

Latvia's Competitiveness at the Crossroads

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Riga, Latvia
21 May 2009

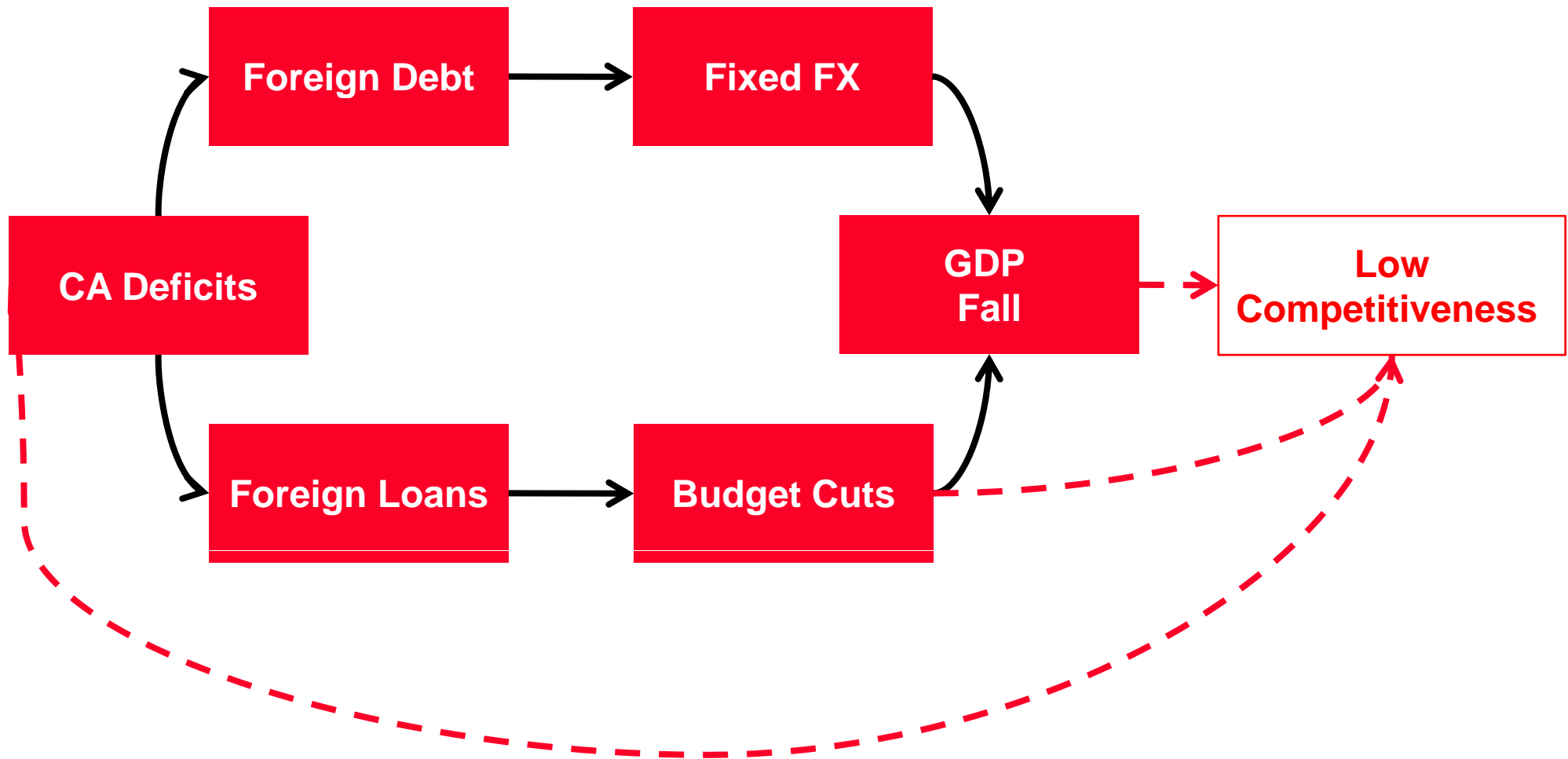
Latvia in 2009

- The Latvian economy has turned from **hyper growth** to **dramatic contraction** within a few months
- While a benevolent global economy supported past growth, it now **exposes and amplifies** the weaknesses of the Latvian economy
- Latvia is facing a mix of **complex, intertwined challenges**
 - Crisis management requires short term policies that carry high economic, social, and political costs
 - Focus on the mounting short-term challenges threatens to undermine the foundations for future prosperity



- How did Latvia get into this position?
- What can be done?

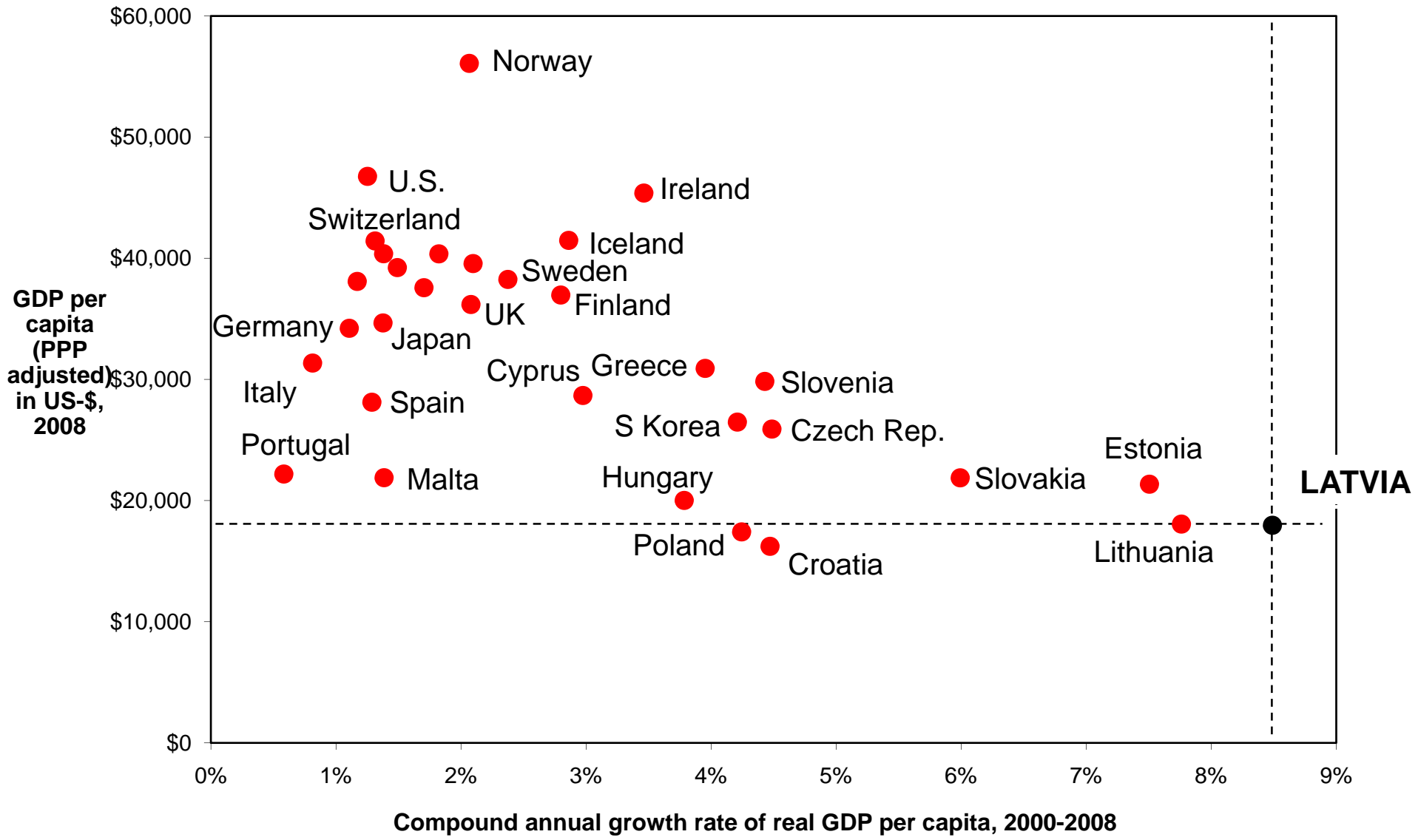
The Dangerous Cycle Ahead



- Higher **competitiveness** is not a long-term luxury, but a necessary condition for avoiding the current macroeconomic crisis to become chronic

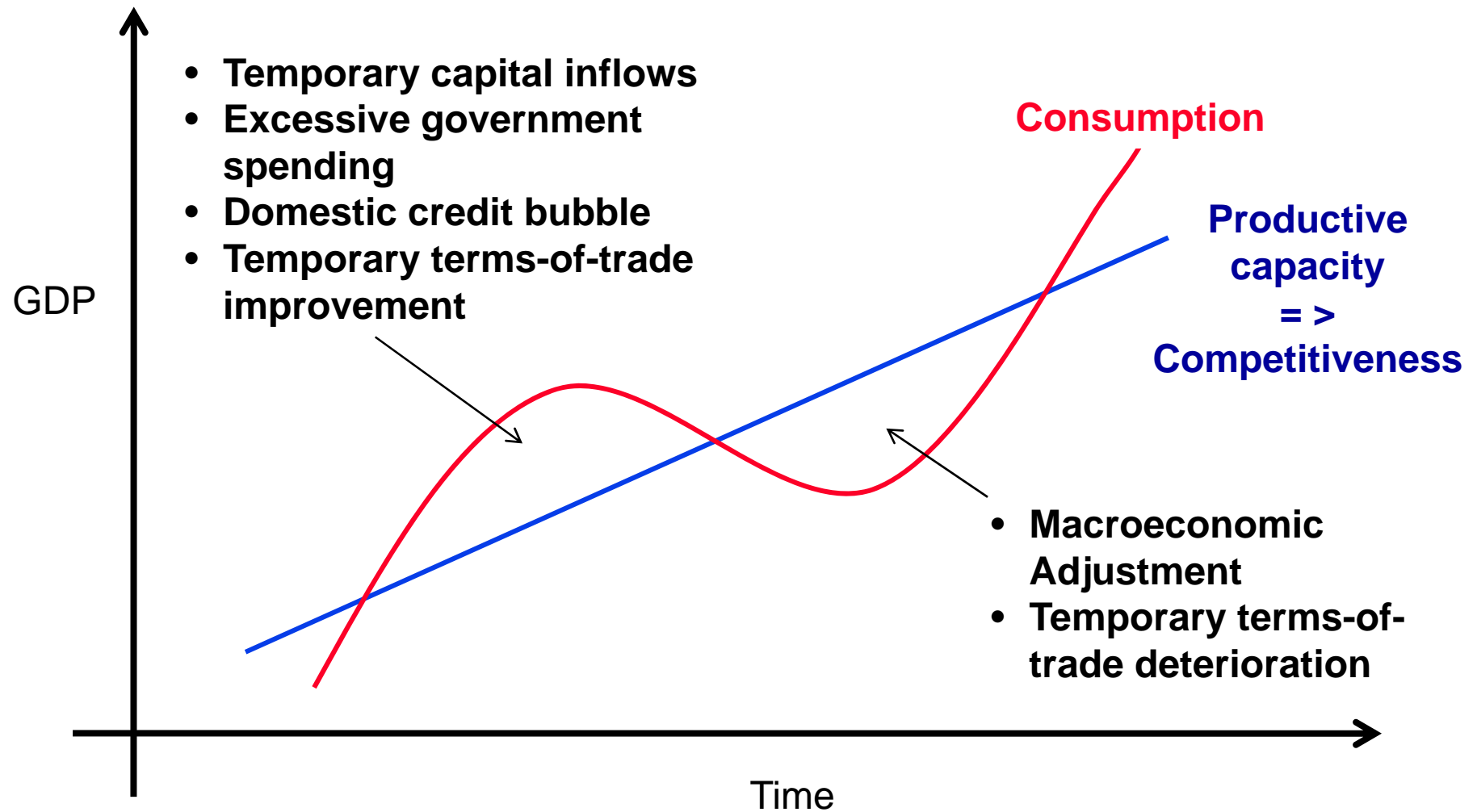
Comparative Economic Performance

Selected Countries



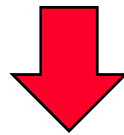
Source: Groningen Growth and Development Centre and The Conference Board (2009), authors' calculations

Growth spurts and competitiveness



Policy Advice for Growth

- Conceptual research has increasingly focused on **endogenous growth-models**
- Empirical literature has aimed to look at the “**deep**” drivers of prosperity differences
 - Analysis of growth rates has highlighted the role of unsustainable “growth spurts”

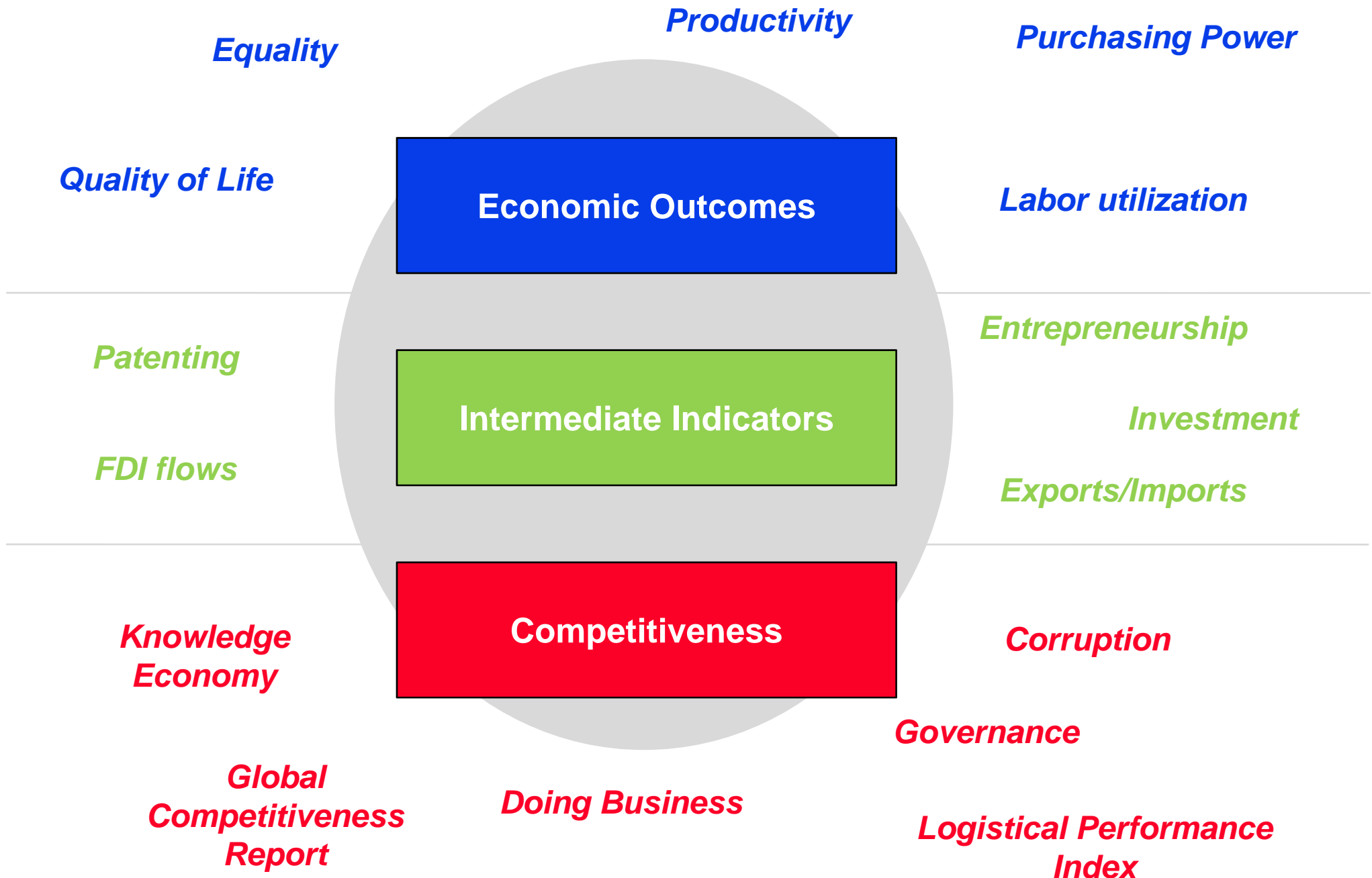


- The general principles (Washington consensus, etc.) derived from this work provide often **insufficient** guidance to policy makers

