Klaus Regling in interview with Luxembourg for Finance: Podcast "Shaping Finance"

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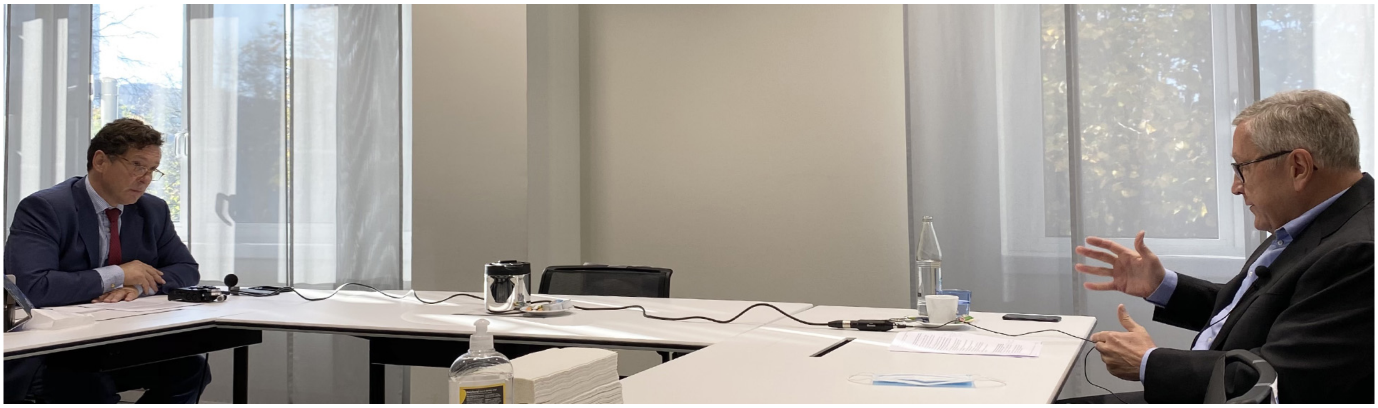
16/11/2020
Interviews



Klaus Regling in interview with Luxembourg for Finance. Transcript of interview with ESM Managing Director Klaus Regling. Luxembourg for Finance in Luxembourg, Luxembourg. Recorded 5 November 2020, published 15 November 2020. Interviewer: Nicolas Mackel

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Transcript

Luxembourg for Finance:

Welcome to Shaping Finance, a podcast, which offers a platform to high-level decision-makers and shapers in international finance. My name is Nicolas Mackel. I am the CEO of Luxembourg for Finance and the host of this podcast.

I am joined today by Klaus Regling, the Managing Director of the European Stability Mechanism (ESM). The ESM also called the euro rescue fund is one of Europe's lesser known, but yet very important institutions and more on the role of the ESM, in a minute. Mr. Regling is an economist by training and has had a distinguished career across the public and private sectors in Europe, Asia, and the US for over 40 years. His time shaping financial services includes different stints in the hedge fund industry, a decade with the German ministry of finance, where he helped prepare the economic and monetary union. A seven-year term as Director General at the European Commission in Brussels, a tenure with the IMF in Washington and Jakarta. In 2010, he became the CEO of the European financial stability fund. And then in 2012, after the creation of the ESM, he became its Managing Director.

I will stop there. And I would suggest that we jump right into the questions. Mr. Regling, Europe progresses in times of crises and the creation of the EFSF (European Financial Stability Facility) and the ESM are proof of that as they are created during the sovereign debt crisis.

Would you remind us briefly about the circumstances of the creation of the two rescue funds and what the principal objectives were?

Klaus Regling:

Yes, it was indeed a crisis. We have to think back and remember that in 2008, we had the first crisis, a global financial crisis, particularly triggered by Lehman in September 2008. And that affected the entire world. But then a year or year-and-a-half later, we and also markets, discovered that there were some accumulating problems inside the monetary union. A number of countries were running very large trade deficits, fiscal deficits, they had lost competitiveness. And maybe the global financial crisis played a role in discovering these problems, which were accumulating for about a decade. So countries began to lose market access, which was something not foreseen. Nobody had imagined that a country after joining the monetary union, which at the time was a complicated process. It is still a difficult process.

