

# PRACE NAUKOWE

Uniwersytetu Ekonomicznego we Wrocławiu

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## Unia Europejska w 10 lat po największym rozszerzeniu

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## **SOME ASPECTS OF ECONOMIC DEVELOPMENT OF THE LATVIAN MARKET DURING 10 YEARS OF ITS MEMBERSHIP IN THE EUROPEAN UNION**

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**Summary:** The article considers development trends of Latvia's economy, based on the restructuring of the national economy over the past 10 years. The main directions for further development of the country as a market with a primary sector of small and medium-sized businesses are determined. The problems associated with the deterioration of the demographic factor are highlighted. Market development indicators which reflect the level of welfare of the country, such as inflation, average and the minimum wage, value of the consumer basket are considered. It is concluded that the purchasing power of the employed population of Latvia during the period of membership in the EU has increased, which can be considered a positive factor. As a whole, it is necessary to consider the experience of interaction of Latvia with all structures of uniform European space in the course of the solution of arising problems as the main outcome of the anniversary of the first 10 years of its membership in EU.

**Keywords:** Latvia, economic development of state, development trends of Latvia's economy, market development indicators.

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### **1. Introduction**

By the time of accession to the EU on May 4, 2004, the country's economy has changed dramatically. Actual restructuring of the national economy, which started lasted at the beginning of 1991, led to the situation in which the country from industrialized territory having sound physical infrastructure (roads, ports, pipelines, large enterprises, energy power) turned into the state where a share of GDP, created in the industrial sector, fell from 69.2% in 2000 to 34.26% in 2004. In the next years this tendency gained development because of the "open doors" policy in relation to foreign investments which led to the excessive growth of financial growth and transactions with real estate.

A landmark moment in this direction can be considered the fact of Latvia's accession to the EU.

Since 2004, the rate of decline in the share of industry and agriculture in the Latvia's GDP has been the highest in Europe. Primary development was gained by services sector, which amounted to 77% of GDP in 2009 [*Развитие экономической...* 2011].

This fact of restructuring cannot be regarded unambiguously positive or negative by itself without an analysis of all components of this process.

Currently there is a statistical data analysis which is accumulated enough and which allows to determine the benefits and losses of Latvia after joining the EU.

The **aim of research** is the analysis of economic development trends in Latvia from 2004 to 2014 determining positive and negative consequences of this process.

**Research objectives:**

1. To analyze key indicators of socio-economic development of Latvia for the last 10 years of its existence.
2. To identify challenges faced by Latvia in its socio-economic development.
3. To identify trends and ways to overcome them in terms of integration into the European Union.

The **object of research** is a development model of Latvia in the context of its membership in the EU, and the **subject of research** – socio-economic indicators when designing the strategy of development of Latvia.

The ideas and concepts presented in classic and contemporary works of scientists on economic development and social welfare form **theoretical basis** of this research. The results of studies, as well as statistical materials form informational basis of the research.

**Research methodology.** The studies are based on the methodology of system analysis, involving the structural-functional approach of allocating objects in the system of structural elements and defining their roles (functions) in the system. We used scientific methods, such as systemic and situational approach, structure and comparative analysis.

## 2. Results and discussion

According to economic theory, one of the ways to develop the country's economy is to increase net exports. One of the advantages of joining the EU is to expand the market, removing barriers to exports to the EU.

Initially, the main advantages of the forecast were as follows: contributions for the country's EU membership would be offset by subsidies from the EU budget.

It was assumed that EU membership would allow the country to successfully attract investment for economic development. If the economy was stable, then it would be safer and more profitable to invest money. With the growth of investments there would be new workplaces that would promote economic recovery. Economic

activity would promote employment growth, and the received tax revenues would improve social budget of the state. With the growth of economic activity, in certain areas the shortage of skilled labour may be exacerbated, which has already been designated. As a result, we could expect the growth of wages to attract skilled workers.

Actual state of affairs identified some other scenario. Many states in the condition of the economy in transition face the need to stimulate investment activity. Foreign investment can actually lead to an increase in real output, but only if aimed at creating competitive products with high added value. Unfortunately the main Latvian economy where the foreign capital began to be invested, became not the industry, but financial intermediation and real estate transactions.

