STUDY

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The Conduct of ECB Monetary Policy Under International Uncertainty

Economic Governance and EMU Scrutiny Unit (EGOV)
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The Conduct of ECB Monetary Policy Under International Uncertainty

Abstract

This paper examines ECB monetary policy amid rising international uncertainty. We focus on three global risks: renewed trade protectionism, euro appreciation, and US fiscal fragility. Using inflation forecasts and survey data, we evaluate the ECB's evolving policy framework. A potential US fiscal crisis poses risks but also creates an opportunity for Europe to supply a global safe asset. We argue that a European Debt Agency issuing common debt could mitigate contagion and enhance Europe's financial sovereignty.

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LIST OF ABBREVIATIONS

APP	Asset purchase programme
DF	Deposit Facility
EBA	European Banking Authority
ECB	European Central Bank
ECB-SPF	European Central Bank Survey of Professional Forecasters
EDA	European Debt Agency
EP	European Parliament
EU	European Union
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
MRO	Main Refinancing Operations
PCCI	Persistent and Common Component of Inflation
PEPP	Pandemic emergency purchase programme
TLTRO	Targeted longer-term refinancing operations
TPI	Transmission protection instrument
USD	US dollar

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EXECUTIVE SUMMARY

- **This paper analyses how the European Central Bank (ECB) conducts monetary policy amid rising international uncertainty, focusing on three main global risks**: renewed trade protectionism, euro appreciation, and US fiscal fragility. These factors challenge the ECB's ability to maintain price stability and financial resilience in the euro area.
- **The ECB's monetary policy reaction is structured around three explicit criteria—headline inflation outlook, underlying inflation trends, and the strength of policy transmission—with a fourth implicit anchor: long-term inflation expectations.** This framework has guided recent rate cuts amid falling inflation and moderate growth forecasts.
- **Despite inflation falling toward the 2% target, risks remain due to uneven inflation dynamics across Member States and sectors**. Core inflation is projected to stay elevated due to wage pressures and services inflation, while energy prices have helped reduce headline inflation.
- **Professional forecasters perceive ECB policy as broadly credible, with inflation expectations remaining anchored.** However, their views on the ECB's reaction function-modelled as a Taylor rule-suggest ambiguity regarding the natural interest rate and output gap responsiveness.
- **A sharp shift in global investor preferences away from US assets-driven by fiscal concerns and policy unpredictability-has led to euro appreciation, which could weaken euro area exports and economic activity.** This deviation from past flight-to-safety dynamics signals a possible regime shift in global finance.
- **Portfolio inflows into euro-denominated assets can ease financial conditions, but it may also trigger contractionary effects via real exchange rate appreciation.** The net macroeconomic impact depends on the composition of asset inflows (safe vs. risky assets) and their interaction with monetary policy.
- **Euro area banks face balance sheet vulnerabilities due to dollar exposure and reliance on synthetic hedging.** A disorderly dollar depreciation could strain euro liquidity via foreign exchange (FX) swap markets, despite a seemingly favourable euro appreciation.
- **Increased demand for safe assets outside the US makes this moment especially favourable to the creation of a European Debt Agency (EDA) to issue common euro-denominated safe debt.** This would reduce bond market fragmentation, absorb global demand for safe assets, and enhance Europe's financial sovereignty.

1. INTRODUCTION

Recent shifts in global financial conditions and geopolitical tensions have heightened concerns about external risks that could significantly impact the euro area's macroeconomic outlook. First, the wave of protectionist measures from the US is an immediate cause for concern for European exports. The fact that this has been accompanied by an appreciation of the euro, rather than by a depreciation, adds to this concern, as a stronger euro reduces export competitiveness.

Second, the possibility of a disorderly US dollar crisis presents a more systemic threat. Given the dollar's central role in global trade, finance, and reserve holdings, a sharp and uncoordinated decline could disrupt international capital flows, increase market volatility, and trigger flight-to-safety dynamics that would reverberate through European markets.

Third, a fiscal crisis in the United States, particularly one driven by unsustainable debt dynamics or political gridlock, could erode investor confidence in sovereign debt markets globally. Such a scenario may not remain contained within the US, as financial contagion could spill over to Europe, raising risk premia and straining fiscal positions in vulnerable member states.

This paper analyses the conduct of ECB monetary policy under international uncertainty by examining how the ECB's decision framework responds to different types of external shocks, how market participants perceive its strategy, and how these shocks transmit through trade, financial, and portfolio channels.

At the same time, the potential fiscal instability in the US also presents a unique opportunity for Europe. As the credibility of US sovereign debt weakens and investors seek alternative safe assets, the euro area could strengthen its international role by offering a credible substitute. But to do so, it must overcome the persistent fragmentation of its sovereign bond markets. A European Debt Agency, tasked with issuing a common euro area safe asset, would address this fragmentation and serve as a stabilising anchor in times of global turmoil. Such an institution would not only shield the euro area from spillovers but also provide the foundation for greater financial integration and resilience—turning a global risk into a European strategic advantage.

The report is organised in three main sections.

Section 2 contains a summary of the current stance of monetary policy, in light of recent available data on the key criteria guiding the ECB decisions.

Section 3 focuses on a central issue in monetary policy communication: how the public interprets monetary policy actions. The chapter uses survey data to provide an interpretation of how the public has viewed the conduct of monetary policy in the last few years.

Section 4 provides an evaluation of what we see as main sources of risks for the euro area in the near future, mostly coming from US protectionism and from shifts in global asset markets associated to increased perceived risks in US investments. It also contains our discussion of the merits of proposals for the creation of a European Debt Agency, and why they seem especially timely in the current environment.

2. THE ECB DECISION FRAMEWORK, THE MONETARY POLICY STANCE AND INFLATION

In this section, we first describe the ECB decision framework, as laid out in the 2024 Annual report of the ECB, we then illustrate briefly the monetary policy stance recently adopted to then assess inflation forecasts and the main factors of risk for the inflation scenario with a particular focus on the role of China.

2.1. The ECB decision framework

The 2024 Annual Report of the European Central Bank (2025a) outlines the context in which the ECB addresses risks arising from global uncertainties and exchange rate fluctuations. It also details the criteria guiding ECB decision-making—specifically, its monetary policy reaction function—by presenting a decision framework built on three key pillars: the inflation outlook, the underlying inflation dynamics and the monetary policy transmission strength. Kamps (2024) refers to these as the "ABCs" of the ECB's reaction function and identifies an implicit fourth element, a hidden "D": anchoring of the long-term inflation expectations.

Monetary policy must be forward-looking because of the time it takes for policy changes to influence the economy and inflation. Accordingly, the ECB uses projections to assess where inflation is heading over a typical horizon of two to three years. If inflation is expected to be above target at the end of that period, the ECB may raise interest rates; if it is expected to be below target, it may lower them. However, the heightened economic uncertainty of recent years—driven by repeated shocks such as the global financial crisis and the COVID-19 pandemic—has cast doubts on the reliability of forecasts. In such environments, the ECB tends to prioritize near-term developments over longer-term projections, making the forecast horizon more context-dependent than fixed.

The dynamics of underlying inflation highlights the importance of isolating its persistent component, which provides valuable insights into medium-term inflationary trends. During periods of heightened uncertainty, the ECB places greater emphasis on measures of underlying inflation to supplement headline projections. Notable among these are core inflation (which excludes food and energy), the Persistent and Common Component of Inflation (PCCI), and domestic inflation (which excludes items with high import content). While core inflation is widely used, it does not always serve as a reliable predictor. In contrast, PCCI and domestic inflation have demonstrated a better performance over time. Divergences among these indicators can signal different sources of inflationary pressure—such as domestically driven, wage-related inflation, and broader supply-side dynamics. The ECB closely tracks these metrics to inform its policy decisions in a data-dependent manner.

The strength of monetary policy transmission refers to the extent to which changes in ECB policy rates affect broader financial conditions, economic activity, and inflation. Although policy rates play a central role, the effectiveness of transmission is not constant: it varies based on factors such as the structure of the financial system, the state of the economy, and prevailing liquidity conditions. The most recent tightening cycle faced additional uncertainty, given the preceding era of exceptionally low interest rates, elevated excess liquidity, and the unprecedented speed of rate increases. Nevertheless, emerging evidence indicates that monetary policy has been transmitting effectively, particularly through the banking sector. Tighter credit standards and subdued loan growth indicate that higher rates are feeding through to the real economy, which is crucial for bringing inflation back to target. This criterion provides also a rationalisation for the Transmission Protection Instrument (TPI), designed to prevent European bond market fragmentation caused by deviations of government bond prices from fundamentals in some of the Member States.

Finally, the anchoring of inflation expectations is a key indicator of monetary policy credibility. When policy is credible, long-term inflation expectations remain aligned with the ECB's stated inflation target.

2.2. The monetary policy stance

The current ECB monetary policy stance is defined by conventional and non-conventional monetary policy.

Table 1 illustrates the evolution of conventional monetary policy that shows a transition from a tightening phase (July 2022–September 2023) to a gradual easing phase since June 2024. As of June 2025, the deposit facility rate stands at 2%.

Table 1 ECB interest rate changes (2024-2025)

Date	DF	MRO	MLF	Notes
December 14, 2023	4.00%	4.50%	4.75%	Holding phase
June 6, 2024	3.75%	4.25%	4.50%	Start of easing
September 12, 2024	3.50%	3.65%	3.90%	Continued easing
October 17, 2024	3.25%	3.40%	3.65%	Further reduction
December 12, 2024	3.00%	3.15%	3.40%	End of 2024 rate
February 5, 2025	2.75%	2.90%	3.15%	First 2025 cut
March 12, 2025	2.50%	2.65%	2.90%	Second 2025 cut
April 23, 2025	2.25%	2.40%	2.65%	Third 2025 cut
June 11, 2025	2.00%	2.15%	2.40%	Fourth 2025 cut

Note: Deposit Facility (DF) rate, Main Refinancing Operations (MRO) rate, Marginal Lending Facility (MLF) rate. Source: ECB.

Non-conventional monetary policy is measured by the size of the Eurosystem's balance sheet, which by EUR 0.5 trillion to EUR 6.4 trillion in 2024. In particular, the reductions in the Asset Purchase Programme (APP), the Pandemic Emergency Purchase Programme (PEPP) and the Targeted Longer-Term Refinancing Operations (TLTRO III) made the Eurosystem assets fall in 2024 by EUR 0.8 trillion to EUR 4.3 trillion, with reserve holdings at EUR 3 trillion.

The ECB plans to reassess its operational framework parameters in 2026, with the TPI remaining in place to safeguard market stability.

This stance is considered as appropriate to achieve the 2% inflation target, supporting economic recovery alongside 0.9% GDP growth in 2024. (European Central Bank, 2025b, 2025c, 2025d, 2025e).

In its latest deliberations, the Governing Council reviewed recent macroeconomic developments. Euro area GDP growth was recorded at 0.9% in 2024, with projections maintained at 0.9% for 2025, 1.1% for 2026, and 1.3% for 2027. The unemployment rate remained stable in 2024 at 6.2%. Against this backdrop, the four rate cuts implemented thus far in 2025—amounting to a cumulative reduction of 100 basis points—were deemed appropriate.

The ECB underscored the importance of effective policy transmission and reaffirmed its confidence in converging inflation toward the 2% medium-term target. Looking ahead, monetary policy decisions will continue to balance the pace of easing against evolving wage dynamics and external risks, particularly those related to geopolitical tensions and shifts in US monetary policy.

The primary challenge in the current environment remains elevated economic uncertainty, largely driven by geopolitical developments and external policy spillovers. In the next sections we explicitly consider the inflation outlook and the role of China as a persistent source of external uncertainty.

