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Western Banks in the Baltic States: a preliminary study on transition, Europeanisation and financialisation

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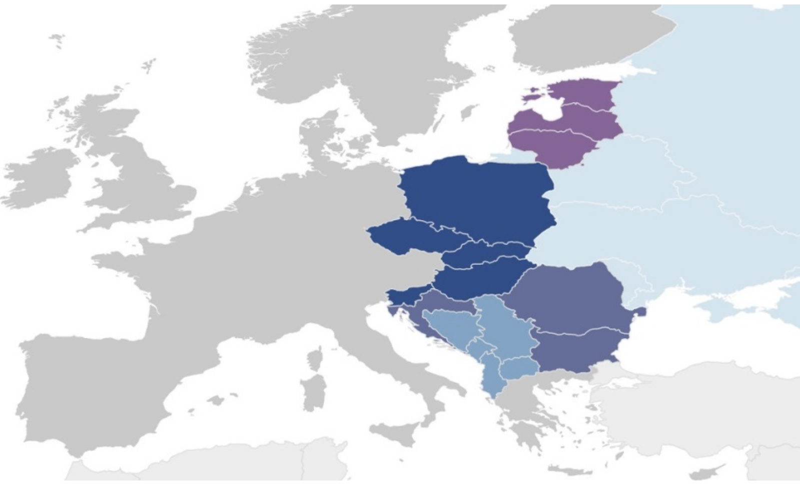

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Western Banks in the Baltic States: a preliminary study on transition, Europeanisation and financialisation

Leonardo Pataccini

Abstract:
Since the restoration of their independence from the USSR, in 1991, the Baltic states of Estonia, Latvia and Lithuania have gone through a tortuous process of 'transition' to establish market economies and join the European Union. However, the Baltic states represent a unique case among the transition economies of East-Central Europe (ECE) due to several factors. First, to date, they are the only former Soviet republics that managed to join the European Union. Second, since the beginning of the transition, these countries have experienced more marked boom and bust cycles than the other ECE economies. Third, the banking sector in the Baltics displays one of the highest rates of foreign penetration in the world.

Therefore, the Baltic states represent an ideal case to understand the role of Western banks in ECE and the new geographies of financialisation. Accordingly, this paper aims to analyse the main developments of the banking sector in the Baltic states. The research shows that the conditions imposed by the processes of transition and Europeanisation, as well as the role of foreign financial agents (fundamentally the role of the banking sector and FDI) have been the key factors in shaping capitalism and promoting the rise of financialisation in the Baltic states.

Keywords: East-Central Europe; Baltic states; transition; Europeanisation, financialisation; banking sector**.**
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1. Introduction

Located on the Eastern shores of the Baltic Sea, in Northeast Europe, the states of Estonia, Latvia, and Lithuania possess a history as rich as it is complex. These states proclaimed their independence for the first time in 1918 but during 1939-1944, they were successively occupied by the USSR, Nazi Germany and again the USSR. Subsequently, after more than four decades of forced annexation to the USSR, the Baltic countries[1] restored their independence in 1991. Thereafter, like most of the other centrally planned economies of East-Central Europe (ECE), these countries implemented a deep and comprehensive set of structural reforms aimed at establishing market economies.

However, the Baltic states represent a unique case among the transition economies of ECE due to several factors. On the one hand, they are the only former Soviet republics that achieved to join the European Union. On the other hand, since the beginning of the transition, these countries have experienced more marked boom and bust cycles than the other ECE economies. Finally, as pointed out by Spendzharova and Bayram (2016), the Nordic-Baltic region constitutes one of the most densely integrated and effective cross-border banking regions in the EU. In particular, the banking sector in the Baltics possesses the highest rates of foreign penetration in the world, with a clear dominion of Swedish institutions (Epstein 2013).

Therefore, it is argued that the Baltic states represent an ideal case to understand the role of Western banks in ECE and the new geographies of financialisation. Accordingly, this paper aims to analyse the main developments of the banking sector in the Baltic states and, in particular, the role of foreign banks and their broader implications for the economic evolution of these countries.

2. Transition and the early reforms

Since the early days of transition, the three Baltic states shared a common objective: joining the EU (Lane 2001, Pridham 2005). Above all, this decision was seen as the main means to achieve two specific objectives: economic development and territorial security[2] (Mole 2012; Grigas et al. 2013). Thus, from the beginning of transition, the three Baltic states applied profound reforms aimed at achieving this goal. The policies applied followed the guidelines of the so-called Washington Consensus and were based on three main pillars: a) liberalisation

[1] The terms Baltic states, Baltic republics and Baltic countries will be used interchangeably throughout the text to refer to Estonia, Latvia and Lithuania.

[2] Yet, to this latter objective, accession to NATO was also considered a priority, which the three countries achieved simultaneously in 2004 (Bilinsky 1999).

of markets, trade and prices, b) privatisation and c) economic stabilisation (Kattel 2009; Bohle and Greskovits 2012). However, despite the initial stance and objectives were very similar in the three countries, the pace of reforms was not the same. While Estonia and Latvia followed a more radical approach, the pace of reforms was somewhat slower in Lithuania (Lane 2001; Wrobel 2015).

One of the main factors to explain these differences between the three Baltic republics is their ethnic composition. During the Soviet period, there was a large relocation of Russian-speaking workers to these countries. However, these flows varied from country to country: while Latvia received a large amount of immigration, the flow of migrants was smaller in Estonia and very limited in Lithuania. Therefore, in 1989, the proportion of ethnic Latvian population in Latvia was 52%, becoming almost a minority in their own republic, while the proportion of Estonians in Estonia was 62% and that of Lithuanians in Lithuania was 80% (Solska 2011). These characteristics had direct political and social implications at the beginning of the transition. Specifically, once independence was restored, the new Lithuanian government granted citizenship rights to all ethnic minorities living in the country, while in Estonia and Latvia citizenship was only granted to those who had held citizenship in 1940 and/or their direct descendants (Chinn and Truex 1996). Subsequently, the first elections after the restoration of independence brought a clear victory for the liberal and nationalist parties in Estonia (1992) and Latvia (1993), where the Russian-speaking populations were mostly excluded. However, in Lithuania, the 1992 elections brought a victory for the successors of the Communist Party.

As argued by Bohle and Greskovits (2007), during the period of transition, Latvian and Estonian governments were able to run an extreme neoliberal model because, despite their high social costs, political stability was based on ethnic support. Moreover, the majority of the losers of the system change were industrial workers from the Russian speaking minorities and many of them did not even have citizenship and voting rights to oppose through the electoral process. On the other hand, in Lithuania, communism was not so directly connected with Russian dominion, such as in Latvia and Estonia. As a result, the transformation process in Lithuania was more gradual, aiming at controlling the social costs. For instance, the process of deindustrialisation in this country has been substantially more limited than in the two other Baltic states (Stojčić and Aralica 2017).

The three countries applied also different approaches to privatisations. While Estonia followed the most radical model, selling the state-owned assets mainly by auctions and open tenders, Latvia and Lithuania initially opted for complex systems of privatisation vouchers aimed to distribute the small and medium enterprises among their citizens (Staehr 2007). However, under EU pressure, these countries also agreed to sell state-owned enterprises to foreign investors by the second half of the decade (Wrobel 2015).

As in most post-socialist countries, one of the immediate consequences of liberalisation was the emergence of hyperinflation. In this way, in 1992 the annual inflation rate in the three countries was around 1000% (Staehr 2015). Yet, in order to fight hyperinflation, the three countries applied strict macroeconomic stabilisation programmes sponsored by the International Monetary Fund (IMF), although they followed different paths in terms of monetary reform (Knöbl and Haas 2003). In June 1992, Estonia replaced the Ruble with its own national currency, the Kroon, which had a fixed exchange rate against the German Mark. Subsequently, in 1994 Lithuania also introduced a currency board, pegging its currency, the Litas, to the dollar. Finally, in 1994 Latvia introduced a conventional fixed exchange rate tying the new currency, the Lats, to the IMF´s Special Drawing Rights (Staehr 2015).

In short, during the early years of transition, the Baltic states applied a broad set of structural reforms to establish market economies. In this context, one of the main developments of this period was the creation of the financial system and, particularly, the banking sector.

2.1. Banking sector in transition

The structure of the Estonian, Latvian and Lithuanian banking sector was very similar at the beginning of the transition, since all of them belonged to the Soviet system. However, a peculiarity of this region is that commercial banks had already been established before the collapse of the USSR. In fact, the first commercial bank of the Soviet Union was founded in Estonia in 1988, the Estonian Tartu Commercial Bank, and this trend quickly extended to the rest of the Baltic countries (Roolaht and Varblane 2009). Thus, when the Baltic countries became independent, the splitting up of the Soviet mono-banking system led to a substantial increase in the number of banks, particularly in Latvia. Already in 1993, there were 62 banks in Latvia, 26 in Lithuania and 21 in Estonia (Myant and Drahokoupil 2010). Yet, the development of the banking sector in each country began to follow divergent paths. A distinctive feature of the Latvian banking sector is that, from the beginning of the transition, a large part of it was geared towards providing offshore services to non-resident costumers, which were mainly based in Russia and other CIS countries (Adahl 2002). However, in all the countries the expansion of the banking sector was based on a weak and highly liberalized regulatory framework. Moreover, the high level of inflation during the first years of transition quickly reduced the real value of the capital requirements. Thus, establishing new banks was cheap and easy and, as a consequence of these factors, episodes of instability soon appeared.[3]

[3] For a brief account of the crises in the Baltic banking sector during the first half of the 1990s, see Fleming et al. (1997).

