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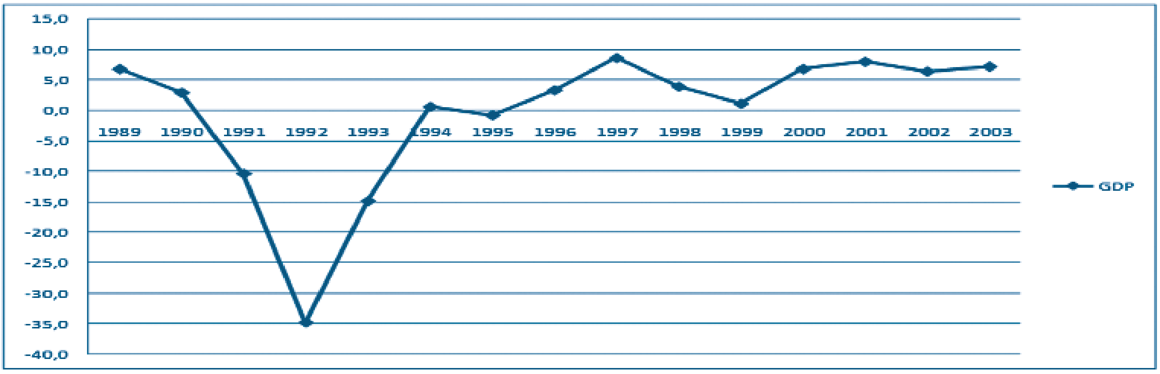
POST-ACESSION LATVIA: IMPACT OF THE EU MEMBERSHIP

The paper focuses on the economic and structural policy trends in Latvia as a new member state of the EU, and before accession to the EU. The role of international financial institutions during the first and second-generation reforms is discussed. The general economic development after the EU membership in 2004 is analysed, when high economic growth was combined with out-migration that calls for policies to promote human capital development in the country. Particular considerations will be given to regional and human dimensions at this time of the current global financial and economic crisis.

1. ECONOMIC AND STRUCTURAL POLICY TRENDS BEFORE THE ACCESSION TO THE EU: INFLUENTIAL FACTORS

In 1991 the Republic of Latvia became an independent country as result of a structural crisis in the socialist system and following the disintegration of the Soviet Union of which Latvia was a part since 1940. Immediately after independence was regained, the process of setting up a market economy system was started. It was based on a liberal economic policy, chosen by the Government that followed the recommendations of the international financial institutions. Institutional reforms, privatization and restructuring of large enterprises in all branches of national economy have been done according to a "policy package" suggested by the "Washington Consensus" and represented "shock therapy" policy [Williamson 1990; Kolodko 2002]. The key fundamental suggestions received from the International Monetary Fund (IMF), related to the establishment of a rigorous macroeconomic framework. Technical assistance, provided by the IMF and the World Bank, allowed to complete the first-generation reforms by the mid of 1990s. During the period of implementation these reforms, the economy has undergone three major downturns. First, in the period of 1991–1994, when the economy in 1992 shrunk by almost 35% with a dramatic decline of production and living standards. However in 1994 the rapid decline of GDP in Latvia was stopped. The second downturn, in 1995, started when the internal banking and financial crisis damaged the economic system in the country. Economic development was especially successful between 1996 and the middle of 1998 when average annual growth rates of GDP reached 6% and by the 1997 growth in the Baltic States was amongst the fastest in transition economies. However another, third downturn, happened in 1998 as the result of the negative impact on the economy of the Russian economic and financial crisis of 1998. Producers in Latvia experienced difficulties in selling their products on Russian market due to the weakening demand and strong Latvian currency. The Russian crisis of mid-1998 reduced Latvian exports to Russia and resulted in decline of production outputs. The impact of the Russian crisis on Latvia strongly influenced trade patterns and forced to reorient trade flows to the countries of the European Union. From a position in 1991 where virtually 100% of trade was with the CIS countries, by the time of accession, the EU accounted for approximately 50% of Latvian exports.



Source: EBRD [2000], CSB

Figure 1. Growth in Real GDP in Latvia before the Accession to the EU, 1989–2003, percent

The reorientation of exports, from Russia and the CIS mostly towards the EU countries after the 1998 rouble devaluation, served to abandon what was once Latvia's main export market; the EU-bound exports growing 16–17 percent per year [Bank of Latvia 2009]. Steadily a trend of inter trade with the EU as changed to an intra trade; the pre World War II trade pattern has been re-established. Structural policies have been based on the previously recognized comparative advantages of the country, particularly as far as the product composition of trade is concerned: wood and wood products dominated in the exports and the production of these also made a decisive contribution to the growth of GDP. Another important industry was textile. Exports to the EU were in general advantaged by cheap labour costs in an industry, which is relatively labour intensive. However, this advantage has eroded over the following years as Latvian wage rates moved to catch up to Western Europe.

