Economic Commentary

QNB Economics
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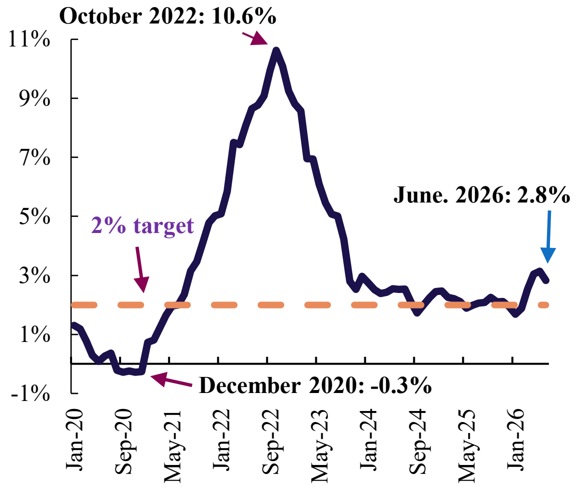
Has the ECB reached the end of its tightening cycle?

At the beginning of the year, the European Central Bank (ECB) appeared set to keep interest rates unchanged throughout 2026. After a successful disinflation process, inflation had fallen close to the ECB's 2% target, while the deposit rate stood at 2%, a level broadly considered neutral. The escalation of the US-Iran conflict abruptly changed this outlook, as severe supply disruptions and constraints on shipping through the Strait of Hormuz triggered a sharp increase in oil and natural gas prices, pushing inflation above target once again.

Euro Area Consumer Price Inflation
(%, headline series, year-over-year)

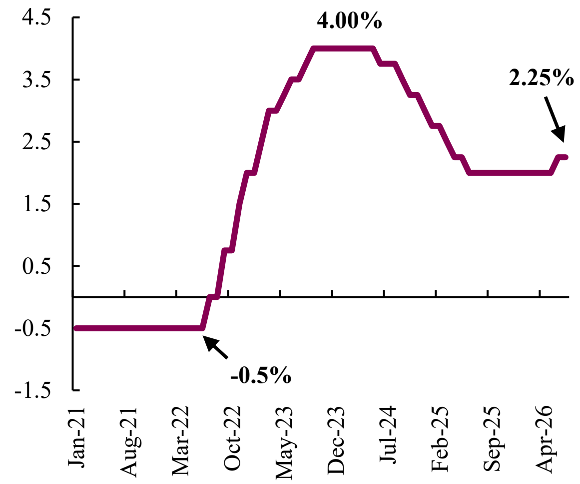


Source: Eurostat, QNB Economics

Policymakers became increasingly concerned that higher energy costs could spill over into the prices of other goods and services, making inflation more persistent through second-round effects. The Euro Area is particularly sensitive to natural gas prices, as gas not only constitutes a major share of energy imports, but also acts as a key price-setting factor in electricity markets.

Against this backdrop, the ECB raised its deposit rate by 25 basis points in June, to prevent what was initially viewed as a temporary energy shock from becoming a broader inflation problem. These effects have for now been captured by monetary policy, unless a further and considerable spike in energy prices should prove more persistent. In this article, we discuss three key factors supporting this assessment.

European Central Bank Policy Interest Rate
(%, ECB deposit rate)



Source: European Central Bank, QNB Economics

First, the inflation risks that prompted the June rate hike have eased. Despite the ongoing conflict between the US and Iran, recent inflation data suggest that higher energy costs are not feeding broadly into the economy. Both headline and core inflation surprised to the downside in June, while wage growth continues to moderate, limiting the risk of second-round effects. Moreover, euro inflation swap rates – a market-based measure of investors' inflation expectations – have fallen below the ECB's 2% target over the next year. Taken together, these developments suggest that the inflation shock is likely to prove temporary, substantially weakening the case for further monetary tightening.

Second, the weakening growth outlook for the Euro Area reinforces the case for no further increases in policy rates. Business activity has remained subdued, with the composite Purchasing Managers' Index (PMI), which combines the manufacturing and services sectors, staying below the 50-point threshold that separates expansion from contraction for the past three months. This weakness has prompted analysts to revise down their growth outlook, with consensus forecasts for real GDP growth this year declining from 1.2% before the US-Iran conflict to 0.6%. Slower economic growth is also likely to reduce underlying inflationary pressures by dampening demand across the economy. Against this backdrop, additional monetary tightening would risk weighing unnecessarily on an already fragile economy.

Third, recent ECB communication suggests that policymakers are becoming more comfortable with leaving interest rates unchanged. At the June meeting, the Governing Council emphasized that it would continue to follow a data-dependent and meeting-by-meeting approach, without pre-committing to a specific path for policy rates. This message was reinforced at the ECB's annual Forum on Central Banking, held in Sintra, Portugal, where central bankers, academics, and financial market participants gather each year to discuss the global economic outlook and monetary policy challenges. There, President Lagarde noted that risks to inflation and growth had become more broadly balanced. Other Governing Council members also indicated that a wait-and-see approach was appropriate, with some expressing openness to keeping policy rates unchanged if incoming data continue to confirm that inflation risks are receding. Taken together, recent communication suggests that the Governing Council is increasingly focused on assessing incoming data rather than preparing for another near-term increase in policy rates.

All in all, the ECB's June rate hike was an appropriate response to the temporary inflation risks. Nevertheless, continued progress in the disinflation process, a weaker growth outlook, and recent ECB communication all point to a reduced need for additional monetary tightening. Unless a new inflationary shock emerges or underlying price pressures prove unexpectedly persistent, the June increase is likely to mark the end of the ECB's tightening cycle, with policy rates expected to remain unchanged over the remainder of the year.

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