

Klaus Regling in interview with The Banker magazine

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Interviews

Interview with Klaus Regling, ESM Managing Director

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Of the five countries to receive assistance from the European Stability Mechanism [ESM] or its predecessor the European Financial Stability Facility [EFSF], four have needed only one programme. Which do you view as the biggest success stories?

All four are successes, although for some the crisis is further behind than others. Cyprus, for instance, came out of its programme only a year ago, but has already joined the other countries as a big success story. That's perhaps not very well-known, because it is a small country. But considering how serious and painful the programme was in Cyprus – where the financial sector shrunk by about half – it has come a long way in a short time. Growth came back earlier than expected, its fiscal accounts are in surplus, and competitiveness has returned.

Based on [economic] growth rates, Ireland, which grew by 5% in 2016, is the most successful. But in Spain, where the banking system was restructured, employment has grown about 3 percentage points the past two years, which is very high, and Portugal is also doing well. So in all four of these countries, the programmes worked.

You have said you expect Greece to return to debt markets next year, before its third ESM/EFSF programme ends, if it delivers on its promised reforms. What is your rationale for this?

It is important to remember that in the middle of Greece's second programme in 2014, the first signs of success were evident. It saw positive growth for the first time in five years, unemployment came down by 2 percentage points, and it issued bonds on two occasions. But while we as economists could see that in the numbers, the electorate didn't. Which isn't surprising, as it takes a while for macro-economic data to become visible to the wider public. The new government from January 2015 had the mandate to do something completely different, and that threw Greece backwards. It proved very costly, despite the fact they were in good shape in 2014.

Greece could have completed its adjustment process with the second programme, but this interruption has meant it has taken longer and required more money. But at the same time, I think it underlines that Greece can be a success story. We saw the beginning of that in 2014, and today I continue to be convinced that if Greece continues with its reforms, it can end the programme next year and will regain market access before the end of the programme.

What is your outlook for Greece's banking sector?

The banks were not the origin of the Greek crisis; the problems were clearly caused by debt and a loss of competitiveness. But the banks suffered as the creditworthiness of the sovereign deteriorated, and they suffered from the private sector involvement (better known as PSI) debt restructuring. So the link actually ran from the sovereign to the banks, not the other way around as we saw in other countries.

They have needed recapitalisations, and quite a large chunk of ESM money loaned to the government was earmarked for that purpose. But they've also found private investors, which of course is a good sign, and the Hellenic Financial Stability Fund has been reformed and now has a stronger governance system.

When up to €86bn was approved for Greece's third programme, the assumption was that its banks would need €25bn. But after an asset quality review by the Single Supervisory Mechanism [SSM] it turned out they needed only €5.5bn. All that indicates its banks have come a long way, and while there may be internal problems relating to governance and business models, they are not a major issue for Greece.

Spain's programme was dedicated to its banking sector while a portion of the other

programmes have helped recapitalise banks. In what ways can the ESM support banks?

We have assisted banks in all programmes in different ways. In principle, the ESM can do this via three instruments. First, when providing a loan to a government, a certain portion can be ear- marked for bank restructurings or recapitalisation. That's what happened in Greece, Portugal, Ireland and Cyprus. The second option is to have the entire programme dedicated to bank restructurings, with the loan being provided to the government which then channels the money to the banks. That's what happened in Spain.

The third instrument, which we have not used, involves taking equity in the bank. This is obviously very different to lending to a government. It was developed in the context of the banking union, and became available in November 2014 when the SSM was established. It was seen as a key tool to break the link between sovereigns and banks, but since then other instruments have been introduced that will be more important in that regard – specifically the Bank Recovery and Resolution Directive [BRRD] which requires creditors to be bailed-in before public money can be used. The funds used for this third instrument are public money, but once BRRD bail-in has occurred, the need for more money becomes very small. That's one reason why this instrument hasn't been used. But of course the overriding reason is that European banks are much stronger today, with significantly higher capital levels, than a few years ago.

Can banks approach the ESM directly or must they rely on their governments?

We will always deal with the government first. We wouldn't have an exclusive relationship with the banks. At the end of the day we do take capital in the banks, and have a role in restructuring and bringing them back to market, but the government needs to be involved.

There is much speculation about Italy's banks. Do you foresee the ESM having to assist them?

No. There's obviously a lot of speculation in the media, but when you look at the situation, it's very clear that there is no banking crisis in Italy. It's well-known that a few banks have problems, and following the SSM's 2016 stress tests we know

exactly how much capital certain banks must raise, which is something they and the government are working on. But that's very different to a general banking crisis. It just doesn't exist. Capital ratios and other measures show that Italy's banks are much stronger than seven or eight years ago. Of course, non-performing loans are high and that affects profitability. Therefore, adjustments are needed.

What are the biggest misconceptions about the financial support provided by ESM?

It has changed a lot over time, and it also depends what you are talking about. Five to seven years ago when the ESFS (and later the ESM) provided a loan, many people thought the money came directly from the taxpayer and would never come back. That's obviously wrong; we fund our lending by issuing bonds in the market. Taxpayers do take on risk, as the ESM's paid-in capital is provided by member state budgets, but we do not use this to provide loans, it is just a guarantee for investors. With four of the five countries being success stories, and with some such as Spain already starting to pay back their loans early, I think it has been shown that these risks aren't as big as some originally thought. Some of this misperception is still there, but I think it's getting smaller.

At the start we also had to explain to investors how we operate, because not everybody was convinced that member state guarantees for the EFSF would be strong enough to support a very good rating. That was understandable, as we were a new issuer, but thanks to our regular contact with investors around the world, I think that misperception has been sorted out.

There may also be misperceptions in some of the borrowing countries, with people blaming us as a creditor for some of the pain that comes with the adjustment and reforms. People forget that these reforms are needed because something went wrong in the first place. The International Monetary Fund has struggled with this for decades, and it remains an ongoing process, which is why we need to explain everywhere what we are doing.

What is your response to criticisms that the eurozone has failed as a monetary union?

It amazes me why some people think that. Imagine the EU today with 28 different currencies. It would be a disaster. People forget that Europe had many currency

crises before the euro was created, throughout the 1980s and 1990s and right up to the final stretch when it was clear the single currency would be introduced.

The last real crisis before the euro was triggered by problems with the Mexican peso, the so-called Tequila Crisis. In 1995 it spilled over into Europe, and within a few weeks the deutsche mark appreciated against the Italian lira and other currencies. For countries that form a single market and where trade is free, these currency moves were very disturbing and costly in terms of growth. So when one looks at problems we've had in the past few years, one should not forget that there were problems before. They didn't start to pop up with the euro.

Another argument is that before the euro, monetary conditions typically were not ideal for most countries in Europe as they were dictated by the Bundesbank. As required by law, the Bundesbank would only look at the economic situation in Germany when deciding on monetary policy, but like what happens with the US Federal Reserve today, many other countries were affected. The European Central Bank, however, looks at the entire eurozone, which means monetary conditions are now much more appropriate for the eurozone as a whole. So before anyone criticises the monetary union, I think they need to look at some of these facts.

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