From independence to the Euro introduction: varieties of capitalism in the Baltic States

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Abstract: The Baltic States, Estonia, Latvia and Lithuania, are very successful in transformation. From 1991 to 2015 they regained independence and transformed their economies from socialist central planning into functioning market economies, joined the EU in 2004 and became member of the Euro zone. Estonia introduced the Euro already in 2011 while Latvia followed in 2014 and Lithuania in 2015. Thereof follow two questions. First, why all three Baltic countries are so successful? And secondly, do we really find everywhere the pattern of the “Shining star” Estonia, followed by Latvia and at least Lithuania? According to modern Varieties of Capitalism theory all three economies can be classified as Central and Eastern European Countries in the style of Liberal Market Economies (CEEC-LME).

As can be shown, there are also differences in the institutional setups of all three Baltic States. During the period of transformation a pattern of Estonia followed by Latvia and at least Lithuania evolved which is also reflected by the sequence of joining Euro area. But institutional patterns are not determined in the long run. Since the crisis of 2008/09 the pattern within the Baltics changed. While Estonia remains on the first rank Lithuania overtook Latvia in terms of growth and wealth. Deregulation in Lithuania – which may be observed by the development of the Economic Freedom Index of the Heritage Foundation within the last ten years – may be the main reason. But also, the low sophistication of the Lithuanian banking system as well as Latvia’s massive suffering from the crisis may explain the last change of the pattern in the Baltics. There are several possibilities to illustrate the different paths of development of the Baltic States. While Geography Hypothesis is not able to explain the differences, the extractive political institutions in Estonia and Latvia can illustrate the lead of both countries in contrast to Lithuania till the crisis in 2008/09. Additionally, different basic values in all three Baltic States are responsible for the different developmental paths. They can also be traced back to the different history and culture of the three Baltic countries.

Keywords: VoC, Baltics, Estonia, Latvia, Lithuania, Euro introduction

JEL: P16, P20, P51

1. Introduction

The Baltic States, Estonia, Latvia and Lithuania, are very successful in transformation, but were starting from the scratch. Within a quarter of a century they regained independence and
transformed their economies from socialist central planning into functioning market economies. As result, all three countries were able to join the EU in 2004 together with five other Central and Eastern European countries. Additionally, after Slovenia and Slovakia they became member of the Euro zone within the last years, too. Estonia introduced the Euro already in 2011 while Latvia followed in 2014 and Lithuania in 2015. Nowadays, Estonia is the only Baltic State which is characterised as “innovation-driven” by the World Competitiveness Report 2014 – 2015 while Latvia and Lithuania remain between the status efficiency-driven and innovation-driven (World Economic Forum 2014: 11). Thereof follow two questions. First, why all three Baltic countries are so successful? Can we trace the fast development back to the introduction of inclusive political and economic institutions in the sense of Acemoglu / Robinson (2013)? And secondly, do we really find everywhere the pattern of the “Shining star” Estonia, followed by Latvia and at least Lithuania? And is this reducible the thesis of Hall / Soskice (2001) that consistent Liberal Market Economies (LMEs) as well as consistent Coordinated Market Economies (CMEs) are more successful than inconsistent types of economic systems? To answer these questions, first the transformation process as well as monetary and fiscal development in the three Baltic States will be described briefly, also focusing on the reactions on the economic crisis in 2008. Then, “Baltic Capitalism” as successful group of market economies will be described using Varieties of Capitalism (VoC) theory. Additionally, differences in institutional set-ups of all three Baltic States will be analysed according to Amable (2003). In the last chapter it will be tried out to find explanations for these differences beyond simple theory of institutions.

2. Transformation in the Baltic States

2.1 Introduction of political and economic institutions

In contrast to the other transformation states in Central and Eastern Europe all three Baltic States were fully incorporated into the Soviet Union till 1991. As result they were deprived of any autonomous institutions and had to build up their political and economic set-up from the scratch in the beginning of the 1990s. Till this time their trade was geared towards the East. But after regaining independence they chose to distance from Russian influence and direct their policies westward, largely following the liberal prescriptions of the Washington Consensus to
become open market economies. Thanks to strong political will and public support reforms in all
domains of institution building – from trade liberalization to privatisation – were really successful.
(Maslauskaite / Zorgenfreija 2013: 34 – 35) First free elections in Estonia brought a clear victory
for the liberal and nationalist parties in 1992. Therefore, first prime minister Mart Laar could start
transformation urgently and radically following liberal patterns. Since then a bipolar political
system developed without extreme parties which may be traced back to the fact that most of the
Russian speaking migrants from Soviet times were not granted with citizenship (Wrobel 2013: 27).
The first free elections in Latvia took place in 1993 but also here the Russian speaking
population was mostly excluded as migrants. Because of huge migration during the Soviet period
Latvians got near-to-minority status in their own country (Norkus 2012: 203). Still in 2010 15.5
% of the population could not participate in the political process because they were not granted
with Latvian citizenship. Additionally, Latvia suffers from weak political parties and power of
oligarchs who dominate political parties (Matthes 2013: 52 – 54). In Lithuania citizenship was
granted to the whole population independent from their nationality but Russian speaking minority
is quite unimportant compared to Estonia or Latvia while the Polish minority must be mentioned,
too. Surprisingly, in the first free elections in Lithuania in 1992 the Post-Communist won and got
power again. At that time that was unique in Europe and slowed down the process of
transformation (Winkelmann 2013: 85).

Remarkably, the first Estonian government implemented measures of market reform
policy that surpassed the demands of all international organisations in its radicalism. For
instance, Estonia abolished all import duties in the year 1992 for what reason it had to implement
them again during EU accession. In contrast, Lithuania and Latvia implemented comparable
measures only under the pressure of international financial organisations later and less
consequently (Norkus 2012: 211). Estonia privatised the state owned enterprises mainly by
selling them to national or international investors. To achieve best results a privatisation agency
was founded following the German model and using tenders (Wrobel 2011: 40). In contrast,
privatisation in Latvia and Lithuania was mostly organised as mass or voucher privatisation
(Buchen 2010: 76). Latvia finished this process in 2006 while some large enterprises like
Lattelecom stayed as state-owned (Matthes 2013: 67). In Lithuania especially a law forbidding
disposing land property to foreigners made the country unattractive for foreign direct investors
As result, FDI flew mainly into Estonia which received most FDI per capita within the Baltics.

