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Are markets mispricing sovereign default risk again?

Some politicians and market participants are proposing to ban the trading of naked CDSs amid the surge in government bond yields in the European periphery. However, we show that the sovereign CDS market does follow a comprehensible macroeconomic rationality. In our view, therefore, politicians must come up with austerity measures instead of searching for scapegoats.

The trading of naked credit default swaps (CDSs)[1] have recently become subject of great controversy. Politicians and market participants alike are proposing to ban the trading of these instruments amid the surge in government bond yields in the European periphery. Wolfgang Munchau, a columnist of the Financial Times, even claimed in a recent article[2] that "*the case for banning them is about as a strong as that for banning bank robberies*". The arguments provided by the proponents is that naked CDSs have no social/economic benefit (i.e. they are merely a speculative gamble) and, therefore, unnecessarily push the yields on government bonds higher. So the main question is: should naked CDSs on sovereign bonds be banned outright because they are mispricing the risk of sovereign default in the European periphery?

A few opponents of this policy principally disagree given that sports betting, the national lottery and other types of gambling should also be outlawed. Moreover, all put options on equities should be banned given that naked CDSs are nothing more than a put option on credit. There are also other disagreements. An important argument against this policy is it's asymmetric nature. Why is it that governments kept silent when the same so-called "irresponsible and evil" speculators were mispricing the risk of sovereign default in the eurozone before the inception of the financial crisis (see figure 1)? In 2007, the spread on Greece's government bond was on average 28bps over the bund (nowadays it hovers around 340bps). Basically, governments cannot state that they believe in markets one day and dismiss them as irrational/damaging another day. An additional argument is that sovereign CDSs are too small to matter, so why bother? For example, during the period Oct. 2009 and Jan. 2010, the CDS volumes traded in Portugal and Greece amounted to roughly 12% and 7% of their cash bonds volumes, respectively.

Although some of these arguments carry some weight, we thought it worthwhile to dig a bit deeper to see whether speculators are seriously destabilizing the governments of the European periphery or whether the CDS spreads perfectly reflect the state of public finances of each country. To do so, we have subjectively selected a number of variables that we deem important in explaining the CDS spreads of a number of OECD countries (see table below). The variable in the first column, required primary balance (RPB), deserves an explanation though. The RPB is an estimation of the average primary (budget) surplus[3] that a country needs to have over the next 10 years – given that the average long-term interest rate and trend growth rate, as forecasted by the OECD between 2010 and 2011, is correct and holds true for the entire period – in order to bring down its debt to the 2007 level. After selecting the variables, we construct a z-score that adds up these seven criteria by equiweighting them (column 8). This approach provides us with a grid for interpreting the countries' relative positions. In the final column, we measure the deviation of each country's z-score with Sweden's z-score, which is the lowest and is set arbitrarily at zero. As such, the greater the deviation of a country's z-score from zero, the riskier it is in our view. Finally, we calculate the market-implied probabilities of default (IPD) of the sovereigns based on their CDS spreads by assuming a fixed recovery rate of 70%.

Figure 2 clearly illustrates that the sovereign CDS market follows overall a comprehensible macroeconomic rationality as our simple model explains more than 70% of the entire hierarchy of the sovereign CDS market. What is noteworthy though is that the market has priced in a higher IPD for Portugal, Ireland, Greece and Spain given their riskiness vis-à-vis some other OECD countries (e.g. the UK, France and Belgium). What could explain this divergence? Could it be that some yield-hungry hedge-funds colluded and are speculating heavily in order to breakdown the eurozone? Highly unlikely! Or is it that our model misses a number of important variables that can explain this divergence? Very possible. But let's assume that the selected variables provide an accurate picture of these countries' fiscal fragilities. In our view, the divergence can then be explained by accounting for four important factors that are not mutually exclusive.

[1] A naked CDS purchase means that you take out insurance on (government) bonds without actually owning them.
[2] "*Time to outlaw naked credit default swaps*" Financial Times, 28 February, 2010
[3] The primary balance is equal to the government budget balance excluding interest payments on outstanding debt.

Shahin Kamalodin

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Rabobank

First, these countries can be suffering from what the Greek prime minister called a "credibility deficit". This means the European periphery have more difficulty than the other OECD countries in the sample in convincing the markets that they will come up with serious austerity measures to get their ballooning debt under control. Moreover, some investors have lost faith in the official statistics of these countries (mostly Greece). Second, markets might believe that the reputational costs of default for these countries is less than, say, the UK which serves as the financial center of Europe. Third, the size of some of these countries (especially France, Italy and the UK) in GDP terms would mean that the chances of a bailout by the other eurozone members are much higher. Fourth, financial markets are prone to fads and fashions given that market participants make an acronym for a group of countries and then choose to treat them almost equally. For years, this has been the case for the BRICs (Brazil, Russia, India and China) whereby many investors purchased a host of indices (e.g. MSCI-BRIC, FTSE BRIC 40 and etc.) that make no distinction between the countries. Sadly, the same rule applies now to the Southern European countries as investors came up with unfortunate names such as the PIIGS or olive countries to bundle these countries together. In other words, sovereign default risks of these countries might be overestimated.

