Klaus Regling in a podcast with Natixis CIB Research

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01/07/2022

Transcript of podcast with ESM Managing Director Klaus Regling

Natixis CIB Research

Weekly podcast series: The week that was in Europe

Episode of 1 July 2022

Interviewers: Klaus Adam, Professor of

Economics, University of Mannheim and Dirk Schumacher, Head of European Macro Research at Natixis

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Natixis CIB · A conversation with Klaus Regling head of the ESM - - Natixis CIB Research

Dirk Schumacher: Hello everyone and welcome to our "The week that was in Europe" podcast. My name is Dirk Schumacher and I'm the head of the European macro research at Natixis. And with me is Klaus Adam, professor of economics at the University of Mannheim.

Klaus Adam: Hello also from my side. Today we have the great pleasure to have with us Klaus Regling. Klaus is Managing Director of the ESM, the European Stability Mechanism, and he's also Chief Executive Officer of the EFSF, the European Financial Stability Facility, which is the predecessor institution of the ESM but still in operation. Prior to these two positions, Klaus Regling was Director General of Economic and Financial Affairs at the European Commission. And I think few people know the sort of inner workings of policy making at the European level as well as Mr Regling does. So thank you very much for being with us today.

Klaus Regling: Hello from Luxembourg from my side and always happy to talk about Europe.

Schumacher: Let me start off with the first question. The ESM was created to help countries in the euro area in severe distress, and the question would be: Why was the ESM or any other similar institution not created right at the onset of the monetary union? Why did governments and experts providing advice at the time not foresee the possibility of severe financial distress? What was that? A kind of a lack of imagination? Or would if it have made the case for the European Monetary Union more difficult to sell to the public if governments would have entertained right from the beginning, the possibility of severe financial distress?

Regling: It’s a good question and I have asked myself that question over the last 10 years from time to time, since I was asked to create these new institutions, that indeed were not foreseen in the initial design of the monetary union. And today, I guess everybody agrees that this was a real gap in the institutional architecture of the monetary union, but it was really not foreseen by the founding fathers of the euro. And I at the time was one of the experts advising politicians. I also did not foresee it. That’s why I ask myself, why not?

But I think the general thinking at the time in the 1990s was that the hurdles for joining the monetary union were so high that once a country managed those hurdles, it was just not imaginable that a country could lose market access. It was really not on the minds of people. You may also have a point that it could have been more difficult to sell the whole project to the public, but people just didn’t anticipate this. And I think I can really say that very clearly because I was part of this process for many, many years and we thought this would never happen. So with hindsight it’s clear that we should have anticipated that, but we didn’t.

Also, I think one has to look at the reasons that led to the euro crisis in a way that was not foreseen. You will remember that the ‘00’ decade was called by economists the Great Moderation, and we all know today that this is like a bad joke because during the first decade of monetary union, a number of imbalances or real economic problems accumulated, like large fiscal deficits and debt in some countries, real estate bubbles in other countries. And importantly, and often underestimated by many, a loss in competitiveness, in particular in those countries that needed our money later on and that develops slowly because it was a decade of great moderation so it could accumulate, and markets didn’t pay any attention.

So there was a market failure there, and that was something that was not foreseen, that one could have a decade of wrong developments in a number of countries where markets would not react. So it’s a combination of things that came together and then all of a sudden, the crisis was there. And when markets woke up, we know markets overreact and becomes very bad.

Adam: But just to follow up on this, maybe there was in the treaty, or still is, the so-called the no-bailout clause, and in some sense, I remember the discussions as saying, well, if some country gets into imbalances, whatever the reason, ultimately it will be able to default or will have to default because we’re not going to make transfers. And I think that is of course

has little credibility when it comes to perhaps a very big country with a lot of outstanding debt. What was the discussion around that point? If a big country gets into potential trouble?

Regling: So first, again the same applies what I said before, we did not anticipate that. Including the fact that markets would not react when problems accumulate over many, many years, and that's what we saw in Greece. The problems accumulated for a decade, but also in Portugal and Ireland and the other countries. And that was the reason.

