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Globalization and the Latvian Economy
Obeservations and Conclusions

Since 1990, when Latvia restored its independence and became a sovereign element of the world's economic system, the country has been described in various ways - an ex-Socialist country, a post-Communist country, a former republic of the USSR, a country that is reforming its economy from a planned to a market economy, a transformation-period country, a transit country, etc. Economists use these designations in concert with the goals of their various research projects, and the designation that is selected serves to characterize the underpinning philosophy of each research project. Latvian economists are no exception to this rule. Usually they analyze problems that are linked to the problems which ex-Socialist countries have in restructuring their economies.
Less attention has been devoted to a factor, which is fundamentally important in Latvia's case - the fact that Latvia is among the world's small countries. Outside of Latvia the problems of small countries are researched both at the theoretical and at the practical level. These issues are also of interest to small ex-Socialist countries.
The main issues to which economists are seeking answers are these:

- Is the status of being a small country an advantage or a shortcoming?
- Is a country's development affected by its size?
- What happens to small countries under conditions of economic globalization, and does globalization affect small countries differently than large ones?
- How can small and backward countries find their place in the global economic system, and is it possible for them to eliminate their backwardness under conditions of increasing competition (and how)?
- Do small countries need special development policies, and what might these policies be?
- What are the specific aspects of Europe's post-Socialist countries, and what opportunities do they have to catch up with the developed countries of Europe?

These issues are not unimportant in Latvia, so in this paper I will seek to look at these issues from Latvia's perspective. My paper is based on an extensive research project prepared by Slovenian economists. [Development...] That project collected recent research done in various countries with respect to the development problems of small countries.

Is the status of being a small country an advantage or a shortcoming?

In order to answer this question, we must first agree on a definition of a "small" country. Several definitions can be found in the economic literature.

Various criteria are used to group countries into ”large” and ”small” ones - the size of each country’s territory, population figures, per capita GDP indicators, the ability of a country to affect the world’s market prices (i.e., trade analysis), the political effect that a country has on others, etc. Usually the selection of the specific criterion depends on the purpose of the research project. If the criteria are used separately in a general process of analysis, we find that countries which are universally deemed to be large ones can end up in the same group as countries which are equally universally said to be small. For example, Latvia, a small country, has a low GDP level, but so does Russia, which undoubtedly is a large country. For that reason economists have sought to elaborate more precise and numerically based criteria for specifying the size of a country, and some of these criteria involve very complex, multi-factor indicators. [Damijan, pp. 46-48] Results that are obtained through the use of various criteria show that the determinant factor in classifying countries as large or small is, after all, the number of residents in each country, but when countries are analyzed fully, other factors must be taken into account, as well. It is generally accepted that the word ”small” is applied to a country that has fewer than 10 million residents (although there have been other proposed cut-off points, too - 15 million, 16 million, etc.). Some economists suggest that there should be a more precise gradation - an extremely small country (fewer than 1 million residents), a very small country (between 1 and 5 million people), a small country (5-16 million), etc. [Salvatore, p. 23] It seems that this distribution is the most apt when it comes to Latvians circumstances, because it does serve to point out the difference between small and very small countries. Latvia is one of the very small countries.

According to the grouping elaborated by Dominick Salvatore, in 1997, of 209 countries in the world that were analyzed, 59 are extremely small, 46 are very small, 51 are small, 21 are of medium size (16-29 million residents), and 32 are large (more than 30 million residents). [Salvatore, p. 24]
A country’s size-based status can change, and it is always relative. As small countries develop, they can become large countries in terms of the aforementioned gradation criterion, but also in terms of economic and political effect. The distribution of countries into the large group and the small group, moreover, must also be seen in a regional context. For example, there are authors who deem Japan to be a small country.

Economists have never been able to come up with a single answer to the question of whether being a small country is an advantage or a shortcoming. This is true first and foremost because the small countries of the world are by no means homogenous. Their level of development, the principles that govern their economic policies, and even the results of applying identical economic policy principles - all of these differ from one state to the next.

In the economic literature we find some arguments suggesting that the status of a small country is an advantageous one, but there is also evidence that the status of a small country creates developmental difficulties. These latter arguments are easy to understand. The main advantages, according to economists are the following:

- It is easier to implement policies that are harmonized in terms of regional considerations, as well as sector-based considerations;
- It is easier to achieve harmony between politicians and society;
- In the political and social sphere it is easier to achieve harmony in society; [Svetlicic, p. 8]
- It is easier to ensure macroeconomic balance (income distribution, taxes, currency exchange rates);
- It is easier to adapt to changing economic situations, including the ability to take advantage of the process of globalization in ways that are favorable to the specific country.

Difficulties that small countries face include the following:

- Economic and political dependence on the surrounding environment;
- A limited domestic market;
- Reduced abilities to use economies of scale and scope that occur when there are major industrial processes in a country;

- Higher R&D costs and lower abilities to maintain national innovation systems, thus hampering competitiveness;
- Greater political instability. [Jundzis, p. 12]

The conclusion here must be that the development of a small country depends on the extent to which the country has chosen the proper development policies, how flexible it is with respect to the opportunities that are offered by the global economic system, and to what extent the country is able to accept these offers and to turn them to its own advantage. [Svetlicic, p. 7] Some economists feel that in countries that are moving from a planned to a market economy, being small is more of a problem than an advantage, but this fact is of lesser importance in very small countries (among which we also find Latvia).

