Interview with Klaus Regling, Managing Director of the ESM

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The troika's programme is coming to an end. Will it be possible for Portugal to go back to the markets without a precautionary credit line?

Portugal has made very good progress with the existing programme; there was real progress in structural reform and fiscal adjustment. I know that for the population it may not look like there's progress, because unemployment is still unacceptably high and the economic situation is not good. But we can see early indicators that demonstrate that there is progress. Competitiveness has improved, exports are growing, the current account deficit has disappeared… These are good indicators that the economy is moving in the right direction. And over time this will also become visible for the people in Portugal, because growth will become stronger and unemployment will continue to fall. I hope very much that the reforms continue, because that will certainly contribute to a good economic performance. What happens when this programme comes to and end? It's a bit early to say. The Portuguese authorities were able to issue a 10-year bond last week. The interest rate is still bit high, but it's a lot better than two or three years ago. In that sense, market access has been regained and I'm sure the government will monitor the situation in the next months before they come to a conclusion on which way to go.

Do we need to make a regular bond auction to prove full market access has been regained?

It's too early to say. It depends on what happens in the next few months. It's right to discuss inside the government and within the Eurogroup the different options. The ESM has the precautionary arrangement available. , We know from the IMF experience that sometimes it is good to use this instrument at the end of a regular programme, but it's a decision of the government to make the request or not. And we know from Ireland, where we also had this debate for a few months before the programme came to an end, that the ESM instrument could have been available but in the end the Irish government decided not to make this request and it's working quite well.

What kind of arguments are being used in favour and against the different options in the discussions between the government and the European partners?

It all depends on the overall market situation. Markets are volatile, so we don't really know how they will look like three months from now. It also depends on the continuation of reforms in Portugal, because markets will look at that. At the moment they have a positive attitude, because early positive indicators are visible. We know that these reforms will have to continue – I have no doubt about that – and that should strengthen even more the economic performance. Markets will take note of that.

You said that the current interest rate, around 5%, is still a bit high. What level would be sustainable? 4%? 4.5%?

I cannot give you an exact figure, but I look where Spain is now, for instance. Spain is paying 3.5% for 10-year sovereign bonds, Ireland is even below that, and certainly that's where Portugal should be able to go over time. In the medium term interest rates will go up. We are at the end of the crisis where worldwide interest rates are low, so at one point the spreads may come down, but global interest rate levels may go up, so that's why the end result may be around 4% and not 3.5%. It depends where we are in the cycle, what happens to inflation and all that, so it's wise for the budget not to permanently assume too low interest rates, because at one point it will go up. Not because of Portugal, but because global interest rates must go up eventually.

Portugal is pre-financing 2015. If it manages to have a safety net for the next 12 months, will it have more room of manoeuvre to negotiate the precautionary credit line?
In general, a safety net helps market confidence – we could see something very similar in Ireland. Does it help to get the precautionary line? There are two sides to that: on the one hand yes, but on the other hand it may not be needed then to have the precautionary credit line. It depends on many elements.

So if we manage to finance the next 12 months, will we still need the safety net from the ESM?
I cannot say for sure. These are considerations that play a role, but I cannot tell you what happens when the safety net reaches a certain level. I'm sure it will be taken into account by your government – and it should be. I can't take their place and try to decide for them. These are complex and important issues, they change all the time, but the size of funding is one of the elements I'm sure we are going to look at.

There are two types of precautionary programmes. There's some kind of consensus that Portugal doesn't qualify for the lighter one and would need to apply for the ECCL. Do you agree?
It's not something that can be decided now.

But there are some criteria…
Yes, the criteria are clear and if Portugal's choice will be for a precautionary credit line rather than a clean exit then at the moment it seems to me that ECCL would be the more likely. Despite all the progress I talked about, which is considerable, Portugal still has some progress to make.

There are some sectors where the progress of the reforms didn't meet the troika's expectations, due to vested interests. How can we be confident that, after the troika leaves, those reforms will be made?
It's a very important question, because the economic performance of Portugal in the next decade or so will depend on how that question is answered. Of course I hope that more progress will be possible. A lot has happened and I really want to recognize that, but Portugal also started the crisis with a huge backlog of reforms and one can see it in fact before the crisis that growth performance was very poor and the explanation is the lack of reforms and loss of competitiveness. Competitiveness is now probably restored, so if reforms continue, the reward in the medium term can be huge. We know from economic history that countries that do implement reforms will see higher growth. Not immediately – and that's a political problem – but in the medium term.

