The international financial turmoil and the economy

Speech by Athanasios Orphanides, Governor of the Central Bank of Cyprus, at a dinner of the Institute of Certified Public Accountants

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It is a great pleasure for me to be here this evening and I would like to thank the Limassol-Paphos Coordinating Committee of the Institute of Certified Public Accountants for the kind invitation. I will use this opportunity to share with you some thoughts on the international financial turmoil, its mounting global impact on the real economy and the concomitant policy response, particularly from a central bank perspective. In this context, I will also review the outlook for the Cyprus economy. I note that the views I express are my own and do not necessarily reflect the views of my colleagues on the Governing Council of the European Central Bank.

The financial system is the heart of the modern capitalist economy. When it functions properly, it efficiently allocates scarce financial resources to the most productive use, allowing a seamless transfer of funds from lenders to borrowers through banking institutions, capital and money markets. If this key role is disrupted, the real economy may suffer. Depending on the magnitude of the disruption, the implications for the real economy could be dire, especially if policy measures do not succeed in isolating and correcting the problem sufficiently quickly. In that case, a negative feedback loop may materialise with a financial disturbance and a worsening real economy reinforcing each other in a downward spiral for a time.

Today the world is facing such an extraordinary disturbance of the international financial system. How bad is it? We need to go back many decades---to the 1930s---to identify a disturbance to the international financial system of a similar magnitude. Over the past several months, we have experienced the collapse of major international financial institutions and a systemic breakdown of key financial markets which have led to a severe and synchronised economic downturn in the world's advanced economies.

How did it happen? Briefly, the trigger for the turmoil is associated with the end of the most recent housing cycle and the related rise in defaults on subprime mortgages in the United States. The cause of the crisis, however, must be traced to an accumulation of imbalances in the world economy that built up over a number a years and gaps in the regulatory framework that permitted excessive risk taking by a number of systemically important financial institutions around the world.

In the years leading to the outbreak of the financial turmoil in August 2007, consumers, firms and investors, especially in the United States and Europe, were encouraged by a benign macroeconomic environment of low interest rates, low inflation and sustained economic growth to expect continued prosperity. More specifically, the success of economic policies during this period to dampen significantly macroeconomic fluctuations as well as the low cost of borrowing contributed to an underestimation of the risk and its under pricing by economic agents. This in turn resulted in excessive risk taking and a proliferation of complex financial instruments. Prices of real estate and other assets as well as leverage rose significantly. Regulators did not sufficiently appreciate the accumulating dangers to the financial system and were not fully aware of their seriousness. When house prices started to fall in the United States and subprime-mortgage-related defaults increased by more than was expected, it became evident that the risk in securities related to subprime mortgages was mispriced. This raised questions about valuations of complex securities that contained elements backed by subprime mortgages and about possible solvency problems of banking institutions holding these securities. From the subprime-related market segment, tensions spilled over to other markets, including the money markets in the US and in Europe. Following the outbreak of the turmoil in August 2007, tensions remained elevated for over a year only to become vastly worse following the failure of the American investment bank Lehman Brothers in September 2008. Money markets essentially froze in September – October 2008 due to a collapse in confidence that made banks unwilling to engage in unsecured transactions with each other. These developments also hastened the deleveraging process that was already under way and prompted an abrupt tightening of credit conditions and a sharp deterioration in the global economy during the fourth quarter of 2008 that appears to be continuing in 2009. It drastically changed the outlook for inflation, reversing the upward pressure exhibited during the first half of 2008, but also vastly raised the uncertainty about the outlook for the economy worldwide.

The policy response to the turmoil in September 2008 was also massive, reflecting the magnitude of the problem. Governments and central banks took a multitude of measures in a concerted fashion with a view to alleviating the impact of the financial crisis on the real economy, restoring confidence and the efficient functioning of financial markets. These included coordinated liquidity provision operations and interest rate reductions by major central banks, measures to enhance the liquidity in the banking system and government programs to buy toxic assets, recapitalise financial institutions and set up deposit protection schemes. At the same time, regulatory and supervisory frameworks have been scrutinised so as to identify how they may be strengthened.