Is a country's development affected by its size?

In order to answer this question, we must first look at whether the economic systems of small countries differ from those of large countries, and how they differ.
The main differences [Svetlicic, p. 6; Damijan, p. 43, et al] are the following:

- Small countries cannot affect world prices;
- In small countries, foreign trade and foreign trade policies are of greater importance than they are in larger countries;
- The economies of small countries tend to be more open (a greater share of GDP is represented by import and export sums);
- In small countries, the multiplier effect of exports is less pronounced;
- In small countries there is greater concentration and specialization of production;
- The economies of small countries are more integrated with the economies of other countries in terms of intra-industry trade;
- In small countries, national budget expenditures represent a greater share of GDP;
- Small countries are more subject to external influences;
- Small countries try to increase their influence by forming coalitions;
- Small countries have lesser autonomy.
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The analysis of small countries that was prepared by Salvatore (the data are from 1995) show that GDP indicators that are specified on the basis of per capita purchasing power parity methods are, on average, larger in the large countries of the world, but this trend differs when it comes to smaller countries. [Salvatore, p. 25] Per capita GDP indicators is lower in small countries which are classified as developmental countries, as well as in those countries that are moving from a planned to a market economy. In the latter group the differences are particularly pronounced. Numbers show that in very small countries that are moving from a planned to a market economy, per capita GDP figures are, on average, 30% lower than in small and large countries, but it does not differ very much at all in the small and large country groups. In developmental countries, by contrast, the trend is quite the opposite: In very small countries the average GDP figure is 33% higher than in small countries, and only 8% lower than in large countries. It is possible that this trend is underpinned by the way in which countries have been divided up into groups. Among the very small countries we find former republics of the USSR that in 1995 were still at the nadir of their reduced developmental levels.

Salvatore's research shows very clearly that the pace of economic development is also faster in large countries in all groups (developmental countries, post-Socialist countries and developed countries), but the process in small countries is such that very small countries are developing better. [Salvatore, pp. 28-30] Figures from 1995 showed that in the post-Socialist group of countries, large countries had better development indicators, and these indicators were equally low, on average, among small and very small countries. Developments in later years require an adjustment of these claims, however. Very small countries have, generally speaking, shown more rapid development (Table 1), which proves that small countries have an easier time in adapting to rapid changes and to overcoming various crises. [Svetlicic, p. 6]

Table 1

Economic development rates (GDP as % over previous year) in the group of post-Socialist countries

	1995	1996	1997	1998
Large countries				
Belarus	89.6	102.6	110.0	112.5
Bulgaria	102.1	89.1	92.6	n.a.
The Czech Republic	105.9	104.1	101.2	99.1
Russia	95.9	95.1	100.4	99.5
Poland	107.0	106.1	106.9	105.5
Ukraine	87.8	90.0	96.8	100.2
Hungary	101.5	101.3	104.0	104.9
Small countries				
Croatia	101.7	104.3	106.3	n.a.
Estonia	104.3	104.0	111.4	109.3
Latvia	99.2	103.3	106.5	105.4
Lithuania	103.3	104.7	105.7	109.7
Macedonia	98.4	100.9	101.5	n.a.
Moldova	98.1	92.2	101.3	95.8
Slovakia	106.8	107.0	105.7	106.2
Slovenia	104.1	103.1	103.7	106.5

Sources: *Statistical Yearbook of Latvia, 1998, Riga: Central Statistical Bureau of Latvia (1997). Also Monthly Bulletin of Latvian Statistics,* No. 9(52), *Central Statistical Bureau of Latvia, Riga,* 1998. For *international comparisons: Latviias statistika (Latvian statistics),* 1998.

Salvatore emphasizes that there are differences between the development of small countries and the development of very small countries (those in which the number of residents is below 5 million). In very small countries, per capita GDP figures are higher.

Still, most economists who are researching this particular area feel that the effect of a country's size on the country's development must be viewed very carefully. There is a view that there is no strict or significant correlation between the size and the welfare of countries. Thus, for example, among the world's wealthiest countries there are small states (Sweden, Denmark, Austria, Switzerland), and among those countries that have posted extremely high development figures recently, there are also small states (Singapore, Taiwan, Hong Kong). [Svetlicic, p. 8] Similarly, we can find large countries in the world that are mired in poverty.

Unlike Salvatore and some other authors, Jose Damijan, looking at a correlative analysis of the economic development indicators of 186 countries, has concluded that there is no correlation, or at best there is a very weak correlation between the size of a country and the developmental specifics of small countries that have been proposed by other authors. [Damijan, pp. 49-79]

Damijan has found that in terms of per capita GDP figures, the location of a country is of greater significance than is its size. The effect of a country's size on the concentration of production, he argues, is also very weak. Damijan and other authors feel that the size of a country is linked to the significance of its foreign trade process, but this is true only in developed countries and in those that do not have any special policies aimed at protecting their domestic markets.