2.3. Evolution and outlook for headline and core inflation

The data show that headline inflation declined from 2.9% in December 2023 to 2.4% in December 2024. The June 2025 projections, reported in Table 2, estimate 2% in 2025, 1.6% in 2026, and 2% in 2027 (ECB, 2025d, 2025e). Core inflation also declined but is still projected to be relatively elevated in 2025 (2.4%) due mostly to domestic factors.

The main drivers of recent inflation dynamics have been identified by the ECB as the diminishing effects of supply shocks, including the unwinding of energy price spikes and supply chain disruptions. Additional factors have been weaker demand, and nominal wage growth largely offset by a recovery in productivity. On the risk side, external factors such as exchange rate volatility and global uncertainties—driven by trade tensions, ambiguous US economic and fiscal policies, and the evolving role of the US dollar in the international system—remain the primary concerns, mostly on the downside.

Table 2: ECB inflation projections (5 June 2025)

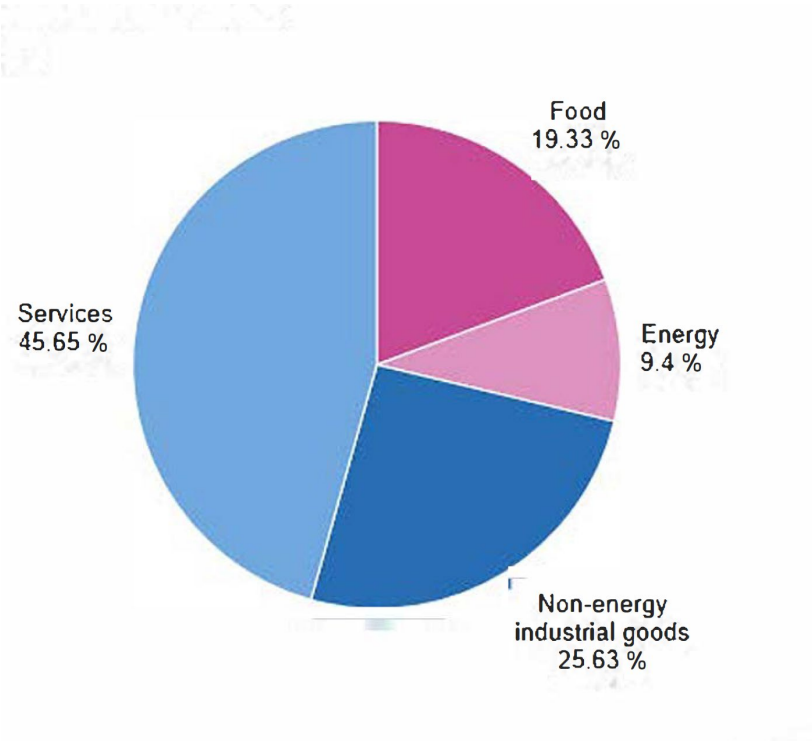
Year	Headline inflation	Core inflation
2025	2.0%	2.4%
2026	1.6%	1.9%
2027	2.0%	1.9%

2.3.1. Inflation differentials across Member States

Table 3 presents inflation dynamics across the four largest economies in the euro area—France, Germany, Italy, and Spain, disaggregated by four main components.

The relative weights of the main components of the Harmonised Index of Consumer Prices (HICP) in the euro area for 2025 are illustrated in Figure 1. Each component contributes to headline inflation to varying degrees. Services represent the largest share, accounting for approximately 45.7% of household final consumption expenditure. This is followed by non-energy industrial goods at 25.6%. Food, alcohol, and tobacco constitute 19.3%, while energy accounts for 9.4%. Although food and energy together represent less than one-third of the total consumption basket, their price volatility means they can exert a disproportionate influence on headline inflation.

Figure 1: Weights of the main components of the euro area HICP, 2025



Source: Eurostat (online data code: prc_hicp_inw).

The annual inflation rate in the euro area was confirmed at 2.2% in April 2025, remaining slightly above the ECB's medium-term target of 2.0%.

The main upward pressure comes from the services sector, followed by food, alcohol, and tobacco, while energy had a dampening effect. Services inflation notably accelerated to 4% in April from 3.5% in March, potentially influenced by calendar effects such as the timing of Easter, as suggested by some analysts (OECD Economic Outlook, April 2025).

Looking ahead, geopolitical factors may introduce further inflationary pressures. Persistent tariff uncertainty and the potential for retaliatory measures from the European Union (EU) in response to US trade actions, combined with Germany's planned large-scale infrastructure package, could drive inflation higher in the medium term.

Table 3: Inflation by sector in the euro area, Germany, Spain, France, and Italy

Category	Country	2024-04	2024-05	2024-06	2024-07	2024-08	2024-09	2024-10	2024-11	2024-12	2025-01	2025-02	2025-03	2025-04
HICP (annual rate of change)	EA	2.4	2.6	2.5	2.6	2.2	1.7	2.0	2.2	2.4	2.5	2.3	2.2	2.2
	Germany	2.8	2.5	2.6	2.0	1.8	2.4	2.4	2.8	2.8	2.6	2.3	2.2	2.1
	Spain	3.4	3.8	3.6	2.9	2.4	1.7	1.8	2.4	2.8	2.9	2.9	2.2	2.2
	France	2.4	2.6	2.5	2.7	2.2	1.4	1.6	1.7	1.8	1.8	0.9	0.9	0.9
	Italy	0.9	0.8	0.9	1.6	1.2	0.7	1.0	1.5	1.4	1.7	1.7	2.1	2.0
Food incl. alcohol and tobacco	EA	2.8	2.6	2.4	2.3	2.3	2.4	2.9	2.7	2.6	2.3	2.7	2.9	3.0
	Germany	2.3	2.1	2.3	2.4	2.6	2.6	3.3	2.9	3.2	1.9	2.9	3.3	3.1
	Spain	4.6	4.3	4.1	3.2	2.7	2.1	2.2	2.0	2.3	2.2	2.3	2.5	2.2
	France	2.1	2.1	1.7	1.4	1.4	1.3	1.5	1.1	1.0	0.7	0.8	1.0	1.5
	Italy	2.7	2.1	1.7	1.2	1.3	1.4	2.5	2.8	2.1	2.3	2.4	2.7	3.0
Industrial goods excl. energy	EA	0.5	0.6	0.6	0.9	-0.5	-1.4	-0.9	-0.1	0.4	0.9	0.4	0.2	-0.6
	Germany	1.0	0.7	0.2	0.3	-0.9	-1.5	-0.8	-0.2	0.5	0.5	0.1	-0.1	-0.9
	Spain	2.2	3.1	2.5	1.6	0.0	-1.4	-0.9	1.0	1.9	2.4	2.7	0.6	-0.6
	France	1.2	2.0	1.7	2.7	0.5	-0.8	-0.3	0.0	0.5	1.4	-1.2	-1.5	-1.8
	Italy	-2.3	-2.4	-1.8	0.0	-0.9	-2.1	-2.1	-1.1	-0.7	0.1	0.3	1.2	-0.1
Energy	EA	-0.6	0.3	0.2	1.2	-3.0	-6.1	-4.6	-2.0	0.1	1.9	0.2	-1.0	-3.6
	Germany	-1.3	-1.2	-2.2	-1.9	-5.1	-7.5	-5.4	-3.6	-1.5	-1.3	-1.3	-2.6	-5.3
	Spain	5.0	7.9	6.0	2.6	-1.7	-6.7	-4.0	2.6	5.5	7.8	8.6	1.7	-2.5
	France	3.7	5.5	4.6	8.2	0.4	-3.3	-1.9	-0.7	1.2	2.6	-5.7	-6.3	-7.4
	Italy	-12.2	-11.7	-8.6	-4.0	-6.2	-8.7	-9.0	-5.4	-2.7	-0.7	0.6	2.7	-0.7
Services (overall index excl. goods)	EA	3.7	4.1	4.1	4.0	4.1	3.9	3.9	3.9	4.0	3.9	3.7	3.5	4.0
	Germany	3.6	4.7	4.7	4.4	4.4	4.4	4.8	4.5	4.6	5.1	4.7	4.1	4.5
	Spain	3.5	3.9	4.0	3.6	3.7	3.4	3.5	3.5	3.7	3.5	3.3	3.1	4.1
	France	3.3	3.2	3.4	3.1	3.6	3.0	2.9	3.1	2.9	2.6	2.4	2.5	2.5
	Italy	3.1	3.2	3.1	3.2	3.4	3.1	3.1	3.2	2.9	2.9	2.6	2.8	3.4

Source: Eurostat.

The comparative analysis in Table 2 indicates similar inflation trends in the four economies considered, except for France. In Germany, after approaching 3% in October and November 2024, inflation appears on a downward trajectory and is expected to continue easing. In contrast, France's inflation rate remains low and steady at 0.9% in April, unchanged from the previous two months.

Energy prices have been a key driver of disinflation, particularly in Germany and France. In March 2025, German import prices rose by 2.1% year-on-year, a slowdown from the 3.6% increase recorded in February. Excluding energy, import prices were up 2.2% year-on-year. On a monthly basis, import prices declined by 1%—the first monthly decrease in six month (Trading Economics, 2025b).

Finally, China may emerge as a source of disinflationary pressure, potentially influencing global inflation dynamics in the coming months.

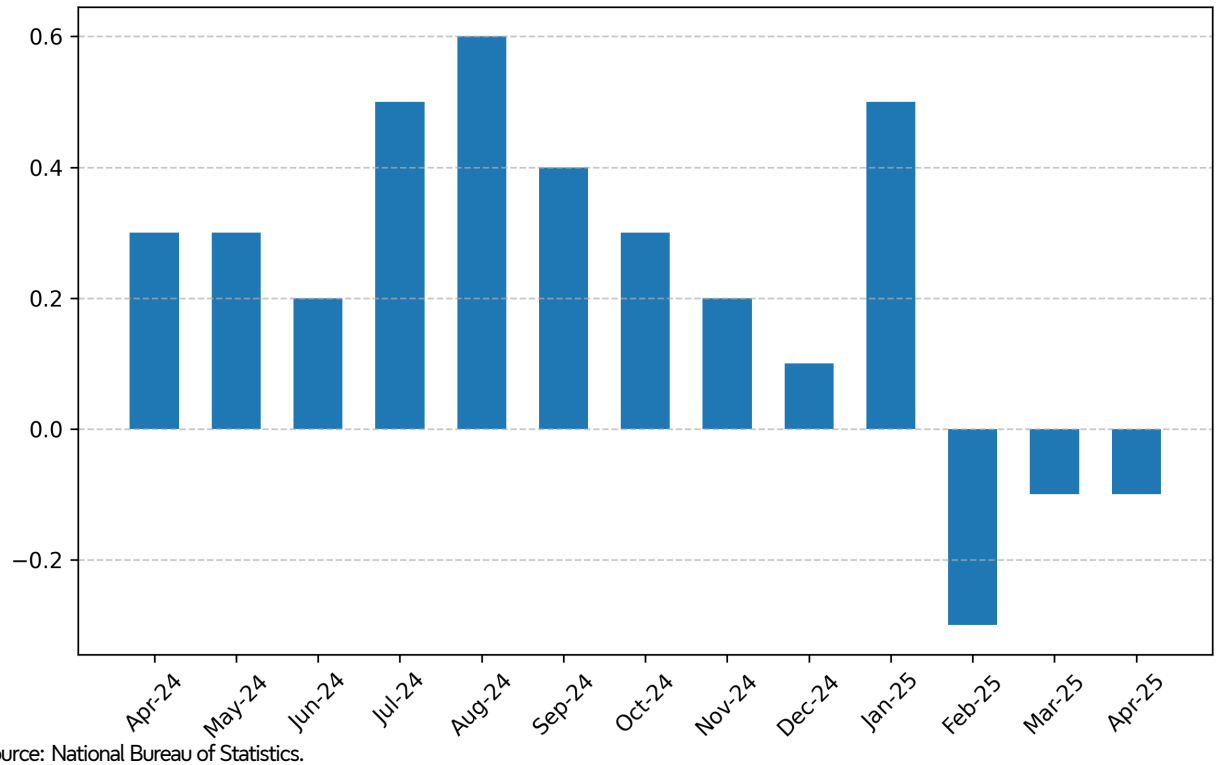
2.4. China as a persistent source of external uncertainty

China continues to represent a key source of uncertainty for the global economic outlook, particularly for the euro area, given the interconnectedness of trade and pricing dynamics. As outlined in our previous report, shifts in Chinese export performance and domestic price developments have potential spillover effects on European inflation and competitiveness.