![Fig. 1: Inward FDI stock as % of GDP 2011](image)

Source: Estonian Chamber of Commerce and Industry.

Estonia was the first of the Baltic States to introduce an own currency, the Estonian kroon, already in 1992. In the same year, Latvia achieved to bring hyperinflation under control, too. Lithuania only achieved this in 1993/94 with the active help of IMF and World Bank who controlled the economic policy in Lithuania during this time (Norkus 2012: 211). While Estonia introduced a Currency Board at the same time when the Estonian kroon was introduced Latvia pegged its new currency, the Lats, first to the SDR of the IMF, and in 2005 to the Euro (Schrader and Laaser 2014: 13). Lithuania introduced the Litas in 1993 and adopted a currency board arrangement in 1994, pegging the Litas first to the US dollar and since 2002 to the Euro (ECB 2014: 121). At all one can say that Estonia preferred shock therapy while Lithuania was characterised by gradual market reforms. As consequence of these diverging paths of economic policy Estonia was the only country from Central and Eastern Europe which was able to join the EU in 2004 without any transition periods. While Estonia became the “shining star” of the Baltics, Latvia’s and Lithuania’s performance was positioned between medium reformers and laggards for years (Norkus 2012: 211 - 212). However, finally all three Baltic States managed their transformation process quite well and developed to “Baltic Tigers”.
2.2 Between EU-membership and crisis in 2008

The mid-2000s were the “Golden Age” of the Baltic Tigers. In 2004 they joined the European Union. In the following years the economies were growing at the spectacular pace of more than 10% (see Figure 3) and the GDP per capita in PPS reached a level of 60 to 68% of EU-28 (see Figure 2). By this way, between 2000 and 2008 the levels of national real wealth more than doubled. Due to the well-educated labour force and the low capital endowment all three countries possessed an “ample room for restructuring”. Pegged exchange rates as well as the EU membership provided the required credibility. As result large capital inflows followed (Maslauskaite / Zorgenfreija 2013: 35). In comparison, Estonia was the forerunner within the Baltics while Lithuania followed and Latvia left behind. Also nowadays, Latvia is the poorest country of the Baltics while its catching-up is as impressive as of the other Baltic States (Schrader / Laaser 2014: 5).

* PPS = Purchasing Power Standards

Source: Eurostat

But the positive developments of these years were accompanied by a significant build-up of macroeconomic imbalances like housing booms and losses of international competitiveness in terms of labour costs (Kuokštis 2012: 13). The causes were several: Firstly, the financial sector was completely liberalised and overtaken by Nordic Banks in all three countries. Secondly, the
Baltics became very attractive for foreign investment quickly which was added to a consumption boom. Thirdly, wage growth outpaced productivity gains (Maslauskaite / Zorgenfreija 2013: 36-38). The crisis hit first Estonia and Latvia in 2008 with negative growth rates of -5.0 % respective -2.1 % while Lithuania faced a slowdown of its growth with + 3.7% only. But in 2009 all three Baltic States had to suffer from their openness and their liberal policies. Output losses reached between -12.8 % and – 14.6 % in Latvia respective Estonia (see Figure 3).

The three countries differed in terms of the severity of the crisis. While Estonia was able to recover urgently, especially Latvia suffered from a necessary bail out of one of the largest domestic banks (Parex Bank). Therefore, the fiscal situation in Latvia was the worst among the Baltics. In contrast, Lithuania which was hit later had no systematically important banks to save. But all three Baltic States reacted with internal devaluation (in contrast to external currency devaluation) that consisted of both expenditure cuts and revenue increases. Additionally, several types of external help were provided by the EU and Nordic countries. The institutional changes in Lithuania were less drastic than in Latvia. Also, Lithuania introduced more stimulus measures than the both other Baltic States. In this way, the Lithuanian economy could be put on a more sustainable path (Maslauskaite and Zorgenfreija 2013: 45-48). However, since the crisis all three
Baltic States suffer enormously from emigration of young and well educated workforce to Western Europe.

Reasons for the different recovery in the Baltics can also be seen in the different political situations. While in Latvian policy was influenced by interest groups, including strong links between politicians and business as well as an increasing number of corruption scandals, in Lithuania the conservative cabinet which took power in 2008 remained in power for the full term of parliament for the first time since independence. Even, in Estonia the political situation during the crisis was most stable because here the traditional socio-political cleavages based on left and right do not exist. Therefore, also in 2011 and 2015 the ruling liberal Reform Party was re-elected (Dudzińska 2013: 3). Currently, all three Baltic States are better off than other South European countries like Spain or Greece because they made structural reforms and believed in austerity.

2.3 The way to the Euro introduction

One cornerstone of the economic policy in all three Baltic States has been the maintenance of the fixed exchange rate and the goal of Euro zone entry as soon as possible. Like all other applicants also the Baltic States had to fulfil several criteria. Firstly, inflation was benchmarked against the three best performing countries in terms of price stability. Secondly, fiscal discipline was necessary, defined as no “excessive deficit” of more than 3 % of GDP as well as a debt-to-GDP-ratio of less than 60 % of GDP. Thirdly, the exchange rate had to be stable, defined as national currency joining ERM-II for a minimum of two years successfully. And last but not least, long-term interest rate had to be on a low level, too (Darvas 2009: 11).

Reasons for the Baltics interest in becoming member of the Euro area can be divided into historical / geopolitical and economic ones. From a historical and geopolitical point of view we have to state that all three Baltic States wanted to turn away from its enforced eastwards orientation under more than 45 years of Soviet oppression. All three Baltic peoples feel as part of Europe rejecting their incorporation into the Soviet empire. Therefore, for all Baltic governments keeping their countries independent from Russia is of highest interest. As result, the incorporation into Western political as well as economic structures – like EU, NATO and Euro area – is very important (Wrobel 2011: 39). Especially in 2014 Estonia and Latvia felt threatened by Russian manoeuvres at their borders because of the crisis in Ukraine. But economic reasons
are important, too. While all three Baltic States decided to peg their currencies to the Euro no single monetary policy was possible. Therefore, it is advantageous to participate in the common monetary decision making process than depending on it without any influence. Additionally, joining the Euro would have beneficial effect on the banking system because access to ECB liquidity will be granted, too. And last but not least, membership in the Euro area will imply significantly lower interest rates for public as well as private borrowing (Wolff 2012: 5).

