Nicholas C Garganas: Why is the role of the central bank important?

Address by Mr Nicholas C Garganas, Governor of the Bank of Greece, at the celebrations marking the 75th anniversary of the Bank of Greece, Athens, 3 November 2003.

*   *   *

Your Excellency the President of the Hellenic Republic
Mr. Prime Minister,
Your Beatitude,
Ladies and Gentlemen,

Allow me to thank you for having accepted our invitation to join us in today's event. Let me also extend a warm welcome to Jean-Claude Trichet, who became President of the European Central Bank on November 1. This occasion marks Jean-Claude's first official function outside of Frankfurt in his new position. Thank you for being with us today, Jean-Claude. We wish you every success in your new position.

I also would like to extend a very warm welcome and a special thanks to my central bank colleagues from the European System of Central Banks as well as those from other parts of the world who have honored us with their presence for this celebration.

This year we celebrate an important anniversary - the 75th year since the establishment of the Bank of Greece. During this period, the conventional wisdom about a central bank's institutional role and about what a central bank can and should do has undergone enormous change. There has, however, been one constant underlying the responsibilities of a central bank - the importance of discharging these responsibilities to the health of the national economy.

Why is the role of the central bank important? Because, an economy's central bank is entrusted with safeguarding the value of the economy's currency and with ensuring the soundness of its financial system. Safeguarding the value of the currency is not always an easy task. The correct answer to this challenge forms the basis of an efficiently running economy and of social cohesion. As John Maynard Keynes observed, "there is no subtler, no surer means of overturning the existing basis of society than to debauch the currency".

It would be comforting to find in the history of central banking a record of steady progress and orderly development from earliest antecedents to present knowledge. The facts, however, are different. The past 75 years have included remarkable achievements and some setbacks both globally and in the Greek economy. The role of the central bank in an economy's fortunes - and misfortunes -is aptly demonstrated by the history of the Bank of Greece. During this sometimes turbulent period, the Bank of Greece demonstrated an ability to adapt to changing circumstances, often playing a leading role in providing solutions to the main economic problems of the day. Let me use the occasion of the Bank's 75th anniversary to elaborate briefly.

Following a period of monetary instability, in March 1927, the Greek government sought the assistance of the League of Nations to improve the health of the economy, to secure monetary stability and to help the Greek banking system function better. Negotiations with the League followed and a stabilisation plan was hammered out. Among the terms of the so-called Geneva Protocol, signed in September 1927, was the establishment of a central bank, exclusively responsible for issuing banknotes. Until that time, the National Bank of Greece, a private institution, had the privilege of issuing banknotes, which it waived in favour of the newly established central bank. The Bank of Greece commenced its operations in May 1928. The two main tasks assigned to the Bank, as specified in its Statute, were to ensure a stable currency and to regulate currency circulation. To this end, the Statute provided for the Bank to have reserve assets; it also set a strict limit on the financing of budgetary deficits by the central bank.

The Bank of Greece could not have begun operating at a more difficult time. This was a time when the international monetary system was operating primarily under the gold-exchange standard. Effectively, the gold standard aimed at securing the stability of a currency by tying money supply to the gold reserves of the central bank, thus leaving little room for conducting an independent monetary policy. The gold standard has been described as nailing the domestic economy to a "cross of gold".

Today, many historians blame the gold standard for helping precipitate the Great Depression that began in 1929. Regardless, the global stock market crash of 1929 and the ensuing global financial crisis of September 1931 saw many countries driven off the gold standard.

The new international environment was hardly a favorable one for a fledging central bank. Concerned about the instability that might follow in the absence of the gold standard -and with the recent period of monetary instability entrenched in their memories - the Greek authorities attempted to maintain the link to gold. The drachma, however, came under heavy selling pressures, and, in April 1932, Greece had to leave the gold standard.

Leaving the gold standard made monetary policy a matter of the discretionary judgement of the authorities at the Bank of Greece. The new monetary regime opened up the possibility of the Bank playing a more active role in domestic economic affairs. The Bank was no longer bound by the discipline imposed by the gold standard. However, in common with most other central banks at the time, it pursued monetary and credit policies geared toward safeguarding price stability and ensuring a sustainable balance of payments; after all, this was in accordance with its Statute. In addition, the Bank sought to remedy the inefficiencies of under-developed money and capital markets by instituting measures to attract savings to the banking system and to improve credit allocation.

