

SPEECH

The conduct of monetary policy

Keynote speech by Philip R. Lane, Member of the Executive Board of the ECB, at the ECB Conference on Monetary Policy 2025: bridging science and practice

Frankfurt am Main, 6 October 2025

My aim today is to explain the conduct of monetary policy in the euro area.^[1] I will first outline the approach to monetary policy that is embedded in our monetary policy strategy statement. Next, I will review the current inflation outlook. Finally, I will outline the considerations most relevant for our near-term policy decisions.

The monetary policy strategy of the ECB

Our recently-updated monetary policy strategy statement provides a comprehensive strategic framework for many dimensions of monetary policy.^[2] Here, I will focus on the elements that are most directly relevant for monetary policy decision making.

Paragraph five of our monetary policy strategy statement states:

The Governing Council considers that price stability is best maintained by aiming for two per cent inflation over the medium term. The Governing Council's commitment to this target is symmetric. Symmetry means that the Governing Council considers negative and positive deviations from this target as equally undesirable. The two per cent inflation target provides a clear anchor for inflation expectations, which is essential for maintaining price stability.

The point target of 2.0 per cent provides valuable clarity; the symmetric commitment reinforces this clarity by treating positive and negative deviations as equally undesirable. Such clarity would not be provided by a zonal inflation target, which would require households, firms and market participants to continuously re-assess which part of the zone constituted the de facto current operational target for monetary policy.

Of course, a clear target does not mean that the ECB seeks to deliver inflation at two per cent at all times. In particular, paragraph seven explains:

The Governing Council confirms the medium-term orientation of its monetary policy strategy. This allows for inevitable short-term deviations of inflation from the target, as well as lags and uncertainty in the transmission of monetary policy to the economy and to inflation. The flexibility of the medium-term orientation takes into account that the appropriate monetary policy response to a deviation of inflation from the target is context-specific and depends on the origin, magnitude and persistence of the deviation. Subject to maintaining anchored inflation expectations, it also allows the Governing Council in its monetary policy decisions to cater for other considerations relevant to the pursuit of price stability.

In terms of origin, different types of shock may move inflation and real economic activity in the same direction (as in the case of demand shocks) or create a temporary trade-off (as in the case of supply shocks): the medium-term orientation provides flexibility to look through temporary shocks to inflation that may dissipate on their own accord, thus avoiding unnecessary volatility in activity and employment.^[3] In terms of magnitude and persistence, a small, transitory shock clearly poses less risk to the medium-term anchor than a larger, more persistent shock. In any event, the lags in the transmission of monetary policy mean that it would not be practical to respond to inflation shocks that are expected to dissipate quickly.

In turn, paragraph eight ties the setting of monetary policy to delivering the two per cent target over the medium-term:

The Governing Council is committed to setting monetary policy to ensure that inflation stabilises at the two per cent target in the medium term.

That is, the ECB follows an inflation targeting regime, but with substantial flexibility provided by the medium-term orientation. This means that monetary policy decisions are firmly grounded by the commitment to stabilise inflation at two per cent over the medium term, with due regard for the value of flexibility under the circumstances that prevail at any given point in time.

Paragraph nine elaborates on the inputs into these monetary policy decisions:

The Governing Council bases its monetary policy decisions, including the evaluation of the proportionality of its decisions and potential side effects, on an integrated assessment of all relevant factors. In particular, it takes into account not only the most likely path for inflation and the economy but also surrounding risks and uncertainty, including through the appropriate use of scenario and sensitivity analyses.

The second sentence in paragraph nine is new and is an important articulation that monetary policy decisions are made under uncertainty, such that it is essential to take a wide-angled perspective that incorporates not only the baseline path but also the surrounding risks and uncertainty. This sentence also reflects the reality that much of the policy debate is about risk management, especially under current conditions of elevated uncertainty.

Indeed, an important conclusion of the 2025 update of our monetary policy strategy is that an array of structural changes is likely to make uncertainty a defining characteristic of inflation environment for the rest of this decade. In particular, paragraph one states:

Ongoing structural shifts related to geopolitics, digitalisation, artificial intelligence, demography, the threat to environmental sustainability and changes in the international financial system suggest that the inflation environment will remain uncertain and potentially more volatile, with larger target deviations in both directions, posing challenges for the conduct of monetary policy.

