BANKERS PUSH THE 'LATVIAN' OPTION

By Michael Hudson and Jeffrey Sommers

Despite Latvia being hailed by bankers as a shining example of how to pay off debts, the true picture is far from rosy; Latvia provides no magic solution for indebted economies.

The "Latvian option" is the buzzword of the moment among European bankers and financial journalists. In October, the Latvian people voted in a coalition headed by the incumbent prime minister Valdis Dombrovskis, whose government had savaged social benefits, cut pay and inflated unemployment in 2009. Was this proof that austerity measures could not only work, but actually be popular? Was Latvia the model that Greece, Ireland and Spain should emulate?

The Wall Street Journal, for one, has published several articles promoting this view. Most recently, Charles Doxbury advocated Latvia's internal devaluation and austerity strategy as the model for Europe's crisis nations to follow. The view commonly argued is that Latvia's economic freefall (the deepest of any nation from the 2008 crisis) has finally stopped and that recovery (albeit very fragile and modest) is under way.

What does Latvia's election result mean?

On politics, the standard narrative (as rolled out in the Economist recently) is that Latvia's taciturn and honest prime minister, Valdis Dombrovskis, won re-election in October even after imposing the harshest tax and austerity policies ever adopted during peacetime, because the "mature" electorate realised this was necessary, "defying conventional wisdom" by voting in an austerity government.

The problem with this interpretation is that the election was not a referendum on economic policy, but a contest primarily driven by ethnic considerations and the desire to punish a select group of oligarchs. Bankers, the financial press, and Latvia's Central Bank, however, would like to portray Latvia's October election as a vindication for austerity policies. Bankers want to get paid. The financial press pines for a return of the fairytale that markets self-correct and austerity brings prosperity. Latvia's Central Bank, about which even the IMF has expressed concern over the stridency of its neoliberal radicalism, wishes to run a victory lap, thus absolving itself for policies that imposed massive suffering on Latvia's people.

Despite these ringing endorsements for Latvia's austerity policies, they are not replicable. First, Latvia has no labour movement to speak of, thus little possibility of mobilising people against austerity. Indeed, there is little tradition of activism based on anything other than ethnicity. Therefore, countries with labour movements and traditions of activism on economic issues can expect very different results. Latvia's election turned on ethnic issues, as its politics have since 1991. Indeed, the election results were not a referendum on economic policy, but on ethnicity. Ethnic Latvians (the majority) voted for the ethnic Latvian parties (mostly neoliberal), while the sizeable 30% minority of Russian speakers voted with similar discipline for their party, Harmony Centre (loosely Keynesian). Three days before the election a spate of stories were released suggesting Kremlin ties to Latvia's ethnic Russian-dominated party that opposed austerity measures. These reports may, or may not, eventually be confirmed; however, released right before the election they moved many ethnic Latvians who were on the fence regarding who to vote for away from Harmony Centre.

Twenty years after independence, the consequences of Russian emigration to Latvia under Soviet occupation still shape voting patterns. Unless other economies can draw upon similar ethnic division as a distractive cover, political leaders pursuing Latvian-style austerity policies are doomed to electoral defeat.

Depopulation

While the economic crisis was deep enough to drive even Latvia's depoliticised population into the streets in the winter of 2009, most Latvians soon found the path of least resistance to be simply to emigrate. Neoliberal austerity has created demographic losses exceeding Stalin's deportations back in the 1940s (although without the latter's loss of life). As government cutbacks in education, healthcare and other basic social infrastructure threaten to undercut long-term development, young people are emigrating to better their lives rather than suffer in an economy without jobs. More than 12% of the overall population (and a much larger percentage of its labour force) now works abroad.

Children (what few of them there are as marriage and birth rates drop) have been left orphaned behind, prompting demographers to wonder how this small country can survive. So unless other debt-strapped European economies with populations far exceeding Latvia's 2.3 million people can find foreign labour markets to accept their workers unemployed under the new financial austerity, this exit option will not be available.

Austerity Medicine

So what about the much-quoted 3.3% growth rate? Projected for 2011, it is often cited as evidence that Latvia's austerity model has stabilised its bad-debt crisis and the chronic trade deficit that was financed by foreign-currency mortgage loans. But the real question to ask is whether 3.3% is really enough. Given a 25% fall in GDP during the crisis, such a growth rate would take a decade to just restore the size of Latvia's 2007 economy. Is this "dead cat" bounce sufficiently compelling for other EU states to follow it over the fiscal cliff?

