Stopping for gas – speech by Alan Taylor

Given at the Exante Data 10 Year Anniversary Conference, New York

26 March 2026

Speech

Introduction

It's wonderful to see everyone here today, and I'd like to express my thanks to the organisers for inviting me to speak. This is the 10th Anniversary of the Exante data conference, so congratulations to you all for that landmark, and for creating a great venue for these kinds of discussions.

When Jens first approached me about giving this speech late last summer, I expected – hoped, really – that today I'd be offering a forward-looking, even speculative set of remarks in relatively calm circumstances. The working title, "The future of monetary policy," was broad enough to let me explore the many challenges ahead. It could have been a talk about longer-term ideas, set against a backdrop of monetary policy normalisation and a post-2022 stabilisation that seemed to be unfolding as a series of mostly soft landings. Even just weeks ago, normalisation appeared to be progressing smoothly as the major shocks of recent years receded and uncertainty finally began to ease.

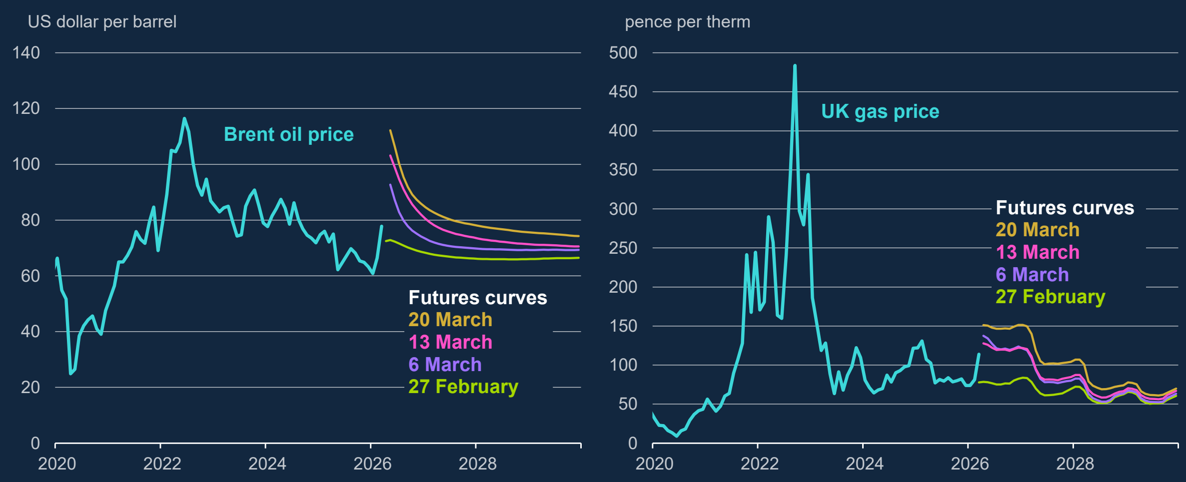
But that is not where we find ourselves now.

And although I spent much of February thinking about how to write **that** speech, I never actually wrote it – and for once, procrastination paid off, because otherwise I would have had to rewrite an entire speech at the last minute.

So now instead let me give an outline of what I do want to speak about today, although I will still incorporate some of the broader themes I had in mind, but focusing on how they apply to the present.

Shocks happen

Chart 1: Oil and gas prices and futures curves
US dollar per barrel and pence per therm

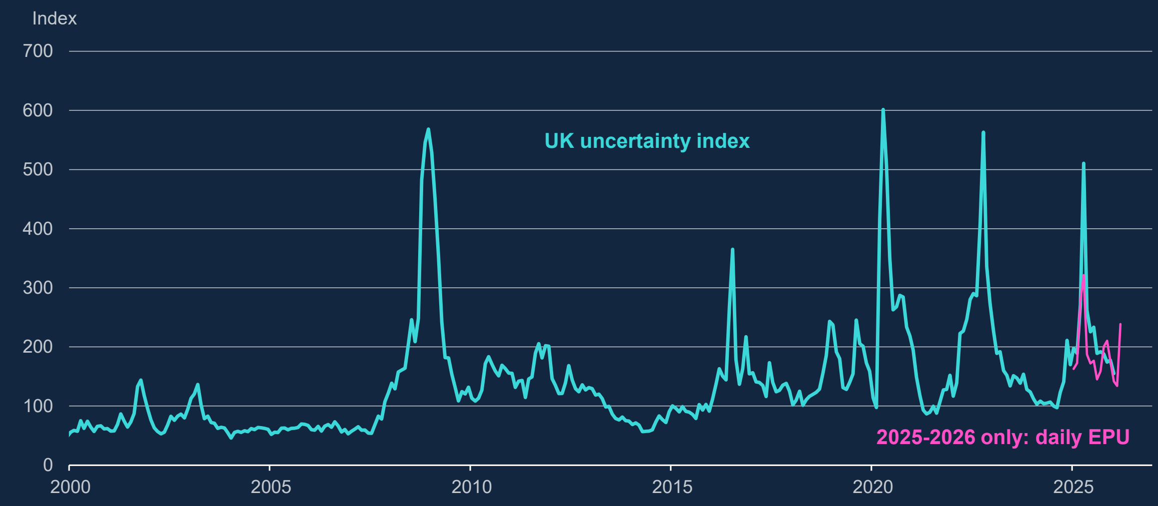


Source: LSEG. Recent observations for the last four Fridays up to 20 March 2026.

