

# ECONOMIC GROWTH VS SUSTAINABLE DEVELOPMENT – THE CASE OF LATVIA

Ivars Brīvers

*BA School of Business and Finance*

*Riga, Latvia*

*E-mail: abrivere@td.lv*

**Abstract:** Latvia has experienced an extremely high economic growth of late years. The same time the present macroeconomic situation in Latvia has been evaluated as the worst in the European Union. Economic growth, which is measured by the increase of GDP, shows the increase of economic activities, and is in correlation with the welfare. Latvia can be considered as an example where there is a rather high discrepancy between the level of economic activities and the welfare of people – high growth with low development. Development is a broader process than economic growth, as well as welfare can not be measured only in monetary terms. The analysis of economic processes in Latvia shows, that the rapid economic growth in Latvia has caused serious problems from the point of view of sustainable development.

**Keywords:** Economic growth, sustainable development, welfare, social inequality, regional inequality.

## 1. Introduction

The economic growth in Latvia in the first years of the 21st century is incredibly high. The annual GDP increase since year 2000 has been no less than 6%, last three years it has been more than 10%. It may seem that the state of mind of Latvian people and their satisfaction with the government is outstanding. But the reality is just the opposite – the political instability in Latvia is very high and one may say that Latvia tastes deep political crisis, and though the economic situation can not be evaluated as a crisis in classical meaning, the situation in economy of Latvia can not be evaluated as satisfactory. The usually mentioned problem is rather high inflation. But there are some more important problems from the point of view of sustainable development – the relevant increase in social and regional inequality, the dramatic loss of infrastructure and rural environment, the lack of national capital, and first of all the exodus of Latvians, mainly young persons, that will cause the aging of population in the nearest future. Some consider that the next generation will be the last generation of Latvians.

The object of research, the results of which are presented in the article, is the structure of economic growth in Latvia in time period 1991-2007, trying to analyze the social, regional, technological and other aspect of economic growth. The goal is to make conclusions about the causes, why the present economic situation in Latvia cannot be evaluated as satisfactory from the point of view of sustainable development.

The paper attempts to present the analysis of economic processes in nowadays Latvia through finding the reasons of the rapid economic growth and the implication of it on other macroeconomic processes. The main methods of research were the analysis of statistic data, quantitative and qualitative comparison of growth process in Latvia and other European countries, qualitative analysis of economic problems of economy of Latvia, based on public opinion, expressed in mass media, and on own observations.

## 2. Economic growth and sustainable development

The causes and development of the processes in Latvia economy can be analyzed taking into consideration the transition process in post-socialist countries, which is rather unique in the history of economics.

At the beginning of the XXI century the increase of GDP is no more considered a main macroeconomic indicator and economic growth is not the main goal of the economy. This

results from the basic concepts of the UN, as the main goal of economy from a modern point of view is considered to be its sustainable development. A rapid economic growth hardly ever is sustainable.

The concept of the sustainable development leads back to the 70-ies of the XX century. In 1972 the so-called “Club Of Rome Report” (1) was published, in which the authors draw a conclusion, that, if the present trends in economy continue unchanged, the limits to growth on the Earth will be reached sometime within the next 100 years. Five years later American sociologist Fred Hirsch published his “Social Limits To Growth” (2), where he postulated, that rapid economic growth does not increase the moral welfare, because a man compares his standard of living not with his own in the past, but with the present standard of living of other his contemporaries.

These essays, though some don't consider them seriously, where among those, which caused changes in minds of the people about the goals of economy. In 1983 the World Commission on Environment and Development (WCED) was established by the United Nations. The report that WCED produced in 1987 – “Our Common Future” (3), advanced the concept of sustainable development - „...development that meets the needs of the present without compromising the ability of future generations to meet their needs”.

This definition does not explain the difference in the concepts “economic growth” and the “economic development”. As it is in the development of any system, growth is a necessary, but not a sufficient condition of the development.

Economic growth is an external notion, which indicates the increase of economic activities in some area. Development is a broader internal process. It includes raising living standards and poverty reduction. Economic growth may result in an improvement in the standard of living of a relatively small proportion of the population whilst the majority of the population remains poor. It is how the economic growth is distributed amongst the population that determines the level of development. The gap between the growth and development may appear also concerning production possibilities – if growth appears mainly from producing consumption goods it will lower production possibilities in the future. It is thus possible to have economic growth with no or little development. To investigate the economic development it is necessary to analyze the structure of the economic growth.

A big mistake in the present time Latvia is that these two concepts are considered to be equal.

Economic growth is measured by the increase of GDP. Economic development is more complicated process, which cannot be measured with one indicator. It is obvious; that each economy has its specific features and problems, and it is hardly possible to create a universal set of indicators, by which one can evaluate the eligibility of a certain economy to the criteria of the sustainable development. An economy should be evaluated not only by quantitative criteria, but also by qualitative expressions, which cannot be measured numerically. Another very important aspect is the “Three dimensions” of the sustainable development: environment – the basis, economy – the tool, social – the target. Still very often dimension of economy is considered as a goal, but other two dimensions only as the constraints, furthermore, environment frequently is considered only in the ecological aspect. But environment includes also political, cultural, religious, moral and other aspects.

