

ECONOMY AND FINANCE

THREE DECADES OF TRANSITION

Lessons learned and prescriptions offered for Latvia's economic development

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State: Latvia's independence coincided with the global ascendance of neoliberal policies. A role for the state in contributing to economic development was then out of fashion, and thus opportunities were missed to accelerate and broadly distribute economic development.



Society: The social sphere in Latvia suffered during the post-Soviet transition. Significant emigration, low birth rates and growing inequality emerged. These imperiled the country's demographic future, but can be reversed with more equitable economic growth and rebalanced development model.



Economy: Offshore finance developed in Latvia to serve the money-laundering needs of oligarchs and corrupt government officials alike throughout the Commonwealth of Independent States and beyond. This structure promoted inequality and worked against balanced economic development.

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Lessons learned and prescriptions offered for Latvia's economic development



Sectoral overview: This report provides a sectoral overview of Latvia's economy. We map its constituent parts to show its relative strengths and weaknesses. Inspecting the past, we examine problems that arose with the development of Latvia's post-Soviet economy. But we also point to improvements in Latvia's economy following the 2008 financial crisis, which exhibits maturing tendencies in some economic sectors that can be further built on.



National champions: Next, we inspect Latvia's economic sectors to suggest where allocation of effort and resources should be deployed, or withdrawn, to further develop Latvia's economy. We put the main sectors of Latvia's economy into three groups: 1) National Champions, 2) the Middle Ground, and 3) Economic Headwinds. In short, our goal here is to suggest enhancements to Latvia's performance through alterations to its economic structure going forward, rather than merely critique its past economic record.



Policy: We point to areas in which policy changes could enhance economic and social development. Tax policy is the proverbial low-hanging fruit where the biggest impact on development could be realized. We offer a select few policy prescriptions on this score, while a more elaborate examination of leveraging tax policy to generate broader, more equitable, and sustained economic and social development, is forthcoming in a future report.

Further information on the topic can be found here:

<https://baltic.fes.de>

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Purpose

This report has two goals, and thus two main parts. One, to understand how Latvia's transition economy developed the past three decades in order to identify problems their model created in the past, present, and by implication, future. Two, provide a sectoral overview of Latvia's economy that shows its weaknesses, strengths, and prospects heretofore underutilized. Identifying and then developing the latter could promote a more complex and therefore more sustainable Latvian economy and society. In this second section, we organize select Latvian economic sectors into three categories in terms of their respective potential for national development: 1) National Champions, 2) The Middle Ground, and 3) Economic Headwinds. In short, we analyze the past and present, with a look toward the future, to suggest policy options for a better Latvia.

Latvia may be small, but everything about its three-decade long transition has been big. These transition years have seen rapid economic growth interspersed with world record-breaking economic collapses. Big population movements, propelled largely by Latvia's economic and social policy choices, have also shaped the country into its present condition. This report endeavors to drill deep into Latvia's economic policy choices in order to render an understanding of how it arrived at its present position three decades out from Soviet occupation. Chiefly, Latvia chose to develop an offshore finance and transit economy from the start. Meanwhile, it rejected anything like a "developmental state" model of the type that facilitated development among various East Asian "Flying Tiger" economies and many others before them. Thus, Latvia shunned industrial policy, or anything that hinted at "picking winners" in the economic realm. Instead, Latvia would encourage an organic economic development driven by "rational choice" through maintaining its macroeconomic "fundamentals" of low inflation and a highly valued currency. It was thought that this would encourage foreign direct investment (FDI) to develop Latvia's economy.

These policy decisions were dictated by timing, ideology and interests. On one hand, Latvia's independence arrived at the point where the United States' power peaked. In the late 1980s and early 1990s America's neoliberal model was ascendent and almost unquestioned as the best economic development model. Given the context of the Soviet occupation and the Cold War, Latvia looked to the United States for

guidance, if not outright military protection. Thus, Latvian policymakers were keen to follow an economic model that appeared to deliver the best answers for developing its economy, while simultaneously currying favor with its chosen protector, the United States. Additionally, this model served the interests of those who had accumulated initial capital at the start of the transition: those in the transit business and currency exchanges that would morph into offshore banks. This neoliberal model further conferred the advantage of putting off messy questions concerning what to do about the desperately poor, which the transition period created in no small number. The entire matter could be easily dismissed by asserting that transitions to market economies invariably create hardships, but that such periods of "shock therapy" are only temporary, or, that anyone's failure to prosper in the market reflected personal shortcomings.

At its worst, the above model resulted in an economy that was long on speculation and corruption, and short on development of the "real" sectors of production. Latvia would create a system rife with rent extraction and high costs, combined with low after-tax income. That said, after three decades, Latvia does have real economic strengths, and areas of economic potential still underutilized or unrealized. Part II of our report delivers a sectoral overview of Latvia's chief economic sectors since the 2008 financial shock to convey a sense of where the country's economic strengths and weaknesses lie. We enumerate several sectors in which Latvia's economic performance can be enhanced and conclude by outlining development-friendly tax and industrial policy recommendations to promote Latvia's continued transformation into a more modern, sustainable, socially responsible and digitally enabled economy.

Theoretical contexts

Latvia has posted solid economic growth numbers in recent years, yet with a relatively low Net National Income (NNI) compared to Estonia and Lithuania. This imbalance between Gross Domestic Product (GDP) and NNI reveals that Latvians are not gaining as much income (purchasing power) as the overall output of its economy suggests (insights into the importance of the GDP vs. NNI distinction for countries such as Latvia can be found in Thomas Piketty, 2014, 2020). The authors conclude that several key economic sectors have been insufficiently developed that could boost both output and income for Latvians. This begs the question of why many industrial areas of the economy have been neglected, while an oversized financial sector prone to serious crises was developed instead? The late Gunnar Myrdal of the Stockholm School of Economics observed nearly a century ago that economic theory was not developed in an interest- or ideology-free vacuum, but rather, with a *Political Element in the Development of Economic Theory*, as his dissertation and later book was entitled (Myrdal, [1930] 1990). Moreover, theories of economic development are situated in specific times and contexts. Latvia's emergence from Soviet rule came at the peak ascendancy of financialized economies (neoliberalism), which encouraged a focus on services, often to the neglect of manufacturing (Tooze, 2018). Neoliberal restructuring took on an extreme form in the Baltic republics as an effort to re-embrace the West while rejecting their Soviet past (Bohle and Greskovits, 2012). Additionally, some argued that the past project of Friedrich von Hayek and Ludwig von Mises to reorient Central and Eastern Europe away from the developmental state and toward a European variant of the financial and trading order of the Austro-Hungarian Empire, began to be implemented in the 1990s (Hayek, 1939; Slobodian, 2018). The collapse of the post-Soviet bloc happened as the global system was still re-organizing from the commodity price shocks of the 1970s and repairing itself through what David Harvey referenced as the "spatial fix" designed to bring more commodities into the global system (Harvey, 2003). The spatial fix was facilitated by financial services, both legitimate and not, with offshore banks handling commodity export revenues from the CIS onto global markets. Tax evasion further enabled supply-side economic policies that suppressed tax collection (Shaxson, 2012; Zucman, 2015). These supply-side reforms have contributed to the erosion of the social sphere and the development of precarious employment (Standing, 2011). Austerity and supply-side pol-

icies designed to stimulate economic recovery starved infrastructure of basic research essential for developing new commercialized technologies under the umbrella of the "Entrepreneurial State" (Mazzucato, 2013). Meanwhile, growing inequality (Piketty, 2014) created social imbalances that, as John Kenneth Galbraith prophesied a half-century ago, would weaken social cohesion (Galbraith, 1967). The supply-side economies (by definition) that emerged relied on wage suppression to increase profits under neoliberalism and sustained consumption through credit (Streeck, 2011). Easy availability of credit led to asset price inflation and non-performing loans, followed inevitably by financial crashes. This led to the imposition of austerity, which historically has impeded industrial development (Blyth, 2013). Austerity budgets were imposed in Latvia after the financial crash in 2008. Research on the advisability of austerity as a solution for a return to economic health came from A. Alesina, K. Rogoff and C. Reinhart. The value of Alesina's thesis on austerity was debunked by many; for example, none of Alesina's austerity cases were in countries that began with economic slumps (Jayadev and Konczal, 2010). Meanwhile, Rogoff and Reinhart's work on austerity was found to be deficient because of significant spreadsheet errors (Herndon, Ash and Pollin, 2013). Some argue that austerity was accepted in Latvia because the idea found partial resonance in Latvian culture (Ozolins, 2019), as ethnic political tensions superseded economic ones. This occurred against the backdrop of a significant exodus of people (Hazans, 2016) that served to dilute political pressures against austerity (Sommers, Woolfson and Juska, 2014). Heterodox critiques of Latvia's development model have been produced, albeit with varying foci (Berzins, 2014; Weisbrot and Ray, 2011; Sommers and Woolfson, 2014). Alternative interpretations to our heterodox overview of Latvia's development through to the crisis and internal devaluation policy in the wake of the 2008 crisis are summarized by A. Aslund and V. Dombrovskis, et al. (2011). Yet our primary aim is to provide a sectoral overview of Latvia's economy, along with ways to enhance it that can be categorized as anchored in the Hamiltonian, Listian and Schumpeterian schools of thought, leveraging active, mission-oriented industrial, innovation and finance policies to promote national development (Reinert, 2007).

1

BACKGROUND

The mid-2000s' economic boom was long overdue. While Latvia's economy saw many years of solid growth after its emergence from Soviet rule in 1991, its economy also experienced many busts. The birth of Latvia's Second Republic was troubled, if not traumatic, for many. Latvia's renewed independence followed the exciting period of the 1980s. A rich cultural and political life emerged. The national reawakening was under way and the return of independence, lost two generations previously, seemed within reach. The Gorbachev reforms accelerated change. *Glasnost* and *Perestroika* provided the greatest opening for democracy in Soviet history. On the economic front, Mikhail Gorbachev looked back to the USSR's New Economic Policy of the mid-1920s for market policy inspiration. Perestroika was designed to invigorate a sclerotic Soviet economy organized around planning and, in practice, *blaht* (favors). While a certain economic dynamism resulted from these reforms, the chief effect was to fully unleash what was already under way: corruption and rent-seeking opportunities vis-à-vis the state. Latvia was doubly plagued by corruption. Not only did it possess the myriad forms of corruption endemic to the USSR, but given its forcible incorporation into the latter, stealing from the state was also a form of resistance. Latvia's geography provided a further dimension. Its ports, especially Ventspils, which was the USSR's largest oil terminal, provided the exit point for raw materials from the entire Soviet Union to global markets (Austere, Ikstens, and Voika, 2006). This was a place where windfall fortunes were made (Sommers, Bezemer, and Hudson, 2010).

Simultaneously, for many the period of transition was punishingly hard, especially for men, who found their previous jobs made redundant, and all too often their very existences. Male life expectancy fell from the peak Soviet of 66 years of age, bottoming out at 59 by the mid-1990s (European Commission, 2001). The Banka Baltija crisis of 1995 wiped out whatever savings remained for many after the early 1990s conversion of the Soviet ruble to the Latvian ruble, then to the Latvian lat (Korhonen, 2002). The Soviet ruble was officially exchanged at a rate of 200 to 1 lat and was representative of the exchange rates prevailing through much of the post-Soviet world (IMF, 1996). The intention of shock therapists throughout the former Soviet bloc was to erase savings. While cruel in its effects, cruelty was not the purpose. The perceived need was to launch an accelerated period of

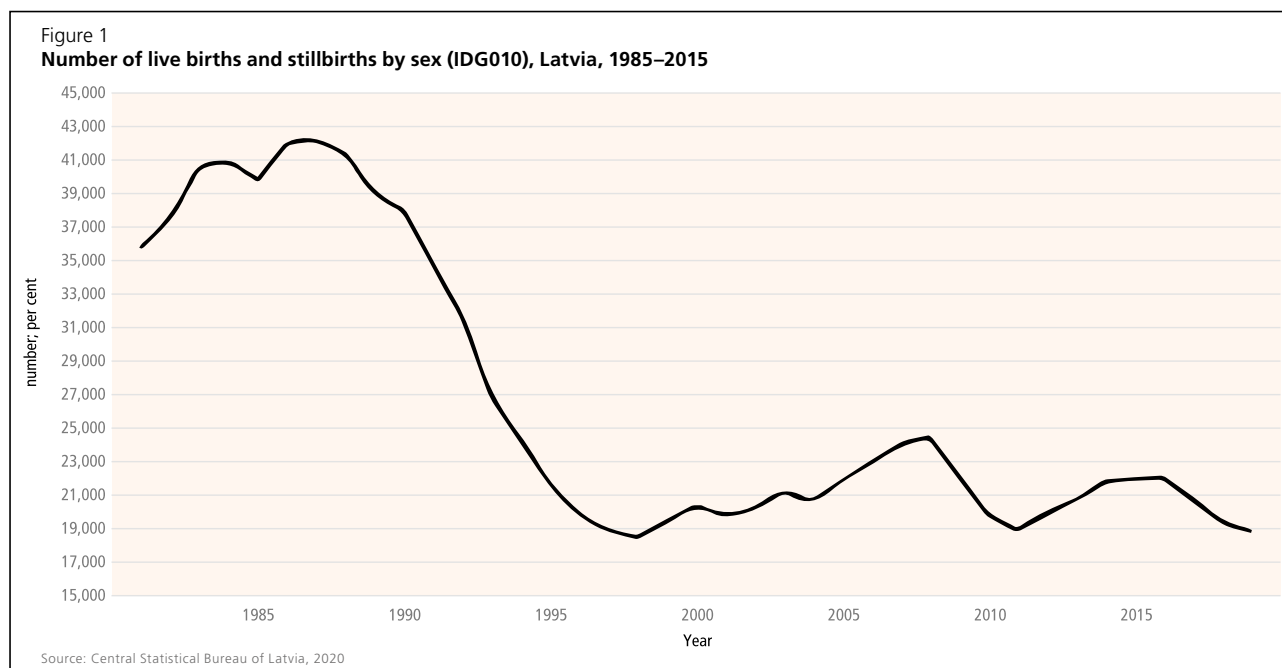
capital accumulation that would dramatically scale down consumption of goods by the public in favor of making resources available to establish new enterprises that were competitive in global markets.

