

## STRUCTURAL CHANGES IN THE ECONOMY OF LATVIA AFTER IT JOINED THE EUROPEAN UNION

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**Abstract.** After joining the EU in 2004 the economy of Latvia has experienced both a period of rapid growth and a deep recession. Particularly, the last crisis caused severe consequences, which was one of the deepest in Europe. The internal and external imbalances were considered as one of the main causes of vulnerability of the economy of Latvia. The global financial crisis has contributed to significant adjustments in accumulated imbalances. At the same time the reduced disparities did not mean that the economy had become less vulnerable, capable of providing stable long-term balanced growth of GDP. The article provides the analysis of the main structural problems of the economy of Latvia and main structural policy directions.

**JEL classification:** O11.

**Key words:** structural unbalances, macro-structural bottlenecks, industrial policy, competitiveness.

**Reikšminiai žodžiai:** struktūrinis disbalansas, makrostruktūrinės kliūtys, pramonės politika, konkurencingumas.

### Introduction

The accession of Latvia in the EU contributed to the deepening of economic integration, radically changing the situation in financial and labour markets. Since Latvia joined the European Union (EU) it has experienced rapid economic growth and considerable recession, stimulated by structural, cyclical and external environmental factors.

The economic crisis in Latvia was the deepest crisis within the EU. During three years (2008–2010) the overall GDP decreased per 21.3 per cent [4], and historically it was the largest drop, experienced by some national economy after the Great Depression in the USA where within four years GDP decreased by 29 per cent [11]. Although in 2011 the growth of GDP in Latvia was positive and reached 5.5 per cent [6], however, the economy in Latvia is still in the recovery phase after the economic crisis, as the pre-crisis level of GDP has not been reached yet. One of the main problems in the economy of Latvia now is its structure which is unable to compete on a global level. Moreover, development of the Latvian economy is limited due to low productivity and export intensity, dependence on imports, the low national savings rate, unfavourable investment breakdown by sector, large private and government debt burden, as well as emigration of the economically active population. The export of goods with high added value in Latvia accounts for only 4.6 per cent of total export (in the EU countries—on average 12%), every year only 0.6 per cent of GDP is spent for research and development in the private and public sectors in Latvia (in the EU countries—on average 2 per cent, including Estonia—1.2%) [3]. In the competitiveness ratings, regularly published by the World Economic Forum (WEF), Latvia lags far behind other new EU countries (Czech Republic, Poland, Slovenia and Slovakia) and other Baltic states. Particularly bad is the sub-index score of innovations in Latvia, according to which Latvia was ranked 68<sup>th</sup> in the world in 2012–2013 (of the 144 countries considered) [8].

Taking into account the situation in Latvia and the EU, as well as global economic trends, the article's scientific problem is to assess the structural changes of the Latvian economy after joining the EU, to identify macro-structural bottlenecks, and the measures necessary for faster economic recovery after the crisis, while ensuring sustainable growth over the medium term. Research aim is analysis of the main structural changes of the economy of Latvia and identification of the main problems limiting Latvian economic development and competitiveness. To reach this target the influencing factors of the economy of Latvia from 2004 until 2011 have been evaluated, the structural changes of the economy of Latvia have been analysed and main macro-structural bottlenecks limiting the Latvian economic development and competitiveness have been identified. Results of the analysis highlighted the potential economic policies of the Latvian economy to improve the structure and competitiveness of the Latvian economy to promote balanced and sustainable development.

The research object is Latvian economic structure. By the assessment of data, used were methods of analysis and synthesis, reference and dynamical line.

