

# The ECB's monetary policy stance in an uncertain environment



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MONETARY POLICY

External authors:

– Christophe BLOT

Jérôme CREEL

François GEEROLF

Giovanni RICCO

Davide ROMELLI





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## **Abstract**

In this paper, we review the recent economic outlook, policy decisions and communication of the ECB against the backdrop of growing uncertainty. First, inflation heterogeneity has receded with inflation, thus contributing to facilitating the design of monetary policy. Second, monetary easing is somewhat dampened by the reduction in ECB's balance sheet. Third, ECB has chosen to foreground uncertainty more explicitly in its public-facing communication, potentially as a tool to manage expectations and signal caution to a broader audience.

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## **AUTHORS**

Christophe BLOT, OFCE/Sciences Po & Université Paris-Nanterre  
Jérôme CREEL, OFCE/Sciences Po & ESCP Business School  
François GEEROLF, OFCE/Sciences Po  
Giovanni RICCO, CREST – Ecole Polytechnique & OFCE/Sciences Po  
Davide ROMELLI, Trinity College Dublin & OFCE/Sciences Po

## **ADMINISTRATOR RESPONSIBLE**

Giacomo LOI  
Drazen RAKIC  
Maja SABOL  
Ronny MAZZOCCHI

## **EDITORIAL ASSISTANT**

Adriana HECSER

## **LINGUISTIC VERSIONS**

Original: EN

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To contact Economic Governance and EMU Scrutiny Unit or to subscribe to its newsletter please write to:

Economic Governance and EMU Scrutiny Unit  
European Parliament  
B-1047 Brussels  
E-mail: [egov@ep.europa.eu](mailto:egov@ep.europa.eu)

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## LIST OF ABBREVIATIONS

|              |                                             |
|--------------|---------------------------------------------|
| <b>APP</b>   | Asset purchase programme                    |
| <b>ECB</b>   | European Central Bank                       |
| <b>EP</b>    | European Parliament                         |
| <b>EU</b>    | European Union                              |
| <b>GDP</b>   | Gross domestic product                      |
| <b>HICP</b>  | Harmonised index of consumer prices         |
| <b>PEPP</b>  | Pandemic emergency purchase programme       |
| <b>TLTRO</b> | Targeted longer-term refinancing operations |
| <b>TPI</b>   | Transmission protection instrument          |
| <b>USD</b>   | US dollar                                   |

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## EXECUTIVE SUMMARY

- **The factors which have weighed on economic growth are expected to ease in 2025, yet global uncertainty remains elevated because of the trade war and the threat of higher tariffs.** However, the decline in inflation has created room for monetary easing: the ECB's deposit facility rate (DFR) has been lowered from 4% in May 2024 to 2% as of June 2025.
- **Inflation heterogeneity has not been a major problem, so far, and was largely driven by differences in energy prices.** A substantial degree of mean reversion has occurred over time: countries with less public support to counter the rise of energy bills tend to experience higher energy inflation during price surges, but also sharper declines when prices fall.
- **The current monetary policy stance reflects a mixed set of signals.** On the one hand, the continued decline in short-term interest rates suggests a loosening of conventional monetary policy. On the other hand, the ongoing reduction of the central bank's balance sheet could signal a tightening in terms of quantitative policy.
- **Ultimately, what matters most is the cost of borrowing for corporations, households, and sovereigns.** While sovereign yields have declined for short maturities, the picture is less clear for longer maturities, where market dynamics remain more ambiguous. Turning to bank interest rates, the decrease in borrowing costs for households seeking to purchase a home has been somewhat more modest, but notable. Synthetising this information with a proxy rate suggests that monetary tightening is not as pronounced as the change in key interest rates indicates.
- **Over the past decade, the ECB has progressively shifted from technical and opaque language towards more accessible and transparent communication.** Between January 2015 and April 2025, the average readability score of press conference statements has become more accessible. In contrast, the monetary policy accounts remain more complex.
- **ECB's communication tone has evolved:** recent references to tariffs are more explicit, frequent, and embedded in broader discussions of global uncertainty and monetary policy risk assessments suggesting that the ECB is increasingly using this channel to explore and pre-empt complex policy trade-offs, potentially providing market participants with earlier insight into the Governing Council's internal deliberations than was common in the past.
- **The ECB has increasingly addressed economic and policy uncertainty in both its press conferences and accounts** suggesting that the ECB has chosen to foreground uncertainty more explicitly in its public-facing communication, potentially as a tool to manage expectations and signal caution to a broader audience.

# 1. INTRODUCTION

Policymakers around the world have been navigating a prolonged period of elevated uncertainty, much of it driven by geopolitical tensions and trade wars. Recently, renewed threats of trade wars from the U.S. administration – met with potential retaliatory measures from China and the EU – have cast a shadow over the fragile post-COVID-19 recovery. Underscoring the persistence of global uncertainty, the Geopolitical Risk (GPR) index developed by Caldara and Iacoviello (2022) spiked after April 2025 and the so-called “Liberation Day”, reaching levels comparable to those seen after the Russian invasion of Ukraine in February 2022.

In addition to these risks – and not entirely unrelated – central banks were faced with an exceptionally sharp rise in consumer and producer prices during 2022–2023. This inflationary surge triggered a complete reversal in monetary policy, from a historically accommodative stance to a contractionary one. Although the extent to which monetary policies have actually contributed to reducing inflation, against the backdrop of declining energy prices, will long remain disputed, inflation has declined and, at least in the euro area, it has stabilised close to, if not below, the inflation target of 2% set by the European Central Bank (ECB).

This context has enabled the ECB to reduce its key policy rate, which has been brought down to 2% in the euro area since 11 June 2025. In its latest monetary policy statement, delivered on 5 June 2025, ECB President Christine Lagarde, emphasized the downward revision of inflation forecasts for next year (2026). She also cautioned that elevated uncertainty continues to weigh on both inflation and growth outlooks in the near term.

While the continued decline in key euro area policy rates signals a shift towards a more accommodative monetary stance, it might also reflect caution amid a potentially deteriorating economic outlook. President Christine Lagarde has acknowledged that an escalation in trade tensions could result in lower economic growth and lower inflation. In this context, the recent 25 basis point cut to the DFR may appear insufficient to keep inflation anchored near the 2% target. In this respect, the recent policy move seems less expansionary than it might have originally appeared. Ultimately, the impact of any monetary policy decision depends on the benchmark against which it is assessed.

Determining the correct monetary stance is further complicated by the wide array of instruments available to the central bank. While policy rates might be going up or down, balance sheet policies like quantitative easing (QE) or quantitative tightening (QT) might either reinforce or offset the effects of interest rate changes on financial and monetary conditions.

In the following analysis, we examine the recent policy rate decisions in relation to the evolution of the ECB's balance sheet. Has the latter amplified the effects of the former – or not? In the U.S., evidence is mounting that the Federal Reserve has amplified its policy rate decisions through QT. By contrast, we present evidence that no such amplification has taken place in the euro area.

Against the backdrop of this unique situation – marked by limited QT in the euro area during both the sharp rise and subsequent decline in policy rates – a new layer of complexity has emerged. Specifically, changes in policy rates do not fully transmit to private sector borrowing costs when QT either fails to accompany policy rate hikes or it dampens the effects of rate cuts.

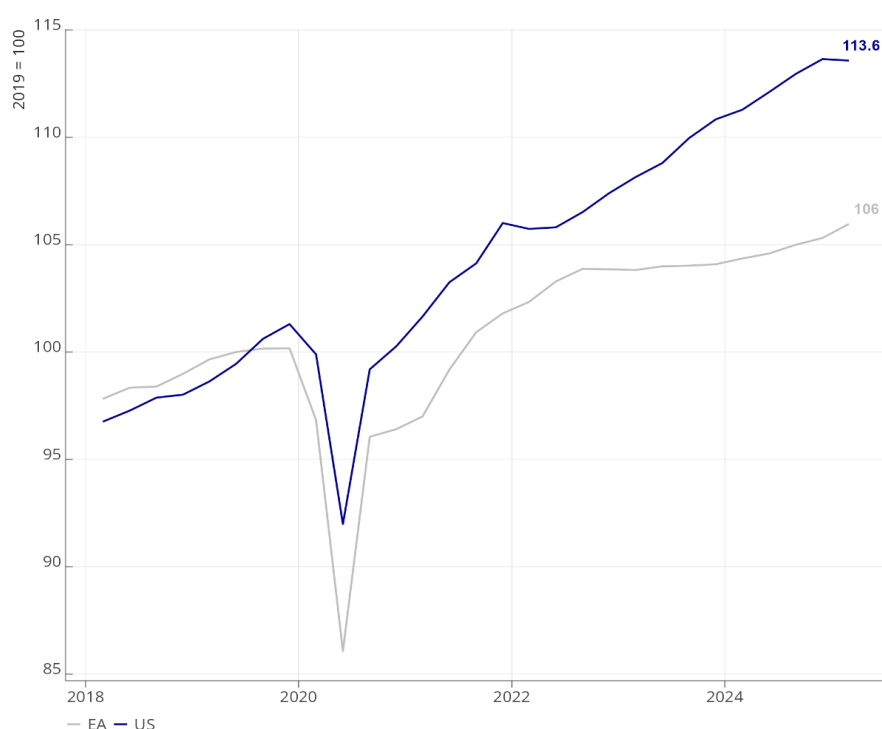
Finally, our analysis reveals a clear evolution in the ECB's communication strategy over the last decade. The ECB has not only improved the clarity of its announcements but has also increasingly emphasized uncertainty more explicitly in its public communication. This shift appears to be a deliberate strategy to manage expectations more effectively and to signal caution to a broader audience.

