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Price stability & risks: Benign outlook vs potential concerns

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STUDY

Requested by the ECON Committee

Monetary Dialogue Papers, February 2026



Price Stability & Risks

Benign outlook vs potential concerns



EGOV
MONETARY POLICY

External authors:
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Volker WIELAND



Price Stability & Risks

Benign outlook vs potential concerns

Abstract

The ECB anticipates stable growth and inflation, while Europe is faced with geopolitical threats, lack of competitiveness and fiscal challenges. At such a time, central bankers need to consider the dynamics of risk scenarios that arise from potentially mis-aligned or mis-perceived trends and policy-relevant parameters and prepare for timely policy responses. This paper focusses on potentially unsustainable fiscal trends, potential growth misperceptions and their implications for inflation developments and the policy stance. It highlights risks for fiscal inflation in the euro area.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 26 February 2026.

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

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LIST OF ABBREVIATIONS

AMECO	European Commission Annual Macro-Economic Database
APP	Asset Purchase Programme
BMF	German Federal Ministry of Finance (Bundesministerium der Finanzen)
CES	Consumer Expectations Survey
CPI	Consumer price index
DFR	Deposit facility rate
DSA	Debt Sustainability Analysis
DSM	Debt Sustainability Monitor
EA	Euro area
ECB	European Central Bank
ETS2	Emissions Trading System 2
EU	European Union
Euribor	Euro Interbank Offered Rate
Fed	United States Federal Reserve
FOMC	Federal Open Market Committee
FRED	Federal Reserve Economic Data
GDP	Gross domestic product
HICP	Harmonized index of consumer prices
IMF	International Monetary Fund
IMF WEO	International Monetary Fund World Economic Outlook
LSEG	London Stock Exchange Group
MRO	Main refinancing operation
NATO	North Atlantic Treaty Organization

NBER	National Bureau of Economic Research
NEER	Nominal effective exchange rate
OIS	Overnight index swap
OW	Orphanides and Wieland (2013)
PCE	Personal Consumption Expenditure
PEPP	Pandemic Emergency Purchase Programme
QT	Quantitative tightening
REER	Real effective exchange rate
SAFE	Survey on the access to finance of enterprises
SMA	Survey of Monetary Analysts
SPF	Survey of Professional Forecasters
STR	Euro Short-Term Rate (€STR)
TPI	Transmission Protection Instrument
US	United States
USD	United States Dollar

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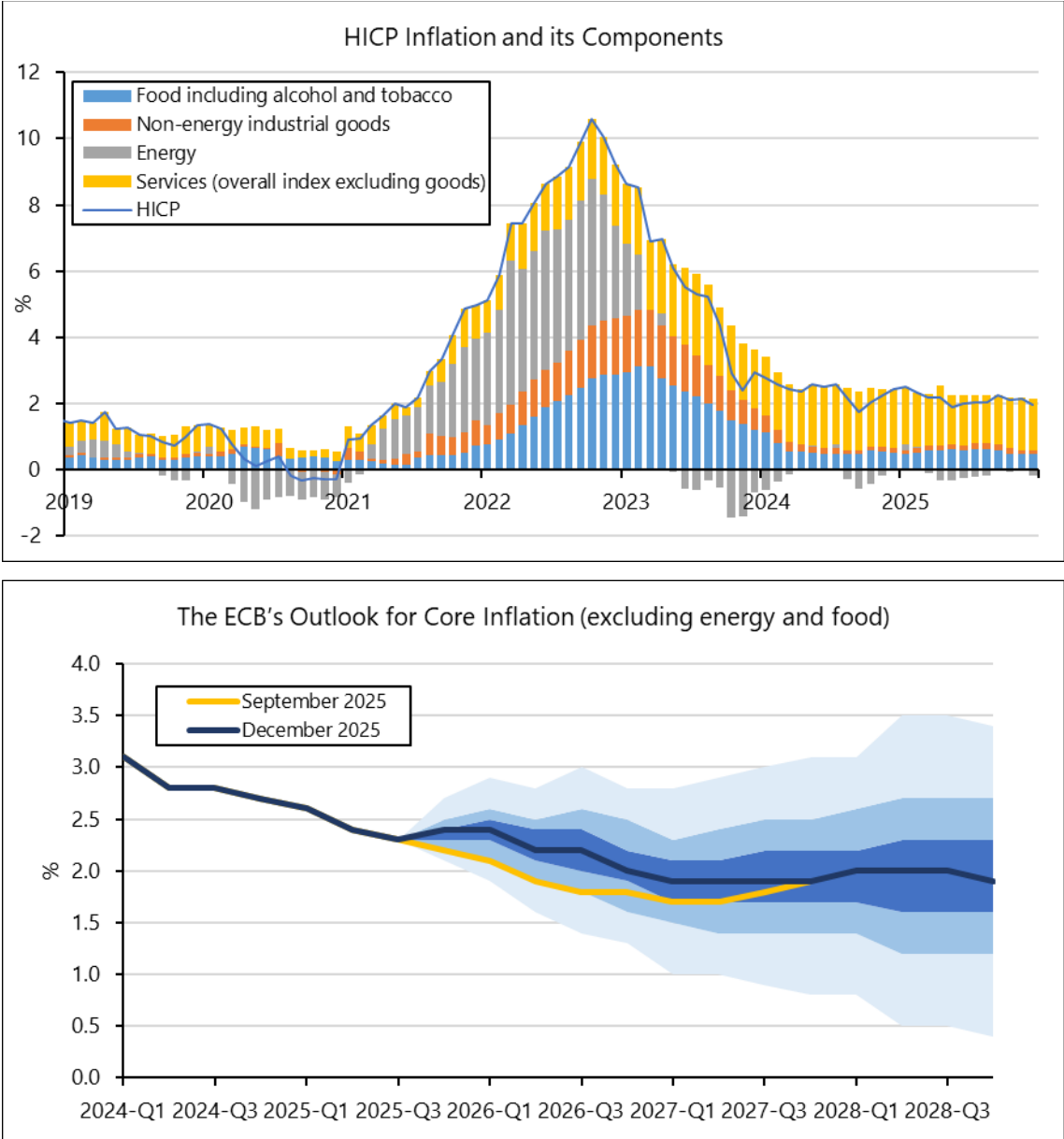
EXECUTIVE SUMMARY

- **The ECB anticipates a benign outlook for growth, employment and inflation in the euro area.** Inflation has converged close to the ECB's numerical target of 2% and is expected to remain close to 2% over the forecast horizon which extends to the end of 2028. Preliminary GDP flash estimates indicate an annual growth rate of 1.5% for 2025 and the ECB projects growth to stabilize at 1.4% by the end of the forecast horizon. Its forecast is consistent with stable money market rates slightly above 2%. Thus, there appears to be little need to change policy rates. Similarly, the recent Survey of Professional Forecasters (SPF) sees longer-term growth at 1.3%, inflation at 2% and policy rates only slightly above 2%, implying a real rate a bit above 0%.
- **Feeding the ECB's forecasts into simple policy rules also suggests that policy may settle near the current interest rate setting.** Simple Taylor rules with an equilibrium real interest rate between 0% and 0.5% are consistent with such a stable and benign outlook. However, these rules can also be used to assess the need for policy responses should there be misperceptions regarding key unobservable variables or parameters underlying the outlook.
- **Europe is faced with geopolitical threats, a loss of economic competitiveness and substantial fiscal challenges.** Thus, the international environment is likely to exhibit significant changes in the future, the European economies are likely to undergo major structural change and fiscal policies may well have to change too. Furthermore, if the past is any guide, stable and benign outlooks are rarely confirmed by subsequent events. Monetary policy decisions should not depend on forecasts beyond a three- to four-quarter horizon.
- **ECB communications and reports list a range of potential risks and shocks that could disturb the benign outlook in one or the other direction.** For these reasons, their forecasts recognize substantial uncertainty bands already one or two years out in the future. Yet, central bankers need to go further in mapping out the dynamics of (worst-case) risk scenarios that may arise from potentially mis-aligned or mis-perceived trends and policy-relevant parameters and prepare for timely policy responses.
- **This paper explores potentially unsustainable fiscal trends and misperceptions** regarding unobservables such as potential growth and equilibrium real interest rates. It analyses their implications for inflation developments and the policy stance.
- **Several euro area Member States exhibit high fiscal deficits and/or rising debt to GDP ratios.** The rise in debt ratios is reinforced by rising interest expenditure. Public finances would benefit from lower interest rates and higher inflation. Hence, there is a potential for conflict with the ECB and for direct or indirect political pressures on monetary policy. Historically, there are many examples of fiscally driven inflation resulting from high and rising public debt including cases with central banks strongly focussed on price stability.
- **The ECB should assess and communicate how high and rising public debt ratios may affect the medium-term inflation outlook.** It is appropriate to emphasize the need for sustainable and resilient public finances, fiscal consolidation in the face of high debt ratios and effective implementation of the EU fiscal framework as a prerequisite for the maintenance of price stability.
- **Tightening policy in an environment with vulnerable fiscal positions will meet with much opposition.** Thus, the ECB should avoid undue policy easing and respond to early signs of inflationary pressure before more aggressive tightening becomes necessary.

1. INFLATION CONVERGENCE AND THE ECB'S BENIGN OUTLOOK

Inflation measured by the Harmonized Index of Consumer Prices (HICP) **declined** to 1.7% in January, down from 2.0% in December and 2.1% in November. Core inflation has eased to 2.2% (after 2.3% in December and 2.4% in November) but remains above the ECB's 2% target. Core inflation is particularly relevant to assess inflation persistence, because it excludes the volatile energy and food prices. Services inflation continues to be the main contributor to inflation and exhibits greater persistence than goods price inflation as shown in the upper panel of **Figure 1**. Services, in particular, reflect persistent wage inflation.