2.4.1. Inflation dynamics and deflationary pressures

Figure 2 shows that, in April 2025, China's Consumer Price Index (CPI) declined by 0.1% year-on-year, marking the third consecutive month of deflation and aligning with market expectations.

Figure 2: China's inflation rate (consumer prices, % change year-on-year)



Source: National Bureau of Statistics.

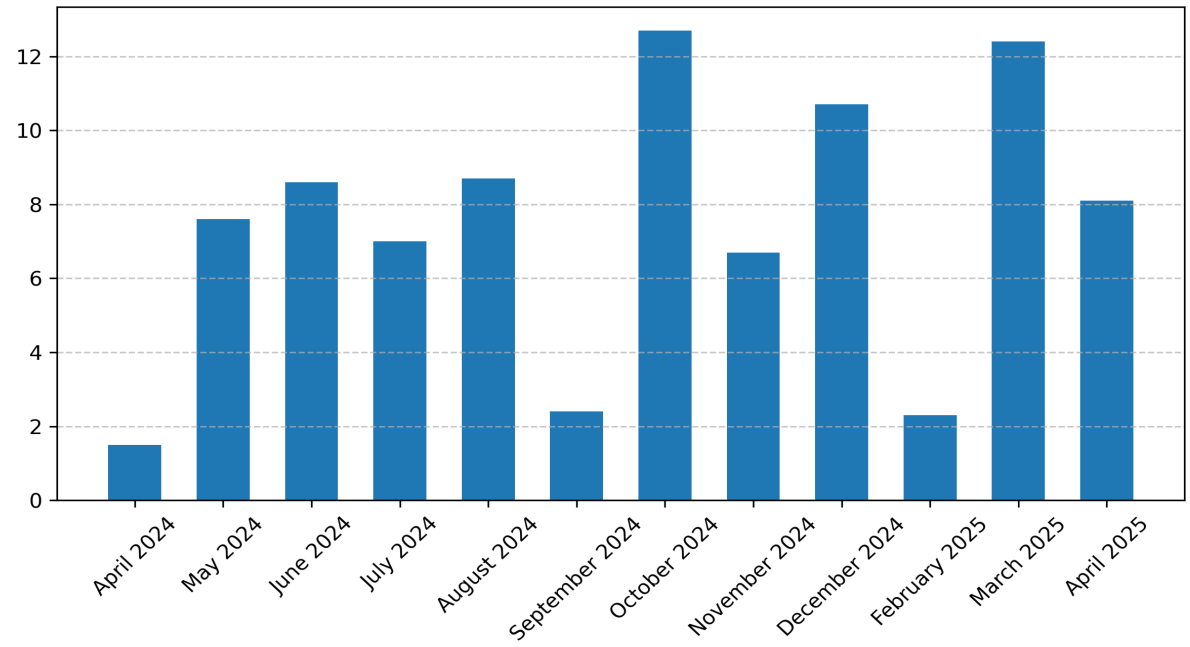
This deflationary trend reflects structural and cyclical factors, including weak domestic demand, labour market fragility, and continued trade frictions—especially with the United States. Core inflation (excluding food and energy) remained stable at 0.5% year-on-year. On a monthly basis, headline CPI rose by 0.1%, partially reversing the 0.4% decline in March and signalling tentative stabilisation (National Bureau of Statistics of China, 2025).

Persistent deflationary trends may reinforce the competitiveness of Chinese manufactured goods in international markets, including the euro area, with potential disinflationary implications for imported goods prices within the European bloc.

2.4.2. Export performance and trade diversification

China's exports in April 2025 expanded by 8.1% year-on-year to USD 315.7 billion, significantly outperforming market forecasts of a 1.9% increase (Figure 3). The increase is less pronounced than the 12.4% growth recorded in March 2025, which marked the strongest monthly expansion since October 2024. The export slowdown primarily reflects declining shipments to the US (-21% year-on-year), attributed to new tariff barriers and persistent uncertainty in bilateral trade relations (National Bureau of Statistics of China, 2025; Trading Economics, 2025a)

Figure 3: China's exports (% Change, year-on-year)

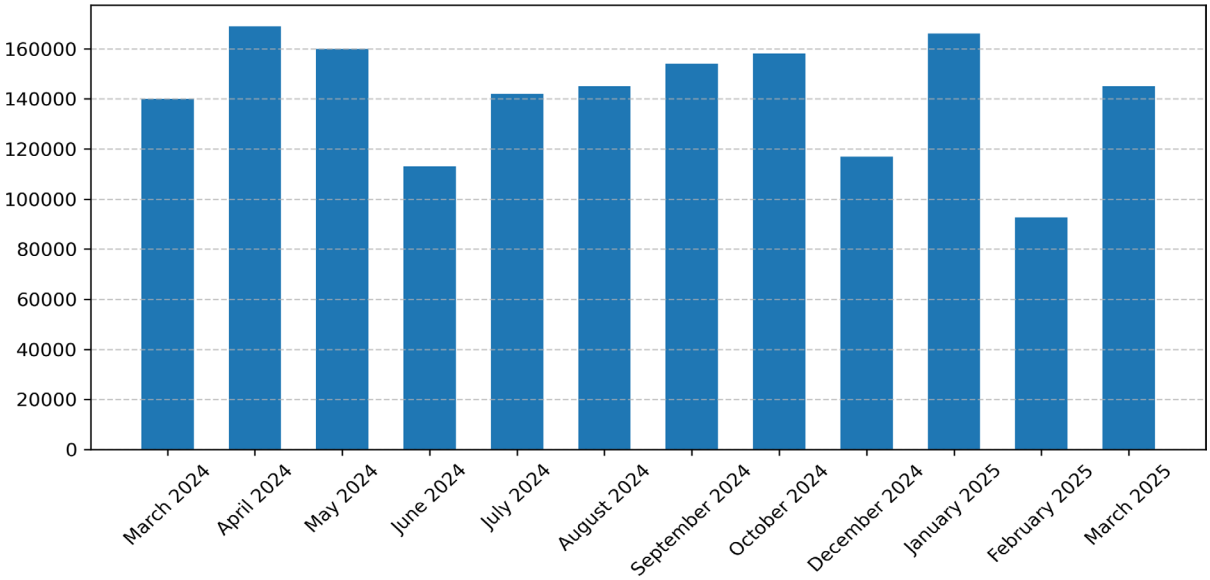


Source: China General Administration of Customs.

In response, Chinese exporters have increasingly reoriented trade flows toward alternative markets. Notable increases were recorded in exports to all its major trading partners outside the US (Japan +7.8%, Taiwan +15.5%, ASEAN member states +20.8%, Australia +5.8%). The EU was no exception, with China's exports growing by 8.3% year-on-year (National Bureau of Statistics of China, 2025).

The electric vehicle (EV) sector continues to represent a key area of export expansion, with broader implications for global value chains and trade policy as shown in Figure 4.

Figure 4: China's electric cars exports (units)



Source: China General Administration of Customs.

2.4.3. Trade policy developments and EU-China relations

As of May 2025, no new comprehensive trade agreement has been concluded between China and theEU. Nonetheless, several notable policy developments have occurred, which could influence future trade dynamics:

- **EV sector tariff negotiations**: In April 2025, the EU and China initiated negotiations to replace existing anti-dumping tariffs—reaching up to 45.3% on Chinese EVs imposed in October 2024—with a minimum price mechanism (Reuters, 2025). The proposed arrangement would establish price floors for Chinese EV imports, potentially de-escalating trade tensions while preserving market fairness.

- **Sanction relief and investment dialogue**: China lifted sanctions on several Members of the European Parliament (MEPs) and the European Parliament's Sub-committee on Human Rights. These sanctions had previously stalled ratification of the EU-China Comprehensive Agreement on Investment (CAI) (European Parliament, 2025).

- **Anti-dumping measures on construction equipment**: Despite these conciliatory steps, trade frictions persist. In April 2025, the EU imposed new anti-dumping duties on Chinese construction machinery following findings of subsidised market behaviour, reflecting continued vigilance against unfair competition (European Commission, 2025).

Hence, China's export rebalancing and domestic price deflation represent critical variables for the euro area's external environment. Elevated Chinese export volumes, coupled with subdued domestic price pressures, may intensify competitive pressures on European producers and exert downward pressure on import prices. While comprehensive trade agreements remain absent, ongoing negotiations and recent diplomatic overtures suggest an evolving framework for EU-China economic relations, with relevance for strategic sectors such as EVs and advanced manufacturing.

3. PERCEPTIONS OF ECB MONETARY POLICY

This section examines how professional forecasters perceive and interpret the ECB monetary policy. It is divided into two subsections. The first focuses on the anchoring of inflation expectations, a key measure of the ECB's credibility. The second analyses the perceived monetary policy rule to assess the effectiveness of the ECB's communication strategy.

To investigate how the public perceives and learns about the ECB's reaction function, we use data from the ECB Survey of Professional Forecasters (SPF). Launched alongside the euro in 1999, the SPF collects quarterly fixed-event (end of current and following year) and fixed-horizon (one-year ahead, two-years ahead, and five-years ahead) forecasts for inflation, real GDP growth, and unemployment in the euro area. Since 2002Q1, the SPF has also included forecasts for the ECB's policy rate—the rate on main refinancing operations (MRO) initially and the deposit facility rate (DFR) for the latest part of the sample. Notably, policy rate forecasts are elicited as part of the assumptions underlying inflation and growth projections. This structure makes the SPF particularly valuable for studying policy perceptions, as shown by Bauer et al. (2024) in the US context, and Czudaj (2023) using the same ECB data for an earlier sample.

3.1. Anchoring of inflation expectations

Anchoring of inflation expectations is a critical indicator of monetary policy credibility.

Figures 5-7 report the distribution of inflation expectations at the five horizons for roughly sixty forecasters on occasion of three key survey rounds: 2021:Q2 (pre-inflation shock, when the annual HICP inflation stood at 1.6%), 2022:Q4 (peak annual HICP inflation, at 9.2%), and 2024:Q4 (annual HICP inflation back to 2.4%, converging and close to the ECB's target).