## 2. ECONOMIC OUTLOOK

### 2.1. Economic underperformance in the euro area

Despite the decline in energy prices, economic growth in the euro area remained subdued in 2024, reaching just 0.8%, in sharp contrast to the dynamism of the U.S. economy, which grew by 2.8%. In the first quarter of 2025, economic activity has accelerated in the euro area (+0.6%), but it is notably related to the exceptional increase of the Irish GDP (+9.7%). Conversely, GDP slightly contracted in the U.S. (-0.1 on a quarterly basis). Imports have sharply increased in anticipation of future tariffs. Economic activity among the big four continues to be led by Spain (+0.6%), while GDP rebounded in Germany (+0.4%) and remains weak in France (+0.1%) after falling in the previous quarter in both countries.

**Figure 1:** GDP in the euro area and in the US (2019 = 100)



Sources: Eurostat, U.S. Bureau of Economic Analysis (BEA).

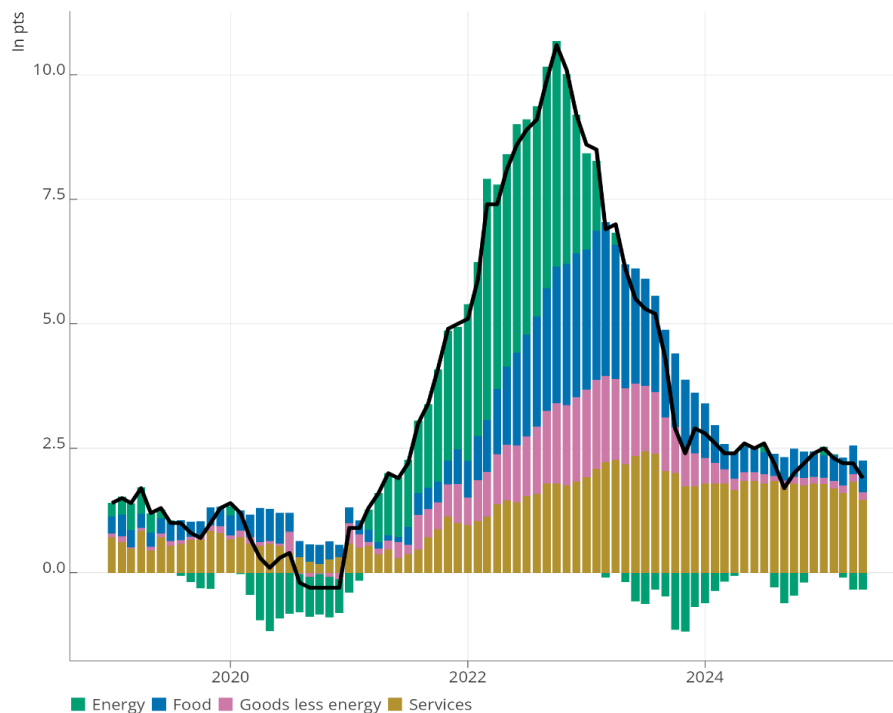
Note: The graph reports the evolution of GDP at constant prices (real GDP) in the euro area and the U.S. since 2018 (base year 2019 = 100). It reports that the severity of the 2020 crisis was larger in the euro area than in the US, and that the latter recovered sooner from the crisis (GDP surpassing 100) and has had a steeper economic growth since then.

The euro area continues to struggle to fully recover from the twin shocks of the COVID-19 pandemic and the global energy crisis. As of early 2025, euro area GDP exceeds its 2019 level by only 6% (Figure 1), hence an average annual growth of just 1% since euro area's most severe recession. In comparison, U.S. GDP is 13.6% above its pre-pandemic level, with an average annual growth rate of around 2.6% during the same period. Even though the U.S. demographic outlook is more favourable, Europe's lagging performance remains a pressing concern, as highlighted in both Mario Draghi's recent report on competitiveness or in OFCE (2024)'s assessment. The global energy crisis has had a more pronounced impact in the euro area, where energy prices have been significantly higher than in the U.S. or China – a disparity underscored by Mario Draghi – see Geerolf (2022) for an early assessment. These effects have probably been exacerbated by ECB's policies, compounding the challenges facing the European economy.

After rising sharply in 2021-2022, euro area inflation continued to decline in 2024, largely driven by falling energy prices. A temporary uptick occurred at the beginning of 2025, reaching 2.5% in January,

due to a base effect, but it resumed its decline in the following months, reaching 1.9% in May. Since May 2023, the contribution of energy prices to headline inflation has been either negative or moderate compared to the peak of 4.8% recorded in March 2022 (Figure 2). Services are now the main driver of inflation, with a 3.2% year-on-year increase in May, and contributed 1.8 percentage points to the overall index. This highlights the need for policymakers to focus less on goods and energy prices and more on the tightness of labour markets. Services are labour-intensive, and their costs tend to be stickier than those in the goods and energy sectors. The strong contribution of services to inflation suggests that inflationary pressures are becoming more entrenched. Nevertheless, inflation has gradually converged toward the ECB's 2% target, and fears of an inflationary spiral have not materialised. The decline in inflation has created room for monetary easing: the ECB's DFR has been lowered from 4% in May 2024 to 2% as of June 2025.

**Figure 2:** Contributions to headline inflation in the euro area, in percentage points



Source: Eurostat, authors' calculations.

Note: The graph reports the headline inflation rate in the euro area (black line), which is the target of the ECB, and the contributions of different components to the inflation rate. For the latest available inflation rate, the main positive contribution is in the services sector, while energy contributes to reducing the inflation rate.

## 2.2. Growth resumes amid trade war

The factors which have weighed on economic growth are expected to ease in 2025, yet global uncertainty remains elevated. As during his first term, President Trump has signalled his intention to use tariffs as a tool to advance U.S. interests. A series of announcements have already reignited trade tensions, though the pace and scope of implementation have varied. On 2 April, President Trump declared his intention to impose "reciprocal" tariffs on all trading partners in an effort to eliminate U.S. trade deficits – including tariffs of up to 20% on EU goods. A week later, these measures were postponed until July 2025, although a minimum tariff of 10% was enacted. On 23 May, citing stalled negotiations with the EU, he announced a 50% tariff, which was suspended on the following Monday.

While there is no doubt that Trump's second term will bring an overall increase in U.S. tariffs, the final scenario remains difficult to predict, given the contradictory motivations and shifting rhetoric behind

these decisions. In the short term, these decisions are causing increased uncertainty about trade policy, which is likely to dampen investment. Trade may also suffer. Beyond the uncertainty channel, estimates by McKibbin et al. (2024) suggest that a 10-percentage-point increase in tariffs would reduce GDP by approximately 0.1 percentage point in countries such as Germany or France. Bouët et al. (2025) find a long-term cost on the EU estimated between 0.2 (scenario without EU retaliation) and 0.1 (scenario with retaliations) percentage points<sup>1</sup>.

The euro area's economic outlook will hinge not only on the tariffs applied to European exports but also on potential retaliatory measures by the EU, which could fuel inflation and therefore prompt a more cautious monetary policy response. Assuming no major retaliation from the EU and a decline in oil prices to an average of less than USD 75 per barrel for 2025, inflation would likely remain close or below the 2% target. This would provide additional leeway for the ECB to cut interest rates further and support growth in 2025 and even more so in 2026. According to OFCE forecasts, euro area GDP would accelerate gradually under this scenario, reaching 1.1% in 2025 and 1.5% in 2026.

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<sup>1</sup> The scenario also includes an increase in the tariffs on imports from China by 60 pp. According to Bouët et al. (2025), the GDP loss amounts to -0.1 % for France in the scenario with or without retaliations. For Germany, the impact on GDP is higher in the scenario without retaliation (-0.3 %) but lower when there are retaliation measures.

