

STUDY

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Wait and Watch: Steering Monetary Policy Under Balanced Inflation Risks



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Abstract

This paper summarises the euro-area economic outlook, assesses the ECB's current monetary policy stance, and reviews its policy communication. Inflation is near target and risks surrounding it are broadly balanced, with a mild upside tilt. The ECB's monetary stance is close to neutral: balance sheet normalisation partially offsets easing from recent rate cuts. Communication has evolved in recent years, and the data-dependent, meeting-by-meeting strategy remains appropriate. Clearer reaction-function guidance could help reduce uncertainty about the inflation outlook.

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This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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CONTENTS

LIST OF ABBREVIATIONS	6
LIST OF FIGURES	7
LIST OF TABLES	7
EXECUTIVE SUMMARY	8
1. INFLATION DEVELOPMENTS, OUTLOOK, AND RISKS	9
1.1. Current inflation developments	9
1.2. Inflation outlook	13
1.3. Risks surrounding the inflation outlook	14
2. MONETARY TRANSMISSION DURING THE RECENT RATE CYCLE	17
2.1. Interest rate and balance sheet developments	17
2.2. The current monetary policy stance	19
2.3. Monetary transmission to long-term rates in the recent rate cycle	20
2.4. Bond market fragmentation and monetary policy transmission in the euro area	21
3. ECB COMMUNICATION: CURRENT STRATEGY AND POSSIBLE REFINEMENTS	25
3.1. Forward guidance vs. meeting-by-meeting approach	25
3.2. Communicating the outlook in the face of uncertainty	28
3.3. Analysis of most recent ECB monetary policy statement and account	30
4. CONCLUSION	34
REFERENCES	35
ANNEX	37
A1. HICPX INFLATION OUTLOOK	37
A2. MEASURING THE TONE OF MONETARY POLICY COMMUNICATION	38

LIST OF ABBREVIATIONS

APP	Asset Purchase Programme
CES	Consumer Expectations Survey
DFR	Deposit Facility Rate
ECB	European Central Bank
GDP	Gross Domestic Product
GFC	Global Financial Crisis
HICP	Harmonised Index of Consumer Prices
HICPX	Harmonised Index of Consumer Prices excl. energy, food, tobacco, and alcohol
LTROs	Longer-Term Refinancing Operations
MLF	Marginal Lending Facility
MP	Monetary Policy
MRO	Marginal Refinancing Operations
NCB	National Central Bank
OIS	Overnight Index Swap
PEPP	Pandemic Emergency Purchase Programme
PSPP	Public Sector Purchase Programme
SMA	Survey of Monetary Analysts
SPF	Survey of Professional Forecasters
SMA	Survey of Monetary Analysts
TLTROs	Targeted Longer-Term Refinancing Operations
TP	Term Premium
TPI	Transmission Protection Instrument

LIST OF FIGURES

Figure 1: HICP and its components over time	9
Figure 2: Cross-country dispersion in headline HICP and components	10
Figure 3: Underlying inflation dynamics	11
Figure 4: Economic growth	12
Figure 5: Labour market	13
Figure 6: HICP inflation outlook	14
Figure 7: Inflation momentum in HICP subcomponents	14
Figure 8: Current rate path and expectations	18
Figure 9: Balance sheet path and expectations	18
Figure 10: Financing conditions	19
Figure 11: Long- and short-term rates in the recent policy cycle	21
Figure 12: Sovereign bond market fragmentation and monetary policy transmission	23
Figure 13: Fragmentation in euro area sovereign bond markets	24
Figure 14: Euro area yields and spreads	24
Figure 15: Disagreement and uncertainty about expected long-term inflation	26
Figure 16: Skewness of expected long-term inflation	27
Figure 17: Net trust in the ECB	28
Figure 18: Distribution of monetary policy tone by year	32
Figure 19: Individual Member monetary policy tone heatmap	33
Figure 20: HICPX inflation outlook	37

LIST OF TABLES

Table 1: HICP inflation and its components	9
Table 2: Summary of risks to the inflation outlook	15
Table 3: Instruments used by central banks for communicating monetary policy outlook	29
Table 4: Scores for Topic-Keywords	40
Table 5: Scores for topic-modifiers (selected)	41

EXECUTIVE SUMMARY

- **Inflation has settled at the ECB's 2% target.** Services remain the stickiest driver, keeping core inflation slightly above target. Cross-country dispersion remains more elevated than before the COVID-19 pandemic, reflecting sizable inflation differentials not only for energy, but also for food and services.
- **Most signals point to inflation hovering close to target in the near term.** Services momentum is still firm, but wage growth is easing, and the earlier energy drag has largely faded—consistent with stable near-term inflation.
- **Risks are roughly balanced with a slight upward tilt.** Fiscal policy, trade frictions, and energy reflect upside risks; a firmer euro and softer global demand lean the other way. Cooling labour markets and easing wage growth also provide some disinflationary pull.
- **A series of eight consecutive rate cuts ended in June 2025.** Markets and analysts now expect a broadly flat rate path, while the balance-sheet run-off continues, partly offsetting the accommodation from lower policy rates.
- **The ECB's policy stance is near neutral, but overall financial conditions remain somewhat tight.** Corporate borrowing costs have declined considerably, yet pass-through to households and sovereigns is incomplete, leaving financial conditions only gradually loosening.
- **Longer-term yields remain sticky as higher term premiums offset declining rate expectations.** Policy surprises faded quickly beyond announcement windows. Sovereign bond market fragmentation may have lowered the effectiveness of ECB policy at the beginning of the tightening cycle but has since receded.
- **The ECB's communication remains broadly appropriate in a high-uncertainty environment.** The shift to a data-dependent, meeting-by-meeting approach supports credibility and avoids premature commitments while policymakers and markets digest mixed signals.
- **There is scope for clearer guidance on the reaction function.** Providing greater transparency on the preferred measurement of key economic variables, the persistence of underlying inflation, and the strength of the policy transmission would strengthen the framework-guidance approach and help anchor expectations in a data-dependent, meeting-by-meeting regime.
- **Communication tone is broadly neutral with a mild dovish tilt.** Official ECB statements following monetary policy decisions and associated monetary policy accounts remain balanced while speeches of Governing Council members indicate a moderate dispersion of views.

1. INFLATION DEVELOPMENTS, OUTLOOK, AND RISKS

In this section, we first describe recent dynamics in headline and underlying inflation as well as their divergence across member countries. We then evaluate the outlook for inflation and discuss upside and downside risks surrounding the current outlook.

1.1. Current inflation developments

Euro area headline inflation, based on the harmonised index of consumer prices (HICP), remained unchanged at 2.0% in August 2025, the same as in July 2025. With inflation stabilising around the ECB’s medium-term target (2%), the disinflationary trend that began in late 2022 appears to have largely run its course. The most recent estimates are reported in Table 1.

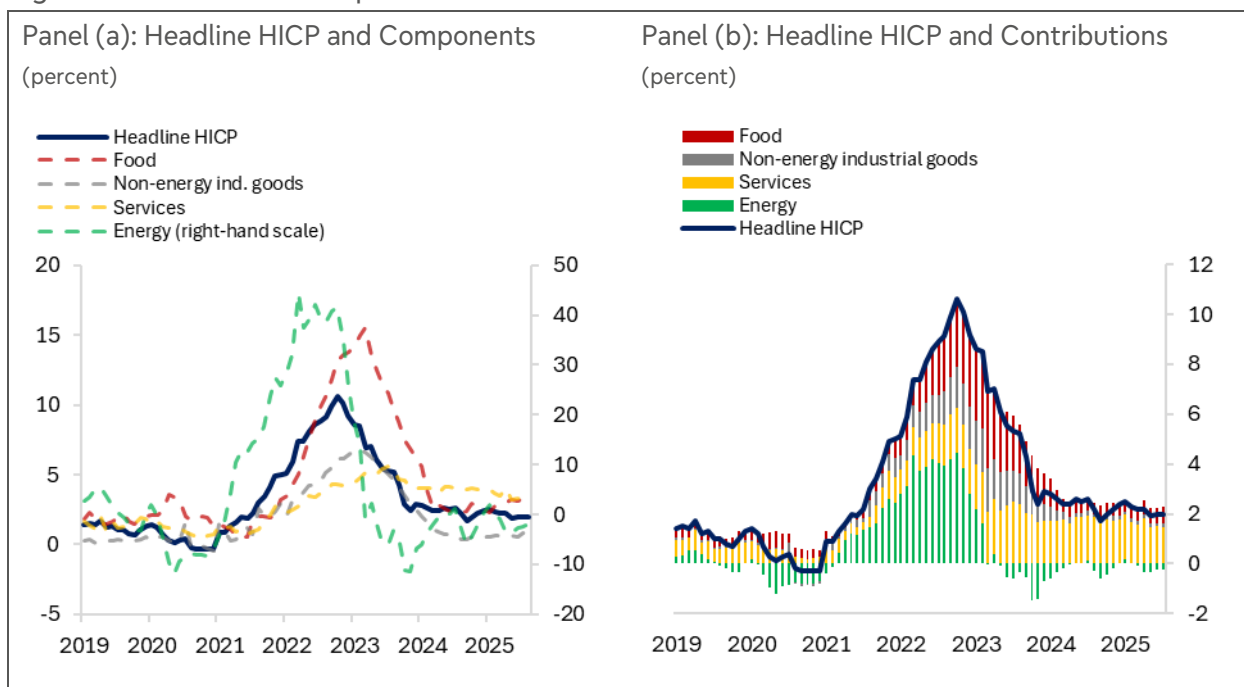
Table 1: HICP inflation and its components

	August 2025 (percent)	July 2025 (percent)	Δ M-o-M (percentage points)	Δ Y-o-Y (percentage points)	Δ YTD (percentage points)
Headline HICP	2.0	2.0	0.0	-0.2	-0.5
Food incl. alcohol and tobacco	3.2	3.3	-0.1	0.9	0.9
Non-energy industrial goods	0.8	0.8	0.0	0.4	0.4
Energy	-2.0	-2.4	0.5	1.0	-3.9
Services	3.1	3.2	-0.1	-1.0	-0.8

Source: Eurostat. Δ M-o-M and Δ Y-o-Y refers to the month-on-month and year-on-year change, respectively. Δ YTD refers to the year-to-date change, i.e. the cumulative change between January and August 2025.

The sustained decline in headline inflation since 2022 primarily reflects the easing of supply chain bottlenecks—visible in the muted price dynamics of non-energy industrial goods—and a sharp correction in energy prices. Energy price inflation stood at -2.0% in August 2025, contributing roughly -0.2 percentage points to headline HICP inflation (see Figure 1b). Additional disinflationary forces included weaker GDP growth and a slowdown in nominal wage growth, which are discussed in more detail below.

Figure 1: HICP and its components over time



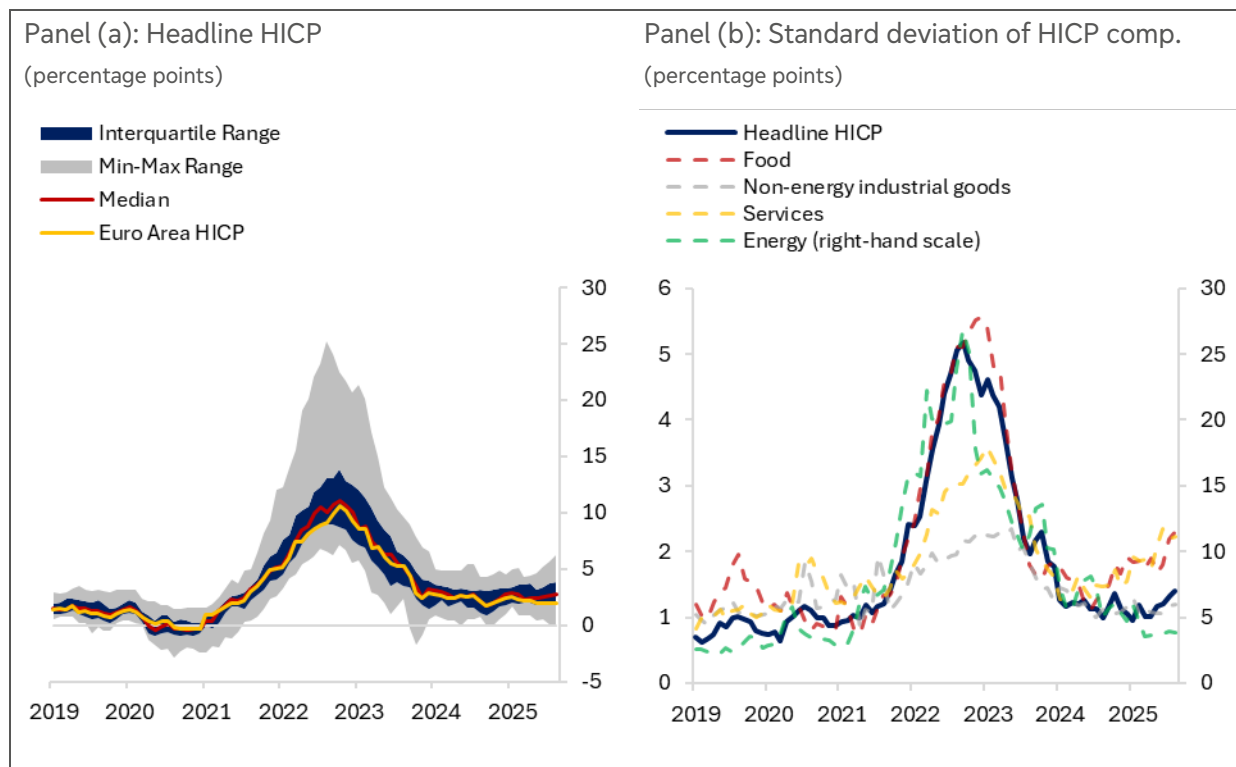
Source: Eurostat. Last observation: August 2025.

