More Turmoil in Greece and Europe

Jacob Funk Kirkegaard notes that the latest estimates of Greece's increasingly large financing needs may compound its difficulties in getting help.

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Steve Weisman: Negotiations between Greece and the European Union and the IMF continue to flounder. This is Steve Weisman at the Peterson Institute for International Economics with Jacob Kirkegaard, who has been writing about this in our RealTime blog. Jacob, thanks for joining me.

Jacob Kirkegaard: My pleasure.

Steve Weisman: Once again Greece's long-term debt problems are recognized as larger than previously thought. There is also fear of contagion from Greece to other parts of Europe. Let's talk about Greece's debt. How big are its refinancing needs over the next few years?

Jacob Kirkegaard: It's a little difficult to put a precise number on it in terms of the yield they have to pay. But just the outright refinancing rollover of the principal of the debt is probably in the region of €120 billion. That is basically the reason why the new price tag for the joint IMF-European three-year program with the Greek government is in that ballpark. Basically the intention is to insulate the Greek government from having to raise private financing for a period of three years.

Steve Weisman: It's now clear that the initial negotiations were only focusing on 2010. So is recognizing that the financing has to be provided over the next three years a step forward?

Jacob Kirkegaard: It's a step forward towards honesty in this. The initial agreement—the eurozone frame, they termed it—[was], we provide €30 billion for the first year, plus the IMF share, and then for the future in 2011 and 2012, that was left to be negotiated. That was never credible. But I would argue that while it is more truthful to put the €120-billion price tag on for three years, it's not clear to what degree this ultimately solves the problem that the Greek government is fundamentally insolvent.

We're going to be in this situation in 2012 where Greece—having gone through what is likely to be a very dramatic recession and at least a couple more years with budget deficits—will probably end up in 2012 having a debt-to-GDP ratio in the range of, in a benign scenario, 140 to 150 percent of GDP. And that begs the question, well, even if the Greek government also puts in place a lot of progrowth [policies]—liberalizing the government, economy-type of reforms—will the private financial markets really be more willing to lend to them at that total debt level than they are today? I think that's very doubtful.

So I think that it is best to perceive this new plan as a very expensively purchased window of opportunity for the European Union to really get down to business and figure out how you restructure Greece's debt for the long term.

Steve Weisman: If Greece's debt is restructured, would the debt-to-GDP ratio look better?

Jacob Kirkegaard: Oh, yes. I mean, by definition, if you—

Steve Weisman: What would be the target in terms of that ratio for negotiators on the restructuring?

Jacob Kirkegaard: That's a little up in the air. But the easy answer is that it'll be very substantial. And if you look at historical default/restructuring experiences in Argentina and Russia and elsewhere, you typically are talking about 50 percent to perhaps even 70 percent reduction in the principal on outstanding debt, which in the case of Greece would also have the ironic implication that then the country would actually be close to adhering to the Maastricht criteria only to have maximum 60 percent government debt. So I think that's about the right ballpark.

Steve Weisman: But realistically any restructuring would have to be negotiated in tandem with the more specific austerity steps that Greece would have to take.

Jacob Kirkegaard: Not necessarily. I think that the austerity measures that Greece will have to take will have to be negotiated upfront, as part of the deal that they're now negotiating with the IMF and the European Union. But the precise terms of a debt restructuring, I think, would be far too complicated to try to do in just a couple of days, which is incidentally why these new proposals from the German opposition parties—which wants to include private sector haircuts in any agreement ahead of time—while they're ultimately very sensible, they come at a very destabilizing moment. It basically raises the question about whether or not Greece will ultimately get the €120 billion over these three years.

Steve Weisman: Now who owns this debt?

Jacob Kirkegaard: Certainly, a lot of it is held by Greek domestic banks and banks elsewhere in the eurozone. But then most of these banks have access to the ECB [European Central Bank] open markets operations and will now, if they are rational and at least expecting a default, they will have used this Greek debt as collateral with the ECB, excess liquidity through the ECB. So ultimately, right now I would suspect that a very large number of these bonds are on the ECB balance sheet in the form of collateral.

Steve Weisman: And you've been writing that the ECB then would have to take a haircut on its collateral or the debt that it has as collateral. But if that were to happen, then that haircut would be, in fact, borne by the treasuries of the participating countries in the ECB, as I understand it.

Jacob Kirkegaard: Yes. Given that they own the paid-up capital structure of the ECB, yes, it would ultimately have to be distributed by some formula among the owners. But the question that the ECB faces is a very tricky one. One of the things that happened this week is that Standard and Poors downgraded Greek debt, understandably so, to junk status. Which means that according to the ECB's own rules, even if before you get it into an outright default, Greek debts should no longer be eligible as collateral with the ECB.

And the problem facing the ECB is that if more credit rating agencies downgrade Greek debt to junk status, they will have to choose. Either they throw out their rulebook once again and thereby accept collateral even though it has junk status, or they refuse to all of a sudden take Greek debt as collateral—thereby ironically handling the credit agency the revolver to fire at

the heart of the eurozone. But that's a different story. They can refuse to accept collateral. But then they will almost certainly trigger a bank run on Greek banks and set in motion the sort of spiral of death that ultimately will lead to a disorderly Greek debt default. So it's really, "Pick your poison, Mr. [Jean Claude] Trichet [president of the ECB]."

Steve Weisman: Jacob, thanks again for helping me understand this phase of it and we'll have you back soon as this unfolds.

Jacob Kirkegaard: My pleasure.