Article | 3 September 2026

Eurozone economy remains resilient

The eurozone economy has weathered the energy shock better than anticipated, and moderate growth is likely to continue. With inflation now expected to remain above 3% until spring 2027, the European Central Bank is likely to raise rates in September, while an additional increase cannot be ruled out

A European Central Bank rate hike in September is likely

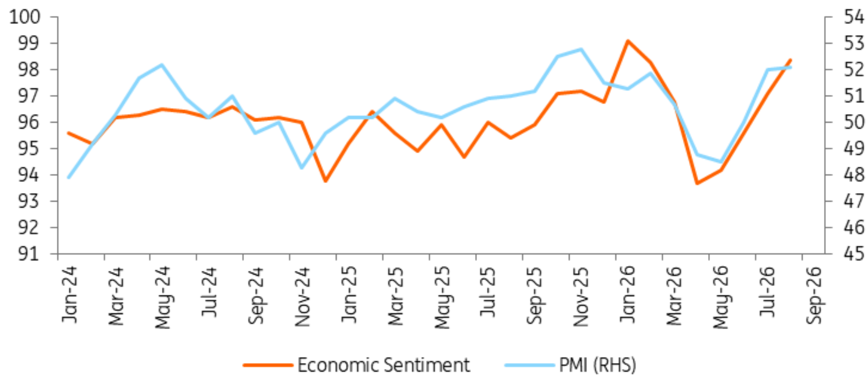
A surprisingly strong second quarter (though not everywhere)

Despite persistent uncertainty and the energy shock triggered by the war in the Middle East, eurozone GDP grew by a stronger-than-expected 0.4% in the second quarter. Excluding Ireland's volatile contribution, the eurozone has now expanded for four consecutive quarters at a pace of around 0.3% quarter-on-quarter. Germany, which had barely grown for three successive years, was among the eurozone's main growth drivers in the first half of 2026. Higher defence and infrastructure spending now appears to be gaining traction, which should support growth over the coming year. France, by contrast, recorded no growth at all in the first half of 2026. This does not bode well for the budget negotiations. With presidential elections due in 2027, putting together the necessary austerity package will be difficult, particularly against an unsupportive growth backdrop. In that context, renewed upward pressure on French bond spreads has become a material risk for the second half of the year.

Underlying growth momentum remains positive

Judging by sentiment indicators, the third quarter began on a firm footing, with both the PMI and the European Commission's sentiment indicator rising in July and August. Encouragingly, the employment expectations index also improved for a second consecutive month, a development reflected in lower unemployment expectations among European households. This should support consumption in the second half of the year. Admittedly, the exceptionally warm summer weather may have shaved some growth off the third quarter: in Germany, for example, low water levels on the Rhine disrupted supply chains. Nevertheless, barring a renewed escalation of the conflict in the Middle East, the underlying growth trend remains positive. Following the upward revision to first-quarter GDP and the stronger-than-expected second-quarter outcome, we have raised our 2026 growth forecast to 0.8%. For next year, we expect growth of 1.3%.

Business sentiment recovered



Source: LSEG Datastream

Inflation to remain above 3% until spring 2027

The renewed rise in energy prices pushed headline inflation to 3.3% in August. Energy is likely to keep inflation above 3% for the remainder of the year and going into 2027, especially as the replenishment of gas inventories in Europe has driven natural gas prices significantly higher over the past month. At the same time, the combination of El Niño and elevated energy costs is likely to cause food price inflation to accelerate towards year-end. Fortunately, underlying inflation remains relatively stable at 2.4% and selling-price expectations have not risen significantly in recent months.

ECB likely to raise rates at least once more

Taken together, these developments make a European Central Bank rate hike in September highly likely. With growth holding up and inflation set to remain above target for some time, several Governing Council members have suggested that a September increase is probable.

The question now is whether the ECB will stop at 2.50%. We certainly cannot rule out a third rate hike in December. However, if our scenario of easing tensions in the Middle East materialises by then, the ECB may still decide against further monetary tightening. Wider government bond spreads, driven by deteriorating public finances in several countries, would also tighten financial conditions implicitly, partly doing the ECB's job.

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