

Opinion | 27 March 2026

Carsten Brzeski: ECB rate hikes? Not so fast

Markets are pricing aggressive rate hikes from the European Central Bank after recent Middle East tensions, but policymakers appear more cautious. In this article, **Carsten Brzeski** argues that policy tightening is far from assured, with the Bank still very much guided by inflation expectations and wages



There is renewed excitement in financial markets about how the ECB might react to the war in the Middle East, with markets now pricing in more than three rate hikes. Needless to say, in such uncertain times, almost anything is possible, and nothing can be entirely ruled out. The real question, however, is whether markets have looked beyond the headlines and taken on board the messages from Wednesday's ECB Watchers Conference, including remarks by Philip Lane and Christine Lagarde.

At least in my own humble opinion, those remarks point to a somewhat different reaction function than what markets are now pricing. After last week's ECB meeting and press conference, it was already obvious that the central bank had made a hawkish pivot and would remain vigilant, arguably more vigilant than in 2022. Back then, however, the ECB was emerging from an extremely accommodative stance and normalising policy from negative interest rates and quantitative easing. With hindsight, the biggest policy mistake was probably the delayed response to an energy price shock that ultimately morphed into a broader inflation surge. Learning from that episode though does not mean a rate hike is imminent.

Lagarde's speech showed that the ECB, like the rest of us, is currently thinking about a range of different scenarios. As long as the energy price shock remains broadly contained, including first-round knock-on effects, it's far from certain that the ECB will react at all. For rate hikes to come back onto the table, the Bank would need to see a rise in inflation expectations and a broadening of inflationary pressures across the economy. So far, the war in the Middle East has instead weighed on business and consumer confidence. Meanwhile, the labour market is entering this energy shock in a weaker position than in 2022, and governments' fiscal pockets are more constrained, making large-scale stimulus to offset higher energy prices less likely.

What does this imply for the ECB's reaction function? While the Bank will continue to update its scenarios, it will be the actual developments, rather than forecasts, that determine the ECB's next steps. The ECB is back to a "driving at sight" approach. Key variables to watch are actual inflation data, survey-based longer-term inflation expectations, and wage developments, all of which will be weighed against the risk of slowing economic activity and financial stability concerns.

Looking ahead to the ECB meeting at the end of April, there will be no new forecasts, and only limited data available: March inflation, a handful of country inflation releases for April, and initial estimates of first-quarter GDP on the day of the meeting. In all honesty, that does not look sufficient to move the needle, unless the ghosts of 2022 are really keeping policymakers awake at night.

For the June meeting, the story is different. Simply put, if we are still talking about the war in the Middle East and high energy prices by then, a rate hike is clearly possible. However, this is not our base case, as we expect the Strait of Hormuz to reopen before then.

In short, our view of the ECB's reaction function has not changed in recent days. We think the ECB – like us – is expecting an initial inflation wave, starting with gasoline prices, followed by knock-on effects on transportation costs, food prices and other industrial products. As long as this remains a single, time-limited wave, there is no need for ECB rate hikes. Even though it's a forbidden word in Frankfurt, some might call this 'transitory'.

That said, three potential pain points remain for the ECB: a psychological one, ie headline inflation above 4%, reviving uncomfortable memories of 2022; an analytical one, ie core inflation above 3%, signalling broader price pressures; and a credibility one, ie a surge in survey-based inflation expectations, which would make inaction increasingly difficult to justify.

In today's environment, almost anything is possible, even ECB rate hikes, but that's still not our base case.

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