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Viesturs Pauls Karnups*

Abstract

This paper examines Latvia's foreign trade and investment relations with Germany and Russia during the interwar period and the period after the restoration of independence up to now. During the period between the two world wars Latvia's foreign trade was completely integrated into the European trade systems at that time. One of Latvia's main trading partners was Germany, whilst trade with Russia (USSR) was minimal. The reorientation of Latvian trade to the West after regaining independence in 1991 meant the reestablishment of links with Germany, as well as the maintenance of links to Russia. In comparison to the pre-war period, Latvia's foreign trade is no longer dominated by Germany, whilst trade with Russia is at a much higher level than in the interwar period. Trade with Germany in 2008 made up 11.1% of Latvia's total trade while trade with Russia accounted for 10.5%.The structure of trade has also changed particularly in relation to Germany and to a lesser degree with Russia. Pre-war Latvia's exports to Germany were mainly agricultural and forestry products; today they consist of manufactured goods and forestry products. Exports to Russia in the interwar period were mainly manufactured goods, but today exports consist of manufactured goods as well as food processing products. In terms of investments, pre-war investment from Russia (USSR) in Latvia was negligible, whilst the largest investor in Latvia was Germany. In 2008 Germany was the 10th largest investor in Latvia (3.6%), whilst Russia was on the 7th position (5.6%). Thus, whilst the role of Germany in terms of trade had decreased substantially since the interwar period Russia's role has increased both in terms of trade and investment.*

Keywords: Latvia, Germany, Russia, Interwar period, foreign trade, investment, post-independence
JEL classification: E 22, F 10, F 21, F 53, N 70,

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Content: 1. Introduction – 2. Historical aspects – 1925-1939 – 3. Trade and investment relations 1992-2008 – 4. Past and present

1. Introduction

This paper examines the historical roots of Latvia's foreign trade and investment relations with Germany and Russia during the interwar period and the period after the restoration of independence up to now.

Trade within the context of this paper refers to merchandise exports and imports, while investments refers to foreign investment stocks, i.e. investments made by non-residents as direct and portfolio investment in the company capital of the Latvian undertakings. The trade statistics analysis for the interwar period has been limited to the time period 1925-1939 to coincide with available data on interwar investments.

During the interwar, period Latvia developed as a successful exporter of agricultural products to industrialised Western Europe. Despite external constraints to trade, Latvia's trade pattern reflected inter-industry specialisation along the lines of classic comparative advantage. Latvia exchanged food and natural resources such as wood and wood products for manufactures such as consumer goods and machinery with Western Europe. Regional trade in the interwar period, however, was in general limited due to the similarity of exports. The singular exception was Germany and to a limited extent also Russia (USSR). Nevertheless, regional trade was important to the manufacturing sector of the Latvian economy – in 1937 some 20% of the total value of the production of industry was exported [*The Latvian Economist* (1938), p.93].

The relationship between foreign investment and foreign trade is complex. Neo-classical economic theory postulates that free trade in goods and factors is efficient. In the real world we observe distortions being implemented both on goods and factors trades. Seminal work by Robert Mundell[1] introduced a substitutive relationship between FDI and international trade. This relationship originated from the neoclassical Heckscher-Ohlin-Samuelson assumptions, whereby international trade is driven by differences in factor endowments and factor prices for homogenous products. These differences become smaller when international factors become mobile between countries and international trade decreases. Thus, Mundell concluded that capital movements, driven by FDI, are the perfect substitute for exports from the home country. Mundell also stated that import tariffs reduce exports from the home country and encourage FDI. Alternatively, Kojima (1975) described FDI as complementary to trade if FDI capital outflows create or expand the opportunity to export products from the home country. Lipsey and Weiss (1981) and Rugman (1999) stated that the production of one product by foreign affiliates may increase total demand for their entire product line, making FDI and exports from the home country complementary.

[1] For a recent overview of Mundell's work see Goldberg & Klein (1999)

Moreover, Giuseppe Nicoletti et al. (2003) point out that [world] trends and patterns in foreign investment and trade offer *prima facie* evidence that the two phenomena are closely linked: both increased sharply over the past decade; both seem to be at least partly affected by factors related to distance, location and size of the economy; and in some cases trade openness seems to go hand in hand with high foreign investment and foreign affiliate activity.

In the theory of international trade and factor mobility,[2] trade in goods and in factors are often studied as if they are substitutes or alternatively complements (see Fontagne (1999) for an extensive overview of theoretical and empirical findings). That is, the amount of investments between two countries should be related to the amount of trade between them. Based on these theories, the amount of foreign investment from Germany and Russia flowing into Latvia could possibly be explained by growing international trade with Germany and Russia. Thus, foreign investment inflows and imports may work as complements. Alternatively, the relationship between trade and investment in Latvia may be that imports have worked as a substitute for foreign investment inflows into Latvia or *vice versa*.

This article analyses the relationship between trade and investments in Latvia in respect of Germany and Russia for both the interwar period and the period after the restoration of independence. It would appear that for the interwar period and in the current period foreign investment inflows and imports have worked mainly as complements.

The structure of the paper is as follows: the second section consists of an analysis of trade and investment in the interwar period, the third section analyses trade and investment in the current period from the restoration of independence to 2008, and the fourth section provides the conclusions derived from the analyses.

2. Historical aspects – 1925-1939

2.1 Latvian Foreign Trade with Germany and Russia 1925-1939

Latvia's foreign trade in the 1920s was based to a large extent on a system of commercial and trade treaties. Up to 1929, Latvia had also concluded commercial treaties with Germany (28.06.1926) and Russia (USSR) (02.06.1927). All Latvia's commercial treaties up to the Great Depression were based upon the unlimited and unconditional most favoured nation (MFN) principle, with its special exception in the form of the Baltic and Russian clause. The Baltic and Russian clause was in the nature of a geographical and regional restriction of the MFN principle and provided that the MFN principle does not apply to rights, preferences and privileges which Latvia reserves or may reserve to Estonia, Finland, Lithuania and the Soviet Union.

2.1.1 Trade with Germany

The first basis for Latvian trade with Germany was the 15 July 1920 treaty which restored peaceful relations with Germany and included a resumption of trade relations. The delay in concluding a formal commercial treaty with Germany (a treaty with Great Britain was concluded in 1923) was due mainly to unsettled claims which Latvia lodged against Germany for the damages sustained during the German occupation of Latvia during and after WWI, to which Germany responded with a counter claim for structures of various kinds erected and

[2] Foreign investment is usually treated as the equivalent to the international movement of capital where the owner has some strategic interest in the firm where he invests.

left in Latvia. Treaty negotiations dragged on from 1921 to 1926 and it was not possible to sign the treaty until 1926 when both sides agreed to give up their mutual claims. The treaty, which came into effect on 1 December 1926, was based upon the MFN principle and contained also the Baltic and Soviet Union clause.