### **3. Short chronological overview (revised from (4))**

Latvia's economy during the period of last eighteen years has gone through dynamic changes, which in a large degree are similar to that were noticed in all the countries of former socialist block during the transition process. This period can be divided into four steps:

Recession and substantial decrease of GDP during 1990-1993,

Stabilization of economy and slight increase of GDP during 1993-1999,

A rapid growth of economy and significant increase of GDP during 2000-2003 with low inflation, a rapid growth of economy and significant increase of GDP during 2004-2007 with high inflation and first symptoms of recession.

The significant decrease of economy after the collapse of Soviet Union and the socialist block is a common feature of economy in all the previous Soviet republics and socialist states in Europe. Economists still are searching for the most precise explanation of this phenomenon. There is a considerable correlation between the decrease of economy and the degree in which the economy of a particular state was integrated into the common economic system of Soviet Union and the socialist block. Latvia was a Soviet republic with one of the highest levels of economic development and perhaps of the most integrated one. That's why the decrease of economy measured by the level of GDP was perhaps the largest among the Soviet republics of European part of the former Soviet Union and socialist countries in Europe. The GDP volume in 1993 was only 52.6 % of that one in 1990, so generally speaking the living standard decreased twice. Only in 2004 the living standard measured by GDP per capita exceeded the level of 1990. So the assertion that Latvia's economy has been moving forwards faster than most of other former Soviet republics, for instance Belarus or Uzbekistan, if we take into consideration only the measure of GDP growth is not true.

**Table 1. Indicators of living standard and economic growth**

Year	Gross domestic product at constant prices of 2000 (Millions of Lats)	Annual growth of gross domestic product (%)	Gross domestic product at average prices of 2000 <i>per capita</i> (Lats)
1990*	6771.5	2.9	2542
1991*	5918.3	-12.6	2218
1992*	4018.5	-32.1	1512
1993*	3560.4	-11.4	1366
1994*	3638.7	2.2	1418
1995	3649.6	0.3	1469
1996	3790.7	3.9	1543
1997	4107.8	8.4	1688
1998	4302.3	4.7	1785
1999	4443.6	3.3	1859
2000	4750.8	6.9	2002
2001	5132.9	8.0	2180
2002	5465.1	6.5	2337
2003	5858.4	7.2	2519
2004	6366.8	8.7	2753
2005	7041.4	10.6	3061
2006	7902.9	12.2	3454
2007	8717.3	10.3	3831

*Source: Data of Central Statistical Bureau of Latvia (until 1995 - from earlier publications) (5).*

The explanation of changes in economy and living standard is more complex, and it cannot be measured only with GDP indicator. First we must say that the statistics of 1990 give only a conventional notion about the economy, because Latvia was a part of Soviet Union and it was hard to separate the activities that were mainly related to Latvia's economy from that were more related to other Soviet republics. The export and import statistics of this period gives only a rough idea about the heart of the matter. Among the reasons of the substantial decrease of economy there are at least two that gives an explanation, that the decrease of the living standard was not so large as the decrease of GDP. One reason is that a substantial part of

Latvia's economy during the Soviet period was the military industry. The wages of Soviet Army officers and military persons that were situated in Latvia also were included in the GDP of Latvia, as well as the industries that attended the Soviet Army. After the withdrawal of the Soviet Army this sector of economy disappeared. Another reason was that a notable part of economy moved to a shadow economy. During the period of institutional changes in Latvia's economy and legislation the legal system was far from perfect and for entrepreneurs and employees it was possible and gainful not to show all their income or to set it as a transfer payment. So the real decrease of economy perhaps was not as large as it was shown in the statistics.

To give the correct interpretation of Latvia's statistic data one must take into the consideration the fact that the decrease of economy was accompanied with a great inflation during the 1990-1993. That means that the inflation can be explained mostly by supply-side factors. Indeed - as Latvia doesn't have its own energy resources they should be imported. After the collapse of the Soviet Union the former Soviet republics, mainly Russia that imported gas, oil products, coal etc. to Latvia, sold it for the market prices, that were much higher than the prices of these products in the Soviet Union. The desultory growth of the price of energy resources caused a notable growth of production and transportation costs in almost all enterprises.

