

Interview with Klaus Regling, Managing Director of the ESM

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Three months ago you said that if Portugal requested some precautionary assistance, it should go for the tougher line available, given its weaknesses. Now Portugal makes a clean exit. How do you explain this?

Klaus Regling: The situation improved faster than most people expected. It is the result of the strong implementation of the programme, but also of a better than expected market situation: more capital inflow into Europe than we had expected three months ago, partly related to emerging markets not doing so well. Experience shows that once markets start moving, they move a lot.

If Portugal asked for a precautionary line, would it access the lighter solution you have available?

Klaus Regling: It is hard to say. That would have to be discussed in the Eurogroup but it is not an issue now.

Portugal issued 10 year bond at 3.5%, the best interest since 2005. Is Portugal as risky today than in 2005?

Klaus Regling: Portugal, like many other countries, is less vulnerable than nine years ago, because of all the reforms adopted. Also, we are better prepared in Europe than before the crisis: we have a much tighter system of policy coordination and we have the EFSF and ESM as permanent institutions that can provide emergency finance if needed; and thirdly we are moving towards the banking union. All these elements have improved the risk assessment of the euro area as a whole and of every country inside the euro area.

The situation in Portugal has improved considerably, but public debt is way higher, the external debt is more or less the same and very high in European terms. How confident are you that all this debt can be dealt with?

Klaus Regling: The risks are there, not only in Europe. All industrialised countries after the crisis have substantially higher debt levels than before the crisis. That is why every country has to work hard to return to a more normal situation, to reduce debt levels.

The private sector indebtedness in Portugal is quite high, and external debt is over 200% of GDP. Not all countries have these figures...

Klaus Regling: Not all, but many countries in Europe and outside Europe have it. But Portugal also has it and one has to deal with that. The current account moved into surplus in 2013. A big success that is not often reported is the export to GDP ratio, which was traditionally very low in Portugal – about one third – has increased 10 percentage points during this adjustment period, from 35% to 45%. That is a big success and the result of competitiveness gains and reforms.

Exports' weight on GDP has grown, but GDP has come down considerably. On the other hand, imports' weight has been stable, which indicates that once the economy picks up, it might rise again. How do you see this risk?

Klaus Regling: Exports are a success, but not all improvement in the current account is coming from that. One part is cyclical, and it comes from the compression of imports, which is normal when GDP declines and some of that will recover. But it is important that through structural reforms competitiveness is further improved and that the current account situation does not become excessive again. That should be a central element in the strategy of the government.

Making sure current account deficits don't come back?

Klaus Regling: At least not a big current account deficit. If it is a small one, and determined by investment, that is OK. The composition is important: if it all goes into consumption, it's bad; if it goes mainly into investment, so that debt can be serviced, it's a completely different story.

A precautionary line, how much would it cost?

Klaus Regling: Until the money is actually needed and drawn, a precautionary line costs almost nothing. The expectation is that it would not be needed, and in that case there is no interest charged.

Portugal has built a cushion of around €15 billion, which might cost around €450 million a year on interest. What economic sense does this make, if this insurance could be granted, with no cost, by ESM?

Klaus Regling: Every country has some cushion. Ireland has it, Spain also, Germany has a big cushion too. That is a normal process and at this moment it is advisable to have a cushion that is large and maybe larger than before the crisis.

But you would concede that if Portugal had chosen a precautionary line, it would not need such a big cushion? Or is not related?

Klaus Regling: Marginally there is a link but I don't think it's a very big one. Interest rates are now historically low and therefore the cost is not that high.

From the European perspective, wouldn't it better not to have a country that is still fragile, spending this amount of money on a cushion?

Klaus Regling: I would not call Portugal fragile, just for the record. Reforms must continue but Portugal has moved beyond that. If markets become less positive on Europe – I'm not talking about Portugal – the ESM is there as a permanent financial backstop.

Would it be better for Europe to have Portugal exiting the programme with a precautionary line, as a way to minimize risks?

Klaus Regling: Risks are much smaller now and markets are very positive.

But a precautionary line is an insurance against the future. And there we can see a lot of risks: emerging markets making capital moving, stress tests by the end of the year, for instance. Wouldn't it be better just to minimize risk?

Klaus Regling: If reforms continue risks are very low. The Portuguese finance minister has expressed the same view: the adjustment is not over, reforms must continue and deficits must get smaller. The momentum in the markets now is extremely positive. We know this can change. But it will not change in the next few months.

If sometime in the next year or two Portugal faces funding difficulties and requests assistance from the ESM, do you think a precautionary line is available? Or it would more likely fall in a full programme again?