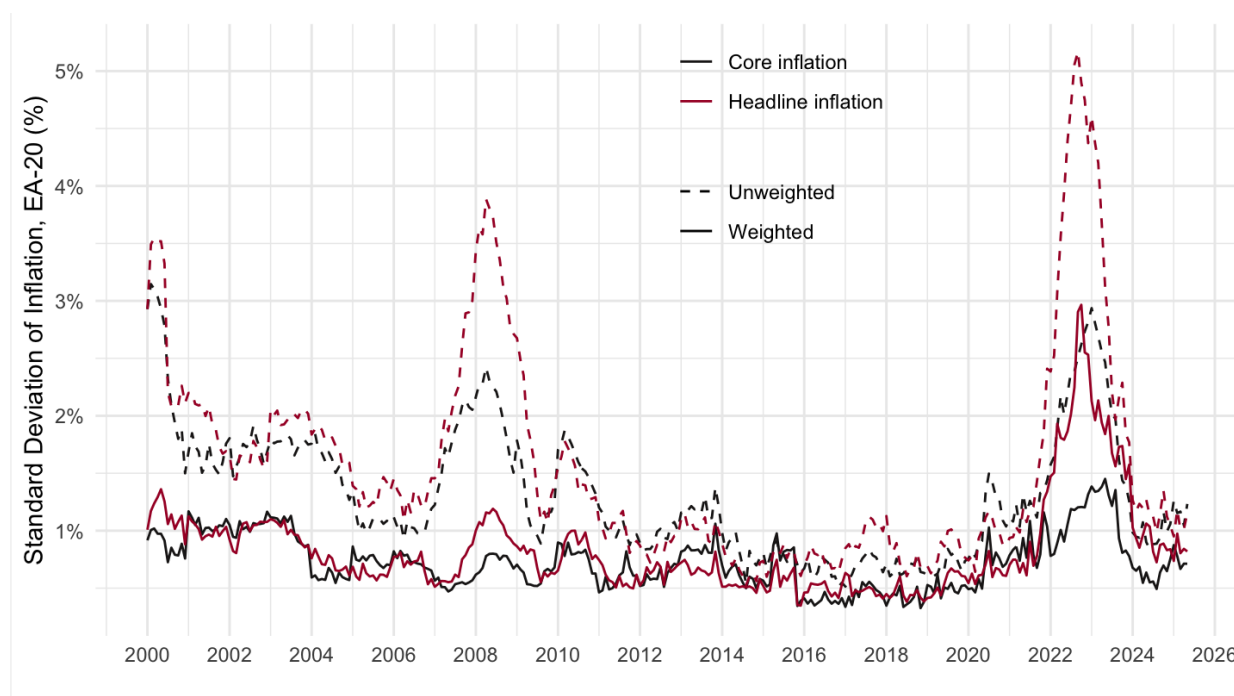
### 3. INFLATION HETEROGENEITY

Inflation heterogeneity — that is, when inflation rates vary significantly across euro area countries — could pose a challenge for the ECB because the ECB conducts a single monetary policy for a diverse group of economies. The ECB sets interest rates based on average inflation across the euro area, but this may not align with the needs of individual Member States. For instance, if inflation is high in one country but low or even negative in another, a policy rate that is appropriate on average may be too loose for some economies and too tight for others. We show in this section that inflation heterogeneity has not been, so far, a problem as one might have feared in the first place. However, there remains a concern regarding the measurement of inflation across countries, as notable discrepancies still persist.

#### 3.1. Weighted vs. unweighted inflation differentials

Inflation differentials are often illustrated using the unweighted standard deviation. However, from an economic perspective, the weighted standard deviation, based on country economic size, is more appropriate, as it prevents smaller countries, which may have idiosyncratic inflation patterns, from disproportionately influencing the aggregate measure (see Blot et al., 2022). That said, the unweighted standard deviation remains relevant from a political standpoint: high inflation in smaller countries can undermine public support for ECB decisions, particularly if citizens feel that their national circumstances are being overlooked. In Figure 3, the solid line depicts the weighted standard deviation, which is notably lower and less volatile, while the dashed line shows the unweighted version.

**Figure 3:** Weighted vs. unweighted standard deviations of 1-year inflation, in %



Source: Eurostat, authors' calculations

Notes: This graph shows the standard deviation of inflation across 20 euro area countries, showing both headline HICP inflation as well as core inflation.

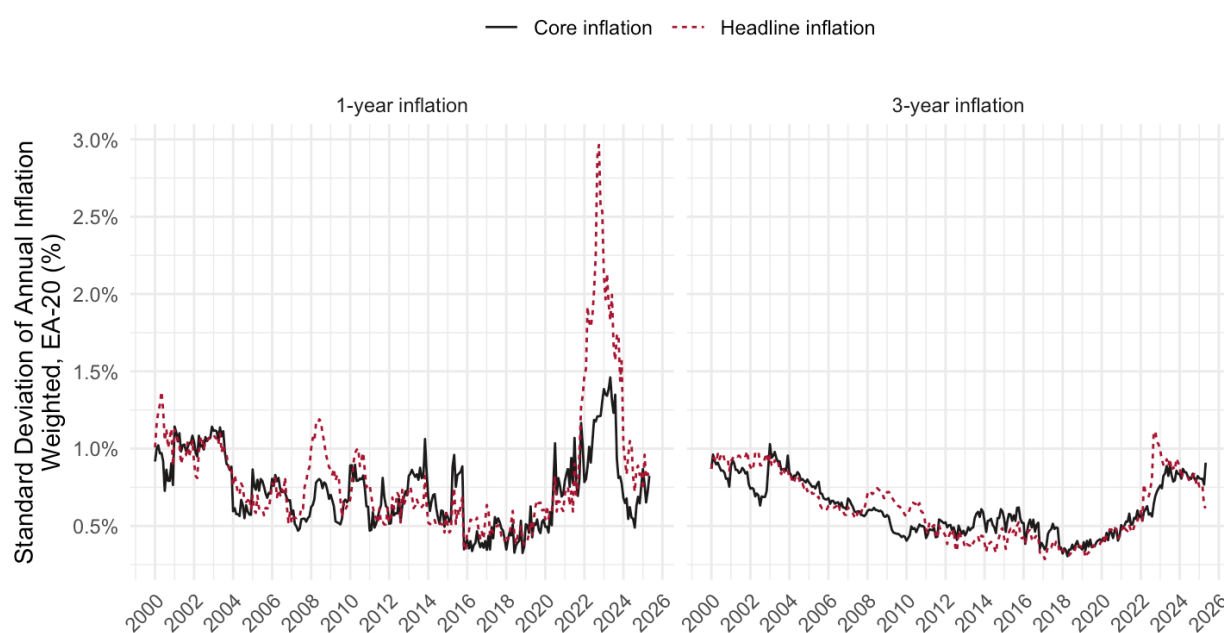
This figure also updates the analysis presented for the Monetary Dialogue in November 2022 (Blot et al., 2022) and reinforces the conclusion that inflation heterogeneity was largely driven by differences in energy prices. Part of this variation stems from structural differences across countries, such as their energy mix, and the extent to which they rely on natural gas versus electricity. It also reflects differences in the scale and design of public support measures, particularly whether such support was

targeted (and thus excluded from inflation calculations). Additionally, a portion of the observed heterogeneity arises from methodological differences in how inflation is measured across countries, an important aspect explored in greater detail in **Box 1**.

### 3.2. Mean reversion

While cross-country differences in energy inflation have been significant over a one-year horizon, a substantial degree of mean reversion has occurred over time. This is partly due to mechanical effects: countries with less public support for energy bills tend to experience higher energy inflation during price surges, but also sharper declines when prices fall. Methodological factors, as discussed in Box 1 also play a role. For instance, countries that incorporate the flow of new energy contracts into their inflation indices tend to show more inflation during price increases and more deflation during price decreases. As a result, over a three-year horizon, inflation appears less heterogeneous from a historical perspective, as illustrated in Figure 4. Overall, inflation heterogeneity has not proven to be as problematic as one might have feared at the outset of this inflationary episode.

**Figure 4:** Weighted standard deviation of core and headline Inflation over 1 year and over 3 years (annualised)



Source: Eurostat, authors' calculations

Notes: This graph shows the weighted standard deviation of annual inflation when computing the change in the price index over 3 years versus over 1 year. It shows that although inflation has been very different over 1 year across countries (left panel), both core and headline inflation are quite similar when computing inflation over 3 years.

**Box 1:** Inflation measurement issues and differences in methodologies

Since the creation of the euro, the Harmonised Index of Consumer Prices (HICP) has been coordinated by Eurostat to ensure the comparability of inflation rates across EU member states. This has led national statistical institutes to align their methodologies with common European standards. Nevertheless, many countries have chosen to maintain their own national Consumer Price Indices (CPI) for domestic purposes – such as better accounting for owner-occupied housing costs. Despite these efforts, substantial heterogeneity in inflation measurement still remains.

The recent inflation crisis has exposed significant short-term differences in how countries measure the energy component of the HICP. A notable example is the Netherlands, which revised its methodology in June 2023 to better reflect the actual costs faced by consumers. Previously, Statistics Netherlands (CBS) based its energy price calculations exclusively on newly signed contracts, failing to account for households with existing fixed-rate agreements. This approach likely led to overestimations of inflation during periods of rising prices and underestimations during periods of decline. The new methodology, based on transaction-level data from energy suppliers, captures both new and existing contracts and thus offers a more accurate picture of real consumer prices. However, this change also introduced a methodological break, as past data were not revised. More broadly, while some countries have succeeded in capturing average energy prices, as intended by HICP guidelines, many have not, due to the considerable data collection effort required. Harmonisation efforts in this area remain ongoing.

In the longer run, methodological divergences persist, particularly in the area of quality adjustments, even for imported goods such as smartphones or computers. As a result, price developments in specific subcomponents, such as the communications sector, are not fully comparable across countries, and this discrepancy carries over into headline inflation figures. These issues could become more pronounced in the context of the green transition. For instance, if one country treats electric vehicles as higher-quality products, this will increase measured GDP and consumption in volume terms. In contrast, another country might treat them as simply more expensive, which would contribute to so-called “greenflation,” reducing measured real GDP and consumption. (See Pisani-Ferry and Mahfouz, 2023, and the thematic report on “Inflation” by Dees et al., 2023, for more detail.)

While Eurostat regularly conducts HICP compliance monitoring exercises, there is still room for both Eurostat (through the European Commission) and the ECB to push for greater harmonisation, especially in quality adjustment methodologies. Without such progress, cross-country inflation comparisons will remain somewhat problematic.

