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# **MONETARY AFFAIRS**

**Preview: ECB To Stay on Hold**

**Amidst War-Related Economic Uncertainty**

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**18 March 2026**

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**Preview: ECB Preview: ECB To Stay on Hold Amidst War-Related Economic Uncertainty**

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**Executive Summary**

✦ **Expected Decision:** *We expect the ECB to remain on hold in March.* In line with consensus, at the March Governing Council (GC) meeting, we expect the European Central Bank (ECB) to keep its main policy rates unchanged i.e. its *i)* interest rate on the ‘main refinancing operations’ at 2.15%; *ii)* interest rate on the ‘marginal lending facility’ at 2.40%; and the key *iii)* ‘deposit facility’ at 2.00%. In terms of *forward guidance*, the ECB is expected to maintain its data-dependent, meeting-by-meeting approach, reaffirming its three-pronged reaction function.

✦ **Policy Discussion:** *The main uncertainty facing policymakers stems from the renewed energy shock linked to the Middle East conflict.* Supply-side shocks create a difficult policy trade-off: higher energy prices push inflation up while simultaneously weakening economic activity. This complicates the ECB’s response, particularly given criticism that it reacted too slowly in 2022 when inflation was initially described as “transitory.”

At the same time, the ECB is mindful of the opposite risk: tightening policy too aggressively into a weakening economy. The memory of the 2008 policy mistake still looms large, when the ECB raised rates as oil prices surged above \$140 per barrel, only weeks before the collapse of Lehman Brothers and the onset of the global financial crisis. The move was widely criticised as a miscalculation, as the ECB soon had to reverse course and cut rates sharply as oil prices collapsed and recession deepened. Today’s environment carries some parallels. Energy prices are again rising while euro-area growth remains fragile, particularly in manufacturing. If oil prices were to surge further, the resulting energy shock could significantly weaken growth, making a premature rate hike look like a policy error. For now, the ECB is likely to stay on hold, though markets are pricing a relatively high probability of tightening by June. April appears unlikely to bring action, leaving June as the key meeting where the debate between hawkish and more cautious policymakers may intensify.

✦ **Changes to Economic Forecasts:** *The conflict in the Middle East has increased uncertainty around the inflation outlook as higher energy prices weigh on market sentiment.* Isabel Schnabel warned that geopolitical tensions pose upside risks to inflation, particularly if energy costs remain elevated. While some economists caution that the war could push inflation higher, others argue the impact may be limited if global oil supply continues to outpace demand. Markets have begun reassessing the ECB’s policy path, with traders now assigning roughly a 25% probability of a rate hike by year-end after previously expecting further easing.

Schnabel said the ECB’s upcoming quarterly projections will partly incorporate the economic effects of the conflict, while stressing that monetary policy remains in a “good place.” The outlook, however, remains uncertain as higher energy prices could both raise inflation and weaken growth depending on how long the conflict lasts. For now, policymakers say it is too early to judge the full impact. Previous ECB forecasts projected inflation to stay just below 2% in the near term before reaching target later in the decade, while wage growth remains solid though gradually moderating.

### Key Picture: European Central Bank Key Forecasts – 2025-2028

	Latest reading	2025f		2026f		2027f		2028f
		December Projections	September Projections	December Projections	September Projections	December Projections	September Projections	December Projections
GDP ( <i>real growth, y-o-y</i> )	1.2	1.4	1.2	1.2	1.0	1.4	1.3	1.4
Inflation ( <i>%, y-o-y</i> )	1.9	2.1	2.1	1.9	1.7	1.8	1.9	2.0
Core-inflation ( <i>%, y-o-y</i> )	2.4	2.4	2.4	2.4	1.9	1.9	1.8	2.0
Unemployment ( <i>%, y-o-y</i> )	6.1	6.3	6.4	6.2	6.3	6.1	6.1	5.9

Source: ECB 'Macroeconomic projections' [December](#) and [September](#) 2025 Note: Latest readings: 1. GDP for Q4 2025; 2. Unemployment for January 2026; 3. Inflation for February 2026. \*Inflation = Harmonized Index of Consumer Prices (HICP).

#### Analysis

- ✦ **EXPECTED DECISION:** *We expect, in line with consensus, the ECB to remain on hold in March.* At the Governing Council (GC) meeting on March 19th, we expect the European Central Bank (ECB) to keep unchanged its main policy rates i.e. its *i)* interest rate on the 'main refinancing operations' at 2.15%; *ii)* interest rate on the 'marginal lending facility' at 2.40%; and the key *iii)* 'deposit facility' at 2.00%.