Against this background, it is of particular interest to focus on the way central banks have reacted to the crisis since the collapse of Lehman Brothers. In addition to operations designed to alleviate worsening liquidity problems, and in light of the deterioration in the real economy and dampening of inflation pressures, all major central banks in the industrialised world have reduced their policy rates. In an unprecedented coordinated interest rate move on 8 October, six major central banks, including the ECB, reduced their policy rates by as much as 50 basis points. With a continued deterioration in the financial system and a related worsening of the real economy and dampening of inflation pressures, policy rates around the world were subsequently reduced even more drastically to record low levels. On December 11, the Swiss National Bank lowered its three-month Libor target range all the way down to 0.0–1.0% and on December 16 2008 the Federal Reserve reduced its target further, to a range of 0 to 25 basis points for the target federal funds rate. Likewise, the Bank of England reduced its rate by a total of 3½ percentage points in only four months to 1½% in January 2009, its lowest ever level. Against diminishing inflationary pressures and downward prospects for the euro area, the ECB substantially reduced the main refinancing rate to 2% in January 2009, matching the lowest rate ever. I note that the Bank of Japan, which had maintained very low rates for a decade, also reduced the target for its policy interest rate from 0,5% to 0,3% at the end of October 2008 and further reduced it to 0,1% in December 2008.

Since short-term nominal interest rates cannot be reduced below zero, the fact that policy rates set by some central banks, such as the Bank of Japan, the Federal Reserve and the Swiss National Bank are already extremely close to zero, and that policy rates of other central banks, including the ECB and the Bank of England, are at historical lows, has rekindled interest in questions regarding possible complications for monetary policy operating at very low interest rates. It is sometimes stated, for instance, that monetary policy becomes ineffective once the short-term interest rate gets close to zero, in the sense that monetary policy cannot be eased any further, even though the central bank may wish to do so. As I have stated before, this idea of such policy ineffectiveness is a fallacy. I should add that the fallacy that monetary policy is ineffective when short-term interest rates are close to zero is dangerous because it may promote inaction. A central bank that has already reduced its policy rate to zero could be incorrectly advised to stop pursuing expansionary measures because these are thought to be ineffective. And a central bank with a policy rate that is positive but rather low, might be incorrectly advised to "save its ammunition" so that it may still be in a position to ease policy later on.

One flaw in the policy ineffectiveness argument and related policy advice is that it focuses too narrowly on the short-term nominal interest rate as the instrument for

monetary policy. While this focus is convenient and appropriate under normal circumstances - that is when rates are not close to zero - it is insufficient for describing changes in the stance of monetary policy when short-term interest rates touch zero. Under such circumstances, attention should shift to the quantity of money and reserves, the size of a central bank's balance sheet, and interest rates at longer maturities that do not touch zero.

Ultimately, a money issuing central bank does not face limitations in increasing the quantity of money by expanding its balance sheet and can continue to do so even if short-term interest rates cannot be reduced further, for example when the overnight interest rate equals zero. By doing so, a central bank can have a positive effect on nominal asset prices and influence longer-term interest rates even if the overnight rate is unaffected. That said, it should be recognised that conducting and communicating additional monetary policy easing is far more challenging when it is not accompanied by a reduction in the policy rate. Because the historical experience with the conduct of monetary policy at very low rates is very limited, calibrating the correct size of a non-conventional policy easing conducted through expanding a central bank's balance sheet is far harder than the equivalent determination of how much to reduce the short-term interest rate under ordinary circumstances.

Precisely because of these challenges, it may be desirable for central banks to take forceful and pre-emptive interest rate action aiming to minimise the probability that they may later find themselves in a situation where they will be forced to resort to unconventional policy easing. Perhaps paradoxically, the greater the concern about conducting monetary policy with zero interest rates, the more aggressive should be the interest rate cuts that are pursued beforehand in response to adverse economic shocks that threaten to bring inflation significantly below the central bank's price stability objective.

