Latvia In Crisis as Thatcher Free Market Model Collapses

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The global financial and economic crisis has hit the small Baltic country Latvia harder than any single country with the possible exception of Iceland. As part of its attempt to join the European Monetary Union the country has fixed its currency the Lats to the Euro. The result has been to make a bad situation catastrophic. How the situation develops will have direct bearing on the fate of many emerging countries of eastern Europe. It marks the death of the radical experiment with Thatcherism in eastern Europe.

On the surface the crisis the country is experiencing the result of a borrowing binge among consumers which got out of control and now must be reigned in by tough government austerity measures. In reality, it is a tale of greed of foreign bankers, a failed economic reform and a political system that is fixated on Euro entry as the Holy Grail for the economy.

Events in Latvia over the past two years signal the death of the radical neo/liberal Thatcher economic shock therapy imposed after the dissolution of the Soviet Union when the West, led by Washington, mandated that the IMF dictate terms of economic transformation for the former Soviet economies.

On the one side are western banks, above all Swedish banks which more of less colonized Latvia after 1990 as their 'sphere of influence.' They are allied with the IMF and the EU, though of late the latter two are themselves in a deep policy split.

On the other side is a growing grass roots popular protest which since January has led major marches against the government, and which has just elected to Parliament an ethnic Russian party for the first time since 1990, with ethnic Latvian support, as a signal of the depth of protest to the free–wheeling plunder era of the past two decades. Until the present crisis, Latvia was praised in western financial markets as the 'poster child' of free market success in the region. It was growth based on easy credit, a real estate bubble and consumer debt. The success was only for a tiny elite of bankers and local oligarchs as now is clear.

The IMF at war with the EU

At the moment all eyes are on what the IMF and the EU will do in terms of emergency financial support to the country. Much of the present crisis has to do with the Governments fixation on holding the currency peg to the euro rigid in hopes it will be able to enter the Euro zone in four years. The only ones that gain advantage from the currency peg are those with Lats-denominated paper assets. It makes little sense ultimately, because the deflation of the economy required to maintain the peg will result in the paper assets defaulting anyway, except for government paper.

As always the IMF is demanding savage austerity from the Government as precondition for its loan. To meet the demands the Government adopted a package of measures last month that include a huge wage and pension cuts.

An average Latvian earns around Euro 400 a month. Slashing wages results in more deflation as consumers buy even less and business bankruptcies climb. The IMF medicine is simple, but deflation something the US and EU countries are desperate to avoid at all costs. Eager to shift blame for the growing fiasco, IMF officials claim they demanded the savage austerity package on the urging of Latvia's neighbors.

According to informed EU banking sources, the EU and the IMF are in a bitter internal fight over Latvian aid terms. In December Latvia got a €7.5 billion emergency "stabilization" aid from an international group including the EU and the IMF, some 34% of total Latvia GDP.

The cost for Latvians has been more than Shylock's "pound of flesh." The donors demanded savage cuts in public sector wages of 20%, in pensions of 20% and 70% cuts for those pensioners still working.

These drastic fiscal cuts are being euphemistically termed "internal devaluation" by IMF technocrats. During the world Depression of the 1930's they were called what they are—wage and price deflation.

In Riga joining the Euro is regarded by the Government as the magic "cure all" for their problems. The examples of Slovenia, which joined the Eurozone in early 2007 and today has the worst economic crisis outside the Baltic in the EU, shows there is no magic in Eurozone membership.

Despite the fact the Parliament agreed in March to draconian budget cuts of $1 billion (€.7 billion) this year and each of the next three, the IMF has refused to release its €200 million loan tranche pending "review." Now breaking reports from Latvia are that the Government has just refused the IMF demand to cut pensions as pre-condition for receiving the €200 million rescue money.

The IMF according to Latvian sources familiar with the demands, is demanding higher real estate taxes in a country where real estate prices are in free fall. Swedbank, the largest lender in Latvia, just reported that fully 54% of all its mortgage loans in Latvia are "under water" meaning the value of the bank's loans outstanding is larger than the current market value of the houses that make up the collateral on the mortgage loans. Tendency: worsening real estate prices. Hardly an ideal climate to add new property taxes and force even more Latvians to default on home mortgages.

