



"Wait and see" – central banks' take on the Iran conflict and interest rates

In Mid-March, decision-makers at the Federal Reserve, the European Central Bank, the Bank of England and other central banks had to weigh potential inflation triggered by the conflict in the Middle East. They are trading carefully until the dust settles.

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Central banks were never going to deliver the rate hikes that markets have been quick to price in since the eruption of conflict in the Middle East earlier in March. Admittedly, the Reserve Bank of Australia did kick off the week with a 25 basis point (bp) hike on 17 March, but it was already on a tightening path. Policymakers elsewhere adopted a cautious tone, left rates unchanged and stressed the need to wait and see how events unfold.

Inflation risk scenarios

We have long argued that the biggest risk to our baseline forecast is the re-emergence of inflation. Oil prices of over US\$100 per barrel meaningfully change the calculus on inflation and are sufficient to add around one percentage point to headline CPI (consumer price index) rates across developed markets. There may also be a second wave of commodity-related inflation, if disruptions to the supply of fertilisers from the Gulf lift global food prices. If that were the case, the usual lags of 9-12 months would mean that food inflation would start to rise just as the more immediate energy shock was subsiding and thus extend the price shock into 2027.

Much will now depend on how high energy prices go, and for how long they remain elevated. A quick resolution to events in the Middle East could see commodity prices fall back and inflation subside by mid-year but hopes for such a benign outcome are fading by the day.

Rate-setters' predicament

Successive waves of energy and food inflation over a prolonged period would heighten the risk of the supply shock becoming ingrained into wage and other price setting, resulting in the dreaded second round effects that keep central bankers up at night.

Scarred by criticism of being too slow to react to the energy price shock that followed the Russia-Ukraine conflict, such a scenario would see policymakers shelve any plans for rate cuts and could ultimately bring rate hikes into play. Attention now turns to how resilient economic growth will be to the ongoing supply shocks. The flash purchasing managers' indices (PMIs) in late-March will give the first broad indication of the impact on the global economy.

The US

Both the Federal Open Market Committee's dot plot and the market still anticipate one rate cut in 2026 – similar to our baseline assumption that Kevin Warsh will become Fed Chair later in the year and deliver some easing.

However, there is a clear risk that an extended price shock will scupper attempts to loosen policy while a reacceleration in core inflation would bring rate hikes onto the agenda.

From a fundamental point of view, the US economy appears most at risk of higher inflation becoming ingrained. After all, despite some recent distortions to incoming data following the government shutdown in 2025, the economy has been performing well, while the Fed's preferred measure of PCE core inflation (a measure based on consumer prices excluding food and energy to show underlying inflation trends) is still elevated at about 3%. It is also worth noting that, as a net energy exporter, the US may be shielded to some extent from the worst of the price shock – particularly when it comes to natural gas.

The eurozone

Elsewhere, though, it seems less likely that there can be a sustained, large commodity price shock with little or no impact on growth. For example, in the eurozone, whereas our baseline forecast is for growth to accelerate over the next couple of years to set the scene for rate hikes in 2027, there is high vulnerability to disruption of both oil and gas supplies. While a sustained crisis would have a significant impact on inflation, the squeeze on energy supplies could also snuff out the manufacturing recovery that we anticipate; squeeze real incomes and negate the risk of second round effects. This makes it unlikely that the European Central Bank will deliver the rate hikes markets have priced in for 2026, and any whiff of recession could see policymakers quickly pivot to rate cuts.

The UK

The energy price shock means that the Bank of England is now less likely to cut rates in 2026. After all, a recent shift in focus had meant that policymakers had signalled a desire to seize on lower food and energy inflation – the latter due to budgetary tax changes that will take effect in April and were expected to knock about 50bp off headline inflation. This now seems unlikely and with services inflation is still above 4%, the Monetary Policy Committee will be vigilant for any signs that wage growth will accelerate again.

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