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EU ENLARGEMENT
- LATVIA IS READY

Ebbe Yndgaard

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UNIVERSITY OF AARHUS • DENMARK

INSTITUT FOR ØKONOMI

AFDELING FOR NATIONALØKONOMI - AARHUS UNIVERSITET - BYGNING 350
8000 AARHUS C - ☎ 89 42 11 33 - TELEFAX 86 13 63 34

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EU Enlargement

- Latvia is Ready

by

Ebbe Yndgaard[1]

Abstract

Last year one of the decisive arguments against inviting Latvia to join the group of 'in' countries was that the European Commission considered Latvia not to possess the sufficient economic and political strength to resist competitive pressure and market forces in the single market. Thus, if exposed to international competition, Latvia may feel inclined to give in to political pressure from sections of society by imposing protective measures, which would collide with the rule of the single market.

Based on a predominantly economic analysis, this paper challenges the European Commission's negative conclusion regarding the competitive strength of Latvia as it was presented in the Avis on Latvia in July 1997. The EU reference to the gains that are collectable within the single market due to economies of scale can be seen as a comparative advantage of the applicant state; the relatively extensive specialisation cannot be held against Latvia as 'distortion'; she possesses potential comparative advantages in core industrial sectors, primarily because of a valuable fund of skilled workers. More modern capital and managerial know-how is still needed, however, as is the case in 'in' countries as well.

The analysis leads to the conclusion that Latvia should be able to resist the inclination to concede to political or other interest group pressures. Thus, this argument cannot be used against Latvian membership.

From a position inside the EU it would be much easier for Latvia to adapt to European standards as far as the economic and structural substance is concerned. An early entry would actually benefit both Latvia and the EU.

Key words: Latvia, transition, EU enlargement, Central and Eastern European Economies.

[1]The author is professor in economics at the University of Aarhus, Denmark; inter alia he has been co-chairman of the Danish Economic Council, chairman of the National Committee on Social Science Educations in Denmark, and dean of Faculty of Social Sciences. Since 1990 his professional main research interest has been transition economics.

1. Introduction

At the end of this year, upon request of the Luxembourg European Council, the European Commission will produce a progress report on Latvia and her readiness for accession.

In the Commission's 1997 report a decisive argument against Latvia's accession was that:

(1) "Latvia would face serious difficulties to cope with **competitive pressure and market forces** within the Union in the medium term. The Latvian economy is relatively open and labour costs are low. However, exports consist mainly of low value–added goods. Industrial restructuring, as well as enterprise restructuring, is still needed. The banking sector is underdeveloped and weak in parts. Agriculture needs to be modernised."(Agenda 2000, section C).

This citation should be read in connection with the following statements:

(2) "... requires ... that the Latvian economy have flexibility and a sufficient level of human and physical capital, especially infrastructure. In their absence, competitive pressures are likely to be considered too intense by some sections of society, and there will be a call for protective measures, which, if implemented, would undermine the single market."(ibid, section B).

and

(3) "... a sustained record of implementation of economic reforms in the face of interest group pressure reduce the risk that a country will be unable to maintain its commitment to the economic obligations" (ibid, section B).

Organisation of the paper

The paper commences with a preliminary discussion of the conceptual and theoretical framework for the ensuing analysis and a highlighting of a couple of more general transition economic phenomena that are relevant in this context, section 2. Then follows a brief survey of the Latvian transition policy during the run-up period to the first EU examination in 1997, section 3.

The first substance section ie 4 deals with the EU arguments for not including Latvia among the 'in' countries in the first round; here we challenge the conclusion of the first quotation as it stands and also throw some doubt on its relevance as an argument against integrating the country at the present stage of transition; also, we shall argue that the negative reaction to the Latvian application for membership could be a political decision, disguised in an economic veil. If the first quotation is correct, implicitly it follows from the two subsequent quotations that the European Council, as far as

Latvia–and analogously Lithuania–is concerned, does not believe her political system to be strong enough to resist domestic interest group pressures.

Section 5 comprises a survey of the achievements since the first round. The ensuing section 6 argues that Latvia possesses comparative advantages in core industrial sectors and section 7 refuses the view that Latvia should not be capable of resisting interest group pressures.

Section 8 argues in favour of accepting Latvia as a full member state, because that would mitigate her adaptation problems. Section 9 concludes.

2. A couple of fundamental economic issues in the present Latvia-EU context

Before entering a more detailed discussion of the specific relationship between Latvia and the EU we find it worthwhile to take a closer look at the concepts applied in the EU text, to discuss on a primarily theoretical foundation the question of the Latvian desirability of a full membership and two other general transitional economic aspects.