In general the first-generation reforms in the beginning of 1990s, that helped establish strong macroeconomic fundamentals resulted in high GDP growth rates. The second-generation reforms have been implemented in the second half of 1990s with the prospect of for Latvia to become a member of the European Union.[1] The country has followed a set of preconditions for accession to the EU according to the criteria introduced by the Copenhagen summit of the European Council. Convergence in indicators of standard of living started with the prospects of EU enlargement and continued since after convergence was viewed in two ways: as the outcome of EU integration, but also as a precondition to it, because each country had to reach a certain level of development before becoming a member of the European Union.

Economic progress of the country required understanding that the emerging composition of production has to be complementary or competitive to the struc-

1 In 1999 the Government of Latvia signed the Joint Assessment with the European Commission on economic policy priorities for the country.

tures prevailing in the European Union. Support of the sectors of the economy that should be developed in order to benefit the most from EU membership, was of crucial importance Latvia's National Development Plan for 2007–2013 [Ministry of Regional Development and Local Government 2006] already in 2006 put the emphasis on the development of knowledge-based industries to stress in the future comparative advantages in those sectors, which Latvia has. This complements the traditional timber industry with such sectors as biotechnology, timber chemistry, pharmaceutics all of which require high technology.

Latvia has been generally following a set of monetary and fiscal policies demanded by the international market. Free convertibility and the liberal foreign exchange policy have secured competitiveness on the foreign exchange market. The national currency (LVL) was pegged to the SDR and shortly after was changed to a Euro peg.[2] It has been quite stable since its introduction and the domestic money supply has 100% foreign exchange coverage. Exchange rate pegs in Latvia have provided currency stability and significant progress with disinflation. However, when the exchange rate is fixed, the burden of adjustment in response to external shocks, or shifts in relative competitiveness, falls elsewhere on the economy. To the extent that prices or wages are not flexible enough, the real economy has to adjust. As a result of comparatively stable and liberal economic policies, the Latvian economy had been successful in attracting foreign direct investments (FDI)[3], which have had a positive influence on the rapid development of the foreign trade relations (see figure 2). However there have been substantial changes in the foreign direct investments over time; the modest investments in 1992–1996 increased considerable in 1997. Largest gains of FDI were experienced after the accession to the EU as the result of combination of political and economic factors. Major part of FDI has been in transport and communications, port facilities, industrial sector food and wood processing textiles chemicals, base metals, metal products and machinery. Investments have also been significant in real estate and construction business.

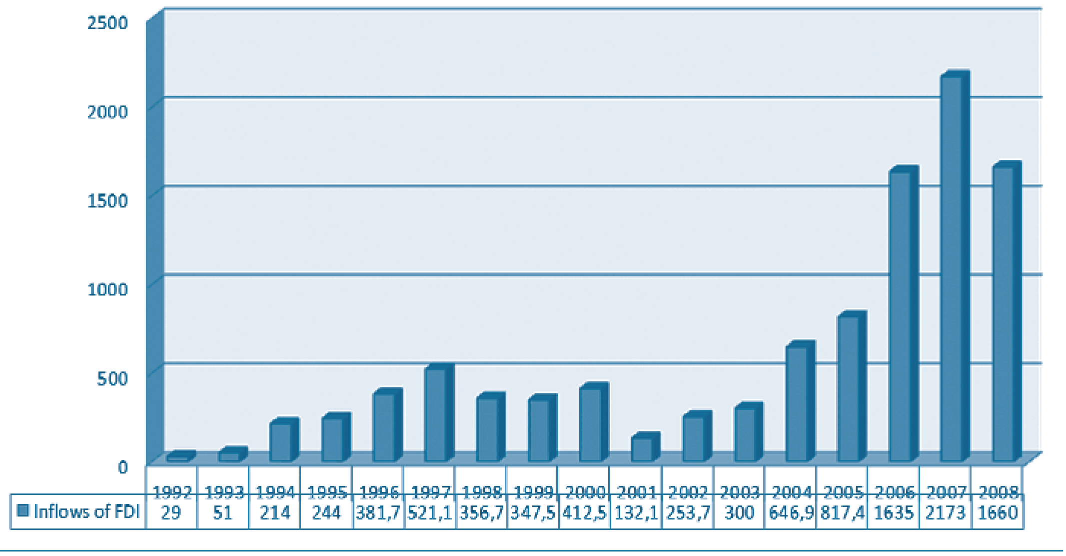
Since accession to the EU Latvia was considered as a capital-attracting country. The FDI stock more than doubled in both, goods and services.[4] However, the majority of FDI were financial transactions that are not included in direct and portfolio

2 Since the beginning of 1994 when the Latvian currency was pegged to the SDR, the unit of accounting of the Internationally Monetary Fund (1 XDR = 0.7997 LVL). The Bank of Latvia on December 30, 2004, has fixed the peg rate of the lats and the euro at 1 EUR = 0.702804 LVL, which took effect on January 1, 2005 in line with the government approved plan for Latvia's preparation for full-fledged membership in the Economic and Monetary Union (EMU). See http://www.bank.lv/eng/main/all/monpolicy/ls-euro/cmp1/ for more information.

