Klaus Regling in interview with European Court of Auditors Journal

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Interview with Klaus Regling, ESM Managing Director
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ECA Journal: You have held senior positions in the financial and economic world, for example at the IMF, as Director-General for Economic and Financial Affairs at the European Commission, and since 2010 as Managing Director of the ESM and its predecessor. You were also, while working at the German Ministry of Finance in the 1990s, one of the co-authors of the Stability and Growth Pact. The functioning of the SGP is quite important for the ESM – if this Pact is not working well, the ESM might have to step in with a financial assistance programme. Did the ESM have to do more than you initially expected when you started as the ESM's first Managing Director in 2010?

Klaus Regling: For sure! When we started building up first the predecessor of the ESM, the European Financial Stability Facility (EFSF), the expectation was clearly that the EFSF would never have to be activated: we all agreed that it was essential to have it in place to calm the markets. We also understood that it was important to demonstrate that it was up and running. And we also hoped that this would be enough to ensure stability. But the reality was different because there was a deep crisis.

By the way, not everything in the crisis countries was linked to the SGP. That is a misconception. Two of the five euro area Member States that lost market access and needed our financing (Ireland, Portugal, Greece, Spain and Cyprus) always met all the criteria of the SGP. For several years, Spain and Ireland had fiscal surpluses and low debt. So they exceeded the SGP targets and still got into a crisis. Therefore, one has to be careful in identifying the reasons for the crisis. They differ country by country and are not always related to fiscal deficits, as the examples of Spain and Ireland show. Other countries like Greece were different; they indeed had an excessively large deficit and debt. So the reasons differ.

What all countries had in common was a loss of competitiveness. This is certainly also true for Ireland and Spain, which had no fiscal issues. I say this just to be clear on what the key reasons for the euro crisis were. But in the end, the possibility that five countries would need almost €300 billion in emergency financing – that was clearly not foreseen when I was appointed in 2010.

Many political players have changed this year. We have a new European Parliament, soon a new European Commission and a new ECB President. And perhaps some key priorities have also shifted a bit, ranging from a Green Deal for the EU to how to develop the EU further as a global player at a time of trade wars, etc. What does this new political environment mean for the ESM, since you also participate in Eurogroup meetings? To what extent will it have an impact on your work?

Well, in principle it does not or at least not a lot. Our mandate is set out in the ESM Treaty, and our cooperation with the European Commission is defined in a memorandum of understanding that I negotiated with the Commission. The ESM and the European Commission signed it and it was endorsed by the Eurogroup and the Euro Summit. As regards the European Central Bank (ECB) and the International Monetary Fund (IMF), we work together because we are engaged together in some Member States that needed financial assistance. Institutionally, it is all set and well defined.

At the same time, we all know how important people are because we work with institutions, but behind institutions are people and they can make a difference. So in that sense there is a new phase that is beginning now and, as we all know, this year is a bit different from normal changeovers since so many top positions became vacant at the same time. That is normally not the case. So we will have new counterparts at the top of the ECB, the President of the Commission, the

Commissioner in charge of Economic Affairs, who will be Paolo Gentiloni but also the Commissioner in charge of the euro area and the euro, although that person remains the same, Vice President Valdis Dombrovskis. So all that can make a difference. But, at the same time, one has to realise that those people are all well known. For instance, I worked very closely with the incoming ECB president Christine Lagarde when she was heading the IMF. I am sure I will work with her as well in her new post as ECB President as I previously did with Mario Draghi.

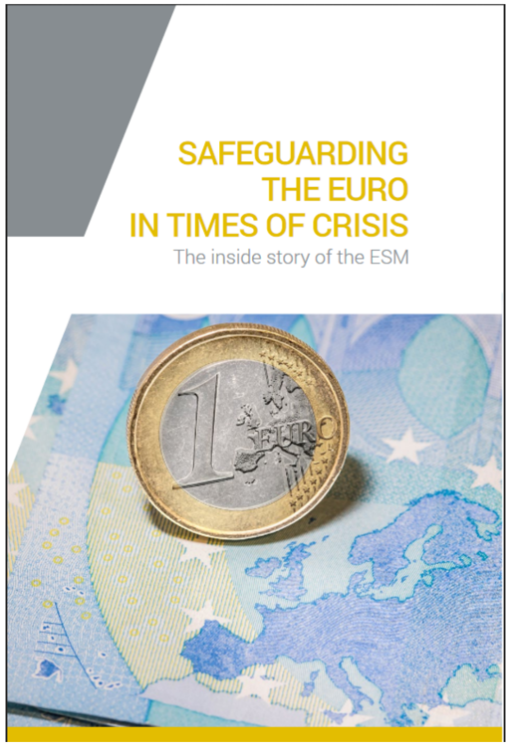
Stability and Growth Pact – up for revision

