Interview with Klaas Knot for Les Echos

The war in Ukraine is entering its fourth week. What are the consequences for Europe?

The war in Ukraine is, first and foremost, a humanitarian tragedy of incomprehensible magnitude. No one could have imagined such a conflict between two sovereign states on the European continent. The Ukrainians defend values to which the European Union is extremely attached. As a central banker, I am focusing on the economic consequences of this conflict, in particular on price stability, which is our primary mandate. The Ukrainian crisis has amplified a pre-existing situation. It is creating a new supply shock that will result in higher inflation over a longer period of time. It will also have a negative impact on growth in the euro area.

How can the impact of this war be estimated? Could it lead to a recession?

We are in an era dominated by what I would call fundamental uncertainties. Several scenarios for the economy can be envisaged, although it is extremely difficult to determine which one is the most likely to happen. Nevertheless, we came out of the pandemic crisis in much better shape than most people imagined. Before the war broke out, growth in the eurozone was expected to be over 4% in 2022, so I don't think we are already facing a stagnation of the economy or even a recession, as some might fear. Especially since the budgetary response to the Ukrainian crisis has not yet been factored into our projections. Fiscal spending to increase the defence budget, develop renewable energies, finance the shelter of refugees or compensate for the loss of household purchasing power will significantly cushion the negative impact of the crisis on growth.

Shouldn't the European Central Bank maintain a safety net via the asset purchase programme?

As far as our monetary policy is concerned, it is clear to me that we have achieved our primary objective. Inflation is converging towards our 2% target in the medium term and the conditions for starting a normalisation are in place. There is no longer a reason to maintain such a high level of monetary stimulus via the asset purchase programme and negative policy rates. This is why it was legitimate to announce, on 10 March, the likely end of our Asset Purchase Programme (APP) in the third quarter. However, if the financing conditions of the euro area countries were to become fragmented again - which would undermine the smooth transmission of our monetary policy to all countries - we would not hesitate to react.

If the spreads (the differences in borrowing rates between the Member States of the euro area, Ed.) were to widen excessively, our first line of defence would be to redirect reinvestments from the PEPP (the “pandemic emergency” purchase programme which ends this month, Ed.). Should this not be enough, then the ECB Governing Council would take further action, as it has done in the past. For now however, despite recent adjustments, spreads remain at historically low levels.

What can a central bank do about inflation that is driven by energy prices?

There is little the central bank can do about rising energy prices. It is a shock that comes from outside the eurozone, beyond our control. On the other hand, it is our responsibility to prevent this temporary inflation from becoming anchored in inflation expectations and leading to structurally higher inflation. The best we can do is to carry out our mandate. As inflation appears to be converging towards our 2% target in the medium term, there is no need to maintain unprecedented monetary support.

The current high inflation rate does not seem to be having an impact on wages...

Although we have already revised our projection upwards, I think the risk is that inflation in the medium term will rise further. For January and February, five of the six different indicators that we use at the ECB to gauge underlying inflation were at their highest levels in 22 years and the sixth is close. There has, therefore, been a build-up of inflationary pressures beyond energy prices. It is true that we do not see any second-round effects on wages at the moment but the task of a central bank is not to wait for these effects to manifest themselves because it is then too late to act. The longer the period of high inflation, the greater the likelihood that wages will start to rise later this year. We have to take this risk into account when deciding on the course of our monetary policy.

Do you think that companies are ready to increase wages at a time when the crisis in Ukraine and inflation are weighing on their business and earning prospects?

The opposite question could also be asked. Why would workers accept a loss of 5.1% of their purchasing power when the unemployment rate in the euro area is at its lowest level since the Economic and Monetary Union was established? The greatest surprise we had after the COVID pandemic was that the labour market strengthened much more than we had anticipated. This gives employees a stronger hand in wage negotiations.

Would you say that the message delivered by Christine Lagarde at the press conference was well understood by the markets?

The markets did not expect us to announce the end of the APP, which I found a bit surprising. The inflation surprises for January and February were well-known, and we had already announced that we would react in March. In times of uncertainty, a central bank must be a beacon of predictability. Our predictability comes from the fact that we have a very clear mandate: price stability. Only when this goal is secured can we turn our attention to secondary goals such as economic growth and unemployment. By the first quarter we had already started to reduce the pace of asset purchases without creating any market turbulence. After a short initial reaction to our March decision, markets stabilized around slightly higher yield and spread levels. In fact, the decision was very well absorbed by the markets, even if it initially surprised them somewhat.

Some at the ECB believe that the cessation of purchases in June should be conditional on the evolution of economic data. What is the most likely scenario for you?

We have announced that net asset purchases under the APP will likely stop in the third quarter. Provided, of course, that in the meantime there is no weakening in the inflation outlook that would lead us to revise our commitment. However, again, a rise in inflation is more likely than a fall. If the outlook is the same in June as it is today, we will decide to stop buying. As for the exact date of this halt – July, August or September – it should be noted that, since the last quarter of 2021, we have been reducing purchasing volumes by 10 billion euros per month without sparking any market turbulence. It should also be noted that in June, we will only have a budget left of 20 billion euros.

In a context where states will have to significantly increase their spending to cope with the consequences of the war, would it not be more appropriate to continue monetary support?

This would imply that we would pursue a different mandate from the one set by the Treaty. The Asset Purchase Programme is an instrument to combat the risk of deflation. Legally, its role is to reinforce the accommodative effects of low interest rates. This is a thing of the past. We are in a period of high inflation. The rationale for the existence of the APP has disappeared. It is desirable to wind down our purchases without creating market turbulence. If we were to maintain bond purchases only to create favourable financing conditions for states, it would create a situation of unacceptable fiscal dominance.

Of course, if the political powers want to change the Maastricht Treaty, which defines our mandate, they can. We live in a democratic society. However, I would regard this as neither likely nor desirable because price stability is the best protection we can offer for our citizens’ purchasing power.

If net purchases stop in the third quarter, would this mean that an initial rate hike will take place before December?

Nothing is completely certain or inevitable in an uncertain environment. Depending on the information available to us at the end of the summer concerning the impact of the Ukrainian conflict on the medium term outlook for inflation, we will decide when it is appropriate to raise the policy rate. Today, I believe that the market's assumption of a first rate hike later this year is quite realistic.

Is the 2% inflation target really symmetrical? It seems that there is a greater tolerance for low inflation...

Over the last decade we have continuously increased our efforts to combat low inflation. I used to quip that we performed a huge 'rain dance' to get it going again. We moved rates into negative territory, we launched waves of LTROs and TLTROs (low-cost long-term loans to banks, Ed.), we put in place asset purchase programmes. We will not hesitate to act if inflation were to stabilize below 2% again.

The war in Ukraine seems to have postponed the revision of the European Stability Pact. What do you think should be changed?

The war in Ukraine has shown us how important budgetary discipline and consolidation are. It is essential to create financial safety margins, not least because during crises like these public spending will have to be increased. We need budgetary rules, but they can be improved for instance by replacing the ambiguities around structural deficits with a more robust expenditure rule. Coming out of the crisis, debt levels will also have to come down in the eurozone. I still think that 60% debt-to-GDP is an appropriate target but that the adjustment path towards this target must be individualised. It is not realistic to think that countries with a debt of over 100% can return to 60% in 20 years.