Tallinn University of Technology Doctoral Theses
Series I: Social Sciences, No. 28

Financial Fragility and Economic Instability in the Context of Transition Economies: The Case of Estonia

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TUT PRESS

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This dissertation was accepted for the defence of the degree of Doctor of Philosophy in Public Administration on April 26, 2016.

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Defence of the thesis: June 2, 2016

Declaration:

Hereby I declare that this doctoral thesis, my original investigation and achievement, submitted for the doctoral degree at Tallinn University of Technology has not been submitted for any academic degree.

/Egert Juuse/

ISSN 1406-4790
ISBN 978-9949-23-946-7 (publication)
ISBN 978-9949-23-947-4 (PDF)

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I Juuse, E. 2015. "'Latin Americanization' of the Estonian Economy – Institutional Analysis of Financial Fragility and the Financialization Process." *Journal of Post Keynesian Economics*, 38 (3), 399−425. (1.1)

II Juuse, E. 2016. "The real sector developments in Estonia: financialisation effects behind the transition process." In E. Hein, D. Detzer and N. Dodig (eds). *Financialisation and the Financial and Economic Crises: Country Studies*. Cheltenham, UK; Northampton, MA: Edward Elgar Publishing, 137-162. (3.1)

III Juuse, E. 2016. "Financial regulation in Estonia - a 'world of "dead letters"': the interplay of Europeanization process and national idiosyncrasies." In: R. Kattel; J. A. Kregel and M. Tonveronachi (eds). *Financial Regulation in the European Union*. London; New York: Routledge Taylor & Francis Ltd., 132-162. (3.1)

IV Juuse, E., S. B. Endresen and R. Kattel. 2015. "Foreign Direct Investment in Estonia - Understanding the Impact of Public Policies on Local Embeddedness and Networking in the Food Retail and Related Industries." In G. Micek (ed.). *Understanding Innovation in Emerging Economic Spaces. Global and Local Actors, Networks and Embeddedness*. Farnham: Ashgate Publishing Ltd., 97-118. (3.1)

V Juuse, E., S. B. Endresen and R. Kattel. 2015. "Twenty Years of the Restructuring of the Estonian Food Retail Industry - the Interplay of the Political Economy of Estonia and the Institutional, Historical and Geographical Factors." In G. Micek (ed.). *Understanding Innovation in Emerging Economic Spaces. Global and Local Actors, Networks and Embeddedness*. Farnham: Ashgate Publishing Ltd., 119-142. (3.1)

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INTRODUCTION

FOCUS, AIM AND METHODOLOGY OF THE THESIS

The Estonian experience of capitalist economy over the last twenty-five years has witnessed the introduction of market institutions from scratch, radical reforms, and several episodes of banking crises. In the process of economic restructuring, most facets of modern life in Estonia, *inter alia,* consumption patterns, the urban landscape, and the production and technological profile of the economy, have undergone profound changes. To a great extent, the evolution of the Estonian political and economic landscape has been affected by the West-oriented integration that led both to converging and diverging tendencies in relation to advanced economies. And, while being one of the more successful transition economies, Estonia's development path is perhaps the starkest instance of applying a *laissez-faire*, liberal market economy model in a transition context and beyond (**I; VI**). Moreover, in light of some properties such as near full foreign ownership of the banking industry, a heavy reliance on foreign public and private financing of capital development, and extreme monetary (and fiscal) conservatism, the country is an atypical or even extreme case and hence allows for exploring the underlying phenomena at hand in a particularly pure form. In a way, one can observe a peculiar variety of a capitalist production system with unique weaknesses and challenges.

By and large, the fragilities and destabilizing conditions in the Estonian political-economic system are the focus of the current thesis. More specifically, the thesis looks at the dynamics in two key market-making economic sectors – banking and food retail – where relatively drastic transformations have taken place in response to regulatory changes within a historically peculiar policy-making paradigm, i.e. an approach of anchoring to the policies of the European Union (EU). Hence, the central research question the thesis addresses is: how has the financial fragility[1] of the economy increased throughout the years and which political, economic and other factors are responsible for destabilizing tendencies? The main arguments for answering the research question are developed in six original articles (listed above) that analyze various, multi-dimensional aspects of the institutional structure of the Estonian political economy. First, articles I and II outline the changes, dynamics and patterns on both the productive and financial sides of the Estonian economy, examine the *financialization* process and its implications, and assess the institutional context.

[1] Increasing financial fragility could be interpreted as the growth of risky (unprotected) assets as well as indebtedness of the private sector, but also the reduced liquidity and refinancing possibilities that can lead to monetary instability in terms of asymmetrical cash inflows and outflows, and hence to a general instability in growth, prices, profits and employment (Minsky 1982a; Minsky 1982d; Papadimitriou and Wray 1999, 4).

Second, articles III and VI deal with the Europeanization process, regulatory convergence, policy-making and coordination in the field of finance, and the policy autonomy and ideational position of policy-makers. Finally, articles IV and V address the developments in the food retail industry and related industries in Estonia with a focus on the embeddedness of foreign direct investment (FDI) and the resilience of domestic actors. Methodologically, the thesis relies on a mixture of research approaches – desk research, (country) case study, and phenomenological research. Accordingly, the empirical data have been gathered through different methods such as structured and semi-structured interviews with different stakeholders in Estonia (see **III; VI; IV; V**), secondary meta-analysis (see **I; II**) and content analysis of legislation, memoranda and explanatory notes (see **III**). To a great extent, the terms of reference or analytical frameworks for studies in the mentioned articles have been set by the research projects – *Financialisation, Economy, Society and Sustainable Development* under the European Union (EU) Seventh Framework Programme for research, technological development and demonstration; *project No EMP264* under the Norwegian Financial Mechanism 2009-2014; *Grant no 8418* of the Estonian Research Council – that have led to the results of this thesis.

The analysis relies on insights from various schools of economic thought within the heterodox economics tradition. In particular, development processes and the transition to a capitalist system have been explained from the perspectives of institutional and classical development economics as well as "financial Keynesianism". On the one hand, the cyclical dynamics and changing financial structures conducive to financial instability are addressed from Minsky's (1992a) financial instability hypothesis (FIH) perspective. And, given a short-lived experience with a market economy in Estonia, Minsky's FIH on financial cycles has been used for understanding a longer-term stage – *financialization* – as in his stages approach of capitalist development. Moreover, Minsky's FIH-based analysis and its extension by Kregel ([2004] 2014; 2006) has been applied for understanding the international financial relations and the economy's vulnerability ensuing from the cross-border financial structure of the whole economy[2] as well as particular institutional sectors.

[2] Not many analyses by Minsky covered the open economy's financing positions and national fragility. In one of his papers, the financial instability hypothesis was applied to a nation-state level balance-of-payments-based analysis in the context of internationally integrated financial system (Minksy 1993c), but mostly his studies have been in relation to the US economy's balance sheet positions (see Minsky 1984; 1993c). Yet, contributions and extensions to his work on international finance and cross-border financial balances have been made Wray (2006b) and Kregel (1996; [2004] 2014; 2006). In a similar fashion, but on slightly different grounds, Hein et al. (2016) has elaborated on the typology of capitalist economies, based on the external financial balances of nation states.

On another level of the *Minskyan* analysis (see Minsky 1993a), the thesis focuses on the interplay between the economy-related ideas that are embedded in institutions, and policies as solutions to defined problems. Hence, aside from covering the interdependent balance sheet positions and the flows of funds across country borders, the thesis sheds light on how and to what extent these cross-border interdependences have been acknowledged and factored in to the policy-making processes. This captures the notion of discourse and ideas (see Schmidt 2002; Schmidt and Radaelli 2004) that reveal the perceptions and understandings of policy-makers on policy problems and policy preferences, and on a broader level also resonate with economic practices as well as the evolution of the socio-economic environment. In this way, the strategies of discursive institutionalism are followed by focusing on both policy ideas and their usage through interactive processes in policy design (see Schmidt 2000; 2002; Campbell 1998; 2002). On the other hand, the analyses elaborate on "snapshots" as critical junctures (see Pollitt, 2008; 2012) and historically constructed and embedded institutions that reveal policy continuity – *path dependencies* (see Pierson and Skocpol 2002; also Hall and Taylor 1996) in terms of the "stickiness" of formal rules and institutions that affect the policy-making processes. In that regard, theoretical propositions from both the historical and constructive (discursive) institutionalist traditions have been relied upon. This enables us to understand historical legacies and see, how institutionalized ideas of different actors as well as formed capacities of policy-makers give way to path-dependent and self-enforcing policy continuity within the *Minsky-Kregel* framework. In fact, the thesis builds on Nurkse's ([1953] 2009, 120) notion of "circular constellation of forces" by focusing not only on economic but also political and institutional interrelationships that operate through feedback mechanisms. Accordingly, by elaborating on the transforming structure of the economy and the state, interwoven economic and policy changes are studied.

More precisely, the thesis elaborates on the institutional structure of two market-making, but largely foreign-owned industries – banking and food retail sector – in light of the adopted macro-economic policies and the established financial governance framework. Furthermore, the effects of these sectors on the productive segments of the economy and the overall economic stability are assessed. The selection of these sectors is warranted on three grounds. First, for covering both sides of the economy, banking represents the finance part and is the major player in the financial markets, while food retail represents the productive side of the economy. Second, both of these industries have absorbed most of the FDI flows into Estonia and are key market-making segments with the transformative power to shape the markets. Lastly, by elaborating on these two market segments in the Estonian case, the specialization profile of the economy as an additional element in the FIH framework can be examined.

While there are numerous critical studies[3], both theoretical and empirical, on international capital flows and their effects on host economies, a comparison of the existing findings with the Estonian case is not a straightforward matter. It would be ill-considered to ascribe development patterns in the Estonian economy to Minsky's notion of "money manager capitalism" (Minsky and Whalen 1996), to a *financialization* process in general [as perceived in advanced Western economies for the last few decades (see Epstein 2005)], or even to long-term dynamic laws of capital accumulation (see Piketty 2014). For example, the Estonian experience, where a typical profile of a business unit is a non-listed, mostly internally funded owner-manager small or medium-sized enterprise (SME) (**I; II**), contrasts to an analysis focused on the U.S corporate form of market capitalism with the endogenous generation of conditions conducive to instability and a crisis (Minsky 1993b). Similarly, the *financialization* phenomenon or *money-manager capitalism* has distinctive characteristics and manifestations in the case of Estonia. Several elements of that typology of a capitalist system have been missing such as money market mutual or hedge funds, or being underdeveloped (a lagging stock market, and late developing pensions funds heavily investing in activities abroad) (**II**). Thus, some of the theoretical propositions have to be taken with reservations, given the peculiar institutional and economic challenges that one of the post-Soviet countries has faced in its transition process to a market economy. The following sections will look at the main findings of the thesis and in particular, discuss the explanatory and analytical power of the main theoretical constructs and concepts. First, dynamics and changes at the macro- and meso-level of the Estonian economy are discussed, including the nature of foreign capital absorption, sources of pressures on balance of payments position, disequilibrating tendencies, and idiosyncratic elements that are behind the increasing financial fragility. Second, institutional backstops and public policies for correcting the destabilizing conditions from the point of view of national autonomy as well as relevance, effectiveness and coherence of policies are elaborated upon. In the last section, conclusions of the thesis are drawn.

[3] See, for instance, Keynes (1934, Chapter 36) on the issues surrounding national autonomy and independent action for dealing with domestic stability and situation of employment in the context of international mobility of capital and adherence to international standards; Nurkse ([1945] 2009) on interrelationships between external accounts, exchange rate regimes and domestic stability of employment, income and prices; Kalecki ([1955] 1979) on lopsided effects of foreign direct investments, development prospects and the transfers issue; and most recently Kregel (1996; 2008b) on issues related to reduced policy space due to financial liberalization.

FORCES AND PROPERTIES OF CHANGING ECONOMIC RELATIONS

The assertion of "the rise in international trade [that] has been accompanied by … a rise in capital movements which both inflate and follow current payment imbalances." (Minsky 1993c, 10) reflects the reality of the Estonian economy for the last twenty-five years. In a nutshell, aside from affecting the development path of the economy, cross-border trade and capital movements have exposed the economy to financial fragility and instability. Hence, in line with the Minskyan analysis on business cycles and changing financial relations (see Ferri and Minsky 1991), the thesis identifies endogenous processes in the Estonian economy that have led to increasing financial fragility, while being amplified by external factors such as a loosening regulatory grip and outsourced institutional decision-making (see below).

According to Minsky ([1986] 2008, 242), "…increase in the fragility of an economy occurs as an externally financed investment boom takes place." External financing in the Estonian context has implied reliance on both foreign capital inflows and bank-based financing that has been increasingly directed towards the household sector in relative and absolute terms (**I; II**). Hence, while Minsky's (1982a; [1986] 2008) analyses focused on dynamics associated debt-financed investment demand[4], in the Estonian case the relative increase in debt-financed consumption and foreign (direct) investment demand were the important factors affecting aggregate profits and the cyclical behavior of the economy. What occurred during the expansionary phase in Estonia before the crisis of 2007/09 could be described as typically Minskyan (see Minsky 1992a; also Kregel 2008a, 7-8) – excessive domestic and foreign borrowing for both capital development and speculative purposes. In particular, overinvestment and risk concentration rendered the economic system more fragile and susceptible to prolonged debt-deflationary developments without counterbalancing government policies to alleviate the negative effects of changing financial structures on the overall stability. In that regard, the *financialization*[5] process in Estonia took mostly the shape of rising private debt with a deteriorating current account balance due to the elimination of trade and capital movement barriers in the early 1990s. Following the liberalization of the external account, the enlarged absorption of foreign capital inflows [including in the banking and retail sectors (**I; III; IV**)] led to growing foreign liabilities at a country level. Moreover, the accumulation of retained earnings as claims against the country and its foreign exchange reserves, which was incentivized by the tax reform of 2000 (**I**) and

[4] Some Minsky's papers (1982b; 1982c) touched upon household financing profiles, their distinction from externally financed investments from the perspective of the length of credit terms as well as sources of incoming funds.

[5] See Wray (2016) on several features of the *financialization* phenomenon.

motivated by a protection against exogenous shocks in an open trading system, increased further the risks and fragility in the economy. Likewise, host market targeting and the extended use of imported capital and semi-finished goods by multinational enterprises (MNE) as well as the debt-financed consumption of imports have put additional pressures on the balance of payments position. These activities also hurt domestic producers and suppliers by crowding them out (**II; IV; V**), in particular, in the context of asymmetric (intra-industry) trading patterns on the Scandinavia-Estonia axis. Thus, in addition to the implications of foreign ownership of assets for income distribution, one cannot overlook the hazards ensuing from the specialization patterns of foreign capital (see Piketty 2014, 44, 67-71; Kalecki [1955] 1979; Nurkse [1953] 2009).

Most of the FDI inflows have been embedded in production profiles and directed into industries such as financial intermediation, real estate activities, and wholesale and retail (**I; II**) that do not pose many possibilities for innovation-led *leapfrogging*[6]. Accordingly, FDI inflows of a modular nature that for years relied on cost-pull advantages, exerted deflationary pressures, not to mention the institutional set-up of a monetary system (see below) that amplified the deflationary bias of the economy. For meeting contingent or dated payment commitments (i.e. investment income transfers and servicing foreign currency denominated debt), squeezing the costs has been related to the need to generate sufficient earnings from net exports. Furthermore, both de-industrializing tendencies and the re-specialization in economic activities towards services (**I; II**; also Kattel 2010) have deteriorated the capacity of the economy to service foreign debt. Further strains originate from the increasing share of overhead and ancillary expenses in relation to advertising, marketing etc. that are associated with the advent and expansion of commerce (**IV; V**; also Tiits 2007). In light of such developments, margins of safety[7] have diminished, implying a speculative, or even a Ponzi, financing position for the country, in particular, in the context of negative trade and current account balances[8] up until the global financial crisis of 2007/09.

In the formed macro-financial situation that the Estonian economy faces, multi-dimensional disequilibrating tendencies can be detected. First, foreign injections have upheld private sector dissaving and chronic trade deficits, while making

[6] See Burlamaqui and Kattel (2016) on this notion as differentiation and productivity enhancement through technological, organizational, financial, and other changes.

[7] Cushions of safety (see Minsky 1982b; Wray 2016) in cash flows, in net worth, and in liquidity have been reduced as a result deflationary pressures, but also private sector deficits with rising indebtedness and increasing share of illiquid assets in households' portfolio.

[8] Minksy's (1984; 1993c) Tier 1 flows – payment commitment on debt – being uncovered by Tier 2 – balance of trade – flows, implying a necessity to cover current account deficit with capital account surplus and changes in the reserve position (short-term capital movements).

possible government surpluses during the boom years up until the crash of 2008[9]. With the prospective negative net transfers (i.e. international payment imbalances under the fixed exchange rate regime), internal funds get squeezed that in turn puts additional pressure on the (wage) cost structure of business entities. Such developments lead to a vicious circle of declined investments, profits, employment, and income. Second, at the domestic level, the institutional setting with the hollowed-out governance (**VI**) has incentivized market concentration for maintaining high enough prices, and thereby profits, that explains both oligopolistic and oligopsonistic market features (**III; IV; V**). However, given systemic relations and interactions between different markets in a small market with low diversification, such concentrated structures have incurred a "too-big-to-fail" problem[10] and thereby posed a threat to the economy, stemming from potential exits of multinational enterprises (see below). As argued by Wray (2012), there is too much imbalance of power, which in the Estonian case is revealed in both market concentration and the increasing control of foreign owners over industries. Indeed, the evolution of the Estonian economy has encompassed increasing imbalances in power relations that, in turn, have implied changing financial balances in favor of particular institutional actors (**III; IV**).

Dynamics in the Banking and Food Retail Sectors

Analogous to drastic changes at the macro level, both industry segments – banking and food retail – that absorbed significant shares of foreign capital inflows in the late 1990s and early 2000s, have undergone a thorough transformation. By and large, financial intermediation and retail activities have been outsourced, which is reflected in the lost autonomy and ability on both business and policy sides to direct domestic developments in a desired way. In food retail, foreign acquisitions in a piecemeal movement towards oligopsonistic market conditions have enabled MNEs to seize the control over the domestic supply chain and related industries, while enjoying the opportunity to substitute local businesses with foreign suppliers that has led to "enclaved" structures (**II; IV**). Likewise, foreign takeovers led to the centralization and concentration of the banking market, which drifted the banking practices away from the locally embedded *relationship-oriented banking* (see Levy Economics Institute 2012, 19-20) or the *logic of voice* (see Deeg 2005; Hall and Soskice 2001). This was manifest in the shift of banks' focus from local businesses to FDI companies –

[9] One could draw a parallel with the experience of the US, where "… rather than the government sector being the main source of injections that allow the leakages that represent private sector savings, we … have the private sector dissaving in order to allow the foreign leakages. This sets up a highly unstable situation because private debt ratios rise quickly and a greater percentage of income goes to service those debts." (Wray 2006b)

[10] See Minsky ([1986] 2008, 354-355, 365-369) on *too-big-to-fail* problems related to market power.

the result of internationalization of production[11], which explains the *follow-the-client* approach taken by foreign banks – and to households in 2000s. Thus, the notion of bank size determining the size of customers (see Minsky [1986] 2008, 355) holds true as much as in food retail and related industries, which is revealed in the *enclavization* of mutually favoring FDI companies with positive feedback mechanisms operational between the financial and non-financial corporate sector and within the latter.

At the same time, elements and developments conducive to financial instability (as covered above) are evident in both industries, although banking in Estonia has been primarily behind the destabilizing conditions and crises. The thesis reveals the transition from the period of meager use of debt in the 1990s to increasing indebtedness of households and non-financial businesses as a result of extensive use of credit products provided by credit institutions that were acquired by foreign financial institutions. This rendered the financial system more fragile in the Minskyan sense (**I; III**). Thus, in the 2000s one can observe "the property boom … [that was] 'ill-done', Smithian' capital development" (Levy Economics Institute 2012, 19) in terms of misallocation of financing for investment activities. This has been reflected in the portfolios of banks that have been undiversified in terms of high exposure risks to a narrow range of economic sectors (Bank of Estonia 2016a). At the same time, on the liability side, foreign ownership has broadened the possibilities to introduce new instruments and expand on existing ones for the position-making activities (e.g. borrowing from foreign, including parent banks; use of subordinated liabilities etc.) (**I**; **III**). Thus, credit policies of financial institutions and decisions affecting balance sheet positions of banks in general, have had a major impact on financial (i.e. business cycles)[12] in Estonia. Loan creation by banks in the mid-2000s financed consumption in a pro-cyclical manner, including the purchases of inflated assets that led to increasing debt levels, while the bust was triggered by the tightening credit policies of Nordic parent banks.

Overall, the Estonian case resembles the Latin-American experience of the 1980s and 1990s (see Kregel [2001] 2014; 1998; 2008b), where foreign capital inflows were channeled through foreign-owned banks to finance a housing market bubble and excess demand for imported consumption goods, while the majority of exports were accounted by the MNEs that were relatively detached from the host economy's financing and market conditions. Similar to the case of Greece (see Kregel 2011), it was foreign banks in Estonia that lent to private sector actors, mostly households, although financing took place through the affiliates operating in the Estonian market. This resulted in current account

[11] See Kregel (1994, 29, 32) on the globalization of manufacturing production and the related transformation of the structure and composition of international capital flows.
[12] See Wray's (2016, 31-33) representation of Minsky on interrelations between the spending decisions and finance within a business cycle.

deficits where consumption growth exceeded income growth, savings rates decreased and indebtedness increased[13] (**I; II**). That said, in spite of a resemblance to other countries, the Estonian economy has managed to hold on to some peculiar features that contrast its development path to a conventional *financialization* or *money manager* capitalist trajectory.

Idiosyncrasies and Complementary Elements of Fragility

During the early days of regained independence, financial institutions, in particular banks, evolved in response to competitive forces and regulatory changes as per Minskyan (1964, 325) argumentation. Nonetheless, lacking market institutions, imprudent practices as well as the overall transition phase, rather than endogenous evolutionary processes in the financial structure of the economy, were peculiar contextual factors that caused banking crises and abrupt changes in the banking industry in the 1990s (**I; III**). And, given such a negative starting point for the Estonian banking sector, it is not surprising that the elements of prudent banking[14] were gradually introduced. This was accompanied by improved conditions for underwriting and evidenced in the strengthened capitalization of banks that deviates from the development trajectory associated with the *money manager* capitalism. Likewise, the acquisition of dubious, complex securitized assets never took off (**III**), even though banks became increasingly leveraged[15] and the issuing of non-deposit debt securities (e.g. money market instruments) increased in absolute and relative terms in parallel with the soaring indebtedness of the household sector in the 2000s (**I; II**). The latter, however, became possible through the cumulative impact of specific political and economic factors[16] that had direct implications for changing financing processes and were conducive to a more speculative financing. Under

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[13] Similar conclusion has been reached by Piketty (2014) who applied his analysis on indigenous socio-economic and income inequality to the explanation of international imbalances and debtor-creditor relations.

[14] See Wray (2016, 164) on the ways banks can reduce risks.

[15] Leverage ratio (total assets to total capital ratio) of banks decreased from 9.4 in 1993 to 6.1 in 1998, when local banks were acquired by foreign investors, but then increased to 10.2 in 2004 and eventually dropped to 8.3 in 2015 (Bank of Estonia 2016b). The share of debt securities in total liabilities stood at 0% in 1993, 11.4% in 1998, 21% in 2004, and 0.05% in 2015 (*ibid.*).

[16] Such as the completion of a privatization process of residential property and tax incentives that opened the way for a booming housing market, while specific institutional arrangements in terms of currency board system and resolute bankruptcy law made possible the take-over of banks by foreign financial institutions and thereby increased foreign lending. At the same time, the adoption of *Treuhand* model in the privatization of state-owned enterprises and re-specialization and re-structuring of the economy towards services and sub-contracting nature of economic activities impaired demand for bank credit (**I**).

these conditions, one of the risks to the local banking industry has been the constrained function of the central bank as the lender of last resort (see below).

Regarding the dynamics in the productive economy, Minsky's analysis on financial capitalism (see Minsky [1986] 2008, chapter 9; Papadimitriou and Wray 1999) does provide a good understanding of the economy's intrinsic predisposition to instability from the perspective of changing balance-sheet commitments and income flows. However, there are also idiosyncratic aspects affecting the developments and fragility of the Estonian economy that need to be factored in. Mainly, these are related to the dual structure of the Estonian productive economy whereby medium-sized and large businesses – as a rule, foreign-owned – are able to affect (cost) prices due to their market power[17]. This contributes to increasing surpluses, while adding to the claims against the country due to accumulation of reinvested profits (as stated above). Under conditions of MNEs being price-setters and hence having heightened sales as well as profit expectations, the fragility of the economy, apart from the endogenously generated one with changing creditor-debtor relations, is increased by the susceptibility to divestments because of unmet expectations on profits. Therefore, on a national level, where the financing of economic growth is undertaken with external (foreign) funds, the rise of portfolio flows as typical for a speculative and Ponzi financing might result from divestments by MNEs as part of a corporate strategy, due to decreasing profitability, increasing costs or any other factor. Exits, which in the manufacturing industries are made smoother by the disembeddedness of MNEs from local conditions and their modular production profile, can trigger further exits and thereby lead to a downward spiral of contracting investment demand, employment, incomes and profits[18]. On the whole, in the context of an undiversified structure of the economy and a relatively large controlling share of foreign-owned companies in several industries [including in the banking, food retail and other segments (**I; II; IV**)], accumulating liquidations of positions[19] can be detrimental to the stability of the entire economy. In this regard, product-, financial- and factor-market developments affect both the financing position of foreign-owned companies and their willingness to operate in the Estonian market. Therefore, the understanding of a country's financial fragility on the international arena from the FIH-centered Minsky-Kregel framework can be complemented by factoring in: first, the importance of external capital for a local economy as well as the

[17] Signs of governments' indifference can be noted in relation to market concentration and even indirectly supporting it via reduced tax burden on capital.

[18] As stated by Papadimitriou and Wray (1999, 10), "some borrowers might find income flows less than expected, leading to "belt-tightening" spending reductions that would cause income flows of others to fall below expectations."

[19] The latest developments on the Estonian market testify such trends of FDI companies in low value-added manufacturing activities leaving Estonia for more cheaper markets, while there has been only one precedent of a foreign retailer leaving the market (**V**).

sensitivity to its fluctuations, and second, the features of a country's production profile in terms of a technological and economic specialization. The value creation profile of a country, in turn, determines the prospects of meeting foreign liabilities either through trade surpluses, by convincing external creditors for continuous lending, or through the sale of assets, including divestments. And, as supported by international experiences (see Kregel 1994; Kregel 1996; also Kalecki [1966] 1979), the volatility in foreign investments and re-occurring divestments have made FDI more temporary and hence reduced both national autonomy and control. In the Estonian context, additional aspects such as the Europeanization process[20] and self-imposed institutional constraints (e.g. hands-tied monetary regimes) have amplified such destabilizing conditions.

[20] See article **III** on an extended discussion on the multifaceted concept of *Europeanization* in relation to the banking regulation and its harmonization in Estonia. In addition, the EU's effects could be observed in both studied industries, e.g. bank lending for "bridge-financing" of the EU projects or market concentration due to the EU regulations and standards (**II; IV; V**).

INSTITUTIONAL BACKSTOPS AND PUBLIC POLICIES

Formal institutions have a central role to play in socio-economic progress and financial stability, because "…institutional structures and systems of interventions affect the behavior of the economy." (Ferri and Minsky 1991, 13; see also Minsky 1992b) That said, in the Estonian case not many options exist for policy intervention that would impose new conditions[21] for forestalling the disequilibrating dynamics in the economy. As shown in the thesis (**I; III; VI**), the embedded institutional setting in the form of an adopted monetary regime, labor market institutions, public finance tools and the regulatory landscape in general, has been inoperative in managing aggregate demand or in alleviating destabilizing effects.

Conservative Monetary and Fiscal Stance

Along the Keynesian and institutionalist traditions, the thesis touches upon public finance and monetary institutions from the uncertainty-containing perspective, but in light of the transition and *financialization* process peculiar to Estonia (see **I; II; VI**). Essentially, in a fixed exchange rate regime – either under the currency board arrangement or in the euro-zone – there is a lack of discretionary economic policies, with little room for expansionary fiscal or monetary policy. The Central Bank of Estonia has not been equipped to deter debt-deflationary trends by imposing itself a lender-of-last-resort constraint, implying an inability to provide reserves or "high powered money" without limits when needed. In this regard, the risks associated with the speculative financing or Schumpeterian financing of innovative activities have not been socialized (see Minsky [1986] 2008, 48-49). On the contrary, a stable exchange rate under the currency board arrangement can be considered as one of the endogenous factors that contributed to heightened expectations of success, underestimation of risks, and decreasing margins of safety associated with increasing foreign capital inflows. In fact, the fragile private sector was to some extent immune to domestically driven exogenous shocks (i.e. changing macroeconomic variables such as exchange rate devaluation that could have negatively affected the value of financing positions). Monetary policy tightening or devaluation to reduce the balance of payments deficits in the mid-2000s would have implied political suicide, given the foreign currency denomination of household loans and the FDI dominance in certain key industries[22]. It is evident

[21] See Ferri and Minsky (1991) on ceilings and floors as thwarting systems that set new initial conditions.

[22] The devaluation of the Estonian kroon would have reduced the value of dividends in foreign currencies and increased the costs of imported inputs, resulting in an unmet income and profit expectations with dire consequences on aggregate demand, while for households, the devaluation of domestic currency would have increased the debt burden in domestic currency (see also Minsky 1984, 17-18).

that the transition path in Estonia contrasted with Nurkse's ([1945] 2009; [1947] 2009; [1958] 2009) development postulates from the international trade and monetary relations perspective. By fixing the exchange rate, the equilibrium rate of exchange through appreciations or devaluations, which would have kept the country's external accounts (i.e. foreign receipts and payments) in equilibrium, was given up. This has implied the need for internal devaluation to restore the external balance, but with detrimental consequences for internal balance – falling employment and prices. Similarly, defensive methods against adversarial external developments were relinquished, as under the currency board arrangement the use of liquid reserves to support domestic expansion and meet the external deficit during the depression was limited. In other words, by focusing on goods' and services' inflation, the inflexibility of liabilities that finance assets with ensuing imbalances between credits and debits has been left out of the policy purview (**VI**).

Fiscal austerity as a counterpart of a fixed exchange rate system has implied a meager government role for providing economic security to private entities. Even worse, a gradual reduction in the tax burden along with the mass-privatization in the 1990s under the neoliberal agenda has resulted in a decreasing capacity for the government to run the economy and serve the public interest (see also Wray 2012 on Western economies). Rather, the government has been behaving as a self-interested market participant by responding in a pro-cyclical manner to market signals and hence aggravating disequilibrating tendencies in both flows of funds and balance sheet accounts. In particular, these effects get amplified in case of a country's high exposure to constraints imposed by an international financial system. Under such circumstances, fiscal austerity for a debtor country like Estonia means sustained recessions causing high unemployment and lower incomes. In a way, foundations for a continuously growing economy fundamental for servicing foreign debts (see Minsky 1984) have been subverted to some extent in light of the hollowed-out public finance institutions. As Kregel ([2004] 2014, 26) claimed, "… improving economic performance may be the most appropriate way for a country … to restore confidence in its ability to meet its external financial commitments." Efforts for improvements, however, have taken a perverse bias towards supporting investment demand in the first place. Policy-makers' focus on improving the business environment for investment activities, while neglecting the employment situation with continuous liberalization of the labor market is in contrast to what Minsky ([1986] 2008, chapter 13) considered as a stability enhancing policy approach with the emphasis on employment rather than investment[23]. The elimination of the corporate income tax, which was even endorsed by Minsky

[23] Misdirected investments lead to a boom-bust trajectory with asset price inflation to be followed by debt-deflationary trends – "inappropriate financing of investment and capital asset ownership are the major destabilizing influences…" (Minsky [1986] 2008, 350)

([1986] 2008, 354; also Wray 2016, 207), was the fundamental reform in early 2000s. Such an emphasis, however, has varying implications for economic and financial stability depending on the context. For instance, accumulation of retained earnings that are reinvested by foreign companies increase the claims against the country and hence, at the national level reduce net worth and cash-flow related margins of safety over time. Likewise, as stated by Mazzucato and Wray (2015, 59), "it is essential to realize that tax incentives create little additionally." While tax incentives in Estonia have enabled businesses to accumulate internal funds, the lack of public finance institutions to reduce uncertainty has kept up the liquidity preference of the non-financial corporate sector for precautionary purposes, in order to ensure that future commitments can be fulfilled (**I; II**). Furthermore, disregarding the taxation of capital gains and financial transactions does not incentivize long-term investments, but tends to reward value extraction from short-term investments (see Mazzucato and Wray 2015, 32).

Under the conditions of tying one's hands so that monetary and fiscal policy cannot be used to maintain employment and growth levels, the only prospect for restoring international competitiveness is to rely upon adjusting (downward-sloped) domestic labor-costs and thereby reduce purchasing power. As stated by Wray (2006a, 17), "on a fixed exchange rate, if a country faces a current account deficit, it will need to depress domestic demand, wages, and prices in an effort to reduce imports and increase exports. In a sense, the nation loses policy independence to pursue a domestic agenda." Suppressed wages are also intrinsic to the system, where the argument of cost-based competitive advantage for attracting foreign investments holds (as discussed above). This has been witnessed in the economic behavior in the food retail market, in particular in foreign-owned discount retailers (**IV; V**), and other industries. Under such conditions and also due to modest industrial policies, which are EU-dictated, the situation of workers has been rendered fragile in terms of high uncertainties about employment and income. Moreover, the focus on stimulating investment activity with fiscal measures and the use of a flat income tax has not addressed the problem of inequality. On the contrary, the tuning of fiscal policy towards investment-led growth has been accompanied by a destructive proclivity to financial instability and socio-economic inequality (**I; II**). Opening the economy to foreign investments and active campaigns to attract these flows to Estonia has disincentivized the progressive taxation of capital owners, in that they are higher income earners. Indeed, in the name of tax competitiveness, the established tax system has become regressive in nature due to the flat income tax, favorable treatment for capital, and taxation of consumption that on the whole benefit capital owners and those who are able to save. Additionally, loopholes in the legislation make it possible to avoid the taxation of income outflows of foreign-owned companies by practicing hidden transfers such as cross-border inter-enterprise loans or purchases of imports with overstated prices within an intra-industry trade. The tax system, therefore, exacerbates income and wealth inequalities (**II; III**). At the same time, fiscal measures such as preferential taxes for stimulating exports and addressing chronic trade deficits have not been considered.

In light of current account deficits that have been financed with foreign loans as well as the evident misalignment of foreign capital interests and development needs (**I; II**), the Keynesian socialization of investment (i.e. determining the volume and assuring a balanced allocation of investment through directed public spending) is warranted (see Kalecki [1968] 1979; Kalecki [1955] 1979; Nurkse [1953] 2009; Mazzucato and Wray 2015, 34-35). In the Estonian case, the adopted approach for socializing investment for innovation and capital development purposes mirrors the established model of the economy. Namely, one can observe a dependency on foreign transfers – the EU funds –, which reflects another form of external anchoring and embeddedness in institutional structures that increase the vulnerability to external developments. Even though the EU-funded socialization of investment has kept up aggregate demand and employment, such a fiscal framework presents hazards to tranquil progress and leads to further dependence on foreign financial assistance, especially when the majority of government expenditures have been consumption demand supporting transfer payments that are not self-sustaining. All in all, the addressing of both Keynesian and Smithian problems of resource allocation for capital development purposes (see Ferri and Minsky 1991; also Mazzucato and Wray 2015, 45) have been greatly affected by the EU transfers and innovation policy. In principle, the stabilization of aggregate demand has to a great extent been outsourced to external actors, i.e. the EU funding in the form of transfer payments for capital formation and the provision of liquidity from foreign public institutions (Scandinavian central banks) to support the banking reserves (**II; III**).

In sum, the stabilizing role of the government, either from the functional finance perspective (see Kregel 2010; Kregel 2014; Forstater 1999) or the Minskyan analysis on investment financing (Minsky 1992b), has been hollowed out in Estonia. In particular, two key institutional backstops – countercyclical fiscal policy and the lender of last resort function of the central bank – that set the ceilings and floors for balancing out the cyclical fluctuations in the private sector (see Papadimitriou and Wray 1997; 1999), have been renounced by the Estonian government. With self-imposed budgetary constraints and embeddedness of foreign investments-led capitalist development, the private sector's rising debts have been an inevitable consequence on the grounds of the sectoral balance accounting identity. Hence, the *laissez-faire*, small government position and the FDI-led development path based on cost advantages have not been conducive for the stability and capital development of the economy in its broadest meaning (see Mazzucato and Wray 2015; Minsky [1986] 2008, 301).

Over- and Mis-Regulation

The thesis reveals also the signs of both incoherence and inadequacy of financial and other policies for financial stability and economic development purposes (**III; VI; IV; V**). The elimination of controls on capital flows in the early 1990s was evidently a milestone in giving rise to the following destabilizing developments in the economy. At the same time the unwillingness, but also incapacity of the government to properly regulate foreign capital – affect its maturity and performance – opened the way for the country to be pushed into a speculative financing profile. Likewise, developments in two studied industries – banking and food retail – went unaffected by prudent FDI management practices[24] (**III; IV; V**).

Pursuant to the lacking view of public policies on issues related to the financing of capital assets, credit restrictions, as anti-inflationary measures that reduce speculative investments, have not been on the political agenda. Thus, qualitative credit controls, as proposed by Minsky and Whalen (1996), have not been adopted in Estonia to direct credit to socially desirable activities by incentivizing or forcing banks to purchase certain assets. To a great extent, such liberalism has been related to the Europeanization phenomenon[25], i.e. the transposition of the EU legislation as the major force affecting and directing developments in banking regulation and also policy-making. Compared to the Western advanced economies, the problems with the EU-driven regulations and the overall harmonization process did not lie in the complex financial innovations on the local financial market, as occurred in the US and the UK in the aftermath of the deregulatory reforms at the end of the last century. Rather, the embeddeness of policy-making based on the EU policies has enabled credit institutions to bypass regulatory oversight through channels and institutions that are regulated less stringently (**III; VI**). Furthermore, the evolutionary formation of financial institutions in Estonia has to some extent deviated from the legally "designed" institutions, which reveals that policies have not been able to keep track with evolving market institutions and operations. Therefore, the effectiveness of regulations, which requires the understanding of local institutional settings and practices as well as endogenous (evolutionary) cumulative processes that lead to financial fragility and instability (see Minsky [1986] 2008; Kregel and Papadimitriou 2012), is undermined in the Estonian case. The anchoring of the

[24] Most of these practices such as measures that limit cross-border transfers or licensing with the view on investments' allocation among economic branches, concentration or geographic distribution (see Kalecki [1966] 1979 on prudent FDI management) were abolished in the early 1990s and have not been considered ever since in Estonia.
[25] See Schmidt (2002), Radaelli (2000), Majone (1996), Schimmelfennig and Sedelmeier (2002, 2005 (eds)), Héritier (2005), Grabbe 2006, Falkner et al. (2005, 2007) on a general discourse on the Europeanization phenomenon and Eastward Europeanization in particular.

financial regulation to the EU directives and policies has detached regulations from real-life business practices on the financial markets.

With regard to macro-prudential regulation, the provisions on setting capital buffer requirements as part of the macro-prudential policy agenda were stipulated only in 2015. At the same time, systemically important credit institutions were determined, as the concentration of market power in the banking industry brought to the policy-makers attention the "too-big-to-fail" issue. Yet, in line with the institutionalized policy approach, such measures have reaffirmed the responsibility of credit institutions for liquidity and solvency issues by relinquishing any significant public backstops, except for the deposit insurance institution. More important, the macro-prudential policy approach has been largely EU-driven, whereby the effectiveness of the measures for mitigating systemic banking crises can be again questioned in light of the cross-border payment commitments and position-making transactions between affiliates in Estonia and their parent banks in Nordic countries. For that reason, the dynamic macro-prudential regulation overseeing the whole financial system that includes financial institutions' transaction at the national as well as cross-border level (see Minsky and Campbell 1988; Kregel 2014) is threatened to be overshadowed by the current policy approach to macro-financial stability. By being anchored to the EU policies that put an emphasis on both micro- and macro-prudential capital requirements, while domestic component of policy measures encompassing primarily reserve requirements[26], the banking regulation in Estonia has not been able to address the underlying problems of the economy and affect the instability causing financial conditions via direct quantitative or qualitative credit controls (**III**).

In broader terms, macroeconomic management strategies (see Schmidt 2002, 22-23), including monetary and fiscal stimulus during recessions, deficit-financed investments, devaluation, credit rationing and credit channeling through banks to alleviate adjustment problems, have been given up. None of the policy measures such as a flexible exchange rate, management of capital flows and/or restrictions on foreign denominated debt to preserve a policy space for a sovereign government (see Kregel 2008b, 177-178) have been opted for. The main conclusion to be drawn from the analyses is that as the Estonian economy has evolved, economic and financial policies have not been altered accordingly, but instead have either been left to stagnate or have been driven by external sources – the EU policies. Accordingly, little attention has been paid to assuring the coherence between the EU-anchored innovation and financial policies and their relevance for the local circumstances, which to some extent has been out of the

[26] Up until 2011, when Estonia joined the euro-zone, the reserve requirement was the main policy tool for affecting the behavior of banks. However, the effectiveness of reserve requirements for controlling credit creation in light of foreign ownership and access to international capital markets is questioned (**III; VI**).

scope of local policy-makers (**III; VI**). Essentially, an entrepreneurial state with a robust macro-financial framework (see Mazzucato and Wray 2015; Burlamaqui and Kattel 2016) has gone missing. Its core elements such as relationship banking, provision of financial services by the government in the form of direct lending, preferential treatment and financing of R&D, taxation of speculative activities and short-termism with financial transactions and a capital gains tax, and encouragement of patient, long-term and committed finance through state investment banks, for instance, are underdeveloped or completely absent. Thus, institutional prerequisites for successful capitalism as instituted by public policies (see Minsky and Whalen 1996) have been undermined.

MULTI-DIMENSIONAL PERSPECTIVE AND CONCLUDING REMARKS

The thesis analyzes both the impact of foreign investments on the host economy in the transition phase and foreign capital's interplay with domestic policies. In this way, the economic development and changing financial structures are addressed in a more comprehensive manner by looking at economic, institutional and political (ideational) aspects that enable one to expand on the explanatory power of the used theoretical constructs and concepts. As revealed in the studies, the Estonian political economy that prevailed during the last twenty-five years has been conducive to the realization of "Minsky's moment", to use an academic or political parlance. The elements of insecurity, uncertainty and instability in Estonia have been coded into a particular variety of capitalist system that has been built around the foreign financed catching-up process and *laissez-faire* policies. In a regime of a non-sovereign currency and a fixed exchange rate, the grounds for a speculative or even *Ponzi* economy in terms of the increasing financial fragility were established in the 1990s when the absorption of foreign inward investments took off. Thus, it is the interlocked investment-directing market relations, flows of funds and liability structures on both domestic and cross-national dimensions that are at the root of instability. Another source of vulnerability for the economy emanates from imbalanced growth[27] – de-industrialization through a decreasing and undiversified manufacturing industry that proceeded during the transition period. And, accompanied by the "enclaved" nature of FDI in Estonia, such a structure of the economy has been conducive to lopsided growth with dependence on MNEs' exports of low value-added products. Yet, in light of a soaring external indebtedness, the most pronounced cause of increasing fragility has been unproductive use of capital that can be observed in the form of hoarding and real estate investments due to weaknesses of domestic market as well as fiscal and monetary incentives. Domestic policies in the form of public finance measures such as forced loans or credit creation by state investment banks, have not been relied upon to assure the effective use of foreign funding for capital formation purposes due to self-imposed constraints. Under the circumstances of asymmetrical policies and institutional arrangements with a deflationary bias, the grounds for expansion into capital-intensive and higher productivity activities that would enable the country to stimulate exports and improve on terms of trade have been eroded. And, even though the productivity increases that were made possible by foreign capital inflows into Estonia expanded the domestic buying power, this was accompanied by an increased propensity to consume imports as is typical for a catching-up economy

[27] This can be interpreted also as the FDI- and EU-directed economic specialization along the lines of comparative advantage. See Nurkse ([1952] 2009; ([1953] 2009; [1957] 2009) on the opposite path of balanced growth and industrialization for sustainable development strategy with a corresponding set of policy measures.

imitating Western consumption habits and reflected in soaring trade deficits. Such a "demonstration effect" (see Duesenberry 1949, 27) in the Estonian case could be extended to the real estate boom of the 2000s that operated on the demand for goods not entered into international trade, yet affecting the balance of payments position. Thus, the economic and institutional prerequisites for a sustainable development strategy, whereby the absorption of foreign capital is used for productive purposes to generate sufficient export surpluses to be able to service foreign liabilities, are inadequate. Yet, the growth prospects as well as economic and financial stability are inherently dependent on foreign trade developments in the long run.

