10 Countries in Deep Trouble

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While the collapsing U.S. housing market may be at the root of the global economic recession, the downturn's effects are being felt hardest overseas. Take Iceland, for instance. Its biggest banks failed, its economy may shrink 10 percent this year, its government fell, its central banker was sacked, the country was bailed out with a $2.1 billion IMF loan, and 7,000 people (in a country of 300,000) took to the streets in protest.

Which countries have the greatest chances of being the next stories of failure? *U.S.News* looked at some countries that are currently facing severe economic disruption that endangers their standards of living, attractiveness to foreign investors, and political stability. First, we examined what Moody's Investors Service and Standard & Poor's had to say about them. These firms rate the risk of sovereign bonds, securities that finance the debt of a country. Many of the countries we identified have poor bond ratings or ratings under review for a downgrade, showing that these governments are perceived as being at greater risk of defaulting on their debt.

Second, we looked at what global markets think about a country's debt, based on data from Markit. The financial information company provides daily pricing on credit-default swaps, contracts between two parties that provide a kind of insurance on corporate and government debt. Analysis was also supplied by credit-rating organization AM Best. It ranks countries into five tiers based on the risk to insurers posed by the countries' economic, political, and financial systems. Using these analyses, here are five countries in deep trouble and five worth keeping an eye on.

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Five Countries in Deep Trouble

Mexico. Thousands of would-be tourists from America and elsewhere had to cancel spring break trips to Mexico due to ongoing violence related to the drug trade. Mexico was the second country recently identified by the U.S. Joint Forces Command as possibly poised for a "rapid and sudden" collapse. Mexico's "politicians, police, and judicial infrastructure are all under sustained assault and pressure by criminal gangs and drug cartels," says the report.

The violence and tourism decline could not come at a worse time. Economists predict a 3.3 percent contraction of the Mexican economy this year. The poor economic growth means that the government is getting strapped for funds. In April, it asked the International Monetary Fund for a $47 billion loan. While credit-rating agencies don't expect Mexico's debt to grow riskier soon, and the risk of its sovereign derivatives has not skyrocketed like some other countries on this list, serious problems still remain for the Mexican economy. The country depends on the United States to consume its exports and pay Mexican immigrants who send money back home. If the U.S. recession deepens, Mexicans will feel the pain as much as Americans.

Pakistan. The country has already almost gone bankrupt once in the past six months. In October, only an emergency $10 billion in support from the World Bank, the Asian Development Bank, and others prevented Pakistan from defaulting on its debt. During that crisis, the cost of insurance on Pakistan's debt exploded. Even though the situation has calmed since then, investors are not getting comfortable with Pakistan. It still costs $2.2 million a year to insure $10 million of Pakistan's sovereign bonds.

The economic situation isn't all bad. The Asia Development Bank recently predicted that Pakistan's economy will grow 4 percent in the next fiscal year beginning in July, compared to 2.5 percent growth estimated this year. But the wild card that could change everything is the country's political situation. Pakistan is one of the most unstable countries in the world. On April 13, White House counterterrorism consultant David Kilcullen said that a political collapse in Pakistan could come within months. A 2008 report from the U.S. Joint Forces Command identified Pakistan as a country at risk of a "rapid and sudden collapse," one that would create a devastating security problem for the world. The report says that "the collapse of a state usually comes as a surprise." Anyone banking their money on Pakistan's economic growth might not know what hit them.

Ukraine. While Iceland may have suffered the worst financial collapse of the global recession, Ukraine has also received a dubious honor: It had the priciest sovereign credit-default swaps for the first quarter of the year. It currently costs about $3.9 million to insure $10 million of Ukrainian five-year sovereign bonds. A year ago it cost just under $3,000. S&P rates them CCC--the seventh-best (out of eleven) rating, indicating that Ukraine is vulnerable to nonpayment.

As the government tries to solve the crisis, Ukrainians are getting squeezed. Kiev, one of the oldest capitals in Europe, has had to shut down free clinics, schools, and increase public transportation costs in order to close a deficit. The Institute for Economic Research and Consulting is forecasting a GDP contraction of 12 percent. The Ukrainian stock market has fallen 25 percent so far this year. The Ukrainian currency, the hyrvnia, is also plummeting, falling 35 percent against the dollar in the last six months. The Ukrainian government's efforts to shore up the currency, including setting a floor for which the hryvnia can be traded, have so far been in vain.

Venezuela. Hugo Chavez has inextricably tied the Venezuelan economy to oil, and that didn't look so bad before the financial crisis. Oil profits helped deliver massive economic growth, so much that 4.8 percent growth in 2008 was seen as a disappointment. But with oil prices having plunged due to the global slowdown, the fortunes for Chavez's strategy have changed. Many economists are predicting negative growth for Venezuela this year, such as the 4 percent drop predicted by Morgan Stanley.