Klaus Regling: All ESM instruments are available to all its members. Different options were designed to the specific circumstances which affect or may affect an ESM member's capacity to access markets. The eligibility criteria are very clear in the ESM Treaty. On that basis, one would have to assess how serious the problems are leading to the request, and act accordingly. This includes the possibility of a full-blown programme but this is very theoretical now.

Portugal has succeeded in correcting important imbalances; it has started to regain market access and has now made a clear decision to stand on its own feet. I do not see now the need for any type of programme.

So, Portugal will be out of the programme in the next few weeks and we will be subject to an Early Warning System from the ESM until all the money is paid, which will happen in 2040. We have a long relationship ahead. What information...

Klaus Regling: I'm looking forward to that. We had a very good relationship with the Portuguese authorities and government.

What information will you need?

Klaus Regling: We have a clear mandate in our Treaty to make sure we get repaid. Twice a year we'll join the Commission on a mission to every country that has borrowed from us. We will check the liquidity situation and the economic outlook to make sure the loans are repaid. That is the interest of all shareholders, including Portugal. This will not mean further conditionality.

But what information will you need regularly?

Klaus Regling: On a continuous basis we will know exactly what is due from each of the countries that borrowed from us. We need reimbursements to be made on time, because we have to repay our bondholders. That means a close look at the budget for the next six or twelve months and also a long-term look at the economic situation and developments, which is needed for the sustainability analysis. It will not be an extra reporting burden.

Will you be looking at policies?

Klaus Regling: In a way, looking at the budget and economic outlook always means to look at policies, but it does not mean that we will, in any sense, negotiate policies. We only have to monitor and make sure no problems will show up.

You've worked at the IMF for many years, from your experience what usually happens in countries after leaving programmes: do they usually relax the reforming effort? Do you see that as a risk for Portugal?

Klaus Regling: The finance minister has shown great determination to continue with reforms, on the fiscal side and on the structural adjustment. When I look at IMF experience around the world, at the end of the programmes the determination to continue with reforms sometimes weakens. This is maybe human, but I'm confident that in the euro area we have built a better system, with continued and close interaction between the European Commission, the ECB, the ESFM/ESM and the countries concerned.

The next Portuguese budget is decisive for the perception of that determination in Portugal?

Klaus Regling: It is certainly one important step. Not only for Portugal: budgets are always important. Several countries in the euro area still have deficits above 3% and they all have committed to get it below 3% and then move toward a structural balance. Any deviation from this adjustment path will be seen negatively.

Were Portugal to need any financial support of some type, would you see it as a normal? It would break the positive cycle you are trying to build?

Klaus Regling: We try to create a situation where that is not needed. Euro area countries decided to have the ESM as a permanent institution and so we want to have this possibility at all times. But what is more important is that every year we keep a continuous debate on improving economic policies in all countries. In the euro area it is particularly important that countries have the right set of policies.

What are the risks for Portugal?

Klaus Regling: Portugal is coming out of a recession and we see better estimates, but growth is still not very strong. The objective must be to raise the potential growth rate. It should be higher than 1.5%, and higher than in the past. This will not happen automatically it will only happen with the right policies.

If that does not happen, will the debt be sustainable?

Klaus Regling: All the international institutions and the troika come to the conclusion that debt is sustainable in Portugal. It will be a lot easier when growth gets higher. And that should be the real incentive: to accept more reforms and adjustment to reach a higher growth path, which would allow for the deleveraging in the private sector and guarantee sustainability of the debt.

We have negative inflation in Portugal and have very low inflation in Europe. That does not worry you, namely due to debt sustainability?

Klaus Regling: We have to differentiate. Portugal is coming out of this very strong adjustment phase, just like Greece, Spain and Ireland. We want these countries to regain competitiveness, and therefore it was necessary to have low or negative inflation for a while. So, it is very good that prices are falling as a result of the painful adjustment

otherwise it would have been in vain. But it is a temporary phenomenon, because wage and pension cuts will not be repeated. For the euro area as a whole, we are in a period of low inflation, not deflation. According to all forecasts, this is the year with the lowest inflation and then it goes up again.

In sustainability analyses a nominal growth of 4% is usually assumed: 2% inflation, 2% real growth. These are not in the projections for Portugal in the next decade. Does this worry you?

Klaus Regling: We have still six years to go before 2020. In my baseline scenario, Portugal should have nominal growth of 4% in the second half of the decade. One more point on debt sustainability: for Portugal and other countries that borrow from EFSF and ESM the debt burden associated is lower than normal because our financing costs are very low.

In Portugal there have been discussions about debt reduction, or lowering interest rates by European institutions. Politically would that be feasible and is it possible to lower your interest on the Portuguese debt?

