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Industry Policy in Transition: the Case of Latvia

The Latvian economy is presently in a state of transition to a market economy. Important steps have been taken to speed up the process, and other steps are being implemented. Still, there is a growing number of signs that the transition to the market economy will be a difficult journey. The economy has been affected by a sharp fall in output. The current situation in Latvian industry is characterized by a permanent decline, which started in 1990, deepened in 1991 and 1992 and is still going on.

There is no general theory of transition nor of industrial policy in transition. It is difficult to generalize the empirical evidence and evaluate the costs and benefits of different strategies.

This study – emphasizing Latvia's brief experience of transition – is summarized as follows:

i) the Soviet legacy of industrial policy in Latvia

ii) causes of decline in output in the initial phase of transition

iii) brief comments on Latvia's comparative advantages

iiii) discussion of industrial policy and the role of the state in industrial restructuring

iiiii) main goals of industrial strategy in the medium and long term and short term crisis management.

1 Soviet Legacy: Industrial Policy in 1980–1990

Latvia had a relatively developed market economy during its period of independence, 1918–1940. The economy was dominated by agriculture, but a fairly advanced industrial sector was emerging.

The economic structure changed dramatically following the Soviet invasion in 1940. During the postwar period industry took a leading role in the Latvian national economy. It developed rapidly due to the so called "narodnokhozyaystvennyi kompleks" of the former U.S.S.R. The central planning mechanism resulted in the establishment of a policy framework emphasizing Latvian industry as a supplier of certain industrial goods in general and food products in particular. Forced growth had a strong impact of the composition of output. A strong emphasis was put on heavy industry and military production. The production of consumer goods and provision of services was relatively neglected (for a description of Latvian industry in 1980–1990 see also references 1,8,11).

Industrial policy has been supported by a high level of investment. The absence of a market environment led to low efficiency of inputs. However, only in 1990 – 1991, when the shortage of material and technical resources began to surface, did the increase in industrial production come to a halt. Nevertheless, Latvian industrial production per capita in 1990 was higher than in all the other Soviet republics except for Estonia.

The share of industry in the NMP estimated at current prices was about 56 % in 1980. During 1985–1990 it fell to 45–51 %.

Table 1 shows the sectoral composition of industrial production. Many enterprises, especially in the chemical and other heavy industries, were organized solely for the needs of the Soviet Union. Latvia had a monopoly in the manufacture of many important items. Such items were railway passenger cars for electric and diesel trains (100 % of the total U.S.S.R. production), telephone sets (53 %), motorcycles (57 %), building instruments, auto and tractor electric devices, agricultural machines, medicines and other goods. About 98 % of all automatic exchanges, 93 % of motorcycles, 92 % of busses, 89 % of washing machines,79 % of radio sets, 77 % of telephone sets and 71 % of diesels and diesel generators manufactured in Latvia in 1990 were exported to the U.S.S.R. This was the main market for these products. As Latvian goods cannot yet compete on quality in world markets, the dependence is still mutual.

Latvia's pattern of industrial development has made it highly dependent on the import of raw materials, especially energy.In 1990, 90 per cent of Latvia's heating fuel, 100 per cent of its oil and 50 per cent of its electricity was imported. The food processing industry uses domestically produced raw materials (although Latvia imports feed and fertilizers), but the textiles industry relies on imports: mostly cotton and wool from Uzbekistan, Kazakhstan and Georgia.

Table 1. **Sectoral Composition of Industrial Production, 1990**

	Percentage of total industrial production	No. of enterprises	Employment (per cent of total)
Total	100	407	100
Heavy Industry:	56.0	240	70.0
Electroenergy	1.6	1	1.8
Fuel	0.4	10	0.7
Metallurgy	1.6	4	0.9
Chemical	7.4	15	5.7
Machinery	27.9	87	38.9
Woodworking, Cellulose and Paper	5.4	55	9.6
Construction material	3.1	30	4.6
Glass and porcelain	0.6	6	1.5
Light Industry	18.6	74	17.0
Food Industry	24.7	89	12.7

Source: Latvijas Tautas Saimnieciba 1990.g.,Riga.

In 1990 there were 407 industrial enterprises and production complexes, of which 240 were in heavy industries, 74 in light industries and 89 in footwear industries. Some 29.8 % of all enterprises were under all-union subordination in 1990.

The orientation of Latvian industry toward the Soviet market prevented any significant competitive pressure from being imposed upon it to improve the quality of its production. The central planning system and non-market intervention created an unbalanced industrial structure leading to the high material, energy and labour intensity of its products.

Of the total population engaged in the national economy, 30 % are employed in industry. Traditionally, there has been a shortage of labour in Latvia. Partly as a result of the demand for labour created by the policy of rapid industrialization, there was large-scale immigration to Latvia from the former U.S.S.R. That is why a large majority of the Russian speaking population is employed in industry, whereas ethnic Latvians dominate the agricultural sector.

2 Latvian Industry at the Beginning of the Transition: Performance in 1991

The decline in output, which started in 1990, deepened in 1991. In spite of relatively favourable initial conditions, the results in all branches as well as in the whole industrial sector appear to be rather poor in the Baltic states in general and in Latvia in particular (Table 2).

Table 2. **Baltic Republics: Selected Economic Indicators for 1991**

Per cent change from 1990
1990 = 100

	Latvia	Lithuania	Estonia
GDP (in constant rices)	92	87	74
Volume of industrial production (in constant prices)	100	98.7	92.6
Wholesale prices of industrial products	255.9	293.8	308.4

Source: Latvia in Figures 1991. Collection of Statistical Data. Riga, 1992.

Real GDP fell about 8 % in 1991. Industrial output remained unchanged from 1990 (Table 1) despite a decline in state enterprises of 2.1 %, as the output of private enterprises and joint ventures surged. Production of consumer goods declined by 8.1 %, with food production dropping by 20.1 %.

One of the reasons often given for the decline in output in the state enterprise sector is the shortage of raw material inputs. However, in my opinion, the shortage in energy and raw materials had a limited initial impact on industrial output.

A more relevant factor in the decline was the manner in which state enterprises adapted to the new market conditions. Up to the collapse of the payment system in the rouble zone in autumn 1991, the main features of economic activity (output, quality, etc.) were determined by supply. In an excess-demand economy, cost-plus pricing[1] allows output to decline: the price rise completely compensates for the decline in output.

