May 2, 2013

Shifting Global Economic Order:

The Impact of Sovereign Debt and Credit Default Swaps

Any state historically had credit to effectively utilize as an important financial instrument for use in controlling its sphere of the global economy and the population within its territory. Debt was also an instrument that notably pertained to the positive and negative side-effects of household management. Debt and credit, efficiently applied by states and strictly these actors, would act as leveraging forces that inherently allowed the state to influence its environment. But, the common norm of states with strict economic control changed rapidly throughout the industrial era. With the creation of more complex financial instruments to regulate credit and debt, and with the formation of international organizations, the economic control that states had has shifted.

Once again, a shift of economic social control presently looms over the contemporary era. First, sovereign debt now is a status that allows international organizations without state sovereignty, such as the Troika, to control states in cases of leveraging that debt. Sovereign debt in the modern context has become increasingly difficult to pay back after a certain point, and holders of that debt interestingly gain control of the agreement; essentially, states want the option of acquiring more debt in the future.[1] This concept does not diminish the role and the importance

1 "Sovereign Debt," *Investopedia*, accessed May 2, 2013, http://www.investopedia.com/terms/s/sovereign-debt.asp.

of the state, but rather increases the level at which analysis of states should occur more precisely because states are potentially subordinate to some international organizations – at minimum economically. Second, Credit Default Swaps (CDS) are extremely powerful economic Weapons of Mass Potential. Not necessarily having inherently poor consequences, an element of responsibility is vital to organizations that encourage their use due to the compounding effects of hedging on assets – both virtual and traditionally known as real. Briefly as an explanation, CDS are comparable to insurance only in that assets are protected for failure.[2] The owner of a CDS receives payments if assets backed through the CDS process lose some or all value. Thirdly, the CDS process occurs with sovereign debt, and continues to create an evermore complex economic system across the world but in Europe, specifically. Most presently, sovereign debt can be hedged against and even speculated to the point that some states may play more significant roles in the global economy in the scenario of defaulting – one defaulting domino, metaphorically, could knock down enough of the other bricks that support the economic system.

Ultimately, in examining the Eurozone Crisis in Europe, I will attempt to convey a radical theory of changing economic order. In finding that economic organizations now use major financial instruments as tools for fighting economic war, this paper will depict the dangerous potential of credit and debt. Specifically, I compare modern CDS and sovereign debt exchanges as financial weapons to catastrophic political weapons such as nuclear weaponry. I also stress the absence of Cold War concept of détente in the financial order. Last, I discuss the deteriorating major financial and economic institutions that existed for much of the human species history, and

2 "Credit Default Swap - CDS," *Investopedia*, accessed May 2, 2013, http://www.investopedia.com/terms/c/creditdefaultswap.asp.

I suggest that the new economic order may be quite different from that of the current economic order. In fact, humans may experience an economy with a radically different price system if the monetary policy of the world does not entirely diminish to non-existence phase. Without a necessary coordination between actors, failure to reach consensus seems quite unlikely, and a dilemma of common interests may fundamentally alter the state of household management of economics.

Roles and Incentives of Organizations and States

Governments that are widely renown for their power notice the major impacts of the Eurozone, and the ability to react effectively is pertinent to their survival. Specifically, the ability to form a consensus in the political realm may be vital to their survival as influential entities in the next international order. “We don't always need to give up national practices but we need to be compatible,' Merkel said. 'It is chaos right now.”'[3] Importantly, as arguably the most influential economic power in Europe, Germany is advocating that states unite and understand the ceding sovereignty to each other politically will prevent the entire European Union from fracturing as pieces of it are controlled entirely by other organizations. This section will describe the roles of major economic actors involved in the Eurozone crisis.

Solvent Governments

Governments that are not experiencing financial distress, like Germany, are able to have a clear vision of survival. Germany leads the political decision-making in the European Union, and

3 Noah Barkin, “Merkel Says Euro Members Must Be Prepared to Cede Sovereignty,” *Reuters*, April 22, 2013, http://www.reuters.com/article/2013/04/22/us-eurozone-merkel-idUSBRE93L0GO20130422.

is determined to ensure that options are still available. By banning naked Sovereign Credit Default Swaps (SCDS),[4] which "are similar to unhedged puts: buying a put on a stock without actually owning the stock..."[5] the European Union is attempting to have clear and decisive methods of preventing speculative practices. Unhedged puts allow buyers to essentially speculate on assets without owning them, similar to having fire insurance on the house of one's neighbor.[6] Essentially, solvent governments are attempting to mitigate the difficult position – one between a loss of all sovereignty and economic collapse – of all Eurozone states.

Insolvent Governments

Meanwhile, Spain appear to have a strong enough position of survival in Eurozone at this point. Spain maintained the 4th largest GDP in the Eurozone at least until 2009,[7] but unemployment rates are quite high at 26.7%.[8] While detestably not insolvent at this point, other countries appear to be unable to pay off their debt in any near future. Cyprus for example, may be "too small to fail..."[9] and the overall conditions that lead billions of dollars of bailout are simply to ensure that Cyprus does not leave the European Union.[10] The cataclysm involved in the potentially state-threatening control of economic sovereignty is not limited to Cyprus. Another of the many other insolvent governments, Greece, strikes the fear of CDS payouts[11] which could

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4 Daniel Bases, "EU Ban on Naked Sovereign Credit Default Swaps Unnecessary - IMF," *Yahoo! News*, April 11, 2013, http://news.yahoo.com/eu-ban-naked-sovereign-credit-195915084.html.

