Neoliberalism, the development of underdevelopment, and the Latvian disease
Janis Berzins

Abstract

The concept of the development of underdevelopment was originally used by Andre Gunder Frank to describe a historical process, which is the result of colonial or the neocolonial forms of economical exploitation and dependence. However, nowadays this concept must be understood in a Schumpeterian way. In the process of economic development, it is the establishment of the new paradigms of accumulation and reproduction of social wealth by leading countries. The countries not following or lately following the last developments experienced by the core countries are reproducing obsolete goods and services, in other words, developing underdevelopment. In some countries, this process may be aggravated by economic restructuring through a process of deindustrialization concomitant with the establishment of non-dynamic unsustainable sectors as result of the activities of the financial sector. This process may be called as “The Latvian Disease”. This paper explicates this idea, showing how Latvia in the last few years faced both a process of underdevelopment and the development of underdevelopment, which would have resulted in the actual crisis with or without the international credit crunch.

Introduction

The beginning of the 1970’s marks the end of the period of economic growth and full employment in the advanced countries. It was sustained by strategies of active national state intervention by a regime of administering commercial and monetary policy under the hegemony of the United States (Hirst & Thompson, 1996). These changes include the effects of the collapse of the Bretton Woods system and the end of the dollar’s gold standard, which enabled the creation of wealth to not be limited by a material criterion represented by U.S. gold reserves. They also include the effects of the Third Industrial Revolution, the end of Keynesianism and the establishment of neoliberalism as the main ideology in economics and the social sciences. This meant an ideological change about the way the State should intervene in the economy, resulting in the establishment of neoliberalism, a falsification of the old liberalism, as the chief ideology determining the policies of promotion of economic development.

The result is the subordination of the debate of economic development to the neoliberal ideology, where the main idea is that liberalising the economy of underdeveloped countries would automatically result in a Pareto equilibrium led by the market forces, thus in development. The main theoretical presuppositions are utilitarianism and its methodological individualism, Ricardo’s theory of comparative advantages, and the macroeconomic Neoclassical Synthesis of Hicks and Samuelson.

1 Rigas Stradins Universitate. Email: janis [at] janisberzins [dot] org
combined with Friedman’s Monetarism, resulting in a new form of economic regulation than the announced laissez-faire. That resulted in the end of any possibility of application of any other form of economic regulation, specially to promote development, causing the capitalist structure to start to present increasingly renting characteristics in prejudice to economic development.

This process was also hugely influenced by the ideological cycle of the Academic mainstream. After the 1970s, the defenders of liberalism, than distorted and falsified as neoliberalism, began to question the Keynesian postulates, mainly in Europe and in the United States, resulting in a turn to the acceptance of the neoliberal paradigms and the consequent disarticulation of the intervention of the State as the ideal model of economic distribution. The mainstream turned to be neoliberalism based on the microeconomic neoclassical approach, continuing to present the characteristic academic totalitarianism, which limits the dialogue.

This is consequence of a process where people’s analysis become fuzzy and distorted by beliefs, and the dialogue turns to be ideological rather than academic. In spite of the claims to pursue “truth”, scientific enterprise is often influenced by personal ambition, rigid defence of theories, and the weight of tradition, in detriment of creative participation directed to the common objectives of science (Bohm, 2003). There is the establishment of a system of beliefs, instead of a system of knowledge based on dialogue, resulting in the dogmatisation of beliefs, like Hans Albert’s idea where dogmatisation is the expression of the tendency to give priority to the need of intellectual certainty over the need to achieve optimal solutions of actual important problems (Geach & Holôwka, 1991). This accounts for the poor level of economic analysis over the last 40 years, together with the fact that many scholars fear that they will be labelled as "Marxist" if they go beyond orthodoxy, as it is tantamount to being accused of witchcraft in the Middle Ages.

These changes’ expression was a structural transformation both in the financial and the real sphere, resulting in the transformation of the manner the capitalist system reproduces itself. There is a rupture between the real sphere (including services) and the financial sphere, resulting that, in terms of size and significance to the generation of wealth, the financial sphere overcame the real sphere. With the end of the dollar-gold standard, which represented a material barrier to the expansion of the capital, the process of fictive valorisation could start to occur detached of any material limitation. Thus, the capitalist system was able to start to reproduce itself independently of the material base, rupturing from the real economy and establishing a fictive financial economy. The main implication is that the real sector is becoming irrelevant to the reproduction and maintenance of the capitalist system, as the wellness is increasingly generated not in the real sector but in the financial sector. It is the "abstract capitalism".
Table 1: World GDP and size of the financial market