The key instrument of industrial policy during the late "perestroika" era was "self-financing" at the enterprise level, along with the launching of cooperatives and liberalization of state control over enterprise investment. Some indirect regulation continued in the form of allocation of raw materials for high priority sectors.

[1] Cost-plus pricing prices are not affected by supply and demand but are determined solely by production costs.

Such policy under soft budget constraints led to a worsening of the macroeconomic disequilibrium. Enterprise profits were far higher than expected for much of 1991, with the result that pressures for restructuring were very weak. In other words, resources accumulated in enterprises and households were used for consumption rather than investment.

3 Problems Facing Latvian Industry in the First Phase of Transition

In 1992 an important chance took place on the road to a market economy. The main elements of the Governments programme for the initial phase of the transition focused on macroeconomic stabilization. These measures have been supported by liberalization of prices and restrictive fiscal, monetary and incomes policies.

The outcome in late 1992 – early 1993 appeared favourable on the monetary side. At the same time, the implementation of the stabilization measures had dramatic effects. The data reflecting trends in Latvian industry imply an unexpectedly high cost for the stabilization phase.

As the payments system was disintigrating the excess demand was apparently replaced by excess supply, with the emergence of market clearing prices. **Supply and demand shock** both conditioned the extremely negative reaction of enterprises, which was manifested in the sharp decline in output.

The economic crises which have affected industry (as well as almost all sectors and branches of the economy) deepened in 1992. One must take into account the poor quality of statistics, which do not precisely portray the real situation. However, similar trends appeared in all three Baltic states.

Table 3. **Baltic Republics: Selected Industrial Indicators for 1992**

Per cent change from 1991
1991 = 100

	Latvia	Lithuania	Estonia
Volume of industrial production (in constant prices)	64.9	48.4	61
Wholesale prices of industrial products	1,424	2,507	1,465

Source: Latvia in Figures 1991. Collection of Statistical Data. Riga, 1992.

3.1 Causes of industrial crisis in the first half of 1992

The **first** reason for the economic recession was connected with the serious problems regarding economic relations with the countries of the CIS. Mutual agreements on cooperation were concluded between the Baltic and CIS countries. In reality, very few actual contracts were signed. For instance, Latvian enterprises closed contracts for only 10 per cent of the necessary inputs at the end of December 1991 and for 15.6 per cent of the inputs at the end of January 1992. In the first half of 1992 energy resources in comparison with normal conditions dropped by 30–40 %, metals and cement by 50–70 % and material resources for the food industry by 20–30 %. The situation was much the some in Estonia and Lithuania.

We note the following major tendencies among industrial enterprises:

- overall fall in output;
- rapid increase in prices of raw materials and resources, as well as of energy resources and fuel;
- drastic rise of prices of finished goods;
- continual increases in wages;
- drastic rise of current assets (cash, raw materials inventory and finished goods inventory); considerable change in the structure of inventories: diminishing share of raw material inventories, whereas the share of finished and unfinished goods inventories is growing;
- enterprises covering the growing costs of production inventories with bank and other loans. Consequently, current liabilities increased rapidly.

The **second** reason for the fall in output was connected with monopoly prices on industrial output. **Enterprises attempted to** gain monopoly profit (monopoly surplus) on the basis of artificially created deficits. **Thus**, profit in industry increased 6.3 times in 6 months in 1992. In a **competitive** economy the rise of prices is limited by purchasing power. In order to increase profits, enterprises must raise output. In a monopoly economy the rise of prices compensates the fall of production output.

According to official statistical reports, profit reflects the "nominal" income for the sale of output. In fact, the real operating income was much smaller due to the collapse of the payment system in the rouble zone. This collapse was the **third** reason for the fall in output. Suppliers were required to pay in cash for raw materials and finished goods at a time when the supply of cash was sharply restricted. On the other hand, the decline of industrial output would have been even greater if the undeveloped state of the financial markets had not enabled enterprises to extend credit to each other.

3.2 Causes and effects of decline in the second half of 1992 and early 1993

The economic decline accelerated in the second half of 1992. Up until the end of the year, Latvian industry had to cope with an enormous negative shock. Real industrial output dropped in 1992 by 35 % from 1991. In the first quarter of 1993 the fall in output amounted to 46 % (Table 2).

The classification schemeused by the Latvian State Committee for Statistics makes it difficult to compare the composition of different branches of industry in 1991–1992 with that of previous years. We presume that the compositional changes do not reflect any significant structural changes.

In 1992 output declined in almost all **branches** of industry (Table 3). The most severe cutbacks occured in engineering and metallurgy, food and light industry. These three branches accounted for 64 % of the total fall in industrial output. The termination of the subsidised energy supply system and the introduction of world energy prices have made the high energy demand sectors uncompetitive (for instance, the building materials industry).

What are the main causes of the decline? In the first half of 1992, the fall in output was brought on mainly by shortages of raw materials. In the second half 1992 and early 1993, the fall in output resulted mainly from financial difficulties in the rouble area countries and the loss of traditional markets.

The pressures on enterprises resulting from a tight monetary policy were intensified with the introduction of the Latvian rouble. The Bank of Latvia converted the export receipts from CIS countries at a rate that was worse than the one-to-one rate that enterprises had expected. Since August 8, according to an official statement of the Bank of Latvia, this measure has been intended to stabilize the Latvian monetary system. On the other hand, producers, losses have increased sharply.

The exchange rate for the Latvian rouble (LVR) fixed by the Bank of Latvia and the rate of the still-circulating Russian rouble in the CIS republics led to a revaluation of the Latvian currency. This has resulted in a decline of exports to the CIS and delays in the payment of wages and taxes.

The **loss of rouble area markets**, particulary that of Russia, affected many engineering plants, including those that had enjoyed a state monopoly in the former Soviet Union. The fall in demand resulted form the loss of orders from the military-industrial complex and the loss of competitiveness of Latvia's products in the eastern market due to high prices.

The loss of domestic demand for Latvian output resulted from both the public's lack of adequate purchasing power and the lack of protection for the internal market.

According to some directors of state industrial enterprises, exports to the Eastern market were no longer profitable due to the revaluation of the Latvian rouble and differences in pricing among the CIS countries.[2] The Western market still remained practically closed. Meanwhile, inventories of finished goods were building up rapidly. In December 1992 finished goods inventories amounted to 79 per cent of output, in March 1993 they rose to 96.4 %.