The demands of the EU for its release of €1.2 billion end of July are that the Government must use 50% of that to help the lending banks. And the Government had to impose €0.7 billion of cuts to get that €1.2 billion, a net "gain" of a paltry €500 million. But when costs of the Budget austerity and wage cuts on total economic growth are factored in, the "rescue" is actually an economic kiss of death for Latvia.

The behind-the-scenes battle between IMF and EU are clearly over the Latvian plans to join the Euro, something the Riga Government falsely believes will be its salvation. The EU is demanding Latvia retain a rigid peg to the Euro in the pre-Euro period to show its "discipline." It has declared it will keep the Lats in a narrow band of 1% plus-minus. However ERM rules allow an applicant to fluctuate 15% plus-minus. It is also desperate to force inflation down via deflationary budget cuts to hold to the EMS Euro Maastricht demands.

The IMF refusal to release its share of the rescue loan according to informed reports, is part of a Washington-backed effort to break the peg and thereby force other fixed-peg pre-Euro EU members—Estonia, Lithuania and Bulgaria—as well to devalue and forget the Euro dream. Former chief economist at the International Monetary Fund Ken Rogoff hinted as much when he recently stated in an interview that,"Latvia should devalue the Lats to avoid a worsening of its economic crisis. The IMF made the wrong decision when it allowed Latvia to keep its currency peg"

Economic disaster

Already the country is one of the worst hit in the EU by the two year old global crisis, and among emerging markets second only to Ukraine. Landmark property developments such as the twin Panorama Plaza towers on the road between Riga and the airport stand all but empty and shopping malls are ghost towns.

The Government debt is now 64% of GDP and official unemployment stands at 16%. In the first three months of this year GDP fell a dramatic 18%. By contrast, during the easy money lending binge in 2005-2007 the Latvian economy was booming at China-style growth rate of 10% a year, all on borrowed Euros.

Now that casino has closed, a victim of the global crisis. House prices fell by one-third last year, business insolvencies are up and banks are repossessing more mortgaged properties and leased cars. In Riga the average price of an apartment has dropped 68% since the crisis first began in August 2007.

The economy is in a free-fall. Latvian foreign trade is down year-on-year by 38%–no green shoot here. Exports are down year-year for January-May by 28% and imports by 40%. Industrial output is down year-on-year by 19%. Retail sales are down by 24%.

Much like Iceland, in Latvia 90 per cent of all loans are in a foreign currency, the euro.

The Government of Prime Minister Valdis Dombrovskis argues that devaluation could bankrupt tens of thousands of companies and individuals. But the price of avoiding devaluation by imposing the IMF's "internal devaluation" will now do the same if not worse, causing huge economic, social and political strains. Dombrovskis admits his main challenge now is "to preserve the social peace." That's an understatement.

If the Latvian Domino Falls…

At this point, with social unrest in Latvia erupting in mass political protests and unrest growing with each new austerity demand on the Government to maintain the Lats fixed peg to the Euro, it is almost certain that the Government will crack and be forced to devalue. At that point, depending on how rationally Brussels reacts—something rarely seen these days—the other dominos across eastern Europe will likely fall.

If a Latvian currency devaluation is orderly and systematic, it may, even at this late date, be a containable process. That would mean the EU Commission would have to admit the Maastricht Treaty conditions are not immutable fixed laws of the universe and to stop playing politics. In short, they need to adopt an exit strategy for Latvia.

That seems highly unlikely given EU demands so far. If Latvia is left to fester, and the country falls into a growing political anarchy, containment will be much more difficult and panic will likely set in. That will impact the plans of Lithuania and Estonia as well as Bulgaria.

For Bulgaria the problem is not one of sustaining the Euro peg, but of restoring competitiveness and economic growth, and this is much more difficult without a formal devaluation. If Bulgaria falls off the cliff trying to hold the peg, it will likely have seismic shock effects across most of South Eastern Europe.

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