

Joint Project of the European Social Partner
Organisations

Study on restructuring in new Member States

LATVIA – COUNTRY DOSSIER



This project is organised with the financial support of the European Commission

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The present report represents an expert view and does not necessarily reflect the view of the European Social Partners

I. INTRODUCTION: THE DOSSIER – WHAT FOR?

The following dossier introduces the main challenges faced by the Latvian economy from the point of view of restructuring, both at the company and at macroeconomic levels. It was discussed by the Latvian Social Partners in the presence of the European Social Partners at a common Seminar that took place on 27 April 2006 in Riga.

The dossier does not aspire to build innovative insight about Latvia's economic or social situation, neither on political nor on academic ground. It seeks to present the existing facts and data from the point of view of restructuring treated as a phenomenon, a process and an object of the public debate.




It presents different points of view. It seeks to stimulate the debate about the future of the Latvian economy, raise issues which can be treated in a constructive way, contribute to build trust and confidence among the stakeholders in view of mobilizing them for the future of Latvia and the Latvian social dialogue within the European Union.

In the first part, the dossier highlights the main economic drivers and trends, and the main concerns expressed by the stakeholders in terms of growth, employment and competitiveness. Then it focuses on restructuring as a process and object of the public debate nourished by concrete cases of restructuring in Latvia. It ends up presenting an overview of the social dialogue challenges and questions currently being discussed or that could possibly influence considerations on restructuring.

It is based upon interviews and the analysis of data and documentation. The list of persons interviewed, as well as sources, are presented in Annex 3.

II. ECONOMIC TRENDS AND CHALLENGES

This section:

-  presents drivers of growth which contribute to pushing forward the Latvian economy,
-  enumerates economic challenges and macroeconomic issues, and
-  identifies employment and labour market challenges.

2.1. MACROECONOMIC CHALLENGES

Reforms carried out in Latvia in the past decade have strengthened the private sector and created favourable macroeconomic conditions. Investments continue to grow rapidly promoting the modernisation of production and transition to new and more productive technologies¹. Reforms and accession to the EU both contribute to the Latvian growth rate, which is among the highest in the EU. If there are no external shocks GDP can be expected to grow by 6-8% in the medium term.

a) GDP growth

Latvia has recorded impressive economic growth in the past few years, with a real GDP growth of 6.4 % per annum in 2002, 7.5 % in 2003, and 8.5 % in 2004. In 2004, Latvia saw the fastest GDP growth among the EU-25 countries. In the fourth quarter of 2005, GDP posted a 10.5% year-on-year increase at constant prices, and the rate of economic growth reached an all-time-high in 2005 (10.2%). The Bank of Latvia forecasts for 2006 point to further robust economic growth, with GDP rising by about 8%. Preliminary statistical data for January 2006 suggests that the main sectors of the economy have started the year with substantial growth acceleration².

¹ <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

² <http://www.bank.lv/eng/info/jaunzin>

Growth has been broad based, with increasing domestic demand and strong export performance³. Capital formation, exports and private consumption were major contributors to growth⁴. The rise in domestic demand has promoted the development of services, especially in trade and construction. High growth rates are also observed in the transport and communications sectors, most notably in 2004. Since 2001 manufacturing output has been rising by 9-10% annually (6.2% in 2004)⁵.

Table 1 presenting GDP by sector and Graph 1 presenting changes in real GDP and major expenditure items can both be found in Annex 2.

b) GDP composition by sector

Latvia's economic structure has changed remarkably and it now corresponds to the economic structure of a small modern economy. Yet some disproportions exist and may have a dramatic impact of economic shrinkage in some production sectors and comparatively weaker performance of some high value added service sectors (e.g. financial intermediation) and social services (health and social work). In 2004, agriculture accounted for 4.4% of GDP, industry 24.8% and services 70.8%⁶.

Table 2 presenting key economic development indicators and Graph 2 presenting comparative GDP growth of Latvia (1998-2002) can both be found in Annex 2.

c) Inflation

Latvia's strong economic performance continues to be accompanied by increasing inflation. The level of inflation in Latvia has decreased from hyperinflation in the early 1990's to 1.9% in 2002⁷. Consumer prices rose steeply in 2004 and exceeded 7% by the end of the year. Annual average inflation in 2004 stabilised at 6.2%. Determinants of such acceleration were in part one-off supply side factors that included administrative changes related to EU accession, increases in food prices as a result of a poor harvest, depreciation against the euro and global increases in commodity prices. Measures of underlying inflation have also deteriorated. Excluding unprocessed food, energy, and regulated items, core inflation peaked in late 2004 and remained high at 5% by mid-2005. In addition, continued credit growth fuelled domestic demand. In response, the Central Bank raised its refinancing rate by 50 basis points in March

³<http://www.worldbank.org.lv/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/LATVIAEXTN/0,,menuPK:361565~pagePK:141132~piPK:141107~theSitePK:361470,00.html>.

⁴ Strategy for Latvia, Document of the European Bank for Reconstruction and Development, 2005, p. 4.

⁵ Macroeconomic development of Latvia, Ministry of Economics of the Republic of Latvia, 2005.

⁶ http://www.indexmundi.com/latvia/gdp_composition_by_sector.html

⁷ *Factors and Impacts in the Information Society. A Prospective Analysis in the Candidate Countries*, Report on Latvia, Joint Research Center, European Commission, 2004

and November 2005 to reach 4%⁸. In February 2006, Latvia's annual rate of consumer price inflation decreased significantly (to 6.9%), whereas the consumer price index posted a month-on-month increase of 0.4%. Although inflation has slightly decreased, it still remains high and taking into account the planned changes in administrative prices, no significant decline in inflation rates can be expected in the immediate future⁹.

The trends observed in the last two years suggest that inflation may become a problematic aspect of convergence criteria for Latvia. Inflation remained low in 1999–2002 and did not exceed the set criterion on average, whereas from 2003 it is on an upward trend, which at the moment poses an overall risk to fulfill the criterion within the prescribed time period¹⁰.

d) Foreign trade

Like every small economy depending largely on trade, Latvia's economy is sensitive to external shocks, of which the most important are shrinking external markets. However, the economy has been able to adjust to changing economic conditions so far¹¹.

Foreign trade is important for Latvia, since the internal market cannot ensure sufficient growth for Latvian manufacturers. Only stable growth of Latvian exports can improve the trade balance and the increase of GDP. Countries of the EU and CIS play the most important role in Latvia's foreign trade at present, and this is not expected to change in the near future. However, in the light of the saturation of EU market and its poor growth rates, the importance of third countries in Latvia's foreign trade is expected to grow. Latvian entrepreneurs increasingly face more new opportunities in such markets as the USA, Russia, Ukraine, China and Japan¹².

Table 3 presenting a SWOT analysis of Latvian trade may be found in Annex 2.

- Export

During 2000-2002 exports of Latvian goods in current prices had grown by 11-12% annually. In 2003 total exports expanded by 17%, while exports to the EU-15 states increased by 20%. The same year, exports grew in all categories of goods with the biggest growth recorded in the wood industry, and the metal processing and machine building sectors, which contributed 45%

⁸ *Strategy for Latvia*, Document of the European Bank for Reconstruction and Development, 2005, p. 13

⁹ <http://www.bank.lv/eng/info/jaunzin/>

¹⁰ http://www.bankofestonia.info/pub/en/dokumentdid/publikatsioonid/seeriad/kroon_majandus/2005_3_3.pdf?objld=661735

¹¹ *Factors and Impacts in the Information Society. A Prospective Analysis in the Candidate Countries*, Report on Latvia, Joint Research Center, European Commission, 2004.

¹² <http://www.em.gov.lv/em/2nd/?lng=en&cat=3884>

and 23% respectively of the total export growth. In 2004 exports increased considerably (by 28%) in all Latvian export sectors. The sharpest increases were in the exports of base metals and base metal products, machinery and wood products. The value of commodity exports continued to increase also in January-February 2005 (by 34% higher than the corresponding period in 2004)¹³.

Tables 4 & 5 presenting top export markets and top export commodities in 2003, as well as Graph 3 presenting commodity exports 2001-2004, can all be found in Annex 2.

Exports of Latvian commodities increased by 17% from 2002 to 2003. Exports of services in 2003 have decreased by 1 percentage point in relation to GDP, as exports of services went up by 13%, and imports by 23%. Approximately 60% of exports of services are revenues from transit haulage – in 2003, revenues from cargo haulage went up by 3%. An increase of revenues from commercial services and the growing number of tourists should also be taken into account.

Latvia's main exports are wood and wood products, machinery and equipment, metals, textiles and foodstuffs. From 1995 to 2002 the value of exports increased by 104%: export to the EU countries has grown by 180 % while export to CIS countries has fallen by 47%.

There are striking differences between what Latvia exports to the EU and to the CIS countries, which are presented in the table below.

Export to the EU countries	Export to the CIS countries
1. Wood and articles of wood (sawn wood, wood in the rough, articles of wood and plywood)	1. Electrical machinery and equipment (electrical instruments, electrical engines and generators, electrical transformers)
2. Non-ferrous metals and articles of non-ferrous metals	2. Machines and mechanical appliances (various machine tools for different industries of the national economy)
3. Furniture.	3. Pharmaceutical and light industry products
4. Iron and non-alloy steel (bars, profiles, wire)	4. Light industry products
5. Men's and women's clothing	

Source: A Brand for the Nation of Latvia, Oxford Said Business School, 2003.

¹³ *Macroeconomic development of Latvia*, Ministry of Economics of the Republic of Latvia, 2005.

The forestry sector is currently the most important single export industry generating as much as one third of export turnover and plays an essential role in generating rural and regional employment. Its main export markets include Great Britain, Germany and Scandinavian countries, but the recent diversification in product range and the desire to improve profit margins have seen Latvian producers increasing their direct presence in more remote markets like the USA and Japan.

- Import

Imports grew considerably from 2003 to 2004 (by 24.8%). The most substantial increase in imports, observed in March-April 2004, was due to entrepreneurs' desire to import, in the last months before EU accession, as many intermediate and consumer goods in compliance with the old terms of trade as possible. An increase in imports was observed in all commodity groups: the steepest being in the mineral products (20% of the total import growth) and machinery products (19%)¹⁴.

Commodity imports increased rapidly in 2003 – by 20%. Imports increased in all groups of commodities, while the biggest growth was observed in the group of metal processing and machinery, which accounted for one-third of the total increase.

Imports from the EU-15 in 2003 went up by 15%, mainly in metal processing and machinery (approx. 1/3 of the total increase). Imports from CIS also grew rapidly in 2003 – by 32%. The biggest part of the increase was for mineral products (again, approx. 1/3 of the total increase). The biggest trading partners of Latvia in 2003 were Germany, accounting for 16% of the total foreign trade turnover, Lithuania 9%, Sweden 8%, Russia 8% and the United Kingdom 7%.

