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What type of capitalism do the Baltic countries belong to?

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This paper draws on the Varieties of Capitalism (VoC) approach to analyse the Baltic countries' politico-economic regimes. The paper discusses the dominant treatment of the Baltic countries as liberal market economies (LMEs) in the literature, and while recognizing many affinities with the LME model, it emphasizes several substantial differences. As a result, a case is made for conceptualizing Baltic capitalism as a distinct variety that is neither LME nor CME. Furthermore, it is not a "hybrid" type, as it has its own logic, distinct institutional complementarities, 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 argues that the functioning of this specific Baltic regime was one of the factors that allowed Estonia, Latvia and Lithuania to successfully implement an "internal devaluation" strategy during the Great Recession of 2008–10.

Key words: Varieties of Capitalism – Baltic States – internal devaluation

Introduction

The global financial crisis provides yet another opportunity to evaluate the merits of the most popular framework for comparing capitalisms – the Varieties of Capitalism (VoC) approach as originally formulated by Peter Hall and David Soskice (2001). Given different institutional structures, VoC predicts distinct responses to exogenous shocks. This paper deals with the empirical case of the three Baltic countries. In the light of recent experience, these countries (Estonia, Latvia, Lithuania) serve as interesting cases for an analysis: After achieving record growth figures prior to the Great Recession, they posted during the downturn – along with the Ukraine – the largest GDP contractions in the world in 2009. At the same time, the three Baltic countries managed to provide an interesting surprise by defying most analysts' expectations: Despite huge macroeconomic imbalances, the three countries refused to devalue their currencies and were able to carry out the so-called internal devaluation which aims to rebuild competitiveness via austerity measures and nominal wage reduction (deflation). Overall, the Baltic countries are an interesting case of capitalist diversity: In the context of the new (and old) EU member states, they are in many respects very "liberal", although lacking certain important characteristics of Western "liberal market economies".

In the light of this, several interrelated questions motivate this paper. What type of capitalism do the Baltic countries belong to? To what extent can the VoC paradigm help us understand the logic of Baltic politico-economic regimes? Can it enlighten us as to the Baltic countries' surprising anti-crisis strategy and its success (defined as the ability to implement "internal devaluation", restore confidence in the currency regime and financial system)?

The paper starts with the outline of the VoC approach by highlighting its main tenets, strengths and weaknesses. It then proceeds to a literature review of scholarly attempts at typologizing Baltic capitalism. The drawbacks are then discussed of the most popular typology representing the Baltic regime as the liberal market economy (LME) type. The following section advances a case for yet another type of capitalism with its own internal logic, complementarities, specific institutional advantages and continuities. Finally, after a brief introduction of the macroeconomic dimension into the picture, the new conceptualization of the Baltic capitalist system is shown to illuminate certain aspects of these countries' ability to implement internal devaluation during the recent crisis. The paper ends with a discussion of the advantages but also caveats of applying the VoC approach to both the specific Baltic case and more generally.

The Varieties of Capitalism approach

The study of what one could call the "capitalist variety" approach started with Andrew Shonfield's Modern Capitalism, and intensified after the economic problems experienced by the Western economies in the 1970s (Bohle/Greskovits 2009: 356). The fall of the Soviet Union gave an additional boost to the study of capitalist varieties. Before then, many researchers had 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 (VoC) 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 Vliegenthart (2009: 674), "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".

This approach attributes primary importance to firms rather than governments or labour. In providing motivation for their framework, Hall and Soskice (2001: 4) note that they wanted "to bring firms back into the centre of analysis of comparative capitalism". 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" (Hall/Soskice 2001: 6). Nevertheless, there is no single way to solve these coordination problems. Hall and Soskice (2001: 8) focus on two ideal types: in LMEs, "firms coordinate their activities primarily via hierarchies and competitive market arrangements"; 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".