Pierre Gramegna, Luxembourg's Minister of Finance, during the presentation of the book *Safeguarding the Euro in Times of Crisis – The Inside Story of the ESM* (see box) on 24 September 2019, indicated that one has to appreciate the ESM's achievements, considering the success of its interventions. Indeed, this is also part of the inside story told in the book. Looking forward, you have indicated that the Stability and Growth Pact – whose working is important for the ESM – may need some revision because its implementation has become too complicated. Where does it need to be changed and how does that leave the countries which stayed within the criteria of the Pact?

Box – Book *Safeguarding the Euro in Times of Crisis – The inside story of the ESM*

The European Stability Mechanism and its temporary predecessor the EFSF provided billions of euros in loans to five hard-hit euro area countries during the European financial and sovereign debt crisis of the early 2000s. This helped to safeguard the stability of those five countries and the euro area as a whole.

This book tells the inside story of those who played key roles in setting up the organisations and combating the crisis. In exclusive interviews, global financial leaders and ESM insiders provide a rich stock of perspectives and anecdotes that bring to life the urgency of the crisis as well as the innovative solutions found to resolve it.



What I have said is that we have seen a lack of trust among the Member States because the implementation of the SGP has become too complicated. Most people do not understand how it works anymore. And that is not good for trust and confidence.

I think it is true that the SGP has become overly complex. By the way, this was not because the Commission wanted it to be so complex. These were decisions taken by the ministers and the member states. To make an exception here, an exception there, and then they asked the Commission to implement it. But the end result is that few understand anymore how it really works. That is not good. That is why many people think it needs to be simplified, because the trust has gone.

Regarding the Pact, one has to look at the underlying economic situation. In the aftermath of the 2008 financial crisis, everybody agreed to increase deficits to get out of the crisis. That was the right decision. So every country was above 3%. It was a common decision. And it was covered by the escape clause of the SGP. It was always there for serious events. But now we have to live with the results: people do not understand the Pact and there is a loss of confidence in each other. And that is regrettable.

One concern could be that we see several Member States being close to or well beyond the deficit and debt limits set by the SGP. Does this mean that, if the ECB's monetary means are exhausted, it will only be a matter of time before the ESM is called in to help mitigate the consequences of serious deficit problems, because the usual shock absorbers are not there anymore?

I am not so sure. Our fiscal position today is better than any time during the last 10 years. 2018 was the first year where almost every Member State of the union had a deficit below 3%. The first time in 10 years! In 2018, the euro area had a fiscal deficit of only half a percent, compared to over 6% in the USA, or Japan, where it was almost 3%, and the UK where it was 1.5%. That is not bad at all. This means there is more fiscal space in the euro area than in any of the other advanced economies. Of course, the distribution inside the euro area is uneven. There are a few countries like the Netherlands and Germany that have a lot of fiscal space, and others, like Italy, that do not have much. But Italy has been below 3% for many years already. In that sense, it does not mean that all the countries can do something. But together there is more fiscal space in the euro area than in the rest of the world. And that's positive.

Now, if a big crisis were to hit again – and I would argue for fiscal actions only in case of a big crisis, not just to smooth out every cyclical development – if it is a big one like ten years ago, which I do not expect, but if it were to happen (and crises are unexpected), then of course we could do again what we did ten years ago. The ECOFIN Council could decide if the circumstances are such that this is a big crisis and we need to do something together, justified by the escape clause of the Pact, as ten years ago, that all countries can increase their fiscal deficits. Some more and others a little bit. Overall, the fiscal space is the one thing I am not worried about. If we compare the eurozone with the US, looking also at interest rates, on the monetary side they have more space, they have more room to act. On the fiscal side, we have more room to act.

In the 2009 crisis the saying regarding banks was that they were 'too big to fail.' Is this saying now applicable to Member States in the eurozone? Did this go from banks to sovereigns, to countries, meaning that some Member States are too big to fail so the Eurogroup has to support them no matter what? Greece may have been relatively easy to support to prevent

it from defaulting, but what if larger Member States get into serious trouble?

I do not think this is really an issue. The ESM has an unused lending capacity, a firepower of €410 billion. That is big enough even to help a big country. I do not expect this to happen but it is reassuring that markets understand that the ESM is big enough also to help large Member States. So we do have the money. On top of that, we have the Outright Monetary Transactions (OMT) programme of the European Central Bank. The OMT combines an ESM programme which gives the conditionality, with the unlimited firepower of the ECB. Of course, it is the decision of the ECB to activate it or not. But if they do, then money is no longer an issue. So money is not the most important issue when I think about a huge crisis.