Despite the fact that Damijan's analysis and its results are quite impressive, there is reason to continue a discussion about those results. The weak link in Damijan's research is the static nature of the work - his revelations apply only to a specific moment in the development of each country. Damijan links his conclusions to the developmental level of each country, but he does not take into account the specific aspects of each country (whether it has a stable economy or one that experiences radical transformations, for example). The cause of differences in his conclusions, one might feel, lies in the differences that exist among the various objects that were researched and the specifics of the group of countries that was analyzed. According to the combined and weighted identification criterion to specify a country's size which Damijan used, small countries are those in which GDP is between USD 10 and 20 billion, the population figure is between 8 and 13 million, and the size of the territory is less than 500,000 square kilometers. Among the 193 countries in the group that was studied, four were deemed large countries according to these criteria, 26 were average, 97 were small and 66 were "microcountries" (fewer than 1 million residents, less than 30,000 square kilometers of territory, and GDP lower than USD 1.3 billion).

Bellak and John Christian Cantwell, meanwhile, have found that the development of post-Socialist countries in Europe has generally occurred under identical external conditions, but there is a bifurcation of the development models of the various countries that is not linked to the size of each country, but rather to the coincidence of other conditions. [Bellak, Cantwell, p. 140].

What happens to small countries under conditions of economic globalization, and does globalization affect small countries differently than large ones?

There have been extensive debates among economists about whether the globalization of the world's economy has affected small countries positively or negatively, and there can be no single answer to this question. It is clear that globalization has both a positive and a negative effect on the development of small countries, but it is not as clear whether this effect is more positive or more negative.

Economists are unanimous in the conclusion that globalization is promoting the convergence of the national income of various countries at the global scale, but it is also promoting the difurcation of income within countries (some people gain a lot, while some lose a lot). Globalization is also creating additional requirements for weaker countries, and among these the most unpleasant is the need to eliminate protectionist systems. Post-Socialist countries, in which there are strong memories of the consequences of deep economic integration during the Socialist period, also are loath to accept limitations on their economic sovereignty, which is another requirement under the aegis of globalization.

Economists tend to conclude, however, that globalization is a favorable factor for small and weakly underdeveloped countries. [Kozul-Wright, et al] The basic factors of globalization - foreign trade, foreign direct investment and the expansion of multinational companies - all allow small countries to liquidate their shortcomings and to foster development.

One of the main trends in foreign trade recently has been the process of trade liberalization. Bellak and Cantwell claim [p. 142] that one-third of the world's market is currently free, another one-third is regulated, while 30-40% of the total external market, in essence, is represented by intrafirm trade by multinationals. In the technology market, the latter sector represents no less than 60-70% of the total volume.

Market liberalization, as well as the globalization that is associated with it, has served to reduce the difficulties that small countries face because of their limited domestic economies [Svetlicic, et al] and markets. These processes have expanded market opportunities and have reduced the significance of local markets, provided that each country establishes an economy that is open and international in nature. Policies aimed at opening an economy allow small countries to establish large production facilities that can find customers in the international market. On the other hand, these processes can also increase the likelihood of monopolization in the various sectors of a small country's economy.

Foreign direct investment and the expansion of multinational enterprises, moreover, have promoted the export of modern technologies and production methods. This serves to even out the technological bases that exist in various countries, as well as optimization of specific sectors of economies. This means that small countries, which are unable to develop their own R&D efforts, face less of a danger that their economies might become uncompetitive.

Some specialists believe that under conditions of globalization, the significance of a country's size is diminishing in terms of the country's influence worldwide. The status of large countries is becoming similar to that of small countries - both groups are increasingly losing their autonomy and becoming more and more dependent on external circumstances. The influence of individual countries in the international arena is declining. [Svetlicic, p. 7]
Of key significance in the evening out of the advantages that are granted by a countrys size is the fact that economic development in the world is relying less and less on the existence or absence of natural resources and physical capital in each country. [Svetlicic, p. 7, et al] Much more important are creative potential and human resources. There are few small countries in the world that are wealthy in terms of natural resources, but it has been proven that under the influence of globalization, economic growth in countries with a lower volume of natural resources can be even more rapid than in those countries that are rich in natural resources. This is particularly significant when it comes to Latvia, because it services to eliminate the need for debates about the country's dependency on the natural resources that it lacks. Instead policy makers are being encouraged to turn to a completely different philosophy when it comes to the country's economic potential - a philosophy that dictates that a new scale of priorities and a new set of economic policies must be developed.