Another important feature – and arguably the most innovative aspect – of the VoC approach is the focus on institutional complementarities: "Two institutions can be said to be complementary if the presence (or efficiency) of one increases returns from (or efficiency of) the other" (Hall/Soskice 2001: 17). 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 in education for specific skills and assets because, first, employees do not face that high a risk of being fired and, accordingly, firms face lower risks from "employee poaching". This is also reinforced by a specific type of investment financing in CMEs, namely, close relations between firms and banks that ensure longer horizons for investment. The process works quite differently in LMEs: the high flexibility of labour markets and reliance on the stock market as a control mechanism implies short-term investment horizons, low motivation to invest in specific assets and skills (hence the trend in these towards general skills education).

The focus on complementarities has several important implications. First, it stresses institutional continuity and 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 complementarities 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 complementarities, 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.

It is not a coincidence that the VoC paradigm emerged as the most prominent approach to the study of capitalist variety. Its attractiveness comes down to two main points. First, VoC offers a sophisticated and parsimonious theory of capitalist variety with the capacity to generate interesting empirical predictions. On a more normative level, VoC offers a theoretical justification for the existence and sustainability of an alternative to the Anglo-Saxon type of capitalism, in contrast to predictions about the inevitable convergence of all capitalisms towards the latter (Bohle/Greskovits 2009).

Despite – or perhaps because of – its wide popularity, VoC has also been subject to numerous criticisms. This is not a place to cover – yet alone address – these criticisms in full detail; one can find good reviews at Howell (2003), Bohle and Greskovits (2009). Briefly, the major points of criticism are the following: VoC's functionalism and economic determinism; neglect of politics; inability to analyse and explain institutional change; inappropriate typology of two types. As often happens in the social sciences, theoretical frameworks involve certain trade-offs, for instance, between parsimony and the ability to capture the logic of individual cases. First of all, given VoC's starting point with firms' coordination problems, there is a bias towards functionalism and economic determinism: There is a risk of conceptualizing political economies as serving the needs of business. A related point is, therefore, the neglect of political factors and conflict. For instance, the role of government comes down to serving the needs of firms in solving their coordination problems. The role of labour is also neglected. In Howell's words (2003: 110), "the theoretical framework of Varieties of Capitalism offers an extremely thin notion of politics and state action, in which governments, whose function is essentially to encourage coordination among economic actors, act largely at the behest of employers". Third, while the VoC framework theoretically offers an understanding of the stability and continuity of capitalist varieties, this comes at a price of not being able to account for the origins of different models and analyse institutional change. In other words, VoC can be said to be too static because essentially it sees the only way models of capitalism can change is through big exogenous shocks. Finally, critics have attacked the particular typology of capitalist variety, viewing the division into two types as possibly too rigid.

Classification of Baltic capitalism as LME and problems with this

Recently, researchers have tried to take the VoC framework beyond Western political economies and see whether its main tenets hold in different settings and whether this helps us understand their institutional developments and patterns. Despite the view of some authors that it is inappropriate to apply the VoC framework to Central and Eastern European countries (e.g. King 2010), the newly emerging post-soviet capitalist systems have also been subjected to this type of investigation (Iankova 2010). Regarding the Baltic states, scholars applying the VoC approach largely come to the conclusion that the Baltic countries – and primarily Estonia – represent the LME type of capitalism or are approaching it (Feldmann 2006; Buchen 2007; Hancké 2010: 140; Norkus 2008). Buchen (2007) analyses two post-communist countries, Slovenia and Estonia, and describes them as antipodes of transition among 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. Both these countries could be considered star performers amongst the new EU member countries (or at least among the best-performing ones, if one considers such aspects as GDP development, corruption perception and competitiveness indices), but they seem to have achieved these results in radically different ways.

In general, Buchen finds very strong similarities between Estonia and the LME type on the one hand, and Slovenia and CME capitalism on the other. For instance, while union membership has declined in both countries (as well as across the whole region), this was much more dramatic in Estonia than in Slovenia. Furthermore, in terms of social security, industrial relations and educational skill 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 into a comparative context. Norkus generally confirms Buchen's findings on Estonia and provides more details to strengthen the conclusion – for instance, employment duration is much lower in Lithuania and Estonia compared to Slovenia (7.6, 6.9 and 12.1 years respectively) (Norkus 2008: 58). Overall, Norkus concludes that Lithuania essentially belongs to the same type as Estonia. In fact, on some measures (for instance, 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 on this interpretation represents a less pure LME type than Estonia does.

