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Baltic Variety of Capitalism as an Explanation to the Success of Internal Devaluation

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Vytautas Kuokštis is a third-year PhD student at Vilnius University, Institute of International Relations and Political Science. The paper presents an attempt to answer the question at the centre of the author's dissertation project – the Baltic countries' surprising ability to implement internal devaluation – building on the insights of the Varieties of Capitalism framework. The author plans to publish the text as a separate article.

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Abstract

This paper draws on the Varieties of Capitalism (VoC) approach to analyse the Baltic countries' politico-economic regimes and provide an explanation for the success of Baltic internal devaluation during the Great Recession. The paper discusses the dominant treatment of Baltic countries in the literature as liberal market economies (LMEs). While recognizing many affinities with the LME model, several substantial differences are emphasized. As a result, a case is made for conceptualizing the Baltic capitalism as representing a distinct variety that is neither LME nor CME. Furthermore, it is not a "hybrid" or "bastard" type, as it has its own logic, distinct institutional complementaries, and displays strong continuities over time. The paper takes into account not only the microeconomic dimension, but also its linkages with the Baltic macroeconomic arrangements. It is argued that it is this very distinctiveness of the Baltic regime which allowed Estonia, Latvia and Lithuania to successfully implement the so-called "internal devaluation" strategy during the Great Recession in 2008-2010 - to the surprise of the majority of foreign analysts.

1. Introduction

During the recent crisis the three Baltic countries became the centre of attention of international financial media. Before 2008, Estonia, Latvia and Lithuania were among the fastest growing economies in Europe. Along with high growth based on the expansion of domestic demand fuelled by credit booms, the three Baltic countries built up massive macroeconomic imbalances that manifested themselves in increasing inflation, real estate price bubbles, as well as very large current account deficits. As a result, the global financial crisis struck particularly hard in the Baltics. In 2009, Latvia, Lithuania and Estonia where among the top four countries in the world in terms of GDP contraction (along with Ukraine).

Apart from massive economic imbalances and the subsequent economic contraction, the three Baltic countries also presented an interesting empirical and theoretical puzzle. Namely, they all chose to defend the fixed exchange rate regimes and instead of currency devaluation opted for the so-called internal devaluation, which aims to rebuild competitiveness via austerity measures and and nominal wage reduction (deflation). The majority of outside economic and financial analysts in 2009 were of the opinion that this strategy was doomed to failure or at least very likely to end this way[1]. For instance, Bengt Dennis, the former central bank governor of Sweden and an advisor to the Latvian government, said: "No one knows if there will be a devaluation tomorrow or in a few months – the time frame is always uncertain – but we have moved beyond the question of whether there will be a devaluation and should instead focus on how it will be carried out"[2]. Similarly, Nouriel Roubini claimed that "at this point, a currency and financial crisis is pretty much unavoidable".[3] Nevertheless, a couple of years after these pre-

1 Kuokštis, Vytautas / Vilpišauskas, Ramūnas: Economic Adjustment to the Crisis in the Baltic States in Comparative Perspective, conference paper presented at the 7th Pan-European International Relations Conference, September 2010, Stockholm, http://stockholm.sgir.eu/uploads/Economic%20Adjustment%20to%20the%20Crisis%20in%20the%20Baltic%20States%20in%20Comparative%20Perspective.pdf

2 Nylande, Johan: Bengt Dennis: Latvia will devalue currency, in: The Swedish Wire, accessed 25 May 2011, http://www.swedishwire.com/business/213-bengt-dennis-latvia-will-devalue

3 Roubini, Nouriel: Latvia's currency crisis is a rerun of Argentina's, in: FT.com, 10 June 2009, http://www.ft.com/cms/s/0/95df08fe-55f3-11de-ab7e-00144feabdc0.html#axzz16uuaG9Jc

dictions, Estonia, Latvia and Lithuania still keep their fix exchange rates – in fact, Estonia managed to fulfil the Maastricht criteria and from 1st of January 2011 is the 17th member of the Eurozone.

This naturally raises a question: why were the Baltic countries able to implement internal devaluation contrary to the consensus expectations? The literature trying to answer this question is rather scant. Purfield and Rosenberg, while noting that the Baltics have already (...) defied many conventional wisdoms, maintained that this came down to a couple of unique conditions: flexibility of the economic structure, shallow financial markets with a few players limiting scope for speculation against currencies, close integration with Nordic financial systems, and fast fiscal adjustment[4]. Kuokštis and Vilpišauskas[5] argue for a more politically and historically informed perspective, stressing the multiple functions of fixed exchange rates (anchoring macroeconomic stability, but also reflecting national sentiments as well as relating to the broad euro-integration project), a particular climate of ideas (further adding to the support for fixed exchange rates and legitimizing fiscal consolidation as the only viable policy option), the structural and ideational weakness of the political left as well as a low capacity for social action on the part of the general society (which limited contestation of drastic fiscal consolidation measures).