Finally, we must answer the question of whether small countries can defend themselves against the influence of globalization, and whether this is a worthwhile effort. It looks like the answer to both questions is - no. Countries and groups of countries that have tried to avoid the influence of globalization by shutting themselves off (Russia, Belarus, Bulgaria) are falling behind in the world. But globalization involves not only advantages, but also threats - problems in one country can lead to problems in others, too, and the power of these difficulties depends largely on the level of integration that exists (the butterfly-wing effect). Events in the global financial system in 1998 proved this very well. If we carry this thought to its logical conclusion, we can assume that global disturbances will affect small countries to a lesser degree, but for the time being that remains merely a hypothesis.
The pro-development factors that are offered by globalization will not work if countries engage in specifically protectionist or nationalistic policies.

How can small and backward countries find their place in the global economic system, and is it possible for them to eliminate their backwardness under conditions of increasing competition (and how)?

If small and backward countries are to find their place in the global economic system, they must survive global competition. In order to do this, however, they must be able to take as much advantage as possible of the positive effects of globalization while simultaneously limiting the effect of negative considerations. This means that countries must have a clear understanding of the mechanism and trends of globalization.
Simply put, the cause of globalization is the fact that there has been enormously rapid technological progress in the world, and as a result of this, domestic markets have become too narrow for the volume of output that is occurring. There has been growing competition, and this has forced producers, as well as countries, to seek out every new developmental opportunities. In concert with these causes, globalization is caused and maintained by three important and dynamic processes: expanded foreign trade, foreign investment, and the appearance of multinational economic agents. The expression of globalization lies in the globalization of the production of goods and services, as

well as in the establishment of a global organizational structure.

The place of small countries in the global economic system is specified by the following considerations:

- The intensity of each country's foreign trade (i.e., the openness of its economy);
- The ability of each countries to take advantage of the positive effect of foreign direct investment;
- The ability of the country to take advantage of those factors that ensure the competitiveness of its economy.

In small countries, and especially in very small ones, foreign trade fulfills two functions - it involves foreign trade as such, but it also replaces the interregional trade that exists in small countries. This means that objectively speaking, small countries must have a volume of foreign trade (as measured against GDP) that is larger than that in a larger country. It is precisely this fact that prohibits small countries from isolating themselves and fosters their becoming involved in the global system. Of course, the main shortcoming to this approach is that it makes small countries more dependent on external circumstances.

Recently the effect of foreign trade (i.e., the movement of goods) has been supplemented and even exceeded by the movement of capital. Foreign direct investment is the most important part of capital movement when it comes to development. The consequences of the dominant movement of capital have not yet been fully evaluated, but undoubtedly there are both positive and negative effects. The main threat from the perspective of countries that receive the investments lies in the mobility of capital. Even though foreign direct investment may be the most stable part of a country's capital, it does react quickly to economic changes in the country.

There is only one way in which small countries, including Latvia, can fight for their place in the global economic system and to eliminate their backwardness - that is to increase competitiveness. Bellak and Cantwell [p. 139] have identified the main factors that increase development and competitiveness - innovation, technologies, trade, foreign investment, resources, the size of the country, and institutional factors.

There can be ongoing discussions over the issue of whether small countries must develop their own factors of increased competitiveness (i.e., national factors), or whether they must rely on the achievements of other countries (regional or global). More precisely put, the question is whether small countries have a need and an opportunity to develop their own national, scientific R&D potential. There is a view abroad that this is not necessary, because small countries can use the achievements of large countries or their partners, and this is sufficient to maintain competitiveness. [Svetlicic, p. 10] Other specialists, however, but one can argue that excessive reliance on the scientific potential of other countries can lead to negative consequences. [Karnite, p. XX]

Do small countries need special development policies, and what might these policies be?

This author agrees that small countries must establish their own special development policies, ones that keep in mind the specific aspects of small countries. The main element of such policies must be the integration of each country into the global economic system, basing this process on the need to increase the country's competitiveness. In developing developmental policies, small countries must bear in mind the trends of economic development elsewhere in the world.

The most characteristic among these trends are the following:

- As new nation states develop and as technical progress occurs, an increasing number of countries is gaining access to the international market, which means that competition is becoming more general in nature and is becoming more intensive all the time;
- Globalization, which can simply be described as the integration of product markets, technologies, labor and capital, is developing;
- In order to ensure the free movement of goods, technologies and people, economic

liberalization is coming to the fore; the economies of the world's countries are becoming much more open to market forces and competition;

- The determinant factor in the movement of economic development, both at the national and at the international level, is, increasingly, market forces;
- International governance institutions are beginning to emerge that seek to supervise and manage the global economic development processes;
- The role of individual states in the management of national economies is receding (the Asian crisis has encouraged us to review the influence of this trend), and the nation stated role is receding when compared to the influence of global economic development;
- Globalization is resulting in reduced economic sovereignty for individual countries, both large and small; countries must subordinate themselves to global norms, at least on such issues as the protection of property rights and the creation of a stable monetary system;
- The economic and political integration of countries is becoming wider and deeper, both at the global and at the regional level.

Does Latvians economic model correspond to these trends, and what changes are necessary?

