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JEL Classification: D72, F30, F40

Keywords: Federalism, Political Institutions, Party Systems, euro

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This paper argues that institutions and political party systems are simultaneously determined. A large change to the institutional framework, such as the creation of the euro by a group of European countries, will realign -after a transition period- the party system as well. The new political landscape may not be compatible with the institutions that triggered it. To illustrate this point, we study the case of the euro and how the party system has evolved in Southern and Northern European countries in response to it.

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1 Introduction

Institutions and political party systems are simultaneously determined by the choices of politicians, voters, and other agents. Institutions shape the political parties that appear, grow, and succeed in winning office and enacting legislation. Parties, in turn, try to change the political institutions (both formal and informal) in ways that favor their goals and the interests of their voters. Thus, when institutions are modified by an external force, such as a process of federal integration, party systems will mutate, and these mutations will feed back into how the institutions themselves evolve.

In this paper, we argue that this was the case in the design of the euro. Most Western European party systems were organized around a left-center pole (with a dominant social-democratic party, perhaps with a smaller competing party to the left from a more radical tradition) and a center-right pole (which mixed, in different proportions, liberal, Christian democrat, and conservative parties). Each of these poles amalgamated heterogeneous coalitions of voters and interest groups. For example, the center-right pole included small businessmen, liberal professionals, and the traditional religious middle classes. The left-center pole gathered support from low- and middle-skill workers, public-sector employees, and young voters. While these different constituencies often disagreed on priorities, a modus vivendi had been forged during the years of fast postwar growth in the countries of Northern Europe. These arrangements were extended to Southern European countries during the democratization wave of the 1970s. The subsequent party systems showed, for many decades, a considerable degree of stability and reliance.

The adoption of the euro and the policies required to sustain it in the face of the financial crisis of 2008 and its aftermath have irremediably damaged those coalitions. For example, many young and low-skilled workers face the prospect of decades of high taxation and low consumption growth required to pay the large public liabilities accumulated between 2008 and 2015 as well as the external debt piled up during the early years of the euro. And this adjustment has to occur without the possible benefits (for them) of an external devaluation that would erode the real value of the debt. Debt issuance has been geared to a large extent to maintain the social welfare benefits enjoyed by retirees, but also the unemployed. Thus, for these voters, breaking down the euro –or at least avoiding the policies required for its survival– has become an attractive

option. At the same time, middle-skilled workers and older voters with financial assets and pension benefits have a vested interest in maintaining the status quo, including the euro and a policy of low inflation.

These contradictory cleavages have fractured the left-center pole in Spain, Portugal, and Greece into more conventional social democratic parties and new left-wing populist parties, such as *Podemos*, *Bloco de Esquerda*, and *Syriza*. Social democratic parties represent the interests of those who benefit immediately from the maintenance of the existing institutions of the welfare state and of the real value of the claims they have against it in the form of pensions and health care. These voters, who tend to be older, benefit much less from the option embedded in radical policies such as the abandonment of the euro. Instead, the "new left parties" capture the constituencies with diminished expectations. Their voters tend to be younger, have less immediate claims on the welfare state, and care more about improving their current prospects. Since the status quo does not bode well for the long-term fiscal sustainability of the welfare state (when current young voters would be old), young voters face a strong incentive for more radical departures from standard, "more-of-the-same," policies. The optionality embedded in a general reshuffling of the "economic cards" is, for them, a more attractive policy. At the heart of the division between different constituencies lies divergent assessments of the risks that each policy alternative represents. Furthermore, these changes have anchored themselves within *les lieux de mémoire* created by old historical turning points that seem to have been buried in these countries (such as the discussion regarding the constitutional design of postwar Europe, how to come to terms with the inheritance of past civil wars, and the policy choices that the left has made over the preceding decades).

A similar process, but from the center-right pole, has occurred in several Northern European countries. Here fractures run along different dimensions. A first source of tension is the realization that the sustainability of the euro may require some form of fiscal union and an ever deeper mutualization of risks. This splits traditional center-right constituencies into two groups: those who benefit from exchange-rate stability and a depreciated currency (anyone linked to the export sector) and those who might bear the tax burden associated with transfers inside the monetary union without being linked to the export sector, such as anyone associated with the local services economy. The first group is willing to consider deeper ties to preserve

the monetary union from which they benefit, whereas the second -though wary of the costs of undoing the euro- want to bound and put a limit on fiscal integration, such as any form of eurobonds or a system of deposit insurance at the European level to complete the banking union. An additional divide, but one closely connected to trade, relates to immigration. A consequence of the freedom of movement of people at the heart of the European Union has been a significant intra-European flow of workers. These flows open a new divide between those who benefit from the cheap-labor immigrants typically supply and those whose wages are potentially hurt by increased labor market competition. Technological progress adds to the woes of those exposed to these trends. Cultural displacement is an additional factor that cuts across political divides.

Note that immigration is a European Union concern (since this is the jurisdiction where the "four freedoms" of movement of goods, services, capital and people operate) and not just a Eurozone problem. Thus even in countries such as the United Kingdom that stayed outside the euro, the consequences of European integration have been a determining factor (although not the only one) in the outcome of the recent Brexit referendum.

In this paper, we will describe these forces and offer tentative arguments about how to analyze them. Of course, we are aware that other mechanisms were important in the political changes witnessed in Europe over the last few years. The historical cleavages of working class allegiance and religious identity that solidified, respectively, the electoral bases of social democrat and Christian democrat parties have been significantly eroded by technological change, structural transformation, and by the broad secularization of European societies. And, as proved by the success of *Podemos* in Spain, social media allow the electoral breakthrough of novel parties with limited budgets by letting their message reach voters without the mediation of traditional "gatekeepers." Finally, as briefly mentioned above, immigration has been central to the success of right-wing populist parties. Nevertheless, we find that the unheralded role of the euro has been crucial in catalyzing many of the previous forces.

We start now to develop the previous arguments in more detail by describing how Western European postwar politics was organized.

2 Western European postwar politics

The end of World War II brought a period of peace and prosperity to Western Europe that few would have foreseen after the turbulent "Second Thirty Years' War" of 1914-1945. Many forces contributed to this era: the U.S. security guarantee to its European allies, the new geostrategic reality inaugurated by nuclear weapons, the reopening of international trade, and cheap energy. But a key element was the creation of party systems in most Western European countries that reflected a broad consensus among political and social elites regarding the basic constitutional and economic arrangements of postwar Europe.

