MNI Connect:
The Luxury of Waiting and The Readiness to Act

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Main takeaways

1. A layer-cake: the euro area economy is facing **multiple, overlapping shocks**, whose interaction may generate **non-linear effects** and increases **uncertainty around macroeconomic outcomes**.

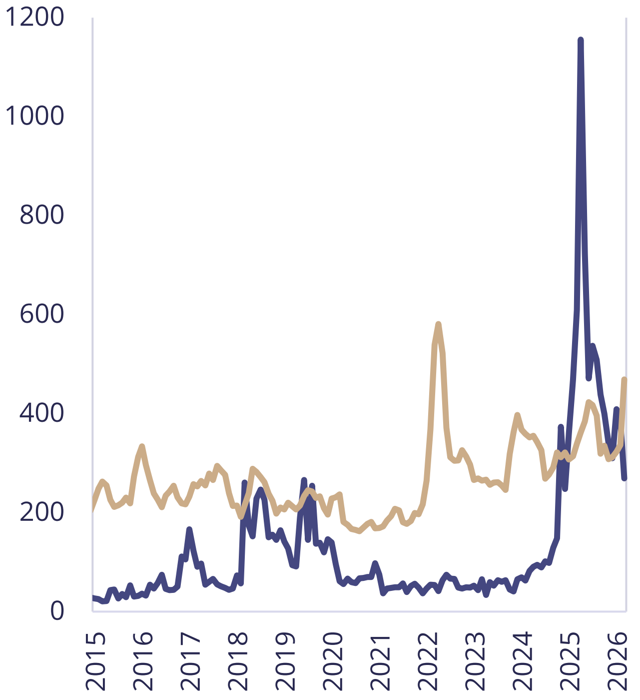
2. **Stagflation is not part of the current baseline**, but higher energy prices and elevated global uncertainty pose **upside risks to inflation** and **downside risks to growth**, thereby **complicating the policy trade-offs**.

3. **Fiscal policy** responses to higher energy prices are expected to be **more limited and targeted**, but the risks remain of more expansionary fiscal policy **adding to inflationary pressures and persistence**.

4. **Monetary policy:**
   - Inflation is likely to **remain elevated for some time**, even if the Middle East conflict were to be resolved quickly.
   - The longer the shock persists, the greater the risks of second round effects and **inflation expectations climbing up**.
   - Safeguarding the anchoring of inflation expectations is the **immediate policy priority.**
   - Revised monetary policy strategy allows **for flexibility**, including responding to a pronounced growth slowdown should this threaten inflation undershooting the target over the medium term.
   - As to **tail risks**... inventory levels, shortages, economic activity and China exports...

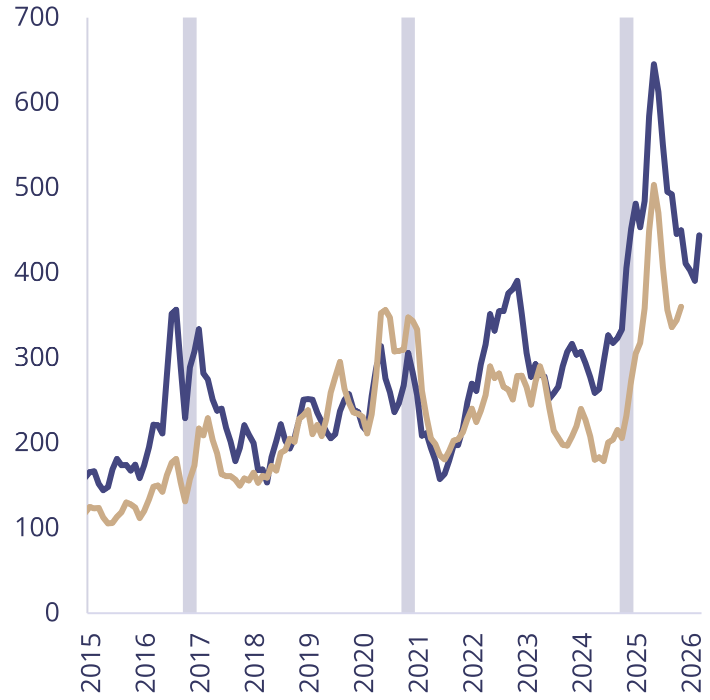
Layer-cake type of shocks:
geopolitical regime, interplay of shocks, non-linearity, volatility, persistence and resilience

Trade Policy Uncertainty and Geopolitical Risk (index)



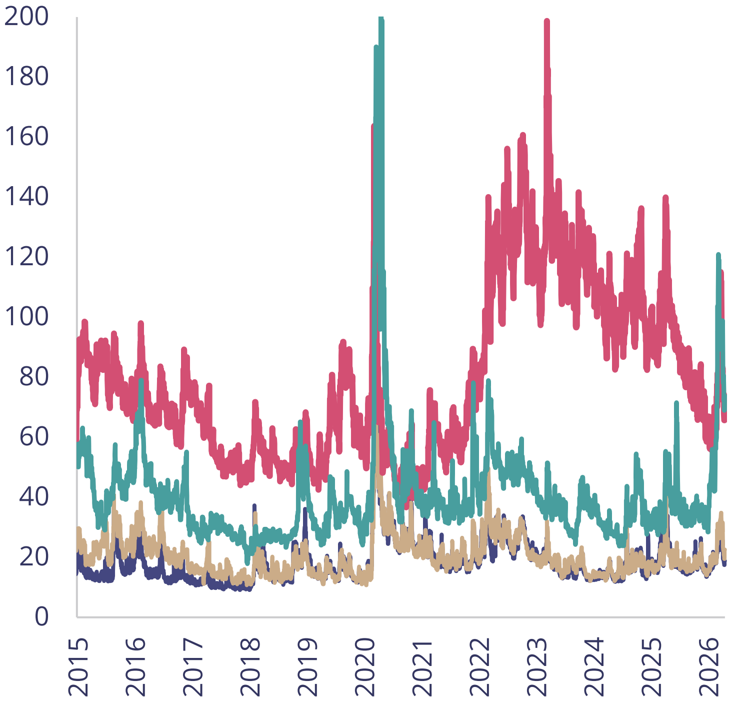
Source: Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo (2020), "The Economic Effects of Trade Policy Uncertainty," Journal of Monetary Economics, 109, pp.38-59.

Economic Policy Uncertainty and US Presidential Elections (index; 3m-MA)



Source: Economic Policy Uncertainty Project; Davis, S., 2016. “An Index of Global Economic Policy Uncertainty,” Macroeconomic Review.

