



Flossbach von Storch  
RESEARCH INSTITUTE

ECONOMY & POLITICS 25/03/2026

# **The Central Errors of Central Banks Are They Heading for a Recession?**

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## Abstract

In 2021/22, the Fed and the ECB acted too late. In 2026, fear-ing the same mistake, they may tighten too early and thereby bring about a recession.

## Zusammenfassung

2021/22 agierten Fed und EZB zu spät. 2026 könnten sie aus Angst vor dem alten Fehler zu früh bremsen und damit eine Re-zession herbeiführen.

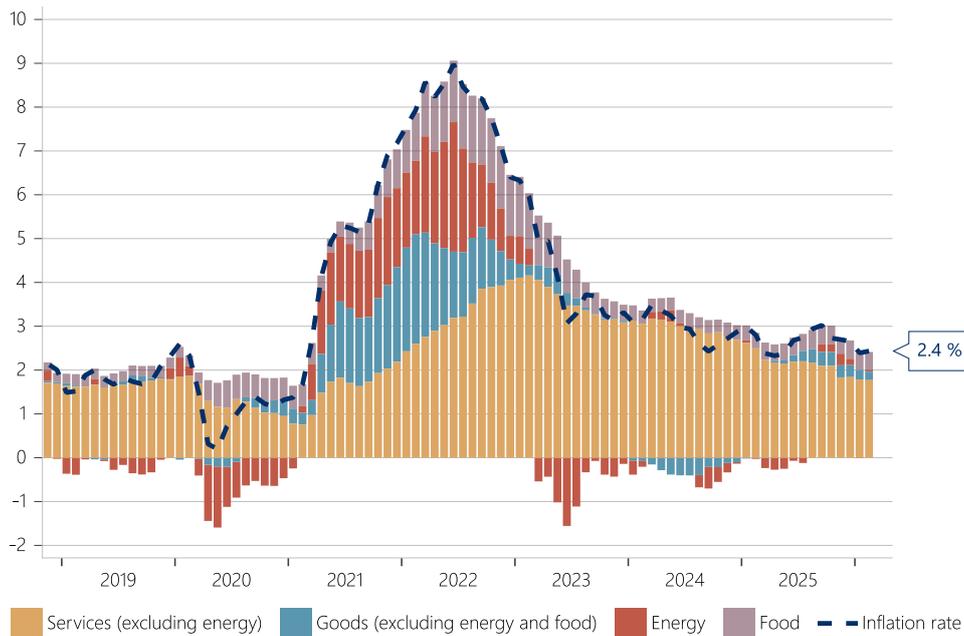


The Federal Reserve and the European Central Bank have been wrong before. They treated the inflation wave that began in 2021 as transitory. Now, afraid of repeating the same mistake, they may trigger a recession and then try to fight it with rate cuts.

### 1. The error of 2021/22: too late

As inflation in the United States and Europe began to trend uncomfortable upwards in 2021, central banks chose not to act. Inflation picked up as Covid lockdowns were gradually lifted. Yet policymakers assumed that the rise in prices would prove temporary and fade even without monetary tightening. The recovery in demand in 2021 collided with broken supply chains and constrained energy production. As a result, imported goods and energy already accounted for almost two thirds of the 7% inflation rate in the United States by the end of 2021 (see Figure 1). The rest was already visible in services, which later became the main driver of inflation.

