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# The Spectre Haunting Europe: Debt Defaults, Austerity, and Death of the "Social Europe" Model

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*A spectre is haunting Europe: the illusion that Latvia's financial and fiscal austerity is a model for other countries to emulate. Bankers and the financial press are asking governments from Greece to Ireland and now Spain as well: "Why can't you be like Latvia and sacrifice your economy to pay the debts that you ran up during the financial bubble?" The answer is, they can't – without an economic, demographic and political collapse that will only make matters worse.*

Only a year ago it was recognized that decades of neoliberalism had crashed the U.S. and several European economies. Years of deregulation, speculation and lack of investment in the real economy had left them with rising inequality and little consumer demand, except for what was financed by running up debt. But the financial press and neoliberal policymakers counterattacked, using the "Baltic Tigers" as an exemplary battering ram to counter Keynesian spending policies and the Social Europe model envisioned by Jacques Delors.

Analysts have viewed Latvia's October election results as vindication of the efficacy of austerity for solving the economic crisis. The standard narrative is that Latvia's Prime Minister won re-election even after imposing the harshest tax and austerity policies ever imposed during peacetime, because voters realized that this was necessary. On politics, the standard narrative (as recently rolled out in The Economist) 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 realized this was necessary, "defying conventional wisdom" by voting in an austerity government.

The Wall Street Journal 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.

This view appeals to bankers looking to prevent defaults on private and public debt, hoping that austerity can lead to economic recovery. But Latvia's model is not replicable. Latvia has no labor movement to speak of, and little tradition of activism based on anything other than ethnicity. Contrary to most press coverage, its austerity policies are not popular. The election turned on ethnic issues, not a referendum on economic policy. 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 (loosely Keynesian).

Twenty years from 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.

While the economic crisis was deep enough to drive even Latvia's depoliticized population into the streets in the winter of 2009, most Latvians soon after 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, health care and other basic social infrastructure threaten to undercut long-term development, young people are emigrating to better their life rather than to suffer in an economy without jobs. Over 12% of the overall population (and a much larger percentage of its labor force) now works abroad.

Moreover, 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 labor markets to accept their workers unemployed under the new financial austerity, this exit option will not be available.

Latvia's projected 3.3% growth rate for 2011 is cited as further evidence of success that its austerity model has stabilized its bad-debt crisis and chronic trade deficit that was financed by foreign-currency mortgage loans. Given a 25% fall in GDP over during the crisis, this 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?

Despite its disastrous economic and social results, Latvia's neoliberal trauma regardless is idealized by the financial press and neoliberal politicians seeking to impose austerity on their own economies. Before the global crisis of 2008, the "Baltic Tigers" were celebrated as the vanguard of New Europe's free market economies. Critics of this economic "miracle," built on foreign currency loans financing property speculation and privatization buyouts, were dismissed as naysayers. Without missing a beat, these commentators have branded the present Latvian option of austerity as policies for other nations to adopt.

The Latvian option serves several masters. The financial press pines for the fairytale that markets self-correct and austerity brings prosperity. Latvia's Central Bank (about which even the IMF has expressed concern over its neoliberal stridency) wishes to run a victory lap, absolving itself for policies that imposed massive suffering on Latvia's people. And Washington and EU neoliberals want other countries to adopt Latvia's version of China's colonial "Open Door" matched with a Dickensian welfare system. Openness to economic penetration is the standard on measure, and the Balts have this in spades, ergo, they are "successes," regardless of how well or bad their economy serves its people's needs.

Given the geographic proximity of Latvia and Belarus, it is illuminating to compare how neoliberals have assessed their respective economies. Latvia suffered Europe's largest economic collapse in 2008 and 2009, with continuing double-digit unemployment. Its economy will show no growth until this year (2011), and its modest growth likely will remain accompanied by double-digit unemployment. Much of its population has evacuated the country, leaving many children with relatives or to fend for themselves. Neighboring Belarus, with few of Latvia's geographic advantages (ports and beaches) or high-tech background, has a per capital GDP not too far behind Latvia's. Belarus had a boom with

double-digit growth before the crisis, and kept its economy at full employment during the crisis rather than collapsing by the 25 percent rate that plagued Latvia. Belarus also has a GINI coefficient (inequality) roughly on par with Sweden, while Latvia's is closer to the widening inequality levels that now characterize the United States.

Yet neoliberal Latvia is declared an economic success model and Belarus a failure. The CIA's World Factbook reminds its readers that Belarus's performance occurred "despite the roadblocks of a tough, centrally directed economy." This is the standard characterization of Belarus. But one needs to ask to what degree its success may reflect its central planning. Latvia has produced greater political freedom for dissidents, but Belarus has less economic inequality and foreign debt.