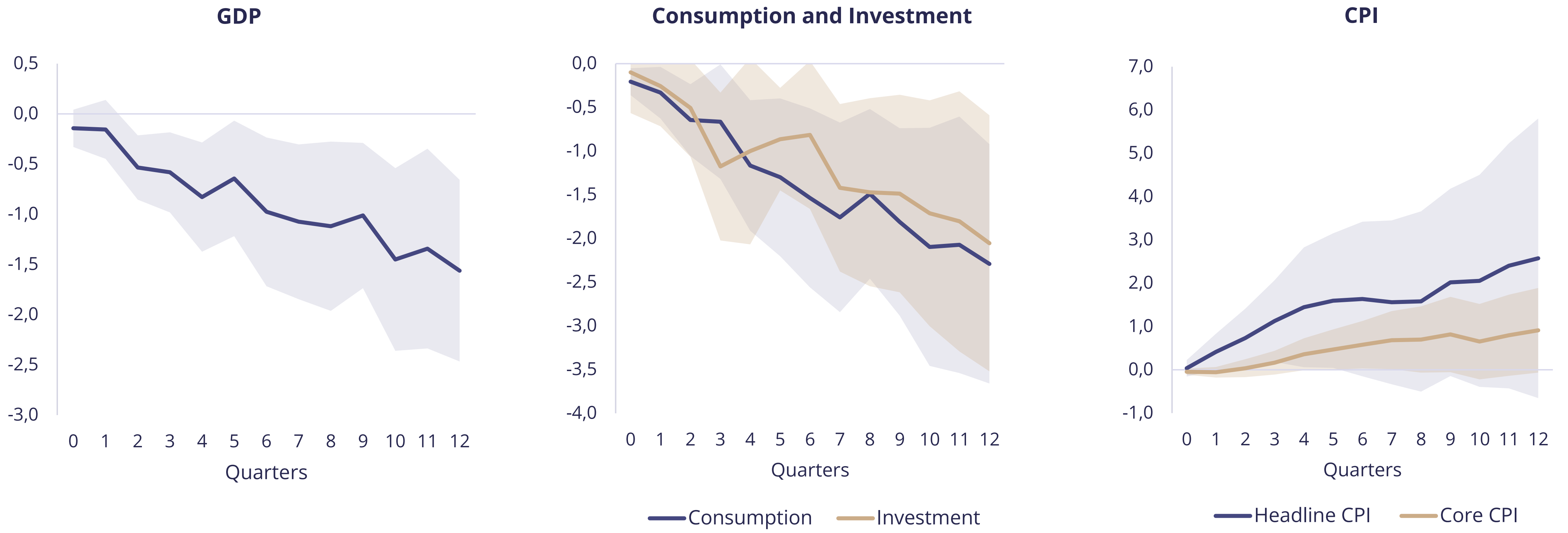
Selected volatility indices



Source: Bloomberg LP.

Geopolitical uncertainty adding negative impulse to the economy on top of rising energy prices

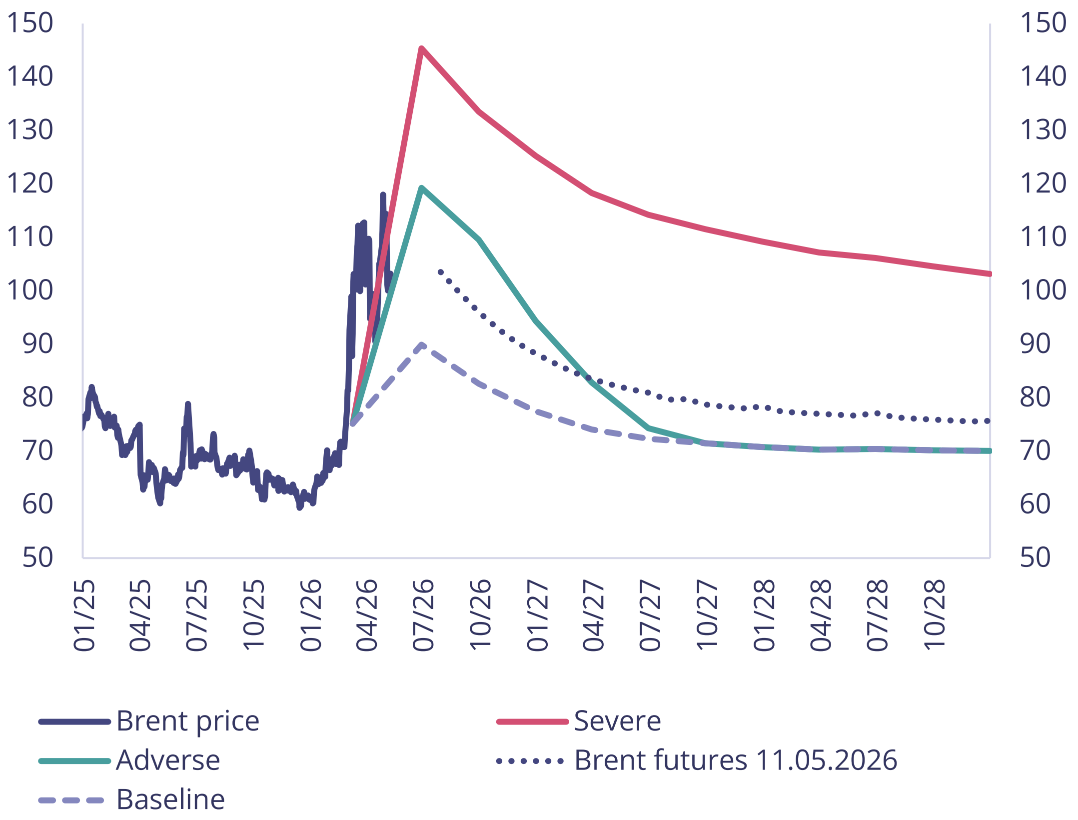
Estimated Impact of Geopolitical Risks (Cumulative IRFs in pp; response of 1 st.dev. GPR shock)



