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## **NATO Parliamentary Assembly**

### **SUB-COMMITTEE ON EAST-WEST ECONOMIC CO-OPERATION AND CONVERGENCE**

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#### **VISIT TO RIGA, LATVIA**

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#### **SECRETARIAT REPORT**

**15 & 16 SEPTEMBER 2005**

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1. Vineta Muižniece, Deputy-Speaker of the Saeima opened the meeting by noting that Latvia has been involved with the NATO Parliamentary Assembly since 1995. The relationship has been an important one, particularly for a country like Latvia where security concerns are a central government priority. Latvian officials have long recognized that their engagement in NATO demands that it become an “exporter” of security and so it has participated in a number of multilateral peace keeping initiatives. The Latvian people, according to Vineta Muižniece, see international stability, freedom and democracy as mutually reinforcing. The Latvian nation is deeply marked by the two totalitarian occupations and one of the central obligations of the state is to ensure that this is never repeated.
2. N. Penke State Secretary of Foreign Affairs continued on the theme of Latvia as a security contributor. He noted that his country is well positioned to share its experiences with countries that are in an early phase of political and economic transition. Latvia has limited resources to dedicate to diplomacy due to its small size. It seeks to maximize its resources by focusing part of its diplomatic efforts on CIS countries, particularly neighbouring states. Ukraine and Moldova are consequently two priorities for Latvian diplomacy. Because of a common set of experiences, the Latvians have also paid particular attention to the Caucasus which today face profound transition and security challenges.
3. Latvian officials have worked hard to establish dialogues with several CIS countries and have sought to deepen their understanding of the myriad challenges they face. Latvia has sent a number of fact-finding missions to neighbouring countries to assess their status and to better understand their needs. This is done bilaterally but with an eye on Latvia’s key roles in European and trans-Atlantic institutions. After these missions, the Latvian government explores financial options for funding projects. It assesses whether some projects would best be shared out with other Western countries that can provide expertise and funding. Latvia has accordingly recognized that it needs permanent diplomatic representation with a number of countries that were once part of the Soviet Union. This can be a challenge for a small country with limited resources, but Latvian officials feel that this should be an important diplomatic priority.
4. In Moldova, the Latvian government is working on prison and judicial reform as well as an effort to upgrade customs procedures. Obviously the problems of Trans-Dniester remain serious and there are many in Europe with a strong interest in building up systems to cope with a range of challenges stemming from this unsettled problem.
5. Latvia’s experience with Georgia is somewhat different. Although it enjoys warm relations with the government, practical cooperation has been rather limited although there is a surfeit of good will. Filling out the practical side of the relationship is now a priority. One idea is to provide training assistance to Georgia’s border guards. Georgia clearly needs international support in this area; its problems with Russia in this regard are particularly daunting. Latvia will soon open an Embassy in Tbilisi.
6. The situation in Ukraine has been a growing concern in Latvia. Latvian officials know that it can be easier to make a revolution than to foster the institutions and practices needed for strong democratic government. Corruption has posed a serious challenge to the Ukrainian transition and threatens to destroy the kind of trust needed to sustain democracy. Latvian officials are eager to expand their cooperation with Ukraine but are looking for more concrete proposals from their Ukrainian partners. Although the Ukrainians too seem keen to deepen relations with the EU and NATO, there often seems to be an absence of concrete thinking there about what exactly this should involve. Latvian authorities are encouraging their Ukrainian counterparts to focus more systematically on the reform process in order to better discern their needs.
7. Belarussia poses a different and, in many ways, a more difficult set off challenges. The Lukashenko government has shown no willingness to engage in reform, and it has targeted the

Polish community as well as dissidents for abuse. The regime remains strong and highly repressive, while the opposition is not well organized. All of this makes it difficult to formulate a policy response.

8. Russia poses a different set of challenges to Latvia. Obviously the historical legacy of Soviet occupation weighs heavily on the minds of Latvian policy makers charged with formulating a Russian policy. It is well known that outstanding national questions in the Baltic region were not settled after the Second World War. The iron curtain simply came down, Latvia lost its independence, and many highly complex issues were swept under the table, some of which to this day remain unsettled. This lack of closure remains a source of tension in the region and there has been some thinking on how to ease this historical burden. Leaders in the Baltic countries lament the fact that Russia simply does not want to engage in a common reflection on the occupation, its meaning and its legacy. Mr. Berzins (Head of the Latvian Delegation to NATO PA) noted that there has been a push to create a Commission to explore this legacy and to build a consensus about Latvia's long period of occupation.

9. On the other hand, there is an important set of business links between the two countries, and this points to the interests each side should have for improved relations. Still these historical questions weigh heavily on the current relationship, with the Russian authorities generally unwilling to see the Soviet occupation of Latvia as ever having been an occupation at all; this has all kinds of implications in current Russian thinking about the Baltic States.