5 "Naked CDS: Exposed," *Derivative Dribble*, August 10, 2009, http://derivativedribble.wordpress.com/2009/08/10/naked-cds-exposed/.

6 Ibid.

7 "SPAIN GDP GROWTH RATE | LATEST DATA | FORECAST | NEWS," 2013, http://www.tradingeconomics.com/spain/gdp-growth.

8 "Greece, Spain Unemployment Rates Still the Highest in the EU," *247wallst.com*, accessed May 2, 2013, http://247wallst.com/2013/04/30/greece-spain-unemployment-rates-still-the-highest-in-eu/.

9 Kenneth Rapoza, "Cyprus Gets Thrown New Life Line," *Forbes*, March 21, 2013, sec. Investing, http://www.forbes.com/sites/kenrapoza/2013/03/21/cyprus-gets-thrown-new-life-line/.

10 Ibid.

11 Abigail Moses, "ECB's Greek Bond Exchange Spurs Likelihood of Credit-Default Swap Payout," *Bloomberg*,

create disastrous compounding payouts. Essentially, insolvent governments are at the mercy of international organizations and solvent governments, and the incentive that insolvent governments have is to retain as much sovereignty as possible. It is clear that exchange has become yet another form of social control, but unlike the power that states had to wield exchange over citizenry, some states are experiencing the aspect of being controlled.

The World Bank

Appearing to be a bystander at first glance, the World Bank recognizes the dangers of the CDS Market and the economic dangers that these Weapons of Mass Potential hold for the world. Many clear indicators exist, and the international organization that is the World Bank seems to have a vantage point that gives it a different a vast perspective of uncertainty in the global economy.

"Real side effects of the recent increase in market nervousness remain uncertain. It is too soon to observe the impact of the renewed financial-market turmoil on the real-side of the economy, but it is likely to be negative — particularly in high-income Europe. How negative is of course unknown."[12]

The global impacts seem uncertain, and the incentive for the World Bank is to communicate the issues that the world may face if an economic catastrophe is triggered in the Eurozone. And, with an over $600 trillion CDS market, the World Bank rightfully makes claims.[13] But, clear collaboration between international financial organizations does not appear to be occurring in a

accessed May 2, 2013, http://www.bloomberg.com/news/2012-02-17/ecb-bond-exchange-spurs-likelihood-of-payout-on-greek-credit-default-swaps.html.

12 Global Macroeconomics Team, "Credit Default Swaps," Text, *Prospects for Development*, May 25, 2012, http://blogs.worldbank.org/prospects/category/tags/credit-default-swaps-0.

13 Kieth Fitz-Gerald, "Derivatives: The $600 Trillion Time Bomb That's Set to Explode - Money Morning," accessed January 28, 2013, http://moneymorning.com/2011/10/12/derivatives-the-600-trillion-time-bomb-thats-set-to-explode/.

fruitful and productive manner. In fact, other organizations state the risk of the major catastrophe is not as high. And, the cost of investing in the CDS market produces enough liquidity to prolong the monetary policies that are necessary for sustained growth.

International Monetary Fund

The IMF finds that the level of effective investment required for continuing the CDS markets has actually diminished over time.[14] And, while the facts are accurately reported, the consideration of one default leading to a cascade of other defaults does not appear to be considered.

"In any case, credit-default swaps on Europe's most at-risk countries have come in considerably in recent months. The price to insure $10 million of Italian government debt against default for five years costs $266,000, down from $578,000 in July, according to data from Markit."[15]

Unfortunately, the risk present in reporting a partial narrative does not actually allow for accurate understanding of the entirety of the economic network. The ramifications of economic catastrophe allude to the nature of a system that is supported and controlled by a small portion of the entire network.[16] The IMF as a member of the Troika also has an incentive to control other states. In this instance, states that are insolvent are coerced into a subservient economic role to the Troika.

14 "IMF Tells Europe That Credit-default Swaps Are Just Fine," *MarketWatch.com*, accessed May 2, 2013, http://blogs.marketwatch.com/thetell/2013/04/11/imf-tells-europe-that-credit-default-swaps-are-just-fine/.
15 Ibid.
16 Stefania Vitali, James B. Glattfelder, and Stefano Battiston, "The Network of Global Corporate Control," *PLoS ONE* 6, no. 10 (October 26, 2011): e25995, doi:10.1371/journal.pone.0025995.

"The IMF's empirical analysis finds that both credit default swaps and government bond spreads exhibit similar and significant dependence on key economic fundamentals, such as government debt-to-GDP ratios and GDP growth prospects. Also, investor appetite for risk and market liquidity similarly influence both swap and bond spreads."