But can we be confident that the reforms will be made?
It's a good point. We have in the EU a big advantage that no country is on its own. They are all under permanent surveillance from each other – and this refers to all the 28, but particularly the 18 euro area countries. Even countries that are not in a crisis, like Germany, they get recommendations every year on how to remove obstacles to growth, how to make progress, and this will continue and will also be relevant for Portugal. So there will be good advice coming from partner countries and from the Commission. And also, after the end of

this programme, there's always something called enhanced surveillance by the European Commission for countries that have borrowed from the EFSF and ESM, so they will pay particular attention. We will also do that from our side, from the EFSF and ESM, because we also need to monitor the situation until we have been repaid. So there will be good advice even though it will be different than being under a programme.

Since we are talking about a long period in time, would you say that it would be helpful to have an agreement between the three major parties regarding the necessary reforms?
When there's a real crisis like we had in Portugal in 2011, it can really help to have also the opposition on board. And that was the situation you had then. It's helpful, but in the end, if it's not possible, what counts is that the measures that need to be implemented to improve the fundamentals go through Parliament. For instance, in Greece, where the situation is much more difficult, there's a very slim majority in the Parliament and so far they have implemented everything that was agreed, so it's possible. But it's more comfortable and maybe easier for society if they see that the major parties are thinking along on the same lines.

If we fail to have such agreement, our situation will get worse from the markets' perspective?
We know that markets do look at the political situation in a country. When they see that there's a big disagreement between the major forces in a country, they don't like that. They like consensus or a large majority willing to move in a similar direction. Not every detail, but a broad direction. So it helps.

If Portugal goes for a precautionary credit line, is it possible to have only the lighter conditions, like keeping up with the European rules that are in the Two-pack and the Six-pack?
A precautionary credit line would have lighter conditionality than a normal macroeconomic adjustment programme, but how exactly it's impossible to say now, it all would depend on the moment it would be requested and it's up to the Commission to come up with a plan. But there has to be conditionality, there's never lending from the EFSF or ESM without conditionality. There has to be an MoU signed by the finance minister and that would have conditionality.

But this MoU would only need to be signed by the finance minister? It doesn't need to be signed by the three main parties?
It's a country decision how to do it and how to organize it internally.

But you don't request it?
No, there is no special requirement of such nature. The signature is a responsibility of the national authorities, normally it's the government.

Portugal's public debt is at 130% of GDP. How can we say that this is sustainable debt?
It's a high level of debt, that's clear and it's important that the government keeps it in mind. The most important point is that there are several elements that need to be considered: one, to reduce the fiscal deficit further, towards what's agreed in the European Stability and Growth Pact, to have in the end a structural balance in the fiscal accounts, because that will limit the further increase [in the debt] and actually would mean that the debt ratio would come down; second, to implement reforms in order to generate more growth; and third, what we are doing so far, the EFSF lending -which is for an average maturity of 22 years - will also help Portugal with its debt structure, because the interest rates we charge are relatively low,

therefore the debt service burden that is associated to the debt burden is much smaller than if it were financed by the markets.

What's the impact?
One can make a quick calculation: in 2012 and 2013 if the money the EFSF is providing had to be financed by the markets, the Portuguese budget would have had additional interest expenditures every year of about a billion euros. Of course these savings can come down as the market situation normalizes, but for the moment it is more than a billion per year. And that helps to make the debt sustainable at the moment, because of the low debt service.

Is it possible to aim at another extension of maturity of the European loans?
I'm not aware that this is a discussion that is on the table.

But would it be possible? There is some news that such a thing can be discussed for Greece. And, in that case, even for a question of fairness, could it be discussed for Portugal?
Well, that's correct, Greece's maturity is longer, it is 30 years, in Portugal and Ireland it's 22 years. But I think it's also a good sign that the Portuguese economy is in a better situation than the Greek. And when we extended the maturity to 22 years, we looked very carefully at the debt profile, the repayment obligations year by year and it's now a very smooth repayment schedule, so that was taken into consideration already. And together with the low interest rate we charge I think it's already a substantial help for the Portuguese budget and therefore for the Portuguese economy. I hope that Portugal can now grow out of it.

