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Preview: ECB To Hike Rate in September, To Insure Against Second Round Effects

by

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7 September 2026

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Executive Summary

- **Expected Decision**: *We expect, in line with consensus, the ECB is expected to hike in September.* In line with consensus, at the September Governing Council (GC) meeting, we expect the European Central Bank (ECB) to raise its main policy rates by 25 bps i.e. its *i)* interest rate on the 'main refinancing operations' to 2.65%; *ii)* interest rate on the 'marginal lending facility' to 2.90%; and the key *iii)* 'deposit facility' to 2.50%.

  On forward guidance, the ECB is expected to maintain its cautious, data-dependent, meeting-by-meeting approach. While resilient growth and rising headline inflation strengthen the case for a September hike, contained core and services inflation argue against committing to further tightening. A second hike could therefore serve as an "insurance hike", aimed at limiting second-round effects while preserving flexibility over the future rate path.

- **Policy Discussion:** *The case for another ECB rate hike in September has strengthened.* Inflation rose to 3.3% in August and is expected to remain above 3% through year-end, while the eurozone economy has proved more resilient to the Middle East conflict than expected. All economists surveyed by Reuters expect a 25bp hike to 2.5%, which could serve as an "insurance hike" to prevent the energy shock from generating broader second-round effects.
  Beyond September, the outlook is less clear. The current inflation shock remains predominantly supply-driven, with core and services inflation contained and little evidence of persistent second-round effects. A further hike would push policy into restrictive territory despite an economy that is resilient rather than overheating. Accordingly, 91% of economists expect rates to end 2026 at 2.5%, although markets are increasingly pricing in another hike before year-end.
- **Changes to Economic Forecasts:** *The ECB's new staff projections are unlikely to provide a strong policy signal, although modest upward revisions to growth and inflation should support a September hike.* However, the early cut-off means the latest rise in bond yields and energy prices will largely be excluded, leaving the outlook somewhere between the ECB's June base and adverse scenarios.
  Currently, inflation is forecast at 3.2% in Q3 and 3.3% in Q4 and is not expected to return to the 2% target until late 2027, while GDP growth is projected at 0.8% in 2026 and 1.2% in 2027. A prolonged Middle East conflict remains the main risk, potentially keeping energy prices and inflation higher while weakening growth.

Key Picture: European Central Bank Key Forecasts – 2024-2028

		2026*f*		**2027*f***		**2028*f***	
	Latest reading	June Projections	March Projections	June Projections	March Projections	June Projections	March Projections
GDP *(real growth, y-o-y)*	1.2	**0.9**	**0.9**	**1.2**	**1.3**	**1.5**	**1.4**
Inflation *(%, y-o-y)*	3.3	**2.6**	**2.6**	**2.3**	**2.0**	**2.0**	**2.1**
Core-inflation *(%, y-o-y)*	2.4	**2.5**	**2.3**	**2.5**	**2.2**	**2.2**	**2.1**
Unemployment *(%, y-o-y)*	6.4	**6.3**	**6.3**	**6.2**	**6.3**	**6.0**	**6.2**

Source: ECB '*Macroeconomic projections*' *March and June 2026. Note:* Latest readings: 1. GDP for Q2 2026; 2. Unemployment for July 2026; 3. Inflation for August 2026. *Inflation = Harmonized Index of Consumer Prices (HICP).

Analysis

- **EXPECTED DECISION**: *We expect, in line with consensus, the ECB will increase rates in September for the second time, If it's also the final hike, this would make this the ECB's shortest hiking cycle in 15 years.* At the Governing Council (GC) meeting on September 10th, we expect the European Central Bank (ECB) to increase its main policy rates by 25 bps i.e. its *i)* interest rate on the 'main refinancing operations' to 2.65%; *ii)* interest rate on the 'marginal lending facility' to 2.90%; and the key *iii)* 'deposit facility' to 2.50%.

  In terms of *forward guidance*, the ECB will stress that it remains data-dependent and the decisions will be still taken meeting-by-meeting, with its usual three-pronged approach about its reaction function confirmed. Looking ahead, the ECB is expected adopt a cautious, data-dependent approach. The case for another ECB rate hike in September has strengthened. The eurozone economy has proved unexpectedly resilient to the Middle East war, supported by fiscal stimulus and European firms gaining orders from Asian competitors more exposed to the Strait of Hormuz disruption. Meanwhile, headline inflation continues to rise. Although core and services inflation remain contained, elevated energy prices raise the risk of broader inflationary pressures. A second hike could therefore serve as an "insurance hike", aimed at preventing second-round effects and reinforcing the ECB's credibility.

