EFSF CEO Klaus Regling in interview with The Irish Examiner

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This is the full text of the Irish Examiner interview with Klaus Regling, chief executive officer of the European Financial Stability Facility (EFSF) and Managing Director of the European Stability Mechanism (ESM), established by the euro area Member States to raise loans for euro area countries shut out of the markets.

Future role of EFSF/ESM in Ireland:

Ann Cahill: Looking forward, what comes next for Ireland - you have a responsibility to the creditors to ensure they recover their loans - what are the most vital things for Ireland to do to ensure the country can repay in your view?

Klaus Regling: That is a by-product. If Ireland conducts the right policies, continues with its adjustment , respecting the recommendations of the Commission given in the context of the European semester the country specific recommendations, removing obstacles to growth then I am sure the economy will continue to recover. We have no reason to doubt that Ireland will do that. Ireland is on a very good way. The European Commission in its latest forecast two weeks ago made a projection that growth would strengthen over next two years. This process will continue with the right policies and with growth coming back Ireland will have no problem repaying its creditors. The EFSF is one of the important creditors and we will monitor this situation and the developments because we have an obligation to protect our shareholders. Ireland is also one of the shareholders so it’s also in the interest of Ireland. But for me that is not the main purpose of good economic policies. The main purpose of good economic policies is to have positive developments in Ireland, and then repaying the existing debt will be no problem, particularly because our maturities are long, on average 22 years. Also our interest rates are low, based on the good rating we have from our Member States that guarantee our activities. As a result Ireland will continue to benefit for 22 years from these low interest rates which I think will be lower than Ireland’s interest rates in the market for that long. We will monitor the situation, the economy, the budgetary situation and we to roll over our own liabilities because they are not 20 years long. So we will have a very active relationship. But that is of secondary importance compared to what the Irish government will do anyway.

AC: What should be the role of the ESM in the post programme surveillance? Is there a difference in the rules for the ESM and EFSF in this regard? What action can the ESM take if there are danger signals about the country’s ability to repay?

KR: The term post programme monitoring is for something that the European Commission does and that is a different process. We have our own process and there will be some overlap and there will of course be some cooperation between the European Commission and the EFSF and ESM. The reason is that we are interested in similar issues. But we will be there for much longer than the Commission because the post programme monitoring ends when the initial loan has been repaid 75%

while we will look at the situation until everything has been repaid. It's a different period of time. We also have a narrower interest: we want to watch the situation and the data that are related to the countries' capacity to repay the debt. The European Commission of course has a much broader monitoring role and obligations. We are in the process of developing our approach. The ESM Treaty talks explicitly about the so called early warning system that we need to develop and we will have a similar or the same approach actually for EFSF programme countries.

AC: What will be the warning signals you will be watching for?

KR: We look on a regular basis, always in advance, of when a payment is due, and they are due on a quarterly or semi-annual basis. Initially there will be only interest payments with the capital repayments to start much later. Whenever a repayment is due we will make a quick analysis of whether the country has made arrangements in the budget so the payment can be indeed be made. As a result we are in a regular exchange with the authorities to get the information on that and we look at the broader developments to ensure the capacity to pay is really there.

AC: In terms of the budget, how do you see the ESM being involved in that? Will you monitor that through the Commission, or will you be there yourself, will you wait until the budget heads are drawn up or will you be involved at an earlier stage?

KR: We are now discussing the details with the Commission how to do this in an efficient way. That means that we don't want to add to the burden of the authorities because we do not want to take too much time away from them and to request the same information, so we will agree with the Commission how to handle this efficiently.

AC: So you will keep a very close eye on the budget?

KR: Yes. This should not be confused with any additional conditionality or anything of that sort required during the period when there were disbursements. But we want to be informed about the budget. Our interest is to make sure that money that has to be repaid to us is actually available.

AC: Will you have an influence on whether there should be spending cuts or tax increases in the budget for instance?

