

**Testimony of Dr. Anthony B. Sanders**  
**Before the House of Representatives Subcommittee on Capital Markets, Insurance, and**  
**Government Sponsored Enterprises**  
**Topic: “Credit Default Swaps on Government Debt:**  
**Potential Implications of the Greek Debt Crisis”**

**April 29, 2010**

Mr. Chairman, and distinguished members of the Committee, my name is Dr. Anthony B. Sanders and I am the Distinguished Professor of Finance at George Mason University and a Senior Scholar at The Mercatus Center. It is an honor to testify before the House of Representatives Committee on Financial Services today.

**The Greek Debt Crisis**

On November 5, 2009, Reuters published a story entitled “Greek debt to reach 120.8% of GDP in '10.”<sup>1</sup> Everyone around the globe is aware of how Greece’s excessive debt fiasco could lead to a meltdown of the European economy at “only” 120% of GDP.

These stories about the Greek economy beg the following question: Was the cause of the Greek fiscal collapse perpetrated by credit default swaps (CDS) or was it the out of control spending and borrowing by the Greek government that led to Greece being, in popular parlance, “broke?”

**Credit Default Swaps (CDS)**

Credit default swaps (CDS) are the current “villain de jure” in the Greek debt fiasco. The Greek crisis is the result of massive government spending and debt issuance to fund the spending. In

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<sup>1</sup> <http://www.reuters.com/article/idUSATH00496420091105>

fact, CDS on Greek sovereign debt actually served a positive role: it alerted everyone around the globe that Greece was in a credit death spiral.

CDS is often misunderstood. Essentially, CDS allows investors to hedge their positions in debt (in this case, Greece's sovereign debt). An investor may hold Greek sovereign debt (long) and may want to fully or partially insure against default on the debt.

By limiting or abolishing CDS, you not only decrease liquidity for investors (which we know is a terrible idea), but you actually decrease liquidity in the underlying asset, in this case Greek sovereign debt.<sup>2</sup> To state it differently, how many investors are willing to go long on Greek debt if they were forbidden or curtailed from purchasing protection on the downside?

As can be seen in Exhibit 1, the CDS spreads started to increase in October and November, 2009. By December 2009, CDS spreads widened dramatically. Of course, the spreads widen even more in January and February signaling the seriousness of the Greek credit crisis. As Peter Wallison has pointed out, "A widening of a reference entity's CD spread will alert investors that they should investigate risk-taking more fully before advancing funds."<sup>3</sup> So, CDS actually serve a public purpose by providing credible information about evolving risk in sovereign debt markets.

Consider further "The Greek Surprise!" when on April 2, 2010, a story in the press revealed that "Greece "Discovers" \$40 Billion of Previously Unknown Debt, CDS Widens." For a country that is already in deep trouble in terms of making its debt payments, the discovery of

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<sup>2</sup> Rene Stulz has argued that eliminating over-the-counter trading of credit default swaps could reduce social welfare and were not responsible for the recent financial meltdown in the US. See [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1475323](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1475323)

<sup>3</sup> Peter Wallison, "Everything You Wanted to Know about Credit Default Swaps—but Were Never Told," American Enterprise Institute, December 2008.

another \$40 billion of debt came as a rude surprise to those that invested in Greek debt. Notice in Exhibit 1 how Greek CDS spiked around the time of the revelation of \$40 billion in undiscovered debt. Markets reacted swiftly to the news, which indicates 1) the value of having CDS as a credit monitoring device and 2) the importance of fully disclosing the debt that a country is obligated to payoff.

The other problem with either abolishing CDS or waiting to create a traded exchange is that, as Ian Malcolm said in Jurassic Park, "Life will find a way." The same thing is true for risk management and investing. Financial markets evolve independently and are often hindered rather than helped by regulation. As we know, it would be fairly easy to create a new security or instrument that would be one or steps ahead of the regulators, but provide the hedging that investors demand.

### **Fannie Mae, LBJ and Hiding the Debt from the Public**

As I mentioned in the previous section, our own sovereign debt has a "Greek surprise" component to it. It's called the GSE and Agency debt. As Secretary Geithner tried to emphasize in a recent House hearing that support to Fannie and Freddie, "does not change the legal status." In addition, he stated that "The corporate debt of the GSEs is not the same as U.S. Treasuries, nor should it be considered sovereign debt."<sup>4</sup>

Secretary Geithner went on to say that he wanted to eliminate the "ambiguity" over the government's involvement in mortgage finance companies Fannie Mae and Freddie Mac. I agree completely with Secretary Geithner on this score. But to end the ambiguity, it is

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<sup>4</sup> March 23, 2010 hearing of the U.S. House Financial Services Committee.

important to revisit why Fannie and Freddie are not considered to be sovereign debt by Secretary Geithner.

