
CREDIT DEFAULT SWAPS FROM THE VIEWPOINT OF LIBERTARIAN PROPERTY RIGHTS AND CONTRACT CREDIT DEFAULT SWAPS THEORY

THORSTEN POLLEIT AND JONATHAN MARIANO*

1. Introduction

In the so-called “international credit market crisis”, which started in the second half of 2007 in the US subprime mortgage market, financial derivatives, most notably credit default swaps (CDS), have been publically blamed for having caused, or at least aggravated, the economic and monetary debacle. The attack followed criticism leveled by famous investors against these financial instruments. For instance, Warren E. Buffett, in the Berkshire Hathaway Inc. 2002 Annual Report, had stated “derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”¹ George Soros, in March 2009, expressed the view that “CDS are toxic instruments whose use ought to be strictly regulated.”²

*Thorsten Polleit (thorsten.polleit@barclayscapital.com) is Professor of Economics, Frankfurt School of Finance & Management, Frankfurt, Germany. Jonathan Mariano (jonathan.mariano@presidioedu.org) is an MBA, Presidio Graduate School, San Francisco, California, USA.

CITE THIS ARTICLE AS: Thorsten Polleit and Jonathan Mariano, “Credit Default Swaps from the Viewpoint of Libertarian Property Rights and Contract Theory,” *Libertarian Papers* 3, 32 (2011). ONLINE AT: libertarianpapers.org. THIS ARTICLE IS subject to a Creative Commons Attribution 3.0 License (creativecommons.org/licenses). Published by the Ludwig von Mises Institute.

¹ Buffett, W. E. (2002), p. 15.

² See Soros, G. (2009). In this context it should be noted that according to the categorization as put forward by Murray N. Rothbard, recommending a policy of restricting, or even banning, of CDS amounts to advocating a policy *triangular interventionism*. A triangular interventionism means that the intervener either compels or prohibits an exchange between a pair of subjects, including, inter alia, price controls, product controls, and grants of monopoly privilege. See Rothbard, M. N. (2009 [1970]), *Power and Markets*, Chapters 2 and 3. See also Mises (1998 [1927]).

However, *sound economic analysis* reveals that CDS are fully compatible with the principles of the free market, and that CDS are not to blame for the disintegration of credit markets—with their tumbling banks, struggling private borrowers and increasingly overstretched government finances. The truth is that CDS provide investors with an efficient and effective instrument for *exposing economically unsound and unsustainable fiat money regimes* and the economic production structure it creates—which, in turn, provokes a (n intellectual) counterattack from government officials (and their “court intellectuals”), who argue for regulating or even banning CDS.

The objective of this article is to review CDS in the light of Rothbard’s libertarian property rights theory and contract theory. Such an analysis seems to be worthwhile, as the use of CDS is not necessarily confined to fiat money regimes: CDS would presumably also emerge in a free, that is commodity, money regime. In the following analysis it will be shown that (i) CDS are instruments which are fully compatible with Rothbard’s libertarian property rights and contract theory—and thus economically and ethically legitimate; that (ii) CDS are an efficient and effective instrument for putting an end to ever higher debt accumulation under fiat money regimes; and that (iii) economic and ethical fault is to be found with fiat money rather than CDS.

The rest of this article has been organized as follows. To start with, the central elements of Rothbard’s libertarian property rights and contract theory, as laid out in his *The Ethics of Liberty* (1982), will be outlined (2). Against this backdrop, the nature and use of CDS will be reviewed against the libertarian property rights and contract theory in some detail (3). What follows is an elaboration on how CDS (if not suppressed by government) put a limit to, or even erode, the viability of fiat money regimes (4). Finally, a conclusion of the findings and an outlook will be given (5).

2. Rothbard’s Property Rights Theory and Contract Theory

In his second *magnum opus* titled *The Ethics of Liberty* (1982), Murray N. Rothbard developed not just a rationale ethics but also a “unified system of rationalist social philosophy”³ by reintegrating ethics and economics via the concept of *private property*. In fact, Rothbard showed that acquiring and respecting private property are “non-hypothetically or absolutely true ethical rules and human rights.”⁴ He did so by following in the footsteps of the natural rights theorists, most notably John Locke, and applying the *Kantian*

³ Hoppe, H.-H. (1998 [1982]), p. xii.

⁴ *Ibid*, p. xvii.