Despite the overall moderation, inflation pressures remain uneven across sectors. Food inflation registered at 3.2% in August, only marginally lower than in July, and services inflation was similarly stable at 3.1%. This persistence underscores the heterogeneity of the disinflation process. Compared to December 2019, food inflation is still 1.2 percentage points higher, adding 0.2 percentage points more to headline HICP than before the Covid-19 crisis (see Figures 1a and 1b). Services inflation continues to display the greatest stickiness: it now contributes 1.4 percentage points to overall HICP, around 0.6 percentage points above its pre-pandemic level, and remains the single most important driver of current inflation.

The dispersion of inflation rates across euro area member states has remained relatively stable since early 2024 (see Figure 2a). Nevertheless, heterogeneity remains sizeable: in August, headline HICP inflation ranged from 6.2% in Estonia to 0% in Cyprus. The interquartile range, a more robust indicator of cross-country variation, stood at 1.5 percentage points, still noticeably above its pre-pandemic average.

As shown in Figure 2b, dispersion is not confined to a single sector but is evident across the main HICP components. Cross-country differences are most pronounced in energy prices (right axis), where the standard deviation of national inflation rates reached 3.8 percentage points. The dispersion of food and services inflation also remains substantially more elevated than before the pandemic, while it is around its pre-pandemic level in non-energy industrial goods. These patterns underscore that, while headline inflation has converged towards the medium-term target, national dynamics remain heterogeneous.

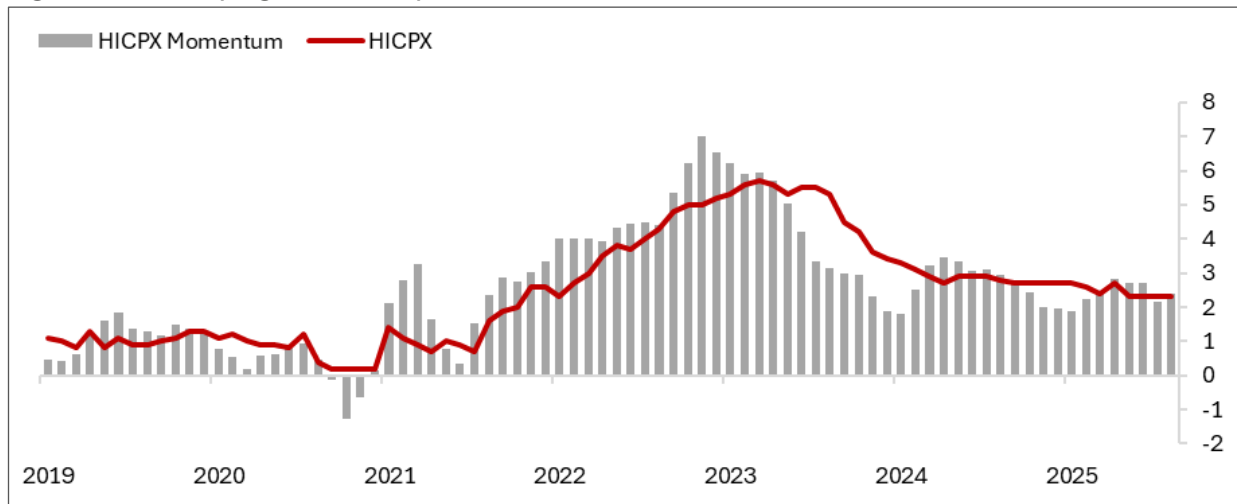
Figure 2: Cross-country dispersion in headline HICP and components



Source: Eurostat and authors' calculations. Last observation: August 2025.

Underlying inflation has broadly declined in tandem with headline inflation. The most widely used indicator, core inflation (HICPX)—which excludes energy, food, alcohol and tobacco—stood at 2.3% in August 2025, unchanged since May (see Figure 3). This stability indicates that while the sharp disinflationary impulse from energy and goods has faded, underlying price pressures remain contained but persistent.

Figure 3: Underlying inflation dynamics

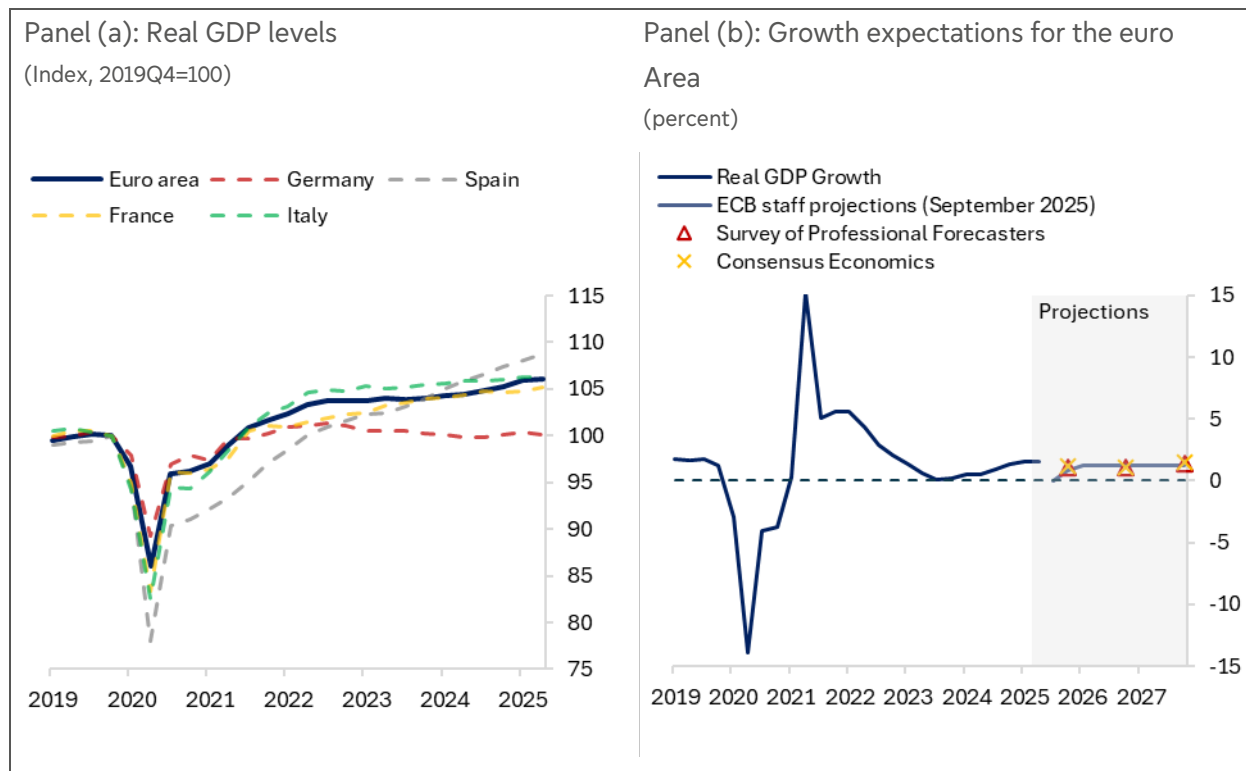


Source: Eurostat, ECB, and authors' calculations. HICPX: HICP excluding the most volatile items, i.e. food, energy, tobacco and alcohol. HICPX Momentum: annualised three-month-over-three-month change in the HICPX. Last observation: August 2025.

Cross-country differences in core inflation are somewhat narrower than for headline inflation. In August, HICPX inflation ranged from 7.1% in Estonia to 1.4% in France, with an interquartile range of 1.4 percentage points, underscoring that national divergences, while still present, have moderated relative to the peak of the inflation surge.

High-frequency dynamics provide additional insight into the short-term inflation path. HICPX momentum, defined as the annualised rate of the three-month-over-three-month change in seasonally adjusted HICPX, stood at 2.4% in August. This implies that annual core inflation would stabilise around current levels if recent trends persisted. Taken together, the evidence points to a decline in underlying inflation compared with the 2022–23 peak, but also to a stabilisation slightly above 2%, suggesting that persistent domestic price pressures have not fully subsided.

Figure 4: Economic growth



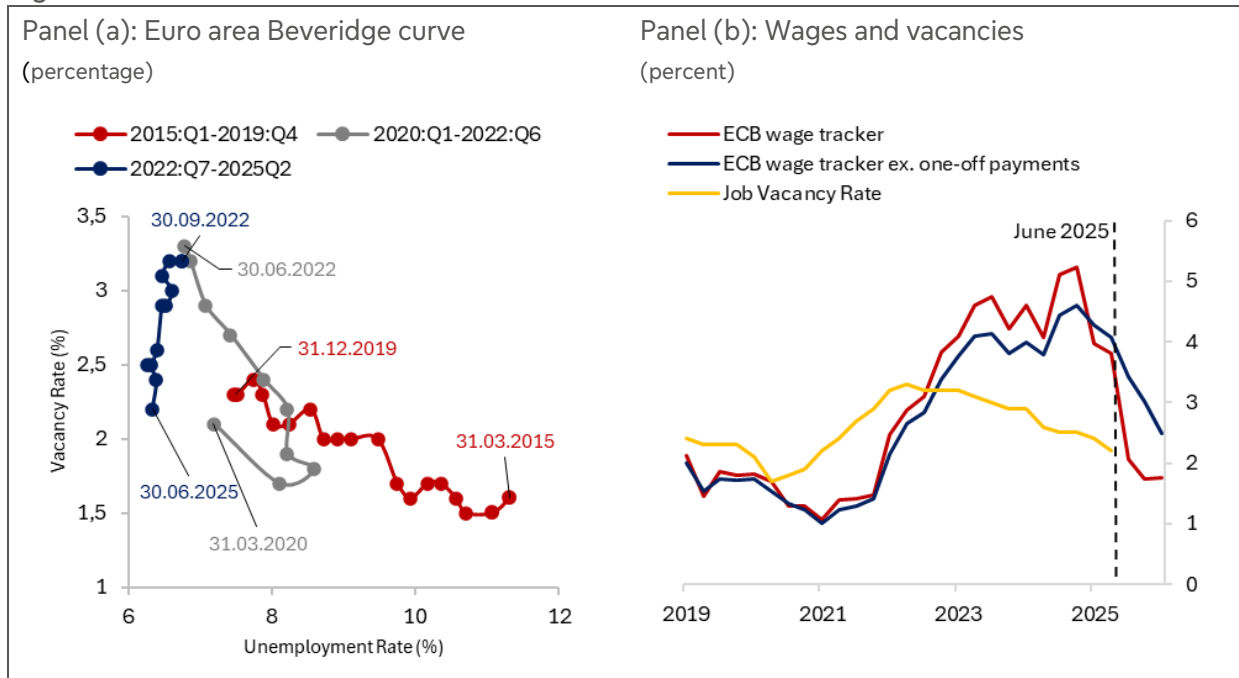
Source: Eurostat, ECB staff macroeconomic projections (September 2025), and authors' calculations.

Real activity remains consistent with a stable-inflation backdrop. Year-on-year real GDP growth has firmed over the past year but is still modest (see Figure 4). Cross-country dispersion is notable: Spain continues to expand steadily, whereas Germany's output is roughly unchanged relative to its pre-pandemic level (see Figure 4a), as also pointed out in the recent report of the Euro Area Business Cycle Dating Committee (CEPR-EABCN, 2025). Looking ahead, both ECB staff and professional forecasters expect only modest real GDP growth over the next two years (see Figure 4b).

The euro-area Beveridge curve—vacancies (y-axis) versus unemployment (x-axis)—shifted up-and-left between 2019:Q1 and 2022:Q2, indicating greater tightness of the labour market (a higher vacancy-to-unemployment ratio). Since the beginning of the recent rate cycle in the summer of 2022, vacancies declined sharply while unemployment changed little, pointing to softer labour demand (see Figure 5a). Consistent with this, negotiated wage growth in the ECB's wage tracker is easing (see Figure 5b),¹ and ECB staff currently projects the growth of compensation-per-employee to slow from an average 3.2% in 2025 to 2.8% in 2026 and 2027, as one-off inflation-compensation effects fade.

¹ The ECB's "wage tracker" uses active collective bargaining agreements to provide a signal about negotiated wage growth. Since many of these agreements are signed in advance and/or stipulate future wage changes, the "wage tracker" can offer insight into future negotiated wage growth rates. That said, it should not be interpreted as a forecast of future wage growth.

Figure 5: Labour market



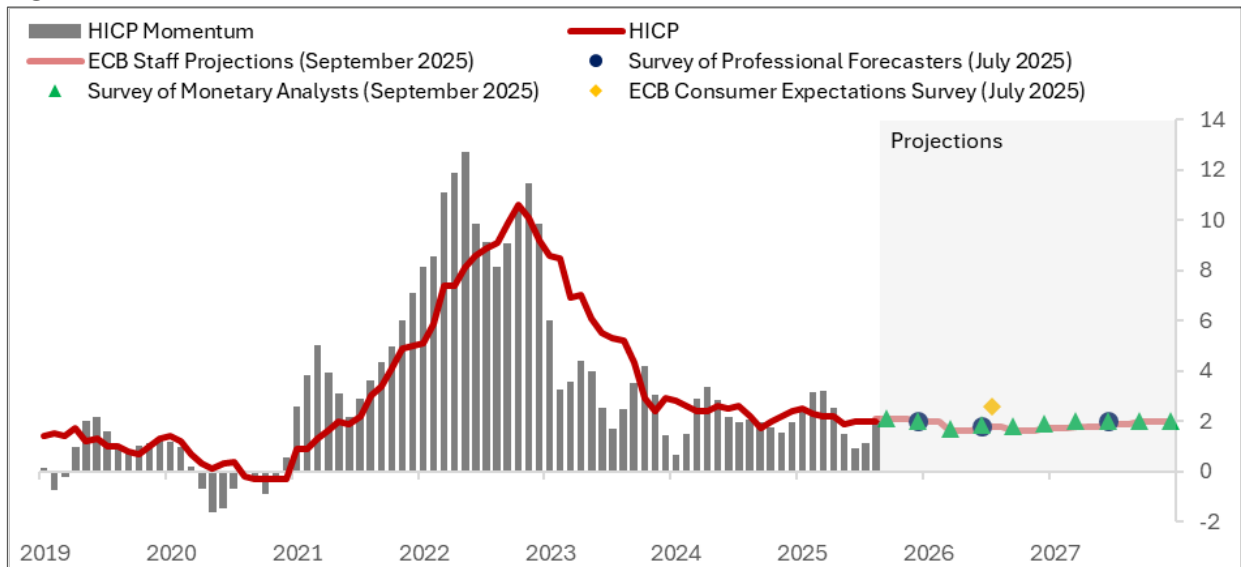
Source: Eurostat and author's calculations. Vacancy rate (JVR) is defined as: $JVR = \text{number of job vacancies} / (\text{number of occupied posts} + \text{number of job vacancies}) * 100$.