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>World GDP (real sector)</td>
<td>29 547,9</td>
<td>31 823,2</td>
<td>36 931,3</td>
<td>41 546,2</td>
<td>44 880,8</td>
<td>48 436,0</td>
<td>54 311,6</td>
<td>60 109,4</td>
</tr>
<tr>
<td>Banks’ assets (a)</td>
<td>9 495,3</td>
<td>12 280,9</td>
<td>18 357,6</td>
<td>21 853,8</td>
<td>23 910,6</td>
<td>29 408,0</td>
<td>34 991,1</td>
<td>37 405,9</td>
</tr>
<tr>
<td>Stock market capitalization (b)</td>
<td>17 123,6</td>
<td>30 956,6</td>
<td>31 309,0</td>
<td>37 245,0</td>
<td>42 156,5</td>
<td>51 749,4</td>
<td>62 727,8</td>
<td>33 299,2</td>
</tr>
<tr>
<td>Debt Securities (c)</td>
<td>27 144,7</td>
<td>35 286,5</td>
<td>50 040,2</td>
<td>57 123,5</td>
<td>58 750,3</td>
<td>67 567,2</td>
<td>78 259,0</td>
<td>82 871,5</td>
</tr>
<tr>
<td>Public</td>
<td>12 847,7</td>
<td>13 998,2</td>
<td>20 365,7</td>
<td>23 515,0</td>
<td>23 570,4</td>
<td>25 771,3</td>
<td>28 627,6</td>
<td>31 656,9</td>
</tr>
<tr>
<td>Private</td>
<td>14 297,0</td>
<td>21 288,4</td>
<td>29 674,6</td>
<td>33 608,5</td>
<td>35 179,9</td>
<td>41 795,9</td>
<td>49 631,4</td>
<td>51 205,7</td>
</tr>
<tr>
<td>Derivatives (d)</td>
<td>40 637,0</td>
<td>95 199,4</td>
<td>197 166,9</td>
<td>258 627,9</td>
<td>299 260,9</td>
<td>418 131,4</td>
<td>595 341,2</td>
<td>591 962,9</td>
</tr>
<tr>
<td>Total (a+b+c)</td>
<td>53 763,6</td>
<td>78 524,1</td>
<td>99 706,8</td>
<td>116 222,3</td>
<td>124 817,5</td>
<td>148 724,7</td>
<td>178 392,8</td>
<td>151 161,8</td>
</tr>
<tr>
<td>Total (a+b+c+d)</td>
<td>94 400,6</td>
<td>173 723,5</td>
<td>296 873,7</td>
<td>374 850,2</td>
<td>424 078,3</td>
<td>566 856,1</td>
<td>773 734,0</td>
<td>743 124,7</td>
</tr>
<tr>
<td>% of World GDP (a+b+c)</td>
<td>182,0</td>
<td>246,8</td>
<td>270,0</td>
<td>279,7</td>
<td>278,1</td>
<td>307,1</td>
<td>328,5</td>
<td>251,5</td>
</tr>
<tr>
<td>% of World GDP (a+b+c+d)</td>
<td>319,5</td>
<td>545,9</td>
<td>803,9</td>
<td>902,2</td>
<td>944,9</td>
<td>1 170,3</td>
<td>1 424,6</td>
<td>1 236,3</td>
</tr>
</tbody>
</table>

Sources: BIS, IMF, World Federation of Exchanges, author’s own calculations.

If the speculative money reached the astronomic sum of US$ 743,12 trillions or more than 10 times the World GDP, there is no possibility of the real sector to offer ways of this fictitious financial capital to reproduce itself. Only the creation of more fictitious capital may feed and reproduces the fiction. Besides, the profitability of the investments in the fictional sphere surpasses the profitability of the investments in the real sector. With the rise of the financial system as an autonomous sphere of the capitalism system, not only the national interest rate is taken into account, but also the possibilities of profitability in the globalised financial market. In this way, money that could be being invested in the real sector is directed to the fictional sphere, deepening the irrelevance of the real sector to the generation of wellness and the reproduction of the capitalism system.

This financial power’s structure has seven characteristics (Braga & Cintra, 2004):

1) A capital market united with the to the credit system that serves of international space to the distribution of the financial savings between superavitary and deficitary agents, as the creations and destruction, inflation and deflation of actives. This space is a very big financial market with technically sophisticated investors, which is the world’s main financial market, attracting a big share of capitals as small term deposits and, simultaneously, partly financing the long term investment flux;

2) A propitious space to the development of the financial capital in a vast variety of combinations of operational and financial profits, inside the private decision centres (industrial, commercial, banking and institutional investors);

3) A very developed stage of capital centralisation - mergers and acquisitions - due the consolidation of the transnational financial conglomerates by mega mergers and gigantic resources from institutional investors;
4) Its profound degree and diversity of financial innovations, including institutional implications;

5) The surpass of the gold as reserve of value, permitting the dollar to constitute itself as the first fiduciary currency without ballast;

6) The use of the Federal Fund's rate by the Federal Reserve as instrument of regulation of the American monetary and financial system and, as consequence, of the monetary and financial international system, as influences the flux of global capitals due the security, liquidity and profundity of the American financial system;

7) Prominence in the determination of the practices of the multilateral institutions (IMF, World Bank, etc), shaping the world's monetary and financial system according to their (United States) needs.

By the side of the real sphere, there was the Third Industrial Revolution, which began after the II World War as the result of the American technological development as a military enterprise. It represents a new form of accumulation, where technical progress is incremental and dependent of the accumulation of innovations. While the technical progress of the First and Second Industrial Revolution could occurs without previous technical and scientific accumulation as it was a diffuse and universal knowledge, the new technical and scientific knowledge is not only protected by patents but is also ephemeral.

