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Addressing Reform with New Energy

Five years ago, Latvia was exhibiting rapid economic recovery. However, the pace of economic growth has declined every subsequent year, i.e. from 6.2% in 2011 to 2.7% last year. In recent years domestic consumption has mainly dominated the growth in economic activity, with favourable conditions for its increase developing. However, this kind of growth model is unsustainable. At the same time, export is continuing struggling, which is why its growth is being hindered, but investment activity is inexcusably low for many reasons.

Overall, the medium-term perspectives for the Latvian economy can be considered to be good, with the availability of EU funding being a significant stabilizing factor. However, there will only be limited growth. In the long term, there will be challenges. They will impact negatively on sustainable economic development if not acted upon in a timely fashion, or if there is a delay in what has already been started. According to the OECD, in the coming five-year period, economic growth of developed, as well as rapidly developing countries, will fall behind that which was achieved pre-crisis. Furthermore, potential global economic growth continues to be subject to uncertainty and the risks of recession. Nowadays when secular stagnation – a lengthy period of slower growth is gaining a firmer traction in economic discourse, Latvia must increasingly focus on creating an image of a country of exceptionally favourable environment for business. This will allow for the attraction of new foreign investors, as well as facilitating existing investors to invest that will enhance the prospects for development of the Latvian economy. Currently, investment activity in Latvia has remained at a low level for a long time, and is a threat to Latvia's long-term development potential. It should be borne in mind that as geo-political tensions continue, investors will be very cautious in their activities. As the government finds it difficult to influence external factors, a reduction in internal hurdles and restrictions is important in these conditions.

Factors, which can be ignored at times of rapid growth, become especially important at times of low economic growth. In the current conditions, the effective functioning of these factors becomes increasingly important. This allows for difficult situations to be more successfully endured in crisis conditions, as well as developing a stable base for competition and readjustment of the economy. Therefore, in the context of Latvia's economic growth, in the coming years the government's ability to achieve real results on delayed reforms, the implementation of which are crucial in the opinion of FICIL for achieving immediate significant progress, will be of critical importance. As a result, Latvia must become a self-evident and attractive target for investments in the region. Therefore, targeted work is important for solving critical points:

- **Timely, effective communication and clear goals.** The government's declaration includes many significant and ambitious goals. Their implementation will have a significant effect on ameliorating the business environment and providing conditions for growth. However, the government must choose and implement clear and specific priorities. These must be explained clearly to the public. The absence of a clear and defined vision on the government's priorities is a shortcoming which interferes with the development of the country's image as being business-friendly and reflects negatively on the government's work.
- **Greater transparency and efficiency in the economy is needed.** The size of the shadow economy within the Latvian economy continues to be a serious barrier for economic development, creating the conditions for unfair competition, increasing inequality in society and restricting the growth of honest businesses. Therefore, an effective reduction in the shadow economy, especially in tax evasion, is a critical factor for Latvia's future growth. Transparent conditions in the economy also lead to a positive assessment by investors of the country. In this context, more active movement towards an e-environment, and its broader use, would allow for a reduction in the turnover of cash in the economy. This would be a significant instrument for restricting the shadow economy, as well as for facilitating efficiency in state administration.
- **The consolidation of the legal environment is rather ineffective and slow.** Effective and transparent operation of the courts is an integral base for the successful functioning of an economy and one of the main criteria in the making of investment decisions. The continuing improvement in the Insolvency Law has still not provided the desired result. Monitoring of the insolvency process continues to be weak and doesn't provide the required protection for investors. Therefore, to break through this delayed process, the reformation of the insolvency process must become one of the government's main priorities. The government must speed up the amelioration of the legal environment, to provide quicker legal proceedings, greater trust in the legal system and transparency in the decisions that are made.
- **A clear lack of perspective in development continues to be observed in taxation policy.** This becomes especially clear each year during the annual drafting of state budget. Even the current indications of potential changes are not specific, and there is a lack of constructive discussion. This increases the risk that the usual changes will be adopted prematurely and with haste and will create hurdles for business. Some specific positive trends can be observed in the sorting out of budget expenditure; however, there is still a lack of clarity and purposefulness. The state must continue to review the scope of existing functions and must duly, in dialogue with business, search for adequate and sustainable solutions. The Latvian government must continue to observe firm fiscal discipline, which up till now, has been a factor facilitating trust in Latvia.
- **Support for manufacturing and export development must be increased.** The policy implemented after the crisis, which was targeted at manufacturing and export development, was the right decision. However, this movement has become bogged down in the unpredictability of energy resources. Therefore, it is very important to develop a sustainable energy policy, as quickly as possible, to allow for current and potential businesses to plan their costs. The current uncertainty significantly restricts the development of investment. The government must also continue creating the conditions for business cooperation, which facilitates competitiveness and allows for the more successful location of, and breaking into, export markets.

The situation with exports continues to be complex and increasing the volume will not be easy. The heterogeneous success of export shows that efforts towards diversification, as well as support for development, must be continued. State support will be important, as with the existing development in domestic demand, the conditions for exporting industries will become even more complicated. This threatens competitiveness, which will cause disbalance in the economy in the longer term.

- **There have to be tangible results in the reform of the education system.** The economy's, as well as the entire community's, potential develops according to the quality of each country's education system. Therefore, we support and encourage more convincing reorganization of the education system, especially that which raises the quality of Latvia's vocational training and higher education.

- **Long-term investment policy must be developed.** EU funding provides stability, but at the same time, the opportunity for sloppy economic policy. Taking into account the great significance of EU funding, effective access to EU funding provides for the modernization of manufacturing, the strengthening of competitiveness, the development of new products and services, as well as other opportunities. Delays in EU funding will slow down this year's growth, but in coming years will create risks of overheating, for example, in construction, which is why an ineffective use of resources is the most possible outcome. In addition, the concentration on acquiring EU funding has meant neglect in work on the development of capital markets, which should be in a position to function effectively, especially when the EU funding ceases. The necessary preparatory work for the period when the flow of EU funds will dry up is insufficient. Therefore, new energy is needed to develop the stock market, risk capital and other financial instruments. In addition, prompt action is required on diversification in existing investment structure, increasing the presence from strategic partner countries, which is especially needed for long-term stability, as well as in the current geo-political security context.

- **Labour market resources are becoming increasingly limited.** Workforce productivity and availability is one of the most important economic challenges for Latvia. Regardless of the improvement in economic indicators, unemployment will retain a large regional aspect and there will continue to be a need to facilitate workforce mobility. Along with trends in Europe, in Latvia too, attention is being focussed on the problem of youth unemployment, which is based on the need to motivate young people to obtain the required qualifications or the desire to study. There is another future problem in Latvia as serious as youth unemployment. Bearing in mind demographic trends, keeping the existing generation of older people in the workforce, as well as the involvement of other able-bodied, but currently economically inactive people will be important. With the assistance of planned administrative reform, the concentration of human and financial resources must be continued. Equal conditions in the country must be provided through investment policy, while correcting market and government failures; the education system must be optimized reducing in the number of infrastructure units, the quality must be improved and the kind of funding mechanisms which facilitate innovation to reduce the unemployment trap must be introduced. In FICIL's opinion, a greater concentration of human resources, financial resources, as well as administrative resources will improve regional development.