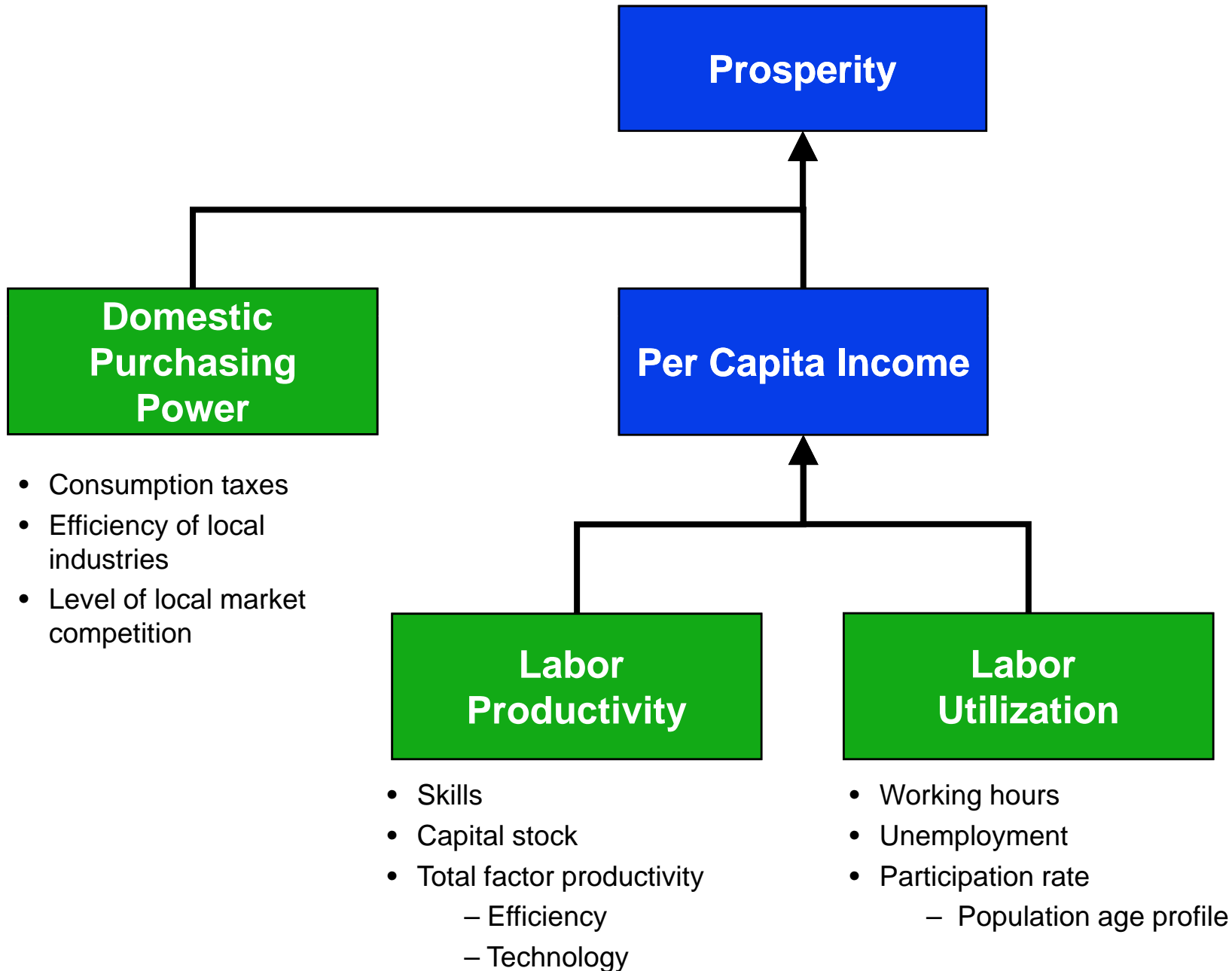


- Emerging consensus for policy advice to become more **context-, i.e. country-specific**
- Need for more country-specific data has led to an explosion of **data collection efforts**