**Table 2. Indicators of inflation and currency performance**

Year	Annual inflation measured by CPI (%)	Annual inflation measured by GDP deflator (%)	Official exchange rate – period average (Lats per US dollar)
1991	172.2	162.6	...
1992	951.2	979.4	0.736*
1993	109.2	71.4	0.675
1994	35.9	38.3	0.560
1995	25.0	14.9	0.528
1996	17.6	15.2	0.551
1997	8.4	7.1	0.581
1998	4.7	4.4	0.590
1999	2.4	4.0	0.585
2000	2.6	4.2	0.607
2001	2.5	1.7	0.628
2002	1.9	3.6	0.618
2003	2.9	3.6	0.571
2004	6.2	7.0	0.540
2005	6.7	10.2	0.565
2006	6.5	11.1	0.560
2007	10.1	13.3	0.480

*Source: Calculations of author, based on data of Central Statistical Bureau of Latvia (5)*

*\* 1 Lats = 200 Latvian rubles*

The same time the high level of inflation was accompanied by a relevant change of the price structure. The prices grew faster in the service sector and not so fast in the production sector. As a result of it was the change of the structure of the GDP. In 1990 the service sector gave only about one third of the GDP, just three years later the share of the service sector was about two thirds. This unbelievably rapid change of the GDP structure can be explained partially by the previously mentioned reason – the change of the price structure, partially by that the decrease of the output in the production sector was bigger than in the service sector (the decrease in the construction sector was more than five times, very large it was also in

fishing and agriculture sectors, but the decrease in service sector was only about 20%). This must be taken into consideration when one looks at the statistic data of Latvia published in the first half of the nineties. Even in the middle of the nineties the base year was not the year 1990, as in most of the countries, but the year 1993, when the change of price structure has been taken place.

After the period of recession in 1994 a slight increase of GDP took place, which was followed by a decrease in 1995. This was the year when banking crisis took place. Latvia was one of the first post socialist countries, which met this problem. Bank "Baltija" which was the largest bank in Latvia in the beginning of nineties went to bankruptcy. It caused serious direct problems to a large part of population as well as enterprises and local governmental institutions. Later it took some time to return the people the confidence towards banks, but at present time this problem along general lines is solved.

The end of the nineties was followed by a slight increase of GDP, and the beginning of the third millennium came with a significant growth of economy measured by increase of GDP. This was a period, which generally can be characterized as a recession in the European economy, so the rapid growth of Latvia's economy may be considered as a surprise of some kind. The same time a rate of inflation was very low, so the real situation seems not concerning the economic theory.

Since the beginning of nineties the foreign trade balance in Latvia permanently has been negative with a tendency to enlarge. The self-regulating process of economy in this case reacts by changes in the monetary mechanism – the depreciation of national currency or the decrease of imports otherwise. In case of Latvia its national currency lats had a fixed exchange rate, but not connecting it to some other currency as in case of Estonia or Lithuania, for instance. Lats was connected to a currency board. In this case the monetary mechanism doesn't react immediately, but cumulates the problems, which spring out after some period of time. Seems that the same has happened in Latvia's economy and the joy about the rapid growth of economy accompanied by low inflation in 2000-2003 was groundless and premature, because the first half of 2004 came with a serious increase of inflation. From January 2005 lats is pegged to euro.

The situation that a significant part of capital resources in Latvia is owned by foreigners means that a notable part of profit is leaving Latvia and can be considered as a part of Latvian GDP but not Latvian GNP. The same time if we compare those two indicators we can see that until 2004 they did not differ significantly. The part of profit that was leaving Latvia was compensated by the income of Latvian employees, which got their salaries outside Latvia. Official statistics doesn't give us the exact picture, but the fact is that a notable part of Latvia's inhabitants are working as guest laborers in Ireland, Norway, Great Britain and other West European countries. After entering European Union the mobility of labor force has only increased and the inflow of foreign capital is accompanied by outflow of domestic labor force.

Generally speaking the economy of Latvia during the recent years has been developing in the most liberal way. It has caused such concomitants, as some kind of shock therapy effect on population, the increase of social inequality, but from the point of view of economic growth, taking into consideration the structural changes of economy, can be evaluated as successful. A controversial point is the survival of Latvian nation, but in the conditions of globalization this problem may be considered as one of little importance.

#### **4. The role of economic culture and education in the entrepreneurial environment**

Economic activities take place in a certain environment, and for an entrepreneur to succeed it is important to know this environment. But in case of Latvia it is necessary not only to know the environment, but also to create it, especially in the economic aspect. Some West-European economists in private discussions have mention as the main problem of economy of

Latvia not inflation or foreign trade deficit, but the awfully low level of economic culture in Latvia.

“Few cultural nations have so few written thoughts in the field of economics. Even translation from the work of other nations is limited. All this indicates that the broader society has little interest in theoretical concepts in economics or in economic policy. Economics is precisely what affects each and everyone’s personal interests, but people in Latvia consider economics something strange and interesting only to narrow specialists.” This is a quotation from the Latvian journal “Economists” (The Economist) in 1935 (6). Since this time the situation in Latvia has not improved, but has become much worse, even compared to the Soviet time. An average Latvian almost doesn’t have a notion of elementary economic laws. Such an environment with a very low economic culture sets different requirements to entrepreneurs as in countries with higher level of economic culture. The polls of entrepreneurs show, that knowledge is considered to be one of the less important things for a successful business. Such a business environment is not sustainable, and causes the increase of crime and other social problems. In such a situation the entrepreneur should be also a teacher, who will increase the economic culture in his surroundings. But to be able to do this, he needs to have a high economic culture himself. This can be ensured by studies of economic theory. The same time the amount of these courses in the study programs commonly is being reduced. Economic theory often is considered to be unnecessary or even cumbersome for a future entrepreneur or financier.