1.2. Inflation outlook

Looking ahead, the major indicators point to headline inflation fluctuating in a narrow band around 2% over the next two years (see Figure 6). The 2025:Q3 Survey of Professional Forecasters (SPF) puts HICP inflation at 1.8% in 2026, 2.0% in 2027, and 2.0% in the longer term—closely aligned with both the September 2025 Survey of Monetary Analysts and the ECB staff projections. Consumer expectations for the next 12 months are only slightly higher at 2.6% as of July 2025. Consistent with these medium-term readings, HICP momentum—the annualised three-month-over-three-month rate—currently sits at 2.0%.

The underlying-inflation outlook is similar (see Annex A1). The 2025:Q3 SPF expects HICPX at 2.0% in 2026 and 2027 and in the longer term. Market experts surveyed in the ECB's September 2025 Survey of Monetary Analysts report median expectations for HICPX inflation of 2.2%, 1.9%, and 2.0% at the end of 2025, 2026, and 2027, respectively. These survey expectations are in line with the September 2025 ECB projections, which foresee HICPX easing to 2.2% by end-2025, 1.8% by end-2026, and 1.9% by end-2027. Taken together, the evidence suggests the disinflation phase has largely run its course, with inflation stabilising close to target.

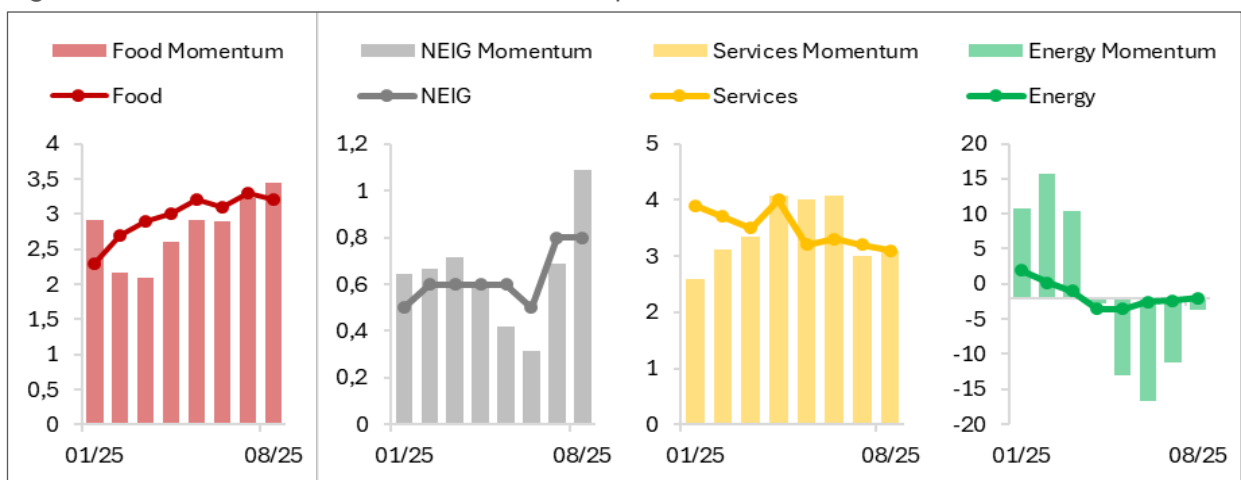
Figure 6: HICP inflation outlook



Source: Eurostat and authors’ calculations. ECB staff projections refer to the September 2025 exercise. HICP Momentum refers to the annualised three-month-over-three-month change in the HICP. Last observation: August 2025.

Turning to momentum by HICP subcomponent (see Figure 7), the short-term dynamics are mixed. Services momentum has edged down since spring but remains near 3%, signalling persistent domestic cost pressures. Food and non-energy industrial goods show a renewed build-up in momentum—reflecting earlier monthly gains—even as the August MoM readings eased slightly. By contrast, the deflationary impulse from energy has faded: energy momentum has moved towards zero from deeply negative readings earlier in the year. We discuss risks to this baseline in the next subsection.

Figure 7: Inflation momentum in HICP subcomponents



Source: ECB and authors’ calculations. Momentum refers to the annualised three-month-over-three-month change in the respective HICP component. Note that while the first three subfigures are based on seasonally adjusted data provided by the ECB, energy momentum is adjusted for seasonality by the authors. Last observation: August 2025.

1.3. Risks surrounding the inflation outlook

In this section, we assess the balance of risks to euro-area inflation over the next 12–18 months. Our focus is on cyclical risks, rather than longer-term risks arising from structural factors such as demographics or climate change.

We focus on five broad sources of risk:

- (i) fiscal policy and sovereign risk,
- (ii) the exchange rate and global monetary spillovers,
- (iii) trade policy,
- (iv) energy, and
- (v) labour markets.

We discuss each category in turn and summarise our findings in Table 2. Uncertainty is elevated and two-sided: several channels are multifaceted and can flip sign depending on the persistence of shocks and which sub-components dominate. Overall, we conclude that the balance of risks is broadly even, with a slight tilt to the upside.

Table 2: Summary of risks to the inflation outlook

Sources of risk	Overall assessment
Fiscal policy and sovereign risk	++/-
Exchange rate and global monetary spillovers	-
Trade policy	++/-
Energy	+
Labour markets	o/-

Note: Assessments reflect our view of risks to euro area inflation. Symbols indicate direction and balance of risks: + (upside), - (downside), o (neutral). Combinations (e.g. ++/-) denote two-sided risks with the first sign indicating the dominant side.

Fiscal Policy and Sovereign Risk. Across Europe, defence and infrastructure spending is rising. The activation of national escape clauses for defence and related priority investments—together with additional flexibility under the reformed EU fiscal rules and EU-level financing instruments—is likely to add contained but noticeable upward pressure on prices in the near term. Germany is a clear example: higher defence outlays and multi-year programmes for rail, energy grids and digital infrastructure may lift prices where capacity in construction or specialised manufacturing is binding. Over time, the effect could turn disinflationary if projects raise potential output and cut logistics and energy costs. On the sovereign side, stress has been most visible in France in recent weeks: the 10-year OAT–Bund spread (France minus Germany) is near multi-year highs and the rating agency Fitch recently downgraded France to ‘A+’ from ‘AA-’, while other country spreads remain contained. For inflation, the sign of the sovereign channel is two-sided: wider spreads tighten financial conditions and cool demand, but they can also weaken the euro and raise import prices if risk sentiment sours. Over the next 12–18 months, fiscal plans point to a modest upside tilt. Sovereign risk mainly matters if it negatively affects financing conditions in some member states or weakens the euro.

Exchange Rate and Global Monetary Spillovers. The euro has appreciated on a trade-weighted basis, supply-chain pressures are normal, and non-energy import prices are subdued, all of which lean against imported inflation. With the Federal Reserve expected to cut policy rates while the ECB is on hold, relative rate expectations may favour some further strengthening of the euro and lower dollar-priced import costs, reinforcing the disinflationary tilt. Higher global sovereign yields and episodes of rate volatility continue to tighten financial conditions and cool external demand and investment, adding a demand-side drag. This channel would turn upside only with a persistent euro depreciation or a material rebound in global goods or energy prices. In the longer run, institutional risk to the Federal Reserve

could weaken the dollar if its credibility were durably impaired, further reducing euro-area import prices even as the financial-conditions drag persists. On balance, we see a downward tilt for inflation risk over the next year (2026).

Trade Policy. The United States' broader tariffs raise import prices in the US. Past experiences suggest that most of this burden sits with US importers, so the direct price channel for the euro area is limited and the impact works mainly via weaker external demand and margin pressure. EU–China trade relations, most visibly on electric vehicles and batteries, selective retaliatory measures, and occasional disruptions to major shipping lanes may lift euro area input costs and push firms toward diversifying their production network. Currently, supply-chain pressures are subdued, but if these frictions re-intensified, contracts and logistics would get repriced, and the cost-push effect would leak into core inflation over time. On the other hand, diversion of Chinese exports toward Europe could lower goods prices, partly offsetting cost pressures. On balance, we expect this channel to be modestly inflationary over the next year, with a downside tail risk if redirected supply intensifies competition in euro-area goods markets.

Energy. Energy pass-through to headline inflation is generally fast and sizable, with indirect (second-round) spillovers to core via transport, utilities, and energy-intensive inputs. In recent quarters, energy—and to a lesser extent food—has been a major driver of disinflation as European gas and power prices fell from crisis peaks. Risks are currently tilted to the upside given the geopolitical backdrop, where regional conflicts could deliver large positive shocks to global energy markets.

Labour Markets. Euro area labour markets are currently close to neutral, with moderate downside risks for inflation. The vacancy–unemployment mix has softened: vacancies have fallen back while unemployment is broadly unchanged, and negotiated wage growth is easing, with staff projections pointing to a further step-down in compensation per employee growth next year. On that basis, services inflation should gradually decelerate further rather than re-accelerate.

2. MONETARY TRANSMISSION DURING THE RECENT RATE CYCLE

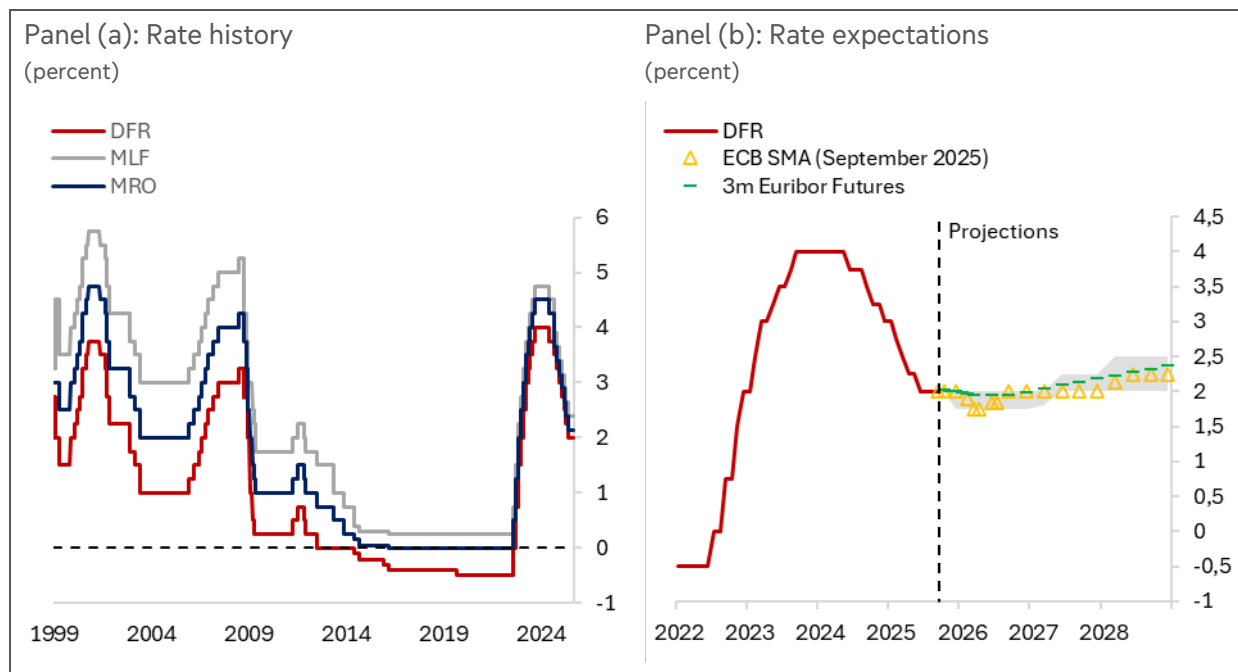
2.1. Interest rate and balance sheet developments

Following the historically steep hiking cycle of ten consecutive rate increases between July 2022 and September 2023 and a short period of elevated but stable policy rates, the ECB started to ease monetary conditions in the summer of 2024, see Panel (a) of Figure 8 below. With eight rate cuts between June 2024 and June 2025, the Governing Council reduced the deposit facility rate (DFR) from 4% to 2%. In their meetings in July and September 2025, the ECB decided twice to keep its benchmark rates unchanged and not to provide concrete guidance about future rate decisions. As will be further discussed in Section 3, this decision reflects the ECB's assessment that the disinflation process has now largely been completed, that risks to economic growth have become more balanced, and that inflation expectations are currently well anchored around the two percent target. In the words of ECB President Lagarde, the ECB remains "in a good place" regarding the inflation outlook.²

This assessment by the ECB is largely mirrored in market- and survey-based rate path expectations, see Panel (b) of Figure 8. Both the median response in the ECB's Survey of Monetary Analysts (SMA) and three-month Euribor futures imply a flat interest rate path over the next one to two years. Importantly, in July 2025, the surveyed analysts still expected one more rate cut this year, which, however, did not materialize. As indicated by the interquartile range of rate expectations, there is relatively little disagreement about this rate path among the surveyed analysts. This may seem somewhat surprising as the uncertainty around the inflation outlook remains elevated (see Figure 15b below), and the ECB is not committing to any rate path but instead follows a data-dependent meeting-by-meeting approach.

