Coming to a Country Near You: Let a dozen Latvias bloom?

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Want to see the real consequence of smash mouth economics? Forget about Greece and take a look at Latvia. Its 25.5 per cent plunge in GDP over just the past two years (almost 20 per cent in this past year alone) is already the worst two-year drop on record. The country recently reported a 12% decline in annual wages in Q4 2009 versus Q4 2008. The IMF projects another 4 percent drop this year, and predicts that the total loss of output from peak to bottom will reach 30 percent. The magnitude of this loss of output in Latvia is *more than that of the U.S. Great Depression downturn of 1929-1933*.

Policies and systems built for failure

Mainstream economics insists that one path to full employment is via lower wages. If you want to sell more labor services, lower the price of them, namely wages. This is a classic fallacy of composition argument. What might work for one firm is unlikely to work for all firms. Wage cuts in the aggregate simply destroy aggregate spending power, unless the lost demand is made up for in other ways.

But even though Latvia's external balance is improving (largely through a collapse of imports as a result of the collapse of domestic demand), the country is unable to deploy fiscal policy effectively due to the external constraints of its monetary system, which is predicated on the existence of a currency board system. True, the current account is now turning positive, but to suggest that every single country can "internally deflate" its economy via wage destruction of this magnitude to achieve this state of affairs is another fallacy of composition argument. The whole world cannot run trade surpluses, especially not if policy is designed to destroy demand via massive wage destruction.

More importantly, the very structure of a currency board is wrong. It requires a nation to have sufficient foreign reserves to facilitate 100 per cent convertibility of the monetary base (reserves and cash outstanding). Under this system, the central bank stands by to guarantee this convertibility at a fixed exchange rate against the so-called anchor currency. The government is then fiscally constrained and all spending must be backed by taxation revenue or debt-issuance. Pegging one's currency, then, means that the central bank has to manage interest rates to ensure the parity is maintained and fiscal policy is hamstrung by the currency requirements (which is why organizations like the IMF love them so much; it ties governments' hands). Latvia pegs its currency at 0.71 lat per Euro and joined the ERM in 2005 with the intent of qualifying for the euro zone. It operates a system similar to Argentina in the 1990s which ultimately collapsed and led to its default in 2001 (Argentina pegged against the US dollar).

The country's debt is projected to be 74 per cent of GDP for this year, supposedly stabilizing at 89 per cent in 2014 in the best-case IMF scenario. A devaluation, however, would substantially raise the debt service ratios, given the high prevalence of foreign debt (about 89% of Latvia's debt is euro denominated). The currency peg, then, not only restricted the Latvia government's freedom of fiscal maneuver, but also created huge financial fragility because Latvians operated under the mistaken assumption that the peg was inviolable, encouraging borrowers to act with no sense of exchange rate risk. As in Argentina nearly a decade ago, a devaluation would, in all likelihood, lead to a default on external debt. Argentina did eventually manage a 25% recovery in output in the two years following Q1 2002, but only after a 190% devaluation (which was 300% at its maximum)

As Michael Hudson and Jeff Sommers have noted, "these debt levels place Latvia far outside the debt Maastricht debt limits for adopting the euro. Yet achieving entry into the euro zone has been the chief pretext of the Latvia's Central Bank for the painful austerity measures necessary to keep its currency peg." They also point out that maintaining that peg has burned through mountains of currency reserves that otherwise could have been invested in its domestic economy. It has also precluded the use of fiscal policy, since (by virtue of Latvia's peg to the euro), the country operates under the same constraints as if it were already working within the Stability and Growth Pact rules.

'Internal devaluation' is a toxic remedy

With no room to adjust the exchange rate, the only other way to make the currency lose value is to engineer a real depreciation — that is, reduce labor costs and prices in order to make its tradable products more attractive. This is euphemistically being described as an "internal devaluation" — a one-off coordinated reduction of wages and prices across the board. It is, in reality, more like an "infernal devaluation". It amounts to a domestic income deflation as wages are crushed in order to get the prices of tradable goods down enough so the current account balance increases sufficiently enough to carry the next wave of growth. The hidden assumption is that a debt deflation spiral does not do the host country in as domestic private incomes are deflated. The argument to justify this toxic remedy is that a reduction in nominal wages and salaries can help Latvia accomplish a boom in net exports, thereby enhancing an economic recovery which would quickly attenuate or short circuit any accompanying debt deflation dynamics that might have been set off at the inception of the internal devaluation.

Here, in a nutshell, is a country which shows us all of the misery that is enacted through the creation of self-imposed political constraints on policy. The Latvian government has voluntarily abandoned the policy tools that could make the lives of their citizens better. Policy makers have tied both their hands and their feet behind their backs so that markets could work their self-adjusting magic. They have pegged their currency; they are furiously slashing their net fiscal spending (under the IMF agreement they are due to cut their net position by 6.5 per cent of GDP — a huge fiscal contraction), and the economy continues to deteriorate.

This is something likely in store for Greece, which has recently introduced a new round of austerity measures in order to ensure the success of its latest bond offering. Greece and other countries now face the prospect falling private sector incomes - that is, after all, the direct and immediate result of higher taxes on businesses and households, and lower government expenditures. Euro area nominal GDP is already estimated by the OECD to have fallen over 3% in 2009. Unless the trade deficits of the nations pursuing fiscal retrenchment can swing sharply into surpluses (as lower domestic incomes lead to less import demand, and lower costs of production lead to higher exports), private debt defaults will now start to multiply and cascade through the system. Last week, as we mentioned, Moody's placed 4 Greek banks on downgrade watch. This is just the start - the fiscal retrenchment has only just begun to take effect. By taking these steps to avoid a public debt default, we would suggest these economies are now poised for more private debt defaults.