We have elections next year in Portugal. Do you think that in political terms it will be hard to sell a new programme, even if it is a precautionary one?
I'm confident that the Portuguese government will continue to be able to explain to the population that the adjustment is tough but is unavoidable and it also provides hope for the future, because this kind of reforms will provide better economic perspective. That's what we see everywhere around the world. So it's better for the population to accept the adjustment pain, which is quite strong, but there's a reason for it and there's hope.

How badly have the Constitutional Court blocks affected that adjustment so far?
I know it happened three times, that makes it more difficult, but it's not my job to criticize Constitutional Courts. I would not criticize courts and certainly not Constitutional Courts, because they are part of democracy and we have to respect their rulings. It made it more difficult for the Portuguese government, as it had to very quickly come up with compensating measures, which has always happened.

Is there a risk for these alternative measures to be of a lower quality than the ones ruled out?
If the Court rules as unconstitutional certain measures, they cannot be used, so the government has no choice, they must decide on compensating measures, that's what they have done and I can only applaud that they have been able to do this quickly in every case and that's why the programme is on track. But it does make their life more complicated.

Portugal has come a long way since last summer. Where you afraid of a need of a second bailout after Mr. Gaspar's resignation? Was that discussed at all?
It was not really discussed, because there was no need. If people thought then about the options for the middle of 2014, that was one of the possible options. Since then the overall

market situation has improved a lot, Portugal has continued to make very good progress and therefore a second full programme seems to be not really necessary.

Markets are volatile. How badly will it be if Portugal leaves the programme with a clean exit and, a few months later, it needs to request a precautionary credit line, even if it is due to external reasons?
That's one of the considerations I'm sure the Portuguese government will have in mind when it takes a decision.

What's your assessment on the Single Resolution Mechanism? How's the whole process right now and what would be a reasonable timeline for the process to end?
What counts for me is that there's an agreement with the European parliament no later than April, when the Parliament closes for elections. I know that there are many detailed discussions here and there and what can go in what direction, but from my perspective the key is to have an agreement, because we need to make progress with the banking union, the ECB has said often that as a complement to the single supervisor they need the Single Resolution Mechanism and that requires a Single Resolution Fund. It's important to have it in place so that at the time ECB has done the quality asset review and EBA the stress test, if there's a need for money – and I don't expect much – there's a system in place that can respond to whatever problems that come up.

Can we get to a point where we have the stress tests made without the resolution mechanism agreed yet?
That's exactly what needs to be avoided.

How credible would the stress test be then?
We could find solutions, because many countries are able to come up with money if needed, and other countries can borrow from the ESM with a macroeconomic adjustment or a Spanish type banking restructuring programme.,
But how's that a good option? Asking the governments to borrow from the ESM and raise the public debt?
It's not the best option and that's why I hope we find a better system. And everybody involved has in mind that by April we should have a conclusion.

Can the European elections put on hold some crucial topics like the banking union and Portugal's exit from its programme?
They are never put on hold and certainly not due to elections, because these are important issues.

But can the outcome of the issues be affected?
It could be actually quite positive to have this deadline in April, so that may force everybody to find a compromise.

Jean-Claude Trichet said in January that the ESM is the farthest Europe will go in terms of Eurobonds. Do you agree?
For the foreseeable future, yes. I would never rule out something twenty years from now, but as many politicians in northern Europe have said, Eurobonds can only become available at the end of a long process. And the process means everybody complying with our fiscal and other surveillance rules, also being confident that the centre, which is the Commission, can intervene when a country is not complying with the rules. When all this is credibly in place,

then Eurobonds might be feasible. But it's a very long process, I don't think I'll see the final point of it before my retirement. And I don't intend to retire early.

How can we be talking about European solidarity and at the same time see things like Germany and the Bundesbank questioning the OMT?
What we are doing with the EFSF and ESM is solidarity, we have disbursed in the last three years 222 billion euros to five countries at low interest rates, so this is solidarity in a crucial moment. And what happens with OMT we have to wait and see. The German constitutional court didn't say anything that makes OMT impossible, they have a clear view, but they are asking the European Court of Justice for their view and I think it's the right approach because only the European Court can deal with a European institution.