3 Foreign investors get national treatment, and they are free to engage in any activity, convert and transfer their earnings. Companies established before 1995 received 4-8 years tax holidays. Since 2001, large investments – both domestic and foreign – are eligible for corporate income tax holiday of up to 40 percent of the invested amount, in line with the limit set by EU competition rules. Companies manufacturing high-tech products enjoy a tax holiday of 30 percent of the investment; in the case of small and medium-sized enterprises it amounts to 20 percent. The corporate income tax rate has fallen gradually, reaching 15 percent in 2004. The withholding tax on dividends amounts to 10 percent.

4 As concerns production of goods, a particularly rapid increase of the FDI has been observed in the energy sector (by almost 5 times), and more than 5 times in the construction sector. The dynamics of FDI was not so rapid in the manufacturing sector and has increased only by 1.5 times.

investment, but represented trade loans, other credits and borrowings, cash and deposits, etc. The biggest share of financial inflows belonged to commercial banks. This trend was stimulated by the open regime of the financial account and the fixed currency exchange rate. Mainly Nordic and German banks (Skandinaviska Enskilda Banken, Swedbank, Nordea, DnBNORD) have increased their stake in ownerships and new acquisitions in the financial sector.



Source: Republic of Latvia Ministry of Economy

Figure 2. FDI Inflow to Latvia in million USD

In 2000 Latvia became an integral part of the European banking system. The real time gross settlement system was introduced, which strengthened the motivation of financial capital to settle in Latvia. And since 2005 the leading position in FDI belonged to financial services *(see Table 1)*.

Table 1. FDI by Sectors of Economy in 2004–2008 (end of period, million LVL)

	2004	2005	2006	2007	3rd quarter of 2008
Primary sectors	49.8	59.5	71.6	112.9	146.1
Manufacturing	276.1	376.0	395.3	465.2	501.9
Energy	164.7	327.6	348.1	270.7	278.5
Construction	36.5	49.7	67.6	86.0	112.5
Trade	395.7	437.8	562.3	681.9	900.3
Transport and communications	333.3	336.4	347.0	398.0	454.5
Financial mediation	375.9	625.4	964.6	1434.7	1610.6
Other services	439.2	529.0	795.3	1214.5	1352.6

Source: Republic of Latvia Ministry of Economy

Inflow of FDI as percent of GDP was the highest in 2006 –8% and then was reduced to 3% in 2009. The high level of investments was stimulated by the intensified inflow of foreign financial resources in the national economy after accession to the EU while domestic savings were too low and cannot be considered as sufficient source of investments. However, a number of potential risks for future real convergence existed and associated with the scale of the current account deficit and inflationary pressures. Stable financing of the current account deficit due to strong flows of FDI plus cross-border credit transfers from Nordic banks to their subsidiaries in Latvia helped to sustainable economic development in pre-crisis period. Inflation increased in 2004, rising to 7.3 percent (according to the LR CSB), due in part to rises in administratively regulated prices, the harmonization of indirect tax rates in the context of EU accession, and high world oil prices. Negative factor in stimulating inflation in the next years that put significant demand pressures was the growth of private sector credit and real estate.

2. EU MEMBERSHIP AND REGIONAL DIMENSION

Accession to the EU provided for Latvia access to the EU Structural Funds (SF). The total accessible financing for Latvia from 2004–2006 was EUR 625 million in the framework of Structural Funds programs and the total Cohesion Fund (CF) financing accessible to Latvia within the period from 2000–2006 amounts to EUR 710 million. In the period of 2007–2013, distribution of the SF and CF financing in the amount of EUR 4.53 billion is available to Latvia.[5] This amounts to about 500 million per year as compared with 1000 million FDI in 2008. As a response to critical economic conditions in the country, temporarily no co-financing is required by the European Commission from the national budget. Successful implementation of this external source of financial resources was aimed at increasing standards of living and reducing gap in GDP per capita in Latvia with the old Member States and increasingly at securing internal cohesion and diminishing regional disparities inside the country. In terms of the EU Cohesion policy, Latvia is one region according to NUTS I, and NUTS II classification, but there are 6 regions at NUTS III level, which are further divided in (self local governments defined by law, being administrative territorial units for municipal elections, governed by "Councils"). The country is also one of the poorest Member State with GDP per capita in purchasing power standards at only 43.7 per cent of the EU-27 (see Eurostat website for more data) average in the recent years. The scale of the gap requires continuing the implementation of a comprehensive catching-up development strategy.

