THE ROLE OF INVESTMENT IN A SUSTAINABLE DEVELOPMENT OF THE ECONOMY OF LATVIA

Maija Senfelde
Technical University – Riga, Latvia

ABSTRACT

In the 1990s Latvia had to face many economic and political problems related with the transformation process. Since the mid 90s, economic activity in Latvia has been on a constant rise and GDP has gone up approximately twice as fast as the average figure in the EU. The role of investment is very important for a sustainable and balanced economic development. Despite the advantages, Latvia has to still resolve a number of problems:1)investment is mainly made into low and medium technology sectors; 2) a serious problem is the differences in the development of Latvia's regions, but depressive regions are not attractive for investors. So the development of qualitative public services and infrastructure is very relevant for balanced and sustainable economic growth in the regions, and article presents the possible solutions of this problems.

Key words: economic growth, investment, foreign direct investment, infrastructure, regional development, public and private partnership

In the 1990s, the same as other countries of Central, East and South-East Europe, Latvia had to face many economic and political problems related with the transformation process. This process is too complicate to be completed overnight, but it is possible to say with surety that the transition from the planned economy to the market economy in Latvia is irrevocable.

Since the mid 90s, economic activity in Latvia has been on a constant rise. The reforms accomplished in Latvia, as well as integration in the EU have left a positive effect on the economic development. The GDP has gone up approximately twice as fast as the average figure in the EU.

Latvia has shown one of the highest economic growth rates in the EU. In the period from 2001 to 2004 the average gross domestic product growth in Latvia was 7.6% a year High growth rates are due to stable domestic demand dynamics and ability of Latvian companies to expand their export markets. Growth has been observed in all major branches of economy.

Output in manufacturing has been growing steadily for several years – by 9-10% every year since 2001. In recent years wood industry, machine building and metalwork production have contributed most to the industrial growth in Latvia. The growing euro exchange rate is having favourable effect on competitive ability of Latvian producers in the EU market. But exports grow not only to the euro-zone countries but also to other EU member states and the CIS countries. This shows that several branches of industry are competitive on foreign markets even upon not so favourable conjuncture conditions. The manufacturing is likely to remain one of the fastest growing branches also in the coming years.

Construction industry keeps showing dynamic growth, rising by 13.7% in 2003 and 12% in nine months of 2004. Construction of industrial and residential buildings, hotels, streets and roads, and other objects is growing rapidly. The construction industry is expected to maintain high growth rates also in future in relation to development of mortgage lending, increased economic activity and investments as well as implementation of projects financed from the EU funds.

There has been a small growth also in agriculture. Low productivity and external competition are the main obstacles to development of this industry. Agriculture development will depend on adjustment of agricultural production facilities and products to the EU standards and quality criteria and the external demand. Latvia's accession to the EU will ensure more equal competition opportunities for farmers in the EU internal market and support from the EU funds will facilitate modernisation and diversification of agricultural business.

Transit services are of great importance for the national economy of Latvia. They constitute approximately 15% of revenues from Latvian exports of goods and services or about 5% of GDP [2].

Economic growth in Latvia has been achieved in conditions of stable macroeconomic environment. The Bank of Latvia is implementing a policy of fixed national currency exchange rate. This reduces uncertainty, eliminates exposure to currency risk and gives entrepreneurs a stable base for planning and price setting.

Starting with January 1, 2005, Latvia stops pegging the lats to the SDR basket and pegs it to the euro instead. The Bank of Latvia on December 30, 2004, has fixed the peg rate of lats and the euro at 1 EUR= 0.702804LVL, which took effect on January1, 2005. When the EU Council decides that Latvia is ready to join the European Monetary Union (EMU), the Latvian national currency will be substituted by the euro and the Bank of Latvia will discontinue to implement an independent monetary policy. According to the forecasts of the Bank of Latvia, this could happen at the beginning of 2008.

In 2000-2003 the average consumer price inflation in Latvia has been within the limits of 2-3%. In 2004 inflation was higher than the price growth observed in previous years. Inflation in November 2004 increased by 7.2% as compared to November 2003. Higher inflation growth in 2004 was due to a combination of several one-time factors, mainly the rise of administratively regulated prices, harmonisation of indirect tax rates, inflation expectations related to Latvia's accession to the EU, high oil prices. It has been forecast that inflation will gradually return to its previous level in the coming years.

