

Julia Alasheyeva

**INTERNATIONALISATION  
OF LATVIAN  
MANUFACTURING  
COMPANIES: IMPACT  
OF POLICIES AND  
FOREIGN INVESTMENT**

The study analyses the situation as of May 2004

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AI 066



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Project consultants:

ALF VANAGS, Director of Baltic International Centre  
for Economic Policy Studies (BICEPS)

Prof. STEPHEN HEYNEMAN, University of Vanderbilt, USA

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## EXECUTIVE SUMMARY

Latvia has entered the European Union as its poorest member. It is widely hoped that economic integration into the EU will benefit Latvia's economy through increased investment flows and new expansion opportunities for existing businesses. Economic liberalisation, however, does not automatically lead to higher economic growth. Latvia's policy framework should enable private sector companies to reap the benefits of integration into the European single market.

This study will address the question of what public policies can do to help Latvian domestic enterprises to internationalise, what benefits can be expected from foreign direct investment and how they can be maximised.

General recommendations for government policies aimed at developing an efficient and competitive industry structure as outlined in the draft of the Integrated Economic Strategy (*Latvijas Tautsaimniecības vienotā stratēģija*) and underlying policy documents are:

First, economic policy should tie economic development goals to specific policy initiatives to make it clear what the government intends to do and how the results can be measured. Currently, economic policies for industrial development fail to establish this link. For example, the number of small and medium enterprises (SMEs) per 1,000 residents is not an adequate indicator for the success of policies aimed at improving the business environment and fostering entrepreneurship. It does not include the measures needed to reach this objective nor does it allow the evaluation of specific policies.

Second, the Integrated Economic Strategy discusses subsidies as a policy tool, but does not make it clear that the government cannot support specific (target) industries through domestic and export subsidies. The government should not attempt to attract investment (foreign or domestic) only to specific industries. Why? First, the government has no superior capacity to predict the path of economic development. Second, it is recognised by the EU that policies targeting only specific sectors of the economy are inefficient because they artificially distort incentives of economic agents. Third, any

public discretion opens up possibilities for corruption. The strategy of building competitiveness of the European Union called the Lisbon Strategy prescribes *continuing efforts to reduce the overall level of government aid, whilst reorienting aid towards horizontal objectives*.

This study argues that government economic policy should clearly focus on the so-called *push* policies, which universally reduce the costs of doing any business for economic agents, rather than *pull* policies, which prescribed a certain course of action for economic agents via specific incentives or subsidies.

Further integration into EU processes will benefit larger companies and those already involved in export. Small and medium domestic companies and companies not involved in export might need help in realizing the benefits of joining the EU single market. This can be done by implementing policies which eliminate market failures – situations where the market solution is clearly suboptimal.

One possible market failure for the domestic economy could be the under-provision of financing for small and medium enterprises. The second possible market failure could be the high costs of expansion faced by small and medium companies in domestic and particularly in international markets. In both cases, there is room for policy improvement and reform.

Specific suggestions for small and medium enterprises (SMEs) include the following:

- Guarantee schemes seem to be superior to subsidised loans. Guarantee schemes adequately address the problem faced by SMEs when seeking financing: the lack of collateral. At the same time, they relieve the state of budgetary costs. Government support should focus on ensuring the availability of more loans at market rates rather than cheaper loans.
- Financing for SMEs with either loan guarantees or other types of support should not be provided through a single bank. SMEs are a target group for many banks that could be eligible for receiving support targeted for SMEs. This would foster competition in the general provision of banking services for SMEs.
- The Latvian Guarantee Agency must strictly require SE borrowers to prove that they have exhausted all available collateral before they apply for a state-guaranteed loan. Guaranteed loans should be used to finance long-term investment rather than working capital needs.
- A procedure for evaluating the credit guarantee programme should be developed to support future policy decisions and to judge the efficiency of the programme. The evaluation procedure for grants programmes in the UK serves as a useful example.

- The target for the credit guarantee programme should be the number of processed applications and not the number of loans. The government cannot influence the number of good projects and should not finance poor ones simply to meet the target.
- Background research should be conducted before government involvement in other non-bank financing provision is introduced. Suggested areas for research are the following:
  - the availability of trade-finance and export-finance instruments from the banking sector;
  - the presence of liquidity constraints on SME export financing;
  - the availability of non-bank financing – seed capital and venture capital;
  - overview of institutional solutions and options for micro-credit.

Foreign direct investment (FDI) is an important route for developing new industries and for internationalisation of the domestic sector. FDI also plays an important role in capital formation in transition economies. FDI has potential benefits for the development of recipient economies through technology spillovers and as a route to internationalisation of domestic companies.

This study reviews the empirical evidence and shows that FDI depends on factors other than government incentives and efforts by development agencies. Market fundamentals and the presence of resources play an important role for FDI flows. Moreover, education policy and financing for domestic companies both help domestic enterprises to benefit from FDI and to attract more FDI.

Specific recommendations for policy aiming to attract foreign direct investment are:

- FDI might produce positive spillovers for the domestic industry. However, these spillovers are not guaranteed and depend on the level of technology and quality of human resources in domestic enterprises. Therefore, individual privileges and concessions should not be granted to individual investors – their costs might outweigh their benefits.
- Latvia's policy for attracting FDI should focus on improving the availability of information on the Latvian market and infrastructure for foreign companies potentially interested in investment. The availability of information on Latvia and its markets is an important condition for attracting efficiency- and resource-seeking FDI in Latvia.
- Promotional activities should be coordinated to benefit domestic exporters. Latvian companies should be given access to promotional materials on Latvia for use in their own marketing activities.

- All policies directed at increasing the capacity of the domestic manufacturing sector by providing a better business environment, financing and institutional support contribute to the potential positive benefits generated by foreign direct investment.

This study argues that benefits from joining the EU can be maximised through a policy framework that focuses on improving business conditions for both domestic and international enterprises, particularly small and medium enterprises, while avoiding distorting measures.

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**Abbreviations**

APR	– Annual Percentage Rate
CIS	– Commonwealth of Independent States
DTI	– Department for Trade and Industry (UK)
EC	– European Commission
EIF	– European Investment Fund
EU	– European Union
FDI	– Foreign Direct Investment
GDP	– Gross Domestic Product
GNP	– Gross National Product
R&D	– Research and Development
SFLGS	– Small Firms Loan Guarantee Scheme (UK)
SMEs	– Small and Medium Enterprises
SWOT	– Strengths, Weaknesses, Opportunities and Threats
VAT	– Value-Added Tax



## 1. GROWTH CHALLENGE

*...Amongst the ten richest countries in the world, in terms of income per capita, only four have a population above 1 million: the United States, Switzerland, Norway and Singapore. ...Singapore, with 3 million inhabitants, experienced the second largest growth rate of any country between 1960 and 1990. These examples clearly show that a country can be small and prosper...*

Alberto Alesina, Enrico Spolaore and Romain Wacziarg,  
*Trade, Growth and the Size of Countries.*<sup>1</sup>

Latvia is a small, geographically well-located country, which has just become a member of the large European internal market. Latvia has defined the framework for its economic development for the years to come by accepting the EU's rules of the game. Its trade policy is now fixed by the EU, and the EU will also determine monetary policy once Latvia joins the euro currency zone. Latvia's fiscal policy is also restricted and subject to talks and future negotiations.

Latvia's current task is to decide what it can do to become more prosperous within the given framework. On the one hand, EU entry presents new opportunities for doing this. With political risks and costs of trade on the decline, more investment is expected to flow in. Foreign investment is important for the upgrading and development of Latvia's manufacturing sector. Lower trade costs with the EU will also benefit domestic companies by reducing export costs and improving their status as EU producers.

However, economic integration alone does not automatically mean that Latvia's economy will grow faster or that its industry will produce more internationally marketable goods. Does the government have a role in developing Latvia's manufacturing capacity?

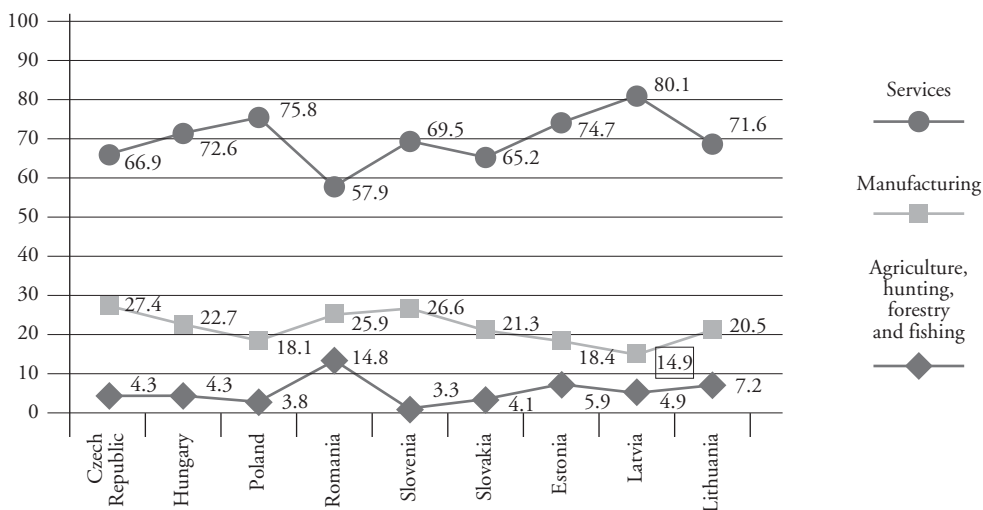
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<sup>1</sup> Harvard Institute of Economic Research, Discussion Paper Number 1995.

### 1.1. Focus on the manufacturing sector

Currently, Latvia's manufacturing sector is the weakest contributor to GDP among the new Member States. The share of manufacturing has steeply declined (in 1990, the share of industry was 38%) in the process of de-industrialisation and post-Soviet restructuring.

Figure 1. The structure of gross value added<sup>2</sup> by industry in EU accession countries in 2001 (% of total gross value added)



Source: Latvian Central Statistical Bureau.

The meagre contribution of manufacturing to value added does not automatically mean that the industrial structure must be altered through policy measures because manufacturing is in some way “better” than other sectors. However, Latvia also has a negative trade balance, which is currently 23% of GDP.<sup>3</sup> Trade is mainly dependent on the manufacturing sector's output (91%).<sup>4</sup> An increase in exports (along with a sustained level of FDI) is necessary to improve the trade balance.

