

# How to tame the inflation python

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This week, the ECB became the first major central bank to raise interest rates to counter the inflationary threat from surging energy costs arising from the Middle East crisis. Next week, the searchlight shifts to key interest rates decisions on either side of the Atlantic. This seems likely to divide opinion at the Federal Reserve and the Bank of England, with decisions hinging on judgments about the degree of inflation persistence the shock is likely to impart.

Central banks still bear the scars of the last energy shock following the start of the Russia-Ukraine war in 2022. Back then, they underestimated the likely degree of inflation persistence, resulting in interest rates being raised too late. As inflation rose, companies and workers adjusted price and wage expectations upwards — so-called “second-round” effects — adding to momentum. An inflationary python was let loose.

Those mistakes arose from an underestimation of both the strength and length of the shock and the pace of recovery of demand relative to supply after Covid. Heeding those lessons, there are good reasons to expect less inflation persistence this time. The energy shock is smaller. And unlike the aftermath of the pandemic, demand is relatively subdued and labour markets fragile, reducing the risk of second-round effects.

The great unknown is the likely duration of the shock — how long will flows through the Strait of Hormuz remain impaired? This is anyone’s guess. But given this uncertainty, alongside the subdued economic backdrop, a monetary policy strategy of “wait and see” has a ring of reasonableness, at least until evidence of second-round effects emerges.

Yet, in doing so, central banks are at risk of repeating their earlier mistake of too little, too late — albeit for different reasons. The lessons they must heed are not from 2022 but from an earlier crisis during which policymakers significantly underestimated the systemic spillovers from another apparently modest shock — the failure of Lehman Brothers in 2008.

The inability to appreciate Lehman’s interconnectivity in global credit chains, and its role as a financial hub, made for far larger than expected spillovers when the bank failed. More than that, Lehman also served as a co-ordinating device for expectations among investors about financial stability. Once de-anchored, these amplified instability into the world’s first genuinely global financial crisis.

Those same mechanisms are in play today, with the hub now Hormuz and global supply chain goods. Recent research with economist Prasanna Gai shows that, if we ignore the rich topology of global supply chains, the inflationary spillovers from shocks to key supply

hubs are significantly underestimated, fattening inflation's upper tail and increasing its persistence.

The channels of transmission are the same as in 2008. The dense cat's cradle of modern supply chains means that shocks to a key supply hub cause far larger and wider ripples across markets and sectors than conventional monetary models predict.

We are already seeing these pressures work their way through the body of the inflationary python. Prices charged by companies are surging across a wide range of goods and countries. On a three-month annualised basis, producer prices are rising 10-20 per cent across Asia, Europe and North America.

For some goods, the rises are far larger. In Taiwan, home of around 90 per cent of the world's fastest chips, annualised export inflation is 30 per cent. In the US, technology inflation has hit 20 per cent annualised. These pressures are now being felt downstream, with consumer prices in the US, UK and euro area rising well ahead of target.

A second trick being missed by central banks is to think the second-round effects they fear depend only on the (unknown) duration of the shock. They depend, as importantly, on the shock's concentration in supply chains. This is known. Because the Strait of Hormuz is a key global supply hub, shocks to it synchronise price and wage-setting expectations, leaving the risk of second-round spillovers higher than in 2022, despite demand being weaker.

Tellingly, price expectations among purchasing managers have picked up more sharply and more synchronously than in 2022 despite the shock itself being smaller. The expectations of consumers have so far moved less but remain fragile. Avoiding the ratcheting up of those expectations requires a preemptive tightening of policy.

What, finally, are the implications of another underestimation of inflation persistence? For financial markets, it risks an underpricing of the pace and scale of rate rises needed to return inflation to target. For consumers and companies, it risks sustained pressures on the cost of living and doing business, damping demand. For politicians, it risks further public discontent on living standards.

As for central banks, they risk déjà vu. They were not lauded for their lethargy last time energy prices spiked. Repeating that mistake would smack of carelessness and risk cratering credibility. That means acting pre-emptively to tame the inflationary python before it once more escapes.