

## **Athanasios Orphanides: Interview with Reuters**

Interview with Mr Athanasios Orphanides, Governor of the Central Bank of Cyprus, by Michele Kambas and Sakari Suonimen, conducted on 19 April 2011.

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### ***Q. Do you think that there will be any implications for the eurozone from putting US on credit watch negative?***

Overall, we should keep in mind that as a result of the crisis over the past three years, in a number of countries in the developed world, government debt has increased considerably. This is something that has affected a number of countries – including the United States and member states in the euro area. Governments around the world have recognised that continued increases in debt would be unsustainable and are taking steps to return the fiscal path towards sustainability. My interpretation of the decision by Standard and Poor's is that it reflects the ongoing budget discussions in the United States. I have no reason to believe that the United States' government and Congress will not live up to their responsibilities, as I have no reason to believe that euro area governments will not live up to their responsibilities and ensure that their fiscal situation is under control.

### ***Q. How do you see uncertainty and outlook?***

A number of reasons have contributed to increased uncertainty in the past several weeks. Let me remind you of the tragic events in Japan with the earthquake and tsunami as one example that has elevated uncertainty. Let me also remind you of the political troubles that are observed in some countries in the Middle East and North Africa.

The factors I have noted are factors that have added to the uncertainty for the outlook for inflation and growth worldwide and in the euro area. Let me also point out the following. Once again, we are observing an increase in food and energy and other commodity prices. This is adding to the risk of upward pressures of inflation. At the same time, it is a dampener on growth. These are real factors that I believe have raised the uncertainty for the outlook both for inflation and for growth.

### ***Q. How do you see the inflation and growth outlook?***

We constantly monitor developments in the outlook for growth and inflation. Our mandate is to maintain price stability over the medium term. We always try to balance the upside and downside risks of deviating from our mandate, so with new developments we always reevaluate the situation.

The developments since the March projection staff exercise give me reason to believe that the near-term pressures on inflation are elevated. In the near-term, the risks are to the upside. That said, we continue to observe that longer-term inflation expectations remain well anchored. I do not think we have evidence of inflation pressures persisting beyond the near term. Over the longer term I see price stability being maintained in line with our mandate.

This hump in inflation is largely due to the food and energy price pick-up that we have seen and that has become worse in recent months. However, at the moment, we have no reason to believe this would be more persistent.

The growth situation maybe a little bit trickier to analyse. The events in Japan and the continuing events in the Middle East and North Africa could be interpreted as a downside risk on growth. At the same time, we see continued evidence of rather robust growth in some parts of the euro area, so I would not say that the overall growth outlook has shifted downwards despite the negative events I mentioned earlier. The risks may be to the downside, but my baseline scenario has not shifted.

**Q. How would you describe the monetary policy stance. Is it appropriate now?**

When it comes to interest rates, I would say that monetary policy is accommodative. In my view, it is appropriately accommodative. It is appropriately accommodative in the sense that we still have some way to go towards repairing the damage that has been experienced as a result of the crisis we have been living through during the past three years.

**Q. Does that mean that you don't see interest rates going up for, say, over the next three months?**

As you know, the Governing Council of the ECB never pre-commits on interest rate policy decisions. And personally I believe that it's not useful to try to forecast the evolution of policy rates. What is more important is to monitor the evolution of the real economy and try to continuously monitor and form an assessment of the inflation risks. If the evolution of the economy over the next few months is such that there are greater upside risks to inflation, I believe that would justify removing some of the accommodation that is currently in place. If, on the other hand, some of the more negative scenarios with respect to the economy materialise and we see inflation risks abating, then that would not be the appropriate reaction.

**Q. Could you phase out more non-standard measures soon?**

As the liquidity needs of the banking system become less pressing and as the transmission mechanism of monetary policy becomes less impaired, there would clearly be less need for continuing with the non-standard measures to the same degree.

**Q. How do you see the state of the money markets right now? Are they improving so that further phasing out could be warranted?**

Overall, the money market is in a much better condition than it was earlier in the crisis, even though I would have to say that we are not anywhere near normal conditions we had before the turbulences started in 2007.

I can envision that as time goes by, it will no longer be necessary to maintain full allotment in all operations.

**Q. Should the interest rate corridor be widened?**

As president Trichet explained in the press conference following the April policy meeting, there were arguments on both sides. We took the decision not to widen the interest rate corridor to its normal size at the April meeting. However, going forward, I would argue in favour of normalising the width of the corridor sooner rather than later. In my view, it is increasingly harder to justify the non-standard width of the corridor as time goes by.

I don't think there is any mechanical link between the decision as to when to phase out specific non-standard measures that have been introduced during the crisis.