Shocks happen, and we always knew that they would. And so many of the important challenges to monetary policy that we face, have crystallised again, acutely and quickly, in the last few weeks.

With the outbreak of hostilities in the Persian Gulf, and the disruption affecting the production and export of a substantial fraction of global oil and gas supplies, economies around the world once more face large adverse supply shocks (**Chart 1**). The twin threats of higher inflation and damage to real economic activity now loom large again.

Chart 2: UK index of macroeconomic uncertainty
Index



Source: [Baker et al. (2016)](), [Caldara et al. (2020)](), Bloomberg Finance L.P., CBI, Consensus Economics, GfK, ICE Data Services, LSEG, S&P Global, and Bank calculations. Notes: The aqua line shows a UK uncertainty index calculated as the first principal component of nine proxies of economic uncertainty, based on data starting in 1985. See Box A of the **May 2025 MPR** for further detail. The pink line shows monthly averages of the daily UK Economic Policy Uncertainty Index of Baker et al. Latest observation: January 2026 for UKUI and 20 March 2026 for daily EPU.

Consequently, a return to the calmer times of old seems to have been further postponed. The mythical pre-2008 era of the great moderation, fleeting as it was, seems ever more distant, as the sequence of shocks pile up: the Global Financial Crisis, the euro crisis, the Brexit shock (for the UK), the Covid pandemic, Russia's invasion of Ukraine, the trade war, and now this new war in the Middle East (see peaks in **Chart 2**).

That adds up to seven major shocks in the space of 18 years, many of them originating from places outside the UK and with causes completely beyond our control.

Given that, I think future economic historians will acknowledge that we have lived through a period of quite unprecedented turmoil, in terms of both the magnitude and frequency of these shocks. And I also think they will recognise in time the long-lasting scars that these events have left behind.

In such an uncertain economic landscape, and after a large new shock of unclear dimension, it is hard to say anything very definitive as a policymaker. But even while we are taking stock of the situation, I think we can start to make out the terrain ahead, so let me share some thoughts on that.

First, I want to talk about the **general set of challenges**, the big tasks, the crucial tasks, that monetary policy and central banks will have to contend with, now and in the future. But I want to look at that, in particular, through the lens of the Bank of England, and the policy challenges we have been confronting in the recent years, which brought us where we were at the time of our February MPC decision.

Second, I want to talk about **how they apply to the current conjuncture**. Here, I want to focus on the new challenges the MPC now has to face in light of a new energy shock to the global economy. Along the way I want to recap the meaning of our mandate, talk about our March MPC decision, and discuss the scenarios and policy implications as I see them.

Challenges for monetary policy

The Bank of England (BoE) operates with a clear and longstanding mandate: to maintain price stability, defined by the UK government as achieving a 2% annual inflation target, and to support the wider economic objectives of growth and employment. The Monetary Policy Committee (MPC) is responsible for setting monetary policy to meet this target, primarily using our main tool of moving Bank Rate, the interest rate on reserves, but also other tools when necessary, such as large-scale asset purchases (and sales).

To achieve these goals is never easy. Even in a normal economic environment, such as the relatively tranquil pre-2008 years, monetary policy is not straightforward. Calibrating monetary policy is a serious technocratic problem, given the size and frequency of shocks, and imperfect information that makes extracting signal from noise very difficult in real time.

But in the more recent past, the MPC has faced an unusually complex environment of shocks. At the same time, the UK economy has experienced other economic headwinds including sluggish productivity growth, new trade frictions, and demographic shifts. Weaker fundamentals and heightened uncertainty, which feed off each other, have been complicating the calibration of monetary policy.

Given this current environment, I want to highlight five key policy challenges confronting the Bank of England, even before the most recent shock:

- preserving focus and discipline
- maintaining credibility and anchoring inflation expectations
- diagnosing slow-moving underlying inflation and wage pressures
- navigating the output-inflation trade-off
- responding to geopolitical and energy price shocks

Together, these challenges illustrate the delicate balancing act required to steer the UK economy back toward stable inflation without undermining economic resilience.

And calibrating our policy correctly given these challenges is as important as ever after the most recent shock.

1. Focus and discipline

The essential, core missions of a central bank are easy to state but challenging to accomplish. But the responsibility for achieving price stability one of the central tasks of a central bank, and the instructions we are given about how to do that are the crux of the MPC's mandate. Other critical goals assigned to the Bank include responsibility for financial stability including the soundness of banks and the payments system, which are assigned to other policy committees (**FPC**, **PRC**, **FMIC**).

But it can be easy for an institution to get distracted from its core goals. As highlighted by my predecessor on the MPC, former-Deputy Governor Paul Tucker, in his book *Unelected Power*, an overarching challenge for all central banks, is one of mission creep.

