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**Preview: ECB To Pause in October,
On the Brink Of Restrictive Policy Stance**

By

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26 October 2026

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Executive Summary

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

On forward guidance, the ECB is expected to maintain its cautious, data-dependent, meeting-by-meeting approach. Economists anticipate a final hike to 2.75% in December, with rates unchanged until May 2028, while markets price in three additional hikes over the next year. The outlook will largely depend on energy prices, with easing tensions potentially reducing the need for further tightening.

- **Policy Discussion:** *The ECB is expected to hold rates in October before a final 25-bps hike to 2.75% in December, balancing persistent inflation against tighter financial conditions.* Headline inflation reached 3.8% in September, driven by rising energy prices, while core inflation remained relatively stable at 2.5%. Although second-round effects on wages and prices remain limited, oil prices above \$110 per barrel, low European gas reserves and potential food price pressures pose upside inflation risks. Meanwhile, rising sovereign bond yields have tightened financial conditions, reducing the need for immediate ECB action. France's 10-year yield reached 5%, its highest since 2002, while the OAT-Bund spread widened to around 175 bps amid fiscal and political instability. Higher borrowing costs have had an estimated impact equivalent to a 25-bps rate hike in Germany and 50 bps in France. ECB intervention through the TPI remains unlikely, as rising yields largely reflect fiscal deterioration rather than unwarranted market disruptions.

The ECB is likely to maintain a gradual tightening approach, awaiting December projections to assess inflation persistence and broader price pressures. A further hike would move policy modestly into restrictive territory, although softer labor market conditions should limit wage pressures. Ultimately, the policy outlook will depend on the Middle East conflict, second-round inflation effects and developments in France's sovereign debt crisis.

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

	Latest reading	2026 ^f		2027 ^f		2028 ^f	
		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)	3.8	2.6	2.6	2.3	2.0	2.0	2.1
Core-inflation (% y-o-y)	2.5	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 August 2026; 3. Inflation for September 2026. *Inflation = Harmonized Index of Consumer Prices (HICP).

Analysis

- ✦ **EXPECTED DECISION:** *We expect, in line with consensus, the ECB is expected to leave interest rates unchanged.* At the Governing Council (GC) meeting on October 29th, we expect the European Central Bank (ECB) to hold its main policy rates i.e. its *i)* interest rate on the 'main refinancing operations' at 2.65%; *ii)* interest rate on the 'marginal lending facility' at 2.90%; and the key *iii)* 'deposit facility' at 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. Economists expect the ECB to hike to 2.75% in December, keeping rates unchanged until May 2028. Markets, however, anticipate three additional hikes over the next year. The outlook will largely hinge on energy markets, with easing tensions and moderating prices potentially allowing policymakers to pause further tightening.

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 ECB is expected to hold rates in October before a final 25-bps hike to 2.75% in December, balancing persistent inflation against tighter financial conditions.* Inflation remains elevated, but second-round effects are still limited. Headline inflation reached 3.8% in September, driven by rising energy prices amid the Iran war, while core inflation stood at 2.5%, just 0.1 pp above its pre-conflict level. With oil prices exceeding \$110 per barrel, risks to the inflation outlook remain elevated. However, the absence of significant wage and broader price pressures gives policymakers scope to await updated December projections before tightening further.

Rising sovereign bond yields have already tightened financial conditions. France's 10-year yield reached 5%, its highest since 2002, while the OAT-Bund spread widened to around 175 basis points amid fiscal and political instability. The increase in borrowing costs since September has had an estimated impact equivalent to a 25-basis-point rate hike in Germany and 50 basis points in France, reducing the need for immediate ECB action. Despite growing concerns about financial fragmentation, intervention remains unlikely: around 90% of surveyed economists rule out activation of the Transmission Protection Instrument (TPI), given that rising yields largely reflect fiscal deterioration rather than unwarranted market disruptions.

The ECB is likely to maintain a gradual tightening approach. Policymakers have signaled little urgency for consecutive hikes, particularly as higher borrowing costs threaten growth. Nevertheless, persistently elevated energy prices, low European gas reserves ahead of winter and potential El Niño-related food price pressures could reinforce inflation expectations and eventually feed into wages and broader prices. With the neutral rate estimated at 2–2.5%, a December hike would move monetary policy modestly into restrictive territory. However, softer labor market conditions than in 2022 should limit the risk of a wage-price spiral.

Overall, the ECB's December decision will hinge on three developments: the duration and intensity of the Middle East conflict, evidence of second-round inflation effects and the evolution of France's sovereign debt crisis. While persistent energy-driven inflation supports further tightening, continued financial market stress could reduce the need for additional rate hikes.

- ✦ **ECONOMIC ANALYSIS:** *Eurozone private sector growth slowed to a four-month low in October, weighed down by rising energy costs and renewed contraction in France amid political and financial instability.* The Eurozone economy grew 0.6% q-o-q in Q2 2026, revised up from 0.4%, following stagnation in Q1. The economy grew 1.2% y-o-y in Q2 2026, revised up from 1% and double Q1's 0.6% growth. The acceleration was driven by stronger household spending (1.2% vs. 1.0%), investment (1.4% vs. 0.3%) and a rebound in

exports (3.9% vs. -0.1%). Import growth also accelerated (3.6% vs. 1.9%), while government spending growth eased (1.9% vs. 2.3%). Among major economies, growth strengthened in Germany and Italy, slowed in France and remained stable in Spain.

