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ECB DECISION: WORSE TO COME INSTEAD OF ONE-AND-DONE?

A modestly hawkish message: Upon delivering the expected 25bp rate hike today, the European Central Bank (ECB) did not answer the key question: will it make a follow-up mistake by tightening the monetary screws again in July or September? As expected, the ECB emphasized that the outlook remains uncertain and that it will follow a “data-dependent meeting-by-meeting approach” and is “not pre-committing to any particular rate path”. However, the significant upward revision to the call for core inflation in 2027 from 2.2% to 2.5% relative to very modest cuts to its staff projections for growth by 0.1ppt each for 2026 (to 0.8%) and 2027 (to 1.2%) sends a hawkish message. That today’s decision to raise rates today was unanimous, as ECB president Christine Lagarde explained at the press conference, also indicates a clear risk that the ECB will tighten policy again in coming months.

Still a chance for “one and done”: Fortunately, the case for further rate hikes is not cast in stone. Amid major volatility and some on-off negotiations between Iran and the US, the price for dated Brent crude has receded from an average of \$120 per barrel in April to \$108 in May and \$98 so far in June. If, big if, tensions ease and energy prices recede further on trend before the ECB meeting on 23 July, as we assume, the ECB should have no reason to raise rates again in July or September, in our view. The demand destruction stemming from higher energy prices and the Iran-related confidence shock will suffice to contain the risk of major second-round effects on inflation without the ECB having to step on the monetary brakes, in our view. While workers will struggle to press for significantly higher wages, weak consumer demand should prevent companies from passing on all of their cost increases. Although consumer confidence is not a reliable predictor of actual spending, the sharp drop in consumer confidence from -12.4 in February to -20.6 in April followed by just a marginal increase to -19.0 in May casts doubt on the ECB’s assertion that consumption “should remain the main driver of growth” in the Eurozone. By late July, the economic damage from the Iran war should be obvious enough to stay the ECB’s hand even if inflation will likely remain elevated for a while. We thus still expect the ECB to stay put for the remainder of 2026 and in 2027. However, today’s ECB statement has added to the upside risk to our forecast for no further hike.

Looking back instead of ahead: Like the proverbial military strategists, the ECB seems to be fighting the last rather than the current conflict. In the inflation surge of 2021/2022, the ECB and other central banks had been caught out by not reacting adequately to the V-shaped economic rebound from the pandemic. As pent-up demand met still-impaired supply, Eurozone inflation had surged to 5.9% yoy even before Putin launched his full-scale assault on Ukraine on 24 February 2022. At the time, the ECB still had a deposit rate of -0.5%. Having failed to act in a timely fashion then, the ECB now seems inclined to overreact to the new spike in inflation. We view this as a mistake as the current situation differs fundamentally from the one prevailing in 2021 and 2022. In the first half of 2022, the Eurozone’s composite output PMI averaged a solid 54.2 whereas it languished at 48.5 this May. With inflation and the ECB’s deposit rate at 2% upon the start of the new energy price shock, the risk of second-round effects on wages and overall price-setting behaviour is now much lower than it was in 2022.

A problematic pattern? The ECB has now reacted to an adverse supply shock with a rate hike to curtail demand. The Eurozone economy can probably withstand today’s move with only modest damage. However, the ECB’s apparent inclination to tighten the screws in response to a supply shock points to a more serious risk. If the Strait of Hormuz remains largely closed for much longer and if energy prices, transport costs and the prices for energy-intensive transport services, package tours and the like thus go up further, the ECB may once again exacerbate the blow to demand by raising rates repeatedly later this year, possibly even going to



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a deposit rate of 3.0% instead of the 2.25% which the ECB set today. In such an adverse scenario, the combination of Trump (Iran war) and ECB mistakes could push the Eurozone into a recession in late 2026 and early 2027. If so, the ECB might be forced to cut rates in 2027. In addition to the economic damage, such a policy rollercoaster would not be good for the ECB's credibility, in our view.

The table below compares the old and new ECB staff projections to the Bloomberg consensus and our calls. The 2026 GDP forecasts are adjusted for a temporary Irish distortion to the data reflecting volatile transaction of multinational firms in Ireland.

	Inflation			Core inflation			Real GDP		
	2026	2027	2028	2026	2027	2028	2026*	2027	2028
ECB June projections	3.0	2.3	2.0	2.5	2.5	2.2	0.8	1.2	1.5
ECB March projections	2.6	2.0	2.1	2.3	2.2	2.1	0.9	1.3	1.4
March adverse scenario	3.5	2.1	1.6	2.4	2.7	2.1	0.6	1.2	1.6
Berenberg forecasts	2.9	2.2	2.3	2.5	2.3	2.3	0.6	1.3	1.6
Bloomberg consensus	2.9	2.2	2.0	2.4	2.3	2.1	0.8	1.3	1.5

**Excluding volatile Ireland, which will likely subtract 0.4ppt from 2026 GDP growth after adding 0.4ppt in 2025*

Changes of consumer prices and real GDP, in %. Sources: ECB, Bloomberg, Berenberg



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