In the same way, with the molecular-digital revolution, both science and technology remain interdependent in the same process.

As Schumpeter argued, capitalism has a cyclical pattern dependent of innovation, where the market configuration may varies from competition to monopoly, passing through oligopoly, in a process of creative destruction (Schumpeter, 1928; Schumpeter, 1947). That is true not only in the productive sectors but also in the services sector, including the financial sphere. Economic growth differs from economic development as the last is the result of the process of innovation, while economic growth is static process. In this way, economic growth is only related to the improvement of economic indicators, in other words, a country's economy may grow in a stationary way without development, which is innovation-dependent. As the process of creative destruction refers to the replacement of what become obsolete by the “new”, which is the result of the process of innovation, those who don't follow the changes tend to disappear as a result of their incapacity in adapting to the new paradigms. Capitalism is dynamic and cyclical. Eventually the increase of the economic indicators will cease, resulting in economic crisis, as there wasn't economic development.

The debate about development is outdated. It must be retaken in a non-ideological way, as also must take in consideration the last 40 years of structural changes of the capitalist system. In
order to do that, it's necessary (1) to understand that the economic dynamics of underdeveloped
countries are different from those already developed; (2) that differences of the terms of trade exists
and they affect international trade, reproducing underdevelopment instead of helping to surpass this
condition; (3) to take in consideration that the process of economic accumulation occurs mainly in the
financial sphere, at the same time that the real sphere is increasingly dependent of the creation,
dissemination and utilisation of knowledge, which have different forms of regulation than forty years
ago. The understanding that the new economic paradigms change the forms of economic interaction
and accumulation is fundamental to perceive that the notions of development and underdevelopment,
as the mechanisms to achieve the first and to avoid the latter, have their dynamic determined by the
control of knowledge, which affects both the financial and the real spheres.

Development of underdevelopment

The term “development of underdevelopment” was coined by Andre Gunder Frank’s essay in
In this essay he rejected the idea of the existence of an “original” underdevelopment and the concept
of “traditional” society. In the same way, he denied the notion of subsequent “stages of growth” and
the analysis of development through neo-Parsonian social pattern variables and neo-Weberian cultural
and psychological categories. Accordingly to Frank, underdevelopment “(...) is not due to the survival
of archaic institutions and the existence of capital shortage in regions that have remained isolated
from the stream of world history. On the contrary, underdevelopment was and still is generated by the
very same historical process which also generated economic development: the development of
capitalism itself” (Frank, 1966).

The main idea was that the development of the core States would mean the
underdevelopment and permanent subordination of the peripheral countries, through colonist
exploitation. In this way, what were being reproduced along with the development of the states at the
centre of the capitalist world economy were the underdevelopment and the permanent subordination
of those states in the periphery, in other words, a result of a situation of dependency. Dependence in
this case must be understood as the conditioning of the economies of a certain country by the
development and expansion of other which the first is subjected, when this expansion results in a
negative affect in their immediate development (Santos, 1970).

The reproduction of this situation of dependence would be maintained because of the
inequalities of the relationships between a dependent economy and the dominant external economy in
politics, military affairs and economics, which would shape the underdeveloped economy to fulfil the
domestic needs of the dominant country. However, dependence is much more a political process and
not a mere imposition from above to below through military force, for example. It’s rather intrinsic to
the system and spread into the cultural, economic, technical and financial arenas, which are reflected
in the political space where groups try to establish themselves as the dominant one.

Although this debate was mainly about the problems of underdevelopment in Latin America,
the concept of development of underdevelopment may be applied to the present situation of many
countries in the world. It’s not feasible to deal with the notion of colonial exploitation nowadays;
however, politics, military affairs and economics at the international arena are still shaping the internal patterns of development of some countries, mainly the peripheral. Nowadays, the main concepts that must be taken in consideration besides politics are free trade and differences of terms of trade, international division of labour, foreign investments and financial (in-out)flows and domination of knowledge.

While in the colonial times the use military force was one of the presuppositions of dominance and impositions of policies (including economic policies), values, culture, at least in the occidental world, it’s not necessary anymore. Much more effective is the use of multilateral agencies as the International Monetary Fund and the World Bank to impose, for example, economic policies. This task was facilitated by the collapse of the Soviet regime, when not only the world division of power became unipolarised, although not completely, but also facilitated the victory of the neoliberal ideology. If before the 1990’s there was a huge debate about the best policies to promote development, here in a wide sense, in the very ending of the 1980’s the monetarist approach of Chicago together with the notion of free trade became practically an unanimity. In the case of the imposition of economic policies to transitioning countries, it became a religion, whose 10 commandments were the conclusions of the Washington Consensus.²

The religious imposition of these commandments to transitioning countries is problematic, as the diversity of historic, political and cultural backgrounds of these countries are not taken in consideration. At the same time, the blind faith of the market mechanism resulting in Paretian equilibrium is not pragmatic. Although much more a The main idea was that the development of the core States would mean the underdevelopment and permanent subordination of the peripheral countries, through colonist exploitation. In this way, what were being reproduced along with the development of the states at the centre of the capitalist world economy were the underdevelopment and the permanent subordination of those states in the periphery, in other words, a result of a situation of dependency. Dependence in this case must be understood as the conditioning of the economies of a certain country by the development and expansion of other which the first is subjected, when this expansion results in a negative affect in their immediate development (Santos, 1970).

