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Overview of the Latvian Economy

(in the context of the development of the Multi-sectoral Macroeconomic Model of Latvia)

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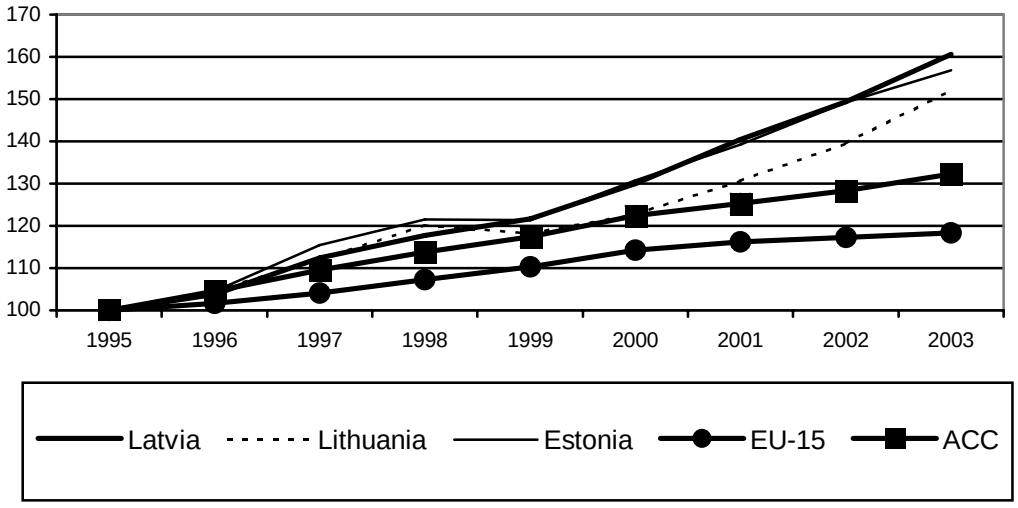
1. GDP growth

The Latvian economy, together with the rest of Eastern Europe, experienced a sharp and deep reduction in GDP in the early stages of transition. Between 1989 and 1995, the cumulative impact of this transition in Latvia is estimated to have halved the total amount of GDP. This implies a somewhat steeper decline than that experienced by other currently new EU member states.

This phase of collapse bottomed out in 1995 and, in 1996, the Latvian economy began to grow again (see Figure 1).

Figure 1

Real GDP, 1995 =100



1997 marked a rapid growth, which was slightly slowed down by the impact of the Russian 1999 and 2000 crisis.

Latvia's growth over the last 8 years was the most dynamic among the new EU member states, annually on average reaching 6.1%. The growth is particularly rapid in the last 3 years – by 7.3%.

At the same time, it has to be noted that the growth was from a very low level. In 2003, Latvian per capita GDP, according to PPS, accounted for 41.5% of the average EU-15 level. In 995, it was only 29.1%.

The GDP growth was ensured mostly by the growth in productivity and to a smaller extent by the increase in employment.

The Ministry of Economics has developed two medium-term development scenarios (till 2009) depending on the variations of the external demand – the slow variant of development (Variant I), with a limited possibility to increase exports, and the dynamic variant (Variant II), when growth of exports is more dynamic, which might happen in case of a more favourable external conjuncture. Table 1 presents the forecasts for the dynamic growth variant.

Table 1

GDP growth

(percentage change over the previous year average in the period)

	GDP	Productivity	Employment
1996-2003	6,1	5,7	0,4
1996-2000	5,4	6,1	-0,7
2001-2003	7,3	4,9	2,3
	Forecasts		
2004	7,5	6,4	1,0
2005-2007	8,0	6,9	1,0