Sources: Statistics Netherlands, Eurostat, Dees et al, 2023, authors' elaboration.

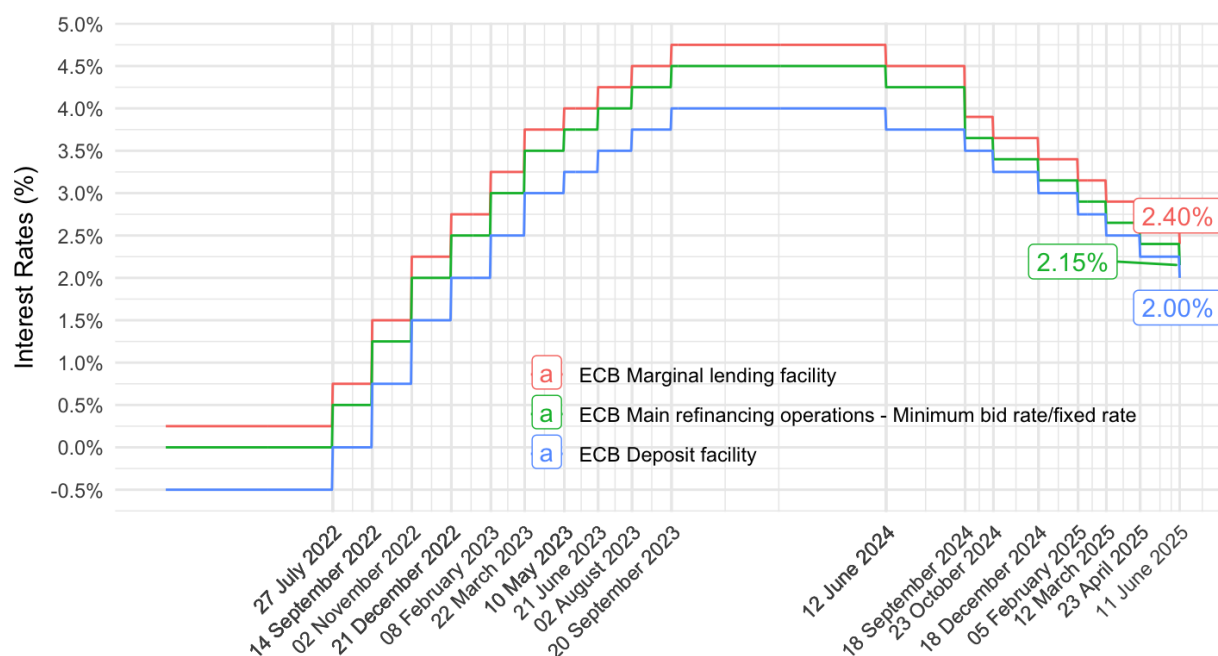
## 4. FINANCIAL CONDITIONS AND THE MONETARY POLICY STANCE

The current monetary policy stance reflects a mixed set of signals. On the one hand, the continued decline in short-term interest rates suggests a loosening of conventional monetary policy. On the other hand, the ongoing reduction of the central bank's balance sheet could signal a tightening in terms of quantitative policy. Taken together, these developments highlight a nuanced approach based only on these very simple indicators: while interest rates point toward accommodation, the balance sheet contraction represents a move toward greater monetary restraint. It is therefore probably necessary to move beyond these indicators.

### 4.1. Interest rate path

The decline in short-term interest rates signals a shift toward a more accommodative stance in conventional monetary policy, likely intended to stimulate economic activity or address signs of slowing growth. Over the past year, beginning on 12 June 2024, the ECB has embarked on a sustained easing cycle. Since that initial move, it has implemented eight consecutive interest rate cuts. The most recent reduction announced on 5 June 2025, become effective on 11 June 2025, bringing the ECB's main policy rate down to 2%. This trajectory seems to prove the central bank's commitment to countering economic headwinds and ensuring that financial conditions remain supportive of recovery.

**Figure 5:** Main interest rates and rate change dates



Source: ECB.

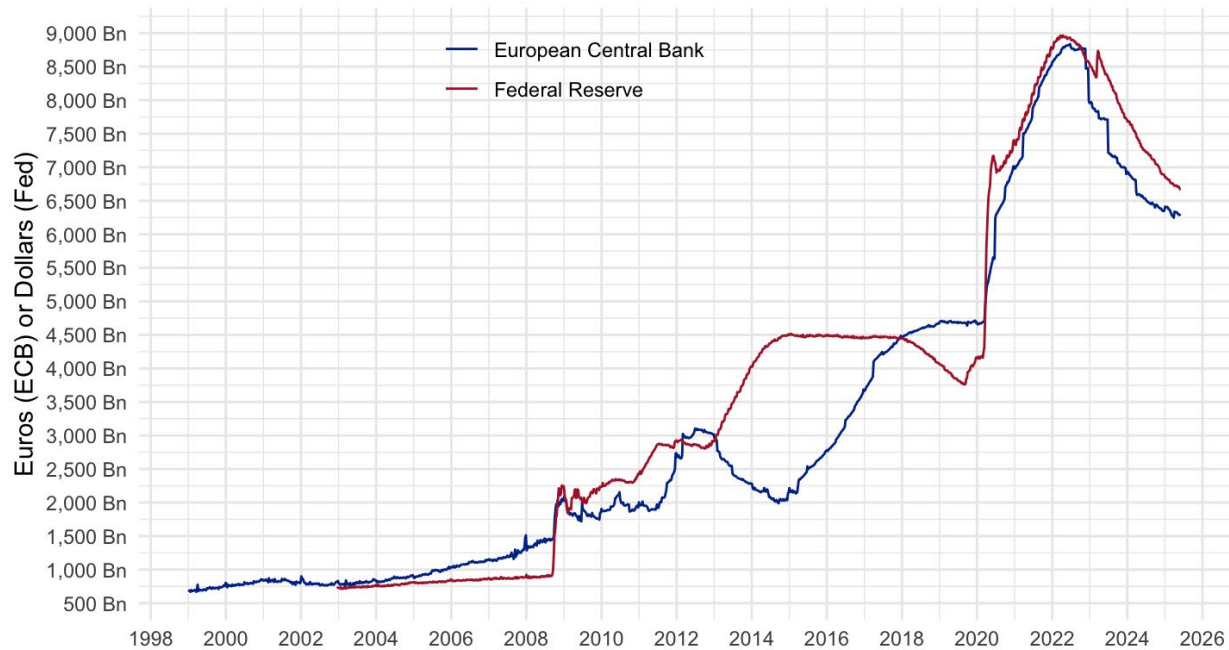
Notes: The deposit facility rate now stands at 2% on June 11, 2025, the main refinancing operations rate at 2.15% and the marginal lending facility rate at 2.40%.

### 4.2. Balance sheet developments

On the other hand, the ongoing reduction of the central bank's balance sheet — indicative of a shift away from asset purchases — signals a tightening in terms of quantitative policy. This process, known as quantitative tightening (QT), involves the active unwinding of previous quantitative easing measures, thereby reducing liquidity in financial markets and possibly leading to higher interest rates

on sovereign bonds. QT has been slightly more important for the ECB than for the Fed (Figure 4), so in this respect, monetary policy in the euro area has not been as accommodative. It remains to be acknowledged that the balance sheet of the ECB was reduced mostly due to TLTRO III repayments, and not QT in the strict sense.

**Figure 6:** Size of the balance sheet of the ECB and the Fed, in billions



Sources: ECB, Board of Governors of the Federal Reserve System (US).

Notes: This graph shows the size of the balance sheets of the Fed (Total Assets less eliminations from consolidation) as well as the one of the European Central Bank (Central Bank Assets for Euro Area – 11-19 countries). At the peak of quantitative easing in early 2022, the balance sheets of the European Central Bank and the Federal Reserve were of roughly the same magnitude, and it has diminished a bit more for the ECB.

### 4.3. The ECB Annual Report: a few remarks

The ECB 2024 Annual Report provides an extensive account of the policy shift from a period of aggressive monetary tightening towards a more accommodative stance, based on key figures and a summary of the Bank's activities, some of which were discussed in the preceding subsections. We limit ourselves to a few brief remarks.

Price stability was achieved, and the ECB's credibility benefited from inflation moving steadily towards its 2% target on a reasonable horizon. The disinflation process, as noted in the report, was largely driven by deflationary pressures in the energy market. The ECB had to navigate difficult trade-offs, as inflation was largely driven by energy shocks and possibly spillovers from U.S demand – both largely outside its direct control, since interest rates primarily affect internal demand within the euro area.

Additional complexity arose from the fact that an interest rate differential with the Federal Reserve could further weaken the euro against the dollar, increasing the risk of pass-through from higher dollar-denominated energy prices. Long-term inflation expectations remained anchored throughout the process – a sign of confidence among consumers and professional forecasters in the ECB's mandate and credibility. The ECB's actions arguably protected and strengthened its role.

The euro area navigated the tightening cycle and the ECB's balance sheet normalisation without experiencing financial turbulence in the sovereign bond market or crises in the banking sector. Notably, the Transmission Protection Instrument (TPI) was not activated, though, arguably, its mere existence

helped stabilise markets in earlier phases of tightening. This can be considered a success of the ECB's policy calibration. The ECB's pivot towards a more accommodative stance, in light of disinflation and weak growth, highlights the proactive nature of the Bank and its understanding of the lags with which interest rates affect aggregate demand and, consequently, inflation.