By 1929, Germany had become Latvia's main import partner (see Table 1). There were a number of reasons for this, including the fact that a large number of Latvian traders were ethnic Germans, which meant that having contact with Germany was rather easier for them. Moreover, a large amount of German capital, as will be shown later, was invested in Latvia's industry, commerce and banks, as well as in credits for the importation of goods from Germany. In certain sectors, such as pharmaceutical and electrical equipment, Germany had a monopoly status in Latvian imports. Together with the growth of imports, exports also increased, but, as can be seen in Table 1, reached only about half the value of imports. Latvia's main export to Germany was butter, which could be transported more quickly and cheaper to Germany than to Britain. In 1929, the advantages of exporting butter to Germany diminished as Germany increased the tariff on butter in the summer of that year.

The onset of the Great Depression in Latvia began in 1930. Latvia, following the lead of the rest of Europe, did everything it could reduce imports and halt the outflow of foreign currency, including the establishment of a currency commission, the establishment of a contingent (quota) system for imports, increases in import duties and the promotion of import-substitution. In 1931, the customs tariff was amended 6 times, in 1932 also 6 times and 10 times in 1933. [*The Latvian Economist* (1934), p.474] Latvia's trade relations with Germany in the period from 1930 to 1934 were complicated by political and social factors, as well as by the economic effects of the Great Depression. In general terms, Germany remained Latvia's most important import partner (Table 1) although its role progressively decreased. While in 1931 37.1% of Latvia's imports came from Germany, they fell to 24.5% in 1933. Exports, on the other hand, moved from 27% on total exports in 1931 to 25.9% in 1933, thus exports more or less maintained their former position.

In early 1932, Latvia signed a so-called bilateral "clearing" agreement with Germany. The basic idea behind bilateral clearing agreements was to even out or "balance" trade between two countries, while at the same time conserving scarce foreign currency and gold reserves. The "agreement" was an exchange of letters between the Bank of Latvia and the Reichsbank. Under this arrangement exports to Germany and imports from Germany increased. During the existence of the arrangement Latvia often had large sums outstanding in Germany in the form of clearing account surplus. For Latvia it was often a problem to find useful and adequate imports from Germany to make use of the frozen millions of lats.[3]

[3] Ēķis, L. (1943), *Latvian Economic Resources and Capacities*. Washington D.C., The Press Bureau of the Latvian Legation, p. 99.

Table 1 Latvia's Trade with Germany 1925-1939

Year	Exports (1000 lats)	Exports % of total exports	Imports (1000 lats)	Imports % of total imports
1925	40636	22.6	116319	41.5
1926	45837	24.3	103886	39.9
1927	58460	26.4	101512	40.6
1928	69001	26.3	127083	41.2
1929	72442	26.5	149177	41.2
1930	65964	26.6	109932	37.1
1931	44158	27.0	65709	37.1
1932	25287	26.2	30140	35.6
1933	21133	25.9	22321	24.5
1934	25185	29.5	23206	24.5
1935	33088	33.5	37205	36.8
1936	42665	30.8	46785	38.4
1937	92374	35.4	62595	27.1
1938	76001	33.5	88659	39.0
1939	82949	36.5	100318	44.6
	Average of total exports, 1925-1939	28.7 %	Average of total imports, 1925-1939	36.6 %

Source: *Latvijas Statistiskā gada grāmata. 1925-1939* [Latvian Statistical Yearbooks 1925-1939] – Rīga: Valsts Statistiskā Pārvalde, and *Strukturbericht über das Ostland. Teil I: Ostland in Zahlen*. – Rīga: Reichskommissar für das Ostland, 1942: 57-58

The rise to power of Adolf Hitler caused further problems. Latvia's large Baltic German minority was becoming rapidly nazified. When Germany's new regime proclaimed a boycott of Jewish businesses on 1 April 1933, social democrats and the Jewish community in Latvia proclaimed a boycott of German goods in Latvia in June 1933 as a protest. Germany's reaction was an announcement that from 12 June 1933 onwards its borders would be closed for Latvian butter. Germany had been for a long time Latvia's largest export partner for butter. In the first four months of 1933 Germany had bought more than 56% of Latvia's exported butter. So, this was a totally unexpected move by Germany and on 13 June 1933, the Latvian government declared that on 12 June the government had issued an order that "no German goods were to be cleared by customs and let into the country… We shall not buy and we may not buy a single kilo of goods from such a country, which behaves in that way with us" [Aizsilnieks (1968), p. 549]. This mutual boycott lasted only a few days. The Prime Minister, A. Bļodnieks, announced to the *Saeima* [the Parliament] on 30 June 1933 that after the Latvian government had given assurances that the government would have taken all legal steps against the proclamation of the boycott of German goods, the German government had revoked the ban on Latvian butter on 17 June [*Saeima* transcript, 30 June 1933, p. 1062].[4] In real terms, the "Butter War" had little direct effect on the trade balance between the two countries. Butter exports to Germany in general had been steadily declining from 14.9 thousand tons in 1930 to 6.2 thousand tons in 1933. Nevertheless, it hastened the

[4] For a detailed examination of the „Butter war" see Cerūzis (2004), pp. 144-158.

displacement of Germany as Latvia's main trading partner by Britain (for example, butter exports to Britain rose from 2.7 thousand tons in 1930 to 7.8 thousand tons in 1933).

On 4 December 1935, another agreement was concluded between Latvia and Germany regarding the interchange of goods and services and the Veterinary Convention. Economic delegations of Latvia and Germany met regularly to draw up lists of commodities to be exchanged and to find ways to hold in balance the exports with the useful imports to be obtained in Germany. Trade accounts with Germany were further adjusted on the basis of a new clearing agreement concluded on 31 October 1937. This agreement superseded the Clearing Convention of 1932 between the Bank of Latvia and the Reichsbank.

The most important goods exported from Latvia to Germany during the interwar period were butter, pigs, seeds, timber and timber products, plywood, flax and flax yarn. German imports into Latvia consisted of all kinds of manufactured goods. The chief items were industrial machinery and motors, yarns, dyes and dyestuffs, pig iron and other metals, coal and coke, chemicals, artificial silk and other textiles, and pipes for industrial purposes.

The commencement of WWII effectively closed the Baltic Sea region to British and allied shipping as it was clear that the Royal Navy would not enter the Baltic Sea to offer protection against German warships. Despite various attempts to maintain trade with Britain in the early part of the war, Latvia's trade was now mainly limited to Germany, the USSR and Sweden. On 15 December 1939, Latvia signed a wartime trade agreement with Germany. Although Germany demanded that Latvia had to officially stop trading with Britain, the Latvian government managed to reject this demand [Zunda (1998), p. 212]. In the last four months of 1939 over 50% of Latvia's imports and exports came from or went to Germany (imports 52.5% and exports 56.5%).

