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Navigating Monetary Policy in Times of Renewed Supply Shocks and Bond Market Turbulence



Economic Governance and EMU Scrutiny Unit (EGOV)
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Navigating Monetary Policy in Times of Renewed Supply Shocks and Bond Market Turbulence

Abstract

This briefing summarises the euro area inflation outlook, assesses the ECB's current monetary policy stance, and reviews its policy communication. Renewed energy pressures have pushed euro area inflation well above target, with upside risks and emerging concerns about the anchoring of household expectations. While there is room for further moderate monetary tightening, high long-term yields and restrictive broader financial conditions alongside fragmentation risks complicate the ECB's policy choices. Clear communication remains essential amid heightened uncertainty.

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This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHORS

Dr. Kerstin BERNOTH, Dean of Graduate Center, DIW Berlin

Dr. Carl-Wolfram HORN, Frankfurt School of Finance & Management

Prof. Dr. Emanuel MÖNCH, Frankfurt School of Finance & Management

Dr. Utso Pal MUSTAFI, Frankfurt School of Finance & Management

CONTACTS IN THE EUROPEAN PARLIAMENT

Coordination: Giacomo LOI, Ronny MAZZOCCHI

Editorial assistance: Ovidiu TURCU

To give feedback or obtain copies, please write to: egov@ep.europa.eu

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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

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LIST OF ABBREVIATIONS

CES	Consumer Expectations Survey
CSI	Communication Stance Indicator
DFR	Deposit Facility Rate
ECB	European Central Bank
EDP	Excessive Deficit Procedure
FCI	Financial Conditions Index
HICP	Harmonised Index of Consumer Prices
HICPX	Harmonised Index of Consumer Prices excl. energy, food, tobacco, and alcohol
OMT	Outright Monetary Transactions
PSPP	Public-Sector Purchase Programme
PEPP	Pandemic Emergency Purchase Programme
SPF	Survey of Professional Forecasters
SMA	Survey of Monetary Analysts
TFEU	Treaty on the Functioning of the European Union
TPI	Transmission Protection Instrument

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EXECUTIVE SUMMARY

- **Driven by a renewed energy shock, euro area inflation stood at 4% in October 2026, up 2.3 percentage points year-to-date and well above the ECB's 2% target.** This rise is pervasive across member countries. Core inflation has increased less but also remains above target.
- **Short-term price dynamics point to persistent near-term price pressures.** Energy momentum remains strong and non-energy industrial goods inflation is accelerating.
- **Forecasters expect headline inflation to return to target by 2028 and their longer-term expectations remain anchored**. However, households' medium-term inflation expectations may have become more sensitive to recent inflation surprises and to perceived inflation, pointing to potential risks to their anchoring**.**
- **Risks to the inflation outlook are tilted to the upside.** A more persistent energy shock, a weaker euro, and a stronger sensitivity of expectations to inflation news could further raise pressures on prices and wages. An easing of geopolitical tensions and weaker demand would lean the other way.
- **The ECB has raised interest rates twice, in June and September, bringing the deposit rate to 2.5%, with another increase widely expected in December 2026.** Taylor-rule benchmarks suggest some scope for a further moderate rate increase, while underscoring the need to monitor whether the recent energy price shock feeds into more persistent inflationary pressures.
- **Financial conditions have tightened considerably.** Long-term yields have increased and banks have tightened credit standards. To what extent this dampens aggregate activity remains to be seen.
- **Diverging financial conditions across member states raise concerns of financial fragmentation.** ECB communication in relation to sovereign debt markets must carefully balance clarity and "constructive ambiguity" to reduce policy uncertainty and non-fundamental volatility.
- **Governing Council communication has turned more hawkish, though less so than in 2022-23, when inflation was considerably higher.**

1. Introduction

Monetary policy in the euro area remains challenging. Following the inflation surge in 2022–23 and its subsequent stabilisation, the ECB is once again facing rising inflationary pressures. These are largely driven by renewed energy price shocks in the wake of the war in the Middle East. At the same time, financial conditions have tightened, along with an increasing divergence in sovereign bond yields across member states. This raises concerns about market fragmentation and the uniform transmission of monetary policy across the euro area.

These developments present monetary policy with difficult trade-offs. Higher interest rates cannot directly reverse rising energy prices or resolve supply bottlenecks. Instead, monetary tightening dampens aggregate demand, potentially exacerbating the economic slowdown caused by such shocks. At the same time, the ECB must prevent temporary price pressures from becoming entrenched in inflation expectations and generating persistent second-round effects. A further challenge arises from sovereign bond markets, where the ECB must closely monitor potential fragmentation risks without compromising the market discipline on fiscal policies. Successfully navigating these trade-offs requires the implementation of appropriate policies and clear, credible communication. This makes communication a key monetary policy tool in the current environment.

In this briefing, we assess the current inflation outlook and the anchoring of inflation expectations. We then examine the ECB's policy stance and the risks arising from fragmentation in the sovereign bond market. Finally, we analyse the communication stances of individual Governing Council members and discuss their potential impact on forthcoming changes to the ECB's Executive Board.

2. Inflation Developments and Outlook

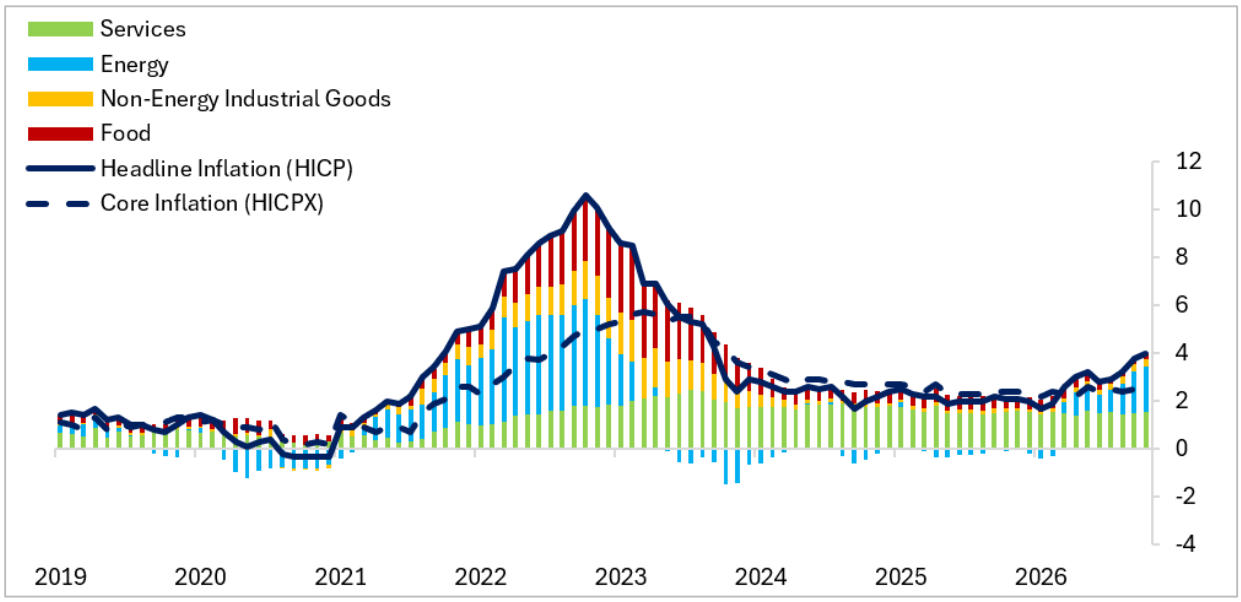
2.1. Recent Inflation Developments

Euro area annual headline inflation, based on the Harmonised Index of Consumer Prices (HICP), stood at 4% in October 2026, up 2.3 percentage points year-to-date and well above the ECB's medium-term target of 2% (see **Figure 1**). The rise has been uneven across sectors. Annual energy price inflation increased sharply by 15.9 percentage points since the onset of the conflict in the Middle East in late February, reaching 21% in October 2026. This makes energy the single largest contributor to headline inflation, accounting for approximately 47% of the overall annual inflation rate. Services inflation remained elevated at 3.3% in October 2026 while food inflation was at 1.5% and non-energy industrial goods inflation stood at 1.2%.