Every economy in history has been a mixed economy. We are not defending Comrade Lukashenko's media and political repression in Belarus. We simply are not going to the opposite extreme of applauding Latvia's neoliberal model. One can reject Belarus' political system without endorsing the electoral oligarchy that characterizes much of Latvia's political life. Yet win or lose on economic outcomes, Latvia and the Starving Baltic Tigers will be declared the winners, while Belarus always will be declared the loser on economic performance, regardless of achievement. You will not see a measured look at both nations' economies to examine objectively where they are succeeding and failing (including by sector) with an eye for what lessons might be derived from such an investigation. Economic comparisons are entirely political.

Our intention is not to blame the Latvian nation for the cruel neoliberal policy experiment to which it has been subjected, to question the global community of policymakers, intellectuals and some of Latvia's own elites that persist in pursuing this failed policy and even recommend it to other countries as a path of growth rather than economic and demographic suicide. Latvia's people have suffered from the ravages of two World Wars and two occupations, capped by neoliberalism dismantling its industry and driving it deeper and deeper into debt – indeed, foreign-currency debt – since it achieved independence in 1991. Neoliberalism has delivered poverty so deep as to cause in an exodus of Biblical proportions out of the country. To call this a forward economic step and a victory of economic reason reminds one of Tacitus' characterization of Rome's imperial military victories, put in the mouth of the Celtic chieftain Calgacus before the battle of Mons Graupius: "They make a desert and they call it peace."

In the several years that we both have been visiting Latvia we have seen an industrious and talented people, with many displaying integrity despite being immersed in a corrupt environment. Our aim here is to explain why the failed "Latvian model" should be seen as a warning for what other countries should avoid, not a policy to be imposed on hapless Ireland, Greece and other European debtor countries. In fact, we both have worked to encourage a policy reversal in Latvia itself. What now is at stake, after all, is the future of European social democracy and the continuation of peace in a region plagued by war for a millennium prior to the 1950s.

The problem is that Europe's economic difficulties are rooted not merely in profligacy, as the press and many politicians typically claim. Debt is a consequence of structural financial, economic and fiscal faults built into the design of post-Soviet Europe. In a nutshell, the European Union never developed sustainable mechanisms to transfer capital from its richest economies to poorer countries, especially on the periphery.

The Bretton Woods order after World War II was part of a more workable system for reconstruction lending and capital transfers between war-torn Europe and the United States. Marshall Plan aid, accompanied by capital controls and government investment to encourage economic development and monetary independence, enabled Western Europe's national economies to buy imports from the United States while building up their own export capacity and raising their living standards. The system was not without fault, but the desire to avoid the previous half-century cycle of economic depression and war (and mounting Cold War concerns) led Western Europe's economies to develop and pave the way for subsequent continental integration.

The post-Cold War period since 1991 reflects similar patterns of underdevelopment in the relationship between rich Western Europe and its poorer East and Southern European counterparts. In contrast what was done after World War II, sustainable structures were not put in place to make the latter economies self-sustaining. Just the opposite outcome was structured in: foreign currency debt, especially for domestic mortgage loans, without putting in place the means to pay it off.

Today, the wealthiest EU states are high-value added manufacturers. EU expansion twenty years ago was marked by rising exports and bank loans from these nations to what have become today's crisis economies – and by rising debt levels in the context of privatization sell-offs without progressive income taxation and with little property tax (a major factor in promoting local real estate bubbles). The Baltics and East European countries have financed their trade deficits over the past decade mainly by Swedish, Austrian and other banks lending against real estate and infrastructure being sold and resold with increasing debt leverage. This has not put in place the means to pay off these debts, except by a continued inflation of a real estate bubble to sustain enough foreign-currency borrowing to cover chronic trade deficits and capital flight.

The Baltic States have since brought their current account into line, not by producing more goods and services, but by impoverishing their people. Their neoliberal planners have slashed consumption – not to create capital for investment, but to pay down debts to bankers. This is how they are adjusting to the cessation of capital inflows from foreign banks now that real estate Bubble Lending has dried up (the Bubble Lending that was applauded for making their property markets "Baltic Tigers" to the banks getting rich off the process). Bankers and the financial press depict this austerity program to pay back banks as the way forward, not as sinking into the mire of debts owed to creditors that have not cared much about how the Baltic economies are to pay – except by shrinking, emigrating and squeezing labor yet more tightly.

The fiscal burden falls much more heavily on employment than it did in Western Europe sixty years ago during its period of reconstruction. Insider dealing and financial fraud was widespread. To cap matters, euro-denominated debt for associate members was secured by income in their own local currencies. Worst of all, banks simply lent against real estate and public infrastructure already in place instead of to increase production and tangible capital formation. In contrast to the Marshall Plan's government-to-government grants, the ECB's focus on commercial bank lending simply produced a real estate bubble. Bank lending inflated their 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. Just the opposite: Their debts rose without increasing foreign-exchange earning power. So it was inevitable that this house of cards would collapse.