In addition to understanding the mechanics of the economy-driven fragility in the Estonian context, one cannot neglect an investigation of the ideational position of policy-makers and industry representatives in order to enable us to address the feedback mechanisms between ideas[28] and industry dynamics as endogenous processes contributing to the build-up of perceived stability. As no endogenously generated financial crisis has been experienced during the post-FDI period since the mid-1990s, the financial fragility associated with the foreign investment led economic development has never really been comprehended. Attention was shifted elsewhere, away from the underlying problems of the economy. The political slogan of the prime minister at the time and his ruling party during the Parliamentary election campaign in 2006, to make Estonia one of the five richest countries in Europe amid the global housing bubble (see Pau 2006), catches well Minsky's argument on how the perceived rapid and robust growth conceal the destabilizing conditions behind the prolonged stability. By and large, the mindset of policy-makers and industry representatives has revealed the embedded thinking along the contours of the institutionalized model of the economy (**III, VI; IV**). This is clearly reflected in a lacking attention paid to the financial structure of the economy, i.e. the set of financial assets and liabilities with payment commitments on both the domestic and cross-border dimension. The understanding of stability has been associated with an internationally competitive business environment[29] that is attractive for foreign investors, who provide employment and pay taxes. Such a simplistic approach to running the economy, where monetary, banking or innovation policies are outsourced to external actors – either the EU or foreign countries – has resulted in uncoordinated and fragmented policies (**VI)**. For instance, the

[28] Seen as sentiments and understandings for framing an agenda of policy-makers and industry representatives.

[29] A mere focus on instituting markets without understanding institutional underpinnings was reflected in the rapid mass-privatization of state-owned assets and companies to strategic (foreign) investors that contrasted to Minsky's (1991) idea on gradual approach to privatization by establishing the transitional financial structure based on public holding companies in order to establish the profitability of business units, value of assets, and patient financing of capital development.

discourse and strategy of foreign investments led development, supported by various policy measures (mostly tax incentives), has not been incorporated into broader financial or industrial and/or innovation policies. Also, the regulatory harmonization in the financial and other markets accounts for a political and bureaucratic staticism in domestic economic and financial affairs, which explains the lacking and subverted dynamism (i.e. understanding context-specificity and adopting the responsive policy approach to evolving market practices, institutions, and overall economic conditions). Such a situation can be denoted as a "foregone autonomy" (i.e. an ineffective institutional structure reflecting a bureaucracy without a holistic insight into and understanding of evolving finance, banking and economy), when approached from Evans[30] (1992, 141) perspective to the features of an autonomous state for development purposes. What can be observed are narrow expertise and inadequate skills rooted in the institutional structure of the Estonian political economy. Thus, not surprisingly, policy-makers are incapable and unwilling to constrain the disequilibrating market tendencies, given the embeddedness of neoliberal ideas in the institutional setup of the Estonian political economy that has been conducive for increasing uncertainty as well as social inequalities. This, however, brings to the fore the issue of economic foundations of democratic order and stability, as noted by Minsky (1996).

In conclusion, the thesis attempts to study the institutional infrastructure and its mutually reinforcing elements, economic practices and corporate strategies, and economic policies and the discourse around them in an interrelated way – along the lines of the varieties of capitalism tradition (see e.g. Schmidt 2002; Hall and Soskice 2001). More precisely, the analyses underline both the institutional complementarities of the Estonian political economy that have provided a comparative institutional advantage for businesses to specialize in particular types of economic activities, and the elements of institutional arbitrage that induced a foreign investment led growth. Such a comprehensive approach for understanding the combined effect and implications of various, but mutually reinforcing aspects for a country's financial fragility and instability enables one to depict the risk profile of a country. In this regard, Minsky's FIH theory, when applied at the national level, can be complemented by factoring in the production and institutional profile of an economy for analyzing the conditions conducive to increased fragility of nation states. This way, the thesis could be seen as an attempt to integrate the political economy studies in the varieties of capitalism tradition with the scholarly discourse on financial cycles and instability. In doing so, it provides avenues for further research and the construction of a political economy framework for the analysis of nation-state economies.

[30] See also (Evans 1985) on negative relation between transnational linkages and state capacities, and Skocpol (1985) on connection between state capacities, institutional structure and goal formation.

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SUMMARY IN ESTONIAN

Finantsiline haavatavus ja majanduslik ebastabiilsus üleminekuriikide kontekstis Eesti näitel

Viimase kahekümne viie aasta jooksul on Eesti majandus olnud tunnistajaks turuinstitutsioonide kehtestamisele, radikaalsetele reformidele ning mitmetele panganduskriisidele turumajanduslikus korralduses. Kuigi Eestit on vaadeldud kui üht edukamat siirdemajandust, on arengutee olnud ehk üks reljeefsemaid näiteid *laissez-faire* ehk liberaalse turumajanduse mudeli kohaldamisest ülemineku faasis ja hiljemgi (**I; VI**). Lisaks sellele võib Eesti riiki käsitleda kui ebatüüpilist või isegi äärmuslikku juhtumit, arvestades mõningaid iseäralikke tunnusjooni nagu peaaegu täielikus välisomanduses pangandus, märkimisväärne sõltuvus välismaisest avaliku ja erasektori rahastamisest kapitalibaasi arendamisel ning äärmuslik nii monetaarne kui ka fiskaalne konservatism. Seega mõnes mõttes võib Eesti puhul täheldada omapärast kapitalistlikku tootmissüsteemi koos unikaalsete nõrkuste ja väljakutsetega.

Laias laastus on käesoleva väitekirja fookuseks Eesti poliitilis-majandusliku süsteemi haavatavus ja destabiliseerivad tingimused. Täpsemalt vaatleb doktoritöö kahte peamist turgusid kujundavat majandusharu (pangandus ja toiduainete jaekaubandus), kus suhteliselt drastilised arengud on leidnud aset vastusena regulatiivsetele muudatustele ajalooliselt omapärase poliitikakujundamise paradigma raames ehk läbi "ankurdamise" Euroopa Liidu (EL) poliitikatesse. Seega on keskne uurimisküsimus, mida väitekiri adresseerib: kuidas on majanduse finantsiline haavatavus[31] (ingl *financial fragility*) süvenenud aasta-aastalt ning millised poliitilised, majanduslikud ja muud tegurid on destabiliseerivate tendentside taga?

Peamised argumendid antud uurimisküsimuse valguses on esitatud kuues teadusartiklis, mis analüüsivad erinevaid, mitmemõõtmelisi aspekte Eesti majanduse ja poliitilise süsteemi institutsioonilises struktuuris. Esiteks, artiklid **I** ja **II** kirjeldavad muutusi, dünaamikaid ja mustreid Eesti majanduse nii reaal- kui ka finantssektoris ning vaatlevad *finantsialiseerumise*[32] protsessi ja selle mõju Eesti institutsionaalses kontekstis. Teiseks, artiklid **III** ja **VI** uurivad euroopastumise protsessi, regulatiivset konvergentsi, poliitikate kujundamist ja

[31] Süvenevat finantsilist haavatavust võib mõista kui riskantsete varade kui ka erasektori võlakoorma kasvu ning likviidsuse ja refinantseerimisvõimaluste ahenemist. Taolised arengud võivad päädida finantsilise ebastabiilsusega, mille ilminguks on asümmeetrilised raha sisse- ja väljavood ning sellest tulenevad kõikumised majanduskasvus, hindades, kasumites ja tööhõives (Minsky 1982a; Minsky 1982d; Papadimitriou ja Wray 1999, 4).
[32] Vt Wray (2016) *finantsialiseerumise* fenomeni mitmete tunnusjoonte osas.

koordineerimist finantsvaldkonnas, autonoomiat ja poliitikakujundajate ideelisi positsioone. Viimaseks, artiklid **IV** ja **V** selgitavad arenguid Eesti toiduainete jaekaubanduses ja sellega seotud tööstusharudes, keskendudes välismaiste otseinvesteeringute juurdumisele Eesti majanduses ja mõjudele kodumaistele osapooltele. Metodoloogiliselt tugineb väitekiri erinevatele lähenemisviisidele nagu dokumendiuuring, (riigi) juhtumiuuring ja fenomenoloogiline uuring. Seega empiiriliste andmete kogumisel on tuginetud mitmetele meetoditele nagu struktureeritud ja poolstruktureeritud intervjuud erinevate huvigruppidega (vt **III; VI; IV; V**), meta-analüüs (vt **I; II**) ja õigusaktide, seletuskirjade jm dokumentide sisuanalüüs (vt **III**).

Väitekirja analüüs tugineb majandusmõtte heterodoksse traditsiooni erinevate koolkondade lähtealustele. Eelkõige selgitatakse arenguprotsesse ja üleminekut turumajanduslikule süsteemile institutsionaalse, klassikalise arenguökonoomika ning "finants-keynesiaanliku" perspektiivi kaudu. Ühelt poolt on tsüklilisi arenguid ja muutuvaid finantsstruktuure, mis põhjustavad majanduslikku ebastabiilsust, esitatud Minsky (1992a) *majandusliku ebastabiilsuse hüpoteesi* vaatenurgast. Teisest küljest keskendub doktoritöö majandusalaste ideede, mis on institutsioonides kinnistunud, ja lahendusi pakkuvate poliitikate koosmõju lahkamisele. Sellega seoses on väitekirjas tuginetud nii ajaloolise kui ka konstruktiivse (diskursusliku) institutionalismi teoreetilistele seisukohtadele. Taoline lähenemine võimaldab mõista ajaloolise pärandi mõjusid ja vaadelda, kuidas erinevate huvigruppide institutsionaliseerunud ideed ning samuti poliitikakujundajate väljakujunenud võimekus sillutavad teed rajasõltuvuseks ehk end võimendavate poliitikate järjepidevusele *Minsky-Kregel*'i teoreetilises raamistikus. Sellest johtuvalt analüüsitakse muutusi omavahel läbipõimunud majanduses ja poliitikates. Ja vaatamata sellele, et on olemas suur hulk kriitilisi uuringuid nii teoreetilises kui ka empiirilises võtmes[33], mis vaatlevad rahvusvahelisi kapitalivoogusid ja nende mõju võõrustaja riigile, ei ole olemasolevate järelduste kohaldamine Eesti konteksti üksüheselt teostatav. See on tingitud peamiselt omapärastest institutsionaalsetest ja majanduslikest väljakutsetest, millega üks postsotsialistlikke riike on seisnud silmitsi üleminekuprotsessis turumajandusele. Seega tuleb teoreetilistele argumentidele läheneda teatud möödustega, mistõttu artulebki käesoleva väitekirja sissejuhatus peamiste väitekirja avastuste sobitumise üle teoreetilistesse diskursustesse ning

[33] Vt näiteks Keynes (1934, peatükk 36) seonduvalt küsimustega, mis puudutavad riiklikku autonoomiat ja sõltumatut tegevust tegelemaks siseriikliku stabiilsuse ja tööhõivega kapitali piiriülese mobiilsuse ning rahvusvaheliste standardite kontekstis; Nurkse ([1945] 2009) seonduvalt seostega väliskonto, valuutarežiimide ja kodumaise tööhõive, sissetulekute ning hidade stabiilsuse vahel; Kalecki ([1955] 1979) seoses otseste välisinvesteeringute ühepoolse mõjuga siirderiikidele, arenguperspektiivide ja ülekannete küsimusega; Kregel (1996; 2008b) seonduvalt küsimustega kahanevast poliitilisest ruumist liberaliseerimise valguses.

hindab teoreetiliste kontseptsioonide nii analüütilist kui ka selgitavat jõudu Eesti kontekstis.

Lähtudes Hyman Minsky lähenemisest majandustsüklite ja muutuvate finantssuhete analüümisel (vt Ferri ja Minsky 1991), identifitseerib käesolev väitekiri endogeensed protsessid Eesti majanduses, mis on viinud suurema finantsilise haavatavuseni, olles samas võimendatud väliste tegurite poolt nagu järk-järgult taandunud regulatiivne sekkumine ja institutsionaalsete otsuste väljapoolt "sisseostmine". Kui Minsky (1982a; [1986] 2008) tööd keskenduvad arengute mõistmisele, mis on võlaga finantseeritud investeerimisnõudluse taga[34], siis Eesti puhul saab rääkida võlaga kaetud tarbimise ja välisinvesteeringute nõudluse suhtelisest kasvust, mis on ühed olulisemad mõjutegurid majanduse tsüklilise käitumise taga. Sellest johtuvalt peegeldab *finantsialiseerumise* protsess Eestis pigem erasektori võlakoorma kasvu koos jooksevkonto saldo halvenemisega. Väliskonto liberaliseerimise järgsel perioodil hoogustus väliskapitali sissevool [sealhulgas pangandus- ja jaemüügisektoris (**I; III; IV**)], mis on päädinud kasvavate väliskohustustega riigi tasandil. Kasvavaid nõudeid riigi ja selle välisvaluuta reservide vastu põhjustasid ka akumuleeruvad eelmiste perioodide jaotamata kasumid, mida soodustas 2000. aasta tulumaksureform (**I**). Niisamuti võib suurenenud riskide ja majanduse haavatavuse taga näha Eesti turule suunatud kaupade ja teenuste pakkumist ning imporditud kapitali- ja pooltoodete kasutamist Eestis tegutsevate rahvusvaheliste ettevõtete poolt, mis on täiendavalt avaldanud negatiivset mõju Eesti maksebilansile. Taoline tegevusprofiil on omakorda survestanud kodumaised tootjaid ja tarnijaid, tõrjudes neid turult välja (**II; IV; V**). Niisiis lisaks sellele, millist tähendust omistab välisriikide omandis olev tootmisvara tulude jaotusele, ei saa mööda vaadata ka ohtudest, mis tulenevad väliskapitali majandustegevusliku spetsialiseerumise mustrist (vt Piketty 2014 44, 67-71; Kalecki [1955] 1979; Nurkse [1953] 2009). Enamik Eestis tehtud välisotseinvesteeringutest on integreeritud tootmisvaldkondadesse ja suunatud tööstusharudesse, nagu finantsvahendus, kinnisvaraalane tegevus, ning hulgi- ja jaekaubandus (**I; II**), mis ei loo palju võimalusi innovatsioonipõhiseks "hüppeliseks" arenguks. Seega väliskapitali sissevool Eestisse, mis oma olemuselt on olnud *modulaarne* ning tuginenud mitmeid aastaid madalate kulude eelisele, on toonud kaasa deflatsioonilise surve majandusele. Taoliste arengute taustal on deindustrialiseerimise nähud ning majanduse re-spetsialiseerumine teenuste suunas (**I; II**; vt ka Kattel 2010) halvendanud omakorda majanduse suutlikkust teenindada välisvõlga. Sellises väljakujunenud makro-majanduslikus situatsioonis on täheldatavad mitmed tasakaalustamatuse tunnused. Sümmeetria puudumine võimutasakaalus avaldub nii turu kontsentreerumises kui ka välisinvestorite kasvavas kontrollis tööstusharude üle, mis selgitab

[34] Mõningad Minsky artiklid (1982b; 1982c) puudutasid majapidamiste rahastamise profiile ja nende eristumist väliselt finantseeritud investeeringutest läbi laenutingimuste pikkuse kui ka sissetulekute allikate vaatenurga.

oligopolistlikke tunnusjooni turgudel (**III; IV; V**). Kõigele lisaks paljastavad toiduainete jaekaubanduse ja panganduse juhtumianalüüsid suundumusi *enklaavilaadseks* kapseldumiseks, kus välisomandis olevad ettevõtted on vastastikku soosivates turusuhetes, peegeldades positiivseid tagasiside mehhanisme nii finants- ja tootmissektorite vahel kui ka nende sees.

Kuigi tunnusjooned ja arengud, mis soodustavad majanduslikku ebastabiilsust on täheldatavad mõlemas majandusharus, on pangandus Eestis olnud peaasjalikult destabiliseerivate tingimuste ja kriiside taga. Riigi välisvõla hüppelise kasvu valguses ilmestab pankade panust finantsilisele haavatavusele väliskapitali ebaproduktiivne kasutamine, mida võib koosmõjus maksupoliitiliste stiimulitega täheldada kinnisvarainvesteeringute soodustamisel. Pankade krediidiloome rahastas 2000. aastate keskpaigas tarbimist, sealhulgas kallineva vara soetamist, protsüklilisel viisil, mis tõi kaasa erasektori kasvava võlakoorma, samas kui kinnisvaramulli lõhkemise tingis Põhjamaade emapankade karmistunud laenutingimuste poliitika. Siinjuures on siiski oluline rõhutada eripäraste poliitiliste ja majanduslike tegurite[35] kumulatiivset mõju, mis omasid otsest mõju muutuvatele finantssuhetele ja lõid eeldused spekulatiivsete tegevuste finantseerimiseks. Tööstussektoris on aga finantsiline haavatavus olnud seotud reaalmajanduse duaalse struktuuriga, kus keskmise suurusega ja suurettevõtted (reeglina välisomandis) suudavad mõjutada (kulu)hindasid oma turupositsiooni tõttu. Olukorras, kus rahvusvahelised ettevõtted on hinnakujundajad ja omavad seega kõrgendatud ootusi nii müügi kui ka kasumi osas, on majanduse habras olek mõjustatud lisaks endogeensetele protsessidele muutuvate võlausaldaja-võlgnik suhete kaudu ka vastuvõtlikkusest välisinvestorite väljumisele riigist ja seda suuresti rahuldamata kasumiootuste tõttu. Ühekülgse majandusstruktuuri kontekstis, kus välisomandis olevad ettevõtted etendavad märkimisväärselt suurt rolli mitmetes tööstusharudes [sealhulgas pangandus-, toiduainete jaekaubanduses ja teistes turusegmentides (**I; II; IV**)], võivad kuhjuvad välisettevõtete likvideerimised[36] kahjustada majanduse kui terviku stabiilsust. Seetõttu arusaama riigi finantsilisest haavatavusest rahvusvahelisel areenil, mis tugineb *majandusliku ebastabiilsuse hüpoteesil* Minsky-Kregel raamistikus, saab täiendada kahe aspektiga: 1) väliskapitali kaasamise tähtsus kohaliku majanduse jaoks kui ka majanduse

[35] Nagu eluruumide erastamise lõpuleviimine ja maksusoodustused, mis avasid tee kinnisvaraturu õitsenguks, samas kui valuutakomitee süsteem ja resoluutne pankrotiseadus võimaldas pankade ülevõtmist välismaiste finantsasutuste poolt ja seeläbi suurendada välislaenude mahtusid. Teisest küljest nõrgendasid korporatiivses sektoris *Treuhand*'i mudeli põhine riigiettevõtete erastamine ning re-spetsialiseerumine teenustekesksele ja allhankepõhisele majandustegevusele nõudlust pangalaenude järele (**I**).

[36] Viimased arengud Eesti turul on tunnistajaks trendidele, kus madala lisandväärtusega tootmisele keskendunud rahvusvahelised ettevõtted lahkuvad Eesti majandusruumist odavamatele turgudele. Samal ajal on ainult üks pretsedent välismaise jaeketi lahkumisest Eesti turult (**V**).

tundlikkus selle kõikumiste osas, 2) riigi majandusprofiil ehk tehnoloogiline ja majanduslik spetsialiseerumine.

Formaalsed institutsioonid mängivad keskset rolli sotsiaal-majandusliku arengu ja finantsstabiilsuse tagamisel, kuna "... institutsionaalsed struktuurid ja riiklik sekkumine mõjutavad majanduse käitumist." (Ferri ja Minsky 1991, 13; vt ka Minsky 1992b) Sellele vaatamata ei saa Eesti puhul rääkida riikliku sekkumise erinevate võimaluste[37] aktiivsest kasutamisest, ennetamaks destabiliseerivaid arenguid majanduses. Nagu johtub väitekirjast (**I; III; VI**), on põhistatud institutsionaalne raamistik raharežiimi, tööturu institutsioonide, riigi rahanduse vahendite ja regulatiivse maastiku näol olnud suuresti ebaefektiivne kogunõudluse juhtimisel või majandusliku ebastabiilsuse leevendamisel. Riiklik autonoomia ja kontroll on Eestis vähenenud volatiilsete väliskapitali voogude, euroopastumise protsessi[38] ja enda kehtestatud institutsiooniliste piirangute (nt valuutakomitee režiim) tõttu. Viljeldavad makromajanduspoliitikad tähendavad vaikimisi vajadust sisemise devalveerimise järele taastamaks välistasakaalu, kuid mis omavad kahjulikku mõju riigi sisemisele tasakaalule – tööhõivele ja hindadele. Range eelarvepoliitika tingimustes ning ka nõrga tööstuspoliitika valguses, mis on EL-i dikteeritud, on tööliskonna olukord kõrge tööhõive ja sissetulekute ebakindluse tõttu halvenenud. Samal ajal on fiskaalpoliitika suunatusega investeeringute poolt juhitud kasvule kaasnenud finantsiline ebastabiilsus ja kalduvus sotsiaal-majanduslikule ebavõrdsusele (**I; II**). Isegi kui riske majanduses on maandatud läbi investeeringute sotsialiseerimise innovatsiooni ja kapitalibaasi arendamise eesmärgil, peegeldab senine praktika juurdunud majanduse mudelit. Nimelt on märgatav ka valitsuse tasandil sõltuvus välisabist – Euroopa Liidu vahenditest –, mis ilmestab teistlaadi "ankurdatust" läbi kohandumise välistest teguritest ja arengutest sõltuvasse institutsionaalsesse struktuuri. Sisuliselt on kogunõudluse stabiliseerimine üle antud välistele osalistele, s.t EL-ile, kes rahaliste ülekannetega toetab kapitali investeeringuid, ning välismaistele riiklikele institutsioonidele (Skandinaaviamaade keskpangad), kes toetavad kohalikku pangandussüsteemi valmisolekuga suurendada likviidsete vahenditega Eesti Panga reserve (**II; III**).

Väitekiri viitab ka finants- ja muude poliitikate seostamatuse ja ebapiisavuse tunnusmärkidele (**III; VI; IV; V**). Kapitalivoogudele kehtestatud piirangute kaotamine 1990. aastate alguses oli verstapostiks, mis lõi eeldused järgnevateks destabiliseerivateks arenguteks majanduses. Samal ajal avas nii valitsuse soovimatus kui ka võimetus reguleerida väliskapitali – mõjutada selle püsivust ja

[37] Vt Ferri and Minsky (1991) seonduvalt "lagede ja põrandatega" kui majanduse käekäiku mõjutavate teguritega, mis taastavad esialgsed majandustingimused.

[38] Vt artiklit **III**, mis esitab põhjalikuma arutelu euroopastumise mitmetahulise kontseptsiooni üle seoses panganduse reguleerimise ja harmoniseerimisega Eestis. Ka võib täheldada EL-i teistpidist mõju uuritud tööstusharudes, nt pangalaenude pakkumine Euroopa Liidu projektide "sild-finantseerimiseks" või turu kontsentreerumised EL-i regulatsioonide ja standardite tõttu (**II; IV; V**).

kasutust – tee, liikumaks riigi tasandil spekulatiivse finantseerimise profiili. Üldised arengud panganduse reguleerimises ja poliitikate kujundamisel on olnud mõjutatud ja suunatud Euroopa Liidu õigusaktide poolt. Teisalt on taoline EL-i põhine poliitikakujundamise protsess võimaldanud krediidiasutustel minna mööda regulatiivsest järelevalvest kanaleid ja institutsioone pidi, mis on leebemalt reguleeritud (**III; VI**). Seega arvestades EL-i direktiividele tuginemist, mis rõhutavad nii mikro- ja makrotasandi kapitalinõudeid, ning siseriiklike meetmete suunatust peamiselt reservinõuetele[39], ei ole pangandusregulatsioon Eestis suutnud lahendada majanduse põhiprobleeme või mõjutada ebastabiilsust põhjustavaid finantstingimusi otseste kvantitatiivsete või kvalitatiivsete meetmete kaudu, mis kehtestatud pankadepoolsele krediteerimisele (**III**). Sellest johtuvalt on Eesti kontekstis küsitav pangandusregulatsiooni tõhusus, mis nõuab arusaamist nii kohalikest praktikatest, institutsionaalsest korraldusest kui ka endogeensetest (evolutsioonilistest) kumulatiivsetest protsessidest, mis viivad finantsilise haavatavuse ja ebastabiilsuseni (vt Minsky [1986] 2008; Kregel ja Papadimitriou 2012). Peamine järeldus, mida saab väitekirja analüüside pinnalt teha, on see, et majandus- ja finantspoliitikad ei ole muutunud vastavalt majandusoludele, vaid on kas jäänud soiku või on mõjustatud välistest allikatest – Euroopa Liidu poliitikatest. Seepärast on ka EL-i põhiste innovatsiooni ja finantspoliitikate sidususe ning nende relevantsuse tagamine jäänud kohalike poliitikakujundajate poolt tähelepanuta, mis on osaliselt selgitatav nende kohaldamisalast väljapoole jääva valdkonnaga (**III; VI**). Niisamuti järgib poliitikakujundajate ja tööstuste esindajate mõtteviis institutsionaliseerunud majandusmudeli kontuure (**III; VI; IV**). Arusaam stabiilsusest on seotud rahvusvaheliselt konkurentsivõimelise ärikeskkonna kujundamisega, mis oleks atraktiivne välisinvestoritele, kes loovad töökohti ja maksavad makse. Taolisel lihtsakoelisel lähenemisel majanduse juhtimisele, kus rahandus-, pangandus- ja innovatsioonipoliitikad pärinevad välistest allikatest, on tulemuseks koordineerimata ja killustatud poliitikad (**VI**). Poliitikakujundajad ei suuda ega soovi piirata tasakaalust kõrvale kalduvaid tendentse, arvestades neoliberaalsete ideede kinnistumist Eesti poliitilis-majanduslikus korralduses, mis on soodustanud ebakindluse kui ka sotsiaalse ebavõrdsuse süvenemist. See aga tõstatab küsimuse demokraatliku korra ja stabiilsuse majanduslikest alustest, millele viitab ka Minsky (1996).

Kokkuvõttes analüüsitakse väitekirjas nii välisinvesteeringute mõju võõrustajariigi majandusele üleminekufaasis kui ka vastastikust mõjustust väliskapitali ja siseriiklike poliitikate vahel. Sel moel käsitletakse majanduslikku arengut ja muutuvaid finantsstruktuure läbi laiahaardelisema perspektiivi, vaagides majanduslikke, institutsioonilisi ning poliitilisi (ideelisi) aspekte,

[39] Kuni 2011. aastani, mil Eesti liitus eurotsooniga, oli kohustusliku reservi nõue üks peamisi meetmeid mõjutamaks pankade käitumist, mille tõhusus krediidiloome kontrolli eesmärgil on küsitav välisosalusega pankade ja rahvusvahelistele kapitaliturgudele vaba juurdepääsu valguses (**III; IV**).

millega on võimalik täiendada kasutatud teoreetilisi konstruktsioone. Täpsemalt vaatleb väitekiri üksteist täiendavaid institutsionaalseid elemente, mis on loonud ettevõtete jaoks suhtelise eelise, spetsialiseerumaks teatud liiki majandustegevustele, kuid heidab valgust ka institutsionaalsele arbitraažile, mis on võimaldanud välisinvesteeringutel põhinevat kiiret majanduskasvu. Taoline terviklik lähenemisviis, mõistmaks erinevate, ent üksteist võimendavate aspektide koosmõju riigi finantsilisele haavatavusele ja ebastabiilsusele, loob pinnase, joonistamaks välja riigi riskiprofiile. Minsky majandusliku ebastabiilsuse hüpoteesi, mida on kohaldatud rahvusriikide tasandile, saabki täiendada majanduse tootmisliku ja institutsioonilise läbilõikega analüüsimaks rahvusriigi finantsilist haavatavust soodustavaid tingimusi. Selles valguses on käesolev väitekiri vaadeldav kui katse integreerida poliitökonoomia uuringud kapitalismi tüpoloogia (ingl *Varieties of Capitalism*) traditsioonis akadeemilise diskursusega finantstsüklite ja ebastabiilsuse kohta.

ACKNOWLEDGEMENTS

On my academic journey that began in 2002 at Tallinn University of Technology I witnessed (read: survived) several rounds of confusing education reforms and even a shift from one school of thought to another. Throughout these years, though, I have been fortunate enough to be guided and academically nurtured by my supervisor, Prof. Rainer Kattel who has been a source of inspiration and a role model not only to me, but many others. Without him and his motivational pat on the back, to the point remarks and advice, and just being there when most needed, I would probably have given up on academic life a long time ago. Hence, Thank You for everything You have done so far, and not just for me, but for our school, discipline and society!

I am also grateful to my colleagues at Ragnar Nurkse School – Piret Kähr for keeping things in order, Dr. Piret Tõnurist for giving an example in my final efforts, Rauno Mäekivi and Aleksandrs Cepilovs for proofreading the articles, the trio of Prof. Ringa Raudla, Prof. James W. Douglas and Dr. Veiko Lember who helped me in sorting out and coming to terms with my own ideas, and all the rest. I am especially thankful to my roommate Dr. Margit Kirs, whose assistance and reflections have kept me afloat. Also, I would like to thank Dr. Sylvi B. Endresen, who contributed to this thesis.

Definitely, some space needs to be spared for expressing my gratitude to the faculty of UMKC, who consented to host me for a semester, and my *comrades* – BJ, Mitch, Mari, Morgan and many others – for Your friendship and enlightening (late-evening) discussions. Without Your timely help my physical existence would be really questionable. So, IOU!

Last but not least, I thank those closest to me – my mother, father, sisters, and grandmother – for both material and immaterial support all the way through my university years. And, Kati – my other side, my friend, my doctor –, only with you it all makes sense.

PUBLICATIONS (Articles I-V)

Article I

Juuse, E. 2015. "'Latin Americanization' of the Estonian Economy – Institutional Analysis of Financial Fragility and the Financialization Process." *Journal of Post Keynesian Economics*, 38 (3), 399−425. (1.1)

Journal of Post Keynesian Economics, 38:399–425, 2015

ISSN 0160-3477 print / 1557-7821 online
DOI: 10.1080/01603477.2015.1070270

EGERT JUUSE

"Latin Americanization" of the Estonian economy: institutional analysis of financial fragility and the financialization process

Abstract: *By drawing on the tradition of institutionalism and the Minsky–Kregel framework on sovereign financial systems, the paper discusses the nature of and the institutional factors behind financial fragility in Estonia within a wider financialization phenomenon. The study reveals the emergence of two interrelated manifestations of the financialization process in Estonia in the form of increased international inequality in favor of foreign actors, accruing from cross-border investment activity, and higher debt burden of the household sector against the accumulation of savings in the economy as a whole. Institutionally, these developments have been supported by the embeddedness of the Washington Consensus policies. Given the lack of intervention in the economy by means of either prudential capital account controls or specific foreign direct investment policies, the result has been a heavy reliance on foreign capital in both the financial and nonfinancial sectors. Furthermore, the privatization process and recurring banking failures associated with the transition process have created a particular historical context in terms of institutional arrangements and idiosyncratic elements that laid the groundwork for deteriorating internal and external imbalances in the economy.*

Key words: *financial fragility, financialization, foreign direct investments, institutions, transition economies*

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Estonia has been portrayed as a poster child not only in terms of adhering to a neoliberal agenda in its catching-up process but also in dealing with the consequences of the global financial crisis of 2008. During its reindependence period of twenty-four years, Estonia has not practiced extensive intervention in the economy beyond fiscal reforms for the purpose of macroeconomic stability. Such conservatism, manifested in a fixed exchange rate regime and flat tax system, has been accompanied by a rapid annual real growth rate of 8.7 percent between 2000 and 2007 and almost a tenfold increase in gross domestic product (GDP) at nominal prices from 1994 to 2007 (Kuum, 2010, p. 48). However, increasing external debt levels and widening current account deficits have at the same time weakened the economy's foundations. In light of these adversarial developments in an extremely open economy, the present study seeks to understand the institutional factors behind the increasing fragility of the economy, that is, broadening internal and external imbalances. More specifically, the paper looks at how particular policies have rendered the economy financially vulnerable during the twenty-four-year period of reindependence and therefore, in line with the insights from the German historical school, endeavors to "underscore the importance of sensitivity to specific cultural and historical circumstances in economic analysis" (Raudla, 2014, p. 3). On that account, Estonia is a good example for understanding the implications of a transition from the socialist socioeconomic system to the capitalist mode within a specific political and institutional context. Moreover, considering the particular historical context, it is possible to follow the interplay between the transition process and the broader *financialization* phenomenon during a relatively short span of time, compared to the decades-long evolution of financial systems in advanced industrial economies.

By drawing on the historical institutionalist tradition (Pollitt, 2008, 2012), "snapshots" relating to critical junctures, that is, institutional and political factors that have a significant explanatory power for understanding paradigmatic shifts, will be presented by relying on the secondary (meta-)analysis method, whereas statistical evidence reveals general patterns in the economy. For instance, the outset of pre-accession negotiations for European Union (EU) membership or mass privatization can be considered as critical junctures in institutional adaptation. This investigation of historical context and institutional arrangements is important for understanding the ensuing economic processes. Hence, on a theoretical level, the study contributes to institutional analysis within different scholarly approaches such as the dependency theory (e.g., Prebisch, 1950; Singer, 1950), classical development economics (e.g., Nurkse, 2011a; Rosenstein-Rodan, 1961) or post-Keynesian tradition (e.g., Kregel, 2004; Minsky, 1992; Wray, 2006), which address the issue of macroeconomic financial (in)stability.

Minsky–Kregel framework and financalization

Notwithstanding the different aspects that various schools within the heterodox economics tradition have underlined, the primary mechanism behind socioeconomic development, particularly in catching-up transition economies, is deemed to be the integrated production structures with demand linkages, that is, balanced investments made in horizontally diversified and mutually supporting industries, which enlarge the size of the market and increase real income per capita (Nurkse, 2011a, pp. 107–121; Nurkse, 2011b, pp. 329–338). The core issue, however, is related to the financing aspect of investments that reveals opposing positions in the finance and development literature. In the orthodox, neoclassical tradition, foreign capital is seen as a solution to deficient domestic savings in developing countries (Perkins et al., 2006, pp. 393–397). The explanation for the flow of capital from developed to developing countries rests on the argument that developing countries have higher prospective rates of return on investment than more developed economies, which in line with the efficient markets hypothesis, should incentivize the movement of capital to developing countries. The heterodox school, on the other hand, sees the mobilization of domestic resources as a precondition of development and neglects the importance of external funds for development (Kalecki, 1993; Nurkse, 2011a; Prebisch 1950).[1] Conceptually, this could be reasoned based on Minsky's (1992) analysis on financing positions, which if extended to the country level, discloses the conditions of financial fragility for (monetarily nonsovereign) countries and enables us to see how the embedded

[1] Theoretically, external financing can contribute to sustainable development by financing investments in competitive manufacturing export industries through balanced growth with the establishment of backward and forward demand linkages that would improve the balance of payments position and ensure a long-term debt sustainable development pattern (Kregel, 2004, pp. 11–13).

structural patterns are related to the financial sustainability of the economy. Minsky's hedge profile for a country entails sufficient external earnings from surplus on goods and services to cover debt commitments, while a Ponzi position implies insufficient trade surpluses to service net capital factor payments, if outstanding liabilities are denominated in a foreign currency (Kregel, 2004; 2006, p. 18; see also Wray, 2006, pp. 17, 24–25). In the context of growing foreign liabilities, both the notion of an enclave economy (Gallagher and Zarsky, 2007; Nurkse, 2011a, pp. 157–163) and the Prebisch–Singer thesis (Singer, 1950; Toye and Toye, 2003) provide an explanation for increased susceptibility to a Ponzi profile. Namely, by extending a lender's economy to a host economy, developing economies become unable to repay debt due to a detrimental position in the international division of labor and the deteriorating terms of trade. Hence, overall financial fragility at the country level implies a heavy indebtedness of the economy with decreasing margins of safety (Minsky, 1991, 1992). In principle, the dynamics of externally financed economies are consistent with the logic behind the credit-driven business cycle with two succeeding phases (Palley, 2001): the period of increasing expenditures, incomes, and demand due to the availability of cheap credit, which is followed by a period of contraction, as loans are to be repaid, that is, the transfers of income from debtors to creditors outweigh the expansionary impact of new loans, causing increased debt burden, constrained investment possibilities, and decreased incomes. The extent of the fluctuations during these stages, however, depends on macroeconomic policies as institutional ceilings and floors that constrain the instability (Ferri and Minsky, 1991; Thabet, 2006). In line with Minsky's financial fragility hypothesis, "the need is for . . . authority for the financial system that accepts that financing development opens the system to losses. . . . The problem therefore is to provide for protecting . . . from the consequences of the losses which may ensue from development financing" (Minsky, 1994, p. 3).

In historical perspective, both increasing financial fragility and cyclicality have been inherent elements of a capitalist system in general, whereas during the latest stage of capitalist development in the late twentieth and early twenty-first centuries, disequilibrating developments on both the micro and macro levels have been associated with the financialization process that reflects the propositions of Minsky–Kregel analysis (Minsky, 1996; see also Wray [2009] on money manager capitalism as an equivalent to the notion of financialization). Aside from a typical increase in the debt level of the private sector due to credit-led investments and consumption, the common characteristics of this phenomenon include among others the deregulation of the financial sector, an increase in financial investments and incomes, and shareholder value orientation (Palley, 2007; Stockhammer 2004). In general, financialization is conceived of the proliferation of financial markets and innovations that have contributed to increasing reliance on the debt-led growth strategy either domestically or in the cross-border dimension. At the micro level, *financialization* processes have contributed to the emergence of the latest—sixth—stage in banking evolution, which introduced securitization (see Chick [1993] on the stages approach). However, all these developments under the financialization notion need to be seen as embedded in the particular institutional environment that has either supported or constrained the realization of its manifestations. For instance, one could see the securitization process within the broader financialization phenomenon as a response to and an impact of financial policies. This brings forth the institutional aspect of economic analysis, particularly when trying to understand the impact of radical reforms on financing patterns in a transition economy.

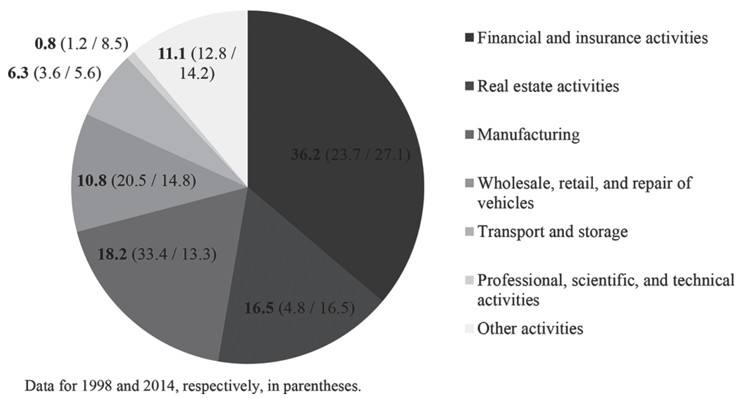
For developing and transition economies alike, the most important institutional anchors in recent history have been development policies—Washington Consensus (WC)—promulgated by the leading international financial institutions such as the International Monetary Fund (IMF) and the World Bank, which have highlighted the importance of capital flows from developed to developing countries with the emphasis on foreign direct investments (FDI) (Kregel, 2004; Ocampo et al., 2007). However, it has not been recognized that FDI is a form of debt that needs to be repaid, and the ability of an economy to service the debt is determined by the economic and financial foundations of a host country. In this regard, financial stability under the outward-looking development strategy is primarily affected by the structural pattern of the economy, but no less by the macroeconomic and prudential time-varying financial policies (UNCTAD, 1998). Hence, without targeted FDI policies and countercyclical measures, reliance on external capital worsens the imbalances and leaves developing economies exposed to both negative net flows and unsustainable debt creation, which renders them prone to financial crises (Kregel, 2004; Ocampo et al., 2007 UNCTAD, 2003, i–xiii).

Growth induced in Estonia by foreign savings

Estonia is one of the best examples of a country that finances its development with foreign capital. By the end of 1997, it was among the top three Central and East European (CEE) countries according to the inward FDI stock per capita. While the inward FDI stock in GDP stood at 46.6 percent in 2000, it increased to 73.4 percent by 2008 (Hunya, 2009, p. 32). More significant change, however, has taken place in the allocation of inward FDI. In the early 1990s, the financial sector ranked only fourth in the share of annual FDI inflows, whereas the manufacturing industry absorbed most of the foreign capital. By 2008, the FDI stock in the FIRE (finance, insurance, and real estate) sector had taken the leading position among economic activities (see Figure 1).

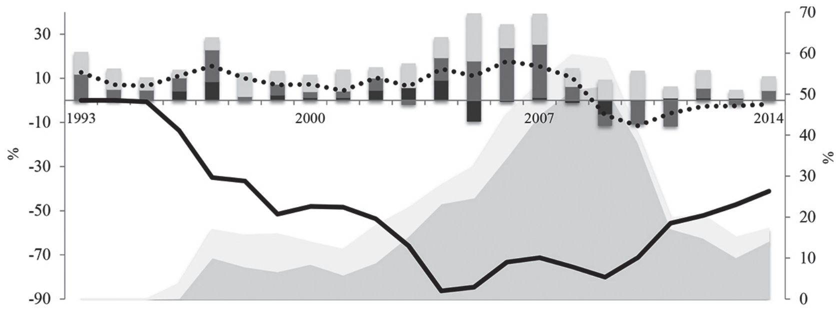
This change in the allocation of foreign capital, which resulted in the acquisition of nearly all Estonian commercial banks by foreign investors, also affected the change in the pattern of capital inflows. Starting with FDI and long-term government loans in the early 1990s, other forms of foreign capital inflows such as loans, currency, and deposits as well as portfolio investments also increased their share during the 2000s. Over a nine-year span before the 2008 crisis, the volume of foreign loan and deposit liabilities grew nearly sevenfold (see Figure 2). Following positive net capital flows until 2008, the net total external debt of the economy grew from 17.6 percent of GDP in 1996 to 54.3 percent in 2008 before turning

Figure 1 Direct investment positions in Estonia by fields of activity, 2006 (% of total inward FDI stock)



Source: Author's calculations based on data from Eesti Pank, 2015.

Figure 2 Capital inflows, net external debt, and international investment position in Estonia, 1993–2014 (% of GDP)



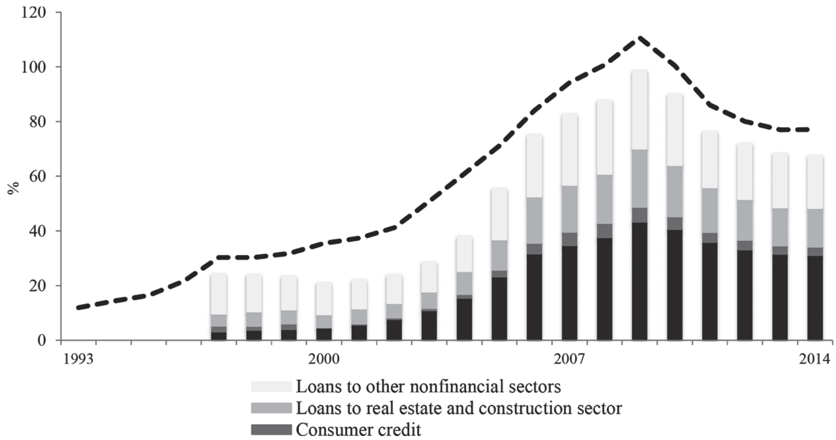
Source: Author's calculations based on data from Eesti Pank, 2015.

negative in 2012 (author's calculation based on Eesti Pank, 2015), even though the private sector has continuously been a net debtor against the rest of the world.

In light of a heavy reliance on foreign savings in both the financial and nonfinancial sectors as well as factors related to a transition economy (see below), the links between the Estonian domestic financial sector and the productive part of the economy were gradually weakened. In the 1990s, bank loans to the nonfinancial corporate sector overwhelmingly dominated the banks' asset portfolio, even though the volume of issued loans was relatively low—around 25 percent of GDP in the late 1990s (OECD, 2000). In the 2000s, however, the distribution of loans to private persons and the corporate sector evened out, in spite of the increased use of bank credit by the corporate sector (see Figure 3).