If they give the OK without restrictions, will it be harder for precautionary programmes from the ESM to pass on some national parliaments, like Germany and Finland?
We are dealing with several parliaments and I cannot predict which parliament will say what in the end. This is complex, but it's not relevant in the short run, because the European Court will take some time to decide.

What were your thoughts when Ireland said it was going for a clean exit? When were you informed about the decision?
It was a bit like Portugal now. There was a discussion for quite a while, in the Eurogroup and mostly within the Irish government, looking at the different options, monitoring the market situation and market access and they took the final decision no more than a month before the programme expired.

But the question was being debated for a while?
Yes, and this is perfectly reasonable, it's good to understand what the options are and what instruments are available.

What about the situation in Greece? There have been divergences between the troika and the Greek government for a while? Can we expect an agreement soon?
I certainly hope so. The troika will now go back to Greece and that's really necessary because there have been delays in the conclusion of the review and therefore also delays in the disbursements of the EFSF and IMF. And the review is needed for that, to have disbursements, but also to have a good basis for our forecasts.

What's the assessment on the financing needs for this year and 2015 and 2016?
We don't have precise numbers for financing needs later this year or next year. We know if there are any, they would be a lot less than in the past. It will only be a fraction of what was needed in the first and the second programme. But we don't have precise numbers because the review has not yet been concluded. I hope very much that they come to conclusions.

When was the last time that EFSF made a disbursement to Greece?
We had one disbursement in December of half a billion but that was a special leftover and based on some milestones. But the last big regular one was in June, so there have been quite some delays.

And it has made quite an impact on their financing needs?
It's difficult to say, because financing needs are a combination of many things. Greece is on track with their fiscal consolidation programme. We don't have the final number yet, but it seems they had a primary surplus last year, so they are on track. It needs to grow over time but they are moving in the right direction. But on structural reforms there have been some slippages and the more slippage there is, the less growth will happen. And in the end that will also have an impact on the financing gap. There are no easy answers. That's why we need the troika in the country to make that assessment.

If the positive outcomes on the fiscal side prove to be right, will more progress still be needed in the economic reforms to have additional help from European partners?
One needs some catching up with structural reforms for the next disbursement and the existing programme and whatever happens after the end of this programme will also depend on another MoU and some understanding on reforms.

Two big topics are now threatening the recovery of the euro area. Do you fear an escalation of the problems in emerging markets? And what's your assessment on deflation risks?
For the world economy it seems that emerging markets have some problems for the moment and given we are all interconnected, this will have an impact on us. However, one must also admit this may have a relatively positive impact because with the problems that have become apparent in the emerging markets, capital is not attracted by these markets so much anymore. And therefore investors look at other markets and Europe can benefit from that. That's one of the reasons why interest rates are low and spreads are coming down. But if emerging markets have real problems then our trade side would be negatively affected. So far I don't see this as getting out of control.

And deflation?
Like the ECB, I don't think there's a huge risk, it's a small risk. The IMF itself discusses this a lot: according to their models there's a risk of 10 to 20%. I don't have my own estimate, but it's a small risk. In the end I don't think we are heading to deflation, because we have a combination of price developments: in the periphery, we are happy that prices are falling or rising very slowly, that's part of the programme design, its deliberate, it's what we want to see so that countries improve their competitiveness. Inflation in the other countries is not that low, it is below the 2% target of the ECB, that's correct, but this is also part of the indirect effects such as falling commodity prices. And in the core of the euro area, like Germany, we have wage increases of 3%, it's very hard to see how that can lead to deflation. We don't have wages falling except in southern Europe.

Do wages need to fall further in southern Europe?
It depends a bit country by country, but according to the data I look at, the competitiveness problem, which was very serious in 2008 and 2009, has almost disappeared now in those countries that have borrowed from the EFSF and ESM. There are some other countries that also need to watch out, but overall in the five cases that are current or former programme countries, if productivity continues to increase I don't think big generalised wage cuts are needed again in nominal terms. The competitiveness position of every country has to be monitored very closely.