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GLOBAL ECONOMICS

FLASH REPORT

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Hawkish ECB Hike Tees Up Additional Tightening

- **The ECB delivered a widely expected 25bp rate hike, taking its deposit facility rate to 2.50%, marking the second quarter-point increase since beginning its tightening campaign in June.**
- **While our freshly-published forecasts indicate that we think the ECB is done hiking, today's decision and the current scenario of higher-for-longer energy prices clearly tee up at least one additional rate increase. October is 'live', though the ECB may wait until December.**
- **According to ECB President Lagarde, today's decision was a "no brainer" and unanimous, noting that risks to the inflation outlook are to the upside and that the ECB was surprised by longer lasting inflation and the bloc's economic resilience.**
- **The bank revised higher its 2027 and 2028 inflation forecasts, accompanied by upward revisions to its 2026 and 2027 GDP growth projections. In its baseline scenario, headline inflation is expected to remain above 2% until late-2027, while core inflation remains a few tenths above 2% at the end of the forecast horizon.**
- **The market reaction was sharp, with traders adding about 15–20bp to hike bets that now stand at a total of 40–45bp by end-2026 (one hike and 60–80% odds of another) and ~80–85bps at the hiking peak by mid-2027 (at least three hikes).**

The ECB delivered a widely expected 25bp rate hike, taking its deposit facility rate to 2.50%, marking the second quarter-point increase since beginning its tightening campaign in June. Continuously high energy prices, with only a short-lived pullback a couple of months ago, and a feeling that a resolution to the Middle East conflict remains months away are strongly pressuring inflation higher for longer, with growing risks that second-order effects materialize the longer the war drags on (over six months and counting).

Our latest forecast update published yesterday showed no more hikes expected after today's 25bp rate increase, with a bias towards penciling in additional tightening to be confirmed by the ECB's communications and how energy prices evolved in the weeks and months to come. The ECB's updated assessment of the Eurozone's growth and inflation trajectory and the latest developments in the Middle East (taking both WTI and Brent oil above the $100/bbl level) that point to continued energy supply strains not only argue for one more 25bp hike but the possibility of one or two more following.

An October or December rate increase looks practically certain if energy prices and risks remain as they are today by the time of these decisions; even a decline in prices to levels of about two weeks ago likely wouldn't be enough to prevent another hike by year-end. News reports published after Lagarde's press conference noted that officials are readying another rate increase, with the next hike possibly coming as soon as the October announcement while an increase by December is more likely than not—though those 'in-the-know' believe market bets on three additional hikes "may be too aggressive."

At writing, traders are pricing in a total of 80–85bps in additional rate increases by the ECB at the hiking peak in mid-2027, with 40–45bps of these expected by year-end, representing increases of around 15–20bps compared to yesterday's close. Note that global yields are moving higher today, not just on the back of the ECB's decision feeding rate hike bets elsewhere, but also a ~7% rise in WTI and Brent oil, and a below-maximum UST buyback operation. For reference, cumulative Fed hikes priced in by December 2026 and June 2027 are up 7bps and 17bps, to ~45bps and ~80bps, respectively. The EUR is getting caught in the USD positive mood amid risk aversion, with a modest 0.2% decline on par with the GBP's.

The ECB is of course sticking to a data/events-dependent stance, but policymakers will likely need large drops in energy prices and sharply reduced geopolitical risks to move away from thinking additional hikes are needed. Between now and the ECB's October 29th rate decision, we will only get HICP data for September, as October HICP figures (as in the case of Q3 GDP data) are out the day and week after the announcement. The bank may have a decent sense of where these readings will land to guide its decision, but it could also choose to act sooner rather than later if come late-October Brent oil has continued to trade above $100/bbl and Dutch natural gas prices remain above €65/MWh (more on the ECB's scenarios later).

According to ECB President Lagarde, today's decision was unanimous and the hike was a "no-brainer." During her press conference, Lagarde highlighted that the Eurozone economy proved resilient in Q2-26 despite the energy shock (GDP grew 0.6% q/q, or 2.6% q/q annualized, after a flat Q1) and that the economic trend probably continued in the third quarter, noting that the near-term growth outlook has improved, although the employment slowdown continues. Regarding inflation, Lagarde did say that most measures of underlying inflation are stable, that longer-term inflation expectations are around 2%, and that wages are not showing a material response to the energy shock (though conceding that their wage tracker points to a modest uptick in 1H27). On the other hand, Lagarde noted that inflation will remain "well above target" into 1H27 with core inflation also rising into early-2027, with inflation risks tilted to the upside and that the ECB was surprised by longer lasting inflation but also lower-than-expected inflation—albeit mainly due to food prices.

The main changes in the statement correspond to the bank's updated forecasts and the justification for today's hike, stating that "the conflict in the Middle East continues to generate inflation pressures, and inflation is set to remain well above target for an extended period," and the "decision underscores the Governing Council's commitment to setting monetary policy to ensure that inflation stabilises at its 2% target." The ECB left its final paragraph unchanged, repeating that "the Governing Council remains well positioned to navigate the uncertainty caused by the conflict" and that "it will follow a data-dependent and meeting-by-meeting approach to determining the appropriate monetary policy stance."

Regarding the ECB's forecast changes, the baseline projection shows that headline inflation will average 3.0/2.5/2.1% in 2026/27/28 (up from 3.0/2.3/2.0% in the June round) and core inflation will average 2.5/2.6/2.3% in 2026/27/28 (up from 2.5/2.5/2.2%). The revisions versus the June round may look modest at first glance, but they reflect a mix of lower food inflation forecasts that contribute a 0.2–0.25 ppts drag on headline inflation over Q3-26 to Q2-27 against a higher energy prices view that adds 0.3–0.4ppts over Q4-26 to Q2-27 and 0.2ppts in Q3-27 headline inflation—all relative to the June quarterly path. The core inflation revisions correspond to the pass-through of higher energy prices, though the document does not specify that this is a greater sensitivity (i.e. it would mostly be a proportional impact). GDP growth was upgraded to 0.9/1.4/1.5% in 2026/27/28 (from 0.8/1.2/1.5%).

As in previous forecast updates, the ECB has included alternative scenarios (Milder, Adverse, and Severe) that consider different energy prices paths and greater second-round inflationary impacts. While the bank's baseline (based on ten working days to the August 19th cut-off date) assumes that that Brent oil will average $90/bbl, $78/bbl, and $74/bbl in 2026, 2027, and 2028, respectively, the ECB's Adverse scenario incorporates an oil futures curve that is higher by 6% in 2026 and 18% in 2027–2028, while the Severe scenario is based on prices being higher by 21% in 2026 and close to 60% in 2028 (the gas price percentage higher assumptions are around double those for oil in both scenarios). At writing, the 2027 Brent oil futures curve averages around $85–90/bbl, so a few dollars short of the ECB's Adverse scenario. Under the Adverse assumptions, the ECB projects that headline and core inflation average 3.1/3.2/2.3% and 2.5/2.8/2.4% in 2026/27/28, respectively, compared to the baseline of 3.0/2.5/2.1% and 2.5/2.6/2.3%.

So, around current prices, if these were to hold in line with today's futures curves (similar to the Adverse scenario), the ECB would be looking at inflation sitting above 3% through the first half of next year to close around 2.5% in 2027 and not falling much more into end-2028, while core inflation spends all of 2027 between 2.5% and 3%. That's a situation where the ECB is not just hiking once again, as is now extremely likely, but two or three additional times—and one cannot rule out more tightening if there are clear signs of second-round effects in wage-setting, inflation expectations, and core inflation. But, this all remains to be seen, and a lot depends on Middle East developments.

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