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Can Countries Really Go Bankrupt?

By SPIEGEL Staff

The bailout packages aimed at shoring up financial markets in Europe are getting increasingly expensive. A creeping depreciation of currency is inevitable and state bankruptcies can no longer be ruled out. Could the euro zone also fall victim to the global financial crisis?

"There's a rumor going around that states cannot go bankrupt," German Chancellor Angela Merkel said recently at a private bank event in Frankfurt. "This rumor is not true."

Of course she's right. Countries can go bankrupt if they allow their deficit spending to spin out of control and are no longer able to service their interest payments. Merkel's comments can be read as a warning that countries need to keep their deficit spending in check. The message is: If governments go too far in trying to bail out companies and the economy, they could face insolvency themselves.

REUTERS

Great Britain is on the brink of financial ruin.

And so far, national governments have gone very far. Be it in the United States or in Europe, the sums governments are having to cough up to prevent the financial system from collapse are staggering.

Germany alone has already provided credit guarantees of €42 billion ($52.28 billion) to prevent the collapse of Munich's Hypo Real Estate, a bottomless pit that most now believe will have to be fully nationalized. The only thing holding up such a move is a legal provision in Germany that limits state holdings in banks to 33 percent. Meanwhile, Germany's second-largest consumer bank, Commerzbank, has been bailed out, with the state taking a one-quarter stake in the company. And the recent fourth-quarter loss of €4.8 billion at Germany's leading financial institution, Deutsche Bank, suggests that it too may ultimately require state assistance.

From Inconceivable to Inevitable

The image is even bleaker in the United States, where economist Nouriel Roubini estimates that losses in the financial sector will total $3.6 trillion. In the United Kingdom, the government has partially nationalized the Royal Bank of Scotland and Lloyds TSB -- and many experts see a full nationalization as inevitable.

There are few who would disagree with such moves. Should large systemically-vital banks go bust, the global financial system would collapse. But how much can countries afford to pay before the deficit-spending bubble bursts? An unimaginable scenario? Less than a year ago, a nationalization of banks in the US, Germany and Britain would have been inconceivable. Today, even the US -- the home of unbridled capitalism -- sees these moves as inevitable.

The borrowing being done by countries to finance the bailouts, economic stimulus programs and shortfalls in tax revenues will create a lasting burden. Worse, with the decline in the banking sector continuing, it is unclear that such massive spending will be effective. Especially when other, less economically stabile countires surrounding Germany have gone into a tailspin.

Take the example of Great Britain. The country is on the brink of financial ruin. Real estate is overvalued, private households are overly indebted and its vast financial sector has been badly hit by the crisis. Confidence in Britain's ability to overcome the economic turmoil is sinking by the day, as evidenced by the precipitous decline of the pound, which has almost reached parity with the euro. Just 13 months ago, it was worth €1.40.

A Second Iceland

"I wouldn't invest any more money in Great Britain," says American investor Jim Rogers. And economist Willem Buiter, a former consultant to the Bank of England, warns of the "risk that Great Britain will become a second Iceland."

One can also look to the example of Italy, which is on track to join a rather exclusive -- and undesirable -- club. At 106 percent of gross domestic product, Italy will have the third-largest national deficit in the world.

In a country that has long had a solid savings rate, deficit spending hasn't proven to be a huge problem in the past. The greatest challenge the government had was luring people to buy bonds at a set interest rate. The country's finance minister has described these investments as the "most solid and secure thing available." Of course, not everyone shares that opinion at the moment -- particularly not the Italians themselves. One bond that was floated in mid-January only found takers after the government markedly increased the interest rate offered.

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Bond returns in the euro zone.

This year, Rome has to pay back €220 billion in short-term bonds. Finance officials have been quoted as saying that were a single bond issue to find no takers, it "would be a disaster for the state." In December, Italian Labor Minister Maurzio Sacconi warned that Italy could go bankrupt if the country were no longer able to sell public bonds because of the glut of offers in other countries. "It would create a liquidity problem for paying salaries and pensions and we would end up like Argentina."

