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Transnationalization

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Abstract

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.

Keywords

East-Central Europe, welfare state, identity politics, transnationalization, financial crisis.

INTRODUCTION¹

The process of transformation towards democratic capitalism in East-Central Europe has given rise to a number of competing interpretations.² The early literature focused almost entirely on domestic variables in order to explain pathways, progress and setbacks on the region's road towards 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 postcommunist transformations. Competing interpretations of internal and external factors of regime transformation are also closely linked with divergent assessments of the chances for the democratic capitalist project to succeed. The early literature was mostly pessimistic about the outcome of the 'dual' or even 'triple' transformation to capitalism, democracy, and nation-states, as they judged the reform agenda as too loaded and full with contradictory requirements. In contrast, approaches focusing on transnational influences took a much more optimistic stance on this issue, arguing that these helped to stabilize the democratic capitalist project in the region.

Recent developments should however 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. While leaving socialism and heading towards transnational integration appeared to be the solution over the 1990s, by the late 2000s full exposure to the risks of an increasingly unstable global order has become a part of the region's problems. Almost all new EU member states have accumulated major economic imbalances, and are boarding on 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 article seeks to contribute to the debate on domestic and transnational factors, and their links to success and failure of transformation. Comparing the Hungarian and Latvian experiences, I will argue that while the pessimistic views were right in pointing to the dilemmas of the dual or triple transformations, they have 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 - 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. Proponents of the 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 teasing out the similarities and differences of pathways towards democratic capitalism and forms of transnationalization in the region. While Hungary was considered a forerunner in the transformation, 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 its industrial sector as

¹ I am grateful to Magdalena Bernaciak, Joan DeBardeleben, Bela Greskovits, Achim Hurrelmann, Kristin Nickel-Makszin for their comments on an earlier version of the paper. I am also most grateful to the Department of Social and Political Science at the European University Institute for all its support. A version of this paper will be published in Joan DeBardeleben and Achim Hurrelmann (eds.): *Transnational Europe: Promise, Paradox, Limits*. Palgrave, MacMillan.

² By East-Central Europe I refer to those 10 post-communist countries that eventually became members of the European Union: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia, and Slovenia.

well, and has given rise to increasing international competitiveness, while Latvia's transnational economic integration is concentrated on the service sector. Despite their differences, however, both countries had to turn to the IMF.

The article is structured as follows. In section two, I will briefly revisit the theoretical debate as a starting point to develop a refined analytical framework of the dynamics of transformation and transnational integration. I then proceed to show how different solutions to the 'dilemmas of simultaneity' (Offe 1991) were applied across cases and over time. In section three, I will show that Hungary mitigated the social costs of 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. These domestic resources were however insufficient to create solid support for democratic capitalism, and showed signs of exhaustion already during the 1990s. Section four argues that increasingly, transnational actors and markets 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 also 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. Section five 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 have forcefully made the case for the incompatibility of the simultaneous economic and political transformations. While the agendas of creating capitalist market economies and democratic societies were inextricably linked, they were also mutually contradictory. Creating a market society was a political project, which required popular legitimacy in order to succeed. The social dislocation marketization would inevitably bring about, would however create masses of dissatisfied voters who could use their newly gained democratic rights to obstruct further reforms. Many countries in the region had not only to cope with the challenges of simultaneously introducing democracy and the market. They also had to build up new nation-states. Most East-Central European countries thus had to traverse three stages of a process which in Western Europe 'were mastered over a centuries-long sequence' (Offe 1991: 873). Early literature saw a real danger, therefore, 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 (Offe 1991, Przeworski 1991, Dahrendorf 1990).

After a decade into the transformation, however, most students of East-Central European transformation got convinced that 'the breakdown literature has failed' (Greskovits 1998: 4). In order to explain successful transformation, scholars turned away from domestic actors to the role of foreign advisers, International Financial Organizations, the European Union (EU), and transnational corporations (TNCs) (for an overview see Jacoby 2006).