<sup>2</sup> Gross Value Added is the difference between output and intermediate consumption for any given sector/industry.

<sup>3</sup> 2nd quarter 2003, Latvian Central Statistical Bureau.

<sup>4</sup> End of 2002, Latvian Central Statistical Bureau.

EU structural funds could provide an additional strain on the trade balance through the effect of “extra cash” for economic agents involved in projects supported by EU funds (the so-called “demand” effect). Incoming EU funds will translate into greater demand for consumer goods – i.e., imports, and could have a further negative effect on the trade balance.

A recent study using a neoclassical growth model calibrated to explain the magnitudes and timing of trade flows in the Baltic States in the last seven years predicts that trade balances should turn positive in the Baltic States around 2010.<sup>5</sup> What could be the mechanism of this reversal?

The analysis of trade flows between the Baltic States and the EU<sup>6</sup> indicates that the Baltic States currently specialise in resource-intensive and labour-intensive goods, and that they are competing in the same broad product categories. Empirical research suggests that most of the trade between the Baltics and the EU is inter-industry (exports and imports occur in non-overlapping product groups). Latvia’s comparative advantage revealed by trade is in wood and wood products, clothing and textiles, some scrap metals and food & beverages.<sup>7</sup>

Economic integration of new members into the EU should bring about the liberalisation of trade flows, factors of production (such as capital and labour) and, more arguably, convergence of the institutional framework. However, empirical evidence does not show that integration clearly means convergence in economic development. Economic theory also provides a variety of models explaining different economic outcomes of integration. In short, economic convergence does not occur automatically.

The challenge for Latvia is to increase its manufacturing output – both in existing industries and in those in which Latvia currently has no comparative advantage. In other words, an increase in manufacturing output across all sectors is the necessary condition for Latvia’s trade balance to turn positive and GDP growth to become sustainable.

Foreign direct investment (FDI) is one route for developing new industries and for the internationalisation of the domestic sector. Research shows that FDI is an important source for capital formation in developing countries,<sup>8</sup> and foreign capital is argued to be often more productive than domestic capital.

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<sup>5</sup> See Bems and Jönsson (2003).

<sup>6</sup> See Kaitila and Windgren (2001).

<sup>7</sup> Ibid, analysis using 1996 data, Revealed Comparative Advantage calculated using the Balassa Index.

<sup>8</sup> See Krkoska (2001) for empirical results; see p. 38–41 for discussion of other effects of FDI on productivity.

FDI produces other, indirect, benefits for domestic enterprises: it can help to develop new industries in recipient economies, particularly in cases where a country already has all the necessary resources but lacks technical knowledge and understanding of what is in demand; or in cases where industrial output forms part of a production chain that must be so closely coordinated with the rest of the chain that it can be managed only by one and the same owner.<sup>9</sup> Ireland is one example of a country whose development has been, to a large extent, driven by FDI.

However, as discussed further (pages 26–26), potential benefits from FDI cannot be fully realised in the absence of a developed and advanced domestic sector. The Latvian manufacturing sector has changed significantly during transition and is now facing the challenge of internationalisation if it is to take advantage of the benefits of joining a single EU market.

Latvia has a very limited internal market. Joining the EU effectively means extending this internal market to the whole of the EU single market. To benefit from this integration, Latvian companies must be able to internationalise – by extending their sales or production networks to the EU and beyond.

Expansion to external markets or internationalisation can occur in various ways. For some companies this is a sequential stage in their life cycle – they move from domestic sales to international sales and, finally, to production abroad. Other companies are set up to produce and sell internationally from the very beginning; companies with a high technological component have greater opportunities to do this.

In Latvia, 98% of enterprises in the manufacturing sector belong to the category of small and medium enterprises (SMEs). They are argued to have higher barriers to domestic and international growth. The main problems they encounter are poorer access to external financing, higher transaction costs, such as the relative costs of acquiring information about markets, labour and raw materials, and costs associated with the administrative barriers erected by governments.

This study starts off by analysing the new policy context – the European Union’s policy framework for support and development of manufacturing capacity – and evaluates its impact on Latvian domestic policy options.

The study then focuses on two issues particularly important for internationalisation of the Latvian manufacturing industry.

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<sup>9</sup> This is often the case in the electronics industry. See Lipsey (2003).

First, it argues that two areas in which Latvia needs a policy are 1) support for small and medium enterprises to improve the availability of external financing for SMEs, and 2) costs associated with the internationalisation of entrepreneurial activities. The study evaluates Latvia's current policies and makes policy recommendations after a review of international practice.

Second, the study explores the ways in which FDI can affect a recipient economy, the possible effects of FDI on economic growth, and the mechanics of attracting FDI. This section analyses available empirical literature on FDI and industry trends in Europe, draws lessons from previous EU accessions – Ireland and Portugal, analyses the impact of FDI on Latvia's economy to date, and delivers conclusions relevant to the development of FDI-related policies in Latvia.

## 2. POLICY FRAMEWORK

Since re-gaining independence, Latvia has not had a consistent, all-encompassing industrial policy. For example, the European Commission's 2002 Regular Country Report on Latvia concluded that "... policy documents, including the industrial policy guidelines, have not been updated and are still very vague on delivery mechanisms, responsibilities, resources and timetable, thus not allowing for proper monitoring."<sup>10</sup> Government involvement has been limited to various short-term policy activities and programmes, most notably the SME loan programme, tax incentives and direct subsidies to individual enterprises.

Currently, Latvia's industrial policy is to a large extent driven externally by the EU. The EU prescribes government involvement via drafting of national development programmes before EU structural funds become available, and requires co-financing from budget funds. EU structural funds seek to make an impact on underdeveloped regions (the whole territory of Latvia is classified as such) by transforming industrial structures. The EU also has a number of documents on issues of national industrial policy, such as the European Charter for Small Enterprises for improving the capacity of SMEs.<sup>11</sup>

### 2.1. The European Union's economic policy framework

Generally, the EU leaves economic and financial policies to be decided by the national governments of the EU Member States (subject to constraints, such as maximum budget deficit, national debt and inflation thresholds). Taxation is one policy area in

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<sup>10</sup> See, for example, the Regular Country Report on Latvia, pp. 91–92. [http://europa.eu.int/comm/enlargement/report2002/lv\\_en.pdf](http://europa.eu.int/comm/enlargement/report2002/lv_en.pdf) Last accessed on March 6, 2004.

<sup>11</sup> See [http://europa.eu.int/comm/enterprise/enterprise\\_policy/charter/index.htm](http://europa.eu.int/comm/enterprise/enterprise_policy/charter/index.htm) Last accessed on March 6, 2004.

which a certain degree of harmonisation has been reached (for example, excise tax and VAT), and a number of restrictions apply to other types of tax. However, there is generally no European economic policy model shared by all EU members.

Direct EU involvement in economic policy is mostly limited to competition policy. This is one area in which the EU requires harmonisation of national competition policy with EU directives.<sup>12</sup> EU competition policy comprises both anti-trust (including merger control) and government aid control. The latter is important for industrial policy in general, since it restricts certain subsidies to domestic producers. There was no control of government aid in any of the Baltic States prior to signing of the European Agreements.<sup>13</sup> At the closing of the competition chapters, the Baltic States had compliant legislation, which will be enforced through a network of national and EU institutions.

Indirect EU involvement in national economic policymaking is set out in the Lisbon Strategy – a declaration signed in March 2000 by EU Member States aiming to make the EU “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion by 2010.”<sup>14</sup>

The Lisbon Strategy is a set of policy priorities coordinated through benchmarking based on quantitative and qualitative indicators, the setting of specific timetables, and the translation of European guidelines into national and regional policies.<sup>15</sup>

The European Commission also issues Broad Economic Policy Guidelines, which focus on the contribution that economic policies can make over the next three years to achieving the EU’s strategic Lisbon goal.<sup>16</sup> Latvia, as a new Member State, will be faced with having to integrate these recommendations into its domestic economic policy.

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<sup>12</sup> Articles 81 and 82 of the EU Treaty.

<sup>13</sup> See article by J. Rasimavicius on competition policy in the Baltic States. In: *Baltic Economic Trends*, 2003, No. 1, pp. 15–20.

<sup>14</sup> The full text (Presidency Conclusions, Lisbon European Council, 23 and 24 March 2000) can be found at <http://ue.eu.int/newsroom/LoadDoc.asp?MAX=1&BID=76&DID=60917&LANG=1> Last accessed on March 6, 2004.

<sup>15</sup> The European Commission monitors the progress of Member States in terms of adopted policy initiatives via a formal annual review with the Competitiveness Report and the Innovation Scoreboard. The Lisbon Scorecard identifying legislative measures taken by EU Member States is published by the Centre for Economic Reform.

<sup>16</sup> Full text of BEPGs for 2003, pp. 8–10, [http://europa.eu.int/comm/economy\\_finance/publications/european\\_economy/2003/comm2003\\_170en.pdf](http://europa.eu.int/comm/economy_finance/publications/european_economy/2003/comm2003_170en.pdf) Last accessed on March 6, 2004.

The objectives set in the Lisbon Strategy are quite diverse in character. Their goals range from economic liberalisation-enhancing policies to environmental sustainability and social inclusion.

The benchmarking study prepared for the World Economic Forum in 2002 concluded that the average new Member State performs significantly worse than the average EU country in all dimensions of the Lisbon Strategy.<sup>17</sup>

**Box 1.**  
**Summary of the main policy areas of the Lisbon Agenda for 2003–2005**

The Broad Guidelines for the Economic Policies of the Member States and the Community (for the 2003–2005 period) set out the following policy measures to achieve the Lisbon objectives:

1. Growth- and stability-oriented macroeconomic policies.
2. Economic reforms to raise Europe's growth potential:
  - a) towards full employment: more and better jobs;
  - b) towards a competitive and dynamic knowledge-based economy with better jobs: increasing productivity and business dynamism.
3. Strengthening sustainability:
  - a) economic sustainability: ensuring the long-term sustainability of public finances;
  - b) social sustainability: contributing to economic and social cohesion;
  - c) environmental sustainability: promoting efficient use of natural resources.

Summarised from the Broad Economic Policy Guidelines. See footnote 16.

The priority area *Towards a competitive and dynamic knowledge-based economy with better jobs: Increasing productivity and business dynamism* of the Lisbon agenda is most directly concerned with policymaking in the area of domestic industrial development.