² See the transcript of the press conference following the Governing council meeting on September 11, 2025: https://www.ecb.europa.eu/press/press_conference/monetary-policy-statement/2025/html/ecb.is250911~a13675b834.en.html#qa

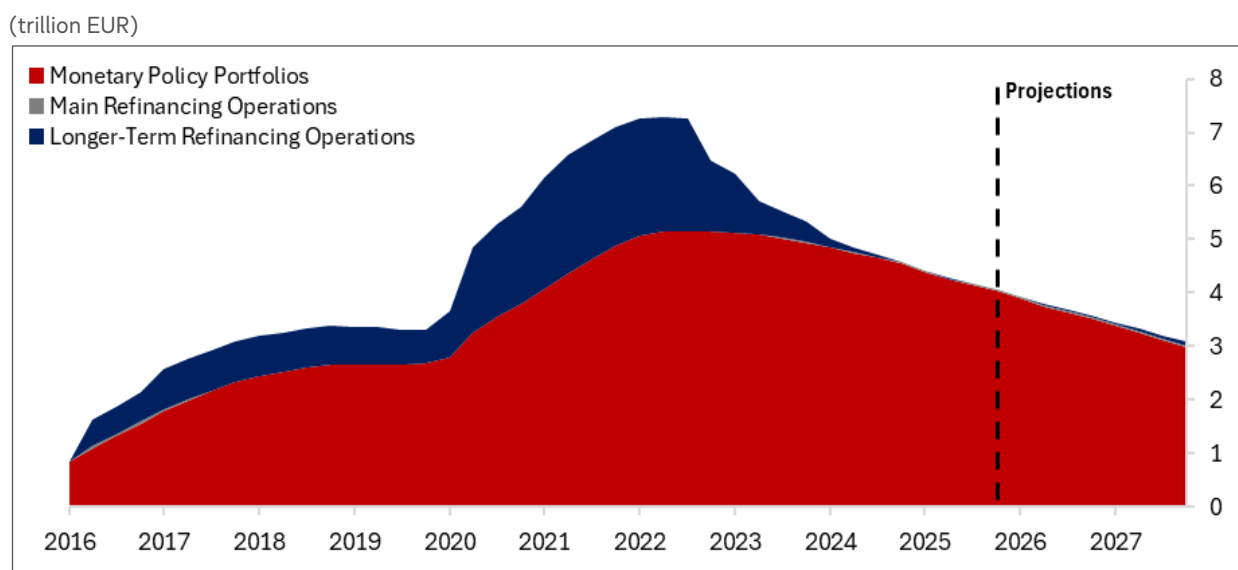
Figure 8: Current rate path and expectations



Source: LSEG Datastream, ECB, and authors' calculations. Last observation: 12 September 2025. ECB SMA refers to the median expectations reported in the September 2025 wave of the ECB's Survey of Monetary Analysts (SMA). The shaded area shows the interquartile range of expectations reported by analysts in the SMA. The 3-month Euribor futures are as of 11/09/2025.

The reduction of policy rates has been accompanied by a steady unwinding of the Eurosystem monetary policy portfolios, following the end of reinvestments under the APP and the PEPP, and a phase-out of targeted longer-term refinancing operations (TLTROs), see Figure 9. In September 2025, median analyst expectations saw the monetary policy portfolios continuing their decline from about 4.15 trillion EUR in September 2025 to around 2.99 trillion at the end of 2027.

Figure 9: Balance sheet path and expectations



Source: ECB and authors' calculations. Last observation: June 2025. For projections, the balance sheet is expected to evolve in line with the median expectations across monetary analysts in the ECB September 2025 SMA.

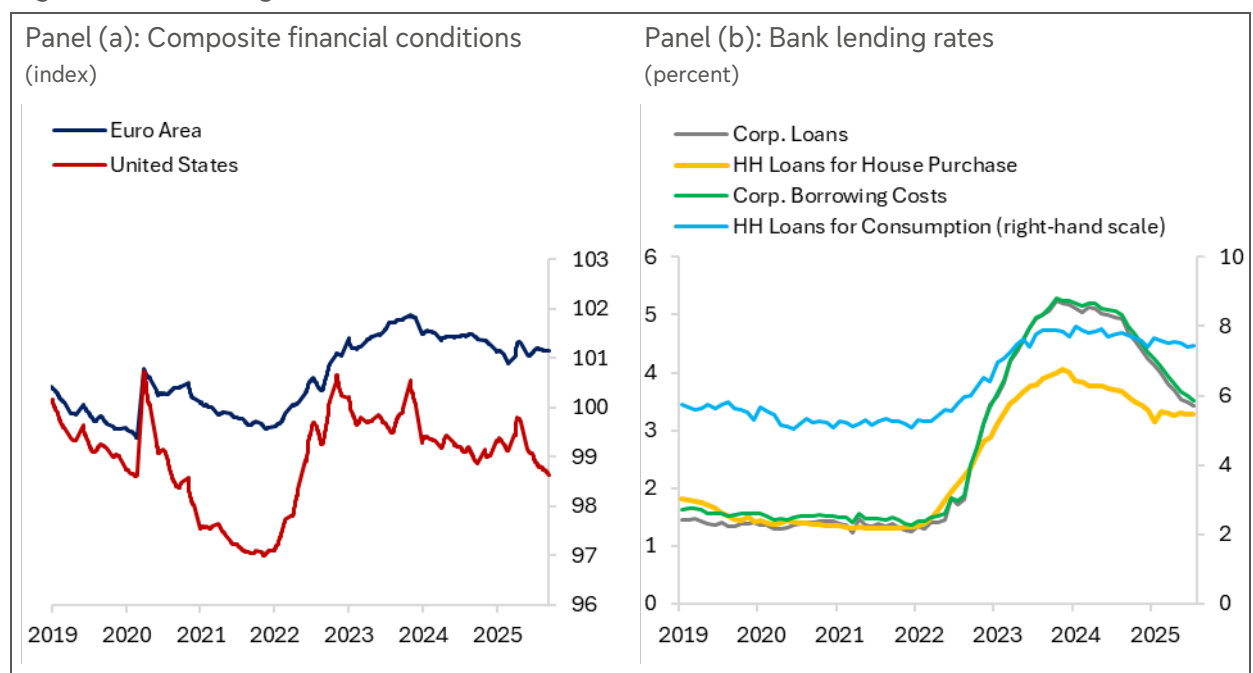
2.2. The current monetary policy stance

An assessment of the current monetary policy stance in the euro area needs to consider both the prevailing and expected path of ECB policy rates as well as its balance sheet size. While the policy rate increases and the balance sheet drawdown moved largely in sync during the 2022–2024 hiking cycle, they have not done so in the subsequent easing cycle. In this cycle, lower short-term interest rates may be partially offset by the ongoing balance sheet reduction. As the Eurosystem continues to withdraw from the euro area sovereign debt markets, monetary conditions do not only reflect policy rate changes.

The ECB's current monetary stance is largely in neutral territory. The DFR and expected inflation are both at 2%. This implies a real policy rate of zero, which is close to common measures of the non-accelerating inflation rate of interest, also often referred to as “*r-star*”.³ That said, some indicators imply a mild tightening tilt. While broad-based financial conditions have been easing over the past year, they are still slightly above their historical average (see Figure 10a).⁴ Compared to the United States, euro area financial conditions remain somewhat restrictive, likely owing to the currently strong euro vis-à-vis the euro area's major trading partners.

Corporate borrowing costs have declined in lockstep with policy rates to around 3.5% from their peak of 5.25% reached in October 2024. That said, bank lending rates to households for home purchases and consumption purposes have only declined by about 80 and 50 basis points, respectively, over the same period. Overall, despite some easing, financing conditions thus remain somewhat restrictive relative to those seen in the pre-pandemic period (see Figure 10b). This raises the question whether the latest monetary easing period has fully achieved the transmission to broad-based financing conditions that the ECB intended.

Figure 10: Financing conditions



Source: Goldman Sachs, ECB, and authors' calculations. For Panel (a), the last observation is from 15 September 2025. For Panel (b) the last observation is from July 2025.

³ See for example here: <https://www.newyorkfed.org/research/policy/rstar>.

⁴ We thank Jari Stehn and colleagues at Goldman Sachs for sharing these data with us.

In the next subsection, we show that rates on longer-dated risk-free bonds did not decline nearly as much as policy rates during the recent easing cycle. As a result, financing conditions remain elevated relative to what one might have expected given the sharp decline in short-term rates.⁵

2.3. Monetary transmission to long-term rates in the recent rate cycle

In this section, we assess the transmission of monetary policy to long-term rates during the most recent rate cycle. Panel (a) of Figure 11 shows the path of the deposit facility rate since 2022. As a benchmark measure of longer-term risk-free interest rates in the euro area, we superimpose the 10-year Bund yield. This captures the rate that the German federal government can lock in for ten years when it borrows in the capital markets. The Bund yield started to rise well before the ECB first raised policy rates in July 2022. This clearly shows that bond investors had been anticipating the monetary tightening for some time. However, once the tightening cycle was underway, longer-term yields remained fairly flat. Furthermore, they moved little when the ECB paused its rate hikes and did not decline any further when it lowered policy rates beginning in June 2024.

The reason for this disconnect between the policy rate and long-term yields is that the term premium (TP) on longer-dated sovereign debt increased during the same period. The term premium, shown as the grey line in the figure, is an estimate of the risk compensation investors demand for holding longer-dated government bonds. It depends on investors' risk perceptions about the future policy path, inflation dynamics, fiscal policy, and changes in the demand for government debt, among other things. As the ECB continues to reduce the size of its balance sheet, this likely exerts some upward pressure on the term premium.

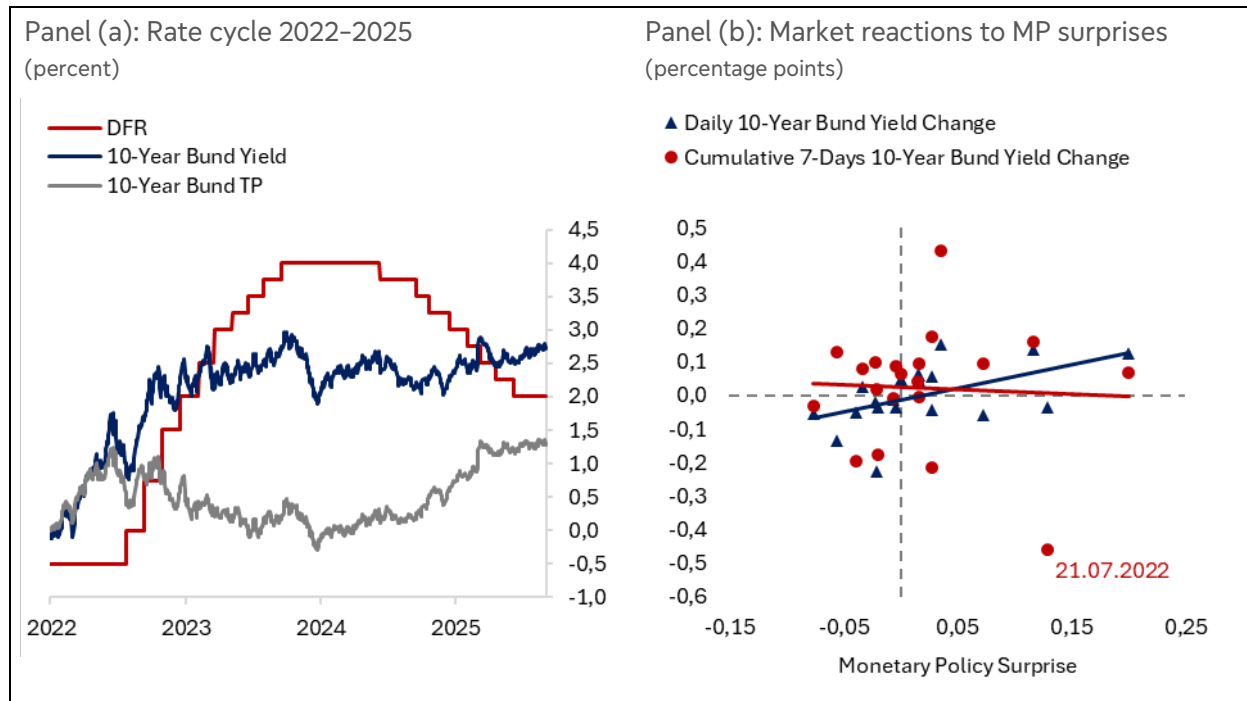
Yields on longer-dated government debt can be decomposed into the term premium and the market's expected path of policy rates. The chart shows that the wedge between the 10-year Bund yield and the term premium started to narrow around the beginning of 2024. This is consistent with market participants correctly anticipating the easing cycle that began six months later. However, the figure also suggests that longer-term financing conditions have remained quite sticky in the most recent rate cycle due to a simultaneous increase in the term premium. As a result, borrowing costs for households and firms—which often comove strongly with those of the government—have not improved as much as one might expect given the substantial decline in policy rates since mid-2024.

One can also illustrate the disconnect between the ECB's policy decisions and longer-term yields in the recent rate cycle by plotting the bond market's response to policy surprises in short windows around the ECB's announcements. These surprises are computed as the first principal component of several short-dated interest rate futures in a short window around the ECB announcement.⁶ Panel (b) of Figure 11 shows that the 10-year Bund yield around ECB announcements broadly comoves with the surprise component of the rate decision on the same day. However, the relationship essentially reverses when considering 7-day cumulative yield changes from one day before to six days after the announcement. This implies that surprise policy tightening and easing decisions have not had a persistent impact on longer-dated yields in the recent cycle.

⁵ This measure is based on the model by Adrian, Crump, and Moench (2013). We thank Tobias Adrian and team at the IMF for sharing these estimates.

⁶ Specifically, we rely on the monetary policy surprise measure by Jarociński and Karadi (2020) which has been obtained from Marek Jarociński's website: <https://marekjarocinski.github.io/jkshocks/jkshocks.html>.