Table 6 presenting top import commodities in 2003 and Graph 4 presenting commodity imports 2001-2004 can both be found in Annex 3.

e) Foreign Direct Investment

Investment in fixed assets in Latvia increased by 40% from 2001 to 2004, i.e., by 12% annually. The share of investment over the last three years has on average accounted for 24.5% of GDP, indicating that nearly a quarter of national income has been used for the total fixed capital formation annually. Since the restoration of Latvia's independence in 1991, foreign direct investments (FDI) have been one of the main driving forces of the Latvian economy. The accumulated FDI stock has doubled every 3 – 4 years since the early 1990s. At the end of September 2004 FDI stock totaled LVL 2.3 billion or approximately 30% of the annual GDP¹⁵. Currently ranked 6th among the new EU member states for FDI stock per

¹⁴ <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

¹⁵ *Macroeconomic development of Latvia*, Ministry of Economics of the Republic of Latvia, 2005.

capita, Latvia continues to enjoy high recognition among both regional and global FDI contributors.

The main sources of FDI in Latvia remain neighbouring countries in the Baltic Sea region, which have been active in Latvia from the very beginning of the 1990s. Currently, investments from Sweden, Germany, Denmark, Finland, Norway and Estonia make up as much as 50% of the total FDI stock covering a variety of fields from finance, telecommunications and trade to fully export-oriented manufacturing.

The second group of more remote investing countries is led by the USA, the Netherlands and United Kingdom, who tend to choose Latvia both as a market base for the Baltic region and as a favourable manufacturing location. Countries to the east, mostly Russia, have chosen Latvia for transit/value-added logistics operations for their main export commodities – such as oil products, chemicals and metals¹⁶.

In Annex 2 the following can be found:

1. Table 7 presenting a SWOT analysis of FDI in Latvia.
2. Diagram 1 presenting FDI in Latvia by industry.
3. Graph 5 presenting cumulative FDI in Latvia.
4. Graph 6 presenting total investment growth rates in Latvia.
5. Diagram 2 presenting FDI in Latvia by country.

f) Why to invest in Latvia?

As a small country with limited private capital resources, Latvia fully appreciates the crucial impact of FDI on its continuing economic development. Company registration procedures in Latvia are fast and streamlined, allowing for the establishment of a business in a minimum of three business days. Other components of a business-friendly environment in Latvia are the following:

- by law, foreign investors have the same rights and duties as local investors;
- the foreign investor may be the sole founder and owner of a company in Latvia;
- no restricted sector activities;
- the foreign investor may freely repatriate earnings after tax profits and investment capital;
- foreign companies registered in Latvia are entitled to buy land and property;
- the standard rate of Corporate Income Tax (CIT) is 15%.

¹⁶<http://www.mfa.gov.lv/en/policy/economic/business-opportunities/>

At regional level, there have been two key drivers behind the current investment activity which are likely to continue into the future. Firstly, there is a substantial difference in operational costs and labour costs between the “east” and “west” coasts of the Baltic Sea.

Secondly, investors wanted to profit from a fast growing Baltic market and the potential for further strategic opportunities in Russia and the CIS. In addition, Latvia has a favourable macroeconomic environment including relatively low inflation and a stable, convertible currency.

For those investors further afield (namely the USA and UK) Latvia is chosen as a market base for the Baltic region and as a favourable manufacturing location. Countries to the east, mostly Russia, have chosen Latvia for transit/value added logistics operations for their main export commodities – oil products, chemicals and metals. In the realm of globalisation it is increasingly important for countries to develop clusters of expertise in key areas. Latvia certainly has the history to develop a cluster to service transportation. There seems to be a potential to develop a financial cluster in Riga. Also, the development of an IT cluster due to the skills of its workforce is possible¹⁷.

There are 4 Special Economic Zones in Latvia: Riga free port, Ventspils, Liepaja and Rezekne. Special conditions, valid until 2017, offered in these zones are: an 80% rebate on real estate tax and CIT (calculated on 25%), but not exceeding 65% of total investment for SMEs and not exceeding 50% of total investment for large corporations. Picture 1 at Annex 3 presents the location of Special Economic Zones. As of January 1, 2002, a new law "On Application of Taxes in Free Ports and Special Economic Zones" came into force. This law regulates the application of indirect taxes in free ports and special economic zones and the application of allowances of direct taxes, and stipulates how state social insurance contributions shall be applied in free ports and special economic zones¹⁸. *It is interesting to note that the employers' representatives believe that these SEZ are NOT especially attractive to investors!!! This information is a conclusion from interviews we have conducted. If you accept, it is OK to remove italics and exclamation marks and have it in a form of a regular text.*

g) Transport

Having been a transport and trade gateway between the East and the West since Hanseatic League times, Latvia has managed to successfully revitalise the role of its location as part of its economic success since regaining independence. With the main component being the handling of Russian/CIS crude material exports, transport and communications made a contribution of 15.5% to the country's GDP in 2003. Total income in the transport and communications sector has gone up by 70% in the last 5 years. The backbone of Latvia's multi-modal transport corridor is the developed east-west railway and pipeline systems concluding at three ice-free ports, with highly developed oil, metals and chemicals transit handling operations. Conversely, value-added handling of freight for regional markets (Baltic

¹⁷ *A Brand for the Nation of Latvia*, Oxford Said Business School, 2003.

¹⁸ More on conditions offered in Special Economic Zones can be found at <http://www.lowtax.net/lowtax/html/latvia/jlvfree.html>

States, Russia, Belarus) show increased growth. The most common value added-operations include re-packaging, assembling and testing/sorting of goods¹⁹.

h) Industry development

The period from 2001 to 2003 witnessed a steady increase in manufacturing, with the annual average growth rate of 9.4% considerably exceeding the average growth rates in the economy. Growth was largely accounted for by export expansion. Manufacturing output in grew by 6.2% from 2003 to 2004. The sharpest acceleration was in the growth of the chemical industry (by 22.2%) and the production of construction materials (12.4%). As opposed to other manufacturing industries, the main stimulus for the development of the construction materials industry is domestic demand.

The sales volume of the food industry, the biggest manufacturing sector in Latvia (a quarter of the average value added in manufacturing) increased in 2004 both on the domestic and external markets. However, exports rose at a faster pace, especially to the EU countries.

The production of metals and metalworking industries together with machinery accounted for approximately 1/4 of the total value added in manufacturing. The share of these sectors in industry is rising year by year. Export accounts for approx. 70% of the total output of these sectors, and there is a recent discernible trend of growing domestic demand as well. Along with the development of construction the demand for metal products is also growing²⁰.

Graph 7 presenting manufacturing output in 2001-2004 and Table 8 presenting key indicators of manufacturing by sectors in 2002 can both be found in Annex 3.

Wood processing industry

The wood industry (including forestry, woodworking and furniture) is the second largest industry in Latvia after the food industry and has very old traditions. Wood is the most important natural resource in Latvia, covering 44% of country's area (2.85 million ha) and constituting the largest part of its GNP. Latvia has 6.5 times more accumulated forest per head than the average in Europe²¹. It accounts for approximately one fifth of the total value added in manufacturing. Latvia's forest sector is explicitly focused on the external market, since it exports approximately 70% of the production to more than 50 different countries all over the world, but mostly to the EU. It is worth noting that recent years have also witnessed a rapid

¹⁹ <http://www.mfa.gov.lv/en/policy/economic/business-opportunities/>

²⁰ <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

²¹ http://www.exim.lv/pls/eximmain/exim_foreign?lang=2&katalogs=FLS&klinks=woodworking.html

expansion of the market to other countries including Lithuania, Estonia and Russia. Every year the share of higher value-added products in total exports increases²².

The product assortment supplied by the wood processing companies in Latvia becomes more diversified year after year. Currently they can offer products ranging from fencing materials to houses. The main export commodities are sawnwood (45%), roundwood (13%), plywood sheets (10%), fuelwood (3.3%) and furniture (11%), that altogether in 2001 reached LVL 461.7 million.

Many of the largest Latvian sawmill companies have Swedish capital, like Vika Wood, Inčukalns Timber, Veko West, Balvi Holm and many others. Here are examples of successful Latvian-Swedish cooperation:

- Swedish company Sodra, one of the largest white cellulose producers in the world, chose to build its new paper factory in Latvia, near to its already functioning cellulose factory.
- Finnish company Thomesto owns 97,76% of Latvian Silva and 39,98% of the second largest sawmill in Latvia Vika Wood.
- Latvian company Pakavs producing sliced veneer (0.6 – 3 mm thick) and saw-timbers from Latvia, Ukraine and Russia, is one of the suppliers of German company Schider and Swedish company IKEA.
- Latvian-Danish joint venture Markuss, delivering materials to furniture producers, is able to double its turnover in Latvia every year.
- Large sawn-timber exporter Weeluk Baltic in 2002 was awarded as the Latvian enterprise with the most dynamics turnover increase (3003%) during 3 years. Income in 2002 increased 32 times.
- Latvijas Finieris, Latvian company with 125-year-old tradition of producing plywood, is now the biggest exporter in Latvia, modern enterprise with new technologies, certification under EU standards and turnover of about LVL 60 million.
- Stora Enso Mežs, Latvian company connected to Stora Enso, one of the largest cellulose, paper and sawn wood producer in Europe and the whole world, supplies 7-8 European factories with cellulose inputs and is the largest Latvian exporter of wood products (in 2001 it has exported 1,27 million m³ of pulpwood).
- Bolderāja, one of the biggest wood complex processing enterprise in the Baltic States, exports 70% of its production of particleboards and furniture to Europe, Baltic and Middle East²³.

Diagram 3 at Annex 3 presents the forest industry share in Latvian exports in 2004.

i) Information and Communication Technologies (ICT)

Latvia's fastest growing economic sector is IT&T industry with a yearly growth by 20 - 30 % during the last decade. Exports of the sector are rapidly rising in the last years, annually growing by approximately 15%. The industry's main asset is highly qualified human resources

²² <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

²³ http://www.exim.lv/pls/eximmain/exim_foreign?lang=2&katalogs=FLS&klinks=woodworking.html

with more than 8000 graduated IT specialists and an additional 6000 in universities and colleges. Support for IT throughout the education system is key to further development. That this has been understood is shown by the doubling of software engineering students in Latvian universities/colleges over the last 3 years, and the increasing popularity of the IT profession among the school-leavers. The key competence areas of the Latvian IT industry include customised IT solutions, financial applications, localisation, implementation of large-scale projects and application services²⁴.

In Annex 3 the following can be found:

1. Graph 8 presenting rapid increase of the number of ICT graduates.
2. Graph 9 presenting percentage of internet users in Latvia.
3. Table 9 presenting major foreign investments into ICT in Latvia.

2.2. MACROECONOMIC CHALLENGES

At present Latvia faces numerous macroeconomic challenges. They concern the infrastructure and environment, and the enterprise sector and financial sectors.

a) Infrastructure and environment

In Latvia there is limited private sector participation in municipal sectors including district heating, water and sewage, and urban transport, and also in the state transport infrastructure. There are persistent energy inefficiencies due to heat losses from municipal-owned heating networks and buildings, and from some privatised industrial enterprises. Latvia remains somewhat reliant on energy imported from neighbouring countries, particularly Russia and Lithuania.

