Klaus Regling - Interview with Diario de Noticias

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Interview with ESM MD Klaus Regling

In its most recent World Economic Outlook, the IMF points out that public investment is crucial to stimulating private sector investment. What do you think about this? Couldn’t this be read as a renewed risk to indebtedness?

We must look at this on a country-by-country basis. So I don't like this generalised recommendation. Some countries have investment shortfalls. Those who went through a difficult adjustment, like we saw recently in Europe, often had to cut investment. Other countries didn’t need this as much. So you are right to remind us that debt levels are high. Although this is a good moment to borrow in the markets - interest rates are lower than ever before - investment also has follow-up costs like repairs which, or personnel who, are needed to run investments. And these are not one-off costs. We also have examples around the world where a lot of investment was not good for the economy.

Where?

In Japan, for instance, during the 90’s and the last decade, they tried to invest more to stimulate the economy and not all of that investment was productive. There are many white elephants in Japan that did not lead to productivity increases.

What do you think of the several infrastructure projects planned for Portugal in the coming years?

I cannot really evaluate. I leave that assessment to the European Investment Bank and the Commission - they have the expertise.

The IMF also stressed that there are new risks in the global financial markets, like the ones related to products called 'plain vanilla funds'. Do you see such risks forming?

There are always risks in financial markets, that's clear. But the risk I see at the moment is coming from the fact that interest rates have been very low for a long time - even negative. Investors look for alternative investment projects and types of investment that give higher yields. This means they have to accept higher risks. And maybe there are bubbles developing in certain markets. This is another risk.

For example?

We know that insurance companies and pension funds have the problem of mismatch between the promises they have made to their clients on guaranteed yields and the yields they can achieve at the moment. Again, this varies country by country and market segment by market segment.

Is there a bubble forming in debt markets and in sovereign debt markets?

It is always difficult to say exactly where bubbles are. Unfortunately, it's much easier to see it ex-post. What we know is that in certain parts of Europe real estate prices are going up strongly again, it's where people are placing their savings. Since they didn't get much return on investments, they shifted to real estate. It's very normal and understandable but it could lead to new bubbles in certain areas, in certain cities. It can also lead to bubbles in the bond markets if interest rates are extremely low for very long.

Are negative interest rates in certain segments of the sovereign bond markets a sign of that problem?

They are not really a sign of a bubble because they are induced by monetary policy actions. So it’s a result of deliberate actions and not an accident.

But there are risks, right?

In this case, the risks are that one day monetary policy will unwind. The ECB has said many times that the actions it is taking now are temporary, to bring inflation expectations up. This policy will eventually be unwound and there are risks associated with this.

I*n Portugal, the government says that sovereign interest rates are very low now because the adjustment programme was a success. Couldn’t this be the ECB effect?*

I think it's really a combination of both because in other countries in Europe, that have not adjusted so successfully, interest rates haven’t come down.

I was just wondering why some investors are now paying for the privilege of having Portuguese debt, like in the 2-year segment. Does this make sense?

This is the result of monetary policy action. For other countries, like Germany, interest rates are negative or zero in segments up to ten years. Also for us, at the EFSF and ESM, we now issue bonds for 2 or 3 years with negative interest rates. All of this is rather exceptional. The ECB is catching up with other large central banks and it is succeeding. The inflation expectations are going up since the quantitative easing was announced.

Very low interest rates are temporary so there could be spill-overs to indebted countries, like Portugal, which have to pay more interest in the near future. Is this a risk to public finances?

Yes, of course, and governments must keep this in mind, not only the Portuguese. All governments will face this problem and there are countries with higher debt than Portugal. Think of Japan, for instance. They will also face this issue. Think of the United States, where public debt is higher than the European average. And Germany will also face this problem. Deficits will go up because interest rates on public debt will go up one day and that will have an impact.

In Portugal, potential growth is very low. The problem could be more severe.

Yes, that is another argument. But first the immediate impact is that when interest rates normalise they lead to larger deficits. And that is why it’s wise for every government to prepare itself and not to ignore this. We are not talking about the next few months, it’s a medium-term risk that is very likely to happen one day. Therefore, it’s wise to start reducing deficits now.

On productivity reforms: Do you agree when the IMF says that the Portuguese economy’s major problem is the lack of managerial skills in the private sector?

When we look at productivity levels in Portugal compared to the EU or the euro area average there is a big discrepancy and there is a lot of scope to act. Increases in productivity have been relatively small for a long time and one conclusion must be that it has something to do with education levels.

