MARKET COMMENTARY

ECB raises rates and keeps door open to more

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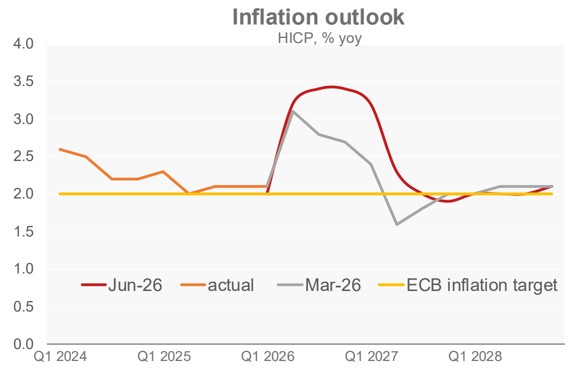
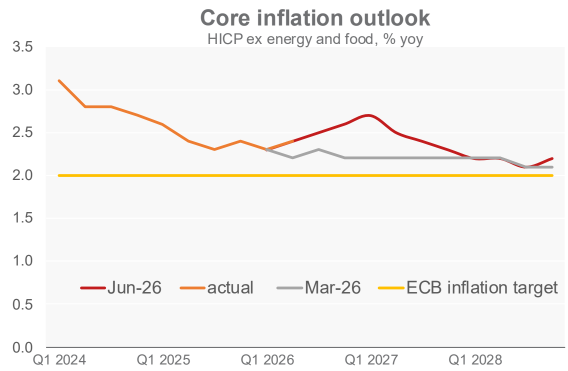
June 11, 2026

- **The Governing Council (GC) unanimously raised rates by 25 bps, as widely expected after recent hawkish communication. The ECB cited additional inflation pressure from the Middle East war, with Pres. Lagarde stressing that the move would also be justified under a more benign inflation scenario.**
- **The new projections revise both headline and core inflation up by a cumulative 0.6 pps over 2026–28, while growth is lowered slightly by 0.1 pp. Inflation is still seen returning to 2.0% in 2028, but core is set to stay at 2.2% while risks remain tilted to higher inflation and weaker growth.**
- **Lagarde rejected the view that this was merely an "insurance hike". Instead, she signalled that the ECB remains ready to respond to persistent uncertainty, keeping the door open to further tightening.**
- **The market is now pricing 43bp of further hikes this year, marginally less than at the close yesterday. In all, no major surprise from the ECB today. Our view of 'only one hike in 2026' largely depends on a pullback in energy prices this summer. Without that, a Sep. hike would be likely.**

At today's meeting, the ECB followed up on the more hawkish tone it had adopted since the April policy meeting by raising its key rate by 25 bps to 2.25%. President Lagarde rejected the view that the move was merely an insurance hike and kept the door open to a further rate increase.



Source: ECB, Datastream, GenAM



Source: ECB, Datastream, GenAM

Updated staff projections painted a more stagflationary picture. With the Iran war now lasting three and a half months, its economic impact is becoming increasingly visible and has prompted the ECB staff to revise inflation higher. Headline inflation over 2026–28 was revised up by a cumulative 0.6 pps to 3.0%, 2.3% and 2.0% (from 2.6%, 2.0% and 2.1%), while core inflation was also raised by a cumulative 0.6 pps to 2.5%, 2.5% and 2.2% (from 2.3%, 2.2% and 2.1%), reflecting the pass-through of higher energy prices into underlying price pressures. In the press conference, President Lagarde said inflation was broadening through both direct and indirect channels, while noting that there were still no signs of wage-driven second-round effects. At the same time, the growth outlook was revised down slightly, by a cumulative 0.1 pps over 2026–28, to 0.8%, 1.2% and 1.5% (from 0.9%, 1.3% and 1.4%). The risk assessment was also telling: unlike in March, the ECB now included a milder scenario alongside the adverse and severe scenarios, acknowledging that a faster resolution of the Middle East conflict could ease inflation pressures more quickly. In that scenario, inflation falls below 2% by mid-2027 and returns to target by end-2028, while growth remains as resilient as in the baseline.

Not an insurance hike, but not the start of new cycle either. During the press conference, President Lagarde repeatedly stressed that today's rate hike was robust across all scenarios. Between the lines, however, the ECB's message was that the current shock is seen as a sizeable but not overly persistent inflation overshoot requiring a measured policy response. Lagarde suggested that, without today's move, inflation would likely have remained above target towards the end of the forecast horizon. At the same time, she made clear that the ECB does not view this step as the beginning of a new hiking cycle.

The door to further rate hikes remains open. Asked about the risk of a policy mistake, President Lagarde argued that the euro area is not facing an environment of absent growth and stressed that bringing inflation back down after a surge can be difficult. At the same time, she said that, with today's 25 bps hike, the ECB is well positioned to navigate the current uncertainty. Overall, her remarks left the door open to additional tightening if needed.

Markets were not overly impressed. Rate pricing suggests investors did not see the meeting as a major hawkish surprise, with markets now discounting around 43 bps of further tightening this year, slightly less than at yesterday's close.

The balance of risks points to a September hike. Today's decision was unanimous and, according to Lagarde, no alternative proposal was discussed, suggesting broad agreement within the Governing Council on how to respond to the current environment. The ECB also highlighted the intensity and duration of the energy-price shock, as well as the scale of second-round effects, as key determinants of the outlook. In our view, the case for only one hike in 2026 depends crucially on energy prices retreating over the summer; without such a pullback, a further 25 bps move in September would become likely.