Tucker highlights the risk that central banks are gradually pressured into other areas, drifting into broader policy domains that sit outside of their original, core mandate and their domain of expertise. This could pose dangers, he argues, given the specific delegation of duties given to the central bank via the democratic system under the umbrella of independence.[1]

To simplify, the thesis could almost be described as a kind of central banking trilemma, one that highlights the tension between three goals that cannot all be maximised at once:

1. High central bank independence
    - Freedom from political pressure in setting monetary policy
2. Strong democratic accountability
    - Elected officials and the public having oversight and influence
3. Broad or expanding central bank mandates
    - Activity outside price stability in non-core domains

[1] Paul Tucker, '**Unelected Power**' (Princeton University Press, 2018): "The Alesina-Tabellini model [in the **American Economic Review (2007)**] points toward delegation to insulated technocrats being the better strategy where the goal can be specified, society's preferences are reasonably stable […], [and] there are not significant distributional trade-offs requiring the policy maker to make big distributional choices." (p. 101); "Vague, indeterminate, or incoherent objectives break the circle of a commitment to the people's democratically agreed purposes that shields [Independent Agency] policy makers and their staff from […] day-to-day politics" (p. 334).

The argument boils down to the idea that you cannot pursue all three at full strength without running into trouble. You can (and should) only really do two out of three. And he would place weight on 1 and 2, as do I.

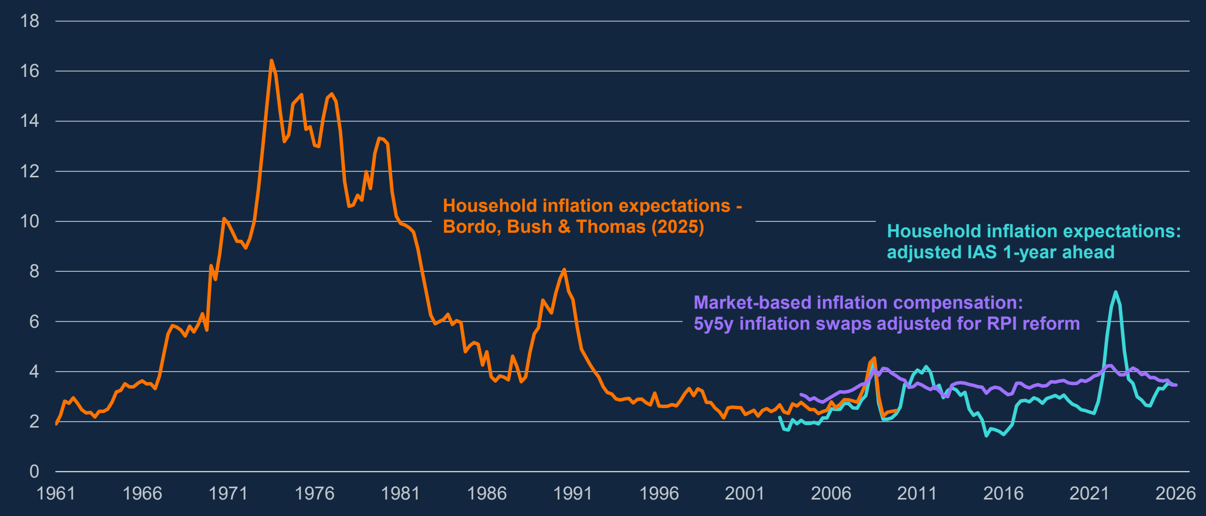
Following Tucker, I would go further and argue that for us, especially now, in a period of heightened uncertainty and limited resources, sticking to our brief becomes even more essential for those within the unique technocratic construction that is the modern-day independent central bank. Cleaving to the discipline of a narrow, well-defined mandate preserves credibility and institutional legitimacy, it ensures policy coherence, and it allows monetary authorities to concentrate their analytical fire-power and operational capacity on returning inflation sustainably to target.

I am certainly not the first, and probably will not be the last, MPC member to touch on this point. The current environment is undeniably complex, so it is important that we focus on our legal mandate and the primary objective of price stability. For the MPC and the outstanding staff at the Bank, this means prioritising core monetary policy responsibilities without letting other issues distract us. By concentrating on these essential tasks, we can deliver the price stability that underpins the UK's economic wellbeing. I believe the Bank has indeed managed this tension well, but we always must be cognizant of the risks.

2. Credibility and anchored inflation expectations

Credibility is the cornerstone of effective monetary policy. As I noted in my speech in **Oslo** a few weeks ago, when monetary policy operated without an effective nominal anchor in the 1970s, credibility was lost, and inflation surged out of control (**Chart 3**). To re-establish that credibility and re-anchor inflation back at target took about two decades, and along the way incurred very high costs, with huge sacrifice ratios and hard landings in the recessions of the early 1980s.

Chart 3: Measures of inflation expectations in the UK
Percent



Source: **Bordo, Bush & Thomas (2025)**, **Bank of England Inflation Attitudes Survey** and Bank calculations. Notes: Historical data on household inflation expectations are from the Annex of Bordo, Bush & Thomas (2025) '**"Muddling through or tunnelling through?" UK monetary and fiscal exceptionalism and the Great Inflation**' based on Chadha et al. (2025) '**A Century of High Frequency UK Macroeconomic Statistics: A Data Inventory**'. From 2010 onwards, household expectations are an adjusted version of the 1-year ahead IAS inflation expectations in which responses are aggregated, where each respondent's weight is the inverse of their estimated forecast error variance. The variance is estimated from a recursive, expanding window regression of squared forecast errors on perception errors and their square, using only data available up to each quarter. Market-based inflation compensation is the 5y5y inflation swap rate adjusted for estimated effects of the RPI reform. See notes to Chart 2.28 of the **February 2025 Monetary Policy Report** for details. Latest observation: December 2025.

