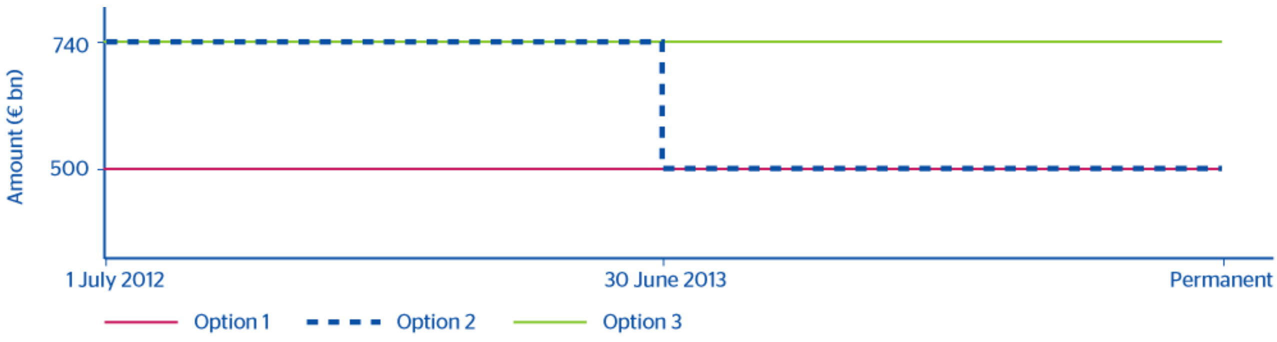
Europe Flash

Options to increase EU firewall on March 30

- After the second bailout of Greece and the approval of the fiscal compact, **the next major step in the European strategy to regain market confidence is strengthening the liquidity firewall** to avoid potential contagion across peripheral countries. In December 2011, the EU decided to put forward the introduction of the European Stability Mechanism (ESM) to July 2012 instead of mid-2013 as previously projected. The ESM Treaty was signed in February 2012. The current debate on how to strengthen the firewall focuses in combining, at least temporarily until the EFSF expires, the firepower of ESM with the EFSF. A decision must be taken by the Eurogroup next Friday. Increasing the funds available is also important to ensure that the IMF raises its contribution to solve the European crisis, as the Fund has made clear that more funds will be ensured only once Europe reinforces its firewall. In this respect, **the European Comission has published a document proposing three different options** to approach the combination of both funds. Here we briefly describe such options and provide an assessment.
- **Option 1 provides a new lending capacity of EUR500bn** beyond the €200bn already committed by the EFSF. The EFSF would no longer be available for new lending after 1 July 2012, but it would continue to service its existing commitments. The size of the firewall would be clearly insufficient, both to convince the markets and to unlock resources from the IMF/G20. The only difference with the current setup is that up to now it was established that the ESM would substitute the EFSF, and therefore it could be assumed that its €500bn would include the €200bn inherited from the EFSF, rather than adding to them.
- **Option 2 provides temporary new lending capacity of €740bn**, by combining the full ESM capacity (€500bn) plus the unused EFSF capacity (€240bn) until the latter expires by July 2013. Afterwards, the permanent firewall would be reduced to €500bn from the ESM. On top of this, there are the €200bn already committed from the EFSF, which would be slowly paid back to member countries and would not be added to the lending capacity of the ESM. The size of the firewall under this option would be enough in the short-term, up to mid-2013. After that date, the lending capacity is reduced while market pressures will possibly still persist.
- **Option 3 provides new lending capacity of €740bn as in option 2, but permanent** rather than temporary, by combining the €500bn from the ESM with the so far unused €240bn from the EFSF, which would be transformed into additional capital for the ESM as from the ESM creation, in July 2012. The already committed €200bn by the EFSF would be paid back to member countries, as in option 2. This option would strengthen both the size of the firewall, and its quality, which in the ESM is in the form of capital contributions rather than guarantees. Furthermore, the size of the resulting firewall would be large enough to convince markets and the IMF to provide more funds, reaching a total power beyond €1tr.
- In all three options **a key aspect will be the speed at which the new capital of the ESM is actually paid**. This is important because markets could perceive that the amount available by July 2012 could be too small in the face of a major accident in the short-to-medium term. Under the current Treaty, the loan capacity of the ESM is limited by the calendar of capital disbursements of 1/5 per year, of a total paid-in capital of €80bn. This limits the initial lending capacity of the ESM to €100bn, once the first instalment is paid by within fifteen days after the 1 July 2012. However, the Treaty allows for an acceleration of such payments. Indeed, a new, more rapid calendar decided on Friday would be welcome by markets. .
- Which option will be approved? Option 1 is clearly insufficient and will probably be discarded by European authorities. Option 3 would be the boldest one, but it will face strong political opposition from Germany, where the provision of new funds will be difficult to be approved by the Parliament. **We think Option 2 is the most probable, with a possible lengthening of the transition period to beyond mid-2013**, such that the extended firepower is available while most countries are still trying to adjust their deficits.
- However, **the temporary coexistence of the EFSF and ESM in option 2 raises some doubts**: Where will new lending to a given country come from, the EFSF or the ESM? Both options have different implications for the interest rate charged to countries, which in principle depend on the funding costs of the EFSF/ESM and these in turn would differ due to their different funding structures (guarantees for the EFSF and paid-in capital for the ESM). In order to maximize the size of the firewall, it would be preferable during the transition period to provide loans through the EFSF before its capacity expires. In addition, the implementation and working capacity of the EFSF has been clearly below expectations since its creation by mid-2011. Now it will have to coordinate its operations with a new body, solving *inter alia* the problem of coordinated debt issuances. Probably it would be more transparent to merge both bodies into a single one, even in the transitory period, although admittedly this could face institutional hurdles.
- **All in all, we expect from Friday meeting an expansion of the firewall** at least using option 2 above. Option 1 would be a disappointment. If option 2 is kept, it would be desirable to extend the transitory period for two more years. In addition, the calendar for the ESM capital payment should be clarified and accelerated, while the coordination of ESM and EFSF during the transitory period should be clarified in key aspects such as rules to access funds from one or the other and debt issuances.

Chart 1
Joint EFSF / ESM effective new lending capacity



Source: European Commission

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