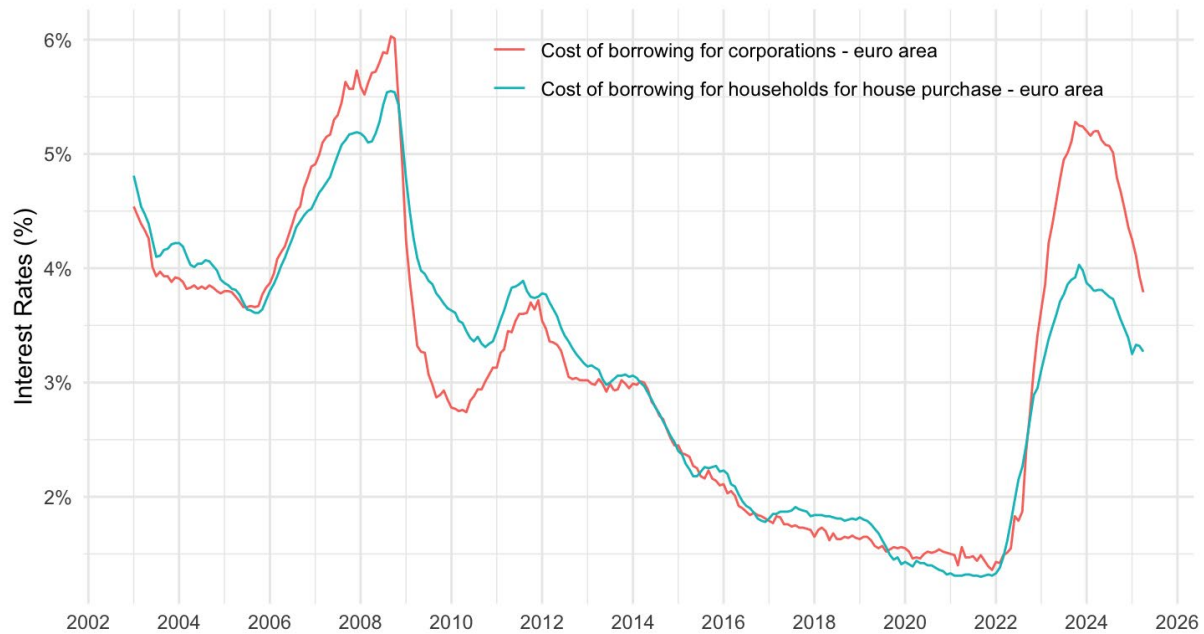
Strategic transformation was another hallmark of the ECB's 2024 agenda. Key among these initiatives was the adoption of the new operational framework.

In 2024, the ECB agreed on the contours of a new operational framework, moving beyond the de facto floor system adopted in the aftermath of the financial and euro area crises. The new framework pivots towards a corridor system with narrow spread limits, while preserving elements of the floor framework. In particular, it stabilises the use of the DFR as the primary policy instrument. The rate corridor is characterised by a 15 basis point spread between the rate on the main refinancing operations and the deposit facility rate. Main refinancing operations will continue to be conducted through fixed-rate tender procedures with full allotment. Three-month longer-term refinancing operations will also continue to be conducted through fixed-rate tender procedures with full allotment. One key element of the framework is the new structural portfolio of securities, yet to be introduced, whose features will be important in shaping the overall operational framework.

The transition away from the crisis-era floor system, with excess liquidity in the system, is a natural adjustment to a different policy environment, but it may reduce the ECB's flexibility in responding to future shocks – especially if financial fragmentation re-emerges across euro area countries. The ECB's plan for the gradual reabsorption of liquidity has so far not created instability in market dynamics but could need to be reversed should financial conditions tighten abruptly.

#### **4.4. Consequences on household, corporate and sovereign rates**

Ultimately, what matters most is the cost of borrowing for corporations, households, and sovereigns. As shown on Figure 8, the composite borrowing costs for corporations have declined markedly—by approximately 150 basis points—bringing the average rate across the euro area down to 3.8%. While the decrease in borrowing costs for households seeking to purchase a home has been somewhat more modest, it remains notable: rates have fallen by around 75 basis points to reach 3.3%.

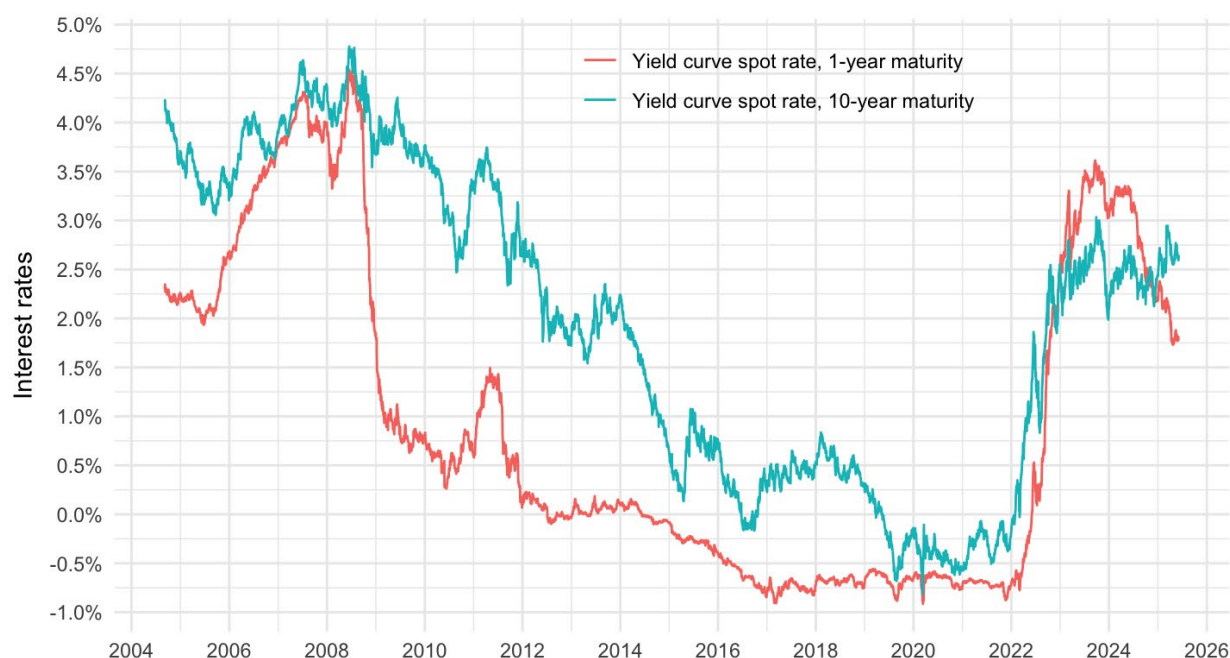
**Figure 7:** Composite cost of borrowing for corporations, and for households for house purchase, in %

Source: ECB.

Notes: The composite cost-of-borrowing indicator for new loans to corporations is currently at 3.79%, while the indicator for new loans to households for house purchase stands currently at 3.27%.

Sovereign interest rates matter because they influence fiscal policy, which in turn shapes overall economic activity. Lower interest charges create more fiscal space, allowing governments to run larger primary deficits while keeping total deficits in check. Long-term sovereign yields are influenced by a complex interplay of factors: they reflect the current and expected path of short-term rates—via the law of iterated expectations—as well as structural factors such as banks' asset-liability management strategies and the size of central bank balance sheets through asset purchase programs. While sovereign yields have declined at the short end of the curve as shown on Figure 9, about as much as the cost of borrowing for corporations, the picture is less clear for longer maturities, where market dynamics remain more ambiguous. This reflects a worldwide phenomenon, with a worldwide increase of 10-year sovereign rates, more particularly in the United States and Japan.

The recent dynamic of sovereign yields may also reflect expectations of market regarding the future decision of the ECB as it also hinges on its own assessment of the monetary policy stance and on the economic outlook.

**Figure 8:** Yield curve spot rate, 1-year maturity and 10-year maturity, in %

Source: ECB.

