ETLA
ELINKEINOELÄMÄN TUTKIMUSLAITOS
THE RESEARCH INSTITUTE OF THE FINNISH ECONOMY
Lönnrotinkatu 4 B 00120 Helsinki Finland Tel. 358-9-609 900
Telefax 358-9-601 753 World Wide Web: http://www.etla.fi/

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Raita Karnite

LATVIA ON THE PATH TO TRANSFORMATION

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ABSTRACT: 1997 was the seventh year which Latvia spend in the new, post-Soviet economic situation. During the first six years the country experienced dramatic decline in economic development, difficulties of restructuring of its economic and social systems, economic stagnation at a very low level of potential use. Still during this time Latvia managed to set up the foundations of a market economy and to begin reforms aimed at the restructuring of nearly the entire economy. Latvia's economic development has been and continues to be influenced to a very great extend by the country's attempts to join the World Trade Organisation and the European Union.

At the end of 1996 and in 1997, gradual improvements in the economic situation could be mentioned and upward trends continued in the first half of 1998. In 1997, the GDP growth was 6.5%, and the inflation rate – 8.4% was the lowest among the three Baltic states.

This article examines Latvia's current economic situation and its development trends, including fiscal and monetary policies, external balance problems, investment and foreign trade issues.

KEY WORDS: economic development, GDP growth, GDP structure, monetary policy, external balance, foreign trade, foreign investment.

1. THE FIRST YEARS OF LATVIAN INDEPENDENCE

was the seventh year, which Latvia spent, in the new, post-Soviet economic situation. The prominent economist Peteris Gulans has separated out two characteristic periods between 1990 and 1996 [4] (Table 1):

Table 1. Latvia's development dynamics between 1990 and 1997

Years	GDP		Investments		Pop. vs. 1990 (%)
	1995 avg. prices	% of 1990	1996 constant prices	% of 1990	
1990	4736.6	100	1404.8	100	100
1991	4243.4	89.6	957.5	68.1	99.8
1992	2764.1	58.4	440.1	31.3	99.4
1993	2353.2	49.7	260.5	18.5	97.5
1994	2368.4	50.0	278.9	19.8	96.0
1995	2349.2	49.6	302.7	21.5	94.6
1996	2427.7	51.0	470.6	33.4	93.6
1997	2586.7	54.6	x	x	92.8

Source: Latvian Statistical Yearbook, 1997, Central Statistical Bureau of Latvia, Riga, 1997, pp. 23, 44 and 232.
Monthly Bulletin of Latvian Statistics, Central Statistical Bureau of Latvia, #5(48), 1998, Riga, 1998.

Between 1990 and 1992, the economy which had been established over the previous years collapsed. The total value of the country's gross domestic product declined on a half during those years, and capital investments in the economy in 1992 were at only 31.3 % of the 1990 level – and the figure was on a downward spiral. Unfavourable trends began to appear in the country's demographic situation. Immigration trends increased, the mortality rate exceeded the birth rate, and the overall number of people in the country declined (Table 1).

The period between 1993 and 1996 can be seen as a period of stagnation during which economic stability prevailed, but at a very low level of potential use. The decline in capital investments continued until 1993, when capital investments reached 18.5 % of the 1990 level. 1994 marked the first year that a slight increase in capital investment was noted. The decline in Latvia's population continued throughout the period. The pace of economic development was affected by a banking crisis that occurred in Latvia in 1995 and a subsequent finance crisis.

During the first six years of post-Soviet life, Latvia managed to set up the foundations of a market economy and to begin reforms aimed at the restructuring of nearly the entire economy. The economic development level, however, remained low. According to European Commission experts, Latvia's GDP in 1996, when calculated according to purchasing power parity (PPP), was approximately 8 billion ECU. Latvia's per capita GDP indicator was only some 18 % of the average European Union level [1, p. 17], and it was the lowest indicator among all EU candidate countries.

Since economic restructuring was begun, the government's declared aims for economic development have not changed: "To establish a Western-type market economy with an economy that is sufficiently liberal and based on the principles of competition and private property, to open foreign trade policy and to gradually adapt the economic environment to the demands of the European Union" [2]. Latvia's economic development has been and continues to be influenced to a very great extent by the country's attempts to join the World Trade Organisation (which may happen in 1998) and the European Union.

2. LATVIAN ECONOMIC DEVELOPMENT IN 1997

At the end of 1996 and in 1997, gradual improvements in the economic situation could be seen throughout the country. In the second quarter of 1997 the Central Statistical Bureau of Latvia recorded the greatest one-year growth in GDP in the post-Soviet era – 6.5 %. GDP growth continued to increase in a stable manner throughout the year (7.6 % in the third quarter). The economic results of 1997 were extremely encouraging with a one-year GDP growth of 6.5 %. In 1997 Latvia also had the lowest inflation rate among the three Baltic States – 8.4 % (the inflation rate in 1992, for comparison's sake, was 951 %, while in 1996 it was 17.6 %) [6,8].

Overall economic development trends in Latvia are well illustrated by basic indicators on macroeconomic development which are published in the country's regular Report on Economic Development [3] (Tables 2 and 3).

