SPEECH

A robust strategy for a new era

Speech by Christine Lagarde, President of the ECB, at the 25th ECB and Its Watchers conference organised by the Institute for Monetary and Financial Stability at Goethe University Frankfurt

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Paul Valéry wrote that “the trouble with our times is that the future is not what it used to be”.

Our expectations have indeed been swept aside in the last few years, and in the last few weeks in particular.

Established certainties about the international order have been upended. Some alliances have become strained while others have drawn closer. We have seen political decisions that would have been unthinkable only a few months ago.

The level of uncertainty we are facing is exceptionally high.

An index of trade policy uncertainty currently stands at close to 350, more than six times its average value since 2021.[1] And indicators of geopolitical risk stand at levels not seen since the Cold War, outside of wars and major terrorist attacks.[2]

This new environment raises fundamental questions for monetary policy. How can we deliver price stability in a new geopolitical era?

Our strategy assessment is ongoing, as you know, and I will naturally not cover every issue in my speech today. I will focus on the factors I consider to be particularly relevant in this new era.

I will ask three questions: how is the environment in which we operate changing? What do these changes imply for our reaction function? And what do the changes imply for our policy communication?

My main message is that in an environment of uncertainty, a strong commitment to maintaining price stability over the medium term is more important than ever.

This commitment will require agility to respond to new shocks, albeit within a well-defined framework that limits short-sighted reactions and unbridled discretion.

As a result, we will need to continue steering the public’s expectations. People will be looking to us – and other policymakers – to understand how we will navigate this more volatile era and help reduce, rather than amplify, uncertainty.

So, agility needs to be combined with clarity. Even when we cannot provide certainty about the rate path, we can provide clarity about our reaction function.

The environment

When we last reviewed our strategy, the main challenge we faced was a prolonged environment of too-low inflation. Although the review provided lessons that are relevant under any circumstances, its main focus was on understanding the causes of too-low inflation and how to ensure that it did not become embedded.

The environment we are facing now is a different one. Three key changes stand out.

First, the direction of shocks is much harder to predict.

In the decade before our last strategy review, we faced a range of structural and cyclical forces that were almost uniformly disinflationary. Now, we are seeing notable shifts in the drivers of inflation.

We still face structural factors like ageing and digitalisation that will probably be disinflationary in the coming years.[3] But we are also now facing new, two-sided shocks – mainly linked to trade and defence, as well as climate change – which can amplify or counteract the existing forces.

Trade fragmentation[4] and higher defence spending in a capacity-constrained sector could in principle push up inflation. Yet US tariffs could also lower demand for EU exports and redirect excess capacity from China into Europe, which could push inflation down.

Second, the size of the shocks to inflation could potentially change.

In the period from the great financial crisis to our last strategy review, we faced some very large negative shocks to growth. The effect of these shocks on inflation, however, took time to materialise. We saw a slow-moving downward drift in inflation that eventually seeped into inflation expectations.

But looking ahead, shocks might feed into inflation more directly and increase volatility. And this risk may be particularly acute for the euro area, as we are highly exposed to some of the new types of shock.

For example, the euro area is very open to trade and part of integrated supply chains. Hence, trade fragmentation is likely to lead to larger, more disruptive relative price changes.[5] In a similar vein, the euro area is highly dependent on energy imports.[6] Geopolitical risks are likely to drive greater volatility in exchange rates and energy and commodity prices, as we have seen in recent weeks.

Third, if the shocks do become larger, the persistence of inflation could in some circumstances be greater.

One feature of the recent inflation shock was an increase in the frequency of price changes.[7] This can lead to a steepening of the Phillips curve and, more generally, to a proportionally stronger impact of large shocks on inflation. A model developed at the ECB suggests that inflation behaves in a visibly non-linear way: it reacts disproportionately more strongly to large shocks, whereas small shocks trigger no significant reactions.[8]

If such state-dependent pricing becomes standard when the economy is hit by large shocks, but the frequency of wage-setting remains below that of price adjustment, we could see inflation becoming more persistent.[9] Large shocks would lead to a faster pass-through to inflation, and then wages would have to catch up with prices in a staggered way.

