Threats and opportunities regarding Latvia's economy

by Raita Karnite

On the surface, Latvia and other Baltic States, have demonstrated surprising progress in developing their economies. Growth rates have been high for several consecutive years in all the Baltic States with varying degrees of success for each country. Estonia attains better positions in all international comparisons and evaluations, whereas Latvia and Lithuania occupy lower positions, yet in the middle of the list, usually next to each other.

Economists know that a high growth rate does not necessarily provide good economic development, or, that quantitative achievement not always transforms itself into adequate qualitative achievement. The adequacy of qualitative and quantitative improvements depends on the growth engines.

Taking Latvia as an example, high economic growth is supported by strong domestic demand; besides a low starting level helps to see high growth rate figures. The average annual GDP growth rate has been more than 9% for five consecutive years, and the steep rise (more than 10%) continues since 2005[1]. The domestic demand is fueled by higher real income, resulting from the dynamic expansion of lending, FDI, financing from EU structural funds and other factors.

It is expected that the present pace of Latvia's economic development will remain unchanged for some years. The Bank of Latvia reports[2] that the annual lending growth rate was 59.5% in QII 2006. However, the positive effect of loans availability is deteriorative as lending activities are focusing on consumption financing. More than half of all the credit issued goes to households, primarily for house purchase. Two-thirds of the corporate loan portfolio is allocated towards real estate, renting and business companies. The third larger borrower is the banking sector itself. Through this disproportional financial provision, banks have encouraged structural changes in the Latvian economy within a short time period. In 2004, the increase in the gross value added was equal in the goods-producing and services sector, while in 2005 growth in the service sector (by 11.2% on y/y basis) surpassed that of the goods-producing sector (7,9%)[3].

The high increase in money supply continues (about 40% in QII 2006), and also domestic deposits grew by more than 40%[4]. The lending activities of foreign-owned banks surpass borrowing; essentially meaning that banks no longer primarily transport money within the Latvian economy, giving earnings to lenders in Latvia, but they allocate deposits accumulated in their parents into Latvian economy thus increasing external debt. The banks focus on the high profit and liquidity sectors – currently the real estate sector, on the basis of mortgage crediting. This business is attractive, and several other foreign-owned banks have entered the Latvian financial market in 2006.

Due to the substantial structural changes, the picture seems less sunny from the supply side of Latvian economy. The Bank of Latvia states[5], that the upward trend in GDP is strongly supported by a steady rise in retail trade turnover, while the progress in manufacturing is considerably less, associated with internal demand. The demand for exports has slowed in the main exporting sectors in QII 2006. The growth was also moderate in the transport, storages and communication sectors due to problems of oil and mineral fertiliser transit.

On other hand, imports grew at the high average pace. The deterioration of the goods balance persisted and the current account deficit jumped to 17.9% of GDP in QII 2006. The deficit was covered by long term capital, of which FDI comprised almost half[6].

The economy faces some other structural problems – tight labour market conditions, emigration, and fast-growing labour costs and salaries, as well as high inflation on the basis of price rises for energy, increasing material and labour costs. The bubble of the real estate market has reached considerable amounts, yet prices continue their growth. It is clear that the current situation can not remain forever and there should be changes. What changes would we like to see?

They must turn the economy from the dangerous "only consumption" oriented path to a more sustainable one, by forwarding a part of the lending to the producing sectors – no matter to the material production or service sectors. It is likely that foreign-owned banks are not going to cut their lending activities and prefer consumption credits unless other sectors show better productivity. The first comers' preferences in using unbelievably cheap labour are almost exhausted. Investors have not yet understood profit from that of investing in productive sectors, and clearly demonstrate their short-term interests in Latvia. In this moment, the winner will be the one who finds new paradigms of competitiveness in Latvia. The external situation also supports investment in NMS in general and Latvia in particular. Economic development in the "core" EU countries remains uncertain – good in projections but moderate in real figures whilst growth rates in NMS remain high.

What are the new paradigms of competitiveness in Latvia? From the current point of development, it is the implementation of the Lisbon pattern in an easy way. The share of industry in Latvia's GDP is only slightly more than 12%, and it is segmented into a large number of small production units. The development of knowledge-intensive service sectors is also moderate, so the market is free and competition stays away. On the other hand, the availability of the highly-skilled workforce is still substantial. At the time being labour resources are used and paid inadequately with regard to their qualifications, labour productivity may be raised several times. Besides, the government has declared support for the knowledge-intensive model of Latvian economy in the National Development Plan that governs investment priorities in forthcoming years.

We may conclude that the development reserves of the Latvian economy remain high. Despite the dual situation at the current moment, and probably because of it, the country is at the beginning of a new development wave.

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[1] Monthly Bulletin of Latvian Statistics, 9(148) 2006, CSB, October 2006, p.4

[2] Monetary Review 2/2006. Latvijas Banka, 2006, p.31.

[3] Bank of Latvia: Annual Report 2005, p. 14

[4] Monetary Review 2/2006. Latvijas Banka, 2006, p.31.

[5] Monetary Review 2/2006. Latvijas Banka, 2006, p.31.

[6] The same.

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