

The EFSF as a European Monetary Fund: Does it have enough resources?

Daniel Gros and Alessandro Giovannini

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The European Council of 21 July 2011, effectively decided to transform the European Financial Stability Facility (EFSF) into a European Monetary Fund by allowing it to engage in precautionary programmes and even to acquire debt at a discount on the secondary market. French President Nicolas Sarkozy declared proudly that euro area leaders "have agreed to create the beginnings of a European Monetary Fund". But does the EFSF have enough resources to become a credible deterrent against a recurrence of the recent turbulences in the euro area sovereign debt markets?

The present EFSF, whose lending capacity is effectively limited to about €250 billion, could not even cope with the commitments taken by the European Council now. The increase in lending capacity of the EFSF, which has been agreed politically but has not yet been fully ratified, is thus urgently needed. Moreover, even the 'full' EFSF of €440 billion would quickly reach its limits should Portugal and Ireland not be able to regain market access soon. A second programme for these two countries (without private sector involvement) might soon exhaust the lending capacity of the EFSF, and thus leave it little firepower left for secondary market purchases.

While contagion has been much reduced in the immediate aftermath of these decisions, the danger of renewed market turbulence remains. Our calculations suggest that the size of the EFSF would have to be increased almost tenfold, to over €4 trillion, to allow it to save Spain and Italy as well. But this might well turn out to be impossible to finance because it would require that global investors buy literally trillions of euros in an untested 'special purpose vehicle'. The SPV, so far at least, is not in any benchmark and has no track record, but only promises from member countries to back it up. This implies that it is crucial not to allow any suspicions to develop that a private sector involvement will also be required for Ireland and Portugal to stop contagion before it extends to Spain and Portugal.

Are there enough resources for Greece, Ireland and Portugal?

In the case of Greece, the second package agreed on the 21st of June foresees another €109 billion in official financial assistance from the EU and the IMF. Even if the technical aspects of this agreement are not yet clear, it raises official European assistance to Greece to approximately €180 billion, of which €47 billion is already disbursed through bilateral loans. The EFSF will become the financing vehicle for the next disbursement.

In the cases of Ireland and Portugal, it seems likely that neither of these countries will be able to access capital markets when their respective programmes expire. In order to stem the

Daniel Gros is Director of CEPS and Alessandro Giovannini is Leonardo Fellow at CEPS.

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contagion that would result from the (selective) default status for Greece, which now seems to be a virtual certainty, it will thus be imperative to provide these two countries with a precautionary offer of additional financing.

Under the hypothesis that the second programme for Ireland and Portugal would be of the same proportion of GDP (around 45%) as the first ones, these two additional programmes would require about €146 billion in additional EU resources (€76 billion for Portugal and €70 for Ireland). In these calculations we do not count on a contribution from the IMF, as it is not obvious that the IMF would accept to be involved again given that already around 40% of the Fund's current financial resources are tied up in euro area rescue programmes. Furthermore, eurozone Heads of State or Government declared that "Greece requires an exceptional and unique solution", so it is unlikely that the financial sector will be involved again, leaving the entire burden on European shoulders.

The total required from European sources to finance Greece, Ireland and Portugal (GIPs) until 2014 would thus amount to approximately €420 billion.

This should be compared to the actual resources put in the field by the eurozone up to now. Today the effective lending capacity of the EFSF is merely €250 billion, but it is scheduled to be increased to €440 billion.¹ This increase has been agreed at the political level, but it will be affective only after ratification by all 17 euro area parliaments. However, this effective capacity is subject to progressive erosion as more countries require support: in the EFSF set-up, a country 'steps out' when it requires financial support itself and the contribution keys of the others (the remaining guarantors) increase. Moreover, the total amount of the guarantee commitment would decrease accordingly (see Table 1 for further details).

Table 1. Progressive erosion of the EU effective lending capacity (billions of euro)

Step out sequence	EFSF	Extended EFSF
STARTING AMOUNT	250	440
STEP OUT: Greece	243	428
STEP OUT: Greece and Ireland	238	421
STEP OUT: Greece, Ireland and Portugal	232	409

Source: Authors' own calculations.

Together with the €60 billion of the EFSM and the first bilateral loans to Greece, but deducting the 'step out' of three countries already under financial assistance (whose combined share is about 7% of the EFSF), the total European effective resources available would be around €372. It is thus clear that the tools available at present are not sufficient to secure all peripheral countries. The increase in the effective resources of the EFSF would lead to €549 billion (combined with EFSM and the bilateral loans), an amount just sufficient to deal with the three smaller problem cases.

¹ For further details, see <http://www.efsf.europa.eu/about/legal-documents/index.htm>

Table 2. Hypothetical European financial assistance predicted until 2014 compared to its resources

Country	European financial assistance until 2014	Total European financial assistance until 2014	Total EU resources: EFSF + EFSM + Bilateral loans	Total EU resources: Extended EFSF + EFSM + Bilateral loans
Greece	180			
Ireland	110	418	390	580
Portugal	128			

Source: Authors' own calculations.

The new role of the ESFS in the secondary market

The European Council of July 21st opened the way for the EFSF to buy bonds in the secondary market; until now (and only from last month's decision of 24 June 2011), the EFSF could merely, on an exceptional basis, intervene in the primary market in the context of a programme with strict conditionality. This is highly desirable given the current state of uncertainty in the markets, but it would remain meaningless without an increase in the lending capacity of the EFSF. In fact, after providing full financing until 2014 for the GIPs, an extended EFSF would have practically no resources left given that its lending capacity would be about €409 billion, not much more than the €370 million involved for the GIPs (counting also the first €80 billion for Greece). Just to have a yardstick, the results of the latest stress tests showed a sovereign direct long exposure of €150 billion of the banks analysed, so the available amount would only cover 25% of the exposure. Thus, the new powers will be dramatically limited not only by the natural political problem in reaching a consensus, but also by insufficient available resources.

Table 3. European bank exposure towards peripheral countries (only banks included in the 2011 stress test)

Country	Sovereign direct long exposure	Sovereign direct long exposure minus loans and advances	Net direct positions
Greece	90.1	79.0	82.7
Ireland	19.3	16.5	15.8
Portugal	40.2	32.8	37.6
Total GIP	149.6	128.3	136.1

Source: EBA, 2011.