For time period of fifty years, when Latvia was a part of the Soviet Union, economy was performing without the fourth factor of production – enterprise. So after the collapse of the Soviet Union people didn’t have knowledge and practical skills in entrepreneurship. In the beginning of the 90-ies of the XX century most of newborn entrepreneurs of Latvia were orientated on profit maximization in a short-run. Since that time most of them have failed. Nevertheless until now profit maximization in short-run prevails. Obviously, such an approach is not sustainable.

Latvia has very good examples of Latvian entrepreneurs, who had a different approach – sustainability and social responsibility of an enterprise. As such an entrepreneur can be mentioned Augusts Dombrovskis – the owner of a lumber-mill in the suburban area of Riga in the beginning of the XX century. He built a nice recreation centre for his workers, where they could spend their free time; the only condition was not to use alcoholic drinks. He also established a creativity workshop for Latvian writers and poets and significantly increased the cultural environment in the area. Other good examples are the owner of the most famous confectionary in Latvia in the 30-ies of the XX century Vilhelms Kuze, who sponsored sports and culture and the owner of a textile factory Roberts Hiršs, who established a daycare centre in his factory, where the most of employees were female persons, and created a lot of other facilitations for his workers. The present generation of Latvians should be told about these examples of sustainable entrepreneurship.

In a contemporary world intellectual capital is becoming more and more important in the economy. Though, the role of the intellectual capital as a subject of business deal is underestimated in Latvia. Frequently the authors of ideas are unaware that they have the right to get the award for them or they consider such an award as desperate. Therefore often such ideas are sold cheap to foreigners, who make them their intellectual property, deriving a very high profit from it. To improve the situation much more attention, even in a governmental level should be paid to the science management.

## **5. Economic growth and inflation**

As mentioned before, the economic growth in Latvia is incredibly high. Author considers four main reasons for this growth: 1) the rapid increase of capital stock mainly on the basis of

foreign investment and foreign credits, 2) the rapid increase of crediting, caused by the liberating of the real estate market, as follows the increase of the prices of the housing and building industry, and necessity for a large part of population to take credits to satisfy their basic needs for dwelling, 3) the increase of the quality of human capital due to the good basis of knowledge acquired still before the renewal of independence along with the entry of the market-orientated professional knowledge in the 90-ies of the XX century, 4) the gradual return of the “shadow economy” sector into the legal economy.

First two reasons can cause serious problems from the point of view of the sustainable development of economy of Latvia.

A rapid economic growth according economic theory links with high inflation. That exactly happened in Latvia the recent years. This was typical demand-side inflation. As the increase of nominal income for various groups of population differs, for a large part of population the real income is decreasing, causing the increase of social inequality. Developed countries are solving this problem, using „stop and go” policy, where rapid economic growth linked with increase of social inequality scales up the popularity of the social oriented parties, which are implementing restrictive economic policy, that hinders economic growth and lessens social inequality. Then the drying up of economic activities creates popularity for liberal orientated parties, which are using expansive economic policy. The political system serves well for this in developed Western democracies. The political system of Latvia is different; by historical reasons “socialism” is considered to be a very harmful thing, and the division in “left” and “right” parties is done by different principles, that may seem enigmatic for the Western democracies. Nevertheless at present there is a sharp necessity for social oriented parties in Latvia in the direct sense of the concept.

The charge for the rapid economic growth is the usage of natural resources and environmental pollution to an increasing degree. The large dependence of economy of Latvia from the foreign investor’s fears for, that from two criteria – profit maximization or environmental pollution minimization, the first one will be preferred. Besides that, the countries with lower level of technological infrastructure (which is Latvia, compared to West-European countries) need a larger increase of capital stock for the same increase of GDP *ceteris paribus*. This means, that the same economic growth causes a larger usage of natural resources in Latvia, compared, for instance with Denmark.

We may conclude that the negative factors, connected with rapid economic growth manifest themselves fully in Latvia. On the other hand the GDP per capita in Latvia is significantly lower than the EU average. People can compare their standard of living with West-European countries, and this comparison is not favorable for Latvia. In the Soviet times this problem was solved with the “iron curtain”, that cannot be considered as a solution nowadays.

The goal to “catch” the European Union the next 10, 20 or 40 years that is often mentioned in public presentations of Latvian politicians reminds the Soviet times, where there was a slogan “to catch and overtake America”. Some of Latvians remember the outcome of this chase. According the statistics, Latvia now is not the poorest one among the EU countries, not mentioning Romania and Bulgaria, Latvia has overtaken Poland. But most of population of Latvia asserts that they don’t sense it, and in a large degree they are true.