First, the defeat of fascism irremediably tainted the old right-wing national conservative parties. These political creeds, due to their more or less open cooperation with fascism, either disappeared or were pushed to fringe positions. In Germany, for instance, there were no political heirs to the German National People's Party (*Deutschnationale Volkspartei, DNVP*).[1] The DNVP had reached as high as 20.5 percent of the votes during the Weimar Republic (in the federal election of December 1924) and became the second party in the Reichstag, smaller only than the Social Democrats (*Sozialdemokratische Partei Deutschlands, SPD*).[2] The Weimar coalition of social democrats, left-wing liberals, and Catholics always faced the handicap of the DNVP (plus a smaller right-wing liberal party), limiting its ability to stabilize the regime. The situation in postwar West Germany was different. After World War II, two minor right-wing parties that appeared in the aftermath of the Allied occupation soon collapsed. Since 1957, no party to the right of the Christian democrats of the CDU/CSU has achieved representation in the Bundestag (although, as we will argue later as part of the central thesis of this paper, this may soon change).

Second, the cold war made communist parties an unacceptable government partner to large sections of the electorate. The most striking case was Italy. The Italian Communist Party

[1] In this paper, we will follow the convention of calling a political party by the most natural translation of its name in English, followed, the first time it appears, by its untranslated name. We will have exceptions to this rule when the party is well-known in English by its original name (i.e., the reader is likely to recognize *Sinn Féin* more readily than "We Ourselves.")

[2] The connections of the DNVP with the social, economic, and military elites of Germany –best represented by Alfred Hugenberg, the party's leader and a media tycoon– gave the DNVP a weight that reached beyond the arithmetic of its electoral base. See Hertzman (1963) for a classic treatment of the origins and evolution of the DNVP and Beck (2008) for how the national conservatives aligned themselves with the NSDAP in 1933.

(*Partito Comunista Italiano, PCI*), the largest in Western Europe, never entered into government even when it gained 34.37 percent of the votes in the general election of 1976.[3] Similarly, postwar West German communists lingered in electoral irrelevance until their party was banned in August 1956 by the Federal Constitutional Court as contrary to the principles of the Basic Law of the Federal Republic.

The pruning of the extremes on both sides of the political spectrum left on the table only three major political families: the social democrats, the Christian democrats, and the liberals.[4] These three families shared many common views. First, all three embraced representative liberal democracy as a political regime. Liberals, of course, had been the creators of such a regime in the long 19th century (1789-1914) and were delighted by the final triumph on the continent of the rule of law, separation of powers, checks and balances, and bills of rights. Social democrats, particularly in the north of Europe and in the United Kingdom, had a long tradition of appreciation for representative liberal democracy that had gone as early as the late 19th century. Many of their leaders were keenly aware of the dictatorial predisposition and duplicitous nature of communist parties and, in the case of Germany, they have seen with their own eyes what Soviet dominance meant in real life. Christian democrats, after several decades of hesitation, reconciled the religious middle classes with modern political structures and gave many national conservative voters an electoral house and a veneer of respectability.

Second, social democrats, Christian democrats, and liberals shared a common view of a mildly interventionist market economy with a relatively generous welfare state and macroe-

[3] During the first months after the end of World War II, the Italian and French Communist Parties were members of national unity governments. After the so-called crisis of May 1947, both parties were excluded from government. The Italian communists never returned to power, although most of them mutated in 1991 into a moderate left-wing party that entered into government in 1996. The French communists only played a secondary role in Mitterrand's government from 1981 to 1984 and later from 1997 to 2002.

[4] Like all taxonomies, we are omitting the rich texture of detail. The biggest anomaly to this classification was France, where Charles De Gaulle's outsized personality created a political movement, Gaullism, with its idiosyncrasies (there was, for instance, a left-leaning Gaullism that combined French nationalism and pro-workers socialization policies). The movement survives until today, although after a bewildering series of party-name mutations. At the same time, Gaullists did not depart in substantial ways from the common threads that we will highlight in the next lines. Therefore, for the purpose of our argument, the peculiarities of the French are of secondary importance. Despite much more recent research, Rémond (1982) is still an outstanding introduction regarding the history of right parties in France for the general reader. Another partial exception was the United Kingdom, where the conservatives were never challenged by a Christian democrat party, to a large extent because it never flirted sufficiently with fascism. Smaller conservative parties also survived in Scandinavia, again having largely avoided cooperation with the extreme right.

conomic stability. Social democrats were more for nationalizations and liberals more inclined toward the market (with the Christian democrats in a somewhat intermediate position and having their dissensions, with both left and right wings of their parties). But the differences were more of emphasis than of substance. As deftly documented by Eichengreen (2008), post-war European countries set a quasi-corporatist system of "coordinated capitalism," where wage moderation was exchanged for growing welfare states and where competition and the entry of new firms were managed to minimize disruption. The Keynesian consensus existing among macroeconomists (partially tempered by German Ordoliberalism) fitted well with that economic view.

Third, social democrats, Christian democrats, and liberals in continental Europe (but not in the United Kingdom, where euroscepticism was widespread across party lines; see Grob-Fitzgibbon, 2016) saw European integration as the path to overcoming a range of challenges, such as collective security and sufficiently large markets, that had plagued their nation-states in the previous decades. Far from being the product of a sudden burst of federalist impulse, Europe was the key to the survival of the 19th-century nation-state in the changed world that emerged from the war (Milward, 2000).

Of the three political families, the Christian democrats were the electorally most successful one, especially until the early 1980s. The most extreme case was Italy, where the *Democrazia Cristiana* ruled (alone or in coalition) uninterrupted from 1944 to 1994. Christian democrats governed West Germany from 1949 to 1969 (alone or in coalition, the last three years with the social democrats) and again from 1982 to 1998 (again, in coalition). Social democrats made inroads into power in the late 1960s and 1970s as younger voters were attracted by the promises of more redistribution and progressive social policies. The liberal parties, in comparison, could never extend their reach beyond the upper-middle and professional classes.

The political-economic consensus was supported by internal and external forces. Among the internal forces, the most relevant was economic growth. The *trente glorieuses* (1945-1975) saw per capita income growth rates between 3 and over 5 percent across Europe even after controlling for recovery from the war. Voters were satisfied with peace, prosperity, low unemployment, and increasingly generous social transfers. The electoral systems were often designed to favor mainstream parties (for example, in Germany, with high threshold requirements to obtain par-

liamentary representation or, as we already mentioned, by judicial decisions declaring radical parties to be illegal). Finally, these were the decades of old-style media: there were limited TV and radio networks (and, in contrast with the U.S., most of them were government-owned), traditional newspapers, and no internet.[5] Dissenting voices were easy to marginalize in the public debate. Among the external forces, the gentle nudging from the U.S., the Soviet menace (ruthlessly exploited by Christian democrats in Germany and Italy), and, above all, the memory of World War II turned many voters into cautious decision makers that favored centrist, consensus-oriented politicians.

