LATVIA'S REINDUSTRIALIZATION: INTERNATIONAL BACKGROUND AND DOMESTIC PROJECTS

Aleksandrs Fedotovs
Dr. oec., Prof., Riga International School of Economics and Business Administration
Riga, Latvia
e-mail: alexandrfedotov@yahoo.co.uk

Abstract

The aim of the paper is to analyse preconditions of reindustrialization of Latvia's economy, as well as potential contradictions of this process. Economic development of Latvia since regaining national independence had been featured by continuously declining share of manufacturing in national economy. In 1997–2007 no country in Europe experienced as rapid deindustrialization as Latvia. Public recognition of urgent need for restoration of production sector came essentially late. Ultimately, an official document, "Guidelines on National Industrial Policy of Latvia", was approved in 2013 by the Cabinet of Ministers. The first among the targets determined by the document is to raise the share of manufacturing in Latvia's GDP to 20% by 2020. As demonstrated in paper, Latvia's National Industrial Policy document is in line with worldwide renaissance of interest in industrial policy. Apprehension appears, however, that this project of reindustrialization of Latvian economy may prove forgotten. Traditional statements concerning inverse relationship between economic growth and share of manufacturing in GDP are verified in regard to the Baltic states. It is argued in the paper that further decline of manufacturing's share in national output is not unavoidable. In regard to economic policy, need for a more active role of government in reindustrialization process is advocated. Simultaneously, some questions on compatibility of reindustrialization with other goals of economic policy are raised. Research methodology is based upon application of economic theory, analysis of literature and official documents, comparison of statistical data, and author's own calculations.

Keywords: industrial policy, manufacturing, industrialization, economy of Latvia, economy of the Baltic States, GDP.

1. INTRODUCTION

In a decade only (1997 – 2007), the share of manufacturing in GDP of Latvia dropped from 25.3% to 13.6%. In no country of Europe had the share of manufacturing decreased so rapidly within such a short time. As a result, the percentage share of manufacturing in GDP of Latvia proved to be one of the lowest in Europe. Latvia had become also a country with one of the least volumes of industrial output per capita among all EU member states.

There is every reason to believe that unjustified drastic deindustrialization was among the main factors of extremely poor economic performance of Latvia during the global economic crisis. Unfortunately, only then the need for restoration of production sector of national economy was admitted. Calls to revive national industry came into fashion under the situation of economic crisis, in pre-election campaigns in particular. The time came when economists and politicians returned to admitting importance of the production sector (first of all, manufacturing) and pointed out its role in ensuring international competitiveness of Latvia. With big delay it had been stated also in official editions that the distorted pattern of national economy proved incapable of supporting sustained economic development (Ministry of Economics, 2009). Ultimately, an official government document, "Guidelines on National Industrial Policy of Latvia", was prepared (Ministry of Economics of the Republic of Latvia, 2012). In May, 2013, it was approved by the Cabinet of Ministers.

Renaissance of interest in industrial policy can be observed worldwide in recent years (Warwick, 2012; Reis, 2012). National industrial policy documents have been produced and adopted in a number of countries of the world, from India to Uganda and Rwanda. Latvia's National Industrial Policy document seemed to be in line with this global trend. It is appropriately therefore to consider conditions, problems, and prospects of possible reindustrialization of Latvian economy.

2. A NEW TURN IN ECONOMIC DEVELOPMENT: REINDUSTRIALIZATION?

It is considered almost a commonplace conclusion in economics that share of manufacturing in GDP and in total employment use to decline along with rise of a country's economic development level. This statement is supported by some research on correlation between GDP per capita and share of manufacturing in GDP. In particular, one can mention a research by McKinsey Global Institute published in 2012 and generalizing data on wide range of countries (McKinsey, 2012). The research shows that before average development level is reached in a national economy (around USD 10,000 per capita in 1990 dollars), industrialization and urbanization processes go ahead, resulting in rapid increase in manufacturing's share in GDP up to 30 – 40%. However, along with further increase in per capita GDP, as high income level is attained, national economy turns into services economy and share of manufacturing in it consistently declines, dropping to 10% or even less (Figure1).

