Political Extremism as a Risk to Financial Stability:
Historical Evidence, Contemporary Implications
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Nontechnical Abstract

This project will analyze the impact of financial instability and recession on political support for right-wing anti-system parties (defined as parties explicitly advocating the overthrow of a country’s political system). Recent commentary suggests that economic hard times and financial instability are breeding support for such parties across Europe. A qualitative literature linking the Great Depression of the 1930s to the rise of National Socialism similarly points to the existence of such a link. This project will provide a systematic analysis of Great Depression experience with the goal of establishing whether there in fact existed such a link, and if so under what circumstances, gathering and analyzing new data on more than 100 elections in the interwar years. It will examine whether national characteristics (extent of religious fractionalization), historical experience (whether a country had its borders redrawn, resulting in the creation of ethnic minorities or the division of ethnic groups by national borders), and electoral institutions (the structure of national electoral systems) worked to accentuate or attenuate the connection between economic hard times and political extremism. The results will be important for understanding the scope for economic hard times in Europe today to foster political extremism.

Detailed Description of Proposed Research

Motivation. Europe is embarked on an arduous process of restoring financial and fiscal stability. Its governments are required to cut spending and raise taxes, with negative short-run consequences for economic growth. Those governments, concerned to restore financial stability, are requiring Europe’s banks to raise their capital-adequacy ratios, which they are doing by selling assets and restricting their lending, which works to further slow growth in the short run. As balance is restored to government and bank balance sheets, confidence is expected to return, and with confidence, it is hoped, will come renewed economic growth.

The problem with trading short-term pain for long-term gain is that the vehicles for the pain are democratically-elected governments, and electorates have notoriously short horizons. Deep recessions may cause incumbent governments, perceived as responsible for poor economic conditions, to lose support. Knowing that the government may not be able to follow through on its strategy of strengthening bank and public-sector balance sheets and uncertain about what kind of government and policy will come next, investors may not regain confidence. Consequently, efforts to restore fiscal and financial stability may end in failure. In the worst case, deep recession may increase support for extremist anti-system parties (defined as parties that explicitly advocate the overthrow of a country’s prevailing political system). Thus, not just the financial system and the economy but the political system and society itself may be destabilized. Recent events in Hungary have been cited as an example of how austerity-induced recession can breed support for anti-system parties (Scheppelle 2012).

The 1930s, when the Great Depression was followed by the rise of National Socialism, is pointed to as a prime case in point. Indeed, memories of the 1930s inform much
contemporary political commentary, just as they have informed economic commentary about
the global credit crisis. But exactly what impact the interwar depression and economic crisis
had on political outcomes and on the rise of right-wing anti-system parties in particular has
not been systematically studied. To be sure, there are statistical studies linking
unemployment to the rise of the National Socialists in Germany and competing studies
disputing that link (see for example O’Loughlin 2000, Stögbauer 2001). Qualitative studies
attempt to link the breakdown of democracy with the rise of authoritarianism in Germany and
elsewhere (see inter alia Stepan 1978, Berg-Schlosser and Mitchell 2000, Saalfeld 2002). A
few informal analyses have attempted to connect macroeconomic distress to political
outcomes in the 1930s more broadly (see e.g. Berg-Schlosser and Mitchell 2000).

But a systematic study that looks across countries and asks not just whether there was
a link between the severity of the interwar Depression and the rise of right-wing anti-system
parties, but also whether there were identifiable economic, political and social conditions
under which that link was especially powerful, has not been undertaken. Such is my goal in
the present project. I plan to study the share of votes for right-wing anti-system parties,
defined as parties that explicitly advocate the overthrow of a country’s political system, in
elections between World Wars I and II. I will focus on right-wing rather than left-wing anti-
system parties since it was right-wing parties, in particular, that made visible and troubling
electoral progress in the 1930s. And it is again right-wing extremist parties that have
seemingly made the greatest electoral gains in response to recent economic hard times
(Fukayama 2012).

Implementation. My preliminary data set includes 171 elections in 28 countries
between 1919 and 1939. The early sample is weighted toward Europe, since interwar
elections were disproportionately European, but I also also include observations for North
America, Latin America, Australia and New Zealand. The data on election results assembled
so far are compiled principally from Capoccia (2005), Mackie and Rose (1991), Nohlen
(2005) and Nohlen and Stöver (2010). Figures from these volumes are supplemented by
Sternberger and Vogel (1969) for Yugoslavia and by the Czech Statistical Office website for
Czechoslovakia.

Anti-system parties are defined, following Sartori (1976), as parties that “would
change, if it could, not the government, but the system of government.” They include fascist,
monarchist and secessionist parties on the right and communist parties on the left. The two
main sources used to identify such parties are Capoccia (2002, 2005). Right-wing parties
classified as anti-system range include obvious cases like the NSDAP and Communist parties
in Germany but also others like the Arrow Cross in Hungary and the Iron Guard in Romania.