Already in 2006, Lithuania almost managed to fulfill all Euro convergence criteria, except the first. Only inflation exceeded the norm by 0.1 %. As result, the country was not accepted into the Euro area (Norkus 2012: 204). Then, in 2008/09 the financial and economic crisis threw back all three Baltic States in their efforts to join the Euro. But already two years after the crisis Estonia was the first Baltic country which was able to introduce the Euro. As the ECB mentioned in its Convergence Report 2010 consumer price inflation in Estonia has been very volatile till 2009 while it fall strongly to 0.2 % in this year. Because of its balanced budget rule the country was not subject of an EU council decision on the existence of an excessive deficit which was 2.0 %, well below the reference value. Additionally, the debt-to-GDP-ratio was 7.2 % of GDP, far below the 60 % reference value. Because of the Currency Board the Estonian kroon has been participating in ERM II since 2004 remaining stable in the two-year reference period. At all, in 2009 Estonia managed a pronounced turnaround in economic activity (ECB 2010: 42-47). One reason for this fast recovery and the urgent introduction of the Euro after overcoming the crisis was the functioning of the Estonian Balanced Budget Rule which enforced the Estonian government to save surpluses. By several surpluses in the years before the crisis Estonia was able to cover the deficits within the crisis partly. Thereby the country was able to fulfill the criteria for the Euro introduction. In contrast, Latvia did not achieve budget surpluses (Schrader and Laaser 2014: 9). Therefore, Latvia suffered from the crisis also in 2009/10. While the country fulfilled the criteria on price stability and debt-to-GDP-ratio etc. the public deficit in the reference period was 9.0 % of GDP. As the Convergence Report mentions “the Latvian economy experienced a deep crisis. In particular in late 2008 and early 2009 macroeconomic conditions weakened abruptly.” Also Lithuania was subject to an EU Council decision on the existence of an excessive deficit which amounted of 8.9 % of GDP at that time. Also long-term interest rates were above the reference value (ECB 2010: 42-47). The development of general government deficits and
surpluses are shown in Figure 4 while the general government consolidated gross debt is illustrated in Figure 5.

![Fig. 4: General government deficit (-) and surplus (+)](chart)


Till 2013 the economic and fiscal position of Latvia improved remarkably. The country introduced some austerity policy with great success according the state budget and other macroeconomic data but with huge costs by cuts of social services. As result Latvia is the country of the EU with the lowest spending on social issues (Schrader and Laaser 2014: 10-12). In the reference period of 2012 the public deficit amounted for 0.8 % of GDP (estimated 1.2 % in June 2013) well below the reference value. Also the other conditions for the introduction of the Euro were fulfilled in the reference period. But one has to mention that general government gross debt-to-GDP-ratio was 40.7 % in Latvia in 2012 (ECB 2013: 35-37). This is a lot compared to Estonia with less than 10 %. (see Figure 5) But as result Latvia was able to introduce the Euro by 1st of January, 2014 (Schrader and Laaser 2014: 3). Although the Lithuanian government declared its willingness to introduce the Euro in 2015, to an extend it was less visibly interested in the common currency than Latvia and Estonia were (Dudzińska 2013: 6). But in the reference period from May 2013 to April 2014 also Lithuania fulfilled all criteria for the introduction of the Euro. For instance, public deficit dropped from 9.4 % in 2009 to 2.1 % in the reference period. The
debt-to-GDP-ratio increased cumulative by 20.1 % between 2004 and 2013, decreasing gradually until 2008, rising sharp in 2009/10 before declining somewhat in 2013 to less than 40.0 % (ECB 2014: 121). Therefore, also Lithuania was able to introduce the Euro in the beginning of 2015.

Fig. 5: General government consolidated gross debt
(in % of GDP, 2012 and 2013)

3. Baltic Capitalism as success model?
3.1 Baltic Capitalism within a VoC approach

All three Baltic States introduced functioning market economic systems during the last two and a half decades. But how can they be described? What are their commons, what are the differences? To answer these questions theory of “Varieties of Capitalism” will be used. Several models of capitalist variety were established during the last decades. A first one-dimensional approach was presented by the French author Michel Albert. In his “Capitalism against Capitalism” Albert (1993) distinguished Rhineland capitalism, led by Germany and Japan, and the Anglo-American model, with France sitting on the fence. But the most influential approach was presented as collective volume edited by Peter Hall and David Soskice (2001): “Varieties of
Capitalism: the Institutional Foundations of Comparative Advantage”. Especially in the book’s introduction both developed a conceptual model of capitalist variety, which distinguishes two different coordination regimes that vary systematically across countries. Hall and Soskice (2001) focus on five subsystems (industrial relations, vocational training and education, corporate governance, inter-firm relations, relationship with employees) demonstrating how in different types of capitalist systems coordination problems are solved. In this way they are highlighting the way different institutional spheres are interacting. At one end of the spectrum there are Liberal Market Economies (LMEs) and on the other end Coordinated Market Economies (CMEs). While the LMEs use markets as their main means of coordinating economic activity, CMEs rely more on non-market institutions to solve coordination problems of society. While the LMEs consist of the six Anglo-American countries including Ireland, CMEs include Germany and its smaller neighbours (the Netherlands, Belgium, Switzerland, and Austria) as well as Scandinavia and Japan. Thereby, Germany is the paradigmatic case of CME for Hall and Soskice (2001). While LMEs are characterised by small governments, low regulations, more innovative capacity but high inequality, CMEs can be described by big governments, high regulations, less inequality and innovative capacities (Continental types) or big government and low regulation as well as high innovative capacity and less inequality (Nordic Social-democratic types) (Ahlborn et al. 2014: 22-23). While both types of market economies have adjusted in the last decades they did not converged. Each regime has largely maintained its peculiarities what confirms Hall and Soskice’s hypothesis that institutional convergence will be improbably. Additionally, VoC theory predicts that mixed systems are less advantageous than typical LMEs respective CMEs (Kuokštis 2012: 19).