## **1. The economic development of Latvia after joining the European Union**

After joining the EU in 2004, the end came to an important phase of the economic development of Latvian, which opened as new opportunities, as new challenges. Accession to the EU can be viewed on the one hand, the transitional period, on the other hand, it can be characterized as the period when Latvia was standing at the new

crossroads and was ready for new, fundamental alternatives. The borders were opened for free flows of finances and capital, that set lower prices for financial resources, and also increased the lending amounts and domestic demands, the freedom of labour movement offered new opportunities for inhabitants of Latvia to get incomes and experience in other EU countries, at the same time causing rapid labour force emigration and rise of salary and inflation in Latvia. The development of Latvian economy from the year 2004 can be divided in three stages:

- 1) 2004–2007 were the years when growth of economics was fast and dynamic, reflecting a rapid rise of GDP, inflation and current account deficit, low unemployment level, small budget deficit and little Government debt;
- 2) 2008–2010 were the years when Latvia was hit by economic crisis, that was promoted by structural, cyclical and environmental factors, that reflected on a drop of GDP, inflation and current account deficit, high unemployment level, rapidly growing budget deficit and Government debt;
- 3) from the year 2011, when there is stability of economics, gradual growth of GDP, unemployment level and budget deficit decreases.

In the first stage (from 2004 to 2007) the Latvian economy was largely based on domestic demand. Essentials of private consumption and investment growth, which exceeded the GDP growth was due to a significant inflow of foreign capital through the commercial banks. It also said the rapid rise in inflation and the current account deficit of excessive and thus Latvian economic vulnerability increases. At the same time increased imbalance in both the domestic and external economy, as evidenced by the low share of manufacturing in GDP, a small high-tech sectors in manufacturing, domestic savings decline in public debt and the loss of competitiveness of Latvian exporters. Economic imbalances intensified government pro-cyclical fiscal policy. According to the authors, the stage from 2004 to 2007 was a significant need for tighter and more restrictive fiscal policy—both capital gains taxes and stricter regulations in real estate foreclosure, which would reduce inflationary pressures and risks of overheating. Until the year 2007 the Government did not take action to reduce economic imbalances, despite the fact that the unbalanced economic development and “overheating” was actively discussed throughout society and economic experts. Also, monetary policy, although focused on the rapid growth in domestic demand and inflation reduction (Latvian bank since the year 2003 implemented by the end of a tight monetary policy several times raising the minimum reserve ratio and the refinancing rate), did not give tangible results, because it is limited by the fixed currency exchange rate and other factors.

In the year 2008 there were a sharp directional turn in Latvian economy. After several years of rapid economic growth the Latvian GDP began to decrease rapidly, and there was a recession. Three years (2008–2010) Latvian GDP as a whole fell by almost 22 per cent, the unemployment rate at the end of 2009 was more than 20 per cent of the economically active population, investment fell by half, deficit in the year 2009 was 1,258 million lats or 9.6 per cent of GDP (in year 2010 it dropped to 974 million lats or 7.6% of GDP), government debt increased from 1,329.8 million at the end of 2007 up to LVL 5,693.6 million at the end of a year 2010, reaching 44.7 per cent of GDP [4].

Historically the economic crisis in Latvia was the largest drop, experienced by some national economy after the Great Depression in the USA where within four years GDP decreased by 29 per cent [11]. Contributing causes of the crisis can be divided into three groups—the cyclical, structural and environmental factors. Cyclical factors were related to the stage from 2004 to 2007 of rapid economic growth, with GDP growth projected ahead and there was a significant in both internal and external imbalances (high inflation and a large current account deficit). Structural factors are mainly related to the sectors of the economy structural disadvantages, which was spontaneously formed by private investment flows and did not result in Latvian competitiveness (share of manufacturing in total value added of Latvian in year 2009 was the third lowest in the EU). However, environmental factors were linked to the global economic crisis and the decline in external demand, which negatively affected the Latvian exports and other indicators of economic activity of LVL 93.6 million at the end of a year 2010, reaching 44.7 per cent of GDP. The banking sector's total losses from the year 2009 to 2010 amounted to 1,134.1 million lats [9]. The economic crisis revealed the years built up over economic disparities, demonstrating the shortcomings of government economic management and control policies and resource allocation procedures. The crisis has forced people to rethink the current model of behaviour and change limiting costs (during the crisis, private consumption declined significantly, while the national savings rate rose reaching 29.1 per cent of GDP in the year 2009). The crisis also contributed to the reform of the public sector, reducing its capacity and improving its operational efficiency. There were also a number of measures to improve the business environment in order to promote the competitiveness of local producers, and increasing economic activity. For example, the Commercial Code amendments, which provided for the establishment of a company to reduce share capital, the largest possible number of economically active people start a business, Micro-enterprise Tax Law and Implementation measures of business start-up cost reduction and simplification.