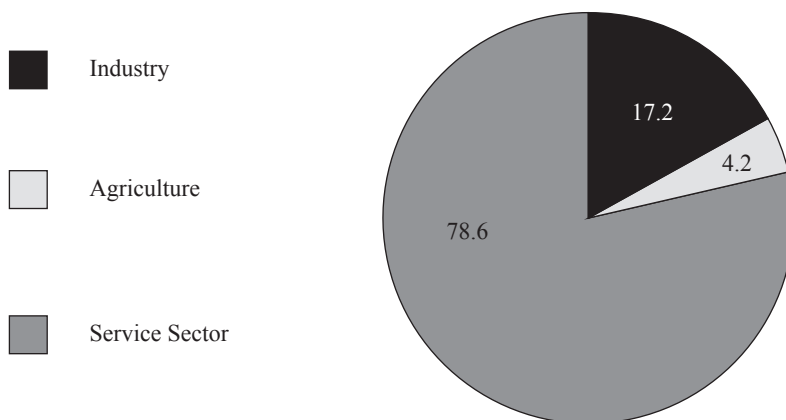
And in essence the following services were rendered to the inhabitants of Latvia: trade, transportation, education, health, finance, public administration, etc.

Part of the export services: hotel, transport and international transportation were few and were not able to fully compensate the losses from the recession in industrial and agricultural sector.

Political euphoria of EU membership led to an underestimation of the economic risks, the most significant of which was the high mortgage debt. At the beginning of 2005, credit debt of financial and non-financial institutions in Latvia was 52.4% of GDP, and by the end of 2008 reached the level of 110%. Overdue loans began to rise sharply and exceeded the safe level of 1-2%.

In parallel there was a rapid growth of external debt. If in 2005 the national debt was 25%, in the crisis year of 2008 57% of the country's GDP.

Currently, the economic structure of Latvia is as follows (Figure 1): industry – 17.2%, agriculture and forestry – 4.2%, services – 78.6% [Statistical Yearbook of Latvia 2014].



**Figure 1.** The share of branch sectors in GDP of Latvia, %

Source: [LR Likums].

Thus, considering that Latvia is a small country with a population of about 2 million inhabitants, without deposits of raw materials and energy which it is forced to import, with a limited domestic market, it is necessary to recognize that it cannot effectively develop, continuously increasing only services sector. Therefore, in general, in the period from 2004 to 2013 the country developed an irrational economic structure, which needs to change.

In this regard the first result of ten years' stay of Latvia as a part of EU is to pay special attention to the efforts that are being made today to stabilize the situation.

The main vector of these efforts is to eliminate problems for the creation and development of small and medium-sized businesses in Latvia under unified European market conditions.

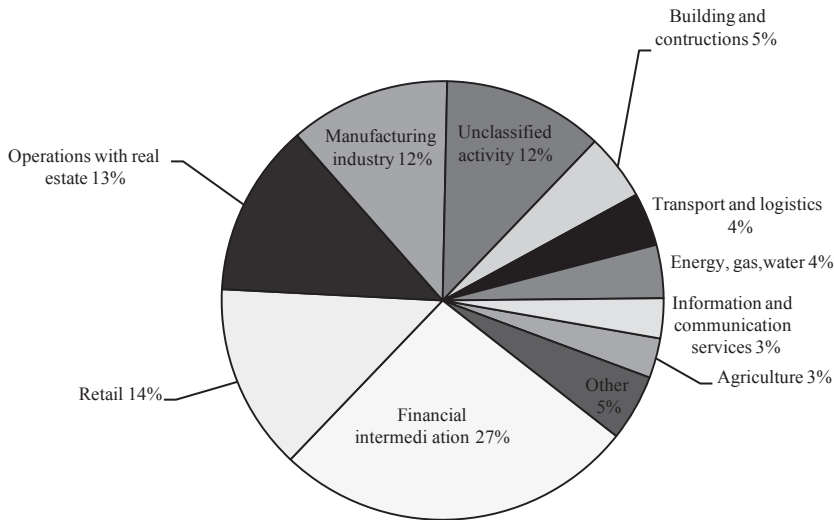
According to the European Commission Regulation number 364/2004 of 25 February 2004, small businesses include businesses with an annual turnover and/or annual balance sheet not exceeding EUR 2 million in the presence of up to 10 employees [ES Komisija, 2004]. In Latvia it is 95% of all businesses that provide work for 70% of the Latvian labor force and generate 65% of gross domestic product [www.gorod.lv]. Small and medium enterprises are the backbone of the socio-economic model of the EU. They account for 60% of value added and for two thirds of the working population of the EU [РИА «РосБизнесКонсалтинг»]. At the same time in Latvia, according to the law on the tax on microenterprises, these include a business with an annual turnover not exceeding 70 000 lats (at the rate of Bank of Latvia – 99 601.03 euro), in the presence of up to 5 employees and wages not exceeding 500 lats [LR Likums].

