Recent policy challenges through the lens of economic forecasts

Speech by Athanasios Orphanides, Governor of the Central Bank of Cyprus, at the CFA Society of Cyprus annual forecast event 2009

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It is a great pleasure for me to be here this evening and I would like to thank the CFA Society of Cyprus for the kind invitation to address this gathering. This being the annual forecast event of the Society, I thought it might be of interest to share with you some thoughts about the policy challenges we have experienced over the past two or so years through the lens of economic forecasts. More specifically, I will trace recent events and policy by looking at the evolution of recent forecasts of the euro area economy prepared by euro area professional forecasters and collected and published quarterly by the European Central Bank. Before I proceed, I should 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 ECB.

Earlier this month, I completed the first two years of my term as Governor at the Central Bank of Cyprus. Having spent my professional career in central banking, and having studied the history of central banking along the way, I was keenly aware that monetary policymakers must always be ready to face difficult challenges, and that sometimes we need to quickly map an appropriate response even when precise guidance from historical experience may be lacking. As Cyprus was preparing to adopt the euro when I joined the Central Bank, it was clear to me that possible challenges would pertain not only to our economy and banking system, but also relate to the economy and monetary policymaking of all the euro area. However, I never imagined that I would be confronted with challenges such as the ones recently encountered.

In broad terms, the euro area macro economy has faced two very different challenges over the past two or so years. The first was an inflationary threat, an adverse supply shock, associated to a large extent with a sharp increase in energy costs and the prices of other key commodities. The acceleration of oil prices from the beginning of 2007 until the summer of 2008 was so dramatic as to bring back bad memories from the 1970s, specifically the painful experience we associate with the oil shocks of 1973 and 1979. Subsequently, though, this inflationary threat subsided and indeed we have experienced a reversal of much of the earlier increase in energy costs during the past several months.

But it was the second challenge that proved more vexing and more threatening for the worldwide economy. This second challenge initially manifested itself as a financial turbulence that erupted suddenly in August 2007, and continues to this day. Although it threatened our financial system, prompt policy action initially contained the impact of this turbulence on the real economy until last September. Unfortunately, following the collapse of Lehman Brothers in the United States last September, this turbulence evolved into a full blown international crisis, one so severe that it eludes comparison with anything experienced worldwide in the post-World War II era. This crisis had a severe adverse effect on confidence worldwide, and evolved into a synchronized severe economic downturn, causing an unprecedented collapse in industrial production and world trade. For several months following last September, there were concerns about a developing adverse feedback loop with the financial disturbance and a worsening real economy reinforcing each other in a downward spiral for a time. The second major policy challenge I focus on is precisely this financial crisis we have experienced since September.

The rollercoaster ride of the past two or so years can be described in numerous ways and is evident in many financial indicators and data. The macroeconomic environment has been associated with extreme uncertainty and poor visibility, a most unfriendly environment for anyone daring to forecast the future. I note as a pertinent illustration the wild swings we have experienced in inflation over the past two years in the euro area, with HICP inflation registering both its highest and its lowest readings recorded in the 10-year history of the euro area (Figure 1). Following several years of relative stability, when HICP inflation fluctuated within just a few tenths of a percentage point around 2 percent, we have experienced over the past year a new peak exceeding 4 percent last July and a new low at 0.6 percent in the past two months, and cannot exclude negative readings in the months ahead. Comparing the path of actual inflation shown in Figure 1 against the one year-ahead forecasts shows how difficult it has been of recent to forecast inflation, even by professional forecasters.

Just how difficult has it been to forecast inflation during these times? The last year-ahead forecast that can be evaluated with available data is the forecast made in the 2008Q2 survey for the 12-month period ending in March 2009. The mean forecast was 2.1 percent while the actual inflation reported was 0.6 percent, a difference of 1.5 percentage points.

Figure 1 also presents the evolution of longer-term inflation expectations from the survey, specifically the expected rate of inflation 5 years ahead. I note that despite the unprecedented challenges in the economic environment and unusually violent swings in inflation over the past two years, long-term expectations have remained remarkably stable and in line with the ECB objective of keeping HICP inflation close to but below 2 percent over time.

