

Klaus Regling in interview with Jornal de Negócios (Portugal)

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Interviews

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Interview with Klaus Regling, ESM Managing Director Published in *Jornal de Negócios* (Portugal)

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Jornal de Negócios: Is the Portuguese economy going in the right direction?

Klaus Regling: Every country, at every moment of time, has some work to do. It is like having a house: there is always something that is not right - at the very least, we have to tend to the garden when spring comes. That is why every EU Member State receives recommendations from the European Commission every year on how to remove obstacles to growth.

Portugal had a very positive development. There were many reforms and adjustments, and they were hard, during the crisis and in the context of the adjustment program. Some of the positive results come from there. But there are issues that remain and the government is well aware of them. The debt ratio remains high, one of the highest in the euro area. It has been falling for three years, and has dropped by about 10 percentage points. But this has to continue, it is not finished. Non-performing loans are coming down and that's good, but the ratio remains the third-highest in the euro zone. Regarding the budget, one should look at expenditure side. One should also perhaps look at the judicial system.

Could there have been a greater effort, with more progress?

No, so far the progress has been pretty good, but it does not mean that it is over.

Public debt is very high. Is it still relevant?

In Europe it is smart to have low debt. It is interesting to look at the crisis and try to understand why some countries were attacked by the market and others weren't. There were two countries, the Netherlands and Finland, which also had big problems in their economies but were never attacked by the markets. I think the main reason is that they had low debt levels. It's a good insurance policy.

If there is a crisis, will Portugal be in the spotlight?

The level of debt in a crisis is only one element. It depends on the current account and today it is completely different from what it was; it is more or less balanced. A few years ago, Portugal had a current account deficit of about 10% of GDP, every year it needed capital from the rest of the world equivalent to 10% of its GDP. And if foreign investors did not want to lend, that was a problem.

The current balance is turning negative.

It may turn out to be negative, but it's a very small figure. It does not have to be positive, but it should not become too negative, as it was some years ago, because it was a sign of loss of competitiveness on a very large scale. It should be monitored, of course. It could be an early indicator that something is wrong, but I don't see that at the moment.

Is the Portuguese financial system still a problem for the eurozone?

No, at the moment it is mainly a question for the Portuguese economy. All economies need a well-functioning financial system that is able to provide credit. And when non-performing loans are so high, the normal functioning of banks to grant loans is compromised. And that can put pressure on economic growth. When we talk about unresolved issues, one is the potential growth rate, which is not high, productivity gains are low, investment has gone down, and foreign direct investment is not so high. These are areas that can be addressed to make the country more

attractive.

Is public investment too low?

It is obviously more productive to spend money on investment rather than on consumption. But these are difficult choices.

Novo Banco was the first bank to be resolved with the single resolution rules. How do you evaluate the result?

It is part of the concerns, where there has been progress, but not enough yet.

But was it a good way to deal with the problem?

It was decided with the European Commission, so I have no reason to question the decision.

The EU economy has slowed down. But there are institutions that say it will get better. What is your perception?

This is also what I hear from people in the market. It's not surprising that we had some normalisation. Already in 2018, growth rates were lower than in 2017, but that was inevitable, Growth was almost double the potential in 2016 and 2017, there had to be some normalisation.

What is "normalisation"?

It means the euro area moving towards a long-term trend of potential growth around 1.5%. But there are some risk factors on top of that. Trade tensions are one of them, but also the slowdown in China, Brexit may also have some negative effects regarding trust. But there is no reason to expect it will continue to decline and that we will end up in a recession.

Why?

The underlying factors in Europe are still positive. Many countries, including Portugal, continue to create jobs and wages are rising. There are more people

employed and earning a little more and this should stabilise consumption and domestic demand. Investment is also expected to increase because capacity constraints exist in many countries. And the profitability of the business sector as a whole is relatively good. Interest rates are low. For the first time in ten years, the euro zone will have moderate fiscal expansion. It is very difficult to see a recession in this environment.

What if the risks materialise? Does the eurozone have the tools to react?

In terms of the budget, there are tools because the budget deficit for the euro area as a whole is below 1% of GDP. Therefore, unlike other major economies, such as the United States or Japan, there is budgetary space.

But debt is very high in some countries.

