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The euro-area economy and the recent monetary policy decisions

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First of all, thank you for your kind invitation to take part in this panel on "Europe for All" which concludes this second day of the "Giornate di economia" in memory of Marcello De Cecco. Marcello followed the ECB Governing Council's decisions and the related analyses and discussions with great interest and with the acumen for which he was known. Today I would like to touch upon three points: 1) the monetary policy decisions that we have just taken; 2) the economic analyses behind them; and 3) the debate concerning, and our assessment of, the effectiveness of the various measures that were adopted.

1. At its September meeting the ECB Governing Council introduced a very broad package of expansionary measures. It lowered the interest rate on deposits that banks make with the Eurosystem (the deposit facility), which has been in negative territory since June 2014, by 10 basis points to -0.5 per cent. It decided to restart net asset purchases at a monthly pace of €20 billion beginning in November, after they were interrupted in December of last year, when they amounted to €2,600 billion since their launch at the end of 2014. It relaxed the terms of its new series of targeted longer-term refinancing operations (TLTRO III) compared with those of the June decision by lowering their cost (to -0.5 or 0.0 per cent depending on the lending performance of the individual banks) and by extending their maturity (from two to three years). It introduced a zero interest rate, as opposed to a negative interest rate, on part of the banks' liquidity reserves ("tiering") to attenuate the risk, feared by some observers, that increasingly negative interest rates on the deposit facility could have counterproductive effects on banks' balance sheets and, in turn, on lending.

In addition, we have strengthened our forward guidance concerning the future path of monetary policy, signalling our expectation to keep the key ECB interest rates at their present or lower values until inflation gets to a level consistently close to 2 per cent over the medium term.

2. These decisions were not made in haste: they are the natural conclusion to the analyses started quite some time ago by the Governing Council and, taken together, are an appropriate and proportional response to the worsening macroeconomic outlook for the euro area. In previous meetings, there was already broad agreement that the outlook for economic activity and prices was disappointing. In July, we reiterated our determination to intervene decisively if the medium-term inflation outlook failed to improve.

Over the last few months, the signs of economic slowdown and weakening inflation have instead intensified. Geopolitical tensions, including those relating to trade tariffs, and the sharp decline in international trade recorded in the last few quarters have continued to weigh on firms' confidence, on investment and on industrial production. The assessments of those who, one year ago, expected that the weakening in economic activity would prove temporary and would eventually subside have been shown to be increasingly optimistic.

The slowdown was substantial for German and, though less so, Italian industrial production, but it would be naïve to underestimate its scope by considering it an asymmetric shock. If the worsening in the manufacturing sector proves to be persistent, it will inevitably reverberate across the other sectors of the economy. This is confirmed by the most recent data, which point to an area-wide slowdown in activity in the service sector, especially in Germany.

In a slowing economy, it is no surprise that inflation has remained very moderate and well below the objective of a close to 2 per cent annual increase in consumer prices in the euro area; even with all the margins of uncertainty, the forecasts indicate that inflation is expected to remain weak over the next two years.

We must counter the significant risk that the economic slowdown and the low level of inflation translate into a permanent reduction in inflation expectations or a re-emergence of the threat of deflation. The analyses conducted by the Bank of Italy clearly demonstrate this risk, regardless of the measure of expected inflation used: similar trends have been observed in the expectations derived from the financial markets, which may be affected by excessive reactivity on the part of investors, and in those obtained from surveys of professional forecasters, firms and households.

A very recent study by Bank of Italy economists finds that the medium- and long-term inflation expectations in the ECB's Survey of Professional Forecasters are now much more susceptible to negative surprises to current inflation than they were in the past. This is a finding that confirms the one that our researchers had already obtained based on inflation expectations derived from inflation swaps. By all measures, in recent months, expectations have remained far from the objective of price stability; they increased slightly in the spring, but then turned down again.

The Governing Council deemed it necessary to respond promptly to the worsening economic situation, in order to reiterate its intention to confront weakening aggregate demand and its effects on prices, to not fall behind the curve and to counter low inflation expectations with determination. The global financial crisis and the sovereign debt crisis have taught us that in these circumstances excessive prudence is counterproductive: by not responding swiftly to the risks of too low inflation for too long, a lengthier and more incisive measure, which carries greater risks of unintended side effects, is then needed to counter the risk of deflation.

3. There was extensive discussion in the Governing Council on the decisions and measures to introduce; of course, opinions varied and some reservations were expressed regarding certain individual instruments and some of their characteristics. The package of measures adopted received the approval of a majority of the members of the Governing Council. The analyses conducted by the Bank of Italy indicate that there is no reason to doubt their overall effectiveness.

