



**“A long view on monetary policy:
Three clarifications prompted by three challenges”**

**Speech of François Villeroy de Galhau,
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Ladies and Gentlemen,

I am delighted to speak before you today on the occasion of this GIC event. As this is my last monetary speech as Governor, let me take the long view and share with you some thoughts about monetary policy over the past turbulent decade, since 2015. Central banks have been both effective and increasingly challenged. Effective, first, because they confronted the low-inflation environment prior to 2020, the deflationary threat associated with the Covid crisis, and then overcame the inflationary surge of 2022–23 without triggering a recession. Despite all these shocks, including those lastly generated by the new U.S. administration, central banks have managed to avert a return of a global financial crisis. In an environment marked by unprecedented unpredictability, they have strengthened their credibility. Ten years ago, a sentence was frequently repeated: *“monetary policy cannot be the only game in town”*. But unfortunately, given the weakness of the other players, monetary policy remains *“the first game in town.”* And for that very reason, central banks have been criticized and challenged on a triple front: their mandate **(1)**, their instruments **(2)**, and their independence **(3)**. Today, I would like to argue that each of these challenges can lead to greater clarity and, ultimately, to a strengthening of monetary policy.

1. A FIRST CHALLENGE TO THEIR MANDATE

a) The price stability objective and the 2% inflation targeting

b) Other objectives?

c) A difficult interaction with financial stability

► Clarification 1 : Success against inflation should lead to more humility about the mandate, rather than overreach.

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1. A first challenge to their mandate

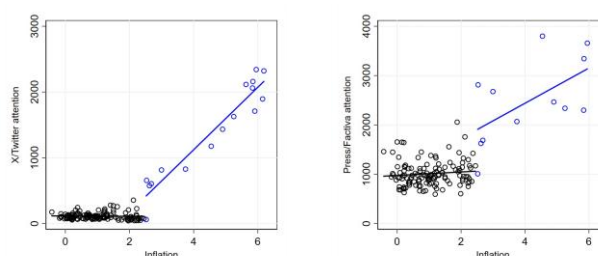
a) The price stability objective and the 2% inflation targeting

The closest thing to a consensus opinion in economics at present is that central banks should focus on price stability, and on inflation targeting. As early as 2013, Jean-Claude Trichet rightly noted that the “conceptual convergence” on the 2% medium-term target had already taken place.ⁱ A decade later, this conceptual convergence has evolved into an operational one, as debates over the level and definition of the inflation target have faded.

First, the Eurosystem’s strategic review of 2021 has clarified unambiguously that our 2% target is symmetric: inflation below 2% is off target. Second, the 2022-23 inflation surge has closed the debate on a higher inflation target by putting the spotlight on the costs it would have, socially and politically, but also economically. At higher levels, inflation attracts attention, becoming ingrained in price and wage setting, and inflation expectations.

A HIGHER INFLATION TARGET? ABOVE 2%, THE PUBLIC'S ATTENTION TO INFLATION INCREASES

Chart 1: The non-linear relation between inflation and attention to inflation in France



Source: X/Twitter, Factive, INSEE, 2011-2022. Authors' calculations. See Hubert, P. (2024, January 26). Attention to inflation depends on its level. Banque de France, Eco Notepad, Post No. 340.
Note: Y-axis: average daily number of tweets (left) and press articles (right) each month. X-axis: French inflation as measured by the HICP.

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In light of these costs, the potential benefits of a higher target, primarily a larger buffer away from the zero lower bound,ⁱⁱ have been reassessed. Accordingly, some who argued for a 4% target have revised their recommendation down to 3%.ⁱⁱⁱ

Admittedly, the optimal inflation target is not a universal constant but it may depend on structural features of the economy, such as the level of the natural rate of interest. But one key lesson of the past ten years is that monetary policy frameworks must be “all-weather”. The low-flation environment of the 2010s quickly gave way to the volatile supply shocks of the 2020s. An inflation target that would be adjusted at every shock would be no target at all.