In 1968, President Lyndon Johnson had difficulty fighting a war, delivering his Great Society programs and financing mortgages on the government's balance sheet. So, it was decided that Fannie Mae would move off budget, reducing federal borrowing rather than making the tough budgetary decisions. If removing Fannie Mae from the Federal balance sheet was intended to create "shadow debt" that had no Federal guarantee, it makes sense that moving it back on balance sheet actually recognizes what most have guessed at over the years: the Federal government will support Fannie and Freddie in times of distress.

While it may have been a clever budgetary trick in 1968, it blew into a full-blown disaster by September 7, 2008 when the Bush Administration placed Fannie and Freddie into conservatorship. On Christmas Eve 2009, the credit markets were taken by surprise by an announcement from Treasury that \$200 billion caps on Fannie and Freddie for capital infusions were lifted and the Federal government would cover all losses at Fannie and Freddie.

In short, if it looks like a guarantee, sounds like a guarantee and acts like a guarantee, it is a guarantee. And the Federal government needs to end the ambiguity and put Fannie and Freddie back on the Federal balance sheet where they belong.

To highlight why this is important, I have prepared Exhibits 2 and 3 that illustrate the situation. In Exhibit 2, it is clearly shown that on-balance Federal Debt is above \$8 trillion. The problem is our off-balance sheet GSE debt and guarantees are also around \$8 trillion. So, President Johnson's budgetary trick has resulted in a shadow debt that is comparable to our on-balance sheet debt.

## Further Budgetary Complications

Veronique de Rugy at George Mason University and The Mercatus Center has pointed out that through 2040, spending on Medicare and Medicaid is projected to grow to 11% of GDP from its current 5%. In terms of interest costs to maintain our debt, interest costs are projected to increase by more than 7 times by 2040 to 9.3% of GDP which is a far larger share of our GDP than is currently dedicated to any single department, war or program.<sup>5</sup> Unfunded liabilities (those for which we need to raise taxes or borrow to fund) currently amount to \$108.4 trillion that is almost 7 times higher than our current Federal debt (with GSEs and Agencies added in). This unfunded liability amounts to \$351,000 per citizen.<sup>6</sup> This further raises the flag that we need, as a country, to acknowledge what we owe today so we can better manage our finances in the future.

Thank you for letting me share my remarks with today.

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<sup>5</sup> <http://mercatus.org/publication/net-interest-rivals-general-spending-2040>

<sup>6</sup> We our progressive tax structure where households earning \$250,000 or more account for approximately 2% of households. If we multiply the number of households (115 million) by 2%, as a rough measure, we find that 2,300,000 households will bear the brunt of the \$108 trillion underfunded liabilities. That amounts to households earning \$250,000 or more responsible for \$47 million each.