As Figure 3 shows, during the 2000s, an increasing share of banking assets was channeled to meet the credit demand of the household and real estate sectors. Over 40 percent of the loans to nonfinancial companies consisted of real estate and construction loans, and coupled with mortgage loans, the share was even higher—over 60 percent of the banks' credit portfolio in 2009. The main contributor in the growth of loans to households was mortgage lending—over a ten-year span, outstanding housing loans grew from 4.5 percent of GDP in 2000 to 43.7 percent in 2009 and the ratio of debt to disposable income grew from 8 percent

Figure 3 The composition of banks' loan portfolio at year-end, 1997–2014 (% of GDP)



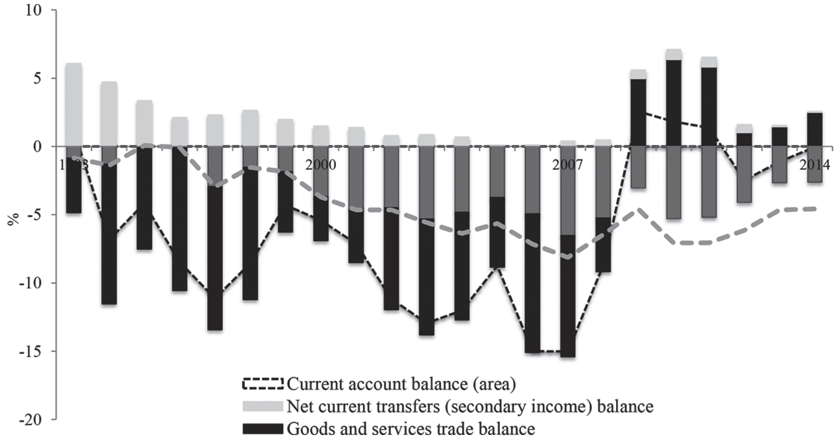
Source: Author's calculations based on data from Eesti Pank, 2015.

in 1996 to 104 percent in 2009 (author's calculations based on Eesti Pank [2015] and OECD [2015]). This indicates that although real estate was one of the most dynamic sectors in the 2000s, the collapse of the real estate boom in 2008 engendered dire consequences for the whole economy—drop in growth by 14 percent due to the drying up of investments and consumption; soaring unemployment and bankruptcies; and deteriorating creditworthiness of borrowers (Eesti Pank, 2010).

Aside from fueling the real estate boom, positive net capital inflows entailed the deterioration of the current account balance throughout the years until 2009, which again turned negative in 2012 after three years of positive balance. Yet, the trade account has been positive since 2009, revealing the vulnerability of the economy in terms of increasing investment-related income outflows on the income account (see Figure 4).

Hence, with cross-border private capital inflows that have shrunk since the 2008 crisis, growing external debt stock has predisposed Estonia to a Ponzi financing position, that is, the inability to cover the service of negative net capital factor with foreign currency earnings from the surplus on the trade and services account. In addition to cross-border external imbalances, the economy, primarily the private sector, also suffered from internal imbalances that resulted from the fact that households and businesses took more leveraged positions in the 2000s, as indicated above. These

Figure 4 Current account balance in Estonia, 1993–2014 (% of GDP)



Source: Author's calculations based on data from Eesti Pank, 2015.

disequilibrating trends in the Estonian economy made the situation especially fragile due to severe financial constraints, attested to by the fixed exchange rate system and the denomination of external liabilities in foreign currency until 2011, when Estonia joined the Eurozone (see Wray [2006] on the United States as an opposite case). Thus, the monetary regime along with other key institutional factors enables us to interpret the presented dynamics from the historical and evolutionary perspectives since the grounds for the development path of Estonia were established in the early 1990s and were further reinforced by the succeeding reforms and the institutional transformation of the socioeconomic environment. Consequently, the following sections will attempt to determine where the seeds for increasing financial fragility in Estonia were planted and to elaborate on the reasons why housing finance gained such momentum in the Estonian economy at the turn of the millennium, that is, which institutional preconditions were met for expanding both internal and external imbalances.

Neoliberalism, privatization, and openness to foreign capital

Even though the political, economic, and social structures of the Soviet heritage were destroyed in the 1990s, the adopted reform agenda in turn set off forces that led to the breakdown of the real economy. Instead of a step-by-step approach, the restructuring was undertaken mainly in the form of shock therapy by implementing macroeconomic reforms and also a liberalization agenda, which changed the composition of the economy relatively rapidly (Hannula and Tamm, 2002; Purju, 2000). From 1992 onward, governments endeavored to attract FDI by abolishing restrictions on capital account transactions already by 1994 and by implementing liberal macroeconomic policies, such as a low tax base, flat tax rates, and a balanced government budget for the purpose of price and macroeconomic stability (Khoury and Wihlborg, 2006; Purju, 2004). The political rhetoric since the beginning of the independence period has reinstated the need to fill the savings gap with foreign capital because development has been conceived as saving constrained. Subject to this mainstream approach, Estonia has sympathized with monetarist principles by relying on market-based self-adjustment mechanisms and controlling the money supply through a currency board arrangement. Hence, institutionally, the strategy of foreign savings-led economic development was built on a currency board system that was supposed to attract foreign investors by providing a guarantee for the stability of the exchange rate (Bernhardtson and Billborn, 2010; OECD, 2000). This openness of the economy reflected the aspiration of governments to adopt policies from the Washington Consensus toolbox as well as the European Union, because these were perceived as "Western standards."[2]

Aside from the enabling factors mentioned, foreign capital was directly attracted through mass privatization in the 1990s because the strategy favored strategic (foreign) investors.[3] By 1992, the advantages of insider owners were removed in order to broaden the possibilities for foreigners to participate in the privatization

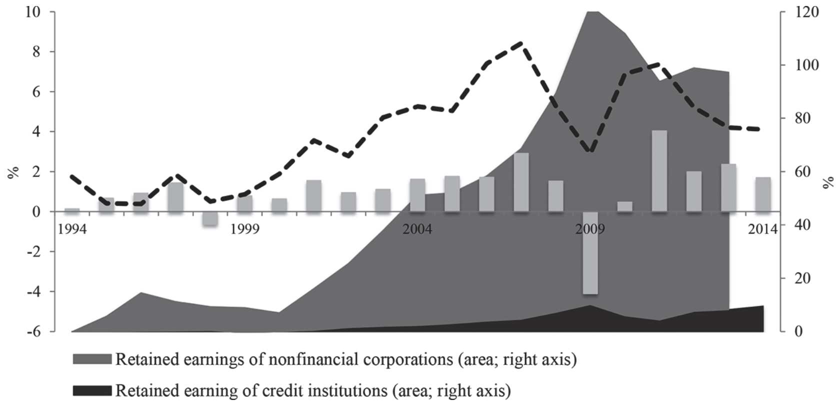
[2] The high degree of financial liberalization in terms of capital account and financial sector liberalization was an essential part of the process of accession to the EU. In particular, the signing of the Europe Agreement in 1995 and the Free Trade Agreement with the EU in 1994 required external liberalization in terms of opening its financial markets to foreign banks and financial institutions after 1999 for further integration. The Europe Agreement stipulated that Estonian and the EU's credit institutions had the right to commence their activities in each other's territory on equal terms with domestic credit institutions. One of the core provisions was the free movement of payments, investments, and other capital and also the obligation that Estonia will not impose restrictions on the movement of capital (Eesti Pank, 1996).

[3] The privatization process in the early 1990s was deliberately targeting foreign investors by implementing the Treuhand model, that is, selling state-owned assets to strategic investors, which explains the key role of foreign investors in the privatization process and high FDI inflows (OECD, 2000; Purju, 1996).

process. The effect of the privatization of state-owned businesses, which in essence dismantled large dominating production complexes in the manufacturing and agriculture sectors (Purju, 2000), was more significant on bank–industry relations. Specifically, the Estonian economy emerged with the proliferation of small and medium-size enterprises (SMEs), which entailed both new and different financing patterns and challenges in comparison with large corporations. Because the privatization policy targeted strategic investors, the result was a high concentration of ownership in the hands of foreign (but also domestic) investors, in particular as of 1994, when the privatization vouchers were made freely tradable—up to 50 percent of the purchase price of a privatized entity could be paid for with vouchers (OECD, 2000). A qualifying holding gave owners a prerogative in making decisions on the payment of dividends as well as on the sale of the company, which is an important advantage, given that only dividends can guarantee sufficient returns on investments under conditions in which lagging development of the capital market has limited the possibilities to sell shares or profit from price appreciation (Pajuste and Olsson, 2001; Postma and Hermes, 2002). This explains why businesses were reluctant to be influenced by external actors, such as banks. As a result, a significant share of the investments by the nonfinancial sector was financed by retained earnings and, in the case of multinational enterprises, by intracompany and banking loans, including loans from overseas banks (Kõomägi and Sander, 2006) (see Figure 5 below).

Bank financing was also discouraged by new businesses having found a niche in commerce, services, and so on, but not so much in production. At the same time, the structure of productive capital was rendered less capital intensive, which indicated a low mechanization of the work and thus a high rate of manual labor (Raudsepp et al., 2003). Therefore, in light of the overall restructuring of the economy in the 1990s, which entailed delinking processes, dualism of the economy, and primitivization of the productive base in terms of industrial decline (Reinert and Kattel, 2007; Tiits et al., 2008), Estonia was faced with a Schumpeterian creative destruction process, albeit without the creative part, which impaired the demand for bank or market-based financing. The specialization of the Estonian economy without significant high-technology sectors accounts for the almost total lack of progress on the local venture capital market. Existing investment and private equity companies have

Figure 5 Economic indicators of the nonfinancial corporate sector and credit institutions, 1994–2014 (% of GDP)



Source: Author's calculations based on data from Eesti Pank, 2015, and Statistics Estonia, 2015.

preferred growth-stage investments rather than risky start-up investments, and have expanded their investment activities outside of Estonia in the CEE region and beyond (Sander and Kõomägi, 2007). As regards market-based financing, FDI largely replaced capital markets in providing corporate financing in the 1990s and the acquisition of Estonian enterprises by foreigners further weakened the position of securities markets in the financial system (Eesti Pank, 1999; Deutsche Bundesbank, 2003).

A neoliberalist stance in terms of monetary orthodoxy, openness to foreign capital, and the adoption of a privatization strategy also affected the developments in the banking sector, whereas the effects resulting from several rounds of banking crises in the 1990s cannot be underestimated either. To some extent, these features of the Estonian (political) economy of two decades ago gave rise to a peculiar evolutionary pattern in the banking industry, if addressed from a stage-based approach, insofar as all phases of the banking development elaborated by Chick (1993) could not be witnessed from the onset of Estonia's banking in the early 1990s. In principle, local banking skipped several stages and reached the fifth stage—attracting wholesale deposits to support expansion—relatively quickly through the takeover of the banking industry by foreigners in the late 1990s, which enabled augmenting the reserves of the system from capital inflows, that is, cross-border lending by parent banks. As a result of mergers and acquisitions by foreign investors, the four largest foreign-owned banks gained control over 95 percent of the market in terms of both total assets and share capital (Financial Supervision Authority, 2014). Before the acquisitions, three episodes of the banking crisis in the 1990s severely undermined the trustworthiness of the banking sector, which discouraged households from depositing in banks and accepting bank liabilities, which is characteristic of the first and second stages, respectively. In this regard, one has to bear in mind the weakness of the supportive institutional framework for the proper functioning of the banking sector in the 1990s, when irresponsibility and excessive risk-taking as well as insider lending, cooking the books, and other fraudulent activities caused the malfunctioning of the industry (on banking misbehavior, see Männasoo [2003] and Zirnask [2002]). Thus, the nonconformity of banking development in Estonia to the six-stage approach can be partially explained by the peculiarities of the transition economy. On the other hand, the introduction of the lender of last resort function of the central bank (fourth stage) did not take place in Estonia due to the currency board arrangement as an institutional constraint in liquidity provision to the banking system, whereas vigorous consolidation, accompanied by a negligible local interbank lending activity (third stage) in the mid-1990s, was the likely result of stricter prudential banking regulation in terms of increased capital requirements as measures for fighting recurring bank failures, but it also motivated the banks to look for strategic investors and possible mergers as an alternative to liquidation (Khoury and Wihlborg, 2006; Zirnask, 2002). Accordingly, idiosyncratic elements and specific institutional arrangements in terms of currency board arrangement, resolute bankruptcy law, more stringent capital regulation, and a distinct privatization approach operated as guiding and restraining factors that led to high concentration, risk-averse credit policies of the banks, and almost full foreign ownership in the banking system. And given the renouncement of monetary sovereignty, the supply of reserves was not guaranteed by the central bank, but by the parent banks of Estonian affiliates. In other words, the establishment of interest rates and credit volumes was left to the market, mostly to foreign (Nordic) decision makers, which paved the way for long-term foreign funding and this was revealed in the ratio of the banking system's assets to GDP, which doubled over eight years in the 2000s. At the same time, the savings of the banking sector increased rapidly in the aftermath of tax reform in the 2000s (see below), which in turn contributed to the growth of credit. This did not imply, however, that the supply-side constraints for getting a bank loan became less severe for SMEs, insofar as consolidated large banks have preferred larger projects, which have been rare in Estonia's small market (Teder, 1998). Moreover, as foreign-owned companies in the manufacturing, real estate, retail and wholesale, and other economic sectors have preferred to use support services and also financial services within the established home-based networks, the corporate credit portfolio of foreign-owned banks has been biased toward Nordic customers (De Haas and Naaborg, 2006; Festić, 2012). Yet, despite some manifestation of positive feedback mechanisms between foreign-owned undertakings in both the nonfinancial and financial sectors in Estonia, with the discouraged use of bank credit for productive purposes in general the growing assets of the banking sector have found a counterpart in skyrocketing liabilities of households and the real estate business.

Transformation of the housing market

An institutional factor of key importance, which brought together bank financing and households was the privatization of land and dwellings in the 1990s and its finalization in the early 2000s that in principle gave the strongest boost to the explosive financing of real estate and the construction sector. By 2001, 98.5 percent of housing units were owned by private persons as a result of privatization, although only ten years earlier, state and municipalities controlled up to 60 percent of housing (Varblane et al., 2009). The privatization of land and dwellings in the 1990s did not give rise to increased demand for mortgage loans because it was accomplished with national capital bonds (Purju, 1996). Hence, mortgage financing was virtually nonexistent in the 1990s with the ratio of mortgage loans to GDP standing at only 5 percent in 2000. The modest impact of banks was also related to difficulties in applying for collateralized bank loans that were curbed by high interest rates, while the low purchasing power of consumers implied an inactive real estate market (OECD, 2000). Yet, one of the main issues in the housing sector not addressed by the privatization process was outdated housing stock. This was dealt with after the privatization, once the real estate property could be used as a collateral for housing loans with the purpose of renovation or building new houses and apartments of higher quality (Varblane et al., 2009). Thus, given the transfer of responsibility for housing maintenance from the state to private individuals that occurred along with the denationalization of commercial banks and the resolution that Estonia would join the EU, institutional preconditions were created for the take-off of the real estate boom. An unprecedented housing and consumption boom gathered further momentum from consumers' confidence in rising incomes, supportive fiscal measures, and low (negative real) interest rates after accession to the EU in 2004. These developments laid the foundation for increasing integration between finance and real estate in the mid-2000s, as the relative backwardness of the real estate market meant expanding investment opportunities (see Eesti Pank [1998] on housing market problems in the 1990s).

Fiscal reforms

Both the foreign savings-led development path and the increasing dominance of the financial and real estate sectors were reinforced by tax reforms in the late 1990s and early 2000s. One of these was the corporate income tax reform in 2000 that exempted reinvested profits from income tax. As a result, the holdings of liquid assets and retained earnings increased (see Figure 5), whereas the share of debt in total assets decreased in the nonfinancial corporate sector regardless of improved access to bank loans and favorable interest rates (Masso et al., 2011; Sander, 2003). From the structural perspective, the corporate tax reform exacerbated the reallocation of capital from the current areas of activity (OECD, 2009). Likewise, Tiits et al. (2008) found that, by and large, the macroeconomic policies implemented during the twenty-year period reinforced the economic specialization that was established during the 1990s. For banks and other financial intermediaries, fiscal policies provided incentives to reinvest accumulated profits, which tripled over a three-year span from 2005 to 2007 before going into decline and eventual losses in 2009. As of 2009, the accumulated retained earnings of the banking sector amounted to 10.2 percent of GDP, compared to 0.006 percent of GDP in 2000 (see Figure 5). This accumulation was supported by the decision of all the largest foreign-owned credit institutions in Estonia to abstain from paying out dividends, which were taken out for the first time in 2014.

Aside from income tax reform, various state guarantees and fiscal transfers contributed to the increased profits of banks that emanated from financing of the housing sector. In 1999, the largest bank proposed that the government partly guarantee the down payment of loans within the housing program for young families that would enable banks to reduce the required down payment rate. The support scheme, which was implemented by the state-owned fund in 2000, also gave access to loans for borrowers who could not afford a loan without state support. In essence, this policy provided security to banks and enabled them to earn higher interest income on the increased number of loans issued (Kallakmaa-Kapsta, 2007). In addition, the Income Tax Act gave taxpayers the possibility to deduct housing loan interests from taxable income. All these reforms contributed to the generation of excess financial capital in the banking sector that was absorbed mostly by the household and the real estate sector. Therefore, neither contributory nor incentivizing reasoning (see Piketty, 2014, pp. 525–526) is tenable in the taxation of capital in Estonia's case, insofar as the loopholes in the legislation have enabled businesses to disguise profits (economic income) and there has been no pressure to invest the idle capital held in financial assets in more productive usage. An emphasis on indirect and consumption taxes has favored those who are able to save, which has increased both wealth accumulation and its concentration, given the conditions for the prevalence of qualifying holdings in the Estonian corporate governance model, which were created in the early 1990s.

Thus, the accomplishment of privatization, the fiscal reforms within the overall laissez-faire political agenda, and the restructuring of the economy toward the service sector dominated by SMEs were the sine qua non of the real estate and consumption boom from 2004 to 2007, which was reinforced by the loosening credit policies of foreign-owned banks.

The economy's ailing productive capacity in light of increasing foreign liabilities

Notwithstanding the prospects of pursuing sustainable long-term FDI-led financing of development, if certain conditions are met (Kregel, 2004), Estonia did not introduce the preconditions for this development path. On the contrary, extreme liberalism in the 1990s brought several vulnerabilities through trade and FDI into the Estonian economy, which eventually weakened the domestic productive base.

The opening of the local market to foreign competitors revealed deficiencies in the supply side, as the overflow of cheaper imported goods of higher quality crowded out local producers (OECD, 2000). In such circumstances, market forces tilted the economy toward expansion of the service sector, while the share of agriculture and the manufacturing industry decreased. More importantly, this approach to restructuring diminished both employment and comparative advantages in the most capital-intensive and knowledge-intensive branches of the economy such as mechanical engineering and electronics (OECD, 2000). Therefore, the financial sector was not behind deindustrialization, the free trade shocks were (Reinert and Kattel, 2007). The loss of technological sophistication in Estonian industries can be explained by the Vanek–Reinert effect (see Reinert, 1980), whereby domestic companies lost their market share due to the rapid liberalization of markets and prices, which undermined demand for their products, and on the other hand paved the way for specialization at the lower end of the value chain with difficulties for technological upgrading (Reinert and Kattel, 2007; Tiits et al., 2008).

With regard to FDI, companies in the Nordic countries have primarily been interested in Estonia as a supplier of raw materials and a suitable location for labor-intensive production with the advantages of relatively low costs and its closeness to the Nordic and other European markets. Quite often, acquired businesses were turned into subcontractors, that is, producers of semifinished goods in international production networks (Purju, 1996; Reiljan, 2006), which induced growth in imports of components and intermediate products. Therefore, despite the increased integration of local industries into regional production networks of Nordic-based multinational companies, the technological structure of industries has not become more knowledge-intensive or complex; on the contrary—the division of labor, specialization, and skilled labor force have decreased with the decline in the capacity to exploit new technologies. The results have been asymmetrical trade patterns with Estonia's specialization in resource-intensive and labor-intensive activities, while the Scandinavian countries have retained knowledge-intensive segments (Tiits et al., 2008). As a consequence, low value-added and relatively low-paid labor-intensive production, including subcontracting, dominated in Estonia's exports for a long period (Tiits et al., 2004). In these circumstances, the possibilities of gaining from increasing returns in the manufacturing sector have been hindered, which is revealed in the relatively important role that the low-technology and medium- to low-technology industrial sectors play in Estonia, as their share in the creation of the total manufacturing value added stood at 53.2 percent and 20.5 percent, respectively, in 2009 (UNIDO, 2012). In addition, vulnerability stems from the volatile flows of subcontracting exports due to dependence on the decisions of parent companies and less on market forces, from which direct exports benefit (Ehrlich et al., 2002, pp. 16–20). Therefore, by following this FDI-led growth model, Estonia started out with a speculative position, which gradually took on a Ponzi profile due to weaknesses on the assets side of the economy's balance sheet in terms of an inability to upgrade the technological level of industries in order to increase productivity and to produce goods with higher value added, which would suffice to cover servicing of the increasing debt from net capital inflows.

Vicious circles and the effects of the 2008 crisis

Evidently, these deeper structural problems of the Estonian economy were overshadowed by the seeming success story of economic growth and development in the 2000s. In this regard, the boom years of the 2000s, when banks channeled foreign capital into the financing of consumption and investments in the nontradable sectors and the eventual crisis were the inevitable consequences of the transition process of the economy undertaken in the 1990s. Everything considered, one could argue that the main outcomes of the liberalization agenda—the primitivization of the local economy with deteriorating competitiveness due to free trade shocks, sustained structural dependence on unmanaged capital inflows, and credit-based consumption—implied hazardous lock-in effects and chronic current account deficits. To some extent, the lock-ins of the economy entailed a whirlpool of mutually reinforcing impulses. Specifically, the exceptional economic growth that was underpinned by the housing boom led to unrealistic expectations of ongoing growth and attracted additional foreign capital in the context of decreasing risk premiums and interest rates. At the same time, positive expectations on the market evoked rampant leveraging by banks, which was manifest in the deterioration of the loan-to-deposits ratio from 69.1 percent in 1993 to 168 percent in 2007 (author's calculation based on Eesti Pank, 2015). These dynamics indicate a positive feedback mechanism between business cycles and capital flows, which increase the danger of financial bubbles during the growth phase (Danilov, 2003). Estonia's idiosyncrasy, however, is nearly full foreign ownership of the banking industry, which has exacerbated "normal" business cycles through the liquidity and funding channel. Buoyant economic growth came to an end in 2007, when a slowdown in credit growth resulted from the decision of foreign parent banks to reduce lending to their Estonian affiliates in the wake of the global turmoil in 2008 (Kaarna et al., 2012, p. 49). And, given the local economy's reliance on external funding, which underpinned double-digit growth rates, the drying-up of both the international interbank and debt markets put the brakes on capital inflows to Estonia. Consequently, reduced access to credit and tightened credit standards, coupled with the increased cost of funding and overall uncertainty about economic prospects, resulted in weakened consumption, borrowing, and investment activity after 2008 (Bernhardtson and Billborn, 2010; Festić, 2012; Kattel, 2010).

Essentially, the strategy built around the foreign-savings-led growth made the economy particularly vulnerable to capital flow volatility and increased the risk of a currency crisis until 2011, when Estonia joined the euro area. At the same time, the economy has been exposed to growing debt service payments on outstanding foreign liabilities or even worse, to large-scale capital flight through deleveraging and divestments, given a high share of foreign liabilities on the balance sheets of foreign-owned banks and other businesses.

Discussion and conclusions

As the study shows, the Estonian development strategy relied on foreign capital without realizing that the roll-over of FDI and foreign loans, if used to finance the domestic market targeting investments and consumption instead of export industries, gives rise to Minsky's Ponzi financing position in terms of covering the current account deficit with the accumulation of foreign liabilities. In this regard, uncontrolled growth of financial liabilities from cross-border investment activities, which could be considered a form of *financialization* (Piketty, 2014, pp. 193–194), poses significant vulnerabilities for small states such as Estonia, if the rise in net wealth falls behind. One of the prospects faced by the local economy is a much lower net national income compared to gross domestic product due to the outflow of profits and rents, which brings to the fore the issue of inequality of capital ownership in an international dimension and may give rise to political tensions (see Piketty [2014] on international inequality). In the long term, the growth of savings accruing to foreigners in the form of capital factor service constrains domestic demand and tilts the economy toward a debt-deflationary regime (see Hudson [2006] on savings, asset-price inflation, and the debt deflation model). In Estonia's case, the issue of inequality has been exacerbated by its special institutional characteristics. In particular, tax reforms have favored the accumulation and concentration of savings, which in turn have been converted into more debt, given an insignificant taxation of capital and income incurred on capital (e.g., the corporate income tax rate is zero and there is no real estate tax whatsoever).

In the setup of an institutional framework for the operation of a market economy, risks associated with the adoption of the Washington Consensus (WC) policies were not acknowledged in Estonia (for a general critique of WC macroeconomic policies, see Herr and Priewe, 2006, pp. 174–179). Among others, these included the rigidity of a currency board arrangement, the destabilizing effect of no controls on capital inflows and outflows, and the liberalization of international flows of goods and finance, which led to growing external debt. As a result, the "euroization" of the economy took place through bank credit channels, which entailed a currency mismatch, and this, in turn, compromised the use of an exchange rate as an adjustment mechanism. This self-imposed monetary conservatism, accompanied by a low commitment to countercyclical macroeconomic policies for the constraint of instability, indicates a disregard for principles of functional finance and a lack of understanding of the impact of fiscal and monetary policies on the processes of cumulative causation in the whole economy. By and large, two lines of reasoning can be offered to explain this observation. First, the neoliberal approach taken in market reforms and tax policies sent clear signals to international capital markets by favoring capital and finance as opposed to labor, and was an incentive for continued financing of internal and external imbalances of the economy. And this, in turn, facilitated the continued pursuit of the established political agenda on economic issues. Here, a kind of symbiosis between the institutional arrangements and the foreign-savings-led economic catching-up process reveals the workings of a vicious circle. At the same time, the historical institutionalist tradition provides sound grounds for understanding the "stickiness" of formal rules and institutions in the long run, that is, path dependence. In Estonia's case, institutional inertia in terms of continuous blind belief in the legitimacy of the established macroeconomic policies accounts for discernible rapid recovery after previous crisis episodes in the 1990s, when the perception of austerity and liberalization of the financial sphere "working" themselves out with positive outcomes got embedded in the political mindset (Kattel and Raudla, 2013).

Thus, in view of passiveness in macroeconomic policies, structural changes in Estonia have been left to the workings of market forces, particularly after the completion of the mass privatization of state-owned assets, which was a key factor behind the ensuing housing market boom in the 2000s and the takeover of the "cream of the crop" of Estonian industry by foreign investors. Unfortunately, as in Latin America, the dual nature of foreign direct investments and the diffusion of technologies in the catching-up process (Gerschenkron, 1962) did not occur. As described above, mainly unsophisticated and lower value-added economic activities were attracted, which indicates a so-called Mexican syndrome, that is, assembly-line production with the exploitation of cheap labor. The outcome of this kind of economic specialization has been a mismatch between the content of exports and imports, which implies in turn a propensity toward deteriorating terms of trade in the long run and weakening of the country's ability to service external debt (on the decline in terms of trade in Latin America, see Prebisch, 1950; see also Singer, 1950). In addition, the enclave nature of FDI in the Estonian economy and the relatively high share of FDI in oligopolistic sectors such as banking, real estate, and retail industries have implied that multiplier effects from profits and productivity growth have increasingly been taken out abroad. In this regard, both asymmetric international intra-industry specialization and foreign investments in the sectors that target a host market have worsened the economy's international financial position and hence predisposed the economy to a Ponzi financing profile.

On the whole, Estonia has followed in the footsteps of Latin American countries, especially in relation to restrictive macroeconomic policies aimed at guaranteeing the stability of the exchange rate and also low inflation for attracting foreign capital (on the Latin American experience, see Huerta, 2006; Vernengo, 2006). The pursuit of this political course has, however, brought adverse consequences to the economy. In the course of two decades, Estonia has been turned into a typical semi-periphery country with a less sophisticated technological level than its Scandinavian partners and very limited control over the financial system. Moreover, the economy has been strongly affected by the global business cycles, let alone those at the regional level, and by the decisions made by the parent companies of Estonian affiliates. This was particularly evident in the actions of foreign-owned banks in the pre- and post-2007 period, which revealed the procyclical lending behavior of the banks. Excessive lending during the boom years in the mid-2000s contributed to real exchange rate appreciation and widened current account deficits, which worsened the financial position of domestic producers against foreign competitors. In light of these negative outcomes of Estonia's approach in an overall transition toward a market-based economy, reasoning about the path to sustainable development, which is predicated on a bank-based financial system in transition economies (on the case of eight Eastern European countries of the EU, see Springler, 2006) is somewhat ambiguous, particularly when the context-specific institutional factors and peculiarities are not taken into consideration. In Estonia's case, by and large, the challenge is to depart from the path dependency set in the 1990s on both the political level and in the structure of the economy, where the financialization process revealed itself in heavy reliance on foreign capital in both the financial and nonfinancial sectors, which underpinned rapid but unsustainable economic growth.

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Article II

Juuse, E. 2016. "The real sector developments in Estonia: financialisation effects behind the transition process." In E. Hein, D. Detzer and N. Dodig (eds). *Financialisation and the Financial and Economic Crises: Country Studies*. Cheltenham, UK; Northampton, MA: Edward Elgar Publishing, 137-162. (3.1)

6. The real sector developments in Estonia: financialisation effects behind the transition process

Egert Juuse

6.1 INTRODUCTION – ESTONIA'S ECONOMIC DEVELOPMENT MODEL SINCE 1991

After regaining independence in 1991, Estonia undertook major economic reforms in order to reinstate institutions necessary for a functioning market economy, some of them being introduced only by the turn of the millennium. More importantly, given the population of 1.29 million, all reforms and institutional arrangements should be seen in the context of a very small country. Also, in contrast to advanced economies with a long capitalist tradition, the legacy of socialism provided a quite different starting point, and influenced the following evolution of capitalist production in Estonia (Myant and Drahokoupil 2011, pp. 299–302; Lane 2007, pp. 13–15). So, it was both institutional and historical-cultural characteristics that yielded a particular result in Estonia, implying a rather peculiar transition process towards a market economy, compared with advanced Western economies and even other Central and Eastern European countries (CEECs). Namely, distinctive institutional approaches such as a *strategic investor* privatisation strategy, neo-liberal radicalism in market reforms, and nationalistic sentiments in socio-economic affairs created path dependencies in the Estonian transformation process (Tridico 2011; Lane and Myant 2007; Knell and Srholec 2007). As it was punctuated by major crises, the period of 1993–1998 saw critical junctures at which key decisions on the shape of the post-socialist regime were taken. However, given the non-presence or immaturity of capitalist institutions and developments, a limited time-range for a full development of economic structures, and inadequate data[1] on some of the issues, it is not such a straightforward matter to undertake an analysis of the Estonian case. The following study endeavours to bring out the peculiarities of the pattern of financialisation in Estonia, with its implications for economic stability and general macro-economic dynamics, that is, the nature and pattern of income distribution, investment financing and household consumption.

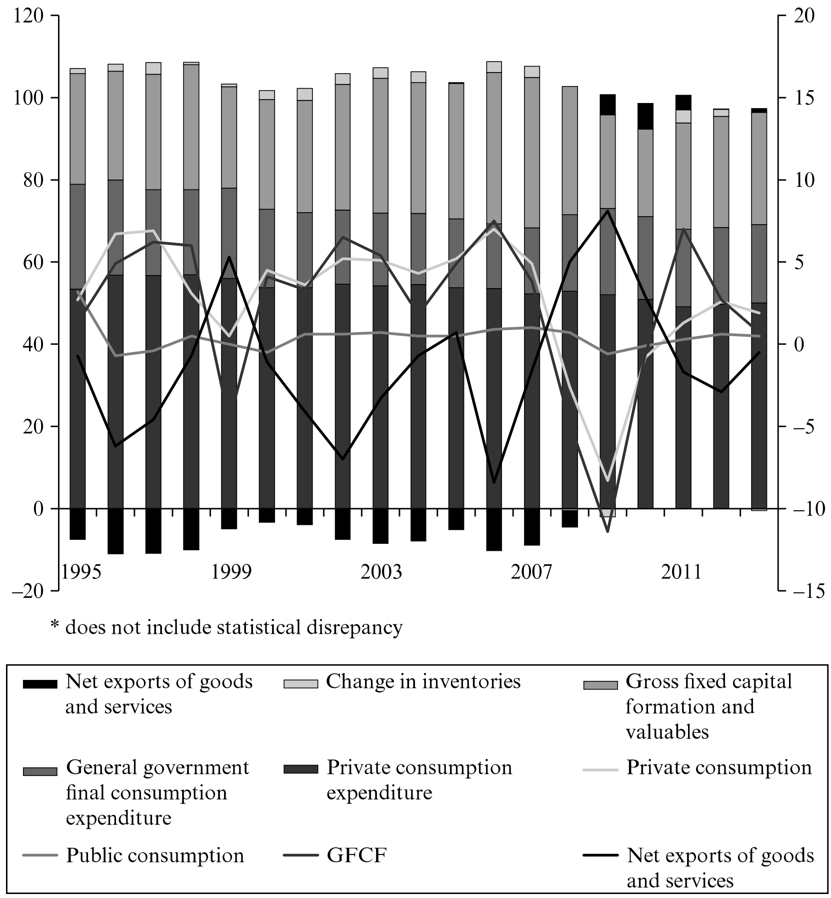
Compared with Western economies, one of the unusual characteristics of Estonia has been the high level of externally financed capital accumulation, through the reliance on foreign direct investments (FDI) and other external funds since the early 1990s.[2] In Estonia, FDI was seen as a supplement to internal resources for financing the growth and restructuring of the economy (Bank of Estonia 1995). A rapid liberalisation of trade and capital flows was the reflection of the neo-liberal political stance of the government(s), which emulated *Washington Consensus* and European Union (EU) policies when constructing the country's institutional framework. Accordingly, Estonia has not relied on intensive intervention into the economy or used any foreign investment management policies beyond macro-economic reforms oriented towards price stability, balanced public budgets and low taxes (Tiits et al. 2008; OECD 2000a; Thorhallsson and Kattel 2013; Raudla and Kattel 2011). Given such an approach and the perception of Estonia as a potential satellite hub, Swedish and Finnish investors acquired privatised companies in Estonia, but also undertook green-field investments due to the relatively skilled and cheap labour force, while the geographical closeness and cultural ties with Estonia created additional incentives to relocate production to Estonia (Ehrlich et al. 2002; Madureira et al. 2007; EBRD 1994; European Commission 2010; Jevcák et al. 2010). Hence, supported by the liberalisation of the financial system and delegation of powers to foreign actors, the deepening internationalisation of the Estonian economy has had a major impact on the form of capitalist production and ramifications for macro-economic stability.

Despite an annual real growth rate of 8.7 per cent in 2000–2007, the business models of multinational companies, in both the financial and non-financial sectors, have caused several weaknesses in the productive system. The weakening of the industrial base, affected by the inability of manufacturing industry to withstand intensifying foreign competition (Reinert and Kattel, 2007), was worsened further by the decisions of foreign companies to relocate primarily low value added labour-intensive stages of production to Estonia with little spillover effects to the local economy (Drechsler et al. 2006, p. 20). By taking advantage of low labour costs and taxes without notable wider positive effects on the whole economy, foreign-owned companies have entailed the *enclavisation* of a significant part of the industrial sectors by rendering the acquired businesses in Estonia into simple extensions of multinational companies (Reiljan 2006, p. 256; Gallagher and Zarsky 2007 on the concept of enclave economies). The implications have been asymmetrical intra-industry trade relations in the manufacturing sector – Estonia specialising in resource- and labour-intensive activities for subcontracting exports, while Scandinavian countries keep the knowledge- and technology-intensive activities (Tiits et al. 2008; OECD 2000b; Varblane and Ziacik 1999; Ehrlich et al. 2002). Essentially, heavy dependence on FDI has entailed de-linking processes and rendered the Estonian economy into a *satellite-platform* (see Markusen 1999, pp. 21–41 for description of the concept) that reinforces the reliance on external technical expertise and funding, as well as services, but subdues demand for bank-based financing of businesses (Kattel 2010, p. 54). In these circumstances, banks that were acquired by foreign financial institutions gradually shifted their credit policy focus towards households. This is reflected in the main demand aggregates contributing to economic growth (see Figure 6.1 and Section 6.4 in detail).

The consequence of these developments has been a dual structure of the economy. On the one hand, industries in Estonia are led by large and medium-sized companies that in general belong to foreign owners, with the advantage of access to foreign credit and know-how, and which do not depend on local demand conditions due to their focus on export markets. Locally owned micro- and small enterprises, on the other hand, which predominantly operate in the services sector, target the volatile local market and rely on both internal funds and loans from domestic banks (Kangur et al. 1999, pp. 17–20; Mickiewicz et al. 2006, p. 78; Kaarna et al. 2012, pp. 15–16). More importantly, industry leaders have outperformed small enterprises in terms of turnover per employee, creditworthiness, and profitability indicators due their economies of scale, which arise from large-scale production and export sales (Golebiowski 2007, p. 26; Männik et al. 2006, p. 283; Varblane and Ziacik 1999).

Thus, the miracle of Estonia's growth has been achieved on the basis of extensive use of foreign savings, as domestic savings have not been sufficient to cover persistently high investment and consumption demand from the 1990s onwards (OECD 2000b; Bank of Estonia 2006a). The financialisation process reveals itself in the reliance on foreign capital in both financial and non-financial sectors (see Figure 6.2) that underpinned rapid but unsustainable economic growth with the culmination of economic crisis in 2007/08. The challenge today is to discontinue this path, set in the economic structure in the 1990s.

As evident in the Figures 6.1 and 6.2 above, one can observe a gradual emergence of the *debt-led private demand boom* structure in Estonia's long-term development pattern (Hein 2012; Dodig et al. 2016), where aside from the non-financial corporate sector, debt accumulation occurred rapidly in the household sector (see Section 6.4). Claims of the rest of the world against Estonia steadily increased until 2007. Those were the natural counterparts of the widening current account deficits Estonia ran since 1994,

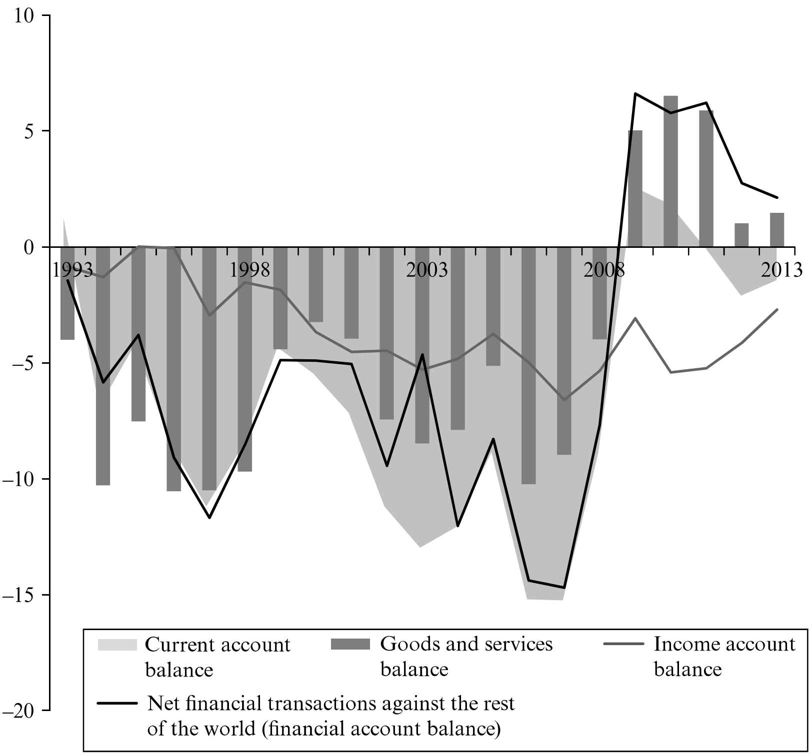


Source: Statistics Estonia (2014).

Figure 6.1 Contribution to the increase of GDP at constant prices (lines; right axis) and share in GDP in current prices (bars; left axis) in Estonia, 1995–2013*

which only reversed with the crisis in 2009. Despite the continuing trade surpluses, the current account turned negative again in 2012, revealing the vulnerability of the economy to increasing investment-related income outflows due to a development strategy built around the reliance on foreign investments-led growth (see Figure 6.2).

Thus, financialisation in Estonia has taken a rather different manifestation, characterised by a heavy reliance on foreign savings in financing



Source: Bank of Estonia (2014).

Figure 6.2 Net financial transactions against the rest of the world and balance of goods and services as well as current account (% of GDP) in Estonia, 1993–2013

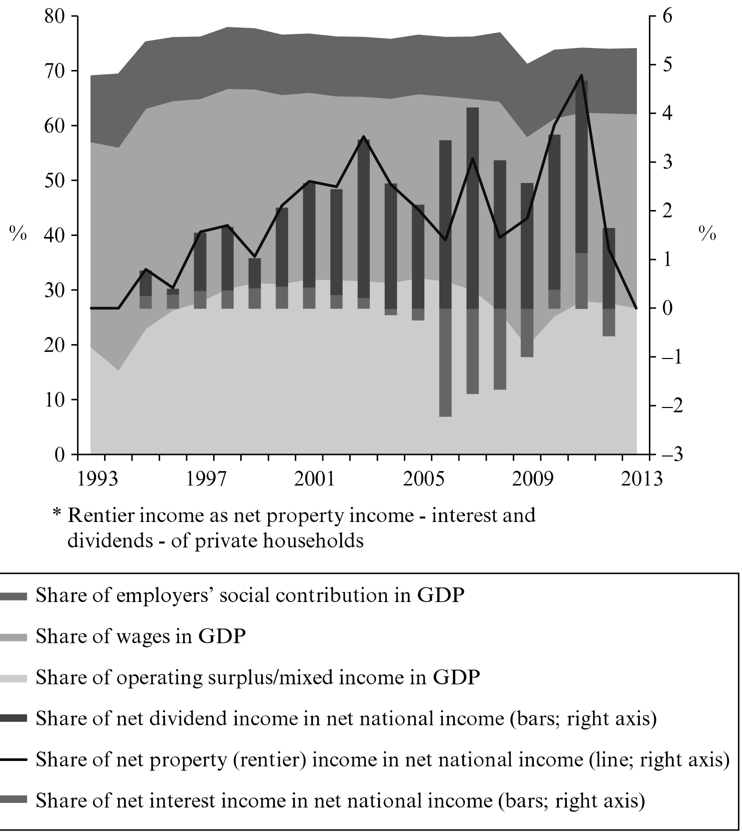
economic growth. In this regard, the FDI-led catching-up process directly relates to all three studied variables of the Estonian real sector, but also to the current account dynamics. Moreover, when considering the long-term effects of financialisation on the real sector variables, one has to bear in mind that the period in which Estonia has had a market economy has been very short – around 20 years. In broad terms, Estonia could be classified as a neo-liberal *peripheral market economy* with structural weaknesses, particularly in the export structure, and reliance on financialised development that essentially has meant dependence on foreign borrowing and other financial inflows to cover current account deficits. As Kregel (2004) has shown, such a development strategy, where imports are paid for with foreign borrowing is inherently unstable, as it requires that the rate of increase of new capital inflows is larger than the rate of interest on these flows; if that is not the case, the strategy becomes automatically self-reversing.

6.2 INCOME DISTRIBUTION

The developments in the Estonian economy can be portrayed by seemingly conflicting tendencies, evidenced in the rapid economic growth that has been accompanied by deepening regional and social inequalities. The last two decades have revealed social inequalities and a marginalisation of weaker members of society as a natural byproduct of market economy reforms (Lauristin 2011). Adherence to the principles of the liberal market economy, manifest in relatively low social expenditures, weak union movement, low minimum wages and low de-commodification levels, contributed to relatively high income inequality in Estonia (Aidukaite 2011; OECD 2003). Income disparities in the early 2000s were such that the poorest 40 per cent of the population received 20 per cent of total income, while the richest 20 per cent acquired around 40 per cent of the total income. This is further reflected in the average 0.356 Gini coefficient for the 1996–2002 period, but also other analytical indicators such as quintiles' ratios, which indicated Estonia's income inequality in the 1990s to be one of the worst in Europe (Paulus 2003; Kokkota 2000).

