

# Relaunching growth and investment: what role for monetary policy?

The session took place against a backdrop of heightened geopolitical uncertainty and overlapping shocks, particularly related to energy prices and global tensions. Discussions focused on the implications of this more volatile environment for monetary policy, inflation dynamics and growth prospects in the euro area. Panellists examined both the short-term policy response and the longer-term structural challenges facing Europe, including productivity, technological change and the evolving role of the euro in the global financial system.

## 1. A more shock-prone world: assessing risks and macroeconomic uncertainties

This first part of the discussion focused on the increasingly shock-prone global environment, examining the nature of recent energy and geopolitical shocks and their implications for inflation and macroeconomic dynamics.

### 1.1 Navigating overlapping shocks: implications for monetary policy and structural change

The Chair began by emphasising that the environment is becoming increasingly prone to overlapping shocks. In that context it was striking that despite frequent large shocks, not least the changing global trade regime, monetary policy was able to stay in "a good place" for around a year. The question now is whether the latest energy price shock is different and requires a reaction from the European Central Bank (ECB).

### 1.2 Lessons from 2022: navigating the current energy shock

A Central Bank official highlighted four key differences between the recent shock and the 2022 energy price shock. First, inflation was already relatively high in 2022 before the energy price shock hit, reflecting supply chain disruptions and the recovery from the initial phase of the pandemic. Second, growth rates were much higher in 2022 than the subdued growth experienced in the euro area over the past two years. Third, interest rates were negative in 2022, whereas they are now at 2% in the euro area, providing the central bank with greater flexibility. The fourth difference is that the public reaction was different in 2022, as people had little recent experience of an inflationary episode. Now, with fresh memories of rapidly rising prices and emerging wage pressures, firms, consumers, and governments may react with greater urgency.

The key to success is to be well positioned, maintain vigilance and be prepared to act quickly should signs of second-round effects emerge.

### 1.3 Geopolitical uncertainty and 'wait and see' dynamics: short-term risks, long-term opportunities

An industry representative emphasised the greater intensity and unpredictability of geopolitical shocks today. It is unclear how long conflicts will last. In such an environment, the natural response is to adopt a 'wait and see' attitude towards monetary policy, the private sector and investment. This delays decisions, with the implications for monetary policy remaining unclear.

In the longer term, however, there is reason for optimism. Technological change is happening more quickly. If industries, the private sector and institutions learn how to harness the benefits of rapid technological change, it will be possible to lead the economy out of this uncertain situation much more effectively than before.

### 1.4 Energy shocks, persistent inflation and the risk of stagflation

A market expert stated that, historically, all crises involving sharp increases in energy prices have led to recessionary pressures and inflation. The current conflict in the Middle East is pushing prices up, creating both inflationary and recessionary risks. Even if energy prices were to decline, the overall price level would be higher than before the shock occurred, indicating that the impact on inflation dynamics would be long-lasting.

Europe needs to intensify its structural policies, which have not been developed sufficiently over time. The current environment points to a prolonged struggle against both inflation and stagnation. In this context, monetary policy cannot be neutral and must maintain a clear anti-inflationary stance. It would be unrealistic to expect prices to return to their previous levels. Some economic damage is inevitable, but it is essential to limit its extent as much as possible.

## 2. Monetary and fiscal policy responses to shifting energy, inflation and growth dynamics

The discussion then turned to the appropriate monetary and fiscal policy responses in this context, with a particular focus on managing uncertainty, preserving policy credibility and avoiding counterproductive interventions.

### 2.1 Monetary policy in a world of overlapping shocks and non-linear risks

A Central Bank official highlighted the increasing significance of geopolitical uncertainty, observing that the global landscape is more prone to conflict and characterised by overlapping shocks that interact in

complex ways. Shocks may initially emerge as supply-driven disturbances before evolving into broader demand shocks, increasing the likelihood of non-linear economic effects. In this context, firms and households may react more quickly and strongly to high inflation, making it more challenging to calibrate monetary policy.

