

Interview with Klaus Regling, Managing Director, ESM

Published in *Hospodárske noviny* (Slovakia) on 16 September 2016

Interviewer: Tomáš Púchly

WEB VERSION

Hospodárske noviny: When Mario Draghi pledged to “do whatever it takes to save the euro” in 2012, it calmed the markets and reduced pressure on highly indebted Eurozone countries. Seemingly, it brought the debt crisis to an end. So why do we still need mechanisms like the ESM?

Klaus Regling: That is a very good question. I do not believe that it was just one statement that rescued the euro. Draghi's statement was indeed very important at the time to help calm down the markets. What the ECB has been doing in recent years has also been very important. But that alone would have not taken us out of the crisis. There are number of elements in addition to monetary policy.

Which were the most important?

The most important is that countries that needed help, because they lost market access, have actually done their homework. They have implemented structural reforms, reduced their fiscal deficits, and reduced their current account and trade deficits. They cleaned up their banking systems – depending on the problems they had. Adjustment in the countries that were in serious problems: that was the key.

Also creating new institutions was very important. If the EFSF had not been created in 2010 and ESM in 2012, probably some countries like Ireland or Portugal would have been forced to leave the euro area. That would have been a big loss and would have changed Europe. Also we have the banking union and other important developments. The ECB actions alone would not have worked if these other elements had not been in place. Overall, it was a whole package of measures that took us out of the crisis.

Speaking of adjustment measures. Countries forced to take them are now enjoying healthy growth. But there are countries, like Italy, that were able to just postpone tackling their problems. Aren't they something like ticking bomb?

In general it's always better to take adjustment measures early. But you are probably talking about the banking system in Italy. I think it is not correct to say that the Italian banking system in general is in trouble. Most recent stress tests have shown that only a small number of Italian banks need to recapitalize, but most banks are fine. They are working on the problems identified. Some banks were already recapitalized, others are in the middle of it. So it is not a general issue.

The recent stress test checked only large systemically important banks. But the source of potential contagion is feared to be in regional banks.

Again, it's not fair to say it is all banks. It is just a limited number and some of these smaller banks have been working already on recapitalization during the last few months, so it is a limited problem. But it needs to be addressed, of course, and the Italian government is doing that.

Alongside the already implemented Atlante fund, Matteo Renzi's government is also trying to negotiate exception from the new EU-wide bail-in rules – in order to implement a more convenient government-backed scheme. Do you think it is necessary to grant such an exception?

The Italian authorities and the European Commission are working hard to find a solution within the existing system. As part of the banking union, we have a complex system but I am sure that solutions can be found within that system.

Can we rely on current measures to prevent the potential contagion from the banking system of one country to the others – in case a crisis would emerge?

In general, the European banking system is in much better shape today than 8 years ago. There are several ways to look at that. The capital of the European banks is twice today as it was in 2008. A total of €600 billion, which is an enormous amount, has been added to the capital of European banks. That also means that capital ratios are doubled today. All of this helps to stabilize the banking system. There are isolated problems, but they are easier to tackle with much higher capital.

And we have the banking union, with several institutions in place, such as the SSM and the SRB. Also, the ESM has instruments available to help banks, if there is a need. I don't foresee that but in an unforeseen and deep crisis, the ESM is another line of defence available for banks. Overall, contagion risks today in general are much less than a few years ago.

But if we look at the beginning of this year, there was a strong turbulence on the European markets, especially of bank shares. Does it mean that the previous crisis is not entirely cured yet?

It's true that bank shares in Europe went down significantly. But not only in the EU – also in other countries like Switzerland and US. Some of that was also triggered by downward revisions of world growth, and in particular in China, which had an impact also on banks.

What about remaining problems in the balance sheets of the banks?

There are some important remaining legacy issues from the crisis the banks have to deal with but, overall, the crisis is over. Earlier I mentioned individual cases in individual countries, but these are legacy issues: the large amount of non-performing loans for instance. For the euro area as a whole, the amount is about €900 billion. That's a big number. But at the same time, it's important to remember that more than half of it is already taken care of, through provisioning which, on average, amounts to 52% of NPLs. Nevertheless, high amounts of NPL are a problem for the profitability of banks. They also may have constraints in their balance sheets to provide new loans, new credit, which is important for the economy. There is also overbanking in certain countries, which may require some mergers. So there are these kinds of problems, but I think it is very, very different from being in the crisis situation for the entire system.

Are we ready for the next crisis?

That is what we are working on. Crisis prevention is important, that's why it's good to have new institutions set up in the context of banking union, like the common European supervisor – the SSM, but also the resolution authority, the SRB, or the ESM, as a last line of defence. Not because we expect them to be needed anytime soon. But at the same time we know that one day, there will be another crisis. It is part of our economic system. With adequate crisis prevention, it should not happen too early and should also not be as deep as the last crisis was in 2009. That is what we are trying to achieve.

But at the same time we have to recognize crises happen when nobody expects them and in areas that are not expected – that is the characteristic of the crisis. That is why it's important to have several mechanisms that can deal with different sets of problems.

