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**REVIEW: ECB Begins Its Rates Adjustment,
To Anchor Inflation Expectations**

By

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Executive Summary

- ✦ **Decision Made:** *The European Central Bank (ECB) decided to raise the three key rates by 25 bps 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' to 2.25%.*

Future decisions will be taken meeting-by-meeting, following its usual three-pronged approach about its reaction function confirmed. It signalled its determination to prevent higher energy prices from becoming entrenched in inflation expectations.

- ✦ **Policy Discussion:** *Widely anticipated 25 bps rate hike comes amid growing concerns that the Middle East conflict and higher energy prices could keep inflation elevated despite a weakening economy.* GDP contracted by 0.2% in the first quarter of 2026, while the ECB's Survey of Professional Forecasters cut its growth forecast to 0.9%, reflecting the impact of the Iran war and higher energy prices. Nevertheless, policymakers judged that rising inflation risks warranted a pre-emptive response.

A key debate is whether the ECB is responding to current inflation pressures or trying to avoid repeating its 2021-22 mistake of underestimating inflation persistence. Although energy prices are pushing inflation higher, the ECB still expects inflation to return to its 2% target by 2028, and longer-term inflation expectations remain relatively contained. Critics therefore warn that policymakers risk overcorrecting, potentially repeating the 2011 error of tightening into a weakening economy.

ECB President Christine Lagarde stressed that the Middle East conflict poses upside risks to inflation and downside risks to growth, while maintaining a data-dependent approach. Executive Board member Isabel Schnabel argued that policymakers could no longer "look through" energy-driven inflation pressures, helping justify the hike. Markets are now pricing roughly a 50% probability of another increase in September, though the ECB remains reluctant to pre-commit to a broader tightening cycle.

- ✦ **Changes to Economic Forecasts:** *The ECB acknowledged that the outlook remains highly uncertain, with risks tilted towards higher inflation and weaker growth,* largely depending on the scale and persistence of the energy shock and its spillover effects. Updated projections show inflation averaging 3.0% in 2026 and 2.3% in 2027 before returning to the 2% target in 2028, while growth forecasts were downgraded to 0.8% and 1.2%, respectively, reflecting the war's impact on energy prices, confidence, and household incomes.

The ECB sees risks to growth as tilted to the downside, as prolonged energy disruptions, weaker confidence, tighter financial conditions, and trade frictions could weigh on economic activity. At the same time, inflation risks remain skewed to the upside, with persistent energy price pressures and potential second-round effects threatening to keep inflation elevated for longer.

Key Picture: European Central Bank Key Forecasts – 2026-2028

	Latest reading	2026f		2027f		2028f	
		June Projections	March Projections	June Projections	March Projections	June Projections	March Projections
GDP (<i>real growth, y-o-y</i>)	0.3	0.8	0.9	1.2	1.3	1.5	1.4
Inflation (% <i>y-o-y</i>)	3.2	3.0	2.6	2.3	2.0	2.0	2.1
Core-inflation (% <i>y-o-y</i>)	2.5	2.5	2.3	2.5	2.2	2.2	2.1
Unemployment (% <i>y-o-y</i>)	6.3	6.3	6.3	6.2	6.3	6.0	6.2

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

Analysis

- ✦ **DECISION MADE:** *On June 11, the ECB raised its interest rates.* In line with consensus, the European Central Bank (ECB) to increase its main policy rates by 25 bps i.e. its *i)* interest rate on the 'main refinancing operations' to 2.40%; *ii)* interest rate on the 'marginal lending facility' at 2.65%; and the key *iii)* 'deposit facility' at 2.25%. The Middle East conflict is adding to inflationary pressures, with the case for a rate hike remaining robust across a range of potential economic scenarios.

Despite the uncertainty, the Governing Council said today's decision leaves it well positioned to respond to evolving conditions. Policymakers will continue to assess incoming economic and financial data on a meeting-by-meeting basis and stressed that they are not pre-committed to any specific path for interest rates.

In its forward guidance, the ECB stated that the decisions will be still taken meeting-by-meeting, with its usual three-pronged approach about its reaction function confirmed. Despite the uncertainty, the Governing Council said today's decision leaves it well positioned to respond to evolving conditions. Policymakers will continue to assess incoming economic and financial data on a meeting-by-meeting basis and stressed that they are not pre-committed to any specific path for interest rates.

In terms of *Balance Sheet policies*, the APP and PEPP portfolios are gradually and predictably shrinking, as the Eurosystem has stopped reinvesting principal payments from maturing securities.

- ✦ **POLICY DISCUSSION:** *25 bps rate hike was widely anticipated, with financial markets fully pricing in the move after both hawkish and dovish policymakers signalled support for tighter policy ahead of the meeting.* The decision comes amid mounting pressure on the eurozone economy. GDP contracted by 0.2% in the first quarter of 2026, raising concerns about stagflation as higher energy prices weigh on growth and confidence. Reflecting these challenges, the ECB's Survey of Professional Forecasters lowered its 2026 growth forecast to 0.9%, citing the economic impact of the Iran war and rising energy costs.

A key question is whether the ECB's rate hike reflects current inflation risks or a desire to avoid repeating the policy mistakes of 2021-22, when it underestimated the persistence of inflation and reacted too slowly. While higher energy prices are pushing inflation upwards, the ECB's own forecasts remain relatively benign, with inflation expected to return to its 2% target by 2028 and growth slowing only modestly. Recent inflation expectations have also remained relatively contained, suggesting that inflation has not yet become deeply entrenched.

ECB President Christine Lagarde stressed that the Middle East conflict continues to pose upside risks to inflation and downside risks to growth, while emphasising that future policy decisions will remain data-dependent. Although the ECB views its rate hike as necessary to address energy-driven inflation pressures, officials remain cautious about committing to a specific policy path amid significant uncertainty over the duration and impact of the conflict.