<sup>17</sup> World Economic Forum (2002).



The following policy areas will have direct impact on Latvian policymaking in this respect:

*1. Completing the single market.* This priority area anticipates full implementation of the internal market to reduce the costs of doing business, with particular attention on the utilities and services sector: gas, electricity, postal services and the single sky initiative.

This priority area also emphasizes continuing efforts to reduce the overall level of government aid, whilst reorienting aid towards horizontal objectives of common Community interest and targeting it to identified market failures.

*2. Development of entrepreneurship and SMEs.* This priority area anticipates coordination of national policies to generate a supportive environment for entrepreneurship and for SME growth by reducing the administrative burden on business; by increasing the efficiency of the public sector; by simplifying the corporate tax system; and by improving the regulatory environment, notably entry and exit mechanisms. Access to finance for small and medium enterprises should be improved. The European Charter for Small Enterprises is the main EU policy document on small and medium enterprises.

*3. Enhancing the contribution of the public sector to growth* by: redirecting (while respecting overall budgetary constraints) public expenditure towards growth-enhancing investment in physical and human capital and knowledge; increasing the efficiency of public spending, inter alia, by introducing mechanisms to assess the relationship between public funds and policy objectives and to help control spending; establishing an appropriate framework for joint public-private initiatives.

Generally, the open method of coordination – the method for implementation of EU policies at the national level – gives Member States considerable latitude regarding the way the common policy goals are fulfilled. There is no direct method of enforcement of the policy goals, and Member States must instead submit themselves to an extensive review of their national reform policies.

## 2.2. Latvian industrial policy evaluation

Latvian economic policies are summarised in a policy document called the Integrated Economic Strategy, which was in the drafting stage at the time when this study was carried out.

One shortcoming of this policy document is that it isolates policy goals from the policies described in the same document and from specific programmes for the

implementation of these policies. Ideally, this strategy document should link economic development goals to specific policy initiatives to make it clear what the government intends to do and how the results can be measured.

Currently, economic policies for industrial development do not have this link. For example, the number of SMEs per 1,000 residents does not give any information about the success of policies aimed at improving the business environment and fostering entrepreneurship. It is not clear how this objective relates to a better economic environment, nor which policy efforts would produce this effect. For example, an increase in the number of SMEs could be the expected outcome of a micro-credit programme or a start-up finance program, where the government, too, would have a role to play, which would be defined in specific policy programme.

The second shortcoming of this policy document is its concentration on specific industries and promotion of the idea that certain industries should be selected and economic agents encouraged to move into these industries. The suggested industries include those with a high technology component or industries in which Latvia has comparative advantage. For example, the priority of increasing manufacturing capacity anticipates “consistently supporting those industries which can produce higher value added and in which Latvia has a comparative advantage,” and gives a list of criteria for choosing such industries.<sup>18</sup> This strategy document also quotes the Latvian National Development Plan, which prescribes “the necessity to direct economic development to the manufacturing of know-how-based output (information and communications, biotechnology, pharmaceuticals, organic foods, advanced wood processing) and services with high value added (transit, tourism, financial services, business management, and distribution of goods and services).”<sup>19</sup>

This study argues that government policies should not aim to motivate economic development in specific industries. First, as the analysis in the chapter on FDI will show, current comparative advantages (as revealed by trade) can prove to be insufficient for predicting future industrial development. In short, the government has no superior capacity for predicting the path of economic development. Second, it is recognised by the EU that policies targeting only specific sectors of the economy are inefficient because they artificially distort the incentives of economic agents. Third, any public discretion opens up possibilities for graft and corruption. As the analysis of EU’s

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<sup>18</sup> *Latvijas Tautsaimniecības vienotā stratēģija*, December 12, 2003 draft, p. 62.

<sup>19</sup> *Ibid.*, p. 48.

Lisbon Strategy shows, the EU agenda on competitiveness – the Lisbon Strategy – prescribes reorienting of government aid towards horizontal objectives – across all sectors of the economy.

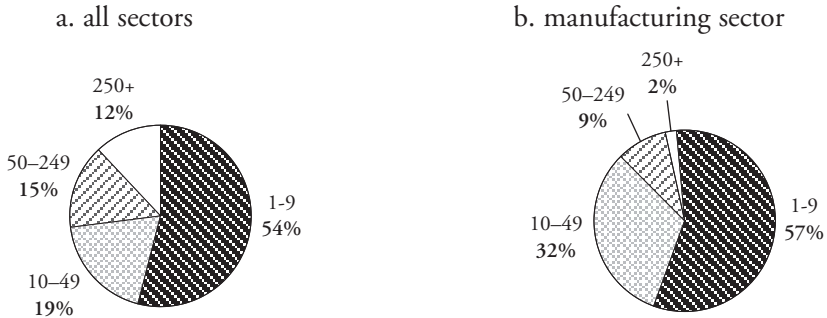
Having discussed the overall policy direction, the study will discuss specific policy initiatives to promote internationalisation of SMEs (Chapter 3) and to maximise the benefits of FDI for industrial growth (Chapter 4).

### 3. SMEs AND INTERNATIONALISATION

This study argues that domestic small and medium enterprises are the group of enterprises encountering particular difficulties when expanding domestically and abroad. Development of the SME sector is necessary to promote innovation and to generate employment. This is recognised by the Lisbon Strategy and empirical research showing that small firms can indeed be more successful innovators: for instance, Acs and Audretsch<sup>20</sup> find that smaller firms are often the innovators in more innovative industries.

Figure 2. Distribution of active enterprises by size in all sectors and in the manufacturing sector

Size is defined by the number of employees:



Source: CSB of Latvia, 2002.

The SME category includes a very broad range of economic agents: due to Latvia's size and industrial structure, many companies operating in Latvia are small. According to

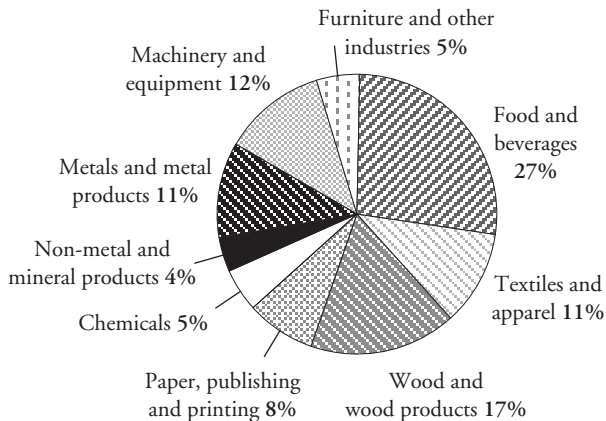
<sup>20</sup> See Acs et al (1998).

Central Statistical Bureau data from 2002, of all active enterprises in Latvia<sup>21</sup> only 12% can be defined as large – employing over 250 employees. In the manufacturing sector, the share of large enterprises is much smaller – only 2 % of companies employ over 250 employees, and the majority of companies are very small (less than 10 employees).<sup>22</sup>

### 3.1. Export performance of Latvian producers

Latvian industries contributing most to GDP are not necessarily the ones that are most-export oriented. This could suggest that there is trade potential within these industries to increase their markets beyond Latvia. Food and beverages is one such industry – it contributes most to GDP, but less than a quarter of its output is exported. Another such industry is paper, publishing and printing – it is among the top 6 industries contributing to GDP, but only a quarter of its output is exported.

Figure 3. Structure of value added in Latvia's manufacturing, 2002



Source: Ministry of Economics. Latvia's Economic Development, June 2003.

With the exception of food and beverages, and paper and printing, all other developed industries export most of their output. This applies to the wood sector, textiles and apparel, machinery and equipment, and metals and metal products.

<sup>21</sup> Defined as having filed at least one quarterly report with the Enterprise Registry.

<sup>22</sup> See Appendix 1 for more data on SMEs in Latvia.

Table 1. Share of exports in turnover, 2002

Share of exports in turnover	%
Textiles and apparel (17–19)	84.1
Metals and metal products (27–28)	78.8
Wood and wood products (20)	69.5
Machinery and equipment	68.9
Chemicals (23–25)	63.0
Furniture, unclassified industries	69.5

Source: Ministry of Economics. Latvia's Economic Development, June 2003.

### 3.2. Immediate impact of EU accession

EU accession in May 2004 will not immediately provide significant export opportunities for domestic enterprises. Most of the benefits of open trade have already occurred through bilateral European Trade Agreements, which have liberalised trade in most product groups with some exceptions: the so-called sensitive sectors enjoying special protection in the EU – agriculture and textiles.<sup>23</sup> Many benefits of free trade have already accrued in the form of restructuring, adoption of new technologies, expansion and re-profiling. Over 60% of Latvia's trade is with EU Member States.

However, further EU integration will lead to continuous elimination of trade costs with the EU. First (relatively quick) changes will entail change of trade terms with other (non-EU) trade partners and free(er) trade in formerly protected areas.

Further liberalisation of trade will be gradual and will include the elimination of real trade costs. It will affect tangible things, such as the elimination of borders (this will take a few years, since the new members will have to wait for border controls to be dropped), and intangible ones, such as the reduction of information asymmetries between market players.

A briefing report by the Economist Corporate Network<sup>24</sup> maintains that the biggest beneficiaries of EU accession will be EU-based multinationals which will enjoy a simpler operating environment, fewer trade barriers and wealthier consumers. The same

<sup>23</sup> See Vanags (2002) for an evaluation of the economic impact of EU accession for Latvia using the Computable General Equilibrium approach.

<sup>24</sup> Economist Corporate Network (2002).

study also maintains that accession will encourage domestic companies to look for international partners and promises more benefits for companies that already have international partners and are selling internationally. The study claims that domestic companies in formerly protected industries will do worst of all – the negative effect coming from increased competitive pressure. Fortunately, Latvia's trade with the EU is quite free.

### 3.3. SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of domestic producers

There are many potential scenarios for development of the manufacturing sectors of the new Member States. Analysis based on historical data has its limitations for forecasting future developments. Whether present factors will indeed have the impact ascribed to them is anyone's guess. However, a SWOT analysis of Latvia's manufacturing industry in terms of its internationalisation potential might help to organize thoughts on its current state of development. This analysis draws on a Pricewaterhouse Coopers report (2003),<sup>25</sup> in-depth interviews with Latvian industry representatives,<sup>26</sup> and industry reports in media.