Privatization vouchers were distributed to the public at this time, giving people stakes in new enterprises (Mygind, 1999). It is unclear, however, whether top policy architects believed that vouchers would democratize the economy, or would, as in fact happened, merely serve as a conduit to funnel resources from the public and concentrate them in the hands of a new entrepreneurial elite that would reorganize old businesses to attain profitability or create new ones. Capital for new businesses, it was hoped, would also come in the form of foreign direct investment.

In Latvia, the resulting experiment in 1991 produced high levels of inequality, significant emigration and declining birth rates, and exacerbated social pathologies (Wong, 2016). There was economic growth as well, but it was unevenly distributed and punctuated by the busts of the 1995 banking crisis and the post-1998 slowdown linked to the crash of the Russian ruble.

PEOPLE

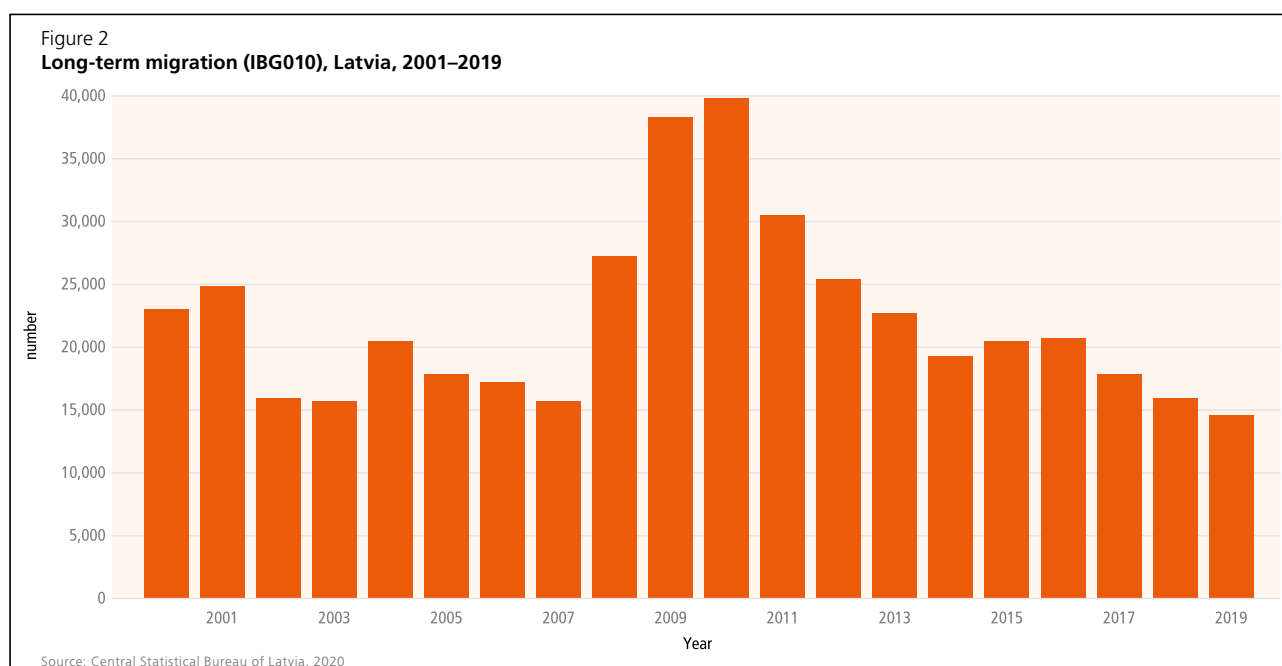
Latvia's demographic profile presents challenges for its future economic and social development. In short, it has lost too many people of working age, and too few of child-bearing years remain. Latvia took several demographic hits in the twentieth century before the present demographic challenges arose. World War I, the Soviet Civil War, foreign occupations (both German and Soviet) during World War II and Stalin's deportations launched at the start of the Cold War all worked to hinder ethnic Latvian population growth. The situation improved following Nikita Khrushchev's 20th Soviet Party Congress of 1956, which brought an end to most Stalin-era terror and saw the USSR transition from a totalitarian state to a strongly authoritarian one. Latvia received significant immigration from other Soviet republics, thus boosting its population. The 1950's era chair of the Soviet-Latvian Council of Ministers, Eduards Berklavs, tried to halt this immigration, but his "national communism" movement was checked by a combination of Soviet generals in Jurmala and ethnic Latvian Stalinists in the mid-1950s. In 1959 he was



deposed (Prigge, 2015). Nonetheless, ethnic Latvian population numbers were now on the mend, with the total number of Latvian residents reaching its peak in 1989 at nearly 2.7 million people, surpassing its previous record of 2.5 million people at the onset of WW I (CEIC Data, 2017). After 1989 the population declined, as emigration, declining birth rates and higher death rates took hold. The collapse of the USSR led to the fairly-rapid exodus of nearly 300,000 people, chiefly back to Russia, as it was unclear whether an unraveling might unfold in Latvia similar to that of the former Yugoslavia in the late 1980s. Live births in Latvia peaked at 42,000 in 1987 during the Soviet period, but steadily declined thereafter, bottoming out at under 20,000 by 1997 and hovering under 25,000 thereafter (Centrālā statistikas pārvalde, 2018). The problem of low birth rates is shared by many European countries. However, Latvia's low birth rate is compounded by significant emigration, not least of women of childbearing

age. There is a demographic gap of some three decades in which relatively few children were born. Combined, these make for a catastrophic demographic imbalance, shifting every year towards the elderly. The collapse in Latvian births over the past three decades is illustrated in Figure 1 (Central Statistics Bureau of Latvia, 2020).

Latvian emigration has continued into the twenty-first century. Contrary to the common narrative, emigration did not accelerate upon accession to the EU. In fact, emigration declined by about a quarter at EU entry in May 2004, as accession signaled to Scandinavian banks that Baltic property markets were a safe investment. Big money followed. This in turn led to construction jobs and increased consumption. But Latvia's 2008 banking crisis and the subsequent imposition of strong austerity policies led to a major exodus of people. By 2010, Latvia had lost another 200,000 people, over



75,000 of them in 2009 and 2010 alone (Central Statistical Bureau of Latvia, 2020).

At the time, the government and advocates of austerity abroad claimed that Latvia's austerity policies were a success. But in that case, why did so many people leave? For many Latvians, the struggle to end Soviet rule was followed by decades of corruption and broken promises that suggested political engagement was pointless. After the brief, but significant protests against austerity in 2009, many Latvians gave up and voted with their feet, exiting the country. Latvia experienced the full effects of austerity. Birth rates plummeted during the crisis, as is the case almost everywhere austerity programs are imposed. Latvia also experienced among the highest rates of suicide, road deaths and alcoholism. Violent crime was high, arguably because of prolonged unemployment and police budget cuts. Moreover, a soaring brain drain occurred in tandem with blue-collar emigration. In short, society itself was collapsing under the weight of austerity policy. The situation has improved in the meantime, but the loss of people and the emerging social pathologies went on for several years following the 2008 financial shock, and their effects are still present in not insignificant measure.

ASCENT: THE CLIMB BEFORE THE FALL

The new millennium brought greater prosperity to Latvia after the very rough decade of the 1990s. Latvia's EU and NATO accession in May 2004 required reforms aligning its economy with EU requirements. ISO 9000 standards on trade had to be met, thus opening up channels for Latvian goods to enter EU markets more readily (Reuvid and Terterov, 2005). Latvians also took the opportunity to clean up some corrupt practices. Not all challenges were overcome, however, particularly with regard to banks, where the United States requested action on problems in Latvia's active offshore banking sector that posed potential security issues for NATO. Later, the considered view of some Americans in the diplomatic corps was that serious action was not taken on this score, which led to it becoming an issue again with the advent of Cold War 2.0 after Russia's annexation of Crimea in 2014. More serious US pressure was applied on the cusp of 2016 OECD accession.

EU and NATO accession was followed by an inrush of FDI, which led to Latvia's (and the Baltics' generally) economic boom (Yucel, 2014). This was the era of the vaunted Baltic Tiger economies as GDP surged, while "Old Europe" struggled. Latvia's Second Republic economy was designed to develop on the foundations of FDI. Its strong currency built on macroeconomic stability was purposed as the means of attracting FDI. This design was advanced by the so-called "Georgetown Gang," a name given to the economic policymakers of the first post-Soviet Latvian government. The "Gang" was led by Juris ("George") Viksnins, a Latvian-American economist at Georgetown University (Lindberg, 2013). They were similar to the so-called "Chicago Boys" (emulating the teachings of the University of Chicago department of economics) in miniature. The Georgetown group

redesigned Latvia's economy along supply-side economic principles, just as the Chicago Boys did in Chile after Augusto Pinochet deposed Salvadore Allende in 1973.

Viksnins identified young talent from the collapsing Soviet-Latvian Republic. He both mentored and organized them into an effective economic policymaking team. Among those mentored were Ivars Godmanis, Einars Repse and Ilmars Rimsevics (Lindberg, 2013). They would go on, respectively, to become Latvia's first prime minister, and the first and second heads of the Central Bank. Repse also subsequently became finance minister and prime minister, while Rimsevics ceased to be Central Bank head in 2018, leaving under the cloud of a corruption investigation. Together they held eight meetings to plan Latvia's economic transition. They produced a report along Washington Consensus lines entitled *Latvia 2000* (Lindberg, 2013). Latvia's economy would be organized around a strong, stable currency that would attract foreign direct investment and be quickly integrated into the global economy. Soviet-era enterprises would not receive state help to be re-organized. This combination of policies ensured that social spending would be minimal and that most Soviet-era factories would collapse. "Shock therapy," however, was seen as the best way to deliver rapid economic recovery (albeit with a planned short period of intense economic pain).

The wave of FDI that arrived following EU and NATO accession in 2004 was welcomed by figures such as Viksnins. Previously, doubts emerged as to whether Latvia's FDI strategy worked, given that Latvia had attracted so little FDI since achieving independence again in 1991. Thus, the arrival, albeit very late, of FDI seemed a vindication of Latvia's economic policies, which rejected industrial policy in favor of creating the right macroeconomic fundamentals (low inflation, tight money supply, and highly valued currency) to attract FDI. The problem, however, was that the FDI was largely speculative in character. Rather than chiefly going to industry, it instead inflated a massive real estate bubble.

Latvia's EU and NATO accession converged with the US policy of creating cheap money to fuel its economy after its 2001 recession (with lessons also learned from the 1997/98 East Asian economic crisis). Moreover, the Japanese had been using the same cheap money policy to fuel their economy following their real estate-induced crash following 1992. These cheap money policies created a global glut of cash that could be readily tapped by banks around the world, which would buy US dollars and Japanese yen at very low cost (low interest) and then lend the money out in a process called the carrying trade. For bankers, this was an *El Dorado* opportunity. Riga, an old European city with an Art Nouveau city center, now resided within the EU and NATO, but with real estate nearly completely unburdened by debt. This was a historic opportunity to load it up with loans. This would create a revenue stream for Scandinavian banks that would make the Baltics the main profit centers for Swedish banking giants such as SEB and Swedbank (Jočienė, 2015). They thus transitioned out of offshore banking and into lending on property following EU and NATO accession.

Swedish banks lent heavily to real estate markets in the Baltics, taking no account of traditional banking due diligence measures, such as borrower income to property price ratios. Swedish banking incentive structures for lending were based on the number of loans made, thus loan officers were incentivized to issue loans without regard to due diligence on repayment, as reported by Latvian heads of real estate divisions at Swedish banks in 2006 (Ferguson and Petro, 2016). When such questions were raised, they were typically dismissed with expressions of faith in income convergence between eastern and western Europe, along with the lack of availability of housing stock. This, then, was the source of the Baltic Tiger model, then celebrated in the world's financial press: a massive property bubble fueled by poor Scandinavian bank oversight and faulty incentive structures for loan officers.

At the peak of the real estate bubble in 2007 real estate consumed 71.8 percent of the credit extended to Latvia by banks (Strazds, 2010). In short, this chiefly represented rent extraction via asset price inflation without adding value to the underlying economy (aside from some useful new construction). This carrying-trade money, seen at the time as "FDI", permitted a massive expansion of consumption that saw the balance of payments deficit reach 24.2 percent by the third quarter of 2006 (Latvian Bank, 2006). In short, the proverbial perfect storm was brewing to deliver a record-making bubble and bust.

