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What Does Monetary Policy Need to Know Now?[1]

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Banca d'Italia-SUERF conference "Inflation, inflation expectations, and monetary policy"

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Good morning, and welcome to Banca d'Italia, I am pleased to open this event. I would like to thank SUERF for organizing the conference with us, and all of you for being here.

We meet at a time when the conflict in the Middle East continues to disrupt global energy supplies, inflation is rising, and geopolitical tensions and technological change are reshaping the global economy. Monetary policy must navigate this uncertain and rapidly evolving environment.

Against this backdrop, what does monetary policy need to know now? I would highlight three questions.

The first is how households and firms are responding to the inflationary shock.

The work of this year's Nobel laureates, Robert E. Hall and Michael Woodford, offers a natural starting point. Hall showed how expectations about future income shape households' consumption decisions, while Woodford demonstrated how expectations about future monetary policy influence economic activity and inflation. Together, they laid the foundations for a deeper understanding of how expectations affect economic behaviour and the effectiveness of stabilisation policies.

To apply these insights to today's economic context, we need to understand the main factors driving expectations and current decisions.

Consider households first. The large shock in 2021-2022 taught us some important lessons. First, large shocks make households and firms more attentive and more

[1] I wish to thank Piergiorgio Alessandri, Lisa Rodano and Fabrizio Venditti for their help in preparing this address.

responsive to news.[2] Second, when forming their expectations about future inflation, economic agents tend to be more backward-looking than our models normally assume. Third, shocks to energy, and indirectly food, have a greater impact on low-income households, whose consumption baskets are more concentrated on these goods.[3]

In the third session of the conference, we will learn more about how heterogeneous inflation expectations are formed and how they translate into different spending responses.

Turning to firms, recent research shows that when margins come under pressure from sharply higher costs, firms have an incentive to bring forward price increases they would ordinarily have deferred.[4] When competitors face similar cost pressures, firms have less reason to hold back. With many firms adjusting sooner, the shock feeds through to consumer prices faster. This can produce important non-linear effects.[5] As Adrien Auclert will show tomorrow in his lecture, in models with menu costs, the pass-through of cost-shocks to prices can be amplified both when inflation is already high and when shocks are larger.

The frequency of price changes is therefore an important indicator of how quickly cost push shocks feed through to consumer prices. Research conducted within the ChaMP[6] network shows that during the 2021-22 inflation surge firms raised prices more frequently, while the size of individual increases changed relatively little.[7] Analysis using Banca d'Italia's survey of Italian firms[8] finds that selling prices respond more strongly to upside than to downside surprises in input cost growth. At the peak of the last inflation episode, faster expected growth in input prices accounted for roughly a third of firms' selling price growth.[9]

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2 Weber, M. et al. (2025), *Tell Me Something I Don't Already Know: Learning in Low- and High-Inflation Settings*, Econometrica, 93(1), 229-264; Malmendier, U. e S. Nagel (2026), *Seemingly Anchored Inflation Expectations*, CESifo Working Paper 12750.

3 Curci, N., M. Savegnago, G. Zevi e R. Zizza (2025), *The redistributive effects of inflation: a microsimulation analysis for Italy*, International Journal of Microsimulation, 18(3), 87-100. In the current episode, the limited transmission to food prices has so far moderated the disparity among income classes.

4 Cavallo, A., F. Lippi e K. Miyahara (2024), *Large Shocks Travel Fast*, American Economic Review: Insights, 6(4), 558-574.

5 Neri, S., C. Conflitti and A. Lin (2026), The awakening of inflation and the return of the Phillips curve in the euro area, Banca d'Italia, Temi di discussione No. 1525.

6 ChaMP (Challenges for Monetary Policy Transmission in a Changing World) is a research network established by the European System of Central Banks in 2023. See the ECB's ChaMP Research Network page.

7 Gautier, E., C. Conflitti et al. (2026), Consumer price stickiness in the euro area during an inflation surge, Banca d'Italia, Temi di discussione No. 1524.

8 Banca d'Italia launched the survey of Italian businesses' inflation and growth expectations in 1999, an early example of an approach that has since become more common among central banks. Since 2012, the survey is used also to experiment how firms update their expectations when provided with new information. See Bottone, M. et al., *The Survey on Inflation and Growth Expectations*, Banca d'Italia, mimeo.

9 De Fiore, F., M .J. Lombardi and G. Mangiante (2025), *The asymmetric and heterogeneous pass-through of input prices to firms' expectations and decisions*, BIS Working Paper No. 1305.

As inflation eased in 2023, the frequency of price changes fell back close to pre-pandemic levels. Yet the experience of high inflation may have left a lasting mark: firms may now pay closer attention to when prices need revising, and wider use of digital tools may allow them to adjust prices more quickly.[10]

Taken together, these findings suggest that the experience of the last inflation shock may still influence how households and firms respond today.

However, this is only part of the story. The economic environment in which households and firms make their decisions also matters.

Indeed, we see significant differences in the propagation of the energy shock today compared with 2021-22. The latest data indicate that energy-related goods have so far accounted for most of the rise in consumer price inflation in the euro area. The pass-through to other goods and services has been limited and we have not observed any increase in the frequency of price changes by firms.[11]

The second question, then, is why the indirect effects of the energy shock have been contained so far and whether this will continue.