2.1. Interpretation of the basic concepts of the negative opinion on Latvia

Let us begin by an examination of the fundamental concepts of 'competitive pressure and market forces' since they play a decisive role in the conclusion of the European Council (1).

A distinctive characteristic of the Latvian inflation containment policy has been its firm rate-of-exchange anchoring. The fixation of the LAT to the SDR since 1993/94 has brought about an exceptionally successful reduction of the rate of growth of prices–and gradually also a fall of the rate of interest to a level comparable to the West. For this reason–and also to fulfil the acquis–any change of the rate-of-exchange is out of the question inter alia to the effect that Latvia cannot neutralize domestic excess inflation by devaluing her currency. We take for granted that this opinion is shared by the EU[2].

Therefore, this regime is the relevant environment for interpreting the above concepts. If Latvia were adopted as a member state and could not cope with the 'competitive pressure and market forces', how would that turn out? Without loss of generality let us assume that the LAT is replaced by the EURO–or alternatively anchored by a currency board to the EURO to the same effect.

Seen from Latvia, since the time profile of the ratio between foreign and domestic

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[2] It could be argued that the present deficit on the current accounts of the balance of payments signals an over-valued currency. In some sense this may be true, but looking more closely at the single balances it should be noticed that the balance of services exhibits a substantial surplus; also it is not surprising that during the restructuring period the investment goods' balance is negative.

prices under these conditions now follows directly from the price profiles of the West and Latvia respectively, the question of maintaining a sufficient competitiveness reduces to the following question: Is Latvia able to keep her rate of inflation lower than–or equal to–that of her foreign competitors ? If she fails to do so, then under free trade conditions imported goods will exorcise domestic (tradeable) goods and she will be unable to export her own products with the result that Latvian firms will fade out and unemployment figures soar; incomes will fall, the public budget will deteriorate, social unrest will turn out, interest group pressures will flourish etc.

This is the simple theoretical interpretation of the impact of lack of competitiveness. However, at a deeper and more faceted analytical level the time profile of prices in a market economy originates primarily from two sources: the rate of growth of wage rates and that of productivity.

If Latvia is able to continue her prudent incomes policy–as is likely to be the case–to prevent excessive cost-push (wages) elements from fuelling inflation, her competitiveness will not suffer for this reason. Therefore the dynamic aspect of competitiveness essentially becomes a question of the possibilities of increasing her labour productivity fast enough, ie in pace with that of her competitors and the (excessive) rise of wage rates. This aspect has two dimensions; if the quality of her products is not changed to the better, it means that the output volume per man hour should grow as fast as in the West and/or the same volume should be turned out at a quality that grows fast enough to neutralize the increasing unit costs. Actually, this is the fundamental issue of the whole matter.

At least in the medium term it is beyond any reasonable doubt that the prevailing overstaffing problem can be converted into a dramatic increase of labour productivity, sales problems left aside. The most prospective avenue of improving productivity undoubtedly should build on improving the product quality to make Latvian goods attractive to Western buyers. The indispensable instrument to call forth such a development is Western technology and management methods.

Since, at the outset, the competitiveness of Latvia is impeded by neither excessively high wage rates nor by a rate of interest level out of line with that of the West, at the macro level the question of competitiveness boils down to the question if Latvia is able to (continue to) attract and finance Western technology and absorb modern market-oriented management methods.

As argued below, once Latvia becomes a full member of the EU her sustained record of dealing with economic policy issues at the macro level in a determined and prudent way will accelerate the already marked inflow of capital and know-how further to the effect that her competitiveness can be not only maintained, but even improved significantly.

2.2. Why would it be advantageous for Latvia to be an insider?

One–of the few–manifest theoretical results of the economics discipline is that it is mutually beneficial for countries to take part in international free trade arrangements. The classical theory relies on the implied possibility of exploiting comparative advantages through specialization in the production of tradeable goods; in the modern and dynamized version of this result, comparative advantages are no longer a static endowment concept, but a dynamic one in the sense that comparative advantages are considered to be producible. Under a technology that exhibits increasing returns to scale this opens up to the possibility that the production processes within a free trade area tend to concentrate in larger firms in fewer countries, exploiting the falling average unit costs; consequently, productivity gains can be beneficial on an extended or even global scale–at the risk of creating market imperfections in the form of monopolistic competition regimes.

The flip side of the coin is that exploitation of such gains requires adaptation, ie resource reallocation within the trading countries at the risk of creating–at least temporary–mismatch problems and unemployment pools. But such phenomena are not unusual in a market economy; constantly the non parallel development of eg technical progress between sectors calls for a steady adaptation and reallocation of resources for domestic causes anyway.