Table 2. Latvia: Economic development indicators (percentage change)

Indicator	1995	1996	1997[n]	1998[p]
GDP (constant prices)	-0.8	3.3	6.5	6.0
Private consumption	0.6n	10.3	3.9	4.5
Government consumption	7.7n	1.8	3.8	2.0
Overall equity capital	8.7n	21.1	11.1	10.0
Consumer prices	25.0	17.6	8.4	6.0

n = Assessment by the Ministry of Economy.
p = Forecast by the Ministry of Economy.
Source: Economic Development of Latvia. Report. Ministry of Economy, Republic of Latvia, June 1998, (p. 10)

GDP growth in 1997 was ensured by increasing economic activity in various areas of the economy, which brought about an increase in value added production, as well as in overall tax collections. In keeping with the state's economic policies, the level of subsidies declined. The proportion of product taxes in Latvian GDP has increased from 8.4 % in 1991 [4], when the new tax system of the independent state took effect, to 13.0 % in 1996 and 13.4 % in 1997 [2,6]. Another reason for the growth in this area is that the fundamentals of the Latvian tax system were changed in 1995, as were the country's tax rates. There is reason to believe that the GDP growth rate has also been influenced positively by an increase in investments, even though overall investments in the economy remain fairly low. According to calculations by the Ministry of Economy, in order to ensure an acceptable development pace, investments will have to outpace GDP growth for some time to come [2, p. 20].

Table 3. Latvia: Basic economic development indicators (stated as % of GDP unless noted otherwise)

Indicator	1995	1996	1997[n]	1998[p]
Fiscal balance in the overall budget	-3.1	-1.4	-1.3	0
External debt	9.2	8.0	6.8	6.7
Internal and external debt	16.0	14.4	12.2	11.9
Foreign trade balance	-13.0	-15.6	-16.5	-16.5
Current accounts in the balance of payments	-0.4	-5.5	-8.0	-8.0
Registered unemployment level (% at the end of the period)	6.6	7.2	7.0	6.9
Exchange rate of the lats vs. SDR (end of period)	0.7997	0.7997	0.7997	0.7997
Exchange rate of the lats vs. USD (average)	0.528	0.551	0.581	0.600*

n = Assessment by the Ministry of Economy.
p = Forecast by the Ministry of Economy.
* = 29.07.1998.
Source: Economic Development of Latvia. Report. Ministry of Economy, Republic of Latvia, June 1997, (p. 10.). See also *Monthly Bulletin of Latvian Statistics*, #5(48), 1998, Central Statistical Bureau of Latvia. Riga, 1998.

In 1997, economic activity increased in virtually all basic sectors of the economy. Because economic development has not proceeded at an equal level in all sectors of the economy, the country's GDP structure is changing continuously (Table 4). In terms of the value added distribution by sector, the share of the service sector is steadily increasing – from 31.9 % in 1990 to 61.9 % in 1997. The proportion of the transportation and communications sector in GDP has almost doubled over the course of seven years, something that is the result of successful development of the country's transit business. The share of the agricultural sector, as well as that of processing industry, has declined considerably.

In 1997, the greatest growth versus the same period in the previous year was noted in construction (8.2 %), the overall service sector (7.4 %), the wholesale and retail trade (12.9 %) the transportation and communications area of the service sector (7.4 %), the use of real estate (9.3 %), and the communal, social and individual service sector (exclusive of the electricity, gas and water supply sectors) (11.1 %), something that has to do with price increases [6, p.26]. The share of the last two sectors in GDP is small, and the influence of its growth on overall GDP dynamics is not felt as much. The growth in the transportation and communications sector, however, fundamentally affected overall GDP growth in 1997.

Among the processing industry sectors, the most successful ones have been the textile industry, the metal processing industry and the food processing industry. There have been structural changes in the food industry, and production has become increasingly concentrated. This is one of the sectors which has managed to attract foreign capital, including investments from Estonia.

Latvia's agricultural sector began to reverse its long-standing decline in 1997, demonstrating an increase of 4.9 % over the previous year [6, p.26]. Grain and milk output increased, but meat production continued to decline.

Table 4. Structure of gross value added by kind of activity (at current prices, in percent)

	1990	1995	1996	1997
Gross value added at basic prices	100	100	100	100
Of which by kind of activity:				
agriculture, hunting and forestry	21.1	10.4	8.7	7.2
fishing	0.8	0.4	0.3	0.2
mining and quarrying	0.2	0.2	0.2	0.1
manufacturing	34.5	22.4	20.9	21.2
electricity, gas and water supply	1.8	5.5	5.3	4.4
construction	9.7	5.1	4.7	5.0
services	31.9	56.0	59.9	61.9
of which:				
wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	5.5	11.3	15.3	16.6
hotels and restaurants	1.3	1.1	1.1	1.1
transport, storage and communications	10.9	16.0	17.0	17.2
financial intermediation	1.7	5.6	5.7	4.8
real estate, renting and business activities	4.4	4.3	3.3	3.3
public administration and defence; compulsory social security	0.7	5.1	5.1	6.1
education	2.6	5.3	5.2	5.1
health and social work	1.8	4.0	3.5	3.9
other community, social and personal service activities	3.0	3.3	3.7	3.8

Source: *Monthly Bulletin of Latvian Statistics*, #12(43), 1997, #5(48), 1998, Central Statistical Bureau of Latvia. Riga, 1997, 1998.

A positive reflection of Latvia's economic development is the fact that the construction volume has increased. The increase in construction work has been facilitated by the reconstruction of Latvian ports, as well as road and housing construction. Latvia has a housing construction concept and a program to promote the building of new homes. The goal is to build economic and comfortable homes, which will allow people to reduce their day-to-day costs and to free up money for other purposes. The idea is to increase purchasing power in other sectors. The significance of dealing with the housing problem is indicated, among other things, by the fact that people save money by installing gas, water and heat consumption counters in their homes. This was probably the main reason for the value-added reduction in the gas and water supply sector. According to household budget research conducted in the first nine months of 1997, urban residents spent approximately 18 % of their per capita income on household maintenance, but it seems that this number is overly optimistic [7]. Some families spend as much as 30-50 % of their income on household maintenance, but they do not receive services of corresponding quality.