Where to Start: The Crucial Role of Analysis

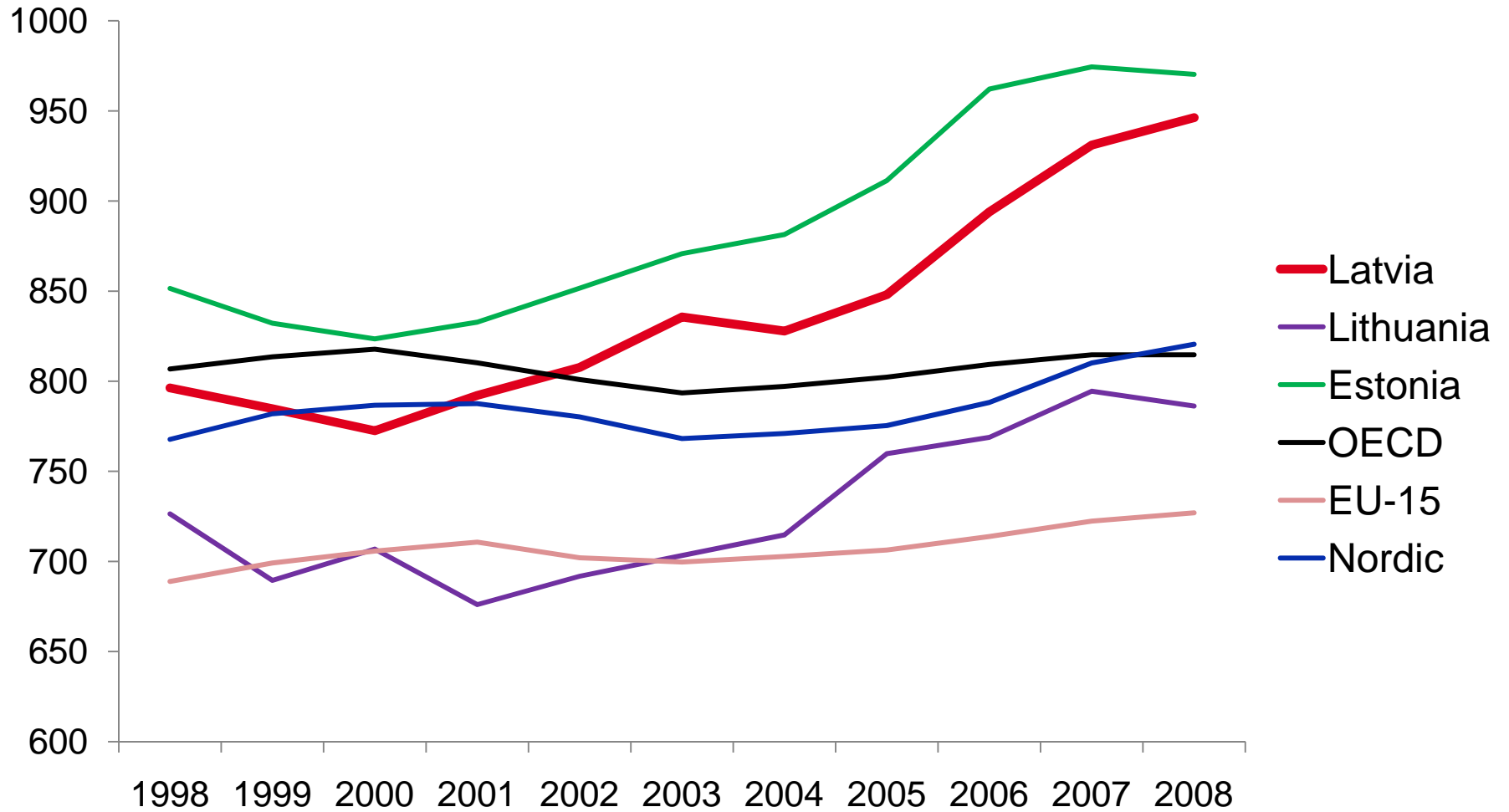


Decomposing Prosperity

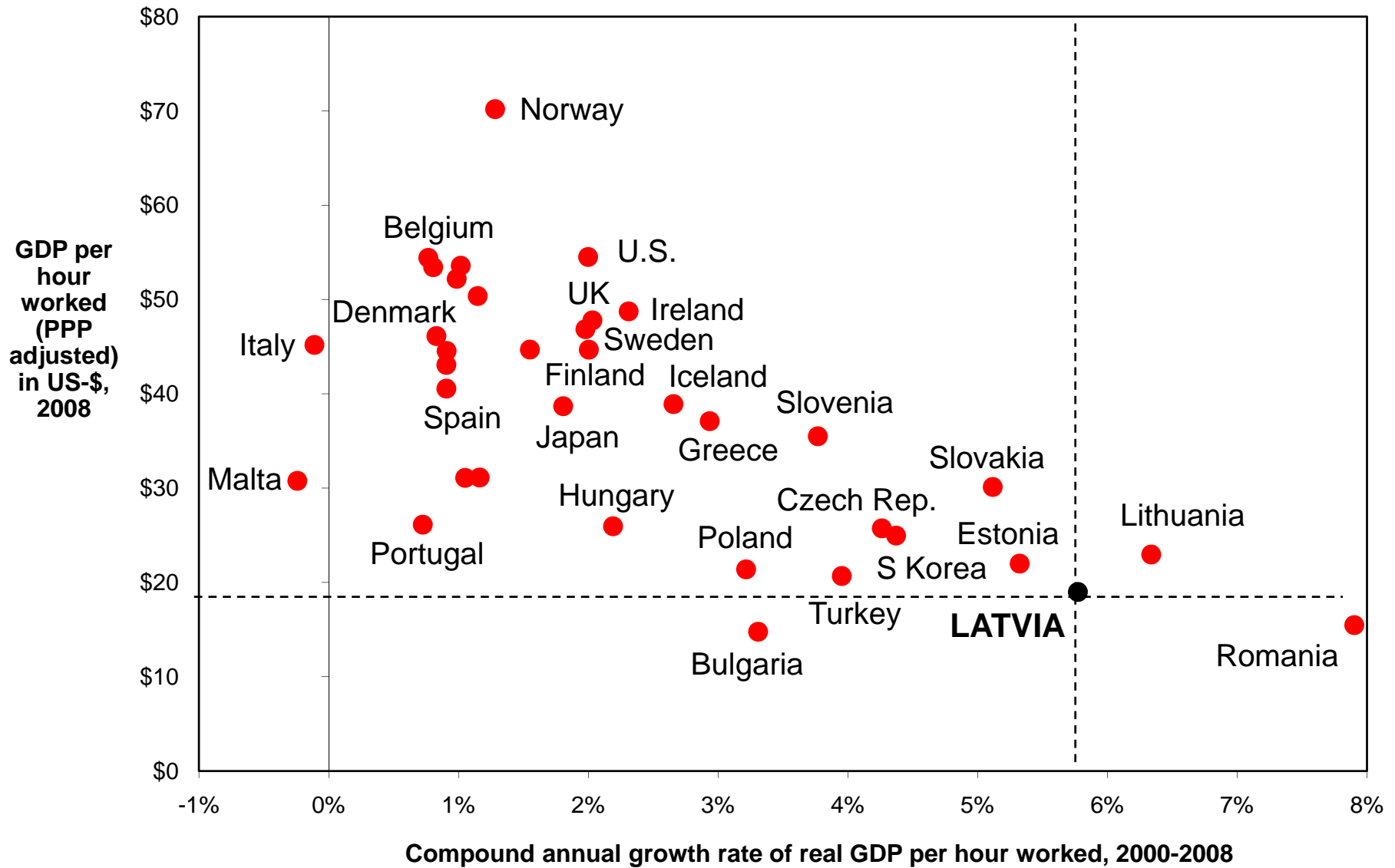


Labor Utilization

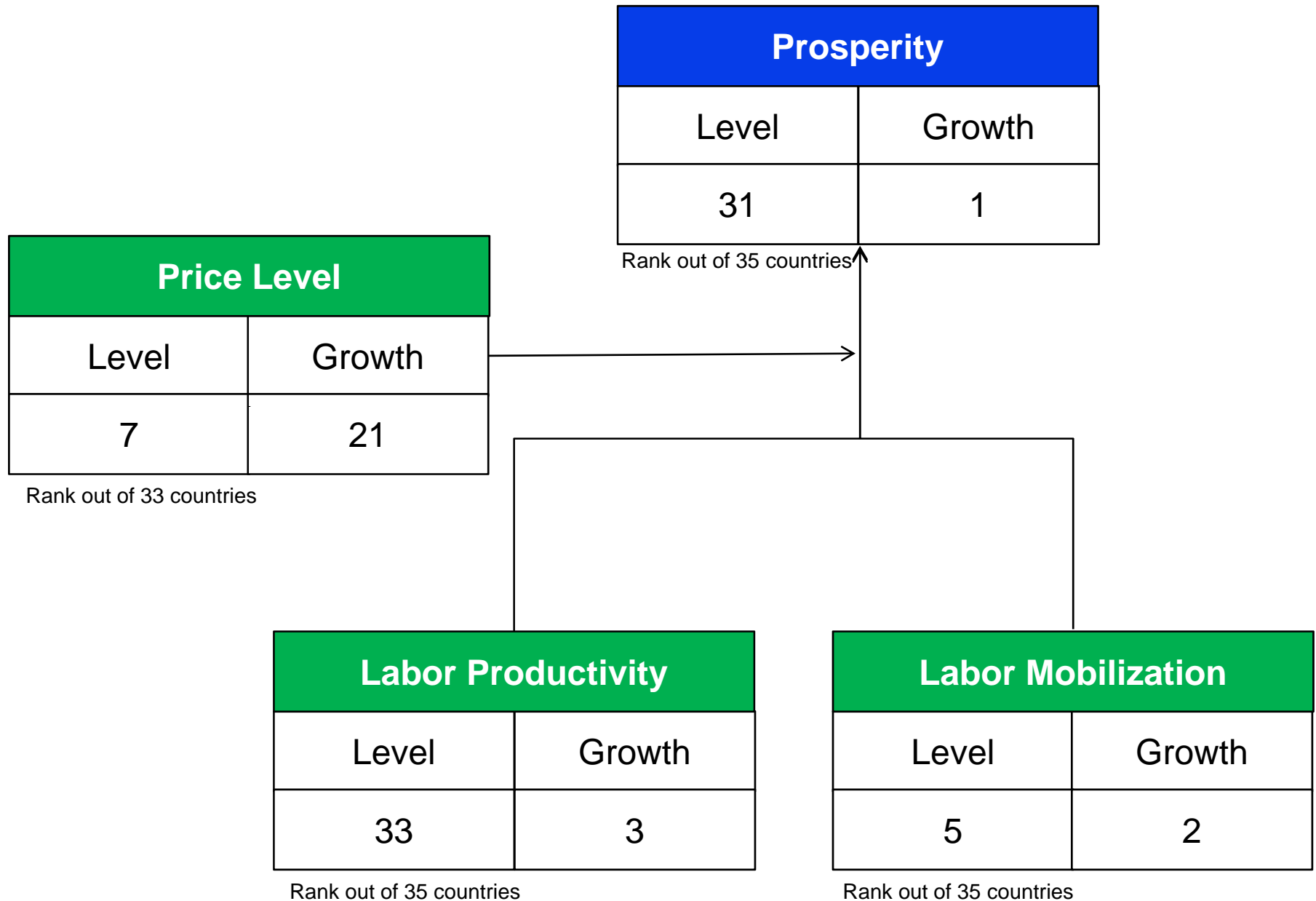
Annual Hours worked
per Capita



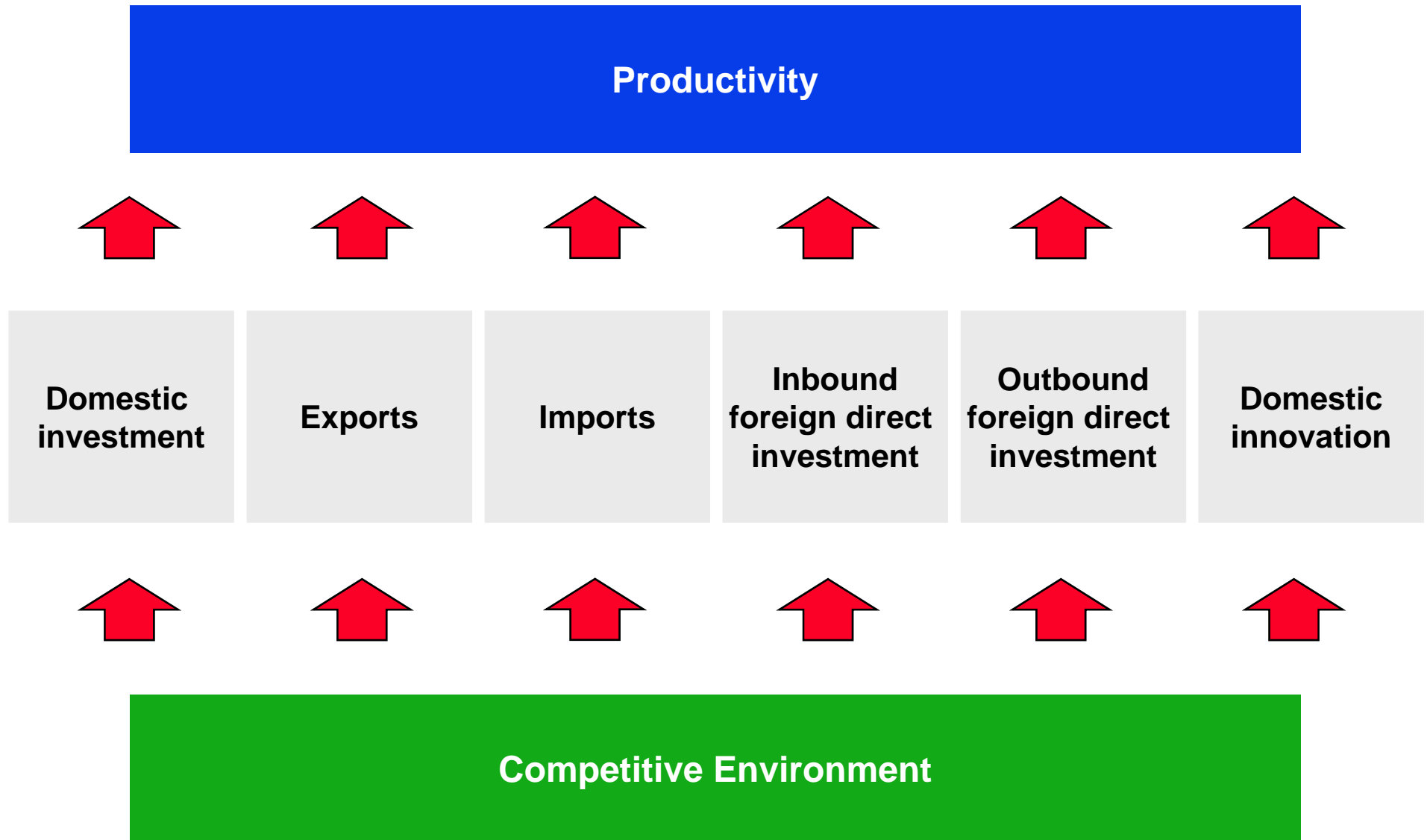
Labor Productivity Selected Countries



Decomposition of Latvia's Prosperity

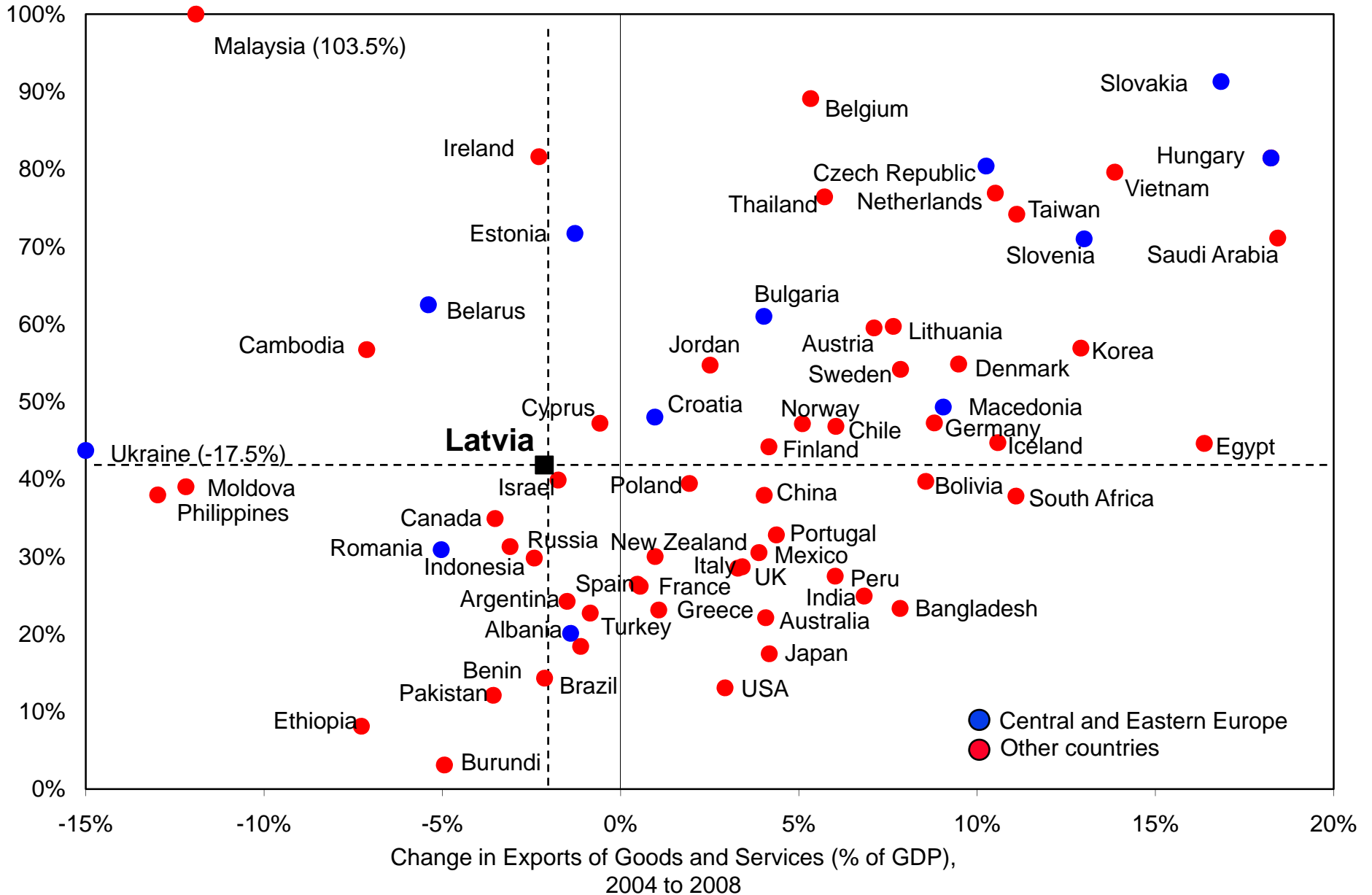


Indicators and Enablers of Competitiveness



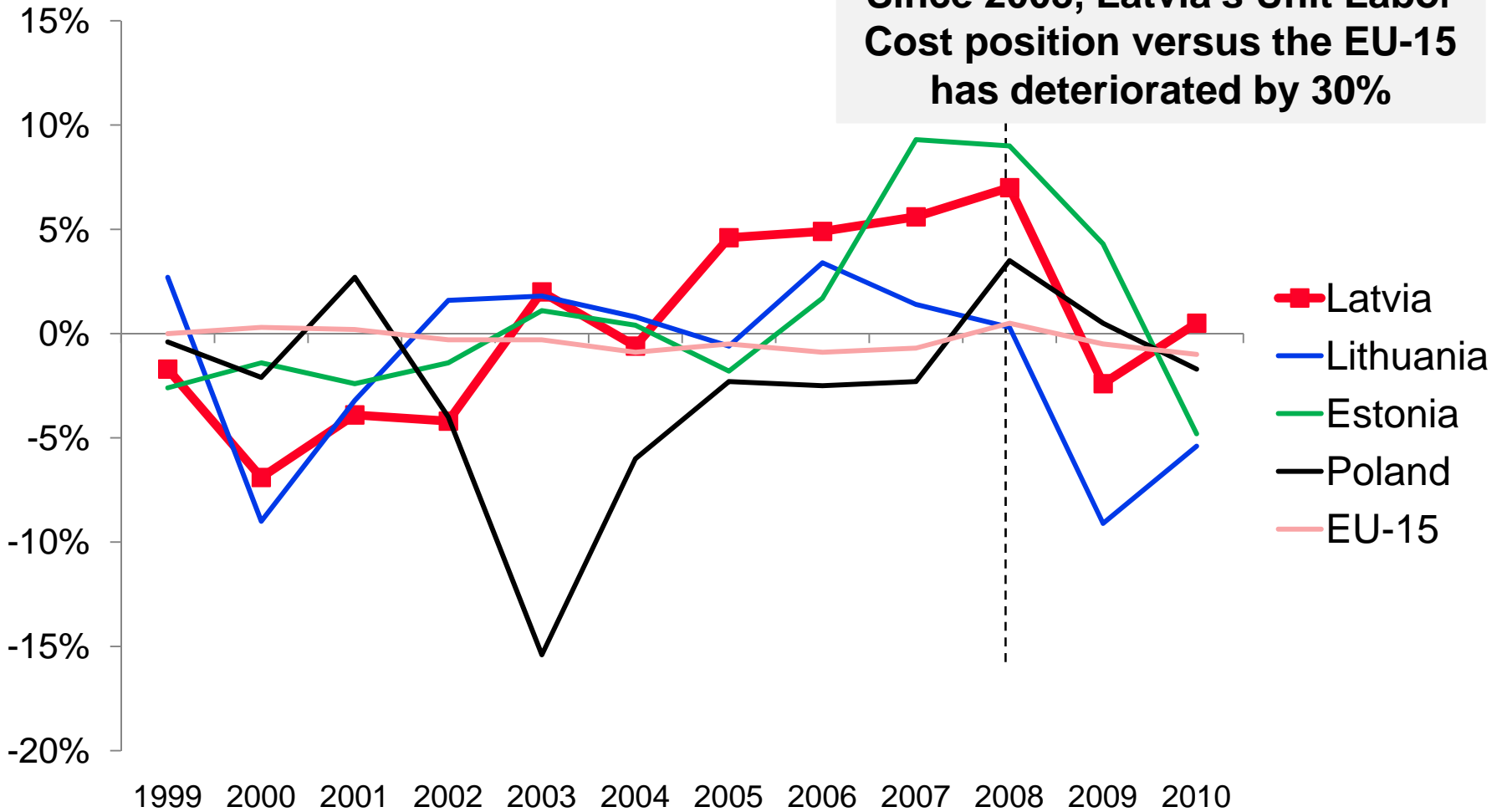
Export Performance Selected Countries

Exports of Goods and Services
(% of GDP), 2008



Unit Labor Costs

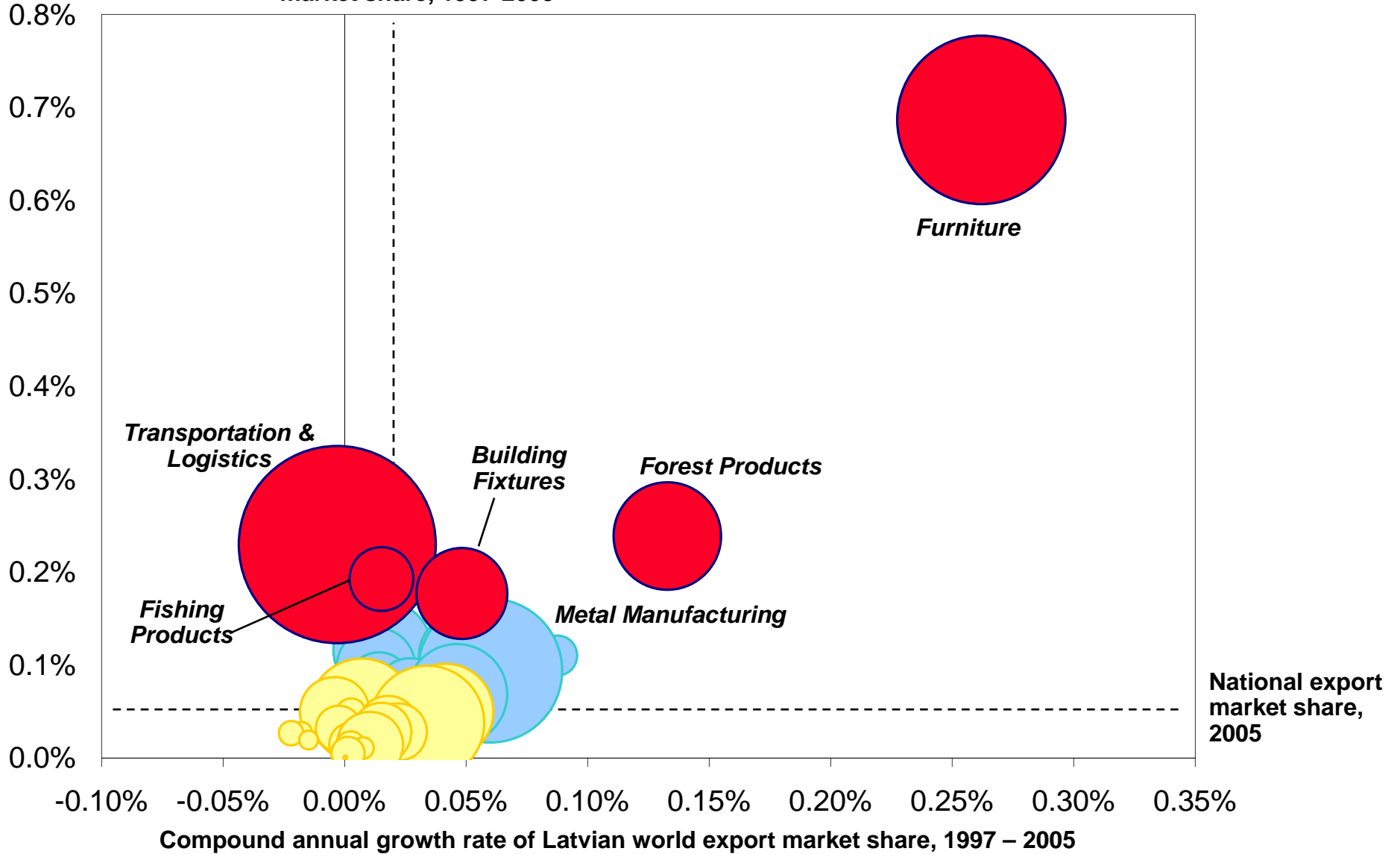
Unit Labor Cost
Growth



Latvia's Exports by Clusters

Latvian World Export
