BY MICHAEL HUDSON

# Fading Baltic Miracle

*A dangerous dependence on the property bubble.*

The Baltics and other post-Soviet economies are financing deepening trade deficits—topped by Latvia's at 26 percent of GDP—by foreign borrowing. But unlike the typical case, it is not governments that are doing the borrowing. The booming real estate market is performing this role. Scandinavian and other foreign banks are extending mortgage credit to Latvians, Estonians, and Lithuanians, mostly denominated in euros, Swiss francs, dollars, and sterling. This breaks the cardinal financial rule that many Latin American and other economies discovered long ago: not to borrow in a hard currency when one's income is in a softer one.

Many Baltic debtors assume that just because their governments have announced their intention to join the euro, it is a sure thing—at today's exchange rates. Yet failure to meet the entry condition of a low inflation rate already has caused the target dates to be delayed indefinitely, and Latvia's currency began to wobble in early 2007.

But now that the Baltic real estate bubbles are peaking (led by that of Estonia), how are the Baltic states to finance their trade deficits? As the Baltic property market slows, foreign-currency loans are following suit.

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First, some background. Soviet planning dispersed the various stages of each major industrial sector widely from the Baltics to Central Asia. From an engineering vantage point, the idea was to gain productivity advantages by creating specialization of labor. The Baltics, for instance, along with East Germany, were the Soviet Union's major computer and high-tech centers. The geopolitical effect was to lock the Soviet republics into a mutual interdependency so that none had a full complement of production facilities. This meant that when the Soviet Union broke up in 1991, its republics were not self-reliant.

Without self-sufficiency in consumer or capital goods, the post-Soviet countries face deepening structural trade deficits. Even as the World Bank applauds them for joining the ranks of the world's most "business-friendly" economies, their post-Soviet policy decisions may doom them to serve as an object lesson for the late economist Herbert Stein's maxim that "a trend that can't go on forever, won't." Their economic problem is how to balance their trade deficit without running even more deeply into debt and thereby building carrying charges into their balance of payments. And if the Latvian and Estonian currencies should decline against the euro, the squeeze will threaten to make their mortgage loans subprime.

The question is, what do they have to exchange? Russia and Central Asia have fuel and other raw materials, but the main endowment of Latvia and Estonia is favorable location—railway and port facilities for trans-shipping Russian exports to the West, and banking services that grew out of this trade by facilitating capital flight from Russia beginning in the late 1980s. Shaped by geography, about a third of the economic activity of Latvia (population 2.3 million) and Estonia (population 1.3 million) involves the trans-shipment of Russian oil and other raw materials. The U.S. Treasury has long placed Latvia on its list of shady banking countries, but finance remains the leading service sector, dominated by Scandinavian banks. Their profits derive mainly from mortgage lending, but they now are moving into auto loans and other consumer debt.

The Baltics import most of their consumer goods, capital equipment, fuels, and raw materials, and finance most construction equipment, cars, and consumer durables on credit. The balance-of-payments task confronting their economies is how to replace their former exports to the Soviet Union with new products and services to Europe and other regions.

Tourism is thriving. The proximity to Russia and Finland makes the Baltics natural meeting grounds for business conferences. (Lithuania does not share a border with Russia; its major links are with Poland and Belarus.) The hotel business is receiving major foreign investment, and Riga's seashore suburb of Jurmala has long been a summer mecca for affluent Russians.

Yet the residue of political anger left over from the half-century of Russian occupation is so deep that politicians in these countries seem to be shooting themselves in the foot by making relations with Russia as difficult as possible—the opposite of Chancellor Konrad Adenauer's policy in the 1950s of taking a pro-Western political stance even while turning West Germany eastward economically.

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Reaction against the Soviet occupation has played a key role in the post-Soviet move to the opposite end of the political and ideological spectrum. It has shaped the post-Soviet fiscal, financial, and social policies into a unique economic system, as different both from most Western social democracies as it is from the old Soviet Union.

Instead of becoming Western-style "mixed" private/public economies, Latvia, Estonia, Lithuania, and other post-Soviet states represent a novel fiscal experiment. Hosts to the world's fastest-growing real estate bubbles, much as Russia's stock market has buoyed world financial markets, their focus is on "rent-seeking" (the proverbial free lunch) and capital gains, not on investing capital to employ labor to produce goods and services. The effect has been to jump out of the frying pan of Soviet bureaucracy (inefficient but at least debt-free) into the fire of "wild capitalism" and "grabitization" by giving away or selling off public enterprises and real estate.

