Current and future monetary policy challenges facing the Eurosystem

20th Walter Eucken lecture

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1 Introduction

Ladies and gentlemen, I am delighted and honoured to be able to deliver the 20th Walter Eucken lecture.

"Good economic policy is regulatory policy" – this motto has been the hallmark of the Walter Eucken Institute ever since it was founded. True to that guiding principle, your institution concerns itself in particular with the question of how our market-based and competitive order can be maintained and further developed.

Monetary policy does not always play the key role in such matters. Nor was Walter Eucken a specialist in monetary theory, but someone who was mainly concerned with the economic system in its entirety. Nonetheless, monetary stability was a key factor underpinning his economic policy thinking.

One impressive example of this belief can be found in his "Principles of Economic Policy", where he writes: "All endeavours to realise a competitive framework are in vain unless a certain level of monetary stability can be assured."[1]

Though many decades have passed in the meantime, that statement still stands up today. And in my view, the fundamental idea behind that remark has since become the core principle for major central banks: guaranteeing price stability is their core mandate.

That said, Eucken's concept of how price stability should be maintained was very different to ours today. One page later he issues this stern warning: "… experience shows that a monetary constitution which gives free rein to those in charge of monetary policy places greater confidence in them than it is advisably possible to do."

This, Eucken argued, harboured the danger that "[…] a monetary constitution that was not automatically constructed will be abused for inflation." It is a remark that articulated his fundamental scepticism about government control. This led Eucken to favour a "commodity-reserve currency" system.[2]

Eucken's misgivings were picked up again decades later in the form of the time-inconsistency problem of Robert Barro and David Gordon.[3] The time-inconsistency problem is a situation where policymakers are often tempted to deviate from their pledge to keep prices stable in the short run in order to stimulate the economy. Economic agents recognise this temptation, however, and adjust their inflation expectations accordingly.

This ultimately drives up inflation without actually stimulating the economy. Policymakers and economic agents end up being worse off than they would have been if the price stability pledge had been credible and adhered to accordingly.

The time-inconsistency problem was mitigated by monetary policy being entrusted to an independent central bank with a clear mandate to preserve price stability. Otmar Issing transformed Eucken's dictum from the "primacy of monetary policy" to a "*primacy of price stability*" – and rightly so, in my view.[4]

In my speech today, I will assess this primacy of price stability from different angles while always looking to incorporate Eucken's regulatory perspective into my remarks. To this end, I would like to pick up on three topical monetary policy issues that the ECB (European Central Bank) Governing Council has been concerned with recently. I will therefore structure my lecture around the following key questions:

- First, the Governing Council last year adjusted its operational framework for implementing monetary policy and, as part of these changes, announced that structural monetary policy operations would be introduced in the future. How do these operations fit in from a regulatory viewpoint? I will share some more details about these structural operations in just a few moments.
- Second, how is the run-off of the asset purchase programmes affecting the stance of monetary policy, and which implications have been given insufficient attention so far?
- And third, how should the current monetary policy stance be assessed?

So I will be beginning with some fairly abstract thoughts and become increasingly more specific as my speech progresses.

2 Operational framework for implementing monetary policy

Let me begin with the Eurosystem's operational framework for implementing monetary policy. The purpose of the operational framework is to help steer short-term money market rates closely in line with the Governing Council's monetary policy decisions.

Decisions regarding the stance of monetary policy, meanwhile – in particular the level of the key interest rates – are taken by the Governing Council on the basis of its monetary policy strategy. And at the heart of this strategy is the primary objective of maintaining price stability.

2.1 Changes to the operational framework for implementing monetary policy

In March 2024, we, the members of the Governing Council, adopted changes to the operational framework for implementing monetary policy.[5] These adjustments came about against the backdrop of the run-off of the extensive asset holdings and thus the gradual decline in excess liquidity.