10. The Latvians want to deal with this matter in an open and transparent manner. Because there are many ethnic Russians living in Latvia, many of whom are citizens of that country, the Russians sometimes seem to reject the full legitimacy of the Latvian state, for example, by constantly reopening border questions that the Latvians and the broader international community view as definitively settled. This is a problem that Estonia, in particular, is also confronting. The Russians have also been very slow to respond to Latvian proposals for the formation of bilateral commissions to deal with outstanding disputes, and this, in turn, has made it difficult to make progress on practical matters hindering deeper cooperation like double taxation, tourism and customs cooperation.

11. Latvian officials see the next presidential elections in Russia as a potentially critical moment for the relationship. The Russian state has accrued enormous powers while high-energy prices are strengthening its hand. The problem is that this windfall is dissuading Russian officials and society from embracing much needed economic and political reform.

12. The rights of the Russian minority in Latvia have also been an ongoing source of tension with Russia. Latvian officials, however, suggest that they have made great strides in accommodating this minority and have established strong integration policies fully consistent with European norms. Their approach, however, begins from the premise that Latvia is a sovereign nation. Members of the Russian minority can become naturalized citizens and many are following this course. It is not difficult to become a Latvian citizen. One needs to learn the Latvian language but the test is not difficult. 95% of those who take it pass on the first attempt. Russian officials are apparently reluctant to recognize this, and do not publicly encourage the Russian community to pursue this straightforward means to achieve political integration. Many Russians privately confide that the Latvian policy does offer the Russian minority a means to participate fully in the life of Latvian politics, but they are reluctant to say so publicly.

13. Ms. Paegle from the Parliament's Foreign Affairs Committee suggested that EU enlargement has triggered a significant realignment of power within Europe. New EU powers like Poland are playing a dynamic role in the life of the Union, and this has significantly altered European perspectives and decision-making. All the new members have introduced unique views on key questions shaping relations with countries like Ukraine and Russia.

14. Immigration has become a central question for all of Europe. How governments order questions pertaining to integration, fealty to the state and citizenship is highly salient in contemporary European politics. The challenge is hardly unique to Latvia. Although there are Russian concerns about ethnic Russian non-citizens living in Latvia, Russia itself has some 2 million people with no status at all. They are neither considered as Russian nor as refugees. They lack social and labour rights. Russia also has no repatriation law. This has made it difficult for many to return to their country.

15. Internationally Latvia is seeking to consolidate the gains it has made over the last decade and now wants to make its own mark on the international system. There is an effort underway to prepare leaders for leading international civil service positions. Latvia is a country with limited resources and so its diplomacy must be targeted. Along these lines, it also works closely with Estonia and Lithuania throughout the Baltic Council to identify common interests and hammer out common strategies for securing these. Baltic unity is thus seen as another priority of Latvian foreign policy.

16. Domestically, Latvia faces a serious demographic challenge. The population is declining and the society is aging, a trend that is unfolding throughout much of Europe. Many residents of Latvia departed after the break-up of the Soviet Union, and there is still evidence of a brain drain that impinges on the productivity of the country. Many young people have moved to the United States and Ireland while highly skilled professionals have left for countries where they can earn more money.

17. The Committee also met with Krisjanis Karinš, Minister of Economy and Ilmars Rimševičs, Chairman of the Bank of Latvia as well as Mr. Ozols Chairman of the Latvian Investment and Development Agency (LIDA) and Mr. O. Slūtiņš, the LIDA representative in Moscow. Latvia is undergoing a very rapid rate of growth, which has raised income levels significantly in the country. One problem has been that most of this growth is focused in Riga and its environs. Pushing development outward has been a priority but this has not proven easy. The international business community is clearly interested in operating in Riga because of its dynamism, high levels of education and infrastructure. But as wages and costs rise in the city, there will be new incentives to operate in the more remote areas of the country.

18. Last year the Latvian economy grew by 9% driven, in part by huge capital investments. This growth was clearly fuelled by the Euro 350 million of foreign direct investment that flowed into the country in 2004. This represented one of the highest per capita investment rates in the world. Money is flowing in not only because of privatisation but also because of the exceptional business climate, Latvia's accession to the EU and NATO, and very low tax rates.

19. There has also been a very substantial increase in lending to households. Indeed, Latvia currently has the highest lending rate to households in Europe. With falling interest rates and with its place in the European Union now secured, economic confidence has soared. This has certainly been a factor in high levels of investment and soaring economic growth. Yet there are also concerns about the balance of payments and the fact that the housing market, in particular, is overheating. Although the economic outlook remains very positive, the worst-case scenarios would involve a sudden deflation of housing prices, significantly reduced trade and soaring energy prices.

