

# **Navigating energy shocks: risks and policy responses\***

*di Christine Lagarde*

It is a pleasure to be back at the ECB Watchers Conference.

If this event had been held a few weeks ago, my speech would have been very different. The euro area economy ended the year with solid growth momentum. Inflation stood at 1.9% in February. And domestic growth engines looked to be strengthening, particularly private consumption, investment in digitalisation and defence spending.

In all likelihood, we would have revised up our March forecasts for growth and revised them down for inflation.

But we find ourselves yet again in a different world, whose contours are not yet clear. We are facing profound uncertainty about the path of the economy.

None of us can resolve the uncertainty about how the war in Iran will play out. But what I can do is set out how we will approach this shock.

The main message I want to convey is that our response will be rooted in our monetary policy strategy, which is well equipped to help us navigate it.

Our strategy sets out three principles that will guide us.

First, it requires us to assess the nature, size and persistence of the shock before taking decisions on policy.

Monetary policy cannot bring down energy prices. But we must identify when higher energy costs risk spilling over into broad-based inflation – be it through indirect effects or through second-round effects via wages and inflation expectations.

Second, it requires us to focus on risks, not only the baseline.

Because the effects of significant price shocks on inflation can be non-linear, we need to work with scenarios and pay close attention to early warning signs that the shock is embedding in broader inflation dynamics.

Third, it gives us a graduated set of options for how to respond, which depend on the intensity and duration of the shock and how it propagates.

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Small, one-off and short-lived supply shocks can be looked through. But as expected deviations from our inflation target grow larger and more persistent, the case for action becomes stronger.

### **Assessing the shock**

Central banks have a long history of dealing with inflationary energy shocks, and over that time we have built up a substantial body of evidence about when they risk spilling over into generalised inflation.

In the euro area, the historical evidence suggests that the risk of broad pass-through from energy prices is the exception rather than the rule. When shocks are small in magnitude and short in duration – as has most often been the case – their inflationary impact tends to largely stay within the energy component itself.<sup>[1]</sup>

But two factors can change that picture.

The first is the intensity and duration of the shock.

ECB research shows that the relationship between energy price shocks and inflation can be non-linear: while small increases trigger no significant reaction in prices, larger shocks have disproportionately stronger effects.<sup>[2]</sup>

The second is the propagation of the shock, which depends on the macroeconomic environment in which it lands.

Firms are more likely to be able to raise prices when demand is stronger, workers are more likely to be able to bargain for higher wages when labour markets are tighter, and both are more likely when inflation is already high.

ECB research confirms that pass-through is measurably stronger when capacity utilisation is high and unemployment is low<sup>[3]</sup> – and that wages feed into prices more forcefully when inflation is already elevated.<sup>[4]</sup>

How people have experienced inflation in the recent past also matters. Research shows that lived experiences of inflation can have lasting effects on how people form expectations, with recent salient episodes carrying disproportionate weight.<sup>[5]</sup>

When the energy shock hit in 2021–22, several of these channels were operating simultaneously. But there are factors today which point to a lesser pass through.

First, the initial shock has so far still been smaller.

In 2022, the shock was exceptionally large and persistent. Even before the Russian invasion began, oil prices had increased threefold between October 2020 and March 2022 – and natural gas prices by even more as Russia gradually throttled supplies.

Thereafter, Europe was effectively cut off from a supplier that had provided around 45% of its natural gas imports and forced to find new suppliers, compete in the global LNG market and build new import infrastructure.

Oil prices peaked at around \$130 per barrel in March 2022, a comparable level to today. But gas prices surged to much higher levels than we have seen so far: €340 per megawatt hour in August 2022 versus around €60 today.

Second, the macroeconomic backdrop today is more benign.

In 2022, the economy was primed for pass-through. Europe was experiencing strong pent-up demand after the post-pandemic reopening. Supply chains were still disrupted after the pandemic. There were significant labour shortages. Headline inflation at the onset of the shock stood at more than 5%.

ECB analysis confirms that this combination of factors exacerbated the inflationary effects.<sup>[6]</sup> In particular, in the absence of demand pressures, the impact of supply-side shocks on inflation would have been considerably lower.