KR: We will not impose any policy measures like that but in our regular monitoring about the ability to pay we have to make sure the money is foreseen in the budget. As long as that is case - and that will be the normal situation because the payments are no surprise, they are known in advance -, there will be no demands of any sort made on the Irish government. Only if we come to the conclusions that payments that are due are not foreseen in the budget, then we would have a serious talk with the government but I would not expect that to happen.

AC: Will the IMF have a role?

KR: The IMF does the same thing. They also have money outstanding. Their maturities are much shorter so the IMF process will be much shorter for that reason. But they also take a regular look whether they are being repaid, and whether the country has made preparations to make payments to them. On top of that with every country in the world there is the normal annual IMF review of the situation that has nothing to do with outstanding claims. But it provides information that will be useful in that context.

FTT and Anglo Irish bonds:

AC: Financial Transaction Tax - should the Irish government join with the other countries adopting this?

KR: I know that eleven countries have agreed to introduce the FTT. I'm not aware Ireland has changed their view. I have not seen any talks on that.

AC: Do you think they should change their mind - their view has been negative?

KR: The FTT is a completely different issue, it's a very complex one. The eleven countries that have agreed to have an FTT implemented are looking at the details very carefully. I see the scope and the rates at which the FTT might be applied are being redesigned, lower rates and more narrow scope because there are some concerns about unintended consequences. This seems to be very much in flux. I cannot forecast today where this will end exactly and whether the redrawing of this proposal might lead to an approach where more countries can join. It would be better if more countries came to a common approach than some countries doing it and others not.

AC: The disposal of Anglo Irish Bank bonds - the government has agreed to a timescale to dispose of specific amounts at specific times, but there is a fear that this may have a negative effect on Irish sovereign bonds - should they be allowed to hold off on the disposal for a more opportune time for the economy or even hold onto them indefinitely?

KR: I don't follow individual transactions for individual banks so I cannot comment on that. What I can say is what has happened in the last few days for some of the big Irish banks is very positive in general. Irish government is getting money back from banks even with profit and I'm sure this will have a positive impact on the sovereign and the relationship between the government and Irish banks is getting back to normal. Beyond that I cannot comment.

Strengthening Ireland's growth:

AC: The economy is small and very open and growth depends very much on global economic performance which is not guaranteed - should Ireland be working to strengthen alternatives and if so what are these?

KR: What Ireland has done in the last few years - and I think that is the right approach - is to strengthen its competitiveness. That will make it easier for Ireland to capture a larger share of the world market. As a result Irish exports are growing and they are increasingly doing well in the world economy. One of the reasons for the crisis was the loss in competitiveness and one can see that in our charts on macro-economic developments in Ireland. For example one can see very well that until early 2008 unit labour costs in Ireland were growing much faster than the average for the euro area and so that meant Ireland was losing competitiveness during the first decade of the monetary union. This was reinforced through fiscal stimulus in the second half of the last decade and through moving from a high interest rate environment to a low interest rate environment. All of that fed the real-estate bubble and the credit bubble but competitiveness was one of the factors here and since 2008 the situation has been improving in that respect. I think that is the right approach and we see the positive benefits of that.

AC: Forbes has just listed Ireland as the best place in the world for business. It mentioned that the fact that unemployment was high and labour costs dropped by 18% was a bonus and I'm not sure that everyone would agree.

KR: That is typical. When I say there has been a lot of progress, on the fiscal side and competitiveness and on restructuring the banks, that is the view from a macro-economic perspective and the view of a creditor that wants to be repaid. But it is very understandable that the man in the street does not see much progress because the labour market is in a difficult situation, incomes have been cut and so most people do not see light at the end of the tunnel. But it is the role of economists and governments to look at early indicators and they point in the right direction. We have to look at the benefits in terms of rising exports and at the elimination of the current account deficit - which has already become a surplus. These positive developments are very clear and visible but it does not mean that people see this. But they should see it in a little while, because growth came back to the country this year, housing prices in Dublin - not in the countryside - are beginning to go up again, so the first indicators are there. But I can understand that the population is very sceptical and this unfortunately is a normal phenomenon in every crisis. We see this in other European countries and around the world when IMF programmes are implemented. There is unfortunately a time lag between structural reforms and fiscal consolidation before the benefits in terms of higher growth and more jobs are visible.