Tax arrears are continuing to grow due to the insolvency of many enterprises. In December 1992 enterprise tax arrears to state and local budgets reached LVR 4.8 billion, or approximately one fifth of a half-year budget.

In November, 1992 the electric power and thermal **energy arrears** amounted to LVR 2 billion Bankruptcy is a threat mainly to enterprises and branches that consume much energy. Almost all the producers of building materials have become debtors for electric power, thermal energy, and gas.

The **mutual arrears** (so called non-payments) represent a form of privileged interest-free credit to enterprises. For instance, on October 1, 1992 the mutual arrears amounted to LVR 31.7 billion, while the bulk of short-term lending amounted only LVR 4.8 billion. Supporting enterprise activity artificially maintains the non-payments.

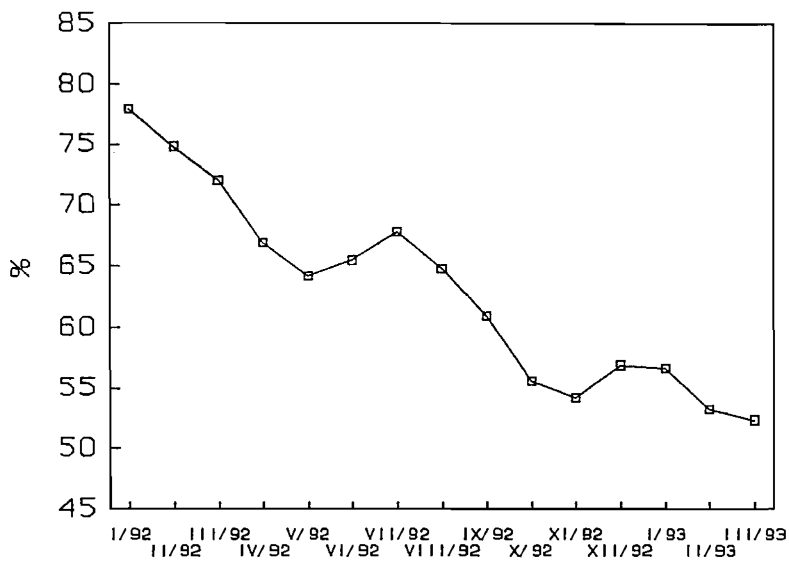
In order to avoid **wage arrears**, enterprises buy goods in regions where finished products were sold. The main idea is to sell those goods in Latvia for cash (LVR or Lats), which can be used to pay employees. It is, however,

[2] The data on enterprises is based on the monitoring of selected industrial enterprises by the Latvian statistical committee.

becoming increasingly difficult to sell anything in Latvia, as purchasing power is decreasing. Lately, employees have been receiving their wages partly in goods produced by the enterprise or bought from CIS countries.

The practice of **cost-plus pricing** continued to exacerbate the decline in industrial output in the second part of 1992 as well.In 1992 and January–February 1993 wholesale prices steadily increased in most branches of industry (Table 4). The fall in industrial output accompanied by the increase in producer prices is shown in Chart 1.

Chart 1. **Industrial Output over same month last year**



In January–March 1993 prices were 6.6 times higher than in January–March 1992. However, in March the rate of price increase declined: in January prices rose by 8.4 % from the previous month, in February by 10.3%, and in March by 4.2 %. As the consumer price index is directly influenced by tight monetary policy, it started to decline in December 1992. Producer (wholesale) prices reacted later to monetary policy. This reaction lag is nearly 4 months.

The above mentioned factors present in the second half of 1992 resulted in a mass work stoppage in industrial enterprises. Unfortunately, the latest data, for early 1993, give new evidence of a deepening economic crisis.

In the first quarter of 1993, the output of **503 enterprises** or 81.6 % of those monitored slowed from the same period in 1992. At the same time, some enterprises increased their production volumes, as for example, did almost all flax plants, shoe and sewing enterprises using foreign capital, wood processing and furniture enterprises, confectionery and perfume enterprises as well as some engineering plants. (Table 5).

In January–February 1993 the output of **100 goods** (out of 111 monitored) was reduced as compured to the year-earlier period. Table 6 shows the goods which experienced at least a twofold drop.

According to data of the State Statistics Committee, on February 1, 1993 the number of registered unemployed workers in Latvia amounted to 2.6 % of the labour force. **Hidden unemployment** exists in Latvia in the form of forced stoppages, shortened working days or shifts and unpaid leaves. For instance, in January 1993 there was idle capacity in 262 state and local government enterprises as well as in statutory companies, of which 217 or 83 % were shut down for several days (Table 7).

In fact, open unemployment is not very high (especially in comparison with Western standards), but the transformation of hidden unemployment into open unemployment in the near future is inevitable. Employment should respond more closely to production trends.

The real income of employees in state industrial enterprises decreased rapidly. Average real income in Latvia amounted to approximately USD 55–60 per month. Meanwhile, consumer prices for the most part reached international levels.

4 Comparative Advantages and Perspectives for Latvian Industry

For a market economy the national comparative advantage may be analyzed using Michael Porter's conceptual framework[3].

The Latvian post-socialist economy, by its nature and definition, is not a market economy. Neither is it any longer a planned economy. Referring to G. W. Kolodko (7) and J. Kornai (12), we are dealing with a transitional recession. Conceptual frameworks, relevant to either a market or planned economy are of limited use in this case. Our attempt to emphasise the Latvian competitive advantages and key issues of development within Michael Porter's conceptual framework is to some extent only illustrative.

The comparative advantages are quite the same in all the Baltic States. Therefore, the speed of the transition is the most important factor for the realization of advantages. A delay in the overall transition process means, at the same time, a loss of comparative advantage to the neighbouring countries.

4.1 Demand Conditions in Latvia during the transition

Demand in the transitional economies does not adjust to supply in a neoclassical way. The experience of Eastern European countries shows that the elimination of shortages and the promotion of structural changes in transitional economies requires control of aggregate demand so that the latter falls below the level which would hypothetically balance the demand and supply flows. In Latvia, as a result of tight monetary control, aggregate demand during the stabilization phase fell so sharply that some of the existing production capacity was not utilized.