The goal of the fiscal policy implemented in Latvia is to secure a balanced economic growth and financial stability. Since 1996, with the exception of 1999 when the fiscal situation reflected the consequences of the Russian financial crisis, the fiscal deficit of the consolidated total state budget has been below the maximum 3% of GDP permitted under the Maastricht Treaty [4].

Table 1. Latvia: Key Indicators of Economic Development [2]

	2001	2002	2003	2004	2005 f
	(changes over the preceding year, %)				
Gross domestic product	8.0	6.4	7.5	8.5	7.5
Private consumption	7.3	7.4	8.6	10.0	7.0
Public consumption	2.8	2.2	1.9	4.0	2.5
Total fixed capital formation	11.4	13.0	10.9	20.0	15.0
Exports	7.5	5.2	5.0	9.8	6.8
Imports	14.5	4.6	13.0	14.0	8.3
Consumer prices	2.5	1.9	2.9	6.2	5.5
	(in % of GDP, unless indicated otherwise)				
General government budget fiscal balance	-2.0	-2.3	-1.6	-1.8	-1.7
Central government debt	13.8	13.3	13.4	13.5	13.6
Current account balance	-7.6	-6.7	-8.2	-10.7	-9.8
Foreign direct investments (flows)	1.6	2.8	2.7	4.5	4.5
Share of job seekers (% of economically active population, 15-64 years old)	13.3	12.1	10.7	10.0	9.5

f – forecast

The EU is the main trading partner of Latvia. Trade with the EU member states has been constantly expanding since restoration of Latvia's independence and currently as many as 80% of total exports and imports are linked with the EU, including also the new EU member states. Most of Latvia's foreign trade turnover in ten months of 2004 was made up by trade with Germany (14% of the total), Lithuania (11%), Sweden (8%), Russia (8%) and the United Kingdom (6%).

During 2000-2002 exports of Latvian goods in current prices grew by 11-12% annually, and in 2003 export growth was 17%. In 2004 Latvian exports increased by 26%, including a 22% growth of exports to the EU-25 states. Exports grew in all categories of goods with the biggest growth recorded in wood industry, metal processing and machinery sectors which contributed respectively 16% and 29% of the total export growth.

The role of investment is very important for a sustainable and balanced economic development. Investments have a decisive role in provision of the national economy growth, as there is a close correlation between the increase of investments and the increase of GDP. The growth of investment and the share of investment in GDP in Latvia are among the highest.in the group of the EU new member countries. From 1996 till 2003 the total fixed capital formation annually increased by 17% on average. Investments grew especially rapidly during 1996-1998 in relation with the privatisation process. Investments are promoted by several factors, including stable macroeconomic environment, inflow of foreign investments, reduction of interest rates on loans and strengthening of the banking sector, increase of general economic activity and formation of positive future expectations. Expenditure for the total fixed capital formation in Latvia during 2001-2003 has increased by 36% or by 10.7% annually. The share of investment in the GDP over the past three years has formed 24.4% on average, indicating that nearly a quarter of national income has been used for the total fixed capital formation annually.

During 2001-2003 investment into the sectors of Latvian economy grew by 28.6% or on average by 8.7% annually. It should be noted that over the past three years the investment dynamics has been faster in the production sectors due to the growth of general economic activities, improvement of crediting terms and investment favourable economic policy. This tendence is very positive because of the great importance of the production sector in the development of the economy. Over the past three years investment into the production sectors went up by 37.5% (or on average by 11.2% annually), whereas investments into service sector grew by 25.2% (on average by 7.8% annually). Over the mentioned period the fastest investment growth was recorded in primary sectors. Investment into mining industry and agriculture in 2003 doubled in comparison with 2002. Meanwhile, investment decrease was fixed in such sectors as education, health care, transport and communications.

Sustainable economic growth is linked not only to the level of investment, its quality and dynamics. Nonetheless important are the sources of financing investment, i.e. domestic and foreign saving.

In the recent years the level of national savings in Latvia amounted to average 18-20% of the GDP or 65-70% of investment into fixed assets. According to the savings – investment balance, funding for fixed assets investment by 30% on average was ensured by the attracted foreign capital, mainly in the form of foreign direct investment.

By the end of 2003 foreign entrepreneurs had invested in Latvia foreign direct investment in the amount of 205.6 million LVL or 775 LVL per capita, which is one of the lowest indicators among the new EU states (see Figure 1).