Figure 11: Long- and short-term rates in the recent policy cycle



Source: IMF, LSEG Datastream, ECB, and authors' calculations. The monetary policy surprises are computed as the first principal component of changes in the 1-month to 1-year overnight indexed swap rate (OIS) in a narrow window around the monetary policy event, incl. both the press release and the subsequent press conference. Last observation: 04/09/2025.

Looking at some individual influential observations in this relationship reveals that yields even declined in the seven days following some tightening announcements. A notable case in point is the ECB decision to lift-off the effective lower bound on 21 July 2022. On that date, the central bank announced a 50-basis-point increase in its policy rates. This was the first rate hike in many years and came as a surprise, as many market participants had interpreted ECB communications as indicating only a 25-basis-point increase. Despite this hawkish signal, however, longer-term rates declined in the following days. A likely reason is the simultaneous announcement of the ECB's Transmission Protection Instrument (TPI): a conditional, secondary-market purchase program designed to address "unwarranted, disorderly market dynamics." This announcement was effectively interpreted as a cap on longer-term rates in fiscally weaker euro area member states. However, as the chart shows, it may also have put downward pressure on Bund yields.

The ECB's main motivation behind the introduction of the TPI was to ensure that the monetary policy stance was transmitted evenly across all euro area countries. Whether a potential unintended side effect of this new policy tool is a lower sensitivity of longer-term rates to changes in short-term policy rates is an open question. In the next section, we discuss to what extent the effectiveness of ECB monetary policy indeed depends on the fragmentation of euro area government bond markets.

2.4. Bond market fragmentation and monetary policy transmission in the euro area

Although the financing conditions of euro area governments clearly depend on the ECB's monetary stance, they are also influenced by a host of other factors. For example, yield differences across euro

area government bond markets should reflect investors' differential perceptions of the debt sustainability across countries. As such, these differences often respond to changes in the fiscal outlook or to episodes of political instability.

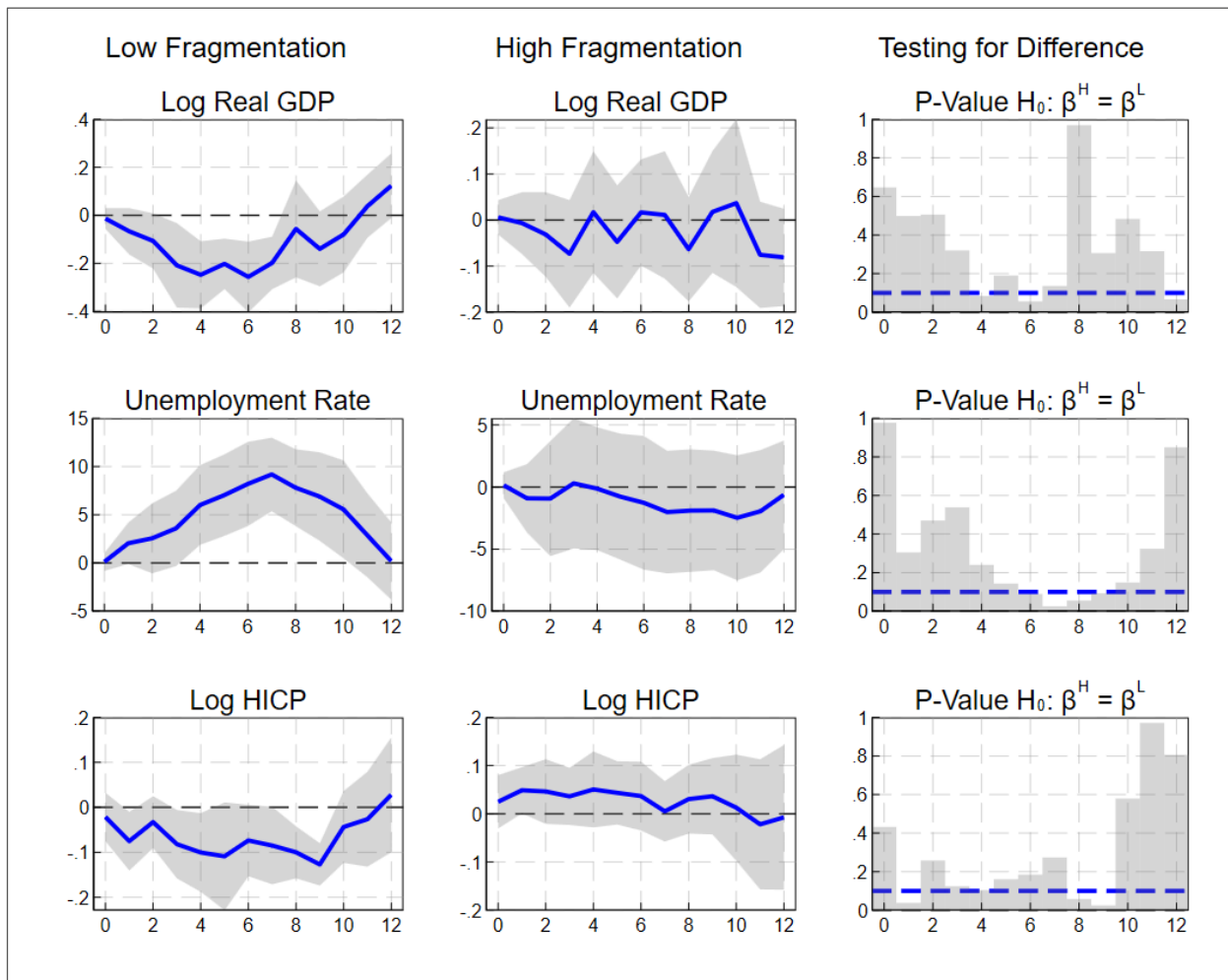
During the sovereign debt crisis of 2011, when yield spreads spiked to historical highs, tremendous strain was put on euro area governments. Ultimately, this led to several changes in the euro area's institutional design. Such divergence of financial conditions across euro area member states matters not only for Europe's long-term economic growth and competitiveness prospects, but it is also a chief concern for monetary policy makers. The stated reason is that fragmented sovereign bond markets in the euro area can distort the smooth transmission of a common monetary policy across member states, which is generally considered a precondition for the ECB to deliver on its price-stability mandate.

Figure 12, taken from recent research by Horn and Moench (2025), shows that sovereign bond market fragmentation—measured as the dispersion of sovereign yields across euro area member countries—indeed weakens the transmission of monetary policy to inflation and the real economy.

During periods of high euro area bond market fragmentation, identified monetary policy shocks have a significantly smaller effect on the economy than in times of low fragmentation. The results are based on the methodology employed, among others, by Tenreyro and Thwaites (2016), Ramey and Zubairy (2016) and Born et al. (2020) to study non-linear effects of monetary and fiscal policies. Sovereign bond market fragmentation is measured following Hoffmann et al. (2020).⁷

⁷ Specifically, we measure sovereign bond market fragmentation using the price-based sub-index for bond markets by Hoffmann et al. (2020) maintained and regularly updated by the ECB.

Figure 12: Sovereign bond market fragmentation and monetary policy transmission

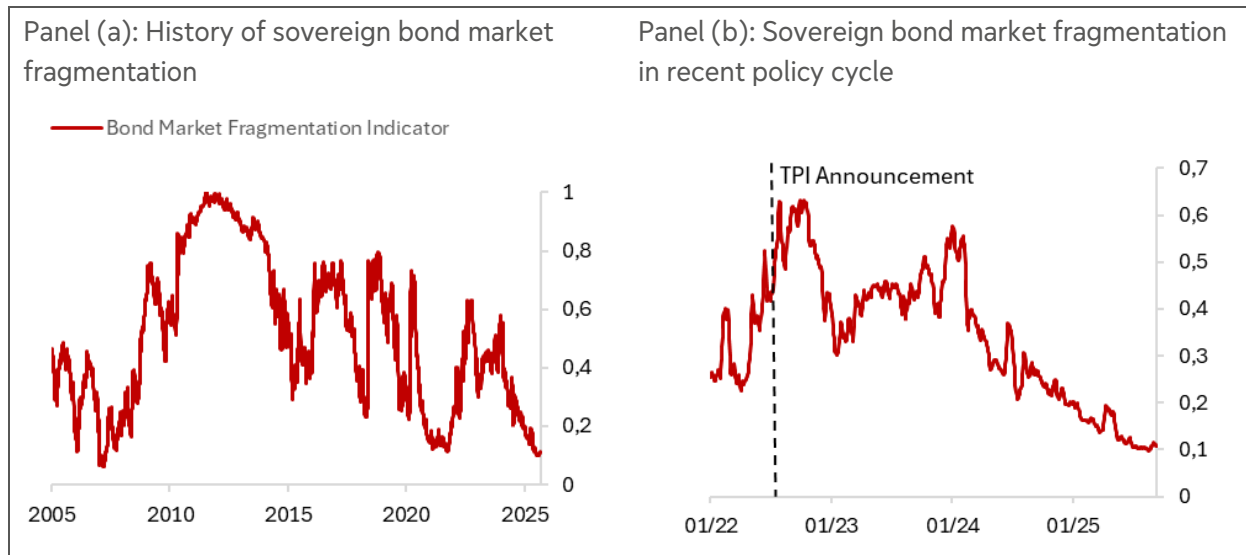


Source: Horn and Moench (2025). The figure shows impulse response functions to a 100 basis points monetary policy shock conditional on the state of sovereign bond market fragmentation. Shaded areas represent 90% confidence bands. Magnitudes on the y-axis are expressed in log differences. The x-axis refers to quarters following the shock. The IRFs are obtained from state-dependent linear local projections. The monetary policy shock series is obtained from Jarociński and Karadi (2020).

As Figure 13 shows, measured bond market fragmentation was elevated at the beginning of the recent rate hiking cycle. Considering the above results, this may have contributed to the weak transmission of ECB policy during the early stages of the rate cycle. Since early 2024, however, fragmentation has declined and is now comparable with pre-GFC levels. This decline is consistent with the evolution of 10-year yields in the four largest euro area countries (see Figure 14). While these countries all experienced a steep increase in yields at the beginning of 2022, yields have largely moved sideways since the ECB began its rate hiking and easing cycle, including the announcement of the TPI in July 2022 (see Figure 13b).

These common trends and low dispersion mask some interesting cross-country differences. Panel (b) of Figure 14 shows that, except for France, yield spreads with respect to the benchmark German Bunds have declined since the beginning of this year. This likely reflects Germany's large fiscal expansion and reform of its debt brake announced in March 2025. The sharp increase in the French spread is mainly due to political instability and a weak fiscal outlook in France. The stable development of the Spanish yield, which fell below the French yield for the first time in September 2024, likely reflects the country's steady economic outlook and fiscal situation, as discussed in Section 1.

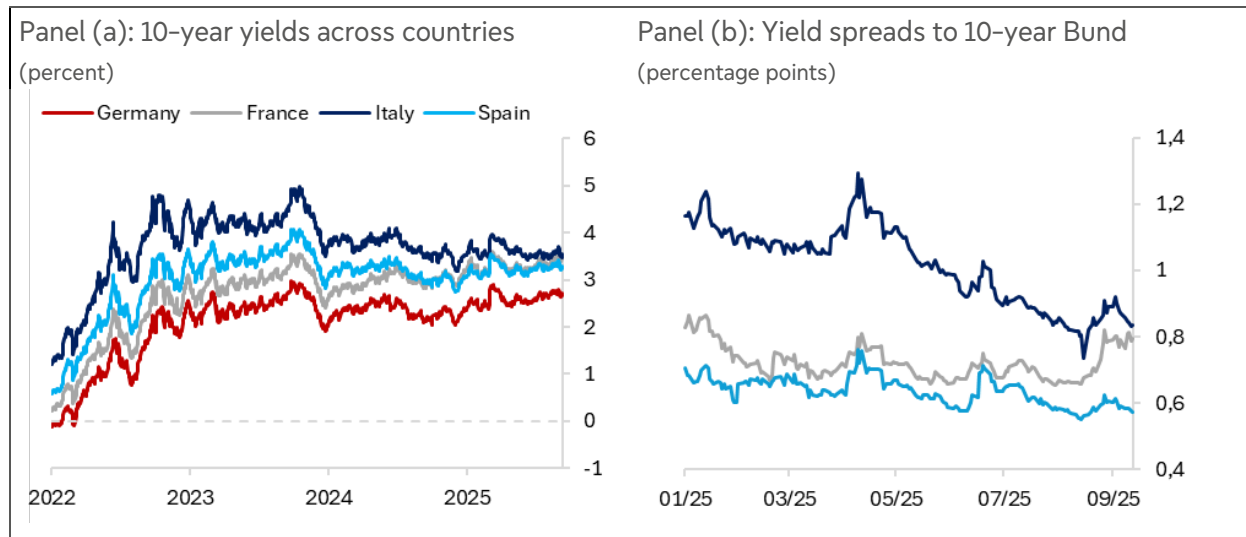
Figure 13: Fragmentation in euro area sovereign bond markets



Source: LSEG Datastream and authors' calculations. Last observation: 12/09/2025. The construction of the index follows Hoffmann et al. (2020).

The divergence in growth paths and recent political turmoil, combined with high levels of global policy uncertainty and an asymmetric fiscal space in the face of large investment needs, bear the risk of a renewed divergence in sovereign bond yields across euro area countries. Given its apparent importance for the strength of monetary transmission, the fragmentation of sovereign bond markets needs to be closely monitored. That said, directly intervening in sovereign debt markets undermines the disciplining role of market prices. Hence, the bar for such an intervention should be very high. Moreover, if fragmentation concerns resurfaced, clear communication about the conditions for a potential activation of the TPI would likely help containing the risks of cross-country spillovers of sovereign stress.

Figure 14: Euro area yields and spreads



Source: LSEG Datastream and authors' calculations. Last observation: 12/09/2025.

