

SM/06/319
Correction 1

September 22, 2006

To: Members of the Executive Board
From: The Secretary
Subject: **Republic of Latvia—Selected Issues**

The attached correction to SM/06/319 (9/20/06) has been provided by the staff:

Factual Errors not Affecting the Presentation of Staff's Analysis or Views

Page 28, chapter II title: footnote inserted to read "Prepared by Allan Brunner."
Subsequent footnotes renumbered.

Questions may be referred to Ms. van Elkan, EUR (ext. 34763).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

- , 2005b, “A Global Perspective on External Positions,” IMF Working Paper 05/161 (Washington: International Monetary Fund).
- , 2006, “Capital Flows to Central and Eastern Europe,” IMF Working Paper 06/188 (Washington: International Monetary Fund).
- Lima, Juan Manuel, Enrique Montes, Carlos Varela, and Johannes Wiegand, 2005, “Sectoral Balance Sheet Mismatches and Macroeconomic Vulnerabilities in Colombia, 1996-2003,” IMF Working Paper 06/05 (Washington: International Monetary Fund).
- Luna, Francesco, 2005a, “A Balance Sheet Approach to Macro prudential Vulnerabilities in Latvia,” *Republic of Latvia: Selected Issues*, IMF Country Report 05/277 (Washington: International Monetary Fund).
- , 2005b, “Preliminary Results on Latvia’s export composition via-a-visa NMS8,” Unpublished mimeo (Washington: International Monetary Fund).
- Peneder, Michael, 1999, “Intangible Investment and Human Resources: The New WIFO Taxonomy of Manufacturing Industry,” WIFO Working Papers No. 114 (Vienna: Austrian Institute of Economic Research).
- , 2001, *Entrepreneurial Competition and Industrial Location* (Cheltenham, UK.: Edward Elgar).
- Rosenberg, Christoph, Ioannis Halilias, Brett House, Christian Keller, Jens Nystedt, Alexander Pitt, and Brad Setser, 2005, *Debt-Related Vulnerabilities and Financial Crisis*, IMF Occasional Paper 240 (Washington: International Monetary Fund).

II. LABOR OUTFLOWS, CAPITAL INFLOWS AND INCOME CONVERGENCE IN LATVIA¹²

A. Introduction and Overview

1. **Latvia, along with many other emerging market economies, is concerned with the economic and social consequences emigration.** This paper addresses the causes and implications of labor emigration in the context of a converging economy with a much lower capital-to-labor ratio than its EU partners.

- Section B examines the extent of Latvian emigration and compares Latvia's experience to two historical episodes of migration—the so-called age of mass migration during 1870-1910 and the migration that accompanied the reunification of Germany starting in 1989.
- Section C briefly summarizes macroeconomic growth and economic geography theories which view migration as a natural part of economic convergence. They suggest a number of possible outcomes, ranging from orderly convergence to permanent divergence. Unfortunately, economic theory is not yet mature enough to put forward specific policy advice, but it does offer an analytical approach for evaluating developments in Latvia, as well as other emerging economies.
- Using this analytical approach section D takes a look at recent trends in economic convergence (labor and capital flows) in Latvia and compares this experience to several current and historical episodes of convergence. The performance is mixed: While Latvia appears to be heading in the right direction, these trends must be interpreted very cautiously, especially since available data ends just as Latvia joined the EU in 2004. With open borders with the UK, Ireland, and Sweden and possibly open borders with other EU members in the near future, both capital and labor flows might look very different in a few years' time.
- Section E reviews the economic and social consequences of outward migration. While the impact of emigration is poorly understood and there are no easy answers for mitigating its economic impact, there are several factors that should be considered in formulating a long-term immigration policy.
- Finally, section F offers some short- and longer-term policy options for coping with labor outflows.

¹² Prepared by Allan Brunner.