But to be very precise here, because you used the word no bailout, the no-bailout clause still applies, and it's legally enshrined, and it has been applied by the European Court of Justice in several of its important rulings. And that was one problem we had to deal with when we set up, first the EFSF and then the ESM. And in a legal sense, there's still no bailout because bailout means other countries in Europe taking debt of countries that are in trouble. We have not done that. What the ESM does and before that, the EFSF, we provide cheap loans. But these loans have to be repaid.

And there's no cost for the European taxpayer. Also, risks are taken on. Private creditors, in the case of Greece, they had to take a haircut and it was the biggest in history. But there's no bailout in the sense of the Maastricht Treaty. So we still apply this principle and I think it continues to be an important principle.

Adam: Right. So we'll come back to that maybe later in the podcast. Now, the financial support that is given by the ESM to a sovereign comes together with a sort of conditions. And this conditionality, which is a bit of euro-speak for an adjustment programme that obliges the government asking for the support to implement certain policy measures.

Now currently there are no active ESM programmes in the sense that are currently ongoing. There are previous ones that are sort of on autopilot more or less, but it's really hard as a result of this for governments to understand what this conditionality might consist of. So today, I mean, how would conditionality at the ESM look like, say in the future programme for a hypothetical candidate country? And what's the rationale at all for imposing conditionality in the first place?

Regling: Yes, conditionality is a very important principle of the ESM operation. And I will say something how that can change over time with changing circumstances. But first, and looking back at the euro crisis, conditionality is not, as you said, euro-speak. Conditionality is something that the IMF has applied globally around the world for 60 or 70 years, with in most cases, great success. And like many things at the ESM, we copied that concept from the IMF; it’s not something we invented. And we applied it in five countries - there were six programmes, but five countries that needed our financing.

And the concept I think is very easy. If a country runs out of money from the markets, loses its access to the market, there are problems, otherwise it wouldn’t happen because it did not happen in countries 10-12 years ago, like the Netherlands or Finland, that also had serious economic problems in the aftermath of the global financial crisis. But they didn’t have fundamental macroeconomic imbalances. The five countries that needed our money had these macroeconomic imbalances, and the conditionality had to be targeted to correct exactly the underlying root causes of these problems.

That’s what we try to do, and I always admit that in a crisis, one makes mistakes and not everything is perfect. But the principle I think is a very sound one. If a country needs money from public sources because private sources are no longer willing to provide any financing, then it’s a good decision and an appropriate decision to link that financing with conditionality in order to tackle the underlying problems.

And I think the result confirms that this was the right approach at the time because Greece – to take that one example – received more money from the EFSF and ESM than any other country, almost €200 billion, more than 100% of GDP, an unprecedented amount of financing from official sources to one country. This has never happened in history. But it worked. Greece had very good economic performance after the end of its programme. And until the pandemic hit all of us then.

But Greece, like also Portugal, Ireland, Spain, Cyprus, the other countries that benefited from EFSF and ESM financing, they all had an economic performance after the end of their programmes that was clearly better than the average of the euro area in terms of growth, in terms of job creation. So the approach worked. But it’s not a static approach. Conditionality always must be linked to what the problems are that the country faces and why it might have problems accessing the market, and that changes over time.

So in my view, 10-12 years ago, it was very clear the countries had lost competitiveness, so they needed what we call now internal devaluation, something that, according to US textbooks, doesn’t even exist. But they all did it, and that restored their competitiveness relatively quickly. They undertook reforms also, in order to improve competitiveness, but also to bring down fiscal deficits, and they all moved to balanced current accounts after that, they had much smaller fiscal deficits and they created the basis with those reforms and adjustments, the basis for more growth in the future, which is also the experience we have with many IMF programmes. So that was no surprise. It surprised many in the media and in the general public when we started the process.

