

BOOSTING GROWTH AND INVESTMENT: WHAT ROLE FOR MONETARY POLICY?



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Balancing inflation risks: what's next for the ECB?

After an unprecedented monetary policy cycle over the past four years, the European Central Bank has successfully engineered a soft landing in the euro area. Headline inflation has hovered in a narrow range around the ECB's 2 percent target since March 2025, while unemployment has remained close to record lows. Yet uncertainty around the inflation outlook persists, shaped by new factors—notably exchange rate movements and shifting global trade dynamics. Are inflation risks still two-sided, and what does this imply for ECB monetary policy?

External forces have been exerting downward pressure on inflation in recent months. The nominal effective exchange rate has appreciated by around 6 percent over the past year, driven largely by external developments—most notably U.S. dollar depreciation amid a changing U.S. policy outlook, stronger demand for dollar hedging, and, more recently, adjustments in

global portfolios. IMF staff analysis suggests that this appreciation is already weighing on euro area price dynamics, lowering January core inflation by about 0.3 percentage point on average across euro area members. A new IMF staff index of exchange-rate-sensitive inflation points to the same conclusion: euro appreciation has begun to dampen inflationary pressures. By contrast, trade diversion into the euro area resulting from higher U.S. tariffs has so far had a more muted effect. While China accounts for about one-fifth of the EU's extra-EU goods imports, Chinese goods represent only around 3–4 percent of EU spending. As a result, even the sizable decline in Chinese import prices observed to date has had only a limited impact on inflation.

However, these external developments have primarily weighed on goods inflation, while services inflation has remained elevated, at 3.4 percent in January—mostly unchanged over the past three months—and shows substantial cross-country variation. Since services are labor-intensive, their prices are particularly sensitive to wage dynamics, which vary significantly across the euro area. High inflation persists in the Baltics, while wage growth—still at around 4 percent at the latest reading—has slowed more gradually than expected in some large economies, notably Germany and Spain. Forward-looking indicators point to wage moderation ahead, but the recent pattern of slower-than-expected deceleration could persist. Finally, the recent softening in headline inflation has been driven largely by highly volatile energy prices. Headline inflation could therefore rebound quickly if energy prices rise again—for example, in response to stronger-than-expected energy demand from AI or renewed geopolitical disruptions to supply.

Overall, risks to the inflation outlook remain two-sided. On the downside, stronger-than-expected effects from trade diversion or exchange rate pass-through could weigh more heavily on inflation. On the upside, persistently elevated services inflation, underpinned by still-robust wage growth, together with ongoing fiscal expansion, continues to pose risks.

Against this backdrop, the current policy rate of 2 percent remains appropriate. It supports inflation stabilizing at the ECB's medium-term target and is consistent

with a broadly neutral monetary policy stance, given inflation near target, firmly anchored expectations, and a broadly closed output gap.¹ A move away from the 2 percent policy rate should therefore be considered only if the inflation outlook or associated risks were to shift materially. While last year's euro appreciation may continue to exert downward pressure on inflation, it represents just one element in a broader set of considerations guiding ECB policy. However, vigilance remains essential to prevent deviations from target that could de-anchor inflation expectations.

The ECB should continue to emphasize the inflation outlook to anchor interest rate expectations.

Forward-looking ECB communication remains important. It is associated with lower market uncertainty about the future path of policy rates.² Financial markets overwhelmingly expect the ECB to keep interest rates steady with no imminent cut or hike—signaling strong confidence in the policy path for the year ahead. As inflation stabilizes around target and forecast errors return to historical norms, the ECB should continue to emphasize the inflation outlook to anchor expectations, including interest rate expectations.

This article was co-authored by Robert Beyer and Allan Dizioli (IMF).

