

Transcript of the interview with Klaus Regling, Managing Director, ESM

Conducted by Benjamin Robertson, *South China Morning Post* (Hong Kong) on 17 November 2015

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South China Morning Post: Portugal has come back into the news recently after the change of government and the problems with Novo Banco. Is it too soon to say that it has been a success?

Klaus Regling: No, I don't think so. Out of the five countries that received emergency financial support from the European Stability Mechanism four countries are now success cases. That does not mean that these four countries – Ireland, Spain, Portugal and Cyprus – are in good shape forever. No country is in good shape forever unless reforms continue. Economies move in cycles. Economies that perform very well for a decade then often turn down. We see that currently in Brazil, for instance. This is very normal. This is partly related to human behavior. It's a normal experience that economies move in cycles. They are not out of the woods forever. Therefore, when I say that the four countries that have received money from the ESM are now success cases that is true. But to have a good performance over the next decades they need to continue to implement reforms. That is also true for other countries like Germany. Germany has a very good economic performance at the moment. But even they, unless they do something on the reform side, may deteriorate one day. We see that in Finland, for instance. Finland did very well for a decade or two. But now for the past three years Finland is also in deep trouble with three years of negative GDP growth. So, the bottom line is: structural reforms must continue. It is a permanent challenge for every country, even for those who are doing well at the moment. But what happened during the euro crisis is that we now have four success cases. And then there is Greece as a special case.

How do you balance – if at all – the social cost to these reforms? Because we have seen protests since 2008 against austerity measures. Do you try to strike a balance or do you have a particular reform agenda you feel has to be imposed regardless of the social cost?

The moment a country loses market access and needs a special adjustment programme in order to qualify for financial support from the ESM or the IMF means that something went wrong in that country. Concerning the reasons this differs country by country. But something went wrong. Otherwise a country would not lose market access. And the idea behind conditionality is that exactly the reason that led to the problems that need to be tackled. Often this includes fiscal consolidation, improvements in competitiveness, structural reforms. But the precise measures differ country by country depending on where the reasons for the origins of the crisis are. This is an approach that the International Monetary Fund has used worldwide for the last 60 years. We imported that approach into Europe with the creation of the European Stability Mechanism. So the approach is not new, the world knows it very well. And when this happens, when a country loses market access and needs special financial assistance from the IMF or in Europe now the ESM there is painful adjustment. Then we see demonstrations. That is not unusual at all and one can expect that. But the adjustment is necessary to correct things that had gone

wrong before. People don't like that. They don't like to have cut-backs. Take Greece as an example. Greece has had the highest increase in wages and salaries in the first decade of monetary union compared to all other countries. Wages and salaries basically doubled. That was a lot more than productivity gains allowed. Therefore they lost competitiveness, they ran very large trade deficits. This needed to be corrected. Because the exchange rate is not available in monetary union this was achieved through direct cuts in wages, salaries and pensions. This is very painful. People obviously don't like that. They forget that this is the consequence of too rapid increase of wages, salaries and pensions before the crisis. But it needs to be done to restore competitiveness and to address the problems that were accumulated earlier. Again: that is nothing new. We have seen that in other countries. That the population protests, that they don't like it is not surprising, one should have sympathy with that. One should try to design the necessary adjustment that it is socially as fair as possible. The IMF tries to do that in its programmes and is still often criticized because it is difficult to do that. For rich people it is much easier to escape the adjustment because they are mobile, their capital is mobile while the average wage earner is not mobile. So it is not easy. But we try to do it, the European institutions, the IMF try to do it as fair as possible in a social sense but we are not always very successful in this area, unfortunately.

You say that Greece is a special case. How can it realistically grow at the rate that is sustainable enough for Greece to be able to pay back its debt and support the social infrastructure that is expected of a Western government?

