Christine Lagarde: Strategy assessment - lessons learned

Introductory speech by Ms Christine Lagarde, President of the European Central Bank, at the opening reception of the ECB Forum on Central Banking 2025 "Adapting to change: macroeconomic shifts and policy responses", Sintra, 30 June 2025.

* * *

As Nietzsche once observed, "it is our future that lays down the law of our today."

When we last reviewed our strategy four years ago, our thinking was shaped – quite naturally – by the recent past: a decade of too-low inflation, compounded by the pandemic.

But as Nietzsche warned, there is a danger in letting the past dominate our thinking. Sometimes, it is the future – still dimly understood – that is already shaping our present.

And soon after that review, the world changed in ways we had not foreseen.

The reopening of our economies after the pandemic brought about major sectoral shifts. Russia's invasion of Ukraine triggered a fundamental shift in energy markets.

The geopolitical landscape was upended, reshaping global trade. And structural changes in labour markets became increasingly apparent – driven by demographics, technological transformation, and evolving worker preferences.

Given all these developments, the fundamentals of our strategy have held up well – as they should, because a sound strategy must be robust to a changing environment.

Our symmetric 2% inflation target has proven effective in anchoring expectations – even through some of the most severe and persistent shocks in recent economic history.

And our medium-term orientation has provided essential flexibility to absorb an extremely large shock – helping to reduce the overall cost of disinflation to the economy, while still enabling a timely return of inflation to target.

We therefore saw no need to revisit these core pillars – which is why we refer to the exercise we have just concluded as a strategy assessment rather than a review.

The central theme of our work has been to update the framework so that monetary policy can continue to deliver price stability in the face of the new types of shocks we are confronting.

This evening, without downplaying the other lessons learned, I would like to highlight three key conclusions that have emerged from this work.

They concern the nature of the new environment, how we assess the risks that arise from it, and how we have adjusted our reaction function to safeguard price stability in this new world.

The changing environment

One word has dominated the public debate in recent weeks: uncertainty.

And this is one of the first key conclusions from our strategy assessment: the world ahead is more uncertain – and that uncertainty is likely to make inflation more volatile.

First, we see clear signs that supply shocks are becoming more frequent.

Model-based analysis by ECB staff shows that, during the recent inflation surge, such shocks played a much greater role in driving inflation than they had over the previous two decades. And even today, supply-side forces continue to generate inflation risks in both directions.

Second, we see mounting evidence that more regular supply disruptions are leading firms to adjust prices more frequently – thereby contributing to greater inflation volatility.

This is not simply an extrapolation from the most recent shock. Rather, it reflects a structural shift in how firms operate under conditions of permanently higher uncertainty.

Research shows that, in such an environment, firms tend to react more quickly to shocks – especially supply ones – in order to protect against potential future losses.[1] At the same time, they are more likely to adopt more flexible pricing strategies, which means prices may respond not just to major shocks, but also to smaller frictions and local disruptions.[2]

Third, if inflation becomes more volatile, we could see non-linearities on both sides.

In our last strategy review, we rightly focused on the non-linear dynamics that emerge in a prolonged environment of too-low inflation – where interest rates are eventually pushed to their effective lower bound. That constraint can, in turn, feed into inflation expectations and risk creating a self-fulfilling low-inflation trap. And we remain alert to the possibility of renewed downside inflation shocks.

But recent experience has also revealed non-linearities on the upside.

Since firms are generally quicker to raise prices than to lower them, more frequent price adjustments mean inflation can rise quickly in response to large upside shocks. If wages then adjust only gradually to these price increases – as we saw in recent years – inflation may remain above target for longer as wage growth slowly catches up. This, in turn, can raise the risk of inflation expectations de-anchoring on the upside.[3]

Assessing the distribution of risks

The next question that follows is: if the economic environment becomes more volatile, how can we make our economic assessment more robust?

Large shocks can trigger feedback loops and non-linear effects that inherently give rise to a broader range of possible outcomes. In a world of higher uncertainty, it is all the more important to augment the baseline with alternative risk scenarios.

This is why the second key conclusion of our assessment is the need for monetary policy to take into account risks and uncertainty, using a systematic but context-specific approach.

The ECB has used both scenario and sensitivity analysis for many years – deploying internal scenarios since the global financial crisis and publishing them for the first time during the pandemic.

But our experience in recent years has underscored the particular strength of scenario analysis in times of elevated uncertainty.

A clear example is Russia's invasion of Ukraine and the resulting energy price shock. In that case, scenarios provided insights that neither our baseline projections nor standard sensitivity analyses around the baseline could fully capture.

For instance, in March 2022 – just a few weeks after the invasion – our baseline projected inflation at around 5% for that year, based on market-implied energy futures. The sensitivity analysis suggested a slightly higher figure of about 5.5%. In contrast, the Ukraine war scenario already pointed to inflation exceeding 7% – close to the final annual figure of over 8%.

At the same time, there were moments when – in hindsight – publishing scenarios could have supported both our policymaking and our communication.

One example was the high uncertainty in 2021 about the speed of vaccine rollout and the nature of post-pandemic reopening, including the sectoral shifts in supply and demand across goods and services sectors, both in the euro area and globally.[4]

Scenario analysis could have helped in illustrating that the range of possible inflation outcomes was unusually wide – and reduced the risk of projecting false certainty to the public.