Current Position	Potential Future Developments
<p>Strengths:</p> <ul style="list-style-type: none"> <li>– local market knowledge;</li> <li>– knowledge of CIS markets (some);</li> <li>– brand awareness in Latvian and CIS markets;</li> <li>– accrued effects of trade integration into the EU market:               <ul style="list-style-type: none"> <li>▪ technologies;</li> <li>▪ partners in export markets;</li> </ul> </li> <li>– geographical proximity to Scandinavian markets and to the Russian market.</li> </ul>	<p>Opportunities:</p> <ul style="list-style-type: none"> <li>– some additional export opportunities;</li> <li>– potential closer cooperation with multinationals;</li> <li>– geographical proximity to Baltic Sea Region countries;</li> <li>– proximity to Russia (geographical and cultural);</li> <li>– increasing sophistication of customers in domestic markets, other Eastern European and CIS markets.</li> </ul>

<sup>25</sup> The study comprised in-depth interviews with senior executives in leading domestic enterprises in five sectors in the Czech Republic, Hungary, Poland, and some additional interviews in Slovakia and Latvia. In addition, the results of the 6th Global CEO Survey were used. PricewaterhouseCoopers (2003).

<sup>26</sup> Interviews were conducted with representatives from the Latvian Chamber of Commerce and Industry, the Association of Industrialists, and the wood, chemicals and pharmaceuticals industries.

Current Position	Potential Future Developments
<p>Weaknesses:</p> <ul style="list-style-type: none"> <li>– small production scale;</li> <li>– high costs of access to EU markets (language barriers, need for additional personnel);</li> <li>– high costs of marketing in EU markets (brand building, distribution);</li> <li>– labour mobility (loss of experts and inability to attract labour force from abroad).</li> </ul>	<p>Threats:</p> <ul style="list-style-type: none"> <li>– new trade regime with third parties;</li> <li>– high cost burden of EU standards (exceedingly strict regulations);</li> <li>– financing constraints on product innovation, expansion and internationalisation in comparison with foreign competitors.</li> </ul>

### 3.4. Barriers to internationalisation of SMEs

The important question for policymakers aiming to increase the capacity of domestic manufacturing is whether small and medium enterprises (SMEs) are inherently disadvantaged when it comes to expanding their output either in domestic or foreign markets?

This study argues that the main factors that impede the growth of SMEs are the high transaction costs of internationalisation and the provision of external financing. The first aspect focuses on the need to institutionalise internationalisation, and the second one – on financing it. Let us examine them in turn.

#### Institutional aspect

Institutionally, SMEs are restricted by their size when it comes to absorbing the costs of expansion. SMEs face higher transaction costs than larger enterprises because they cannot internalise all of the costs involved. This logic generally applies to all “overhead” functions where there are benefits of larger scale – such as marketing, sales-related activities, and lobbying or policy discussion. For example, SMEs often cannot afford to employ a specialist who would concentrate on finding export opportunities. It is difficult for SMEs to find information on product specifications and licensing required for potential export markets. Large companies solve these problems internally by employing in-house export specialists. SMEs cannot afford such specialists, do not know where to look, and do not speak English.

#### Financial aspect

The second aspect in which SMEs are disadvantaged is access to financing. SMEs normally have a shorter credit history, less collateral, and face high costs of loan proposal



evaluation relative to bank fees (due to the small loan size). On these grounds, it is often suggested that there can be grounds for policy intervention in the provision of financing for SMEs.

A survey of SMEs conducted by the Latvian Central Statistical Bureau<sup>27</sup> indicates that approximately 34% of enterprises mentioned difficulties in obtaining credit in 1995, and only 16% of the enterprises that remained active in 2000 mentioned this problem. An entrepreneur's own or a partner's savings along with money borrowed from relatives remain the major sources of seed capital. In transition countries, the level of savings is rather low, since the intertemporal preferences of consumers are skewed towards current consumption.

Meanwhile, the share of bank loans in start-up capital is increasing: among individual companies, 12% took advantage of bank loans for their seed capital in 1995, and 30% in 2000; among limited liability companies, this share was 12% in 1995, increasing to 32% in 2000. This corresponds to UK survey data showing that only 40% of SMEs sought external financing in the period between 1997 and 1999.<sup>28</sup>

The main problem reported in the SME survey is insufficient capital or lack of financing in all industries. In manufacturing and construction, the often-cited problems are insufficient capital and clients defaulting on payments. The same applies to companies involved in trade, although the shortage of capital is even more pronounced here. A report on Latvia's measures to increase the competitiveness of SMEs notes that lending for start-ups, micro-companies and SMEs in the development stage (with insufficient collateral) covers only a small part (estimated 25–35%) of total SME capital needs.<sup>29</sup>

### 3.5. Current Latvian SME policy

The National Programme for SME Development is the main SME-related policy document. Currently there is a "gap" between two policy periods: the previous programme covered the period up to 2002, while the new National Programme for SME Development was adopted only at the end of April 2004. Nevertheless, some of the policy instruments incorporated into the programme are already working.

<sup>27</sup> Latvian Central Statistical Bureau (2003).

<sup>28</sup> Bank of England (2003).

<sup>29</sup> 2004 Implementation Report on the European Charter for Small Enterprises in the acceding and candidate countries, [http://europa.eu.int/comm/enterprise/enterprise\\_policy/charter/charter-2004\\_cc.htm](http://europa.eu.int/comm/enterprise/enterprise_policy/charter/charter-2004_cc.htm) Last accessed on March 6, 2004.

The rationale for policies aimed at SMEs is to increase the number of active enterprises in Latvia, based on the reasoning that there are only approximately 18 enterprises per 1,000 people in Latvia, while in the EU this number is, on the average, between 40 and 60. For this reason, the government is assuming the role of promoting and increasing entrepreneurial activity in Latvia.

Currently, there is no sectoral focus, although discussions about the need to identify priority sectors are ongoing. There are regional instruments for SME policy – notably, these are interest rate subsidies in regions with inferior economic development (including all of Latgale, with the exception of Daugavpils and some rural areas in other regions).

State credit programmes for SMEs are administered through the Latvian Mortgage and Land Bank and the recently re-launched Latvian State Guarantee Agency (LGA). The first phase of the state credit programme took place in the period between 2000 and 2001, resulting in 350 loans with a total amount equal to 17.1 million EUR issued against state guarantees. The next phase for 2004–2005 earmarks 20 million LVL for state guarantees.

Regional programmes supporting SMEs were administered by the Ministry of Economics up until 2001 and are currently administered by the Ministry for Environmental Protection and Regional Development. They focus on least developed regions and include an SME-related component, which comprises interest rate subsidies on loans issued by private banks in these regions. The subsidy is equal to 12% APR in priority 1 regions and 8% APR in priority 2 regions. The second instrument is tax concessions, but this is not widely applied.

Table 2. Government programmes for SME financing

	<b>1. SME development credit program</b>	<b>2. Latvian loan guarantee program</b>
<b>Responsible organisation</b>	Latvian Mortgage and Land Bank; technical supervision – Ministry of Economics; state guarantees and credit line – Ministry of Finance	Latvian Guarantee Agency, combination of state financing and EU funds
<b>Target group</b>	– start-up companies; start-ups run by women and young people (up to the age of 25);	– start-up companies that do not have sufficient credit history and collateral;

	<ul style="list-style-type: none"> <li>– support for enterprises hiring un-employed persons and unskilled workers;</li> <li>– support for crafts, restructuring of SMEs, and introduction of EU standards in product quality and the environment.</li> </ul>	<ul style="list-style-type: none"> <li>– SMEs that plan to invest in new technologies.</li> </ul>
<b>Type of support</b>	<ul style="list-style-type: none"> <li>– loans for capital investments and working capital for those SMEs and start-ups which have difficulties in attracting private financing due to insufficient collateral or credit history;</li> <li>– minimum collateral required is 100% of the loan (private banks generally do not finance more than 70–80% of the collateral value). Loan tenure up to 10 years, with a possible 2-year grace period. Interest rates will be slightly subsidised.</li> </ul>	<ul style="list-style-type: none"> <li>– loans to start-ups satisfying two conditions: loans of no more than 20,000 LVL and guarantees for 70% of the project;</li> <li>– loans to promote development of SMEs, mainly intended for capital investments. Loans of no more than 50,000 LVL and guarantees for 50% of the project;</li> <li>– loans to promote entrepreneurship, for acquisition of new patents and licences, professional know-how or unpatented technological know-how;</li> <li>– maximum guarantee sum is 25,000 LVL and may not exceed 70% of a project's budget. Maximum tenure of a loan is 8 years, which can be extended to 10 years. Fee for a guarantee is up to 3% of the guarantee sum.</li> </ul>
<b>Eligibility criteria:</b>	<ul style="list-style-type: none"> <li>– companies which have less than 250 employees;</li> <li>– priority given to start-ups or SMEs in a development stage, and to SMEs with less than 10 employees.</li> </ul>	<ul style="list-style-type: none"> <li>– companies which have less than 250 employees, turnover under 23 million LVL and total assets under 12 million LVL.</li> </ul>

<b>Scope of the programme</b>	In the 1st phase of the programme, 350 loans were issued for a total of 17.1 million EUR. Average loan was 48,000 EUR. The second phase is to start in 2004 and continue until 2005, with total financing of 20 million LVL (30 million EUR).	Budget allocations for the programme include 0.75 million LVL (1.7 million EUR) from the national budget and 0.7 million EUR reserved from EU funds.
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Source: Ministry of Economics, interview; LGA webpage ([www.lga.lv](http://www.lga.lv))

### 3.6. SME policies co-financed with EU structural funds

The Latvian Single Programming Document is another policy document developed with the clear goal of enabling Latvia to receive EU structural funds. Adopted in late 2003, this document is followed by the more specific Programme Complement for Latvia, which allocates EU funds together with national co-financing to specific programmes. This document devotes a lot of attention to SMEs and is quite specific in describing policies and budget allocations, but not execution mechanisms.<sup>30</sup>

#### Box 2.

#### Eligible activities related to SMEs under the Single Programming Document for 2004–2006

##### Measure 2.3

- Financial support for SME participation in international exhibitions and trade missions, enabling Latvian enterprises to obtain international exposure.
- Financial support for SMEs to use external consultancy services and transfer of know-how in the following areas (but not only): market research, marketing, elaboration of business plans, financial management, quality requirements.