According to this literature, it is especially the (perspective of) EU membership which was crucial for stabilizing the regions' development paths (Schimmelfennig and Sedelmeier 2005; Vachudova 2006). EU accession has bestowed the transformation with greater legitimacy, as it offered a concrete perspective for the desire of 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 onwards, transnational capital flows kept pouring into the region, greatly assisting the catching-up 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 us with two puzzles. First, neither proponents of the challenges of simultaneity thesis nor the transnationalization thesis can account for the initial success of democratic capitalism in the region. While we have seen occasional lapses into authoritarian temptation and some backsliding in economic reforms in the first seven or so years of the transformation, it is nevertheless remarkable that despite a 'transformational recession' (Kornai 1993) which was comparable with the Great Depression of 1929-33 for its extraordinary depth and length, no wholesale attack on the project of democratic capitalism has been launched. Furthermore, East-Central Europe made remarkably fast progress in creating a market order. For proponents of the dilemma of simultaneity thesis this outcome was not to happen. But neither can the transnationalization literature account for the initial success. International Financial Institutions and foreign advisors were mostly engaged into propagating radical economic reforms, thus contributing to the stress the new democracies were exposed to, rather than seeking to lock in these countries in a democratic process. The EU itself, far from embracing the newly democratic countries, was very hesitant in its attitude towards the region. It is only from the second half of the 1990s onwards that it indeed developed into a 'causal behemoth' of transnational influence in postcommunist 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 can we then explain that right after the 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 drawback with the current global crisis. To qualify as the dark matter that holds together democracy and capitalism in East-Central Europe, the beneficial influences of transnationalization should surely stretch beyond the short period of EU-accession.

While neither the dilemma of simultaneity nor the transnationalization thesis can thus fully account for the successes and calamities of the democratic capitalist project, I submit that this is not so much because these approaches are wrong, but rather because they are incomplete. In the remainder of this section I will present the building blocks of a solution to the puzzles by drawing on and combining both literatures. I take the proposition about the vulnerability of the capitalist democratic project in East-Central Europe as my starting point. In fact, this vulnerability is not specific to the east. The very history of the 'short 20th century' (Hobsbawm 1994) is a powerful reminder that combining capitalism and mass democracy is a very challenging agenda indeed, and 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 were able to successfully mediate 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 which 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 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' (Crouch 2008: 476). 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.

As I will argue below, politicians in the region at first relied on domestic resources to temporarily cope with the dilemma of simultaneity. These resources started however 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 by the transnationalization literature. Deep integration, however, also only presents a partial 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? In my work with Bela Greskovits we found that political elites either drew on the legacies of socialist welfare states or revitalized ideological traditions which were oppressed under the communist regimes, such as nationalism, or combined both (Bohle and 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. 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 neighbouring 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 ‘divide and pacify’ opposition to market reforms by relatively generous welfare provisions. Access to disability and early retirement was liberalized, unemployment and family benefits as well as encompassing schemes of public healthcare and education were continued. The overall welfare packages had the effect that the better off and vocal parts of the population could exit from the labor market under more advantageous conditions than less resourceful workers (Vanhuysse 2006).

‘Goulash post-communism’ (Kornai 1996), while capable of generating some consent and legitimacy for market reforms, however soon was seen to impair the effectiveness of the new economic system. Major macroeconomic imbalances and a fear of losing international competitiveness motivated the second 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 through facilitating a shift towards 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 dissatisfaction with market economy and democracy reached a historical low (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 together with 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 among its citizens.³ A most important symbol of national independence with crucial welfare implications was the (re)introduction of its 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 have an important role in building national identities. Latvia opted for a strong currency. It pegged it against an external anchor, and the Central Bank's policy has mimicked successfully the currency board arrangements of its two Baltic neighbors (Knöbl et al 2002: 20). As a corollary of the choice of the 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 stayed very low (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. Still in 2006 only 18% of the Latvian resident population were non-citizens (OSCE 2006). This had also 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 among Latvian citizens for the new political and economic system (table 1). Already by the mid 1990s, nationalism as an ideology shared by the masses had lost much of its appeal. Soon teachers and doctors started to 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, towards the second half of the 1990s the first set of solutions to the challenges of the double or triple transitions started to reach their limits.

³ According to Brubacker, 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' (Brubaker 1996: 105). Hughes (2005) applies this concept to Latvia's and Estonia's post-communist projects.

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 in time onwards, transnational actors and markets came increasingly at the rescue of the democratic capitalist project in East-Central Europe. It was especially the EU's decision to start entry negotiations which had crucial impacts on the development prospects in the region. Most importantly, it offered an external anchor for further reforms. The criteria animating the accession process were encompassing, and included political and economic requirements which pushed the candidates further on the road towards democratic capitalism. Compliance was assured through a number of instruments which put the members-to-be under constant surveillance of the European Commission.