While annual headline inflation increased by 2.3 percentage points between January and October 2026, largely driven by energy prices, core inflation (HICP excluding energy, food, alcohol, and tobacco (HICPX)) has increased by just 0.4 percentage points over the same period. Nevertheless, at 2.6% in October 2026, it remains above the ECB's medium-term 2% target.

The dispersion of inflation rates across euro area member states has remained contained since early 2024 (see **Figure 2**, Panel (a)). Nevertheless, heterogeneity remains sizable. In October 2026, headline HICP inflation ranged from a minimum of 2.3% in Malta to a maximum of 6.1% in Lithuania. This likely reflects the uneven exposure to energy-price shocks across euro area countries. With headline inflation having come in above the 2% target in all member countries since April 2026, these recent inflation dynamics appear increasingly pervasive and persistent rather than reflecting transitory or country-specific developments.

Figure 1: Recent Euro Area Inflation Dynamics and Contributions



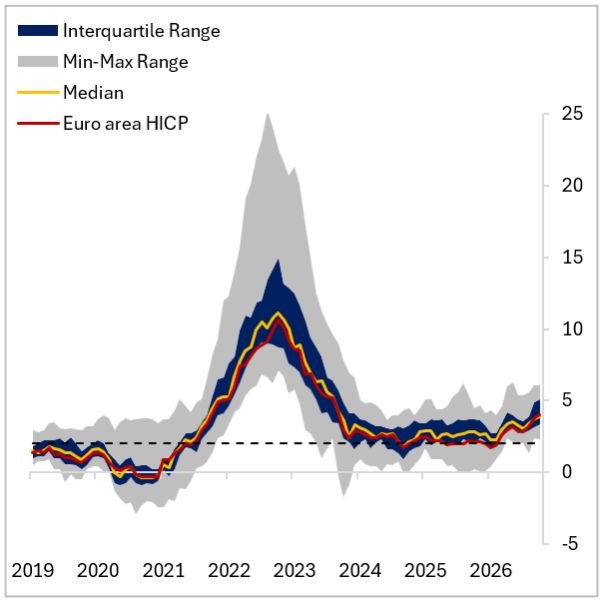
Source: Eurostat and authors' calculations.

As **Figure 2**, Panel (b), shows, dispersion in HICP inflation is evident in all HICP components. Cross-country differences are most pronounced in energy prices (right axis), for which national inflation rates in October 2026 were particularly spread out, by 8.2 percentage points, around the cross-country average. The dispersion of food and services inflation also remains substantially more elevated than before the pandemic, while it is around its pre-pandemic level in non-energy industrial goods. Thus,

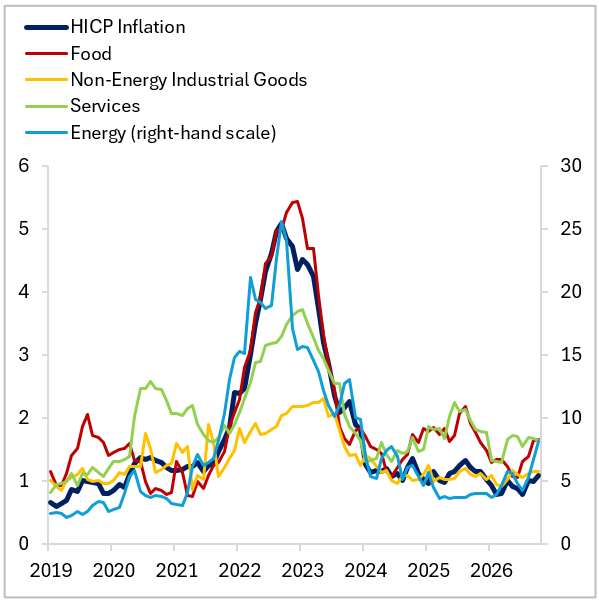
the HICP components, in particular energy prices, that drive the overall increase in inflation are also responsible for the rise in cross-country inflation differences.

Figure 2: Inflation Dispersion

Panel (a): Headline HICP
(Percent)



Panel (b): Standard deviation of HICP comp.
(Percentage points)



Source: Eurostat and authors' calculations. Last observation: October 2026 (Eurostat estimate). Countries are included in the calculations only from the date of their accession to the euro area.

2.2. Inflation Outlook and Expectations

Looking ahead, indicators of expert inflation expectations point to both headline and core inflation remaining elevated in the near term before gradually declining (see **Table 1**). While headline inflation is expected to return to the ECB's 2% target by 2028, core inflation is projected to remain somewhat above 2%, suggesting that inflationary pressures outside the energy and food sectors are expected to persist.

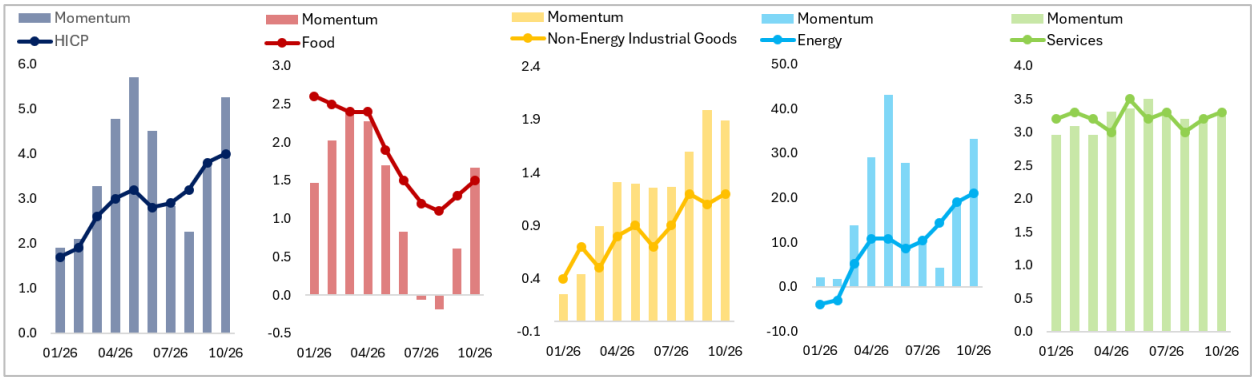
Table 1: Inflation Expectations

		Survey of Professional Forecasters (SPF) (October 2026)	Survey of Monetary Analysts (SMA) (October 2026)	ECB Staff Macroeconomic Projections (September 2026)
Headline Inflation (HICP)	2026	3.0	3.9	3.0
	2027	2.6	2.8	2.5
	2028	2.0	2.0	2.1
Core Inflation (HICPX)	2026	2.4	2.5	2.5
	2027	2.5	2.6	2.6
	2028	2.2	2.2	2.3

Source: European Central Bank. Note: Data for the Survey of Professional Forecasters refers to Q4 2026 (survey period October 2-7), to October 2026 (survey period October 12-14) for the Survey of Monetary Analysts and to September 2026 for the ECB Staff Projections. Reported figures measure average annual inflation except for the SMA, where we report Q4 expectations for 2026 and annual averages of quarterly expectations for 2027 and 2028.

To detect turning points in inflation early, it is instructive to look at inflation momentum, i.e. annualised inflation rates that would realise if the most recent price dynamics were to persist. As shown in **Figure 3**, based on Eurostat's estimate of October inflation, headline HICP momentum rose to 3.8% in September and 5.2% in October. This is above the year-on-year HICP inflation rate of 4.0% estimated for October and indicates that inflation is currently further accelerating.

Figure 3: Sectoral Inflation Momentum (Percent)



Source: European Central Bank and authors' calculations. Momentum refers to the annualised three-month-over-three-month change in the respective seasonally-adjusted HICP component. Last observation: October 2026 (Eurostat estimate).