To stimulate the development of small and medium-sized businesses in the EU, two regulatory documents have been created: [The European Charter for Small Enterprises] and [Small Business Act for Europe].

According to Eurobarometer, 61% of Latvian residents would like to work for themselves, becoming small business owners (the EU average is 45%) [Competitiveness and Innovation Framework Programme (CIP) (2007-2013)]. It should be noted that in the period 2007-2013 within the framework of the EU program for innovation and competitiveness about 3.6 billion euro has been allocated to invest in the renewable energy, information technology and environmental technology [Competitiveness and Innovation Framework Programme (CIP) (2007-2013)].

This contributed to the fact that in 2012 126,606 small businesses were registered in Latvia, but only 48,796 of them were actively operating by the end of the year [Monthly Bulletins of Latvian Statistics].

Over the same period foreign direct investment also fell mainly in traditional sectors of the Latvian economy such as financial intermediation, wholesale and retail trade and operations with real estate (Figure 2).



**Figure 2.** Foreign direct investment according to activity at the beginning of 2013

Source: [LR Likmus].

Investments in the industrial sector accounted for 12%. The areas of production such as the manufacture of food products, textiles, clothing, paper products, machinery and equipment repair and wood processing have developed. This factor could be considered encouraging, if not for the serious problems faced by small business in Latvia. Among these problems there are: the lack of funding at the formation stage of the enterprise, the current tax system and the government's reluctance to deal with the management of human resources.

We shall discuss the last position in more detail, because it is not just about the state of human capital, but the fundamental basis of the state existence.

**Table 1.** Number of inhabitants in Latvia

Year	Number of people	Changes in comparison with 2004 (%)
2004	2 276 520	100.0
2005	2 249 724	98.8
2006	2 227 874	97.7
2007	2 208 840	97.0
2008	2 191 810	96.3
2009	2 162 834	95.0
2010	2 120 504	93.1
2011	2 067 888	90.8
2012	2 044 813	89.8
2013	2 023 825	88.9

Source: [Eurostat].

The total population of Latvia continues to decrease. According to Eurostat [www.eurostatt.com], since 2006, the growth of the population of Latvia has been negative (Table 1).

In fact, the population of Latvia in 2013 fell to the level of 1959 [www.eurostatt.com].

The population of Latvia is rapidly falling, both due to low birth rates and migration. Official statistics do not take into account the fact that about 5% of the population temporarily went to work abroad and remain there without any wish to come back on semi-legal status.

With regard to the migration of the population of Latvia, according to the official statistics these figures show much less than its actual value. The study of the Bank of Latvia, as well as some commercial banks operating in Latvia for over 15 years, determines the number of Latvian residents who left for permanent residence and work abroad to 200 to 300 thousand people.

As far as the quality of workforce is concerned, the number of years to study in high school increased from 11 to 12 years, but at the university level it was reduced from 5 to 3 years. The number of students at universities increased slightly, but the quality of their training has fallen significantly. The structure of training of specialists did not correspond to the demand structure of the national economy. Those who had higher demands left to work in other countries [Гапоненко 2009].

