YPFS Lessons Learned Oral History Project: An Interview with Klaus Regling

Klaus Regling

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Klaus Regling is the managing director of the European Stability Mechanism (ESM) and ran its predecessor organization, the European Financial Stability Facility (EFSF). The EFSF was created in 2010 to address the euro crisis; the ESM is its permanent successor. The institutions provide financial help to eurozone countries that cannot access borrowing markets because of their economic or fiscal problems. They provide this assistance by issuing bonds, then lending that money to the troubled countries at favorable rates.

Regling, who is German, is an economist with experience in the public and the private sectors in Europe, Asia, and the United States, including with the International Monetary Fund in Washington and Jakarta and with the German Ministry of Finance. From 2001 to 2008, he was Director General for Economic and Financial Affairs of the European Commission.

This transcript of a Zoom interview has been edited for accuracy and clarity.

Transcript

YPFS: We're going to talk about lessons learned more than a decade ago, and how they're carrying forward now, with an eye to things that could be useful for other people who have to face crises in the future. Let's start just a little further back. Can you talk about how lessons learned during the 2007-09 Global Financial Crisis affected the response to the 2010 euro crisis?

Regling: Not very much, because these were two very different types of crises. Of course, there were some links, because the Global Financial Crisis showed some of the weaknesses in the euro area. And, for instance, banks in Europe were weaker after the Global Financial Crisis than they would have been

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1 The opinions expressed during this interview are those of Mr. Regling, and not those any of the institutions with which he is affiliated.

2 A stylized summary of the key observations and insights gleaned from this interview with Mr. Regling is available here in the Yale Program on Financial Stability's Journal of Financial Crises.
without that Global Financial Crisis. So there were some things that were linked.

But in principle, the euro crisis was something completely different, because it was not caused by banking problems. The causes were macroeconomic imbalances in different countries, either on the fiscal side, or housing bubbles, or countries had lost competitiveness, with huge trade and current account deficits. But only some of the euro area countries, and others not. In the end, there were five that needed financial support from my institutions. So it was a limited problem for some countries that were members of the [Economic and] Monetary Union, while the Global Financial Crisis hit everybody around the world. These are really two different types of crises. And therefore, one cannot really look back and say, we learned this lesson from the Global Financial Crisis that then was helpful to respond to the euro crisis, except maybe that we all learned that the weaknesses needed to be strengthened, and banks needed more capital and better regulation. That is also true for all European banks. And it would have been helpful. But apart from that, two different crises.

YPFS: What was the rationale for the creation of the EFSF and ESM and what does the facility do that the European Central Bank or European fiscal authorities can't do?

Regling: It follows a bit from what I said. The euro crisis happened because there were these macroeconomic imbalances that had accumulated over decades and they needed to be addressed. But when they became visible, these countries lost market access. So, they needed a lender of last resort, which the International Monetary Fund (IMF) is globally. But the IMF resources are far too small when a country that is a member of a monetary union loses market access, because in the Monetary Union, countries are so interconnected in the real economy and also capital flows that when market access is lost, the amount of financing needed from a lender of last resort is very, very high. The IMF is just not equipped to do that.

The European Central Bank could also not do it because one of the important principles on which the Monetary Union is based is that the ECB cannot do what we call monetary financing of public budgets. It's prohibited by law for the ECB to step in. What the Federal Reserve can do in a crisis in the US or the Bank of England in the UK, the ECB cannot do. It can intervene in the secondary debt market, something the ECB does a lot these days, but they can never directly finance a sovereign. And that was a gap in the institutional architecture of the Monetary Union because nobody had imagined that a country after joining the Monetary Union—these are all advanced economies in a way and joining is a difficult process. After going through that difficult process, that then the country could lose market access—that was not anticipated, was not foreseen. But it became clear that this actually did happen. That was the one and only reason why the EFSF was created first. And it was
created as a temporary institution. But then it became clear that several member states of the Monetary Union were facing problems like Greece and that's when it was decided to create a permanent institution, which is the ESM. EFSF was temporary; ESM is permanent, an international financial institution that will always be now part of the Monetary Union.