Across the board?

Yes. Productivity has a lot to do with the education level, but there are other factors. Competition, for instance. More competition leads to stronger productivity gains.

GREECE

Are you more or less confident about Greece compared to one month ago?

There are ongoing discussions between the still new Greek government and the European partners and the IMF - which we now call the institutions. I hope there will be some progress soon because the liquidity buffers in Greece are clearly becoming very, very small. So far the Greek Government has done what they promised to do: they paid all their creditors, including the EFSF, the IMF, and others. That is positive, it was one of the commitments made.

But Greece needs more money in the short term, right?

I think there is a need for some more assistance for Greece to continue to honour its debt. Market access is not available at the moment and, before considering any further assistance, what European partners want to see is a comprehensive list of reforms. A list that is credible enough to guarantee that after a while Greece can return to a sustainable situation, like what happened in Portugal and in Ireland. At the moment we don't see that.

Why?

We must admit that the Greek government is still fairly new, it has spent only about 70 to 80 days in office. Quite often we give new governments a margin of 100 days to learn and to come up with comprehensive policies. Greece hasn’t had so much time. We must be patient and hope the government can deliver on its commitments to the Eurogroup of February 20th and put together a comprehensive reform programme. We are waiting for that.

100 days is the maximum?

I mentioned 100 days because that is usually the timeframe given to new governments and it happens to be about another month. We do have another Eurogroup meeting in Riga in one week. That's the next opportunity at a political level to exchange views with the Greek Finance minister.

The Greek government is still new to their business. But are they technically well prepared? I'm asking this because there is always a lot of noise about their proposals...

That's part of a new government learning. But it is true: communication has not been very helpful.

How much money does Greece need in the short run?
The institutions are still assessing the current situation and that means putting together the numbers, the budget, growth projections. Only then will we know what the situation really is and
what the financial gap looks like. Any numbers mentioned now are speculation.

PORTUGAL

In the case of Portugal there is this concern about the debt sustainability and its level. Do you think there is time enough to do the required adjustment and comply with the rules and don't you feel there is a risk of the country not being able to pay on time in the future?

No, not really. Of course, debt has reached a high level. To some extent this was unavoidable because the crisis meant that GDP was shrinking. When the denominator decreases the debt ratio goes up. But once the country concludes its major reform efforts there is a new basis for higher potential growth, it will come out of these very high debt ratios.

In Portugal, should the Government pay the EFSF/ESM earlier like it did the IMF?

Substituting EFSF debt with private debt would not help because the debt level would remain the same. And the problem is that market interest rates would be higher than our rates.

Even now?

Sure. Our rating is AA+ and although interest rates came down a lot for Portugal – I think the 10-year maturity was about 1.6% this week – for us it’s far below 1%. The IMF charges much higher rates and fees than the EFSF/ESM. So it makes commercial sense to repay the IMF. At the moment it doesn’t make sense to repay us because our terms are very favourable.

Is it possible to repay earlier?

Yes, it is possible if approved by Eurogroup.

But there are still people raising doubts about Portuguese debt. Why is that? Because of the economy?

I think it’s mainly academics who question that. People who claim that a haircut, a debt restructuring is needed. I don't think they are right.

Why?

In the debt sustainability analysis done by the institutions we can see that sustainability is possible if reforms continue. A small fiscal deficit is an important element, as it reduces the additions to debt stock every year. All the structural reforms will over time deliver stronger growth and further help to cut the debt ratio.
…

But to comply with the Treaty rules, Portugal needs to grow a lot faster than ever in the past. Is that realistic?

Not in the next two years, but over time, yes. The ECB is determined to bring up inflation to its target of close to 2% and I don’t see why Portugal should not be able to reach potential growth rates of 2%. Real growth in Portugal should be higher than the euro area average because there is this significant gap in productivity levels.

How quickly should that happen?

I believe this gap will be narrowed significantly over the next 10 to 20 years. With the right policies, Portugal can grow much faster than the euro area average.

Is 2% potential growth realistic?

That is a rough figure. For the euro area, the potential growth rate is about 1% to 1.25% at the moment. That could be strengthened with structural reforms although we have to be realistic because demographics are not very favourable. I don’t know why Portugal should not catch up again like it did in the past.

Is there enough commitment to that in Portugal? In the long run, I mean.