Operational priorities are the following:

- to encourage and support private sector participation in the financing of municipal infrastructure and in the state transport infrastructure; this could be achieved with a variety of private public partnerships, including privatisation where appropriate, for example in district heating;
- to include greater energy efficiencies in project design, implementation and operations;
- to support the development of alternative energy sources.

b) Enterprise sector

²⁴ <http://www.mfa.gov.lv/en/policy/economic/business-opportunities/>

In Latvia corporate governance, strategic development potential and market competitiveness are relatively weak. There is an apparent lack of a coherent government strategy to invest in education, science and technology in order to identify and develop Latvia's core competencies for the future.

Operational priorities are the following

- to provide primarily equity investments to companies with potential (restructuring or corporate governance support required), environmental investments or cross-border investments, for example into or from Russia or other CIS countries; cross-border investments, for example, are envisaged in the manufacturing sector, wood processing or retail and distribution and where expanding enterprises seek the Bank's ability to share CIS country risk, provide long-term funding and to strengthen corporate governance in new markets;
- to support privatisation where appropriate of remaining partially state-owned enterprises in sectors including telecommunications and district heating.

Rigas Siltuma- Privatizacijai- NE!

The Cabinet of Ministers voted not to privatize the state owned *Rigas Siltuma* (Riga's Heat), the concern being that it was the object of interest of two foreign companies, drawing a storm of criticism. The state said it wanted to retain control over the enterprise, and reverse an earlier government decision to open the company up to privatization. The two interested parties were Finland's *Fortum* and *Dalkia City Heat*, a subsidiary of France's *Dalkia International*. French ambassador to Latvia Michel Foucher reportedly said the move would send the wrong message to investors. The government decision can be appealed at the administrative court level.

Source: *The Baltic Guide* February 2006, p.15.

c) Financial sector

All financial institutions in Latvia need to ensure that the risk of money laundering is eliminated from their operations and that they operate according to international best practice in preventing money laundering, fraud and other financial crimes. Meanwhile as a growth opportunity, financial intermediation remains low, particularly to the SME sector. However there is a lack of equity and mezzanine capital to support growth of the financial sector and the consequent economic growth.

Operational priorities are the following:

- where appropriate, strengthen banks' corporate governance and business practices; this shall be achieved, for example, through active participation on a bank's supervisory board;
- provide long-term capital to selected mid-tier banks that lack a strategic owner;

- provide medium to long-term credit lines to selected financial institutions to provide funding primarily for corporate lending;
- selectively commit capital to new equity funds, particularly those which focus on SMEs, for whom access to equity capital for expansion continues to be very limited²⁵.

According to the World Bank - *Country Brief 2006*, despite many achievements, the following issues still require attention:

- strengthening banks' corporate governance and business practices;
- completing the structural reform agenda and ensuring the competitiveness of the Latvian economy in the European Union;
- becoming a competitive and innovative EU member with living standards and incomes at average EU levels in the long term;
- sustaining Latvia's current economic growth and maintaining macroeconomic stability and fiscal discipline;
- improving the performance of the public sector by strengthening public administration, the judicial system, and public expenditure management;
- promoting regional development and raising the quality of social services for poverty reduction and social inclusion efforts²⁶.

d) Expanding sectors

The transformation of the Latvian economy has promoted the development of sectors and industries, some of them are based on intensive use of information, such as:

- transportation services: port and railway networks;
- communication services;
- trade:
 - the tradesmen association points out that it is very hard for small shops to operate as there is competition from the chain supermarkets that sometimes sell products below market price (price dumping);
- commercial and financial services and the banking sector: these were mainly joint ventures, shareholders companies, off-shores; the ownership of which has been changing very rapidly to the point that it is now hard to know who is the owner;
- IT sector;
- advanced wood-processing production, i.e. modern furniture, log houses technology;

²⁵ *Strategy for Latvia*, Document of the European Bank for Reconstruction and Development, 2005, p. 20-21.

²⁶

<http://www.worldbank.org.lv/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/LATVIAEXTN/0,,menuPK:361565~pagePK:141132~piPK:141107~theSitePK:361470,00.html>

- construction of log houses: in 1991 the first enterprise was established, in this business know-how is extremely important, equipment itself is not that expensive; the Latvian craftsmen's know-how is very rare and Latvia is hosting study trips from abroad to train in the log houses building technique;
- tourism;
- construction sector is the most dynamic and quickly developing sector; however, it is important to note that there are many illegal workers; when they start working legally they turn into small enterprises or become self-employed.
- manufacturing sector;
- construction materials;
- textile sector;
- chemical industry.

In general, dynamically developing sectors are the services sector and export oriented industries. This trend should be maintained as for the years 2007-2013 more investment for the HR field has been programmed in the Structural Funds, especially in the field of services, tourism and transport corridors.

e) Declining sectors

One of the declining sectors is a port-related and shipbuilding sector: it used to prosper during the Soviet times and is now declining. It may be a result of not a very successful privatization process and also the fact that transportation corridors are not fully exploited.

Employers' representatives believe that the enterprises the most exposed to change are companies that have been in business for a long time, those that preserve "the ancient way of thinking and old methods of work organization" and it is not necessarily linked to the sector of operation.

f) Restrictive legal environment

Representatives of the SMEs sector point out that the legal environment in which they operate is restrictive and the side effect of this is that many enterprises employ illegally. In 1996 many enterprises were closed – SMEs representatives perceive it as a typical example of "*political will and regulation that hinder operations of SMEs*". The reduction in the number of SMEs was really hard to estimate, there is a lack of statistical data, but approx. 2/3 enterprises have disappeared.

Another regulation that may be perceived as restrictive is a requirement for SMEs to associate with big, government-owned enterprises.

Some restrictions also concern the electric works and fisheries sectors.

There are also some restrictions emerging from European directives such as labour protection law. For the SMEs these may sometimes make their conditions of operations harder.

Restrictive regulations can be found in the construction sector and in the food processing industry in the form of professional requirements.

The SMEs sector representatives believe that taxes are very high and this makes product prices very high.

The tradesmen's association enumerates problems that hinder their effective operation:

- there is a lot of bureaucracy to fill in monthly/every 3 months/yearly and if not filled in at a right time the penalty of 400 EUR has to be paid; also "indebtedness of the company" is calculated on the basis of monthly reports sent to the state which is not always very clear;
- employee sickness: the employer has to pay for the first 14 days and the cases of false illness are quite frequent;
- high taxes;
- the minimum wage is not taxed, but the minimum wage is very low; it would be better to have a defined amount of money that can be deducted from tax. At present it is common that employees officially earn only the minimum wage and the rest is paid unofficially (under the table);
- there are exaggerated standards for organizing/reorganizing/rebuilding premises, meaning a lot of bureaucracy;
- labour force: people do not want to enter the food processing industry – therefore there is a workforce shortage;
- changes in legislation are taking place very often, creating an unstable legal environment;
- grey economy, where money is used to finance the political campaigns.

g) Economic challenges as seen by the Latvian social partners

One of the challenges seen by the Latvian social partners is the fact that politics very strongly influences the economy and the political lobby is very strong. As a consequence, big enterprises benefit from more favorable conditions of operations. For the SME sector the Latvian, very aggressive form of capitalism is hard and makes their operation harder.

Employers' representatives enumerate the following challenges:

- for the sake of a well-functioning economy, leveling out income tax is very important: now the self-employed are subject to a tax of 25%, while enterprises are subject to a tax of 15%;

- creating a favourable economic environment for manufacturers and trade, both for chain stores and small units;
- reforming the education system to ensure that vocational education better answers the needs of the labour market;
- revision of the real estate tax: a solution for increasing real estate prices;
- reducing inflation in order to meet the Maastricht criteria;
- reducing dependence on Russia (gas) by developing and promoting alternative energy sources.

Employers' representatives also point out that the differences among the 3 Baltic States can be a potential drawback: in Latvia the costs of economic activity are higher for the entrepreneurs - there is more bureaucracy and operation costs are higher than in Lithuania or Estonia.

Another challenge is to rethink the absorption of the Structural Funds that in the first programming period was centered in the Riga region; for the next programming period a more "polycentric policy" is planned.

The Latvian social partners also perceive future challenges in possible relocations of the textile industry to China where the production costs are significantly lower, as well as growing competition from Asia more generally.

2.3. LABOUR MARKET & EMPLOYMENT CHALLENGES

a) Employment

In the 2nd quarter of 2005, the employment rate in Latvia for persons aged 15-74 was 56.7%. The employment rate for men was 61.9%, for women it was 52.1%. As far as the structure of employment is concerned, 16.8% of employed persons were employed in industry or in the energy sector, 17.7% in the retail or hotels and restaurants sector and 12.6% in agriculture or fishing.

Classification by the main professional groups (age bracket 15-47)

- 4.6%: services or retail sector;
- 14.1%: qualified workers and trade people;
- 13.5%: specialists;
- 12.2%: senior specialists;
- 11.8%: representatives of unskilled professions;
- 10.7%: equipment and machine operators and product assemblers;
- 10.3%: lawmakers, leaders and senior state officials;
- 6.7%: qualified agriculture and fisheries specialists;
- 6.0%: salaried personnel.

In the 2nd quarter of 2005, 87.8% of all employed persons aged 15-74 were employees, 6.3% were self-employed, and 2.3% were unpaid persons assisting another family member. A total of 9.6% of employed persons aged 15-74 worked part time.

There are regional differences in the employment rate. In 2004, 67.3% of residents in Riga District were employed, in the Kurzeme, Vidzeme and Zemgale regions approximately 59.6% to 62.0% of residents aged 15–64 were employed, while the lowest employment rate was in the Latgale region- 53.6%²⁷. Graph 10 at Annex 3 presents the employment rate in Latvia in 2002-2004.

b) Characteristics of the labour force

In the 2nd quarter of 2005, there were 1 028 200 employed persons aged 15-74 in Latvia. With respect to educational attainment, 24.4% of employees have tertiary qualifications, 25.1% general education, 37.0% a mid-level professional or trade education, while 13.4% have only primary or a lower educational level²⁸.

The education level of the employed population in Latvia is relatively high. On average 21.6% of those employed in basic work in 2002 had higher education (24% in the EU), 64.3% had secondary education, including vocational education (46% in the EU). However, many employees lack the skills necessary for work in the fields that are in highest demand in the labour market - information technologies, communications, marketing and entrepreneurship. Another factor is insufficient knowledge of the national and foreign languages. Only 6/7 of the whole Latvian population speak the national language²⁹.

c) Unemployment characteristics

In the 2nd quarter of 2005, according to data from the Workforce Survey (the number of job seekers as a proportion of economically active residents) the unemployment rate for persons aged 15-64 was 9.2%, broken down into 9.6% for males and 8.7% for females. Based on State Employment Agency information, in the 2nd quarter of 2005 the average registered unemployment level was 8.2% (the number of unemployed persons registered with the State Employment Agency as a proportion of total economically active residents). The unemployment level varies significantly by region. According to Workforce Survey data, in 2004 the unemployment level in Riga and the Vidzeme region fluctuated from 9.2% to 9.9%. There were higher unemployment levels in Kurzeme and Zemgale –10.8% and 11.7%

²⁷ <http://europa.eu.int/eures/main.jsp?acro=lmi&catId=2776&countryId=LV®ionId=LV0&lang=en>

²⁸ <http://europa.eu.int/eures/main.jsp?acro=lmi&catId=2776&countryId=LV®ionId=LV0&lang=en>

²⁹ http://europa.eu.int/comm/employment_social/soc-prot/soc-incl/lv_jim_en.pdf

respectively – and an especially high level in Latgale – 13.0%. The Workforce Survey shows that in the 2nd quarter of 2005 the number of jobseekers as a proportion of total economically active residents aged 15-24 was 19.0%, while for older residents (aged from 55-64) it was 7.2%. According to Workforce Survey data, in the 2nd quarter of 2005 46.9% of jobseekers aged 15-74 were long-term jobseekers³⁰.