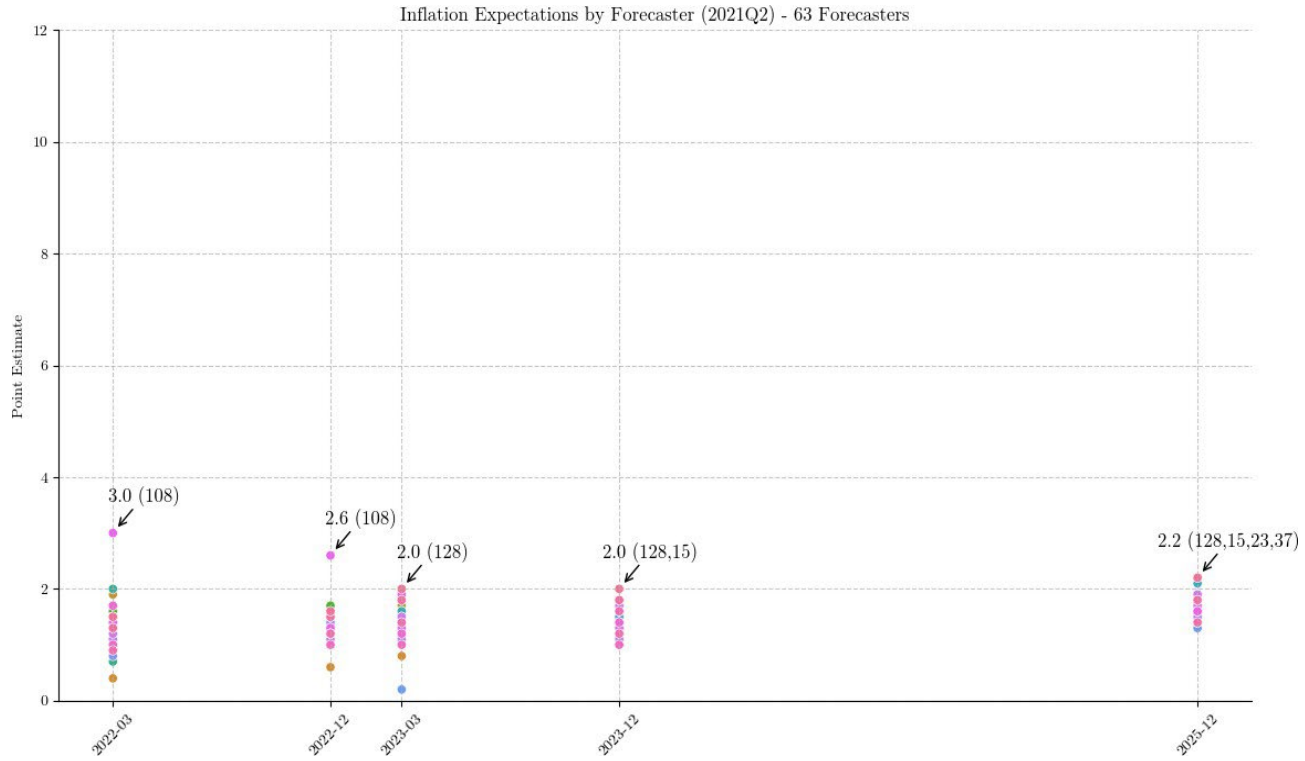
The Figures report, for each of the three relevant data points, the forecasts of survey participants for inflation at the five-horizons; each dot in the figure represents the forecast of the individual survey participants, therefore the dispersion of the dots is a visual indicator of the uncertainty about inflation forecasts among survey participants. The graphical evidence strongly suggests that, despite the volatility of the distribution of inflation expectations for short-horizons, long-run inflation expectations remained well anchored.

In 2021:03 the distribution of inflation expectations was stable and very similar across all horizons.

In 2022:09 the mean of short-horizons expectations shifted significantly, and their variance exploded, while the distribution of long-run expectations remained stable around the same mean with a small modification in the variance, mostly driven by a single outlier, projecting 5.8% five-year-ahead inflation.

In 2024:09 the pattern of expectations fully reverted to the pre-shock equilibrium.

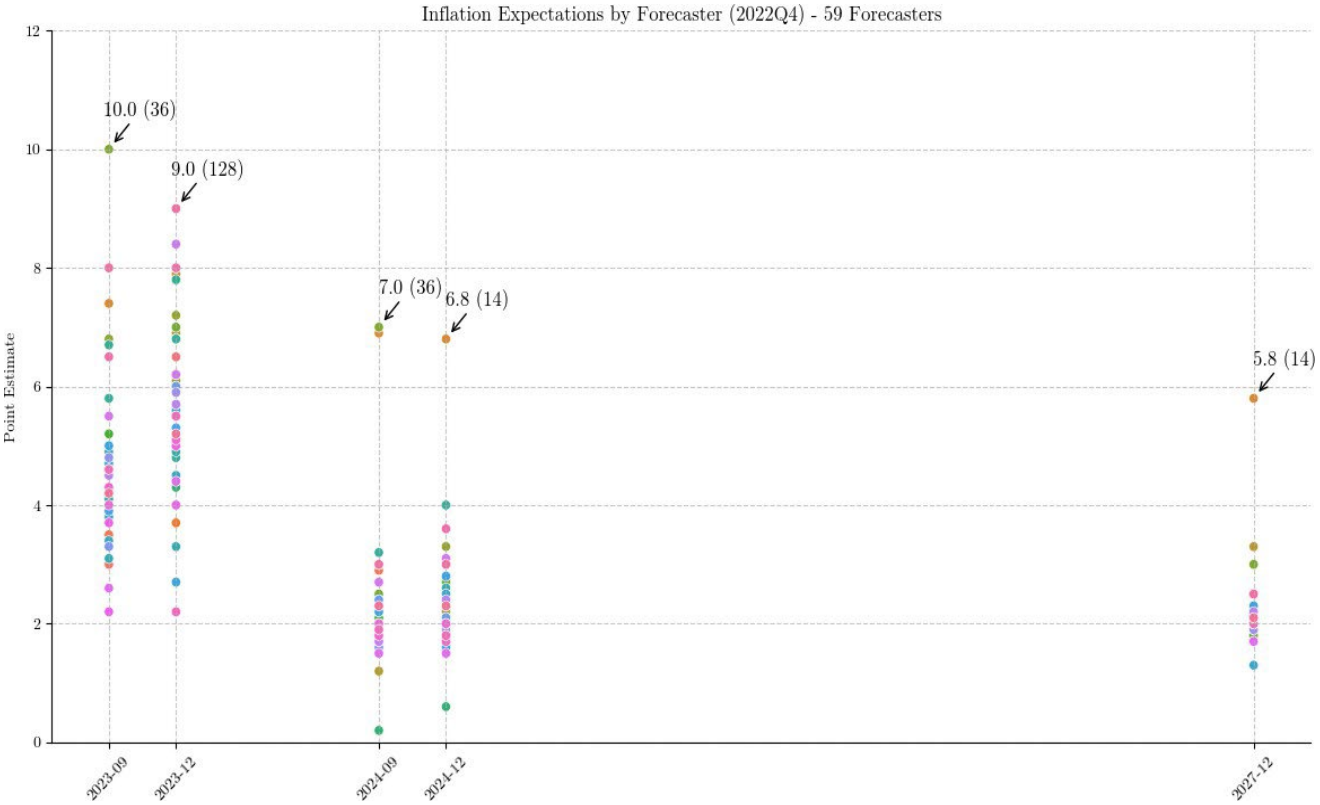
Figure 5: Inflation expectations, 2021:03 (pre-shock)



Note: Dots in the figure represent the forecast of the individual survey participants.

Source: ECB, SPF.

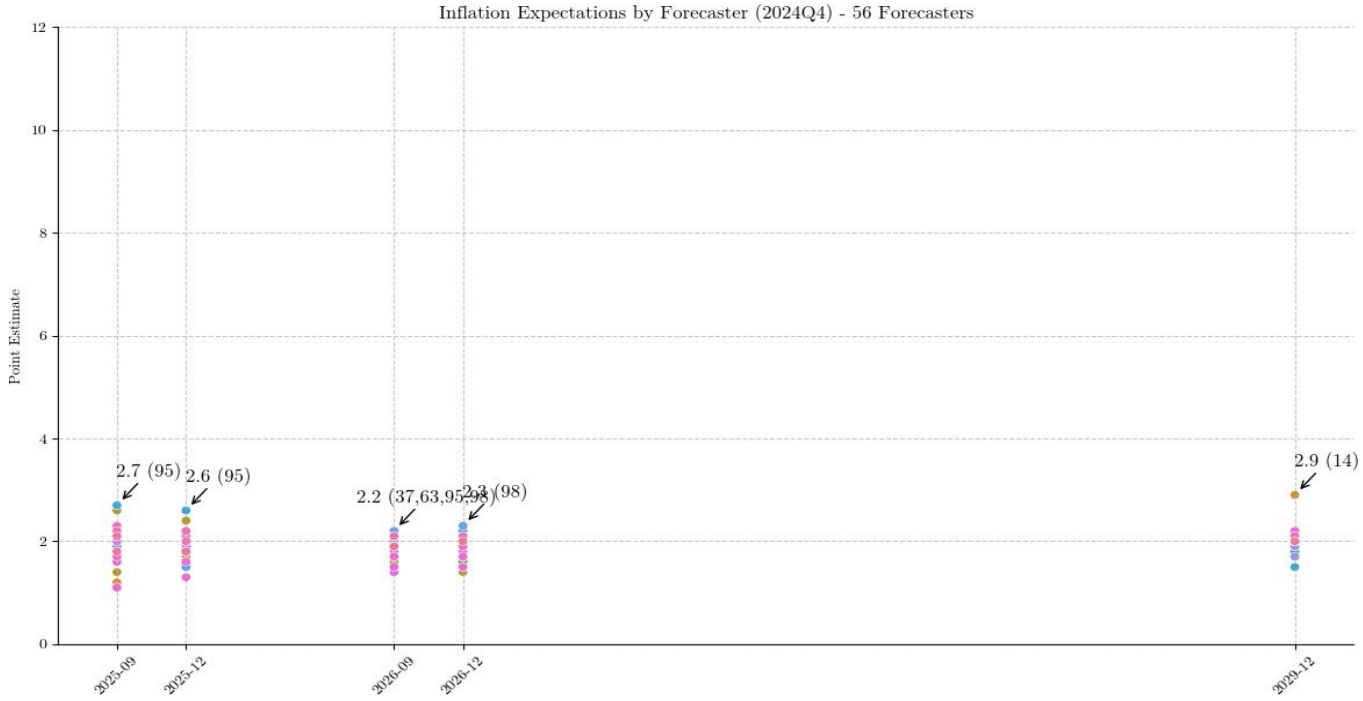
Figure 6: Inflation expectations: 2022:09 (peak inflation)



Note: Dots in the figure represent the forecast of the individual survey participants.

Source: ECB, SPF.

Figure 7: Inflation expectations: 2024:09 (after-shock)



Dots in the figure represent the forecast of the individual survey participants.

Source: ECB, SPF.

3.2. Perceived Taylor Rules and ECB communication

Because forecasts for the monetary policy rate are collected as inputs to inflation and growth projections, they offer a unique window into how forecasters perceive the ECB's policy rule. In particular, changes over time in the estimated parameters of a perceived Taylor (1993) rule—derived from the cross-section of SPF forecasts—reveal how clearly the ECB's policy framework is understood by market participants.