20. Latvia has built a very open economy and the current account deficit has been hovering between 12% and 9% of GDP in recent years. At the same time, exports last year grew by 35%. The government hopes that the current account deficit will shrink to 7% of GDP. The deficit on the current account is largely driven by the country's burgeoning demand for capital goods; firms operating in Latvia are importing many production inputs. Imports are financed through the significant capital inflows—something that has been facilitated by the peg to the Euro. This peg,

however has limited the capacity of the central bank to stem inflationary pressures. Bank authorities have thus had to rely on changes in reserve requirements to manage inflation but this is not always easy. Fiscal policy is also an important tool for macro economic management; there are significant pressures on the government to bring down budget deficits. The government hopes to accede to the Euro by 2008, and this ambition is helping to discipline fiscal policy. Next year's elections, however could pose problems as the temptation to spend will be higher. There are also concerns about inflation. Energy and food prices have risen considerably in recent months and the inflation rate is now approaching 6%

21. Since the Russian financial crisis of 1997, Latvia has shifted its commercial links so that it is less dependent on trade with Russia, although Russian gas supplies remain essential. Latvia's biggest trade partners include Germany, Lithuania, Sweden and Estonia. 80% of its trade is with EU.

22. The Latvian Investment and Development Agency (LIDA) is charged with promoting Latvian business abroad through trade and export promotion. It also works to attract investment to Latvia while administering those European structural funds dedicated to advancing the work of private entrepreneurs. Over the last year and half, LIDA has worked on projects worth more than Euro 100 million, which have generated 100 thousand jobs. Latvian exports have soared over the last decade, while just in the past year, foreign direct investment has increased by 40%, encouraged, in part, by the country's very open investing rules. This investment will inevitably lead to further increases in exports. Latvia has also created special tax-free economic zones. The accession agreement with the EU will allow these zones to operate until 2017. Latvia appears quite welcoming to foreign investors; it is now firmly anchored in the West yet it is very close to Russia and knows that country well. It is also near important Scandinavian markets, and because of its liveability, it is a country where international business managers can easily live and operate from.

23. Latvia's key exports include wood products, machinery and mechanical appliances and textiles. Although 90% of textiles produced in the country are exported, the industry is not directly threatened by the rise of China's textile business. In Latvia, that sector is very specialized and operates in niche markets that the Chinese are unlikely to fill. Latvian investment specialists suggest that it can be terribly difficult to compete with China for plants when the investor foresees the need to create more than 1000 jobs. At that point, the wage component of the investment is very important. It is, however, far more competitive for investments that will create fewer jobs. In these cases other factors become important such as the education level of workers, geographical proximity to markets, and business ethics become more important.

24. Economic analysts in Latvia recognize that its highly qualified labour force is one of its strongest assets. Latvia enjoys a very high level of education and a strong tradition in the sciences. The level of enrolment in the universities is the second highest in the world. One problem is that the universities are not turning out a sufficient number of engineers. Government authorities believe that Latvia must move quickly to play a role in emerging high technology and service sectors in order to exploit the capabilities of its work force and to avoid having to compete with lower wage countries. But it must target its activities simply because it is such a small market with finite resources. Latvian officials also expect to generate high foreign exchange earnings in transport and tourism.

25. Latvian trade with Russia remains important. It imported Euro 614 million of goods from Russia last year and made Euro 255 million in exports. Exports to Russia include food, machinery, chemicals and textiles as well as electronics. Imports from Russia include energy, metal products and timber, which are processed in Latvia. Latvia is clearly emerging as a business hub for the CIS, and this is why Russians are also investing in the country. Russian investors are attracted to the country's place in the EU, its stability, the fact that Russian is widely spoken, and

its proximity to Russia itself. Latvia is a Western country that clearly understands the East. It is also a safe haven for Russian investors who fear the political vagaries of operating in the ever more politicised Russian market.

26. Indeed, Russia's president and the government have begun to reassert state control over the market and are using economic assets to extend their political power and leverage over its neighbours and particularly those countries that were once part of the Soviet Union. This is particularly apparent in the oil sector. This has been described as stealth imperialism in Keith Smith's recent study of Russian oil geo-politics.

27. Of course, Latvian relations with Russia are closely related to EU relations with Russia. Russia, of course, is the largest neighbour of the EU and the relationship has been defined by a series of agreements made over the last decade. The launch of the Tacis programme was the first of these and it was followed by the signing of a Partnership and Cooperation Agreement which outlined an institutional framework for cooperation including two summits a year, parliamentary cooperation and frequent opportunities for dialogue. In 1999 the EU outlined a common strategy that stressed deeper cooperation with Russia in areas like energy investment, transportation and environment. This document is still being refined and it has had little practical effect although the energy dialogue has produced some tangible results. Clearly the EU and Russia have several shared interests in the energy sector. Russia is the most important energy supplier to the EU followed by Norway and Saudi Arabia. The EU meets 35% of its energy needs through Russian imports and has become Russia's most important market.