Buchen and Norkus discuss additional observations in support of their conclusions about Baltic capitalisms as LMEs. First, as already mentioned, both Estonia and Slovenia have achieved good results in 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 complementarities 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 (2007: 81) writes that "Slovenian trade figures reveal a comparative advantage in typical CME-sectors, such as road vehicles, electric machinery and rubber manufacturing". Estonia, on the other hand, had comparative disadvantages in these very sectors. A related point further strengthening these conclusions are FDI patterns, as this flowed primarily into manufacturing in Slovenia and financial intermediation in Estonia (Buchen 2007: 83). These observations are also consistent with the VoC predictions concerning different institutional comparative advantages that provide a basis for the development of different comparative trade advantages.

The very same scholars that characterize Baltic capitalisms as LMEs also recognize certain important problems. First, while with regard to many dimensions (sub-systems), Baltic countries do resemble the LME type, there is one area where there are striking differences, namely, in corporate governance. In contrast to United Kingdom's dispersed ownership pattern, Estonia has a "very strong largest voting block" and "considerable foreign ownership" (Buchen 2007: 73) Besides, to put it in Norkus' words, ownership structure in the Baltic countries is very different from LMEs:

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 (Norkus 2008: 70).

It is possible to add further insights to this observation. Appendix 1 shows that the Baltic countries (especially Estonia) distinguish themselves in terms of SME importance in the economy. They surpass all the new EU member states in terms of employment and value-added share (except that Slovenia scores higher than Lithuania in value added). In fact, in terms of small and medium enterprises' share in non-financial business employment and value added, the Baltic countries record the highest figures in the whole EU (Schmiemann 2008).

The second problem in characterizing Baltic countries as LMEs is the fact that they, just as the other new EU member states, are net importers, and not exporters, of capital. This point is related to the wider issue of the Baltic economic underdevelopment and lack of innovation capacity. One should remember that the LME and CME types were formulated on the basis of developed Western economies. For instance, how should one apply the differentiation between CMEs and LMEs in terms of innovation type (incremental vs. radical) to countries that have little leading innovation capacity? Norkus (2008: 73) 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 radical new technologies". 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) (Bohle/Greskovits 2007). This point is also related to a crucial VoC dimension – financial market development. Baltic countries have much lower market capitalization rates than not only Western LMEs, but also Western CMEs (see Table 1).

In Table 1, Estonia appears to not entirely fit the model described, as it has significantly higher R&D intensity than do the other Baltic countries and the "Visegrad countries" (Czech Republic, Slovakia, Poland and Hungary) except for the Czech Republic. Moreover, it managed to increase this figure from 0.71 in 2001 (Eurostat data). It has also moved up in the European Innovation Scoreboard rankings (Pro-Inno Europe 2010). On the other hand, it has not significantly increased its share of high-tech exports and lags in other dimensions such as patenting (Table 1). According to the OECD (2011: 110), "some evidence of a 'low-quality trap' can be found for the Baltic countries with respect to low-end specialization within industries". How can we reconcile these views? It seems that Estonia is characterized by a small enclave of highly successful leading companies (Skype is the best-known example) that are however isolated from the rest of the economy (Salu 2010).

Table 1. Innovation capacity, export sophistication and financial-market development in selected countries

	R&D expenditure as % of GDP in 2009	High-tech patent applications to the EPO per million inhabitants in 2008	High-tech exports in % of all exports in 2006	Increase in high-tech share in total exports between 1995 and 2006 (in percentage points)	Market capitalization of listed companies, in % of GDP in 2010
Czech Republic	1.53	1.5	12.7	7.8	22.4
Hungary	1.15	2.1	20.3	15.6	21.2
Poland	0.68	0.5	3.1	1.1	40.6
Slovakia	0.48	0.9	5.8	2.5	4.7
Germany	2.82	23.5	14.1	2.4	43.2
Ireland	1.77	8.3	29.0	-3.9	16.5 (in 2009)
United Kingdom	1.87	7.9	26.5	4	138.3
US	2.77 (in 2008)	9.7	26.1	0.3	117.5
Estonia	1.42	0.7	8	4	12.1

Latvia	0.46	1.3	4.2	1.2	5.2
Lithuania	0.84	0.4	4.7	2.5	15.6

Sources: Columns 1, 2, 3: Eurostat; Column 4: author's calculations based on Eurostat; Column 5: World Bank Data.