Future key issues affecting the ESM

What would you identify as three key financial/economic issues currently on the table for the ESM?

The most important issue for the ESM for many decades will be to monitor developments in Greece. The ESM lent more than €200 billion to Greece and we want to make sure that Greece is also able to pay back these loans. In addition, in the short and medium term, there are a number of issues related to Economic and Monetary Union [EMU] where we need to find solutions, and they are all at different stages, with different degrees of controversy around them. One is the European Deposit Insurance Scheme (EDIS), where my feeling is that Member States do agree in principle to create a common deposit insurance. I am confident that such a scheme will eventually be set up, as part of banking union, after legacy problems have been sorted out. But there are arguments – and I have no problem with that – about the necessary preconditions that need to be in place first so that one can move to something like EDIS. It does not have to be EDIS nor called like that, it might be better to talk about a common deposit insurance scheme because it may be different from what the Commission proposed under the name of EDIS. I think this will happen eventually and should happen, since it is important to complete the banking union.

The second one is a very technical issue, but is also important for the functioning of the banking union. It concerns liquidity and resolution. So you have the Single

Resolution Board (SRB) and the Single Resolution Fund (SRF), they exist, they are up and running. They are accumulating their own resources, which by 2024 will be equivalent to 1% of all deposits. That will be around €55-60 billion. And we, the ESM, will provide a backstop to the SRF in case the normal resources are not sufficient. Then we can double that amount. And that takes care of resolution needs or bank capital needs. What is not covered is when a bank is in resolution and competent institutions like the Single Supervisory Mechanism (SSM) and the SRB have sorted out the capital needs and resolution costs, and the bank goes back on Monday morning and opens again, not everybody in the market might immediately have confidence in the decisions. And then liquidity is needed. So to provide capital is one thing, and so are resolution costs, but liquidity is something else.

The problem is that liquidity needs can be huge. For a big bank, it can be several hundred billion euros. And they may be needed for a few days or a few weeks, but the need may be immediately. In countries where you have one government, one central bank, one supervisor, the central bank will typically provide the money and the government provides the guarantee. In the euro area, however, we do not have a government. Therefore we do not have a ready-made solution and we cannot just copy what others have done. So we know that we need to find a solution but it is not in place yet. It is rather technical but very important to respond to a banking crisis. I am confident we will get there but it requires some work.

Finally, I would identify the fiscal capacity for macroeconomic stabilisation. This is the most controversial topic when we consider how to make EMU more resilient. Here I do not see an agreement anytime soon. However, it needs to be discussed. Simply because macroeconomic stabilisation in euro area countries cannot happen via monetary policy. In the euro area, there is one monetary policy for all. Rebalancing cannot happen via exchange rate policies. Fiscal policy is the only macroeconomic instrument. Of course, every country should have its own national fiscal buffer. If countries are within the SGP then they have around 3% of their GDP as a national buffer. But we know that when there is a real shock, it might not be enough. So it could be useful also to have a European buffer for that.

There are several proposals on the table. There is the investment protection facility, proposed by the Commission. Secondly, the reinsurance of national unemployment systems proposed by the German Finance Minister. The IMF has proposed a ‘rainy day’ fund. From the ESM side, it could be a shorter-term ESM facility, which in a way is similar to the ‘rainy day’ fund. What is interesting is that for each of these four proposals – and there are probably more – the mechanism would be completely different. They sound very different but in the end, the objective is always the same: macroeconomic stabilisation. They all can be designed in such a way that there will be no permanent transfers. This is the interesting part because it would be unacceptable for a number of Member States to have more transfers. But they can be designed without leading to more transfers. If every government knows that they have to repay relatively quickly, then also the risk of moral hazard is low.

As the EU’s external auditor, the European Court of Auditors (ECA) has published several audit reports regarding EU activities in financial and economic governance areas, looking at set-up, proceedings and impact. They range from assessments of measures taken regarding the macroeconomic imbalance procedure to the support programmes during the Greek crisis. Are these reports helpful for you to have?

Some of your reports are not so relevant for us, like for example on the macroeconomic imbalance procedure. That is something the Commission and the Council deal with, not us. Regarding Greece: yes, we looked at that, and we started a few months ago with the second evaluation of the ESM work that is focused on Greece. There, our experts have of course looked at all relevant studies and analyses that have already been published. For example, by the IMF, but also by the ECA. In order to learn from them and not to duplicate work. Either to confirm it or to contradict it when we do not agree! So that is an example where we have looked at the ECA’s reports very carefully. But some others, they are just not that relevant for us.