1. *Real Equilibrium Interest Rates in the Euro Area, IMF/WP June 2025.*
2. *Central Bank Communication in Times of Uncertainty: AI-assisted Decoding of Recent Trends in Europe. IMF/Manuscript 2025.*



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Innovation and regulatory lags drive Europe's investment gap

The investment gap between EU and US has widened significantly, reflecting structural differences in economic dynamism, innovation capacity and the regulatory environment.

Over recent years, total US investment rose by ~17%, compared with 7% in the EU. But the sharpest divergence concerns intangible assets where US investment surged by 47%, more than double the EU's 20%. This matters because intangible capital is one of the strongest drivers of productivity growth and technological progress.

Domestic demand dynamism has played a major role in driving the US investment outperformance. Since 2019, US domestic demand has expanded by 16%, compared with just 5% in EU. This provided US firms with stronger market conditions, supporting capital expenditure. EU, by contrast, has been held back primarily by the persistent fragmentation of its markets which limits scale and weakens investment incentives.

Energy and geopolitics have further amplified the gap. The EU suffered a severe negative terms-of-trade shock following Russia's invasion of Ukraine which led to higher production costs,

greater uncertainty, reduced investment appetite and a weakening of its position in global markets.

Policy choices have compounded these differences. US fiscal policy was overly expansionary sustaining aggregate demand and capital spending. The EU response, by contrast, has been more cautious and uneven.

Regulation represents another source of divergence. EU faces longstanding structural rigidities: market fragmentation, slower legislative processes and prescriptive rules. These constraints have become increasingly evident in fast-evolving technologies such as AI. The EU AI Act introduces detailed, ex ante risk classifications and specific regimes for general-purpose AI, including extensive transparency, documentation, and – when models are deemed “systemic” – evaluation and cybersecurity obligations. While this provides legal certainty, it can also limit experimentation and delay scaling. The US follows a more flexible, principles-based, sector-specific approach, enabling faster iteration and broader early adoption.

In the financial sector, EU continues to deduct software investments from capital under a strict interpretation of Basel rules, whereas the US does not. This makes large-scale digital investment structurally more expensive for EU banks. Regulatory uncertainty also affects DLT-based innovations.

The treatment of dollar-denominated stablecoins and the permissibility of multi-issuance models remains unclear. While Europe must consider strategic sovereignty, excessive isolation would deprive the market of the liquidity required to build competitive EU alternatives.

The EU-US investment gap is widening due to structural and regulatory differences.

In the US, new technologies develop and diffuse more rapidly, also thanks to the dominant role of big tech firms, now increasingly active in financial markets as well. AI is a clear example: the US is advancing quickly in both development and adoption, while EU lags behind.

For EU, accelerating AI adoption should be the immediate priority, as it promises the fastest productivity gains. Yet long-term strategic autonomy also requires developing sovereign AI

capabilities. Today, AI adoption in EU remains concentrated in large firms, while SMEs face operational barriers: lack of expertise, uncertainty over legal and data-protection obligations, insufficient data quality, and legacy IT systems. The EU's 2025 Apply AI Strategy aims to remove these bottlenecks, promoting an “AI-first” mindset in key sectors and supporting diffusion across the SME landscape.

Over the medium term, EU is also pushing to build autonomous technological capabilities – large language models, AI “gigafactories”, high-performance computing, and secure data spaces – to reduce dependency on US and Chinese providers.

Geopolitical tensions create a fundamental trade-off for the EU: on one side, the Union must accelerate the adoption of AI technologies developed globally to immediately boost productivity and competitiveness; on the other side, it must invest heavily in building a domestic AI ecosystem to reduce external dependencies. The challenge lies in balancing the short-term gains from rapid adoption with the long-term need for technological sovereignty. Reconciling these two imperatives will be essential to closing the investment gap and redefining the EU's competitive position in an increasingly fragmented global landscape.

The related competitive process often leads to agglomeration, as firms seek to exploit shared advantages. This phenomenon, in turn, intensifies competitive pressure and gradually selects the most efficient players, ultimately contributing to the emergence of leading ‘champion’ companies.