In setting up the EU's economic relations, free-market trade theory assumed that direct investment and bank lending would provide the capital needed to help Europe's poorer regions catch up. This assumption turned out to be unwarranted. Banks lent against real estate and other assets already in place, inflating their prices on credit. It is the debt overhang and related aftermath of this narrow-minded economic philosophy that now needs to be cleaned up.
These arrangements served the major EU exporters but did not develop European-wide stability based on more extensive economic growth. Without the looming threat of war or political threat from Russia, Europe's richest nations pushed for trade liberalization and privatizations that accelerated de-industrialization in the former Soviet bloc. Southern European members were brought into the Eurozone with its strong currency and strict limits on government spending that failed to enable these countries to develop their manufactures in the way that Western Europe (and the United States) had done.

This state of affairs could only be temporary, because the East was reconstructed in a way that made it import-dependent and financially subordinate to the West, treated more as a colony than as a partner. And as in colonial regions, the West became a destiny for capital flight as property was sold on credit and the proceeds moved out of the post-Soviet and southern European kleptocracies and oligarchies. The foreign currency to pay banks on the loans that were bidding up real estate prices was obtained by borrowing yet more to inflate property prices yet more – the classic definition of a Ponzi scheme. In this case, European banks played the role of new entrants into the scheme, organizing the post-Soviet economies like a vast chain letter, providing the money to keep the upward-spiraling flow moving.

The problem was that credit only was extended to fuel real estate and to finance the exportation of goods from the industrial export dependent Western Europe (with its Common Agricultural Policy crop surpluses) a deindustrialized and agriculturally unmodernized East. The expanding debt pyramid had to collapse, as no means of paying it off were put in place.

There was a vague hope that levels of economic development eventually would equalize across the EU, as if bank lending and foreign buy-outs would lead to greater homogeneity rather than financial polarization. The problem was that the EU viewed its new members as markets for existing banks and exporters (including as dumping ground for its agricultural surpluses), not to help these new members become economically self-sustaining or set up viable national financial systems of their own.
Given the restrictions the euro places on its member countries, the path of least resistance EU's creditor nations and banks understandably 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 Third 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 and Ireland, and now perhaps Spain and Portugal as well, understand just what they are being asked to emulate? 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 plunging their economies into poverty. How much "Latvian medicine" can these countries take? If their economies shrink and employment plunges, where will their labor emigrate?

Without public investment, how can they become competitive? The traditional path is for mixed economies to provide public infrastructure at cost or at subsidized prices. But if governments "work their way out of debt" by selling off this infrastructure to buyers (on credit whose interest charges are tax-deductible) who erect rent-extracting tollbooths, these economies will fall further behind and be even less able to pay their debts. Arrears will mount up in an exponential compound interest curve.

The EU's creditor nations and banks are seeking to resolve the crisis in way that will not cost them much money. The best hope, it is argued, given the inability of the crisis countries to depreciate their currencies, is "internal devaluation" (wage austerity) on the Latvian model. Bankers and bondholders are to be paid out of EU/IMF bailout loans.

The problem is the austerity imposed by existing debt levels. If wages (and hence, prices) decline, the debt burden (already high by historical standards) will become even heavier. This is what the United States suffered in the late 19th century, when the price level was driven down to "restore" gold to its pre-Civil War (and hence, pre-greenback) price. Presidential candidate William Jennings Bryan decried crucifying labor on a cross of gold in 1896. It was the problem that England earlier experienced after the Treaty of Ghent ended the Napoleonic Wars in 1815. Aside from the misery and human tragedies 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.

The basic problem is whether it is desirable for economies to sacrifice their growth and impose depression – and lower living standards – to benefit creditors. Rarely in history has this been the case – except in a context of intensifying class warfare. So what will Latvians, Greeks, Irish, Spaniards and other Europeans do as their labor is crucified by "internal devaluation" to shift purchasing power to pay foreign creditors?

What is needed is a reset button on the EU's economic and fiscal philosophy. 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.
Is this the path that Europe will embark on? Is it the fate of the Jacques Delors' project of a Social Europe? Was it what Europe's citizens expected when they adopted the euro?

There is an alternative, of course. It is for creditors at the top of the economic pyramid to take a loss. That would restore the intensifying GINI income and wealth coefficients back to their lower levels of a decade or two ago. Failure to do this would lock in a new kind of international financial class extracting tribute much like Europe's Viking invaders did a thousand years ago in seizing its land and imposing tribute in the form of land. Today, they impose financial charges as a post-modern neoserfdom that threatens to return Europe to its pre-modern state.
3,350 words

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