

Central bankers 'concerned about inflation'

The governor of the Dutch National Bank, Klaas Knot, wants the European Central Bank to speed up its planned increase in rates

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Knot is an established 'hawk' at the European Central Bank (ECB). Together with his counterparts from the central banks of Germany, Finland and Austria, De Nederlandsche Bank (DNB) governor Klaas Knot has always fiercely opposed negative interest rates and a monetary policy he views as too lax.

Long a minority voice, Knot is now on the right side of history. Inflation has returned with a vengeance, and on Thursday 9 June the ECB announced two upcoming interest rate rises, to be implemented in July and September. In an interview with Le Monde, Knot highlights what he sees as the need to move as quickly as possible.

The ECB has already announced that its deposit rate, currently standing at -0.5%, will increase in July by 0.25 points. However, whereas the ECB is contemplating a more flexible rate rise in September, Knot is keen to speed things up. "If conditions stay the same as today", he stated, "we'll have to increase the rate by more than 25 basis points. The logical next step is 50 basis points, but our options are not confined to it." Would he recommend raising rates by 0.75 points all at once? "All I can say is the hike would have to be more than 25 basis points."

The ECB has planned two more meetings before the end of the year, one in October and another in December, and Knot intends to take those opportunities to continue the rate increase. "It is data dependent and will depend on the conditions, but there is a certain likelihood that rates would continue to go up in October and in December."

That would lead to the ECB setting a rate of 0.75, or even 1% – a level not seen since January 2011. When asked if that is his preferred outcome, Knot simply responds, "It's what the financial markets currently price is." Without saying so outright, it is clear that he intends to continue raising rates in 2023. The markets are anticipating rates of 1.5% in the first quarter, and Knot seems comfortable with that idea.

'Overheated economy'

The Dutch central banker sees an urgent need to act. Inflation in the Eurozone rose to 8.1% in May, and Knot views it as essential to halt that. "We are very worried about inflation."

Knot acknowledges that higher prices are primarily a result of the soaring cost of energy, which is under pressure from the coronavirus pandemic and now also from the war in Ukraine; he concedes too that these factors will not be seriously affected by interest rate changes. However, the inflationary phenomenon which the ECB initially viewed as transitory is now spreading throughout the economy. "We are particularly worried about the broadening of inflation across the entire basket. Over 75% of all the items in the consumption basket registers more than 2% inflation. Core inflation [excluding energy and food] is at 3.8%, almost double the target we have for headline inflation [of 2%]."

Doesn't raising rates risk plunging the Eurozone into recession? "No, I don't believe so. The eurozone economy will clearly take a hit from the conflict in Ukraine, but its starting position coming out of

the pandemic was excellent.” Of course, soaring energy prices are cramping household purchasing power, but the governor of the DNB is keen to stress that other areas of the economy are experiencing strong growth.

“The tourism season this summer will be the first unfettered, unrestricted since the pandemic. We have chaos at Schiphol and other airports. I wouldn't talk about an overheating economy for the Netherlands, but there are signs of overheating in the housing market and the labour market.” Property prices in the Netherlands are up 20%, and the country effectively has full employment (3.2% unemployment).

The problem is that the ECB has to juggle countries like the Netherlands with other, much less dynamic economies such as those of Italy and Spain. Financial markets tightened following the ECB's announcement of the increase in interest rates, and Italy's ten-year borrowing rate spiked to its current level of 3.9%, the highest since January 2014.

“Of course, economies are different but inflation is above target everywhere, core inflation is high everywhere... And some countries have even higher inflation. Look at Estonia, up to 20%.” But isn't there a risk of a return to a Eurozone crisis, a 'fragmentation' separating countries investors see as safe, such as Germany, from countries such as Italy, Spain or even France? According to Knot, the ECB will be ready to intervene. “If there were to be disorderly market conditions that would threaten the homogeneity of monetary transmission, then it's squarely within our mandate to respond.”

He recalls that in March 2020, at the start of the pandemic, markets were seized by a temporary financial panic and this had a significant impact on the Eurozone. “Within five days, the Pandemic Emergency Purchase Programme [“PEPP”, an asset purchasing programme now worth €1.7 trillion] was created. Within two or three weeks, spreads were back to levels where we were more comfortable with.”

For Knot, the normalisation of monetary policy and the shift away from negative rates signal the end of an episode which has not been healthy for the economy. “I am very satisfied with the fact that we can finally leave negative interest rates behind. We all know that low-for-long has all kinds of long-term side effects. It creates misallocation in the economy, financial exuberance, in housing markets, in crypto asset markets, in stock markets.... It is good that we come to an end of this.”