Categorical Imperative for proving that acquiring and respecting private property in a non-aggressive way represents just rules—valid and applicable at all times and for everyone.⁵

As Rothbard puts it: “Consider the universal status of the ethic of liberty, and on the natural right of person and property that obtains under such an ethic. For every person, at any time or place, can be covered by the basic rules: ownership of one’s own self, ownership of the previously unused resources which one has occupied and transformed; and ownership of all titles derived from that basic ownership—either through voluntary exchanges or voluntary gifts. These rules—which we might call “rules of natural ownership”—can clearly be applied, and such ownership defended, regardless of the time or place, and regardless of the economic attainments of society.”⁶

In the following, Rothbard’s libertarian property right theory and contract theory, with the latter logically derived from the former, will be briefly reviewed along the following aspects: (1) individual ownership, (2) voluntary exchange (including gifts), (3) property titles; and (4) enforceable contracts.

Re (1): INDIVIDUAL OWNERSHIP.—Each individual has ownership over one’s own self and one’s actions. Through introspection of one’s own consciousness, an individual “discovers the natural fact of his mind’s command over his body and its actions: that is, of his natural ownership over his self.”⁷ An individual can then use one’s body, to perform actions, transforming unused resources. An individual mixes one’s labor with unused resource. In doing so, the individual appropriates the resource, thus homesteading or establishing its ownership. As Rothbard states: “Any man’s

⁵ The Kantian Categorical Imperative says that all rules aspiring to the status of just rules must be general rules, applicable and valid at any time for everyone without exception. For an *a priori explanation* of Rothbard’s ethics of liberty, namely via the *a priori of argumentation*, see Hoppe, H.-H. (2006 [1993]).

⁶ Rothbard, M. N. (1998 [1982]), p. 43. It should be noted here that Rothbard’s (re)integration of economics and ethics follows Mises, who assigned a central role to private property in (classical) liberalism. Mises wrote (2002 [1927], p. 19): “The program of liberalism, therefore, if condensed into a single word, would have to read: property, that is, private ownership of the means of production (for in regard to commodities ready for consumption, private ownership is a matter of course and is not disputed even by the socialists and communists). All the other demands of liberalism result from this fundamental demand.”

⁷ Rothbard, M. N. (1998 [1982]), p. 31.

property is ipso facto what he produces, i.e. what he transforms into use by his own effort.”⁸

Re (2): VOLUNTARY EXCHANGE.—Voluntary exchange (including gifts) directly follows from individual property rights and is expressive of *inequality of wants*. Each trading partner exchanges the good that he values less highly against the good he values more highly. Two individuals have ownership of their respective goods. Each individual subjectively values the others good more so, than their own good. If each individual valued his or her own good more highly, an exchange would not occur. Likewise, if each individual valued each other’s goods equally, exchange would not occur, because there is no reason to exchange. Only when there is an inequality of subjective wants will a voluntary exchange occur. Each individual thus voluntarily exchanges ownership of the goods he values less against the good he values more.

Re (3): PROPERTY TITLES.—What happens in voluntary exchange? Rothbard’s answer is: “What is really being exchanged is not the commodities themselves, but the rights to ownership of them.”⁹ A property title is the right to ownership of a commodity. Only the property titleholder has ownership, and thus control of goods in question. That said, exchange means, an exchange of the rights of ownership to the property, or a *transfer of title of the property*. Once property titles are exchanged, the previous owner no longer has ownership or control of the commodity.

The owner of property can utilize the property to his or her desires. It can be saved, consumed, exchanged, or even gifted. Gifts are exchanges, where only one party gives, but does not receive any good in exchange. “The right of property implies the right to make contracts about that property: to give it away or to exchange titles of ownership for the property of another person.”¹⁰ Gifting implies relinquishing ownership of a good to another individual. Hence, with the action of either voluntary exchange or gifting of property titles, only the current holder of the property title has a rightful claim to ownership and control. No ownership, no control.

Re (4): ENFORCEABLE CONTRACTS.—If one holds the title of private property, one is rightfully allowed to enter into contract. As Rothbard states, “the right to contract is strictly derivable from the right of private property, and therefore that the only *enforceable* contracts (i.e., those backed by the

⁸ Ibid, p. 34.

⁹ Ibid, p. 36.

¹⁰ Ibid, p. 133.

sanction of legal coercion) should be those where the failure of one party to abide by the contract implies *theft* of property from the other party.”¹¹ Free contracting includes engaging in contract over time, that is, exchanging property titles in the present for property title in the future.

Rothbard imparts: “A contract should only be enforceable when the failure to fulfill it is an implicitly theft of property. But this can only be true if we hold that validly enforceable contracts only exist where title to property has already been transferred, and therefore where the failure to abide by the contract means the other party’s property is retained by the delinquent party, without the consent of the former (implicit theft).”¹² The contract needs to be fulfilled, otherwise such action is *theft*. Legal coercion may only be used if one party is unable to fulfill their end of the contract.

