Lucas Papademos: Interview with Financial Times and Financial Times Deutschland

Interview with Mr Lucas Papademos, Vice President of the European Central Bank, conducted by Mr Ralph Atkins and Mr Marc Schieritz and published in the Financial Times and Financial Times Deutschland on 19 December 2005.

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Mr Papademos, you have responsibility as ECB Vice-President for financial stability issues. Are the risks to financial stability of interest rates remaining low greater than the risks involved when short-term rates are rising?

A comparison of the risks involved when short-term rates are rising with the risks to financial stability of rates remaining low is not easy, as it depends on the relative assessment of the two types of risks and on the magnitude of a potential increase in short-term rates.

On the whole, I would expect that potential increases in global interest rates – not necessarily in the euro area – that are moderate and anticipated should not involve risks to financial stability. Needless to add, the size of possible risks will differ across countries and sectors. Let me elaborate.

When interest rates remain at a low level for a long period of time, they may entail risks to financial stability as a result of their effects on households, corporations and financial institutions. For example, low interest rates have contributed to the rapid rise in household debt and the fast increase in house prices in many countries in the euro area, but also elsewhere. The sustainability of household indebtedness and related credit risks when interest rates rise depend on the ability of households to service their debts and on their buffers.

In the euro area, despite increased indebtedness, households have comfortable buffers. Debt-to-asset ratios are sufficiently low in the euro area as a whole, and the ability of households to service their debt is not expected to be substantially affected by potential future increases in interest rates. Of course, the impact of higher rates on household debt-servicing costs will differ across countries and socio-economic groups.

Among investors, the low level of global interest rates has contributed to the so-called “search for yield” and the flattening of the yield curve. At least some investors have tended to acquire assets of higher risk without requiring a commensurate higher rate of return. The low interest rates may have influenced investors’ risk-return preferences. And in an environment of higher interest rates, there may be a readjustment of these preferences with consequences for the level of long-term interest rates.

For corporations, the low level of interest rates has helped to improve their balance sheets after a period of excessive investment and borrowing. This restructuring, or repair of balance sheets, has been very important in the euro area. More recently, however, low interest rates have fuelled an increase in borrowing and a tendency of firms to borrow short term, rather than long term. But despite this development over the past year, the ratio of short-term to long-term obligations of euro area firms is not high.

The flattening of the yield curve has exerted some pressure on bank profits. However, the profitability of euro area banks has evolved in a very satisfactory manner as a result of the positive influence of other factors, increased lending, especially mortgage lending, higher non-interest income and as a consequence of cost cutting and a reduction in the flow of provisions. Low interest rates may encourage banks to increase their holdings of more risky assets and this could have implications if credit conditions change when interest rates increase.

Is that the same as saying that there are no risks to economic growth of rising interest rates?

It is not the same thing, but under the present circumstances the consequences would be similar. With respect to the specific adjustment in the monetary policy stance of the ECB that took place earlier this month, I would not expect this to have a significant adverse effect, if any, on the ongoing economic recovery in the euro area.

Will the general global monetary policy tightening have an impact on euro area growth?

In principle, a tightening of monetary policy – global and domestic - would be expected to contain aggregate demand growth. The extent, however, of this effect depends on the initial conditions and on the influence of a variety of other factors. In the US, despite the substantial increase in interest rates since the middle of 2004 which followed a fairly long period of low interest rates, economic growth has remained robust because of the cumulative impact of the previous monetary accommodation and of other factors that have at least partly counterbalanced the effects of higher interest rates.

An important channel through which monetary policy influences the economy is through its effects on long-term interest rates. If long-term interest rates remain at a low level – as a result of favourable inflation expectations influenced by a credible monetary policy oriented towards price stability and as a consequence of the impact of other factors– then the effect on economic activity of a rise in short-term interest rates is going to be more muted. Moreover, the expected strength of euro area economic growth in the coming year is mainly based on the projected evolution of internal demand.

Which effect is stronger - the impact of higher short-term rates on growth, or the beneficial effects of low long-term rates?

Well, it depends of course on the term-structure of debt and the proportion of long-term debt with variable rates. But the general point that I would like to emphasise is that although a higher level of short term rates can be expected to dampen growth in principle, it may not dampen growth in practice because of the influence of other factors, including those that determine the functioning of labour markets and productivity growth.

