ECB Watch

AIB Treasury Economic Research Unit

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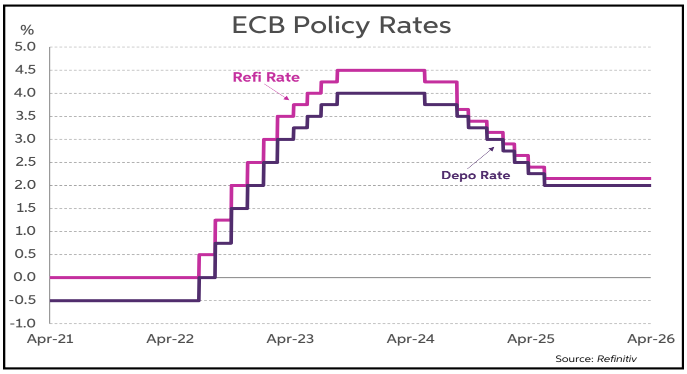
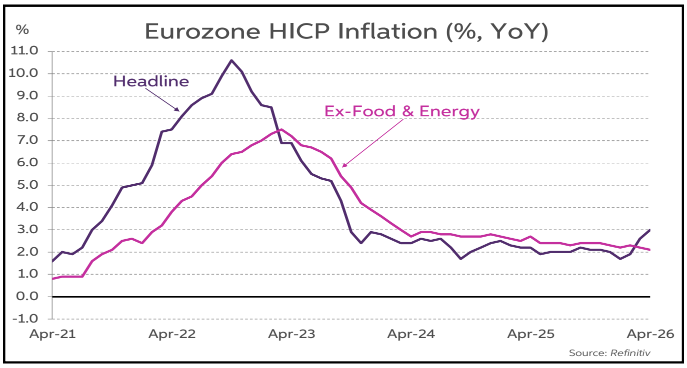
ECB adds a hawkish tilt to its “wait-and-see” stance

The third ECB Governing Council policy setting meeting of 2026 saw the central bank leave interest rates on hold. The deposit and refi rates were maintained at 2.00% and 2.15%, respectively. This outcome was in line with market expectations, and marks the seventh consecutive meeting that the central bank has left its official rates unaltered. The market focus today was very much on any change to guidance following the surge in energy prices since the conflict in the Middle East broke-out.



The April meeting statement contained some hints regarding the ECB’s evolving thinking on the impact of the Middle East conflict. The statement noted that the recent data have been “broadly consistent” with the Council’s assessment of the inflation outlook, albeit “the upside risks to inflation and the downside risks to growth have intensified”.

The latest economic projections were published at the previous ECB meeting in March. These forecasts showed a more downbeat view regarding the outlook compared to the December projections. The ECB is forecasting Eurozone GDP to average 0.9% this year (was 1.2%). For 2027, growth of 1.3% is being pencilled in (was 1.4%). In terms of its inflation outlook, the macro forecasts show that it expects stickier inflation in the near term, with headline HICP anticipated to average 2.6% (was 1.9%) this year. For 2027, it sees inflation at 2.0% (was 1.8%). Today, the ECB emphasised that the economic outlook is “highly uncertain”, but acknowledged that the conflict is “weighing on economic activity”. Meantime, President Lagarde stated that, higher energy prices “will keep inflation well above 2% in the near-term”, but underlying inflation metrices “have changed little over recent months”, suggesting that the ECB has yet to see evidence of second-round price effects.



The ECB also provided alternative, higher inflation scenarios might in March. This analysis outlined two alternative “adverse” and “severe” scenarios, which project a longer lasting and higher energy price shock. The worst-case scenario (Oil peaks close to $145) shows inflation reaching a peak of over 6% in 2027, including core inflation of 4%, which remains above target until end-2028.

At the post-meeting press conference, President Lagarde stressed that the Eurozone economy had “certainly” moved away from its base case projections, but she refused to be drawn on where it is compared to the alternative scenarios. However, she made it clear that the ECB will closely monitor “the size and persistence of the energy price surge, and how it feeds through to price and wage-setting”. In other words, the ECB is highly sensitive to second round inflation effects. President Lagarde also let it be known that the Council “debated in length and in depth” about hiking rates today, before unanimously voting to hold rates steady.

ECB Macroeconomic Forecasts for the Euro Area—Mar 2026

(%)	2025	2026	2027	2028
HICP	2.1	2.6 (4.4)	2.0 (4.8)	2.1 (2.8)
Real GDP	1.5	0.9 (0.4)	1.3 (0.9)	1.4 (1.9)

Base forecasts based on Brent oil prices avg. $81 in 2026, and $72 2027, and $70 in 2028. Severe (in brackets) has Brent peaking at $145 in Q2 2026, and averaging c.$120 thereafter until end-2027.

