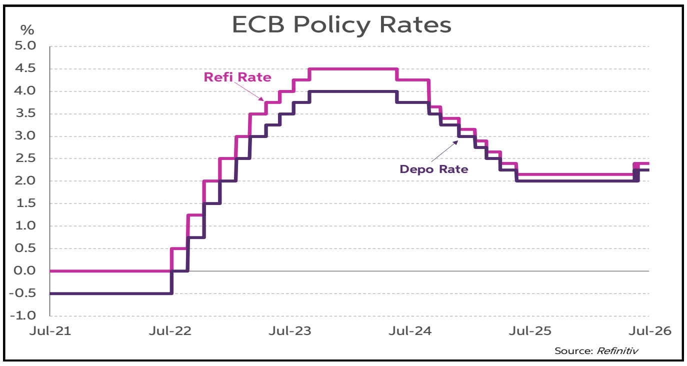
ECB Watch

AIB Treasury Economic Research Unit

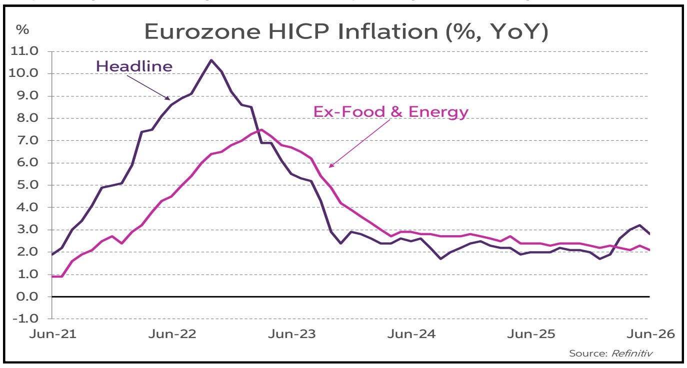
23rd July 2026

ECB holds rates steady but a September hike is possible



The July meeting of the ECB's Governing Council saw the central bank leave its key interest rates unchanged. The deposit and refi rates were maintained at 2.25% and 2.40%, respectively. This was very much in line with market expectations**. The decision to remain on hold was unanimous.** However, President Lagarde commented that some Governing Council members did discuss if the central bank should consider a hike. The most recent policy change from the ECB occurred at its previous meeting in June. It hiked rates by 25bps in response to concerns over the elevated risks to achieving its inflation target due to the energy price shock from the Middle East conflict. This was the first rate change from the ECB since June'25 and it was the first time it had hiked rates since September 2023. **Today's meeting statement showed that the Governing Council remains concerned about the upside risks to inflation.** It noted that "uncertainty remains high and the full inflationary impact of the energy shock has yet to play out". Overall though, it was the ECB's assessment that its policy setting is "well positioned" to deal with the uncertainty arising from the Middle East conflict.

The ECB's most recent set of macro forecasts were published at its previous meeting in June. In terms of the outlook for headline inflation, the June forecasts contained upward revisions. Not surprisingly, this was largely due to "a higher path for energy prices". The ECB expects inflation to average 3.0% this year (was 2.6%), 2.3% next year (was 2.0%), and 2.0% in 2028 (was 2.1%). Meanwhile, the ECB is forecasting that core inflation will run above the 2% target over the forecast period, averaging 2.5% this year and next, before easing slightly to 2.2% in 2028. In terms of growth, the ECB revised lower its baseline GDP projections to 0.8% (was 0.9%) in 2026 and to 1.2% in 2027 (was 1.3%). It stated again today that the "risks to the growth outlook are to the downside"



At the post-meeting press conference, President Lagarde continued to stress that the ECB will take a "meeting-by-meeting" approach to any rate changes and that it was not pre-committing. She stated that the current policy setting was "positioned adequately to wait". In this regard, President Lagarde noted that there would be some key data published over the next few weeks that will inform its decision on whether to hike or not in September. She referenced a "volume of data" that included two inflation readings, two consumer inflation expectations indices, Q2 GDP and PMI surveys. President Lagarde emphasised that the "burden of proof is on the data". In other words, if this data suggests upside risks to the inflation outlook, the ECB will hike again. However, it was notable that she stated that the ECB is not currently seeing the emergence of second round effects and that inflation expectations are "broadly anchored" to the ECB's medium term 2% target.

The market continues to anticipate further rate hikes from the ECB. However, in the aftermath of today's meeting, futures contracts did soften slightly, with the market now attaching around a 70% probability to a 25bps rate increase at the ECB's next meeting on September 10th (was nearer to 90% before the meeting). This suggests that the market had envisaged a stronger signal from the ECB today regarding a September hike. Further out, the market is pricing in another 25bps of tightening during the first quarter of 2027, with the deposit rate seen reaching 2.75% and remaining at this level over the remainder of 2027. Given today's communications from the ECB, it seems reasonable to factor in a 25bps rate hike over the coming months if the incoming data justify this policy action. Any additional policy tightening though from that point on, will be very much dependent on the duration of the Middle East conflict and its impact on energy prices. If the conflict de-escalates and second round effects remain muted, then a further increase in rates above 2.5% may not be warranted.