But the dualist approaches seem to be too simple to form concrete groups of countries as ideal types. Therefore, in this paper the author follows the most sophisticated approach by Amable (2003), who is using factor-analytical econometric techniques on a large set of macroeconomic variables to distinguish five types of market economies. Amable’s quantitative data are on a vast range of characteristics, e.g. product and labour markets, financial, social and educational system, etc. The results of his analysis are five groups of countries: Market-Based Economies, Social-democratic Economies, Continental European Capitalism, South European Capitalism and Asian Capitalism:
(1) Market-Based Economies: This group consists of the six English-speaking countries including Ireland which are characterized by a non-involvement of the state in product markets and coordination through price signals. They are open to foreign investment and competition. Financial markets are highly sophisticated. Here exists only a low employment protection but flexible labour markets. The social protection systems are weak and public expenditures for education are low. They are adequate to Hall and Soskice (2001) LMEs.

(2) Social-democratic Economies: To this group belong all Scandinavian countries which are characterized by a high involvement of the state in product markets and a high degree of coordination through channels other than market signals, but also by openness to foreign investment and competition. The financial markets are not sophisticated. Employment protection is moderate and wage bargaining is centralised coordinated. Social protection is on a high level, also public expenditure for education.

(3) Continental European Capitalism: Germany and its direct neighbours build an additional group. In this case public authorities are involved into the product markets and the non-price coordination is on a high level. A low degree of protectionism against foreign competitors and investors is discriminatory, too. Financial markets are only low sophisticated. High employment protection is combined with low labour market flexibility and active employment policy. Social protection is on a high level, also public expenditure for education.

(4) South European Capitalism: While Amable (2003) describes France as ambiguous, others add it to the Mediterranean group which – as a result - consists of the Romance and Greek speaking countries as well as Malta. This model consists of involvement of the state into the product markets and a little non-price coordination. Protectionism against foreign competitors and investors is moderate. Small firms are dominating. Sophistication of financial markets is low. Furthermore, a moderate level of social protection is combined with low public expenditures for education.

(5) Asian Capitalism: Amable’s group of Asian capitalism consisted of the OECD countries Japan and South Korea, only. This model is characterized by a high involvement of the state in the product markets and a high degree of non-price coordination. Protectionism against foreign competitors and investors is on a high level. Sophistication of financial markets is low. Also the level of social protection is low as well as public expenditures for education.
Additionally, we can describe two more types of capitalism in Central and Eastern Europe. Concerning transition to VoC-prototypes of transformation countries it must be kept in mind that developed economies already reached a level of development at which they are only able to improve their performance by exploiting institutional complementarities while transformation countries may achieve a better economic performance through an increase in the quality of institutions. In this way, transformation countries may develop to a hybrid type of market economy possibly converging to an ideal type of market economy with complementary institutions (Ahlborn et al. 2014: 4). Another explanation was provided by Nölke and Vliegenthart (2009) who claim that transformation has come to an end in most of the transformation countries by establishing a third variety of capitalism characterised as (external) Depending Market Economies (DME) in contrast to LMEs and CMEs. As they show some transformations countries lean towards the CME type and others towards the LME type. They argue that a mix of skilled labour as well as a transfer of technology from abroad basically by FDI allows to define an own model.

The results of Nölke / Vliegenthart (2009) were confirmed by Bohle / Greskovits (2012) who distinguish between the Baltic States which are labelled as nation builders and neoliberals, the Visegrád group (Poland, Czech and Slovak Republic, Hungary) basing on a manufacturing miracle but already burdened by welfare state problems as well as neo-corporatist, weak states in Southeast Europe (Romania and Bulgaria). Quite similar are the results of cluster analysis by Ahlborn et al. (2014) who define two new types which may be added to the five basic types of advanced market economies:

(6) Central and Eastern European Countries / Liberal Market Economies (CEEC-LME), mainly the Baltics as well as Bulgaria and Romania, and
(7) Central and Eastern European Countries / Coordinated Market Economies (CEEC-CME), mainly Visegrád countries and Slovenia.

As they mention most stable clusters are both the traditional LMEs (as defined by Hall and Soskice (2001) as well as by Amable (2003)) and the CEEC-LME, mainly the Baltics. There is also little evidence that the CEECs constitute a new model similar to the Mediterranean type of capitalism. Within both CEEC groups this evidence is most consensual in the VoC literature for Slovenia as CEEC-CME and Estonia as CEEC-LME (Ahlborn et al. 2014: 12-17). Both transformation states are as successful as their models, LMEs and CMEs (see Figure 6). But both
are associated with opposing approaches to the transformation process. While Estonia is commonly seen as radical reform (shock therapy), Slovenia’s way of reform was more gradual and slow (Buchen 2010: 44). Therefore, it is not surprising that EBRD in its Transition Report 2013 states Estonian and Slovenian institutions as the best in Central and Eastern Europe (see Figure 6). As result, the three Baltic States can be seen as single group within VoC approach in contrast to Visegrád countries as CEEC-CME but with huge similarities to Romania and Bulgaria. Thereby, many features make them affine to LMEs.

**Fig. 6: Measures of economic institutions 2011**


### 3.2. Varieties of Capitalism within the Baltic States

While both patterns of transformation – shock therapy and establishment of an LME-type economy in the Baltics as well as gradualism and establishment of a CME-type economy in Visegrád countries and Slovenia – are very successful examples of transformation also differences within these groups must be possible to be explained by the theory of VoC. According to the VoC prediction that mixed systems are less advantageous than typical LMEs respective CMEs Estonia was more successful than Lithuania for a long period. (Kuokštis 2012: 19.) Therefore, the degree of liberalism should be able to explain the differences in economic success of the three Baltic States. As already mentioned, following Amable (2003: 104 - 106) we
can distinguish types of market economies which can be defined by the following characteristics: (1) product market competition, (2) wage labour nexus, (3) financial sector, (4) social protection, and (5) education. These characteristics can also be applied to the Baltic countries as CEEC-LMEs.

According to product market competition one has to analyse the degree of coordination by price signals as well as the openness to foreign competition and investment. As Table 1 shows Estonia is leading in both, goods market efficiency and trade openness, within the Baltics. With 171 % trade of GDP it is more open than both other Baltic States (Lithuania: 156 % and Latvia 122 %) but also much more open than Continental European Capitalism in Germany, Nordic Social-democratic Sweden or the Market-Based UK. But the goods market efficiency in these developed market economies – led by the UK – is higher than in the Baltics at all, while Estonia is only 0.1 score or 7 ranks far away from Germany, followed by Latvia and Lithuania.