Figure 1: Inflation Developments and the ECB's Outlook



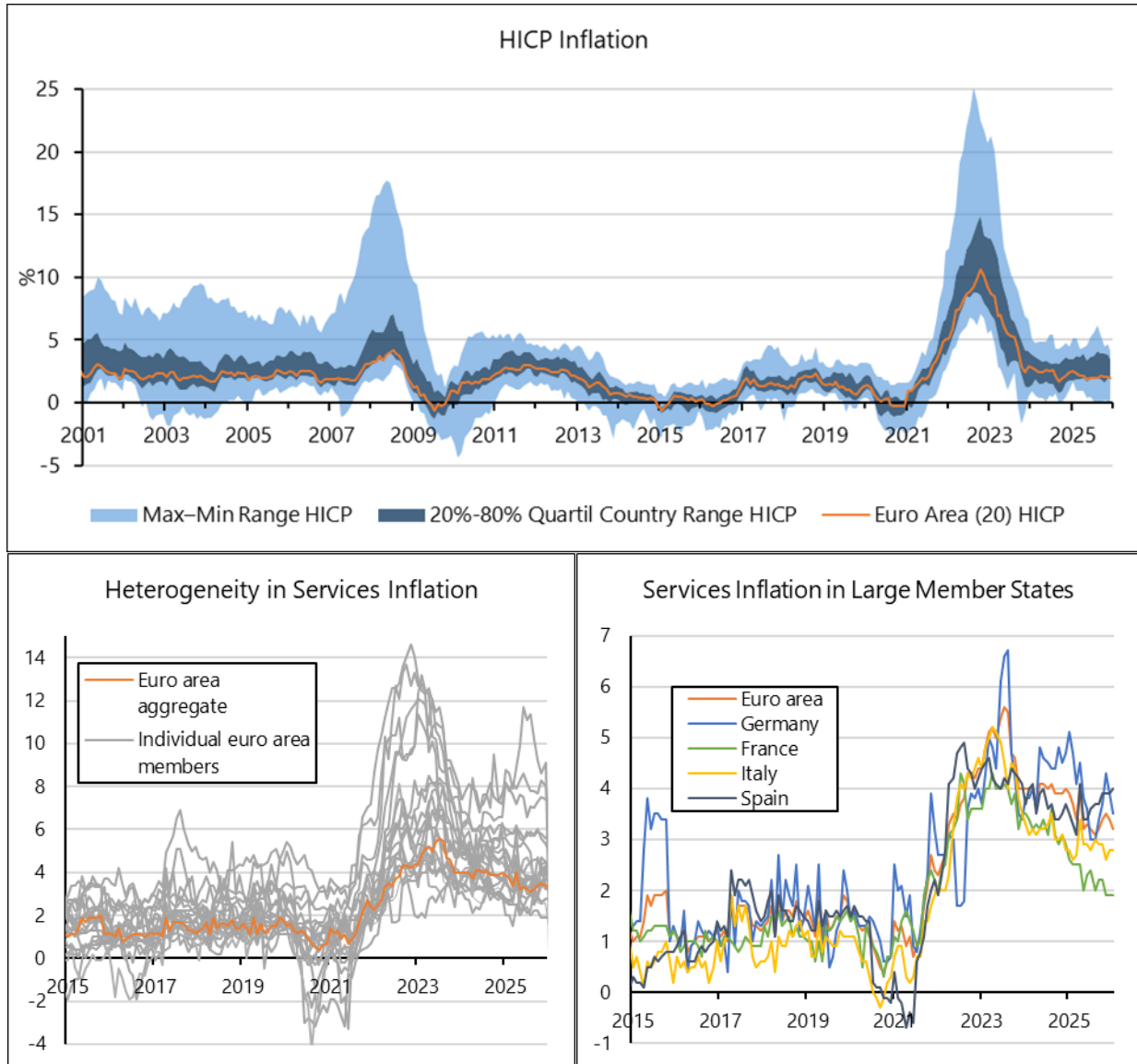
Note: In the ECB outlook for core inflation, the bands, from darkest to lightest, depict the 30%, 60%, and 90% probabilities that core HICP will fall within the respective intervals.

Sources: Eurostat and ECB staff forecast.

The ECB's staff forecast from December 2025 has **core inflation stabilizing** at the ECB's target (**Figure 1**, lower panel). The anticipated undershoot below 2% from previous projection rounds has mostly been revised upwards. The recent SPF and Survey of Monetary Analysts (SMA) forecasts of HICP inflation are also stable near the 2% target.

Cross-country **dispersion in HICP inflation has narrowed** markedly compared to the 2022 peak as shown in **Figure 2** (top panel). Yet, it is still above the level observed prior to the inflation surge. Services inflation accounts for most of the remaining inflation differentials across Member States. In the large economies, it is between 4% in Germany and Spain about 2% in France.

Figure 2: Heterogeneity in HICP Inflation Across Euro Area Members

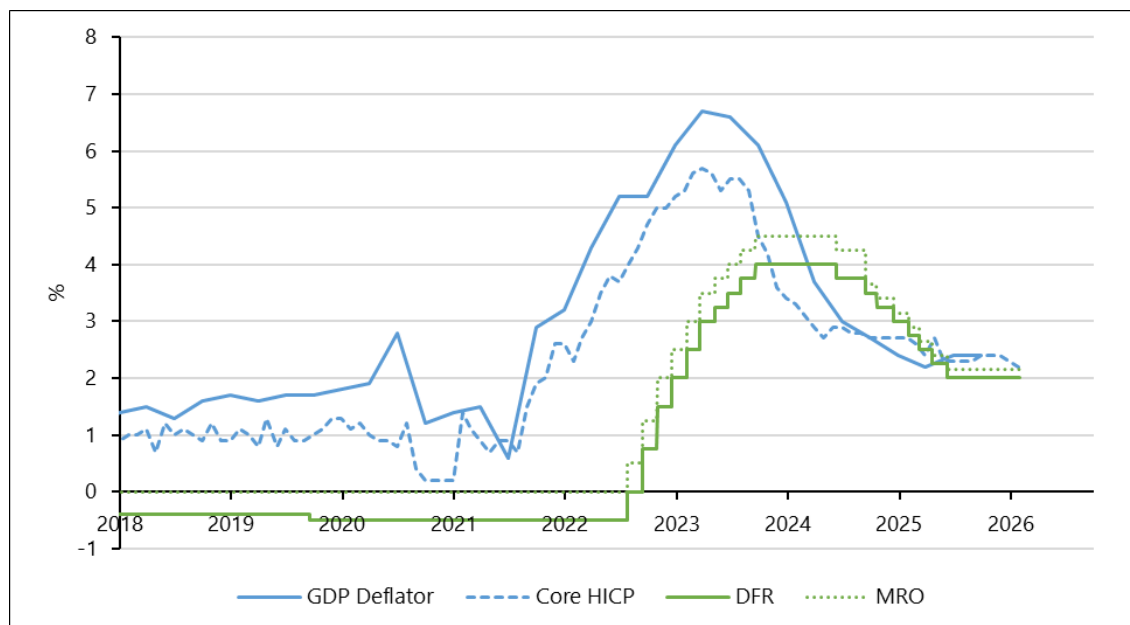


Source: Eurostat.

Domestic inflation as measured by the GDP deflator has also declined substantially but remains above 2%, with the most recent observation from the third quarter of 2025 at 2.4%. It is shown together with core HICP inflation and ECB interest rates in **Figure 3**.

The ECB has lowered its **key policy rate**, that is the deposit facility rate (DFR) to 2% and has held it at that level since June 2025. Hence, the safe short-term real interest rate is close to 0% or slightly negative depending on the inflation rate chosen for its computation.

Figure 3: Inflation and Interest Rates in the Euro Area



Source: Eurostat and ECB.

In fact, the ECB’s inflation projection is computed on the basis of the assumption that 3-month Euribor **rates remain quite stable** at levels slightly above 2%. Its GDP forecast is 1.4% in 2025 (recently a flash GDP estimate of 1.5% has become available¹), 1.2% in 2026 and 1.4% in 2027 and 2028. Similarly, the recent SPF sees longer-term growth at 1.3%, inflation at 2% and policy rates (DFR) only slightly above 2%, implying a real rate a bit above 0%.²

Table 1: The Stable Outlook for GDP Growth, Inflation and Interest Rates (DFR)

Forecasts and Measures			2025	2026	2027	2028
ECB:	Core Inflation/GDP Growth/Interest		2.4/1.4/2.2	2.2/1.2/2.0	1.9/1.4/2.1	2.0/1.4/2.3
SPF:	Core Inflation/GDP Growth/Interest			2.0/1.2/2.0	2.0/1.4/2.1	2.0/1.3/2.2

Source: ECB

This **remarkably stable outlook** by the ECB and professional forecasters suggests that there may be little need for adjusting monetary policy in coming years. Implied real interest rates stabilize at near zero or slightly positive levels. Stability appears to reign. This is a seemingly comfortable situation for the monetary union’s central bankers. It suggests that **policy can stay on hold**, they can observe developments and take time before making any adjustments to policy.

¹ See, [Eurostat, GDP and employment flash estimates for the fourth quarter of 2025, 13 February 2026.](#)

² See, [ECB Survey of Professional Forecasters - First quarter of 2026, 6 February 2026.](#)

Such stability is surprising given the volatile geopolitical and economic environment. One explanation may be that there is a large degree of uncertainty, but prevailing risks are perceived to have offsetting effects on the inflation outlook.³ Another explanation may be that forecasters simply do not know much about the direction of possible effects. In any case, the confidence bands of these projections are already quite wide a few quarters out (for further discussion, see section 3).

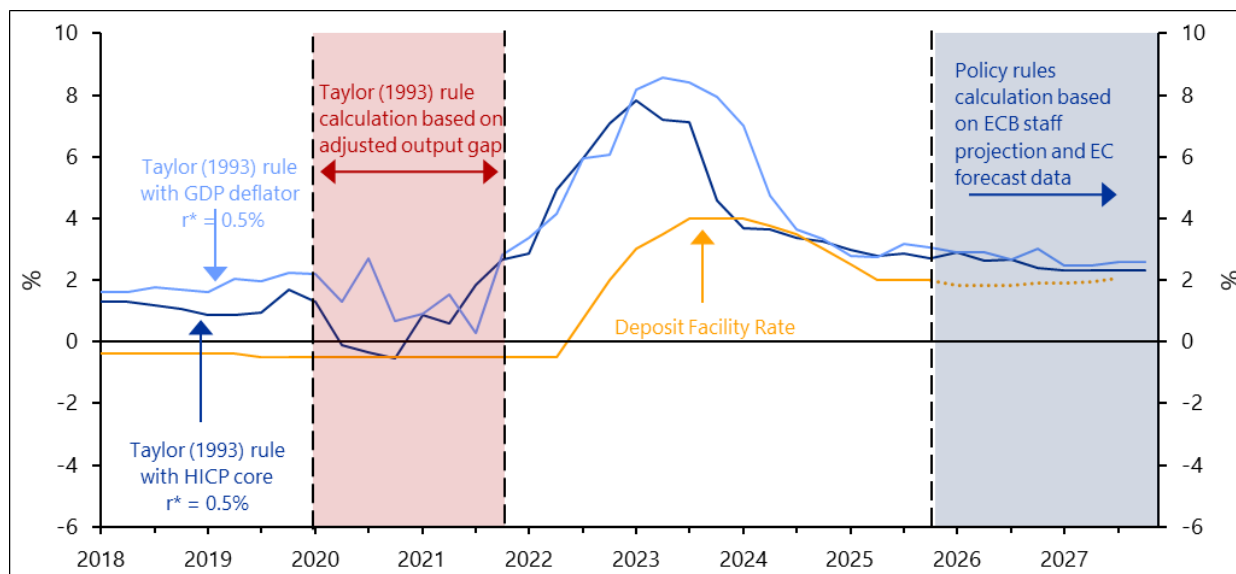
Furthermore, there are **policy-relevant variables and parameters** that underlie this outlook but are **themselves unobservable**. This includes, for example, potential GDP growth, the output gap and the equilibrium real interest rate. These are often denoted as **"star" ("*") variables**, in order to illustrate that they are associated with some form of steady state but remain fundamentally unobservable and therefore need to be estimated on the basis of data on observable variables and modelling assumptions. A straightforward approach for assessing the role of such unobservables consists of combining the economic outlook with simple policy rules.