However, these short-term dynamics differ substantially across the major inflation components. Non-energy industrial goods momentum stood at 1.9% in October, well above its 1.2% year-on-year inflation rate and suggesting that inflation in this component is currently accelerating. The strongest acceleration was observed in energy prices, where momentum rose sharply to 33.2% in October 2026, well above the annual rate of energy inflation of 21% observed in October 2026. Food inflation momentum also turned positive but remains subdued relative to the other components. Services momentum remains near 3%, slightly below its annual rate, indicating persistent above-target price increases but thus far showing no sign of acceleration.

2.3. Anchoring of Inflation Expectations

Anchored inflation expectations are key to the successful conduct of monetary policy, because forward-looking households and firms base their consumption, investment, and price-setting decisions on the inflation outlook. Consequently, central banks rely on communication, alongside policy actions, to guide agents' expectations toward their inflation target.

Median household inflation expectations for the next 12 months from the ECB Consumer Expectations Survey (CES) stood at 3.1% in September 2026. In contrast to the survey evidence for professional forecasters and financial market analysts, the median household expects inflation to remain above the 2% target in the medium term. Three- and five-year ahead median household inflation expectations stood at 2.9% and 2.5% in September 2026, the same as in August 2026 and up 0.3 and 0.2 percentage points respectively since the beginning of the year.

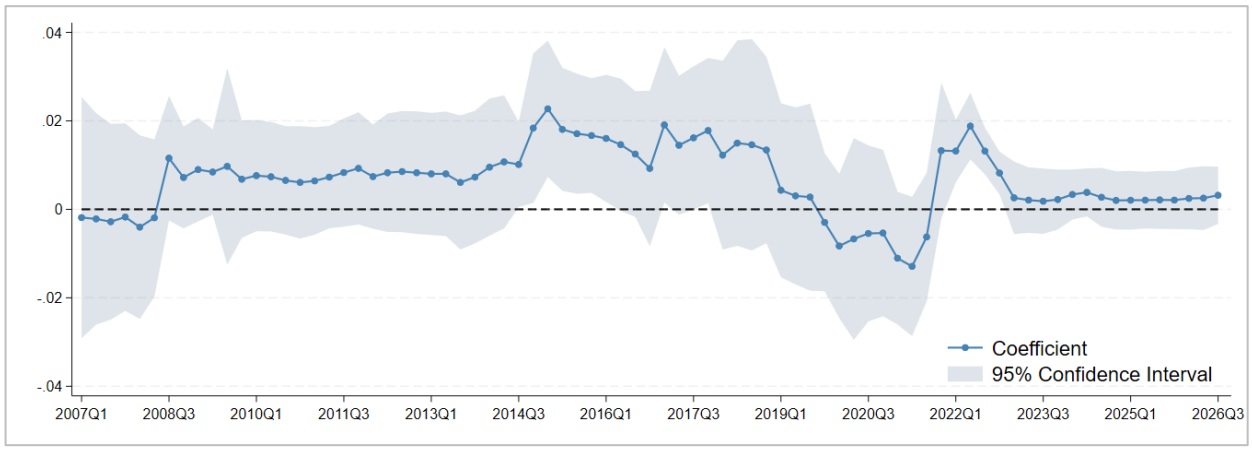
Longer-term inflation expectations are generally considered "anchored" if they remain close to the inflation target and respond little to incoming inflation surprises (Carvalho et al., 2023). To assess the sensitivity of longer-term inflation expectations to inflation news, we relate individual forecasts from the ECB's Survey of Professional Forecasters (SPF) and Consumer Expectations Survey (CES) to respondents' short-term inflation forecast errors (see Annex for methodological details). **Figure 4** presents the results. Panel (a) suggests that professional forecasters' longer-term inflation expectations have been well anchored since 2023, following a temporary increase in their sensitivity to inflation surprises during the recent high-inflation episode.

Turning to Panel (b), household expectations have also been firmly anchored since early 2025, after having been quite sensitive to near-term inflation surprises from late-2022 to late-2024. In the latest survey round in September 2026, however, households significantly revised upwards their medium-term expectations in response to recent inflation news, showing sensitivities similar to those observed in 2023 and 2024. While it remains to be seen whether this uptick persists in the coming months, the ECB should closely monitor the responsiveness of medium- and longer-term inflation expectations to current inflation surprises and respond forcefully to any robust sign of de-anchoring.

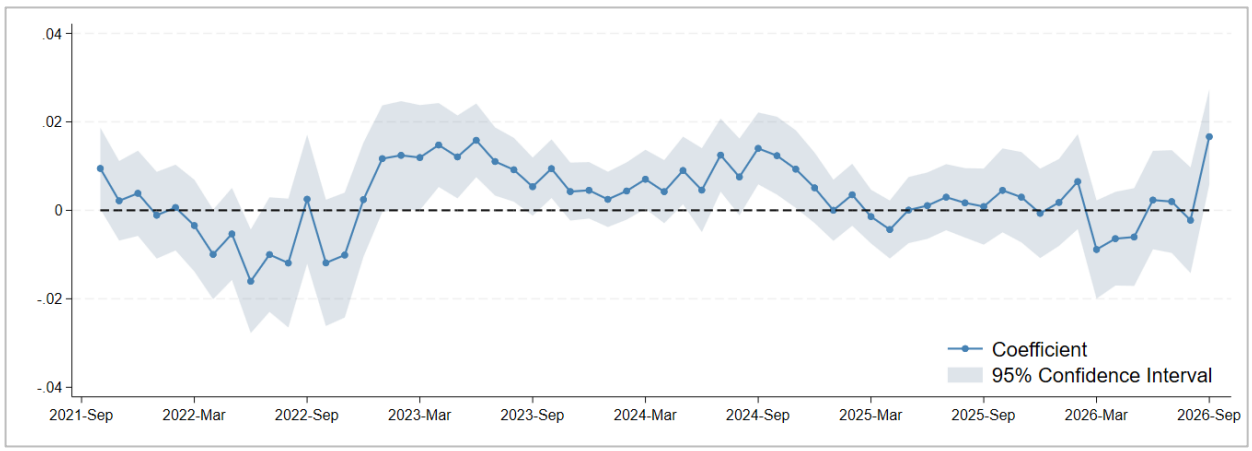
Historically, well-anchored inflation expectations have often been attributed to a high level of central bank credibility and the broad success of inflation-targeting strategies. However, recent research by Malmendier and Nagel (2026) suggests that, in particular for consumers, the apparent historical anchoring might also reflect individuals' accumulated lifetime experiences of low inflation rates, rather than confidence in a central bank's ability to stabilise inflation at the target. As a result, the recent experience of very high inflation may have a lasting influence on households' inflation expectations and their anchoring. This is particularly salient as the median household's *perceived* rate of inflation over the past twelve months as reported in the CES has increased from 3% in January to 3.6% in September 2026.