The first country to experience a banking crisis was Estonia, during the years of hyperinflation. In 1992-93 some large banks went down due to bad loan portfolios, while many smaller banks were affected by the lack of confidence. Subsequently, in 1995, Latvia experienced a severe banking and economic crisis when the largest bank in the country, Banka Baltija (BB), was liquidated. BB accounted for approximately 40% of the total assets and deposits in the Latvian banking system, and it was equal to 10% of the country´s GDP (Nissinen 1999). The causes of BB collapse were mainly associated with fraudulent activities. However, the BB collapse exposed the lack of proper supervision in the country. Finally, at the end of 1995, the two largest Lithuanian banks were closed by the government authorities, and the former bank managers were accused of fraud (Fleming et al. 1997).

In sum, banking crises in the Baltics had two main effects. On the one hand, they frustrated the economic recovery and deepened the effects of the transitional recessions. Consequently, in 1995, Latvia's real GDP had fallen by 50% compared to the pre-transition levels, that of Lithuania 45% and that of Estonia 35%, respectively (Svenjar 2002). On the other hand, the banking crises triggered a rash of mergers and liquidations that led to a rapid concentration and a sharp decline in the number of banking institutions in the Baltics (Fleming et al. 1997). However, far from finding stability, the Baltic banking sector was about to suffer another dramatic transformation with the outbreak of the Russian financial crisis.

3. The Russian financial crisis and the arrival of the foreign banks

During the early years of transition, the initial pattern of foreign influence in the financial sector varied among the Baltic countries. For instance, in Estonia, foreigners could purchase shares in banks from 1992, while in Latvia and Lithuania foreigners faced more restrictions to enter the banking sector (Adahl 2002). Nevertheless, until 1998, in all the three countries the domestic owners had a majority in the stock capital of the largest local banks (Myant and Drahokoupil 2010).

However, the Russian financial crisis was the ‘Bing Bang’ that transformed the banking Baltic system. Briefly, due to the effects of the Asian financial crisis and the transitional recession, in August 1998, the Russian government devalued the Ruble and defaulted on its Soviet-era debt, mainly the GKO bonds.[4] These events had a double impact on the Baltic economies. On the one hand, many Baltic exporters were dependent on Russian markets. As the Ruble lost about 70% of its value in six months, the Baltic exports to Russia declined sharply. On the other hand, many local financial firms still had strong ties with the Russian markets. In Estonia, because of the exposure to the crisis, the national government had to provide financial support

[4] GKO stands for Государственное Краткосрочное Обязательство (Government Short-Term Obligations).

to the main bank in the country, the Hansabank (Roolaht and Varblane 2009). The situation was worse in Latvia, where many local banks were providing offshore services to Russian and other CIS customers. As noted by Adahl (2002), by 1998 more than 10% of Latvian banks´ total assets were exposed to the Russian market, and more than one third of this exposure was related to Russian bonds that lost most of their value with the crisis. Particularly, Rigas Komercbanka, the fifth-largest bank in the country held 14% of its assets in Russia, and about 20% of its capital was owned by Russians. Consequently, in 1999 the central bank was forced to declare Rigas Komercbanka insolvent along with three other smaller banks, with serious effects for the financial sector and the real economy.[5] For its part, the situation was somewhat less dramatic in Lithuania. The banking and financial sector in this country was relatively less developed than in its Baltic neighbours. However, Lithuania felt the impact of the Russian crisis through the commercial channel, since Russia was its main trade partner (Taro 2002).

In summary, in 1998 the banking system of the Baltic countries was greatly weakened both by the transitional recession and by the impact of the Russian financial crisis. In this context, the governments of the Baltic countries saw the Nordic banking groups as strategic investors for the restructuring and consolidation of the banking system (Sheridan et al. 2004). More importantly, this perspective was shared by the EU in light of their possible accession (Jacoby 2014; Bohle 2018). Therefore, the Russian financial crisis was the turning point that triggered the foreignization of the Baltic banking system. Once in motion, this process was largely dominated by two Swedish institutions: Swedbank AB and SEB Group, which will be examined in a little bit more detail below. The list of western banks that have been active in the Baltic countries since then also includes Danske Bank (Denmark), Nordea (Finland), DNB (Norway) and UniCredit (Italy). Subsequently, in October 2017, Nordea and DNB combined their Baltic business and created Luminor Bank AS (for the market share of these banks in the Baltics see also appendix 3 and 4).

3.1. The Swedbank group

Swedbank AB was formed in 1997, after the merger between Sparbanken Sverige and Föreningsbanken. In turn, Sparbanken Sverige was the result of the mergers of 500 savings banks over the period 1820-1995, while Föreningsbanken resulted from mergers of several cooperative banks between 1915 and 1994.[6] Despite its founding institutions didn't have any substantial international experience, already in 1997 Swedbank acquired around 40 per cent

[5] Bank of Latvia, "Par stāvokli a/s ´Rīgas Komercbanka´" [On the situation of the JSC "Rīgas Komercbanka"], available online at: https://www.bank.lv/par-mums/jaunumi/479-preses-paziojumi/5544-par-stavokli-as-rigas-komercbanka. Last accessed: 6 June 2020.

[6] "From savings bank to Swedbank", available at: https://www.swedbank.com/about-swedbank/our-history/swedbank-and-the-savings-banks.html. Last accessed: 1 June 2020.

of Hoiupank (Estonian Savings Bank) and in 1998 it obtained majority of Hansapank, the main banking group in the Baltics by the time (Roolaht and Varblane 2009).

Hansapank (Hansabank in English) was founded in Estonia, in 1991, and started independent operations in 1992. Between 1992 and 1994, Hansabank gained strong market position in this country and in 1995 it established a branch in Latvia, followed by the acquisition of another Latvian bank, the Deutsche-Lettische Bank, in 1996. That same year, Hansabank also expanded operations in Lithuania with the creation of Hansa Leasing in this country. In July 1998 Hansabank merged with Hoiupank, which already owned Zemes Banka in Latvia.[7]

As mentioned above, when the Russian crisis hit, in 1998, Swedbank AB, which already had a minority share in Hoiupank, acquired a significant part of Hansapank's share capital (Roolaht and Varblane 2009). The financial partnership with Swedbank allowed Hansabank to continue a rapid expansion in the region during the following years. Thereby, in 2000, Hansabank Latvia acquired Ventspils United Baltic Bank. Furthermore, in May 2001, Hansapank acquired 99% of the privatized Lithuanian Savings Bank, the country´s second-largest bank, and in that same year, Hansabank Group acquired the largest retail bank in Lithuania, Lietuvos Taupomasis Bankas, through the privatisation process. A decisive step in the foreignisation of the banking sector in the Baltic countries occurred in spring 2005 when Swedbank acquired 100 percent of Hansabank's shares.[8] Finally, in 2008 the Hansabank brand was withdrawn and replaced by the Swedbank brand throughout the Baltic.[9]

In the following years, Swedbank has consolidated its position as the leading banking institution in the Baltic markets. In turn, these markets have become a substantial part of Swedbank's' operations and more than 20% of its total profit is currently generated in the Baltic states (see Annex 1).

3.2. The SEB Group

SEB was founded in 1972, when Stockholms Enskilda Bank and Skandinaviska Banken merged. However, its history dates back to 1856, when the first private bank was founded in Stockholm.[10] SEB entered the Baltic market in November 1998, when it signed cooperation agreements and acquired a minority in Eesti Ühispank (Estonia), Latvijas Unibanka (Latvia), and Vilniaus bankas (Lithuania) (Adahl 2002).

7 "The Hansabank History", available at https://www.swedbank.com/about-swedbank/our-history/hansabank-history.html. Last accessed: 1 June 2020.
8 Idem
9 Idem
10 "Our history", available at: https://sebgroup.com/about-seb/who-we-are/our-history. Last accessed: 2 June 2020.

Eesti Ühispank was established in December 1992 and by 1994 it had become the second largest bank in Estonia, after Hansabank (Roolaht and Varblane 2009). In early 1998, it merged with Tallinna Pank (Estonia), obtaining also its subsidiary Saules Banka from Lithuania (EBRD 1999). Meanwhile, Latvijas Unibanka was established in September 1993, as a public bank. However, in 1995, Unibanka was reformed into a private stock company and in the next year it was listed on the Riga Stock Exchange. As a consequence, Unibanka received considerable investments from foreign institutions, such as the European Bank for Reconstruction and Development and Swedfund International AB (Sherif et al. 2003). For its part, Vilniaus Bankas was founded in 1990 by six Lithuanian publishing and printing organisations (it was initially called Spaudos bankas) and by 1997 it was one of the biggest banks in Lithuania (Roolaht and Varblane 2009).

In March 1998, Eesti Ühispank, Latvijas Unibanka and Vilniaus Bankas agreed on strategic cooperation in order to expand their operations in the Baltic market. However, when the Russian crisis hit, the plans for future cooperation and enlargements were hindered (Adahl 2002). Consequently, in late 1998 the three banks started negotiations to find a strategic partner from abroad. Initially, SEB acquired a minority in all the three banks but in the following years it took full control in all these companies and formed SEB Baltic Holding. By 2001, SEB Baltic holdings was the second biggest banking group in the Baltics and controlled about a third of the total Baltic banking sector. Since then, SEB has expanded its activities and consolidated its position in these countries. However, unlike Swedbank, SEB is a bank with longstanding international expertise and a strong corporate profile, mainly oriented towards serving large business clients and Swedish multinationals (Roolaht and Varblane 2009). Therefore, the proportion of its revenues from the Baltic countries is less significant than that of Swedbank (see Annex 2).

3.3. The Baltic banking sector at the end of the Russian financial crisis

As shown in the previous paragraphs, in the midst of the 1998 crisis, the Baltic banking sector started an intensive phase of regional consolidation led by two Swedish institutions. This process intensified in the following years and by 2002, foreign ownership exceeded 95% in Estonia, 85% in Lithuania and 70% in Latvia (Adahl 2002). This process was facilitated by several factors, such as bank failures and reduced share prices as a consequence of the crises, a conscious decision by the national authorities to open the sector to foreign investors and strengthened regulations which were harder for domestic institutions to comply with.