³ ECB communication has recently characterised risks to the inflation outlook as broadly balanced (ECB, February 2026).

2. POLICY STANCE, RULES AND UNOBSERVABLES

In an earlier paper for the European Parliament (Hegemann and Wieland, 2025), we have introduced several simple interest rate rules and applied them to the COVID-19 pandemic period and the inflation surge.⁴ Here we report updates of those rules and **project their interest rate prescriptions for the euro area using forecasts** from the ECB, the SPF and the European Commission. The first rule is the well-known Taylor (1993) rule applied to the euro area as in Tatar and Wieland (2025) and shown in **Figure 4**.

Figure 4: Taylor (1993) Rule applied to Euro Area



Note: The adjusted output gaps equal to one eighth of the original gaps. The calculation of the forecasted values is based on the ECB staff macroeconomic projections and the European Commission's forecasts. Since the deflator series are available only with a delay of over two months, for the calculation of the policy rules the GDP deflator series are lagged by one period. The forecasted values for the ECB's deposit facility rate refer to the 1-month Euro Short Term Rate (STR) forward rates which were derived from the Euro STR Overnight Index Swap (OIS) Rates on February 5, 2026 and refer to the third month in the quarter, respectively.

Source: Eurostat, ECB, European Commission, LSEG/Refinitiv, Wieland and Tatar (2025) and authors' calculation.

The rule includes an equilibrium real interest rate r^* , the inflation rate and target and the output gap—the deviation of actual GDP from potential GDP q_t^* . The response coefficients on the gaps are 0.5. GDP deflator and core HICP are used as inflation measures. We do not use headline HICP to avoid reacting to volatile energy prices. The output gap is calculated using the European Commission's estimate of potential GDP. The resulting estimate stands at 0.2% by 2027. For r^* we consider 0.5%, which was the upper value in Tatar and Wieland (2025). **Figure 4** shows that the prescriptions for those rules settle somewhat above 2% and the current 1-month Euro Short Term Rate (STR) forward rates (yellow, dotted) by 2027.

The prescriptions from the Taylor rule are to be understood in a normative sense. The Taylor rule has a number of desirable characteristics such as guaranteeing long-term stability of inflation in a wide range of macroeconomic modelling frameworks. US and euro area monetary policy were close to prescriptions from the Taylor rule in some historical periods that were associated with fairly stable outcomes for inflation and economic activity. Finally, the rule has delivered useful warning signals. For

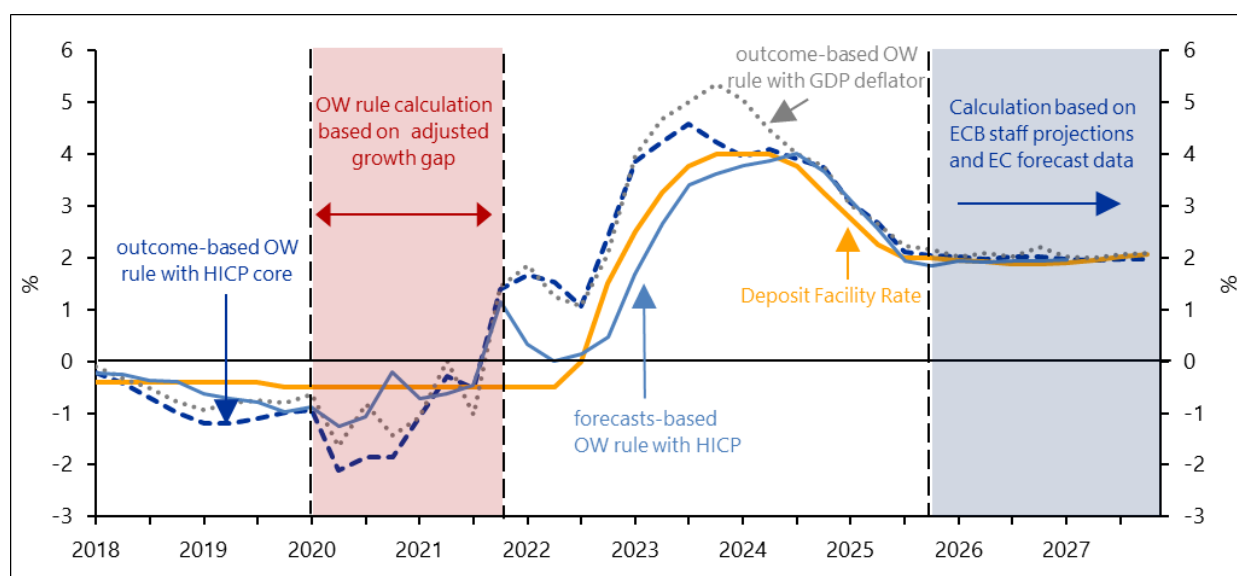
⁴ For further information, see also Tatar and Wieland (2025) and references therein.

example, **Figure 4** shows that the Taylor rule would have prescribed an earlier response to the rise of inflation in 2021.

At the current juncture the rule suggests that ECB policy could be a bit tighter. Of course, this conclusion depends on the particular value chosen for the unobservable equilibrium real interest rate r^* . If one were to use a lower value, the interest rate prescriptions would shift down one-for-one. Thus, a value of r^* **closer to 0% would put the anticipated prescriptions for 2026 and 2027 closer to 2%**, thereby suggesting that policy could essentially remain unchanged for quite some time.

By contrast, a first-difference interest rate rule would not require an estimate of r^* as emphasized by Orphanides and Wieland (2013). Its prescriptions are not sensitive to the policymakers' view on the appropriate r^* . Nor does it need an estimate of the level of potential GDP. An estimate of the growth rate of potential GDP suffices. **Figure 5** shows three variants of the OW rule as in Tatar and Wieland (2025).

Figure 5: Forecast- and Outcome-based Orphanides–Wieland Rule



Note: The adjusted output gaps are equal to one-eighth of the original gaps. The forecasted values are based on the ECB's macroeconomic projections and the European Commission's forecasts. Since the deflator series are published with a delay of over two months, the GDP deflator series is lagged by one period for policy rule calculations. Forecasts for the ECB's Deposit Facility Rate correspond to the 1-month Euro STR forward rates, derived from Euro STR OIS rates as of February 5, 2026. These rates refer to the third month of each quarter.

Source: Eurostat, ECB, European Commission, LSEG/Refinitiv, Tatar and Wieland (2025) and authors' calculation.

The blue line in **Figure 5** corresponds to the original OW rule with SPF forecasts for inflation and actual GDP growth. This rule has matched past ECB policy quite well.⁵ Additionally, **Figure 5** shows two outcome-based versions of the OW rule, with outcomes for core-HICP and domestic (GDP deflator) inflation. These two versions provided useful signals for the need of an earlier ECB policy tightening in 2021 as discussed in Tatar and Wieland (2025). Such outcome-based rules also performed better in the model-comparison analysis conducted by Orphanides and Wieland (2013).

All three variants of the OW rule make use of the European Commission's estimate of potential growth. For 2027 the Commission estimates a **potential growth rate of 1.2%**, which is little below the SPF

⁵ See, for example, Bletzinger and Wieland (2017).

forecast and ECB forecast for GDP growth. Hence the growth gap contributes little to the interest rate prescription. Similarly, the anticipated inflation gaps remain near zero for 2027 and 2028.

The rules shown in **Figure 4** and **Figure 5** indicate no major need for changing the policy setting. Of course, this is not surprising given the near-zero inflation, output and output growth gaps resulting from the stable outlook. However, **policy rules can be very useful for exploring the direction and the extent of policy responses** that would become necessary if these inputs change. This would be the case, if inflation or economic activity develop differently from the forecasts, or, and this is quite important in the current situation, **if policy-relevant but unobservable variables or parameters are different from the estimates** underlying the economic outlook.

Consider the following **example concerning the potential growth and r^*** estimates. In simple real economic models, the growth rate of real economic output in a longer-run equilibrium or steady state is closely related to the long-term real interest rate r^* . Unless there are other factors pushing down r^* , a potential growth estimate of 1.3%, which is largely driven by productivity growth, would imply a higher real rate than the long-run estimate of close to 0% that is incorporated in the economic outlook discussed in section 1.⁶

Accordingly, **a nominal interest rate of 2% would be too low** for inflation and GDP growth to remain stable. Inflation would rise and policy rules call for tightening. There may be other factors holding r^* down such as an increase in life expectancy and related savings incentives or a contractionary fiscal policy resulting in lower sovereign borrowing. Yet, if these factors change, the current policy stance would be too accommodative, and the rules would call for tightening policy either because the r^* estimate is adjusted or because inflation and economic activity turn out stronger than anticipated.

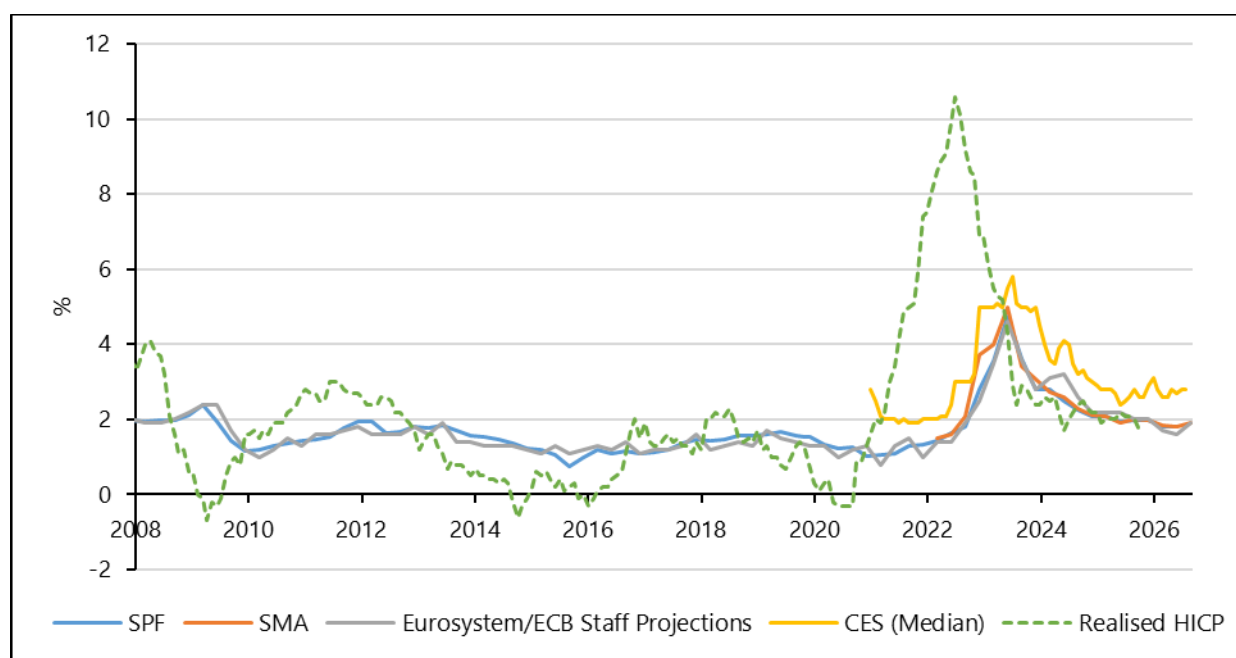
⁶ See also Beyer and Wieland (2019) for further analysis of the implications of inconsistent use of equilibrium real interest rates in monetary policy.