Finally, with regard to important dimensions (e.g. social protection – see Annex 1) the Baltic countries are actually more liberal than Western LMEs. Knell and Srholec (2007) use 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 parts: level of social cohesion; labour-market regulation; business regulation). 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 a par with the latter. While the Baltic countries achieve much less liberal scores on labour-market regulation 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 (Eamets/Masso 2004; Vilpišauskas 2009); in fact, labour markets in the Baltic countries are very liberal and flexible. Finally, regarding business regulation, the Baltic countries are ranked between the UK and the US; here one must remember that this index includes stock-market capitalization relative to the banking sector in the economy, which decreases the "liberalism" 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, i.e. they do not yet have all that model's characteristics. In Norkus' (2008: 75) opinion, it was simply impossible to reform all systems at once. This is why Buchen and 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 on pensions and higher education, as well as the development of credit, as signs of its movement towards the LME type – presumably to better serve its functional requirements.

Are these arguments convincing? There are grounds for some serious doubts. First and foremost, given the lack of a fundamental feature – highly developed financial markets and related forms of ownership – it is questionable whether one can still describe the Baltic countries as LMEs (even immature ones). On the basis of the very low stock-market capitalization levels, David Lane (2007: 24) 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". Furthermore, there is a lack of evidence that the Baltic countries are temporarily displaying incongruent institutions and are actually on the way to eliminating these incongruencies and converging with the LME type either in stock market development or export structure. Concerning comparative advantage, there is thus far little evidence of the Baltic countries moving out of their current production profile into a more complex one (see Table 1 on export sophistication and innovation capacity; Bohle/Greskovits 2007).

Baltic countries: a distinct model of capitalism?

Given the above, is it possible to formulate an alternative interpretation? Can we describe the Baltic countries as representing a distinct model of capitalism, i.e. neither as LME, CME, nor a "hybrid" type? One should of course proceed carefully with such an exercise, for there is a danger of an excessive multiplication of different capitalisms (with in the end as many capitalisms as there are countries, which would hardly serve any analytical purpose). Nölke and Vliegenthart (2009: 676) 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 complementarities, 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.

Here it is useful to briefly summarize Nölke and Vliegenthart's investigation. They propose that the Visegrad countries (Czech Republic, Slovakia, Poland and Hungary) represent 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" (Nölke/Vliegenthart 2009: 676). In DMEs, the primary method of coordination is hierarchical decision-making by transnational corporations (TNCs). Nölke and Vliegenthart show how the functional needs and preferences of TNCs fit the different elements of DMEs together: Corporate governance reflects the hierarchical 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 labour costs; innovation activities are also heavily controlled by TNCs. Overall, Nölke and Vliegenthart stress that DMEs are not simply mixed types or represent a convergence to either CME or LME. Instead, they posit a more-or-less stable model with its own coordination mechanism, internal logic and distinct comparative advantage – "an assembly platform for semi-standardized industrial goods" (Nölke/Vliegenthart 2009: 679).

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 (heavy dependence on foreign capital and relatively large share of foreign ownership), on many dimensions the Baltic countries are different: they diverge on employment and unemployment protection, industrial relations and skill orientation (see Annex 1; Bohle/Greskovits 2007). Furthermore, in contrast to Visegrad DMEs, the Baltic countries do not have a comparative advantage in the assembly of semi-industrial goods. David Lane (2007) notes that all three Baltic countries have a moderate share of primary products in their exports. On the contrary, the Czech Republic, Slovakia, Hungary along with Slovenia are the only four countries that have "low primary exports similar to the profiles of high-income industrialized countries" (Lane 2007: 29).