One of the main features of the banking sector in the Baltics after the Russian financial crisis is that both leading groups opted for expanding their operations through subsidiaries rather than branches. On the one hand, this strategy implied that they were doing long-term

investments (World Bank, 2012). On the other hand, subsidiaries are separate legal entities that must be independently capitalized. Thereby, the subsidiary model implies less financial responsibility for the parent banks (Epstein 2014). Additionally, due to their submission to local regulatory authorities, subsidiaries are licensed to engage in the full range of banking activities, providing broad access to host markets (Bonin et al 2014).

Yet, the three countries also showed some significant nuances. On the one hand, Estonia was the country with the most concentrated and foreignized banking sector. On the other hand, Lithuania possessed a less developed banking sector and it was the only country where the state remained as an important player. Finally, Latvia´s Parex banka was the only major locally owned bank, while the banking sector in this country was less concentrated that in the two others. Interestingly, all these aspects are fundamental to understand the impact of the Global Financial Crisis (GFC) in these countries.

4. Europeanisation, crisis and recovery

As pointed out in section 2, since the beginning of the transition, the Baltic states set EU accession as a strategic and priority objective. Likewise, the EU (at the time, the European Economic Community) was very responsive to the Baltic countries' aim. Thereby, in 1992 the Baltic countries were included in the PHARE program, the main pre-accession instrument financed by the EU to assist applicant countries in ECE (Grabbe 2006). Furthermore, in the following years, the ties between the Baltic countries and the EU were strengthened, including trade and cooperation agreements signed in 1992 and free trade agreements signed in 1994 (Cameron 2009). In June 1995, the three Baltic countries submitted their applications for EU membership and, as a reward for their progress in economic and political reforms, Estonia was invited to open accession negotiations in 1997, while Latvia and Lithuania were invited in 1999 (Jeffries 2002).

The prospects for EU membership had a positive impact on the Baltic economies at the beginning of the new millennium. Thus, between 2000 and 2007, the three countries experienced strong annual growth rates and this performance gained momentum after their simultaneous accession to the EU, in 2004. In this way, the average annual growth rates for the Baltic republics between 2004 and 2007 were 10.3% in Latvia, 8.5% in Estonia and 8.2% in Lithuania (Kattel and Raudla 2013). This process was driven by strong inflows of FDI, the sustained expansion of domestic consumption and the decrease in unemployment (Bohle and Greskovits 2012). In addition, during this period, the governments of the three Baltic countries adapted their monetary policies to meet the convergence criteria and adopt the euro as soon as possible: in 1999 Estonia switched anchor currency from Deutsche Mark to the common

EU currency. Similarly, Lithuania switched anchor currency from dollar to euro in 2002, and Latvia set a fixed exchange rate between the Lats and the Euro in 2005 (Staehr 2015).

Regarding the role of EU membership in this process, Cameron (2009) and Jacoby (2014) argue that the liberalisation policies promoted by the EU and the integration into the Single Market, as well as the large liquidity available for new EU members, had a strong pro-cyclical effect. Moreover, in the Baltic states this boom was also stimulated by expansionary monetary policies (Bernhardtson and Billborn 2010). Thus, the combination of these factors led to unprecedented growth rates that fuelled the expectations of a rapid economic convergence with Western European members, reinforcing the trend. However, this economic expansion was accompanied by significant macroeconomic imbalances which, to large extent, were related to the role of foreign banks in these countries.

The first aspect that should be analysed to understand these imbalances is that of FDI inflows since they have been a key factor in the configuration of the economic profile of the Baltic states. As Medve-Balint (2014) has demonstrated, the EU has been a key player in opening ECE countries to foreign investors. In particular, this was done through the financing of national investment promotion agencies and the regular reports from the Commission on countries' progress towards accession, which openly advocated privatisation, including the banking sector, and the promotion of foreign capital inflows.[11] Moreover, Jacoby (2010) and Bohle (2018) assert that the compliance with the European rules and regulations not only opened these economies for capital flows, but also provided legal security for investors. For its part, Ross (2013) argues that in some cases, such as capital requirements for mortgage lending and capital adequacy requirements, the harmonisation of Baltic countries´ norms with EU regulations led to a procyclical loosening of previously stricter national regulations and a reduction of requirements for financial institutions.

These conditions resulted in a massive inflow of FDI from the early 2000s onwards. Estonia was the most successful among the Baltic states in attracting FDI. During the period 1995-2015, the annual average of FDI net inflows to this country amounted to 8.2% of GDP. In Latvia, this indicator accounted for 4.2% and in Lithuania, 3.2% of GDP, respectively.[12] However, besides the volumes, also the patterns of the FDI inflows differed. For instance, over the period 1997-2009, 54% of total FDI inflows in Estonia were allocated to the FIRE sector.[13] Similarly, between 1992 and 2011, almost 44% of inward stocks in Latvia went to the FIRE

[11] As the author explains, these reports served as the main documents for the decision on whether an applicant country would gain candidate status or not.

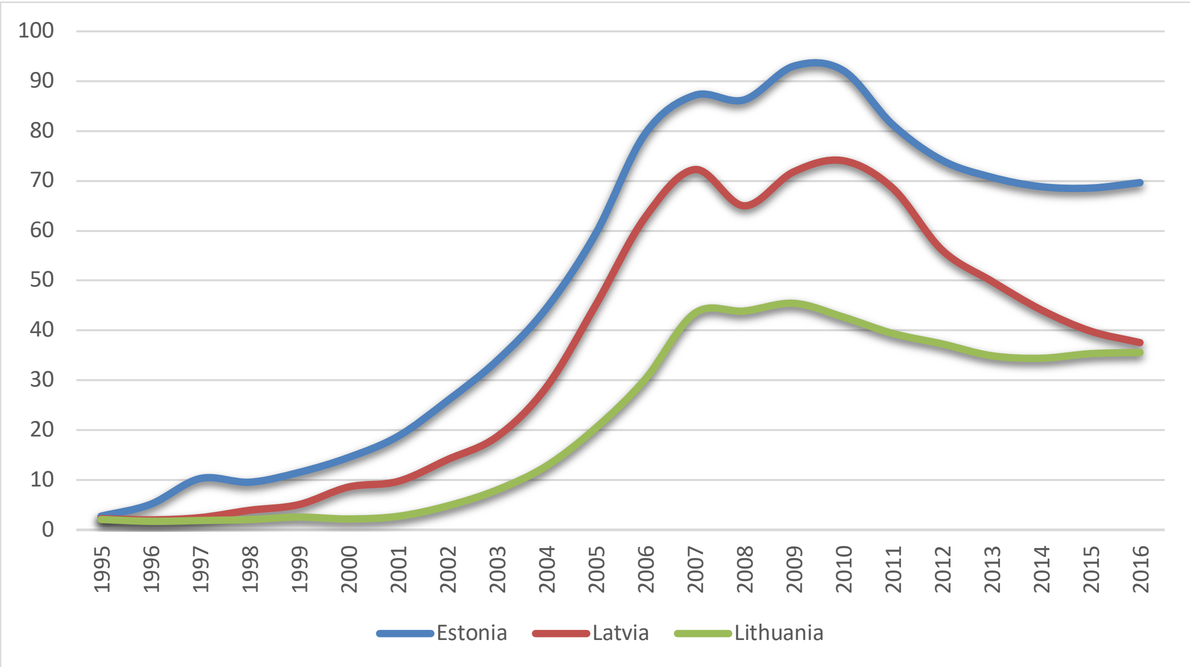
[12] Author's own calculations based on World Bank´s World Development Indicators Database [https://databank.worldbank.org/source/world-development-indicators]. Last accessed on 5 May, 2020.

[13] FIRE stands for Financial, Insurance and Real Estate activities.

sector, while only 27.5% did so in Lithuania.[14] This dynamic not only explains the rapid expansion of the banking sector before the crisis, especially in Estonia and Latvia, but also the marked dominance of foreign institutions (See Annex 3).

Since their arrival, these institutions aimed to develop the credit markets, particularly the mortgage markets (Bohle 2017). Thereby, during this period the foreign banks increased their lending activities to the private sector, mainly households. As Figure 1 shows, until the late 1990s this ratio remained moderated: by 1999, gross debt represented slightly more the 10% of households' income in Estonia, approximately 5% in Latvia and less than 2.5% in Lithuania, respectively. However, since the early 2000s, and particularly after the EU accession, the level of household indebtedness to income increased exponentially, peaking at almost 90% in Estonia, over 70% in Latvia and near to 45% in Lithuania. Meanwhile, annual credit growth to the private sector increased at a rate of 50% to 70% in Estonia and Latvia and 40% to 60% in Lithuania in the pre-crisis years, tripling the ECE average (Herzberg 2010).