Figure 4: Sensitivity of Medium- to Long-Run Inflation Expectations to 1-Year Ahead Forecast Errors

Panel (a): Survey of Professional Forecasters



Panel (b): Consumer Expectations Survey



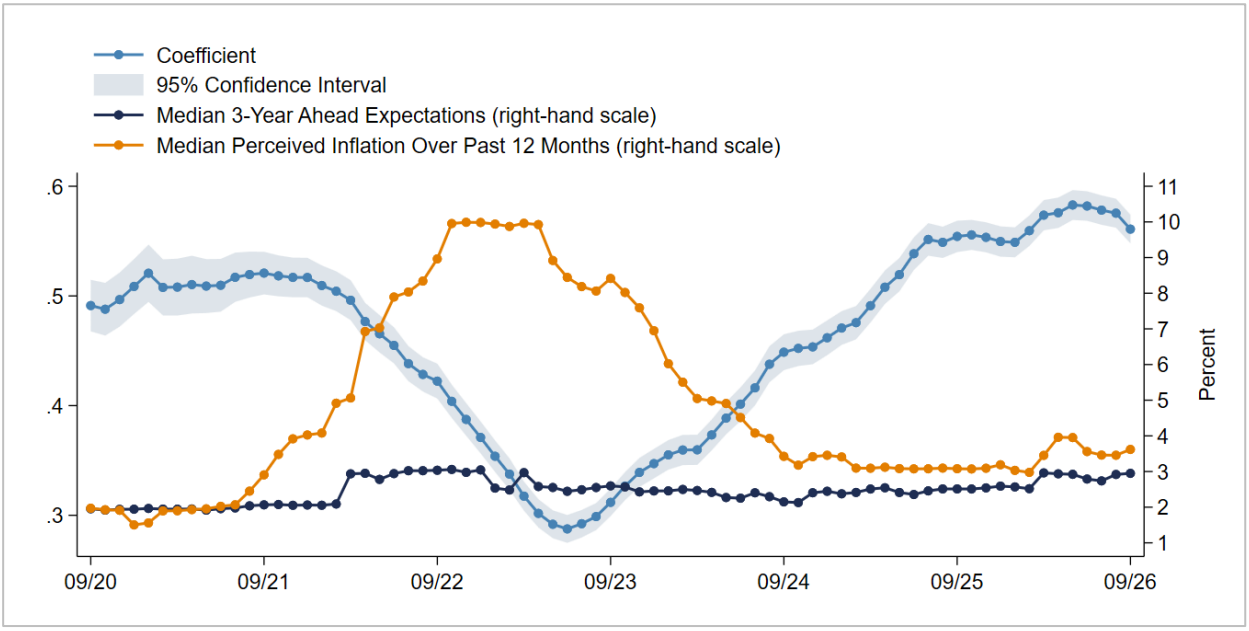
Source: European Central Bank and authors' calculations.

Against this backdrop, we examine how closely households' medium-term inflation expectations are associated with their perceived inflation over the past twelve months (see Annex for methodological

details). **Figure 5** shows that the sensitivity of households' medium-term inflation expectations to their perceptions of last year's rate of inflation is currently elevated compared to previous years. If this heightened sensitivity were to persist, a further rise in experienced and, thus, perceived inflation could give rise to a strong increase in household's medium-term inflation expectations.

Overall, these findings suggest that the anchoring of expectations should not be taken for granted. There are some first signs of an increased sensitivity of households' longer-term inflation expectations to recent inflation news. Moreover, as inflation expectations become more sensitive to perceptions, the ECB can no longer rely on a period of low and stable inflation in household's recent experience. Heightened inflation perceptions could then easily spill over into higher inflation expectations going forward. This underscores the importance of closely monitoring inflation expectations and perceptions.

Figure 5: Sensitivity of Household Inflation Expectations to Perceived Past Inflation



Source: European Central Bank and authors' calculations.

2.4. Risks to the Inflation Outlook

Current risks to the euro area inflation outlook remain tilted to the upside, mainly as a result of the renewed energy shock. More persistent energy disruptions would increase the risk of second-round effects on non-energy prices and wages, making inflation more broad-based and persistent. According to the latest ECB wage tracker release from 4 November 2026 which covers wage agreements signed through mid-October 2026, underlying wage growth, excluding one-off payments, is expected to increase slightly from 2.6% in 2026 to 2.8% in the first three quarters of 2027. This suggests that second-round wage effects from higher energy inflation remain contained so far. That said, wage growth often responds to inflationary shocks with a lag and the pass-through of inflation to wages is faster in countries with stronger wage indexation. The fragile geopolitical environment and a further weakening of the euro against the U.S. Dollar remain additional sources of upside risk to inflation.

In contrast, downside risks arise from a potential easing of geopolitical tensions, faster adjustment of energy supply and demand, and weaker-than-expected pass-through into prices and wages. The energy shock itself reduces consumers' purchasing power and firms' profitability, potentially weakening consumption and investment. Higher uncertainty, tighter credit conditions, and higher long-term interest rates could further weaken demand, thus dampening underlying inflationary pressures.

3. Assessment of Monetary Stance

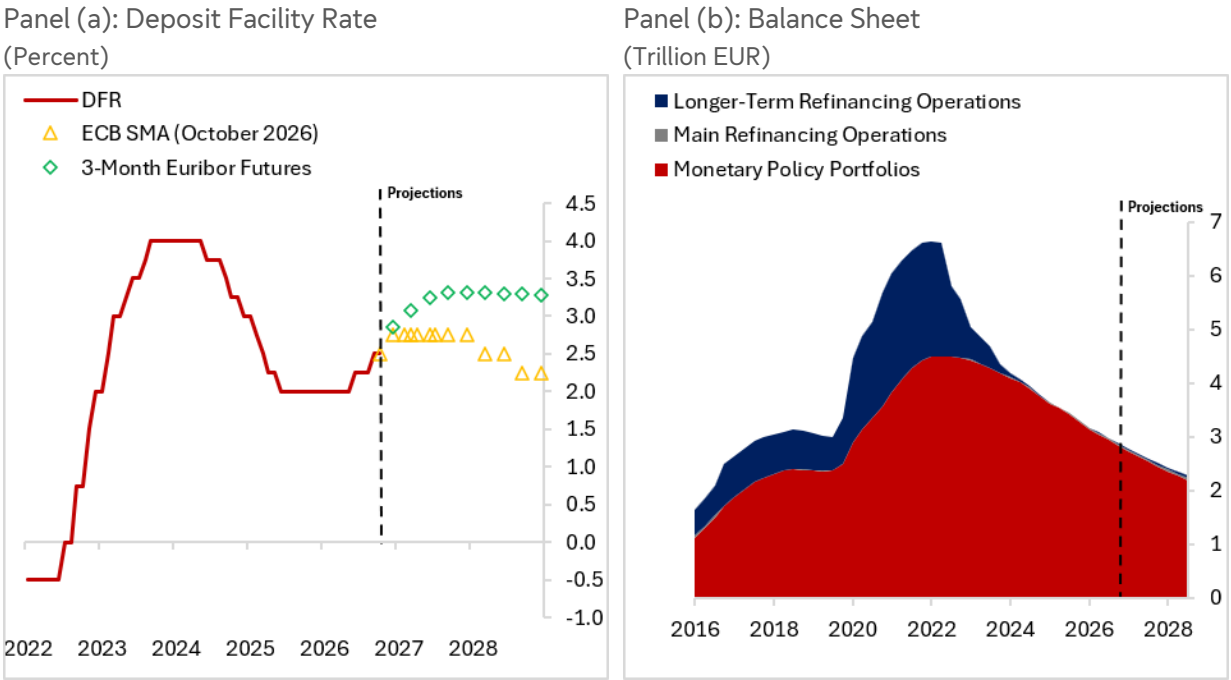
3.1. Interest Rate and Balance Sheet Developments

Following the easing cycle comprising eight rate cuts between June 2024 and June 2025, which brought the deposit facility rate from 4% to 2%, the ECB increased this rate in June and September 2026 from 2% to 2.5%. The Governing Council kept the policy rates unchanged at the October 29 meeting (see **Figure 6**, Panel (a)). This decision reflects the ECB's assessment that the full effects of the energy shock are still unfolding and the upside risks to inflation in the near term require confronting the current assessment with more data. On the one hand, the Governing Council emphasised the meeting-by-meeting, data-dependent approach and that it does not pre-commit to any rate path. On the other hand, President Lagarde indicated that "unless there was a major development, the direction of travel is quite clear [...]" (ECB, 2026). In line with this communication, the market-implied rate path currently suggests further rate increases in the coming months. This is in contrast with analyst expectations from the October 2026 ECB Survey of Monetary Analysts (conducted about two weeks before the October 29 Governing Council Meeting) who pencilled in only one more rate hike in December, followed by stable rates in 2027 and a decline to 2.25% in 2028.