Certain criteria have to be met that after going through that, a country could lose market access. And therefore we had an institutional gap inside the monetary union, the architecture of the monetary union. There was no lender of last resort for sovereigns, for governments and with the creation of first the EFSF and then ESM, that gap was closed. And it was necessary to close the gap, because countries starting with Greece, but then also Portugal and Ireland, lost market access. And we had to find a way to keep them going. At the same time, as we provided money, we also had to make sure that they were fixing their problems.

Permanent rescue fund, the European Stability Mechanism, has truly come a long way. What have been the most important developments and achievements of the ESM over the last decade?

So once that difficult step was taken to close the gap in the architecture of monetary union, creating the EFSF and the ESM, we really became much more active than was anticipated. Over the years, we provided loans to five countries, not only Greece, but also Ireland, Portugal, Spain, and Cyprus, and in order to prevent a default of these countries. And we did this with conditionality. Conditionality means that we only made disbursements to these countries after they met agreed reform targets. This is an approach that we did not invent, it is well-known at the International Monetary Fund (IMF). So, we copied that approach and it was necessary, because as I said, these countries had real problems. They had big deficits on the fiscal and trade side. They lost competitiveness, but with the help of our financing, and it was also complemented by some money from the IMF, the countries got out of their problems.

It took less than three years for most of them. For Greece, it took eight years and three different programmes, and overall EFSF and ESM disbursed 300 billion euros. During that period. It helped those countries greatly. It was painful to do the adjustment, to do the reforms. But it paid off, because after the end of their programmes, they all had a better economic performance than the average of the euro area, which is, again, the experience that we know from the IMF: painful adjustment when it is necessary, but it paid off later on. Now more recently we have changed our approach, because the circumstances have changed.

And, we may want to talk about that later, in response to the pandemic that we are facing this year, we also changed our approach of lending. And we now can lend money without conditionality, which is justified under the circumstances, but seven, eight, nine years ago, it was good what we did, I think, to only disburse money when reforms were implemented. That is what the countries needed at the time. Of course, we have many other things that we work on. We have to invest our paid-in capital, more than 80 billion euros. So, we do not only issue bonds to finance our loans. We are also busy on the other side of the balance sheet. We are a big investor. We also look more and more at ESG – environmental, social and governance criteria – on our investment side. We can also issue now social bonds if our PCS (Pandemic Crisis Support) is used. So, we are active here in many areas as we should as an international financial institution.

And before the current pandemic brought the world to a hold, the reform of the European Stability Mechanism and its possible transformation into something coming close to a European monetary fund was being discussed. What have you leaders decided in this regard and what is your view on it?

We will not change our name. We like our name, European Stability Mechanism, but it is correct that we had a long discussion how to broaden the mandate of the ESM. We will very soon finalise the process to amend the ESM treaty, which is our legal base. That needs to be ratified in all the parliaments of our member states, so 19 countries. Because we have 19 member states, all the countries that use the euro. So, that will take about a year and that will have an impact on our work, because we will make available one new lending channel. The so-called backstop to the Single Resolution Fund (SRF) that is in charge of resolving banks, if needed. That fund is accumulating its own resources, but for a big crisis, they also need to have access to a credit line. That is what we see in the United States, for instance, where the FDIC works very similarly.

They have their own accumulated funds that come from the banking industry, but in a real crisis, they have access to the US treasury, in the euro area we have no treasury. And that is why the approach was developed to ask the ESM to provide such a credit line. But we need to change our treaty to be able to do that. So, that is one important aspect.

The other is that the ESM, that initially, when it was created in 2012, two years after the creation of the EFSF, initially we just were charged of getting money from markets by issuing bonds. But over time, because we had to disburse 300 billion euros to five countries, we also had to develop economic expertise like any large creditor wants to look after the clients and make sure that the money is paid back one day.

