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## Europe's financial stability chief awaits reforms in Japan

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TOKYO -- The head of the organization charged with safeguarding financial stability in the eurozone sees a need for Japan to carry out structural reforms to strengthen its relatively sluggish economic growth.

Klaus Regling, managing director of the European Stability Mechanism, spoke with The Nikkei here Monday. He talked about the situation in Europe, noting that deflation risk is not high there, in addition to giving his take on Prime Minister Shinzo Abe's economic policies.

Excerpts from the interview follow.

**Q: Bailouts of Ireland, Spain and Portugal have concluded successfully. Greece has been able to issue sovereign bonds. How do you assess the current situation on the eurozone's periphery and how it is affecting global financial markets?**

**A:** The progress in program countries is very encouraging and reassuring for our crisis response strategy in the euro area.

Three of the five euro area countries that requested assistance from the European Financial Stability Facility and the ESM have now exited their program because they are able to refinance themselves again in the market, at very reasonable interest rates.

Cyprus is still in the early stages of its program, but implementation is going in the right direction. Greece has made a serious reform effort in the last few years of the program and issued long-term bonds last month. This overall progress is a demonstration that our strategy of granting loans against conditionality is working.

This does not mean that all problems have been solved, particularly not for the people in those countries where the unemployment rate is still high. The adjustment is also not over yet. These countries still need to proceed with structural reforms and fiscal consolidation. Fiscal deficits in Ireland and Portugal are still between 4% to 5% of (gross domestic product). But, (the countries) are committed to tackle these imbalances. They will continue with reforms and this is important in order to get a good and sustainable growth rate in the future and to bring down unemployment rates.

The labor market has been adjusting. Unemployment is still high, but the turning point is visible. In all these countries, the unemployment rate is lower than a year ago. In Spain, there is good progress, not only in returning to the market, but also for the people of the country, which is also improving competitiveness. Current account deficits are basically disappearing. Fiscal deficits are still there, but are much smaller than three years ago. Greece this year, for example, will have a fiscal deficit of 1.5% of GDP -- that is much lower than most industrialized countries. Considering a fiscal deficit of 15% of GDP five years ago, this is tremendous progress.

All five program countries have made good progress. If they continue with their reforms I am confident that they will benefit from a better economic performance in the medium term.

That is positive for Europe because we remove uncertainties, and it is also good for the world economy because these uncertainties had an impact in the world economy as a whole. So, it is good for everybody.

**Q: Do you think Greece will need a third bailout, from the ESM and/or the International Monetary Fund? What should Greece do to secure sustainable growth and job creation?**

**A:** We don't know if a third program will be needed. Greece's financing situation will be reviewed after the summer break. There will be another review mission of the *troika* because the current program is still running. There are still 3.8 billion euros to be disbursed from the EFSF. One particular issue where we do not have clarity at the moment under the current program is with regards to the money that was disbursed to the Greek bank recapitalization fund, the Hellenic Financial Stability Fund, a domestic fund meant to help keep Greece's banks afloat. There, 11 billion euros are unused. This may be needed for the banks, or not. We will know more when the European Central Bank has completed the Asset Quality Review and Stress Test exercise. If these funds are not needed for the banks, they can be used for budgetary financing. That will be an important element since overall financing needs, if these still exist, will be very small compared to



Klaus Regling, managing director of the European Stability Mechanism, speaks during an interview in Tokyo on May 19.

the current second program. They may be covered by this money, parked at the banking fund. We will only know for sure in the autumn.

**Q: It seems that the eurozone has escaped its recession. Is there a risk that complacency could set in and derail structural reforms and the fiscal consolidation process?**

**A:** The risk is there because a program with conditionality forces countries to undertake reforms. Now without a program, without conditionality, pressure becomes less clear. I cannot say that risk is zero. But I am not too worried about it because these countries learned the importance of reforms during the crisis. Also, in the European Union we have a permanent system of mutual surveillance, peer pressure, and this will also help to remind every country of what they should do. Lastly, the ESM will monitor former program countries regularly in the context of the ESM Early Warning System to make sure that they can pay back what we lent them.

But there is a risk of complacency because interest rates are very low now and there is a lot of liquidity in the market.

**Q: The IMF and the Organization for Economic Cooperation and Development have warned that the eurozone faces a risk from deflation. These organizations have urged the ECB to implement unconventional measures like quantitative easing. How do you see the possibility of deflation in the eurozone?**

**A:** I think the IMF is exaggerating. The risks are there. But I think that risk is not large because we are in a period of low inflation, partly because southern European countries are seeing a fall in prices. This is not an accident but a desirable consequence of policy actions. In northern Europe, we see wage increases of 2% in France and 3% in Germany. It is more than half of the Euro area. Deflation, as a self-reinforcing process that changes the behavior of consumers and postpones purchases, is not what can be expected when wages go up at 2% or 3%. Japan's wages fell 10% in one decade in nominal terms.

**Q: What do you expect from the ECB's Asset Quality Review and Stress Test? How many banks will fail and will need official assistance?**

**A:** The Asset Quality Review and Stress Test is a very important exercise because they mark the beginning of a new era of European banking markets and the beginning of the Banking Union, where the ECB will take over the role of supervisor. There will be one common rulebook that will apply to the relevant banks in each country, regardless of their location. We will understand much better afterwards whether there is a problem or not. The ECB has said many times they do not expect big surprises. Some banks will need capital, but the ECB does not expect big surprises.

I share this view. In the five countries that received money from the EFSF and the ESM, we know the banking systems very well because stress tests were conducted before, several times, not only by the national supervisors but also by outside experts. That's why I am fairly confident we understand the banking systems in those five countries. So, no big surprises are to be expected there.

**Q: Is it likely that Asian investors are still interested in ESM bonds? How can you attract investors in Asia now that the crisis seems to have passed?**

**A:** We have always been attracting Asian investors from the beginning of our EFSF bond issuances. Generally, 40% of our investors in 2011 were coming from Asia. The ESM only started to issue late last year. Now, Asian investors make around 30% of our investor base. It seems the Asian investors like the capital structure of the ESM. It has the largest capital of any international financial institution. We have capital of 700 billion euros, and 80 billion euros is paid in capital. This money is not there to be provided in loans to countries in need. It is invested conservatively with a goal of capital preservation, aiming to protect our bond holders.

**Q: What is your impression of Abenomics?**

**A:** There are several angles to analyze in terms of policy strategy. On one hand, the inflation rate and inflation expectations are going up, which is exactly what the Bank of Japan wanted.

The increase of the sales tax has occurred, and we are waiting for a substantial structural reform package. I think this will be important because challenges are there. Japan has an aging society. The population is shrinking. The trend growth is relatively low. But the government can do a few things to raise trend growth. It's important for the future, particularly in order to get the fiscal side under control.

Europe has a similar situation. The population of the euro area will shrink and will face similar problems. If the Japanese government adopts a structural policy package to complement monetary and fiscal policy, then the overall package is quite impressive, it would be positive for the Japanese economy.

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