Capital in Latvia: Notes on a Hungry Tiger

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The Baltic states have been seeking economic, social and political convergence with the Western World since they regained independence in 1991. While their primary motivation was to regain their nation-state status, their secondary hope was to achieve the income and prosperity levels of OECD countries. After twenty-five years of independence, EU and NATO membership in 2004, the introduction of the euro currency in 2014 and OECD membership scheduled for 2016, Latvia's population has still not abandoned its initial hopes and economic expectations. Its society is still struggling with income discrepancies within the country, relatively low salaries, the middle income trap, inefficient social policies, and a decline in the working age population due to demographics and emigration, and slow productivity growth, which are often cited as modern Latvia's key macroeconomic problems.

It is the low levels of foreign direct investment in real production and companies, however, that have haunted the small Baltic economy for over two decades. Low levels of accumulated capital have a negative impact not only on Latvia's growth prospects, but also on multiple economic and societal activities. The availability of financing is crucial both to the development of Latvia's tiny stock market, as well as to promoting a culture of sponsorship and donation. The lack of financing in Latvia, which still boasts a materialistic society, is a key factor in both economic and political terms. Welfare and political stability in a country that is short on high-priced natural resources and labour depends heavily on the availability of capital.

The planned economy during the Soviet period left a significant imprint on Latvia's accumulated capital. The communist experiment, with its regulated prices, wages, income distribution and class-less society, left the Latvian population mired in debt. The nationalization of the 1940s and followed by subsequent decades of capital transfer from the Baltic states to other parts of the Soviet Union, combined with prolonged economic stagnation in the former Soviet Union as a whole, led to low levels of capital accumulation by Latvian families. The availability of energy resources and raw materials from other parts of the Union of Soviet Socialist Republics (USSR) substituted the fundamental need for capital, higher competitiveness and quality products. This resulted in the emergence of multiple production facilities, and even entire industries, that were incapable of operating in a capitalist country due to a lack of experience and insufficient capitalization.

The promise of rising living standards during the post-communist period was widely publicized shortly before the breakup of the Soviet Union and in the early 1990s by both foreign sources like Radio Free Europe/Radio Liberty, as well as by new domestic politicians. Hopes of a rapid rise in prosperity gradually faded away during Latvia's transition period to a capitalist economy, with GDP contracting by 60 percent from 1990–1993, increased unemployment and price liberalization caused by hyperinflation of 172.2 percent in 1991, 951.2 percent in 1992 and 109.2 percent in 1993; and the subsequent decrease in per capita GDP, which fell to 1,743 US dollars (in current prices) in 1993. This economic downswing was especially hard for a society that did not have the money or savings to adequately absorb the economic effects of the downturn.

The years after the shock therapy of the early 1990s and prior to Latvia becoming a member of the EU can therefore be characterized as years of searching for FDI and domestic investors. National and private financing capacities only started to accumulate after a capitalist market system was fully introduced in Latvia. Its foreign policy choices and domestic reform paths were tied to national security reasoning, as well as to hopes of rapid economic development. "Apparently, in the 1990s, foreign investors were still too cautious about the long-term prospects of Latvia or, also very probably, met with resistance from the local

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power elite to cede the control of the economy. Besides this, allegedly a major part of foreign investment in Latvia at that time was of local origin, as domestic businesses moved their earnings to offshore zones, from whence they reinvested it as foreign investment with the aim to profit from the beneficial treatment accorded to foreign investors" (Austers 2014, 13).