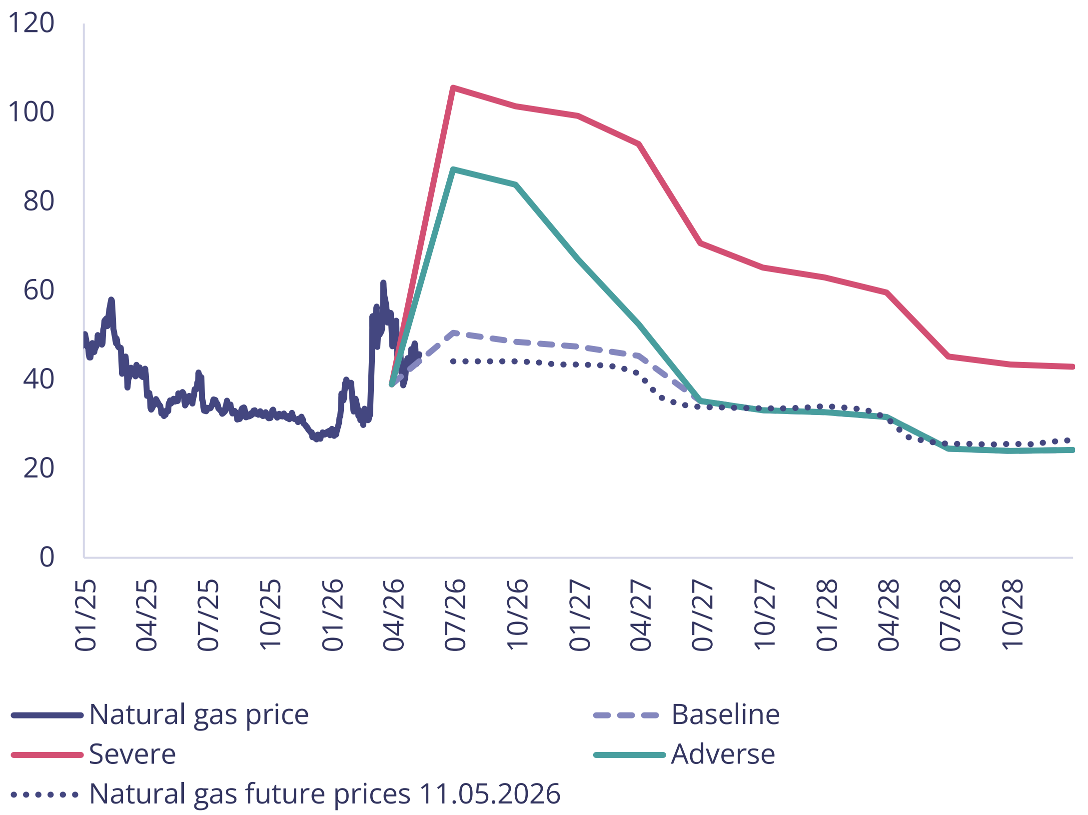
Source: Caldara et al (2026); IMF estimates.
Notes: The analysis uses local projections, controlling for lagged country-specific geopolitical risk and changes in macroeconomic variables, as well as country and time fixed effects. Geopolitical risk is measured based on newspaper archives. See Caldara and others (2026) for details. The country-level data were downloaded from https://www.matteoiacoviello.com/gpr.htm. The lines denote point estimates, and the shaded areas denote 90 percent confidence intervals.

Short-term outlook for energy prices: we are moving away from the March 2026 baseline

Brent crude (USD/bbl)



TTF natural gas prices (EUR/MWh)



Source: LSEG, ECB.

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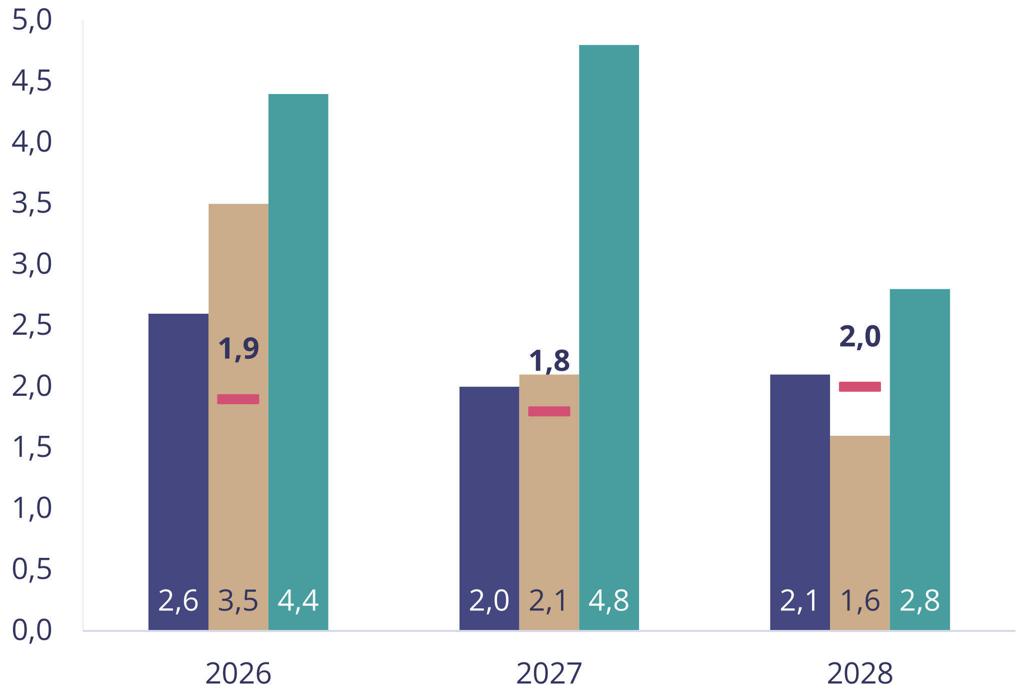
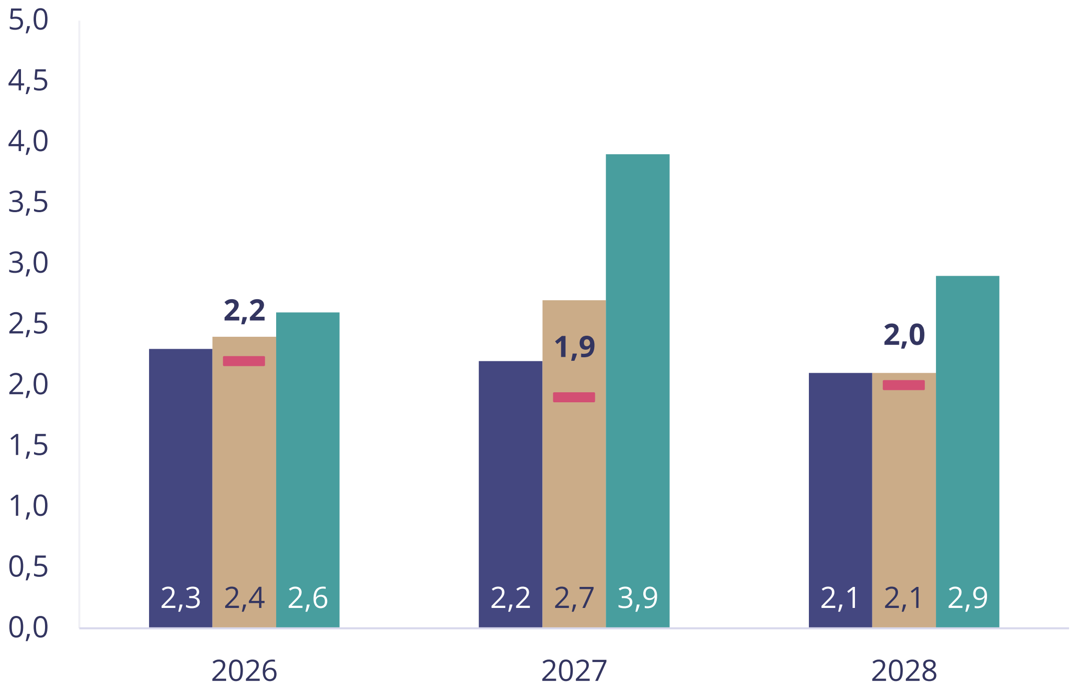
A more persistent conflict implies higher inflation, passthrough to other sectors, larger second-round effects

Euro area headline HICP inflation scenarios (%)



Euro area core HICP inflation scenarios (%)



Baseline scenario | Adverse scenario | Severe scenario | Dec. 2025 forecast

Source: ECB, Euro area Macroeconomic Projections, March 2026.