The empirics will involve estimating the determinants of vote shares in interwar
elections. The explanatory variables of special interest will be the percentage change in GDP
and the incidence of financial instability and/or crises. GDP data will be primarily from
Maddison (2010). Financial crisis indicators will be from Bordo and Eichengreen (2003),
suitably extended.

Some regressions will include in addition the effective electoral threshold (the
minimum share of the vote a party had to attract in order to gain parliamentary
representation), these thresholds having been shown to be important in my own prior work
(Eichengreen 1992; see also Lijphart 1994). Others will include the percentage of the
population which was urbanized, ethnolinguistic and religious fractionalization, for how long
a country had been a democracy, whether it had an agrarian elite prior to 1914, whether it was on the losing side in World War I, and whether it had its borders redrawn as a result, creating new ethnic minorities or resulting in existing ethnic groups being divided by new national boundaries. Data on electoral thresholds are from Boix (1999), while urbanization is constructed using data from Banks (2011). Polity scores are obtained from the Polity IV database (2009). Dummy variables relating to World War I are constructed using individual country histories. Measures of ethnolinguistic and religious cleavages and the existence of a prewar agrarian elite can again be based on classifications in Berg-Schlosser and Mitchell (2002).

Many of the explanatory variables are available only at an annual frequency. This is satisfactory for present purposes insofar as there was only one election per year for the vast majority of countries. One explanatory variable that I can measure at a higher than annual frequency is time since the last election: I measure this in units of four months, since there was never more than one election in a trimester (i.e. January-April, May-August, September-December).

Since the vote share of anti-system parties was sometimes zero, rendering ordinary least squares or a logit transformation of vote shares inappropriate, I plan follow Jackman and Volpert (1996) and Golder (2003) in using a Tobit model. I plan to use both the semi-parametric fixed effects Tobit estimator proposed by Honoré, and the maximum likelihood fixed effects Tobit estimator (MLE) discussed in Greene (2004), since there may have been country-specific factors not captured by the model that led to the anti-system vote being systematically higher in some countries than in others.

A possible objection is that one only observes elections, by definition, in countries that held them. When countries ceased being democracies, elections were no longer held. It is possible and indeed likely that some of the same factors that led to higher votes for anti-system parties, such as poor economic performance, resulted in their becoming non-democratic. The simplest way of addressing this sample selection problem will probably be to employ a two-stage Heckman-style approach.

With data gathering only started, it is still too early to report even preliminary results. But early scatter plots of data confirm the existence of a strong positive correlation between extent of economic contraction in the immediately preceding period and subsequent electoral support for right-wing anti-system parties. That correlation appears to be stronger when one considers persistent movements in output (the contraction over a period of, say, three years rather than in the current or immediately preceding year). Scatter plots similarly suggest that the extent of urbanization is negatively associated with support for right-wing anti-system parties. Finally, although the electoral threshold variable is choppy and availability of data on this variable is incomplete, there does seem to be a negative correlation between the height of that threshold and votes for right-wing anti-system parties (as if voters in countries where high thresholds has to be surpassed in order for a new party to gain parliamentary representation were reluctant to throw away their votes). Whether these correlations will survive more rigorous statistical analysis remains to be seen.

Use of Fung Center Funding. Graduate student research assistance will be required to successfully complete the project. Further checking of both national and comparative sources will be needed to verify that the sample of elections is complete and representative. Little work has been completed at this point on gathering explanatory variables other than the
change in GDP. Constructing internationally-consistent measures of electoral thresholds will require consulting national electoral laws, using information that tends to be poorly catalogued at the government documents division.

Finally, a graduate student with programming skills will be needed to write down and numerically maximize the likelihood function for a problem combining nonlinear probit techniques with sample selection.

Outlets for Research. The findings of this project will appear mainly in the form of working papers and journal articles. I should be able to submit the research paper(s) to the NBER and CEPR working paper series and post them to the Fung Center’s own website. In addition, the fact that I am affiliated with the faculty of the Berkeley Political Science Department as well as the Economics Department and have published in the past in political science journals provides further possibilities for the dissemination of research results.

Given the topical nature of the subject it should also be possible to publicize the research and results through columns in Project Syndicate and VoxEU.

Interim Report on Previous Project

As part of this proposal, I am also providing this interim report on the project for which I am receiving support from the Coleman Fung Risk Management Center in the 2011-12 academic year. While my previous proposal was dated January 2011, funding was provided from the summer of the year. As a result, what follows is properly read as an interim report, since the earlier project is still underway.

My current project, “Reserve Currency Competition as a Risk to Financial Stability,” seeks to analyze the operating properties of an international monetary system based on multiple reserve currencies as opposed to purely the dollar). Because this new proposal is being submitted in January (for a February deadline), work on that project is still underway. The project in question has nonetheless already given rise to a number of publications:

“When Currencies Collapse,” Foreign Affairs (January/February 2012).


“Managing a Multiple Reserve Currency World,” Insights of the Melbourne School of Business and Economics (November 2011).


“What Can Replace the Dollar?” Project Syndicate (11 August 2011).

“How To Kill a Dollar,” Project Syndicate (7 June 2011).


References Cited in the Current Proposal