It is possible. There is no doubt about that. Because on the one hand our lending terms are so favorable. We charge very low interest rates. We have very long maturities. Therefore the debt stock itself is not very meaningful when we try to assess the debt burden on Greece. It is much lower than the debt to GDP ratio would suggest. It is a little bit comparable to Japan where we have a debt to GDP ratio of almost 250% but obviously Japan has no problem servicing it because the interest rates are very, very low. So it is a little bit in that direction. The other side of the equation is indeed: what is a reasonable expectation for growth for Greece in the future. We saw that growth came back last year with the right policies. This year this was interrupted because the new government that came into office early this year tried a different approach for 6 or 7 months. They reversed some of the reforms and the country got back into trouble. But we know from the experience of last year and from the assessment of the institutions that with the right reforms Greece can have a good growth performance. The OECD has said that with the right reforms Greece can have the highest potential growth rate in Europe. At the same time they get all this very favorable lending from us. So it can add up. After a while the debt can begin to fall and they can grow out of their problems. This is possible but it requires a continuation of the reform efforts.

Growth has returned to Europe. But given where oil and the commodities are, given that the euro has fallen quite a bit against other major currencies shouldn't European growth be stronger?

European growth always looks low compared to the United States, for instance, because the population developments are weak, our demographics are bad, at least until recently. Birth rates are low and immigration traditionally has been much, much lower than in the United States. This may change now with migration but this is a recent phenomenon. But it is important to realize: if one takes out the difference in population developments in Europe and the US growth in Europe has not been low. It has been the same rate for the last 25 years as in the United States. What the economists call the GDP per capita growth has been identical until the crisis. So it is not correct to talk about slow growth. It is low

only compared to the US because of the different population developments. Compared to emerging market economies, China among others, growth is low because the standard of living is already very high. So we hope that China and the others can continue to catch up and have very high growth rates for many, many years. That is the catching up process. Europe and the US basically grow at the same rate. This is not surprising because they are advanced economies at the cutting edge of technology developments that determine the potential growth rates on a per capita basis.

Can you tell me a bit more about your trip to Asia? Who else are you meeting while you are here? Also, I would like to hear a bit more about the Asian investors who buy your bonds. Who are they? How much do they weigh in terms of how much they own?

This trip to Hong Kong is one of many trips I do every year around the world including to Asia. I also go to China, Japan, Singapore every year, sometimes even several times. One reason is to explain to authorities and to private investors what is happening in Europe. Of course, at the moment Europe is less in the limelight than two or three years ago when the euro crisis was at its peak. Then it was very important to inform investors because they wanted to know. I also come because I want to learn about developments in this region in the major economies and in Asia as a whole. That is an important part. But ultimately I want to sell the bonds that my institution, the European Stability Mechanism issues. We issue every year 40 to 50 billion euros in bonds in order to mobilize the financing that we need to do the lending to countries in the euro area. And that we will continue to do for many years even after we stop disbursing new money because we need to refinance our existing claims on the five countries. That is why we will continue to issue for many, many years. We stay in close contact with the big investors. We do that around the world. But Asia is an important part of our investor base. On average, over the last five years, Asia has bought about 20% of our bonds that we have issued.

And who are the buyers?

In Asia as in the other countries we see many different types of buyers: central banks, sovereign wealth funds, commercial banks, insurance companies, pension funds. So it is a very broad mix. There are also hedge funds. We have buyers who may not hold our bonds for very long. And there is the other extreme: private investors like pension funds who are interested in very long-term bonds and holding them to maturity. And we are very happy to have such a diverse investor base. Because the investors who are more short-term oriented are helpful for the liquidity of our bonds. They are traded actively in the markets and that is good. But we are also very happy that many of our investors buy and hold. That is a stable basis. So the mix is important and we are happy about that. The mix is important in the geographic sense and looking at the different institutions.

Can we say that the Chinese central bank, the Japanese central bank and the Hong Kong Monetary Authority buy your bonds?

I never talk about individual buyers. I only talk about Asia and who are the different categories of buyers. I will not reveal individual buyers. We don't do that and others don't do that either.

Presumably you hope to be able to increase those 20% of investors from Asia. And do you see this as a growth area in terms of investor demand?

We would be happy about that. But it has been a relatively stable share and I do not necessarily expect that this will go up a lot. If it does, fine, we would be happy about that but we are not actively trying.

Is your role still necessary given that the ECB has said that it would do whatever it takes to act as a lender of last resort? How are your respective roles defined? Are you still necessary once the central bank has made that kind of a commitment?