In terms of *forward guidance*, the ECB will stress that it remains data-dependent and the decisions will be still taken meeting-by-meeting, with its usual three-pronged approach about its reaction function confirmed. Looking ahead, the ECB is expected to adopt a cautious, data-dependent approach.

In terms of *Balance Sheet policies*, the GC has decided to move forward with the normalization of the balance sheet. GC confirmed that it will reduce the Eurosystem's holdings of securities under the PEPP. As of December 2024, the ECB has stopped re-investing the PEPP proceedings. The process for reducing PEPP holdings will generally follow the same approach as the APP.

- ✦ **POLICY DISCUSSION** *The main uncertainty facing policymakers now comes from the renewed energy shock linked to the Middle East conflict.* Such supply side shocks typically create a difficult policy trade-off: higher energy prices push inflation up while simultaneously weakening economic activity. This asymmetry complicates the ECB's response, particularly given the institution's experience in 2022, when it was criticized for waiting too long to respond to inflation that was initially labelled "transitory."

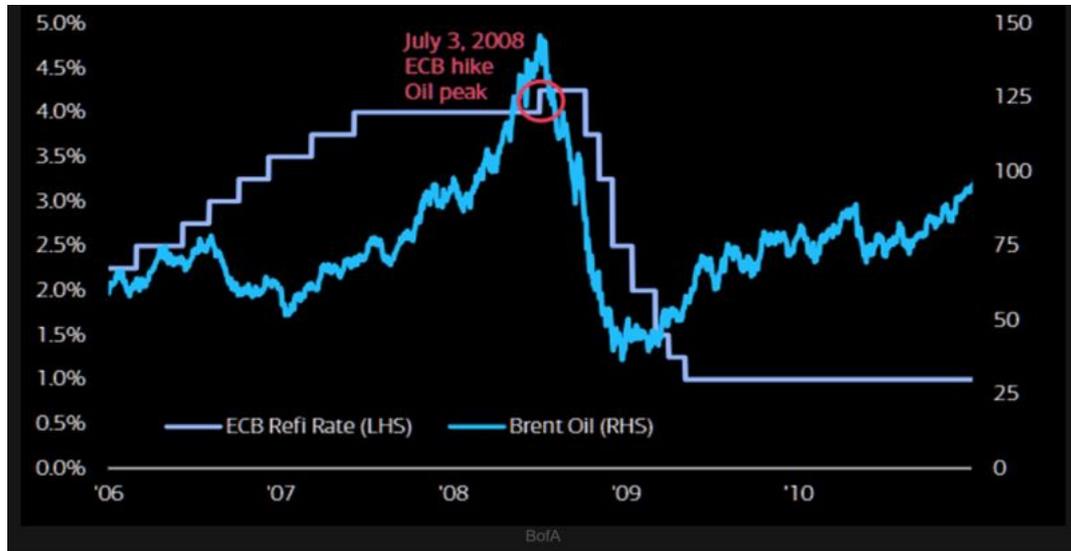
At the same time, the ECB is acutely aware of the opposite risk: tightening too aggressively into a deteriorating economic environment. The memory of the 2008 policy mistake still looms large. At that time, under Jean-Claude Trichet, the ECB raised interest rates in July 2008 as oil prices surged above \$140 per barrel, only weeks before the collapse of Lehman Brothers triggered the global financial crisis. A traditional German policy bias toward fighting inflation, rooted in the Bundesbank's price-stability culture, also played a role. With inflation rising and interest rates already high, hawkish policymakers saw tightening as the appropriate response.

As the **Figure 1** illustrates, the ECB's rate hike coincided almost exactly with the peak in oil prices. The move was widely criticised as a major policy error: inflation driven by energy prices prompted tightening even as the financial system was deteriorating. Just 74 days later, the collapse of Lehman Brothers triggered the global financial crisis, oil prices collapsed to around \$40, and the ECB was forced to reverse course rapidly, cutting rates by roughly 325 basis points as the recession deepened.

Today's environment shares some similarities. In 2022, the ECB was criticized for reacting too slowly, initially treating inflation as "transitory." That experience now makes policymakers reluctant to appear complacent in the face of another energy-driven inflation shock. However, energy prices are again rising

due to geopolitical tensions, while underlying economic momentum in the euro area remains fragile, particularly in manufacturing. If oil prices were to surge further, for example toward \$150–200 per barrel, the resulting energy shock could significantly weaken growth. In such a scenario, a premature rate hike could ultimately be viewed as a policy error.

