

Interview with Klaus Regling, Managing Director of the ESM

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by Dorita Yiannakou

In what way does the ESM provide financial assistance to countries facing economic crisis?

Klaus Regling: The ESM plays an important role in the countries facing an economic crisis. The reason is that the ESM provides these countries for a determined time period with loans because they can no longer finance themselves on the market. But I want to stress that it is the Troika – the European Commission, the European Central Bank and the International Monetary Fund - that defines the conditions under which the ESM lends the money. It is the ESM's approach to provide countries facing an economic crisis with long-term loans at very low interest rates, as long as these countries comply with these conditions and change bad economic policy that caused the problems.

Economists know this strategy, because the International Monetary Fund has been using it successfully for 50 years now in many countries worldwide such as Indonesia, South Korea, Brazil, Mexico or Turkey. We have been successful with this approach in the euro area as well. This is shown by the successful ongoing reform process in all countries under a rescue programme, namely Ireland, Portugal, Greece, Spain and Cyprus. But I do understand that some of the conditions are unpopular and not easy to understand for the population. The people have to accept sacrifices in order to change economic policies that have proven to be disastrous. Often this involves higher taxes, lower wages and lower pensions. But the ESM loans buy time for these countries to implement the reforms needed to resolve their problems. I believe this strategy works well. Cyprus has made a lot of progress. However, one should keep in mind that the country has just finished the first year of a three-year programme. I understand that the people mainly see the negative aspects of the Memorandum of Understanding. But I am convinced the overall benefits of our support package will become obvious once some more time has passed. The fact that Ireland and Spain were able to successfully exit their programmes at the end of last year shows that the strategy is working. If the reforms continue, all the countries that have borrowed from us will eventually create a solid basis for financing themselves on the markets again. Initially,

this will involve pain and hard measures. But the hard political decisions will eventually bring back growth and jobs.

Will Cyprus need additional financial aid?

Klaus Regling: Cyprus has concluded one out of the three years that the Memorandum of Understanding defines as the programme duration. So far, Cyprus has received about half of the 9 billion euros committed by the ESM. Judging from the progress that Cyprus has made, I have no reason to believe that Cyprus may need additional financial support. The implementation of the requested reforms has been satisfactory following the three reviews by the lenders. The ESM has an ongoing collaboration with the Troika. From that we know well that the Cyprus programme is on the right path. I would even dare to say that things are better now than what we had predicted because, for example, the deficit reduction has exceeded expectations. This doesn't mean that the problems people face have disappeared. But many things are changing. There are the restrictions for capital movement, which I understand will be gradually withdrawn. The main concern for people is that they have lost part of their deposits, which is obviously unpleasant. But the programme implementation is progressing normally. At the start of the programme there was a sharp and abrupt decline in GDP, but this decline was smaller than expected. The unemployment rate rose, but this was expected. In Cyprus the shock was bigger than in other countries, because the Cypriot economy was based on an oversized banking sector and this economic model collapsed. But let me stress again: the determined implementation of the reforms defined in the ESM programme will lead Cyprus back to growth.

Are Cypriot banks struggling at the moment to cope with the problem of non-performing loans? What is your opinion?

Klaus Regling: In Cyprus, the main problem was the banking sector, and the non-performing loans constitute an important obstacle for the return to normal in the banking sector, as there are many of them and as they tend to increase at the same time. The Cypriot authorities should address this issue with great attention, and I believe this is a challenge. This requires proper handling by the banks and authorities, as new a banking policy should be applied, in order to recover large amounts. The ESM is monitoring this issue closely. The

Troika will discuss some recovery measures and this is what they will try to achieve during their next review mission starting 6 May. The Troika will be actively involved in this procedure during their next visit. But from then on, it is up to the Government to meet the so-called milestones that define the implementation of certain reforms which are the condition for further disbursements from the ESM loan.

One year after the deposit haircut, do you believe that the economy of Cyprus has benefitted from that decision?

Klaus Regling: I believe that the decision for the deposit haircut was inevitable. But I realize that this was very tough for the people. This was a unique decision, just as the magnitude of the problem in Cyprus was unique. In relation to its GDP, the problem in Cyprus was greater than what we had ever seen. Also keep in mind that the banking sector was not sustainable. As a result a harsh decision was unavoidable in order to balance the situation.