This paper offers another possible interpretation and argues for the importance of taking into account the functional logic of capitalist systems in the Baltic States. In doing so, it starts from the Varieties of Capitalism (VoC) framework, and uses it to reveal how the functional logic of capitalist system's working in the Baltic contributed to the success of the strategy of internal devaluation – even if it did not determine it. Overall, the paper serves two purposes: in addition to providing an explanation for the developments during the crisis, it also presents a test case for the validity and usefulness of the Varieties of Capitalism approach in another setting. Despite – and perhaps because of – its wide recent popularity, it has attracted numerous criticisms, such as its functionalism and economic determinism. In highlighting the functional logic of the Baltic capitalist system, the paper illustrates the fruitfulness of the VoC framework in a broad sense.

The paper is structured in the following way. The first section presents the Varieties of Capitalism framework. The second section presents the dominant treatment of Baltic capitalisms as liberal market economies in the literature along with a critical discussion. In the third section the case for a distinct Baltic version of capitalism with its own functional logic is presented, and lessons for Baltic adjustment during the crisis are drawn.

2. Varieties of Capitalism approach

The study of what one could call a capitalist variety started with Andrew Shonfield's *Modern Capitalism,* and intensified after the economic problems experienced by the Western economies in the 1970s[6]. The fall of the Soviet Union gave an additional boost to the study of capitalist varieties. Before that, many

4 Purfield, Catriona / Rosenberg, Christoph B.: Adjustment under a Currency Peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008–09, IMF Working Paper WP/10/213, 2010.

5 Kuokštis, Vytautas / Vilpišauskas, Ramūnas: Economic Adjustment to the Crisis in the Baltic States in Comparative Perspective, Conference paper presented at the 7th Pan-European International Relations Conference, September 2010, Stockholm, http://stockholm.sgir.eu/uploads/Economic%20Adjustment%20to%20the%20Crisis%20in%20the%20Baltic%20States%20in%20Comparative%20Perspective.pdf

6 Bohle, Dorothee / Greskovits, Bela: Varieties of Capitalism and Capitalism “Tout Court”, in: European Journal of Sociology (Vol. 50), No. 3, pp. 355-386.

researchers focused on comparing socialism and capitalism. Since socialism was now gone and discredited, attention naturally turned to the way capitalism worked in different countries.

The most popular perspective on capitalist diversity is the Varieties of Capitalism paradigm developed by Peter Hall and David Soskice, which focuses on two ideal types of capitalism – liberal market economies (LMEs) and coordinated market economies (CMEs) – each representing a different form of coordination. In the empirical reality, the US is closest to the LME type, while Germany and Japan are paradigmatic cases of a CME. According to Nölke and Vliegenhart, "although there are a number of comparative capitalism alternatives that propose a much larger number of types of capitalism, most authors still prefer to depart from the juxtaposition of CMEs and LMEs"[7].

This approach attributes primary importance to firms, rather than governments or labour. In providing motivation for their framework, Hall and Soskice note that they want "to bring firms back into the centre of analysis of comparative capitalism"[8]. Accordingly, the main focus is on the problem of coordination, which arises due to firms' engagement in relational activities (with their suppliers, labour force, other firms, stakeholders, etc.). A firm's "success depends substantially on its ability to coordinate effectively with a wide range of actors"[9]. Nevertheless, there is no single way to solve these coordination problems. Hall and Soskice focus on two ideal types: in LME's, "firms coordinate their activities primarily via hierarchies and competitive market arrangements"[10]; in contrast, in CMEs "firms depend more heavily on non-market relationships to coordinate their endeavours with other actors and to construct their core competencies"[11].

Another important feature – and arguably the most innovative aspect – of the VoC approach is the focus on institutional complementaries: "two institutions can be said to be complementary if the presence (or efficiency) of one increases returns from (or efficiency of) the other"[12]. Hall and Soskice focus on five sub-systems (industrial relations, vocational training and education, corporate governance, inter-firm relations, relationship with employees) and demonstrate how in different capitalisms coordination problems are solved by highlighting the way different institutional spheres interact. Thus, for instance, in CMEs high employment and unemployment protection creates motivation for employees (and firms) to invest more into specific skill education and specific assets because, first, employees do not face that high a risk of being fired and, accordingly, firms face lower risks of employee "poaching". This is also reinforced by a specific type of investment financing – in CMEs, close relations between firms and banks ensure longer time horizons for investments. The process works quite differently in LMEs: high flexibility of labour markets and reliance on the stock market as a control mechanism imply short-term investment horizons, low motivation to invest in specific assets and specific skills (hence the drive towards general skills education).

