

Interview with Financial Times

Interview with Athanasios Orphanides, Governor of the Central Bank of Cyprus,
conducted on 16 December 2009 by Ralph Atkins, published on 21 December 2009

Q. Has the European Union handled the crisis over Greece's public finances in the best possible way?

Evaluating policy decisions in real time is very hard, so I think we will have to wait many years before we can fully study this episode – as would be the case with any policy problem. It is a really challenging question when you put it like that. I would try to answer it by reminding you that we do have very clear rules in the European Union that all countries need to adhere to inside the monetary union. I expect that this will be the case for Athens.

Q. But in the past the rules were not enforced and now we are seeing the consequences?

I am not sure I would agree with you. We are in a very unusual situation –in a recession after the worst crisis we have had in a number of decades. So this changes somewhat the implementation of the rules. This has been recognised by the EU.

I do expect that the rules will be adhered to going forward. I see that there is a determination by the Greek government to take the necessary steps towards the fiscal consolidation that we all recognise is necessary.

Q. Should the ECB or euro area politicians offer any guarantees or assurances about outside help?

We have rules and we need to abide by those rules. I fully expect that the Greek government will take the necessary actions in order to correct the dramatic situation that Greece is in right now. The rules do not call for other countries volunteering to come in. But at the same time we do recognise that the situation in Greece affects the rest of us.

Q. So a default by a euro area member is perfectly possible?

I do not expect such a development at all because I am confident that the Greek government will resolve the difficulties.

Q. Fiscal difficulties could become more widespread in the euro area next year. Do you think the mechanisms to cope with these difficulties need to be strengthened – or made clearer?

Even though we are not a fully-fledged union we have very close ties and mechanisms in the EU and in the euro area to help each other address difficulties. I will give you an encouraging example that others could follow – including Greece. Ireland has also come under tremendous stress, starting with the deterioration in its banking sector. I very much welcome the determination that the Irish government has shown in addressing the fiscal difficulties they are facing.

Q. So the Greek government should be cutting wages like the Irish are?

Listening to the speech of the Greek prime minister the other day and the statements of the finance minister in the new government, I see the determination to do what is necessary in order to solve the problem.

I should have said at the very beginning that I am a Greek citizen in addition to being a Cypriot – so I have a stake there. My mother is from Greece, she comes from Vrahos, a small village in Kastoria.

Q. So, as a Greek, do you think outsiders are right to be sceptical about whether the Greek public sector can be reformed? It is perceived as corrupt, over-staffed and inefficient.

Some of the criticism is fair and some is unfair. Watching the economies in various parts of the world I believe that there is scope for improvement everywhere. There is some corruption and inefficiency everywhere. I do agree with you that the recent difficulties in Greece have exposed these problems and have brought them to the fore. This is something which is common in a crisis and presents an opportunity for improvement.

Q. I have the impression that at the ECB and in Brussels there has been a deliberate policy of "constructive ambiguity" as to what exactly would happen in the case of a serious risk of default by a eurozone government. Is that correct – and is the policy perhaps more coordinated than we imagined?

Speaking for myself, I would not subscribe to that view. We have some very clear rules but as is invariably the case with rules, there may always be possibilities that had not

been contemplated or experienced in the past. So decisions may have to be taken that were not contemplated. This is a fact of life.

Q. But is the euro area best served by this "rules-based system" when there are obviously holes in it? In the US they can simply throw away the rule book at a time of crisis.

Exactly because we have the common currency it is much more important that we adhere to the rules that we have.

You mentioned the US. In my mind there is arguably a greater risk of a default on the debt of a US state than there is on the debt of a euro area member. I consider it unthinkable that a euro area country would default.

Q. Are you saying that financial markets are wrong to worry about the break-up of the euro area or of a default?

I would say that fears of the euro area breaking up are unfounded.

