European Stability Mechanism

Transcript of interview with Klaus Regling, Managing Director, ESM

Published in the *Wall Street Journal*, 12 April 2016

Klaus Regling, the managing director of the European Stability Mechanism, the eurozone bailout fund, spoke to The Wall Street Journal about a range of issues, including ongoing negotiations between Greece and its international creditors and potential ways to relieve the country's debt load. This is a transcript of the interview with Viktoria Dendrinou.

WSJ: To start with Greece, it would be good to get your sense on how negotiations are going. It seems they ended quite abruptly in Athens [on Monday]. We were expecting them to come up with two documents, one on what is agreed with the Europeans and one with the IMF's reservations but that just didn't happen. Why do you think that didn't happen and why was there not enough progress?

KR: It is not easy, because Greece had the most difficult starting position, they do not have a big implementation capacity, and that's why it is difficult. It is disappointing that we have seen this long delay in the review because we were supposed to be done five to six months ago. I would still not say it ended abruptly this week because we know why there was a pause agreed in Athens. Because of the people who are involved in this, the Greek minister of finance and his colleagues but also the negotiating teams from the European Commission, the European Stability Mechanism the European Central Bank and the International Monetary Fund are all moving to Washington the next few days because of the IMF spring meeting. So it is not an abrupt interruption here. People who did the work in Athens until today, they are now on planes and there will also be talks about the remaining issues in Washington, because everybody is there.

WSJ: So when do you think they could realistically conclude these negotiations on the first review?

KR: It is very hard to say because we are dealing with politically difficult issues like pension reform, income tax reform, non-performing loans of the banking sector. Under the best of circumstances these are technically and politically difficult issues. And that's why it is very difficult to say whether this takes another two weeks or another four weeks. But I think it is not unrealistic to expect that over the next four weeks this is going to conclude.

WSJ: Do you think this is more of an issue of the creditors not finding a common line with each other or more an issue of Greece and the Greek government not offering enough measures to meet the creditors' demands? Because it seems that there is both a debate on the creditors' side and both one with the Greek government.

KR: Yes there is a debate that is correct. But such a debate is useful because I don't see a disagreement on the key objective that one wants to reach. The key objectives were already defined in the agreement of the heads of state and government together with Greek Prime Minister Alexis Tsipras last July, confirmed by the finance ministers of the euro area in August last year. And that's important: we agree for instance on the fiscal objective over the next two years. And we agree that the pension system should become sustainable. And also Mr. Tsipras has said that the current pension system is not sustainable and will run out of money over the next few years unless it is reformed. So there is agreement on the objectives and then it is relatively easy to see that there are different ways to reach the agreed objectives. And it is good to have a debate about that because nobody can argue that only one way is the possible way. There are different ways to reach the same objective.

WSJ: But it seems that it is not just about the different ways to reach the objectives, there is this objective of primary surplus of 3.5% of gross domestic product by 2018. But I think this is more of a case of the EU creditors and the IMF disagreeing on how much these measures are yielding, and the IMF not thinking that these measures would lead to 3.5% of GDP. There seems to be a 2% of GDP disagreement on how much these measures will yield, why do you think that is?

KR: There can also be disagreements on the effectiveness of certain measures, that's part of the discussions but the 3.5% of GDP primary surplus in 2018 was agreed at the top level last July and I don't think that that will be put into question.

WSJ: Do you think the IMF is being unreasonable in its forecasts and its demands for reform from the Greek economy given that at least the forecasts seem to be substantially gloomier than what the European side is seeing?

KR: We all know that forecasts have a high degree of uncertainty. Even for the current year revisions happen frequently for all our countries, this has nothing to do with Greece. For Greece yes we need to find a common approach over the next two years and then beyond that. Even when we look at debt sustainability one has to find estimates and forecasts for the next few decades and that is difficult. So nobody can claim that one institution has the monopoly of knowing everything that happens over the next two years, so that's why it's important to have a good debate.