**Figure 1: ECB Refi Rate (LHJS) vs Brent Oil Price (RHS)**



Source: [BofA](#)

What matters now is how markets are pricing this risk. The ECB is almost certain to remain on hold in the near term, yet market pricing currently implies roughly an 80% probability of a rate hike by June. That appears excessive. A probability closer to 25% would likely be more consistent with the uncertain macro backdrop. The April meeting is therefore likely to pass without action. June, however, remains genuinely open. The debate within the Governing Council will likely intensify between hawkish members, who remain focused on inflation risks, and more cautious policymakers concerned about the potential growth impact of higher energy prices.

✦ **CHANGES TO ECONOMIC FORECASTS:** *The conflict in the Middle East has added uncertainty to the inflation outlook as energy prices fluctuate and market sentiment weakens.* Schnabel, one of the Governing Council’s more hawkish members, emphasized that geopolitical tensions pose upside risks to inflation, particularly if energy price increases persist. Economists warn that the war could complicate the inflation picture by raising energy costs, though some analysts argue the overall impact may be limited as global oil supply is expected to grow faster than demand. Markets have begun reassessing the ECB’s policy path, with traders now assigning a roughly 25% chance of a rate hike by the end of the year, reversing earlier expectations of further rate cuts.

The European Central Bank’s upcoming quarterly forecasts will partially incorporate the economic impact of the war in Iran, according to Schnabel. Speaking in Frankfurt, Schnabel reiterated that monetary policy remains in a “good place,” noting that euro-area inflation is still projected to converge to the ECB’s 2% target over the medium term, though new projections in March will reflect recent geopolitical developments.

Looking ahead, the outlook is increasingly uncertain. The conflict involving Iran has pushed energy prices higher, raising the risk of renewed inflation and weaker growth, depending on how long the fighting lasts. ECB officials say it is too early to assess the full economic impact, though Bundesbank President Joachim Nagel warned inflation risks may be more significant than growth effects. The ECB previously projected inflation to stay just below 2% in the near term and reach target by 2028, with growth gradually

strengthening. Wage growth remains solid, though compensation per employee slowed to 3.7% year-on-year in the fourth quarter from 4% in the previous quarter.

- ✦ **ECONOMIC ANALYSIS:** *Eurozone economy expanded less than first estimated in Q4 2025.* Euro-area growth at the end of last year was weaker than initially estimated, with trade weighing on activity. In Q4, GDP rose 0.2% q-o-q, below the preliminary 0.3% estimate. Domestic demand supported the expansion, led by household consumption, while public spending and investment also contributed. Growth varied widely across member states. Malta posted the strongest quarterly expansion at 2.1%, followed by Lithuania (1.7%) and Croatia (1.4%), while Ireland recorded the sharpest contraction at 3.8%, ahead of Romania's 1.9% decline. For 2025 as a whole, the euro-area economy grew 1.4% year-on-year, compared with 1.5% growth across the EU.

Eurozone inflation rose unexpectedly to 1.9% in February, slightly above economists' forecasts of 1.7% and up from 1.7% in January. Despite the increase, it marked the first time since April 2021 that inflation remained below the European Central Bank's 2% target for two consecutive months. The uptick came before the escalation of conflict in the Middle East, which has since pushed oil and gas prices higher and increased uncertainty around the inflation outlook. Core inflation, which excludes food and energy, rose to 2.4%, while services inflation — a key measure of domestic price pressures — climbed to 3.4%.

The eurozone labour market strengthened in January 2026, with the unemployment rate falling to a record low of 6.1%, down from 6.2% in December and 6.3% a year earlier, according to Eurostat. The decline brought the number of unemployed across the bloc to about 10.77 million. Across the wider EU, unemployment also edged down to 5.8%. Germany and the Netherlands recorded the lowest jobless rates at 4%, while Spain (9.8%), France (7.7%) and Italy (5.1%) remained higher.

Youth unemployment eased slightly to 14.8% in the eurozone and 15.1% across the EU. The figures suggest the European labour market remains relatively resilient, supported by steady economic growth in 2025. By contrast, the UK unemployment rate rose to 5.2%, a five-year high. Meanwhile, the European Central Bank said artificial intelligence has not yet led to widespread job losses in Europe, noting that firms using AI intensively were slightly more likely to hire workers as they expand production and implement new technologies.

