Greece Back on the Front Burner

Nicolas Véron says new tensions have arisen over creditors balking at Greek debt restructuring and Greece itself falling short of its commitment to reform.

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Steve Weisman: Tensions and uncertainties are on the rise again over Greece and its sovereign debt problem. Nicolas Véron, visiting fellow at the Peterson Institute, is with me, Steve Weisman, to give us an update. First, what are the latest tensions and difficulties caused by?

Nicolas Véron: There's a discussion on the so-called private sector involvement of private sector creditors to Greece that has been going on for a long time has been announced in July, reworded in late October.

Steve Weisman: The term "private sector involvement" refers to the enforced write-downs on debt.

Nicolas Véron: Exactly. This is involvement of the private sector in the collective effort to put Greece back on a sustainable track. So it's about reduction of the debt burden and the part of the private sector in it. The public sector involvement, if you will, has been providing new loans to Greece from individual eurozone member states from the European Financial Stability Facility [EFSF] and from the International Monetary Fund [IMF] and also having some reduction of the rates of those loans compared to what private sector creditors were willing to accept at the same time. That was a public sector involvement, if you want to put it that way. In the current jargon, private sector involvement is basically debt restructuring, but in a way that the private sector is supposed to be happy with because they see it's in their interest to put Greece on a sustainable track.

Steve Weisman: Right. They take a loss on the debt, but at least Greece remains solvent enough to pay something off.

Nicolas Véron: Exactly. They get something in exchange. Now, of course there's a sort of fine line between a voluntary and an involuntary deal because taken individually, every creditor would like to be a free rider, right? [They] would like the others to take the burden of debt reduction and to be repaid in full. And this is exactly why these discussions on private sector involvement tend to be so complicated, because there's a big collective action question in them intrinsically.

Now, there has been a choice to bridge this gap by having the Institute of International Finance [IIF] acting as an agent for the private sector creditors. This has been the framework of the discussion since the start in July or even before in a way. And so the discussion, formally, is between the IIF acting on behalf of private sector creditors with the structure of committees and all that to represent the creditors' interests on the one hand and on the other hand, the Greek government, but with a very significant involvement of the IMF, the ECB [European Central Bank], the European Commission, and individual member states. That's the discussion that's taking place right now. Parameters of the discussion were announced in July. Then a different, harsher set of parameters was announced in late October, but we still don't have a deal. And the question is what happens if they cannot find an agreement not only on broad parameters, but on detailed financial conditions?

Steve Weisman: Sorry to interrupt. The IIF had offered a proposed deal, but it's having trouble selling that to its members in the Institute?

Nicolas Véron: The original IIF deal is basically obsolete because this was predicated on a haircut or a reduction in the economic value of the holdings that is much smaller than the haircut that is currently envisaged. Basically, the IIF deal of this summer was based on a twenty-one haircut, if my recollection is correct.

Steve Weisman: Twenty-one percent?

Nicolas Véron: Twenty-one percent haircut. Now we're talking about fifty to sixty or even more than sixty percent haircut. So we are talking about a much harsher restructuring. And that's basically the decision that had been announced in late October and at the time the IIF was saying, "Well, we agree with this. We understand it's necessary and we'll gather the creditors on this deal." But this was more than two months ago. And again, we still don't have it.

Steve Weisman: Have they achieved any success at all? Have any major players stepped forward and said, "We'll accept this deal"?

Nicolas Véron: You know, as long as there is not a deal, there is not a deal.

Steve Weisman: As long as they don't have everyone, they don't have anyone?

Nicolas Véron: It's still a work in progress and they haven't finalized the terms of the deal that individual creditors would have to take a decision on. And even when they finalize this, which in the jargon is a "term sheet," which may be in the next few days or not, we don't know, but certainly there's an expectation that there will be some progress in the next few days. Even then, you have to see how many creditors take it and the participation rate is one of the most important parameters here. Not only financially—because the more participants you have, the more debt burden reduction you have for Greece—but also politically because if you have a low participation rate, that means you have many free riders and there will be a backlash against this both from the ones who participate and from the Greek public and other political participants. So what are the terms of the deal? We don't know yet. What is the participation rate? We don't know yet. And what the negotiators are trying to do is to optimize this, to have a deal that is harsh enough to reduce the debt but good enough to have a high participation rate. And then to see how they can force the holdouts to--let's put it that way, how they can incentivize those who are not enthusiastic about participating to be more enthusiastic about participating.