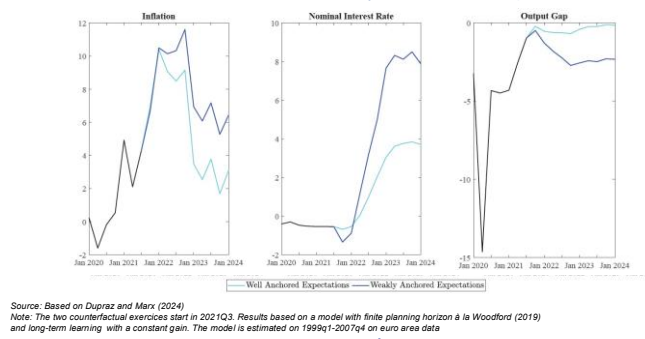
b) Other objectives?

Beyond the core objective of price stability, there is ongoing debate about how much scope central banks should have to address other objectives. In the Eurosystem, which does not operate under a dual mandate, some advocate a broader mandate that would encompass growth or employment. The topic of inequality is discussed everywhere. And above all, climate change is a pressing concern. Critics are quick to interpret those debates as signs of a politicized mission-creep diverting central banks from their core mission of price stability.

In my view, this is largely a false debate: the clear focus on the primary price stability objective is fully warranted, but does not contradict other considerations. Regarding economic activity, our recent victory over inflation has shown that, provided monetary policy is credible and responsive, the short-run trade-off between activity and inflation is much easier to navigate than the painful experience of the 1970s led some to expect.

OUR CREDIBILITY AVOIDED A REPLAY OF THE 1970s

Chart 2 : Two counterfactuals with well and weakly anchored inflation expectations for the euro area



Had we reacted less forcefully to the supply shocks of 2022-23, not only would inflation have run higher. Over time, trust – and thus economic activity – would have suffered more as well. The output cost would simply have been postponed, with vengeance. By allowing inflation to become ingrained in expectations, a sharp tightening would have been unavoidable to bring inflation back under control.^{iv} It would have caused a painful recession.

Similarly, concerns about economic inequalities do not put into question the harmful effects of inflation. Low-income households are the most sensitive to inflation, as they are the most exposed to its costs. They dedicate a higher share

of their income to consumption rather than savings and are hence directly exposed to CPI, especially on goods with more volatile prices such as food and energy.

Finally, our attention to climate-related risks stems from the increasing effect of climate risks on price stability. There are more and more severe weather events with significant effects on activity and inflation, including in advanced economies. In addition, facilitating the green transition can help mitigate the inflationary impact of more traditional supply shocks. When comparing 2026 to 2022, gas prices had significantly less impact on electricity prices in France, which had seen the return of its full nuclear capacity, and in Spain, where the share of solar energy has expanded rapidly.^v The real risk to price stability would be to ignore the green transition. The current conflict in the Middle East has been a sobering reminder.

c) A difficult interaction with financial stability

The interaction between financial stability and price stability is much more delicate. In some circumstances, the two are aligned: financial crises often lead to prolonged recessions that are among the main threats to price stability.

However, there are also situations in which the objectives conflict. A very accommodative monetary policy, while justified to achieve price stability today, can contribute to the build-up of financial vulnerabilities: excessive asset valuations (including real estate whose prices increased disproportionately everywhere in the OECD since 2015), excessive leverage, and excessive risk-taking.

To be sure, financial regulation and supervision should remain our first line of defense to address these vulnerabilities. Since the Global Financial Crisis, we are deploying additional tools. But, let us acknowledge that macroprudential tools are still poorly understood by the public, and their efficiency is difficult to fully assess. Against this backdrop, the American economist Jeremy Stein has argued that monetary policy should “lean against the wind”.^{vi} While the argument is plausible, it remains far from clear whether the unobservable reduction in the

risk of a financial crisis is enough to justify an observable short-term deviation of inflation from target.^{vii}

Another approach is to embed financial stability considerations in the analysis of transmission of monetary policy through the financial system. At the ECB, the 2021 strategic review repurposed our historical monetary pillar into a broader financial analysis which includes an assessment of financial vulnerabilities. But in practice, this has had barely any impact on policy so far.

Financial stability considerations are different during a tightening cycle, but also not convergent with monetary policy. The concern here is that interest rates rise too much and too fast, triggering a financial crisis.