Latvian experience in coping with the crisis triggered a broad discussion about currency devaluation and the associated risks, demonstrating that the devaluation (which the IMF was previously considered to be a universal instrument of financial crises) are not always necessary and inevitable [1]. This view was defended during the crisis by Prime Minister V. Dombrovskis, who took up these responsibilities after I. Godmanis in February 2009, and management of the Latvian bank, stressing that the cost of devaluation of the Latvian case would be greater than the gain [2]. Latvia, like the other Baltic countries, showed the international community that they are able to make massive cuts in public spending (the biggest budget cuts—15 per cent of GDP—Latvia made in the first nine months of a year 2009 [1]), while fiscal consolidation in the short term hinder economic growth and create “painful experiences” for its people.

Since 2011 Latvia has reached some stability and slow recovery is happening after the crisis, but there are still a number of significant issues that may limit the development of the future:

- inflation persistence;
- slow productivity growth;

- high GDP volatility and low average growth rates;
- low growth in the Baltic States and the EU and the world in general, limiting external demand and Latvian exports;
- the need to reduce government debt;
- dependency increases (due to negative natural increase and emigration);
- a large external debt and its servicing-related expenses;
- volatility in global financial markets, which makes it difficult to obtain loans for refinancing of existing debt in both the public and private sectors;
- unsustainable demand uncertainty and major trading partners;
- poor Latvian competitiveness in the EU and world markets;
- political instability (from 2004 to 2010 changed the 7<sup>th</sup> Latvian government);
- cooperation between policy-makers.

Recent experience in the global crisis has highlighted the factors that affect any crisis proportions and is critical to its successful management. Crisis less rigid countries were those, whose growth in recent years was a balanced economic structure and evenly developed. For example, in Poland, where, thanks to the smooth development of the economy (from 2004 to 2007 Poland's GDP grew on average was 5.5 per cent per year [7]) and balanced field structure of GDP growth rate, however, remained positive in 2008 and 2009, when in all other EU countries the GDP growth was negative. But more severe the crisis hit the countries in which they deployed aggressive lending, such as Ireland, as well as countries with an open economy, whose growth is heavily dependent on external demand, such as Estonia and Slovenia. To reduce the impact of the crisis it is also important to keep track of their own financial situation and create a balanced budget, as well as provisions for contingencies. This is evidenced by the Estonian example that, although it was the 2<sup>nd</sup> most injured country in EU after Latvia, however, quickly and without connecting international assistance regained pre-crisis levels.

## **2. Structural problems and bottlenecks of the economy of Latvia**

Population welfare depends not only on economic growth, which tends to be characterized by quantitative indicators of growth, but also the economic stability preservation in maintaining a stable macroeconomic environment is a necessary condition for the attraction of investment and business development, as well as competitive jobs. In turn, economic stability is possible only when there is compliance with the principles of balanced development. Balanced development of the principle of non-compliance increases the economic vulnerability to internal and external shocks. This means that rapid changes in the behaviour of economic subjects may result in significant adjustments to goods, capital and labour markets, with serious negative socio-economic effects in the short term, as well as reducing the potential for economic growth over time.

The authors believe that the analysis of economic development must distinguish macroeconomic and structural imbalances. Both imbalances are closely interrelated and represent a country's competitiveness problems. However, it should be noted that

so far the policy makers and researchers focus mainly on the found macroeconomic imbalances. Macroeconomic theory is discussed in more stable and balanced economic development, dividing both internal and external balance (stability) values, which are reflected in several documents, including the European Stability and Growth Pact. By contrast, the structural imbalances in the question development increases the most when it is facing problems that are associated with economic growth, regeneration and growth potential in the long run. These issues are closely related to structural formation and they are covering such aspects as the role of state intervention and the need for intervention and regulation of the depth of the market economy.

It should be noted that the global economic historical development showed that the macro-economic disparities are an important factor—on the one hand they increase cyclic variation, but on the other hand, in times of crisis, the market economic forces tend to reduce. So, the crisis is a unique way to achieve macroeconomic balance. As for the structural imbalances, the ability of market forces to solve it is much weaker and the crisis only exacerbates existing problems, highlighting the urgency of putting policy makers in a number of questions on the need for structural reforms and the implementation of the road. Moreover, if the structural imbalance problems are not addressed, there is a risk of the future economic development of the inevitable formation of macro-economic disparities.