Titles of ownership to property can only be exchanged if said property is *alienable*. Physical property owned by an individual is alienable, and can thus be voluntarily exchanged. However, Rothbard asserts, “there are certain vital things which, in natural fact and in the nature of man, are inalienable, i.e., they *cannot* in fact be alienated, even voluntarily. (...) Since his will and control over his own person are inalienable, then so also are his rights to control that person and will.”¹³ Voluntary slavery is not an enforceable contract. An individual has an inalienable right to free will. Since free will is not alienable, a contract of voluntary slavery, albeit voluntary, is unenforceable. Only alienable property can be voluntarily exchanged.

It should be noted that a *promise* is not a *contract*. A promise is only one’s word to exchange, not an actual exchange. One may face moral scrutiny if a promise is broken, but no legal action may be executed. On the other hand, a contract explicitly requires property *title-transfer*. Legal action can thus be used to enforce the contract. “The theory of contract enforcement should have had nothing to do with ‘compensation’; its purpose should always be to enforce property rights, and to guard against implicit theft of breaking contracts which transfer titles to alienable property.”¹⁴ Since there is no *title-transfer* of property rights in a promise, a promise cannot be enforceable.

Against the backdrop of the issues discussed in (1) to (4) one can conclude that each individual owns his or her own physical body. Furthermore, each individual owns the unused resources of which the

¹¹ Ibid.

¹² Ibid.

¹³ Ibid, p. 135.

¹⁴ Ibid, p. 140.

individual has labored to transform (homesteading principle). From such an acquiring of ownership of resources, the individual has the right to utilize the resources as desired, for savings, consumption, voluntary exchange, granted the individual does not uninvitedly infringe on the property rights and titles of other individuals in doing the same with their private property.

3. CDS and the Property Rights and Contract Theory Viewpoint

In what follows, CDS transactions (for details see the box below) shall be reviewed from the viewpoint of Rothbard's libertarian property rights theory and contract theory. To this end, the use of CDS shall be reflected against four theoretical aspects: (1) doing justice to the freedom of contract, (2) respecting the physical integrity of private property, (3) preventing effects on property values, and (4) opposing the *creation of additional risk* (allegedly) caused by CDS.¹⁵

Re (1): DOING JUSTICE TO THE FREEDOM OF CONTRACT.—Freedom of contract is a direct result of private property, which, in turn, follows logically from self-ownership and the acquisition of property through homesteading, production and voluntary exchange.¹⁶ It is an expression of freedom of contract if and when two parties agree voluntarily to engage in, say, a CDS contract. Such an exchange is, like any voluntary exchange, a mutually beneficial transaction—otherwise there would simply be no such transaction, and it arises because there is an *inequality of subjective wants*.

Box: Credit Default Swaps (CDS)—an overview

A CDS is a contract that insures against the default of a credit (or bond, or *reference obligation*). The buyer of credit protection makes periodic payments to the seller of the credit protection until either the contract

¹⁵ For details of the CDS market see European Central Bank (2009), European Commission (2009). For an overview of financial derivative risks see, for instance, Gerken, A., Karseras, H. (2004) and Yavorsky (2008). On price determination see, for instance, Baz, J., Chacko, G. (2004). On (mainstream) policy implications see, for instance, Speyer, B. (2006); Hirtle, B. (2007).

¹⁶ Freedom of contract is basically the most obvious consequence of individual ownership. As Rothbard notes (2004 [1962], p. 91): “A society based on voluntary exchanges is called a contractual society. In contrast to the hegemonic society based on the rule of violence, the contractual type of society is based on freely entered contractual relations between individuals.”

