European Central Bank lifts interest rate amid rising inflation

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The European Central Bank (ECB) lifted its interest rate by 0.25 percentage points on Thursday, making it the first central bank of the G7 group of major powers to do so, in response to the rise in inflation set off by the US war on Iran.

Announcing the decision following a meeting of the bank's governing council, ECB president Christine Lagarde said the war in the Middle East was "generating inflation pressures" with the estimate for inflation for 2026 expected to come in at 3 percent. She noted that energy price inflation has "ticked up" to 10.9 percent in May after rising by 10.8 percent in April.

The figures on economic growth in the euro area revealed that its economy has basically stalled. The ECB's baseline forecast was for growth of 0.8 percent in 2026, and 1.2 percent for 2027. This was a downward revision on previous forecasts "reflecting a more pronounced impact of the war on commodity markets, real incomes and confidence."

"The outlook remains uncertain, with upside risks for inflation and downside risks for economic growth," she said.

While the first quarter of the year saw additional jobs being created, at a slower pace than at the end of 2025, labour demand had "cooled further, and firms and households" expected to weaken.

This will be accompanied by a worsening of living standards. Lagarde said the ECB expected wage growth to slow in the second half of this year, while firms would find other inputs more expensive and "therefore expect to put up their selling prices."

The ECB's baseline forecasts, like those other economic and financial institutions, are predicated on the assumption that the war against Iran will come to a conclusion in the immediate term. But events are moving in the other direction as the so-called "ceasefire" breaks apart and the Trump regime steps up its attacks amid intensifies threats, including discussion of the possible use of nuclear weapons.

Lagarde warned that prolonged disruption of energy supplies could increase energy prices further and for longer than currently expected, eroding "real incomes even more and make firms and households more reluctant to invest and spend."

But, she maintained, there should be restrictions on government spending on measures to ease the energy shock. They should be temporary and maintain "fiscal sustainability as a crucial anchor for broader economic stability."

In line with the transition to war economies, especially in Germany, this does not apply to the military. In fact, she touted increased government spend on the military and infrastructure as posing "some cushioning against the fallout from the war."

On the financial front she offered the usual reassurance that euro area banks are "resilient" supported by a strong capital and liquidity base, solid asset quality and robust profitability.

But as Lagarde well knows from experience that all that can change very quickly in conditions of global financial instability, particularly because of the greater involvement of nonbank financial institutions in the global financial system, a factor detailed by the ECB and other central banks.

Accordingly, she issued a warning that "a sudden sharp drop in asset prices, potentially amplifies by the nonbank financial sector and deteriorating asset quality, particularly in energy and trade-sensitive sectors, would pose risks to financial stability. These risks increase the longer the current geopolitical conflicts last."

The ECB decision sets the stage for other central banks to at least maintain their present interest rates

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stances—cuts having been ruled out for the foreseeable future—and even for rises. The Japanese central bank is expected to lift its rate next week and the US Federal Reserve, despite the urgings of US president Trump for a major cut, is expected to keep its rates on hold, under conditions where inflation has surged to 4.2 percent, when it meets under new chairman Kevin Warsh next week.

And the ECB could raise rates further, despite Lagarde's insistence that it was not on a predetermined path.

The interpretation in sections of the financial markets is somewhat different. Seema Shah, the chief global strategist at Principal Asset Management, told the *Financial Times* (FT), that the combination of high inflation projections indicated that the ECB "must have a clear bias towards addressing inflation risks."

The bank's own projections, she said "point away from a one-and-done move, with further tightening likely as policymakers seek to contain the inflation shock."

Central banks have only one way of "dealing" with inflation—that is by suppressing economic growth through interest rate hikes, and driving the economy into recession if that is considered necessary.

This was the warning delivered by Holger Schmieding, the chief economist at Germany's Berenberg Bank, on the decision in remarks to the FT. He said the rate decision was a "policy mistake" that would deliver a "new blow to euro area growth."

In a note to clients on the eve of the announcement, he said: "The ECB should look through the adverse supply shock rather than weakening the Eurozone economy further."

Earlier this week the Organisation for Economic Cooperation and Development (OECD), which includes 37 of the larger economies, warned that global growth would slow to 2.8 percent this year from 3.4 percent in 2025.

OECD chief economist Stefano Scarpaetta said the "big issue of uncertainty" was not only the depth of the energy crisis but unknown factors such as the supply of fertilisers for agriculture and helium, crucial in making semiconductors.

In a pessimistic scenario, in which energy prices stay high until next year and shortages of fertilisers and industrial products develop, inflation would rise, unemployment would increase and investment, including in AI, would weaken "significantly."

In that case global growth would fall to 2.1 percent this year and 1.7 percent in 2027 and some countries would move into recession.

"That is half of the average growth rate in the global economy in the past 25 years. This, of course, means that households and firms will face a very dire situation," Scarpetta said.

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