<sup>30</sup> Both documents can be downloaded from <http://www.esfondi.lv> Last accessed on March 6, 2004.

#### Measure 2.4

- Loans (including micro-credits) to support business start-ups.
- Development of loan guarantee systems.
- Venture capital funds. This measure will support equity investment in SMEs, and partially cover the administrative costs of the venture capital funds.
- Interest-rate subsidies. This measure will provide interest-rate subsidies on loans (credits) for establishment or renewal of fixed assets.

The impact of these policies is sensitive to the way in which they are carried out. As with any pull policy, their impact on the behaviour of economic agents can be distorting. For example, it is important to make sure that activities financed under measure 2.3 are not simply ones that companies would carry out in any case. In this way, these policies serve as a financial transfer to an enterprise and not as an enabling tool with a wider impact. The policies directed at SMEs mentioned in the Single Programming Document can generally be categorised as *pull* policies – they rely on spending money to motivate a certain type of behaviour by economic agents.

A different type of policy, the so-called *push* policy, is one that enables agents to carry out their activities more efficiently without altering their incentives. Such policies would include, for example, efforts to provide entrepreneurs with concise information on administrative procedures, assistance in filling out of forms, such as tax declarations, and opportunities to fill out these documents on-line.

Another example of a push policy would be the inclusion of information on international exhibitions and trade missions together with information on financing opportunities in a single on-line resource, and marketing it widely. This measure would ensure that new companies apply for funding or themselves finance participation in such events, and not only those that are well informed and have possibly already taken part.

The outcome of SME-related policies depends on their execution mechanisms – existing policy documents do not specify clear implementation mechanisms for new policies.

The study proceeds with analysis of and policy recommendations for existing SME financing programmes in Latvia. It describes the theoretical considerations behind financing programmes targeted at SMEs and examines experience with loan guarantee schemes in the UK before drawing recommendations for Latvia's SME-related policies.

### 3.7. Evaluation of SME financing programmes and policy recommendations

Capital market imperfections that are caused by asymmetric information between borrowers and lenders are the main justification for state loan guarantee programmes. The mechanism of restricting the access of small enterprises to capital which evolves as the market response to this problem is called credit rationing.<sup>31</sup>

The argument here is the following: banks cannot fully assess the quality of the borrower when the loan application is submitted. Hence, they cannot give lending rates that correctly match the risk profile of each lender. Banks request collateral as a way of reducing information asymmetry and as an additional criterion for defining a good project.

However, it is unlikely that all “good” entrepreneurs will have access to collateral. As a result, banks limit the number of credits to an extent where the supply of credits no longer meets the demand, and, subsequently, good projects are turned down. If collateral is used as a screening device, then SMEs are clearly disadvantaged, since they have less collateral and fewer funds for self-financing. This reasoning is behind most state-sponsored programmes which address the lack of collateral by issuing state guarantees.<sup>32</sup>

In short, state credit guarantee schemes aim to stimulate capital flow to the SME sector. At the same time, they limit the need for direct budget allocations to SMEs. And finally, they outsource the screening of projects to the financial sector, which has the know-how for this type of work.

In a paper attempting to evaluate the impact of a government scheme devised to assist enterprises, Cowling and Mitchell (2003) evaluate the UK Small Firms Loan Guarantee Scheme (SFLGS) for the period between 1984 and 1998. As a condition for minimising adverse selection, a borrower is required to exhaust his initial wealth (as collateral and co-financing). If the bank turns the loan down, an application for SFLGS is made and the borrower pays the government a premium in exchange for a guarantee.

The Cowling and Mitchell paper provides evidence of credit rationing and shows that, in the early phase of the program, 55% of the enterprises participating in SFLGS suc-

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<sup>31</sup> This mechanism was formalized by Stiglitz and Weiss (1981).

<sup>32</sup> This view is supported by literature showing that individuals are more likely to start a business after receiving a cash windfall such as a lottery win or an inheritance.

cessfully repaid their loans (despite a positive correlation between higher cost of borrowing and default on payment). In a later phase (1993–1998), the higher interest rate had a negative correlation with the probability of default, suggesting that a large proportion of the enterprises participating in SFLGS had been groundlessly credit rationed by banks. The paper shows that firms using credits to finance working capital had higher default rates.

**Box 3.**  
**Examples of loan guarantee schemes**

**The UK Small Firms Loan Guarantee (SFLG)**

The UK Small Firms Loan Guarantee Scheme was established in 1981 by the Department for Trade and Industry (DTI). The aim of the Scheme is to improve access to debt finance for viable businesses which are unable to gain conventional finance because of a lack of collateral or trading record, or a combination of both. The SFLG guarantees loans from banks and other financial institutions for small firms that have viable business proposals, but which have tried and failed to get a conventional loan because of lack of security.

Loans are available for periods of between two and ten years on sums from £5,000 to £100,000 (£250,000 if a business has been trading for more than two years). SFLG guarantees 75% of the loan. In return for the guarantee, the borrower pays DTI a premium of 2% a year on the outstanding amount of the loan. The commercial aspects of the loan are matters between the borrower and the lender.

Summarized from the DTI's Small Business Service website. Booklet describing SFLGS is available on-line: [http://www.dti.gov.uk/sflg/pdfs/sflg\\_booklet.pdf](http://www.dti.gov.uk/sflg/pdfs/sflg_booklet.pdf) (Last accessed on March 6, 2004.)

**The European Commission SME guarantee facility**

The European Investment Fund (EIF) manages various guarantee programmes on behalf of the European Commission (EC). The SME Guarantee Facility was implemented in 1998 as part of the European Union's Growth and Employment Initiative, a larger programme of financial assistance to SMEs. In December 2001, the EIF signed a new agreement with the European Commission in the framework of the Multi-Annual Programme for Enterprises 2001–2005 (MAP). Such agreement extends the coverage of the facility to other products and countries.

The Latvian Mortgage and Land Bank has become EIF's intermediary, making it eligible for guarantees targeted at SMEs from 2004.

The following debt financing windows are available under this facility:

- The EIF Loan guarantees to support enterprises with growth potential, with up to 100 employees. Under this window, the EIF issues partial guarantees (directly or indirectly) to cover portfolios of loans. EIF guarantees up to 50% of the intermediary's commitment (exceptionally up to 75%). Loan maturity of up to 10 years.
- Guarantees for portfolios of micro-loans for very small enterprises with up to 10 employees to encourage financial institutions to become more involved in this area by offering loans of a smaller amount which proportionally involve higher handling costs. EIF guarantees up to 75% of the intermediary's commitment. Loan maturity of up to 5 years.

Summarized from the European Investment Fund website. Programme description available on-line: [http://www.eif.eu.int/Attachments/productdocs/sme\\_gf\\_summary.pdf](http://www.eif.eu.int/Attachments/productdocs/sme_gf_summary.pdf) (Last accessed on March 6, 2004.)

### Recommendations for SME financing programmes

Theory and evidence show that, even in mature or efficient markets, lenders may under-supply credit to SMEs. Guarantee schemes adequately address the lack of collateral problem faced by SMEs when seeking finance and relieve the state of the budgetary costs.

Guarantee schemes are superior to government subsidies for SMEs because subsidised loans do not directly address financial market gaps. Giving interest rate subsidies is essentially similar to giving a certain amount of money to an enterprise as a gift. The SME development credit programme and LGA guarantees contradict each other in this respect: LGA charges premiums for state guarantees, whereas the SME credit programme provides subsidised credit. In this way, the SME credit programme combines a policy that seeks to correct possible market shortcomings in the provision of financing with a policy of providing direct financial transfers to SMEs.

There also appears to be no clear logic behind confining financing for SMEs to one bank – the Latvian Mortgage and Land Bank. SMEs are a target group for many banks that meet the criteria for receiving funds earmarked for SMEs and distributing these to



eligible proposals. This would foster competition in the provision of banking services for SMEs.

The bylaw of the Latvian Guarantee Agency (LGA) must be formulated more precisely: it must eliminate the adverse selection problem by requiring the borrower to demonstrate that he/she has exhausted all available collateral. If this requirement is not made more explicit, a borrower might turn to the LGA instead of mortgaging his loans, or pursue higher-risk projects, saving collateral for bank-financed projects. Of course, the liability of verifying compliance with this requirement should rest with the lender, as would be the case in any normal credit review process.

The LGA must clearly outsource decisions on granting credits to banks. Its loan review function should be limited to auditing all required documents and occasionally checking whether prudent credit decisions have been taken by the bank.

Analysis of available research on Latvia's manufacturing sector and current policy suggests a number of areas in which research is necessary for further policy decisions on non-bank external financing. Suggested areas for research are:

- the availability of trade-finance and export-finance instruments in the banking sector;
- the presence of liquidity constraints on SME export financing;
- the availability of non-bank financing – seed capital and venture capital;
- overview of institutional solutions and options for micro-credit.

### Institutional support for SMEs

SMEs clearly face higher overhead costs when expanding their business. During the course of the study, there was no clear policy in this respect, although specific initiatives were being carried out: support for participation in trade fairs and exhibitions, an information centre, an on-line database for facilitating trade. In addition, increased coordination of SMEs is taking place – in 2003, the Council of Latvian Small and Medium Companies and Craftsmen, was established by 26 business organisations.

However, the institutional problems faced by SMEs are different because these companies are not a homogenous group: SMEs are set up with different goals. Some SMEs are clearly established to exploit opportunities in export markets – there are examples of this in the IT industry and in the furniture industry. Others are established to service the local market and may want to move to export once they have exhausted their opportunities domestically.

Institutional support for exporting companies should take into account the internationalisation strategies of small and medium companies to formulate specific policy goals and measures. Before specific policy programmes are developed, it would be necessary to carry out research to understand how the existing SMEs internationalise. Research is necessary in the following areas:

- To determine the role of SMEs as suppliers to multinational companies and the process of direct internationalisation by SMEs. It is argued, for instance, that excessive support for export can lead to over-investment in exporting activities by small firms in areas where there are no market gaps.
- To evaluate the impact of the existing institutional support for international marketing activities and the usefulness of promotional tools, such as supported participation in international exhibitions and trade missions, free consulting services, and similar instruments.
- To define the appropriate target group(s) for institutional support. Some empirical studies show that the traditional view that firms internationalise gradually does not hold universally.<sup>33</sup> A growing number of firms are set up with a global focus from their conception. In these cases the characteristics of the owner – his or her education, experience, expertise, resources and intentions – play a crucial role in the export performance of such start-up firms. Therefore, educational policy could be one of the most direct measures to generate more internationally-oriented start-ups.