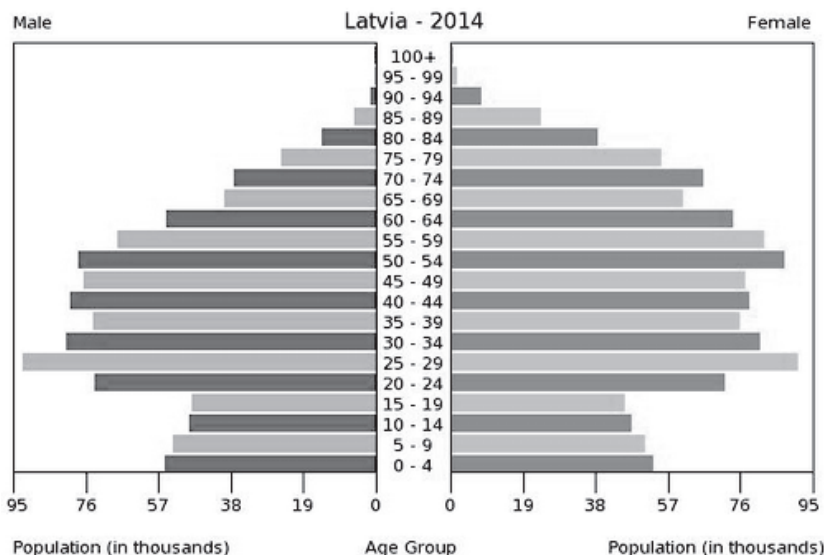
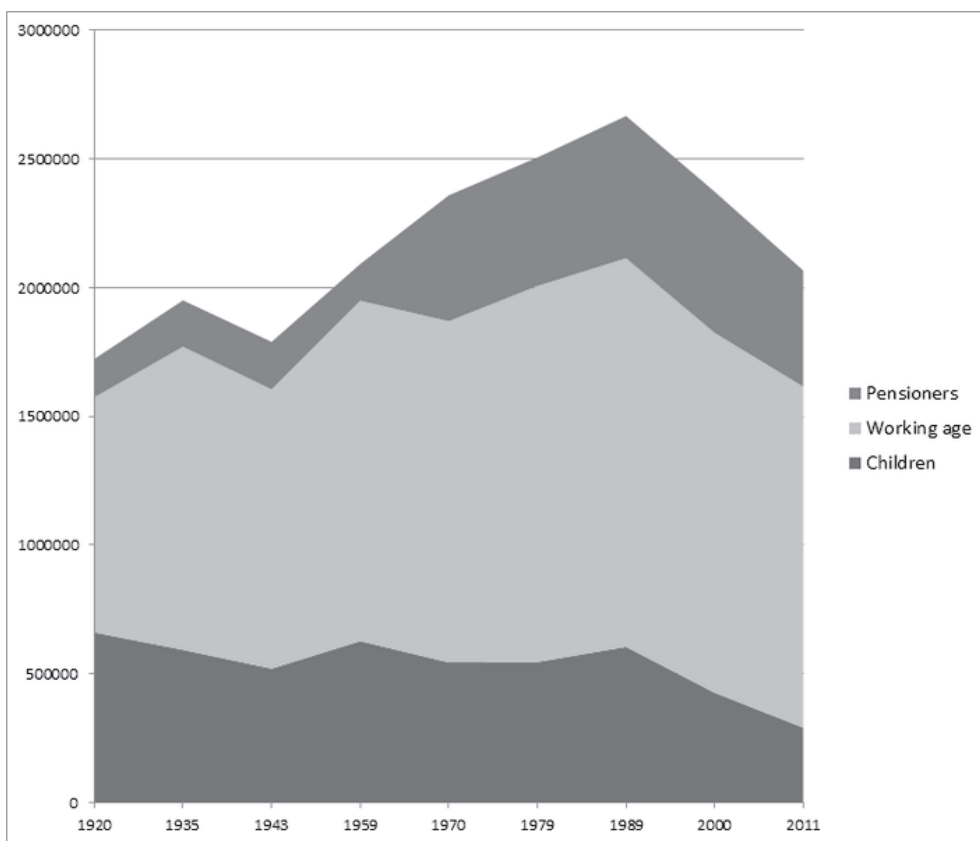


Figure 3. Age structure of the population of Latvia

Source: [The World Factbook].

In recent years, Latvia has continued to experience a decline in the birth rate: during 10 months of 2012, 15,700 children were born, which is 500 babies, or 2.9% people fewer than in the same period last year. In 2011 fertility decline was 12.7%. At the same time, during 10 months in 2012, 23,800 people died, compared to 25 thousand in the same period last year.

Thus, the age structure of Latvian population is close to the following parameters: the number of children and young people under the age of 27 years is lower and the number of elderly people aged 65 to 85 years is higher (Figure 3).



**Figure 4.** Structure of population in Latvia

Source: [LR Likmus].

There are 1.2 million people aged from 17 to 65 years today (the years when people are most necessary for reproduction and the production sector) (Figure 4).

The calculations of the European Commission show that in the next 50 years the population of Latvia will be lower by another 25%, and the number of residents at working age – by 43%. This is a dramatic impact on the age structure of the

population. If today in Latvia for four residents being at the working age, there is one person aged 65 years and older, by 2060 this ratio will amount to 4 to 3 [www.demoscope.ru].

Aging and declining population will occur more rapidly in rural areas or in economically weak regions (e.g. in Latgale).