The share of people looking for jobs for more than a year is relatively high (45%). The main causes of long-term unemployment are education levels that fail to meet the requirements of the current labour market and outdated work skills or a lack of work experience³¹.

Table 10 presenting basic indicators of registered unemployment and Graphs 11 & 12 presenting unemployment and labour productivity improvement trends can be found in Annex 3.

d) Labour market challenges

There are numerous challenges Latvia is facing in the field of employment. Social partners feel that among them the following are the most important:

- stimulating entrepreneurship;
- addressing work shortages:
 - the biggest shortages are in the construction sector;
 - there are work shortages in the food processing industry: people do not want to enter jobs in this sector;
 - other sectors with the workforce shortages:
 - metal workers association officially declared shortages;
 - fisheries sector;
 - medical services;
 - education: the teacher generation is changing, young people are not attracted to this profession as it is perceived as not very prestigious and underpaid.

Employers' representatives point out that the Latvian government has acted as a recruitment agency for work in the UK and Ireland. The problem may become really acute as there are not only shortages of a highly skilled workforce, but also people with low skills leave Latvia to work abroad. The estimation says that officially there are 23 000 tax payers in Ireland and in the grey economy sector another 30 000 employees are working.

At the moment according to the estimations, the number of inhabitants is declining: the "army people" left the country, some people left for work to the Western European countries, there

³⁰ <http://europa.eu.int/eures/main.jsp?acro=lmi&catId=2776&countryId=LV®ionId=LV0&lang=en>

³¹ http://www.unep.ch/scoe/archive/baltic/Background%20report-Latvia_Draft_rev15Jun04.doc




were also nationality-related migrations (i.e. Russians went back to Russia, Estonians went back to Estonia and Lithuanians went back to Lithuania).

There is also inflow of workers from Bielarussia and Russia, but these people mainly enter grey sector employment.

Trade union representatives note that there are new challenges on the labour market linked to the new technologies being introduced. In such cases outsourcing is a common procedure. Most often, outsourcing takes place in regards to transport and training services and the former employees provide services within the framework of this new arrangement. Trade union representatives perceive outsourcing procedure as problematic, because at present, outside providers are dictating the conditions that are remarkably more expensive.

III. RESTRUCTURING CHALLENGES

This section:

-  presents a sector overview of the restructuring process,
-  presents the Latvian social partners' understanding of the restructuring phenomenon, and
-  describes further developments and challenges of restructuring as perceived by the social partners.

a) Privatisation process in Latvia

Latvia, the most industrialized of the Baltic countries, has suffered most from the collapse of the socialist networks. While some branches have converted their trade flows to the West, most industrial enterprises are still suffering from the former supplier-client relations that are only gradually being monetarized. This situation makes the Latvian case particularly relevant to other post-socialist republics of the former Soviet Union. Since more than 90% of their markets were in the Soviet Union, Latvia had to opt for a radical method of changing its economy – privatisation.

Voucher privatization

The issue of voucher privatization illustrates the permanent conflict between efficiency and "political justice" that the Latvian government had to cope with. Right from the beginning of the reforms, the use of vouchers was considered a "just" way to undo the injustice of the socialist past. In 1991 the Supreme Council stated that vouchers would be used as a means of privatizing apartments and dwellings, as well as small and large enterprises. Vouchers were supposed to represent approximately half of the value of objects to be privatized. Firstly, because of the complex process of attributing vouchers, this caused long delays. Secondly, once distributed, it turned out that people were mainly interested in purchasing their flats; there was no demand for the industrial objects on sale. Hence, the trading value of the voucher fell continuously.

One major result of the incoherent governance structures was the quasi-absence of large-scale privatisation. Between 1992 and early 1995, only some 47 large enterprises were entirely privatized. The remaining combines (~200) were all "corporatized", i.e. transformed into state enterprises, so-called "Closed Joint-Stock Companies"; yet the state was often

unable to exercise any real control on their activities or, alternatively, to close them down. In the absence of clear-cut privatization, mixed ownership forms emerged. "Leasing" has been the major technique to engage the restructuring process: private individuals - most often managers - can agree long-term lease contracts with the state. The financial obligations were often negligible: leasers can use vouchers and obtain favourable payment conditions for cash transactions. For the time being, this peculiar way of creating new enterprises has been the most efficient: 78% of all privatization have been carried out through long-term lease³².

Graph 13 presenting the share of the private and public sector in gross value added in Latvia 1994-1999, and Table 11 presenting gross value added by activities can both be found in Annex 3.

Representatives of the Latvian Chamber of Crafts point out that in the privatization process they had to buy the equipment from the government on the basis of a purchase agreement. They also underline that the privatization process brought some adverse effects such as introducing a more restrictive legal environment which resulted in illegal employment performed by many enterprises. The same concerns the construction sector: more restrictive legal regulations reduced economic activity within this particular sector. .

b) Restructuring process seen by the social partners

Employee representatives state "*Restructuring is not on the top of our agenda. We do not have any official statement on restructuring*".

Trade union representatives recall that the largest restructuring took part in the beginning of the 90's. At that time the changes were very dynamic: there were collective dismissals and the enterprises were collapsing, there was a rapid decline in Trade Union membership along with a collapse of the agriculture sector. It was the time when micro enterprises started to appear, later followed by SMEs. This trend is especially worth underlining as there was no tradition of entrepreneurship, so people were starting from scratch. Trade Union representatives point out that it was a time of unfair competition, even "*mafia influence*" - everybody tried to get something, it was a "*brutal free economy*".

Towards the end of 90's a complete restructuring of all industries took place, some of them collapsed and approx. 20 000 employees were laid off³³. The biggest enterprises employed approx. 200 000 employees. These were mainly production enterprises, mainly manufacturing for the army needs (hi-tech products and radio) for the Soviet Union. With the changes on the

³² *Industrial restructuring in the Baltic Countries: Large-scale privatisation, new enterprise networks and growing diversity of corporate governance*, CERNA, Centre d'économie industrielle Ecole Nationale Supérieure des Mines de Paris, Communist Economies and Economic Transformation vol. 7, no 4, 1995, p. 16-17

³³ Trade union representatives estimation.

labour market there were social changes: Latvians took up jobs mainly in the state institutions, Russians turned to trade. It is also important to note that there were no assistance programmes for those who suffered from the restructuring process. Also, employers were not obliged to provide the dismissed employees with any assistance. If there were any programmes these were individual cases.

It was very hard to start up a business at that time. The Latvians did not have the start up capital and it was extremely expensive to obtain loans or credits - the interest and financial conditions were changing very rapidly, the only valid regulations were Labour Law regulations. Trade union representatives believe that there is a tendency “*when a foreign investor takes over a company he divides it into many branch offices and they care for profits and not for people. The example of it can be division of LAUMA to LAUMA Fabrics and to LAUMA Lingerie. Naturally there are dismissals*”. They are also convinced that the Latvian entrepreneurs are better for employees than the foreign investors.

Trade union representatives also underline that it is possible to observe “*creative forms of restructuring*” such as:

- establishing branch offices, daughter companies;
- relocation;
- reorganization of the company in order to eliminate trade unions;
- employment restructuring: the method is to dismiss and re-employ on worse conditions, i.e. lower wages, with no collective agreements in force.

Trade union representatives believe that consultations prior to the restructuring processes may help to avoid exaggerated demands and work out effective solutions in the bottom-up manner. Moreover, they stand at the position that sometimes restructuring is an inevitable process, but the employer has to make sure that the employees’ rights are protected.

Forestry sector restructuring

Approx. 40% of Latvian forestry products are exported, mainly to Europe. There are 6000 trade union members from among approx. 25 000 employees (the detailed statistics are missing). At the moment there is a dual ownership structure: state-owned entities and the ones owned by private individuals. There have been 3 big reorganizations of the sector:

- when production was separated from the forestry sector;
- when the state-owned forests were separated;
- optimalization of the forestry industry.

While forestry and industry separation was taking place, there were conflicts over resources, there was no appropriate regulation created at that time and some deals had been concluded before the legal regulation was passed. Measures introduced during the process of

restructuring included pre-pension measures such as early retirement schemes and “bridge” pensions.

During the process of restructuring trade unions lost some members as some people left the forestry sector; officially only 50 people were dismissed. At that time 90% of the forestry sector was unionised and it helped employees to keep their jobs. Employment offered in the daughter enterprises was not always taken up: it turned out that the fact that people had to spend more time on commuting to work was perceived as a negative factor and hindered mobility.

There are good perspectives for the future of the forestry sector:

- it is a sector with long, well-rooted traditions and it gives solid perspectives for the future;
- there is a supply of wood from Bielarussia, Russia;
- at present new types of product and ways of manufacturing are being introduced;
- production methods become more advanced;
- subcontractor for other enterprises: production of accessories, i.e. for IKEA.

IV. SOCIAL DIALOGUE

a) Decline in trade union membership

During the period when Latvia was a part of the Soviet Union up until its declaration of independence in 1990, trade unions were present in all enterprises and organisations, and were grouped in sectoral unions. The number of sectoral unions fluctuated between 21 and 25 at various times. Union activities were led by the Latvian Central Trade Union Council. Today, trade unions act as 'social organisations' that express workers' views, and represent and defend their employment, social and economic interests and rights. Their activities are governed by the Law on Trade Unions, other relevant legislation and the unions' own articles of incorporation. Trade unions representatives perceive it as a success that there is a law in force that regulates trade unions operation and that the restrictions associated with establishing trade unions have been abolished.

In March 2004, 137 trade unions were registered - 1.7% of the total number of "social organisations". At present, about 20% of the Latvian workforce is unionised. It is important to note that trade unions are not present in the emerging sectors as well as in the new types of enterprises (SMEs).

Attitudes of companies towards the establishment of unions are varied. Trade union representatives say "*It is easier to start an enterprise than a trade union within an enterprise*". In the case of Storenso, a Finnish timber production company: there was an attempt to establish a trade union, but trade unionists were not able to enter the enterprise and therefore do not have any access to employees.

Companies that care about introducing good management practices not only do not object, but also actually facilitate the establishment of unions. Trade union representatives observe that sometimes, when management calls for creating a trade union, cooperation emerging from this invitation is usually very effective.