3 The democratization wave of the 1970s

Three countries in Southern Europe had resisted the consensus described in the previous paragraphs: Spain, Portugal, and Greece. Spain and Portugal had right-wing dictatorships for decades (from 1926 to 1974 in Portugal, from 1936 to 1975 in Spain). After World War II and a bitter civil war between the communist and the official government returned from exile (from 1946 to 1949), Greece had a period of turbulent democracy followed from 1967 to 1974 by the so-called Regime of the Colonels. Then, in just a few months, all three countries started transitions to democracy: the Carnation Revolution in Portugal on April 25, 1974, the fall of the military junta in Greece on July 24, 1974, and the death of Francisco Franco in Spain on November 20, 1975.

Each transition had its unique traits. Portugal, after the collapse of the dictatorship, toyed with widespread collectivization and a transition to socialism, while, in Spain, the late Francoist elites kept a much closer control of the political process, of the commanding heights of the economy, and of the security forces. Greece started on a moderate route, but it radicalized with the 1981 electoral victory of Andreas Papandreou and his Panhellenic Socialist Movement (*PASOK*).[6]

[5] Private TV stations were opened in France and Germany only in 1984 and in Spain in 1989. Even in more liberal countries, such as the United Kingdom, private stations were strictly regulated. Private TV stations were allowed more as a result of a grudging acceptance that, in the world of satellites and cable, these stations were unavoidable than out of a conviction of their merits.

[6] Papandreou's fascinating voyage from Professor of Economics at the University of Minnesota to firebrand Greek populist is superbly narrated by Draenos (2012).

Despite these distinctive features, all three countries ended up with a political and party system that looked remarkably similar to those in Northern Europe: first, a parliamentary democracy with modern constitutions and extensive protection of political and civil rights; second, a market economy with a fair degree of government intervention and integrated into the European Union; and third, two major parties, one in the social democratic family and one in the liberal/Christian democrat families taking peaceful turns in power.[7]

This outcome was not, in retrospect, an accident. Spain, Portugal, and Greece, thanks to decades of fast growth, had by the early 1980s social and economic structures that resembled those of their northern neighbors (thus, calling for similar parties to represent similar constituencies). Also, the desire to imitate Europe and the discreet political and financial support from other European parties helped to consolidate their equivalent partners in Southern Europe.

In summary, by the mid-1990s, the party systems of most Western European countries were noticeably homogeneous. Even if national histories meant British conservatives were not fully exchangeable with French Gaullists or German Christian democrats, an outside observer would have easily understood why these parties could cooperate with a fair degree of efficacy in the European Parliament. And, while the fast growth of the *trente glorieuses* had evaporated by the early 1980s and signs of structural economic troubles were accumulating,[8] prosperity was still acceptable to most voters, especially during the high phase of the expansionary cycle originated in the U.S. in the second half of the 1980s. But things were about to change from an unexpected direction: the introduction of the euro.

[7] Regarding the social democratic parties, the *PASOK* in Greece was the most left-wing, with a weak commitment to NATO and a populist streak until the 1990s. The Spanish Socialist Party (*PSOE*) was surprisingly moderate on social issues, pro-Atlantic, and friendly to markets. The Portuguese Socialist Party was close to the Spanish one. Regarding the liberal/Christian democratic parties, Spain and Greece ended up with catch-all right-wing parties that included Christian democrats, liberals, and, as a dominant force, more old-fashioned conservatives, such as the People's Party (*Partido Popular*; formerly known as *Alianza Popular*) in Spain and *New Democracy* in Greece. In Portugal, there was a *Partido Social Democrata*, which despite its name was a liberal-conservative alliance with a few progressive and Christian democratic add-ons and the *Centro Democrático e Social-Partido Popular*, a combination of Christian democrats and conservatives.

[8] For instance, much economic growth in France or Italy had come from moving workers from agriculture to manufacturing and services during the 1950s and early 1960s. Once the number of agricultural workers had shrunk enough in the mid-1960s, labor became scarcer and workers' militancy increased (as shown by the large strikes of 1968-1969).

4 Policy experiments and political realignment in post-Bretton Woods Europe

The monetary union was an additional step, albeit a critical one, in the process of European integration that we introduced above as the proposed solution to the challenges facing European nation-states. The euro was the logical step following the Single European Act (SEA), the effort to finally transform the then-called European Economic Community (EEC) into a true single market. The SEA's passage sprang from a felicitous coincidence of political views in the United Kingdom, France, and Germany over the need to renew the impetus of the EEC. The election of Margaret Thatcher in 1979 and the turnaround of the Mitterrand government in matters of economic policy in 1983 allowed an agreement with Germany, which, as an exporting powerhouse, had always been keen on advancing a free trade agenda. This coincidence of views between the three heavyweights of the EEC was crucially facilitated by the dynamism of Jacques Delors, the then president of the European Commission and a convinced European federalist.

It is useful to linger briefly on the French decision to support this process as it bears on our central thesis. The election of Mitterrand to the presidency in 1981 was followed by a program of nationalizations and expansionary fiscal policy aimed at reactivating the flagging French economy. But these measures quickly put the European Monetary System (EMS), the managed exchange-rate system that was the second iteration of the European response to the collapse of the Bretton Woods exchange-rate system in the early 1970s, under severe pressure. Expansionary policies and rising nominal interest rates (the result of Volcker's decisions at the Federal Reserve) resulted in three small devaluations of the franc between 1981 and 1983. Mitterrand was confronted with the unpalatable choice of sticking with his policies or abandoning them to preserve the EMS and good trading relations with Germany.[9] In 1983, Mitterrand chose the latter, "a pivotal moment in the political economy of French socialism, heralding a neo-liberal shift towards competitive disinflation" (Clift, 2002, p. 325).[10] This turnaround explains why

[9] In fact, this was the second French experiment of fiscal expansion in a system of managed exchange rates in less than a decade. In 1975 the Gaullist Jacques Chirac, then prime minister to the newly elected Valery Giscard D'Estaing, launched a stimulus package that forced a devaluation of the franc and the break-up of the European "snake," the first iteration of the EMS after the fall of Bretton Woods.