Of particular importance for economic progress is the expanded effort to build roads in Latvia. During the course of 1997 nearly all-major roads were improved. The increase in road building has been facilitated by improved financial conditions. A roads fund has been established for this purpose. The fund receives a contribution from the excise tax on fuel. In order to finance port renewal work, money is being transferred from the state's investment program. Increased construction work also has the secondary effect of boosting the construction materials manufacturing industry, as well as other related sectors. Improvement of the country's transportation infrastructure, meanwhile, facilitates economic development and foreign investment alike.

3. THE CURRENT ECONOMIC SITUATION

Of course the increase in GDP in 1997 must be seen as a positive thing, but on the other hand, care must be taken to ascertain that growth continues over time. Latvia currently has sufficient GDP growth reserves, because the reference level continues to be low (in 1997 GDP was at 55 % of the 1990 volume), but these reserves will disappear eventually. The stability of future development is dependent upon the way in which GDP is used. The statistical bureau provides an analysis of the aggregate use of the official GDP with a two-year delay, but we also have access to data about this from the Ministry of Economy [3] (Table 5).

Table 5. The structure of aggregate use of Latvia's GDP (%)

	1995	1996	1997	1998^{p}
GDP	100.0	100.0	100.0	100.0
Private consumption	62.6	67.6	67.2	66.1
State consumption	22.2	21.6	23.3	22.3
Overall equity capital establishment	15.1	18.1	19.3	20.3
Changes in inventory*	2.5	0.7	0.4	1.2
Gross balance	-2.4	-8.1	-10.1	-9.9
Exports	46.9	54.5	56.2	-
Imports	49.3	61.3	61.4	-

p = forecast – Version 1 / Version 2
* = Including statistical shift
Source: Economic Development of Latvia. Report. Ministry of Economy, Republic of Latvia, June 1998, (p. 23).
Monthly Bulletin of Latvian Statistics, Central Statistical Bureau of Latvia, #5(48), 1998, Riga, 1998.

Because the negative gross balance between exports and imports increased in 1996 and 1997, domestic consumption had to increase at a rate greater than GDP growth in these two years. State consumption and expenditures on the establishment of overall equity capital increased the most, and the latter is a favourable trend for economic development. The rapid increase in the share of the indicator "changes in inventory" was driven by an increase in fuel inventories at the end of 1996 because of an increase in the excise tax rate on fuel at the beginning of 1997.

As the result of austerity policies, state consumption declined in real terms in such areas as education, science, health care, defence and other socially sensitive areas. The proportion of local government budgets in the overall budget also declined, and that is not a good thing. Money spent directly on the financing of state institutions increased in real and absolute terms. Large sums from the state investment program also went toward the needs of state institutions. Improved state governance has a favourable effect on the ongoing development, but in Latvia's case the effectiveness of resources spent on state governance could be higher.

The pace of private consumption growth continues to lag somewhat behind the pace of GDP growth, and that means that the standard of living in Latvia is continuing to deteriorate. Stratification of the population also continues.

Overall, an analysis of Latvia's GDP from the perspective of output and consumption suggests that the ongoing development is not threatened, but neither is it sufficiently well grounded. Most attention is currently being devoted to various aspects of macroeconomic stabilisation. Macroeconomic stabilisation is an important condition for development, but not the only one. The time has come to devote more attention to microeconomic processes. In order to achieve greater stability, much more detailed analysis must be conducted on the effectiveness of the utilisation of labour and capital, and this effectiveness must be boosted. Latvia must urgently prepare for conditions of increased market competition, because the "honeymoon" during which foreign countries turned a blind eye to Latvia's uncompensated trade advantages is coming to a rapid end. As is being done in other countries, Latvia must also devote more attention to increasing the competitiveness of its economy. Work has begun: together with Finnish specialists a state innovation policy document is being elaborated. The Latvian Development Agency is working on specifying new development opportunities, and other steps are being taken, too.

4. FISCAL AND MONETARY GOALS

These steps to stabilise Latvia's macroeconomic situation have had a positive effect on the economic development in the country. Macroeconomic stabilisation must be a priority area during a period of transformation – that much is clear – but undeniably the process has also been affected by external considerations. For example, by implementing efforts to join the European Union and the WTO as quickly as possible, Latvia is carefully observing the terms of directly and indirectly mandatory agreements, and in the area of macroeconomic stabilisation, some of these are quite strict. Latvia has made some notable accomplishments in the area of macroeconomic stabilisation. The country meets the Maastricht requirements for EMU in all three major areas: the volume of government debt, the budget deficit, and the stability of the currency exchange rate.

The state's external debt – 6.8 % of GDP (Table 3) is much lower than the norm that is specified in Maastricht, and government controls it very strictly. We can say that there is no likelihood that the country will have problems with its external debt in the near future.