Exhibit 1. Greece CDS Rates

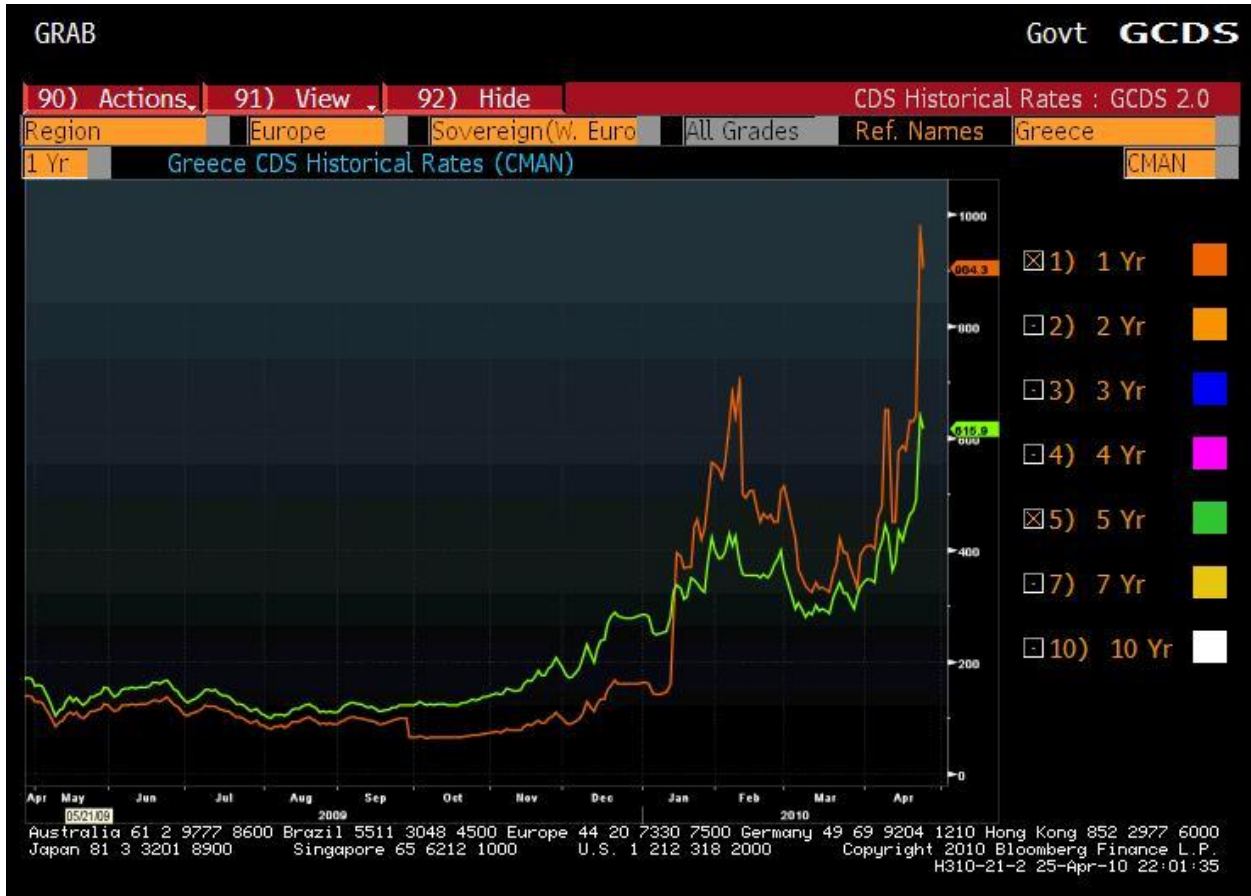


Figure 2.

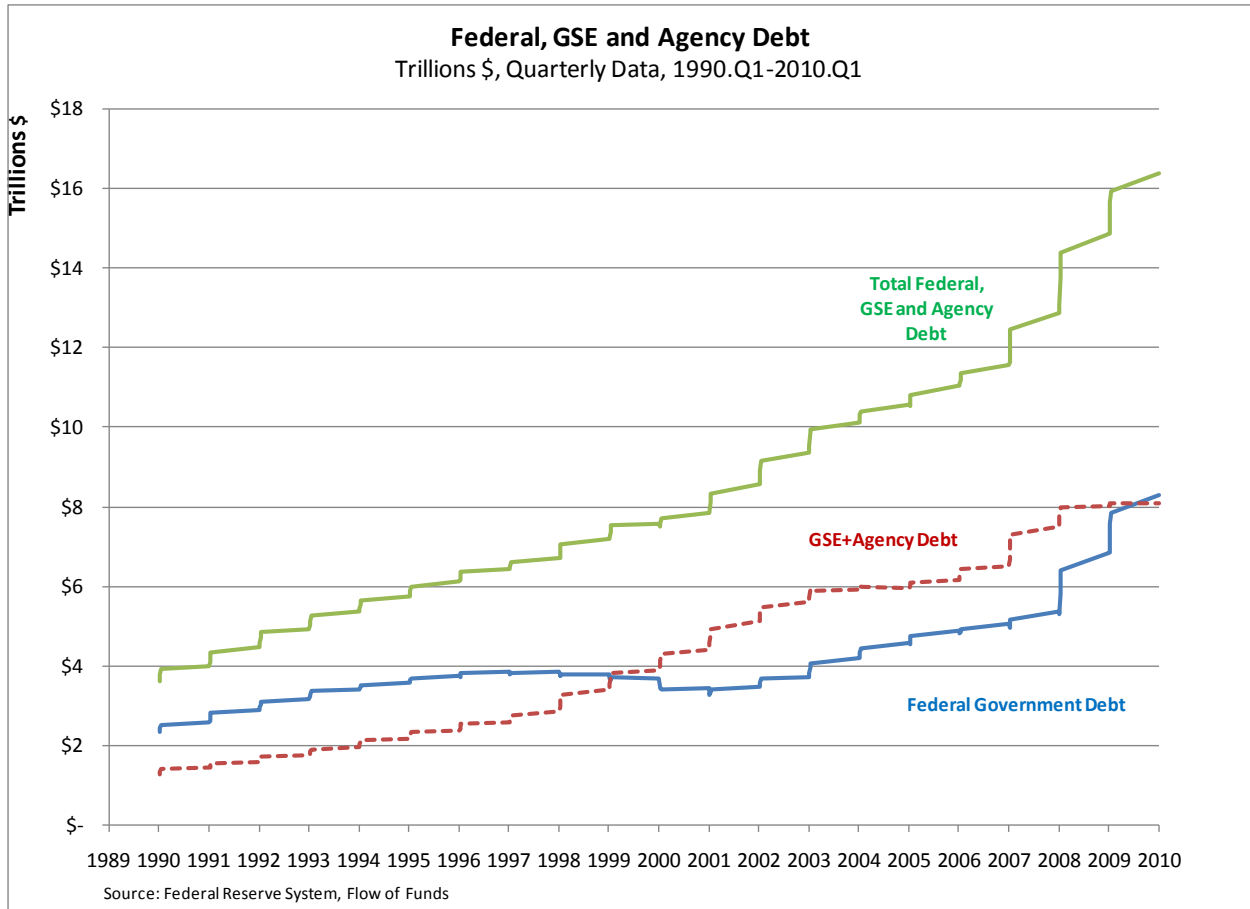


Figure 3.

