AQUILA

Are we also in for national bankruptcy?

- There is a growing fear among financially sound Western European countries too that increasing government debt and the escalating banking crisis could result in national bankruptcy.
- There are no objective criteria for determining when national bankruptcy occurs. It all depends on the degree of confidence in the markets - which is generally acknowledged to be difficult to forecast.
- National bankruptcy would have considerable implications for the investors and the national economies concerned

The English say, “When it rains, it pours“. This is proving to be the case in the current crisis tool. Until recently there was a widespread belief that national bankruptcy was something that might happen far away in the Third World. Iceland has suddenly brought this threat much closer. Market expectations (measured against credit default swaps) in countries such as the Ukraine, Pakistan, Venezuela or Argentina indicate a 100% probability of national bankruptcy in the coming ten years. In the Eurozone, Ireland and the so-called “PIGS” (Portugal, Italy, Greece and Spain) have been the subject of rumours. Is national bankruptcy also conceivable in countries such as Germany, Austria, Switzerland or Great Britain?

I am afraid so, even if it is not likely at present. National bankruptcy occurs when a country is unable to service its debts or is unable to service them on time. Historically, this has mostly happened in connection with wars until now. In the 19th century Austria was bankrupt after the Napoleonic Wars (1811). Denmark suffered the same fate shortly afterwards. Germany was insolvent after both world wars. Interestingly, the global economic crisis in 1930 did not result in bankruptcy because great importance was attached to sound national finances at that time.

The fact that this issue has arisen now is of course due to the financial crisis, which has resulted in much greater risk awareness. All decisions now consider what could go wrong. The fear of national bankruptcy is not just a psychological state, however. It is also grounded in reality. The economic stimulus measures and rescue packages for the banks are causing national debt to increase at an unprecedented pace in peacetime. In the USA the federal budget deficit is shooting up from just under USD 500bn to a potential USD 1,700bn and in Germany from zero to a probable EUR 70bn. This is a real cause for concern.

Added to this are the completely new risks for countries in the financial market sector that the crisis is disclosing. In Great Britain the banks have foreign claims totalling USD 6.7bn, two and a half times its gross domestic product. In Austria the foreign claims (mostly in the countries in Central and Eastern Europe that have been shaken by the crisis) are one and a half times its national product. If difficulties arise here and the banks have to be rescued, the question arises whether the countries concerned will be in a position to shoulder this. Switzerland has the additional problem of loans in Swiss francs outside the Confederation. According to the Bank for International Settlements, they amount to USD 675bn (with a national product of USD 430bn). Part of these loans have been apportioned to Eastern Europe in this case as well.

Not every difficulty necessarily results in national bankruptcy though. Countries are backed by the economic power of the taxpayer. This provides substantial security. The central bank may, moreover, “print” money if it doubts that it will otherwise be unable to pay its creditors’ claims. It may print as much at it likes in theory. This is of course only helpful if the debt is in the national currency. There are also limits on the extent to which this is feasible in the Eurozone because its members have surrendered their monetary sovereignty.

The third source on which countries’ creditors can rely is foreign debt. As long as a country is able to obtain money on the international financial markets it has no problem with insolvency. Their lack of domestic savings forces the Americans to finance the bulk of their public deficits overseas, predominantly in China, as is well known. At the moment low interest rates are a sign that the finance ministers are having no problems obtaining the necessary resources. But woe betide them if this were to change.

There is no objective limit that might determine when this is the case. Everything depends on the confidence of international investors. This confidence is partially determined by objective criteria such as indebtedness, interest payments or the current account of the balance of payments. These criteria are to a certain extent the traffic lights that can change to red. Sentiments and moods also play a role. It is generally acknowledged that investors and their money are not easily parted. Some countries in the Eurozone are already noticing that it has become more difficult to raise money. An emergency will soon occur if this trend exacerbates. This makes it all the more important for the governments concerned to adopt confidence-building measures. It is helpful that the American President has announced a further reduction in government deficit during his current term of office. Curbing debt is helping in Germany.

The mutual assistance that allies are able to provide is ultimately essential if we are to avoid national bankruptcy in our part of the world. In my opinion, it would be inconceivable in the Eurozone for the Community to allow one of its members to become bankrupt (this also applies to Great Britain and Switzerland). The obligation to exercise financial discipline must not be revoked though. Otherwise everyone would be dragged down. The Community loan that is currently under discussion – however desirable it might be for reasons of European policy – is consequently a difficult balancing act.

What are the implications for the investor if the worst comes to the worst and we were to experience national bankruptcy as well? First of all, every investor would naturally lose his money in the government bonds concerned. That would probably be the least of the losses though. The macroeconomic consequences would be far more serious and would have far greater implications for the investor. Interest rates would rise in the country concerned. Its currency would plummet on the foreign exchange markets (this would apply to Switzerland and the UK in particular; the euro would help in the Eurozone). The cost of imports would rise and inflation would ensue. Foreigners would sell their securities on the stock market. Economic growth would fall. The country’s credit rating would be downgraded. If national bankruptcy really occurred, countries would have to fulfil the painful economic and monetary conditions imposed by their foreign creditors. The state would lose its function as a representative of last resort. It is this function that is preventing the system from collapsing at present. A currency reform might even be necessary in the worst case scenario.

Aquila Investment Ltd.
Dr. Martin Hüfner, 26 February 2009

The information and opinions contained in this document are based on sources we consider to be reliable. However, we can make no guarantee as to the reliability, accuracy or completeness of these sources. This information and these opinions constitute neither an offer nor a solicitation of an offer nor a recommendation to buy or sell investment instruments or to enter into any other transactions. Before reaching any decisions based on this document, we strongly recommend that interested investors consult their personal investment adviser in order to ensure that their personal investment goals, financial situation, individual requirements, risk profile, and other information are suitably taken into account as part of a comprehensive advisory service.