Could it be that the recent move by the ECB represents a case where increase interest rates might stimulate growth?

I would agree with this. Public perceptions and expectations of future inflation should be favourably influenced by a change in the monetary policy stance that aims at preserving price stability. It [a higher level of interest rates] could foster expectations of lower inflation and higher real disposable incomes, and increase confidence, particularly in countries where public perceptions of current inflation are less favourable than actual inflation and financial markets' inflation expectations.

[So] you expect the adjustment to higher interest rates to be orderly?

Your question suggests that it is a certainty that higher interest rates are coming. I think that we have clarified that we have not decided, ex-ante, to engage in a series of interest rate increases.

So I will answer the question in a general way, as a hypothetical question on whether an evolution of interest rates towards a higher level will be orderly?

As far as policy rates [set by central banks] are concerned, it is important that any future changes are well understood by the markets and the public and are predictable. As regards changes in market rates, particularly potential adjustments in long-term rates partly in response to a change in the monetary policy stance, I would say that the likely scenario would be one of an orderly adjustment, although the relationships between long-term and short-term rates are complex.

Although there is a risk of an abrupt correction in the level of long-term interest rates as a result of the impact of other developments, this is not the likely outcome on the basis of currently available information.

Is there a risk of house price bubbles bursting?

It is always difficult to identify whether property price rises are indicative of a bubble because property prices are influenced by changes in fundamentals as well as by speculative behaviour. We know that in a number of countries, including those where house prices have increased at a fast pace, such as France, Spain or Italy, fundamental factors can account for at least a substantial part of the change in prices.

On the basis of some estimates that have been made to try to assess the extent to which bubbles exist, one can say that in some countries there are indications of an overvaluation of property prices, but there are many caveats associated with these estimates which have to do with the difficulties in disentangling fundamental and speculative effects.

On the whole, I would say that a slowdown in the pace of increase of house prices is likely but the risk of a correction – that is, of a decline – is small in the period ahead. Needless to say, conditions in housing markets and the size of associated risks differ considerably across countries, and even across regions within countries, in the euro area.

Will the ECB raise interest rates again in coming months?

The change in the ECB's monetary policy stance in early December was both necessary and prudent. It was necessary in order to preserve price stability over the medium term in view of several upside risks to price stability that had been identified and in order to send a clear signal that the ECB is determined to continue pursuing a credible policy that will preserve price stability over the medium term and continue to anchor inflation expectations to price stability.

It was prudent to act promptly in view of increased upside risks, taking into account the long lags involved between a change in monetary policy and its effects on price developments. It was also prudent to decide on a moderate change in the stance, taking into account the uncertainty surrounding the evolution and effects of other determinants of inflation dynamics.

With regard to the future, we did not decide ex ante to engage in a series of interest rate increases. In the future we will assess, as usual, all relevant information and analyse it in order to reach a conclusion about the outlook for price stability over the medium and long term. On the basis of this assessment, decisions will be taken with regard to the monetary policy stance but there is no reason or case for communicating anything more than what we have said.

What should be perfectly clear is the ECB's commitment and determination to fulfil its mandate to deliver price stability.

In general, is the ECB following a different strategy to that followed by the US Fed in raising interest rates? Do the differences relate to changes in economic circumstances, or conceptual differences?

The difference is mainly related to the economic circumstances and, to be more precise, to differences in the assessments about the economic outlook and in particular the outlook for price stability. In the US, the policy stance changed and the decision to preannounce a measured increase in interest rates was made at a time when interest rates were at the very low level of 1 per cent and had stayed at that level for a considerable period and also at a time when it was assessed that inflationary pressures were building up on both the demand and the supply sides of the American economy.

Our case is somewhat different. First, we had a higher level of interest rates when the decision was taken to change the monetary policy stance. Second, our assessment about the outlook for price stability is that inflation is expected to stay above 2 per cent for a period of time but it is expected to moderate gradually.. In the absence of second-round effects, the relatively modest increase in unit labour costs, partly related to the fact that the pace of the recovery is moderate and there is still an output gap and a high rate of unemployment, is expected to help contain inflationary pressures. But several and significant upside risks surround this assessment.