In April 1941, the Axis Powers occupied Greece. For several years, London became the seat of both the exiled Greek government and the Bank of Greece, with the Bank's gold secretly transferred to South Africa. Within occupied Greece, the economic situation became increasingly grim and hundreds of thousands of Greeks died of hunger. The Axis powers forced the country to pay not only for the upkeep of the occupying troops, but also for their military operations in Southeastern Europe. The puppet regime established by the occupiers forced the Bank of Greece to resort to the printing press. As a result, the country was beset with hyperinflation; between April 1941 and October 1944, the cost of living rose 2.3 billion times. In these difficult circumstances, the country's economic system collapsed. To give another example of the magnitude of inflation during the occupation, let me mention that in November 1944, immediately after liberation, a so-called "new" drachma was introduced; it was set equal to 50 billion "old" drachmas!

In March 1946, a stabilisation plan, which was part of the London Agreements, set up the Currency Committee, which was to become responsible for monetary, credit and exchange rate policies for several decades. This Committee consisted of five members, including the Minister of Coordination, the Minister of Finance, and the Governor of the Bank of Greece. The Committee was given control over the issuance of money, and the authority to allocate credit among sectors and activities as well as to determine lending terms.

After suffering through World War II and the civil war, the economy was in ruins. The hyperinflation produced long-lasting effects on attitudes, and savers were unwilling to deposit their funds in the banking system. To help attract funds back to the banking system, the central bank sought to re-establish price stability. At the same time, the Bank of Greece was also called upon to support economic reconstruction and to help lay the foundations for growth. However, circumstances were difficult, since certain factors, including substantial expenditures on defense, social policy, and support of the agricultural sector, caused strong growth of the money supply. The Bank's task was made even more difficult in view of the country's underdeveloped financial markets. Yet, the Bank was successful in conducting a tight monetary policy. This, together with the decline in fiscal deficits, resulted in inflation falling dramatically, from over 40 per cent in 1948 to 5 per cent in 1952. This created suitable conditions for a reform in exchange rate policy.

In April 1953 the drachma was devalued by 50 per cent against the US dollar and then joined the Bretton Woods system of pegged exchange rates. In the following year, another "new" drachma was introduced and set equal to 1,000 "old" drachmas. Coupled with the nominal anchor provided by the Bretton-Woods system and tightened fiscal policy, the "new drachma" played a key role in reducing inflation expectations.

During the next fifteen years real GDP growth averaged 7 per cent, one of the highest in the world. At the same time, average inflation in Greece was less than 2.5 per cent, confirming that strong long-term growth is not feasible without price stability. The Bank of Greece not only helped restore and maintain monetary stability, but its interest-rate policy was decisive in channeling private saving to the banking system.

The nominal anchor of the Bretton Woods system proved unsustainable in the long term. Pressures to finance the Vietnam war led to an expansionary monetary policy in the United States and inflationary pressures spilled over to the rest of the world. This, along with the inherent weaknesses of the arrangement, proved the undoing of the Bretton Woods system, which broke down in March 1973. Once again, the lesson that there is a need to separate monetary policy from political influences had to be re-learned. The drachma's link to the US dollar was maintained up to the spring of 1975.

The decades of the 1970s and the 1980s were difficult ones for policy makers worldwide. Among other things, they had to deal with two oil price shocks in 1973-74 and in 1978-79, an international debt crisis in the early 1980s in Latin America and a global stock market crash in 1987. Particularly during the 1970s, Keynesian ideas, which, to some extent, downplayed the connection between monetary policy and inflation, were at their peak. In Greece, during the second half of the 1970s and the 1980s, the central bank conducted monetary policy under difficult circumstances, as the policy mix was often inappropriate. Compounding the difficulty of the Bank's task was the fact that the financial system operated under a complex framework of rules and provisions, which proved not only ineffective, but also distorted credit allocation and limited the scope for conducting an effective monetary policy. The abolition of the Currency Committee in 1982 and the transfer to the Bank of Greece of its functions in the fields of monetary, credit and exchange-rate policies as well as banking supervision marked the beginning of a new era in the Bank's history.

With broader responsibilities, beginning in the mid-1980s and until the mid-1990s, the Bank of Greece undertook the leading role in the deregulation of the financial system. Financial liberalisation was a gradual process, however, so that the lifting of controls could take place in tandem with the restructuring of the economy and thus avoid the potentially destabilising effects of abrupt and sharp reversals of international capital flows. This strategy proved wise; in the 1990s many Asian economies, which had not given sufficient consideration to sequencing, were exposed to severe financial crises.

After financial liberalisation in Greece had been completed in the mid-1990s and up to entry into EMU and the adoption of the single monetary policy in January 2001, the Bank of Greece had at its disposal more effective and flexible market-oriented means of monetary control and was able to react quickly and effectively to changes in economic conditions.

