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Eurozone needs more clarity

By Kunal Kumar Kundu

As Europe lurched from one disaster to another last year, with even large economies like Spain and Italy being under threat, the 27 member states of the European Union agreed May 9, 2010, to the creation of the European Financial Stability Facility (EFSF) in order to financially support euro-area member states in difficulties supposedly caused by exceptional circumstances beyond their control.

The idea was mooted after the bailout of Greece, as member states could not prevent the impact of the Greek debt crisis from spreading to other nations. It has been designed as a special purpose vehicle (SPV) from which member states in need, can draw the funds. The EFSF will have a corpus of 440 billion euros (US$603 billion) to be shared by 16 members as per details below:

Member State	Guarantee commitments (€ mn)	%age share
Austria	12,241.43	2.78%
Belgium	15,292.18	3.48%
Cyprus	863.09	0.20%
Finland	7,905.20	1.80%
France	89,657.45	20.38%
Germany	119,390.07	27.13%
Greece	12,387.70	2.82%
Ireland	7,002.40	1.59%
Italy	78,784.72	17.91%
Luxembourg	1,101.39	0.25%
Malta	398.44	0.09%
Netherlands	25,143.58	5.71%
Portugal	11,035.38	2.51%
Slovakia	4,371.54	0.99%
Slovenia	2,072.92	0.47%
Spain	52,352.51	11.90%
Total	**440,000.00**	**100.00%**

Source: www.efsf.europa.eu

The EFSF can issue bonds or other debt instruments to raise the funds needed to provide loan to eurozone countries. These financial instruments would be backed by guarantees given by the euro area member states in proportion to their share of commitment to the fund. The instruments will be structured in such a way (mainly over collateralization, which involves irrevocable guarantee by the member states to the extent of 120% of their commitment) that these will carry a triple A rating. This will ensure lower borrowing costs and make these attractive to investors. The fund thus raised will be utilized to buy the bonds of the sovereigns under threat.

The facility may be combined with loans up to 60 billion euros from the European Financial Stability Mechanism (EFSM) and up to 250 billion euros from the International Monetary Fund (IMF) to obtain a financial safety net up to 750 billion euros.

The EFSF will be available until June 30, 2013, and it will be closed down after that if it is not tapped. If there is a financial operation in activity, then the facility will exist until its last obligation has been fully repaid. Post the expiry, a permanent mechanism to deal with future eurozone financial crises will come into place.

During last December, the concept of the European Stability Mechanism (ESM) was mooted to succeed the EFSF on June 2013. The difference is that application under ESM will result in a rigorous analysis of debt sustainability by the European Commission, the IMF and the European Central Bank.

During the process of setting up of the ESM, two developments are noteworthy:

- It has been decided that the ESM would be activated only "if indispensable to safeguard the stability of the euro as a whole". This clause was added on the insistence of Germany
- There was no discussion whatsoever with regard to whether the temporary rescue fund under the EFSF will be enlarged

These do create friction among the various eurozone countries. It is a common knowledge that the existing fund under EFSF will be sufficient to rescue only Ireland and Portugal and the fund will prove to be insufficient if Spain were to fail. Yet, the decision not to enhance the capital is intriguing.

In essence, the basic problem that plagued the formation of a single eurozone has clearly manifested itself once again. The European Central Bank had failed to prevent the profligate governments from budgetary mismanagement (despite the "Stability and Growth Pact", dating from 1997, which consists of fiscal monitoring of eurozone members and allows for sanctions against offending members), since politics continued to take precedence over prudent single zone policy.

The success of EFSF and subsequently of the ESM will depend on the ability of the governments to ignore their national sovereignty, else these are likely to suffer the same fate as the Stability and Growth Pact. A change in mindset may occur, but this author is not very confident of that happening.

That apart, the EFSF does seem to have a basic structural flaw. While the fund raised by the issuance of a triple A bond will be used to buy the debts of a sovereign under the threat of default, only a few of the guarantors actually have a triple A rating. What if one of the guarantors goes under? Does it not remind one of the situation that led to the current crisis when the underlying collaterals of the debt obligations turned out to be junk?

However, I do believe that the ESM is an important step forward and especially if there is a very strong political will to preserve the euro. But there are risks. Some politicians are trying to separate two things: the resolution of the current crisis and the creation of a framework to deal with future crises. But in practice the separation between pre- and post-2013 debt is, to some extent, artificial.

By 2013, many peripheral EU countries will not have achieved debt sustainability (defined as a primary balance that stabilizes the debt to gross domestic product ratio) and some existing debt will need to be rolled over after 2013. Thus the ESM is likely to cause the risk premiums to rise, eliciting the kind of self-fulfilling prophecies we have seen this year. This means there is still a risk that the current outstanding debt cannot be serviced fully, which is exactly what makes the markets so nervous. It is not yet clear how the European Union will deal with this, but politicians need to act swiftly to limit negative sentiment.

The ESM will enhance the disciplinary function of the bond market, which will be expressed in the risk premium, and it will encourage countries to pursue a more stringent budgetary policy. However, politicians need to take a uniform stance and agree to a clear implementation course. If they do, the markets will price in the new situation, with debt write-downs, or haircuts, as a possible consequence - which may have adverse consequences for some banks.

The chances of government debt having to be written down are considerable in the case of Greece and somewhat less so in the case of Ireland. A bigger risk premium is therefore justified. Haircuts, should they take place, will probably not happen next year, if only because policymakers are still not convinced that these are inevitable and will debate this question for some months yet. Countries also have no incentive to default as long as their primary balance (expenditure excluding interest payments) is not negative.

This leaves two possible options. Countries in difficulties will make use of EFSF support whether or not they will need to tap the market in the months ahead. Or they will decide to muddle on until they no longer wish to or can no longer raise finance in the bond market.

Until there is greater clarity with the ESM on a number of key issues, there will continue to be volatility. Fears over restructuring of eurozone debt, and worries about the proposed new clauses in the ESM (collective action clauses, or CACs), which will enable creditors to pass by qualified majority legally binding decisions to change terms of payments, could hit liquidity as investors shy away from such bonds. Will debt issued with CACs have to trade cheaper than existing debt, and will it create a two-tiered market? Or is a euro paper market on the cards. These questions are difficult to answer and, until they are, will create uncertainty and volatility.

The only thing that is certain is that as long as European policymakers fail to agree upon a clear course, volatility in the bond markets will continue.

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