The reproduction of this situation of dependence would be maintained because of the inequalities of the relationships between a dependent economy and the dominant external economy in politics, military affairs and economics, which would shape the underdeveloped economy to fulfil the domestic needs of the dominant country. However, dependence is much more a political process and not a mere imposition from above to below through military force, for example. It’s rather intrinsic to the system and spread into the cultural, economic, technical and financial arenas, which are reflected in the political space where groups try to establish themselves as the dominant one.

² The ten commandments were: 1) fiscal discipline; 2) prioritization of the public expenses; 3) tax reforms; 4) financial liberalization; 5) free exchange regime; 6) commercial liberalization; 7) free direct foreign investment; 8) privatisation; 9) deregulations and 10) defense of intellectual property.
Although this debate was mainly about the problems of underdevelopment in Latin America, the concept of development of underdevelopment may be applied to the present situation of many countries in the world. It’s not feasible to deal with the notion of colonial exploitation nowadays; however, politics, military affairs and economics at the international arena are still shaping the internal patterns of development of some countries, mainly the peripheral. Nowadays, the main concepts that must be taken in consideration besides politics are free trade and differences of terms of trade, international division of labour, foreign investments and financial (in-out)flows and domination of knowledge.

Although the concept of creative destruction and innovation used by Schumpeter is often used to analyze the competition patterns in a microeconomic approach, it is very valuable to understand the economic relations between countries in the globalised world. Nowadays, the world economic structure may be divided in four spheres, relating to the degree of innovation: First, there are the countries where the process of innovation often begins: in the last 30 years with little exceptions, United States and Japan. Second, there are the countries where the innovation rapidly follows and acquires the new technological paradigms, being able to compete with the pioneers, mostly the European Union and Canada. Third, countries that survive with economic paradigms that don’t refer to the new, besides few innovative sectors, as Brazil. These countries have an industrial complex of the Second Industrial Revolution, some developed financial system, but the greatest part of the economy is reproduced within another paradigms and innovation is very poor and rare. Fourth, the countries where the new paradigms are just a utopia as most of Africa.

The consequence is that countries or regions that don’t have a strong policy stimulating R&D can only copy the ephemeral but not the source of the technological and scientific paradigm; the second is that the process of economic reproduction that is carried copying the ephemeral also become obsolete rapidly, meaning that a strong effort to follow the innovative process could lead a country or region to remains in a subordinated position at the international economic system.

This division isn’t a static model, because in the same geographical space simultaneously may subsist several forms of reproduction of the social economic life based in a multiplicity of paradigms, resulting in the coexistence of various modes of production together in a country or region, frequently changing through time. In other words, in the same geographical space there is a clash of societies, with abstract capitalism existing besides capitalism, mercantilism or even feudalism. Thus, with the rise of a new mode of reproduction as result of economic development, one part of the society starts to reproduce itself within the new paradigms which are substituting the old ones, whilst another continue reproducing itself within the former structure.

This occurs because of the idiosyncratic character of the process of innovation, which excludes those who don’t or can’t adapt to the new form of economic reproduction. As these people have to continue to live, they reproduces their existence by the old forms, constituting themselves a living corpse of an old socioeconomic organisation that doesn’t integrate the new society. This idea may be applied to the economic relationship between countries.
As the process of economic reproduction and concurrence is increasingly dependent from new technologies, the economic leadership remains with the country or region that develops these technologies and detains the patents and the rights to use and to sell the rights to use it to other countries or regions, which assume subordinated position. This is the essence of the development of underdevelopment. Economic growth turns into development only when it may be reproduced in a sustained way, i.e., within the borders of the most advanced paradigms of reproduction of the economic system that is in effect. Any form of economic growth based on paradigms already superseded by the process of creative destruction implies in the reproduction of the “old” and, thus, in the reproduction or development of underdevelopment.3

Latvia and the development of underdevelopment

The process of development of underdevelopment begun in Latvia as result of the process of transition to capitalism, mainly with the application of a conjunction of monetarist/neoclassical policies known as “shock therapy”. These policies were imposed by the international community, which counted with the inability of the local politicians to deal with the economic paradigms of the neoliberal capitalism. The international community, mainly through the IMF and World Bank, traded help for neoliberal reforms. As the transitioning countries were in deep need of financial support, even in the case the politicians were able to deal pragmatically with the process of transition, these policies would be implemented anyway. From the independence until now, Latvia passed through a process of deindustrialisation and establishment of non-dynamic sectors, which was aggravated by joining the European Union in 2004.