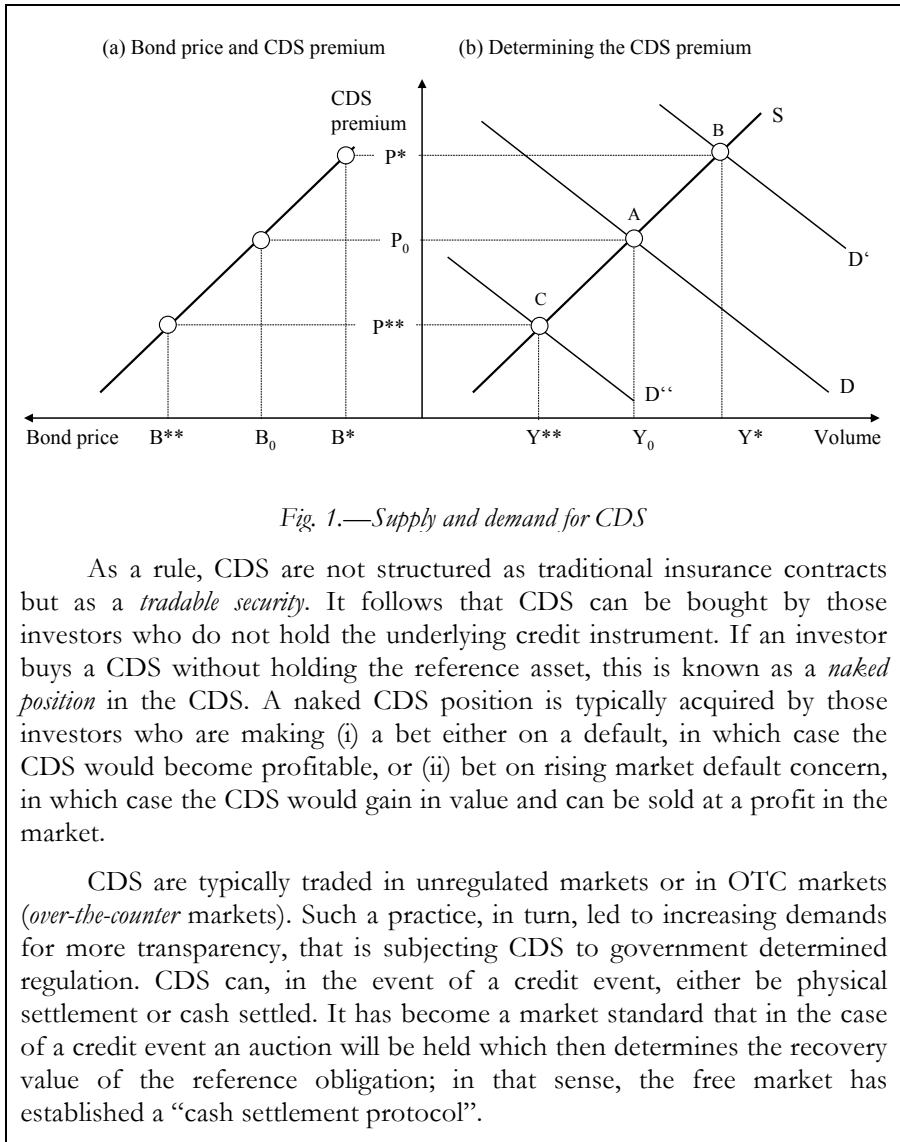
matures or a default event occurs during the maturity of the contract. In return for the periodic payments made by the buyer, the seller agrees to pay the buyer the difference between the face value (or *notional principle*) and the market value of the *reference obligation* (the underlying credit) if a credit event occurs.

To give an example, an investor buys a 5-year CDS on a bond amounting US\$100 million for paying 1.15% p.a. to the seller of protection. If there is no credit event, the buyer of protection pays an annual premium of US\$1.15 million to the seller of protection over the maturity of the contract. If, however, a credit event occurs, the buyer of protection will receive the difference between US\$100 million and the *recovery value* of the bond. If the latter is, say, US\$40 million, the seller of protection has to pay US\$60 million to the buyer of protection.

The buyer of protection pays the so-called default swap premium (which is usually expressed in basis points). As in any swap, the premium (which determines the annuity payments) is the rate that equates the expected streams of cash flows that the buyer and the seller agreed upon in the contract. The CDS premium therefore contains information on the default probability associated with a reference entity: A rising (falling) premium would signal a rising (falling) default probability from the viewpoint of market agents.

The CDS premium is determined by the free supply (S) and demand (D) for protection (see Figure 1, right hand side chart). Assume that the market is in equilibrium in point A , with the CDS premium at P_0 and the amount of CDS contracts Y_0 . A rise in the demand for protection (due to a rise in expected default) raises the CDS premium to P^* and the amount of CDS contracts to Y^* (other things being equal). Likewise, a decline in demand for protection (due to declining default expectations) brings about a lower CDS premium, namely P^{**} , and a lower CDS contract volume, namely Y^{**} .

The left hand side of the graph in Figure 1 shows the relation between CDS premia and the bond price. The higher (lower) the CDS premium is, the lower (higher) will be the bond price. The CDS premium has a direct bearing on bond prices if and when the CDS premia (other things being equal) affect, or determine, the bond prices in the market place. For instance, if the CDS premium rise from P_0 to P^* , the bond price falls to B^* from B_0 (implying a rise in the bond yield).



