

Interview with Klaus Regling, Managing Director of the ESM

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CBN: We know that two of the five countries which received money from ESM have graduated from the program. Europe seems to be in a better shape today. Do you think the optimism towards European economies is justified? What kind of risks do you still have in mind?

Regling: Compared to Davos one or two years ago, there is a much better mood towards Europe. We do know that markets are volatile. They can be overshooting, which is a very normal behavior, and it may go too far. But I think the reason for this improvement is clear. There are several good reasons why the mood in the market is so much better today than one or two years ago. There are in my view four elements why markets are more positive in Europe.

First, in the countries that had problems in the past, and some of them still have problems in financing, i.e. Greece, Ireland, Portugal, Spain and Cyprus, reforms and adjustments are progressing and their competitiveness has been improved.

Second, we now have a much better system of policy coordination in the euro area. The criticism, particularly from our American academic friends, is that monetary union cannot work, because it centralises monetary policy and decentralises fiscal and economic policies. We say it will work, if it's well coordinated. Now the system we have is much broader and stricter.

Besides national adjustment and better policy coordination, we have new institutions in place. We have created institutions such as the EFSF (European Financial Stability Facility) and ESM (European Stability Mechanism), and also other instruments that didn't exist before the crisis, in particular the ECB's announced OMT (Outright Monetary Transactions) programme. So the third point is institutional innovations, basically closing institutions gaps. Fourth: strengthening the banks. European banks today have €480 billion more capital than in 2007. That's 4% of the euro area's GDP. We are moving towards banking union to strengthen the banks and banking system and to reduce the fragmentation in the European banking market.

These are all very good reasons, because progress in each one of them will continue. This is why the market is more positive, it is not just a mood swing.

CBN: Last October, you said that Greece may need a third aid package as soon as in 2014. Do you still hold this view?

Regling: That's a possibility. It's not decided yet but it seems like a real possibility compared to other countries. Ireland and Spain exited their programmes and do not need more money. Portugal will conclude its programme in a few months, and they probably also do not need more money.

If everything goes very well in Greece it may not need more assistance. But my central scenario would be that more loans are needed. In any case, the amount will be very small. The last programme (the second Greek programme) was €140 billion. If there is a third programme for Greece, it will be a fraction of that, probably less than 10% of the second. It's a big change, because they have made so much progress on the fiscal side. The fiscal deficit in Greece this year will be 2% of GDP, which is one of the lowest numbers in the world. It is lower than the US or Japan, even Netherlands, Finland or some of the most fiscally responsible countries in Europe. This is big progress, particularly if you remember Greece had a deficit of 15% four years ago.

CBN: We met the Prime Minister of Greece last year and asked him if the country needed a new plan. He said no and ruled out every possibility. Have you had talks with the leadership in Greece? Why did they say no to the next aid package?

Regling: If they can avoid it, that is great and everybody will be happy. But it means that they have to be very strict on their adjustment, and have to be able to go back to the market. Nobody knows how the market will react to that six months from now, which is too far away. Whether the interest rate Greece will have to pay in the market is reasonable or excessive, we will see. If they manage, everybody will be happy. I am just saying what is more likely in my view, but I will be very happy if a third programme is not necessary.

CBN: There are some options of solutions for Greece, e.g. debt rollover, extension of bond maturities. Which one do you prefer in terms of debt sustainability?

Regling: That is something we will discuss in detail in the summer. My point is that it is not sufficient to look at the debt ratio (debt to GDP), which is very high in the case of Greece. We should also look at the financing flows, the level of real burden on Greek budget and the Greek economy. We know that for Greece, for the next ten or twenty years, there will be no debt overhang. Our financing is very long term. The EFSF is the biggest creditor of Greece, and the average maturity of EFSF loans is 30 years. So Greece is not repaying any capital in the next 25 years. The interest rates we charge are very low; they are half as high as the IMF interest rate. That is just our funding cost. For the next 10 years, we agreed on an interest deferral, which means Greece is not paying any interest and no amortisation to us. So there is no debt burden for the next ten years. In that sense, there is no debt overhang, because the normal argument is that too much debt will be a burden on the budget. Foreign

investors are reluctant to invest because they are afraid that taxes might be raised to pay these debt services. But all this will not be an issue for Greece in the next twenty or thirty years. Investors have to understand this, and can see that there won't be much debt service burden in Greece in the next twenty years. And therefore, it is not sufficient to look only at the debt to GDP ratio.