Smaller firms are more reluctant to see unions established. Furthermore, unions have not yet been established in several sectors (for example for road transport workers), while in some sectors several unions are active (for example in the metalworking and machinery construction sectors)³⁴. Trade union representatives point out that among the barriers to create trade unions there is a threat that if one becomes a trade union member, one will be dismissed. They also believe that creating a trade union is especially hard in the foreign-owned companies as the foreign employer wants to offer minimum level of required conditions as stipulated in the Labour Code. However, there are positive examples such as the IKEA case in

³⁴ <http://www.eiro.eurofound.eu.int/2004/03/feature/lv0403104f.html>

Riga: there are well-established and functioning trade unions and they have been getting a significant help from the Swedish trade unions headquarters.

Rotations of managers in foreign enterprises can also be seen from different perspectives. As a consequence there are poorer conditions offered for employees. Sometimes, on the contrary, this rotation helps in signing collective agreements to secure employment conditions. In some cases, i.e. Lattelecom, the “yellow” trade unions, supported by directors, were established. Here, a HR Director is also a boss of the trade union. In such cases most often the architecture for social dialogue within company exists, but there are not any regular meetings.

As far as industrial action is concerned there were only a few strikes in Latvia after it gained independence, the last strike being in September 2005. Trade union representatives believe that sometimes trade union activity prevents collective dismissals or other negative effects such as worsening work conditions. They note, however, that trade unions usually appear in the enterprises when problems appear, not when the situation is stable. In one company employees were not interested in unionisation when they were earning decent salaries. They only became interested when there was a proposal to reduce salaries; it is therefore a reactive rather than a proactive approach.

b) Tripartite relations in the social dialogue process

In Latvia after regaining independence in the 1990s, the state has played a very important role in setting the framework for industrial relations and social dialogue. On one side, the state acts as legislator by setting up the legal and institutional framework on social issues, including the functioning of industrial relations systems and the activities of social partners, on the other it acts as an employer.

The first attempt to create tripartite dialogue in Latvia was accomplished in 1993 when several tripartite councils were established (the Tripartite National Council of Employers, State and Trade Unions, the Tripartite Consultative Council on Labour Protection and the Trilateral Council on Social Insurance). These councils acted purely as consultative bodies. The signing of the new Tripartite agreement of the National Trilateral Co-operation Council on 30 October 1998 marked a new qualitative phase in the development of tripartite social dialogue. Four sub-councils operate within the institutional system of the National Trilateral Co-operation Council: the Social Insurance Council (from December 1st, 2003 - Sub-council of Social Security), Vocational Education and Employment, Labour Affairs, and Health Care. All sub-

councils are designed for consultations and exchange of information at preparatory stage of policy making³⁵.

On October, 1, 2004, a “tripartite agreement on socioeconomic partnership” was signed. The general objectives of the agreement are:

- promoting sustainable economic development in Latvia;
- creating favourable social conditions;
- strengthening democracy, civil society and a fair, open and successful state administration;
- respecting human rights, labour rights and environmental protection principles³⁶.

Trade union representatives believe that there are many actions that need to be taken in order to strengthen this dialogue. Officially social partners are involved, but it is a long way to find compromise in such issues as social protection, wages and/or budget. Trade union representatives feel that sometimes their opinions are ignored. They stand in the position that the architecture of the social dialogue is appropriate, but sometimes there is a lack of will for effective cooperation between trade unions and employers and add that there are 3 success factors for the effective social dialogue process: will, knowledge and culture.

Trade union representatives claim that among the subjects discussed at present the most important issues are new methods of work organization, part-time agreements, and transposition of directives and stress at the work place.

c) Collective agreements

There are approx. 2000 collective agreements concluded in approx. 30 000 enterprises. It is different in the SMEs sector: SMEs constitute 90% of all enterprises, but there are no collective agreements in this sector. At the same time sectoral agreements are concluded in the majority of sectors.

Trade union representatives believe that collective agreements that are concluded during the process of restructuring are enforced and executed after the restructuring process is completed. They are convinced that such agreements guarantee more security for employees.

³⁵ *Social dialogue and conflict resolution in Latvia*, European Foundation for the Improvement of Living and Working Conditions, 2004, <http://www.eurofound.eu.int/publications/files/EF0450EN.pdf>

³⁶ <http://www.eurofound.eu.int/2004/10/feature/lv0410102f.html>

Annex 1

Regional restructuring and enterprise start-up – SIA Gija in the Valka – Valga region

Regional restructuring: the Valka-Valga region

The Valka – Valga region is situated in the north-east location on the Latvian-Estonian border. Enterprises located in the region used to provide products and services for the Soviet Union, i.e. where 800 people were providing service for the Soviet tractors, now only 76 people are still employed. In the beginning of 90t's these enterprises have gone bankrupt. A similar situation concerned enterprises producing fertilizers – the workforce was reduced by 50%. Disappearing enterprises and lack of jobs resulted in many serious social problems such as alcoholism, unemployment and lack of motivation for job search. The situation was aggravated by the fact that at the time of the biggest bankruptcies there were no assistance programmes or other measures - they were only introduced 3-4 years ago. The consequence of such a situation is still visible today when there are families with serious problems such as unwillingness to work or to study. The Soviet army used to be stationed in the region as the city was (and still is) an important transport centre (especially railways).

Another feature of the region was that in Valka there used to be many branch offices of both Latvian and foreign enterprises. In the times of transformation, enterprises very often decided to close the branch offices to save the operation of Headquarters.

Latvian social partners extrapolate this situation to the whole country. They agree that massive reductions in employment have had a serious impact on living standards in the regions. The most sensitive group hit by these changes were employees at the pre-retirement age and those who had not paid social contributions. All these processes brought adverse and negative social effects.

Privatization

The success of the privatization processes greatly depended on the attitude of management – there were cases of management being proactive and privatising the enterprises in the right time (with or without participation of the employees) and of the management being passive and allowing for bankruptcy. To a certain extent this situation was caused by the fact that the Latvians seemed to believe that since independence was gained, the economy would be naturally regulated by market forces. There were no programmes that could help people, enterprises or regions in the time of transition in the beginning of 90's.

There were 2 types of enterprises that were restructured: government-owned and cooperative ones and these restructuring processes were the subject of 2 different legal regulations. There were 3 main types of privatizations: by employees, with the assistance of the Privatization Agency and through issuing shares. All these processes - apart from the sensitive sectors such as energy – have been completed 3-4 years ago. There were also very dynamic changes of the owners of privatized enterprises.

Another interesting feature of the privatisation process in Latvia was the fact that everything that was once nationalised was given back to the former owners. It resulted in a very complicated ownership structure, i.e. there are many cases of land belonging to one person and building built on this land to another person. Therefore this type of privatisation process is a very lengthy one.

- Employment challenges

The unemployment rate is estimated at the level of 8%. The most acute employment problems are the following:

- a significant share of unemployment in the age group of over 55 years old;
- lack of motivation to work, especially among long-term unemployed;
- the long-term unemployed people lack skills required by the labour market;
- a significant number of people, both highly skilled and with law qualifications are leaving the country to work abroad (mainly to the UK and Ireland), the estimation of the municipality of Valka are that approx. 20% of the labour force has left.

The future employment challenge is to ensure that the people from the region have the skills that allow the SMEs sector to develop. A couple of years ago negotiations with Nokia were conducted in order to establish an enterprise that would offer jobs for 500 people. At that point there was insufficient labour supply with the required qualifications. However at present the biggest challenge is actually to ensure that there is a sufficient number of people that could work in newly-established enterprises, not only their skills levels.

- Future challenges

Not only has the structure of the local economy been dramatically altered, but so have trade relations. Things have evolved from the monopolistic position and “clients begging” that this produces to the position when it is very important to care for clients and to acquire new clients. While taking into consideration that the private enterprises did not exist at all before the beginning of 90’s, the change of attitude is a big challenge.

Entrepreneurship development: new enterprises are being established in the region, sometimes it is done with the assistance of municipality that helps to look for investors. In 2005 there were 2 new enterprises established in Valka. The strategy of the region is to stimulate development of the SMEs sector. This strategy has been chosen as the Valka authorities believe that SMEs are more flexible and are able to more quickly adapt to changes on the market than the big enterprises, while big enterprises are always looking for more favourable conditions for operation and there is a real threat of relocations. At the moment, mainly production enterprises as well as trade and services are being established. There was also a call centre relocated from Riga to Valka – mainly involving female employment.

It is important to note that Estonia is currently a more favourable investment location: there is less bureaucracy, therefore it is easier to register a company and there is 0% tax on the reinvested-profits. However, Estonia experiences labour force shortages and there are everyday migrations of Latvians from Valka to work to Estonia, in Valga. The authorities of Valka do not perceive it as a problem as for them *“It is important that the region develops, and the development of the city will follow. Anyway, we perceive Valga-Valka as one city and it’s been like this since we gained independence. Two countries, one city we believe”*. For the moment people earn more on the Estonian side and there are still some differences in the prices of products and services between the two countries.

The Valga-Valka region has worked out its development plan. It comprises of long-, medium- and short- term perspectives and is based on developing:

- production and logistics – the region has always played the role of a transport corridor and the local authorities are convinced that maintaining this tradition would be an effective solution, however, sometimes investment decisions are undermined by the political factors which can halt implementation of the most efficient solutions;
- tourism: the Valga-Valka region is a transit area, the ambition of the local authorities is to attract tourists to make a stop on their way to St. Petersburg; in order to realise such a plan it is necessary to assure necessary infrastructure, i.e. hotels, products, tourists attractions; in the long run the region could become a holiday destination;
- education: the education development strategy was prepared while taking into consideration features of the Estonian education infrastructure (mainly business education) – Latvia is to provide higher education in the field of architecture, technology;
- quality of life: understood of making Valka a place where people want to live, i.e. building sport halls, a stadium, improving housing situation, etc. The authorities say: *“We want people from other cities to want to come to live to Valka”*.

It is interesting to note that the Structural Funds allocated for regional development and entrepreneurship development in the regions have been absorbed within the first 1-2 months as the biggest share of the funds was allocated for the city of Riga and the Riga region. The condition for future development is that there is more money allocated to the regions, realising so-called “polarization programme”.

In the opinion of Valka municipality the biggest threat for the stable development of the city and the region are relations with Russia as here “*economics get mixed with politics*”.

Enterprise start-up: SIA GIJA

Organization	SIA “GIJA”
Established	1991
Ownership	3 private share holders
Sector	Services
Structure	
Turnover	60 000 LVL in 2001 (8000 LVL in 1991)
Investment	Private funds
Employment	15 employees, including owners of the company
Unionisation	No trade unions

Reasons for establishing the company

Owners of the company used to work in Valga, the Estonian part of the city. After the collapse of the Soviet Union, the company collapsed and people of non-Estonian origin started to leave Estonia (there were 80% of Latvians working for the former company). The 3 SIA “Gija” shareholders were of the Estonian origin, therefore they decided to go back to Valka and establish their own company. The decision to continue the service business was easy to take as there was no such a service in Valka. At the same time Valka is located on a frequently used transport corridor.

Start- up process

The lot where the service premises were built up was rented and the shareholders were gathering their financial means to start up the activity. The privatisation process of the lot and premises is a typical example for the privatization processes in Latvia: the building was privatised in 1994, while the land in 1997. “*Privatizacionnyj departament*” of the municipality was involved in the privatisation process and the price was negotiated with them - finally they paid a little lower price than the initial price.