28. Yet the situation is not as rosy as Brussels likes to claim. Recently German Chancellor Gerhard Schroeder met the Russian President Vladimir Putin to sign a deal that gave a green light to the construction of a 1200 km gas pipeline under the Baltic Sea. Russia will pay 51% of the capital cost of this pipeline that should be completed by 2010. There are also plans to build trunk lines to Finland and Sweden. The Baltic states, however, are very unhappy that these deals were made bilaterally without EU wide consultation. Latvian officials feel that this will mean that the Baltic states will have to make separate deals with their Russian neighbours. This will put them at a disadvantage, particularly given Russia's penchant to wield the energy card against those states that it sees as somehow challenging their broader international ambitions. The Latvians know that energy price hikes are inevitable. They are concerned however that the Russian energy policy will become increasingly politicised and used to apply pressure on issues that the Latvians feel are matters of sovereign concern.

29. This is why there is great unease with the German pipeline deal and particularly the fact that broader European interests were not considered when the deal was signed. Chancellor Schroeder simply wrote off Baltic objections. The Latvians are thus pushing the EU to develop a coherent energy policy and a unified policy toward Russia that will better reflect these concerns and to better anticipate a Russian pattern of using energy for political purposes-something that has been particularly evident in Ukraine and in the Caspian. The Latvians are also concerned that Europe may put itself at risk by relying too heavily on Russia to provide its energy needs. Germany, for example, seems willing to secure as much as 50% of its needs from Russia, and this will give the Russians a great deal of political leverage over that country and its neighbours. The Latvians do not see Russia simply as an energy provider; it is, from their perspective, a huge neighbour confronted with a continuing identity crisis and a great deal of uncertainty about its values and direction. If Russia ignores the needs of new EU members, while meeting the energy demands of the old 15, then Europe will be divided and considerably weakened. Russia understands this very well and it is playing this card to the obvious chagrin of Latvian political leaders.

30. The Committee also had an opportunity to meet NATO Ambassadors. The Ambassadors reinforced several of the points that Latvian speakers had made the day before. Several interesting points were made in these discussions:

31. Latvia has grown substantially but only recently has it reached the wealth level that it enjoyed in 1991. This is indicative of how difficult the transition has been and the amount of sacrifice that has been made to build a functioning market where previously none existed. There are still some challenges that have to be met. Now that it has achieved membership of both NATO and the EU, it is now challenged to define a new set of national policy objectives. Of course, it wants to continue to grow economically and bring its standard of living at least up to the European average. It is also true that countries like Latvia are going to change the EU in important ways. Moreover the Baltic states in particular can become EU ambassadors in the CIS countries. They have a particularly valuable role to play in countries like Moldova and Ukraine whose experience they understand all too well.

32. Latvia is also seen as a very assertive country with a very clear understanding of its national interests. It is playing an important role in the region, and in many respects its diplomatic clout is greater than its size. Its visceral understanding of Russia is very important to the EU and its voice is thus welcome in both EU and NATO circles.

33. The delegation also had an opportunity to meet the President of the Riga airport authority, Mr. Dzintars Pommers and Ms. Tina Kuze, a board member of Hansa Bank, one of the largest banks in Latvia. The airport is state owned and is not slated to be privatised. Over the last 14 years it has undergone massive change. In Soviet times, it only handled flights from the Eastern block. After the Soviet system collapsed air travel to Riga did as well. Passenger traffic fell from 2 million passengers a year to 250,000. But since then the airport has made very steady gains in passenger numbers while undergoing a total transformation of its management principals, and flight links. The airport has invested some Euro 53 million to reconstruct the terminals—funds that have been largely raised through airport usage fees. The facility is now very highly regarded; it has attracted a number of airlines including Ryan Air and has won awards for the quality of its services. The goal ultimately is to handle five million passengers a year. Obviously achieving this hinges on several factors, not the least of which includes future gasoline prices.

34. The banking sector has also experienced a massive transformation over the last 14 years. In a sense it has gone through two transitions. There was the initial effort to create a market-based banking system after the collapse of communism. This nascent system had to be reconstructed subsequently after the banking crisis of 1995, which was in part due to an inadequate regulatory system. Once a strong supervisory system was in place, however, Latvia's banking system developed swiftly and provided a stable financial anchor for the economy and a key vehicle for mediating relations between savers and investors. Hansa bank itself was founded in 1992 when there were 63 banks operating in the country and it was the second smallest of these. Since then it has emerged as the largest bank in the country having undergone two mergers. It is today part of a larger Swedish bank. Hansa is a universal bank offering a range of financial services from deposit retail banking to life insurance and commercial lending. 70% of middle managers at the bank are women as are three of the 8 board members.

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