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Varieties of Capitalism in the Baltics: A view from commercial banking

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Abstract. On this occasion to review the thirty years of transition, this short conceptual piece focuses on the theoretical framework of 'Variety of Capitalism' (VoC). Specifically, it comments on the perceived uniqueness of the Baltics within the VoC framework and highlights the 'missing pieces' – or shortcomings – in applying VoC to small- and medium-sized transition economies. It argues that, in absence of strong investment banking, the post-communist/socialist transition (or transformation) was largely realized and observed through commercial banking reforms, limiting the comparability between the Baltics and the United States or Germany (i.e. the original VoC typology). Thus, financial centre development (including labour market development for financial and business services) in capital cities may hold a key to understand the true 'varieties' among transitional/ transitioned economies. In this context, financialization in terms of gross value added and employment, foreign ownership in the banking sector, and corporate governance mechanisms are listed as suggestions for future empirical studies.

Varianten des Kapitalismus im Baltikum: Eine Betrachtung aus der Perspektive des kommerziellen Bankwesens

Anlässlich der inzwischen mehr als dreißig Jahre dauernden Transformation konzentriert sich dieses knappe konzeptuelle Werk auf den theoretischen Rahmen des ‚Variety of Capitalism' (VoC). Insbesondere berücksichtigt es den singulären Status der Baltischen Staaten innerhalb des VoC-Rahmens und hebt die Schwächen des Ansatzes bei der Anwendung auf kleine und mittelgroße Übergangsvolkswirtschaften hervor. In Abwesenheit starker Investmentbanken wurde die postsowjetische Transformation weitgehend durch Reformen im Bereich der Geschäftsbanken realisiert, was die Vergleichbarkeit zwischen den Baltischen Staaten und den USA oder Deutschland (also der ursprünglichen VoC-Typologie) einschränkt. Daher könnte die Entwicklung von Finanzzentren (einschließlich der Entwicklung des Arbeitsmarktes für Finanz- und Dienstleistungssektoren in den Hauptstädten) ein Schlüssel sein, um die tatsächlichen ‚Varietäten des Kapitalismus' in den Übergangs-Volkswirtschaften zu verstehen. In diesem Zusammenhang wird auf Finanzialisierung in Bezug auf Bruttowertschöpfung und Beschäftigung, ausländische Investitionen im Bankensektor und Mechanismen der Unternehmensführung als Anregungen für zukünftige empirische Studien verwiesen.

Keywords: Baltic Model, Commercial Banking, Economical Transition, Financialization, Market Liberalization **|** Baltisches Modell, Geschäftsbanken, Wirtschaftstransition, Finanzialisierung, Marktliberalisierung

1 Introduction

As we revisit post-communist/socialist transition (or transformation), we seem to increasingly encounter disheartening keywords, such as 're-nationalisation', 'state capture', and 'democratic backsliding'. Perhaps, we are no longer able to laugh like Drakulic (1992), while the regional differences in the transition identified by Aslund (2012) merely spell out different types of crises we are facing.[1] Yet, the process of democratization has always been intertwined with the market liberalization, and commercial banking (including retail banking, as opposed to investment banking) is a clear symbol to visualize the transition in everyone's daily life. Commercial banking is situated at the intersection between economic growth and socio-economic policymaking, while the sector is often dominated by foreign-owned banks, carrying another set of corporate cultural arrangements within their intra-firm office networks. In other words, commercial banking reforms and development inform us about the *experience* of the transition, supplementing the macroeconomic and socio-political narratives we are relatively familiar with.

Theoretically, this brief analysis traces the 'Variety of Capitalism' (VoC) framework. As Hall and Soskice (2001) highlighted in their introduction, the VoC framework focuses on the game-theoretical relationships between institutions and economic actors. Specifically, various institutional arrangements (e.g. regulatory environments, labour market conditions, capital market structures) exhibit a series of incentives to firms in terms of their locational decisions and strategic behaviours. In turn, their presence strengthens the said institutional arrangements as the economies of agglomeration are attributed to the comparative advantages. As the VoC framework gains popularity, observers and scholars began to ask which type of 'capitalism' transition economies belong to (or head towards). The comparison is done between the transition economy in question and the original VoC framework (i.e. the United States or Germany), between the regions within the transition economies (e.g. the Baltics vis-à-vis the Visegrád

1 Drakulic (1992): *How We Survived Communism and Even Laughed*; Aslund (2012): *How Capitalism Was Build: The Transformation of Central and Eastern Europe*.

four), or between the transition economies within the given region (e.g. Lithuania vs Estonia). In absence of strong investment banking, this paper argues that the comparability of post-communist/socialist economies within VoC is limited and calls for investigating financial centre development in their capital cities (including labour market development for financial and business services) as a core of VoC adaptation, especially in the Baltics.

