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Interview Q&A with Euro Zone Bailout Fund Chief Klaus Regling

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By David Thomas

Part 1:

BRUSSELS(MNI) - Klaus Regling, chief of the Eurozone's bailout fund, explains key differences between European Stability Mechanism (ESM) and European Financial Stability Fund (EFSF) bond issues, why the temporary EFSF is not going away any time soon, why the Eurozone was right to create the ESM as a permanent bailout fund and the potential role of private investors in bank recapitalisations in this exclusive MNI interview.

**Q: As you start to launch bond issuance for the European Stability Mechanism in earnest, with plans for a long-term bond issue in October, what top-line message do you want to get across to your global investor base as you travel around the world? And how important does Asia remain as a buyer of EFSF/ESM bonds?**

KR: "We have a very good, very broad investor base globally, including Asia. That's very important because Asia and the Middle East are the biggest source of funds outside Europe. So it's very important that they understand what we are doing, what's happening in Europe, what the EFSF will continue to do and what the ESM will begin to do - starting in October."

**Q: EFSF bond / ESM bond - what is the difference to your traditional clients?**

KR: "For investors it is a different legal entity - that is an important point. Politically, EFSF and ESM are very similar - they have the same mandate and instruments, but legally as issuers they are completely different because the EFSF is a guarantee-based financial structure while the ESM is based on capital, including a big chunk of paid-in capital.

"Investors need to understand that - one can't assume an investor who buys EFSF bonds will automatically buy ESM bonds, they need to go through an internal approval process, such as an internal credit committee. All the big investors have something like that. They need all the information about the ESM to arrive- hopefully - at a positive decision. That is why we need to be in close contact with them. That is why we are doing roadshows and now focus on the ESM."

**Q: How was your recent visit to Latin America? What kinds of questions did investors have for you in that part of the world?**

KR: "In Latin America interest was huge. Some people believe the EFSF will stop issuing - which is wrong! We will have to continue to finance the three existing programmes (Ireland, Portugal and Greece). Those will continue to be financed by the EFSF and there is about E22.8 billion of undisbursed funds in those programmes.

"In addition, the maturity of our liabilities is much shorter than the maturity of our loans which means we have to do rollovers. For instance, the Greek programme has an average maturity of 30 years but, of course, we haven't financed our disbursements with 30-year bonds.

One day the EFSF will close but it will be in the market for the next 30 years. At the same time investors need to understand the ESM and why it is now appearing on the scene."

**Q: But these are essentially identical bonds - to all intents and purposes?**

KR: "Well, for some investors probably not, because they look at the legal 'nitty-gritty' and from the financial market perspective these are two different issuers."

**Q: But, the ESM's capital structure should make its bonds an even safer investment?**

KR: "The ESM is a bit stronger - that is our view. You can see that a little bit in the credit ratings, which are very close but not identical - especially with Fitch. Overall, I share the view that the ESM is a stronger issuer as it is less vulnerable to any downgrades of some of our stronger member states because of its paid-in capital. Even if that capital comes from a very fiscally weak or low-rated member state - cash is cash. We will have E80 billion of paid-in capital next year."

**Q: Asia has been a very significant buyer of EFSF bonds from the start. Are you satisfied that your investor base is adequately diversified - both geographically and institutionally?**

KR: "It's always nice for every issuer to have a broad-based investor base so one can be confident about success in the markets. Asia has a very strong share but Europe is our core investor base. Our base is broad based in both a geographical sense and also by investor type, we have official investors - central banks, sovereign wealth funds and also insurance companies, pension funds and so on.

**Q: How important are central banks among your Asian clientele?**

KR: "In Asia, central banks are important but our customers there are not exclusively central banks. Japan has huge insurance companies and pension funds - Japan used to have a very high savings rate but that is falling now with ageing, but the stock of savings remains very high. Interest rates in Japan are very low so they are on the lookout for alternative investments."

**Q: Would the EFSF/ESM ever consider doing a foreign currency-denominated bond?**

KR: "We could in theory go into other currencies, our legal base allows us to do that. We could do that whenever we think it's appropriate but so far we haven't seen the need. So far we havFeare been able to raise all the funds we need for member states by staying in euro which makes our life a bit easier - we don't have to deal with currency mismatch risk management. Because all our assets are in euro, to have all the liabilities in euro as well makes life easier, but of course it's possible and we would know how to handle that problem."