In the Latvia EU context the above-mentioned arguments–in both a static and a dynamic setting–imply that it would be beneficial for both parties to integrate the Latvian economy into the EU; the decisive criterion is if the–not so transparent–gains to the EU side are sufficient to outbalance the distributional costs released by a Latvian share of the EU funds and otherwise. In the opinion of the author the net effect to the EU would be positive at least in the long run; if negative in the short term, the magnitude of the EU net costs would be negligible taking into consideration the fact that the Latvian population is about 2.5 million people versus the present EU population of about 300 million people. On the other hand the benefits to Latvia would be large as compared with her present GDP or any other Latvian yardstick. In conclusion, the economic theoretical arguments are in favour of adopting Latvia as an insider; obviously, the political arguments should support the same conclusion.

The general line of reasoning of the Commission builds on the idea that to be welcomed as a new member, an applicant must pre-qualify to meet the acquis, cf the *Accession Partnership* documents. Most of the EU reservations in these 'checklists' are of a formal nature in the sense that they identify primarily administrative and judicial disharmonies between the Community rule and the current national rules. Of course, such disharmonies have to be removed before membership comes into effect. By comparing the list for Estonia with that of Latvia in this respect–paragraph by paragraph and line by line–it is difficult to see that on balance the two countries differ markedly. The formal deficiencies of the national systems cannot have been the touchstone when the European Council adopted Estonia and not Latvia.

In the same lists the items of substance do not differ qualitatively either–and less so by now. As to economic and fiscal affairs, sectoral policies and economic and social cohesion the texts–and realia–on Estonia and Latvia differ only marginally and certainly no more than they could be brought in line during the pre entry period in both countries.

Hence, the decisive criterion for letting Estonia in and Latvia out is summarized in the first quotation (1) at the beginning of this paper, ie the lack of sufficient competitive power–or rather its implications! Even if it were true, would that be a rational reason for leaving Latvia in a pre-in position?

In contrast to the pre qualification approach to membership an alternative strategy for EU could be to demand only–but categorically–that all formal, judicial and administrative rules must be harmonized and enforceable as a prerequisite for access, leaving out structural differences as part of the evaluation foundation (competitive power, lack of investment, insufficient know-how, etc). Beyond any doubt such a policy would make it much easier for the transition applicant to converge to the real economic standards of the EU because the access to the internal market and the EMU would 'privatize' the convergence process; by keeping Latvia outside the Community leaves the national government with a very difficult–if possible–task, viz to mimic membership (via eg a currency board for the LAT to the EURO, full harmonization of rules etc) but without the advantages of membership; in this connection the current accounts of the balance of payments could easily be a very tight straight-jacket to the economic political manoeuvrability options.

Outside the EU the national authorities must keep a close eye on the balance of payments, even if the public share of the foreign debt is kept at a very low level. If, at the same time, the public budget deficit is kept within very narrow limits, foreign debt originates from private borrowers only; outside the EU accumulation of foreign debt tears on Latvia's credibility, at least to the extent that the debt is denominated in LATs because of the potential risk of a devaluation. Inside the EU this risk is abolished as is the significance of the foreign debt as such[3]; this aspect of credibility is the most important single beneficial gain to Latvia. A status like eg Norway vis-a-vis EU would not solve this

[3]Inside the EU, who cares about the 'foreign debt' of Bavaria–except the private Bavarian borrowers? Certainly not the Landestag of Munich.

basic credibility problem.

In short, all advantages of credibility as to the rate of exchange could be transferred to Latvia at a very low price and the gains from an enhanced international division of labour and other resources would be exploitable.

2.3. The fiscal squeeze problem to restructuring

If–as has steadily been the case until now–Latvia sticks to a 'prudent fiscal policy' ie keeps her public deficit within a narrow limit, the public balance tends to restrict the possibilities of restructuring. As is usually the case, a restructuring implies a lay off of redundant labour which seen from the public sector produces an upward pressure on the expenditure side for compensation payments. If full employment were constantly guaranteed this aspect could be neglected; but in a typical transition economy the alternative to 'redundancy' employment is open unemployment. This raises the question of which 'compensation payment' is the lower one: soft budget transfers or open compensation payments.

