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Preview: ECB Takes a Breath In its “Measured Tightening Cycle”, Ahead of a Likely December Hike

By

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Executive Summary

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- ✧ **Decision Made:** *The European Central Bank (ECB) keeps its key interest 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%.

Future decisions will be taken meeting-by-meeting, following its usual three-pronged approach about its reaction function confirmed. ECB remains committed to returning inflation to 2% over the medium term. The Governing Council discussed the possibility of hiking rates in October, but then unanimously decided to wait for more information, maintaining that it was well positioned to keep rates unchanged for now, despite rising energy prices and higher long-term borrowing costs.

- ✧ **Policy Discussion:** *The ECB leaves the door open to a December rate hike amid rising inflation risks.* Having raised rates twice this year in response to the Iran war-induced energy shock, the ECB signalled that further tightening may be necessary. Although the Governing Council considered a rate hike, it unanimously agreed to hold rates amid heightened uncertainty, broadly stable underlying inflation and limited evidence of additional second-round effects. Lagarde warned that prolonged energy price pressures could push inflation higher and weaken growth, emphasising that incoming data over the next six weeks would be crucial for the December decision. Lagarde repeated that “the direction of travel” is well established, hinting at the near certainty that a rate hike will be adopted in December.

Rising sovereign borrowing costs have further complicated the ECB’s policy outlook, with average 10-year yields increasing by around 35 basis points since the previous meeting. In France, the 10-year yield spread over Germany has reached 155 basis points, raising concerns about financial stability and weaker economic activity. Lagarde reaffirmed the ECB’s readiness to intervene against disorderly market movements threatening monetary policy transmission. Markets interpreted the decision as a hawkish pause, pricing in a 67% probability of a December hike, while economists expect only one or two further increases.

Separately, Lagarde announced that she will step down on February 7, 2027, nearly nine months before her term expires, seeking greater freedom to express political views ahead of France’s presidential election. Her departure comes amid broader ECB leadership changes, with Philip Lane and Isabel Schnabel also due to leave in 2027. Klaas Knot and Pablo Hernández de Cos are among the leading candidates to succeed her.

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

	Latest reading	2026 ^f		2027 ^f		2028 ^f	
		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)	3.8	3.0	3.0	2.3	2.5	2.1	2.0
Core-inflation (% , y-o-y)	2.5	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 August 2026; 3. Inflation for September 2026. *Inflation = Harmonized Index of Consumer Prices (HICP).

Analysis

- ✦ **DECISION MADE:** *On October 29, the ECB kept its interest rates unchanged.* In line with consensus, the European Central Bank (ECB) hold 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%. In a statement, the GC said energy prices pose upside risks to inflation and downside risks to growth. Although underlying inflation and wage pressures have remained broadly stable, the prolonged and intensifying energy shock could amplify indirect and second-round effects, pushing inflation higher and weakening growth. Meanwhile, tighter financing conditions are expected to weigh on both inflation and economic activity.

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 Leaves door open to December rate hike amid rising inflation risks.* Having raised rates twice this year in response to the Iran war-induced energy shock, the ECB signalled that further tightening may be necessary, although it remains cautious in the absence of significant second-round inflation effects.

ECB President Christine Lagarde identified rising energy prices and tighter financing conditions as the main developments since the previous meeting, with average 10-year sovereign yields increasing by around 35 basis points. Although the Governing Council discussed a potential rate hike already in October, it unanimously agreed to hold rates amid heightened uncertainty, broadly stable underlying inflation and no evidence of additional second-round effects beyond those incorporated into September's projections.

The ECB warned that the prolonged and intensifying energy shock poses upside risks to inflation and downside risks to growth. While underlying inflation remains broadly stable and wages have yet to respond materially to higher prices, persistent energy costs could generate stronger indirect and second-round effects. Lagarde emphasised that incoming data over the next six weeks would be crucial in determining the December policy decision, suggesting that a rate hike remains a possibility if current inflationary pressures persist.

Meanwhile, rising sovereign borrowing costs have complicated the ECB's policy outlook, particularly in heavily indebted France, where the 10-year bond yield spread over Germany has reached 155 basis points. Tighter financing conditions could weigh on both economic activity and inflation, requiring the ECB to balance inflation risks against the possibility of financial instability. Lagarde reaffirmed the ECB's readiness to intervene against unwarranted and disorderly market movements that threaten monetary policy transmission. Against this backdrop, economists generally expect only one or two additional rate hikes before the tightening cycle ends.