Finally, paragraph six highlights that the biggest threat to the medium-term inflation target comes from large, sustained deviations from the target. In particular, paragraph six states:

To maintain the symmetry of its inflation target, the Governing Council recognises the importance of appropriately forceful or persistent monetary policy action in response to large, sustained deviations of inflation from the target in either direction, to avoid deviations becoming entrenched through de-

anchored inflation expectations. In the event of significant disinflationary shocks, the effective lower bound on nominal interest rates needs to be taken into account. In the event of significant inflationary shocks, possible non-linearities in price and wage setting need to be taken into account.

Taken together, these elements of the monetary policy strategy statement provide essential foundations for the conduct of monetary policy. Still, at any given point in time, these strategic principles have to be converted into an operational approach to making monetary policy decisions.

In particular, there is a clear difference between “standard” phases in which there may be inflation shocks but not to the degree that would constitute “large, sustained deviations of inflation from the target” and “acute” phases in which the central bank must act with appropriate force or persistence to avoid deviations becoming entrenched through de-anchored inflation expectations. If a deviation of inflation from the target is in the intermediate range that is neither “small and transitory” nor “large and sustained”, the appropriate monetary policy response will be nonzero but will also necessarily be more restrained than the scale that constitutes “appropriately forceful or persistent”.

In this range, the optimal calibration of monetary policy is a question of cyclical adjustment within a more narrow interval for the policy rate. By and large, the monetary policy literature has primarily focused on such cyclical adjustments, with many models examining the optimal monetary policy response to relatively “small” shocks that can be captured by linearised treatments of the dynamic adjustment of the economy and inflation.

In contrast, the frequency of “large, sustained” deviations of inflation from the target is relatively rare. Indeed, in the absence of an extraordinary constellation of shocks (such as the combination of the pandemic and Russia’s unjustified invasion of Ukraine), a large and sustained deviation of inflation from the target would most likely result from a persistent failure in the conduct of monetary policy, with an insufficient response to cyclical shocks fostering an incremental, cumulative drift away from the target that de-anchored inflation expectations through a lack of policy responsiveness to material inflation shocks.^[4]

In what follows, I turn to analysing the current inflation outlook before outlining some considerations for the conduct of monetary policy in the near term.

The baseline inflation outlook

In this section, I discuss some features of the baseline in the September 2025 staff macroeconomic projections. I turn to the surrounding risks in the final section.

As a preliminary caveat, the baseline is conditioned on the prevailing economic and financial data at the time the projections are constructed, including the expected path for short-term policy rates that is embedded in the market curve. Since the projection exercises are comprehensive in scope, it is only of limited value to attempt “real-time updates” in between projection exercises that are based on the mechanical impact of shifts in individual variables, since a shift in any given variable may reflect a broader underlying dynamic process that jointly affects many variables. For this reason, I focus on the September projections rather than attempting to comment on the subsequent data flows.

Under the baseline, inflation is projected to average 2.1 per cent in 2025, 1.7 per cent in 2026 and 1.9 per cent in 2027. Compared to the 2021-2024 inflation rates of 2.6 per cent, 8.4 per cent, 5.4 per cent

and 2.4 per cent respectively, the current inflation outlook is much more benign. At the same time, the projected downward deviations from the 2.0 per cent medium-term target warrant close examination.

It is analytically helpful to differentiate between energy inflation and non-energy inflation (the aggregate of food, goods and services inflation).^[5] Under the baseline, non-energy inflation is projected to stand at 2.5 per cent in 2025, 2.0 per cent in 2026 and 1.9 per cent in 2027 (see Chart 1). Relative to the 2021-2024 non-energy inflation rates of 1.5 per cent, 5.1 per cent, 6.3 per cent and 2.9 per cent, we can interpret the baseline as indicating that further non-energy disinflation will take place in the coming quarters before stabilising at around two per cent.