"WE TAKE ALL CURRENCIES, WE ASK NO QUESTIONS": LATVIA OFFSHORE BANKING AS THE SWITZERLAND OF THE BALTICS

For some in the Latvia 2000 group, however, macroeconomic stability leading to FDI was not the only path toward prosperity. One member of the group had another plan. Einars Repse, the first head of the Central Bank and later finance minister and prime minister, looked to what is generally – albeit euphemistically – called "financial services", or more directly, offshore banking as another sector of the economy to develop. Repse thought that Latvia could serve as a bridge between East and West in this area. In short, Repse thought that Latvia could be the "Switzerland of the Baltics", with all this implied. At this point, one might recall the genesis of Switzerland's secretive offshore banking model. At the end of World War I, France had hundreds of thousands of young men who had been maimed and disfigured by the "war to end all wars". Caring for them represented no small expense and France imposed a top marginal income tax rate of 70 percent to pay for their care. For French capital wishing to avoid this taxation, Switzerland's banks provided a flight destination (Zucman, 2015). Conversely, as the post-WW II Bretton Woods order unwound in the 1970s, offshore banking resurfaced in order to provide capital with opportunities for "tax optimization", "wealth management" and other euphemisms for tax evasion. The United States and the United Kingdom quietly encouraged this system both because their New York and London financial centers were the ultimate destinations for this money and their economies were losing

manufacturing competitiveness, but also because it served to discourage over-taxation by states as capital could always exit (Mullineux, 1991). The downside (or upside, depending on whether one was a Polanyian or Hayekian) was that it undermined the ability of social democracies to support their social models.

During the late Soviet period, the process of grabbing assets, such as oil and metals at state prices (and the need to conceal the windfall gains) was already under way. Latvia has been an offshore economy from the start of the Second Republic. This is largely a function of its history and location. The Soviet-occupied Republic of Latvia contained the USSR's largest port for oil exports. As the Soviet Union unraveled, Latvian ports became magnets for corruption, theft and windfall profits that overnight made oligarchs of selected Soviet-era hustlers and communist party connected persons. It was in this context that Einars Repse saw and promoted Latvia as the Switzerland of the Baltics (IFC, October 1, 2020).

Among the first figures to take advantage of the opportunities for capturing windfall gains in an unraveling USSR was a former Vice-Rector of the University of Latvia in the early 1980s, Gregori Luchansky. Luchansky was removed from his post for selling university furniture and supplies on the black market (Ferguson and Petro, 2016). Luchansky, a leading Komsomol member, responded by moving into more lucrative terrain, chiefly acquiring Soviet oil at subsidized state prices and selling at market prices on the world market. Luchansky later partnered with the infamous Marc Rich in shady oil deals (Ferguson and Petro, 2016). Rich was later pardoned on tax evasion charges by Bill Clinton on his last day in office, which former President Jimmy Carter called "disgraceful" (Gibbs and Duffy, 2012).

Such arbitrage opportunities were abundant both while the Soviet Union was collapsing and during the chaotic years after its demise. Offshore banks emerged in Latvia to handle the torrents of cash generated by selling off the former USSR's oil and metals, directing the money away from taxation (which might be earmarked to fund social services) and into accounts whose owners' names remained secret.

The largest of these Latvian offshore banks was Parex, established by Valery Kargin and Viktor Krasovickis, two enterprising Komsomol (communist youth league) figures who started their careers by hauling duffle bags full of rubles by train between Riga and Moscow, and making money on the slight exchange rate differences existing between these locations. They hit paydirt by securing the Soviet Union's first legal private currency exchange in 1990 (Watts, 2000). Co-ops and various enterprises emerging throughout the USSR came to Riga to avail themselves of their currency exchange services and the chance to convert rubles into Western hard currencies. In 1992, they created Parex Bank, and made clear their intention to establish themselves and Latvia as an offshore banking center. Their original advertising boasted that "we exchange all currencies and ask no questions!" As late as 2005 they were still proclaiming the offshore-banking nature

of their bank by announcing that “Riga was closer to Moscow than Switzerland and that all at Parex spoke Russian” (Aslund, 2010). Thus, with greater proximity to Russia’s capital and Russian as the language of business, Riga enjoyed a comparative advantage as the place for Moscow oligarchs to launder their money.

Their business expanded in the twenty-first century from handling offshore accounts throughout the former USSR to encompass even West African warlords and East Asian capital (Ferguson and Petro, 2016). Parex became Latvia’s biggest bank and Kargin and Krasovickis among Latvia’s richest men. Yet, Parex went bust following the 2008 global financial crash, as Latvia experienced the world’s largest contraction of GDP.

Tiny Latvia nevertheless saw its government make available upwards of 1 billion euros to guarantee Parex’s offshore deposits and protect oligarch investors and international bondholder syndicates, who pulled above market rates from the bank. The purpose of this massive bailout was twofold: 1) protect Latvia’s “core business”, offshore banking by demonstrating that the country would “do whatever it takes” to protect this “industry”, including imposing punishing austerity on its people; 2) prevent a contagion effect on European banks by cauterizing the run on deposits that was beginning to bleed over to Sweden’s Swedbank and SEB, as Swedish banks were massively exposed in the Baltic states (Sommers and Woolfson, 2014). The above-described austerity regime restored Latvia’s macroeconomic stability and confidence in its offshore banking. The demographic implications of this restoration through austerity were catastrophic. Young people exited Latvia in the hundreds of thousands, which risks turning the country into a retirement home and nature preserve (Hazans, 2016). Latvia’s population peak was reached in 1989 at nearly 2.7 million people, surpassing its previous record of 2.5 million people at the onset of WWI in 1914 (CEIC Data, 2017). By 2021, however, it was down to 1.87 million.

The biggest offshore banking player, post 2008 became ABLV, followed by Rietumu. Among scandals after 2008 were the Swedish TeliaSonera bribes of nearly a billion euros to Uzbekistan leaders, run through Latvian banks (Lasslett, Kanji, and McGill, 2017) and the looting by a Moldovan oligarch of a billion euros passed through Latvian banks en route to London (National Bank of Moldova, 2017).

Latvia’s offshore finance economy did little for ordinary Latvians upon achieving independence. Incomes for most remained low, taxes on labor high, while business taxes remained low. A lost decade (the 1990s) was followed by a property bubble in which foreign banks (largely Scandinavian) extracted rents by loading down property with debt, capital outflow from which continues today (and will do so into the distant future). The enormous size of the financial crash that ensued in 2008 led to triage measures in the form of austerity and internal-devaluation policies, with minimal social protections in place as Latvia restored macroeconomic

stability. Latvians fled the disaster to work abroad, leaving the country’s very demographic future in doubt. A harsh austerity plan was implemented to restore Latvia’s macroeconomic fundamentals following the financial shock that was so severe that even the International Monetary Fund tried to restrain Latvia’s then Finance Minister, Einars Repse, from pursuing it (Wood, 2009).

Although not in the same league as London, New York and Zurich as kleptocratic capital flight centers, Latvia carved out a substantial niche in the global money laundering and tax evasion system. According to Bloomberg even after the 2008 financial shock, Latvia continued operating as a major offshore banking player: “As non-European inflows into Cyprus stagnate, about \$1.2 billion flooded into Latvia in the first half of the year [2012]. Non-resident deposits are now \$10 billion, about half the total, regulators say, exceeding 43 per cent in Switzerland, according to that nation’s central bank” (Eglitis, August 29, 2012). These were large amounts given that Latvia’s population was only around 2 million (a quarter of Switzerland’s population) and annual GDP \$28.2 billion (roughly only a tenth of Swiss GDP). But these deposits represented only a small share of the cash Latvia handled in transit to points West (mostly New York in the 1990s and then London after 9/11) via offshore companies designed to evade oversight and taxation.

2

ECONOMIC SECTORAL OVERVIEW AND PROSPECTS

This overview of Latvia's significant economic and social failures does not necessarily predict continued economic and social underdevelopment going forward. Latvia's economy has become more complex and hints at what might be a prosperous and sustainable future. That outcome is by no means guaranteed and many of Latvia's past problems persist, but a turn of sorts has been made with regard to economic development. In the second half of this article we provide a sectoral analysis of Latvia's economy to show what is working and where we think significant improvements can be made. Here, we break down Latvia's main economic sectors into three categories to prioritize industries and economic activities that should be developed further, areas that have middling potential, and activities that add little to, or even detract from, the country's economy. In order, we designate them as: 1) National Champions, 2) the Middle Ground, and 3) Economic Headwinds. In short, our goal here is to suggest enhancements to Latvia's performance through gradual alterations to its economic structure, rather than merely critiquing its economic record.

IN SEARCH OF "NATIONAL CHAMPIONS"

Unlike many successful countries, which have built their prosperity and competitiveness on targeted and highly activist industrial and development policies, Latvia has largely neglected the wide policy arsenal at its disposal to promote sustainable competitiveness and economic development. Although some attempts have been made to formulate government policy in this area – most notably the *Smart Specialization Strategy*¹ and the *National Industrial Policy Guidelines 2014–2020*² – they do not constitute a solid basis for a mission-oriented national industrial development strategy. For example, while the first of these two strategies provides a balanced assessment of sectoral priorities – a mix of export competitiveness in traditional industries, sectors with high value-added potential, and activities with a significant horizontal impact – it recommends only a small subset of specialized areas for national strategic support, such as Information

Communication Technologies (ICT), bioeconomy, biomedicine and smart energy. The second strategy, on the other hand, while rightly emphasizing the importance of an export orientation, shies away from "picking winners" on a sectoral, industrial or product level, instead reinforcing the passive paradigm of market governance with minor "market failure" adjustments based on orthodox policy tools, such as labor availability and skills development, promotion of management know-how, industrial zoning, (private) funding availability, export marketing, and cooperation with universities. While these are clearly instrumental policy tools, the overall strategy lacks a mission orientation and clear focus.

In the following section, therefore, we profile a selection of key Latvian industries and categorize them according to their long-term development potential. The aim is to identify special focus areas for targeted and mission-oriented government support as part of a comprehensive industrial and innovation policy. Naturally, given the wide range of activities in a given industry, the intention is not to endorse the entire scope of a particular industry (that is, "picking winners" at industry level), but rather to identify those sub-activities that have a significant growth potential in terms of added value, scalability, complexity and technological intensity, sustainable employment and skills development with rising wage levels, commercial viability, and, crucially, export competitiveness and revenue.

Three tiers are subsequently proposed.

1. Areas with most potential for development and, therefore, primary targets of a mission-oriented industrial policy. Here we propose a strategic mix between the forestry-based value chain on the back of Latvia's rich natural endowment; increasing returns³ activities of the manufacturing sector (wood processing, machinery and metalworking, and electronics and electric

¹ Informative report "On the development of the smart specialization strategy": <http://tap.mk.gov.lv/mk/tap/?pid=40291636> (infograph: http://tap.mk.gov.lv/doc/2005/IZMZip4_161213_shema_VSS3623.3623.docx)

² <http://polsis.mk.gov.lv/documents/4391>

³ Erik Reinert: "Throughout all experiences of catching up, successful strategies always involved a principle of emulation involving measures aimed explicitly to acquire knowledge in increasing returns activities. Only later, after the success of industrialization, can countries effect forms of market governance relying on the principle of comparative advantage as they emerge from the dynamics of international specialization and trade". Source: <http://www.oxfordscholarship.com/view/10.1093/acprof:oso/9780199235261.001.0001/acprof-9780199235261-chapter-4>

equipment are highlighted as the Big 3; however, any similar export-oriented manufacturing activities should be top priority) and the two services export superstars: transport and logistics, and ICT.

2. Areas with a middling development potential with some lucrative niches, but overall featuring risks in terms of revenue potential, scalability, technological maturity and export competitiveness. These areas should, nevertheless, be supported by more generalized industrial policy tools and overall improvement of the competitive environment and cost efficiency. This second category features the agribusiness value chain; manufacturing sub-industries of pharmaceuticals and chemical processing, textiles and other light industries, and printing and publishing, as well as tourism and construction services.
3. The last category consists of industries and economic activities which have the least potential to provide a sustainable contribution to long-term economic development, and may even be downright harmful.

1. NATIONAL CHAMPIONS

Forestry

Forests take up 52 percent of Latvian territory or around 3.4 million hectares (Ministry of Agriculture 2018, 2), up from 2.8 million hectares in 1983. Forestry employs 15 000 people, with 30 000 more jobs in the related wood-working and furniture industries (CSB, 2019, NBG081). Although somewhat better organized as an industrial value chain than agriculture (discussed further below), the forest industry similarly features a high number of small forest owners (according to State Land Service, in 2016, 60.9 percent of the owners owned less than 5 hectares of forest land (Ministry of Agriculture, 2018: 13), alongside several large-scale foreign owners, who use it as a timber resource base, and the state, which owns half of Latvian forests and generally tends to promote sustainability, with the exception of government-mandated clearance spikes in an effort to generate cash during the financial and economic crisis of 2008–2010.

