

Klaus Regling in interview with Jornal de Negócios (May 2022)

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Interview with Klaus Regling, ESM Managing Director

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Jornal de Negócios: With interest rates rising, is there not a risk that the burden of public debt will become very difficult to manage?

Klaus Regling: At the moment, according to our analysis, debt in all European countries is sustainable. But that does not mean that countries do not need to be

careful. In particular, countries that have a debt-to-GDP ratio above 100% are vulnerable because, for many reasons, we don't know how the current crisis will affect the growth, how long inflation rates will be high or how high interest rates may have to go. These are all very difficult risks to predict and we know, unfortunately, that even after this crisis, there will be another crisis one day. We don't know when, we don't know where it will come from, but experience tells us that there is always another crisis. So all countries should prepare for that by creating fiscal space so that you can react again when there is another crisis. It is good to be cautious, although, at the moment, debt sustainability is not in question.

The fiscal rules of the Stability and Growth Pact (SGP) are suspended until the end of this year. Shouldn't this be the time for governments to support businesses and households more?

That is what governments are doing. They have done it a lot in the last two years in response to the crisis. Some of these measures are still in place at national level, but also at EU level. Next Generation EU continues to support economies. Most of the financial support will still come, because it has not been disbursed so far, and that is very positive.

How?

Money will flow until 2025 to support public investment and reforms to support the digital and green transitions, which is very positive. But what individual countries do at the national level, beyond that, depends on each country. Most are helping the most vulnerable cope with rising food and energy prices, which is positive. But governments still have to be careful that [debt] doesn't get too high. But that does not exclude that support is given to the most vulnerable families.

Do you believe that, with the current economic conditions, the general escape clause should continue in 2023?

That will be discussed in the coming months. It is a possibility and it depends, of course, on how complicated the situation [the impact of the war in Ukraine] becomes and the consequences on growth, inflation and budget deficits of member states. It is possible and may even become unavoidable. Euro area ministers have decided to discuss this again in two or three months. Then the Commission will make a proposal and the Council will decide.

And what is your opinion?

It depends on how the situation evolves. If the impact becomes more serious than it is now, it will probably be unavoidable. But eventually we will have to return to a situation of normality of the rules.

At the same time, the fiscal rules are under review. Do you still defend raising the debt threshold to 100% of GDP or have the conditions changed?

That is the ESM's proposal. I think it is a useful proposal. We made this proposal because, in my view, interest rates will increase from today's levels but will remain, for good economic reasons, lower than they were 30 years ago, when the SGP was drawn up, which allows countries to have a higher stock of debt than would have been advisable 20 or 30 years ago. We have already talked about the [economic] risks and there will be [in the future] another crisis. But in my opinion, 60% is not a number that countries should try to reach and certainly not in the short term. It could be higher and that's why we suggest 100%.

The ESM is still one of Portugal's main creditors. Ten years after the start of the adjustment programme, were the reforms necessary?

Yes. I believe they were necessary because Portugal entered the crisis in late 2010, early 2011, because it had problems. Portugal, like other countries in the euro area, accumulated problems during the first decade of Monetary Union. External and budget deficits were high, the banking sector was weak, and reforms were designed to address those problems. In a crisis not everything is perfect, because decisions have to be taken quickly. But overall, the results show that these reforms were positive.

Why?

Because since the end of the programme in 2014, economic developments have been positive - until the pandemic interrupted them. But even after the pandemic, Portugal is doing better than the euro area average. And certainly, before the pandemic, the Portuguese economy, in terms of growth, job creation and external balance, was better than the euro area average. I think that shows that the reforms were the right ones. Without those reforms it wouldn't have happened.

How do you see João Leão as a candidate to head the ESM? Is the former finance minister suitable for the job?

Yes, of course. I know him very well from his two years as Finance Minister in the Eurogroup. We always worked well together, as we did with his predecessor and as I would like to work with his successor. In the ESM we always have good relations with finance ministers, including with him. I cannot comment further on the individual candidates. But I am pleased to see that the member states have put forward four strong candidates.

At the beginning of the war, it was believed that the rise in inflation might be temporary. Is there still reason to believe that?

We could not know how much energy and food prices would rise. It was a surprise. Energy prices are at the highest level in 20 years, food prices are probably higher than ever. The war in Ukraine has a very strong impact on food, because both countries are big exporters of certain agricultural products. Inflation is rising much faster than we thought, and the ECB is no longer talking about it being a temporary phenomenon. Nor do the US Federal Reserve and the Bank of England say that anymore. Of course, one day inflation will fall and we may be close to the peak. But that doesn't mean it will soon fall to 2%, which is the target in the US, UK, in the euro area. I think we will be above that for some time, but not necessarily at current levels.

What will be the impact of the war on highly indebted countries like Portugal?