Within the non-energy category, Chart 2 shows that further disinflation is projected both for the food and services categories. Food inflation is projected at 2.9 per cent in 2025, 2.3 per cent in 2026 and 2.3 per cent in 2027; services inflation is projected at 3.4 per cent in 2025, 2.7 per cent in 2026 and 2.3 per cent in 2027. The inflation rate for non-energy industrial goods (the NEIG category) is relatively flat at 0.6 per cent in 2025, 0.4 per cent in 2026 and 0.8 per cent in 2027.

The projected further ongoing disinflation in non-energy inflation can primarily be connected to the anticipated further deceleration in wage growth: growth in compensation per employee is expected to decelerate from 3.4 per cent in 2025 to 2.7 per cent in 2026 and 2027. This profile of wage growth deceleration is cross-validated by the ECB wage tracker and an array of survey evidence. In turn, wage deceleration reflects the recovery in real wage levels after several years of above-average nominal wage increases and the softening in labour market conditions.

Ongoing disinflation also reflects euro appreciation, the spillover from energy deflation, and the deflationary impact of lower export prices from China. Furthermore, the 2024-2025 inflation rates were also pushed up as governments reversed the array of fiscal subsidies that were introduced to mitigate the surge in the cost of living in 2022-2023; these effects wash out of the inflation data in 2026. The lagged impact of our past phase of a restrictive monetary policy stance contributed to disinflation by moderating domestic demand, which put downward pressure on both wage growth and profit growth. In combination, these forces are projected to level out in 2026-2027, such that non-energy inflation is projected to stabilise at around two per cent. The switch from a disinflation dynamic to a projected stable inflation rate around the target has been supported by the 200 basis points in rate reductions since June 2024 and, of course, is conditional on delivering a target-consistent monetary policy stance over the projection horizon.

The baseline for energy inflation presents quite a different profile. Energy inflation is projected at -1.6 per cent in 2025, -1.1 per cent in 2026 and 2.4 per cent in 2027. The projected 3.5 percentage point jump in energy inflation in 2027 is in part related to the impact of the scheduled introduction of the EU Emissions Trading System 2 (ETS2) in 2027, which should have a one-off impact on the energy price level.

This profile for energy inflation should be understood in the context of the extraordinary surge in energy inflation during 2021-2022 (Chart 3). Having initially declined during the first year of the pandemic to -6.8 per cent in 2020, energy inflation rose to 13.0 per cent in 2021 and 37.0 per cent in 2022. Subsequently, there has been a mild deflation pattern, with energy inflation at -2.0 per cent in 2023 and -2.2 per cent in 2024. Accordingly, we can interpret the energy inflation projections for 2025

and 2026 as reflecting ongoing-albeit-weaker energy deflation in the aftermath of the extraordinary surge in the relative price of energy during 2021-2022.

An important open question is whether the projected jump in energy inflation in 2027 reflects the end of this energy deflation episode or is rather just a one-time deviation from an ongoing correction process by which the relative price of energy re-attaches to its trend line after the extraordinary 2021-2022 surge. In turn, the level and direction of energy inflation has spillover implications for food, goods and services inflation rates: a material departure from the baseline energy inflation path would also trigger a material departure from the baseline non-energy inflation path.

I will return to the discussion of energy inflation in the context of the risk assessment in the next section.

Chart 1

Non-energy inflation and September 2025 projections

(annual percentage changes)



