

“Latvia’s Bursting Property Bubble”

By Michael Hudson and Jeffrey Sommers

Written April 2008 and published on June 16, 2008 in *Diena*

In the fall of 2004 we recognized that Latvia’s real estate prices already were becoming too high in, given the nation’s income and underlying economic fundamentals. Beginning in July 2005 we published a series of articles in *Diena* arguing that the real estate boom was a form of asset-price inflation that raised the cost of housing and commercial space, diverting resources from being invested to expand the real economy of production – especially the export production needed to pay for Latvia’s imports.

To make matters worse, much of this real estate credit was extended by foreign banks, and was repayable in foreign currency. This created future balance-of-payments outflows – without putting in place the means to pay off these debts. We warned that this would lead to inflation and economic instability. Speculators were borrowing to fix up housing only to keep off the market – and hence did not notice that few Latvians could afford many of the most luxurious properties that were being hoarded.

As was well known at the time, Latvia suffered from the typical post-Soviet problem of insider dealing by kleptocrats using their connections to obtain property at mere giveaway prices. Without property taxation on anywhere near the scale common in North America and Western Europe, the property’s entire net income stream was pledged to banks, mainly foreign, for mortgage credit. In fact, this foreign-currency borrowing is how Latvia managed to finance its trade deficit. Even so, much of this mortgage credit was sent abroad as flight capital. The rest was poured into Latvia’s construction boom.

The result was a giveaway of land and properties that were mortgaged to obtain foreign-currency loans for properties where vacancy rates are turning to be high and rising because few Latvians can afford to pay rents high enough to cover the mortgage payments. Hotels and tourist sites are doing much better than the domestic economy. In fact, this drove younger workers to emigrate at one of the highest rates in the post-Soviet world.

Borrowing mortgage credit to finance a real estate bubble that is now losing steam, has been now been revealed to most as the pyramid scheme it has always been. It worked for a while, just as the Banka Baltija system did prior to its collapse in 1995, when the inflow capital stopped. (As the American novelist F. Scott Fitzgerald quipped on the eve of the Great Depression, the Roaring Twenties went out “when there was no more money to burn.”)

In 2005 we proposed the introduction of North American and Western European levels of land taxes to hold down property prices. This would have steered investment into sectors that produce real wealth, and deterred speculators from buying and holding apartments off the market. Higher property taxes also would have raised revenue to finance infrastructure and even to reduce Latvia’s extremely high taxes on labor – taxes so high as to make it unemployable in producing exports or competing with countries that tax their property rather than labor. High property taxes reduce the price of land and make labor and industrial capital more competitive. Latvia has followed exactly the opposite strategy – a policy of microscopic property taxation that is directly at odds with how the United States and other countries built up their own economic dominance, before some of them became speculative economies as well.

Enormous sums of quick money were made by playing the real-estate kleptocracy game, but it left the economy and society with correspondingly high cleanup costs. As

the real estate manager of one of Latvia's chief banks reported to us in June of 2006 (on the condition of anonymity): "We all know this will collapse. But everyone's bonus is based on continuing this behavior." One of Latvia's chief regulators told us that we would have no further cooperation if we printed this comment in a public article. However, the Western press was filled with such stories. In Latvia, the regulators told us to keep it quiet.

The inevitable consequences have now arrived. Latvia's real estate market peaked in April, 2007, like most other real estate markets throughout the world. The global real estate bubble is deflating, as is Latvia's. Parex Bank is exploring the creation of an investment funds to buy foreclosed property to prevent a more widespread price collapse, and similar plans are being sponsored in the United States. Meanwhile, Latio is lobbying for government support. As in the United States, speculators and their bankers now are trying to get the government to bail them out.

These are the same people who got rich without actually producing anything, but merely transferring property into their own hands. They now are trying to impose a substantial "tax" on the rest of society through the inflation they helped generate. They want their economic victims to save them.

This would only prolong the real economic restructuring that failed to occur in the wake of the Soviet Union's collapse. From the outset, the Latvian government – like those of other post-Soviet countries – has needed to direct investment toward real enterprises making real goods. This will not happen as long as it is quicker, easier and less highly taxed to make returns by debt-financed property speculation.

In this respect Latvia's price decline will have a silver lining. Falling property prices will push investment into more productive sectors. Mortgages as such are not bad, but they lead to defaults when they exceed rental income. The proper model to follow is

that of Germany. A higher percentage of their people hold mortgages than Latvia, but they have relatively low debt service obligations as a percentage of their income, and thus are not in danger of defaulting. Housing costs today typically absorb 40% of U.S. family incomes, twice the level that is normal for German wage-earners. And the price of buying a U.S. home typically is five times one's total annual income, substantially above the figure of three to three and a half times one's income during much of the post World War II period. Meanwhile many Germans prefer to rent, especially from non-profit co-operatives that debt-servicing to banks. This enables families to build wealth through savings, and for these savings to finance industrial growth. The alternative followed in Latvia is for prospective home buyers and commercial companies to borrow heavily from bankers – largely in foreign exchange – to obtain access to housing. High debt service payments are coming due already for Latvia's most highly debt leveraged property, and it is likely to experience the same high level of defaults that other countries are experiencing. ***Another positive outcome will be that lower property prices will reduce the cost of Latvian labor and goods, which currently are upward adjusted to pay for Riga's exorbitant housing costs. The pain of a real estate crash, unfortunately, will be the necessary tonic for reducing prices and making Latvian goods and services more competitively priced.***

Another example of poor policy leading to an addition "tax" on the public is the south bridge. In 2006, we advised the City Development Agency to not take large foreign loans for its financing, as this would create a net outflow of Latvian resources. We counseled domestic financing as much as would be possible, including using future higher property taxes in areas along the bridge, as these zones would prove attractive for those looking for quick access to both sides of the Daugava. Instead, a huge foreign loan was taken at unattractive rates that will prove a burden on Latvians for years.

It doesn't have to be this way. Latvia has real economic advantages that could place it on the path of prosperity if its tax system encouraged investment instead of capital flight and emigration. Its geography makes it a natural transit corridor linking Europe to Asia via Eurasia in a new Silk Road. This idea has now become familiar since we introduced it in a February 2005 *Diena* article. This month, China is sending its first container traffic through Latvia. The nation has agricultural potential to produce biofuels and also wheat, where soils permit. Latvia also might serve as a supplier to the automobile hub emerging in St. Petersburg, where Asian investors are keen to see stability and good relations between Balts and Russians that economic integration might deliver. **Other examples of good enterprise are firms like Latvia's *GroGlass*, which makes use of high technology, some of it locally created, to create distinctive products for the global marketplace. Companies like these should be targeted by the government as demonstration plants with credits available for others following suit, hopefully with industrial clusters emerging around them. This is a proven model which other nations, including many in West Europe's past, have pursued on the path toward development.**

As speculative opportunities diminish and the economy declines, Latvia will require a new economic focus on producing wealth that in which many more people will share, in contrast to the speculator economy with roots in the 1980s corruption of the Soviet economy that morphed into the kleptocracy of the post-Soviet period, fueled by neoliberal giveaways ("bad enterprise" that gave the word "reform" a bad name), which opened the way for capital to get rich by preying on the public sector rather than by channeling "good" enterprise into creating a real economy.

* The authors (Dr. Jeffrey Sommers and Dr. Michael Hudson) head the Baltic research group at the Institute for Study of Long-Term Economic Trends. They can be reached at <jsommers@fulbrightweb.org>