The recent rate hikes have been accompanied by a continued passive unwinding of the Eurosystem monetary policy portfolios, following the end of reinvestments under APP and PEPP as well as the phasing out of targeted longer-term refinancing operations (TLTROs) (see **Figure 6**, Panel (b)). In October 2026, median expectations from the SMA saw monetary policy portfolios continuing to decline from about 3 trillion EUR in September 2026 to around 2.2 trillion at the end of 2028.

With the unwinding of the ECB's balance sheet proceeding gradually and predictably, and with a meeting-by-meeting approach to policy decisions, the policy rates currently remain the ECB's primary instrument. We now assess the evolution of the deposit facility rate against the rate path implied by some simple monetary policy rules.

Figure 6: Current and Expected Interest Rates and Balance Sheet Developments



Source: Refinitiv, ECB, authors' calculations. The 3-month Euribor futures are as of 30/10/2026.

3.2. A Simple Interest Rate Rule

As a point of reference, we compare the current policy rate with the interest rate derived from a policy rule in the spirit of Taylor (1993). As shown by Clarida et al. (1998), Taylor rules provide a plausible approximation of the historical monetary policy implemented by the major central banks. Evidently, such rules cannot capture the complexity of monetary policy decision-making and should not be interpreted as a benchmark for optimal policy. Nevertheless, they offer a useful yardstick for relating interest rate decisions to prevailing economic conditions. The `Taylor reference rate´ is determined as follows:

$$i_t^{TR} = \pi_t \ + r_t^* + 0.5(\pi_t - 2) + 0.5(y_t - y_t^*)$$

According to this simple rule, the benchmark short-term interest rate i_t^{TR} is related to the natural real interest rate r_t^*,[1] the deviation of inflation π_t from the 2% target, as well as the output gap, $y_t - y_t^*$.[2] We consider three alternative measures of inflation. The first is headline HICP inflation, which serves as the baseline. The second is core inflation, which focuses on underlying inflationary pressures by excluding volatile energy and food prices. The third is one-year-ahead inflation expectations from the ECB's Survey of Professional Forecasters (SPF), to allow for a forward-looking perspective. And finally, to account for the gradual adjustment of policy rates typically observed in monetary policy, we also consider a Taylor rule with interest-rate smoothing. This specification assumes that the policy rate only partially adjusts towards the level prescribed by the simple Taylor rule, starting from the previous quarter's actual deposit facility rate, i_{t-1}^{DFR}. We use a smoothing coefficient of 0.85, which is consistent with the interest-rate persistence documented by Clarida, Galí, and Gertler (1999):[3]

$$i_t^{sTR} = \rho_m i_{t-1}^{DFR} + (1 - \rho_m) i_t^{TR}, \ \rho_m = 0.85$$

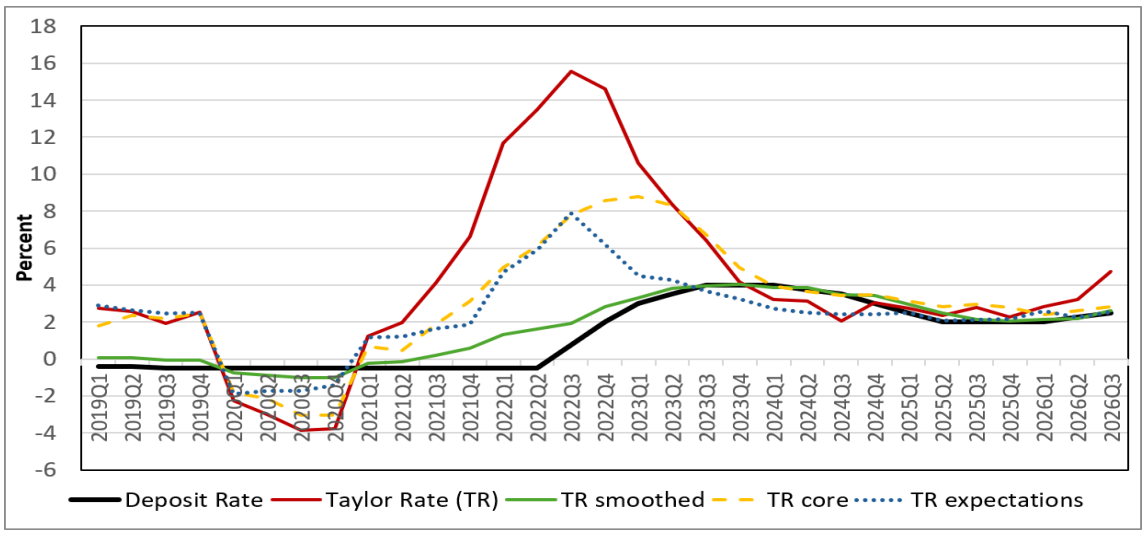
As shown in **Figure 7**, the Taylor rule based on headline inflation yields particularly volatile benchmark interest rates. During the COVID-19 pandemic, it would have suggested strongly negative policy rates and called for an earlier and substantially more aggressive tightening cycle in response to the subsequent inflation surge. In contrast, the specifications based on core inflation and one-year-ahead inflation expectations imply considerably more moderate policy adjustments. This illustrates the importance of distinguishing temporary price shocks from underlying and expected inflation. Since it puts a large weight on the previous quarter's policy rate, the smoothed rule also implies smaller adjustments.

[1] We use the Holston-Laubach-Williams (HLW, 2017) estimate as a measure of the natural real interest rate. Note that there is considerable estimation uncertainty regarding the level of the natural rate, with the HLW estimate being at the lower end of the range of estimates considered by the ECB (see, e.g. Schnabel, 2026). With higher natural real rates of interest, all policy rule specifications considered here would prescribe higher levels of nominal policy rates.

[2] We use the European Commission's estimate of the output gap for the euro area, provided by DG ECFIN.

[3] The quarterly smoothing coefficient of 0.85 is consistent with the interest-rate persistence documented by Clarida, Galí and Gertler (1999) and is also used in the Federal Reserve's FRB/US model.

Figure 7: Simple Taylor Rule



Notes: The figure shows the observed ECB deposit facility rate and four Taylor-rule benchmarks: (i) headline TR, based on headline HICP inflation; (ii) core TR, based on HICP inflation excluding energy and food; (iii) SPF TR, based on one-year-ahead inflation expectations from the ECB's Survey of Professional Forecasters; and (iv) smoothed TR, based on headline inflation and a smoothing coefficient of 0.85, using the previous quarter's actual DFR.
Source: Macrobond and authors' own calculations.

Looking at the current situation, the Taylor rule based on headline inflation suggests a benchmark rate of just over 4%, which is considerably higher than the current deposit facility rate of 2.5%. By contrast, the specifications based on core inflation and expected inflation imply rates closer to current policy. The core inflation rule suggests a rate of around 2.8%, which would be consistent with one additional moderate rate increase given the current levels of inflation and the output gap. This is in line with the expectations of participants in the ECB's Survey of Monetary Analysts (SMA).The results suggest some scope for a moderate additional tightening. At the same time, the ECB should closely monitor whether the recent energy price shock leads to more persistent underlying inflationary pressures or higher expected rates of inflation.

3.3. Financial Conditions and Bond Markets

After a substantial easing from 2023 through 2025, they financial conditions tightened sharply since the beginning of 2026 (**Figure 8**, Panel (a)). One important factor has been the sharp increase of longer-term government bond yields over the course of 2026 (Panel (b)). In line with this, the ECB's October 2026 Bank Lending Survey shows that euro area banks reported a further net tightening of credit standards for loans and credit lines to firms.