Fig. 1 - Gross debt-to-income ratio of Households, 1995-2016 (as %)



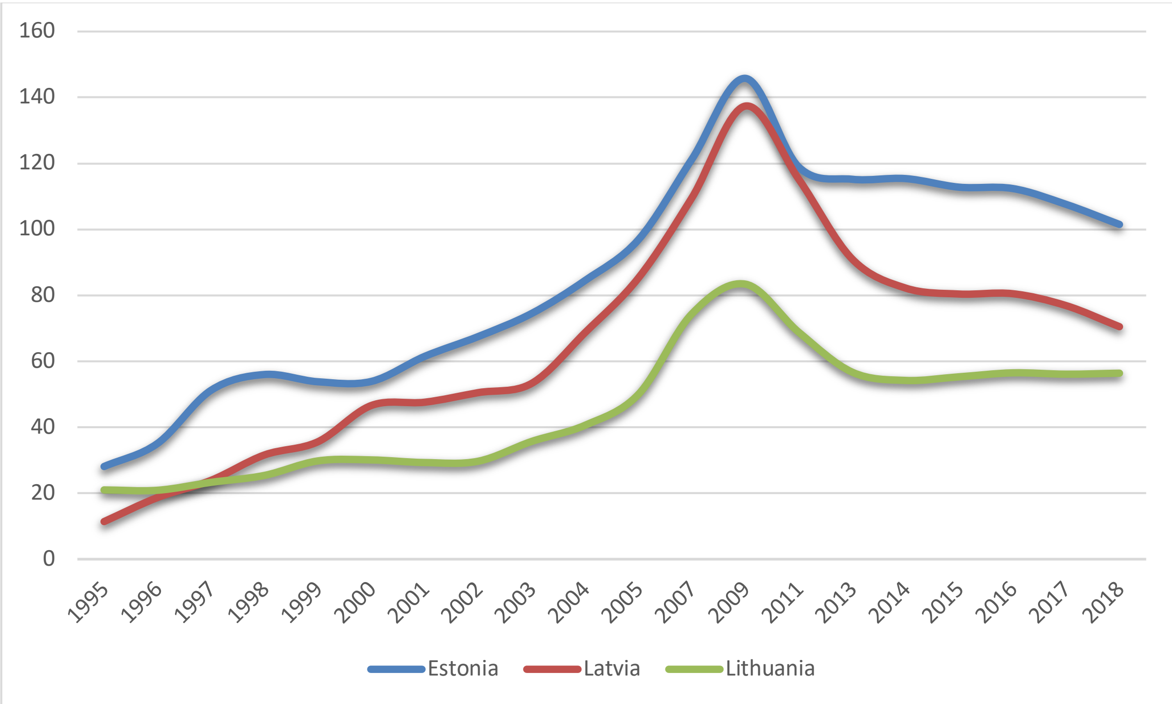
Source: Author's elaboration based on Eurostat Database. Available online at: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=tec00104&lang=en. Last accessed: 15 April 2020.

Another way of looking at the rise of financialisation in the Baltic economies related to the role of (foreign) banks is the rapid increase in the ratio of private debt to GDP (Figure 2). In all

[14] Author's calculations based on wiiw Databases Central, East and Southeast Europe [https://data.wiiw.ac.at/fdi-database.html]. Last accessed on 30 March, 2020.

cases, they experienced a moderate rise during the second half of the 1990s and the early 2000s. However, there was an exponential increase after the EU accession, reaching its peak during the crisis, when GDP was in free-fall: private debt accounted for about 140% of GDP in Estonia and Latvia and over 80% in Lithuania. Since then, the private sector debt ratios have declined considerably, responding to the more conservative lending policies applied by banks, but they still remained close to pre-crisis levels. All in all, the rapid increase in private debt was one of the key factors in increasing the external vulnerability of the Baltic countries during the crisis, not only due to its size but mainly due to its composition.

Fig. 2 - Consolidated Private debt to GDP (as %)



Source: Author's elaboration based on Eurostat database. Available online at: https://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tipspd20 . Last accessed: 15 April 2020.

One of the main features of the lending in the Baltics during this period is that most of loans were denominated in euros rather than local currencies. Euro loans were very attractive for consumers because they had lower interest rates than credits in local currencies and they were considered riskless due to the pegged exchange rates and the strong commitment of Baltic states to join the EMU (Becker and Jäger 2012). Moreover, while inflation was relatively low in all three countries until 2004, it rose steadily after the EU membership: in 2007, it had reached more than 10% in Latvia and Lithuania and close to 7% in Estonia. In this way, the combination of fixed exchange rates with high inflation led to the appreciation of real exchange rates, creating more incentives to take debt in euros (which in some cases even reached

negative interest rates). Thereby, in 2008 the share of credit to private sector denominated in foreign currency amounted to 88% in Latvia, 85% in Estonia and 64% in Lithuania (EC 2010).

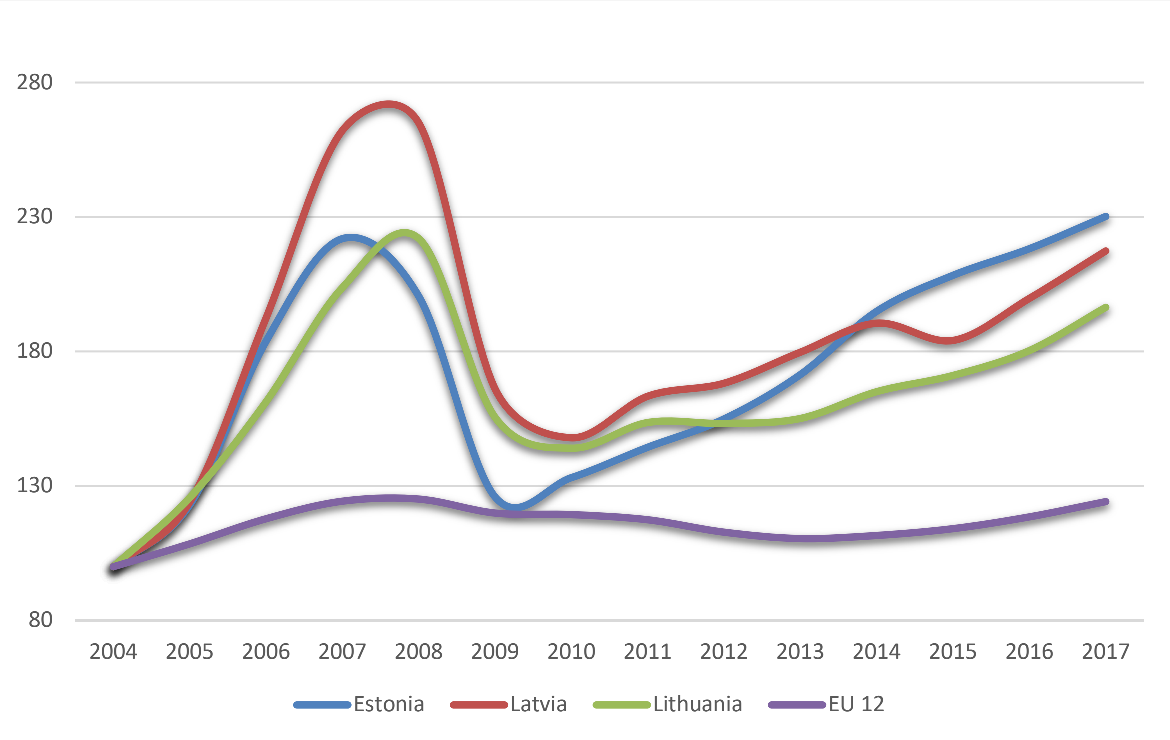
The easy access to mortgage credit also had direct effects on the price of real estate assets. As reported by the European Commission (2010), between 2003 and 2007, the real prices of residential properties increased more than three times in Latvia, and more than twice in Estonia and Lithuania. As shown in Figure 3, since 2004, the housing price index increased sharply in all the three countries, especially compared to the average of housing price index in EU12 countries.[15] This is particularly interesting considering that the population in the three Baltic states has decreased steadily since the beginning of transition.[16] In a nutshell, it shows that speculation, both domestic and foreign, has played a key role in the evolution of real estate prices. Another aspect that must be considered to understand this phenomenon is the lack of investment alternatives with comparable profitability to that of the Real Estate sector. In particular, capital markets had a very limited development throughout the period, which increased incentives to invest in the property market.[17]

[15] EU12 countries are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

[16] According to World Bank statistics, in 1990, the last year under Soviet rule, the total population of Estonia was approximately 1,570,000 inhabitants, that of Latvia 2,700,000 and that of Lithuania 3,700,000. However, since the beginning of the transition, the population in all countries decreased steadily. Thus, in 2007, the population of Estonia had fallen to approximately 1,350,000 inhabitants, that of Latvia to 2,200,000 and that of Lithuania to 3,230,000 (World Bank; World Development Indicators Database; Population, total. Available online at: https://data.worldbank.org/indicator/sp.pop.totl).

[17] It is worth mentioning that, since the beginning of the transition, stock exchanges have only played a marginal role in the Baltic economies. For instance, according to the World Bank WDI database, at the historical peak of their activity before the GFC, the total value of traded shares to GDP barely exceeded 12% of GDP in Estonia in 1998, while it was close to 4% in Lithuania (2006-2007), and 2% in Latvia (2001).

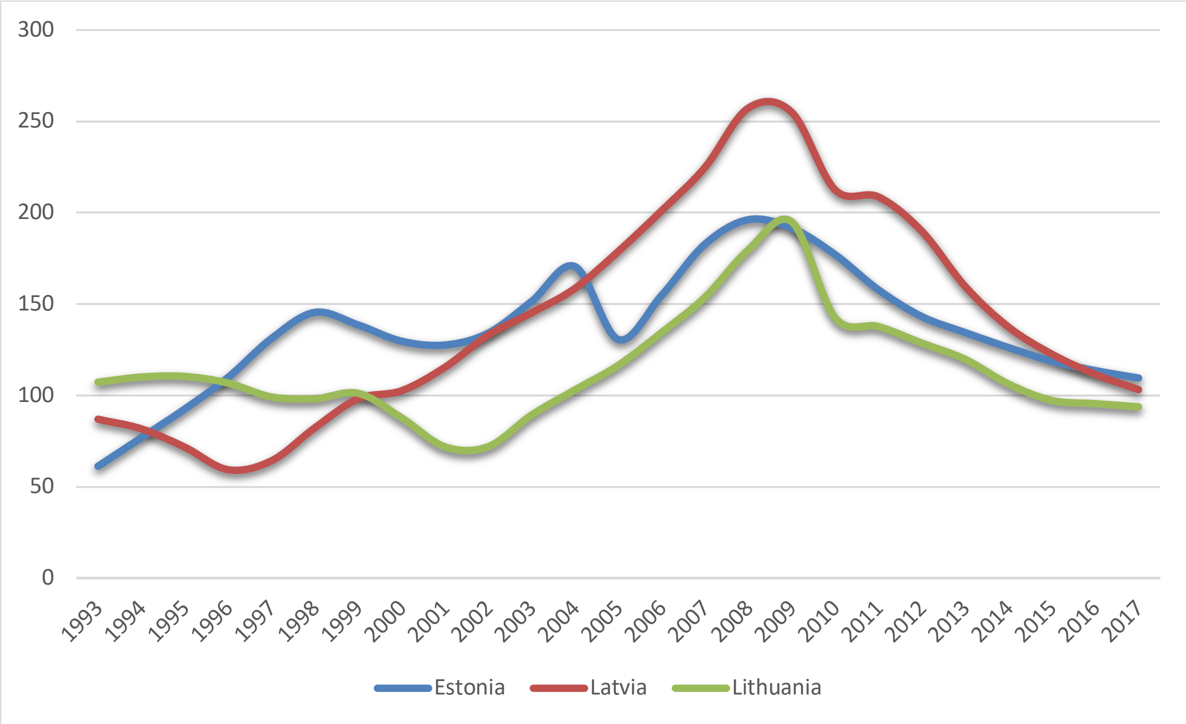
Fig 3 - Housing Price Index for Baltic states and EU12 (2004=100)



Source: Author's calculations based on Eurostat - House price index - annual data. Available online at: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tipsho20. Last accessed: 15 April 2020.

