

Markets Worry More about Sovereign Debt

As the financial crisis has unfolded, market expectations have changed: Investors now see a greater risk that countries with large (and likely persistent) fiscal deficits may default on their obligations. The rising prices of credit default swaps (CDSs) reflect this change.

CDSs function much like insurance for bonds, although they are not regulated like insurance. The buyer of a CDS agrees to pay the seller an annual premium in exchange for the seller's agreement to buy the bond at face value (par) if the bond issuer defaults on a principal or coupon payment. Just as the likelihood of an auto accident affects the price of auto insurance, CDS prices reflect changes in market expectations about the likelihood that a bond issuer—such as a corporation or government—will default. As of January 6, 2009, CDS buyers were paying sellers almost 70 basis points for insurance against a U.S. Treasury default. If the CDS sellers expect to make no profit, on average, this price implies the perception of a 0.7 percent chance of default each year.

The chart shows that CDS premia have risen several-fold since September 2008 on 5-year German, Japanese, and U.S. government securities. Three facts are noteworthy: First, major changes in U.S. Treasury CDS rates have been associated with events that may affect the long-term fiscal situation of the U.S. government. For example, U.S. CDS rates rose substantially on July 11, 2008, the day that IndyMac Bank, a large mortgage lender in the United States, collapsed. CDS rates started rising again over the weekend of September 13-14, when Lehman Brothers declared bankruptcy and AIG sought a bridge loan from the Federal Reserve. U.S. Treasury CDS rates also soared on December 2, the day the Government Accountability Office issued a report advising greater transparency and oversight for the Troubled Asset Relief Program (TARP).

Second, the financial crisis has affected other sovereign CDS rates almost as much as those of the United States. From June 6, 2008, to January 6, 2009, U.S. CDS rates rose from 8 to 69 basis points; German

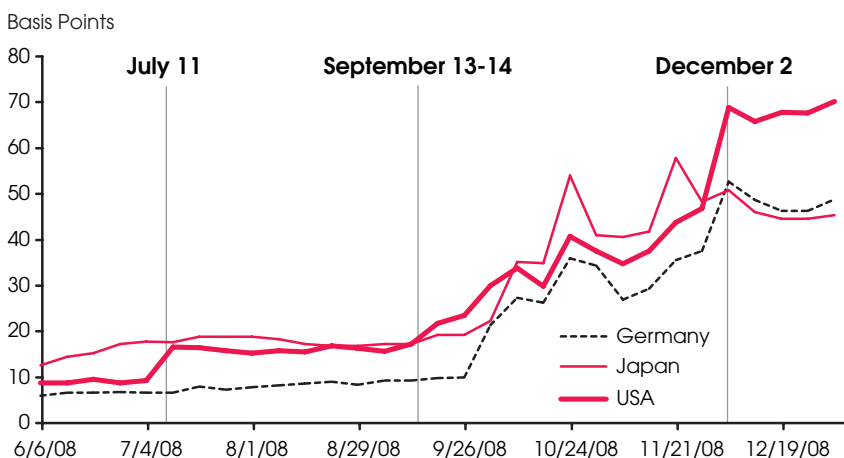
CDS rates rose from 5 to 48 basis points; and Japanese CDS rates rose from 12 to 45 basis points.

Third, despite projections of very high U.S. fiscal deficits for the foreseeable future, it is puzzling that U.S. CDS rates should be higher than Japanese CDS rates, given the relative fiscal situations in the two countries. The U.S. net debt-to-GDP ratio is only about 0.462, while the corresponding Japanese ratio is 0.878. The Japanese fiscal situation seems even less favorable than that of the United States when comparing gross debt or considering demographic effects on long-term deficits.

Regardless of its fiscal situation, a country that borrows in its own currency never has to default because it can always create its own money to cover the bond payments. Issuing new money to retire debt—while still very unlikely for the United States—normally creates inflation that devalues existing debt. Inflating away debt is much more likely than a formal sovereign default in which a country simply refuses to make payments. Although markets still perceive very small probabilities that Germany, Japan, or the United States will default on their bond payments, those probabilities have risen substantially lately.

—Christopher J. Neely

5-Year Credit Default Swap Rates



NOTE: Weekly data on credit default swap premia for 5-year government securities from June 6, 2008, to January 6, 2009.

SOURCE: CMA Datavision.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.