But, the IMF's explanation is extremely surface level and trite because it does not think of the entire narrative of causality. In other words, the IMF clearly states the immediate outcomes, but does not consider the complete list of effects where one outcome creates a path-dependent series of other potentially negative outcomes.

The Troika

To restate the ideas of the IMF, the overall market forces that impact the global economy are not as inherently separate as the international economic organization states. "The clearest impact has been on those markets with direct links to Cyprus—notably Greek government bonds and Greek and Russian bank stocks."[17] But, the IMF reports show the effects of the contagions. It appears that the IMF even contradicts itself as an organization. The Troika, which includes the European Central Bank, the IMF, and the Euro Commission, appears to have adopted similar economic policies to that stated by the IMF publicly. For example, "(c)redit-default swaps insuring Greek government debt may pay out because a proposed bond exchange by the European Central Bank paves the way for losses to be imposed on private investors."[18] While the Trokia is a regulatory body, it has gained a great deal of control. And interestingly, the decisions it is making appear to be in line with organizations that change global order.

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17 IMF, "Global Financial Stability Report: Old Risks, New Challenges" (April 2013): 8.
18 Moses, "ECB's Greek Bond Exchange Spurs Likelihood of Credit-Default Swap Payout."

Theories of John Ikenberry

In the final section before the conclusion, I will discuss the role of changing order. I will briefly establish the process of changing order with examples of settlements, and I will attempt to discuss the full ramifications of differences between political and economic settlements. On page 98 of John Ikenberry's book *After Victory,* foregoing more direct domination was a strategy that the British used in controlling others.[19] Therefore, the idea of control does not have to be direct or apparent. Indirect control can be just as effective in shaping the options available to other actors, and it appears that the Troika may be attempting to do so in the case of both solvent and insolvent governments. Stated on page 72, similar to the settlements of 1815, 1915, and 1945, "the state [or the international organization to speak more broadly than Ikenberry, knows that the resolution of institutional controversies will have lasting consequences and therefore it allocates power assets to this purpose even at the expense of losing more immediate distributional conflicts."[20] Ikenberry notices, on page 72, the "path-dependent logic" of these "postwar institution-building moments."[21]

Conclusion

Economic conditions with CDS are in fairly poor condition. "In Europe, the top ten counterparts of each surveyed large bank account for 62-72% of its CDS exposures..." which increases liquidity risk; to make matters worse, "chains of OTC derivative contracts, results in increased contagion risk."[22] Moreover, "CDSs are widely – and increasingly – used as price indicators for other markets, including loan, credit and even equity markets. Thus, these

19 John Ikenberry, *After Victory* (Princeton, New Jersey: Princeton University Press, 2001).
20 Ibid.
21 Ibid.
22 European Central Bank, "Credit Default Swaps and Counterparty Risk," *Eurosystem* (August 2009): 4–5.

instruments are playing a broader role in the determination of prices...” and are fundamentally changing the accounting procedures in the Eurozone; signs indicate that worsening conditions may lead to liquidity crunches, and the markets could cease economic activity given the necessary conditions.[23]

In describing the roles of each prominent actor – solvent Governments, insolvent governments, the World Bank, the IMF, the Troika – I have attempted to describe an invisible economic war. I see the instruments of this war as economic weapons – primarily debt and credit and the most primitive. But, with the advancement of technology and computing, more advanced Weapons of Mass Potential have been developed by the human species. Economic weapons like CDS of different varieties resemble the politically dangerous weapons of nuclear weapons. But, the arrangement of détente does not appear to apply to the economic war that is being fought right now. Seemingly, a “$600 Trillion Time Bomb”[24] is ticking.

If this bomb were to ever detonate, then the results could be disastrous due to the amounts of insolvency, lack of liquidity, overaccumulation of capital, and overall lack of exchange that the globe world experience. A fundamentally new order may change the international environment, and some states may find themselves ceding sovereignty that they once had. In another scenario, the prices system could be catastrophically altered or even destroyed, and the monetary policy could also vanish. Humanity may be entering a very unknown and exciting world – a world that has unforeseen consequences and conditions. Many

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23 Ibid.
24 Fitz-Gerald, “Derivatives.”

individual citizens have relatively zero actual control, and are simply along for the ride. It is of vital importance to note that these individuals may become caught in the crossfire of the economic war. And, humanity is already seeing some of the results due to high unemployment, major financial crisis, slowing growth, and the collapse of major financial institutions during 2008.[25]

Yet as a disclaimer, I realize that my theory is quite radical. I find that a great deal of further insight really ought to be dedicated into fully understanding the complete picture because I have only glossed over the surface. The vantage point that I have provided is very blurry, and further investigation should discover the specific relationship between the main actors that I provided. Further research would also support or reject my theories quantitatively and qualitatively. Finally, I suggest that greater focus be applied to the historically significant roles that each actor has accumulated in its existence as an international organization. In this manner, the human species may be able to preserve the best parts of prior order, predict the possibilities of the future order, and discover the nuances of international organization.

25 "Uncertain Financial Markets: The Global Systemic Economic Crisis 2013 | Global Research," accessed March 20, 2013, http://www.globalresearch.ca/uncertain-financial-markets-the-global-systemic-economic-crisis-2013/5327633.