The bottom line is that a unified framework that can resolve all tensions between price and financial stability is unlikely to exist. The 2022-23 tightening cycle has shown that our supervision and regulation framework provided us with all the necessary freedom to act on the monetary side. The most reliable way to minimize tensions is likely to perform each task more effectively, in line with the traditional “separation principle”.

2. A SECOND CHALLENGE TO THEIR INSTRUMENTS

a) Balance-sheet instruments

b) Negative interest rates and forward guidance

► Clarification 2 : Efficiency of QE calls for caution on other non-conventional instruments

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2. A second challenge to their instruments

What has changed most over the past ten years is the set of instruments available to central banks. With interest rates at or close to the effective lower bound for most of the 2010s, non-conventional instruments included: balance-sheet instruments with quantitative easing and TLTROs, and new interest rate instruments, with negative interest rates and forward guidance.

Towards the end of the ELB episode, there was a consensus that these instruments had become part of the regular – almost conventional – monetary toolkit. Since 2022 and amidst the recent inflation surge, this consensus has weakened. The view has gained traction that their costs – beyond the financial losses they caused for central banks themselves – had been underestimated. Some suggested that they bore some responsibility for the return of inflation.^{viii} The latter is simply false. Inflation resulted from the sequence of two opposite shocks—the Covid pandemic, then the Russian invasion of Ukraine—both of which were totally unpredictable.

In my view, this debate deserves a less Manichean approach. First, because the use of non-conventional instruments depends on circumstances. Criticism voiced once they are no longer needed often overlooks what made them necessary in the first place. Second, because the different instruments must be assessed separately. If we do so, a clear hierarchy emerges.

a) Balance-sheet instruments

The clearest contribution lies in balance-sheet instruments. Asset purchase programmes and LTROs were designed in crisis times when conventional tools were constrained by the Effective Lower Bound (ELB). We should however better distinguish their objectives: either to preserve an effective monetary policy *transmission* when specific market segments were under strain (equivalent to *financial stability* purpose), or to provide additional policy space when required especially at the ELB (i.e. monetary *stance* purpose). And let me accordingly suggest four lessons ^{ix}:

1) First, when the objective is to preserve **transmission or financial stability**, there is no reason to hold the purchased assets in the balance sheet till maturity. This was the case of the BoE's purchases in the Gilts crisis in September 2022, or could be for the TPI (Transmission Protection Instrument) of the ECB. There is no obligation to re-sell at short notice – if so, the central bank would be under market dominance, and its intervention less effective –; but there is an option open at any time.

2) Second, when it is about further easing the monetary **stance**, we should distinguish whether we aim to provide liquidity (i.e. volumes) or to reduce long-term rates (i.e. prices). When the primary objective is to inject **liquidity**, it should be done not through purchases of long-term bonds, but by lending short term or at floating rates for LTROs. These were by the way a powerful and successful innovation of the ECB, not used in the US.

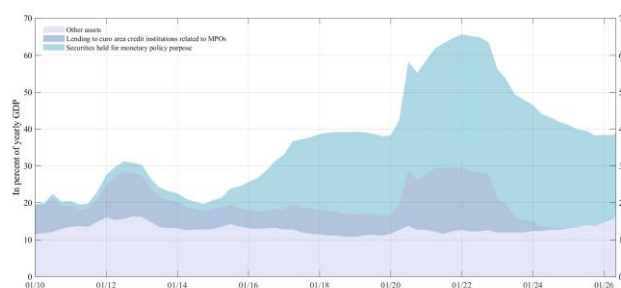
3) That leaves “**core QE**” – **purchasing and holding long-term bonds** – for the purpose of reducing the term premium and therefore the long-term yields. It entails taking interest rate risk in central banks’ balance sheet, and hence possible losses as we have seen: we should however, **if** the purpose is clear and warranted, be ready to accept such risks, while looking more closely at the average maturity of the purchased portfolio. Let me stress, on a positive note, that the exit of QE – quantitative tightening (QT) or rather quantitative normalisation (QN) – has been proceeding smoothly in the recent past, without provoking a reverse rise in long-term yields contrary to what many had feared.

