

Interview François Villeroy de Galhau – NRC

Inflation is top of mind for citizens now. In the eurozone it came in at 10 percent year-on-year in September. In the Netherlands, it is extremely high at 17.1 percent. Many people are asking themselves: does the ECB still have a grip on inflation?

“Yes, it is citizens’ main preoccupation. It is also ours. It is our mandate: price stability. We must and we will get inflation back towards 2 percent, within the next two or three years”.

“About our grip, look at the nature of inflation in Europe. About half is due to price rises in energy and raw materials. Barring new shocks, this part is hopefully close to its peak in the bad September figures and will gradually fade away. We already saw it for oil prices, we will see it possibly in the next quarters for other energy sources. This is outside the influence of monetary policy. But the other half is about core inflation, excluding energy and food. It is much too broad and high. For the euro area it is about 4.8 percent. This is our responsibility as a central bank. And we will raise interest rates as much as necessary to bring core inflation down. By the way, this will have a positive effect on banks’ net income; European banks are hence more solid than feared by some”

Critics say the ECB started raising rates too late and that it was also late with the analysis that inflation is structural.

“There was worldwide, including in the US, a significant upside surprise on inflation, due to two things: the strength of the post Covid recovery last year and the Russian invasion of Ukraine. Yes, forecasts were mistaken, but no one expected this unprecedented accumulation of shocks.

“When we saw core inflation in Europe going beyond 2 percent, clearly, it was time to act. And we did. People may have forgotten that as early as last December we decided to stop the pandemic emergency purchases. This was a very significant step. Then we stopped the remaining other net purchases in June and we had the first rate hike in July.”

But the ECB was relatively late with the first rate hike, compared to the Fed for example.

“The nature of inflation is not the same on both sides of the Atlantic. The headline inflation figure in the US is now a bit lower than in the euro area, but core inflation excluding energy and food is higher at 6.3% in August, and the labour market is much tighter with stronger wage pressures. So we go in the same direction, without any doubt, but not necessarily with the same speed and up to the same level.”

France has an inflation of 6.2%, it decreased in September. Dutch inflation is 17.1% and is still went up. Why these differences in the eurozone? And does it make it more difficult for the ECB to formulate a single monetary policy?

“The main explanation is the timing and the efficiency of fiscal measures to address the energy crisis. France started earlier with a price cap on gas and electricity for households, and with gasoline price rebates. It is now taking place in the Netherlands, and in Germany too. So my guess is that these inflation differentials will diminish over time. But anyway, our compass is euro area inflation. We don’t guide our monetary policy after our national differences.”

What should be the next rate increase, 50 or 75 bp, and where is the neutral level of interest rates in the euro zone?

“I find the public “betting game” about the next move premature and too narrow focused. Let us decide on October 27th, looking also at financial conditions then: they recently tightened significantly due to markets deterioration. The neutral rate is a more useful landmark: while not precisely observable, my estimation is that it is below or close to 2 percent. It’s an important stage for our normalisation: we should go there without hesitation, by the end of the year. We could start then a second part of the journey, a more flexible and possibly slower one: I don’t say that rate hikes will stop there, but we will have to comprehensively assess the inflation and economic outlook.”

The most important rate at the moment, the deposit rate, is 0.75 percent. This means that ECB policy is still accommodative: it is not the brake that you would want to have on inflation. The ECB is still fueling the economy.

“We are changing course rapidly. In July we hiked rates by 0.5 % and in September by 0.75. We are no longer gradual, but it is important to remain orderly. It means that you neither excessively surprise markets, nor tighten financial conditions for households and firms too abruptly.”

When as a central bank you want to suppress demand, does that mean you need to spark a recession? And does it mean higher unemployment?

“Luckily enough, employment is quite favorable. Especially in the Netherlands, but also in many other European countries, unemployment rates are at a record low. Without excluding a recession, we rather expect at this stage a significant slowdown. Our purpose is to bring inflation back to 2 percent, it is not to provoke a recession.”

How would you define your own position within the Council, on the scale from dovish to hawkish?

“I don’t like this ornithological scale. Personally, I am a pragmatist. I sometimes read that « the hawks took control of the Council ». This is not an accurate description. The situation changed, we have to adapt monetary policy to rising inflation, but none of us should be on an ideologically preset course. As the good old Keynes said: “when circumstances change, I change my mind.”

What can the eurozone learn from what is happening now in the UK?

“The substance of UK’s fiscal announcements changed yesterday, but let us focus on the method: policymakers should not add uncertainty to uncertainty in this very troubled environment. You must keep a predictable monetary and fiscal course.

Second, if monetary policy fights inflation and fiscal policy risks fuelling it, you can create a vicious loop. So you need dialogue and trust between monetary and fiscal authorities. In this case, trust was weakened by undue criticism of the Bank of England.”

In the eurozone governments are also subsidizing people to help them pay their energy bills, in a way that could fuel inflation. On the other hand the ECB is trying to put a cap on inflation. Is that different from the UK situation?

“I would make a difference between targeted and temporary measures on this energy crisis for households and SMEs, and permanent expenditures increases or tax cuts. The latter increase deficits in the long run. In the British case, the market reaction was much more due to this additional part.”

And you don’t see these permanent expenditures anywhere in the euro zone at the moment?

“Not at this stage, but we must remain vigilant. Let me put it this way: Europe needs bold reforms fostering supply and growth; but this cannot mean lazy and unfair tax cuts”