If a firm, paying wages to redundant labour, is able to produce goods of some value, say 1 million LATs, but inter alia because of redundant labour runs a deficit of say ½ million LATs (labour costs equal to 1.5 million LATs for simplicity) then a soft budget transfer of ½ million LATs to such a company is beneficial to the government budget if the alternative would be unemployment transfers, amounting to more than ½ a million LATs[4]. Part of the argument in defence of such a policy is that it keeps alive the attachment of workers to the labour market. To rely on a Phillips-curve philosophy in this connection to bring about a decrease of the wage rates is irrelevant; the competitive power of Latvia is not impeded by her nominal wage rates.

Also, if privatization releases a foreseen restructuring, ie sacking redundant labour, the costs implied for the public sector in the form of unemployment compensation payments may easily collide with the budgetary limit; the government cannot 'afford' to restructure as much as it would like to, cf Philipp Schröder (1998).

2.4. The corporate governance problem

The final comment under this heading is concerned with the general transition economic problem, viz that of corporate governance. By and large–at least at the outset of the transitional process–Latvia was void of Western-style professional managing competence.

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[4]In fact, this model is not unknown in the West either where many unemployment schemes build on transfer payments to firms who take on else unemployed persons.

Until this problem is solved inter alia by means of a (time consuming) upgrading of her educational system, cf in this connection her adoption of the Swedish Business School producing Western-trained managers, there exists a fundamental problem. Most of the present managers of firms are not qualified to run large firms according to profitability principles; they may even have incentives to be soft on efficiency measures to protect their self-interest, cf Philipp Schröder (1998), and they have only marginal experience with respect to trading at the world market.

3. Latvia has pursued a consistent integration policy during the run-up period 1991-1997

Even though it has come at a relatively high cost the 'revealed preference', broadly backed by all segments of society, has been consistently to approach the Western society. Let us begin by documenting this statement by means of a brief survey of the policies applied in the period from independence to the first examination round 1997.

Since August 1991 when Latvia regained her independence from the FSU on the basis of a politically very broad consent in the Saeima–and among inhabitants: citizens or not–on replacing the former centrally planned economic system by a market economic system, the country has taken many and fundamental steps to make her economy converge to a Western type:

Liberalization

As recognized by the Commission, Latvia very quickly liberalized her economy; the formerly centrally settled prices (and quantities) were set free already in 1991/1992 and–as was to be expected–the release of the monetary overhang in line with a dramatic increase of especially energy import prices immediately triggered a vehement inflationary one–time explosion which in its turn both practically eroded private savings overnight and created large capital gains on stocks of the (State Owned Enterprise) SOE companies, cf below.

It was also the policy of the Latvian authorities to open the economy fully to the outer world, allowing not only goods and services to flow freely over the borders, but also capital transfers, implying full convertibility of its currency.

Stabilization

The liberal policy immediately created large adaptation problems; the erosion of purchasing power of ordinary people, brought about primarily by under indexation of (public) wage rates and social transfer payments, inflationary erosion of private savings and the collapse of the economies of the former main trading partners, primarily the present CIS economies, resulted in a dramatic fall of demand for and consequently collapse of the Latvian output, viz by about 50 per cent in one to two years.

Already at a very early stage of the transition process the Latvian parliament and government were–and still are–heavily influenced by and also abiding with the recommendations and prescriptions of inter alia IMF, WB and EU advisors to the effect that the authorities have pursued a so-called 'prudent fiscal policy and a tight monetary policy'.

The first part of this prescription meant that the authorities kept the public deficit within a few percentages of the (falling!) GDP, a policy that required public demand to be cut back to leave room for the endogenously growing expenditures for social transfer payments (unemployment compensations, other social transfer payments to inter alia old age people, deprived of their private savings etc).

The immediate effect of the price explosion and subsequent capital gains of firms–ie the collectable part of them in the form of profit taxes–was that initially the public budget exhibited a surplus; as soon as, however, the rate of inflation decelerated and the social costs began to soar, the tendency of the public budget to become negative emerged and actualized the necessity of reducing public demand, in its turn aggravating the depression of the economy further.

The situation, characterized by extreme uncertainty, deficient consumption demand, malfunctioning of the financial sector, and lack of finance–and confidence– in practice eradicated firms' demand for investment goods.

Also, on the one hand the access to the world market produced a demand for imports of especially formerly non accessible Western goods; on the other hand, the demand for exports was impeded by lack of know-how with respect to trading at Western markets, inferior product quality and the collapse of the FSU.

In short, the Latvian economic authorities were–and still are–in a squeeze; they could (can) not stimulate the economy by public, expansionary demand measures (eg for much needed infra–structural purposes) and respect the 'prudent fiscal policy'–requirement simultaneously; and tax reductions were (are) absolutely out of the question, cf section 2.3.

