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Greece Is Not Out of the Woods

Jacob Funk Kirkegaard foresees more difficulties impeding German approval of a Greek rescue—and grave problems for Greece in meeting Europe's terms.

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Steve Weisman: The outlook for Greece continues to be cloudy. This is Steve Weisman at the Peterson Institute for International Economics, with Jacob Kirkegaard, research fellow at the Peterson Institute, who has been writing a lot on our blog and elsewhere about Greece and Europe as a whole. Thanks for coming here to shed some more light on this situation.

Jacob Kirkegaard: My pleasure.

Steve Weisman: What is the current state of play in terms of the European-wide and also IMF rescue plans for Greece? Are they a done deal?

Jacob Kirkegaard: Yes and no. It's clear that the commitment over the weekend of the €30 billion by the euro-zone countries is fairly credible. When I say fairly, I mean that the latest news coming out of Berlin actually suggests that the German government has decided that they need the equivalent of a [parliamentary] roll call vote for this loan to be approved, which obviously, with Germany heading into a very important regional election on May 9, is a significant political problem. And the other issue is that there is certain to be a legal challenge with the German constitutional court about the legality of the German government entering into this deal.

Steve Weisman: And the basis for that challenge?

Jacob Kirkegaard: The basis for that challenge is that the German Constitutional court has previously ruled that it was only legal for the German government of Chancellor Kohl, back in the 1990s, to give up the deutsche mark if the deutsche mark was replaced with a monetary system of the euro, which also had a basic pillar of monetary stability—basically no inflation. But critically in this case also an ironclad guarantee that there could be no bailout of a country like Greece and therefore, no moral hazard. And that is essentially the basis for such a lawsuit.

Steve Weisman: I'm not sure what the German word is for bailout. You could call it something other than a bailout. Is that how they're going to get around this?

Jacob Kirkegaard: Yes, they're trying all sorts of things. They refer to it as a "bilateral loan" offered to Greece at what they say is market rate. I mean, that's obviously patently wrong. It's significantly below what Greece would have been able to [borrow] in the markets. But I think the fundamental premise here is that they're arguing that there is no risk involved in this because the loan is sure to be repaid. I have to say that personally I have become significantly more pessimistic because of events this week. I have started to question for the first time whether or not Greece is able to do this without being forced through a debt restructuring.

Steve Weisman: So you see two problems. One is the legal problem of trying to get parliamentary approval in Germany. But you're mentioning a larger problem, which is whether Greece can go through the austerity measures and other steps without a debt restructuring or some kind of default or bankruptcy proceeding.

Jacob Kirkegaard: Yes. To answer the first question, I think the German government will probably win the first vote in Parliament so that the initial German share of the 30 billion, which is €8-something billion, that will go through. But the issue is that it'll be a little bit like TARP [Troubled Asset Relief Program] in the United States and bailouts. It will simply be: "OK, we might give you this but don't come back for seconds." There's no way that the Germans, in my interpretation at least, also partly related to this legal challenge, there's no way that they're going to get an additional loan.

Steve Weisman: In 2011?

Jacob Kirkegaard: Yes. This ties into the second part of your question. So far Greece has basically been promised 30 billion with an additional potential of 15 from the IMF. That's still to be negotiated. But that's only for 2010. And that essentially is equal to at least 50 percent of the total refinancing needs of Greece, actually significantly more than that.

Steve Weisman: Over how many years?

Jacob Kirkegaard: For the rest of 2010.

Steve Weisman: So that's only 50 percent for this year alone—

Jacob Kirkegaard: Yes. I don't remember the exact numbers but it's at least 50 percent. It's probably a little more than that. But the point is this is really why the longer-term issue actually looms larger after this week.

The key set piece of information was that even after the eurozone had shown its hand and committed credibly to help Greece financially through 2010, the Greek government on Monday issued some very short-term bills of 6-month and 12-month maturity. And you would think, given that they had just received assurances for funding over this period, essentially a eurozone guarantee for at least a short-term debt, that they would be able to borrow money in the markets at very low risk. But actually they had to pay 4.5 percent, between 4.5 and 5 percent, for this incredibly short maturity, and that is just demonstratively not sustainable.

And that raises the question if there are essentially no effects of the committed official financial assistance, if that has no effect on the interest rates that Greece can get in the financial markets, we are essentially now in a situation where if Greece were to be able to refinance any of its debt, it would have to be done or at significantly lower rates. It would have to come exclusively from official sources, meaning the IMF and the eurozone. And that's where, as I said, keeping in mind what we talked about earlier in Germany, "Don't come back for seconds." There was another rumor in the German press earlier this week that said that the real number wasn't 30 billion; it was actually €90 billion over the three-year period. So it's like 30-30-30, and if that's true—

Steve Weisman: And it probably is.

Jacob Kirkegaard: Well, exactly. I mean if you look at just the Greek refinancing numbers, if you then say that markets will only lend to Greece at unsustainable rates, [the] eurozone, the European Union, or the IMF or some combination thereof would essentially have to guarantee the entire Greek foreign debt. And I think that's just not sustainable.

Steve Weisman: And that would be in the hundreds of billions?