For economists it's very easy to say what has to be done. I fully realise that political implementation is difficult in every country, be it small or big. As an economist I can only encourage Portugal and others to do it because rewards will come. We are already seeing that today in Europe.

Where?

We see it clearly in Ireland and Spain but also in countries that did not go through a crisis in the last few years. Compare France and Germany, for instance. People forget that between 1995 and 2005, for ten years, France grew on average, per year, one percentage point more than Germany. Now Germany is doing better than France. Why? Because Germany implemented more reforms than the others in the last decade. That's the key reason.

Even before these reforms Germany was already a strong economy at a global level, *wasn't it?*

Yes but it had big problems. The biggest one was unemployment. There were about five million unemployed people, today there are only 2.7 million, which is still high but the country has the lowest unemployment rate in Europe. There was no market access crisis, but an internal crisis because there were some many unemployed people.

Do you feel the Portuguese can be like the Germans in that sense?

I think Portugal is already a bit like Germany in that sense because Portugal started to implement reforms five years ago.

Successfully? With results? Some, like the IMF and the European Commission missions, say reforms were announced and they feel sort of an increase in complacency.

I am aware of that. But if you are asking me: was it a success? I say yes. And it's not only about market access. If you see the indicators put out by the OECD, the World Bank, the World Economic Forum - Portugal is among the top 5 reformers.

In implemented or announced reforms?

OECD and World Bank statistics look at implemented reforms or even results. This doesn't mean that all is done. The concerns expressed by the IMF and the Commission focus on the fact that there is still unfinished business. The ESM, which participated in the post-programme surveillance to Portugal, also shares this view. But looking back, we must give credit to the Portuguese population and to the Government for what has been achieved already.

You talk with a lot of international investors. Do they feel comfortable with a scenario of a change in government in Portugal, with a possible centre left Socialist government, for example?

Foreign investors always look to the political environment: even more closely now after the global crisis than they did in the past. In democracies, changes in government happen. I think investors are taking note where the different parties stand. They do not see any anti-European party in Portugal. They don't see a kind of radical opposition here like they saw in Greece for instance and I think that's reassuring for markets.

Is that the most important asset in a market perspective?

Yes, that is a positive factor when investors assess the country's future.

How do you assess the health of the Portuguese banking sector?

The ESM is not involved in banking sector oversight as other institutions are but after the comprehensive assessment made by the SSM, the single supervisor, in November last year, basically the situation seems fine. The BES episode was an unpleasant surprise but it was managed successfully. And at the moment I'm not aware of any significant problems.

Couldn't the deferred tax assets be a problem? It could affect major banks in Portugal. What do you think?

We have to see how the SSM wants to handle that. This is not a Portuguese problem alone. It could affect Italy, Spain and other countries. You are right: Depending on how the SSM wants to interpret that, there could be an additional need for capital but I'm not part of those assessments.

EMU DEEPENING

I*n Lisbon you proposed new tools to deal with future crisis like a "rainy day fund". How big should a fund like this be?*

It's too early to say in terms of a European-wide fund. We do have the experience of rainy day funds at a national level. Some Scandinavian countries have that and I think it could accumulate to a few percentage points of GDP – 2%, 3%, 4%. It depends on how it is designed and used. At the moment it is a broad idea. It's important that it does not lead to debt mutualisation over a cycle. This means that if every country can draw on it, it would be a revolving fund and there would be no transfers, it would be very different from the EU budget.

Who would manage the fund?
It could be the ESM, it could be a private bank. In case of an asymmetric shock, countries can draw on it and then they must repay later.

You also see no need for a European monetary fund. At least for now.
Basically, we have the equivalent of a European monetary fund already today. We should recognise that the IMF role in Europe exists but that it is spread over several institutions.

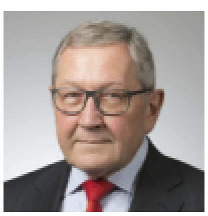
But, in a cost-benefit analysis perspective, couldn't Europe benefit a lot from less bureaucracy if we had a sole institution?

In terms of efficiency it could be better, as the central bank governor Carlos Costa said. On the other hand, to get there, it would require a lot of work, political determination and energy, which are counter-arguments. I don't really see this happening before we have an EU Treaty change.

Which countries are in favour and against it?

At the moment, hardly any country is clearly in favour of this.

Author



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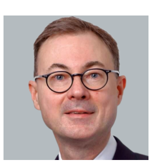

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