Labor and economic activity will be more clearly concentrated around a small number of economically powerful cities. Quality and availability of public infrastructure and services will worsen. The reduction of able-bodied population and shadow economy will increase the risk of poverty for older people and will threaten the long-term viability of pension system. To mitigate these trends and reduce their negative economic impact structural reforms should be implemented.

To mitigate the negative demographic trends it is necessary to stimulate not only fertility, but also the return of the country's inhabitants from abroad who can apply their knowledge and skills in the domestic market. As the main direction of human resources development, the question of the small businesses development is raised here again. For Latvia this moment has two aspects. On the one hand, a small business can develop based on local human resources which are necessary to be on the market and to increase in number. On the other hand, it is possible to reduce human resources only by developing small and medium enterprises in Latvia.

To improve the development of human resources and small business development, Latvia joined the European Charter for SMEs, pledging to create national policy development activities in accordance with the Charter, namely:

- increase business activity according to the programs of education and training,
- make setting up of enterprises cheaper and quicker,
- introduce favorable business tax policy,
- strengthen the technological capacity of small and medium-sized businesses, etc.

Thus, the first decade of Latvia's membership in the EU ended with the complete understanding of the necessity of the creation of a complete balanced economic infrastructure of the country connected with the creation of public administration system by the development of small business and the provision of adequate information to this task, as well as financial, organizational and other resources.

It can also be concluded that the accession to the EU has caused migration and workforce reductions in Latvia. However, reducing the workforce in the country leads to a decrease in the unemployment rate, which is a positive indicator, as it leads to higher wages and it is a good solution for busy people. At the same time, in terms of international competitiveness, the increase of production costs reduces the advantage of Latvian exports, which is a negative element in an integrated environment.

To determine the general market trends we will address to such an important indicator as the welfare of the population, which is determined by the index of purchasing power for basic foodstuffs. Given inflation rates and income levels, as reflected in data from the statistical department of Latvia, we will determine what grew faster – price or income of the population after the country joined the EU.



We will address to an average annual indicator of inflation in Latvia since the end of 2004 (Table 2):

**Table 2.** Inflation in Latvia from 2004 to 2013 (in %)

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.4	2.3	0.2

Source: [The World Factbook].

These data indicate that inflation until 2007 was within acceptable parameters. However, due to the crisis, the inflation rate increased sharply in 2008 and Latvia became a leader in terms of inflation (15.3%). The year 2009 was a turning point – prices began to fall, and in one year they decreased by 1.2% for products and by 1% for services. The main reason of the deflation in 2010 was a drop in prices for food, energy, clothing and footwear. Lower prices for hotel and restaurant services had also a negative effect on consumer prices, which led to an increase in deflation in 2011. Then there was a boosting effect on consumer prices in general due to a rise of utilities, electricity and public transport prices. Nowadays the rate of inflation is 0,3% [www.eurostatt.com].

The second measure, which is necessary for the analysis of purchasing power index is the level of income.

We take the minimum and average wages in net terms as a basis.

**Table 3.** Minimum and average wages (2004-2013) in euro/per month

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Minimum wages	114	128	171	228	256	256	285	285	285	285	320
Average wages	292	350	430	509	645	667	633	660	684	716	751

Source: [Eurostat].

As the comments to the above data it should be noted that since Latvia joined the EU, the level of minimum average wage tends to increase. We can state that after joining the EU, incomes in Latvia have increased, and their growth determines inflation. The second positive component of the income growth dynamics is outpacing the growth of net wages compared to gross wages by increasing the amount of non-taxable minimum.

Finally, for the final illustration of welfare in Latvia, we will consider such statistics of the market's economic development as the consumer basket.

According to data of statistical department of Latvia, the consumer basket – it is none other than the living wage that provides a person the least amount of goods and services, based on changes in the price level.

Subsistence minimum monthly is characterized by structure and financial security.

**Table 4.** Minimum wage and minimum cost of subsistence as per a resident of Latvia (in Ls)

Date	Before taxes	After taxes	Minimum cost of subsistence
01.01.2007	170.74	130.76	189.24
01.01.2008	227.66	183.84	227.66
01.01.2009	256.12	206.81	239.04
01.01.2010	256.12	185.43	236.20
01.01.2011	284.57	205.96	246.16
01.01.2012	284.57	205.96	250.42
01.01.2013	284.57	207.85	249.00
01.01.2014	320.00	229.67	252.19

Source: [LR Likmus].