**Q: With countries potentially exiting their bailout programmes and the Eurozone economy improving, what is the future for the ESM? Does it go into hibernation?**

KR: "This crisis will be over - it is not over yet - but it will be over one day. But one day there will be another crisis. If you recall that economies move in cycles this is what happens. So it's very good to have the ESM as a permanent institution because the IMF history shows very clearly that after a long time of no crisis there will be another crisis and then it is good to have an institution.

"The ESM also has paid in capital of currently E48 billion that will rise to E80 billion by the middle of 2014 and that capital will need to be invested very conservatively and we have to manage our existing loans and liabilities for a long time. However, we have made preparations for quieter times. We can reduce our staff somewhat and adjust to a normal situation."

**Q: Are you making plans so that private investors can get involved in future ESM-led bank recapitalisations should next year's stress tests show the need for stronger bank balance sheets?**

KR: "Assuming that the direct bank recapitalisation instrument does become available as planned and as currently discussed then we will try to create a new mechanism - a subsidiary where private investors can participate, that is the intention. We have had some tentative discussions with some big investors on how that can be done in a useful way so that there is interest. We still have some time."

**Q: Are you happy that Ireland and Portugal have adequate bond market access now?**

KR: "Portugal issued a 10-year government bond in June to the surprise of many and it was a big success. Ireland issued a 10-year government bond already in March."

**Q: Is a 10-year issue - a kind of litmus test for these countries?**

KR: "It's one important indicator - and neither country had been able to do that for two years. So once that is possible, that is a breakthrough but it is one of many indicators and Portugal is not yet where Ireland is. The crisis is not over, the adjustment must continue, but it is now much easier to see that the strategy that has been adopted is working."

**Q: There have been reports that Ireland may be able to rely on an IMF Precautionary Credit Line and/or an ESM Enhanced Conditions Credit Line. What is the state of talks on that?**

KR: "The EFSF/ESM have that instrument available but so far there has been no request. Let's wants to wait until the programme really comes to an end. I realise there is talk in the background in the media and among bank analysts but there are no official talks - it is too early."

Part 2:

BRUSSELS (MNI) - Klaus Regling, chief of the Eurozone's bailout fund, discusses the prospects for the bailout states, the Eurozone recovery and why the euro will protect the periphery against 'spillovers' from the recent market volatility in the second part of MNI's exclusive interview.

**Q: There have been reports recently of strains and tensions within the Troika. Do you think the Troika system is still sustainable and fit for purpose?**

KR: "The Troika has played its role successfully but that doesn't mean it has always been easy. One shouldn't expect that when three big institutions work together. But, looking at the successes in the countries we are dealing with, one can only come to the conclusion it has worked very well under difficult circumstances. That doesn't mean that every day, on every decision it was without friction but the overall result is very, very positive because the countries are moving out of their problems - all of them.

"There has been clear progress now for over a year on tackling the root causes of the crisis which are basically competitiveness and the budget situation. What is particularly encouraging now is that since the second quarter of this year the positive adjustment one could see in early indicators, such as unit labour costs, exports and current accounts, are now spilling over into the real economy.

"And, that is what ultimately matters for the populations of borrowing countries. People don't feel anything immediately when the current account disappears or when unit labour costs fall but now they see that unemployment has stopped rising in Greece, Spain and Portugal and industrial production has stopped falling in Greece. Things are improving on a broad- based basis."

**Q: But do you see risks out there - even of the crisis returning?**

KR: "There are still risks. The crisis is not over. Unemployment rates are very high. Lending - particularly to SMEs - continues to drop. So there are risks and it is easy to make mistakes also.

"But in all countries indicators are pointing up. So in that sense I would say the recovery is no longer tentative, it is broad based.

"At the same time one should not get at all overly exuberant here. We know that the potential growth rate in Europe is low because of stagnation in population growth. Most experts put it around 1 1/4%, which is almost a percentage point below the U.S. But that gap is explained entirely by demographics. The standard of living is improving at the same speed in the U.S. as in the euro area - as it has in the past 10-20 years - it's always the same story."

