Target achieved, but challenges still remain – monetary policy since the 2021 strategy review

10th Bundesbank IAW Lecture

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Check against delivery.

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1 Introduction

Ladies and gentlemen,

It's a great pleasure for me to be here in Tübingen and to be giving the 10th Bundesbank IAW (Institut für Angewandte Wirtschaftsforschung) Lecture. Many thanks to the Institute for Applied Economic Research and my colleagues from Stuttgart for organising this event.

Let me start with a quote.

"I acknowledge that our strategy is complex. However, we have to recognise that we live in a rather complex economic world (…). It would therefore be impossible for the Eurosystem to conduct a successful policy by mechanistically following a simple rule (…)."[1]

The person who said this would have celebrated his 90th birthday today. It was Wim Duisenberg, the first President of the European Central Bank (ECB (European Central Bank)). Unfortunately, the Dutchman passed away back in 2005, not long after the end of his presidency.

He played a key role in the successful establishment of the ECB (European Central Bank)'s reputation as a credible and stability-oriented central bank. This success was due not least to the ECB (European Central Bank)'s monetary policy strategy.

The original strategy was announced before the introduction of the euro, in October 1998. Following a first review in 2003, it took almost two decades for the strategy to undergo its second review in 2021.

Quite a long interval. But considering the challenges that had to be mastered in the meantime – the financial crisis, the sovereign debt crisis, the period of persistently low inflation – it is understandable that a review was postponed time and time again.

The 2021 review, once undertaken, was particularly thorough and comprehensive. It covered not only the inflation target and the set of monetary policy instruments, but also the role of financial stability, the impact of climate change and the role of communication.

2 Monetary policy since the 2021 strategy review

2.1 The symmetric inflation target

Four years ago, the Governing Council presented its revised strategy. The most important element of this revision was probably the introduction of a symmetric inflation target.

The new strategy replaced a relatively complicated and de facto asymmetric formulation of the price stability objective. As you may recall, it included a quantitative definition of price stability, which was "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP (Harmonised Index of Consumer Prices)) for the euro area of below 2 %". Within this definition, however, the aim was to keep inflation "below, but close to, 2 %". Which left some room for interpretation (and misinterpretation).

Since 2021, the Governing Council has been aiming for inflation of 2 % over the medium term. This target is symmetric, as negative and positive deviations are considered equally undesirable.

Furthermore, the Governing Council then went on to confirm the role of key interest rates as the primary policy tool. However, it also stated that other instruments known as unconventional measures would remain in the ECB (European Central Bank)'s toolkit. I'm talking here in particular about rate forward guidance, asset purchases, and longer-term refinancing operations.

In addition, the Governing Council expressed its intention to regularly assess its monetary policy strategy. The next assessment was intended to be carried out in 2025. Ten days ago, we concluded the third update and published the results.[2]

This time, we have adjusted our monetary policy strategy only marginally. For example, we have confirmed our symmetric 2 % inflation target over the medium term. We regard positive and negative deviations from that target as equally undesirable. We will act forcefully or persistently as appropriate if we see large, sustained deviations from the target in either direction.

The latter point is a direct lesson taken from the past few years, which were characterised by exceptionally high inflation. By contrast, the 2021 strategy review was undertaken with the persistently low inflation of the preceding years in mind.

2.2 The inflation surge and the monetary policy response

Four years ago, euro area inflation began its steep climb to up beyond the 2 % mark. Thereafter, it rapidly rose to levels not seen since the introduction of the euro. To 5 % by the end of 2021, and – after the Russian invasion of Ukraine – to more than 10 % over the course of 2022.

Monetary policymakers counteracted the post-pandemic surge of inflation through a drastic change of course. First, we ended net purchases of assets, then we raised key interest rates sharply. Within ten consecutive meetings by 450 basis points.

This helped to lower inflation again and bring it back to target. In effect, we were able to start lowering interest rates one year ago.

In June 2025, it was not only the current inflation rate that was exactly 2 %. The Eurosystem staff also presented a new inflation forecast, according to which we will achieve the target over the medium term.