Industrial output fell 1.5% in January after a 0.6% drop in December, bringing production to its lowest level since December 2024. While the sharp decline was partly driven by volatile Irish data, production also fell in Germany, Italy and Spain. Hopes for a recovery still depend on increased public spending on defence and infrastructure, but another prolonged surge in energy costs could further weigh on energy-intensive industries that have already struggled since the 2021–22 energy shock, raising fresh downside risks for the sector.

- ✦ **MARKET IMPLICATIONS:** *The market is extremely fragile and sensitive to news and central banks communication.* So Lagarde will need to reassure market participants that the ECB will weigh carefully its options and the consequences of its actions before acting. To put things into context, *in the bond market*, since the latest ECB meeting Germany's 10-year Bund yield climbed to its highest level since October 2023, as escalating Middle East tensions fuelled inflation concerns and reinforced expectations for further ECB tightening, prompting money markets to fully price in a rate hike by July with an 85% probability of a second increase by December — a sharp reversal from late February when traders had assigned roughly a 40% chance of a rate cut before year-end. Since the last meeting on February 15 and as of March 18, the yields on a: i) 10y German Bund rose by approximately 3 bps to around 2.88%; and ii) 2y German Bund rose by approximately 22 bps to around 2.37%. In the periphery of the Eurozone, the 10y Italian BTP yield rose to 3.64% as of March 18, up approximately 14 bps since February 15. The gap between Germany and Italy's 10-year yields has widened to approximately 75 bps. In the *currency space*, the euro came under significant pressure, falling below \$1.15 to its weakest level since late July, as the US dollar gained broadly amid escalating tensions in the Middle East, with rising oil prices above \$100 per barrel highlighting Europe's vulnerability to energy shocks. Since mid-February, EUR/USD declined by approximately 2.0% over the month, trading around 1.153-1.154 as of March 18. *In the equity space*, European equities fell

sharply, with the Eurostoxx 50 declining approximately 1.7% over the past month and trades around 5,824 at the time of the writing, as higher energy prices and rising credit costs continued to weigh on the outlook for margins, with bond yields across major Eurozone economies surging toward their highest levels in 15 years.

- ✦ **MACROECONOMIC ANALYSIS (APPENDIX):** *The eurozone closed 2025 with solid growth despite weak exports and escalating U.S. trade tensions.* Q4-2025, the eurozone GDP advanced by 0.2% q-o-q (c: 0.3%; p: 0.3%). Spain led growth with its strongest quarter in a year (0.8%), expanding faster than expected on strong household consumption and investment. The Netherlands grew 0.5% on export strength, while Germany and Italy each posted 0.3%, both beating forecasts. France grew 0.2% as expected, its weakest quarterly pace since Q1 2025. Eurozone GDP rose 1.3% y-o-y (c: 1.2%; p: 1.4%, above the 1.2% forecast. For 2025, growth reached 1.5%, up from 0.9% in 2024 and above the European Commission's 1.3% projection.

*Leading indicators point to the strongest expansion in private sector activity in three months.* In February, the HCOB Eurozone Composite PMI rose to 51.9 (p: 51.3). Services PMI increased to 51.9 (c: 51.8; p: 51.6). Manufacturing PMI rose to 49.4 (c: 49.1; p: 48.8).

*Eurozone unemployment dips matching the record lows seen in late 2024.* In January, unemployment rate edged down to 6.1% (c: 6.2%; p: 6.2%). The number of unemployed decreased by 184K to 10.77mn. Amongst the largest Euro Area economies: *i)* the unemployment declined to 5.1% in December in January; *ii)* the unemployment rate rose to 7.9% (c: 7.7%) in Q4 in France; and *iii)* in Germany the seasonally adjusted jobless rate held steady at 6.3% (p: 6.3%) in February. The 'youth unemployment rate' – measuring job-seekers under 25 years old – fell to 14.8% in January (p: 15.0%). Wages and salaries in the EZ eased to by 3.0% y-o-y (p: 3.8%) in Q3-2025.

*Inflation unexpectedly rises in February before the Middle east conflict sent gas and oil prices skyrocketing.* In December: *i)* headline inflation rose to 1.9% y-o-y (c: 1.7%; p: 1.7%); and *ii)* core inflation – which excludes food and energy prices – increased to 2.4% y-o-y (c: 2.2%; p: 2.2%). In Germany, annual CPI inflation eased off to 1.9% y-o-y (c: 1.9%; p: 2.1%). In France, the inflation rate cooled to 0.9% y-o-y (c: 1.0%; p: 0.3%). In Italy prices inflation increased to 1.6% y-o-y (p: 1.0%).

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