So, we are now much more able than initially to assess what is happening in Greece and the other countries that received money from us. And our member states want us to develop this expertise further. And in the future, if, and we do not know whether it happens, but if there were a new adjustment programme, our initial activity, then we would be much more involved in designing such a programme, defining conditionality together with the European Commission. That [European Commission] was also very much in charge initially, but in the future, we will do that together.

So, those are the main elements of the reform. And some people thought that could justify changing the name, but I think it is much easier to stick to what we have. Itis also easier for issuing our bonds, because investors know the name ESM by now very well. We worked very hard on developing good investor relations and we do not want to confuse anybody by changing our name.

Very good. Covid-19 is a truly epoch-making crisis, which could very well throw the world economy into the biggest

recession since the 1930s. Is the EU according to you, rising to the challenge and what is the role of the ESM in Europe's recovery?

Yes, we are indeed in the deepest economic crisis of the last 100 years. And it came as a surprise. Nobody was prepared for this, and I think Europe has responded quite convincingly to that. The decisions were taken quite quickly. It is never easy to reach a consensus among 27 countries for the EU or 19 countries for the euro area. But we had already the first package ready in April this year that included three safety nets. One for workers, that is a SURE programme managed by the European Commission. The European Investment Bank (EIB) provides additional financing for corporates, and the ESM was asked to create a new facility that we did not have before called, Pandemic Crisis Support (PCS), which is available to all the 19 euro area countries. Each country can draw up to 2% of its [2019] GDP. If all our member states were to do that, that would add up to 240 billion Euro.

Of course, not all of them will do [request] it, but probably some of them. Together this first package amounted to 540 billion euros with three safety nets. And then in July, as you know, the [EU] Summit agreed on the next generation EU programme managed by the European Commission amounting to 750 billion euros, all this happened quickly. It was well coordinated between the different European institutions and also the European institutions well- coordinated with what was happening at the national level. Where, of course, every member states implemented significant amounts of fiscal support for corporates and for people. The European Central Bank (ECB) played its role with additional programme. The Commission made it easier to provide state aid and lifted the 3% ceiling on the Stability and Growth Pact. So, it was well coordinated. And in my contacts with markets, we have very good relations with our investors around the world, normally I go to the biggest of them, now we see them on the video screen, I hear again and again that the mood on Europe is better than at any time during the last 10 years, because they see that we acted quickly, well-coordinated and with big amounts of money. Now we have to implement this, but I think Europe indeed rose to the occasion. And it is very important that not only the individual countries did their work and had different responses to the challenge, reacting to the pandemic, but that these European measures were designed deliberately to help more those countries most affected by the pandemic.

So, we have a degree of solidarity here in Europe that goes beyond what we have seen in the past. And I think that is important to protect the [EU] single market and make sure that also the monetary union works well and that we do not see excessive divergences among the different member states of the monetary union.

It is very reassuring to hear and leads me straight into the next question, which is about, you have talked previously about the need to strengthen the role of the euro in the international monetary system. Why do you think this is necessary and what are steps we should take to do this?

I think it is good for two reasons. One, it would be good for Europe and second, it would also be good for the international monetary system. It would be good for Europe, because it would strengthen the European sovereignty. This is something that we talk more and more about these days. Partly, because we see that the previous US administration, as of today we do not know about the next one, the previous one clearly was moving away from multilateralism. They also sometimes misused the dollar for foreign policy objectives and the US economy has derived huge benefits from the fact that the dollar, since the Second World War, has been clearly the dominant reserve currency in the world. So, I think to get a bit of that for the euro, the euro will never replace the dollar, but it could become more important. It is already today, clearly the number two in the world by different measures, but with a big difference compared to the dollar.