YPFS: We're being joined online by another member of your staff.

Regling: Yes, he's my senior adviser.

YPFS: As you mentioned, so far five countries have received assistance from your organizations. Ireland, Portugal, Greece, Spain, and Cyprus, right?

Regling: Correct.

YPFS: What are the goals of your loans? What were you attempting to accomplish? Did you and those countries meet those goals?

Regling: So the goal is very simple. How to get there might not be so simple, but the goal is to restore market access at reasonable interest rates. Because no country in the Monetary Union is prepared to help another country in the Monetary Union permanently. So the programs therefore have to look at the reasons why a country lost market access. And then the conditionality that comes with every loan, it's very much like an IMF loan. We copied the IMF simply. We did not try to reinvent the wheel; we copied IMF approaches with conditionality. For an IMF program, it's also the goal to reestablish market access, which means the problems that led to the loss of market access need to be tackled. The reasons differed, as I already mentioned briefly, housing bubbles, large fiscal deficits, large trade deficits, all countries had a loss in competitiveness, but to different degrees. And the conditionalities that were part of the loans were tailored in every country to address these problems.

In an even broader sense, one can argue that ultimately, the goal was also to keep every country in the euro area. If the countries had not addressed their problems, they would have been forced to leave the euro area, and devalue their new national currency again, which is not possible in the Monetary Union. That would have been the alternative and that was prevented. It was a real possibility, definitely for Greece; they could have been forced to leave. If EFSF and ESM had not been created, maybe even one or two other countries would also have been forced to leave the euro area. So a breakup of the euro area was prevented, and in that sense, the programs were successful. They were also successful in that all these countries did eliminate their macroeconomic imbalances. It took them two or three years, in most cases, eight years in the case of Greece, but in the end, they all became success cases.

And we saw, again, what we know from IMF programs. There may be IMF programs that don’t work well, but the large majority do work as intended.
After a painful adjustment, and after problems have been eliminated, then the economic performance is actually quite good. We have seen that in Latin America and Asia, Turkey. The same happened in Europe. These five countries, after they left the ESM programs, had a better economic performance than the average of the euro area.

YPFS: Can you crystallize lessons that your institution has learned over time as you've evolved, how you've applied them, and how others might learn from them?

Regling: It depends a bit country by country because the problems differed country by country. Looking for instance at Ireland and Spain, they suffered from a very huge real estate bubble. Or they suffered from it when it burst, so the aftermath of the bursting of the bubble. And when that happened, we had no good instruments in the European Monetary Union, to help the banks, because when the real estate bubble burst, there were lots of problems in the banking sector. And the only way to deal with that and prevent the collapse of the economy was for the public sector to take over the problem loans from the banks. Ireland and Spain had a very, very solid fiscal policy and very low debt levels before the euro crisis. But in Ireland, the debt levels went from 30 to 100 percent overnight, because they had to take on all these problems from the Irish banks. If they hadn't, the Irish economy would have collapsed.

There was no other instrument at that time. In the years that followed, we created mechanisms in Europe, to deal with that differently. Now, if this were to happen again, bank creditors would be bailed in, they would lose a lot of money before any public money is used.

YPFS: What's that mechanism? Could you explain that?

Regling: We have a bank resolution regulation that makes it very explicit and very transparent. Depending on your place as a creditor in the hierarchy, either 100 percent of your money, your investment in the bank, is lost, or maybe 75 or 50 percent. In order to protect the taxpayer, there's a mandatory bail-in of bank creditors. And that clearly goes back to that experience.

YPFS: That was not the case in Ireland, obviously.