  In terms of *Balance Sheet policies*, the GC has decided to move forward with the normalization of the balance sheet. GC confirmed that it will reduce the Eurosystem's holdings of securities under the PEPP. As of December 2024, the ECB has stopped re-investing the PEPP proceedings. The process for reducing PEPP holdings will generally follow the same approach as the APP.

- **POLICY DISCUSSION:** *The case for another ECB rate hike in September has strengthened.* Eurozone inflation rose to 3.3% in August and is expected to remain above 3% for the rest of the year, largely reflecting higher energy costs linked to the Middle East war and the closure of the Strait of Hormuz. At the same time, the eurozone economy has proved more resilient to the conflict than initially expected, supported by fiscal stimulus and, in some sectors, European firms gaining orders from Asian competitors more exposed to disruptions in the Strait of Hormuz.

  Against this backdrop, all economists surveyed by Reuters expect the ECB to raise its deposit rate by 25bp to 2.5% in September. Such a move could be viewed as an "insurance hike": rather than responding to an overheating economy, the ECB would be seeking to reinforce its inflation-fighting credibility and prevent the initial energy shock from feeding into inflation expectations, wages and other second-round effects.

  Importantly, the nature of the current inflation shock argues for a more cautious tightening cycle than in 2021-22. The earlier inflation surge combined energy and supply-chain disruptions with strong post-pandemic demand and accommodative fiscal and monetary policy. By contrast, the current episode remains predominantly supply-driven. Core and services inflation are relatively contained, and there is so far little evidence that higher energy costs are generating persistent second-round effects.

  The outlook beyond September is therefore considerably less certain. Markets are pricing in the possibility of another hike before year-end and views within the Governing Council are diverging. ECB member Martin Kocher has highlighted the economy's resilience and warned that higher manufacturing costs, food prices and wages could eventually broaden inflationary pressures. He nevertheless stressed that clear evidence of such second-round effects has yet to emerge and that their evolution will be crucial in determining the future rate path.

  A September hike would take the deposit rate to 2.5%, around the upper end of the ECB's estimated neutral range. Moving beyond that would imply shifting monetary policy into restrictive territory. This is a higher bar: the eurozone economy has demonstrated resilience, but it is not overheating, while rising bond yields and strained public finances are already tightening financial conditions. Further hikes could therefore impose substantial costs on growth in response to what remains largely a supply-side shock.

For now, economists remain more cautious than markets about additional tightening. Around 91% of economists surveyed by Reuters expect the deposit rate to end 2026 at 2.5%, while 78% expect it to remain there through mid-2027 as inflation gradually moves back towards target. If September proves to be the final hike, this would be the ECB's shortest tightening cycle since 2011. The key question for the months ahead will therefore be whether the energy shock remains temporary and supply-driven or begins to generate persistent second-round inflation.

- **CHANGES TO ECONOMIC FORECASTS:** *The ECB's new staff projections are unlikely to deliver a strong policy signal, although modest upward revisions to both growth and inflation should remain supportive of a September hike.* Growth and inflation forecasts are expected to be revised slightly higher, reflecting earlier upgrades to Q1 growth and somewhat higher oil prices. Base and carry-over effects could also result in slightly stronger growth and inflation projections for 2027.

  However, the projections may already understate some of the latest risks. Their relatively early cut-off means the recent rise in global bond yields and renewed increase in energy prices will largely be excluded. The economic environment has also deteriorated since July, when the ECB's milder scenario appeared increasingly plausible. Conditions now seem to lie somewhere between the base and adverse scenarios presented in June.

  Current forecasts already point to inflation remaining elevated for some time. Inflation is expected at around 3.2% in Q3 and 3.3% in Q4 and is not projected to return to the ECB's 2% target until late 2027. Meanwhile, eurozone GDP growth is forecast at 0.8% in 2026 and 1.2% in 2027.

  The main uncertainty remains the Middle East conflict. A prolonged or intensified war could keep energy and food prices higher for longer, lift inflation expectations and eventually feed into wage pressures. This creates upside risks to the inflation outlook that may not yet be fully reflected in the ECB's new projections, while simultaneously posing downside risks to growth.

- **ECONOMIC ANALYSIS:** *Eurozone inflation nears three-year high ahead of ECB meeting.* Eurozone GDP grew 0.4% in Q2, beating expectations of 0.2% and rebounding from flat growth in Q1 despite energy market volatility caused by the US-Iran conflict. Growth was broad-based across major economies, with Spain leading at 0.7% q-o-q, while Germany, France and Italy each expanded 0.2% q-o-q. The stronger-than-expected data reinforced market expectations of a 25bp ECB rate hike in September as inflation remains above target, although economists cautioned that renewed Middle East tensions and higher energy prices could weigh on growth in the coming quarters.