I present this evidence as confirmation of the credibility of the ECB in achieving its mandate even under the challenging circumstances experienced over the past year or two. Well-anchored inflation expectations are of the essence not only to facilitate attainment of the ECB's primary objective to maintain price stability but also to allow the flexibility that monetary policymakers can have to alleviate the adverse effects of financial disturbances as well as shocks to the real economy.

Economists sometimes find it useful to decompose economic disturbances into "aggregate demand" and "aggregate supply" shocks. This decomposition is also useful for understanding differences in how policy might respond to different challenges. Recognizing the risk of oversimplification, it may nonetheless be instructive to categorize the two challenges mentioned above in this manner. The first challenge, as I already mentioned, could be seen as an adverse supply shock. Adverse supply shocks tend to put upward pressures on inflation while also dampening aggregate demand. The policy response is not straightforward and depends on a number of factors. If inflation expectations are well-anchored and there is no threat that second round effects on inflation could potentially materialize, then monetary policy could ease slightly, thus dampening the drop in economic activity. But if threats of second round effects on inflation appear on the horizon, then a tightening of policy is appropriate to ensure that inflation expectations will not become unmoored. In this manner, monetary policy secures price stability over time and the sustainable growth in economic activity that comes with it.

The experience with the evolution of short-term forecasts of the euro area during the second half of 2007 and the period prior to the Lehman collapse in 2008, suggests the pattern of an adverse supply shock. As can be seen in the top two panels of Figure 2, in successive quarters from 2007Q4 to 2008Q3, the outlook for inflation deteriorated, with inflation projected to exceed significantly 2 percent, while at the same time growth prospects also deteriorated somewhat in successive forecast rounds. But expectations beyond the very short-term horizon remained well-anchored and the ECB Governing Council decided it was appropriate to adjust monetary policy only very slightly during this period, a 25 basis points increase in its policy rate on 3 July 2008. As shown in Figure 1, for the longer-term forecasts, and confirmed by the pattern of convergence towards the ECB's definition of price stability shown in the forecasts in the upper left panel of Figure 2, this slight policy adjustment succeeded in maintaining inflation expectations in the medium and longer-term well anchored.

The effects of the second challenge on the economy, that is developments associated with the financial crisis since the collapse of Lehman last September, could be seen as an aggregate demand shock---indeed, a massive demand shock of unprecedented size in the post-World War II era. Adverse demand shocks tend to put downward pressures on inflation, while also dampening aggregate demand which tends to reinforce further downward pressures on inflation. Unlike the case of adverse supply shocks, in this case the policy response is quite a bit clearer. Policy easing is required so as to avoid a severe depression in economic activity since such an outcome could threaten price stability by increasing the risk of deflation.

The experience with the evolution of short-term forecasts of the euro area since the second half of 2008, suggests this pattern of an adverse demand shock. As can be seen in the two bottom panels of Figure 2, forecasts for both inflation and growth prospects have been revised significantly downwards as the crisis evolved. The sharpest downward revisions could be seen in the forecasts from the survey for the first quarter of this year, when the sharpness of the downturn started to become more clearly evident. Some further downward revisions can be seen in the most recent survey, but these revisions are not as large as those recorded in the previous quarter. The deterioration in the forecasts over the past two quarters has been unprecedended in the history of the survey. I note that the pattern of forecasts in the Survey of Professional Forecasters is not significantly different from that of forecasts by other organisations.

Looking more closely at the most recent survey results from the 2008Q2 survey, it should be noted that although the inflation forecast for 2009 is well below the ECB's price stability objective, forecasters expect a sizeable pick-up in inflation for next year. In addition, inflation expectations five-years ahead remain at 1.9 percent, which is in line with the ECB's definition of price stability. I consider it important to monitor closely inflation expectations going forward. A protracted period of inflation below our definition of price stability could risk unmooring inflation expectations on the downside, with all the associated adverse consequences.