### **2.1.1 Scenario analysis as a tool to navigate uncertainty without guiding market expectations**

A Central Bank official explained that the ECB's recent strategy update has placed greater emphasis on dealing with uncertainty, particularly through the enhanced use of scenario and sensitivity analyses. Although monetary policy decisions remain anchored in a baseline scenario, alternative scenarios are employed to evaluate risks and gain a clearer understanding of how the economy could evolve under different circumstances. In the latest projection round, the ECB introduced adverse and severe scenarios based on different energy price development assumptions. Unlike the baseline scenario, these scenarios are not consistent as they do not incorporate an endogenous monetary policy response and should therefore not be interpreted as alternative policy paths. Instead, they serve as analytical tools to gauge the potential economic impact of shocks and the scale of policy adjustments that might be required, without constituting alternative policy paths or direct signals for market pricing.

### **2.1.2 Monitoring high-frequency data, expectations and fiscal interactions to detect regime shifts**

A Central Bank official stated that a key challenge lies in assessing in real time whether the economy is deviating from the baseline towards one of these alternative scenarios. It is important to closely monitor the source of shocks and the emergence of non-linear dynamics. This requires a greater reliance on granular, high-frequency data in order to detect early changes in behaviour. De-anchoring of inflation expectations or more aggressive repricing by firms would be critical signals requiring immediate policy action.

In 2022, fiscal policy added a significant positive demand shock. In the current context, however, fiscal space is more limited, suggesting that policy responses should be smaller, more targeted and focused on alleviating peak pressures rather than providing broad income support.

Overall, the ECB's approach remains meeting-by-meeting and data-dependent. In an environment of heightened uncertainty, it is more appropriate to clearly communicate the reaction function of monetary policy than to provide forward guidance on future decisions.

## **2.2 Communicating monetary policy in uncertainty and avoiding counterproductive fiscal responses**

The Chair added to the previous intervention, noting that in times of uncertainty scenario analysis can be a very useful tool to communicate for central banks. The Chair also agreed that an untargeted fiscal response that distorts the price signal and prevents demand for energy from adjusting accordingly would be problematic. There is no reason for such a response at this stage, as the current energy price shock is not as severe as the Russian gas shut-off. The impact on household balance sheets,

including for vulnerable households, remains limited. Untargeted, fiscally costly measures could create the expectation that the government is the main insurer against all external shocks.

## **2.3 Rising debt, energy shocks and the return of inflation risks**

A market expert identified two significant trends that are currently shaping the environment. OECD countries are grappling with mounting public debt, with government debt projected to surge from 83% to 86% of GDP by 2026. Furthermore, the IMF forecasts that European public debt will reach approximately 130% of GDP by 2040. This is the most serious fiscal situation since the Second World War and must be taken into account when assessing inflation risks. Secondly, geopolitical tensions in the Middle East are impacting energy prices. Oil prices have risen significantly, from around \$60 at the start of the year to above \$100. This combination of rising debt and higher energy prices creates a challenging macroeconomic environment.

### **2.3.1 Fiscal deterioration and higher energy prices as key drivers of a more fragile macroeconomic environment**

A market expert acknowledged that a temporary increase in energy prices could, in theory, be overlooked by monetary policy, but there are four important caveats. First, if the increase persists, it could be passed on to consumers, resulting in permanently higher prices even if energy prices subsequently decline. Secondly, it is important to closely monitor core inflation, which remains high, particularly in the eurozone and the US. Thirdly, there is an abundance of global liquidity; years of accommodative monetary policy continue to fuel strong debt dynamics and relatively narrow spreads. Fourthly, the recent rise in long-term interest rates may reflect growing investor concerns.

### **2.3.2 The case for a more preventive monetary stance and stronger fiscal discipline to avoid stagflation**

A market expert argued that the balance is shifting towards a more preventive monetary policy stance. Given that the primary objective of central banks is to maintain price stability, interest rates may need to increase further despite high public debt levels and risks of fiscal dominance in order to avoid a stagflationary scenario.