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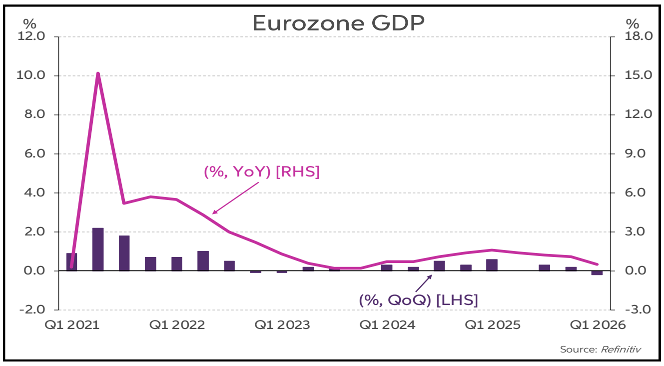
Eurozone economy lost momentum in H1 2026

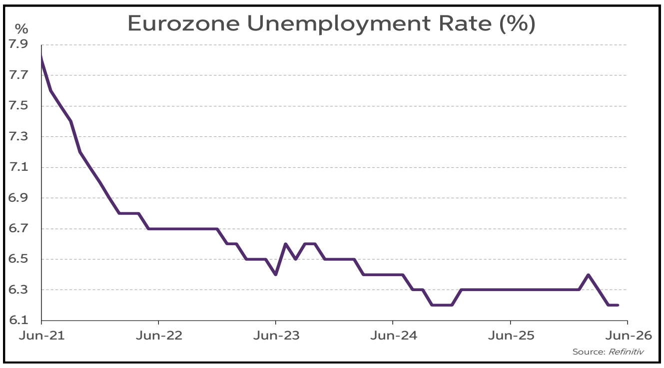
The Eurozone economy expanded by a solid 1.4% last year, up from 0.8% and 0.5% in the two years prior. However, the economy has lost some momentum at the start of 2026. GDP contracted by 0.2% q/q in Q1 of this year. It was the first quarterly contraction since Q4 2022. Furthermore, the deterioration in performance was broad based. Personal consumption and government expenditure both expanded more slowly, meaning each component contributed just 0.1 percentage points (p.p.) to growth in Q1. At the same time, fixed investment declined by 0.3% q/q, clipping 0.1 p.p. from the total. In terms of external trade, imports increased and exports fell. As a result, net trade knocked 0.3 p.p. off GDP. Changes in inventories also reduced GDP by circa 0.1 p.p. in the quarter. However, it should be noted that excluding the volatile Irish GDP data (which fell by 12.1% in Q1), the Eurozone economy would have expanded by 0.2% q/q in Q1.



Meanwhile, the available survey data for Q2 indicate that economic conditions softened in the quarter. The services PMI moved back into contraction territory in April, falling to 47.6, its lowest level since the early part of 2021. Overall, it averaged just 48.2 in Q2, down from 51.2 in Q1. In contrast, the manufacturing PMI has stayed in expansion territory, albeit the headline index fell slightly as the quarter progressed, suggesting the pace of growth in the sector eased. Meanwhile, economic sentiment weakened across the board amid the onset of the war in the Middle East, but the surveys may have now troughed. However, despite improving in June, consumer, industrial, services and investor sentiment all remain at subdued levels. In terms of the limited available hard data for Q2, retail sales and industrial production both suggest the Eurozone economy gathered little if any momentum in recent months.

Regarding the labour market, conditions remain solid though. Employment expanded for a twentieth successive quarter in Q1, by 0.1% q/q and by 0.5% y/y. It means that the number of people at work has risen by 5.8% since the end of Q4 2019. Meanwhile, the unemployment rate averaged 6.3% for a second consecutive year in 2025. Furthermore, it has averaged 6.3% once again in the first five months of 2026. Ongoing tight conditions continue to support wage growth. The Indeed wage tracker indicates that earnings rose by 2.5% y/y on average in the second quarter, compared to 2.6% y/y during the same period in 2025.

On the inflation front, price pressures were 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 several 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 four months.** It rose from 1.9% to a peak of 3.2% in May, before declining to 2.8% in June. However, there has been limited evidence to date that energy price rises have let to broader inflationary pressures. Core inflation has printed in a narrow 2.1-2.3% range in the past four months.



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 first half of 2026. Furthermore, 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 0.9% this year (was 1.3% previously) and by 1.2% next year (was 1.4%).

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