It is worth noticing that in the process of company start up was financed only by the owners of the company. They did not take any loans from the bank as the interest rate was as high as 10-20% a year. They invested their private money and reinvested the profit to finance the company development.

In the very beginning there were 6 founders of the company and 3 employees. Now there are 3 owners and 12 employees. The fluctuation of personnel is very low.

Future development

The company has been gradually growing, acquiring new equipment which was followed by the training programmes for the employees. Company owners believe that new methods of working and work organization always require relevant training programmes. Recently the computer diagnosis methods have been introduced and the company in applying for the European funds to extend its operation.

The management stresses that at the moment entrepreneurial and skilled people are leaving Latvia to work abroad, therefore the company owners believe that the biggest challenge is guaranteeing decent salaries and ensuring that the company has the employees with the right skills and attitude. At present their employees earn more than the average in the region. Another challenge is to guarantee relevant training programmes so the employees can acquire the required skills. In general there is a lack of good training programmes. The company has an agreement with the vocational school and their students are sent for internship programme to SIA Gija. There were cases that after the internship they were employed in the company. Another technique to ensure that the employees have the right skill is job rotation. It is the kind of internal training organized within the company.

The company owners believe that the success factors that made SIA Gija prosper so well now are education of the owners and their entrepreneurship. They also claim that they succeeded thanks to the fact that Latvia has gained independence and the support of their families. For the future they believe that their success will be determined by the quality of their services, new technologies and skills of their employees. The biggest risk according to them is that people are leaving Latvia, they are earning the money and spending them abroad, and as a consequence the demand for services can decrease.

Annex 2

Interviewed persons

Name	Organization and affiliation
Vilinis Kazaks Kristine Finka Valdis Poikans	LAK (UEAPME)
Vents Armands Krauklis	Mayor, Municipality of Valka
Andris Morozs	Owner, GIJA SIA
Arnolds Taukulis	Vice-president, LAT (Latvijas Tirgotaju asociacija)
Inara Orlovska	Apdarnieks (Arejie un ieksejie apdares darbi)
Daiga Ermsone Marcis Dzelme	LDDK (UNICE)
Peteris Krigers Iveta Ozola	LBAS (ETUC)
Zoja Semjonova	LASB (Latvian Post and Telecommunication Worker's Trade Union)
Aiga Stabulniece	Industrial Workers Trade Unions
Aivars Simansons	Forest Workers Trade Union

Annex 3

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Table 5. Top export commodities 2003	Graph 5. Cumulative FDI into Latvia 1999-2005
Table 6. Top import commodities 2003	Graph 6. Total investment growth rates in Latvia
Table 7. SWOT analysis of FDI in Latvia	Graph 7. Manufacturing output 2001-2004
Table 8. Key indicators of manufacturing by sectors in 2002	Graph 8. Increase of ICT graduates in Latvia
Table 9. Major foreign investments in ICT in Latvia	Graph 9. Internet users as % of population
Table 10. Basic Indicators of Registered Unemployment	Graph 10. Employment rate in Latvia 2000-2004
Table 11. Gross value added by activities, 1995-1999	Graph 11. Unemployment rate in Latvia, 200-2004
	Graph 12. Labour productivity improvement
	Graph 13. The share of the private and public sector in gross value added in Latvia, 1994-1999
Diagrams	Pictures
Diagram 1. Accrued foreign direct investment by industry, September 2004	Picture 1. Location of Special Economic Zones in Latvia
Diagram 2. Total FDI in Latvia by country, 2002	
Diagram 3. Forest industry share in Latvian export, 2004	

Table 1. GDP by sector

(increase over the corresponding period of the previous year, %)

	2003				2004			2001	2002	2003
	I	II	III	IV	I	II	III			
GDP	8.8	6.2	7.3	7.5	8.8	7.7	9.1	8.0	6.4	7.5
Agriculture ¹	4.5	0.7	-1.8	2.5	5.6	4.1	2.0	6.4	4.4	1.0
Industry	9.6	7.3	8.6	6.1	9.7	6.5	5.1	9.7	8.1	7.8
Construction	17.5	10.3	20.4	7.4	13.0	12.0	11.4	6.1	10.8	13.7
Trade ²	16.9	9.8	8.5	11.1	11.2	8.2	10.4	10.8	11.9	11.6
Transport and communications	7.8	7.6	10.1	10.3	8.3	10.9	17.0	9.5	3.4	8.9
Public services ³	2.5	2.7	2.8	3.5	4.5	4.1	3.5	1.7	2.3	2.9
Other services	4.5	3.2	3.4	6.2	8.3	7.9	10.4	10.6	5.4	4.4

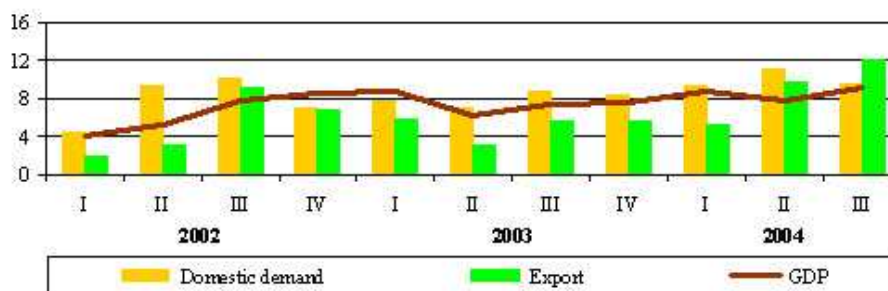
¹ Including forestry and fishing

² Including hotels and restaurants

³ Public administration including healthcare and education

Source: <http://www.am.gov.lv/en/stocholm/bilateral-relations?economic-affairs/>

Graph 1. Quarterly Changes in Real GDP and Major Expenditure Items (% of the corresponding quarter of the previous year)



Source: <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

Table 2.

Key Indicators of Economic Development

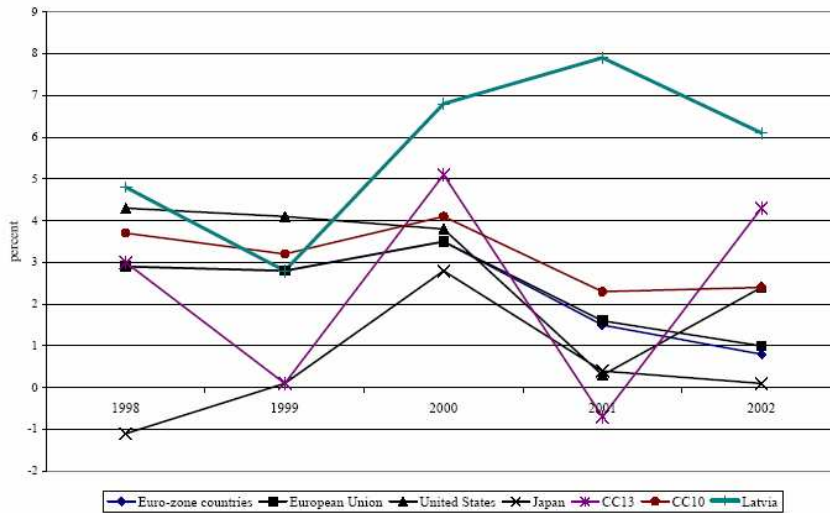
	2001	2002	2003	2004	2005 f
(increase over the previous year, in per cent)					
Gross domestic product	8.0	6.4	7.5	8.5	7.5
Consumer prices	2.5	1.9	2.9	6.2	5.0
(% of GDP)					
General government budget fiscal balance	-2.0	-2.3	-1.6	-1.1	-1.7
Central government debt	13.8	13.3	13.4	13.2	13.3
Current account balance	-7.6	-6.7	-8.2	-12.3	-9.8
Exchange rate, LVL per US dollar	0.628	0.618	0.571	0.540	0.520
Exchange rate, LVL per euro	0.563	0.583	0.645	0.671	0.703
Unemployment rate (rate of job seekers as % of economically active population, aged 15-74 years)	13.1	12.0	10.6	10.0	9.5

f - forecast of the Ministry of Economics

Source: *Macroeconomic development of Latvia*, Ministry of Economics of the Republic of Latvia, 2005. Graph 2.

Graph 2.

Graph A1. GDP (at constant prices) growth in selected countries and groups of countries in 1998-2002, percentage change over previous year



Source: Macroeconomics of Latvia in figures, 2003, Central Statistical Bureau of Latvia, Riga, 2003, p.100, 110

Table 3.

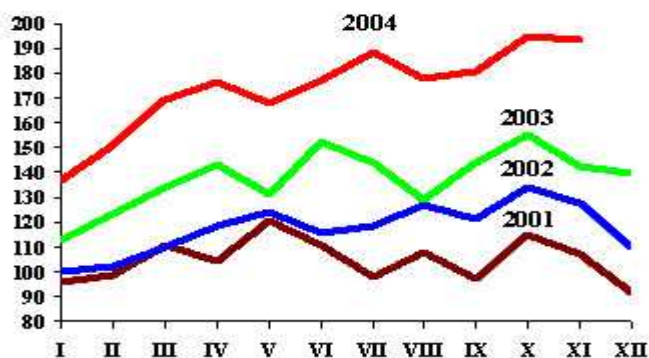
SWOT Analysis

We now analyse the Strengths, Weaknesses, Opportunities and Threats, which pertain to Latvian trade – these are illustrated in the diagram below

<p>Strengths</p> <ul style="list-style-type: none"> • Reputation for high quality goods in the CIS • Timber resource • Location for transit • Educated work force 	<p>Weakness</p> <ul style="list-style-type: none"> • Over reliance on commodity exports • Trades mainly low value added goods with West • Poor trade relations with Russia & CIS • No understanding of what 'Made in Latvia' means in West
<p>Opportunities</p> <ul style="list-style-type: none"> • Developing service sector • Expanded markets with EU entry • EU funding to improve agriculture • Russia joining WTO 	<p>Threats</p> <ul style="list-style-type: none"> • Difficult border situation with Russia which may get worse with EU • No point of differentiation with other Baltic states • Deterioration of timber prices • St Petersburg

Source: A Brand for the Nation of Latvia, Oxford Said Business School, 2003.

Graph 3. Commodity Exports (mln lats)



Source: <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

Table 4. Top 10 Export Markets as a percentage of the total market (2003).