Membership of the EU and NATO, and national commitment to achieving these goals, were tied to promises of economic improvement. The bet was correct, as a rapid increase in FDI in Latvia can clearly be seen shortly before and after 2004. As early as 1998, when Latvia started EU accession negotiations, the Scandinavian banking, retail and media sectors in particular started to expand their presence. Investor safety, political predictability and the economic outlook were improved due to the Latvian government's geopolitical choices and successful foreign policy alignment with richer markets. Accumulated foreign direct investment in Latvia grew gradually. In 1996 its volume had reached around 700 million euros, while by 2000 this figure had grown to roughly 1.8 billion euros, with main investments going into the financial services, energy sector (due to privatization of the natural gas monopoly *Latvijas Gaze*) and telecommunications (Benkovskis 2001). The period from 2000 until 2004 saw an accumulated FDI nearly double to 3.33 billion euros, a sum that was again mostly invested in the non-production sectors of financial mediation, real estate and retail trade, with the production sector receiving only 18.5 percent of the total amount (Šumilo 2010). This period of rapid economic growth helped to increase the volume of accumulated investments to 8.06 billion euros, followed by a small decrease in 2009; and continued growth in investments, which reached 10.3 billion euros in 2012. Previous trends of investment stock being dominated by financial services and real estate continued in the pre-crisis years.

The influx of capital fuelled consumption and a real estate bubble that eventually led to extreme imbalances in the economy and banking and a crisis in the real economy. The domestic population demanded to see the promised increases in living standards and the borrowed money now offered the chance of social and economic convergence with OECD living standards. The political elite embraced economic growth and pursued pro-cyclical policies to gain additional votes, while neglecting emerging imbalances. The influx of capital was celebrated by businesses, the government and the population. The modernization of companies and production processes, and the availability of capital for financing projects were among the most productive applications of the capital, while spending the money on consumer goods naturally had a lesser long-term effect on investment. As a result of the pre-crisis years, Latvia's foreign debt grew to 165 percent of GDP in 2010, before falling to an estimated 110 percent of GDP in 2015 (Briegel 2014). At the same time, GDP per capita convergence was also visible. This figure increased from 45 percent in 2005 to 60 percent in 2008 and 64 percent in 2014. In more absolute numbers, Latvia's GDP per capita increased from 4,600 euros in 2003 to 11,200 euros in 2008 and to 11,800 euros in 2014. Capital imports by foreign banks, from Latvian labourers working in other EU member states and *via* European Union funds have made this catching up process with the EU average possible.

Latvia's attractiveness to foreign investors has clearly grown in recent years, but many more problems still remain, both domestically and externally. Its present external problems include not only the openness of the Latvian economy, which makes it volatile to global, but especially to regional processes, but also the geopolitical challenges caused by Russia's unpredictable behaviour as demonstrated in 2014, which caused some worries among foreign investors regarding the safety of their investments. Nevertheless, the post-crisis evaluation of the Latvian economy has resulted in a positive or stable outlook, with the Northern European country scoring an A3 rating from Moody's, and an A- from both Standard & Poor's and Fitch Ratings in 2015. Although some praise Latvia's achievement and compare its scores to those of many other European countries with lower results, in absolute terms as well as relative to Estonia, such comparisons reveal that Latvia still lacks competitiveness when it comes to attracting FDI.

A variety of domestic problems have been identified by various sources, the most notable and most recent of which being the staff working paper by the European Commission 'Challenges to Member States' Investment Environments' published on 26 November 2015.[1] The paper lists a large number of problems that Latvia has to address in order to become more interesting to foreign investors. They include the lack of predictability and stability in its legislation, the low number of successful insolvency cases, favouritism towards state-owned enterprises, including the fight

[1] See http://ec.europa.eu/europe2020/pdf/2016/ags2016_challenges_ms_investment_environments_en.pdf.

against anti-competitive behaviour, and especially tailor-made specifications and a lack of transparency in public procurement procedures. Additionally, Latvia has a significant problem with retaining highly-qualified and motivated people in its public administration due to low wages, as well as the negative public image of public servants and politicians. These administrative and political hurdles do not contribute to the attractiveness of the country, which is in great need not only of an inflow of foreign capital, but also of a less complicated and accessible business environment for domestic newcomers.

