

Drawing lessons from banking and financial history for the current crisis

Welcome address by Athanasios Orphanides, Governor of the Central Bank of Cyprus, at the 2009 Annual Conference of the European Association for Banking and Financial History

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I would like to thank the European Association for Banking and Financial History for inviting me to address this conference in Nicosia. The venue is most appropriate, especially when considering the rich numismatic history of our island. Cyprus is synonymous with copper, the metal added to gold and silver coinage since the 7th century BC and used as an ingredient of small value and wide circulation coins since the 5th century BC. The export of copper was a pillar of our island's economy from the Late Bronze Age (1600 - 1100 BC) to the middle of the 20th century.

Cyprus's links to monetary intermediation and payment systems can be traced to the Knights Templar who intermittently based their headquarters on the island during the 12th and 13th centuries AD. Among other tasks, this medieval religious order was charged with covering the economic needs of the Crusaders by collecting and transferring funds between Catholic Europe and the Holy Land.

Monetary, banking and financial history is invaluable for central bankers. As you know, when faced with a new challenge, we are not in a position to perform repeated controlled experiments to study the most appropriate policy response. Examining and comparing historical episodes, as best as we can through the filter of our imperfect theoretical understanding of modern economies, is what we have to rely upon to form judgements about how to react to an evolving crisis. I will use this opportunity to offer an illustration that I consider to be pertinent to the present. Before I proceed, I should note that the views I express in this brief welcome address are my own and do not necessarily reflect those of my colleagues on the Governing Council of the ECB.

The study of history, I would argue, has already proven invaluable for dealing with the current crisis that the global economy is facing. Following the aftermath of the collapse of Lehman last September, the global economy has been undergoing a severe and synchronized downturn. The collapse in world trade and production has been so severe that it defies comparison with any of our historical experiences in the post-World War II era. Increasingly, the crisis that started last fall and economic developments since

then, are compared to the Great Crash of 1929 and the subsequent global economic destruction experienced during the Great Depression of the 1930s. Naturally, the question arises: Could the present episode take such a bad turn for the worse?

From a monetary policy perspective, I would argue that the reasonable answer must be no. Based on the accumulated historical knowledge and experience, we have improved knowledge to draw upon for dealing with the present situation. Although the initial shock experienced by the global financial system last fall was immense, possibly even more threatening than the crash in the fall of 1929, the monetary policy response has been very different, owing, in large part, to the historical lessons drawn in the aftermath of 1929.

The response of many governments and central banks around the world following the 1929 crash and into the 1930s is widely recognized as a dramatic failure⁽¹⁾. One of the key mistakes was that the policy action that was needed to alleviate the stress in financial markets and to avert deepening problems in banking, was not properly implemented. In retrospect, policy proved to have been overly timid. A key lesson is that prompt and decisive action was essential under the circumstances. And this lesson, I believe, is well reflected in the unprecedented and decisive policy easing that central banks around the world have already implemented in the current episode.

The policy error did not go unnoticed at the time. A prominent example of this can be found in the writings of John Maynard Keynes. As I pointed out in earlier work (Orphanides, 2004), Keynes expressed concern that the monetary policy necessary to restore prosperity following the crisis of 1929 might not be forthcoming. "I repeat that the greatest evil of the moment and the greatest danger to economic progress in the near future are to be found in the unwillingness of the Central Banks of the world to allow the market-rate of interest to fall fast enough" (Keynes, 1930, p. 207). He expressed concern that the "mentality and ideas" of the policymakers themselves could stand in the way of the necessary policies (Keynes, 1930, p. 384). Keynes dismissed what would later be called a "liquidity trap," the notion that monetary policy would become ineffective under the circumstances. And talking about the world's two most important central banks at the time, he went on to offer a specific remedy: "The Bank of England and the Federal Reserve Board should put pressure on their member banks ... to reduce the rate of interest which they allow to depositors to a very low figure, say ½ percent. At the same time these two central institutions should pursue bank-rate policy and open market operations *a outrance*, ... [t]hat is to say they should combine to maintain a very low level of the short-term rate of interest, and buy long-dated securities ... until the short-term market is saturated" (Keynes, 1930, p. 386).

Unfortunately, the consensus view at the time, and the one policymakers followed, was not to pursue the decisive policies that Keynes had called for in 1930.

The value of studying history is that it helps us increase the likelihood that similar mistakes can be prevented. Indeed, major central banks in the current episode have reacted in a decisive manner, in large part because of our present appreciation of these lessons. To be sure, I still expect future historians to study many questions such as: Was the monetary policy response to the crisis of 2008 appropriate? If not, were the alternatives feasible, considering the information available at the time policy decisions were made? If yes, how could policy have been improved? Judging from the continuing debate about the 1930s, these are questions I expect will take centre stage at future events of the European Association for Banking and Financial History for decades to come.

ENDNOTES:

- (1) Classic expositions of the policy failures appear in Friedman and Schwartz (1963) and Meltzer (2003).

REFERENCES:

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