Even if energy price shocks prove temporary, the combination of persistent fiscal deficits and elevated inflation risks should not be underestimated. In the most pessimistic scenario, inflation is projected to reach 4.8% in 2027. Monetary policy must be considered in relation to fiscal policy. A lack of fiscal discipline would necessitate a more restrictive monetary approach; conversely, if fiscal policy were to become more disciplined, monetary policy would be under less pressure. In other words, if fiscal policy remains expansionary, monetary policy would need to be more restrictive, whereas greater fiscal discipline would ease pressure on monetary policy.

A prolonged conflict in the Middle East would lead to lasting increases in price levels. Vigilance is important, as the failure to act appropriately could result in a more difficult stagflationary environment.

### 3. Structural challenges and long-term transformations for European growth

Beyond short-term policy challenges, the panel also addressed longer-term structural issues shaping Europe's growth prospects, including productivity, technological change and the evolving financial landscape.

#### 3.1 Resilience, structural weaknesses and policy priorities in the euro area

A Central Bank official explained that the domestic euro area economy was showing a fair degree of resilience before the start of the war, but this has now changed. Over the past six years, the euro area has experienced four significant crises: Covid, the Russian invasion of Ukraine, the announcement of tariffs and the conflict in the Middle East. During Covid, projections proved wrong. In this context, central bank models struggle to capture sudden changes in the behaviour of households and firms.

##### 3.1.1 Resilience, forecasting errors and changing economic dynamics

A Central Bank official underlined that the euro area is facing a structural problem of weak potential growth and productivity. Addressing this requires continued progress on key European policy priorities, such as completing the banking union, advancing the savings and investment union, and deepening the single market. Studies by the IMF and the ECB suggest that there is substantial untapped potential within the European Union. Given the current situation, structural reforms should be accelerated.

##### 3.1.2 Structural reforms, targeted support and the role of monetary policy in sustaining growth

A Central Bank official cautioned against placing too much emphasis on short-term challenges, such as calls to offset rising energy prices. Any support should be temporary, targeted at the most vulnerable and not undermining price signals or slowing down the energy transition. Recent developments highlight the need to accelerate the transition and to reduce Europe's dependence on fossil fuels for economic and geopolitical reasons. The weak fiscal position of many countries limits the scope for policy responses. The primary role of monetary policy is to maintain price stability; this is the most effective way in which central banks can support sustainable growth.

The Chair noted that, while Europe is currently experiencing a big structural shock, if it continues with the energy transition, the impact of such a shock would be very different 10 years from now. Therefore, it is important to continue with and accelerate the energy transition, and to be careful with bailout packages because of the fiscal costs.

#### 3.2 Artificial intelligence, investment and policy challenges for European growth

##### 3.2.1 AI as an opportunity amid uncertainty and Europe's structural constraints

An industry representative described artificial intelligence (AI) as a major opportunity, while cautioning against excessive optimism regarding its short-term impact on productivity. The economic effects of AI are still uncertain. The associated investments are substantial because they require not only intangible assets but also significant physical infrastructure. While the new technologies are extremely powerful, they must be governed. The governance of the distribution of these technologies should promote larger rather than fragmented markets and support the development of skills.

There is a growing disparity between the United States and Europe in terms of investment, innovation and resource allocation. Europe could risk entering a period of low growth if it fails to act decisively. There is a need for clear policy signals to make Europe an attractive place to invest. The incomplete implementation of key initiatives such as the banking union and the capital markets union hinders Europe's economic performance. Institutional fragmentation, often driven by non-economic considerations, further complicates the situation.

##### 3.2.2 AI, policy mix and financial stability risks: macroeconomic implications

A Central Bank official agreed that, in a geopolitical environment characterised by frequent shocks, fiscal interventions should be used only where necessary and withdrawn quickly. While the primary objective of central banks is to manage inflation, inadequate action from other policies could necessitate tighter monetary conditions, which might dampen demand.

Europe did not benefit fully from the previous digital transformation and cannot afford to fall behind in the AI transition. Failure to act would result in persistent underperformance, with significant geopolitical and social implications. Europe can still succeed if it acts decisively on structural reforms.

There are potential financial stability risks linked to the scale of investment in AI infrastructure. In 2025, US investment in AI-related infrastructure reached 2.1% of GDP, a historically significant level, second only to the US purchase of Louisiana in 1803. If this momentum were to weaken due to energy shocks, this could cause instability at both the investment stage and the stage of delivering expected productivity gains.