The forestry industry would benefit greatly from forest owner cooperation, taking inspiration from the historical success stories of the Swedish and Finnish vertically integrated small forest landowner cooperatives (*Södra* and *Metsäliitto*), as well as Latvia's own cooperative tradition in the interwar period. Latvia's consistent inability to emulate the success of Nordic forestry and agricultural cooperatives stems from social trust issues, lack of government promotion and the stigmatization of the very concept of cooperation in light of the long-standing resentment of the Soviet *kolkhoz* and the powerful mythology of *the tragedy of the commons*, a long-standing criticism from neoliberal analysts. The state should deploy a comprehensive strategy to encourage forestry (and agricultural) cooperation that involves initiatives aimed at education and business skills development; Nordic best practice benchmarking; promotion of social trust, not least by more active municipal engagement; investment incentives and tax benefits for cooperative members; promotion of economies of scale in

production and joint procurement; as well as availability of small loans and favorable insurance terms. Added value and cost efficiencies should be the primary drivers of cooperation to ensure closer integration between forest owners and other segments of the wood industry value chain. A government policy to discourage roundwood exports and further encourage local processing should be considered. The large state ownership of forests should provide the necessary resource platform for a long-term sustainable forestry industry as an efficient feeder to high value-added wood processing and wood biomass energy industries.

Wood processing

While electronics and machinery are recognized in Latvian statistics as the largest export category with a value of more than 2.3 billion euros – heavily driven by re-export, as illustrated by the mirroring import figure of more than 3.4 billion euros – the wood processing industry remains the true champion of Latvian goods exports, with a trade surplus of almost 1.7 billion euros (CSB 2019, ATG015), roughly equivalent to the industry's annual domestic output. With output more than doubling since 2008, the industry's gross value added has dropped from 43 to 35 percent, well below the manufacturing sector average of 43 percent. The share of exports in the industry's output increased from 65 percent in 2008 to 75 percent in 2015⁴ (CSB 2019, RU040c), not least as a reflection of the high demand and prices in global commodity markets for timber. The lion's share of the wood industry's 2.3 billion euros in exports – 17.9 percent of Latvia's total goods exports – comprises sawn timber (1.36 billion euros), by far the largest single export commodity for Latvia and one that is a symbol of Latvia's persistent lock-in at the relative low-end of the global wood processing value chain (some of that is re-exported, given the 370 million euro sawn timber imports). The United Kingdom is consistently at the top of the list of key recipients of Latvian timber exports, with additional uncertainties in light of Brexit. Almost 30 years since regaining independence, Latvia still exports 300 million euros of roundwood – doubling in 2018 compared with 2017 and often as a result of quasi-colonial behavior on the part of foreign owners of Latvian forests – as well as 350 million euros worth of wood fuel (biomass), instead of encouraging its wider use in the domestic energy mix as a substitute for imported and environmentally detrimental fossil fuels. On the bright side, the much higher added-value products – plywood, laminates and particle board – collectively drive an additional 740 million euros in exports (in similar proportions), wood articles add another 270 million euros in industrial exports, with the wood industry also playing a key role in the 230 million euro furniture export industry (CSB 2019, AT060m, AT070m).

Wood processing and the wider forest industry value chain should be at the forefront of a new national industrial policy promoting added value, export competitiveness, sustainable human capital development, scalability and technological

⁴ Sectoral value-added data for 2017 and 2018 not available as of 31.07.2019; 2015 used as reference year.

intensity. Alongside established national champions such as birch plywood (*Latvijas finieris*), wood panels (*Kronospan*) or furniture (*Daiļrade koks*), new niches must be developed and carefully nurtured in a comprehensive national industrial effort, not least in such areas as wooden and log houses (already penetrating the Nordic export markets with success), wider and more innovative use of wood in construction (together with advanced, software-based design and construction technologies), wood polymers and wood-plastic composites, wood chemicals, as well as wood biomass energy (not least by reforming the existing renewable energy promotion scheme – “OIK” – which has encouraged energy industry overinvestment and until recently supported the gas-fueled TEC-2 power plant, notwithstanding the widespread rent-seeking and fraud under this scheme). Although the reform of professional trade schools is seen as a success, more progress is necessary in forest and life sciences R&D and alignment of the national innovation system with the needs of Latvia’s flagship industries. Continued and extended support in export market penetration, marketing, skills development and technology transfer is highly warranted.

Machinery and metalworking

Collectively, these interrelated industries – encompassing basic metals, metal products, machinery and equipment, and automotive – generate output worth more than 1 billion euros, almost half of which is added value (CSB 2019, RU040c, IK10_060). Some of the highest added value segments, such as automotive and machinery and equipment, export more than 90 percent of their output (CSB 2019, RU040c), reflecting the continuation of a very promising trend in Latvian manufacturing: Western global brands and OEM manufacturers have been moving production to Latvia to capitalize on the relatively skilled, yet much lower paid labor force. The products of the machinery and metalworking industry range from simple steel reinforcement bars and mast structures to power generators, electric substation equipment, specialized wood processing and forestry machinery, all the way to performance parts for the automotive industry (*AKG, Dinex, Lexa*). Industrial policy should, however, target those segments that have the potential for continued increases in complexity, added value, technological intensity, scalability and revenue. Technological and revenue dead-ends must not be actively promoted, if not discouraged altogether.

Electronics and electric equipment

Electronics industry output has quadrupled since 2009, reaching almost 330 million euros in 2018 with a value added share of 70 percent and an export share of 90 percent (CSB 2019, RU040c). Once a country operating on the global electronics innovation frontier, not least with the revolutionary *VEF Minox* miniature photo camera invented in 1937, and a Soviet electronics hub, many of Latvia’s technology-intensive industries were wiped out during shock therapy and mass looting, officially referred to as “privatization”. While Lithuania managed to salvage some of its electronics industry through the 1990s despite its initial relative backwardness by global comparison, Latvia has gradually had to rebuild its

competence in this area, not least in view of the considerable brain drain during the 1990s. Today, however, it has successfully developed several lucrative niches, including data transmission equipment (*SAF Tehnika*), internet routers (*MikroTik*), contract electronics manufacturing (*HansaMatrix*), electric instruments (*Rebir*), and hi-tech cabling (*Axon Cable*).

Transport and logistics

The transport and logistics industry is the undisputed champion of Latvian services exports. Accounting for roughly 9.5 percent of total gross value added and employment (CSB 2018, IK10_060, IK10_050c, NBG081), this industry has a spectacular 2.13 billion euro export volume or 40 percent of total Latvian services exports. Set against transport services imports worth around 850 million euros – 30 percent of Latvia’s total services imports – it has a trade surplus of almost 1.3 billion euros (Bank of Latvia, 2019, 03 BOP). This has served as a key factor in the persistent overall services trade surplus and helped to offset the persistent goods trade deficit, which spiraled out of control in the run-up to the 2008–2009 financial crisis as a result of the unsustainable credit-fueled consumption bubble, the real estate bubble’s twin. Transport services exports proved fairly resilient during the crisis, with relatively marginal declines during the period. Manufacturing, by contrast, suffered from double-digit drops. Even more so since 2009 the industry’s exports have grown by more than 700 million euros, despite the long-anticipated fall in Russian natural resource transit flows and the corresponding loss of exports in rail and sea transport and ports business. The industry has grown mainly because of the tripling of road freight services (from 280 million euros in 2009 to 760 million euros in 2018) and the more than doubling of air passenger services (from 190 million euros in 2009 to 470 million euros in 2017) (Bank of Latvia, 2019, 03 BOP), courtesy of the successful transformation and growth of Latvia’s national carrier *Air Baltic Corporation*, which serves as the backbone of Latvia’s strategic air connectivity with a more than 50 percent market share at its home base at Riga International Airport. Naturally, as of the end of 2020, it remains to be seen how the global aviation industry will recover from its most severe crisis ever. *Air Baltic* suffered a 70 percent revenue collapse in 2020. Because of the continued government support to the national carrier, however, not least through timely equity injections, *Air Baltic* should be well placed to continue to provide and expand strategic connectivity for Latvia in the emerging “new normal” environment for aviation.

Furthermore, in order to reinvent the Latvian transport and logistics industry in an era in which the old low-value transit trade model is rapidly fading, Latvia must invest in and develop a modern, sustainable and digitally-enabled connectivity, mobility and logistics infrastructure that prioritises people and national competitiveness over the narrow interests of politically connected coal and oil transit beneficiaries. Unlike Lithuania, which broke its dependency on Russian resource transit much earlier, Latvia has failed to invest its generous EU Cohesion funding into multimodal logistics infrastructure. Instead, it has favored capacity-driven investments in the rail

system and ports to subsidize its competitive advantage in low-value, high-capacity bulk freight transit, effectively subsidizing Russian resource exports. Now as Russia is completing its own port and railway capacity upgrades, Latvia finds itself struggling to diversify its freight flows. Efforts to develop integrated Latvian transport and logistics solutions – involving all key elements of the supply or value chain based on transparent and fair competition among industry players – have borne little fruit. *Latvian Railways*, the state-owned national railway infrastructure manager and operator, as well as one of the nation's largest employers, is increasingly looking like a paper tiger, as in January 2020 (before the coronavirus pandemic hit) cargo volumes were at 17-year lows (LSM.LV, Jan 21, 2020). Meanwhile, ports are still engaged in mutually destructive competition and feature poor, opaque and highly politicized corporate governance. Riga Freeport still has massive undeveloped or idle plots, courtesy of the speculative behavior of long-term lease contract holders with limited to no penalty measures to induce efficient use of these strategic territories.

Latvia must consider managing its ports under a centralized governance model to allow them to develop as mutually synergistic logistics and industrial hubs, instead of competing with each other in a race to the bottom and through political favors. A more effective use of the special economic zone privileges, especially in Riga, must be promoted, not least by attracting FDI from global logistics players, something that Klaipeda, for example, has managed with great success. Latvia must also fully capitalize on the long-term benefits that the new *Rail Baltica* infrastructure and economic corridor would bring. It not only has the potential to transform passenger mobility and freight logistics patterns in the Baltic region, but also to serve as a platform for cross-industrial synergies, not least by improving Latvia's terms of trade through more competitive transportation costs. However, critical long-term risks still remain that must be urgently addressed. For example, the narrow view that *Rail Baltica* is a construction and EU funding absorption project still prevails over seeing it in the wider context of multi-dimensional national and cross-border development. There are also diverging views about the future management of the *Rail Baltica* infrastructure, primarily due to incumbent monopolistic interests. There are thus potential barriers to a dynamic and well-functioning future railway services market and investment climate along the *Rail Baltica* economic corridor. In terms of multi-modal integration, Latvia must reverse myopic past decisions and ensure a direct *Rail Baltica* rail connection with the Riga Freeport. Failing to do so would be a strategic blunder with long-term consequences.

Last but not least, Latvia must prioritize the continued development of its aviation value chain – the cornerstone of Latvia's strategic connectivity – by consolidating Riga's role as a growing North-East European aviation hub, supporting its national carrier Air Baltic's continued growth and sustainable expansion, ensuring synergies between the national carrier and its home airport, as well as promoting new long-term value segments, not least in air freight, especially with a view

towards Euro-Asia e-commerce trade and long-haul air connectivity. A high-speed *Rail Baltica* integration with Riga International Airport, both for passenger traffic and freight logistics, will also provide new long-term opportunities.

IT

The IT industry is one of the unsung heroes of the Latvian economy's post-crisis development. In 2000, the Latvian IT industry produced a negligible 17 million euros in services exports, climbing slowly to 95 million euros by 2008. Thereafter, the industry produced double-digit export growth rates year after year, reaching an impressive 489 million euros by 2018 – a fivefold increase since 2008 (Bank of Latvia, 2019, 03 BOP). Unfortunately, the sustainability of this successful development is jeopardized by a chronic shortage of IT specialists, a low presence of world-leading IT companies with future cutting-edge technologies and know-how, limited cooperation among domestic IT companies in attracting larger scale contracts, as well as insufficient interdisciplinary know-how and level of synergy with other industries. Although Latvia is seen as an international success story in broadband deployment, future development prospects are unclear, while access to high quality IT infrastructure in areas of low population density is already constrained. The public sector – which could be a source of additional competitive advantage to the IT industry's leading enterprises – is characterized by a low level of automation and digitalization. Nearly every governmental institution maintains its own IT system and support staff. Public IT systems have suffered from dubious quality (e-school, e-health), interface difficulties (Internal Revenue Service tools), as well as maintainability, integration and security issues. The high degree of public data access limitation, as well as a poor, though improving, level of data presentation are unfortunate characteristics of the Latvian public sector, also as a reflection of Latvian society's generally inadequate computer, data and security literacy.

These structural challenges need to be resolved if Latvia wishes to maintain its current, highly successful IT industry development and export trajectory. The key prerequisites for Latvia to emerge as a modern, data-driven nation include the following:

- improved IT education and literacy;
- industrial and public sector digitalization;
- attraction of global brand companies and their R&D capacities;
- shared service-center development, intra-industry cooperation and promotion of synergies with other industries;
- unified data centers;
- continued infrastructure development (such as 5G), not least along the greenfield *Rail Baltica* corridor; and
- a commitment to the principles of open data and open source solutions.

All these things would create the necessary conditions for the development of Latvia's IT export capabilities and competitiveness

2. THE MIDDLE GROUND

Agriculture

Agriculture is characterized by a very low level of cooperation and a large number of small farms. For example, more than half of cows are kept in herds of fewer than 50. Although it was among the pioneers of agricultural cooperation in the interwar period, modern Latvia finds itself in the unenviable position of being surrounded by ultra-competitive and vertically integrated Nordic cooperatives, on one hand, and Lithuanian dairy and grain processing giants alongside Polish producers, on the other. The agricultural landscape is replete with uncultivated land, while small farmers suffer from an asymmetric distribution of bargaining power vis-à-vis the processing companies and supermarket chains. Latvia still ranks among the recipients of the lowest area payments among all EU member states. Benefits from EU agricultural funding and state support are reaped disproportionately by privileged large-scale, politically connected “couch-farmers”.

