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THINK Ahead: Opening the rate-hike Pandora's box could unleash fresh turmoil

Central banks are flirting with rate hikes, and markets have gone crazy. Memories of the 2022 inflation battle are clearly still fresh. Yet talking about rate rises is one thing, delivering them is quite another, and they could win the 'wrong' inflation fight. The bar is higher than markets think, says James Smith, as we look ahead to next week

Pandora unleashed the world's evils. We might be stretching this a bit

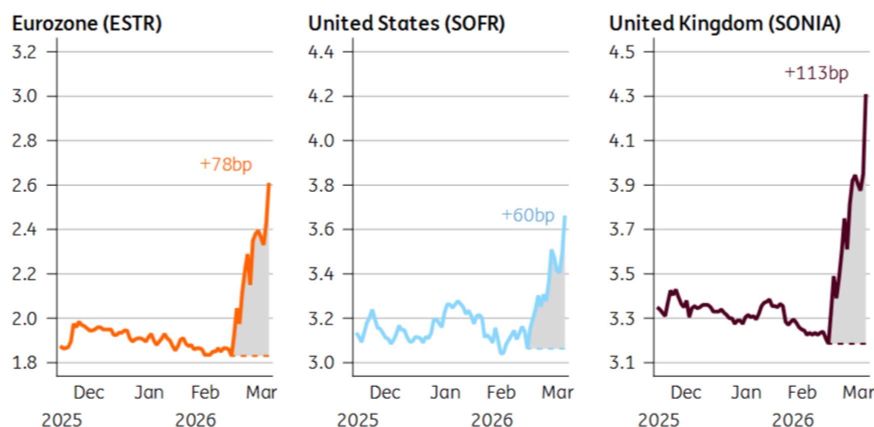
Why rate hikes risk winning the wrong inflation fight

This was the week when central banks gave an inch on rate hikes, and investors took a mile. As far as markets are concerned, Pandora's box is open; the path to higher interest rates is set.

Just look at the chart. One year from now, interest rates are priced more than half a percentage point higher than they were pre-war in both the US and the eurozone – and considerably higher still in the UK. Three hikes or more are priced from both the ECB and the Bank of England by year-end.

Markets have repriced interest rates dramatically higher

Implied one-month rate in one year (1Y1M swap)
Change since 27 February



Source: Macrobond, ING
Data as of 19 March close

That says as much about markets as it does central banks. Positioning and liquidity are exaggerating the story. My Rates Strategy colleagues caution against taking market pricing entirely at face value.

Yet central banks were unquestionably hawkish this week. And it didn't have to be that way.

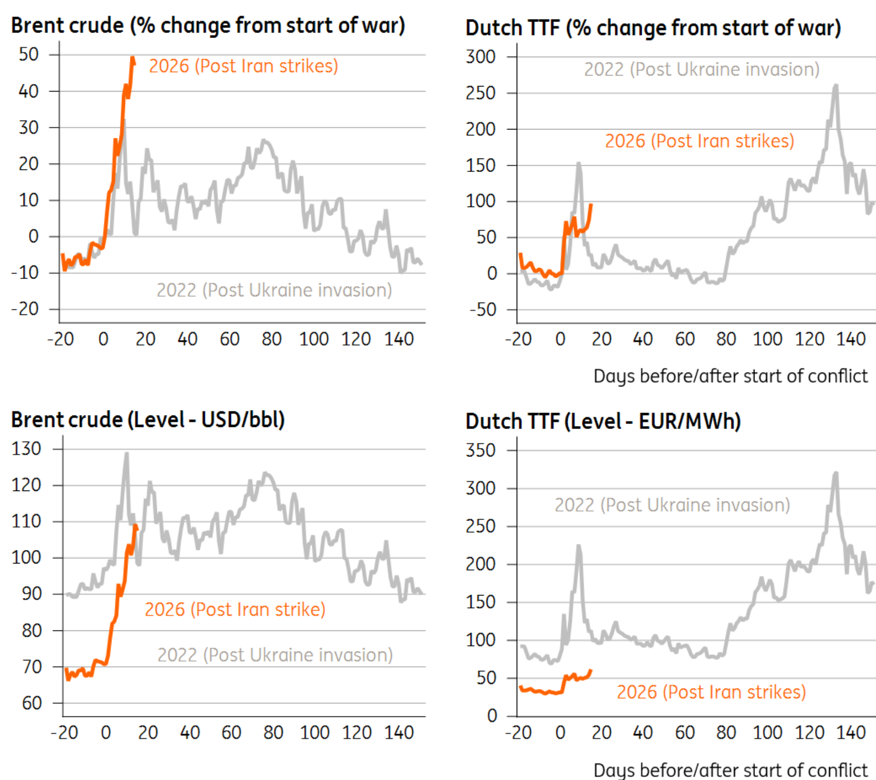
Officials could have simply said that the situation is uncertain, that nobody knows how long the disruption will last, that they're being vigilant and will see where the dust settles by the next meeting. And left it at that.