Investment of the developed countries dominate in the geopolitical structure of the FDI stock (see Figure 2). Notably, that investment of the EU-15 states account for more than half of the total FDI stock. According to the Bank of Latvia data, the biggest amounts of investment have been received from Germany, Sweden, Denmark, Finland, USA, Norway and Estonia, contributing to almost 70% of all FDI stock in Latvia. Majority of these countries are also the biggest trade partners of Latvia.

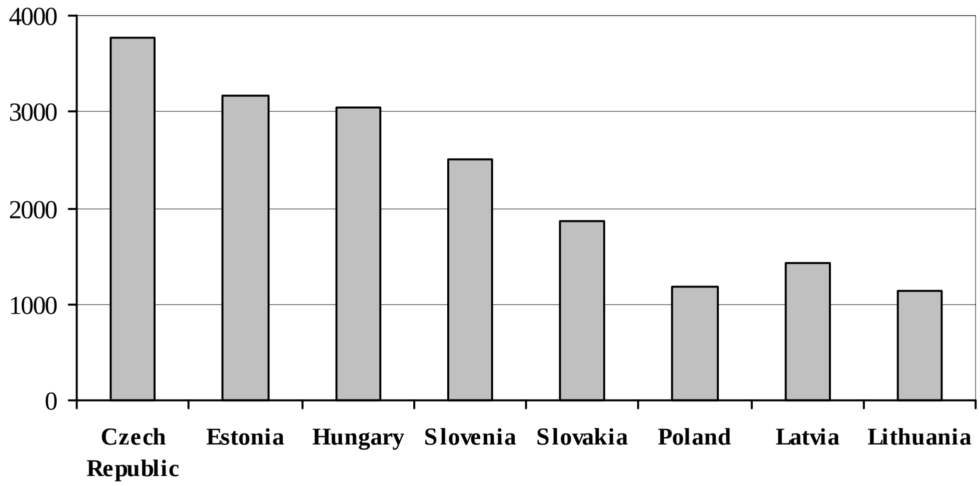

Figure 1. FDI Stock per Capita in the new EU states (end of 2003, USD) [2]

In 2003 the most significant amounts of direct investment in Latvia were made by Swedish, Dutch and Finnish entrepreneurs, contributing almost 60% of all incoming investment (Figure 2).

Very important for the further development of economy is the structure of FDI stock (see Figure 3). The highest share in the total structure of FDI stock belongs to the commercial services sector. Manufacturing sector experiences stable annual investment growth. In 2003 the amount of FDI in this sector grew by 30.5 million LVL or three times more than in the preceding year. (Figure 3)

In terms of the qualitative structure of foreign investment into manufacturing we must note that

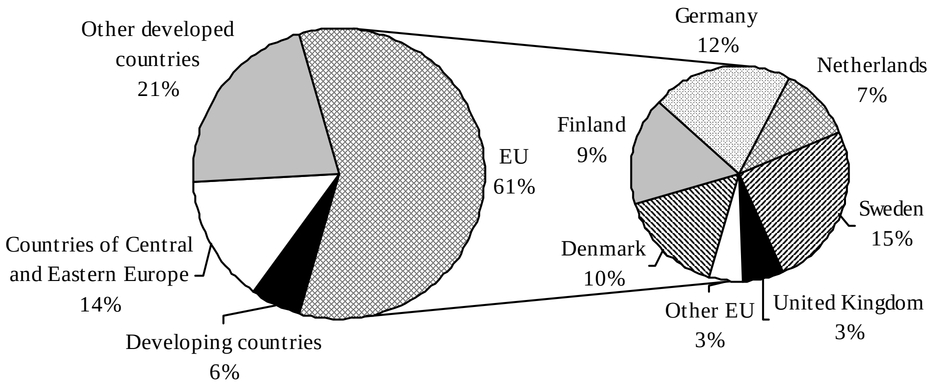

Figure 2. FDI Stock by Group of Countries (end of 2003, percentage) [2]

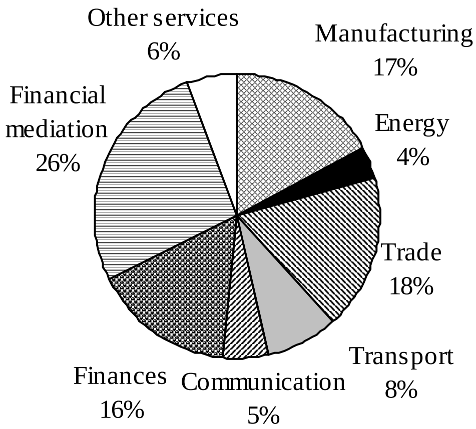

Figure 3. FDI Stock by Sectors (end of 2003, percentage) [2]

investment is mainly made into low and medium technology sectors (see Figure 4). Germany made the biggest investment into manufacturing or 14% of the total investment into manufacturing, channelling its investments mainly in the sectors of low and medium technologies. These sectors have also absorbed UK and Swedish investment. Meanwhile, Ireland is the biggest investment contributor to the medium technology sectors.

