

## How high the firewall? Potential financing needs for the periphery

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The informal Eurogroup meeting in Copenhagen on March 30<sup>th</sup> was the focus of intense attention, with observers eager to learn the size of the increase in the combined lending power of the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF), that should represent the firewall against economic contagion from heavily indebted countries like Greece to other eurozone members. Regardless of the headline figures discussed and eventually agreed upon, and beyond the doubts raised by the ‘fuzzy maths’ of the assembled finance ministers, the key question is whether the amounts will be sufficient to cater for all the possible economic scenarios.

In particular, the height of the firewall should have been determined with a view to securing all eurozone peripheral countries. To check if the commitments are in line with that ambitious objective, one should start by estimating the total potential financing needs under a worst case scenario.

According to IMF estimates, the total financing needs of Greece, Ireland and Portugal (GIP) amount to over €500 billion. Of this, about 80% is expected to be covered by the existing financial assistance programmes. Indeed, as shown in Table 1, the financial support promised to these three countries amounts to €390 billion. As of March 2012, a total of €155 billion, i.e. about 40% of the total amount, has already been disbursed by the various mechanisms (bilateral EU loans, EFSF, EFSM and IMF assistance).

Table 1. Overall assistance to GIP countries (€ billions)

Plan	Paid by	Disbursed	Agreed
GREECE	Bilateral	52.9	80
	EFSF		117
	IMF	20.1	48
	<b>Total</b>	<b>73</b>	<b>245</b>
IRELAND	Bilateral		4.8
	EFSM	18.4	22.5
	EFSF	9.3	17.7
	IMF	16.1	22.5
	<b>Total</b>	<b>43.8</b>	<b>67.5</b>
PORTUGAL	EFSM	15.6	26
	EFSF	9.6	26
	IMF	13.6	26
	<b>Total</b>	<b>38.8</b>	<b>78</b>
<b>TOTAL ASSISTANCE</b>		<b>155.6</b>	<b>390.5</b>

Source: Authors' calculations based on European Commission data.

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This means that once the ESM takes over and consolidates the existing commitments of the EFSF (as originally planned), out of its €500 billion lending capacity, only a 'safety buffer' of about €300 billion, still uncommitted, would be left.<sup>1</sup>

A firewall of this size is likely to be insufficient for two main reasons. First of all, the financial assistance plans assume that the countries are to cover part of the financing needs by returning to the market before the end of the programme. As shown in Table 2, the GIP are assumed to be able to gather over €120 billion of private funds before 2016. This assumption may turn out to be too optimistic.<sup>2</sup>

Secondly, the experience of Greece has shown that programmes tend to become insufficient over time.

Table 2. Financial needs covered by the market (€billions)

	2012	2013	2014	2015	2016
GREECE	0	0	0	0	0.3
PORTUGAL	0	9.3	15.9	14.5	25.4
IRELAND	3.9	14	14	14	14
<b>TOTAL</b>	3.9	23.3	29.9	28.5	39.7
<b>Cumulative</b>	3.9	27.2	57.1	85.6	125.3

Source: Authors' calculations based on IMF data.

Both these factors could quickly erode the margin left of the ESM. If a second programme were to be needed in Ireland and Portugal, this could lead to an additional financing need of easily over €100 billion, given that the second Greek programme was larger than the first one, and could make it impossible to find private investors willing to buy bonds issued by governments still under financial assistance.

All in all, one can thus conclude that an ESM of €500 billion would barely be able to cope with Greece, Ireland and Portugal should the programmes not work out as planned and should the markets remain closed for these countries for another couple of years. Neither of these hypotheses seems far-fetched.

### Spain and Italy: What if?

Given that the ESM could already reach its limits by helping the GIP alone, it seems clear that it would not be able to provide substantial support for Spain and Italy.

At present the spreads for these countries are at a sustainable level, but the events of late 2011 have shown that market conditions can deteriorate very quickly. Moreover, if the conditions deteriorate for Spain and Italy, the worst scenario for the GIP will almost certainly become a reality.

This leads to the question: how much would be needed in addition to the €500 billion, if Spain and/or Italy lose market access and need financial assistance?

Table 3 reports the estimated the financial needs of the two countries, based on the known rollover schedules of existing debt in 2012-16, plus the forecasted public deficit, according to IMF estimates.

<sup>1</sup> The ESM's remaining lending capacity could be even smaller, if it also had to take on the existing commitments of the EFSM.

<sup>2</sup> Portugal is expected to regain access to the market in 2013, Greece only in 2016 and for Ireland it is assumed a modest market access later in 2012 and more substantial market funding in 2013 (Table 2).

Table 3. (Re-)financing needs of Spain and Italy (€ billions)

	2012	2013	2014	2015	2016
ITALY	427	230	201	194	139
SPAIN	161	132	107	99	102
<b>TOTAL</b>	<b>588</b>	<b>362</b>	<b>308</b>	<b>293</b>	<b>241</b>
<b>Cumulative</b>	<b>588</b>	<b>951</b>	<b>1,259</b>	<b>1,552</b>	<b>1,793</b>

Source: Italian Treasury, Spanish Treasury, IMF and authors' calculation.

A cumulative refinancing need of almost €1,800 billion for Italy and Spain implies that the size of the ESM would have to be increased well beyond one trillion euro if it is to be able to deal with a worst case scenario. Even if the European mechanism providing financial assistance 'only' had to cover half of the financial needs of Spain and Italy, the additional funding needed for the ESM would be in the region of €600 billion, for a total size of €1,100 billion – well above the €700 billion just agreed by the Eurogroup.

One plan that seems to have been abandoned at the summit today was that of letting the ESM and the EFSF run in parallel, to combine their funding capacity. Table 4 shows that slightly less than €1,000 billion would have been available in such a case.<sup>3</sup>

Table 4. Remaining lending capacity assuming all three instruments run in parallel (€ billions)

<b>ESM</b>	<b>500</b>
<b>EFSM</b>	60
<b>EFSF*</b>	410
<b>Total</b>	<b>970</b>

\* Reflects the fact that Greece, Ireland and Portugal have already stepped out of the EFSF.

Sources: European Commission, EFSF and authors' calculations.

In a worst case scenario, however, it will become very difficult for the GIP, Spain and Italy to actually contribute to the financing of the ESM. Under such circumstances, the effective lending capacity of the ESM would in all likelihood be substantially lower. Should all five peripheral countries no longer be able to pay their contributions to the ESM, its lending capacity would be reduced by about 35%, leading to an overall European lending capacity of about €670 billion (65% of €940 billion given by the €440 of the EFSF and €500 of the ESM, plus the EFSM) or about one-half of what might be needed if the crisis were to seriously engulf Spain and Italy.

<sup>3</sup> One should keep in mind that at present, Greece, Ireland and Portugal have already 'stepped out' from the EFSF, reducing its lending capacity (before subtracting the already agreed plans) to €410 billion.