Latvia's most notable problems, at the same time, are of a structural nature. The European Commission identifies the following challenges facing Latvia in terms of its current FDI attractiveness: a shortage of skilled workers in some sectors, including the economic heavyweights – ITC, food processing, machinery, construction sector; tax avoidance and a high tax burden on low-wage earners; and insufficient cooperation between the scientific sphere, academia and entrepreneurs. These are the problems of the underdeveloped and inexperienced economy that Latvia largely is today. The economic problems cited stem from insufficient competition and entrepreneurship in Latvia. Over the last two decades economic development and entrepreneurship has not been based on innovation, advancement and excellence, but on a less risky approach. The low-risk economy that Latvian businesses have cultivated is related to repeated victories in public procurement procedures, producing high liquidity goods for basic domestic consumption and providing those services and products for which there is a clear demand. These factors create an unbreakable cycle, reduce the country's attractiveness for foreign investors and limit the availability of capital for the expansion of economic activity. The smallness of the Latvian market limits the possibilities of capital accumulation purely from domestic sources, while global-thinking is complicated by a lack of initial financing and funds for marketing purposes.

The Commission also highlights several direct problems causing the shortages of financing in Latvia. An improved legal framework (and specifically a more unified legal framework for insolvency, security rights and collateral) and credit information could ease access to credit for small and micro firms, and start-ups. SMEs in Latvia tend to face high collateral requirements or have limited options for obtaining required loan amounts. This distrust of SMEs in Latvia can also be attributed to the overall shortage of financing. Creditors carefully evaluate each new business and every project, and decide in favour of those with a strong track record, or better formal or informal recommendations. The abundance of capital and higher levels of credit would solve the access to credit problem for small enterprises, but it would not immediately solve the domestic legal challenges in Latvia. This assertion is also supported by an announcement made by the Latvian Ministry of Economics: "capital availability for start-up businesses in Latvia ranks among the highest in Europe; Estonians and Lithuanians can only envy us. […] At the same time, it must be understood that the volume of available resources is very limited, so we should use these resources as efficiently as possible".[2] Hence, high levels of cheap capital would make the evaluation process laxer, but should not be made available in an environment without strong legal backing and protection for lenders.

The final notable recommendation expressed in the aforementioned document is that the *Latvian stock market* could be further developed. This recommendation cannot be further from the truth. At the end of 2015 only 34,000 people owned stocks, many of which do not even receive any dividends.[3] As early as 2011 experts highlighted the small size and underdevelopment of the Latvian stock markets compared to other Baltic states and the Eastern European region as a whole. Lithuanian and Estonian stock markets are about twice the size of Latvia's. In terms of liquidity the difference is even more visible, as the turnover in other Baltic states is approximately 12 times bigger, while in Nordic countries it is as much as 93 times bigger.[4] Latvia's bond markets are also half the size of those in the two other Baltic states. Market capitalization in Latvia is only 7 percent of GDP, while developed markets like Sweden's boast 106 percent capitalization. It is quite clear that financial markets in Latvia are still very underdeveloped and its banking sector is less active than in Estonia and Lithuania. The state of play in the Latvian stock and bond markets is a shining example of the lack of investment and domestic

[2] See *EM: finansejuma pieejamiba uznemejiem – iesacejiem Latvija ir viena no labakajam Eiropa* [Ministry of Economics: The Availability of Finance for Startup Enterprises in Latvia is among the Best in Europe], BNS/Tvnet, 1 December 2015, http://financenet.tvnet.lv/viedokli/586372-em_finansejuma_pieejamiba_uznemejiem_iesacejiem_latvija_ir_viena_no_labakajam_eiropa.

[3] *34 000 personas nav parvedušas sev piederošas akcijas uz kontu,* [34000 Persons Have Not Transfered Their Stock to Bank Account], Latvijas Sabiedriskie Mediji, 2 December 2015, http://www.lsm.lv/lv/raksts/ekonomika/zinas/34-000-personas-nav-parvedusas-sev-piederosas-akcijas-uz-kontu.a157708/

[4] *See Latvijas konkuretspejas novertejums 2011* [Analysis of Latvia's Competitiveness 2011], Riga: BiCEPS, 2012, p 122, http://biceps.org/assets/docs/LCR_LV_1804_Final_1.pdf.

financing for economic growth. The country's inability to improve its legal framework is only one of the barriers to the attraction and accumulation of capital in Latvia. It is worth remembering that a perfect domestic environment is also of little value if Latvia's international image and recognition of the country is inadequate.

