The Eurozone: Can't Live Within It, Can't Live Without It

Jacob Funk Kirkegaard says talk of debt restructuring or "haircuts"" for creditors is inevitable but is also fanning the flames of contagion and discord in Europe.

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Steve Weisman: First Greece, then Ireland, then maybe Portugal and Spain. What next for the contagion in Europe? We've had Jacob Kirkegaard of the Peterson Institute here on these developments a number of times. Thanks for coming again today.

Jacob Kirkegaard: My pleasure.

Steve Weisman: Give us a snapshot of the state of play at the end of November and beginning of December.

Jacob Kirkegaard: First of all one thing that is clear, the thing that everybody feared so to speak, which is contagion to a systemically important eurozone country—whether it's Spain or Italy doesn't really matter—has already materialized. That really is a significant change of events in the last couple of days.

Steve Weisman: It must be said, Jacob, that you yourself weren't sure this was going to happen.

Jacob Kirkegaard: No, I personally have been very skeptical about it. And I don't think the sky is falling yet. But it's obvious that there are fewer and fewer straws to grasp, so to speak, for someone like me. But I think it is important to understand a couple of things to frame this very serious turn of events.

First of all I think it is important to keep in mind the specific circumstances of the sovereign debt market. There are a lot of people, certainly among politicians in Europe, who think that it is all due to speculators—hedge funds, shorting, and these types of things. I basically don't think that it's true at all.

If you look at the typical bond investor in Europe, it's not a hedge fund. It's actually a pension fund or another sort of large-scale investor that is not speculating but is really just worried about getting their money back at par value. These are basically pretty conservative people. They're not speculators at all.

Steve Weisman: You're saying, whether it's speculation or prudent investors and pension funds, it's not irrational.

Jacob Kirkegaard: Exactly. It's not irrational because these are investors in a market where you have had seen an enormous expansion of supply in recent years simply because of the scale of government deficits. They're being asked to buy more of the stuff they usually buy, and they're also being asked to buy stuff that is not as good as they thought it was. And here I think it's important to keep in mind that the downgrades in sovereign debt ratings by the credit agencies actually play a large role for this group of investors.

Steve Weisman: But it's not just downgrades in a vacuum as you yourself have noted. There is more talk of debts, either current or future debts, after 2013, not being paid back on par. Isn't that contributing to this contagion?

Jacob Kirkegaard: This is the last part of this bad cocktail for sovereign debt investors. It's, of course, this aspect brought forward by the German proposals for a permanent crisis resolution mechanism that involved having haircuts on sovereign creditors in return for an international eurozone bailout.

Steve Weisman: Is the European proposal for sacrifices by creditors in the future similar to the US resolution mechanism in the Dodd-Frank Bill?

Jacob Kirkegaard: I think it's important to distinguish between Dodd-Frank, which refers to governments rescuing banks in their own country, and certainly Dodd-Frank allows for haircuts also on senior creditors. What Germany has proposed is essentially not bank debt, but sovereign debt, which is another category of assets that were traditionally referred to as risk free. Therefore, all of a sudden, investors who thought, "We're buying nominally risk-free government debt" found out actually that maybe this debt wasn't risk free at all.

Steve Weisman: It is less risk free when government debt is used to back up bank debt.

Jacob Kirkegaard: Yes. Absolutely. But the fact is that all of a sudden these types of investors faced what was initially, at least, potentially automatic haircuts, initially from the German proposal.

Steve Weisman: That was what was contemplated in the original German proposal.

Jacob Kirkegaard: Yes, that has since been clarified—

Steve Weisman: Revised.

Jacob Kirkegaard: Revised down. In my opinion, the German government has caved in. They have had to scale back their proposals quite dramatically in the face of —

Steve Weisman: Away from the automaticity.

Jacob Kirkegaard: Absolutely, there is no automaticity. There is to be a case-by-case discussion about the extent and even a requirement for debt restructurings.

Steve Weisman: Were the markets impressed with that?

Jacob Kirkegaard: Not really. This was something that was announced together with the details of the Irish bailout.

Steve Weisman: Over the weekend.

Jacob Kirkegaard: Yes, over the weekend. And the markets were not impressed by that at all. To a certain extent, I don't think they should be either. The core issue, apart from the retreat from automaticity, was that the eurozone basically ruled out this new mechanism. This new potential for haircuts would apply to debt issued before 2013. They would essentially grandfather all existing debt into this new mechanism. And that fundamentally, in my opinion, is not credible.

Steve Weisman: For a lot of reasons, but one of them is just the fiscal realities of these different countries.

Jacob Kirkegaard: Yes, the fundamental is that it's not credible to ask a country that is potentially insolvent, as in the case of Greece, to begin issuing new debt with these collective action clauses that facilitate restructuring. If it already has existing debt that makes it insolvent, it already has too much debt.

It's not credible to say that this debt isn't going to be touched, but we're only going to restructure your new debt. It means that this new debt is essentially going to be subordinated debt, or at least more risky debt. Which means Greece will never be able to go back and issue this type of debt at any sustainable or even close to a sustainable interest rate. Therefore, ultimately, this mechanism is just going to accelerate Greece's requirement for a debt restructuring.