3. ECB COMMUNICATION: CURRENT STRATEGY AND POSSIBLE REFINEMENTS

The ECB's monetary policy decisions are among the most watched events on the financial calendar. The Governing Council meets eight times a year. On the second day of each meeting, a press release announces the decision, followed by the President and Vice-President's statement and Q&A. Four weeks on, the Monetary Policy Accounts offer a detailed summary of the Governing Council's discussions. Beyond these core communications, the ECB signals its stance and provides supporting materials through a broader set of publications and speeches. These include addresses by Governing Council members, the Annual Report, Strategy Review outputs, survey releases, and at four of the eight meetings each year, Macroeconomic Projections for major indicators.

With global uncertainty elevated, clear central-bank communication matters. Miscommunication can create volatility in financial markets which could spill into the real economy. In this regard, two features of the ECB strategy have stood out recently. First, since mid-2022, the ECB has transitioned from explicit forward guidance to a meeting-by-meeting approach. Second, at its last two meetings, the ECB has explicitly emphasised inflation risks in the policy statement, providing a somewhat clearer view of its reaction function. Although risk assessments were always present, highlighting them in line with the 2021 Strategy Review signals that inflation risk is now a key parameter in decision-making.

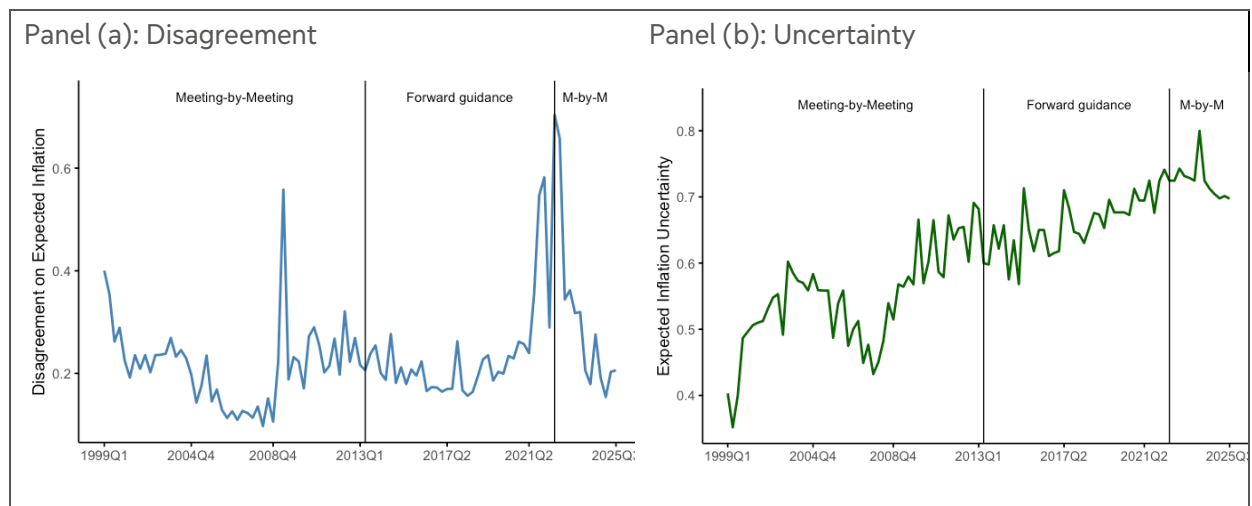
The two features are deeply interconnected. As President Lagarde noted at the *ECB and Its Watchers* conference in March 2025, strict forward guidance can misfire when the size and distribution of shocks are unknown. In such times, a meeting-by-meeting approach paired with *framework guidance* and *scenario analyses*—outlining scenarios and conditional policy responses—provides a more robust communication strategy. Given today's unusually high level of global uncertainty, both shifts warrant closer study because they will shape the future playbook for monetary-policy communication. Much remains to be seen about the efficacy of these policies, whether they can be improved upon, and the potential costs of doing so.

3.1. Forward guidance vs. meeting-by-meeting approach

Following the GFC, the Federal Reserve pioneered forward guidance, committing to a future rate path to anchor expectations when policy was constrained by the zero lower bound. In subsequent years, the ECB and other central banks followed suit by adopting variants of forward guidance. Although forward guidance can powerfully anchor long-run inflation expectations, it has drawbacks. In highly uncertain environments, maintaining credible commitments is difficult and flexibility to react to new data is reduced. Over time, missed guidance can damage central bank credibility.

On the other end of the spectrum is a meeting-by-meeting approach. While it preserves flexibility, it can allow for higher market uncertainty if asset prices and expectations aren't well anchored. In practice, central banks weigh these risks. Forward guidance is commonly used to stabilise expectations when the effective lower bound is binding or to clearly communicate a sequence of anticipated rate changes. A meeting-by-meeting approach is usually employed when the central bank is unwilling to pre-commit to a particular policy stance.

Figure 15: Disagreement and uncertainty about expected long-term inflation



Source: ECB Survey of Professional Forecasters and authors' calculations. For Q1 and Q2, long-term expected inflation refers to inflation in 4 years and 5 years from the current year, respectively. Disagreement is measured by the standard deviation of the point forecasts among all respondents in each wave. Uncertainty is measured by first calculating the standard deviation for each respondent and then taking the median across respondents for each wave.

Against the background of this strategic shift in communication, we now examine whether the anchoring of inflation expectations has changed across ECB communication regimes. Using data on the individual responses of the ECB's Survey of Professional Forecasters from 1999Q1 to the present, we track two proxies. First, we measure disagreement as the dispersion in long-run inflation point forecasts across respondents. Greater cross-sectional dispersion implies weaker anchoring at the aggregate level. And second, we compute median individual uncertainty about long-run inflation from respondents' reported density forecasts. A higher median indicates that forecasters are less confident in their estimates.

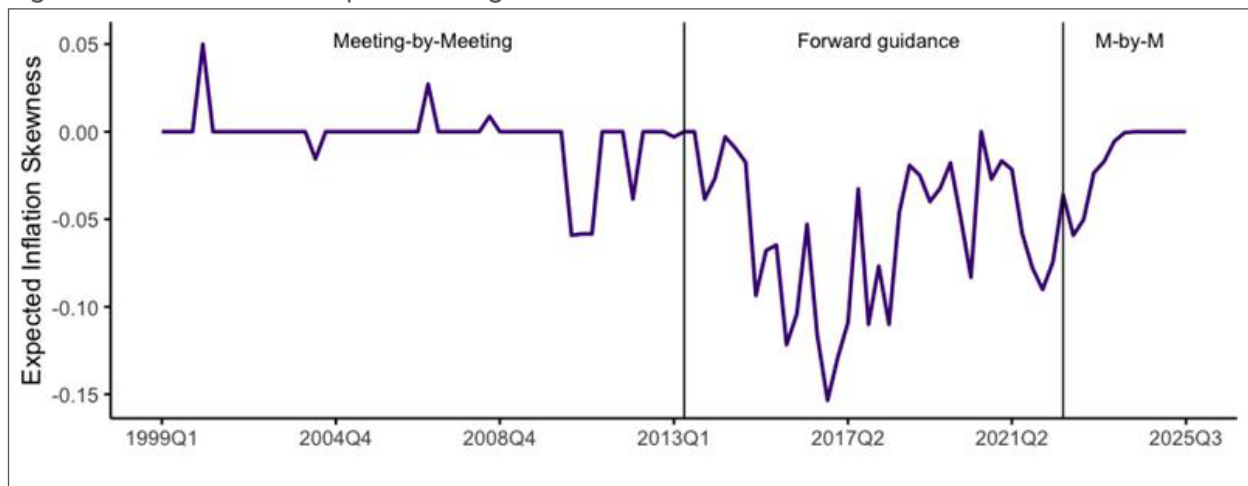
These measures allow us to compare anchoring across regimes at both the cross-sectional (disagreement) and individual (uncertainty) levels. We split the sample into three regimes:

- Pre-2013Q2: largely meeting-by-meeting communication with little forward guidance.
- 2013Q2–2021: Different variants of forward guidance characterised by more explicit signalling about the future path.
- Since 2022: an explicit data-dependent, meeting-by-meeting approach.

Figure 15 shows that there is no clear overall trend in forecaster disagreement, though there are spikes around crisis events such as the GFC and the beginning of the war in Ukraine. Under the current meeting-by-meeting regime, disagreement has substantially declined, suggesting a better anchoring of expectations at the aggregate level. Conversely, individual uncertainty has trended up and reached a record high in 2024:Q1. Why might cross-sectional disagreement fall while individual forecast uncertainty rises? One plausible explanation is that, while forecasters broadly agree on the modal scenario for the economy, they anticipate larger future shocks. Consequently, they converge on the same central path of inflation, yet assign a higher probability to tail outcomes, thereby increasing personal uncertainty without widening the cross-sectional dispersion. This suggests that the ECB has room to reduce individual uncertainty and strengthen anchoring at the micro level by leaning into its policy of framework guidance. The ECB could do so by setting out clearer scenarios and effectively communicating its reaction function, including how it would react to certain tail risks materialising.

The steady increase in expectations uncertainty naturally raises the question of asymmetry in the distribution of expectations: Do forecasters see risks tilted one way? Skewness in expectations captures this phenomenon. Previous studies have found that the skewness of professional forecasters' perceived probability distributions for future inflation has predictive power for realized inflation (Andrade et al. 2012). Figure 16 shows a stark contrast in expectation skewness across regimes. Under the meeting-by-meeting approach, the skewness is nearly zero, implying little perceived asymmetry. In contrast, in the forward guidance period it turned negative, indicating that, on average, forecasters anticipated greater downside risk. More recently, however, skewness has returned to around zero, suggesting a balanced view of risks similar to that of the 2000s.

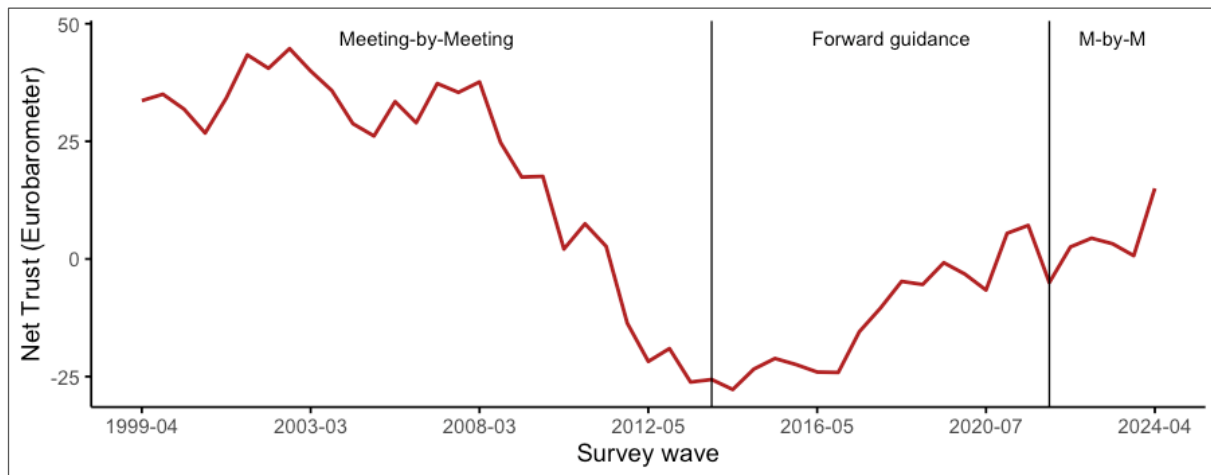
Figure 16: Skewness of expected long-term inflation



Source: ECB Survey of Professional Forecasters and authors' calculations. For Q1 and Q2, long term expected inflation refers to inflation in 4 years and 5 years from the current year, respectively. Skewness is measured by first calculating the skewness for each respondent and then taking the median across respondents for each wave.

Changes in communication can affect both the anchoring of inflation expectations and central bank credibility. In highly uncertain environments, it is difficult to maintain credible forward-guidance commitments, and repeated misses can erode trust. Ehrmann (2024) argues that trust in the central bank depends on a broad set of macroeconomic conditions, such as inflation, growth, debt, and exposure to crises. In turn, stronger trust helps anchor expectations and reduce political pressure.

Figure 17: Net trust in the ECB



Source: European Commission Eurobarometer Survey and authors' calculations based on Ehrmann (2024) and Dreher (2024). We thank Michael Ehrmann for sharing the data file for Ehrmann (2024). Net trust is measured by taking the difference between percentage of respondents who say they trust the ECB minus the percentage of respondents who say they do not. Respondents who are undecided are ignored.

Following Ehrmann (2024) and Dreher (2024), we use Eurobarometer microdata to calculate net trust in the ECB. Net trust is defined as the percentage of respondents who say they trust the ECB minus those who do not. As Figure 17 shows, net trust was at a post-crisis low when the ECB began adopting forward guidance but then trended up over subsequent years. While net trust in the ECB has continued its upward trend over the most recent period, it has yet to recover to its pre-GFC level. Since research shows that trust in the central bank can improve the anchoring of inflation expectations (Christelis et al., 2020; Rumler and Valderrama, 2020), it is important to monitor these dynamics.

3.2. Communicating the outlook in the face of uncertainty

Having examined anchoring across regimes, we turn to a second feature of recent ECB communication: How should the outlook be conveyed when risks appear balanced but uncertainty is unusually high?

In her speech, President Lagarde argues for clarity on two fronts. First, the ECB should spell out the main contingencies it is considering. Second, it should provide framework guidance to clearly signal its reaction function. This approach aligns with the ECB's 2025 Strategy Review, which discusses potential communication strategies in terms of clarity across these two dimensions (ECB, 2025).

Regarding the first dimension, the ECB uses a suite of internal models for sensitivity and scenario analysis (Lane, 2024).⁸ Sensitivity analysis is routinely included in the Eurosystem/ECB quarterly staff macroeconomic projections, whereas scenario analysis is published only intermittently, as in the 2025 ECB Strategy Review.