As an illustration, energy inflation peaked in October 2022, while services inflation only peaked in July 2023 and is still being pushed up by past shocks today, mainly through their delayed impact on wage adjustments.

In this environment of more uncertain, larger and possibly more persistent shocks, the way we have formulated our inflation target matters – that is, we aim for 2% inflation, our target is symmetric and we work to achieve it over the medium term.

This symmetric target has served us well during the recent inflation surge, helping to coordinate expectations and guide the inflation process back down towards 2%.

But the formulation does not mean that headline inflation will always be at 2%, which is impossible in the kind of environment we are facing now. It means that, regardless of the shocks we face, we must set our policy appropriately so that inflation is *always converging back towards 2% over the medium term*.

So, how can we do that? This brings me to the second area: the reaction function.

The reaction function

Our reaction function has always been state-dependent. In other words, policy should react differently depending on the context and the origin, size and persistence of shocks.

Our medium-term orientation enables us to avoid reacting to small or passing shocks that will have faded by the time the effects of a policy change kick in. And it allows us to flexibly adjust the horizon within which we must return inflation to target.

Classically, monetary policy reacts more forcefully to demand shocks where output and inflation move together, and "looks through" or reacts less to supply shocks that push output and inflation in opposite directions – if they are sufficiently small and transitory.

Empirical evidence based on the last two decades finds that the ECB has largely followed this prescription. Generally, it has reacted more strongly to demand shocks than to supply shocks. But it has responded to supply shocks more forcefully when these shocks were persistent and inflation was high.[10]

The new environment requires us to emphasise two factors.

The first is the anchoring of inflation expectations.

For the ECB, "looking through" has always been conditional on inflation expectations remaining well anchored. The recent inflation surge has confirmed just how critical maintaining a strong anchoring is to successfully navigate a more volatile world.

Our analysis finds that, if inflation expectations had been as poorly anchored as they were in the 1970s, policy rates would have had to rise to 8% at the peak of the recent tightening cycle to tame inflation, with very high costs for the economy. With well-anchored expectations, recent disinflation has instead been achieved at a relatively low cost compared with similar episodes in the past.[11]

This experience can, in some ways, give us confidence for the challenges ahead: the relative stability of longer-term inflation expectations during a massive inflation surge suggests that our inflation target has a high degree of credibility, which was reinforced by the decisive actions we took to keep inflation expectations anchored.[12]

At the same time, our starting point for the recent inflation episode was a decade of too-low inflation and correspondingly subdued inflation expectations. This meant the public were initially inattentive to inflation and took time to update their views.

But there is some evidence that public awareness has been awakened by recent experience. Once consumers took notice of rising inflation, their inflation perceptions responded quickly but reduced more sluggishly when inflation started to fall. This sluggish response has contributed to the slow adjustment of consumer inflation expectations, especially one year ahead.

We will only know through careful observation how long these memories will last, and consequently how sensitive inflation expectations will be to new shocks. But in all scenarios, close monitoring of inflation expectations – across markets, analysts, forecasters, households and firms – will be central to our policy reaction function.

Once the anchoring of inflation expectations is assured, the second factor we need to assess is how the current environment affects the optimal policy reaction to different type of shocks.

If the Phillips curve becomes steeper at higher levels of inflation, meaning inflation responds faster to changes in activity, then it should also be easier for monetary policy to bring inflation down without imposing heavy costs on the economy. This would weaken one of the main rationales for "looking through" large supply shocks.[13]

At the same time, there may be risks in generalising from recent experience where disinflation was relatively painless.

Alongside well-anchored inflation expectations, the relatively low "sacrifice ratio" during this disinflation episode may reflect a unique set of conditions that will not be applicable to future shocks. In particular, the fact that we faced a series of negative shocks to income reduced the extent to which demand needed to be dampened by monetary tightening.[14]

Any future shocks we face – such as energy price shocks and supply chain disruptions or a large increase in spending on defence or infrastructure – will therefore have to be assessed through this framework.

All told, simple policy prescriptions will not be appropriate in the environment we now face. Within a well-articulated strategy and an unwavering commitment to price stability, we will need to retain agility to respond to complex circumstances as they arise.

This has implications for our policy communication, which brings me to the third area.