Steve Weisman: How vulnerable is the banking system in Europe, and also the pension funds that you mentioned earlier, to the debt restructuring causing major instability in the banking system?

Jacob Kirkegaard: I don't think that the European banking system is as vulnerable as we thought perhaps in May of this year. I think that they could quite possibly absorb the losses entailed from a Greek restructuring. But what we've seen in the case of Ireland, that's a slightly different process.

First it's important to note that the exposure of the European banking system to Ireland is considerably bigger than its total exposure to Greece, simply because the Irish banks are far larger. And particularly it pertains to several large banks in the United Kingdom and elsewhere. So Ireland is a different concern. But here there's this other aspect where traditionally senior bank creditors have always been guaranteed by the national governments and therefore been, shall we say, perceived as the de facto sovereign risk-free debt.

But the problem is that in Ireland—despite the fact that the European Union was very clear in emphasizing that what they were announcing did not entail any haircuts on senior bank creditors—I don't think that is by any means certain in Ireland. Which means that you can get to a situation where there is a new, shall we say, precedent for senior bank debt in Europe taking a haircut, which could potentially lead to bank runs across all European banking markets—but definitely a substantial increase in the cost of capital for banks. And that could have a lot of sustaining implications.

Steve Weisman: How quickly is Europe going to face a decision on whether to proceed with some kind of debt restructuring for Greece and Ireland?

Jacob Kirkegaard: Ironically, one of the aspects that we had some clarity on over the weekend concerned the maturity of both the Irish and the Greek financial assistance packages. Ireland got up to 10 years to repay [its] loans. And Greece was supposed to have begun repayment as early as 2014. They actually got an extension of the maturity of between three and seven years, as far as I read. Which would essentially suggest that the European leaders are throwing more money at the problem and trying to kick it further into the future to avoid the kind of decision of whether or not to go into a restructuring for sovereign debt or not. But I think ironically because of these concerns, and because of this actually manifested contagion, this could be quite soon.

Steve Weisman: You've discussed the question of which poison is worse. What if the debt restructuring weakens the banking system and requires government assistance to banks, borne by the same taxpayers who are trying to avoid the pain of not restructuring the debt? No matter what, the living standards in these countries are going to be reduced, with consequences socially and politically that we can't measure.

Jacob Kirkegaard: Yes, I think absolutely. You can say that for a number of eurozone peripheral countries, the convergence in economic terms is going to stop—

Steve Weisman: Explain what you mean by that.

Jacob Kirkegaard: It means that the peripheral countries—Greece, Portugal, Spain, certainly Ireland—aren't going to grow faster than the eurozone average for the foreseeable future.

Steve Weisman: As they have over the past decade.

Jacob Kirkegaard: With the exception of Portugal, as they have. And, for Ireland by a very large margin, in the last 10 to 15 years. That means that the euro and European integration will, as a positive political idea or vision, is going to disappear. Instead you're going to have what you alluded to, more and more European governments having to mete out very painful austerity measures and issue reforms that are going to hurt the middle class. They are going to impose a lot of pain on the middle class in the name of the euro or in the name of European integration. And that's going to be politically tricky.

Steve Weisman: But you still don't see a danger of countries dropping out of the euro?

Jacob Kirkegaard: No, I think—

Steve Weisman: Because the cost is too great.

Jacob Kirkegaard: Exactly, I mean precisely for that reason. I think that while the politics of European integration will change—and they will become more demanding—when you compare them with the actual costs for a country of leaving the eurozone, I will very safely declare that no democratic government in Europe will ever leave the eurozone. And that's incidentally also true for Germany. I don't believe that you can construct any conceivable economic and political scenario that makes it worthwhile for Germany to quit the euro. First of all, it would require that Germany essentially abandon everything that it has stood for since the end of World War II, in terms of European integration, etc. And secondly, it would entail far bigger losses on the German banking system and the German financial system. Which as you know, could be well over a trillion euros, and exposure to the periphery that any debt restructuring within the eurozone would. Because all of this exposure of German banks to Spain, to Italy, to other peripheral countries—if these liabilities were all of a sudden to be repaid in new pesetas, new lira, new escudos, new drachma etc., the ultimate losses will be far, far larger.

So I don't regard it as a credible or even feasible for the eurozone to break up, which underpins my optimism about this. It also means that what we have seen so far with the European Financial Stability Facility—the €440 billion facility, and all the other measures taken in May as well as the new measures announced last weekend—aren't the end of the line for the willingness of European governments to do things that had been considered inconceivable before the day that they happened.

There are a lot of things they can do more than they have already done. I think two things will happen. One is that ultimately Germany will pay or guarantee much more than we've seen up until now. And ultimately the European Central Bank is going to end up being far more activist than what we've seen so far. It's just that the politics have not yet made this possible. But as this crisis continues to spread and contagion continues to spread, the politics of unconventional measures like this will change.

Steve Weisman: Jacob thanks very much.

Jacob Kirkegaard: My pleasure.