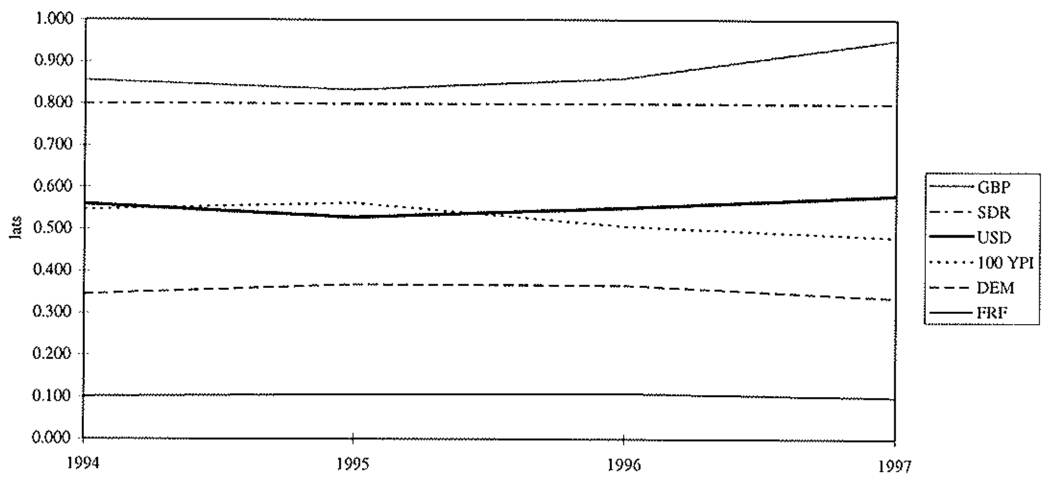
Due to strict austerity policies, the country's budget deficit has been all but eliminated in the two years since the 1995-finance crisis. In 1995 the deficit was equal to 3.4 % of GDP, but in 1997 the basic budget had a surplus of approximately 38.4 million lats (1 LVL = 1.68 USD). For comparison's sake we can note that in 1995 the basic budget had a deficit of 90.1 million lats, but in 1996 the government succeeded in reducing the deficit to 27.5 million lats [5].

Unfortunately, strict observance of policies of limiting the external debt and the budget deficit has created problems in the area of capital investment. Even though slight growth has been noted, the volume of capital investment remains insufficient for rapid development of the country. Strict fiscal policies, which undoubtedly affect labour and capital returns and limit income, do not promote the accumulation of capital. The demands of the Maastricht treaty, meanwhile, properly protect Latvia against excessive internal and external loans. This, however, means that the economy does not have access to any type of resources – state, private or money from foreign loans.

Table 5 shows that the cost of equity capital establishment increased more rapidly in 1997 than in 1996. Specialists at the Ministry of Economy feel that the rapid increase in construction work and the import of capital goods in 1997 signifies this [2, p. 20]. Investment growth at this time is based on the attraction of foreign capital, but this source is not limitless. Foreign investments affect the gross balance of Latvia's current account, and it reduces the national GDP by the share of profit repatriation (and not only by that).

The currency exchange rate in Latvia has been kept stable against the IMU's currency exchange unit since 1994 (SDR/LVL = 0.7997), but there is a floating exchange rate versus every other currency. Fluctuations in the currency market change the exchange rate also for the lats. That is why there have been shifts in the exchange rate for the lats against the American dollar and the German mark (Figure 1).

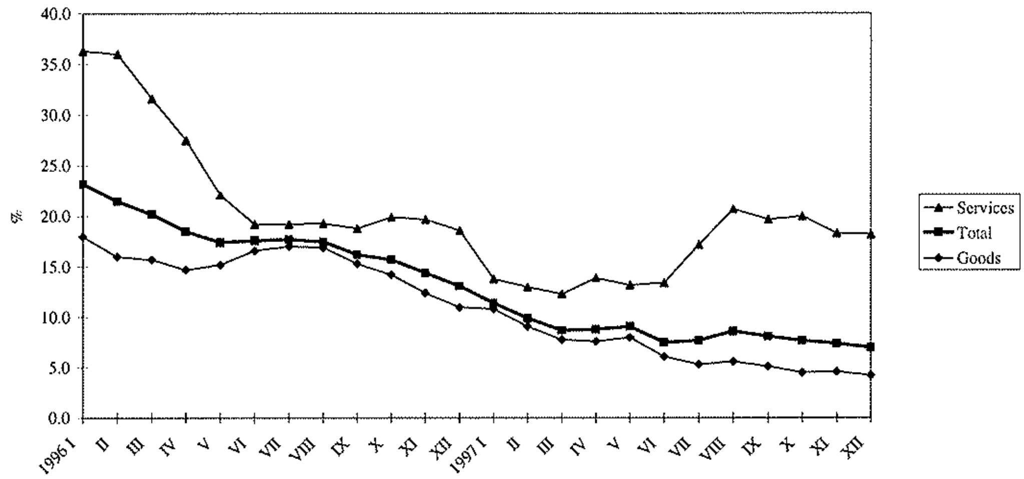
Figure 1. The dynamics of foreign currency exchange rates as specified by the Bank of Latvia, average in the period, in lats



It is expected that the overall goal of monetary policy in Latvia – to preserve the stability of the national currency, thus limiting inflation – will not change in the medium term. The guarantee of the stability of Latvia's currency system is a safe cover for the currency that has been emitted. Both before and after the national banking crisis the unencumbered external assets of the Bank of Latvia exceeded the money base, and it was only in mid-1995, when there was upheaval in the currency exchange market, that the international reserves of the central bank declined somewhat. It is expected that the currency exchange rate will remain stable versus the SDR "basket" of currencies. After the implementation of the European common currency, the possibility of linking the lats to the euro will be considered.

The consumer price inflation rate in Latvia has been the lowest among the Baltic States for several years [2, p.21]. Average inflation in 1997 was 8.1 % [9], and it reached 8.4 % at the end of the year [5, p.12].