How could such a small country reach a point where it had to face such a big problem?

Klaus Regling: The issue in Cyprus was that it took too long before action was taken. As a result, nothing was done to address the problems for a long time and these problems grew to the proportions we know. Everyone involved knew that for the past 2-3 years Cyprus had been facing great difficulties. It would have been better if the previous government had implemented the requirements of the Memorandum.

Also, I believe that there was a negative effect by the fact that Russia gave a loan to Cyprus with low interest rates, but without conditionality. The effect was only that necessary reforms were postponed and the problems continued to get bigger. What is necessary in such circumstances is tough government decisions for economic reforms and healthy public finances. This is brought about by an ESM programme with financial assistance granted upon conditionality. The money from the Russians was given without any conditionality. This has aggravated the problems for Cyprus and postponed the needed reforms. But there are further advantages the ESM brings: It provides money at very low interest rates with a very long pay-back period. These loans allow to introduce reforms gradually and to regain

investor confidence over the programme period. Without the support of the ESM, the adjustment would have to be done overnight, as a Government without market access would be able to only spend its remaining incomes.

Do you agree with the view that Germans, by imposing the haircut, actually wanted to remove Russian capital from Cyprus?

Klaus Regling: I do not believe that this is true. Foreign funds and investments can be found everywhere. All money and investments from all countries are welcome everywhere in Europe if it is legitimate money. Also, I do not believe that the haircut in Cyprus was an experiment, as some people claim. This decision was taken because of the size of the problem in relationship to the Cypriot economy. There was simply no other way to solve the problem.

Do you believe that other countries will have to ask for an ESM programme?

Klaus Regling: For the coming years, I do not believe that there will be other euro area countries that need a programme. But one day there will be another crisis. The ESM is the permanent crisis resolution mechanism of the euro area. This creates confidence on the markets. Also in the context of our so-called Early Warning System, we will continue to regularly visit former programme countries to make sure that the ESM will get its money back in due course.

What was the role of banking supervision before the crisis and how did it affect the situation that Cyprus is facing today?

Klaus Regling: It is true that five years ago, all over the world including in Europe, banking supervision was not working as it should have. This was one reason why countries were facing a financial crisis. This was not a problem that only Cyprus was facing. Today everyone

acknowledges the fact that five years ago banking supervision was fragile and incomplete.

Do you believe that the difficult measures for Cyprus have ended, or are there still strict decisions that we need to implement?

The Cyprus package lasts three years. So in the next two years there are important measures that should be implemented. The fiscal deficit is still there and the balance should be controlled. Additionally, an important condition of the Memorandum is the reforms of the welfare system. This can significantly affect certain people. The privatization of state-owned companies is equally important, and has not been done yet. It is possible that in 2014 some people will lose their jobs because of these difficult decisions that will need to be implemented. I am convinced that Cyprus will fulfil all its commitments. Then there will be a chance to develop the foundations for a healthy and sustainable growth.

When is Cyprus going to regain its credibility in order return to international markets?

Klaus Regling: Regaining credibility will take time. But it will be achieved and it will lead to growth. The example of other countries showed that if the Memorandum conditions are followed, the recovery will come in due course. Greece's return to the international markets was achieved after four years of Memorandum regime. Concerning Cyprus, it is estimated that by 2015 the economy will start growing again.

At this stage, can Cyprus attract investors?

Klaus Regling: Yes. With the implementation of the Memorandum reforms, Cyprus will become an attractive investment destination again. The latest upgrades that Cyprus received from international credit rating agencies have been a positive factor for investors. With the reforms Cyprus will regain competitiveness. I firmly believe that 5 years from now the countries that have borrowed from us will have the best economic performance across Europe.

Do you think that Cyprus may fail the stress test?

Klaus Regling: I have no reason to believe this. As part of the programme, the Cypriot banking system was analysed in detail. So I do not expect any surprise. It is important that the stress tests are performed in the same way in all EU member countries in order to see the full picture. Carrying out the tests properly will offer credibility and confidence to the markets.

What would be the benefits for the EU countries from the banking union?

Klaus Regling: The decision to create the banking union was imperative for Europe and it should have been put in place earlier. However, it is through the crisis that we learn what is missing in order to create an integrated monetary union. The banking union is important for Europe because it creates a single banking market where the same rules apply. The ECB will be the supervisor of this union that will be put into action in November.