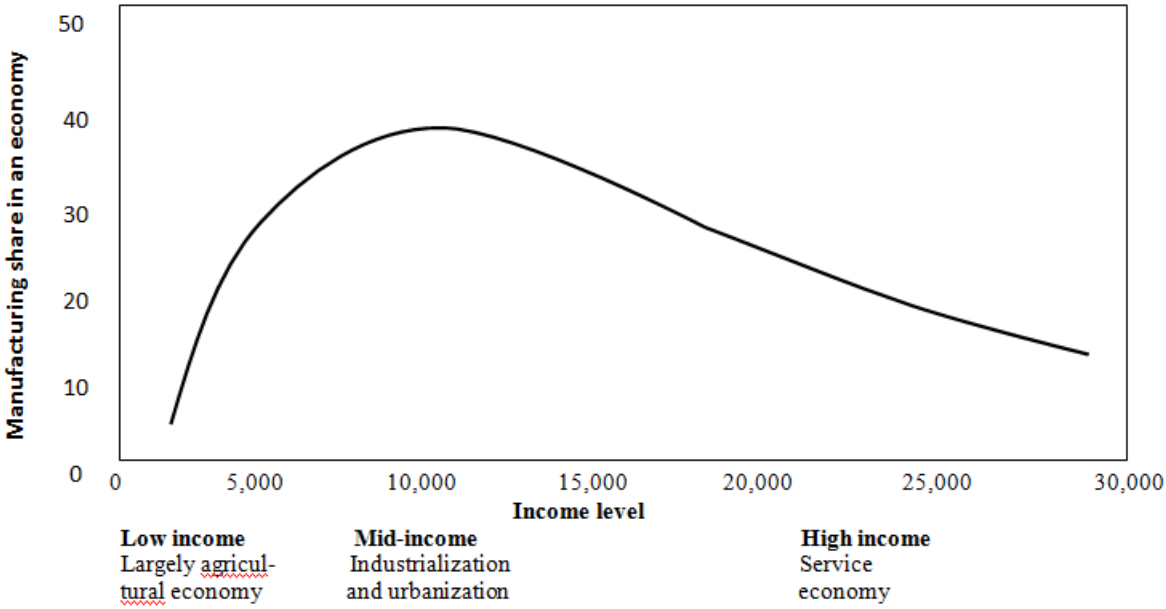

Figure 1. Relationship of GDP per capita and share of manufacturing in GDP (with income level measured in 1990 US dollars per capita)
Source: McKinsey, 2012; Novie zakoni mirovoi indusrii, 2012

Questions may be reasonably posed: how long such a trend will continue, to what an extent the share of manufacturing in national economy can decline, and can't it start increasing again from a certain point? Author tried to verify the above-mentioned conclusions of foreign research on the basis of data on economies of the three Baltic states – Estonia, Latvia, and Lithuania. Table 1 shows dynamics of GDP per capita in relation to the share of manufacturing in GDP of the Baltic states in 1997 – 2011. It must be noted, however, that for the period in question, data on manufacturing are including energy sector. Comparison with earlier period proves more complicated since in years preceding 1997 Eurostat data reflected manufacturing together with construction.

Initially, dynamics of manufacturing's share in GDP of the Baltic states during 1997 – 2009 will be observed (Figure 2). To remind, the period in question was for the three Baltic states a time of rapid economic growth before severe global economic crisis. As can be seen, before the crisis share of manufacturing in the Baltic states' economies was consistently decreasing.