Regling: Yes. And other experiences, in Greece we had massive debt restructuring in 2012, two years after the Greek problem became very, very, very visible. This is also something that had never been anticipated, that a member state of the euro area would have to restructure its public debt. So again, we had no experience, no good instruments. If it took very long before we got there, a lot of money could leave the country in the meanwhile, so the ESM programs had to become bigger and bigger to replace that. Now, if this were to happen again, we would use that experience and would be able to address the issues much faster. That's another lesson, but it depends on the country. And of course, the
best lesson is to watch out and not let those kinds of macroeconomic imbalances develop at all. That of course is the best lesson. And I think that we have learnt a lot. It may be forgotten 20 years from now, but at the moment everybody in the policy world, and that includes the European institutions like mine, but also the Commission, the ECB—we all remember what happened and what went wrong, but also governments. And we will pay much closer attention to make sure that these massive imbalances are not repeated.

The imbalances accumulated during the first decade of Monetary Union. And they happened during a period that was called the Great Moderation, which sounds almost like a bad joke with hindsight. But because it felt like a Great Moderation at the time. These imbalances that were accumulating were not seen as very important. It seemed like this could happen and wouldn’t have any negative consequences. But I think in the future, everybody will remember, at least for a while, what the consequences can be, when such developments happen again. In Greece, wage increases were the highest in Europe, but productivity increases were not so strong. Unit labor costs during the first decade of Monetary Union went up in Greece by 40 percent more than in Northern Europe. That led to a loss of competitiveness and a big current account deficit.

YPFS: Speaking of Greece, they've come to you three times. They're still in an ESM program. What does success look like for them? And what do they still need to get there?

Regling: No, they are no longer in an ESM program.

YPFS: Oh, they're not. I was reading old stuff, then. I'm sorry.

Regling: That was the last one of the five that ended, the last of the five countries; that happened in 2018. In a way, they are still under surveillance, like the other countries, which is also again, something the IMF does. So even when the program has ended, and the money is outstanding, European institutions monitor economic developments, so in that sense, there’s a relationship with the country, but the program as such, with additional disbursements from time to time, that has ended.

YPFS: But the loan is still outstanding; they still owe you money?

Regling: Absolutely. Money is outstanding with all the five countries. And our maturities are much longer than the maturities of the IMF. It differs country by country. For Greece, 42 years is the average maturity, and the Greek debt or the Greek loans, our claims are equivalent to 100 percent of Greek GDP. And we have 60 percent of Greek public debt in our books. So we have a very special relationship. That’s why we have to monitor, like every creditor has to monitor what happens to a big debtor, because creditors want to be repaid eventually. So that’s why we go on missions, we discuss policies with the
government, but they are not in a program. Greece also eliminated all its massive macroeconomic imbalances, like the other countries, but they were bigger than the other countries. That’s one reason why it took longer.

They had massive fiscal and current account deficits of 15 percent of GDP. They improved their competitiveness, they strengthened their public sector and pension system, tax system, everything. So the country began to work quite well until the COVID-19 hit all of us. They had actually fiscal surpluses, not just primary surplus, but an overall fiscal surplus. They had a current account balance, they had really eliminated many of their problems, they regained market access at very reasonable interest rates. And ultimately, the success was that they stayed in the euro area. And they got very close to leaving in 2015. But they were successful.

YPFS: Let’s think back to 2010, and the start of your facilities. You’re founding a new institution, huge balance sheet, you’re there because you’ll be a bigger balance sheet, bigger resource than the IMF. What do you know now that you wish you knew then?

Regling: Many things. But you have to be aware that we evolved considerably over these years. When we were created, the EFSF but also the ESM, we were only created to raise money in the markets, to issue bonds, to be able to finance a program. And the program and the conditionality of the program was defined by the other institutions, European Commission, ECB, and IMF. They were called the troika, they were in charge of the economic things, defining the right policies to eliminate the problems that had accumulated and led to the loss of market access. We were only in charge of the money. And that we could do, because I had put together a team that knew how to issue bonds. We didn't know we would have to issue so much, but we knew what to do.