2.1.2 Trade with Russia (USSR)

Before WWI Latvia was one of the most developed parts of the Tsarist Russian Empire. Rīga was the largest trading port in the empire with total exports and imports of some 405 million roubles in 1913 [Skujenieks (1927), p.663]. In 1913, 28.2% of total empire exports and 20.6% of total imports went through Latvia's three main ports – Rīga, Liepāja and Ventspils. [Skujenieks (1927), p.677]. While they were mainly export-orientated ports, Rīga and Liepāja also handled a large import trade. This was mainly due to the rapid industrialisation of Rīga and Liepāja at that time. Of course, much of the volume of trade came from and went into the empire rather than from or into the territory of Latvia itself. Thus, in this sense the ports were also transit ports. It was only after the gaining of independence that Latvia became an importing and exporting nation in its own right.

From 1918 (the year of Latvia's declaration of independence) until 1920 Latvia was at war with Soviet Russia. In 1919, with the assistance of Soviet Russia the Latvian Soviet Republic was established in most of Latvia. The regime did not last long and by May 1919 it was forced out of Rīga and retreated to Eastern Latvia. On 30 January 1920, an armistice between Latvia and Soviet Russia was signed with effect from 1 February and the final Peace Treaty was signed on 11 August 1920. The peace treaty contained a provision for the need to enter into a bilateral trade agreement as soon as possible. However, as Soviet Russia established trade relations with the West, the need for a formal agreement with Latvia receded and no agreement was signed until 1927.

Latvia believed that its main economic role vis-à-vis Soviet Russia was that of an intermediary, the classic ‘bridge between West and East’. Trading on the border began even prior to the signing of the armistice on 30 January 1920, firstly as contraband and then as semi-legal “speculative” exchanges. On 16 February 1920, the government took a decision to combat these semi-legal “speculative” exchanges and began to issue six-month border zone concessions for trade and exchange with Soviet Russia [Stranga (2000), p. 180]. In 1921, the government established specially fenced in customs areas on the border where private persons and organisations could open trading shops for cross-border trade. The cost of a six months trading permit was 250 gold francs [Aizsilnieks (1968), p. 203]. In 1922, the government established the stock company “Robežtirdzniecība” [Border Trade], which owned some 200 of such shops. In 1922, the turnover at these cross-border exchange points was some 22.8 million lats. At the end of 1924, after protests from Soviet Russia the cross-border trade exchange points were closed.

Already in April 1921, Soviet Russia began a regular trade with Latvia. In that year Russia exported to Latvia flax and hemp (95% of exports) and oil (5%). Latvia exported to Russia seeds, rye, food products and linseed. The establishment of Soviet Russia’s New Economic Policy (NEP) raised hopes that normal trade relations could be established on a permanent basis. In 1923, the Latvian government submitted a draft trade agreement to Russia. However, negotiations continued off and on for the next four years. In 1925 intensive talks took place, but they came to nought mainly because of the demands of Russia for extremely low tariffs on transit goods and no customs duties on imports from Russia. It was clear that as long as there was a conservative government in Latvia no trade agreement would be signed.[5] Up to 1927, both Latvian imports from and exports to Russia (USSR) were fairly minimal averaging 3.3% of total Latvian imports and 5.3% of total exports for the period 1921-1926.

In December 1926, a Centre-Left government, led by the social democrat M. Skujenieks, came to power in Latvia. Although initially suspicious of this “left-wing” government in Latvia, by February 1927 Russia (USSR) was willing to talk again about a trade agreement. The breaking off of diplomatic relations between the USSR and Britain in May 1927 over a spying scandal concentrated Moscow’s attentions on neighbouring countries as conduits for trade. The undiplomatic suggestion by the British envoy in Rīga that Latvia should not sign a trade agreement with Russia (USSR) only added fuel to the fire [Stranga (2000), p. 223].[6] Negotiations intensified and on 2 June 1927 a Commercial Treaty between Latvia and the USSR was signed, partly because the USSR saw it as a support for a “fellow” left-wing government, and partly as a reward for not succumbing to the British pressure and maintaining a friendly neutral position in the dispute between the USSR and Britain.

The trade agreement was concluded for five years and was based upon the most-favoured-nation principle.[7] The Soviet government undertook to buy annually Latvian goods (mainly manufactures) to the value of 15 million roubles (40.7 million lats). Thus, agricultural Latvia would export industrial products amounting to 82 per cent of the total value of goods to be exported to the Soviet Union. These goods included railroad cars (in the amount of 5.3 million roubles), paper (2.3 million roubles), woollen yarn and leather goods, hardware goods and wire, bicycles, agricultural machinery, knitted goods, furs, cellulose, glass, linoleum, cinema

[5] For a detailed examination of Latvian-Russian trade relations in the early 1920s see Stranga (2000), pp. 178-200.
[6] „The right-wing British newspapers had advocated a credit blockade against Latvia if she ratified the treaty.” [Andersons (1962), p. 308]
[7] The following is based upon Andersons (1962), pp. 296-321

accessories, paints, needles, and oilcloth. Latvian agricultural products exported to the Soviet Union, representing only 18 per cent of the total value of exports to that country, included clover seeds, pedigreed cattle, horses, fowl, canned fish, etc.

Latvia undertook to buy annually USSR goods to the value of approximately 7 million roubles (approx. 19 million lats). Latvia imported petroleum, naphtha, gasoline, wheat, sugar, sunflower and cotton seed oil, perfumes and eau de cologne, automobile and bicycle tires, pig iron, sheet iron, fibrous vegetable substances, dried fruit and berries, tobacco, cotton goods, feathers, bristles, caustic soda, sodium carbonate, salt, electric motors, etc. Therefore, imported goods from the Soviet Union consisted mostly of raw materials and agricultural products.

The most important part of the treaty was the practical realisation of the Russian clause – the special customs convention. This established special customs reductions on the minimum rates of the customs tariffs of the contracting parties. The Soviet authorities reduced customs duties on Latvian railroad cars (50 per cent), hardware goods and wire manufactures, agricultural machinery and implements, knitted and woven goods (25 per cent), preserved and canned fish, leather goods, plate glass, photographic glass, and needles (20 per cent). There were no customs reductions on Latvian agricultural products. The Latvian authorities, on the other hand, reduced customs dues on Soviet chemical products, cast iron and sheet iron, fibrous vegetable substances, bristles (100 per cent), mineral waters, mustard, salt and tires (60 to 50 per cent), dried fruit and berries and nuts (33 per cent), wines, naphtha, petroleum, and electric motors (25 per cent), wheat, oils, perfumes, and some other products (20 per cent). Most commentators consider that the reductions in customs rates heavily favoured the Soviet Union [Aizsilnieks (1968), p. 412; Andersons (1962), p. 306]

In addition, the treaty granted the Soviet Union the privilege of maintaining a commercial mission in Rīga with the head of mission and some of its members being conferred diplomatic immunity. A similar status was not granted to Latvian trade representatives in the USSR. The treaty also provided a short-lived stimulus to Latvia’s industrial sector and delayed the onset of the effects of the Great Depression for one year.

As can be seen in Table 2, the treaty was more honoured in the breach than in the observance. Only in 1929 exports to Russia did reach the 40 million lats annual target and imports from Russia never reached the promised 19 million lats annually. The treaty was not renewed when it ended in 1932 and trade between the two countries dropped back to minimal levels. Nevertheless, between 1928 and 1932 exports rose substantially to an average of 14.5% of total Latvian exports for the period (Table 2), which was an average not reached again until early 1990s.

