Interview Klaas Knot with Reuters

Interview with Klaas Knot, President of De Nederlandsche Bank, conducted by Balazs Koranyi and Francesco Canepa of Reuters on April 6. A shortened version was published on April 7.

Q: What is your assessment of the current economic outlook given the third wave of COVID-19 and a further extension of lockdown measures?

A: You should make a distinction between the near term and the medium term, ie from the second half of the year onward. The risks you refer to mainly affect the near term. Indeed, there is reason to be disappointed by the slow pace of vaccination, the on and off noise that this creates with respect to lockdowns, and their consequences for the economy.

But we can see through these very short-term developments as long as there is a credible perspective of around 70% of our population being vaccinated around the summer. Then there is very good reason to expect a robust recovery in the second half of the year.

There are clearly some upside risks for the second half of the year. If you look for instance at the consumer, who is in excellent financial shape and is sitting on additional, forced savings that will likely be unlocked after the restrictions will be lifted. On fiscal policy, I think there will be more fiscal stimulus forthcoming in the second half of the year as in many of the euro area countries there are currently discussions ongoing about follow-up support packages for after the summer. These are also not included in our baseline.

And the external environment is also improving greatly and very rapidly, which is also positive for an economy like the euro area with a persistent surplus in foreign trade.

So, all in all, the deterioration is focused on the short term but hasn't changed the outlook beyond the short term all that much. It seems that the weakness in the economy is very much concentrated in those services that are directly impacted by the lockdowns but the rest of the economy is doing fine and is increasingly immunizing itself from the effects of the pandemic. Manufacturing industry is doing fine, world trade has fully recovered and even some of the services are doing fine. So, there is, from a slightly longer perspective, reason to be optimistic. But I must admit that these short-term ups and downs in infections and the slow pace of vaccinations are annoying.

Q: What is the risk of the U.S. and Europe growing at such different pace?

A: If the U.S. is doing fine and better than expected, it means the global economy is doing better than expected and that's also good news for the euro area. We are a region with a current account surplus, so net trade is quite important and the fact that our trading partners are doing fine is a net positive for us.

I find it also difficult to make these comparisons between fiscal policy in the U.S. and Europe. In Europe the overwhelming bulk of fiscal policy is national, and we only know at the end of the year what is the euro area fiscal stance when we can sum up the impact of 19 different fiscal policies.

The structure of our fiscal policy also differs very much. Part of what is discretionary stimulus in the U.S. would be covered by automatic stabilizers in Europe, which is less visible but plays an important role.

I would also argue that this type of fiscal policy is more targeted, so probably the efficiency of per euro or per dollar spent is somewhat higher than in the U.S.

On the monetary policy side, it means that the Fed may have to exit its super accommodative policies earlier than the ECB, but of course there is still so much uncertainty that it's too early to speculate on that.

Q: Does that mean you're not terribly concerned about the delay in approving the EU's recovery fund?

A: I am concerned about some of the reasons behind the delays, but the Next Generation EU Recovery Fund is not a cyclical instrument. It is meant to improve the growth potential of the euro area. It's a longer-term investment instrument. I would want to see that public investment freed up as quickly as possible. But at the same time, one of the good things about this recovery fund is the combination of public investment and structural reforms. In order to put credible structural reform packages together, you need some time and as long as such time is well spent, I would prefer to have it somewhat later in time rather than a rushed version that would compromise on reform. Quality trumps speed here.

Q: Yields have come down since your last policy meeting. Is this what you had in mind at the time of your March decision? Are you comfortable with the current level of financing conditions?

A: I am indeed comfortable with the level of financing conditions as they currently stand. Conceptually, when talking about favourable financing conditions, one has to look at real interest rate gap, with that I mean the actual real interest rate vis-à-vis one's estimate of the equilibrium real interest rate. As such a comparison contains many unobservables, we have to start by analysing developments in nominal yields and then try to decompose them into various drivers.

To the extent that higher nominal yields are driven by better inflation and growth prospects, to me that's entirely benign. If real rates are roughly constant, it means that higher nominal rates are entirely due to higher inflation expectations and that is something I'm comfortable with.

Q: Are you now putting greater weight on real or nominal rates?

A: Conceptually, one should have a look at real rates. But to tabulate real rates, you have to take a measure of inflation expectations and we know that inflation expectations are not homogeneous across economic agents. But I nonetheless think real rates are the right indicator to focus on.

In March, however, it was clear that part of the rise in nominal yields was due to a spillover from the United States, and we ran the risk of euro area yields frontrunning the euro area recovery in growth and inflation. That's why I felt it was entirely appropriate to increase the pace of purchases to push back against the spillover component.

Q: Would you agree that as long as 10-year government bond yields are negative, then you still have favourable financing conditions?