The EU's devotion to push the agenda of democratic capitalism further and 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 with the course their countries have taken after the breakdown of communism. A number of compensatory effects however contributed to turning the process of EU accession into a stabilizing device for the new regimes – at least initially. First, the membership perspective bestowed the new regimes with more legitimacy. 'Returning to Europe' was the main destination of the East-Central European societies and leaders alike. Europe was seen as a place abundant in all those properties which their own region lacked in the late 1980s and before: an efficient economy, generous public welfare provision, political freedom, and respected national sovereignty. Second, accession conditions aimed at achieving conformity with the EU's laws, regulations and norms have strengthened governance effectiveness in the region. This coincided with periods of higher catch-up growth in many countries. Both processes taken together have helped to increase 'output legitimacy' (Scharpf 1999). Finally, the accession process also made the region very attractive for transnational capital flows, which were getting abundant in the 2000s. The ensuing debt-economy allowed 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 to start entry negotiations with the EU in 1997. By this time, Hungary fulfilled the political criteria for membership, and the Commission considered its economic reforms as going into the right direction. The 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 wish to join the EU. Arguably, therefore, the major impact of the EU accession for 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, and 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. A most important policy measure was a program for generously subsidized housing loans, coupled with hefty personal income tax exemptions, through which it sought to appeal to middle and upper-middle classes (Greskovits 2006). According to estimations, the total housing subsidies reached about one point five per cent of GDP (Rozsavolgyi and Kovacs 2005).

After the conservative government 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 increasing budgetary costs of the housing subsidies program, the government however decided to cut the subsidies sharply in 2003-2004. At this moment, transnational banks stepped in to allow the Hungarian middle class to continue their only recently acquired consumer habits. Transplanting a fashion created earlier in their home country, Hungary's dominantly Austrian-owned banks offered foreign-exchange – mostly Swiss franc - denominated mortgage loans to their private customers. By the end of 2007 roughly half of the contracted mortgage and personal loans were denominated in Swiss franc, and between 2006-2007 alone 80 per cent of all new home loans and half of small business credits and personal loans were taken out in Swiss franc (Hugh 2008).

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 however relieved middle class consumers from the impact of restrictive domestic monetary policy, and simultaneously extended available credits.

The move into private foreign currency denominated lending can be called a transnational form of privatized Keynesianism, a term coined by Colin Crouch (2008). Crouch refers to the shift from countercyclical 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 allow to maintain 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 to consumers. Yet, both consumers and financiers seem to have been banking on Hungary's eventual euro entry, which was going to put an end to exchange rate risks.⁴

Middle-class oriented policies and public as well as private forms of consumer subsidization have allowed the country to face a period of somewhat greater political stability and satisfaction with

⁴ For a thorough discussion of the euroization and swissfrancization in Eastern Europe see Becker (2007).

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 an East European comparison (Toka 2004). For the first time in the history of post-communist Hungary, an incumbent government coalition could secure its re-election in 2006. Overall satisfaction with democracy increased over the 2000s compared to the 1990 (see table 2), and popular protests against market reforms subsided after 1995, to take off again in 2004 (Greskovits and Varhalmi 2009). It is important to note, however, that '[o]verall 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, west-integration, and welfare policies implies that socio-economic cleavages – however weak they might be – were not articulated by the existing party system. This was not a problem as long as enough (external) resources were available to keep the economy afloat and allow a broad share of the population basic security, and access to housing and consumption. But as we will see 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 Commission found Latvia's policies towards the Russian speaking minority wanting and urged the country to accelerate the naturalization process and ensure more equality of non-citizens in respect to their access to professions and political participation. In addition, the Latvian economy was not yet considered sufficiently prepared for an eventual 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 the Hungarian one, as the Commission kept pushing the country both on political and economic reforms. Political conditionality was however only very weakly enforced, which allowed Latvia to enter the EU without major changes in its discrimination regime against the Russophone population (Hughes 2005). In contrast, the economic and administrative agenda of the EU in Latvia seemed to have had a beneficial effect on government effectiveness (Kaufmann et al. various years). To a greater degree than in Hungary, the indirect effect of the EU accession as a vehicle for massive transnational capital flows which allowed the promotion of welfare of Latvian citizens financed by increasing indebtedness seemed therefore to have been the major stabilizing device (table 2).

Latvian governments continued to rely mostly on market forces to promote the living standard of their citizens. During the 2000s governments stayed committed to prudent fiscal policies, and were reluctant to stretch fiscal limits by increasing social spending, minimum wages, or public sector salaries. The high catching-up growth rates of more than eight per cent on average between 2000 and 2006 made it however 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 the country joined the EU. Six to eight per cent of the labor force was working abroad in 2006 (Hugh 2007). As a consequence, labor markets tightened, leading to exceptional wage growth (table 2).