**Table 1: Goods market efficiency and openness to trade in 2013**

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank (out of 144)</th>
<th>Score (1 – 7)</th>
<th>Trade* (% of GDP)</th>
</tr>
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<tbody>
<tr>
<td>Estonia</td>
<td>26</td>
<td>4.9</td>
<td>171 %</td>
</tr>
<tr>
<td>Latvia</td>
<td>36</td>
<td>4.7</td>
<td>122 %**</td>
</tr>
<tr>
<td>Lithuania</td>
<td>47</td>
<td>4.6</td>
<td>156 %**</td>
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<tr>
<td>Germany</td>
<td>19</td>
<td>5.0</td>
<td>85 %</td>
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<tr>
<td>Sweden</td>
<td>17</td>
<td>5.0</td>
<td>83 %</td>
</tr>
<tr>
<td>UK</td>
<td>13</td>
<td>5.2</td>
<td>62 %</td>
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* Trade is the sum of exports and imports of goods and services measured as a share of gross domestic product.  
** in 2011  

In Estonia, no significant attempts to cooperate “beyond the market” were made because of encompassing business organisations (Buchen 2010: 53). In contrast, business in Latvia is characterised by oligarchs with strong relations between politics and business as well as by a high degree of corruption. The openness to trade was supported by the macroeconomic stability by currency boards respective currency pegging. Here also Estonia was the model later copied by Lithuania and Latvia, too. Together with opening for FDIs this monetary discipline brought down inflation urgently and created opportunities for international trade, especially in Estonia. Until now, Estonia is the most successful receiver of FDI in the Baltics (see Figure 1). At all,
Macroeconomic stability was the chief advantage of the “neoliberal” Baltic Capitalism. But Latvian stabilisation policy was not so resolute like in Estonia. Also other market reforms were even slower and less consistent than in Estonia or Lithuania. Therefore, after one decade of transformation key economic indicators in Latvia were not superior to those in Lithuania. On the other hand, the Lithuanian Right did not behave so consequently like their counterpart in Estonia (Norkus 2012: 221).

Relative to the wage labour nexus one has to observe the differences between liberal “hired and fired” and employment protection as well as coordination of wage bargaining. In all three Baltic countries labour markets are very flexible. Foreign direct investors can leave the country without barriers and domestic entrepreneurs can cut wages easily or liquidate business (Kuokštis 2012: 25). As Table 2 shows flexibility of wage determination is worldwide on the highest level in Estonia, followed by Latvia on rank 6 and Lithuania on rank 8. This is quite similar to the situation in the Marked-Based UK with rank 10. Therefore, it is quite clear why the Baltics can be described as CEEC-LMEs in comparison to CMEs like Germany or Sweden holding ranks 136 respective 134. The reason is a quite small degree of unionising of workers in the Baltics. For instance, in Estonia from 1990 to 2000 the percentage of unionised workers dropped from 93 % to 14 %. By bipartite or tripartite agreements only working conditions and minimum wages are negotiated (Buchen 2010: 45).

### Table 2: Flexibility of wage determination in 2013

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<tr>
<td>Latvia</td>
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<td>6.0</td>
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<tr>
<td>Lithuania</td>
<td>8</td>
<td>6.0</td>
</tr>
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<td>Germany</td>
<td>136</td>
<td>3.4</td>
</tr>
<tr>
<td>Sweden</td>
<td>134</td>
<td>3.6</td>
</tr>
<tr>
<td>UK</td>
<td>10</td>
<td>5.8</td>
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Also during the crisis of 2008/09 firms in the Baltics were able to cut spending and salaries as well as liquidate their businesses. Moreover, enterprises were able to redirect their sales to new markets which enabled the Baltics to rebound their exports urgently. The absence of powerful labour unions enabled firms and the government to adjust nominal wages downward.
relatively smooth in both sectors, the private as well as the public one. Additionally, low unemployment benefits meant that state budgets were less burdened than otherwise would have been the case (Kuokštis 2012: 26).

In Market-Based Economies (LMEs) the financial sector is well developed. Financial markets are sophisticated. But in comparison to developed LMEs (and also to developed CMEs) in CEEC-LMEs like the Baltic countries the financial sectors are quite underdeveloped (Norkus 2012: 253). Within the Baltics it must only be mentioned that Estonia has one of the highest stock market capitalisation rates among the new EU member states (Buchen 2010: 49). This can also be shown by the ranks respective scores for financial market development measured for the World Competitiveness Report of the World Economic Forum. As Table 3 indicates within the Baltics Estonia’s financial markets are most developed followed by Latvia and Lithuania backmost. But in comparison to developed market economies like the UK (LME) or Sweden (CME-Nordic) and Germany (CME-Continental) all three countries suffer from an underdeveloped financial sector.

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<tr>
<td>Estonia</td>
<td>29</td>
<td>4.7</td>
</tr>
<tr>
<td>Latvia</td>
<td>33</td>
<td>4.6</td>
</tr>
<tr>
<td>Lithuania</td>
<td>65</td>
<td>4.1</td>
</tr>
<tr>
<td>Germany</td>
<td>25</td>
<td>4.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>12</td>
<td>5.2</td>
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<tr>
<td>UK</td>
<td>15</td>
<td>5.1</td>
</tr>
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In Market-Based Economies (LMEs) the level of social protection is quite low compared to CMEs (Continental European Capitalism as well as Social-democratic Economies). But according to social protection the three Baltic countries are actually more liberal than developed LMEs. For instance, unemployment benefits as percentage of GDP stand at 0.17 % in the UK but only at 0.02 in Estonia (Kuokštis 2012: 21). As Figure 7 shows expenditure on social protection is quite low in all three Baltic States while Estonia spends continuously more Euros per inhabitant than Latvia or Lithuania.
As result, according to Eurostat inequality of income is biggest in Latvia and Lithuania with Gini coefficients at 35.2 respective 34.6 while Estonia ranks 32.9 in 2013. Within the EU this is surpassed only by another CEEC-LME, Bulgaria with 35.4. Average of EU-28 is 30.5 while Nordic countries like Sweden rank at 24.9 or Central European like Germany at 29.7.