Excess liquidity is the name given to the reserves held by commercial banks with the Eurosystem above and beyond the banking system's structural liquidity needs. Structural liquidity needs arise, first, from what are known as autonomous factors over which we, as a central bank, have no direct influence. These factors include the general public's demand for banknotes, for example. Second, structural liquidity needs come about because commercial banks are required to hold a minimum reserve.

The high level of excess liquidity can be traced back to the monetary policy asset purchase programmes adopted during the period of low interest rates. As the asset purchase programmes run off, this excess liquidity will gradually decline.

To prevent this from causing excessive fluctuation in short-term money market rates, the Governing Council, as a precautionary measure, staked out a framework for steering money market interest rates in the future. Last year, we agreed to narrow the spread between the main refinancing rate and the deposit facility rate from 50 to 15 basis points.

This is the key lever for steering money market interest rates going forward. However, its impact will only become more visible as the balance sheet normalises, once excess liquidity has declined significantly. We will closely monitor how money market rates are discovered based on this change.

We will continue to conduct our weekly main refinancing operations and the three-month tenders based on the full allotment procedure. This means that banks will be able to tap into an extensive source of liquidity – and do so in return for a broad variety of collateral. This helps make sure that banks across the euro area are treated equally and enables banks to participate in our operations, no matter what business model they run.

In addition, the Governing Council agreed in principle to introduce what are known as structural operations at a later stage. These are expected to be implemented in the form of structural longer-term credit operations and a structural portfolio of securities.

These operations will make a significant contribution to covering the banking sector's structural liquidity needs. You will remember how I explained that structural liquidity needs come about due to autonomous factors, which can be predicted relatively well, as well as the minimum reserve requirements.

2.2 Structural liquidity operations: assessment from a regulatory perspective

By agreeing on structural operations, we laid out some fundamental groundwork very early on. But how exactly these structural operations should be designed and how they will relate to each other once the monetary policy asset holdings have run off are matters for another day. There is still time to take these decisions.

Because in all probability, it will take a few years yet for the asset holdings to shrink to such an extent that we see a structural liquidity deficit again. Right now, though, there is nothing to stop us from formulating regulatory principles – inspired by Walter Eucken's line of thinking – that might provide guidance for the structural operations.

What matters first of all is that these structural operations should be, and should remain, strictly focused on their intrinsic purpose, which is to cover a substantial portion of the banking sector's structural liquidity needs. These operations are not there to fund individual Member States, banks or enterprises. Nor are they intended to stimulate lending. And they are most certainly not there to influence the stance of monetary policy.

A key factor underpinning economic and monetary policy in the European Union is the requirement to act in accordance with the principle of an open market economy with free competition – that is a principle that has shaped the EU (European Union) ever since the Maastricht Treaty. It is about promoting the efficient allocation of resources, which is an objective that is closely linked to economic growth and prosperity.

This principle echoes the thinking of Walter Eucken, who always stressed the importance of competition and the avoidance of market distortions. Structural operations should therefore be designed such that they do not interfere with relative market prices and the allocation of resources any more than they have to.

In a structural portfolio, say, having fewer longer-dated bonds and more bonds with short maturities could help to reduce interference with the term premium. Limiting structural refinancing operations to sensible maturities would allow policymakers to deliver a timely response to potential declines in liquidity needs.

Using a variable rate tender procedure for the refinancing operations would play a part in upholding competition among bank funding instruments and avoiding subsidy elements. Because then, banks' demand and their alternative funding costs would be reflected in the interest rates they bid.

The specific design of a structural portfolio raises a variety of granular questions, like which bond classes should be purchased? How can market price effects and subsidy elements be minimised? These decisions are particularly challenging in a monetary union.

One thing is clear: the target volume of a structural portfolio should be sensibly proportionate to the volume of purchasable bonds. To avoid market distortions, only small portions of individual bond issues should be purchased.

One possible question from a regulatory perspective is whether corporate bonds belong in a structural portfolio in the first place. Because the main beneficiaries of this would be large enterprises that can tap capital markets. This, in turn, could distort the allocation of resources.

