

Why the case for raising interest rates is growing

Financial Times Europe

05 giu 2026

Megan Greene The writer is an external member of the Bank of England's Monetary Policy Committee

In the face of a significant energy shock from the war in the Middle East, most major central banks have so far followed the Econ 101 manual and kept policy rates on hold. Energy shocks only impact inflation on an ongoing basis if they change wage and price-setting processes — so-called second-round effects — and it's too early to know if this has happened. But using history as a guide, there's reason for the Bank of England to proactively push against secondround effects from the current shock in the UK.



Wage-setting processes shift when households' inflation expectations rise and workers demand higher wages to minimise any hit to their living standards. Price-setting processes shift when company inflation expectations rise and they increase prices to protect or improve their margins. The two can create a feedback loop between higher wages and prices that results in persistently high inflation.

History can help us gauge the extent of second-round effects set off by the current energy shock. Following political unrest in the Middle East and north Africa that prompted an energy shock in 2011, such effects were moderate. Inflation peaked around 5 per cent and the Bank of England kept rates steady. In 2022, when Russia invaded Ukraine, second-round effects were significant. Inflation soared to more than 11 per cent and interest rates rose. The difference in outcomes boils down to both the nature of the shock and the nature of the economy when the shock hit.

We can't know the size of the current shock, given it's ongoing. So far, real oil prices are below previous peaks, while gas prices have topped their 2011 high but are nowhere near 2022 levels. Gas shocks have a large inflationary impact on the UK, partly because they help to determine electricity prices.

We do, however, know more about the state of the UK economy. The key differences between 2011 and 2022 were that inflation expectations jumped and the labour market was tighter in 2022. Short-term household inflation expectations remained fairly stable after the energy shock in 2011. But in 2022 they were already high at about 5 per cent and roughly doubled after the shock. The conflict in Iran this year has already led to a significant jump in household expectations and company year-ahead price expectations are up sharply.

Rising expectations are necessary but not sufficient to generate second-round effects — workers must secure higher wages and companies must pass higher costs on as well. The ratio of voluntary job-to-job moves to redundancies is a rough-and-ready measure of worker bargaining power. This is slightly higher today than in 2011, but materially lower than in 2022. Other measures of labour market slack, such as the vacancy-to-unemployment ratio and unemployment rate, also suggest the labour market is looser now than it was in 2022 but tighter than 2011.

Given labour market weakness, there is a larger risk of second-round effects coming through price setting than wage setting. After years of profit margin squeeze, companies may raise prices in the face of an energy shock that also hits competitors. This could explain the sharp rise in the composite purchasing managers' index output prices since the war started.

In my view, the current shock differs from both 2011 and 2022 in one crucial way. It is our third negative supply shock in six years, and inflation has been above target for the best part of that period. This is important for two reasons.

First, there is evidence that second-round effects from the 2022 shock had not been fully squeezed out by our restrictive monetary policy stance before the war. Inflation remained persistently above target, household and company inflation expectations were elevated and forward-looking indicators suggested wage growth disinflation was slowing.

Second, households and companies are probably more sensitive to rising inflation now than in 2011 and 2022. The threshold for inflation feeding into expectations is 3 to 3.5 per cent, which we expect to reach this year. Longer-run inflation expectations have become more sensitive to short-term surprises since 2022, which suggests they may be less solidly anchored now.

Inflation isn't on the same trajectory as in 2022. But greater sensitivity to it will trigger some second-round effects, despite labour market slack. Tighter financial conditions are pushing against these for now, but that won't last in the absence of interest rate increases. The longer the war persists, the greater the case for hiking.