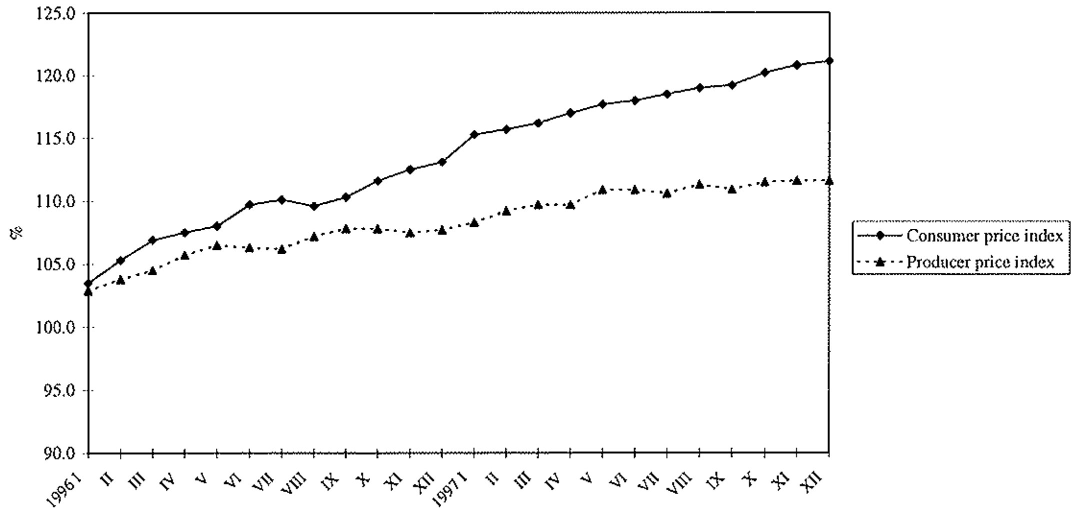
Figure 2. Increases in consumer prices for goods and services (% increase compared to the previous month)



The inflation level in Latvia is strictly controlled, and reasons for changes in the inflation rate usually involve administrative decisions on increases in tax rates or monopoly prices. In 1997 the cost of housing maintenance increased rapidly. The average rental cost in Latvia increased by 77.5 % during the year [2, p.22]. Telecommunications tariffs and the cost of telephone installation increased, as did electricity tariffs. The price of goods increased much slower, however (Figure 2).

The producer price index in industry lagged behind the consumer price index throughout the year (Figure 3).

Figure 3. Consumer and producer price indexes in 1996 and 1997 (as % of December 1995)



The goal of the Latvian government is to continue to reduce inflation, thus increasing Latvia's economic stability. The trends which can be seen in Figures 2 and 3 suggest that possibly this goal should be adjusted somewhat. In maintaining macroeconomic stability, the inflation level should be kept in line with the increases in costs. This is objectively necessary in order to ensure that the real costs of goods and services are covered and modernisation steps can be taken.

It is clear that the decline in the inflation rate is being ensured through strict monetary policy, by limiting the amount of money in circulation. Even though the amount of money in circulation has increased in recent years, there is a clearly sensed shortage of money in the economy. This is reflected in an indirect way, when as the result of price increases the proportion of one part of the consumer price "basket" (services) increases, while the share of other parts of the "basket" decreases. This leads to a reduction in prices in these particular groups (Figure 2). The amount of money in circulation is used to compensate for the increase in service prices, and in part to compensate for the gross balance of the current account (to cover the cost of imported goods and services). This analysis allows us to conclude that the result of Latvia's strict monetary policy is a decline in purchasing power in the goods production sectors.

Inflation, combined with stability in the currency exchange rate, also means that the absolute purchasing power of the lats is declining gradually (a hidden devaluation of the lats). This is not purely a bad thing, because it helps to even out the purchasing power parity of the currency, as well as shifts in exchange rates, which are common in countries with a low level of development [4]. According to Professor Gulans' estimates, which were based on data from 1993, if we compare the purchasing power of Europe's national currencies with the Austrian shilling then the exchange rate of the lats versus the shilling exceeded its purchasing power by a factor of 4.37. Adjusting this by the relations between inflation in Austria and inflation in Latvia, as well as the shifts in its exchange rate, we find that the purchasing power of the lats versus shilling were between 2 and 2.5 times higher than exchange rate in 1996. Because the exchange rate of the lats versus the Austrian shilling during this period declined only to a minor extent, we can conclude that the purchasing power of the lats declined. If the decline in the purchasing power of the lats is more rapid than is the increase in consumer income, the real income of the population declines. Unfortunately, this process is difficult to analyse in Latvia's circumstances.

5. EXTERNAL BALANCE PROBLEMS

As is the case with other countries that are transferring from a planned economy to a market economy, Latvia is having problems with its balance of payments and with foreign trade.

The gross balance in Latvia's current account was distinctly favourable in the early 1990s, and it was distinctly negative in 1996. In 1997, however, the deficit in the balance of payments represented 10.4 % of GDP, but the overall gross balance of payments was positive – 3.7 % of GDP. This was because of an inflow of capital from foreign direct investments and credits [2, p.25].

The basis for the negative gross balance in the current account is the rapid increase in Latvia's foreign trade deficit, which reached 18.5 % of GDP in 1996 [2, p.25]. The cause of the trade deficit is a more rapid increase in imports than in exports. The import of consumer goods and intermediate consumption goods has increased more rapidly than the import of capital goods, although in 1997 it was precisely capital imports that increased the most (Figure 4).

The main causes of the negative gross trade balance are the need for higher quality goods which cannot be manufactured locally, the quality of goods manufactured in Latvia, the image of the Lat-