And one matter that certainly merits consideration as regards public sector bonds is that we should not reduce the incentives for sound fiscal management as far as we can avoid it.

As you can see, then, some issues still need to be clarified in future. We still have plenty of time to do this because the asset holdings are only running off slowly and excess liquidity levels will stay high for the foreseeable future.

Leaving this aside, there are practical reasons for introducing the structural longer-term credit operations first and only turning to the matter of the structural portfolio of securities at a later stage. That's because the extensive legacy bond holdings from the monetary policy asset purchase programmes will be taken into account when the structural operations are introduced – the Governing Council agreed as much last year.

This leads the Bundesbank to expect that structural refinancing operations will be introduced first and that a structural portfolio of securities will only be built up at a later stage. In addition, the Bundesbank believes that suitably designed structural refinancing operations will cover the bulk of the banking system’s structural liquidity needs in future.

3 Quantitative tightening

Let me move away from this perhaps somewhat abstract discussion and more towards monetary policy in practice. The passive run-off of our asset purchase programmes is significant not only with regard to our operational framework for implementing monetary policy.

It also plays a role for monetary policy in practice, as it is tending to tighten the monetary policy stance. And it is doing so despite the fact that the Eurosystem has already loosened its monetary policy by lowering interest rates eight times since June 2024.

But does this not mean that these two measures are contradictory and that the run-off of the asset purchase programmes should therefore be stopped? The answer to this is a clear “no”. Allow me to explain to you in more detail why I can give such a clear answer.

3.1 Steering monetary policy via key interest rates

The asset purchase programmes were introduced when the Eurosystem was operating close to the effective zero lower bound on interest rates. As a result, it was hardly possible to further ease monetary policy to any significant extent by cutting key interest rates. In this context, the asset purchase programmes proved to be a useful instrument of monetary policy.[6] This was because they enabled monetary policy to exert additional influence on medium to long-term interest rates, in particular. In turn, this helped to stabilise price developments.

However, considerable purchase volumes were needed to achieve a notable impact on inflation. For example, an overview study from the Journal of Monetary Economics shows that, in the euro area, purchases totalling around €150 billion raised the price level by 11 basis points.[7]

While the macroeconomic effects of quantitative easing have already been studied in great depth, quantitative tightening, especially for the euro area, remains a largely unexplored field. In any case, the impact of quantitative tightening is likely to be weaker overall than the impact of quantitative easing.[8]

First, financial markets were prepared at an early stage for the run-off of the asset purchase programmes. As a result, there is no noteworthy announcement effect. Second, the Eurosystem's balance sheet will shrink by around €30 billion per month over the coming years.

For the sake of comparison: at its peak, the Eurosystem purchased bonds worth around €80 billion per month under the expanded asset purchase programme (APP (asset purchase programme)). Under the pandemic emergency purchase programme (PEPP (pandemic emergency purchase programme)), monthly purchases amounted to more than €100 billion at times.

On the whole, the run-off of our asset purchase programmes should therefore have only a marginal impact on the monetary policy stance. And we also take this effect into account indirectly when setting the level of key interest rates. This is because medium-term and long-term interest rates feed directly into the Eurosystem's inflation forecasts, which are a key foundation for our monetary policy decisions.

To sum up: the Eurosystem is now effectively steering its monetary policy stance via key interest rates. This means that we can continue to allow the monetary policy purchase programmes to passively run off without any cause for concern.

3.2 Taking greater account of the impact on central bank finances

Thus far, I have focused on the desired monetary policy effects of large-volume asset purchases for the purposes of quantitative easing. However, we must not lose sight of their side effects. These include, for example, incentives for lending to less productive firms, widening wealth inequality, and rising real estate prices.[9]

Another possible effect of large-volume asset purchases in the low interest rate environment was the rapid rise in inflation, when the monetary policy stance had to be tightened significantly. The income interest rates on the purchased medium-term and long-term securities on the assets side of the Eurosystem's balance sheet were largely fixed. By contrast, the expenditure interest rates on the liabilities side of our balance sheet are variable, as banks' balances are remunerated at the deposit facility rate.

