Interview with Klaus Regling, Managing Director, ESM

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By Dalius Simenas

- **Why does Lithuania have to become a Member of the European Stability Mechanism, as a new euro zone Member State, and what role does the ESM play?**

Becoming a member of the European Stability Mechanism, the ESM, is the logical consequence of joining the euro area; all its current 18 Members are part of the ESM. Since the ESM is the euro area's crisis resolution mechanism, Lithuania's ESM membership is like an insurance policy for the unlikely event that Lithuania should re-experience a deep crisis and get cut off the market.

- **How does this insurance against crisis scheme work?**

The ESM was founded in October 2012 as the euro area's permanent crisis resolution mechanism. The ESM provides loans or credit lines to euro area countries that lose investor confidence and therefore cannot borrow on the market any longer. By doing that the ESM safeguards financial stability in the euro area. So far, the ESM has provided financial assistance to Spain and Cyprus in the amount of around €51 billion. Prior to the ESM, the euro area Member States founded in 2010 the European Financial Stability Facility (EFSF) as a temporary rescue fund, which has provided loans in the volume of €185.5 billion to Ireland, Portugal and Greece. ESM and EFSF loans come with conditions attached. Beneficiary countries have to undertake far-reaching reforms and consolidate their budgets so that their economies become sustainable and competitive again. This strategy is working, as the successful end of the programmes in Ireland, Portugal and Spain demonstrate.

- **Everyone understands there is no free lunch. What costs does this crisis resolution mechanism bear for Lithuania?**

Lithuania has subscribed a share of the ESM capital. A part of that capital has to be paid-in. As a country with a GDP per capita of less than 75% of the EU average, Lithuania benefits from the temporary correction for new members of the ESM. Based on this key, Lithuania's contribution to ESM paid-in capital will be €327.2 million. It will be paid in five annual tranches of €65.4 million. Once the temporary correction comes to an end in 12 years (in 2027), Lithuania will make a further contribution of €159.4 million to ESM paid-in capital. There are no other costs for Lithuania as the ESM covers its own administrative and operational costs. Also, I would like to stress that Lithuania is not becoming a member of the EFSF. Therefore Lithuania has no obligations in the context of the EFSF programmes for Ireland, Portugal and Greece.

- **Euro area Member States participating in the ESM are committed to unpaid, so called callable capital which exceeds by far the paid-in capital. What are the circumstances under which Lithuania would have to put in all callable capital to ESM?**

Only in the very unlikely event that the ESM's paid-in capital proved insufficient to cover losses, the callable capital, which for Lithuania stands at €2.54 billion out of a total of €702 billion, would have to be called. Currently this is excluded. The reason for that is that the ESM's total paid-in capital of €80 billion exceeds the €51 billion the ESM has committed in financial assistance to Spain and Cyprus. And even if the ESM was to provide more loans to countries – and there is no reason to believe this will the case at the moment - we have mechanisms built in our system to make sure that countries do repay their obligations towards us. Most importantly there is the conditionality for the countries that benefit from our loans. The evolution in all our programme countries shows that conditionality works. It forces our beneficiary countries to adopt better policies which lead to better economic performance and then the countries have no problem repaying their loans. This also is the experience of the International Monetary Fund, the IMF. The IMF has done this in hundreds of cases in the last 60 years and the institution has never made any losses.

- **Why was the ESM created in Europe when IMF financial aid is available and it has proven to be to works well?**

The way the ESM works is indeed very similar to the IMF. This is not surprising because we have imported their recipes and approaches into our system in Europe. It was necessary to do this for two reasons: first, our problems in the euro area were European problems so it was normal that the Europeans get engaged in solving it. Secondly, the IMF would have been unable to provide enough money to keep Greece, Cyprus, Ireland, and Portugal in the euro area. Without the EFSF and the ESM some of our beneficiary countries would have had to leave the euro area. That would have been a real tragedy for the euro area and Europe as a whole. I think Europe would be a different place today if that had happened.

- **Why should Lithuania join the ESM if there is already the IMF?**

There are several advantages of ESM assistance compared to the IMF. Most importantly, it is cheaper for the beneficiary country because the interest rates for ESM loans are much lower than IMF rates. Also, the maturities of EFSF and ESM loans are much longer than for IMF loans, they are up to 20-30 years compared to 10 years at the IMF. Should Lithuania ever get into a situation where it would need loans from the ESM, it would benefit from the solidarity of euro area countries. We have to go to the market and issue bonds to be able to lend, and then we pass our low funding costs, which at the moment are around 1.5 percent and we do not add any margins. Ireland for instance was paying on a large part of the IMF borrowing around 5 percent interest rates while for us, for recent loan tranches, they pay just around 1.5 percent. So they decided to repay the IMF back in advance, but not to do the same with us. And for Ireland it is good to repay the expensive loans back in advance and to keep the cheap loans with us. Also Greece and the other programme countries benefit from our comparatively cheap loans. Because of the favourable financing terms from ESM, Greece saved 4.7 percent of GDP on their budget in 2013. That corresponds to €8.6 billion. That is a tremendous amount, a sign of solidarity from the euro area. Importantly, this is achieved without any costs for taxpayers in the euro area. Also, keep in mind that the ESM has instruments that the IMF does not have such as, for example, indirect bank recapitalisation and primary and secondary market purchases. As a last line of defence, the ESM is able to directly recapitalise banks by acquiring common shares in the beneficiary institution.

- **In its latest forecast the IMF raised its probability estimate of a recession in the Eurozone from around 20 to 40 percent. What probability do you see of another spree of sovereign bailouts like we witnessed during 2010-2013 ?**

It is very unlikely that any new countries would need a financial assistance from the ESM in the foreseeable future. It is true that the economic forecasts have need revised downwards but they are still positive. But I think that the probability of 40 percent of the recession seems a bit on the high side.

- **The Lithuanian parliament last week passed the budget law for 2015. Experts labelled it as too optimistic and it may need change. What would you recommend to keep the country**

finances intact and how to resists the temptation of swelling up the sovereign debt due to low borrowing costs as we enter the Eurozone?

As far as I know, before approving the budget there were some last changes made without changing the balance of the budget. What I can say is: I have always seen Rimantas Sadzius, Lithuania's finance minister, in the ECOFIN Council and more recently in the group of euro finance ministers displaying a very stable and very determined attitude towards the budgetary situation and I expect that this will be the case again this time. We know that there are uncertainties in the economy. This is true for all countries. There are a number of uncertainties where governments have no influence, particularly what is happening beyond the external EU boarder in the East. So, I think one has to live for a while with uncertainty and see what the actual growth rates will be. However, from the forecasts I have seen from different international forecasters, Lithuania next year will grow significantly more than the EU average, which is a bit below 2 percent of GDP. It seems that the developments are quite sound and I am sure that the finance minister, the Government , and your President Dalia Grybauskaite whom I know from her times as Commissioner in Brussels, where she was a very strong manager of the EU budget, will make sure that the budget will continue to be managed in a sound way .

Short bio of Klaus Regling

Klaus Regling is the first Managing Director of the European Stability Mechanism. He is also the CEO of the European Financial Stability Facility (EFSF), a position he has held since the creation of the EFSF in June 2010.

Klaus Regling has worked for 38 years as an economist in senior positions in the public and the private sector in Europe, Asia and the U.S., including a decade with the IMF in Washington and Jakarta and a decade with the German Ministry of Finance where he prepared Economic and Monetary Union in Europe.

From 2001 to 2008 he was Director General for Economic and Financial Affairs of the European Commission.

Mr. Regling studied economics at the Universities of Hamburg and Regensburg.