Looking forward, Latvia may not have the economies of scale of the highly industrialized Dutch or German agri-business, but it may regain some of its historic glory if agriculture is finally recognized as a strategic component of numerous economy-wide value chains and consistent state-led efforts are deployed to promote value added activities and development of profitable new niches. There is a massive potential to add value to existing cultures, as the success of Latvia’s leading grain processor *Dobeles dzirnavnieks* proves, an example of successfully climbing the ladder of added value and product sophistication that urgently needs an equivalent in the dairy industry. Fresh milk and milk powder exports to neighboring countries (while Latvian supermarket shelves are filled with Lithuanian yogurts and gourmet cheese) is not a strategy that promotes sustainable development. Latvia imports large volumes of fruit and vegetables. A potential clearly exists to promote a higher degree of self-sufficiency in this area by promoting economies of scale, R&D and development of variety. Fresh apples have a higher added value than juice, as Poland has successfully recognized. In the wider context, fruit and vegetables carry a higher added value in storage – to enable availability at premium pricing during off-season – than in processing. This is a great potential avenue of mutually beneficial cooperation between agriculture and the domestic logistics industry. Wheat is already Latvia’s primary agricultural commodity with yearly export values consistently above 300 million euros (CSB, 2019, AT060m) with a temporary dip below that level in 2018 due to a poor harvest caused by drought and abnormally high temperatures across Nordic and Central Europe. Latvia must further capitalize on global trends in this area and its emerging geo-climatic advantages. As Zemgale continues its traditional specialization in cereals, owing to its highly fertile land, Latgale has cost advantages for bio-cattle breeding and bio-dairy. Lucrative new, export-capable niches must be actively developed, such as cranberries, halal lamb meat and breakfast cereals (muesli). Eco-tourism is also a growing global trend. On the institutional side, government should actively promote agricultural cooperation (similar to the forestry industry). An efficient use

of agricultural land alongside discouragement of land-hoarding and idle couch farmers scooping up EU area payments should be achieved through a more comprehensive use of land value taxation.

Food and beverages

The food and beverage industry is the other giant of Latvian manufacturing with a 1.5 billion euro output in 2018, and around 40 percent value added, roughly on a par with 2008. The industry exports 35 percent of its output, up from 24 percent in 2008. Overall, the industry accounts for 1.1 billion euros worth of prepared foodstuffs exports (8.9 percent of total Latvian goods exports) and 1.3 billion euros of imports (8.3 percent of total Latvian imports). Although these figures also reflect sizeable re-export volumes, the trade deficit is quite telling, as – similar to wood processing – Latvia displays some low-value lock-in effects also in the food and beverage industry (especially when viewed in the wider context of the food industry value chain). The deficit disappears if one also takes into account vegetable (700 million euros, of which wheat exports contribute 280 million euros) and animal (500 million euros) product exports, with corresponding imports of around 1.15 billion euros (vegetable products – 680 million euros; animal products – 470 million euros). But statistics may be misleading due to re-export volumes. Historically, the industry played an important role in the early capital accumulation for the pre-oligarchic “entrepreneurial” elite via the untransparent and often reckless privatization process of the 1990s. Many internationally recognized Latvian companies represent this important industry, ranging from the traditional herbal liquor producer *Latvijas Balzams* and chocolate flagship Laima to legendary meat producer *Latvijas miesnieks* and producers of the famous Riga sprats. Some important segments have recently experienced consolidation under foreign ownership, with a strong presence of Russian capital, not least in beverage production, dairy and meat processing, reflecting the industry’s traditional eastward positioning (CSB, 2019, RU040c, ATG015, AT060m, AT070m). A more balanced trade orientation with a growing degree of EU market penetration, especially in the immediate Baltic Sea region, is critical to ensure the long-term sustainability of Latvian agribusiness. The significant trade deficits with neighboring Lithuania and Poland must be critically assessed, not least to ascertain whether non-discriminatory market access conditions exist for Latvian exporters.

Light industry

The textile, apparel and leather industry has recovered from the sharp drop in 2009 back to 2008 levels, with output worth around 260 million euros and a more than 80 percent export intensity (CSB, 2019, RU040c). The industry strikes a balance between East Asian low-cost mass production and top-quality European producers, often serving as sub-contractor to well-known global brands and niche specialty products. *Ogres trikotāža* is a long-standing partner of such premium brands as Pierre Cardin, Ungaro and Marks & Spencer, while *Lauma Lingerie* is capturing new export markets under its own brand. While some of these niches feature

a significant level of added value, overall, light industry has clear scalability and complexity limits, alongside low-cost competition, which will have a limiting impact on its long-term export revenue.

Pharmaceuticals and chemical processing

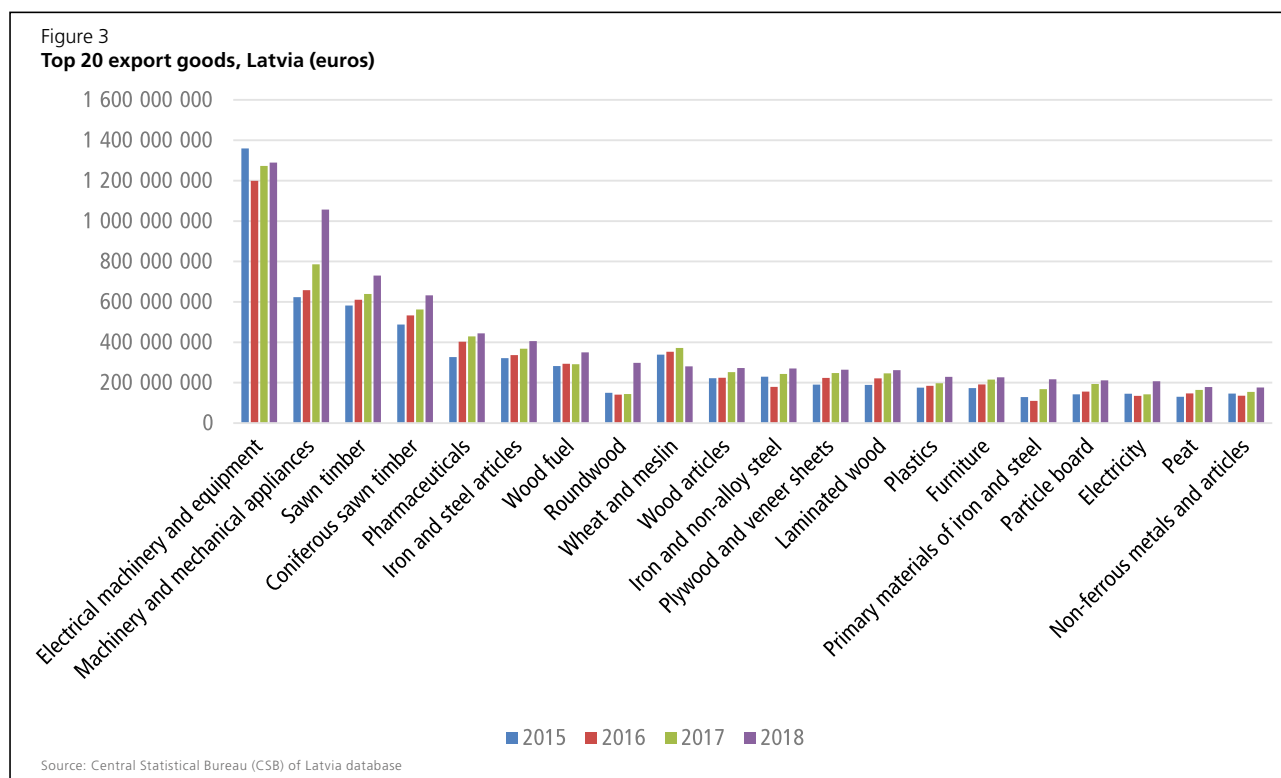
The confidentiality of pharmaceutical production statistics, as well as the re-export component in pharma trade does not allow us to gauge effects precisely, but a single person – tennis star Maria Sharapova – may have done more to promote Latvian pharmacological exports than decades of marketing. Cardiovascular drug *Meldonium* (also known as *mildronate*), produced and marketed by both Latvian pharma giants *Grindeks* and *Olainfarm*, shot to international fame following Sharapova’s doping scandal in 2016, triggering all-time sales records. For an industry with annual output in the range of around 100–140 million euros and exports more than 80 percent of its output (CSB, 2019, RU040c), mainly to Russia and CIS countries, this opened the door to the more lucrative Western markets. Nevertheless, the industry has failed to fully capitalize on its potential to develop a full-fledged domestic full-cycle industry, ranging from innovation and R&D to sales and marketing, engaging instead, for example, in the controversy surrounding the marketing of the dubious cancer treatment drug *Rigvir* that has sparked sharp disputes in Latvian academia. Also, the ongoing and highly visible corporate governance issues at *Olainfarm* are likely to have a negative impact on the industry. While in global terms, the pharmaceutical industry will be a major growth area, not least due to Covid-induced awareness of the importance of health care, Latvia currently has limited ability to capitalize on this trend. At the same time, in terms of best practice benchmarking on research-based pharma and bio-

medicine development one need look no further than the world-class collaboration between *AstraZeneca* and the Karolinska Institute in nearby Sweden.

The chemical processing industry has also experienced considerable growth in output, reaching 250 million euros in 2018 and exporting an impressive 85 percent of that (CSB 2019, RU040c). *Dzintars* remains one of Latvia’s most recognized brands in the former Soviet Union but has failed to conquer Western markets. Soap and organic cosmetics producer *Stenders*, on the other hand, has developed a highly successful franchise model with stores from Europe to Asia. It was recently acquired by Chinese investors to take its development to the next level. *Valmiera Fibreglass* – one of the few privatization success stories – is an established national champion, exporting to almost 40 countries and anchoring Vidzeme regional employment with its 900-strong workforce, albeit having been shaken to the core and only recently exited legal protection proceedings after the bankruptcy of its US subsidiary.

Printing and publishing

Lacking its former paper production industry – the paper industry tradition in Ligatne reaches back to the seventeenth century – Latvia is instead leveraging its relatively modern, EU co-financed technological base and labor cost advantages to develop a printing and publishing industry that is gradually capturing ever new export markets, not least in the Nordics. Having doubled its output since 2009 (from 80 to 175 million euros) and export share (from 38 to 69 percent), this industry has been a quiet success (CSB, 2019, RU040c). *Livonia Print* is among the most visible export success stories. The survival and continued development of the industry will rely heavily on its ability to adapt to content digitalization, which, if suc-



cessful, may significantly improve the scalability of its services, for example, in e-books and other digital production.

Tourism

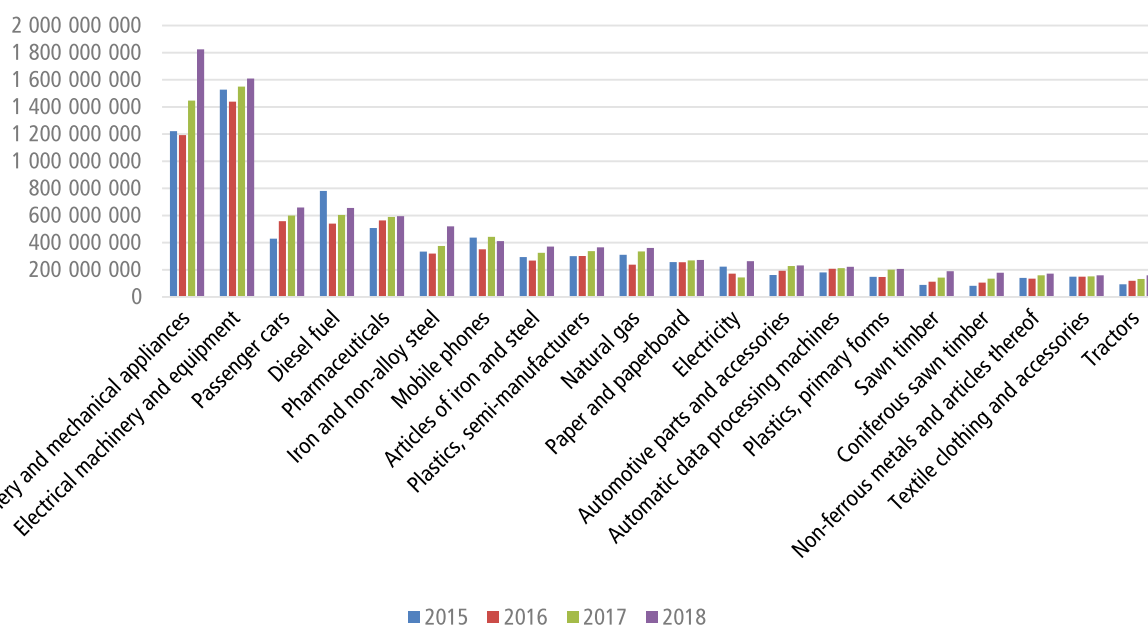
Travel services (capturing all goods and services purchased by travelers, except international carriage) account for 17 percent of total services exports (900 million euros) and 23 percent of total services imports (660 million euros). While in 2008 the tourism industry ran a trade deficit – with Latvian tourists spending almost 250 million euros more abroad than foreign visitors in Latvia – pre-Covid it enjoyed a healthy 240 million euro surplus, driven by Latvia’s increased air connectivity attracting foreign visitors and an outgoing tourism industry still recovering from the rapid fall in 2009. In 2019, foreign travelers spent more than 380 million euros more in Latvia than they did in 2009 (Bank of Latvia, 2019, 03 BOP). The future of this industry, however, will rest on its ability to recover from the current crisis, after, in all probability, several years of depressed tourism demand. Meanwhile, many service providers will by then have gone out of business, not least as a result of the Latvian government’s reluctance to support the hard-hit hospitality industry properly.