How did the demand shock affect industrial enterprises and quality of output?

i) Firstly, one notes a sharp decline in **investment**. In principle, every post-socialist stabilization process entails a temporary decline in economic activity. The decline is more or less unavoidable. The permissible extent of decline is another question.

   The decline of net fixed investment started in Latvia in 1988: investment decreased by 23 % that year from the previous year, and by 20 % in 1989 and 9 % 1990. At that time, the fall in investment was caused by the reallocation of enterprises' accumulated resources from investment to consumption.

   Another factor came up during the stabilization phase. The Bank of Lativia's refinance rate reached 120 per cent in December 1992 and was reduced to 60 per cent in April 1993. The high interest rates led to a sharp

[3] This is one theoretical approach for to analysing the comparative advantage of a nation. The model is based on the four corners of a diamond which are: demand conditions, factor conditions, relating and supporting industries, and firm strategy, structure and rivalry.

fall in investment: in 1992 and early 1993 investment amounted to only 57 % of its level in the previous period.

Due to the tight budget constraint, the government has had to curtail public investment, including investment in infrastructure.

ii) For **state** enterprises, the system of budget subsidies and advantageous credits was replaced by a system of mutual indebtedness and payments insolvency. Even though this factor was responsible for the decline in industrial output, it had only a marginal impact on the "creative" destructuring.

In addition to having financial problems state-owned enterprises expecting to be privatized were practically paralysed. Managers were not prepared to commit themselves to the development of their enterprises before the ownership questions were settled.

iii) The sharp contraction of demand affected the **private** sector. Its share of total industrial output is rather small (about 10 per cent) and the impact on the total output seems to be negligible. Still, an evaluation of the reaction of the private sector is important.

Private firms, even if positioned to grow, have been afraid to invest: the political environment is not stable, the capital market is still weak, the tax burden is heavy, and the banking sector is extremely cautious, charging high interest rates. The main activity of private firms is trade, intermediation and money exchange.

iiii) The influence of **domestic** consumers (low-income) and CIS consumers on Latvian producers is quite limited and does not lead to improved quality.

iiiii) The **foreign demand** for Latvian products works now in the same direction. Latvia is a re-exporter of raw materials and intermediate goods, rather then of finished goods. Latvia also exports standard quality cheap goods rather than high quality or high-tech goods.

In the **short-run**, a strong and stabilized currency under the given constraints of aggregate demand helps to:

i) increase of domestic savings;

ii) improve credibility as regards both domestic and foreign investors and increases the inflow of foreign investment and domestic resources;

Still, an investment-saving mechanism will start to function only if a stable political and legal framework is achieved.

This clearly indicates that aggregate demand management is necessary in the short run but insufficient in **the long run** as a precondition for industrial revival. According to Kornai, in the long run, the problem of recovery "includes the Shumpeterian process of creative destruction: those able to develop new products and apply new technologies to meet demand win the competition, while the losers exit the market. If the pace of creation is slower than the process of destruction, if new capacities satisfying new demands cannot counterbalance the rapid liquidation of obsolete capacities, the result is recession (12).

4.2 Competitive factors and conditions

For Latvia, the cheap, well-educated **labour force** represents the most important comparative advantage. As natural resources are limited, capital equipment is old and the internal sources of financial means are inadequate, the labour force is practically Latvia's only hope.

Unfortunately, the decrease in real government expenditures affected education and science. The quality of the educational process is declining rapidly. Research work (especially basic research) has been reduced substantially. Of course, the necessity to develop basic science is not present in a small country. But this is not a sufficient reason for giving up the research potential which already exists.

Generally speaking, **the technological base** in Latvia is better than in a some of the other CIS states. In comparison with CIS states, Latvia has an advanced position in light industry and in the food industry. Latvia had a monopoly position in the manufacture of many important industrial items (railway passenger cars for electric and diesel trains, telephone sets, motorcycles, auto and tractor electric devices, agricultural machinery, medicines). Still, even in the Eastern market, manufactured goods produced in Latvia are gradually losing their competitive advantages due to pricing.

The remaining comparative advantages on the CIS market are geographic position, good knowledge of the Russian mentality, language and culture and close ties with Russian enterprises, due to the legacy of the planned Soviet economy.

4.3 Related and supportive industries

One task of the government under central planning was to manage and directly control all enterprises in the country. This was performed through industrial concentration. This process of concentration has simultaneously been a process of cross-industry disintegration affecting the separation of related and supporting industries.

As long as the market infrastructure remains very weak, will continue to be there a lack of horizontal coordination among the related industries. The emergence of an integrated structure is a long-lasting process, which needs the support of the government.

It is reasonable to shift Latvian manufacturing towards those branches that have comparative advantages in labour skills, natural resources and geographic location.

Good possibilities exist in **food processing** based on Latvian agriculture and fishing. In March 1993 prices were stabilized or even reduced in almost all branches of food processing. However, the decline in output has been substantial: in 1992 food processing output decreased by 30.3 % and in the first quarter of 1993 by 48.8 %. State support (customs tariffs and other measures) of Latvian agriculture and food industry is necessary.

The Latvian government would also like to see an expansion of **wood processing, timber** production, **furniture** manufacturing and **cellulose** and **paper**

production. The situation in all these branches is rather difficult. In 1992 output decreased by 34.3 percent.

Substantial reductions occurred in all 12 of the enterprises in the **paper** industry. The decline in output in the first quarter of 1993 is estimated to be 63 %. The decline was caused by a steep rise in prices of energy and raw materials. As a result, the paper enterprises have lost their markets not only in the East but also in Latvia. Paper imported from Russia was estimated to be 2-3 times cheaper than domestic paper in November 1992.

The following examples are helpful in understanding the underlying problems at the enterprise level. The information is based on quarterly monitoring of selected industrial enterprises by the Research Department of the Latvian Ministry of Finance in cooperation with the World Bank.

Brief Note on Joint Stock Company "Jaunciema Papirs"

By November 1, 1992 the debt of enterprises of the CIS and Latvia for delivered goods amounted to LVR 13.4 million of which:

Latvia	LVR 12422.9	thousand
Lithuania	LVR 896.3	thousand
Ukraine	LVR 50.4	thousand
Kazakstan	LVR 49.9	thousand
	LVR 13419.4	thousand

Meanwhile the enterprises have not paid for raw materials and energy resources receveid. By November the debt of "Jaunciema Papirs" was LVR 15.4 million, of which:

energy and gas	LVR 5644	thousand
raw materials	LVR 5993	thousand
other expenses	LVR 1351	thousand
total internal debt	LVR 12998	thousand

Ukraine	LVR 987	thousand
Russia	LVR 1431	thousand
total external debt	LVR 2460	thousand

The payment of wages is delayed for about 10 days every month. Energy-intensive paper production from cellulose is unprofitable because of high energy prices. The chief raw material is maclepaper.