In recent years, the ECB has provided increasing clarity about its reaction function. In March 2023, the ECB announced a three-element reaction function consisting of an inflation outlook (including the

⁸ The terms 'sensitivity analysis' and 'scenario analysis' are often used to refer to different, sometimes overlapping strategies. In this report, we use the term 'sensitivity analysis' in line with the Eurosystem Staff Macroeconomic Projections which report how central forecasts vary based on various non-policy contingencies, holding the policy path fixed. We refer to 'scenario analysis', following the Bernanke Review (2024) and the ECB Strategy Review 2025 (which term it as 'scenario analysis as contingency planning'), to mean both sensitivity analysis with respect to alternative policy paths, and providing framework guidance on the policy reaction function for each non-policy contingency.

baseline and associated risks), dynamics of underlying inflation, and the strength of monetary policy transmission. Furthermore, since the publication of the 2021 Strategy Review, the risk-assessment section of the monetary policy statement has expanded to encompass risks to economic activity and inflation. The measurement and communication of risk now play a larger role. In its last two statements, the ECB has explicitly specified that inflation risk is an argument in the reaction function in the opening section of the statement, stating that, *"In particular, the Governing Council's interest rate decisions will be based on its assessment of the inflation outlook and the risks surrounding it"*.

Although the ECB's communication strategy has clearly evolved in recent years, improvements can be made in several areas. According to the ECB Strategy Review 2025, scenario analysis best provides clarity regarding potential contingencies and the policy reaction function. This aligns with the Bernanke Review (2024) conducted for the Bank of England, which suggests communicating scenario analyses to the public to increase transparency about the reaction function. Currently, the ECB communicates contingencies through sensitivity analyses each quarter. Although scenario analysis is used internally, it appears only sporadically in communication to the public (e.g., in the 2025 Strategy Review). Therefore, as Weber (2025) also notes, a clear and regular communication of the mapping of each contingency to the policy reaction function is yet to be established.

The ECB could provide guidance on its reaction function in several areas: preferred measurements of key referenced economic variables, the importance of other indicators, and the contingent policy responses to certain risks to the outlook. Providing greater transparency on these points would strengthen the framework-guidance approach and help anchor expectations in a data-dependent, meeting-by-meeting regime.

Table 3: Instruments used by central banks for communicating monetary policy outlook

	Scenario analysis	Sensitivity analysis	Forward guidance*	Framework guidance	Meeting-by-meeting	Dot plot	Fan charts / uncertainty bands	Press conference at every meeting	Forecast error reporting	Charts at non-report meetings
Federal Reserve		✓		✓	✓	✓	✓	✓	✓	
Bank of England		✓		✓	✓		✓		✓	
Sveriges Riksbank	✓	✓	✓	✓			✓	✓	✓	✓
Bank of Canada		✓		✓				✓	✓	
Swiss National Bank								✓	✓	N/A
Norges Bank			✓	✓			✓	✓	✓	
ECB	Not published regularly	✓		✓	✓		✓	✓	✓	

Source: Central banks' websites. The comparison is drawn according to current central banks' communication and does not include past strategic tools. *In this table, forward guidance refers to the publication of an expected future policy rate path by the central bank.

During these unprecedented times, it is helpful to see how peer central banks address similar challenges. Do they perform scenario analyses and regularly communicate the results? If not, how do they convey the outlook under uncertainty? Table 3 summarises the communication approaches of several central banks. The Sveriges Riksbank stands out for its regular publication of scenario analyses, particularly alternative policy-rate paths. Several banks use sensitivity analysis to spell out contingencies. Similar to the ECB, most banks describe the factors guiding their decisions with framework guidance, though none offer exhaustive lists of variables or weights. The Riksbank and Norges Bank are notable for being the only central banks currently providing explicit signals about the medium-term rate path. Many use fan charts and uncertainty bands in some form. However, as the Bernanke Review notes, these tools have limited value in explaining the sources of uncertainty. Overall, the ECB meets most communication standards and compares favourably with peer central banks.

Although adding scenario analyses would complete the checklist, as the 2025 Strategy Review notes, it is challenging to operationalise. The energy crisis is a case in point. In March 2022, the “severe” contingency predicted 7.1% inflation in 2022 and 2.7% inflation in 2023; however actual inflation exceeded 10% in 2022 and 5% in 2023. Furthermore, it is often difficult to agree on which scenarios are important, how to quantify them, and what likelihoods to assign to them. If the ECB improves upon these factors and strengthens its communication by pairing sensitivity analysis with a clear explanation of how it would respond to contingencies, it will close much of the remaining gap. Supplementing the current approach with clear, regular communications of scenario analyses would help set a benchmark for effective communication in uncertain times.

3.3. Analysis of most recent ECB monetary policy statement and account

The September 2025 monetary policy statement reflects the ongoing stabilisation of inflation and economic activity. Compared to the July statement, the ECB revised its risk assessment for economic growth from “tilted to the downside” to “more balanced”. The assessment of risks to the inflation outlook remained unchanged. This assessment and the associated decision to leave policy rates unchanged were reported to reflect unanimous agreement in the Governing Council.

Since the monetary policy account for the most recent Governing Council meeting will be made available only in October, we focus on the 23-24 July 2025 meeting to gain further insights into the ECB’s current decision-making process. In their reviews of markets and the economy, both Ms Schnabel and Mr Lane noted that medium-term inflation expectations had moved towards the Governing Council’s 2% target, in line with the June staff projections. Members agreed that these projections were still valid, and considered the evolution of headline inflation, as well as its main components, to be broadly reassuring. Regarding growth, however, the Council agreed that risks were tilted to the downside. Some of the earlier strength reflected front-loading ahead of new tariffs, and members expected activity to slow down as trade uncertainty and geopolitical risks weighed on exports, investment, and consumption.

Mr Lane concluded his review with two key points. Firstly, the option value of waiting for additional evidence to support the assessment of the inflation outlook and its risks is high, which reinforces the ECB’s wait-and-watch stance. This tone continues in the account’s conclusion, where members reaffirm the data-dependent, meeting-by-meeting approach and the need for caution. As the accounts state, *“Communication should maintain a careful, neutral tone and be deliberately uninformative*

about future interest rate decisions”—a clear departure from forward guidance in an era of elevated global uncertainty.

Secondly, following a detailed discussion of inflation drivers and the balance of risks, he recommended keeping the three key ECB rates unchanged. In line with the updated strategy statement, he then recommended refining the wording of the reaction-function to: *“Our interest rate decisions will be based on our assessment of the inflation outlook and the risks surrounding it, in light of the incoming economic and financial data, as well as the dynamics of underlying inflation and the strength of monetary policy transmission”*. Most members supported Mr Lane’s proposal to maintain the three key rates, as there was no immediate pressure to act. However, not everyone agreed. At least one member deemed the rising downside risks to output and inflation to be consistent with another cut. This lack of unanimity may indicate a willingness to consider further easing if the data weakens.

While the Council agreed to add “the risks surrounding the inflation outlook” to its reaction-function wording, opinions differed on the balance of risks. Most members saw the risks as being broadly balanced. However, several judged them to be tilted to the downside, at least in the next two years, citing higher-than-assumed tariffs and weaker economic activity. A few identified upside risks in the medium term, highlighting persistent services inflation and potential demand resulting from defence and infrastructure spending in the euro area. There was more agreement on the other arguments in the three-element reaction function. Members concurred that the drivers of underlying inflation were generally consistent with the 2% medium-term target and that monetary policy transmission continued to be smooth, albeit with a slow impact on credit. The discussion highlights that the balance of inflation risks is the most debated aspect of the ECB’s reaction function. The overall view of “balanced risks” likely reflects opposing views on the direction of risks rather than a consensus across members.

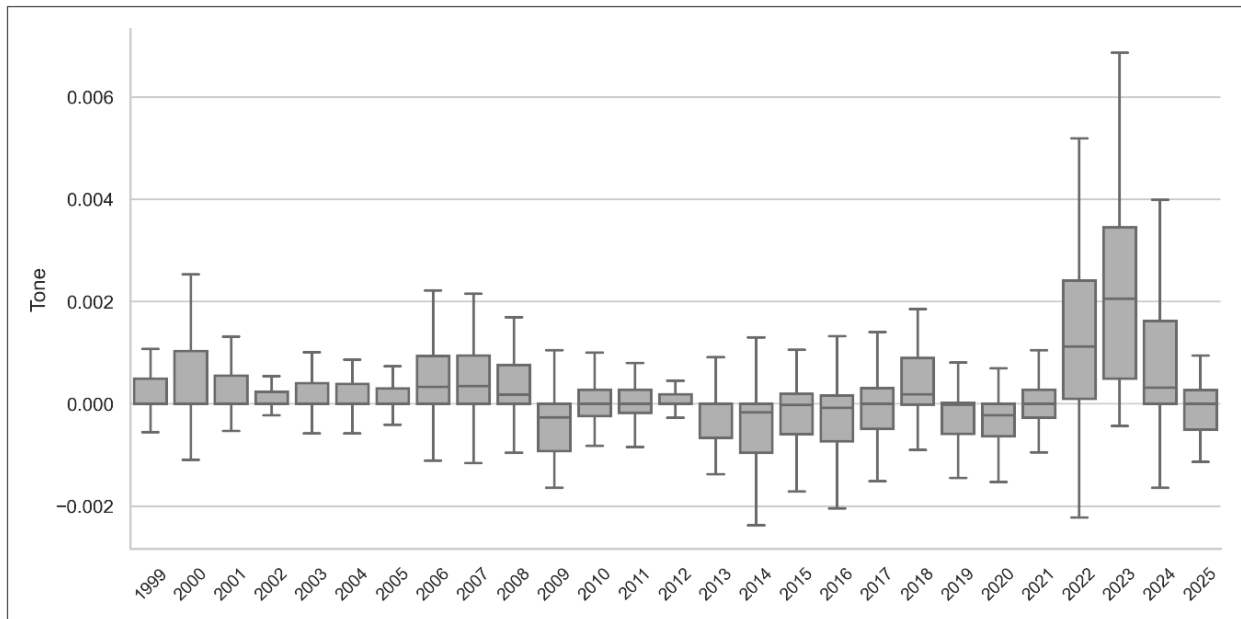
According to Hansen, McMahon & Prat (2018), greater transparency in the accounts strengthens accountability and discipline. For the general public, the accounts offer insight into underlying economic uncertainty. A consensus would suggest that the signals about the economy are clearer, whereas more disagreement would suggest that the data is noisy. However, the format limits how much disagreement can truly be observed. Similar to the Federal Reserve’s minutes, the ECB’s monetary policy accounts are curated summaries written in the passive voice, without named attributions or recorded votes. The language gravitates towards consensus, so disagreement must be inferred from qualifiers such as “However, there was some concern...”, or “However, the view was also expressed...”. That said, transparency involves trade-offs and the ECB probably keeps some information deliberately private. If taken too far, transparency can create conformist behaviour (Prat, 2005).

As the introductory statements and accounts summarising the decisions and deliberations of the Governing Council emphasise the broad consensus among the committee members, dissenting policymakers may feel incentivised to explain their views in speeches and interviews. Therefore, to gauge dispersion of views across members, we analyse the tone adopted in public speeches by Governing Council members regarding monetary policy.⁹ Tone refers to the number of monetary-policy-related sentences classified as hawkish relative to the number of sentences classified as dovish based on a

⁹ We consider only the members of the ECB’s Executive Board as well as the governors of the four largest NCBs. Annex A2 contains a detailed description of the data and methodology used to construct speech tone. We thank Zhuo Wang for providing excellent support with this analysis.

dictionary approach. Higher values of tone, hence, refer to more hawkish communication. Figure 18 shows that the range of tones was narrow and clustered near neutral until around 2019. From 2022 to 2024, the range widened markedly, which is consistent with greater disagreement as policymakers balanced inflation against growth risks.

Figure 18: Distribution of monetary policy tone by year

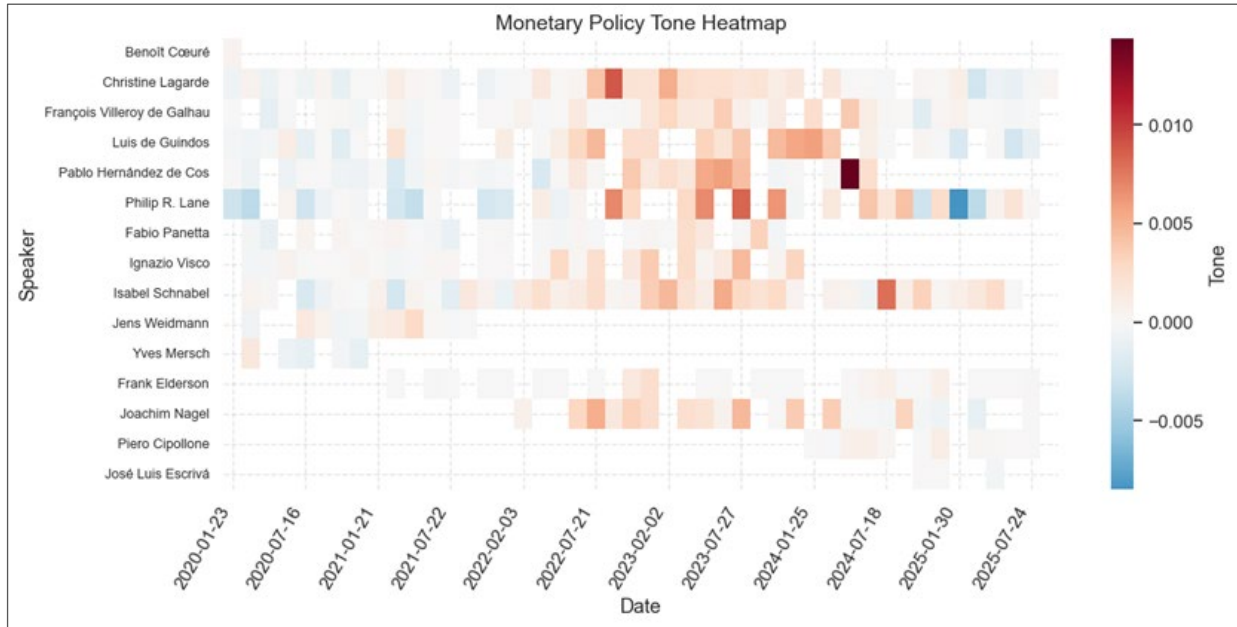


Source: Authors' calculations based on public speeches of members of the ECB Executive Board and the governors of the French, Italian, Spanish, and German NCBs obtained from the ECB and the BIS. Higher values of tone refer to more hawkish communication. See Annex A2 for further details.

