EUROPEAN CENTRAL BANK

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Christine LAGARDE
President

Mr Fabio De Masi
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

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L/CL/25/374

Re: Your letter (QZ-018)

Honourable Member of the European Parliament, dear Mr De Masi,

Thank you for your letter on monetary policy and risks to growth and inflation, which was passed on to me by Ms Aurore Lalucq, Chair of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 20 October 2025.

Regarding your question about the Transmission Protection Instrument (TPI), the TPI is a monetary policy instrument available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area.[1] By safeguarding the transmission mechanism, the TPI allows the Governing Council to more effectively deliver on its price stability mandate. Subject to established criteria being fulfilled, and in order to counter risks to the transmission mechanism to the extent necessary, the Eurosystem is able to make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals. The TPI has been designed carefully, with adequate safeguards in place to ensure that the jurisdictions in which purchases are conducted pursue sound and sustainable fiscal and macroeconomic policies. The ECB continuously monitors financial market developments, and available evidence shows that euro area sovereign bond markets are

[1] For the conditions for activating the TPI, please see "The Transmission Protection Instrument", *press release*, ECB, 21 July 2022.

orderly and functioning smoothly with good liquidity. The normalisation of the Eurosystem's balance sheet that was initiated in late 2021 is proceeding smoothly. The portfolios built up under the asset purchase programme (APP) and the pandemic emergency purchase programme (PEPP) are declining at a measured and predictable pace, as the Eurosystem no longer reinvests the principal payments from maturing securities.

As regards your second question, while uncertainty remains elevated, some of the downside risks to economic growth in the euro area have been mitigated by the US-EU trade deal reached over the summer, the recently announced ceasefire in the Middle East and progress in US-China trade negotiations. However, the growth outlook still depends on several factors. On the one hand, the still volatile global trade environment could disrupt supply chains, further dampen exports and weigh on domestic spending, and a deterioration in financial market sentiment could also lead to tighter financing conditions, heightened risk aversion and weaker growth momentum. On the other hand, higher than expected defence and infrastructure spending, together with productivity-enhancing reforms, could boost growth. In addition, a further easing of geopolitical tensions or a faster resolution of remaining trade disputes would support sentiment and spur activity.

Turning to the inflation outlook, risks remain on both sides, largely driven by the still volatile global trade policy environment. A stronger euro, reduced demand for euro area exports owing to higher tariffs or redirected exports from countries with overcapacity could push down inflation more than expected. Conversely, inflation may rise if fragmented global supply chains increase import costs and add to domestic capacity constraints. Extreme weather events, and the climate crisis more broadly, may push food prices higher than currently expected.

There is considerable uncertainty about the magnitude of the effect that higher defence and infrastructure spending will have on output and inflation, as this will depend on the scale, speed and nature of additional spending and on the fiscal multipliers. At the NATO summit on 24-25 June 2025, NATO allies made a commitment to spend 5% of GDP on defence annually by 2035, of which 3.5% will be spent on core defence and 1.5% on defence- and security-related investments. This contrasts with the current guideline of 2% of GDP on core defence, and with the actual core defence spending in the euro area of 1.9% of GDP (according to the NATO definition). Taken together, this implies that there will be a substantial increase in defence and infrastructure spending.

Concrete government announcements on increases in defence spending have so far been relatively modest, but policy implementation takes time and more announcements might follow. According to a Eurosystem staff assessment, the impact on growth of the new defence spending measures announced since the Munich Security Conference in mid-February 2025, as factored into the June 2025 Eurosystem staff baseline projection, is expected to total 0.3% of GDP in 2027.[2] The bulk of this new spending is coming from Germany.

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[2] See the box entitled "Fiscal aspects of European defence spending: implications for euro area macroeconomic projections and associated risks", *Economic Bulletin*, Issue 5, ECB, 2025.

Address
European Central Bank
Sonnemannstrasse 20
60314 Frankfurt am Main
Germany

Postal Address
European Central Bank
60640 Frankfurt am Main
Germany

Tel. +49-69-1344-0
Fax: +49-69-1344-7305
Website: www.ecb.europa.eu

This upward impact on growth is expected to range between 0.06 and 0.12 percentage points per year over 2026-27, while the impact on inflation is seen to be limited. Illustrative risk scenarios that assume a gradual increase in additional defence spending to 3% of GDP at euro area aggregate level by 2027 yield larger effects on GDP growth (rising to 0.4-0.6 percentage points above the baseline in 2027) and somewhat greater effects on inflation (about 0.1 percentage points in 2027).

The uncertainty surrounding the impact of additional spending on growth and inflation is related to the factors mentioned in your letter. As a general rule, the impact of additional defence spending on inflation will be lower if the spending improves productivity − through civilian spin-offs of military technology developments, for example − and higher if the additional spending pushes the economy closer to its full productive capacity.[3] Bottlenecks due to limited public administration capacities in the area of planning might lead to a more gradual build-up of defence sector capacity, thereby moderating the impact on growth and inflation. At the same time, given the current tightness in some labour market segments, the impact on inflation could be greater if labour income expands more strongly than under normal circumstances. Similarly capacity constraints in the defence sector, bottlenecks in the steel industry or in other inputs, and limited options for repurposing civilian production plants for defence, would be expected to contribute to a stronger upward impact on inflation.

Yours sincerely,

[signed]

Christine Lagarde

[3] The effects of additional defence spending would be expected to be lower if (i) the stimulus is partially financed through cuts in other spending instead of through the issuance of new government debt, and (ii) the defence spending has a higher import content than average government expenditure. For instance, according to data from the Stockholm International Peace Research Institute (SIPRI), almost two-thirds of the arms imported by European members of NATO over the period 2020-24 were produced by the United States. However, the projected increase in defence spending appears to be more oriented towards domestic production – especially in Germany.

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