Amidst fast growth and abundant transnational credit, to further promote middle class living standards Latvian governments relied to a much stronger degree on privatized Keynesianism than Hungary. The European commission had encouraged Latvia to open its banking sectors 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 (Leitner 2007, Swedbank 2002). 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, while by 2006 more than 70

per cent of the construction loans were issued in foreign currency, primarily euro (Latio Real Estate 2007). Housing prices in the Baltic States have exhibited growth rates ‘unseen in the industrial world.’ (Egert and Mihaljek 2007: 4).⁵ Mortgage loans, as well as consumer and firm credits were mostly issued in Euro.

In political terms, Latvian democracy has long been among the least stable in East-Central Europe. As argued above, it started off as highly exclusionist, and naturalization was slow. Electoral volatility and party fragmentation has been notoriously high, and while political elites did not change 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). Some signs of stability however found their way even into this highly volatile environment. Similar to Hungary, for the first time in 2006 an incumbent government coalition has won reelection, if only by a tight margin. Consistent with Latvian political economic patterns, this silver lining of stability amidst political instability has been achieved against the background of mass exit from politics. Voter’s turnout decreased significantly, from almost 89 per cent in the early 1990s to 71 percent in 2002 and just above 60 percent 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, Colum 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 EU accession and the credit-boom fuelled by transnational banks offered to Hungarian and Latvian political actors in order to mediate the social costs of marketization started to be on the wane. A number of developments conspired to this end. Even after accession, the EU pressure for further reforms did not weaken. Almost immediately after enlargement, the EU started to scrutinize its new members for their economic convergence with the Maastricht criteria. This led to increasing tensions with 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 (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 Autumn 2008, finally, pulled the rug from under the existing social contracts.

⁵ These authors 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.

HUNGARY'S ROAD TO ECONOMIC CRISIS AND POLITICAL DESTABILIZATION

It was Hungary that first felt increasing pressures, although its fundamental macroeconomic and financial imbalances were by no means worse than those of Latvia. But its twin fiscal and current account deficit as well as persistent exchange rate instability brought it on the radar screen of several transnational actors at once. 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 however rejected by the European Council, who invited the government to present a new program by September 2006. To comply with this request, the just re-elected socialist-liberal coalition took a radical departure from 'goulash post-communism'. Shortly after his reelection, Prime Minister Ferenc Gyurcsany delivered his (in)famous speech at a National Assembly of the Socialist Party in Balatonöszöd, where he suggested that only '[d]ivine providence, the abundance of cash in the world economy, and hundreds of tricks, which you obviously don't need to know about, have helped' the government to survive and be re-elected, but that now had come the time to finally stop lying and bring the house in order (Gyurcsanyi 2006). The austerity package envisaged short-term measures to redress the budget deficit, as well as long term structural reforms of the public sector, healthcare 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 turn to the IMF. While the loan – all in all 20 billion euro granted by the IMF, the EU and the World Bank – is huge by any comparison, the conditions attached to it are bound to be grim for a large part of the Hungarian population.

What have been the political repercussions of the increasing problems of capitalism? Far from being a resource for solving the problems, Hungarian democracy has suffered as well. Its seemingly stable and consolidated party system is on the brink of a major reshuffle. As a corollary to its reinvigorated economic reform drive from 2006 onwards, the Socialist Party has downsized its engagement with civil society by severing its remaining ties to the trade unions. Neither does the party seem to care about its unprecedented drop in voters' support, and the prospect of being reduced to a marginal political actor with the next elections. Not any longer much concerned with generating popular support, the Socialist Party has 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 TNCs.

While the Socialists (and their previous junior partner, the Liberal Party) have 'evacuated' the 'the traditional world of party democracy – a zone of engagement in which citizens interact with their political leaders' (Mair 2006: 33), the national-conservative 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. FIDESZ current success is based on nationalist-populist mobilization. In economic terms, it has so far fallen short of offering a credible alternative to the Socialists' austerity package. More recently, an extreme right competitor has emerged with realistic chances of getting to the parliament. While not formally in danger, the future of Hungarian democracy will be played out in the competition and alignment between extreme right and nationalist-conservative parties amidst an increasingly alienated electorate.

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 below the radar screen of international attention. The first signs of stress occurred when after successfully joining the ERM II in 2005 Latvia's inflation rate was persistently higher than the EMU reference value. At the 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 rapid growth of credits to private households, and duly warned that '[a]s numerous cross-country studies have documented, rapid credit growth is the single best predictor of banking crises' (IMF 2006).

