

Interview

Klaus Regling, Managing Director of the ESM, with *Valor Economico* (Brazil)

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Valor – Is this your first visit to Brazil?

Klaus Regling – No, I have been there a few times, and I tell everybody one should go at least once to Brasilia, because it's really interesting to see the architecture of Oscar Niemeyer at least once. But of course, the most astonishing city must be Rio de Janeiro. I have never been there, but I am looking forward to going there.

Valor – Why are you going to Brazil searching for investors just now?

Regling —We visit investors around the world all the time. So this is part of our regular roadshows. We had to cancel a trip to Brazil last year because at the last minute important meetings in Brussels had been scheduled. Now it is really time to go and talk to big investors in a few countries in Latin America, both private and public investors.

Valor- Do you think this is the right time, when Brazil is going through turbulence?

Regling – Of course, Brazil has been doing very well. It has been one of the best performing economies in the world for the last five or six years. The last few months have been a little bit more difficult, but we also saw some problems in other emerging markets. But overall, Brazil has come a very long way. It's a big economy, it's the largest in Latin America. We know a number of funds in São Paulo and Rio that are really interested in Europe. Some of them buy our bonds from time to time. So it's good to visit them.

Valor- Do you have any target how much you would like for countries like Brazil to invest in your bonds?

Regling – No, we don't have a target, and we don't look at Brazil primarily as a country, because most of the investors there are private sector investors. But of course we will also talk to the Central Bank. We know some of these investors have been buying our bonds and that is very positive. We want to encourage them to continue in that direction and to buy more. Our experience in contact with investors worldwide shows how important it is to provide information. Also they have questions. Another important issue is to explain how the ESM works. So far the ESM has not been in the market with long-term bonds. The ESM has only issued short bills with maturities of three months or six-month bills. Now we will start to issue long-term bonds in the autumn and we want to issue around €9 billion until the end of 2013. We have not decided yet if the first bond will be seven or ten years. As the ESM is relatively new, we need to explain how it operates. We will explain the ESM's robust capital structure with a paid-in capital of €80 billion and a callable capital of €620 billion and that as a result the ESM has a very good rating. We want investors in Brazil to understand that they can always be assured that they will always be paid. Furthermore we will explain how the euro area is working hard to overcome the crisis. Also we will explain our on-going policies in the euro area: the banking union and how the euro countries which are currently in a crisis

overcome their difficulties with important economic policy adjustment. We hope that as a result the investors will be there when we issue next time.

V – What is the share of Latin American investors?

A – For the time being Latin America is a small percentage. But some of the data you need to interpret cautiously. Some of the big investors have an office in London, and if they buy via their London office the deal shows up in the statistics as if somebody from the UK (United Kingdom) made the purchase. In reality it might ultimately be a decision taken by the headquarters of a fund in Rio.

V- Could the policy of the US Federal Reserve affect EFSF or ESM bonds, because of the higher return on US debt?

A – It is correct that the interest rates in the US yield curve are higher than for example the German yield curve. But that's not so unusual and the capital is still flowing to Europe. We have no problem attracting investors to buy our bonds. Also for Southern European countries, it is easier today than a year ago to get investors to buy their bonds. Money is coming into Europe. One explanation may be that part of that money is currently flowing out of some emerging markets. The money has to go somewhere as not all of it is going to the US. Investors don't only look at the yield. They also look at other factors such as the exchange rate expectations. Everybody has his or her own exchange rate assumptions. In any case we don't see a lack of capital in Europe.

V– The emerging countries have some economic problems at the moment. Will you take advantage of this situation?

A – We don't want to take advantage of problems somewhere else. Statistics show that in the last few years the Federal Reserve's quantitative easing in the US has initiated larger than usual capital flows into emerging markets. I think that is a widely accepted observation although it is difficult to quantify how much of that exactly was triggered by quantitative easing. Today we don't exactly know if and when there will be an exit from quantitative easing. But the Federal Reserve's announcement triggered some outflows from emerging markets.

V- Do you think the amount going to Europe is large?

A – I don't know exactly. I think a lot of that money is going to the US, probably also to other countries like Australia, the UK, Switzerland, Norway. But some of it probably is probably also going to the euro area.

Valor – You are perceived as the person in charge of preventing the collapse of the euro. What do you say when investors ask about risks to the existence of the euro?