To the seller of the CDS (who receives periodic payments from the buyer of the CDS), the subjectively expected payout related to the (potentially arising) credit event is smaller than the value of the sum of premium payments received over the maturity of the contract. To the buyer of the CDS (who pays premiums to the seller of the CDS), the subjectively expected

gain from hedging against a potentially arising credit event is higher than the value of the sum of premium payments he surrenders to the seller of the CDS. No voluntary trade will take place unless all parties to the trade expect to benefit.

The truth that a voluntary exchange, such as voluntarily engaging in a CDS, is mutually beneficial is not affected if the expectations of the contract parties will be disappointed. If, for instance, the seller of protection eventually finds out that his payout will be higher than initially expected, he will have to accept a loss, which is simply the result of having made a bad decision. However, this does not alter the truth that at the time when he voluntarily engaged in a CDS (as a seller of protection) such action reflected the highest level of (subjectively felt) want satisfaction: It ranked highest on the actor's individual preference scale at the point in time the decision was made.

Re (2): RESPECTING THE PHYSICAL INTEGRITY OF PRIVATE PROPERTY.—The libertarian property rights theory requires respecting the physical integrity of private property (based on self-ownership and property acquired through homesteading, production or trade). Economically speaking, a CDS contract operates, in effect, as either an *insurance contract* (in the case the buyer of protection owns, or holds, the underlying credit) or as a *speculative trade* (in the case the investor engages in a *naked CDS position*). Would there be a difference in terms of respecting the integrity of private property whether the CDS is an insurance contract or a speculative trade?

In the case the CDS has the economic character of an insurance contract (namely the buyer of protection owns the underlying credit), there can be no doubt that such a contract is fully compatible and permissible with the libertarian property rights and contract theory. The buyer of insurance receives something that he values more highly (namely insurance against potential damage) against surrendering something, which he values less highly (namely the periodic insurance payments). In turn, the insurer has a diametrically opposed value scale: He values the periodic insurance payments more highly than the value of being obliged to make a payout in the credit event.

However, what if the CDS represents a *naked CDS* position? Can one argue that this is *not economically justified* as the buyer of protection would not be directly exposed to the economic consequences of the credit event of the underlying reference obligation, and that he therefore should not be allowed to engage in a naked CDS position? From the libertarian viewpoint such conclusion is untenable. If naked CDS are restricted, or even banned, by

government decree, the investor who wishes to engage in naked CDS (because he sees a higher probability of a credit event than other market agents) would be prevented from taking advantage of a (supposedly) profitable activity, causing him financial damage (in the form of an *opportunity loss*). The borrower who has issued the reference obligation can, in turn, (continue to) enjoy lower refinancing costs compared with a situation in which investors are free to engage in naked CDS positions. That said, restricting, or even banning, the use of naked (as well as covered) CDS effectively amounts to a *coercive redistribution of income* from the potential investor in naked CDS to the benefit of the issuer of credit—which amounts to an uninvited aggression against private property.

All the same, what if the seller or protection defaults on his payment obligations, as he has, for instance, not put aside sufficient reserves for financing protection payouts? Again, such an event would again not argue in favor of any banning or restricting (naked) CDS trades. For the buyer of protection—like any other market agent entering a credit market transaction—necessarily runs, and knowingly so, a *counterparty risk*. In view of this risk, the buyer of protection can be expected to take great effort to find a seller of protection who is considered as *good credit*. He has every incentive to do so. If the buyer of protection makes a bad decision in terms of selecting his counterparty, he will take a loss.

In the case that the buyer of protection has made a *bad decision*, it is upon him to deal with the consequences of his decision. The buyer of protection could of course rightfully demand compensation from the seller of protection. And in the case of the latter's default, the buyer of protection may hope to regain at least some of his lawfully claim from recovery values. Of course, the buyer of protection can also voluntarily forgive the compensation, but only at his discretion. Actions of the buyer of the CDS in either case are consistent with Rothbard's property rights and contract theory.

Re (3): PREVENTING EFFECTS ON PROPERTY VALUES.—An argument against the (unrestricted) use of (naked) CDS is that these CDS may unduly affect the *value* of the reference obligation. For instance, if the demand for CDS increases (as, say, investors expect a credit event), the price of protection increases and translates into higher yields of the reference obligation. Rising bond yields, in turn, increase the chances of the borrower defaulting on his debt, fanning expectation that makes even more investors buy protection. As a result, it is said, an unrestricted demand and supply of CDS could result in a *self-fulfilling prophecy*, eventually leading to a collapse of even healthy borrowers.

