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Preview: ECB To Increase Rates by 25bps

To Anchor Inflation Expectations

By

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Preview: ECB

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Executive Summary

- **Expected Decision**: *We expect, in line with consensus, the ECB to increase rates by 25bps in June.* In line with consensus, at the June Governing Council (GC) meeting, we expect the European Central Bank (ECB) to increase its main policy rates i.e. its *i)* interest rate on the 'main refinancing operations' at 2.40%; *ii)* interest rate on the 'marginal lending facility' at 2.65%; and the key *iii)* 'deposit facility' at 2.25%.

  The ECB is expected to maintain its data-dependent, meeting-by-meeting approach, reaffirming its three-pronged reaction function. With the hike already priced in, market attention will shift to President Lagarde's guidance and any signals on future policy moves.

- **Policy Discussion:** *The ECB is expected to raise its deposit rate to 2.25% on 11 June, with a further increase likely in September as policymakers balance persistent energy-driven inflation against a weakening economic outlook*. With the move largely priced in, markets will focus on updated staff projections and President Christine Lagarde's guidance. ECB Chief Economist Philip Lane has signaled that inflation forecasts are likely to be revised higher as the Iran conflict keeps energy prices elevated, while weaker growth data point to a softer economic outlook.
  Lagarde is expected to maintain a hawkish tone, emphasizing inflation risks while preserving the ECB's data-dependent approach. Although policymakers are unlikely to pre-commit to future hikes, inflation is expected to remain above target, keeping the door open to further tightening. Markets increasingly see a follow-up rate increase later this year—potentially as early as September—though expectations for an extended hiking cycle remain constrained by weakening growth and uncertainty surrounding the Middle East conflict.

- **Changes to Economic Forecasts:** *The ECB is likely to raise its inflation forecasts and lower the growth projections in June as the Iran conflict keeps energy prices elevated and fuels broader price pressures*. Higher oil and commodity costs, alongside stronger core inflation, are expected to push inflation projections higher, while weaker Q1 GDP data and soft PMI readings may lead to lower growth forecasts. The resulting outlook of higher inflation and weaker growth moves the ECB closer to its adverse scenario and strengthens the case for further policy tightening despite a deteriorating economic backdrop.

Key Picture: European Central Bank Key Forecasts – 2024-2028

		2026*f*		**2027*f***		**2028*f***	
	Latest reading	March Projections	December Projections	March Projections	December Projections	March Projections	December Projections
GDP *(real growth, y-o-y)*	0.8	0.9	1.2	1.3	1.4	1.4	1.4
Inflation *(%, y-o-y)*	3.0	2.6	1.9	2.0	1.8	2.1	2.0
Core-inflation *(%, y-o-y)*	2.2	2.3	2.4	2.2	1.9	2.1	2.0
Unemployment *(%, y-o-y)*	6.2	6.3	6.2	6.3	6.1	6.2	5.9

Source: ECB *'Macroeconomic projections' March 2026 and December 2025* *Note:* Latest readings: 1. GDP for Q1 2026; 2. Unemployment for March 2026; 3. Inflation for April 2026. *Inflation = Harmonized Index of Consumer Prices (HICP).

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Analysis

- **EXPECTED DECISION**: *We expect, in line with consensus, the ECB to increase rates by 25bps in June.* At the Governing Council (GC) meeting on June 11th, we expect the European Central Bank (ECB) to increase its main policy rates i.e. its *i)* interest rate on the 'main refinancing operations' at 2.40%; *ii)* interest rate on the 'marginal lending facility' at 2.65%; and the key *iii)* 'deposit facility' at 2.25%.

  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 adopt a cautious, data-dependent approach. With the move fully priced in, President Lagarde's forward guidance—and signals on future rate hikes—will be the key driver of market reaction.

  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 ECB is expected to raise its deposit rate to 2.25% on 11 June, with a further increase likely in September as policymakers balance persistent energy-driven inflation against a weakening economic outlook.* The ECB is widely expected to raise rates by 25 bps, with support for the move extending across both hawkish and dovish policymakers. This follows the scenarios set out in Frankfurt at the ECB Watchers Conference in March, when Lagarde said that between the two extreme scenarios of doing nothing and doing a lot in terms of policy adjustment there's also the possibility of "doing something", so a small adjustment to anchor inflation expectations.