The Eurozone Composite PMI fell to 51.9 in October from 53.1 in September, missing expectations of 52.7. Business activity expanded for a fourth consecutive month but at its slowest pace during this period, reflecting renewed contraction in French services and weaker growth elsewhere. Manufacturing PMI declined to 52.4 from 52.9, while Services PMI dropped to 51.7 from 53.0, both below expectations. Manufacturing employment edged lower, while services job creation slowed to a five-month low amid weaker new business growth. Services input cost inflation eased, although slowing activity and persistent inflationary pressures weighed on business confidence.

The Eurozone unemployment rate remained at 6.4% in August 2026, unchanged since February, reflecting labor market resilience despite rising energy costs and interest rates. Among EU countries, Finland recorded the highest unemployment rate (10.3%), followed by Spain (10%), while Czechia had the lowest (3.2%). Germany's rate remained at 4%, France's eased to 8.2%, and Italy's rose to 6.2%.

Eurozone annual inflation rose to 3.8% in September 2026 from 3.2% in August, its highest level in three years, driven by faster increases in energy (18.9%), services (3.2%) and food, alcohol and tobacco (1.3%) prices. Meanwhile, non-energy industrial goods inflation eased to 1.1%, while core inflation edged up to 2.5% from 2.4%.

✦ **MARKET IMPLICATIONS:** *While the decision is fully priced in, French bonds remain in the spotlight.* French government bonds faced renewed selling pressure amid fiscal concerns and social unrest, pushing the 10-year yield above 5% to its highest level since 2002. The OAT-Bund spread widened to 164 bps, its highest since 2011, while German Bund yields fell as investors sought safer assets.

To put things into context, *In the bond market*, since the last meeting on September 10th and as of October 26, the yields on a: *i)* 10y German bund fell by 14 bps to around 3.36% (+50 bps y-t-d); and *ii)* 2y German bund declined by 11 bps to 3.07% (+95 bps y-t-d). In the periphery of the Eurozone, the 10y Italian bonds increased by 13 bps to 4.52% since the last meeting. The gap between Germany and Italy's 10Y yields is at around 116 bps. *In the currency space*, the euro weakened against the US dollar and yen over the week as a selloff in French government bonds pushed the country's debt risk premium to its highest level since the 2011 eurozone debt crisis. Since last meeting in September 10, EUR/USD fell by 3.7% to around 1.12 (-4.8% y-t-d). *In the equity space*, major indexes declined over the week, weighed down by surging oil prices, Middle East tensions, inflationary pressures and political unrest. The Eurostoxx 50 fell by 2.6% since the last meeting in September and at the time of the writing trades around 6107 as of October 26 (+4.4% y-t-d). major indexes declined over the week, weighed down by surging oil prices, Middle East tensions, inflationary pressures and political unrest.

✦ **MACROECONOMIC ANALYSIS (APPENDIX):** *The euro Area economy grew 1.2% y-o-y in Q2 2026, revised up from 1% and double Q1's 0.6% growth, driven by stronger household spending.* In Q2-2026, the eurozone GDP advanced by 0.6% 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 0.7% growth, followed by the Netherlands (0.6%), Germany (0.3%) and Italy (0.2%). France stagnated (0.7%). Eurozone economy grew by 1.2% y-o-y (c: 1.0%; p: 0.6%).

Business activity expanded for a fourth consecutive month but at its slowest pace during this period, partly due to renewed contraction in French services. In August, the HCOB Eurozone Composite fell to 51.9 (c: 52.7; p: 53.1). Services PMI declined to 51.8 (c: 52.5; p: 53.0). Manufacturing PMI decreased to 52.4 (c: 52.7; p: 52.9).

The labour market has remained resilient despite rising energy costs and interest rates amid the prolonged Middle East conflict. In August, unemployment rate stood at 6.4% (c: 6.4%). The number of unemployed increased by 26K at 11.36ml. Amongst the largest Euro Area economies: i) the unemployment increased to 6.2% in July in August; 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 September. The 'youth unemployment rate' – measuring job-seekers under 25 years old – fell to 15.0% in August (p: 15.1%). Wages and salaries in the EZ increased by 3.0% y-o-y (p: 3.4%) in Q2-2026.

Inflation rose to the highest since September 2023. In September: i) headline inflation accelerated to 3.8% y-o-y (c: 3.8%; p: 3.2%); and ii) core inflation – which excludes food and energy prices – rose to 2.5% y-o-y (c: 2.5%; p: 2.4%). In Germany, annual CPI inflation increased to 3.3% y-o-y (p: 2.9%). In France, the inflation rate rose to 3.1% y-o-y (p: 2.4%). In Italy prices inflation picked up to 4.2% y-o-y (c: 4.2%; p: 3.3%).



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