Market Share, 2005

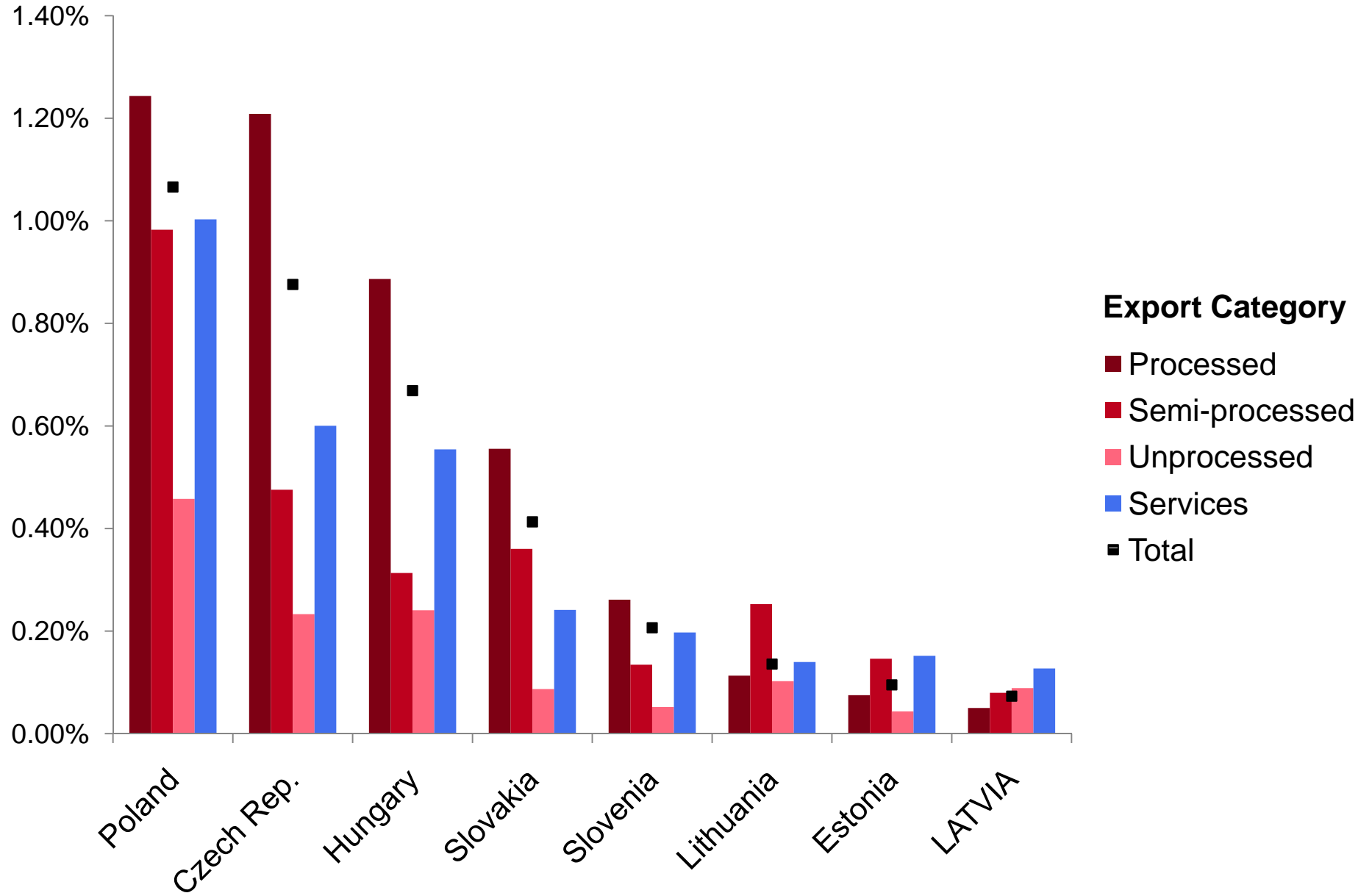
Change in national export
market share, 1997-2005



Note: Bubble size is proportional to absolute export value; cluster with RCA > 2 in red
Source: UNCTAD Trade Data; International Cluster Competitiveness Project at ISC (HBS)

World Export Market
Share, 2007

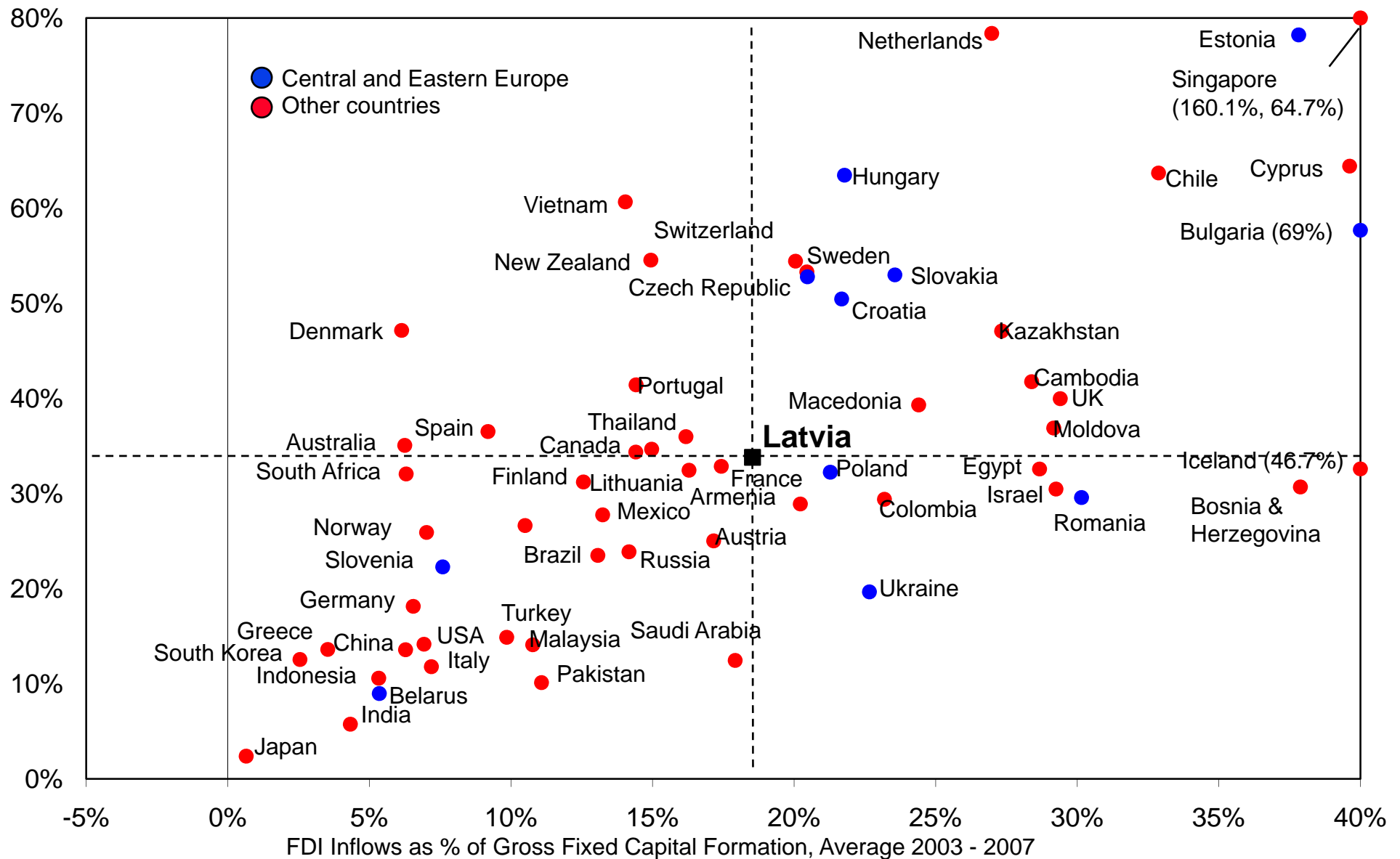
Export Sophistication Central European Economies



Inbound Foreign Investment Performance

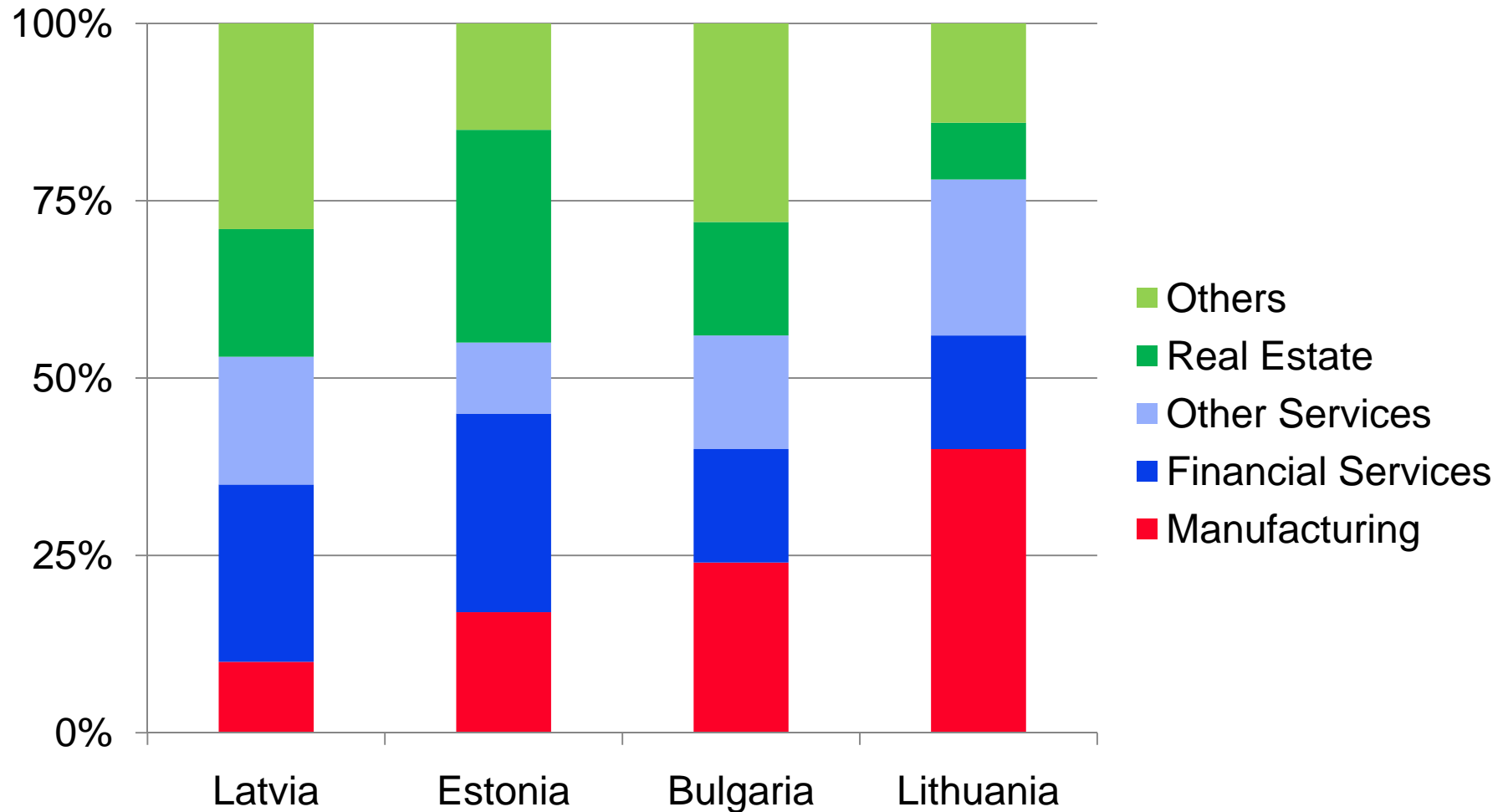
Stocks and Flows, Selected Countries

Inward FDI Stocks as % of GDP, Average 2003 - 2007



Sectoral Composition of Inbound FDI Stock

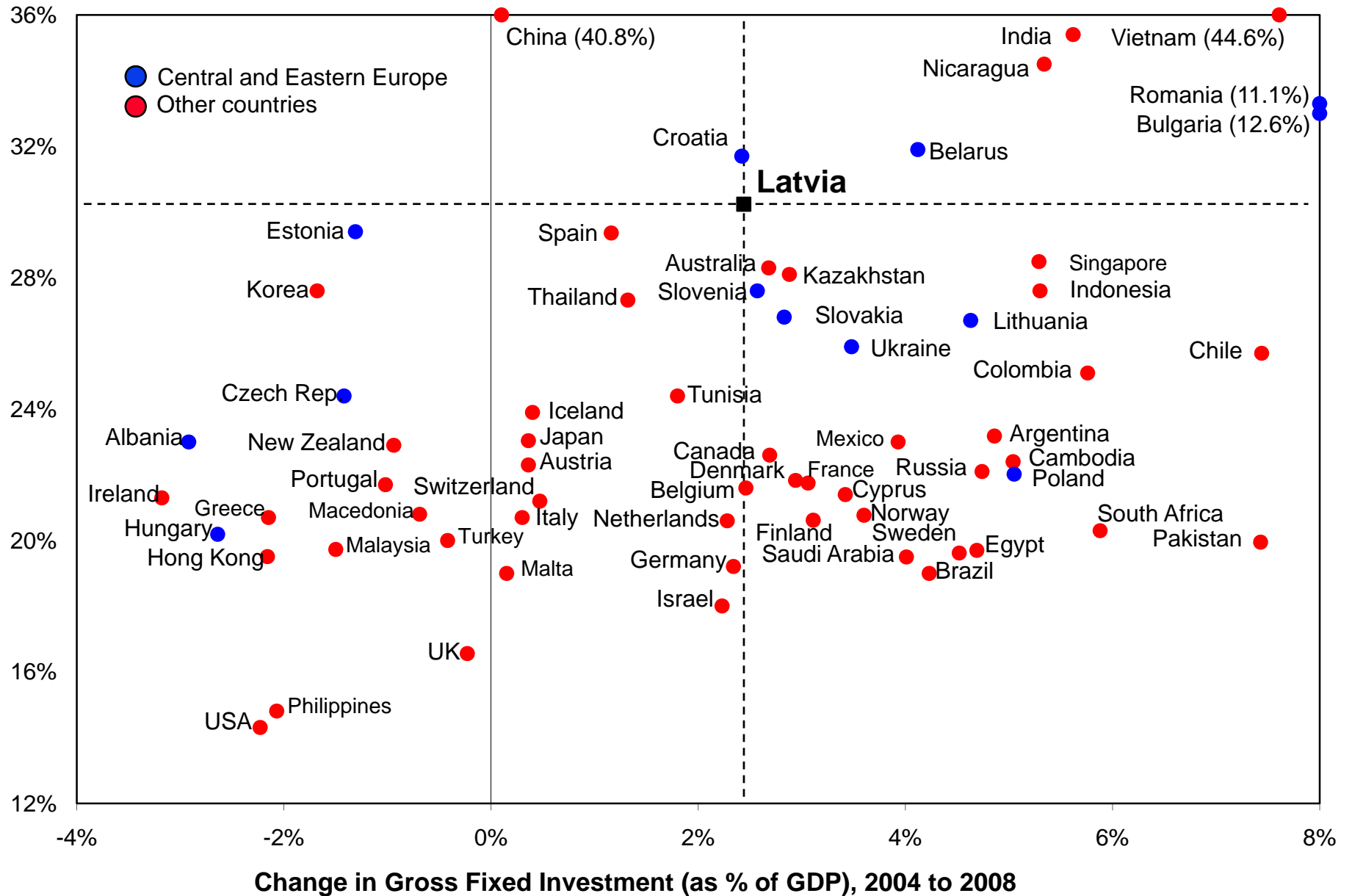
High Current Account Deficit Countries, Central Europe