In the autumn of 1933 negotiations began for a new trade treaty, which was signed on 4 December 1933. The new treaty was mainly declarative and there was no reference to the Russian clause. No customs reductions were included; however, the most-favoured-nation principle was retained. The treaty also stipulated that trade between the two countries should be as balanced as possible and that 50% of Latvian exports to the USSR were to be agricultural products [Leits (1958), p. 193].

In September 1935, a bilateral clearing agreement was signed between the USSR State Bank and the Bank of Latvia. However, the new agreement did not stimulate trade between the two countries in any way.

Table 2 Latvia's Trade with Russia (USSR) 1925-1939

Year	Exports (1000 lats)	Exports % of total exports	Imports (1000 lats)	Imports % of total imports
1925	7519	4.2	10638	3.8
1926	10240	5.4	11703	4.5
1927	3753	1.7	18319	7.3
1928	23505	9.0	17588	5.7
1929	40079	14.6	17022	4.7
1930	35118	14.2	17601	5.9
1931	33101	20.2	16539	9.3
1932	14222	14.7	8506	10.1
1933	1181	1.4	3643	4.0
1934	1913	2.2	2767	2.9
1935	2738	2.8	3702	3.7
1936	4140	3.0	3558	2.9
1937	6645	2.5	8679	3.8
1938	7634	3.4	8382	3.7
1939	11588	5.1	14213	6.3
	Average of total exports, 1925-1939	7.0 %	Average of total imports, 1925-1939	5.2 %

Source: *Latvijas Statistiskā gada grāmata. 1925-1939* [Latvian Statistical Yearbooks 1925-1939] – Rīga: Valsts Statistiskā Pārvalde, and *Strukturbericht über das Ostland. Teil I: Ostland in Zahlen*. – Rīga: Reichskommissar für das Ostland, 1942: 57-58

The last trade treaty with the USSR was signed during the first months of WWII and under the shadow of the infamous "Treaty of Mutual Assistance between the Republic of Latvia and the Union of Socialist Soviet Republics" signed under duress on 5 October 1939. The Mutual Assistance Treaty provided for the establishment of Soviet Air Force, Naval and Army bases in Western Latvia and the stationing of up to 25,000 troops, more than the peacetime strength of the Army of Latvia. As a sop to the Latvians the USSR concluded an "Agreement regarding Trade Turnover between Latvia and the USSR" on 18 October 1939. In the circumstances of WWII and the closing of the Baltic Sea to British and world trade the agreement was a lucrative one for the Latvians. The agreement was to come into effect on 1 November 1939.

The agreement provided for a substantial increase in trade between the two countries. Latvia was to export goods worth 30 million lats by 31 December 1940 and to import the same amount of goods from the USSR. These volumes were four times bigger than Latvia's exports and imports to the USSR in 1938 (Table 2). The agreement included a list of goods to be exported and imported. Latvia exported mainly agricultural products, including live pigs, butter, meat, cheese, and railway wagons, while it imported mainly fuel, raw cotton, chemical products, agricultural machinery, salt and sugar [Leits (1958), p. 198]. In the last five months of Latvian independence (January-May 1940) Latvia's exports to the USSR were six times larger than the exports in the same period in 1939 and imports were five times larger [Leits (1958), p. 200].

2.2 German and Russian (USSR) investment in Latvia 1925-1939

Foreign capital in Latvia was mainly invested in banking, industry, transport and trade. By 1927, over 60% of the equity capital of all Latvian joint-stock banks[8] was foreign owned, while foreign capital comprised 27.8% of aggregate capital in insurance, 33.9% in trade, 63.1% in transport and about 50% in industry [*The Latvian Economist*, 1928:24]. Many investors hoped that they would be able to expand in the huge Russian market from Latvia. Until the beginning of the Great Depression the largest investor was Germany, closely followed by Great Britain and the Nordic countries. Table 3 provides an overview of German and Russian investments in the interwar period.

2.2.1 German investment

German capital returned to Latvia gradually after WWI. It was only after the stabilisation of the mark in 1923 that German capital began to invest in a substantial way in Latvian undertakings, especially banks. German investors were familiar with the circumstances and markets in Latvia and were ready to invest across the whole spectrum of the economy.

Table 3 Foreign Investment Stock of Germany and Russia in the Company Capital of Latvian Undertakings (as at 1 January) 1925-1939

	Germany		Russia(USSR)	
Year	(1000 lats)	% of total investments	(1000 lats)	% of total investments
1925	5828	10.4	1054	1.9
1926	9509	12.8	2166	2.9
1927	12508	14.7	2166	2.5
1928	16120	17.0	2563	2.7
1929	18124	19.2	2869	3.0
1930	21891	21.3	3570	3.5
1931	25558	24.4	3700	3.5
1932	27110	27.7	4153	4.2
1933	26517	27.9	3380	3.6
1934	23045	25.7	3553	4.0
1935	21654	24.9	3541	4.1
1936	19324	26.9	427	0.6
1937	13895	21.7	394	0.6
1938	12194	19.9	381	0.6
1939	13395	22.3	305	0.5
	Average of total investments, 1925-1939	21.1%	Average of total investments, 1925-1939	2.6%

Source: *Latvijas Statistiskā gada grāmata. 1929, 1939* [Latvian Statistical Yearbooks 1929, 1939] – Rīga: Valsts Statistiskā Pārvalde; Statistikas tabulas [Statistical Tables] – Rīga: Latvijas PSR Tautsaimniecības Statistikas pārvalde, 1940

[8] For a brief overview of banking in Latvia in the interwar period see Hidens (2000), pp. 133-149.

As can be seen in Table 4, German capital in 1927 was mainly invested in the textile industry, chemical industry, metallurgy, timber and paper industry, and commerce, in particular, banking.

Despite the Great Depression, German capital investment continued to increase up to 1932 (Table 3). From this year it started to decrease and accelerated after 1934 when the nationalistic Ulmanis regime began to reduce systematically the amount of the foreign investment stock. Foreign investment stock in the company capital of Latvian undertakings overall was reduced from 50.4% in 1934 to 25.4% in 1939 of which the reduction in industry was from 52.4% in 1934 to 31.9% in 1939, in commerce from 35.9% to 28.2% and in finance and banking from 62.4% to 9.7% [*Finanču un kredita statistika* (1939): 172].

The reduction of German capital was gradual in most sectors, except banking, where investment fell from a high of 4 826 000 lats in 1931 to 2 862 000 lats in 1939 – a reduction of some 40%. German capital in 1939 was mainly invested in the textile industry, chemical industry, metallurgy, trade and banking (Table 4).

2.2.1 Russian (USSR) investment

Russian investment in the interwar period was negligible (ceramics and trade – see Table 4). The USSR was more interested in increasing investments at home than abroad.