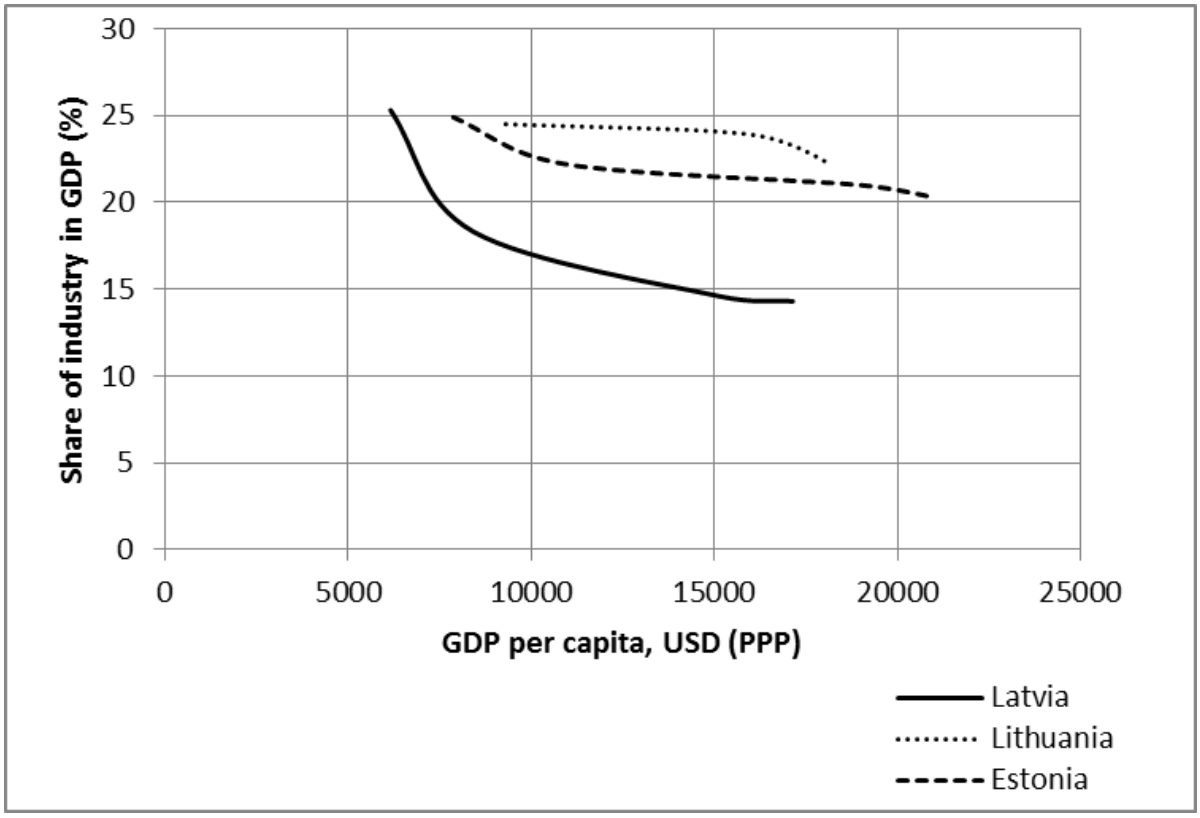

Figure 2. GDP per capita and share of industry in GDP of the Baltic states, 1997 – 2007
Source: produced on the basis of Table 1

Decline of manufacturing's share in national economies of the Baltic states began immediately after regaining of national sovereignty in the beginning of 1990s. It does not prove possible to directly link this process with changes in per capita GDP (as is demonstrated in the above-mentioned McKinsey Global Institute research). Firstly, GDP per capita levels in the Baltic states by the early 1990s had hardly reached 10,000 USD (in 1990 dollars). Secondly, the main direct factor that determined destroying of industry in the Baltic states proved political one. Namely, it was reorientation of the Baltic economies towards the West, combined with widespread hostile attidude to big industry since the latter was perceived a heritage of the Soviet rule. Moreover, Latvia was outstanding – not only among the other Baltic states, but even in Europe as a whole – for especially rapid deindustrialization.

Table 1

Relationship between GDP per capita and share of manufacturing in GDP of the Baltic states, 1997 – 2011

		1997	2001	2006	2007	2008	2009	2010	2011
Lithuania	GDP per capita (USD, PPS)	…	9 306	15 993	18 169	19 212	16 596	17 333	19 125
	Share of manufacturing in GDP (%)	23.5	24.5	23.9	22.2	21.5	20.4	22.1	24.5
Estonia	GDP per capita (USD, PPS)	7 871	10 919	18 927	20 971	20 672	17 886	18 539	20 379
	Share of manufacturing in GDP (%)	24.9	22.2	21.0	20.3	20.3	19.6	23.1	23.9
Latvia	GDP per capita (USD, PPS)	6 163	8424	15 105	17 134	17 018	14 183	14 407	16 818
	Share of manufacturing in GDP (%)	25.3	18.3	14.6	14.3	14.1	14.0	16.7	19.3