Policy communication

Maintaining agility affects how we can talk about the future. And this applies particularly to our ability to give detailed guidance on the future path of interest rates.

Forward guidance about the rate path is particularly useful under two circumstances.

First, when the economy is faced with one-sided, persistent shocks pushing it towards the effective lower bound. In this setting, it gives the public confidence that monetary policy will be sufficiently persistent to dislodge those shocks and deliver on its target, while also helping insulate monetary conditions from spillovers from abroad.

These benefits were all visible in the euro area from 2013 onwards when we first introduced rate forward guidance.

Second, forward guidance can be useful when shocks become two-sided following a long time at the lower bound. In this case, it can help to lay out the conditions for rate lift-off in a way that hedges against false positives and prevents a premature tightening, and thereby reduces uncertainty about the future path of rates.

However, one of the lessons of the recent period is that such guidance can become less helpful when uncertainty about the nature of the shocks is rising. In particular, some of the lift-off criteria we applied to our 2021 rate forward guidance were tied to the baseline inflation projections, but the projections were slow in catching on to the reality of a much more persistent inflation shock.

The combination of factors that created this shock – a worldwide pandemic producing bottlenecks in various sectors upon reopening and a major energy crisis – had not been seen since the end of the World War One. But with hindsight, it would have been beneficial in our forward guidance to explicitly account for the risks and uncertainty surrounding the baseline.

A general conclusion emerges: when the size and distribution of shocks becomes highly uncertain, we cannot provide certainty by committing to a particular rate path. Otherwise, forward guidance may constrain policy agility in the face of abrupt changes to the inflation environment.

But we can provide clarity about our reaction function. We can still help the public to understand how we will navigate the new environment.

First, we can clarify how we are likely to be affected by different states of the world.

Since the pandemic, the ECB has been making greater use of scenario analysis and sensitivity analysis precisely to make our policy more robust to changing circumstances. These exercises, together with our discussion of the balance of risks, are designed to ensure that policymaking can remain forward-looking and stay ahead of the shocks to come.

At present, we are considering various scenarios related to tariffs and fiscal policy changes, and what they will imply for growth and inflation.[15]

Second, we can clarify what kind of data we will look at to make our decisions, which helps the public to distinguish signals from noise. This is why in March 2023 we set out three key inputs for policy decisions:

the inflation outlook – comprising both the baseline and risks around it – the dynamics of underlying inflation and the strength of monetary policy transmission.

In the early phase of our rate tightening, before these criteria were introduced, we saw large monetary policy shocks – linked both to rate decisions and indications on future rates – as markets were looking for orientation. But after March 2023, market moves were less pronounced despite similar levels of interest rate uncertainty, which suggests that the markets better understood our reaction function.

We also saw increased sensitivity to new data releases in the early tightening phase. But this diminished as markets understood which data we were focusing on and, especially, that data dependence should not be confused with "data-point dependence".[16]

The lesson I draw is that laying out a clear reaction function is critical to tempering volatility in a world of exceptional uncertainty. The public must understand the distribution of possible outcomes ahead and how the central bank will react once it is sufficiently confident about which scenario it is facing.

In this way, clarity on the reaction function can be seen as providing *framework guidance* – i.e. a type of guidance that comes from the discipline implicit in a monetary policy framework – without pre-committing to any particular rate path, as the latter would excessively constrain agility.

The three inputs we are currently using are designed to deliver robust policy in the face of the particular constellation of shocks that have hit the euro in recent years, especially the staggered pass-through of a large inflation surge to wages. Whether we continue to use those same inputs in future will depend on the nature of the shocks that confront us.

Our strategy assessment should nonetheless commit to integrating risk and uncertainty about key factors into our reaction function. The data we draw on should capture not only our central projection for the economy, but also the uncertainty surrounding that projection and a rich, diverse set of risks.

Conclusion

Let me conclude.

Thomas Jefferson said that "eternal vigilance is the price of liberty". The same can be said of stability.

Maintaining stability in a new era will be a formidable task. It will require an absolute commitment to our inflation target, the ability to parse which types of shocks will require a monetary reaction and the agility to react appropriately.

Our response to the recent inflation episode should give the public confidence that we will always do whatever is necessary to deliver price stability – and that our policy frameworks can adapt to new circumstances.