With interest rates at or very close to the zero bound, central banks inevitably have to deploy beyond the key interest rate some other facilities, in their operational frameworks. These measures essentially constituted quantitative expansion in that they all make use of the asset side of the central banks' balance sheet. A multitude of tools have been used to that end which comprise the provision of liquidity, the purchase of commercial paper, asset-backed securities and bonds. The mounting importance of the use of these operations, especially after the intensification of the crisis in September – October 2008, can be illuminated with a cursory look at the evolution of the balance sheets of some major central banks. For the Federal Reserve, the size of the balance sheet more than doubled between July and December 2008. This expansion includes

numerous credit easing measures but also bail-outs as well as some of the government measures already taken. This also holds for the total assets in Bank of England's balance sheet. The Eurosystem's total assets also increased by around 40% between July and December 2008. It is interesting to note however, that the expansion of the Eurosystem's balance sheet did not require any legislative or related efforts, reflecting the flexibility inherent in its framework. In the case of the Bank of England and the Federal Reserve, some of the measures taken needed to be approved or coordinated by the respective ministries of finance before they were applied.

Focusing briefly on the Federal Reserve, its policy toolkit now can be thought of as having three sets of tools. The first set, involves the provision of short-term liquidity to sound financial institutions through the creation of new facilities for auctioning credit and making primary securities dealers, as well as banks, eligible to borrow at the Fed's discount window. The Federal Reserve's second set of policy tools involves the provision of liquidity directly to borrowers and investors in key credit markets. An example is the introduction of facilities to purchase highly rated commercial paper at a term of three months and to provide backup liquidity for money market mutual funds. In addition, the Federal Reserve and the Treasury jointly announced a facility that will lend against AAA-rated asset-backed securities collateralised by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. The Federal Reserve's third set of policy tools for supporting the functioning of credit markets involves the purchase of longer-term securities for the Fed's portfolio.

Comparable tools that can facilitate further policy easing, as needed, are also part of the Bank of England's toolkit. The Bank of England is prepared to purchase a range of financial assets in order to expand the amount of reserves held by commercial banks and to increase the availability of credit to companies. Further, as was announced earlier this month, the Bank will be authorised by the Treasury to purchase high quality private sector assets. This should encourage the banking system to expand the supply of broad money by lending to the private sector and also help companies to raise finance from capital markets. The Bank of England will also use asset purchases for monetary policy purposes should the Monetary Policy Committee conclude that this would be a useful additional tool for meeting the inflation target.

The Bank of Japan, which about a decade ago was the first central bank in modern times to embark on quantitative easing, has also introduced additional tools. A new operation has been announced through which financial institutions can borrow low-interest funds from the Bank against corporate debt.

The ECB has also stepped up its efforts to ensure access to central bank liquidity by solvent banks. To that end, the ECB adopted new measures in its monetary policy implementation framework. Among others, it proceeded with the enlargement of the basis of eligible collateral for the conduct of its main refinancing operations. Further, it proceeded with the provision of liquidity in dollars and Swiss francs, in cooperation with the US Federal Reserve Bank and the Swiss National Bank, respectively. It also increased the number and duration of longer-term refinancing operations. By adopting a fixed-rate tender procedure with full allotment in all refinancing operations the ECB essentially made available unlimited liquidity to banks for up to six months, upon presentation of appropriate collateral.

These measures have contributed towards averting a devastating collapse of the financial system, both in the euro area and internationally. However, despite their benign impact on the functioning of financial markets, the global economic outlook has continued to deteriorate in the past few months. As new data were coming in, all international organisations revised their forecasts for the next couple of years. The European Commission in its interim forecasts, released on 19 January 2009, anticipates a broad-based economic downturn during 2009, with forecast GDP growth at -1,9% for the euro area, -1,6% for the USA, -2,4% for Japan and -2,8% for the UK. This represents a substantial downward revision from the Commission's earlier projection that was released in November of last year. The corresponding European Commission forecasts for 2009 GDP growth released just three months ago were considerably more optimistic, specifically, by 2% for the euro area, by 1.1% for the USA, by 2 percent for Japan and by 1.8 percent for the UK.

Inescapably, Cyprus could not be exempted from such an across the board deterioration of the economic outlook. According to the Commission Cyprus GDP growth for 2009 is expected to average just 1,1%, compared to the 2,9% forecast presented in the autumn.