  While the hike is largely priced in by markets, attention will focus on the ECB's updated projections and forward guidance. New staff forecasts are expected to show higher inflation and weaker growth, reinforcing the case for further tightening despite a deteriorating economic backdrop. ECB Chief Economist Philip Lane signaled that the ECB is likely to raise its inflation forecasts in June as the Iran conflict keeps energy prices elevated. While a 25-basis-point hike next week is widely expected, Lane warned that a prolonged conflict could require further monetary tightening.

  President Christine Lagarde is likely to strike a hawkish tone, emphasizing persistent inflation risks linked to elevated energy prices and broader price pressures. However, the ECB is expected to maintain its data-dependent, meeting-by-meeting approach and avoid explicitly committing to future hikes. Still, inflation is projected to remain above target over the forecast horizon, suggesting that additional rate increases remain likely.

  Policymakers are likely to frame the move as a precautionary response to inflation risks stemming from energy prices and geopolitical uncertainty, while avoiding firm commitments on future hikes. Although June could be a one-off move, it is more likely that the ECB will increase rates at least one more time this year, likely in September, with December remaining an open question. Market participants increasingly view a further, back-to-back 25-basis-point hike in July as possible, if inflation pressures continue to broaden. Some analysts expect up to four consecutive rate hikes, which would lift the deposit facility rate to 3.0% by October. However, risks to this outlook remain tilted to the downside, given weakening economic momentum and uncertainty surrounding the Middle East conflict.

- **CHANGES TO ECONOMIC FORECASTS:** *ECB Chief Economist Philip Lane signaled that the central bank is likely to raise its inflation forecasts in June* as the Iran war keeps energy prices elevated and increases the risk of broader price pressures. The ECB's June projections are likely to reinforce expectations of further rate hikes, as inflation forecasts are set to be revised higher while growth remains weak but positive. Higher oil prices linked to the Middle East conflict, rising non-energy commodity costs, and stronger-than-

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expected core inflation are expected to lift the ECB's inflation outlook, with headline inflation potentially rising from 2.6% to around 3.0% in 2026 and from 2.1% to above 2.5% in 2027.

At the same time, the growth outlook has deteriorated. Following weaker-than-expected Q1 GDP data and PMI surveys pointing to a possible contraction in Q2, the ECB could lower its 2026 growth forecast. While the baseline scenario still assumes positive growth, the balance of risks remains skewed to the downside due to uncertainty surrounding the Iran conflict, energy markets, and potential disruptions to global trade and shipping routes.

Taken together, the revised projections would move the ECB's baseline closer to its March adverse scenario, characterized by higher inflation and weaker growth. This combination is likely to support additional policy tightening despite the deteriorating economic backdrop, as policymakers remain focused on preventing energy-driven price pressures from becoming embedded in broader inflation dynamics.

- **ECONOMIC ANALYSIS:** *The unexpected downturn in Eurozone GDP highlights growing economic weakness as the Middle East conflict and resulting energy shock weigh on activity.* Eurozone Q1 GDP was revised down to -0.2% q-o-q from an initial estimate of +0.1%, marking a contraction at the start of 2026 and raising the risk of a technical recession amid fallout from the Iran conflict. The downgrade was driven largely by Ireland's 12.1% GDP decline, reflecting the unwinding of a temporary export surge by multinational tech and pharmaceutical firms ahead of US tariffs. Excluding Ireland's distortion, most major Eurozone economies recorded positive growth in Q1. On the expenditure side, modest gains in household consumption and government spending (+0.1% each) were outweighed by declines in investment (-0.1%), inventories (-0.1%), and net exports (-0.3%).

The unemployment rate held steady at 6.3% in April, with the number of unemployed falling by 84K, underscoring labor market resilience despite economic uncertainty linked to the Iran conflict. A tight labor market is likely to remain a key consideration for the ECB as it weighs persistent inflation pressures against slowing growth. While wage growth is expected to moderate in 2026, prolonged energy disruptions could reignite wage pressures and keep inflation elevated. Separately, manufacturing surveys pointed to accelerating factory job losses and the sharpest rise in input costs since 2022, reflecting mounting strain from higher energy and commodity prices.

Regarding the inflation, the Eurozone prices accelerated to 3.2% in May, the highest since September 2023, while core inflation rose to 2.5%, reinforcing expectations that the ECB will deliver an "insurance" rate hike at its upcoming meeting. Although higher energy prices from the Middle East conflict are expected to push inflation higher in the coming months, policymakers anticipate a gradual rather than sharp increase, supported by easing inflation expectations, limited fiscal support, and weaker consumer spending power. Unlike 2022, inflation remains less broad-based and interest rates are already restrictive, reducing the likelihood of an aggressive tightening cycle.

