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The EU is running out of choices to tame the crisis

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Last year, the Euro Area faced an unprecedented crisis when sovereign bond markets cut off Greece's access to debt financing. Since May 2010, Greece is being funded by an *ad hoc* mechanism set up on a multilateral basis by the IMF and on a bilateral basis by the Euro Area member states.

Europe's belated reaction vis-à-vis Greece succeeded in containing the crisis only temporarily. One month after Greece's rescue, markets were severely testing Spain. The Euro Area could not afford to bail out Spain too. The effective lending capacity of the European Financial Stability Facility (EFSF), set up in May with a view to mobilizing financing for rescue purposes until mid-2013, would be insufficient. In November, Ireland requested assistance from the EFSF.

At the end of last year, while it was becoming clear that Portugal would have to tap EFSF too, the Euro Area understood that –for containing the spreading crisis– it could no longer allow markets to count on the deep pocket of its financially strong nations and keep on lending money to its debt ridden periphery no matter how high interest rates would be. It, therefore, embarked on the elaboration of the so-called «comprehensive solution».

Euro Area's comprehensive solution to the debt crisis

On March 25th, the Euro Area succeeded in setting out a comprehensive package of rules with a view to addressing future debt crises. The new package is governed by a core tripartite contribution approach. Financially strong nations conceded to increase the effective lending capacity of the EFSF and the European Stability Mechanism (ESM), the Euro Area's permanent support instrument that will succeed to the EFSF after 2013. In exchange, financially weak member states conceded to strengthen their fiscal adjustment policies so as to maintain their creditworthiness. They all agreed, however, that bond holders would also be required to waive part of their claims against a state requesting assistance from the ESM, in case its debt burden would prove unsustainable following a «rigorous» sustainability analysis test. At the same time, the EU adopted a set of increased coordination measures, with a view to enhancing convergence of national economies, and more rigid monitoring procedures, so as to prevent fiscal destabilization at an early stage.

Admittedly, the Euro Area has made significant institutional progress in addressing sovereign debt crises; but only in theory, since the ESM will become operational after 2013, whereas the contagion of the crisis needs to be addressed at the very present moment. For the time being, it seems that Spain –not to mention Italy– has been safely distantiated from the other most vulnerable PIIGS. Apparently, markets did receive Euro Area's bold message to adopt a more responsible approach vis-à-vis Spain. S&Ps, no less, maintained the country's high creditworthiness and Spain has been successfully tapping the markets ever since, albeit at an increased borrowing cost. Spanish government also has received the message by demonstrating increased determination to implement more stringent adjustment policies, so as to avoid jeopardizing access to markets. It results that, for the time being, Europe's new strategy to contain the crisis within the three weaker PIIGS (a rather convenient solution both politically and economically, if sustained) is working.

The application of the comprehensive solution, a credibility issue

This achievement will be precarious in case the Euro Area fails to walk now the entire distance it has announced on March 25th. Its credibility in handling sovereign debt crises according to the rules it has enacted is at stake. The worsening fiscal situation in Greece, Ireland and Portugal maintains the European bond markets highly volatile. Such a volatility risks to deteriorate Spain's borrowing cost, if sustained. Europe's «comprehensive solution» will become obsolete in case Spain fails to keep on raising funds at affordable rates. It would have to be changed before even applied! This is an institutional *accident de parcours* the Euro Area cannot afford to experience.

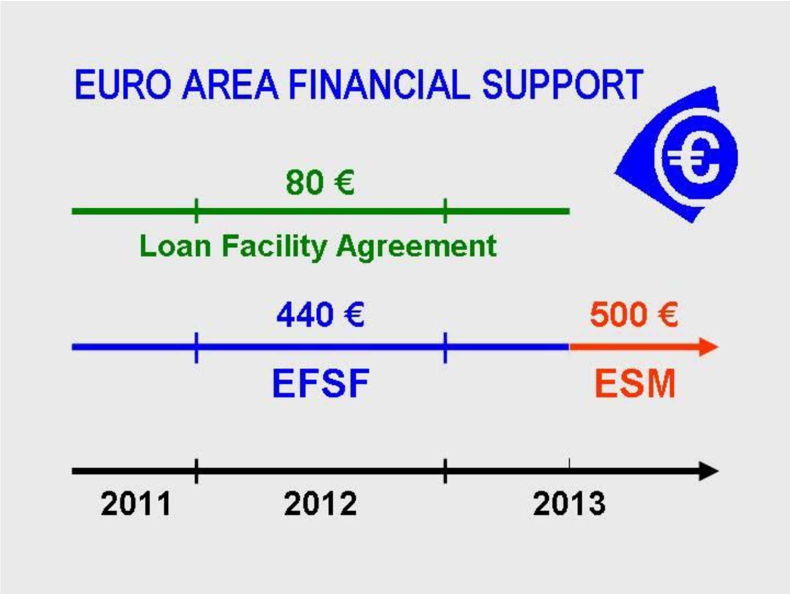
On March 25th, the Euro Area determined how its permanent support mechanism, the ESM, will address *in vitro* a future debt crisis faced with by one of its member states. It now has to address the current crisis *in vivo* by using its provisional support mechanisms, namely the Loan Facility Agreement, with respect to Greece, and the EFSF, with respect to Ireland and Portugal, as well as Greece, in case the latter fails to return to markets next year as scheduled. To this effect, the Eurozone has no other choice but to apply now to the EFSF the theoretical solution it has designed for the ESM, including its tripartite contribution approach in handling severe debt crises.