So, I think we should take action to strengthen that role. And I will talk about how to do that, but it also would be good for the international monetary system, because the fact that there is one dominant currency has led again and again to problems for many emerging and developing countries, because they tend to borrow in that one dominant currency. And then when the exchange rate of the dollar moves, which has nothing to do with emerging markets, they are hugely affected by that. It triggered for instance, the Asian financial crisis in 1997, that the dollar went up during those years and that the dollar debt that many emerging markets had in national currency became more and more expensive. So, the international monetary system would also benefit if we have a multipolar system with three or four currencies of roughly equal importance. The dollar would of course be one. And it might be for a long time, even Primus inter Pares , but the euro should be there more important than today. I am sure the Renminbi will be there and maybe another currency one day, Brazil, or we will see, or India. Then it would be better for the international system, because then emerging markets would not incur debt in one currency, but they can choose in several, and they will be much less affected by exchange rate fluctuations or it would even out. So, I see benefits for Europe, I see it for the world. What to do to get there? For one, it is good that in Europe, we are more aware these days. When the euro started, this was not an issue. Sometimes I read that euro was created to replace the dollar, but that was not there when [the] Maastricht [treaty] was negotiated. And when the euro was introduced in 1999, but slowly we are discovering that this could be good for European sovereignty.

What we need to do is to deepen monetary union further. We have come a long way the last 10 years, but we are not at the end of the process. We should take a number of steps that would make monetary union work better, make it less vulnerable and more resilient. And that includes completing the banking union, with the backstop and a common deposit insurance, it includes making progress on the capital markets union. It would include steps for a fiscal capacity for macroeconomic stabilisation. And we need more safe assets. So, there as a full range of topics. Some of them are very controversial among our member states. So, I do not expect progress the next two or three years, but others – like the backstop, capital markets union – we are actively working on in the Eurogroup, and the European Commission is making proposals. So, I expect that this process will happen, but to complete it will take some time, also for a true global role of the euro. The ECB needs to be more active providing swaps to other central banks, which they have done to some extent in the context of the pandemic. And we need to make sure that our financial infrastructure is really up to speed. So financial innovations, including a digital euro, all that would be important.

Good. You mentioned multipolar world, another event that will probably create more multipolarism, at least in Europe, is Brexit. I am speaking to you a few weeks before the end of the UKs transition period, after which the full impact of Brexit will start to become clear. Do you think that UK's

final departure will have a significant impact on Europe's financial stability and capital markets, or has this risk now been priced in what preparations has the ESM made in light of this departure?

Yes, no. I would not expect a major problem here. Financial markets had four years to adjust to this, and that is a long time for financial markets that react very quickly. In the manufacturing sector, maybe not every company is so well prepared, but when you asked about financial markets, I do not expect big problems. They had enough time. There will be economic costs, but mainly for the UK. I think that is well documented and researched. There will be some costs on the continent, or let us say the European Union, because that includes Ireland, which is not on the continent. And the Republic of Ireland will be more affected than the other member states, because they have a common border and that could, hopefully not, but there could be also political implications. Some companies on the continent that have particular strong trade relations will be affected, but all that is not really financial sector.

And of course it will depend whether there will be a no deal Brexit or whether it is still possible the next few weeks to agree on a deal. And some people are working very hard on that. So let us hope. And I think it is particularly important also for Ireland. The ESM is not directly affected, because unlike the Commission and the EIB, where all EU member states are members, at the ESM, the UK was not a member, because they do not use the euro. And we have only 19 members and not some other countries that are or were members of the European Union. We had to do some indirect adjustments, because we deal with quite a number of banks, including in the past, banks located at London. So we did what is called novation: we had to shift some of these relationships to subsidiaries located on the continent, but all the London banks have either created these subsidiaries or they already existed and they have been built up and become bigger. We have done that. That was the only effect that really was relevant for us directly.

Before we conclude, allow me to ask also about Luxembourg first, why was it chosen to set up the EFSF

and then the ESM at the time? Second, what were the reasons for choosing Luxembourg law when you switched away from English for issuing euro-denominated bonds? And finally, what surprised you most in Luxembourg in your time living here?