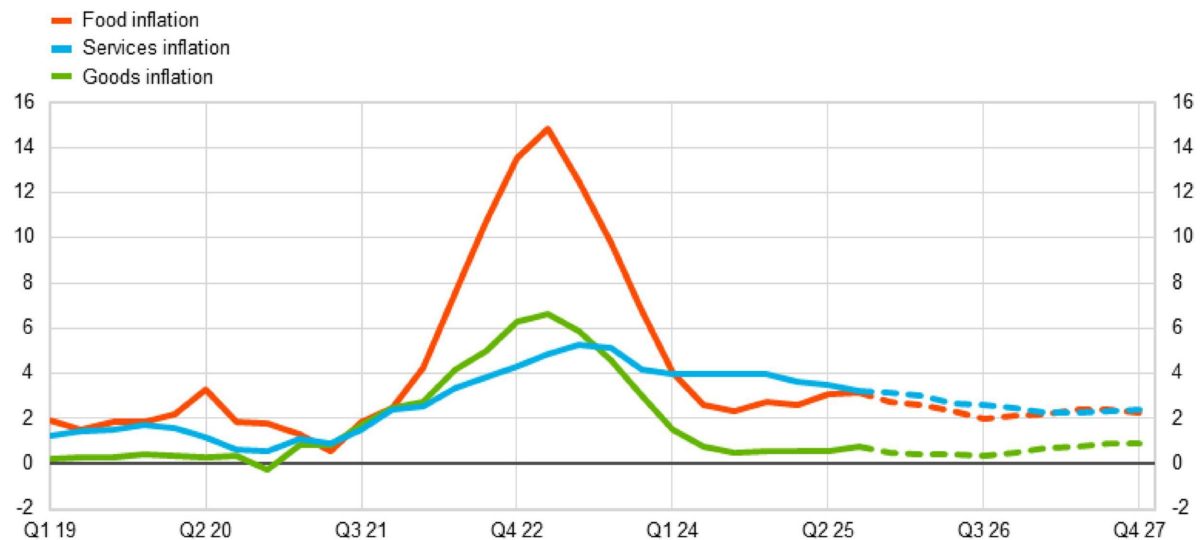
Sources: Eurostat, September 2025 ECB staff macroeconomic projections and ECB calculations.

Notes: The latest observations are for the third quarter of 2025 (flash estimate).

Chart 2

Components of non-energy inflation and September 2025 projections

(annual percentage changes)



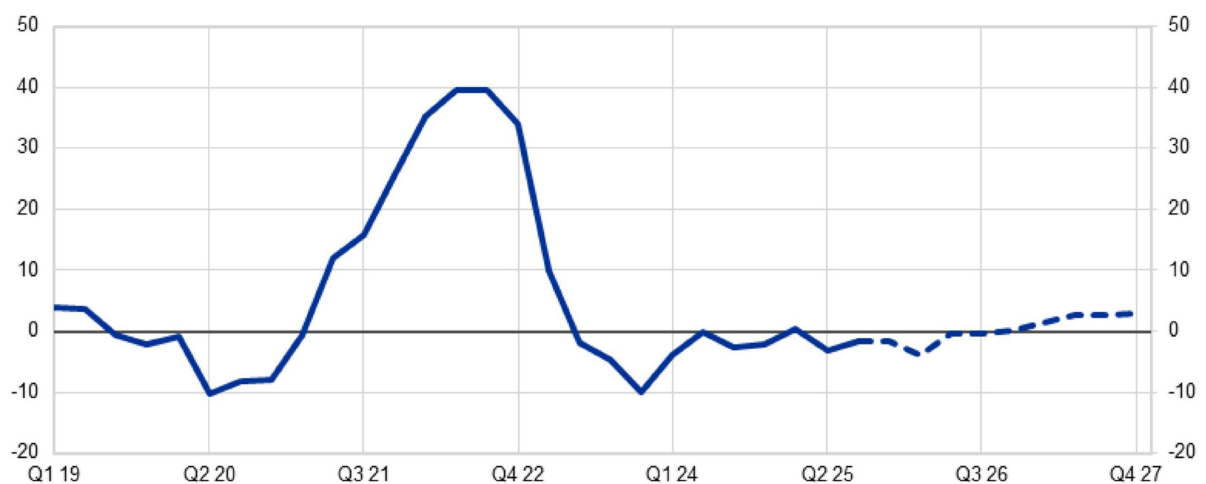
Sources: Eurostat, September 2025 ECB staff macroeconomic projections and ECB calculations.

Notes: The latest observations are for the third quarter of 2025 (flash estimate).

Chart 3

Energy inflation and September 2025 projections

(annual percentage changes)



Sources: Eurostat, September 2025 ECB staff macroeconomic projections and ECB calculations.