Portugal has very little direct exposure to Russia or Ukraine, and in addition, it is much less dependent on energy imports from Russia than most European countries. The direct impact is not very big, but the indirect one will still be felt. We already see this in the higher food and energy prices. The consumer price index is higher, at about the same rate as in the euro area, above 7%, and that, of course, is an important indirect effect that will be felt by everyone.

And Portugal cannot disconnect itself from that.

Portugal is part of the global market. If energy prices are high all over the world, Portugal will also suffer from that. But if the conflict escalated and, for example, if all energy imports from Russia stopped, that would have a much greater impact on

other countries than on Portugal. Coming back to indirect effects, if we see the world economy growing less, that is going to have an impact on Portuguese export performance as well, it's inevitable. And as financial conditions tighten in response to inflation, Portugal will also feel that.

Europe wants to move faster in reducing its dependence on Russian energy. What effects will it have on the eurozone in the short and long term?

Numbers show that dependence on energy imports from Russia is already decreasing. It is already lower today than a year ago, and that process will continue. Governments are trying to find a balance, because the intention is to weaken the Russian economy without harming the European one too much. That is the approach and within that it is possible to further reduce dependency. In the long term it can be positive because as we reduce dependence on Russian energy, which is exclusively fossil fuel, we will accelerate the process towards greener energy, and that is good. But first we will have to go through a difficult period.

In Europe there is talk of the chance of stagflation. How likely is this scenario?

Not all of Europe is talking about stagflation. Some people and media are talking about it.

And some analysts and researchers too.

Yes, but not all of Europe. The European Commission, the ECB, the Eurogroup are not talking about stagflation. But it depends on how you define stagflation. If it means stagnation and high inflation, that is not in the current forecasts. The European Commission will publish its forecasts next week. The latest comprehensive estimate we have is from the IMF, which has revised down Europe's growth estimate by almost two percentage points from previous projections. Still, that means growth around 3% this year. That is for the euro area average. There is a carry-over effect from last year. We are dealing with the unfortunate consequences of the war with a strong economy. All European countries were overcoming the consequences of the pandemic - a big drop in 2020 and strong growth in 2021, which was also very visible in Portugal - and this continued in January and February. Portugal had particularly strong growth in the first quarter, while in the euro area it was much lower. But on 24 February the war started, and it had an impact. But even if there is

no growth in the coming quarters, the annual growth for 2022 will be around 2%. This is not a stagflation scenario. But there are risks that could lead to a downward revision of the projections. If the war escalates, if there are stronger disruptions of supply chains, notably in energy, it could be worse. But right now, I believe there is no stagflation scenario. In principle, there will be growth this year, but lower than we anticipated at the beginning of the year.

What effects could a change in ECB interest rates have on the European economy and on indebted countries like Portugal?

We don't know what the ECB will do. The US Federal Reserve and the Bank of England have raised interest rates in recent weeks, and I think eventually the ECB will follow too, in light of the high inflation rate, but I don't know when. Inflation is so high that even some increase in interest rates would still mean that real rates would remain highly negative. They have never been so negative, and an increase does not mean we will see positive interest rates. That is a long way to go. Monetary policy will continue to support economic developments, even if interest rates go up a bit.

The EU has admitted it may issue more debt to finance defence investments. Is this the right way forward?

Within Next Generation EU there is still a lot of money available. Most of it has not been disbursed, it will be available in the next five years, and that is very useful to overcome problems associated with the pandemic, but also for countries suffering from high energy and food prices, and the additional cost of war. About €230 billion of the €800 billion has not yet been allocated. That can be allocated now, specifically where there are additional problems arising from the war. I don't think new arrangements will be necessary, at the moment. This may change in the future, but for now there is no need and there is not even a discussion among the member states about it.

What is the role of the ESM in this crisis?

The ESM is always there for the euro area member states. We were very active 10 years ago, including helping Portugal overcome the crisis, and without our money, the adjustment would have been much more painful. Many people remember the pain of adjustment, but are not fully aware that without our money, it would have been much, much worse. The ESM is still there. It was available two years ago, when

Covid-19 broke out. We created a new credit line for member states. It was not activated, it was not necessary because liquidity was abundant, but it was very useful to calm the markets, and indirectly it therefore helped the countries. We are there to help. That is what we were created for and that continues to be the case.

Looking back, with the euro crisis, covid-19, and now the war in Ukraine, you have gone through three economic crises. What has Europe learned from them?

I believe we have learned a lot from each crisis. The euro crisis also helped us a lot in dealing with the pandemic and the current crisis. During the euro crisis, countries addressed their macroeconomic imbalances. So countries like Portugal, Greece, Ireland, were better prepared to deal with the pandemic than 10 years ago. This also includes the banking sector, which is now stronger. Countries solved their problems and we created new institutions, including the ESM. During the pandemic, an additional step was taken: the Commission created Next Generation EU, something completely new and which would not have happened without the pandemic. And now with the war, there is still a lot of money available from Next Generation EU that can still be used.

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