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Preview: ECB To Take a Pause in its Rates Adjustment in July

By

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Executive Summary

- **Expected Decision**: *We expect, in line with consensus, the ECB hold rate in July.* In line with consensus, at the July Governing Council (GC) meeting, we expect the European Central Bank (ECB) to maintain 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. Markets continue to expect a 25bp rate hike in September, as persistent core inflation and elevated energy prices support the case for further, but measured, tightening. Lagarde may signal that further tightening remains possible following renewed energy price pressures, with the June meeting minutes already indicating an implicit bias toward additional rate hikes.

- **Policy Discussion:** *The ECB is widely expected to keep rates unchanged in July, although Lagarde may signal that further tightening remains possible as renewed Middle East tensions and higher energy prices revive inflation risks*. Policymakers, including Bundesbank President Joachim Nagel, have said current rates remain appropriate, while softer June inflation (2.8%) has reduced the urgency for another immediate hike. Lagarde reiterated that June's rate increase was driven by persistent inflation—not as a precaution—and reaffirmed the ECB's data-dependent, meeting-by-meeting approach, with inflation projected to return to the 2% target only by late 2027 under further tightening.
  ECB officials Piero Cipollone and Martin Kocher said there is still no evidence of second-round inflation effects. Although the July meeting will not include updated macroeconomic projections, officials are expected to reassess the June outlook in light of higher oil prices. Markets, and us, continue to view a 25bp rate hike in September as the most likely outcome, with the June meeting minutes already pointing to an implicit bias toward further tightening if inflationary pressures persist.

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

		2026*f*		2027*f*		2028*f*	
	Latest reading	June Projections	March Projections	June Projections	March Projections	June Projections	March Projections
GDP *(real growth, y-o-y)*	0.3	**0.9**	**0.9**	**1.2**	**1.3**	**1.5**	**1.4**
Inflation *(%, y-o-y)*	2.8	**2.6**	**2.6**	**2.3**	**2.0**	**2.0**	**2.1**
Core-inflation *(%, y-o-y)*	2.4	**2.5**	**2.3**	**2.5**	**2.2**	**2.2**	**2.1**
Unemployment *(%, y-o-y)*	6.2	**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 May 2026; 3. Inflation for June 2026. *Inflation = Harmonized Index of Consumer Prices (HICP).

Analysis

- **EXPECTED DECISION**: *We expect, in line with consensus, the ECB to stay on hold in July.* At the Governing Council (GC) meeting on July 23th, we expect the European Central Bank (ECB) to maintain 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. ECB policymakers called for caution on interest rates but stopped short of advocating further tightening, noting that second-round inflation effects have yet to emerge. While another rate hike remains possible later this year, officials signaled that a July increase is unlikely despite rising oil prices.

  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:** *While ECB is expected to keep rates unchanged, Lagarde may signal that further tightening remains possible following renewed energy price pressures, with the June meeting minutes already indicating an implicit bias toward additional rate hikes.* The ECB is widely expected to leave interest rates unchanged at its July meeting, with markets assigning only a small probability to another immediate hike. Although renewed Middle East tensions and higher oil prices have revived inflation concerns, policymakers, including Bundesbank President Joachim Nagel, have indicated that current interest rates remain appropriate. Softer-than-expected June inflation, with headline inflation slowing to 2.8%, has also reduced the urgency for further tightening. Nevertheless, the collapse of the US-Iran ceasefire and the rebound in energy prices have reinforced the rationale behind the ECB's June rate hike.

  Lagarde reiterated that the ECB's June rate hike was a response to persistent inflation, not merely a precautionary move. She emphasized a data-dependent, meeting-by-meeting approach, noting that inflation is projected to return to the ECB's 2% target only by late 2027 with further policy tightening. ECB officials Piero Cipollone and Martin Kocher said there is no evidence of second-round inflation effects, supporting a cautious, data-dependent approach.

  While the July meeting will not include updated macroeconomic projections, policymakers are expected to reassess the June outlook in light of higher oil prices. Markets continue to view a 25bp rate hike in September as the most likely outcome, with the June meeting minutes already indicating an implicit bias toward additional tightening if inflationary pressures persist.

- **ECONOMIC ANALYSIS:** *Eurozone downturn slows as US-Iran tensions cool.* The eurozone Services PMI improved to 49.4 in June from 47.7 in May, while the Composite PMI rose to 50.0, signaling stabilization in overall business activity. Input cost pressures eased at their fastest pace outside the pandemic, supporting expectations that the ECB may face less pressure to raise rates further.