We were created before this commitment was made and I think we complement each other. We work very closely with the ECB but we can do things that the ECB is not allowed to do. The ECB is not allowed to do what we call in legal terms monetary financing of governments. That is one of the key rules in the European monetary union. So the ECB is not allowed to finance governments directly. We can do that. So we are the lender of last resort for governments. The ECB is the lender of last resort for banks. They can create a lot of liquidity, they already do that through different instruments. But they are not allowed to finance governments directly. That was a gap in the initial design of Economic and Monetary Union. That gap was closed with the creation of the rescue funds, the European Stability Mechanism. So we play that role. That was an important complement to the possibilities that the ECB has.

Why has Europe not done QE to the level that was done in the US to expand the fiscal deficit and to allow the central bank to buy bonds as we have seen in the US?

The ECB has used different instruments. When you look back when the crisis started the ECB was actually the first central bank to take crisis measures - before the Fed. The ECB is also the first big central bank that introduced negative deposit rates. The Fed has not done that. When you look at how the balance sheets of the ECB, the Fed but also the Bank of England developed over time in terms of GDP – to put it into relation to the size of the economy – the expansion has been the same. So you are right: different central banks use different instruments. But overall I think one can say that the ECB has been fast and has been as expansionary as the Fed in the sense of expanding its balance sheet even though they are using different instruments.

In the early days of the financial crisis the ECB even raised interest rates and were criticized for that. Was there a sense that initially the ECB was behind the learning curve?

No. If you look at economic developments after the crisis in 2009 when we had a big drop in GDP in Europe there was an upturn. Then the euro crisis hit two years later and then there was another downturn. When there was this upturn inflation was at a normal level and growth was coming back and the ECB decided it was the right moment to get out of the crisis measures. I think that is the right attitude. Central banks should not remain longer than necessary in crisis mode. Because they know there will be another downturn one day and then it is helpful to have ammunition available. With hindsight one may have a different assessment but I think that helps explain what happened in 2009 and 2010.

Turning to this part of the world: I would like to talk about what is called the internationalization of the Renminbi. What impact will the likely inclusion of the Renminbi in the SDR basket have on global currency flows? What impact might that have on what you are doing? What impact has being added to the basket on the role of Renminbi?

Everybody assumes that the IMF will do this. The staff of the IMF has announced it. The head of the IMF has supported this. Therefore I think it will very soon be formally decided that the RMB will be included and become the fifth currency in the SDR basket. This is a symbolic act at the end of a long process that has made the Renminbi as an international currency more useable and more widely used. That is one of

the IMF criteria. To reach that stage the People's Bank of China has done many things. I think it is fair to say that the interest rate and the exchange rate in China are more market driven and less controlled. Those are important criteria. The bond market in China denominated in Renminbi has expanded greatly over the last few years. And as a symbolic act of all that and given the size of the Chinese economy it makes sense and the moment has come to include the RMB into the SDR basket. I think this trend will continue. I see it as a trend towards a multipolar currency system where the dollar will continue for a long time to be the most important currency. But it will not be the only dominant currency as it was for many, many years in the past. In a multipolar currency system the dollar will be there but there will be other important currencies like the euro and the RMB. Other currencies will also play a role. If countries are successful they may also gain a higher status. There will be several currencies next to the dollar that will be very important. And that will have implications for all institutions that issue, that invest. We will also begin to issue in other currencies than the euro. So far we have only issued in euro. We need to issue bills and bonds that we need to generate our lending activities. In that sense we are very different from the IMF. So far we have done that in euro. We are preparing ourselves to do it in other currencies.

Which currencies?

That is not decided. It will depend what looks attractive the moment when we do it.

So it could be more than one other currency?

We will probably start with one. I cannot say which one it is. It may be the dollar but we will really decide the moment we do it. And one day it will also be the RMB. I have no doubt about that. But I cannot say when exactly. We intend to issue in more currencies than the euro in order to broaden our investor base. Because that helps to sell our bonds which we will continue to do for decades - even after the end of the crisis when we don't need to disburse new money. But we need to continue to issue bonds because we have to refinance our outstanding claims against those five countries that received emergency assistance.