Top 10 Export Markets in 2003	LVL th.	Percentage of Total
UK	256595	15,5%
Germany	245313	14,9%
Sweden	174204	10,6%
Lithuania	135144	8,2%
Estonia	108452	6,6%
Denmark	99029	6,0%
Russian Federation	88797	5,4%
The Netherlands	53686	3,3%
USA	47680	2,9%
Finland	44288	2,7%

Source: <http://www.liaa.gov.lv/eng/Trade/Statistics/>

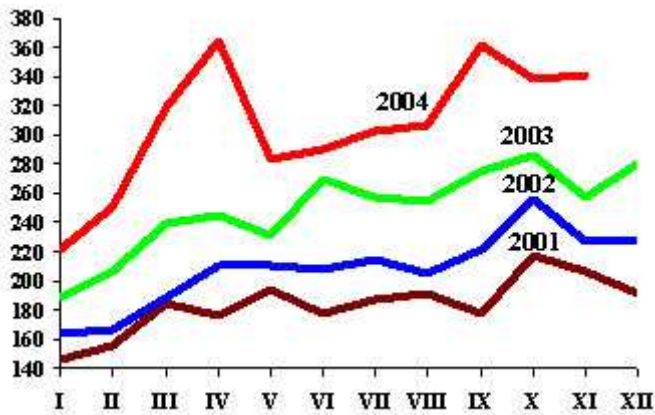
Table 5.

Top 10 Export Commodities in 2003[1]	LVL th.	Percentage of Total
Wood & Wood Products	581801	23,1%
Transport & Logistics [Services]	512176	20,3%
Textiles & Apparel	208670	8,3%
Metals & Metal Products	207423	8,2%
Tourism & Hospitality [Services]	126723	5,0%
Machinery & Electronics	116820	4,6%
Chemicals & Pharmaceuticals	96691	3,8%
Furniture	89735	3,6%
Food & Beverages	94104	3,7%
Financial [Services]	52754	2,1%

*Special trade statistics system (goods and services)

Source: <http://www.liaa.gov.lv/eng/Trade/Statistics/>

Graph 4. Commodity Imports (mln lats)



Source: <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

Table 6.

Top 10 Import Commodities in 2003	LVL th.	Percentage of Total
Machinery & Electronics	629649	17,9%
Transport Vehicles	313622	8,9%
Chemicals & Pharmaceuticals	300539	8,5%
Energy, Fuel & Minerals	296857	8,4%
Metals & Metal Products	277324	7,9%
Textiles & Apparel	193897	5,5%
Tourism & Hospitality [Services]	187205	5,3%
Food & Beverages	180656	5,1%
Transport & Logistics [Services]	171843	4,9%
Plastic & Rubber Products	153431	4,4%

Source: <http://www.liaa.gov.lv/eng/Trade/Statistics/>

Table 7.

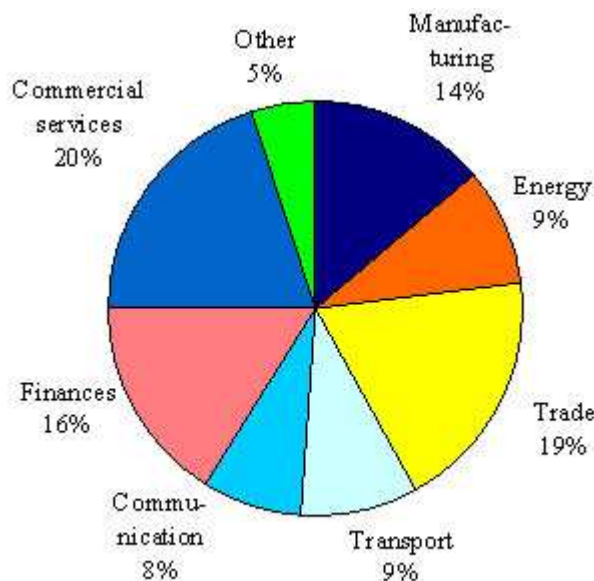
SWOT Analysis

We now analyse the Strengths, Weaknesses, Opportunities and Threats, which pertain to FDI – these are illustrated in the diagram below

<p><i>Strengths</i></p> <ul style="list-style-type: none"> • Strategic location • Understanding of Russian language and culture • Growth potential of markets • Low cost educated workforce • Riga: largest Baltic capital • Large financial sector 	<p><i>Weakness</i></p> <ul style="list-style-type: none"> • Perception of corruption • Bureaucracy • Unclear strategic direction • Infrastructure • Lack of entrepreneurial experience • Lack of raw materials / energy sources
<p><i>Opportunities</i></p> <ul style="list-style-type: none"> • EU and NATO funding • IT industry • Tourist Industry • Heavy and Light industry 	<p><i>Threats</i></p> <ul style="list-style-type: none"> • Russia developing St Petersburg as transit • Slowing growth after initial catch up • High competition for FDI within Eastern Europe

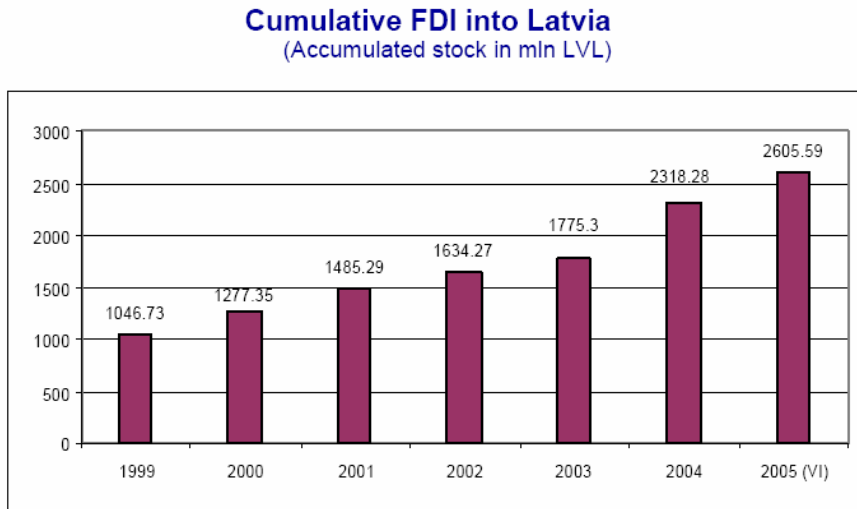
Source: A Brand for the Nation of Latvia, Oxford Said Business School, 2003.

Diagram 1. Accrued foreign direct investment by industry (at end of September 2004, per cent)



Source: <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

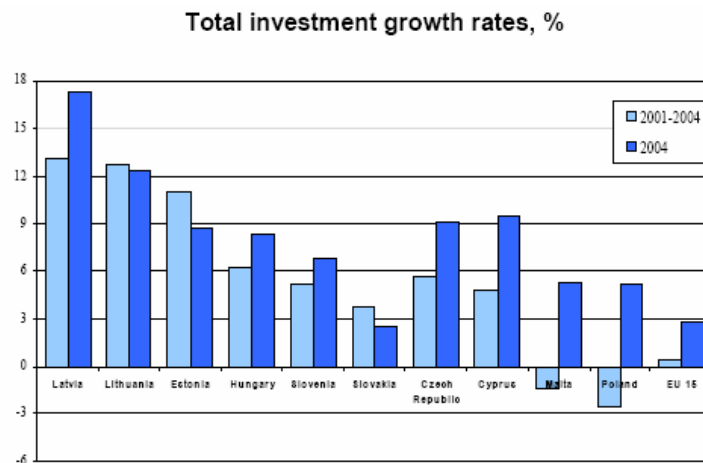
Graph 5.



Source: Bank of Latvia

Source: *Business environment and opportunities in the fastest growing economy of the EU*, Latvian Development and Investment Agency, 2005.

Graph 6.

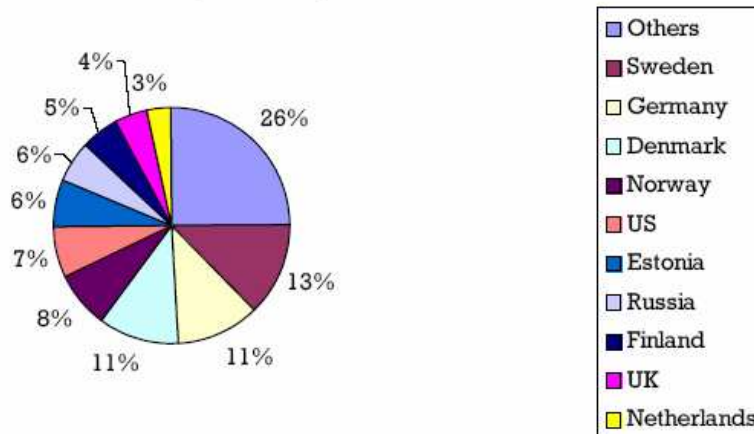


Source: Statistical Annex of European Economy, Spring 2005

Source: *Business environment and opportunities in the fastest growing economy of the EU*, Latvian Development and Investment Agency, 2005.

Diagram 2.

FDI by Country 2002



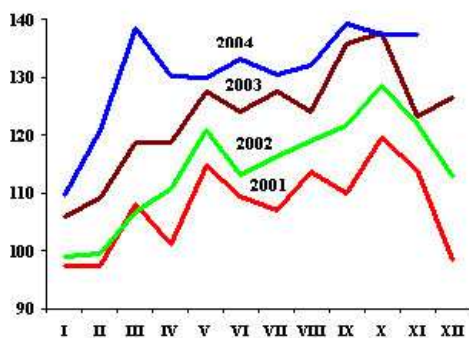
Source: *A Brand for the Nation of Latvia*, Oxford Said Business School, 2003.

Picture 1. Location of Special Economic Zones in Latvia



Source: <http://www.lowtax.net/lowtax/html/latvia/1lvfree.htm>

Graph 7. Manufacturing Output (average monthly output in 2000 = 100)



Source: <http://www.am.gov.lv/en/stockholm/bilateral-relations/economic-affairs/>

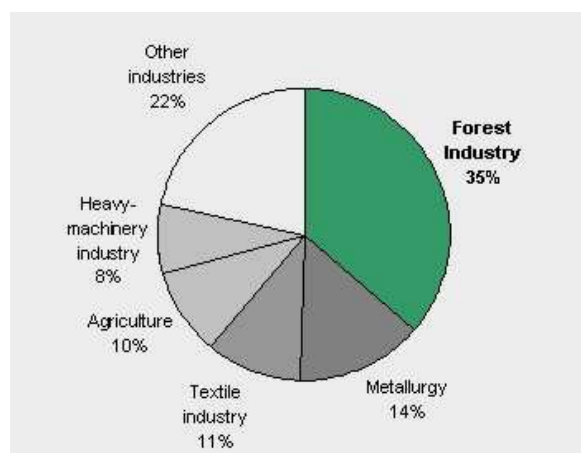
Table 8. Key indicators of manufacturing by sectors in 2002 (per cent)

	Structure (by added value)	Growth	Share of exports in sector's sales
--	-------------------------------	--------	---------------------------------------

Manufacturing – total	100	6.2	52.2
Food industry	24.7	6.5	21.8
Light industry	8.5	-0.4	79.1
Wood processing	20.1	5.9	68.2
Paper production and publishing	8.3	2.2	20.0
Production of chemical, rubber and plastic products	6.4	19.8	51.9
Production of other non-metallic mineral products	3.5	12.5	35.0
Production of metals and metalwork	11.3	6.9	76.4
Production of machinery and equipment	11.3	5.9	69.3
Other industries	5.8	10.4	68.1