The member-level tones shown in Figure 19 reveal a clear divergence. The fading of the blue shade from 2021 to 2023 indicates a general shift towards more hawkish language, followed by more nuanced signals in 2024–2025. For example, on 16 September 2024, Mr Lane argued that it was “appropriate to take another step in moderating the degree of monetary policy restriction,” signalling confidence in a cut. On 2 October 2024, Ms Schnabel noted that policy easing and rising real incomes would support growth. However, she also cautioned that “monetary policy is no panacea,” highlighting its limitations even as the stance softened.

The July accounts show a widening dispersion of views. While the Governing Council members broadly agreed on a 2% inflation outlook, opinions differed on the direction of risks. With growth risks skewed to the downside and global uncertainty elevated, further dispersion is plausible. It will be interesting to see how these measures evolve, particularly if the ECB provides further clarification on its reaction function and is more explicit about the scenarios under consideration.

Figure 19: Individual Member monetary policy tone heatmap



Source: Authors' calculations based on public speeches of members of the ECB Executive Board and the governors of the French, Italian, Spanish, and German NCBs obtained from the ECB and the BIS. Higher values of tone refer to more hawkish communication. See Annex A2 for further details.

4. CONCLUSION

Inflation has largely returned to target, with medium-term expectations remaining well anchored. Underlying pressures, particularly in the services sector, are slowly easing alongside softer wage growth, while the drag of energy prices has faded. Overall, the evidence supports the view that risks around the inflation path are broadly balanced. On balance, we see a mild upside tilt stemming from fiscal spending, trade frictions, and energy. But downside risks could emerge from a strong euro, soft external demand, and a cooling labour market.

Policy transmission remains uneven across channels. While short-term rates have fallen markedly, longer-dated yields have been sticky as higher term premia have offset declining rate expectations. With balance-sheet runoff continuing, overall financial conditions are normalising only gradually. Although sovereign-bond market fragmentation—an apparent headwind earlier in the cycle—has receded, country-specific risks still warrant monitoring.

Against this backdrop, the current wait-and-watch approach is appropriate. Keeping options open while inflation hovers near 2% limits the risk of policy error in a two-sided environment. That said, the near-neutral stance should be reassessed as new information emerges. Further easing would only be warranted if disinflation proves more durable or growth risks intensify. Conversely, persistent above-target core inflation combined with renewed inflationary pressures would require vigilance.

Communication has adapted to greater uncertainty. The shift towards meeting-by-meeting decisions and the explicit mention of “risks surrounding the inflation outlook” as part of the reaction function are positive developments. To reduce the currently high level of uncertainty around modal forecasts, the ECB could further clarify its preferred measures for key inputs to the reaction function, explain how these inputs inform decisions, and publish scenario analyses more regularly.

Credibility and trust are key prerequisites for maintaining price stability. Households’ reported trust in the ECB has only partially recovered to levels enjoyed before the GFC. Even in the presence of heightened uncertainty, transparent and cautious communication—acknowledging two-sided risks while avoiding premature commitment—can sustain credibility, contain risk premia, and support the orderly transmission of policy.

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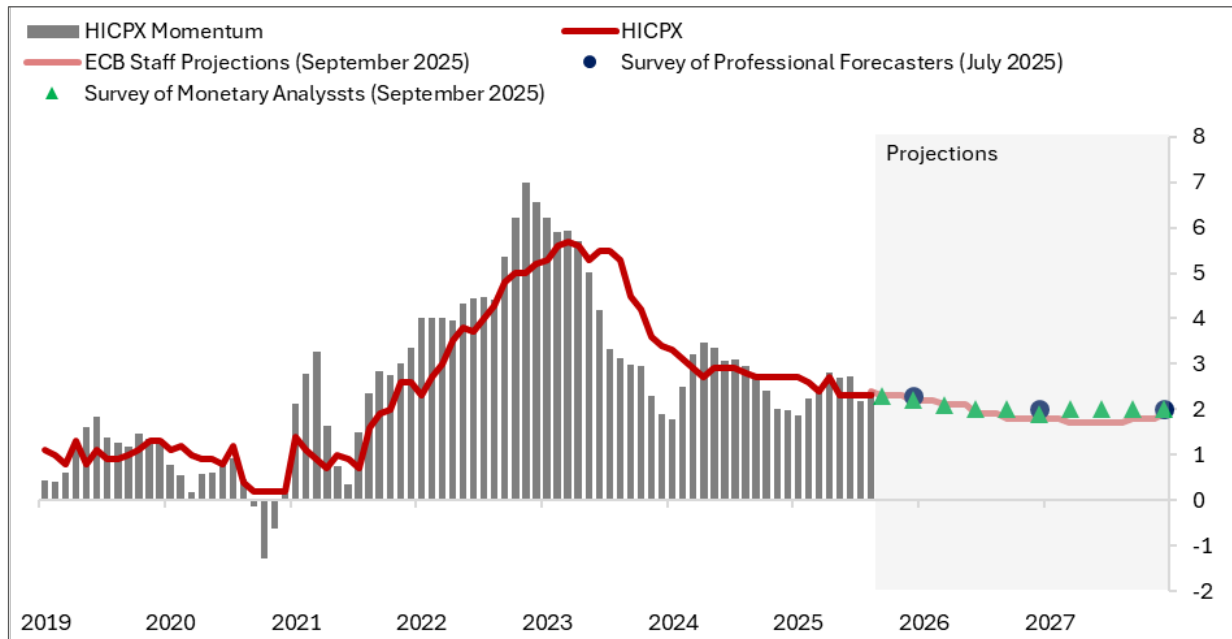
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ANNEX

A1. HICPX INFLATION OUTLOOK

Figure 20: HICPX inflation outlook



Source: Eurostat, ECB, and ECB Staff Macroeconomic Projections (September 2025). Last observation: August 2025.

A2. MEASURING THE TONE OF MONETARY POLICY COMMUNICATION

This annex describes the data and methodology used to measure the tone and disagreement among ECB Governing Council members using text analysis applied to public speeches.

A2.1. Data

We use a dataset containing all speeches by members of the ECB's Executive Board, supplemented with speeches by central bank governors from Germany, France, Italy, and Spain available in the Bank for International Settlements (BIS) database.¹⁰ The dataset covers the period from February 1997 to August 2025 for ECB speeches, and from September 1996 to July 2025 for the BIS-sourced speeches, respectively. After removing empty speeches, duplicates, and speeches delivered outside the speakers' terms in office, the final sample includes 39 speakers with 4,717 speeches in total.

A2.2. Dictionary-based tone construction

Our methodology adapts Gardner, Scotti, and Vega (2022) (GSV here after) to the ECB context. We construct dictionaries of topic keywords and modifier keywords and assign values to topic–modifier pairs at the sentence level.

Specifically, we distinguish four topics: labour, output, inflation, and monetary policy/rates. Throughout, we focus on the monetary-policy/rates topic. Compared with GSV's original framework, we exclude "financial conditions" and "future monetary policy" since they rarely appear in ECB speeches and instead introduce a dedicated "monetary policy/rates" category with terms such as interest rate, deposit facility, and policy rate. The full list of topic keywords is provided in Table 4.

For each topic, we identify directional modifiers within the same sentence, choosing the closest modifier by word distance. Modifiers are assigned values of +1, 0, or –1, depending on whether they signal an increase, stability, or decline. This allows us to capture contextual meanings such as inflation has risen (+1) versus inflation has declined (–1). A sample of topic–modifier pairs is shown in Table 5. The interpretation naturally follows monetary policy conventions: positive values are associated with a hawkish stance (e.g., rate hikes), while negative values are associated with a dovish stance (e.g., rate cuts).

For example:

- *"Instead, ... inflation has fallen sharply, and at a remarkably low cost in terms of employment."* (Delivered by Christine Lagarde on August 23, 2025), the scores of "inflation" and "labour market" topics are –1 and +1, respectively.
- *"Based on our current assessment, over the next several meetings we expect to raise interest rates further to dampen demand and ..."* (Delivered by Christine Lagarde on September 8, 2022), the scores of "monetary policy/rates" and "output" topics are +1 and –1, respectively.¹¹

¹⁰ Speeches by ECB Executive Board Members are retrieved from the ECB: <https://www.ecb.europa.eu/press/key/html/downloads.en.html>. Other speeches come from the BIS speech dataset retrieved from <https://www.bis.org/cbspeeches/download.htm>.

¹¹ The underlined words are keywords of the topic and modifiers.

For each sentence j in speech s , a topic–modifier pair score, $Score_{i,j} \in \{-1, 0, +1\}$, is assigned. The speech-level tone for topic i is then obtained by aggregating sentence-level scores to the speech level as follows:

$$Tone_{i,s} = \frac{1}{N_s} \sum_{j=1}^{J_s} Score_{i,j}$$

where J_s is the number of pairs in speech s and N_s is the number of effective words.

Since multiple speeches can be delivered by the same member between two Governing Council (GC) meetings, we use speech-level tone as described above and then aggregate it. For each member m and meeting window t (defined as the period from the end of GC meeting $t - 1$ to the end of GC meeting t), we average tone values within each topic across all speeches delivered by m during this window:

$$Tone_{i,m,t} = \frac{1}{S_{m,t}} \sum_{s=1}^{S_{m,t}} Tone_{i,s}$$

where $S_{m,t}$ is the number of speeches of member m between meetings $t - 1$ and t .

Table 4: Scores for Topic-Keywords

<i>keyword</i>	<i>score</i>	<i>topic</i>
inflation	1	inflation
price	1	inflation
cost	1	inflation
inflation persistence	1	inflation
persistence of inflation	1	inflation
disinflation	-1	inflation
employers	1	labour
employment	1	labour
employment growth	1	labour
jobgains	1	labour
joblosses	-1	labour
labor	1	labour
hiring	1	labour
underutilization of labor resources	-1	labour
unemployment	-1	labour
utilization of the pool of available workers	1	labour
business conditions	1	output
business outlook	1	output
confidence	1	output
consumption	1	output
strengthening in final demand	1	output
demand	1	output
output gap	1	output
expenditures	1	output
export	1	output
income	1	output
indicators	1	output
investment	1	output
investment spending	1	output
output	1	output
production	1	output
sales	1	output
sentiment	1	output
spending	1	output
interest rate(s)	1	monetary policy/ rate
deposit facility	1	monetary policy/ rate
lending facility	1	monetary policy/ rate
refinancing operations	1	monetary policy/ rate
monetary	1	monetary policy/ rate
monetary policy	1	monetary policy/ rate
policy rate	1	monetary policy/ rate

Table 5: Scores for topic-modifiers (selected)

<i>modifier</i>	<i>score</i>	<i>topic</i>	<i>modifier</i>	<i>score</i>	<i>topic</i>
decline	-1	labour	slow	-1	inflation
deteriorate	-1	labour	decline	-1	inflation
diminish	-1	labour	subdued	-1	inflation
disappoint	-1	labour	weak	-1	inflation
inhibit	-1	labour	diminish	-1	inflation
losses	-1	labour	down	-1	inflation
low	-1	labour	fallen	-1	inflation
modest	-1	labour	low	-1	inflation
moderated	-1	labour	reduction	-1	inflation
expand	1	labour	elevate	1	inflation
gains	1	labour	expand	1	inflation
high	1	labour	foster	1	inflation
improv	1	labour	height	1	inflation
increase	1	labour	strong	1	inflation
pick up	1	labour	strength	1	inflation
picking up	1	labour	upward	1	inflation
picked up	1	labour	high	1	inflation
record expansion	1	labour	increase	1	inflation
negative	-1	output	lower	-1	monetary policy/rates
below	-1	output	decline	-1	monetary policy/rates
contract	-1	output	fell	-1	monetary policy/rates
cooling	-1	output	reduce	-1	monetary policy/rates
cut	-1	output	cut	-1	monetary policy/rates
damp	-1	output	downward	-1	monetary policy/rates
decelerate	-1	output	loosen	-1	monetary policy/rates
depress	-1	output	drop	-1	monetary policy/rates
decline	-1	output	easing	-1	monetary policy/rates
uncertain	-1	output	dovish	-1	monetary policy/rates
weak	-1	output	fallen	-1	monetary policy/rates
bolster	1	output	lift	1	monetary policy/rates
expand	1	output	hike	1	monetary policy/rates
remains firm	1	output	tighten	1	monetary policy/rates
firm	1	output	raise	1	monetary policy/rates
firmer	1	output	higher	1	monetary policy/rates
gains	1	output	increase	1	monetary policy/rates
increase	1	output	push up	1	monetary policy/rates
lift	1	output	rise	1	monetary policy/rates
rebound	1	output	hawkish	1	monetary policy/rates
rise	1	output	tightening	1	monetary policy/rates

This paper summarizes the euro-area economic outlook, assesses the ECB's current monetary policy stance, and reviews its policy communication. Inflation is near target and risks surrounding it are broadly balanced, with a mild upside tilt. The ECB's monetary stance is close to neutral: balance sheet normalisation partially offsets easing from recent rate cuts. Communication has evolved in recent years, and the data-dependent, meeting-by-meeting strategy remains appropriate. Clearer reaction-function guidance could help reduce uncertainty about the inflation outlook.

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