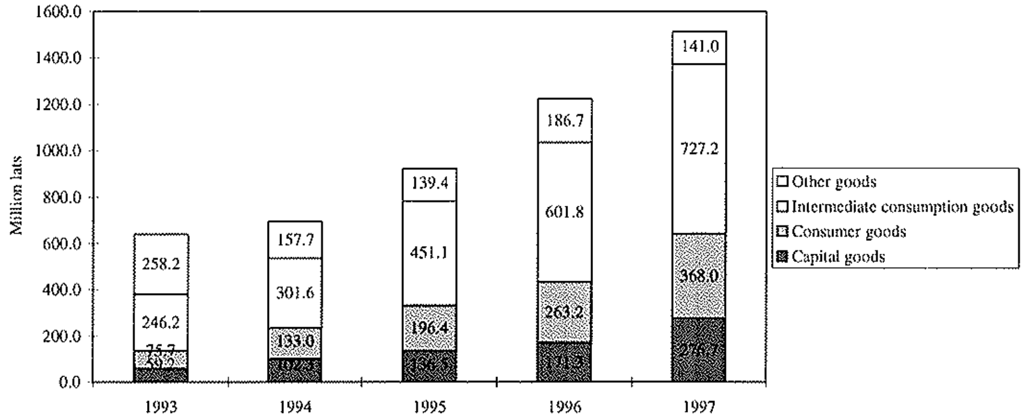
Table 6. Latvia's balance of payments

	1993*	1994*	1995**	1996**	1997**
			(million lats)		
Goods and services balance	232.2	33.3	-56.7	-228.7	-325.9
Trade balance	12.6	-168.5	-306.4	-440.0	-545.4
Exports	710.6	571.3	721.7	819.7	1016.8
Imports	-698	-739.8	-1028.1	-1259.8	-1562.2
Services balance	219.7	201.8	249.6	211.3	219.5
Factoral services, net	4.9	4.8	9.8	22.9	26.3
Current transfers, net	51.8	74.3	37.5	51.6	42.5
A. Current account	**289.0**	**112.4**	**-9.4**	**-154.2**	**-257.1**
Direct investment, net	33.0	154.4			
Portfolio investment, net	0.0	-12.5			
Other investment, net	62.9	90.7			
Reserve assets, net	-243	-55.7			
Capital and financial account	**-147.0**	**176.9**			
B. Long term capital , net			130.1	152.5	250.1
Basic balance (A+B)			**120.6**	**-1.7**	**-7.0**
C. Short term capital, net			205.4	130.1	-134.6
Net errors and omissions	-142.0	-289.3	-343.2	-25.9	180.0
Total balance (A+B+C+D)			**-17.1**	**102.5**	**38.3**
			(% of GDP)		
Goods and services balance	15.8	1.6			
Trade balance	0.9	-8.2	-13.0	-15.6	-17.0
Exports	48.4	28.0	-30.7	29.0	31.7
Imports	-47.6	-36.2	43.8	44.5	48.6
Services balance	15.0	9.9	10.6	7.5	6.8
Income, net	0.3	0.2	0.4	0.8	0.8
Current transfers, net	3.5	3.6	1.6	1.8	1.3
Direct investment, net	2.3	7.6			
A. Current account	**19.7**	**5.5**	**-0.4**	**-5.5**	**-0.8**
B. Long term capital, net			5.5	5.4	7.8
Basic balance (A+B)			**5.1**	**-0.1**	**-0.2**
C. Short term capital, net			8.7	4.6	-4.2
D. Net errors and omissions			-14.6	-0.9	5.6
Total balance (A+B+C+D)			**-0.7**	**3.6**	**1.2**

Source: * Economic Development of Latvia. Report. Ministry of Economy, Republic of Latvia, December 1997, (p.25. in Latvian)

** Economic Development of Latvia. Ministry of Economy, Republic of Latvia, June 1998, p. 28, (According to IMF methodology).

Figure 4. Import by broad economic category classifications



Source: Economic Development of Latvia. Report. Ministry of Economy of the Republic of Latvia, June, 1998, p. 32.

vian market which makes it difficult for manufacturers to enter the Western market, and the inadequacies of the Eastern market in terms of operations under difficult economic conditions (delays in settling of bills for the supply of goods, difficulties in border crossings, political reasons).

Latvia's foreign trade developments have not been entirely negative, however. Both export and import volumes have increased (Figure 5), and an important structural change lies in the fact that the proportions of the EU countries have increased both in the export and the import of goods (Table 7).

The export structure did not change significantly in 1997. The main export product is wood and wood products (32.3 %), followed by transport vehicles, products of metal industry and engineering (20.2 %), light industry output (17.5 %) and food products (14.5 %) [3, p. 31]. Latvia's exports, however, consist largely of products with low added value. The most important import goods are machinery and equipment, as well as chemicals.

The negative gross trade balance is partly covered by a positive balance in services (7.6 % of GDP in 1996). But because there was a change in registration procedures in 1997, and also because of increasing import operations resulting in increasing imports of transportation and insurance services, the gross services balance is declining and was 6.8 % of GDP in 1997 (Table 6).

Experts predict that as foreign direct investment increases in Latvia through such processes as the privatisation of large state-owned companies, the gross balance of international deals will decline. Efforts must be made to a certain that foreign investors are interested in reinvesting income in the Latvian economy instead of exporting profits to other countries.

6. HARMONISATION OF LEGISLATION AND PRIVATISATION

As Latvia goes about meeting the conditions which have been set out for European integration and for WTO membership in terms of questions such as limitation of monopoly operations and reduction of obstacles to free competition and the free market, the government has been working in two directions: harmonisation of legislation and privatisation.