3. REALITY OF MAJOR CHALLENGES AND RISKS

While the ECB and professional forecasters expect output growth, inflation and interest rates to remain fairly stable through 2028, Europe is currently faced with geopolitical threats, a loss of economic competitiveness and major fiscal challenges. Thus, the international environment is likely to exhibit substantial changes in the future, the European economies are likely to undergo major structural change and fiscal policies may well have to change too. As a consequence, it is not very likely that output growth, inflation and interest rates remain stable over the forecasting horizon.

Of course, ECB economists and professional forecasters understand that. Their forecasts are characterised by substantial uncertainty. For this reason, the Eurosystem staff's projections (from December 2025) of core inflation shown in the **lower panel of Figure 1** indicates rather wide uncertainty bands, stretching from 0.5% to 3.5% by mid-2028. Thus, there is substantial uncertainty even concerning the most persistent components of inflation. These bands underscore the limited information content of those forecasts, especially beyond a horizon of 3 to 4 quarters. Furthermore, past history of inflation forecasts for the euro area shows that at a one-year-horizon actual inflation most of the time turned out quite different from forecasts as shown in **Figure 6**. Often times, these differences also exhibited substantial persistence. In fact, it is a fairly robust finding of research on monetary policy, that central bank interest rate decisions should not give much weight to forecasts beyond a 3 to 4 quarter horizon.⁷

Figure 6: History of HICP Inflation Forecasts One Year Ahead versus Actual HICP Outcomes



Source: Eurosystem/ECB Staff Projections, ECB Survey of Monetary Analysts (SMA), ECB Survey of Professional Forecasters (SPF) and ECB Consumer Expectations Survey (CES).

The stable outlook with symmetric uncertainty bands, however, also indicates **confidence that the probabilities** of potential upside and downside deviations from the outlook are roughly equal. Accordingly, the ECB lists different risks, potential disturbances and shocks in its communications and reports but concludes that these are **roughly balanced** (see ECB, February 2026).

⁷ See, for example, Levin et al (2003), Wieland et al (2017) and Conrad et al (2025).

However, at such a time, central bankers also need to **go further in mapping out the dynamics of (worst-case) risk scenarios** that may arise from potentially mis-aligned or mis-perceived trends and policy-relevant parameters and prepare for timely policy responses. Scenario analysis could also be used in ECB communication.

The ECB publishes **ECB accounts** which summarise discussions by ECB Governing Council members at monetary policy meetings.⁸ While the accounts for the December 2025 policy meeting suggest that some members contributed arguments concerning various risk scenarios, this type of summary communication is **not conducive to explain the dynamics of such scenarios in an effective manner**. The summaries published do not map out scenario dynamics and resulting potential for policy mistakes. The risks and scenarios mentioned in the accounts would still appear to be covered under the Governing Council statement that the risks to the outlook are balanced.

In the remainder of this section, we first go through a range of potential risks, most of which are also mentioned at least briefly in recent ECB communications.⁹ Then we take a closer look at diverging dynamics in the US and the euro area and the implications of the euro appreciation.

Finally, in the next section, we explore in more detail particular risk scenarios arising from potentially unsustainable fiscal trends, potential growth misperceptions and their implications for inflation developments and the future policy stance.

3.1. Risks to the outlook that the ECB sees as balanced

Upside and downside risks mentioned in ECB communications include the following:

Inflation upside risks

- **Services inflation persistence:** Services inflation has been high and is closely linked to wage dynamics. Wage pressures may ease more slowly than currently expected by the ECB. Hence, services inflation would stay elevated.
- **Wage surprises:** The ECB sees wage moderation underway but considers the wage drift to remain quite uncertain. Hence, services inflation may decline more slowly.
- **Supply-side / geopolitics / fragmentation:** Renewed supply-chain fragmentation, critical raw material constraints, and capacity bottlenecks (including in defence and construction) could push up import prices and/or domestic costs.
- **Stronger fiscal impulse:** Defence and infrastructure spending could add more demand pressure than anticipated so far, and, if it hits sector capacity, lift inflation over the medium term.
- **Climate/food shocks:** Extreme weather events and broader climate/natural crises could push food prices up by more than assumed in the ECB outlook.

Inflation downside risks

- **Trade-driven disinflation:** Tariffs could weaken external demand for euro area exports more than anticipated and trade diversion from China and other economies with excess capacities could depress prices more strongly than accounted for.
- **Stronger euro:** According to the ECB, the appreciation of the euro since last year has been taken into account in the economic outlook. However, the euro could appreciate further,

⁸ The accounts are typically published four weeks after the meetings.

⁹ These communications include, in particular, the Monetary Policy Statement (including the Q&A, 18 December 2025), Monetary Policy Statement (including the Q&A, 5 February 2026) and the Governing Council account (29–30 October 2025) and the Eurosystem staff projections from December 2025.

lowering import prices and reducing external demand for euro area goods. This would have an additional negative effect on euro area activity and inflation.

- **Financial risk-off shock:** A deterioration in global financial sentiment, perhaps triggered by developments in the US, could also render financing conditions in Europe more restrictive and reduce euro area aggregate demand.
- **“Leontief input” disruption channel:** If scarcity of certain key inputs (e.g., rare earths) constrain production to a significant extent and lead to a substantial reduction in work and output, the dominant effect could be lower activity and disinflation instead of higher inflation.

Growth upside risks

- **Domestic-demand engine:** Rising real incomes and a gradual fall in the savings rate, which is still rather high, could unlock stronger consumption demand than anticipated so far.
- **Investment upside, including AI:** A surprise boost to investment, with a notable role for AI-related capital expenditure and IT modernization could accelerate GDP growth.
- **Public investment:** Sustained and more extensive infrastructure and defence spending could boost growth with spillovers across economies.
- **Confidence effects:** Easing of trade tensions could improve confidence and bring forward private spending and investment.

Growth downside risks

- **Global trade drag / tariff uncertainty:** Even if tensions have eased somewhat, the volatile trade environment could continue longer than expected to weigh on the economy.
- **Geopolitical shocks:** Uncertainty about the Ukraine war and continued geopolitical risks remain a major channel for negative effects on confidence, energy, and trade.
- **Household savings staying high:** If households keep saving, consumption may disappoint despite real income gains.
- **Capacity constraints:** If defence and construction hit bottlenecks, they may lead primarily to higher prices in these sectors rather than the extent of real growth that is anticipated.

As noted in the **risk balance assessment** ([February 2026](#)) the ECB Governing Council currently sees the inflation and growth risks it considers as **broadly balanced**. However, this should not prevent the Governing Council from exploring the dynamics of particular worst-case scenarios in its deliberations. Such **scenarios may well turn out to give more weight to a particular direction of adverse developments**. While probabilistic assessments may remain elusive at the current juncture, such analysis would help being prepared to take swift steps in a particular direction when such scenarios become more evident.

Next, we evaluate exchange rate developments that have been highlighted in the media. Then, we will move on to look in much more detail at fiscal trends and the resulting risks for fiscally driven inflation.

3.2. Exchange rate appreciation and US–euro area interest rate divergence

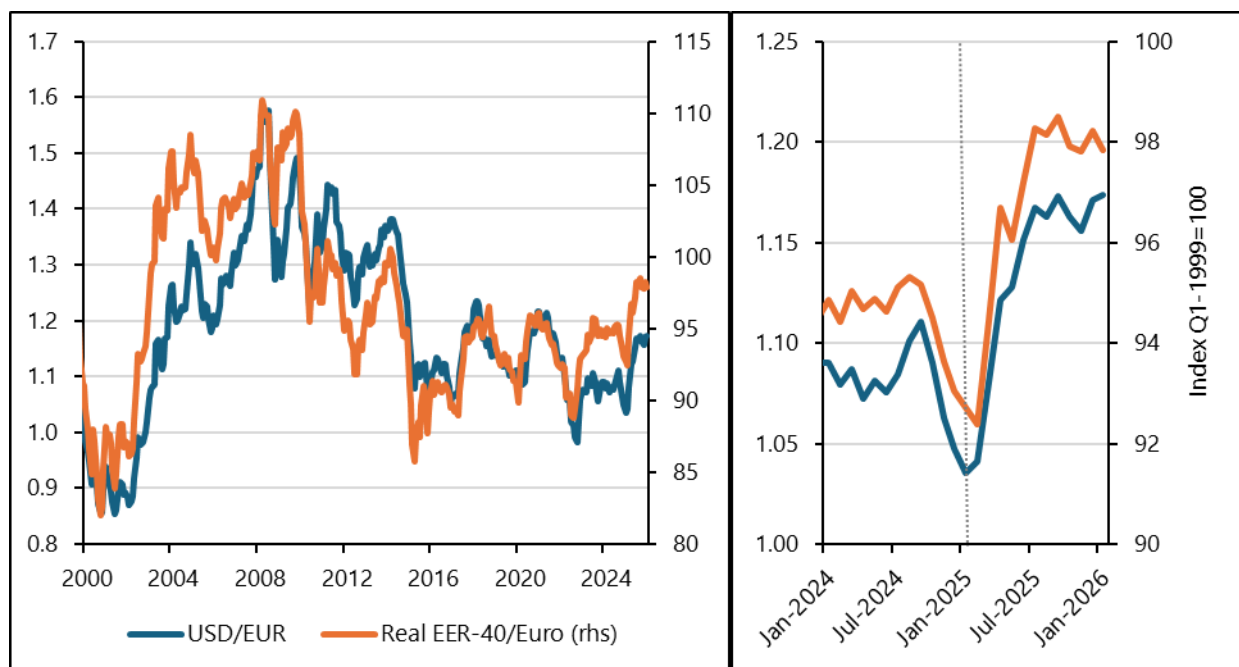
Since the beginning of 2025 the euro has gained in value relative to the US Dollar, from 1.03 US Dollars on January 4, 2025, to 1.19 US Dollars on February 11, 2026. An increase of about 10 US cents happened within three months of the tariff announcement of President Trump on “Liberation Day” in April 2025. This is a substantial appreciation of the euro as shown in **Figure 7**. It ran counter to expectations that an increase in tariffs on imports to the US would be partially counteracted by an appreciation of the US Dollar. Overall, the euro has appreciated by about 5% in real terms vis-à-vis major trading currencies. Neither of these movements is unprecedented. As shown in **Figure 7**, the euro last reached 1.20 US Dollars in May 2021 and in January 2018. Its peak of almost 1.60 US Dollars occurred in May 2008.