This is why our updated strategy commits to ensuring that our policy decisions account not only for the most likely path of inflation and the economy, but also for the surrounding risks and uncertainty – including through the appropriate use of scenario and sensitivity analyses.

The reaction function

So what should our reaction function be, if we know that the road ahead is likely to be more uncertain?

In our last strategy review, we explicitly acknowledged the risks posed by the effective lower bound. Our strategy statement called for "especially forceful or persistent" action when policy rates are close to the lower bound.

This "asymmetric" focus was grounded in the asymmetry of policy space and the downward inflation bias it can produce. The lower bound continues to constrain monetary policy in the face of large disinflationary shocks.

But the recent inflation surge has revealed upside non-linearities – and with them, the need for a two-sided reaction function, both in terms of forcefulness or persistence. This is the third key conclusion of our strategy assessment.

This is not about reacting to small or temporary deviations, but about a symmetric commitment to respond to inflation dynamics that could de-anchor inflation expectations in either direction.

When disinflationary shocks risk pushing policy rates towards the lower bound, acting forcefully early on helps minimise the time spent near that constraint. Likewise, when inflation overshoots raise the risk of a feedback loop between frequent price adjustments and staggered wage responses, forceful tightening at the outset is key to anchoring expectations.

We began our recent policy cycle with historically large rate hikes delivered at an unprecedented pace. Our analysis shows that, had we not acted, the probability of inflation expectations de-anchoring would have exceeded 30% in 2022 and 2023.[5]

At the same time, this policy cycle also offered new perspectives on optimal policy paths.

One insight from our last strategy review was that, when rates are near the lower bound, persistence can substitute for forcefulness – helping to deliver the necessary policy stance with fewer side effects. Until recently, however, this concept had not been widely applied to tightening cycles.

Typically, forceful tightening follows an inverted V-shape – with rapid rate increases followed by relatively swift cuts. But as rates move deeper into restrictive territory, the costs and side effects of further tightening also grow.

At that point, it can become optimal to shift the focus from forcefulness to persistence – even if, in principle, there is no upper bound constraining policy space.

Model simulations support this insight: forcefulness and persistence can act as substitutes, both capable of delivering the necessary disinflation. But persistence, in particular, can help limit the economic and financial stability costs compared with continued rate increases.

This was borne out in our own experience. When we entered what I described as the "holding phase", we placed greater weight on the persistence dimension.[6] This allowed the disinflation process to advance at a steady pace, while the so-called "sacrifice ratio" remained historically low compared with previous disinflation episodes.[7]

Reflecting this experience, the Governing Council considers that its reaction function is best described as requiring "appropriately forceful or persistent monetary policy action in response to large, sustained deviations of inflation from the target *in either direction*."

To this end, all our instruments remain available in our toolkit. But the word "appropriately" is important, as it underscores that the choice of instruments, and the intensity with which we use them, must reflect proportionality.

Conclusion

Let me conclude.

Our strategy assessment has been an exercise in evolution, not revolution – and in fact, many of its conclusions are already reflected in our current policy conduct.

We responded to the recent inflation shock with initially forceful and then persistent action, aiming to steer inflation back to target as swiftly as necessary, but as painlessly as possible.

And scenario analysis is helping us to better understand the range of risks ahead – and how best to respond to them.

For example, our scenarios on potential US import tariffs have helped us navigate an uncertain global trade landscape, while also enabling us to communicate more clearly the two-sided risks shaping our current monetary policy stance.

At our last monetary policy press conference in June, I described our monetary policy stance as being "in a good place".

Following the conclusion of this strategy assessment, I would add that our monetary policy strategy is also in a good place – strengthened by experience, and better equipped for the challenges of the future.

To close the circle with Nietzsche: "he who has a why to live can bear almost any how."

Even as the world changes around us, we know our purpose. And we will do whatever is necessary to deliver on it – ensuring price stability for the people of Europe.

---

[1] Kase, H. and Rigato, R. (2025), "Monetary Policy, Supply Shocks, and Input-Output Linkages in the Euro Area", mimeo.

[2] Arndt, S. and Enders, Z. (2024), "The Transmission of Supply Shocks in Different Inflation Regimes", *Working Paper Series*, No 938, Banque de France, January; Khalil, M. and Lewis, V. (2024), "Product turnover and endogenous price flexibility in uncertain times", *CEPR Discussion Paper Series*, No 18941, Centre for Economic Policy Research, Paris and London, 22 March.

[3] Lagarde, C. (2025), "A robust strategy for a new era", speech at the 25th "ECB and Its Watchers" conference organised by the Institute for Monetary and Financial Stability, Goethe University, Frankfurt am Main, 12 March.

[4] Lagarde, C. (2021), "Monetary policy during an atypical recovery", speech at the ECB Forum on Central Banking "Beyond the pandemic: the future of monetary policy", Frankfurt am Main, 28 September.

[5] Christoffel, K. and Farkas, M. (2025), "Managing the risks of a de-anchoring of inflation expectations", *Working Paper Series*, ECB, forthcoming.

[6] Lagarde, C. (2024), "Building confidence in the path ahead", speech at The ECB and its Watchers XXIV Conference, organised by the Institute for Monetary and Financial Stability, Goethe University, Frankfurt am Main, 20March.

[7] Deutsche Bundesbank (2024), "The global disinflation process and its costs", *Monthly Report*, July.