MONETARY AFFAIRS

REVIEW: ECB Hikes Rates For a Second Time, Bringing The Closer To Neutral Level

By

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Executive Summary

- **Decision Made:** *The European Central Bank (ECB) decided to increase its three key rates,* 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%.

  Future decisions will be taken meeting-by-meeting, following its usual three-pronged approach about its reaction function confirmed. The Middle East conflict continues to fuel inflation, which is expected to remain above target for an extended period. The ECB remains committed to returning inflation to 2% over the medium term.
- **Policy Discussion**: *The ECB raised the deposit rate by 25bp to 2.5%, with Lagarde calling the unanimous decision a "no-brainer".* The move can be seen as an insurance hike against the energy shock, supported by stronger-than-expected eurozone growth and rising inflation risks. However, underlying inflation, wages and expectations still show limited evidence of second-round effects, while the latest surge in oil prices and bond yields is not incorporated in the ECB's updated projections.

  Further tightening is therefore less clear. Rates are already at the upper end of the ECB's neutral range, and moving into restrictive territory could unnecessarily weaken growth in response to a largely supply-side shock. While markets price further hikes, the ECB remains data dependent, with additional tightening likely to depend on whether elevated energy prices persist and feed more broadly into domestic inflation.
- **Changes to Economic Forecasts:** *The outlook remains highly uncertain, with upside risks to inflation and downside risks to growth.* The impact of the energy shock will depend on its intensity, duration and potential second-round effects. The ECB expects headline inflation to average 3.0% in 2026, before easing to 2.3% in 2027 and 2.1% in 2028, with the latter forecast revised higher since June. Core inflation is projected at 2.5%, 2.6% and 2.3%, respectively. Growth is forecast at 0.9% in 2026, 1.4% in 2027 and 1.5% in 2028, with the 2026 and 2027 forecasts upgraded as the eurozone economy has proved more resilient than expected.

Key Picture: European Central Bank Key Forecasts – 2026-2028

		2026*f*		2027*f*		2028*f*	
	Latest reading	September Projections	June Projections	September Projections	June Projections	September Projections	June Projections
GDP *(real growth, y-o-y)*	1.2	**0.9**	**0.8**	**1.4**	**1.2**	**1.5**	**1.5**
Inflation *(%, y-o-y)*	3.3	**3.0**	**3.0**	**2.3**	**2.5**	**2.1**	**2.0**
Core-inflation *(%, y-o-y)*	2.4	**2.5**	**2.5**	**2.6**	**2.5**	**2.3**	**2.2**
Unemployment *(%, y-o-y)*	6.4	**6.2**	**6.3**	**6.1**	**6.2**	**5.9**	**6.0**

Source: ECB *'Macroeconomic projections' September 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

- **DECISION MADE**: *On September 10, the ECB increased its interest rates.* In line with consensus, the European Central Bank (ECB) increased 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%. The Middle East conflict continues to fuel inflation pressures, with inflation expected to remain well above target for an extended period. The ECB reiterated its commitment to ensuring inflation returns to its 2% target over the medium term.

  In its forward guidance, the ECB stated that the decisions will be still taken meeting-by-meeting, with its usual three-pronged approach about its reaction function confirmed. Policymakers will continue to assess incoming economic and financial data on a meeting-by-meeting basis and stressed that they are not pre-committed to any specific path for interest rates.

  In terms of *Balance Sheet policies,* the APP and PEPP portfolios are gradually and predictably shrinking, as the Eurosystem has stopped reinvesting principal payments from maturing securities.

- **POLICY DISCUSSION:** *The ECB raised the deposit rate by 25bp to 2.5%, with Lagarde describing the unanimous decision as a "no-brainer".* The move can be viewed as an insurance hike aimed at staying ahead of the energy shock and preventing higher energy prices from feeding into broader inflation. The recent Middle East escalation and oil surge further strengthened the case for tightening.

  The eurozone economy has proved more resilient than expected, prompting upgrades to the ECB's 2026-27 growth forecasts. However, Lagarde warned that inflation will remain well above the 2% target for an extended period, with risks tilted towards higher inflation and weaker growth. Updated projections also raised inflation forecasts for 2027-28, although they do not incorporate the latest surge in oil prices and bond yields.