Almost all contracts with CIS countries have been voided because of high prices.

The number of employees has declined from 400 (Jan.1,1992) to 130. The first cut occurred on April 1,1992, when the pensioners were dismissed. Then skilled workers who were not satisfied with working conditions started to leave the company.

The enterprise experienced periodic stoppages, for example, in June, August, October and mid-November. In the case of a forced stoppage, the boilers, which at the same time heat the neighbouring residential district, cease to operate

The decline in **the timber** industry in the first quarter of 1993 amounted to 28.3 %, as compared to the first quarter of 1992. According to the Latvian Forestry Ministry, the Latvian timber industry sould aim to reach the level of 1930s, when timber exports were 1.5 million cu metres a year (in 1992 Latvian exports were two times lower, amounting to 0.7 million cu metres). Presently, there are 980 saw-mills in Latvia, but only 80 of them produce exportable timber.

Theoretically, **the building industry** has a relative advantage provided by local resources. According to the Baltic News Service, the leading Finnish firm in construction and the production of building materials (Lohja) signalled its interest in developing its Baltic market, and it is ready to invest in the production of building materials in the Baltics in general and in Latvia in particular.

The decline in investment and construction caused a sharp decrease in domestic demand. Those producers of construction materials who were working for Latvia's domestic market (there are 26 producing enterprises) were left without customers. In 1992 the output in this branch decreased by 51.3 %. In the first quarter of 1993 the output of cement and wall materials reached only 8.3 % and 10.1 %, respectively, of the their levels in the first quarter of 1992.

Finnish experts predict that before the year 2003 the production of building materials is unlikely to exceed 50 per cent of Latvia's 1987 level. They also foresee structural changes in the building industry, with particular priority being given to repair and reconstruction works along with a breakup in the monopoly of reinforced concrete construction on the domestic market. Reinforced concrete construction plants are in a very difficult situation.

Brief Note on Reinforced Concrete Construction Enterprise

There are problems regarding both supplies of raw materials and sales of products. Basic raw materials are received from Latvia (road metal, sand), Russia, Ukraine (metal, cement). Cement produced in Latvia is much more expensive than that produced in Ukraine and, therefore, its use is disadvantageous.

Treaties with the suppliers have been concluded, but there is a lack of money to pay for the raw materials time. The plant is a debtor chiefly to local suppliers, as the CIS suppliers take 100% advance payments.

90 % of the manufactured products are delivered to local construction organizations in Latvia. The realization of reinforced concrete abroad is unprofitable (very expensive transport).

The debt of local building organizations to the plant was LVR 26 million on November 1, 1992.

In turn, the plant owes LVR 50 million to local suppliers of raw materials. The share of the debt to the state budget is large, as neither the income nor social taxes were paid for several months.

September and October wages were paid in November due to the credit received from the bank.

Finally, let us briefly describe situation in **light industry**. The increase in output is seen, for instance, in the production of stockings. But in most cases there has been a sharp decline in output. Two examples illustrate the problems in this branch.

Brief Note on the State Enterprise "Rigas Manufaktura"

In November 3, an almost total workstoppage occurred at "Rigas manufaktura" because it could not pay for the electric power it was consuming. 2 500 workers were sent on three-week unpaid leave. The biggest debtor of the enterprise is the Ministry of Home Affairs of Latvia, which has not paid LVR 600 million for cloth for police uniforms. The stock accumulated is worth LVR 200 million.
Brief Note On the State Enterprise "Rigas Tekstils"

For Rigas Tekstils, problems have arisen both in the provision of raw materials and in production. The basic raw materials are wool and synthetic fibres. Wool is imported from CIS countries (Kyrghyzstan, Daghestan), although previously the bulk of imports came from Western countries. Presently, imports of wool are suspended because of a lack of money.

The bulk of manufactured products are exported. However, some trade partners have not paid for the goods delivered.

During November the enterprise worked three days a week. Because of a shortage of cash, wages are partly paid "in kind" (in wool).

As at November 1, 1992, the enterprise had debts in:

Latvia	LVR 131.1	million
CIS countries	LVR 56.3	million
	LVR 187.4	million

Debt to the enterprise: LVR 99.7 million

Thus the problem of recognizing sunset industries is not evident. This is one of the reasons why the state's selective protectionism in order to support "promising" industries might be ill-advised because of the wrong priorities.

4.4 Firm strategy, structure and rivalry

The policy of **privatization** plays the central role in Latvia in the development of the fourth corner of Porter's diamond.

In addition to the inertial sector of state-owned firms, an important sector of small and medium sized private firms had emerged.

Small-scale privatization has proceeded rapidly in Latvia. At the same time Latvia has so far been unable to accelerate the privatization of its 1,200 large-scale firms. The composition of industrial output by type of entrepreneurial activity clearly illustrates the predominance of state-owned enterprises (Table 8).

The creation of the private sector is related to the problem of **coexistence** of state and private sectors. In the leading state sector, the dominant mechanism is quite different from the economic mechanism of the private sector.

Within the framework of institutional change, a complete **legislative** transformation based on the introduction of business and civil law is necessary. The new legal system is not completed yet. One particularly important issue is **the efficient implementation** of the new legal system. The legal uncertainty limits the degree of economic competition and entrepreneurial activity in the area of production.

5 Latvian Industrial Policy

Latvia, like almost all post-socialist societies, has chosen a strategy for transition inspired by neoliberal theory. In 1992, a short-term IMF-supported programme gave top priority to anti-inflationary policy.

In the same programme, the government tasks were defined as the development of conditions for industrial performance, the promotion of innovation activities and in general to serve as a catalyst. The strategy of IMF-supported stabilization measures explains the present stage of industrial policy, which is connected to systemic changes as a part of the overall transition process.

A similar approach is manifested in the European Community's industrial policy document "Industrial Policy in an Open and Competitive Environment"(5). The key issue is what conditions must obtain in order to ensure that market forces are capable of allocating resources so as to accelerate structural adaptation and increase competitiveness.