Central bankers will need to show agility to adjust their stance and their tools to changing circumstances, and they will need intellectual curiosity to challenge established principles and conventional wisdom.

1.

Index based on Caldara, D., Iacoviello, M., Molligo, P., Prestipino, A. and Raffo, A. (2020), “The economic effects of trade policy uncertainty”, *Journal of Monetary Economics*, Vol. 109.

2.

Iacoviello, M., Wells, L., Yang, W. and Nate, S., “Geopolitical Risk Index” (accessed on 10 March 2025).

3.

See Aldasoro, I., Doerr, S., Gambacorta, L. and Rees, D. (2024), “The impact of artificial intelligence on output and inflation”, *BIS Working Papers*, No 1179, Bank for International Settlements, April; and Lis, E., Nickel, C. and Papetti, A. (2020), “Demographics and inflation in the euro area: a two-sector New Keynesian perspective”, *Working Paper Series*, No 2382, ECB, March. For an alternative view on the effects of ageing on inflation, see Goodhart, C. and Pradhan, M. (2020), *The Great Demographic Reversal*, Palgrave Macmillan.

4.

Attinasi, M.G. et al. (2024), “Navigating a fragmenting global trading system: insights for central banks”, *Occasional Paper Series*, No 365, ECB.

5.

ibid.

6.

Arce, O., Koester G. and Pierluigi, B. (2022), “Challenges for global monetary policy in an environment of high inflation: the case of the euro area”, *ICE: Revista de Economía*, No 929, pp. 115-130.

7.

Dedola, L., Henkel, L., Höynck, C., Osbat, C. and Santoro, S. (2024), “What does new micro price evidence tell us about inflation dynamics and monetary policy transmission?”, *Economic Bulletin*, Issue 3, ECB.

8.

Bobeica, E., Holton, S., Huber, A. and Martinez-Hernandez, C. (2025), “Beware of large shocks! A non-parametric structural inflation model”, forthcoming.

9.

For details on data allowing an analysis of the frequency of wage-setting in the euro area, see Górnicka, L. and Koester, G. (eds.) (2024), “A forward-looking tracker of negotiated wages in the euro area”, *Occasional Paper Series*, No 338, ECB.

10.

See De Santis, R.A. and Tornese, T. (2023), “Energy supply shocks’ nonlinearities on output and prices”, *Working Paper Series*, No 2834, ECB. This pattern holds more generally for central banks in advanced economies; see Hofmann, B., Manea, C. and Mojon, B. (2024), “Targeted Taylor rules: monetary policy responses to demand- and supply-driven inflation”, *BIS Quarterly Review*, Bank for International Settlements, December, pp. 19-36.

11.

Deutsche Bundesbank (2024), “The global disinflation process and its costs”, *Monthly Report*, July. See also Christoffel, K. and Farkas, M. (2025), “Monetary policy and the risks of de-anchoring of inflation expectations”, forthcoming.

12.

Lagarde C. (2024), “Monetary policy in an unusual cycle: the risks, the path and the costs”, introductory speech at the opening reception of the ECB Forum on Central Banking in Sintra, Portugal, 1 July.

13.

Karadi, P., Nakov, A., Nuño, G., Pasten, E. and Thaler, D. (2024), “Strike while the Iron is Hot: Optimal Monetary Policy with a Nonlinear Phillips Curve”, *CEPR Discussion Paper*, No 19339, CEPR Press, Paris & London, 9 August.

14.

Lane, P.R. (2024), “The effectiveness and transmission of monetary policy in the euro area”, contribution to a panel at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, 24 August.

15.

In addition, there needs to be clarity that the central bank will respond appropriately in the event of large market disruptions. The ECB has a strong track record in providing liquidity during financial stress episodes and has two backstop instruments in its toolkit (the Outright Monetary Transactions and the Transmission Protection Instrument). In turn, investor confidence in the liquidity policies and backstop instruments of the ECB acts as a self-stabilising force by limiting incentives to “run for the exit” during stress periods.

16.

Lagarde, C. (2024), op. cit. and the Q&As during the September 2024 and October 2024 press conferences are prominent examples.

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