If you issued a Renminbi bond, would there be technical hurdles to issue that bond if you wanted to do that? Or is it more other reasons like the need to prepare?

We need mainly to prepare ourselves internally. Because the move from a situation that we had up to now where everything is done in euros – our lending of course is in euro and so far our liability side is also only in euro – and that makes life a lot easier. We are not in the business of running any currency risk. So we would need to use hedging instruments if we issued in non-euro currencies. That makes the accounting much more complex. So we are preparing for that kind of thing in order to be able to do it. That will be achieved soon and then we will be ready. Then we will see what is attractive. Because our main purpose is to achieve funds at low costs which we pass on to our debtor countries, the borrowing countries. The cheaper we can deliver the money to them the easier it will be for them to grow out of their debt problems. That is really the reason behind our operation. We want to help countries to return to a healthy situation, debt sustainability and stronger growth again. So the cheaper we can give them funds the better. That is why we look permanently at how to deal with our investor base, how to broaden it, how to use currencies that allow us to generate funds at the lowest possible cost.

When we need to use hedging instruments, how much extra cost are you looking at compared to what you currently charge?

We will only do it if it will lower our cost. So whatever the cost of issuing in a different currency is then we have to add or to deduct the hedging cost. If the cost is not below the euro cost then we won't do it. That is the reason why it is not predictable which currency we will use. It changes permanently. The swap costs change. We have to assess at the moment when we issue which currency makes sense.

If you look at what a Chinese government bond pays it is a lot more than what your products pay.

But then the hedging may reduce that. If we hedge it into euros that will reduce the cost.

Besides selling bonds your role is also selling Europe as somewhere to invest, to do business. Does this form part of your conversation when your travel to Asia and elsewhere?

In a way that is a by-product. You are right. I have to explain what is happening in Europe. This was particularly important two, three, four years ago. Maybe that was not so much the case in Asia, but on Wall Street and in London. Market participants expected that the euro would disappear within a few years. When somebody expects that the euro disappears they are very reluctant to buy ESM bonds denominated in euro. Therefore I had indeed this role of explaining what is going on, how we were dealing with the crisis and what the ways were to get out of the crisis. You can call that selling Europe. That is not my main job but it is an important by-product when I travel to investors and get them interested in buying our bonds.

From the Asian, Hong Kong, China perspective: has the interest in investing in euro denominated bonds or other assets increased or decreased recently? What is the feedback you are getting from the people you speak to?

The share of Asian investors in our bonds has fluctuated. But on average it is 20%. It was a bit more initially, four or five years ago. This was because other parts of the world were more reluctant about the prospects of the euro. From Wall Street we know from surveys that the majority believed that the euro would disappear and in London there was a similar feeling. The experience shows that investors that believed in the story that we would be successful, that we would get out of the crisis, they made a lot of money. If they invested early, the interest rate fell, the price of the bond went up, so they made good profits. Investors that bet on the euro problems continuing or getting worse lost huge amounts of money. That is a very clear experience. Of course, I am happy that those who believed in the euro and our strategy were rewarded for that. That is a good sign and we saw clearly more support for our strategy in Asia than in the US, for instance.

Are there other things that you are looking at – other than issuing in Renminbi – that would make your offer more compelling to investors in China? Are there other linkages or ideas you are working on with partners over here?

As I said: issuing in non-euro currencies is for the future. We have not done that and we have not decided which currency. In general it is very simple. Big investors – and we are mainly dealing with big, sophisticated investors – they want to diversify their portfolio. They do not want to invest only in Asia or only in the US dollar. Europe is about one fifth of the world economy and for a big investor it just makes sense to diversify and also include euro assets. It is up to every investor to decide what their risk appetite is, whether they want to invest in bonds or more in equity or real estate or more risky assets in order to get higher yields, if things go well. That is up to every investor. But to be in euro is a very normal thing given the importance of Europe in the world economy and the euro as the second most



important currency in the world. It does not match the dollar but it is at the moment clearly the second most important currency. All that is not surprising. That is why investors including in Asia have always looked at what we are doing and what the investment possibilities in euro are. Now, that this fear that the euro could disappear - that was never so developed in Asia while it was very developed in the US - has disappeared, this is even more compelling.