WSJ: You mentioned debt sustainability. The IMF has been very vocal about how Greece needs substantial debt relief and how [the fund] needs the debt to be sustainable for it to go on board with the program. Do you think it is right that Greece needs substantial debt relief? In the past you have advocated a much more "flow vs stock" approach and you've said that it is more about ensuring that the debt payments are manageable, that that is more important than a nominal haircut.

KR: First of all on this old disagreement of flow vs stocks, I think that's behind us, I think we all agree that it makes sense to look at the annual debt service flow and if that is manageable then we also know that the debt stock will come down over time. And also, it is understandable why European institutions have a somewhat longer term view than the IMF because the IMF wants to be repaid over a ten-year horizon while we only look at repayments with an average maturity of 30 years so our timeframe is longer. There is agreement also that nominal haircuts will not be part of any additional debt relief. But the euro area has made commitments already since 2012 and they have been renewed already several times that additional debt relief is possible for Greece if Greece implements reforms and if it is needed. How much is needed we will not know before we have a clearer view for the forecasts for the economy, for the budget over the next few years because then we will see whether there is a remaining gap and how much. But the commitment is there and that is not questioned: if reforms are implemented if more is needed the euro area is prepared to look at that. Again no nominal haircuts but we know the other instruments that were already used in 2012, how significant reduction in net-present value terms can be achieved and there are possibilities but we don't know the magnitude before we have clarity on the forecasts of the economy and the budget.

WSJ: So we are looking at a debt reprofiling essentially, right? Extending maturities, capping interest rates, longer grace periods. Are these the instruments that you have in mind?

KR: Those are the instruments that led to net present value improvement for Greece in 2012 without a burden for the creditor countries. The creditor countries take on risks, and they may take on more risk for longer. But there would be no immediate budgetary cost for the other euro area countries.

WSJ: It seems that last summer when there was a discussion about this a lot of eurozone countries were against even a large maturity extension because they thought it would be equally burdensome to them if they had a large net present value reduction. Do you think it is fair?

KR: If there is an net present value reduction through these instruments there is no burden on creditor countries. I think the exercise we did in 2012 demonstrates that also. I think sometimes the broad public doesn't understand that it is possible at the same to have a benefit for the borrowing country without a burden for the creditor countries. But it is possible. Every IMF program works with this principle. Because in every IMF program there is an NPV gain for the borrowing country because they get IMF money at relatively cheap terms compared to what they would have to pay at the market. But there is no cost, the IMF has never lost money. So the principle is very well known, we work with the same principle. That there is this asymmetry between gains for the borrower and no cost for the creditor. But again the credit assumes risks and that is why we can mobilize funds in the markets through EFSF/ESM on very favorable terms that we pass on to the borrowing country.

WSJ: Just on the mechanics of debt relief, in these discussions you are still looking at capping gross financing needs at 15% of GDP annually, that is the threshold you are looking at?

KR: All this so far is technical work, this has not been discussed at the political level. The political level has to take the decision at the end so we only look at possibilities. Again we don't really know exactly how much additional debt relief Greece will need. But to be prepared once we know it we have looked at these different possibilities, what can be done to help Greece while at the same time excluding nominal haircut. And then maturities, interest deferral, capping payments in terms of GDP these are options that we have looked at in a technical way but I cannot say today which way it will go politically.

The 15% is something that the IMF has used for other countries, as a kind of a benchmark. But one has to realize that there is not one scientific number that clearly indicates when debt becomes unsustainable, that is true for the debt-to-GDP ratio, it is also true for the gross financing needs.

WSJ: Again on a more mechanical point, there is this idea that's been floated that would also bridge different views between creditors on how the economy is going to go and that would be to link debt repayments to the performance of the economy. So when the economy is doing better repay more, when the economy is doing worse repay less. Do you think there is merit to that idea?