Seen in the light of the deterioration in the economic outlook experienced over the past several months, it is easy to understand why the Governing Council of the ECB thought it was appropriate to proceed with a series of decisive monetary policy easings. Since October 2008, the main policy rate has been cut drastically, with last week's decision bringing it down to an all-time low level of 1 percent. Similarly, the interest rate on the deposit facility is at a historic low 0.25 percent.

We should keep in mind that when policy rates are close to the zero lower bound, they may no longer suffice as the best indicators of the monetary policy stance and of how expansionary monetary policy may be. In these circumstances, non-standard policy measures acquire an elevated role. To evaluate policy, it is important to look at the complete policy package, accounting both for standard and non-standard policy easing.
In this light, it should be recalled that the Governing Council has implemented a series of non-standard policy easings since October 2008, and further expanded upon those at the policy meeting last week. All in all, the present level of monetary accommodation should be considered appropriate, taking into account the information and analysis available at the last policy meeting.

In closing these brief reflections, I cannot avoid but reiterate the extreme uncertainty we still face at the moment and the need to remain alert and ready to react appropriately to incoming information. Needless to say, in addition to data releases it would remain of interest to keep monitoring the evolution of forecasts and I can safely predict that you may wish to continue this tradition of your annual forecast event.

Figure 1: Inflation Expectations in the Euro Area

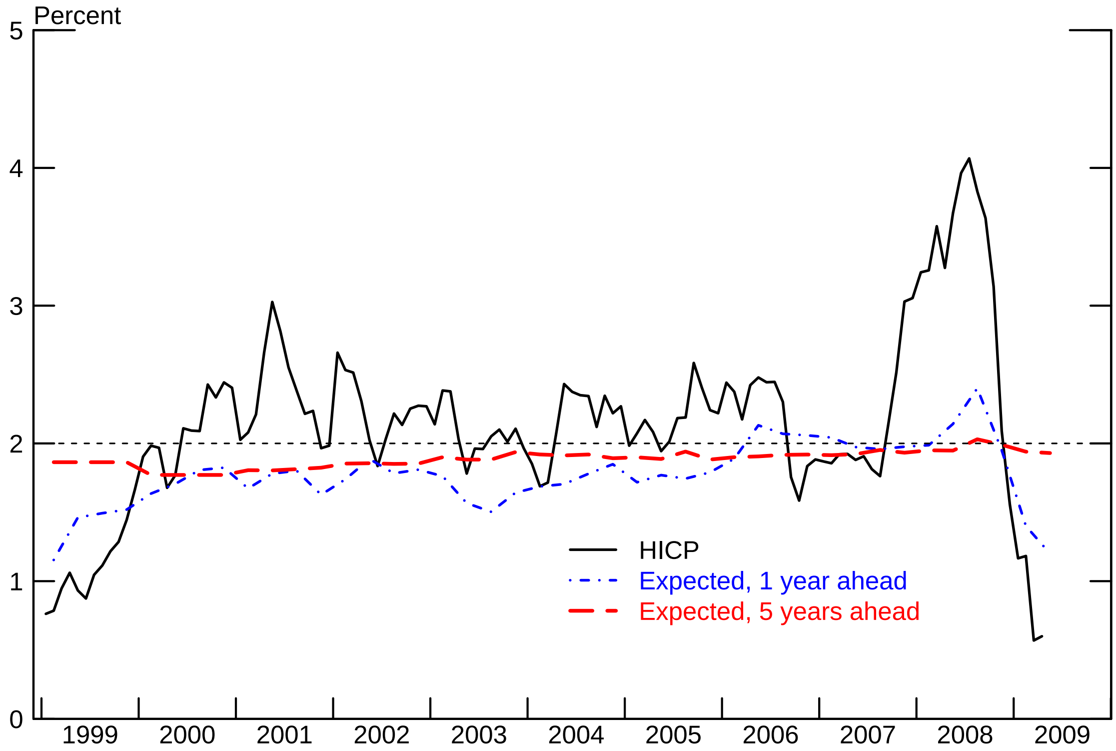
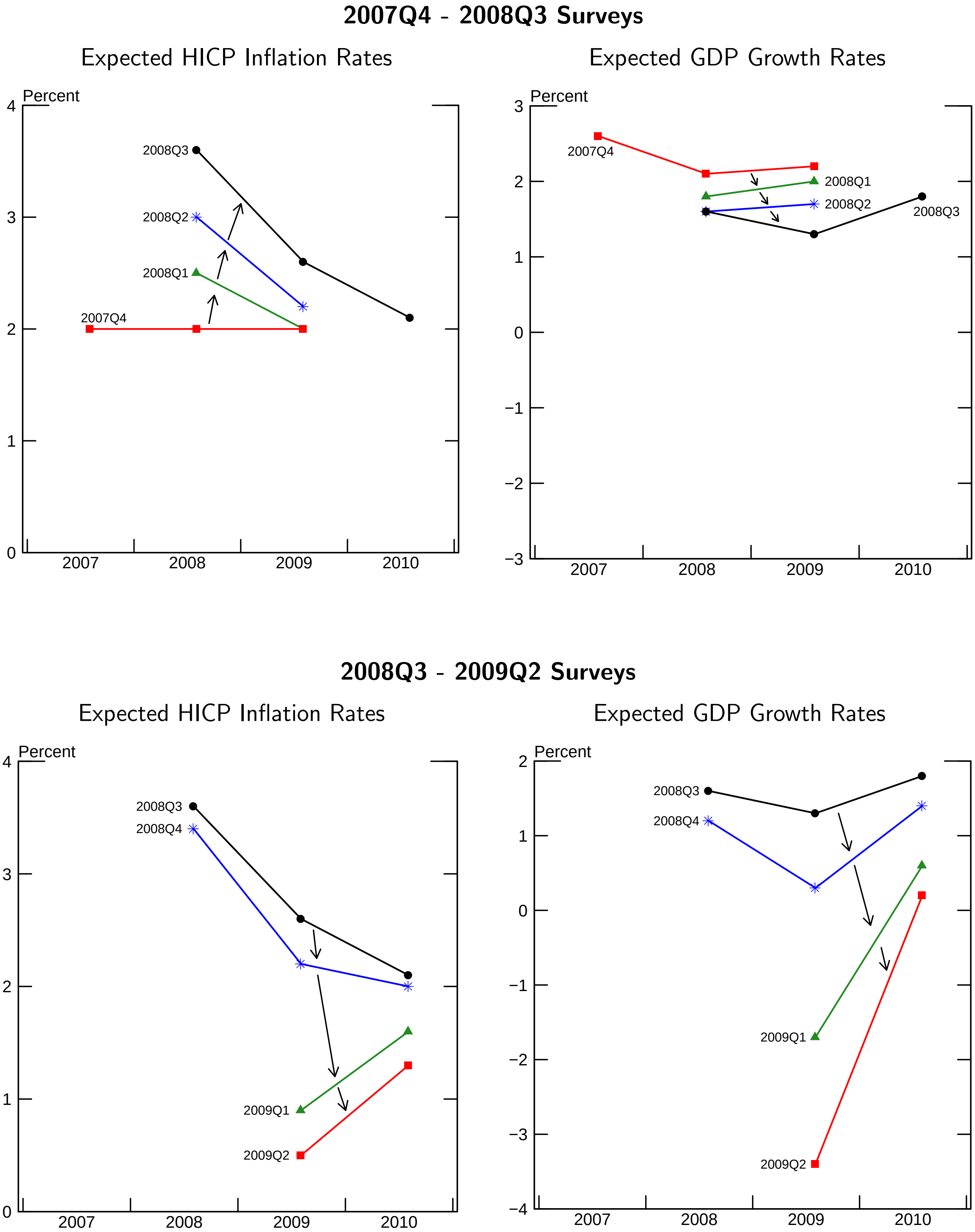


Figure 2: Evolution of Euro Area Forecasts



Note: The forecasts shown are taken from successive vintages of the ECB's Survey of Professional Forecasters. Each line connects the forecasts collected during the quarter noted next to the line. For example, in the upper left panel, the red line shows the forecasts for HICP inflation made in 2007Q4 for 2007, 2008 and 2009.