Similarly, the real effective exchange rate had substantially exceeded its current value between February 2003 to May 2010. Even so, the recent appreciation weighs on economic activity and inflation.

ECB research (Ortega and Osbat, 2020) reviewing empirical findings on exchange rate pass through to import prices and euro area inflation suggests that a 1% change in the nominal effective exchange rate (NEER) is associated with an impact on HICP inflation of roughly 0.01 to 0.1 percentage points over a horizon of about one year. In 2025, the NEER appreciated by approximately 6 to 8%. An ECB sensitivity analysis published in the [Eurosystem staff projections in December 2025](#) indicates that a 1% change in the USD/EUR exchange rate corresponds to a change in HICP inflation of around 0.025–0.05 percentage points. In the [ECB press conference on 5 February 2026](#), President Lagarde emphasised that anticipated exchange rate developments are already incorporated into the inflation projections. The baseline assumes a constant USD/EUR exchange rate of 1.16 through 2028 (compared with a current level of around 1.18).

Thus, the euro appreciation that has occurred so far is reflected in the current ECB outlook. However, the magnitude of geopolitical shocks and threats, the pressure exerted on the Federal Reserve to lower interest rates and structural challenges for European economies all carry the potential to lead to further exchange rate volatility.

Figure 7: Exchange Rates



Source: ECB Data Portal.

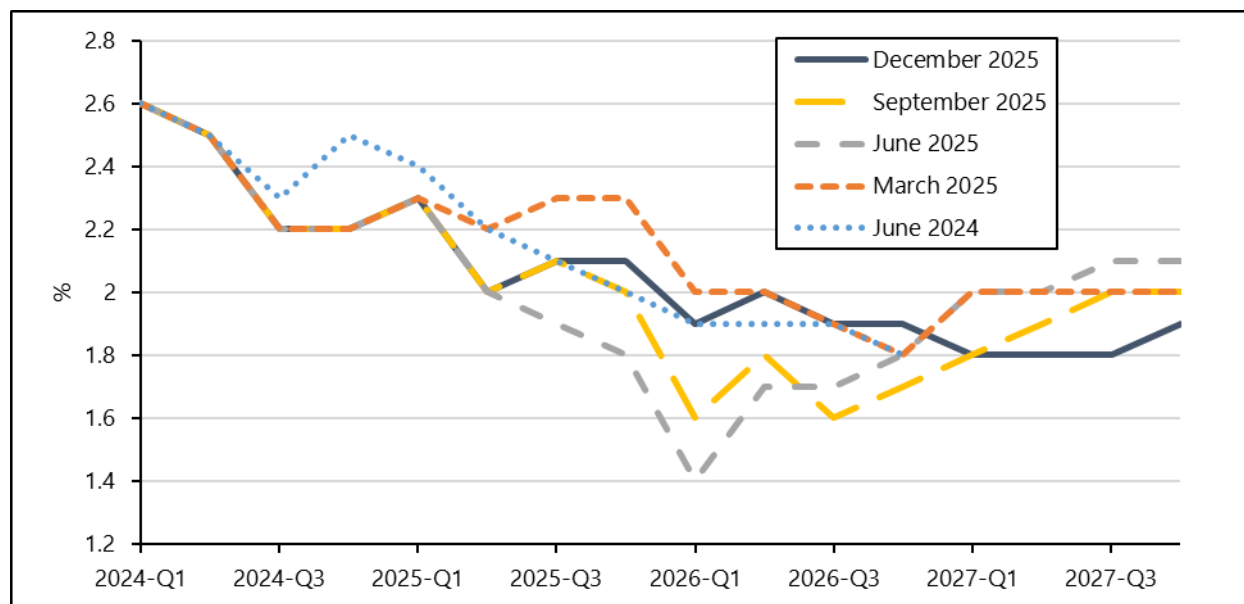
Generally, exchange rate changes are not very predictable. Hence, it is sensible to produce forecasts on the basis of constant exchange rates. Yet, policy makers may still give different weights to risk scenarios resulting from changes in different directions. Although the euro appreciation must have produced some downward pressure on euro area inflation, the ECB had to revise its earlier projection of a sustained undershoot of core inflation. This becomes clear if one considers the sequence of ECB and Eurosystem staff projections over time as shown in **Figure 8**.

Consequently, a moderate additional euro appreciation would simply tend to push down the core inflation forecast towards the modest undershoot of the target that the ECB had anticipated last spring. Back then, that anticipation of undershooting may well have been an argument for lowering

policy rates to the level that prevails now. Hence, one might argue the ECB has already bought insurance against the effect of additional euro appreciation by lowering the DFR to 2% by June 2025.

By contrast, a depreciation would have core inflation remain above the 2% target for quite a bit longer and may call into question lasting convergence of inflation to the target from above. This may serve as an example, that the **cost-benefit analysis of divergences** from assumptions used in the forecast may be perceived differently from the probabilistic uncertainty bands derived under technical assumptions around the outlook.

Figure 8: Eurosystem/ECB Staff Projections HICP Inflation Excluding Energy and Food



Source: Eurosystem/ECB Staff Projections.

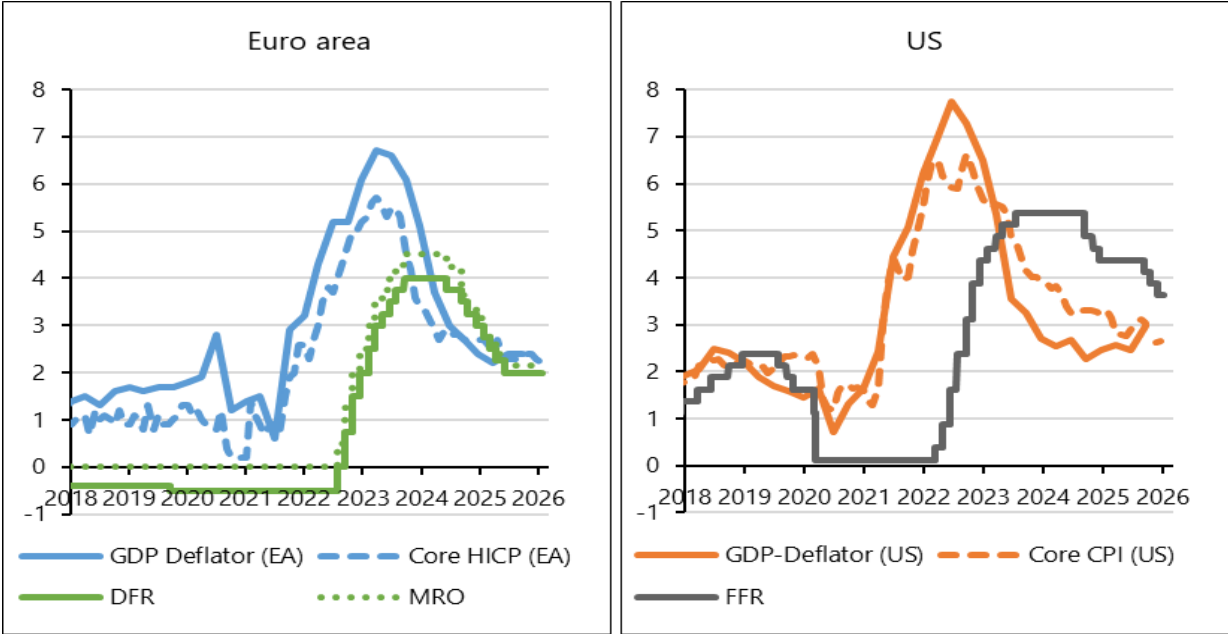
Furthermore, a **comparison of inflation and interest rate levels in the euro area versus the US** may serve to highlight additional risks. The broadest measure of domestic inflation, that is the GDP Deflator, remains above 2% in both economies as shown in **Figure 9**. In the US, it is even tilting up a bit in the course of 2025. This may be due to higher tariffs¹⁰ pushing up domestic inflation, or it may be due to expansionary fiscal policy (tax cuts and tax reform) increasing government borrowing and inflation.

The policy stance, however, is very different. While the ECB lowered the policy rate most relevant for money markets, that is the DFR, to 2%, the Fed's target range for the federal funds rate remained much higher and was only reduced slowly. As of February 21, 2026 it still stands at 3.5 to 3.75%.¹¹ Thus, there is a **marked divergence of US and euro area policy rates** as can also be seen from **Figure 9**.

¹⁰ Empirical counterfactual estimates (Cavallo et al, 2025; Dvorkin et al, 2025) indicate that tariffs contributed several tenths of a percentage point to US headline and core inflation in mid-2025 relative to a scenario without tariffs. The cumulative impact on CPI has approached around 1 percentage point by early 2026, indicating measurable inflationary effects. This may have induced second-round effects in domestic inflation. ECB staff projections had incorporated a marked Q3 2025 euro area GDP slowdown due to US tariffs and the expected reversal of earlier export frontloading; in the event, growth proved stronger, as the anticipated payback effects did not materialise to the projected extent. According to the recent Eurosystem staff projections, much of the forecast deviation was attributable to Ireland and volatility from the Irish pharmaceutical sector which weighed on the euro area aggregate. Excluding Ireland, underlying growth dynamics were more stable.

¹¹ See, Federal Reserve Bank of New York, [Federal Funds Data](#).

Figure 9: Inflation and Interest Rates in the Euro Area and the US



Source: Eurostat and FRED.

At the same time, the **projections** of the members of the US Federal Open Market Committee (**FOMC**) also suggest a **fairly stable outlook**. The most recent median projections from January 2026 indicate that GDP growth is anticipated to settle at 1.8%, inflation at 2% and the federal funds rate at 3%. This would imply a sustained real interest rate differential relative to the euro area of 1 percentage point and a correspondingly higher estimate of r^* . A bit less than half a percentage point could be explained by the higher estimate of potential growth. The remainder could be due to expansionary fiscal policy and the rise of public debt. Thus, we will further explore monetary-fiscal linkages and the risk of fiscal policy causing inflation in the next section and examine potential implications for ECB monetary policy.