Thus, the absence of direct industrial policies during the initial stage of transition is replaced by the indirect impact on various segments of the structure of Latvian industry. Such an indirect industrial policy – conscious or unconscious – has affected the negative trends of industry performance during 1992 and most recently in 1993. This is why the role of state-planned industrial policy should be increased as quickly as possible.

The definition of the role of the state in the implementation of industrial policy is one of the crucial issues in Latvia. By **industrial policy,** we mean the composition of direct (influencing individual sectors) and indirect (infrastructure, demand, institutional framework, etc.) measures of the state aimed at improving the competitiveness of state owned as well as private industries.

In the pre-election political environment in Latvia, discussions on industrial policy have been heated because of the clash of views between Latvian "monetarists", who support "shock therapy", and so-called Keynesian economists and hard-line industrial lobbyists, who oppose the IMF programme.

The so-called Keynesian economists represent the school of the former economics minister of the Soviet Union, Lev Abalkin, and reflect the guidelines of the gradualism-approach supported by the Russian Civil Union led by Arkady Volsky. In Latvia this group includes Georg Libermanis and Valerijs Praude, both Professors at the University of Latvia, and Vjacheslav Mishin, an advisor to Prime Minister Ivars Godmanis. The group of hard-line industrial lobbyists involves the top management from the largest state-run enterprises and commercial banks. Several representatives of the group are members of the Latvian parliament and government. The leader of the Latvian Social Democratic Labour Party and member of parliament, Prof. Juris Bojars as well as the leaders of the Latvian Free Union are among those who oppose the IMF-supported programme.

Latvian "monetarists"(the author of this paper included) trust the solution of the problems of industry to market forces and certain aspects of competition policy and dismiss all forms of state intervention. They argue that sectoral intervention is ineffective and must be limited in both scope and duration.

The hard-liners have been "playing" on social problems in the pre parliamentary election period. They challenge not only the approach and outcome of the stabilization programme but also the fundamental guidelines of macroeconomic policy. To abandon these guidelines would mean undermining the stabilization process while leaving the integrity and consistency of macroeconomic policies at the mercy of populist sentiments.

The Keynesians argue that under present Latvian conditions the view of the "monetarists" is wrong. The viewpoint of the Keynesians was voiced in a document prepared in mid-January 1993 by the prime ministerial Council of Economic Experts "On Performance of the Memorandum of Latvia's Economic Policy and need for its Modification in View of the Deepening Crisis"(10).

Focusing mainly on negative aspects of the Latvian economy, the document states that:

i) Only monetary measures have been supported by the IMF programme without paying attention to industrial restructuring. The decline in output has not been cured by structural changes.

ii) The tight monetary measures have not succeeded in restraining price increases because of high degree of the monopoly in the economy, which degree has not been influenced by the reduction in the money supply.

iii) The effort of overcoming the crisis in Latvia by implementing restrictive monetary, fiscal and incomes policy has not been successful in most respects: output has collapsed and prices continue to rise.

iiii) The revaluation of the Latvian rouble against the Russian rouble has considerably reduced Latvian exports to the CIS market, thus worsening the balance of payments. This has aggravated the financial position of state enterprises and contracted their output.

iiiii) The deepening crisis in the Baltic states and the threat of economic collapse should be interpreted as the failure of the IMF programme.

Their conclusions are clear. The shock-therapy turned out to be unable to prevent the crash of the Latvian economy. The IMF-supported tight monetary programme is too stringent and must be changed. The Memorandum must be modified in line with the changes that have been made regarding the ex-Soviet republics (primarily Russia).

What are the alternatives? More stress should be placed on the direct participation of the state. This intervention would take the form of selective support of state-enterprises based on

i) "purposeful" subsidies

ii) "purposeful and directed" money emission aimed at the revival of economic activity, domestic demand and exports

iii) selective price controls.

It could be argued that an interventionist government policy would be the best way to guide the structural adjustment required in Latvia. There is no long-term evidence that an approach based on market forces is more effective than a strategy based on state intervention. Even in advanced market economies, the market mechanism does not function immediately, and it often has to be supplemented and corrected by government action. R. Dornbush's conclusion(2) that market forces alone could hardly resolve the problem of revival appears to be even more relevant in the transition economies.

Similar views are expressed by many representatives from Eastern post-socialist countries. According to J.Klacek and M.Hrnčíř, the market can clearly best adapt to the changes in demand, supply of inputs, and technology, if market agents are able to plan and operate under stable and predictable conditions. If macroeconomic problems interfere with market signals and make investment highly risky, markets may fail to fulfil their function (6).

The same opinion is voiced by G.W.Kolodko (7). He stressed the fundamental importance of both macro- and microeconomic policies of the state, since the recession in the post- socialist economy cannot be overcome without the active state intervention in the process.

Paul G.Hare(3) points out that it would be a serious mistake to rely on conventional macro-policy to bring about structural change. Macro-policy alone, or in conjunction with micro-policy, is not sufficient to guide the structural adjustment required if the legal naiton's framework is not adequate.

Moreover, the recent German example also shows that the out-of-hand disregard of all forms of state intervention, is ill-advised. Indeed, Germany, in the interest of revitalizing its eastern provinces, assists economic restructuring and survival with significant budgetary support in its regional programmes.

In my opinion, under present conditions the Latvian Keynesian viewpoint is wrong for the following reasons:

i) The experience of each country in transition is unique. Each country plays out its own transition scenario, which depends on historical, political and social factors. Thus, the transition experience in the post-Soviet Baltic states is quite different from that of Czechoslovakia, Hungary, and especially the former GDR. It difficult yet to generalize on the empirical evidence and to evaluate the different industrial strategies.

ii) The financial potentials of Latvia and for instance, Germany are incomparable. Perhaps, state subsidies are the best strategy for Germany. But what is good for Germany may not be good for Latvia.

iii) Regarding the role of the state in the initial stage of transition, one should keep in mind two opposing options: rapid stabilization and implementation of market conditions, accompanied by a sharp decline in output or gradual stabilization with a gradual decrease in output.