Initially, the funding of lending by foreign subsidiaries in the Baltic countries was done with deposits from the public. However, soon the parent banks began borrowing euros on the international capital markets at very low interest rates and lending this capital directly to the Baltic subsidiaries, especially during the boom years. This is observable in the Loans-to-deposits ratio of Baltic countries during this period (Figure 4). Deroose et al. (2010) argue that excessively low risk premia in the global market and improved access to cross-border bank finance permitted large and sustained investment rates and fuelled consumption expenditure in the Baltic states, while Kattel (2010) claims that in essence, the increase in domestic foreign currency borrowing and the development of the banking sector in the 2000s represented a massive carry trade operated by foreign banks with local households and companies.

Fig. 4 - Loan-to-deposit ratio



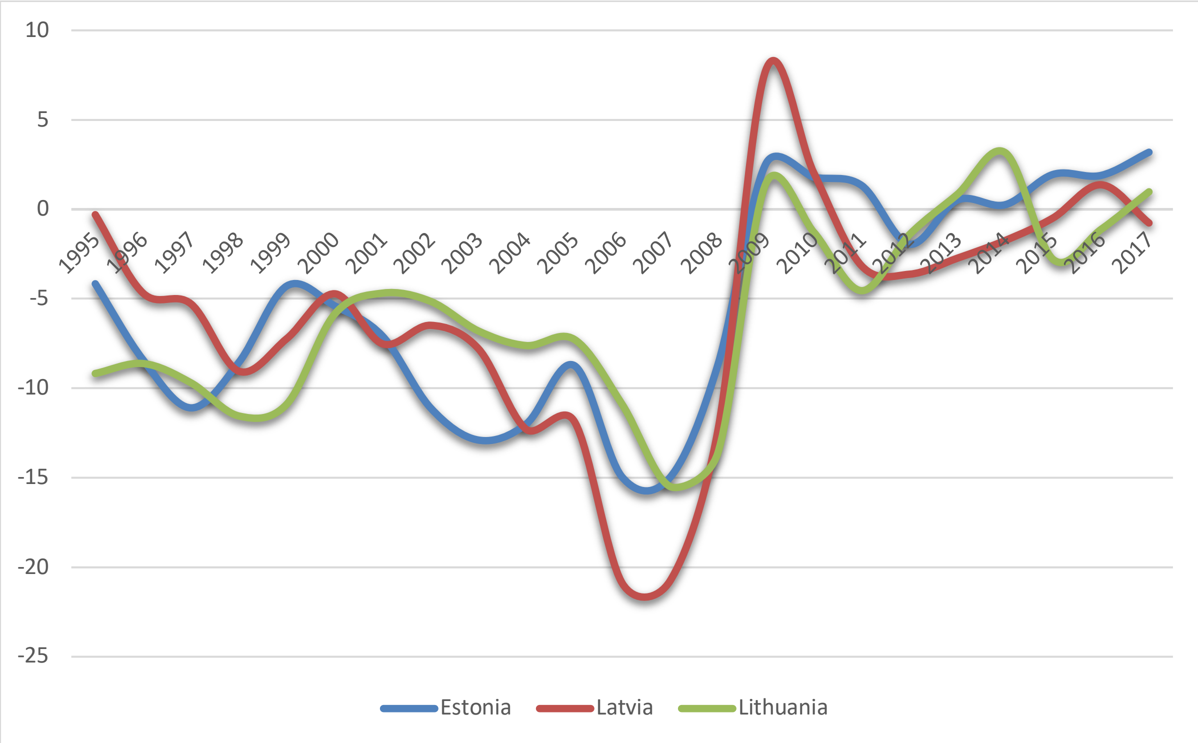
Source: Author's elaboration based on World Bank, Global Financial Development Database. Available online at: https://databank.worldbank.org/source/world-development-indicators. Last accessed: 4 May 2020.

The sharp increase in indebtedness of local subsidiaries with their parent banks through their internal capital markets could be seen as a prime example of 'financial chains' (Sokol 2017a, 2017b). These financial chains not only cemented the asymmetries between parent banks and subsidiaries, but they also substantially increased the external exposure of the Baltic economies and reinforced their strong dependence on foreign capital. Moreover, in a context of free of capital mobility and fixed exchange rates, the money supply in these countries came to depend largely on the volume of credit injected by foreign banks rather than the national central banks' policies (Karilaid et al. 2014).

Another key indicator to understand the economic evolution of the Baltic countries during these years is the current account balance (see also Mikuš 2019, p.12-13). Since the beginning of transition, the Baltic states run persistent foreign trade deficits. Initially, this was directly related to the application of radical liberalisation policies at the early stages of the process, following the Washington Consensus guidelines (Hudson 2014). However, during the stage of Europeanisation, the integration into the Single European Market and cross-border loans provided by foreign banks favoured non-tradable sectors, fuelling an extraordinary rise in imports and a decline in external competitiveness, deepened by the increasing inflation rates.

As a result, foreign trade deficits reached over 20% in Latvia in 2006-2007, and 15% in Estonia (2006-2007) and in Lithuania (2007) (Figure 5). Once again, these sizable trade imbalances were mainly covered with foreign liabilities.

Fig. 5 - Current account balance as % of GDP, 1995-2017



Source: Author's elaboration based on International Monetary Fund, World Economic Outlook Database, April 2018. Available online at https://www.imf.org/external/pubs/ft/weo/2018/01/weodata/weoselgr.aspx. Last accessed: 12 March 2020.

When the subprime mortgage crisis broke out in the United states, the economies of the three Baltic countries were already showing clear signs of overheating. Thus, by late 2007, the Swedish banks responded by decelerating the domestic credit supply and started tightening credit conditions (Kattel and Raudla 2013). These new conditions burst the domestic bubbles and dragged the economies into recession (Deroose et al. 2010). The situation was worse in Latvia, where the collapse of the banking sector led to a fiscal crisis, which soon turned into a balance of payments crisis (Pataccini and Eamets 2019). The main reason for that was that in the fourth quarter of 2008, approximately 40 per cent of total bank deposits in Latvia belonged to non-residents, of which, more than 85 per cent were on-demand (OECD 2016). Thus, the crisis triggered a flight to quality by investors, which significantly weakened the Latvian banking sector and one bank in particular, Parex Banka, created a serious burden for the Latvian economy.

Parex was the second largest bank in Latvia before the crisis (see Annex 3). During the boom years, Parex mainly relied on European wholesale markets to finance loan expansion (Epstein 2013). Moreover, Parex Bank also attracted a significant amount of non-resident depositors. In the months following the collapse of Lehman Brothers, Parex lost 25% of its deposits, while it had to face the repayment of substantial syndicated loans, equivalent of 4.6% of Latvian GDP (Aslund and Dombrovskis 2011). In this context, the government decided to nationalise the bank in November and due to this decision, Standard & Poor's downgraded Latvia's credit rating to BB+, considered as 'non-investment' or 'junk', virtually banning the Latvian government from taking debt in the international financial markets (Pataccini and Eamets 2019). Thereby, in February 2009 the government negotiated a 'bailout' loan with the IMF, the EU, the WB, the EBRD and other international actors, including the Riksbank of Sweden, amounting €7,500 million, equivalent to almost 40 per cent of Latvia's GDP (Aslund and Dombrovskis 2011). Overall, the losses of the Latvian banking system in 2009-2010 were almost equal to the total profits of banks since 2000 (Latvijas Banka, 2010).

The Baltic republics opted for the internal devaluation and austerity to cope with the crisis. To this end, in 2008–2010 all the three countries implemented sizable fiscal consolidations and tax increases (Sommers et al 2014). Furthermore, these measures were complemented with a downward adjustment of nominal wages. Overall, the procyclical nature of the policies applied had direct effects on the economic activity. Accordingly, the accumulated GDP contraction during the GFC amounted to 17% in Lithuania, 20% in Estonia and 25% in Latvia (Kattel and Raudla, 2013). However, one of the most dramatic and enduring consequences of the crisis was the rapid demographic decrease, caused by massive emigrations (Woolfson and Sommers 2016). The main argument put forward by the governments of the three countries was that a devaluation of the exchange rate would have forestalled the integration into the EMU (Hudson 2014). Yet, it was evident that given the large share of loans denominated in Euros, a nominal devaluation would have had serious consequences for creditors and debtors.