  The case for further tightening is less clear. Rates are now at the upper end of the ECB's neutral range, while core and services inflation, wages and inflation expectations show little evidence of significant second-round effects. Economic resilience should also not be confused with overheating. With bond yields already elevated and fiscal pressures mounting, moving into restrictive territory could risk weakening growth in response to what remains largely a supply-side shock.

  The ECB therefore remains data dependent and has not committed to a future rate path. Markets price further hikes, but additional tightening is likely to depend on whether the energy shock persists and begins feeding more clearly into domestic inflation. Geopolitical and energy risks nevertheless leave the policy outlook tilted towards higher rates.

- **CHANGES TO ECONOMIC FORECASTS:** *The outlook remains highly uncertain, with upside risks to inflation and downside risks to growth*. The impact of the energy shock will depend largely on its intensity, duration and potential second-round effects. The latest escalation in the Middle East and surge in oil prices strengthened the case for an ECB hike, which was already likely under a more benign energy outlook. However, core and services inflation and survey-based expectations still show little evidence of second-round effects from the energy shock.

  The ECB expects headline inflation to average 3.0% in 2026, before easing to 2.3% in 2027 and 2.1% in 2028. Core inflation is projected at 2.5%, 2.6% and 2.3%, respectively. Compared with June, the 2026 inflation forecast is unchanged, while projections for 2027 and 2028 have been revised lower and higher respectively. Growth is forecast at 0.9% in 2026, 1.4% in 2027 and 1.5% in 2028, with 2026 and 2027 upgraded on stronger-than-expected eurozone resilience.

- **ECONOMIC ASSESSMENT:** *The euro area economy remained resilient in Q2 despite the energy shock, with growth broad-based across countries and sectors*. Manufacturing has benefited from higher defence and infrastructure spending, while recovering consumer confidence has supported services. The labour market remains robust, with unemployment at 6.4%, although employment growth is slowing. The near-term growth outlook has improved, supported by resilient consumption and public spending, while investment should increasingly support medium-term growth.

  Inflation rose to 3.3% in August from 2.9% in July, driven by a sharp increase in energy inflation to 14.3%. Core inflation eased slightly to 2.4%, while wage pressures remain contained and productivity gains have slowed unit labour cost growth. Higher energy prices are expected to keep headline inflation above target through the first half of 2027, before easing towards 2% by the end of 2027.

  Risks remain tilted towards weaker growth and higher inflation, primarily due to geopolitical tensions and the energy shock. Further energy supply disruptions could raise prices, weaken real incomes and investment, and generate broader second-round inflation effects. Tighter global financial conditions and renewed trade tensions also pose downside risks to growth, while faster adaptation to the energy shock, technology adoption and higher defence and infrastructure investment could provide upside support.

- **OUR TAKE:** *The ECB will consider whether another hike may be needed in December.* After two hikes, and with rates close to neutral level, the ECB will consider whether another rate hike will be necessary in December. This will also depend on what the Fed will do in September, October and may do in December.

- **MARKET REACTION AND IMPLICATIONS**: *European bonds extended their selloff after Lagarde warned that elevated energy prices could keep inflation above target for longer*. *In the bond market*, German 2Y yields rose to 3.19%, their highest in almost three years, as markets priced three additional ECB hikes by mid-2027. French spreads also widened amid fiscal concerns, while UK yields climbed sharply alongside stronger BoE tightening expectations. *In the currency space,* the dollar rebounded, reversing some of this week's losses, while the euro weakened after the ECB's expected rate hike. The euro fell 0.3% to around $1.16, while the dollar index gained 0.3% to 99.12, on track to end a three-day losing streak. *In the equity space,* European equities reversed early gains after the ECB hiked and warned of broader inflation risks from higher energy prices. The STOXX 600 fell 0.4%, while the DAX and CAC 40 slipped 0.2% and 0.1%, respectively. The FTSE 100 underperformed, falling 0.5%.