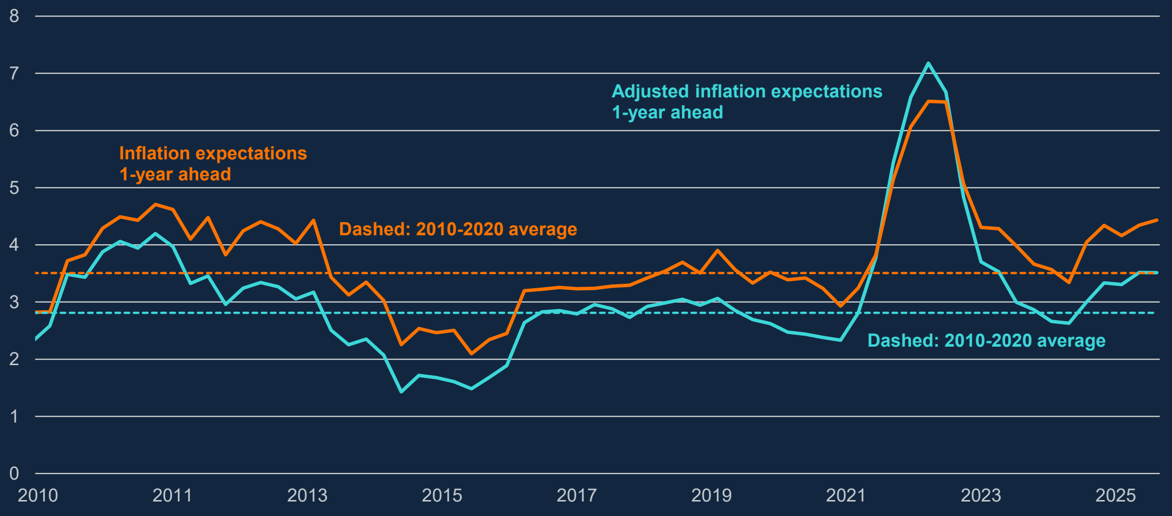
The current regime of independent central banks with inflation targets is the legacy of the great errors of that earlier period. And the payoff to this institutional change has been large and should not be taken for granted. Bringing inflation back to target in the last few years was achieved at much lower costs, with softer landings, thanks to well-anchored long-term inflation expectations.

From a macroeconomic policy perspective, this is the bigger, longer-run historical achievement that should not be lost in the noise. When households, firms, and investors trust that the Bank of England will return inflation to target, their expectations remain anchored, aside from short-term disturbances, reducing the risk of wage-price spirals and allowing monetary policy to operate with greater power and precision.

So that credibility is crucial. But the events of 2022, and now 2026, remind us not to take that credibility for granted. Short-term inflation expectations, especially among households, rose sharply in the inflation surge of 2022 (**Chart 4**). But while longer-term expectations remained more stable, they were not immune to upward drift.

Chart 4: Short-term inflation expectations of households

Percent



Source: **Bank of England Inflation Attitudes Survey** and Bank calculations. Notes: Adjusted 1-year ahead household inflation expectations are aggregated using inverse-variance weights, where each respondent's weight is the inverse of their estimated forecast error variance. The variance is estimated from a recursive, expanding window regression of squared forecast errors on perception errors and their square, using only data available up to each quarter. Latest observation: December 2025.

Now, admittedly, household inflation expectations are not a perfect indicator. A large fraction of responses suffers from bias in the Bank's survey. Many respondents declare that inflation is currently very high, 10%, say, which also suggests their one-year ahead response may also be similarly errant and less informative (this is indeed the case). A pinch of salt is needed, and those data need to be debiased for a clearer read. Such expectations also tend to be a moving average of spot inflation, and not much more, so they get pulled up mechanically during inflation humps like in 2022, and to a lesser extent in 2025. But that kind of process can also go into reverse, as in 2024, as the disinflation took hold. In our February forecast we were projected to return to the 2% target as early as Q2 2026, and again expectations were expected to follow with a lag. Financial market expectations are less volatile and have remained quite calm.

To guard against drift, and to try to reset errant beliefs about current or future inflation, the MPC must therefore communicate clearly and consistently to reinforce its commitment to the 2% target. Communications in all forms – speeches, testimony, the Monetary Policy Report – play a role in shaping expectations.

Yet communication itself has become more challenging: the economic environment is volatile, the drivers of inflation are more complex, most shocks are outside of our control, and supply shocks are not well addressed via monetary policy. The hope that these problems would ease in 2026 is now forlorn.

And, to make matters even more challenging, as I will show later, the risks around the economic trajectory are very much two-sided and beset with difficult trade-offs. Communication will have to be very carefully calibrated indeed.