Construction

In the run-up to the 2008–2009 crisis, the construction industry accounted for more than 10 percent of Latvia’s total gross added value and almost 12 percent of employment (CSB, 2018, IK10_060, IK10_050c, NBG081). It suffered a severe blow as the crisis hit and the real estate bubble collapsed. Today the industry generates around 7 percent of Latvia’s value added and provides 8 percent of employment. It is known for its dependency on EU structural funding (especially the Cohesion fund), which has a wave-shaped distribution pattern, thereby leading to a relatively volatile construction business cycle. Some of the more competitive

construction companies have tried successfully to insulate themselves from this volatility by diversifying into foreign markets (especially in the Nordics). As a result, construction services exports have increased 4.5 times since 2008, plateauing at 270 million euros in 2017–2018 (Bank of Latvia, 2019, 03 BOP). At the same time, the construction industry – not least the segment specializing in state-funded infrastructure projects – is still dominated by politically connected, allegedly cartelized “general contractors”, who gain access to projects via murky procurement procedures and often sub-contract actual work to smaller contractors to dilute responsibility. As a result, the industry often experiences severe quality issues (failures), as tragically demonstrated by the Zolitude supermarket collapse in 2013, or cost issues, such as with the South Bridge (a fairly simple structure) that became one of world’s most expensive bridges on a per-square-meter construction cost basis. The domestic construction industry is also characterized by a low participation rate of international companies – some, such as Swedish flagship *Skanska*, have in the past exited the Baltic market – not least due to poor regulation, lack of transparency in large-scale public procurement, as well as political rent-seeking by domestic incumbents. The *Rail Baltica* project is a generational opportunity to establish a new standard of quality and transparency and to reverse Latvia’s international reputation as an unattractive construction market, dominated by local vested interests. Simultaneously, it is an opportunity for local construction companies and railway infrastructure component manufacturers (for example, for concrete precast elements) to work alongside global players, absorb their know-how and lay the foundations for long-term export competitiveness in high-speed railway infrastructure development, as many other countries, from Japan to Spain, have demonstrated during their deployment of national high-speed railway networks.

Figure 4
Top 20 import goods, Latvia (euros)



Source: Central Statistical Bureau (CSB) of Latvia database

3. ECONOMIC HEADWINDS

Finance

In the years immediately preceding the financial crisis, finance emerged as Latvia's second largest services export industry, as banks serving non-resident clients, such as soon-to-be-insolvent *Parex Bank*, expanded their risky business. The industry produced more than 600 million euros in export value in 2008, shrinking by almost half in 2010, thereafter gradually growing back to around 460 million euros by 2015 when more stringent anti-money laundering legislation was put in place en route to Latvia's accession to the OECD (Bank of Latvia, 2019, 03 BOP). As a result, the industry's exports were scaled back to 2011–2013 levels (370 million euros in 2017 and 314 million euros in 2018), with a further decline to be expected as the ongoing Latvian financial reputational crisis unfolds. This has already led to the closure of ABLV, *Parex Bank's* successor to the title of Latvia's offshore banking champion, and the arrest and trial of the long-standing former Bank of Latvia Governor Ilmars Rimsevics, whose over-arching influence in the Latvian banking world is well known. The latter also calls into question the integrity of the controversial decision in 2009 regarding the full compensation of *Parex Bank's* international bondholder syndicates, instead of negotiating haircuts or debt-for-equity swaps as, for example, Iceland did. This rendered *Parex's* highly speculative investments – which for many years yielded high risk-adjusted returns – essentially risk-free. Despite the systemic and reputational risks that the offshore finance industry creates, Latvia has, until very recently, turned a deaf ear towards a growing discourse in the European Union regarding a financial transaction tax (Tobin tax). This would be the perfect measure to tame this high-risk industry and generate an additional stabilization reserve to deal with potential calamities. While profits in the banking industry are high, Latvia's real economy is not given the opportunity to enjoy the historically lowest interest rate environment, as commercial banks continuously display a low risk-appetite for lending, requesting heavy collateralization and charging excess risk premia. In the absence of a proper national development bank (not recognizing *ALTUM* as such due to its limited scale and policy mandate), the private banking sector seems an unlikely ally if Latvia engages in an ambitious and comprehensive re-industrialization drive to further consolidate and expand on its recent manufacturing success.

Low-value transit trade

As already noted, the so-called transit industry has been a notorious battleground for oligarchic interests and a source of phenomenal wealth and, subsequently, political influence for a narrow elite. As the western outpost for Soviet Union's oil exports, the newly independent Latvia inherited a vast port infrastructure, duly captured by a select few with influence over the privatization process. Ever since, the trans-shipment of mainly Russian liquid and dry bulk (predominantly, oil products and coal) cargo had been a permanent cash cow, further subsidized by significant EU funding investments in port terminal and related railway infrastructure. As a result, this crowded out more forward-looking investment options

aimed at developing a modern multimodal logistics infrastructure adapted to high added value supply chain management, including strengthening the logistics competitiveness of Latvian exports. As the old transit model is collapsing – as predicted more than a decade ago when Russia embarked on a large-scale transformation of its own transit trade infrastructure – Latvia finds itself without a clear plan amidst rapidly falling port and railway cargo volumes. The decline of this segment, however, is more of a blessing than a curse, as finally Latvia must face up to reality and find renewed competitiveness in the international logistics division of labor without the parasitic influence and technological dead-end of transit trade.

Raw material exports

The large export volumes of sawn timber, fresh milk and other primary commodities are clear evidence of Latvia's failure to deploy a mission-oriented industrial policy. For reasons discussed earlier, Latvia finds itself at the short end of the stick of key international value chains, condemning itself to a quasi-colonial dependency on other nations – not necessarily leading highly-industrialized ones, as evidenced by Latvia's trade deficits, for example, with Lithuania and Poland – which, in turn, use Latvia's raw material inputs in final goods that are then sold back to the Latvian market with significant added value. Reversing such tendencies should be a key early objective of a mission-oriented, export-led industrial development strategy.

Rentier activities

As a direct consequence of several decades of a deeply neoliberal development model, Latvia's economy is characterized by a high degree of rentier activity. Economic rents are defined as surplus revenue or value acquired not as a result of productive effort, innovation, entrepreneurship under fair competition, research or outstanding knowledge or skills, but rather as a result of mere asset ownership or special privileges. The classical progressive economists as far back as the early first Industrial Revolution observed the exorbitant free-riding stemming from aristocratic and feudal privileges, especially with regard to land ownership and its negative impact on overall economic competitiveness. In classical economics (in the proper sense), a free and socially responsible market economy is not free from regulation, but rather free from rent, non-value added costs (Hudson, 2015). In modern-day Latvia, economic rents are most often the result of either asset (especially land and real estate) ownership – often as a result of privatization or tax-free inheritance – or rental rights, on one hand, or privileges obtained as a result of monopolization, artificially constrained competition, corruption and active political rent-seeking, scheming and other opaque methods, on the other hand. The former category includes rents stemming from real estate asset (predominantly land) value appreciation; collateral confiscation from bankrupt debtors (especially rife in the aftermath of the 2008–2010 financial and economic crisis with assets still remaining on commercial bank balance sheets), long-term land rental agreements in ports and special economic zones; private ownership of land subsurface natural resources down to

the center of the Earth (with Latvia, in stark contrast to most other EU countries, featuring US-style legislation). These rents are dealt with most effectively by a comprehensive and targeted land-value taxation policy. The latter category of rents features a diverse set of often predatory and mostly harmful economic activities that thrive in environments of lax regulation and political corruption: instant loans, gambling, the mandatory procurement component (OIK) in energy, regional waste collection services and other privatized/liberalized ex-natural monopolies, public tender lots for intercity bus services, insolvency administration, public construction procurements, public IT administration contracts and many others. Overall, these have a significant negative impact on the cost competitiveness of the Latvian economy and should be chief targets of immediate progressive regulatory measures, in line with Nordic and other global best practices.

Conclusions and recommendations

Although some progress in rebalancing the economy towards a more sustainable structure has been achieved following the 2008–2009 crisis, Latvia continues to ignore basic lessons, dating back to the classical economists and the progressive tradition, in promoting national development. Latvia's neoliberal economic model, implanted during the Shock Therapy of the early 1990s, overlooks the vast historical track record of today's successful industrialized nations and their development strategies, from Alexander Hamilton's United States, to Friedrich List's mid-to-late nineteenth century Germany, or from the Nordic countries to the Asian Tigers and beyond. Underpinning these highly successful development strategies is a diverse body of development literature, which may be broadly categorized as the "Hamiltonian-Listian-Schumpeterian" school of thought, building on the view that a nation's economic development is rooted in its historical, social and institutional context, and must, therefore, not be guided by universal formulae based on deductive and axiomatic reasoning, as characterized by neoclassical economic theory. In the absence of monetary policy autonomy and its fiscal levers, which are severely constrained by the European Fiscal Compact straightjacket, tax policy and industrial policy are the two primary activist national development tools still available to Latvia.

TAX POLICY

The "flat tax" policy (effectively leading to a regressive tax regime), with low levels of capital taxation, was seen by Latvia's early policymakers as a means to promote the influx of foreign direct investment (FDI). Thirty years later, we observe that this has not attracted significant production-seeking and long-term competitiveness-building investments in the real economy, but rather a mix of foreign investment geared towards sales market penetration (import-intensive global brand marketing infrastructure), access to raw material inputs (Nordic investment in Latvian forests and farmlands), monopolization (privatization of infrastructure companies) and asset speculation (real estate bubbles fueled by commercial banking). As a result, the structure of the Latvian economy remains unsustainable and lacking resilience against both sudden macroeconomic shocks (such as Covid-19), as well as cyclical fluctuations. A shift of the tax burden away from labor (work) and the real economy onto high-value real estate (land, in particular), capital gains and other rentier income,

inheritance and unproductive consumption would go a long way to promoting a more sustainable economic structure and a favorable environment for (re)industrialization, as well as combating wealth and income inequality, and insulating the economy from toxic financialization. A comprehensive new land value taxation policy, not least building on its successful deployment in Singapore, Hong Kong, Australia and beyond, could promote a more territorially balanced national development, ensure a more efficient use of land, constrain real estate speculation and rentier windfall income, and lower taxes on labor, as well as generate – in a progressive fashion – additional tax income to finance a modern welfare state, a key prerequisite for the development of Latvia's people and their potential, which might lessen emigration as well as facilitate births.

INDUSTRIAL AND INNOVATION POLICY

In addition, drawing inspiration from historical national development success stories, Latvia requires a comprehensive, proactive and mission-oriented national development policy that mobilizes state support, in line with EU state aid and industrial development guidelines, to economic activities – "national champions" – that would promote Latvia's transformation into a more modern, sustainable, diversified, socially responsible and digitally enabled economy. As illustrated in the sectoral analysis above, among the criteria for selecting economic activities, segments or companies for targeted national industrial support, one might include:

- added value,
- scalability,
- complexity and technological intensity,
- sustainable employment and human development with a growing wage level,
- commercial viability,
- export competitiveness and/or contribution to import substitution,
- tax and ownership transparency and reputation,
- quality of corporate governance.

It would also be important at the same time to exclude any rentier activities that generate zero-sum or negative-sum outcomes vis-à-vis other industries or society at large, Furthermore, as many notable historical examples show, from

Germany to South Korea, an ambitious, mission-oriented national development bank is an indispensable tool for the promotion of national development as part of a wider industrial strategy. A full-fledged national development bank – likely based on Latvia’s state-owned development finance institution, *ALTUM*, – should also serve as a vehicle of coordinated distribution and investment of available EU structural funding towards key focus areas, including the EU horizontal priorities of digitalization and green transformation. In addition, in order to further promote access to finance while balancing out the exorbitant transaction fees of the commercial banking sector, Latvia must promote a more active development of cooperative lending institutions (*krājaizdevu sabiedrības*) – not least as a key pillar in promoting forestry and agricultural cooperation – as well as postal banking, not least to reduce the market for consumer loan sharks.

Industrial policy must go hand-in-hand with development of a comprehensive national innovation system, with OECD best practice guidelines in mind and through a close tripartite collaboration between the state, the private sector and academia. Industrial policy must be further cemented by an active employment policy, with full employment as the main macroeconomic objective, featuring subsidized on-the-job training and other forms of job guarantee as a means to establish a minimum threshold for sustainable employment conditions and remuneration. Other – highly interdependent – elements in the wider national development toolbox to promote industrial development and long-term economic complexity include outstanding physical and digital connectivity and mobility infrastructure and related integrated public services, the promotion of industrial cooperation and cluster development, industrial zone development, as well as investments in education and health care.