Pressure on corporate tax:

AC: Forbes listed the accommodative tax regime in Ireland as one of its advantages for multinationals, but they are under pressure to change it. What is your view?

KR: There has been pressure on the Irish government for many years and the Irish government succeeded at the beginning of the programme to fend off these pressures. But tax issues are very difficult issues. As an economist I like to look at the effective tax rates and not the nominal rates. When I look at that data from Eurostat I can see that the effective tax rates in Ireland are not that low. They are higher than in some of the countries that have criticised Ireland so I think the Irish government has some good arguments on its hands on that.

AC: The pressure is perhaps not so much on the rates now as on the tax regime with the so called double Irish being criticised and with pressure coming from the OECD etc?

KR: On some details I cannot comment - we are not tax experts and my comment is on the overall, particularly on corporate tax rates. I know that the effective tax rate is higher than in many other countries in the EU which shows there are not that many tax exemptions or loopholes in Ireland.

European help for Banks and tracker mortgages:

AC: Tracker mortgages - some believe they are no longer a major problem as the cost of funding especially for Bank of Ireland is now low enough to cover their costs. Others say trackers remain a huge burden for the banks. What is your view?

KR: The burden seems to be getting smaller. I know it has been a problem and probably continues to be a problem for some banks. But if you want to imply that the ESM could be of any help here, we do not have an instrument that would be useable for that.

AC: The Irish government believes that the best solution would be for the banks to guarantee 10% of the tracker mortgage book and the government guarantee the remaining 90% with the ESM overlaying this with a guarantee to ensure a double A credit rating so they could use them with the ECB LTRO to access a funding line. How do you view this?

KR: We do not have an instrument that would make that possible. There is no attempt in our governing bodies to create new instruments like that.

AC: If it made a difference to a country's ability to grow and repay its debts, should this be reconsidered are there any circumstances under which you would reconsider?

KR: This is a specific problem to Ireland and not in other countries and I do not so far see an appetite to create such an instrument for that. One should remember that such a decision would have to be taken unanimously among all the euro area Member States.

AC: If the stress tests next year on the Irish banks, and especially AIB and PermanentTSB, indicate they need further capital, given that they are state owned do you see the state providing this at a time when it is trying to re-enter the market which would surely be bad timing? Would the ESM consider directly recapitalising the banks themselves or insist that it be done through the sovereign as with Spain? Minister Noonan has said there would have to be a ESM recap otherwise Ireland will never succeed in breaking the link. What do you think?

KR: There are different possibilities. But first the ECB, who knows more about this than we do at the ESM, has said they do not expect big problems in the euro area in general. This is particularly the case for countries that have been under a programme and where the asset quality of the banks has been reviewed several times with the help of outside experts. So of course the situation could change but that is the view of the ECB. If there were capital needs the ESM has one instrument that can be used now to restructure the banking system via a loan to the government as we did with Spain. That is an instrument that is available. The eurogroup, the finance ministers of the euro area, has agreed in principle to create a new instrument for direct bank recap. But this instrument does not exist yet and requires another unanimous decision. Also the finance ministers have made it clear they don't want it to be used before the ECB is playing its role as the Single Bank Supervisor and that will not be before autumn of next year. So this instrument is not available at the moment. Also we have state aid rules which are in place since August of this year which require some bail-in before any public money, whether it is national money or ESM money, can be given to a bank. That would apply in any case and then we have to see what governments are able to do themselves, and whether there is really a gap.

AC: Would the situation like Ireland's where banks are almost entirely state owned make a difference to the arguments?

