Lucas Papademos: Interview with Corriere della Sera

Interview with Mr Lucas Papademos, Vice-President of the European Central Bank, conducted by Ms Marika de Feo (Corriere della Sera), Frankfurt, 31 March 2005.

Corriere della Sera publishes an abstract of the text below.

*   *   *

The markets are under the impression that the ECB is unhappy with the current level of interest rates. Why not raise them here and now?

Our message has been clear: the current level of interest rates is in line with maintaining price stability over the medium term. Our latest assessment confirmed that underlying inflationary pressures remain contained and that inflation is projected to decline over the medium term. There are, however, a number of upside risks to price stability, such as high and volatile oil prices. These risks stem mainly from potential second-round effects of higher oil prices on wages and prices. Up till now past oil price increases had no significant effects on wage developments, inflation expectations and core inflation.

But the risks also stem from money growth, don't they?

Yes, they do. The excess liquidity accumulated over the past few years and the acceleration of money and credit growth since the middle of last year poses medium-term risks to price stability. Stronger economic growth in 2005 and 2006 could imply an increased likelihood that inflation risks associated with monetary and credit growth could materialise. This prospect requires continued vigilance.

With regard to high oil prices, are you more concerned about their impact on growth or on inflation?

It is an unpleasant fact that high oil prices pose simultaneously upside risks to inflation and downside risks to growth. Estimates of the impact of higher oil prices on growth and inflation are surrounded by uncertainty and must be interpreted with caution. Having stressed this, I can say that the average estimated effect of an oil price increase of 10 % is to add about 0.1 percentage point to euro area inflation in the first year and to reduce GDP growth by approximately the same amount, that is by 0.1 percentage point in the same year. In subsequent years, the effects on both inflation and growth decline. Our aim is to prevent oil price shocks from having second round effects on inflation so as to minimise their cumulative adverse effects on both inflation and growth.

Are you still optimistic about growth?

I am cautiously optimistic and expect that the economic recovery in the euro area will pick up momentum in the course of 2005. The somewhat lower GDP growth projected in 2005 by ECB staff compared to earlier projections mainly reflects the carry-over effect of weaker economic developments in 2004 rather than a downward revision of the expected pick-up of activity this year. There are some signs of an upturn in investment. As far as consumption is concerned, we expect that it will increase in line with real disposable income, which is projected to rise by about 1.4% in 2005.

Despite the increase in oil prices?

Oil prices are assumed to decrease gradually in the future as implied by futures markets. We are making no assumptions about other factors, such as an improvement in confidence, that could positively influence consumer behaviour. Of course, if oil prices turn out to be higher than currently envisaged, they would dampen disposable income and consumption growth.

What constitutes a natural interest rate for the ECB?

The concept of a natural interest rate refers to an equilibrium real interest rate that reflects productivity and population growth. Although most recent analyses seem to indicate that in the euro area it lies within a corridor of 2% to 3%, I would not be surprised if the lower bound of the estimated range is revised downwards as a result of the lower growth in productivity in the euro area during the past ten years. Owing to the high level of uncertainty surrounding the estimates of the natural interest rate, great caution is called for when using them. The natural interest rate does not constitute an intermediate objective of the ECB's monetary policy.

Competitiveness is improving in Germany, including as a result of wage cuts. Is this a "recipe" for other countries, like Italy?

Germany has indeed succeeded in significantly improving its international competitiveness. Without giving advice to individual countries, I must stress that it is essential to improve competitiveness to effectively compete in the global economy. Italy's competitiveness has declined during the past five years. It is therefore important to reverse this developing trend.

How?

For example, by increasing productivity growth and enhancing market flexibility.

The Wall Street Journal views Italy as a "fortress" because of its restrictive attitude towards imports. Do you support this policy, or is it better to be more competitive?

Past experience has shown that protectionism is not effective and can never be an appropriate response in the long term. It may even be damaging in the short term, if it leads other countries to introduce protectionist measures as well. Besides, such measures are not in accordance with the European Union's fundamental principle of an open and competitive economy. Competition is an important condition for stimulating productivity growth. This in turn increases the competitiveness of a country and its capacity to sustain a higher rate of economic growth.

So do you think that protectionism acts as a brake on growth?

Trade protectionism can temporarily help shield certain sectors from external competition. However, over the longer term, it will have a negative impact on the overall level of economic activity and lead to lower growth. This is because protectionism tends to preserve inefficient production and market structures thus eroding the competitiveness of a country and its ability to sell its goods on the global market.

Are you disappointed that the single market is not proceeding at the desired rate, particularly in the banking sector?

It is a rather discouraging fact that financial integration has been much slower than expected and hoped for. The ECB favours increased financial integration and more competition in all sectors, including the banking sector. This is because, as I previously stressed, increased competition is key to sustaining higher levels of growth in the long term.

Will you increase interest rates because of the reform of the Pact?

The ECB sets interest rates at the level that is in line with our objective of maintaining price stability. The stance of fiscal policy is one factor influencing price developments. The agreed changes in the fiscal framework per se do not automatically imply that the stance of fiscal policy will change in the euro area. There is, however, a serious risk that the revised Pact, notably the changes in its corrective arm, may lead to a weakening of fiscal discipline.

Such an outcome could affect the prospects for price stability and, consequently, it could require a change in the stance of monetary policy. Of course, the ECB's decision on interest rates at a given point in time will depend on a comprehensive assessment of the anticipated effects of all factors determining the price level over the medium term. I should also point out that market expectations regarding the fiscal policy stance in the future will influence long-term bond yields, given the ECB's firm commitment to maintain price stability.

Are there any new rules of the Pact that you recognise as good?

The proposed arrangements to improve governance and strengthen national ownership of the fiscal framework are welcome. Moreover, some changes in the preventive arm of the Pact could strengthen it and thus help prevent the emergence of excessive deficits. The declared commitment of member states to actively consolidate public finances in good times is a positive development. Also, the greater emphasis on the long-term sustainability of public finances and the increased focus on debt should contribute to a better implementation of the Pact. Needless to say, and this is crucial, the expected - in principle - positive effects of these changes on the conduct of prudent fiscal policies will have to be proved in practice and will depend on a rigorous implementation of the revised fiscal framework.

What do you think of the new rules about debt?

The increased focus on debt, in both the preventive and corrective arms of the Pact, is definitely warranted, as the overall indebtedness of a country, including a government's implicit liabilities resulting from pension systems and ageing populations, allows for a more comprehensive assessment of a country's fiscal situation and prospects. At the same time, the application of the debt criterion in "qualitative terms" will not be straightforward and, for this reason, it is essential that this be done in a systematic and credible manner. The increased emphasis on debt is expected to strengthen the Commission's position to launch an excessive deficit procedure on the basis of its assessment of debt developments.

Do you think that the new rules are more credible for the governments and that, consequently, they will try to stick to the new rules more than to the old ones?

Credibility is gained through actions. It cannot be established and it cannot be predicted on the basis of good intentions and theoretical arguments. All parties to the Pact are expected to fulfil their responsibilities and implement the revised fiscal framework in a rigorous and credible manner.