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Dealing with persistent uncertainty and multi-shock environment: ECB data-dependent and meeting-by-meeting approach

The revised Monetary Policy Strategy

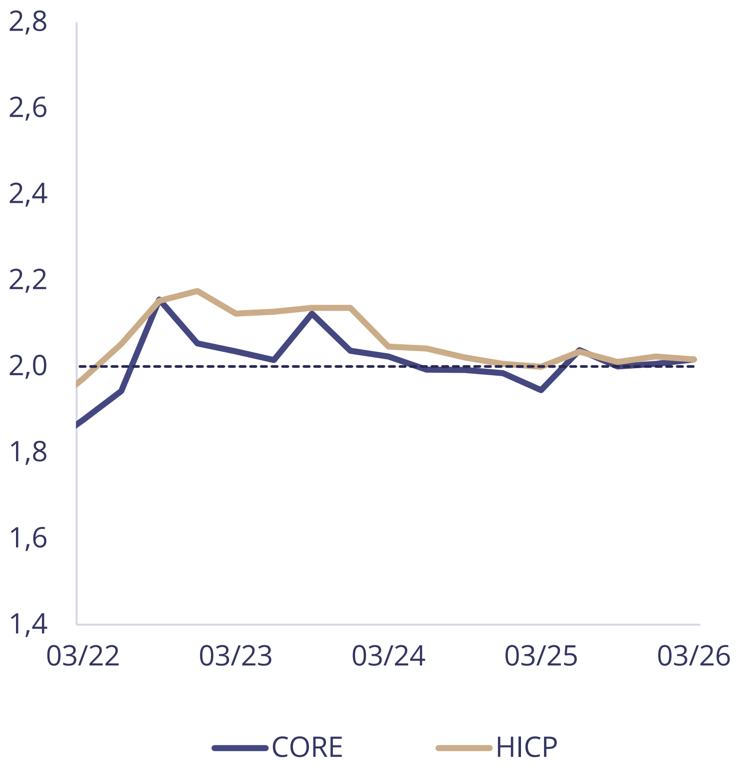
- Recognizes the importance of appropriately forceful or persistent monetary policy action in response to large, sustained deviations of inflation from the target in either direction, to avoid deviations becoming entrenched through de-anchored inflation expectations.

The practical implementation and monetary policy decisions are based on:

- Assessment of the inflation outlook and the risks surrounding it, in light of the incoming economic and financial data;
- The dynamics of underlying inflation;
- The strength of monetary policy transmission.

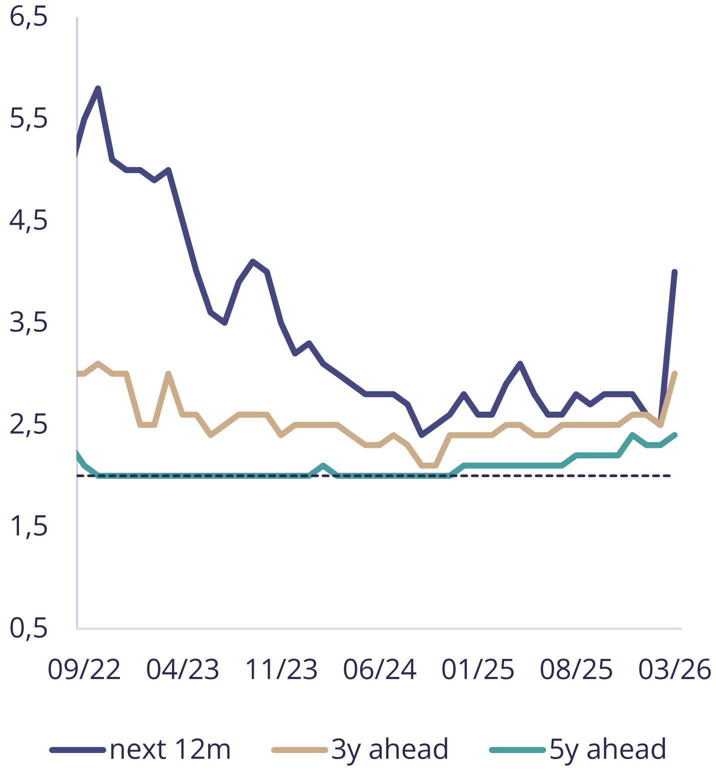
Financial market inflation expectations broadly anchored while the consumers becoming more anxious

Longer term (after 5 years) euro area inflation expectations, SPF



Swap implied inflation expectations in euro area (%)

ECB Consumer expectation Median expectations inflation



Source: Bloomberg, ECB, LB calculations.