As the economic growth in a large degree happened owing the large increase in the speculative sectors of economy, not in real economy, it had a small impact on the potential of economy. Not considering the small sectors economy, which share in GDP is less then 2%, the most rapid growth during the time period 2003-2007 has been in building – 93.3%, trading – 91.3%, financial intermediation – 76.3% and real estate sector – 67.8%, but the lowest increase in healthcare – 17.5%, agriculture – 21.9%, energetic industry – 21.8% and manufacturing – 26.7% (calculations of author, based on data of CSB of Latvia (7)). These

figures may seem rather optimistic, as building industry is considered to be the main in production of capital goods. But in case of Latvia even this industry in some degree can be considered as a speculative sector of economy, as there are examples, where buildings have been pulled down just some years after their completion and though obviously have been built not for direct use, but some speculative purpose. Anyway, there is a reason to assert, that the rapid economic growth has made a small impact on production possibility curve and consequently the aggregate supply in the nearest future.

The opening of the real estate market in Latvia caused a situation, when persons, mainly from abroad, who had savings, had an opportunity to place this money more profitable, than in banks. Real estate became the object of speculative transactions. The demand in this market was increasing very rapidly, the prices as well. Latvians, who needed real estate not for speculative transactions, but for living, had to compete in this market by taking credits with the further increase of demand and prices. Due to the multiplier effect there was an increase of the demand in other sectors – building, trading, financial services, insurance etc. This was the reason for the rapid economic growth, but in a large degree it was on credit and then not sustainable. This caused a situation, where not only the households didn't recognize the risk of returning the credits, but the banks didn't recognize the risk of regaining the credits as well.

If the real estate is considered as consumption good, then it is close to a perfectly non-tradable good, hence the price convergence does not happen. If the real estate is considered as capital good, then it is close to a perfectly tradable good, hence the price convergence happens rapidly. After the real estate market in Latvia was opened, it became just like the counterpart of the security market.

Herewith the rapid economic growth goes a rapid increase of social and regional inequality. A large number of mainly young Latvians have left the country not because only the reason, that they can earn more money abroad, but because the better other factors of welfare – dwelling and environment.

Sooner or later the rush had to be finished. Experts from West-European countries already have made forecasts, that Latvia will be no more source of easy profit – now Bulgaria, Romania, even Georgia and Kazakhstan are on the agenda. Perhaps these countries will repeat the Latvian scenario. Problems, that now are critical for Latvia, we have to solve ourselves.

Inflation in economy can be considered the same as the blood pressure in a human body. When a person runs very fast his blood pressure is higher than normally. The same happens in the economy. Inflation at present is the most discussed item in Latvia. Usually it turns out that the main problem that causes inflation is that Latvia will not join the Euro zone as soon as it was expected. This is a misleading way. Much more serious problems are:

the increase of social inequality,

the decrease of the international competitiveness of Latvian economy.

To discuss how to reduce the inflation, it is necessary to evaluate, what would be the impact on those measures on the problems mentioned before.

Until now the inflation in Latvia was a typical demand-side one. It was caused by the increase of the purchasing power as a result of:

- 1) Rapid increase of the monetary amount of the population,
- 2) Inflow of financial resources from abroad,
- 3) Rapid increase of crediting.

The first one mentioned in case of Latvia cannot be considered the same as income, because a large part of monetary means was formed by credits given from banks to households. According the data of the Financial and Capital Market Commission (8), on the end of February 2008 the total sum of household credits is 6 246.5 million lats, i.e. approximately 2800 lats on each inhabitant of Latvia, including nurslings and ancients.

Inflation from the demand side was pulled also by the increase of amount of consumers as the result of significant increase of number of tourists. For such a small economy like Latvia, one million tourists per year can be considered a large increase of the aggregate demand. Among other demand-side factors of inflation the expectations of inflation as a cause of it should be mentioned.

Starting from year 2008 most of economists consider that the economic growth will be slower in Latvia, especially taking into consideration the international situation. But the forecasts of inflation still remain rather pessimistic. The main reasons of it are the supply-side factors of inflation – prices of resources. Latvia in a large degree depends from the price of imported strategic resources – oil products, energy resources, grain, also sugar, etc. Even in 1918 after the proclamation of independence the famous Latvian economist Karl Ballod pointed out, that one of the first things that Latvia should do, is to eliminate its dependence from the imports of strategic resources. In 20-30-ies of the XX century, there were built three sugar-refineries and one large hydropower station. At present Latvia for 100% is dependant from the imported oil products, for 50% from imported energy resources, and all the three sugar-refineries currently are closed down. This is a striking example, that the sustainable development is only in the words of politicians, but the real processes in economy of Latvia are far from the concept of the sustainable development.