Latvians economic model permits for involvement in the processes of globalization. The Latvian economy is responsible toward the integration of product markets, technologies, labor and capital, and it is subject to global competition. The economy cannot, however, take full advantage of the opportunities that are offered by globalization. Latvians economic system is sufficiently liberal, and the situation where the main factor in directing economic development is market forces has been achieved. The main problem in terms of Latvians economic development is the country's low level of competitiveness. This has kept Latvia from finding its place in the world market quickly and easily.

But Latvia is beginning to develop an economic development model that is typical of a modern small country.

Figure 1 shows the relationship of Latvians foreign trade volumes to GDP. The relationship of foreign trade to GDP shows that Latvia's economy is open. In fact, the country's foreign trade volume is increasing all the time (Figure 2). The main problem in terms of foreign trade in Latvia is the negative export-import balance. A second difficulty lies in the excessive role of re-export procedures (there are few locally produced goods and services that are exported), and this has to do with the low competitiveness of local producers. The share of products with low added value is excessive (Figure 2).

The relationship to GDP of Latvia's GDP growth rate, foreign trade volume and FDI volume

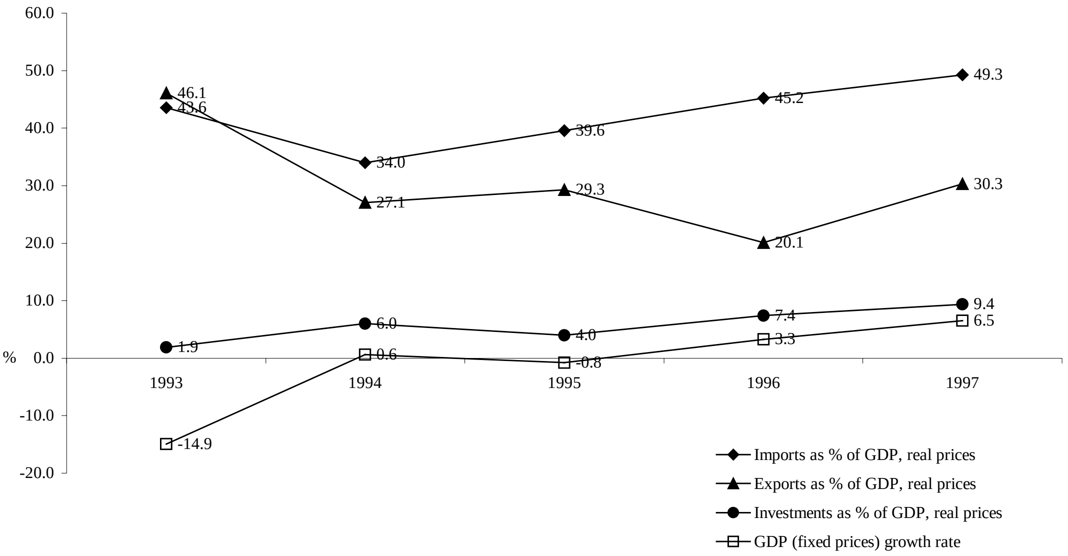

Figure I

Source: *Latvian Statistical Yearbook, 1993 and* 1997. *Central Statistical Bureau of Latvia, Riga. Also Monthly Bulletin of Latvian Statistics,* No. 8(51), *September 1998.*

The relationship of annual FDI flows to GDP is shown in Figure 1. In terms of Latvia's development, it is not only the volume of investments that is important, but also the quality of investment. Among investors in Latvia there are several multinationals (Finnish Telecom, Polarbek, Den Norske Stats Oljeselskap, Shell Overseas Holdings, Ltd., Neste Oy, et al), The largest foreign investments have gone to the service sector, the food industry, energetics and wood processing (see a separate article by Inna Steinbuka in this volume). Since 1992, the distribution of FDI among various countries has improved significantly, and this signifies that Latvia is becoming increasingly integrated into the European economic space.