When it comes to 'tight monetary policy', the independence of the Central bank, guaranteed by its Bundesbank inspired constitution, in connection with its firm stance with respect to fighting inflation has meant that the Latvian success in this respect is second to none within the family of transition economies.

At the beginning, ie already mid-1992, the determined anti-inflationary policy of Latvia revealed that the 1:1 currency exchange rate between the (new) Latvian and the

Russian rouble was not tenable. Hence, the Latvian rouble was allowed to float freely to neutralize the real depreciation that followed from the comparatively more successful inflation containment policy of Latvia; the consequence was that the Latvian rouble appreciated very quickly against the RRBL.

After some preliminary attempts to contain the inflation by Western-like monetary policy measures, the Bank of Latvia decided to switch to an exchange rate anchoring of the inflation containment policy. In 1993/1994 the Latvian currency, the LAT, was introduced and pegged to the SDR at a level that has been defended since. Until recently this has meant that the Latvian rate of interest has been relatively high; presently, however, it has dropped to a level that is comparable to Western standards as has by now the rate of inflation.

Thus, the front side of the coin is a success story; the reverse side of the medal, however, is that the output of Latvia is still at a level that is far below its 1990 level[5].

Privatization

The privatization scheme of Latvia was less impressive during the first years of the regained independence than the two above-mentioned policy areas but since 1995 major progress has been achieved. The country acted relatively slowly with respect to privatizing, especially of large SOEs. We can, however, forward two specific reasons for Latvia to have performed less successfully in this respect, especially during the first years.

Firstly, as also pointed out by the Commission, Agenda 2000, the manufacturing sector of Latvia has been dominated by relatively large SOEs, many of them formerly supplying special goods to the whole FSU (electronics is one example). It is well known that it is much more difficult to privatize such large companies than small to medium sized firms.

Secondly, the budgetary squeeze of the public sector, referred to above, represented a serious impediment in this respect, viz if privatization could be foreseen to trigger a restructuring that would imply a fiscally costly lay off of redundant labour.

Restructuring

Under this heading it is customary to include improvement of efficiency and introducing eo ipso profitability as the guiding principle for economic activity.

[5]There is some controversy between the national statistical authorities and eg the IMF advisors about the actual GDP level; according to the IMF the national statistical authorities underestimate the output of the expanding private sector. In fact the controversy is about the size of the (undeclared) black economy.

As measured by labour productivity Latvia has experienced a very dramatic curtailment since the launch of the transition process; even though output has fallen by about 50 per cent since 1990, the (official) rate of unemployment amounts to only a single digit. Part of the explanation for this is that the spell of time during which laid off workers are able to collect compensation payments, ie being officially out of job, is relatively low; they simply fade out of the statistics. That, however, cannot conceal the fact that many formally employed people are producing 'nothing'.

Summary of the run-up period policy

As to liberalization and inflation containment Latvia performed second to none; in fact she behaved as the top boy of the class.

In the other respects she performed quite well under the conditions given; since the first examination she has markedly speeded up the adaptation processes[6]. In this connection it should be emphasized that the Latvian adoption of the '*Medium Term Economic Strategy in the Context of Accession to the EU*' clearly demonstrates a strong determination to stick to the integration approach

From a bird's eye perspective if not for purely–and certainly legitimate–political reasons it is difficult to see why Estonia proved able to pass the needle's eye and Latvia not. The differences with respect to the above economic characteristics between Latvia and Estonia were not so marked that by themselves they could tip the balance between the two–and even less so in 1998. Latvia–like Estonia–has pursued a prudent policy, almost fully abiding with the Western advisors' recommendations and the view that Latvia's competitive capacity should be inferior to that of Estonia is unsubstantiated, cf below.

4. A closer scrutiny of the negative opinion on the Latvian application for EU membership

On this background it was surprising that the European Council turned down the Latvian application for membership in the first round. The rejection does not seem to build on unsurmountable formal, judicial deficiencies; neither do the economic structural differences qualitatively identify Estonia as convincingly superior to Latvia. Therefore, let us take a closer look at the arguments forwarded by the EU.

We assume that the decision made rests on an economic foundation and its anticipated implications–and not a disguised purely political one. Therefore a closer

[6] ' What matters is not when you enter the train, but when you arrive' (a free reproduction of a statement made by van den Broek).

examination of the text (1) is worthwhile.