The restrictive monetary policy helped to keep inflation expectations anchored. In the meantime, a quantifiable risk of de-anchoring emerged. In other words, if we had not acted so decisively, medium-term inflation expectations might have risen substantially.[3] And that would have delayed the return to target.

Central bank action has a significant impact on inflation expectations. But communication is also becoming more and more important. By making a clear commitment to price stability and communicating their decisions in a comprehensible way, policymakers help inflation expectations to remain firmly anchored.

Central bank communication works well in steering households' expected inflation toward the target. Bundesbank researchers have recently demonstrated this in an experiment. Moreover, they found that the effect depends on how the central bank communicates.

How did they do that?

First, in our Bundesbank online survey on consumer expectations, respondents were given different messages. The researchers then examined how the different messages affected the respondents' medium-term inflation expectations.

According to their study, information on the inflation forecast given in terms of percentages has an impact on expectations. However, using positive, non-technical language to describe the outlook reduces households' inflation expectations more effectively. And using a simple chart is even more effective than just using words. Holding true to the saying that a picture says more than a thousand words.[4]

So good communication is one important factor for good monetary policy. But at the end of the day, of course, it is central bank action that matters.

Experience gained from the 1970s has taught us that in the event of a de-anchoring of expectations, a much more restrictive policy stance is required.[5] In contrast to the situation back then, we were able to reduce inflation at much lower economic costs in terms of GDP (gross domestic product) growth this time.[6]

While we have seen weak growth in the euro area, there has been no recession so far, although we have had to face a series of negative shocks. The pandemic and its associated supply chain disruptions, along with the Russian war of aggression and the resulting energy crisis, played significant roles here. More recently, the economic outlook has been clouded by trade tensions and elevated uncertainty.

Nevertheless, economic growth is expected to pick up gradually in the coming years. Eurosystem staff forecast growth for the euro area economy of 0.9 % this year, 1.1 % in 2026 and 1.3 % in 2027.

As regards prices, in June the Eurosystem predicted an inflation rate of 2.0 % for this year. This is good news for all of us and especially for those who need to see that they can make ends meet with their money.

Unfortunately, we cannot turn back the time and undo the inflation surge.

Unlike statisticians, consumers usually do not think in terms of annual changes in the price of a representative basket of goods. They compare the current prices of the goods and services they buy with previous prices they still have in mind. And they often think: Wow, that’s expensive.

But when we decide upon our monetary policy, it’s not the level of prices that guides us, but the rate of change. We consider that price stability is best maintained if we aim for 2 % inflation over the medium term.

Note that there are monetary policy concepts that have a target for the price level, so that past deviations would have to be compensated to return to the trend path. The Eurosystem evaluated such price level targeting in the 2021 strategy review and discarded it. In my view, for good reasons.

Currently, we are at about 2 % inflation. And what is even more encouraging: our experts expect inflation to broadly remain at this sweet spot over the medium term. On average, they expect 2 % for 2027, as they do for this year. In the year between, base effects will tend to push the inflation rate a bit lower, to 1.6 %.

This is the benign baseline scenario. However, uncertainty is currently unusually high. There are risk scenarios that – in the event that they materialise – could lead to results that are more unfavourable.

Our experts also calculated an adverse risk scenario for Germany, in which the tariffs announced by the US (United States) administration on 2 April come back into effect from 9 July onwards.[7] This would mean that an additional tariff of 20 % on US (United States) imports from the EU (European Union) would be imposed as of today.

For this risk scenario, it is assumed that the EU (European Union) retaliates symmetrically, the US (United States)-China trade conflict escalates, and uncertainty remains elevated. Such a scenario would trigger considerable upheaval in the financial markets.

For Germany, the experts’ calculations show a considerable downside risk to economic growth in Germany. The overall loss in real GDP (gross domestic product) growth by 2027 could add up to 1½ percentage points.

Regarding inflation, there are countervailing effects in this scenario: On the one hand, retaliatory import tariffs would raise price pressure, but on the other hand, weaker economic activity in Germany would dampen inflation.