7 Nölke, Andreas / Vliegenthart, Arjan: Enlarging the Varieties of Capitalism: The Emergence of Dependent Market Economies in East Central Europe, in World Politics, 2009 (Vol. 61), No. 4, pp. 670-702.
8 Soskice, David W./ Hall, Peter A.: An Introduction to Varieties of Capitalism, in: Soskice, David W./ Hall, Peter A. (eds): Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford: Oxford University Press, 2003, pp. 1-70, here p. 4.
9 Ibid., here p. 6.
10 Ibid., here p. 8.
11 Ibid., here p. 8.
12 Ibid., here p. 17.

The focus on complementaries has several important implications. First, it stresses institutional continuity and the distinctiveness of the two different types of capitalism. Therefore, globalization does not imply a simple convergence of different models of capitalism into one – quite the opposite, it only reinforces those institutional complementaries that different capitalisms already have (hence the concept of comparative institutional advantage instead of Ricardian comparative advantage). More specifically, LMEs specialize in radical innovation, while CMEs have their comparative advantage in incremental innovation. Furthermore, given institutional complementaries, there is no "best" or "optimal" form of capitalism, but "hybrid" or less pure types of capitalisms are expected to perform worse than "pure" types. In fact, both types of capitalism can be successful in terms of economic performance.

3. Type of capitalism in the Baltic countries: close proximity to LMEs

Recently researchers have tried to extend the VoC framework beyond Western political economies and see whether its main tenets hold in different settings and whether they help understand institutional developments and patterns. The newly emerging post-soviet capitalist systems have also been subject to this type of investigations. Before proceeding, one should state that some researchers find that it is not useful to apply Western concepts to the study of the East European institutional set-up. The "neo-classical sociologists" argue that Eastern European capitalist systems are not sufficiently similar to the Western ones to be analysed using the same conceptual framework[13]. As will be seen, certain unique features of the East European capitalisms (and the Baltic one in particular) do indeed cause problems for a straightforward application of the VoC framework.

Regarding the Baltic states, although findings have not been unequivocal, most scholars come to the conclusion that the Baltic countries – and primarily (or at least) Estonia – represent the LME type of capitalism[14]. Buchen[15] analyzes two post-communist countries – Slovenia and Estonia – and describes them as essentially two antipodes of the paths of transition within the new EU member states. While Estonia opted for the most radical transition, Slovenia pursued a much more gradual approach – as revealed, for instance, by the nature, extent and pace of the privatization policies undertaken in these countries. While both countries could be seen as star performers amongst the new EU member countries (or at least as belonging to the best performing ones, if one considers such aspects as GDP development, corruption perception and competitiveness indices), they seem to have achieved these results in radically different ways. Subsequently, Buchen focuses on five sub-systems (institutions) first formulated by Hall and Soskice and compares Slovenia and Estonia to the ideal types of LME and CME, the empirical paradigmatic cases of the UK and Germany, as well as among themselves.

13 Norkus, Zenonas: Lietuva tarp Estijos ir Slovėnijos, in: Politologija, 2008 (Vol. 49), No. 1, pp. 42-84, here p. 53.

14 Feldmann, Magnus: Emerging Varieties of Capitalism in Transition Countries: Industrial Relations and Wage Bargaining in Estonia and Slovenia, in: Comparative Political Studies, 2006 (Vol. 39), No. 7, pp. 829-854; Buchen, Clemens: Estonia and Slovenia as Antipodes, in Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, pp. 65-89; Norkus, Zenonas: Lietuva tarp Estijos ir Slovėnijos, in: Politologija, 2008 (Vol. 49), No. 1, pp. 42-84.

15 Buchen, Clemens: Estonia and Slovenia as Antipodes, in Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, pp. 65-89.

Table 1. Comparison of Slovenia and Estonia

	Estonia (Baltic)	*Slovenia*
Industrial relations	Firm-level wage setting, accompanied by weak unions and employers organizations; low employee loyalty	Industry-wide wage bargaining; unions and employers strongly cohesive; neocorporatism is a formal practice
Corporate governance	Neither a pure shareholder nor a perfect stakeholder approach	Stakeholder approach to corporate governance with insiders and state influence
Inter-firm relations	No significant attempts at cooperation "beyond the market"	Trust necessary for inter-firm cooperation still low, but institutional structure supports inter-firm relations
Social security systems	Policy of very low replacement rates and expenditures similar to LMEs in the 1990s, although somewhat higher later Duration of benefits same as in the UK	Built CME-like system with a generous replacement rate, relatively high overall expenditures, and a long maximum duration of payments
Vocational training	Abolishing older vocational education systems, movement towards general skills education	Introduction of a dual system of apprenticeships, reminding of the German one

Sources: Buchen, Clemens: Estonia and Slovenia as Antipodes, in Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, pp. 65-89; Norkus, Zenonas: Lietuva tarp Estijos ir Slovėnijos, in: Politologija, 2008 (Vol. 49), No. 1, pp. 42-84.