The first sentence raises the question if the EU decision aims at shielding Latvia from disastrous competitive pressure and market forces. As a sovereign state Latvia is the first one to care of her own interests. Since she has applied for membership that must be interpreted as being in her own interest. Conversely, if Latvia cannot match the competitive pressure etc as a member what would that imply for the EU? If the Latvian economy temporarily breaks down, cf section 2.1, would that mean extraordinary costs to the EU? Hardly. If Latvia in such a situation tends to take refuge to protective measures the EU has at her disposal sanction possibilities that could easily prevent such steps from coming true. Hence, it is difficult to see any serious negative consequential effects to the EU if Latvia were accepted as a member.

It seems to be a drawback that the Latvian economy is relatively open; yes, it would be open to international competition–as is already the case–and could run the risk of being an unemployment island–that, however, would be primarily a Latvian problem. On the other hand, it is a requirement for EU member states to 'be open'; so, per se that state of affairs cannot be held against Latvia.

'Labour costs are low': under prudent incomes policy guidance of the Latvian economy would not that be advantageous? It would have been more relevant for the Commission not to focus on nominal wage rates–under the given rate of exchange –, but to look more closely at the unit labour costs which are not so impressively low because of the by Western standards inferior labour productivity. In comparison with Estonia the Latvian unit labour costs are not out of line. The background for the lower labour productivity of the transition economies is the lack of modern capital equipment, a phenomenon shared not only by the Baltic states but also by transition 'in' countries like Poland, Hungary and the Czech Republic.

The Commission is correct in pointing to the fact that the Latvian exports–at present–rely mainly on low value-added goods. That, however, is not a valid argument against Latvian membership. What is relevant here is not the unit value-added contribution, but total value-added. Apparently the Commission overlooks that the latter concept is a product of a unit value-added factor and a *volume*. If the quantity produced and exported is high enough, there is no problem here, competitive profitability conditions being met by assumption of course.

To point to the need for further industrial restructuring as well as enterprise restructuring is justified–also in the 'in' countries. If the judicial system is in place and enforced, however, a full membership of the EU will remedy this admittedly very important deficiency. Here again probably the process would be speeded up more from an inside-EU position than from a continued status quo position inter alia because the ensuing acceleration of economic growth along with an improved tax collection system would ease the budget squeeze.

The banking sector is underdeveloped and weak in parts; not quite true. After the banking crisis in 1995, Latvia has managed to implement some of the most stringent banking regulations in Eastern Europe and a sound and profitable banking sector is now emerging. Judged on credibility the banking sector of Latvia is unparalleled in the region not least because it has proved able to keep its credit expansion in accordance with economic fundamentals, cf her successful inflation containment, sections 3 and 5.

Finally, nobody could dispute that overstaffing is a conspicuous problem in the agricultural sector.

In conclusion to this paragraph, the above quotation (1) does not have the argumentative strength for economic reasons to carry the negative conclusion of the European Council; the stumbling block undoubtedly was the anticipated political weakness with regards to resistance to pressure groups, cf section 7 below.

5. Latvia has made significant progress and is well prepared for the second examination in 1998

Since the first examination by the Commission, Latvia has not only continued, but also intensified her endeavours to meet the requirements set up for accession to the EU. The liberalization process has been continued and is practically fulfilled by now.

As to stabilization the prospects for low inflation become ever more positive; inflation is down to a single digit and falling; at the same time the rate of interest is rapidly approaching that of the EU[7]. As to real economic development it seems as if the extended depression of the economy has been brought not only to a stand still, but converted into a convincing catch up track. GDP is growing at a rate that is more than the double of the EU average[8] ie 6.5 per cent in 1997.

The recovery tendency is unevenly distributed, both by sectors and by regions. The most rapidly growing main sectors are manufacturing and services; geographically, the most satisfactory development is concentrated in the metropolitan area.

A constrained, but still relatively high rate of growth of private (1997: 3.9 per cent)–and public(1997:3.8 per cent)– consumption leaves room for an impressively high

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[7]No doubt in due time Latvia will be able to meet all the EMU-requirements, by now only failing those of the rates of inflation and interest.

[8]Incessantly a significantly higher rate of growth in Latvia is required if she is to catch up to a Western economic standard within a foreseeable future. As an illustration: If we set the present Western per capita income level equal to 100 and that of Latvia equal to 33 and further assume that the rates of growth are 2.5 and 6 per cent per year respectively, it will take 33 years for the incomes to be equalized.

rate of growth of fixed capital formation.

The growth of investment which amounted to 11 per cent in 1997 is a very positive sign because it signals a more wide spread confidence in the future. The investment climate is also reflected in the rapidly improving international ratings by eg 'Standard & Poor's' and 'Moody's'. The rating levels are high by now and at the top among transition economies.

