The Coming European Debt Wars

EU Countries sinking into Depression

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Government debt in Greece is just the first in a series of European debt bombs that are set to explode. The mortgage debts in post-Soviet economies and Iceland are more explosive. Although these countries are not in the Eurozone, most of their debts are denominated in euros. Some 87% of Latvia's debts are in euros or other foreign currencies, and are owed mainly to Swedish banks, while Hungary and Romania owe euro-debts mainly to Austrian banks. So their government borrowing by non-euro members has been to support exchange rates to pay these private-sector debts to foreign banks, not to finance a domestic budget deficit as in Greece.

All these debts are unpayably high because most of these countries are running deepening trade deficits and are sinking into depression. Now that real estate prices are plunging, trade deficits are no longer financed by an inflow of foreign-currency mortgage lending and property buyouts. There is no visible means of support to stabilize currencies (e.g., healthy economies). For the past year these countries have supported their exchange rates by borrowing from the EU and IMF. The terms of this borrowing are politically unsustainable: sharp public sector budget cuts, higher tax rates on already over-taxed labor, and austerity plans that shrink economies and drive more labor to emigrate.

Bankers in Sweden and Austria, Germany and Britain are about to discover that extending credit to nations that can't (or won't) pay may be their problem, not that of their debtors. No one wants to accept the fact that debts that can't be paid, won't be. Someone must bear the cost as debts go into default or are written down, to be paid in sharply depreciated currencies, but many legal experts find debt agreements calling for repayment in euros unenforceable. Every sovereign nation has the right to legislate its own debt terms, and the coming currency re-alignments and debt write-downs will be much more than mere "haircuts."

There is no point in devaluing, unless "to excess" – that is, by enough to actually change trade and production patterns. That is why Franklin Roosevelt devalued the US dollar by 75% against gold in 1933, raising its official price from $20 to $35 an ounce. And to avoid raising the U.S. debt burden proportionally, he annulled the "gold clause" indexing payment of bank loans to the price of gold. This is where the political fight will occur today – over the payment of debt in currencies that are devalued.

Another byproduct of the Great Depression in the United States and Canada was to free mortgage debtors from personal liability, making it possible to recover from bankruptcy. Foreclosing banks can take possession of collateral real estate, but do not have any further claim on the mortgagees. This practice – grounded in common law – shows how North America has freed itself from the legacy of feudal-style creditor power and the debtors' prisons that made earlier European debt laws so harsh.

The question is, who will bear the loss? Keeping debts denominated in euros would bankrupt much local business and real estate. Conversely, re-denominating these debts in local depreciated currency will wipe out the capital of many euro-based banks. But these banks are foreigners, after all – and in the end, governments must represent their own home electorates. Foreign banks do not vote.

Foreign dollar holders have lost 29/30th of the gold value of their holdings since the United States stopped settling its balance-of-payments deficits in gold in 1971. They now receive less than a thirtieth of this, as the price has risen to $1,100 an ounce. If the world can take that, why shouldn't it take the coming European debt write-downs in stride?

There is growing recognition that the post-Soviet economies were structured from the start to benefit foreign interests, not local economies. For example, Latvian labor is taxed at over 50% (labor, employer, and social tax) – so high as to make it noncompetitive, while property taxes are less than 1%, providing an incentive toward rampant speculation. This skewed tax philosophy made the "Baltic Tigers" and central Europe prime loan markets for Swedish and Austrian banks, but their labor could not find well-paying work at home. Nothing like this (or their abysmal workplace protection laws) is found in the Western European, North American or Asian economies.

It seems unreasonable and unrealistic to expect that large sectors of the New European population can be made subject to salary garnishment throughout their lives, reducing them to a lifetime of debt peonage. Future relations between Old and New Europe will depend on the Eurozone's willingness to re-design the post-Soviet economies on more solvent lines – with more productive credit and a less rentier-biased tax system that promotes employment rather than asset-price inflation that drives labor to emigrate. In addition to currency realignments to deal with unaffordable debt, the indicated line of solution for these countries is a major shift of taxes off labor onto land, making them more like Western Europe. There is no just alternative. Otherwise, the age-old conflict-of-interest between creditors and debtors threatens to split Europe into opposing political camps, with Iceland the dress rehearsal.

Until this debt problem is resolved – and the only way to resolve it is to negotiate a debt write-off – European expansion (the absorption of New Europe into Old Europe) seems over. But the transition to this future solution will not be easy. Financial interests still wield dominant power over the EU, and will resist the inevitable. Gordon Brown already has shown his colors in his threats against Iceland to illegally and improperly use the IMF as a collection agent for debts that Iceland doesn't legally owe, and to blackball Icelandic membership in the EU.

Confronted with Mr. Brown's bullying – and that of Britain's Dutch poodles – 97% of Icelandic voters opposed the debt settlement that Britain and the Netherlands sought to force down the throat of Allthing members last month. This high a vote has not been seen in the world since the old Stalinist era.

It is only a foretaste. The choice that Europe ends up making will likely drive millions into the streets. Political and economic alliances will shift, currencies will crumble and governments will fall. The European Union and indeed, the international financial system will change in ways yet to be seen. This will be especially the case if nations adopt the Argentina model and refuse to make payment until steep discounts are made.

Paying in euros – for real estate and personal income streams in negative equity, where the debts exceed the current value of income flows available to pay mortgages or for that matter, personal debts – is impossible for nations that hope to maintain a modicum of civil society. "Austerity plans" IMF and EU style is an antiseptic, technocratic jargon for life-shortening and killing impact of gutting income, social services, spending on health on hospitals, education and other basic needs, and selling off public infrastructure for buyers to turn nations into "tollbooth economies" where everyone is obliged to pay access prices for roads, education, medical care and other costs of living and doing business that have long been subsidized by progressive taxation in North America and Western Europe.

The battle lines are being drawn regarding how private and public debts are to be repaid. For nations that balk at repayment in euros, the creditor nations have their "muscle" waiting in the wings: the credit rating agencies. At the first sign a nation is balking in paying in hard currency, or even at the first hint of it questioning a foreign debt as improper, the agencies will move in to reduce a nation's credit rating. This will increase the cost of borrowing and threaten to paralyze the economy by starving it for credit.

The most recent shot was fired n April 6 when Moody's downgraded Iceland's debt from stable to negative. "Moody's acknowledged that Iceland might still achieve a better deal in renewed negotiations, but said the current uncertainty was hurting the country's short-term economic and financial prospects."[1]

The fight is on. It should be an interesting decade.

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[1] THE ASSOCIATED PRESS, "Moody's Downgrades Iceland Outlook," *The New York Times*, April 7, 2010.