Obviously, one ECA publication that could have been relevant for us was the ECA opinion on the Commission proposals to turn the ESM into a European Monetary Fund (EMF). However, regarding this proposal, from the beginning it was very clear that it would go nowhere. I understand that the ECA had to give an opinion because the European Parliament had asked for it, and your institution had no choice. Maybe the Parliament should not have asked for it because it was clear from the beginning that only two or three Member States supported the Commission proposal or were prepared to look into it. The others refused from the start. That’s why I thought that it was not very useful to spend a lot of time and resources on that. But I think we can all agree with the ECA’s take on the Commission proposal: to keep the accountability framework as understandable, transparent and direct as possible.

The ‘S’ in ESG

An important issue that many people want to address is climate change. We see this in the proposals of President-elect Von der Leyen, and in September 2019 there was an important UN climate meeting in New York. In June, the ECA organised a conference on sustainable development goals and one of the issues was the power the world of investment can have through private equity funds going ‘green’. Do you see a role for the ESM to actually stimulate Environmental, Social and corporate Governance (ESG) and contribute to Sustainable Development Goals (SDGs)? So not only for the ESM itself, in terms of its organisational functioning, but also as regards ESM lending.

We are indeed active on both sides of our balance sheets. We provide loans to countries that lose market access. That is where we disbursed almost €300 billion in the last eight years. And then we have the liability side, our paid-in capital, which needs to be invested. On our lending side, I feel more responsible for the ‘S’ of Environmental, Social and corporate Governance. Because we provide money to governments and that has a very strong social impact. If we did not provide that financing, then the countries that lose market access have to cut expenditure back overnight to the revenue they have. That means that the fiscal deficit needs to disappear overnight. In the case of Greece, that was 15% of their GDP. So when a government has to cut 15% of its GDP in expenditure overnight, because it can only spend what it takes in revenue, that has a huge negative social impact. They have to cut pensions, wages, medical services, social services, everything.

In Greece, the government also had to make cuts, but these were small compared to what would have happened if they had not received ESM money. It is the same when the IMF comes in; it is the same effect. That is why I pick foremost the ‘S:’ it is the social component. Our lending has a very positive social impact on the borrowing countries. On our investment side, we have more than €80 billion in paid-in capital from our Member States. We do not use that money for lending. It is there to protect our bondholders. That is why we have strong ratings and pay low interest rates in the market. And we need to invest it. We are increasingly looking at how to do that also in an ESG friendly way. But we are not a pacesetter here, we are more of a follower, we see what is possible in the markets. Then the third dimension is that we also try in our organisation, in our operations, to comply with ecological guidance and be a green institution.

Objective: a better monetary union with fewer ESM loans

From an economic/financial perspective, what would you say are the important issues that the new Commission should have on its agenda for the coming five years?

There are many important agenda items: climate change or defending common borders, and if we do not succeed on these issues, they can also become macroeconomic issues. Because there might be disruptions in the single market, which is bad for economic performance. Looking at economics and finance, an important issue continues to be – nothing new – to always look for the right policies that strengthen potential growth. This is even more important considering the demographic problems that the majority of European countries face. The former Commission did that, and there are many mechanisms to deal with that, and the Commission issues country-specific recommendations every year to Member States. They do this not only to Member States with an acute problem but each and every one of them since every Member State has obstacles to growth. The Commission is right – and should continue to do so – to identify these obstacles to growth and remind Member States to work on that.

In the more narrow area, as far as the ESM is concerned, the good functioning of the monetary union is the main interest of the ESM. We want to help the monetary union to work better, so that fewer ESM loans are needed. That is what I see as our main mandate. Of course, when there is a crisis, our mandate is to provide financing but now the main mandate is to prevent it and make the monetary union function better. There we need a more complete banking union. And a complete capital market union, which will take even longer with many dimensions like insolvency laws and a common tax base for corporates and things like that. So the banking union, the capital markets union and a facility for macroeconomic stabilization that we talked about – they all fit well together, and would lead to a more robust and less vulnerable monetary union. So you can see, we still have a lot do in the years to come.

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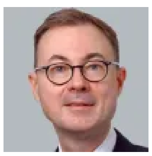

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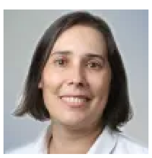

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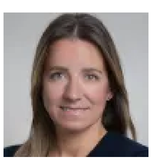

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