- **MARKET IMPLICATIONS:** *a June rate hike fully priced in, market expectations is likely to be driven by the ECB's forward guidance rather than the decision itself.* A hawkish signal pointing to further tightening could strengthen the euro and lift rate expectations, while a more cautious tone may trigger a reversal.

To put things into context, *In the bond market,* German bund yields increase on ECB rate hike expectations. Since the last meeting on April 30 and as of June 5 the yields on a: *i)* 10y German bund rose by 1 bps to around 3.04% (+18 bps y-t-d); and *ii)* 2y German bund increased by 6 bps to 2.69% (+57 bps y-t-d). In the periphery of the Eurozone, the 10y Italian bonds fell by 5 bps to 3.82% since the last meeting. The gap between Germany and Italy's 10Y yields is at around 78 bps. *In the currency space,* the US dollar strengthened after a stronger-than-expected jobs report led investors to scale back expectations for Fed rate cuts, pushing Treasury yields higher. EUR/USD retreated toward 1.1500 following heavy post-NFP selling. Since last meeting in April and as of June 5, EUR/USD decreased by 1.8% to around 1.15 (-1.9% y-t-d). *In the equity space,* the STOXX Europe 600 fell 0.53% as investors assessed geopolitical developments and the prospect of new US tariffs. Germany's DAX led losses (-1.38%), while France's CAC 40 gained

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0.43%; Italy's FTSE MIB and the UK's FTSE 100 fell 0.29% and 0.40%, respectively. The Eurostoxx 50 rose by 3,1% since the last meeting in April to 6062 as of June 5 (+3.6% y-t-d).

- **MACROECONOMIC ANALYSIS (APPENDIX):** *The eurozone economy contracted in the first quarter, marking the first contraction since Q4 2022.* Q1-2026, the eurozone GDP shrank by 0.2% q-o-q (*c:* 0.1%; *p*: 0.2%). The Eurozone recorded its sharpest decline since mid-2020, largely due to a 12.1% contraction in Ireland and a 0.1% decline in France. Spain led growth among major economies (+0.6%), followed by Germany and Italy (+0.3% each) and the Netherlands (+0.1%). The slowdown reflects tight energy supplies, Middle East-driven inflation pressures, and expectations of tighter ECB policy. Net trade and inventories reduced GDP growth by 0.3 and 0.1 pp, respectively, while investment fell 0.3%. Household consumption and government spending grew modestly at 0.2% and 0.5%.

  The latest PMI signaled the sharpest private-sector contraction in 18 month. In May, the *HCOB Eurozone Composite* PMI fell to 48.5 (*c:* 47.5; *p:* 48.8). *Services PMI* increased marginally to 47.7 (*p: 47.6*). *Manufacturing PMI* declined to 51.6 (*c*: 51.4; *p*: 52.2).

  Labour market shows resilience despite Iran-related geopolitical uncertainty. In April, *unemployment rate* stood at 6.3% (*c:* 6.2%; *p*: 6.3%). The number of unemployed declined by 84K to 11.08mn. Amongst the largest Euro Area economies: *i)* the unemployment declined to 5.1% in April in Italy; *ii)* the unemployment rate rose to 8.1% (*c:* 7.9%) in Q1 in France; and *iii)* in Germany the seasonally adjusted jobless rate fell to 6.3% (*p*: 6.4%) in May. The 'youth unemployment rate' – measuring job-seekers under 25 years old – decreased 14.7% in April (*p:* 15.1%). Wages and salaries in the EZ eased to by 3.0% y-o-y (*p*: 3.2%) in Q4-2025.

  Inflation rises to the highest level since September 2023. In May: *i) headline inflation* rose to *3.2%* y-o-y (*c:* 3.2%; *p:* 3.0%); and *ii) core inflation* – which excludes food and energy prices – increased to 2.5% y-o-y (*c:* 2.4%; *p:* 2.2%). In Germany, annual CPI inflation slowed to 2.6% y-o-y (*c*: 2.9%; *p*: 2.9%). In France, the inflation rate accelerated to 2.4% y-o-y (*c*: 2.5%; *p*: 2.2%). In Italy prices inflation increased to 3.2% y-o-y (*c*: 3.2%; *p:* 2.7%).

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