4. FISCAL DEFICITS, RISING INDEBTEDNESS AND INFLATION RISKS

4.1. The risk of fiscally driven inflation

The **link between fiscal policy, interest rates and inflation** is well established in the macroeconomic literature. A standard Keynesian-style mechanism is as follows: (i) expansionary fiscal policy may **boost aggregate demand relative to supply** and create room for firms to raise prices and pay higher wages; (ii) higher government borrowing creates additional demand for savings and for the supply of savings to meet this demand, **real interest rates have to rise**; (iii) monetary policy needs to respond by raising nominal (and thereby also real) interest rates sufficiently to account for the higher equilibrium real interest rate and to **return inflation back to target**.

Additional linkages arise, **because monetary policy has fiscal consequences**. For example, central bank money creation results in seigniorage income for the government. Inflation is a tax on money holdings. Price level increases reduce the real value of outstanding government debt. Interest rate and balance sheet policies have effects on sovereign bond rates and spreads, respectively.¹² Thus, an increase in government debt can lead to higher inflation, either because inflation expectations rise in anticipation of future monetary accommodation creating additional revenue in the future (so-called fiscal dominance) or because the increase in the price level itself reduces the real value of outstanding debt (fiscal theory of the price level).

There are many **historical examples** of fiscal inflation as discussed in **Box 1** in the appendix. In particular, fiscal deficits have led to persistent inflation when they were financed via money creation and not backed by future tax increases or government spending cuts. Yet, high fiscal deficits do not mechanically lead to higher inflation. Their consequences are influenced by the independence and credibility of monetary policy, the effectiveness of fiscal rules and fiscal institutions and the degree of economic slack. However, high and rising levels of public debt increase the **risk of fiscally driven inflation**. Inflation expectations among participants in financial, goods or labour markets may partially presuppose a delay of monetary policy reaction. Thus, fiscal deficits and rising government debt may be followed by inflation **even if the central bank** is independent and **committed to achieve price stability**. An example discussed in **Box 1** is the period after German reunification. More recently, the inflation surge of 2021 to 2023 has partially been attributed to expansionary fiscal and monetary policies (see references in Box 1).

Alternatively, political pressure may induce central banks to focus more on the consequences of their decisions for public finances than price stability. The **relationship between monetary and fiscal policy** is inherently **asymmetric** and so are the resulting risks. In periods of recession monetary and fiscal policy work hand in hand. Expansionary monetary and fiscal policy stabilise the financial sector and the real economy. Easy monetary policy also keeps the financing cost of fiscal expansion contained. As long as demand remains weak, inflationary pressures are absent.

By contrast, when economic activity and inflation are stable, but government debt and interest expenditure on an upward trajectory, there is **potential for conflict** between the central bank and fiscal policy makers. The central bank should keep monetary policy sufficiently tight to hold inflation stable, yet public finances would benefit from lower interest rates and higher inflation. Hence, there is strong

¹² Prior to the inflation surge, the ECB absorbed a very large share (in some periods more than the entirety) of net sovereign bond issuance through APP and PEPP purchases. This situation has now reversed, the Eurosystem no longer acts as a net buyer and lets its bond portfolio shrink, albeit very slowly. Survey evidence (SMA, Akkaya et al. 2024) suggests that a EUR 1 trillion reduction in bond holdings could raise ten-year term premia by roughly 30–50 basis points, with larger effects in higher-debt jurisdictions.

potential for political pressure on the central bank. This pressure can be exerted directly, as in the case of the US Fed and the Trump Administration, or indirectly.

4.2. Rising indebtedness in the US and the Euro Area

The fiscal environment in the US is characterised by a high deficit and rising debt as shown in **Figure 10**. By contrast, the average deficit and the average debt ratio is lower in the euro area. The deficit of the US government is projected to remain at around -8% of GDP until 2029. In the euro area it is expected to stay at -4% (IMF, World Economic Outlook, October 2025).

Figure 10: Fiscal, Growth and Interest Rate Trends in the US and the Euro Area



Note: Debt-to-GDP ratios, net lending/borrowing and real GDP growth are based on IMF World Economic Outlook projections. The implicit interest rate is defined as interest expenditure divided by the lagged stock of public debt. For the US, it is calculated using Congressional Budget Office projections of net interest outlays and federal debt held by the public. For the euro area, the implicit interest rate is taken from AMECO for EA (20) until 2027 and from the European Commission's Debt Sustainability Monitor (2025) thereafter and represents a GDP-weighted average of Germany, France, Italy, Spain and the Netherlands.

Source: IMF World Economic Outlook, Congressional Budget Office, European Commission, Debt Sustainability Monitor (2024) and authors' calculations.

There has been a substantial difference in deficits for almost two decades. As a result, the debt to GDP ratio in the US has risen much faster. The ratio for total public debt to GDP in the US stood at 124% in

2024, compared to 87% in the euro area. This divergence has occurred even though GDP growth in the US has been higher.

Furthermore, **interest rate expenditure is trending up** in the United States and the euro area and threatens to accelerate the rise of debt. These trends could be alleviated, at least temporarily, by lower interest rates and unanticipated inflation. In fact, during the COVID-19 pandemic recession, the debt to GDP ratio was higher, and the decline from 2021 to 2023 was at least partially due to the unexpected surge of inflation. Since then, however, debt to GDP ratios rose again and IMF projections suggest they will continue to do so in the future.

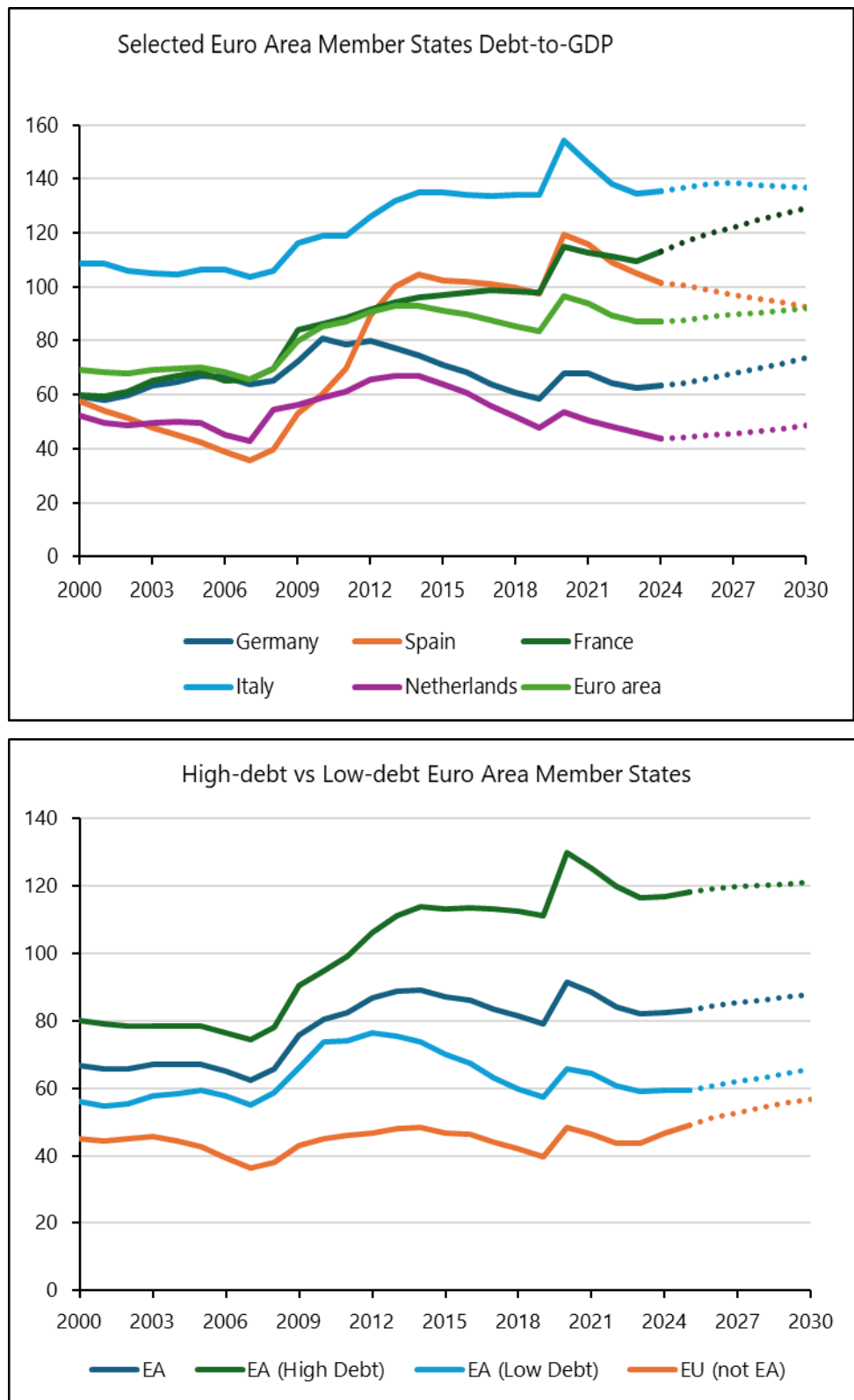
Projections of the US debt to GDP ratio indicate it will rise rapidly beyond the peak of 130% from 2020 (IMF, World Economic Outlook, October 2025). In his [February 2026 Statement](#), the director of the Congressional Budget Office, Philip Swagel, concludes “Our budget projections continue to indicate that the fiscal trajectory is not sustainable.” This **lack of fiscal sustainability in the US may cause** a further rise in **inflation**, which in turn **may spill over to the euro area**, especially if the ECB were to respond to US dollar depreciation with interest rate cuts.

The slower rise of the euro area debt to GDP ratio hides **substantial heterogeneity among euro area Member States**. Among large economies, the IMF forecasts the sharpest rise in France and Germany as shown in the upper panel of **Figure 11** (World Economic Outlook, October 2025). In the case of Italy, where the debt ratio is already much higher, it is expected to stay at a high level. In Spain it is anticipated to decline. To assess whether a higher debt ratio induces greater fiscal consolidation, we create two groups, those with debt-ratios above 90% and those with ratios below 90%.¹³ It turns out that high debt countries, on average, did not reduce debt ratios after the euro area debt crisis of 2011/12 as shown in the lower panel of **Figure 11**. The reduction in the euro area average prior to the coronavirus pandemic was driven by the (average) consolidation in lower-debt countries. Furthermore, IMF projections suggest that both groups will exhibit rising debt ratios in the future.

Although euro area debt ratios, on average, are projected to rise slowly, **debt dynamics could deteriorate** more quickly in case of sustained positive real interest rates, particularly in high-debt Member States. Debt dynamics depend on the **interest rate-growth differential** ($r-g$). If nominal interest rates remain below nominal GDP growth, debt ratios can decline even in the presence of primary deficits. However, as nominal interest rates rise and exceed nominal growth rates, this so-called snowball effect reverses. Then, debt ratios can increase even in the presence of primary surpluses. In an environment with elevated uncertainty about future economic growth and rising government interest expenditures, fiscal trends may deteriorate rapidly. High debt levels significantly increase sensitivity to adverse growth shocks.