Latvian economic development analysis shows that by 2007 it was both macro-economically and structurally unbalanced. In order to characterize the macroeconomic disproportions in the Latvian economy authors used the list of indicators that were developing macroeconomic imbalances procedure (Macroeconomic Imbalance Procedure) program, in order to identify the time (the early warning mechanism (alert mechanism) developed a list of indicators (scoreboard) assistance) and correct macro-economic imbalances.

Each indicator has also established a threshold above which shows the macroeconomic imbalance problem (see Table 1).

**Table 1.** Latvian macroeconomic imbalance indicators

	Thresholds	2004	2005	2006	2007	2008	2009	2010
<b>External imbalances and competitiveness</b>								
3 year average of Current Account Balance as a per cent of GDP	-4/+6%	-9.3	-11.2	-16.0	-19.2	-19.4	-9.0	-0.5
Net International Investment Position as % of GDP	-35%	-52.3	-59.6	-69.9	-74.7	-79.0	-82.7	-80.2
% Change (3 years) of Real Effective Exchange Rate (REER) with HIPC deflators	±5% & ±11%	-6.9	-4.5	4.7	11.0	24.1	23.7	8.5
% Change (3 years) in Nominal ULC	+9% & +12%	10.5	29.2	42.9	71.4	79.4	42.0	-0.1
% Change (5 years) in Export Market Shares	-6%	29.8	43.3	32.0	45.9	41.1	31.8	14.0

<b>Internal imbalances</b>								
3 year average of Unemployment	<b>10%</b>	11.0	9.9	8.7	7.2	6.8	10.2	14.3
Private Sector Debt as % of GDP	<b>160%</b>	75	95	122	128	132	147	141
Public Sector Debt as % of GDP	<b>60%</b>	15	13	11	9	20	37	45
% y-o-y change deflated House Prices	<b>+6%</b>	-3.2	23.1	65.5	26.8	-23.1	-42.4	-3.9
<b>Private Sector Credit Flow as % of GDP</b>	<b>15%</b>	18.1	26.4	43.0	36.6	14.3	-6.1	-8.8

Source: Eurostat data basis

The table below shows that by 2009 the Latvian economy had imbalanced macroeconomic issues, in particular on the external imbalances and competitiveness level, while internal imbalance scores were generally within the threshold. The authors note that this data sheet is not included in the inflation rate, which until 2008 was the entire plant (reaching 15%), indicating the internal imbalance problems. Since 2008, macroeconomic imbalances gradually declined, mostly due to the crisis in the yearly adjustments.

The crisis and its consequences allows to clearly notice that an economic model, in which, thanks to an influx of foreign capital, was a rapid increase for domestic demand, which was a base for economic growth by 2007, has ceased to exist. The established structure of the economy of Latvia has not been deliberate, but spontaneous under the impact of private investment flows that has been determined by the different productivity level and return on investments in product and services sectors. Currently, the transition to a sustainable economic model, which will be the main driver of exports, is in progress. Economic structure is changing in favour of export industries, greater contribution to the growth is manufacturing (see Table 2).

**Table 2.** Structure of the Latvian Economy (by value added, percentage)

	<b>2000</b>	<b>2008</b>	<b>2011</b>
Agriculture, forestry and fishery	4.5	3.0	4.5
Manufacturing	14.4	10.8	14.1
Other industries	4.2	4.3	5.2
Construction	6.8	10.1	6.1
Trade, accommodation and catering	18.5	18.8	18.6
Transport and storage	9.5	8.1	13.0
Other commercial services	25.1	28.4	24.7
Public services	17.0	16.5	13.8
Total	100	100	100

Source: Economics Development of Latvia. Report (2012). Ministry of Economy of the Republic of Latvia, Riga, June 2012, p. 26.