The geographical distribution of population and migration shows a strong urbanization trend in Latvia like in the rest of Europe. In terms of population concentration in capital cities Latvia ranks second, after Portugal at the EU level. Over forty per cent of the population is located in the capital city of Riga, which produced in 2007-mid 2008 around sixty per cent of the domestic GDP. The central part of the country, where Riga is situated concentrates most of the economic activities and population. The next cities in terms of their contribution to GDP are

5 For more information see the National Strategic Framework Document (NSFD) for the period of 2007–2013.

Daugavpils, Liepaja and Ventspils, which each produce around three per cent of national GDP. In the pre-crisis period, regional trends represented metropolisation of the economic development; Riga and area that is called Pieriga significantly contributed to the GDP and employment. The latest pre crisis data shows that the biggest part of Latvian GDP (57.3%) was produced in Riga. The second biggest region by contribution to GDP was Pieriga (11.1%). Following EU accession, in 2005, GDP per capita in Riga was 1.8 times greater than in the country on average. The continued concentration of economic activities in Riga and Pieriga significantly reduce the importance of the other regions in the country. These disparities are in part due to differences in the residential and working locations of some citizens i.e. the level of GDP per capita in Riga partly reflects the effects of commuting from other areas [Muravska et al 2004]. Major efforts are still needed to improve the transport and communication system throughout the country. The whole road sector in Latvia, including the TEN network, primary roads and secondary roads needs substantial improvements; the latest data show that 44 per cent of the State's roads are in very poor condition. However, it will be of prime importance to make the correct policy choices when allocating funds between potential infrastructure investment projects. There are four special economic zones across the country, three of which are located in the free ports of Ventspils, Riga and Liepaja – the fourth being an inland zone in the city of Rezekne (in Eastern Latvia, close to the Russian and Belarusian borders). As the result of negotiations with the European Commission these zones are allowed to operate until 2017. Latvian authorities consider this a big achievement that would attract FDI. Special Economic Zones were established with the object to develop trade, industries, international freight flow, shipping and air traffic, implement modern technologies and create additional workplaces for the population of these regions. Regional and local authorities can also provide and sell land as well as real estate under favourable conditions to companies intending to create employment. Before the economic downturn local governments suggested to grant up to 90 percent property tax reduction for investment projects conforming to their local/regional development strategies. Despite of the above incentives, the gap between Riga and the rest of the country is still increasing. The highest registered unemployment rate was in Latgale area (17.8 percent in 2003) and the lowest is the Riga area (5.1 per cent in 2003), while the unemployment rates of the other three areas were around 10 per cent. Regional disparities are strong with the registered unemployment rate in 2003 ranging from 4.5 percent in Riga capital to over 25 percent in several districts in the Latgale region (see LR CSB website for more details). Labour migration was always limited between regions and cities due to transport infrastructure, public transport services that are not advanced enough. Lack of jobs and employment opportunities in Riga as well as in other major towns in the country reduces commuting and keeps disparities in employment. Another trend that influenced the labour market is migration as the result of Latvia joined the Common market of the EU and its freedom of movement of persons. A comparison of population and out-migration patterns in Latvia before and after accession to the EU show a significant population decline and out-migration [Muravska–King 2008]. Higher migration abroad was in Riga and Latgale – 1.6 and 1.4 persons per 1000 inhabitants respectively (1 per 1000 on average in Latvia). According to the LR

CSB, higher long-term migration within Latvia was observed in Vidzeme (5.2 persons per 1000 inhabitants). It is typical that inhabitants from Vidzeme more willingly migrate to Riga or Pieriga, not abroad. Out-migration from Vidzeme to foreign countries is two times lower than in the country on average (0.4 persons per 1000 inhabitants). Higher positive balance of migration was only observed in Pieriga region. There is also a need to consider whether the likelihood of further restructuring in the agriculture sector implies the need for Cohesion policy intervention in rural areas, particularly those with high rates of unemployment and social inclusion. Efforts will be needed to improve the skills and flexibility of the labor force in these areas, particularly among people in long-term unemployment. Measures to enhance the overall context for job creation in rural areas with low levels of entrepreneurship and a low density of firms have been in focus of Structural Funds projects. In order to develop the long-term structural potential of such areas, intervention may be needed to upgrade the quality of transport and communication linkages with nearby towns that could become a focus for business activities further development of SMEs and investments. One of the other main problems that Latvia is facing is insufficient administrative capacity at national, regional and local levels. At national level one of the main challenges is to build an effective and modern public administration, to ensure the efficient management of public funds. There is still a need for far-reaching changes in the practices and operations of all levels of the public administration.