Table 4 Foreign Capital from Germany and Russia (USSR) in Latvian Joint-stock Companies 1927 and 1939 by Main Sectors of Investment

	From Germany		**From Russia (USSR)**	
Main sectors of foreign investment	**1927 (1000 lats)**	**1939 (1000 lats)**	**1927 (1000 lats)**	**1939 (1000 lats)**
Ceramics	39	185	27	64
Metallurgy	2158	102	0	0
Chemical	1879	2308	0	0
Textile	1976	2837	0	63
Timber	1045	509	0	12
Paper	335	834	0	0
Foodstuffs etc.	295	237	0	122
Trade	750	1696	133	43
Real Property	253	398	0	0
Transport	173	76	0	0
Banks	2000	2862	2000	1
Totals	10903	12044	2160	305

Source: *Latvijas Statistiskā gada grāmata. 1927-1939* [Latvian Statistical Yearbooks 1927-1939] – Rīga: Valsts Statistiskā Pārvalde; *The Latvian Economist,* 1928: 26; and *Statistikas tabulas,* 1940: 170

The main investment in which the USSR participated in Latvia in the interwar period was the establishment of the *Kooperatīvā transitbanka* [Co-operative Transit Bank] in 1923. Russia invested 1.16 million lats directly through the All-Russia Co-operative Union and 0.84 million lats indirectly through the London branch of the Moscow Narodnyi Bank [Zālīte (1994), pp. 12]. The bank was mainly established to finance the transit business to Russia through Latvia. However, the transit trade with Russia never picked up again after the Great Depression. The bank had liquidity problems with balances falling from 26.4 million lats in 1930 to 3.7 million lats in 1935, and in 1936 the bank was liquidated.

3. Trade and investment relations 1992-2008

3.1 Latvian Foreign Trade with Germany and Russia 1992-2008

After the restoration of independence in 1991, Latvia faced the same task as in 1920 – to re-integrate into the European economy. In particular, to restore trading links with its former trading partners such as Germany, whilst at the same time maintaining trading links with Russia. In 1991, 88.2 percent, of Latvian exports went to the countries of the former Soviet Union, and only 3.2 percent went to Western countries [Iwaskiw (1995)].

3.1.1 Trade with Germany

On 28 August 1991, Germany re-established diplomatic relations with Latvia, which had just regained its independence on 21 August 1991. Trade relations had already commenced some time previously and by 1992 exports to Germany had reached 7.9% of total exports while imports from Germany accounted for 15% of total imports (Table 5).

The first formal agreement on trade, which included Germany, was the Agreement between the Republic of Latvia and the European Economic Community (EEC) on Trade and Commercial Economic Co-operation signed on 11 May 1992. An Agreement on Free Trade and Trade Related Matters between Latvia and the EU signed in 1994 replaced the 1992 agreement. By 1994, exports to Germany had reached 10.5% of total exports while imports accounted for 13.5% of total imports (Table 5). In 1995 the EUROPE AGREEMENT establishing an association between the European Communities and their Member States on one side, and the Republic of Latvia on the other side, was signed and in the same year Latvia made a formal application for accession to the EU. However, it was not until 1998 that the first meeting of the Latvia-EU Association Council (established by the Latvia - EU Association Agreement) took place in Brussels. By 1998, exports to Germany had reached 15.6% of total exports while imports accounted for 16.8% of total imports (Table 5). In the same year Germany became Latvia's main trading partner for the first time since regaining of independence.

On 1 May 2004, Latvia acceded to the EU and whilst there is a subsequent increase in both exports to and imports from Germany, Germany is no longer Latvia's main export partner. In 2008, Germany was Latvia's second main import partner (after Lithuania) despite a slight decrease in imports from the all-time high of 2007 (Table 5).

Table 5 Latvia's Trade with Germany 1992-2008

Year	Exports (1000 lats)	Exports % of total exports	Imports (1000 lats)	Imports % of total imports
1992	45492	7.9	81176	15.0
1993	44548	6.6	63679	10.0
1994	58271	10.5	94011	13.5
1995	93662	13.6	147825	15.4
1996	109575	13.8	176880	13.8
1997	133793	13.8	253201	16.0
1998	166822	15.6	315547	16.8
1999	169984	16.9	261297	15.2
2000	194288	17.2	302601	15.6
2001	209501	16.7	374863	17.0
2002	218269	15.5	429459	17.2
2003	245313	14.9	479788	16.1
2004	267472	12.4	546483	14.4
2005	294500	10.2	679011	14.0
2006	331554	10.2	954297	15.2
2007	353068	8.7	1180607	15.2
2008	354176	8.1	962882	12.9
	Average of total exports, 1992-2008	12.5 %	Average of total imports, 1992-2008	14.9 %

Source: Latvijas statistikas gadagrāmata [Latvian Statistical Yearbook] 1993-2006., Rīga: LR Centrālā statistikas pārvalde, Latvijas statistikas ikmēneša biļetens (2007) [Monthly Bulletin of Latvian Statistics] #1, 2007, Rīga: Latvijas Republikas Centrālā statistikas pārvalde and Latvijas statistikas ikmēneša biļetens (2009) [Monthly Bulletin of Latvian Statistics] #1, 2009, Rīga: Latvijas Republikas Centrālā statistikas pārvalde

In 2008, Latvia's main exports to Germany were wood and articles of wood (22.3%), base metals and articles of base metals (17.4%), transport vehicles (10.8%), agricultural products (7%), machinery and mechanical appliances; electrical equipment (6.8%) and live animals and animal products (6.3%). Main imports from Germany in 2008 were transport vehicles (30.4%), machinery and mechanical appliances; electrical equipment (24.1%), products of the chemical and allied industries (8.9%), base metals and articles of base metals (7%) and plastics, rubber and articles thereof (5.3%).

3.1.2 Trade with Russia

The Russian Federation formally recognised the restored independence of Latvia on 24 August 1991 and diplomatic relations were renewed on 4 October of the same year. Latvia's trade relations with Russia up to Latvia's accession to the EU were based upon the Agreement regarding Basic Principles of Trade-related Economic Relations between the Republic of Latvia and the Russian Federation signed on 1 June 1993. Although Russia never ratified this agreement, the article, which contained the mutual granting of most-favoured-nation treatment, was deemed by both parties to be provisionally in force from 2 June 1993. On 1 May 2004, the Agreement was formally denounced by Latvia, which had ratified it in 1993.

Up to 2004, Latvia's trade with Russia can be divided into two main periods of six years: from 1992 to 1998 and from 1998 to 2004. As noted earlier, in 1991 over 88% of Latvia's foreign trade was with the countries of the former Soviet Union, and in 1992 exports to Russia accounted for 26% of total exports while imports amounted to 27.9% of total imports (Table 6). By 1997, exports to Russia had fallen to 21% and imports from Russia to 15.6% of total imports. Nevertheless, Russia was still Latvia's main trading partner in 1998.