Figure 1: Components of inflation in the United States

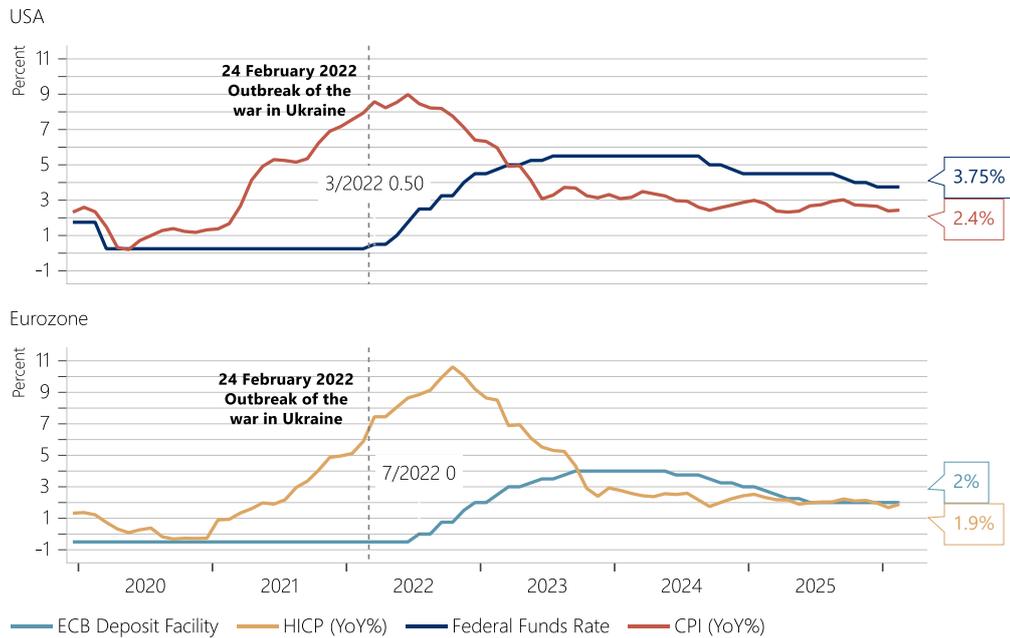


Source: Flossbach von Storch Research Institute, Macrobond, U.S. Bureau of Labor Statistics (BLS). Data as of February 2026.

By the time Russia invaded Ukraine on 24 February 2022, US inflation had already reached 7.9% year on year (see Figure 2). The subsequent rise in oil and gas prices, amplified by sanctions, intensified an inflation dynamic that was already well under way. The Fed did not start raising rates until March 2022. The ECB waited even longer.



**Figure 2: Inflation rate vs. policy rate in the United States and the euro area**



Source: Flossbach von Storch Research Institute, Macrobond, Fed, ECB, Eurostat, BLS. Data: 2/2026.

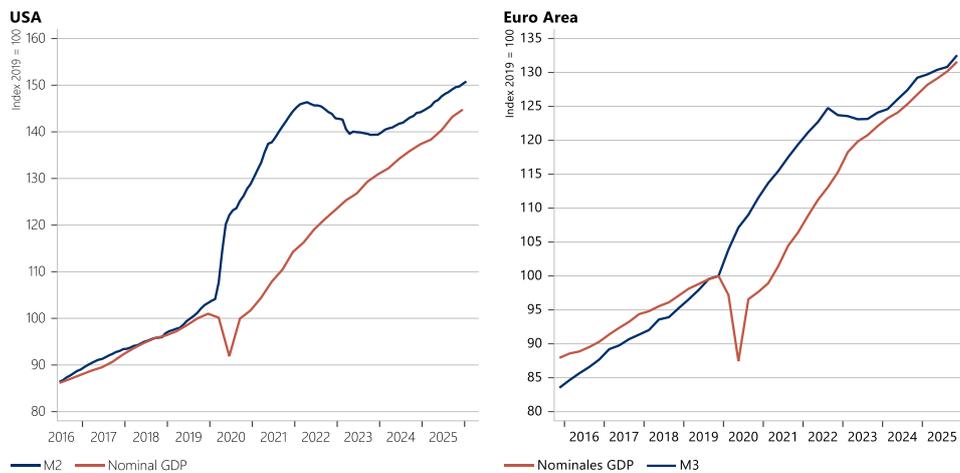
Source: Flossbach von Storch Research Institute, Macrobond, Fed, ECB, Eurostat, BLS. Data as of February 2026.

The core of the mistake lays in the failure to grasp the monetary overhang built up in 2020 and 2021. A monetary overhang emerges when the money supply expands without a corresponding increase in money demand. One rough way to gauge it is to look at the gap that opens up between the money supply and nominal GDP over a period of time. During the Covid crisis, highly expansionary fiscal and monetary policy sharply increased the amount of money available in both the United States and the euro area (Figure 3). At the same time, especially during lockdowns, the demand for money to finance spending in the real economy remained unusually weak, as the initially falling and only later gradually recovering path of nominal GDP makes clear. Some of that excess liquidity flowed first into financial assets.

Later, as lockdowns were gradually lifted in 2021, the money created earlier began to finance consumption. Demand for goods and services rose quickly, while supply remained constrained by bottlenecks in production and transport. Because central banks reacted late, too much money ended up chasing too few goods. First food and energy prices rose, then services, and then almost everything else.



**Figure 3: Money supply M2 and M3 and nominal GDP in the United States and the euro area**



Source: Flossbach von Storch Research Institute, Macrobond, ECB, Eurostat. Data as of Q4 2025.

## 2. The potential error of 2026: too early

Today the situation seems different. The latest rise in energy prices is hitting an economy in which the monetary overhang appears much smaller. In the United States, the money supply has started to grow again, but since early 2022 the overhang has narrowed markedly (Figure 3). Much of the excess built up between 2020 and 2022 has probably been absorbed by inflation and, in the United States, by real growth.