It is useful to compare Latvia to Russia and Lithuania. In Russia, all efforts by the government and the central bank to support industries through subsidies failed completely. The outcome was always the same hyperinflation and continued slump. The trends in output are more or less similar in Latvia and Lithuania, but monetary policy has been more successful in Latvia. (Of course, it is still too early for general conclusions.)

iiii) If we accept the logic of the above-mentioned document, prepared by the prime ministerial Council of Economic Experts, sticking to the planned distribution system seems inevitable. There is no doubt that "purposeful" subsidies "purposeful and addressed" emission and selective price control are the attributes of a planned economy. Yet, the planned economy has demonstrated its weakness, and a return to a state-run economy would not be easy. With money having become actual money, any attempt to give easy state loans and subsidies coupled with free prices would lead to hyper-inflation. A return to administrative control of the economy would mean political and economic isolation from the Western world.

6 Industrial Policy Objectives and Priorities – What Should Be Done ?

The stabilization of output and restructuring of Latvian industry became one of the most important goals of industrial policy. What should be done to stop the decline in industrial output in Latvia and to change the output structures developed under the communist regime?

The present recession is an outcome of a broader range of interrelated factors. Thus, the fundamental issue is to find an appropriate mix of the various segments of economic policy, including industrial, monetary, tax, incomes, competition, external and regional policy. This means that industrial revival and restructuring can be achieved only as part of the overall economic development of Latvia.

First of all, it is important to complete the legislative framework and set out generally valid principles of economic policy. These are the following: privatization, taxes and financial markets. The privatization process in particular needs to be accelerated. The implementation of a legislative framework will provide the necessary preconditions for the realization of the goals of industrial policy. It is also necessary to stimulate foreign investment, primarily in fixed capital, install new technologies, establish new production cultures, and create jobs.

The key issues for the short term can be summarized under one broad heading: how to overcome the more immediate problems concerning the shortage of raw materials and working capital.

Crisis management using IMF and EC loans is the only way to alleriate the short-term problems. These loans are the only means for surrival for Latvia's small and medium-sized businesses. A special Latvian government commission will supervise the distribution of the loan, which is to be managed by the largest Latvian commercial banks. According to some estimates, about USD 300 million will be needed to stabilize the Latvian economy, of which USD 200 million would be used for stabilizing the balance of payments.

The Latvian government will use the EC loan for financing badly-needed imports for Latvian industry: energy, raw materials, equipment and technology. Individual allocations will be made after a careful screening process to ensure that the loans can be repaid. Individual loans will also be distributed to medium-sized enterprises. The maximum loan per enterprise will be USD 3 million and all loans are to be repaid over a period of two years.

Of course, the Latvian government needs to exercise great care. Unfortunately, there is little doubt that money is flowing out of Latvia. Millions of dollars were transferred out of the country during the "pre-privatization agony" of state enterprises. From this viewpoint, it is likely that some of the new loan money will have the same destiny. On the other hand, without the support of successful and progressive enterprises Latvian industry will sink into deeper maters.

The demand shock arising from the combination of reduced domestic consumption and collapsed Eastern trade is so severe that some enterprises unable to compete will be wrongly forced into bankruptcy. There is a serious danger that short-term liquidity problems could force the closure of firms which might have a bright future for the longer term, whereas other firms might survive longer than they should. Unless the government is prepared to accept the situation, it must be prepared to prevent certain potentially successful firms from closing down. It would be a serious mistake to protect firms in general without discrimination, or to protect none and rely totally on privatization (e.g. through offers from foreign investors) to pick out the good ones.

The medium-term and **long-term** the goals are as follows:

i) reduction of material and energy consumption

ii) improvement of export prospects

iii) more efficient utilization of domestic resources

iiii) protection of the environment.

Creating the preconditions for reducing the high level of demand on the part of industry for labour, energy and raw materials and halting the decline in the efficiency of fixed capital are dependent on the promotion of the market and on accelerating the transfer of technology, entrepreneurship and foreign capital. Restructuring can be supported both by the privatization programme and by measures taken to stimulate the formation and growth of new private sector business.

Industrial policy for the medium-term will have to promote the stimulation of successful and progressive industries. Such a role should be supported with special analysis. Industrial policy must be considered from a macroeconomic as well as a microeconomic standpoint. This is especially important since at the micro-level it will always be easy to think of special reasons why one or other firm should be protected(for instance to protect employment).

The relevant approach can help to form the basis for an effective industrial policy.

According to Paul G. Hare (3,4), possible approaches are as follows:

i) Concentrate investment on those branches (or individual enterprises) which are already performing relatively well in domestic or international markets, which already posses relatively advanced technology, and where locally available materials are of good quality.

ii) Pay more attention to the demand side of the market, promoting concentration on those branches or firms in which demand is likely to rise relatively rapidly in the future. A sub-category of this approach would focus on the likely growth of export demand.

iii) The third approach is based on the notion of competitiveness. The basic indicator of competitiveness, domestic resource cost (DRC), can be calculated by using input-output tables, and data on the ratios between world prices and domestic prices. It is then possible to calculate vectors of value added in domestic prices and world prices. DRC is the ratio of the value added at domestic prices to that at world prices. The most competitive branches are those with the lowest (positive) values of the DRC indicator.

All of these approaches are very subjective (especially the first, which is predominated in Latvia) and can be highly misleading. It could be argued that the third approach, based on input-output calculations, is only theoretically better than the first or the second. Actually, due to unreliable statistics one can get unreliable conclusions. The third approach does not prevent subjectivism in decision-making. It does not mean that additional information would be useless. On the contrary, all three approaches combined with accurate estimates can help to form the basis for an effective industrial policy.

Finally it should be emphasized that the next steps toward the market in Latvia will probably be characterized by an alteration of the relative weight's given to direct and indirect measures by the state. It is unrealistic to assume that there will be no direct state investment forthcoming. In the medium and especially the longterm, state intervention in industry will be possible if only the financial situation in Latvia stabilizes and market forces play a predominant role in the economy.

The formulation of goals and priorities of the relevant indirect and direct industrial and structural policies at the different stages of transition is not a simple task. But a comprehensive programme should provide the harmonization of indirect and direct instruments in the long and mediumterm, including short-term crisis management.

The guidelines for this programme will depend, apart from purely economic needs, on the political situation: pre-election disputes concerning the transition model appropriate for Latvia and the post-election choices for Latvia.