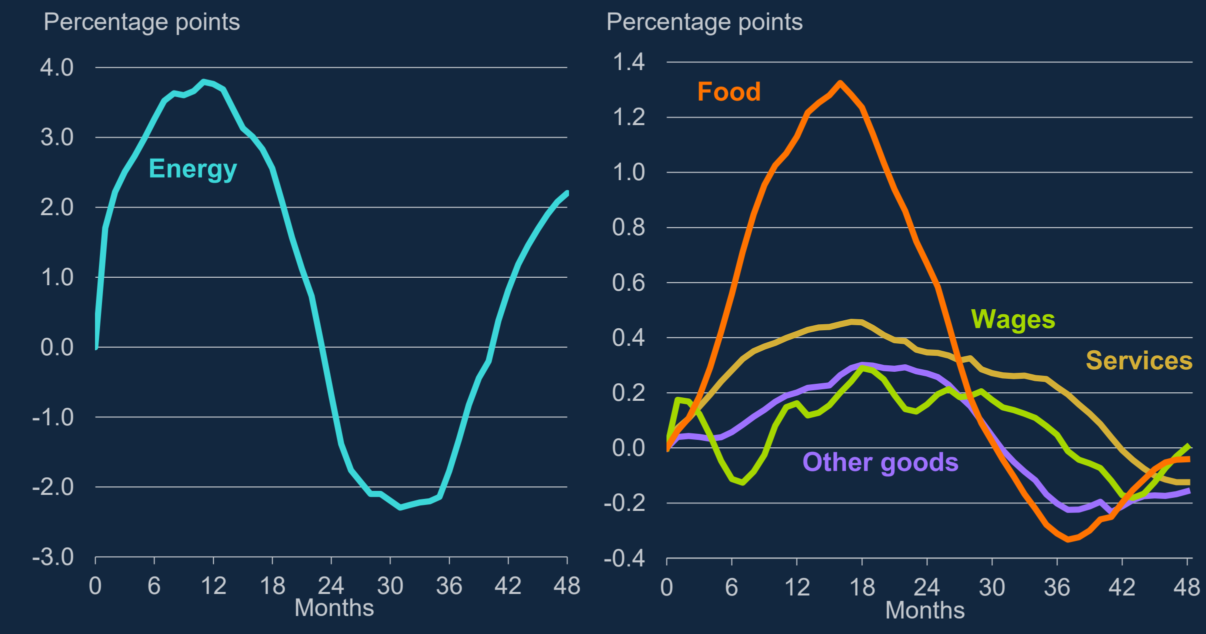
3. Slow-moving underlying inflation and wage pressures

After a major external price shock – especially to energy, which sits so far upstream in the production chain – central banks inevitably face the propagation of higher prices through the rest of the economy. With no instantaneous control over prices and no mandate to stabilise the price level itself, the Bank of England can only prevent this propagation from becoming too broad or too persistent.

The UK's 2% inflation target is forward-looking, so the task after a shock is to ensure that inflation returns to target within a reasonable horizon, even if some degree of pass-through is unavoidable. This requires the MPC to judge how quickly the shock will fade, how deeply it will embed itself in wage- and price-setting behaviour, and how forcefully policy must respond to prevent second-round effects from taking hold.

Chart 5: Estimated responses of CPI sub-components and wages to energy price shock

Energy (left); food, other goods, services and wages (right)



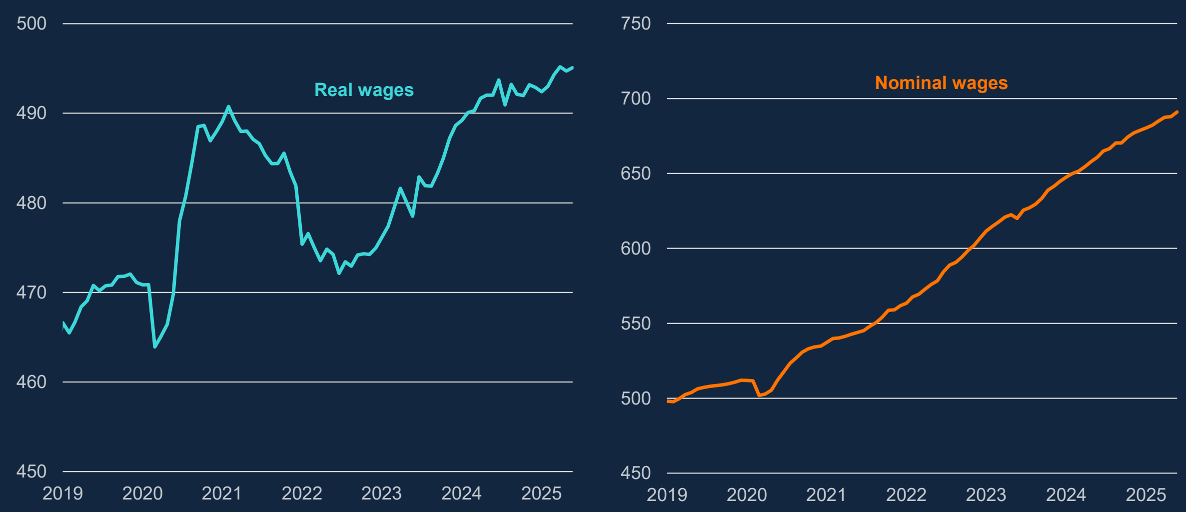
Source: ONS, US Energy Information Administration, Bank calculations. Estimates from a local projection model, responses of year-on-year inflation and annual wage growth on a rolling monthly basis, to an energy price shock in period 0. Given the limited time series and usual noisiness of these estimates, we take a three-month average of the left-hand side variables in the regressions. Energy includes fuels and lubricants, electricity, gas and other fuels; food includes food and non-alcoholic beverages; wages is private sector regular pay from Average Weekly Earnings. Data sample from January 1988 to September 2024. See Appendix of Taylor (2025), '**The last half mile**' for details of the local projections model.