We assume each forecaster j believes the ECB follows a Taylor-type rule, estimated each quarter from SPF data:

$$i_t = r_t^* + \pi_t^* + \beta_t(\pi_t - \pi_t^*) + \gamma_t x_t + u_t$$

For each forecaster, the cross-sectional relationship is specified as:

$$E_t^j i_{t+4} = E_t r_t^* + E_t^j \pi_t^* + \beta_t\left(E_t^j \pi_{t+4} - E_t^j \pi_{t+4}^*\right) + \gamma_t E_t^j x_{t+4} + u_t^j$$

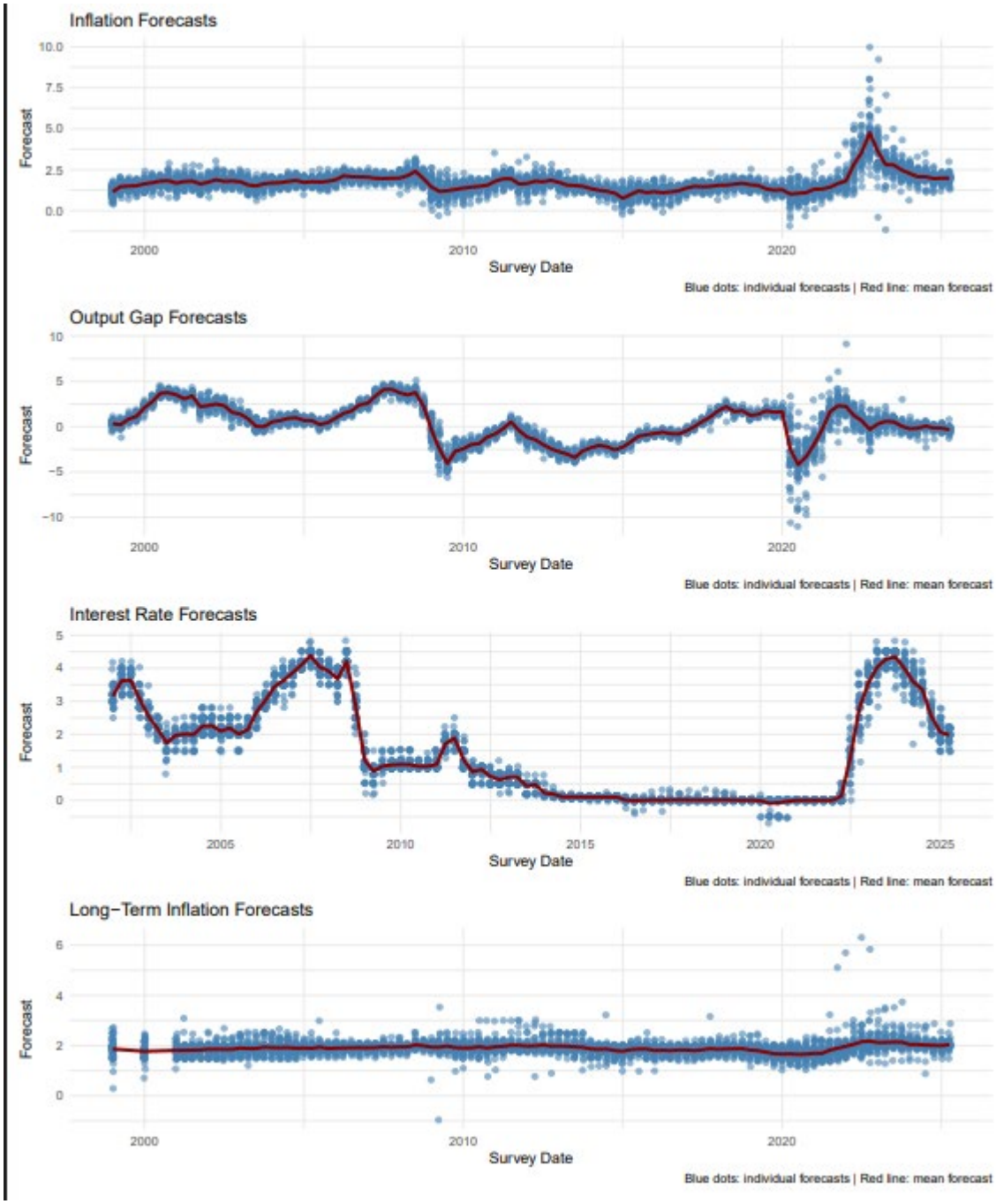
Here, $E_t^j i_{t+4}$ is forecaster j's one-year-ahead policy rate forecast; $E_t^j \pi_{t+4}$ is expected inflation; and $E_t^j x_{t+4}$ is the expected output gap.[1]

Long-run inflation expectations $E_t^j \pi_t^*$ are proxied by five-year-ahead SPF forecasts. The regression constant captures the perceived natural rate, $E_t r_t^*$, which is constant across survey participants and therefore not indexed by j. Therefore, the residuals in the cross-sectional regressions capture also heterogeneity in forecasters' view on the natural rate.

[1] Output gap forecasts are constructed from expected output growth and actual potential output, assuming no heterogeneity in beliefs about potential output.

With about 40 to 60 active respondents per round (drawn from an unbalanced panel of roughly 100 institutions), the equation can be estimated in each quarter by exploiting cross-sectional variation. This procedure yields time-varying estimates of the Taylor rule parameters.

Figure 8: The variables in the Taylor Rule



Source: ECB, SPF data.

The evolution of the cross-sectional distributions and time series of the variables in the Taylor rule, reported in Figure 8, offers several insights into ECB communication and credibility. First, the anchoring of inflation expectations for the long-run during the 2022–2023 inflation shock is confirmed in the

broader sample. Both the time series and the cross-sectional dispersion of long-run inflation expectations suggest tight alignment with the ECB's 2% target and low uncertainty.[2]

Second, the time series of expected output and inflation gaps shows limited deviation from target levels, with two notable episodes: a deflationary period during the 2008 financial crisis and euro area debt crisis, and an inflationary episode post-COVID. In the first episode, the strong positive correlation between inflation and output gaps points to a demand-driven shock. In contrast, the post-COVID inflation episode reflects a more complex supply-driven dynamic, with a weaker or negative correlation between the two gaps.

Third, fluctuations in expected monetary policy rates are broadly consistent with a Taylor-rule interpretation of the ECB's policy.

Having analysed the variables entering the Taylor rule let us now consider the coefficients. Figure 9 reports the time series of the three relevant coefficients, namely the intercept, the Coefficient on the expected inflation-gap and the coefficient on the expected output-gap

Three different patterns of coefficients emerge over three periods.

In the pre-zero lower bound period, with inflation fluctuating very close to the target and sometimes below it, the response of expected real policy rates to deviations of expected inflation from the target is positive significantly different from zero but significantly lower than one. The response to the output gap is of a slightly smaller magnitude and less precisely estimated.

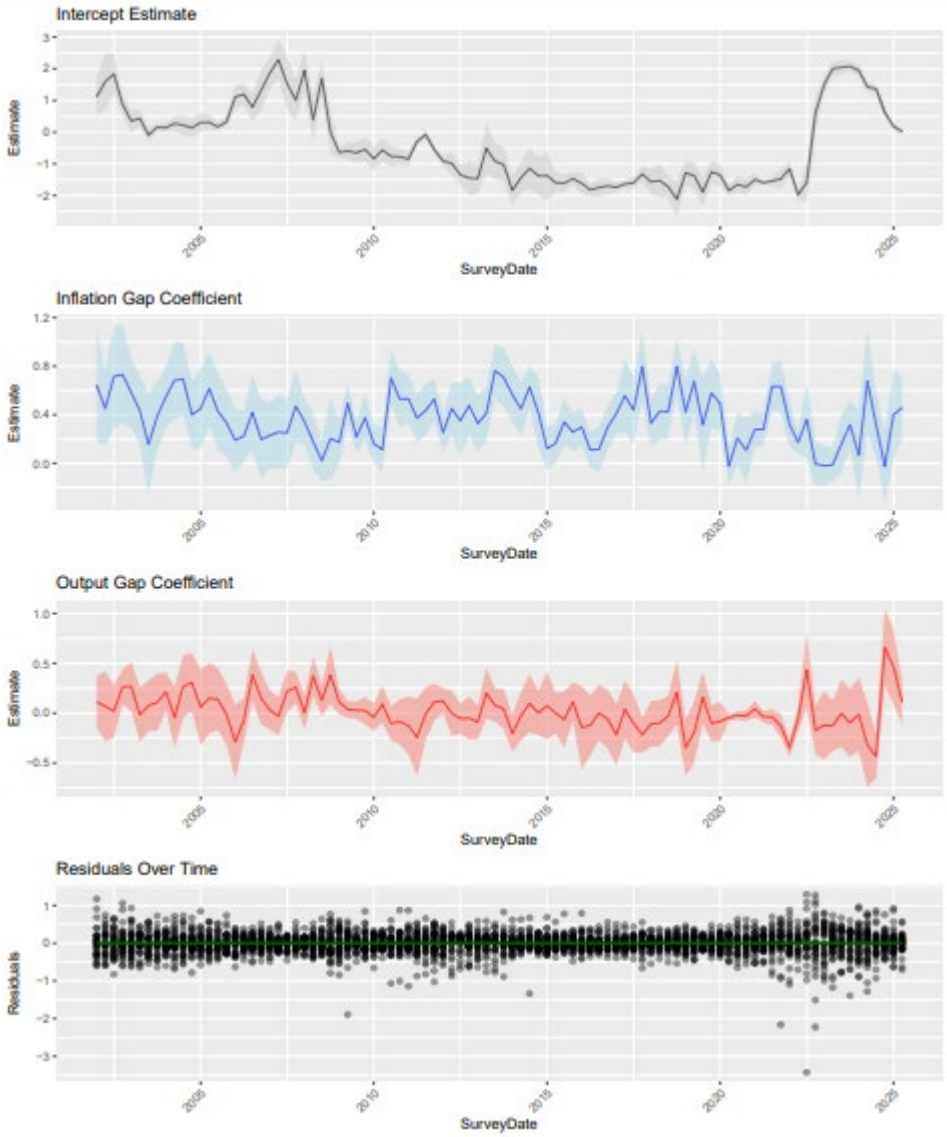
During the zero lower bound period, the coefficients on the inflation gap and the output gap keep a similar pattern with that of the previous period, while the estimate of the real rate becomes negative.

A third pattern for the coefficients emerges during the post-COVID inflationary period. In this phase, the lack of statistical significance for the inflation and output gap coefficients results in a time-series variation for the constant in the cross-sectional regression that appears more closely related to short-run fluctuations in real policy rates than to long-run movements in the natural rate.

Overall, our analysis of the SPF suggests that the ECB has been successful in anchoring inflation expectations and in fostering convergence in expectations regarding future monetary policy. However, the perceptions of monetary policy among participants in the SPF cannot be fully captured by a Taylor-type rule.

[2] Successful anchoring of long-run inflation expectations extracted from market prices is also found in the case of the Bank of England by Mangiante et al. (2024).

Figure 9: The coefficients in the Taylor Rule over time



4. GLOBAL RISK AND CHALLENGES FOR THE EURO AREA

In this section, we focus on identifying the main macroeconomic and financial risks for the euro area in the current volatile policy environment.

The last few months have been characterised by high volatility in asset prices and exchange rates, along with some unusual patterns in their joint behaviour. We offer tentative interpretations of these patterns, but given the uncertainty surrounding the new policy environment, we emphasize that multiple interpretations are possible and that the nature of the risks ahead will depend on which of these interpretations proves most accurate.

When we wrote our last report for the European Parliament in March (Bottazzi et al., 2025), we assumed that the effect of tariffs would be partially offset by an appreciation of the US dollar. This assumption was consistent with the typical response of currencies to tariff measures.

However, the unprecedented degree of policy uncertainty generated by the actions of the US Administration has produced a movement of the exchange rate in the opposite direction: the euro has strengthened by about 5% against the US dollar from 2 April to 1 June. Our first objective here is to interpret this unusual pattern and explore its implications.

We begin with a broad interpretation in terms of a relative shift in asset demand. We then show that this shift may amplify aggregate demand pressures, as the contractionary impact of US tariffs on European exports is reinforced by an appreciation of the euro, which further deteriorates the external price competitiveness of euro area firms.

However, once we consider the possibility of a significant regime shift in international financial markets, the exchange rate is no longer the only channel of concern.