The attractiveness of the country has been promoted since the 1990s. Generally, Latvia receives little international media or pop-culture coverage, which negatively affects the country's recognition and its attractiveness for both tourists and businesses. The country's image is relatively underdeveloped, and Latvia has not found its specific selling point yet. Low levels of funding for country marketing purposes and numerous domestic failures to advertise Latvia properly on international media and during various expos, demonstrate the lack of dedication and understanding of decision-makers regarding the importance of country's image to attracting investment and financing. Often the targeted approach taken by the institutions responsible is insufficient, as potential investors are bombarded by different proposals and requests on a daily basis. Thus, a wider country narrative should be developed to outshine not only the other two Baltic states, but also many more attractive countries.

A coherent, clearly stated and popular image is essential for Latvia to support its investment claims. But it is even more important for the Baltic region to advertise its common image. The Baltic region is one of the richest parts of the world and among the most developed economies. The magnetism of the region as a whole should also support Latvia's appeal. Moreover, the country's recognition is now already largely tied to the positive image of the three Baltic states. Wrong or negative stereotypes, undesirable affiliations, low results in international rankings, lagging behind other countries, 'mis-association' with neighbours and many other aspects build not only the country's external, but also its internal image. An understanding of Latvia as a place and its potential, self-awareness and self-image are also essential to domestic businesses. Local businesses function as one of the strongest elements and image-builders for Latvia. But insufficient marketing and advertisement financing, together with generally low recognition of Latvian companies abroad, have not helped the overall image of the country in terms of being individualized and widely promoted. More internationalised Latvian companies have often chosen to promote themselves as either coming from the European Union, or from the respective countries they cooperate closely with. This naturally does not help to attract capital and investment from both abroad or from domestic savers.

Another key aspect that needs to be addressed is *competition between the three Baltic states.* The three countries with similar historical experiences in the 20th century, with roughly the same population sizes ranging from 1.3 to 3 million people, similar demographic and emigration problems to other parts of the European Union, the same lack of natural resources and similar dependencies in energy sector, very similar tax structures with an emphasis on lower corporate taxation, flat taxes and higher direct taxes, same geostrategic dispositioning have defined the need for countries to compete for better and bigger foreign investments. Some claim that the proximity and cultural similarities between the Estonian and Finnish nations have contributed to higher levels of attractiveness for foreign capital, while German and Polish businesses have been more active in their cooperation with Lithuanian counterparts. The Baltic states' cooperation and mutual economic, and even their political interdependence, was clearly visible during both the rapid growth period and also the subsequent economic problems. The largest export markets for Latvia are still the two other Baltic states, while Lithuania is also one of Latvia's main import partners. In spite of this, any larger projects and investments usually constitute a bone of contention for all three countries.

Larger infrastructure or business projects, including those in which all three countries are interested, have been met with competition and often viewed with distrust by the countries themselves. One of the most recent examples is a pan-Baltic liquefied natural gas (LNG) terminal that would serve all three Baltic countries in securing their independence. After prolonged discussions and negotiations, no common project with the planned co-financing of the European Commission took place. Lithuania's resolution was to buy its own terminal, which could be subsequently used by all three Baltic states, especially after Latvia completes the liberalization of its gas market.[5]

Another recent example of Baltic economic competition is the case of the Latvian national airline 'AirBaltic',

[5] See *Lietuvas saškidrinatas gazes terminalis no trešdienas oficiali sacis darbu* [From Wednesday Lithuania's LNG Has Officially Become Operational], LETA/Tvnet, 3 December 2014, http://financenet.tvnet.lv/zinas/538104-lietuvas_saskidrinatas_gazes_terminalis_no_tresdienas_oficiali_sacis_darbu.