### General SME policy recommendations

Policies related to SMEs should apply to all sectors of the economy and should address clearly formulated goals such as increasing the number of start-ups exporting their products and services, improving the project-management skills of entrepreneurs, reducing the number of hours/costs of registering a business, finding export-financing solutions, etc.

The state should not aim to replace market mechanisms when fulfilling these goals – it cannot coerce people into creating new companies or working more productively. However, it can reduce the costs of doing business or fill in the gaps where the market

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<sup>33</sup> See Etemad and Wright (2003) for a literature review.

fails to provide a solution. Mechanisms for implementing these policies should then be developed with clear indicators for evaluating their impact and with a clear evaluation mechanism.

The most damaging entry barriers for SMEs are those created by governments: regulations, restrictions, legal logistics, taxes and corruption.<sup>34</sup> Economic research argues that artificial barriers to market entry encourage innovative people to invest in exploitation of the system, rather than in socially useful innovation. SMEs find government-erected barriers particularly hard to overcome – they are less experienced and have fewer resources than the large firms which can afford delays, lawyers, bribes and party contributions.<sup>35</sup> Hence, the first and foremost recommendation is to reduce the costs of business for SMEs.

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<sup>34</sup> Acs et al (1997).

<sup>35</sup> See Murphy, M. et al (1993).

## 4. ROLE OF FDI IN INCREASING MANUFACTURING CAPACITY

Foreign direct investment (FDI) plays an important role in capital formation in transition economies. Empirical research shows that FDI, domestic credit and local capital markets are all important financing sources for capital formation.<sup>36</sup> A survey of German companies investing in Central and Eastern Europe between 1989 and 2001<sup>37</sup> found that over 70% of German FDI was financed by transfers of own funds or bank borrowing in Germany. Moreover, FDI is generally regarded as beneficial for the development of recipient economies, producing direct and indirect effects on the host economy.

### 4.1. Direct effects of FDI

The direct positive influence of foreign firms that invest in developing countries is that they often have superior managerial skills, reputation, and technological know-how as compared to local firms. Multinational companies that dominate FDI flows are often more productive than local companies – this is their competitive factor, which allows them to expand internationally.

There is an increasing amount of empirical literature on the positive economy-wide spillovers of FDI, yet the evidence is often fragmented (it is difficult to measure cross-industry spillovers) or contradictory. In addition, FDI spillovers are even more difficult to predict than they are to measure.

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<sup>36</sup> Krkoska (2001).

<sup>37</sup> Sample represented 62 investment projects undertaken in this period, representing 45% of all German FDI. See Lorentowicz et al (2002).

## 4.2. Indirect effects of FDI

FDI can produce positive effects on the host market in one and the same industry or in related industries. These so-called spillovers originate from a number of sources.

First, domestic firms can copy technology or hire local employees who have worked in a foreign-owned company. In this way, FDI can generate a transfer of know-how and technology to domestic firms in the same sector. This can also happen through supplier and buyer relationships that link domestic firms with a foreign-owned companies.

Second, FDI increases competition in the domestic market and hence increases the motivation of domestic companies to adopt new technologies and processes. This competition effect depends on the level of technology and the quality of human capital in domestic firms – on whether or not they are able to address the challenge of the foreign competitor. If the technology gap is small and human capital is well developed, the increased competition may stimulate a productivity catch-up by domestic firms.

Technological complementarities between multinationals and domestic firms lead to more spillovers. This means that FDI “in a vacuum” is unlikely to increase productivity in other sectors of the economy.<sup>38</sup>

Much of the evidence on FDI spillovers originates from case studies that indicate potential spillovers but give little information on the magnitude of their effect and how common they might be.

One of the recent empirical studies on FDI that include the Baltic region is Smarzynska’s (2002) study on the effects of FDI on Lithuanian manufacturing, and the Lorentowicz et al (2002) study, which analyses factors that encourage German FDI in this region.

The study on Lithuanian manufacturing finds that the productivity of Lithuanian firms is positively correlated with the extent of potential contacts with multinational companies (whether or not they are physically located in Lithuania), but not with the presence of multinationals in the same industry.

Lorentowicz et al (2002) in their survey of German investors in Eastern Europe find that at least of 45% of investment projects fall into superior or high technology

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<sup>38</sup> Blomström, M., S. Globerman, A. Kokko (1999).

categories (characterised by share of R&D in output) judging by the parent company expenditure structure. They also find that the technology imported in approximately half of the projects was difficult to copy, yet less than a quarter of German-financed projects exhibited any degree of technological advantage over competitors in host markets.

### 4.3. Types of FDI

What makes companies set up operations in foreign markets? Dunning (1983) identifies the following four types of foreign direct investment:

- Market-seeking FDI to serve domestic and regional markets. This type of FDI is also called horizontal because it involves replication of production facilities in the host country.
- Resource- or asset-seeking FDI looks for natural resources, raw materials and low-cost inputs. A lot of export-oriented FDI is driven by these considerations. This is called vertical FDI because it requires relocation of a certain part of the value chain to a location, instead of replication.
- Efficiency-seeking FDI takes advantage of economies of scale and scope, with companies gaining from common governance of geographically dispersed activities.
- Strategic asset-seeking FDI usually acquires the assets of foreign corporations to promote their long-term strategic objectives.

Most of FDI world-wide is horizontal or market-seeking in nature. As discussed above, this type of FDI can be beneficial to the economy beyond its positive impact on employment, balance of payments and, possibly, tax revenue – it can have positive spillover effects on the rest of the economy.

### 4.4. Determinants of FDI

Market-seeking FDI is particularly dependent on the size of the market. Openness of the economy is argued to be positively related to FDI because it effectively extends the size of the economy.<sup>39</sup> Endowments, such as resources, labour cost and qualification, and others explain the resource- and asset-seeking FDI.

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<sup>39</sup> Caves (1996).

Research suggests that foreign companies are mainly attracted by host economies' strong economic fundamentals, such as market size, skill levels, availability of infrastructure, trade policies, political and macroeconomic stability, and incentives offered by host governments.<sup>40</sup> Agglomeration economics suggests that existing investment stock in a location attracts more investment due to the positive externalities it generates, such as knowledge spillovers, presence of specialised labour, and greater supply of intermediate inputs.

Political and economic risk indicators comprise macroeconomic stability (growth, inflation, exchange rate risk), institutional stability (policies towards FDI, tax regimes, transparency of legal regulations, and scale of corruption), and political stability, which are all conducive to FDI inflows. It is argued that good institutions help to attract more investment, where other indicators are equal. For example, it is suggested that corruption in a host country significantly deters inward FDI.

Incentives such as subsidies and tax incentives have been used by many countries although the evidence of their success is mixed. There is no comprehensive data on the use of incentives; however, one example from the 90s is Dow Chemical, which received \$6.8 billion for an investment in the petrochemicals industry in Germany, topping the list of incentives offered per job created – 3.4 million USD. Other examples include incentives for Hyundai, LG, Ford, and Dupont in the UK at the end of the 90s.<sup>41</sup>

There are a number of international policy initiatives trying to limit the use of these incentives. The EU's Lisbon Agenda calls for phase-out of sector-specific support. WTO rules also stipulate restrictions on specific subsidies via the WTO Agreement on Subsidies and Countervailing Measures.

#### 4.5. FDI in Latvia

The FDI share of GDP for the years 1993–2001 in Latvia is higher than the average in Central Europe: 28 per cent of GDP vs an average of 19 per cent in Central Europe. Latvia had received approximately 1,100 USD per capita in FDI by the end of 2002. This is very similar to the Lithuanian FDI rate of 1,000 USD per capita, but significantly lower than the Estonian FDI rate of 2,800 USD per capita.

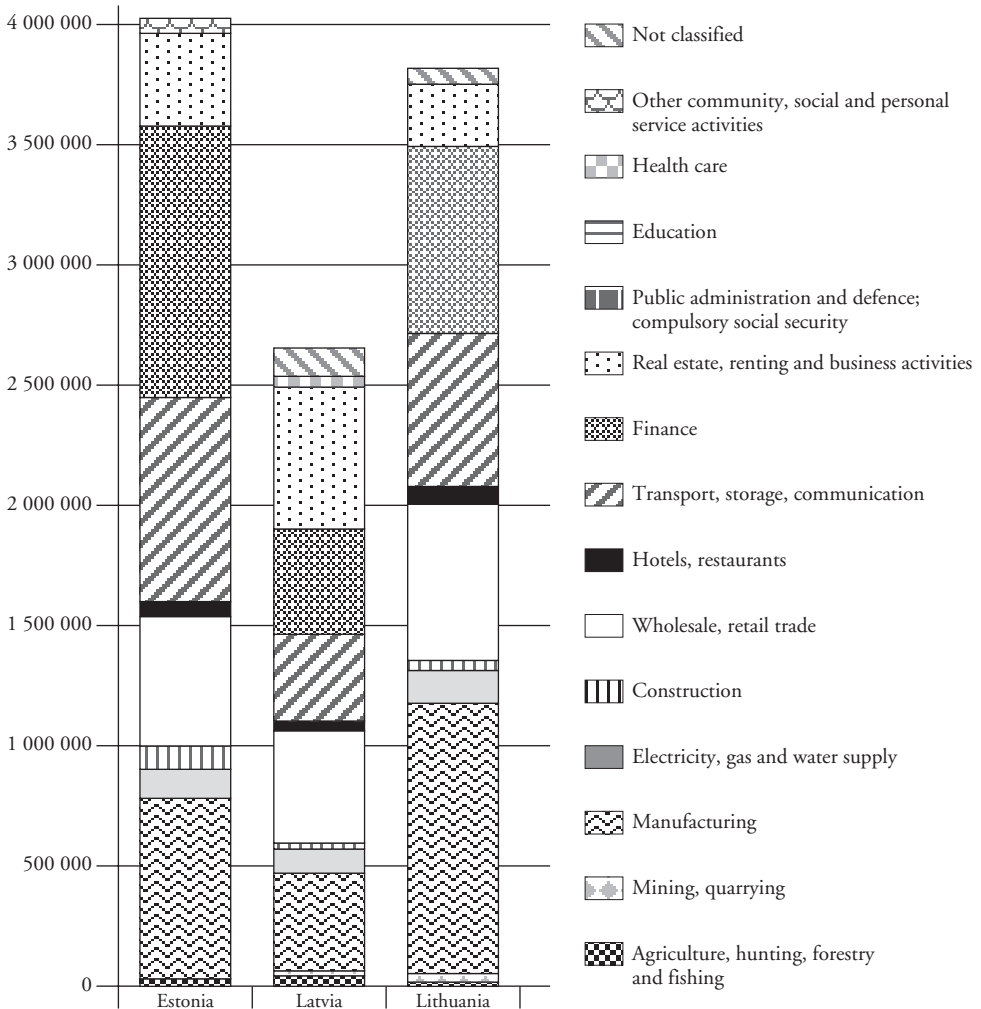
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<sup>40</sup> Blomström, M., A. Kokko (2003).