Great Britain as a second Iceland, Italy as a second Argentina. Iceland today is as a good as bankrupt, and Argentina actually became insolvent in 2001. It's no wonder then, that quotes like that from government officials are making people nervous. There has been no other time in history since the end of the Great Depression that the risk of national bankruptcies was this great in Europe as it is right now.

The national budgets in most of the European Union member states are in a miserable state. Finance experts at the European Commission in Brussels estimate that, this year alone, deficit spending in the 16-member euro zone will total 4 percent of GDP, with that figure rising to 4.4 percent next year. The euro Stability Pact, however, only allows 3 percent. The Commission estimates that in 2010, 17 EU states will surpass this total. The list includes countries like Germany (4.2 percent), France (5 percent), Spain (5.7 percent) and Britain (9.6 percent). Ireland is expected to top the list with deficit spending of an anticipated 13 percent.

These predictions, of course, exist only on paper for the moment. But Austrian Finance Minister Josef Pröll warns that "someday, payment day will come."

Euro Bonds?

Last week, Pröll and his colleagues formulated a call for a change of course, saying a coordinated fiscal stimulus was needed and that it must include a "coordinated budget consolidation" across Europe. Just how that might happen, though, is unclear.

In a hearing before the economic affairs committee of the European Parliament last week, EU Economics and Currency Commissioner Joaquin Almunia was showered with questions for which he had few answers. As a first step, he suggested that six to eight countries should reduce their deficits. But he didn't suggest how they might go about doing that.

For some governments, budget consolidation is the furthest thing from their minds at the moment. Instead these countries are doing everything they can to find ways of securing credit, which is getting increasingly difficult. "Smaller countries are being pushed out of the credit markets because the larger countries are borrowing billions," members of parliament told Almunia. His response: That's true, but you still can't "do away with capital markets."

In order to solve the problem, Luxembourg Prime Minister Jean-Claude Juncker, who is also his country's finance minister, proposed that the 16-member euro zone states should create common "Euro Bonds." Smaller countries praised the proposal, but it met with instant rejection in Berlin.

Germany, so far, has been able to borrow cheaply because it still has an excellent credit rating. If the country were to fill its coffers by floating Euro Bonds, it would have to pay €3 billion more this year. Austrian Finance Minister Pröll also seemed uninterested, dismissing the Euro Bonds as giving carte blanche for creating new debt at the expense of others.

Many European leaders have been critical of Germany's approach to the financial crisis -- it was slow to implement an economic stimulus package and some derided Chancellor Angela Merkel as "Madame Non." But in Germany, the government has been concerned about the risk of over-borrowing and burdening future generations with debt. The government has already abandoned its plan for a balanced budget by 2011, and Merkel has warned of the limits of Berlin's role in any bailout.

Merkel is concerned that the bailouts will overstrain the government. After all, if the government's debt continues to rise, at some point it will no longer be capable of paying the interest. Already, 2009's planned borrowing of €18.5 billion is higher than the previous year, and this week the government is now in the process of approving a second economic stimulus package that, combined with other borrowing, could push 2009 deficit spending past the €50 billion mark. No German government has ever had to borrow that much money.

To ensure that future generations aren't saddled with massive debt, the plan contains a provision that will funnel €1 billion a year in revenues from Germany's central bank, the Bundesbank, that previously went into the government budget starting in 2011. Currently, the Bundesbank pumps €3.5 billion a year into the budget. Until 2012, any profits at the bank exceeding €3.5 billion would go toward paying down the growing national debt.

Most experts believe the German government still has room to maneuver, but further deficit spending may be inevitable and few know how much will be needed. Berlin may soon have to establish one or more so-called "bad banks" where troubled financial institutions can park their bad loans -- a program that would require yet further government borrowing.