Q. But are financial markets being unfair?

We can never explain every movement in financial markets and we have to respect the accumulation of opinions and views that are reflected in financial markets. But I can state my personal view which is that I see absolutely no risk of the euro area breaking up at all. I am confident the debt of every euro area country will be honoured.

Q. Moving onto the euro area economic outlook: eurozone "core" inflation is just 1 per cent – the lowest for nine years – if this deceleration trend continues, is there not a serious risk of the ECB seriously undershooting its price stability objective?

I would start by stressing my agreement with [Jean-Claude Trichet] the ECB president – and this is extremely important for the effectiveness of our monetary policy – that inflation expectations in the medium to long term have remained very well anchored. If you look over the past three years we have had, first, a very unusual set of circumstances that drove inflation upwards and away from our definition of price stability largely because of increases in energy and other commodity prices. Then we experienced exactly the reverse for two reasons. First was the reversal of the energy and commodity price boom. Second, and even more dramatic, was the financial crisis that brought the

industrialised world into the most severe recession that we have had for many, many decades.

In the face of these dramatic developments it is remarkable that medium to long term inflation expectations remained so well anchored. I think this speaks very well for the credibility of the monetary policy framework of the ECB. It is one of the positive elements that facilitates decision making. Well-anchored inflation expectations make it easier for us to respond to short term disturbances and improve macroeconomic performance.

We have avoided the threat of deflation which, you will recall, was a major concern a year or so ago. I now think we face a much smaller threat of deflation.

This is precisely because the medium to long term inflation expectations have remained so well anchored. That refers to medium to long term inflation expectations. With that in mind, I agree that over the past year or so we have observed a decline in core inflation away from our definition of price stability and that is something which personally I find to be of concern.

Looking at the projections that the ECB recently published I also see that for three years – 2009, 2010 and 2011 – HICP inflation is staying below our definition of price stability. We need to watch this very carefully because in my view it would be problematic if this deviation of inflation from our definition of price stability became embedded in expectations. Indeed such a deviation would risk de-anchoring inflation expectations on the downside.

Q. How do we avoid this low inflation becoming embedded?

In my view we are already doing that by keeping monetary policy sufficiently accommodative as long as necessary to ensure that price stability will be maintained in line with our definition.

Q. You regard policy now as sufficiently accommodative?

Yes, indeed I do.

Q. Would you err on the side of delaying an "exit strategy" when it comes to monetary policy? This is what the IMF suggests.

The most important thing is to be symmetrical in pursuing our primary objective which we define as inflation, measured by the HICP, close to but below 2 per cent. At the moment, with core inflation trending away from our definition of price stability, I believe we need to ensure that policy remains sufficiently accommodative in order to avoid the risk of a very extended period of undershooting. The evaluation at the moment, as Mr Trichet said, is that policy is appropriate.

When we examine the mix of policy – the combination of conventional and non-conventional measures – it is very important to note that the president said that in phasing-out some of the unconventional measures, as we have started doing, we do not want to give any impression of a change in interest rates or be perceived as changing in any way market perceptions about interest rates.

I interpret the phasing-out of the [non-conventional] measures as reflecting purely the improvement in money markets and not in any way as a tightening of monetary conditions.

Q. Are you saying that markets are right not to expect any increase in ECB interest rates before the third quarter of next year?

I do not find it useful to try to forecast interest rate moves and give guidance to markets that far ahead. We have said current interest rates are appropriate. Subsequent policy decisions will depend on the evolution of the economy and associated risks to our price stability objective.

Q. Before you became Cyprus's central bank governor you wrote papers at the US Federal Reserve about Japan in the 1990s and the US in the 1930s. Do you think the ECB learnt the lessons of those periods?

I was at the Federal Reserve Board in the late 1990s and became interested in following developments in Japan at that time. It was the first time in the developed world that we had experienced a deflation and policy interest rates being very close to zero since the 1930s. Long term interest rates were also at historic lows.