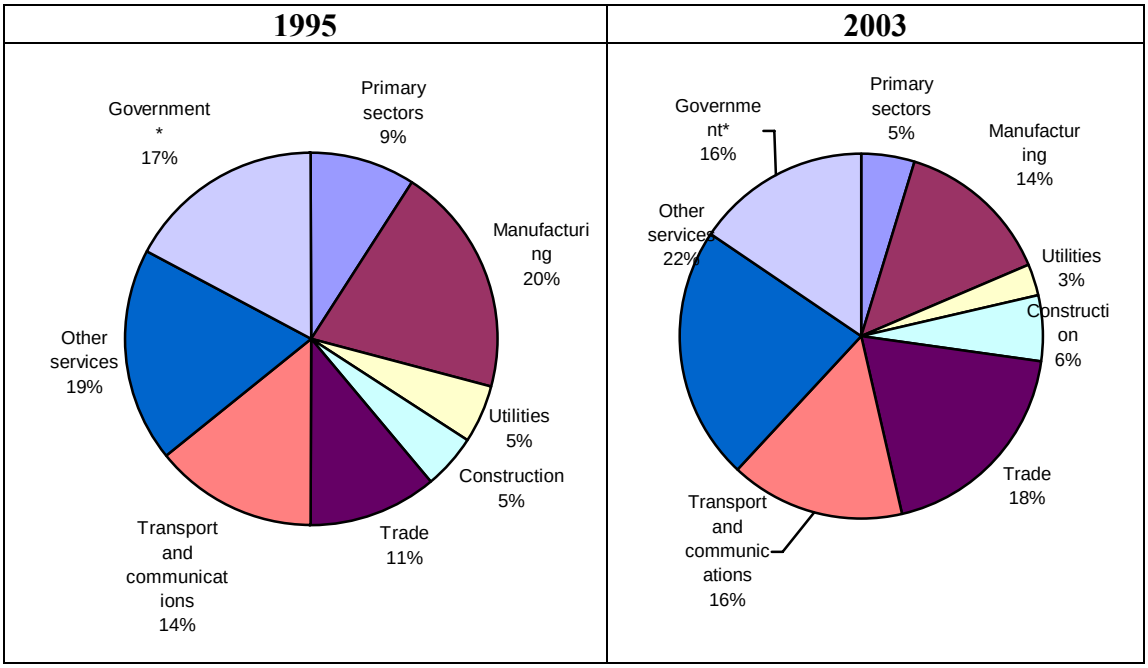
It is projected that the insofar tendencies will persist also in 2004 and 2005, namely, the stable domestic demand and expansion of exports. Additional incentive for growth might be provided by the accession to the EU.

2. Sectoral composition of GDP

In order to elaborate more accurate and more substantiated national development forecasts, it is necessary to design and apply appropriate modelling instruments, especially such that would enable to more adequately forecast structural (sectoral) changes in the national economy. It is a topical objective, considering the fact that over the recent 8 years the structure of the Latvian national economy has essentially changed (see Figure 2 and Table 2).

Figure 2

Sectoral composition of GDP



* Government sector includes public administration, health and education.

Table 2

GDP growth by sectors

(percentage change over the previous year average in the period)

	1996-2003	1996-2000	2001-2003	1994f	1995-1997 f
Primary sectors	2,3	0,8	4,8	3,0	3,8
Manufacturing	6,6	5,0	9,4	10,0	10,5
Utilities	0,3	-2,0	4,2	2,0	2,2
Construction	9,6	9,3	10,2	15,0	12,7
Trade	10,7	10,3	11,4	10,0	8,4
Transport and communications	5,8	4,9	7,3	9,0	8,7
Other services	7,7	8,2	6,8	6,0	8,6
Government*	1,8	1,5	2,3	2,0	2,7
GDP	**6,1**	**5,4**	**7,4**	**7,5**	**8,0**

f - forecasts

The share of the branches of services has essentially increased, especially that of trading services. At the same time, the share of primary industries and manufacturing industry has reduced. However, it has to be noted that over the last 3 years the share of manufacturing industry in the national economy is no longer reducing, but is even slightly increasing. The structure of the branches of the manufacturing industry has also undergone significant changes (Table 3).

Table 3.

Structure of Manufacturing
(value added, %)

	2000	2003
Total manufacturing*	100	100
Food industry (15, 16)	27,4	24.9
Light industry (17-19)	11,4	9.6
Wood and articles of wood (20)	19,1	20.4
Paper industry, publishing and printing (21, 22)	8,7	7.6
Chemical industry (23-25)	4,6	4.4
Other non-metal mineral products (26)	2,9	2.8
Metal and metal products (27, 28)	9,7	9.7
Manufacturing of machinery and equipment (29-35)	10,9	14.6
Other industries (36, 37)	5,4	6.1

* NACE codes are given in parentheses

The industrial structure of Latvia is dominated by sectors using cheap labour and natural resources or sectors with a low value added. The value added created in the food industry, light industry and wood industry accounts for more than a half of the total industrial value added. The same refers to export proportions. One must note that the situation is gradually changing in the last years due to the rapid growth of some sectors in manufacturing of machinery, especially in 2003.