A central difficulty is that not all prices adjust at the same speed. Goods inflation tends to fall back relatively quickly once the shock abates, but wage and services inflation are slower moving and more domestically driven. Illustrating these dynamics, **Chart 5** is taken from my **speech** in Leeds in January 2025, echoing similar points made by Deputy Governor Dave Ramsden in his **speech** there a few weeks before.

After Covid, the UK experienced an exceptionally tight labour market, with historically low unemployment and record-high vacancy-to-unemployment ratios. Wage bargaining, however, adjusted only gradually and real wages fell during the initial inflation surge (**Chart 6**). When it did, however, we observed high nominal wage gains for a number of years. But this was to be expected, and nominal wage catch up was inevitable to restore real wage equilibrium.

Chart 6: Real and Nominal average weekly earnings

Real and nominal AWE in pounds[(a)]



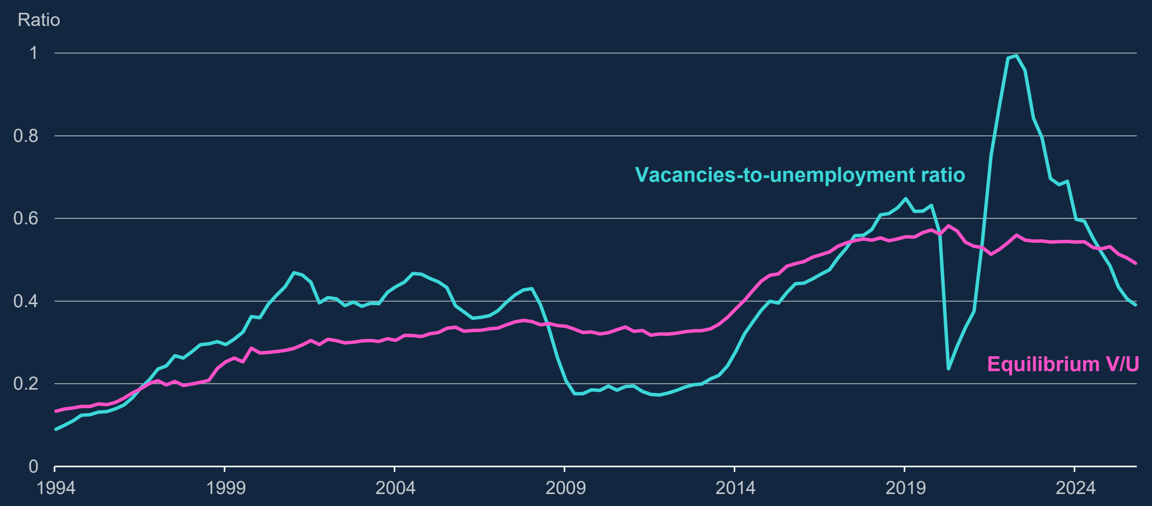
Source: Office for National Statistics. Notes: Real Average Weekly Earnings (seasonally adjusted) in 2015 pounds and Nominal Average Weekly Earnings (seasonally adjusted) from ONS. Last observation: December 2025.

Thus, nominal pay growth lagged behind the initial inflation surge, and it was only in the second half of last year that wage settlements fell back toward target-consistent levels of around 3-3.5%. Because services are labour-intensive, this slow wage adjustment feeds on into services inflation, delaying its return to more normal levels. Even as headline inflation fell sharply with the unwinding of previous energy price rises, underlying inflation remained elevated due to these slower-moving domestic pressures.

Today, however, the labour market backdrop looks very different from the acute overheating of 2022. Recent data show that vacancies have fallen by roughly a quarter from their peak, unemployment has continued to move up, and participation has only partially recovered. Staff estimate that the vacancies-to-unemployment ratio is now well below equilibrium, and they judge that slack in the labour market is material and expected to widen further (**Chart 7**).