The Eurosystem thus took on a high level of interest rate risk with the asset purchase programmes. This risk has materialised since we had to raise interest rates quickly and significantly in response to the wave of inflation. And this entails considerable balance sheet losses for the Eurosystem and the Bundesbank.

Let me make one thing clear: the primary objective of the Eurosystem is to maintain price stability. On the ECB (European Central Bank) Governing Council, we do everything necessary to achieve this – even if using the specific instruments required is likely to lead to a loss. There must be no doubt about this. And the balance sheet losses that we are incurring at present do not restrict our ability to maintain price stability.

However, in light of recent experience, we should only use the instrument of large-volume asset purchases at the lower bound in absolutely exceptional cases in future.

4 Monetary policy stance

Finally, let us touch upon day-to-day monetary policy business. Earlier, I described how quantitative tightening influences the Eurosystem's monetary policy stance. But how should we assess the current monetary policy stance overall?

A well-known concept for this is the natural rate of interest. It is defined as the real interest rate that would prevail if the economy were at normal capacity utilisation and growing at its potential rate and if prices were stable.

As the natural rate of interest cannot be observed directly, it needs to be estimated. Eurosystem calculations using various models put the nominal natural rate of interest at the end of 2024 at between 1.75 % and 2.25 %.[10]

To put this into perspective: since the key interest rate cut at the monetary policy meeting at the beginning of June, the deposit facility rate, which is relevant to the monetary policy stance, has stood at 2 %. This is exactly in the middle of the range that I just mentioned. It is therefore likely that the Eurosystem's monetary policy is currently within neutral territory, even if the estimates are subject to great uncertainty.

Owing to this high degree of uncertainty, it would be risky to base decisions solely on the natural rate of interest. As a result, we on the ECB (European Central Bank) Governing Council always look at a wide variety of real and financial indicators along the entire monetary policy transmission chain.

This provides us with the most comprehensive picture of the current monetary policy stance possible. Overall, we are now in a good position with regard to the interest rate level in anticipation of further developments in inflation.

For our future monetary policy stance, the greatest uncertainty at present – alongside events in the Middle East – is undoubtedly the unpredictable US (United States) trade policy. It is not only unclear how strong its effects could be. It is also ultimately uncertain whether US (United States) trade policy will have an inflationary or disinflationary impact on the euro area.

This is because the end result depends on a large number of factors. These include the response to US (United States) tariffs by the Federal Reserve, developments in the exchange rate between the US (United States) dollar and the euro, any potential retaliatory tariffs in Europe, and the impact on international supply chains.

The degree of uncertainty is exceptionally high. And this is the reason why the ECB (European Central Bank) Governing Council is now, more than ever, making its decisions on a data-dependent and meeting-by-meeting basis.[11] So, if you were expecting me to give a detailed outlook of interest rates, then I am afraid that I will have to disappoint you.

Critics may argue that our data-dependent and meeting-by-meeting approach provides financial markets with too little clarity and that we should commit ourselves more firmly to a future path of interest rates. There is no doubt in my mind that Walter Eucken would be on our side here.

Eucken was critical of monetary policy aimed at active stabilisation, as it is the central bank that decides the appropriate level of interest rates, not the markets. To put it bluntly, central banks suffer from Hayek's "pretence of knowledge" – which is to say, the presumption of possessing more knowledge than we actually do.[12]

There is no question: setting the optimal level of interest rates to stabilise prices is an extremely challenging task. However, this task is by no means impossible, as shown by the average inflation of just over 2 % during the 25 years since the introduction of the euro.

