



## Making an Example of Greece

*Jacob Funk Kirkegaard argues that Greece's balking at reforms sets such a bad example for Europe that contagion from a Greek default might be containable.*

*Transcript of interview recorded January 19, 2012 . © Peterson Institute for International Economics.*

Steve Weisman: Jacob Kirkegaard, research fellow at the Peterson Institute for International Economics, has been more sanguine about prospects in Europe than others. But on Greece, Jacob, you now say that things have gone south since the beginning of the year. This is Steve Weisman. Jacob, what are the chances of Greece avoiding a default?

Jacob Kirkegaard: I think we're at the point where Greece is going to default. It already has defaulted. The question we're talking about now with private creditors is this issue: is the restructuring going to be voluntary or not? On that point, I believe that in the end, over the next couple of weeks, we will have a deal between Greece and its private creditors. But I think, unfortunately, that this will only prove to be the first, and in fact, the smallest obstacle that the country is facing. What we have seen in the last couple of months is that even though at the end of 2011, we did have what looked, at least to me initially, as a pretty seismic shift in the domestic politics of Greece -- with the change of prime minister, the formation of a new unity government, which has more than 80 percent support in the Greek parliament and therefore, in principle, should be able without any political obstacles, to actually pass a lot of the structural reforms that the previous Greek government had been unwilling to take the political responsibility for alone.

But I have to say that, unfortunately, I am increasingly coming to the conclusion that even with this new unity government and even though the Prime Minister Lucas Papademos increasingly talks a good game -- he knows what to say -- the fact of the matter is that nothing happens on the ground. None of the structural reforms that Greece had been compelled to implement a long time ago by the existing IMF [International Monetary Fund] program is actually being put through parliament. There is a complete standstill on this agenda, which leads me to believe that even if Greece cuts a deal on private sector involvement with its private creditors and gets some debt relief in that in the next couple of weeks, I am increasingly skeptical over whether or not the country will be able to get or negotiate a new IMF program with the International Monetary Fund as well as the other European creditors. It doesn't seem that even a government that has overwhelming majority in the Greek parliament is actually able to seriously reform and implement the structural agenda that the country has ahead of it.

Steve Weisman: Why should the private sector creditors give Greece the concession of a restructuring that reduces the debt load on Greece if Greece is blocking the reforms in return?

Jacob Kirkegaard: I think that the private sector should do that because it's like choosing your poison. This isn't going to be pleasant. They're obviously going to be facing very significant losses, 50 percent on the notional value of the debt. Quite likely somewhat more, perhaps up to two thirds in net present value terms. But the reality is, unless they do this, they're going to get

even less, and Greece will change domestic laws and they will impose a probably bigger haircut on them. So it really is plague or cholera for the private sector. But because it looks likely that the bonds that the private bond holders are going to get in return are going to be governed not by Greek law, but by UK law, which means that these bonds are essentially impossible to restructure, what the private sector basically gets out of it is that they're out. They're essentially no longer part of the Greek debacle. They have accepted a very significant haircut and it is very unlikely that the European politicians or the IMF for that matter -- once that deal is struck, let's say six months or nine months or a year from now -- can come back from the private sector creditors and say, "Oh, we need to have an even bigger haircut."

Steve Weisman: But you said this would happen in the couple or three weeks.

Jacob Kirkegaard: What I'm basically saying is that the private sector gets this haircut ...

Steve Weisman: This will be it from the terms of the debt.

Jacob Kirkegaard: Yes, because the haircut is so big, that this will be it.

Steve Weisman: What does Greece do then? What if they default on that new structured debt?

Jacob Kirkegaard: Then they will be sued under UK law and they will basically be ultimately, I suspect, forced to pay out. But it will be very costly.

Steve Weisman: What if they refuse?

Jacob Kirkegaard: Then it becomes a political question for the euro area. And the broader political question that the euro area has got to ask itself is that if Greece -- after having gotten debt relief and been given the option of having continued IMF and European financial support for potentially a very long time, -- is still not able to reform its economy sufficiently -- the Euro area, I fear, is going to be asking, "Can a country that is essentially turning out to be unreformable actually remain a member of the euro area?"

I think it's important to note that once the private sector haircut is implemented, it is quite likely that the fear of contagion from Greece to other euro area countries is going to diminish somewhat. By this time, we know where their losses are going to be. Six to nine months from now when I suspect this will potentially come to a head unless there is an improvement in Greek domestic economic reforms, Ireland and Portugal and the other peripheral countries would actually look better than they do today. So there is a clear indication that Greece really is a special case.

Steve Weisman: So Greece can be a one-off. If this disastrous course takes place, what are the chances of protecting Spain, Italy, Portugal, and even France?

Jacob Kirkegaard: Let's say Greece, ultimately, is not able to get a new IMF program or very quickly that IMF program proves to be insufficient simply because the Greek economy continues to deteriorate, which is what we have seen ever since the first bailout. If that happens, the euro area faces a question. The fundamental one is: can such a country be a member of the euro area? I think it's important that in order to contain any risk of spillovers from Greece

to particularly Ireland and Portugal, the euro area is going to have to do more to show markets that, “We’re drawing a line in the sand here, Greece is a special case and we’re not going to allow countries, like Ireland and Portugal, that actually have been sticking to their IMF programs and actually have implemented the reforms that they have been asked to do, we’re not going to let them default. We’re going to continue to support them.” So you can actually have this ironic situation that countries like Ireland and Portugal may end up benefiting financially from Greece doing worse, because it becomes more important for the euro area to save them while essentially letting Greece implode.

Steve Weisman: It’s not really drawing a line in the sand. It’s more like throwing somebody overboard in a storm and hoping that that’ll satisfy the gods.

Jacob Kirkegaard: I think that there is that element in it. As I said, unfortunately, in the event that there is very reduced or a much more limited contagion risk from Greece, I think the euro area is going to be playing much more hardball with the Greek government and basically tell them, “You have the choice of doing all this list of reforms that you have so far been unwilling or even unable to do, or you’re not going to get any more money. And you are going to essentially be cut off.” And if after having all that money already been lent to Greece, which clearly is going to cost European taxpayers a lot of, there’s not going to be a lot of sympathy for Greece in the other European capitals. More importantly, the risks of letting Greece implode, if you like, I think are going to be much reduced. And you could even argue that as the publics in Ireland, in Portugal, in Spain and in Italy are watching what is going to happen in Greece, if they continue to not be able to reform their economy, that’s going to be a pretty ugly spectacle in my opinion. It’s going to mean bank runs. It’s going to mean, quite likely, that they are forced to leave the euro area and these types of issues.

Steve Weisman: People just won’t be able to go and get money out of their banks.

Jacob Kirkegaard: Exactly. I actually think that the political spillover from such an unfortunate scenario for Greece is going to be a re-doubling of the determination of publics in other peripheral euro area countries that whatever happens, we will not go down the route of Greece. So you end up in this scenario where, regretfully for Greece, you get rid of the weakest link of the chain, but the chain gets stronger in the process.

Steve Weisman: Thank you, Jacob. As they say in Texas, “It’ll get ugly.”

Jacob Kirkegaard: I’m afraid, unfortunately, potentially so.