In general, Buchen finds very strong similarities between Estonia and the LME type on the one hand and Slovenia and the CME capitalism on the other. For instance, while trade union membership declined in both countries (as well as across the whole region), its fall was much more dramatic in Estonia than in Slovenia. Furthermore, in terms of social security, industrial relations, and skill education policy choices, Estonia displays remarkable similarities to the LME type.

Norkus has applied an essentially similar strategy in order to place the Lithuanian type of capitalism in a comparative context. Norkus generally confirms Buchen's findings on Estonia and even provides some more details – for instance, he includes a measure for employee loyalty and demonstrates that it is the lowest in Estonia (and Lithuania) among the new EU member countries, while it is highest in Slovenia. Besides, employment duration is also much lower in Lithuania and Estonia compared to Slovenia. Overall, Norkus concludes that Lithuania essentially belongs to the same type as Estonia. In fact, with regard to some measures (for instance, liberalism of industrial relations), Lithuania is even more "liberal" than

Estonia, although it deviates more from the ideal-LME in other dimensions (for instance, financial development and social security), and apparently represents a less pure LME type than Estonia does.

Buchen and Norkus discuss additional observations that corroborate their conclusions about the Baltic capitalisms as LMEs. First, as already mentioned, both Estonia and Slovenia have achieved good results in terms of economic development, employment and competitiveness. Furthermore, Estonia was more successful than Lithuania. This is consistent with the VoC prediction concerning the efficiency of "pure" types of capitalism due to the effects of institutional complementaries and, conversely, worse results in the case of less coherent types. Second, Estonia (and Lithuania) on the one hand and Slovenia on the other are developing distinct comparative advantages. Buchen writes that "Slovenian trade figures reveal a comparative advantage in typical CME-sectors, such as road vehicles, electric machinery and rubber manufacturing"[16]. Estonia, on the other hand, had comparative disadvantages in exactly these sectors. A related point further strengthening these conclusions are FDI patterns. While Slovenia attracted FDI mainly into manufacturing, Estonia primarily received such flows in financial intermediation and real estate sectors. These observations are also consistent with the VoC predictions concerning different institutional comparative advantages that give basis for the development of different comparative trade advantages.

The very same scholars that characterized Baltic capitalisms as LMEs also recognize certain problems, however. First, while with regard to many dimensions (sub-systems) Baltic countries do remind of the LME type, there is one area where there are striking differences, namely corporate governance. In discussing this subsystem, Buchen breaks it down into three dimensions: ownership structure, management, and representation of stakeholders. Regarding the first two dimensions, Estonia departs strongly from the LME ideal type.

Table 2. Corporate governance in Estonia and the UK

Estonia	**UK**
Ownership structure	
largest voting block very big; considerable foreign ownership, declining insider ownership	largest voting block rather small; overall dispersed
Management	
Two-tier board structure with management and supervisory board	One-tier management board
Representation of stakeholders	
Voluntary	Voluntary

Source: Buchen, Clemens: Estonia and Slovenia as Antipodes, in Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, pp. 65-89, here p. 73.

16 Buchen, Clemens: Estonia and Slovenia as Antipodes, in Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, pp. 65-89, here p. 81.

A related point is the fact that financial systems in the Baltic countries are very underdeveloped in comparison to the Western LMEs, but also the Western CMEs (although Estonia has one of the highest stock market capitalization rates among the new EU member states). This is especially true in terms of stock market development (capitalization and liquidity), while on credit-to-GDP ratio the Baltic countries have been catching up lately, as they experienced rapid credit booms in the pre-crisis period. Furthermore, other related indicators of stock market liquidity present a similar picture.

Besides, the ownership structure in the Baltic countries is very different from LMEs, to quote Norkus:

In Estonia, and especially Lithuania, a very popular legal corporate form is the private company, whose owners are also managers (directors). Such a company's stocks are not traded on the stock market, and "outsiders" cannot purchase its stock. In this regard, post-communist capitalism is different from both the LME "stockholders" capitalism, where corporate control over managers is ensured by the threat of "hostile takeover" and managers aim to improve their positions on the managers' labour market, and from CME "stakeholders capitalism", where managers supervision is carried out by banks that have enough human resources to competently fulfil this function[17].

It is possible to add further insights to this observation. The table below reveals that the Baltic countries (especially Estonia) distinguish themselves in terms of importance of small and medium enterprises (SME) in the economy. They surpass all the new EU member states in terms of employment and share of value added by SME (with the only exception that Slovenia scores higher than Lithuania in terms of value added). In fact, the Baltic countries have the highest share of SME in non-financial business employment and value added in the whole EU, as table 3 demonstrates.

Table 3. SME share of employment and value added.