In addition, a declining oil price caused by weaker global growth would contribute to lower consumer price increases. Overall, the inflation rate would be slightly lower than in the baseline scenario.

As no agreement has been reached in the trade conflict so far, uncertainty remains for the time being. The White House has just extended the deadline for levies to 1 August.

In any case, we can assume that the heightened uncertainty will not quickly disappear. Therefore, we emphasised in the most recent assessment of our monetary policy strategy that we will not only take into account the most likely path for inflation and the economy. Rather, we will expand our use of scenario and sensitivity analyses.

Under the current circumstances, the ECB (European Central Bank) Governing Council would be well advised to act prudently and to make data-dependent decisions on a meeting-by-meeting basis.

Services inflation, which continues to be elevated, still warrants caution. Encouragingly, though, it has eased significantly in recent months. And based on the latest data on wage developments, price pressures in the services sector are expected to decline further.

The key interest rate now stands at 2 %. In nominal terms, this is in the middle of the range for the natural rate of interest (r*) calculated by Eurosystem experts.[8] This suggests that current monetary policy is having neither a tightening nor a stimulating effect on the economy.

Although I would not put too much emphasis on the uncertain estimates of the theoretical concept of r*, it seems fair to say we are in a good position to respond to further developments. Yet it would be unwise to commit to a certain interest rate path, to envisage a further step or indeed, to rule it out.

2.3 The 2025 strategy assessment and the monetary policy toolbox

So, what did we learn from the experiences of the past couple of years in terms of our monetary policy instruments?

Although this is not the time for rate forward guidance, forward guidance remains in our toolbox. The same is true for the other instruments, notably large-scale asset purchases and targeted longer-term refinancing operations. However, we will usually use these tools only at the lower bound of interest rates, where they have proven to be useful.

Our experience was that our forward guidance on interest rates and our asset purchases bound us too strictly. The rapid inflation surge clearly showed the disadvantages of committing to a certain timeline once circumstances change quickly.

We will therefore aim to formulate forward guidance in more flexible terms. A state-dependent formulation would help in this regard. State-dependent forward guidance means that it is tied to certain economic conditions, for instance an inflation threshold, and not to a specific schedule. It makes it clear under what circumstances monetary policy will deviate from an announced path.

Moreover, forward guidance needs to be more robust to forecast errors. Otherwise, we cannot react quickly enough to unexpected developments. Monetary policy must be reliable, but policymakers must not overly restrict its flexibility.

In general, our monetary policy should use all its instruments more flexibly to adjust its course when macroeconomic conditions change. This also applies for asset purchases.

A more flexible use of asset purchases would take account of their potentially diminishing effectiveness over time. And it would allow us to react swiftly by ending them once the inflationary outlook improves.

Furthermore, previous large-scale asset purchases exposed our balance sheet to a significant interest rate risk. This risk materialised with the sharp interest rate reversal and led to considerable balance sheet losses.

As you will remember, the Eurosystem had purchased trillions of euros’ worth of low-yielding assets as part of its monetary policy to stimulate the economy.

These purchases were recorded on the assets side of the balance sheet. On the liabilities side, the purchases created very large excess reserves, which are remunerated at the deposit facility rate.

When the policy rates had to be raised, expenditure on the liabilities side rose, while revenue on the assets side remained low. By and large, this explains the balance sheet losses.

In the Bundesbank’s case, it will take several years until we make profits again.[9] To be clear, we do have a sound balance sheet. We do not aim to maximise profits, and the losses do not impede our ability to maintain price stability. We can cope with this.

Still, with the recent experiences in mind, I am convinced that the use of large-scale asset purchases should remain the absolute exception.

2.4 Forceful or persistent monetary policy response

The 2021 Strategy Review was significantly shaped by the challenge of combating persistently low inflation at the time. It took explicit account of the asymmetry induced by the lower bound, which constrains conventional interest rate policy. And declared that “when the economy is close to the lower bound, this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched”.[10]

Four years on, this risk still exists. However, the past four years have shown that there is also a distinct possibility of pronounced positive deviations from the target.

