

MARKET COMMENTARY

ECB discussed rate hikes but is still waiting for more information

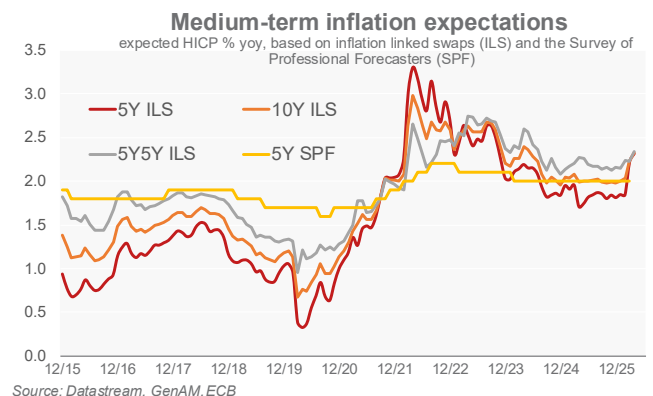
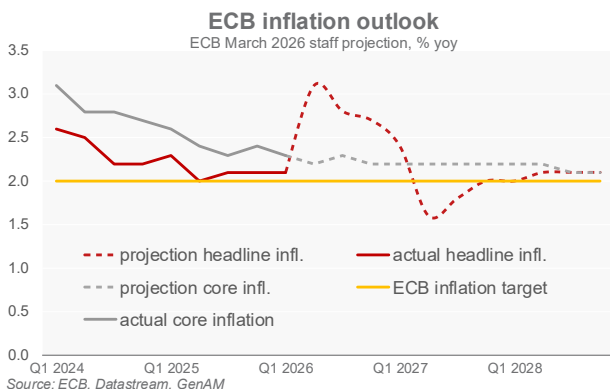
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- The Governing Council (GC) saw its policy stance at today’s meeting still “*well positioned to navigate the current uncertainty*”. While unanimously leaving rates unchanged it has started to seriously discuss rate hikes.
- What seemed to have held back the GC from acting today was apart from the Iran war evolution that so far data are broadly in line with the March projections and that the ECB wants to avoid a policy mistake. Key will be the June meeting when updated macro projections and data on second-round effects are available.
- In the Q&A Pres. Lagarde stated that we were certainly moving away from the base case suggesting higher inflation in the updated June inflation base case and that markets understood the ECB’s reaction function while emphasizing data dependence.
- Surprisingly, markets reduced their rate hike expectations for June somewhat. We stick to our base case that a 25 bps insurance hike by June would be enough to manoeuvre through stagflationary waters but acknowledge that the overall hawkish tone of today’s press conference tilts the risks towards more rate hikes.

At today’s meeting the ECB did not act, in line with overall expectations. Yet, after two months of Iran war the GC has started to discuss rate hikes and, in the Q&A Pres. Lagarde characterised today’s outcome merely as an informed decision on the basis of yet insufficient information paving the way for a hike by June.

Data still in line with March staff projections. At the March meeting ECB staff had already anticipated a spike in inflation. The April flash reading of 3.0% yoy is in line with assumption of 3.1% yoy for Q2 from the March staff projections. Likewise, it sees



longer term inflation expectations well anchored albeit noting that short term inflation expectations have moved up significantly. In contrast, flash Q1 GDP growth of 0.1% qoq is below the projected number of 0.3% qoq. Amid high uncertainty the growth risks are on the downside but the inflation risks on the upside, both crucially linked to the development of the Iran war. Hence it is highly uncertain how the tug of war between disinflationary effects from lower growth and higher inflation through increased energy prices ends. In our view, beyond the duration of the conflict and the risk of disruptions around the Strait of Hormuz, the severe downside tail risk to growth (including the possibility of physical supply constraints) has reinforced the case for a wait-and-see approach.. During the press conference, President Lagarde was asked about the lesson from 2011—when the ECB hiked but then had to cut again soon after—and she responded that the ECB remains very attentive to history. All in all, there were sound reasons for not rushing into action at today’s meeting.

Moving away from March base case. That said, President Lagarde also signalled that the Governing Council should be in a better position to make a more informed decision at the June meeting. Reiterating the ECB’s data-dependent approach, she highlighted that any policy action would be guided by incoming information—particularly inflation expectations, supply-chain disruptions, wage settlements and firms’ pricing behaviour. Several key releases over the coming weeks will help shape the macro outlook. So far, there are no clear signs of second-round effects via wages—an area the ECB is monitoring closely. At the same time, Lagarde appeared confident enough to state that the economy is “certainly moving away” from the March baseline. While she did not elaborate, the comment suggests the inflation outlook may need to be revised higher.

Paving the way for a rate hike in June. In the Q&A, President Lagarde noted that the latest staff projections implicitly embedded two rate hikes via the market-implied short-term rate path—suggesting, in her view, that the ECB’s reaction function was well understood by markets. Indeed, following the March meeting, she had outlined in a series of speeches (which she also referenced today) how the ECB’s strategy would translate into action, signalling that—purely to safeguard credibility—a rate hike could become warranted. With the next central macro scenario likely to point to a higher inflation trajectory, this can be read as an additional indication that a June hike is increasingly in play. A hike would likely be taken off the table only if the conflict involving Iran were to de-escalate unexpectedly and energy prices were to fall materially. We find it surprising that markets reduced their June rate hike expectations somewhat over the course of today’s press conference.

Risks tilted towards more hikes after June. A 25 bps increase in the key policy rate to 2.25% by June would place it at the upper end of the ECB staff’s estimated neutral range (1.75%–2.25%). Beyond June, developments in the conflict involving Iran remain pivotal. In our view, however, the bar for additional hikes is higher than for June: further tightening would take policy into restrictive territory, financing conditions have already tightened and would be expected to tighten further in a more inflationary environment, and—under a more adverse scenario—the resulting hit to growth should dampen inflation pressures strongly. That said, we acknowledge that today’s overall hawkish tone at the press conference tilts the risks towards further rate hikes beyond June.