Separately, Lagarde announced that she will step down on February 7, 2027, nearly nine months before her term expires, citing a desire for greater freedom to express political views ahead of France's presidential election. Her early departure initiates a leadership succession process amid broader changes at the ECB, with Chief Economist Philip Lane and Executive Board member Isabel Schnabel also due to leave in 2027. Klaas Knot and Pablo Hernández de Cos are among the leading contenders to succeed her.

- ✦ **ECONOMIC ASSESSMENT:** *Incoming data suggest that the euro area economy continued to expand in Q3, supported by a recovery in services, AI-related investment in manufacturing and digital services, exports, and government spending on infrastructure and defence.* However, rising energy prices have weakened

consumer confidence, while higher financing costs are expected to weigh on growth. Unemployment remained at 6.4% in August, with subdued employment growth but gradually improving productivity.

Over the medium term, recovering confidence and real incomes, easing energy prices, and a resilient labour market should support domestic demand. AI investment, public spending and stronger foreign demand are also expected to underpin growth. The ECB emphasised the need for structural reforms, fiscal sustainability, deeper Single Market integration, an accelerated energy transition and progress on the savings and investments union. It also called for swift agreement on the Single Currency Package.

Inflation rose to 3.8% in September from 3.2% in August, primarily driven by energy inflation, which accelerated to 18.9% from 14.3%. Inflation excluding energy increased to 2.3% from 2.1%, while food inflation rose to 1.3% from 1.1% and services inflation to 3.2% from 3.0%. Goods inflation eased slightly to 1.1% from 1.2%.

Underlying inflation remained broadly stable, although upstream price pressures have intensified. Wage growth moderated, with compensation per employee slowing to 3.3% in Q2 from 3.6% in Q1, while improving productivity helped contain unit labour costs. Negotiated wage growth is projected at 2.5–2.8% for the remainder of 2026 and an average of 2.6% in the first three quarters of 2027. Short-term inflation expectations have increased, but longer-term expectations remain anchored around 2%.

Energy prices have exceeded the ECB's September projections, suggesting that headline inflation will remain well above target in the coming quarters. However, easing energy inflation and the effects of higher interest rates are expected to bring inflation back towards target over time.

Risks to growth remain tilted to the downside, primarily due to the Middle East conflict and the war in Ukraine. Prolonged energy supply disruptions, tighter global financing conditions, fiscal uncertainty and renewed trade tensions could weaken real incomes, consumption, investment and exports. Conversely, faster adaptation to energy disruptions, a sustainable resolution of conflicts, technological advances and productivity-enhancing reforms could support stronger growth.

Inflation risks remain tilted to the upside, particularly from further energy supply disruptions and stronger indirect and second-round effects on prices and wages. Additional risks include rising gas prices amid low storage levels or a cold winter, renewed trade fragmentation, supply constraints and extreme weather affecting food prices. Conversely, a sustainable resolution of geopolitical conflicts, weaker energy-price pass-through or tighter financial conditions could reduce inflationary pressures.

✦ **OUR TAKE:** *A December hike has been telegraphed, barring exceptional circumstances.* Specifying that a rate hike was discussed at this meeting adds to the near certainty that the ECB will deliver another of its quarterly hikes in December. Whether the ECB will also increase rates in 2027 is subject to discussion and depends on a number of variables that cannot be fully predicted at this stage.

✦ **MARKET REACTION AND IMPLICATIONS:** *Despite the cautious stance, markets continued to price in nearly three 25-basis-point rate hikes over the coming year*, pricing in a 67% probability of a December rate hike. *In the bond market*, Eurozone bond yields also declined, with Germany's 10-year Bund yield falling 4.8 basis points to 3.336% and France's 10-year yield dropping around 10 basis points to 4.833%. *In the currency space*, the euro fell to a 17-month low of \$1.1103 against the dollar and a near 19-month low against sterling following the ECB's decision to hold rates without signalling imminent tightening. *In the equity space*, European equities rose to nearly two-month highs, supported by strong corporate earnings and the ECB's decision to hold interest rates unchanged. The pan-European STOXX 600 gained 1%, its strongest performance in over a month, while Germany's DAX and France's CAC 40 advanced 1.3% and 1.23%, respectively. Gains were led by energy and industrial stocks, including Shell, TotalEnergies and Airbus, while banking shares underperformed.



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