Last but not least, following Amable (2003) Market-Based Economies are characterised by low public expenditures for education while the Continental European Capitalism as well as Social-democratic Economies spend a lot of money for the educational sector. But an analysis of data provided by the World Bank does not show this pattern at all (see Table 4). As one can observe the public spending on education in percent of GDP is on the same level in all three Baltic States. In comparison to other “typical” countries we have to emphasize that Sweden as Nordic “Social-democratic Economy” spends continuously more for education but Germany as typical CME spends less. At all, spending of all Baltic States is on the level of the UK between Germany and Sweden.

**Table 4: Public spending on educational institutions as percent of GDP**

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</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>4.8</td>
<td>5.0</td>
<td>5.0</td>
<td>4.8</td>
<td>4.6</td>
<td>..</td>
<td>4.5</td>
<td>5.3</td>
<td>5.8</td>
<td>5.4</td>
<td>4.9</td>
</tr>
<tr>
<td>Latvia</td>
<td>5.0</td>
<td>5.3</td>
<td>4.9</td>
<td>4.7</td>
<td>..</td>
<td>4.8</td>
<td>4.8</td>
<td>5.5</td>
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<tr>
<td>Lithuania</td>
<td>5.5</td>
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<td>Germany</td>
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<tr>
<td>Sweden</td>
<td>6.0</td>
<td>6.4</td>
<td>6.3</td>
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<td>6.1</td>
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<td>6.1</td>
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<tr>
<td>UK</td>
<td>4.5</td>
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<td>4.0</td>
<td>3.9</td>
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<td>4.4</td>
<td>4.7</td>
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To summarise, we have to state that Estonia is not more the only “shining star” in the Baltics. Also Lithuania achieved a level of wealth of 73 % of EU-28 average in 2013. But Estonia led the Baltics till the crisis in many criteria. Nowadays, the data is a little bit different. Therefore, can Estonia’s success be explained by its more liberal economic system? Partly, yes. Estonia is leading within the Baltics concerning a functioning coordination by prices. Within the Goods Market Efficiency Index 2013 Estonia holds rank 26 worldwide, while Latvia and Lithuania are on ranks 36 respective 47. Also according to openness to trade Estonia holds the first rank in the Baltics with trade of 171 % of GDP in the same year while here Lithuania follows with 156 % and Latvia with 122 % at least. Also according to flexibility of wage determination Estonia is most liberal within the Baltics. The country holds rank 1 worldwide but Latvia and Lithuania follow on ranks 6 respective 8. So far, all three Baltic States can be described as LME-types. Only according to financial market development one has to state a typical CEEC underdevelopment. But also here Estonia leads with rank 29, followed by Latvia and Lithuania with ranks 33 respective 65. Maybe here we find a first possible explanation for Lithuania’s catching-up after the crisis. With a less developed financial sector it was less hit by the financial crisis and could recover faster than both other Baltic countries. Relative to expenditures on social protection the level in all three Baltic States is quite low compared to the developed economies in Europe. But since the beginning of the new millennium expenditures in Euros per inhabitant are higher in Estonia than in both other Baltic countries. Since EU membership in 2004 they are rising in all three Baltic States, too. According public spending on education one can summarise that all three Baltic States spend as much money like the LME UK.
At all, Estonia seems to be the best performer in the Baltics until now but since the crisis fast followed by the catching-up of Lithuania. While it seems that the crisis made a disadvantage of the Lithuanian economic regime with its gradualism and lesser degree of openness and economic freedom an advantage it must be stated that Lithuania outrun Estonia in terms of liberalism in the last years, overtaking Latvia since the beginning of the new millennium. As the Heritage Foundation observed Lithuania’s economic freedom achieved the Estonian level of 76.8 score points nearly in 2015 with 74.7 score points while Latvia 69.7 remained with score points far away from that. (see fig. 8) Maybe, this success can be traces back, firstly, to EU accession in 2004 but also to the reform and deregulation policy of the conservative-liberal government of Andrius Kubilius 2008 till 2012. However, Lithuania was able to manage the crisis with a flatter recession than in the other Baltic States.

3.3 Explanations beyond institutional analysis
3.3.1 Explanations for similarities of “Baltic Capitalism”

The main driving force behind the liberal Baltic transformation was the broad logic of state-building, identity politics and particular perceptions of the Soviet past. This is what explains the divergence of the Baltic and Visegrád types of capitalism, despite similar structural background conditions (Kuokštis 2012: 27). Especially because of their common history as by the Soviet Union occupied nations all three Baltic States tended to Western integration to keep their independence from Russia (Schrader and Laaser 2014: 3). As result, all three Baltic nations share narratives about the Baltic States as victims of Soviet aggression ending the first period of independence between World War 1 and 2 and nowadays defending Western civilization from authoritarian and aggressive Russia as Eastern border bastions (Norkus 2012: 203). Additionally, currency stability was a symbol of the newly established independence. Therefore, it was of highest priority for all three Baltic States (Szanyi 2011: 8). Also the small size of territory and population is a common characteristic of all three Baltic States. Therefrom it can be explained why all three countries chose openness and export orientation to manage the transformation process.

As Bohle and Greskovits (2007) argue the Baltics were able to run an extreme neoliberal model only because these countries concentrated policies on macroeconomic stability which was a sign of vitality after breaking the ties with the Soviet Union and Russia. Although these policies had extremely high social costs political stability was not challenged because majority of the losers of the system change were industrial workers from the Russian speaking minorities. Many of them did not have citizenship and as result could not dissent via the election process. In contrast, in Visegrád countries dissent of the population had to be taken into consideration of the politicians deciding for a more gradual approach of transformation. Basically this argument seems to be suggestive but it fits only for Latvia and Estonia because Lithuania granted citizenship to the whole population after independence. Therefore, it must be asked what explains the differences within the Baltics? Different institutions and different paths of transformation must have reasons away from economics. Arguments can be found by applying several theories of institutional change.
3.3.2 Explanations for differences in the Baltics

3.3.2.1 Geography Hypothesis

One widely accepted theory of the causes of world inequality is the geography hypothesis. Following this theory the great gap between rich and poor countries is created by geographical differences (Acemoglu and Robinson 2013: 48). But can this theory be applied to the Baltics? Firstly, one can imagine that Estonia has an obvious economic advantage due to its geographical proximity to Finland. But Finland was in deep recession in the early 1990s, suffering from the dissolution of the Soviet economic world. Therefore, the country could not support Estonia in its most important years of transformation. During its transformation Estonia became only an attractive place for Finish weekend shopping tourists. Which seems to be more important is that already in Soviet times Northern Estonians could watch Finish TV. Taking into consideration that Estonians understand Finnish because of the similarity of both languages, Estonia was less separated from the Western world than other parts of the Soviet Union. This makes the situation in Estonia comparable to that in the GDR where nearly all citizens watched West German TV to be informed about Western institutions, products and level of development (Lepp and Pantti 2012). Additionally, Estonia and Latvia could also profit more from the role as offshore and a transit country for Russian capitalism than Lithuania.