Yeah. Good questions. And I am often asked, why are you in Luxembourg? Why are you not in Brussels or in Frankfurt, maybe, but traditionally of course, Luxembourg has been host to institutions, to EU institutions that have a financial mandate, the European Investment Bank is here, also certain directorates of some DG's of the [European] Commission are here. When I was Director General in the Commission, one of the directorates was here. And that is the one that actually issues bonds, which the Commission has been doing for many years, small amounts. Now it will become much bigger. It will all happen from Luxembourg. So, there is this tradition and that tradition was agreed among member states many, many years ago. So, in that sense, it is nothing new and nothing surprising. Of course, we are legally speaking, not a European institution. We are an international financial institution, which may change one day when we have an EU treaty change, we may be integrated, but still, I think it made sense to follow this tradition.

And clearly we are very happy here. The staff is happy to be located in Luxembourg and the Luxembourg government has also been very cooperative, because when a new institution is built up, there are many, many things that need to be sorted out. And there the Luxembourg government has been very helpful. As you mentioned, last October, indeed we changed our approach and all new ESM bonds and bills are from then on issued under Luxembourg law. Before they were issued under English law. But as it became clear that the United Kingdom will leave the European Union, we thought it was not really appropriate to continue to use the legal system of a country that is not member of the European Union. That is very simple. So once we had decided no longer English laws, then we looked around and said, what do we do instead? And it was then a very easy step to say, well, Luxembourg has a very good system.

And we use that one and other European institutions have followed that step. So, since then we use the Luxembourg law.

What has surprised me, and I think I can probably speak on behalf of my colleagues also, who are here, who are quite happy living in Luxembourg, which has a very, very diverse community. It also has a beautiful scenery. So, it is very green, when you leave the capital. I love the “Philharmonie”, for instance, I try to go as often as possible, which is not that often, because of the work right now, because of the pandemic, but it is a beautiful building and has fantastic acoustics and very, very good orchestras.

The local Luxembourg for the Philharmonic orchestra is good. But there are many guest orchestras that come from all over the world. But then I think like many others, it is very impressive to be in Luxembourg and see how European it is. Many Luxembourger's speak four languages fluently, which is very impressive. We have staff from 44 nationalities here at the ESM, because we are not an EU institution. We are allowed to recruit worldwide, which we do, and they feel comfortable here, because they see that people speak all these different languages and they meet other foreigners, large numbers, and we really enjoy that.

One last question, Mr. Regling, in your downtime, if you have any, have you recently read a book that you would like to recommend to our listeners?

Yes, I do have some downtime. I do take vacations. Although we all work hard at the ESM. I want to recommend a book written by Olli Rehn, who is now the governor of the Finnish central bank. And last decade, he was Commissioner for economic and monetary affairs. And he wrote a book first in Finnish, and then it was translated into English. Now it is right now translated into German. The English title is, "Walking the high-wire – rebalancing the European economy in crisis". So obviously, this is about the euro crises, the sovereign debt crisis. He was Commissioner at the time and was very actively involved.

So he really understands what happened. And readers who are interested to get a good overview, over the crisis, why it happened, what was done to get out of the crisis, which includes the creation of the ESM, of course. I can recommend this book because it is comprehensive, it is well-written, very analytical. And also it ends by explaining what we talked a little bit about: what else should be done to make monetary union more robust, less vulnerable. So this is a good overview, but as I talk now about that book, which I recommend, I can also mention that the ESM published a book a year ago. About our early years, the creation of the institution. It is not about the crisis, but how to develop a new institution from scratch. This book is on our website in electronic form and can be downloaded for free.

Luxembourg for Finance:

Thank you very much, Mr. Regling, for this fascinating discussion and for sharing your experience with our listeners. And thank you also to our audience who has tuned in again to our podcast. In our next episode, I will be chatting to Sherry Madeira from Refinitive on the increasing importance of data in financial services. Stay up to date with our podcast. Please feel free to subscribe on iTunes, Spotify, Google, and you can also find more information on our website, luxembourgforfinance.com.

[1] Latin, meaning first among equals.

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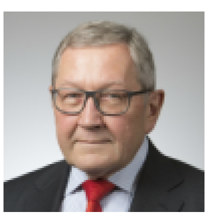

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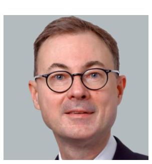

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