In regard to the banking sector, after the crisis, FDI inflows declined significantly and the banks applied more conservative credit policies (Bohle, 2018). On the one hand, this led to a considerable reduction in the economic imbalances. However, due to the strong dependence on FDI and credit, the economic recovery for the Baltic states was slow. Lithuania recovered the pre-crisis level in 2013, Estonia, in 2016 and Latvia, in 2017.[18] Additionally, despite the dramatic effects of the GFC in the region, no substantial changes occurred in the banking sector after the crisis and, on the contrary, most of the preceding patterns were deepened.

[18] World Economic Outlook Database October 2019, IMF - Gross domestic product, constant prices.

Thus, the Baltic banking markets still show a high level of concentration and foreignization with a marked dominance of the Swedish institutions (Annex 4).

Eventually, the three Baltic republics managed to adopt the Euro currency, although they didn't do so simultaneously: Estonia was the first one, joining the eurozone on 1 January 2011; then Latvia, on 1 January 2014; and finally Lithuania, on 1 January 2015. However, the unfettered expansion and liberalisation of the banking sector in the Baltic countries have proven to have complex implications, since in recent years it has been discovered that major local and foreign banks have been directly involved in massive money laundering networks originated mainly in Russia. These events, uncovered in 2017 and still under investigation, have had direct consequences for the sector, including the dismissal of senior officials at SEB and Swedbank.[19]

5. Conclusions

The paper shows that Europeanisation and foreign banks were the determining factors in the economic rise of financialisation in the Baltic countries. On the one hand, the EU has been a key force in opening the Baltic markets to FDI and promoting their financial integration. On the other hand, upon their arrival in the region, following the Russian financial crisis, foreign banks promoted the rapid development of 'financial chains' through the credit markets, which strongly accelerated the economic growth of these countries. However, given the lack of genuine drivers of growth and the fall in external competitiveness, the Baltic economies became dependent on external funds, whether in the form of FDI, non-residents deposits or banking credit. This dynamic led to the accumulation of strong imbalances, which ultimately were the main cause of the impact of the Global Financial Crisis on these countries. Subsequently, the economic recovery was slow and difficult, largely due to the austerity and internal devaluation policies that the respective governments of the Baltic countries imposed, but also due to the decline in FDI inflows and the conservative lending policies of foreign banks. Interestingly, the policies chosen by the Baltic governments not only sought further economic and financial integration with the EU but also shielded the foreign bank´s interests.

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[19] "Swedbank Fires CEO Over Money Laundering Allegations", Bloomberg, 18/03/2019. Available online at: https://www.bloomberg.com/news/articles/2019-03-28/swedbank-ceo-has-been-fired-amid-mounting-laundering-allegations, last accessed on 1 June 2020; "Swedbank Risk Chief and Baltic Head Leave Amid Laundering Probe", Bloomberg, 9/12/2019, available online at: https://www.bloomberg.com/news/articles/2019-12-09/swedbank-risk-chief-and-baltic-head-leave-amid-laundering-probe, last accessed on 1 June 2020; SEB replaces Baltic chief amid money laundering investigation, Reuters, 07/02/2020, available online at: https://www.reuters.com/article/us-seb-money-laundering-idUSKBN2012EB, last accessed on 1 June 2020.

In summary, analysing the role of foreign banks in the Baltic countries allows us to understand not only the economic dynamics of these countries during the last decades but also how 'financial chains' have contributed to shaping the new geographies of financialisation in East-Central Europe.

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APPENDICES

Appendix 1: Swedbank AB (profile)

Table 1.1.: Swedbank business areas
As of March 2020, Swedbank AB possesses three main business areas:

- Swedish Banking
- Baltic Banking
- Large Corporates & Institutions

Source: Swedbank AB. Available online at: https://swedbank.com/about-swedbank/organisation.html. Last accessed: 1 June 2020.

Table 1.2.: Swedbank's operations

Swedbank´s operations are divided into home markets and international branches:

Swedbank's home markets	International branches
Estonia	China
Latvia*	Denmark
Lithuania*	Finland
Sweden*	Luxembourg
	Norway
	USA
	South Africa (representative office)

Source: Swedbank AB. Available online at:[https://swedbank.com/about-swedbank/organisation/our-markets.html. Last accessed: 1 June 2020.

* These are fully owned subsidiaries

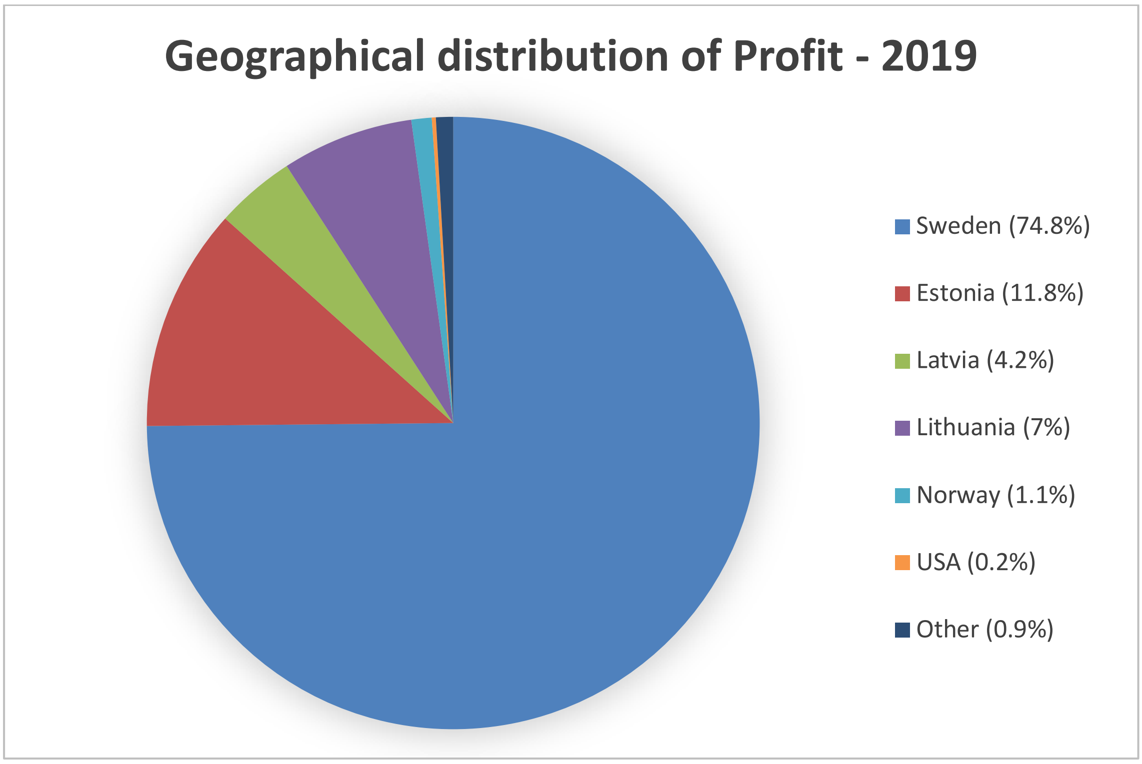
Table 1.3.: Swedbank Group - Key figures

	2019	2018	2017	2016	2015
Return on Equity (%)	14.7	16.1	15.1	15.8	13.5
Full-time employees	15,218	14,865	14,588	14,061	13,983
Total assets (EURbn*)	230.65	219.12	224.86	225.31	235.64
Total equity (EURbn*)	17.59	13.42	13.58	13.57	13.52
Operating profit (EURm*)	2,339.08	2,600.20	2,470.22	2,485.46	2,233.66

Source: Swedbank annual reports. Available online at: https://swedbank.com/investor-relations/reports-and-presentations/annual-reports.html. Last accessed: 1 June 2020.

* The amounts in Euros are approximate, according to the ECB reference exchange rate Euro-SEK as of December 31 of each year.

Figure 1.1.: Swedbank - geographical distribution of profit (2019)



Source: Swedbank AB Annual Report, 2019. Available online at: https://internetbank.swedbank.se/ConditionsEarchive/download?bankid=1111&id=WEBDOC-PRODE53581973. Last accessed: 1 June 2020

Appendix 2: SEB Group (profile)

Table 2.1.: SEB Group business divisions

As of March 2020, Skandinaviska Enskilda Banken AB – SEB Group possesses five main business divisions

- Corporate & Private Customers
- Large Corporates & Financial Institutions
- Investment Management
- Life
- Baltic

Source: SEB Group. Available online at: https://sebgroup.com/about-seb/who-we-are/organisation. Last accessed: 5 June 2020.

Table 2.2.: SEB Group markets

SEB´s operations are divided into home markets and international:

SEB´s Home Markets	SEB International
Sweden*	Luxembourg
Denmark	Poland
Norway	Russia
Finland	Ukraine
Germany	China and Hong Kong
Estonia*	Singapore
Latvia*	India
Lithuania*	United States
United Kingdom	Brazil

Source: SEB Group. Available online at: https://sebgroup.com/about-seb/our-locations. Last accessed 5 June, 2020.

*Universal bank. In all other home markets, SEB only performs as a corporate bank.