A Real Test for the Euro Zone

The government has exercised a degree of caution in deficit spending in recent years that has often been lacking in some other EU states. And politicians in Berlin have been reluctant to push through massive economic stimulus programs that might encourage others to abandon any sense of fiscal responsibility.

In the past, a handful of EU member states borrowed and borrowed without giving it a second thought. Now, they've been hard hit by the current downturn because their credit ratings have been lowered and they are being forced to borrow at higher interest rates. Spain, Italy, Ireland and Greece have been particularly hard hit.

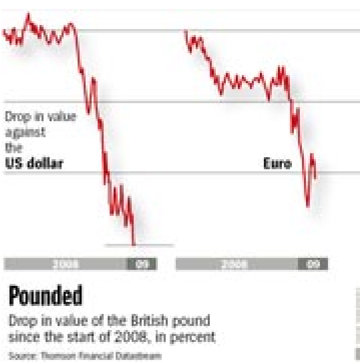
Countries that have to borrow so expensively are threatened with constantly rising interest rates that in turn increase their debt. In response, credit ratings agencies further lower ratings, pushing interest rates even higher in what becomes a vicious circle.

Market speculators create additional pressures. The tensions could escalate even further and create a real test for the euro zone.

The Euro Safety Net

Prior to their adoption of the euro, countries like Italy, Greece or Spain simply devalued their currencies in troublesome times and lowered their interest rates to increase the export opportunities for their economies. As members of the euro zone today, however, this option is no longer available because of stringent budget rules in place to ensure the common currency's stability.

The potential collapse of the euro zone has been a hot topic in financial market circles recently. One problem is that the euro treaty doesn't have provisions aimed at allowing highly indebted countries to voluntarily exit the common currency. Even if it did, though -- any countries to leave the euro zone would simply exacerbate their problems. Their credit ratings would plummet further, loans would get more expensive. And old debts would have to be repayed in euros. If their own currency devaluated, that would get even more expensive. Germany's EU commissioner, Günter Verheugen, considers the debate over exiting the euro to be "purely cheap propaganda against the euro from speculators in the Anglo-American capital markets."



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European currencies are having a difficult time.

But what would actually happen if a euro zone member state went bankrupt? During the next 24 months, for example, Greece will have to come up with €48 billion in order to service old debts, while at the same time plugging holes in its budgets.

If a country like Greece became insolvent, it would be initially be spared of the worst consequences of bankruptcy because of its membership in the euro zone. The euro would lose some of its value, certainly, but the Greek economy doesn't play huge role in Europe and the depreciation would be limited.

The consequences for Greece would also be limited. Because the currency would remain relatively strong, there would be no crisis in the retail sector, there wouldn't be any consumer hoarding and no black market -- in other words, it wouldn't create an economic crisis any greater than the one that would already exist. Nor would it lead to an increase in unexmployment.

Under the protective shield of the European Union, life in a bankrupt state would be relatively comfortable. The more important question, though, is how the EU would react.

Worst-Case Scenario

One scenario is that it could declare Greece to be an exceptional case and provide bridge loans in order to prevent the bankruptcy. But it would have disastrous consequences. After all, why would weak countries make any effort to balance their budgets if they knew the EU would bail them out in the worst-case scenario.

If the EU remained firm against Greece, that would certainly be fair to the member states who have practiced balanced budget discipline in the past. But that would also be politically untenable because it would drive investors away from any country that showed even the slightest signs of not being able to service its debt. They would have to continue raising the interest rates on bonds, and eventually the Greek virus would spread further, driving other countries into bankruptcy.

In this highly theoretical scenario, the euro would, indeed, collapse. The currency could survive the bankruptcy of one member state, but it couldn't sustain a series of them.

Euro-skeptics have long warned that tension inside the euro zone could destroy the currency one day. They now feel their convictions have been affirmed -- even if the aforementioned scenarios remain far from reality.

