

Interview with Klaus Regling, Managing Director, ESM

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Politis: The main goal of the programme is to restore confidence in Cyprus. Is this mission complete?

Klaus Regling: Cyprus has come a long way in restoring confidence. Most of the work has actually been done and although the programme is not over yet, it is clearly becoming a success. I know that for the population this process was very painful. Unemployment is high and incomes dropped. But we can see at a macro level clear indications that the situation is improving. Growth is coming back, stronger than expected, unemployment is beginning to fall, employment creation returned. The country is clearly on the right track and the progress is very clear. Competitiveness is much better than 2-3 years ago, the current account deficit is smaller, the fiscal situation is under control, and the banking system is much smaller. At the same time, there is still work to be done.

Progress is clear, even if not all the population can feel it. I encourage the government to continue this work and tackle remaining problems. We know that the banking system has a very large amount of NPLs. There is a new legal framework in place and that must be used now to manage the NPLs. There is also more to be done in privatisation, public sector reform, the legal system and tax administration.

The Cypriot government is talking about a clean exit from the programme. Is this possible?

The three-year programme expires in March 2016. Given that progress is significant, even stronger than assumed two years ago, I can understand very well that the government is thinking about a “clean exit”. This is also what we saw in countries like Ireland and Portugal. The markets are looking favorably at Cyprus because of the reform progress and good programme implementation. That’s why Cyprus was very successful recently in issuing a 10-year bond, at 4,25% interest rate. That would have been unthinkable two years ago. Of course, there are instruments available at the ESM if needed. But at the moment it looks like there is no need and Cyprus should be able to have a “clean exit” from the programme, particularly if the government continues with implementation as strongly as in the last two years.

Cyprus is already beginning to return to the markets. By next year, there will be more bond issues. The country will not need to rely on the ESM anymore. We only provide emergency funding and the objective is that a country will be able to finance its needs from the markets. But of course, the need for reform never stops. This is valid for all countries.

The Cypriot debt is assessed by credit rating agencies as non-investment grade and it seems that it is going to remain there for the foreseeable future. Isn't that problematic? For example, what will happen with the QE programme?

We know that given the current situation, Cyprus will not be eligible for QE after the end of the programme. But on the rating side we also see a positive trend over the last few months. I have no doubts that with continued implementation of reforms, this positive trend will continue. The rating over time will return to investment grade but I can't say when. The government should take that as encouragement to continue implementing reforms.

Last Tuesday the eighth review of the programme started. This will be the final review?

It depends on the outcome of this review. It may be the final one or there may be another visit before March. I cannot say today. But it's not so important if this is the final review. We will be in close contact with the government for a long time to come. All creditors have their own mechanisms to stay in touch with the government. The ESM Treaty requires us to do that given the amount of money that we have disbursed to Cyprus. We call it the early warning system. We will monitor developments in the country because we need to be confident that we will be repaid on time. The first repayment of the principal is set for 2025 and the last payment is due in 2031.

The Commission also has a post – programme monitoring system. After the crisis, we set up the European Semester, which is a monitoring mechanism for every euro area country. So there is a continued dialogue between the European institutions and every country of the euro area, which is particularly close between creditors and the countries that borrowed from us.

So the surveillance will not stop this March?

Surveillance happens everywhere in the euro area, also for Germany and others. The euro relies very much on surveillance. We all have to live together and avoid wrong policies. That applies for every country, not only to countries that borrowed from the ESM. As an example, again, Germany and France also receive (from the European Commission) so-called Country Specific Recommendations once a year, and Cyprus will receive these Recommendations every year too. This is a normal activity inside the euro area. This will get stronger, not lighter. Surveillance before the crisis wasn't good enough, otherwise we should have been able to detect earlier that a number of countries had problems accumulating. Surveillance helps to avoid problems from becoming too big, like loss of competitiveness or housing bubbles. At the same time, surveillance has a second objective, to identify areas where countries can do more to strengthen this growth potential. And this applies to every country in the euro area. If not for anything else, every country has the objective to strengthen its growth potential. Growth potential is low in Europe, partly for

demographic reasons, partly because productivity gains are low. Every country has a job to do. So reforms never end, even after the difficult, painful reform agenda adopted in the context of the programme. This pays off. Countries that implement reforms, like Ireland, Spain, Portugal, they have now very good economic performance. Ireland and Spain have the highest growth performance in the European Union and I am not surprised. This is the result of all their reform efforts. If Cyprus continues on this reform path, I'm convinced that strong growth also will return.