[10] Already in the spring of 1982, Prime Minister Mauroy and Jacques Delors, then economic and finance minister, presented a plan to President Mitterrand by which devaluations would be accompanied by wage

politicians as radically different as Mitterrand and Thatcher could agree on a project of the magnitude of the SEA, which was to be spearheaded, as already mentioned, by Jacques Delors, the same man who had convinced the French president of the wisdom of reversing policies.

Mitterrand's about-face had momentous political consequences for "[t]here was nothing like a converted left government to destabilize the labour movement" (Moss, 1998, p. 235). Indeed, the French Communist Party, which had four cabinet members, did little to resist the turnaround and their share of the votes dwindled throughout the 1980s.

What drove Mitterrand's U-turn? Was he convinced of the need to preserve the EMS and the economic collaboration with Germany? Or, more simply, was there a lack of popular support for radical policies? To some extent, the reason is irrelevant to our argument. What matters is that the EMS forced a choice on French policymakers. Either option –expansionary policies and abandonment of the EMS or deflation and exchange-rate stability– would realign the coalition on which Mitterrand had been elected. Mitterrand's choice and his conversion to the pro-market ethos of the time meant that radical left parties, such as the communists, would be on their own and could not count on the socialists to be in power. The euro lives in the shadow of that episode in French politics.

For Mitterrand's policy change was indeed a momentous event for France and Europe. Consider first the case of Spain. In 1982, the Spanish socialists won a general election for the first time since Franco's death. Prime Minister González, an astute observer of European politics, drew the inevitable lessons from Mitterrand's botched experiment and implemented an orthodox stabilization policy. González was, in any case, elected on a different platform: the modernization of the obsolete framework of the Spanish state. Furthermore, he enjoyed a favorable landscape that gave him broad electoral support. He could safely pivot to the unoccupied center because of the right's perceived links with the Franco regime. Furthermore, his hands were free to veer to the center because he did not need the votes in parliament of the Spanish communists, who were never able to capitalize on having been the true opposition to Franco's regime. The traumatic realignment of the left in France never occurred in Spain because it was realigned from the start. It would take the disenchantment with the politics of

freezes to reduce real wages, reversing the redistributive spirit of the "projet socialist" on which Mitterrand had been elected.

the euro in the late 2000s to rekindle the fortunes of the Spanish extreme left.

Italy was unique in that alone among major European countries its communist party, *PCI*, commanded a significant fraction of the votes. Unlike in France, Spain and certainly Germany, *PCI* was the left. But even there, the merciless logic of the constraints on economic policy of a fixed exchange-rate regime in an open economy reasserted itself. The Keynesian experiments of the Christian Democrats in the mid-1970s led to similar results as the Chirac experiment in France. The run on the Italian lira was even more severe. Only in 1976, the lira depreciated by more than 20 percent against the basket of currencies of its main trading partners. By 1977, a coalition government led by Prime Minister Andreotti, with the benevolent neutrality of the *PCI*, was reorienting Italian economic policy toward monetary orthodoxy. Enrico Berlinger, the historical communist leader, advocated "austerità" in a preview of the heated economic debates of the late 2000s. The *PCI* could not recover from that alignment, and its share of the vote never returned to its 1976 high-water mark. Though the *PCI* remained a large force in Italian politics for another decade, it would never again regain its preeminence. The *PCI*'s decline allowed the old, but traditionally weak, Italian Socialist Party (*Partito Socialista Italiano, PSI*) to achieve significant electoral inroads during the 1980s.

In sum, the failed policy experiments of the 1970s, the inevitable consequence of the lack of coordination across countries participating in the EMS, led to an embrace of policies that emphasized structural reforms and supply-side policies. That such ideas were gaining credence among academic economists was more a convenient rationalization than a cause (see, for another assessment, McNamara 1998).

That exchange-rate policies have redistributive consequences and lead to political realignments has long been recognized. But our point is not just that the Eurozone crisis is simply a more extreme version of the political realignment of the late 1970s and early 1980s. Rather, we argue, as well, that the creation of the euro was the recognition that fixed exchange-rate regimes of the EMS imposed constraints on the set of feasible policies, but that the EMS lacked commitment devices to enforce these constraints. European governments could always fall into the temptation of a devaluation to avoid the unpleasant short-term sacrifices imposed by the supply-side reforms needed to render national economies more flexible, the EMS sustainable in the long run, and the single market a reality. Policy U-turns notwithstanding, the EMS

in the 1980s saw several devaluations leading to the complete breakdown of the system in the early 1990s. A full monetary union was the logical conclusion to the intellectual progress of the European establishment and the lack of commitment devices in the design of the EMS.

5 From the SEA to the euro

Monetary union had been a topic of discussion in the EEC since the Werner report in 1969. This was part of a process of constantly thinking about the optimal global monetary arrangements among increasingly integrated European economies. The history of this process is absorbing and reflects both political and conceptual developments. We do not need to summarize this process here (James, 2012, is an excellent review of the historical events and the ideological motivations of the European monetary unification). For our purposes, it is more important to focus on the political-economy effects the euro was supposed to have, both in the core and on the periphery of Europe.

In the core, the euro would anchor, once and for all, a rule-based approach to monetary and fiscal policy as defined by the Maastricht Treaty and to isolate the project of European integration from the vagaries of financial turbulences.[11]

On the periphery, the expected changes were more profound. Traditionally, Southern European countries responded to economic crises through devaluations, either by choice or forced by the financial markets. By playing with their exchange rate, these countries could increase their exports and lower their imports, rebalancing their current account. These improvements came at a cost: real wages fell (imported goods and services were more expensive) and borrowers in foreign currency were left with a higher real burden. But the more favorable trade balance increased employment and output and improved the fiscal situation. Devaluations were a crude and painful, yet effective, stabilization tool, at least in the short run.

Critics of these devaluations pointed out that few of the structural problems of the economies were solved by variations in the exchange rates. Rapid inflation quickly erased the relative price advantages delivered by devaluation, and profligate public sectors spent all the additional tax

[11] Although how these rules would be interpreted in practice was either ambiguous or conceptualized in different ways by the Germans and the French; see Brunnermeier, James, and Landau (2016) on how these views were informed by the historical experience of each country.

revenue. After a few years, the Southern European economies were back to square one. The euro was the silver bullet to break this vicious cycle, the commitment device that would deliver on the promise of the EMS and would justify the turnaround by the European left. Without the "easy way out" of devaluations, Southern European countries would finally address the reforms in their goods and labor markets they had been postponing for decades. The political and economic elites hoped that the euro would transform Southern European economies into versions of their Northern neighbors, but, as the joke went, with better food and weather.