So you are saying that in order to prepare for the next crisis, it is necessary to strengthen institutions at the European level.

We have come a long way over the last six years. We have new instruments, much better and broader economic surveillance, which means better economic policy coordination and cooperation. This is true for the fiscal area but it goes much beyond the fiscal area. It includes other areas, where we did not have it before the last crisis. We have the so-called macroeconomic imbalances procedure, to detect other risks to the economy, such as housing price booms, divergences in competitiveness or excessive current account deficits. This is a very important process for the better functioning of the EMU.

We have the new institutions, not only ESM, which has a €500 billion firepower, but also in banking supervision we have the EBA, there is also the ESRB, the Single Resolution Fund, and the SSM. These are institutional innovations that did not exist before the crisis and are very important to have.

Most of the problems that existed in many countries in 2008 and 2009 – substantial macroeconomic imbalances – have disappeared or become much smaller. So we are in better shape today and better prepared for whatever may come. That does not mean there are not some remaining issues that we should look at.

Let's stick with the firepower of the ESM. What exactly would unfold, if a hypothetical debtor country to the ESM (let's call it "Debtland") ended up in default? This was the subject of heated discussion and lot of misconceptions in Slovakia during basically every crisis in Greece.

That is very legitimate question and not only in Slovakia. When the ESM was created, parliaments in all the countries wanted to know what risks they were taking. Also credit rating agencies looked at that very carefully, because they rate the ESM and they gave us a very strong rating – that's why we can issue bonds at low interest rates. They need to have confidence that we have good mechanisms in place to deal with those hypothetical, even very unlikely events.

So how exactly this mechanism works?

It's technically very simple. If indeed a country cannot repay –which I don't expect to happen – we would still need to repay our bonds with investors and pay interest on those bonds. We would draw on our reserve buffer, which is filled up with our annual profits we have generated over the last four years. At the moment it is €1.4 billion. That would be our first line of defence.

If it were not enough to honour our commitments with investors, we would go to our paid-in capital, which is more than €80 billion. That is a big amount. All 19 member states paid that money to the ESM, including Slovakia, which paid about €660 million. We could draw on that, which at a later stage would need to be replenished. So there would be no immediate consequence for the national budgets and any costs would be spread over many years, so budgetary impacts would be very small every year.

Just to put it very simplistically, just as some of the politicians like to do it: Could Slovak taxpayers expect to receive some kind of invoice from Luxembourg right away, if hypothetical default should occur?

No need to worry about that. This is ruled out. In the worst scenario, if there were a big loss, it could be spread over 30-40 years so that an annual impact would be very small. But again, it is hypothetical and we have paid-in capital and reserve buffer – big amounts of money available for such a situation – that is why it was created that way and I think countries can be assured there won't be any unpleasant surprises.

Another issue is triggering default. The last crisis situation in Greece revealed that there is some leeway. Greece missed a payment to the IMF, which threatened to trigger the cross default, but basically nothing happened. How much is it matter of rules and how much a political decision?

Cross-default comes from a clause in our lending contracts, which following a given trigger we would call on all our outstanding loans with Greece. This has nothing to do with our bondholders and does not require any immediate capital from our shareholders. It is a legal technical issue. There is some leeway on the exact timing. If there is real default for long time, then cross default clauses will be triggered.

Let's stick with Greece. Both the first and second package turned out not to be sufficient to pull the country out of trouble. Right after the third package was barely approved, heated discussion broke out whether it would be different this time. It is possible that a fourth program could ensue?

I don't think there is a debate whether the third programme will be sufficient. This third package was agreed about a year ago in a volume up to €86 billion and from today's perspective, not all of that will be needed. It runs until the middle of 2018 and if Greece implements all the reforms that are part of this programme, by mid-2018 Greece can again stand on its own feet and will be able to have market access and refinance itself. So I am quite confident this is sufficient.

But you are right: Greece needed three programmes. That is a lot of money over a very long time. The other four countries that received loans from the EFSF and ESM, each of them needed just one programme. This shows that the problems in Greece were much bigger in the beginning. So the country had to do more.

What exactly created the need for other two packages?

The implementation capacity of Greece was weak. The administration was weaker than in the other countries, so that is why we have seen again and again delays which are regrettable.

And, not to forget – during the first half of the last year, Greece went backwards, in the wrong direction. The first government of Prime Minister Tsipras tried a new approach. They reversed some of the reforms and the economy went back in recession. That has been now corrected and since August of last year, cooperation is again good and Greece is making progress.

So if Greece hadn't gone backwards after the elections, it could have avoided the third package at all?

That is a good question. I remember that at the end of 2014, as we were coming to the end of the second programme, there was a discussion about a possible third programme, but the amounts that people were talking about – if at all a programme was needed – was 10, maybe 20 billion euros. In the end we needed €86 billion. That shows how big the problem became after policies went in the wrong direction for six months.

If I remember correctly, by the end of 2014, European Commission already expected Greece to return to economic growth as soon as 2015.