Regling – For the markets the situation is very clear. And you see it in the movement of interest rates. A year ago, there was widespread scepticism about the euro, and many people in the market thought the euro area might break up. Of course that was exaggerated then. But the markets had this belief and this has disappeared today. So we have seen a very big swing in sentiment in the last twelve months. The reason for this changed sentiment is that investors have become convinced that our strategy to counter the crisis in the euro area is producing

results. In a nutshell, this strategy consists of four elements: there is significant national economic adjustment with structural reforms and budgetary consolidation; the economic policy coordination among the euro area Member States has been strengthened a lot; the European banking system is in a much better shape, although there is still some work to do; and we have the fiscal back-stops with the EFSF and the ESM and other institutional innovations.

Valor – But how do you convince potential investors that investment is safe and profitable in Europe, when political leaders are still a long way from addressing the root causes of the euro crisis?

Regling- I don't agree with your assessment. I don't think we're that far from addressing the root causes of the crisis. We're doing exactly that, and we have put a lot of energy in doing that for the last three years. There is significant progress and our strategy is working. We are moving out of the very acute crisis management and we can now increasingly focus on growth.

Valor – How can you illustrate that the strategy is producing results?

Regling - The countries that were in a crisis are doing their homework. They are making the necessary adjustments. One example: the difference in competitiveness between Northern European countries and countries in Southern Europe was around 50 percentage points before 2007. But since 2008, they have lowered their unit labour costs every year and the gap is now down to 20 percentage points. The main reason is their improved competitiveness and that is also why the current account deficits are disappearing. Additionally every country is reducing fiscal deficits. That is the other adjustment. But it's not only austerity and fiscal consolidation. Crucially there are also the structural reforms at the national levels. So I think it is obvious that we are tackling the root causes of the crisis.

Valor - But this process takes so much time. Why is Europe so slow?

Regling - I don't think that Europe is slow. First you have to keep in mind that the euro area consists of 17 democracies and it takes some time to take democratic decisions in 17 countries. You also have to keep in mind that the competitiveness problem has developed for a decade, and now we are fixing it within three or four years. That is not so slow and one has to keep in mind that the process is painful for the population. I don't think we should do it much faster. It just takes time to enact structural reforms. You know that when Brazil had International Monetary Fund programmes in the 80s and early 90s, it took a number of years. Experience with the IMF programmes in Brazil but also in other countries like Mexico, South Korea, Indonesia or Turkey shows that it takes a number of years before you can see the benefits of tough adjustment. In this period the population never likes it and I'm sure it was the same in Brazil. In Europe we are currently at that phase where the reforms improve the economies but the population does not feel it yet. But the efforts will be rewarded and growth and jobs will eventually come back.

Valor – The markets speculate that Portugal and Greece could need a new bail-out. Can Portugal and Greece avoid another bail-out?

Regling - I'm not excluding that at all. Portugal has been doing very well until the last few weeks when political problems in the government started. Progress in Portugal is very strong,

they have implemented very strong measures. It's not over yet, Portugal needs to continue. If Portugal needs further help, the government can ask for that. But it's too early to say because the Portuguese programme still has almost a year to go until the end of the programme in the middle of 2014. There's still money available for them coming from us and the IMF. At the end of the programme we will see where they are. They already made good progress because they could access financial markets with several bond issues including a 10-year-bond. Until very recently the markets also realized that Portugal has made considerable progress. Interest rates have come down significantly to around 6.8 per cent, which is half of what it was at the height of the crisis

Valor – Do you see any possibility of debt restructuring in Portugal? Would that affect the EFSF?

Regling - I don't see the necessity although there may be some speculations. But it does not affect EFSF bonds because the good rating we have comes entirely from our guarantee structure. So, it has nothing to do with whether there is a problem in one of the countries that borrows from us.

Valor – The IMF said it underestimated the negative repercussions of the austerity programs. How do you see that, because you just said the contrary?

A – My view is not in contradiction with the IMF. The IMF has just revised its estimate of the so-called fiscal multiplier which calculates how much economic contraction is caused by budgetary consolidation. But the IMF has made it very clear that even if they believe today that the negative consequences of fiscal consolidation are bigger than they thought three years ago, that it does not mean that a country like Greece, for instance, should do less fiscal consolidation. The reason is simple: when the Greek programme started three and a half years ago, Greece had a fiscal deficit of almost 16 per cent of GDP, 15.6 per cent to be exact. When the deficit is so large, and nobody is willing to finance it any longer, it doesn't make sense to discuss the size of fiscal multipliers. In such a situation the country has no other choice than to adjust.