At the Summit of March 11th, the Eurozone set a ceiling to its collective liability to be incurred by the insolvency of its members: the EFSF and the ESM would be able to lend up to € 500 billion altogether. Before the latter becomes operational, the former risks to disburse as much as € 440 billion, considering that it has to subsidize three countries in a deteriorating macroeconomic environment, mainly driven by the increase of ECB's interest rates. One can hardly imagine the Euro Area allocating through its provisional mechanism as much as € 440 billion under different rules than those to be applied by its permanent mechanism, which would only dispose of an additional funding capacity of merely € 60 billion. Therefore, the rules will be the same or similar and –as announced on March 25th– they will be incorporated in the respective instruments of the EFSF Agreement and the ESM Treaty, to be signed simultaneously in the next few weeks.

The Eurozone may not defer for 2013 the application of the tripartite contribution principle it has set out on March 25th. Not only because such a deferral would severely undermine its credibility in handling efficiently future debt crises, but also for very simple practical reasons: crisis is now, it is spreading, money is not enough for all three countries without a restructuring in case they remain cut off from the markets, and total money available risks to run out substantially before 2013, if the Eurozone has to handle efficiently the crisis until then, so as to contain it within the borders of the three weakest PIIGS and to avoid having to rescue Spain too, in which case it may soon have to break the liability ceiling at the expense of its credibility.

Testing the comprehensive solution in Greece

It is beyond doubt that Eurozone's credibility in addressing solvency problems in the region in accordance with its comprehensive solution will be tested first in Greece in the weeks to come. Indeed, some sort of restructuring of the Greek debt now is unavoidable and advisable in case Eurozone wishes its comprehensive solution to be taken seriously by markets and governments. 2013 is not an option with respect to Greece, since the country will not be able to return to markets in 2012 so as to raise more than € 25 billion at affordable rates, as now scheduled. Therefore, in 2012, Greece will need either to tap the EFSF for additional support or default on its debt. The consequences of a possible restructuring now will be harsh from an economic, social and political point of view. Those of a possible default later will be unforgiving from an historical point of view.



Euro Area's instruments providing financial support to Greece

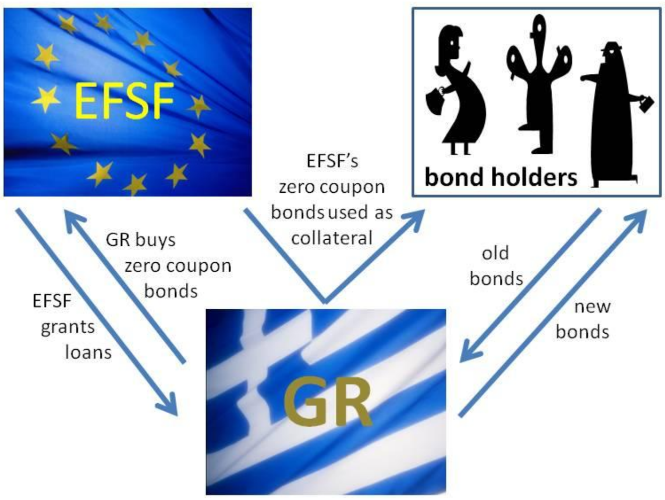
Politically, several influent Eurozone states may not afford to provide additional support to Greece in 2012 on top and above of the € 24 billion the country will be entitled to receive by the IMF and under the Loan Facility Agreement next year. Slovakia does not participate in the *ad hoc* mechanism that supports Greece since May 2010, while Portugal and Ireland cannot continue to support it, not to mention Spain that the Euro Area strives to distantiate from the war zone. The continuing implementation of Greece's Loan Facility Agreement will become more burdensome economically and politically for many rich Eurozone states, if –in addition to, and in parallel with, the funding they provide under this agreement, which constantly increases– they will be requested to allocate through the EFSF another € 25 billion to Greece in 2012, only to postpone the final resolution of its debt crisis.