KR: This is one of the options that we have looked at, because it could make sense given that we are dealing here with long periods of time where then necessarily uncertainty is very very high. And that is why this could make sense, again without implying haircuts. So if economic developments are less good than foreseen then payments that are due would be postponed, they would not be forgiven. So these are options that are possible and we will see what is needed and what the political discussions bring.

WSJ: One key issue in this debt relief debate, and that is probably particularly important to you because you look at investors as well is whether [debt relief] is going to be tied to some conditionality for Greece. It seems like at least on the EU end they want any debt relief to be tied

to quite a lot of conditionality for Greece so when Greece does X reforms it will get Y debt relief. But it seems like the IMF is on the other side of the spectrum and would like as much relief up front as possible. And that would probably make sense for you because that is a good signal to investors, because Greece's implementation record hasn't been the best. How do you think this conditionality should work?

KR: I think there are arguments on both sides indeed to give clarity both for the Greek government and for potential foreign investors and domestic investors in Greece. It would be an argument in favor of deciding everything up front. But that could also lead to moral hazard and would mean no more incentives from that perspective for Greece to continue with reforms. So I think the two sides, the two arguments are there, we will see where we find a good balance.

One additional point one should not forget in Europe countries, member states of the EU and the euro area in this respect are very different from countries that have an IMF program. Because a country outside Europe that has an IMF program, once the program comes to an end, the leverage of the IMF over that country is relatively small. In Europe that's very different because members of the EU and even more so of the euro area are part of a very complex network of agreed rules that have been agreed unanimously. And therefore there are always obligations to comply with certain rules that have been adopted in the past and that provides more certainly that in none-European countries that policies remain on track. There is leverage. Countries have a multitude of relationship. For instance, Greece receives every year 3% of GDP out of the EU budget and they want to continue to receive that money out of the EU budget and that gives some certainty that they will always be cooperative. Inside the EU there is a multitude of leverage that does not exist countries outside Europe that borrow from the IMF.

WSJ: On this balance that you mentioned earlier, would that imply giving part of the debt relief upfront to give a message to investors and deal with the IMF concerns and then make the rest of it conditional, using this leverage that you mentioned.

KR: Possible but as we don't know today whether debt relief is needed or how much is needed it is very hard to now give any clear indication where the balance then would be. But these are the options possible.

WSJ: You say "whether debt relief is needed," do you think there is a chance that no debt relief at all will be needed for Greece?

KR: Who knows? I want to see the numbers first.

WSJ: I am not sure the IMF is going to be on your side on this one.

KR: Well it depends very much on how the forecasts look like and some of the forecasts of growth and the Greek budget are under the control of the Greek government. Others are not. Like today world interest rates are a lot lower than 1-2 years ago, that means that our lending rates are lower than 1-2 years ago, even lower than when the program started. So there are savings on that side for a borrowing country, also for Greece. And then of course the more they save on the debt servicing the less debt relief they need. So just to say there are elements in the forecasts that are beyond the control of the authorities and can be positive development, they can be negative developments and one really has to look at the outcome before one can decide what is needed.

WSJ: Again, on debt relief, it just seems that some of the creditor countries that want the IMF to be on board like Germany, for example, they really don't want to hear about debt relief even though they signed on to some notion of it over the summer in the agreement. Whereas the IMF

has stated time and time again that it wants substantial debt relief to come on board. And it seems these two positions are really far apart. How do you think these can be bridged? Can they be bridged with more austerity from the Greek end? How can these two points meet?

KR: I cannot say that today, but they will meet.

WSJ: It seems like the solution on the disagreement on the primary surplus numbers lies on debt relief. It doesn't seem like there is some form of debt relief, at least right now, that will be sufficient for both the IMF and Germany.

KR: As I said, we don't have all the information at the moment, therefore it is very difficult to answer such hypothetical questions. It is also true that not all positions are compatible at the moment but I am sure there will be an outcome where all parties concerned can agree.