Instead, the main elements of the Baltic model seem to be the following: comparative advantage in services, manufacturing of non-complex, resource- or unskilled-labour-intensive goods (Bohle/Greskovits 2007); very high proportion of small and medium-size businesses; underdeveloped financial markets, especially the stock market; low levels of innovation and investments in R&D (compared to developed market economies); training systems increasingly oriented towards general skills (Martinaitis 2010); small share of government welfare spending; flexible labour markets (Eamets/Masso 2004; Vilpišauskas 2009); weak employee loyalty (Norkus 2008). One feature of the Baltic financial system that differentiates it from those of Western LMEs is the almost complete domination of it by foreign-owned commercial banks. In 2008, the asset share of foreign owned banks stood at 98.2, 65.7 and 92.1 percent in 2006 in Estonia, Latvia and Lithuania respectively (EBRD 2010).

Importantly, these elements do not seem to represent a contradictory "mixture" of different models of capitalism. In fact, one can see complementarities 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 incentive to invest in specific skills (and, in contrast to LME economies, governments have less capacity or motivation, given these production regimes, to support high public spending on quality general educational skills). In light of this situation one can see the logic behind the predominance of small and medium-size enterprises in the Baltic countries: Such companies are more flexible in their decisions and presumably can more easily change or liquidate their activities in the face of changing market conditions. Another particular element of the Baltic economies is a high degree of volatility and the absence of established companies. Vyacheslav Dombrovsky (2009: 34) points out that only 25 Latvian firms were among the country's largest 100 companies (by revenue) in both 1997 and 2007. By comparison, the respective figure for the US is 49 firms. Dombrovsky links this small size and volatility to low investment in 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" ((Dombrovsky 2009: 34).

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 (Bohle/Greskovits 2007) (for instance, incentives, subsidies, tax breaks and preferential regimes). The level of industrial protection is much lower than in the Visegrad four (see Annex 1; Bohle/Greskovits 2007). The second dimension is a broader macroeconomic regime – namely fiscal and monetary policy. Most applications of the VoC framework largely stay within the confines of microeconomic regimes. However, the VoC framework can be fruitfully extended into the macroeconomic realm (e.g. Soskice: 2007). After all, Hall and Soskice (2001: 5) themselves note that they were trying "to connect the new microeconomics to important issues in macroeconomics". For instance, according to Soskice (2007) there is a greater compatibility between LME institutions and flexible, discretionary aggregate demand management, while CMEs are more compatible with conservative, rules-based regimes.

The Baltic macroeconomic regimes are characterized by very strict monetary arrangements in the form of currency boards. Under currency board regimes, all monetary base is covered by foreign exchange reserves (Latvia does not officially have a currency board regime, but de facto it has an equivalent arrangement). Currency board regimes are the strictest possible monetary arrangements except for full dollarization or currency union. These regimes also imply that fiscal discipline is necessary to ensure the long-term sustainability of fixed exchange rates. Currency board regimes help to ensure macroeconomic stability in two ways: First, as has been noted, they put a straitjacket on fiscal policies (and in turn on excessive 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, and this is exactly what happened in the Baltic countries when they introduced currency boards in 1992 in Estonia and 1994 in Latvia and Lithuania.

Adding these two dimensions extends the analysis of institutional complementarities and allows a better understanding of the Baltic regimes. First, typical activities of the Baltic economies in production and finance do not require high-level industrial or macroeconomic "protection" (for instance, of depreciated exchange rates). Besides, given the low level of complexity of production and very flexible labour markets, Baltic businesses are less sensitive to changes in market situation: foreign investors 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 orient 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 in education (especially for specific skills), while they do require a general framework for macroeconomic stability and establishment of "appropriate" formal institutions (e.g. the rule of law) – hence the need for macroeconomic policies ensuring stability and discipline (low budgets, strict monetary regimes), rather than policies acting as "protectors" of industrial complexes. The three Baltic countries and especially Estonia consistently receive relatively high scores on global competitiveness rankings. Financiers – mainly in the form of commercial banks – also care about the broad stability of macroeconomic regimes, and less about potential damage to specific long-term investment projects. Finally, the low level of need for 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 (2007) described the chief advantage of the Baltic "neoliberal" model as macroeconomic stability. In the light of the recent boom and bust (2003-2010) however, this interpretation could be re-formulated. The Baltic countries' main strength lies not in macroeconomic stability (after all, they went through a wild roller-coaster ride of economic development ranging from double-digit growth figures to double-digit contractions – see Annex 2), but in flexibility. As Morten Hansen (2010) 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".