**Q. On bond buying programme. What is your point of view with Greece, Ireland and Portugal being in the hands of the EU and IMF? Does it give rise to the need for the ECB to intervene?**

It is increasingly hard to justify the continuation of the SMP in light of the fact that it was introduced in order to alleviate some of the dysfunction in the monetary policy transmission mechanism in some markets, and I do not think that those conditions hold at the moment to the same extent.

**Q. Do you think it should be stopped completely or just be there in case the need arises again?**

The mere presence of the programme, even if no purchases at all are made for a very long time, can be a stabilising force in the markets in case additional tensions appear on the horizon. That would be an argument for keeping the programme in place while recognising that it may not be employed unless unusual circumstances appear.

***Q. How would you evaluate the programme. Has it been a success?***

The programme has been a success. One has to ask what is the counterfactual for what would have happened in the euro area had the programme not been in place. In the dramatic situation that we were facing in May 2010, the damage that could have resulted from the absence of this programme could have been quite severe.

***Q. Is the transmission mechanism working now?***

Speaking for myself, I have less concern for the transmission of monetary policy today than in May 2010 when it was introduced.

***Q. Could Portugal government bonds be extended similar treatment as Greece and Ireland regarding collateral use in ECB operations?***

Regarding the eligibility of collateral, as a rule we rely on the rating agencies, but in those circumstances when we can make an independent evaluation of the country we don't need to rely on the rating agencies. This has happened in the case of Greece, this is what has happened in the case of Ireland and I trust that if it becomes necessary to have an independent evaluation in order to assess the eligibility of collateral of any other sovereign in the euro area, then this will be done as well.

***Q. Do you believe Greece can manage without restructuring its debt, and how likely is it able to do without one?***

Let me first point out that I am saddened by the fact that this public discussion and market speculation is taking place because it is quite damaging to the euro area overall. As you know the Greek government at the moment is implementing a tough but appropriate programme of reform for the Greek economy. This programme was evaluated by the IMF and the European Commission, in liaison with the ECB. This evaluation has determined that the debt-deficit dynamics of Greece are indeed sustainable, as long as the programme is being successfully implemented.

With this in mind, I am puzzled by the continuing questioning of the sustainability of the Greek debt.

In my mind, restructuring of the Greek debt is not necessary as long as Greece continues to implement the programme that is in place. But more importantly, I believe that a restructuring of the Greek debt would be unwise. Under the circumstances, restructuring would be quite damaging to the Greek economy. In addition I believe it would be quite damaging to the euro area overall because of the possibility of contagion effects.

Since restructuring is both undesirable and unnecessary I believe that it is not helpful for officials in the EU to keep bringing it up.

***Q. Even though officials continue saying that restructuring is undesirable, this does not appear to have convinced the markets. We have seen a spike in borrowing costs in past few days. Do you believe that this debate about restructuring can become a self-fulfilling prophecy?***

In the case of a euro area member state, and Greece is a euro area member state, talk of restructuring cannot become a self-fulfilling prophecy in the same sense that could have been the case for other countries that are not part of the European Union. The reason for that is very simple; in the European Union a member state can count on political support and solidarity from other member states. It would take a political decision against supporting a member state in need in order to force a restructuring in the sense you describe.

So in my view, to the extent the Greek government continues to implement the programme of structural reforms that it is implementing right now, and to the extent that it recognises that a restructuring would be undesirable and unnecessary, then restructuring can be avoided so long as the Greek government enjoys the support of other member states in the European Union. Under these circumstances the support from other member states is critical.

***Q. Greece is expected to go back to the markets next year. Do you think this could still happen or do you think there is a need to extend the programme?***

I think this will be evaluated as time goes by. I have to say that one of the difficulties we are experiencing in markets right now reflects the fact that at a political level, in the European Union, we have disappointed market expectations by failing to make sufficient progress towards strengthening euro area governance and towards putting in place a robust crisis management framework. It is a price that we unfortunately have to pay for the delay. This delay is causing uncertainty in markets and this uncertainty is damaging the euro area.

***Q. If the euro area has not come up with a comprehensive plan to handle the crisis, how can it be expected to support Greece?***

As you know, European Union governments are currently offering support to Greece in the form of loans subject to strict conditionality and I fully expect this support will continue as long as Greece continues to implement the structural reforms that are necessary in order to restore healthy fiscal finances. At the same time those reforms will promote growth in Greece, which at the end of the day is necessary in order to alleviate the debt burden.

***Q. There seems to be in the general population less and less appetite for continuation of reforms. Do you see that as a real problem or will they definitely do what is necessary to get onto a sustainable path?***

I expect the Greek government to live up to its responsibility and continue with the implementation of the reform programme. I do observe frustration in the Greek people and frankly I believe a lot of this frustration is entirely justified. The Greek public was unprepared for the sacrifices that it now has to make because successive Greek governments gave the impression to the Greek citizens that they could be living a lifestyle that they should have known was beyond the means of the country. Frustration, I think, is entirely justified. At the same time I trust that now the situation is clear; there is much better information about the necessary adjustment and the Greek people will persevere.