KR: The ESM instruments are still the same even . f there were gaps. But I am not predicting that and the ECB does not expect big capital gaps in any of those banks. But if there were some, the possibilities are still the same whether the banks are state owned or not.

Breaking the link:

AC: There was a commitment given to the Irish government on 29 June 2012 that the link between the banks and sovereigns in the euro area would be broken? What is your understanding of what this means in practical terms?

KR: This was not a commitment given to the Irish government. This was a general commitment of the euro area summit that day - it is in the communique of that summit - to break the link between sovereigns and banks. That is correct, and that is why we have all these moves towards banking union to break the link, including the creation of a new instrument for the ESM, the direct bank recapitalisation. We have made good progress in that area and also there is agreement not to use that instrument before the autumn of next year and it still requires another unanimous decision.

AC: Oliver Wyman described Anglo Irish Bank as the best bank in the world prior to the banking crash which raises questions about the quality of their analysis. Oliver Wyman will be involved in the 2014 stress tests. Does this concern you?

KR: They were selected by the ECB and I am sure they picked a good company. It is a very big company with a lot of expertise, but that was the decision of the ECB. We also work with Oliver Wyman and have good experiences.

Retrospective bank recap:

AC: In previous interviews you have not ruled out retrospective recapitalisation in the future once the elements of banking union are in place - is this correct?

KR: I quoted the statement from the eurogroup that said that on a case by case basis and based on a unanimous decision, it might be available. My personal impression is that the appetite is not very high to do it. But that sentence is there in the communiqué and that is what the ministers have said.

AC: Do you think the Irish government is likely to require a recapitalisation of the money they put into the banks in the future?

KR: It would always be attractive for those affected, but the question is whether there is a unanimous view to do it, and there I am sceptical. But ministers have said it is a possibility. Because nobody knows what the future will look like, so not to close a door is probably wise. But given the circumstances as they are at the moment, it does not look like there would be a consensus in the eurogroup to go in this direction.

Changes and lessons learned:

AC: As author of the original report on Irish banking - has your analysis changed?

KR: No not really, because that report, that I did with my co-author Max Watson talked about the origins of the crisis. I would still maintain that analysis today. The origins of the crisis were a combination of many things: there were the macro economic developments that were partly related to the introduction of the euro, but only partly. Partly they were related to the financial market integration, to non-Irish banks entering the market which depressed interest rates even further and which pushed up the credit bubble and pro-cyclical fiscal policy in the second half of the last decade. Then there was a failure of bank governance, the failure of banking supervision - all these things, came together. Add to that this surprising Irish attitude widespread in the population that one had to invest as quickly as possible in real estate. I think that was partly related to the fact that in Irish history real estate prices had never declined and so there was no collective memory, unlike in some other countries that prices that have been going up for some time can also come down one day. So all this came together to create this tremendous bubble - that is what we tried to describe in the report. I think that remains the right analysis.

AC: Have the lessons been learned - house prices rose higher in October than in any month during the bubble?

KR: That may be a reaction to the steep fall. These developments are often not gradual and there was this 50-60% drop in prices and so there could be a bounce back. I would hope that this would not continue for a long time, we don't want to have another bubble. I'm sure the government does not want to have another bubble. But lessons have been learned because the government has been addressing these issues that we identified as being at the origin of the crisis. Banking supervision has been tightened in Ireland as in other European countries and actually globally. Fiscal policy of course is a very different story at the moment because there were large deficits in the context of the crisis and certainly the collective memory of the population is very different than in the past and that will be taken into account in individual decisions. Also it is important to realise that as a result of the euro accession Ireland quickly moved from a high interest rate environment to a low interest rate environment. But this was a one-off process that will not be repeated so that problem will not reappear anyway. So I think in the broad sense the government has been drawing the right conclusions.

Future development of EU and ESM:

AC: We have seen the German approach to economics having a huge influence on the eurozone and this will continue with the Bundestag approving every ESM decision for instance. Should this change and under what conditions should it change?