CBN: Do you see any country in the euro zone that may need help from you in the near term?

Regling: No, I don't see that. I'm realistic. I think developments have proved that I am not optimistic, but realistic. There was for a while a debate about Slovenia, but that has died down. We now know the results of stress tests for the banks. Slovenia is able to finance those capital needs by themselves. Beyond Slovenia, there wasn't even a debate for any other countries.

CBN: As to the macroeconomic situation in Europe, the managing director of the IMF used an interesting term called "the ogre of deflation". Are you afraid of deflation in the euro zone?

Regling: No. Most people in Europe are less afraid of deflation than the IMF and some other observers. The IMF's view is not well reflected in the headlines but in the fine print. They say the risk of deflation is 10%-20%. That may be true, which means that the risk is low. I also think it's low. I don't know whether it is going to be 10% or 15% or 8%. I'm not saying it's zero but it is low, for the simple reason that when I look at euro area countries we are clearly in a period of low inflation, like in the US and most industrialised economies. In Southern European countries, we are happy that prices are falling. This is part of the design of the programmes, we wanted it to be that way, so that these countries will gain competitiveness. This is not unintended, or undesired, quite the opposite, it's wanted. Peripheral countries accumulated problems in the past and once they have done their adjustment they will go to a normal situation. At the core of Europe, when you look at Germany and France, the two countries are 55% of the euro area, we see wages growing 2% to 3%. A growing cost base around 2% to 3% is not compatible with deflation. It is very hard to see why deflation can happen.

CBN: If the risk of deflation is very low, do you think ECB needs to take any further steps in accommodative monetary policy in the near future?

Regling: Mario Draghi knows what to do. In my view, the most urgent task for the euro area is to make sure the monetary transmission mechanism works again. It is not working at the moment. We have a fragmentation in markets, and that is why the low interest rates of the ECB do not reach the Southern European countries. In my view, that is the biggest problem. Whether rates are 10 basis points higher or lower is not of key difference. But if we manage

to bring down high spreads in Southern Europe, not only for the sovereigns, but also for private borrowers, corporates, SMEs, consumers, that would be very important to reintegrate financial markets in Europe, and will also help the real economy in Southern European countries.

CBN: Do you see any improvements in terms of fragmentation of different countries? It seems that when the markets' mood towards the euro zone improved, the yield spreads have shrunk quite a bit across the countries. Do you think it is a natural result?

Regling: Fragmentation began when there were doubts in markets about the long-term prospects of the euro. To the extent that this fear that the euro area might break up has disappeared, we see a positive impact on fragmentation and spreads. But we are still not where we would like to be. There is still some fragmentation, and that is why we are all working very actively on banking union. The main purpose is to create a real integrated banking market again without fragmentation. I think that truly is a priority.

CBN: What are useful tools here to fix the monetary transmission mechanism?

Regling: I think we have to do many things. In the context of banking union, now the ECB will become the common supervisor and they will do the asset quality review and the stress tests. We will discover whether there are any problems anywhere in the system. We do not expect big ones, maybe a few small ones. So it is important to understand better what the situation of all the big banks is. Particularly because some people of the market are suspicious that there may be problems. Either we find some problems or they are really not there. So that will be important. Also, we need to set up the other instruments that complement the SSM (Single Supervisory Mechanism). There is work going on with the SRM (Single Resolution Mechanism), and the SRF (Single Resolution Fund). We will have, in the end, a real integrated banking market. I think it is the best we can do for the real economy in Southern European countries.

CBN: The three pillars of the banking union are in progress. But still the skeptics believe more is needed. Do you think we have reached a critical point that things will get better soon?