3. Factors of growth

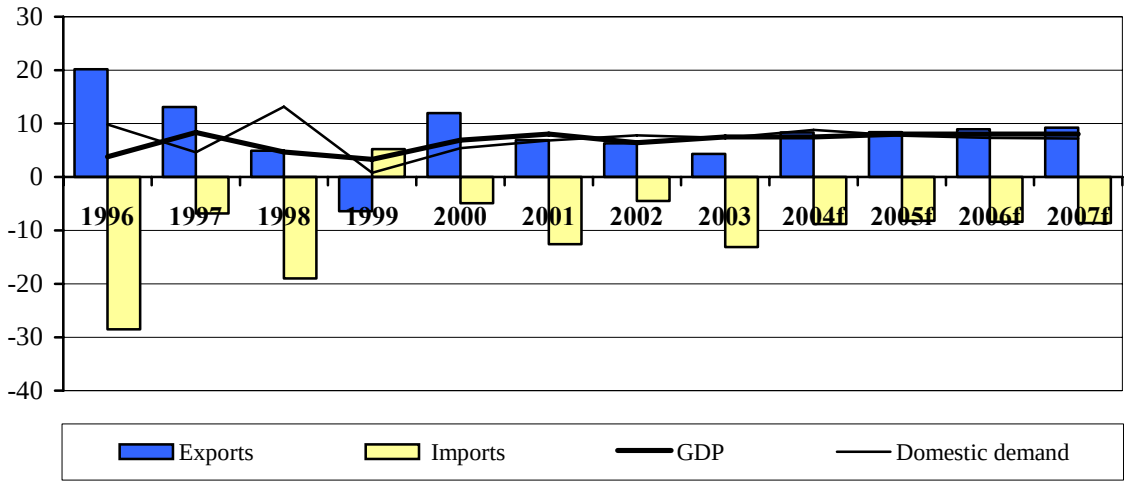
The design of multi-sectoral model is not possible without establishment of the most relevant growth factors both in the national economy on the whole, as well as in separate its sectors, and the research of their impact and dynamics. We consider that currently the most significant growth factors are the following:

3.1. Domestic demand

The stable growth over the last years was mostly ensured by the growing domestic demand. The volume of private consumption has increased. Private consumption is favourably influenced not only by the annual increase of wages of the gainfully employed people but also by the ability of private individuals to benefit from consumption credits and loans to purchase and repair housing that are offered at affordable interest rates. Also the rate of investment is high.

Figure 3

Changes in real GDP and major expenditure items
(percentage change over the previous year)



The increase of the domestic demand has left the most sizeable impact on the development of service sectors and, especially, on retail trade. Other sectors of services, such as commercial services and financial mediation, have also developed quite dynamically.
At least 2/3 of the growth in the sector of transport and communications is triggered by the domestic demand, which is stable and grows faster than the external demand. This especially refers to supporting and auxiliary types of transport activity. Among these, one should mention the development of warehousing, parking services, expansion of services offered by travel firms and other services. The external demand of transit services is quite changeable. Due to the discriminatory attitude of Russia with regard to transit of oil products through the Ventspils Port, total volumes of delivered cargo in ports have declined (especially, in the second half of 2002). In 2003, the indicators improved mainly due to the increase of cargo turnover in other ports of Latvia. However the Ventspils Port is recovering, since more and more cargo is transported to the port by rail.

The drastic growth of investment has a favourable impact on the development of construction. Growth rates of the latter are substantially higher than the average growth rate of the national economy.

It is forecasted that private consumption and GDP will increase at the same rate. This will be ensured by the growth of wages, which in turn will be encouraged by the annual increase of the minimum wage. The insofar-fast crediting rates may continue growing, as the volume of private credits against GDP is still very low. The growth of domestic demand directly influences the development of the services sector; its influence on the growth of industry is smaller.

3.2. Accession to the EU

The strengthening of the competitiveness of Latvia in the conditions of the EU single market, the ability to use structural funds and external conjuncture will determine the speed of growth in the period till 2007.