Property in the post-Soviet republics was free of debt in 1991, leaving substantial prospective income to be pledged to bankers. Most post-Soviet republics levy only a token property tax, preferring a flat tax that falls overwhelmingly on labor. The neoliberal Baltic governments do not even track realistic property prices. Latvia's "Land Book" is based on Soviet-era registration prices and has only recently begun taking current sales data into account. Rental revenue not paid as taxes can be capitalized into bank loans, raising housing and commercial property prices to among the highest in Europe.

By contrast, Latvia's effective flat tax on wages exceeds 60 percent—a straight 25 percent tax on wages, a 24 percent social-service tax paid by employers (which treats Social Security and medical care as user fees rather than as normal parts of the public budget) and another 11 percent paid by wage earners, on top of which Latvia imposes a value-added tax. No Western industrial economy has so devastatingly high a wage tax or lacks a significant property tax. The high tax on labor adds to production costs, pricing investment and employment out of world markets and even the domestic market.

Emerging from an economy without rent or interest charges, the post-Soviet economies turned into a caricature of Western economies without checks and balances, progressive taxes, or even the property taxes found in North America and Western Europe. The result has been an experiment (and it is beginning to look like a cruel one) in replacing Western-style social democracy with an economic philosophy that aims at making money by buying property already in place, then running up debt without creating new means of production except for new luxury construction.

What has emerged is a symbiosis combining the worst vestiges of the old Stalinist bureaucracy with new Western predatory finance. Instead of promoting industrial investment and rising living standards, post-Soviet policy has permitted political operators, Red directors, and outright criminals to obtain and sell off assets in the public domain or collateralize them for foreign loans. The flat tax on labor has been set so high as to make it uncompetitive, while the property tax is so low as to spur a real estate bubble. The experiment seems doomed to collapse as a result of trade and debt dependency, extending credit to make quick capital gains, not to increase self-sufficiency and labor productivity.

Today, seventeen years after their political independence, Latvia, Estonia, and Lithuania remain in many ways more post-Soviet than Western. Yet their free-market rhetoric has prevented their contrast with traditional European and American economies from being more widely noted. Government enterprises (most of them natural monopolies) were privatized without much attempt to ensure new capital investment to improve infrastructure or provide its services at prices that minimize the economy-wide cost of living and doing business.

The upshot is a curious kind of economic miracle, by Western standards. The industrial sociologist Charles Woolfson points out a striking contrast. On the one hand, the three Baltic Tigers have Europe's fastest growing GDPs, and their business-friendly tax policy has produced Europe's fastest-growing real estate bubbles. The World Bank applauds them for being in the world's top thirty in terms of "ease of doing business," ranking Lithuania (fifteenth) and Estonia (sixteenth) ahead of Switzerland and Germany, and Latvia (twenty-sixth) right after Chile. The Bank calls this "a remarkable achievement, as only a decade has passed since they first began reforms."

But unlike the Asian Tigers, the Baltics are not industrial exporters with rising foreign-currency reserves. Little effort has been made to re-industrialize. Baltic labor productivity and research and development spending as a percentage of GDP is the lowest in Europe, with Latvia at the bottom of the scale.

The major export is labor itself, especially educated young men seeking better jobs. Woolfson notes that 3.3 percent of Lithuania's working-age population has emigrated, 2.4 percent of Latvia's, and 1 percent of Estonia's—with a remarkably high 7.5 percent of their labor force expecting to move in the next five years. This is largely because the Baltics have become Europe's worst place to work. Unionization rates are low. Eurostat reports that the Baltics have the continent's lowest living standards and per capita purchasing power, as well as the longest working hours per week. Spending on "social protection per head of population" is only a quarter of average EU levels, inverting the idea of "Social Europe" established after World War II. Gini coefficients of income inequality show the three Baltic countries to be the most polarized of all Europe's post-Soviet economies. The aging populations of these countries are now shrinking as widespread poverty has led to falling birth rates and low life expectancy at birth, while labor emigrates.

The economic price being paid for this policy has been deepening foreign dependency. Mortgage borrowing from foreign banks or their branches is approaching Western debt levels (compared to zero domestic and foreign indebtedness sixteen years ago) rather than putting in place new means of production to pay the debts. The effect is to build in future outflows of debt service on top of deepening trade deficits.

The Baltic experiment poses the question of whether economies can create riches (at least at the top of the pyramid) simply by handing out the public domain and inflating property prices without employing labor, and in fact driving it out of the country. How long can a trade deficit, import dependency, de-industrialization and an uncompetitive tax structure be sustained simply by running deeper

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into debt? The logical limit is the point at which all property income and economic surplus is pledged for debt service. But long before this point is reached, the real estate bubble will slows and foreign mortgage lending will dry up, leaving the balance of payments with little visible means of support.