"Flexibility" is therefore chosen as a name to describe the Baltic variety of capitalism in Table 2. The table is an attempt to present the main features of this model as already discussed. One aspect has not been covered, however: While both LMEs and Baltic capitalisms rely on market as the chief coordination mechanism, they seem to do so differently. Particular features of Baltic businesses make them at the same time more, and less vulnerable to market conditions when compared to LMEs. On the one hand, the low level of differentiation of products, and the lack of protection in terms of industrial policy or macroeconomic regime mean that the Baltic firms face a volatile and unpredictable economic environment. On the other hand, the fact that Baltic countries have undeveloped financial markets and concentrated ownership means that owners of firms are potentially less subject to the threats of "hostile" takeovers or minority shareholder revolts. Owners of Baltic businesses (SMEs, where owner and manger roles are not separate) can exercise a much more direct and immediate control over their firms' operations than their Western counterparts do over theirs.

Table 2. Baltic capitalism (FME) compared to LMEs, CMEs and DMEs

Institution	Liberal market economy (LME)	Coordinated market economy (CME)	Dependent market economy (DME)	Flexible market economy (FME)
Distinctive coordination mechanism	Competitive markets and formal contracts	Interfirm networks and associations	Dependence on intrafirm hierarchies within transnational enterprises	Competitive markets and formal contracts
Corporate governance	Outsider control/dispersed shareholders	Insider control/concen-trated shareholders	Control by headquarters of transnational enterprises	High ownership concentration, predominance of SMEs and private (limited liability) companies
Industrial relations	Pluralist, market based; few collective agreements	Corporatist, consensual; sector-wide or even national agreements	Appeasement of skilled labour; company-level collective agreements	Market-based; very high degree of labour-market flexibility
Education and training system	General skills, high research and development expenditures	Company- or industry-specific skills, vocational training	Limited expenditures for further qualification	General skills, low research and development expenditures
Transfer of innovations	Based on markets and formal contracts	Important role of joint ventures and business associations	Intrafirm transfer within transnational enterprise	Limited innovation capacity

Macroeconomic regime	Discretionary, centralized aggregate demand management	Rules-based aggregate demand management; automatic stabilizers important	Float or managed float exchange rate regimes and independent monetary policy	Very strict monetary arrangements; budgetary policy subordinated to exchange-rate support
Industrial policy	Limited industrial policy	Important industrial and structural policy	Important, focused on attracting TNCs	Very limited

Source: microeconomic dimensions for LMEs, CMEs and DMEs: Nölke and Vliegenthart (2009: 680); macroeconomic dimension for LMEs and CMEs: Soskice (2007); industrial policy for LMEs and CMEs: Campbell and Pedersen (2007: 321-324); industrial policy for DMEs: (Bohle/Greskovits 2007); author's own research.

VoC insights into the Baltic anticrisis strategy

The insights of VoC may help advance an explanation for the recent Baltic puzzle during the economic downturn. During the crisis the Baltic countries (especially Latvia) became the centre of attention in the international financial media. Most foreign analysts were surprised that the Baltic countries chose not to devalue their currencies, and even more by the fact that they were actually able to implement the so-called internal devaluation, i.e. reduction of prices and salaries inside the economy to restore competitiveness that deteriorated during the years of economic "overheating". Many experts, including Nouriel Roubini, were predicting an exchange rate collapse. Nevertheless, the Baltic countries were able to defy these expectations (Kuokštis/Vilpišauskas 2010).