3. GLOBAL CRISES AND ITS IMPACT ON LATVIA

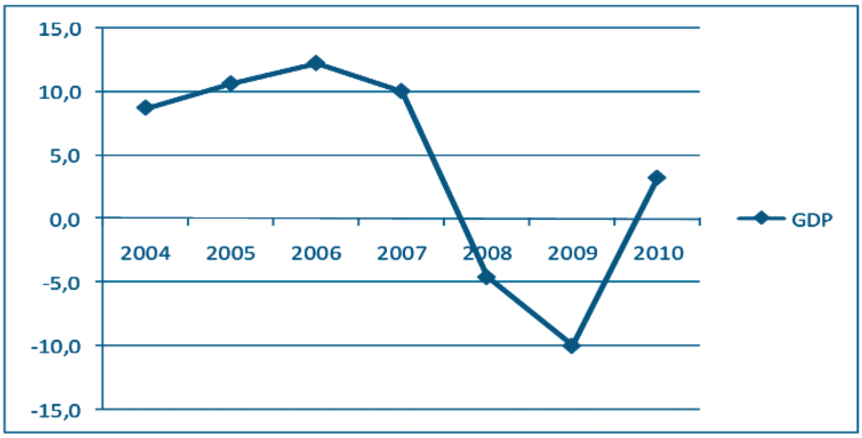
The Baltic States had shown positive and strong economic development until mid-2008. The most impressive growth rate among the Baltic States was experienced by Latvia, which was also the fastest in the EU until recently. Latvia's GDP growth was more than 10% per year during 2004–2007.[6] Latvia has followed an ambition reform strategy in recent years after the EU accession. This strategy was based on the twin pillars of fiscal consolidation and structural reform.

The recession started in the first half of 2008 [European Commission 2009]. Economic downturn originated in the reversal of the domestic real estate boom, worsened rapidly and affected GDP growth rates, which dropped to 4.6% in 2008. The hardest downturn was in retail, real estate and construction. Large domestic consumption as the result of a liberal credit policy by banks (majority of them are Scandinavian credit institutions) in Latvia was one of the reasons for loan-boom in the country, where foreign currency loans dominated. Experts and government leaders prior to the crisis had stressed the danger of this situation. Unfortunately government's decision to limit housing loans through request to buyers to provide co-funding in the value of at least ten per cent of the value of the purchase and the proof of taxed income from the State Revenue Service, was introduced too late.

The catalysis of the rapid economic downturn was the fact that in November 2008 the second largest bank (measured by total assets) and the only Latvian-owned

6 10.4% in 2004; 11.9% in 2006; 10.2% in 2007 – see the Eurostat website for more details.

commercial bank, Parex Bank announced insolvency. Despite nationalisation of the bank, rapid capital outflows continued and the government introduced deposit withdrawal restrictions. Consequently non-resident deposits had in general diminished by 19.2% compared to the end of last year in December of 2008 in Latvia[7]. In general, the global financial turmoil put a blockage on credit channels, and investment flows into Latvia drained off. The Parex Bank case very seriously affected this process. The outflow of FDI according to the Central Statistical Bureau amounted of 16.5 million LVL in Q1 of 2009, down almost 94 % from 260.8 million LVL in Q1 2008. In the coming years Latvia is still facing economic downturn, through unstable financial sector situation, crash of real estate markets, fall in production and growing unemployment.



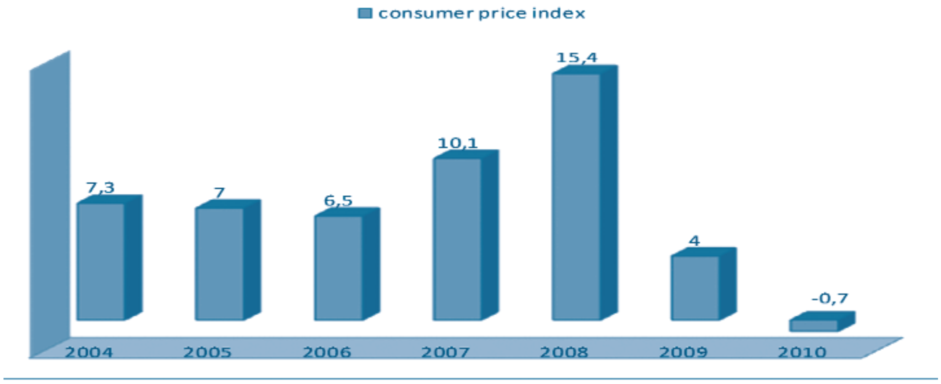
Source: Republic of Latvia Ministry of Economy, European Commission

Figure 3: GDP Trends in 2004 –2010(EC forecast)

The adjusted GDP figure for the first quarter of 2009 was –8.0%. International experience shows that economic growth was not just a symptom of economic overheating. So called overheating of the Latvian economy was and is continued to be discussed by experts. However, no forecasts have been made for such deep downturn as in Latvia and the other Baltic States are experiencing now.