But then, as time went by, and we had to support five countries with much bigger amounts than ever anticipated, we became the biggest creditor in all these five countries, and it became unavoidable to develop the economic side of the institution. Because otherwise, we could not really assess the repayment capacity of these countries, whether they would ever be able to repay us. We had to start doing debt sustainability analysis. And that’s why the other half of the institution then came into existence and has been developing ever since. It’s a development that was not anticipated from the beginning. That’s the best way to describe it.

It was not clear in the beginning where we would end up. Moving from being just a financing institution to also being a political economy institution was the unexpected development. And we learned a lot in the process, how to do it. But everybody who works in the process is experienced; I've worked at the IMF 10 years, so I had that experience. I have people on the financing side who had issued bonds in other institutions. So we brought it all together.
YPFS: Again, we’re back in 2010. How was the institution received at first by the eurozone member countries and their leaders in your perception? And also, are we talking EU or eurozone here? Just wanted to keep it clear.

Regling: We are talking about eurozone because, the other members of the EU, like at the time, the United Kingdom, have their own currencies and their own central banks. They care about what’s happening in the euro area but they were not involved in the creation of the ESM. They are not part of our bodies. So the ESM has 19 member states. The EU has 27. With the UK, it used to be 28. And they have their own bodies. But the ESM has only the 19. How governments and parliaments look at the ESM is important. Of course, the governments created us, so they all wanted the EFSF and the ESM to work. And in important decisions, like starting a new program, all 19 finance ministers had to agree to that. So they will always be behind it, at government level.

For parliaments and population, it was quite different. We were not popular at all, but for very different reasons. In the countries that had programs, we were not popular. And sometimes we are not even popular today. Because the population associated the painful adjustments they had to go through with the institutions that were behind those programs. So not only ESM but also the commission, plus the IMF, in some cases. And it’s understandable, because nobody likes cuts in salaries, wages, pensions of 20, 30 percent. There were tax increases, expenditure cuts. So we were not popular in those countries.

Then for another group of countries, including my own Germany, but also other Northern European countries, we were not popular because people thought that we would just reshuffle German taxpayers’ money to Greece and Greece would not really do anything. That was for a while the story, so I was not popular in Germany either, but for very different reasons. And that’s why we have a very strong communications department. We had to explain a lot.

YPFS: How do you explain? I mean, you have five countries that are at one point or another going through some level of economic and fiscal pain, and 14 countries that are seeing themselves as the source, where the money comes from. What is your explanation? What’s your public message?

Regling: Well, quite different for the two groups, of course, although in the end, that has to be all consistent. For the countries that needed our money, I had to explain why they were facing problems. As I mentioned earlier for Greece, when unit labor costs went up 40 percent, 50 percent, more than in Northern Europe, it’s no surprise that they lost competitiveness. And then had a huge current account deficit of 15 percent of GDP, which required capital imports of 15 percent of GDP every year. This could not continue forever. We worked a lot with the media, the parliaments in these countries, and the politicians. We worked very closely with the Finance ministers. Like the IMF, one always
works with the finance minister of the countries that are in trouble, because they understand what needs to change. But there also needs to be a lot of public relations efforts.

And in Northern Europe, we had to explain that we operate in a way that does not cost taxpayers any money. They guarantee our operations, so they take on risks. And if things go badly wrong, then these risks may materialize. Then there could be a cost for the budgets of all the 19 countries. But we are exactly set up in a way to prevent that. We have very good, very solid, legally solid, guarantees. That’s why we have top ratings from the rating agencies, that’s why we are triple A and get money cheaply in the markets. And we pass on our own low refinancing costs to the countries that borrow; we don’t want to make any profit. And that’s how they gain a lot, because that’s much cheaper than the financing they could find in the markets before the crisis, or even now. That’s a big advantage.

So one can explain that, again, to the borrowing countries, but also to our other shareholders, explaining that their tax revenue is not used by us. One just has to explain how we operate, how we were set up, in order to avoid costs for the taxpayer. We are leveraging the high rating of our strong member states to provide cheap financing to the weaker member states.

