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ECB preview: How to hike rates without creating more market turmoil

We expect the ECB to hike interest rates by 25bp next week. As long as inflation remains mainly energy-driven, hiking rates further beyond next week would not make a lot of sense and could harm the eurozone economy

The European Central Bank looks set to hike rates by 25bp next Thursday

The stage looks increasingly set for another rate hike at next week's European Central Bank meeting. Not only because some ECB members already advocated for a rate hike at the July meeting, but also because, since then, the eurozone economy has shown an almost unexpected resilience to the war in the Middle East. This is partly due to good luck and to Asian competitors being hit harder by the closure of the Strait of Hormuz and losing orders to European competitors, but also to long-announced fiscal stimulus.

At the same time, headline inflation has continued to edge higher and looks set to stay above 3% year-on-year for the remainder of the year, even if other inflation measures like core and services currently provide no reason to panic. With oil prices remaining elevated and the risk of a fresh gas price shock increasing, it will be hard for most ECB policymakers not to see a clear case for another rate hike.

Even if the ECB doesn't like the term, the second rate hike this year would also fall into the category of 'insurance rate hike', or maybe more to the central bank's liking: a rate hike to strengthen its credibility and to preempt any possible indirect or even second-round effects from the current energy price shock.

No clear signals from the new staff projections

The new round of staff projections will not bring any significant changes but should remain supportive for the rate hike proponents. Given that the cut-off date for the staff projections is normally some two weeks before the Governing Council meeting, the latest surge in bond yields as well as higher energy prices again will not have played a role in the forecasts. In fact, until a week ago, the so-called external assumptions were almost at similar levels as in the June forecasts.

Against this background, we expect the ECB's growth and inflation forecasts to be revised upwards slightly, mainly due to earlier statistical upward revisions of first-quarter growth and slightly higher oil prices. Base and carry-over effects could lead to marginally higher growth and inflation forecasts for 2027. More generally speaking, it will be interesting to see whether the ECB will also present updates of the alternative scenarios from June. While in July it almost looked as if the ECB's 'milder' scenario could materialise, we are now rather somewhere between the 'base' and 'adverse' scenario.

Looking beyond next week

Whether the ECB will really go beyond a September rate hike is a completely different story. Markets have started to price in at least another hike before year-end, and views at the ECB seem to increasingly diverge. While an ECB blog article this year supported our own view that the current inflation wave is mainly driven by energy prices and that drivers matter when identifying (and reacting to) an inflation shock, comments by Isabel Schnabel and Irish central bank governor Gabriel Makhlouf hint at a clear willingness to hike further.

However, with one additional rate hike (next week), the deposit rate at 2.5% would still be within the range the ECB itself calls neutral. Going further would mean that the ECB sees restrictive monetary policy as necessary. But there is a big difference between an economy that has shown resilience and an overheating economy that needs restrictive monetary policy. We still find it hard to see – amid public finance woes and surging bond yields – that the ECB would really be willing to add more fuel to the fire. Or in other words, it's difficult to envisage the ECB being willing to risk a recession to tackle what is still a textbook supply-side shock.

ECB's reaction to the recent surge in bond yields

Another topic for next week's ECB meeting and the following press conference will be the latest surge in bond yields – and, related to this, concerns about debt sustainability in Europe (and elsewhere). At first glance, this surge is actually coming in handy for the ECB. Bond markets are doing the ECB's job, i.e., tightening financing conditions. According to macro models, a 50bp increase in bond yields has a slightly larger impact on inflation and GDP growth than a 50bp increase in the ECB's policy rate.

Consequently, the main challenge for the central bank will be not to add too much fuel to the fire. Remember the unwarranted tightening of financing conditions. In fact, as long as inflation is not under control, it is not so much the absolute level of long-term interest rates but rather the spread between eurozone countries that is of most concern for the ECB. Some tightening of financing conditions can ease the ECB's job; too much tightening, and unequal tightening, would bring new problems.

This is why questions may eventually arise as to whether the ECB would be willing to restart asset purchases, now under the label of the Transmission Protection Instrument. Let's be clear, this is not a debate for now. But if debt sustainability concerns grow, possibly ahead of next year's French presidential elections, markets might want to test the ECB. We have seen it before. In this context, a debate that has so far been confined largely to the yellow press might become more policy-relevant: the possibility of an early exit for Christine Lagarde as ECB president and the question of who would be her successor. Some of the names of possible candidates currently circulating have, at least in the past, not been strong supporters of quantitative easing.

All in all, we expect the ECB to hike interest rates by 25bp next week. Another insurance rate hike. Or for those who don't like this term: a dovish rate hike.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

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