But those who understand the IMF were not surprised because it worked very much like that. But that was the situation then. When we moved into the pandemic, all of our Member States had economic problems as a result of lockdowns, and countries also needed financing. The EU Member States and the euro Member States then created special facilities. At the ESM, there was one called Pandemic Crisis Support, which was, in the end not used, but it was available, which had already a positive impact on markets. The Commission created programs like SURE, Next Generation EU, the EIB made available additional investment and lending possibilities.

And all that came without the type of conditionality that we had to apply 10-12 years ago because the problem was completely different. The economic fallout from the pandemic was not the result of policy mistakes or excessive wage growth in the past. It was an external shock, a symmetric shock with asymmetric consequences in the different Member States, because the economic structure of Member States is very different. That’s why some countries need more money and get more support under Next Generation EU than others. And I think that’s exactly the right approach. So that was an example where macroeconomic conditionality wouldn’t make sense. At the ESM, for example, the facility that we created at the time, which was not activated, but it’s a precautionary arrangement that can be used if there’s a need. There, the only so-called conditionality was that the money for countries that decide to draw it, must then be spent on health expenditures related to the pandemic. So the money was earmarked. That was the only condition, and that’s a good example, completely different from 10-12 years ago, how conditionality should look like to be effective and useful.

If there are underlying problems that need to be corrected, then there has to be real conditionality. If that is not the case, it can look very different and therefore the question of how it will be in the future is very difficult to answer because it will depend on the root causes of the future problem. And we all know there will be another crisis. It’s part of our economic system, but I cannot predict today what kind of crisis it will be, where it comes from, what will trigger it, and only when we know that, can we define the appropriate conditionality.

Schumacher: That partially answers already my next question, but I’m going to ask it anyway because it was only partially answered. The ECB has now more or less announced that it will come up with an anti-fragmentation tool to fight the strong spread widening we’ve seen since the June meeting, though they have come down since that announcement, those spreads.

But the ESM was never really mentioned in a discussion as a potential solution to that problem or an OMT programme which had to go through the where the ESM would need to be involved or be a necessary condition for getting that programme. Why is that this kind of almost full-blown crisis - at least it smells and looks a bit like it - why the ESM, which seems to be created exactly for that kind of problem, is not being involved or is not really mentioned in the debate?

Regling: We should also talk about what you call a full-blown crisis - I don’t agree with that, but that’s maybe the next question or the next point. First on OMT: It is part of the toolbox of the ECB. You can even check it on the website of the ECB where it’s described. And it has a big advantage that it’s a tool that is legally compatible with the Maastricht Treaty. Because the European Court of Justice has ruled on the possible use of OMT and they have declared that it is compatible. And then also the German constitutional court, for instance, has agreed with that explicitly. So it’s part of the toolbox, so it can be used.

That it is discussed today less frequently than in 2012, and it was created after Mario Draghi said he would do all it takes. That was very much part of the answer. I think this has to do with the conditionality. There was no need for this type of conditionality that in last two years in response to the pandemic. Because there was Next Generation EU created with a lot of money, €800 billion, that will be disbursed over five years. And OMT was not relevant. Also, market conditions were very generous, let's say, because monetary policy was very relaxed.

But interestingly, when we created our Pandemic Crisis Support as part of the European answer to the pandemic, so the possible precautionary arrangements that the ESM could provide. Many people thought that such a programme - Pandemic Crisis Support coming from the ESM - could have served as the ESM part of the OMT package. OMT means the ECB Council has to decide to activate it or not and decide what's the basis. So it never got that far. But when the discussion took place at the time, I know that this was a widely held assumption. So it could have served that purpose at the time. But it was not needed.

And again, it's very difficult to predict what will happen over the next few years, what kind of crisis will come next. And therefore, I think it's good to have OMT on the books. Of course, we know that countries are reluctant to go to the ESM because they are afraid that conditionality might be very tough, but those who understand Pandemic Crisis Support know that the conditionality for that kind of facility was very, very soft, appropriately soft, as I explained earlier, but still, there's this kind of political stigma, not a market stigma.