In theoretical terms, the main problem was the ideological view that neoliberalisation and the adoption of neoclassical/monetarist policies would result in the best in terms of development. In other words, that the invisible hand of the market would lead the transitioning countries to an optimal level of development. The point again is the faith in the infallibility of the market forces resulting in an optimal point; nevertheless, there is no doubt that the market forces may lead to equilibrium, however there’s no guarantee that the level of economic activity and development at the equilibrium point is the optimal to the society. At the same time, the presupposition that the instantly exposure of an underdeveloped closed economy to the international system will result in development is false. The clash of the endogenous structural fragilities with the dynamics of the international economic system usually results in the development of underdevelopment. In the case of Latvia, the clash with the European economic system resulted in a deepening of the process of development of underdevelopment.3

3 The idea is that fragile economies cannot deal with the pressures of the international system, being subordinated to foreign interests, which may not be the most valuable to a country’s development
The most significant issue after joining the European Union was the complete openness of its financial and capital accounts, and in this way the change of the structure of the credit market. Credit is the most powerful instrument to promote economic development, although the availability of credit is not a guarantee that the development will occur. In the period 2004-2008, there was a credit boom, as a consequence of the strategy of the foreign banks operating in Latvia. The chart 1 shows the bank credit growth in the period 2001-09.

**Chart 1**

**Bank credit growth, 2000-2009**

In the last quarter of 2008, the loans issued to residents amounted Ls 14,737,4 million, or 90,1% of the GDP. In comparison with the end of 2003, there was a significant change in the structure of the loans issued, because of the strategy of the banking sector and the demand of the public. While in 2003 the most privileged sectors were individual services (23,1%), wholesale (16,1%) financial intermediation (12,5%) and manufacturing (11,73%), in the end of 2008 the situation had changed drastically. Since 2004, the banks started to lend relatively cheap money to finance operations in the real estate sector and consumption of durable goods. Besides, because of the process of increasing financial needs, the availability of credit for financial intermediation also rose. In this way, the money lent to non-banks in the last years turned to be mainly directed to finance operations with real estate actives (56,6%), consumption of durable goods (11,2%) and financial intermediation (7,2%), while all other sectors experienced a relative reduction. The result was a process of economic restructurisation, making the process of development of underdevelopment to deep.
In 1995, manufacturing, agriculture and energy accounted for, respectively, 20.7%, 8.7% and 5.0% of the GDP. However, in 2008 the same sectors accounted for 10.6%, 3.0% and 2.8% of the GDP. The main point is that although the GDP was growing, the result of the structural changes was to deepen the underdevelopment. First, because the demand for durable goods has a natural limit. As there was a huge repressed demand of these goods as people wanted to get rid of the old soviet durable goods, with the availability of credit the consumption of these goods experienced a boom. However, when this demand is fulfilled, the sectors associated to it tend to experience a strong reduction in their level of economic activity. Second, as economic history shows, artificially inflated prices of real estate always go down, in other words, bubbles always deflate. Third, and most
relevant, because the capacity of people to borrow is directly related to the amount of money they may dispose to pay back the credit, limiting the credit market.

![Chart 3: Structure of Latvia’s GDP- 1995 and 2008, %](chart3)

Source: Latvia’s Central Statistic Bureau, own calculations

Also, the transport and storage sector depends on the production of goods, which by its time is dependent of their demand. With a crisis, both in the internal and in the external side, this sector tends to suffer a reduction in its performance. As Latvia’s manufacturing sector had been shrinking, besides the inevitable decrease of the commerce of durable goods, the transport and storage sector has also experienced a slow down. In this way, nearly a half of the Latvian GDP has been remaining in an unsustainable basis, showing that a crisis would occur with or without the current financial crisis. Although the GDP was growing fast, in reality the structure of the Latvian economy was debasing and becoming increasingly dependent of four sectors that, by their own idiosyncrasy, aren’t sufficiently dynamic to push the economy in the medium and long terms. In other words, the failure of the internal model was a natural consequence of its own structure.

Besides the process of economic restructurisation, another problem was inflation. As result from the influx of foreign money by the banks, from 2003 to 2007, the monetary basis of Latvia
increased 181%⁴. From May 2004 to June 2008, the increase was 163%. By the side of M1, the biggest growth was in overnight deposits, leading to the conclusion that the issuance of money by Bank of Latvia hasn't been the main cause of the increase of the monetary basis. Rather, this is the result of the strategies of the private banks operating in Latvia. If by one side they may naturally create money, by other the increase of their activities have been financed by external remittances of money.

Usually inflation is seen as a bad indicator, it's also true that it may signalise economic growth. What developing countries must take in consideration, is that an annual rate of 13% of inflation isn't so bad, if there is economic growth and, more important, development. Inflation is a problem when it's 13% a month. A yearly inflation of about 2-3% is the case of developing countries in deep recession or of developed countries approaching stagnation and starting to face problems as unemployment. Before achieving an inflation rate of 2-3%, a country first must develop. On contrary, such a low inflation rate is going to be under the expense of small economic growth/development.

**Chart 4**

Monetary base and inflation in Latvia 2003-2008, million lats and %

![Chart showing monetary base and inflation in Latvia 2003-2008](chart.png)

Source: Bank of Latvia and Latvia’s Central Statistic Bureau, own calculations.