But we can surely agree that the difficulty of this task is dependent on the degree of uncertainty. In times of high uncertainty, as we are experiencing right now, central banks should not claim to be able to see far into the future. The interest outlook should therefore be kept correspondingly short-term at present.

5 Conclusion

Ladies and gentlemen, I hope that my remarks have shown that the principles of Walter Eucken are still relevant to monetary policy today. The structural operations planned for the future should therefore also be based on regulatory policy principles.

The gradual reduction of our current asset holdings is a necessary step towards monetary policy normalisation. Despite the gradual decline in asset holdings, the ECB (European Central Bank) Governing Council is steering the monetary policy stance effectively via key interest rates.

These are within an appropriate range at present. Uncertainty remains high, especially following the US (United States) military strikes in Iran. It would therefore be wise for us on the ECB (European Central Bank) Governing Council to continue focusing on flexibility and data dependence.

I suspect that Walter Eucken, too, would have called for precisely this restraint and humility faced with the complexity of economic interrelationships. Thank you for your attention.

1. See Eucken, W. (2004), Principles of Economic Policy [Grundsätze der Wirtschaftspolitik], 7th edition, Mohr Siebeck, p. 256.
2. A detailed review of the commodity-reserve currency system can be found in Friedman, M. (1951), Commodity-Reserve Currency, Journal of Political Economy, Vol. 59(3).
3. See Barro, R. and D. Gordon (1983), Rules, discretion and reputation in a model of monetary policy, Journal of Monetary Economics, Vol. 12(1), pp. 101-121.
4. See Issing, O. (2004), On the primacy of price stability, Prague Spring Lecture, Liberální Institute, Prague, 10 June 2004.
5. This topic is explained in greater detail in Deutsche Bundesbank (2025), Review of the operational framework for implementing monetary policy: outlook for the Eurosystem balance sheet and structural operations, Monthly Report, June 2025.
6. See Rostagno, M., C. Altavilla, G. Carboni, W. Lemke, R. Motto and A. Saint Guilhem (2021), Combining negative rates, forward guidance and asset purchases: identification and impacts of the ECB (European Central Bank)'s unconventional policies, Working Paper Series No 2564, European Central Bank.
7. See Fabo, B., M. Jančoková, E. Kempf and Ľ. Pástor (2021), Fifty shades of QE (quantitative easing): Comparing findings of central bankers and academics, Journal of Monetary Economics, Vol. 120, pp. 1-20.
8. See Du, W., K. Forbes and M. Luzzetti (2024), Quantitative Tightening Around the Globe: What Have We Learned? NBER (National Bureau of Economic Research) Working Paper No 32321, April 2024.
9. See, for example, Acharya, V., T. Eisert, C. Eufinger and C. Hirsch (2019), Whatever It Takes: The Real Effects of Unconventional Monetary Policy, The Review of Financial Studies, Vol. 32(9), pp. 3366-3411; Asriyan, V., L. Laeven, A. Martin, A. Van der Ghote and V. Vanasco (2024), Falling Interest Rates and Credit Reallocation: Lessons from General Equilibrium, Review of Economic Studies; Battistini, N., M. Falagiarda, A. Hackmann, and M. Roma (2022), Navigating the Housing Channel of Monetary Policy Across Euro Area Regions, Working Paper Series No 2752, European Central Bank.

10. See Brand, C., N. Lisack and F. Mazelis (2025), Natural rate estimates for the euro area: insights, uncertainties and shortcomings, ECB (European Central Bank) Economic Bulletin, 1/2025.
11. For more detailed comments on the impact of uncertainty on monetary policy, see Nagel, J. (2025), European monetary policy in times of high uncertainty, lecture at ZEW (Zentrum für Europäische Wirtschaftsforschung GmbH) – Leibniz Centre for European Economic Research, 27 May 2025, Mannheim.
12. See von Hayek, F. (1974), The Pretence of Knowledge, Lecture to the memory of Alfred Nobel, 11 December 1974.