which has become a strong player in regional air services, out-competing its Estonian and Lithuanian rivals. During the search for new investors for AirBaltic, the Minister of Transportation stated that if AirBaltic were to be shared with Estonia and Lithuania, the Latvian side should retain the controlling majority of shares.[6] This proposal did not garner support among the Baltic partners, who did not want to be minority stakeholders and the search for investors continued. Instead of this becoming one of the positive examples of Baltic cooperation, it became yet another illustration of competition among the countries.

Finally an example with a more positive outcome is the construction of 'Rail Baltica 2', which is a project to modernize and connect all three Baltic states to the rest of the EU national railway system. After some emotional public and political discussions, a declaration on the cooperation between Estonian, Latvian, Lithuanian, Finnish and Polish ministers of transportation and the European Commission was signed on the 25 June 2015,[7] whereby the Baltic states shared financing for the bureau and the first agreement regarding 442 million euros worth of co-financing for the Estonia-Latvian-Lithuanian company was signed on 24 November.[8] These examples, with their different outcomes and situations, demonstrate the importance of the Baltic cooperation for private businesses and the mutual political suspicions when economic interests of national level are at stake.

When discussing the Baltic competition, it should not be forgotten that money attracts money. Thus the competition between the Baltic states to date has left Latvia side-lined. In terms of investments in production in particular, Latvia demonstrates the lowest proportion of accumulated investments of just 21.4 percent, while Estonia leads with 47.6 percent and Lithuania has 31 percent in 2013.[9] Another example of Latvia lagging behind in Baltic competition is the Baltic Sea Index. Estonia and Lithuania have a total score of 7.7, while Latvia scored just 6.8. Despite the fact that the Baltic Sea region ranks in the top 24 percent of the world's most competitive countries, Latvia's relative results did not change in the Baltic competition in 2015 and by sub-index of financial sector, for instance, it even decreased to 4.9 points.[10] Latvia's low competitiveness is thus exacerbated by lower levels of accumulated capital and investments in the production sector, making its economy more vulnerable to capital flight.

Last but not least, it is essential to note that almost the only way to boost investment in Latvia is *via* the inflow of capital from abroad. The domestic public's inability or unwillingness to invest in local companies is also clearly visible. This can be illustrated by the fact that non-residents hold about 85 percent of general government debt, compared to a median of 57 percent for their A- rated peers. This is due not only to the substantial borrowing programme during the crisis years and institutional lending, but is also related to low interest rates paid by domestic investors. The January 2014 emission by the Latvian government of 7 year bonds with 1 billion euro worth of obligations resulted in only 4 percent of those bonds being bought by Latvians.[11] Most activity was from Britain and Ireland, Germany and Austria, the United States and other Western countries, with 60 percent of the bonds bought by asset managers.

Low income levels over a longer period of time have not provided the middle class with vast financial resources to save and investment. Additionally, the Latvian population has little faith in its government's ability to manage the economy and the activities of domestic investors. Recent Eurostat data show that only 22 percent of the population trusts national institutions.[12] This figure is not encouraging for private entrepreneurs or the government. Therefore one of the first moves made by Latvians with funds at their disposal is not to invest in government bonds or stocks, but to open a savings account. Savings accounts are especially popular because of Latvia's turbulent economic history. The transition period, together with

[6] See *Matiss: Pardodot «airBaltic» akcijas kaiminvalstim, Latvijai butu jasaglaba kontrolpakete* [Matiss: Latvia Should Keep the Control If "AirBaltic" Shares Are Sold to Naighbouring Countries], LETA/Tvnet, 18 June 2015, http://financenet.tvnet.lv/viedokli/564732-matiss_pardodot_airbaltic_akcijas_kaiminvalstim_latvijai_butu_jasaglaba_kontrolpakete.