A closer look at the nature of the financial shocks we are experiencing, and their transmission mechanism reveals that opposing arguments can be made. Increased appetite for euro-denominated assets could potentially ease financial conditions in Europe. At the same time, a disorderly dollar crisis has the potential to generate negative contagion effects on the European financial system, causing tighter financial conditions. Below, we review the analytical basis for this second argument.

Summing up, the ECB may have to prepare for a worst-case scenario in which negative shocks to aggregate demand originate from three fronts: higher US tariff protection, a stronger euro, and tighter financial conditions for both private and public borrowers in the euro area.

4.1. Twin shocks: goods markets and asset markets

The simplest interpretation of the recent weakening of the dollar against the euro is that there has been a broad shift away from US assets, triggered by rising uncertainty about US policymaking.

For now, we do not need to take a stance on the nature of this shift—whether it reflects a temporary repositioning by portfolio managers or a deeper re-evaluation of the dollar's role in the international financial system. Our working assumption is that weeks of conflicting announcements, poor communication on policy objectives, and the visible lack of policy analysis behind recent decisions have led international investors to reassess the risks associated with US assets.

Blanchard et al. (2005) offer a useful analytical framework to examine the joint effects of policies that reduce US demand for foreign goods while also reducing international demand for US assets. A key assumption in their model is imperfect substitutability—both for goods and for assets.

In the Annex, we provide a formal analysis of the Blanchard et al. model under "twin shocks": a shock to the relative demand for goods and a shock to the relative demand for assets. We summarize the key findings as follows. A decline in US demand for foreign goods—such as that induced by tariffs—typically

leads to dollar appreciation, consistent with standard trade- based models. However, a concurrent shift in global portfolio preferences away from US assets exerts downward pressure on the dollar. The underlying mechanism is straightforward: a dollar depreciation partially offsets the asset-demand shock by improving the relative valuation of US assets, thereby supporting portfolio reallocation by international investors. The dollar's response to these two shocks depends on their relative strength. Since tariffs pass through to prices only gradually and trade flows adjust with lags, it is plausible that the financial shock dominates in the short run. This interpretation aligns with the depreciation observed in recent weeks.

Empirically, following the US trade measures announcements on 2 April, the US dollar depreciated by approximately 0.8% against the euro. From 2 April to 1 June, the euro continued to strengthen, gaining about 5% against the dollar. This indicates that, at least up to this point, the asset market shock has been the prevailing influence.

The main piece of evidence supporting this broad interpretation is that, following the 2 April announcements, we observed declines not just in the dollar, but also in US stock and bond prices—consistent with a broad shift away from US assets.

This evidence raises an important question for Europe: what are the potential consequences of a persistent portfolio shock—one that leads global investors to shift away from US assets?

4.2. Implications for monetary policy

To think about the implications of a shift in asset demand for monetary policy, we can employ a standard New Keynesian dynamic general equilibrium model of a small open economy with incomplete markets and imperfect asset substitutability. The model brings the logic of Blanchard et al. (2005) into an explicit monetary framework. To do so, the key feature of the model is that foreign (dollar) assets deliver utility services, capturing their role as safe and liquid stores of value. Due to this benefit, dollar bonds in equilibrium tend to pay a lower rate of return. This lower rate of return is interpreted as a convenience yield. It is then easy to introduce a shift in demand for dollar assets by changing the investors' preferences for safe dollar bonds, that is, introducing a shock to dollar bonds' convenience yield.

A distinctive feature of a convenience-yield shock is that it changes the desired spread between the return investors get on dollar and euro bond investments, inducing a shift in the uncovered interest parity (UIP) relation[3] that governs exchange rate movements in this class of models. Indeed, the shock causes at the same time a real appreciation of the domestic currency (the euro), as the capital inflow strengthens the exchange rate, and a lower real interest rate in the euro area. The simultaneous real appreciation of the euro and decline in domestic real interest rates breaks the conventional UIP logic, which typically predicts an exchange rate depreciation when domestic yields fall.

Going more in detail, the shock triggers three equilibrium effects. First, the real exchange rate appreciation reduces the competitiveness of domestic goods vs. foreign goods, reducing exports and shifting domestic demand from domestic goods toward imports. Second, the shift in investor preferences toward domestic assets reduces the domestic real interest rate, which encourages intertemporal substitution towards current consumption. Third, the improved terms of trade for the domestic consumers induces an increase in domestic consumption and, at the same time, a negative income effect on labour supply. Taken together, these channels yield a mixed macroeconomic impact.

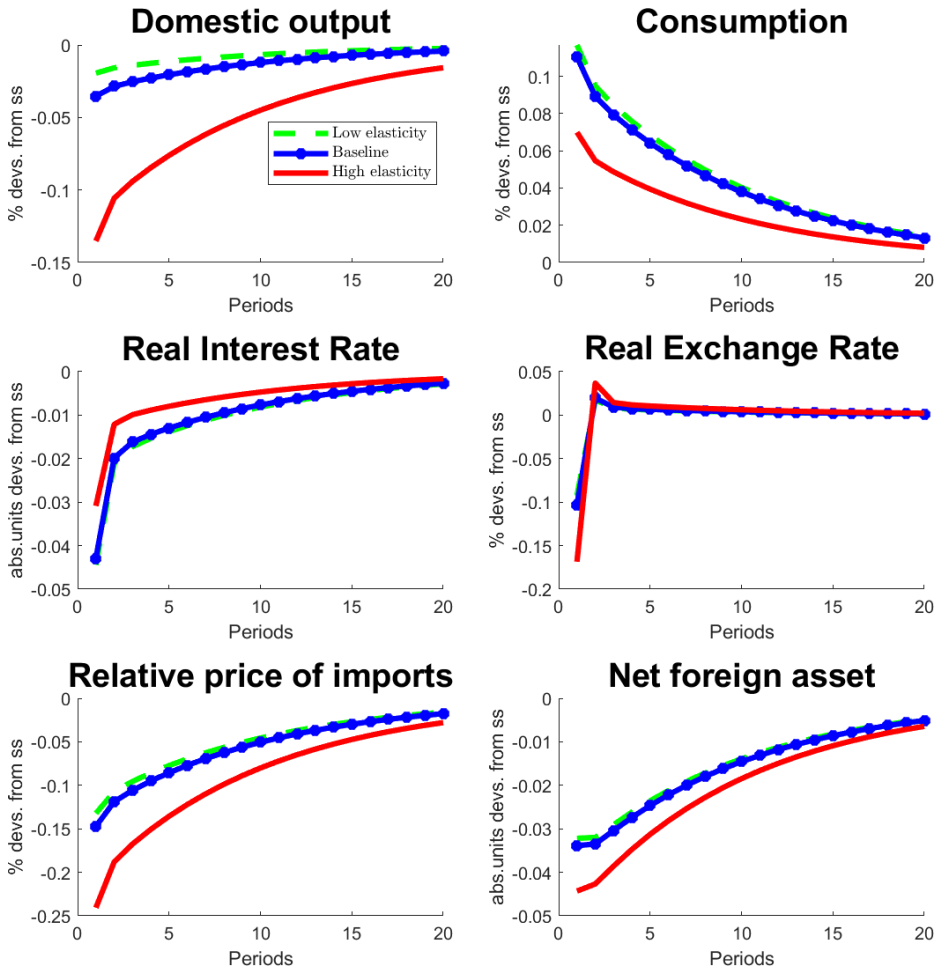
[3] Uncovered Interest Parity (UIP) states that the difference between the interest rates of two countries should equal the expected change in their exchange rates. In simple terms, if a foreign investment offers a higher interest rate than a domestic one, the domestic currency is expected to depreciate in the future to offset the gain—so that there is no arbitrage opportunity.

The real appreciation and the negative income effect on labour supply tend to reduce domestic activity. In contrast, the decline in the real interest rate supports domestic demand through higher consumption.

The overall effect on domestic economic activity depends on the relative strength of these opposing forces.

Figure 10 illustrates the macroeconomic effects of an exogenous reduction in the convenience yield on foreign assets. For simplicity, we focus on what happens under a neutral assumption on monetary policy, that is, assuming that the central bank aims to replicate the equilibrium that would arise under flexible prices, or, equivalently, assuming that the central bank keeps inflation in domestic good prices stable.

Figure 10: Impulse response functions of domestic variables to a reduction in the convenience yield on foreign assets (low, baseline and high labour supply elasticity scenarios)



We illustrate the effect under three different calibrations of the model parameters, corresponding to three different values for the Frisch elasticity of labour supply[4]. That elasticity governs the strength of the equilibrium response of employment to the income effect, which induces domestic agent to reduce their labour supply. The size of the shock is normalised in such a way to induce a real appreciation of the exchange rate of 10% on impact.

The shock triggers a reallocation of asset portfolios away from the now less attractive foreign asset and toward domestic-currency assets. The increased demand for domestic assets drives up their price and

[4] The Frisch elasticity of labor supply measures how much a person is willing to adjust the number of hours they work in response to a temporary change in wages, it reflects the flexibility of labor supply over time.

reduces the domestic real interest rate, as shown in the lower- left panel. The drop in the domestic real return reduces the incentive to save, resulting in a sharp but temporary increase in consumption (upper-right panel), consistent with an intertemporal substitution motive under standard preferences. At the same time, the shift in portfolio demand reduces the holdings of net foreign assets and strengthens the domestic currency, leading to a real appreciation (middle-right panel). This appreciation reduces the relative price of imported goods (bottom-left), leading to a contraction in net exports. These dynamics reflect the model's departure from the conventional UIP logic: despite the drop in domestic real interest rates, the currency appreciates in real terms, as the capital inflow dominates the usual arbitrage motive based on real rate differentials.

Economic activity, as measured by output and employment, declines in all cases, even though the central bank is lowering interest rates. Quantitatively, the size of the effect on output and employment is sensitive to our assumptions on labour supply elasticity.

The dynamics described above underscore the potentially contractionary impact on euro area activity of a form of flight away from dollar assets and in favour of euro assets.

This marks a departure from the standard dynamics typically observed during recent episodes of elevated market volatility, wherein investors have historically reallocated toward safe US dollar-denominated assets. Such flight-to-safety behaviour has generally resulted in dollar appreciation relative to the euro, indirectly benefiting the euro area through improved competitiveness. However, should the global financial system be transitioning toward a regime in which the dollar's safe-haven status is diminished, periods of financial stress may instead be characterised by euro appreciation. This potential structural shift would necessitate an adjustment in the ECB's reaction function to account for the altered transmission mechanisms and macro-financial conditions.

Going back to the specifics of the current episode, notice that the simulations above look at the effect of the convenience-yield shock in isolation. When coupled with the trade shock due to increased tariffs on euro area exports, we would have twin contractionary shock on the euro area: weaker exports from higher trade barriers and a real appreciation. In the current environment, the twin shocks raise the risk of a persistent and asymmetric drag on euro area economic activity, posing new challenges for Eurozone euro area stabilisation policy.

4.3. Effects on financial conditions

So far, our analysis has focused on a simple shock that shifts investors away from US assets and in favour of euro assets. While this approach is sufficient to explain observed exchange rate movements, thinking more broadly about the transmission of policy shocks from the US to the euro area requires going in more detail.

We want to identify two interpretations of current shifts in global asset markets, two interpretations with very different implications.

The first interpretation is more benign and sees the shock as just an orderly movement away from all dollar investments. This may in part reflect a natural readjustment after a period of exceptionally bullish sentiment for US assets in general, and for the US tech industry in particular, that characterised the end of 2024. A rebalancing of this sort may benefit risky asset classes in the euro area. Some evidence in favour of this interpretation is the rally in euro area stock markets in the period immediately following 2 April.