The accession to the EU provides new incentives linked with:

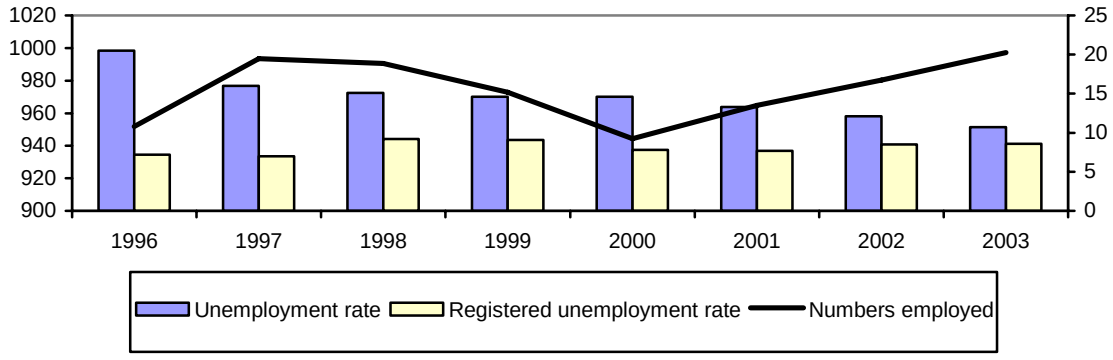
- integration into the EU single market, which will provide Latvia the opportunity to benefit from the advantages of a wide and stable market. It will raise interest of local and foreign investors in the economy of Latvia;
- growing of competition, which will have a different impact on different economic sectors. Some sectors will gain from the expansion of their markets and some sectors will lose. The pressure of the competition will become noticeably stronger in the domestic market with smaller changes in the external market. However, there is no doubt that competition will facilitate modernisation, restructuring and also specialisation, which, in turn, will accelerate the change of the structure of the Latvian national economy;
- improvement of competitiveness in relations with the third countries since Latvia will participate in international trade within the scope of the common EU foreign trade policy;
- possibility to get access to substantial resources from the EU given to Latvia as an EU member state, which will stimulate structural adjustments upon integration into the single market allowing to intensively modernise and expand infrastructure and encourage business activity in all regions of Latvia;
- reduction of financial risks providing access to cheaper loans for Latvian undertakings.

3.3. Employment and productivity

As has been already mentioned above, the total number of employer persons has slightly grown, over the period of 8 years by 3.3%. Due to the Russian crisis the number of employed reduced, but started to grow with the rapid economic growth in 2001-2003. At the same time, substantial improvement in the unemployment rate indicators is due to the reduction of the number of economically active population.

Figure 4

Employment and unemployment



The number of the registered unemployed persons is smaller than the total number of the unemployed (approximately by 20%). There are several reasons for this. Not all can get unemployment benefit since social insurance contributions have not been paid (declared); many are not interested or not able to master retraining programs, especially, in a pre-pension age; often it is quite burdensome to follow all the provisions to get the status of a registered unemployed. Besides, the status of an unemployed is not awarded to persons that are outside the labour age defined in legislation.

As already mentioned above, the main source of growth is the growth in productivity. Productivity growth has been in almost all branches of national economy, except in such a monopoly industry as utilities.

Table 4

Productivity (GDP per worker) growth rates
(percentage change over the previous year average in the period)

	1996-2003	**1996-2000**	**2001-2003**
Primary sectors	4,9	5,4	4,0
Manufacturing	8,8	8,2	9,9
Utilities	-1,2	-4,0	3,8
Construction	3,3	6,5	-1,8
Trade	7,6	7,0	8,6
Transport and communications	3,7	6,8	-1,3
Other services	4,7	6,0	2,6
Government*	2,7	2,2	3,5
GDP	**5,7**	**6,1**	**4,9**

