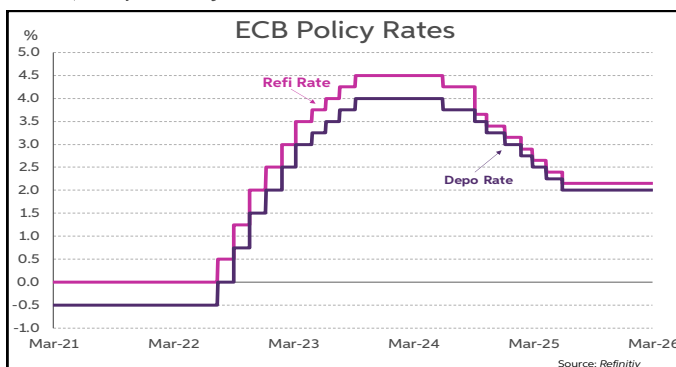


ECB plays for time on oil shock, but expects higher inflation

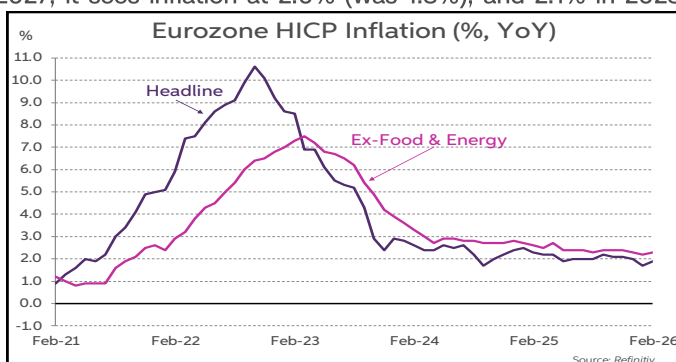
The second ECB Governing Council policy setting meeting of 2026 saw the central bank leave interest rates on hold. The deposit and refi rates were maintained at 2.00% and 2.15%, respectively. This outcome was in line with market expectations, and marks the sixth consecutive meeting that the central bank has left its official rates unaltered. In total, the central bank cut rates by 200bps during its easing cycle. **However, the market focus today was very much on any change to guidance following the recent surge in oil prices.**

The March meeting statement contained some hints regarding the ECB's evolving thinking on the impact of the Middle East conflict. The context of today's decision to keep policy on hold was that the outlook was "significantly more uncertain, creating upside risks for inflation and downside risks for economic growth."



The latest economic projections were also published today, but they were somewhat stale on arrival, as they were based on March 11th energy prices, when Brent Crude was around \$90/barrel. 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%). It sees growth of 1.4% in 2028.

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%), and 2.1% in 2028. Again, these forecasts are based on a more benign outlook for energy prices from March 11th compared to current prices (Mar 19th), so could prove to be higher, if the current shock persists.



The ECB also provided colour on what alternative, higher inflation scenarios might look like. 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. GDP is c.0.5 percentage points lower in both 2026 and 2027, in this scenario.

The post-meeting press conference for February was closely watched and offered some further insights on the ECB's view of the current situation. President Lagarde's comments suggest the ECB is happy to remain in a 'wait-and-see' position for now, with her comments emphasising both "risks to the downside" for growth, alongside "upside" risks to inflation. She also stated the ECB starts from a "good place", pointing to a dynamic of "three times two" - 2% inflation, 2% inflation expectations, and the current 2% deposit rate.

Market expectations for the ECB rate outlook have shifted abruptly in recent weeks. From partially pricing in a 25bp cut before the conflict, markets were pricing in more than 50bps of hikes in its aftermath. Today's release has not changed that expectation materially. **Our view since the start of last year had been that the deposit rate will settle at 2%, but there are clearly now upside risks.** The tone of today's communications suggests the ECB is happy to play for time for now. However, rate hikes are a distinct possibility in the coming months if oil prices remain at current elevated levels, as tacitly conceded by President Lagarde in her closing remarks.