Due to over performance in public finances a significant amount of money of over 2 billion euros is not going to be disbursed. Could that amount of money be used for other purposes, for example compensating depositors or for the establishment of a "bad bank"?

I don't think that is possible. The financial assistance agreement to Cyprus in March 2013 was very clear: the money made available from the ESM and IMF can be used for budgetary financing, for debt repayment, and for bank recapitalisation.

NPLs remain at high levels and the banking system does not contribute to the real economy. Is there a danger of disrupting the recovery of the economy, due to the inability of the banking sector to support households and companies?

That is right. There is a link between a large amount of NPLs and the reduced ability of the banking sector to provide new loans. That's why it is so urgent to deal with the NPLs. We know that takes some time. The Government and the Parliament put in place a legal framework to deal better with the NPL problem. Now the issue is to apply this framework to manage the NPLs, which is relatively new. Banks should expect some losses and owners should also be prepared to come to an agreement with the banks. The faster that process unfolds, the sooner we can expect banks to be able to play their normal role of providing credit to the economy.

In this process you describe, how important is new legislation on selling loans and securitization? Selling loans is the big issue of the current programme that remains to be implemented?

These two important laws are still pending. Once they are implemented, this should help to improve the NPL management and banks should then return faster to a healthy situation and start providing credit.

But public opinion is afraid this legislation and the discussion in parliament are not easy. Could a legislative dead end become an obstacle for the upcoming reviews?

I won't comment on the political situation, but I see that the parliament in Cyprus, on previous occasions has been willing to accept difficult legislation for good reasons. Because it was needed to help the economy to move forward. We are again at such a moment. We

don't want to penalize anybody. The purpose of this legislation is to reduce the NPL burden for the banks in order to provide loans again. That will help everybody in the end. In this process, both sides have to make compromises. Banks and homeowners have to try to find a fair deal.

A question concerning Greece. There exists an obvious difficulty in fulfilling the commitments. Is Grexit still on the table, as a possibility, even by accident?

Greece was always a special case compared to other countries that received money from the ESM. Earlier this year, this became very clear again as Greece went through a very special and dramatic situation. Some people tend to forget but last year we had seen growth in Greece, unemployment started to fall and the country was able to issue, again, a bond in the markets. That was a good development, although with the election process this progress stopped and the new government decided to reverse many reforms. The result was that Greece returned to negative growth rate, unemployment went up again and we saw a loss of confidence. That's why Greece needed a third programme.

In the meantime, there was a new election and the new government, with the same prime minister, have shown renewed commitment to the reforms. Prime Minister Tsipras has a clear mandate now to implement reforms. So this election was very important. Greece can restart a process which was interrupted for almost a year. This interruption became very costly for the economy and that makes the situation now very difficult because the country had to start from a lower base than it would have otherwise. As a consequence, the people will have to endure again some difficult measures. We had to provide more money and euro area governments had to defend a third programme in their parliaments. If Greece implements reforms - as it proved it is able to do -- the country can return to a positive growth path and the population can feel the benefits.

For the Greek government, a very important issue is debt relief. The IMF asks from the Eurozone a formal restructuring of Greek debt before the IMF will lend new money to the country. I understand that this is an ongoing situation, but which is the margin for a new restructuring of Greek debt?

The position of the IMF is not new. At the moment, they are not disbursing money. We are. But the IMF is willing to enter the new programme under some conditions - debt relief is one of them. The euro area countries, at the same time, have made the promise to provide additional debt relief and to discuss it after the conclusion of the first review of this third programme. Hopefully, this review can be concluded later this month. We have some delay already as it was supposed to be concluded in October. After the review, the euro area will do what it has committed to do - explore options for further debt relief.

It is clear that we will not provide a nominal "haircut". I also believe that is not necessary because there is no debt overhang in Greece and we already provide a huge debt relief every year. It is in fact, the biggest debt relief that any country has ever received in history.



Given that our financing to Greece is so big and extends through 3 decades, our extremely generous lending terms (around 1% interest rate) represent a saving for the Greek budget of more than 4,5% of GDP, every year. The euro area has said that it is prepared to move further and deliver more. How much more we will see later in the year.