Supporters of the hike argue that it serves as an insurance measure against the risk of falling behind the curve if the energy shock proves more persistent. However, critics caution that policymakers may be overcorrecting for the mistakes of 2022. Unlike that period, inflation is lower, underlying price pressures are less widespread, and interest rates are already restrictive rather than deeply negative.

The risk, therefore, is that in attempting to avoid repeating the ECB's delayed response to inflation in 2022, policymakers could instead repeat the error of 2011, when the Bank tightened policy in response to rising inflation only to reverse course as growth deteriorated. This suggests that while today's hike may be justified, the case for a prolonged tightening cycle remains far less clear.

Nevertheless, markets are also pricing in roughly a 50% chance of another rate hike in September, indicating that investors view today's move as the start of a renewed tightening cycle rather than a one-off response to the energy shock.

Executive Board member Isabel Schnabel argued that policymakers could no longer "look through" the inflationary effects of the Middle East conflict. She warned that rising energy prices were increasingly feeding into the broader economy and raising the risk of inflation expectations becoming unanchored, making a June rate hike necessary regardless of the outcome of Iran peace talks. ECB Chief Economist Philip Lane similarly acknowledged that economic conditions had deteriorated since the Bank's March projections and signalled an upward revision to inflation forecasts. Schnabel went further, warning that eurozone inflation could rise to 4% before the end of the year.

Regarding the digital euro, Lagarde also reiterated the ECB's support for deeper financial integration and technological innovation, stressing the importance of swiftly adopting legislation establishing the digital euro as part of broader efforts to strengthen Europe's competitiveness, financial autonomy, and payments infrastructure.

- ✦ **CHANGES TO ECONOMIC FORECASTS:** *The ECB acknowledged that the outlook remains highly uncertain, with risks skewed towards higher inflation and weaker growth.* The ultimate impact of the Middle East conflict will depend on the magnitude and duration of the energy shock, as well as any broader second-round effects on prices and wages.

The ECB's latest projections show headline inflation averaging 3.0% in 2026, 2.3% in 2027 and returning to target at 2.0% in 2028. Compared with March, inflation forecasts for 2026–27 were revised higher due to rising energy prices and their spillover effects on food, goods and services. At the same time, growth forecasts were lowered to 0.8% in 2026 and 1.2% in 2027, reflecting the war's negative impact on commodity markets, household incomes and confidence.

- ✦ **ECONOMIC ASSESSMENT:** *The ECB expects the Middle East conflict to slow growth and keep inflation elevated through higher energy prices, prompting a rate hike as policymakers seek to contain rising inflation risks despite a still-resilient labour market and weakening economic momentum.* In Q1, the economy grew, supported by domestic demand and exports, although the Middle East conflict is beginning to weigh on activity, particularly in services. Manufacturing has remained more resilient, helped by inventory building and increased defence spending. The labour market remains strong, with unemployment at a historically low 6.3% in April. However, job creation has slowed, labour demand has softened, and both firms and households expect weaker labour market conditions ahead.

Looking forward, the ECB expects higher energy prices and weaker confidence to weigh on domestic demand and investment. Nevertheless, resilient household balance sheets, investment in digital technologies, and higher public spending on defence and infrastructure should provide some support to growth. The ECB also reiterated the importance of fiscal discipline, structural reforms, and deeper financial integration to strengthen long-term competitiveness and growth.

Inflation rose to 3.2% in May from 3.0% in April, driven primarily by higher energy prices. Core inflation increased to 2.5%, with both goods and services inflation picking up. While domestic cost pressures eased in the first quarter due to slower wage and profit growth, firms continue to face rising input costs and expect to raise prices accordingly. Higher energy prices are expected to push inflation further up over the summer and keep it above target into the first half of 2027, before easing back towards 2% in the second half of the year. However, the ECB stressed that the duration of the energy shock remains a key uncertainty, as prolonged price increases could trigger broader inflationary pressures through indirect and second-round effects.

The ECB sees risks to growth as tilted to the downside, with prolonged energy disruptions, weaker confidence, tighter financial conditions, and trade frictions potentially weighing on consumption, investment, and output. Conversely, faster adaptation to the energy shock, a resolution of the conflict, and stronger defence spending and productivity growth could support activity.

Inflation risks remain skewed to the upside. Higher and more persistent energy prices could spill over into wages and broader prices, while supply chain disruptions and trade tensions may add further pressure.

However, inflation could prove lower if the conflict's impact fades more quickly or if weaker demand limits second-round effects.

- ✦ **OUR TAKE: *Next move likely in September:*** We expect the next rate increase to take place in September, as a back-to-back increase in July would likely be too aggressive, while a one-off move in June would not make any sense. December remains an open question, but with plenty of time for the ECB to decide, without needing to pre-commit.
- ✦ **MARKET REACTION AND IMPLICATIONS:** *The ECB's widely anticipated 25 bps rate hike triggered a limited market reaction*, with investors focusing instead on higher inflation forecasts and comments from ECB President Christine Lagarde. *In the bond market*, the yield on the 10-year German bund held above 3.05% but then declined by around 2-3 bps and trades around 3.03% at the time of the writing. The 2Y German bund yield also declined to around 2.67%. *In the currency space*, the euro was flat against the dollar and the British pound. At the time of the writing, EUR/USD trades around 1.153 and EUR/GBP trades around 0.86. *In the equity space*, European equities rebounded, with the STOXX 600 rising 0.7% and the FTSE 100 gaining 0.9%, as investors digested the ECB's widely expected rate hike. However, gains were tempered by renewed geopolitical uncertainty following fresh threats by President Trump towards Iran



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