Source: Europe in figures, 2012; Eurostat; www.imf.org

Table 2

Share of industry in GDP, 1997 – 2011

Country	1997	2000	2002	2004	2005	2006	2007	2008	2009	2010	2011
Norway	32.5	37.8	33.4	35.1	38.2	39.9	36.8	39.8	33.4	35.1	36.4
Czech Rep.	33.0	30.4	29.2	30.7	30.1	30.5	30.8	29.6	29.2	29.3	31.1
Finland	27.4	28.4	27.5	26.3	25.8	26.8	26.8	24.8	21.1	22.5	20.9
Germany	25.1	25.3	24.7	25.3	25.4	26.1	26.5	25.7	22.4	23.8	26.2
Poland	26.1	24.0	22.3	25.2	24.7	24.7	24.5	24.3	24.3	24.5	25.5
Ireland	33.1	34.1	34.1	27.2	25.0	23.9	24.0	24.1	26.4	25.9	28.1
Sweden	25.1	24.5	23.3	23.2	23.3	23.2	22.9	21.6	19.3	20.9	20.5
Lithuania	23.5	23.6	23.3	25.7	25.2	23.9	22.2	21.5	20.4	22.1	24.5
Estonia	24.9	22.0	22.5	21.9	21.5	21.0	20.3	20.3	19.6	23.1	23.9
Denmark	20.9	21.3	20.4	19.4	20.1	20.4	20.0	20.1	17.5	17.6	17.5
Netherlands	20.6	19.3	18.4	18.5	18.8	19.1	19.1	19.8	17.8	18.5	18.7
Belgium	23.5	22.0	20.7	19.7	19.2	18.9	18.5	17.6	16.2	16.4	17.0
UK	24.9	22.1	19.4	17.3	17.1	17.1	16.5	16.2	14.9	15.5	16.5
Latvia	25.3	17.6	17.4	16.5	15.6	14.6	14.3	14.1	14.0	16.7	19.3
France	18.4	17.8	16.6	15.5	15.1	14.5	14.3	13.7	12.5	…	12.6
Greece	13.9	13.9	13.3	12.3	13.0	12.8	12.5	13.4	13.6	14.4	13.5

Source: Eurostat

In no European country had manufacturing's share in economy dropped as drastically during 1997 – 2007 as it had in Latvia. To compare, in 1997 the share of industry in Latvian economy (25.3% of GDP) was similar to that in most European countries or even exceeded it. In the following decade, however, this share shrunk by one half. As a result, the share of manufacturing in Latvia's GDP has become one of the lowest in Europe. In fact, by 2007 only Luxembourg and Cyprus had less proportion of manufacturing in their national economies. Furthermore, the share of industry in GDP of Latvia continued to slowly decline and dropped to 13.5% (together with energy sector) in 2009 (LR Ekonomikas Ministrija; LR Centrālā Statistikas pārvalde, 2010). Even assuming that decrease of manufacturing's share in national economy is in line with global trend, in Latvia this process looked unnecessarily fast and too painful.

However, actual statistical data for recent years let to doubt the statement on inevitable decline of manufacturing's share in economy. As Table 2 shows, there are countries in which share of manufacturing in GDP does not decrease (at least from 1997), e.g., Germany and Norway. In some other countries, such as Ireland, the share of manufacturing had stopped decreasing and started to increase just before the global economic crisis. And finally, during the crisis, in 2009 – 2011, increasing share of manufacturing in GDP is observed in most European countries. In regard to the Baltic states, this phenomenon is illustrated by Figure 3.