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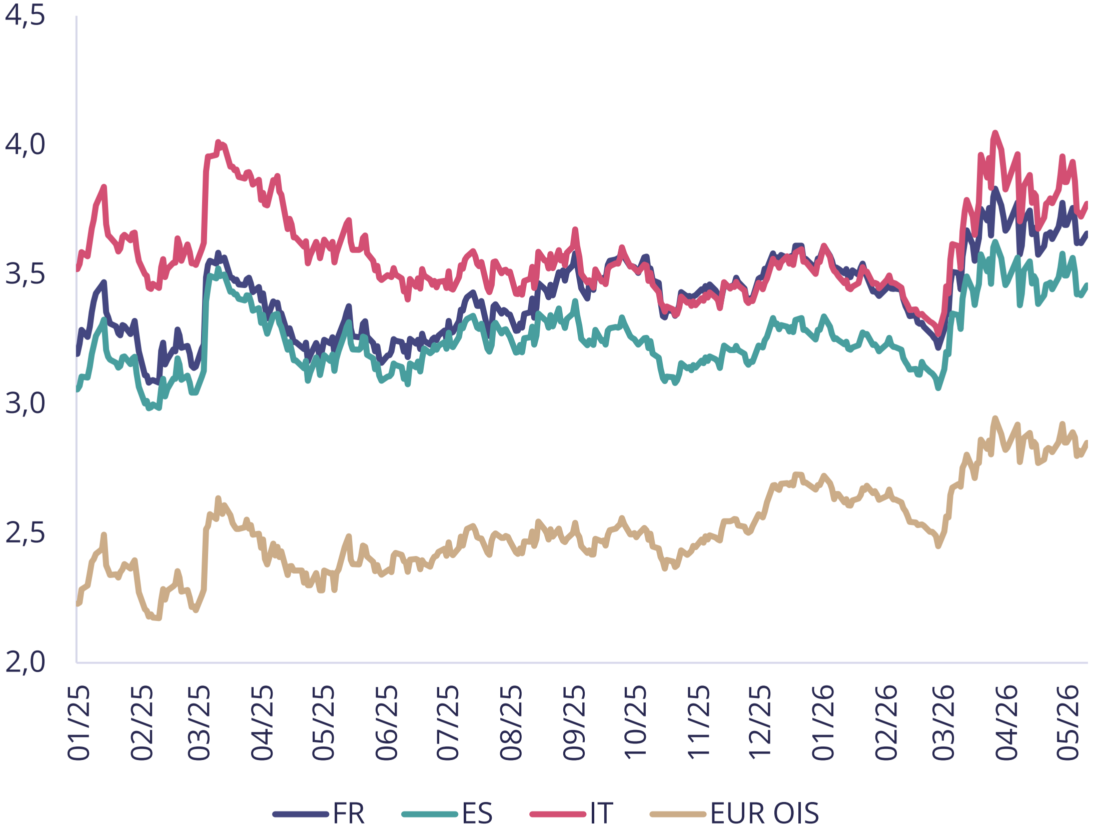
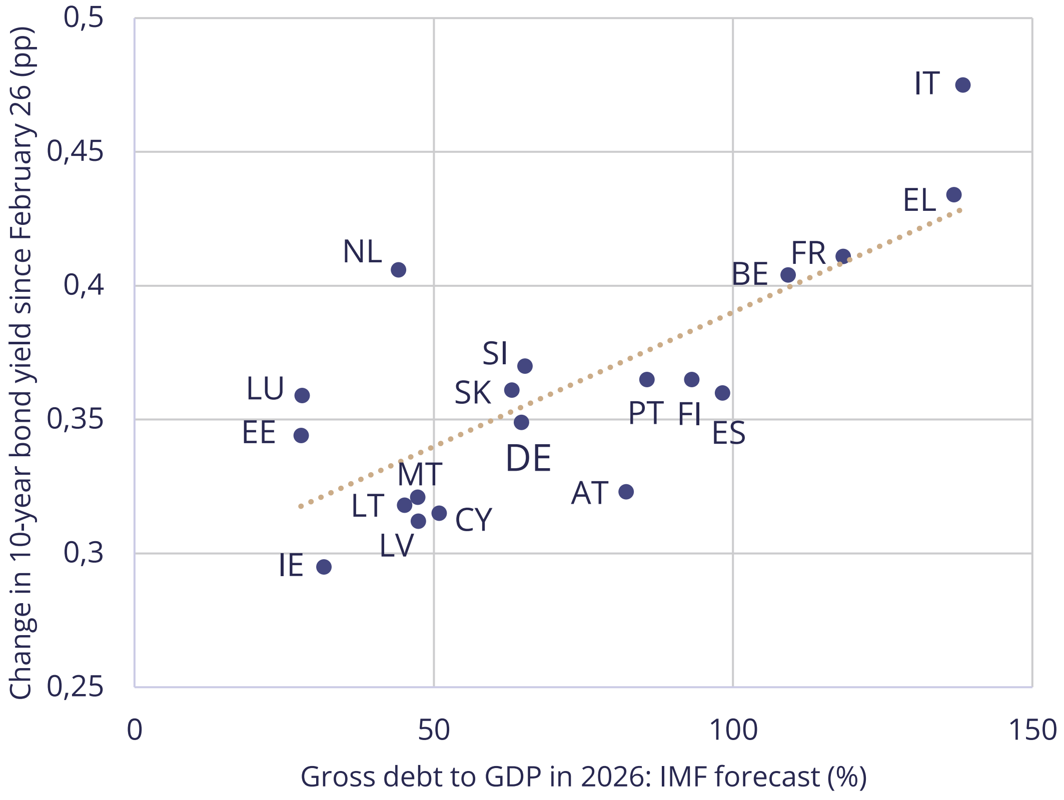
Fiscal concerns are driving up term premia and/or signalling expectations of higher inflation

10Y government bond yields (%)



Change in 10-year bond yield since February 26 and debt to GDP (ppts, %)



Source: Bloomberg LP, Latvijas Banka staff calculations.

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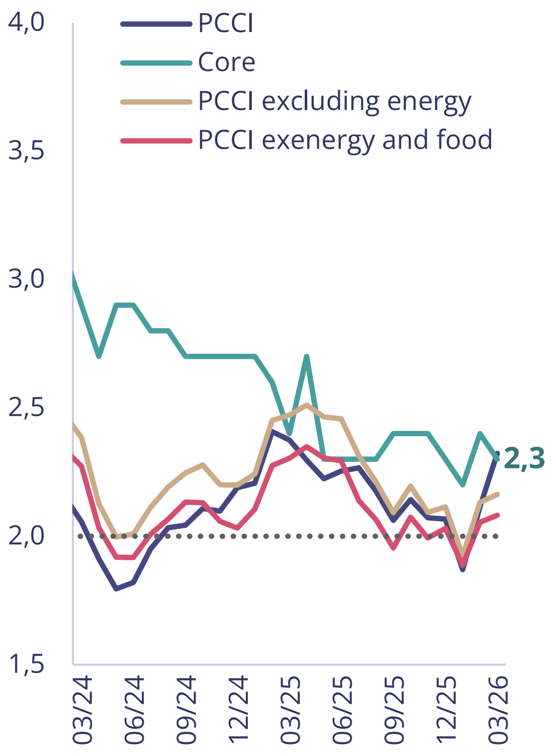
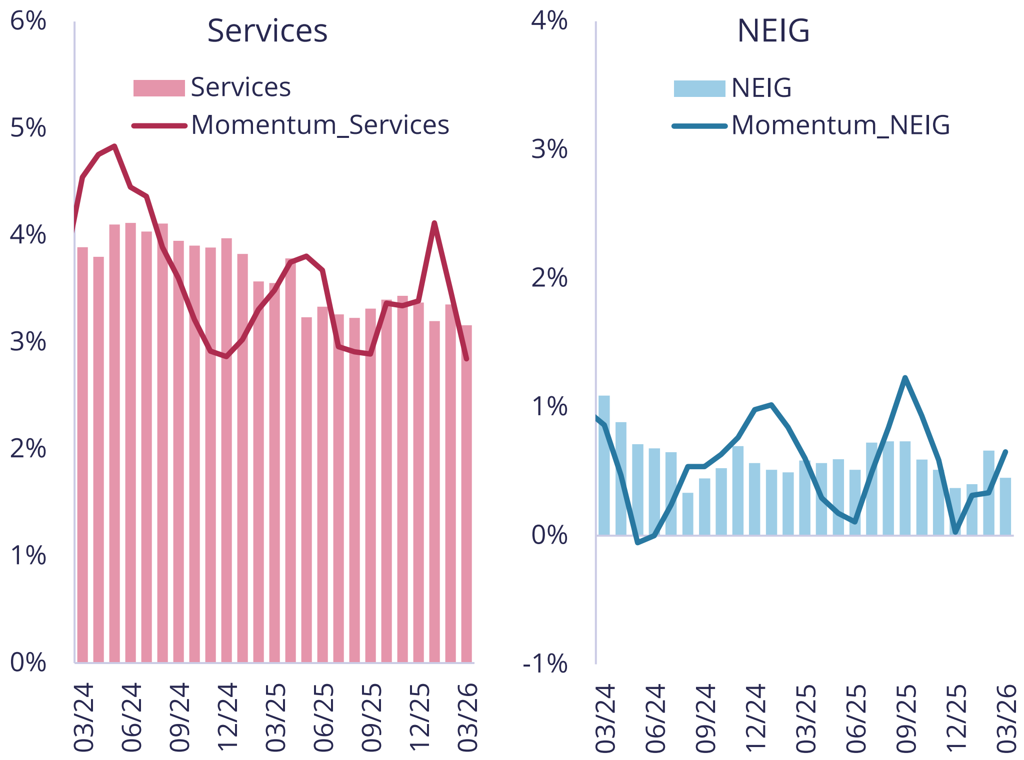
Underlying inflation indicators stable so far amidst external price shocks