A: No, I think that view is way too specific along multiple dimensions. First, we look at favourable financing conditions for all agents in the economy, not just the government. Second, we don't do yield curve targeting. Neither inflation expectations nor the equilibrium real rate is constant over time so we cannot target constant nominal interest rates either.

Q: Do you expect to spend the entire PEPP envelope?

A: I don't have a crystal ball but it's clear we had to frontload some of our purchases to counter this spillover effect. But if the economy develops according to our baseline, we will see better inflation and growth from the second half onwards. In that case it would be equally clear to me that from the third quarter onwards we can begin to gradually phase out pandemic emergency purchases and end them as foreseen in March 2022. My sense is that the envelope is sizable enough and that we have enough fuel in the tank to maintain favourable financing conditions throughout.

Q: After your last Governing Council meeting you made a quantitative commitment to increase the pace of purchases but you also have a qualitative target to maintain favourable financing conditions. Aren't those two targets contradictory?

A: I wouldn't make such a black and white distinction. We made no public commitment to a number and the amount that we will effectively purchase is a function of keeping financing conditions favourable. But we felt we needed to frontload some of the purchases. A "significant increase" is in my view still a predominantly qualitative guidance.

In December we made a rotation away from a volumes-based approach towards a favourable financing conditions-based approach and we are still very much in that new regime.

Q: Will you review your PEPP volume commitment in April?

A: In the way we purchase, there is always flexibility. I haven't used that word yet, but it should be emphasized. We can flexibly adjust, even within a quarter if we feel that is appropriate.

Q: What is the mechanism for deciding the actual volume of purchases?

A: In principle the Governing Council discusses this every three months and then within the three months, it is up to the discretion of the Executive Board, which can deviate from the pace suggested by the Governing Council.

Q: But at the end of the three months, does it have to reach the target the Governing Council set?

A: There is more flexibility on either end of it, depending on market conditions, redemptions, availability, feasibility. There is enough flexibility for the Executive Board.

Q: Is a rate cut now off the table?

A: For months if not years we've provided forward guidance on rates where the words "or lower" are still part of it. As long as these words are part of our forward guidance, the rate cut is always on the table. A few months ago there was a specific situation when the euro's appreciation threatened to derail the convergence towards our inflation aim and that is why perhaps deploying that instrument was more relevant than today.

Q: Is it worth keeping it on the table?

A: I think it is. For the moment it is still integral part of our monetary stance. The stance consists of emergency and standing instruments. In the course of the year, we have to take decisions on our emergency instruments as the pandemic emergency gradually comes to an end. But the inflation outlook does not provide any case for tightening our standing instruments, like our forward guidance on rates or the APP.

Exiting our emergency measures does not equate to exiting our accommodative monetary stance. Monetary conditions will continue to be determined by the inflation outlook and the inflation outlook is still below our aim.

Q: Should we expect another quantitative guidance on PEPP purchases in June?

A: We will have a discussion on the pace of purchases for the third quarter and the guidance thereon will likely remain predominantly qualitative. Whatever that decision will be, there will continue to be a lot of flexibility in our purchase strategy. This has served us really well, so we won't give up that flexibility.

Q: Could the release of pent up savings lead to a surge in inflation?

A: I expect a bump in inflation in the second half of the year. Whether this will be only temporary depends on how wages will react. Given that Corona has created renewed slack in the labour market, the pre-Corona process of gradually increasing wage claims has suffered a setback. It's therefore quite unlikely that we'll see the kind of wage claims that would make the rise in inflation more persistent. So I expect this to be a temporary bump in inflation.

Q: How concerned are you about the side effects of policy

A: I am still concerned, particularly what is happening in our housing markets. I find it quite worrisome that we're seeing the deepest recession since the Second World War and yet house prices rise unabatedly.

For me this has been one of the reasons why we shifted in December from a more aggressive volumes-based policy towards not striving for ever lower rates and ever more favourable financing conditions.

Q: How long can you keep borrowing conditions frozen?

A: As soon as the recovery stands on firmer ground, I expect that the better growth and inflation outlook will start to convince more and more market participants to rotate out of fixed-income instruments to more risk-bearing instruments. That development will inevitably lead to higher bond yields and no purchasing volume will be large enough to completely undo that. In nominal terms that will imply higher bond yields.

Q: Do we need a digital euro and, if so, what should it look like?

A: The usage of cash is going down quite rapidly. Within the euro area the Netherlands is one of the economies that are at the forefront of this development. If one believes that citizens should continue to have access to the central bank's balance sheet, then I think that a central bank digital currency would be a logical response to the decline in cash.

Secondly, there are lots of digital currencies currently under development; some of them are private. I'm not convinced we should leave this space to the private sector only. Maybe this will also work out perfectly well and after five years we'll discover that there is less need for a public-sector central bank digital currency than we initially thought, but I wouldn't take that for granted now and I would therefore want to prepare ourselves.