[7] *Paraksta deklaraciju par Rail Baltica attistibu* [Declaration on Development of Rail Baltica Signed], Riga: RailBaltica, 25 June 2015, http://railbaltica.info/paraksta-deklaraciju-par-rail-baltica-attistibu/

[8] See *Paraksta ligumu par 442 miljonu eiro ES finansejumu Rail Baltic/Rail Baltica* [Contract on 442 Million Euro Financing for Rail Baltic Signed], Riga: Ministry of Transportation of the Republic of Latvia, 24 November 2015, http://www.sam.gov.lv/?cat=8&art_id=5363.

[9] See *Arvalstu investiciju vide Latvija* [FDI Environment in Latvia], Riga: BalticExport.com, 2014, http://balticexport.com/?article=arvalstu-investiciju-vide-latvija&lang=lv.

[10] See *Baltijas juras regions ir starp konkuretspejigakajiem pasaule, Latvija turpina atpalikt* [Baltic Region Is among the Most Competitive in the World, Latvia Keeps Lagging Behind], LETA/Tvnet, 2 December 2015, http://financenet.tvnet.lv/viedokli/586500-baltijas_juras_regions_ir_starp_konkuretspejigakajiem_pasaule_latvija_turpina_atpalikt.

[11] See *2014.gada janvari Latvija starptautiskaja finanšu tirgu sekmigi izceno obligacijas eiro valuta* [In January 2014 Latvia Emits Bonds in International Financial Markets], Riga: The Treasury of the Republic of Latvia, 18 September 2015, http://www.kase.gov.lv/?object_id=8313.

[12] See *Public Opinion in the European Union. Latvia. Eurobarometer,* European Commission, Autumn 2014, http://ec.europa.eu/public_opinion/archives/eb/eb82/eb82_lv_lv_nat.pdf.

the latest economic crisis, have encouraged people to stockpile savings for economically difficult times over the past two decades. At the same time, the polls demonstrate that majority of the Latvian population – 63 percent, does not have any savings.[13] Residential savings in Latvian banks at the end of 2014 totalled 10.7 billion euros.[14]

To conclude, it is clear that the Latvian economic tiger is hungry for capital. Historical experiences, together with relatively unsuccessful regional cooperation, has lowered Latvia's attractiveness to capital, leading to the underdevelopment of its stock markets, lower personal savings, and little interest in more active participation in financial markets on the part of the domestic population. The European Union Structural Funds and the Cohesion Fund, together with high levels of activity by foreign banks prior to the economic crisis of 2008–2011, has been crucial in providing the Latvian economy with much needed capital. At the same time, convergence with the European Union average and the catching-up process is not possible without the more active presence of foreign businesses and their capital investments. The Latvian economy is located on the periphery, and its markets are marginalized as well as tiny, creating additional pressures on economic sustainability and growth prospects. The influx of capital and feeding the Baltic tiger means pushing for improved business and public sector management, as well as modernization and greater economic activity. These developments are essential to the future of the Latvian prosperity, economic, social and political advancement. Higher use of its domestic resources, at the same time, is limited by the psychological need to save resources rather than put them in risky business activities due to the low levels of the available and accumulated capital in the country.

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[13] See *Aptauja: 63 percent iedzivotaju naudu uzkrajumiem neatliek* [Poll: 63 Percent of the Population Does Not Save], Tvnet, 9 December 2014, http://financenet.tvnet.lv/zinas/538845-aptauja_63_iedzivotaju_naudu_uzkrajumiem_neatliek.

[14] See *Banku darbiba Latvija 2014. gada – attistiba izaicinajumu pilnaja vide* [Banking Activities in Latvia in 2014 – Development in Challenging Environment], Riga: Financial and Capital Market Commission of Latvia, 12 February 2015, http://www.fktk.lv/lv/publikacijas/pazinojumi-masu-informacijas-l/2015/894-2015-02-12-banku-darbiba-latvija-2014-gada-attistiba-izaicinajumu-pilnaja-vide.html.