However, the general trend has been towards a reduction in income inequality, both when looking at the Gini coefficient (0.313 in 2009), the ratios of income deciles' top cut-off points, or the ratios of average disposable income per household member within deciles. For example, the D10/D1 average disposable income ratio dropped from 13.1 in 1995 to 8.4 in 2009 (author's calculations based on Eurostat 2014 and Statistics Estonia 2014). Despite the improving tendencies in income inequality, one has to bear in mind large initial disparities, which can be attributed to socio-economic turbulences at the beginning of the transition process. Aside from general income inequality, one of the most pressing issues over the years has been gender inequality, as on average the difference in wages between men and women has stood at around 31 per cent, the highest in Europe (Anspal and Rõõm 2011; Nurmela and Karu 2009). In addition, regional disparities exist, such that the average salaries of the capital city region is almost 1.5 times that of the periphery (Anspal and Rõõm 2011; Statistics Estonia 2014).

We can see the development of functional income distribution, by looking at the shares of total employee compensation in Figure 6.3. Even



Source: Statistics Estonia (2014); OECD statistics (2014), author's calculations.

Figure 6.3 Functional income distribution (without net taxes on production and consumption of fixed capital) and rentier income in Estonia, 1995–2013

though Dünhaupt (2013, pp. 2–3) found that the labour share fluctuates with the business cycle and has been in a general downward trend in advanced economies, in Estonia one can see a decreasing share of wages in the 1990s and then a relative stability of the wage share in total income since 2000. At the same time, the rentier income share in net national income has increased from 0.8 per cent in 1995 to 4.8 per cent in 2011, although with significant drops during the boom years of 2003–2006 that were mostly due to increased servicing of interest liabilities. Net dividend incomes have grown steadily with occasional year-on-year declines (in 1996, 1999, 2005, 2009 and 2012).

6.2.1 Labour Unions

The following sections will look into the potential factors behind the income inequality, in particular, unionisation, privatisation, and fiscal and monetary policy. It is found that the wage share is affected by the bargaining power of labour, which is usually shaped by trade unions' density, unemployment benefit replacement rates, and employment protection legislation (Dünhaupt 2013, p. 18; Stockhammer 2009, p. 14). In the Estonian case, these three last-mentioned dimensions have been affected by the prevailing neo-liberal model with non-corporatist and national-conservative attitudes that is reflected in the government's limited consultation and consensus decision-making with domestic actors in the formation of economic policies. Accordingly, the position of labour unions in the private sector has been weak. While almost all employees belonged to labour unions in the early 1990s, the share of unionised labourers decreased throughout the next two decades. One of the reasons for the small influence of labour unions is their bad reputation from the Soviet period, and the dominance of micro- and small enterprises in Estonia (Hinnosaar 2003, p. 9). By the late 2000s, unionisation and collective bargaining in the Estonian private sector covered only 12 and 9 per cent of employees, respectively (Dabušinskas and Rõõm 2011). Consequently, wage formation takes place mostly at the company level with individual agreements, although some sectoral level minimum wage agreements exist, e.g. in health care and road transportation (Nurmela and Karu 2009). Similarly, employment protection legislation has been liberalised throughout the years in terms of notification procedures and compensation mechanisms (Hinnosaar 2003, p. 22). After a labour market reform in 2009, which made legislation more flexible and considerably lowered layoff costs for employers, Estonian labour regulation was the least strict in Europe (Dabušinskas and Rõõm 2011, p. 60).

6.2.2 Privatisation, Technological Change and FDI

Aside from decreasing workers' bargaining power, the mass privatisation in Estonia in the 1990s could also explain the reduction in the labour income share. In addition, one has to bear in mind idiosyncratic elements in the transition process, e.g. the downsizing part of the *downsize and distribute* approach could be seen as a result of technological and organisational innovations that were envisaged to reduce over manning, typical in socialist economies, and to introduce new labour-saving technologies (Tiits et al. 2006, p. 61).

The impact of technological change on functional income distribution, as argued by the mainstream literature (IMF 2007; European Commission 2007), could be seen in the Estonian case in the developments of the 1990s, but not in a sense of becoming capital augmenting but of a radical restructuring of the economy that was largely FDI-driven and entailed the destruction of existing productive capacities. In other words, the *primitivisation* of the productive base and the reliance on cheap labour as a competitive factor necessitated continuous cost squeezing to keep foreign investors in Estonia, which constrained income growth (Tiits et al. 2006, p. 57). In addition, FDI-companies have entered the Estonian market in relatively resource-intensive and low-tech industries such as food and wood processing, textile and clothing (Tiits 2006, p. 109), which in the long-run do not entail possibilities for increasing returns and hence higher wages. Interestingly, these changes affected incomes of workers with vocational training favourably, whereas increasing supply of those with higher education pushed wages for this type of workers downwards, and therefore income inequalities based on educational background diminished throughout the period of 1997–2006, which is opposite to global trends (Rõõm 2007).

It is also noteworthy that the relatively highly concentrated ownership structure in individual firms together with low turnover of shares has had implications for income distribution. The concentration of ownership started already with the first rounds of privatisation, when in addition to the control of strategic foreign investors, small companies in services, catering and retail were gradually taken over by managers. In light of a relatively poor protection of minority shareholders, the concentration of ownership has increased: the largest owners in Estonia having a stake of over 60 per cent and the second largest more than 20 per cent on average (Pajuste and Olsson 2001; Gerndorf et al. 1999), implying an inequality in capital ownership and wealth concentration to a great extent. The importance of corporate control of local companies is revealed in the preference for external common equity from existing shareholders or target capital providers, as opposed to bonds or other forms of incorporation of external investors (Raudsepp et al. 2003, pp. 61–67; Kaarna et al. 2012, p. 52).

6.2.3 Fiscal and Monetary Policies

Incomes have been also affected by fiscal policies, mostly through different taxation of capital and labour. Contrary to other EU countries, Estonia has opted for a flat tax system, based on the principle of proportional and uniform tax rates – the tax reform in 1994 introduced a flat 26 per cent[3] tax rate for both personal and corporate income tax, while from 2000 undistributed profits have been exempted from corporate income tax. Hence, due to the regressive character of flat taxes, a larger portion of income is taken from those with lower incomes. In addition, the amount of basic exemption deductible from the income is relatively low (154 euros per month in 2015), while social security contributions including unemployment insurance premiums are one of the highest in Europe (Ruusalu 2014). In general, labour and consumption taxes have a dominating share in tax revenues with 50.8 per cent and 41.3 per cent, respectively, while the corporate income tax level has been one of the lowest in Europe – with an average implicit tax rate of 5.8 per cent in 2000–2007 and with a share of tax revenues on capital in total tax revenues of 7.9 per cent in 2007 (Võrk and Kaarna 2010).

Moreover, during the crisis years of 2008 and 2009, increases in value added tax and excise taxes hit the poorest segments of the population hardest (ibid.). This reveals the aim of the Estonian tax policies, namely to support entrepreneurship, while no attention has been paid to either vertical or horizontal fairness of the taxes. Propagated flexibility in the labour market has also been a precondition for the operation of a currency board arrangement that has implied a reliance on internal devaluation as an adjustment mechanism and approach to improve international competitiveness (Hinnosaar 2003, p. 3). In light of these developments, governments have adhered to mainstream arguments by relying on the reduction of benefits and taxation as well as improving the flexibility of the labour market (Tiits et al. 2006, p. 51).

In conclusion, it can be said that given the large income disparities at the starting point, income inequality has decreased throughout the years, partly due to changes in the labour market and the structure of the economy. Nonetheless, the problem is still present today, although with a more narrow focus on topics such as gender and regional inequality. Similarly, the share of wages in functional income distribution fell significantly in the 1990s, but stabilised in the 2000s. One of the reasons behind the initial high income inequality and declining wages share was massive privatisation that targeted strategic investors, which explains high ownership concentration in Estonia. In addition, the deteriorating position of employees has been affected by weak labour unions, increasing flexibility in labour market legislation, and basically non-existent collective bargaining systems in the private sector, but also by the reliance on FDI, implying a cost-based competitive advantage of the economy. Finally, incomes have been affected by different taxation of capital and labour, but also by the currency board arrangement, which pressured wages further. Therefore, persistent social inequalities and the overall decline in the wage share have been related to the introduction of market economy institutions, market reforms, the restructuring of the economy and the elimination of overmanning. Similarly, decisions on dividend payments have been driven by other motives than financialisation, as dividend payments increased only in the 2000s, once businesses had matured and surpassed the development and growth phases. Also, dividend and interest payments have fluctuated according to the business cycles in Estonia, with an increasing trend of dividend and interest payments during the 1996–97 and 2005–07 economic boom periods. It is also noteworthy that Estonian businesses have practised the remuneration of top management with dividends, rather than wages or stock options, due to lower taxation level of capital income.

6.3 CAPITAL STOCK INVESTMENTS

In the analysis of patterns in capital stock investments and their financing in Estonia, it is necessary to acknowledge the context and peculiarities of the Estonian development. The research approach to the Anglo-American type of corporate governance that focuses on stock ownership issues is not exactly applicable in a situation where the ownership structure has been in rapid transition. At the same time, market institutions and the whole business environment do not operate in the same way as in advanced market economies, or began to operate in this way only lately (Tafel et al. 2006). Several of the phenomena often associated with financialisation such as the proliferation of new financial instruments, the rise of financial investment and income, but also the increase in shareholder value orientation and the transfer of earnings from non-financial corporations to financial markets (see Orhangazi 2008; Stockhammer 2004) are non-present or have only recently emerged in Estonia. Even if detectable, the reasons behind the emergence of these manifestations of financialisation have been different, compared with the ones in advanced market economies. For instance, the *downsize and distribute* approach was an integral part of the privatisation waves during the transition process in the 1990s. This was reflected in the squeezing of labour costs to attract foreign investors, and the destruction of existing productive capital to get rid of the Soviet-time production complexes, which incurred distribution of assets and massive sales.

Similarly, literature has related the spread of the shareholder value approach to the emergence of institutional investors (Orhangazi 2008; Crotty 2002, p. 23). In the Estonian case, however, domestic institutional investors such as investment funds, insurance and pension funds have played an insignificant role on the local market because they mainly invest abroad.[4] Moreover, since shareholder value orientation and changes in corporate governance refer to listed companies, that is, large corporations (Stockhammer 2004, pp. 728–729), Estonia is again an outlier in terms of having only few public limited companies that are listed on the stock market – 15 in total as of 2014 – which explains a modest role of foreign institutional investors as well. Also, hostile takeovers with junk bonds or stock options in the pay structure of managers, associated with the *shareholder revolution* (Lazonick and O'Sullivan 2000), have not been characteristic features of the Estonian business landscape. Rather, what is typical in Estonia is the dominance of owner controlled and managed small enterprises (SMEs[5]), *core owners* and active involvement of foreign investors (Alas et al. 2010, p. 39; Juhkam 2000), which indicates a different financing pattern of Estonian firms, compared to conventional corporations (Raudsepp et al. 2003, pp. 58–59). Furthermore, contemporary professional managers emerged in the Estonian business organisations around 2000 or slightly earlier (Kooskora 2008, p. 203; Alas et al. 2010, pp. 30–35). As a result, the manager-shareholder dichotomy as found in the financialisation literature has not been on the agenda from the domestic capital's point of view. On the other hand, substantial presence of FDI-companies and the central role of foreign investors in the Estonian stock market[6] have had implications for corporate governance, which has been adapted to the strategies of foreign (Nordic) owners (Juhkam 2000). The enormous importance of foreign funds could be seen in the dynamics of the primary income balance of the current account that shows negative net investment income flows of the magnitude of 5 to 8 per cent of GDP between 2003 and 2013 (see e.g. Figure 6.2).

6.3.1 Investment Financing in Estonia

As Estonian businesses gained improved access to foreign capital, accompanied by a high level of FDI inflows in the 1990s (Randveer 2000, p. 13), both foreign capital inflows and internal funds from accumulated profits increased the ability to finance investments. Between 1994 and 1998, reinvested profits of Estonian businesses accounted for 49 per cent of all funds used for capital investments (Kangur et al. 1999). In general, the preferred source of financing of Estonian enterprises has been internal equity capital, while external funds such as bank loans or funds from intra-group foreign parent companies have been used in case of dire necessity or when internal resources were insufficient (Kõomägi and Sander 2006; Sander and Kõomägi 2007; Raudsepp et al. 2003, pp. 61–67). For instance, between 1996 and 1999, the average leverage ratio of the Estonian non-financial corporations stood at 1.12 as one of the lowest in CEECs and the share of long-term liabilities was also one of the lowest in international comparison, while almost half of short-term liabilities were inter-enterprise arrears (Randveer 2000, pp. 4–5). Nonetheless, the net financial position of enterprises has become more negative over time. This is partly due to the increasing reliance on bank financing that was used for real estate purchases before the 2008 crisis (Juks 2004, p. 17; Bank of Estonia 2010a). All in all, the shares and other equity category that saw a gross growth from 2.3 to 25.3 billion EUR and loans that increased from 0.8 to 17.5 billion EUR from 1995 to 2008 have made the most significant contributions to changes in the structure of financial liabilities (OECD Statistics 2014).

Table 6.1 indicates a negative correlation between internal finance and bank lending, but also the increasing contribution of internal funds during the low investment period, while low investment is linked with the low use of external funding. Aside from dynamics in investment demand, the financing patterns in Estonia have been significantly affected by tax policies. The corporate income tax reform in 2000 that lowered the income tax on reinvested profits to zero[7] supported the reliance on internal funds further (Sander 2003). Concerning the effects of the tax reform, one can observe an increase in investment volumes and reinvested profits, in particular, in case of small businesses (Kuusk and Jürgenson 2010; Kaarna et al. 2012). Similarly, Hazak (2009) has found that the tax reform decreased dividend payouts, but also the utilisation of external financing (loans), while liquid assets and the share of retained earnings in total assets have been found to increase (see also Masso et al. 2011). For instance, accumulated retained earnings of the non-financial corporate sector increased from 7 per cent of GDP in 2000 to 113.5 per cent of GDP in 2009 (author's calculations based on the Statistics Estonia 2014). Hence, the availability of internal resources, that is, increased deposits and high excess capacities, has thwarted credit demand in the non-financial sector, even though slower growth in profits after the crisis and the need to finance current expenses with accumulated financial assets curtailed internal buffers.

With regard to bank loans, these were discouraged for a long time by macroeconomic volatility, high interest rates, insufficient collateral, the lack of credit histories of enterprises, and inadequate accounting standards. Bank lending got an impetus only in the 2000s in light of a thriving real estate market – the share of loans granted to commercial real estate companies has been the largest, accounting for almost 40 per cent in the banks' corporate loan portfolio at the peak of the boom in 2006. It is also interesting that since joining the EU in 2004, the growing volume of EU structural funds[8] has induced the demand for bridge financing, that is, bank loans for required self-financed contribution of subsidised investment projects. The main issue with bank lending, however, has been the

Table 6.1 Net sources of finance and gross fixed capital formation in Estonia, 1995–2012 (percentages)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Internal (net savings + consumption of fixed capital)	65.6	58.5	50.2	63.1	85.4	85.9	68.9	66.9	49.6	69.5	87.5	71.4	56.5	67.3	104.2	113.7	50.6	71.6
Bank (loan) financing (loan liabitilities – loan assets – currency and deposits)	14.4	25.4	17.6	40.5	−7.5	17.8	20.2	17.7	20.3	20.9	5.3	25.5	28.5	13.0	−14.0	−50.1	7.1	0.5
Bonds (net securities other than shares, except financial derivatives)	−0.2	3.9	12.5	−15.2	5.0	1.7	2.1	15.3	0.2	1.0	4.3	0.8	4.2	−5.9	0.1	2.2	5.0	4.5
New equity (net shares and other equity, except mutual funds shares)	27.6	13.6	29.0	6.3	10.0	4.4	9.4	6.2	21.6	3.4	4.2	−1.2	2.5	4.6	−20.5	19.7	5.6	0.8
Trade credit	0.7	−4.1	3.0	9.8	−1.2	−7.8	6.0	−2.6	4.9	3.4	−0.8	2.2	2.6	8.8	16.3	−6.8	18.8	15.1
Capital transfers	3.0	1.9	2.5	3.3	2.7	1.3	0.9	1.8	1.8	5.4	2.6	4.2	3.7	7.1	17.3	14.0	6.2	8.6
Other	−11.1	0.9	−14.8	−7.9	5.6	−3.3	−7.4	−5.3	1.6	−3.5	−3.1	−2.8	1.9	5.1	−3.4	7.1	6.8	−1.1
Physical investments (gross fixed capital formation) as % of GDP	17.1	17.1	18.8	21.3	16.7	18.5	18.4	20.0	22.3	21.5	21.3	22.0	22.0	19.1	11.9	10.9	15.0	15.0

Source: OECD Statistics 2014, author's calculations.

priority given to the banks' home-country customers, as the inflow of foreign capital into the non-financial sector was one of the reasons for Scandinavian banking groups to enter the Estonian market (De Haas and Naaborg 2006).

All in all, the financing of capital investments in the Estonian businesses has mostly relied on internal funds and has been accompanied by bank loans, as typical for a bank-based financial system. Reliance on own funds has been supported by the relatively low dividend payments and the corporate income tax reform in 2000. Moreover, high ownership concentration in business entities and the related reluctance of owners to share profits explain the preference for the use of internal funds. Modest credit demand, on the other hand, could be explained by the restructuring of the economy that has entailed the destruction of parts of the production base and the increasing share of the service sector in the economy. Thus, one can observe increasing accumulated retained earnings (savings) in the non-financial corporate sector until the 2008 crisis. This in turn has spurred increased investments in financial assets, even though a relatively large and positive contribution of gross fixed capital formation to GDP growth existed throughout the years, except for 1999 and the 2008–2010 period (see Figure 6.1) The prevalence of non-listed SMEs, whose investment rate and growth increased in the post-reform period, further puts into doubt the negative effect of increased financial investments on real investments. It is important to acknowledge that increasing investments in financial assets have not been the result of the financialisation process in its conventional meaning, but rather incentivised by the fiscal policies and meagre capital investment possibilities due to the small market as well as the *primitive* productive and technological structure as demand- and supply-side constraints in Estonia.

6.4 HOUSEHOLD CONSUMPTION

Private consumption has been the main contributor to GDP growth in Estonia, which has been supported by the increasing net incurrence of financial liabilities by households since the early 1990s, even though the net financial position of the households has been positive; only from 2005 has it started to deteriorate due to the decreasing value of shares and other equity, and the considerably stronger growth of households' financial liabilities compared with assets (OECD Statistics 2014). In the structure of households' assets, shares and other equity (mostly unquoted shares) constitute the largest share, followed by demand and time deposits. Current accounts have been the most popular and liquid channel to save among private persons, despite the introduction of several investment and depositing products by banks. The high share of demand deposits in the asset structure of households can be explained by the fact that employees in Estonia receive their monthly salaries on this account (Sõrg and Tuusis 2008, pp. 12–13). The growth of households' liabilities, on the other hand, where loans have comprised between 80 and 90 per cent of financial liabilities since 2007, has been led by the more than 40 per cent annual increase in the total volume of housing loans and leases between 2000 and 2005 (Bank of Estonia 2006b). Loans to individuals increased from 5–6 per cent in the late 1990s to 53 per cent of GDP in 2009 and the ratio of debt to disposable income grew from 8 per cent in 1996 to 104 per cent in 2009 (author's calculations based on Bank of Estonia 2014 and OECD Statistics 2014). At the dawn of the credit boom in 2004, on average 18 per cent of a households' monthly net income went to service loan and interest payments, while for one-fifth of the debtors loan-servicing costs stood above 29 per cent of the family's net income (Bank of Estonia 2005). By 2010, the average monthly debt servicing had climbed to 26 per cent of households' monthly net income (Bank of Estonia 2011b).

In light of persistent high income inequality, low public social safety nets and relatively low minimum wages (Aidukaite 2011; Eamets 2011), it is not surprising that paid employment as the primary source of income has not been able to uphold growing private consumption without the use of debt financing. More importantly, given that 68 per cent of households have problems with meeting subsistence needs, the majority of people living in Estonia spend their monthly income on everyday needs, while only a few households have managed to accumulate some savings as an additional source to cover costs. Hence, in order to pay for larger lump-sum expenses such as more expensive durable goods, tuition fees etc. or investments such as purchase or renovation of housing, Estonian households have increasingly used bank loans. The share of households with outstanding loan liabilities in all Estonian households grew sharply from 23 per cent in 2001 to 50 per cent in 2011 (Meriküll 2012, p. 2). Hence, bank loans to individuals have been one of the main factors affecting the formation of consumption patterns of households. Expanding credit enabled households to broaden consumption during the boom years, while the credit crunch in post-2008 period suppressed it (Männasoo 2003).

These increasing mortgage loans caused several vulnerabilities in both the household institutional sector and the economy as a whole. The first stems from the high level of foreign-currency denominated loans up until 2011, when Estonia joined the Euro area. Namely, 90 per cent of the mortgage loans were denominated in euros at adjustable interest rates before the crisis (Bank of Estonia 2010b). This made the repayment capacity of borrowers dependent on their employment situation, the evolution of real estate prices, and to a significant extent on continued low interest rates. Secondly, the rapid growth in the debt burden, together with the rise in real estate prices that preceded the recession, created the preconditions for a creditless recovery. The sluggish recovery in credit demand can be partly explained by changed household endowments, such as income reduction and lower income expectations, although changed behavioural relations also matter. In addition, Estonia's pre-crisis real estate boom and the subsequent drop in the value of collateral played a role in lowering credit demand (Meriküll 2012). Third, the debt burden of households has increased through the re-financing of previous loans. Irresponsible lending by credit institutions during the boom years in the mid-2000s, coupled by the *e-hype*, paved the way for the emergence of payday loan providers, who have extended high interest rate loans to no-income and no-job borrowers via easily accessible electronic channels, including mobile phones. The propensity to apply for these high interest rate payday loans increased during the post-2008 recession period, as on average the share of expenditures on food and housing in households' budgets increased to 45 per cent due to the fall in real incomes (Bank of Estonia 2011a, p. 13). Therefore, in the Estonian household sector, one can observe a vicious cycle of debt-financed expansion that went together with increasing financial fragility due to greater leverage. In accordance with a typical scenario of the realisation of this fragility, foreign-owned credit institutions tightened credit standards and raised risk premiums that contracted debt and shut down the engine of demand growth. In that sense, bank lending to individuals has behaved in a pro-cyclical manner.

In conclusion, given the persisting income inequalities and overall pressures to squeeze labour costs, thriving private consumption that drove rapid economic growth for years was increasingly financed with debt. To some extent, the increasing borrowing that has been secured on rising real estate values has enabled households to withdraw part of the rise in housing wealth and use the proceeds for additional consumption financing, although the marginal propensity to consume out of housing wealth stood at only 1.1 per cent before the crisis of 2007/08 (Paabut and Kattai 2007), which does not support the financialisation argument in terms of the wealth effects. On the other hand, the explosive increase of different banking products and services – mortgage loans, banking cards and consumer credit – reveals the typical elements of the conventional financialisation process, which was made possible by the inflow of foreign capital, intermediated to households through the foreign-owned banks. In light of skyrocketing bank lending to individuals and a deteriorating ratio of debt to disposable income, savings of households decreased steadily until the dawn of the crisis. In a way, the relative income hypothesis applies to the Estonian case due to meagre living standard that necessitated the use of bank loans and savings, when available. Related to the relative income hypothesis argument, one cannot overrule the workings of demonstration effects in the transition process in terms of catching up with consumption patterns of the Western economies, which was accompanied by the introduction of new financial products and services to households. This in turn reveals the interaction of changing institutional structures and social norms that resulted in the debt-financed consumption boom in the mid-2000s. The portrayed developments in the household sector could be referred to as *privatised Keynesianism* (Bohle and Greskovits 2012, pp. 131–137) that entailed a shift from counter-cyclical state policies to the growth of private credit to households for compensation of low wages. All in all, one can observe soaring loan liabilities, in particular, among higher income earners, and a living beyond one's means that reveals the overall poverty of the majority of population.

6.5 2008 CRISIS AND CONCLUSIONS

In the Estonian case, it is hard to detect long-term trends among the real sector categories and variables that could be attributed to the financialisation process as conceived and perceived of in the West. This has been due to the manifestation of financialisation as a heavy reliance on foreign savings in financing economic growth. In this regard, a FDI-led catching-up process has affected all variables of the Estonian real sector to a great extent. Moreover, when considering the long-term effects of financialisation on the real sector, one has to bear in mind that Estonia's market economy is very young, and has revealed peculiar features, not found in many other economies, if any. Thus, many dynamics in the economy are therefore attributable to the transition process rather than to the financialisation process, which makes it difficult to see the financialisation effects as conventionally understood behind the transition process. For instance, widening current account deficits throughout the last two decades could be ascribed to the status of a catching-up economy that incurred higher demand for capital goods and hence a negative trade balance for most of the years. On the other hand, financialisation also affected external imbalances, given the soaring indebtedness of the Estonian private sector that made it possible to cover the current account deficits. Everything considered, fluctuations in the Estonian economy have depended on developments outside the country, such as EU monetary policy, decisions made by parent companies in the Nordic countries and lately, the overall conditions in export markets.

In the context of the global financial crisis of 2008, the housing market boom in the mid-2000s, followed by the economic recession in Estonia, was the inevitable consequence of deeper structural problems that were created during the restructuring of the economy in the 1990s. Specifically, under the conditions of accelerated deindustrialisation and collapse of complex industries that co-occurred with the marginalisation of R&D and innovation activities, only credit could expand the purchasing power of most of the population. As a result, one can observe a vicious circle of consumer credit, mortgage lending and a housing boom reinforcing each other with dire consequences for export competitiveness due to galloping inflation and an appreciating real exchange rate. In other words, macroeconomic vulnerability has been associated with a structural savings shortfall, evident in current account deficits, excessive loan-to-deposit ratios, and an ongoing funding need from parent banks. This external debt-led growth in Estonia entailed a typical situation of increasing financial fragility that Minsky's (2008) analysis addressed, that is, a growing risk of reversal of capital flows, which was amplified by the extreme openness of the economy, highly leveraged structures and external financing being concentrated in a limited number of economic activities, such as real estate and construction (Kattel 2009, pp. 11–13; Thorhallsson and Kattel 2013). Such domestic market orientation of foreign loans gradually eroded the safety margins by insufficient generation of foreign currency earnings to meet external liabilities, which revealed the *Ponzi* financing position of the Estonian economy when the global crisis of 2008 hit the country.

One of the main channels of the 2008 global crisis that impacted the Estonian economy was liquidity and funding channel, as in an international comparison, Estonian banks rely less on deposits than other new EU member states, implying foreign external borrowing (Juks 2004, p. 20). A remarkable finding in Danilov (2003) is asymmetric capital flows in relation to stages of business cycles, that is, positive feedback mechanisms between business cycles and capital flows that could increase the danger of financial bubbles during the growth phase of the cycle. Also, given a high share of foreign liabilities on the balance sheets of foreign-owned banks, there has always been the possibility of deleveraging and divestment. In that respect, foreign banks reduced lending first and faster than domestically owned banks in the wake of the global turmoil in 2008 (see EBRD 2013). Moreover, the local banking sector was affected by capital outflows that were materialised through portfolio investment and financial derivatives, and followed by outflows of other investments (Jevcák et al. 2010). Another channel was external trade due to high openness of the Estonian economy that has implied the dependence of its economic performance on trade partners' business cycle and other external events, including shocks.

In particular, the trade channel has a significant role in transmitting the EU's impacts to Estonia as well as in increasing the synchronisation of business cycles. The important role of exports for the local economy in the form of intra-industry subcontracting trade between Estonia and foreign countries is revealed in selling more than half of industrial output on foreign markets (Tiits et al. 2008). Thus, the way Estonia was affected by the 2008 crisis, can be traced to regime-specific economic structure and patterns of international integration. As a result of the global financial crisis and the realisation of its impact through the two main channels, the Estonian economy plummeted by 14 per cent in 2009. The main consequences of the crisis in 2008 were rapidly increasing unemployment, bankruptcies, underutilisation of productive resources, stricter credit conditions, and the drop in assets prices, which undermined investments and private consumption (Bank of Estonia 2010b).

Because of the embeddedness of neo-liberal features in the Estonian political-institutional system, analytical competences to deal with the consequences of crisis were non-existent for policy-makers. At the outset of financial crisis in 2008, there was essentially no experience with alternative macroeconomic policy ideas among politicians or public officials due to the lack of a domestic heterodox economic tradition. The same macroeconomic policy environment in terms of conservatism in fiscal policies and neutrality in monetary policies has been sustained for almost 20 years since the early 1990s with the belief in simple taxation system, based on the principle of proportional and uniform tax rates, and balanced government budget. Essentially, by creating a condition of *economic Darwinism*, that is, by leaving the survival of enterprises to be determined by the market forces alone without any significant assistance from the government, the economy has been locked into a continuous dependence on foreign capital inflows to keep the economy afloat and maintain the ability to service debt.

NOTES

1. Immature accounting practices and loopholes in the legal framework enabled the manipulation of figures, which undermines the reliability of statistical data from the early 1990s (Terk 1999, p. 160).
2. For a time, Estonia held the second place among CEECs with regard to the cumulative per capita inward FDI stock (Gerndorf et al. 1999).
3. In 2015, personal income tax and VAT rate stood at 20 per cent, but there was no capital gains tax on institutions, while individuals were taxed at a flat rate of 20 per cent.
4. The share of the foreign assets of investment and pension funds has steadily grown, reaching 83 per cent of total assets by the end of 2011 (Bank of Estonia 2012).

5. In 2010, 99.9 per cent of all business enterprises were SMEs, which employed 79 per cent of the labor force, exported 76 per cent total export value and invested 79 per cent of total investments in fixed assets (Kaarna et al. 2012, p. 22).
6. By the turn of the millennium, Swedish and Finnish companies controlled 46 per cent of the securities' market capitalisation. Only 20 per cent of the stock market capitalisation belonged to resident investors in 2004, while the share of residents among bond investors reached 92 per cent. However, the share of resident investors in the bond market capitalisation has decreased since 2003, standing at 69 per cent in 2009, while in case of stock market, the share of local investors has slowly increased reaching 48 per cent by 2009 (Bank of Estonia 2005; Bank of Estonia 2010b).
7. A peculiar feature of the Estonian corporate income tax system is the provision of list of profit usages that are subject to taxation. However, as the list is non-exhaustive, there are possibilities for tax avoidance, which in turn distorts the profit and rentier income figures.
8. The Baltic States have been among the leaders in absorbing the EU funds for entrepreneurship and social policy measures (see Table 6.1). In particular, the inclusion of banks as intermediary bodies that assess projects, disburse funds, monitor and carry out on-site inspections, is perceived to accelerate the absorption of these funds (Bohle and Greskovits 2012; The European Bank Coordination Initiative 2011).

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Article III

Juuse, E. 2016. “Financial regulation in Estonia - a 'world of "dead letters"': the interplay of Europeanization process and national idiosyncrasies.” In: R. Kattel; J. A. Kregel and M. Tonveronachi (eds). *Financial Regulation in the European Union*. London; New York: Routledge Taylor & Francis Ltd., 132-162. (3.1)

6 Financial regulation in Estonia – a ‘world of “dead letters”’

The interplay of Europeanization process and national idiosyncrasies

Egert Juuse

1 Introduction

The 2008 financial crisis revealed the shortcomings of financial policies on both national and international levels. Though views have differed on the exact causes of the crisis and policy failures, meagre requirements in trading, lack of transparency in complex financial instruments and freedom left to unregulated non-bank actors have been presented as some of the reasons behind the turmoil in the financial markets (see European Commission, 2010; Montanaro and Tonveronachi, 2011). Still, deeper understanding of the implications of regulatory environments has been a challenging task, in particular, in the European Union (EU) context, where limited real convergence of policies and institutions has been observed, that is, inconsistencies in the adjustment to EU policies and more specifically to the *acquis communautaire* across policy areas and countries (see Kohler-Koch and Eising, 1999; Héritier, 2001; Jacoby, 2004).

Inside the EU, Central and Eastern European countries (CEEC) stand out for deep integration with international markets, including for capital markets and various financial services, which explains why and how they were hit to greater or smaller extent by the 2008 global crisis. The crisis itself revealed several vulnerabilities of these economies, particularly dependence on high-volume cross-border funding via internal capital markets within the banking groups (De Haas and Naaborg, 2005, 2006; Lehmann et al., 2011; see Bohle and Greskovits, 2012). That being the case, CEECs have found themselves in a position where the governance of finance, dictated by regional or global regimes, has disabled national governments to shield their economies against the crises as evidenced by their unsuccessful attempts to control the credit boom of the 2000s (see Pistor, 2009). Therefore, the challenges in the governance of finance for CEECs arise from the multidimensionality of financial regulation in terms of the interplay of national and supranational actors as well as institutions that could be addressed from both the Europeanization and ‘regulatory state’ thesis (see Majone, 1996).

So far, the scope of the eastward Europeanization research has been rather wide with the focus on the entire *acquis* without any single country or issue on the agenda. Most of the research attention has been also placed on the output level, that is, legislative decisions with the focus on explanatory factors that affect the correct and timely transposition of the EU policies, and not so much on outcomes in terms of implementation performance (see Falkner et al., 2005; Treib, 2008). Hence, in light of the regulatory failures in finance and the impact of the EU on the evolution of financial policies at the national level, the current paper addresses the development of the banking legislation in one of the CEECs – Estonia – during the period of 1991–2011. Compared to other CEECs, the peculiarity of the Estonian financial system stems from the operation of the currency board system operating until 2011 and substantial foreign ownership in the banking industry with the four largest foreign-owned banks controlling over 95 per cent of the market in terms of both total assets and share capital (OECD, 2011). Furthermore, the tendency of Estonia to outperform Western European counterparts, but also other CEECs, when it comes to compliance with the EU regulation (see Sedelmeier, 2008; Toshkov, 2008) presents the grounds for a study on the effectiveness of regulatory harmonization in terms of potential divergence between legislation and 'real-life' developments in the banking industry. In this regard, the current chapter aims to explain the factors affecting the formation of the regulatory practices and also to understand the implications of the alignment with the EU banking regulation for financial supervision and overall stability.

The following analysis will be undertaken within the conceptual framework of Europeanization and the institutionalist tradition. The first section will present a brief overview on the current theoretical literature and presents the analytical framework for understanding the dynamics in regulatory and supervisory practices. The second section of the study presents the development of Estonian banking legislation to be followed by the sections discussing the factors affecting it and the implications for the banking sector supervision.

2 Multifaceted concept of Europeanization

Europeanization as a reflection of the convergence process has been presented in several ways: (1) the impact of the EU on countries through the absorption of EU norms and logic, that is, the transposition and implementation of European legislation in EU member and non-member states (Grabbe, 2006; Schimmelfennig and Sedelmeier, 2005a; Kaeding, 2006), (2) the substitution of national policymaking with supranational policymaking that modifies patterns of political and administrative behaviour (Radaelli, 2000; Majone, 1996), or (3) more narrowly, conceived of as the impact of individual EU policy measures on the existing policies, political and administrative processes, and structures of both member and non-member states (Héritier, 2005; Pollack, 2010). Even though all three interpretations are applicable in the analysis of banking regulation, it is the mechanisms of the Europeanization and the constructs behind them that give a better understanding of the dynamics in the field of study. In the context of the CEECs, these mechanisms have transformed throughout the (pre-/post-)accession period since 1989, starting with lesson-drawing, also imitation or institutional isomorphism, and ending with coercion, that is, conditionality and eventual membership obligations (see Grabbe, 2006; Jacoby, 2006). In that respect, theoretically informed studies on the Eastward Europeanization reason that compliance, enforcement and policy changes could be built around: (1) a rational choice institutionalist tradition, that is, the 'external incentives model', which captures the dynamics underpinning the EU's conditionality, (2) an institution-based historical (constructivist) tradition, that is, the 'social learning model' that emphasizes identification with the EU and persuasion of the legitimacy of EU rules as conditions for rule adoption, and (3) an ecological organization tradition, that is, the 'lesson-drawing model' with the focus on the adoption of EU rules as induced by the CEECs themselves through copying, emulation, combination or inspiration (see Radaelli, 2000; Schimmelfennig and Sedelmeier, 2002; Börzel and Risse, 2003; Schimmelfennig and Sedelmeier, 2005a; Pollack, 2010; Etienne 2011).

Schimmelfennig and Sedelmeier (2005b) claim that in the early transition period CEECs were receptive to lesson-drawing and social learning approaches due to the widespread perception of policy failure and the need to replace socialist legacies or to adopt new rules in areas where none existed before. This was evidenced by selective and limited EU-induced rule adoption (see also Andonova, 2003; Grabbe, 2002). However, they concede that the external incentives model, associated with EU membership conditionality, generally explains the broader patterns of rule adoption in CEECs from 1995 onwards. Despite the fact that the EU's influence worked through the conditionality for accession during the pre-2004 period, the given set of institutions once established has influenced and constrained the behaviour of the actors who adopted them. Perception of the embeddedness of national policies, institutions and regulation in line with EU requirements and accompanied significant 'sunk costs' in the adjustment process highlight the explanatory strength of the historical institutionalist tradition. In this regard, CEECs have eventually got locked in the Europeanization process in terms of setting in path-dependencies in externally directed policy formulation and implementation (Grabbe, 2006; Fink-Hafner, 2007).

Most of the research on the Europeanization process along these three main traditions has mainly focused on explanatory factors like misfit ('goodness of fit'), veto players or national bureaucracies, including administrative capacity and coordination as more broadly defined independent variables affecting the transposition of EU legislation and explaining deadlocks as well as delays (see Knill and Lenschow, 1998; Haverland, 2000;

Héritier, 2001; Falkner et al., 2005; Berglund et al., 2006; Hille and Knill, 2006; Steunenberg, 2006; Toshkov, 2007, 2008; Pollack, 2010; Young 2010). By criticizing the veto player argument and misfit hypothesis, Falkner et al. (2005, 2007) and Falkner and Treib (2008) have proposed an alternative approach that theorizes on the intuitive notion of the culture. They presented four worlds – obedience, domestic politics, neglect and 'dead letters' – as typical patterns in implementing EU policies, where national cultures, ideology and preferences on both political and administrative levels significantly affect the implementation performance. In their analysis, a world of 'dead letters' applies to new member states, where formal rules exist as a result of transposition ('obedience'), but they do not get implemented in practice ('neglect'). In a similar way, Goetz (2002) identifies 'four worlds of Europeanization' – Nordic world, north-west world, Mediterranean world, and Central and Eastern European world – by focusing on the timing of the adoption of the EU requirements by member states and links this categorization of member states to varying patterns of domestic behavior and effects. Also, Jacoby (2004) identifies four different types of impact that the EU can have on the CEECs' attempts to emulate EU rules, ranging from 'open struggle' and 'scaffolding' to 'continuous learning' and 'homesteading' by domestic groups.

However, as already stated, existing theoretical and empirical studies on Eastward Europeanization within all these traditions have had a rather narrow scope with the focus on factors affecting the implementation process in universal, homogeneous areas of study, such as social policy (e.g. Falkner et al., 2005; Linos, 2007) and environment (e.g. Héritier, 2001). The eastward Europeanization as a field of study falls short of the analysis on the effectiveness of externally induced policies and relevance of the Europeanization process for the CEECs, in particular in banking and finance. Hence, the following analysis tries to shed some light on these missing pieces in the discussion on Europeanization with the case of the banking regulation in Estonia.

3 Twenty years of the banking regulation in Estonia

Already in the early years of the independence in the 1990s, there was a clear tendency towards a 'regulatory state' model in socio-economic reforms in Estonia, as public institutions were not supposed to intervene in the economy other than to regulate (see Bohle and Greskovits, 2012). As one of the key reformers at the time, Siim Kallas, who was in charge of the central bank then, has argued that this choice was a conscious one, as there was low trust in government's ability to get interventions right (Kallas, 2003, p. 511). Further, the preference for the principle of firmly rooted rules instead of discretionary policies was reasoned with the need to stop past practices of socialist management and reduce uncertainties in a highly risky environment of the transition process (see Steinherr and Gilbert, 1994). This was manifest in the monetary institutions, that is, the currency board arrangement, which in essence depoliticized monetary policy and limited the function of the central bank as lender of last resort, but also was evidenced by the strict approach taken to the bank and bad-debt restructuring that resulted in bankruptcies and liquidations in the early 1990s with a clear message from public authorities in terms of not bailing-out commercial banks (Lainela and Sutela, 1994; OECD, 2000). It can be argued that one of the underlying motives behind both limiting the role of the central bank and the strict approach to crisis resolution in the early 1990s was to divide two main functions of the banking sector between domestic and external actors. Domestic actors (banks) should enable functioning and safe payment systems; external actors, through foreign direct investments, should enable the financing of productive investment into restructuring of the economy.

Though 1995 marks the beginning of the integration process into the international (banking) community, when the modern Credit Institutions Act, Accounting Act and Commercial Code were adopted, the starting point for Estonian banking regulation could be considered 1989, when a bill was passed to allow the establishment of commercial banks. On the grounds of the specifics of main reforms and legislative amendments, the following 25 years of the evolution of Estonian banking regulation and supervision can be divided into six periods (see also Zirnask, 2002; Sõrg and Tuusis, 2008), punctuated by critical junctures in both Europeanization and institutional progress of the banking sector, as presented in Table 6.1 at the end of the chapter:

1990–1992 – a period of monetary reform and a multitude of restrictions on capital account transactions, including a legal prohibition on foreign ownership of local banks, but no measures adopted to restore the solvency of banks in light of the first banking crisis (Sõrg, 2003; Lainela and Sutela, 1994). The main problems at that time lack of supervision and lenient requirements for establishing a bank due to the objective of public authorities to enhance competition by granting an easy entry via fairly low minimum capital requirements and lax review process of applications for a licence (OECD, 2000).

1993–1994 – the first attempts at regulating banking activities with prudential ratios – solvency ratio,[1] liquidity ratio,[2] risk concentration ratio,[3] net foreign exchange position ratio – in order to restrict the excess risks taken by banks (Bank of Estonia, 1994a). Also, new methods were adopted in the supervision of credit institutions that included a complex assessment of the quality of the bank's assets, the strength of capital base, profitability and the effectiveness of administration, while pre-emptive control was strengthened in the stage of issuing licences to credit institutions by approving the members of management (Bank of Estonia, 1995). Initially, the Bank of Estonia followed the recommendations of the Basel Committee on Banking Supervision, but later the requirements of the EU directives in elaborating prudential ratios (Bank of Estonia, 2003).

1995–1997 – qualitative changes in the regulatory framework with the enactment of the *Credit Institutions Act 1995*. Legislation on credit institutions established the basis for a universal banking model and enabled banks to own and finance other financial institutions, which also entailed the introduction of principles for consolidated financial statements. Aside from provisions on the establishment, management and supervision of the bank, tighter regulation of different risks (credit, foreign exchange, market, etc.) was adopted. One of the aims of the 1995 law and following amendments was to restrict lending to bank staff and owners as well as to prevent large exposures.

1998–2004 – a modern banking period with the focus on requirements arising from macroeconomic and international, in particular, the EU developments. In the aftermath of the 1997–1998 banking crisis, Estonia introduced the institution of deposit guarantee and adopted a European-type Credit Institutions Act 1999, based on the EU banking directives and materials from the Basel Committee on Banking Supervision. The new Credit Institutions Act was more specific in establishing the roles and responsibilities of the Banking Supervision Department at the central bank in executing oversight by stipulating specific rights for obtaining information, executing on-site inspections, demanding revitalization plans and issuing prescriptive orders, including the removal of a member of the Executive Management or Supervisory Board of the credit institution. By 2000, Estonian legislation on banking activities, accounting practices and organization of supervision was harmonized with Western practices, except for the deposit guarantee system. Amendments made in the early 2000s were mostly related to continuous harmonization of national legislation in banking to achieve full integration with the EU directives for joining the EU in 2004.

2005–2008 – continuous adaptation to the existing and new banking regulation of the EU. Further strengthening of capital adequacy regulation was caused by the need to adopt the new Basel II framework.

2009–… – the post-crisis period with reactive measures to the global financial crisis of 2008, including the improved guarantee of deposits and establishing a framework for granting emergency liquidity assistance to troubled credit institutions (OECD, 2011). Also, the rights of the Financial Supervision Authority were expanded for intervention into and inspection of the activities of banks in crisis. Moreover, the state was granted the right to consider expropriating the shares of banks operating in Estonia (Bank of Estonia, 2011). The most significant development was the enforcement of the Debt Restructuring and Debt Protection Act in 2011 to enable individuals in financial difficulty to restructure their debts. As a consequence of joining the eurozone, the minimum reserve requirement had to be lowered from 15 per cent to 2 per cent in 2010 (ibid.).

