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Orphanides Takes on Trichet Over ECB's Rate Policy (Update2)

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By Ben Sills

March 3 (Bloomberg) -- A former Federal Reserve economist who made a name for himself telling his superiors they were wrong is now taking on European Central Bank President Jean-Claude Trichet.

Athanasios Orphanides, who left the Fed in 2007 to become the governor of Cyprus's central bank, was the first ECB official to argue in favor of zero interest rates, challenging Trichet's position that cutting them so low would have "drawbacks" and should be avoided. Now, investors and economists are betting Orphanides, 46, is winning the argument as the euro region suffers its worst recession since World War II.

The ECB "can't stand on the sidelines and use some weird voodoo economics," said Erik Nielsen, chief European economist at Goldman Sachs Group Inc. in London. "Over time, the power of the right argument tends to win out over the wrong."

At least seven members of the ECB's 22-member Governing Council have lined up behind Trichet as they struggle to agree on new tools that would be needed with zero rates. Still, some have started to warm to the idea of deploying all the ECB's rate ammunition and turning to unconventional methods, suggesting Orphanides may be securing support.

Bond markets expect Orphanides to prevail: Yields on two- year German bunds have fallen to their lowest level since at least 1990. All 55 economists surveyed by Bloomberg News predict the ECB will cut its main rate by a half-point to a record level of 1.5 percent on March 5.

Torn by Conflict

The market move accelerated after Orphanides, in a Jan. 28 speech, said the idea that monetary policy becomes ineffective when rates near zero is "dangerous" and a "fallacy."

Orphanides was born in communist-ruled Czechoslovakia in 1962 to a Cypriot father and Greek mother. He grew up in Nicosia, the capital of Cyprus, a nation torn in two by violence between its Greek and Turkish communities. He was 12 years old when Turkey invaded, occupying a third of the Mediterranean island nation and dividing its main city.

Orphanides cut his teeth at the Massachusetts Institute of Technology, where he studied for his doctorate under Rudiger Dornbusch, the professor who told the Mexican government it was facing a currency crisis before the 1994 peso crash.

In his 17 years at the Fed, from 1990 until 2007, Orphanides became known for his willingness to disagree with bosses, said Vincent Reinhart, a former director of monetary affairs at the central bank and himself a target of the Cypriot's criticism.

Inflation Forecasts

While Reinhart defended the Fed's use of inflation forecasts in setting rates, Orphanides countered that such predictions were unreliable. In 2003 and 2004, Orphanides argued that the Fed should raise borrowing costs faster because they could not be sure that inflation would remain subdued.

Reinhardt recalled that when Fed Vice Chairman Donald Kohn asked him to justify his decision to appoint Orphanides as his senior adviser in 2006, he replied: "It shows that I have sufficient self-confidence to be told I am wrong often."

Orphanides returned to Cyprus to head up the central bank in May 2007 in preparation for the country's accession to the euro area in 2008. As a result, the ECB gained another 800,000 constituents and a monetary-policy heavyweight.

Orphanides may nevertheless have to adjust to European realities as rates approach zero. While his old Fed colleagues are deploying non-conventional measures, ECB officials are struggling with rules that restrict their room for maneuver.

Ignoring Difficulties

The ECB is forbidden from buying debt directly from governments and purchases in the open market may run into political opposition from some countries.

German council member **Axel Weber** said today there are "pros and cons" to buying commercial paper and France's **Christian Noyer** said the ECB is still examining all its options.

"Orphanides is ignoring the enormous political difficulties that the ECB would actually face," said **James Nixon**, an economist at Societe Generale in London and a former ECB forecaster. "That lack of political acumen may limit his chances of higher office."

That isn't stopping Orphanides from deploying his scholarship bluntly.

"The fallacy that monetary policy is ineffective when short-term interest rates are close to zero is dangerous because it may promote inaction," the central banker said in his Jan. 28 speech. A central bank has many policy tools at its disposal once the benchmark rate nears zero, Orphanides argued.

Winning Support

A 1999 **research paper** co-written by Orphanides may contain the seeds of future ECB action. The paper, titled "Efficient Monetary Policy Design Near Price Stability," examined how policy makers might deal with deflation by steering market borrowing costs rather than just focusing on the key bank rate.

"This is a solution that may gain consensus in the council more easily than other direct measures of quantitative easing," said **Aurelio Maccario**, chief European economist at UniCredit MIB in Milan. Orphanides, he said, "knows what he's talking about, much more than other council members."

The Frankfurt-based ECB left its **main refinancing rate** unchanged at 2 percent on Feb. 5. By contrast, the Fed's key rate is close to zero and the Bank of England's is at 1 percent.

Both have now started using other tools to boost their economies: They are buying debt securities in an effort to lower long-term interest rates and revive economic growth, and the Bank of England has asked for permission to create money.

At the ECB, meanwhile, more policy makers are beginning to back Orphanides publicly.

ECB policy makers "have not exhausted our creativity and our capacity to take initiatives," Finland's **Erkki Liikanen** said Feb. 20. A day later, Italian council member **Mario Draghi** said that "worrying about getting too close to the lower limit for nominal interest rates cannot be a reason for inaction."

As the economy continues to contract, the ECB will eventually be forced to follow Orphanides's advice, said Goldman's Nielsen.

"He shot down all the nonsense," he said. "Quantitative easing is just a matter of time."

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