Lucas Papademos: Interview with Il Sole 24 Ore

English translation of an interview with Lucas Papademos, Vice President of the European Central Bank, conducted by Beda Romano (Il Sole 24 Ore), Frankfurt, 5 August 2004.

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The oil price has reached its peak for the last 20 years (in nominal terms at least). The price since the beginning of the year averages out at $37/barrel. Some governments are already very concerned, talking in terms of an oil crisis, and many are recalling the recession in the 1970s. What is your assessment?

The assessment of the magnitude of the problem and of the potential impact of the increase in oil prices is somewhat complex. It must be put in perspective. Oil prices have been rising since the end of 1998. If we compare the recent increase in the price of oil with two similar episodes, we will note that, in percentage terms, the increase since 1998 is similar to the one recorded between December 1973 and January 1974 and exceeds the rise between the end of 1978 and the end of 1979. The same conclusion is reached regardless of whether oil prices are measured in dollars or in euro.

So there are good grounds for fears of a repetition of the crisis that struck in the early 1970s?

There are major differences from that period. First of all, the increase in oil prices in the early 1970s occurred over a limited, two-month period, whereas the current upward trend in the price of oil has lasted 67 months: it has already exerted much of its impact on inflation and growth. I would also add that, in real terms, the oil price is at a relatively low level and far lower today than it was in the late 1970s. Moreover the reliance of many economies on oil has declined.

In other words, the oil price trend has to be viewed in perspective. All the same, the increase over the last few months cannot fail to make an impact on the European economy, in terms of both a rise in inflation and a decline in growth.

It has been estimated that a 10% increase in the oil price pushes inflation up by about 0.1 percentage point per annum in the first year and by roughly the same amount in each of the two subsequent years. The impact in the first year is mainly direct, whereas the repercussions are indirect in the following two years, meaning that they reflect the effect on the prices of non-oil products and possibly “second-round” influences thorough wages.

And what about the impact on growth?

According to our estimates, a 10% increase in the price of oil reduces growth by about 0.05 percentage point in the first year and in the second year and by approximately 0.1 percentage point in the third year. In other words, the size of the impact that an increase in the oil price has on growth and inflation is virtually the same over a three-year period. The direction of the impact is of course different and the time lags involved also vary.

Be that as it may, the impact on growth seems to be more spread out over time.

Quite. However, I should like to stress that these estimates embody a degree of uncertainty. Moreover, it must not be forgotten that the repercussions of a rise in oil prices on the economic variables also depend on the economic situation at the time. For instance, if the oil price increase is mainly a consequence of robust global growth, the negative impact of that oil price increase on euro area growth could be offset.

The ECBs Governing Council met on Thursday, leaving the cost of money unchanged at 2.0%. What was its assessment of the economic situation in the light of the latest figures?

At the present time, we confirm the scenario of a gradual recovery in the euro area’s economy. At the same time, we believe that inflation prospects remain compatible with price stability over the medium term.

In its last communiqué in July, the ECB cited elements of uncertainty in the economic situation. In its last report on the European economy, published on Wednesday, the International Monetary Fund explained that the risks are still on the downside.

There are still uncertainties and risks. The oil price is a risk to be taken into account. If the price of oil were to remain high for some time, it might have an impact on growth, albeit to a limited extent in the first year. I would also add that consumer confidence remains low, even though there are signs of recovery in consumption in some countries, such as France and Italy. On the other hand, the relative strength of the economic expansion in the first quarter, robust growth worldwide, and the increase in industrial production in the euro area are positive developments all suggesting that growth in the euro area might exceed the rate previously forecast for this year.

What uncertainties do you see on the inflation front Europe-wide?

The oil price trend creates inflationary pressures over the short term. If the oil price were to remain in excess of but not far above $40/barrel for some time, inflation in the euro area would exceed 2.0% per annum (it stood at 2.4% in July - editorial note) until the end of 2004 and for a few months in 2005. That being said, from our point of view, and taking account of the likely influence of all the determinants of price developments, we believe that annual inflation will average below 2.0% in both 2005 and 2006.

Despite the increase in the oil price, wage moderation has been striking. In Germany, what is more, the two sides of industry have struck agreements in some sectors in favour of an increase in the working week without any wage increase.

Indeed, until now, there have been no signs of inflation spilling over into wages. Wage moderation has helped to contain inflationary pressures, partly due also to the high unemployment rate in the euro area and the gradual pace of the recovery. It is interesting to note that the annual growth rate of compensation per employee declined to 1.9% in the euro area in the first quarter of 2004. Total hourly labour costs increased by 2.5% in the same quarter, somewhat faster than in the previous quarter, but still moderately. That being said, we are keeping a close watch: we want to prevent the recent increase in inflation and, in particular, the visible rise in oil prices from spilling over into wages. What we said in July still stands: we remain vigilant and we are monitoring the situation and all the risks to price stability very carefully. There is, however, no bias regarding the monetary policy stance in the future.

In its latest report on the euro area, the IMF said it took a cautious line on the Monetary Union's economic prospects. While it was about it, it lowered the euro area's non-inflationary potential growth from 2.5 to 2.0%.

First of all, I would point out that the IMF estimate is broadly similar to that of the ECB (2.0-2.5%), it is equal to the lower limit of the range of our estimated potential growth. However, these estimates are surrounded by many uncertainties: the European economy's modest growth performance in recent years and the progressive ageing of the population may have swayed the IMF's calculations.

Might the IMF be suggesting that, with growth at 2.0%, the euro area is creating inflation?

Not necessarily. When appraising the potential emergence of new inflationary pressures, it is not only the actual growth rate that has to be compared with the potential rate, but also the level from which growth started out at the time of the recovery and the remaining gap between the actual and potential GDP levels. In other words, 2.0% growth does not automatically mean further inflation, regardless of the size of the so-called GDP gap and the rate of unemployment.

The ageing of the population might lead some observers to think that Europe's potential growth is set to fall, or at any rate to remain inexorably low, at a time when the United States continues to present growth rates that are double those of Europe.

It would be a mistake to reach such a conclusion in general. Other factors could counteract the effects of the ageing of the population. The factors explaining the difference in growth rates between the United States and the euro area are population trends, differences in the growth rates of productivity and the degrees of labour force utilisation. The negative impact of population ageing can and must be offset by introducing measures to boost the contribution of the other two factors to euro area growth.

To sum up: the ECB remains cautiously optimistic as to the trend in the European economy. Would you say that interest rates stand at the appropriate level?

You will have noticed that we have preferred since last April to cease using this term in our communiqués.

Is it no longer appropriate to use the adjective "appropriate"?

In a way. We have preferred to cease using the word so as to dispel the impression that had prevailed in financial markets that by using it, we are committing ourselves to maintaining interest rates unchanged for a considerable period of time.

It is a controversial decision. Some observers are wondering whether the ECB may perhaps be losing some of its transparency.

This decision must not lead people to think that the ECB is less transparent about its policy stance or that it no longer wants to guide the markets. We believe that monetary policy must be, generally speaking, predictable in the light of our strategy and goals. However, this does not mean that we have to send out specific signals or express a "bias" regarding the future stance of monetary policy. Indeed, I take the view that, in general, although there can be necessary exceptions, it is not a good idea for central banks to give overly-clear, explicit indications about the future policy stance. Policy decisions are made in an uncertain environment. Should an unforeseen event arise, a central bank would be forced to surprise the markets unpleasantly.