This periodization corresponds to three general stages in the banking sector's development: (1) a rapid increase in the number of banks as result of the liberalization of the banking environment in 1991–1992, (2) a decrease in the number of banks and a stabilization period until 1997–98, as the regulatory environment was made stricter, and (3) a growth phase after 1998 with increasing share of foreign ownership through organic growth and takeovers (Myant and Drahokoupil, 2011, p. 261). Such a periodization of institutional developments with general trends in the banking sector also reveals potential factors that have affected the banking legislation.

3.1 National idiosyncrasies and perseverant Europeanization

In light of the developments in the banking sector, the challenge in the 1990s was the establishment of institutions in both private and public sector by finding compromises between international regulatory trends and *ad hoc* country-specific needs, while the post-1997/98 period set the regulators the task of adjusting the regulatory and supervisory environment to suit a multinational cross-border context (Ross, 2013). Also, one has to bear in mind that Estonian banking regulation in the early 1990s was accompanied by the elimination of restrictions on capital movement and full convertibility of current account transactions under the general liberalization agenda (see De Castello Branco et al., 1996; Kattel and Raudla, 2013). The late-1990s and the following years, on the other hand, saw convergence with the EU banking directives that implied either extensive regulation of uncovered issues or re-regulating. In this regard, de- and re-regulatory cyclicality can be observed to some extent. For instance, approach taken in authorization of credit institutions was very loose in the early 1990s, followed by more stringent licensing requirements in the mid-1990s, but then again loosened due to adoption of the principles of the Second Banking Directive on cross-border banking activities.

Thus, different motives and situational circumstances in the early and late 1990s as well as the 2000s account for varying explanatory strength of theoretical concepts within the institutionalist approach on the matter of eastward Europeanization.

Although the build-up of the regulatory environment in the early 1990s was aligned with the international framework, specific domestic circumstances, such as a currency board system, influenced its design, while banking crises led to stricter regulations than international minimum standards (Ross, 2013). Thus, the crises-wrecked banking system needed a pragmatist approach in policymaking for finding solutions to single episodes of failing banks, but at the same time building an institutional environment from scratch (see De Castello Branco et al., 1996). In the conditions of reoccurring banking crises, policymaking was of a rather reactionary nature that was manifest in rule amendments after every major crisis and mostly related to practical issues in accounting, reporting, reserve and capital requirements. Consequently, attention was turned to international practices and example was taken from other Central and Western European countries in forming banking legislation, e.g. practices of Germany, Austria, Denmark, Finland, Iceland and Hungary were relied upon in drafting the legal acts, but also the Basel I principles and the EU directives were used as source of inspiration to the extent it was appropriate and possible, given the circumstances at that time (Bank of Estonia, 1994b, 1998; Khoury and Wihlborg, 2006). This indicates to the predominance of a bottom-up imitative-copying approach, associated with the 'lesson-drawing model'. The 'external incentives model', on the other hand, has cogency in explaining banking regulation from 1995 onwards, when the EU gained the leverage to spell out the content of legislation that had to be adopted as a precondition for membership, implying a rather political commitment and reasoning in adjusting the legislation to the *acquis*. Thus, the start of pre-accession negotiations can be considered as a critical juncture in the institutional adaptation. First, the adaptation to the EU banking directives was one of the key aspects of the Association (Europe) Agreement reached between the EU and Estonia in 1995 that foresaw the right for EU financial institutions to operate in Estonia by the end of a transition period at the latest, although the Europe Agreement contained transitional rules (see EBRD, 1998; Tison, 2002, p. 39; also Table 6.1 on specific examples). A second and more important development was the inclusion of Estonia in the first group of membership negotiations in 1997 and the enforcement of Association Agreement in 1998, which explain major harmonization efforts in banking legislation around the turn of the millennium in 1998–1999, as can be seen from the Table 6.1. Hence, the EU's impact on the alignment process intensified especially once the EU opened accession negotiations, which signalled the credibility of EU's membership incentive (see Sedelmeier, 2010). Moreover, EU banking policies have become embedded in Estonian legislation due to an expectation on fulfilment of conditions without opt-outs in an asymmetrical relationship and a dependence on EU's input (see Grabbe, 2006; Schimmelfennig and Sedelmeier, 2005b on asymmetry issue in the EU governance) that has allowed the EU an unprecedented influence on domestic institutions and policies in private finance. In the words of Bohle and Greskovits (2012) the period of 1989–1998 included the historical turning points with key decisions shaping the post-socialist legislative order, while the following period until the 2008 crisis brought about consolidation and further embeddedness of created structures. Such a path-dependence in adopting the EU banking directives is witnessed in the adoption of institutions and legislating financial instruments that were non-existent before the harmonization with the EU rules was initiated. For instance, investment firms and agents, financial conglomerates, securitization transactions, hybrid capital instruments, etc. were introduced into the legislation only as a result of the EU's influence, although the necessity of provisions on these notions could be questioned (see below). In that respect, Estonian banking legislation has been exposed to path-dependence in policy formulation from the late 1990s and essentially being locked in the Europeanization process, supported by the statements by the Ministry of Finance and the FSA:

> Since financial sector regulation is pretty much harmonized with European Union law, then all the reforms and changes generally start from there. In this sense, one cannot talk about specific changes and reforms …Financial stability policy is quite successful in Estonia [given the developments in the banking sector for the last 15 years], but there are also indirect external factors [operational in Estonia] that are beyond the control of the Estonian state.
>
> (Senior civil servant at the Ministry of Finance, 2014)

> If we look at Estonian legislation on financial markets, 95 per cent is comprised of European Union law, while the share of the domestic input is minuscule. The domestic component consists basically of two things: the second pillar of the pension system, even though it is partly built upon the UCITS Directive, and the Estonian Central Register of Securities …
>
> (Member of the Management Board at the Financial Supervision Authority, 2014)

This kind of embedded socialization in terms of the 'stickiness' of formal rules and institutions transposed to Estonia, emphasized in the historical institutionalist tradition, has been also supported by the prevalence of a 'simple polities' approach. Namely, policymakers seek to govern with the means for constructing communicative discourses, the purpose of which has been the persuasion of the legitimacy of policies and regulations on the grounds of the EU's accession or membership obligations (see Bohle and Greskovits 2012; Kattel and Raudla, 2013).

It can be concluded that despite the strengths of both rationalist and constructivist arguments in explaining the adoption of the EU rules in the 1990s and 2000s, the realization of several idiosyncratic risks during these times caused *ad hoc* reactive actions and were guided by more pragmatic considerations due to high political salience of the issue, namely dealing with several rounds of banking crises in the 1990s. Hence, in the 1990s the legislative development in the banking sector was driven by the interplay between the Europeanization process as an exogenous factor and the post-communist transition process, seen as an endogenous factor. One could argue, then, that the regulation in finance, and in banking in particular, has been consistent with the differentiation thesis, that is, simultaneous Europeanization, liberalization and (re-/de-)regulation (see Eberlein and Grande, 2005). However, none of the theoretical discourses has addressed the issue of potential impact, not to mention the significance of discussed regulatory tendencies for the institutional development of the banking sector.

3.2 Peculiarities and direct implications of the harmonization process

Veto player and goodness of fit propositions, associated with the aforementioned theoretical concepts, are of little significance in explaining transposition of EU banking directives into national legislation. First, the rationale underlying the misfit argument never emerged in banking regulation, as regulatory philosophies or deeply entrenched models were only taking shape and were largely missing prior to the harmonization process. This could be also reasoned with the new regulation and re-regulation of the banking sector, while the communist legacy endowed no institutional resistance to EU policies (see Schimmelfennig and Sedelmeier ,2005b; Grabbe, 2002 on misfit and veto player discussion in CEECs). Second, as already stated, it was common to justify policies by referring to EU norms and expectation in the harmonization process with the *acquis*. Moreover, the nationalist logic of integration required efficient work in order to guarantee a positive evaluation in the Commission's Progress Reports (see Laar, 2000). Similarly, nationalist sentiments on the premise of safety nets against the 'eastern' influence implied openness to foreign ownership in the banking (Bonin et al., 2009; Bohle and Greskovits, 2012). Consequently, the transposition of directives, including in the field of banking, has been excluded from daily political struggles, implying technocratic policymaking, that is, the persistence of a simple polity stance of the government and depoliticization of EU matters (Kaik, 2002; Börzel, 2010; Bohle and Greskovits, 2012; Kattel and Raudla, 2013). Estonian political leadership tended to make integration an elite project because of its complexity or importance for wider democratic politics with legitimation coming from the EU rather than from citizens. This explains the diminished role of the Parliament that was supposed to be a mere enforcer of legislation without actual influence on the formulation of legal acts, and hence, the executive bias in the overall accession process (see Grabbe, 2006).

> The whole legislative body embraces to large extent, and will do it even more in the future, European Union law. Legislation will become directly applicable and the role of the Estonian parliament and ministries here disappears altogether.
>
> (Member of the Management Board at the Financial Supervision Authority, 2014)

However, because of low administrative capacity and priority given to speed in improving banking regulation, legal acts were of low quality with technical inaccuracies (Kasemets, 2000; Bonin et al., 2009). This implied prolonged transposition of the EU directives into national legislation, evidenced by several rounds of amendments in banking-related legal acts in consequent years in the late 1990s and the early 2000s.

Such an approach in dealing with the EU affairs has reduced both political and administrative capacity to address the developments in the financial sector that have not been dealt with on the EU level, such as issues related to non-bank credit providers (SMS-loan providers), new forms of financing (P2P platforms), etc. The first credible measures for regulating pervasive activities of non-bank financiers, who have extended so-called ninja loans, that is, high interest rate loans to no-income and no-job borrowers via easily accessible electronic channels, including mobiles phones, were drafted only at the beginning of 2014 (Valdre, 2014).

> As distinctive from European Union reforms, the Ministry of Finance has developed a regulation on how SMS-loan providers would go under the supervision of the Financial Supervision Authority. This is not directly related to financial stability, as the SMS-loan providers do not pose a risk to financial stability … rather, as their behavior has caused social problems, and secondly, the business is relatively opaque, then the state has decided to pinch a bit and take control over their activities. The supervision of these loan providers is related to more social issues, where there is clearer political will and agenda, while in the case of major [EU level] reforms, no political pressure has been felt.
>
> (Senior civil servant at the Ministry of Finance, 2014)

3.2.1 'Dead letters' manifestations

Grabbe (2006) raised concerns over the encouragement of institutional isomorphism for gaining political legitimacy for institutional and policy changes during the post-communist transition period, as that could lead to functional dualism whereby institutions resemble the EU ones, but are not functional. Hence, questions have been raised about the real impact of the adopted formal rules with the possibility of a mere existence of regulations on paper, that is, 'formal structures without substance' (see Bugaric, 2006). Dimitrova (2010) raises the danger of the EU rules being created for a different set of preferences and economic conditions that might not fit the domestic economic conditions, when transferred to candidate states. In a similar line of argument, institutionalization is undermined if there is a mismatch between formal and informal rules, meaning that the adopted formal rules will remain rather rules-on-the-books than rules-in-use without any real effects. In addition, Jacoby (1999) has observed a specific kind of superficial domestic change through 'Potemkin harmonization', where political and regulatory changes were carried out for the purpose of EU monitoring without significant institutionalization.

Similar developments are present in the field of banking regulation in Estonia. For instance, financial conglomerates, 'significant branches', e-money institutions and their practices have been regulated in detail, but without real use in practice due to the lack of such institutions operating in the Estonian financial market. Similarly, provisions on hybrid capital instruments, credit risk mitigation techniques, securitization transactions and instruments were legislated, although being not practised in the banking sector (Rahandusministeerium, 2010a). Neither banks nor investment firms in Estonia conclude any complicated financial transactions. The types of financial instruments and transaction negotiable on the Estonian market have been restricted, and trading activity has been very low, implying non-existent speculative transactions in Estonia (see Oja, 2012, 2013; Auväärt, 2013). For instance, foreign debt securities have been the dominant assets in the portfolio of banks, the shares held for trading staying at low levels (3 per cent of securities portfolio in 2001) (Lepik and Tõrs, 2002). Essentially, mortgages denominated in foreign currency, not complex financial structured instruments such as CDOs, CDSs etc., were considered as innovative financial products that proved to be risky practices in Estonia and other CEECs (EBRD, 2012). The insignificance of some of the capitalization regulation regarding the trading book and counterparty risks is due to the fact that the banking sector operates in mostly commercial banking field.

> As the Estonian financial sector is still small and we do not have quite a number of these financial services or sophisticated financial instruments on the local market as found in the rest of the world, we do not possess any significant expertise here to have an opinion on one or another EU proposal or impact … And there is really no one to discuss [these issues] with. Estonia's problem is that in some areas there is not really any knowledge.
>
> (Senior civil servant at the Ministry of Finance, 2014)

In addition, banking policies do not allow any claim that managers of the Estonian financial institutions have been paid unreasonable salaries or bonuses in light of the recent EU's attempts at reining excessive remuneration episodes (Rahandusministeerium, 2010b). In principle, one can witness nominal (legislative) convergence with the EU legislation, but to some extent divergence between adopted rules and real life practices. This, in turn, raises the question on the effectiveness of financial policies and regulations in addressing real-life financial practices.

Furthermore, when analysing the cases of the worlds of 'dead letters', Falkner and Treib (2008) found that literal translation of EU Directives at the expense of careful adaptation to domestic conditions implied frequent shortcomings in enforcement (see also Sissenich, 2002; Schimmelfennig and Sedelmeier, 2007). In this regard, the basic elements of the EU banking regulation, including the risk-weighted capital adequacy requirement, large exposure limits, the initial minimum capital requirement, etc. were copied into Estonian legislation in the 1990s (Ross, 2013). This explains the lack of analysis and assessment of banking legal acts in the 1990s, evidenced by the limited consultation with outside organizations as well as civil society (Kasemets, 2000) and low-quality explanatory notes that accompanied legislation (European Commission, 1999).

It could be argued that the regulatory evolution of the banking sector was driven by pragmatic considerations in the 1990s, only to be permeated by the embedded formalist approach afterwards, that is, mechanical adoption of EU legislation in this policy field. In principle, one can observe both path-dependence in terms of a continuous alignment with the EU policies, and 'dead letters' in the evolution of the EU-led banking regulation in Estonia. Hence, one of the problems in Estonian banking regulation is related to its isolation from the underlying economic substance, as rules have not been adapted to the market structure.[4] Consequently, operational functionality of regulation has been reduced with repercussions for financial supervision.

3.3 Supervisory obstacles and challenges

In contrast to the transposition of prudential regulation, the EU directives have left ample room for national discretion in supervisory intrusiveness without any clear quality standards to be followed (Tonveronachi, 2010). This has been evident in the failures to enforce policies, including transposed EU legislation, due to constrained administrative and judicial capacities in new EU member states. Weak enforcement of contracts, legal restrictions on disposal of assets backed by real estate, difficult access to collateral and low collateral recovery were just a few examples of problems in the 1990s and early 2000s (see De Castello Branco et al., 1996; Steinherr, 1997; EBRD, 1998; Scholtens 2000; Schimmelfennig and Sedelmeier, 2005a; Falkner and Treib, 2008; Sedelmeier, 2008). Even banks perceive legal enforcement as the weakest area, although capital regulation in Estonia is seen as strict and the local legal system considered as adequate (EBRD 2011). In the words of Wagner and Iakova (2001), the effectiveness of financial regulations was lagging behind the extensiveness of regulatory coverage.

By the mid-1990s banking regulation in Estonia was considered to be on par with international standards, but adequate implementation was lacking by public authorities and also bank owners. Although the central bank established basic rules for commercial banks such as minimum capital requirements, capital ratios, exposure requirements, etc., the scope of adherence to the rules was undetermined due to ineffective supervision (Lainela and Sutela, 1994). This was evident in several cases of mismanagement, like incorrect reporting of the value of the securities and non-performing loans. For instance, at the Hoiupank, equity was pledged by senior managers to back a loan to finance purchases of the bank's shares by the very same managers, while at Eesti Maapank, mismanagement of the bank's equity portfolio, including fraudulent behaviour, brought about losses that resulted in the bank's bankruptcy (see EBRD, 1998). *Eesti Maapank* reported the higher face value of the securities instead of marking them to market – as required by the Bank of Estonia – thus inflating both its assets and profits. Essentially, the bank abused the option given by the central bank to undertake sophisticated transactions with forward contracts and also managers could make deals with themselves (Khoury and Wihlborg, 2006). Aside from cases of engagement in extensive insider and connected lending, banks also violated standard prudential banking norms by using illegal mechanisms such as shell companies in order to disregard or actively circumvent legislative restrictions (Lainela and Sutela, 1994; Hansson, 1995, p. 156; De Castello Branco et al., 1996; Myant and Drahokoupil, 2011, p. 266). Thus, fraud was present mostly due to lax enforcement of laws in the 1990s, which in turn was caused by institutional and human capital constraints. For instance, in 1992 there were only ten officials at the Bank Inspection department in the central bank, who were mostly inexperienced newcomers, to supervise over 40 banks (see Hansson, 1995, p. 159). General weaknesses in supervision were also related to a lack of adequate training arrangements for upgrading of skills and knowledge in new financial products (Khoury and Wihlborg, 2006). Problems were further aggravated by limited reporting requirements and the lack of specificity in rules for transparency, disclosure of information and insider trading (Bank of Estonia, 1997). Thus, the banking problems in the 1990s were to great extent attributable to lacking supervision as well as inexperience of supervisors.

In the 2000s, the rights of the Financial Supervision Authority were expanded for intervention into and inspection of the activities of banks. Particularly in 2010 and 2011, the powers of the Financial Supervision Authority were expanded by giving authority to require a reduction of performance pay, amendments in internal rules, an increase in own funds in the reorganization plan, including increase in share capital, and to make a proposal to amend or supplement the organizational structure of a credit institution among others (Finantsinspektsiooni seaduse, investeerimisfondide seaduse, krediidiasutuste seaduse ja tagatisfondi seaduse muutmise seadus, 2010; Investeerimisfondide seaduse ja sellega seonduvate seaduste muutmise seadus, 2011). Yet, most of the actions have been taken against investment firms as well as insurance companies and have been related to withdrawal of licences (mostly on the request of investment firms themselves), issuing recommendations on credit policies of banks, notifications on misleading advertising and violations of information requirement, and dealing with complaints filed against financial institutions (Financial Supervision Authority, 2014). Essentially, precepts have mostly addressed the issues in relation to consumer protection. This indicates that the emphasis has been laid on market conduct supervision by the FSA, whereas prudential supervision has been challenged by the broader internationalization of banking activities.

3.3.1 Challenges in addressing cross-border banking activities

As suggested by Pollack (2010) and Bohle and Greskovits (2007), the substantial presence of foreign ownership in the banking sector has implied that policy priorities in CEECs have been influenced by the outside players form other EU member states. Similarly, Lenschow (2006) has attributed domestic changes to forces other than the impact of the Europeanization process, such as the increasing internationalization of finances and markets. Further, Andonova (2003) has shown the absence of opposition by potential veto players to the EU's demands, if a policy area lacks institutional legacies or the regulated sector is highly internationalized, as is the case with the banking industry in Estonia.

Sweden and other Nordic countries as home countries of banks operating in Estonia have been proactive in guiding subsidiaries and thus endowing Estonian authorities with coordination and supervision challenges (see Lehmann et al., 2011). The dominance of foreign capital in the Estonian banking sector renders all banks subject to consolidated supervision by the home country authorities. In that respect, the division between consolidated and delegated supervision is not so distinct, given the provisions in the legal acts that provide the opportunity to transfer the supervisory duty to the home country authorities (Credit Institutions Act, 1999). Further, the local supervision of subsidiaries is rendered ineffective, given that banks tend to treat subsidiaries increasingly as branch offices. Within the vertically integrated financial groups, centralized strategies are being implemented in a manner that is oblivious of national legislation and where subsidiaries remain relevant only for tax and accounting purposes (see ECB, 2005; Pistor, 2009). Consequently, the cross-border dimension of banking activities and supervision has allowed for political risks, associated with regulatory and fiscal policies (see Kudrna and Gabor, 2013 on political risks). Moreover, political risks are present due to two unaddressed issues in the current regulatory regime: the misallocation of regulatory responsibility and a related lack of accountability for failures in markets beyond the home regulator's jurisdiction (Pistor, 2010).

Potential legal loopholes in Estonia exist in the area of the reallocation of capital and liquidity through internal capital markets, which enable banks to evade taxes and undermine any countercyclical financial (monetary) policies at the disposal of the Bank of Estonia. The duty of corporate income tax that has been levied in Estonia only in case of profit distribution (reinvested profits exempted from taxation) has been circumvented by substituting repatriation of retained earnings with lending to parent companies (Sulg, 2014; also Vedler, 2010). As of 2009, the accumulated retained earnings of the banking sector amounted to €1461.5 million or 10.6 per cent of GDP, compared to €400,000 and 0.006 per cent of GDP in 2000 (author's calculation based on Bank of Estonia, 2012), and none of the foreign subsidiaries had paid out dividends before 2014. Out of €1.4 billion as net profit of the four largest banks for the period of 2010–2013 (3rd quarter), only €21 million were paid in income tax (Arumäe, 2014).

Similarly, the effectiveness of entity-based regulation in Estonia, such as higher capital and reserve requirements, in curbing the credit growth has been impaired by the possibility of parent banks to circumvent Estonian legislation and prudential policies by providing cross-border financial services to local businesses or lending to leasing,[5] asset management and other non-bank financial institutions within the same group that are not included in the banking statistics (Pistor, 2010; Lehmann et al., 2011; Atanas and Sanne, 2013; Ross, 2013). This, in turn, has been made possible by the universal banking model, stipulated in both Estonian legislation and EU banking directives. Financial intermediation was envisaged to be built around universal banks that eventually resulted in credit institutions growing into banking groups (Lepik and Tõrs, 2002; EBRD, 1998).

Therefore, effect-based regulations have been curtailed within the established regulatory framework, particularly in relation to the cross-border provision of financial services and the activity of branches. Banking supervision has focused on the solvency of individual institutions, but not on macro-prudential issues, such as dynamic systemic risks in the whole system (see Kregel, 2014 for a general discussion of this issue). This, however, has not been seen as a problem by the public authorities.

> In the case of a small environment, this [micro and macro-prudential regulation] is nebulous … actually, one can achieve with micro-prudential instruments the same as with macro-prudential instruments, because there are few market participants and they have such a large market share. Therefore, this issue is not so important to deal with …
>
> (Member of the Management Board at the Financial Supervision Authority, 2014)

Nonetheless, in the established legislative framework, the potential danger for Estonia lies in insufficient interest of a home country regulator in a subsidiary that might have an insignificant part at the banking group level but entails systemic risks for the financial sector in Estonia (see Bonin et al., 2009; EBRD, 2012). In that respect, the liquidity and credit squeeze pose significant threats to the Estonian financial sector and the economy as a whole, should the liquid assets be repatriated from Estonia, when parent banks face funding difficulties. Such an international dimension of banking activities has put Estonia in a complicated position in guaranteeing financial stability (see Begg, 2009). All in all, the overall outcome of financial liberalization, the dominance of financial groups from Nordic countries and the systematic 'outsourcing' of regulatory supervision to home country authorities has been a form of financial governance that emphasizes *positive* integration, but is void of feasibility to control the risks associated with exposure to capital flows (Pistor, 2009; Khoury and Wihlborg, 2006). The outsourced nature of supervision was exemplified during the crisis by the emergency loan taken by the Swedish central bank to cover the potential losses of Swedish banks in Estonia and elsewhere in the Baltic States. Hence, Estonia has been lacking an effective governance regime for finance that has addressed only the credibility aspect of finance (and thus, security of the payment systems), but not money supply – two sides of the same coin that are conventionally interlinked. As stated above, this division of labour within the banking sector follows in Estonia the dividing line between domestic and foreign actors.

And even if any 'bottom-up' domestic regulatory efforts for financial stability could be well reasoned on economic grounds, the Europeanization process has put brakes on these initiatives. For instance, in relation to higher capital requirements for mortgage lending and to counter overheating, new EU level regulations meant for Estonia procyclical loosening of requirements as domestic regulations had to be scaled down in mid-2000s. Similarly, stricter rules could not be introduced in Estonia alone that would have made the equal treatment of branches and subsidiaries problematic, while the initiatives to introduce stricter risk weights on mortgage loans at the regional level would have contradicted the broader process of harmonization of regulations (see Sutt et al., 2011; Ross, 2013). As it happened, petition by the Estonian supervisors for stricter capital requirements, when the economy was booming, was rejected by the Swedish peers on the grounds of sufficient capitalization at the group level (EBRD, 2012).

As a response to the regulatory voids left by EU legislation in addressing cross-border financial stability and the allocation of responsibility, new types of informal institutions have been introduced such as the transnational regulatory network in the form of memorandum of understanding (MoU). As a coordination mechanism this informally harmonizes regulatory activities of regional members (Eberlein and Grande, 2005). The Baltic-Nordic MoU, signed in August 2010 has been considered as one of the most specific burden-sharing models, which considered the asset share of the financial groups in a given country and introduced exacerbating and mitigating factors (Kudrna, 2012).

> The monitoring of the entire group is located in Sweden … for which a college of supervisors has been established, where supervisors from Estonia, Latvia and Lithuania are invited … and basically information is exchanged on what is happening down here [in Estonia] and what we think of things. In such a debate or dialogue, decision-making takes place that is implemented across the group level. Sweden is good in the sense that this college system originates from the Nordic countries, where the culture of consensus prevails, which means that a lot is contributed to discussions and all taken decisions are implemented.
>
> (Member of the Management Board at the Financial Supervision Authority, 2014)

Compared to other similar agreements, it was peculiar for including *ex ante* burden-sharing procedures and for engaging ministries of finance along with central bankers and financial supervisors for introducing a permanent body – the Nordic-Baltic Cross-Border Stability Group (NBSG) – to oversee financial stability issues (EBRD, 2012). Yet, Märten Ross, the former deputy governor of the Bank of Estonia has acknowledged the difficulties in such a coordination of regulations in the region, although stressing the importance of cross-border coordination of banking supervision (Ross, 2013).

It has been established that within the emerged architecture of the financial regulation on cross-border banking activities, the presence of two supervisory authorities challenges the supervision as well as the application of macro-prudential measures. This was seen in the credit boom in the mid-2000s that was encouraged by the limited control by the Estonian authorities over the crediting of the economy and insufficient cross-border coordination that impaired prudential regulation to halt the overheating of the economy (see EBRD, 2012). This raises the question on the compatibility of two characteristics of the integration process, namely the simultaneous liberalization of external accounts and national responsibility for financial stability without the EU-wide lender of last resort facility.

4 Conclusions

Regulation of the banking industry in Estonia is theoretically significant in many respects. There is no clear straightforward model that would explain the evolution of banking legislation, as all theoretical concepts – lesson-drawing model, rationalist institutionalism and historical institutionalism – are applicable for understanding the dynamics at certain periods in the regulatory development trajectory. This is witnessed in the interplay of domestic features such as banking crises in the 1990s that required steadfast responses by public authorities,[6] and external factors such as the increasing presence of foreign financial intermediaries in Estonia from the late 1990s. Both the need to build up the institutional framework for private finance and address reoccurring crises anchored banking regulation and supervision (nominally) to the EU and other international principles and practices, as seen from the Table 6.1. This has been supported by the position of the Ministry of Finance:

> It could even be argued that the financial sector is overregulated … In the past 5–10 years, a lot of new rules or new proposals have been adopted that we considered as excessive regulation … especially considering that our market is small and the new requirements or charges may be too hard to deal with. So, we have tried to fight as much as possible against such a heavy regulation, which we have not been very successful at.
>
> (Senior civil servant at the Ministry of Finance, 2014)

Nonetheless, Estonia has been ‘accused’ of meticulous punctuality in applying the EU regulations, in some cases directly copying from external legal sources and setting even stricter requirements than the EU would dictate. For instance, Estonia has implemented a reserve requirement on liabilities of 11–15 per cent and a 10 per cent capital requirement throughout the accession and post-2004 period, compared to the ECB's minimum requirement of 2 per cent on liabilities with maturity up to two years and an 8 per cent capital requirement in most Western European countries (ECB, 1998). This, however, has created a paradox of exemplary compliance with the EU standards in terms of its extensiveness, but meagre effectiveness in addressing real-life developments in the banking industry. This chapter has shown the pragmatic approach to establishing regulatory and supervisory framework in the 1990s in the context of crises, internationalization of banks and also EU-accession aspirations, while the 2000s marked gradual outsourcing of oversight and embedded formalism or regulatory 'autopiloting' in terms of deepening reliance on external (EU, Basel) normative standards with insignificant economic substance, given the local circumstances. As indicated, several institutions and prudential norms were introduced in Estonia only due to the harmonization process with EU legislation with little or no intersection with practices in the banking sector. Furthermore, given the ideological (neoliberal) position of government coalitions on the one hand and the necessity to establish new institutions from scratch on the other hand, the evolution of the regulatory framework in Estonia has been a mix of deregulation and re-regulation at the same time. Particularly, this was the case in the early 1990s, when several institutions were established and corresponding regulations implemented but with gradual easing of the overall supervisory grip.

One of the peculiarities of the Estonia banking industry has been a high degree of internationalization, which has entailed important ramifications for the local financial system. Foreign acquisitions in Estonia have changed the institutional landscape and deepened the financial sector's cross-border integration, but also posed the economy new challenges. As a result of the institutional transformation and internationalization of the Estonian banking sector throughout the last 20 years, several challenges for the regulatory and supervisory framework have emerged in addressing the problems in cross-border banking-crisis management such as insufficient information, limited power and conflict of interest (see Kal Wajid et al., 2007). Moreover, the general tendencies toward supervisory consolidation based on the home-country principle and the centralization of key business functions such as liquidity and risk management have made separate assessments of subsidiaries more difficult. This in turn compromises the government's responsibility for general financial stability run along national borders. Thus, deep Europeanization in terms of both normative but also industry-wide convergence has locked Estonia into dependency in terms of decreasing political and economic autonomy, essentially trapping the economy into settings that tend to reproduce, but also contribute to financial fragility.

Table 6.1 Transposition of the EU banking directives and the Europeanization of the Estonian banking sector, 1992–2011

	1992	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Institutional developments and crises	1st banking crisis	2nd banking crisis. Repeal of capital controls	First Credit Institutions Act		Stock market crash & 3rd banking crisis. Take-over of banks by foreign investors. Introduction of the deposit guarantee institution in 1998		Second Credit Institutions Act		Creation of joint banking, insurance and securities supervision: FSA
Internationalization and the EU accession process	Joining the IMF		Signing Association (Europe) Agreement with the EU		Opening of accession negotiations with Estonia	Estonia's Europe Agreement entered into force			
Transposition of the EU banking directives		88/361/EEC on liberalization of capital movements (1)							
			Second Banking Directive 89/646/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (2)						
			89/229/EEC on the own funds of credit institutions (3)						
			89/647/EEC on a solvency ratio for credit institutions (3, 4)						
			92/121/EEC on the monitoring and control of large exposures of credit institutions (5)						
				92/30/EEC on the supervision of credit institutions on a consolidated basis (10)					
				86/635/EEC on the annual and consolidated accounts of banks and other financial institutions					
						94/19/EEC on deposit-guarantee schemes (13)			
							95/26/EC on amending Directives 77/780/EEC and 89/646/EEC (11)		
						93/6/EEC on the capital adequacy of investments firms and credit institutions (6)			
									93/22/EEC on investment services in the securities field

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Institutional developments and crises				Division of FSA's work: Supervision of capital and Services		Collapse of real estate and consumption bubble			The Baltic-Nordic MoU, signed in August	
Internationalization and the EU accession process			Estonia joining the EU							Estonia joining the euro-zone
Transposition of the EU banking directives			2001/24/EC on the reorganisation and winding up of credit institutions (14)					2007/44/EC on acquisitions and increase of holdings in the financial sector		
				2004/39/EC on markets in financial instruments					2009/111/EC on amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC (8)	
					2006/48/EC relating to the taking up and pursuit of the business of credit institutions and 2006/49/EC on the capital adequacy of investment firms and credit institutions (7)					2010/76/EC on amending Directives 2006/48/EC and 2006/49/EC (9)
	92/121/EEC on the monitoring and control of large exposures of credit institutions									
	2002/87/EC on supplementary supervision in a financial conglomerate (12)									
									2009/14/EC amending Directive 94/19/EC	
	98/31/EC on amending the Directive 93/6/EEC (6)									

Source: author's elaboration, based on the comparison of the Estonian legal acts and the EU directives

Notes to Table 6.1

(1) Implicit transposition of the directive by repealing the legislation on restrictions on non-residents' possession of shares of the Estonian commercial banks, on foreign currency transactions (inflow and outflow of foreign cash), requirements on registration of foreign loans and on residens' foreign accounts. The obligation to renounce capital account restrictions stemmed also from the IMF Agreement.

(2) The transposition process lasted until 204 due to harmonization with the amending directive 2000/12/EC. In 1995, mostly the principles of the First Banking directive 77/80/EEC were transposed, while the regulation on authorization and supervision of foreign branches according to the principles of mutual recognition of banking licenses and home country control was adopted in 1999. Estonia had much broader and stringent requirements for application for authorization and bases for refusal as well as withdrawal of authorization and acquiring a holding, but also on the principles of the management, that is, requirements for the members of and tasks for council and board of credit institutions. Also, provisions on the cross-border establishment of subsidiaries and branches of foreign credit institutions were specified in 2004 pursuant to amended articles of the Directive 2000/12/EC.

(3) Although the principles on own funds, risk exposures and risk categorization on the balance-sheet assets for the calculation of the solvency ratio were present already in 1993, they did not comply fully with the principles of the EU directives. Given the non-membership in the EU and the development level of the banking sectors at that time, these directives were adopted gradually by broadening the regulatory principles according to the needs and possibilities, and often being even stricter than EU regulation, e.g. in relation subordinated liabilities, possibility to exceed the thresholds and limits, etc.

(4) Estonia did not adhere to the same allocation of asset items between 4 categories as was stated in the directive and in comparison with the directive, not all listed assets items were incorporated into the legislation. Solvency regulaton was again stricter in terms of applying higher weightings on particular assets and capital adequacy ratio set at 10 percent level (8 per cen was the EU's minimum).

(5) Strictness position in the transposition of the directive, e.g. renouncing the possibilities for exemptions in the calculation of exposure limits and transitional provisions relating to exposures in excess of the limits.

(6) Introduction of regulation on market risks and capital requirement in relation to trading-book business. Furhter, the possibility to delegate the responsibility for supervising solvency of subsidiary of a parent undertaking situated in another member state to a competent authority that authorized and supervised the parent undertaking, which was adopted in 1999 in Credit Institutions Act. 2002 amendments in the regulation included the introduction of specific definitions of previously undefined financial instruments (warrants, repos, OTC financial derivatives, underwriting commitments, etc.), regulation on commodities trading and commodity instruments, the possibility for contractual netting, and elaboration on option risk, commodity risk, trading-book credit and counterparty risks, based on the Directives 93/6/EEC and 98/31/EC, the latter being essentially translated into the Estonian legislation with its annexes.

(7) Introduction of credit risk mitigation, operational risk, internal ratings based approach, the regulation of securitization transactions with majority of the provisions of the directives being implemented into the Estonian law by more or less identical provisions. Several regular provisions were not transposed due to irrelevance and peculiarities in the institutitonal structure of the Estonian financial system, e.g. FSA has not been responsible for any supervision on a consolidated basis or existence of any credit institution whose parent company would be an investment firm.

(8) Amendments included the grounds for common decision-making procedures for ensuring capital adequacy of banking groups operating cross-border, defining significant branches, and operating in the colleges of supervisors. The inclusion of the so-called hybrid instruments in the calculation of own funds. The acts also specified the requirements related to securitization.

(9) Amendments in the Credit Institutions Act were mostly related to the principles of remuneration of managers and employees, requirements on the disclosure of securitization instruments and trading-book portfolios, the regulation of "re-securitization", capital requirement for additional – default and migration – risks (calculation, methods, risk mitigation), and capital requirement on counterparty credit risk from unregulated securities transfers/transactions.

(10) Principles of the directive adopted in the national legislation concerned the consolidated and sub-consolidated supervision, calculation of large exposures, delegation of supervisory

responsibility, cross-border cooperation between competent authorities that were introduced for the first time in 1999 for supervisory purposes.
(11) Legal harmonization included the introduction of a notion 'close links', the grounds for an exchange of information between competent authorities and other authorities (information from and an obligation to provide information to the central bank and the Ministry of Finance), and the regulation on professional secrecy and confidential information.
(12) The regulation covered the thresholds for identifying a financial conglomerate with regulation on intra-group transactions, internal control, and supplementary supervision on a group-wide basis. Regulation on financial conglomerates was only provided in the Insurance Activities Act that copied the structure and the the wording of the directive. Regulation on financial conglomerates was introduced into Credit Institutions Act in 2013.
(13) The Deposit Guarantee Act of 1998 was harmonized with the directive, but the full implementation of the directive was not undertaken due to transition period until 2007. Provisions on definitions, range and scope of the guarantee coverage, membership conditions in the guarantee scheme, host-home country guarantee schemes in case of cross-border banking activities were adopted during that period.
(14) Before the 2004 amendments in the Credit Institutions Act, the regulation on winding-up and reorganization was too narrow and did not address the cases of cross-border banking, including information sharing and disclosure between the competent authorities of different member states. The new sections in the act established uniform procedures, publication and language requirements with regard to winding-up operations, and provided the basis for cooperation between competent authorities of member states, associated with liquidation proceedings.

Notes

1 The ratio of a bank's own means to the total of risk-weighted assets and liabilities.
2 The ratio of a bank's liquid assets to current liabilities.
3 The ratio of total liabilities of high risk-concentration clients to the bank's own means.
4 In a study on the Hungarian banking sector, Petrick (2002) found that neither *acquis communautaire* nor the Basel rules were similarly appropriate to deal with the situation that Hungary was faced with, that is, dominating state-ownership, a newly formed but financially weak and inexperienced banking sector, and a pervasiveness of inter-enterprise debt relations.
5 In 2004, credit provided by bank-owned leasing companies accounted for 15.4 per cent of GDP in Estonia (Mihaljek, 2006).
6 Estonia was a 'path-setter' not only in the number of banking sector bankruptcies in the whole of Eastern Europe in the early 1990s, but also the responsiveness by the central bank to the growing problems of the banking sector (Lainela and Sutela, 1994). In 1992, the authorities closed one bank without rescuing its depositors and merged two banks with a partial bailout. Further, after the prudential measures were introduced in 1993–1994, the Bank of Estonia did not renew the licences of eight banks, while ten banks were forced to merge into one bigger bank, two smaller banks were forced into bankruptcy with dire consequences for depositors, and three banks declared a moratorium as a result of not meeting new requirements. Similarly, in 1998 and 1999 the central bank initiated bankruptcy proceedings and some banks were merged in order to prevent possible instability in the Estonian banking sector (Hansson, 1995, p. 143; Khoury and Wihlborg, 2006).

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Article IV

Juuse, E., S. B. Endresen and R. Kattel. 2015. "Foreign Direct Investment in Estonia - Understanding the Impact of Public Policies on Local Embeddedness and Networking in the Food Retail and Related Industries." In G. Micek (ed.). *Understanding Innovation in Emerging Economic Spaces. Global and Local Actors, Networks and Embeddedness*. Farnham: Ashgate Publishing Ltd., 97-118. (3.1)

Chapter 5

Foreign Direct Investment in Estonia—Understanding the Impact of Public Policies on Local Embeddedness and Networking in the Food Retail and Related Industries

Egert Juuse, Sylvi Birgit Endresen, Rainer Kattel

Introduction

Many scholarly works have been published on foreign direct investments (FDI) in developing and transition economies with the focus on inward FDI's impact on the host economy. Even though modern retail in these economies has been extensively studied, analytical research on FDI in the food retail industry in Estonia represents a missing link. On the theoretical level, Estonia is a significant example. Being one of the more successful transition economies, Estonia's economic policy framework is perhaps the clearest example of applying a neoliberal policy toolbox in a transition context and beyond (see Thorhallsson and Kattel 2012).[1] Hence, the study of Estonian retail offers an opportunity to understand the impact of neoliberal policies on retail and related industries. As the neoliberal policy toolbox would prescribe, Estonia has not used any foreign investment management policies beyond macroeconomic reforms oriented towards price stability and low taxes. Consequently, while being a small and extremely open economy, the Estonian experience offers relatively unique opportunity to understand the consequences and impacts of an unmanaged FDI policy. On the international comparative basis, the Estonian case reveals the challenges for the host economy that have resulted from rapid developments during a relatively short period (less than 15 years), compared to the decades-long transformation of retail business in the Western hemisphere.[2]

We analyze the role of FDI in the Estonian retail industry in forming the relations between retail and related industries, that is, the embeddedness of FDI in retail in the Estonian economy and the resilience of domestic players to outer

1 For a useful discussion of varieties of capitalisms emerging from the transition context, see Drahokoupil (2007, 2008).

2 See Wrigley and Lowe (2002) on the historical development of modern retail.

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From Grzegorz Micek (ed.), *Understanding Innovation in Emerging Economic Spaces: Global and Local Actors, Networks and Embeddedness*, published by Ashgate Publishing.
See: http://www.ashgate.com/isbn/9781472410337

pressures. The first section presents the theoretical framework for analyzing the embeddedness of and linkages between Estonian retail and related industries by outlining stylized facts, while the next section deals with the analysis of the Estonian case, followed by the discussion section and concluding remarks. The empirical analysis relies on statistical information and secondary data, based on previous surveys and journalistic literature, as well as interviews conducted with key stakeholders in 2010–11: the Estonian Chamber of Commerce and Industry, the Estonian Traders Association, the Association of Estonian Food Industry, the Estonian Chamber of Agriculture and Commerce, the Estonian Dairy Association, the Estonian Ministry of Economic Affairs and Communications, and the Estonian Ministry of Agriculture.

Theoretical Considerations—Analytical Framework and Stylized Facts

The current analysis is based on the foundations of the heterodox economics tradition, which views the capitalist economic system as cyclical and institution-rich (Lavoie 2009, Keen 2011). Pursuant to this tradition, the study embraces a holistic approach by focusing on economic and political institutions as well as the power relations between economic sectors that determine the level of economic activity. For understanding the current state of the economy, the changes in the productive structure with the notions of path-dependency (irreversibility) and lock-in effects need to be addressed.

From the heterodox perspective, modern capitalist economies are seen as monetary production systems with firms operating in an imperfectly competitive environment, that is, oligopolistic markets with interdependent business relations. Firms endeavor to increase their size and market share by utilizing the mechanisms of economies of scale and scope. Efficiency gains achieved by cost advantages and increasing returns enable large businesses to out-compete small enterprises and thus render perfectly competitive markets into an oligopolistic situation. Economies of scale are an important reason why most industries are dominated by a small number of large companies. Yet, by acknowledging the importance of systemic monetary structure with interlinked sectoral balance sheets and cash flows, balanced as well as stable demand–supply relations between different sectors, that is backward and forward linkages, need to be established for sustainable growth. Therefore, heterodox tradition calls for state regulations and economic policies as institutional constraints for stabilizing the inherently unstable and cyclical market economy with deepening sectoral imbalances (see Minsky 2008, Lavoie 2009, Keen, 2011). In essence, such a framework assumes that government intervention is present in a given economy, notwithstanding the prevailing ideologies and power coalitions; that is, a lack of policy is also a policy with discernible impact on industry dynamics.