Against this background, the rest of this paper is divided into three sections. First, it comments on a claim that the Baltics is a unique example within the VoC framework, referring to the literature. Second, it elaborates on the 'Baltic' model of VoC, especially on the difference within the region, and lists the limitations of such analysis from the banking sector point of view. The paper then concludes with suggestions for further empirical studies.

2 Regional differences in the VoC framework

The original VoC framework places the world between two extremes: the US-style Liberal Market Economies (LMEs) and the German-style Coordinated Market Economies (CMEs). As Hall and Soskice noted, these groups 'constitute ideal types at the poles of a spectrum along which many nations can be arrayed'.[2] In LMEs, actors interact in competition and formal contracting, and the market rhetoric (i.e. demand and supply) is a major coordination tool. In CMEs, actors cultivate and rely on non-market relationships to solve coordination problems, and their strategic interactions shape market dynamics. As also noted by Hall and Soskice (2001), both institutional arrangements as well as social arrangements (e.g. culture, customs, history) influence the placing of economies on the LME-CME spectrum. To interpret, the institutional 'legacy' of the communist regime (which assumed to be non-competitive and more 'coordinated') alone cannot explain the transition economies in terms of VoC, and the regional and national differences are often used as a reminder of their pre-socialist past.

Surely, the vast majority of reformers envisioned the transition towards the Anglo-American model of capitalism, but various non-market relationships differentiated "the *extent* to which capitalism has been constructed".[3] These relationships include not only the restored network of the diasporas and compatriots, but also the oft-corrupted informal regulatory arrangements for many econ-

2 Hall / Soskice (2001): "An introduction to Varieties of Capitalism", p. 8.
3 Lane (2007): "Post-state socialism: A diversity of capitalisms?", p. 21.

omies. The Baltic states alongside the Visegrád four have achieved a high degree of privatization (in comparison to the rest of the former Soviet Union countries and the Balkans), enabling the reformers to utilize the market mechanisms (e.g. investor ownership and corporate governance) as tools to reduce inefficient informal ways of coordination.[4] The results prompted, for example, Wrobel to ask, "why all three Baltic countries are so successful",[5] an owe echoed in the general socio-economic observations (e.g. Aslund, 2012).

While the LME-CME spectrum seems to be understood in a dichotomic manner when it comes to non-market relationships, market and regulatory relationships[6] increasingly show nuanced (i.e. non-dichotomous) development. Buchen (2007), for example, took an example of Estonia and Slovenia as extreme examples of LMEs and CMEs within transition economies, implying the rest situating somewhere between. Feldmann (2017) echoes such an observation from industrial relations point of view and links it to the resilience to external economic shocks. Whether the 2007/08 financial crisis or the European Sovereign Debt Crisis in 2010, financialized growth "was tied to some specific features within different economies rather than to one particular variety of capitalism".[7] Dixon (2011) reminds us that the VoC framework is firm-centric and yet its localised game-theoretical arrangements lead to methodological nationalism. Rather than focusing on the nationally attributed local socio-economic variance, investigating how firms perceive and strategise the financialisation phenomenon in each city may provide a more systematic (hence, universal) understanding to the varieties of or variegated capitalism(s).[8]

To take an example of the Baltics, the elements characterizing the Baltic model "do not seem to represent a contradictory 'mixture' of different models of capitalism", as Kuokstis has analyzed.[9] Unlike the Visegrád four[10] where the heavy foreign investments carry a layer of intrafirm hierarchies in addition to

4 cf. Hashimoto (2021): "The agency of reformers in new European financial centres".

5 Wrobel (2015): "From independence to the Euro introduction: varieties of capitalism in the Baltic States", p. 9.

6 e.g. state-industry and state-labour relations, see Cernat (2006): *Europeanization, Varieties of Capitalism*.

7 Myant / Drahokoupil (2012), p. 31.

8 Dixon (2011): "Variegated capitalism and the geography of finance".

9 Kuokstis (2011): "International integration, varieties of capitalism and resilience to crisis in transition economies", p. 7. See also Kuokstis (2018): Explaining National Preferences on the New European Banking Policy Framework: The Case of Lithuania (bendraautoris Marius Skuodis), in: *Journal of Baltic Studies* 49 (3), p. 351-369.

10 See Bohle/Greskovits (2007): "Neoliberalism, embedded neoliberalism and neocorporatism".

the competitive market relations among these foreign-owned firms, the Baltics (especially Estonia) remains close to LMEs in terms coordination mechanism. While the education in the Baltics focuses on general skills (much like LMEs), a low degree of investment in research and development reflects the SME-oriented local industry landscape with high labour-market flexibility. Highlighting the waves of state interventions and industrial policymaking, one can state that the Visegrád four are closer to CMEs (as the Baltics to LMEs). Therefore, the regional differences can easily be claimed to be a guiding concept in VoC. However, we can also state that these differentiations come from extrinsic attributes (e.g. foreign ownership) rather than the socio-economic intrinsic attributes the original VoC framework emphasizes.