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Table 1. **Increase in Rate of Gross Industrial Production**

Year	Industry total	of which: Mining	Manufacturing	Electric energy and water supply
		1980=100		
1985	119	112	119	156
1990	141	108	139	206
1991	141	106	139	186
		1985=100		
1990	118	97	117	132
1991	118	95	117	119
		1990=100		
1991	100	98	100.1	90

Source: Latvia in Figures 1991. Collection of Statistical Data. Riga, 1992.

Table 2. **Monthly Industrial Output**

Per cent change from year earlier month

	1992	1993
January	77.9	56.6
February	74.8	53.3
March	72.0	52.4
First quarter	74.6	54.0
April	66.9	
May	64.2	
June	65.5	
First half	70.8	
July	67.8	
August	64.8	
September	60.9	
9 months	68.4	
October	55.6	
November	54.2	
December	56.9	
1992 year	64.9	

Source: Zinojums par LR tautas saimniecibas darba rezultatiem 1992.g.

Table 3. **Output Changes in Manufacturing, 1992**

Per cent change from 1991	
Manufacturing – Total	64.9
of which:	
electric energy industry	70.0
fuel industry	79.0
metallurgy	57.0
chemical and petrochemical industry	63.6
engineering and metalworking	61.6
forestry, wood processing, pulp and paper industry	65.7
building materials industry	48.7
glass, china and faience industry	79.8
light industry	67.2
food industry	69.7
microbiology industry	44.3
flour, groats and mixed forage industry	58.9
medical industry	81.2
printing industry	150.9

Source: Bulletin of Latvian Economic Statistics, 1992. State Committee for Statistics of the Republic of Latvia. Riga, 1993.

Table 4. **Wholesale Price Inflation in Industry**

In per cent

	1992 (compared to 1991)	December, 1992 (compared to November 1992)
Total manufacturing	1,410	109.0
of which:		
Ferrous metallurgy	3,545	100.0
Chemical industry	2,757	100.0
Petrochemical industry	1,677	114.2
Engineering	1,039	109.5
Forestry, wood processing pulp and paper industry	1,376	107.3
Wood processing industry	1,260	109.6
of which:		
Furniture industry	819	112.7
Paper industry	1,735	100.0
Building materials industry	2,659	120.9
Light industry	926	104.9
of which:		
Cotton industry	1,486	127.8
Wool industry	639	100.0
Silk industry	2,954	108.1
Knitwear industry	803	97.8
Wearing apparel industry	587	107.2
Footwear industry	1,009	94.7
Food industry	1,424	112.9
of which:		
Food and spices industry	1,853	122.6
Macaroni industry	1,721	100.0
Baking industry	2,266	107.1
Meat industry	777	107.9
Butter, cheese and diary industry	1,766	100.0
Fishing industry	1,074	105.8
Flour, groats industry	2,102	125.3
Mixed forage industry	1,617	107.9

Source: Bulletin of Latvian Economic Statistics, 1992. State Committee for Statistics of the Republic of Latvia. Riga, 1993.

Table 5. **Output Changes in Industrial Enterprises, First Quarter, 1993**

	Number of enterprises	%
Stoppage of production	10	1.6
Decrease in output of which:	493	80.0
less than 10,0 %	16	2.6
10,1 - 20,0 %	33	5.3
20,1 - 30,0 %	35	5.7
30,1 - 40,0 %	52	8.4
40,1 - 50,0 %	51	8.3
50.1 - 60.0 %	61	9.9
60.1 - 70.0 %	77	12.5
70.1 - 80.0 %	47	7.6
80.1 - 90.0 %	70	11.4
90.1 % and more	51	8.3
Output stabilized or increased	113	18.4
Total	**616**	**100**

Source: Zinojums par LR tautas saimniecibas darba rezultatiem 1993. g. janvari-marta. Latvijas Valsts Statistikas komiteja, 1993.

Table 6. **Curtailment of Goods Output**

Per cent change form year-earlier the same period

	Decrease in output 1992	January–February 1993
General use electricity generated by hydro- and block power stations, (mln kwh)	32.1	7.7
Thermo-energy, (mln Gkal)	25.9	27.8
Steel (except for duplex process on the spot), (thsd tons)	34.2	41.5
Rolled metal, (thsd tons)	42.1	38.2
Glass fiber fabric, (mln m2)	30.0	72.1
Plastic and resin, (thsd tons)	47.8	64.3
Technical lighting equipment (mln rub.)	27.9	54.0
Automatic telephone exchanges, (thsd pieces)	44.5	78.8
Centrifugal, steam and drive piston pumps, (thsd pieces)	32.2	36.0
Main line passenger cars, (pieces)	47.4	31.2
Cattle-breeding and forage making machines and equipment, (pieces)	23.3	76.1
Timber, (thsd m3)	22.2	46.5
Paper, (thsd tons)	57.6	62.6
Cement, (thsd tons)	52.8	95.0
Panels and other constructions and materials, (thsd m2)	50.7	82.4
Slates, (mln relative pieces)	48.1	93.6
Glass, (thsd m2)	17.0	44.0
Microbiological forage albumen, (tons)	31.9	60.0

Source: Zinojums par LR tautas saimniecibas darba rezultatiem 1992.g. un 1993. g. janvari–februari. Latvijas Valsts Statistikas komiteja, 1993.

Table 7. **Forced Losses in Central and Local State Manufacturing, January 1993**

Total working time losses (mondays)	of which Full day stoppages	Forced unpaid leaves	Working time losses due to reduced working day	Average number of emploees absent from work the whole month	Estimated labour re-numeration to employees for forced idle stoppages, (in thousand LVR)
754,143	448,652	204,219	101,272	37,707	50,920

Source: Bulletin of Latvian Economic Statistics, 1992. State Committee for Statistics of the Republic of Latvia. Riga, 1993.

Table 8. **Volume of Industrial Production by Type of Entrepreneurial Activity**

per cent

	Industrial output in real terms	
	in 1991	in 1992
All industry	100	100
of which:		
State enterprises	78.9	74.3
Local government enterprises	0.7	0.7
Enterprises of public organizations	0.3	0.3
Statutory companies	20.1	24.7
Stock companies	10.3	13.4
of which: companies with foreign participation	0.2	0.1
Companies with limited liability	6.0	7.5
of which: companies with foreign participation	0.7	1.5
Share-holding companies	3.8	3.8

Source: Bulletin of Latvian Economic Statistics, 1992. State Committee for Statistics of the Republic of Latvia. Riga, 1993.

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