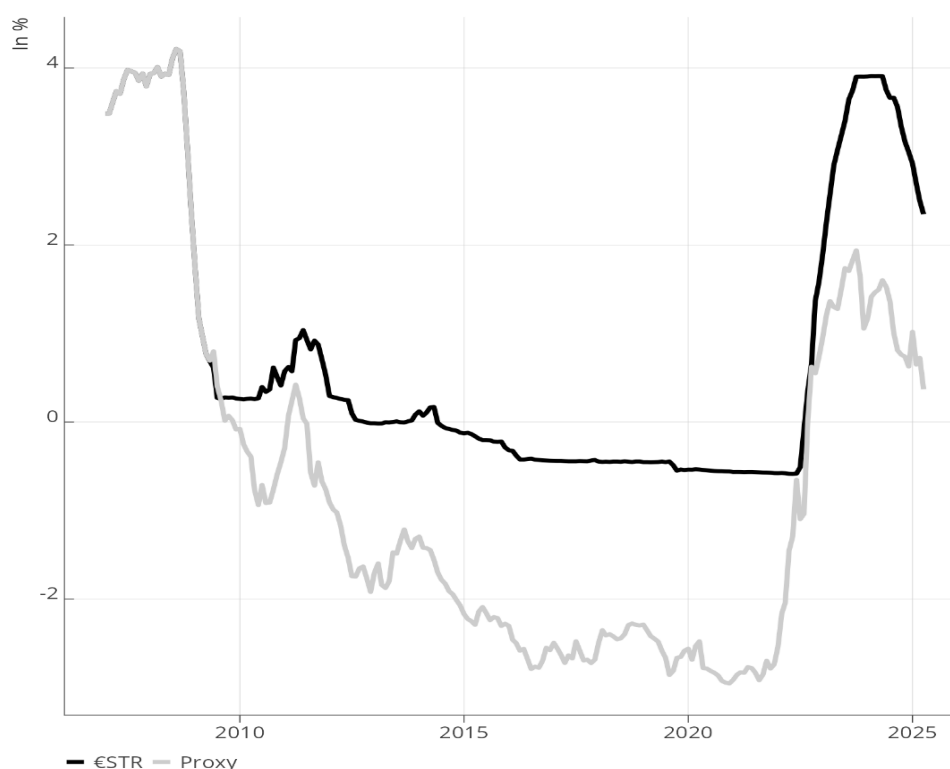
Notes: This figure shows nominal interest rates at 1-year and 10-year for government bond, all issuers whose rating is AAA.

#### 4.5. Construction of a proxy rate

The recent rise and decline in interest rates signal a return to a more conventional monetary policy framework, following an extended period during which ECB's key interest rates remained at exceptionally low levels. However, assessing the stance of monetary policy cannot rely solely based on interest rate decisions. As highlighted in section 4.2, the ECB's policy normalisation since 2022 has also included a gradual reduction in the size of its balance sheet, which had expanded considerably as a result of massive asset purchases and liquidity injections. It is widely recognised that balance sheet policies like quantitative easing – played a key role in reinforcing the expansionary stance implemented by central banks after the global financial crisis. These tools influenced financial conditions by lowering market interest rates at different maturities, reducing retail banking rates, and compressing spreads. Therefore, the current phasing-out of these policies may have involved an additional tightening during the cycle of rising interest rates or tamed the easing cycle which started in June 2024.

To better capture the overall stance of monetary policy, it has become useful to group together, under a single metric, conventional (i.e. changes in key interest rates) and unconventional monetary policy decisions (i.e. balance sheet-related). Naturally, assessing the effectiveness of monetary policy requires looking beyond short-term interest rates to evaluate how well policy is transmitting to its ultimate targets: sovereigns, corporations, and households, who are the end borrowers in the economy.

By aggregating financial information from very different time horizons, proxy rates offer a way to express, into this single metric interpreted as a policy rate, all unconventional measures that have been implemented. We first update the indicator presented in the September 2024 Monetary Dialogue (Blot and Creel, 2024) to account for recent monetary policy decisions up to April 2025 (See Box 2 for methodological details).

**Figure 9:** A proxy rate for the euro area, in %

Source: ECB, authors' own elaboration.

Note 1: See Box 2 or Blot and Creel (2024) on the elaboration of the proxy rate.

Note 2: the figure shows that the period of slightly negative DFR, between 2015 and 2022, has been fully passed-through the overnight interest rate (€STR). The implementation of unconventional policy measures by the ECB (mainly the APP and PEPP programmes) amplified the easing of monetary policy as reflected in the proxy rate. In 2022, the €STR and proxy rates increased substantially in response to the inflation surge. However, the limited decline in the ECB balance sheet during the phase of rising DFR has maintained the proxy rate below the DFR while, in the phase of decreasing DFR, it has contributed to reducing the difference between the proxy rate and the DFR.

The analysis of the monetary stance yields contrasting conclusions depending on whether one examines monetary policy in levels or in terms of changes. The level of the proxy rate in the euro area suggests that monetary tightening is not as pronounced as the change in key interest rates would suggest (Figure 7). In fact, in March 2025, the proxy rate stands at 0.7%, compared with 2.5% for the euro short-term (€STR) rate<sup>2</sup>. However, this conclusion must be qualified: if monetary policy is measured not by its level but by its change over a given period, the monetary stance offers a more uniform picture during the tightening phase. Between July 2021 and October 2023, the proxy rate rose by 4.9 percentage points, compared with 4.5 percentage points for the ECB's key policy rate. During the easing phase, the DFR was reduced to 2.25 % until May 2025, a decrease of 1.75 percentage points, while the proxy rate fell by 1.2 percentage points. This suggests that the ongoing reduction in ECB's balance sheet size is partially offsetting the intended monetary easing.

<sup>2</sup> The €STR rate is an interbank overnight interest rate. The DFR fixed by the ECB provides a numerical target for this rate.

**Box 2:** Construction of a proxy rate for the euro area

The proxy rate for the euro area is constructed following the methodology proposed by Choi et al. (2022) for the U.S. However, our approach is adapted to reflect the specific characteristics of the euro area's monetary policy transmission, namely the presence of heterogeneous sovereign yields and the more prominent role of the banking sector.

In a first step, we extract three latent factors from a set of 24 financial variables (listed in the Annex), selected for their dependence on both conventional and unconventional monetary policy decisions. The first factor is strongly correlated with the German sovereign yield curve across maturities from 2 to 30 years and captures the underlying cycles of monetary policy easing and tightening. The second factor primarily reflects the dynamics of sovereign spreads, while the third factor is associated with the term premium, defined as the yield difference between the 10-year and 2-year bonds.

In a second step, we estimate the relationship between the overnight interest rate and the three factors over the pre-zero lower bound (ZLB) period. The predicted value from this relationship is then used to derive the proxy rate following May 2009.

Source: Authors' elaboration.

In the next section, we examine the ECB's communication strategy over the last ten years, i.e., since the introduction of the monetary policy accounts. In parallel with our analysis of the proxy rate, we highlight shifts in the ECB's discourse and the nuances that have emerged during the recent period of high economic and geopolitical uncertainty. How has the ECB adapted its communication to navigate a more unpredictable environment?

## 5. EVOLUTION OF ECB COMMUNICATION AT PRESS CONFERENCES AND MONETARY POLICY ACCOUNTS

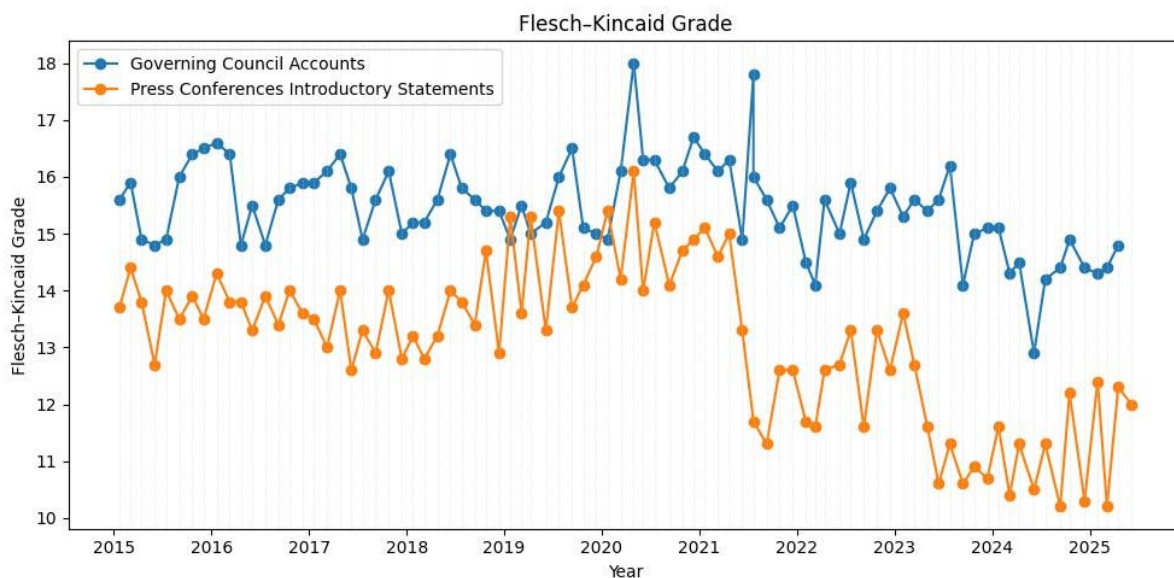
Over the past decade, the ECB has progressively shifted from technical and opaque language towards more accessible and transparent communication. This evolution reflects a broader central banking trend aimed at improving public understanding, enhancing accountability, and strengthening the transmission of monetary policy. To evaluate this shift, we analyse the ECB's monetary policy press conference introductory statements and the monetary policy accounts since the first account was published on 19 February 2015.

### 5.1. Improving clarity: readability and length

Figure 10 illustrates the evolution of the Flesch-Kincaid reading grade level, a widely used metric of textual complexity, across both communication formats<sup>3</sup>. Between January 2015 and April 2022, the average readability score of press conference statements corresponded to approximately 14 years of formal education. Since June 2022, this has dropped to 11.75 years, indicating a substantial improvement in clarity. Over the same period, the average length of these statements increased from approximately 1,370 to 1,500 words.

In contrast, the monetary policy accounts remain more complex, with an average reading level of 15.75 before June 2022, declining only slightly to 15 thereafter. These accounts, intended for a more specialised audience, also increased in length, from 6,900 to 9,600 words, suggesting more detailed accounts of the deliberations of the Governing Council.