Chart 7: Vacancies to unemployment ratio and equilibrium level

Ratio



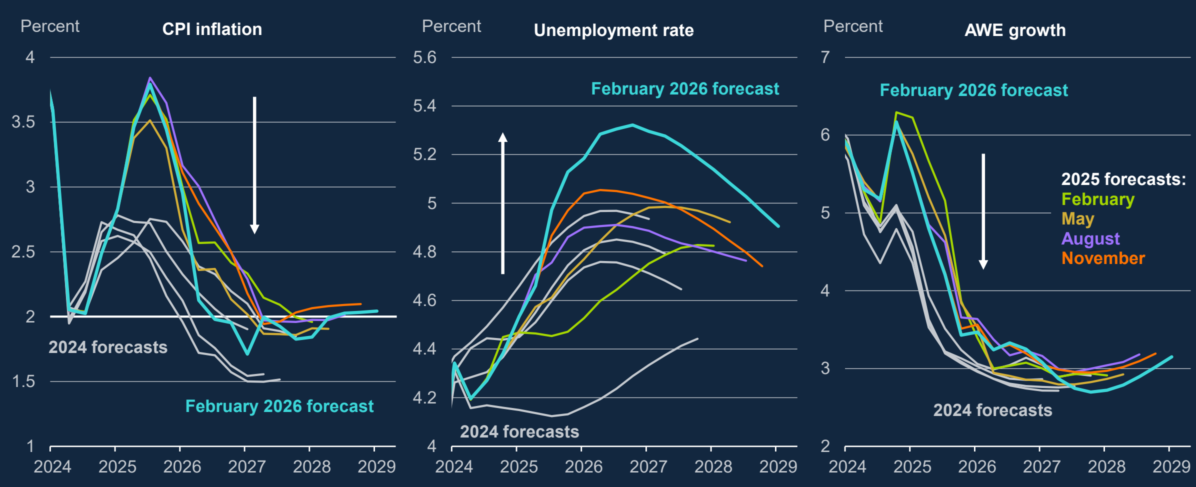
Source: Office for National Statistics and **Stelmach et al. (2025)**. Latest observation: December 2025.

Hiring intentions have remained soft, and surveys point to a weak labour market, and staff anticipate future wage settlements coming in close to 3% and thus slightly below target-consistent levels, as elevated unemployment bites on wage bargaining.

At the same time, signs of strain are increasingly visible across the corporate sector. Business insolvencies have risen to their highest levels in a decade, reflecting the cumulative impact of higher interest rates and subdued demand. Redundancies, while not surging, have begun to rise from their post-pandemic lows, and firms report greater caution in hiring and investment.

Chart 8: Revisions to the MPR forecast up to February 2026

Forecasts for inflation, unemployment rate, and wage growth



Notes: The chart shows successive vintages of MPR forecasts for annual CPI inflation, the unemployment rate, as well as annual growth in private sector average weekly earnings. Latest observation: 2026 Q1 (nowcast).

Given my outlook during 2025, I have been calling out increasing downside risks for some time now, with my expectations having been for a much weaker trajectory than the MPC's central forecasts. Hence, my frequent dissents. And by the February forecast, albeit with a lag, my past expectations had started to materialise in the MPC central forecast, with large cumulative revisions apparent in the latest forecast in F26 relative to F25, in the direction of lower inflation and more slack expected in 2026 and 2027 (**Chart 8**).

The shift to weaker labour market conditions and a widening output gap matters because it governs the backdrop to what we do next. The MPC is no longer confronting a above-potential economy but rather one in which slack has taken hold and is widening quite quickly. The challenge is therefore more nuanced than in 2022: the MPC must judge how quickly underlying inflation will fall in an economy that is already well below potential, and which is likely to develop even wider slack in the very near future.

At the time of our February 5-4 decision to hold Bank Rate at 3.75%, these developments highlighted the risks of continued restrictive policy. But now, complicating matters further is the emergence of a new energy price shock driven by geopolitical tensions and renewed volatility in global oil and gas markets.

For the MPC, the key question is whether this shock remains a temporary, supply-driven disturbance or whether it will cause self-reinforcing wage and price setting behaviour. Distinguishing between these possibilities is essential for calibrating policy appropriately, especially when the broader economic environment is already characterised by uncertainty and activity has been near stall speed for some time.

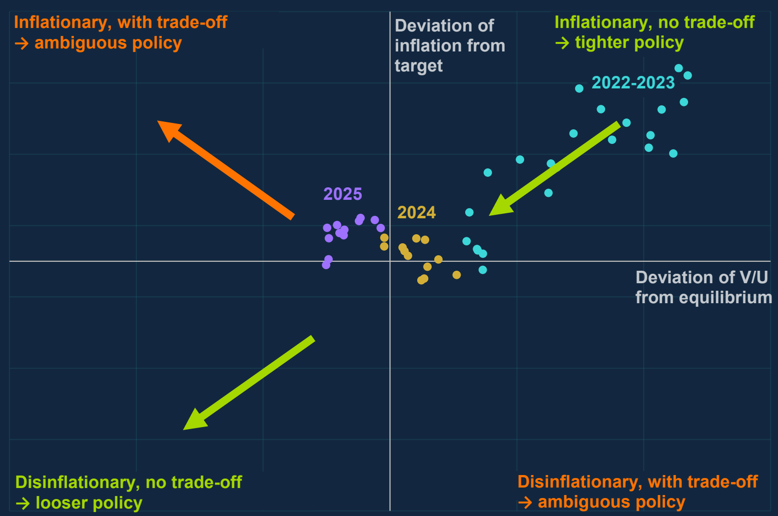
At the end of the speech, I will consider some scenarios and alternative policy options depending on how this new shock plays out.

4. The output-inflation trade-off

Monetary policy often involves a varying degree of trade-off between stabilising inflation and supporting economic activity.