	Number of persons employed	*Value added*
Bulgaria	72.6	53.2
Czech Republic	68.9	56.7
Estonia	78.1	75.1
Latvia	75.6	71.1
Lithuania	72.9	58.5
Hungary	70.9	50.2
Poland	69.8	48.4
Romania	60.8	48.4
Slovenia	66.4	60.6

17 Norkus, Zenonas: Lietuva tarp Estijos ir Slovėnijos, in: Politologija, 2008 (Vol. 49), No. 1, pp. 42-84, p. 70.

Slovakia	54.0	44.5
Germany	60.6	53.2
UK	54.0	51.0
EU-27	67.1	57.6

Source: Schmiemann, Mangred: Enterprises by size class – overview of SMEs in the EU, accessed 25 May 2011, http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-08-031/EN/KS-SF-08-031-EN.PDF.

The second problem when characterizing Baltic countries as LMEs is the fact that they, just as the other new EU member states, are importers, and not exporters, of capital. This point is related to the wider issue of the Baltic states economic underdevelopment and the lack of innovation capacity. One should remember that the LME and CME types were formulated based on the reality of developed Western developed economies. For instance, what should one make of the division in terms of innovation types between CMEs and LMEs (incremental vs. radical innovation) in countries that hardly innovate at all? Norkus himself recognizes this: "countries of medium development (leaving undeveloped countries aside) are not able to compete in the sophisticated technology diffusion process as creators and exporters of radically new technologies"[18]. Furthermore, regarding comparative advantage, the Baltic countries are not exporting high-technology goods, but focusing on services, resource- and unskilled-labour intensive products (agricultural goods, timber, textiles, furniture with low value added).

Finally, with regard to important dimensions (social protection) the Baltic countries are actually more liberal than the Western LMEs. For instance, unemployment benefits as percentage of GDP stand at 0.17 in the UK and only 0.02 in Estonia[19]. Knell and Srholec use a factor analysis to arrive at a typology of post-communist capitalisms based on the level of coordination in the economy (the level of coordination is broken down into three components: level of social cohesion; labour market regulation; business regulation)[20]. Interestingly, all three Baltic countries and especially Estonia are found to be more "liberal" in terms of social cohesion than the United Kingdom, and Estonia surpasses the US, while Latvia and Lithuania are essentially on par with the latter. While on labour market regulation the Baltic countries get much more liberal scores than the UK and the US, one must bear in mind that formal labour market regulation in the Baltic countries is not indicative of the true situation – in fact, labour markets in the Baltic countries are very liberal and flexible, as witnessed, for instance, during the last crisis when salaries decreased substantially (as will be described below). Finally, regarding business regulation, the Baltic countries are in between the UK and the US – here one must stress that this index includes stock market capitalization relative to the banking sector in the economy, which naturally decreases the liberality of the Baltic score.

The above-mentioned authors have tried to address these concerns. Their main argument is that the Baltic countries are currently immature LMEs – they do not yet have all the model's characteristics. In Norkus' words, it was simply impossible to reform all sub-systems at once. This is why Buchen and

18 ibid, here p. 73.
19 Buchen, Clemens: Estonia and Slovenia as Antipodes, in Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, pp. 65-89, here p. 78.
20 Knell, Mark / Srholec, Martin: Diverging Pathways in Central and Eastern Europe. in: Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, pp. 40-64.

Norkus focus on general trends of convergence, also taking into account certain legacies from the Socialist past. For instance, while Estonia has a relatively high employment protection level as a legacy of the Soviet regime, it has declined over time. Taking this perspective, one should expect further convergence of the Baltic models towards the LME type. Therefore, Norkus interprets the recent reforms in Lithuania (pensions and higher education) as well as the development of credit as signs of convergence towards the LME type – presumably to better serve its functional requirements.

Are these arguments convincing? There are some serious doubts about this. First and foremost, given the lack of a fundamental feature – highly developed financial markets and related forms of ownership – it is doubtful whether one can still describe the Baltic countries as LMEs (even if immature). Based on exactly this point – the very low stock market capitalization levels – David Lane argues that "one might conclude that the stock market as a coordinator of the economy (in Hall and Soskice's terms) can be ruled out for all the post-socialist societies"[21]. Furthermore, there are doubts as to whether the Baltic countries are simply displaying incongruent institutions and are along the way of eliminating these incongruencies to converge onto the LME type. Take the case of comparative advantage, for instance – there is no long-term trend that would show the Baltic countries moving out of their current comparative advantages into more complex products and developing innovation capacities[22].

4. Baltic variety of capitalism

Given what has been said, is it possible to formulate an alternative interpretation? Could we describe the Baltic countries as representing a distinct model of capitalism – i.e. neither LME nor CME and neither a "bastard" or "hybrid" type? One should proceed carefully with such an exercise, of course: there is a danger of an excessive multiplication of different capitalisms (finally one could even end up with as many capitalisms as there are countries, which would hardly serve any analytical purposes). Nölke and Vliegenhart laid out the following conditions:

In order to qualify as a distinct variety of capitalism, three conditions have to be met: (1) the existence of an alternative overall economic coordination mechanism closely related to (2) a relatively stable set of institutions based on marked institutional complementaries, that leads to (3) a set of specific comparative advantages (in relationship to CME and LME) and a superior economic performance over comparable, but less pure, socioeconomic systems[23].

