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The ECB's June Decision and the Stagflation Problem It Cannot Solve

The ECB meets on June 11. Markets are pricing a rate hike at near certainty. The inflation numbers justify it on the surface. The problem is that this inflation does not come from too much spending, and no rate hike can close the Strait of Hormuz.

MONETARY POLICY

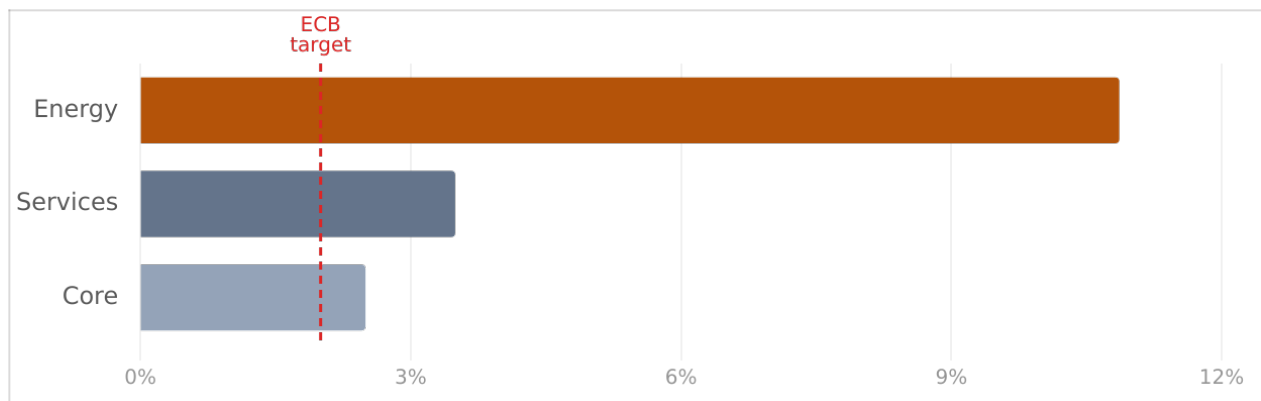


FIG. 1 · HORIZONTAL BAR CHART OF HICP COMPONENTS, MAY 2026. ENERGY 10.9%, SERVICES 3.5%, CORE 2.5%. ECB TARGET IS 2.0%.

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The ECB Governing Council meeting on June 11 will according to market predictions decide a 25-basis-point hike: from 2.00% to 2.25%. On the surface this hike is not without merit. Inflation rose from 3.0% in April to 3.2% in May, marking the third consecutive month above its target of 2.0%. The immediate driver is the Iran war, which has effectively closed the Strait of Hormuz to commercial shipping and pushed Brent crude to \$110 a barrel, driving energy inflation to 10.9% across the bloc. Against this, growth forecasts point to roughly 0% for Q2. The problem is that a hike treats a supply shock like a demand problem.

The challenge all central banks face with stagflation is that their tools are not designed to handle high inflation and slow growth simultaneously. In a demand-driven inflationary episode the central bank's strategy works by tightening monetary conditions, which in turn reduces aggregate spending. This eases the pressure on prices and restores equilibrium. The costs consist of slower growth and

higher unemployment, but they are usually worth it to keep inflation in check. A supply shock, as the Strait of Hormuz illustrates, works differently. Energy prices surge simply due to geopolitical tensions and a real contraction of supply. This leads the economy to face a cost-push dynamic: production becomes more expensive across every sector that uses energy as an input, which is nearly all of them. The real cost of output rises. Households are not spending too much; the pressure is on the cost of production. No central bank decision can open the Strait of Hormuz. All it can do is decrease demand further, but in an economy that is already barely growing.

Doing nothing instead is a different kind of trap. If the supply shock persists it could feed into inflation expectations and transmit into wage negotiations and services pricing, which could prolong and intensify price inflation. That could force the central bank to tighten a weakened economy anyway, just later and at higher costs. The policy question is therefore whether a rate hike can address a shock that originates outside spending at all, rather than simply whether to tighten.

The current Eurozone data points to a supply shock, with one demand-side complication. The energy component of HICP (at 10.9% annually) is the dominant driver of headline inflation, directly tracing to the disruption of shipping through the Strait of Hormuz following the Iran conflict. Maritime flows in the Strait remain more than 90% below year-ago levels, with Brent oil near \$110 per barrel and Dutch TTF gas around €50 per megawatt-hour. This points to supply-side pressure on prices rather than demand-side. Meanwhile demand-side indicators still play a role. Core inflation (stripping out food and energy) rose to 2.5% in May, its highest level in over a year, with services inflation running at 3.0–3.5%. Services pricing is the most labor-intensive and domestically driven component of the index. A rising services number suggests that some second-round transmission is occurring: the energy shock is beginning to feed into wage expectations and broader price-setting. This is the exact concern that leads the ECB to raise rates. Professional forecasters, however, expect limited indirect and second-round effects, concentrated in 2026 and 2027, with longer-term inflation expectations anchored at 2.0%.

The data points toward restraint. Instead of a preemptive hike into an economy growing at 0.1% per quarter, the ECB could hold and watch whether second-round effects actually materialize, since the energy shock is outside the reach of monetary policy anyway. Yes, core inflation is elevated, but it is not yet spiraling. Hiking now means accepting the output cost of tighter conditions in exchange for a marginal reduction in a supply-driven price level that rate increases cannot meaningfully compress. Managing expectations is a real mechanism: credible central banks do influence wage-setting and price-setting through their signals. But that channel works when inflation is demand-driven to begin with. Sending tighter money signals does not make the Strait of Hormuz less closed. Monetary tightening compresses demand uniformly across the economy at the moment the shock calls for differentiated sectoral adjustment. Energy-intensive industries need to contract and reallocate, not face blanket credit tightening alongside everyone else. Tightening further into that uncertainty does not resolve it.

Still, the ECB will hike anyway. The institutional pressure is clear: three months above target, a rising core number, hawkish signals from Governing Council members, and a market already priced for 25 basis points. To hold against that consensus would require a level of confidence and authority that the Governing Council currently lacks, especially after the 2021-22 episode. The Eurozone also enters

this shock with sovereign debt levels that narrow the margin for error beyond what the inflation-growth trade-off alone suggests, with Italy above 135% and France above 110%. These limit the tools at the ECB's disposal. That is a more difficult institutional problem than the monetary policy problem itself. The June 11 decision will very likely be the wrong one. Not catastrophically wrong, but wrong in the precise sense that matters: tightening into a supply shock is the textbook policy error, and the Eurozone will pay for it in foregone growth before the energy shock resolves on its own terms.

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