Going back to the simple New Keynesian model used above, that model emphasizes the contractionary effects of a shock in favour of euro area assets through an appreciation of the euro. But it is possible to enrich that model by adding a larger set of assets and by distinguishing safe euro bonds and risky

European stocks. In that context, it is possible to consider a shock that, while causing a euro appreciation, also leads to a lower price of risk and thus to easier financial conditions in the euro area. The appreciation of the euro has contractionary effects, but easier financial conditions are expansionary through their effects on investment and household borrowing.[5]

Recognizing the presence of potential opposing forces implies that a deeper understanding of the nature of the financial shock is required. If the inflow is primarily directed toward euro safe assets, the dominant effect will be contractionary, via the exchange rate appreciation. By contrast, if the inflows also favour European risky assets, the dominant effect will be expansionary. A closer look at portfolio data may be useful for the ECB in evaluating the risks ahead.

4.3.1. Financial tensions and contagion

We now turn to a less optimistic interpretation of the shifts in international financial markets triggered by the actions of the US Administration. Under this less optimistic view, a disorderly crisis in US government bond markets and in the dollar is a possibility, and it would have mostly negative repercussions on euro area financial markets.

The main concern here is that the shifts we are experiencing reflect a deeper concern, spreading in financial markets, about the safety of US Treasuries and their role in providing liquidity to international financial transactions. This special role is reflected in the larger convenience yield associated to US Treasuries relative to other global safe assets.

A recent paper by Jiang et al. (2025) points to the recent joint movements in long term yields and the dollar as a specific symptom that something is happening to markets' perceptions of US Treasuries special role. The usual pattern, pre-2 April, is that when long term Treasury yields go up the dollar tends to strengthen. A standard interpretation is that higher long yields reflect expectations of faster US growth. After 2 April, there are many instances in which the yields have increased while the dollar was sliding. A possible interpretation of this new pattern is that in recent episodes higher long-term yields reflect higher term premia due to heightened uncertainty about US policy, associated to potentially more volatile rates in the future. This increased perceived risk in US policy would also cause the dollar to fall. Investors are willing to pay a premium to hold highly liquid and safe US dollar instruments, such as Treasury bills. This premium reflects the unique advantages of these assets—their liquidity, safety, and global acceptability. The term convenience yield is borrowed from commodity markets, where it captures the benefit of holding the physical good (such as oil, gold, or wheat) as opposed to a futures contract. Similarly, for US Treasury securities, the convenience yield represents the advantage of immediate access to risk-free, dollar-denominated assets in times of uncertainty or financial stress.

Jiang et al. (2025) have developed a way of backing up the convenience yield uniquely attached to US Treasuries from measures of the spread between US Treasuries and German bonds of equal safety[6]. They show a significant decline in this measure of convenience, offering additional evidence of existing tensions in US Treasury markets.

The reason why this is an important possibility to consider is that it is associated not only with the vagaries of recent trade policy, but also to concerns with US fiscal sustainability, with persistently large primary deficits and limited political will to address them. These concerns have been accumulating in

[5] This point is related to a classic debate about the expansionary or contractionary effects of shocks to capital flows. The standard logic of the Mundell-Fleming model, which is present in the New Keynesian model in the previous subsection, is that a positive shock to capital inflows has contractionary effects on the destination country, through an appreciation of the exchange rate. But this prediction seems contradicted by many episodes of booms in capital inflows associated with economic expansions. There are models that can explain this evidence. For example, Blanchard et al. (2016) does so by introducing a distinction between domestic bonds and stocks. The argument in the text builds on the logic of that model.

[6] For this comparison, German yields are converted into dollar yields using FX swaps.

recent years, under both Republican and Democratic administrations (for a recent analysis see Auerbach and Yagan, 2024). The "One Big Beautiful" tax bill currently under discussion in the US Senate only adds to these concerns. Why do we think that this interpretation of recent events is especially worrisome for Europe? Wouldn't this shift favour European safe assets and thus benefit Europe?

We will return below to a potential silver lining: the possibility that increased demand for safety may be directed toward European assets. But first, we focus on the risks.

The key risk lies in the potential interaction between currency mismatches, synthetic hedging, and dollar funding markets.

A fall in the convenience yield signals declining global demand for dollar-denominated safe assets, which contributes to a dollar depreciation. Yet, because of the global role of the dollar as a funding and reserve currency, the impact of a weakening dollar on financial conditions can be far-reaching.

Euro area banks hold significant positions in dollars, including US securities, loans to emerging markets, and exposures via foreign branches, while having relatively less dollar liabilities. According to European Banking Authority (EBA) data, approximately 33% of euro area bank assets are denominated in foreign currencies (mostly US dollars), while this share is around 20% for liabilities. This creates a structural currency mismatch: the net long position in dollars exposes banks to valuation losses when the dollar depreciates. While banks typically hedge the associated currency risk—primarily via FX swaps and forwards—they remain vulnerable to rollover risk and liquidity shocks. The hedging instruments are typically short-term contracts, often with maturities of just one to three months. While they effectively hedge the currency risk in the near term, they must be rolled over continuously for banks to maintain protection on longer-term dollar exposures. In normal conditions, this rollover is routine. But in the midst of a disorderly dollar depreciation, the demand to exit dollar positions rises globally, potentially disrupting the functioning of FX swap markets.

A key symptom of this potential stress is a widening of the cross-currency basis—the spread between the actual market forward rate and the rate implied by covered interest parity. When this basis widens, especially against the euro, it signals that synthetic dollar funding via swaps has become more expensive. This directly raises the cost for euro area banks to maintain their hedges: to keep rolling their dollar positions, they must commit more euros per dollar received, effectively tightening their own euro-denominated liquidity.

Moreover, a volatile dollar exchange rate can lead to mark-to-market losses on existing hedges, triggering margin calls on these derivatives. Even though the exposure is hedged in accounting terms, the bank/investor is required to post additional (cash) collateral—usually in dollars—to counterparties. If the bank does not have immediate access to cash dollars, it must obtain them on the spot market, contributing to a broader scramble for liquidity. This "dash for dollars" (Cesa-Bianchi and Eguren Martin, 2025) emerges not because the dollar is strengthening, but because the mechanisms used to manage currency risk become more costly and liquidity-intensive when the dollar weakens in a volatile or disorderly fashion[7]

Non-financial firms in the euro area are not immune to these dynamics. Those with dollar liabilities experience rising debt burdens in real terms if their revenues are in euros, while exporters earning in dollars see the value of their revenues fall in local currency. Most importantly, tighter dollar funding conditions for banks may spill over into the real economy, through reduced credit availability or higher lending spreads for firms relying on bank financing.

[7] Annex 1 illustrates with an example the technical aspects of the "dash for dollars".

In a nutshell, a depreciation of the dollar stemming from a lower convenience yield can act as a negative balance sheet shock for euro area banks, due to their USD asset-heavy positions. Combined with reliance on synthetic hedging and short-term funding, this makes the system vulnerable to a tightening of financial conditions through the dollar liquidity channel, even in an environment of dollar weakness.

Summing up: a worst-case scenario cannot be ruled out — one in which Europe faces simultaneous headwinds to real activity and financial stability. These include lower exports due to high tariffs and a stronger euro, as well as tighter financial conditions resulting from spillovers stemming from tensions in the US Treasury market and in dollar funding markets.

4.4. Opportunities for Europe

The increased perception of US fiscal risks—due to persistent primary deficits, political gridlock, and doubts surrounding long-run sustainability—presents a risk to global financial stability, but it also offers a strategic opening to the euro area. If concerns about US fiscal credibility intensify, they may induce investors to search for safety in non-US assets. In this context, the euro area could step in as an alternative source of stability, provided it offers a unified and credible financial instrument that markets can treat as a genuine substitute for US Treasuries. In recent remarks, President Lagarde described this situation as a "global euro moment," suggesting that the euro could achieve greater international prominence—provided that Europe strengthens its financial and security infrastructures (Lagarde, 2025).

One significant weakness of the euro area in this dimension, is the fragmentation of its government debt markets. National governments issue debt independently, and yield spreads reflect both credit risk and liquidity premia. The lack of a common fiscal backstop makes the system vulnerable to contagion: in times of market stress, increases in sovereign spreads for one member state can quickly spill over to others, even in the absence of direct fiscal linkages. These dynamics were visible during the euro area debt crisis and remain latent today.

A key institutional innovation to address this vulnerability would be the establishment of a European Debt Agency (EDA), tasked with issuing common euro area government debt instruments. Some of the authors of this report have worked on two separate proposals along those lines (D'Amico et al., 2022, and Amato et al., 2024).

The common element of these proposals is that the EDA would act as an intermediary between the national governments and the debt market, and that EDA liabilities would provide a liquid, euro-denominated safe asset without requiring a full fiscal union.

The main difference between the two proposals is the source of financing for the EDA. D'Amico et al. (2022) consider an agency that replaces a portion of the existing stock of sovereign debt and finances its liabilities directly from transfers from Member States, defined in proportion to the stock of debt absorbed. Some simulations on the feasibility of a similar scheme are provided in Ando et al. (2023). Amato et al. (2024), on the other hand, consider an agency that is financed by making loans to national governments, at prices calibrated to reflect national default risk. Amato et al. (2024) argue that the introduction of an EDA with these features improves the efficiency of debt risk management in the euro area by reducing rollover risk and allowing for more effective coordination of fiscal issuance. Their simulations show that even partial debt mutualisation, when coupled with market-based risk pricing and credible governance, can reduce average borrowing costs while improving systemic stability.

A recent proposal along similar lines comes from Blanchard and Ubide (2025), who suggest using dedicated sources of tax revenue to finance the European debt issued.

The size of the program will have to be chosen to balance two main risks. On the one hand, a program that replaces all existing national debt would raise excessive concerns of debt mutualisation. On the other hand, a program too small would fail to provide a sufficiently large and liquid supply of safe euro assets.

A well-designed and well-tested program, however, has the potential to achieve three desirable objectives. First, it would lower borrowing costs for European governments, by allowing them to reap some of the convenience yield which is being gradually lost by US instruments. Second, it would provide a useful complement to the expansion of euro-based financial markets, open to non-European participants. Third, by helping business raise financial resources directly on euro-based markets, it would reduce the European markets' exposure to the dollar risks which we discussed in Section 4.3, thus limiting the risk of contagion from a disorderly fiscal crisis in the US.

5. CONCLUSION

This paper has examined the conduct of ECB monetary policy under conditions of heightened international uncertainty. We identified three key external risks for the euro area: (i) the possibility of a strong euro appreciation due to global financial repositioning, (ii) the implications of a US fiscal crisis and the potential erosion of the dollar's global role as a safe asset, and (iii) renewed trade protectionism, particularly in the form of tariffs imposed by the United States.

Through a combination of theoretical analysis and empirical evidence—ranging from inflation forecasts to financial transmission indicators—we showed that the ECB has responded to these challenges within a structured decision framework. This framework relies on the inflation outlook, measures of underlying inflation, and the strength of monetary policy transmission, with inflation expectation anchoring as an implicit fourth pillar. Our analysis of the ECB Survey of Professional Forecasters indicates that market participants broadly understand and internalise the ECB's strategy, although they continue to face uncertainty over the natural rate of interest and the exact transmission mechanism in a post-zero-lower-bound world.

A central insight of our analysis is that the evolving global financial architecture may generate both risks and opportunities for the euro area. While a US fiscal crisis could trigger contagion effects and raise sovereign spreads in Europe, it could also prompt a reallocation of global capital away from US Treasury securities. In this scenario, Europe has the chance to offer an alternative source of global stability—provided it can adequately supply a credible, euro-denominated safe asset.