That is true. But looking at the eurozone as a whole, there is budgetary space and the debt-to-GDP ratio has been dropping for four years now. This is not true for every country, but overall it is. In the US or Japan the deficit is much higher and debt continues to increase.

What about monetary policy? Is there room for action?

The ECB always says that it has instruments available and I think this is true, I see no reason to question that, although they have used many of the instruments. The US obviously has more room to lower interest rates.

Have the Member States fixed the roof in time?

We have fixed the basement, which is very good. Countries that had real macroeconomic problems ten or eight years ago - with high current account deficits, high debt levels and high budget deficits - have all done their work, particularly those countries that went through EFSF and ESM programmes.

Is Portugal a good example?

Yes, of course. I always give credit to the countries first, if they had not solved their problems - through a sometimes very painful adjustment - we would still be in a

crisis. I am aware of this. In Portugal, Greece, but also Cyprus, Ireland, countries adjusted. But on top of all that, the ECB played an important role through unconventional measures, and we have used the last eight years to fill institutional holes in the design of monetary union. With the creation of the ESM, we are in better shape today.

The question is if it's enough.

We are in a stronger position than we were ten years ago, but it's not the end of the road.

What is the status of the decisions of the Euro Summit?

We have been asked to provide the backstop for the Single Resolution Fund; we are developing it. We are also reviewing our precautionary instruments, which have not yet been used. The role of the ESM in future crises will increase: with the European Commission, it will design, negotiate and monitor adjustment programmes. There are two areas where work continues, but there is no agreement. One is European deposit insurance. It is important to have it one day, but there is a legacy issue from the crisis, mostly regarding non-performing loans, that is still unresolved.

Banks have to choose between solving bad debt quickly, taking on costs, or doing it slowly and delaying the European deposit insurance.

It is not an easy issue, because to solve it you need capital. But until it is dealt with, banks' profitability will remain low because a large slice of their loans don't perform. There is no income but they have the cost.

But if they solve it too quickly...

There is a plan for each bank, agreed with the Single European Supervisor – the SSM – for the major banks. Progress is visible in all countries. In Portugal, non-performing loans have declined about a third in the last two years. This is good progress but it needs to continue.

Until when?

In any banking sector, there are some non-performing loans, we do not need to go to zero, but something like 3%, 4%, 5% of total loans, it shouldn't be much more.

In all the banks?

Ideally yes. Otherwise, they won't be truly capable of lending and supporting the economy. It is a precondition for returning to a healthy banking sector. That is the goal.

And how long can it take?

It depends on the banks, on their ability to generate profits, that is, to build capital to get rid of the non-performing loans. But there is progress, year after year. And all banks know what they should do.

We may need to wait two or three years for European deposit insurance? Or more?

It can be even longer.

How much longer?

It is very difficult to say because there is no agreement on the appropriate level of non-performing loans. There are also other factors when it comes to reducing banks' risk. Some Member States say that there are banks with a very large volume of national sovereign bonds. One day there will be European deposit insurance. I do not know what year.

Do you agree with the creation of a budget for the euro zone?

It is another controversial point. The Summit agreed to create a budgetary instrument for competitiveness and convergence.

What does that mean ...?

It says exactly what it means. It will be a euro-zone fiscal instrument that will support reforms to improve competitiveness and convergence of living standards. If

it is successful, it will be positive. But some people, including myself, see the lack of a budgetary capacity for macroeconomic stabilisation. That will take much longer.

Is the reform running late?

We are working hard on what was decided in December. When there is a crisis, there is pressure to act more quickly. But when there is no crisis, bringing together all the national interests takes more time. We may feel that it is slow, I feel it too when I am in a debate, but when I look at the last five or ten years, I see that much has been achieved. We should be a little bit more patient.

What is the status of the new functions of the ESM?

We are preparing the changes to the ESM treaty. It requires a unanimous decision of the 19 governments and then has to be ratified in all 19 parliaments. We are preparing the text so it can, ideally, be ready by June, to be approved by the member states in the following months. It is necessary for the backstop, for example. Some of the rest does not need a treaty change. If there was a crisis, hypothetically speaking, we could already play our strengthened role. Ratification will take at least a year from June.

Only after that can you start hiring people?

No. We can anticipate this because we have an agreement. But we will not hire many people, we should grow by about 20%, so 30 or 40 people.

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