The restructurisation of the economy and the inflationary process were the result of ineffective regulation of the market by the Financial and Capital Market Commission and the inability of the Bank of Latvia to deal firmly with the increases of the monetary base. The Financial and Capital Market Commission assumed a position of not intervening in the market, being rather an observer. It

---

⁴ Here considering M2
didn't perform its basic function of regulate the financial system to guarantee its stability, controlling the explosion of the market credit and therefore protecting both banks and clients from overexposing to risk.

The case of the Bank of Latvia is different. Its institutional discourse relies on the impossibility of performing monetary policy due to the “impossible trinity”, as Latvia's exchange rate is practically fixed against the euro and the capital and financial accounts of the Balance of Payments are opened. Also, by the fact that the currency of more than 85% of the credit lent in Latvia is in Euros, meaning that the Bank of Latvia cannot use the interest rate as an instrument to control inflation. Although this may be a true situation, this rhetoric has been used to shield the institution from criticism, through the discourse of impotence in face of the actions of the market.

Much more important for the Bank of Latvia was to artificially maintain the exchange rate from going beyond the fluctuation band, and to maintain the long-term interest rate in accordance to the Maastricht criteria. These goals have been achieved administratively, without active interventions disciplining the market. Therefore, although aware of the growing inflation, it completely ignored the role of the monetary base as main determinant of inflation in Latvia. It also ignored that regulating the expansion of the monetary base, it could avoid the process of economic restructurisation to be so drastic.

A working paper of the Bank of Latvia even discussed the change of the expectations of the economic agents as determining inflation, but the authors didn't go to the monetary aggregates, what would be logic to try to explain why the expectations are changing. Although mostly of the sectors of the Latvian economy were developing based on unreal positive expectations, people have been feeling they were getting richer and richer and that this was occurring in a sustainable way. The result was a distortion of the apprehension of reality by the majority of the economic agents. Even in 2008, some international consulting companies were still defending the idea of Latvia becoming an international financial centre, when a superficial analysis of basic macroeconomic indicators was already clearly showing that the Latvian economy was starting to face a structural crisis.

To put inflation down, as to avoid the economic structural changes as well, it would be necessary to impose some regulations. This is a delicate issue in Latvia, as the concepts of ‘economic freedom’ and ‘economic liberalism’ are understood by the Latvian authorities, politicians, and a significant part of the private economic agents as a synonym of complete anarchical freedom. Anything more than the regulations imposed from the outside, for example, the regulatory framework of the European Union, is considered or communism or populism. This cultural specificity helps to

---

7 The word ‘populism’ has a lot of concurrent uses by the Latvian politicians and authorities. Usually, it is used to criticise any idea or action from opposition groups, even if the idea isn’t really populist.
explain the lack of initiative of the regulators to perform their basic function of regulate efficiently. In addition, there is a lack of effective co-operation between the Bank of Latvia, the Financial and Capital Market Commission, and the central government, as they tend to act independently from each other.

The Bank of Latvia was the unique institution several times alerting about the structural problems the Latvian economy was going to face, although did nothing to avoid them. The central government never took in consideration these alerts, often discrediting them, while the Financial and Capital Market Commission was ignoring the macroeconomic aspects of its chosen regulatory model. In this sense, the passiveness of the Financial and Capital Market Commission, together with the autistic attitude of the politicians is an important component of the formation of the structural crisis.

By the side of the private banks, even with the signs that this process was unsustainable, as the structure of the loans appeared to be very sound - mainly mortgage loans and commercial pawn, in the beginning of 2008 the banks were still considering secure to continuing lending.\(^8\) Also, there was a strong component of moral hazard. The answer of the head of the real estate division of one of the top three banks of Latvia to the question why they were inflating the real estate market with credit was that it was known that “(...) it is unsustainable, but everyone’s annual bonus depends on making more money. We know it will crash, but we are all making to much money now to stop it”\(^9\) Although appetite for risk by large foreign banks was particularly strong given the modest exposure of their portfolios to the Latvian market and the very high returns on equity invested there, international experience shows that perceptions of loan quality are notoriously procyclical- positive during economic upswings, but deteriorating rapidly when conditions turn less favourable.

\(^8\) Although not as profitable of other services, mortgage guarantee that the client will stay with the bank for a long period and that he/she will buy other products as, for example, insurance.
The consequences of the end of the speculative cycle in the Real Estate market in Latvia were two. By the side of the banks, (a) the soundness of the loan portfolio experimented a reduction of its quality, in other words, the material guarantee of the issued loans is considerable less than the amount to receive, implicating in losses and (b) the assets of the banks suffered a reduction that may affect the profitability of the banks. As foreign-owned institutions dominate most of the banking system of Latvia, this means to export losses to the mothers, what is already suggested by the International Monetary Fund in the last “Request for standby arrangement”. By the side of the general population, the main problem has been the psychological impact affecting consumption and thus credit and the general level of savings. As buying a real estate property is seen as an investment and a form to save money, a decrease on the price of property makes people consider they’ve lost part of their savings. This affects negatively their level of confidence in the national economy, resulting in a fall of the consumption level, in the expectations of the economic agents, thus in a lower level of economic activity and employment. This effect has been magnified in Latvia.