The significant growth of social inequality is one of the most important problems, which endanger the sustainable development of Latvia.

**Table 3. Inequality of income distribution - income quintile share ratio**

	2000	2006
Latvia	5.5	7.9
Estonia	6.3	5.5
Lithuania	5.0	6.3
Germany	3.5	4.1
Czech Rep.	3.4 (2001)	3.5
Finland	3.3	3.6
EU 25	4.5	4.8

*Source: Data from Eurostat (9).*

The most rapid increase of social inequality in Latvia started in 2004, when there was a sudden flash of inflation. That causes a treat for the social dimension of the sustainable development, the deformation of the social environment, the growth of hostility, which meaningly or accidentally are incited by the mass media, showing examples of senseless splendor among the toffs. History shows a lot of examples where such a deformation of the social environment has caused bloody events in form of revolutions and civil wars. Most of revolutions, for example the Great Revolution of France, year 1905 revolution in Russia, the “Song Revolution” in the Baltic states in the end of 80-ies of the XX century, happen not because people are living bad, but when they realize that they can live better.

## **6. Infrastructure and regional inequality**

The history of Latvia obliges us to be thankful to our ancestries, especially in the XVII century, when in the territory of Latvia there took place a rapid development of infrastructure, taking as the example the most developed West-European countries. The Courland Duchy, ruled by the talented mercantilist Jacob Ketler became on of the most developed economies in the Baltic region. The Swedish Vidzeme developed a perfect infrastructure for agriculture. The developed infrastructure is one of the main reasons for efficiency of capital, which attracts investment and has a positive further impact on the infrastructure. This gives the explanation to the rapid development of economy in the XIX century, when Latvia was the

most developed part of the Russian Empire. The same time this was the root of one specific feature of Latvia: its capital – Riga is too large for the country. Approximately one half of the whole population lives in Riga and its surroundings. The difference in the standard of living in Riga and other parts of Latvia is larger than the difference between average level of Latvia and the one of the European Union.

**Table 4.** Dispersion of regional GDP per inhabitant - in % of the national GDP per inhabitant

	2000	2005
Latvia	46.8	51.3
Estonia	38.7	41.2
Lithuania	19.0	23.5
Germany	28.1	28.3
Czech Rep.	21.3	23.3
Finland	21.8	19.8
Sweden	15.1	15.5

*Source: Data from Eurostat (9).*

At present, due to increasing regional inequality, Latvia rapidly is losing its carefully created infrastructure. Single regional centers: Riga, Ventspils, have rather high level of the capital efficiency, so they attract investment and are developing rapidly. The same time in the most part of the territory economic activity is very low, so people are leaving this unfavorable environment either to Riga or to Ireland, England, Norway, etc. The sources of the European Union provided to reduce regional inequality in case of Latvia mainly arrive in Riga or other comparatively developed centers, and only are sharpening the problem.

For maintenance of infrastructure a significant role plays one of the sectors of economy – agriculture. This explains why almost all the countries support and try to maintain this very unprofitable sector. Joining the European Union Latvia agreed to the quotas of the agricultural production. These quotas even in such sub sector as milk industry, which perhaps is the one of the few sectors of agriculture, where Latvia has comparative advantage to other European countries, are lower than domestic demand for milk and milk products. This is a serious threat to existence of agriculture in Latvia. The latest events in the sector of sugar industry in Latvia are only the first stage in the prospective avalanche of events. The financial support of European Union to agriculture in case of Latvia can be considered like some kind of “coffin money” to this sector of Latvian economy. For most of peasants it is more profitable to sell their land and move to Riga, Ireland, England, etc.

The situation of Latvia, where half of population lives in the capital city and produces two thirds of the GDP is unique in the Europe, except ministates. According the data of the CSB of Latvia the GDP per capita in Riga was 7.36 times more than in Rezekne district, or taking bigger territorial units, in Riga statistic region 3.72 times more than in Latgale statistic region.

The rapid economic growth of Latvia would be causing no problems from the point of view of the sustainable development, if it would be even in all the regions and for all the social groups. Obviously, it is not so. Investors, doing their choice about the place of their business, are guided by one main criterion – profit. Obviously, profit will be higher in places with better infrastructure and higher qualified labor force. Therefore, if this process will be not controlled, the regional inequality will be only increasing, what exactly one can see in Latvia. This can be done, for instance, using different tax policy for different regions of Latvia, different credit policy, scattering the state administrative establishments throughout the whole territory, etc.

Only in the case if economic growth will be even in all the regions of Latvia, it will promote the sustainable development. At present it is not so, and people, who are visiting Riga and not other parts of Latvia, may have wrong impressions about the standard of living in this country.