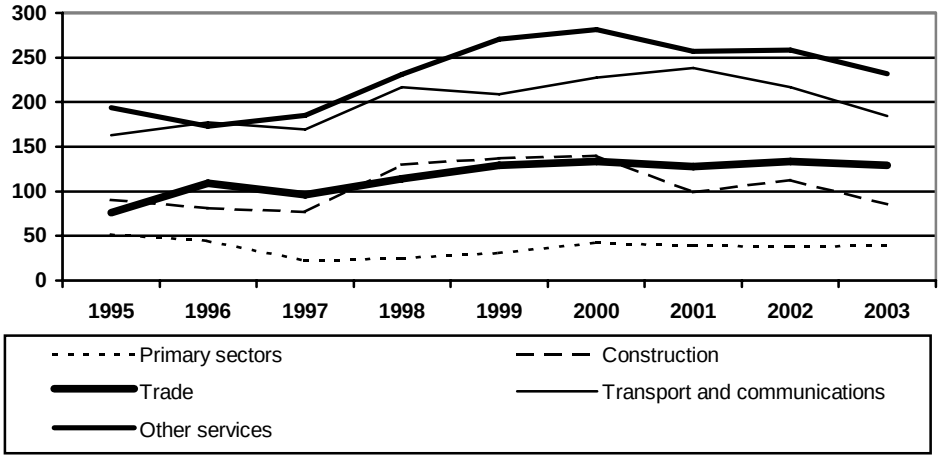
The productivity growth rate in the recent years is slowing down, however the indicators may not be treated unequivocally, since the number of employed taken for determining productivity does not always adequately reflect the actual situation, which is connected with the relatively high share of the shadow economy in such sectors as building construction and trading services. As every year the shadow economy in these industries is reducing, then the actual growth of productivity is higher, and, e.g., over the recent three years productivity in construction has most likely grown rather than fallen.

Despite the fact that productivity has most rapidly grown in manufacturing, its level is still lagging behind the indicators of several service sectors (Figure 5.).

Presently the Ministry of Economics does not elaborate productivity forecasts by sectors, we look forward to cooperation in this area.

Figure 5

Productivity by sectors relative to manufacturing (100)



3.4. Wages und unit labour costs

On the whole, productivity of national economy is growing much more rapidly than labour costs, on average by 2.7 percentage points.
At the same time, productivity growth in manufacturing is more dynamic, which results in the reduction in annual unit labour costs.

Figure 6

Unit labour costs
(percentage change over the previous year)

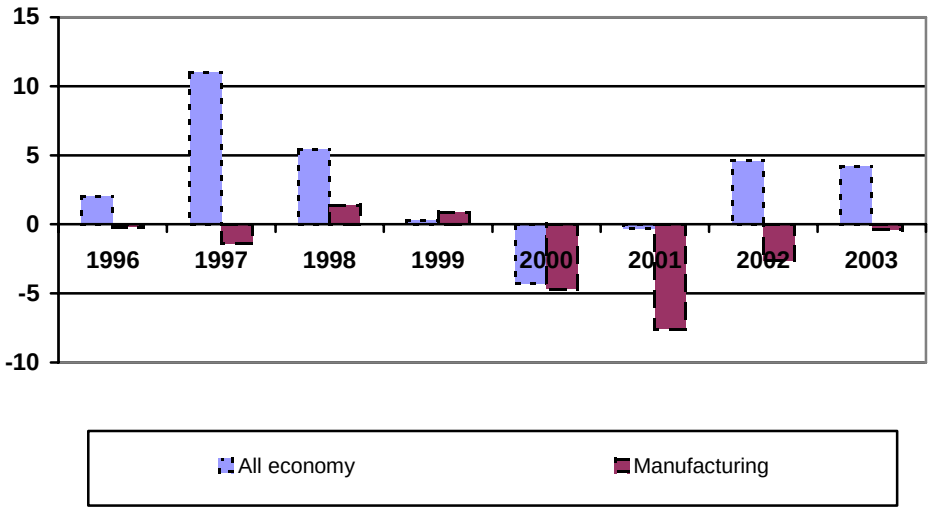


Table 5

Wages and costs
(percentage change over the previous year average in the period)

	1996-2003	1996-2000	2001-2003	2004 f	2005-2007 f
	All economy				
Wages	8,7	9,2	7,9	10,0	7,5
Productivity	5,7	6,1	4,9	6,4	6,9
Unit labour costs	2,9	2,9	2,9	3,3	0,5
	Manufacturing				
Wages	6,8	7,3	5,9	-	-
Productivity	8,8	8,2	9,8	-	-
Unit labour costs	-1,9	-0,8	-3,6	-	-

At the same time the trend over the recent years shows that wage increase in the years to come will be faster and, as a result, unit labour costs will increase.