But policymakers went out of their way to burnish their rate-hiking credentials. Fed Chair Jerome Powell expressed his mounting frustration that inflation has been above target for five years now. In Britain, even the arch-doves, who until a month ago were ardent rate-cutters, were out floating the possibility of rate increases. And over in Frankfurt, the ECB hawks are on the airwaves actively talking up the chances of an April hike.

Above all, this tells us the painful memories of the last inflation spike are playing a key role in policymaking right now. Speak to many central bankers, and they will tell you both that they were too late to hike rates back then, and too quick to cut them when inflation started coming down.

That is not a mistake they want to make again. And to be fair to them, the percentage change in energy prices has now eclipsed the immediate fallout of the 2022 Ukraine invasion. That is what matters for inflation, even if, in level terms, things aren't looking quite so dramatic, at least on natural gas. The missile strike against Qatari LNG facilities – and the reportedly lengthy repair times involved – may well have influenced the tone of the ECB/BoE decisions.

2022 vs 2026: How the spike in energy prices compares



Source: Macrobond, ING

The central question that policymakers need to answer is this: *Will higher energy prices drive up core inflation?* That is what will determine whether they can "look through" the Middle East crisis or not.

Evidently, one big concern among officials is that the higher prices go, and the longer they stay high, the more likely it is that the inflationary impact snowballs. The relationship between energy prices and areas like food and services inflation is not necessarily linear.

Firms can weather short-term price fluctuations in their margins, but not forever. And the higher inflation goes through the second half of the year, the greater the impact on next year's annual price resets. Think of your internet or phone bills, for instance, that might explicitly be indexed to prior rates of inflation. Something similar is true of collective bargaining discussions in Europe.

That kind of thing risks making the whole inflationary episode longer-lasting – and if you listen to Bank of England Chief Economist Huw Pill, we're probably close to the inflection point. He's previously argued that when inflation hits 4%, it's statistically much more likely to stay high for a prolonged period. And by my reckoning, if energy prices are sustained at today's levels (a big if), it just about gets us there.

That's the fear, anyway. Personally, I just don't buy it.

Central banks are concerned about rising inflation expectations. And rise, they will. Ask any consumer where they think inflation is going, when they can see their petrol prices rising, and surprise! They will tell you it is going up.

But that makes no difference whatsoever if consumers (and businesses, for that matter) can't act on that information. In an environment where vacancy rates are dramatically lower than when the last energy shock hit, workers simply don't have the same power to seek faster pay rises. Nor, in many cases, do companies possess the power to materially pass on higher energy costs, either.

If that's the case, then those firms are much more likely to deal with higher costs by cutting staff. And remember, the whole "non-linear" argument applies just as much to the jobs market as it does inflation. Job losses, once they begin at scale, have a habit of spiralling as economic demand weakens across the economy.