As it was clear that the process of economic restructurisation was deepening at least since 2006, some measures could be taken to avoid it. In this case, the Bank of Latvia could have at least taken one significant measure. Although its possibilities to perform a comprehensive monetary policy are limited, in this specific case one instrument was available: the compulsory reserves. As the monetary base was increasing mainly as consequence of the remittance of capital from foreign banks to their subsidiaries to be issued as credit, together with the endogenous creation of money by banks operating locally, a more strict increase of the compulsory reserves would be sufficient to dry the
liquidity of M2\textsuperscript{10}. Combined with stricter regulations for lending by the Financial and Capital Market Commission and a more prudent tax policy by the Ministry of Finance, the process of economic restructurisation wouldn’t be so radical\textsuperscript{11}.

\textbf{Chart 6}

\textit{Structure of Latvia’s exports - 2008}

\begin{center}
\begin{tikzpicture}
\begin{pie}
\piece{21.5\%}{Food and agricultural products}
\piece{16.9\%}{Products of chemical and allied industries}
\piece{12.5\%}{Wood and articles of wood}
\piece{16.6\%}{Base metals}
\piece{16.7\%}{Machinery}
\piece{7.4\%}{Transport vehicles}
\piece{8.4\%}{Other}
\end{pie}
\end{tikzpicture}
\end{center}

Source: Latvia’s Central Statistic Bureau, own calculations

However, the result was the deepening of the process of development of underdevelopment. Latvia must be understood as a sub-developed country integrating the European Union in a subordinated position. This means that Latvia’s international insertion in the international economic system has such a structural dynamic that the paths of dependence are strengthened instead of lightened. The structure of the foreign trade shows that the Latvia exports mainly primary products or products of the paradigm of the Second Industrial Revolution, while the imports are constituted by machinery and equipments to the fragile real sector of the economy, together with imports of mineral combustible and its derivates. Besides, Latvia also imports a considerable share of prepared foodstuff, showing that the agriculture is not capable to attend the internal demand and the agribusiness in the country is not quite developed. The conclusion is that the Latvian economy is poorly developed and

\textsuperscript{10} The Bank of Latvia increased the compulsory reserves three times since 2005: in the beginning of 2005 from 4\% to 6\%; in december 2005 from 6\% to 8\%; and in 2006 through the inclusion of the financial liabilities due in more than two year, in order to limit the Scandinavian banks, which were able to attain longterm financing and were playing the major role in the sector. It’s not clear why the bank of Latvia didn’t use all the potential of this instrument to control.

\textsuperscript{11} Until now, there are no taxes on capital gains, as very low taxes on real estate as well. Taking in consideration that other sectors are much more labour intensive, resulting in more taxes to be paid, there was a natural tendency to the development of the real estate sector.
dependent on imports of technology and material products, assuming an underdeveloped and subordinated position in the international system.

That’s the essence of what may be called the “Latvian disease”, a modern version of the “Dutch disease”, as the latter is a concept dealing with economic paradigms surpassed by the establishment of the abstract-capitalism. Accordingly to the Routledge Dictionary of Economics, the Dutch Disease must be understood as:

The harmful consequences for a national economy of discovering natural resources, especially the decline in traditional industries brought about by the rapid growth and prosperity of a new industry. New dominant industries can afford to pay wages far in excess of other industries, so the latter raise their wage levels to unaffordable levels causing unemployment. The successful new industry has high exports, creating a foreign exchange surplus and raising the country’s exchange rate, with the consequence that other industries of the economy become internationally uncompetitive. This was noticeable in the Netherlands after the discovery of North Sea gas. There rising prosperity brought about higher levels of welfare benefits which persisted after the downturn in the economy, causing immense difficulties for the financing of public expenditure.12

While the concept of Dutch disease deals with natural resources and the real sector, the concept of Latvian disease deals with the financial sphere and its relationship with the economy in its totality, in the sense of the notion of abstract capitalism explained before. It must be understood as the harmful consequences for a national economy of receiving huge amounts of financial capital, resulting in a process of economic restructurisation not simply related to losses of competitiveness due to an over-appreciated exchange rate. Rather, the transformation comes through the associated changes on credit availability and costs, together with revised expectations of income growth and of increases in financial wealth, resulting from upward movements in real estate prices and consumption of durable goods financed by cheap credit. The situation is aggravated by inflation due the increase of the monetary base and, naturally, losses of competitiveness because of the over-appreciated exchange rate.

