

## MONETARY POLICY IN AN UNCERTAIN INFLATION ENVIRONMENT



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### Setting Europe's monetary compass amid high uncertainty

Europe's economic landscape has changed markedly since the inflation surge of 2021. A prolonged period of elevated inflation caught forecasters off guard and exposed the limitations of traditional models, especially when inflation diverges significantly from target levels. In the fall 2022, amid soaring natural gas and commodity prices, inflation peaked at 8.7 percentage points above target.

IMF analysis shows that when inflation is persistently above target, expectations become stickier, amplifying the inflationary effects of any negative supply shock.<sup>1</sup> In response to this historical rise in inflation and expectations, the ECB undertook the steepest monetary tightening cycle in its history. This aggressive response was appropriate to prevent inflation expectations from de-anchoring, and it worked.

Today, headline inflation in the euro area is close to target, expectations are well-anchored, forecast errors have normalized, and the ECB's policy rate is broadly neutral—neither stimulating nor restricting economic activity.

However, renewed geopolitical and trade tensions have raised uncertainty. Significant and prolonged deviations from the inflation target—upward or downward—are once again possible. How should the ECB navigate this uncertain environment?

The current macroeconomic configuration—headline inflation near target, core inflation slightly above, and a mildly negative output gap—supports maintaining a neutral monetary stance. IMF projections suggest inflation will remain around target if the policy rate stays at the current level of 2 percent. Trusting in the improved accuracy of its forecasts, and given that monetary policy typically takes at least six months to influence price dynamics, the ECB should thus avoid creating market noise through fine-tuning policy in response to data that suggest only a small, temporary departure of inflation from the target.

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Instead, rate changes should be considered only if incoming data point to a material shift in the inflation outlook—especially if there's a risk that expectations could become de-anchored. If such a shift occurs, monetary policy should respond forcefully. IMF analysis shows that the welfare costs of underestimating inflation persistence outweigh those of overestimating it.<sup>2</sup> Once high/low inflation becomes embedded in expectations, the effort required to bring it back to target is significantly more costly. This approach anchors expectations, reduces market noise, and preserves flexibility in the face of future shocks.

To support this approach, one must define what constitutes a "material shift." Recent IMF scenario analysis

offers guidance, highlighting how energy price volatility, wage pressures, or changes in external demand could affect the policy path.<sup>3</sup> For example, with inflation expectations currently anchored, it would take a cost shock that reduces core inflation by 0.2 percentage points for four consecutive quarters to justify a 25-basis-point policy rate adjustment. Such a shock could stem, for example, from a sustained 10 percent drop in oil prices. Similarly, a temporary demand shock of around 0.7 percent of GDP would have a comparable effect.

This approach also suggests a change in communication: as inflation stabilizes and uncertainty eases, the ECB should place greater emphasis on forecast-based communication, while reinforcing its readiness to act decisively if new shocks threaten to de-anchor inflation expectations. The recent high-inflation episode underscores the risk of large second-round effects on wages and prices triggered by temporary supply shocks.

Europe's monetary policy must be forward-looking, not merely reactive. That means embracing uncertainty, communicating with precision, and steering with a steady hand.

This article was co-authored by Francesca Caselli and Allan Dizioli (IMF).

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2. *Monetary Policy with Uncertain Inflation Persistence*, IMF/WP March 2024.
3. *Interest Rate Sensitivity Scenarios to Guide Monetary Policy*, IMF/WP May 2025.



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### Monetary policy in uncertain times: Back to basics

Thornton and Bagehot laid the intellectual groundwork for modern monetary policy in the 19th century. The central bank needs to make sure that in good times the amount of money grows at a rate sufficient to maintain broad stability of the value of money and in bad times the amount of money grows at a rate sufficient to provide the liquidity for unpredictable swings in demand.<sup>1</sup> In 1998, the ECB was set up to conduct monetary policy in the EU with the primary objective of maintaining price stability and a secondary and subordinate objective of supporting the general economic policies in the EU.

#### Price stability

The ECB quickly interpreted the price stability mandate as an inflation stability mandate, with a reference value of 'below 2%'. In 2003, the ECB altered its objective towards an inflation rate 'below, but close to' 2% and rephrased it to a symmetric target around 2% in 2021. This evolution towards a symmetric target is quite fundamental. In a scenario where prices would be on average stable for the years to come, the ECB would still use its heft to try to stimulate the economy towards small inflation, whereas before that could be classified as 'below 2%'. For instance, in the period 2014-2019, the economy was

rather calm and steadily growing, but inflation remained low. In hindsight, that time could have been used by the ECB to diminish its market influence and return to higher interest rates. Instead, its balance sheet more than doubled in size from 2014 to 2019.

When Janet Yellen asked Alan Greenspan how he defined price stability, he answered 'that state in which expected changes in the general price level do not effectively alter business or household decisions'. This definition was echoed by Paul Volcker, but he was sceptical about a precise numerical target as 'no price index can capture, down to a tenth or a quarter of a percent, the real change in consumer prices'.<sup>2</sup> He also noted that a 2 percent inflation rate, successfully maintained, would mean the price level doubles in little more than a generation.

The fear that lies behind the shift in the target is deflation. A 2% target allows for some room before countries reach deflationary numbers. However, the occurrence of protracted periods of deflation has been rare in the developed world. Deflation can also just be the benign consequence of technological progress. The dramatic U.S. deflation of the 1930s was shaped by the drastic decrease in the money supply.<sup>3</sup> In this regard, avoiding deflation spirals would benefit most from a strong lender of last resort, rather than a target that keeps room for manoeuvre. Volcker warned that encouraging inflation comes with increased risk-taking and the formation of bubbles, which might, in the end, bring about the feared deflation.

#### Supporting the EU's general economic policies

Since the sovereign debt crisis in the EU of the early 2010s, the ECB has gradually become more involved in sovereign debt markets. Here as well, the boundary has been shifting steadily, as documented by Cochrane, Garicano and Masuch.<sup>4</sup> From the Securities Market Program, over Outright Monetary Transactions to the Transmission Protection Instrument (TPI), the ECB's capacities to purchase sovereign bonds have been widening. Nowadays, the ECB gains a reputation as a fiscal backstop to ensure effective transmission of monetary policy. However, its large role in the sovereign debt market may turn up as an important consideration in the ECB's policy responses and thus complicate its role to preserve price stability.

The ECB has also ventured into green central banking, as climate change is deemed a threat to price stability. Even though this may well be true in the longer term, numerous other factors can thus be found to affect price stability. A

war would evidently have an impact on prices, but that does not mean the ECB should have defence capabilities.

#### Conclusion

The ECB's independence is important for stable monetary policy and is linked to the popular consensus around price stability. In other cases, such as fiscal policy and how to tackle climate change, a political and democratic debate is essential. A return to the basic principles of conducting monetary policy is therefore due. In these uncertain times, we can conclude with the view of Friedman, that monetary policy can foremost prevent money itself from being another major source of economic disturbance.<sup>5</sup>

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