However, such a line of argumentation does not hold water from a libertarian viewpoint. While the respect of the integrity of private property is a *conditio sine qua non*, the libertarian position does *not* apply to property *value*. Value, it should be noted, is a purely *subjective* category of human action. It is in no way related to any objective criterion, but it is determined, so to speak, Rothbard put it as follows: “Everyone has the right to have the physical integrity of his property inviolate; no one has the right to protect the value of his property, for that value is purely the reflection of what people are willing to pay for it.”¹⁷

From a libertarian viewpoint the criticism that the use of CDS needs to be restricted, or banned, because its will effect (negatively) bond *values* and thus borrower’s refinancing costs, must be rejected. It cannot be legitimately claimed that a certain market action (of any kind, including engaging in CDS or any other derivative contract) should be restricted, or banned, because it changes market *values*—as long as there is no uninvited violation of the physical property rights of others. From the libertarian point of view it is therefore legitimate if investors engage in naked CDS positions, trying to benefit from a credit event, even if this means that the borrower may default on his debt.

This is far from being a cold-blooded conclusion, for it is the borrower’s entrepreneurial decision that determines his credit risk. If his credit risk is perceived as being acceptable from the viewpoint of market agents, investors have no rationale to start speculating on the borrower’s default. What is more, the borrower is by no means “helplessly exposed” to any potential changes in investor risk perception. In a free market he has the opportunity to seek protection against a deterioration of his borrowing costs (by, for instance, engaging in forward loans etc.). In fact, shielding against adverse financial conditions must be seen as an integral part of entrepreneurial activity.

Re (4): OPPOSING THE CREATION OF ADDITIONAL RISK.—Critics of CDS, and naked CDS in particular, maintain that the use of such a credit derivative would create *additional* risks—beyond the “level of risk” that would prevail had no CDS been bought and sold. Such a position is entirely untenable from the viewpoint of praxeology. To start with, the *axiom of human action* logically implies that there is *uncertainty*.¹⁸ The limits of human

¹⁷ Rothbard, M. N. (1997 [1982]), p. 62.

¹⁸ See in this context Mises, L. v. (1996), p. 105–15. In particular, see Mises’s distinction between “class probability” and “case probability”, and it is the latter that is

knowledge are, first, the unpredictability of human action in terms of making choices and acting and, second, insufficient knowledge about nature.

It would be misleading to think that by prohibiting certain types of human action, such as engaging in CDS, uncertainty could be reduced. First and foremost, there is no rationale for suggesting any *functional relation* between the *scope* of human action and the *level* (or scope) of uncertainty. A credit event may or may not occur, regardless whether a CDS was contracted or not: The economic success of credit financed investment projects depends on a great variety of factors, namely whether the investor has anticipated correctly the future course of, say, consumer tastes, new process technologies, new etc.

Second, preventing a certain type of action, such as engaging in CDS, will provoke attempts to circumvent government prohibitions. Market agents can be expected to seek ways to satisfy their needs by taking recourse to second-best measures. For instance, if prevented from shorting, say, government credit *A*, investors would presumably start shorting those credits which serve as a proxy for credit *A* such as, government credit *B*. As a result, the prohibition of CDS on government credit *A* does not reduce uncertainty, but will merely encourage circumventing action.

4. How CDS Threaten Fiat Money Regimes

CDS are a particularly efficient and effective instrument for exposing the unsound and unsustainable nature of fiat money regimes: either by speeding up the process of chronic borrowers to default on their debt, or by provoking government sponsored central banks to take recourse to a policy of high inflation to prevent unduly leveraged borrowers from defaulting. To see this, three basic characteristic features of fiat money must be borne in mind.

the relevant category of uncertainty when it comes to issues of human action. As Mises noted (p. 110): “Case probability means: We know, with regard to a particular event, some of the factors which determine its outcome; but there are other determining factors about which we know nothing. Case probability has nothing in common with class probability but the incompleteness of our knowledge. In every other regard the two are entirely different.”

First, fiat money has been established through *coercive action* on the part of government.¹⁹ The very existence of fiat money represents a (rather) far-reaching violation of the very principles on which the free market rests. Most importantly, once fiat money serves as the universally accepted means of exchange, it undermines the concept of mutually beneficial transactions. For fiat money, which is created through a non-market conforming production—namely through *circulation bank credit*, and typically in (much) greater quantity than commodity money—benefits early-receivers of the newly created money at the expense of late-receivers of the increased money (“Cantillon Effect”).