The focus on the functional logic of the Baltic regimes helps us understand the Baltic flexibility: firms were able to cut spending and salaries as well as liquidate their operations; moreover, firms were able to reorient their production to new markets (hence the quick rebound in exports which added to economic recovery in 2010 in the context of very weak domestic demand); the absence of powerful labour unions ensured a relatively easy downward adjustment of nominal wages in private and public sectors; finally, the low unemployment benefits meant that the state budgets were ceteris paribus less burdened than otherwise would have been the case (see Annex 2 for an overview of economic developments in the Baltic countries during the crisis). In fact, during the crisis existing patterns were further reinforced – in all three countries, there was a high level of consensus behind fixed exchange regimes (anything was to be undertaken to defend them) and adherence to orthodox adjustment policy via fiscal consolidation (Kuokštis/Vilpišauskas 2010); also, in all three countries labour markets were further liberalized while the power of labour diminished even more (Gonser 2010); finally, there were some steps made towards further consolidation of the existing system, such as the higher education reform in Lithuania.

The unique features of their financial systems also enabled the Baltic countries to implement internal devaluation and defend the peg: First of all, the banking sector dominated by Western owners was interested in keeping the peg. Second, the banks did not move out of the Baltic countries as had been feared by some at the onset of the crisis. (One must remember that potential weaknesses in the financial system are the Achilles heel of a currency board system: If substantial problems develop in the financial sector, the government cannot provide liquidity without undermining confidence in the peg.) Moreover, the 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 (Purfield/Rosenberg 2010: 31-32).

Finally, while the Baltic countries have essentially been treated in this article as representing one “ideal” type of a “flexible” market economy, it is worthwhile to point out certain differences among them. (Interestingly, the different performance of their economies during the crisis is compatible with the degree of their institutional coherence. To begin with, Estonia of the three Baltic countries seems to be the closest to the ideal type described in this article, as evidenced by its earlier and stronger commitment to economic liberalization and safeguarding the specific macroeconomic regime by sticking to budgetary discipline. Estonia, in contrast to Latvia and Lithuania, had accumulated fiscal reserves before the downturn, which allowed the country to deal with the crisis better in terms of restoring investor confidence and entering the eurozone. Of the three countries Latvia faced the biggest difficulties. At least two factors, both indicating a lower level of institutional coherence in Latvia, affected this outcome. First, Latvia's banking system was not as fully “outsourced” to Western banks. The domestically-owned Parex was a major player on the market, and its problems were crucial in forcing Latvia to ask for international financial assistance. In addition, while consensus behind fixed exchange rates has historically been very strong in all three countries and remained so during the crisis in Estonia and Lithuania, it weakened in Latvia, as politicians and economists started debating the wisdom of sticking to a fixed exchange rate in the face of such deep economic contraction (Kuokštis 2011: 81). A plausible reason for this is the fact that economic actors responded somewhat differently in these countries. The Latvian labour market was the most “overheated” before the crisis, and wage rigidity there was the greatest during the crisis: Some evidence suggests that labour costs in the Latvian private sector did not adjust as quickly as in Estonia and Lithuania (see Annex 2; Purfield/Rosenberg 2010: 24). Latvian employers preferred to lay off workers rather than reduce salaries, “while in the other two Baltics there appears to have been a greater preference to hoard labour or protect jobs at least at the margin” (Purfield/Rosenberg 2010: 24). In other words, this would suggest that Latvia did not respond as “flexibly” or “coherently” to the changes in economic conditions.

Conclusion

Before I draw conclusions, it is necessary to provide certain caveats. This paper has highlighted institutional complementarities and the self-enforcing nature of the Baltic politico-economic regimes. While recognizing these aspects, one should be careful not to identify functional business needs as the only 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, because 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. According to Bohle and Greskovits (2007: 450-452), the main driving forces behind the Baltic transition was the broad logic of state-building, identity politics and particular perceptions (overtly negative) of the Soviet past. Furthermore, in analysing the continuities of Baltic capitalism, it would be a mistake to neglect the role of politics. In fact, during the recent crisis the Baltics’ decision to defend exchange rate pegs and their ability to do so crucially depended on certain unique features of these countries’ social and political situation (Åslund 2010; Kuokštis/Vilpišauskas 2010). Inter alia, what supported the continuity of Baltic capitalisms is the weakness of the political left and a particular climate of ideas concerning macroeconomic and industrial policy.