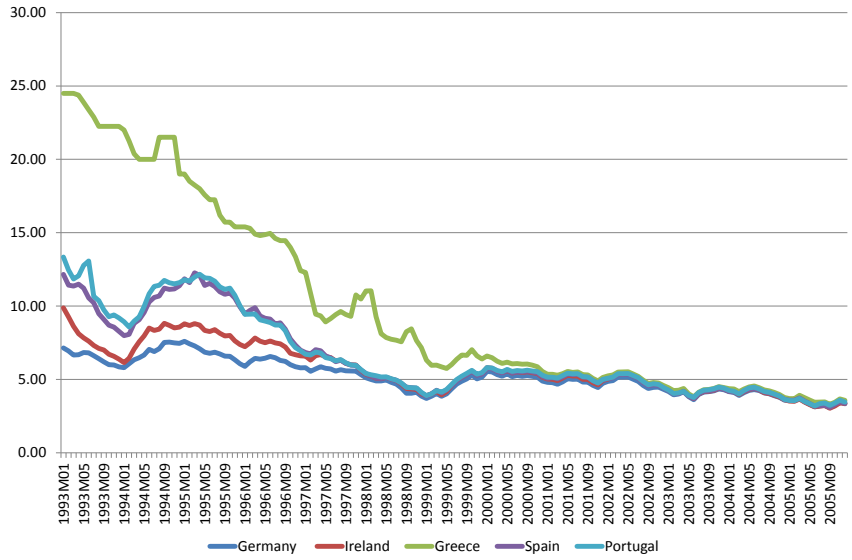

Figure 1: Convergence in yields of government bonds, 10-year yields. Monthly: 1993M01-2005M12. Source: Eurostat.

To nearly everyone's surprise (including academics'), these positive developments did not materialize. Instead, the euro unleashed some perverse political-economic effects that had been largely absent from the public discussion. Fernández-Villaverde, Garicano, and Santos (2013) describe this process in detail, but we can summarize the main lines of the argument here. The euro brought a fast convergence of interest rates to German levels (see the by-now famous Figure 1 of the 10-year yields of several European countries' government bonds from 1993 to 2005). Countries such as Ireland, Greece, Portugal, and Spain, which had historically faced high interest rate spreads, suddenly had easy and cheap access to practically unlimited amounts of capital. Greece and Portugal used this capital to finance large increases in government debt. Ireland and Spain used the funds to fuel an unprecedented real estate boom.

The abundance of capital triggered three mechanisms. The first mechanism was that cheap financing worsened the signal-extraction problem at the core of many relations in modern societies. Often, a principal (voters, shareholders, ...) must learn about the performance of an agent (a politician, CEOs, ...) in a dynamic context to evaluate the agent and to reward it (re-election of the politician, bonuses for a CEO, ...). The performance of the agent is difficult to evaluate both because it is subject to random shocks (even incompetent politicians can take, out of sheer luck, good decisions or profit from a favorable world economic environment) and because the agent can manipulate the information that the principal receives (a politician can play smoke-and-mirrors with the budget, postponing the accounting of expenses and front-loading revenues). The principal must, therefore, solve a complex signal-extraction problem. This problem can become acute during a boom since it is hard to tell who is being successful due to skill and who due to widespread prosperity.[12] Furthermore, agents understand this problem and lower their effort: in a boom, even low-effort endeavors are successful. A crucial consequence of this aggravated principal-agent problem is that bad agents are not replaced and the quality of governance deteriorates.

The second mechanism was that a boom might change the distribution of relative political power in negative ways. Political power correlates, not perfectly but significantly, with economic power. Important industries can mobilize votes, donations, lobbying efforts (legal and illegal), prospects for future jobs, and public support for their favorite politicians and political agendas. The clearest example of this phenomenon was during the real estate boom in Ireland and Spain. In both countries, real estate developers became central actors in the political game, with an outsized influence in decision-making at different government levels. This increase in relative political power made it harder to steer these economies back to a more sustainable growth path before the boom burst and, when it did, to undertake decisive early action to counterbalance the fallout from the financial crisis.

The third mechanism was the ability of politicians to use the revenue triggered by the real estate boom or the capacity to borrow to finance a growing government consumption and

[12] In fact, worse agents may deliver, in the short run, better results. Think of bank managers who load too much risk in their portfolios. While the expansion continues, they may obtain higher rates of return than their more cautious colleagues. It is only when the crisis hits that the principals discover the sad state of the loan books.

generous social transfers. Many of these spending plans were not sustainable in the long run. Those politicians more reluctant to engage in this "buying out of the electorate" were eased out of the elite-selection process and punished in elections. This generated a process of adverse selection, where the more capable or honest politicians were replaced by incompetent and often corrupt decision-makers.

A common feature of these three mechanisms is that they favored incumbents and, while the boom continued, limited the entry of new political contenders. The limitation on elite circulation prolonged the boom and blocked the recovery.

We will describe now how the fallout from the crisis has altered the political landscape across the euro area. To do so, we will analyze first the case of the four large European countries that entered into a memorandum of understanding with the European Union that involved external financing: Ireland, Portugal, Spain, and Greece. Then, we will briefly review the evidence from Northern European countries in the order of the size of each country's output: Germany, France, the Netherlands, Belgium, Austria, and Finland. Because of space limitations, we will only make passing references to Italy. This country shares features, like its economy, with both southern and northern patterns. Italy shares with the south a lower level of income per capita and a crisis-prone productive system in dire need of reform. But Italy has been a democracy since 1945, it was one of the original signatories of the 1957 Treaty of Rome, and some of its northern regions are among the richest in Europe. Also, we are omitting the former communist countries such as Slovenia or the Baltic states (with their very own features that may have little to do with our main argument) and the smaller nations of Luxembourg, Cyprus, and Malta.

6 The party system and the euro

6.1 Southern Europe

The first years of the euro were an era of optimism. The pessimistic forecasts made by U.S. economists that Europe was not an optimal currency area seemed to have been proven wrong (see, from many diverse ideological perspectives, Feldstein, 1997, Friedman, 1997, and Krugman, 1998). Spain, Ireland, and Greece were booming (Portugal not so much) and even Germany, having cleared its fiscal house after unification, was growing again. The party systems of

many European countries were showing signs of strain, particularly in France during the 2002 presidential election (when Jean-Marie Le Pen qualified for the runoff ahead of the socialist candidate), but the situation seemed manageable. There was concern, not alarm.