Today, the euro area economy is in a moderate recovery, without the pronounced demand-supply imbalances that characterised 2022. Headline inflation has been close to our target for almost a year. The unemployment rate is low by historical standards but we no longer face acute labour shortages.

Third, macroeconomic policies are less supportive.

When the invasion began in 2022, monetary policy was highly accommodative, with interest rates at -0.5% and the ECB still engaged in net asset purchases. The fiscal stance was also expansionary, with an aggregate deficit of over 5%.

Interest rates today are broadly at their neutral level and the fiscal stance is neutral, too, with an aggregate fiscal deficit of around 3%.

At the same time, there are reasons for vigilance.

The International Energy Agency has described this as the largest supply disruption in the history of the global oil market<sup>[7]</sup>, and with the attacks on energy infrastructure – especially the Ras Laffan facility in Qatar last week – the likelihood of a quick normalisation is diminishing.

A further cliff edge is also approaching: global oil reserves are being drawn down, and the last LNG tankers that loaded in the Gulf before the war are now reaching their destinations, meaning the full impact of lost supply is only about to be felt.

And if the shock does intensify, the response of firms and workers may be faster than last time. We have a more recent memory of high inflation, which could affect how quickly costs are passed on and compensation is sought.

During the inflation surge, firms shifted to adjusting prices significantly more frequently: the share of consumer prices changing in any given month rose from around 8% to 12%.<sup>[8]</sup> As inflation came down, that frequency returned to near-normal levels. But the operational experience of rapid repricing remains.

On the worker side, the initial response was relatively slow: after a long period of price stability, it took time for employees to seek inflation compensation. But research shows that as inflation rose, people began paying more attention to price developments, particularly when inflation was far from target.<sup>[9]</sup>

Even though the 2022 shock was brought under control, that experience has left a mark. An entire generation has now lived through its first episode of high inflation – and it may not be as slow to react a second time.

### **Managing uncertainty**

So we face a situation where, if the current shock remains contained in energy markets, it may have a limited effect on broader inflation. But if it intensifies or persists, the pass-through could accelerate.

How can we calibrate policy under this uncertainty?

There are two key elements.

The first is agility. We have followed for some time now a meeting-by-meeting, data-dependent approach without pre-committing to a particular rate path. This was precisely because we did not want to have our hands tied in an environment where the outlook could change rapidly.

In 2022 we were still bound by forward guidance on asset purchases and rates when the energy shock hit. That pre-commitment limited our flexibility to act. Now, we are prepared, if appropriate, to make changes to our policy at any meeting.

The second element is a focus on risks.

Last year, we updated our monetary policy strategy with precisely the type of challenge we face today in mind. We judged that we were moving into a world of more frequent supply shocks – we have faced at least four major ones since 2020 – and structurally higher uncertainty.

We decided that, in this environment, we needed to take into account not only the most likely path for inflation, but also the risks and uncertainty surrounding the baseline. This emphasis on risks was embedded in our reaction function in July 2025.

Given the range of possible outcomes we face today, scenarios are an especially valuable way to capture risks. They allow us to explore what could happen if key variables were to change – in particular, if the intensity, duration and propagation of the shock differ from our baseline assumptions.

ECB staff published two such scenarios last week. These are not forecasts: they are illustrations, constructed among other things under a no-policy-change assumption. And we will review and update our scenario analysis regularly.

The adverse scenario assumes that the shock intensifies but its duration is relatively short, containing its propagation through the economy.

Relative to the baseline, annual inflation moves almost one percentage point higher this year but falls back steeply by 2028, as indirect and second-round effects are outweighed by a large energy-related base effect. Growth would be somewhat lower in 2026 and 2027, before recovering in 2028.

The severe scenario assumes greater intensity, longer duration and broader, more persistent propagation.

Relative to the baseline, annual inflation would be significantly higher across the horizon – by almost three percentage points in 2027 – and would not return to target within the projection period.

Growth would be notably weaker in 2026 and 2027, by almost one percentage point cumulatively, before rebounding in 2028.