Notes: The latest observations are for the third quarter of 2025 (flash estimate).

The near-term conduct of monetary policy

Striking the balance between the baseline assessment and the risk assessment in determining the monetary policy decision at any given meeting is not straightforward and the guidance from the research literature on the setting of monetary policy under uncertainty is highly nuanced, with no universal results. In particular, it is highly context-specific as to: (i) whether the risk assessment should call for a “wait and see” approach or, alternatively, trigger an immediate response due to insurance-type risk management considerations; and (ii) whether a rate move should be attenuated or amplified by risk considerations.

In the coming weeks and months, it makes sense to follow a data-dependent and meeting-by-meeting approach to determining the appropriate monetary policy stance, with no-precommitment to a particular rate path. In particular, 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. In addition to the evolution of the baseline inflation outlook, shifts in the risk distribution will also matter for our rate decisions: an increase in the likelihood or intensity of downside risk factors would strengthen the case that a slightly-lower policy rate might better protect the medium-term inflation target; alternatively, an increase in the likelihood or intensity of upside risk factors would indicate that maintaining the current policy rate would be appropriate in the near term.^[6]

The downside risks highlighted in our September 2025 inflation risk assessment include: a stronger euro; the risk that higher tariffs could lead to lower demand for euro area exports and induce countries with overcapacity to further increase their exports to the euro area; the risk that trade tensions lead to greater volatility and risk aversion in financial markets, which would weigh on domestic demand and would thereby also lower inflation.

By contrast, inflation could turn out to be higher under some upside scenarios: a fragmentation of global supply chains could push up import prices and add to capacity constraints in the domestic economy; a boost in defence and infrastructure spending could also raise inflation over the medium term; extreme weather events, and the unfolding climate crisis more broadly, could drive up food prices by more than expected.

More broadly, we also assess the risks to economic growth, in view of the relation between economic slack and medium-term inflation pressures and, especially if inflation is close to target and subject to maintaining anchored inflation expectations, the consideration that the flexibility of our medium-term orientation also allows us in our monetary policy decisions to cater for other considerations relevant to the pursuit of price stability.

In September, we assessed that risks to economic growth have become more balanced, especially relative to the downside risks of more severe configurations of policy-induced trade and financial fragmentation that were much debated in the April-May period. While recent trade agreements have reduced uncertainty somewhat, the overall impact of the change in the global policy environment will only become clear over time. Moreover, a renewed worsening of trade relations could further dampen exports and drag down investment and consumption. A deterioration in financial market sentiment could lead to tighter financing conditions, greater risk aversion and weaker growth. Geopolitical tensions, such as Russia’s unjustified war against Ukraine and the tragic conflict in the Middle East, remain a major source of uncertainty.

By contrast, higher than expected defence and infrastructure spending, together with productivity-enhancing reforms, would add to growth. An improvement in business confidence could stimulate private investment. Sentiment could also be lifted and activity spurred if geopolitical tensions diminished, or if the remaining trade disputes were resolved faster than expected.

In thinking about these risk factors, two important considerations are the impact on energy prices and the impact on the euro. In relation to the former, the above analysis of recent energy inflation serves to underline the high amplitude of energy prices and the possible spillovers from energy inflation to food inflation, goods inflation and services inflation. At the same time, it is clear that the sensitivity of overall inflation to energy inflation is state dependent and will be lower under subdued demand conditions than if demand were buoyant. In the current context, a further open question is the extent to which the substantial increase in the relative price of energy during 2021-2022 will bear down on energy inflation in the coming years due to the “error correction” mechanism by which deviations from the long-term trend relative price are reversed over time.^[7]

Similarly, in relation to the exchange rate, a persistent movement in the euro on average has a multi-year impact on economic activity and inflation. However, these effects will be larger than the average if euro appreciation is more due to external factors (such as weakness in main trading partners or portfolio rebalancing due to an increase in the risk premium in overseas financial markets) and smaller than the average if more due to domestic factors (such as a surge in domestic demand or a decline in the domestic risk premium). In particular, the pricing power of domestic firms will be lower in the former case (such that euro appreciation induces firms to cut prices in an attempt to protect market share) than in the latter case (such that euro appreciation might be taken as an opportunity to boost profits).