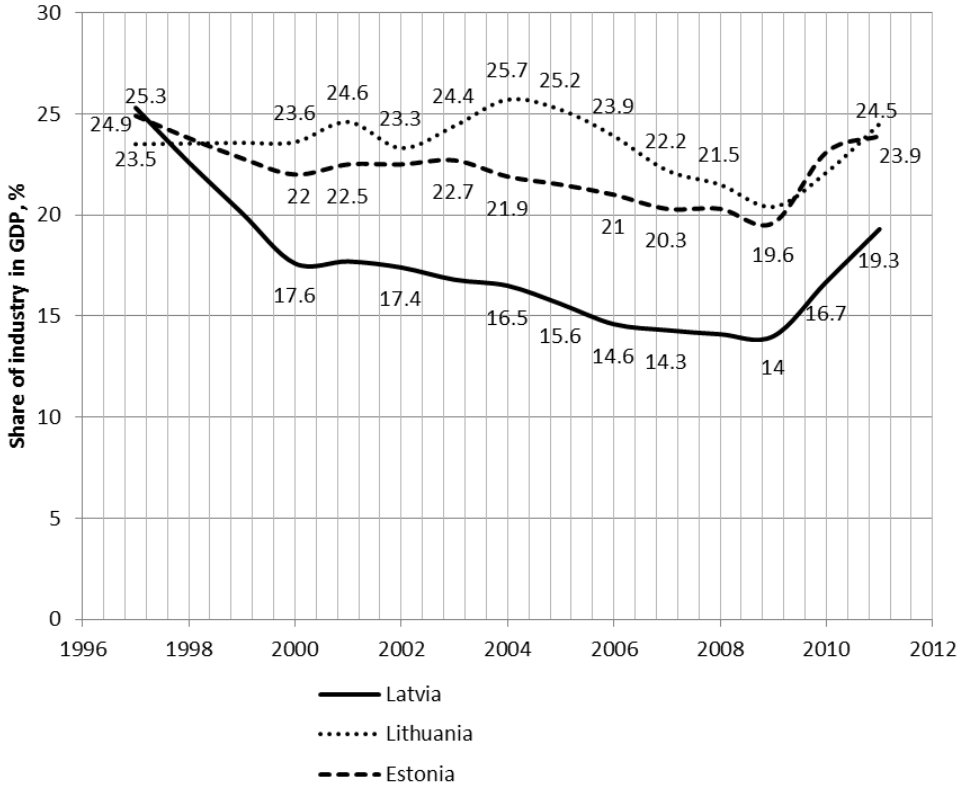

Figure 3. Share of industry in GDP of the Baltic states, 1997 – 2011
Source: produced on the basis of Table 1

Several explanations for such a phenomenon can be suggested:

1) under the crisis, services sector shrinked more drastically than industry; as a result, the share of manufacturing in GDP somewhat increased;
2) interest for domestic production sector revived in some countries (including Latvia) under the circumstances of crisis;
3) possible statistical tricks.

In any case, statistical data for 2009 – 2011 do not fit the simplified picture of consistently declining share of manufacturing in GDP along with economic growth. Similarly, these data do not support the conclusion about stable inverse relationship between GDP per capita and manufacturing's share in GDP. Returning to Table 1, it is possible to argue that in the Baltic states' economies relationship between the two variables – GDP per capita and share of manufacturing in GDP – after 2007 becomes chaotic and disputable. This can be seen in Figure 4, in which, as compared to Figure 2, the observation period is expanded to 2011.