But as Norkus (2012: 213-214) mentions doubt remains whether these differences are sufficient to explain the variation in the economic performance in the three Baltic States. As he points out one can find more geographical similarities than differences: all three countries are located in the same climate zone and have rather similar endowments with natural resources, especially timber. The only important difference is oil shale mining in Northeast Estonia. But taking into consideration given world prices for energy in the 1990s and environmental pollution oil shale mining has to be seen as a liability more than an asset for the Estonian economy. But if, as Acemoglu and Robinson (2013: 49) pointed out inequality cannot be explained by “any version of the geography hypothesis” at all is questionable, too. Different economic-geographical situations were given in the Baltics by existing industries. While Lithuania possessed the only oil refinery as well as the only nuclear plant in the Baltics Latvia suffered from old-fashioned heavy industries from Soviet times. This different basic equipment with industries led to very different economic structures in the Baltic States: While Estonia’s current main export products are from the information and telecommunication sector, Latvia exports mainly timber, timber products as
well as furniture and Lithuania petroleum products. (Deutsch-Baltische Außenhandelskammer 2015) Therefore, Estonia is labelled as “innovation driven” by the World Economic Forum (2015) while Lithuania is more industrialised and Latvia highly specialised in timber industry.

3.3.2.2 Inclusive political institutions and change of elites

Acemoglu and Robinson (2013: 398) state that “nations fail economically because of extractive institutions” because they prevent them from catching up. As already mentioned, citizenship rights were granted to all national minorities in Lithuania only but not in Estonia and Latvia after regaining independence. So researchers in democratic transformation are in favour of Lithuania. Therefore, despite naturalisation requirements were softened because of international pressure both Estonian as well as Latvian democracy may be described as ethnocratic or “extractive”. In both countries only those persons were recognised as citizens who were their citizens in 1940 or their descendants. There is no discord about the reasons: massive immigration of Russian speaking workers in the Soviet period brought down the share of Estonians in Estonia from 88 % in 1934 to 62 % in 1989, and that of Latvians respectively from 77 % to 52 %. In contrast, in Lithuania the proportion of ethnic Lithuanians as a total population was about 80 % in 1989 (Norkus 2012: 208-209).

After the first elections in 1992 the ethnic Estonians as well as ethnic Latvians voted for liberal and nationalist parties. Especially in Estonia a sharp exchange of political elites took place, enabling the new and young prime minister Mart Laar to implement a radical neoliberal transformation policy. This new elite believed in the neoliberal ideas of Friedrich August von Hayek, Milton Friedman or politicians like Margaret Thatcher. Additionally, they implemented a lustration of the public administration from the former communist elite (Norkus 2012: 223). In Latvia the political situation was quite similar in the first beginning but the country suffered from weak political parties and power of oligarchs in the following years (Matthes 2013: 52-54). As result, already in the 1990s politics were not able to create sufficient support for capitalism (Bohle 2009: 33). In contrast, Lithuania was ruled during the main period of transformation (1992 – 1996) by an ex-communist party with a preference for gradualist economic reforms. Here “old cadres” could keep their positions. This was possible only because in Lithuania communism was not connected with Russian or Russianized Estonian respective Latvian agents. In these
countries Communist parties had no broad support among the population with only exemption of the Russian speaking minorities while in Lithuania also a Lithuanian Communism existed (Norkus 2012: 213 – 218).

As result, in Lithuania the privatisation process was carried through mainly as “insider privatisation” giving priority rights to the employees to buy out “their” enterprises for vouchers, while in Estonia state enterprises were sold by tender to foreigners and residents for the same conditions (Norkus 2012: 220). Therefore, in Estonia recovery of the economy started earlier and in turn the country achieved better macroeconomic results. This became also an advantage in the crisis 2008/09 when austerity governments in Latvia and Estonia were re-elected afterwards. But also while austerity government in Lithuania lost in recent polls it was the first government after independence to have served its full term (Maslauskaite and Zorgenfreija 2013: 56). This implies that the “ethnocratic” de-mocracies in Estonia and Latvia were preserved from post-communist government and postpone-ment of economic reforms. Therefore, it must be contradicted Acemoglu and Robinson (2013: 429) partly who prefer inclusive political as well as economic institutions as only motor of wealth creating. During transformation processes democratic or “inclusive” institutions may be contra-productive because they hinder fundamental changes. Last but not least, economic institutions in all three Baltic countries are inclusive and allow all ethnical groups to participate in the economic process. Even, in Latvia ethnical Russians dominate economy.

3.3.2.3 Institutional path dependency, religion and history

Basic theories of culture do not fit for the Baltics. If language – a Finno-Ugrian in Estonia but Indo-European in Latvia and Lithuania – play an important role is very questionable. Also Max Weber’s Protestantism hypothesis cannot be applied because Estonians and Latvians are mostly Protestants indeed but Lutherans and not Calvinists. Therefore, Norkus’ (2012: 232) idea to explain Estonian top performance in the Baltics by an influence of Herrnhuter’s movement in the 18th century is questionable, too. Also Acemoglu and Robinson (2013: 63) explained why “differences in beliefs, cultural attitudes, and values” do not explain the differences in wealth. But there are cultural patterns in the Baltics which cannot be ignored. Therefore, beside a simplified cultural hypothesis the importance of traditional beliefs must be taken into consideration. This
can be shown by observing the results of a survey in basic value orientation between Lithuanians, Latvians and Estonians from the year 1990 as is pointed out in Table 5.