Precisely because today's economy does not appear to be carrying a monetary overhang comparable to that of 2022, an energy price shock does not have to automatically produce another inflation wave. Without accompanying monetary expansion, a sharp rise in oil and energy prices mainly forces an adjustment in consumption. Households and firms must devote more income to energy, leaving less for other goods and services. When goods such as energy and food cannot easily be replaced by cheaper alternatives, the loss of purchasing power forces spending cuts elsewhere, dampening price pressure in other sectors such as services. In other words, today's energy shock looks more like a change in relative prices than the start of another broad inflation wave such as that of 2021/22.

Yet weaker demand for other goods and services also weakens economic activity. That is where the monetary policy risk lies. If central banks, with the memory of past mistakes still fresh, now decide to raise interest rates, they may commit the opposite error. They would be tightening policy into an economy that is already weak. The ECB's decision to revise up its inflation forecast for 2026 suggests that it does not see the latest increase in energy prices merely as a relative price shift, but as an inflation risk relevant for monetary policy.



### 3. Markets and consequences

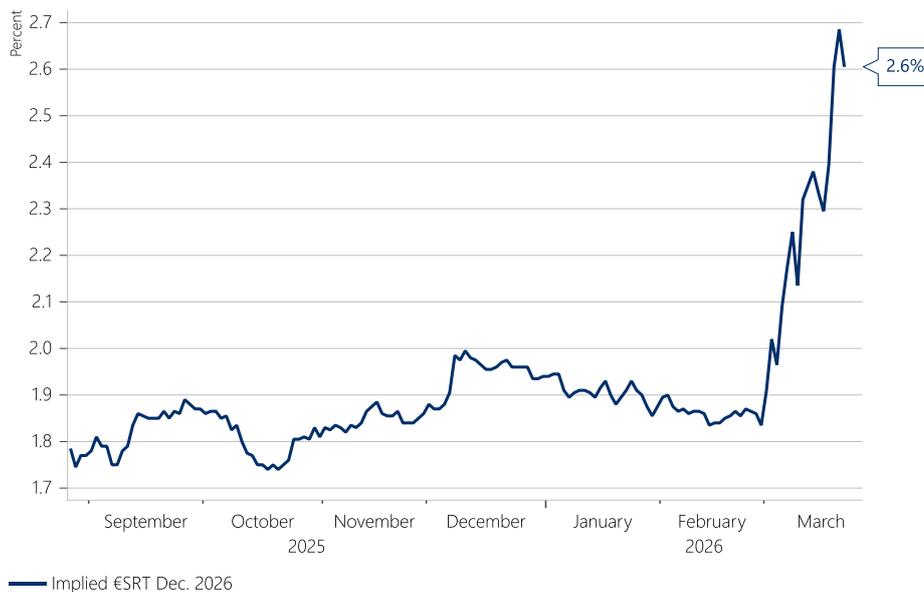
Markets have been pricing in exactly that scenario for several days. The yield on two-year US Treasury bonds, a good barometer of expectations for short-term interest rates, has risen since the start of the war in Iran and jumped again after the Fed's recent decision not to cut rates (Figure 4). In futures markets, almost three ECB rate hikes, amounting to a cumulative 75 basis points, are now priced in by the end of 2026 (Figure 5).

**Figure 4: US policy rate and yield on the two-year US Treasury**



Source: Flossbach von Storch Research Institute, Macrobond, New York Fed, U.S. Treasury. Data: 3/20/2026.

**Figure 5: ECB policy rate implied by futures markets for December 2026**



Source: Flossbach von Storch Research Institute, Macrobond, ICE. Data: 3/23/2026.

Source: Flossbach von Storch Research Institute, Macrobond, ICE. Data as of 23 March 2026.



When investors expect higher policy rates, financial conditions tighten even before the central bank moves. Higher rates and more expensive credit slow growth. If central banks were then to validate that tightening with further rate hikes, the risk of recession would rise, especially in the euro area. Europe is more exposed to energy costs, while productivity growth has disappointed for years.

At the same time, with public debt levels already high in both the euro area and the United States, it is hard to imagine that a restrictive policy stance could be maintained for long. A renewed policy turn, driven by fears of recession and deflation, looks more likely. In that case, expectations of rate cuts would return, and the cuts themselves would probably follow.

#### **4. Conclusion**

Perfection in monetary policy is impossible. Central banks always move between two errors: reacting too late or tightening too hard. In 2021 and 2022 they erred because they failed to tighten in time despite a substantial monetary overhang. In 2026 the risk may be different: that, fearful of repeating the old mistake, they react too aggressively even though today's energy shock does not have the same inflationary character as it did then. If that diagnosis is correct, a recession could arrive sooner than many now expect



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