

**Introductory remarks by Ilmārs Rimšēvičs,
Governor of the Bank of Latvia,
at the conference**

LATVIA ON ITS WAY TO PROSPERITY: GROWTH POTENTIAL AND DEVELOPMENT PROSPECTS

Ladies and Gentlemen!

It is a great pleasure to welcome you to the third annual conference organised by the Bank of Latvia. As far as these conferences are concerned, there is an interesting pattern emerging: every time the time period about which we would like to stimulate a discussion is getting longer. If two years ago we talked about developments likely in the next couple of years, last year the subject of our discussion was the full economic cycle. I would like to point out that the themes we discussed at the previous conferences, the role of the European Union in our economy and sustained development have not lost their topicality and we are pleased that they are still under public discussion. Today we would like to tackle a topic and a period spanning even several decades yet still linked to what we discussed at our previous conferences. And namely, today we invite you to focus on **the prospects for long-term development and prosperity of our country**.

We are fully aware of the great challenge presented by any attempt at economic analysis, let alone making any predictions, when talking about the rapidly changing economy of our country. Given our experience in the art of predictions, I can assure you that they will never be one hundred percent correct. On the other hand, many relationships described by economic theories are most pronounced in a longer period of time. With that in mind, it is often easier to analyse and predict what will happen in the economy of a country in ten, instead of, say, two years.

As an adviser to the Government, the Bank of Latvia has participated in evaluating various strategic documents pertaining to the country's development, and, for that reason, we feel a degree of responsibility over how the stated strategic goals are being achieved. That is one of the main reasons for choosing this particular topic for our conference.

Yet, before we attempt an analysis of the prospects for the country's development, it is important to remind ourselves of our "starting position". In this respect, the current situation in Latvia can be likened to the proverbial glass that, depending on the perspective of the observer, can be characterised as half-empty or half-full. Thus, optimists who tend to see the glass as half-full never fail to mention the pace of growth that for several years running has been the highest in the European Union and among the highest in the world (Slide 1). Those who see the glass as half-empty, on the other hand, observe that, despite the high economic growth in recent years, Latvia still remains the poorest country of the European Union, where the nominal income levels are just a little above one fifth of the EU average (Slide 2). When we take into account the different price levels, this difference becomes slightly less, yet the fact remains that of the EU countries Latvia has the lowest average income levels (Slide 3).

Taking into account the two facts I just mentioned, a favourite recent pastime has been the development of various scenarios for the future, extrapolating the current pace of growth and calculating **the number of years it would take for the prosperity level of Latvia's population to reach** a particular benchmark: most often, **the level of the economically developed EU countries**. It must also be said that, given the currently high pace of growth, such calculations, which are based on the past, are quite flattering to Latvia. The greatest optimists even expect Latvia's prosperity levels to have caught up with those in the developed EU countries sometime in the next decade. Looking back at the pace of growth Latvia has reached over the last ten years, the progress achieved is striking, indeed (Slide 4). And yet, as we cheer the high pace of growth achieved in the past, we should not fail to ask ourselves the question: to what extent can past

events and development be carried into the future? Does the up-to-now successful economic development necessarily mean that such development will be endless or at least very long?

In this regard, it might be appropriate to consider the analogy with a pile of sand presented by the science journalist Mark Buchanan in his book *Ubiquity: Why Catastrophes Happen*. As a child, almost everybody has been building sand castles. We remember quite well that initially every single grain of sand which is added to the pile makes it bigger. In time, however, a certain point is reached, where the next grain causes a landslide instead of adding to the size of our edifice. Moreover, it is important to note that it is next to impossible to predict either which particular grain of sand will cause the landslide or how great and significant it will be. The author has a theory that this unpredictability is related to the instability that is unavoidable in the development process of any system. According to this theory then, even the most important events do not have special or extraordinary causes. These events can result from any, even the most insignificant of causes: a mere grain of sand that under different circumstances would probably be totally inconsequential and harmless.

How does this theory relate to today's topic: namely, Latvia's prosperity level in the future or in the long term? First, if a certain amount of instability gradually builds up in any system, then the relationships observed and information gained in the past may not be good reference points for the future. Second, even the tiniest events or phenomena that we are hardly aware of may result in significant changes in the structure of the economy and have a crucial effect on the long term development of our country.

