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# If Entire Countries Go Broke, We'll Go With Them

**By David Smick**
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The global financial market is like a rich, generous but occasionally paranoid great uncle. Normally, this benevolent great uncle sprinkles money calmly and wisely throughout the family, taking a careful reading of risk and potential investment reward. But every so often, a deep paranoia overtakes him. Panicked, he turns off the spigot. Why? Sometimes he thinks his relatives are not telling him everything he needs to know. Other times, paranoia sets in because the facts of a relative's scenario don't add up.

Today the great uncle has reached a level of paranoia not seen since the 1930s, and the massive "shock and awe" campaign of bold rescue efforts from the world's wealthiest countries has not calmed him down. The world financial market still thinks the numbers don't add up.

This is primarily because of a new and fast-moving blip on the global radar screen: the growing concern that entire countries could default on their financial obligations. While Washington frets about bank failures and the potential collapse of the corporate sector, the financial market is far ahead of it. Global markets are now fixated on the economic, social, political and foreign policy shipwrecks that could be triggered if waves of country defaults sweep across the world.

In an alarming number of nations, the amount of dubious debt held by the domestic banking system dwarfs the country's GDP. This is particularly true in such emerging capitalist economies as Hungary, Iceland, Belarus, Ukraine and Pakistan.

That's scary. In the past, some emerging market economies have defaulted (Argentina comes to mind) and managed to survive without dragging the rest of the world off a cliff. But things are different today. The global financial system itself is on life support. If an emerging market collapses, the damage won't be limited to just one country.

Here's why all this matters to the average working American: Emerging markets are major purchasers of U.S. exports and a critical engine of global growth. If their economies fail, ours will fail, too.

The root of today's credit crisis is not that the world lacks money; the world is awash in cash, with $6 trillion sitting idly in global money markets alone. But if countries start to fail, the remainder of the world's investment capital could be spooked out of productive investments as well.

Nor do we have the tools to avert disaster. The International Monetary Fund's resources are a pittance compared to the financial exposure of the countries in most danger. And as a result of the industrialized world's government bailouts and bank guarantees, there won't be any more capital for emerging markets that are still flailing.

Take, for example, a country as large and powerful as Germany: Deutsche Bank's assets represent 80 percent of the nation's GDP. In Switzerland, the assets of the bank UBS represent 450 percent of the country's GDP. The financial exposure of the British banks is similarly alarming: Barclays PLC's assets amount to more than 100 percent of the United Kingdom's GDP, and the Royal Bank of Scotland's holdings reach 140 percent of British GDP.

These countries aren't even the biggest worry. That honor goes to the nations of Eastern Europe and some of the undercapitalized Asian countries. But globalization means we're all connected. If Hungary were to default on its financial obligations, Austria's banks would soon collapse. If that happened, Germany's banks might well follow suit.

There's plenty to fret about in Asia, too. Pakistan is facing default. Many investors worry about South Korea as well: Its exports are plummeting, and foreign investors are fleeing an already weak stock market. In an emergency, would the South Korean government, or even the IMF, have the resources to come to the rescue? We can't be sure.

American investors wouldn't be of much use, either. After all, what banker in today's partially taxpayer-owned, soon-to-be-politicized financial system would want to testify before Congress about a risky loan to some small foreign country when safe domestic investments had been available?

Note, too, that the slowdown in securitization—the slicing and dicing of assets to be sold as securities—will add to this potential mess. In the past, the much-maligned process funneled huge amounts of capital to the developing world. That's not going to be happening anymore, at least not for a while.

No wonder global markets are so jittery about the prospect of countries defaulting. The rich, developed countries enjoy huge resources that can save them from financial collapse. But those resources are not unlimited. In Europe, taxes as a percentage of GDP have grown to 43 percent (compared to roughly 20 percent for the United States). Translation: If Hungary, Pakistan or South Korea went broke and European governments were forced to raise taxes to finance a bailout, the economic pain would be excruciating.

That is why the "shock and awe" of the current bank bailout efforts hasn't yet stabilized world financial markets. Investors suspect that the problem is just too expensive to confront. The IMF estimates that global banks have already lost $1.4 trillion. By the time the world fully enters into recession next year, global bank losses will almost certainly have increased dramatically. Some experts expect them to reach a whopping $5 trillion.

So the question remains: Do the world's governments have the resources to take on such a massive rescue operation? The global markets aren't sure.

Our next president, beginning the day after the election, needs to call for global contingency plans in case countries collapse—because the financial market will bet against the global economy as long as this uncertainty exists. Eliminate that uncertainty, or at least show how the world economy will cope with such calamities, and our policymakers can return to the thorny job of cajoling our bankers into lending again. The great uncle is not assuming that the worst is over.

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