Jacob Kirkegaard: Yes. That takes us into significantly above $100 billion over the three-year period, perhaps as high as $150 billion. And that kind of commitment, I think, is very hard for me to see politically sustained. And it still doesn't get into the issue of: How is Greece going to repay its debt? Because it has to be kept also in mind that in the earlier plan to bring back Greece's public finances from the brink, the eurozone basically told the Greeks to implement a 4 percent reduction in the deficit this year, another 4 percent next year, and then in 2012 there is a chance that we'll get down below a deficit of 3 percent of GDP. And then maybe in 2013, you can go back to a surplus. And with the dynamics we've just talked about, the way financial markets are looking at that, keeping in mind again that Greece already has about 130 percent debt-to-GDP, that is not a sustainable path. That is simply not going to be feasible—to continue to add on to the 130 percent debt stock we already have today for the next couple of years.

And just another point, which also brought me more into the bearish camp, was that there were some pretty unambiguous statements made by both ECB [European Central Bank] President Trichet and also the managing director of the IMF. Both answered, when they were asked about whether or not Greece should actually go into deflation, both said unequivocally yes. That was the way that Greece would have to regain its external competitiveness—by simply lowering prices and wages. And I think politically, there is clearly a precedent for that in the eurozone. We saw it in Ireland, we saw it in Latvia. And in both cases, I would actually argue that it has basically worked.

Steve Weisman: But can it work in Greece?

Jacob Kirkegaard: Well, exactly. That's exactly the issue because the key thing here is that both Latvia and Ireland were relatively low-debt countries when they went down this deflationary path. Which means that it doesn't matter so much that their GDP shrinks because, depending on how you treat bank liabilities in Ireland, they have a much lower debt stock than Greece. So if the denominator shrinks a little bit, it doesn't actually matter so much as it does for Greece. If Greek GDP were to shrink by 10 to 15 to 20 percent as we've seen it in Latvia, when you the mountain of debt you carry on your shoulders is already 130—

Steve Weisman: The ratio is even more of a killer.

Jacob Kirkegaard: The ratio just becomes unsustainable.

Steve Weisman: You mentioned something about restructuring Greek debt. How would that happen?

Jacob Kirkegaard: Well, yes—

Steve Weisman: I mean, who are the creditors?

Jacob Kirkegaard: This is of course an added layer of complexity, which plays into why the German government has been in favor of this ultimately. The majority of—at least to the degree that you're able to see in the available data who actually owns Greek debt outside of Greece—a lot of it is held by Greek banks domestically. But the share that's held externally is about—70 percent of that is held by other eurozone banks.

Steve Weisman: You mean 70 percent of the total or 70 percent of the external?

Jacob Kirkegaard: Seventy percent of the external debt is held by German banks, which according to the BIS's [Bank for International Settlements] latest data has about € 40 billion exposure, and French banks, which have about 70 to 75 percent. They will be among the large creditors, which obviously is also why the German government and the French government—who earlier guaranteed the survival of these large banks—are basically sitting back and asking themselves, "Would we rather give the money as bilateral loans to Greece to avoid a default or have to bail out our own banks again in the event of a default?" So that's sort of like a choose-your-poison scenario, you could say, from the perspective of the German taxpayer.

But it raises a whole host of issues in terms of the preferred ranking of these creditors. Because if at this late stage in this crisis, all of a sudden [to] have the IMF and/or the eurozone come in as substantial creditors, at least from their perspective, at least from the eurozone, in a political sense, I think it's unavoidable that they will become a super-preferred creditor vis-à-vis Greece.

Steve Weisman: If they have good lawyers negotiating the loan agreement, they will.

Jacob Kirkegaard: Yes, they have considerable leverage over Greece also as fellow members of the European Union and other European fora. And this is clearly something that must play into the minds of non-eurozone private sector creditors in holding Greek debt, which they would presumably want to get rid of. Which takes us to another complicating aspect: no one really knows how much of this Greek debt is actually held by the European Central Bank as collateral. But there's no doubt that there is a significant amount of that, not only the ones ultimately transferred to it by foreign banks but also the debt that was initially bought by domestic Greek banks and then used as collateral with the ECB.

So how this is ultimately going to play out and who's going to have to be paying what and what haircut [there will be]. Also the role of the ECB will be very important here because they probably hold a significant amount of this outstanding debt that will have to be restructured.

Steve Weisman: I've always been curious about the term haircut because a haircut really doesn't hurt but this one will.

Jacob Kirkegaard: Undoubtedly, there will be a lot of egos bruised and there'll be a lot of—

Steve Weisman: Other body parts.

Jacob Kirkegaard: Yeah, a lot of other body parts will come out of this with significant bruises.

Steve Weisman: Jacob Kirkegaard, thank you.

Jacob Kirkegaard: I will say finally, the one good piece of news this week seems to be that the contagion effect on other eurozone countries has actually been very limited. So Greece now seems to be a bit more of an outlier than it looked just a few weeks ago. And I think that's very important and that may in fact mean that we will be talking about Greece very soon but hopefully not about other European countries.

Steve Weisman: Thanks, Jacob.