Table 6 Latvia's Trade with Russia 1992-2008

	Exports		Imports	
Year	(1000 lats)	% of total exports	(1000 lats)	% of total imports
1992	148737	26.0	150825	27.9
1993	200105	29.6	181941	28.5
1994	155719	28.1	164178	23.6
1995	174386	25.3	208335	21.7
1996	181603	22.8	258416	20.2
1997	203587	21.0	246946	15.6
1998	129007	12.1	221290	11.8
1999	66412	6.6	180971	10.5
2000	47266	4.2	224459	11.6
2001	73506	5.9	202152	9.2
2002	82546	5.9	218750	8.8
2003	88797	5.4	260718	8.7
2004	137467	6.4	332034	8.7
2005	228336	7.9	413802	8.5
2006	291923	9.0	499063	8.0
2007	386181	9,6	653491	8,4
2008	442171	10,1	801271	10,7
	Average of total exports, 1992-2008	13.9 %	Average of total imports, 1992-2008	14.3 %

Source: Latvijas statistikas gadagrāmata [Latvian Statistical Yearbook] 1993-2006., Rīga: LR Centrālā statistikas pārvalde, Latvijas statistikas ikmēneša biļetens (2007) [Monthly Bulletin of Latvian Statistics] #1, 2007, Rīga: Latvijas Republikas Centrālā statistikas pārvalde and Latvijas statistikas ikmēneša biļetens (2009) [Monthly Bulletin of Latvian Statistics] #1, 2009, Rīga: Latvijas Republikas Centrālā statistikas pārvalde

The turning point came with the economic and financial crisis in Russia in 1998.[9] The devaluation of the rouble meant that the price of Latvian goods in Russian roubles doubled overnight and the amount of exports to Russia was almost halved from 21% in 1997 to 12.1% in 1998 and to 6.6% of total exports in 1999 (Table 6). Imports were not as affected as exports

[9] For an overview of the effects of the Russian crisis on the Baltic States including Latvia, see Taro (1999).

but nevertheless fell from 15.6% in 1997 to 11.8% in 1998 and of 2to 10.5% in 1999 (Table 6). Russia had lost its leading position in over-all Latvian trade and by 2008 was fourth in terms of exports (10.1%) and third in terms of imports (10.7%). Nevertheless, Russia is still Latvia's largest non-EU trade partner.

Since Latvia's accession to the EU in 2004, Latvia's trade relations with Russia have been regulated by the EU Partnership and Cooperation Agreement (PCA) of 1997 that grants Russia the Most Favoured Nation Status. The Agreement was extended to the new member states including Latvia by a Protocol on 27 April 2004 and ratified by Russia on 22 October 2004.

The EU and the Russian Federation are currently negotiating a new agreement to provide for the contractual framework for EU-Russia relations in the years to come, replacing the 10-year old PCA. This new legally binding agreement will provide a comprehensive framework for bilateral relations. A mandate for these negotiations was agreed in May 2008 and the negotiations were launched on 4 July 2008.

As can be seen from Table 6, since 2004 Latvia's trade with Russia increased substantially.[10] In 2008, Latvia's main exports to Russia were machinery and mechanical appliances; electrical equipment (21%), prepared foodstuffs (19.7%), products of the chemical and allied industries (14.1%), base metals and articles of base metals (9%), transport vehicles (6.8%) and textiles and textile articles (5.4%) and. Main imports from Russia in 2008 were mineral products (50.1%), base metals and articles of base metals (23.9%), wood and articles of wood (6.5%), products of the chemical and allied industries (5.1%) and prepared foodstuffs (3.2%).

On 3 October 2006, the Latvian cabinet approved a regulation developed by the Ministry of Economics "On the Agreement between the Government of the Republic of Latvia and the Russian Federation regarding Economic Co-operation". The Agreement provides fostering the development and strengthening of economic relations between the Republic of Latvia and the Russian Federation based on the principles of equality and mutual benefit. The Agreement on Economic Co-operation between the governments of Latvia and Russia had been co-ordinated and initialled during a meeting of experts in Moscow on 19-20 June 2006. The Agreement will be the most important umbrella agreement regulating the bilateral economic co-operation between Latvia and Russia. The Agreement came into force on 16 Nov 2006.

There is also active co-operation with the regions of the Russian Federation. On 9 April 2008, the Ministry of Economics concluded an agreement on economic co-operation with the government of Vologda Oblast (Russian Federation), and there has also been negotiations with the governments of the Russian Federation, Ivanovo and Yaroslavl Oblast, the administration of Pskov Oblast and the government of Bashkortostan Republic regarding the conclusion of agreements in the field of economic co-operation.

[10] Studies utilising the Gravity Model have shown that, despite political rhetoric, merchandise trade between Latvia and Russia is within normal bounds and there is no „missing trade" (see Dombrovsky and Vanags (2006), pp. 104-105.

3.2 German and Russian investment in Latvia 1992-2008

Latvia introduced a legal framework for FDI a few months after regaining independence in 1991 [Shen (1994)]. In November 1991, a foreign investment act was passed permitting joint ventures in the form of either public or private limited companies. Since 1991, the level of foreign investment into Latvia has increased significantly. The rapid privatisation of former state-owned undertakings during the 1990s was a significant factor behind the inflow of foreign investment. Privatisation started soon after regaining of independence and is now essentially complete except for large transactions in infrastructure, especially the energy sector.

With Latvia's accession to the EU, the volume of the FDI inflow increased considerably. During the two years after the accession, foreign entrepreneurs invested in Latvia in the form of direct investment almost as much as in the period from 1999 to 2003.

Table 7 Foreign Investment Stock of Germany and Russia in the Company Capital of Latvian Undertakings (as at 31 December) 1992-2008

	Germany		Russia	
Year	(1000 lats)	% of total investments	(1000 lats)	% of total investments
1992	596	2.6	2102	9.3
1993	3663	7.3	5392	10.7
1994	12002	6.9	10289	5.9
1995	16370	6.0	51281	18.7
1996	17791	4.7	50758	13.4
1997	48422	8.8	52665	9.5
1998	56663	8.6	56955	8.6
1999	65475	8.8	56380	7.6
2000	105859	12.7	60594	7.3
2001	134822	12.6	64983	6.1
2002	128937	11.0	66914	5.7
2003	126337	9.9	80937	6.4
2004	129975	10.1	86345	6.7
2005	90031	6.5	95008	6.9
2006	121056	6.9	90971	5.2
2007	87519	3.8	108021	4,7
2008	90254	3.6	141003	5,6
	Average of total investments 1992-2008	7.7 %	Average of total investments 1992-2008	8.1 %

Source: Investīcijas Latvijā. Ceturkšņa biļetens. [Investment in Latvia. Quarterly Bulletin] #4/1997, #4(24)/2001, #4(32)/2003, #4(40)/2005, Latvijas statistikas ikmēnēša biļetens [Monthly Bulletin of Latvian Statistics] 2007/4 and Latvijas statistikas ikmēnēša biļetens [Monthly Bulletin of Latvian Statistics] 2009/4.