Domestic Fixed Investment Rates

Selected Countries

Gross Fixed Investment
as % of GDP, 2008



Note: Includes inbound FDI
Source: EIU, 2009

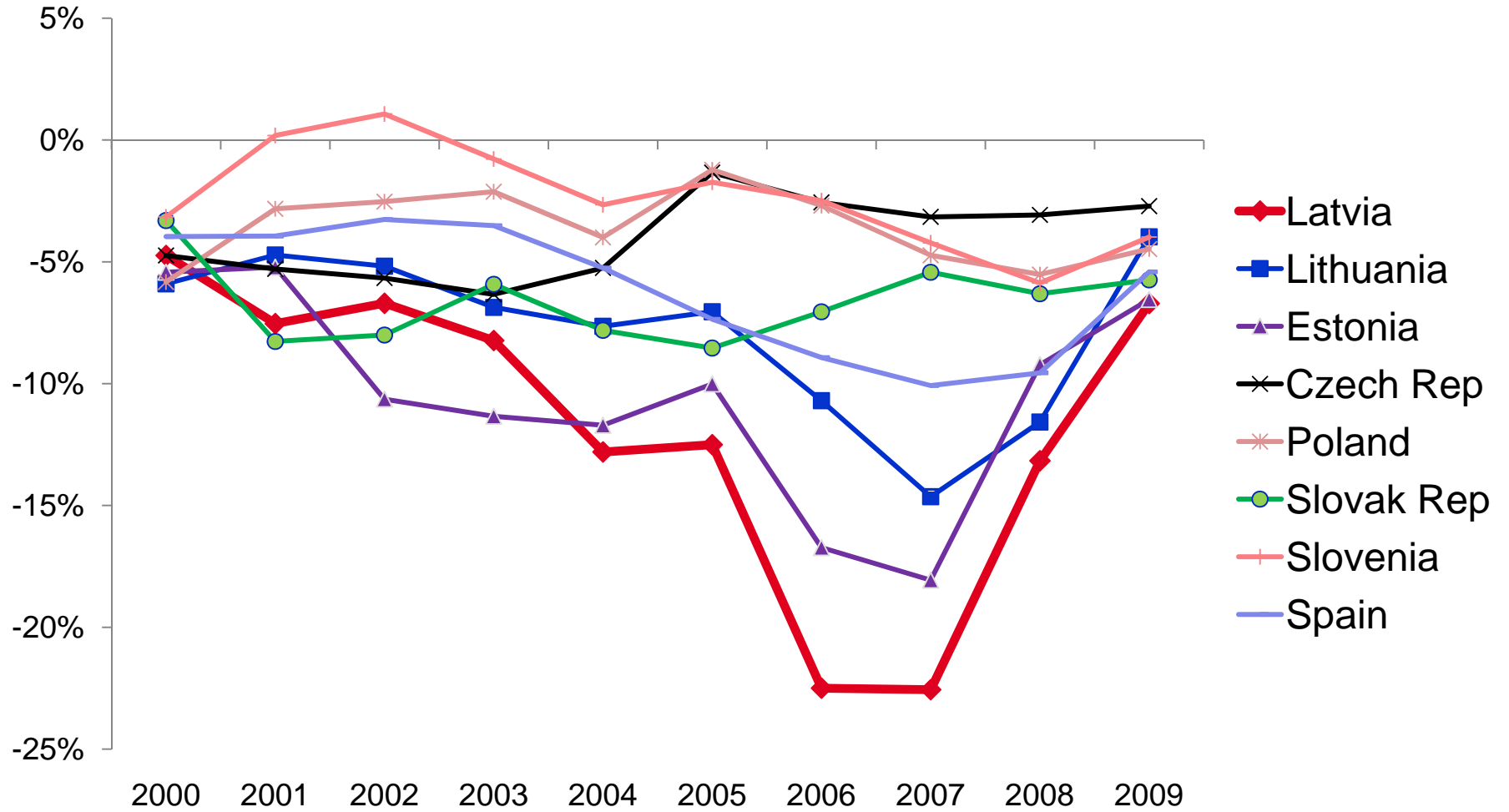
Construction

	Share of Construction in GDP, 2007	Real Growth of Construction, CAGR, 2001 - 2007
Spain	11.5%	4.8%
Kazakhstan	10.2%	22.2%
Ireland	9.4%	8.5%
Republic of Korea	9.2%	3.8%
Iceland	8.8%	4.5%
Latvia	8.4%	14.8%
Lithuania	7.9%	12.3%
Estonia	7.9%	10.2%
United Arab Emirates	7.3%	12.0%
India	6.8%	10.8%
Russian Federation	5.8%	7.7%
China, People's Republic of	5.7%	10.5%
Brazil	5.2%	2.2%
Saudi Arabia	4.8%	4.5%
United States	4.8%	0.4%

Source: UN, 2008

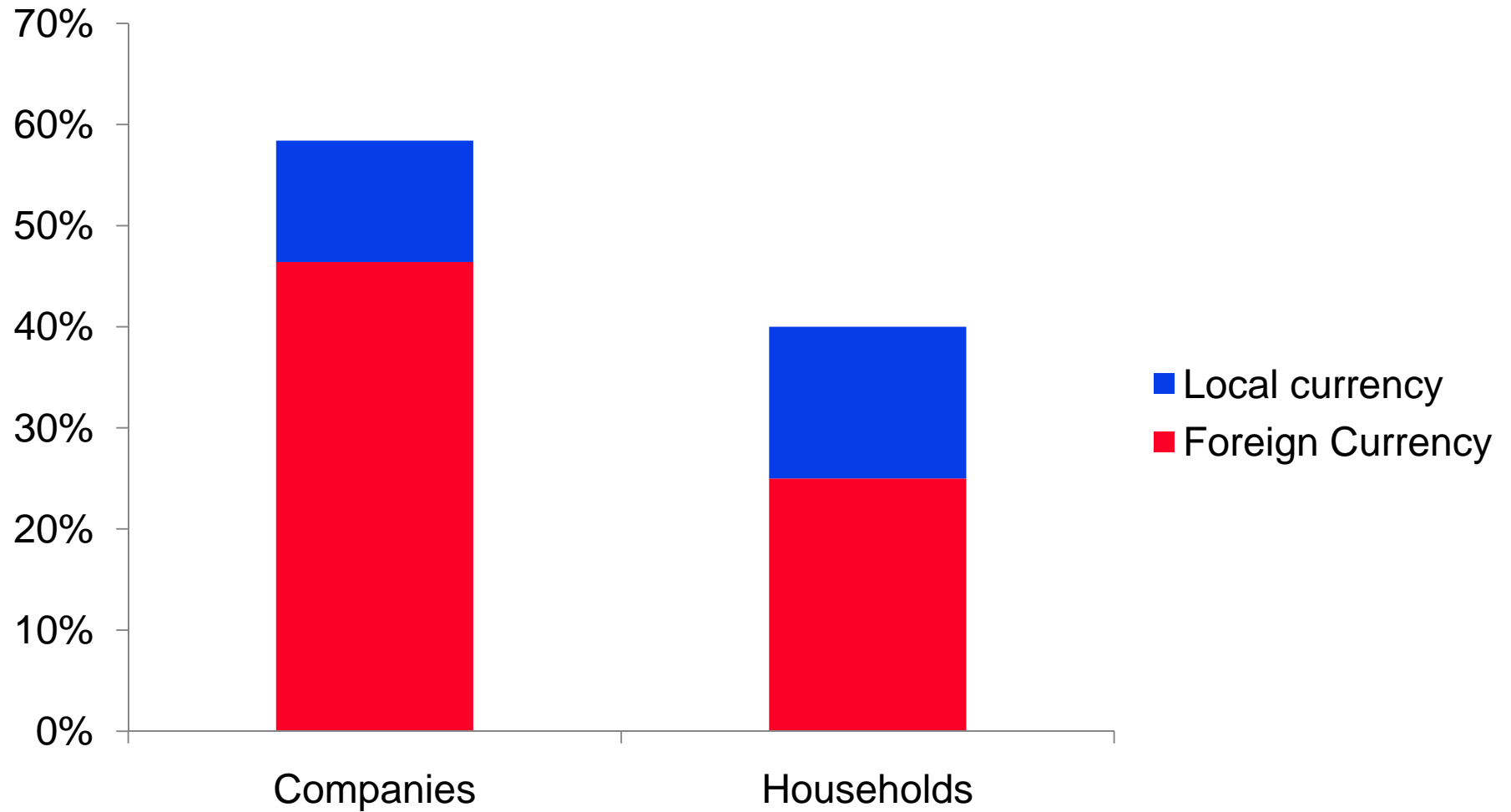
Current Account Deficit

Relative to GDP



Domestic Bank Credit Latvia, June 2008

Relative to GDP



European Innovation Scoreboard

Ranking

Country	2003	2007
Sweden	1	1
Estonia	20	18
Czech Republic	22	21
Lithuania	30	27
Hungary	28	28
Greece	27	29
Portugal	33	30
Slovakia	31	31
Poland	32	32
Croatia	29	33
Bulgaria	34	34
Latvia	35	35
Romania	36	36
Turkey	37	37

Observations so Far

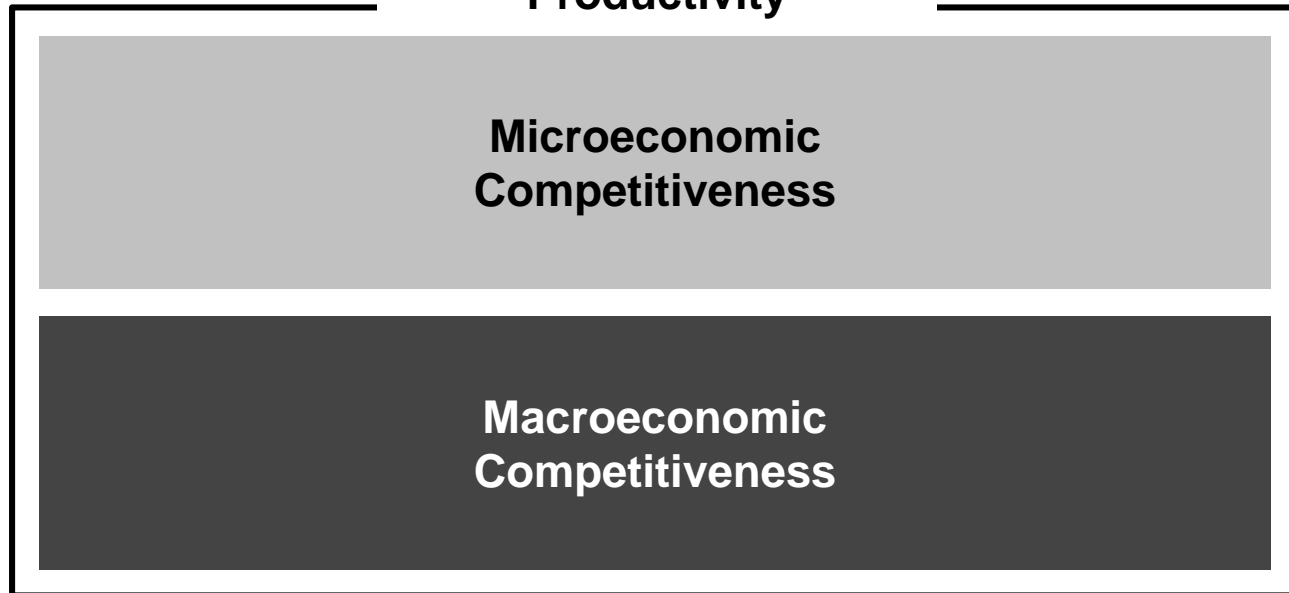
- Recent growth was increasingly **domestically fuelled**, financed by unsustainable borrowing abroad
- High growth has driven wage increases not supported by productivity catch-up; Latvia's relative **cost position has deteriorated**
- Future growth will have to come from **labor productivity** increases
- **Innovative performance** so far has been weak, indicating that much of recent productivity increases were cyclical