From June to September, the cost for an investor to buy insurance against Venezuela's debt almost doubled. Right now, to protect $10 million in Venezuelan sovereign bonds against default, an investor would need to spend $1.8 million each year. S&P gives Venezuela's sovereign bonds a BB rating, meaning Venezuela faces "major ongoing uncertainties" that could lead to "inadequate capacity" to meet its obligations. S&P also has a negative outlook for the bond rating, meaning it could decline in the next six months to two years.

Argentina. The Argentine economy is notorious for its boom and busts. The country last defaulted on its debt in 2002, but enjoyed economic improvements through most of this decade. During that last financial crisis, citizens staged protests known as cacerolazos, which means "banging of pots and pans," but the demonstrations resulted in broken windows and fires. Argentina has not seen that kind of violence stemming from the current financial crisis yet, but foreign investors are worried the economy is back to "bust" mode. CMS Datavision ranks Argentina as having the third most expensive credit derivatives in the world. Right now, Markit composite prices show an annual cost of $3.2 million for an investor to buy protection against $10 million of Argentina's sovereign debt. Moody's rates Argentina's sovereign bonds as B3, meaning a high, speculative credit risk, and S&P as B-, meaning that more bad economic news for Argentina could lead to default. The Organization for Economic Cooperation and Development gives Argentina a seven, its riskiest classification rating.

Five Countries to Keep An Eye On

Latvia. Iceland isn't the only country that's seen massive protests against economic hardship. In January, a 10,000-strong demonstration in Latvia's capital, Riga, turned into a riot. Tremendous economic growth since the end of the Cold War earned Latvia its place as one of the "Baltic Tigers." GDP growth was 11.2 percent in 2006, for instance. But Latvia's Ministry of Finance forecasts a 14.9 percent drop in GDP this year. Latvia is getting a $7.5 billion emergency loan from the IMF, but the organization is sitting on part of the money because of the Latvian government's failures thus far to reform its budget. The past two years have seen the cost of Latvia's credit default swaps increase over one-hundred fold. Moody's rates Latvia's bonds as Baa1, or "moderate" credit risks, and projects that they could become riskier bets in the medium term.

Croatia. The country's beaches on the Adriatic Sea draw so many visitors that tourism is almost 20 percent of the country's GDP. But since the recession is taking a bite out of travelers' pocketbooks, Croatia's economy is getting bitten as well. The government forecasts unemployment could rise as high as 12 percent this year. And a recent poll found that 78 percent of Croatians think the country is going in a bad direction, with unemployment cited as the primary reason. All this bad economic news might be one of the reasons S&P projects a possible rating decline for Croatia's BBB-rated bonds. The BBB rating means that Croatia does not have payment problems yet, but are in a position where their ability to pay for debt could be easily weakened.

Kazakhstan. While the Central Asian nation's GDP has grown in recent years, Kazakhstan has two problems that have created the potential for economic disaster: a reliance on foreign lending and a reliance on oil. Kazakhstan holds 3.2 percent of world's oil reserves. But the soaring oil prices that have boosted Kazakhstan's economy are no more, and investors have pulled money out of Kazakhstan in response. The cost of buying protection against Kazakhstan's debt has skyrocketed about 75 percent during the past year. The cost is back up to a peak reached in October, and it currently costs $875,000 a year to insure $10 million of Kazakhstan's debt. S&P has a negative outlook on Kazakhstan's BBB-rated sovereign bonds, meaning they could get riskier in the next six months to two years.

Vietnam. Unlike many of the other countries on this list, Vietnam has had some good news recently. The Asian Development Bank forecasted Vietnam's economic growth at 4.5 percent for the next year, the highest in Southeast Asia. Yet the country just registered its slowest economic growth in a decade. A survey found that 46 percent of Vietnamese were afraid of unemployment in January, up from 9 percent in September. Both Moody's and S&P have a negative outlook for Vietnam's sovereign bonds. The price of its sovereign derivatives has almost doubled in the past year. Vietnam falls into the riskiest of the five tiers as rated by AM Best. In particular, the firm identifies Vietnam's financial system, plagued by "relatively poor infrastructure and cumbersome bureaucracy," as "very high" risk.

Belarus. Minsk, the capital of Belarus, was mostly destroyed during World War II and much of the city was rebuilt in the form of hulking, utilitarian, Soviet-style buildings. Belarus also retains a heavy Soviet influence in its financial system--all but one of the country's 31 banks is controlled by the state, according to AM Best. Because of Belarus's failure to reform its financial system, the firm gives the country its highest score for financial risk. Even though Belarus scores relatively well for political stability, that economic rating is enough to push it into the riskiest of the report's classifications.

Belarus's problems aren't just speculative. Although its economy is still growing, the IMF expects it will expand 1.4 percent this year, compared to 10 percent last year.The country's government has also been approved for a $2.46 billion IMF loan. But the IMF now forecasts that the country will need a further $10.7 billion in 2009. Still, other experts disagree about just how fragile Belarus's economy is. Its bonds are rated as B1 from Moody's, meaning high credit risk but also at the top of the pack of the high-risk countries.

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