Interview with Klaus Regling, Managing Director of the ESM, by Viktor Munkhammar

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Dagens Industri: How would you describe the current state of the euro zone economy?

Klaus Regling: The euro area situation has stabilized and there are very good reasons for that. It has not happened by accident or because there are mood swings in the markets. It is a result of the euro crisis strategy that has been put in place over the past three years.

DI: Which are the most important parts of that strategy?

KR: First, the significant adjustments in the peripheral countries that lost access to markets. Second, we have a much broader and stricter system of economic policy co-ordination in the euro area. Third, we have closed some of the institutional gaps that existed in the initial design of the monetary union. Also the ECB is now using instruments that they did not use before the crisis, the most famous being the OMT. Fourth is the strengthening of the European banks.

DI: Isn't Mario Draghi's London speech in 2012, promising to do "whatever it takes" to keep the euro zone together, the main reason for the improved stability?

KR: I read that often but I do not agree. It was an important statement and the follow up work from the ECB, which is OMT, was a crucial moment. But all the other elements I mentioned have played an equally important role.

DI: Germany's constitutional court has yet to rule on the legality of the OMT. Are you worried about their ruling?

KR: It is impossible to predict rulings of courts, but most observers expect that their view will not prohibit the ECB from using its policy instrument. The German constitutional court has no direct power over euro area institutions.

DI: The euro area economy is finally growing again. But growth is very weak. What kind of growth rates should we expect over the next ten years or so?

KR: One has to be realistic about how strong growth can be in Europe. In the short run it can be higher than trend because there is a lot of slack in the economy but over a ten-year period, most economists do not expect a growth rate in the euro area of much more than 1.25 - 1.50 per cent. That sounds low but once the demographical situation is taken into account it is not that low. It is roughly the per capita growth rate that is expected in the US.

DI: Some argue that the fiscal squeeze in the euro area has been too drastic, strangling growth. Do you agree?

KR: I think the pace of consolidation has been broadly right. Deficits were too high, certainly in the countries that lost access to the markets. Greece five years ago had a fiscal deficit of 15.6 per cent of GDP. When a deficit is that high, one has to do something. There is just no another way.

DI: Does the risk of deflation worry you?

KR: I worry much less than some people in the markets. The risk is very low. According to the IMF's models, for example, the probability of deflation in Europe is 10 - 20 per cent. For me that is not very high. One should not overreact.

DI: Would you agree that there is a conflict between having credible stress tests and not risking the recovery by forcing banks to improve their capital ratios too drastically?

KR: I don't think a harsh stress test could hamper the recovery. I think the ECB knows that the markets expect credible stress tests. The stress tests in the past were not good enough. But it does not mean one needs a stress test that is artificially tough. It has to be transparent so that market participants can do their own work.

DI: Estimates of how much additional capital European banks need reach as high as 100 billion euros. What is your estimate?

KR: I have seen estimates that are actually higher than that, which I consider unrealistic. The ECB itself has said that they do not expect big numbers. The argument is as follows: the peripheral economies have gone through several stress tests with the help of outsiders. One can be fairly confident that we understand the banking systems in Greece, Portugal, Ireland, Spain and Cyprus, so there will be no big surprises there. My baseline scenario is that no country will need additional assistance because of banking problems.

DI: The maximum amount the ESM will be able to use for direct bank recapitalization is 60 billion euros. Is that enough?

KR: 60 billion euros certainly is more than enough, because we are now working under a new bail-in regime in Europe. The shareholders will lose their capital, senior bonds will be bailed in and from 2016 most likely the Bank Resolution and Restructuring Directive will become effective. This requires that 8 per cent of a bank's liabilities will be bailed in before any public money can be used. Thus the need for public funds will be reduced dramatically.

DI: What about so-called legacy assets? Can ESM money be used for that purpose?

KR: Legacy assets are problems that come from the past. The question is should this be dealt with differently going forward as we develop new instruments like the direct bank recap. What the Eurogroup has said is that this can happen on a case by case-basis . On the one hand it could happen, but at the same time it would be an exceptional solution. But there is so far no consensus on this.

DI: So basically we won't really know until we get there?

KR: No.

DI: Concerning Greece, there is talk of extending the loans even further, to 50 years, and lowering interest rates. Any comments?

KR: This will be discussed in the Eurogroup in the summer. Some people have mentioned that as a possibility, particularly on the Greek side. We have already gone a long way by extending the maturities to 30 years and deferring interest payments for the first ten years, which clearly helps Greece a lot. In 2013 Greece's debt service costs would have been 8-9 billion euros higher if they would have had to refinance themselves on the capital markets. One could consider going further than that, but there is not very much room because we cannot lower our interest rates further. We did it in the past because initially the EFSF charged a premium on our funding costs but that was abolished already two years ago. Now we charge only our own funding costs plus a very small margin to cover our operational costs. So I do not see that happening. However there are some loans from the first Greek package where this might be a possibility.

DI: Greece has a financing gap of around 10 billion euros. How can that be dealt with?

KR: Many people believe that a small third package might be needed. But we do not have the numbers since they depend on the review which is about to begin in Athens. However, any package would be a fraction of the earlier packages. The second package, for example, amounted to 140 billion euros.

DI: Will Portugal be able to exit their support program this year as planned?

KR: Portugal is on a very good way and may be able to repeat what Ireland did in December and exit the existing program without any need for any further direct or indirect assistance. But it is too early to say.

DI: Market pressure has eased. Is there a risk of complacency in terms of reforms?

KR: The five countries that have borrowed from the ESM and EFSF have done so under strict conditionality. That is why these five countries have implemented more reforms than any other country. They are the reform champions of Europe. They will, in my view, have the highest growth rates in Europe in the medium term.