The GDP expenditure data suggest that both the persisting decline in domestic demand and the fall in exports, which began in the second half of 2008, have con-

7 The Parex Bank restructuring component required large funding as Parex Bank (assets equivalent to more than 20% of GDP) was taken over by the government following a run on deposits and the consequent need to avoid default on the 775 million euros of syndicated credits due in 2009. The problems at Parex Bank were one of the main reasons why Latvia applied to the IMF and EU for financial help, since the syndicated credit had the right to demand repayment of the debt immediately following a change in ownership at the bank, and the government needed the institutional support to be able to renegotiate and rollover the debt. As a result the Latvian authorities have been able to issue guarantee for the refinancing of syndicated loans due in 2009. The risk of further deposit withdrawals from Parex Bank, especially by non-residents, will continue despite the effective nationalisation of the bank. At present negotiations with the EBRD take place for the EBRD to become a partner of the Bank.



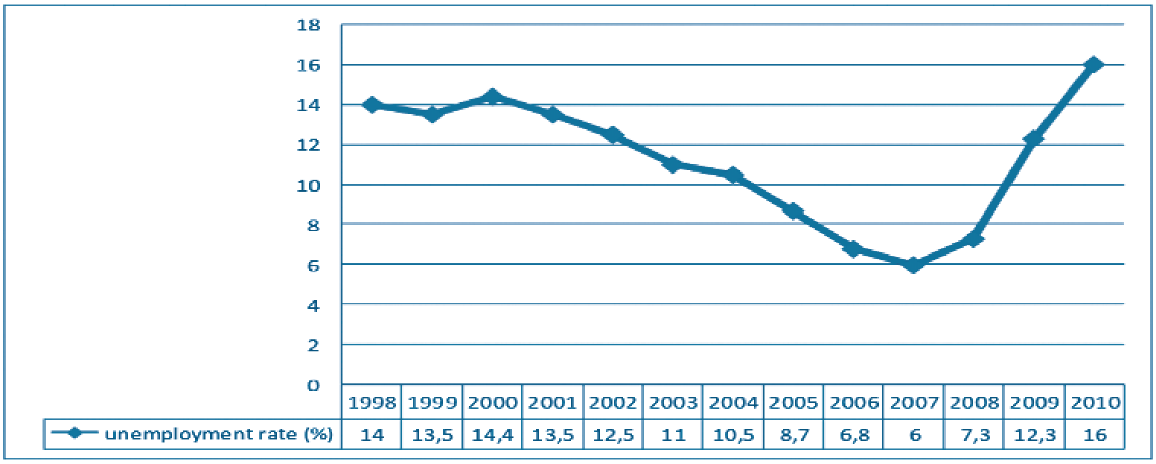
Source: Republic of Latvia Ministry of Economy CSB, European Commission

Figure 4. Consumer Price Index 2004- 2010

tributed to the intensification of the slowdown. Slowdown in the economic activity caused a sharp decline in inflation: in 2009, the average annual inflation forecast of 2.5%–3.5% was substantiated, but at the close of the year inflation turned into deflation.

The price decline was supported by the persistently low demand and a decrease in the energy prices. Furthermore, on the backdrop of declining natural gas prices for businesses, heating tariffs recorded a notable reduction of 8.9%. However, the rising global oil prices curbed the fall in consumer prices.

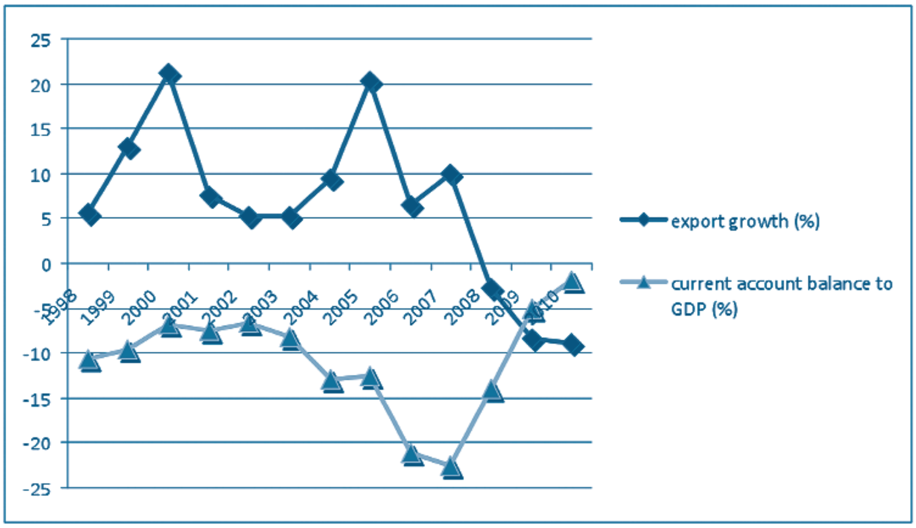
Raising unemployment escorted the economic downturn. According to the State Employment Agency, the unemployment level was 11.8% in July 2009, and it reached