And then, in 2007, the financial crisis hit. In Europe, the first few months were comparatively calm. Many observers thought the crisis was a phenomenon limited to the U.S. and its excesses in real estate lending. But by early 2009, the problems in Europe were apparent for all to see. The real estate booms in Ireland and Spain and the public debt accumulation in Greece and Portugal were first-order trials. International lending to these countries suffered a "slow stop" and their economies were forced into a complex rebalancing act in the middle of a world recession. From 2009 until the moment these lines are being written (summer of 2017), Ireland, Spain, Greece, and Portugal have suffered an acute economic crisis. Robust output growth has returned to Ireland and Spain, but not to Portugal and Greece, and in all four countries, high public debt and unemployment will take years to be digested.

The economic crisis has been reflected in profound mutations in the party system during the last rounds of elections. In Ireland, the main winner of the crisis has been *Sinn Féin*, which has increased from 6.9 percent of the vote in 2007 to 13.8 percent in 2016. *Sinn Féin*'s electoral fortunes in Ireland were revived after the Good Friday Agreement of 1998 (which laid down the peace process in Northern Ireland), growing from a mere 2.5 percent in 1997 to 6.5 percent of the vote in 2005. But the nationalists seemed to have lost momentum in the 2007 general election. Then, in 2011, they increased their share to 9.9 percent and, in 2016, to 13.8 percent, with even higher numbers in recent opinion polls. In addition to *Sinn Féin*, a new party, *Anti Austerity Alliance-People Before Profit*, got 3.9 percent of the votes in the 2016 elections, given the radical left 17.7 percent of votes in a country such as Ireland, which had traditionally been conservative-leaning.

In Portugal, the Left Bloc (*Bloco de Esquerda*, a merger of small left-wing parties with a strong Trotskyist influence) had been mildly successful in the early 2000s (with 6.4 percent of the vote in 2005), perhaps as a reflection of the pre-crisis stagnant Portuguese economy, and it suffered a disappointing result in 2011. But, by 2015, the Left Bloc had reached 10.2 percent of the votes. In the same year, the Portuguese Communist Party and its small green allies (*Coligação Democrática Unitária*) stopped their long-run decline and obtained 8.3 percent of

the vote. Thus, the radical left achieved, the support of 18.5 percent of the electorate.

The situation in Spain is the hardest to explain. The traditional representative of the radical left was an electoral coalition, United Left (*Izquierda Unida*), built around the core of the Spanish Communist Party, which only obtained 3.8 percent of the vote in 2008 (an election right before the crisis was widely felt; the result in 2005 had been the only slightly better 5 percent). To complicate the picture further, several small left-wing nationalist parties existed in different Spanish regions. The United Left was radical in principle, but in practice, as its more militant critics never ceased to point out, it often found easy accommodation with the mainstream socialist party to govern in coalition in local governments and to deliver a few votes in the national parliament. Then, in March 2014, a new and proudly populist left-wing party, *Podemos* ("We Can"), was founded by some committed activists. After many disputes, what was left of the United Left (under a new, more radical leadership), a green party, a bewildering set of local and nationalist parties and groups, and *Podemos* forged an electoral coalition called *Unidos Podemos* ("United We Can") in most of the national territory and with a colorful set of names in other regions (our favorite is "In Tide" -*En Marea*- in Galicia). This conglomerate was able to get 21.10 percent of the vote in 2016. Together with the Catalan, Basque, and Galician left-wing separatists (Republican Left of Catalonia, Basque Country Gather, and the Galician Nationalist Bloc), the radical left in Spain got to the unprecedented level of 24.7 percent.

Greece is the country where the party system has been shaken the most. A new radical-left party, the Coalition of the Radical Left (*Synaspismós Rizospastikís Aristerás*), widely known by its abbreviation *Syriza*, grew exponentially from 3.3 percent of the vote in 2004 to 36.3 percent in the first legislative elections of 2015 and 35.5 percent in the second ones a few months later. Together with the orthodox Communist Party of Greece (*KKE*) and other minor groups, the radical left polled around 45 percent. The old-style socialist party, *PASOK*, collapsed to 6.28 percent and a neo-Nazi group, New Dawn (*Chrysi Avyi*), got 7.0 percent (all numbers are from the latest legislative election).[13]

What common patterns do we see in the evolution of the party system in these four Southern European Countries? First, the radical left has moved from a peripheral position to a much more

[13] Another mesmerizing case is Italy, where the hard-to-classify Five Star Movement (*Movimento 5 Stelle*) obtained 25.6 percent of the vote in 2013.

pivotal role, reaching power in Greece and deeply altering the arithmetic of feasible coalition governments in the other three countries. Moreover, the key players among the radical left are relative newcomers (*Podemos*, *Syriza*, *Bloco de Esquerda* and, in some sense, *Sinn Féin*), with new organizational and strategic priorities.

Second, the main electoral losers of the crisis have been the mainstream social democratic parties. From a central position in the political game, the Greek socialists have been marginalized to a minor role, the Spanish socialists have recently obtained their worst results since the return of democracy, and the Irish Labour Party has seen its always small weight reduced even further. Only the Portuguese socialists seem to have weathered the storm with success.

Third, the mainstream conservative parties have shown a considerable level of resilience. The People's Party in Spain is bound to remain in power for the foreseeable future, New Democracy is leading the polls in Greece as of summer 2017, *Fine Gael* is running the government in Ireland (with *Fianna Fáil* being either first or second in opinion polls), and even in Portugal the *Partido Social Democrata* and the *Centro Democrático e Social-Partido Popular* are a credible electoral alternative to the ruling socialist party.

Fourth, the extreme right has been nearly absent from the new electoral map. No extreme right-wing party has achieved an electoral breakthrough in Ireland, Portugal, or Spain. Only in Greece, New Dawn has reached 7 percent of the votes and, despite the boisterousness of its leaders, remains isolated from the mainstream.[14]

6.2 Northern Europe

The evolution of the party systems in Northern European countries has been, except in France, less dramatic than in the south, although the landscape might change during the next couple of years. Political change follows its own calendar, deeply influenced by the election cycle.

In Germany, the biggest economy of the euro area, the 2013 German federal election yielded a conventional *Bundestag*. The Christian Democrats were only 5 seats short of a majority and the radical left of *Die Linke* were stuck at 8.6 percent. However, in 2016, Alternative for

[14] Even in Italy, with an older tradition of extreme-right parties, the *Lega Nord*, a Northern Italian semi-separatist group, has fallen from 4.6 percent (2006) to 4.1 percent (2013) and the *Fratelli d'Italia-Alleanza Nazionale*, a hard-core group of national conservatives and descendants from the old fascist party, have gone from 12.3 percent (2006) to 2.0 percent (2013).

