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Reforms on the framework of the European Financial Stability Facility to dominate discussions at today's Eurogroup meeting

Highlights

- **Eurozone Finance Ministers to consider reforms on the size and the scope of the EFSF bailout mechanism as part of efforts to tackle the ongoing debt crisis.**

- **But concrete decisions are unlikely to be taken as soon as this week, given a number of political and technical complexities**.

While Eurozone's economic recovery is expected to proceed in 2011, albeit at a gradual pace and uneven across member states, peripheral economies continue to struggle with the profound debt crisis. European authorities' initiatives to prevent a sovereign debt restructuring so far, including the creation of the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) on May 9, 2010 for providing financial assistance to member states in economic difficulty, have failed to contain contagion worries. Investors are increasingly concerned that, in an environment of elevated funding costs, other fiscally vulnerable countries will also have to follow Greece and Ireland and tap the European Financial Stability Facility while uncertainty on whether the existing EFSM/EFSF/IMF mechanism has sufficient funds to deal with a further escalation of the EU debt crisis, persists. While Greece and Ireland are fully funded for the current year by their EU/IMF emergency lending programs, substantial sovereign financing needs will hit the market the next few months. Last but not least, sovereign credit rating fears linger while worries over the outlook of the European banking sector are on the rise especially for countries highly exposed to the housing bubble, namely Ireland and Spain.

With investors eagerly awaiting a more comprehensive approach to the lingering sovereign debt crisis, widespread speculation for potential changes on the size and the scope of the European Financial Stability Facility at today's Eurogroup meeting, has caught market attention over the last few sessions.

On the sidelines of an economic conference about the economic situation in Europe mid-last week, EU Commissioner Olli Rehn said that the European Commission and Eurozone countries are discussing changes to the current European Financial Stability Facility. He did not elaborate on the details of the potential changes noting that it would be premature as discussions are ongoing. Along these lines, EC President Jose Manuel Barroso called on EU leaders last week to widen the scope and activities of the EFSF's €440bn bailout-out fund as well as to boost its lending power at the next EU leaders summit on February 4, a proposal that had been staunchly opposed by Germany last month.

According to unnamed officials involved in the discussions, the proposals euro zone Finance Ministers will probably consider at today's meeting, are:

i) an increase in the lending ceiling of the EFSF. To secure its covered triple-A rating, the EFSF can not lend, in its current form, more than €255bn. Cumulated with the EFSM (€60bn funds raised by the European Commission and backed by the EU budget) as well as a further 50% IMF contribution of the total of the EFSF and EFSM programmes, the full amount of the available fund stands at €409.8bn after subtracting €62.7bn for Ireland. That said, room for manoeuvre to deal with an escalation of the crisis is limited. Potential options for increasing the EFSF's lending capacity could be for euro countries to boost their guarantees or relaxation of the fund's collateral rules. However, it is worth mentioning that higher guarantees pose the risk of higher financial burden on euro governments while the triple-A rating might be lowered, increasing the EFSF's own funding costs.

ii) EFSF purchases of sovereign bonds of financially distressed euro countries, a move that would release the ECB from the need to make such purchases itself.

iii) lower interest rate charged for EFSF loans.

iv) short-term loans for countries facing temporary liquidity problems. This could be the case for Belgium. Investors are demanding a high risk premium for holding Belgian debt following the persisting political instability and the lack of any fiscal consolidation measures even though the country has the third highest debt-to-GDP ratio in the European Union, behind Italy and Greece. Belgium has been without a permanent government since April when a fragile coalition collapsed over tensions splitting the Dutch-speaking and Francophone communities. In December, S&P lowered its outlook for Belgian debt, citing the political deadlock (the 10-yr Belgian/German bond yield spread soared to 135bps two-year highs on January 10 before easing to levels around 108bps at the time of writing, a few hours ahead of the Eurogroup meeting).

Although elements of the above options are expected to dominate eurozone Finance Ministers' agenda today as part of efforts to boost market confidence, a final decision on potential changes to the EFSF's framework does not seem to be yet in sight. The EU leaders gather for their first summit of the year in only three weeks while the aforementioned proposals are highly politically sensitive, especially for Germany which is expected to spend most of 2011 in election mode. Seven out of the 16 German states hold elections this year. The first one is scheduled on February 20 and the last one on September 18. Recent opinion polls suggest that the centre-right CDU/FDP coalition government, which has suffered a severe slide in popularity over the last year, is likely to loose several regional elections (Angela Merkel is the Chairman of the Christian Democratic Union –CDU- since 2000 and Chairman of the CDU-FDP -Free Democratic Party- parliamentary coalition since the election of September 27, 2009). Regional elections in Germany are especially important as the state parliaments determine which political parties get seats in the Bundesrat, the upper house of parliament. It is worth recalling that the North Rhine Westphalia state election on May 9, 2010 had a major impact in delaying the approval of Greece's bailout package. Adding to potential hurdles for a final agreement on bolder EU policy measures as soon as this week, we should be aware that any change to the EFSF's framework requires a new round of parliamentary endorsement. The EFSF, in its mechanism and current size, went through a parliamentary procedure last spring/summer.

The issue of prolonging the Greek loan repayment period, could also be endorsed at today's Eurogroup meeting with German Fin Min Wolfgang Schaeuble suggesting that his country is open to a discussion regarding the extension of Greece's repayment schedule. After EU/IMF agreed on Ireland's €85bn bailout package on November 28, Eurozone finance ministers opened the way to an extension of Greece's debt repayment period as a means of aligning the maturities of the financing of Greece to that of Ireland. A repayment extension until 2021, as Greek FinMin George Papaconstantinou noted early last month, would certainly help the state address possible liquidity problems it may face after the expiration of the present EU/IMF lending program in Q2 2013.

Even though concrete decisions on potential changes to the EFSF's framework are unlikely to be reached as soon as this week given political and technical complexities, the Eurogroup meeting will be important, as it could provide the seeds for a more forceful euro-wide response to the ongoing debt crisis.

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