It didn't have to be this way. The post-Soviet republics emerged free of domestic and foreign debt in 1991, and had low rent and housing costs. This meant a low cost of doing business, inasmuch as housing charges (largely mortgage debt) represent between a quarter and 40 percent of U.S., British and other Western family spending. They could have locked in this advantage by turning over housing and commercial real estate to its users. But the Baltic States privatized their housing late and at high prices. Housing and other property costs now account for a larger proportion of Baltic budgets than in competitors such as Germany.

The Baltic states did face heavy catch-up charges for new construction, as well as for infrastructure and capital investment to fit their labor into the West's trade patterns. But they had few assets to sell and little stock-market potential. The largest asset was real estate, followed by public infrastructure. Foreign borrowing and asset sales accordingly were used to balance international payments instead of addressing the trade deficit.

This indebtedness increases the property's carrying charges, raising the cost of new housing and office space. The Baltic tax system therefore is highly inflationary despite its high flat tax on wage income. Taxes on real estate would lower land prices by leaving less rental income to be capitalized into bank loans. This would enable the government to lower taxes on labor and industry—taxes that raise the supply price of labor and industrial capital.

Latvia in fact enacted a 25 percent capital gains tax in May. But it will not generate much revenue for at least three years. Property owners are given that long to sell their real estate without having to pay the tax. It will fall only on real estate bought after June 12 of this year, or sold after July 1, 2010. Residential owner-occupants who have owned their property for at least five years (and have been registered as residents for at least a year prior to the sale) are exempt from the tax. The new law will deter new buyers for a while and no doubt lead some owners to put their property up for sale. And in view of the fact that it was largely speculators who were pushing the market up, property prices will taper off as their demand slows.

This means that borrowing in foreign currency also will slow. Meanwhile, existing mortgages denominated in hard currency threaten to squeeze Baltic debtors by rising in domestic-currency terms if the local currency depreciates. The extent to which families have been forced into their existing homes is reflected in the fact that only 15 percent of Latvians were reported to have mortgages as of last year. The wealthiest layer of the population thus accounts for most borrowing, along with commercial developers. As in central London, much of the highest-priced property is owned free and clear, bought largely with flight capital. This means that while most Baltic families suffer from high flat taxes, the top layer threatens to be squeezed by foreign-currency debt.

There was no Soviet-era banking class, and outside of Russia few oligarchs tried to start their own banks, so Latvia, Estonia, and Lithuania have relied on foreign bank branches to create most credit. These branches in turn have denominated the great bulk of housing debt—75 percent in Latvia's case—in foreign currencies.

Riga's city finances are in a straitjacket. On April 17 the government ruled that it cannot charge tolls on the bridges and tunnels to be built, on the ground that these would be taxes, which only the federal government can levy. (There is no local property tax, only a national tax.) This means that Riga can finance its transport infrastructure only through grants or by selling off its remaining land. (The city still owns 40 percent of Riga's land, although most of it consists of parks, roadways, and public buildings.) The problem is that public land continues to be disposed of at giveaway prices, mainly to insiders, with only token tax reform to achieve better economic balance and stability.

Property owners are well represented and protected in Parliament. In the high-priced suburb of Jurmala they oppose higher land taxes by trotting out the usual specter of local retirees who have long held dachas there and would be squeezed. The fact that these properties often are worth at least half a million dollars makes this is a non-problem in humanitarian terms. Prime Minister Aigars Kalvitis has suggested a general tax exemption for a hundred square meters of owner-occupied housing. He also seems sympathetic to deferring tax payments by letting arrears accrue against property, to be paid (with interest) at the time of sale, perhaps as long as five years in the future. One might think that the heavy Russian ownership of Jurmala property would catalyze higher property taxes to help the economy. But even this is not enough to introduce higher land taxes.

On June 26, a Latvian Parliamentary committee approved a new property tax law. If passed, it will not affect Latvian property owners much for the next few years, as real estate will remain a fairly minor proportion of tax revenue. Residential dwellings will not begin to be taxed until 2011, and the overall volume of property taxation is not to rise by more than 25 percent per year until then, from the time the new law comes into effect this January.

The Land Book's notoriously low assessments have been updated (in some cases fivefold or more), but its statistics were so obsolete to start with (typically only a tenth or even less of the market price) that most official statistics remain considerably below market rates. Commercial and industrial properties were re-assessed last year, in some cases dramatically in view of soaring property prices in prime locations. Their tax already has gone up, but only to levels that most Western economies would deem trivial.