From a macroeconomic perspective, stronger productivity growth driven by AI could eventually lead to higher interest rates. In the short term, however, productivity gains could exceed wage growth, creating disinflationary pressures. The overall impact will depend on whether investment-driven demand materialises in Europe or elsewhere. Significant uncertainty remains regarding these dynamics.

#### 3.3 Stablecoins, monetary sovereignty and the challenges for policy transmission

A Central Bank official emphasised that the digitalisation of payments and financial markets is a positive development that offers significant opportunities.

However, from a monetary policy perspective, it also poses important risks, particularly with regard to monetary sovereignty and the transmission of monetary policy.

The growing popularity of stablecoins, particularly those tied to foreign currencies, could diminish the significance of central bank money as the foundation of the monetary system. Furthermore, stablecoin issuance could alter banks' funding structures by shifting resources from stable retail deposits to more volatile wholesale funding. This would increase liquidity risks, weaken intermediation capacity, and potentially affect the transmission of policy rates, given that wholesale rates tend to adjust more rapidly than deposit rates.

There are two main responses to these developments: regulation and adaptation. In terms of regulation, micro-prudential, macroprudential and conduct supervision is important, including the role of the EU's Markets in Crypto-Assets (MiCA) framework. Regarding adaptation, central banks must adjust to the evolving financial landscape. A key example of this approach in the retail sector is the digital euro. Central banks are seeking collaboration rather than competition with the banking sector.

More broadly, technological developments could have a significant impact on monetary policy and how it is implemented, meaning that central banks will need to adapt their frameworks. The financial liberalisation of the 1980s led to a shift away from targeting monetary aggregates; similar adjustments may be necessary today. Rather than trying to resist technological innovation, Europe should look to proactively adapt to it.

The Chair noted that the digital euro is a key path to bring central bank money into the digital age.

### **3.4 The international role of the euro in a changing geopolitical environment**

A Central Bank official observed that, for the euro to play a stronger international role, it is necessary to respond to increasing demand. The new repo facility is one such response. However, further steps may be needed. Geopolitical uncertainties are prompting discussions about the extent to which the euro should assume a more prominent role. History shows that periods in which different currencies compete for dominance can be challenging.

However, a stronger international role for the euro may also entail downsides, such as appreciation pressure and other challenges that need to be taken into account. The best approach is therefore to be well prepared, which is what the ECB is aiming to do in response to these inherently political developments. In terms of transactions and reserve holdings, the US dollar still remains the dominant currency worldwide. It is unclear how the situation may evolve in the future, underscoring the importance for Europe to be well prepared.

The Chair noted that, for Europe to be well prepared, it needs to have a single market and a deep capital market.

In concluding the discussion, the Chair stressed the importance of structural reforms in strengthening

Europe's medium-term growth potential. Europe must move forward with EU-level reforms to remove market frictions, deepen the capital markets union and establish an energy union, while national reforms are also needed to increase productivity and living standards. Growth is essential to maintain Europe's social contracts, particularly given long-term spending pressures and the need for fiscal consolidation. Every crisis leaves scars, but there was confidence that Europe can enact policies to limit the impact of this shock and emerge stronger over the medium to long term.

The discussion highlighted the increasing complexity of the current policy environment, marked by overlapping shocks, persistent inflation risks and heightened uncertainty. While there was broad agreement on the need for vigilance, views differed on the appropriate policy stance. Some participants emphasised the need for a more preventive monetary tightening to contain inflation risks, particularly in the context of rising energy prices and fiscal imbalances. Others underlined the importance of a cautious, data-dependent approach, given the uncertainty surrounding the duration and transmission of current shocks.

At the same time, there was a shared recognition of the importance of an appropriate policy mix, including more targeted fiscal measures and greater fiscal discipline. Looking beyond the short term, strengthening Europe's growth potential through structural reforms, technological adoption and deeper financial integration emerged as a key priority. Despite the challenges, there was confidence that Europe can adapt and enhance its resilience over the medium to long term.