By Reuven Brenner

The Story *Of* Risk

And the illusion of the Federal Reserve's power to forever control rates.

An insurance company offers catastrophic insurance against a volcano erupting—but the company's assets are all on the slope of that same volcano. So if you bought credit default swap protection on such bonds from this insurance company, it would not pay out the value of the "insured" bond for people having escaped the flowing lava.

I am giving this extreme example because it sheds light on the fact that headlines about U.S. debt, deficits, and likelihood of default notwithstanding, Markit's credit default swap prices during November 2021 for insuring $10 million of five-year Treasuries have been hovering at about 14 basis points ($14,000), implying a 0.23 percent probability of default. This price was the ninth cheapest on November 3 in a list of twenty-eight countries—including Germany, Austria, and the United Kingdom—priced between 7.8 and 12.5 basis points. The highest price is for insuring Turkey's bonds at $443,000, implying a 7.39 percent probability of default (as of November 3). All these numbers assume a 40 percent recovery, though what would guarantee this percentage except military invasion or heavy sanctions before countries could ever borrow again on global credit markets is a good question.

Now say you bought this protection on U.S. Treasury bonds, and the United States unexpectedly defaulted. It is unlikely then that companies that sold the insurance would be able to pay—like the case of the insurance company located on the volcano slope. Recall that after the 2008 crisis, the government bailed out financial institutions (including AIG)—in fact bailing out the banks—which now it would no longer be able to do.

If so, what do the prices in the credit default swap market reflect? The numbers below answer not only this question but also shed light on bond and stock prices for the last few years, and also the non-appearance of bond vigilantes, and Fed policies—and what their normalization would imply.

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INTEREST RATES: INFLATION AND DEFAULT

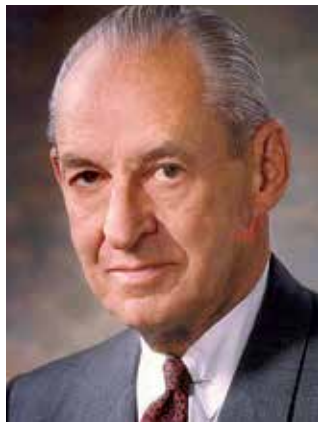
Interest rates reflect, among other things, expectations of inflation and default. Over the last year, the ten-year U.S. Treasury bond yielded roughly between 0.8 percent and 1.56 percent (as of November 3). Credit default swap prices allow purchasers to disentangle the risk of default from that of inflation, and allow fund managers to use the information as part of their portfolio management—hoping not to find themselves being the last investors holding the securities when catastrophe happens.

The higher the risk of default, the higher should be the interest rate and the price of the credit default swap. This indeed has been the case. For example, the price on credit default swaps on Portugal's debt went from $267,000 in 2017 down to $27,000 at present. Spain's went from $163,000 in 2020 to $28,000 at present. During this same period, the U.S. credit default swap price went from the high of $24,000 in 2017 to a low of $8,000 in June 2021, rising to $12,200 as of September 27, 2021. During the same time, the yield on Portugal's ten-year government bond went from about 4 percent in 2017 to 0.3 percent in 2021. Over the same time span for Spain, its ten-year government bond went from about 1.75 percent to 0.4 percent now.

Portugal, Spain, Italy, Greece, and others have pursued for years more irresponsible domestic policies than other countries. Without getting into the policies of the European Union and European Central Bank that contributed to bringing about the expectations of diminished chances of default, the fact was that savers looking for relative safety found it in the credit and stock markets of the United States, Germany, and other countries.

The flight to safety brought about the prices in bond and credit default swap markets. Consider an investor in, say, Turkish bonds, making a simplistic calculation using the 6.5 percent probability of default and the prospect of losing 60 percent of his capital. This amounts to losing 3.9 percent (0.065 multiplied by 0.6) of his capital—which is enough to induce buying safer countries' bonds at minuscule returns or even paying a bit to park the money—at a negative interest rate—until the storms pass.

Marriner Eccles: *"It is an illusion to think that to eliminate or to restrict the direct borrowing privilege reduces the amount of deficit financing. Or that the market controls the interest rate. Neither is true."*



In other words, the very low interest rates in some countries have not been the consequence of domestic central bank policies, but of heightened expectations of default in many countries around the world: better lose some basis points of interest, be it because of negative real rates or because of inflation and small devaluations, or even paying fees for parking your money—than lose significant parts of your capital. The low interest rates under such conditions reflect neither expectations of recession, nor deflation, but far lower chances in these select countries of defaults, confiscations, and other ways of losing one's savings. They certainly do not require novel monetary theory.

As to the role of the Fed: With many politically unstable and unreliable countries, the flow of savings went to the select few countries with minimal chances of defaulting. The sudden inflow of savings into them brought about lower rates—even negative ones. Maybe if the flight of capital were matched with the massive flight of brainpower to these same shores, then borrowing and investments could have increased. But capital moves much faster than people.

With such waves of savings thus unleashed on select more-stable countries in a world of floating exchange rates, the U.S. Federal Reserve and European Central Bank bought these governments' bonds, and foreign entities (many Asian pension funds among them) bought up these countries' bonds and stocks. One unintended impact of this sequence of events has been that the more stable governments had access to cheap financing. There was nothing bond vigilantes could do.

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Nothing Novel

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—R. Brenner

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This same sequence of events that sheds light on bond and credit default swap prices and on capital flows also sheds light on how central banks can get back to what were once considered their orthodox mandates. The answer is that as more countries move toward more stable institutions, diminishing expectations of default, savings would move toward those countries—assuming that their domestic talent pool did not move away during their periods of instability. As this reverse process unfolds, interest rates in select countries would rise, on their own government bonds in particular. The historically more stable countries that got the large influx of savings would then find themselves with enlarged governments and high debts at higher rates unless they manage the present—hopefully transitory—global situation prudently.

Capital moves much faster than people.

Here is what I mean by "transitory" and "prudently." Back in 1947, Federal Reserve Chair Marriner Eccles in his testimony before the House Committee on Banking and Currency had this to say:

> *[I]t is the Congress which decides on the deficits or the surpluses, and not the Treasury. If Congress appropriates more money than Congress levies taxes to pay, then, there is naturally a deficit, and the Treasury is obligated to borrow. The fact that they cannot go directly to the Federal Reserve bank to borrow does not mean that they cannot go indirectly to the Federal Reserve bank, for the very reason that there is no limit to the amount that the Federal Reserve System can buy in the market. That is the way the war was financed.*
>
> *Therefore, if the Treasury has to finance a heavy deficit, the Reserve System creates the condition in the money market to enable the borrowing to be done, so that, in effect, the Reserve System indirectly finances the Treasury through the money market, and that is how the interest rates were stabilized as they were during the war, and as they will have to continue to be in the future.*
>
> *So it is an illusion to think that to eliminate or to restrict the direct borrowing privilege reduces the amount of deficit financing. Or that the market controls the interest rate. Neither is true.*

During World War II and until 1951, the year the U.S. Federal Reserve ceased to be an agency of the U.S. Treasury, there were "transitory" situations, with global credit markets immobilized, and the United States an oasis of relative safety—as has been the case during these Covid years. During such circumstances, central banks have the power to control rates. However, as more countries stabilize, the Fed's control becomes an illusion—as it did in 1951, when, as inflation risks loomed, the Fed refused President Truman's request to finance the Korean War as it did World War II.

Do central banks now remember these past patterns? I do not know, but time will tell. ◆