Valor- In case of a new bail-out in the Eurozone, do you think the IMF should still take part in that?

Regling - The Europeans are working very closely with the IMF in all the programmes that we are doing at the moment. There's good cooperation and the IMF's experience in crisis resolution is currently very useful. In the short to medium-term the IMF should continue to play this role in Europe. But this should not be an arrangement that lasts forever.

Valor - Did you ever fear that the Eurozone could break-up?

Regling - No. There were difficult moments, in particular for some countries, but the euro area as a whole was not at risk.

Valor – What is currently the biggest problem in Europe?

Regling – The biggest problems are in the financial market in Europe because the European banking sector is fragmented. Until 2008 the European financial market was integrating and that was one of the objectives of the euro. Now some of this integration is being reversed,

which causes fragmentation. As a consequence interest rate levels in different countries are quite diverse. This is not only the case for the governments. We know for example that when the government of Portugal issues bonds it has to pay much higher interest rates than Germany. But this is also the case for the private sector. We have the interest rates that firms from the non-financial private sectors have to pay and there is a big difference between Northern Europe and Southern Europe. That is detrimental for the economic developments in these countries.

Valor - ESM will have €60 billion for direct bank bail-outs. Is it enough?

Regling - As we are moving towards banking union one of the elements is that the ESM may be authorised to do direct bank recapitalisation. We already do the indirect bank recapitalisation in Spain where we have given the government €41.3 billion to recapitalise the Spanish financial sector. Financial assistance for the banking sector is also a part of all our macroeconomic adjustment programmes. In Greece for instance €50 billion of our disbursements were earmarked for banks. But the direct bank recapitalisation will be different because then we would acquire directly a stake in a bank whereas up to now we give a loan to the government which then recapitalises the bank. But direct bank recapitalisation requires a new ESM instrument. For now it has only been approved in principle but not yet legally. In any case it will only start to be used once the Single Supervisory Mechanism at the ECB is up and running.

Valor – When will this be the case?

Regling - This is planned for the second half of next year. And the ministers have said that if they agree to give us that instrument, €60 billion would be the cap. For me €60 billion is more than enough. When I look around, I don't see any big problems. The reason is that in Greece, Portugal, Ireland and Cyprus the banks are already being indirectly supported. There's no need at the moment for much additional money. Also if some economically strong countries like Austria, Finland or Germany have a banking problem, they would not come to the ESM. It will be very good to have the instrument in place. But at the moment I don't see the need that it will be in use very much.

Valor – Do you still believe the crisis could end in two years, as you said last year?

Regling - I said it would be two to three years, and I still say that. When you look at the adjustment, two-thirds of this adjustment has already happened.

Valor- How do you see the future of the Eurozone after the crisis?

Regling – After all these adjustments, the euro area will be quite different. The Monetary Union will function much better than before the crisis, because countries will have done their homework. Maybe not the complete banking union will be in place in two or three years. But we will have important parts of the banking union in place. There will be the backstops and institutions that did not exist before the crisis, like the ESM, which is a permanent institution. The ESM fills an institutional gap that was there when the monetary union was created.

Valor - Do you see China in the medium term as a financial giant globally?

Regling – In a certain sense China is already a giant, because of the size of its foreign exchange reserves. These reserves are the biggest in the world and of course the size of the real economy also spills over into the financial sphere. It is now clearly the second largest economy and we know it will overtake the United States one day. If the Chinese financial markets are not yet as significant as the real economy, the reason is because their capital account is not yet liberalised. But the Chinese are working on capital account convertibility and I'm sure they will get there. China has changed the world economy. Twenty years ago, or even ten years ago, the world economy was dominated by the G7 countries, which accounted for about half of the world output. But the emerging economies have become very strong. Not only China, but also Brazil and others. The share of the G7 countries is declining continuously. They are now down to clearly less than 50 per cent. And I think that this will continue. In relative terms, Europe's importance will also shrink, because we have a demographic trend that's very clearly different from the US and the emerging markets. Our population is stagnating and we know it will shrink in a few years. Our standard of living does not need to shrink but the relative size of the European economy will shrink. Other parts of the world will continue to grow much faster. They can grow much faster as the emerging markets including Brazil still have a catching-up to do. Also productivity levels for example in China are still only about 10 per cent of European and US levels, despite 30 years of strong economic growth. So there is a lot of room to grow much faster and this is good for everybody.