***Q. What can the ECB do to help Greece? Is there anything else to do apart from eased collateral requirements for Greek government debt?***

If I may correct you, I would not say that we have eased collateral requirements. What we have done is eased the reliance on credit rating agencies for evaluating the collateral for a very specific reason. This is because our assessment of the sustainability of the Greek debt situation and the path of the Greek economy is different from what is reflected in credit ratings. We have made our own assessment in the case of Greece.

In terms of your question on how the ECB can help, as you know the ECB is helping by providing advice and by being present in the discussions that are associated with the programme that involves the IMF and the European Commission in liaison with the ECB. But beyond that, it is not the ECB's role to have additional involvement. What we have in the case of the European Union is additional responsibilities for crisis management, which are responsibilities of the governments in the euro area, not the responsibility of the ECB.

***Q. The Irish Central Bank has an emergency liquidity assistance programme. Do you think there could be a similar one for Greece or is there actually already one in place?***

I would not comment on emergency liquidity assistance. This is a national responsibility that each national central bank in the euro area may apply as is necessary in their own context.

***Q. Cypriot banks hold a sizeable quantity of Greek debt. How damaging or potentially damaging could that exposure be? Could the Central Bank have taken any steps to limit banks exposure to a single borrower?***

With respect to the exposure of Cypriot banks to Greek debt, we have examined the situation and we have come to the conclusion that even though there is exposure in our banking system, that exposure is manageable because our banks are very well capitalized.

So even in the highly unlikely situation, if you wanted to run the counterfactual, for example, of imposing losses on the holdings of Greek debt, our banks would manage to weather that.

To understand how well capitalised our banking system is, a comparison may be useful. Our banks already meet the stricter capital requirements that are being phased in under Basel III. By contrast, in some other member states in the euro area there have been explicit calculations about how much additional capital would need to be infused into banking systems in order to meet those requirements. This is testament to the very strong capital position of our banking system.

Regarding steps to limit exposure by any of our banks to any sovereign holdings in the euro area, as part of the supervisory process of the Central Bank of Cyprus we demand that all of our banks have good risk management systems in place. Of course, we do not control the specific decisions on portfolio holdings of banks. Whenever we determine that there is undue concentration of risks then we demand that additional capital be held in order to account for these risks. This way we manage risks to the system.

***Q. Do you agree with an assessment recently made by Cypriot officials and the finance minister to be precise, that his hands are actually tied in terms of future ratings of the Republic if rating agencies continue to make a linkage between the economic fortunes of Greece and the economic fortunes of Cyprus, and do you think that this linkage is appropriate?***

In my view, all authorities must live up to their responsibilities. What we are experiencing in Cyprus over the past many months is a very unfortunate cycle of downgrades of the sovereign. In large part, and according to the analysis of the ratings agencies, these downgrades are due to the fact that as a country we have not yet taken the fiscal consolidation measures that our government and our parliament agreed were necessary to implement last year. It is a very costly delay as it raises the cost of financing of our public debt, it raises the cost of financing by private business, and it reduces employment and growth opportunities. There are things that can be done in order to reverse this. The policies that could reverse this deteriorating situation are well known, and they involve shoring up the long-term public finances of the Republic. So I repeat, all authorities must live up to their responsibilities.

***Q. Would you give me specific examples on how you believe the structural problems in the Cypriot economy can be addressed? We hear a lot about fiscal consolidation but what exactly should be done?***

I could mention a couple of the things that were already agreed by our parliament and government last year which unfortunately have not been implemented as of yet, with the associated damages from the delay. The most obvious I believe, because it has been repeatedly mentioned, is the sustainability of our pension system. Our government has repeatedly over the past year stated that the current state of our pension system is, I quote, "a ticking time bomb which could destroy the Republic." This is something that can be fixed by changing the parameters of the pension system going forward. Everybody recognises that these changes need to be made in order to ensure the sustainability of the system and the longer our country delays making these changes the more costly it will be to solve the problem. This is one example that is recognised. I do not think we have to look very far. In my view, it is not the most responsible policy not to defuse what has been recognised as a ticking time bomb.

***Q. How worried are you at the unfolding fiscal situation on the island and the inaction on the part of the authorities?***

I am indeed worried about our government's delay in implementing the necessary fiscal consolidation measures because, as I mentioned earlier, any further delay raises the cost to the economy. The unemployment rate is already at historic highs. We do not help the economy generate additional growth and new jobs by not correcting the fiscal imbalances

that we face. The fiscal imbalances push up the cost of financing on businesses and discourage investment. I am quite worried about this.