3.5. Investments

Latvia is characterised by a relatively high share of fixed investment in utilization of GDP. It has increased from 13.8% in1995 to 24.2% in 2003.

As there is no direct access to Latvian statistics on distribution of investments by sectors, presently, the information prepared for the analysis covers only the recent three years.

During 2001-2003, investments 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 production sectors due to the growth of general economic activities, improvement of crediting terms and investment friendly economic policy. Over the past three years investments into the production sectors went up by 37.5% (or on average by 11.2% annually), whereas investments into the service sector grew by 25.2% (on average by 7.8% annually). Over the period mentioned the fastest investment growth was recorded in primary sectors. Investment into mining industry and agriculture in 2003 doubled in comparison with 2002. Meanwhile, a decrease in investment was fixed in such sectors as education, health care, transport and communications.

Table 6

Investment by sectors (excluding investment in individual construction)

(percentage)

	Growth rates				Structure
	2001	2002	2003	Average in 2001-2003	Average in 2001-2003
Primary sectors	-12.1	90.8	2.8	19.9	3.0
Manufacturing	21.8	15.5	4.0	13.5	16.2
Electricity, gas and water supply	16.8	4.3	-9.0	3.5	8.1
Construction	-0.9	10.9	27.0	11.7	2.9
Trade	7.4	4.1	32.8	14.1	17.6
Transport and communications	7.8	12.4	-18.0	-0.3	21.5
Other commercial services	20.7	1.2	13.0	11.3	17.3
Public services	-6.7	30.1	15.1	7.6	13.4
Total	**8.1**	**12.4**	**5.9**	**8.7**	**100.0**

In the years to come investment growth will also be one of the most stable items of internal demand.

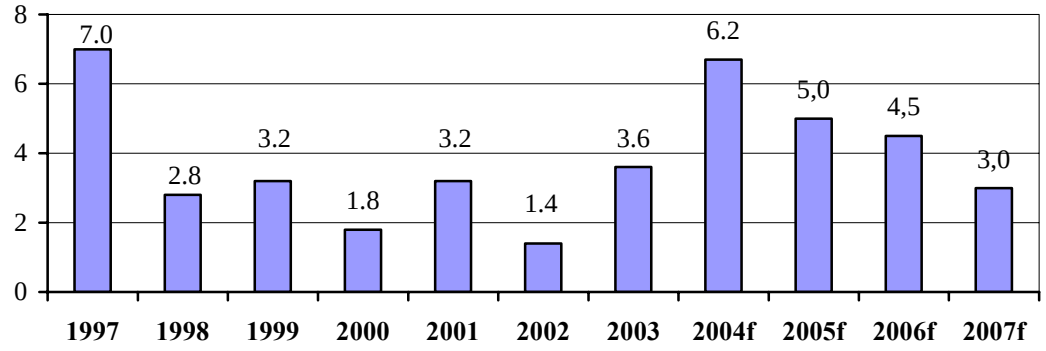
3.6. Price behaviour and inflation

Consumer price inflation in Latvia (see Figure 7) in the recent years was close to the level of inflation in the developed countries and among the lowest in Central and Eastern Europe.

Figure 7

Consumer price changes

(12-month inflation, percent)



In the second half of 2003 and at the beginning of this year, the inflation rate has rocketed in Latvia. At the end of 2003, the inflation rate reached 3.6% (12-month inflation, December over December), which was the highest level in the last six years.

The rapid growth of inflation was due to the coincidence of several factors having an impact on the rise of prices:

- the rise of the euro exchange rate (especially in 2003), which made import more expensive;
- the continuously high and growing domestic demand, which, in turn, was fuelled by the rapid upsurge of wages and crediting;
- the expectations of inflation triggered by psychological reasons and speculations about the expected huge price rise when Latvia joined the EU;
- the growth of administratively regulated prices. In 2003 and at the beginning of 2004, administratively regulated prices grew more rapidly than in the preceding periods;
- the worldwide rise of fuel prices which mostly affected the increase of prices in April and May 2004.

We consider that the factors we have outlined above as well as their impact should be at the focus of attention when elaborating the Latvian Multi-sectoral Macroeconomic Model. Cooperation with regard to the development of the model has been commenced with Professor Maurizio Grassini of the University of Florence.