KR: I think this is the wrong perception. The ESM is not dealing with the Bundestag. We have a governance at the ESM and previously at the EFSF where important decisions are taken by consensus of the 17, and from January on by 18 finance ministers. Every finance minister has a different situation at home. The decisions related to the ESM are important decisions so certainly all the finance ministers would get the backing of their Prime Ministers. In a number of countries - and this goes far beyond Germany - they also need the backing of their national parliaments. This parliamentary approval is required in at least 5 or 6 countries but this is the intra-national arrangement that every finance minister has to make sure that he or she has the backing at home. So we do not deal with any particular parliament.

AC: Do you think that is fair to have it like that, should there be changes, it give each parliament a very big say in what is seen as the sovereignty of another country?

KR: The parliaments or the national governments - that is why we have unanimous decisions - take on very large risk. Therefore every country has a say in this. Every country has a veto right. How each country organises this is their business and those countries that do have a strong role of their parliaments have to involve them in the decisions. These 5 or 6 countries are unlikely to change their approach at any time soon because the parliaments take the view - and some of them are even supported by their Constitutional courts - that they must take a strong interest because they take on a strong risk in guaranteeing our lending operations. So I do not expect this to change. But the important point is that despite what seems like a complicated system, the ESM and EFSF have been able to do what is required in a crisis: we are supporting five countries and there was always a unanimous decision of our Member States despite the complicated procedures. We have disbursed €220 bn which is a lot of money. It is understandable that parliaments want to know what is going on and have a say in some countries. That may make it complicated sometimes but it has not stopped us doing what needed to be done to stabilise markets.

AC: Is there a fear that as the economic cycle proceeds the German economy for instance will once again dip as it did a decade ago while much of the rest of the eurozone will perform well and so is there a risk of recreating the same conditions that led to the current crisis?

KR: I do not know why you draw that conclusion. Another important reason for the crisis were macroeconomic imbalances within the euro area. I am often asked whether it is not bad if the northern European countries are permanently strong and growing fast while the southern European countries and the countries of the periphery including Ireland are permanently weak and on a low growth path. I think this is not what I would expect. We have to remember that economies move in cycles. We never have a situation where some countries are permanently strong and others are permanently weak. All countries move in cycles. I think we can see very clearly now that those five countries that have borrowed from the EFSF and the ESM are implementing tough reforms. These reforms are painful for the population but they are creating a better basis for sustainable growth for the future. They will benefit from that with a time lag, other countries that will not have as many reforms will not do as well in the future. So countries are moving in cycles. We know that Germany has higher increases in unit labour costs in the last two years than other countries in the euro area. This is a normal cyclical phenomenon because growth has been stronger. This is normal and it will help narrow down the macro-economic imbalances inside the euro area so it is a positive development overall.

AC: Do you think it is important that the euro area countries all come around so that they are all at the same stage of the cycle at the same time?

KR: We will never have a situation when all 17 - 18 countries always move at the same speed. That would be unrealistic to expect and it would not be healthy. Countries do move in cycles, and if it is within certain margins that is very healthy and can help each other. What we should avoid is that these normal cycles become excessive and that deviations become excessive. That is what we saw last decade and that is why we now have rules in the euro area to avoid excessive macro-economic imbalances. The aim is not to avoid cycles in general because these cycles will be there, cycles on trade developments, on credit flows, on competitiveness. One should try to avoid that these cycles and these divergences become excessive. We have learned in the crisis that corrections can be very painful and very costly. But we should not try to avoid all cycles and you would not be able to succeed that states of the euro area all move in synch, exactly at the same speed.

Banking and fiscal union:

AC: Do you believe there will be a full banking union? When? And do you think this must be accompanied by political union? Do you think that as envisaged over the past few years there can be banking union?