In this respect, a structural change in the euro area may be helping to cushion the shock: the growing role of renewable energy in the EU's electricity mix. In 2025, renewables accounted for half of all electricity generation, up 12 percentage points from 2021. In some markets, this shift has made wholesale electricity prices less sensitive to increases in gas prices.[12]

However, the key factor is likely to be weaker aggregate demand.

Back in 2021-22, post-pandemic reopening released pent-up demand while supply bottlenecks were still holding back production. Moreover, fiscal support mitigated the loss of purchasing power following the energy shock. When energy costs surged, strong demand made it easier for firms to pass those increases on to consumers.

This time, there is no comparable boost to demand. The euro area economy continues to expand, but at a moderate pace. Fiscal support in response to the energy shock has been much smaller and consumption is held back by high uncertainty and low confidence.[13]

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10 Brown, Z. Y. e A. MacKay (2023), *Competition in Pricing Algorithms*, American Economic Journal: Microeconomics, 15(2), 109-156.

11 This observation is based on granular data of individual prices, which however covers only part of the consumer price basket in some euro area countries. For details on the coverage of the micro price data, see Gautier et al. (2026), cited above.

12 Panetta, F. (2026), *Il risparmio nella società che cambia*, World Savings Day, 30 October, footnote 4, for the EU figures. See also Kuik, F., E. Lis and J. Schäfer (2026), *The uneven journey of wholesale gas and electricity prices to consumer bills*, ECB Economic Bulletin, Issue 6/2026.

13 Energy-related fiscal support averaged around 0.9 per cent of euro area GDP per year in 2022–24 and around 0.1 per cent in 2026. See Bouabdallah, O., C. Checherita-Westphal and P. Muggenthaler-Gerathewohl (2026), Assessing the scope for compensatory fiscal measures in response to the recent energy shock, ECB Economic Bulletin, Issue 5/2026.

Labour demand has also eased and there are no signs of wages responding to inflationary pressure so far. One session of this conference is devoted precisely to the role of the labour market in monetary policy transmission.

But we may not have seen the end of the story yet. Up in the production chain, producer prices for intermediate goods are well above their levels a year ago.[14] We know that cost pressures take time to feed through the production chain, so some indirect effects on consumer prices are to be expected[15] – and indeed they are already incorporated in the projections of major institutions, including the ECB. Still, substantial uncertainty remains about the size of these effects.

The third question is how much financial conditions have tightened, and why.

Faced with a worsening inflation outlook, major central banks have raised policy rates, starting with the ECB last June. Markets have anticipated further hikes and incorporated them into the pricing of financial contracts. This is the standard "Woodford mechanism": expectations about future policy rates tighten financial conditions today, restraining demand and helping to keep medium-term inflation expectations aligned with central banks' objectives.

The strength of the monetary policy transmission will have to be assessed over time; its quantification remains subject of academic debate as we will see later today in the keynote address by Stephanie Schmitt-Grohé.

However, monetary policy is not the only force at work.

Over recent months, long-term interest rates have risen sharply, by more than can be explained by expectations of higher short-term rates alone, particularly in the US. Explanations range from an increase in the natural rate, driven by expectations of a productivity boost induced by artificial intelligence (AI), to rising real term premia. The latter may reflect a shift in investors' perceptions towards more frequent supply shocks relative to demand shocks. But it may also reflect growing concerns about high and increasing public debts, in the US and globally. The possible role of large issuances of long-term bonds by hyperscalers and other AI firms has also been discussed, although evidence of their quantitative relevance is still scant.

In the euro area, the increase in the term premium partly reflects spillovers from the US, but domestic factors are contributing as well. In particular, renewed tensions in sovereign markets in some euro area countries are adding pressure on yields.

Together, these developments are tightening financial conditions beyond the effects of monetary policy alone. For firms, most of the increase in bond yields has so far come

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14 Euro area producer prices for intermediate goods were 7.1% higher than a year earlier; source: Eurostat.

15 Corsello, F. and S. Pica (2026), *Indirect effects of energy supply shocks in 2026: a VAR based analysis*. mimeo, Banca d'Italia.

from higher benchmark rates, though credit spreads are also coming under pressure. The impact will become more pronounced as firms refinance their debt.

Finally, there is a deeper concern: could a sudden loss of investor confidence in the prospects of AI trigger a disorderly correction, with repercussions across the financial system?[16]

AI-related valuations have already fallen in recent weeks. Some sizeable swings are to be expected for a potentially revolutionary technology whose development and ultimate impact remain highly uncertain. However, the concentration of exposures and circular financing arrangements in the AI industry are clear sources of vulnerability.[17] Should a disorderly repricing occur, interconnectedness and high leverage in parts of the financial system could further amplify the shock, spreading financial stress and ultimately affecting the real economy.

To conclude, an energy shock can look familiar and still play out differently. With so many forces shaping growth and inflation at once, monetary policy must draw on the widest possible range of evidence. I am confident that the research presented here and the discussions over the next two days will deepen our understanding of those forces and sharpen our judgement about the choices ahead.

I wish you all a stimulating and productive conference.

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16 Panetta, F. (2026), *op. cit.*; see also Lane, P. R. (2026), *AI and monetary policy*, speech at the ChaMP closing conference, Rome, 6 July.

17 Circular financing refers to the widespread practice in the AI industry, where suppliers finance their clients and vice-versa. See International Monetary Fund (2026), *Global Financial Stability Report*, October.

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