Something similar is true in financial markets: the higher energy prices and interest rate expectations go, the greater the risk that something breaks. And when that happens, the ripple effects can often be felt far and wide.

Central banks are naturally well aware of this – and said as much this week. The BoE, for instance, said explicitly that higher energy prices could necessitate rate cuts if the fallout is primarily through the jobs market.

Still, that won't stop central banks talking up the possibility of rate hikes over the coming days, in the hope words can do some of the work for them. Some of this is directed squarely at governments. ECB President Lagarde explicitly warned them to keep energy support "*temporary, targeted and tailored*". The message is clear: government support, of the likes we saw in 2022, will build the case for rate hikes. Spain is the first out of the traps today with VAT cuts on electricity bills.

Regardless of that, there may come a point, if this crisis worsens, where central banks feel they have no choice but to preserve their inflation-fighting credentials and tighten policy.

In our team's more extreme energy price scenario, where oil averages 120 USD/bbl in Q2, we'd expect the ECB to hike twice this year. The same is probably true of the BoE. Markets are certainly right about one thing: if the central banks do raise rates, they are unlikely to do so only once.

But it's a risky strategy. Central banks rightly need to avoid a re-run of the previous inflation overshoot. But in doing so, they risk fighting the last battle.

It's one thing to talk about rate hikes, quite another to deliver them. They are not our base case for the Fed, ECB or BoE just yet.

Ultimately, this is not 2022. The economy looks markedly different. And rate hikes may only compound the economic challenges coming down the track.

James Smith

THINK Ahead in developed markets

United States (James Knightley)

- It is a very quiet week for scheduled data and events, but there will be plenty of Fed officials speaking to the media. Their "dot plot" continues to point to a 25bp rate cut this year and a further cut next year, but markets are increasingly concerned about stagflation risks from higher energy costs and ongoing supply distribution issues through the Straits of Hormuz.

We argue that the US is insulated from this to some extent relative to Asia and Europe, but is not immune to the issues. The longer the blockages last, the greater the concern about fertiliser, food and plastics prices.
- That said the Fed has a dual mandate - preserving price stability and maximising employment - and the second part is also facing greater challenges. If the jobs market was stalled when the economy was looking in decent shape before the Middle East conflict started, an overlay of heightened geopolitical, economic and market angst is not going to incentivise business to suddenly start hiring now. Hence why we still feel the Fed is more likely to cut than hike rates and that is the messaging we expect to hear from Fed officials.

United Kingdom (James Smith)

- **Inflation (Wed):** February's data, which is likely to show headline CPI unchanged and services inflation dipping back, is largely irrelevant at this point. Nor is the fact that inflation is set to dip close to 2% by April, given that it will take until the third quarter to see the full effect of higher natural gas prices on electricity bills. At this stage, we think the BoE is headed for a prolonged pause.

THINK Ahead in Central and Eastern Europe

Poland (Adam Antoniak)

- **Retail sales (Mon):** Retail sales remain the bright spot of Poland’s economy in early 2026. While industrial production was stagnant and construction nose-dived amid harsh weather conditions in the first two months of this year, the cold winter even boosted garment sales in January. We believe that the positive trends in durable goods demand observed in recent quarters were sustained in February. March should indicate how resilient consumer demand is to uncertainty and higher gasoline prices triggered by the outbreak of military conflict in Iran. Deterioration in March consumer confidence indicators suggests that this new shock may pose some risks to consumption ahead.

Hungary (Peter Virovacz)

- **Rate setting meeting** (Tue): Governor Varga's words from the February NBH rate setting meeting, 'this is not a rate cut cycle', aged pretty well. Eventually, it has aged too well. On 24 March, we saw the NBH turn into a hawkish currency defender, eventually closing the door on easing for now, but citing maximum flexibility to keep inflation on track and calm investors. We now anticipate only one more rate cut in 2026 as our base case scenario. If our 'long war' alternative scenario materialises, we see no room for a rate cut this year.