Q. So at the ECB you had the chance to put your thoughts into practice?

At the Federal Reserve the chance actually came earlier. We were able to use some of the analysis already in 2003 when the US faced what the Federal Reserve called a period of "unwelcome disinflation" and there was some concern that the US might enter a period of deflation with very low interest rates.

There are a number of lessons in my mind from studying the historical experience but let me mention one of the most important: that refers to the concern that monetary policy may become ineffective once interest rates become very low – the so-called "liquidity trap".

I found it useful to know that the concept of the liquidity trap was already discredited in the 1930s. One should not be overly concerned about monetary policy becoming ineffective. That being said, we need to recognise – and this was one of the lessons that were put into practice in the US and in Europe during the current episode – that once conventional monetary policy easing becomes nearly exhausted it is important that the monetary authorities revert to unconventional means of expanding monetary policy.

Q. Do you think that the ECB took on board all the lessons of history? Or did it remain hesitant?

It is too early to know whether we could have done something slightly differently that would have led to a better outcome. This is something that historians will have to evaluate later. I would say now that we have been very successful in steering monetary policy in the right way. Let me just remind you of the rapid and large accommodative moves that we had in the euro area and the unconventional measures that we took at the ECB – some of which were then implemented at other central banks, following our lead. With all this in mind, I feel comfortable with the decisions we took.

That said, let me tell you one of the frightening thoughts I had as a policy maker. When studying US monetary history in the 1930s and Japanese monetary policy a decade ago, I came across some pertinent words by Keynes. In 1930, even before the great depression had taken hold, he was concerned that the mentality and ideas of policymakers could actually hinder the appropriate action needed to avoid the worst. During the 1930s, his concerns proved well founded. But we have respected the lessons of history and I feel confident that we have learnt tremendously from it. I think we can already say that we have avoided an experience as terrible, as catastrophic, as in the 1930s.

Q. Looking at your 2003 paper [*Monetary policy in deflation: the liquidity trap in history and practice*] you say that the Federal Reserve in the 1930s implemented its "exit strategy" too early, and said that its increase in reserve requirements in 1936 was not a monetary policy tightening. The ECB is currently implementing its exit strategy quite early in the cycle and also says that the moves it has taken so far are not a tightening of policy. Are there parallels?

I would dispute the premise that the ECB is phasing out its non-conventional measures too rapidly. I think the phasing-out of some – I stress "some" – of the unconventional measures is appropriate.

What is different compared with the US experience during the 1930s is that then we had an upward spike in interest rates after the removal of excess liquidity by the Federal Reserve, which was evidence of an inadvertent tightening. In my mind this just shows what problems arise if one incorrectly estimates the demand for liquidity at exceptional times, such as we face right now. In contrast to that experience, at the ECB today we are very sensitive to the demand for liquidity and the uncertainty associated with that demand. Let me remind you that we are continuing our policy of full allotment at a fixed rate which ensures that we avoid undesirable increases in interest rates.

Q. How long will that policy have to continue?

As long as necessary. We do not pre-commit on our policy, and I think it is inappropriate to address what policy might be like in a year's time. That depends on economic developments.

Q. Going back to core inflation, I thought the ECB orthodoxy was always that core inflation would trend towards headline inflation, and that we should focus on headline inflation?

I don't agree with the premise. I must start by saying that the most important measure of inflation is total, headline HICP inflation. However there are periods when the volatility in some of the components of the index makes readings of headline inflation not the best summary of where prices are heading. This has been the kind of environment in which we have been in for the past two or three years. In these circumstances where energy, food and other commodity prices are extremely volatile, it becomes more useful to monitor core inflation as an indicator. But it is just an indicator; it is not an objective *per se*.

As regards the premise of your question, I would argue the reverse – that headline inflation tends to move towards the underlying trend in core inflation over time and not the other way around. But at the end of the day our focus is on total inflation.

Q. Is there a danger that the ECB might have underestimated the degree of slack in the economy [and its implications for inflation]?