Here, it is useful to briefly summarize Nölke's and Vliegenhart's investigation. They propose to conceptualize the Visegrad countries (Czech Republic, Slovakia, Poland, Hungary) as representing a different variety of capitalism – namely dependent market economies, or DMEs. In their words, "the common denominator of the third variety is the fundamental dependence of the ECE economies on investment decisions by transnational corporations"[24]. In DMEs, the primary method of coordination is hierarchical decision-making by TNCs. Based on the functional needs and preferences of TNCs, Nölke and Vliegenhart show how different elements of DMEs fit together: corporate governance reflects the hierarchical

21 Lane, David: Post-State Socialism: A Diversity of Capitalisms?, in Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, here p. 24.

22 Bohle, Dorothee / Greskovits, Bela: Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe, in: West European Politics, 2007 (Vol. 30), No. 3, pp. 443-466.

23 Nölke, Andreas / Vliegenthart, Arjan: Enlarging the Varieties of Capitalism: The Emergence of Dependent Market Economies in East Central Europe, in World Politics, 2009 (Vol. 61), No. 4, pp. 670-702, here p. 676.

24 ibid.

nature of TNC-subsidiary relationship; industrial relation regimes are not entirely liberal (to ensure certain level of employee loyalty and satisfaction), but not as cohesive as in CMEs due to the preference for low labor costs; innovation activities are also heavily controlled by TNCs. Overall, Nölke and Vliegenhart seek to stress the fact that DMEs are not simply bastard types or converging to either CME or LME. Instead, they represent a more or less stable model with its own coordination mechanism, internal logics and distinct comparative advantage – "an assembly platform for semistandardized industrial goods"[25].

What is the logic of the Baltic model? The first thing to note is that the Baltic countries do not represent the DME-type either. While there are certain similarities (notably, high dependence on foreign capital and a relatively high share of foreign ownership), on many dimensions the Baltic countries are different. First, employment and unemployment protection levels are much lower, industrial relations are much more liberal, skills are oriented towards general knowledge (this is exactly the reason why the Baltic countries were characterized as LMEs). Furthermore, in contrast to Visegrad DMEs, the Baltic countries do not have a comparative advantage in the assembly of semi-industrial goods. David Lane notes that all three Baltic countries had a medium share of primary products in their exports. On the contrary, the Czech Republic, Slovakia, Hungary along with Slovenia were the only four countries that had "low primary exports similar to the profiles of high-income industrialized countries"[26].

The main elements of the Baltic model are the following: comparative advantage in services, manufacturing of non-complex, resource or unskilled labour-intensive goods; relatively high share of foreign ownership (especially in financial intermediation), while on the domestic side a very high presence of small and medium-sized businesses; underdeveloped financial markets, especially in terms of stock markets; investment financing coming from retained earnings, FDI or foreign-controlled commercial banks; low levels of innovation and investments into R&D; training systems oriented towards general skills; low share of government welfare spending; flexible labour markets; low employee loyalty; relatively high social inequality (in comparison to other new EU member states). Furthermore, these elements do not seem to represent a contradictory "mixture" of different models of capitalism. In fact, one can see complementaries among different systems, much in the spirit of the VoC perspective: since both foreign investors and domestic capitalists do not pursue high value-added activities and do not invest into specific, immobile assets, they are interested in low labour costs, including low unemployment benefits, highly flexible labour markets, and low government welfare spending (all of which are lower than in certain LMEs, like the UK). Furthermore, given this environment, employees have little incentives to invest into specific skills (and, in contrast to LME economies, governments do not have either the capacity or motivation, given these production regimes, to support high public spending into general skills education). In the light of this situation, one can see the logic behind the predominance of small and medium enterprises in the Baltic countries: such companies are not engaged in high value-added activities, do not invest much (and especially not into long-term projects or fixed assets), and are more flexible in their decisions. Moreover, one particular element of the Baltic economies is a high degree of volatility and the absence of established companies. Vyacheslav Dombrovsky pointed out that only 25 Latvian firms were among the largest 100 companies (by revenue) in both 1997 and 2007[27]. For comparison, the respective figure for the US was 49 firms. Dombrovsky links this high volatility to low in-

25 ibid.

26 Lane, David: Post-State Socialism: A Diversity of Capitalisms?, in Lane, David / Myant, Martin (eds): Varieties of Capitalism in Post-Communist Countries, New York: Palgrave Macmillan, 2007, here p. 29.

27 Dombrovsky, Vyacheslav: Can we revive a 'Baltic Tiger'?, in: Baltic Rim Economies, 2009, No. 1, pp. 34.

vestment into innovation. Furthermore, "some 69% of the new entrants were in wholesale, retail, or construction industries, which are related to the recent bubble and, usually, have little R&D activity"[28].