We also had two independent evaluations of our country programs. This follows best practice of other institutions and promotes accountability, credibility and public trust.

The first one was a cross-country evaluation report on the EFSF and ESM’s financial assistance published in 2017. The second one assessed the financial assistance to Greece, primarily focusing on the ESM program from 2015 to 2018 up to end-September 2019.

Drawing these lessons will help to improve the effectiveness of program activities and support us in addressing future crises.

YPFS: Let’s move closer to now, 2020 and 2021. I was reading some of your earlier speeches. I think they were a year ago. You described the coronavirus crisis as the biggest economic and humanitarian crisis of our times. What role does the ESM have in addressing that crisis? And how is that different from roles of other European institutions?

Regling: So I think my statement a year ago, was pretty correct, unfortunately.

We do play a role, but a relatively smaller role, much smaller than during the euro crisis. One reason is that COVID-19 has hit all countries. So not just the 19 euro area countries, but in this case, the European Union with all its 27 member states, is affected. So it would not be enough if only we were to play a role, then Sweden and Denmark and Bulgaria would all complain, rightly so.
We also contribute, but it’s only a relatively small contribution compared to what the European Commission does.

We created a special facility based on our precautionary credit line called Pandemic Crisis Support that allows all our 19 member states to draw up to 2 percent of their respective GDP to cover health care costs. And that’s relatively small. The commission has much bigger programs, has a 750 billion [euro] program, and gives also grants, something we cannot do. So, they are the big player in this crisis, and there are good reasons for that. This is not a euro area issue.

The facility that we have created has not been used by any country yet. But when it was created, last year, in April, it had a positive impact in markets. And it will be available for two more years. Countries can draw it in case they have some problems. That is a good signal for the markets, because it’s a kind of assurance. So, despite the fact that it has not been activated, it had a positive impact.

YPFS: Is there any reason nations have not applied for this Pandemic Crisis Support from you? Are you all the way down, so that you're less attractive than...

Regling: So, the conditionality basically has disappeared. The only condition is that the money is earmarked for health care expenditures. But all countries have health care expenses that are much higher than 2 percent of GDP. In some countries, there’s a fear that stigma might come just by using ESM money, something we know well from the IMF experience. But we know that there’s no market stigma. The market people—and we talk to them a lot because we issue bonds, and also invest our own capital—they know that this is positive for the countries, or for one-half of our member states, because if they use our money, they save money compared to going to the markets themselves. No country has a problem going to the markets these days, partly because of the monetary policy in the US and in Europe.

Still, for about half our countries, they would save some money if they used us instead, because we have a triple-A rating, and half our countries have a lower rating. However, the difference has become less evident because monetary policy is so generous now in response to COVID-19.

YPFS: Aside from the role you've played over the last decade, specifically at ESM and its predecessor, you're an expert on this. You've been doing this your whole career. What other lessons would you point out for nations that are dealing with the current crisis? Whatever you’re comfortable addressing, and if you need to clarify what role you're speaking in?

Regling: I think this crisis, again, shows that crises happen. And a crisis typically comes as a surprise. If it were not a surprise and you could prepare yourself,
countries could prepare themselves. And then it's not really a crisis anymore. So, the real crisis comes always as a surprise. And that's why, when I look at the policy world, fiscal policy, monetary policy, I think it's important that in the crisis, fiscal and monetary policy must become very active. But then as soon as one gets out of the crisis, one should start re-creating buffers, fiscal buffers, monetary policy buffers, because there will be another crisis one day. We don't know when, but that's the nature of crises. So, it's crucial to create those buffers, and I think, in Europe, but also in the US, we were not very good at doing that before COVID-19 hit.