Table 2

Foreign trade turnover by country (I-VI 1998) million LVL

Countries	Animals and livestock		Various industrial		Chemical goods products		Metals and metal products		Machines and machinery, electrical systems		Food products		Textiles and textile products		Wood and wood products	
	Export	Import	Export	Import	Export Import		Export	Import	Export	Import	Export	Import	Export	Import	Export	Import
Total	16.1	19.8	25.6	20.3	33.4	190.0	52.6	76.4	39.9	177.3	47.4	69.4	87.5	70.6	184.0	7.7
Russia	5.3	0.6	1.8	0.1	7.4	9.6	4.2	19.3	16.4	6.8	20.2	0.4	11.7	1.9	0.9	1.0
France	2.4	0.2	2.6	0.4	0.1	5.2	0.1	0.7	0.1	3.2		2.7	2.1	1.4	2.2	0.1
Estonia	2.2	1.7	0.8	1.3	4.5	7.1	3.2	8.0	1.6	7.4	3.2	6.3	2.1	3.5	1.6	0.7
Lithuania	0.9	2.7	0.6	1.4	9.6	6.9	4.9	3.5	2.9	7.4	4.5	6.2	5.2	2.2	2.7	0.6
Norway		3.0	0.3	0.6	0.1	0.5	0.0	0.5	0.1	3.1	0.0	0.1	1.6	1.8	1.6	0.0
Poland		1.8	0.5	2.0	0.0	4.3	0.2	2.1	0.5	4.9	0.4	2.3	0.4	2.1	3.2	1.0
Germany	1.0	1.2	6.6	3.6	1.5	17.2	8.0	9.4	7.4	35.2	1.0	7.2	17.9	16.6	29.7	1.2
Denmark	1.0	1.2	5.6	0.8	0.9	2.0	0.3	1.1	0.5	8.2	0.1	2.6	8.8	6.9	5.6	0
Italy		0.0	0.3	2.8		0.8	1.7	3.2	0.1	10.9		1.9	4.6	3.9	0.9	0.1
Finland	0.0	0.1	1.2	1.5	0.1	10.2	0.2	5.6	0.8	28.4	0.1	2.8	2.2	2.5	3.3	1.1
the United States	0.0	1.8	0.2	0.3	0.3	1.9	12.8	0.3	2.9	6.2	0.3	1.4	0.6	0.5	0.8	0.1
Ukraine	0.3	0.0	0.2	0.0	2.3	4.9				0.3	4.3	0.3	2.1	0.1	0.9	0.0
Sweden	0.6	1.0	1.3	1.3	0.3	5.2	0.6	3.2	1.3	13.7	0.0	1.7	9.3	10.9	41.2	0.4
Great Britain	0.0	1.2	1.1	0.5	0.2	4.9	0.4	3.6	0.4	7.4	0.0	2.2	2.4	2.3	65.9	0.1

FDI by country, end of period

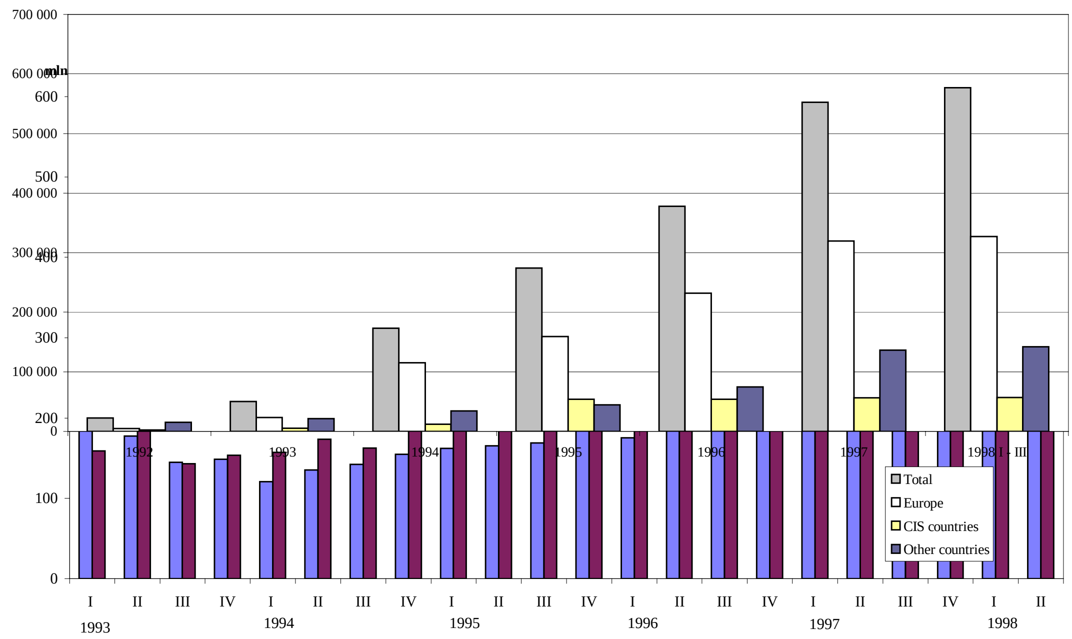

Figure 2

Source: *Latvian Statistical Yearbook, 1993 and 1997. Central Statistical Bureau of Latvia, Riga. Also Monthly Bulletin of Latvian Statistics, No. 8(51), September l998.*

Latvia cooperates with intentional governance institutions and pays heed to their recommendations. This corresponds to Latvia's desire to join the major intentional organizations that focus on security and economic cooperation - the EU and NATO. This also serves Latvia's national interests in that the positive evaluation of Latvia's economy that has been made by these institutions has served to increase the country's prestige, helping it to become more closely involved in the global economic system.

The government's role in Latvia's national economy is somewhat contradictory. Direct state interference in the setting of prices and in the resolution of other economic issues has been eliminated. The state's regulatory activities are implemented through financial and monetary policy. It seems that the state is not doing enough in terms of strategic leadership, however. The governance instruments that are at the disposal of the state are all too frequently utilized for the resolution of short-term problems (sudden changes in the tax system, implementation of norms that discriminate against entrepreneurs in the name of fiscal goals, etc.).

Latvia, like many ex-Socialist countries, must considerably improve the quality of operations in its movement institutions, because in these countries the adaptation of economic policies to changing global economic processes is very important, as is the ability to forecast future events. Latvia must increase the theoretical foundations that underpin the management of its economic processes. These foundations must be based on proper economic research.

