ECB to keep raising interest rates unless wage growth slows, says official

Financial Times – Martin Arnold

Belgian central bank governor ‘not surprised’ if eurozone key rate increased to 4%

Investors are underestimating how high eurozone borrowing costs will rise, the head of Belgium’s central bank has warned, insisting he will only agree to halt interest rate rises once wage growth starts to fall.

Pierre Wunsch, who sits on the European Central Bank’s rate-setting governing council, told the Financial Times: “We are waiting for wage growth and core inflation to go down, along with headline inflation, before we can arrive at the point where we can pause.”

His focus on wage growth raises the bar on the conditions that have to be fulfilled before the ECB will stop raising rates. The central bank has already raised its deposit rate at an unprecedented pace from minus 0.5 per cent last July to 3 per cent in March.

“I would not be surprised if we had to go to 4 per cent at some point,” said Wunsch, indicating that borrowing costs could rise further than expected by investors, who are betting on a rise in the ECB’s deposit rate to slightly above 3.75 per cent. Investors expect the ECB to keep raising rates further than the US Federal Reserve and Bank of England, which are both expected to increase policy rates by a quarter percentage point next month.

Several members of the ECB council have said they expect another rate rise at its next meeting on May 4, but most are waiting for data on bank lending and inflation before deciding whether to slow down to a quarter point move.

Some council members worry the banking sector turmoil of the past month, following the collapse of Silicon Valley Bank and forced rescue of Credit Suisse, will cause lending to dry up and reduce the need for more rate increases.

But Wunsch said Belgian bank executives he met last week told him they had no plans to cut the supply of credit in response to the tumult.

“It’s not like I love hiking,” said Wunsch, who worked at the Belgian central bank for eight years before taking charge in 2019 and had become one of the more hawkish ECB council members, often pushing for higher rates.

“What we try to do is always to go for a soft landing and nobody is going to err on the side of destroying the economy for the sake of destroying the economy,” he said. “But I have absolutely no indication that what we are doing is too much.”

Hourly labour costs in the 20-country single currency zone rose by a record 5.7 per cent in the fourth quarter from a year earlier, exceeding the pace of wage rises in the US.

German trade union Verdi agreed a two-year deal at the weekend to boost the wages of about 2.5m public sector workers and end weeks of strikes. The deal will mean that staff receive a series of one-off payments totalling €3,000 up until February 2024, after which their wages will be raised by €200 a month, plus an extra 5.5 per cent increase.

Analysts at Barclays said the deal was equivalent to an annual pay rise of 5 per cent, in line with expected eurozone wage growth this year. But it falls short of German inflation, which was 8.7 per cent last year. It is also below the 10.5 per cent Verdi initially demanded.

In Belgium, one of the few European countries to still formally link pay to inflation via indexation clauses, many workers were given a 10 per cent pay rise at the start of the year.

Wunsch said there were already clear signs of “second-round effects” in the bloc, as workers demand higher wages to offset a higher cost of living and that pushes prices up even more.

“I’m not a fetishist,” he said. “I’m not going to hike rates even in a recession just because we have 2.3 per cent or 2.1 per cent inflation in the two-year forecast. But I’m not seeing inflation numbers going in the right direction yet.”

The ECB set out a new three-part guide to its future policy decisions last month, saying future rate moves would be decided by a combination of its inflation forecast, past changes in underlying price pressures and how much impact its policies are having.

Wunsch said wage growth was a key part of this due to its impact on the inflation forecast. “If we see wage agreements remaining around 5 per cent growth for longer than this is going to be in the forecast and then inflation is not going to go back to 2 per cent on a structural basis,” he said.

Wunsch called on governments to start reducing their budget deficits, even before they withdraw the widespread energy and fuel subsidies.

“We are flirting with a weak form of fiscal dominance,” he said. “The base case is we can hike, but there are risks that something will happen, a political crisis in a country, where we will be faced with fiscal trade-offs.”

ECB president Christine Lagarde has taken pride in her ability to persuade most of its 26 council members — including the 20 heads of each national central bank — to support carefully constructed compromises on rate moves. As the ECB gets closer to the peak rate, bringing everyone together will get harder, Wunsch said.

He “very much appreciates” Lagarde’s approach, but added: “Where there is room for discussion is if there is too much consensus. I think it removes relevant information from the market.” Hiding divisions between rate-setters risked surprising the market, as has happened several times already, he added.