However, the authors note that for transition to a new economic development model Latvia has to overcome a number of macro-structural bottlenecks [10]:

- reduction in the deficit;
- a well-functioning and stable financial sector in the light of the high indebtedness of the private sector;

- balanced economic development, contributing to the tradable sectors and raising productivity;
- reducing structural unemployment, better matching in the labour market;
- improving the business environment, efficient use of EU funds, access to finance for businesses to support productive investments.

One of the most important structural obstacles to economic growth is the low share of industry in the structure of the Latvian economy. At the EU level, the manufacturing industry is seen as particularly important. European industry is of critical importance for the EU as a global economic leader. A competitive industry can lower costs and prices, create new products and improve quality, contributing thus decisively to wealth creation and productivity growth throughout the economy. Industry is also the key source of the innovations required to meet the societal challenges facing the EU [5].

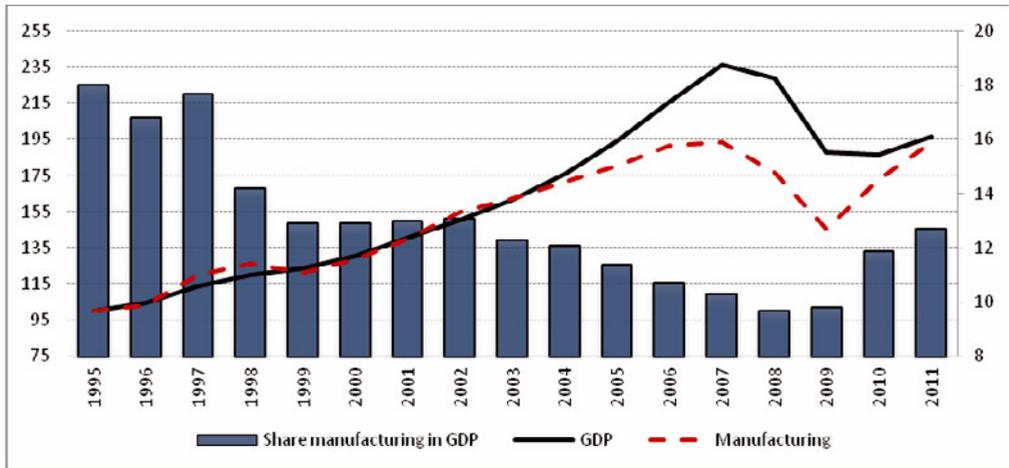
Although the theory has not specified what should be the industry's share in the total structure of the national economy, however, is often noted that weak industry may limit a country's competitiveness and sustainable growth. One of the arguments as to why development is an important factor contributing to the competitiveness of that industry serves as a technology development and innovation base. In addition to maintaining human resources in science, industry or industrial sector contributes the access to technologies—technologies that create a potential new products and services, as well as contributing to the process of industrial restructuring necessary for the modernization of the industrial structure.

The current structure of the Latvian economy by sectors, compared to year 1990, has changed substantially in favour of the service industries. The share of value added has increased to 70.2 per cent in 2011 comparing to 38.6 per cent in year 1990 [4].

The most rapid changes occurred during the first 3 years (1991–1993), the total production volumes per year fell by almost 1/5 and, at the various sectors of the economy that happened with a different intensity. In particular, a large decrease was observed in industry, where three years of production volumes decreased by 65 per cent. In 1994 the situation stabilized—the total production volumes did not decrease anymore, but the structural changes continued to increase in service-sector output, while still declining industrial production. In 1997 significant growth was observed that was suspended for two years by Russia's financial crisis on industrial sales market due to the reduction (see Figure 1.).

Since 2000 the Latvian economy experienced rapid growth and continued to increase share of service sectors. From 2000 to 2007 more rapidly than other sectors of the economy the construction, trade services and transport and communications have evolved. Significantly increased volume branches of production and number of their employees. Economic growth is ensured by increased domestic demand and, to a lesser extent, export opportunities. Domestic demand directly influenced by a number of service sectors in the rapid growth of the industrial production increase was mainly based on export growth.