Source: Republic of Latvia Ministry of Economy CSB, European Commission

Figure 5. Unemployment 1998-2010 (EC forecast)

22% in 2010. According to the Ministry of Economy, the government further reduced public spending and the budget deficit by 500 million LVL in 2009. Currently the budget deficit is 8.5% (see LR CSB website for more details). Additional cuts of public spending are foreseen in 2010 and 2011, this will increase



Source: Republic of Latvia Ministry of Economy, CSB, European Commission

Figure 6. Export Trends and Current Account Balance to GDP 1998-2010(EC forecast)

the number of unemployed people and the followed reduction in demand will result in further staff cuts in private sectors.[8] According the EU Lisbon Strategy "Europe2020", the aim should be to reach an employment level of 75% for age group 20 to 64; currently in Latvia this percentage is only around 58%.

Most enterprises are currently trying to reduce wages instead of reducing staff. With the deterioration of the economic situation, there is also a risk that small companies could cross into illegal employment and the grey economy.

In 2008 Latvian exports to the EU started to decelerate, while foreign trade with the Community of Independent States (CIS) remained active. Exports changes over the previous year, show decrease of 6.4% in 2008. Import decrease was 13.8% in 2008. In 2008 Q4 the most serious decline in export was to the EU 15 by 18%, and to the EU 27 by 11.5%, but exports to the CIS showed an increase of 6.7%. Imports in 2008 Q4 decreased by 15% from the EU15, 17.6% from the EU27 and increased 7.5 from the CIS. According to the forecast of the Ministry of Economy, decreases in export and import could reach 8.4% and 21.2% in 2009. Over 2009 as the whole foreign trade turnover totalled annually about 12 billion euros, a drop of 31% when compared to 2008.

The latest CSB data showed that in June 2009 the share of the EU countries in Latvia's export was 69%, while the CIS had 14% share. Comparative advantages of the economy are significantly damaged especially by decrease in wood products and textile. Considerable decline was due to the lower external market demand. Consequently production of these goods was seriously reduced as local demand for wood products and textile also declined.

8 Due to the requirements of the EC and IMF to cut the budget expenditure, the government must reduce the number of employees in the public sector, which resulted in high unemployment of public servants and other groups of employees in different areas of the public sector located in Riga and major cities in the country.

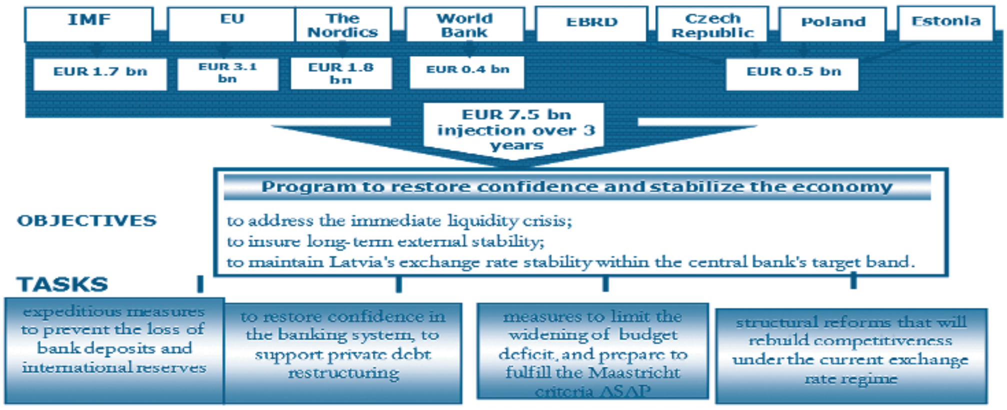


Figure 7. Programme to restore confidence and stabilise the economy of Latvia

The current account worsened considerably over recent years *(see Figure 6)*.

The current economic crisis in Latvia represents major threats for the further development of the country. Capital outflows are already taken place and the country's economy is facing a new wave of emigration and "brain drain".