Only a few so-called greenfield projects, involving introduction of new and modern technologies, have been implemented in Latvia. Even in sectors that have the highest potential to implement such projects, only that part of work, which requires a relatively low labour qualification, is being performed in Latvia.

To ensure long-term sustainable development of Latvian economy it is necessary to continue to develop infrastructure, invest into education and create other preconditions to lure foreign investors to

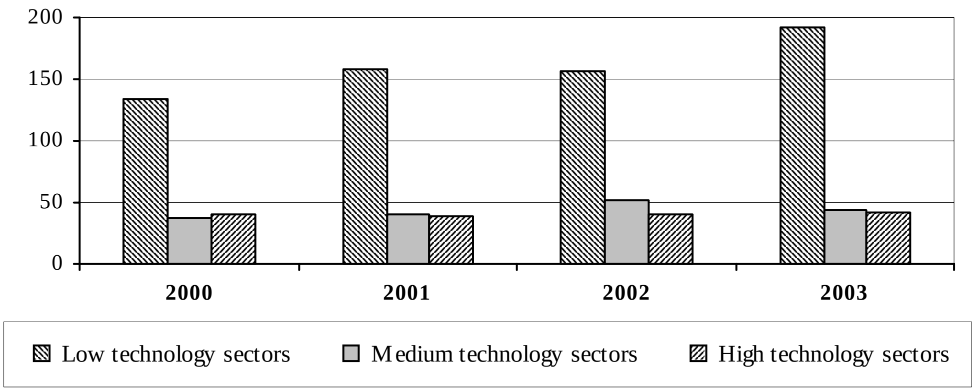

Figure 4. FDI Stock in Manufacturing (end of 2003, million LVL) [2]

invest in knowledge intensive and high technology sectors.

Infrastructure and its level of perfection and accessibility are the preconditions for the growth of the national economy. However, the Soviet time infrastructure (roads, water and heat supply systems, etc.) is already worn out and does not comply with the requirements of up-to-date market and environment. Besides, the state has to invest in the spheres where the private sector is not interested to invest. Insufficient investments in putting the infrastructure into order lead to the decrease of foreign investments, raise costs of the private sector and lead to a slower development of economy on the whole.

Latvia has joined the European Union, and it means introduction of different directive requirements and additional investments. Latvia is determined to ensure compliance with environmental requirements until 2015. It has been calculated that the total amount of investments could exceed 800 million lats, from this amount roughly 660 million lats are needed for bringing into order water supply systems, 190 million lats – for the erection of hazardous waste dumping grounds[3]. Apart from the compliance with the environmental requirements, Latvia has to ensure the introduction of all other requirements of the directives, which means additional investments.

An other serious problem is the differences in the development of Latvia's regions. Latvia is divided into six statistical regions (see Figure 5)

Marked social and economic differences between regions exist in Latvia. More than a half of

-

Figure 5. Statistical regions of Latvia

the total GDP of Latvia is produced in Riga (see Table2)

In 2002 Riga and Riga district together produced 68% of Latvian GDP. Riga is the only region which exceeds the average level of 10 new EU member states reaching 138% against this level. Average indicator for Latvia makes 76% of this level and the poorest region Latgale makes only 37%.

Most of entrepreneurs prefer Riga region as the most suitable place for developing their business. In 2003 the number of economically active enterprises in Riga region was 25 385 but their total number in Latvia was 45 300. In Latgale there were only 10 economically active enterprises per 1000 inhabitants, which was three times less than in Riga (see Figure 6). In 2003 the number of economically active enterprises in Latvia increased by 2766 enterprises, and the most significant increase was characteristic to Riga region (by 2008 enterprises).