Beyond this overall tightening, financial conditions have become increasingly uneven across euro area countries of late, particularly in sovereign bond markets. Concerns about fiscal sustainability and political stability in some member countries have contributed to this divergence. As a result, the cross-country dispersion of sovereign yields, which represents a measure of sovereign bond market fragmentation, rose markedly in recent months (**Figure 8**, Panel (c)).[4]

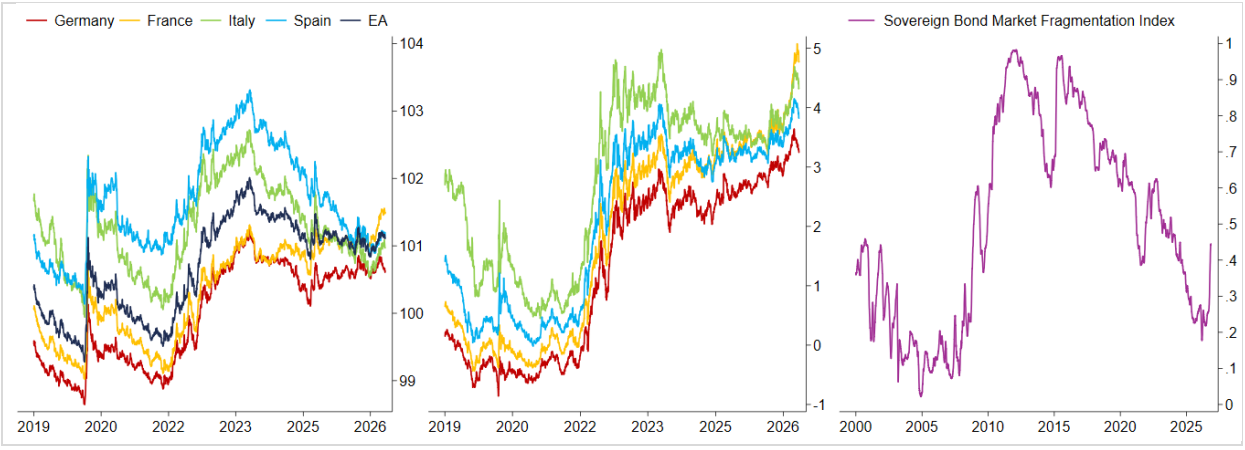
[4] Sovereign bond market fragmentation is measured as the average of the cross-country dispersion in 2-year and 10-year sovereign bond yields across euro area countries, following Hoffmann et al. (2020).

Figure 8: Composite Financial Conditions and Sovereign Bond Markets

Panel (a): Composite Financial Conditions (Index)

Panel (b): 10-Year Gov. Bond Yields (Percent)

Panel (c): Sov. Bond Mkt. Fragmentation (Index)



Source: Goldman Sachs, LSEG Refinitiv, authors' calculations.

Diverging financial conditions across euro area member states are a key concern for monetary policymakers. The stated reason is that fragmented financial markets could impair the smooth transmission of the ECB's common monetary policy across member states and stymie its ability to deliver on its price-stability mandate. Recent research by Horn and Moench (2026) finds that sovereign bond market fragmentation—measured by the dispersion of sovereign yields across euro area member countries, as in **Figure 8**, Panel (c)—indeed attenuates the average strength of the transmission of monetary policy to inflation and the real economy across member countries.[5] Importantly, this weakening is not driven by an increased dispersion of policy effects across countries during periods of elevated fragmentation. While these findings support the case for safeguarding transmission, they should not be interpreted as suggesting interventions in sovereign bond markets, which arguably have important political economy implications including the threat of fiscal dominance and concerns over moral hazard and risk sharing within the euro area.

Nonetheless, in case bond market turbulences continue, market participants and observers might seek more clarity on the ECB's reaction function. At the press conference following the October Governing Council meeting, President Lagarde emphasised that "should market developments threaten the smooth transmission of our monetary policy, including through unwarranted and disorderly market movements, we have instruments available to respond. And the criteria and conditions under which this applies are well known, they are published" (ECB, 2026). In principle, the ECB presently has three tools at its disposal: (i) the Transmission Protection Instrument (TPI); (ii) the Outright Monetary Transactions (OMT) programme; and (iii) a suspension or reversal of the ongoing passive balance sheet reduction through renewed reinvestments of maturing public-sector securities held under the PEPP and PSPP programmes.

The TPI is designed to "counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area" (ECB, 2022). Distinguishing warranted from unwarranted market dynamics, however, is inherently difficult, rendering the activation of the TPI a politically charged decision. Moreover, the precise conditions under which the instrument could be

[5] The results are based on the estimation of quarterly state-dependent local projections in a system of seemingly unrelated regressions across nine euro area countries (Austria, Belgium, Finland, France, Germany, Italy, the Netherlands, Portugal, Spain) between 2002:Q1 and 2019:Q4. Robustness is shown along several dimensions, including the sample period and potential confounding state variables such as the state of the business cycle or monetary policy cycle.

activated are not well understood by market participants. The press release accompanying the TPI announcement in July 2022 merely set out four eligibility criteria: (i) compliance with the EU fiscal framework; (ii) the absence of severe macroeconomic imbalances; (iii) fiscal sustainability; and (iv) sound and sustainable macroeconomic policies. However, rather than establishing binding activation rules, these criteria serve as "inputs" to the Governing Council's decision-making process that can be "dynamically adjusted to the unfolding risks and conditions to be addressed" (ECB, 2022). Consequently, they provide limited clarity on the circumstances that would trigger an intervention. Instead, a "decision by the Governing Council to activate the TPI will be based on a comprehensive assessment of market and transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB's primary objective" (ECB, 2022).

Survey evidence suggests that market participants increasingly perceive TPI activation as a possibility. In the October SMA, the reported probabilities of TPI activation over the following 0–3 and 4–6 months rose markedly to 9.3% and 12.7%, respectively, from 4.7% and 8.5% in September. Several euro area countries are currently subject to an Excessive Deficit Procedure (EDP), including France, where heightened political uncertainty and concerns over fiscal sustainability have contributed to a significant widening of sovereign bond spreads . While being subject to an EDP does not automatically preclude eligibility for the TPI, the ECB's criteria require that countries under such a procedure have not been assessed as having failed to take effective corrective action in response to an EU Council recommendation under Article 126(7) of the Treaty on the Functioning of the European Union (TFEU) (ECB, 2022). The existence of an EDP could therefore potentially raise the threshold for TPI activation.

The OMT programme provides a second avenue for targeted interventions in euro area sovereign bond markets. Unlike the TPI, however, OMT purchases are subject to strict conditionality, notably the requirement for an appropriate macroeconomic adjustment or precautionary programme under the European Stability Mechanism (ESM).

A third option would be to halt quantitative tightening by resuming reinvestments of maturing securities, potentially allowing for more targeted reinvestments to address fragmentation. However, such a move would represent a reversal of the ECB's balance sheet policy which is aligned with its current policy rate stance. Previous ECB communication stressed that purchases under the TPI would be conducted "such that they cause no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance" (ECB, 2022). However, whether and to what extent asset purchases aimed at safeguarding the monetary policy transmission mechanism can effectively be separated from the determination of the monetary policy stance through interest rate policy and the overall size of the Eurosystem balance sheet remains an open question.

4. Communication Stance

Against the background of the political sensitivity of ECB interventions in euro area government bond markets, careful communication is particularly important. The key challenge is to strike a balance between "constructive ambiguity" and providing sufficient clarity about the conditions under which intervention may be warranted. While greater transparency could help reduce policy uncertainty and limit excessive market volatility, overly prescriptive guidance could constrain the ECB's discretion and potentially encourage market participants to anticipate or test the conditions for intervention. Clear communication about the objectives, guiding principles and limits of potential interventions, without committing to specific protocols or thresholds, therefore appears warranted at the current juncture.

Clear communication is also important regarding the outlook for inflation and the appropriate policy path. By clearly articulating its assessment of inflation risks and signalling its expected monetary policy response, the ECB can help contain second-round effects, thereby potentially reducing the need for more aggressive monetary tightening. In this context, the communication by individual members of the ECB Governing Council is particularly revealing. Their public statements shape expectations regarding future monetary policy and provide insights not just into their individual monetary policy preferences but also the degree of consensus within the ECB Governing Council.

