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ECB preview: Time for a panic room in the ECB's 'good place'

The war in the Middle East and the surge in oil prices revive memories of the ECB's more traumatic experience in recent times: the 2022 oil price shock. While we expect the ECB to remain on hold next week, a more hawkish tone should show that these 2022 memories are still very much alive

ECB President Christine Lagarde in Italy last week

We don't know if ECB President Christine Lagarde has a favourite actor, but if the run up to next week's meeting was turned into a Hollywood film, Jodie Foster would be our pick – not as Clarice Starling in *The Silence of the Lambs*, but as the mother hiding from burglars in a panic room. For the ECB, the war in the Middle East and rising energy prices are the intruders threatening Lagarde's 'good place'. The key question for next week is what Lagarde and the rest of the Governing Council decide to do from inside their own panic room.

Jodie Foster in Panic Room: a mirror for an ECB bracing against geopolitical and energy price intruders

War in the Middle East takes any rate cut discussion off the table

By the time the ECB meets on 19 March, the macro backdrop will have shifted markedly since the last meeting. With the conflict in the Middle East, the risk of inflation undershooting – and any discussion of further rate cuts – should be firmly off the table. Gone is a scenario in which a stronger euro could push down the ECB's own inflation forecasts for longer, leading to a more controversial debate on inflation undershooting and what it would mean for the ECB's credibility.

Oil prices were already rising, and the outbreak of war in the Middle East likely coincided with the cut off date for the ECB's latest forecasting round. But recent market moves will have rendered those projections outdated almost immediately. Like everyone else, the ECB can only work with a range of oil price scenarios. At this point, anything is possible – from a short-lived episode of higher oil prices and some supply chain frictions, to a full-blown energy crisis. The big question for the ECB is, therefore, no longer how to react to an inflation undershooting but rather how to react to another oil price shock.

Tackling oil price shocks has been an important challenge for global central banks since the 1970s. In the case of the ECB, the thinking about how to react to oil price shocks has clearly evolved over the last 25 years.

Phase 1 (1999–2004): "Don't repeat the 1970s". When the ECB was launched, oil prices had just hit a two-decade low but were beginning to rise. Back then, oil shocks were treated as exogenous, supply-side events. What mattered was the domestic response, particularly on wages and inflation expectations, and not so much the source of the shock. For the ECB, reacting to oil price shocks meant preventing second-round effects.

Phase 2 (2004–2008): "It's the source that matters". By the mid-2000s, the ECB's approach became more sophisticated, distinguishing between direct effects on consumer prices and disposable income, indirect effects through the pass-through of higher input costs, and the critical importance of avoiding second-round effects through "appropriate wage reactions." This tripartite distinction became the standard ECB analytical vocabulary for oil price shocks. The ECB also started paying attention to the source of oil price movements. Demand-driven oil price shocks in the eyes of the ECB asked for a much more hawkish reaction than supply-driven shocks. However, even this distinction did not prevent the ECB from making mistakes. In 2008, the ECB under President Jean-Claude Trichet hiked rates, attempting to avoid second-round effects, when the financial crisis was in full swing. A move that had to be corrected only a few months later.

Phase 3 (2010–2020): “Look through becomes consensus”. In the 2010s, the ECB’s view on how to react to oil price shocks took a turn. Based on academic work but also the deflationary or disinflationary episodes, not only the ECB but many major central banks started to look through oil price shocks, focusing on core inflation and inflation expectations. The reasoning was straightforward: oil price shocks had historically been short-lived, and tightening policy in response would likely push down on demand and inflation precisely as the shock was already reversing – amplifying rather than correcting the disruption. This “look through” doctrine was reinforced by the structural observation that the pass-through of oil price shocks to wages and core inflation had declined significantly since the 1970s and 1980s.

Phase 4 (2021–present): “The failed look through”. The 2021-22 episode exposed the limits of the “look through” framework and generated a significant ECB rethink, both on substance and communication. In early 2021, the ECB applied the standard “look through” logic to the initial post-pandemic energy price surge. Inflation was described as “transitory”, a word that became the label of a wrong assessment. Little did they know. Since then, the question is no longer just “is this an oil shock?” but: "what is the starting level of inflation? Are expectations already at risk? Is the shock compounding other inflationary pressures? How persistent is it likely to be?" ECB Executive Board member Isabel Schnabel signalled this new conditionality explicitly: “Monetary policy, for its part, cannot afford to look through energy price increases if they pose a risk to medium-term price stability.” The look-through is conditional, no more automatic.

What do the lessons of the past mean for the current situation?

What do the lessons of the past now mean for the ECB’s current reaction? We shouldn’t forget that the 2022 misjudgement has been imprinted in the ECB’s institutional memory since then. Whether or not it is the right approach, the 2022 experience will shape the current thinking.

Admittedly, this is not yet a 2022 environment as it is mainly a price shock and not a supply shock; Europe doesn’t have to ‘derisk’ from a single energy provider. The labour market also isn't as strong as it was in 2022, with structural transitions and additional wage increases rather unlikely, the economy not going through a post-lockdown boom and governments more hesitant to provide new fiscal stimulus.

At the current juncture, the risk of a wage-price spiral looks small. Still, in a ‘forever war’ scenario of a longer-lasting disruption of the Strait of Hormuz, oil prices above $100/b for several months and knock-on effects on transportation, food prices, and more generally supply chains, are likely to force the ECB’s hand and consider rate hikes. In such a scenario, one or two symbolic rate hikes could be enough to preempt any second-round effects and could strengthen the ECB’s inflation-fighting credibility.

No rate change next week but a more hawkish tone

For next week’s meeting, we don’t expect any rate moves. The latest round of staff projections will be less relevant than normal, being just one of many input variables for the meeting. Who cares about some percentage point model-based revisions of inflation or growth forecasts if the oil price can move $30/b in a few minutes?

The ECB will, however, try to use its second most powerful policy instrument, words, to keep inflation expectations at bay. Sounding a bit more hawkish by, for example, stating that the ECB stands ready to act, is monitoring the situation very closely and would not refrain from any preemptive rate hikes, looks like the most likely outcome. In this context, we don't expect Lagarde to repeat the phrase 'good place'. There is still no reason for the ECB to panic – but installing a panic room within that 'good place' might not seem like such a bad idea for now.

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