DPA

Iceland is as good as bankrupt: Will other European countries follow?

Germany itself has little trouble getting money. But even here, in light of the multibillion euro shortfalls in the national budget, investors are slowly starting to get nervous about German bonds. Many uncertain investors are starting to ask "what the future looks like for countries with AAA ratings," says Moody's analyst Alexander Kockerbeck. Experts at the US ratings company are already feeding worst-case scenarios into their computers. In one, they input test data for 2010 and 2011 assuming the economy would shrink by 3 percent each year. In that model, the national deficit rose quickly from today's close to 70 percent to 80 percent of GDP.

"The interest burden would be around 7 percent of government revenues," Kockerbeck said, saying Germany could still manage to preserve its high credit rating. But if that figure got up to 10 percent, the country might lose the best rating, causing its financing costs to soar.

Competing ratings agency Standard & Poors, which last week cut Spain's rating, holds a similar view. Analyst Kair Stukenbrock last week confirmed Germany's AAA rating. He also said he currently "assumes that the German economy and government budget can weather the current financial crisis without losing its credit worthiness."

Strangled by Interest Payments

In normal times, assuming a country has a solid credit rating and a good economy, borrowing is routine. Germany routinely floats short- and long-term bonds that pay interest. They can have a duration from anywhere between one day and 30 years. But some other countries, including Spain and France, even issue 50-year bonds. They are mostly sold through auctions -- and the higher the price, the cheaper it is for countries to borrow, but that also reduces profits for investors.

Repaying that debt is far more complicated. In the simplest case, the country just pays back the debt. It's extremely rare, of course, for a country to do that. In most cases countries renew their debt rather than repay it -- and by doing so they create new debt. Already today, the German government must pay €43 billion a year in interest. It's the second-biggest chunk in the federal budget after social expenditures.

But that could quickly change. If, for example, interest rates were to rise to their 1995 levels, the country would be faced with an additional €20 billion in payments, and that's without factoring in any new debt. Of course, given the nature of the current crisis, the debt burden will rise. Nobody knows how high, nor how the country can eliminate that debt before it starts to get strangled by interest payments.

One way to pay down debt, of course, is massive spending cuts and austere savings probrams. That, though, is difficult. Much more attractive is the inflation route. The state can just print money and pay its bills. Or the central bank prints money and pumps it into the economy. The currency becomes devalued, but the state doesn't care because that makes it easier to pay off its debts.

AFP

Riot policemen walk during clashes with demonstrators during a protest in Riga on Jan. 13.

No matter how a country elects to pay down its debt, it's the taxpayers who are left to foot the bill in the end. Indeed, the only time it is possible to repay the deficit by government savings is during boom phases, periods when the government can increase taxes, or if it can reduce its expenditures.

The people also pay the price of inflation because as the currency get devaluated, prices increase.

Up until now, the process has been subtle. Since the end of the 1990s, the major central banks in the US and Europe have trippled the volume of money in circulation. In recent months, the volume of money in circulation in the US and Europe has increased by almost half.

Universal Phenomenon

Central banks are trying to use the flood of liquidity to prevent a collapse of the global financial system and, as a result, of economies. At the same time, they may also be laying the path for the next crisis. Money is already insanely cheap: the US Federal Reserve has sunk its key interest rates to almost zero, and the European Central Bank is already down to 2 percent. It is extremely likely that interest rates will be lowered even further.

But if the bailout packages take effect and the economy starts to rebound, then central banks will again raise interest rates -- otherwise we would be threatened with a massive wave of inflation and the next, even worse crisis, would be inescapable. But the move may also lead many highly indebted countries to go bankrupt.

In a study for the International Monetary Fund, US economists Carmen Reinhart and Kenneth Rogoff researched financial crises of the last 800 years and concluded that state bankruptcies were a "universal phenomenon." Many countries have, in fact, gone bankrupt more than once.