<sup>41</sup> UNCTAD, World Investment Report 2002: Transnational Corporations and Export Competitiveness, pp. 204–205.

Latvia's market is small and a large share of foreign investment has been concentrated on satisfying the demand of this small market. The industries that received the greater part of the investment are domestic in the sense that their products are consumed by Latvia's population and not exported. Investment went into industries such as trade (retail chains), finance (banks), and construction (recent commercial real estate developments).

Figure 4. FDI stocks at the end of 2002, shares of FDI by industry



Source: National Central Banks, 2002.



The table below shows that only one of the ten largest investments in Latvia was not targeted at satisfying domestic demand (and that has been invested in an oil pipeline).

Table 3. Largest foreign investors in Latvia at the end of 2001

Company in Latvia	Activity	Foreign investor	Country	Total investment, million USD
Lattelekom	Telecommunications	Tilts Communications A/S	Finland	155.61
Latvijas Unibanka	Finance	Skandinaviska Enskilda Banken	Sweden	136.33
Hansabanka A/S	Finance	A/s Hansapank	Estonia	106.99
Latvijas Mobilais Telefons	Telecommunications	Telia AB / Sonera	Finland/ Sweden	66.21
Latrostrans	Transit of oil products	Transpeteprodukt A/S	Russia	62.55
SIA Linstow Varner	Real estate	Varner Gruppen AS, ICA Ahold AB, Linstow ASA	Norway	56
Domuss	Real estate, insurance	New Century Holding	USA	45.3
TELE2 Ltd.	Telecommunications	Tele 2 AB	Sweden	40
Pirmā banka	Banking	Norddeutsche Landesbank (NORD/LB)	Germany	38.94
Stockmann Centrs	Retail	Stockmann AB Oy/ Rautakirja Oy	Finland	38

Source: Latvian Development Agency.

A number of analyses of trade flows and FDI show that 91% of Latvia's exports in 2002 could be attributed to the manufacturing sector, but year-end figures for 2002 show that only 16% of FDI had been invested in this sector. However, it is true that FDI flowing into the manufacturing sector is generally concentrated in areas with the highest share of export. These industries are identified in Table 4.

Table 4. Share of export by industry

Industry	Share of export 2001	Share of export 2002
Wood, wood and cork products, with the exception of furniture	27%	35%
Basic metals	10%	11%
Food products and beverages	9%	9%
Apparel, furs	8%	9%
Chemicals and chemical products	6%	8%
Textiles	7%	6%

Source: Latvian Central Statistical Bureau.

Table 5 shows the industries that received the highest shares of FDI in 2002 (percentage of total FDI stocks in manufacturing at the end of 2002).

Table 5. Share of FDI by industry

Industry	Share of FDI 2002
Wood, wood and cork products, with the exception of furniture	22%
Basic metals	6%
Food products and beverages	23%
Apparel, furs	3%
Chemicals and chemical products	9%
Textiles	9%

Source: Latvian Central Statistical Bureau.

### Comparison of Latvian FDI pattern to CEE

There are two main types of FDI in Latvia: 1) market-seeking FDI in the services industry, such as financial services, retail and hotels, and partially market- and resource-seeking FDI in the food processing industry, and 2) resource- and asset-seeking FDI in the wood processing and textile industries.

This FDI pattern does not contradict the overall pattern for CEECs. There is evidence reported by Mayhew (1998) that foreign companies (in Central and Eastern Europe)

“...have been at the forefront of demands for protection.” Mayhew cites above-average tariffs on imported cars in countries with FDI presence in the automotive sector, such as Poland, Hungary, Romania. Thus, small market size explains the low share of manufacturing FDI in the Baltics and is in line with the thought that manufacturing FDI in Central and Eastern European Countries has been, at least in part, market seeking.

Central and Eastern Europe-bound FDI has been relatively low-tech, more similar to that flowing into Spain and Portugal rather than the high-tech FDI that went into Ireland. Vanags (2003) presents an interesting analysis of Latvian FDI broken down into high-tech and low-tech FDI.<sup>42</sup> He estimates that only 14% of FDI in Latvia’s manufacturing sector went into high-technology sectors, further 15% into intermediate-technology sectors and the remaining 71% into low-technology sectors.

Bevan and Estrin’s (2000) empirical analysis of the determinants of FDI flows into transition economies demonstrates that, despite low credit ratings, the Baltic States receive more FDI than their market figures would suggest (most likely as a result of their market size and geo-political history). Their study also revealed that accession announcements<sup>43</sup> had a direct impact on FDI flows in accession countries, including the Baltic States. This could indicate that the effects of some actions (such as EU entry) might be felt even before the actions themselves are taken.

One forward-looking hypothesis about development in the Baltic Region could be that Russian companies will increasingly try to gain access to EU markets using the Baltic States as their production platform. This could be similar to Ireland’s experience with US companies. Russian is spoken in the Baltic States, there is a shared past, and geographical proximity. How quickly this might happen depends on the development of Russia’s non-resource-intensive manufacturing sector. One example of such development is Latvijas Balzams, which produces Stolichnaya and Moskovskaya vodka for European and US markets. The Latvian company was acquired by the S.P.I. concern with roots in Russia when it became impossible to produce these brands in Russia.

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<sup>42</sup> Chemicals, electrical machinery, optical instruments and motor vehicles are regarded as high-tech. Intermediate technology includes wood products, oil products, rubber products, plastics, metal products, non-metal products, and transport equipment. Other sub-sectors of manufacturing are regarded as low technology. [Eurostat: R&D and Innovation Statistics; Ninth EEA Working Party Meeting – Luxembourg, 16–18 October 2000].

<sup>43</sup> Copenhagen criteria in 1993, Essen pre-accession strategy in 1994, Madrid commitment to enlarge the EU in 1995, and Agenda 2000 identifying two waves of enlargement in 1997.

## 4.6. Lessons from previous accessions

### Ireland

Ireland has experienced spectacular economic performance in the period since the late eighties. Its GNP per capita increased from less than 65 per cent of the UK level in 1990 to parity with the UK and EU average today. FDI played a crucial role in Ireland's turnaround. The main factors behind FDI were the low corporate income tax, investment originating from the US attracted by the English-speaking workforce, liberal labour laws, labour mobility, and the inflow of structural funds from the EU.

Barry (2002) describes the Irish pattern of FDI since the 50s and notes that pre-EU accession Irish FDI originated mostly from the UK and Western Europe, was predominantly market-seeking, and was located in low-technology sectors. This pattern has changed after Ireland's accession to the EU.

Irish FDI is currently located in export-oriented industries, with a high R&D expenditure component. Foreign-owned enterprises employ a higher proportion of skilled labour than domestic companies and pay higher wages.

Barry (2002) draws two lessons for new EU countries based on Irish performance:

1. Using comparative-advantage indices as revealed by trade could yield very misleading predictions for future specialisation patterns of a country. In Ireland, analysis of comparative advantage as revealed by exports would have indicated that the country should specialise out of chemicals, metals and engineering into sectors such as food.
2. The impact of EU accession on Ireland's FDI was unclear *a priori*, because, while easing Irish exports to the EU, Ireland also lost preferential trade status with the UK. Barry claims that accession has increased the confidence of foreign investors, ensuring the possibility to appeal beyond the courts of the associated countries to those of the European Union in the event of disputes, and a perceived irreversibility of trade policy measures.

The Irish case is perhaps extreme in that 50% of its manufacturing output is exported, but export-oriented FDI is the channel that could be expected in the new Member States, as they continue economic integration into the EU.

## Portugal

Convergence in all of Southern Europe is positive, with Spain the fastest and Greece the slowest in catching up with the EU. FDI is an important reason for this economic convergence. Portuguese GDP per capita has increased from 55% of the EU average to 71.8% in 1999. However, overall FDI flows were unstable during the 1990s. Portuguese FDI is export-oriented, occurring mostly in intermediate-technology industries: transport equipment (Ford – Volkswagen Project), and mechanical and electric machinery.

The study of Portugal's trade advantage is interesting for Latvia's case. Similarly to Ireland's experience, Portugal's comparative advantage turned out to be a poor indicator of future specialisation patterns. The structure of revealed comparative advantage in Portugal showed a comparative advantage in textiles, clothing, and wood and cork products, and disadvantage in the sectors of metal products and transport equipment.<sup>44</sup> 10 years after EU accession, Portugal had lost its comparative advantage in the industries where this had previously existed, and disadvantage had decreased in industries where there had previously been no advantage. FDI was partially directed to industries in which Portugal previously had not revealed comparative advantage.

### Box 4. Industry location trends in Europe

Foreign direct investment is a cause for changes in the output structures of countries. A report prepared for the DG for Economic and Financial Affairs of the European Commission, *The Location of European Industry*, looks at individual countries' share of aggregate industrial output. The report concludes that European industry has experienced divergence from the early 80s onwards, with the most pronounced effect in the development of high-technology and high-skill industries in Ireland and Finland.

Econometric analysis presented in the report concludes that countries' specialisation within the European Union generally follows comparative advantage. This happens because economic fundamentals determine location patterns.

<sup>44</sup> Lima (2000).

More specifically, the study indicates that:

- the location of R&D-intensive industries has become increasingly responsive to countries' endowments of researchers;
- the location of non-manual-labour-intensive industries remains sensitive to the proportion of countries' labour forces with secondary and higher education;
- industries with strong forward and backward linkages are sensitive to the centrality/peripherality of countries. In other words, firms want to locate where their buyers are and where they have access to intermediate supplies. The importance of the location decision depends on the strength of linkages to supplies and/or buyers;
- industries with increasing returns to scale tend to locate in central regions;
- services are becoming more dispersed.