3.2.1 German investment

Bevan and Estrin (2000) found that FDI flows to Central and Eastern Europe from Germany were significantly larger than expected on the basis of labour costs, market size, and credit ratings alone. Although this could be expected given Germany's geographical proximity to these countries, once the study controlled for this 'neighbourhood effect', Germany was still found to send a disproportionately large amount of FDI to CEE [Bevan and Estrin (2000), p.17-19]. The study also found that traditions, languages and institutions of the Baltic States are linked to the Baltic basin and "though they are geographically distant from most potential investors, they are psychologically much closer, and this greatly reduces the cost of undertaking operations" [Bevan and Estrin (2000), p.10].

Typically investing countries are also important trading partners – thus Germany, with just over 8% of Latvia's exports and 13% of imports in 2008 (Table 5), is one of Latvia's biggest trading partners, as well as the fourth biggest source country for FDI. Germany's share of FDI stock was 10% of the EU Member States in 2008. The main sectors of German investment are banking, energy, insurance, real estate and manufacturing. In 2008 some 33% of German investments in Latvia were in real estate.

Interestingly, Latvian investments in Germany rose dramatically from 1.4 million LVL in 2007 to 24.6 million LVL in 2008 of which some 89% was in real estate.

3.2.2 Russian investment

Apart from being an important export market for goods and services produced in Latvia, Russia is also a major foreign investor in the Latvian economy. It ranks as the 8th largest investor in terms of the stock of foreign direct investment (FDI) in 2008.

The amount of Russian investment has increased since Latvia's accession to the European Union in 2004, possibly reflecting the desire of Russian companies to establish a foothold in the European economic area. A large part of Russian FDI (25.8%) went to the energy sector. Russia's energy giant, *Gazprom*, is one of the major shareholders in *Latvijas Gaze*, the Latvian gas monopoly. Overall, Russian FDI is very concentrated in just a few sectors. In 2008, 72.3% of the capital is invested in the sectors of energy, transport (pipelines), and banking.

Latvian investments in Russia have steadily increased over the last years; from 2.7 million LVL in 2000 to 44.4 million LVL in 2008; the main sector for investing are the wholesale and retail trade sector.

4. Past and present

The above analysis shows many similarities and differences between the two periods.

In terms of trade, Germany is no longer a dominant partner in the period after 1992. Average exports have fallen from 28.7% of total exports in the interwar period to 12.5% now. Similarly, average imports have fallen from 36.6% to 14.9%. The structure of trade has also changed. Although wood and wood products continue to be Latvia's main export to Germany, agricultural products no longer have the same role they had in the interwar period. Manufactured goods now dominate exports to Germany. In terms of imports, the structure of trade has remained more or less the same in both periods – chiefly manufactured goods.

Table 8 Largest Undertakings in Latvia with German Capital

Investor	**Latvian undertaking**	**Sector**
Norddeutsche Landesbank Girozentrale	A/S „DnB NORD Banka”	Banking
RUHRGAS AG	A/S „Latvijas Gāze”	Energy
P-D Glasseiden GmbH Oschatz		
	A/S VALMIERAS STIKLA ŠĶIEDRA	Manufacturing
	SIA "P-D-P Fiberglas Consulting"	
VEREINS-UND WESTBANK A.G.	HVB Bank Latvia	Banking
CE-Beteiligungs-GmbH SIA	SIA "LIDL LATVIJA"	Real estate
ERGO International Aktiengesellschaft		
	Apdrošināšanas A/S "ERGO Latvija"	Insurance
	Apdrošināšanas A/S "ERGO Latvija dzīvība"	Insurance
Fishfriends Corp.S.A	A/S "Rīgas Transporta flote"	Transport
Knauf International GmbH	SIA "KNAUF"	Manufacturing
RETTENMEIER INTERNATIONAL GmbH	SIA "Rettenmeier Baltic Timber"	Forestry
SIA Handels GmbH	SIA "Impress Metal Packaging"	Manufacturing
Buchel & Co	SIA "BALTIK-VITTKOP"	Manufacturing
BALTIKA Holzindustrie GmbH		
	SIA "LAMEKO IMPEX"	Wholesale trade
	SIA "LAMEKO INTERNATIONAL"	Wholesale trade
Martin Ziegler GmbH & Co. KG Martin Ziegler GmbH & Co. KG	SIA "ZIEGLERA MAŠĪNBŪVE"	Engineering
Strenge Heinrihs	SIA "FLORABALT	Peat extraction

Source: Lursoft

Table 9 Largest Undertakings in Latvia with Russian Capital

Investor	Latvian undertaking	Sector
TRANSŅEFTEPRODUKT AO	SIA "LatRosTrans"	Oil pipelines
GAZPROM	A/S „Latvijas Gāze”	Energy
Boiko Oļegs	SIA "FINSTAR BALTIC INVESTMENTS"	Holding company
	AS "BALTIC TRUST BANK"	Banking
	SIA "X1"	
Moskovskij Delovoj Mir.	A/S "Latvijas tirdzniecības banka"	Banking
Maskavas municipālā banka-Maskavas Banka	A/S "Latvijas Biznesa banka"	Banking
Krupnik Igor	LSEZ SIA "KOLUMBIJA LTD"	Wholesale trade
	LSEZ SIA "PK INVEST"	Fish canning
	SIA "ROŅU 6"	Fish canning
	SIA "HOUSE INVEST"	
Jelfimovs Mihails	SIA "Mežaragi"	Construction
	SIA "URALCOM"	
Prokofiev Vadim	BORNHOLM PROPERTY DEVELOPMENT SIA	
	LSEZ SIA "PK INVEST"	Fish canning
	SIA "ROŅU 6"	Fish canning