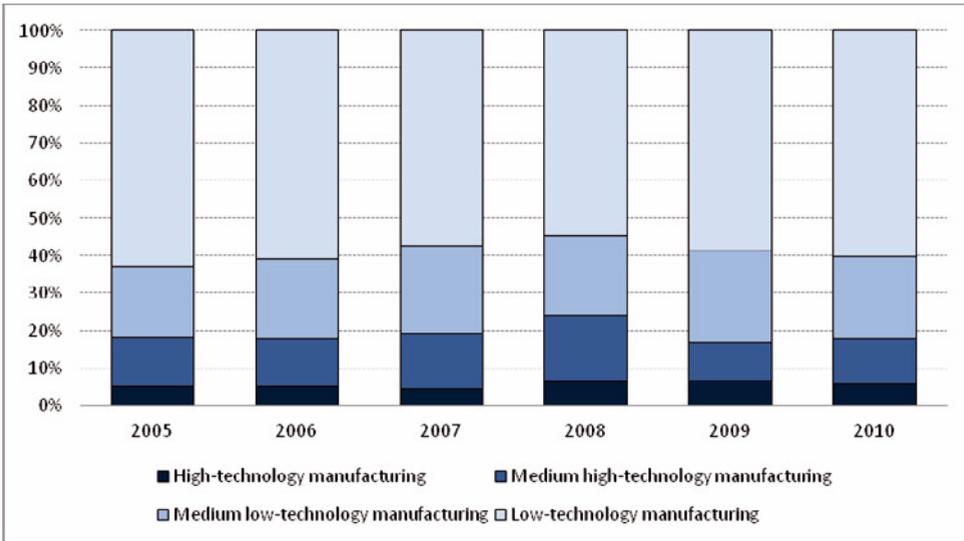
**Fig. 1.** Latvian GDP and manufacturing dynamics (1995=100, left axes) and share manufacturing in GDP (% , right axes)



Source: CSB data basis

Therefore, the rapid growth of industrial share of the economy has continued to decline and in 2008 it reached 9.7 per cent. It should be noted that the share of manufacturing in the Latvian economy is one of the lowest in the EU Member States. Also, the Latvian productivity rate of industries is considerably below the EU average. Low Latvian manufacturing productivity level is largely due to the qualitative sub-structure. As according to the Latvian Central Statistical Bureau data processing industrial structure dominate the low-tech industries, which account for 60 per cent of manufacturing value added (the EU average share of these sectors is almost one and a half times higher than Latvian). It should be noted that compared to 2005, the manufacturing sector in the technological structure is slightly improved. There have been persistent trends in the medium-high technology sectors share and a low-tech industries share decline (see Fig. 2). As for high-tech industries, the dynamics of development is rather unstable, and the changes in evidence of the competitive position do not show any signs of strengthening.

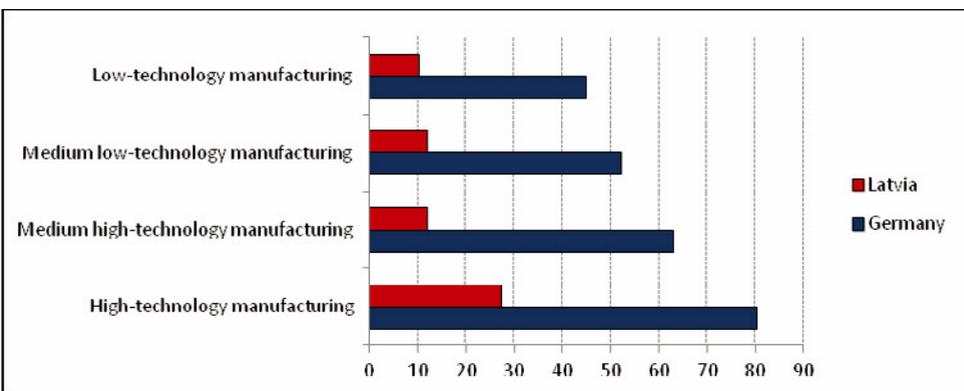
**Fig. 2.** Structure of the Latvian manufacturing industry



Source: CSB data basis

In an analysis of Latvian manufacturing productivity levels, the authors conclude that the high-tech industry company employees productivity almost double that of the average manufacturing productivity. At the same time, comparing Latvian and German productivity levels, it is clear that regardless of the technological level of intensity, it is considerably below the level of productivity in Germany (see Fig. 3).