Czech Republic (David Havrlant)

- **Confidence** (Tue): Czech consumer confidence likely weakened in March, continuing its descent from last year's November peak. That said, the index remained at a relatively optimistic level, supported by lower energy bills and solid economic growth. However, the rising unemployment rate and the onset of the Middle Eastern conflict weigh on consumer sentiment. The outlook of higher oil and natural gas prices, along with potential disruptions to supply chains, also cooled the business sentiment in March, despite the recent stabilisation in manufacturing.

Key events in developed markets next week

Country	Time	Data/event	ING	Prev.
		Monday 23 March		
Eurozone	1500	Mar Consumer Confidence Flash	-	-12.2
		Tuesday 24 March		
US	1215	ADP Employment Change Weekly (000s)	10	9
	1345	Mar S&P Global Manufacturing PMI Flash	-	51.6
	1345	Mar S&P Global Services PMI Flash	-	51.7
	1345	Mar S&P Global Composite PMI Flash	-	51.9
Eurozone	0900	Mar HCOB Manufacturing PMI Flash	-	50.8
	0900	Mar HCOB Services PMI Flash	-	51.9
	0900	Mar HCOB Composite PMI Flash	-	51.9
Germany	0830	Mar HCOB Manufacturing PMI Flash	49.5	50.9
	0830	Mar HCOB Service PMI Flash	52.5	53.5
	0830	Mar HCOB Composite PMI Flash	52	53.2
France	0815	Mar HCOB Composite PMI Flash	-	49.9
UK	0930	Mar S&P Global Composite PMI Flash	-	53.7
	0930	Mar S&P Global Manufacturing PMI Flash	-	51.7
	0930	Mar S&P Global Services PMI Flash	-	53.9
		Wednesday 25 March		
US	1230	Q4 Current Account (USD bn)	-310	-226.4
Germany	0900	Mar Ifo Business Climate	87.5	88.6
	0900	Mar Ifo Current Conditions	87	86.7
	0900	Mar Ifo Expectations	88.5	90.5
UK	0700	Feb Core CPI (YoY%)	3.2	3.1
	0700	Feb Services CPI (YoY%)	4.2	4.4
	0700	Feb CPI (MoM%/YoY%)	0.4/3.0	-0.5/3.0
		Thursday 26 March		
US	1230	W 1 Initial Jobless Claims (000s)	215	205
Eurozone	0900	Feb Money Supply (YoY%)	-	3.3
Germany	0700	Apr GfK Consumer Sentiment	-25.6	-24.7
Italy	0900	Mar Consumer Confidence	96.8	97.4
Spain	0800	Q4 GDP (QoQ%/YoY%)	-/-	0.8/2.6
Norway	0900	Key Policy Rate	-	4.00
		Friday 27 March		
US	1400	Mar Michigan Sentiment Final	53	55.5
UK	0700	Feb Retail Sales (MoM%/YoY%)	-/-	1.8/4.5
Spain	0800	Mar CPI Flash NSA (MoM%/YoY%)	-/-	0.4/2.3

Source: Refinitiv, ING

Key events in EMEA next week

Country	Time (BST)	Data/event	ING	Prev.
		Monday 23 March		
Poland	0900	Feb Retail Sales (YoY%)	7.8	4.4
	1300	Feb M3 Money Supply (YoY%)	9.6	10
		Tuesday 24 March		
Poland	0900	Feb Unemployment Rate	6.1	6
Czech Rep.	800	Mar Consumer Confidence	105.2	107.6
	800	Mar Business Confidence	98.2	99.8
	800	Mar Composite Confidence	99.4	101.1
Hungary	1300	Mar Hungary Base Rate	6.25	6.25
		Wednesday 25 March		
Russia	1200	Feb Industrial Output	2.8	-0.8
		Friday 27 March		
Hungary	0730	Feb Unemployment Rate	4.7	4.6
	0730	Q4 Current Account (EUR bn)	-0.14	0.9

Source: Refinitiv, ING

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