Klaus Regling in interview with Jornal Economico (Portugal)

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Interview with ESM Managing Director Klaus Regling

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Interviewers: Filipe Alves and Ania Ataide

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Jornal Economico: We would like to start by asking your opinion about the revision of the inflation target by the ECB [to 2%] announced a few days ago.

Klaus Regling: The ECB's revision is positive because quite some time has passed since the last revision and economic structures have changed. The economic situation changed. The inflation target is easier to understand now. It is also interesting that over time the ECB will include costs related to owner-occupied housing to determine the calculation of the inflation index, something you could find, for example, in the United States, but not yet in Europe. This will be useful. It's not a dramatic change, but it follows quite logically from what the ECB has been doing for some time.

Do you think that the increase in inflation that we are seeing will be a temporary phenomenon? Or are we facing a more permanent effect?

We all expect to have somewhat higher inflation than in the last five, six or even ten years, and the ECB, like other central banks, has been working to raise inflation. So if it is higher than in recent years, that is desirable, and that is what monetary policy wants to achieve. In recent months, however, there are some countries where inflation is above the target. I believe that this is largely temporary. I do not expect that inflation will remain above the average rate of 2% for a long time.

Has the crisis shown that the traditional tools of central banks are no longer effective?

Yes, but that goes back to the sovereign debt crisis and the global financial crisis of 2008. All major central banks in the world reduced interest rates. And the lower bound, zero, was reached quite a few years ago. That's why central banks have developed other tools, like increasing their balance sheets and introducing forward guidance. This is not new. It has been going on for some time. The pandemic that hit us in the last year and a half is a very different kind of crisis, but of course also has an impact on financial markets and policies. It became clear that central banks could, to a large extent, no longer use traditional instruments, like changing interest rates, so other instruments had to be introduced.

The ESM will return to Portugal the prepaid margin it paid for the loan granted in the last crisis. How important is this step?

It is a very positive step. We transferred €1.1 billion to the Portuguese Treasury last week. This goes back to a time when we didn't have the ESM. The EFSF lent Portugal €26 billion during the euro area crisis. Later we developed the ESM, which works quite differently, with paid-in capital. But the EFSF worked with guarantees and the loans had to be backed by additional credit enhancement. We issued a larger amount than was necessary for the loan to have an additional buffer to achieve an

AAA credit rating and we charged a certain margin that was agreed and a small service fee to cover operational costs.

Already in 2011, the euro area finance ministers decided to reduce the margin to zero because they considered that the main objective of our lending was to help countries return to debt sustainability and therefore the lower the rates, interest rates and margins we had to charge, the better for debt sustainability. We agreed that we would keep the amount of the pre-paid margin in our accounts, accumulating interest, until the maturity of the 10-year bond. That happened last week. It’s €1.1 billion, €827 million of which correspond to the amount of the prepaid margin and the rest is the investment return on that amount.

It is an important sum of money that is available at a time when the country is recovering from the crisis caused by the pandemic.

It was always clear that the money would return to Portugal. This is not a surprise, but now it happens during the pandemic and I am sure that the Portuguese government will be able to put this money to good use.

And what are your expectations regarding the evolution of Covid 19 and the impact on the economy? In Portugal we are seeing a significant increase in the number of infected.

There are still risks because we don't know exactly what is going to happen. According to the European Commission's forecasts, Portugal would return to the pre-crisis GDP level of 2019 by around the middle of next year, with good growth rates. The economy was still badly affected by the pandemic in the first quarter, but growth was expected to be very strong from the second quarter. Now, it has been affected by another wave of the pandemic. It's a risk that all of our countries face because we don't know how the new delta variant will develop or if other variants may emerge, and we don't know how effective the vaccinations will be in the end.

Variants that might be resistant to vaccines...

That we don't know, but it's certainly a risk. It's a race between vaccination, infections and new variants. But we also know that there is talk about the need for a third vaccine dose that would also cover a new variant. So it's not impossible to overcome, but there are risks.

At the same time, there are other positive variables, such as the high levels of household savings. One part of the population really suffered from Covid 19. These are people who lost their jobs or stopped having an income. But others kept the same income during the pandemic and were not able to spend it as much as before. This is something that has never happened before. How quickly will these extra savings be spent?

So there are 'upside' risks. In the United States and in all European countries, including Portugal. There is also the possibility that growth in some countries will be faster than in the baseline scenario and Portugal will benefit from that. Portuguese exports of goods have been doing very well. Not exports of services - that's tourism – which have suffered and that is another downside risk. But the risks are balanced. Six or nine months ago, economists only saw negative risks, now they are more balanced. And that is good.

Has this crisis strengthened the role of the EU institutions? And that of the ESM in particular?

The European institutions played their role well. The European institutions' response to the crisis has been very useful and goes beyond what governments are doing. The increase in spending and the loss of revenue meant budget deficits in all countries skyrocketed. Which was inevitable given the circumstances. The European Commission's decision to suspend the 3% deficit limit and activate the general escape clause was the right approach. Some loosening of state aid rules was helpful and the extra action by the European Central Bank was also important. The European Investment Bank provided extra loans in response to the pandemic and the ESM, my institution, offered an additional credit line to countries. It has not been used yet, but it works like an insurance. The idea is not necessarily that the money is used, but countries and financial markets understand that it is available if needed. That had a positive impact on financial markets when it was decided last year. As a whole, it was a very comprehensive and necessary approach, given that this was really the biggest economic crisis of our lifetime.