4. POLICY RESPONSES OF THE GOVERNMENT, THE EU AND THE INTERNATIONAL COMMUNITY WITH SPECIAL REFERENCE TO THE HUMAN DIMENSION

A program to restore confidence and stabilize the economy has been initiated in accordance with an agreement with the IMF. This program involves a 7.5 billion euro injection of liquidity into Latvia, including contributions from the EU, the IMF the Nordic countries, the World Bank, and other European countries.
The main issue concerning the currency peg is for how long the Bank of Latvia will be able to maintain the existing exchange rate. Devaluation of a national currency of Latvia, which is hardly debated by policy makers and experts in the international, European Union and national financial and government institutions, could have positive and negative effects that will impact trade and investment flows. It will seriously damage the real income of the population as most of the resident credits have been taken in euro. Devaluation of the LVL could also negatively affect the economies of the other Baltic States by the so called "domino effect". However an internal devaluation took place already in 2009 by deep cuts in wages and public spending.

Currently the government of Latvia continues to be occupied with reforms of the management system of the country, and follows the path of so called internal devaluation:

- 20% salary cuts in public institutions and overall expenditure of ministries;
- Tax-exempt minimum of natural person's remuneration is to be reduced from 90 to 35 LVL and possible increase of VAT;
- 10% reduction in all kinds of pensions; extra benefits remain unchanged;
- Pensions for working retirees are to be reduced by 70%;
- 10% cut is planned in maternity allowance;

The internal devaluation measures resulted in dramatic budget cuts with bad news every day: severe salary reductions in the public sector, including the health and education system, decrease in number of places for students and researchers and almost total elimination of the research budgets. Unfortunately, under the presure of Washington institutions, short-term thinking dominated. Despite the severity of the crisis a number of constraining factors could still prevent fast recovery:

1. Disagreements between major political parties have prevented public sector structural reforms;
2. Government expenditure rose by 9.3% year-on-year in the first six month of 2009;
3. Fiscal deficit reached 9% of GDP in 2009 and is unlikely to improve in 2010;
4. Risk of the erosion of the public sector, loss of country's competitiveness and appeal for investors.

Nevertheless, it would be particularly important to coordinate business support measures with active labor market policies, in order to mitigate structural long-term unemployment.

From the point of view of stemming the flow of out-migration from Latvia to foreign countries, reduction of internal disparities as well as increasing overall economic performance are important. That most out-migration from Latvia originates from Riga and Pieriga as well as in the geographically more peripheral Latvian regions of Latgale and Kurzeme. Overall economic decline, coupled with decreases in salaries and wages give people a more pessimistic outlook about their potential career in their own country and induce them to emigrate. On the other hand diminishing regional disparities would presumably reduce the incentives for residents of the regions outside commuting distance from Riga to migrate to foreign lands – either directly or indirectly, with a first temporary stay in or near Riga.

Current global financial and economic crisis has influenced economies of the EU and employment level. Cohesion policy could provide means for long term stabilisation of EU economy, in order to reduce long term impact of the financial crisis. Still, the current crisis should not impact the future Cohesion policy's direction of development. The Cohesion policy cannot become a primary compensation mechanism. In order to address the consequences of financial and economic crisis, the Cohesion policy is slightly adjusted to provide urgent support, as, for example, no need for national contributions, but this does not mean long term changes and does not make changes in main political targets.

This puts strong pressure on the government regarding effective policy choices for sustainable development and cohesion policy implementation; given that the country's human resources for successful economic restructuring are limited.

CONCLUSIONS

When the financial crisis hit, Latvia suffered an exceptional slump. GDP has fallen, unemployment has increased and exports to the EU have decelerated. The economic crisis and fall in growth of GDP could be explained by the following factors: rapid growth of domestic demand generated by loans from foreign banks, low interest rates, real estate boom, positive growth expectations of foreign investors, FDI and export growth oriented on cheap labour. Latvia's service and construction sectors grew rapidly, but manufacturing was left lagging behind. Strong domestic demand and a disproportionate current account balance pushed inflation beyond the 10% threshold. But, at some point, the process spiralled out of control. In just a year, the economic boom was replaced by a crisis, which made foreign borrowing unavoidable.

The previously widespread policy of lending without any in-depth research into a loan applicant's credit history was suddenly replaced by a much more cautious approach. Together with an increase in value-added tax, this has profoundly influenced consumer trends. Unemployment will continue to increase and there is possible development of social unrest with further GDP decline: a looming social crisis. The Latvian government has been stabilising exports and promoting exports guarantees and partial import substitution with locally manufactured goods. It is well positioned between the West and East; it has a coastal infrastructure near the Baltic Sea; and it can still provide a well-educated and skilled workforce. These factors will certainly help to maintain the appeal of the Latvian economy in the long term. The key factors for conducting successful national policies are targeted and coordinated innovation policies, flexible labour markets, systematic investments into human capital, proper migration policies etc.

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