Klaus Regling: Haircuts on claims from European institutions are not politically feasible; the Eurogroup has made that very clear: it will not happen. Regarding interests, we charge our funding costs, that is around 1½% on our loans to Portugal, Greece and Ireland. That cannot be lowered because we have to pay our bondholders. If our lending charges were lower, someone would have to pay the difference and I don't see an appetite for that.

Deferring interest payments like it happened in Greece. Would that be feasible?

Klaus Regling: That is an additional loan for the 10 years that the interests are deferred. The outstanding amount goes up so it has to be repaid later on. That instrument is available and it was decided to be used for Greece because the situation was the most serious and much more serious than in Portugal. It was never discussed for Portugal.

The major opposition party in Portugal has said the debt service in Portugal is too high. They have talked about either lowering the interest rates or deferring the interest rates. Does this make sense to you at this point?

Klaus Regling: This wasn't discussed in the euro area because the interest cost to Portugal is very low. It is probably historically low compared to the 1990s. Even with a lower debt level, the burden on the budget was probably higher than today.

The programme still has the €6.4 billion for banks. The money will stay as a backstop until the stress tests. And after that?

Klaus Regling: The ECB is doing its asset quality review and then the stress tests. We will know the results probably in October. Only then will we know if banks need additional capital. If the money is not needed for banks then, it can be used for something else.

Portugal has low funding needs this year and the next but from 2016 onwards it will need to fund itself with 16 to 17 billion euros a year. This is much more than Portugal was used to before the crisis. Is this a risk?

Klaus Regling: The debt level is high and therefore there can be refinancing humps, but at the same time the deficit is expected to come down further and Portugal should move to a primary surplus. When we extended the maturities close to 22 years we looked very carefully at the repayment profile and tried to smoothen this. In the end it will all depend on the market situation, which is always a combination of the general market view on Europe, plus the specific situation on the country and that will depend on the reform progress.

Don't you consider that amount of money per year a risk?

Klaus Regling: I can't say there is a zero risk there but it is certainly manageable with the right policies.

One risk for Portugal is the fact that Portuguese debt is eligible as ECB's collateral due to the rating of one single agency. Some people argue that rating agencies were too slow in improving ratings. Is this a risk? Do you agree?

Klaus Regling: I'm not saying the Portuguese economy does not face risks, but this is another small risk because we are in a situation where indeed rating agencies are in the process of moving many countries up. Portugal will be among those economies that will be upgraded because there has been a lot of progress. My expectation is that over the next twelve months this eligibility will not depend only on one single rating agency.

The link between sovereign and bank risk is broken in Europe as promised by European leaders?

Klaus Regling: Banking union has many objectives and that is one of them. We are making progress: the link is not broken yet but this will happen gradually. Over time we will have a fully funded Single Resolution Mechanism to support the Single Supervisory Mechanism – the full implementation will take 8 years. Also we may have an additional instrument at ESM for direct bank recapitalization.

Would you expect to go faster, namely the direct recapitalization tool for the ESM, which is not developing?

Klaus Regling: It is developing: we at the ESM are preparing ourselves, because the Eurogroup has already requested it sometime ago. The Eurogroup chairman expects by June to have agreement on this new ESM instrument. I don't know if it will be used in the next 12 months but it is important to have it ready in case of need.

The direct recap from ESM is used only in very specific situations. It was the big instrument to break the link between sovereigns and banks, but as it is, it remains...

Klaus Regling: It is the last line of defence. But there are other elements that would break that link, because the SRM and SRF will be built up over time, and will also help.

Where do you see the ESM in 5 to 10 years' time?

Klaus Regling: We will be very busy even if there is no new lending or programmes. We have a balance sheet of €230 billion of disbursed loans to 5 countries with maturities from 15 to 30 years that need to be managed, because on our liability side we have a maturity of only six years, so we need to roll over. We will be in the market every year for around €30 billion,

which is a big amount. Also, we invest €80 billion of paid-in capital from our shareholders. We are still building up some internal processes. So we have enough work to do. And we will always have to be prepared for the next crisis which will come one day.

ESM is not a “European institution”, but an intergovernmental one. Would you expect that to change?

Klaus Regling: There is a debate about changing the EU treaty, and the European Parliament has taken a very strong view that the ESM should develop further. I’m not sure what will happen, but we will have a debate on how the euro area, inside the EU, will have more integration. The ESM is the only euro area institution, so it will be part of that debate.

There was the idea the EFSF/ESM would have loans to programme countries, probably also precautionary lines, and direct bank recapitalisation too. But much of this is not happening. If everything is OK you will be basically managing debt repayments. How do you motivate your team?

Klaus Regling: This is exactly what we wanted to reach: to calm the markets and to make sure that our support will no longer be necessary. We know we will be needed again one day. One should never assume there will never be a crisis again.