Germany (*Alternative für Deutschland*, a national conservative and eurosceptic party) did well in several state elections (from 12.6 percent in Rhineland-Palatinate to 24.3 percent in Saxony-Anhalt). Although its performance in recent months has been poorer (in the May 2017 elections in North Rhine-Westphalia, the most populous state in the Federal Republic, Alternative for Germany only got 7.4 percent of the vote), opinion polls still suggest that after the 2017 federal elections, Germany will have a significant, openly right-wing party in the *Bundestag* for the first time since the end of World War II.

In France, the leader of the National Front (*Front National*), Marine Le Pen, qualified for the run-off of the 2017 presidential election. In the run-off, she obtained a new record for her party: 33.9 percent of the votes. However, the surprising eruption of Emmanuel Macron and his centrist party "The Republic Onwards!" (*La République En Marche!*) has dramatically altered the electoral map, destroyed the French Socialist Party (reduced to 7.4 percent of the vote in the subsequent legislative election), crushed the hopes of the traditional right, and left the National Front disoriented.

Among the smaller countries, the extreme-right has gained votes in the Netherlands (the Freedom Party, *Partij voor de Vrijheid*), Austria (the Freedom Party of Austria, *Freiheitliche Partei Österreichs*), and Finland (Finns Party, *Perussuomalaiset*). In comparison, in Belgium, the party system has been much more stable. The surge of the New Flemish Alliance (*Nieuw-Vlaamse Alliantie*) has much more to do with realignments within the Flemish nationalism than with the euro.

What common patterns do we see in the evolution of the party system of these Northern European countries? Nearly the mirror image than the patterns we described in the previous section in Southern Europe.

First, there has been no improvement in the situation of the radical left, except partially in France. *Die Linke* in Germany or the Socialist Party (*Socialistische Partij*) in the Netherlands are still minor parties without real influence. The radical left plays next to no electoral role in Belgium and Austria, and the Left Alliance (*Vasemmistoliitto*) in Finland continues its long-run electoral twilight. In France, the collapse of the Socialist Party has allowed the surge of Indomitable France (*La France Insoumise*), with 11 percent of the votes in the first round of the legislative election, but this percentage is not much higher than what the extreme left achieved

in the past.[15]

Second, besides the French and Dutch socialist parties, the main electoral losers of the crisis have been in the mainstream right wing: the Christian Democrats in several state elections in Germany, the Gaullists in France, the Dutch Christian Democrats (*Christen Democratisch Appèl*, which went from being the biggest party in the Netherlands with 26.5 percent of the vote in 2006 to being the fourth party with only 12.4 percent in 2017), and the Austrian Christian Democrats (*Österreichische Volkspartei*).[16]

Third, in contrast, mainstream social democrats have weathered the crisis much better, except in France and the Netherlands.

Fourth, the national conservatives have considerably improved their stand. The Finns Party is part of the Sipilä Cabinet in Finland and, as we mentioned above, they may become important players in Germany in future electoral cycles.

7 New parties: an interpretation

What mechanisms account for the empirical observations regarding party systems documented in Sections 6.1 and 6.2? Our hypothesis is that the new party systems reflect a changed set of economic constituencies created, to a large extent, by the euro. The fractures in the political order of the different countries in the Eurozone mirror those of earlier times. The tenuous European consensus that animates the 25 years between Mitterrand's U-turn in 1983 and the onset of the crisis in 2007 was sustained by the remarkable drop in nominal interest rates and the more benign economic conditions that followed the oil shocks of the 1970s. The severity of the euro crisis has loosened the stitches that were so skillfully sewn in the 1980s.

Matters related to exchange rate and price stability are always about redistributive policies. The welfare state of the Southern European countries, with their generous benefits, has created a

[15] In several of these countries, there are successful green parties (*Bündnis 90/Die Grünen* in Germany, *Groen Links* in the Netherlands, *De Vlaamse Groenen* and *Écologistes* in Belgium, *Die Grünen* in Austria, and *Vihreä Liitto* in Finland). But we are far from the days in the early 1980s where green parties challenged the establishment. Nowadays, green parties are the electoral vehicle of highly educated, progressive urban middle classes with rather limited revolutionary aspirations.

[16] We will discuss the case of the Flemish Christian democrats momentarily. The Walloon Christian democrats have survived better, although still with electoral losses and starting from a much smaller basis.

constituency for price stability and the support for the euro remains high among those favored by it. Seniors and other recipients of benefits understand that abandonment of the single currency can only come at the expense of the real value of their claims. Instead, low-skill, younger voters and public sector workers with diminished expectations and who are unlikely to enjoy the generous social benefits when they retire want the "deck of cards" reshuffled. These voters would benefit from expansionary fiscal policies and a write-off of existing debts. In the Spanish case of *Podemos*, the over-representation among its leaders of nurses, teachers, and junior university faculty is noticeable. These public workers, particularly in the lower and middle ranges, view with concern a new "normal" of tight government deficits required to maintain the euro and to service the debt.

This split mostly affects the left. The social democrats were to some extent the architects of the European consensus on currency matters and, thus, cannot serve as a political vehicle for the disaffection with the monetary union and its unpleasant consequences. Pointedly, much of the rhetoric of parties such as *Podemos* in Spain or *Syriza* in Greece is precisely about the grievances with the old compromises of the left in the challenging political environment of the late 1970s and early 1980s.

The pressure of the sudden real adjustment that was required of Greece, Spain, or Portugal is easing. These countries are, after all, market economies and rigid as they may be, their internal prices eventually drop and markets clear. Growth has resumed and unemployment is trending down; housing prices have recovered somewhat. The tension of the early years of the crisis that propelled these new parties to the forefront of political life is no longer there. Thus, a possible euro breakup is not the urgent matter that it was in 2011 and 2012. But the diminished expectations remain, mostly driven by low wages and a reduced capacity to accumulate wealth. In particular, wages and prices in the non-tradable sector bear the brunt of the adjustment to address the enormous external liabilities accumulated by these countries. These diminished expectations will remain a source of support for the new left parties in the years to come.