To compensate for more realistic property assessments, the government is lowering the property tax by a third, from 1.5 percent of assessed value to just 1 percent. This is only a fraction of most U.S. rates. As in the west, the Land Book's new assessments will require higher pro rata stamp fees to register real estate sales. They also will provide higher groundrent to absentee owners of land under buildings or apartments—5 percent of the new official assessment as "fair value." This gives groundrent owners more revenue than they will have to pay out as tax.

Latvia's heavy 60 percent flat tax on labor income will remain the major tax, and will continue to make labor and industry uncompetitive. The focus of "wealth creation" will remain property ownership, not industry and employment. The tendency for real estate assessments to lag behind market prices will reward "bubble"-type gains more than industrial investment. New tunnels, bridges, transport and other infrastructure will increase the site value for property owners, but this public investment is to be financed mainly out of taxes on labor.

Did Latvia miss its chance for needed tax reform by not using higher real estate taxes to lower the flat tax on wage income? The longer it defers shifting the tax base off labor and industry onto real estate, the more it will fail to address the need for industrial renovation. High taxes on labor and industry are inflationary because they increase production costs, but higher property taxes would hold down debt-financed property gains, by leaving less rental income to be pledged to banks to pay interest on higher loans. How can Latvia stabilize its currency over time, without building up an export sector, and hence employing more labor on more competitive terms?

This hardly can be done, given today's high flat-tax rates on wage income. Their hope seems to be for asset-price inflation to persist, centered on the seashore, hotels, and conference centers, and the old city centers of Riga and Tallinn that have attracted the usual cosmopolitan retail malls. But how long can these trends be maintained? Given the fact that a shrinking domestic economy limits the ability to pay rent, the only hope to sustain real estate investment is for travel and tourism to spur the demand for hotels and other services for foreign visitors.

Not to shift the tax burden means trying to survive as a debtor economy whose trade deficit is soaring. Admittedly, moving toward a Western-style property tax would slow the property bubble. By deterring new foreign lending, this would lead the currency to weaken in the short run, increasing import prices and thus spurring inflation, making it harder to join the euro. That is the quandary facing the Baltic states. They have become a new form of economy—no longer Communist, but living off their past by selling off or loading down with foreign debt their land and public assets put in place for half a century.

The Baltic trajectory of unproductive credit has not put in place the means of repaying the debt except by further asset-price inflation to attract yet more loans—a bubble economy that seems unlikely to survive even another year without a basic restructuring as radical as that of the early 1990s. Last year saw Iceland's currency buckle as the government tried to finance its trade deficit by borrowing at rising interest rates. The Baltic currencies may represent the next pack of cards likely to fall. The problem is that once the real estate market ceases to rise, this mortgage borrowing will dry up, the inflow of foreign loans will stop, and the exchange rate will weaken.

The Baltic experiment seems likely to remain a neoliberal "miracle" only until they burn out—which will occur at the point where there is no more property to privatize, sell off, or pledge for foreign-currency loans. ◆

The Baltic Exchangeâ€™s main sea freight index has plunged to its lowest levels in six months as world trade continues to fade amid signs the so-called â€œfront-loadingâ€ effect ahead of tariff deadlines is starting to wane. Chinese firms and US importers rushed to ship goods to the US through Q1 to Sept. as the US and China were engaged in a tit-for-tat trade war.Â  The Baltic index .BADI, which tracks rates for capesize, panamax and supramax vessels that ferry dry bulk commodities, fell 20 points, or 1.8%, to 1,103, its lowest since June 17. Fading Baltic miracle: a dangerous dependence on the property bubble. Typically, this is the result of one of two factors: (1) a mismatch between the risk of inventory and the cost of capital, or (2) the mixing of after-tax capital charges with before-tax noncapital carrying charges. Let's first explore how to properly match the risk of inventory with the appropriate cost of capital. The Baltic miracle did not happen, and one should not expect it - such a categorical opinion was expressed by 72% of the participants of the public opinion survey in the Republic of Lithuania, organized by the information agency ELTA. The survey itself was conducted by experts from the company Baltijos tyrimai. The main question of the study was devoted to what route modern Lithuania is taking. The three Baltic states - Lithuania, Latvia and Estonia, all ex-Soviet countries now in the EU and NATO - boycotted the military parade. Many other EU states were represented by their ambassadors. Putinâ€™s spokesman Dmitry Peskov had said that dignitaries had not been invited this year as it was not as big an occasion as the 75th anniversary.