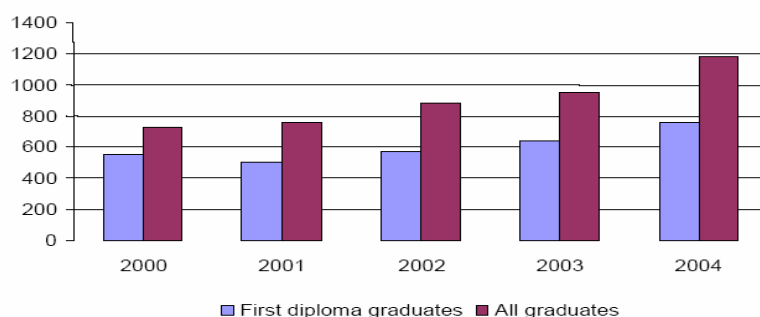
Source: <http://www.em.gov.lv/em/2nd/?cat=51>

Diagram 3. Forest industry share in Latvian export, 2004



Source: <http://www.latvianwood.lv/default.aspx?tabID=2&lang=2>

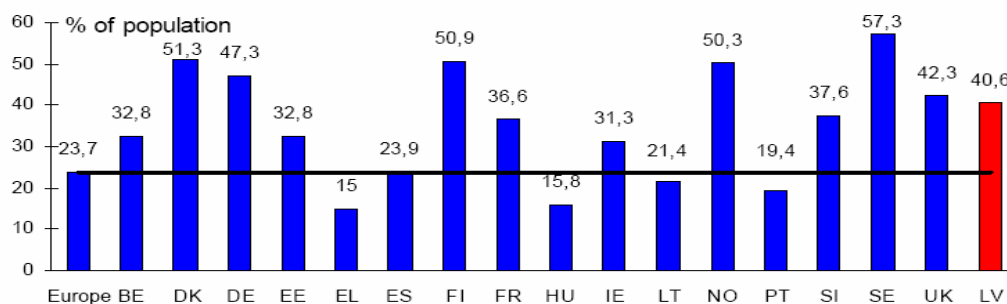
Graph 8. Increase of ICT graduates in Latvia



Source: *Business environment and opportunities in the fastest growing economy of the EU*, Latvian Development and Investment Agency, 2005.

Graph 9.

Internet users as % of population



Source: International Telecommunications Union , 2004

Source: *Business environment and opportunities in the fastest growing economy of the EU*, Latvian Development and Investment Agency, 2005.)

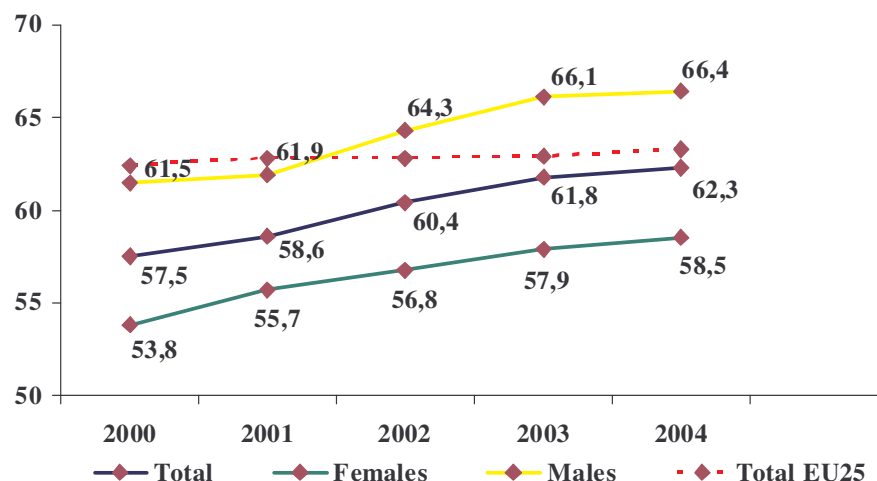
Table 9.

Major foreign investments in ICT

Company	Country	Activity
TeliaSonera	Sweden/ Finland	Acquisition of the national fixed telecommunications operator, IT and ASP services
Tele 2 Aktiebolag	Sweden	Acquisition of a locally-established mobile operator; mobile and fixed telecom, internet services
Telia Aktiebolag	Sweden	Shares in the mobile market leader; internet & data networking services
Microsoft	USA	Sales and customer services; HQ for the Baltic states
Exigen Group, Inc	USA	Acquisition of a local software house; software development for financial, communications
TietoEnator Financial Solutions	Finland/Sweden	Acquisition of a local software houses; software development for banking solutions and POC/POS systems

Source: *Business environment and opportunities in the fastest growing economy of the EU*, Latvian Development and Investment Agency, 2005.

Graph 10. Employment rate in Latvia 2000-2004



Source: http://w3.datanet.hu/~kopint/nfa/download/efs3/EES3_Alonia_Nikolajeva_The_Labour_Market_Peculiarities_in_Latvia.ppt

Table 10. Basic Indicators of Registered Unemployment

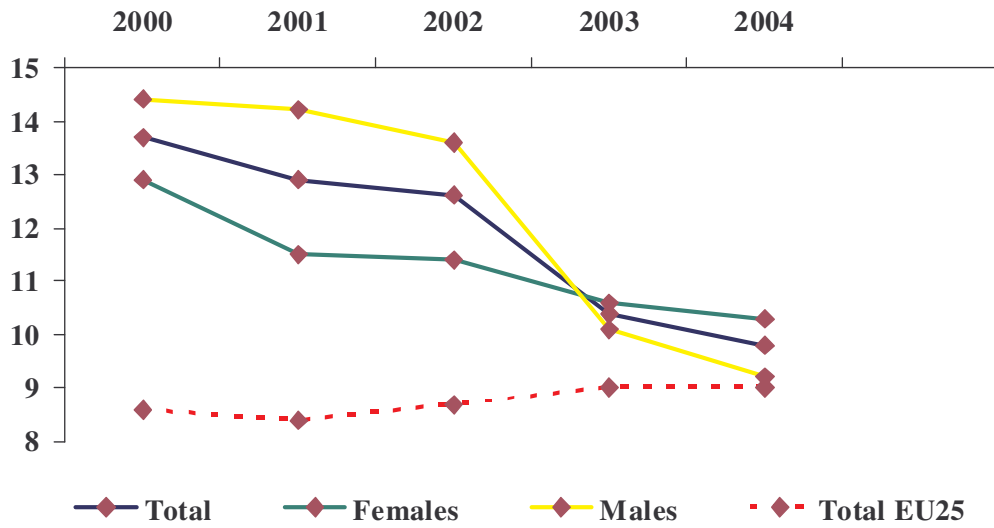
	1996	2000	2001	2002	9 months of 2003
Unemployed persons (end of period, thousand persons)	90.8	93.3	91.6	89.7	89.8
Long-term unemployed/total unemployed, %	31.2	29.0	26.6	26.4	26.7
Unemployed women/total unemployed, %	54.7	57.6	57.4	58.7	59.1
Unemployed young persons (15-24 years old)/ total unemployed, %	20.0	14.7	14.6	13.9	13.5
Pre-pension age unemployed ² /total unemployed, %	11.3	14.7	15.3	16.5	17.6

¹ Data of State Employment Service

² Women from 50, men from 55 till the pension age, according to the law "On State Pensions".

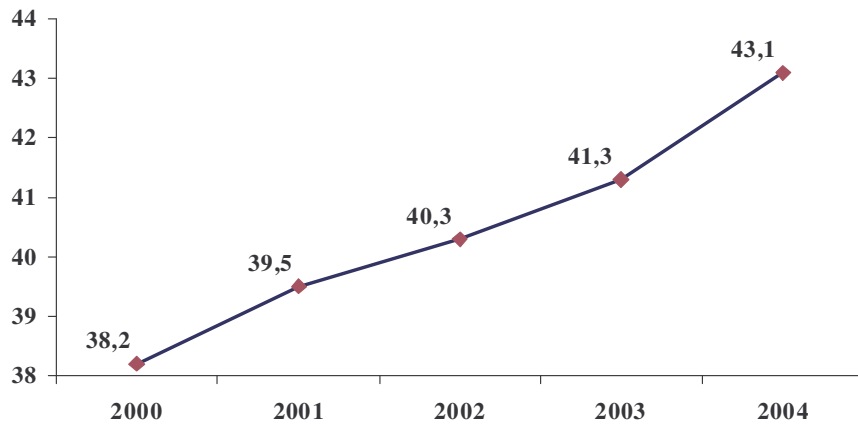
Source: http://www.unep.ch/scoe/archive/baltic/Background%20report-Latvia_Draft_rev15Jun04.doc

Graph 11. Unemployment rate in Latvia



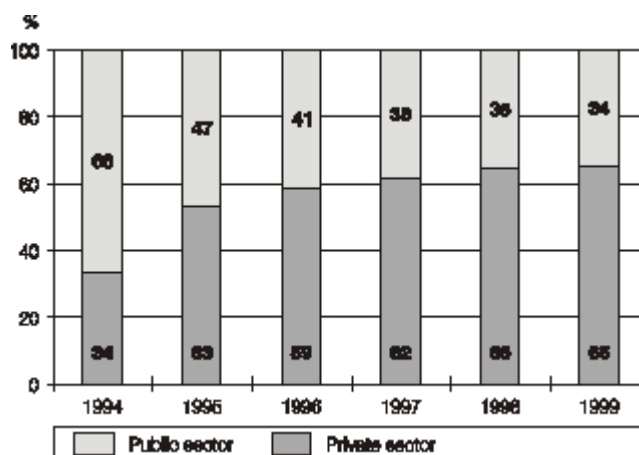
Source: <http://w3.datanet.hu/~kopint/nfa/download/efs3/EES3> Alona Nikolajeva The Labour Market Peculiarities in Latvia.ppt

Graph 12. Labour productivity improvement



Source: <http://w3.datanet.hu/~kopint/nfa/download/efs3/EES3> Alona Nikolajeva The Labour Market Peculiarities in Latvia.ppt

Graph 13. The share of the private and public sector in gross value added in Latvia



Source: *Report on the Economic Development of Latvia—Rīga*: Ministry of Economics of the Republic of Latvia, June 2000.

Table 11. Gross value added by activities

	1995	1996	1997	1998	1999
Gross value added at basic prices from the following activities:	53	59	62	65	66
Agriculture, hunting and forestry	88	91	91	91	91
Fishing	37	58	77	92	92
Mining and quarrying	35	74	85	95	95
Manufacturing	71	80	90	96	96
Electricity, gas and water supply	2	8	8	12	12
Construction	91	97	98	98	98
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	93	95	98	98	98
Hotels and restaurants	78	88	92	92	93
Transport and communication	25	36	41	42	43
Financial intermediation	73	80	84	82	83
Real estate, rental and business activities	49	56	67	69	70
Public administration and defense, compulsory social security	***	***	***	***	***
Education	4	4	4	7	8
Health and social work	15	22	22	26	27
Other community, social and personal service activities	39	53	58	62	63

Source: <http://www.tbr.ee/issues/vol20/latpriv.html>

Annex 4

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10. <http://www.eiro.eurofound.eu.int/2004/03/word/lv0310102s.doc>
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22. <http://www.mfa.gov.lv/en/policy/economic/business-opportunities/>
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