Between 1500 and 1800, France became insolvent eight times. Spain went bankrupt seven times during the 19th century. Insolvency is a common phenomenon in every period of history, they concluded, and it would be erroneous to think that state bankruptcies are a "distinctive feature of the modern financial world."

Nothing Is Unimaginable Anymore

In most cases the country's coffers were wiped out by war. But in each case, the countries managed to bring themselves back from ruin. They proved to be incredibly resourceful in using their connections to banks, companies and, especially, the people.

The simplest solution was for states to just outright refuse to pay back their debts. In 1557, Spain's King Philipp II refused to pay his country's debts after its expensive military battles against the Dutch and the Ottomans. It was a decision that seriously damaged lender banks in Augsburg, Germany, and they never fully recovered.

Even after the Revolution, France's new regents had an even more extreme answer. They expropriated property from churches, major landowners and executed some lenders.

A similarly brutal option was to go to war to in order to plunder occupied areas. But such methods of budget consolidation tended to only happen when things started to collapse. Even in the old days, inflation was the preferred method of dealing with debt. They created more money and devaluated it. It's a method that was adopted as early as ancient Rome, where the Romans devaluated their coins by using fewer precious metals in them. It became a standard practice. In Vienna, the silver content in the Kreuzer coin was reduced by 60 percent between 1500 and 1800 and the Ausgburg pfennig lost more than 70 percent of its value.

Once paper money was introduced, the process was further simplified, since you could just print it. The first country to start printing money on a grand scale was France in the 18th century, when it needed to pay off the mountain of debt accrued by Louis XIV. In times of crisis, French governments ever since have fallen for this temptation.

The Warning of Hyper-Inflation

In 1914, with the start of World War I, the German Reich also began to unpeg its currency from gold. Until then, anyone could trade paper money for precious medals. Unpegging the currency meant that the amount of money in circulation rose from 13 to 60 billion marks by the end of the war, while the products on offer were reduced by one-third. Prices skyrocketed.

The disastrous development reached its peak in 1923 with hyperinflation. The exchange rate at the time was 4.2 trillion marks to the dollar. Bank notes were printed in 130 private printing presses, often on one side only to save ink. The only thing that could stop the mass devaluation was to change currencies.

In November 1923, the government issued the so-called Rentenmark. The previous currency could be exchanged at a rate of 1 trillion marks for 1 Rentenmark. Inflation quickly stopped. People spoke of the "miracle of the Rentenmark." But the truth is that it wiped out the savings and investments of large swaths of the German middle class as well as wealthy people who had been forced to finance the war by buying government bonds that had now been rendered worthless. Banks and insurance companies also lost their capital. The greatest winner, besides people who had loans or mortgages they no longer had to pay back, was the government. Its war debt shrank into insignificance.

These traumatic events remain a part of the Germany's collective memory and they fuel a latent fear of hyperinflation here today. Should people be afraid?

For the moment they don't need to be. Compared to many other countries, Germany is well positioned to ride out the crisis. The economy in recent years has been a lot stronger than other EU members and it is not as dependent on the financial sector as Great Britain. And unlike the United States, it isn't dependent on foreign lenders.

Iceland, for its part, is already as good as bankrupt. In Eastern Europe, a number of countries are wobbling -- Latvia has already had to request aid from the IMF and the Eastern European Development Bank. In the capital city of Riga, 40 people were injured in a violent protest that took place on Jan. 13.

Great Britain is also in trouble. And if it weren't for the protection that their membership in the common currency provides them with, some euro zone countries would be fighting for financial survival right now. America, on the other hand, is banking on the fact that it is still considered stabile despite it's enormous problems -- and that the Chinese still hold a huge chunk of their currency reserves in US bonds.

So will things get better? It would be an illusion to believe that countries have learned from their past mistakes, US economists Reinhart and Rogoff warn. In fact, another state could go bankrupt at anytime and take its people down with it.

In this crisis, nothing is unimaginable anymore.

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