Overall, while the ECB was happy to remain in “wait-and-see” mode, the tone of today’s communications was more hawkish than in March. President Lagarde made repeated reference to the next meeting in June, as being “the right time” to assess the possible economic outcomes from the war in the Middle East. Thus, if energy prices remain elevated, the possibility of a rate hike in June appear to have increased following today’s meeting. Market expectations for the ECB rate outlook have shifted abruptly in recent weeks in a hawkish direction. Currently, markets see around a 70% chance of a rate hike in June, and up to three rate hikes in total by year-end. **However, the outlook for Eurozone rates remains highly dependent on developments in the Middle East.**

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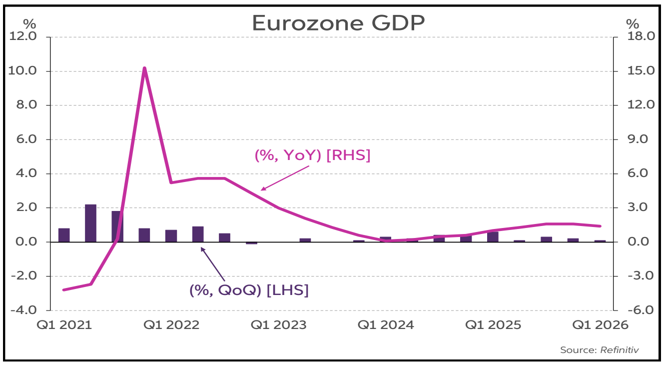
Eurozone growth revised lower due to Middle East war

Having expanded at a meagre pace in 2023 and 2024, the Eurozone economy gathered some momentum last year. However, the expansion in activity levels remained modest, with the economy growing by 1.5% in 2025, up from 0.9% in 2024, and just 0.5% in 2023. **Furthermore, growth was very muted in the first quarter of 2026, with GDP expanding by a meagre 0.1% q/q.** Eurostat did not provide the underlying breakdown of the Q1 GDP reading, but details from some of the national statistic offices indicate that exports boosted growth, offsetting mixed levels of domestic demand and weak investment.

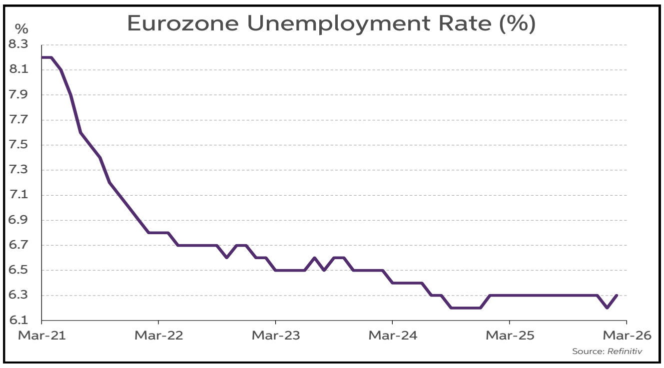


However, among the large national economies, growth continued to vary. Of the “Big Four”, the Spanish economy remained the best performing, with GDP expanding by 0.6% in the quarter. Meanwhile, the German economy defied expectations, as growth accelerated slightly to +0.3% q/q at the start of 2026. Italy also recoded a modest expansion of 0.2% q/q. In contrast, the French economy stagnated, and only avoided an outright contraction because of a sharp rise in inventories.

Regarding the labour market, conditions remain solid. Employment expanded for a nineteenth successive quarter in Q4, up by 0.2% q/q and by 0.7% y/y. It means that the number of people at work has risen by 5.7% since the end of Q4 2019. Meanwhile, the unemployment rate averaged 6.3% for a second consecutive year in 2025. Furthermore, it printed in a narrow 6.2-6.3% throughout the first quarter of 2026. Despite ongoing tight conditions, wage growth has cooled somewhat. The Indeed wage tracker indicates that earnings rose by just 3.8% y/y on average in Q4, down from 4.8% y/y during the same period in 2024. It also shows that wage growth has averaged 3.7% y/y in the first two months of 2026.

On the inflation front, price pressures appeared to be relatively stable in the Eurozone ahead of the recent surge in energy prices. Following a gradual downtrend in the first half of 2025, inflation remained in and around the ECB’s 2% target rate for a number of months. Indeed, the headline rate averaged just 2.1% overall in 2025. Meantime, underlying inflation proved to be somewhat sticky, with the core rate averaging 2.5% last year. It should be noted though, that it printed between 2.2-2.4% throughout the final nine months of 2025. **However, amid the war in the Middle East, headline inflation has increased sharply in the past two months.** It rose from 1.9% in February to 2.6% in March, and the flash estimate released today indicates it moved higher again to 3.0% in April. In contrast though, the core rate has edged slightly lower in the past two months and stood at just 2.1% in April, its lowest level since October 2021.

Meantime, the limited data available at the start of the second quarter have been weak. The services PMI moved back into contraction territory for the first time since last May, falling to 47.4 in the month. Similarly, the EC economic sentiment indices all deteriorated markedly in April. Notably, consumer confidence declined to –20.6, its weakest level since December 2022. In contrast to this, the manufacturing improved and remained in expansion mode in April.



In summary, the Eurozone economy gathered some momentum last year, albeit the pace of growth remained moderate. Meantime, the labour market stayed in robust shape and inflation returned to target. However, the economy appears to have lost some momentum in the early part of 2026. Furthermore, it should be noted that the Eurozone faces a number of challenges. Geopolitical tensions between the EU and US in Q1 serve as a reminder that relations with the bloc’s main trading partner are less certain than they have been in the past. **Meanwhile, the ongoing war in the Middle East and the surge in wholesale energy prices now pose a clear stagflationary risk to the economic outlook.** Against this backdrop, growth projections for this year have been revised lower. The IMF now sees GDP rising by 1.1% this year (was 1.3% previously) and by 1.2% next year (was 1.4%).

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