Philip R Lane: Monetary policy - new challenges

Speech by Mr Philip R Lane, Member of the Executive Board of the European Central Bank, at the Barclays-Centre for Economic Policy Research (CEPR) International Monetary Policy Forum 2025, London, 24 June 2025.

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Since the extraordinary inflation surges in 2021-2022, the primary challenge facing monetary policy has been to return inflation to target in a timely manner.[1] In terms of interest rate policy, this required a rapid hiking cycle from July 2022 to September 2023, followed by a "hold at peak" phase and then a gradual reversal of the restrictive stance starting in June 2024.[2] The gradualism in the easing phase reflected ongoing uncertainty about the speed of the disinflation process.

While headline inflation is currently around the target, services inflation still has some distance to travel to make sure that inflation stabilises at the target on a sustainable basis. Still, there has been sufficient progress in returning inflation to target to consider that this monetary policy challenge is largely completed. This assessment is reinforced by the accumulating evidence that the remaining services disinflation is well on track: first, the projection errors for inflation, including for the services subcomponent, have been relatively small during the disinflation process; second, both the wage tracker data and survey indicators suggest that further deceleration in wage growth can be expected in both 2025 and 2026, facilitating further declines in services inflation.

However, this disinflation challenge has been superseded by a new set of challenges and monetary policymakers have to make sure that the medium-term inflation target is protected in a volatile environment in which, amongst other factors, there is high uncertainty about the future of long-standing international trade system.[3] This uncertainty extends beyond the calibration of new tariff regimes and includes the possibility of a broader set of non-tariff barriers, a deeper intertwining of economic policies and security policies and possible revisions to the treatment of foreign portfolio investors and foreign direct investors. In addition to policy uncertainty, geopolitical tensions, such as Russia's unjustified war against Ukraine and the tragic conflict in the Middle East, remain a major source of uncertainty. Reflecting these developments, we have seen high volatility in energy prices this year and substantial currency repricing. There has also been considerable financial market volatility.

At the same time (and largely as an endogenous reaction to the changed security landscape), the fiscal outlook for the euro area has materially changed for the coming years, with the overall fiscal deficit looking set to remain above three per cent over the projection horizon. The near-term and medium-term implications for output and inflation of the structural changes associated with the green transition, the increasing business adoption of artificial intelligence applications and global shifts in comparative advantage are also highly uncertain, operating both on demand and supply with potentially different timelines.

Especially under current conditions of high uncertainty, it is essential to remain data dependent and take a meeting-by-meeting approach in making monetary policy decisions, with no pre-commitment to any particular future rate path. In addition to observing how activity and inflation are actually behaving, data dependence also extends to the incoming data on policy settings outside the monetary domain, since shifts in international and domestic policy regimes are highly relevant for future inflation dynamics. In this environment, the primary task for monetary policy makers is to make sure that any temporary deviations from target do not turn into longer-term deviations.

This orientation explains our June decision to cut rates by 25 basis points. The June projections were conditioned on a rate path that included a quarter-point reduction of the deposit facility rate (DFR) in June: model-based optimal policy simulations and an array of monetary policy feedback rules indicated a cut was appropriate under the baseline and also constituted a robust decision, remaining appropriate across a range of alternative future paths for inflation and the economy. By supporting the pricing pressure needed to generate target-consistent inflation in the medium-term, this cut helps ensure that the projected negative inflation deviation over the next eighteen months remains temporary and does not convert into a longer-term deviation of inflation from the target. This cut also guards against any uncertainty about our reaction function by demonstrating that we are determined to make sure that inflation returns to target in the medium term. This helps to underpin inflation expectations and avoid an unwarranted tightening in financial conditions.

It is worth noting, in particular, that the robustness of the decision was also supported by a set of model-based optimal policy simulations conducted on various combinations of the trade scenarios discussed in the Eurosystem staff projections report, even when also factoring in upside scenarios for fiscal expenditure. By contrast, leaving the DFR on hold at 2.25 per cent could have triggered an adverse repricing of the forward curve and a revision in inflation expectations that would risk generating a more pronounced and longer-lasting undershoot of the inflation target. In turn, if this risk materialised, a stronger monetary reaction would ultimately be required.

Looking ahead, our monetary policy will have to take into account not only the most likely path (the baseline) but also the risks to activity and inflation. To this end, it will be important to explore how alternative rate paths hold up in various plausible sensitivity and scenario analyses, in order to make sure we minimise the risk of extended deviations from our medium-term target.

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

[2] The monetary policy tightening also included moving the asset purchase programme (APP) and the pandemic emergency purchase programme (PEPP) into runoff mode and the expiry of the TLTRO III funding programme.

[3] See Lagarde, C. (2025), "Drawing a common map: sustaining global cooperation in a fragmenting world", speech at the People's Bank of China in Beijng, 11 June.