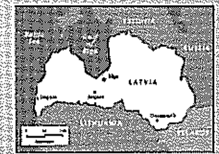
The method by which the EU's creditor nations and banks would like to resolve this crisis is "internal devaluation": lower wages, public spending and living standards to make the debtors pay. This is the old IMF austerity doctrine that failed in the developing world. It looks like it is about to be reprised. The EU policy seems to be for wage earners and pension savers to bail out banks for their legacy of bad mortgages and other loans that cannot be paid – except by going into poverty.

So do Greece, Ireland and perhaps Spain and Portugal understand just what they are being asked to emulate? How much "Latvian medicine" will these countries take? If their economies shrink and employment plunges, where will their labour emigrate?

Apart from the misery and human tragedy that will multiply in its wake, fiscal and wage austerity is economically self-destructive. It will create a downward demand spiral pulling the EU as a whole into recession. What is needed is a reset button on the EU's economic and fiscal philosophy. Bank lending inflated its real estate bubbles and financed a transfer of property, but not much new tangible capital formation to enable debtor economies to pay for their imports.

How Europe handles this crisis may determine whether its history follows the peaceful path of mutual gain and prosperity that economics textbooks envision, or the downward spiral of austerity that has made IMF planners so unpopular in debtor economies.

LATVIA - Australia Without Minerals?



By Terry and Debbie Dwyer

When we visited Latvia with Professors Michael Hudson, Jeff Sommers, Dirk Bezemer and Ted Gwartney et al, several things struck us.

The first was the extent of the passivity of the population in the face of a catastrophic collapse in employment and living standards - 20% unemployment, wage cuts of 30-60%, people servicing debts in euros on properties which had declined in value by 70% on the purchase price.

Latvia has undertaken a programme of austerity beyond anything the IMF had sought to impose. Half the schools and hospitals in the country were closed and infant and maternal mortality rates increased. Latvia had borrowed very heavily to maintain parity between the national currency (the Lat) and the Euro, in hopes of joining the economic union. Lativa has put off joining the Eurozone until 2014 and its harsh austerity programme is aimed at keeping its lending banks as well as the European Union on side, despite the extreme hardships faced by the majority of Latvians. In effect, Latvia was imposing austerity on its people to pay off the foreign banks which the IMF admitted were responsible for the land speculation bubble and subsequent collapse.

Another astonishing thing was that it seemed many of the loans, being made in a foreign currency and without warnings to consumers required under Latvian consumer law were potentially unenforceable. Yet Latvians prefer not to litigate and the authorities, it seems, are more concerned with ensuring the solvency of banks rather than Latvian consumers, some of whom are emigrating to declare bankruptcy in the UK or elsewhere.

Latvia is a case study in economic collapse. The average tax rate on labour income was around 51% with a marginal tax rate around 56%. People were emigrating at the rate 30,000 per annum from a population of some 2 million. In other words, in 10 years Latvia will lose 300,000 mainly young workers, from a workforce of 1 million or so. Combined with a collapsing birth rate as young people cannot afford to raise families, this amounts to a demographic and economic death spiral.

The cold truth is that Latvia is a precursor to the fiscal implosion of the European welfare states as bankrupt governments try to pay unfunded social security and other liabilities. Latvia will never repay its debts. It cannot and will not. All that is happening is that debts are being repaid to foreign banks by the government pledging its credit on the basis of taxes to be levied on supposed future – but, in reality, non-existent – generations of workers.

Unless Europeans learn to tax their land values and shift their tax systems off labour by cutting VAT, PAYE and social security taxes, all European States will go the way of Latvia.

The lesson for Australia is clear. You cannot have a continuing welfare state built of taxes for future workers you won't have. Australia's good luck has been to have a wonderful natural resource endowment which has meant that our tax receipts have held up, along with a relatively young (though ageing) population.

The danger for Australia is that if we do not do as the Henry Tax Review indicated and learn to tax land and mineral rents we, too, in 30 years will go the way of Latvia.