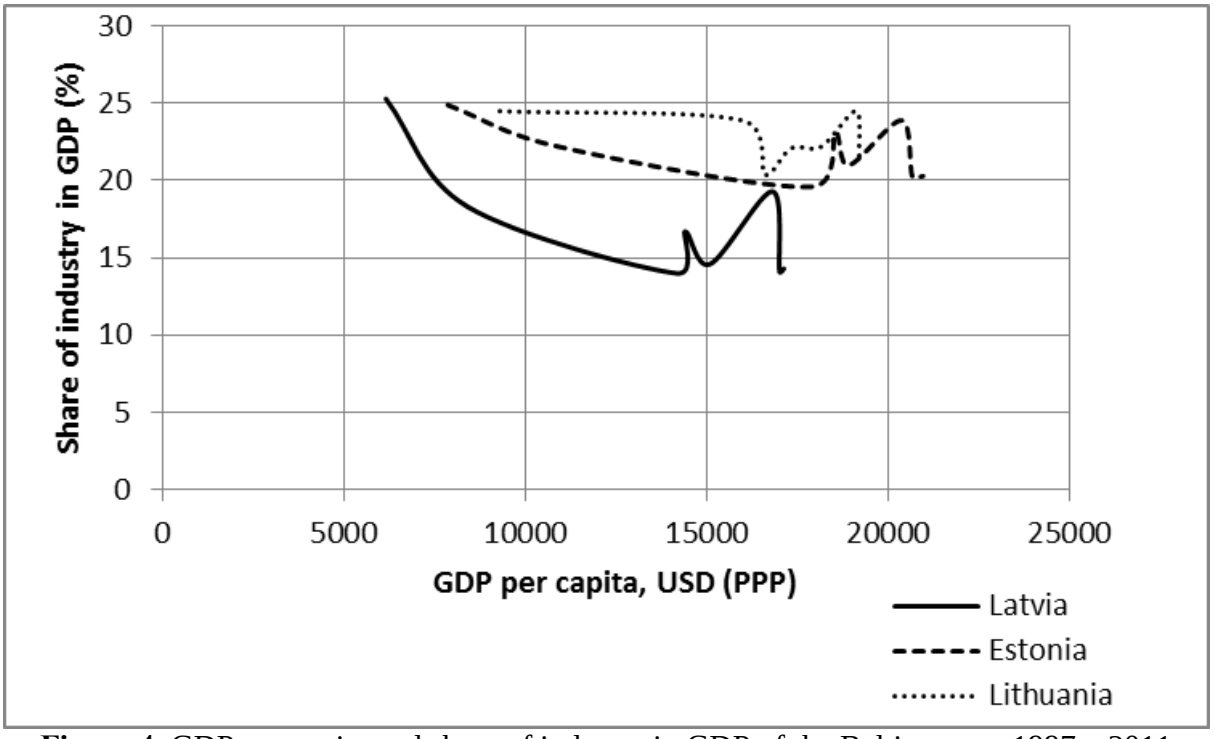

Figure 4. GDP per capita and share of industry in GDP of the Baltic states, 1997 – 2011
Source: produced on the basis of Table 1

In the 1st half of 2012, share of manufacturing in GDP of Latvia was said to reach 15.3% (Pavļuts, 2012). The most essential question, remains, of course, whether it is just a short-term fluctuation or an evidence of a turn in economic development? Will the share of manufacturing in GDP continue to grow or the process will reverse when economic growth resumes and the services sector would again grow faster than the production sector? Nonetheless, the continuous and unavoidable decline of manufacturing's role in national economy does not look now as fatal as it had been believed.

3. IMPLICATIONS FOR POLICY

The aim of industrial policy in Latvia promulgated in the "Guidelines on National Industrial Policy of Latvia" was to promote structural changes in economy in favour of production of goods and services with higher value added, namely by increasing the role of industry, modernizing industry and services and sophistication of exports (Ministry of Economics, 2012).

In order to reach the aim, the following targets were set to be reached by 2020:

- to increase the share of manufacturing in GDP to 20%;
- to raise productivity in manufacturing by 40% as compared to 2011;
-to increase volume of output in manufacturing by 60% as compared to 2011;
-to increase investments in research and development to 1.5% of GDP (Ministry of Economics, 2012).

Latvia was not unique in respect to renewed attention towards industry. Resurgence of interest in industrial policy is being observed worldwide in recent years, to great extent as a response to the global economic crisis. National industrial policy documents have been prepared and adopted in a number of countries of the world in recent years. For example, India's *National Manufacturing Policy* document covering time period until 2022 was adopted in 2011 (National Manufacturing Policy, 2011); *National Industrialization Policy Framework* for 2011 – 2015 including vision of the country's industrial development to 2030 was published in Kenya (Ministry of Industrialization, 2010); *National Industrial Policy Framework* setting a goal to intensify long-term industrialization process of the country, was produced and implemented in the Republic of South Africa (Department of Trade and Industry, 2007); National industrial policy documents exist in Rwanda

(Rwanda National Industrial Policy, 2011), Uganda (Ministry of Tourism, Trade, and Industry, 2008), and other countries. Thus, Latvia's National Industrial Policy document seemed to be in line with global trend.

Moreover, it seems interesting to point out some parallels appearing between National Industrial Policy of Latvia and India's National Manufacturing Policy. For instance, Latvia's National Industrial Policy envisages raising manufacturing's share in GDP to 20% by 2020; in its turn, India's National Manufacturing Policy supposes to reach 25% share in 2022. Both programmes point out creating industrial zones as one of major tasks; similarly, both include objectives of increasing employment (Ministry of Economics of the Republic of Latvia, 2012; National Manufacturing Policy 2011).

Undoubtedly, industrialization, if it takes place, has to be carried out under new economic reality of the 21st century, on new technological basis and in other directions than industrialization known in the previous centuries. Nevertheless, the main hopes related to industrialization remain the traditional ones (McKinsey Global Institute, 2010; McKinsey Global Institute, 2012):

- economic growth (measured primarily by GDP growth);
- raising employment;
- growing productivity.