### **7. Foreign trade deficit and lack of national capital**

A large part of foreign investment in Latvia came into the real estate sector causing the problems mentioned before. Foreign investment in other sectors of economy had less impact on inflation but caused the increase of the foreign trade deficit. The balance of payment in Latvia has deficit since 1992. This is causing threats to the stability of national currency, and the forecasts about possible devaluation of lats, though are strictly denied by the Bank of Latvia, already have caused some fluctuations in the exchange market.

At present the gap between GDP and GNP is significantly increasing, even the compensation employees received from the rest of the world since 2003 has increased three times. The same time property income paid to the rest of the world in this time period has increased four times, in 2006 it was 930.4 million lats, and interest paid to the rest of the world 413.0 million lats. Together these two figures make 11.9% of the GDP. In 2007 the gap between the GDP and GNP was 531.5 million lats, the GDP exceeded GNP for 3.9%, and in nearest future these figures will be only increasing.

**Table 5.** The gap between GDP and GNP

Year	GDP/GNP ratio (nominal)	Growth of real GDP (%)	Growth of real GNP (%)
1995	0.996	0.3	...
2001	0.998	8.0	...
2002	0.997	6.5	8.4
2003	1.003	7.2	5.5
2004	1.023	8.7	6.5
2005	1.014	10.6	12.5
2006	1.028	11.9	10.3
2007	1.039	10.2	9.1

*Source: Calculations of author, based on data of Central Statistical Bureau of Latvia (7).*

Uncritical approach to foreign investments can be estimated as a serious threat for the sustainable development. According the expert data of IFO Institute for Economic Research in Munich, Germany, Latvia is among the few countries, that don't have any control of the foreign investments. The distribution of the accumulate foreign investments by sectors of economy show that most of them flows to the most profitable sectors, including those, which have speculative nature – real estate activities, financial intermediation and trading. The profitability in the sectors of economy differs in a long run and in a short run, but the statistic shows, that short-run interests are determinative in the behavior of foreign investors in Latvia.

Sometimes it is presumed that foreign investments are the consequences of the foreign trade deficit, but the same time they may be considered the causes of it.

Of course foreign investment cannot be considered only as harmful for economy. But in the present situation of Latvia, they may cause serious problems to economy from the point of view of sustainable development. Usually it is regarded that foreign investment is the factor, that is increasing the competition, but in case of Latvia domestic investors frequently are crowded-out. Therefore the foreign investment should be regulated according their source, sector of economy and region of destination.

**Table 6.** Distribution of accrued foreign investment by sectors of economy year 2006 (%)

Sector	Share in GDP 2007	Foreign investment
Agriculture	3.4	1.0
Fishing	0.1	0.0
Industry	13.8	14.3
Building	7.8	0.9
Trade	20.1	12.0
Hotels & rest.	1.7	1.2
Transportation	12.3	11.5
Financial interm.	7.0	25.5
Real estate & oth.	15.7	20.1
Public administer.	6.4	0.0
Education	4.3	0.0
Health	3.0	0.0
Others	4.4	0.7
Not classified	X	12.6

*Source: Data of Central Statistical Bureau of Latvia (7).*

The economic growth in a very large degree was based on credits of Latvian households and enterprises. At present (quarter IV 2007) foreign debt, according the data of the Bank of Latvia (10) is 18.725 billion Ls. The total foreign debt has been increasing faster than GDP.

**Table 7.** Economic growth and foreign debt

Year	Growth of real GDP (%)	Ratio of foreign debt to GDP	Annual growth of foreign debt (%)	Annual growth of foreign debt (%) in comparable prices of 2000
2003	7.2	0.795	...	...
2004	8.7	0.933	36.5	27.5
2005	10.6	0.994	29.7	17.7
2006	11.9	1.131	41.5	27.4
2007	10.2	1.333	47.0	29.9

*Source: Calculations of author based on data of Central Statistical Bureau of Latvia (7) and the Bank of Latvia (10).*

The table shows, that in the context of the global economic crisis Latvia can meet extremely serious problems in economy even in the short run. Indeed, if the total foreign debt exceeds GDP for 33%, if 43% of the total debts are short-time liabilities, then it is only a fractional consolation, that 68% of the total foreign debt and 85% of short-time liabilities constitutes the debt of domestic commercial banks to their parent companies in Scandinavia, etc.

**Table 8.** Imports and exports of Latvia

Year	Imports (million lats, current prices)	Exports (million lats, current prices)	Import – export ratio
2003	3493.4	2689.5	1.299
2004	4428.9	3268.2	1.355
2005	5637.8	4334.7	1.301
2006	7412.3	5014.3	1.478
2007	9024.7	6197.1	1.456

*Source: Data of Central Statistical Bureau of Latvia (7).*

If the global financial and economic crisis will reach them, it is rather obvious, that Latvian banks will be in a grave situation and the economy of Latvia as well. The situation could be

considered as less dangerous, if the foreign trade balance will be positive. In case of Latvia it is not so. The latest data show some improvement in the balance of payments, but the situation still is far from satisfactory.