¹³ The reformed EU fiscal framework also introduces a stricter debt sustainability safeguard for countries with debt ratios exceeding 90% of GDP.

Figure 11: Projected Paths of Public Debt-to-GDP Ratios in the Euro Area: 2000 to 2030



Note: High-debt countries, defined as those with a debt-to-GDP ratio above 90%, include Belgium, France, Greece, Italy, Portugal and Spain. Low-debt countries comprise the remaining euro area members: Austria, Croatia, Cyprus, Estonia, Finland, Germany, Ireland, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Slovakia and Slovenia. The euro area average based on adding up debt and GDP of member states using IMF data is not exactly equal to the Eurostat average measure.

Source: IMF WEO and authors' calculations.

The reformed **EU fiscal framework** has replaced uniform numerical rules with country-specific expenditure paths based on debt sustainability analysis (DSA). Since DSA results hinge on **assumptions about growth and interest rates**, debt sustainability is sensitive to the monetary environment. Even moderate differences in macroeconomic assumptions **can significantly alter projected debt developments**. As a result, governments' fiscal space as well as the required fiscal adjustments can also change substantially. Also, these projections may not yet incorporate the full extent of increased defence spending that is likely to become necessary.

Wieland (2024), for example, compares European Commission recommendations with adopted national fiscal plans and discusses that, despite broadly similar expenditure paths, different underlying assumptions (e.g. regarding potential growth) can lead to significantly more favourable debt dynamics. Likewise, the comparative overview of medium-term fiscal-structural plans by six Member States by Becker et al. (2025) shows that DSA results are highly sensitive to different underlying assumptions. Importantly, the debt and deficit bias of governments that is well-known from the political economy literature creates incentives to adopt overly optimistic assumptions. This entails a risk of unequal treatment across Member States and can weaken the credibility of the fiscal framework. Thus, it is essential to use DSA assumptions that are robust and avoid **optimism bias** on growth, interest rates and fiscal adjustments.¹⁴

In a monetary union with persistent debt bias and heterogeneous debt levels, the increased flexibility for national fiscal policy requires conservative calibration and credible enforcement. The **credibility of the new framework** is not only a fiscal issue: it **shapes** market expectations, sovereign risk premia and the **conditions under which monetary policy operates**. If implementation proves weak or overly optimistic, fiscal space narrows and inflation becomes more of a risk.

4.3. Rising interest expenditure may worsen fiscal and inflation risks

Interest expenditure is trending up in many euro area Member States since the surge of inflation and interest rates. More and more, low-interest rate debt issued from 2015 to 2020 is being rolled over into much higher-rate debt. As shown in **Figure 12, interest expenditure as a share of GDP is projected to rise** quickly in the future. The projections imply historically high levels of interest expenditure. In several countries (notably France and Spain) interest burdens are projected to reach levels not previously observed since the start of the euro, in the case of Spain despite projected fiscal consolidation.

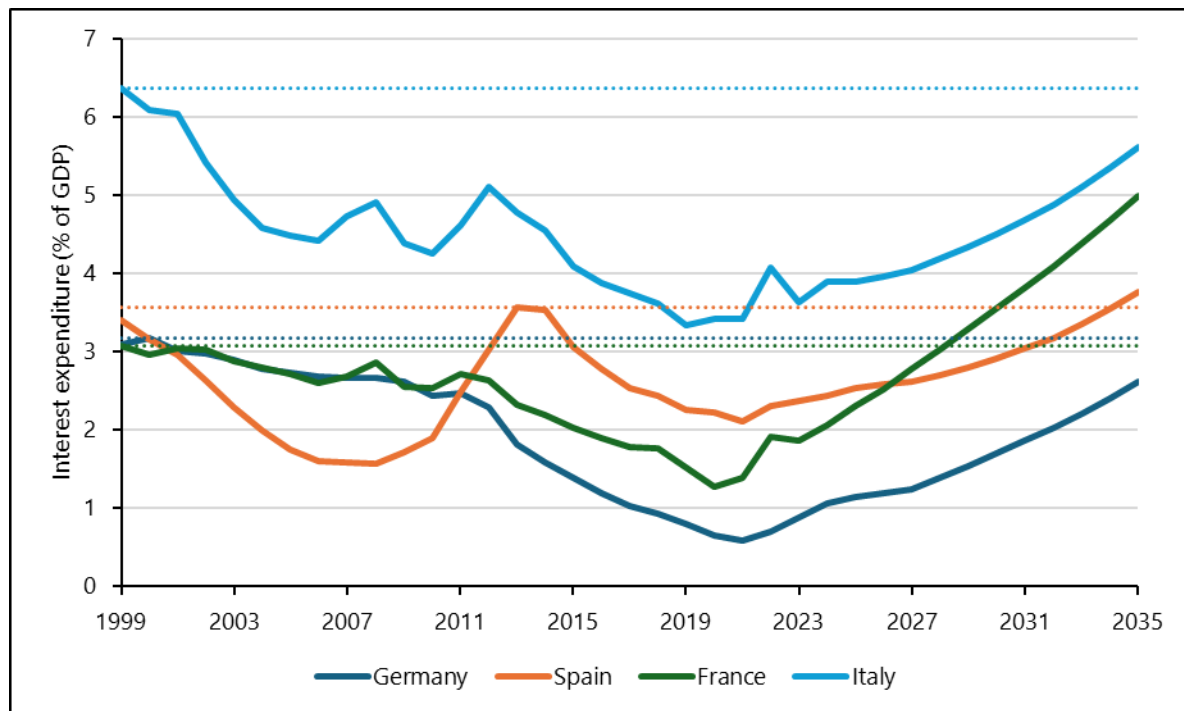
Rising debt to GDP ratios could also trigger increases in **sovereign bond premia**. As shown in **Figure 14** in the appendix, projected debt to GDP ratios are closely correlated with the sovereign bond spreads of euro area Member States over German bunds. Thus, a faster increase in debt ratios may push spreads higher than currently anticipated. While government bond spreads have declined in recent years, the cross-sectional relationship between spreads and five-year-ahead debt projections remains visible across all years, albeit with a flatter slope in the more recent period (Figure 14).

Furthermore, as the **German debt ratio is rising**, it **may lift the overall level of real interest rates** in the euro area. For decades Germany has been perceived as a **fiscal anchor** of the monetary union. During the European sovereign debt crisis it provided a safe haven as well as fiscal backing for the new stabilization mechanism and support programs. After the European debt crisis, the reformed German constitutional debt brake likely helped put the debt ratio on a downward trajectory (e.g. Langer et al.,

¹⁴ Wieland (2024) proposes several measures to strengthen the DSA framework. These include greater transparency and replicability regarding the assumptions and calculations used which are currently not fully ensured, a regular assessment of the national independent fiscal institutions on the replicability and credibility of key assumptions of the national plans, scrutiny of the Commission's methodology and its application by the European Parliament, as well as systematic stress testing during the adjustment period.

2025). As a result, it declined towards 60%, thereby also reducing the euro area average.¹⁵ Since then, the **anticipation of ECB interventions in future crises** or potential future fiscal transfers, backed by the borrowing capacity of low debt Member States, **may have reduced sovereign spreads** and kept bond yields in high debt member states lower than they would have been otherwise (Altavilla et al., 2014; Falagiarda and Reitz, 2015; Krishnamurthy et al., 2018).

Figure 12: General Government Interest Expenditure in Selected Euro Area Countries (DSM)



Note: Data points from 2024 to 2035 are based on European Commission forecasts.

Source: European Commission AMECO and Debt Sustainability Monitor 2025

With the German debt ratio rising quickly (although its level still remains low relative to other large euro area Member States), its **role as a fiscal anchor may be reduced**. As German Bunds have historically functioned as the primary safe asset within the euro area a sustained increase in German government debt could raise the benchmark risk-free rate used in sovereign bond pricing. Last year's [changes to the constitutional debt brake](#) that allow greater borrowing for defence and infrastructure spending and structural borrowing by the "Länder", now make a steady and unchecked increase of the debt ratio possible. This is directly apparent from long-run projections provided by the Deutsche Bundesbank (2025). By the early 2050s the ratio reaches 100% and keeps rising. Of course, this would also drive up the euro area average. A Germany with a debt ratio above 90% is not likely to serve as fiscal anchor and the anticipation of such a development may have effects well before such a level is reached.

¹⁵ Based on Eurostat data on general government gross debt, the share of German debt in the aggregated euro area (20) debt decreased from 25.7% to 20.5% between 2010 and 2019.

5. CONCLUSIONS AND POLICY RECOMMENDATIONS

We draw the following conclusions from our analysis of the ECB's policy, its outlook and the surrounding risks and challenges at the current juncture.

First, monetary **policy makers should not assign too much weight to the seemingly stable long-run outlook** for inflation, GDP growth and interest rates. Forecasts are not particularly informative at horizons beyond 3 or 4 quarters. If the past is any guide, inflation outcomes will be very different. Statistical measures of uncertainty with regard to the mean forecast are necessarily symmetric. But policy makers should not take too much comfort from this seeming balance of risks. Furthermore, cost-benefit analysis of divergences from assumptions embedded in the forecast may lead to different and not necessarily symmetric conclusions.

Second, while simple Taylor rules with an equilibrium real interest rate between 0% and 0.5% are consistent with the stable ECB outlook, there are some **reasons to doubt whether zero real rates may persist** so long in the euro area. The level of real interest rates in the US is quite a bit higher. This difference can only partially be explained by higher potential growth. Fiscal deficits and rising debt also put upward pressure on real interest rates. Thus, currently low ECB policy rates are not likely to be sustainable for as long as suggested by the ECB's and other forecasters' outlook.

Third, Europe is faced with geopolitical threats, a loss of economic competitiveness and substantial fiscal challenges. Thus, the international environment is likely to change substantially, member economies are likely to undergo major structural changes, and their fiscal policies will also have to adjust. At such a time, it is important to **map out the dynamics of (worst-case) risk scenarios** that may arise from mis-aligned or unsustainable trends and prepare for timely policy responses.

Fourth, the US and several euro area Member States exhibit high fiscal deficits and/or rising debt to GDP ratios. Debt is anticipated to grow faster than potential output. The rise in debt ratios is reinforced by rising interest rate expenditure. **Public finances** would benefit from lower interest rates and higher inflation. Hence, there is a potential for **conflict with central banks** and direct or indirect political pressure. Historically, there are many examples of fiscally driven inflation resulting from high and rising public debt. This includes cases with independent central banks focussed on price stability.

Fifth, the ECB should **consider the potential medium-run inflationary consequences of high and rising debt ratios**, in particular in some large euro area Member States. ECB communication (e.g. statements, reports, speeches) should emphasize the need for sustainable and resilient public finances, fiscal consolidation in the face of high debt ratios and effective implementation of the EU fiscal framework. The purpose of the EU's fiscal rules is to guarantee that the sustainability of public finances is achieved by adjusting government expenditure and taxation, and not by adjusting interest rates and allowing higher inflation. They protect the ECB's ability to secure price stability.

