

# Five years later

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*Will the ECB avoid its major policy mistake of 2021-22 when it was almost a year too late to react to the **inflationary run-up**? To keep **inflation expectations well-anchored**, **interest rates will have to rise soon.***

It didn't take economic foresight of the genial sort to see that the **Iran war** and its major impact on **oil and gas prices** would quickly lead to a substantial rise in the overall **inflation rate**. After stabilizing at **2.4%** in the first months of this year, **American annualized inflation** rose to **3.3%** in March, primarily driven by **energy prices**. The annualized inflation rate in the **euro area** stood at **1.7%** in January of this year and subsequently moved upward, also mainly due to rising energy prices, to **1.9%** in February, **2.6%** in March, and **3%** in April.

For the euro area, the profile of **inflationary dynamics** recently changed drastically. Euro area inflation reached a peak of **10.6%** annualized in October 2022 and then began a gradual decline, with inflation coming close to the **European Central Bank (ECB)** target inflation rate of **2%** annually in both **2024** and **2025**. **Energy prices** have been an important driver of this downward trend

in euro area inflation. In January of this year, energy prices declined annualized by **4%**, and in February by **3.1%**. However, in March, energy prices jumped up by **5.1%**, and in April even by **10.9%**.

What remained stubbornly elevated over the last few years is inflation in the **service sector** of the economy, which makes up roughly two-thirds of the euro area economy. Service sector inflation basically oscillated between **3%** and **4%** annually. Declining energy prices have consistently masked the stubbornness of inflation in the larger part of the euro area economy. Now that energy prices have turned around drastically, the upward push on overall inflation is coming from two powerful sources.

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Unless some unexpected beneficial developments, like **structural peace** in and around Iran, start taming inflationary forces, further rises in the overall inflation rate are to be expected. In her press conference at the end of April, ECB President **Christine Lagarde** stressed that "for now we're not seeing **second-round effects**." This is essentially a correct statement, but one that is destined to become obsolete in the coming months. **Food prices** are starting to rise significantly, and substantial upward price movements in the sphere of **raw materials** are becoming very noticeable. A recent survey carried out by the **Financial Times** of first-quarter earnings calls for **S&P 500 companies** showed that mentions of "**surcharges**" (additional price increases) had jumped to the highest level since at least **2018**.

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President Lagarde is clearly aware of what is coming on the inflation front; otherwise, she would not have stated, "I think directionally I know where we're heading." Freely translated: after keeping the most relevant policy rate (the **deposit rate**) constant at **2%** since June **2025** and confirming that rate at the April ECB Council meeting, a rise in this and other policy rates is written in the stars for the June ECB Council meeting. One can only hope the ECB will not repeat its major mistake of five years ago when reacting to the rising inflation rate came much too late.

## **History Lesson**

In the spring and early summer of **2021**, annualized inflation in the euro area was relatively steady around the ECB's target inflation rate of **2%**. By **August 2021**, inflation stood at **3%**, climbing steadily to **5%** by the end of the year, a rise substantially driven by **energy prices**. Most ECB policymakers agreed at that time that this inflation uptick was temporary. In this blog, doubts were voiced about that judgment. When in **February 2022** Putin started his war against Ukraine, energy prices shot through the roof, and by **March**, inflation had already reached **7.4%**, and by **June**, even **8.6%**. Only in **July 2022** did the ECB start moving, bringing the deposit rate to **0%**. This major policy rate had been in negative territory since early **2014**.

Serious, credible action on the ECB's side only began in **September 2022**, a year after the first signs of substantial inflation increases had started to show up. Clearly frightened by its own biased evaluation, the ECB then moved very quickly, bringing its deposit rate to **4%** by **September 2023**, a significant tightening of monetary policy in a little over a year. Inflation reacted quickly to this heavy dose of monetary tightening, dropping from its peak in **October 2022** of **10.6%** to **4.3%** by **September 2023**. Subsequently, the annualized inflation rate in the euro area quickly moved into the **2% to 3% range**.

Unlike in the **1970s**, President Lagarde concluded in her end-of-April press conference, "we will tame inflation." However, the more appropriate historical comparison should be with the **2021-22 mistaken approach** by the ECB. For inflation to remain "tamed," it is of utmost importance that inflation expectations remain, as the saying goes, **well-anchored**. In plain language, this means that consumers and producers behave as if the **2% inflation target** will be rigorously respected. If that belief vanishes, all prices within the economy will tend to rise because a majority is convinced that inflation will be (much) higher than the **2% target**.

For the "**2% belief**" to be respected, the central bank needs to signal loud and clear that it will act accordingly. That means that **now** is the time to show determination. Given what is happening on the inflation front, **reassuring words** can no longer suffice. Despite the negative impact interest rate rises will have on national budgets, especially for countries carrying a heavy debt burden, **restrictive monetary policy action** has become imperative for the ECB.

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