Klaus Regling in interview with Neue Zürcher Zeitung (Switzerland)

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Interview with Klaus Regling, ESM Managing Director
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Neue Zürcher Zeitung: Mr. Regling, is the European Monetary Union a fair-weather construction?

Klaus Regling: No. The euro area has stayed together despite the crisis. No country has exited. That is a good thing, otherwise the character of the Union would have changed profoundly. The states that lost market access worked hard to return to the market.

Nevertheless, the differences of opinion between the north and the south, in terms of how fiscal and monetary policy should look like, seem hardly bridgeable.

I see it differently. Look at Portugal. The country lost market access during the crisis and received a loan from us of €26 billion. The country made tough adjustments with cuts in income and pensions. Today Portugal has a nearly balanced budget, good growth and lower unemployment than before the crisis.

Portugal is a positive exception.

It is not the only positive example from the south. Look at Greece. In Greece we see growth again. For three years, we have also seen a surplus in the overall budget. The unemployment rate is more than ten percentage points lower than at the peak of the crisis in late 2013. The population has even voted out a populist government and elected a reformist government.

And what about Italy?

Italy is a special case. It was never really in crisis and never lost market access. The country has a current account surplus. This means that there is no need for foreign capital to finance the deficit. Italy is also a special case because it has been growing not even half as fast as the euro area for the last 20 years. Accordingly, it is difficult to reduce the debt. But one cannot say that southern Europe is in a bad state.

Italy shows, however, that the euro countries do not want to be lectured on fiscal policy.

That is not true. There are agreements on how to coordinate budgetary policy in the euro area. But, of course, fiscal policy remains an important part of national sovereignty. We live with this tension. We are not the United States of Europe. Monetary policy is centralised, but not fiscal policy. That can work, but you have to coordinate. This coordination does not always work one hundred percent, but it works reasonably well. Last year, the euro area had a budget deficit of 0.5% of GDP, while in the US it was about 6%. If there is a crisis, the euro area has the necessary fiscal space to react.

So the views on stability policy are not so far apart in the euro area?

Certainly, there are different philosophies, and these have not converged, as I had once expected. But the coordination with the Stability Pact shows some success.

But this Pact is toothless. There have never been sanctions for violating the Pact.

The imposition of sanctions cannot be the yardstick of whether something works.

There are also sanctions in road traffic, if you drive too fast. Just because someone has never been penitent cannot say that the sanctions would not affect his behaviour on the road.

But the Pact is full of exceptions. There is always a rule for waiving sanctions.

That is indeed a problem. Over time, more and more exceptions were added. But one must remember that these exceptions were decided by the Member States, not by the European Commission. This leads to confusion. It is often difficult to understand how a decision is made. It [the Pact] needs clearer rules again.

Among the German public, ECB monetary policy is debated very emotionally.

That is right. The European Central Bank (ECB) was already accused under Jean-Claude Trichet, the predecessor of Mario Draghi, that its monetary policy would lead to hyperinflation and gigantic losses due to the purchase of Greek bonds. Personally, I have been told that the work of the EFSF and ESM rescue funds was creating a huge burden on taxpayers. That was an overly bleak outlook.

But the criticism also refers to the fact that the rules and regulations are being bent or even violated. For example, with the “no-bailout” clause.

The clause was never violated. This is proved by five rulings of the German Constitutional Court and three judgments of the European Court of Justice. As I said, in Germany excessive criticism was expressed during the crisis. The doomsday prophesies regarding hyperinflation, breaking the law, huge losses did not materialise. As a result, people who always criticise in such a fundamental way have lost credibility.

Brussels is seeking a stronger international role for the euro. Do you see any results yet?

The euro is the second most important currency in the international monetary system. Its importance is increasing. But that is a gradual and slow process that would have started earlier if we had not had the euro crisis. But the interest in the euro is increasing. I notice that when I issue ESM bonds internationally.

What is the reason?

One reason is the US government and its opposition to multilateralism. This affects central banks and traders in the rest of the world, such as in Asia. Also think about the Iran sanctions, where the US is trying to enforce its legal thinking extraterritorially. This also affects European exporters. There are good reasons to strengthen the international role of the euro.

But the euro cannot diminish the dominance of the dollar?

That was never the goal. Even the international role of the euro has hardly been a topic for the ECB or governments for a long time. This has changed under the influence of the new American attitude. It is good to move more towards a multipolar currency system. But that does not happen from one year to the next.

Speaking of multipolarity. Is there a new systemic competition between the economic blocs? And does Europe need more centralism to survive?