These scenarios highlight a crucial feature of the current environment: the non-linearity of the risks to inflation. As the shock grows in size and persistence, the response of prices and wages accelerates. The deviation from target widens disproportionately unless monetary policy steps in.

Because of these non-linearities, it is essential to identify as early as possible when the shock is at risk of broadening. That means tracking closely the indicators that can signal ahead of time the size and timing of indirect and second-round effects.

This will depend, naturally, on developments in commodity markets, because a sufficiently large shock will always spread beyond the energy component.

But it will also depend on how the burden of the shock is shared. As a net energy importer, a spike in energy prices creates a terms-of-trade tax for the euro area, which must be absorbed by some combination of workers, firms and governments.

If firms increase their selling prices disproportionately – as we saw in 2022 – it could trigger an equivalent response from workers, what I have called in the past tit-for-tat inflation.<sup>[10]</sup> We will therefore watch carefully firms’ selling price expectations and micro evidence on price changes, as well as paying close attention to wage trackers.

We will also monitor the demand side, as the risks to growth are on the downside. A negative supply shock weighs on demand, which can reduce the ability of firms to pass on costs and of workers to bargain for higher wages.

So far, consumer confidence has fallen more sharply in Europe than following the 9/11 attacks and the war in Kuwait in 1990, but not as steeply as following the Russian invasion of Ukraine. If households increase precautionary saving as they budget for higher energy bills, it could point to a more limited pass-through.

The fiscal response will matter. Targeted government policies can help smooth the shock by reducing energy demand and compensating lower-income households. But broad-based and open-ended measures may add excessively to demand and strengthen the pass-through.

### **On the appropriate policy response to supply shocks**

Our strategy also helps us define how to set monetary policy appropriately.

Supply shocks are often presented as offering central banks a binary choice: either look through, or react when inflation expectations are at risk of being de-anchored. But in reality we can respond in a more graduated way.

In line with the medium-term orientation of our strategy, the appropriate response to a deviation of inflation from the target is context-specific and does not depend only on its origin – here, a supply shock – but also on its magnitude and persistence.

This points to three broad cases.

First, if the energy shock is seen to be limited in size and short-lived, the classical prescription of looking through should apply. Transmission lags mean that a monetary policy response would arrive too late and risk being counterproductive.

Second, if the shock gives rise to a large though not-too-persistent overshoot of our target, some measured adjustment of policy could be warranted. The optimal response to such a deviation is smaller when the cause is exogenous supply disruptions rather than strong demand, but it is not necessarily zero.<sup>[11]</sup>

Moreover, to leave such an overshoot entirely unaddressed could pose a communication risk: the public may find it difficult to understand a reaction function that does not react.

Third, if we expect inflation to deviate significantly and persistently from target, the response must be appropriately forceful or persistent. Otherwise, self-reinforcing mechanisms would kick in and the risk of de-anchoring would become acute.

Our updated strategy is explicit on this point: large, sustained deviations call for forceful monetary policy action, shifting to persistence as the tightening cycle matures, to prevent those deviations from becoming entrenched.

It is too early to say where on this spectrum we will need to be. Fortunately, we can assess the situation carefully, because we are entering this shock from a good starting point. The policy stance is broadly neutral, inflation has been on target for around a year and longer-term inflation expectations are well-anchored.

In the period ahead, incoming information will give us greater clarity on how the conflict is likely to evolve and how the economy is responding. We will monitor developments closely and set monetary policy as appropriate to deliver on our target.

## **Conclusion**

Let me conclude.

Four years ago at this conference, as the energy shock from Russia's invasion of Ukraine was unfolding, I borrowed a line from Bertrand Russell: that the challenge we face is learning “how to live without certainty, and yet without being paralysed by hesitation.”

Those words capture our challenge today just as precisely. But we are not in the same position as we were four years ago.

We have a strategy that is built for a world of higher uncertainty, with risks and scenarios at its core. We have a graduated set of options for responding. And we are starting from a better place should we need to act.

We will not act before we have sufficient information on the size and persistence of the shock and its propagation. But we will not be paralysed by hesitation: our commitment to delivering 2% inflation over the medium term is unconditional.

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