We all, of course, need a dream to believe in and a goal to strive for. It would be wonderful, if the dream about a fast growth of prosperity in the country became reality. Yet it may give rise to some anxiety to know that the calculations for such a growth in prosperity are made and conclusions arrived at not on the basis of economic laws but with the help of a ruler, by simply extrapolating past tendencies. According to this line of reasoning, if Latvia reaches the level of prosperity that is the EU average, then in twenty years it should be the most prosperous country on the face of our planet (Slide 5)! Of course, given the limitations on any predictions regarding long-term development, we cannot totally dismiss such a possibility. Yet, to make the analysis of possible economic development of the country a little more credible, in my opinion, it should be based on a few fundamental principles.

First, the economic laws state that economic development is not linear: periods of high growth are followed by periods of sluggish growth. This basic thought ran like a red thread through our last year's conference and, if we analyse the current public discussion arena, it seems that hardly anyone has any serious doubts about it. Many macroeconomists forecast the GDP growth of the next year at an annual rate of 6–7%, those more pessimistic put it even lower. Second, the classic theory of growth and the law of diminishing returns will determine that, with income levels on the rise, there will be a slowdown of growth in the future.

Both of these regularities are important and should be kept in mind, as we attempt to analyse the prospects for long-term development of our country. Yet a much more fundamental question that requires an answer from any analysis of long-term growth is: what are the factors that will determine the future growth of the country's economy? It is precisely this answer that will determine not only the future pace of economic growth but also the level of overall prosperity that we can achieve in this country. Without analysing these factors, we can only make approximate conclusions about the near future, and in the case of Latvia they would be more or less as follows: on account of the momentum of the current fast growth, in terms of income levels Latvia can pull ahead of some countries and leave the status of the poorest EU country behind. However, without a deeper analysis, it is not possible to predict what is of utmost interest to all of us right now. Namely, will Latvia prove capable of sustaining this level and gaining on the old EU countries in terms of prosperity?

It is precisely to the analysis of these factors of growth that the rest of the conference will be devoted. In this respect, the theme of today's conference is a continuation of the discussion started last year on sustainable economic development, because the stability of economic growth determines how soon our country will approach a particular level of prosperity. We have emphasised again and again and it is worth repeating again today that Latvia's economic development to a large extent can be compared with a marathon where the ability to reach the

finish line does not depend on a fast start or separate segments of the course covered at great speed but on physical endurance and the knowledge of how to distribute our strength to last the entire distance.

The experience of several decades in various countries across the globe has clearly shown that the long-term development of a country, the level of prosperity to be attained and the timeframe within which it should be attained are basically determined not by higher or lower interest rates but whether or not the country is in the process of a structural reform that stimulates the supply side of the economy. Where such structural reforms are vigorously and thoughtfully carried out, the country can develop at a relatively high rate for a long enough period, thereby achieving a high level of prosperity.

We should bear this in mind, when we think about the future of Latvia. If we can solve the problems related to modernisation of our economy, to increasing the ability to compete and enhancing the development of human resources, increasing the number of small and medium size enterprises, enhancing exports and raising productivity in the next few years, the national economy is going to be in a good "physical" shape. Then the rate of 7–8% can be maintained in the coming years as well.

The thematic range of our conference, in our opinion, singles out the areas wherein the current trends may one day become a cause for decreasing the rate of growth and which require utmost care and effort if we want to see the situation improved. One of the main areas, without doubt, is the human resources of our country or the quality of our labour. It seems that it hardly merits a discussion that in Latvia, which cannot boast of plentiful natural resources, it will be the quality of the labour force that will determine the future level of productivity, competitiveness and prosperity. Everybody knows that. What is more complicated is the question of how we can achieve better quality of labour and improved overall human resources, in which areas and by means of what levels of support. This is closely related to the issue of labour migration which has become particularly topical with Latvia joining the European Union and lifting the limitations that existed up to then. We propose that the current problem of qualified labour be analysed in the context of Latvia's long-term development trends, separating the part of problems resulting from fluctuations of the economic cycle.

Finally, I would like to emphasise that during these years of independence much has been done to enhance the prosperity levels of the population and this work has hardly been wasted. Yet the view that everything possible has already been done and all that remains is to sit and wait for that effort to bear fruit in the next few years is but a beautiful dream that, unfortunately, is not likely to come true. For this dream to become reality, it is necessary to work towards this goal and work even harder than before. I am really pleased that the public discussion about these issues that are essential to the economic development of our country is growing in scope and depth. Our objective, as always, is not to pronounce some absolute truth but to keep the issue in the limelight and participate in finding the best solution. May the discussions today be rewarding and full of challenge!