Markets like OMT and they know that ESM loans are good for any country because it reduces the debt service payments - because we charge a AAA interest rate and therefore our loans are cheaper for at least one half of our Member States than what they can get in the markets. So it's good for their creditworthiness, for their debt sustainability when they have lower debt service payments. So from the market perspective, rating agencies have written about that and made it clear they like ESM programmes, they like OMT, but politically it's difficult in some countries.

Again, it's something that's not completely surprising. The IMF has the same experience. Again, looking at the IMF helps. Countries typically go at the last moment. They don't like that the IMF goes and tells the government where to adjust. So that is something we know is not easy to deal with.

But when you look at the ECB now, OMT is on the books. So for difficult cases where adjustments are needed, I think it's an option. It's of course an ECB decision always. And now I think the ECB is also looking for tools where maybe less conditionality is sufficient or where markets are overshooting. We know there's always herd behaviour and markets overshooting is almost normal and they want to be prepared for that. And I find that very understandable.

Schumacher: But there's less need for conditionality right now, and that's why OMT, you think, is not in the limelight or not, the main instrument the ECB is looking at?

Regling: Yes, that's the main point. Although countries till the end of this year could still apply for the Pandemic Crisis Support. So if things in the second half of the year get rough, and you never know what the economic consequences of the war in Ukraine might be, in case Putin stops all energy exports to Europe, who knows what happens. But in principle, the way you put it, I think is right. There's no need for tough conditionality. We don't have fundamental disequilibria at the moment in the euro area and that relates now to the statement you made earlier where I objected. I don't see a debt crisis the next few years; I find this really far-fetched. I read it often in the media, where the argument is just too simple. They say the ECB raises interest rates and therefore some countries in southern Europe would have debt problems. And I think that's, I want to be polite, but sometimes I've said it's absurd.

For three reasons. One is that, as I mentioned, there are no huge fundamental misalignments in the euro area. Of course, every country can do more to raise the potential growth rate, to implement reforms, and that's now supported by Next Generation EU. So that's all good, but it's not comparable to these big macroeconomic imbalances that we saw at the outset of the euro crisis, that triggered the euro crisis - like loss of competitiveness, large current account and fiscal deficits. That just doesn't exist at the moment.

The second reason why I'm more relaxed than many over the next few years is that the debt burden for a country comes from debt service payments. The debt-to-GDP ratio is not an important indicator. It's the annual interest payments from the budget that are burdens for the budget, for the economy. And when you look at the numbers, it's clear that the debt service payments, interest payments from budgets in all our Member States today are the lowest of the last 50 years. And even in the high-debt countries, they are only about one-third of what they were 20 years ago, despite the fact that the debt ratio is much higher today. And of course, interest rates will now increase and so the debt burden will go up, but it will be slow because the average maturity of government debt is 7 to 8 years. Therefore, the full impact of any interest rate increase will take quite a while to show up.

And I think we still have this underlying secular trend towards lower real equilibrium interest rates. I don't think that will go away anytime soon. So the interest burden will remain low. That does not mean that countries can continue what they have done, for good reasons. The last three years they spent money in response to different crises, and there’s a little bit same mentality now that money is always available to fix everything.

And that would certainly then lead to problems in the long run, so countries, particularly those with debt-to-GDP ratios above 100%, should be careful because there are additional costs coming up for climate change, for demographic reasons. And there’s a low potential growth rate. And there will be another crisis one day. So it’s very important to create fiscal space to respond to that next crisis. So countries need to be careful. But to argue that there will be now a debt crisis, a repetition of what happened 10-12 years ago because the ECB begins to raise interest rates, I find really absurd.

I gave you two reasons. The third one is that we have institutions now in the monetary union. We started out with that point in our conversation. We have institutions that did not exist at the outset of the monetary union, and there’s not only the ESM, which continues to be important. I think we also have now the beginning of banking union with the single European supervisor, the bank resolution fund - the SRB (Single Resolution Board). We also have smaller but important institutions like the ESRB (European Systemic Risk Board), EBA (European Banking Authority) and EIOPA (European Insurance and Occupational Pensions Authority).