Steve Weisman: Well, one way of incentivizing them would be to say, "Take this deal or you get nothing, and Greece defaults on your debts." But that would have huge repercussions.

Nicolas Véron: And this is where this is exactly right. This is where I think the terms of the discussion are shifting in a way that is quite fast-moving right now. Initially, the whole point of the discussion was to avoid what financiers call a "credit event." A credit event, technically, is defined as something that triggers credit default swap protection. If you buy a credit default swap and you buy credit protection on the Greek default, the International Securities Dealers Association—Swap and Derivatives Association – sorry, ISDA. We all talk about ISDA, but I'm never sure what the acronym stand for. I think it's Swaps and Derivatives, actually. So the ISDA has a committee that determines what triggers the payment of the protection when there is credit default swap which from this perspective is a sort of insurance contract. Even so, it doesn't have all the features as the other features of an insurance contract. So the big question, or the big objective at the early stage of the negotiation was: we have to put it in a way that doesn't trigger a CDS payment. We have to put it in a way that isn't considered a credit event under ISDA criteria.

Steve Weisman: If there were such a credit event triggering a credit default swap, would the institutions that have sold these swaps be able to pay?

Nicolas Véron: That's a different question. In the case of Greece, the answer is probably yes, because Greece is small in this bigger scheme of things. The problem is that Greece is a precedent that will affect other markets. So the question is, what is the contagion pattern? We basically don't know what it will be, but we can be sure there will be some contagion. And obviously, the European policy makers, including the ECB, are insisting that Greece is a case of its own, [that it] doesn't have any precedent value and will be a completely isolated event. But this means nothing from the market perspective. Nobody is ready to believe that because we know that other countries can have problems, have had problems, and will have problems. Even so, none is exactly the same as Greece.

Steve Weisman: While these discussions are going along, there are discussions about whether Greece can live up to its commitments in the enforced fiscal consolidation.

Nicolas Véron: That's one other dimension of this set of issues. This discussion would be complicated enough if the outlook for the Greek economy was stable, but actually it's deteriorating and in terms of structural reforms, the Greek government hasn't been exactly delivering in terms of implementation even of the things that were passed by the Greek Parliament. And of course, there had been a change of government in Greece in November and there will be an election possibly in April. So you have also this political instability, but the bottom line is the Greek government hasn't delivered and for the creditors, it's not a very good thing to hear.

Steve Weisman: It sounds also like the Germans and others are getting more impatient.

Nicolas Véron: And so is the Greek public for different reasons because they feel that there is a lot of hardship. There are a lot of sacrifices and there is no payout for this. So you have a buildup of tensions in Greece, once again, which means that in way, I suspect, we will be looking at the November-December or late 2011 period, and with hindsight wonder why Greece was so far from the headlines during that period, because it remains the epicenter of the crisis. I mean, maybe everything will play out well. There will be a PSI deal and the Greek economy finally will see the end of the tunnel, but at this point the landscape of risk is certainly not completely smooth.

Steve Weisman: And what is the timetable going forward for deadlines and other factors in forcing resolution of this?

Nicolas Véron: Greece has a big debt redemption deadline in mid-March. So basically they have to find cash before then or at that moment or there will be problem of being able to honor the commitments. So that sets a broad timeline of what we're talking about. Now, of course, there have been expectations built in addition to this, especially on the PSI deal, which was supposed to be resolved quickly. And now there is a lot of discussion in the policy community and in the financial community about wrapping up that deal, at least in terms of the so-called term sheet, the things that creditors would have to make a decision upon in the next few days. So I think the next few days will be interesting and important to watch from this perspective and certainly a number of things have to happen until mid-March if an outright default is to be avoided.

Steve Weisman: So you think it'll be clearer by then?

Nicolas Véron: Certainly not everything will be clearer, but we'll have some additional elements to judge the seriousness of the situation or the prospects for optimism.

Steve Weisman: Thank you, Nicolas.

Nicolas Véron: Thanks very much to you, Steve.