We believe private investors do not yet get this connection, but it will be made very clear in the months ahead. Latvia, with a GDP collapse of nearly 25%, will become the poster child of the region in this regard. This private debt distress will back up into higher loan losses at German banks. Germany's hard won current account surplus will continue to fade Loan growth is already dead in the water in Europe, and if the above analysis is correct, banker perceptions of private sector creditworthiness are about to go "pear shaped", as they so delightfully put it in London.

Paradox of public thrift

But that's not all. Each of these countries are about to discover what we will call the paradox of public thrift. Argentina discovered this in 2001-2. Latvia and Estonia have recently rediscovered it. Ireland is rediscovering it, and within the next three months, Greece will no doubt discover it as well. We will let Bill Mitchell's comments depict the nature of this paradox for you, because it really does capture the essence of the dilemma at hand:

From Ireland: Gov't took billions of €'s out of the economy in the form of public service pay cuts, pensions cuts, dole cuts + wave of private employees replaced by agency workers at minimum wage rates... Guess what? January tax receipts crashed yet again below projections. After two systemic budget cuts, the tax receipts keep tanking. The mainstream consensus? We need more cuts (except for bankers and top civil servants who don't have to take wage cuts)! And the international bond market is happy with Ireland. One day we shall be able to compete with China on a level wage scale, and generous tax incentives for Multinationals. In the meantime, say hello to all the Irish immigrants for me.

This is the future discovery awaiting Greece, Spain, Portugal, Italy...and the UK...possibly Japan...and perhaps the US, although it could manage to skirt the issue for another year. In each of these nations, if the private sector is retrenching already, and the public sector tries to retrench on top of that, unless a massive swing in foreign trade can be accomplished, policy makers are unwittingly inviting falling private nominal incomes and private debt distress into the picture as they reverse fiscal stimulus.

As private incomes fall, tax revenues fall. In order to hit fiscal targets promised to global bond holders, further expenditure cuts must be implemented, and further tax hikes must be rolled out. As the Irish blogger reveals above, this is not a theory — it is already happening, but policy makers and investors are not willing to acknowledge it. Yet for those who understand the fiscal balance cannot be changed without influencing the cash flows and financial balances of the remaining sectors of the economy, the paradox of public thrift at this juncture is far too evident.

We are by no means defending the generous pension benefit levels of euro zone government workers, the early retirement ages, the corrupt tax practices, etc. These are decisions the citizens of each nation need to make on their own, preferably in full awareness of their consequences, both short and long run. It is not our place to dictate the trade-offs citizens chose in each nation.

The question we are raising, however, is whether the private leverage ratios in many of these countries will allow them to withstand the pressures of transitioning back to growth in the absence of fiscal autonomy. The now prevalent global quest for "fiscal sustainability" may place these economies on a path of private debt default, which is ultimately unsustainable for the economy as a whole. If fiscal retrenchment is to be enacted, then orderly private debt renegotiation and private asset liquidation must be accomplished at a large scale and in a timely fashion. Yet our experience is that this is no easy trick, as the near locking up of various financial channels following the Lehman debacle illustrated in no uncertain terms. Usually such a recipe delivers a financial implosion.

Even the Honorable David Walker, CEO of the Peter G. Peterson Institute, former Comptroller General, and ardent foe of government waste and reckless spending is coming to understand the precarious nature of the current situation. In a February 24th piece on Politico.com with Larry Mishel, Walker insists on the primacy of job creation at this juncture, and recognizes this may actually serve his goal of reducing fiscal deficits in the long run:

President Barack Obama is in a difficult position when it comes to deficits. Today's high deficits will have to go even higher to help address unemployment. At the same time, many Americans are increasingly concerned about escalating deficits and debt. What's a president to do?

The answer, from a policy perspective, is not that hard: A focus on jobs now is consistent with addressing our deficit problems ahead.

We have seen this movie before

That, dear readers, is the real deal, and it is not being reported or openly discussed. We have seen this movie before in Argentina almost a decade ago. They eventually got out with a massive "external" currency devaluation of 300% and an equally massive swing in the trade balance. But the costs of delay were enormous: from 1998-2001, Argentina suffered its worst recession ever and pushed 42% of its households into poverty.

And not every country can do what Argentina has done. Again, the whole world cannot run trade surpluses, the first mover has an advantage until the second mover moves, etc. Plus, Argentina had an explicit debt repudiation and a 300% "external" devaluation that was timed right with global recovery, hardly the sort of conditions that pertain today.

The US has so far managed to resist anything of this magnitude. But as the voices of fiscal retrenchment intensify, a future not unlike Latvia, Greece and Argentina could await. It has taken the people of Iceland to make the first stand against this growing neo-liberal madness. In a historic referendum, over 90 per cent of the population has rejected a proposal for the repayment of billions of pounds lent by Britain and Holland to compensate depositors in a failed Icelandic bank.

The deal would have saddled citizens of Iceland with an additional $16k in debt to compensate the UK and Holland with a $5.3 billion note for the failure of their local banks. This, in a country of a mere 300,000 citizens. The vote failure has already prompted the ratings agencies to downgrade the country to junk, as well as leaving an IMF-led loan in limbo. The "experts" are declaring this a disaster for Iceland, but they and their banking allies must secretly be dreading the result, demonstrating as it does that an international bailout watchdog is truly powerless when the people of the bailout recipient nation want to have nothing to do with a poisoned chalice of an economic "rescue", which does nothing but create a country of indentured serfs.

It is now time for the rest of us to follow the Lilliputians of Iceland: to take the rentier juggernaut down before it completes the task. Time to pry the vampire squid off our faces so we can see the light of day again. Hopefully, Iceland represents the future, not Latvia.