has sent shock-waves through the countries' political establishment.

The crisis thus is a formidable challenge to Hungarian democratic government. The new Fidesz government under Viktor Orban, backed by an unprecedented support of two thirds of the votes, is not finding it easy to reconcile the demands of international markets and institutions with their electoral promise of ending austerity for the population and rewarding their middle class electorate by hefty tax decreases. Fidesz has embarked on an unorthodox economic strategy. In order to abide by its international obligations of restoring a balanced budget, it has turned to foreign banks, energy, telecommunication and retail companies for generating revenues. It also envisages a lower exchange rate for the Forint to stimulate exports and domestic business, and aims at renationalizing the pension system in order to free the state budget from its obligations towards the private pension pillar. Fidesz' economic strategy, as well as its antagonistic stance towards the Central Banks' President have put it repeatedly at loggerheads with the EU and the IMF. While these policy measures have so far boded well with the electorate, it is not clear whether they will put the Hungarian economy back on track. It is therefore not surprising that Fidesz also tries to cement its power position by resorting to a strong dose of nationalism and implementing substantial changes of the institutional rules of the game.

Latvia's road to economic crisis and political instability

Latvia's more disciplined approach to fiscal policies, which is grounded in its effort to defend the currency peg, has allowed the country to cruise longer under the radar of international attention. The first signs of stress occurred when after successfully joining the Exchange Rate Mechanism II in 2005 Latvia's inflation rate was persistently higher than the European Monetary Union reference value. At that time, however, it was generally assumed that

inflation would soon be brought under control (Feldmann 2006). In 2006 the IMF published one of the first critical analyses of Latvia's growing imbalances. The report drew attention to the rising current account deficit and the country's limited capacity to close the gap through exports. The same report also stressed the problems of rapidly growing credits to private households and duly warned that 'as numerous cross-country studies have documented, rapid credit growth is the single best predictor of banking crises' (IMF 2006: 54).

Despite signs of increasing imbalances, Latvia stayed committed to its currency peg, thus severely limiting the policy options available to confront its problems. In March 2007, the center-right coalition government headed by Aigars Kalvitis endorsed an anti-inflation plan, which seemed modest for an economy that had spiraled out of control. Latvia's current account deficit reached more than 25 per cent of its GDP in the first quarter of 2007, wage and price inflation accelerated, and the real exchange rate rapidly appreciated (Hugh 2007; IMF 2009).

In Autumn 2008, both its banking system and the currency peg came under strong pressure. While the Swedish-owned banks could still rely on lending from their parent institutions, investors lost confidence in the domestically owned Parex Bank, which soon encountered serious liquidity problems. The government's injection of liquidity to the bank and its partial take-over failed to restore confidence. Simultaneously, the Bank of Latvia was forced to strongly intervene in order to defend its currency peg, which caused a heavy drain on the country's foreign reserves. In December 2008, the Latvian government turned to the IMF to get support for its ailing economy. Latvia received a loan of 1.7 billion euro from the IMF, and additional funds from the EU, the World Bank, and several bilateral creditors for a total package of 7.5 billion euro.

During the negotiations, the IMF-delegation initially was open to a widening of the lats corridor. The government, however, would not budge in the question of the peg. In this, it was supported both by the Swedish government and the EU, both of which had put their eyes on stabilizing the strongly exposed Swedish banks. The Latvian government accepted an adjustment program which is tough even by IMF standards. IMF Managing Director Dominique Strauss-Kahn said as much: "It is centered on the authorities' objective of maintaining the current exchange rate peg, recognizing that this calls for *extraordinarily strong domestic policies*, with the support of a broad political and social consensus". (quoted in Hugh: 2008b).

Broad political and economic support for the austerity package has however been in short supply. In January 2009, tens of thousands of demonstrators gathered in front of the parliament to protest against the worsening social and economic conditions and to demand the government's resignation. Shortly thereafter, farmers blockaded the capital city and forced the resignation of the agriculture minister. The "penguin revolution" bore fruits.⁵ In late February 2009, the government collapsed and Prime Minister Godmanis resigned, leaving a new government under Valdis Dombrovskis - again solely made up of center-right political forces - with the task of complying with the IMF program. The appointment of Einars Repse - the former president of the National Bank and architect of the re-introduction of the lat - as finance minister is a strong signal that the government has no intentions of touching the currency peg, no matter how high the social costs will become.

With this, political troubles were not over. In spring 2010, Latvia's center-right coalition government collapsed when the largest coalition party, the People's Party, withdrew its ministers. What is more, the People's Party has frequently criticized its coalition partner for its fiscal austerity course, and its chairman has also raised the possibility of a devaluation of the lats. This way, the party sought to distance itself from an unpopular government in order to halt the evaporation of its support before the upcoming elections (Cherian et al. 2010).