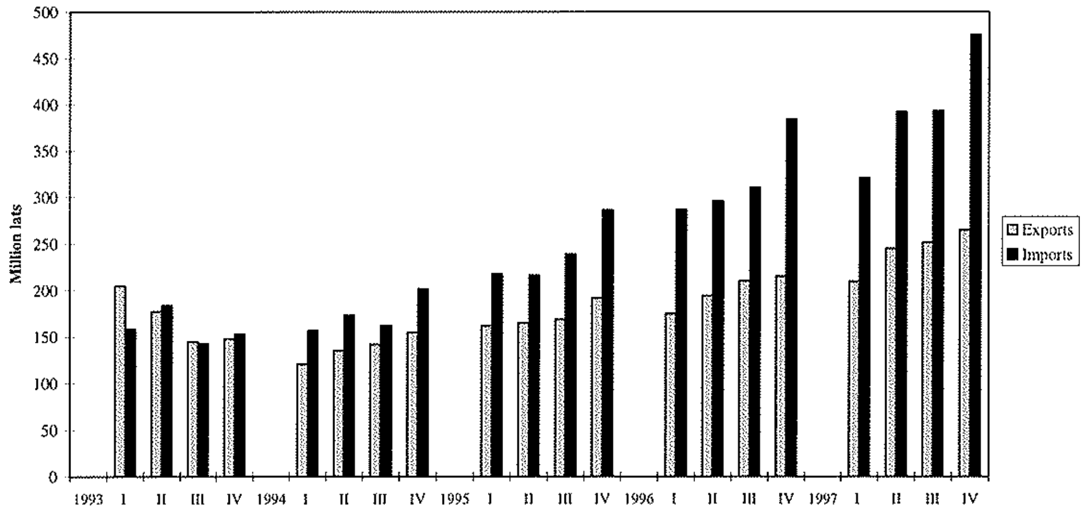
The largest successes have been reached in the field of harmonising social and labour legislation. This is necessary in order to create one of the main freedoms of the market place – the freedom of labour mobility. In implementing EU and WTO recommendations on market liberalisation, however, a contradiction has emerged. In the pre-accession period, EU applicant countries must take steps to liberalise their markets so that goods and services from European countries can flow into new markets and so that four new freedoms, which are linked to the common market and which are equally applicable to all countries with which Latvia maintains foreign trade contacts, can be established. Once Latvia joins the EU, however, it will have to reinstate limitations against those countries which are not EU member states so that the policy of defending the EU local market can be implemented.

The main steps in limiting monopoly operations and promoting market competition have been the privatisation of large companies, as well as the adoption of two important laws – a new commercial code and a new law on competition. The privatisation of the stock company *Latvijas Gaze* (the gas supplier) is almost finished, and foreign partners are guaranteeing 55 million lats for the development of the company. Throughout 1997, potential privatisers of the stock company *Latvijas Kugnieciba* (the Latvian Shipping Company) were selected. Privatisation proposals are also being prepared for the state stock company *Latvenergo* (electricity supplier) and for *Lattelekom* (the phone company). No steps have been taken, however, toward the privatisation of other major monopolies: the state stock companies *Lidosta Riga* (the Riga airport), *Latvijas Dzelzcels* (Latvia Railroad), *Latvijas Pasts* (the postal service) and the Riga free port. Overall, 95% of the state-owned companies have already been turned over for privatisation.

The privatisation process in Latvia has taken a long time, but it is nearing conclusion. The operations of companies, which have already been privatised, have not been uniformly successful. Among the reasons for many problems is the fact that privatisation required so much time, that the traditions of a state-owned company are hard to overcome, and that many companies have trouble competing in the market.

Apart from the influence of the privatisation of large companies, of much greater importance is the development of new companies, and this process has slowed down. At the beginning of 1997 the private sector provided 59 % of Latvia's GDP and employed 64% of the country's workers.

Figure 5. Export and import volumes



Source: Monthly Bulletin of Latvian Statistics, #2, 1996, Riga, Central Statistical Bureau of Latvia, (1996)
Monthly Bulletin of Latvian Statistics, #5(48), 1998, Riga, Central Statistical Bureau of Latvia, (1998 June).

7. THREATS AND POSSIBILITIES

Several processes, which are important in terms of Latvia's economic development, continued in 1997.

At its December Luxembourg summit, the EU confirmed that will differentiate between the ten Central and East European countries which have applied for membership. While all ten CEECs are to participate in standing European Conference in March, only five may a formal screening process in April leading to accession negotiations. The remaining five are to have 'pre-accession partnerships', involving annual reviews by the European Commission of their progress towards EU membership criteria. Latvia was on the second list. The main reasons why European Commission experts cast doubt on Latvia's readiness to begin negotiations were the following:

1) Political criteria:

- Unsatisfactory operations of the courts system and possible corruption (this has not been proven);
- The slow pace of naturalisation among non-citizens;
- Equality guarantees for non-citizens and minorities, including the right of people to choose their profession and to participate in the democratic process (no human rights violations have been noted in Latvia, and existing norms implement steps aimed at securing the political safety of a small country, and to protect the state from the indirect intervention of another country; the Commission's accusations, therefore, seem unfounded).

2) Economic criteria:

- The slow pace of implementing laws to regulate the economy;
- Incomplete privatisation;
- An insufficiently developed banking sector (it is difficult to agree with this conclusion);
- The slow pace of privatisation;
- Inability to handle the pressure of EU competition and market forces.

3) The ability to carry out the obligations of an EU member country (in terms of observing the EU's basic laws):

- A comparatively slow approximation of national laws to EU directives and regulations in concert with the instructions given in the White Book (at the time when the Commission recommendations were prepared, Latvia had adopted 253 of the 899 directives and regulations that are listed in the White Book that was published on May 3, 1995);
- The weakness of Latvia's public administration system – work must be done to improve the operations of the state governance apparatus;
- Poor border controls;
- Problems with statistics and the customs system;
- Difficulty in implementing the EU's common agricultural policy.

Even though the European Commission's conclusion was negative, it did spur encouragement, and it provided specific instructions for future work in the area of European integration. At the beginning of 1998, with the help of the PHARE program, work was begun on elaborating a medium-term development strategy for Latvia. Work is also continuing on the harmonisation of legislation.

The main attention is being paid to eliminating obstacles against entrepreneurial activity and to promoting competition and free market development, thus preparing the country for the four freedoms, which are integral in the EU's common market. These efforts correspond both to potential membership in the EU and to potential membership in the World Trade Organisation.