Yes, and I also remember the IMF forecast from the end of 2014. In December 2014, the IMF projected 2.5 percent growth for 2015 and 3.5 percent growth for 2016. We know forecasts can be wrong, but that was a consensus view at the time. So instead, it was reversed by policies and Greece went back to negative growth in 2015. In the second quarter of 2016, there was small positive growth again. So I think now Greece is getting back to where it was in 2014.

So what we have seen in Greece is just the cost of postponing the reforms.

Not only postponing, but also reversing some of them. The governor of the Greek central bank has come out publicly and said that cost of the first half of 2015 was €86 billion.

Where does the ESM stand in the discussion between the creditors and the IMF about further debt relief for Greece? Is Greece's debt sustainable?

First of all, it's important to remember that a lot has happened since 2010. Greece received substantial debt relief in 2012. Private creditors accepted a nominal haircut of more than 50 percent. That was the biggest haircut in world history. And of course, it saves Greece a lot of money until today.

Official creditors also granted debt relief in the form of longer maturities, lower interest payments and interest deferral for 10 years. The result is that Greece actually saves a lot of money every year in its budget. At the ESM we estimate that every year Greece saves more than €8 billion in debt service payments. These are real savings. That is equivalent to 4.5 percent of GDP for Greece, every year.

Without any cost for Slovak or German taxpayers. These savings are generated because we have taken on so much of the Greek debt – almost half by now – and we charge our own very low funding costs, which are much lower than what Greece would have to pay in the market. This really helps Greece's economy and budget. This is solidarity from the rest of Europe for Greece. So it really helps them and there is no burden to the taxpayers. This is the beauty of our setup.

One could say that every debt is ultimately payable, if we stretch its maturity long enough...

Yes, but we don't need to exaggerate. Take Germany as an example which had a similar experience with its debt agreement of 1953, after the Second World War. Debt was paid back over a 50-year period. And it worked.

Back to the debt sustainability issue. Greece shouldn't have problems with that in the foreseeable future. But some economists argue that there is another problem – that the sheer amount of debt would prevent Greece from regaining market access.

Some academics who present these arguments have not really looked at the facts. How small is the amount is that Greece has to pay to its creditors? At the moment, it is lower than in many other euro area countries. At the moment, there really is no burden. And there won't be one for a long time, because our loans to Greece already have an average maturity of around 30 years. There is also no risk that we will withdraw money like private investors might do if there were a new problem. So it is a safe investment. Other investors know that. They know that Greece has no debt service problem for at least the next 10 or 15 years and that is why I am very confident that Greece will be able to start issuing bonds – maybe next year.

What is necessary, of course, is to continue with reforms. If they stay on course, they will get out of these current problems. The savings every year are so big, that they have a real possibility to grow out of their debt issues.

You seem to be quite confident about it...

If Greece continues to implement its reforms. And that is a big if.

But we have heard similar optimistic predictions also during the first and second package. What is different this time?

As I've said, the problem was that Greece reversed some of its policies. Implementing adjustment policies is key. But unlike the other four countries, we have seen delays again and again. And, of course, it makes the adjustment longer, more difficult and problems become bigger.

What are the key lessons you have learned from this programme?

There are many. To start with, our surveillance mechanisms in euro area. They were not adequate before the crisis. That has been improved. The data collection for instance was not good before the crisis. We know today that Greece cheated on its fiscal and debt numbers for many years, because Eurostat did not have the power to go to the country and check the data. After the crisis that was changed, so now we can be more confident the data that are reported are correct. And therefore, I

think I can rule out we will ever again have a surprise like we had in Greece in 2009, when all of the sudden, the fiscal deficit was 15 percent of GDP, which nobody expected.

How did we deal with the crisis when it happened? I think one has to accept that in crises, decisions have to be taken very quickly without all the information that one would like to have. And therefore, mistakes can happen. But looking at the results, I'd say we have prevented a worse crisis and placed the euro area in a better position than before the crisis.

And then, there is a question of ownership of the programme by respective governments. In the past, you repeatedly pointed out that this is a key for successful adjustment. How can the ESM and other creditors contribute to it?

It is indeed important to have ownership of the programme by the country. That is also a reason why negotiating a programme often takes time. One has to have detailed talks with the government, authorities and administration, so everybody understands why certain measures have to be taken. Also, even if we all agree on certain objectives, there are different ways to get to them and some ways might be more acceptable for governments. It is a complex process, but to have a successful implementation you absolutely need to have this ownership.

In Greece, unlike the other four countries, that was a problem from time to time – ownership was not always so evident.

To what extent is an adjustment programme a matter of negotiations with the respective governments and to what extent is it matter of just pushing through solutions prepared by the ESM?

No, it is really a negotiating process. And it has to be an agreement between the creditors and authorities of the country concerned. There has to be a consensus.

So it is nothing like imposing austerity on the country, like some critics like to point out.

No. That would simply not work. Countries may feel something is being imposed, because many in those countries don't realize that –what they call - austerity measures are a response to something that has gone wrong before. Austerity is only needed when there is a big fiscal deficit that nobody can finance any more. Something goes wrong first, it needs to be corrected and that's when a programme is necessary. It doesn't come out of the blue.