Table 2
Latvia’s Balance of Payments main items, 2003-2008

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current account</strong></td>
<td>-522.8</td>
<td>-954.9</td>
<td>-1 131.6</td>
<td>-2 510.0</td>
<td>-3 327.2</td>
<td>-2 051.5</td>
</tr>
<tr>
<td><strong>Current account (%) of GDP</strong></td>
<td>-8.2</td>
<td>-12.8</td>
<td>-12.5</td>
<td>-22.5</td>
<td>-22.5</td>
<td>-12.6</td>
</tr>
<tr>
<td><strong>Goods</strong></td>
<td>-1 141.0</td>
<td>-1 502.9</td>
<td>-1 715.1</td>
<td>-2 856.4</td>
<td>-3 536.2</td>
<td>-2 755.6</td>
</tr>
<tr>
<td><strong>Capital and Financial Account</strong></td>
<td>529.4</td>
<td>945.9</td>
<td>1 303.0</td>
<td>2 438.4</td>
<td>3 430.1</td>
<td>2 357.0</td>
</tr>
<tr>
<td><strong>Capital account</strong></td>
<td>43.4</td>
<td>77.9</td>
<td>119.8</td>
<td>134.0</td>
<td>288.1</td>
<td>239.1</td>
</tr>
<tr>
<td><strong>Financial Account</strong></td>
<td>486.0</td>
<td>868.0</td>
<td>1 183.2</td>
<td>2 304.4</td>
<td>3 142.0</td>
<td>2 117.9</td>
</tr>
</tbody>
</table>

Source: Bank of Latvia

The marginal efficiency of capital in manufacturing and other traditional sectors turns to be much less than in real estate and commerce of durable goods, with a process of canalisation of investments to the latter sectors. As the core of the economy turns to be directed to the internal market, there is an increase of the deficits of the current account. Thus, there is also a process of social change, i.e. employment patterns. When the real estate bubble burst and the demand for durable goods is fulfilled, the result is crisis and unemployment; also, there is the deterioration of the expectations of the financial actors and the consequence contraction of credit lending.

In Latvia’s case, the Latvia disease is connected with the notion of development of underdevelopment. Not only the process of economic restructurisation was too profound, but the Request for Standby Arrangement with the International Monetary Fund foresee that real exchange rate overvaluation would need to be addressed through a recession in the short run, and slow growth for several years to come. This will only aggravate the present situation of dependency and underdevelopment. As the politicians are unable to discuss or to accept development policies beyond the neoliberal ideological boundaries, most probably Latvia will not experiment socioeconomic development at least for the next ten years.

**Final Remarks**

The capitalist system has a cycle of transformations and crisis. In the 1970’s, the conjunction of the end of the Bretton Woods system with the III Industrial Revolution changed the way the capitalist process of accumulation occurs, establishing what may be called as abstract-capitalism. Nowadays, the reproduction of the core of the capitalist system occurs detached from any materiality, mainly in the financial sphere. By the side of the real sector, the process of economic accumulation is now dependent of the control of the processes of creation, diffusion and use of knowledge. As consequence, the economic approaches that don’t take in consideration these changes in a multidisciplinary manner are becoming increasingly detached from reality. This affects the debate about economic development, which in the last 40 years has been victim of the neoliberal/neoclassic ideological crusade.
As the process of economic development is now dependent from the control of knowledge, the economic leadership remains with the country or region that creates knowledge and detains the patents and the rights to use and to sell the rights to use it to other countries or regions, which assume subordinated position. This is the essence of the development of underdevelopment. Economic growth turns into development only when it may be reproduced in a sustained way, i.e., within the borders of the most advanced paradigms of reproduction of the economic system that is in effect. Any form of economic growth based on paradigms already superseded by the process of creative destruction implies in the reproduction of the “old” and, thus, in the reproduction or development of underdevelopment.

Countries or regions that don't have a strong policy stimulating R&D can only copy the ephemeral but not the source of the technological and scientific paradigm. The process of economic reproduction that is carried copying the ephemeral also become obsolete rapidly, meaning that even with a strong effort to follow the innovative process a country or region remains in a subordinated position at the international scenario. The neoliberal policies of the European Union are not resulting in economic development, because developing and small countries suffer a process of dominance, even if involuntary. The application of these policies in Latvia - mainly the complete openness of the financial account, resulted in an incredible influx of financial capital, which was used by foreign banks operating locally to be given as credit. It resulted in a process of economic transformation, in favour of speculation and consumption of durable goods.

This was similar to the process represented by the concept of “Dutch disease”. However, as it deals with natural resources and the real sector, the problems of Latvia are result of the dynamics of the abstract-capitalism. That's way in this text it's proposed the concept of “Latvian disease”, which deals with the financial sphere and its relationship with the economy in its totality. It must be understood as the harmful consequences for a national economy of receiving huge amounts of financial capital. The result is the creation of a foreign exchange surplus, permitting or making the exchange rate to be overvalued. There is a dual process of economic transformation: deindustrialization and shrinkage in services sector by the lack of competitiveness resulting from the overvalued exchange rate; economic reorganisation in favour of speculative and/or non-sustainable sectors, as for example consumption of durable goods.

This process could be softened by adopting pragmatic policies, not only regulating the financial market with the objective to avoid inflationary pressures due to the increase of the monetary base, but to force the credit issued by the banks to other sectors than real estate and durable goods. At the same time, should be necessary development policies beyond the borders of the neoliberal ideology, dealing with the idea that countries in a condition of underdevelopment cannot surpass it without the intervention of the state, which may occur in different degrees. The lack of understanding of this dynamic, together with the adoption of ideological policies are the main factors determining the fact that Latvia has turned to be, sadly, one of most explicit examples of failure of the neoliberal project and of a situation of development of underdevelopment.
References