Our economy could not of course remain unaffected from the global economic downswing I described above. However, we cannot overlook the fact that any negative repercussions will be substantially milder as a result of our accession to the euro area and the adoption of the euro which acts as a shield against an exchange rate crisis. In addition, the stability of the single currency has been a significant factor in preserving the attractiveness of our banking system for foreign deposits in Cyprus. The biggest risk factor facing the banking system has been avoided and so far no serious problems have been experienced. To sum up, the euro adoption in combination with the banking supervision by the Central Bank and the conservative lending policies of the commercial

banks have contributed to the shield against the crisis. Of course, the fact that the UK, one of our major trading partners is one of the countries most affected by the financial crisis continues to be a source of concern. We will have to wait and see whether the expected decline in UK tourist arrivals and British purchases of houses will be as bad as is anticipated. In any event, our economy is doing relatively better than most other economies in the European Union.

While our economy compares well with other economies in the euro area, it must be recognized that it is slowing down. The construction and tourism industries are facing a downturn and overall consumer confidence has fallen. More important, the degree of uncertainty regarding the outlook of the global economy is so substantial at the moment that the country should be prepared with an emergency recovery plan in case a worst case growth scenario materializes owing to a worse than expected deterioration in the euro area, the UK, and the economies of out other major trading partners.

It is essential to plan in advance of the need to implement measures that might be deemed appropriate for limiting the repercussions of the crisis in Cyprus. In light of the well known lags associated with the implementation of government initiatives, it is imperative that the preparatory work needed to implement specific and carefully planned measures is done well in advance. As always, attention should be given to those development projects from which our economy would derive a higher value added and a larger productivity gain. The issue of productivity is extremely important in the current situation of slowing foreign demand, increased competition and tougher borrowing conditions as a reduction in competitiveness can undermine the performance of Cypriot enterprises compete overseas. The increase in productivity that our economy has achieved so far, even if it continues to be above the corresponding increase in the euro area, is not sufficient to eliminate the differences in labour costs that still prevail. Productivity boosting measures, such as the adoption of innovations and new technologies, should constitute a high priority for the business world and the government. Further progress can also be achieved with more simplified administrative procedures dealing with businesses and a reduction of bureaucracy.

Whatever expansionary measures may be contemplated, they should also be targeted and temporary, with an expiration date. It would be undesirable to risk a long-term deterioration in the country's public finances, in an effort to provide a temporary boost to consumption. Undoing the hard-earned gains of fiscal consolidation of the past several years would be ill advised and would undermine public confidence in the sustainability of public finances.

With regard to our banking sector, and contrary to the problems appearing in several other countries including some in the euro area, I continue to believe that it remains healthy and strong. Nevertheless, the international turmoil has inevitably affected the lending conditions in Cyprus. As in many other countries, deposit and lending interest rates have increased considerably, along with the interbank rate Euribor, which constitutes a reference rate for lending and deposit rates. However, these interest rates increases are gradually being reversed, as can already be seen from the continuing decrease in Euribor interest rates. The drastic and decisive action taken by the ECB and other central banks, has contributed decisively to this process of normalisation.

Our government could also contribute to the enhancement of credit availability in the private sector by taking measures similar to those that have already been implemented in a number of other euro area countries in line with the Common European Action Plan agreed to by the EU and national authorities in October. Such measures could include the issuance of special government bonds which could be lent to banks, which in turn, would use them as collateral to access cheap funding from the Eurosystem, as well as the provision of government guarantees to banks wishing to access the international capital markets through bond issuance. The implementation of such measures may facilitate credit at lower cost. Because such measures have already been implemented in other euro area countries including Greece, it may be particularly important for our government to consider them also in order to promote a level playing field between local and foreign banks and thus avoiding putting our banks in a competitive disadvantage.

I would like to conclude with an observation and a wish. The observation is that we live in interesting times. Since last September, in particular, we are experiencing a financial crisis, the magnitude of which we hope not to experience again in our life time. The policy response was swift and massive. The measures taken so far appear to have succeeded in averting the worst that could have otherwise materialised. Unfortunately the financial crisis has spilled over to the real economy and, compared to 2008, 2009 is set to be a difficult year. I wish that it proves to be less interesting.