Competitiveness and Prosperity

Prosperity



Productivity



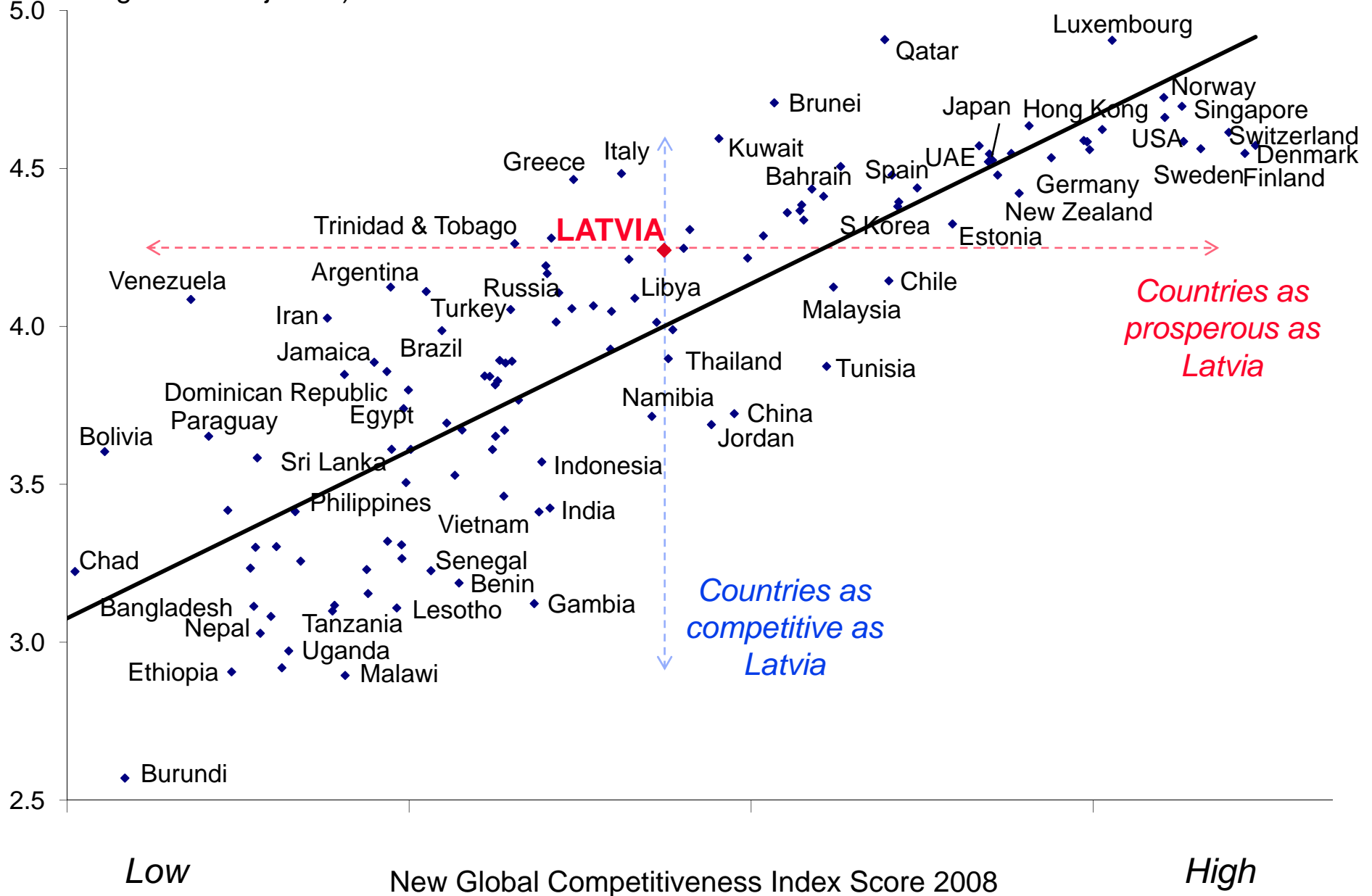
Competitiveness



Endowments

Competitiveness and Prosperity

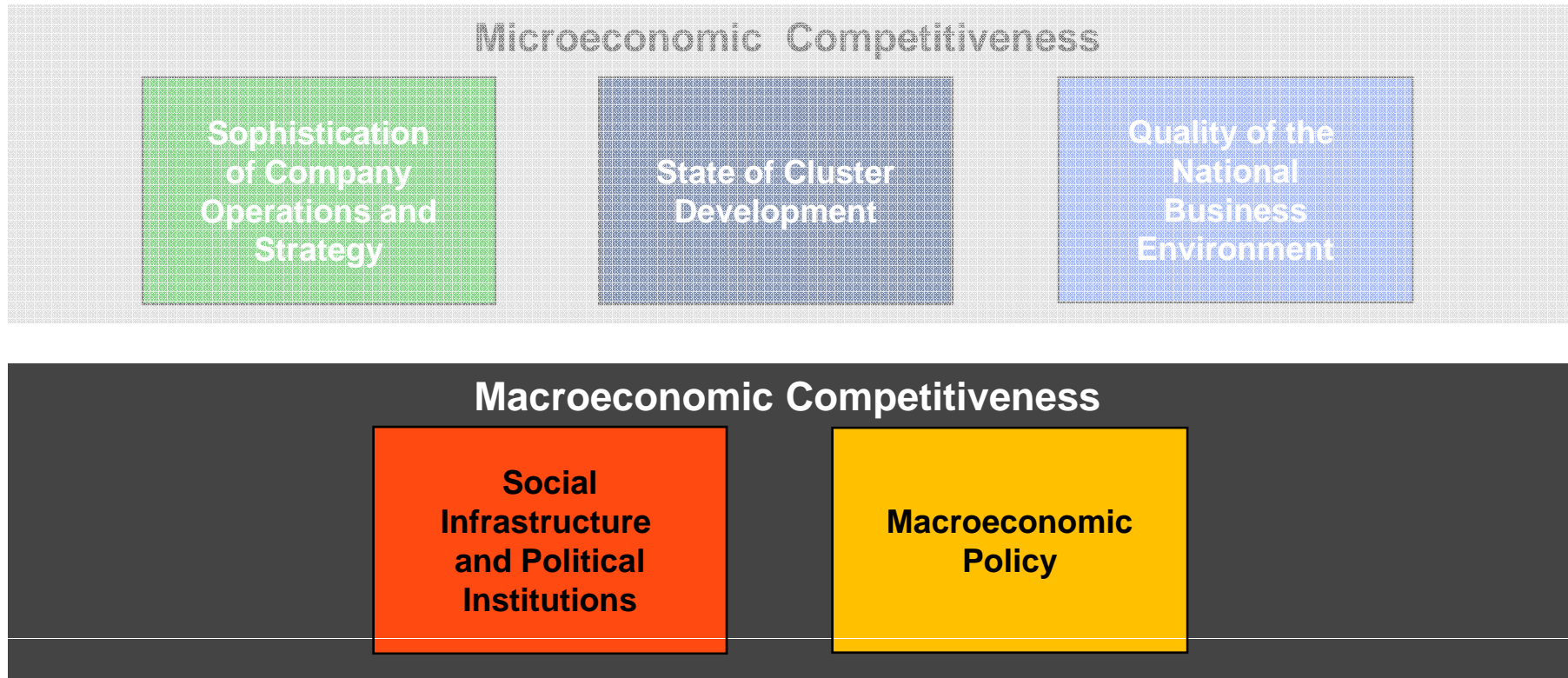
Log 2007 GDP per Capita
(Purchasing Power Adjusted)



Note: The graph does not depict the impact of the control variables, which increase the fit of the relationship to an R square of 85%

Determinants of Productivity

The Macroeconomic Agenda

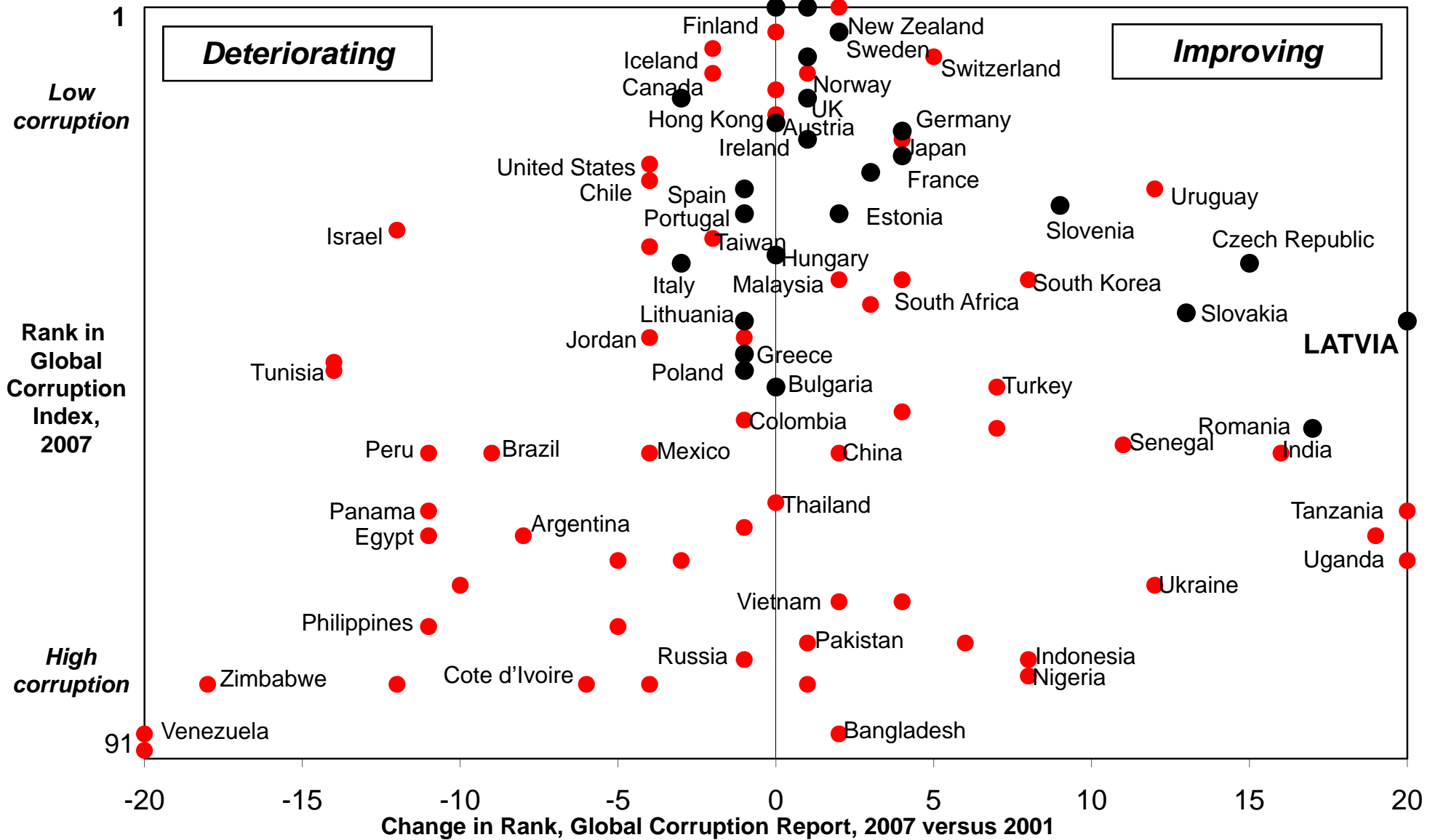


- Institutions critical in the **long-term** but hard to change in the short-term
- Macroeconomic policy more amendable to fast reform but often **unsustainable** if not matched by policy changes in other areas



- Macroeconomic reforms alone are **insufficient** to achieve long-term sustainable growth

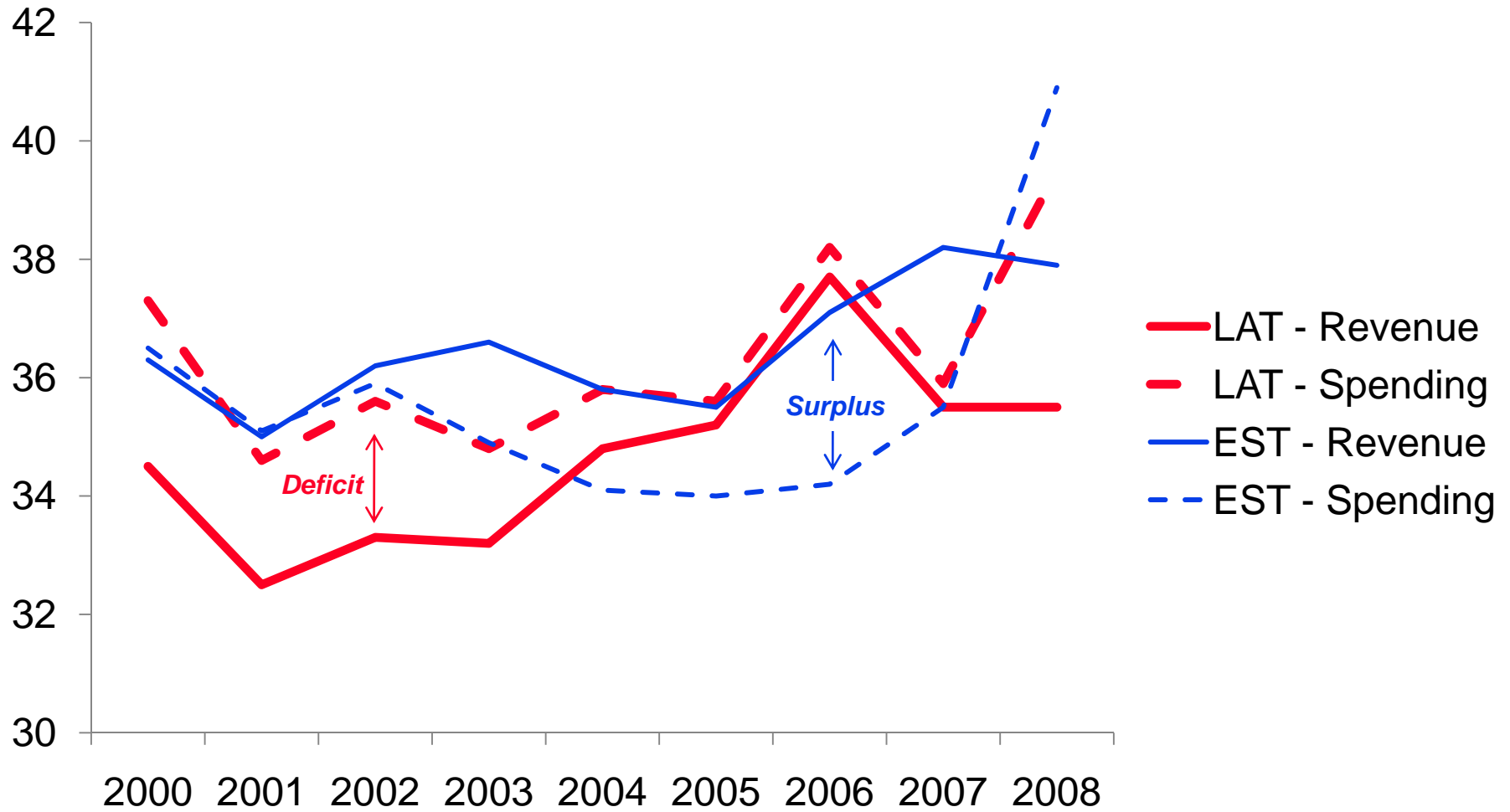
Corruption Perception Index, 2007



Note: Ranks only countries available in both years (91 countries total)
 Source: Global Corruption Report, 2007

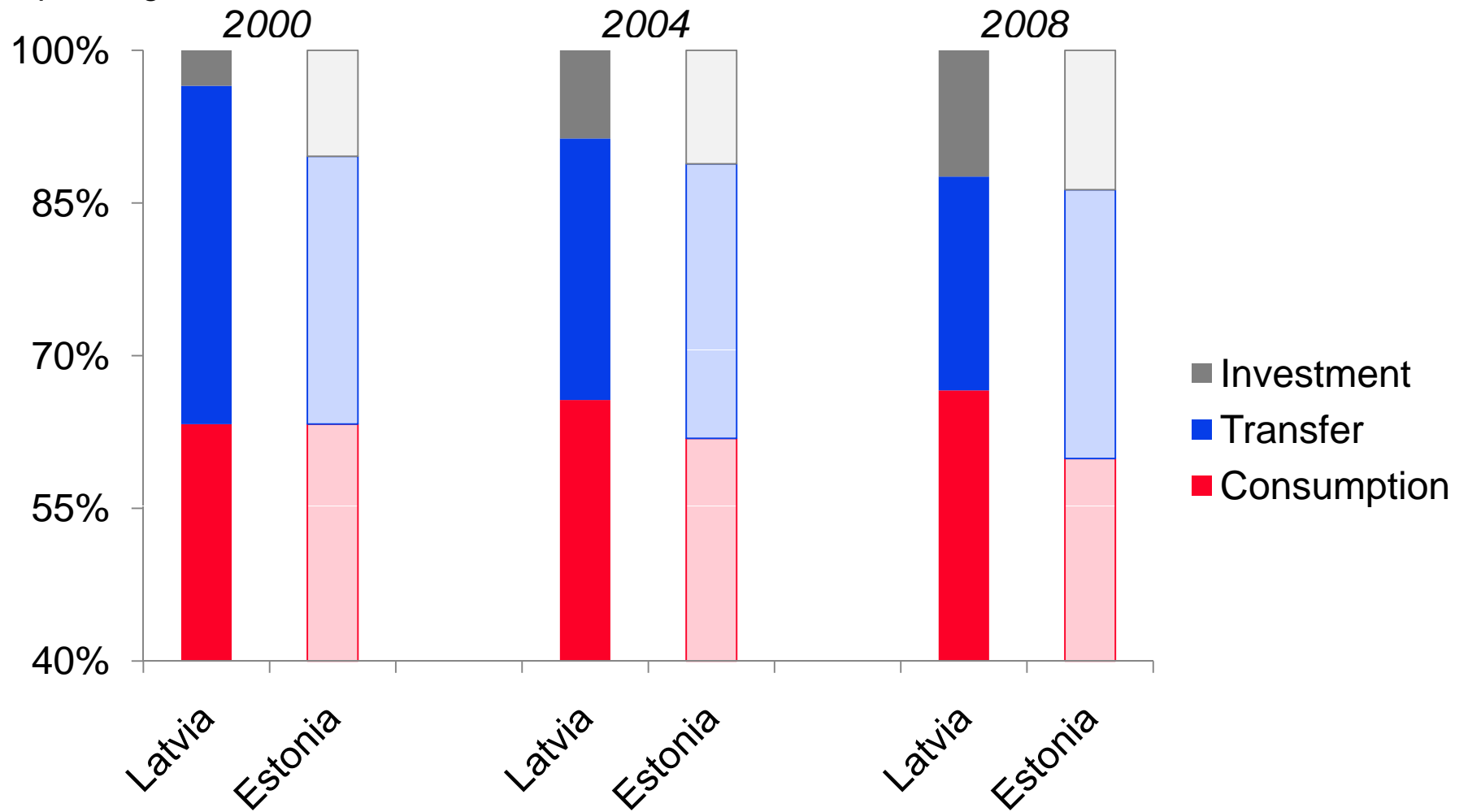
Public Sector Balances

Share of GDP



Structure of Government Spending

Share of Government Spending

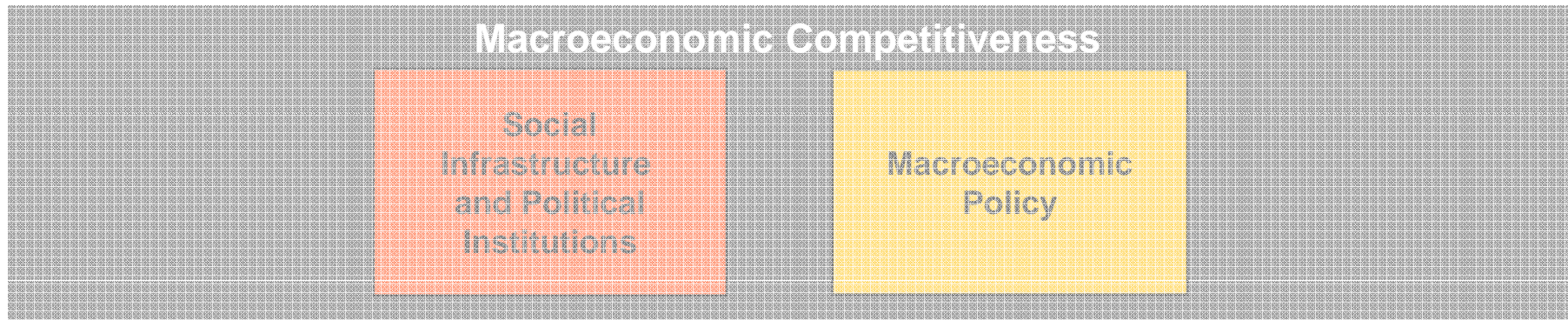


Latvia's Macroeconomic Competitiveness

- Latvia's institutional infrastructure has **benefited** from the EU accession process but remains in the group of **weaker EU countries**
 - The country's position on the rule of law has improved the strongest
 - Political institutions, especially their effectiveness and transparency, remain more problematic
- On macroeconomic policy, Latvia's position relative to its peers has **deteriorated** over time
 - Government deficits have fallen during the period of high growth, driven by cyclical improvements of tax revenues
 - But even when the economy was growing fast, public spending was expansionary and dominated by government consumption
 - Private sector balances, both corporate and household, have deteriorated even more, with high credit growth fuelling inflation and high current account deficits