Second, the increase in fiat money through *bank circulation credit*—namely credit that is not backed by *real savings*—leads to an artificial lowering of the market interest rate to below the natural rate of interest (which is determined by the societal *time preference rate*).²⁰ This, in turn, provokes an *unsustainable boom*, leading to *malinvestment*. The credit induced boom can only be prevented from collapsing through ever higher doses of fiat money creation, created through bank circulation credit at ever lower market interest rates.

Third, fiat money regimes lead to an ongoing rise in the economy’s overall indebtedness relative to income. The correction of malinvestment, caused by bank circulation credit expansion, is largely prevented by further expansion of bank circulation credit. Lower interest rates prevent unprofitable investment projects from liquidation, as maturing credit can be rolled-over at even lower interest rates. In addition, the lower interest rates provoke even more investment projects, which would not have been undertaken had the interest rates remained unchanged.

CDS are an effective and efficient instrument for affecting borrowers’ credit costs according to the views of investors in an unhampered market. One could argue that even in a world without CDS, investors could, if they wish, engage in short-selling of, say, outstanding cash bonds of a borrower deemed financially unsound. Such short-selling would also dampen the underlying bond price and, *uno actu*, raise its yield. However, short-selling of cash bonds tends to be costly, as any short-selling has to be financed by the short-seller (via, for instance, repurchases transactions). Furthermore, bond markets are not always that liquid, so that is not always

¹⁹ See in this context Rothbard, M. N. (2005 [1963]). In this book Rothbard explains the lengthy process through which government obtained full control over money production, setting up a fiat money system.

²⁰ See in this context Mises (1996), p. 433–34 and also p. 571.

that easy for investors to engage in (and, no less important, disengage from) short-selling positions.

CDS are more convenient instruments for translating investor expectations into marketable transactions when compared with spot market transactions. Perhaps most important, CDS transactions require relatively little capital (namely just premium payments capacity for the buyer of protection) for building up a sizeable claim (and substantial profit opportunities) against potentially struggling borrowers. This explains why CDS have become an economically attractive instrument for building up exposures vis-à-vis highly exposed borrowers in (such as, for instance, governments and commercial and investment banks).

Under today's fiat money, governments increasingly finance their outlays through borrowing—for this is the most convenient way of financially subsidizing its supporters and protégées in excess of what taxpayers would be prepared to shoulder.²¹ With a fiat money regime in place, government-sponsored central banks push down the interest rate to ever lower levels (at least temporarily), as this allows ever greater amounts of debt issuance for financing government outlays at low costs. Such a practice explains a rise in government debt relative to income that can be observed in virtually all western countries, which have adopted fiat money.

The debt pyramid built up under fiat money regimes is therefore increasingly vulnerable to the spreading use of CDS—as CDS are an efficient and effective instrument for making a subjectively held view on a borrower's credit quality *tradable*. This, in turn, increases the disciplinary pressure on borrowers, who are about to build up unsustainable debt levels, to consolidate; or it makes borrowers, who have become financially overstretched, go into default. Against this backdrop it may not come as a surprise to see why governments—which are mostly heavily in debt—must view an unrestricted use of CDS as a potential threat to their feeding on ever

²¹ Dismissing the notion of government debt being an ethically legitimate contract, Rothbard (2004) wrote: "Deficits and a mounting debt (...) are a growing and intolerable burden on the society and economy, both because they raise the tax burden and increasingly drain resources from the productive to the parasitic, counterproductive, "public" sector. Moreover, whenever deficits are financed by expanding bank credit—in other words, by creating new money—matters become still worse, since credit inflation creates permanent and rising price inflation as well as waves of boom-bust "business cycles."

higher doses of debt²²—and it explains why efforts are being made to regulate and restrict the use of CDS.²³ However, such efforts serve only to hinder or halt the process of forcing borrowers to consolidate debt levels or go into default. Such prohibition would only perpetuate a fraudulent fiat money regime.

5. Conclusion and Outlook

The purpose of Credit Default Swaps (CDS) is to make a borrower's credit risk tradable (like, for instance, market risk). A CDS is analogous to an insurance policy written against the possibility of some kind of negative credit event, such as, a bank declaring bankruptcy and defaulting on its liabilities. Our analysis showed that CDS are, from Rothbard's libertarian property rights and contract theory viewpoint, fully compatible with the free market. This conclusion applies for covered as well as for naked CDS.