The policy-relevant conclusion of this study is that, as industry follows comparative advantage in terms of relative factor endowments, policy should be directed at developing relevant factor endowments rather than attempting to attract industry directly. This explains, for example, the development of a high-tech industry in Ireland in the 90s by the presence of necessary production factors, not merely by FDI policy:

...Ireland's high-tech policy may well bias high-tech firms towards locating in Ireland. But, as compared to Portugal, Ireland has twice the number of 25 to 59-year-olds with at least secondary education. If the availability of a correctly-skilled labour force is important in determining location patterns (and our regression results suggest that it is), then the difference between the Portuguese and Irish experiences is likely to be as much explained by this last fact as it is by the existence of Ireland's high-tech policy...

Summarized from K. H. Midelfart-Knarvik, H. G. Overman, S. J. Redding and A. J. Venables. *The Location of European Industry*, report prepared for the DG for Economic and Financial Affairs of the European Commission, 2000.

#### 4.7. FDI policy recommendations

Attracting foreign direct investment is one of clear policy goals of Latvia. In 2003, the Latvian Development Agency's role in attracting FDI was strengthened by the introduction of industry experts and the establishment of more active and capable representations abroad.

The policy instruments for attracting FDI can be broadly divided into two categories: first, those aiming to attract FDI to the country and, second, those capturing the benefits of FDI for the domestic industry. As the analysis in this chapter has shown, FDI flows are determined by a long list of factors, many of which are not part of FDI-policy as such, but relate to economic fundamentals.

Increasing the capacity of development agencies is one clear instrument for attracting FDI. Countries must often compete for investments by multinationals.<sup>45</sup> Latvia will be competing with its neighbouring countries. Clear efforts by development agencies will have to be employed to reduce information asymmetries about potential host markets for potential investors.

It is important for development agencies to engage in best-practice sharing agreements and consulting projects. As executives of the Irish Development Agency, which consulted Costa Rica on its FDI strategy, put it – if they did not engage in training potential competitors, there were many other international consulting agencies which would do that.<sup>46</sup>

As was discussed above, government incentives play a role in attracting foreign investment. However, before any active FDI-seeking policy is introduced, the question should be asked whether these incentives are likely to yield benefits at least as large as the costs. Blomström and Kokko (2003) conclude in their overview that it is not easy to determine where and how FDI spillovers occur, which creates a problem with “picking the winners” and increases incentives for corruption.

Another problem with FDI incentives is that they must be smaller than the benefits from FDI to be welfare improving – and benefits are difficult to predict and quantify.

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<sup>45</sup> For example, four countries competed for Intel's semiconductor facility. The competition was won by Costa Rica.

<sup>46</sup> Barry (2002).

Due to the fact that spillovers are not automatic and depend on the development of the domestic sector, and that it is hard to pick winners, policies must ensure equal conditions for all investors irrespective of industry or country of origin, and they must be rules-based. Incentives should not be paid before investment, but should be used to create potential for spillovers: education, training and R&D activities.

The second area that provides room for policy intervention is policies that maximise spillovers for domestic enterprises. Such policies may require a multinational company to source a certain proportion of its supplies from local suppliers or help domestic enterprises to find potential multinational customers for their products.

Research shows that more spillovers occur in cases where the domestic industry and the foreign investor are on similar levels of technological development. In this case, it seems that Latvia can benefit from attracting relatively low-tech FDI due to its larger potential spillovers.

Most importantly, the European experience shows that FDI is driven not only by policies but also by certain market characteristics, which need to be promoted for FDI to be efficiency-inducing. These include, first and foremost, the level of human capital and exposure to better technologies.

In this way, all policies directed at increasing the capacity of the domestic manufacturing sector by ensuring a better business environment, finance provision, and institutional support, all contribute to potential positive benefits generated by foreign direct investment.



## APPENDICES

## Appendix 1

## SMEs in Latvia

Most micro-enterprises operate in the wood and wood processing industry, publishing and printing, and the manufacture of food products. Food and food products, along with wood and wood products, also have the highest share in the medium- and large-enterprises sector.

Table A1  
Industries with the highest number of micro-enterprises  
(% of enterprises of the given size operating in these industries)

Industry	Micro-enterprises	Small	Medium	Large
Wood and wood products	19%	28%	23%	15%
Publishing, printing, recording replication	14%	9%	4%	3%
Food products, beverages and tobacco	12%	18%	26%	29%
Furniture	10%	8%	5%	11%
Apparel	8%	7%	9%	11%

Source: CSB 2002, own computations.

The majority of companies operating in the industries that contribute most to GNP are micro-enterprises with fewer than 10 employees.

**Table A2**  
Distribution of enterprises by size in the largest industries

<b>Industry</b>	<b>Micro-enterprises</b>	<b>Small</b>	<b>Medium</b>	<b>Large</b>
Food products and beverages	43%	37%	16%	4%
Wood and wood products	48%	40%	10%	1%
Apparel	59%	28%	10%	3%
Chemicals, chemical products, chemical fibres	60%	25%	11%	3%
Furniture	65%	27%	5%	3%
Medical, precision and optical instruments	77%	21%	1%	1%

Source: CSB 2002, own computations.

## Appendix 2

### Overview of manufacturing in Latvia and in the new Member States

#### Food, beverages and tobacco

This is a key industry in terms of output and employment in Latvia and in most new Member States. Unit labour costs have been growing in all countries. Latvia's EU share as export destination was only 12% in 1998 – as compared to Hungary's 40%, Lithuania's 24% and Estonia's 16.5%. This sector is very much affected by EU standards and requirements. There is a segregation between producers by size in this respect: larger companies involved in exports are up to EU's standards whereas small ones often have not yet invested in compliant production processes.

#### Textiles and apparel

This industry is third in output in Latvia, but with a very significant share of employment due to its labour intensity. In 1999, Latvia employed 16% of the labour force in this industry, compared to 19.3% in Estonia and 23.5% in Lithuania. The bulk of trade is with the EU, outward processing trade is significant. Textiles are not an important sector in the other new Member States, with the exception of Slovenia and Romania.

#### Wood and wood products

The second industry by volume of output in Latvia. This industry is important only in Estonia and Latvia among the new Member States. Most of the export goes to EU markets, and there is a trade surplus here. Export prices are low (export price gap of 24% in 1999 for Latvia – similar in all other new Member States with the exception of Slovenia). Main global exporters are Canada, Sweden and Finland. Latvia's main competitors are Estonia and Lithuania and, increasingly, Poland. Russia will be a stronger competitor in the future; currently it sells lower-quality wood and cannot be relied on to deliver on time.

Most of Latvia's exports in the forestry sector are wood (83% in 2002), of which 64% belongs in the category of non-processed wood – either logs or sawn timber.

Approximately one-third of all wood is exported as logs. However, the unit value of timber product exports has been growing – which means that companies are increasingly engaging in more processing activities.

It will take time for Latvia's manufacturers to move into goods with a higher processing component because so far Latvia's resources and labour costs have allowed for profitable exports. Also, smaller companies find it easier to sell commodity-type products since they are less buyer-specific.

With the increasing cost of resources (wood and labour), there will be more pressure on local producers to differentiate into various groups of finished products. This is determined by the fact that the cost of resources as a percentage of production costs is quite significant in the wood processing industry (over 60% in Sweden).

The wood processing industry has few economies of scale, which means that the trend towards increasing cooperation and reducing the number of players will not be as strong here. For instance, in Sweden, at the beginning of 90s, 2,000 mills with less than 5 employees were still operating. Limited economies of scale, however, do not preclude the advantages of reducing overhead expenses for small firms by cooperating. Indeed, in Sweden most successful companies are coordinating the operations of several sawmills.

In addition, the wood processing industry has strong economies of scope with the pulp and paper industries. In Sweden, some of the larger sawmills are often integrated with plants producing pulp, building materials or wood houses.

#### **Machinery and equipment**

This sector is important in Slovakia and Bulgaria. Latvia's unit values of exports are much lower than those of imports. Unit labour costs are significantly increasing. Trade competitiveness is currently very low.

#### **Paper, publishing and printing**

Share of output ranges between 4 and 9 percent in all candidate countries. Production is growing in Poland, Slovakia, Estonia and Latvia, with unit labour costs growing in Latvia.

*Summarised from Havlik et al (2001), interviews with Latvian Association of Industrialists representatives, and the business press.*

## Appendix 3

### Summary of FDI policy options in developing countries in Asia and Latin America

A recent study by UNCTAD (December 2002) identifies four types of policies pursued by developing countries in Asia and Latin America in past decades:

1. **Autonomous** – based on development of capabilities in domestic firms. Extensive industrial policy (shaping trade policy, finance, education, training, etc.), selective restrictions on FDI, strong export-oriented regime (export subsidies and concessions). Korea.
2. **Strategic FDI-dependent** – driven by FDI and exports to MNC global networks. Strong effort to upgrade MNC activity according to strategic priorities, directing investment into higher value-added activities. This strategy involves extensive intervention in market factors: skill creation, institution building, infrastructure development, and attracting, targeting and guiding investments. Singapore.
3. **Passive FDI-dependent** – driven by FDI, but relying on market forces to upgrade the structure with rising wages and growing capabilities. Main tools: open FDI regime, strong incentives for exports, export infrastructure. Skill upgrading and domestic technological activity not a priority, and domestic industrial sector tended to develop in isolation from the export sector. Malaysia, Thailand, the Philippines.
4. **Import-substituting-industry restructuring** – development of export capabilities in long established import-substituting industries. Main tool is trade policy liberalisation or strong export incentives. This leads to considerable upgrading, restructuring and expansion of these industries along with their supplier networks. In some countries, the main agents were domestic; in others, these were MNCs. The main difference from type 1 is lack of selective industrial policy. China, India, large Latin American economies.

The UNCTAD study notes that attracting FDI is part of a larger debate on promoting the industrial competitiveness of a country. The main structural drivers of industrial competitiveness are FDI, domestic R&D, skills, licensing and physical infrastructure. The choice between domestic and foreign firms to lead the capacity-building process depends on the existing base of skills and experience, and the demands of exporting. The strong points of foreign (multinational)-led technological development are their experience with technology, their internal reserves (capital, R&D, skills), access to markets, marketing channels and brand names. This is particularly relevant for Latvia, which aims to expand into industries that are currently practically undeveloped.

Summarised from UNCTAD (2002).

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