A forceful or persistent policy response is therefore essential not only when approaching the lower bound. It is also required in the event of significant upward deviations from our inflation target.

This point has now been clarified, which I appreciate.

3 Conclusion

Ladies and gentlemen,

Let me conclude.

The recent return to price stability is encouraging. It is now important to stabilise inflation sustainably at 2 %.

However, we need to be prepared for price developments to become more volatile in general. I am afraid that heightened uncertainty will become the new normal. And a number of structural developments suggest that price pressures will remain elevated over the medium term.

These developments include the ageing of the population, climate change and climate policies, and geopolitical fragmentation.

Maintaining price stability will remain a challenging task going forward. However, with a credible commitment to its mandate, transparent communication and a clear strategy, the Eurosystem can master this challenge.

It is still true what Wim Duisenberg said. Our strategy is complex, but we have to recognise that we live in a complex world. In comparison to the early days of the single currency, the world has probably become even more complex.

With the strategy assessment of 2025, I see the Eurosystem as being well-equipped to master the challenges of our time. We have incorporated what we have learned from the unique experiences of the past decade.

The Governing Council is committed to clear and transparent communication to ensure that its actions are well understood by markets and the public. In this vein, I very much hope that I expressed myself clearly and comprehensibly here today.

I am looking forward to the discussion with you and thank you for your attention.

Footnotes:

1. Duisenberg, W. (1999), Introductory Statement at the Frankfurt European Banking Congress *[https://www.ecb.europa.eu/press/key/date/1999/html/sp991119_1.en.html]*, Session I: “Do markets need guidance?”, Frankfurt am Main, 19 November.
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3. European Central Bank (2025), Report on monetary policy tools, strategy and communication *[https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op372.en.pdf]*, Workstream 2: Monetary Policy Tools, Strategy and Communication, ECB (European Central Bank) Occasional Paper, No 372.
4. Hoffmann, M., E. Moench, L. Pavlova, G. Schultefrankenfeld (2025), A KISS for central bank communication in times of high inflation, *[https://www.bundesbank.de/en/publications/research/discussion-papers/a-kiss-for-central-bank-communication-in-times-of-high-inflation-925558]*
Bundesbank Discussion Paper, 12/2025.
5. Nagel, J. (2022), Stagflation redux can be prevented with smart policy. Is it now the economy’s turn to experience a 1970s revival? *[https://www.politico.eu/article/stagflation-redux-prevented-smart-policy/]* Politico, 25 June.

6. Nagel, J. (2024), What can we learn from the recent disinflation episode? *[https://www.bundesbank.de/en/press/speeches/what-can-we-learn-from-the-recent-disinflation-episode--938964]* Dinner speech at the CEBRA (Central Bank Research Association) Annual Conference, 29 August.
7. Deutsche Bundesbank (2025), The potential impact of a more restrictive US trade policy on the German economy *[https://publikationen.bundesbank.de/publikationen-en/reports-studies/monthly-reports/monthly-report-june-2025-958724?article=forecast-for-germany-us-tariffs-initially-weigh-on-economic-growth-fiscal-policy-provides-impetus-with-a-delay-958718#The-potential-impact-of-a-more-restrictive-US-trade-policy-on-the-German-economy]* , June Monthly Report, supplementary information.
8. See Brand, C., N. Lisack and F. Mazelis (2025), Natural rate estimates for the euro area: insights, uncertainties and shortcomings, *[https://www.ecb.europa.eu/press/economic-bulletin/focus/2025/html/ecb.ebbox202501_08~3be5a005f9.en.html]* ECB (European Central Bank) Economic Bulletin, 1/2025.
9. Nagel, J. (2025), Introductory statement at the press conference presenting the Annual Report *[https://www.bundesbank.de/en/press/speeches/introductory-statement-951882]*, 25 February.
10. European Central Bank (2021), The ECB's monetary policy strategy statement *[https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_statement.en.html]* .