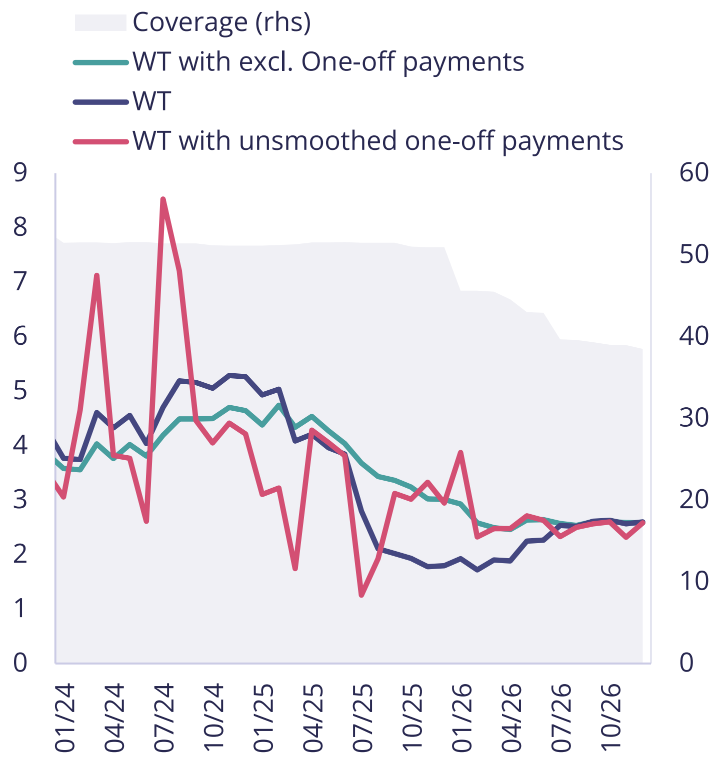
Underlying inflation measures (y/y, %)



Core inflation components momentum
(sa, 3m/3m and annualised)



ECB Wage Tracker (y/y, %)



Source: ECB Data Portal, BoL calculations.

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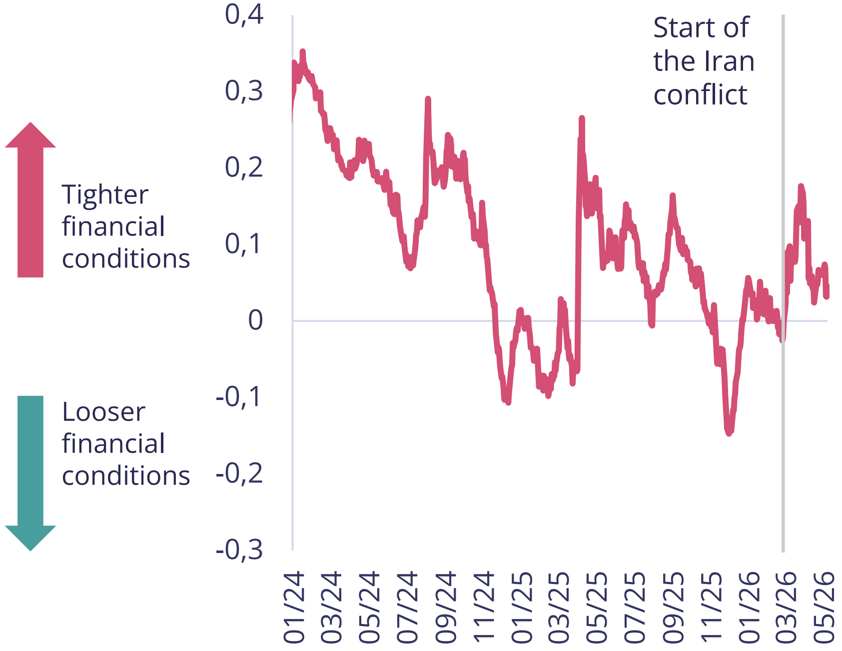
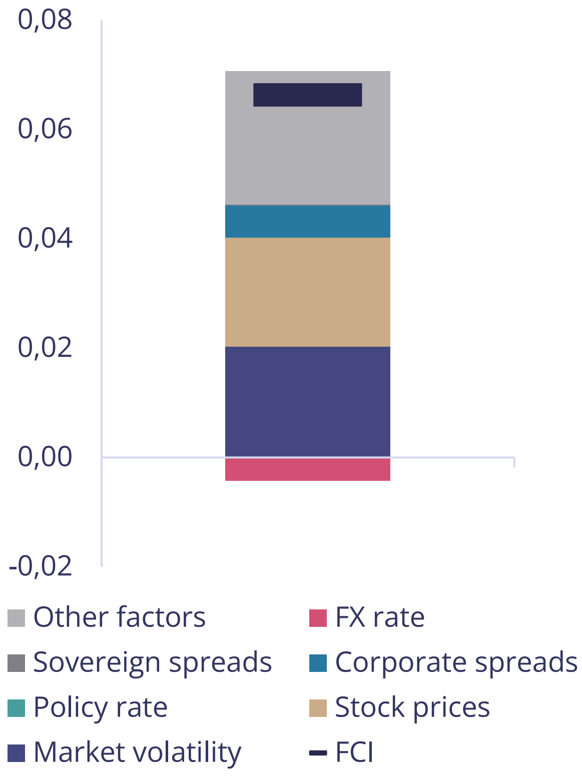
Financial conditions tighter since the start of the conflict in the Middle East, credit flows slowing down

BoL financial conditions index
(Stdv. from LT avg.)