Table 5: Differences in basic value orientation in the Baltics in 1990

<table>
<thead>
<tr>
<th></th>
<th>Lithuanians</th>
<th>Latvians</th>
<th>Estonians</th>
</tr>
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<tbody>
<tr>
<td>Religion is important in life</td>
<td>44.0 %</td>
<td>29.6 %</td>
<td>21.8 %</td>
</tr>
<tr>
<td>Death is inevitable, it is pointless to worry about it</td>
<td>28.4 %</td>
<td>79.2 %</td>
<td>89.6 %</td>
</tr>
<tr>
<td>In the long run, hard work brings a better life</td>
<td>41.2 %</td>
<td>50.4 %</td>
<td>65.6 %</td>
</tr>
<tr>
<td>Income should be made more equal</td>
<td>75.2 %</td>
<td>71.2 %</td>
<td>60.2 %</td>
</tr>
<tr>
<td>Enterprises should be directed by the state or the people</td>
<td>40.5 %</td>
<td>23.3 %</td>
<td>22.9 %</td>
</tr>
</tbody>
</table>


These differences in basic values across the Baltics can be explained only by different cultural tradition and mentality that are inherited from older times. After decades of similar political indoctrination in all three Baltic States by the Soviet Communists, Lithuanians remained very religious despite the pressure of Soviet atheism. Additionally, they can be characterised by traditional values, having a demand for more equality but less believes in their own performance. In contrast, Estonians are more secularised and display the individualistic, autonomous, and achievement-oriented understanding of their role in society. To a lesser degree they have internalised the requirements of equality. Thereby, they provide more support for capitalist ideas of management and social differentiation. With respect to all these basic values Latvians take the middle position which makes it look like a mixture of different traditions (Norkus 2012: 225).

This may be traced back to differences in history, religion and culture. Persistence of beliefs and other internal institutions may reflect the influence of long-lasting historical periods on social norms, which have been subsequently transmitted from generation to generation. Therefore, the EBRD (2014: 54) states that the level of transition is markedly higher in countries that formed part of the Habsburg or Prussian empires compared to that under Russian or Ottoman rule. Broadly speaking, Estonians and the majority of Latvians lived under German rule for about 700 years, first under the rule of the Livonian Brothers of the Sword respective the Teutonic Order, then under a quite autonomous rule of German noblemen while the Baltic provinces belonged to the kingdom of Sweden or after 1721 to the Russian Empire. In contrast, parts of Latvia were under Lithuanian-Polish control for centuries and Lithuania built up a state together with Poland till its division in the end of the 18th century when it came under direct control of
Russia. As result most of Latvians and all Estonians became Lutherans in the 16th century while Lithuanians and the Southeast part of Latvia (Latgale) remained catholic. Additionally, it must be asked if Estonians ever have been Christianised basically. Especially here in the North of the Baltics farm houses are far away from few churches. Lutheran pastors were mostly German speaking and pastoral care on a bad level (Wrobel 2002: 246-248). Therefore, one can agree with Norkus (2012: 227) who carefully tries to explain the differences in basic values among the Baltic countries by a much weaker religiosity of contemporary Estonians and Latvians “by the less deep inculcation of their cultures with Christian faith in the distant past.”

While in the end of Soviet times all three Baltic States were quite similar in their economic structures in the end of the 19th century Lithuania was quite underdeveloped in comparison to Latvia and Estonia. The country remained as agricultural periphery in contrast to the “German Baltic Provinces” (Estonia and almost of Latvia) which were better industrialised and connected with railway tracks from inner Russia to its harbours in Tallinn, Riga etc. Also urbanisation was on a higher level in the North of the Baltics than in Lithuania. This gap in socio-economic development between Estonia and Latvia on the one hand and Lithuania on the other continued into the interwar time (Norkus 2012: 215-216). Panther (1997: 111) for instance, emphasises the conception of “civicness” which is strongly connected to urbanisation. From his point of view „civicness is centered in a set of values and norm requiring actors to treat each other as equals, be tolerant of each other and encouraging mutual solidarity.“ But urbanisation and by this way “civicness” reached first of all the larger cities in the “German Baltic Provinces” and to a markedly lower degree Southeast Latvia and Lithuania. But while these arguments are able to explain the pattern of transition success in the 1990s they don’t fit for the current position of Lithuania in the Baltics. Therefore, it must be pointed out that change of institutions is possible at all times independently of historical or cultural roots.

4. Conclusion

At all, the model of „Baltic Capitalism“ or CEEC-LME is a success model beside CEEC-CME like in Slovenia. Basically the developments in all three Baltic States are quite similar. All three Baltic countries joined the EU in 2004, within four years – between 2011 and 2015 – they
were able to introduce the Euro, too. But there are some different patterns within the group likewise. As could be shown extractive political institutions were helpful for success in early transformation. Also the radical exchange of elites in Estonia as well as partly in Latvia supported the transformation process. Additionally, especially Estonia but also partly Latvia benefited during the period of transformation from their historical informal institutions that were more compatible with the set of formal market institutions known as the “Washington Consensus”. But, while Estonia is characterised by one history and culture (with a Russian minority mostly in the northeast of the country), only, Latvia is suffering from a bi-cultural history and an economically dominant Russian minority. In contrast, Lithuania’s culture is different at all. Thereby, a pattern of “shining star” Estonia, followed by Latvia and Lithuania emerged which became obvious in the sequence of Euro introduction in the Baltics, too.

But, while institutions may have deep roots they can change over time. Or, as Acemoglu and Robinson (2013: 432) emphasized: “History is key, since it is historical processes that, via institutional drift, create the differences that may become consequential during critical junctures.” For instance, Lithuania’s catching-up may be a result of the country’s challenge of national pride by the star performer Estonia (Norkus 2012: 203). As result, especially since the beginning of the new millennium Lithuania became more liberal and overtook Latvia in respect thereof. Additionally, its less developed financial sector allowed a better overcoming of the crisis of 2008/09. In contrast, strong cuts of wages as well as into the social system in Estonia and Latvia brought great intensives for young and well educated people to leave the country. This was facilitated by the countries’ joining of the EU in 2004 and the introduction of free movement of workers for the Baltic population between 2004 and 2011. Therefore, nowadays the sequence of success in the Baltics changed: While Estonia is still the model pupil, Lithuania is catching up urgently, but Latvia is falling back.

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FROM INDEPENDENCE TO THE EURO INTRODUCTION …


Od niepodległości do wprowadzenia Euro: odmiany kapitalizmu w krajach nadbałtyckich

Streszczenie:


Słowa kluczowe: odmiany kapitalizmu, Kraje Bałtyckie, Estonia, Łotwa, Litwa wprowadzenie euro