4) In our portfolio holdings, we should prioritize **government and supranational bonds** to limit our direct balance sheet exposure to the nonfinancial corporate sector. That being said, such programmes are not and should never be designed to fund governments nor to help fiscal stimulus.

There are good reasons why the “new normal” should involve a larger central bank balance sheet than before 2008.

A LEANER BALANCE SHEET THAN AT ITS PEAK, BUT A HIGHER « NEW NORMAL » LEVEL

Chart 3: Eurosystem's balance sheet relative to GDP

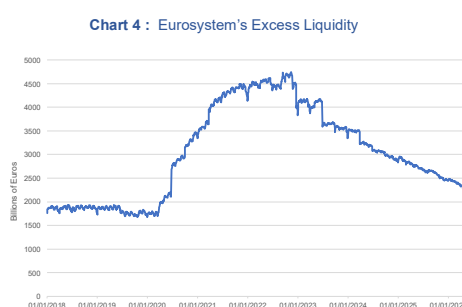


Source: ECB and Banque de France calculations.

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The Federal Reserve has stated its intention to keep an ample reserves regime. And the Eurosystem should aim in the same direction through its future structural portfolio and longer-term credit operations. At present, liquidity is still abundant^x, with our excess liquidity of about EUR 2,300 bn. It is to be compared with the necessary level of liquidity to have money market rates anchored to the floor policy rates, namely FREL (*Floor Required Excess Liquidity*) which is estimated on average at about EUR 1,500 bn, albeit with a wide confidence interval.

EXCESS LIQUIDITY IS DECREASING BUT STILL ABUNDANT



Source: ECB.



But if we were to come to a situation of scarcer liquidity in the euro area, or perceived as such by banks, this could trigger an undue credit tightening, as well as an uneven playing field vis-à-vis international banks. By covering the banking sector's liquidity needs, a system with ample reserves can both control the interbank interest rate more effectively and mitigate risks to financial stability.^{xi}

b) Negative interest rates and forward guidance

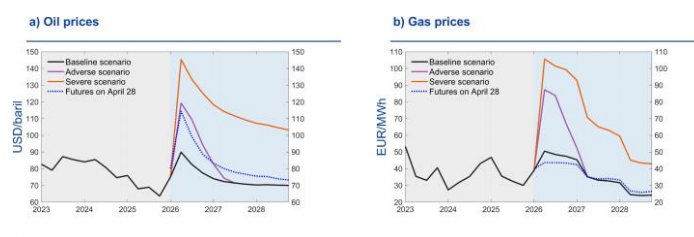
By contrast, greater caution is needed regarding two more overreaching instruments: negative interest rates and forward guidance. Negative nominal interest rates are poorly understood and potentially destructive of social cohesion. As for forward guidance announcements that claim to pre-commit future policy, they cannot be unconditional. Conditionality, it should be recalled, was part and parcel of early forward-guidance proposals.^{xii}

Even when explicit forward guidance is formally conditional, however, there is always a risk that this conditionality is overlooked or misunderstood by the public. What matters at least is that the economic agents understand how central banks will react to future economic developments. Explicit forward guidance is one way to achieve this, but it is not the only one. Soft signaling that shapes financial market expectations without explicit commitment is one option.

ECONOMIC SCENARIOS TO COMMUNICATE IN THE FACE OF UNCERTAINTY



Chart 5: Oil and gas prices in the ECB scenarios (March projections) and market expectations



Source: ECB, Refinitiv.



The use of economic scenarios offers another way which, by design, makes the conditionality of policy impossible to miss. This benefit of scenarios comes on top of more obvious ones, such as testing the robustness of policy and better anticipating tail risks.

Shifting our emphasis from long dated forward guidance to economic scenarios means evolving from some kind of “assertive interventionism” to a mindset of “agile pragmatism” that I strongly advocate for monetary policy. It is a humbler and data-driven approach that acknowledges the limits of foresight, but which makes no concession to our determination to act whatever the future unfolds.