It is, anyway, unlikely that additional liquidity will allow Greece to regain market confidence by 2013 at pre-crisis levels. The country lost the battle with the markets as early as autumn 2010. And in any case, the Eurozone may not run the risk to compromise a successful containment of the crisis so as to give Greece more time to return to markets or give Greece's lenders another chance to get rid of Greek bonds. After all, what is good for the Eurozone, will be good for Greece in the long run. Moreover, geopolitical changes occurring in the financial sector worldwide will not allow some developed nations, such as Greece, Portugal and Ireland, to re-finance their debt in the future at pre-crisis rates. This is a demonstration that the line between developed and emerging countries is moving.

A potential scheme that could be used

Currently, Greece's official lenders are assessing the country's compliance with its adjustment path, prior to approving the disbursement of the next installment in June. So far, their assessment in view of the previous installments has been rather flexible. Now, they would have little difficulty in finding that Greece is behind its adjustment path, one year after the country's MoU was agreed upon. Under the circumstances, the European lenders could be reluctant to disburse the next installment under the Loan Facility Agreement and might select to force Greece into the EFSF instead. A new, stricter MoU would be drafted for these purposes, based on the current medium term adjustment plan elaborated by the Greek government.

The EFSF might replace the Loan Facility Agreement and establish a credit line in favor of Greece, so as to support the country until mid-2013 and facilitate the restructuring of its debt on a voluntary basis according to viable market practices. To the latter effect, the EFSF might draw up low-interest loans at the request of Greece that will be used by Greece to buy zero coupon bonds to be issued by the EFSF. The Greek government might then use these bonds as collateral to support its exchange offers addressed to its bondholders, who would agree to abandon part of their claims against Greece in exchange of new bonds of a longer maturity and smaller interest rates to be issued by the Greek government.



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Eurozone member states could extend the maturity of the loans already accorded to Greece under the Loan Facility Agreement and concede to a smaller interest rate, as decided at the Eurozone Summit of March 11th.

Eurozone member states might then transfer or assign to the EFSF their rights and obligations under the Loan Facility Agreement, pursuant to article 13 of said agreement.

Following such a transfer or assignment, the EFSF would pay to the Eurozone member states the amounts they have already disbursed to Greece under the Loan Facility Agreement. These states could invest this money, as well as the remaining amounts promised to Greece under said agreement, totaling € 80 billion, in order to recapitalize their banks and/or the ECB as needed, following the restructuring of the Greek debt held by these banks.

Greek banks would have to merge and receive equity support from Greece's Financial Stability Fund, sponsored by the country's official lenders in order to deal with potential capital shortfalls of Greek banks and preserve the soundness of country's financial sector.

Whatever the arrangements sponsored by the EFSF with regard to facilitating a Greek debt restructuring may be, Greece will have to eliminate its deficit and produce primary budget surplus as soon as possible. Otherwise, it will not be easy for Greece to remain in the Eurozone, a question which is not raised but it exists.

The central question, the key player and the alternative

The central question is to what extent a Greek debt restructuring can be viable within the limits of the total available funds of € 500 billion, considering the financing needs of the two other debt ridden nations funded by the EFSF.

The key player for the enforcement of any restructuring plan is the ECB, which holds some € 50 billion of Greek debt purchased in the secondary market in the framework of its Securities Program launched on May 10th last year, and almost twice this amount as collateral for the provision of liquidity to commercial banks in the framework of its other non-standard mechanism instituted to combat the financial crisis in the Euro Area. Following the above scheme, however, the ECB would finally succeed in replacing Greek junk bonds with triple-A EFSF bonds.

If no restructuring, in whatever form, takes place now, the Euro Area needs to make a clear decision to continue supporting not only Greece, but also Ireland and Portugal, for as long as these countries are unable to return to markets, and be prepared to pay the corresponding institutional and economic price, in case it really wishes to contain the crisis now. Because, what markets fear right now, is that these countries (particularly Greece) will ultimately not be able to pay back their debt in full and on time, in case they fail to return to markets before mid-2013 and the Euro Area is not prepared to provide additional support without a restructuring after that date.

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