Several laws were adopted in 1997, which promote business activity:

- The number of types of business which require licensing was reduced from 165 to 118 in 1996 and then to 66 in 1997;
- Laws were adopted to regulate the mortgaging of property that is involved in business operation, as well as the mortgaging of movable property;
- A new commercial law was elaborated which will implement new terminology and theoretical principles that are in harmony with those of the EU;
- A small and medium business support program is being carried out;
- A program to support specific regions in Latvia is also in place, and other steps are being taken, too.

In terms of European integration, greater importance is being assigned to the mutual co-operation among the Baltic States, as well as Latvia's co-operation with countries of the Baltic Sea region, including Finland. The most important recent political event in terms of Baltic integration was the signing of the US-Baltic Charter in January 1998.

The organisations of Baltic co-operation all continued their work in 1997, but accomplishments were modest. At the government level, Baltic unity was hampered by lack of agreement on border questions and inability to find a common ground for this issue. The question of a unified Baltic market (a customs union, free flow of capital and labour, harmonisation of tax systems) is proceeding slowly. A unified Baltic market is considered to be a mini-model of the EU's common market, so its establishment is important not only in terms of Baltic co-operation, but also in terms of European integration. It was only in 1997 that the positive effects of the Baltic free trade agreement began to appear – trade among the Baltic States expanded (Table 7).

Table 7. Latvia's foreign trade

	1994		1995		1996		1997	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
Total	553.4	694.6	688.4	959.6	795.2	1278.2	971.7	1582.3
of which in %:								
EU	39.2	40.6	44.0	49.9	44.7	49.2	48.9	53.2
CIS	42.7	30.5	38.3	28.2	35.8	25.5	29.5	19.7
Estonia	2.6	3.5	3.1	5.1	3.7	5.7	4.2	6.0
Lithuania	5.5	5.9	5.5	5.5	7.4	6.3	7.5	6.4
Finland	2.4	8.5	3.2	10.4	2.4	9.2	8.3	7.7

Source: Statistical Yearbook of Latvia, 1997. Central Statistical Bureau of Latvia, Riga, 1997. Also *Monthly Bulletin of Latvian Statistics*, #12(43), 1997, #5(48), 1998. Riga, 1997, 1998.

Investments from Estonia also increased. Estonian businesses have invested money in the Latvian banking and insurance sector, in food industry (meat and fish processing) and in computer manufacturing, and they also carry out various projects inside Latvia.

Table 8. Total foreign investment stock and share of Estonia, Lithuania and Finland, cumulative at end of period, million LVL

	1992	1993	1994	1995	1996	1997*
Total	22.5	50.3	173.3	274.2	371.5	531.8
Estonia	0.06	0.39	0.21	0.28	1.4	3.8
Lithuania	0.24	0.3	0.33	0.27	0.17	0.09*
Finland	3.5	3.0	2.2	2.8	2.7	2.9

* Investment in large enterprises, which made up 60% of Lithuania's total investment in Latvia.
Source: *Investment in Latvia, Quarterly Bulletin*, #2/1997, Central Statistical Bureau of Latvia, Riga, 1997. Also *Monthly Bulletin of Latvian Statistics*, #12(43), 1997, Riga, 1997.
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Baltic co-operation takes place also in other fields, including regional planning, trans-frontier co-operation, co-operation in scientific research, and co-operation in local government issues. Latvian co-operation with Estonia has been more active than the co-operation with Lithuania. Recently Latvia's co-operation with Finland has also expanded and taken on a new face. If previously co-operation concentrated mostly in the cultural field (a process of long-standing traditions), then now economic co-operation has expanded, and one can sense interest among Finnish government and business representatives in Latvia. There is reason to believe that Finnish businesses implement their interests in Latvia at least in part through Finnish-Estonian joint ventures. In addition, Finland has always been one of Latvia's main trade partners. The interests of Latvia, Estonia and Finland coincide in such major infrastructural projects as the *Via Baltica* highway project, the development of a Tampere-Helsinki-Tallinn-Riga development zone, the Baltic Ring, the "Baltic gate", etc.

Latvia's accomplishments have been recognised by foreign experts. The credit ratings assigned to Latvia by the international independent agencies *Standard & Poors* and *Moody's* are among the highest in Central and Eastern Europe, and they correspond to the so-called investment level of ratings. There are hopes that the high rating will provide an impulse for greater foreign investment in the country.

One can say that Latvia's economic performance in 1997 exceeded the forecasts of foreign observers concerning the near-term development.

Latvia's further economic development will be affected positively by several things:

- The main free market institutions are in place and are functioning;
- Privatisation and the extensive process of establishing new companies are almost complete, the legal status of companies has been clarified, and competition-based selective processes are in place;
- Wherever institutional barriers do not block it, a process of manufacturing concentration has begun;
- Thanks to economic stability, processes of capital accumulation and effective utilisation have begun, and this serves to promote increased investment;

- The state's attitude toward infrastructural development has changed, and the volume of the state investment program is increasing;
- As the securities market develops and banking operations improve, opportunities to attract foreign and local capital have expanded;
- Income and savings of the population have increased slightly, and these are resources which can also be used for financing the economy;
- The institutional base for entrepreneurship has improved;
- The work of those institutions which work to promote the state and its entrepreneurs has become stronger and more purposeful (exhibitions, seminars, market research, etc.);
- As the result of educational programs, the professional qualifications of those who are engaged in business have improved;
- As the result of economic development, the whole country becomes more attractive as a place to live and work, and this may serve to promote the inflow of foreign capital.

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ELINKEINOELÄMÄN TUTKIMUSLAITOS (ETLA)
THE RESEARCH INSTITUTE OF THE FINNISH ECONOMY
LÖNNROTINKATU 4 B, FIN-00120 HELSINKI

Puh./Tel. (09) 609 900
Int. 358-9-609 900
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