One of the consequences of the positive investment development is an apparent deterioration of the trade balance; investment goods to a great extent must necessarily be imported. Even though the import of consumption goods is growing, in line with private consumption, there is a clear tendency for the ratio of capital goods out of total imports to increase.

The public budget is practically balanced–presently even tending to show a small surplus and the tax collection system is subjected to a continued improvement process.

At face value, the only, but important item that traces an unsatisfactory profile is the current accounts of the balance of payments. In a comparative setting the Latvian foreign trade elasticities are not out of line with comparable, recovering market economies[9]. It is noteworthy–and very positive– that the economy apparently is about entering an export driven recovery track; according to *the Economic Development of Latvia, Report* (1998, p.30) exports account for 2/3 of the GDP growth in 1997.

It is even more noticeable that the bulk of this increase was realized at Western markets. EU now accounts for almost 50 per cent of Latvian exports; for imports the figure is even higher, 53.2 per cent. Both ratios are growing and reflect an ongoing deepening of the integration process.

The privatization of especially large SOEs has been put on a much higher pace than in the run-up period; according to the Latvian Privatization Agency almost all SOEs have been privatized by now, viz 95 per cent. In statistical terms this means that currently about 2/3 of GDP is produced by the private (declared) sector, accounting for nearly 70 per cent of total employment (ibid, p. 103).

The already conspicuous and continued improvement of the Latvian economy has produced the sine qua non for a beginning catch-up process, viz confidence among investors, both national and international. Inter alia this means that the finance needed to cover the deficit on the current accounts of the balance of payments does not represent

[9]The rates of growth of GDP in 1996 and 1997 were 3.3 and 6.5 respectively in real terms. The author has calculated the rates of real growth for exports to be 10.6 and 21.0 for the same years and those for imports to be 21.0 and 22.5 per cent respectively. These figures correspond to an export elasticity of 3.2 and a range for import elasticities from 6.4 in 1996 and 3.5 in 1997. These results are high–but neither implausible in the present recovery situation nor worrying.

a problem; Latvia is a successful attractor of international capital, both in the form of short term capital influx, but also in the foreign direct investment (FDI) form. During the last couple of years the FDI has accelerated very markedly, bringing Latvia in line with eg Poland, the Czech Republic and Hungary.

The restructuring process has been speeded up; the extensive and almost full privatization programme in interaction with the determined market oriented strategy of the authorities, cf the *Medium Term Economic Strategy* (1998) has prepared the ground for recovery in a stable and forward looking environment.

Summarizing, the Latvian economic situation in all relevant respects is much more positive now than it was on the occasion of the first EU examination[10].

6. An additional argument in favour of Latvia: Comparative advantage in core industrial sectors

In the Agenda 2000, section 2.2 the Commission points out that

(4) "Firms need to invest to improve their efficiency, so that they can both compete at home and take advantage of economies of scale which flow from access to the single market".

This reference to the beneficial effects of increasing returns to scale could be taken as an argument in favour of Latvia.

In the Agenda 2000 on Estonia, section 2.2 it says: "... The allocation of capital and labour was less distorted than in other states of the former Soviet Union..."

In contrast to this, section 2.1 of the Agenda for Latvia inter alia reads: "Relatively large and sophisticated industries were established in Latvia, because of its comparatively well developed infrastructure." and also: "Under the Soviet regime the main areas were machine building, electronics and light industries." and "The large-scale industries were completely integrated with the Soviet industry and depended on cheap supply of raw materials and energy from other republics." The list of large scale industries could include the chemical industry as well.

In a comparative advantage context Latvia is in possession of a large fund of know-how within the above-mentioned large-scale industrial sectors; in the short to medium term the scarcest resources of all, human capital alias skilled workers are at hand within these branches, ready to exploit the economies of scale. To collect this valuable resource the tolerable lapse of time is probably about running out or will do so in a few

[10]This view is shared by the Maciej Krzak: “Latvia is making substantial efforts to become a viable candidate for inclusion into the first wave of countries, which have already started accession negotiations with EU”, (Focus on Transition, 1998).

years. It is a mistake to write it off completely, even though the collapse of the former markets at present has sent these large sectors into a disastrous situation. If modern capital equipment and management know-how were introduced, a rapid recovery of a substantial part of the Latvian economy could result, cf the general discussion of the concept of competitiveness and productivity in section 2.1 above.

The recovery of a transition economy does not necessarily have to rely solely on the building up from the bottom of small firms.