Regling: It will definitely get better. It has been better, more than expected, because most people thought that Europe will disappear. To create a full banking union will take a decade. It is a big project, and some people think it is as big as creating the euro. Therefore one needs a bit more patience, because it is a complex technical issue to create a banking union. Many steps are needed, and new institutions will be established, so it cannot be done in one night. But I think it is important that the process has started, the ECB has become a common supervisor, and they are preparing themselves. The ESM has been asked to prepare for the

possibility of direct bank recapitalisation. That may not happen but the possibility will exist. I think that is very useful to have the instrument. The other elements of banking union are still under negotiation with the European Parliament, but I am optimistic that we will make progress in the next few months.

CBN: What would be the progress in terms of banking deposit insurance schemes?

Regling: That was agreed in December. It was a harmonisation of national deposit insurance schemes. So there will not be one scheme for all. Every country has its own system, and those who don't have it will create it, and they will all follow the same standards and comparative rules.

CBN: On the situation of banks, when people compare European banks with those in the United States, they would say that the latter have finished deleveraging, and are very well capitalised now, while European banks are believed to be much more fragile. Do you agree with this observation?

Regling: I would agree with the first part of the statement, but not the second part because European banks are much stronger now. I agree that the US system is more advanced. They have done more deleveraging, and probably are in a good shape on the capital side. But deleveraging has come a long way in Europe, and it is not over. On the capital side, I already mentioned that since 2007, €480 billion in additional capital was raised for the European banks. For that reason, I think banks in Europe are much less fragile than three or four years ago. But there is still more to be done. The stress tests and asset quality review will show where our gaps are.

CBN: If the deleveraging process continues, it will have a negative impact on the economy, which might risk the recovery of euro zone in the near future.

Regling: There are risks, but to the extent that capital is becoming adequate, then of course the need for the deleveraging is smaller. So there is a link with the level of capital. And also, we have interest in this movement in Europe. Europe has been relying much more on capital, on bank financing (about 70% of capital flows come traditionally from the banking sector) than the United States. The percentage is coming down, and other resources are stepping in and taking over. We know a lot is happening. We know that many mid-sized companies that never went to financial market do it, now that bank financing is difficult. SMEs began to do what big corporates usually do, to issue bonds, corporate bonds and P2P (Peer to Peer) loans. These are all new sources of financing. I am sure the trend will continue, because a few years ago, banks provided 70% of financing in Europe and only 30% in the US. So there will be some movement in the US system. But I won't be surprised in a few years if banks only provide 50% and other sources of financing will step in. So you cannot only look at bank deleveraging and say this is bad, there may be other sources of financing that make up for it.

CBN: During the deleveraging process, if some banks failed, what will happen to them? Would that cause another round of market turmoil?

Regling: The ECB has said many times that they do not expect big surprises, and I agree with that because in the five countries that borrowed from us (the EFSF and ESM), we know the banking sector quite well. In the context of these five country programmes, the banking sector receives or received money from us. In Spain, all the money went to the banking sector. But in the case of Greece, for instance, out of the €140 billion overall support package, €50 billion went to Greek banks, that is why we are in close contact with HFSF, the Greek banking fund. Banks have been scrutinized several times in Greece, Spain, Portugal and Ireland. So that is why I have some confidence that we understand them quite well. And those are the five countries that created most problems in the past. In northern/core countries, e.g. Germany, Austria, Netherlands, if something happens it can be taken care of by the governments so I'm not too worried. That means very few countries are left, and therefore I do not expect any turmoil to reappear for that reason. We have enough resources in the ESM, which could be used if necessary. All in all, I don't think this will be reason to re-trigger another crisis.

CBN: Is it for the same reason why you said that we don't need the Troika or the IMF anymore?

Regling: No. I said that for the next crisis we may not need the IMF. For this one, nobody wants to throw out the IMF. We are in the middle of a process, Spain and Ireland have exited their programmes, but the other three countries (Greece, Portugal, Cyprus) and we are happy the IMF is there. But in the long run, in the next crisis which may come in 20 years or so, we will be in a different situation. Normally there is a crisis once in a generation. It is important that countries adjust to avoid new crises. They are part of our economic system but if a country does its homework and has good fundamentals, it should not happen too soon. With better policy coordination, with adequate institutions, with stronger banks, which are the essential elements of our crisis response, it should also mean that next crisis will not come that soon.