And for how long should we keep the fiscal stimulus?

There is a very clear understanding in the Eurogroup, the 19 euro area finance ministers, that the general escape clause of the Stability and Growth Pact will remain suspended next year as well. And then it will be reinstated, possibly reformed. That is an important element. The other is that there is also consensus that fiscal stimulus should not be withdrawn prematurely, only when the recovery is fully assured. These are the agreed principles. And that makes it very clear what happens this year and next year. Given the risks that we talked about, we can't be absolutely sure when we will get to that situation, but conceptually it's pretty clear.

During the euro crisis, Mario Draghi uttered the famous phrase "whatever it takes," signalling to the whole world that the ECB and the European Union would do whatever was necessary to ensure the survival of the single currency and the European project. Can the European Union say the same if some of these risks materialize, new variants appear, and the pandemic crisis does not go away in the coming years? Will Europe do whatever it takes?

In the last 18 months we have done everything that was needed not only on the monetary side, but also on the budgetary side. And that was absolutely the right approach. Otherwise the recession, which was already the worst recession of our lifetimes, the worst since World War II, would have been much, much worse.

Despite all the risks we talked about, I believe the worst is behind us. I don't expect us to go back to the situation we had last year, where GDP in Europe fell by 6%, which is a very high number.

The uncertainty is around the growth rates of 4.8% and 4.5% this year and next year. If some of the risks materialize, then fiscal stimulus may have to be in place for longer.

So Europe must hope for the best, while preparing for the worst. But above all it must believe in the best?

It's good to have a solid base scenario and hope that some of the positive factors come into play. But if growth is lower than in the baseline, we know what to do. In Europe, we have shown that we can act quickly if we need to. And I have no doubt that if it really becomes necessary, we will do it again.

Portugal was for centuries considered a peripheral country when compared to the main centers of European economy. Is technology an opportunity to bridge that 'gap' by enabling us to attract new industries to Portugal, as well as skilled people [the so-called "digital nomads"], making our

economy more competitive?

Technology can help countries that are on the periphery and help regions that lost out during the globalization process. With new information technologies, less capital-intensive industries are generated. It's a great benefit for the future that becomes possible with today's technology.

In Portugal's Recovery and Resilience Plan (RRP) most of the money will go to the government and public entities. The private sector directly receives only a small part of the "pie". What are your thoughts on this?

From what I have seen, the plan also provides incentives for research and development, which will indirectly benefit the private sector. And part of the funds will be used to strengthen the education system. Funds may be going to the public sector - schools and universities - but the students that come out of these institutions will be better prepared, and this will help the private sector. I believe there is an important link there.

Do you believe there will be an indirect effect on the economy?

I am sure there will, if it is well implemented. The plan is good, as in other countries, for example Italy, Greece and Spain. The implementation will be a challenge in all these countries, not only in Portugal. Because increasing public investment spending significantly in a short period of time is not easy. Implementation will be the focus.

Portugal already has high public debt levels, but do you think we could have gone further in supporting the economy and businesses?

I don't know if that was really an option. The Portuguese government did what all European countries did to support the economy. In 2019, the debt-to-GDP ratio was around 117% and it was the first time, in about 40 years, that Portugal had a budget surplus, quite a significant achievement. It was a good starting point to face the economic consequences of the pandemic. It made it easier to mobilize all the budgetary resources needed to fight the pandemic. Now, the debt ratio is a little higher than it was after the euro area crisis. For good reason. No one criticizes that. Once the economic consequences of the pandemic are overcome, it is clear that Portugal, like other European countries, will start to reduce its budget deficit. Part of this will happen automatically because most of the measures to combat Covid-19 are temporary. That means they will expire at a certain point this year or next.

Without any additional decisions, the deficit will automatically become smaller. That's a good approach.

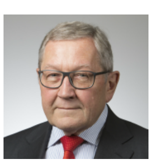
Loan moratoria are one of the measures. In Portugal, there is some concern about the moratoria expiring in September. Is there a risk for the financial system?

The Portuguese banking system, like the banking systems in most European countries, is much stronger today than before the last crisis. The work done in the last 10 years is paying off. That doesn't mean that all the problems are solved, but when we look at capital ratios and liquidity levels, they are much better than they were in 2011, and this is positive. When the credit moratoria expire, we will see what happens. The degree of uncertainty is still high and it is very difficult to make clear predictions but all the measures taken should help to mitigate the impact. It may mean that governments' budget deficits will increase because some of the guarantees will be triggered. But again, it's a problem that other countries also face, not just Portugal.

You mentioned that banks are stronger now than ten years ago, but besides the pandemic crisis the sector faces competition from new digital players. Is a wave of mergers and acquisitions in the banking sector necessary in Europe?

In most European countries, bank profitability is low. Capital ratios are much higher than a decade ago, but profits, compared to banks in the United States or Asia, are low. It is a widespread problem, not only in Portugal. Banks have to respond to this new environment. If they don't do that, they won't be able to improve their profitability. So there are challenges and a lot of work to be done. But this is true in all European countries [and not only in Portugal].

Author



Klaus Regling
Managing Director

Contacts

Cédric Crelo
Head of Communications and Chief Spokesperson
+352 260 962 205
c.crelo@esm.europa.eu

Anabela Reis
Deputy Head of Communications and Deputy Chief Spokesperson
+352 260 962 551
a.reis@esm.europa.eu

Juliana Dahl
Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu

George Matlock
Senior Financial Spokesperson
+352 260 962 232
g.matlock@esm.europa.eu