**Q: Ireland's programme is due to come to an end in December and Portugal is also due to exit in the near future - although there has been much speculation of a second bailout in the latter country - do you think there will be a need for a second Portugal programme?**

KR: "Ireland's programme comes to an end in December. The progress is tremendous but they must continue to do their homework, particularly on the fiscal side. Competitiveness is back. Ireland is a flexible economy and once they have digested the real estate bubble and the banking problem there is no reason why the country should not be back to normal.

"Portugal started its programme later therefore progress can't be as strong. They had their political crisis in early July but they resolved it. Life is still difficult because the constitutional court ruled for the third time against one of the government's programme measures. So the government has to come up with something new.

"The Portuguese government is very committed to what has been agreed - they have to do more on the structural side than Ireland - in that sense it's more difficult. On the other hand, it's easier because Portugal never had a banking problem that is in anyway comparable to the Irish.

"In the second quarter Portugal had the fastest growth rate in the EU, that was very encouraging and that had a positive effect on the unemployment rate which dropped. So Portugal is a good example, they have come a long way and the signs are all pointing in the right direction."

**Q: The German finance minister has said that he thinks a third Greek programme is likely. Do you think that is inevitable?**

KR: "I take note that the German finance minister has said that he considers it very likely that a third programme is necessary and that may be the right judgement. But nobody knows how the world economy will look, how Europe will be doing or how important neighbours for Greece like Turkey will be doing in 10 months' time.

**Q: Various numbers have been attached to the size of a potential third Greek programme. I believe the German finance minister has suggested around E11 billion. What do you make of those estimates?**

KR: "It may be a realistic assessment at the moment. The IMF has also put out a number - but one has to understand the quality of such a number - it is all very tentative, based on today's judgement, and we will only really know in a year what is really needed."

**Q: What's your assessment of general Greek progress towards achieving the goals of its second programme?**

KR: "Greece had the most difficult starting point. That's also why Greece, unlike the others, is already in a second programme.

"Also looking at how the economy is going, the need for reforms and the weakness of the public administration - these are all more serious problems than in any of the other countries. Given this very difficult starting point, Greece has made a lot of progress, maybe not enough, but it is a lot of progress.

"For instance, Greece has improved its cyclically adjusted fiscal balance by 12% of GDP over the last three years - that is the biggest fiscal adjustment of any country ever in history. Some of this gets lost when you look at the nominal numbers.

"If you keep the magnitude of the adjustment in mind it is not surprising that people are demonstrating in Athens from time to time.

"Competitiveness has also improved. Greece is implementing a full range of structural reforms. The programme is more than 120 pages and there are 90 structural reform measures, which they are implementing one by one. A recent OECD study showed Greece is leading all other countries on the implementation of structural reforms."

**Q: Some major Emerging Market Economies are getting negatively impacted by 'spillovers' as a result of the Fed's 'taper' announcement. What worries do you have that this new contagion could spread to the Eurozone periphery states?**

KR: "The euro protects all member states. Some Emerging Market economies are hugely affected by U.S. monetary policy and I accept very well that the Fed has to look after the US economy, so whatever spillovers there are - they can't do much about it. But other countries are affected and in Europe we had a similar situation up until 1998 when we changed it with the introduction of the euro.

"Our Anglo-Saxon friends should understand that this is one important reason why the euro exists - because the ECB takes into account the situation in the entire euro area, while before the euro's introduction Bundesbank could only look at the situation in Germany and not the needs of other European countries -just as the Fed only takes into account the situation in the US.

"I think the euro area periphery will not be much affected by spillovers because when QE started there was not the inflow you saw in many EM markets. So it is also not surprising that you don't see an outflow now. At the same time you see that fundamentals are strengthening in Southern Europe so there is even less reason for any such outflow."

**Q: But tensions can still express themselves in intra-Eurozone bond spreads?**

"We now have the lowest spreads of the last two years between Germany, Italy and Spain - so there is no contagion from the recent market volatility. Otherwise, spreads are of course higher than during the first decade of EMU, it is important that they are coming down - but they will not go back to where they were in the first decade of EMU."

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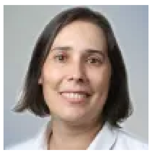


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