All those institutions did not exist 15 years ago, and they closed important institutional gaps in the architecture and these institutions are also now during this crisis helpful. They were mainly created to deal with the euro crisis, but they are also helpful in this crisis, which is quite different, and they will exist also when the next crisis hits. So I think there are three good reasons why I’m more relaxed than many.

Adam: So you mentioned that higher interest rates would take time to sort of get into government budgets because of the long maturity of debt, but at the same time it is true that spreads went up, especially for those countries that had high debt-to-GDP levels and perhaps some other structural issues like perhaps lower than average growth rates and so on. At the same time, you said there’s this mentality amongst politicians, that they seek to continue spending, and especially now in these difficult times, that energy prices have gone up, they seek measures to sort of relieve the public from the consequences of these large price movements.

So do you see any point where this may get critical, especially in connection with the discussion on the reform of the Stability and Growth Pact that is currently undergoing? I mean, in the past this pact hasn't been all too successful, we haven't seen the counterfactual, of course, but it hasn't been all too successful in sort of breaking the upward tendency in the debt-to-GDP dynamics that we see in many countries. So if you look at the discussions around the Stability and Growth Pact, do you think there a need for changing the rules we have? And if so, what should the main motivation be?

Regling: I'm convinced we continue to need a good Stability and Growth Pact because monetary union has this unique situation of a completely centralised monetary policy, one exchange rate, but the rest of fiscal but also structural reforms, are basically done at the national level under the responsibility of national governments and national parliaments. And I think this calls for coordination of fiscal policies.

I think the Stability and Growth Pact has functioned a little bit better than you describe and I can give you the counterfactual. Look at other advanced economies, large economies like the United States, Japan, UK, they had a much faster build-up of debt in the last 20 years than the euro area. Fiscal deficits in the euro area were smaller than in those countries, and one can see that very clearly in the numbers. It has of course, not worked 100%. Otherwise, deficits would have been smaller, debt would be lower, but it has worked. I think without this coordination and surveillance framework, and I see it every month discussed in the Eurogroup among finance ministers, and that leaves an impression on every finance minister. There is peer pressure, maybe not as much as I would like, but there is peer pressure that other countries just don't have and I think that has had a positive impact. The old Stability and Growth Pact, as we had it, is still in place of course, although the deficit thresholds were suspended with a general escape clause.

By the way, this is an important part of this coordination framework that was always there from the beginning when Germany made its first proposal for the Stability and Growth Pact; it already had an escape clause. So it's not something that came all of a sudden because we had a crisis. It was always seen as important to have for very special situations, this possibility to suspend the 3% deficit limit and that is what rightly happened in the last two years and may continue into next year because we are in very special situations.

So that clause is there and should be maintained. Also, I think the 3% deficit limit continues to be useful. But certain parts of the of the existing Stability and Growth Pact have become outdated, have become too complicated. There are methodological problems that it relies on non-observable variables like the structural balance; and to calculate the structure balance one has to calculate an output gap, potential growth. There's no agreement any longer to do it, since the global financial crisis. Before that, there was agreement, we had a common system that worked well. It doesn't work now, it has become too complicated, so there are a number of reasons why there should be a reform.

And not just continue with the existing pact, and that debate has started, as you know, the Commission invited recommendations, proposals from institutions from anybody. Academics, maybe some of your colleagues, Mr Adam, also made some proposals. So the Commission is now looking at all those and then will come up with its own proposal. We also have seen good proposals from the European Fiscal Board that are quite useful.

The important point is to have something that is easy to understand by policymakers, by the general public, by financial markets, and that is no longer the case with the old pact, and something that is manageable, so a bit simpler, but does lead to the intended result because the overriding objective of the Stability and Growth Pact, in my view remains that sustainability in all Member States at all times, one can have secondary objectives like the ECB has a primary objective and secondary objectives.

I think for the Stability and Growth Pact, the primary objective is debt sustainability, and once that is met, then one can have secondary objectives like supporting public investments in green transition and those things that are under discussion. How to put all that together will be not easy because we need consensus among Member States to change the existing framework. But I think the key problems are quite obvious. And the key objective should also be clear, and then it will require a bit of work based on a Commission proposal, to come to a result.