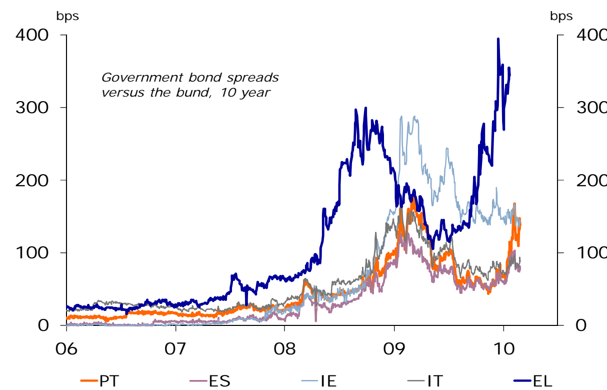
Thus, markets may be mispricing sovereign default risk up to a point. But this does not justify banning naked CDS trading outright, in our view. Against this backdrop, we believe politicians must focus their attention on solving the problems from its root cause (i.e. introducing credible austerity measures) instead of blaming CDSs for governments borrowing costs, which is akin to blaming the mirror for an ugly face.

Z-score

	Required primary balance 1	Net interest payments as % GDP 2	Net debt as % GDP 3	External gov debt as % total external debt 4	Weighted average years to maturity 5	Corruption perception index 6	Curr. acc. balance as % GDP 7	Sum of Z-scores 8	Deviation from min. Z-score 9
Greece	-0.16	1.75	1.21	2.49	0.52	2.43	2.26	10.50	**17.24**
Italy	0.85	1.88	1.37	1.67	0.27	2.29	0.39	8.72	**15.46**
Portugal	-0.16	0.63	0.44	0.30	-0.08	0.86	1.67	3.67	**10.41**
UK	0.23	0.54	0.35	-1.27	3.48	-0.23	0.14	3.24	**9.98**
Japan	2.01	-0.54	1.46	0.76	-0.62	-0.01	-0.64	2.42	**9.16**
France	0.13	0.49	0.40	0.26	0.12	0.25	0.29	1.94	**8.68**
Belgium	-0.21	1.05	0.99	0.13	-0.52	-0.01	-0.28	1.16	**7.90**
Ireland	2.74	-0.39	-0.15	-1.25	0.07	-0.23	0.31	1.08	**7.82**
Spain	-0.35	-0.55	-0.07	-0.43	0.02	0.54	0.85	0.00	**6.74**
Austria	-0.59	0.47	-0.04	0.32	0.17	-0.44	-0.03	-0.14	**6.60**
US	-0.50	-0.03	0.50	0.32	-0.92	-0.01	0.43	-0.20	**6.54**
Germany	0.03	0.36	0.25	0.29	-0.42	-0.34	-0.89	-0.72	**6.02**
Netherlands	-0.06	-0.05	-0.19	-0.53	-0.62	-0.80	-1.10	-3.35	**3.39**
Australia	-1.17	-0.41	-1.10	-1.23	-0.82	-0.71	0.62	-4.83	**1.91**
Denmark	-0.59	-1.19	-1.03	-0.93	0.62	-0.95	-0.87	-4.96	**1.78**
Switzerland	-1.32	-0.91	-0.81	-0.03	0.02	-0.84	-1.52	-5.40	**1.34**
Finland	-0.50	-1.55	-2.20	0.09	-1.16	-0.84	-0.24	-6.39	**0.35**
Sweden	-0.40	-1.55	-1.39	-0.95	-0.13	-0.95	-1.37	-6.74	**0.00**

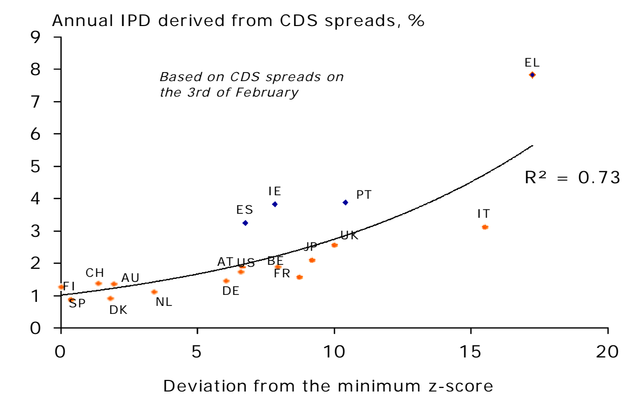
Source: Rabobank, OECD, IMF, EIU, Transparency International

Figure 1: Default risk was mispriced in the past



Source: Reuters EcoWin

Figure 2: Sov. risk measured by fundamentals



Source: Reuters EcoWin

Macro Comment 10/10

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