Against this backdrop, we examine how the monetary policy communication of ECB Governing Council members has evolved since 2020, paying particular attention to recent developments and differences in their communication tone. Specifically, we analyse speeches by members of the ECB's Executive Board as well as the governors of the five largest national central banks in the euro area (the Deutsche Bundesbank, the Banque de France, the Banca d'Italia, the Banco de España, and De Nederlandsche Bank) delivered during their tenure on the ECB Governing Council between January 2020 and September 2026.[6]

To measure the monetary policy tone of each speech, we use the Communication Stance Indicator (CSI) developed in Bernoth (2026). It is based on a Transformer-based language model that was initially trained using Federal Reserve statements (Shah et al., 2023) and subsequently fine-tuned using ECB statements.[7] The CSI for a speech corresponds to the proportion of 'hawkish' (suggesting a tighter monetary policy) sentences minus the proportion of 'dovish' (suggesting a looser monetary policy) sentences. It ranges from –1 (entirely 'dovish') to +1 (entirely 'hawkish'), with a value of zero indicating a balanced tone. We only consider speeches containing at least ten relevant sentences. **Table 2** in the Annex provides examples of sentences assigned to each category. For each Governing Council member, we calculate a monthly CSI as the equally weighted average of the CSI values of all speeches delivered by that member during the month.

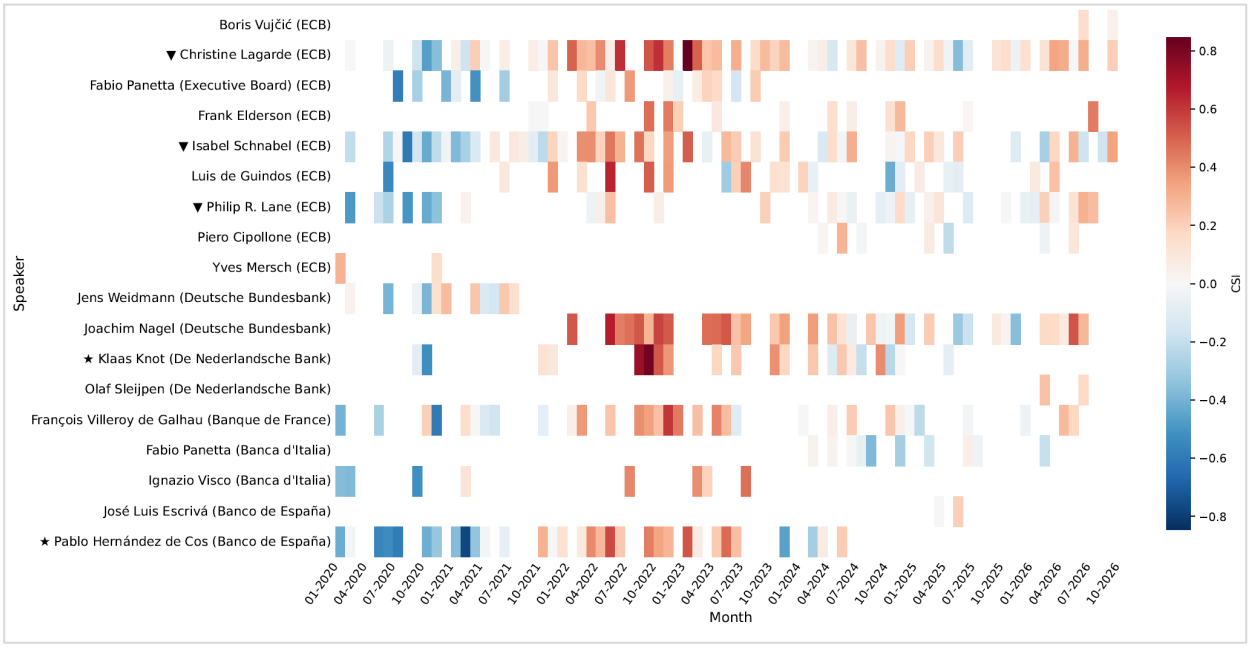
Figure 9 shows the results in the form of a heatmap. Red cells indicate a hawkish and blue cells a dovish tone. The stronger the colour, the more pronounced the tone. Blank cells mean that the member

[6] Speeches by members of the ECB's Executive Board are taken from the ECB website. Speeches by the governors of the five largest euro area national central banks are taken from the central bankers' speeches collection of the Bank for International Settlements (BIS). At the time of writing, the latter collection covered speeches only up to July 2026, so results for the most recent months are based on speeches by Executive Board members only. Because the language model works in English, we include only speeches published in English.

[7] First, we partition each speech into individual sentences and retain only those that explicitly refer to monetary policy or the macroeconomic outlook by looking for the following keywords: inflation, inflationary, inflation expectation, deflation, price, prices, interest rate(s), key rates, bank rate(s), deposit rate, deposit facility, main refinancing rate, policy rate(s), monetary policy, quantitative easing, quantitative tightening, economic activity, economic growth, demand, productivity, employment, unemployment, job market, exchange rate(s). The language model then classifies each of these sentences as 'hawkish', 'dovish', or 'neutral'. The classification captures the monetary policy implications of a statement.

did not give any speeches in that month that met our selection criteria.[8] The tone adopted by members of the ECB Governing Council has become increasingly hawkish since the start of 2026, in line with the higher inflationary pressures caused by the war in the Middle East. Almost all members who took the floor adopted a hawkish stance. This shift in communication preceded the ECB's renewed monetary tightening in June, when interest rates were raised for the first time, followed by a second hike in September. Nevertheless, the tone currently remains well below the levels observed during the 2022–23 tightening cycle, when inflation was considerably higher than it is today.

Figure 9: Monetary Policy Tone Heatmap



Notes: Monthly averages of individual speech CSIs. Blue: dovish; red: hawkish. Blank cells: no classified speech; near-white cells: CSI near zero. Black triangles indicate individuals leaving the Executive Board in 2027. Black stars report a candidate for the ECB Executive Board. *Source: Own calculation.*

Although the overall communication tone of Governing Council members shifts with economic conditions, there are meaningful differences across members. This is to be expected, reflecting their diverse backgrounds, perspectives, and roles. With three Executive Board members due to leave in 2027, it is interesting to examine these differences, while recognising that communication tone does not necessarily reflect underlying monetary policy preferences.

[8] Fabio Panetta appears twice: once for his term on the ECB's Executive Board (2020–23), and once as governor of the Banca d'Italia (since November 2023).

5. Conclusion and Policy Recommendations

The ECB is navigating difficult trade-offs for monetary policy. The renewed energy price shock is driving up inflation and slowing economic activity. Higher interest rates cannot directly counter rising energy prices but can only ease price pressures by dampening aggregate demand. At the same time, rising and diverging sovereign bond yields are making the ECB's task more difficult. Widening sovereign spreads risk weakening the uniform transmission of monetary policy across member states. Tighter financial conditions must also be taken into account when assessing the need for further interest rate increases. The ECB is therefore faced with the challenge of containing inflation while avoiding excessive monetary tightening and safeguarding the transmission of its policy across the euro area.

Clear and credible communication is particularly important in this environment. The ECB must explain how it assesses inflation risks and the conditions under which further policy adjustments might be necessary. Although longer-term inflation expectations remain broadly anchored, our analysis suggests that households' expectations may have become more sensitive to recent inflationary developments. This increases the risk that renewed inflationary pressures could feed more quickly into expectations, and eventually into wages and prices. Maintaining credibility and preventing such second-round effects is therefore essential.

At the current juncture, the ECB should consider providing even clearer forward guidance on the near-term direction of monetary policy and its reaction function. Forward-looking communication can help to stabilise inflation expectations, reduce uncertainty, and enhance the effectiveness of monetary policy. The ECB also faces a delicate communication challenge regarding potential interventions in sovereign bond markets. It may need to reassure markets that it is prepared to counteract unwarranted fragmentation while being clear that its instruments are not intended to shield governments from the consequences of unsustainable fiscal policies. This requires striking the right balance between providing sufficient clarity about the purpose and conditions of potential intervention while preserving flexibility through "constructive ambiguity". Too much ambiguity could increase uncertainty, while overly precise commitments could undermine market discipline and restrict the ECB's ability to respond to changing circumstances.

