Lucas Papademos: Interview with Il Sole 24 Ore

Interview with Mr Lucas Papademos, Vice President of the European Central Bank, conducted on 19 February 2007 by Mr Beda Romano, Il Sole 24 Ore.

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What type of recovery are we seeing?

According to the latest estimates, growth in the euro area was 2.8% in 2006 almost double the growth rate recorded in 2005. The economic recovery was mainly driven by aggregate demand – both domestic and international. Private investment – both business and residential – rose strongly and private consumption growth also strengthened. Gross exports increased substantially and played an important role in stimulating domestic demand, but the contribution of net exports to GDP growth in the euro area as a whole was marginal, as imports also rose at a fast pace. On the supply side, there were positive signs of structural improvements in the labour market and these are reflected in a further rise in employment. Over the past eight years, the average annual increase of employment was 1.2%, four times higher than the corresponding figure in the eight years before the start of Monetary Union. In this context, it is encouraging that productivity growth also increased.

Is the increase in productivity structural or cyclical?

It is still too early to say with certainty. However, it seems to me that the increase in productivity mainly reflects cyclical factors, although there is evidence, including suggestive anecdotal evidence, that in some sectors of the European economy and in some countries of the euro area gains in efficiency have been achieved that are of a structural or permanent nature. These gains are the result of the introduction of economic reforms, for example the deregulation of markets, and of the efforts of companies to be more competitive in the increasingly globalised economy.

Why such caution in assessing the increase in productivity growth?

Several facts suggest caution: first, labour productivity in the euro area increased at an annual rate of 1.2% in the first three quarters of 2006, which is approximately equal to the average annual rate recorded during the past fifteen years. Second, much of the increase occurred in industry, primarily for cyclical reasons, while in the services sector – which today represents 70% of the European economy – productivity growth remained sluggish. Indeed, in the third quarter of 2006, it declined to just 0.3%, year-on-year.

What explains this divergence?

It is mainly due to the fact that in services competition is relatively limited, unlike in industry, which is much more exposed to the challenges of globalisation. An excess of regulatory obstacles and a variety of barriers impede free competition and the completion of the Single Market in services, including segments of the market for financial services. Such limited competition has not facilitated the adoption of new productivity-enhancing technologies, especially information and communication technologies which, in recent years, has played a decisive role in boosting productivity growth in the United States.

But Europe is indeed making increasing use of information technology.

That is true, but particularly in the production of goods, much less in the services sector. The environment within which the services sector functions has not, in general, been conducive to the efficient use of new technologies.

What can be done in this situation?

It is important to complete the creation of the Single Market in Europe by removing legal, regulatory and other barriers to competition in the services sector. More competition will bring about an increase in overall efficiency and labour productivity through various channels, including the more extensive and effective use of new technologies. The financial markets provide a good example. Improving the efficiency and development of the financial sector will not only raise that sector's productivity but it can contribute to the better and faster allocation of capital and foster innovation and the productivity performance of the whole euro area economy.

There is much discussion of non-inflationary potential growth. It is considered to be an indicator for assessing the flexibility and degree of competition of an economy. Has potential growth increased in Europe in recent years?

In 1999, the estimates by international organisations of non-inflationary potential growth in the euro area ranged between 2.0% and 2.5%. In 2004-2005, the same organisations considered that potential growth was close to the lower limit of this range and even slightly below 2.0%. However, I believe that, in the light of recent developments in the labour market, the increase in the rate of utilisation of the labour force, and indications of a slight pick-up in trend productivity growth, the potential growth of the euro area economy over the next couple of years might be somewhat higher, but only marginally: it remains close to, though possibly slightly above 2.0%.

Therefore, the 2.8% growth recorded in 2006 is not sustainable?

In the absence of further economic reforms to enhance market flexibility and adaptability and raise labour utilisation and productivity at a faster pace, the growth seen last year cannot be sustained without causing inflationary pressures. The euro area economy is reaching peak levels of capacity utilisation, and the rate of unemployment is today 7.5% – a level, which, according to various estimates, is considered as consistent with non-inflationary long-term growth. Taking into account the current structure and functioning of the labour market, a tighter job market could exert pressure on wages and therefore on prices.

So are new labour market reforms needed?

Precisely, to enable the economy to further reduce unemployment in a sustained manner, that is, without creating inflationary pressures. However, I should point out that much has been done in recent years to improve the functioning of the labour market. A 7.5% unemployment rate is three percentage points lower than the level reached in the mid-1990s. And job creation in the eight years since the launch of the euro has been substantial, as I noted earlier. Nevertheless, we cannot be content with the current level of unemployment: it is nearly three percentage points higher than in the United States.

The picture that you have painted so far is partially positive. Italy has also recorded better than forecast growth in 2006, at 2.0%. How should we see the Italian recovery?

Following years of stagnation or very low growth, the performance of the Italian economy last year was very encouraging. The recovery is due in large part to increased aggregate demand from the euro area and the rest of the world. There are also signs of improvement on the supply side and of a revival of investment. However, based on the available data, productivity growth seems to have remained rather low in 2006.

Can you be more precise?

Some data on Italy have surprised me. The fall in Italian competitiveness is not predominantly the result of excessive wage growth, as is sometimes argued, but rather of a very low increase in productivity. While the latter increased in the euro area by an average of 1.1% per annum between 1999 and 2005, in Italy it rose by just 0.4%. With regard to wages and salaries, the average annual increase in the same period was 2.6% in the euro area and 3.0% in Italy. The poor productivity performance and the cumulative effect of higher wage increases compared to the rest of the euro area over a fairly long period of time have resulted in a substantial loss of price competitiveness.

What should Italy do to increase its productivity?

The goal is to introduce more competition. This is a challenge not only for Italy, but also for Europe. Bear in mind that, as a result of population ageing and a projected increase in the "dependency ratio", without further improvements in productivity and the degree of labour utilisation, potential growth in Europe is estimated to fall from 2.0% to 1.5% in the decade 2010-2020. This would be a considerable drop. This risk forces us to continue our efforts to make the European economy more efficient and competitive.

Let us now move on to interest rate developments. The markets expect a further rise in the cost of money in March, to 3.75%. What will influence monetary policy in the coming quarters?

The ECB's Governing Council will assess the outlook for inflation over the medium term and the potential risks to price stability in order to prevent the upside risks on the horizon from materialising. The key words are "medium term" and "potential risks". The emphasis on the medium term is particularly important: in the short term, inflation is, in fact, likely to fall in the coming months as a result of the effects of special factors; subsequently, however, inflation is expected to rise again in the course of the year, as the favourable influence of these factors dissipates.

What are the risks as far as prices are concerned?

There are a number of upside risks. The fall in the price of oil may prove to be temporary; the danger that past increases in the price of oil and other commodities will have a stronger pass-through into consumer prices; the likelihood of overly generous increases in wages, not in line with productivity gains, at a time of robust economic growth and as the unemployment rate is reaching a level that can generate inflationary pressures; and, lastly, continuing strong money and credit growth.

The ECB maintains that monetary policy is still accommodative. In what sense?

I will underline three factors: interest rates – both short and long-term interest rates – are still relatively low; liquidity is ample as a result of rapid monetary expansion since mid-2004; and the fact that, in spite of the increase in the ECB's policy rates from 2.0% to 3.5% between December 2005 and December 2006, money and credit growth remain strong.

In this context, which is positive as far as growth is concerned, and less so for productivity, what should financial markets expect?

I will only say that the ECB's Governing Council stands ready to do what is necessary and act pre-emptively so as to ensure that the above-mentioned risks to price stability do not materialise.