The supervisory functions of the Bank have also changed considerably, shifting from the task of ensuring commercial banks' compliance with credit and exchange controls and regulations, to the monitoring and the evaluation of bank asset quality, and the solvency and capital adequacy of these financial institutions.

During the late 1980s and the 1990s, a substantial shift occurred in thinking about the role of the central bank in the economy. Experience of past episodes of hyperinflation in various countries, as well as of moderate inflation, exemplified in the breakdown of the Bretton Woods system, led to the finding that monetary policy is not necessarily independent of the government of the day. Sometimes central banks have to finance government spending and this results in higher inflation and, ultimately, lower growth. Thus, the views that the goal of monetary policy should be to provide price stability and that the central bank should be made an independent institution in the pursuit of this goal gained ground.

These ideas underpinned the monetary policy of the Bank of Greece in the 1990s as it sought to support the effort to satisfy the Maastricht Treaty criteria and to join the euro area on 1st January 2001. The Bank's ability to attain its goals was considerably improved by the abolition of the monetary financing of the fiscal deficit, mandated under the Maastricht Treaty, in 1994, and the law, enacted in 1997, granting independence to the Bank of Greece with a mandate to achieve price stability.

In an effort to bring down inflation, in the mid-1990s the Bank adopted a "hard-drachma policy", under which the exchange rate was used as a nominal anchor. Real interest rates were kept at high levels to help ensure the success of this policy. The hard-drachma policy operated, at times, under difficult conditions, yet it proved highly credible and immensely successful. Ironically, the source of the difficulty was related partly to the success of the policy. The policy's credibility led to enormous inflows of foreign capital, complicating the conduct of monetary policy. The Bank was able to neutralise these inflows, absorbing excess liquidity and thus buying time for other policies to adjust. Within three years of the policy, inflation was more than halved, falling to under 5 per cent, while economic growth accelerated sharply. The fiscal consolidation that took place beginning in the mid-1990s, and moderation in wage increases, contributed importantly to an increasingly-sustainable policy mix, enhancing the credibility of monetary policy.

With the outbreak of the Asian financial crisis in late 1997, and its spread to other parts of the world, there were pressures on the drachma. The Bank of Greece initially raised interest rates to stem these pressures. Then, in March 1998, the drachma entered the Exchange Rate Mechanism of the European Monetary System, so that it could satisfy a Maastricht criterion, and was devalued to help maintain international competitiveness. Unlike the currency devaluations in many other countries around this time, the drachma's devaluation was not followed by the aftershock of a banking and financial crisis. A well-supervised Greek banking sector, with adequate prudential regulations in place, limited the exposure of commercial banks to foreign currency risk and, therefore, safeguarded the financial system.

In the years following the drachma's entry into the ERM, the Bank of Greece maintained a tight monetary policy so that the inflation criterion of the Maastricht Treaty could be satisfied. Fiscal policy continued to be tightened and wage restraint was maintained. With an ever-more-balanced policy mix, real economic growth accelerated. The rest, is history. On 1 January 2001, Greece became the 12th member of the euro area, where price stability is entrusted to the independent European Central Bank and the Eurosystem.

The Bank of Greece is now part of a larger family, the Eurosystem, and continues to exercise extremely important functions. It is an integral part of the Eurosystem, which comprises the European Central Bank and the national central banks of the euro area. The Governor of the Bank participates in the ECB's Governing Council, which, among other things, sets monetary policy for the euro area. The Bank is responsible for implementing monetary policy in Greece and ensuring the smooth operation of the payments system, which it runs and which is part of the EU's Target System. The Bank also is in charge of supervising the banking system and maintaining financial stability With the opening of financial borders in the euro area, these functions will take on added importance in the coming years.

In carrying out its responsibilities successfully the Bank has benefited enormously, in the present and in the past, from an extremely well-trained and highly dedicated staff. In my view, this has been the key to its success.

Such has been the journey of the Bank of Greece during the past 75 years. As you can see, in common with the experiences of other central banks, the journey has not been without bumps and turns along the way. Yet, the history of the Bank demonstrates that the Bank has always fulfilled its obligations and, in so doing, it has earned the trust of the Greek citizens.

In the early part of the last century, the famous Swedish economist, Knut Wicksell, said that "Monetary history reveals the fact that folly has frequently been paramount; for it describes many fateful mistakes. On the other hand, it would be too much to say that mankind has learned nothing from these mistakes". I might add that in recent years we have learned a great deal from the mistakes of the past. As confirmed by the history of the Bank of Greece, the role of central banks, both institutionally and in actual practice, has been upgraded in such a way that it contributes to the improvement of living standards.

Ladies and Gentlemen, thank you for your attention.