  Inflation rose to 3.3% in August from 2.9% in July, its highest since September 2023 and well above the ECB's 2% target, largely due to surging energy prices. The data reinforced expectations of a 25bp ECB rate hike this month. Energy inflation jumped to 14.3%, while services inflation eased to 3.0% and core inflation edged down to 2.4%. Inflation also accelerated across Germany, France, Spain and Italy.

  Eurozone business activity maintained solid growth in August, with the composite PMI unchanged at 52.0. Manufacturing strengthened to 52.7, its highest since May 2022, while services remained in expansion at 51.6. New export orders rose for the first time in four and a half years and employment increased for the first time this year, pointing to continued solid Q3 growth.

- **MARKET IMPLICATIONS:** *European bond yields surged amid a global sell-off driven by inflation, fiscal and debt concerns*. Germany's 10-year Bund yield climbed above 3.36%, a 15-year high, while French, Italian and Dutch yields also rose sharply. Higher energy prices and increasingly hawkish central-bank expectations reinforced higher-for-longer rate bets, pushing borrowing costs across the region higher.

  To put things into context, *In the bond market,* since the last meeting on July 23th and as of September 4 the yields on a: *i)* 10y German bund rose by 13 bps to around 3.34% (+48 bps y-t-d); and *ii)* 2y German bund increased by 4 bps to 2.93% (+81 bps y-t-d). In the periphery of the Eurozone, the 10y Italian bonds increased by 7 bps to 4.14% since the last meeting. The gap between Germany and Italy's 10Y yields is at around 81 bps. *In the currency space,* EUR/USD held near $1.16, as expectations of a 25bp ECB hike supported the euro while strong US employment data strengthened the dollar. Since last meeting in July and as of September 4, EUR/USD increased by 2.1% to around 1.16 (-1.1% y-t-d). *In the equity space,* the Eurostoxx 50 rose by 2.9% since the last meeting in July and closed at 6392.93 as of September 4 (+9.3% y-t-d). Equities initially came under pressure as renewed US-Iran hostilities lifted energy prices, inflation concerns and bond yields, before sentiment stabilized as energy prices eased. Technology stocks outperformed on renewed AI optimism.

- **MACROECONOMIC ANALYSIS (APPENDIX):** *Eurozone GDP grew in Q2, up from flat growth in Q1 and marking its strongest quarterly expansion since early 2025.* Q2-2026, the eurozone GDP advanced by 0.4% q-o-q (*c:* 0.4%; *p*: 0.0%). Strong AI-related investment, resilient government spending and one-off factors helped offset the impact of the Iran conflict and higher energy prices. Spain led the major economies with 2.7% growth, followed by the Netherlands (1.3%), Italy (1.0%), Germany (0.9%) and France (0.7%). Eurozone economy grew by 1.0% y-o-y (*c:* 1.0%; *p:* 0.5%).

  Data point to solid Q3 growth, supported by stronger industry and recovering services as the energy shock fades. In August, the *HCOB Eurozone Composite* stood at 52.0 (*c:* 52.1). *Services PMI* declined to 51.6 (*c:* 51.5; *p:* 51.7). *Manufacturing PMI* rose to 52.7 (*c*: 52.8; *p*: 51.9).

  Unemployment was unchanged in July, while the number of unemployed rose year-on-year.. In July**,** *unemployment rate* stood at 6.4% (*c:* 6.3%). The number of unemployed was unchanged from June at 11.26ml. Amongst the largest Euro Area economies: *i)* the unemployment remained at 5.8% in July in Italy; *ii)* the unemployment rate rose to 8.3% (*c: 8.1%*) in Q2 in France; and *iii)* in Germany the seasonally adjusted jobless rate stood at 6.4% (*p*: 6.4%) in August. The 'youth unemployment rate' – measuring job-seekers under 25 years old – fell to 14.9% in July (*p:* 15.0%). Wages and salaries in the EZ increased by 3.4% y-o-y (*p*: 3.1%) in Q1-2026.

  Inflation rose to the highest since September 2023. In August: *i) headline inflation* accelerated to 3.3% y-o-y (*c:* 3.3%; *p:* 2.9%); and *ii) core inflation* – which excludes food and energy prices – cooled off to 2.4% y-o-y (*c:* 2.4%; *p:* 2.5%). In Germany, annual CPI inflation increased to 2.9% y-o-y (*p*: 2.8%). In France, the inflation rate rose to 2.4% y-o-y (*p*: 2.1%). In Italy prices inflation picked up to 3.3% y-o-y (*c*: 3.3%; *p:* 2.9%).

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