WSJ: On this discussion [debt relief], when do you think it is going to start at a more political level? There are technical discussions ongoing, but when do you think the big decisions are going to be taken?

KR: Well first we need to have the first review done, at least be very close because if we don't have the very precise outcome of the review which will include a view on the budgetary situation, on the growth situation for this year and next two years, we cannot answer the question on how much debt relief is needed.

WSJ: So, if you said four weeks earlier [for the conclusion of the review] probably within the next four weeks we can expect this discussion to start in earnest?

KR: Yes.

WSJ: When do you see Greece being able to borrow in the markets again?

KR: We know that Greece already was able in 2014 to go back to the markets, they issued on two occasions one five-year and one three-year bond and there was great appetite for that. So I believe based on that experience that if Greece implements the agreed reforms fully that by next year they will be able to do that again and that would also make a lot of sense because the program runs until the middle of 2018 and they would have to begin to test the market a while before then, like Ireland did and Portugal did and a few other countries that received emergency financing for a while. They have before the program comes to an end go and test the market.

At the same time the countries have to be careful not to go and mobilize too much money in the markets because the money will initially be expensive. Much more expensive than our money. So they have to find the right balance on the one hand test the markets that makes sense but not take on too bug amounts because that would be a burden on debt sustainability. But if you ask when are they able to do it for the first time I think within 12 months that would be possible.

WSJ: So first half of 2017?

KR: Sometime in 2017.

WSJ: Clearly the situation this year is quite different from last year in terms of the different crises Europe is facing. You have this big migration crisis that wasn't as big last year as it is now, do you think that is pressuring the creditors, both the institutions but also individual countries as well to also be a bit softer on Greece because it has taken quite a lot of the burden?

KR: The situation indeed is very different than 12 months ago. First of all in Greece it is completely different because Prime Minister Tsipras after the second election in September got a completely different mandate, namely to implement the agreed reforms. While the first half of last year he followed his first mandate he got in January 2015 to try a completely different approach, which failed and was very costly for the Greek economy.

At the same time you are right, we face new political challenges in Europe, migration is one of them and that's the one in which Greece is also directly affected. But everybody is very careful not to mix the two. Because to solve the migration issues Greece receives unconditional help from its European partners, unconditional with money, with personnel. And these are budgetary resources, not loans that Greece has to repay. And that makes a lot of sense. Unconditional in the sense that it is not linked to policy reforms. Greece just demonstrates that they make good use of the money they receive to deal with the migration cost like providing medical care, housing. That should not be mixed with the other program where you have conditionality; we only disburse new loans if Greece implements reforms that were agreed to bring the Greek economy back on a sustainable growth path. So these are two different issues although it is true that Greece is very much affected by both and the government is involved in both. But on substance they are different processes and that makes sense, to keep it separate.

WSJ: Speaking of the migration crisis, there seem to be quite a lot of new political risks that are hitting the EU more broadly this year, from a potential Brexit, to the migration crisis to a security crisis. Are you concerned that the situation might affect the economy in a more adverse manner?

KR: First, it is good to realize that on the economic side Europe has made a lot of progress. We are basically out of the crisis although Greece remains a difficult case. But Greece is only 2% of the euro area. But it's good to be aware that those economic problems that we faced a few years ago, particularly in this city [New York] where the majority of people thought the euro would disappear, that we have come a long way. So I am happy about that. At the same time it is fair to recognize that there are a number of political problems. Some new political problems like migration, like Brexit, like terrorism. These are challenges that we have to deal with. If we are not successful in dealing with them then they can have an economic impact, that's true. But at the moment, I don't see that growth forecasts have not changed much over the last six or nine months. The IMF just came out with its most recent forecast for the euro area for this year and the next two years and they are basically in line with what the IMF said six months ago. But we have to work on these political issues. They are difficult. Therefore all the more important that we have been able to successfully deal with all these problems that many people thought we wouldn't be able to do.