YPFS: **Do you anticipate any other specific changes to the ESM safety net due to the pandemic?**

Regling: Not due to the pandemic, but we are in the process of revising the ESM Treaty, which is our legal base. The ESM is an international financial institution, so it's based on international law, and the legal base is a treaty that was ratified in all member states of the euro area. And right now, we are in the ratification process of changing that treaty. And we are changing several things. I can talk about it, but it's not as a result of the pandemic, it's related to the development of the institution as I described before.

We started out only as an institution to organize money, then we evolved, performing, economic and debt sustainability analysis. The revised ESM Treaty puts these roles into legal texts. And we will play an even bigger role if an adjustment program, like the ones we had in the past with the five countries, is needed in the future. Then the ESM would play a much more prominent role, also on defining conditionality, together with the European Commission. There would be no more troika. The work would be done by the European Commission and by us. That's the new set up.

And that is one important change based on the experience of the euro crisis, not the pandemic. Another is that we will be able to provide a new facility, a so-called backstop to the Single Resolution Fund, which works a bit like the FDIC in the US. It's in charge of bank resolution. It works with its own money, contributions from the banks, and normally, that's enough. But when there's a crisis, the FDIC has a credit line with the US Treasury. And because in the euro area, we don't have a Treasury, the ESM will play that role. We will provide a backstop to that other European institution. That also requires changing our treaty, which before only allowed providing loans to governments, but not to institutions. So these are two significant changes that are happening right now this year. And hopefully, the ratification process will be done in the second half of this year, and then we will play this wider role.

YPFS: **Could you just clarify so that I understand it. Troika would be ECB, the European Commission, the IMF.**
Regling: Yes.

YPFS: And the newer structure—

Regling: Is Commission and ESM.

YPFS: So, the Central Bank is not overseeing the conditionality. Okay.

Regling: Of course, their advice will be asked and might help on financial sector developments. Also, the IMF’s advice will be welcome, but they will not play the role they did 10 years ago, when we invented this approach of a troika, because we didn’t have an institutional setup that was appropriate for such a crisis. It was an ad hoc solution. It worked, and we are grateful that ECB and IMF played that role. But both of them will play a reduced role in the future, because the ESM in a way has matured and can take over, together with the European Commission that will continue to play a key role.

YPFS: Before I let you go, is there anything that you would like to add, questions I should have asked you about lessons that other people can take from your experience?

Regling: I looked at the presentation that I gave at Yale three and a half years ago, a seminar organized by Tim Geithner and colleagues. And we covered a lot of what we discussed today. But there was a special session on so called Regional Financial Arrangements, I don’t know whether you are familiar with that at all.

YPFS: Not so much.

Regling: The so-called global safety net, and internationally available public money, has several layers. One is made up of the foreign exchange reserves that every country has. Then you have the IMF. Then—and this is a lesson from the Global Financial Crisis, the euro crisis—come what we call Regional Financial Arrangements. The ESM is one of these Regional Financial Arrangements. You also have one in Southeast Asia, the Chiang Mai Initiative, and there’s an institution called AMRO in Singapore. This comprises the 10 ASEAN countries plus China, Japan, and Korea. And they provide money in a crisis. There is one in the Middle East, the Arab Monetary Fund. There’s one in Latin America called FLAR, and there are two others.

Four years ago, we took the initiative of coordinating this a bit, because together we have a lending power that’s higher than the IMF’s lending power. So, we cooperate, try to learn from each other. And we coordinate very closely with the IMF; we don’t want to move away from the IMF. We all understand, and the IMF understands, that we can be very strong together. If there’s a real big crisis, we will need all these financial resources. And that in a way is also a clear lesson from the Global Financial Crisis. Some arrangements appeared after the crisis and some have existed for longer, but became more important,
or increased the lending power, lending capacity, we saw an opportunity to cooperate and provide a global financial safety net with the IMF that is really powerful. I think that’s maybe also an interesting point when you look at lessons from the crisis.

YPFS: Okay. On that note then, I think that I will let you get back to financing, the saving of the world. Anyway-

Regling: To ensuring the financial stability of the euro area!