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# Credit Default Swaps Made European Debt Crisis Worse: Study

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Riot policemen stand guard in front of the Greek parliament during a protest near Athen's Syntagma square on April 5, 2012. A new study suggests credit default swaps have made life harder for Greece and other sovereign borrowers in Europe.

Complicated credit derivatives turned the financial crisis into a catastrophe back in 2008. Now comes a study claiming evidence that these financial instruments are making the European debt crisis worse.

In a paper published in the April edition of the *Journal of International Money and Finance*, three French researchers say they have found evidence that derivatives, namely credit default swaps, have actually made the European debt crisis worse, driving up interest rates for shaky sovereign borrowers such as Greece and Italy.

"[I]n times of market distress the much smaller CDS market could drive up the bond interest rates of sovereign nations, amplifying the crisis," wrote Natalie Kettner, a spokeswoman for the Rouen Business School, one of the French institutions involved in the study. "The study showed that no country is safe from this perverse effect."

Credit derivatives played a clearly important role in the U.S. financial crisis, but in a much different way. AIG was nearly dragged under by its massive portfolio of CDS, which nearly brought down the entire financial system and required a massive government bailout of the insurance giant. And CDS helped make it easier for banks to load up on other weapons of mass financial destruction, bundles of risky mortgage securities.

This is not, theoretically, how these things are supposed to work. CDS are basically insurance contracts that help an investor hedge against the risk that a borrower will fail to pay its debts. In practice, it works a little differently, with hedge funds and other investors using CDS as a tool for speculation.

There may not be anything wrong with this -- speculation by itself is not inherently evil, and speculators in the CDS market can offer important early warnings to other investors that trouble is on the horizon. What's more, the CDS market's defenders point out that the market is too tiny to actually shove around borrowing costs, which moved around long before CDS even existed. As a matter of fact, CDS might actually smooth out bond markets by letting bond buyers hedge their risk. If an investor can buy insurance on a bond, she might be more likely to buy that bond. Everybody wins.

*Mais non*, say researchers Anne-Laure Delatte of Rouen Business School, Mathieu Gex of the University of Grenoble, and Antonia López-Villavicencio of the University of Paris North. Higher CDS rates lead to higher bond rates, according to their research.

"Based on these findings, the researchers conclude that the CDS are used to speculate against the deteriorating conditions of sovereign states and have a very perverse, self-fulfilling effect," writes Kettner.

Without seeing the research, it's hard to say how seriously we should take it. You could argue that it makes perfect sense for CDS prices to rise ahead of borrowing costs, if CDS are being bought by savvy investors who see trouble on the horizon before plain-vanilla bond investors do.

Less controversial is the assertion by the paper's authors that the market for credit derivatives should be better regulated.

“Today transactions occur over-the-counter and 80 percent of them happen between five major players,” Delatte said in the press release. “This market needs more transparency. "

While many may disagree with the concept that speculation in CDS moves markets, it's a lot harder to disagree with that. Unless, that is, you are on Wall Street, where disagreeing with derivatives transparency is a full-time job. And a successful one at that -- the financial industry has won rollback after rollback of Dodd-Frank derivatives regulation rules. The latest victory came this week, when the House of Representatives passed the "Small Business Credit Availability Act," which exempts more banks from derivatives oversight.

"Despite the title, this legislation has nothing to do with the regulation of small business," the consumer group Americans for Financial Reform wrote this week in opposition to the bill. "Instead, it represents an effort by major financial entities to expand already extensive exemptions they were given in both the original Dodd Frank Act and in rules currently being finalized by regulators."