However, each of these expectations deserves special comments.

Economic growth. One should remember that under generally used statistical methodology the main part (60 – 70%) of GDP in modern economy is represented by the terciary (services) sector. Consequently, the services sector makes up the biggest fraction of GDP increase while manufacturing's contribution to overall progress of national economy looks much more modest. This phenomenon displayed itself quite clearly in rapid economic growth of Latvia during the pre-crisis period when the bulk of economic growth in the country was provided by the services sector. Therefore, expansion of the manufacturing sector would not result in drastic acceleration of GDP growth, at least in the short run.

Raising employment. Similarly, the services sector is, as known, the main employer in modern economy. Manufacturing, given its comparatively modest share in total employment, would not be able to provide as big increase in number of jobs as one might expect (McKinsey Global Institute, 2010).

Growing productivity. One of essentially disputable assertions of modern economic statistics is that productivity proves higher in the services sector than in manufacturing. Statements of such kind were regularly repeating in Latvian statistics and official documents; moreover, advantage of the services sector over manufacturing in this respect was believed to consistently increase. For instance, one could find in the semi-annual "Reports on Economic Development of Latvia" that productivity level in financial services in Latvia was 2 times higher than in manufacturing (Ministry of Economics, 2007), 2.7 times higher (Ministry of Economics, 2008, June), and, ultimately, 4 times higher than in manufacturing (Ministry of Economics, 2008, December), In fact, even the phrasing itself looks somewhat strange as productivity is measured in a sector producing no tangible product. However, assuming the above-mentioned advantage of the services sector, it implies that (reflected in statistics) productivity growth due to progress in manufacturing would not prove as impressive as it could be from expansion of the services sector.

In addition, we should touch upon some other problems related to reindustrialization projects of the Latvian economy.

Industrialization and SME. There is one more problem in view of attempts to encourage expansion of manufacturing. Namely, it is a contradiction with one of the EU present-day dogmas – support and development of small and medium-size enterprises. This support is declared in numerous programmes at the EU and national levels. It is well known, however, that vast majority of micro-, small-, and medium-size enterprises in the EU as well as in Latvia are operating in the services sector and not in manufacturing. Hence, stimulation of further increase in number of SME would not contribute to industrialization. It means that the two goals: industrialization and support

to development of SME – may turn out mutually contradicting.

To intervene or not to intervene? Implementation of National Industrial Policy of Latvia sharpens once again the eternal question of government intervention in economic development. Should the government regulate the process of industrialization – in particular, by determining the priority sectors and industries that deserve support? Historical experience of successful industrial policies in many countries of the world, such as South Korea, Singapore, Malaysia, as well as Ireland and Finland, and other, testifies to expediency and necessity of a purposeful deliberate government regulation – even if it is not free of faults (McKinsey Global Institute, 2010; Petrin, 2012; Reis, 2012; Toh Kin Woon, 2013; Warwick, 2012). A differentiated approach to industries, selection of the most promising areas for future development and support granted to them seem especially needed at such a crucial moment as the intended reindustrialization of national economy. Avoiding its regulatory role looks unjustified for government in this situation. Ministry of Economics of Latvia, however, had chosen to evade direct regulation and pointing out priority sectors.

Unfortunately, the National Industrial Policy of Latvia during its preparation and official approval attracted only limited attention of scholars and public. The document had been several times criticized in press as being insufficiently elaborated; nonetheless, it could become a good starting point for further steps. After government change in 2014, official mentions of the document tend to disappear. Information concerning the National Industrial Policy was just briefly repeated in the "Report on Economic Development of Latvia" in December (Ministry of Economics, 2013); in the website of Ministry of Economics the information has not been renewed since September, 2013. Moreover, despite the declared commitment to reindustrialization, the government permitted bankruptcy of "Liepājas metalurgs", the only metallurgy plant in the Baltic states. The National Industrial Policy of Latvia has not caused any interest in the European Union. Apprehension appears therefore that the project of reindustrialization of Latvian economy may prove forgotten just a year after it was born. Experience shows that there is no lack of good declarations and officially approved government programmes in Latvia. Ability to implement these plans, however, seems doubtful.