In absence of strong investment banking in many transition economies, the game-theoretical relations between institutions and economic actors are limited to observe. Through investment banking, we can observe investor-investee coordination mechanism and corporate governance, as well as transfer of innovations and industrial policies. When we apply VoC to transition economies, we must be aware of this 'missing piece'.

3 The 'Baltic' model and the banking sector

The list of attributes presented by Kuokstis (2011) suitably summarizes the so-called 'Baltic' model. These economies focus on service and non-complex/non-resource-heavy light manufacturing sectors, and these sectors are dominated by small and medium-sized enterprises (SMEs). While the financial markets in general are underdeveloped in the Baltics, the causal relations can be observed in both ways: the underdeveloped equity finance markets limit the accessibility to capital, while the SMEs do not necessarily require a large amount of capital which the local loan and debt-finance markets can clear. Likewise, the demand for a large capital in research and development (as well as the supply) is weak, shifting the emphasis on commercial banking rather than investment banking. Relatively general (i.e. US-style) educational system allows the labour market to be flexible, while weak employee loyalty leads employers to reduce their effort to cultivate non-market relationships and to focus on tasks and projects which require less tacit knowledge (such as shared services). While many of these attributes – despite somewhat overgeneralized – place the Baltic economies closer to LMEs, the dominance of London/New York as global financial centres highlights the intertwined relationship between investment/equity markets and many attributes for LMEs and questions the categorization of the Baltics under LMEs.

Even within CMEs, the presence of investment banking is essential for the development of capital markets (and thus the whole corporate ecosystem). While the US-based investment banks, such as J.P. Morgan, Goldman Sachs, Morgan Stanley, Citi, Bank of America etc., are clearly at the top of the game, Frankfurt-based Deutsche Bank or Paris-based BNP Paribas and Société Générale closely follow. As these investment banks in CMEs seem to have general preferences towards shared ownerships and debt syndication as opposed to, for example, hostile takeovers, it would be more informative to observe investment banking activities to further analyze the characteristics of 'capitalism' within the VoC framework. In absence of such large investment banking activities, placing the Baltics within the LME-CME spectrum – or thinking of the 'Baltic' model – highlight the incomparability between the Baltics and the US/Germany in a meaningful sense and the local desire to be a part of 'capitalist family'.

Surely, it remains in the realm of speculation how each author from the transition economies is motivated to utilize the word 'capitalism' when they describe their own economies. However, when the general public sees the likes of Swedbank and Nordea, even though their main activities remain in commercial banking for a long time, it gives the impression that the local financial markets are well integrated to, for example, the Scandinavian markets and that any classifications in financial economy shall reflect such 'close' ties across the Baltic Sea. When the labour market also moves to this direction, for example, positively accepting the intra-office socio-cultural influence from the parent companies, then, various attributes characterizing two economies (i.e. the economy where the parent company is located and the economy where the subsidiary is located) began to be closer to each other on the LME-CME spectrum.

In other words, while the original VoC framework emphasizes on the socio-economic dynamics intrinsic to each economy as well as interactions between institutional/regulatory frameworks and firms' localization strategies, the VoC framework can be an effective tool to observe how transition economies reacted to the liberalization processes. At this stage, this reaction largely comes from the commercial banking sector.

4 Conclusion

On this occasion to review the thirty years of transition, this short conceptual piece[11] revisited the theoretical framework of 'Variety of Capitalism' (VoC). While it raises a doubt on the concept's full applicability in the Baltics due to the weak investment banking sector, it acknowledges how the presence of foreign-owned commercial banks makes VoC relevant. Institutionally, these banks bring another layer of coordination mechanism through their intra-office networks. Socially, the liberalisation of financial markets can be perceived as an integration (or threat thereof in case of scepticism) with the economies where the parent companies of these banks are located.

In this context, we can ask how important the financial sector in each economy is. For example, we can critically and periodically review the degree of financialization in terms of gross value added, sector employment, command and control, debt/equity balance (assuming the latter to have more corporate governance influence) and so on. The analysis on foreign ownership shall include the personal attributes of top managers (e.g. where they have been educated, where they have been posted previously). Investor activism and behavioural analyses of shareholder meetings are also essential. Case studies on hostile takeovers, analysis on general trust towards banks, and developments in financial literacy are some of the examples which gradually become available.

When our reformers faced the transition more than thirty years ago, their tasks spread from electoral reforms to judicial reforms, from price liberalization to monetary policies. Without combining our analytical efforts across disciplines, we cannot even scratch the surface of market liberalization, democratization, and post-communist/socialist transition/transformation.

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