In the current circumstances, uncertainty about the effects of the individual instruments is naturally widespread, but our analyses suggest that the purchase programme is, in the present conditions, the most effective instrument (aside from being the most "conventional" one, given that open market operations have always featured in central bankers' "toolbox"). Our estimates suggest that the impact of the new purchases on economic activity and on inflation, through the contraction of term premia and the transmission to the yields of all financial assets, can be much bigger today than that of a cut in the official rates. From a conceptual and empirical perspective, there is no reason to rule out the possibility of further contractions in term premia, which in any event had already occurred with the consolidation of expectations of the new measures.

As I have often observed, the effects of a reduction in official rates to negative values – the truly "unconventional" instrument among those introduced so far by the Governing Council – are surrounded by greater uncertainty. We estimate that so far, the cuts in the reference rates have had significant expansionary effects; down the road, however, their effectiveness could prove more doubtful, especially in view of the downwards rigidity of interest rates on deposits.

In any event, it should not be forgotten that the persistence of negative nominal interest rates across a broad spectrum of maturities for lengthy periods cannot be attributed solely to the decisions of central banks, which react to macroeconomic conditions, but rather reflects the enduring underlying weakness of the economy and a possible market response to a resurgence of Fisherian debt deflation. We are still quite far from the "normal" economic conditions to which we ought to return (also in view of the structural factors that could explain lower growth rates worldwide than in recent decades).

The introduction of a two-tier system for bank reserve remuneration – which was also adopted in other jurisdictions – is intended to prevent the reduction in official rates to negative values from having, beyond a certain level, the undesirable side effect of impairing banks' ability to grant credit and, therefore, from being transformed into a restrictive factor. Nevertheless, encouraging greater trading between banks seeking higher returns on their liquidity may spark tensions on money market rates, a risk that is countered by the calibration chosen but one which must still be carefully monitored.

In its forward guidance, the Governing Council confirmed its determination to respond symmetrically to inflation developments, in other words to intervene when inflation falls below the target with the same determination as when it rises above it. The aim is to avoid a further downward revision of inflation expectations, or the resurfacing of the deflation risks we successfully countered three years ago, whilst simultaneously guaranteeing financial conditions capable of supporting the economic cycle.

Monetary policy resolutely pursues the objective of price stability. To achieve the maximum benefits from our action, the Governing Council unanimously agrees that, given the slowdown in production and the significant downside risks that weigh on the outlook, fiscal policy must make a more incisive contribution to strengthening aggregate demand. During this phase, the countries that have room to intervene can play an important stabilizing role; those with a high public debt must prioritize a rebalancing of expenditure towards measures that are better able to support growth, such as public investment, and to reduce the tax burden on businesses and employment.

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In conclusion, I think that the package of measures we adopted was necessary and appropriate to counter the cyclical risks and the weak inflation outlook, and fully in line with our previous decisions. In the past, I have always avoided giving my opinion of monetary policy decisions immediately after Governing Council meetings. I have decided to do so today, a few weeks after the last decisions were taken, mainly because of the recent media attention given to the discussion that followed that meeting.

Intense and detailed internal discussions on the monetary policy options are indispensable, and always take place. Many observers have wondered whether the dissemination of comments immediately following a common decision is a practice that is counterproductive, useful or even necessary. We can debate the merits of introducing at the ECB the procedure followed by other central banks, where, following their monetary policy meetings, they publish the positions of the participants (as well as the reasons for any disagreements). This solution, which I personally find appropriate, was at one point considered but then rejected by the Governing Council.

In his remarkable scientific output, as in his numerous articles for the public at large, Marcello De Cecco always highlighted the close ties between geopolitical issues and economic events. It is interesting today to go back and read one of his last articles published in *Affari e Finanza* at the end of 2015. It dealt with the decision adopted by the ECB Governing Council in December of that year to expand asset purchases. Just as happened a few days ago, a member of the Council had publicly expressed disagreement with that decision; I am not sure that today the disagreement regarding the possible results of that decision would have been expressed quite so forcefully.

I do not think that the comments made by some Governors at the end of the Governing Council meeting were guided by preconceived ideas or by political considerations, as Marcello seemed to think was the case back then, nor were they guided by an abstract division into “hawks” and “doves” as the press sometimes likes to believe. I am sure that these comments reflect the genuine conviction of Council members about the most useful measures for the euro-area economy. However, in the institutional context of the Economic and Monetary Union, it is still important to avoid the risk that, also due to the extemporaneous nature of the remarks made, the positions of the individual Council members be interpreted as an expression of national perspectives or interests, rather than as relating to the area as a whole. For this reason, I believe we all need to work to make our decision-making process as transparent as possible.