Hence, for analyzing the Estonian food industry, a network perspective (Markusen 1999a, Wrigley and Lowe 2002, Coe and Wrigley 2007, Dicken

2011) is applied to gain insight regarding the transformation of retail and related sectors affected by transnational companies (TNC). This type of embeddedness in Hess's (2004: 180) typology is addressed in the study of inter-firm relations with local suppliers and other extra-firm relations within a specific institutional and regulatory framework (see Figure 5.1). Network embeddedness can be studied regardless of the location of actors; however, aspects of territorial embeddedness are also covered, which occurs "when foreign actors build considerable links to the actors present within the respective host localities" (Hess, 2004). Furthermore,

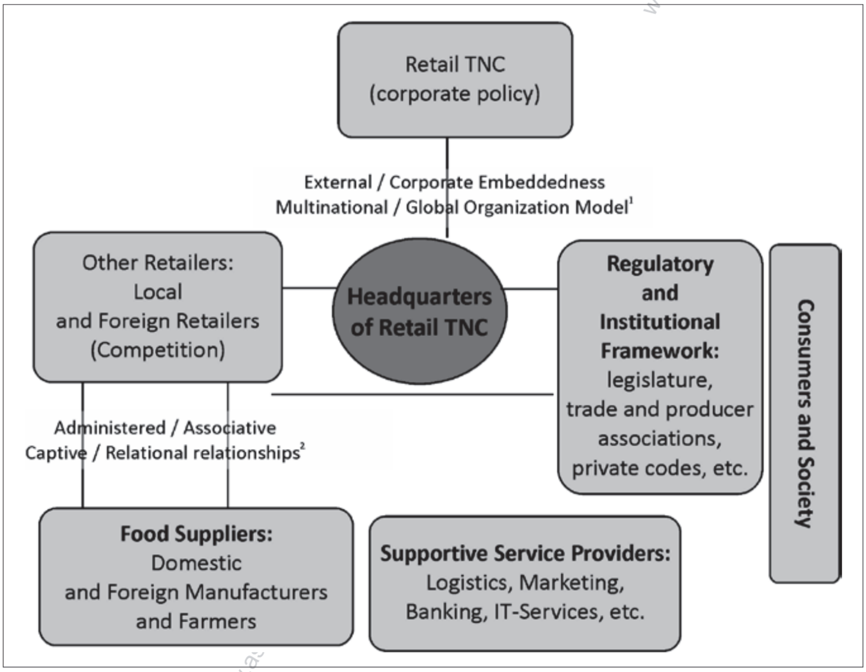

Figure 5.1 Retail network and societal embeddedness perspective

Note: [1] The *multinational (external) organization model* is based on decentralization, a high degree of autonomy, informal coordination, simple financial control, and local focus. By contrast, the *global (corporate) model* signifies stringent control, impelling coordination by headquarters, centralization, and standard approach (Dicken 2011: 121–41). [2] *Administered (close-control or dependent) relationships* imply supply relationships in which one party coordinates activity on the basis of power (short-term contracts, inequality in trading). Retailers assume control of and coordinate many of the supply chain functions, whereas *associative (arms-length or developmental) relationships* involve a high level of collaboration and cooperation between retailers and manufacturers—value-adding partnerships, often long-term, and centered on information sharing networks (Wrigley and Lowe 2002: 55, Dicken 2011: 438).

Source: own elaboration.

the Estonian political, economic, and social context is captured by the concept of societal embeddedness, that is, the exposure of retail TNCs to the "different cultures of their foreign network partners" (Hess 2004). In addition to local embeddedness in Estonian society, TNCs import their "cultures" and may seek to transform the host society according to their priorities, as will be revealed in this chapter.

In line with the notion of societal embeddedness, the key to the successful internationalization of retail lies in the adaptation to local circumstances. Nonetheless, the primary way for retail TNCs to reap profits has been to transfer the operational techniques and business models to host markets in order to gain control over the production systems and to obtain bargaining power (see Dawson 2007: 390–94, Humphrey 2007: 449, Christopherson 2007: 464). Studies on FDI in food retail have found several features that are evident in host economies. Firstly, there are signs of consolidation, accompanied by vertical integration, and secondly, there is the introduction of higher value added products, coupled with private label products. Both aspects have had a significant impact on business operations in the food manufacturing industry and other related sectors in host economies. For instance, the institutional landscape has been transformed by the introduction of private quality standards as well as third-party logistic firms together with the establishment of centralized distribution centers and preferred global supply networks (Coe and Wrigley 2007: 9–16, Reardon and Hopkins 2006: 523–9). Furthermore, the academic literature on retail internationalization presents a positive relationship between retail concentration and the intensity of private label products as well as private label supply networks (see Wrigley and Lowe 2002: 64). Even though the latter may involve the development of local supply linkages within vertically integrated global production networks and thus provide opportunities to source from the host economy for other markets, the search for operational and cost efficiencies tilts the preference of foreign retail chains towards imports that enable TNCs to capitalize on price arbitrage (see Dicken 2011: 436, Jacobs 1984: 195–6). Furthermore, evidence on the relocation of suppliers and other partner companies from home to host economies could be considered as covert imports (see Reardon, Henson and Berdegue 2007: 425–6), leading to an enclavization[3] processes within the host economy (see Gallagher and Zarsky (2007) on the concept of an enclave economy).

Irrespective of the host economy or cross-border dimensionality, retail chains tend to source from a few large suppliers for each product category due to the requirements imposed on suppliers in terms of product quality, safety, quantity, delivery consistency, and so on that are difficult for small producers to comply with. This has indicates the need for food manufacturers and farmers to adapt

3 One could consider FDI in retail as a *satellite platform* (see Markusen 1999b: 21–41) that reinforces the reliance on finances, technical expertise, and services external to the region. Such a high dependency on foreign capital implies hazardous lock-in effects and hence undermines the host economy's autonomy and economic sustainability.

to the demands of the retail sector (Humphrey 2007: 433–47, Reardon, Henson and Berdegue 2007: 406–26, Weatherspoon, Reardon 2003: 333–4, Blythman 2005: 184–92). In these circumstances, the development of modern retail has entailed positive feedback mechanisms, that is, the self-reinforcing dominance of interlinked large companies (Simms 2007: 6–13). As a result, retail chains tend to stock national brand leaders plus private labels, which leads to the demise of small producers. All in all, the emerging imbalances between retail and related industries, incurred by the increased concentration and control over a range of functions on the part of retailers, have made it possible to capitalize on price arbitrage and to demand price discounts from suppliers with the threat of delisting (see Wrigley and Lowe 2002: 51–3). With requirements that incur extra expenditure, suppliers have been unable to gain from economies of scale and often sell the produce under the cost of production. These tendencies have made producers susceptible to financial losses that could culminate in bankruptcies as well as increased unemployment (see Blythman 2005: 171–83, 258–78). Moreover, established inequalities in contractual relationships between retailers and suppliers have enabled retail chains to apply exploitative practices such as fees and fines for various forms of misconduct on the suppliers' side. Such patterns indicate an *oligopsonistic* condition (see Aoyama 2007: 472, Blythman 2005: 3–15, 148–92), whereby risks and costs are passed down the value chain.

As monopolistic or oligopolistic markets entail intrinsic vulnerabilities as well as systemic risks for the whole economy (see Lavoie 2009: 12), the possibilities of alleviating this fragility depend on the extent of government intervention in the economy. The potential for government intervention in the retail industry directly via competition and trade regulations or indirectly with taxes cannot be underestimated when broader macroeconomic as well as industrial policy measures are expected to have positive effects in stimulating economic growth and supporting capacity building in manufacturing industries. For these reasons, countries with a long tradition of modern retail, for example, the UK, the USA and Scandinavian countries, have relied on alternative interventionist policies[4] to direct developments in food retail and related industries in their economies.

4 Examples are restrictions on the ownership and *anti-market-extension* mergers; regulations on employment and "below-cost" selling; pricing and payment regulations to clamp down on unfair price war practices; requirements to explain the value of TNC to the host economy in terms of increasing employment, infrastructure investments, skills, and exports (see Coe and Wrigley 2007: 24–5, Reardon and Hopkins 2006: 532–6, Wrigley and Lowe 2002: 119–20, Blythman 2005: 323–4, Simms 2007: 53–4). Concerns over the increasing imports and balance of payments problems can be mitigated by the restrictions on profit repatriation as well as requirements to source from local producers (see Weatherspoon and Reardon 2007: 347, Dicken 2011: 286).

The Formation of the Estonian Food Retail Industry

After the collapse of the Soviet Union in 1991, Estonia faced the challenge of instituting a capitalist free market economy with a supportive institutional-legal framework. Transformations in the economy did not leave the retail and related sectors untouched, where the subsidiaries of retail TNCs were the catalysts of major adjustments by setting the path and creating spillover effects on the local market. During the last 15 years, Estonia has witnessed aggressive expansion of both domestic and foreign retail chains of diverse formats, geographic dispersion patterns, and market-targeting strategies. As a result of takeovers as well as organic expansion of retail chains, the food retail landscape has changed drastically over the years by gradually crowding out independent small shops and open markets in the fierce cost-based competition. While less than 40 percent of the retail market was controlled by the chains and around 15 percent by foreign owners in 2002, the same figures for 2010 were 78 percent and 45 percent, respectively (Centre of Registers and Information Systems 2012, see also Chapter 6 of this book).

Today, one can observe *pan-Balticanization* of the retail market in terms of the same foreign companies operating in all three Baltic States (Kaljuvee 2007), as the expansion of Lithuanian, Swedish, and Finnish retail chains in Estonia and other Baltic countries can be explained by the cultural proximity of investor and host countries. Big chains like Tesco and Carrefour have not invested yet, probably due to the relatively small markets and linguistic–cultural differences (Merilai 2011).

The interweaving of different business cultures in a competitive environment has gradually led to the standardization of service provision and business relations in the Estonian retail landscape in line with the best practices of Nordic countries. Highlighting packages deposit and recycling systems, the Estonian Traders Association underlines that in general, the foreign presence is positive: "The main impact of foreign retailers on Estonian economy has been the transfer of business culture, management best practices, and equipment as well as capital inflows" (Interview, M. Merilai 2011).

Aside from the aforementioned advantages, the increasing dominance of foreign ownership in the food retail industry has entailed several threats and risks for food retail and related industries. As competition among food retailers has intensified, pressures have been transmitted down the value chain to the producers of food products. This is reflected in the better bargaining position of chains against producers and vendors as compared to independent stores, which enables the chains to lower the prices (Taube 2005). On the other hand, there is a clear recognition in the Estonian Traders Association that when companies are run from abroad, this may limit local linkage formation. A case in point is Rimi Baltic which is managed from Latvia, limiting the autonomy of local managers (Merilai 2011).

Even though it has been found that Estonian consumers tend to be loyal to or at least have preference towards local products, which are considered to be safer and more reliable (Potisepp 2010), in deteriorating economic conditions people have shifted their purchases towards imports, which are cheaper (EIER 2010).

The Association of Estonian Food Industry emphasizes the Estonian consumers' preference for local products and their consciousness regarding origin, but claim that the price factor is important and therefore imported food may invade the market (Potisepp 2011). Thereby, during the economic recession, the ensuing effects of price competition on food retailers can lead to the deterioration of the economic sustainability of local food producers which cannot compete with cheaper imports: "Local producers are restricted in dictating the developments and affecting prices, as retailers can turn to imported goods" (Interview, E. Sokk, Estonian Ministry of Agriculture 2011).

Therefore, the main channels whereby FDI in retail has influenced the Estonian food industry are: 1) imports by relying on global production networks, 2) local procurement, and 3) private labels that reflect overt or covert aspirations towards vertical integration and are manifest in both foreign trade as well as cross-border and local linkages. The following sections address these issues and, in particular, how these patterns have emerged and what the enabling factors have been.

A Fragile Situation for Estonian Food Manufacturers

Aside from local competition, Estonian food manufacturers face additional pressures from imported goods, although openness to international trade and its high share in GDP (reaching 200 percent in Estonia in 2000) is not an uncommon feature of small economies. Yet, the high exposure to foreign competition and its detrimental effect on the local economy has been aggravated by the weaknesses in the regulation of production and trade. Unlike their European competitors, the Estonian farmers have not been equally subsidized, implying high imports (Sõrmus 2011).

Moreover, the Estonian economy has suffered from "Dutch disease" syndrome in terms of an appreciating real exchange rate due to the influx of foreign capital and accompanying increases in domestic prices, which have had a deleterious effect upon exports, but subsidized consumers by making imports cheaper. In these circumstances, surges of food imports that have negatively affected local producers by decreasing their sales and profits have not been rare (Erilaid 2004).

Furthermore, Estonian producers cannot often supply the volumes preferred by the big chains (Palts 2011). Here, the risk for local producers of being crowded out by imports has been amplified by foreign food retailers' reliance on corporate business model, whereby the decisions regarding the assortment of produce are made abroad with the preference towards foreign suppliers (EIER 2010, Potisepp 2011). This is illustrated by the cases of *Rimi Eesti Food Ltd* and *Maxima Ltd* (with the market shares of 21 percent and 15 percent, respectively, as of 2010): decisions about the assortment of produce and other business related issues are made in Latvia and Lithuania, respectively. By using the same retailing methods as applied in Lithuania and Latvia, the strategy of *Maxima Ltd.* has been to centralize procurement in order to squeeze out the lowest possible prices to the consumer, implying the dominance of cheaper foreign products. Local Estonian producers have not endeavored to market their goods through *Maxima Ltd* due to their higher price category products and unfavorable contractual terms (Ronk 2004, EPLO 2004, Reimer 2009). In contrast, by operating a purchasing department in Estonia, Finnish *Prisma Peremarket Ltd* (with the market share of 7 percent in 2010) has procured a large share of products from local suppliers in order to meet the demand of various local consumer segments, as has the local chain *Selver Ltd* (with the market share of 19 percent in 2010) (Kallas 2009, Lohk 2008, 2009).

Nevertheless, local producers have expressed concerns about the dominance of foreign retailers and their preference to procure from foreign producers, operating either in Estonia or abroad (Neudorf 2002). A case in point is *Prisma Peremarket Ltd* who decided to cooperate with Finnish *Fazer Amica* to supply the retail chain with processed food products such as frozen ready meals (Villak 2008). Due to foreign retailers' outward oriented supplier strategy, the challenge of enclavization and lack of backward linkages in the Estonian economy is acknowledged by the Estonian Traders Association. For instance, *Prisma Peremarket Ltd* benefits from their contact with partners abroad, even regarding IT support services (Merilai 2011).

Tensions between Producers and Retailers

The lack of resilience of domestic producers to withstand the pressures from the retailers could be attributed to the pyramidal structure of the value chain. Views differ between the retail business community and the producers on just how asymmetric power relations are. An informant in the Ministry of Economic Affairs and Communications holds this opinion: "It is evident that in a pyramid scheme, where there are six retail chains, around 40 dairy producers and hundreds of farms, leverage tends to be in favor for retailers" (Interview, M, Sõrm 2011). A spokesman for the Estonian Chamber of Agriculture and Commerce concurs: "Clearly, retailers dictate what products are to be produced. The quality requirements need to be guaranteed by producers" (Interview, R. Sõrmus 2011).

The Estonian Traders Association also perceives the conflict of interest between the parties but considers disagreement regarding the distribution of profits in the value chain as part of a normal business life: "The confrontation between producers and retailers is overemphasized and overplayed in the media" (Interview, M. Merilai 2011).

Her views are shared in the Estonian Chamber of Commerce and Industry with some concessions. Denying that retailers generally dominate producers, it is admitted that recently, changes have occurred: "The attitude of foreign retailers has been somehow different and there have been issues concerning the enforcement of contractual terms upon producers" (Interview, M. Palts 2011).

The "issues" referred to may be termed *predatory business practices* that reflect asymmetrical relations. In addition to requiring discounts and bonus payments from suppliers, there have been cases where retailers have imposed various penalties on producers as well as charges related to logistics, administration, and marketing. In general, there tend to be deductions from producers' sales price of up to 25 percent to cover the costs related to such services (Bank 2010, Saron 2011). The Estonian Chamber of Agriculture and Commerce refers to general exploitative practices such as payment delays and extra charges, driven by intense competition between retailers seeking a dominant market position (Sõrmus, 2011). Such practices are detrimental to suppliers in farming as well as manufacturing. In the Association of Estonian Food Industry, contracts between the parties are seen to favor retailers. Penalties and delisting are considered part of their corporate strategies. The major barrier for producers is a lack of alternative marketing channels (Potisepp 2011). For instance, rigidness in negotiations, threats of delisting, and penalizing contractual terms with suppliers have been the features of *Maxima Ltd.*, whereas any revolt by the suppliers has been suppressed by the argument of a leading marketing channel (Karotamm 2008).

Hence, in order to withstand the pressures from retailers, imports, and foreign companies, local food manufacturers have responded with consolidation and market concentration into the hands of a few companies operating in different product categories. On average, the five largest companies in all food categories have gained control of around 60–75 percent of the market (Lindpere et al. 2011). Concentration is evident to the Estonian Chamber of Agriculture and Commerce: "Companies are getting larger, which is one way of resisting the dominance of retail. In fresh vegetable market, there are few players, less than ten" (Interview, R. Sõrmus 2011).

He has found that the marketing situation improved as farmers began to form cooperatives over the last five years. A similar proposition has been made by the Estonian Dairy Association:

> Today, there are too many dairy producers for a limited local market. Most of the companies in the food industry are small or medium-sized enterprises, which has given them more flexibility in rearranging product portfolios. Yet, larger foreign companies tend to have an advantage of economies of scale and a larger market share. Thus, more concentration is needed, but the question is to what point. (Interview, T. Saron 2011)

An alternative to increased concentration has been the establishment of network systems. In the meat sector, both local and foreign manufacturers have built up their own local supply systems, but have also depended on imported packaged *ready-to-be-sold* products or raw materials to be processed into final products (Sõrmus 2011, Merilai 2011). Networking is reflected in a higher specialization, as some of the product lines have been outsourced to competitors to optimize the costs (Sokk 2011).

The concentration of capital can also be observed in farming. In contrast to other Central and Eastern European countries (CEE) countries, except for the Czech Republic, large farms dominate in Estonia (Saron 2011, Sokk 2011), and according to the Estonian Chamber of Agriculture and Commerce, they will become larger and the number of firms will decrease (Sõrmus 2011). The average area per agricultural holding (farm) was 47.7 hectares in Estonia compared to 14.1 hectares in the EU27, 21.5 and 13.7 hectares in Latvia and Lithuania respectively. At the same time, the total number of agricultural holdings in Estonia is the third smallest in the European Union—19,700 compared to 83,000 in Latvia and 200,000 in Lithuania (Eurostat 2011).

Overall, these consolidation trends have been strengthened by retail chain policies. By the mid-2000s, all retail chains had narrowed the number of local suppliers in the meat and dairy categories (Männiste 2006). The focus of food retailers has been on procuring from large manufacturers, who in turn have shifted their marketing rhetoric, arguing that the procured amounts by small retailers are insignificant and thus running business with them is inconvenient or even risky (PM Online 2002, Johanson 2007, Raudoja 2007). As a consequence, the possibilities for small producers to supply retail chains have deteriorated due to inconsistent quantities and deliveries (Niitra 2009, Ninn 2009). The Estonian Traders Association observes a dualism in retail outlets: supermarkets for large manufacturers and open markets as well as small shops for the small producers. This is attributed to a lack of cooperation between small producers (Merilai 2011). Cooperation as a solution to the problem of scale is recognized in the Estonian Chamber of Agriculture and Commerce as well. The major barriers are considered to be quality assurance and supply continuity (Sõrmus 2011). Even though all stakeholders have emphasized the importance of cooperation, extensive vertical integration among the layers of the value chain in the food industry up to the retail segment has not occurred (Pällin 2007). Vertical integration has been mainly observed where foreign companies have bought farms and invested in agribusinesses. However, the Estonian Chamber of Commerce considers conservatism among consumers regarding mass production to be hampering the process (Sõrmus 2011).

Introduction of Private Label Products and the Transformation of Wholesale

Retailers' own brand product—a private label—is a phenomenon that is directly attributable to FDI in Estonian retail (Sõrmus 2011). This may be seen as a covert attempt by retail chains to deepen their vertical integration or firmly root the presence of imported goods. Vertical integration that increases the value capture at the retail end of the value chain could be seen as the rationale behind the strategy of private labels. The informant in the Ministry of Economic Affairs and Communications recognizes this, but weighs it against the price advantages for the consumer (Sõrm 2011).

With regard to private label products and the consequences of this innovation, views among stakeholders tend to differ. Even though these low price products remove the marketing costs for producers, meet the needs of price-sensitive consumers, and enable producers to absorb excess capacities, private labels create confusion for consumers by losing distinctive features and becoming anonymous. From the producers' perspective, private labels cause additional competition by forcing them to lower production costs or by being imported due to the inability of Estonian food manufacturers to supply retailers with the required quantities (see Kallas 2011, Sokk 2011, Sõrmus 2011). Critics claim that private labels are designed to increase market share, gain control over product development and marketing, as well as mimic best-selling items. In this way, the possibilities to compensate research and development (R&D) expenditures of innovators are undermined and local producers' own brands are eventually outcompeted by the lower prices of private labels (Pällin 2007, Potisepp 2011, Sõrmus 2011). In particular, product categories that have high R&D costs as well as producers of *organic food* are sensitive to this (Saron 2011).

The Estonian Chamber of Agriculture and Commerce, on the other hand, highlights the new export opportunities that this innovation opens up for product segments that operate with excess capacities. The quality of Estonian produce is still questioned outside the volatile Russian market and private labels thus represent an opportunity (Sõrmus 2011). Hence the international networks provided by foreign retail chains might be conceived of as an export platform for Estonian local producers. For instance, *Prisma Peremarket Ltd* has provided the opportunity to market local food to other Baltic States and Finland under the chain's private label (Reimer 2010). Even though several obstacles have occurred in exporting, for instance, insufficient financial resources for promotion, low competitiveness, and low productive capacity, the quantities of exported products, either under producers own or a retailer's brand, have seen an upward trend (Pällin 2007, Potisepp 2010).

Aside from close-control relationships with suppliers, even deeper vertical integration has taken place by gaining control over different functions, for example, retailers' diversifying into deli, pastry, and bakery businesses by establishing wholly owned production units. In 2006, *Rimi Eesti Food Ltd* opened its central kitchen that services all its stores with ready-made meals in 13 different product categories with over 300 products (Kirsipuu 2006). Furthermore, the logistics and wholesale landscape has been transformed by retail chains. Traditionally, companies in the Estonian wholesale market tended to operate as sales representatives or distributors of imported goods. The early 2000s, however, witnessed the arrival of logistics centers which specialized in servicing large retail chains and paved the way for the concentration in the wholesale market (Merilai 2011). By 2010, all major retail chains were operating their own centralized distribution centers that enabled them to achieve efficiency gains on the distribution side and firmer control over the supply chain. Although suppliers were supposed to benefit from the increased capacity of freight transportation and less administration, they have been burdened with logistics fees imposed by retail chains. In addition, producers have been required to make substantial investments into information technology systems to comply with the operation systems of distribution centers (Raig 2011). Thus, out of the available channels of influence (see Munson, Rosenblatt and Rosenblatt 1999), retail chains in Estonia have mainly used pricing control, performance requirements, and control over the supply chain structure.

Governments' Positions—Belief in the Non-Interventionist Free Market

The finding of the study (see Potisepp 2006) that more than 80 percent of Estonian consumers prefer local food has been reflected to some extent in recent government initiatives to support local producers. In 2010, the government initiated a measure to fund the groupings of independent local farmers that would enhance their business performance, cooperation, and improve their bargaining position against manufacturers and retailers (Maasalu 2010). In particular, promoting so-called alternative food networks is high on the agenda (see Tregear 2011): both the Estonian government and the EU have stressed the importance of enhancing direct marketing among producers, and a priority of the Ministry of Agriculture has been to foster the consumption of short-distance food produce. In addition, cooperation between the food industry and R&D institutions has been supported in order to develop higher value-added products (Sokk 2011). The Estonian Dairy Association would welcome the support to small producers' marketing and limits to the size of shops to curb the retail chain power. However, these interventionist measures are met with skepticism, as Estonia would not be able to run such policies alone (Saron 2011).

Given the importance of the EU funds, major resentments have been related to the discrimination of Estonian agribusinesses within the Common Agricultural Policy (CAP) in terms of the differential allocation of agricultural subsidies between the new and the old members of the EU (Sokk 2011, Sõrmus 2011). Further concerns have been raised over the lack of public investment in the food manufacturing sector as within the CAP, the main focus of the government support has been on small farms (Merilai 2011, Saron 2011).

All things considered, public policies that have targeted productive sectors have provided the leeway to alleviate the imbalances in food retail and related businesses, as no specific legal acts have been enforced to deal with retailers directly due to the constraints that stem from international treaties and agreements, for example, within the WTO or the EU. It is producers who are mostly affected by regulations, not retailers (Palts 2011).

There is a strong belief in a free market economy among the stakeholders, very clearly expressed by M. Merilai of the Estonian Traders Association: "It is the market that self-regulates and allocates resources most efficiently" (Interview 2011).

The policy of the Estonian Food Producers' Association is equally free market friendly, as "government should not intervene into everyday business or do it as little as possible." (Potisepp 2011). Hence, they would not support any restrictions; all players should be treated equally and supporting measures that distort competition should be avoided. That interventions in markets for food may be necessary for socioeconomic reasons is, however, recognized in the Estonian Ministry of Agriculture (Sokk 2011). The Estonian Chamber of Agriculture and Commerce finds that the economy should be free of government intervention, unless competition law is infringed. But the concentration of capital, leading to retail giants, may pose problems; therefore, restrictions could be imposed during recessions "to rein the dominance of retailers and enforce stricter competition law by lowering the 40 percent threshold to eliminate the exploitative practices" (Sõrmus 2011).

In accordance with these standpoints, government coalitions have adhered to neoliberal policies that have obliterated any consideration of strong interventions such as the ceilings on profit margins in food produce or the requirements for retailers to procure from local producers, although similar restrictions have been contemplated in Lithuania, Latvia, and also in Slovakia (Äripäev 2009, Merilai 2011). To make things worse, the affinity of governments towards conservative fiscal policy reveals its pro-cyclical nature, as the tax base was lowered during the years of rapid economic expansion, while several taxes were introduced or increased during the post-crisis years (value added tax increased from 18 to 20 percent, plastic bag and sales tax were introduced, and excise duties on packaging rose), which resulted in a price hike and subsequent decline in sales. Given the recessionary trends in the Estonian economy, there was a general aversion to the introduction of new taxes from retailers and associations (Merilai 2011). Moreover, before the tax reform, several retailers warned of being forced to increase retail prices and pass on the burden of increased costs to suppliers due to tax amendments (Kalmus 2009, Kaljuvee 2010).

Discussion and Conclusions

The dynamics in the Estonian food retail and related industries that were presented in the previous sections are a reflection of the general political economy in Estonia over the last 20 years. The cornerstones of the transition process have been an extreme openness to foreign trade and international capital flows with conservatism in fiscal and monetary policies. Given the high social inequalities, low decommodification level, and non-corporatist attitudes that are revealed in weak labor unions, Estonia has been categorized as a neoliberal welfare state (see Aidukaite 2011, Thorhallsson and Kattel 2012). By liberalizing capital and current account transactions at the beginning of the 1990s, Estonia has served as a low-tax and low-wage investment hub for foreign investors. Given these pull factors, which were accompanied by the global FDI wave in retail as well as the ICT-led transformation of economies in the late 1990s, the Estonian retail industry and related sectors became an attractive destination for Western investors.

Throughout the years, the ensuing developments have been revealed in the drastic transformation of business relations between and within the industries against the contradicting interplay between conservative (nationalistic) consumer preferences and the imported business culture of foreign TNCs (see Chapter 6 of this book). Aside from the established local networks and signs of vertical integration, one could also witness increasing cross-border network embeddedness on the side of manufacturers as well as retailers with a lesser extent of territorial embeddedness which could be explained by the small size of the market. These tendencies are manifest in the reliance on external networks, the increasing share of private label products, and the enclavization processes. The latter have incurred positive feedback mechanisms in the Estonian food industry in terms of prevailing business relations between large companies in different industries. Moreover, the early 2000s, when foreign-owned retail chains established their position in the Estonian food retail market, witnessed an almost 100 percent acquisition of the Estonian banking sector by Nordic financial institutions with the motive of providing financial services to home-country businesses that invested in Estonia. In this way, subsidiaries of TNCs have got preferential access to bank credit in order to finance their investments and rapid expansion in Estonia (see De Haas and Naaborg 2006: 169–74). Therefore, the working of interlinked foreign capital in both financial and non-financial sectors, including food manufacturing and retail, has exposed Estonia to the processes of cumulative causation.

These positive feedback mechanisms in the Estonian food industry have also been revealed in the dualistic structure of the retail sector, that is, niche produce of small enterprises marketed either in open markets or small independent stores with a trivial one to two percent market share, while industrial mass-production dominates in retail chains. Furthermore, the proliferation of a variety of modern retail formats has entailed agglomeration economies which have opened up opportunities for the rejuvenation of small shops in shopping centers or nearby the supermarkets that sell niche farm products. These open markets and medium-sized shops have recently been vigorously developed, with the support by local municipalities. The Estonian Chamber of Commerce and Industry recognizes the popularity of small shops and the trend towards environmentally friendly but more expensive local products, but currently the economic situation favors bigger outlets (Palts 2011).

It is noteworthy that the evolution of the food retail business, led by wholly foreign-owned subsidiaries, has been characterized by the fierce price-based competition among local and foreign retail chains. This, in turn, has laid the ground for aggressive expansion and the active exploration of opportunities to gain higher market share as well as more power and control. In particular, foreign-owned retail chains have put an emphasis on fast growth with increasing investments in fixed assets, which is reflected in relatively high level of debt liabilities compared to local chains (see Figure 5.2).

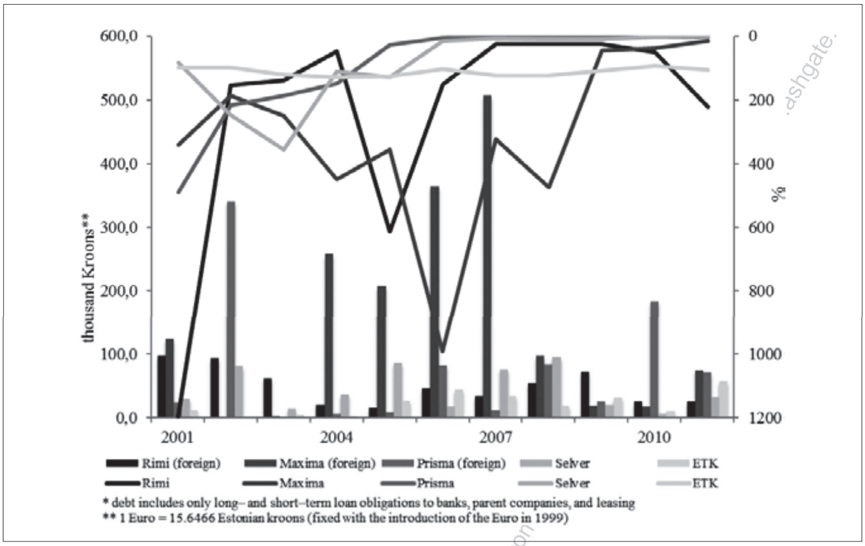

Figure 5.2 Debt-to-equity ratio* (lines; right scale) and gross fixed investments per worker (bars; left scale) of retail chains in Estonia, 2001–2011

Source: Centre of Registers and Information Systems 2012, author's calculations.

On the other hand, contrary to the findings by Baud and Durand (2011), foreign-owned chains have performed less successfully than domestic ones in terms of profitability and solvency indicators (see Figure 5.3), which could explain the tensions arising around the TNCs in the food retail industry.

The business models established in the food retail business have had several implications for general macroeconomic stability and sustainable development. First, multiplier effects in the economy have been undermined by increasing foreign trade, especially cheap imports, and oligopsonistic asymmetrical as well as exploitative business practices that have limited investments in upstream sectors, but also reduced the opportunities to profit from the economies of scale. The vulnerability to the production system stems from the low R&D intensity and outdated productive equipment in the food manufacturing and beverages division, which among other factors, have been affected by the small size of the domestic market as well as retailers' policies (see Pällin 2007, Oppar 2006, Saron 2011). Furthermore, the position of local producers has been influenced by the lack of positive intra-industry spillover effects (Kalvet 2010: 142–143). These tendencies have been reflected in the *primitivization* of the industrial base as well as the de-linking processes that undermine local demand while being further aggravated by the retailers' reliance on global production networks, private labels, or lack of adjustment to Estonian market peculiarities (Sõrmus 2011).

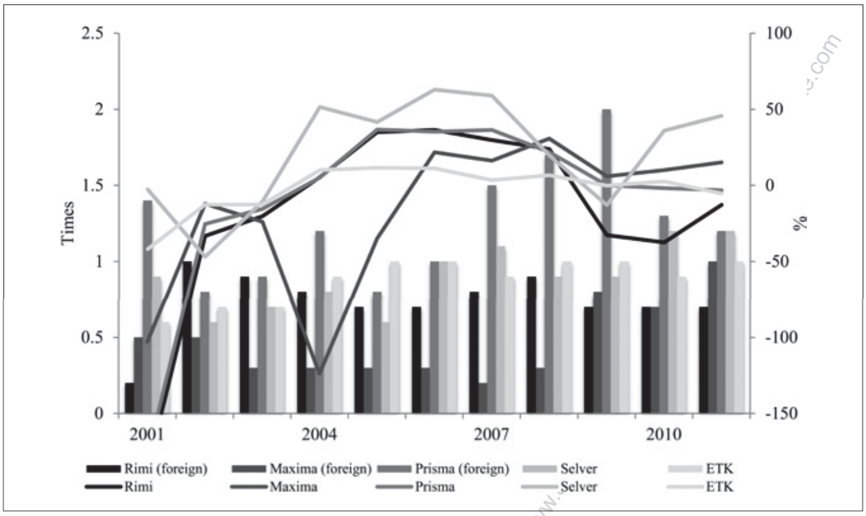

Figure 5.3 Return on equity (lines; right scale) and current ratio (bars; left scale) of retail chains in Estonia, 2001–2011

Source: Centre of Registers and Information Systems 2012, author's calculations.

Second, the reciprocal interdependence between retail chains and large producers has increased systemic risks due to the established business relations. The problems lie in unbalanced market relations and income distribution that have increased the vulnerabilities in the interrelated food production, R&D, distribution, and marketing, where backward and forward linkages have been created over many years: the local food industry cooperates with the producers of added ingredients, packaging, and equipment, while product development is undertaken with R&D establishments. Therefore, the locked-in effect in terms of "too-big-to-fail" exists, that is, increased fragility in the economy due to the concentration and increasing presence of foreign capital in interrelated banking, logistics, retail, and food manufacturing. One could observe the *Kaleckian* principle of increasing risks in terms of a higher reliance on the external financing of investments and growth (see Lavoie 2009). Furthermore, the economy has become vulnerable to pass-through effects, stemming from the dependence on decisions taken and developments occurring abroad. As a transplant region (Jacobs 1984) or a satellite platform (Markusen 1999b) for Scandinavian enterprises, and occupying a fraction of the international value chain of TNCs, Estonia has undermined its resilience with severe difficulties in creating reproductive as well as self-sufficient industries.

We aimed to contribute to the understanding of the interplay between external and internal forces of change that manifests itself when the internationalization of retail and the adoption of a neoliberal political regime meet within the Estonian context. Given the push and pull factors for retail internationalization, Estonia has witnessed the increasing penetration of foreign companies into the food retail industry as well as the gradual market concentration into the hands of six major retail chains, while similar tendencies could be witnessed in farming, manufacturing, and other related businesses. Concentration in all layers of the value chain has been manifest in the movement towards larger enterprises, as predicated in the heterodox economic theory. In a monetary production system, these processes of concentration represent the private sector's attempt to control prices in order to maintain sufficient profits and the ability to undertake further investments (see Minsky 2008). Thus, from a theoretical perspective, the Estonian case displays precisely these outcomes, what could be expected from the introduction of a capitalist economic order with limited government intervention, and, in particular, without the active management of FDI, the central mechanism of accumulation compels firms to grow, gain more control, and increase market share in order to survive. The Estonian retail experience is an example of a short, transitory episode of pure competition followed by the present state of imperfect competition with increased interdependencies, but also imbalances. Thus, when analyzing the impact of FDI on food retail and related economic activities, parallels can be drawn between the Estonian experience over the last 15 years and international decades-long practice, while exceptions can be ascribed to the small size of the market, Estonian political economy, and cultural peculiarities. Local consumers have to some extent managed to constrain the activities of foreign retail chains and push through their preferences for local food with grass-root initiatives in terms of different campaigns and petitions by the civil society groups in order to countervail imports, promote local food produce, and increase the vitality of local producers. The government, though, has mainly focused on promoting higher economic growth, while disregarding the effects of growth on the allocation of resources and distribution of income. Thus, the negative outcomes of the cyclicality and the economy's explosiveness have not been alleviated by government interventions (see Minsky and Ferri 1991). The macroeconomic environment, that is, general fiscal and monetary measures, has instead contributed to the suffocation of the whole economy from the above mentioned "Dutch disease" syndrome and increased instability created by the debt-financed investments during a boom period that unraveled into the 2008 crisis.

Acknowledgments

The research for this article was partially funded by the Estonian Research Council (grant no 8418).

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Article V

Juuse, E., S. B. Endresen and R. Kattel. 2015. “Twenty Years of the Restructuring of the Estonian Food Retail Industry - the Interplay of the Political Economy of Estonia and the Institutional, Historical and Geographical Factors.” In G. Micek (ed.). *Understanding Innovation in Emerging Economic Spaces. Global and Local Actors, Networks and Embeddedness*. Farnham: Ashgate Publishing Ltd., 119-142. (3.1)

Chapter 6

Twenty Years of Restructuring in the Estonian Food Retail Industry—the Interplay of the Political Economy of Estonia and Institutional, Historical and Geographical Factors

Egert Juuse, Sylvi Birgit Endresen, Rainer Kattel

Introduction

After the collapse of the Soviet Union in 1991, Estonia faced the challenge of instituting a capitalist market system with a supportive institutional-legal framework. Transformations in the economy were paralleled with the changes in the food retail sector by the gradual introduction of modern retail practices. More importantly, the subsidiaries of retail transnational companies (TNCs) can be considered catalysts of major shifts as from the late 1990s foreign retailers have set the path for the local retail market. By considering the foreign companies in the Estonian food retail market, the current study maps the dynamics in the food retail sector by presenting the key features of the Estonian political economy and the most significant events that have set the trajectory of the development in food retail. Hence, the objective is to present the evolution of the Estonian food retail industry and elaborate on critical junctures, that is, institutional, economic, and political factors that have affected the transformation of the industry. The significance of the study stems from the fact that the introduction of modern retail in Estonia occurred within a very short time period compared to the decades-long transformation of retail in the countries in the West.[1] Moreover, the study offers an opportunity to understand the impact of neoliberal policies, in particular openness to foreign capital and trade, on the retail industry in a small transition economy. Aside from the country's affiliation to the neoliberal policy toolbox which provides a window of opportunity for understanding the outcomes of certain political decisions, FDI in food retail has been an understudied field despite the numerous analyses in the field of FDI in Estonia.[2] Thus, this study offers an opportunity to

1 See Wrigley, Lowe (2002) on the historical development of modern retail.
2 See for instance Tiits (2007), Masso, Roolaht and Varblane (2010), Varblane (2010).

understand the impact of neoliberal policies, in particular the openness to foreign capital and trade, on the retail industry in a small transition economy.

We draw upon the historical institutional perspective (see Pollitt 2012: 39) that enables us to gain insights on the inward internationalization of the Estonian food retail industry and its overall reorganization during the post-Soviet period. In spite of the internationalization aspect of the study which could be addressed with the theoretical approach of *retail internationalization* in terms of furnishing the notion of internationalization in this sub-industry (Alexander and Myers 2000) or analysis of factors affecting the internationalization process (Vida and Fairhurst 1998, Evans et al. 2008), we emphasize the most important indigenous developments that have affected the transformation of the food retail industry, including its internationalization, during the last 20 years.

The chapter is structured as follows: firstly, we give a brief overview of the development of the Estonian food retail industry from the early 1990s, including the introduction of modern food retail and its impact on local independent stores as well as open food markets. Secondly, the impact of FDI on retail transformation and on consumption patterns is elaborated upon by drawing on the understanding and perceptions of key stakeholders within the Estonian business community. Finally, the discussion and concluding remarks convey our understanding of the processes that have shaped the pattern of retail business today, focusing on the interplay of FDI dynamics and weak regulation that explain the concentration of capital and domination of foreign retail chains. With regard to the methods, empirical data has been collected by using statistical information and secondary data, that is, previous surveys and journalistic literature, as well as interviews conducted with key stakeholders in 2010–2011: the Estonian Chamber of Commerce and Industry, the Estonian Traders Association, the Association of Estonian Food Industry, the Estonian Chamber of Agriculture and Commerce, the Estonian Dairy Association, the Estonian Ministry of Economic Affairs and Communications, and the Estonian Ministry of Agriculture.

The Transformation of the Food Retail Industry during the Turbulent 1990s

The 1990s and 2000s are two periods in the Estonian retail sector development with diverging, but also converging trends. In contrast to the Soviet political and economic structures, the establishment of new market-based production systems was carried out under the neoliberal agenda. Belief in the self-adjusting market mechanisms was also reflected in the privatization of retail companies. The decision to sell state owned retail companies for cash to strategic investors was motivated by the need to foster entrepreneurship and decentralize economic power (see Terk 1999). In essence, the aim was to create as many independent retailers as possible by dismantling the huge retail complexes of the Soviet period, such as cooperatives and regional service consortia, and by selling individual stores. The privatization process in Estonia entailed the fragmentation of the market

Table 6.1 Retail chains in Estonia (as of June 2013): Formats* and entry to the market

Retail chain	Formats	Establishment/ownership
ETK co-op.	Mostly supermarkets and convenience stores in rural areas + 7 hypermarkets	Established already in 1902, but operated also during the Soviet period; locally owned company.
Selver Ltd.	Mostly supermarkets and 6 hypermarkets in urban areas.	Established in 1995; locally owned company.
Comarket Ltd.	Only convenience stores in 3 largest urban areas.	Established in 2002; locally owned company.
Rimi Eesti Food Ltd.	Operates mostly hard discounter stores, but also supermarkets and hypermarkets in the largest urban areas.	Entered in 1999; wholly foreign-owned subsidiary.
Prisma Peremarket Ltd.	Only 9 hypermarkets in 3 main urban areas.	Entered in 2000; wholly foreign-owned subsidiary.
Maxima Ltd.	Operates mainly supermarkets and convenience stores + 1 hypermarket in urban areas.	Entered in 2001; wholly foreign-owned subsidiary.

Note: * Hypermarkets, supermarkets, convenience stores, and hard discounters differ in terms of the spanning area and the assortment (see Wrigley, Lowe 2002).
Source: own elaboration based on data from retail chains' websites.

and the proliferation of small retailers. Similar dynamics could be observed in wholesale: the number of wholesale companies increased from two before independence in 1991 to 4,980 in 1994 (Voog 2011). While over 90 percent of the companies in services and commerce were state-owned in 1991, 94 percent of retailers and 90 percent of wholesalers were privatized by 1994 (OECD 2000). Such drastic changes took place against the slack regulations and low level of institutional development that explain the emergence of open markets as focal points in food retail at that time. For instance, several rounds of the banking crises in the 1990s and the low level of supportive technological infrastructure in terms of non-existent non-cash payments in the early 1990s prevented the food retail industry from taking off (Voog 2011). However, more important for the long-term development of the food retail business was the concentration of control over the privatized companies into the hands of the top management of enterprises, as the Estonian privatization model did not favor mass privatization such as the takeover of privatized companies by employees. The reason for this was that a significant share of non-native language speakers in the population incurred tensions on the grounds of nationality after regaining independence.

Furthermore, local residents did not have sufficient financial resources to partake in the privatization process, which explains why many small and medium-sized companies in commerce that could serve as a gateway to the Baltic markets were taken over by foreigners. The attractiveness of the Estonian commercial sector for foreign investors became evident; by 1995, half of foreign-owned companies were involved in commerce and trading activities (OECD 2000). In general, the political economy of the Estonian food retail industry was from the outset geared towards establishing many independent retailers in a free and perfectly competitive non-interventionist market economy that was subject to foreign competition and a low level of unionization (see Thorhallsson and Kattel 2012 on the Estonian political economy). Affected by the stabilization of the economy and the adjustment of the Estonian legal-institutional framework in line with international standards, the gradual takeover of manufacturing companies as well as banks by foreign companies prepared the ground for foreign investments in the Estonian food retail (and other service sectors).

The first foreign capital based retail chain *REMA1000* launched its business operations in Estonia in 1995; and a year later, the first stores under the *SPAR* brand name were opened. In spite of their expansion plans in both the retail and wholesale segments (see Pirn 1997, Tomak 1997a), there was an even division of the market between open markets and grocery stores (Murde 1995). Moreover, only about *one quarter* of the grocery and convenience stores were operating in chains in the mid-1990s. These chains were local ones—*ETK* and *A-Selver*—and foreign owned—*SPAR* and *REMA1000* (Tomak 1997b). The rest of the market was shared between smaller convenience stores and food stalls in open markets. Thus, the second part of the 1990s was still favorable for local businesses in retail and production due to relatively low competition from foreigners. Yet, the consolidation among retailers as well as organic expansion of retail chains intensified cost-based competition and triggered the gradual demise of independent small shops that was spurred on by ill-advised business strategies and management failures. The economic reason behind the demise of independent retailers and the expansion of chains was found in the workings of economies of scale that enabled the chains to outcompete small shops with lower prices. Moreover, retail chains also had a better bargaining position against producers and vendors as compared to independent stores and could therefore keep costs lower (Taube 2005). Other factors behind the closure of small shops were stringent regulations in terms of hygiene, safety, and other norms that required compliance with European Union (EU) directives (Hint 2002); but also a virtual lack of local land-use planning. Of the idiosyncratic contributors to the worsening situation of retailers were the 1997–1998 economic crises that forced some of the retailers and wholesalers to leave the market or merge with each other. Given these developments, on average 4.5 independent shops were closed per day and in total 1,600 units disappeared during a two-year period from 2000 to 2001 (Neudorf 2002). In general, tightening competitive and regulatory pressures displaced small shops and open markets with supermarkets, hypermarkets, hard discounters as well as shopping centers that offered lower prices, a wider assortment of products, and longer opening hours. Independent retailers were conceived of as mainly the intermediaries of fresh farm products (Tigasson 2002).