CBN: Do you mean that the IMF will become irrelevant in Europe in the medium and long term?

Regling: No, I wouldn't go that far because all European countries are members of the IMF, like China also is. . If there is another crisis in Europe, we will see how much we can do on our own. But each member state of the IMF supports it and if a country is in trouble it has the right to seek help from the IMF. Why should European or other countries give up that right?

CBN: If you have a blueprint for the euro zone in the long term, which part is the most important now?

Regling: The countries must conclude their adjustment processes. They have come a long way, but it's not over. Even Ireland, though it has exited, still has a fiscal deficit of 7% of GDP, which must be reduced and cannot stay at 7% forever. So, the first thing is that countries should conclude their adjustment. The other focus at the moment is the move towards banking union. Regarding fiscal union, one extreme definition of fiscal union is that all countries give up their national budgets and there is one budget for all of them. Then we would have the United States of Europe. This is unrealistic and will not happen soon. But we have moved towards a fiscal union in several important ways: tighter rules for policy coordination, particularly on the fiscal side, are a step towards fiscal union, not a complete fiscal union, throwing all budgets together, but on a system of much tighter rules to conduct fiscal policy.

CBN: In the long run, will the ESM continue to raise money from emerging markets including China, or there is no need for that?

Regling: Once the crisis is over, there is no need for additional money. But we will continue to be in the market, because our average lending maturity for Greece is 30 years, and for Portugal and Ireland it is 22 years. The average maturity on our liability side issuing bonds and bills is only 6 years. We need to refinance until all the countries repay their debts. That means for that the next 30 years, the EFSF and ESM will continue to be in the market issuing bonds and so we need international investors to buy these bonds. I hope that China will continue to be there, like many other countries.

CBN: Could you shed some light on how big the share of Chinese investors is?

Regling: As you know, from last year, we do not give details about that. But now we have the share of Asia at 21%. We are very happy about the support from Asia.

CBN: If we compare post-crisis economic performance between Europe and the US, US is somehow performing better. Some observers think that this is because monetary policies adopted in the US are more accommodative. Do you think such difference was more due to policies or economic fundamentals?

Regling: We are not so sure that the US is doing better. First, you have to take out population differences. On a per capita basis, GDP growth in Europe is not that much below the US. Second, the labor market has developed much better in Europe than in the US. Despite the fact that our unemployment rate is twice as high as it is in the US, more people actually have a job in Europe than in the US. In the US the participation rate has been dropping. Another positive point about Europe is that the income growth in Europe is widely shared. We know from official data that in the US 95% of the income gains for the last five

years went to the top one percent! That means most people don't have any income gain. In Europe, income gains are shared much more widely. Income equality is much better, so more people have jobs. More people, expressed in percentage of the population, actually have a job, and an income, and most of them have income gains, unlike in the US. Which system is better?

CBN: Inequality in Europe is better than the US, but the trend doesn't look good.

Regling: The Gini coefficient also went up in problem countries in Southern Europe, but it is still far below the US. While in Germany and the Netherlands, the Gini Coefficient has been decreasing. Income equality is much better in Germany. The fact that inequality is much better in Europe is a strength, because it means more cohesion. This also explains why Europe managed to get through the crisis without a revolution.

CBN: As head of the ESM, your life seems easier now as the crisis is almost over.

Regling: I wouldn't say the crisis is over. We still have things to do. In the narrow sense, the ESM will be in this business for thirty years because of our loans for Greece are that long, so we have to work a lot to manage this. But it will not be under the same crisis mode that we had some years ago. Life is a bit easier. At the moment, it is still interesting because we are building up new institutions, increasing staff, working on our processes. We will be asked to develop direct bank recapitalisation, which is a new business line, and different types of staff are needed. There is a lot going on and I'm sure we will not get bored very soon.