In establishing Latvia's development model, it is worth keeping in mind that in weaker countries, the significance of government activities is greater. Market forces alone, even though they promote convergence among countries, cannot ensure the more rapid development of weaker countries. The key to successful state governance lies in the ability to harmonize the influence of internal and external economic forces in a way that ensures that development is promoted [Kozul-Wright]. Some specialists feel that small and backward countries cannot accept the offers that are made by the global economy right away and that initially their economies require protection. This is a popular view in Latvia, but it is not being implemented in practice. An excessive limitation of the government's role in economic development can cause pain to those sectors which depend on external financing - education, science, the cultural heritage of a country, etc. The period of adaptation must not be too long, because that can serve to foster backwardness.

Latvia's society is coming to understand (with some difficulty) that shortly after the restoration of national sovereignty, people must make peace with the idea that the role of the nation state is receding. The effect of external forces in the resolution of important economic development is on the rise. Particularly sensitive in this sense are issues concerning property rights and the country's monetary system – these are the issues to which international institutions devote major attention. In terms of forming a proper understanding of these issues and of gaining public support for the processes that are occurring in the state, educational and explanatory procedures are of critical importance, and Latvia must be more active in these efforts.
Latvia is becoming actively involved in the economic and political integration processes that are occurring globally and regionally. Latvia was admitted to the World Trade Organization in October 1998, and it is intensively preparing for membership in the European Union. Latvia has also expressed a desire to join NATO, Much work is being done in terms of integration with the Nordic countries. It seems that the integration of the three Baltic States themselves is proceeding most slowly, and that is not right. It is precisely the integration of the Baltic States that could help the three countries to find common positions in dealing with large and well-developed countries. Latvia and the other Baltic States have virtually little cooperation with other post-Socialist countries in Europe.

Which parts of the Latvian economic development model require improvements?

The main thing is to change the country's understanding of the potential of economic development. There must be a proper evaluation of the need to strengthen creative economic potential in Latvia, and this basically means that a new economic philosophy must be elaborated.
Economists argue that the most important factors in determining economic development are capital accumulation and technological progress [Kozul-Wright, et al]. A natural and necessary addition to those two items, however, is a well-educated, creative and healthy individual.
The view prevails in Latvia that the main factor in ensuring economic development is capital. There is not enough national capital in Latvia, so in order to achieve the desired pace of development, international capital must be attracted through investments. Latvian law is basically ready for this process, and it is still being upgraded, but the flow of FDI could be greater, and the quality of investments could be better. Latvia might also desire a more intensive return on capital, because that

would lead to a more rapid increase in the standard of living in the country. But how can this be achieved?

There is no doubt that the country's work in attracting foreign investments must be more purposeful in nature. Investments that come into Latvia must, first and foremost, correspond to the country's interests. They must be stable and long-term in nature, and in pursuit of this, the capital of large, transnational companies must be brought into the country. Latvia must take advantage of the fact that at the global level, a geographic dispersal of production processes is occurring in pursuit of lower production costs. This is accompanied by expanded internal trade among companies. The issue, then, is how to encourage table companies to make investments in Latvia.

Bellak and Cantwell [p. XX] have grouped motivations for foreign investment into five categories:

- To gain access to new natural and man-made resources;
- To increase production efficiency (labor costs, the location of production);
- To fulfill strategic goals (strategic alliances, neutralization of competitors by mergers, etc.);
- To conquer new markets;
- To establish new agglomerations (clusters).

Latvia can be of greater or lesser interest to foreign investors in relation to all five of these motivations. An analysis of FDI in Latvia shows that the quality of investments is improving. Stable and safe foreign companies are entering Latvia, and investments in production are increasing. Latvia is of interest to foreign banks, which could serve to increase the stability of the Latvian banking system (while also, however, increasing external risk). Under the influence of foreign investments, the Latvian economic structure is becoming more modern, but the competitiveness of Latvian products has remained low.

Economists stress that the positive influence of direct investments by large multinational companies and foreign countries in terms of the development of small countries is sometimes exaggerated [Svetlicic, p. 7]. Kozul-Wright has pointed out that the efficiency of the movement of goods and capital is influenced by the way in which institutional and political obstacles that hamper trade are liquidated (openness), by the way in which local producers manage to maintain stable positions in international labor distribution (competitiveness), and by the extent to which laws and norms, institutional foundations and technologies have been standardized at the international level. [Kozul-Wright, pp. 113-114].

These prerequisites can be merged into two large and mutually linked groups:

- The ability to develop those sectors that produce competitive products;
- The existence of an infrastructure and a labor force of appropriate quality.

Multisectoral production continues to be the norm in Latvia, and in almost every sector there are large state-owned or privatized companies that were inherited from the previous economic system. The products produced by some of these companies are appropriate only for low-quality markets. The attitude of foreign investments toward these enterprises shows very clearly that many of them are not very promising at all and that Latvia must urgently begin a restructuring of its economy.