It is therefore important that second-round effects of oil prices are avoided and that monetary policy helps to minimise the likelihood that other risks materialise.

From a conceptual point of view, I agree that monetary policy predictability is a desirable feature that enhances policy effectiveness. However, predictability does not require, in general, giving explicit signals or pre-announcing the medium-term evolution of the monetary policy stance.

What is your perspective for the long- term growth potential of the eurozone? Have you lowered your estimates?

In the past, we reported a range of estimates for potential growth of 2 to 2.5 per cent in the euro area that had been obtained by academic research. There is a risk that, unless there are changes in policies – more reforms in labour and product markets - as well as in the behaviour of private economic agents, this range may have to be revised downwards. But it is not our working assumption that no action will be taken to strengthen potential growth in the euro area.

To cut a long story short, the main way that potential growth could increase is through policies that boost productivity growth and raise labour utilisation by increasing the average hours worked and the participation rate in the labour market and by making this market more flexible and adaptable. I would agree that the pace of reform in these areas has been relatively moderate, but progress has been made in a number of countries and the overall sentiment on the need for, and the support of, reforms is changing in the right direction.

The experience of the Nordic countries illustrates that it is possible to implement reforms that have a significant positive impact on employment and growth without at the same time changing in fundamental ways the social model that is in place.

What are the implications of your assumptions about potential growth and productivity for the what economists would see as the neutral level of eurozone interest rates?

A simple concept of the neutral, or natural, rate of interest over the long term is the one derived from models of long term economic growth in which the equilibrium real interest rate is determined by productivity growth, demographics and saving preferences. Estimates of this concept of the natural real interest rate have ranged between 2 and 3 per cent. The estimated range suggests that there is uncertainty about its value – and the uncertainty is greater than that implied by the fact that I mentioned a range and not a number.

Another, more short-term, concept of the natural interest rate is that it is the real rate that ensures macroeconomic equilibrium at every point in time at the potential output level and it is consistent with price stability. This real rate can fluctuate considerably precisely because the different factors and shocks that impinge on supply and demand in product and asset markets vary over time. Estimates of this concept of the real interest rate are broadly similar to the range that I mentioned earlier [2-3 per cent], though closer to the lower limit. But the uncertainty surrounding these estimates is higher.

These are useful concepts to monitor and see how they evolve over time, but they do not play a prominent role in the ECB's strategy for determining the monetary policy stance. They are useful benchmarks – not intermediate objectives – that can be used together with other measures – such as the output gap and the difference between the unemployment rate and what could be labelled the 'natural' rate of unemployment – to provide information about the strength of inflationary pressures in the economy.

At what unemployment rate do inflationary pressures start to build up in the eurozone?

There are various estimates. Recent research at the ECB and by academic economists and international institutions suggests that the natural rate of unemployment or the NAIRU [non-accelerating inflation rate of unemployment] is currently close to 8 per cent. This is surprisingly and disappointingly high, because it implies that, other things equal, there are certain limits imposed by the functioning of the labour market on the conduct of a stability-oriented monetary policy. These estimates emphasise the importance of reforms that would contribute to reducing the unemployment rate that is compatible with price stability. If the NAIRU is reduced, a higher level of employment and a lower rate of unemployment can be supported by monetary policy without creating inflationary pressures.

Some eurozone politicians suggest that the eurozone or eurogroup could form the basis for enhanced cooperation within the European Union. If the eurozone does not develop a political character, can it survive over the longer term?

There are suggestions that may be potentially useful but I have not seen precise proposals that specify the framework and mechanisms for achieving enhanced cooperation in practice. As a central banker I feel that it would not be appropriate to comment on means of enhancing political integration in the euro area.

If there are no changes in the institutional structure or deeper political integration within the euro area, can monetary policy function effectively? My answer would be a straightforward yes, without this implying that certain institutional improvements on the economic and political front would not help enhance the functioning of the European monetary union. What is important is that economic policies and, in particular, fiscal policies are consistent with, and supportive of, the objectives of monetary union, including the objective of price stability. The present institutional framework is overall adequate to allow the ECB to perform is tasks effectively.

Otmar Issing steps down as executive board member next may. Would you like to take over his role as ECB chief economist?

I have read the speculation in the press but I prefer not to comment. The decision will be taken by the Executive Board together with our new colleague.