  The eurozone economy contracted by 0.2% q-o-q in Q1 2026, reversing the preliminary estimate of 0.1% growth, while annual growth slowed to 0.3%. Although Ireland's sharp GDP decline weighed heavily on the headline figure, weaker net exports and investment also dragged on growth, partly offset by stronger performances in Germany, Italy, and Spain

  The IMF cut its 2026 eurozone growth forecast to 0.9% (from 1.1%) and raised its inflation forecast to 2.8% (from 2.6%), citing the US-Israeli war on Iran and higher energy prices. The Fund warned that persistent energy shocks could further weaken growth and push inflation higher, increasing the likelihood of additional ECB rate hikes. The IMF also urged governments to avoid broad-based energy subsidies, recommending targeted support for vulnerable households instead.

The eurozone's seasonally adjusted current account surplus widened to €25.1bn in May (from €17.5bn in April), driven by stronger primary income that offset a narrower trade surplus. Over the 12 months to May, the current account surplus declined to 1.7% of GDP from 2.0% a year earlier.

Eurozone inflation eased more than expected to 2.8% in June (from 3.2% in May), while core inflation fell to 2.4% and services inflation to 3.2%, signaling easing price pressures following the Iran ceasefire and lower oil prices. However, renewed U.S.-Iran tensions and rebounding oil prices continue to pose upside inflation risks, leaving the door open for a potential rate hike later this year. Despite the softer data, markets continue to expect one additional 25bp ECB rate hike this year, though investors increasingly question whether June's rate increase was necessary.

- **MARKET IMPLICATIONS:** A Eurozone government bond yields rose as renewed Middle East tensions and higher energy prices increased expectations of further ECB tightening. Markets see around a 90% chance of a 25bp rate hike by September, while the spread between German and US 10-year bond yields narrowed to its lowest level in about a month as softer US inflation tempered Treasury yields.

To put things into context, *In the bond market,* since the last meeting on June 11th and as of July 20 the yields on a: *i)* 10y German bund rose by 14 bps to around 3.04% (+31 bps y-t-d); and *ii)* 2y German bund increased by 12 bps to 2.69% (+67 bps y-t-d). In the periphery of the Eurozone, the 10y Italian bonds increased by 17 bps to 3.81% since the last meeting. The gap between Germany and Italy's 10Y yields is at around 81 bps. *In the currency space,* the euro weakened against the US dollar after stronger-than-expected US labor market data reinforced the Greenback. Since last meeting in June and as of July 20, EUR/USD decreased by 1.3% to around 1.14 (-2.8% y-t-d). *In the equity space,* the Eurostoxx 50 rose by 2.8% since the last meeting in June to 6224.75 as of July 20 (+36.4% y-t-d). Markets also weighed corporate earnings, renewed Middle East tensions, and higher oil prices. Among major indexes, Germany's DAX fell 0.94%, Italy's FTSE MIB declined 1.39%, France's CAC 40 was little changed, while the UK's FTSE 100 gained 0.98%.

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%.

Composite PMI was revised up, indicating stabilized private sector activity. In May, the *HCOB Eurozone Composite* increased to 50.0 (*c:* 49.5; *p:* 48.5). *Services PMI* increased to 47.7 (*p:* 47.7). *Manufacturing PMI* declined to 51.4 (*c*: 51.3; *p*: 51.6).

The unemployment rate fell to its lowest level since late 2024. In May**,** *unemployment rate* stood at 6.2% (*c:* 6.3%; *p*: 6.2%). The number of unemployed declined by 55K to a near of 1-1.5 year of 10.99mn. Amongst the largest Euro Area economies: *i)* the unemployment declined to 5.0% in May 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 stood at 6.3% (*p*: 6.3%) in May. The 'youth unemployment rate' – measuring job-seekers under 25 years old – remained unchanged at 14.7% in May (*p:* 14.7%). Wages and salaries in the EZ increased by 3.4% y-o-y (*p*: 3.1%) in Q1-2026.

Inflation fell to the lowest level since February. In June: *i) headline inflation* eased off to 2.8% y-o-y (*c:* 2.8%; *p:* 3.2%); and *ii) core inflation* – which excludes food and energy prices – cooled off to 2.4% y-o-y (*c:* 2.4%; *p:* 2.6%). In Germany, annual CPI inflation slowed to 2.3% y-o-y (*c*: 2.3%; *p*: 2.6%). In France, the inflation rate eased to 1.8% y-o-y (*c*: 1.8%; *p*: 2.4%). In Italy prices inflation cooled off to 3.0% y-o-y (*c*: 3.1%; *p:* 3.2%).

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