**Figure 10:** Readability of ECB's introductory statements and monetary policy account



Source: Authors' elaboration.

### 5.2. Trade tensions: a surge in tariff-related communication

While readability has improved, the presence of complex policy jargon and references to unconventional monetary measures (e.g., PEPP, TLTROs) may still limit accessibility for the general public. Additionally, growing geopolitical and trade-related risks pose new challenges for central bank

<sup>3</sup> The Flesch-Kincaid Grade Level is a readability metric that estimates the U.S. school grade required to understand a piece of text. For example, a score of 10 suggests the text is understandable to someone with a 10th-grade education (roughly 15–16 years old). This measure is based on the average number of words per sentence and syllables per word.

communication. In particular, the resurgence of tariff-related tensions, linked to the second Trump Administration, has reintroduced a layer of economic uncertainty.

Figure 11 presents the evolution of tariff-related language in the ECB's monetary policy communications, specifically, the density of tariff-related words per 1,000 words in both the introductory statements and the monetary policy accounts. The data provide clear evidence of two distinct periods of heightened trade-related communication, corresponding to the two Trump administrations in the United States.

The first wave began in early 2018, when the U.S. initiated a series of tariffs primarily targeting China. ECB communication responded promptly as references to tariffs began appearing more regularly, peaking in late 2018 and early 2019. These references were often tied to downside risks to global trade, investment sentiment, and growth. While the ECB acknowledged the trade conflict's impact, its references remained cautious, reflecting the limited pass-through to euro area inflation at that time. By early 2020, however, mentions of tariffs had largely faded from ECB communication as global trade tensions eased and the COVID-19 pandemic took centre stage.

The second wave, which started in early 2025, appears broader in scope and more intense in ECB communications. Even before the official "Liberation Day" announcement on 2 April 2025, ECB policymakers had begun to acknowledge the renewed trade policy uncertainty linked to Donald Trump's re-election. Notably, the monetary policy account published on 27 February 2025 explicitly discussed concerns around a potential new wave of U.S. tariffs, noting "considerable uncertainty" about their inflationary effects and the negative implications for euro area growth. This early recognition underscores the Governing Council's increased sensitivity to external geopolitical risks.

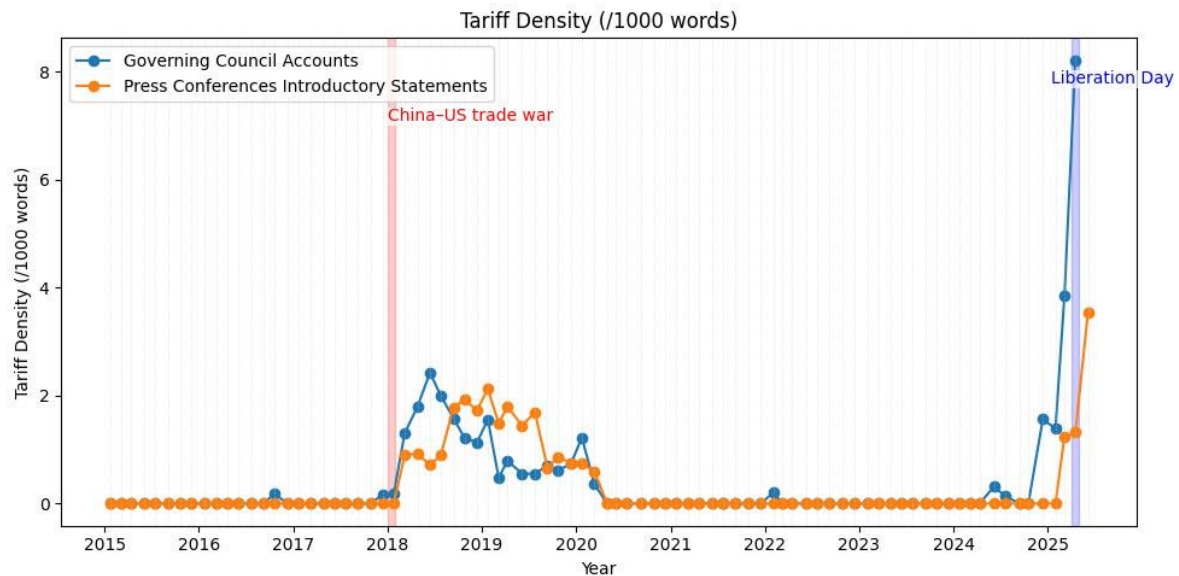
Since then, tariff-related mentions have surged across both communication channels, particularly in the monetary policy accounts. Over the most recent four accounts (from December 2024 to April 2025) and three press conferences (from March to June 2025), tariff-related word density has consistently risen, reaching levels roughly four times higher than those observed during the peak of the 2018–2019 trade tensions. This sharp increase not only reflects the broader geographic scope of the proposed tariffs, no longer limited to China, but also extends to key U.S. trading partners, including the EU, but also suggests greater concern among ECB Governing Council members about the potential spillovers to euro area inflation dynamics and external demand.

The contrast between the two episodes is striking. Whereas the first trade conflict was often framed as a bilateral dispute with indirect euro area effects, the current episode is framed more prominently as a global shock. Moreover, the ECB's communication tone has evolved: recent references to tariffs are more explicit, frequent, and embedded in broader discussions of global uncertainty and monetary policy risk assessments.

These patterns raise two important implications for the ECB's communication strategy. First, they confirm that monetary policy communication must remain flexible and responsive to global developments, especially when external shocks introduce nonlinearities in inflation forecasting. In this context, flexibility refers to the ECB's ability to adapt its communication in real time to reflect new developments, as evidenced by the recent spike in tariff-related mentions. This supports the continued relevance of a data-dependent approach, where policy signals are conditional on incoming information. At the same time, to enhance transparency and better manage expectations, the ECB could further strengthen its use of scenario analyses, i.e., clarifying how different policy paths (e.g., future interest rate trajectories) would respond under alternative macroeconomic scenarios. This approach would not only reinforce the ECB's credibility but would also allow different stakeholders, including market participants and the general public, to better understand the ECB's reaction function under uncertainty. Second, the prominence of tariff-related risks in recent accounts suggests that the ECB is increasingly using this channel to explore and pre-empt complex policy trade-offs, potentially

providing market participants with earlier insight into the Governing Council's internal deliberations than was common in the past. Yet, the (around) 4-week delay in releasing the Monetary Policy Accounts undermines both the transparency and the interpretability of monetary policy decisions.

**Figure 11:** Frequency of tariff-related words in ECB's introductory statements and monetary policy account



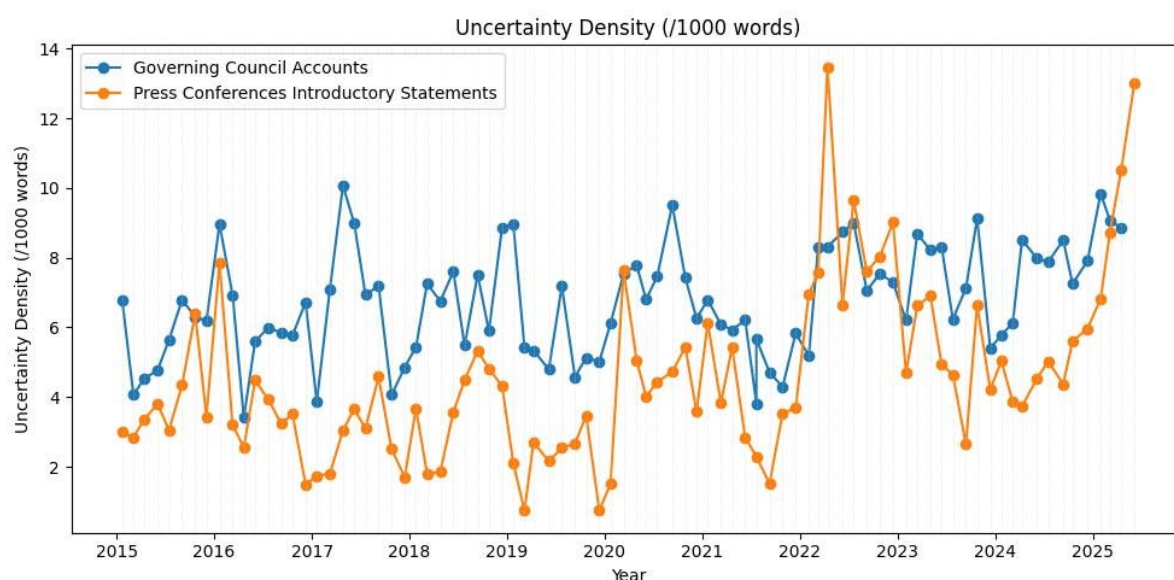
Source: Authors' elaboration.

### 5.3. Elevated uncertainty in ECB communication

In the current environment, characterised by heightened geopolitical and economic uncertainty, it is crucial to analyse not only how the ECB communicates on tariff-related developments, but also to analyse its broader treatment of uncertainty. Tracking how the language of uncertainty has evolved can provide important insights into the ECB's risk perception and its efforts to guide market expectations amid shifting global conditions.