### **8. Demographic situation and morality**

The renewal of independence was greeted with bright hopes about the future of the Latvian nation and the guarantee of maintenance of national identity. But the facts show, that in years of independence the number of population has decreased for more than 380 thousand or approximately 15%. Only in a very small degree it can be explained by emigration of non-Latvians. The official statistics does not include those approximately 100 thousand mainly young Latvians, who have left their native country for work in the Western Europe. That has caused a situation, where in different segments of the labor market there is insufficient supply, which likely will be increased by inflow of labor force from abroad. Usually it is explained only by the difference in the salaries, which arise from different marginal efficiencies of labor. Not disclaiming this reason, one cannot mention other important reasons, which shortly can be called “the state attitude and social environment”.

For some period of time we have the institution, which is responsible for the image of Latvia. This image is being made just like a ghost, which roams along the Europe. It is stressed that the main priority is to make this image attractive for anyone else except the citizens of Latvia. The main accent is put on that how we look, not how we feel. Such an attitude from the state is destroying the patriotic feelings of population and promoting the emigration processes. The distortion of the Latvian language leaves far behind the same processes in the Soviet time period. It will cause the loss of national identity in a large part of society, which may turn out to be a delayed action bomb.

A large part of Latvian society still remembers the Soviet time period, which cannot be considered as a good period in the history of Latvia. What was the worse thing in this time period? Perhaps the worse thing was the double standards in the morality. The state policy was based on lie. As it is hard to get on lie, the society met a strange phenomenon – duality of consciousness, where in daytime a person was thinking and speaking differently as in the evening and nighttime. This was done with full assurance and belief. During the 70-80-ies of the XX century this phenomenon had become already a norm. Therefore the changes in the beginning of 90-ies were met with great enthusiasm, because such a duality of consciousness is not normal for a human being. But with time it turned out, that nothing has really changed. The state policy is still based on lie; double standards in morality are even more popular than in the Soviet period. The blasphemy of religious sensibilities has such manifestations, which however were not allowed in the Soviet times. The morality has been so distorted, that a part of the society even not assumes possible the existence of such human qualities as virtue, and identify it with hypocrisy. This is perhaps the main threat to the sustainable development, because a human being comes to an end not when his body, but when his mind is being broken.

According the data of CSB of Latvia the demographic projections 2005-2050 forecast, that the number of population will continue to decrease, it will fall down the level of 2 million in 2033, and will be approximately 1.87 million in 2050 – a little more than after the World War I in 1920, when Latvia lost 40% of population (5).

### **9. Conclusions**

Development is a broader process than economic growth, as well as welfare cannot be measured only in monetary terms. For the people welfare is more important than economic growth. Economic growth is a necessary, but not sufficient condition for the development.

The analysis of economic processes in Latvia shows, that the rapid economic growth in Latvia has caused serious problems from the point of view of sustainable development. Sustainable development is an instant increase of welfare for all inhabitants, not compromising the welfare in the nearest and further future.

At present the main threat to the sustainable development of Latvia consists of:

- social inequality
- regional inequality
- the loss of agriculture and infrastructure
- the lack of national capital
- emigration of young people
- the loss of national identity
- degradation of morals

The only strategic goal for an economy of any country, including Latvia, should be sustainable development of the economy, not of another kind.

### References:

1. MEADOWS, H.D.; MEADOWS, D.L.; RANDERS, J.; BEHRENS, W.W. The Limits to growth; a report for the Club of Rome's project on the predicament of mankind. New York: Universe Books, 1972, p.205
2. HIRSCH, F. Social Limits to Growth. Routledge: New Ed edition, 1995, p.232
3. WORLD COMMISSION ON ENVIRONMENT AND DEVELOPMENT. Our Common Future. Oxford; New York: Oxford University Press, 1987, p.383
4. BRĪVERS, I.; LAIZĀNS, T.; LEŠINSKIS, K.; ŠREIBERE, S.; VOLKOVA, T. Thirteen hard years of transforming a heavily integrated economy: Latvia. *Rebuilding the Market Economy in Central-East Europe and the Baltic Countries*, ed. Kiglics, I. Budapest: Akademiai Kiado, 2007, p. 319-370, p.413
5. Statistical Yearbook of Latvia 2007. Riga: CSB of Latvia, 2007, p.561
6. AIZSILNIEKS, A. History of Economy of Latvia. 1914-1945. (Latvijas saimniecības vēsture. 1914-1945.). Stockholm: Daugava, 1968, p. 445 (in Latvian).
7. Homepage of the CSB of Latvia: <http://data.csb.gov.lv>.
8. BARKĀNS, E. The Vallets of the Credit Takers Will Be Controlled Less (Kredītņēmēja naudas maku kontrolēs mazāk). *Nedēļa*, No.17, 2008, p.13-14. (in Latvian).
9. Homepage of the Eurostat: <http://epp.eurostat.ec.europa.eu>.
10. Homepage of the Bank of Latvia: <http://www.bank.lv>.