For comparison, let us turn to the same indicators of some EU Member States: Lithuania consumer basket by the end of 2013 amounted to 472 euro, in Estonia – 580 euro, in Poland – 554 euros, in Germany – 1000 euros, in France – 1300 euros, in UK – 1591 euros. Thus, despite the apparent current trend of increasing the subsistence level in Latvia, within the 28 EU Member States, this figure is on the 25th place.

**Table 5.** Purchasing power parity for basic food and energy supplies from 2001 to 2012, 2003=100

	2001	2002	2003	2004	2005	2006	2010	2012
Beef	79	85	100	102	103	114	140	147
Pork	77	87	100	104	115	137	168	173
Chicken	72	82	100	107	119	141	149	162
Sausage	70	84	100	109	120	138	166	189
Butter	84	93	100	94	93	106	121	99
Milk	87	90	100	87	87	97	108	103
Sour cream	86	101	100	90	97	111	136	125
Curd	101	95	100	95	91	104	119	115
Eggs	81	99	100	105	125	145	165	161
Rye bread	88	92	100	102	107	110	113	107
White bread	85	92	100	101	108	116	124	112
Sugar	93	94	100	94	108	129	154	191
Potatoes	101	67	100	109	108	89	98	135
Vodka	85	93	100	107	126	137	174	193
Energy	83	90	100	85	110	129	158	150
Fuel oil A-95	88	96	100	97	92	105	132	143
Diesel fuel oil	90	103	100	91	79	91	115	115

Source: [LR Likmus].

Having considered the main parameters, we will define the index of purchasing power as an indicator of the growth of welfare. Previously it was shown that increased both incomes and costs; in Latvia has been marked both inflation of demand

and offer. To determine the index of purchasing power, the 2003rd year was taken as the starting point (the year before the entry into the EU). This indicator reflects the change in price ratios and net earnings during the time investigated (Table 5).

Table 5 shows that in 2004, the year after joining the EU, the purchasing power for certain food products (mainly dairy products) decreased and for other food products it decreased only for a short period of time. Within two years, the purchasing power was restored or it even increased. On this basis, we can conclude that after joining the EU the growth of wage was higher than the increase of prices.

### 3. Conclusions

Joining the EU envisaged the increase of grants from the EU budget for Latvia and the empowerment of capital inflows for positive changes in the domestic economy of the country, undergoing a restructuring of its economy. However, the economic model operating in Latvia did not allow to “feel” an essential inflow of the capital to industrial sector and concentrated investments in the branches connected with movement of the capital. Thus, the main advantage of EU membership in the first 10 years was lost.

In addition, after the entry into the EU, Latvia has started to export labor. As a result, the actual migration encompassed almost  $\frac{1}{4}$  of the economically active population of the country, that at constantly decreasing population created a negative market development demographic indicators.

At the same time in Latvia the unemployment has decreased, and wages and the purchasing power of the working population, which allows to establish positive development of welfare, have increased in the period from 2004 to 2014.

As a whole, as the main outcome of the first 10<sup>th</sup> anniversary of the Latvian's membership in the EU it is necessary to consider the experience connected with the interaction of the country with all structures of uniform European space in the course of the solution of arising problems.

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## WYBRANE ASPEKTY ROZWOJU EKONOMICZNEGO RYNKU ŁOTWY W CIĄGU DZIESIĘCIU LAT JEJ CZŁONKOSTWA W UNII EUROPEJSKIEJ

**Streszczenie:** W artykule rozpatruje się tendencje rozwoju gospodarki Łotwy na podstawie restrukturyzacji gospodarki narodowej za ostatnie 10 lat. Wyznacza się główny kierunek późniejszego rozwoju kraju jako rynku z przeważającym sektorem małego i średniego biznesu. Poruszane są problemy związane z pogorszeniem czynnika ludnościowego. Omówiono też wskaźniki rozwoju rynku, które odzwierciedlają poziom dobrobytu kraju, jak: inflacja, średnia i minimalna pensja, wielkość koszyka spożywczego. Można wysnuć wniosek, że nabywcza zdolność ludności Łotwy w okresie członkostwa w UE się podniosła, co uważa się za czynnik pozytywny.

**Słowa kluczowe:** Łotwa, ekonomiczny rozwój państwa, tendencje rozwoju gospodarki Łotwy, wskaźniki rozwoju rynku.