Latvian democracy is ill-prepared to deal with the increasing popular dissatisfaction. As a result of its nationalizing project, political parties that could offer an alternative to radical neoliberalism stand little chance to form a government. The parliamentary elections in October 2010 confirmed as much. Despite wide-spread popular dissatisfaction with sustained budget cuts, tax raises and a severely depressed economy - as a result of the credit crunch and

austerity, the Latvian economy declined by almost 19 percent in 2009, and another 2 percent in 2010, while unemployment soared to almost 20 percent - Valdis Dombrovskis' Unity coalition could score a victory. In contrast, left-leaning Harmony Center, formed to represent the Russian-speaking minority, could not reach its goal of a relative majority and came in only second. In Latvia, then, there is no alternative to further austerity.

Conclusion

Twenty years after Hungary and Latvia embarked on their path towards democratic capitalism, the challenges of the double transformation have once again come to the fore. Their remarkably smooth transformation so far has relied on the mobilization of a number of resources to mitigate the social costs. In the case of Latvia, a nationalizing project has lengthened the time horizon of reformers, while Hungary pacified its society through generous welfare policies. These policies were not sustainable: already in 1995, macroeconomic imbalances and the external constraint forced Hungary into a tough austerity package. In Latvia socio-economic grievances started to displace the national question, while its external imbalances got worse. The fragile new regimes however got a grace period. Their rapprochement to the EU encouraged their mostly foreign banks to channel a significant amount of liquidity to the region in a period of easy money, when international financial markets were ready to finance external imbalances of unusual proportions. Under the protective shield of EU accession, Hungary could renew its welfare effort and rely at the same time on privatized Keynesianism backed by informal swissfancization. Latvia relied more on private market forces to ensure the compatibility of capitalism and democracy. Mass emigration resulting in tight labor markets, and a euro-loan financed housing boom of unusual proportions improved the living standards of its citizens.

The global financial crisis put an end to all of this. It also reversed the impact of the institutions and devices which have so far contributed to mitigate the costs of transformation. Rather than a resource for democratic capitalism, welfare spending has turned into a liability for Hungary. Latvia's stable lats, once the proud symbol of renewed nationhood, has turned into a straightjacket. Short-cuts to Western capitalism, such as foreign dominated banking systems, have revealed their price tags: in order to stay committed to the region, the region has to stay committed to austerity. Informal euroization or swissfrancization, once backed by the perspective of formal euro entry, has turned into a major trap for the debtors who bear the exchange rate risk. The EU itself, which provided the protective umbrella for social and economic progress in the region, has meanwhile turned into a guard over economic orthodoxy.

The resurfaced economic woes have put the fragile democracies at risk. In Hungary, a profoundly frustrated electorate has turned its back on a government that tried to stand by its international obligation, and gave an overwhelming mandate to a government which combines an unorthodox but risky economic strategy with a hefty dose of nationalism and an increasingly open attack on the institutions of democratic checks and balances. Latvian voters are being trapped by the political and economic consequences of the nationalizing project without believing any longer in the remedies of identity politics. Latvia's democracy is not capable to generate political alternatives to an economic course, which, while imposing harsh austerity on the population, has no answer as to what should replace housing bubbles as a source of future growth and competitiveness.

Does this mean that with a detour of 20 years, the early prophecies of democratic breakdown in East-Central Europe have finally come true? As so often, reality is more complex. While it is true that in Hungary and Latvia, domestic – as well as international - resources for democracy seem to have dried out together with the credit economy underlying the recent decade, the picture in the region is overall more mixed. Take the example of Estonia. Its boom and bust cycle fell nothing short of the Latvian one, and it was – if at all possible - even more determined to keep its currency peg. As a result, Estonia's crisis

management was – as argued by a *Financial Times* editorial - not merely about “belt-tightening but amputation”. The Estonian government could however rely on an unusual degree of popular acceptance of deep wage cuts, massive public sector layoffs and soaring unemployment. Unparalleled in Europe, there have only been very minor protest events. Moreover, Estonians’ trust in government stayed high throughout the crisis. Similarly, Hungary’s Visegrad neighbors could escape the route of political destabilization as well. What all of this suggests, is that even in times of unparalleled economic hardship, it is not democratic breakdown so much as the quality of democracy that is bound to suffer.

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Notes

- 1 East–Central Europe refers to those 10 post-communist countries that eventually became members of the European Union: Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia, and Slovenia.
- 2 According to Brubaker (1996: 105), who coined the term nationalizing, it entails ‘a state of and for a particular ethnocultural “core nation” whose language, demographic position, economic welfare, and political hegemony must be protected and promoted by the state’. Hughes (2005) applies this concept to Latvia’s and Estonia’s post-communist projects.
- 3 For a thorough discussion of the Euroization and Swissfrancization in Eastern Europe, see Becker (2007).
- 4 Egert and Mihaljek (2007) do not provide data for Latvia, but according to all available sources Latvia is at the high end of the housing boom in the Baltic countries.
- 5 The penguin revolution refers to Prime Minister Ivars Godsmanis New Year’s Eve address of 2008 where he suggested his people to learn from the penguins of Antarctica, which huddle up close to each other during the winter frost.

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