Determinants of Productivity

The Microeconomic Agenda



- Involves many **parts of the economy** and society, including several parts of government, companies, universities, and platforms for collaboration
- Many individual factors and systemic interactions among them are frequent; **prioritizing** and sequencing actions is a crucial task



- Microeconomic progress is **critical** and requires a **new policy approach**

Company Operations and Strategy

Latvia's Relative Position 2008

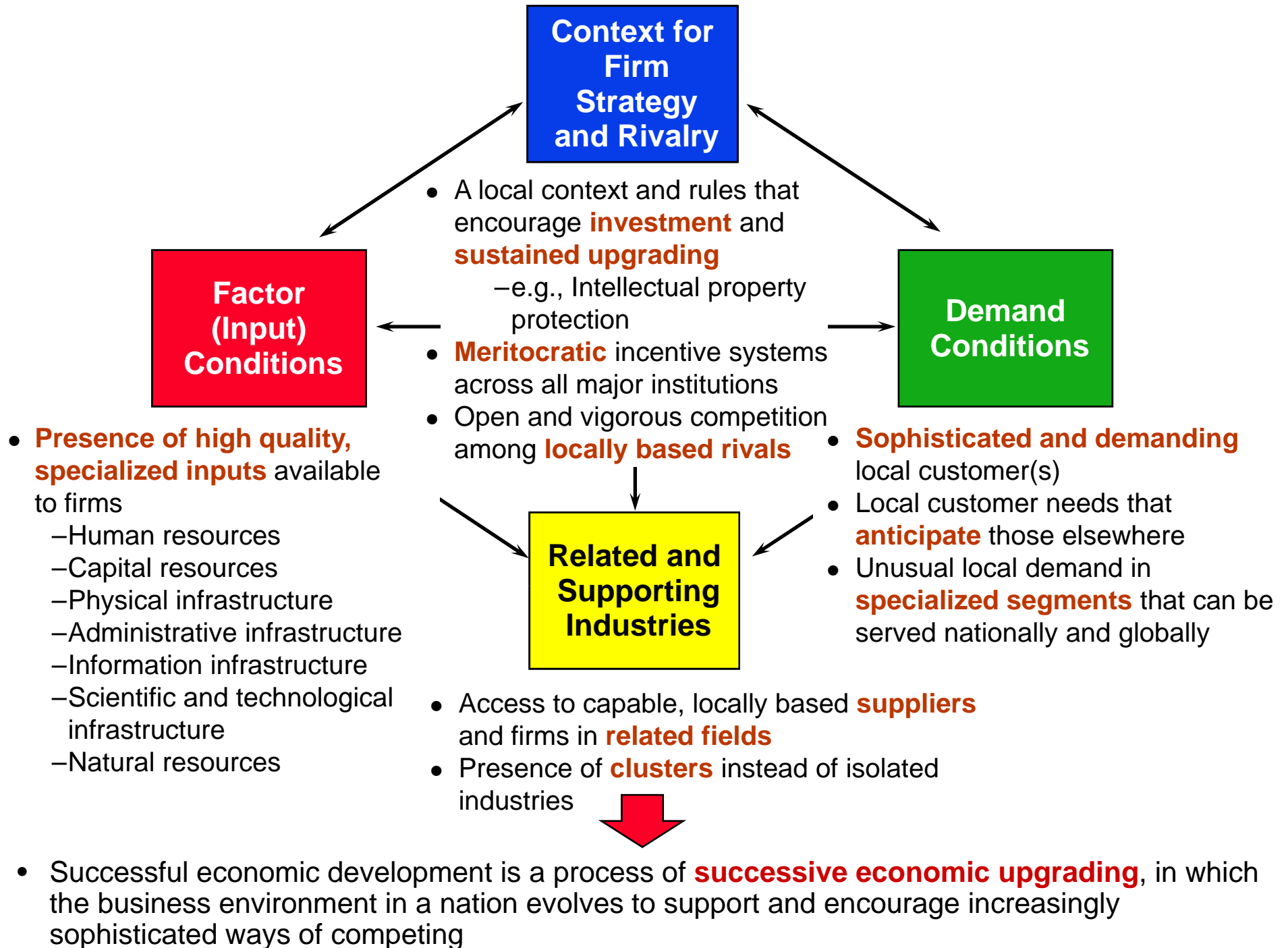
Competitive Advantages

	Country Ranking,
Reliance on professional management	38

Competitive Disadvantages

	Country Ranking,
Control of international distribution	66
Breadth of international markets	62
Company spending on R&D	59
Extent of regional sales	59
Extent of marketing	57
Firm-level technology absorption	56
Value chain breadth	55
Willingness to delegate authority	55
Degree of customer orientation	53
Nature of competitive advantage	52
Prevalence of foreign technology licensing	50
Capacity for innovation	49
Production process sophistication	48
Extent of staff training	47

Productivity and the Business Environment



Factor (Input) Conditions Latvia's Relative Position 2008

Competitive Advantages

	Country Ranking,
Tertiary enrollment	12
Internet users per 100 population	25
Personal computers per 100 population	28
Quality of air transport infrastructure	30
Domestic credit to private sector	30
Quality of railroad infrastructure	31
Ease of starting a new business	31
Mobile phone penetration	33
Quality of port infrastructure	35

Competitive Disadvantages

	Country Ranking,
Availability of scientists and engineers	68
Financing through local equity market	61
Quality of scientific research institutions	59
Quality of roads	56
Ease of access to loans	53
Regulation of securities exchanges	53
Soundness of banks	45
Venture capital availability	45
Quality of the educational system	44
Quality of telephone infrastructure	43
Financial market sophistication	43
Quality of math and science education	43
Quality of domestic transport network	42

Doing Business 2009 Ranking

Latvia

Category	Rank (change)
Enforcing Contracts	4 (+1)
Getting Credit	12 (+1)
Trading Across Borders	25 (-7)
OVERALL	29 (-3)
Starting a Business	35 (-5)
Paying Taxes	36 (-6)
Protecting Investors	53 (-4)
Registering Property	77 (+14)
Dealing with Constr. Permits	78 (+5)
Closing a Business	86 (-19)
Employing Workers	103 (-4)

World Bank Logistics Performance Index



Context for Strategy and Rivalry

Latvia's Relative Position 2008

Competitive Advantages

	Country Ranking,
Absence of trade barriers	12
Low restrictions on capital flows	16
(Low) Distortive effect of taxes and subsidies on competition	25
Regulatory quality	25
Prevalence of foreign ownership	26
(Low) Tariff rate	28
(Low) Impact of taxation on incentives to work and invest	32

Competitive Disadvantages

	Country Ranking,
Low market disruption from state-owned enterprises	58
FDI and technology transfer	52
(Low) Rigidity of employment	51
Business impact of rules on FDI	48
Intensity of local competition	48
(Low) Extent of market dominance by business groups	48
Cooperation in labor-employer relations	47
Effectiveness of antitrust policy	42
Efficacy of corporate boards	42
Intellectual property protection	40
Strength of investor protection	37

WEF Enabling Trade Index



Of 118 countries

Clusters' Impact on Economic Performance

Local externalities

- Access to specialized labor
- Access to specialized suppliers
- Opportunities for local outsourcing
- Knowledge spillovers
- Intense competitive pressure
- Fast market feedback



- Higher productivity



- Higher innovation

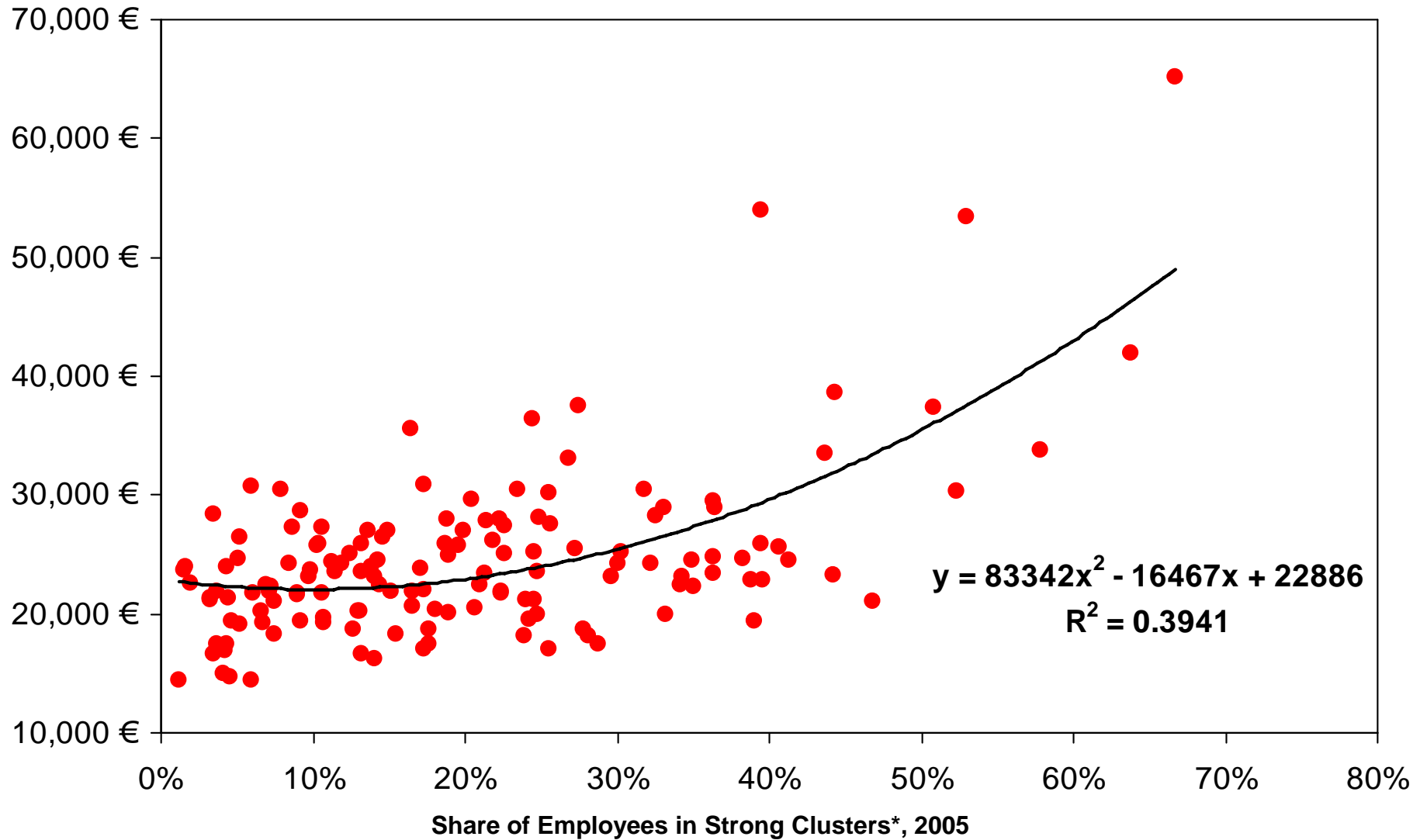


- More new business formation

Clusterportfolio Strength and Regional Prosperity

EU-15 Countries

GDP per Capita (PPP adjusted), 2004



Note: Strong clusters defined by LQ>2; NUTS Regions excluding Portugal and Greece.
Source: European Cluster Observatory. ISC/CSC cluster codes 1.0, dataset 20070510

Related and Supporting Industries

Latvia's Relative Position 2008

Competitive Advantages

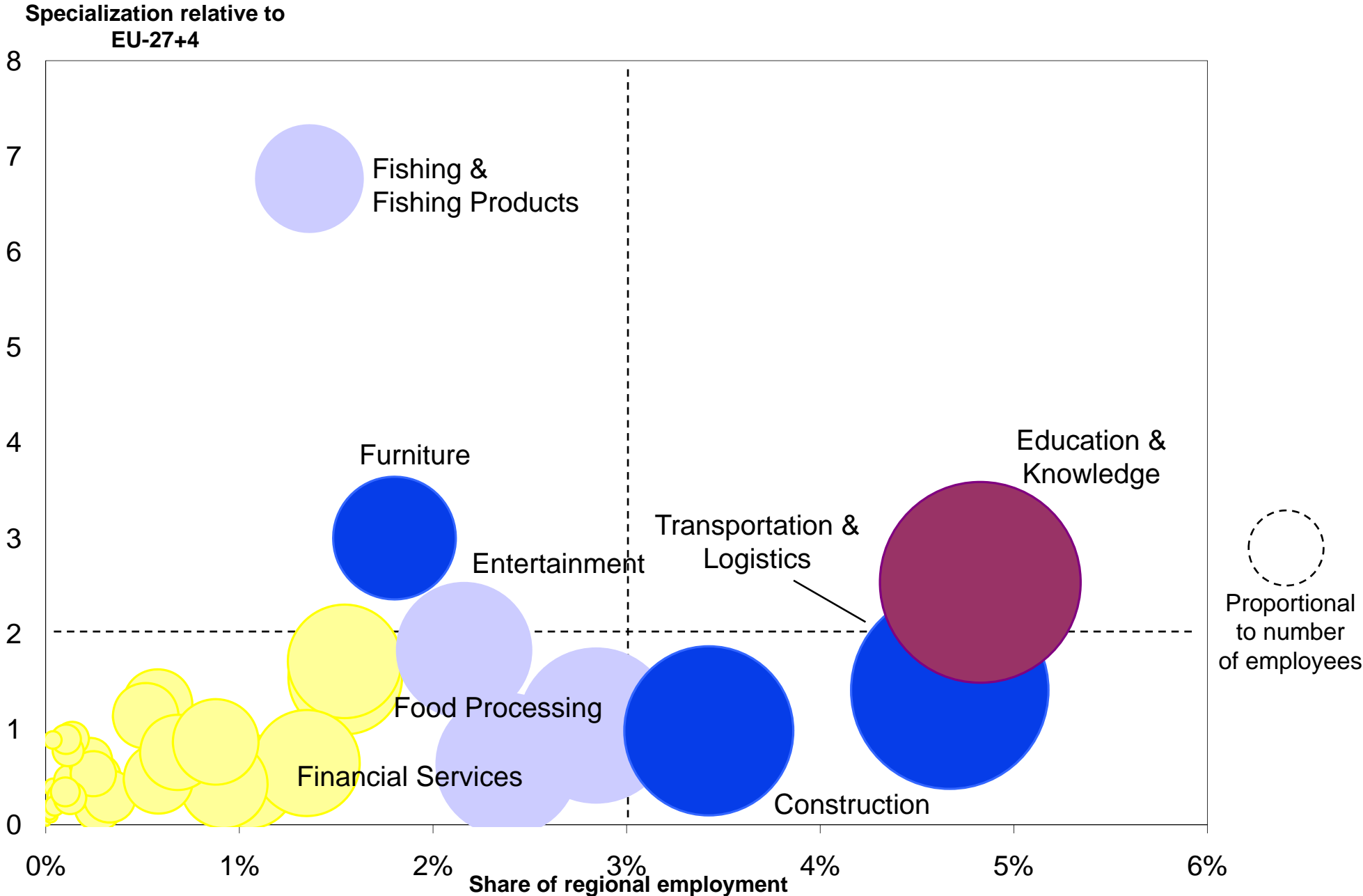
Country Ranking,

Competitive Disadvantages

Country Ranking,

Local supplier quantity	68
State of cluster development	67
Extent of collaboration in clusters	64
Local availability of process machinery	62
Extent of cluster policy	60
Local supplier quality	54
Local availability of specialized research and training services	53
Availability of latest technologies	51