4. CONCLUSIONS

- Recognition of urgent need for restoring production sector of national economy in Latvia has come essentially late.
- Statistical data on European countries do not support the simplified view concerning inevitable decline of manufacturing's share in GDP.
- Latvia's National Industrial Policy document proved to be in line with global resurgence of interest in industrial policy.
- Despite its drawbacks, the National Industrial Policy document could become a starting point for further steps towards reindustrialization of Latvian economy.
- Apprehension exists now that the National Industrial Policy document may prove forgotten by the new government of Latvia.
- It looks unjustified for government to evade its regulatory role at one of the crucial moments in development of national economy.
- Some problems may arise in regard to compatibility of reindustrialization with other goals of economic policy such as economic growth, employment, productivity increase, and support of small and medium-size enterprises.

REFERENCES

1. Department of Trade and Industry, Republic of South Africa. "A National Industrial Policy Framework" (2007), available at: http://www.thedti.gov.za (accessed 24 June 24 2014).

2. "Europe in figures: Eurostat yearbook 2012" (2012). Luxembourg: Office for Official Publications of the European Communities.
3. LR Ekonomikas Ministrija; LR Centrālā Statistikas pārvalde (2010). "Latvijas tautsaimniecība: Makroekonomiskais apskats". Nr. 3 (44). Rīga.
4. McKinsey Global Institute (2010). "How to compete and grow: A sector guide to policy", available at: http://www.mckinsey.com (accessed 3 March 2014).
5. McKinsey Global Institute (2012). "Manufacturing the future: The next era of global growth and innovation", available at: http://www.mckinsey.com (accessed 5 March 2014).
6. Ministry of Economics of the Republic of Latvia (2012). "Guidelines on National Industrial Policy of Latvia", available at: http://www.em.gov.lv (accessed 24 June 2014).
7. Ministry of Economics, Republic of Latvia (2013). "Economic Development of Latvia: Report". December 2013. Riga.
8. Ministry of Economics, Republic of Latvia (2009). "Economic Development of Latvia: Report". December 2009. Riga.
9. Ministry of Economics, Republic of Latvia (2008). "Economic Development of Latvia: Report". December 2008. Riga.
10. Ministry of Economics, Republic of Latvia (2008). "Economic Development of Latvia: Report". June 2008. Riga.
11. Ministry of Economics, Republic of Latvia (2007). "Economic Development of Latvia: Report". December 2007. Riga.
12. Ministry of Industrialization, Republic of Kenya (2010). "Kenya National Industrialization Policy Framework", available at: http://www.scribd.com (accessed 24 June 2014).
13. Ministry of Tourism, Trade, and Industry of Uganda (2008). "National Industrial Policy: A Framework for Uganda's Transformation, Competitiveness and Prosperity", available at: http://books.google.co.ug (accessed 20 June 2014).
14. "National Manufacturing Policy" (2011), available at: http://www.indiaenvironmentportal.org.in (accessed 5 March 2014).
15. Pavļuts, D. (2012). "Latvijas ekonomikai jāturpina eksporta un industrializācijas ceļš", available at: www.bizness.lv/Makroekonomika (accessed 20 March 2014).
16. Petrin, T. (2012). "Industrial Policy in Practice From design to implementation: the Slovenian Case", available at: http://www.em.gov.lv /em/2nd/?cat=30834 (accessed 20 June 2014).
17. Reis, J. G. (2012). "Competitiveness, diversification and the role of modern industrial policy", available at: http://www.em.gov.lv /em/2nd/?cat=30834 (accessed 21 June 2014).
18. "Rwanda National Industrial Policy – NIS Final draft" (2011), available at: http://www.scribd.com (accessed 10 March 2014).
19. Toh Kin Woon (2013). "Malaysia's Industrial Policy- Some Lessons", available at: http://www.em.gov.lv /em/2nd/?cat=30834 (accessed 21 June 2014).
20. Warwick, K. (2012). "Industrial Policy: Emerging Issues and New Trends", available at: http://www.em.gov.lv /em/2nd/?cat=30834 (accessed 24 June 2014).
21. www.eurostat
22. www.imf.org
23. "Novie zakoni mirovoi indusrii" (2012). Biznes & Baltia. 12 дек. (in Russian)