We are witnessing today – more than five years ago – a systemic competition between the US and China. This is reflected in trade policy, but also in the technology sector. Some feel this resembles the Cold War between the US and the Soviet Union. Europe has to be careful that it finds its place and is not crushed between the major powers. It [Europe] has to work more together.

What is needed to make the currency union more secure against crises?

First, we have to acknowledge that the euro area has become more stable. There are no massive macroeconomic imbalances in any country of the currency union today. Ten years ago, we had half a dozen countries with budget and current account deficits of more than 10% of Gross Domestic Product (GDP).

You do not see a high debt level as a problem?

You can live for a while with a high debt level. That does not lead right away to a crisis. But a budget deficit of 15% of GDP, as was the case in Greece, is extremely dangerous.

What are the reasons for the stabilisation?

We created a banking union with European supervision for nearly 120 systemically most important banks. The banks' capital is almost twice as high as compared to ten years ago. That amounts to almost €500 billion. And we have created the euro rescue fund, the ESM.

But the Italian banks remain a cause for concern.

Italian banks also satisfy all capital requirements. But they need to further reduce their non-performing loans. Two-thirds are taken care of, one third is still outstanding.

Is a European deposit insurance needed?

That is part of deepening the currency union. But it will only come if the non-performing loans are further reduced.

Which other steps are necessary?

A central element is a unified financial and capital market. There are many prerequisites that are difficult to implement, such as the harmonisation of insolvency laws. Many of these steps are necessary in order to overcome the fragmentation of the European capital market.

Why is that so important?

In a European capital market, risk-sharing through the market would be improved. That would make the euro more attractive for international investors.

You are arguing for a fund in addition to the ESM that could grant budgetary aid to countries in a crisis. Why?

For stabilisation in case of a crisis, we currently only have the national fiscal buffers. They should be complemented by a European fiscal buffer. This support would have to be paid back over an economic cycle.

How big would such a stabilisation fund have to be?

I think €100 to 200 billion.

Would a sovereign insolvency mechanism combined with the threat that a bankrupt country would have to leave the currency union not be an alternative to the ESM?

Both would be a massive intervention in the property rights and in the markets. It is very daring to think that this would make things easier in a crisis compared to what we have now built up.

But would this not lead to a higher degree of discipline of the countries?

In the case of Greece, an exit from the euro was discussed a lot four years ago. We had estimates that the GDP, which had already shrunk by a quarter, would have dropped by another quarter. That cannot be a goal we aim for. In addition, this would have altered the character of the currency union. Every time a country faced problems, we would have a massive increase of speculation.

So the introduction of the euro in a country is irreversible?

That is necessary for the good functioning of the currency union.

But you do see the problem – whenever a country gets into trouble, cash is made available?

That is the reason why loans always come in exchange for economic and financial policy conditions. This conditionality is a massive intrusion into the sovereignty of a country.

The International Monetary Fund (IMF) did not participate in the third programme for Greece. Does that not imply that the ESM's conditions are too weak?

On the contrary. The IMF's conditionality would have been weaker because the Fund wanted to grant extensive debt relief.

But Greece is still far away from sustainable debt?

We have granted Greece very cheap loans for 50 years. At the end of the day, the relief for Greece has an effect like a debt cut. But this approach is allowed within the currency union and does not lead to any cost for the other member states.

But there is the allegation that all you do is sugar-coat the problem with such long redemption periods.

There is no sugar-coating. Greece's debt is sustainable because the country is benefitting from massive relief. Last year, the budgetary relief was in the magnitude of €13 billion. That corresponds to 7% of Greek GDP. And this relief, combined with reasonable economic policies, will bring back growth and that in turns leads to debt sustainability. But that lasts a few decades.

Greece pays for 10-year government debt an interest rate of only 1.17%. Are investors becoming too reckless again?

No, this is rather a sign that Greece is now implementing a credible policy. This is the reason why Greece is swimming with the tide again in the financial markets.

When such a country de facto does not have to pay risk premia on its government bonds, this shows that the markets are distorted, does it not?

The country does pay a premium, interest rates are 156 basis points higher than in Germany.

Does this reflect the risk differential adequately?

This low premium shows that Greece is perceived as a competitive by the markets.

Let us briefly touch upon your home country Germany. International organizations insist that Germany invest more. How do you see this?

From a German point of view, I think it makes sense to invest more. But I do not think that this will have huge implications on the rest of the currency union. In the short-term, not so much can be done because capacities are fully used. For me, the mistake was made in the past years. One should have invested more continuously in order to prepare for the future. Berlin cannot catch up on that overnight.

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