Latvia's Cluster Portfolio by Employment

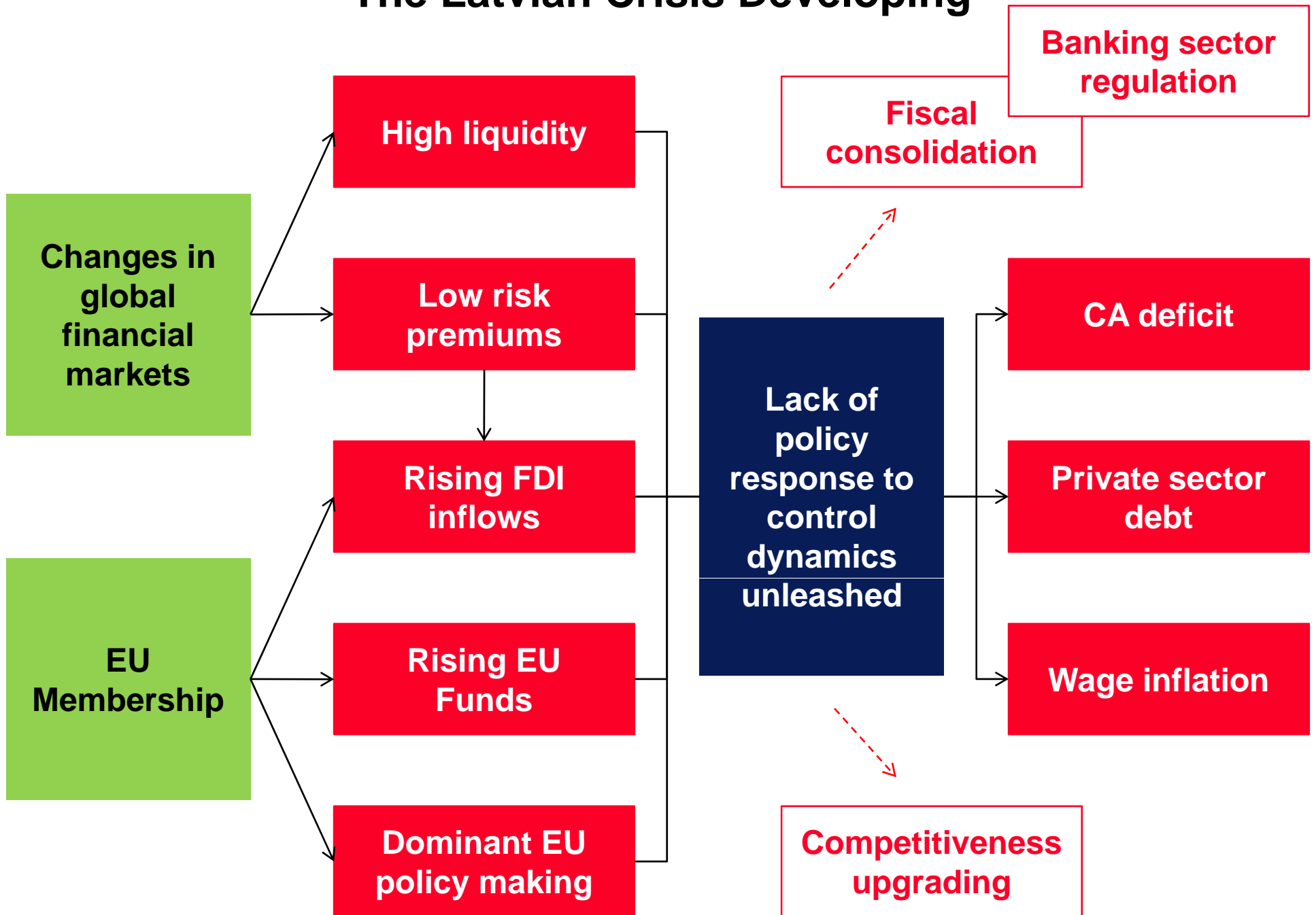


Source: European Cluster Observatory. ISC/CSC cluster codes 1.0, dataset 20070510

Latvia's Microeconomic Competitiveness

- Microeconomic competitiveness has **remained sluggish** over the last few years
- Especially on **company sophistication** Latvia continues to lag behind
- Business environment quality remains **stronger**, especially on physical infrastructure, formal market openness, and moderate distortions through the tax system
- **Challenges** remain in the innovation system, the financial infrastructure, the lack of actual market openness, and weak cluster dynamics

The Latvian Crisis Developing



The Latvian Crisis Unfolding

Global financial markets

Low liquidity

High risk premiums

Shrinking FDI

Shrinking trade

Global economy

Solvency problem

FX rate under pressure

Debt availability shrinking

Falling FDI

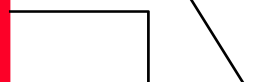
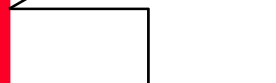
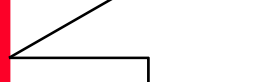
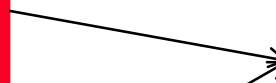
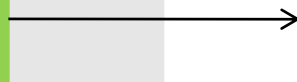
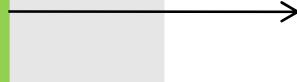
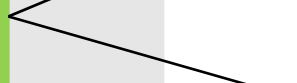
Falling exports

Financial sector crisis

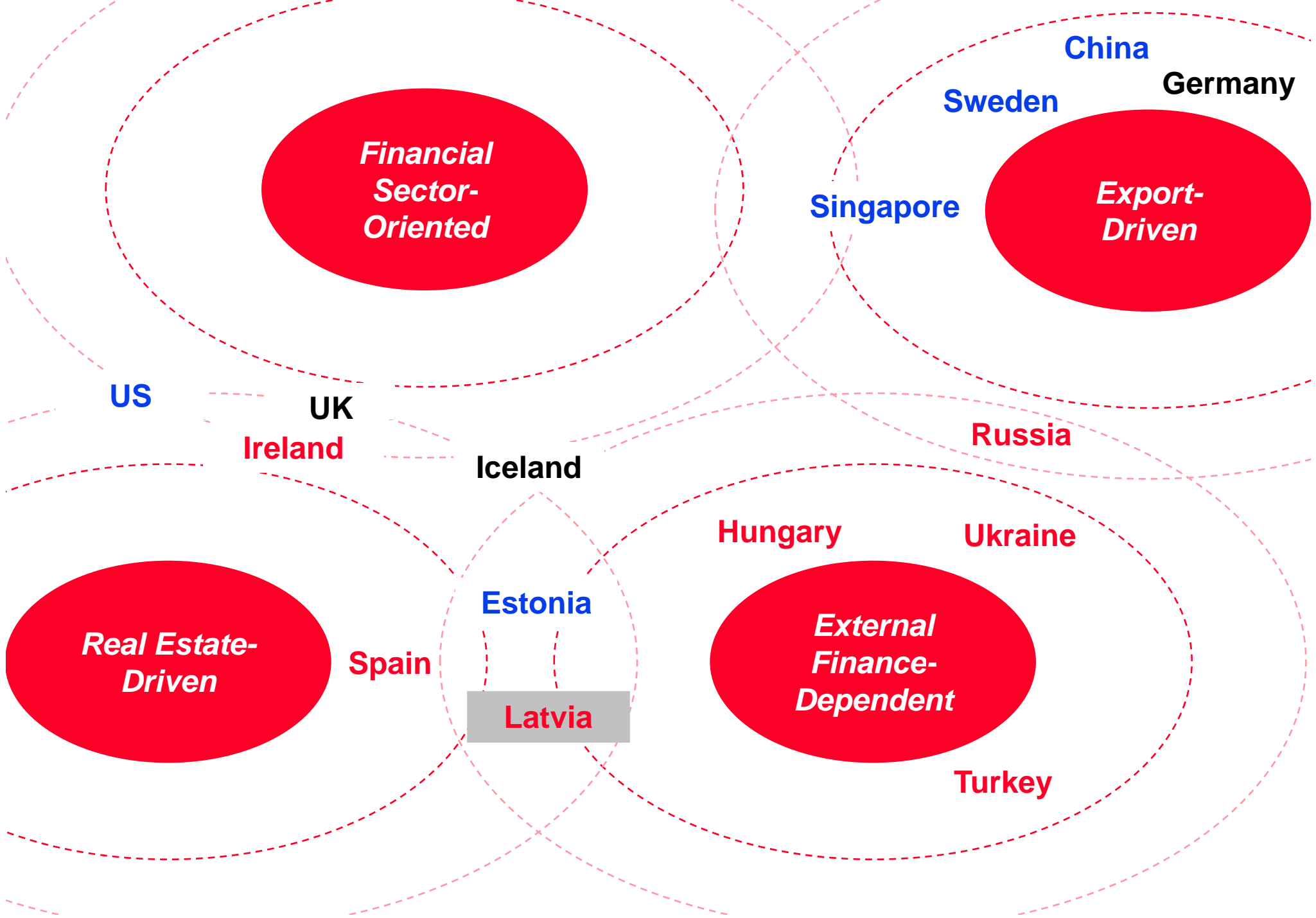
Fiscal consolidation

Internal devaluation

GDP contraction

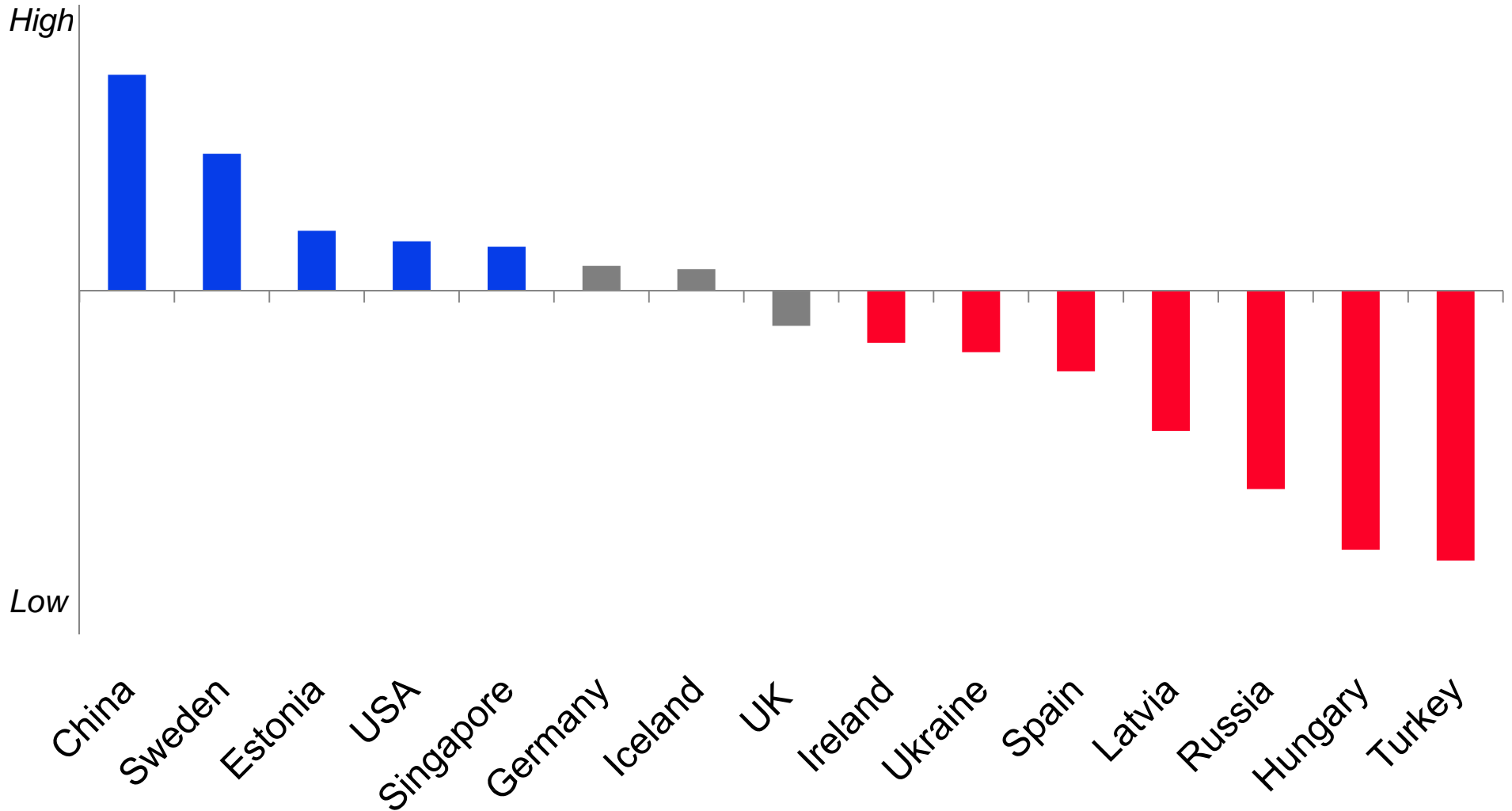


Impact of the Global Financial Crisis



Prosperity and Competitiveness

Economic Sustainability of Current Prosperity



Competitiveness and the Crisis

High

- High short term impact given high openness
- Quick recovery possible
- Remain on course

Moderate

- Short term impact depends on openness
- Recovery likely to be prolonged
- Balance crisis management with upgrading

Low

- Short term impact depends on openness
- Recovery only with reforms
- Use the crisis as a promoter of change

Competitiveness Upgrading: Latvia's Action Agenda

- Transform **company sophistication**
- Strengthen **cluster** collaboration and dynamics
- Upgrade **workforce skills**
- Address **infrastructure weaknesses** in roads and energy
- Improve **rules and regulations** for doing business and their implementation
- Increase effectiveness of **local competition**
- Pursue more sustainable **macroeconomic policies**

Getting it Done

Old Model

- **Government** drives economic development through policy decisions and incentives



New Model

- Economic development is a **collaborative process** involving government at multiple levels, companies, teaching and research institutions, and institutions for collaboration