Depressive regions are not attractive for investors. So the development of qualitative public ser-

Table 2. GDP of Statistical Regions in 2002 [1]

Name of territory	GDP in real prices		GDP per capita	
	total in thousands LVL	% of total	LVL	% against the state average
Latvia	5 689 376	100	2 433	100
including:				
Riga	3 283 356	58	4 418	182
Pierīga	572 612	10	1 596	66
Vidzeme	354 951	6	1 407	58
Kurzeme	637 296	11	2 015	83
Zemgale	394 993	7	1 354	56
Latgale	442 871	8	1 176	48

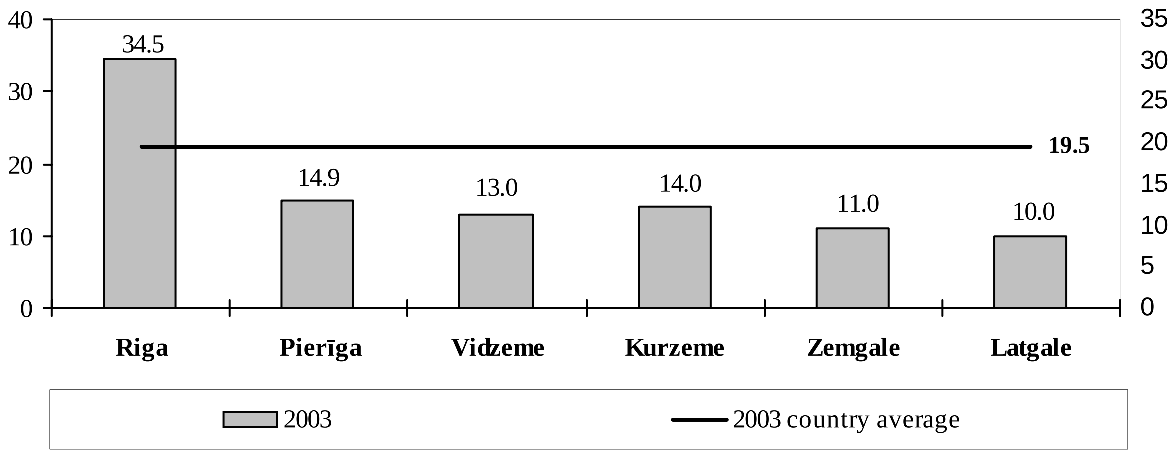

Figure 6. Number of Economically Active Enterprises per 1000 Inhabitants [2]

vices and infrastructure is very relevant for balanced and sustainable economic growth in the regions. Environmental infrastructure is for the most part the property of local authorities or their companies, and this means that implementation of environmental requirements is to be ensured by local authorities. However, local authorities have very restricted resources at their disposal, in most local authorities these resources are sufficient only for covering maintenance costs. Besides, it is necessary to take into account the long repayment period of the projects of environmental infrastructure, they are not profitable to local authorities. For local authorities the introduction of environmental requirements is impossible without attraction of other sources of financing, including public investments.

At the same time, these are not only huge investments that are necessary to ensure the compliance of public services and infrastructure to the contemporary requirements, efficient investment policy pursued by the state is also an essential precondition. Investment proposals in Latvia are still considerably lagging behind investment amounts required. The state has a shortage of financial resources, and additional cost limitations are subject to the Maastricht criteria on the state debts and budget deficit constraints. In such a situation Latvia began to realize the experience of the other EU countries to use the public and private partnership as one of the ways to attract private investments.

PPP is a cooperation between a public or municipal institution and a company from the private sector, within the framework of which a public service or object on terms of agreement is provided to a private entrepreneur, who invests funding for rendering/improvement of the mentioned infrastructure or service project. It is essential to remember that such cooperation is not privatization, but is performed temporarily (up to 25-30 years) and in compliance with state/municipality determined conditions. In literature we can divide several PPP models, which can differ depending on risk allocation in the project.

For example, a concession is only one of the PPP kinds, where the private entrepreneur recovers investments by user's charge.

The development of qualitative public service and infrastructure has a significant role in the balanced and sustainable national economy growth. In Latvia the institutions responsible for promotion of public-private partnership in comparison with such countries as Ireland and Great Britain are at the beginning of their development, but that does not stop them from bringing forward ambitious aims and already now efficiently using the foreign experience.

Literature

1. Report on the Economic Development of Latvia. Ministry of Economics,Republic of Latvia. Riga, December, 2003.
2. Report on the Economic Development of Latvia. Ministry of Economics,Republic of Latvia. Riga, June, 2004.
3. Report on Environmental Investments 2001-2002. Ministry of Environmental Protection and Regional Development, Republic of Latvia. Riga, 2001.
4. Statistical Yearbook of Latvia 2004. Central Statistical Bureau of Latvia, 2004.