We therefore argue that the establishment of a European Debt Agency (EDA), tasked with issuing common euro area debt, should be a strategic priority. An EDA would help overcome the longstanding fragmentation in European sovereign bond markets, reduce the risk of financial contagion, and enable the euro area to absorb demand for safe assets in an environment of declining US fiscal credibility. As such, the EDA is not only a financial backstop but also a geopolitical lever—allowing Europe to assert a stronger role in the global monetary system.

By stabilising internal financial conditions and enhancing the international role of the euro, this institutional innovation would transform a moment of global uncertainty into a catalyst for deeper European integration.

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ANNEX

6.1. The Dash for the Dollars

For illustrative purposes, consider the following example. Suppose at time t = 0 a euro area bank holds dollar-denominated assets worth $A^{\$}$ and funds itself in euros. To hedge exchange rate risk, it enters an FX swap: it delivers $\frac{A^{\$}}{S_0}$ euros at the spot exchange rate S_0 (USD per EUR) and receives $A^{\$}$ dollars.

The forward leg of the swap is set at rate F_0 which typically satisfies:

$$F_0 = S_0\left(\frac{1+r^{EUR}}{1+r^{USD}}\right)(1+\varphi_0)$$

where φ_0 is the cross-currency basis, capturing possible deviations from covered interest parity (CIP). A value $\varphi_0 > 0$ reflects a premium for synthetic dollar funding via swaps.

At maturity t = 1 , the bank must roll the hedge. Suppose there is a dollar depreciation ($S_1 > S_0$) paired with an increase in the basis ($\varphi_1 > \varphi_0$), caused by tensions in global dollar funding markets. For instance, dollar liquidity becomes scarce relative to euro liquidity. Alternatively, hedging demand intensifies as institutions try to exit USD positions or manage FX exposure. Then

$$F_1 = S_1\left(\frac{1+r^{EUR}}{1+r^{USD}}\right)(1+\varphi_1)$$

As a result, euro area banks rolling over FX swaps face higher costs not because of changes in fundamentals alone, but due to market frictions in global dollar funding. Thus, the cost of maintaining the hedge rises, due both to the change in S and to the widening of the basis. The effective increase in the cost of hedging (in euros) is:

$$\Delta Hedge\ Cost = \left(\frac{1}{F_0} - \frac{1}{F_1}\right)A^{\$}$$

The amount of EUR received at maturity from hedging USD is equal to the inverse of the forward rate, so if $F_1 > F_0$, then $\frac{1}{F_1} < \frac{1}{F_0}$, meaning that the EUR proceeds decline and the cost of hedging rises.

Additionally, if the dollar depreciates and the bank holds a contract to receive dollars in the future, the euro value of that future payment declines. The bank's position loses value, and the bank must post variation margin to its counterparty. The bank must post actual dollars as collateral, potentially under tight liquidity conditions. If FX swap markets become illiquid or extremely expensive, the bank may face rollover failure, triggering a dash for dollars even in an environment of dollar weakness.

6.2. US Exchange Rate Dynamics in the Blanchard et al. (2005) model

Blanchard et al. (2005) use a model with imperfect substitutability between assets and goods that produces a phase diagram that helps understanding the dynamics and the steady state effect of the two shocks we are interested in: a shift in the demand for US assets and a shift in the demand for US goods.

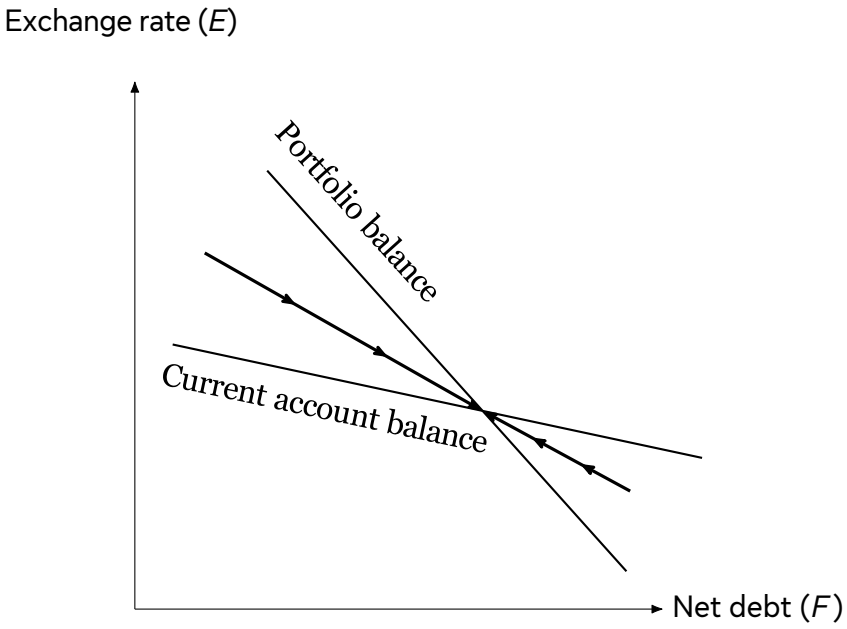
The phase diagram is built around two steady state conditions.

The first is a negative relation between net US international debt and the dollar real exchange rate. In the presence of home bias, a larger US net debt, which transfers wealth to foreign investors, shifts demand away from US assets and thus causes US dollar depreciation (it lowers the exchange rate, defined as EUR per 1 USD).

The second relation is the current account balance condition which also implies a negative relation between net debt and the exchange rate. The larger net debt, the larger the trade surplus required in steady state to pay for interest payments on the debt, and thus the lower the required exchange rate.

Under reasonable conditions the system is (locally saddle point) stable. The following figure illustrates the determination of the equilibrium:

Figure 11: The determination of equilibrium



The system is (locally saddle point) stable if, the portfolio balance locus is steeper than the current account balance locus. Consider an increase in US net debt. This increase has two effects on the current account deficit, and thus on the change in net debt: it increases interest payments, but it also leads, through the portfolio balance relation, to a lower exchange rate and thus a decrease in the trade deficit. For stability to prevail, the net effect must be that the increase in net debt reduces the current account deficit. The model can be used to study, separately one from the other, the two shocks we are interested in: a tariff on US imports and a shift away from US assets. An increase of US tariffs, illustrated in Figure 12, at a given level of foreign debt, requires, for current account balance, a higher USD exchange rate. On impact the USD appreciates and US foreign debt falls. On the path to the new steady state the USD keeps appreciating and net debt starts falling. In the new steady state (relative to the old one) the USD is appreciated and net foreign debt is lower.

Figure 12: A shift towards US goods

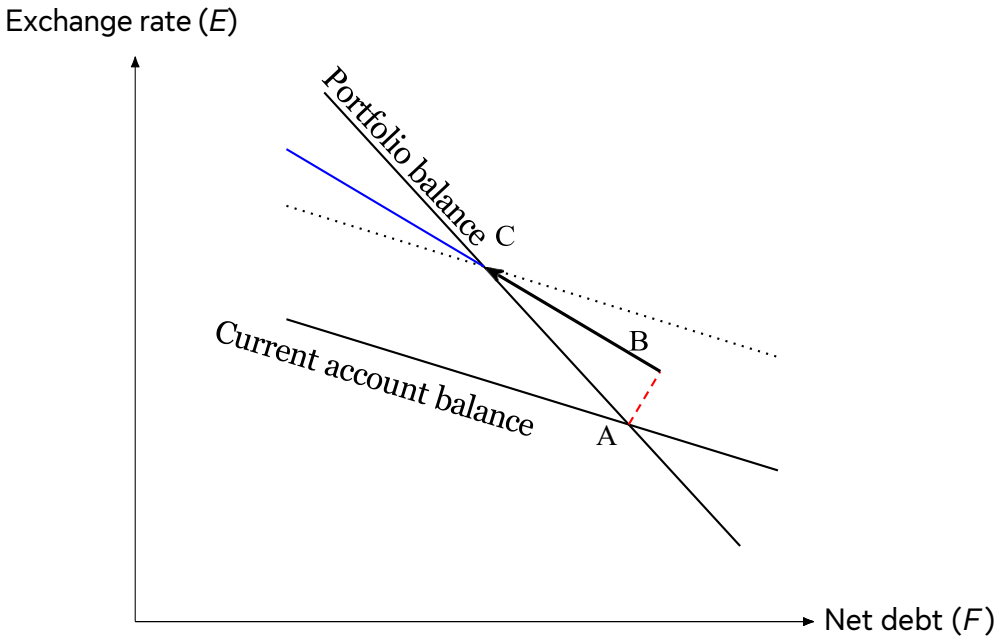
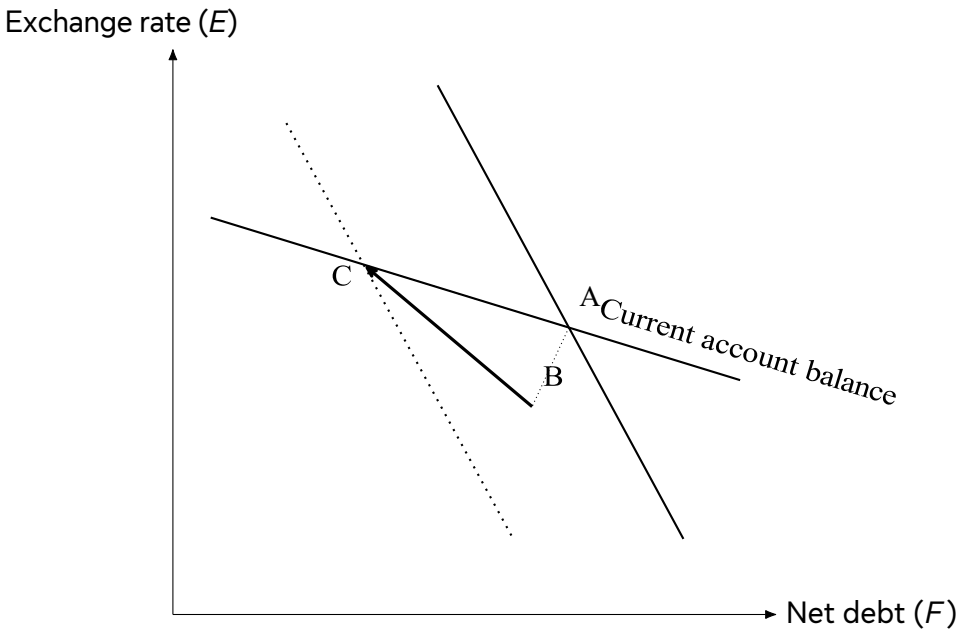


Figure 13 illustrates the effects of a shift away from US assets. On impact, at a given level of foreign debt, portfolio balance requires a fall in the exchange rate (point B). This triggers an improvement in the trade balance which over time lowers US net debt. In the new steady state (relative to the old one) the USD is appreciated and foreign debt is lower. The USD is lower because foreign debt is lower and thus a smaller trade surplus is needed to pay the interest on the lower stock of debt.

Figure 13: A shift away from US assets



What happens to the dollar initially depends on the relative size of the two shocks: an appreciation in the case of the tariff shock, a depreciation in the case of the portfolio shock. Then, in both cases, along the adjustment path the dollar appreciates while net foreign debt falls.

This paper examines ECB monetary policy amid rising international uncertainty. We focus on three global risks: renewed trade protectionism, euro appreciation, and US fiscal fragility. Using inflation forecasts and survey data, we evaluate the ECB's evolving policy framework. A potential US fiscal crisis poses risks but also creates an opportunity for Europe to supply a global safe asset. We argue that a European Debt Agency issuing common debt could mitigate contagion and enhance Europe's financial sovereignty.

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