In addition to the inflation outlook and the risk assessment, monetary policy decisions also turn on the strength of the transmission mechanism and, more broadly, overall financial conditions. In this context, ongoing assessments of the strength of monetary transmission remains of central importance, especially in view of shifts in the structure of the financial system and the complex relation between aggregate credit dynamics and aggregate demand conditions.^[8]

The incoming data flow will help us assess the relative likelihoods, timing and impact of these alternative risks, in addition to providing guidance on possible future revisions to the staff baseline projections. In addition to the financial and macroeconomic data, we will also learn from the latest editions of an array of internal and external surveys. In relation to our internal surveys, these include: the Corporate Telephone Survey (CTS); the Bank Lending Survey (BLS); the Survey on Access to Finance (SAFE); the Consumer Expectations Survey (CES); the Survey of Professional Forecasters (SPF); and the Survey of Monetary Analysts (SMA).

Procedurally, our approach to monetary policy must remain open-minded if we are to properly incorporate the evolving information on the inflation outlook and the surrounding risks. In particular, as stated by President Lagarde at the Bank of Finland conference last week: **“For our part, we cannot pre-commit to any future rate path, whether one of action or inaction. We must remain agile, and ready to respond to the data as they come in.”**

The views expressed in this speech are personal and should not be interpreted as representing the collective view of the Governing Council of the ECB.

2.

The monetary policy strategy statement is [here](#); an accompanying overview note is [here](#). The underlying Eurosystem staff analysis is contained in two ECB occasional papers: Nickel, C. and al. (2025), "A strategic view on the economic and inflation environment in the euro area" *ECB Occasional Paper Series*, No. 371 and Kamps, C. et al. (2025), "Report on monetary policy tools, strategy and communication" *ECB Occasional Paper Series*, No. 372.

3.

See also Nakamura, E., Riblier, V. and Steinsson, J. (2025), "[Beyond the Taylor Rule](#)", Federal Reserve Bank of Kansas City Symposium, Jackson Hole.

4.

On the importance of a reactive monetary policy in providing clarity on the central bank's reaction function and thereby supporting the anchoring of inflation expectations, see Bauer, M., Pflueger, C. and Sunderam, A. (2024), "Perceptions about monetary policy," *Quarterly Journal of Economics*, Vol. 139, Issue 4, pp. 2227-2278.

5.

In recent years, we have heavily emphasised the importance of underlying inflation indicators for understanding medium-term inflation indicators. My focus today is on non-energy inflation as a useful indicator of underlying inflation. See also Lane, P.R. (2024), "Underlying inflation: an update", Speech at the Inflation: Drivers and Dynamics Conference 2024 organised by the Federal Reserve Bank of Cleveland and the ECB, 24 October 2024; Lane, P.R. (2023), "Underlying inflation", Speech at Trinity College Dublin, 6 March 2023; Lane, P.R. (2022), "Inflation diagnostics", ECB Blog, 25 November 2022; Bańbura, M., Bobeica, E., Bodnár, K., Fagandini, B., Healy, P. and Paredes, J. (2023), "[Underlying inflation measures: an analytical guide for the euro area](#)," ECB Economic Bulletin, Issue 5.

6.

While the current risk distribution does not indicate that an increase in the policy rate is a significant possibility in the near term, the future direction of the policy rate over a longer horizon has two-sided risks.

7.

Given the importance of regulatory and tax policies for energy prices, the relative price of energy also operates through political economy channels. An alternative view of the sharp increase in the relative price of energy during 2021-2022 is that it effectively accelerated an increase in the trend in the relative price of energy that would have played out over a longer horizon in the absence of the pandemic and Russia's war against Ukraine. The potential strength of error correction mechanisms for

the relative price of goods versus services has been flagged in recent years. Our risk assessment also highlights the potential impact of climate change on the trend in the relative price of food.

8.

Our monetary policy assessment also includes an assessment of the strength of monetary policy transmission. I will turn to this topic in a separate speech in the coming weeks.

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