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Convincing the Markets

***Peter Praet** revisits the ECB's unconventional monetary policy response to the euro crisis*

Rebecca Christie

BELGIAN CENTRAL BANKER Peter Praet retired in June 2019 after an eight-year run on the executive board of the European Central Bank (ECB), where he served as chief economist. Reflecting on his time on the front lines, Praet shared with journalist Rebecca Christie the high points of his tenure. The interview takes us behind the scenes of Europe's sovereign debt crisis leading up to ECB President Mario Draghi's famous July 2012 promise to do "whatever it takes" to protect the euro—an unprecedented pledge designed to quell market panic and give policymakers time to follow through on their crisis-fighting commitments—and the subsequent challenge of reviving the euro area economy in a time of negative interest rates.

F&D: What was the atmosphere like at the ECB when you arrived?

PP: I came to ECB in June 2011, a few years after the crisis began, and I became chief economist in January 2012. It was not pleasant because it was a panic environment similar to what I had lived through during the Belgian banking crisis of 2008 and 2009. But this time it was a market panic. In these situations, you have to be mentally prepared for the worst and be ready to take bold measures. When I came in 2011, the first decision we faced, in July, was whether to increase interest rates. I was not chief economist at that time. I can tell you now that I was in favor.

The mind-set then was still, in spite of the financial crisis, very much to avoid certain second-round effects related to oil price increases. Inflation was at about 3 percent at that time, and there were some wage pressures. That was one part of the story.

The other part of the story was the follow-up of the financial crisis, and we had tensions in the sovereign debt markets at that time as well. The stance in 2011 became a bit more restrictive. The first interest rate hike was in the spring, and then there was a second hike in July when I came. But the financial crisis was still considered at that time as something manageable by abundant liquidity provision to the financial sector.

Now we know that things didn't go that way.

F&D: What happened when you realized that things weren't getting better, even after oil prices started to fall?

PP: The situation was totally different by then. And so we started to talk about a radically different sort of framework for monetary policy, given a situation that was more akin to disinflation, or worse.

F&D: How much could European leaders accomplish with their plans to create a banking union, with common euro area supervision and a sovereign debt firewall, the European Stability Mechanism? What could be done only by the ECB?

PP: The market panic of 2012 could only be stopped by Mario Draghi. Of course, the background for the success of his "whatever it takes" line was the June European Council meeting of heads of state and governments, about putting in place the banking union and crisis management mechanisms. So that was the political background.

To give credit to Mario, when you have to stop a panic you need strong communication skills. You have to be able to convince markets. "Whatever it takes" was well chosen.

F&D: Were you relieved when it worked?

PP: When we ended 2012 the panic had stopped. It created a feel-good factor, of course. It showed that you can do things to change the course of events and take control. I think that was extremely important in motivating us to press on with our work.

But then we started to be confronted with a slowing economy following all these episodes, and we had to think about unconventional tools. This was a third crisis I've dealt with—the first was the banking crisis in Belgium, the second was the euro crisis—and this one was of a different nature. It was more insidious, unfolding progressively. Deflationary pressures were building up as a result of a persistent weak economy and dysfunctioning credit markets.

We had to think about how to support aggregate demand at a time when interest rates were already at very low levels. What do you do? We came up with plenty of innovations and nonstandard measures.

F&D: What kind of leadership and preparation is needed in this situation?

PP: You have to be very open with your staff and collaborators. You have to think outside the box and allow your staff to do the same. In all stressful situations, acting as a team is of the essence. I was always surprised that I was relatively calm. I think that the key reason is that I was always part of cohesive teams.

F&D: How do you see the role of the IMF during the crisis?

PP: I remember one IMF mission that was trying to evaluate the merits of doing a separate Article IV evaluation for the euro area, and there was a question about whether there was too much agreement between the Fund and the ECB's monetary policy. The evaluation team didn't see a lot of contradiction or friction. They found us to be very much in line, asking: "Aren't you too close and not critical enough?" I strongly denied that.

When you deal with unconventional measures, you don't have much experience, by definition. Certainly not in the euro area. There was a little bit of knowledge in Japan and the United States, but the context was different. So I met with top economists who had a lot of policy experiences in other countries, a process I found extremely enriching. It was also necessary to have this dialogue with a qualified external partner such as the IMF.

F&D: What are the lessons of this relationship going forward?

PP: There is value in investing more in people with experience in monetary policymaking, and the IMF could be mindful of this. The reason is very simple: we are in a low-interest-rate environment where, at the peak of the cycle, you may need to cut rates that are already close to zero or even negative. You need to have a lot of people thinking about that not just theoretically but also from a practical standpoint. It's different than classical interest rate policy because you're buying assets or making promises on the future—what we call forward guidance.

There are a lot of debates about unconventional becoming conventional. That's something we need to explain and communicate to the public. The link between financial stability and monetary policy in a zero-lower-bound environment deserves particular attention. When rates remain low for a long period of time, how do you operationally integrate more financial stability considerations into your monetary policymaking? It is not obvious, because when you do that you increase the risk of losing the focus on your primary objective, which is price stability.

"When you have to stop a panic you need strong communication skills."

F&D: What are the communication challenges facing the central bankers of tomorrow? Is there a balance between the simplicity of Twitter and the less immediate channel of, say, speeches?

PP: I'm not much in favor of tweets in general, especially central bank tweeting, because you cannot simplify to the extreme. Nor can you say it's too difficult for the average person to understand what's really going on. You must make an effort at communication to the public, but you have to be careful not to use too simplistic terms to describe a complex situation. FD

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This interview has been edited for length and clarity.