Going further, it is useful to introduce two other dimensions into the picture. The first one is industrial policy as a form of industry's "protection" from market fluctuations[29] (for instance, incentives, subsidies, tax break and preferential regimes). Industrial protection stands at very low levels in the Baltic countries. This is in sharp contrast to the Visegrad four[30]. The second dimension is the broader macroeconomic regime. Most applications of the VoC framework largely stay within the confines of microeconomic regimes. However, the VoC framework can be fruitfully extended to macroeconomics. After all, Hall and Soskice themselves noted that they were trying "to connect the new microeconomics to important issues in macroeconomics"[31]. Subsequent applications have tried to elaborate on these relationships[32].

First of all, the Baltic macroeconomic regimes are characterized by very strict monetary arrangements – currency boards. Under currency board regimes, the full monetary base is covered by foreign exchange reserves (Latvia does not officially have a currency board regime, but *de facto* has an equivalent arrangement). Currency board regimes are the strictest possible monetary arrangements except for full dollarization or currency union. These regimes also imply fiscal discipline. Fiscal discipline is necessary to ensure the long-term sustainability of fixed exchange rates. Currency board regimes help to ensure macroeconomic stability in a couple of ways. First of all, as has been noted, they put a straitjacket on fiscal policies (and in turn on welfare spending and other measures that could expand the deficit and thus undermine exchange rate stability). Second, if implemented successfully, they help to bring down inflation – this is exactly what happened in the Baltic countries when currency boards were introduced in the first half of 1990s (in 1992 in Estonia and in 1994 in Latvia and Lithuania).

Adding these two dimensions extends the analysis of institutional complementaries and allows a better understanding of the Baltic regimes. First, the typical activities of the Baltic economies in production and in finance do not require high industrial or "macroeconomic" protection (for instance, in terms of a depreciated exchange rate). Besides, given the low level of complexity of production and very flexible labour markets, Baltic businesses are less sensitive to the damage caused by market changes: foreign subsidiaries can easily leave the country and find other markets, while domestic investors can in bad economic conditions relatively easily cut wages, liquidate business altogether or direct exports to other markets (which is easier for standardized basic products than for complex ones). Also, Baltic business strategies do not require high (private or public) investments into education (especially specific skills education), while they do require a general framework of macroeconomic stability and the establishment of "appropriate" formal institutions (rule of law) – hence the need for macroeconomic policies ensuring certainty and discipline (low budgets, strict monetary regimes), rather than for policies acting as "protectors" of industrial complexes. Financiers – mainly in the form of commercial banks – also care about the broad certainty of macroeconomic regimes, and less about the potential suffering of specific

28 ibid.

29 Bohle, Dorothee / Greskovits, Bela: Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe, in: West European Politics, 2007 (Vol. 30), No. 3, pp. 443-466.

30 ibid.

31 Soskice, David W./ Hall, Peter A.: An Introduction to Varieties of Capitalism, in: Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford: Oxford University Press, 2003, pp. 1-70, here p. 5.

32 Hancke, Bob / Rhodes, Martin / Thatcher, Mark: (eds.): Beyond Varieties of Capitalism: Conflict, Contradictions, and Complementarities in the European Economy, Oxford: Oxford University Press, 2007.

long-term investments. Finally, the low levels welfare and industrial spending mean that it is easier to achieve fiscal discipline, thus ensuring macroeconomic stability and sustainability of currency pegs.

Given these characteristics, Bohle and Greskovits named macroeconomic stability as the chief advantage of the Baltic "neoliberal" model. In the light of the recent boom and bust (2003-2010), however, this interpretation could be re-formulated. It seems that the Baltic countries' main strength lies not in macroeconomic *stability* (after all, they went through a wild roller-coaster ride with economic development ranging from double-digit growth figures to double-digit contractions), but in *flexibility*. As Morten Hansen put it in the midst of the recent crisis, "here in Latvia the internal devaluation continues and the debate is whether the economy is flexible enough for this experiment (...) one thing is for sure: the Latvian economy is (possibly perversely) indeed flexible"[33].

The focus on the functional logic of Baltic regimes helps us understand the Baltic flexibility: during the recent crisis firms were able to cut spending and salaries as well as liquidate their operations; moreover, firms were able to redirect their sales to new markets (hence the quick rebound in exports); the absence of powerful labour unions ensured a relatively smooth downward adjustment of nominal wages in private and public sectors; finally, the low unemployment benefits meant that the state budgets were less burdened than otherwise would have been the case. In fact, during the crisis existing patterns were further reinforced – in all three countries, there was high consensus in support of fixed exchange regimes and adherence to orthodox adjustment policies via fiscal consolidation[34]; also, in all three countries labour markets were further liberalized; finally, there were some steps made towards further consolidation of the existing system, such as the higher education reform in Lithuania.