Finally, the forthcoming changes to key positions on the ECB's Executive Board are set to attract considerable attention. President Christine Lagarde, Chief Economist Philip Lane, and Executive Board member Isabel Schnabel will all leave the central bank in the first half of 2027. The new appointments may therefore shape the future communication of the ECB at a critical juncture. At the same time, to preserve confidence in the ECB's commitment to price stability, it is essential to maintain a coherent and credible communication strategy irrespective of changes in the Council's composition.

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ANNEX

Assessing the Anchoring of Inflation Expectations

To assess the prevailing degree of anchoring, we use respondent-level forecasts from the ECB's Survey of Professional Forecasters (SPF) and the ECB's Consumer Expectations Survey (CES) to relate forecasters' revisions of longer-term HICP inflation expectations to incoming news about inflation. We proxy inflation news for each survey respondent with the difference between realised annual HICP inflation minus their one-year ahead projected rate of inflation one year ago. We winsorise responses at the 2nd and 98th percentile by country and survey-wave. We then run the following regression in a 20-quarter rolling window for the SPF and a six-month rolling window for the CES[9]:

(SPF) $$\Delta\pi_{i.t}^{e,lr} = \alpha + \beta^{SPF}\left(\pi_{t-1} - \pi_{i,t-4}^{e,1y}\right) + \varepsilon_{i.t}$$

(CES) $$\Delta\pi_{i.t}^{e,3y} = \alpha + \beta^{CES}\left(\pi_{t-1} - \pi_{i,t-13}^{e,1y}\right) + \eta_{i.t}$$

$\Delta\pi_{i.t}^{e,lr}$ and $\Delta\pi_{i.t}^{e,3y}$ denote changes in long-run inflation expectations of professional forecasters and three-year ahead inflation expectations of households in the CES, respectively. α denotes an intercept. $\widehat{\beta^{CES}}$ and $\widehat{\beta^{SPF}}$ are the regression coefficients of interest while π_{t-1} denotes lagged inflation. $\pi_{i,t-4}^{e,1y}$ and $\pi_{i,t-13}^{e,1y}$ are 1-year ahead inflation expectations of professional forecasters and households, respectively, one year ago. $\varepsilon_{i.t}$ and $\eta_{i.t}$ are error terms. The regression sample includes on average around 580 respondents for the SPF and around 41,000 respondents for the CES in each window, respectively. **Figure 4** in the main text shows the respective estimated coefficients, $\widehat{\beta^{CES}}$ and $\widehat{\beta^{SPF}}$, over time.

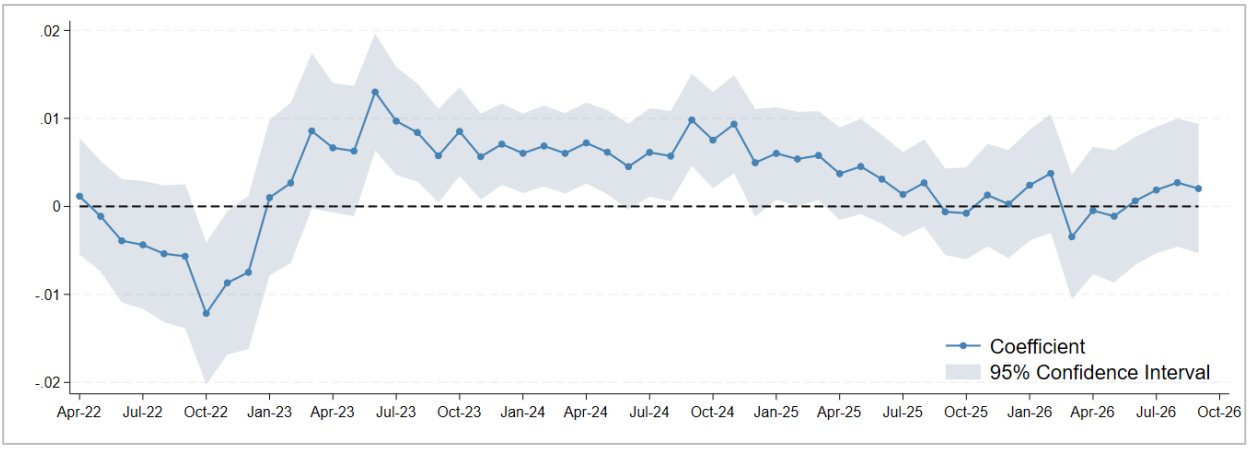
To analyse the sensitivity of households' medium-term inflation expectations to their *perceived* inflation over the past twelve months, we estimate the following regression for respondents in the ECB's CES survey in a six-month rolling window:

$$\pi_{i,t}^{e,3y} = \alpha + \beta\pi_{i,t:t-12}^{p} + \varepsilon_{i,t}$$

For robustness, we also run the regression of households' revision to incoming inflation news in the CES in slightly larger rolling 12-months windows. The results are shown in **Figure 10**.

[9] We use a 20-quarter window for the SPF, following Gáti (2023), to obtain 5 years of time-series variation. We use a shorter window for the CES, since the sample data is only available from April 2020 onwards, to better capture short-term dynamics in the anchoring of inflation expectations.

Figure 10: Sensitivity of Households' Medium-Run Inflation Expectations to 1-Year Ahead Forecast Errors (12-months Rolling Window)



Notes: European Central Bank and authors' calculations. With 12-months windows, the regression sample includes approximately 83,000 respondents on average in each window.

Table 2: Examples of Hawkish–Dovish Classification of Selected Speech Sentences

Date	Speaker	Sentence	Classification
2023-06-06	Klaas Knot	As a consequence, monetary policy needed to be tightened quickly and decisively.	Hawkish
2022-05-11	Isabel Schnabel	In April, inflation in the euro area is expected to have increased to a new record high of 7.5%, causing significant concern among firms and households.	Hawkish
2022-07-08	Ignazio Visco	Rising energy prices and problems in the supply of raw materials pose further challenges.	Hawkish
2022-11-16	Pablo Hernández de Cos	According to OECD estimates, so far most of the measures adopted in advanced economies to limit the impact of high energy prices have been non-targeted.	Hawkish
2021-09-15	Isabel Schnabel	Record low real interest rates provide substantial policy accommodation, supporting the recovery and paving the way for inflation to reach our 2% target in the medium term.	Dovish
2024-12-16	Isabel Schnabel	Considering the risks and uncertainties we are still facing, lowering policy rates gradually towards a neutral level is the most appropriate course of action.	Dovish
2020-09-04	Ignazio Visco	With its diffusion, the prospects of long-lasting negative consequences for economic activity, employment and the distribution of incomes have become more daunting.	Dovish
2025-02-25	Joachim Nagel	While private consumption is bolstering economic activity, it is seeing only very subdued growth.	Dovish
2023-01-16	Pablo Hernández de Cos	Those projections were based on the market expectations for the future path of interest rates when they were prepared.	Neutral
2022-09-19	Pablo Hernández de Cos	The most recent surveys of professional forecasters put inflation in 2024 at, or just over, 2%.	Neutral
2023-11-21	Christine Lagarde	That is why, at our last meeting, we held interest rates at their present levels.	Neutral
2020-06-22	Jens Weidmann	The design of the PEPP shows that the Governing Council is also aware of the risk that undue volatility in sovereign bond spreads might impair the transmission of monetary policy.	Neutral

This briefing summarises the euro area inflation outlook, assesses the ECB's current monetary policy stance, and reviews its policy communication. Renewed energy pressures have pushed euro area inflation well above target, with upside risks and emerging concerns about the anchoring of household expectations. While there is room for further moderate monetary tightening, high long-term yields and restrictive broader financial conditions alongside fragmentation risks complicate the ECB's policy choices. Clear communication remains essential amid heightened uncertainty.

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