Morgan Stanley
INVESTMENT MANAGEMENT

ECB Raises Rates During September Meeting

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The European Central Bank (ECB) raised the Deposit Rate by 25bps to 2.50% as inflation risks from the Middle East conflict outweigh concerns about the growth outlook. The unanimous decision reinforced the Governing Council's focus on returning inflation to target, with policymakers emphasizing the need to remain responsive to evolving growth and inflation risks.

The ECB highlighted that the conflict in the Middle East continues to generate inflation pressures and is expected to keep inflation well above target for an extended period. Higher energy prices remain the most immediate transmission channel, although policymakers also pointed to the risk of broader second-round effects on prices and wages. ECB staff scenarios continue to show a wide range of potential outcomes depending on the duration and severity of the energy shock.

Inflation accelerated to 3.3% y/y in August from 2.9% in July, largely reflecting renewed energy pressures. At the same time, the Eurozone economy has proved more resilient than previously expected. GDP grew 0.6% q/q in Q2 2026, while employment increased 0.1% and the unemployment rate remained at a historically low 6.4% in July. The combination of firmer inflation and resilient activity provided the backdrop for today's decision.

The ECB revised its economic projections higher for both inflation and growth. Headline inflation is now seen at 3.0% in 2026, 2.5% in 2027 (+0.2%) and 2.1% in 2028 (+0.1%), while GDP growth was raised to 0.9% in 2026 (+0.1%), 1.4% in 2027 (+0.2%) and 1.5% in 2028. Together, these upgrades reflect greater than expected resilience in the euro area economy, set against an extended period of above target inflation.

Looking ahead, the ECB reiterated that decisions will be taken meeting-by-meeting and that they are "not pre-committing to a particular rate path." Policymakers are closely monitoring energy prices, the stronger euro, fiscal developments, global trade uncertainty and the broader geopolitical situation. Overall, the Governing Council highlighted an uncertain outlook, with risks to the upside for inflation and to the downside for economic growth.

Market pricing suggests that the ECB may need to tighten policy further, with investors currently assigning a meaningful probability to additional rate increases at the October and December meetings. However, the ECB provided little explicit guidance on the likelihood or timing of further moves, leaving the path of rates dependent on incoming inflation and activity data, as well as the evolution of the energy shock and broader financial conditions.

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