Yet, foreign owned retail chains were struggling in the 1990s as well, which led to the collapse of *SPAR Estonia*—the only exit of a foreign retailer from the Estonian market. By 1999 it was evident that bad investment decisions and indebtedness indicated financial problems and forced the owners of *SPAR Estonia* to sell the chain to its main foreign competitor (Erilaid 1999). Nonetheless, *SPAR Estonia* collapsed in 2001 because of the conflicts and misunderstandings between the owners and management, highly leveraged investments, and increasing indebtedness to suppliers (EPL 2001). After the bankruptcy in 2002, liabilities were obtained by the local company *ABC Group*, which turned former *SPAR* stores under a new concept into a retail chain *Comarket* that has been operating ever since (ETA 2002). The case of *SPAR Estonia* shows clearly how financial problems in one of the largest retail chains were transmitted to banking and other sectors, reflecting a *Minsky* moment,[3] where highly leveraged positions with inadequate cash flows increased systemic risks.

The Expansionist 2000s

Notwithstanding the problems of *SPAR Estonia*, the 2000s mark the advent of aggressive market expansion of Nordic and Lithuanian retail chains in Estonia. Between 2002 and 2010 the FDI stock in Estonian retail, wholesale, and vehicle maintenance increased by around 300 percent from 477.5 to 1403.6 million Euros (Bank of Estonia 2011). By 2010, three foreign and three local capital based chains dictated the market with approximately 80 percent of the market share (see Figure 6.1).

Geographic Expansion and Diversification of Format

With regard to geographic expansion, retail chains followed a hierarchical *diffusionist* pattern, starting from the capital city Tallinn, moving to regional centers, and eventually occupying small town markets (Baltic News Service 2001, Riikoja 2006). The inflow of foreign capital coincided with the urbanization process that contributed to the demise of small shops in rural areas, implying the direct link between the retail transformation and urbanization (Palts 2011). The Finnish *Prisma Peremarket Ltd*. operated only in Tallinn for 10 years with five hypermarkets, before moving to Tartu and Narva in the eastern part of Estonia. The exception has been the Lithuanian *Maxima Ltd.* which entered the Estonian retail market in 2001 through the city of Pärnu in southern Estonia with a hard discounter format, but later engaged in super- and hypermarket formats. A peculiarity of the Lithuanian chain has been

3 See Minsky (2008) for his financial theory of investment as well as investment theory of business cycles and their relatedness to financial fragility.

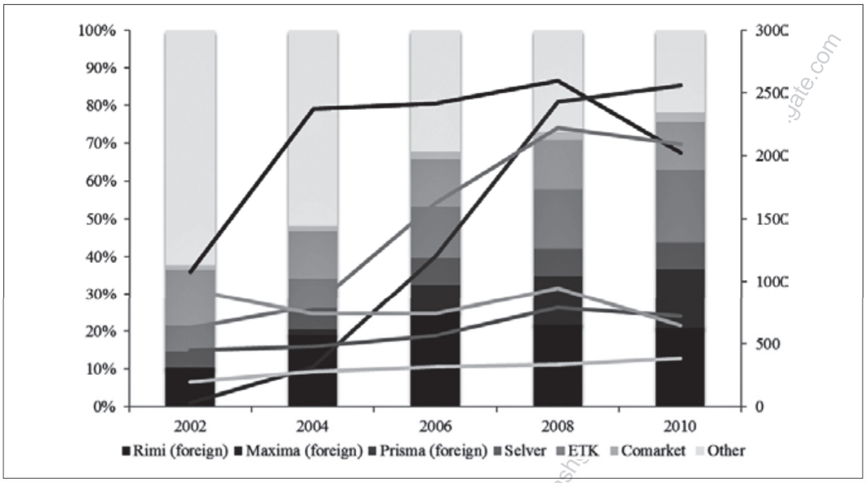

Figure 6.1 The share of net sales (bars; left scale) and the number of employees in the six largest retail chains (lines; right scale) in Estonia, 2002–2010

Source: own elaboration based on data from Centre of Registers and Information Systems (2012).

its policy to target geographical areas where competition is slack such as the eastern parts of Tallinn and Estonia. In these areas, dominated by the Russian speaking population, consumers have been very price sensitive and receptive to imported goods (see Karotamm 2008). As seen in Figures 6.2 and 6.3, the introduction of modern retail with diverse formats has significantly affected the landscape of urban areas. The two largest cities, Tallinn and Tartu, where approximately 40 percent of the Estonian population resides, have witnessed the explosive development of 51 new hypermarkets and supermarkets by local and foreign retail chains after 2000, amounting to a total number of 63 of these formats in 2012.

Increasing competitive pressures have been the incentive for such a rapid expansion. During the first period there was an emphasis on hypermarket formats and shopping centers that primarily expanded through greenfield investments. The next round of expansion consisted mostly of foreign as well as local capital based supermarket and discounter chains (see Roonemaa 2003). The expansion of supermarket and discounter chains has been carried out through mergers and acquisitions as well as organically. Furthermore, retail chains have vigorously diversified into deli, pastry, and bakery businesses as well as engaging in insurance and travel brokerage, and are considering expansion into pharmacy and postal services (Erala 2009b, Merilai 2011). More importantly, the financing of expansion has varied among retailers. While *Prisma Peremarket Ltd.* has relied on accumulated retained earnings, *Maxima Ltd.* has used external sources

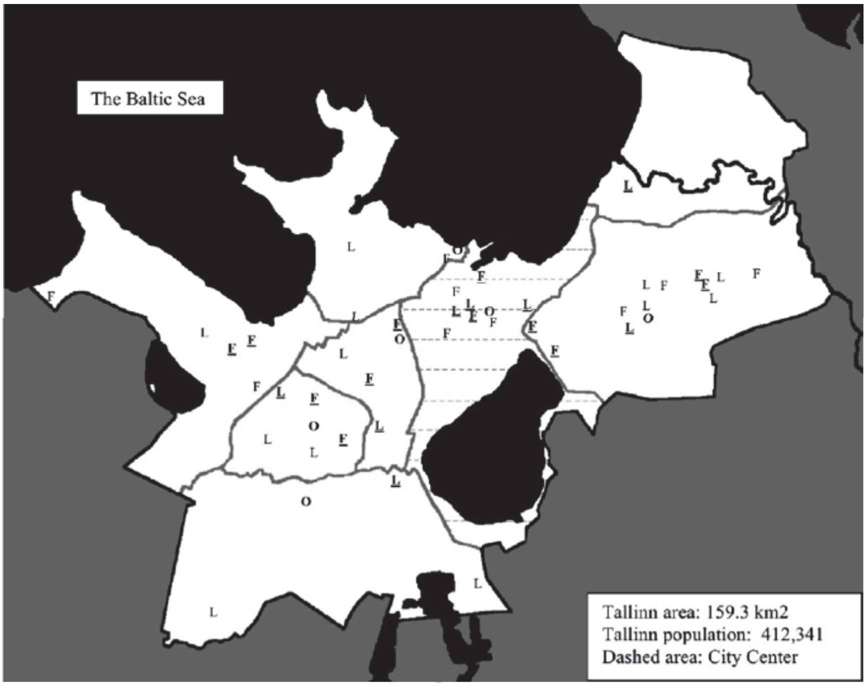

Figure 6.2 Location of open markets, super- and hypermarkets, and shopping centers in the capital city, Tallinn, 2012*

Note: Key: L – Local Hypermarket/Shopping Center; L – Local Supermarket; F –Foreign Hypermarket/Shopping Center; F – Foreign Supermarket; O – Open Markets. * Does not include 18 *Maxima* convenience stores, 16 *Rimi* convenience stores and 9 *Comarket* convenience stores.
Source: own elaboration based on data from Tallinn official website (2012), Mmh (2008).

(Koovit 2009). As covered in Chapter 5, compared to competitors, *Prisma Peremarket Ltd.*, among the foreign chains, and local chain *Selver Ltd.* have been the most financially sound food retailers with sufficient margins of safety, which indicates the sustained ability to service liabilities and rely on retained earnings in financing investments. All in all, it was during the 2000s that retail chains gained leverage in the value chain of producer–wholesaler–retailer–consumer, whereas shopping centers in all major cities in Estonia were turned into the centers of commerce.

Nationality of Owners and the Impact of FDI

Given the importance of cultural factors for the successful expansion of retail chains that has been studied by Aoyama (2007) and Christopherson (2007), the expansion of Lithuanian, Swedish and Finnish retail chains in Estonia can be explained by the cultural proximity of investor and host countries, which makes

Figure 6.3 Location of super- and hypermarkets, and shopping centers in Tartu, 2012*

Note: Key: L – Local Hypermarket/Shopping Center; L – Local Supermarket; F –Foreign Hypermarket/Shopping Center; F – Foreign Supermarket; O – Open Markets. * Does not include 5 *Maxima* convenience stores, 4 *Rimi* convenience stores and 4 *Comarket* convenience stores.
Source: own elaboration based on data from Alts (2012), Tartu Linnavalitsus (2012).

it possible to overcome the trade-off between standardization and localization. There are, according to the Estonian Traders Association, peculiarities in Estonia, since local chains thrive too, unlike in other CEE countries (Merilai 2011).

As discussed in Chapter 5, the blending of different business cultures in a competitive environment has to some extent standardized the service provision and business relations in the Estonian retail industry. Estonian *Selver Ltd.* and Scandinavian retail chains have managed to set best practice standards in the retail business which has caused troubles for Lithuanian *Maxima Ltd.* For years, the media has published cases of law infringements by *Maxima Ltd.*, mainly related to insufficient command of the Estonian language by their personnel, a lack of or misleading information about products, violations concerning the price tags, and troublesome employment relations (Lohk 2007, Mallene 2011). Supported by the media, Estonian civil society concerned about the undesirable general effects of the chains' expansion has placed most of the complaints at *Maxima's* doorstep (Seaver 2009). By capitalizing on the frayed reputation of some of the foreign retailers, the local retail chain *Selver Ltd.* has managed to create a positive image among consumers. The company underlines that they follow the principles of corporate social responsibility by having programs for its workers and supporting sports activities (Niitra 2010). Given the problems surrounding the Lithuanian retail chain, the lack of interest for investments in Estonia from non-Nordic countries, including the Russian Federation, could be explained by the cultural peculiarities, very small and saturated local market, and legal-institutional differences.

One of the consequences, related to foreign ownership, has been an increased propensity of foreign owned retail chains to prefer to have imported goods instead of local products on their shelves, which is reflected in Figure 6.4 below.

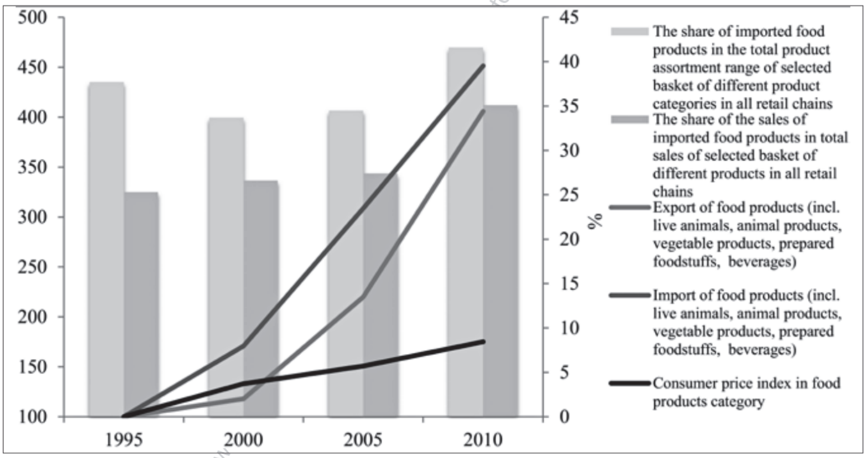

Figure 6.4 The share of imported food products in retail chains (bars; right scale) and foreign trade of food products and consumer price index (lines; index 1995=100; left scale) in Estonia, 1995–2010

Source: author's calculations based on data from Statistics Estonia (2011), EIER (2003, 2010).

In spite of the detrimental effect of the increasing reliance on imports on local producers, a major stakeholder, the Estonian Traders Association, does not see any problems with the operation of foreign retail chains in Estonia and even welcomes the inflow of FDI in retail. Competition leads to the upgrading of local shops, increases efficiency and quality, and external financial support provides buffers during difficult times (Merilai, 2011).

Private Label Products as Overt and Covert Imports

An innovative tool for gaining larger market share has been the introduction of private label products, that is, products marketed under the retailers' own brands. The number of these products has significantly increased in Estonia, as this is a direct consequence of FDI (Sõrmus 2011). In 2002, one percent of all products were private labels, while in 2010 the same figure was eight and reaching 30 percent in the category of dairy products (EMOR 2010). Over the years, private labels have extended into different product categories, including both food and non-food products (Erala 2009a). Their increased popularity could be explained by the increased price sensitivity of local consumers, as lower prices are achieved due to the insignificant marketing costs and scale economies (Kallas 2011). More importantly, private label products tend to be imported (EIER 2010). For instance, most of the *Prisma Peremarket Ltd.'s* private label items are imported due to bottlenecks in the local supply (Villak 2010). It is argued that Estonian food manufacturers are too small to supply retailers with large quantities of these products (Sõrmus 2011, Palts 2011). The argument is supported by the dynamics seen in Figure 6.4 above: imported goods have increased their share and sales, as the overall prices of food products have been on an upward trend. The Estonian Institute of Economic Research has highlighted two main factors behind the rising prices. First, the prevalence of local products on the retail market and second, the business model of foreign-owned subsidiaries in the retail segment has been based on values other than low costs (Männiste 2006). Furthermore, trends in global market prices, rising production costs, and speculative investments before the crisis of 2008 caused inflationary pressures in the retail market (Josing 2007). An additional factor behind the price hikes has been the role of support service providers. Due to the popularity of credit and debit cards among consumers as a means of payment and the dominance of a few commercial banks, banks have been able to impose a fee as a percentage of turnover, ranging between 1 and 3 percent, related to card payments. This can be seen as an extra value added tax on retailers and thus added to the price of items sold (Reinap 2003). Therefore, the promotion of private label products that counter the price increases has been welcomed by the most price sensitive consumers, especially, given the deteriorating purchasing power that suppressed local demand after the 2008 financial crisis.

On the other hand, the very characteristics of private label products that bring prices down—they tend to be cheaper imports and narrow the assortment—run counter to consumer preferences for food products (see Chapter 5 on the impact of private labels on related industries). It has been found that Estonian consumers tend to have a preference for local products, which are considered to be safer and more reliable (Potisepp 2010). A journalistic survey (Sikk 2009) has found that Estonian consumers value a wide range of low-price and high-quality products that are locally produced. They expect spacious shopping areas, more immediate customer service, freshness, and would like to see more locally-owned retailers. Hence, consumer preferences clearly indicate a positive relationship between the higher share of local food products in the assortment and the improved standard of living, but as Figure 6.4 (above) indicates, inflation and deteriorating purchasing power have increased the popularity of cheaper imported goods. While 70 percent of consumers preferred local products in 2010, worsening economic conditions forced people to shift their purchases towards imports (EIER 2010, Merilai 2011, Potisepp 2011).

Countering the Dominance of Retail Chains

Given the increasing dominance of food retail chains and unfavorable legislative amendments, the outlook for small independent shops has not been positive. Nonetheless, novel retail formats have brought about agglomeration economies and thereby opened up possibilities for the rejuvenation of small shops. These stores have been established either permanently or seasonally in shopping centers or nearby supermarkets and have been selling niche farm products. In some cases, retail chains and shopping centers have organized fairs of their own, where small local producers and farmers may rent an area to sell their products (Tammela 2009, Merilai 2011). This has been made possible due to high charges and requested discounts, complicated logistics, and penalizing fines by retail chains. Hence, getting niche products "listed" by food retail chains is a major barrier. This has motivated small producers to combine forces with small shops to sell niche and exclusive products in a highly competitive market, a recognition shared by the Estonian Ministry of Agriculture (Reimer 2009, Sokk 2011).

Many Estonian consumers would also like to see reverse trends in retail towards more direct contact with sales persons (Saar cited in Salu 2008). This coincides with another trend that has recently emerged, namely locally produced and environmentally-friendly food that is increasingly promoted in the media. The Estonian Chamber of Commerce and Industry believes that this trend will increase in the future (Palts 2011). In addition, local authorities have recently given support to the development of open markets in urban areas. However, they have less than one percent of the market for green products, and only 20 green producers have started to supply directly to consumers (Sõrmus 2011). Furthermore, the peculiarity of open markets in the capital city has been their "politicization" in terms of favoring companies that sponsor political parties in power in the municipality (Gnadenteich 2009). Such a policy has caused disdain and made open markets unattractive. Yet, the large-scale expansion of modern retail in populous urban areas could be considered as the main reason behind the low popularity of open markets. In addition, there are two problematic issues in connection with open markets and small producers who sell goods without a license near to shopping centers; these are food safety and tax evasion (Potisepp 2011). Thus, there tends to be a trade-off between vigorous support for small producers that infringes the equality principle, and lack of responsibility towards consumers and the state.

There has been resistance to the practices of retail chains on the demand side as well. Estonian civil society has been vocal in determining the developments of the retail market by supporting Estonian farmers and demanding local products. For instance, in spring 2010, *Rimi Eesti Food Ltd.* decided to discard Estonian pork and beef with the argument of insufficient supplies as well as relatively high prices, and sell only imported meat under private labels (see Östholm cited in Hankewitz 2010). That decision caused a heated reaction from civil society as well as producers, who called for the boycott of *Rimi* supermarkets, and the case caused an outbreak of public anger, even in social media. The Ministry of Agriculture and local producers considered the low price as the main reason behind *Rimi's* decision to favor imported meat and the step was interpreted as a tactic to pressure local producers (see Seeder cited in Kass 2010, Lohk 2010a). After one week, *Rimi* admitted the mistake and reintroduced Estonian pork and beef. In the aftermath of that scandal, press releases about support of local small producers could be interpreted as the pursuit of rehabilitation—around 30 small producers, mainly farms in the dairy industry, supplied *Rimi* hyper- and supermarkets with diverse niche products (Sõrmus 2011, Erala 2010). Yet, in direct competition to local *green* producers, *Rimi* introduced its own private label in 2010 in the green products category, comprised of organic food produced in Sweden and other foreign countries (Lohk 2010b). Thus, in order to countervail imports, promote local food produce, and increase the vitality of local producers, there have been several campaigns[4] launched during the last couple of years against the increasing dominance of retail chains.

Aside from the grass-root level initiatives, there have not been any legally binding measures to intervene in the food retail business to put the brakes on rapid expansion or concentration. The commerce law from 2004 regulates issues of importance for retail, but currently there is neither a deliberate retail policy nor political discussions aiming to change the status quo. Among other factors, this is due to the restrictions imposed by the international agreements:

> Policy measures that distort the functioning of the free market are not feasible in the EU. In general, the European Union dictates what government can and cannot do. After all, Estonian retail sector is well regulated in terms of competition, contractual arrangements, and labor relations. (Interview, M. Sõrm, Ministry of Economic Affairs and Communication 2011)

Thus, stricter state regulations have not been on the agenda. The authorities see foreign companies in a good light as long as those provide jobs, reinvest profits,

4 Campaigns like *Estonian Flag*, *Eco–Sign*, *Best Food Product*, *Homegrown*, and other.

and pay taxes (Sokk 2011, Sõrm 2011). In general, there is a strong belief in the free market economy among the stakeholders (Merilai 2011, Potisepp 2011). The overall stance is that the economy should be free of government intervention, unless competition law has been infringed (Sõrm 2011).

The only political measures that have affected retailers as well as producers have been related to alcohol policy. These are restrictions on advertisements as well as sale areas and opening hours for the sale of alcohol (Paves 2010). Even though such measures could have confined retailers, regulators succumbed to the threats of retail chains to start closing stores earlier in the evening (Masing 2007). Authorities at the local government level have only occasionally directed or hindered the expansion of retail chains with an argument of contradicting city planning principles as well as health and safety requirements (Merilai 2011, EPLO 2003, Peensoo 2003). As specific and targeted policy measures have been off the agenda, only fiscal policies have been of noteworthy relevance for retailers: 'Economic cycles influence the consumption patterns and affect retailers' turnover the most. Other factors that affect retailers are taxes and demographic situation.' (Interview, M. Merilai, Estonian Traders Association 2011)

Discussion and Concluding Remarks

From 1991 onwards, the food retail industry has undergone profound changes. The first stage of restructuring was marked by the proliferation of independent shops and open markets, while the second stage was characterized by the consolidating tendencies among local and foreign owned retail chains. There are several reasons for such a path-changing evolution, and in the following section we discuss the processes we consider most important when seeking explanations for the patterns observed. Given the small market in Estonia with a population of around 1.3 million, fierce price- and cost-based competition among local and foreign food retail companies laid the ground for active exploration of possibilities for expanding market share as well as gaining more control. The result has been the concentration of the retail market into the hands of six leading retail chains; of these, three are non-local and control about 40 percent of the market. The most general process that we wish to highlight here is a consolidating trend that can be predicated in the heterodox economic tradition whereby market forces induce imperfect competition among firms—oligopolistic markets with interdependent relations. Firms endeavor to increase their size and market share by utilizing the mechanisms of economies of scale. By exploiting the cost advantages, large firms drive small firms out of business and thus render perfectly competitive markets into a situation of either monopoly or oligopoly. Therefore, economies of scale are an important reason why most industries are dominated by a small number of large companies. This, in turn, has created a situation, where the strong either crush or absorb the weak (see Minsky 2008, Lavoie 2009, Keen 2011). From this theoretical vantage point, Estonian experience reflects the central mechanism of accumulation that compels firms to grow in order to survive and gain more power, while a short, transitory state of pure competition in the early 1990s was succeeded by the present state of imperfect competition in oligopolistic markets.

Second, macroeconomic policies lie behind the process of change and explain the described concentration in the food retail market. From the very beginning in the early 1990s, Estonian governments have adhered to the free market (laissez-faire) approach by implementing the so-called *Washington Consensus* policies. For many years, Estonia has endeavored to serve as a low-tax and low-wage investment hub for foreign investors. In that respect, the tax reform of 2000 that exempted undistributed profits from corporate income tax, boosted foreign investments. In addition, relatively expansionary fiscal policies during the 2000s before the 2008 crisis stimulated the growth of domestic consumption, as during the boom years, wage increases in the public sector were coupled with the easing of the general tax burden, all of which contributed to the overheating of the economy (see Bernhardtson, Billborn 2010: 10).

The third process that explains the aggressive expansion of retail chains in urban areas, particularly in metropolitan centers, was the increasing *financialization* of the economy since the late 1990s. The turning point in the development of the Estonian banking system came in 1997–1998, when local commercial banks were taken over by Scandinavian financial institutions. The credit supply was thereby increased due to the access to long-term foreign funding. Essentially, the ratio of the banking system's assets (mostly loans and leasing) to GDP doubled in eight years and reached 132 percent at the beginning of 2008. Thus, 2000s saw an unprecedented credit boom that was made possible due the declining cost of credit on the global scale, Estonia's catching-up process from the initial low-level of bank intermediation, high GDP growth, consumer confidence from rising incomes, and expansionary fiscal policies (Voog 2011). Followed by the real estate sector and private persons, most of the bank loans, allocated by the two largest commercial banks in the early 2000s, were absorbed by retail and wholesale industries (SEB 2011, Swedbank 2011). Hence, given the high growth rate of the overall economy in 2000s that was fueled by debt-led domestic consumption as well as investments, both local and foreign owned food retail chains undertook aggressive expansion that enabled them to attain continuing annual increases in sales throughout these years.

The cumulative impact of the commercial banking activities and the neoliberal environment on the development of the food retail industry has been effectuated through the fourth process that we wish to highlight: the urbanization process from the early 1990s and, in particular, the suburbanization trends in the 2000s (see Tammaru et al. 2009). These trends have been affected by the transformation of the structure of the Estonian economy towards services that spurred migration out of rural areas. Suburbanization has been made possible by the increasing mortgage lending that was non-existent in the 1990s due to difficulties in applying for collateralized bank loans and high interest rates, while low purchasing power contributed to an inactive real estate market (OECD 2000). However, the underlying causes for such deepening interdependencies between commercial banking, real estate development, (sub)urbanization, and the expansion of retail chains were the privatization process and land restitution. This placed property in private hands, and eventually paved the way for urban sprawl with increasing in-fills and multifamily housing constructions around the urban centers (Tammaru et al. 2009). These developments are revealed in the locations of retail stores in Tallinn and Tartu (see Figures 6.2 and 6.3, above), as new hyper- and supermarkets in the two largest cities (but also in other urban areas in Estonia during the late 1990s and 2000s) were established either in the city centers or the surrounding districts in the residential areas within the borders of the cities. Essentially, the investment decisions of retail chains followed the geographical expansion of demand and real estate development that was increasingly financed through credit during the 2000s. To some extent, these findings are in contrast to the general pattern of the spatial location of retail outlets in urban areas of western economies—in the outskirts of cities—in particular, in Anglo-American countries (see Wrigley, Lowe 2002).

Our starting point was the prospect of higher returns on investments that gave an impetus and thus rendered the Estonian economy an alluring destination for Western investors in late 1990s and early 2000s. Cultural and geographic proximity of Nordic (and Lithuanian) retailers cannot be overlooked as a factor behind the expansion into the Estonian market. Aside from strengthening their position, foreign retail chains have managed to set the standards by transferring their operational techniques and business models, which have enabled them to increase the market share and thus influence production systems (see Chapter 5, also Humphrey 2007, and Christopherson 2007 on the international experience). However, as several cases indicate, foreign food retail chains have also struggled in Estonia and have been constantly seeking to adjust to the Estonian socioeconomic environment. Moreover, further dominance of foreign retail chains in the future can be seriously compromised, given the nationalistic mood and the preference for local produce among consumers, the resilience of local chains in withstanding the competitive pressures from foreign TNCs, and the rejuvenation of alternative food stores and open markets. In addition, according to European standards, the Estonian retail market was already saturated in 2002. Rapid commercial property development in the Tallinn area that exceeded the growth of real income by three times between 2000 and 2002 resulted in a supply glut (Kivistik 2002).

Irrespective of these peculiarities in the Estonian market, clear parallels can be drawn between Estonia's 15 year long experience in the food retail industry and international practice, including Central and Eastern European countries, given the common heritage of the planned economies (Knezevic and Szarucki 2001, Michalak 2001). General patterns in the food retail industry on the global scale offer evidence on a rapid expansion of subsidiaries of retail TNCs in terms of: 1) geographic diffusion, retail format, and customer segments, 2) consolidation patterns and the increasing market share of these subsidiaries, 3) introduction of private label products. These effects can be identified in Estonia as well. The oligopolistic position of foreign retail chains has been achieved through the increasing reliance on international supply networks to source the products. This is witnessed by the rapid spread of private label products in Estonia that attests the positive relationship between retail concentration and the intensity of private label products as well as private label supply networks in retail internationalization processes (see Wrigley, Lowe 2002: 64). These developments are supported by the increasing share of imported products that enables retailers to capitalize on price arbitrage in search of operational and network efficiencies (see Dicken 2011: 436). There are several implications of such developments. On the one hand, risks stem from the retailers' stocking policy in terms of sourcing the national brand leaders plus private labels, which lead to the demise of small manufacturers and a consequent reduction of choice (see PM Online 2002, Voog 2011). On the other hand, the potential outcome of increasing market share in the hands of foreign retail companies could be higher prices for consumers due to cost or exchange rate based pass-through effects (see Bloch and Olive 1999). Furthermore, the vulnerabilities in relation to pass-through effects stem from the dependence on decisions and developments that are taken and determined externally. As stated above, the option of government intervention to mitigate these risks has been taken off the table. The same macroeconomic policy environment in terms of conservatism in fiscal policies has been sustained for almost 20 years with the belief in a simple taxation system and balanced government budget for the purpose of price and macroeconomic stability. In practice, such an environment has had a significant effect on the unsustainable credit growth and deepening imbalances in the economy created by debt-financed investments during the boom period that unraveled into crisis and threatened the economy with an eventual debt-deflation process. Thus, the period of tranquility and financial stability before 2008 fed buoyant moods in terms of high profit expectations, which were manifest in higher investment activity in the retail and real estate markets in 2000s (see Chapter 5). With hindsight, the pre-2008 boom period bred instability due to the propensity to hold less in liquid assets and issue more liabilities. Furthermore, the increasing share of FDI in the Estonian food retail industry has had a negative impact on the external balance of the industry in terms of its increasing debt liabilities to foreigners, and contributed to the deteriorating balance of the payment position of Estonia due to continuous FDI inflows, not to mention the negative food trade balance. On top of it, given the shrinking population and volatile purchasing power of consumers, the food retail industry faces excess supply with a saturated local market. In these circumstances, keener competition and mounting accumulation of foreign capital have increased the concentration level and rendered Estonian retail business more fragile. Yet, according to stakeholders, for instance the Estonian Chamber of Commerce and Industry, the strategy of attracting foreign capital has been successful: "FDI has been beneficial for Estonia, while not incurring so much negative aspects. The main impact has been in terms of employment creation. Reliance on FDI is quite inevitable for small countries" (Interview, M. Palts 2011).

We aimed to understand the restructuring of the Estonian food retail industry by drawing upon the international experience of the expansion of retail FDI. For comprehending the dynamics in retail business, key features of the Estonian political economy and crucial events in determining the trajectory of the development in food retail business have been highlighted. As demonstrated, the development path of Estonian food retail has been affected by institutional and economic adjustments such as radical change in the political regime and ideology in the early 1990s, transformation of the structure of the economy and the related urbanization process, acquisition of the banking sector by Scandinavian banks, and the conclusion of the privatization process, while peculiarities could be attributed to the historical legacy of the Soviet period, small market size, and *non-corporate—conservative(neoliberal)—nationalistic* socioeconomic environment. As shown, cultural inertia in society has constrained the retailers' activities in shaping the tastes and implementing business practices. On several occasions, civil society has managed to influence foreign retail chains by pushing through consumers' preferences for local food with different initiatives, such as campaigns and petitions, in order to countervail imports, support local food producers, and hinder the establishment of stores. Yet, in many respects, the Estonian case mirrors general trends in modern retail in the international arena. Thus, from a theoretical perspective, the Estonian case displays the outcomes that could be expected from the introduction of a free market order with limited government intervention and, in particular, without the active management of FDI. Unfettered private interests led spatial planning and development of residential and commercial real estate, determined by the activities of commercial banks, real estate developers, and the preferences of residents and companies. Without significant policy constraints, the central mechanism of private capital accumulation has compelled retail companies to grow, gain more control, and increase their market share.

Acknowledgments

The research for this article was partially funded by the Estonian Research Council (grant no 8418).

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APPENDIX

Article VI

Juuse, E. 2016. "Regulatory Convergence, Financialization and Hollowing Out of the State: The Case of Financial System in Estonia." *Halduskultuur – Administrative Culture*, xx-xx *(forthcoming)*. (1.1)

Regulatory Convergence, Financialization and Hollowing Out of the State: The Case of Financial System in Estonia

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ABSTRACT

This paper addresses the effects of regulatory convergence and international capital flows on national institutions, policies and concepts on the functioning of the economy and the financial system in particular. Based on the case of Estonia it is shown how these two factors – foreign investments and international integration – have affected and essentially hollowed out policy-makers' institutional understanding of money, finance, banking and the market economy in general. Moreover, the financial system in Estonia has been riddled with institutional incompatibilities, while the macroeconomic strategy, based on the harmonization process and the restrictive monetary regime, has reduced policy autonomy for financial stability purposes. Likewise, in light of the harmonization process, one can detect dissonance in the perceptions of financial regulators, fragmentation of policies and inadequate financial governance in terms of steering the developments in the finance sphere. Policy-making that has resulted both in over- and misregulation has lacked a holistic, system-wide view on the relationship between the financial industry and other institutional sectors.

Keywords: discursive institutionalism, financialization, regulatory convergence, financial system, financial bureaucracy, policy-making, Estonia

1. Introduction

Economists often differentiate between financial and production capital (see, e.g., Reinert 2009; Perez 2002; Mazzucato and Wray 2015). It is safe to assume that this also means the existence of policy capacities on both sides of the economy: there are public organizations dealing with finance and there are also organizations dealing with production. The varieties of Capitalism literature exemplified how these two public-private systems co-evolve in different settings (particularly well developed in Zysman 1983). What this and other institutionalist analyses are missing so far is the question of how the evolving patterns of financial and production capital impact the capacities of the public sector, particularly how bureaucracies function.

Over the past decades we have seen a rapid increase in what has been called *financialization*; in other words, the dominance of financial capital over production capital, but also growth in cross-border capital flows, rise in both financial investments and household indebtedness, and shareholder value orientation as the features of the financialization process (see Lazonick and O'Sullivan 2000; Sawyer 2015; Epstein 2005). How these shifts have impacted financial bureaucracies and regulators, however, is yet to be studied. This question is perhaps of particular importance within the euro area, where most member states are to a large extent policy takers, i.e., they have somewhat limited policy independence (Kattel et al. 2016). This – limited policy scope – is of particular importance in the case of recent members within the euro area, as these economies tend to also be very open to and dependent on foreign capital inflows, which is the most evident characteristic of the financialization process there (see Juuse 2015; Juuse 2016a). In this article, we use Estonia as an example for new euro area members to exemplify how financial bureaucracies are influenced by shifts in the makeup of the capital structure of the economy and the EU regulatory convergence.

Literature on both the Europeanization and international finance has offered insights into how the policies of the European Union (EU) and reliance on foreign capital in the reconstruction of national political economy tend to entail a loss of control and national autonomy in terms of an inability to make independent decisions on economic and monetary goals and thereby to affect socio-economic developments in the desired way (Schmidt 2002a; Evans 1985; Kregel 1996). Yet, after regaining independence in 1991, Estonia aspired to become a member of leading international organizations, primarily the EU, and that implied the transposition and adoption of international legislation and practices, including in the field of banking. At the same time, transformation towards a liberal market economy incurred radical openness to foreign capital and trade, and hence triggered a significant inflow of foreign direct investments (FDI) and other flows, which was further supported by the introduction of political and socio-economic institutions along the lines of Western standards. Several studies (see Juuse 2015; Juuse 2016b; Kattel 2010) have elaborated on the rationale as well as implications of the harmonization of the Estonian banking regulation, but also on the impact of foreign capital[1] on the economic growth and financial stability in Estonia during the last two decades since the early 1990s. This article, however, aims to take a step further in the analysis of legal harmonization and openness to FDI by looking at the ideational side behind the policies and practices. We thus seek to understand the policy feedback linkages between the political economy of the euro area integration and market openness, workings of financial regulators and the financial system. The rationale for this stems from the argument that the concept of the European integration, accompanied by the globalization discourse, has been increasingly internalized at the national level in terms of introducing the discursive context for local policy-makers (Hay and Rosamond 2002; Lynggaard 2013). In this regard, we analyze financial bureaucracy's conceptions in the context of the euro area integration and openness to FDI by using broad heterodox ideas on monetary capitalist economies as a canvas to tell the story, which enables us to contrast ideational evolution in the sharpest possible sense.

As this research endeavors to establish a relationship between ideas, institutions and policy-making, the methodological approach follows the traits of discursive institutionalism with the focus on both ideational and discursive interaction side, i.e., on a set of broader frames[2], paradigms[3], norms, etc. as policy ideas and their usage

[1] Banking sector in particular has absorbed the majority of foreign capital inflows and this has resulted in nearly 95 per cent of the banking sector being controlled by foreign capital in terms of both total assets and share capital (Juuse 2015).

[2] For instance, the notions of globalization and Europeanization as well as the European integration could be seen as frames for legitimizing and justifying neoliberal policies (Campbell 2002)

[3] Keynesianism and monetarism (neo-liberalism) are examples of paradigms, i.e., economic premises, which support and question present policies as well as institutions (Beland 2009, 705).

through interactive processes in policy design (see Schmidt 2000, 2002a, 2013; Campbell 1998, 2002). Thus, by looking at the discourse – seen as statements made and positions taken by policymakers on public policies and their coordination as well as communication – we are able to understand policy problems, actors' policy preferences and their capacity to implement policies (Schmidt 2002a, 6; Schmidt and Radaelli 2004, 188), but also give a meaning on a broader scale to economic practices and the dynamics in the socio-economic environment. Moreover, as ideas have a long-term impact on policy-making through their embeddedness in regulations and in bureaucratic routines (Goldstein and Keohane 1993; Pierson 1993; Thelen and Steinmo 1992), such institutionalized ideas give way to path-dependent policy continuity or become self-enforcing. Therefore, institutions as sets of formal rules and procedures[4] that govern policymaking are on the one hand outcomes of policy discourse and on the other hand, constraints on policy change (Campbell 2002, 20; Schmidt and Radaelli 2004, 197). In particular, institutional arrangements, including organizational structures, affect both policies and (in)capacities through the unequal distribution of resources and power to different actors (Mahoney and Thelen 2010, 8; Hancke et al. 2007, 20; Evans 1985, 351). This implies bringing the focus onto the interaction of both institutional and ideational variables that underlie policy formation. Thus, from the perspective of discursive institutionalism, the paper addresses the effects of the Europeanization process and foreign actors as institutional factors on the finance and banking-related policy discourse in terms of policy formation, its institutional context and policy content in Estonia.

Given the central role of institutions in policy discourse, money and banking as the core social institutions in the financial system have been elaborated upon in terms of their political and institutional setting in Estonia. The first section outlines the prevailing ideological affiliation in macroeconomic perspective and, in particular, in the adopted monetary regime, followed by their implications for policy formation and policy measures. The monetary framework discussed in the first part of the article sets the frames for the interpretation of the views and ideas of policy-makers in the field of finance and banking. The second section directly addresses the effects of the regulatory convergence and foreign capital on the bureaucracy's perceptions analyzed. Insights into the domain of finance, banking and financial stability were gained through interviews with civil servants from the Central Bank (CB), the Ministry of Finance (MoF) and the Financial Supervision Authority (FSA); altogether, we conducted eight interviews during 2014. The paper ends with a concluding discussion on the missing elements of financial policies within the established economic regime, which have rendered the Estonian macro-financial environment fragile.

2. Macroeconomic Policies and Institutions in Estonia – Unperceived Fallacies within the Currency Board System

In light of the process of transition to a market economy that necessitates a long-term structural transformation, there are theoretical justifications for a co-coordinated state intervention and autonomy in order to introduce both economic and financial

[4] These institutional arrangements could be seen in terms of the political rules of conduct (consensual vs. conflictual), governance structures (unitary vs. federal), governance processes (corporatist vs. non-corporatist), regimes of industrial relations (coordinated vs. fragmented), knowledge regimes etc. that affect both the content and formation of policies (see Schmidt and Radaelli 2004; Campbell 2002; Beland 2009; Schmidt 2002b; Campbell and Pedersen 2010).

institutions, alleviate negative distributional effects and sustain capital accumulation and allocation through the central bank's policy instruments (Bhaduri et al. 1992; Zysman 1983; Amsden 2001; Reuschemeyer and Evans 1985, 44–49). The model of macroeconomic policies adopted in Estonia, however, was based on the opposite principles (Kattel 2010, 1). Here, the central role was played by the EU, whose ideological support and imparted stance of economic liberalization in terms of fiscal constraints, monetary inflexibility and the logic of free competitive environment was unquestionably embraced by Central and Eastern European countries (CEECs), including Estonia[5]. Hence, under the umbrella of the *Washington Consensus* paradigm, which conceptually was simple enough to be easily grasped by different stakeholders[6] (see Campbell 1998), the supply-side macroeconomic policies such as the currency board system and the accompanying fiscal doctrine were adhered to in Estonia throughout the last two decades for the achievement of macroeconomic stability. Yet, such an approach had dire consequences for macroeconomic management in the context of weak state capacities and under-institutionalized financial system, as seen below. The following section focuses on the currency board system, which was one of the key institutional variables that shaped the understanding of the role and functions of the state in relation to the financial system from 1992 to 2011.

2.1 Estonian monetary regime and its implications for central banking

In contrast to a *chartalist* approach to monetary and fiscal policies (see Wray 1998; Knapp [1924] 1973), Estonia adopted a currency board arrangement in 1992 as suggested by international advisers and implemented it to fight inflation but also to encourage international trade and foreign inward investments. While such an approach supported the foreign-savings-led restructuring of the economy, state's capacities, its autonomy and hence the possibilities for steering the economic development have been constrained (Kattel 2010; also Evans 1985, 205–207). In fact, some leading actors at the time have argued that this was done on purpose (Kallas 2003, 511; Knöbl et al. 2002, 11–12) in order to fit the country into a golden straitjacket of macroeconomic stability.

Under the currency board system, a central bank was deprived of the right to credit commercial banks or governments with either advances or purchases of government securities, respectively (see Godley and Lavoie 2012, 214 on the currency board system in general). The conservative monetary regime adopted and also a banking industry dominated by foreign capital in Estonia entailed a commitment to fiscal prudence in turn (Hansson 1994 cited in Feldmann 2013, 361). Hence, the neoliberal agenda with a currency board arrangement in Estonia implied the loss of monetary sovereignty and a gradual degradation of a welfare state. In that respect, countercyclical demand management and active industrial policies as the inherent elements of Keynesianism (see Soskice 2007; Davies and Green 2010) have been eschewed in Estonia and replaced by the emphasis on the improvement of supply-side conditions such as the labor market and business environment. It is the

[5] See Jessop (2002); Hancke et al. (2007); Abdelal (2007); Streeck and Thelen (2005).

[6] One cannot underestimate the Soviet legacy, which made neoliberal ideas appealing to the Estonian political elite and led to the aspiration for the accession to the EU and adoption of the EU principles. Furthermore, it could be observed that these ideas have had a tremendous power, as they have informed preferences and behavior far more than research, as evidenced in Estonia in the 1990s when political elite was influenced by mainstream think-tanks and scholars such as Milton Friedman (Laar 2007).

monetarist argument of inflation targeting[7] rather than employment and output, which has been adhered to in the political rhetoric, while monetary flexibility in terms of interest rate and money supply adjustment, credit loosening and currency devaluation has been given up. Likewise, capital controls were dismantled at the early stage of development. This contradicts the view that "… the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this." (Keynes 1980, 149)

Furthermore, the currency board system has diminished the institutional role and hollowed out some of the essential functions of the central bank in Estonia (see Singleton 2011; Davies and Green 2010; Goodhart 1991 on central bank's conventional functions). *Inter alia*, the implementation and formulation of monetary policy through interest rates, open market operations or loan facilities has been renounced or outsourced to external actors – liquidity provision is under the control of foreign financial institutions that essentially control monetary and credit conditions, the aggregate level of spending and other key economic variables. Further, the function of a lender of last resort has been severely limited and the central bank has not been mandated to promote economic development by financing development projects or corporations. Cooperation between the Eesti Pank and other financial institutions on the provision of industrial finance was never on the agenda for overcoming long-term financing bottlenecks, typical for a transition economy (see Singleton 2011, 139). In addition, the space for discretionary financial policies has been restricted by gradual phasing out of the financial sector regulation (Juuse 2016b). Thus, the takeover of commercial banking by foreign financial institutions and also the anchoring of monetary targets to external institutions and developments have confined the functions of a central bank primarily to the operation of payment systems.