7. Latvia can stand up to domestic interest group pressures

The basic argument by the Commission against immediate access to the EU family as pointed out above rests on the conclusion that the Latvian ability to cope with competitive pressure and market forces[11] is not strong enough. Disregarding this deficiency in the parlance of the Commission could mean that "... there will be a call for protective measures, which, if implemented, would undermine the single market" (Agenda 2000, section 2.2); also the Commission is not convinced that the "... sustained record of implementation of economic reforms in the face of interest group pressure (*is sufficient to/author's insertion*) reduce the risk that a country will be unable to maintain its commitment to the economic obligations of membership" (Agenda 2000, section 2.2).

In this context it is important to keep proportions right. On the background of the demonstrated political record of the young Latvian democracy for the short period from 1991 to 1998 the fear hinted at does not seem to be substantiated; much more controversial political problems have already been coped with by Latvia.

In a very short period from a status as a 'far from Moscow provincial region' Latvia has performed the extremely difficult task of establishing an autonomous state, ruled by a democratic system with most of its institutions in place. Numerous overrulings of pressures from interest groups during this process have demonstrated a Latvian political resolution that is impressive and second to none.

Even though in some cases the Latvian authorities seem to have given in to the argument that some SOEs are 'too big to fail', this cannot unconditionally be held against the Latvian Saeima. As argued above this apparent leniency may be rational–if not necessarily consciously recognized as such–in a dynamic perspective to preserve the productive capability of a substantial part of the labour force; and the budgetary squeeze in itself may make such a 'soft' policy rational.

[11] It is important to realize that Latvia will be exposed to this pressure whether she is a member or not. Her liberal policy in connection with eg the Europe Agreement, WTO etc produces a 'tough' economic environment, anyway.

In consideration of the interest groups' pressures that have been coped with by the Latvian political system so far, it is not substantiated to claim that the country in the medium term cannot continue to stand up against pressure groups, so much the more as the political influence of labour unions is practically nil.

In short, Latvia has a convincing record of coping with pressure groups and it does not seem to be fair to hold this as a political argument against her.

8. The Latvian economy will recover much faster when integrated with the EU

When it comes to economic arguments the conclusion of the European Council deserves to be reconsidered. The country possesses comparative advantages in significant sectors (wood industry, electronics, chemical industry et alii) primarily in the form of human capital. If integrated with the EU, an accentuated transfer of modern capital equipment along with an upgrading of management skills, will be able to release a significant exploitation possibility of economies of scale in these sectors. What Latvia needs is (free) trade, not aid[12].

To finance the imports of modern capital equipment it is a necessity that Latvia is allowed to export domestic products in return. Obviously, international loans could play a significant if not decisive role in this connection; the financial need for Latvia to be able to catch up to Western standards is so high that the primary source of capital must be domestic savings; hence a keen effort must be made to create incentive structures for private savings to accumulate, also at the cost of pushing the functional distribution against the wage share; by a wide ownership system at the individual level such a policy is not necessarily in conflict with an acceptable personal income distribution.

On the other hand the production potential of the country and the extent to which 'hidden' productivity gains are collectable is sufficient to prevent the country from getting caught in the rate of interest trap[13]; here, it should be kept in mind that the foreign debt is still relatively low.

Finally, it is obvious that the administrative and educational systems of Latvia need a profound overhaul. Already in the very short term it is especially important that the policy to improve the tax collection system is intensified even further, not least to provide public means for such and other infra structural purposes.

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[12]In this connection it is especially harmful that some of the sectors in which Latvia already possesses comparative advantages represent sensitive goods, eg agricultural and textile products.

[13]This phenomenon turns out if the rate of interest on foreign debt is higher than the domestic rate of growth of GDP; in such a situation the debt/GDP ratio tends to grow ceteris paribus.

9. Conclusion

From the EU side a reconsideration of Latvia's application for membership is called for; neither economic (1) nor political (2) & (3) arguments against an 'in' status seem to have a convincing, solid bearing.

We have argued that in accordance with a widely backed liberal policy attitude the Latvian economy will be exposed to international market pressure anyway; from an inside position it will be much easier for Latvia to remain on her convincing upward economic catch-up track. The determinative gain for Latvia would be to come under the credibility umbrella of the EURO eo ipso easing the foreign debt straight-jacket. An integration of Latvia into the EU would be beneficial to both parties.

It is worth noticing that the EU commissioner van den Broek during a recent short visit to Riga demonstrated a very open minded attitude to the question of moving Latvia from a pre-in position to an in-position: "If by the end of the year it is noted that countries fulfill the relevant criteria, then obviously the recommendation of the commission should be to open negotiations with them as well" (The Baltic Times, July 23).

The track that Latvia has followed both during the run-up period and not least during the last one to two years should render her a good position to take the commissioner at his word.

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