Despite signs of increasing imbalances, Latvia stayed committed to its currency peg, thus severely limiting the policy options available to attack its problems. In March 2007, the center-right coalition government under 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 GDP in the first quarter of 2007, wage and price inflation accelerated, and the real exchange rate rapidly appreciated (IMF 2009; Hugh 2007). With the outbreak of the global financial crisis, both the banking system and the peg came under pressure. In December 2008, facing bankruptcy, the center-right coalition government under Ivars Godmanis turned to the IMF for support.

Latvia receives a loan of 1.7 billion euro from the IMF complemented by additional funds from the EU, the World Bank and several bilateral creditors bringing the total amount to 7.5 billion euro. Latvia's adjustment program is severe even by IMF standards. IMF Managing Director Dominique Strauss-Kahn said as much: 'It [the program, D.B.] 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 2009). Although the IMF in the end endorsed Latvia's commitment to keep the currency peg, it initially opted for a widening of the lat corridor (IMF 2009: 10).

Support of a broad political and economic consensus for the austerity package has however been in short supply. In January 2009, 10.000s of demonstrators gathered in front of the parliament to protest against their worsening social and economic conditions and demand the government's resignation. Shortly after, farmers blockaded the capital city and forced the resignation of the agriculture minister. In late February, the government collapsed, and Prime Minister Godmanis resigned, leaving a new government – equally solely made up of center-right political forces - with the task of complying with the IMF program. The appointment of former National Bank President and architect of the re-introduction of the lats, Einars Repse, as Finance Minister is a strong signal that the government has no intention to touch the currency peg, no matter how high the social costs. Latvian democracy is ill-prepared to deal with the increasing popular dissatisfaction. As a result of its nationalizing project, no political party questioning the currency peg and the extraordinarily strong domestic adjustment it necessitates has ever had a chance to form a government. The lats, symbol of the newly gained nationhood, is pitted against responsiveness to popular demands for social safety. In contrast to Hungary, the political resources nationalism can offer in times of crisis seem however exhausted. Latvian democracy, then, is bound to see exit on a grand scale.

CONCLUSION: THE PARADOXES OF TRANSNATIONALIZATION AND THE RE-EMERGENCE OF THE DILEMMA OF SIMULTANEITY

Twenty years after Eastern Europe embarked on its path towards democratic capitalism, the challenges of the double transformation have once again come to the fore. The remarkably smooth transformation in the region 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 swissfrancization. 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 improved the living standards of its citizens.

With the outbreak of the global financial crisis we are in a better position to evaluate the conditions under which Europeanization could contribute to greater economic and political stability in the region. Most importantly, it was the abundance of transnational capital flows that eased the tensions inherent in the transformation and European accession process alike. The rapprochement to the EU encouraged transnational companies to invest heavily in the region, transnational banks to channel a significant amount of liquidity into the domestic markets, and global financial markets to finance economic imbalances of unusual proportions.

The crisis put an end to all of this. Even worse, it 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 turned into major risk factors, as their huge loan books in the East are not necessarily covered by their home countries' bailout plans. Informal euroization or swissfrancization, once backed by the perspective of formal euro entry, has turned into a trap of gigantic proportions 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 turned into a guard over economic orthodoxy to the point of risking a fallout with the IMF when denying the crisis-ridden countries the relief of early EMU entry.

The resurfaced economic woes have put the fragile democracies at risk. Neither the Hungarian nor Latvian party systems allow for politicizing socioeconomic questions. In Hungary an increasingly frustrated electorate is left with the choice between voting nationalist, extreme right or not at all. Latvian voters, being trapped by the political consequences of the nationalizing project without believing any longer in the remedies of identity politics, might once more punish barely established parties by voting for a new start up, or, more likely, defect from politics altogether. In short, democratic politics in the region is not prepared to address their citizen's demands for basic security and predictability in their lives.

Does this mean that with a detour of 20 years, the early prophesies of democratic breakdown in East-Central Europe will finally come true? The argument developed in this article would lead us to a different conclusion. While transnational support for democracy and stability in the region seems to have dried out together with the debt-economy underlying it, the new democracies have already ventured into yet another temporary solution to their dilemmas: while not challenging democracy on

formal grounds, political elites are increasingly inclined to 'ruling the void', that is to govern a democracy 'stripped of its popular component' (Mair 2006: 25). For how long this solution is there to stay and which tensions and contradictions it entails for democratic capitalism in hard times remains to be explored.

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