ECB Macroeconomic Forecasts for the Euro Area—Mar 2026

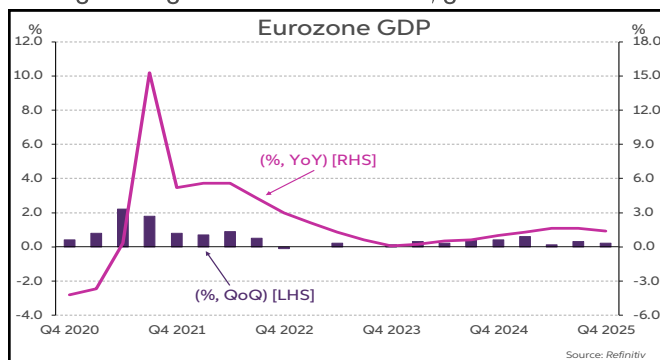
(%)	2025	2026	2027	2028
HICP	2.1	2.6 (4.4)	2.0 (4.8)	2.1 (2.8)
Real GDP	1.5	0.9 (0.4)	1.3 (0.9)	1.4 (1.9)

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

Middle East conflict could blunt Eurozone growth

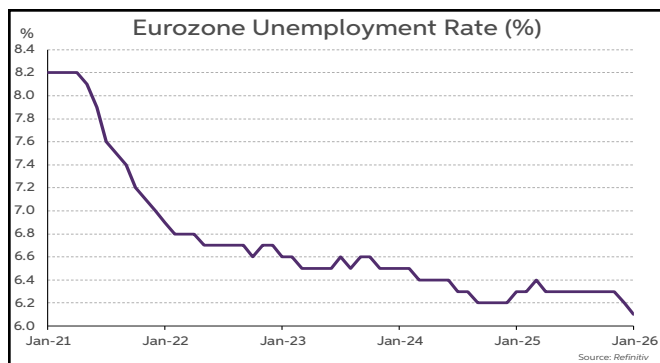
Having expanded at a meagre pace in 2023 and 2024, the Eurozone economy gathered some momentum last year. However, the expansion in activity levels remained modest, with the economy expanding by 1.5% in 2025, up from 0.9% in 2024, and just 0.5% in 2023. Among the largest national economies, growth continued to be uneven. German GDP expanded by 0.4% in 2025, having contracted in the two years prior, albeit while remaining the weakest performing of the 'Big Four'. In contrast, the Spanish economy was the best performing of the group once again, registering robust growth of 2.8%. Meanwhile the French and Italian economies recorded moderate expansions of 0.9% and 0.7%, respectively.

Meantime, the limited data available for Q1 have been mixed. The services PMI remained above the key 50 threshold, but fell to 51.6 and 51.9 in the first two months of the year, consistent with a slower pace of expansion in the sector. Meantime, the manufacturing PMI improved in January, and in February it printed in expansion mode for only the third time since April 2022. However, economic sentiment fell somewhat in February, amid a broad-based decline. Industrial sector sentiment had been improving but it slipped to -7.1 in the month, while services sector sentiment deteriorated to 5.0. It should be noted though, that both measures were at multi-year highs in January. At the same time, consumer confidence has continued to trend higher, following a weak end to 2025.



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 fell to a new all-time low of 6.1% in January. Despite ongoing tight conditions, wage growth has cooled somewhat. Wages in the Eurozone rose by 3.0% y/y in Q4, down from 4.1% y/y a year earlier. Furthermore, the Indeed wage tracker - a more frequent measure of wage pressures - indicates that wages 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 oil shock. Following a gradual downtrend in the first half of 2025, inflation has remained in and around the ECB's 2% target rate for a number of months. Indeed, the headline rate started last year at 2.5% but averaged just 2.1% overall in 2025. Meantime, underlying inflation has proven to be somewhat sticky, with the core rate averaging 2.5% last year. However, it should be noted that it printed between 2.2-2.4% throughout the final nine months of the year. Furthermore, the headline and core rates have remained quite steady so far in 2026, standing at 1.9% and 2.3% in February. Looking ahead, the ECB sees the headline and core rate averaging 2.6% and 2.3% this year, and 2% and 2.2% in 2027.



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. Looking ahead, the recent bout of disinflation and rate cuts in the first half of 2025 have supported real incomes and consumer spending. Increased fiscal spending in Germany, as well as higher defence spending at the EU level could also begin to support growth this year. For now though, modest rates of growth are expected to remain the norm in the Eurozone. The ECB sees GDP expanding by 0.9% this year and by 1.3% next year. It should also be noted that the Eurozone continues to face a number of challenges and potential downside risks. Recent geopolitical tensions between the US and EU serves as a reminder that relations with the bloc's main trading partner are less certain than they have been in the past. More pressingly, the recent surge in energy prices amid the conflict in the Middle East may generate a renewed inflation shock, which may well stem the recent momentum the economy has gathered.

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