The criticism leveled against the use of (in particular naked) CDS—especially by governments and government-supporting quarters—can be explained by the fact that CDS provide an efficient and effective instrument for unraveling fiat money regimes, which have now become the state-of-the-art monetary arrangement the world over. In particular, CDS can help with adjusting funding costs more effectively for the proper default risk, most notably as far as government borrowers are concerned. This, in turn, runs counter to government efforts of pushing down the interest rate to ever lower levels, for having access to cheap credit funding.

Finally, government intervention leads to more intervention. An example par excellence is the fiat money system. It is government interventionism in the field of money production, predictably causing great damage to the economy, for instance, causing boom and bust cycles, thereby paving the way for even more government interventionism in an effort to sort out the problems that have been caused by government interventionism

²² See Bagus, P. (2010), who concludes: “CDS may be used as bets that can make unsound financial institutions and reckless governments fall sooner than they otherwise would. Therefore, they are feared by governments.”

²³ In the US, for instance, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on 21 July 2010. The bill's objective is to strengthen consumer protection, rein in complex financial products, including derivative transactions, and head off more bank bailouts. In Germany, the government prohibited on 19 May 2010 the sale of naked CDS if the reference obligation is a euro area government liability.

in the first place. Government is then encroaching not just on money, but also in how that money is to be used. Regulating and restricting CDS, in essence, is forcing people to use (or not use) money in only certain ways. This is not only antithetical to Rothbard's libertarian property rights and contract theory, but further perpetuates effectively fraudulent fiat money regimes.

References

- Bagus, P. (2010), "The Social Function of Credit-Default Swaps," *Mises Daily*, 29 June.
- Baz, J., Chacko, G. (2004), *Financial Derivatives, Pricing, Applications, and Mathematics*, Cambridge University Press.
- Berkshire Hathaway Inc., 2002 Annual Report, Letter to shareholders, (www.berkshirehathaway.com/2002ar/2002ar.pdf).
- European Central Bank (2009), Credit Default Swaps and Counterparty Risk, August.
- European Commission (2009), Commission Communication, Ensuring efficient, safe and sound derivative markets, Staff Working Paper, Brussels, 3 July.
- Gerken, A., Karseras, H. (2004). "The real risks of credit derivatives", *The McKinsey Quarterly*, No. 4.
- Hirtle, B. (2007), Credit Derivatives and Bank Credit Supply, in: *Federal Reserve Bank of New York Staff Reports*, No 276, February.
- Hoppe, H.-H. (2006 [1993]), Rothbardian Ethics, in: *The Economics and Ethics of Private Property*, Ludwig von Mises Institute, Auburn, US Alabama, pp. 381–97.
- . (1998 [1982]), Introduction to Rothbard, M. N. (1998 [1982]), *The Ethics of Liberty*, New York University Press, New York and London pp. xi–xliii.
- Mises, L. v. (2002 [1927]), *Liberalism*, Institute for Humane Studies, Inc., Fairfax, Virginia.
- . (1998 [1940]), *Interventionism: An Economic Analysis*, Greaves, B. B., ed., The Foundation for Economic Education, Inc., New York.
- . (1996), *Human Action*, 4th ed., Fox & Wilkes, San Francisco.

- Rothbard, M. N. (2004 [1970]), *Power and Markets*, in: *Man, Economy, State*, scholar's ed., Ludwig von Mises Institute, Auburn, US Alabama.
- . (2005 [1963]), *What Has Government Done To Our Money?* Ludwig von Mises Institute, Auburn, US Alabama.
- . (2004 [1962]), *Man, Economy, State*, scholar's ed., Ludwig von Mises Institute, Auburn, US Alabama.
- . (1998 [1982]), *The Ethics of Liberty*, New York University Press, New York and London.
- . (1997 [1982]), Law, Property Rights, and Air Pollution, Originally published in the *Cato Journal* 2, No. 1 (Spring 1982): pp. 55–99; reprinted in *The Logic of Action Two*, Cheltenham, UK: Edward Elgar (1997), pp. 121–70.
- . (2004), Repudiating the National Debt, Mises Daily Article, 16 January; originally published in: *Chronicles*, June 1992, pp. 49–52.
- Soros, G. (2009), One Way to Stop Bear Raids, Credit default swaps need much stricter regulation, in: *Wall Street Journal*, 24 March (online.wsj.com/article/SB123785310594719693.html).
- Speyer, B. (2006), Credit derivatives—short-term challenges and long-term implications, in: *Journal of Financial Transformation*, Volume 16, pp. 143–52.
- Yavorsky, A. (2008), Credit Default Swaps: Market, Systemic and Individual Firm Risks in Practice, Moody's, October.