Clearly after observing output drops so drastic, especially in the fourth quarter of last year and the first quarter of this year, there is considerable room for expansion in the economy without material concerns about inflation pressures. Indeed we need considerable growth in order to avoid the other risk – of inflation continuing to undershoot our price stability objective. That said, I have been in my career one of the people who has been most doubtful about the usefulness of actual measures of economic slack in real time for guiding policy decisions. In my historical analyses I have come across too many times when policymakers would have been misled if they took at face-value estimates of slack or measures of the ‘output gap’.

You said earlier the risks of deflation had fallen a lot...

Indeed, they have. If I go back to the Spring of this year, when the economy seemed to be in free-fall, there was a lot of uncertainty about whether things would deteriorate further or much faster than they actually did. This created a risk of deflation at that time. At the moment, I must say that I welcome the signs of the recovery that we have in the euro area. The third quarter GDP increase was nice confirmation that we are back on the track to recovery. At the same time the recovery is fragile and we have to remain cautious.

Q. How worried are you about remaining weaknesses in the eurozone banking system? Only last week, Austria had to nationalise a bank because it was worried about systemic risks...

Despite of the improvements that we have seen, we are not yet out of the woods. We have to be aware of the fragility of the banking system. The taking-over of a bank by the Austrian government was a reminder of how careful we need to be.

Q. The latest FT European economic weather map has black clouds over Cyprus and it seems that rather belatedly, the island is entering a period of contraction. Is that a knock-on effect of what is happening in Greece?

It is indeed unfortunate that the Cypriot economy is now experiencing greater difficulties than had been anticipated a year ago. I have to say that despite the recent deterioration, we have weathered the worldwide economic recession considerably better than Europe and the euro area as a whole. But it does appear that the most negative effects came with a lag. This is in part because our economy is driven by foreign demand and tends to react with a lag to developments in the rest of the EU.

Q. Is now a good time to buy a house in Cyprus?

It is always a good time to buy a house in Cyprus. Our weather is as great as it was a year ago and two years ago.

Q. What role might the euro or monetary union conceivably play in helping the reunification of Cyprus?

The president of the Republic has been in talks with the leader of the Turkish Cypriot community over the past year and the negotiations seem to be at a critical point. There is the prospect that the political problems of the island might be solved. I am cautiously optimistic that we might have positive developments.

Economic and monetary union can enhance peaceful coexistence between people and I take great comfort from how this has worked in other areas of the EU. For instance, look at Germany and France and their peaceful coexistence following a long history of war. We are in Frankfurt today talking about the European economy. A few minutes ago we were talking about ECB policy, where we have a president who comes from France. We don't really talk about the nationality of the people taking decisions. We all share the common goal, which is the advancement of the dreams and the welfare of the people of the EU, respecting the diversity that we have. The example of Germany and France is something that we can aspire to emulate as part of the solution of the political difficulties we have in Cyprus.

Since Cyprus is part of the euro area, the euro has to be the common currency of the unified Cyprus as soon as a peaceful solution is negotiated. The adoption of the euro has removed one of the hurdles in thinking about how you would unify two areas that have not been unified for a long time. I recall that a few years ago people were talking about

how many currencies a unified Cyprus would have. The rules of the economic and monetary union within the euro area must be adhered to and can serve as a catalyst for progress.

Q. You were a pupil of Paul Samuelson, who died recently. Is there anything that you learnt from him that you found particularly useful as a policymaker over the last couple of years?

I feel humbled and blessed at having had the opportunity to study economics at the Massachusetts Institute of Technology when Paul Samuelson was teaching there. Paul Samuelson was everywhere. I was lucky enough to have him as my teacher in one class – just for one semester. He had a strong belief that economics can influence policymaking and can have a tremendous role in advancing the welfare of mankind. Many of his students, who went on to teach, tried to instill this idea that we must be deeply involved in policy work if we want to really utilise what we learn in economics.