Furthermore, the unique features of their financial systems also enabled the Baltic countries to implement internal devaluation and defend the currency peg. In the Baltic countries, financial systems are dominated by foreign ownership. These foreign banks were, first of all, interested in keeping the peg. Second, they did not leave the Baltic countries, as had been feared by some at the onset of the crisis. Third, one must remember that potential weaknesses in the financial system are the Achilles heel of a currency board system: if substantial problems arise in the financial sector, the government cannot provide liquidity without undermining confidence in the peg. Overall, a lower share of foreign ownership in Latvia's financial sector was one of the chief reasons why the country suffered more from the recession than its Baltic neighbours. Finally, this under-development of financial markets in the Baltic countries also worked in favour of Baltic regime continuity: financial markets were shallow and precluded speculation against the Baltic currencies[35] (which was also reinforced by the fact that banks controlled borrowing, and they were not interested in devaluation); relatively lower indebtedness also meant lower costs in terms of adjustment. In other words, had the Baltic countries been genuine LMEs, they would not have been able to implement internal devaluation under such adverse circumstances.

33 Hansen, Morten: Latvia: Living in the Land of Extremes, in A Fistful of Euros, 20 July 2010, http://fistfulofeuros.net/afoe/latvia-living-in-the-land-of-extremes/
34 Ibid.
35 Purfield, Catriona / Rosenberg, Christoph B.: Adjustment under a Currency Peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008–09, IMF Working Paper WP/10/213, 2010.

5. Conclusions

Before drawing conclusions, it is necessary to provide certain caveats. This paper has highlighted institutional complementarity and the self-enforcing nature of the Baltic politico-economic regimes. And indeed, this has been true in many respects, not least during the last economic downturn. However, one should be careful to identify functional business needs as the main operating forces behind the Baltic capitalist system. Researchers have pointed out that the emergence of Baltic regimes can hardly be explained as deriving from firms' preferences – after all, the early transition period marked a situation with few established interest groups, and a new institutional structure could be created on the ruins of the old one. The main driving force behind the Baltic transition was the broad logic of state-building, identity politics and particular perceptions (overly negative) of the Soviet past[36]. This is what explains the divergence of the Baltic and Visegrad regimes, despite similar structural background conditions upon embarking on the transition process[37]. Such findings reflect the conclusions of an investigation about the origins of the German and Japanese capitalisms: "Thus, in *The Origins of Nonliberal Capitalism,* the causal arrows run not from a production regime to a set of supporting institutions, but in the opposite direction; the 'historical sequence…extends from state-building through social policy and labor relations to the organization of production'[38]. Furthermore, while analysing the continuities of Baltic capitalism, it would be a mistake to neglect the role of politics and especially ideological factors. Inter alia, what has ensured the continuity of Baltic capitalisms was the structural and ideological weakness of the political left and the resulting hegemony of orthodox ideas regarding macroeconomic and industrial policy.

Having said this, one could still see a role played by certain functional factors, and in particular by the needs of firms operating in the Baltic countries, in acting as consolidating forces for the existing system. Specific Baltic comparative advantages and ownership structures result in a comparatively low need for social and industrial protection, as well as private or public investment into education. Instead, there is a need for high labour market flexibility and general macroeconomic stability ensuring low public deficits and exchange rate predictability. The specific Baltic capitalism can also contribute to the explanation of the successful Baltic strategy during the last crisis (as far as the defence of the currency peg is concerned).

As for the question on origins, one must remember that at the core of insights on path-dependency lies the idea that the forces that created institutions do not necessarily have to be present for those institutions to continue to exist. Therefore, while arguably political and ideational factors were the main driver of Baltic choices that gave birth to these regimes, subsequently emerging business preferences started affecting and reinforcing the system on their own.

Finally, on a broader level, the Baltic lessons to the study of varieties of capitalism seem to be twofold. On the one hand, the Baltic experience illustrates the utility of a broadly-perceived VoC approach by highlighting continuities and institutional complementaries at work. On the other hand, it also speaks against a direct and strict application of the framework without taking into account the specific effects

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36 Bohle, Dorothee / Greskovits, Bela: Neoliberalism, Embedded Neoliberalism and Neocorporatism: Towards Transnational Capitalism in Central-Eastern Europe, in: West European Politics, 2007 (Vol. 30), No. 3, pp. 443-466.

37 ibid.

38 Howell, Chris: Review: Varieties of Capitalism: And Then There Was One?, in: Comparative Politics, 2003 (Vol. 36), No. 1, pp. 103-124; inside citation from Streeck, Wolfgang: Introduction: Explorations into the Origins of Nonliberal Capitalism in Germany and Japan, in Streeck, Wolfgang / Yamamura, Kozo (eds.): The Origins of Nonliberal Capitalism: Germany and Japan in Comparison, Itacha: Cornell University Press, 2001, pp. 1-38, here p. 14.

at work in a given case. For instance, a straightforward application of the VoC approach categorizing the Baltic regime as LME would have been unable to account for the successful internal devaluation during the crisis.