Let me illustrate this with a single, topical remark. Since last Thursday’s meeting of our Governing Council, I have read a great deal of speculation and several statements about the timing of our next interest rate hike at the ECB; this strikes me as looking a bit too much like disguised forward guidance. What should guide us is not a date, but the data. And the soft signaling I referred to consists in clarifying our reaction function. Our attention must be focused on second-round effects, and for that purpose on three key indicators: core inflation, both

current and projected; medium-term inflation expectations, in particular those of households and firms; and developments in wages.

3. A THIRD CHALLENGE TO THEIR INDEPENDENCE

a) *Reporting and communicating broader*

b) *Lending our credibility?*

► Clarification 3 : Fiercely defended independence places an even stronger obligation on us to deliver results and provide explanations to our fellow citizens.

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3. A third challenge to their independence

Finally, central banks are facing a growing challenge to their independence **(3)**. The populist critique of central bank independence is today the loudest, but also the least relevant. Central banks are portrayed as technocratic institutions, escaping democratic control and sacrificing employment and/or growth on the altar of price stability. Allow me to respond with a triple “no”.

No, independence is not a democratic anomaly: on the contrary, independence was conferred by democracy itself. Attacking it in contradiction with the law is what is dangerous for democracy.

No, independence is not designed for us central bankers; it is for the benefit of all citizens.

And no, independence is not an obstacle to reasonably low interest rates; on the contrary, it is a precondition for them, by making it possible to durably control inflation close to its 2% target.

This populist critique is not only unfounded; it is also counterproductive. Monetary policy has evolved over the past ten years: alongside the traditional channel of credit demand, another decisive channel has emerged – that of expectations.^{xiii} In a more uncertain world shaken by repeated shocks, the effectiveness of monetary policy relies increasingly on the ability of central banks to anchor inflation expectations, that is, on their credibility in the eyes of

households and firms. Weakening central bank independence therefore also means weakening one of the key foundations of price stability.

But defending fiercely central banks' independence does not mean that we must stop reflecting on **two current issues** surrounding it.

a) Reporting and communicating broader

The first issue relates to the democratic accountability of central banks. An essential counterpart to independence is the duty to give an understandable account of monetary policy decisions.^{xiv} Contrary to a long-prevailing approach by which central banks communicated only with financial specialists, we now direct our communication towards all economic agents, including the general public. A better understood monetary policy is a more effective one. Over the past ten years, the Banque de France and the Eurosystem have made considerable progress in this area; but let us acknowledge that distrust towards traditional media has grown even faster. We therefore need to invent new channels to reach all audiences, including younger ones, by making greater use of social media, content creators, or chatbots.

b) Lending our credibility?

The second issue is delicate: to what extent can/should central banks comment on other aspects of economic policy? We now operate in a world of at one and the same time weaker governments and increasingly frequent supply shocks. In this “supply-led” environment, structural policies – rather than traditional fiscal stimulus – are more important, but also more difficult to decide and implement. Central bankers can “lend their credibility”^{xv} by giving publicly their views and expertise on broader economic challenges which are essential to fostering future growth and productivity.

Using this credibility to speak, beyond monetary policy, about structural reforms and fiscal consolidation is nevertheless not without risk. As central banks, we must clearly state that we are not the decisionmakers here; that we refer to structural policies insofar as they are relevant for price stability; that our role is to contribute data, expertise, and explanations to the public debate in full

independence; and that we accept that our viewpoints may be debated and even contested. But in today's Europe and world, where non-monetary action is both more necessary and more difficult than ever, it may be worth central banks taking the risk. If we do not advocate debt sustainability in France, or the Letta and Draghi reports in Europe, who will?

Let me conclude with a touch of philosophy: Immanuel Kant ^{xvi} once observed that “in a forest, trees, because each seeks to take air and sunlight from the others, force one another to grow upward”. The same holds true for central banks. Subjected to a succession of shocks, and confronted with a triple challenge, they are compelled toward greater clarity. Today, I tried to develop this idea through another Kantian moral approach, moving from “What can we know?” to “What should we do?”. And what we should do can be summed up in three paradoxes: success against inflation should lead to more humility about the mandate, rather than overreach. Efficiency of QE calls for caution on other non-conventional instruments. And fiercely defended independence places an even stronger obligation on us to deliver results and provide explanations to our fellow citizens. Let us aim to be Kantian central bankers, and thank you for your attention.

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