**Fig. 3.** Apparent labour productivity (gross value added per person employed) in Latvia and Germany in 2009



Source: Eurostat data basis

This means that even without any changes in the production structure, there is the further improvements of production technologies or cross-specializations. At the same time the authors note that without a change in the technological structure of manu-

facturing in favour of high- and medium high-tech industries, there is a high probability that the difference between productivity levels remain sustained and Latvian ability to generate faster economic growth and convergence will be limited.

In order to achieve faster growth in the economy, not only in Latvia, the production technology modernization in all sectors of manufacturing, but also to develop the structure of production, which would increase the share of public sector in the economy, which is marked by higher productivity. It means to implement a targeted industrial policy. Industrial policy has eliminated the barriers that have so far limited the industrial competitiveness of the economic restructuring period and the years of rapid growth.

It should be noted that the increase in productivity is determined by several factors, such as:

- structures that are related to scientific and technical progress in the role of intensification of production;
- social-economic, which is mainly related to investment in human capital (human capital of education, training, body of knowledge, influencing people to be productive);
- organizational, which are related to the production process organization and management, production specialization and concentration of production territorial, as well as horizontal and vertical cross-link establishing.

The main problem of all these above mentioned activities is how to allocate investments to increase productivity between employers, workers and the state. Technology development key contributions, of course, are done by operators. State aid is related to the promotion and scientific research base. However, it was the state that had a key role to play in development, but it also increases the individual contribution. Less developed is the collaboration between business and vocational education and lifelong learning programs and has its own reasons. Return from investment in business education is not clear and has a higher risk (the workers can change jobs, employee qualifications obtained by visiting these or other training programs may not meet a host of needs, it requires time). Organizational factors are mostly corporate responsibility. Latvia has currently poorly developed such macro-level measures, such as clusters and all related activities are not conscious of their role in increasing productivity.

## Conclusions

1. Since independence, the Latvian economic structure has undergone significant changes, substantially increased share of service sectors. Distinct structural changes continued after accession to the EU, the trend remained—the services sector growth was faster than goods industries.
2. The current structure of the economy of Latvia has not been deliberate, but spontaneous under the impact of private investment flows that has been determined by the different productivity level and return on investments in product and ser-

- vices sectors. Asymmetric structure of the economy has developed and it cannot ensure stable and sustainable growth, and it is particularly dangerous when capital flows change, as it has been proved by the recent global financial crisis.
3. Latvia, compared to the EU average, has very low share of manufacturing in the economy (in 2011—12.7% of GDP), which points to the need for industrial policy in Latvia.
  4. Industrial policy has eliminated the barriers that have so far limited the industrial competitiveness of the economic restructuring period and the years of rapid growth.
  5. The rapid pace of development of service sectors, which was observed from 2004 till 2007, the industry was unable to replace the relatively slow export cap manufacturing growth, which resulted in a disproportion— exports grew at a slower pace than imports, leading to substantial external imbalances.

Latvia has one of the lowest productivity levels in the EU, largely on account of very low productivity directly in the industry. The low level of productivity in export industries shows that the country is gradually decreasing international competitiveness.

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## STRUKTŪRINIAI LATVIJOS EKONOMIKOS POKYČIAI ĮSTOJUS Į ES

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Įstojus į ES 2004 m. Latvijos ekonomika patyrė greito augimo bei gilios recesijos laikotarpius. Itin skaudžių pasekmių Latvijos ekonomikai turėjo paskutinioji ekonomikos krizė, nes ji buvo viena iš didžiausių Europoje. Vidinis ir išorinis disbalansas buvo laikomi viena svarbiausių Latvijos ekonomikos pažeidžiamumo priežasčių. Globali finansų krizė turėjo teigiamos įtakos susidariusio disbalanso išlyginimui. Tačiau sumažėję skirtumai nereiškia, kad ekonomika tapo mažiau pažeidžiama ir gali užtikrinti tvarų ilgalaikį subalansuotą Latvijos BVP augimą. Straipsnyje pateikta pagrindinių Latvijos ekonomikos struktūrinio disbalanso priežasčių analizė bei numatytos struktūrinės politikos kryptys.

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