In terms of selecting a proper sectoral structure, of key importance is the extent to which national decisions conform to global demands. These days this is far more a global issue than a national issue. Survival is the realm of those sectors that can be developed in an individual country but that are also competitive at the global level. That is, however, also a national issue. Countries must study the global conjuncture in order to harmonize their policies to it, developing a sectoral structure that conforms to national interests. In the interests of a country's economic and political independence, it is necessary to ensure that the selected sectoral structure relies as much as possible on national resources (i.e., it must be less dependent on external resources).

The main natural resource in Latvia is its educated and creative labor force. It is, therefore, in the interests of the state to establish and to maintain an economic system that is based on the utilization of the creative abilities of the Latvian population. This means that those sectors that require high scientific capacity must be boosted, and other sectors that establish and promote the creative abilities of individuals must also be developed. The flow of foreign investment must be subordinated to this model (although it is also true that a model of this type is automatically receptive to such investments).

In establishing a sectoral structure, the country must also keep in mind contemporary trends in the movement of goods. Goods are increasingly being exported from low-wage zones to high-wage zones, while services are being exported in the opposite direction. Latvia remains a low-wage zone at this time, but that will not continue to be true for a very long time. Therefore, we must assume that foreign investment in the mass production of goods will not be long-term in nature. These investments are aimed at earning quick profits at the expense of the country's inexpensive labor force, and that will stop once Latvians labor costs even out with those in other countries (e.g., as the result of the higher social guarantees that are demanded in the context of European integration).
In the integration of the market for goods, of increasing significance are those sectors and those market alliances of individual companies that can affirm that it is advantageous for Latvian companies to become part of the structure of large, transnational companies as independent companies in their chains of supply and consumption, or as subsidiaries of the larger firms. It is very important that new forms of capital integration are joining the traditional forms - contractual agreements, networks, strategic alliances, etc. [Bellak, Cantwell, p. 141].

Becoming involved in new forms of economic integration is the very best way for a small country to integrate into the global economic system. If this is to be achieved, however, each country must demonstrate achievements and stability in terms of its economic development, and each country must establish a viable and progressive economic system.
Integration with transnational companies could promote the monopolization of some sectors of an economy, but in small countries with an open economy, a greater specialization of sectors and production facilities that is part of a ”niche” strategy is to be permitted, or even encouraged.

An analysis of the developmental models of small countries in the European Union [Cartello, Olienye], for example, shows that small countries need to develop both product diversification and specialization and market diversification. Both of these strategies supplement and improve each other. The diversification of products in a small country means the creation of new types of products for export. There are two options here - cooperation with foreign companies in the production-supply chain, thus becoming involved in production cycles in the new sectors, or else learning to produce new niche products. The production and export of niche products must be combined with the development and export of monopoly services that conform to the products.
In order to boost the positive effect of foreign investments, each country must improve the investment environment specifically in terms of production factors. Two aspects of this issue can be influenced by governments: the quality of the country's infrastructure and the quality of its labor force. Latvia understands the significance of the infrastructure, and much work has been done to improve the transportation and communications infrastructure, as well as other areas of the infrastructure. The significance of the quality of the country's labor force in terms of Latvians economic development, however, has not been evaluated sufficiently. The internal potential of Latvians labor resources is extensive (the desire to be educated, quick learning about modem technologies, language skills, etc.), but opportunities to develop that potential have not been put in place. In pursuit of its macroeconomic goals, the Latvian government has sought to scrimp on spending aimed at the education, creative activities and health of the population. This represents unforgivable short-sightedness, and it is clearly a serious mistake.

In terms of foreign investment, Latvia must orient itself toward the role of a provider and a recipient in order to prepare in a timely way for the developmental model of a developed country. The fact that

Estonia has begun to make direct investments in neighboring countries provides proof that this can be done.

Globalization requires countries to deal not only with foreign policy, but also with domestic policy issues. Globalization often involves increased unemployment among people who have few or no qualifications, and it also leads to a stratification of income among various groups in a country. [Slaughter, Swagel] We cannot say that globalization is the direct cause of these problems. On the contrary - globalization serves to promote overall welfare. But is also creates a rapidly changing economic environment to which some social groups - especially blue-collar workers - adapt more slowly. People in these groups take more time to learn about new opportunities and to undergo retraining, and this means that they often spend more time under socially unfavorable conditions. This must be kept in mind in developing a country's economic policy. The stated economic policy must provide for a flexible labor market in which employment is regulated by economic, not political factors. On the other hand, the country must also see to it that information about job opportunities is widely available, that the certification of employees is universally recognized, and that there are opportunities for training and retraining. The most important thing is to set up an educational system that provides as high a level of education as is possible.

This analysis serves to show that the nucleus of Latvians developmental model is the country's educated and healthy labor force – the main and most valuable factor in production in Latvia. This model must be underpinned, however, by systems that maintain the quality of this factor in an active way (education, health care, systems for professional development, etc.). There must also be traditional systems to help this process along (capital accumulation systems, technologies, innovations). The result of this model must be the creation of a competitive structure of sectors and products, a proper system of market development, etc.

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