2.2 Policy approach with self-imposed constraints

While the macroeconomic strategy adopted in Estonia can be seen as a success in the context of other CEECs, it also introduced underlying fragility into the system: such stability-oriented and foreign-savings-based strategy has a self-reversing logic built into it, i.e., growth relies on foreign savings, but once these are not forthcoming, growth recedes, turning the economy effectively into a *Ponzi* scheme (see Kregel 2004). Thereby, in such institutional setting, several pieces of macro-finance (see Burlamaqui and Kattel 2014, 177) as prerequisites for macroeconomic stability and economic development have gone missing. First, any valid macroeconomic policy-making under the currency board system was constrained by a legal prohibition on financing the government deficit. The central bank has not rendered any banking or agency services to the government for crediting the government either directly or on the secondary market. Thus, complementary to a currency board arrangement, Estonian government has adhered to fiscal conservatism with a piecemeal reduction in tax burden and has diminished possibilities to perform tax-based income

[7] One could question the argument of inflation fighting by the central bank, given the tendency of fixed exchange rate regime to be deflationary via internal devaluation in order to keep up the international competitiveness of the economy, especially when it is made possible by weakening the position of labor unions and workers.

redistribution. The lower taxes argument[8] has particularly been justified on the grounds of attracting foreign capital (Kattel 2010, 11). In this regard, there has been a lack of institutions in the Estonian political economy for addressing the issue of distribution or of how to allocate economic returns between capital and labor with a minimum of industrial conflict; but also for addressing the balances between financial and production capital. Moreover, under the auspices of financial regionalization, we can observe tax base erosion, associated with legal loopholes allowing for tax avoidance (Juuse 2016b), which is a clear indication of legitimacy issues and another evidence of lost monetary sovereignty (see Wray 1998, 36 on 'taxes drive money' arguments).

Second, without taking into account the dynamics of asset prices, a singular focus on consumer-price inflation does not serve the purpose of stabilization or development (Singleton 2011, 242; Epstein 2015; Epstein and Yeldan 2009). Given the focus on inflation for macroeconomic stability, there has been no need for coordination with other government policies, e.g., those concerning employment[9], wages or export objectives in order to sustain levels of demand consistent with growth (Kattel 2010, 9). This is also reflected in the position that "... the Eesti Pank should not play any role in the fiscal policy. The Fiscal Council at the Eesti Pank already has a role to play in the budgeting process." (Interviewee A) The intersection of the central bank's mandate and the fiscal policy implemented by the Ministry of Finance is the Fiscal Council, which was established in 2014, but once again was driven by the developments at the EU level (Fiscal Council 2016). As an advisory body, it is a "backroom or analysis center. ... the central bank as an independent institution will not present opinions on fiscal policy issues, it will rather do the analytical work." (Interviewee E) Similar non-coordination of the financial stability policy with other policies could also be observed within the Ministry of Finance:

> Maybe inside the house [Ministry of Finance] there is not so much cooperation. As one of the main roles of the Ministry of Finance is the budgeting and tax policy, but as the financial sector is pretty much out of this, we are not directly engaged in state budgeting and taxation, perhaps, to some extent, we do deal with taxes, whereas within the Ministry there is not much communication. All the communication is targeted outwards [towards the EU and Nordic countries]. (Interviewee B)

Thus, as a testimony to the dominance of foreign capital in the banking industry in Estonia, "... the Ministry of Finance and the Eesti Pank do cooperate, but maybe not as intensively [as with foreign public institutions in cross-border banking supervision]." (Interviewee B)

Focus on abstract macroeconomic indicators has likewise drifted the bureaucracy away from the social partners and has undermined their administrative capacity to engage in any meaningful cooperation with the representatives of the industry or research arena, which limits the possibilities for consensus-based new or refurbished policy toolbox (Kattel 2010; Karo et al. 2015; see below on engagement). This reveals a connection between the capacities of the state and the character of policy goals (see Skocpol 1985), whereby reliance on simple economic orthodoxy, which could fairly

[8] With the accumulation of retained earnings from FDI, the anticipation of reversed capital movements can put further pressures on taxes (see e.g., Kregel 1996; Cerny 1994).

[9] This is a particularly sensitive issue, given the Estonian trade balance deficit for approximately two last decades as a counterpart for heavy reliance on foreign capital inflows that implies a net transfer of employment to trading partners and hence a loss for some circles of workers and businesses (see Friedman 2008, 56).

easily be transferred from abroad, has implied a policy-making style with little research, relatively short deliberation and lacking consultation, and hence, the incapacity to deal with complex issues in Estonia.

Finally, with inactive monetary policy, the Eesti Pank has not been able to influence monetary aggregates on financial markets and hence, the financial stability. By leaving both the interest rates and the distribution of credit to particular sectors and also the liabilities (leverage) of commercial banks out of the central bank's purview and thereby to be determined by foreign actors, including foreign-owned subsidiaries and their parent banks, the central bank has not tackled the complexities and uncertainties in the relations between the productive economy and finance. In particular, not enough attention has been paid to the flows of funds in aggregate and between the sectors. Hence, the negative effects of debt accumulation on the economy and ensuing imbalances between assets and liabilities, but also in currency and maturity positions have gone unaddressed[10]. Moreover, the anti-inflationary policy followed by the central bank has implicitly favored financial institutions that despise inflation more than other actors (see Jayadev 2006; Epstein 2015). In other words, for about two decades there was insufficient focus on wider sectoral and system-wide risks[11] stemming from unfettered finance with no use of macroprudential instruments. With regard to macroprudential regulation and supervision, there was a "... conceptual change, and policy direction started to deal with it four or five years ago after the crisis. The central bank's role in Estonia has been supplemented, as before, there was no direct macro-financial supervision. ... [formerly] banking regulation was applied to manage the disequilibria risks in the economy." (Interviewee E) As with the rest of the financial regulation, macroprudential supervision with the implementation of different measures by the central bank has been undertaken as a result of the reforms at the EU level. Yet, the necessity and relevance of it in Estonia has still been questioned:

> ...it [macroprudential regulation and supervision] certainly increases the credibility and, it is particularly important and useful in the context of large financial institutions, which we do not have on the market. ... insofar the market is concentrated and small, the 'odor' of a systemic crisis immediately arises once a larger market actor faces some troubles. (Interviewee C)
>
> In a small environment like ours, those boundaries [between micro- and macroprudential supervision] are blurred. ... for example, what the Financial Supervision Authority is able to achieve with a micro-surveillance, is exactly the same as it would do with macro-instruments. There are so few actors on the market and those few have at the same time a large market share. The whole topic is so unimportant for Estonia. (Interviewee F)

As seen, the FDI-aligned 'monetarist' policies have focused on abstract targets without factoring in the variables and systemic aspects of the real economy or even worse, have tended to be fragmented[12]. Such a 'linear' thinking – foreign savings as a solution to scarce domestic savings to undertake investment activities under the

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[10] See Davies and Green (2010), also Crockett (2003) on the central banks' monetary and stability policies in general.

[11] One of the few instances of acknowledging this issue, although only within the financial sector can be found in the explanatory memorandum 795 SE of Creditors and Credit Intermediaries Act of 2014. It stated that considering the complexities of financial markets and interrelatedness of economic agents, indications of lost credibility in one segment of the financial market can be spread to and negatively affect other actors in the financial market.

[12] See Bhaduri et al. (1992) on similar issues in CEECs; also Reuschemeyer and Evans (1985), Skocpol (1985) and Hudson (2006) on general discussion.

liberalized capital account regime – did not reckon the risks and systemic interdependencies it causes within the complex system of feedback loops and unintended consequences. In this respect, the ideational position and institutional understanding of the economy in Estonia could be described as reflecting equilibrium, where causes are linear and change comes from exogenous variables (see Blyth 2010; Cartwright 2007 on the features inherent to non-ideational theories). Therefore, the possibilities of reducing uncertainty by meeting the institutional actors' expectations, e.g., on prices and liquidity (see Minsky [1986] 2008; Thabet 2006; Chwieroth 2009), or of addressing the issues of exchange rate appreciation and external imbalances (see Bresser-Pereira 2014), but also of disequilibrating saving preferences and debt-deflationary developments (see Kregel 2010; Wray 1998; Hudson 2006) have been severely impaired due to self-imposed (demand) constraints. In fact, none of the issues listed above are part of the financial policy discussion. All this reflects the lack of consensus politics (see Menz 2005, 28; Chwieroth 2009, 64 on that), as manifest in missing Keynesian-style adjustment, state interventionism, and neo-corporatist elements.

These choices, which were made for monetary and fiscal regime, shaped institutions and practices, which in turn took a path-dependent nature in Estonia in terms of paradigmatic continuity (Raudla and Kattel 2011; Feldmann 2007). The set-up of key institutions was established by right-wing coalitions in the 1990s, and ever since no shifts have occurred in the balance of power that would have allowed for radical shifts in institutions. Coming up with novel policy solutions to socio-economic problems has been restrained by dogmatic stance, vested interests and historical legacies that put the brakes on institutional transformation[13]. What has taken place is institutional conversion (see Streeck and Thelen 2005), i.e., policy adaptation and alignment of institutions along the interests of new actors[14]. Hence, different problems and challenges have been approached with *one-size-fits-all* solutions in Estonia. In this regard, one can observe institutional complementarities (see Hall and Soskice 2001) in terms of the transferability of institutional approach from the whole economy to the financial sector, in particular. The next section takes a closer look at the bureaucracy's ideas on the financial sector and how these have been affected by both the regulatory convergence and the dominance of foreign capital in banking.

3. The Implication of the Regulatory Convergence and Capital Inflows – Standing of the Estonian Financial Bureaucracy

As was shown above, adherence to neoliberal ideas in domestic macroeconomic policies has to a great extent been supported by the internationalization processes (see also Mjøset 1996). Likewise, decision makers' discourse in justifying financial reforms in Estonia was built around the EU conditionality for the transposition of the

[13] For instance, even if policy-makers have turned their focus to advocating an alternative SME-focused development strategy, such post-FDI policy has been built around the support of the EU Structural Funds. Thereby, one could observe an institutional gearing towards financial support dependency (Varblane 2013).

[14] This is revealed in the central bank's adjusted operations after joining the eurozone, including also in activities related to the ECB's policy of quantitative easing, as well as post-2004 period practices after joining the EU with the incentive for public institutions to reconfigure their focus on absorbing the EU funds.

EU legislation as a prerequisite for accession into the EU[15] (Feldmann 2013). In this respect, the EU regulations could be seen as an exogenous entity to explain the regulatory transformation at the national level. As commented by one of the interviewees:

> if you look at the share of Estonian law in the financial sector legislation, 95 per cent of it is the European Union law. There is hardly any domestic invention ... thus, the Parliament's role in Estonia will disappear altogether. ... in the legislative terms, as far as the banks' capital issues are concerned, the role of member states has shrunk. Also, the role of the Ministry of Finance in this regard has decreased. (Interviewee F)

The EU-driven developments in the financial regulation in Estonia could be summed up with the statement: "... because the regulation of the financial sector has been largely formulated at the EU level, the initiatives and changes generally start from there. In this sense, we cannot talk about very independent Estonian reforms and initiatives." (Interviewee B) On top of that, even "… in our own initiatives, we did not perceive how much the frames of the European Union actually restricted us." (Interviewee E) These statements raise the issue of lost national autonomy in relation to the harmonization process and indicate that the reliance on the EU makes the adoption of other practices and conditions less likely, as asserted by one of the interviewees: "... insofar there are various directives on the board to be addressed, other things get in a jam, so to say." (Interviewee D)

3.1 Small states, legalism and policy coordination

On the one hand, such a path-dependency in policy devising could be explained from the *small states* perspective (see Randma-Liiv 2002; Kattel et al. 2011, 8–11), but on the other hand, with the *legalist* reasoning in the financial regulation. The *small states* argument is associated with the issue of lacking human resources and capabilities. As attested by interviewees, "I do not see that state capacities would grow. … officials will have to adjust. … the administrative burden is really high and because of that, fewer other things can be undertaken. For me this is the biggest problem." (Interviewee E) or "...some of the [EU-posed] requirements and obligations might be beyond our capabilities." (Interviewee B) On top of this, two senior civil servants interviewed at the Ministry of Finance admitted that their educational background was not in any way connected with the tasks assigned to them at work. As a testimony to that "… [with regard to] the financial sector, I basically began [working for the Ministry of Finance] from scratch." (Interviewee D) Or in the words of another official,

> I have not come across many of those who are familiar with the financial sector regulation and supervision peculiarities, when hired. The situation at the Eesti Pank is even worse, because usually people have not heard anything on the topic of macroprudential supervision, and in this sense practical experience is needed, and for that we send people to learn these things abroad. (Interviewee E)

The legalist approach, on the other hand, is related to the dominance of law in the educational background of financial regulators. This explains to some extent, why civil servants follow law-related rather than economics-related academic discussions

[15] Such a practice has resembled older EU member states, where domestic actors have used European integration and globalization discourses to implement banking sector reforms (see Lynggaard 2013).

(Interviewees C and B) and why the Ministry of Finance who is responsible for shaping the legal environment of the financial sector does not use any model for financial stability indicators or as a tool for obtaining input into legislative process (Interviewees A, C and D). As one official noted, "... the impact analysis was there [in legal drafts], which is mandatory in the legislative drafting ... but I did not come to any contact with such models in my work [at the MoF]." (Interviewee D) Even when the analyses are conducted, the impacts on the local financial market, state budget and economic growth are mainly assessed in the explanatory memos to legal acts. Thus, the understanding of the financial regulation primarily reflects the legal-normative perspective and less the macro-financial perspective, which in turn explains why there is little coordination across ministries and various policy domains (see above), except for coordination within the 'troika' of the MoF, the central bank and the FSA (Interviewees B and E). Still, from the institutional perspective, there are issues such as the division of tasks and financial stability mechanisms where consensus is yet to be reached. For instance, the views expressed on the mandates and functions of the FSA in areas such as payday loans and cyber currencies, or the institutional status and affiliation of a Guarantee Fund still cause discontent and also tend to be different (Interviewees B, E and F).

Likewise, anchoring to the EU regulations has not necessitated the build-up of coalitions or networks for achieving compromises or opening ways for institutional change. As explained above, this discloses meager coordinative discourse, which has been backed by some peculiar institutional features such as centralized and unitary state, power concentration in the executive branch and statist policy-making[16]. That said, all interviewees stated that the engagement of social partners such as the representatives of the financial sector in the policy formation process has been quite extensive, particularly for the last ten years. However, this has rather taken place due to legal requirements and hence tends to bear a character of a mere formality. One of the interviewees stated:

> it [drafting of legal acts)] is often done quietly in the Cabinet's back office based on their [policy-makers] own discretion. ... I felt then and still feel today that it often happens that you work on a draft and talk to people at the ministry and one moment you just come out with it, but in fact, one could have involved [stakeholders] in the formalization of ideas beforehand so to get feedback and save energy. (Interviewee D)

Another official noted that "there are quite many and various partners, but it [communication with and involvement of stakeholders] has not been our main function here [at the MoF], it is rather a secondary task, although in the future we intend to put more emphasis on that." (Interviewee B)

In addition, one of the interviewees pointed out that the engagement of external experts is both administratively and financially burdensome to public institutions. Namely, "if [external experts are] involved, one has to pay remuneration. There are also administrative restrictions that are troublesome. At the same time, the value added from the engagement [of external experts] might not be significant at all. Partly, it [financial regulation] is a very specific topic, and so everyone cannot contribute to it." (Interviewee A) The last aspect has been particularly emphasized, as attested by one of the respondents:

[16] See Schmidt (2002a, 230-246), Campbell and Pedersen (2010), Swank (2002) on the inherent elements of coordinative and communicative discourses.

> ... it often happens that because of the small financial sector and a narrow range of financial services ... and also a lack of complex financial instruments on the market, there is no expert knowledge available. People do not know what to think about some kind of proposal and then it happens that there is not anybody to have a discussion with. (Interviewee B)

In that respect, neither the Ministry of Finance nor the central bank hold discussions with academic circles or other external expert groups, as these institutions rely mostly on the in-house expertise and analyses (Interviewees E and B).

At the same time, the technicality of the financial regulation has gradually taken the issue off the political agenda. Policy formation at the political level is not very systematic, as the topic of financial regulation is considered not important or not understood at all (Interviewee A). This is because "the initiatives of the European Union and the resulting documents are so voluminous, specific and linguistically complex that most politicians are not even able to read the materials." (Interviewee C) Not to mention the low appeal of the topic and hence the lack of political motives: "... the area is such that it is not politically very sexy... it is such a niche topic you could say" (Interviewee D) or "... the area is sufficiently specific and complex, the effect of which is great, but it is not easy to sell it to voters. ... politicians understand that you would not gain votes with these topics, so they do not interfere." (Interviewee B)

In light of such institutional tendencies for non-corporatist interest mediation, the *knowledge regime* (see Campbell and Pedersen 2010, 179) tends to be determined externally through adherence to outside rules and standards. At the same time, the financing of economic growth has also been subjected to strategies and decisions made by non-residents, as any activist industrial policies have been relinquished (Feldmann and Sally 2002; Kattel 2015, 141; King 2007). In this regard, the foreign-controlled financial sector poses challenges for policy-makers in terms of steering the developments in the banking and finance in a desired way. In particular, the 'autopiloting' nature of the financial regulation in Estonia through the attachment to the EU law (see Juuse 2016b) has not enabled it to properly address the changing contextual conditions, including those related to the issues of resolution, solvency and liquidity provision in light of cross-border banking activities.

3.2 Misplaced financial (banking) policies and adverse outcomes

One of the problems of the EU-driven banking legislation is related to the operational functionality of regulations. Although the Estonian banking legislation had adopted the universal banking model in line with the EU directives, the understanding of the economy, which was based on arm's length business relationships, gradually penetrated, as increasingly more emphasis was put on quarterly reports, greater transparency and the quality of information, reasoned by the need to reduce risks and enable better-informed lending decisions (see Chwieroth 2009; also Hall and Soskice 2001 on similar trends in advanced Western economies). This implied a gradual shift towards commercial banking activities and from the logic of voice to the logic of exit in the late 1990s, i.e., during the takeovers by Nordic banks. Thus, despite regulatory harmonization, investment banking in Estonia did not take off, which was constrained by an increasing share of deposits in the banks' structure of liabilities and the central bank's limited function of the lender of last resort (see Forsyth 2003 on factors affecting the banking models). Similarly, shallow securities markets, the restructuring of the economy towards light manufacturing and services, and mass privatization[17] that broke the existing linkages, reduced the need for universal banking services with tight links between the productive economy and finance. This demonstrates how financial regulation and the banking business got diverged[18]. In this respect one can observe both over- and misregulation of the financial sector in the case of Estonia. This problem was pointed out by most civil servants interviewed who are involved in the financial stability policy making and implementation, especially on the EU part. As claimed by one respondent, "the fact is that there is too much legislation and at the same time, the Estonian market is very small and trivial." (Interviewee F) And as an indication of misregulation, "of course, there must be basic capital requirements in place. For example, it was extremely strange that at one point there were no liquidity requirements [from the EU]. It was inappropriate liberalism." (Interviewee C) On the other hand, it has been noted that

> ... it is often the case in Estonia that we want to be an exemplary student at any cost. If there is a need for some kind of directive to be harmonized with, then we do the maximum, as foreseen in the Directive. … it seems that we have placed emphasis on the quantity rather than quality. All that comes from Europe is presented as critically important. Inevitably, there are examples of such directives, instructions and regulations that Estonia simply takes over and says that we will apply them, even though we do not have that kind of market, and this is a total waste of resources. (Interviewee D)

In this regard, one can notice cognitive dissonance or ambiguity in the positions of regulators on the transposition of the EU legislation. And where not dictated by the EU legislation, financial regulation has been reactive, which indicates the presumption of self-regulatory mechanisms in a free market environment. In general, policy-makers have rarely relied upon economic heterodoxy in presenting rationales for state intervention, partly due to their educational background. As stated by one civil servant, "the name [Keynes] came through, but otherwise it did not have any role [in the academic education]." (Interviewee D) Moreover, the pursuance of Keynesianism in the financial regulation has been seriously questioned (Interviewee A). Accordingly, the analysis of the factors that affect the shape of the regulatory environment does not reveal that economy is treated as inherently cyclical and unstable. Even the aftermath of the recent crisis has not led to drastic changes in policy-making practices (see Kivisikk 2015) or even ideas behind financial policies[19]. As noted by one official, "perhaps policy objectives have not changed, but the attitude has. If before it was thought that regulations harassed and interfered with development, then now there is a perception that they seek to ensure stability." (Interviewee E)

Thus, in view of the institutionalization of policies that favor the absorption of foreign savings – as opposed to Keynesianism –, and the embeddedness of the EU

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[17] The *Treuhand* privatization strategy for restructuring implied reliance on international financial markets and foreign investors rather than local banks (see Terk 1999; also Deeg 1999 on a similar case of Germany), which deterred the provision of bank credit to businesses. Furthermore, negative net worth of newly privatized enterprises due to the inherited liabilities of previous state-owned companies implied a hoarding of bad loans on the balance sheets of banks that were thus unwilling to extend any new loans to businesses (Bhaduri et al. 1992, 12).

[18] On other mismatches between the regulatory framework and real-life banking, see Juuse (2015).

[19] Even when significant institutional changes have been made on the regulatory landscape, e.g., the enactment of the Financial Crisis Prevention and Resolution Act in 2015, which enabled public authorities to apply early intervention measures with resolution tools, as a rule, these policies have been enforced in consequence of the EU requirements.

rules, it is not surprising that Estonia has virtually given up all administrative controls over the permissible quantity and direction of bank lending, which could have been imposed on banks. As admitted by one respondent, "if you wonder, why the bubble burst and whether one could have done something, then probably no-one could have foreseen it to such an extent. And the instruments for controlling the boom did not exist in the same form as in some other countries, such as Sweden and Denmark who had more options." (Interviewee B) Essentially, by anchoring financial policy to external developments and allowing the takeover of financial institutions by non-residents, the ability of public authorities to affect the links between banks, government, firms and households through directed credit supply and industrial policy tools has been eschewed[20] (see Avaro and Sterdyniak 2014 on similar discussion on the Banking Union in the EU; also Skocpol 1985). This way, the Estonian financial bureaucracy does not deal with financialization in almost any form, while the development of productive capital has been abandoned to be dictated by external factors, i.e., foreign investors. The issue has further been aggravated by the ineffectiveness and avoidance of policy instruments via 'regulatory arbitrage' (see Cerny 1994; Schmidt 2002a). When adopted, some of the monetary policy instruments have been inoperative, as the Nordic banks who own Estonian subsidiaries have had the option to channel credit directly to local customers and thereby bypass all credit controls (Feldmann 2013, 358). While the financial stability policy in Estonia has been considered successful, it has been admitted that "... at the same time, there are indirect factors that Estonia cannot steer." (Interviewee B) Namely, the way how the parent banks of subsidiaries and branches are managed abroad has a direct impact also on financial developments in Estonia. And furthermore, reserve and liquidity requirements as a key measure for exerting monetary control were also void in the pre-euro period, as reserve positions could have been adjusted through access to parent bank funding or international wholesale markets, which also revealed the misconception of money creation through money multiplication by the central bank (see Wray 1998, 68, 107; Singleton 2011, 131–132; McLeay et al. 2014 on money creation). This indicates the so-called 'financial trilemma' issue[21] in terms of the incompatibility of financial stability, cross-border banking and national financial regulation, and supervision (Juuse 2016b; also Schoenmaker 2011).

Thus, inadequate regulation and supervision under the general liberalization agenda have not contributed to robust 'productivity-biased' financial governance, which is essential for development and financial stability (see Burlamaqui and Kattel 2014, 189–190). On the contrary, the approach taken in financial policies has exposed the economy to several hazards. For instance, exuberant confidence building took place in light of the EU accession and embracing of the EU standards as clear signals for investors that were not factored in by policy-makers – the issue of euphoric expectations in the Minskyan sense (see Minsky [1982] 2015). Consequently, foreign capital poured in to Estonia and banks enjoyed a rapid growth of assets with the

[20] From a historical perspective, the indifference of foreign banks towards the needs of domestic industries is nothing peculiar in the liberalized economic environments, where dividend and interest payments by foreign subsidiaries constitute a significant share in net factor service (see e.g., Levy 1991).

[21] This is similar to the arguments made in the monetary regime section on the incompatibility between fixed exchange rate regime, liberalized capital movements and national policy space for countercyclical monetary and fiscal policies (see Chwieroth 2009, 64; Abdelal 2007, 75; also Wray 2014, 81).

expected higher returns from credit allocation into a booming real estate business. At the same time, the economy suffered from the weakening of labor cost competitiveness and exchange rate appreciation (Gabrisch 2011; Gabrisch and Staehr 2014). Furthermore, excessive growth of assets, portfolio concentration in real estate business and leveraged positions increased the fragility of the banking sector (Kattel 2010; Juuse 2015; also Tonveronachi 2016 on fragility of banks in general). Until 2011, the vulnerability of macro-finance was further affected by the maturity and currency mismatch[22] – in 2007, unhedged foreign currency borrowing constituted more than 70 per cent of all private sector loans in Estonia (Miklaszewska et al. 2014, 255). All these developments exposed the economy to systemic risks, influenced by the activities of banks. In particular, it was the changing financial structure (balance sheets) of economic entities that went unnoticed during the housing boom-bust cycle in the mid-2000s. Likewise, the business of payday loan operators has not been considered essential from the financial stability perspective, as "... when [such] a company goes bankrupt, it will not have a major impact." (Interviewee B) Such a micro-view, however, neglects the systemic ramifications of the increasing stock of short-term debt and hence the indebtedness of the household sector for the overall financial (in)stability (see Juuse 2015). Therefore, without a holistic understanding of the dynamics and transforming financial structures of the economy, i.e., without adequate macroprudential measures and the coordination of countercyclical monetary, fiscal and other regulatory policies, which would provide systemic safety cushions (see Tonveronachi 2016 on the latter), the government is left with bleak perspectives for mitigating the negative effects of emerging imbalances or financial crises.

4. The Missing Pieces and Concluding Remarks

Given the supply-side bias in policy approach to the economy, it is not surprising that economic practices and market relations in Estonia have been of the type of liberal market economy (LME)[23]. As described by Feldmann (2007, 331-335), LME in Estonia is revealed in low union membership, decentralized wage bargaining, low coverage of wage agreements, no social dialogue, limited coordination and underdeveloped cooperation among businesses, and an education system that fosters general skills, which form institutional complementarities in relation to each other. It is important to note that these institutional aspects, conducive for FDI-directed economic activities have underpinned disintegrated modular production processes (see Kattel 2010, 7; Kregel 1994, 37), which hinder industrialization in general and increase in technological intensity with productivity upsurges in particular[24]. Moreover, acquisitions by foreign investors have gradually displaced local input suppliers and have outsourced market making to non-residents (Juuse et al. 2014; Bhaduri et al. 1992). On that account, it is evident that the overall institutional setting in terms of industrial policy, fiscal incentives, infrastructure development, public education, R&D, etc. has neither fostered cooperation nor integrated foreign businesses into local supply chains, but has instead laid grounds for *institutional*

[22] The case of 'the original sin' – the loss of exchange rate adjustment due to currency mismatch in cash flows (see Eichengreen and Hausmann 1999; Herr and Priewe 2006).

[23] See Soskice (2007), Schmidt (2002a), Hall (2007), Hancke et al. (2007) on the main features of LME.

[24] Corresponds to an argument of a non-concurrency of interests of *developmentalist* states and FDI companies (Evans 1985).

arbitrage (see Hall and Soskice 2001, 56) for attracting foreign capital without acknowledging its hazards for economic sustainability.

So, which pieces in the understanding of the economy have gone lost, given the adopted policy approach and embedded economic practices? Aside from the EU-driven initiatives in the innovation policy area, economic policies have in general delivered a micro-level perspective by aiming at isolated, abstract categories rather than interrelated structures on the sectoral (meso) level. This gives rise to a fallacy of composition issue, but also reflects an inadequate institutional approach, i.e., lacking realization of the compound structure of the economy with multiple interdependent relations through transactions, balance sheets and financial balances (see Godley and Lavoie 2012 on capitalist institutional complexities). Policy-makers have lacked a *Minskyan* systemic view (see Minsky 1996, 77; also Burlamaqui and Kattel 2014, 189; Dos Santos and Macedo e Silva 2009) in terms of not considering the relationships between the balance sheets of various sectors and the changing stocks of assets and liabilities, accompanied by concurrent adjustments in cash flows and debt payments. In Estonia's case, there has been a mere focus on GDP growth figures without factoring in the institutional creditor and debtor relations and hence, the implications of financial imbalances of institutional sectors – households, financial institutions, government, and non-financial corporate sector – for financial stability. In this regard, the institutionalization of monetary and fiscal conservatism, including insufficient focus on asset price movements, has been at odds with the essence of public finance within the frames of the financial balances identity[25]. In other words, the capacity of policy-makers to affect balance sheet operations and flows of funds for the purpose of addressing insolvency and illiquidity problems that stem from balance sheet disequilibrium has been limited. The most apparent indication of this is a missing *buffer stock policy* in Estonia (see Lavoie and Godley 2006; Godley and Lavoie 2012 on institutional buffers) – there have been no government securities such as bonds or bills to offset the economic agents' unfulfilled saving expectations. And while there is a potential for a currency board arrangement to act as a buffer stock policy (see Wray 1998, 10), it was inoperative due to liberalized capital account transactions and passive employment coordination in the export sector, implying hardly any automatic stabilizers in Estonia.

Likewise, indifference towards the institutions of public finance has rendered the government incapable of addressing the boom-bust cyclicality stemming from the changing financial structures of economic entities. In view of unfettered credit creation by foreign-owned banks and the recycling of accumulated savings, the economy has been made vulnerable to asset-price inflation and debt-deflation cycle, accompanied by both internal and external imbalances[26]. The latter have been affected by cross-border capital flows, which are geared at meeting domestic demand and

[25] Sectoral financial balances identity – Private Financial Balance (net saving) = –Government Financial Balance (government budget deficit) + Current Account Balance (surplus) – as a proxy of adjustments in net financial assets and hence financial fragility (Dos Santos and Macedo e Silva 2010; Wray 1998; Tymoigne 2014). See also Kregel (2010) on fiscal responsibility.

[26] Development strategy built around foreign investments, including profit reinvestments from FDI, implies an allocation of an increasing share of national income to servicing foreign liabilities, which accumulate at compound rates and thereby give rise to deteriorating balance of payments position with increasing claims on reserves (Kregel 1996, 58–59; Friedman 2008, 56; Piketty 2014; similar arguments by Palley 1996, 213; Hudson 2006, 108–116; Davies and Green 2010, 125).

banking finance that increasingly targets households[27], implying the double effect on the speculative position of the economy. At the same time, industrial frames in terms of output structure, the level of competition and capital ownership configuration have been left out of purview (see Bhaduri et al. 1992 on CEECs' experience), which is a testimony to non-existent industrial policy in terms of no credit rationing or channeling, no use of devaluation and non-existent subsidies, except for those funded by the EU in some sectors. It thus follows that little consideration has been given to the institutional profile of the country from its innovation or financial position regardless of the fact that the speculative profile[28] of the Estonian economy would require a robust structure of assets in terms of technological level and production profile, which would suffice to cover foreign liabilities.

4.1 Concluding remarks

Extensive reliance on foreign capital inflows and the Europeanization and convergence processes in Estonia have essentially hollowed out policy-makers' institutional understanding of money, finance, banking and the market economy in general. More importantly, the state and its capacities have been impaired as a result of these processes. The established institutional environment has not equipped the government with many options or tools to reduce uncertainty and fluctuations, absorb financial shocks or bring stability into expectations[29]. On the contrary, one can observe self-imposed constraints for affecting the developments in the economy or for alleviating internal and external imbalances. Both the degree of uncertainty and disequilibrating tendencies have further been aggravated by uncoordinated policy-making in economic affairs and also by inadequate financial governance in terms of steering the developments in the sphere of finance. Without coordinated approach to labor, financial and product markets, the exposure of the economy to systemic risks and financial fragility is amplified, in particular in the context of a low diversity of economic activities and privatized Keynesianism (Kattel 2010, 5; Juuse 2015). The latter is revealed in the rising household indebtedness, developments dictated by foreign capital and the speculative profile of the economy as some manifestations of the financialization phenomenon, which public authorities have disregarded. In this respect it can be observed, how an insufficient systemic approach in financial, industrial, employment and other policies corresponds to the fragmented and disintegrated productive economy that has slowly detached from the local financial industry. On the whole, policy-making that has resulted both in over- and misregulation, has first and foremost lacked a holistic, system-wide view on the relationship between the financial sector and other institutional sectors; and second, it has missed the implications of market and non-market institutions for the financial and development profile of a country.

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[27] In light of soaring housing and consumption credit, the impaired *hedge* financing profile of households implies increasing financial fragility that may culminate in the cross-sectoral crisis, as happened during the 2007/09 financial meltdown in Estonia.

[28] See Juuse (2015) on Estonia's case and Minsky (1992), Kregel (2006), Kattel (2015) on general discussion on financing profiles.

[29] To some extent, this explains the absence of sophisticated financial instruments on the market, despite those instruments being regulated due to harmonization with the EU directives (see Juuse 2016b).

Acknowledgements

The research leading to these results has received funding from the Norwegian Financial Mechanism 2009–2014 under project No EMP264.

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Interviews

Interviewee A: Higher civil servant at the Ministry of Finance, 22 September 2014.

Interviewee B: Higher civil servant at the Ministry of Finance, 25 September 2014.

Interviewee C: Senior civil servant at the Ministry of Finance, 30 September 2014.

Interviewee D: former senior civil servant at Ministry of Finance / banking representative at the Estonian Banking Association, 16 October 2014.

Interviewee E: Higher civil servant at the Bank of Estonia, 9 October 2014.

Interviewee F: Higher civil servant at the Financial Supervision Authority, 6 October 2014.

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E-mail:	egert.juuse@ttu.ee

2. Education and academic degrees

2011 –	Tallinn University of Technology, Public Administration (technology Governance), PhD
2006 – 2010	Tallinn University of Technology, Technology Governance, Master's degree (cum laude)
2002 – 2006	Tallinn University of Technology, Public Administration, Bachelor's degree (cum laude)

3. Language skills

Estonian	Native language
English	Proficient
Russian	Proficient
Finnish	Beginner

4. Employment

2010 –	Tallinn University of Technology, Faculty of Social Sciences, Ragnar Nurkse School of Innovation and Governance, Chair of Innovation Policy and Technology Governance; Junior Researcher Fellow (1.00)

2010 –	Estonian Athletics Association - member of the board of International Technical Officials (0.05)
2007 – 2010	Tallinn University of Technology, Faculty of Social Sciences, Ragnar Nurkse School of Innovation and Governance, Chair of Innovation Policy and Technology Governance; Specialist (1.00)

5. Selected scientific projects

2015 – 2016	Norwegian Financial Mechanism 2009-2014 under project No EMP264, researcher
2012 – 2016	FP7 research project "Financialisation, Economy, Society and Sustainable Development" (FESSUD), researcher
2009 – 2011	TUT coordinator and implementer of the project 1.2.0402.09-0046 on Innovation capacities

6. Academic administration

2010 –	Member of defense commission of Technology Governance (MA)
2009 –	Technology Governance (MA) program manager
2009 –	Member of the commission of curriculum, Faculty of Social Sciences

7. Defended theses

2010	The Risks and Failures of External Financing of Development in Small States – The Case of Baltic States, (MA), (sup) Rainer Kattel, Tallinn University of Technology, Faculty of Social Sciences, Ragnar Nurkse School of Innovation and Governance
2006	Balanced Scorecard in the Context of New Public Management Paradigm – Opportunities, Drawbacks and Challenges, (BA), (sup) Rainer Kattel, Tallinn University of Technology, Faculty of Humanities, Department of Public Administration

8. Supervised theses

2015	Kaisa Kivisikk, Majandusliku ebastabiilsuse hüpotees ja turutõrgete kontseptsioon riigipoolse sekkumise põhjusena ning sekkumisviisid Eesti kiirlaenuturu regulatsioonide näitel, (MA), (sup) Egert Juuse, Tallinn University of Technology, Faculty of Social Sciences, Ragnar Nurkse School of Innovation and Governance
2013	Mariliis Kampus, The Usability of the Patient Centric Telemedicine Monitoring Solution for Diabetes – The Case of E-Medic, (MSc), (sup) Peeter Ross, Egert Juuse, Tallinn University of Technology

9. Teaching

2016	Case Studies in Technologies and Industries (Master's level) and Case Studies in Business, Government and International Economy (Master's level) (in English)
2012	Introduction to Heterodox Economics (Batchelor's level)
2014 –	Graduate Seminar (Master's level) (in English)

10. Publications

Juuse, E. 2016. "Regulatory Convergence, Financialization and Hollowing Out of the State: The Case of Financial System in Estonia." *Halduskultuur – Administrative Culture*, xx-xx *(forthcoming)*.

Juuse, E. 2016. Financial regulation in Estonia - a 'world of "dead letters"': the interplay of Europeanization process and national idiosyncrasies. In R. Kattel, J. A. Kregel, M. Tonveronachi (eds). *Financial Regulation in the European Union.* London; New York: Routledge Taylor & Francis Ltd., 132-162.

Juuse, E. 2016. The real sector developments in Estonia: financialisation effects behind the transition process. In: E. Hein, D. Detzer, N. Dodig (eds). *Financialisation and the Financial and Economic Crises: Country Studies.* Cheltenham, UK; Northampton, MA: Edward Elgar Publishing, 137-162.

Juuse, E. 2015. “'Latin Americanization' of the Estonian Economy - Institutional Analysis of Financial Fragility and the Financialization Process.” *Journal of Post Keynesian Economics*, 38 (3), 399−425.

Juuse, E. and R. Kattel, R. 2015. “Implications of the Transformation of the State-Owned Banking System into System of Foreign-Owned Banks in New Member States for Macroeconomic and Financial Stability.” *FESSUD Working Paper Series*, 103, 1−105.

Juuse, E., S. B. Endresen and R. Kattel. 2015. “Foreign Direct Investment in Estonia - Understanding the Impact of Public Policies on Local Embeddedness and Networking in the Food Retail and Related Industries.” In G. Micek (ed). *Understanding Innovation in Emerging Economic Spaces. Global and Local Actors, Networks and Embeddedness*. Farnham: Ashgate Publishing Ltd., 97-118.

Juuse, E., S. B. Endresen and R. Kattel. 2015. “Twenty Years of the Restructuring of the Estonian Food Retail Industry - the Interplay of the Political Economy of Estonia and the Institutional, Historical and Geographical Factors.” In G. Micek (ed). *Understanding Innovation in Emerging Economic Spaces. Global and Local Actors, Networks and Embeddedness*. Farnham: Ashgate Publishing Ltd., 119−142.

Juuse, E. and R. Kattel. 2014. “Financialisation and the Financial and Economic Crises: The Case of Estonia.” *FESSUD Studies in Financial Systems*, 20, 1−117.

Juuse, E. and R. Kattel. 2013. “The Estonian Financial System.” *FESSUD Studies in Financial Systems*, 1, 1−188.

ELULOOKIRJELDUS

Egert Juuse

1. Isikuandmed

Sünniaeg ja -koht:	15.03.1982, Tallinn
Kodakondsus:	Eesti
Aadress:	Ragnar Nurkse innovatsiooni ja valitsemise instituut, Akadeemia tee 3, 12618 Tallinn, Eesti
E-post:	egert.juuse@ttu.ee

2. Hariduskäik

2011 –	Tallinna Tehnikaülikool, Avalik haldus (tehnoloogia valitsemine), PhD
2006 – 2010	Tallinna Tehnikaülikool, Tehnoloogia valitsemine, magistri kraad (*cum laude*)
2002 – 2006	Tallinna Tehnikaülikool, haldusjuhtimise õppesuund, bakalaureus (*cum laude*)

3. Keelteoskus

Eesti keel	Emakeel
Inglise keel	Kõrgtase
Vene keel	Kõrgtase
Soome keel	Algtase

4. Töökogemus

2010 –	Tallinna Tehnikaülikool, Sotsiaalteaduskond, Ragnar Nurkse innovatsiooni ja valitsemise instituut, Innovatsioonipoliitika ja tehnoloogia valitsemise õppetool; Nooremteadur (1.00)

2010 –	Euroopa Kergejõustikuliit, Euroopa Kergejõustiku Assotsiatsioon - rahvusvaheline tehniline esindaja, paneeli liige (0.05)
2007 – 2010	Tallinna Tehnikaülikool, Sotsiaalteaduskond, Ragnar Nurkse innovatsiooni ja valitsemise instituut, Innovatsioonipoliitika ja tehnoloogia valitsemise õppetool; spetsialist (1.00)

5. Valitud teadusprojektid

2012 – 2016	FP7 uurimisprojekt "Finantsialiseerumine, majandus, ühiskond ning jätkusuutlik areng (FESSUD)," põhitäitja
2015 – 2016	"Norra ja EMP finantsmehhanismide teaduskoostöö toetus" projekt EMP264; põhitäitja
2009 – 2011	AR9116 "Tallinna Tehnikaülikooli ja Tartu Ülikooli innovatsiooni valdkonna õppekavad arendus innovatsioonivõimekuse ja teadlikkuse tõstmiseks koostöös avaliku sektori ning ettevõtlusorganisatsioonidega (1.09.2009−30.06.2013)"; koordinaator ja põhitäitja

6. Muu akadeemiline töökogemus

2010 –	Tehnoloogia valitsemise (MA) õppekava kaitsmiskomisjoni liige
2010 –	Tehnoloogia valitsemise (MA) õppekavajuht
2009 –	Sotsiaalteaduskonna õppekavakomisjoni liige

7. Kaitstud lõputööd

2010	The Risks and Failures of External Financing of Development in Small States – The Case of Baltic States, (magistrikraad), (juh) Rainer Kattel, Tallinn Tallinna Tehnikaülikool, Sotsiaalteaduskond, Ragnar Nurkse innovatsiooni ja valitsemise instituut
2006	Tasakaalus Tulemuskaart Uue Avaliku Halduse paradigma kontekstis – võimalused, puudused ja väljakutsed, (bakalaureusekraad), (juh) Rainer Kattel, Tallinna

	Tehnikaülikool, Humanitaarteaduskond, Avaliku halduse instituut

8. Juhendatud väitekirjad

2015	Kaisa Kivisikk, Majandusliku ebastabiilsuse hüpotees ja turutõrgete kontseptsioon riigipoolse sekkumise põhjusena ning sekkumisviisid Eesti kiirlaenuturu regulatsioonide näitel, (magistrikraad), (juh) Egert Juuse, Tallinna Tehnikaülikool, Sotsiaalteaduskond, Ragnar Nurkse innovatsiooni ja valitsemise instituut
2013	Mariliis Kampus, The Usability of the Patient Centric Telemedicine Monitoring Solution for Diabetes – The Case of E-Medic, (magistrikraad), (juh) Peeter Ross, Egert Juuse, Tallinna Tehnikaülikool

9. Õpetamine

2016	Tehnoloogia ja tööstus. Juhtumiuuringud Ettevõtlus, valitsemine ja rahvusvaheline majandus. Juhtumiuuringud (mõlemad magistri tase; inglise keeles)
2013	Sissejuhatus heterodoksesse majandusteadusesse (bakalaureusetase; eesti keeles)
2014 –	Magistriseminar (magistri tase; inglise keeles)

10. Publikatsioonid

Juuse, E. 2016. “Regulatory Convergence, Financialization and Hollowing Out of the State: The Case of Financial System in Estonia.” *Halduskultuur – Administrative Culture*, xx-xx *(avaldamisel)*.

Juuse, E. 2016. Financial regulation in Estonia - a 'world of "dead letters"': the interplay of Europeanization process and national idiosyncrasies. In R. Kattel, J. A. Kregel, M. Tonveronachi (eds). *Financial Regulation in the European Union.* London; New York: Routledge Taylor & Francis Ltd., 132-162.

Juuse, E. 2016. The real sector developments in Estonia: financialisation effects behind the transition process. In: E. Hein, D. Detzer, N. Dodig (eds). *Financialisation and the Financial and Economic Crises: Country Studies.* Cheltenham, UK; Northampton, MA: Edward Elgar Publishing, 137-162.

Juuse, E. 2015. “'Latin Americanization' of the Estonian Economy - Institutional Analysis of Financial Fragility and the Financialization Process.” *Journal of Post Keynesian Economics*, 38 (3), 399−425.

Juuse, E. and R. Kattel, R. 2015. “Implications of the Transformation of the State-Owned Banking System into System of Foreign-Owned Banks in New Member States for Macroeconomic and Financial Stability.” *FESSUD Working Paper Series*, 103, 1−105.

Juuse, E., S. B. Endresen and R. Kattel. 2015. “Foreign Direct Investment in Estonia - Understanding the Impact of Public Policies on Local Embeddedness and Networking in the Food Retail and Related Industries.” In G. Micek (ed). *Understanding Innovation in Emerging Economic Spaces. Global and Local Actors, Networks and Embeddedness*. Farnham: Ashgate Publishing Ltd., 97-118.

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Juuse, E. and R. Kattel. 2014. “Financialisation and the Financial and Economic Crises: The Case of Estonia.” *FESSUD Studies in Financial Systems*, 20, 1−117.

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