The ECB has increasingly addressed economic and policy uncertainty in both its press conferences and accounts. Figure 12 shows the density of uncertainty-related terms, e.g., "uncertain", "volatile", "risk", etc., based on the extended vocabulary of Baker, Bloom, and Davis (2016), showing a sharp increase in 2025. This figure also shows that mentions of uncertainty-related keywords have recently reached levels surpassing those observed during the COVID-19 pandemic, underscoring the heightened perception of economic and policy risk in the current environment. Notably, the density of these terms (measured per 1,000 words) was higher in the latest introductory statement than in the corresponding monetary policy account. This suggests that the ECB has chosen to foreground uncertainty more explicitly in its public-facing communication, potentially as a tool to manage expectations and signal caution to a broader audience.

**Figure 12:** Frequency of uncertainty-related words in ECB's introductory statements and monetary policy account



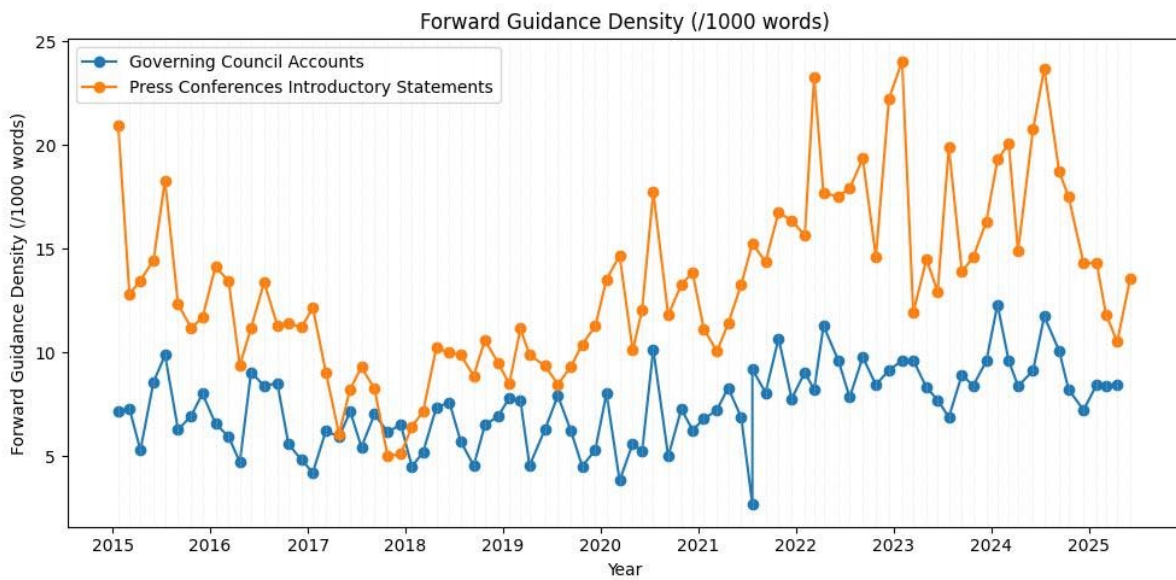
Source: Authors' elaboration based on keyword-driven text analysis methods used in the Economic Policy Uncertainty (EPU) literature (Baker et al., 2016), extended to cover broader expressions of linguistic uncertainty relevant to central banking communication.

As seen during the global financial crisis and the sovereign debt crisis, clarity alone does not ensure effective communication. Forward guidance has become a central tool in the arsenal of modern central banks, especially in environments where traditional instruments may be constrained or where managing expectations is critical. Figure 13 presents the frequency of forward-looking expressions, e.g., "expect", "going to", "may", "might", "shall", "will" (see Galardo and Guerrieri, 2017; and Coenen et al., 2017), in both the ECB's introductory statements and its monetary policy accounts. These expressions offer insight into the extent to which the ECB seeks to provide directional cues about its likely policy path.

The data reveal a decline in forward-looking language between 2015 and 2018, a period marked by subdued inflation and low volatility, when policy was relatively stable and less forward signalling was needed. This trend reversed during the COVID-19 pandemic, when the ECB increased its reliance on forward-looking language to reassure markets and the public about the continuity of its accommodative stance. The frequency of these expressions peaked in 2022–2023, coinciding with the ECB's shift towards policy tightening in response to the post-pandemic inflation surge.

Interestingly, while the use of forward guidance in introductory statements has exhibited greater volatility, the frequency of such terms in monetary policy accounts has remained more stable, suggesting that internal deliberations continue to balance caution and flexibility.

**Figure 13:** Frequency of forward-looking words in ECB's introductory statements and monetary policy account



Source: Authors' elaboration based on keyword-driven text analysis methods used in the Economic Policy Uncertainty (EPU) literature (Baker et al., 2016), extended to cover broader expressions of linguistic uncertainty relevant to central banking communication.

## 6. CONCLUSION

Currently, the ECB faces multiple policy and communication challenges, particularly in conveying policy decisions clearly amidst elevated economic uncertainty driven by external shocks such as trade tensions. Although the economic recovery is underway and inflation is approaching the 2% target, these developments remain vulnerable, with ongoing uncertainty and trade-related disruptions posing significant risks to the economic outlook. As long as retaliation measures are contained, uncertainty and the increase of tariffs might delay or tame the recovery.

The current monetary policy stance reflects a mixed set of signals. On the one hand, the decline in inflation has created room for monetary easing: the ECB's deposit facility rate (DFR) has been lowered from 4% in May 2024 to 2% as of June 2025. This continued decrease in short-term interest rates suggests a loosening of conventional monetary policy. On the other hand, the ongoing reduction of the central bank's balance sheet could signal a tightening in terms of quantitative policy.

Ultimately, what matters most is the cost of borrowing for corporations, households, and sovereigns. While sovereign yields have declined for short maturities, the picture is less clear for longer maturities, where market dynamics remain more ambiguous. Turning to bank interest rates, the decrease in borrowing costs for households seeking to purchase a home has been somewhat more modest, but notable.

Synthesising this information with a proxy rate suggests that the recent phase of monetary easing has not been as pronounced as the change in key interest rates indicates. In that context, the ECB still has room for manoeuvre to use both conventional and unconventional tools to adjust its monetary policy stance.

The ECB would also benefit from further enhancing the transparency and clarity of its communication channels, particularly regarding its monetary policy accounts, which are released with an eight-week delay. This undermines the full transparency of monetary policy decisions. Furthermore, given the importance of central bankers' speeches (Swanson, 2024; Altavilla et al., 2025; Campiglio et al., 2025), the ECB could improve its scenario-based communications. This is particularly important in light of recent developments, such as the resurgence of tariff-related uncertainty, which led to a shift in the ECB's language across communication channels. Speeches, given their frequency and flexibility, are well suited to convey scenario-based narratives and should be more systematically used to complement the delayed release of monetary policy accounts.

Communicating explicitly about the conditional nature of policy choices and the data-dependent criteria underlying these decisions would further strengthen market understanding and reduce volatility. Clarifying how different potential scenarios might influence ECB actions could effectively align market expectations with policy intentions.

In conclusion, adopting a clearer, scenario-based communication approach that highlights the ECB's data dependency and outlines plausible policy responses to various economic outcomes will significantly enhance policy credibility, reduce market uncertainty, and support effective monetary policy transmission.

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## ANNEX: LIST OF VARIABLES USED FOR THE CALCULATION OF THE PROXY RATE

|                                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
|-------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                 |                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Sovereign yields</b>                         | <p><i>German Bund (2, 5, 7, 10, 20 and 30 years maturity)</i></p> <p>Sovereign yield of the 10-year bond for France, Italy and Spain</p>                                                                                                                                                                                                                                                                                                               |
| <b>Private bonds yield</b>                      | <i>Corporate rate for Germany</i>                                                                                                                                                                                                                                                                                                                                                                                                                      |
| <b>Market and retail-banking interest rates</b> | <p><i>Interest rate on German Pfandbriefe</i></p> <p><i>Banking interest rates :</i></p> <p><i>-Consumption loans (up to one year)</i></p> <p><i>-loans for house purchase (5 to 10 years)</i></p> <p><i>-loans to Non-financial corporations (below 1 M; € and 5 to 10 years maturity)</i></p> <p><i>-loans to Non-financial corporations (over 1 M; € and 5 to 10 years maturity)</i></p>                                                            |
| <b>Interest rate spreads</b>                    | <p><i>10-year Pfandbriefe – 10-year T-Bund</i></p> <p><i>10-year Tbund – 2-year Tbund</i></p> <p><i>Corporate spreads</i></p> <p><i>Sovereign spreads (France, Italy and Spain – German yield)</i></p> <p><i>Spread consumption loans – 10-year Tbund</i></p> <p><i>Spread loans for house purchase – 10-year Tbund</i></p> <p><i>Spread loans to NFC(below 1M, €)- 10-year Tbund</i></p> <p><i>Spread loans to NFC(over 1M, €)- 10-year Tbund</i></p> |

Sources: ECB, Datastream Eikon Refinitiv.

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In this paper, we review the recent economic outlook, policy decisions and communication of the ECB against the backdrop of growing uncertainty. First, inflation heterogeneity has receded with inflation, thus contributing to facilitating the design of monetary policy. Second, monetary easing is somewhat dampened by the reduction in ECB's balance sheet. Third, ECB has chosen to foreground uncertainty more explicitly in its public-facing communication, potentially as a tool to manage expectations and signal caution to a broader audience.

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