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IMF Managing Director Christine Lagarde speaks at a news conference on Sunday.

Euro-Zone Crisis Funds Face a Market Test

Finance Ministers Hope Expanded War Chests Calm Investors; Battles Remain on How to Deploy the Money if Needed

By SUDEEP REDDY and BRIAN BLACKSTONE

WASHINGTON—After months of wrangling, government leaders have assembled a pair of war chests to guard against deepening euro-zone turmoil.

Now their plan faces the big test: Will markets buy it?

The world’s finance ministers, who concluded meetings in Washington on Sunday, hope their new funds will convince investors that governments have the financial firepower to combat the crisis. The war chests could be used to provide emergency loans to governments in danger of debt defaults because of soaring borrowing costs. The ministers hope the combined pool is now big enough to prevent borrowing costs from rising to that point.

But officials face huge constraints in how the funds could be deployed and persistent investor doubts about whether the money is enough.

The test could come quickly. Borrowing costs for Spain and Italy have climbed in recent weeks. European banks are bracing for credit-rating downgrades. Elections in France and Greece could renew doubts about political commitments to painful budget cuts and economic reforms.

"You never know" whether Europe will be tested again, Austrian central bank governor Ewald Nowotny said in an interview, as the International Monetary Fund and World Bank concluded their spring meetings. "In any case you have to be prepared."

The two enlarged war chests—about $700 billion in lending capacity at the IMF and Europe’s €700 billion ($925 billion) rescue fund—are designed to be large enough to reassure markets that governments won't default on their debts. But both funds, due to political constraints, are substantially smaller than officials originally sought when they assessed the economic threat over the past year.

Asked last week whether the IMF’s new war chest would be enough, the institution’s Managing Director Christine Lagarde replied, "It has to be enough."

The next battles could be centered on how to deploy the new funds if needed. To access Europe’s rescue fund, Spain or Italy would have to request the aid and other European governments would need to agree to provide it, a process that exposed deep divisions within Europe when Greece sought help.

Analysts doubt the money would be enough if borrowing costs in Spain and Italy—two of the euro zone's largest economies—increase so much that they needed bailouts.

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**European firewall: €700 billion**

The 17-nation currency bloc recently bolstered its rescue fund. Using that money requires case-by-case approvals from European governments, which must overcome political constraints at home to more bailouts.

**International Monetary Fund: More than $700 billion**

The world’s emergency lender will see its lending capacity roughly double after securing new pledges last week. That money was raised under the premise that crisis “bystanders” outside the euro zone could need more aid. Further IMF aid to the euro zone will be met by strong opposition from non-European countries.

**European Central Bank**

The euro zone’s central bank could expand its balance sheet further to support struggling nations. But it has already bought government bonds to push their interest rates down and recently issued more than €1 trillion in cheap, three-year loans to banks. Any further moves could draw a backlash from some stronger governments, especially Germany.

Source: WSJ

Tapping the IMF money would be even more difficult. Nations outside the euro zone pledged new money to the IMF at last week’s meeting, helping to nearly double the fund’s lending capacity. But a struggling nation’s request for aid would require a separate vote of the IMF’s board, which represents its 188 member governments.

Many of the top IMF shareholders, including some of the latest contributors, remain strongly resistant to the IMF coughing up more money for the 17-nation currency bloc after already supporting large rescues for Greece, Ireland and Portugal.

Many international officials here acknowledged that the funds would be too small if investors don’t believe the recipient governments will undertake needed reforms, such as budget cuts and structural overhauls, to make their economies more competitive.

Mario Draghi, the European Central Bank president, put the onus on governments to remain on Europe’s course of austerity and structural economic reforms. “If that is not in place, there is no firewall that is enough to cope with the unavoidable fluctuations of the market,” he said.

In a best-case scenario, these reforms will take many years to deliver results, and it is difficult for investors to judge progress along the way. Mr. Nowotny warned of the danger of a “Japanese style long-term stagnation” in parts of Europe.

Based on past experience throughout the crisis, markets are unlikely to be satisfied by governments’ latest actions. So far, each response by policy makers has provided only temporary relief. And investors’ uncertainties are centered less on the size of rescue funds and more on fundamental economic problems, such as Southern Europe’s grim economic growth outlook.

If the economies of Spain and Italy continue to shrink, their debt burden will rise even if they take tough measures to cut government spending and raise tax revenue.

Additional IMF funds are “little more than a tranquilizer for the markets as investors are increasingly doubtful regarding future prospects for Spain and Italy,” said economists at Commerzbank.

Europe has haggled about the size and sources of the firewalls for two years, raising doubts in markets about the resolve to halt the crisis. The amount of money put up at each stage proved insufficient.

The first bailout by the European Union and IMF for Greece, in May 2010, was for €110 billion, an impressive amount at the time for a country whose entire gross domestic product only totaled around €225 billion.

Europe’s crisis commitment has grown to more than €1 trillion, including additional bailouts of Ireland and Portugal, a second Greek aid package, the creation of Europe’s rescue fund, national loans to the IMF and the ECB’s purchases of more than €200 billion in government bonds. That doesn’t include the €1 trillion in cheap, three-year loans to banks from the ECB since December.

"I'm always surprised when I read that Europe hasn't done enough," Klaus Regling, head of Europe’s bailout fund, said Friday.

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