As a cautionary note, Latvia must avoid overfocusing on start-ups. Highly scalable, innovation-based “unicorns” have a fashionable appeal in the digital age and can indeed drive long-term value. However it is obvious that systematic start-up success is usually the result of highly integrated industrial innovation ecosystems, often anchored around large ultra-competitive enterprises (San Francisco Bay Area, Berlin’s Siemensstadt and Ericsson’s Kista campus are great examples), rather than individual Newtonian “spark-of-genius” efforts. Latvia should, therefore, primarily focus on putting in place innovation-nurturing ecosystems, preferably around its “national champion” activities and companies, while significantly increasing public and private R&D spending. The good news is that Latvia’s economy saw robust growth averaging over 4 percent annually in 2017 and 2018, while its economy became more complex in its composition (countryeconomy, 2020). This increasing sophistication, however, appears to have been more hindered than helped by government policy (and prevailing theories of development in Latvia). In 2019, growth halved from the preceding two years, and 2020 then brought challenges from the Covid-19 virus, followed by slippage into negative growth. The pandemic virus only lightly touched Latvia until October 2020 (at the time of this writing), when there was a dramatic increase in rates and the

imposition of a lockdown on November 9. Some in government felt that the lockdown was being imposed too early, but set against that is the fact that Latvia only spent 6.3 percent of GDP on health care in 2019, and in earlier austerity years spending had fallen below 6 percent (Statista, 2020). This maintenance of Latvia’s health spending below optimal minimum levels under its neoliberal model left little spare capacity in the event of a public health crisis. Thus, Latvia’s recent lockdown, and its economic costs, may represent another price of neoliberalism imposed on it from lack of investment.

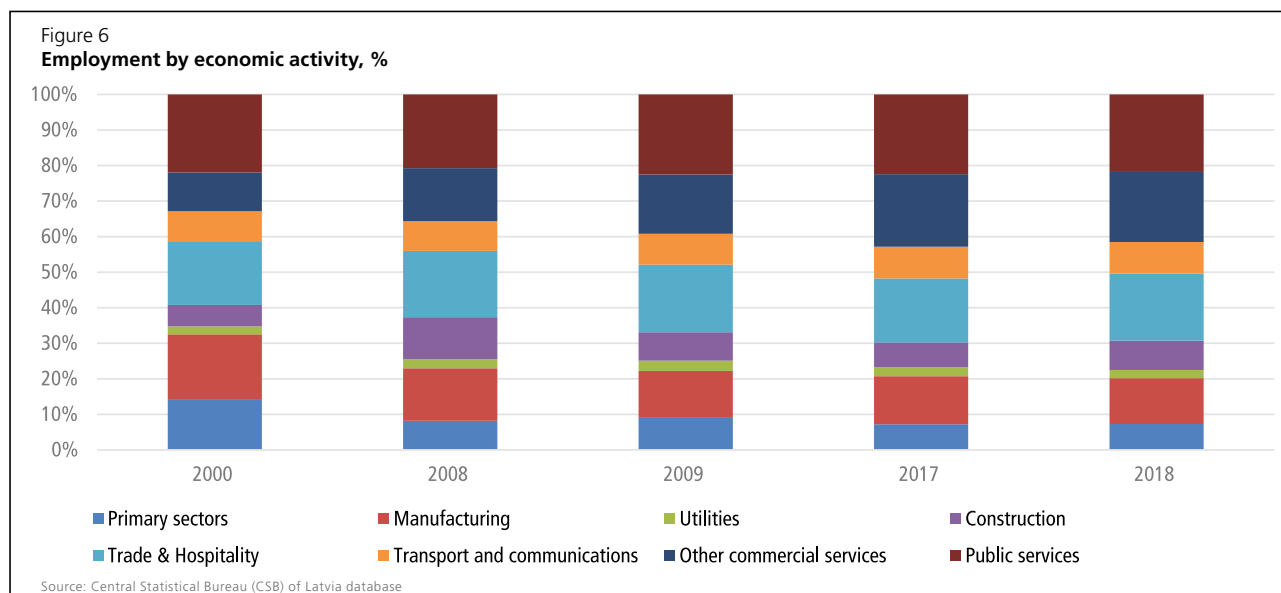
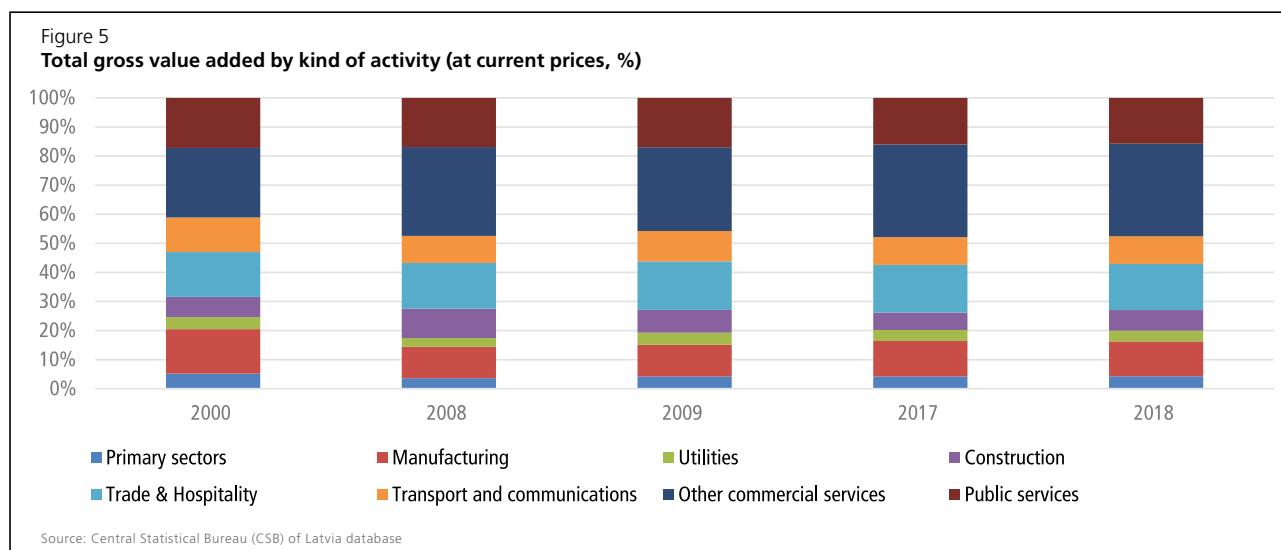
Our optimistic view, finally, is that policy changes of the type recommended in our analysis could result in economic development that returns Latvia to a growth trajectory, doing so along more broadly distributed sectors that enable sustained growth.

Appendix: Latvia's primary sector, manufacturing and services data

PRIMARY SECTOR

The share of the primary sector in the gross value added of the Latvian economy increased marginally, from 4.2 percent in 2009 to 4.3 percent in 2018 (Central Statistical Bureau of Latvia [hereinafter – CSB] 2019, IK10_060, IK10_050c). Today it accounts for around 7 percent of total employment (CSB, 2019, NBG081). The sector (primarily

agriculture) has lost more than 20,000 jobs since 2008, out of the almost 150,000 jobs – or around 14 percent of the employed workforce – that the Latvian economy has lost over the past decade, mainly as a result of economic emigration. Compared with 2000, the Latvian primary sector has lost more than half of its jobs, falling from more than 130,000 jobs to around 63,000. The primary sector is a critical source of domestically available inputs and a key

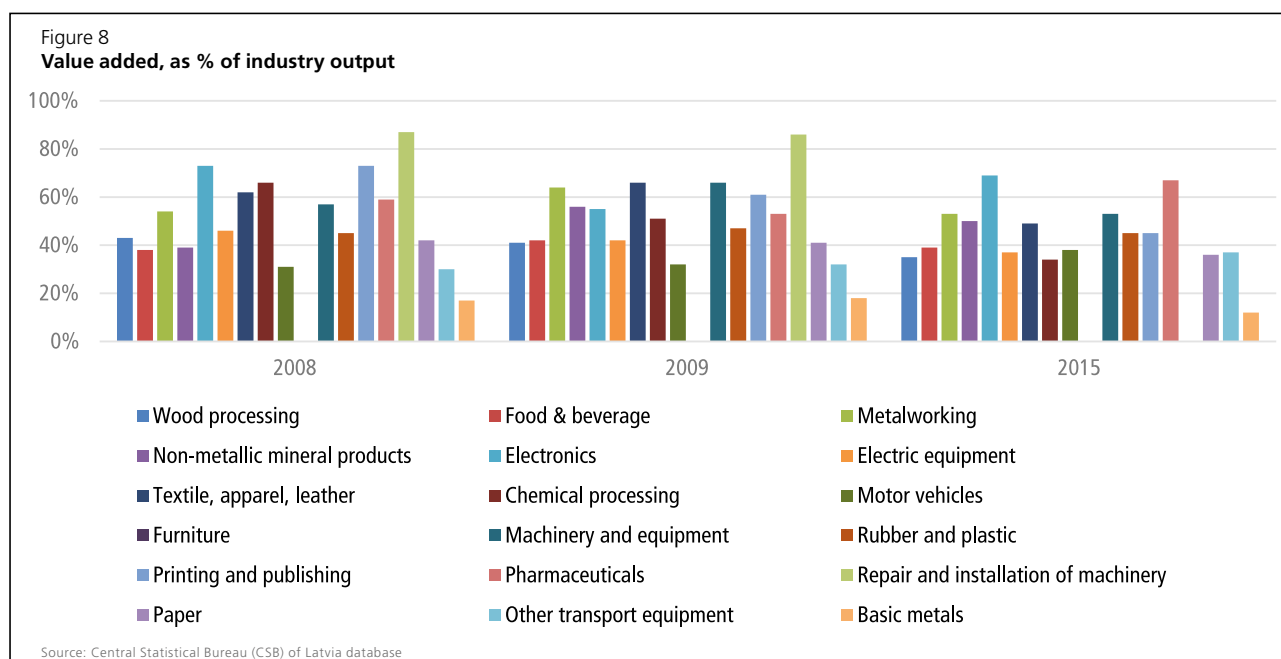
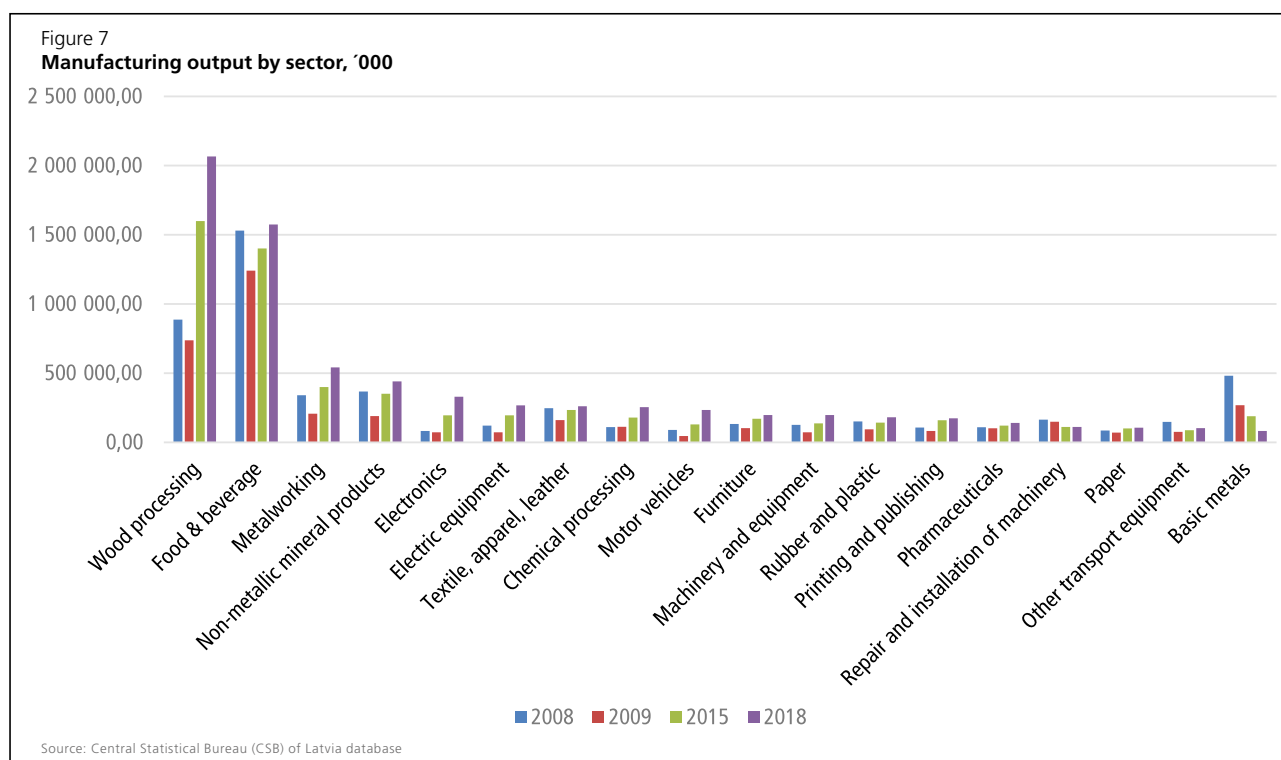


component in the wider value chains of such strategic industries as wood processing, food production and renewable energy.