Schumacher: The ESM can also be seen as a kind of intermediate step towards fiscal union and that it provides fiscal support, financial support to countries in distress, and that's backed by other countries. Do you think that fiscal union is necessary for the monetary union to function and survive in the long term? That that's often one line of argument. People

looking at the current situation say it is no surprise that we are where we are because we're still missing that final part - the fiscal union. Would you agree that without a fiscal union, the euro area will eventually blow up?

Regling: No.

Schumacher: OK, that was easy to answer, I know.

Regling: The easy answer is if we have a full fiscal union, I think then we are basically the United States of Europe and then many things would get easier. My life would get a lot easier at the ESM. But I think it's unrealistic to expect that. I don't think it's necessary to have a full fiscal union, and politically it's not possible because I don't expect the creation of the United States of Europe anytime soon.

But you're right, the ESM is one step towards a fiscal union, and that is important. There are other steps that have been taken or made stronger the last few years. Next Generation EU is also one fiscal step in that direction. I would also argue that monetary union needs – next to a full banking union and capital markets union – also another facility for macroeconomic stabilisation, a central fiscal capacity that would be another step towards the fiscal union. All that would be helpful and to some extent would close the institutional gaps in the construct and the architecture of monetary union. But to argue that full fiscal union is needed so that the euro area can survive, I don't buy that argument.

I think with good coordination, a reformed Stability and Growth Pact and these other elements that now exist, plus a central fiscal capacity, plus a banking union and capital markets union that also lead to more risk-sharing inside the monetary union via private market channels, fiscal elements then can provide more public risk-sharing. But if all that comes together, then I think the area is pretty safe.

Schumacher: I guess a fiscal union also creates its very own instability, at least politically.

Regling: I agree with that, yes.

Schumacher: And there are some very tough challenges, even if you have that [fiscal union], keeping it alive may not be always easy, either.

I'll try quick summary of all what you have said. So why not the ESM from the beginning? While it was not foreseen that the euro area would face

these kind of difficulties, it was assumed that given the rather tough hurdles that needed to be overcome in order to get into the monetary unit, that countries who managed that would be safe in a sense they would then fulfil the criteria and therefore not face these problems down the road. And at the same time also it was not foreseen that markets would be kind of dormant for 10 years, looking at the build-up of macroeconomic imbalances, but not respond.

Conditionality - it's an important principle. It is, if you will, taken from the IMF and the main argument is when there are underlying problems, root causes that need to be addressed, then this is what the conditionality does. Just giving money without addressing the underlying problems obviously is not helpful.

Why not use the ESM in the current situation? Or why doesn't it play the kind of role it could play? In that respect, why is the ECB not pushing OMT more? On the one hand there's a stigma, a political stigma, understandably, but also there's less need for conditionality because the current situation is not like the debt crisis.

Reform of fiscal rules - they are needed in a monetary union that is not also a political or fiscal union. But you think it has worked; that the peer pressure in these [Eurogroup] meetings clearly shows that compared to countries without these rules, there's nothing to be ashamed of, to put it that way. But the current rules are probably also too complicated, too opaque and some reform is needed. And finally, fiscal union, do we need it? You made it quite clear it's unrealistic politically to get that any time soon. At the same time, it's not necessary to make the euro work, though some fiscal capacity would be helpful to counter future crises, I guess. Was that a fair summary?

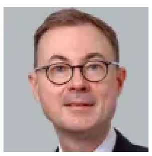
Regling: Yes, good summary.

Schumacher: Thank you very much again for your time today and I'm sure our listeners will enjoy listening to that. I certainly learned a lot.

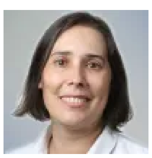
Author

Klaus Regling
Managing Director (2012 - 2022)

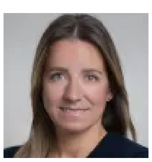
Contacts



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