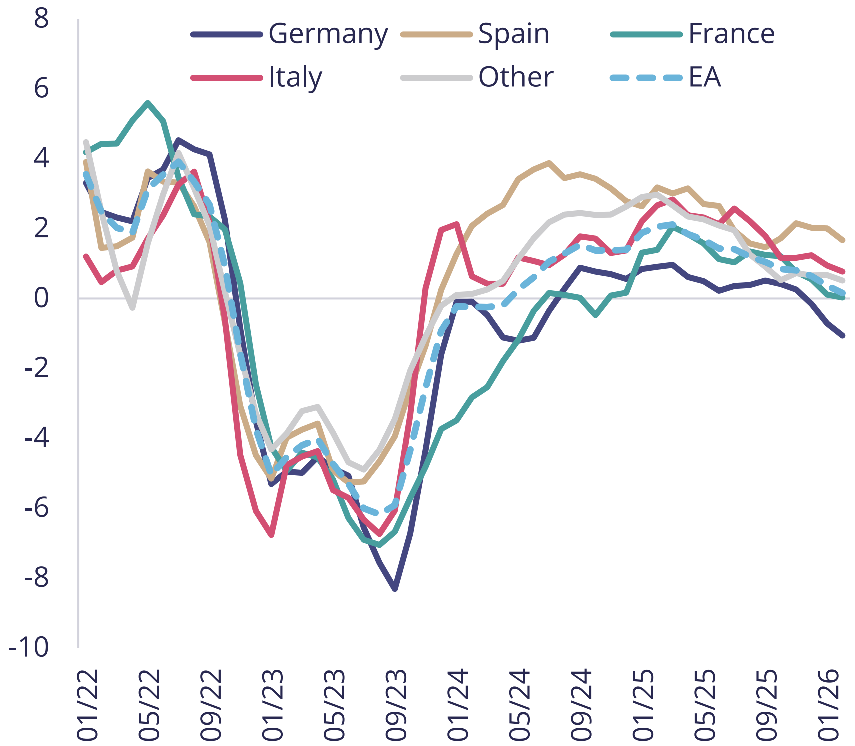


Notes. In the Financial Conditions Index, each factor is assigned a weight based on its impact on GDP growth. This impact is assessed using a vector autoregression (VAR) model, which helps determine how GDP responds to unexpected changes in factors or shocks. The significance of each factor is calculated using impulse response functions, as the 12-month cumulative impact following a shock. The index is expressed in standard deviations from the long-term average level. The higher the index value, the more restrictive the financial conditions.

Change in BoL FCI by its components since start of the Iran conflict (Stdv. from LT avg.)



Credit impulse by country
(3-month avg.)



Notes. Credit impulse is the ratio of the annual difference in the flows of private non-financial sector credit to nominal GDP.

Sources: Bloomberg LP, ECB (BSI), Latvijas Banka staff calculations.

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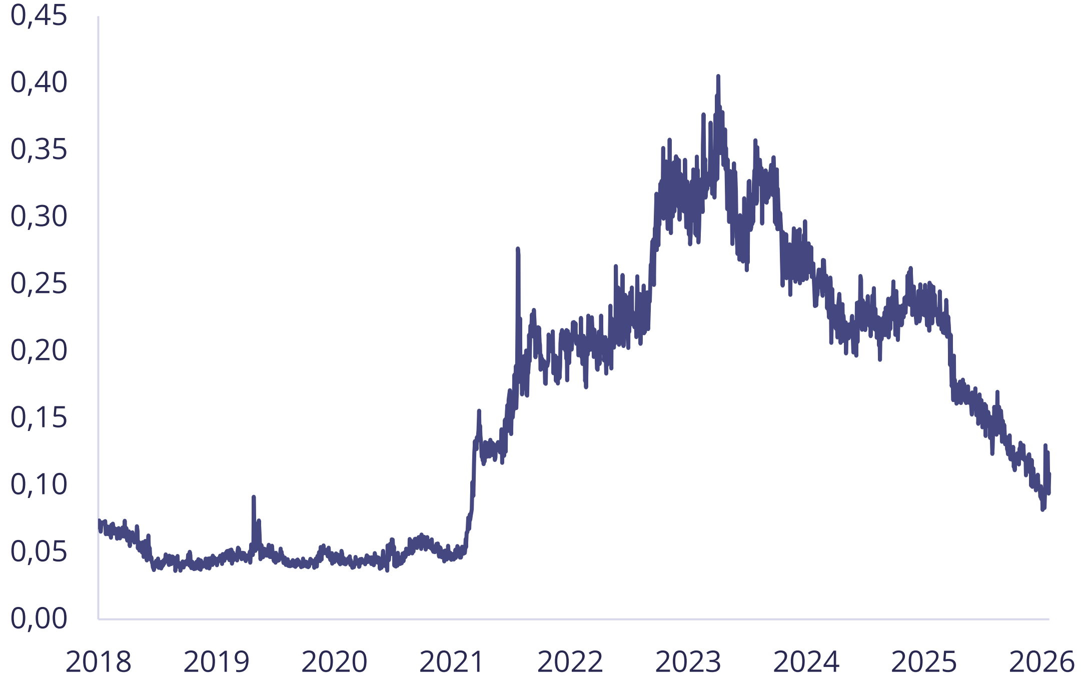
Bank of Latvia analysis: inflation expectations better anchored in 2026 than in 2022 (left). But that is largely due to expectations of stronger monetary policy reaction (right).

Impact of an oil supply shock on 1Y1Y inflation expectations (p.p.)