Nevertheless, it can be argued that certain functional factors, such as the needs of firms operating in the Baltic countries, contributed to consolidating the existing system. The specifically Baltic production regime has a comparatively low-level need for social and industrial protection and private or public investment in education. Instead, there is a need for greater labour-market flexibility and general macroeconomic stability ensuring low public deficits and exchange-rate predictability. A specific “Baltic capitalism” can also contribute to explaining the successful Baltic strategy during the last crisis (as far as the defence of the currency peg is concerned). As for the question of origins, one must remember that at the core of insights on path-dependency lies the idea that the forces that create institutions do not necessarily have to be present for those institutions to continue to exist. Therefore, while political and ideational factors were arguably the main driver of the Baltics' 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 for the study of capitalist variety 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 complementarities at work. On the other hand, it speaks at the same time against a direct and strict application of the framework without its taking into account the specific effects at work in a given case.

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Annex 1. Comparative data on Baltic, Visegrád and selected Western-European countries

	Expenditure on social protection in % of GDP in 2008	State aid to industry and services as % of GDP in 2008 (excluding railways, agri-culture, fish-eries, transport and crisis measures)	SME share of employ-ment in non-financial business economy in 2005	SME share of value added in non-financial business economy in 2005	Union density rate (net union membership as a proportion of wage and salary earners in employment) in 2009
Czech Republic	18	0.78	68.9	56.7	17.3
Hungary	22.9	1.81	70.9	50.2	16.8
Poland	18.6	0.8	69.8	48.4	15.1
Slovakia	16	0.42	54.0	44.5	17.2 (in 2008)
Germany	30	0.57	60.6	53.2	18.6
United Kingdom	26.3	0.17	67.1	57.6	27.5
Ireland	22	0.38	67.5	58.2	36.6
Estonia	14.9	0.09	78.1	75.1	6.7
Latvia	12.7	0.53	75.6	71.1	14.8 (2008)
Lithuania	16.1	0.2	72.9	58.5	8.5

Sources: Column 1, 2: Eurostat, Columns 3 and 4: Schmiemann (2008: 3), Column 5: Visser (2011).

Annex 2. Baltic performance during the economic crisis

Real GDP growth in % change on previous year (forecasts for 2011 and 2012)

	2007	2008	2009	2010	2011	2012
Estonia	7.5	-3.7	-14.3	2.3	8	3.2
Latvia	9.6	-3.3	-17.7	-0.3	4.5	2.5
Lithuania	9.8	2.9	-14.8	1.4	6.1	3.4

Source: European Commission (2011: 206).

Exports of goods and services at current prices in % change on previous year (forecasts for 2011 and 2012)

	2007	2008	2009	2010	2011	2012
Estonia	3.7	0.6	-18.6	22.5	25.2	3.8
Latvia	10	2	-14.1	11.5	11	5.8
Lithuania	3.1	11.4	-12.5	17.4	12.2	6.3

Source: European Commission (2011: 228).

Current account balance in % of GDP (forecasts for 2011 and 2012)

	2007	2008	2009	2010	2011	2012
Estonia	-15.7	-9.1	4.6	3.8	3.1	1.5
Latvia	-22.4	-13.1	8.6	3	-0.4	-1.1
Lithuania	-15	-13	2.8	1.1	-1.7	-1.9

Source: European Commission (2011: 229).

Annual wage changes in the Baltic countries by sector in % change

Industry	Estonia		Latvia		Lithuania	
	2008	2009	2008	2009	2008	2009
Total economy	14	-5	21	-4	19	-4
Primary	18	-7	17	-5	23	-8
Industry	12	-4	13	-4	18	-4
Manufacturing	11	-4	20	-2	18	-4
Energy	17	7	6	-5	16	0
Construction	8	-13	19	-1	10	-21
Business services	12	-4	21	-2	19	-5
Public services	17	-5	20	-10	22	-11
Public administration	16	-8	16	-18	23	-10
Education	20	-3	23	-10	26	8

Source: Masso and Krillo (2011: 29).