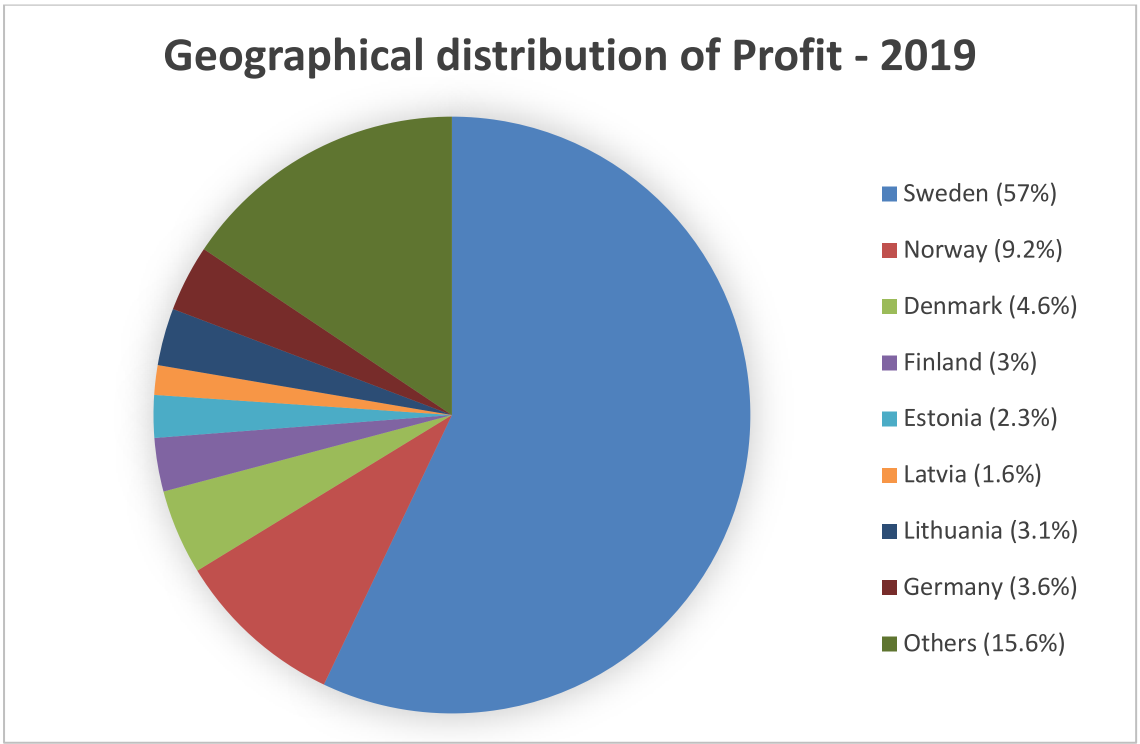
Table 2.3.: SEB Group - Key figures 2015-2019

	2019	2018	2017	2016	2015
Return on equity, %	13.7	16.3	11.7	7.8	12.2
Full-time employees	14,939	14751	14946	15,300	16,599
Total assets (EURbn*)	273.56	250.44	259.76	274.06	273.57
Total equity (EURbn*)	14.91	14.52	14.62	14.74	15.66
Operating profit (EURm*)	2,384.48	2,661.95	2,109.65	1,555.13	2,287.83

Source: SEB Annual Reports. Available online at: https://sebgroup.com/investor-relations/reports-and-presentations/annual-reports. Last accessed: 5 June 2020.

* The amounts in Euros are approximate, according to the ECB reference exchange rate Euro-SEK as of December 31 of each year.

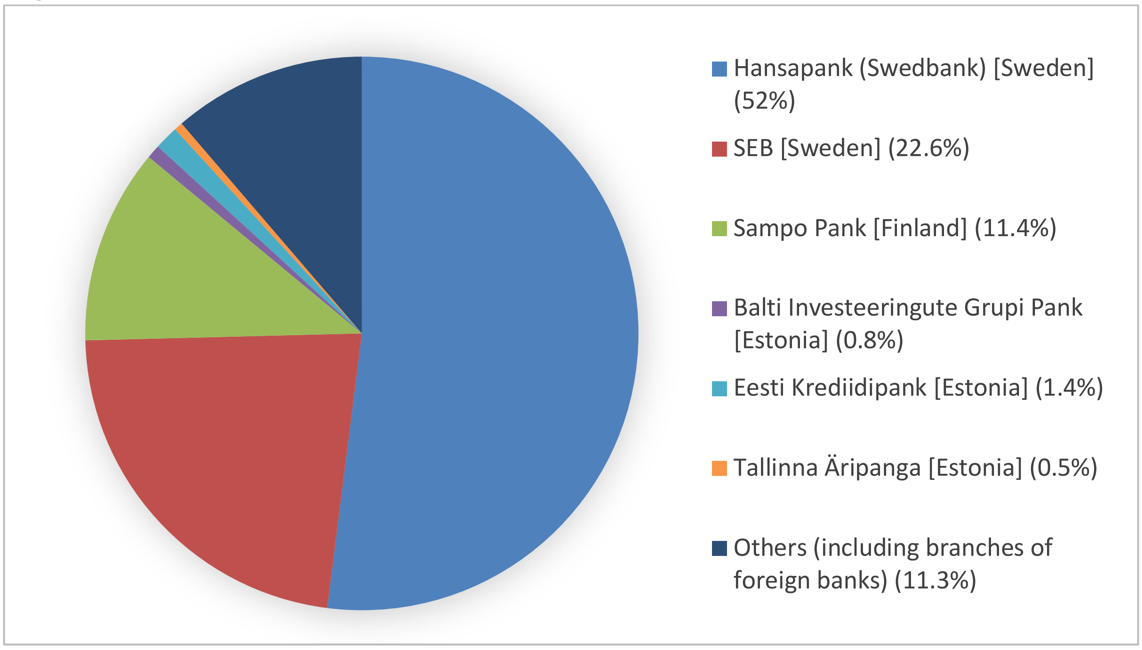
Figure 2.1.: SEB Group - geographical distribution of profit (2019)



Source: SEB Group Annual Report, 2019. Available online at: https://sebgroup.com/siteassets/investor_relations1/annual_reports/annual_report_2019.pdf. Last accessed: 1 June 2020.

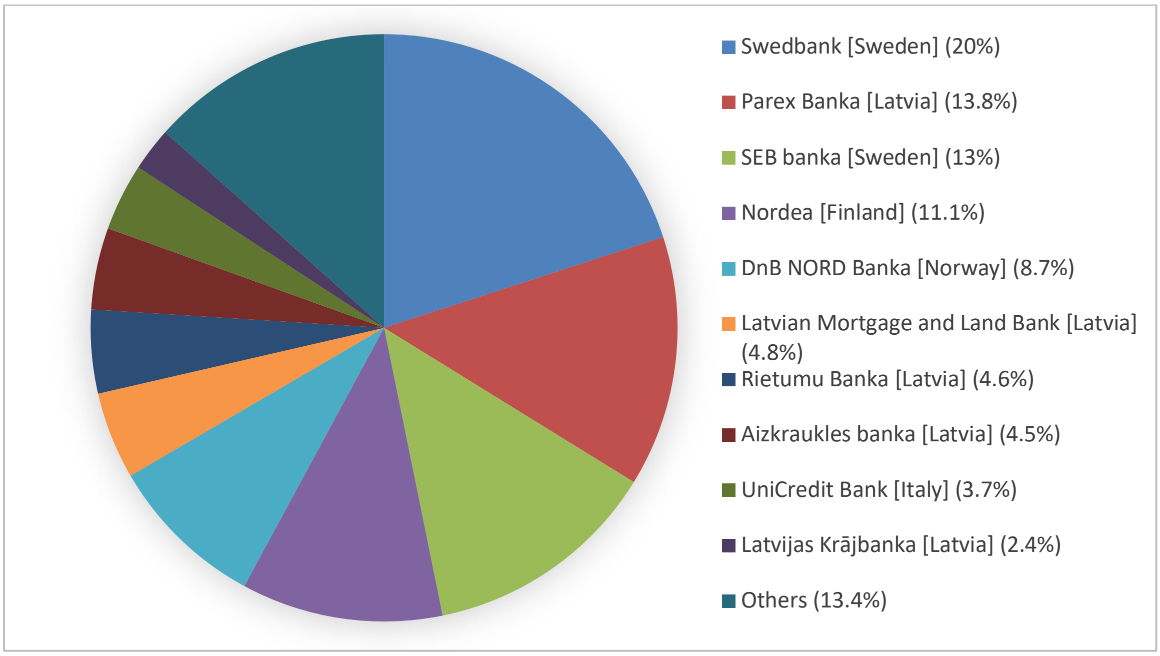
Appendix 3:
Banking sector market shares by assets in the Baltic states as of 31.12.2007

Figure 3.1.: Estonia



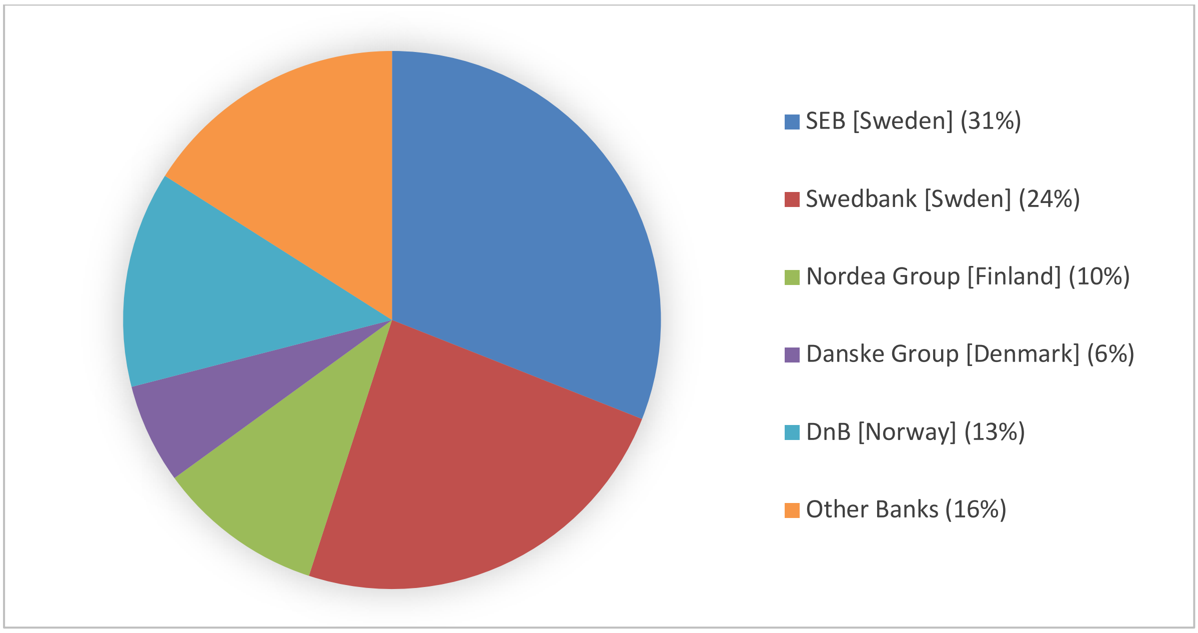
Source: Financial Supervision Authority of Estonia (2007).