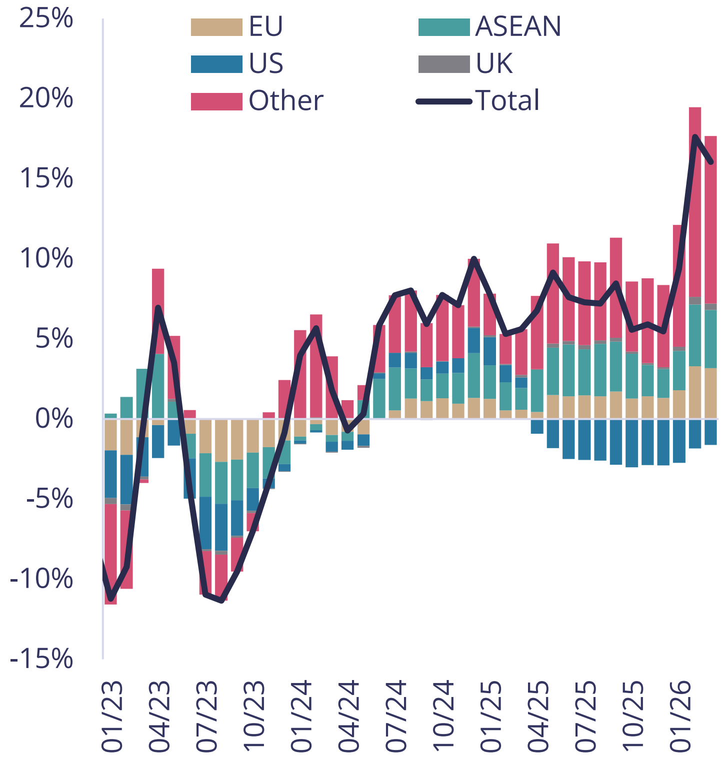
Impact of monetary policy shock on 1Y1Y inflation expectations (p.p.)

Notes: Figures show the peak impact from impulse response functions to an oil supply shock or a monetary policy shock, inferred via the daily Bayesian SVAR estimated over a rolling window of 260 days (January 2, 2018 – April 13, 2026). Each shock is normalised to generate a 10% increase in the Brent crude oil price (oil supply shock) or a 25 bps increase in the OIS rate (monetary policy shock), ensuring comparability of the estimated elasticities across rolling windows.

Source: Latvijas Banka staff calculations.

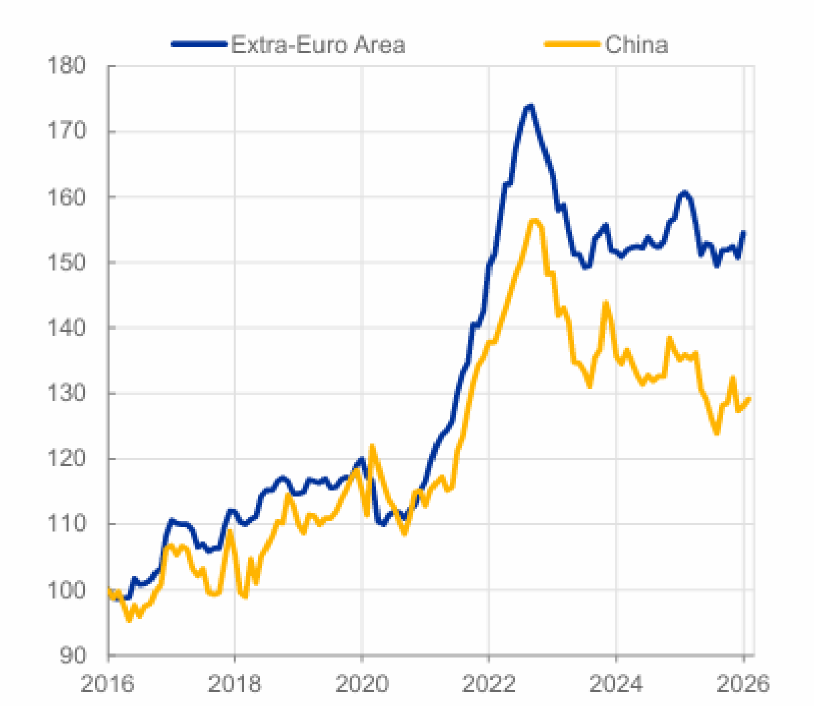
Longer – term perspective: China effects will be important

China exports (3 months moving average, annual %-changes)



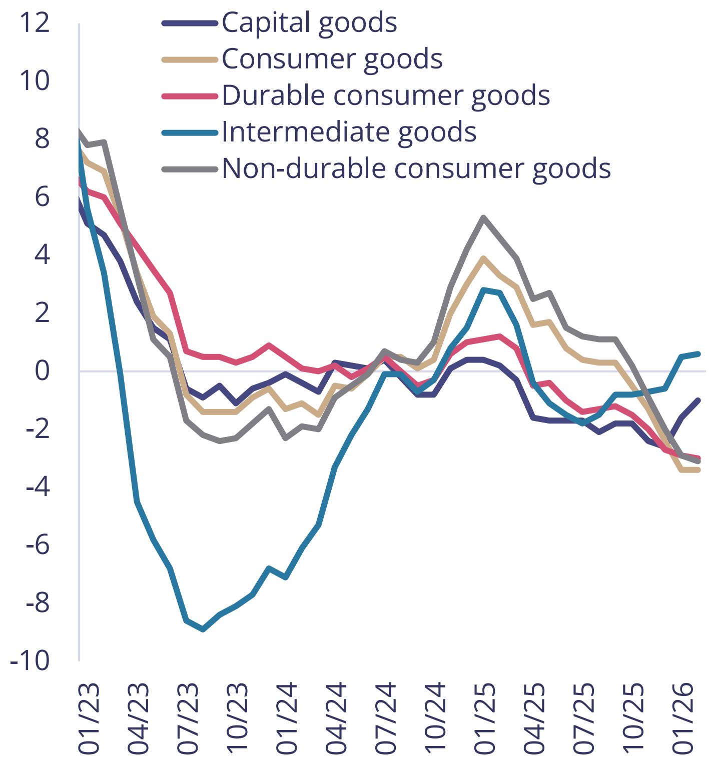
Last obsevation March

Euro area import prices (index, January 2016 = 100)



Last obsevation March

Import prices by type of goods, Extra-Euro Area (y/y, %)



Last obsevation February

Source: LSEG, Datastream, China Customs, Bank of Latvia calculations, Eurostat.

Conclusions: medium term monetary policy outlook

- According to the ECB’s three-pillar policy assessment, no need for immediate policy action in April, yet this does not imply a looking-through approach to current inflation episode.
- Financial markets have tightened financing conditions, supporting policy transmission, but for sustained effect this needs to be reinforced by monetary policy.
- Elevated inflation and downside risks to growth increase the complexity of trade-offs.
- In line with the Monetary Policy Strategy, large and persistent inflation deviations will not be tolerated; anchored inflation expectations is the near-term policy priority.
- Over time, if weaker growth intensifies downward pressures to medium-term inflation, policy would need to adjust accordingly.
- The Monetary Policy Strategy allows for flexible action in either direction, with policy agility particularly important in the current environment.

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Thank you!