MANUFACTURING

The National Development Plan 2014–2020, approved by the Parliament at the end of 2012, set out to increase the share of manufacturing in the economy to 20% (Cross-Sectoral Coordination Centre 2012, 17) – comparable to 1995 levels, after which a steady decline of this industry ensued. In reality, despite a relatively small increase since the crisis of 2009 – from 10.9 to 12.0 percent in 2018 – Latvia has failed

to achieve even the pre-EU accession level of just above 15 percent (2000: 15.3 percent). Manufacturing employment has stagnated at around 13–14 percent during the past decade (CSB, 2019, NBG081). Value added as a percentage of manufacturing output has remained roughly on a par with 2008 at 43 percent (CSB, 2019, IK10_060, IK10_050c), while the share of exports in manufacturing output has increased considerably from 51 to 65 percent (CSB, 2019, RU040c). While this sector has produced numerous success stories, as the sub-industrial profiles below illustrate, it still suffers from the Latvian economy’s deep-rooted structural and policy-level deficiencies, not least regional underdevelopment and inefficient regional municipal governance,



skilled labor shortages and low productivity, high labor taxation, disproportionate energy costs, lack of a well-functioning national innovation system supporting industrial R&D and a modern national industrial policy, not least as a tool to mobilize national and European funding for manufacturing development.

SERVICES

The services sector accounts for 80 percent of Latvia's total gross value added, down from 83 percent in 2008, and more than 77 percent of the employed workforce, up from around 65 percent in 2000 (CSB 2019, IK10_060, IK10_050c, NBG081).

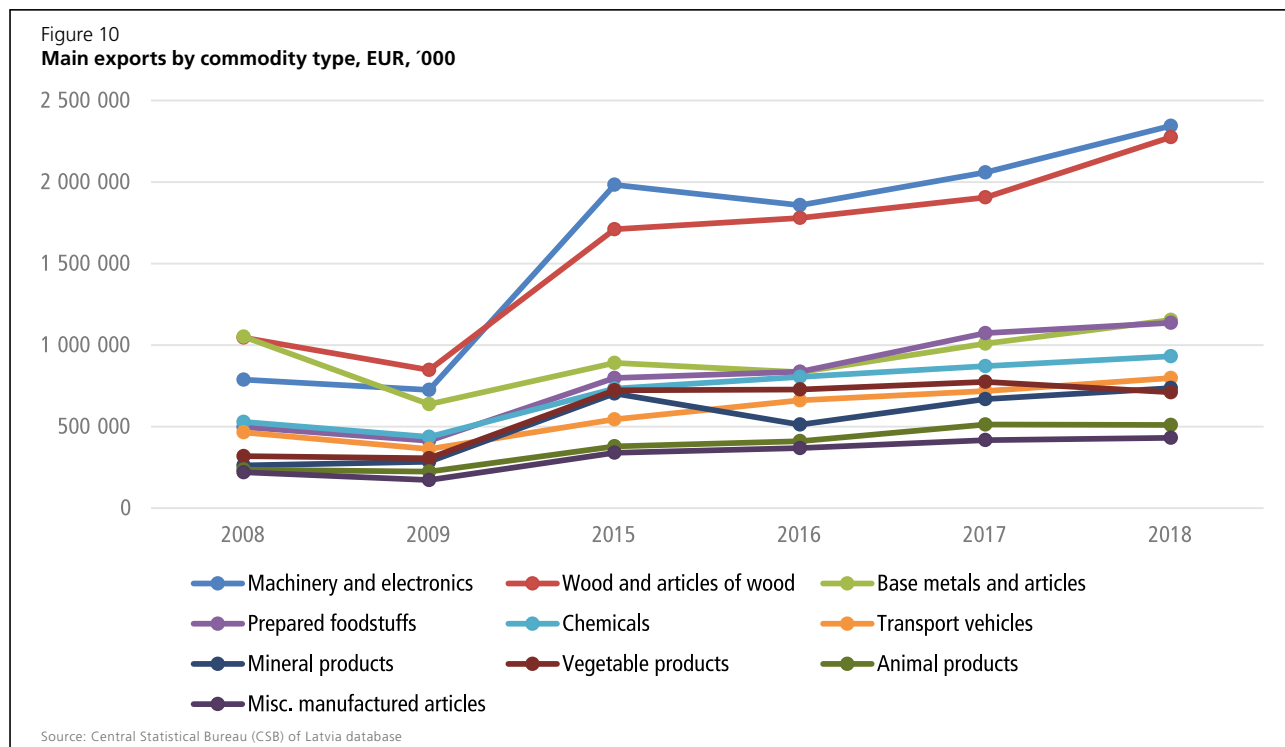
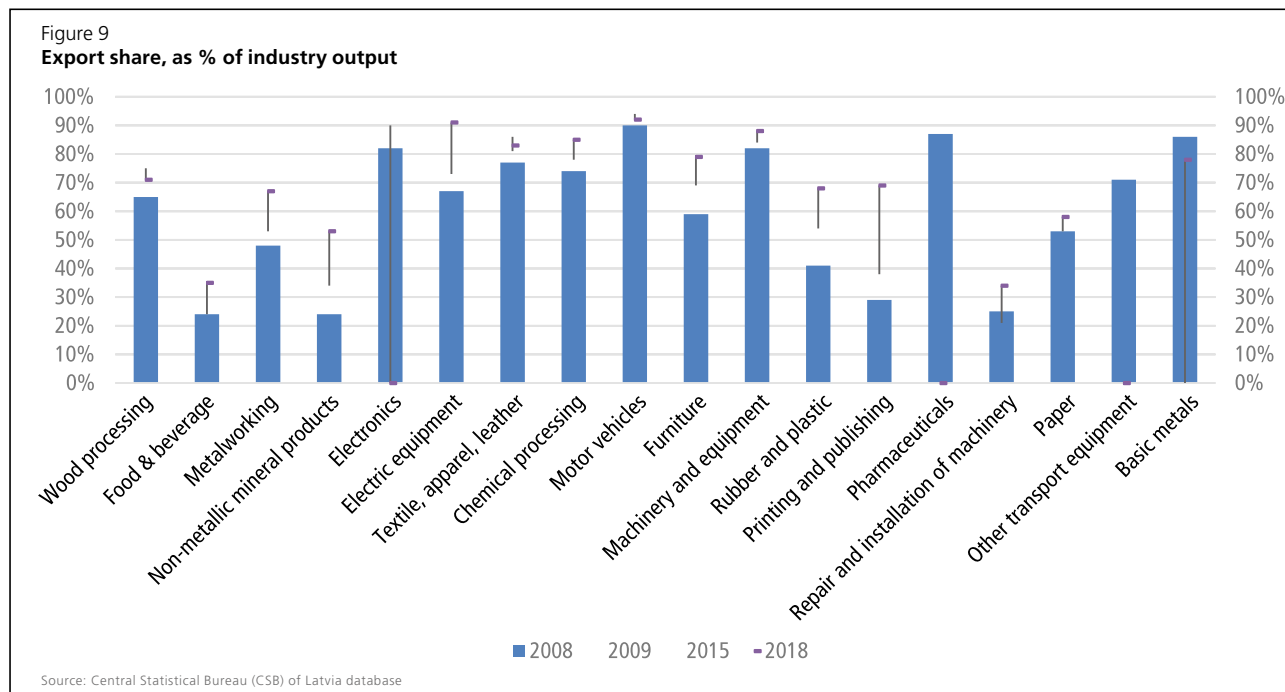
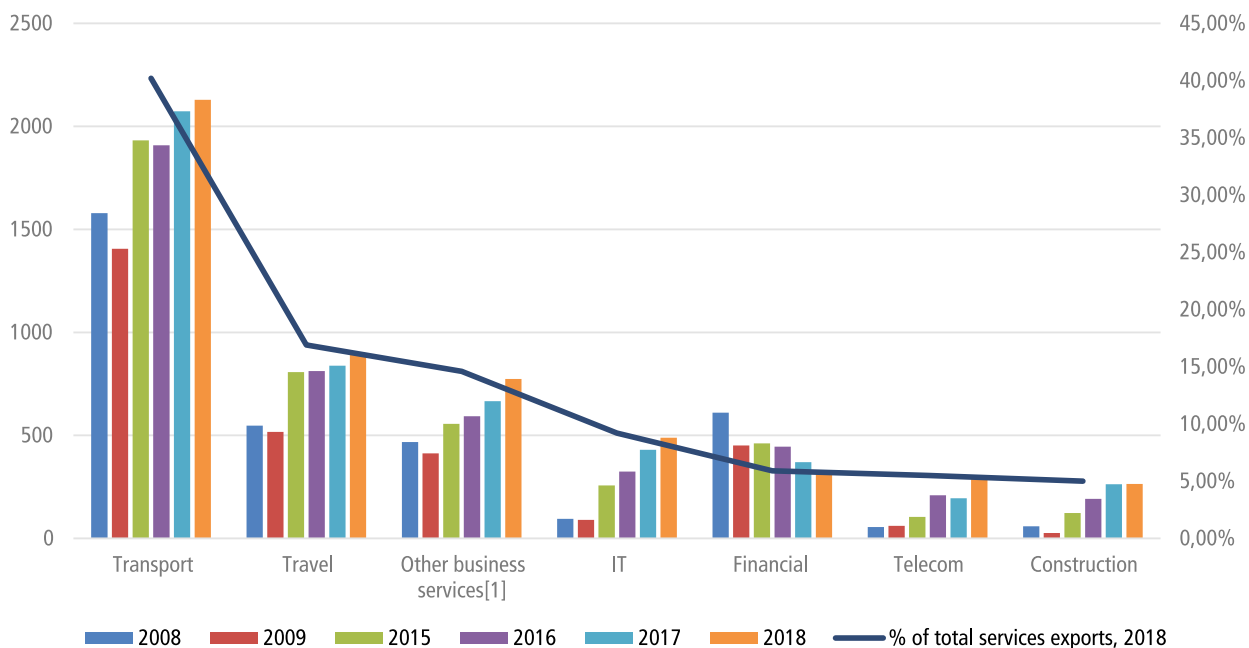
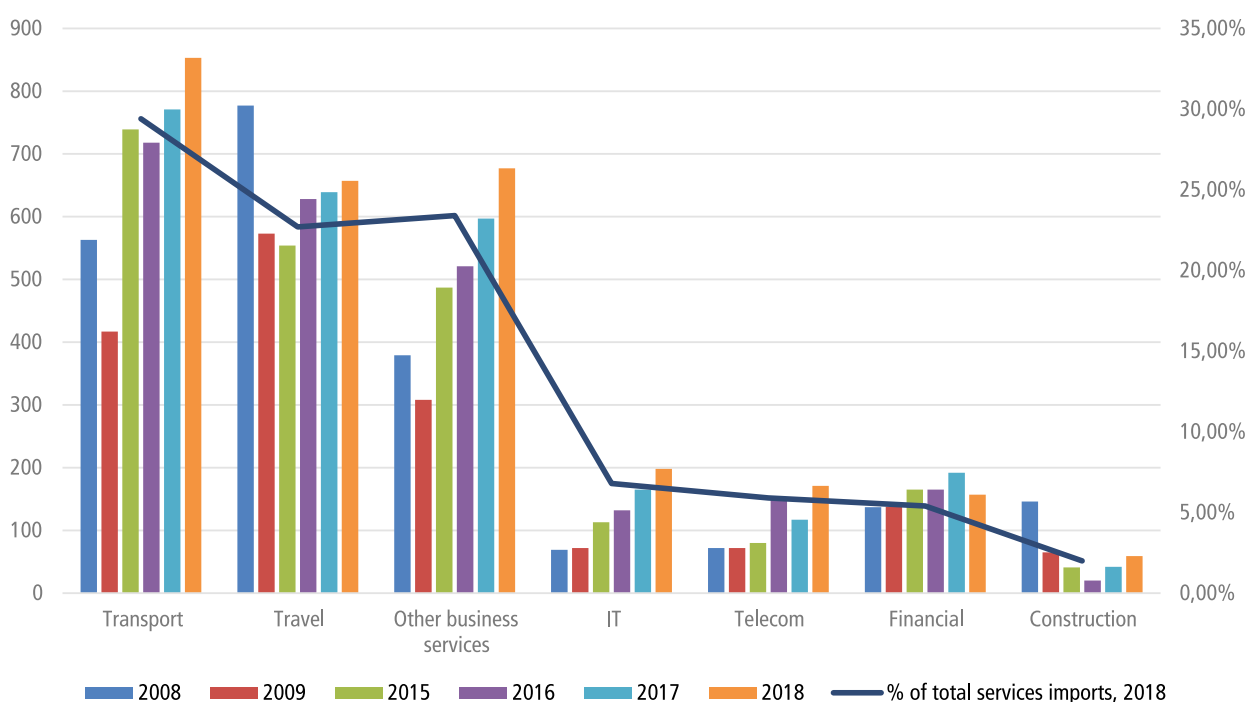


Figure 11
Main exports by type of services, EUR, million



Source: Bank of Latvia

Figure 12
Main imports by type of services, EUR, million



Source: Bank of Latvia

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FES IN THE BALTIC STATES

Shortly after the restoration of independence, in 1992, the Friedrich-Ebert-Stiftung started its activities in the three Baltic States and opened offices in Riga, Tallinn and Vilnius. The core concern was to support the democratic transition processes, to accompany the Baltic States on their way to the European Union and to promote the dialogue between the Baltic States and Germany, and among the countries of this region. The current focus of the work of the Friedrich-Ebert-Stiftung in Estonia, Latvia and Lithuania is:

- strengthening democracy and active civil society;
- supporting the European integration process;
- contributing to the development of a common European foreign and security policy;
- promoting a fair and sustainable development of economic and social policies in the Baltic States and in the EU.