Sixth, the ECB should take into account that the **risks emanating from the fiscal trends are not balanced**, in the sense that it would be equally easy to adjust policy in either direction. For example, if infrastructure spending turns out more effective in boosting potential growth than anticipated, this would help slow the increase in debt ratios and reduce inflation pressures. Low central bank rates would be welcomed by governments. If potential growth is lower than anticipated, however, the fiscal outlook would worsen, while inflation pressures rise. Monetary policy would need to be tightened, but higher interest rates would increase the burden of fiscal adjustment. Hence, the ECB would likely face substantial opposition to raising rates. This implies that effective communication and timely policy reaction are preferable to delayed responses.

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ANNEX

Box 1: Under what circumstances have increased fiscal deficits led to inflation?

In their paper *“Do Enlarged Fiscal Deficits Cause Inflation: The Historical Record”*, Bordo and Levy (2020) analyse evidence from the last two centuries concerning the link between fiscal deficits and inflation. They argue that fiscal deficits have led to persistent inflation when they were financed via money creation and not backed by future tax increases or government spending cuts. High inflation rates followed especially when monetary policy was effectively subordinated to fiscal policy, that is, under fiscal dominance, and when the behaviour of the central bank was not shaped by the objective of price stability but by the stabilization of public finances.

Fiscally driven inflation is particularly evident in wartime, from the Napoleonic Wars to the American Civil War and the two World Wars. These periods were characterised by very high government deficits that were at least partly monetized and caused strong surges of inflation. Bordo and Levy also present many examples of fiscally induced increases in inflation in peacetime. These include France in the 1920s and the Great Inflation in the US and the United Kingdom in the 1970s. Even absent direct monetisation the persistence of deficits raised doubts about future fiscal consolidation and political pressure on monetary policy led to rising and persistently high inflation rates. Bordo and Levy refer to the Fiscal Theory of the Price Level to explain that unbacked deficits that are not credibly supported by future taxes and revenues can generate inflation through expectation channels.

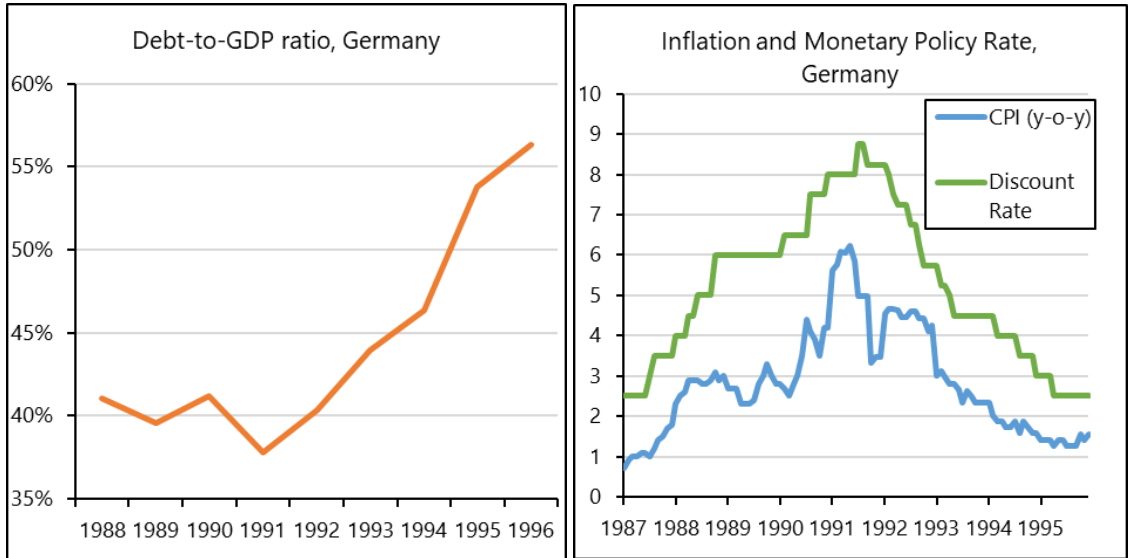
Fiscal deficits, however, are not always associated with inflation. For example, the Global Financial Crisis of 2008 and 2009, which was preceded by period of excessive credit growth and asset inflation, was followed by a long period of private and public debt consolidation. Although crisis fighting policies had involved large fiscal deficits and an increase in public debt, inflation stayed low for more than a decade.

By contrast, the expansionary fiscal and monetary policy and the rise of public borrowing during and after the COVID-19 pandemic was followed by inflation. Recent empirical contributions by Barro and Bianchi (2023), Dynan and Elmendorf (2024), Giannone and Primiceri (2024), and Ascari et al. (2024) suggest that the surge of inflation from 2021 to 2023 was to a significant extent driven by demand-side stimuli, including both monetary and fiscal policies. The rise in inflation was therefore not caused exclusively, or even primarily, by the war in Ukraine, the resulting energy crisis, or other supply-side factors.

Even central banks that are independent, credible and strongly focused on price stability may find it difficult at times to prevent the inflationary effect of fiscal expansions and growing government debt. An example is the Deutsche Bundesbank in the 1990s. German re-unification in 1989 was followed by a substantial fiscal expansion, an infrastructure-spending driven boom and an increase in the public debt to GDP ratio of close to 20 percentage points (an increase of about one half at the time) as shown in **Figure 13**. Consumer price inflation rose by close to 6 percentage points.

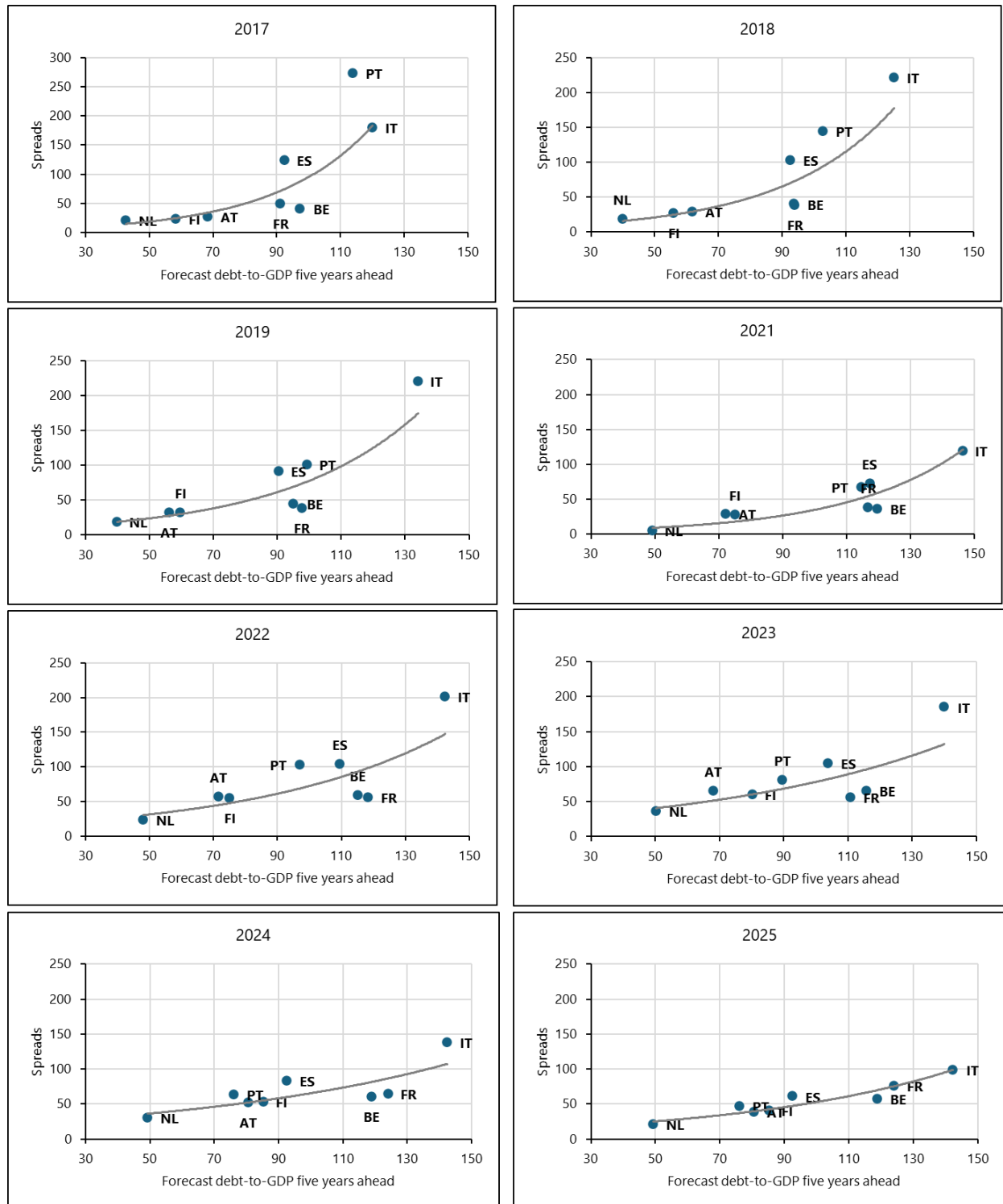
The Bundesbank raised interest rates along with the rise of inflation and by more than one-for-one. It was able to contain the surge of inflation eventually, but it took an immediate and determined policy response. This policy tightening also had major side effects on other member states of the European Monetary System that did not experience a fiscal expansion but were attempting to keep exchange rates fixed by matching the Bundesbank’s interest rate hikes.

Figure 13: Historical example: German Re-Unification



Source: Bordo and Levy (2020), Barro and Bianchi (2023), Dynan and Elmendorf (2024), Giannone and Primiceri (2024), and Ascari et al. (2024).

Figure 14: Spreads and Forecasted Debt-to-GDP Ratios



Note: Each panel shows the relationship between government bond spreads and projected public debt across euro area member states in the indicated year. Government bond spreads are measured as the annual average yield on ten-year government bonds relative to German Bunds in year t . Debt-to-GDP ratios correspond to IMF projections five years ahead ($t + 5$). For example, the 2010 panel relates spreads observed in 2010 to debt projections for 2015.

Source: IMF, ECB and authors' calculations.

The ECB anticipates stable growth and inflation, while Europe is faced with geopolitical threats, lack of competitiveness and fiscal challenges. At such a time, central bankers need to consider the dynamics of risk scenarios that arise from potentially mis-aligned or mis-perceived trends and policy-relevant parameters and prepare for timely policy responses. This paper focusses on potentially unsustainable fiscal trends, potential growth misperceptions and their implications for inflation developments and the policy stance. It highlights risks for fiscal inflation in the euro area.

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