It is here that Italy remains in a unique position. The reason is that its external liabilities were never as large as those of Spain and Greece. As a result, the sudden adjustment that was required of these two countries was not required of Italy. And because the Italian adjustment remains to be undertaken, the pressure to abandon the euro in this country remains much

more intense (Roth, Jonung, and Nowak-Lehmann, 2016). Support for the euro in Italy has consistently fallen whereas it has stabilized or even slightly increased in the other Southern European countries. The impeccable logic of the monetary union has reasserted itself, but the fragmentation of the political left is likely to remain in place for the foreseeable future.

The success of extreme-right parties in the north is fueled in large part by the resentment about fiscal transfers to Southern Europe and the possibility of even larger transfers in the future (although opposition to immigration from outside the euro area is also a central factor). Thus, the weakness of left-wing mainstream parties in the south and the weakness of right-wing mainstream parties in the north are the mirror image of the same phenomenon: the position of each country in the debtor and fiscal transfers within the euro area.

Our hypothesis is not entirely deterministic. It depends on the arrival of a financial crisis, and the concrete form that the change in party systems takes depends on the preconditions of each country and shocks such as the presence of a charismatic new leader. Our theory predicts patterns of behavior (technically, a probability distribution), not a precise accounting of each national experience.

Financial crises are often accompanied by a strong weakening of political legitimacy. This may be due to the obvious redistributive aspects of these crises and the subsequent bailouts (in comparison, for example, with more plain vanilla business cycle fluctuations) or by the perception that these financial crises are avoidable (see the evidence in Funke, Schularick, and Trebesch, 2015, of political radicalization and fragmentation after financial crises, but not after regular recessions). Financial crises are, then, moments in which we tend to observe political realignments where historical compromises are revisited, either explicitly or implicitly, and where historical memory, social structure, and economic interest interact to generate a new "regime."[17]

For example, in Ireland, *Sinn Féin* represents those in favor of an Ireland of 32 counties,

[17] Our interpretation is heavily influenced by Luebbert (1991), who argued that the way party systems were reconfigured in interwar Europe responded to the underlying social structures. In the United Kingdom, France, Belgium, and the Netherlands, middle classes were sufficiently strong that they could absorb the shocks of the period (France being the most problematic case and also the country with the weakest middle classes of the group). In Germany or Italy, the middle classes were weaker, and they aligned themselves with agricultural landowners and traditional elites to violently defeat the workers' parties by adopting fascist regimes. In Scandinavian countries, the workers and farmers forged an alliance that guaranteed social democratic dominance for decades.

not of 26, and voters seeking a socialist alternative to the conservative structures created after independence. In Portugal, *Bloco de Esquerda* revives the spirit of the failed coup d'état of November 25, 1975 (*Golpe de 25 de Novembro de 1975*) and the promise of a socialist Portugal. In Spain, *Unidos Podemos* has challenged the constitutional consensus (*consenso constitucional*) of 1978. In their view, many of the current problems of Spain come from the lack of a clear rupture with the Francoist regime during the transition to democracy from 1976 to 1979. Finally, in Greece, *Syriza* borrows much of its historical pageantry from the civil war and the provisional democratic government (*Prosoriní Dimokratikí Kyvérnisi*) that lost the conflict.

In Germany, Alternative for Germany revisits the commitment of the Federal Republic to unlimited European integration around which Konrad Adenauer organized reconstruction. The euroscepticism of Alternative for Germany links itself with a historical thread of national conservatism in the German-speaking world that never disappeared; it just went underground. The euro crisis allowed it to resurface.

Finally, the National Front in France is the heir to the forces behind the Vichy regime and, even before that, of *Action Française* and legitimism. Even if draped with the flag of republican values as a battering ram against emigrants, the National Front embodies all the forces in French life that never fully accepted the revolutionary inheritance from the 19th century.

Conversely, this framework also explains why we do not see successful extreme-right parties in the south of Europe or successful radical-left parties in the north of Europe. The memory of the right-wing dictatorships of the second half of the 20th century is still sufficiently strong to prevent the electoral success of these parties (except in Greece, where the secular animosity against its Middle East neighbors helps to fuel a virulent anti-immigration *Gestalt*). And radical-left parties have little appeal in countries such as Germany that are large holders of debt. It is hard to rally against "capitalists" when your electorate is composed of bond-holders.

Of course, many other forces are at play in the evolution of the party system. We mentioned in the introduction how the rapid secularization of European societies over the last three decades must have played a role in the sharp negative trend of Christian democratic parties. In the Netherlands, the Christian democrats have gone from dominance to minority and, in Flanders, their hegemony has been destroyed by the New Flemish Alliance, more nationalist, more pro-market, and more secular. Christian democrat parties in Germany and Austria face the ghost

of a negative electoral trend lurking behind them. It is not a surprise, perhaps, that in Southern Europe, where the new right-wing parties that appeared after the fall of the dictatorships were not openly Christian democrats (New Democracy in Greece or the People's Party in Spain, while including some Christian democratic cadres, were more traditional conservative parties) have resisted better the caprices of the crisis. Similarly, the disappearance of traditional unions and manufacturing jobs has damaged the fortunes of social democratic parties, which cannot any longer appeal to class solidarity to sell tough economic adjustment programs whose benefits would only be seen in the future.

But the euro crisis has been the catalyst of change. For example, if economic prosperity had continued, one could have seen the gradual electoral substitution of Christian democratic parties by secular liberal-conservative parties (as the *VVD* in the Netherlands or the *Venstre* in Denmark seemed to be doing during the early 2000s) and the growth of green/social liberal parties as an alternative to social democratic parties (such as the *Bündnis 90/Die Grünen* in Germany or the *Democraten 66* in the Netherlands). None of these parties would have fundamentally challenged the constitutional arrangements of postwar Europe. Instead, they would have preferred to evolve them to reflect new social and economic circumstances. In fact, in Spain, part of that substitution has occurred in the last two elections with a new liberal party, Citizens (*Citizens*) committed to the European integration and "The Republic Onwards!" in France can play a similar role if it survives in the middle run (French political parties are notoriously fickle in names and incarnations).

Now, in contrast, we are in a situation where the future of the euro might be in danger because the party systems that created it no longer exist. There is a non-trivial possibility that, sooner or later, one the new radical parties will reach power in a central country of the euro area and that, by design or accident, a major crisis will lead to the collapse of the euro.[18] Political parties are endogenous and changing a central piece of economic policy is bound to change them as well.

[18] A more positive interpretation is that even these apparently more radical parties would find, as *Syriza* did in Greece, that their degrees of freedom are limited. Perhaps voters support more radical parties precisely because they understand that their policies cannot be implemented, but they want the political system to reflect part of their preferences. See, for a similar idea, Acemoglu, Egorov, and Sonin (2013).

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