KR: We are in the middle of this process. The first important step was taken to make the ECB the single supervisor. Without the crisis this would never have happened because even during the negotiations of the Maastricht Treaty, more than 20 years ago it was discussed whether the ECB should play a role in this area or not and there was no consensus. Now we know there are next steps that should follow. The Council, the Commission and the European Parliament will be working intensively on this over the next few months. The Single Resolution Mechanism and Single Resolution Fund are the important complements to the Single Supervisor. There is also the ESM's instrument of direct bank recap which is part of the elements but not the most important one. And there is also the issue of whether the ESM should be a backstop to the fund. All these issues are controversial, they are also very complex. So it is understandable that it takes a little bit of time to come to an agreement. The crisis has clearly demonstrated that we are able even when the starting point is very controversial to come to a resolution in the end. Sometimes it takes some months longer than expected but everybody knows it is important to come to an agreement on these complimentary issues, particularly on the resolution mechanism and fund within the next few months. Nothing works without the European Parliament in this area and it will close in April to have elections in May and therefore the time pressure is there and that can also be quite helpful sometimes.

AC: The ESM providing a back stop for the Resolution fund, where has that got to now?

KR: It has not been decided. It's a proposal - some countries are in favour and some against. I don't know what will happen in the end.

AC: You appeared to be open to it?

KR: There are many proposals of what the ESM should do. One proposal is that the ESM should become the Single Resolution Mechanism. But I don't think this is an efficient solution, we are not lobbying for that. Concerning the Single Resolution Fund I see some merit for the ESM to become a backstop. The reason is that we could be helpful here and there would be some synergies to give that function of backstopping the Single Resolution Fund to the ESM although it would require a change of our ESM Treaty which is never easy politically. But on the substance I see some merit so we have to see what the political outcome will be.

AC: The future role of the ESM, do you see that expanding?

KR: We have expanded more than I ever expected, so I am not pushing for any more. But we have to see how the euro area develops.

AC: How would you like to see the euro area develop - is development on the banking, fiscal sphere possible without political union?

KR: It always depends how you define political union, fiscal union. I think we have moved quite a bit in that direction. Of course we do not have a fiscal, political union in the sense that we have one budget and one government. Then we would be the United States of Europe and that is not what the majority of the population wants or what governments want. That was more popular 30 or 40 years ago. So it seems unlikely that we reach full political and fiscal union, but steps have moved us in that direction a lot more than before the crisis. I believe is important for the good functioning of EMU. With all the rules that have been adopted the last few years to have much tighter and broader economic policy coordination, also in the fiscal area and beyond that we have moved a great deal towards political union. That move is truly important and if the new rules are fully implemented I am confident that monetary union will work better after this crisis than before the crisis.

AC: Do we need another crisis to move us to another stage?

KR: Unfortunately Europe has always seen more integration during a crisis. It's unfortunate because this crisis was the worst in 80 years. It has been very painful for the population in many countries. Therefore one should not wish to have another one. But it is true that these crisis provide an opportunity for more European integration in certain areas and I think monetary union needed more Europe in certain areas to get out of this crisis and avoid future crisis.

Austerity and human rights:

AC: The Council of Europe's Commissioner for Human Rights produced a report this week saying that some of the austerity measures may breach human rights and calls on both national governments and the creditors to take into account human rights such as an income above the poverty line, structures to ensure human rights are protected including those of asylum seekers when designing programmes or implementing economic governance. The UN in relation to Greece specifically has been similarly critical. Do you agree with this, that institutions such as the ESM have such a responsibility?

KR: The ESM was not given the task to design adjustment programmes. That was done by the Troika and we provide the financing. As an economist I fully support these programmes. It is quite common to criticise the impact that these adjustment programmes have on the population. But I am convinced that without these programmes and without our financing, the pain would have been worse because what we do with our financing in Europe - like the IMF internationally - , is to ease the pain. The pain comes from the fact that economic policies went in the wrong direction before. That created a crisis and in response to the crisis some things had to be adjusted and that created a painful process. If the EFSF or the ESM or the IMF did not provide emergency financing at a time when a government loses access to the markets, the pain would have been worse and the adjustment would have been brutal and much faster.