Figure 3.2.: Latvia



Source: Financial and Capital Market Commission of Latvia (2007).

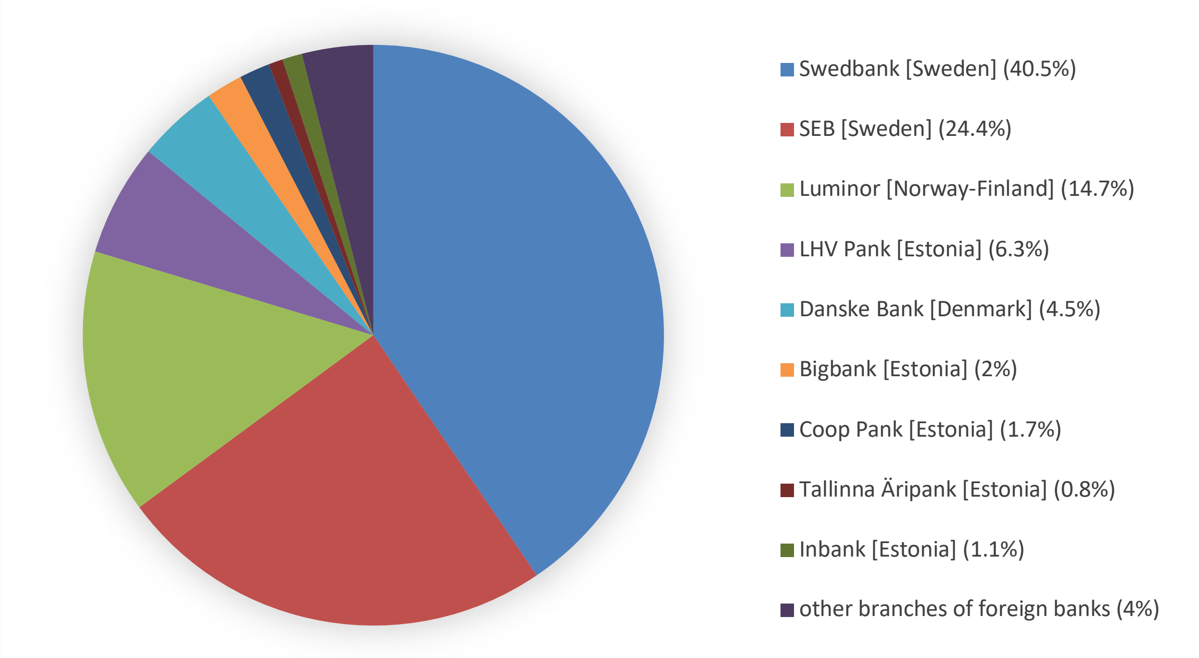
Figure 3.3.: Lithuania



Source: Bank of Lithuania, Financial Stability Review 2008. Available online at: https://www.lb.lt/en/publications/financial-stability-review-2008. Last accessed: 5 June 2020.

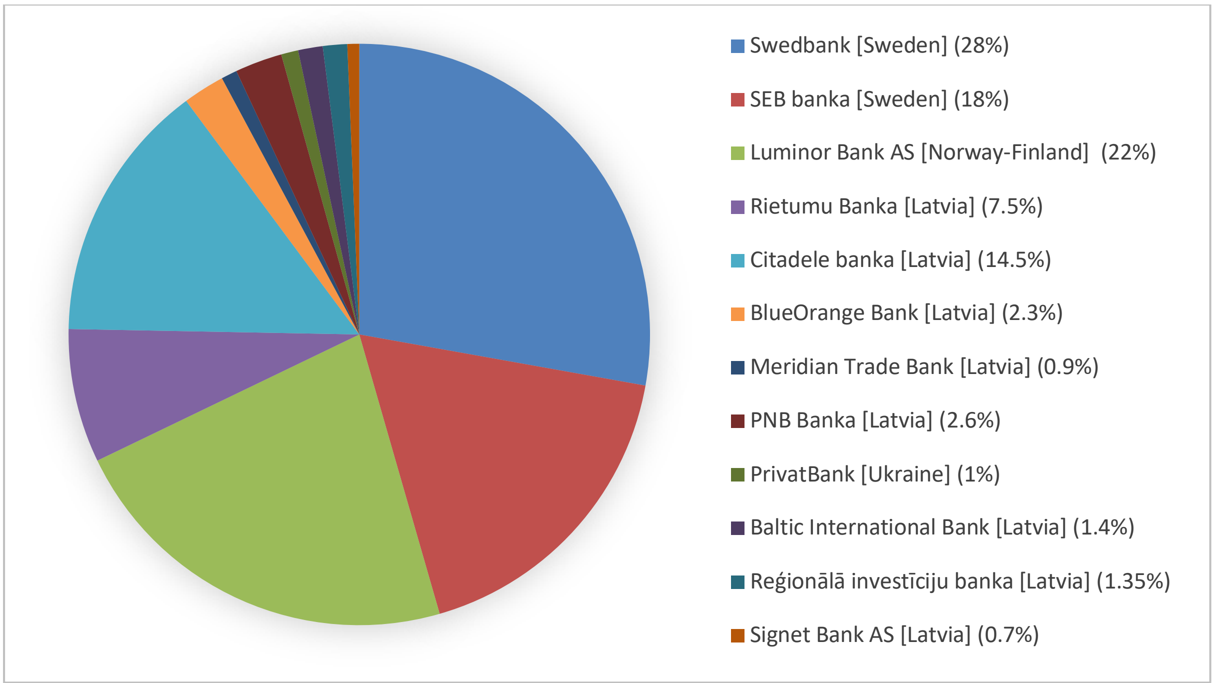
Appendix 4:
Banking sector market shares by assets in the Baltic states as of 31.12.2018

Figure 4.1.: Estonia



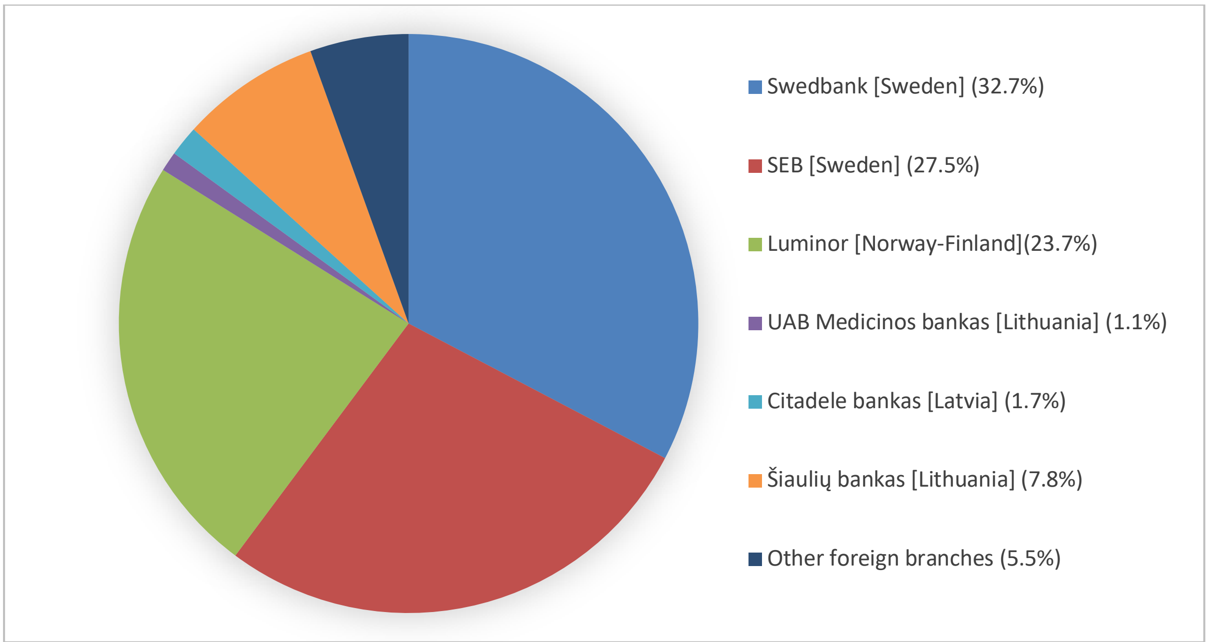
Source: Overview of the Estonian Financial Market 2018, Finantsinspektsioon. Available online at: https://www.fi.ee/en/publications/q4-2018-overview-banking-sector. Last accessed: 10 June 2020.

Figure 4.2.: Latvia



Source: Financial and Capital Market Commission of Latvia, Public Quarterly Reports by Banks 4th quarter 2018. Available online at: https://www.fktk.lv/en/statistics/credit-institutions/public-quarterly-reports-by-banks/public-quarterly-reports-by-banks-4th-quarter-2018/. Last accessed: 10 June 2020.

Figure 4.3.: Lithuania



Source: Banking Activity Review 2018, Bank of Lithuania. Available online at: https://www.lb.lt/uploads/publications/docs/21647_6d190138b42e719f2ff154b054b86d62.pdf. Last accessed: 10 June 2020.

Appendix 5:

Map of the Baltic states

Source: The Nations Online Project. Available online at: https://www.nationsonline.org/oneworld/map/Baltic-states-map.htm

GEOFIN
Western Banks in Eastern Europe: New Geographies of Financialisation

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