Source: Lursoft

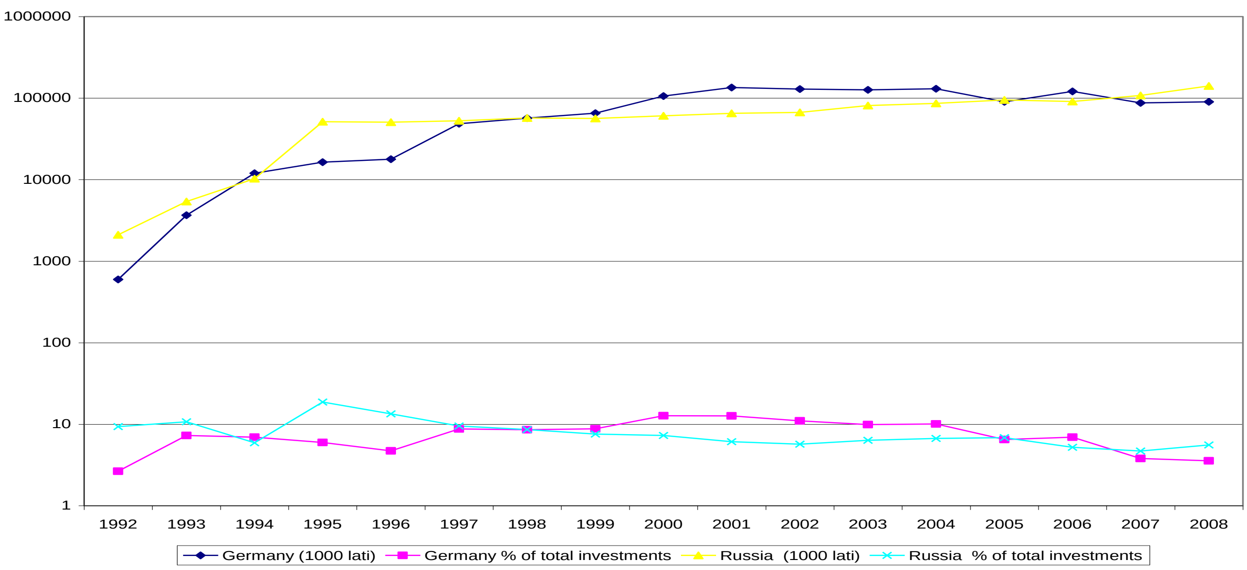
The most dramatic change has happened in trade with Russia. Average exports have risen from an average of 7% of total Latvian exports in the interwar period to 13.9% now. Similarly, imports have risen from an average of 5.2% to 14.3%. The interwar period contained the anomaly of the 1927 Trade Agreement which inflates the average percentage. As far as the development within the period after 1992 is concerned, Latvia has managed to disengage its trade with Russia to a remarkable degree. In the beginning of this period trade with Russia were very intensive due to the fact of fifty years of Soviet occupation. Exports to Russia fall from 25.8% in 1992 to 10.1% in 2008. Imports also fall from 27.8% to 10.7%. The dependence upon the Russian market in the early 1990s inflates the average percentage for the period as a whole. The structure of trade has remained remarkably similar for both periods, both in exports and imports. Agricultural products play a less important role now than in the interwar period, although Russia is an important market for processed food products from Latvia.

The last point is that the balance of trade for Latvia has always been negative in both periods, i.e., Latvia has always imported more from Germany and Russia than it has exported to them.

As far as investment is concerned the biggest change is the large increase in investments from Russia and the decrease of the percentage of German investments compared to the interwar period. The result is that in the period 1993-2008 German and Russian investments in Latvia account for practically identical values (Fig. 1). Also the structure of investments since 1991 has been similar with banking and energy resources being the main areas of investment.

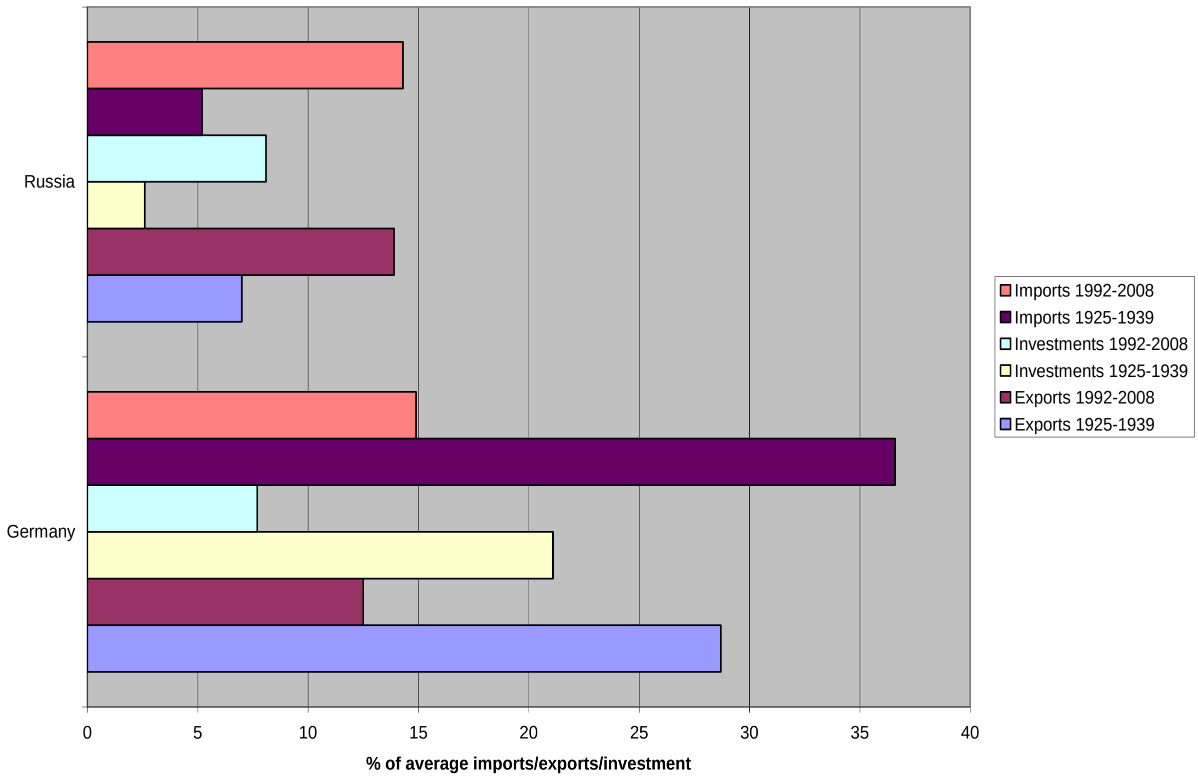
As far as the relationship between FDI and trade is concerned, the ratio of Latvian trade to foreign investment stock of Germany and Russia is similar in both periods (Fig. 2). That is, imports from or exports to these states far exceeds investments. In the case of Germany for both periods, it would appear that investments in Latvia were accompanied by an increase in imports from Germany, rather than an increase in exports to Germany. This would suggest that the investments stimulated an increase in demand for imports from the investing country based on the economic growth stimulus of investments to the economy in general.

Figure 1: German and Russian investment in Latvia 1992-2008 (logarithmic scale)[11]



[11] Conversion to logarithmic scale evens out the effects of price inflation.

Figure 2: Trade and Investment in Latvia according to Origin, German and Russian Share of total Latvian Imports/Exports and Investments Received 1925-1939 and 1992-2008



In the case of Russia, the negligible investments during the interwar period suggest that the increase in trade was due to factors other than investment (e.g. the 1927 Treaty). In the period after 1992, however, a pattern similar to that of Germany has emerged.

Thus, in general it would appear that for the interwar period and in the period after 1992 foreign investment inflows and imports from Germany and Russia mainly were complements rather than substitutes for each other.

With the slowing down of the Latvian economy in late 2007 and the onset of the world-wide economic crisis in late 2008 it is clear that both trade and investments from Germany and Russia have been affected. It is still too early to predict the degree to which the current crisis in the Latvian economy will have a lasting effect on trade and investments from Germany and Russia. In January–May 2009, Latvian exports and imports decreased in all the groups of goods, although a breakdown by country is not yet available.[12] Similarly, foreign direct investment flows in the current Latvian economic situation have decreased.[13]

[12] Exports decreased by 27.7% and imports by 39.9% compared to the corresponding period of the previous year (*Economic Devlopment of Latvia Report*, June 2009, pp. 19-21)
[13] *Economic Devlopment of Latvia Report*, June 2009, pp. 58-61

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