Chart 9: Inflation and vacancies-to-unemployment ratio

Inflation in deviations from target and V/U ratio in deviation from equilibrium

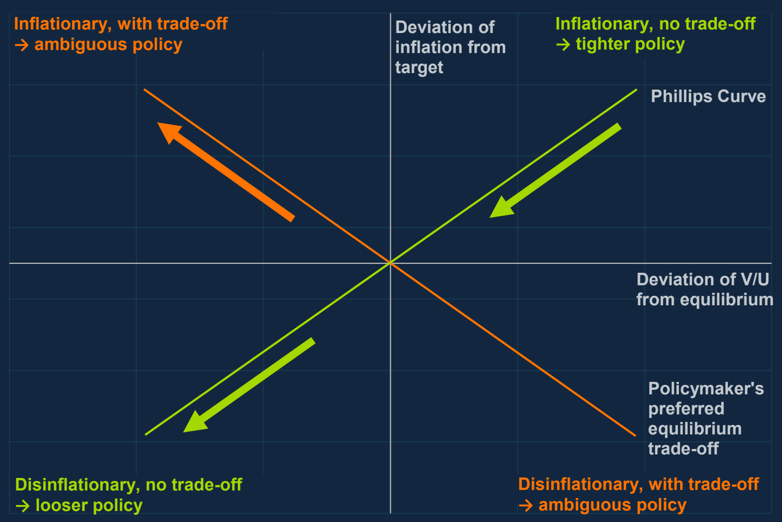


Source: Office for National Statistics. Notes: The chart plots 3-month-on-3-month CPI inflation (at annualised rates and expressed as deviations from the 2% inflation target) against the vacancies-to-unemployment ratio (expressed as deviations from its equilibrium level). The equilibrium vacancies-to-unemployment ratio is estimated following the methodology of **Stelmach et al. (2025).** Latest observation: December 2025.

In the most straightforward circumstances, the economy faces excess demand and high inflation, or conversely deficient demand and low inflation. In these cases, inflation and the output gap move in the same direction because the dominant force is a demand shock. This was the situation in the UK and many other economies in 2022–23, when thanks to a variegated mix of supply and demand shocks, inflation was well above target and labour markets were tight, with a high vacancy-to-unemployment ratio and a positive output gap (**Chart 9**).

But this time the current energy shock hits a very different economy. In 2026, the opposite configuration was starting to emerge in the forecast. To me, low inflation and weak demand, in a disinflating economy was the core message in our February MPR, which showed inflation somewhat undershooting the 2% target for much of the horizon alongside a rising unemployment rate which would peak in the mid 5s.

Chart 10: Stylised policy responses



Source: Adapted from Carney (2017), '**Lambda**'.

These are the scenarios monetary policy is best equipped to address, since it primarily operates by shifting demand in the short run. Tighter policy can cool an overheating economy with above-target inflation, while looser policy can support a depressed economy with below-target inflation. Policymakers may feel relatively comfortable in these spaces, indicated by the top-right and bottom-left quadrants of this diagram.

This chart (**Chart 10**), from a 2017 **speech** by then-Governor Mark Carney, illustrates well these problems, and I shall return to a quantitative version of this analysis later on.

As the chart indicates, the real challenges arise in the other quadrants, when inflation and the output gap move in opposite directions because the economy is hit by supply shocks. In these cases, traditional demand-management tools are poorly equipped to address this type of shock.

Inflation driven by energy price spikes, supply bottlenecks, or structural labour market frictions presents a dilemma: tightening policy too aggressively risks unnecessarily suppressing output, while tightening too little risks inflation expectations becoming un-anchored.

This is the classic and well-known territory of trade-offs, and the MPC's mandate has always required policymakers to confront these tensions directly. This has been especially so after the 2013 revision to our mandate, which made the importance of the trade-offs more explicit. We were reminded of the importance attached to the trade-off in the mandate by Governor Andrew Bailey in his recent speeches in **Jackson Hole** and **Reykjavik**.

In the same vein, as I discussed in my recent speech in **Oslo**, MPC members are instructed to weigh the costs of excessive output volatility against the risks of returning inflation to target too quickly, a concern that becomes particularly acute after large shocks. And make no mistake, shocks such as the global financial crisis, the pandemic, and the energy shock of 2022 were unambiguously large shocks. As this shock could be too.

How then are we to manage the trade-off? The principle of balancing objectives was discussed by former Governor Mervyn King in his 1997 paper **Changes in UK monetary policy: Rules and discretion in practice** in the Journal of Monetary Economics.

King coined the memorable phrase 'inflation nutter' (now a standard part of the Bank lexicon) to emphasise that the Bank of England is not an institution blindly fixated on hitting the inflation target regardless of economic conditions. He argued that credible inflation targeting does not require ignoring the real economy and that monetary policy must remain flexible, allowing temporary deviations from target when shocks occur. The MPC's role is to return inflation to target over a reasonable horizon, not as fast as technically possible.

King's framing encapsulates the essence of *flexible* inflation targeting. We should aim for the target in the medium term while smoothing output fluctuations when feasible, supported by transparency and accountability, and always grounded in a mandate that clearly lays out the objectives and constraints.

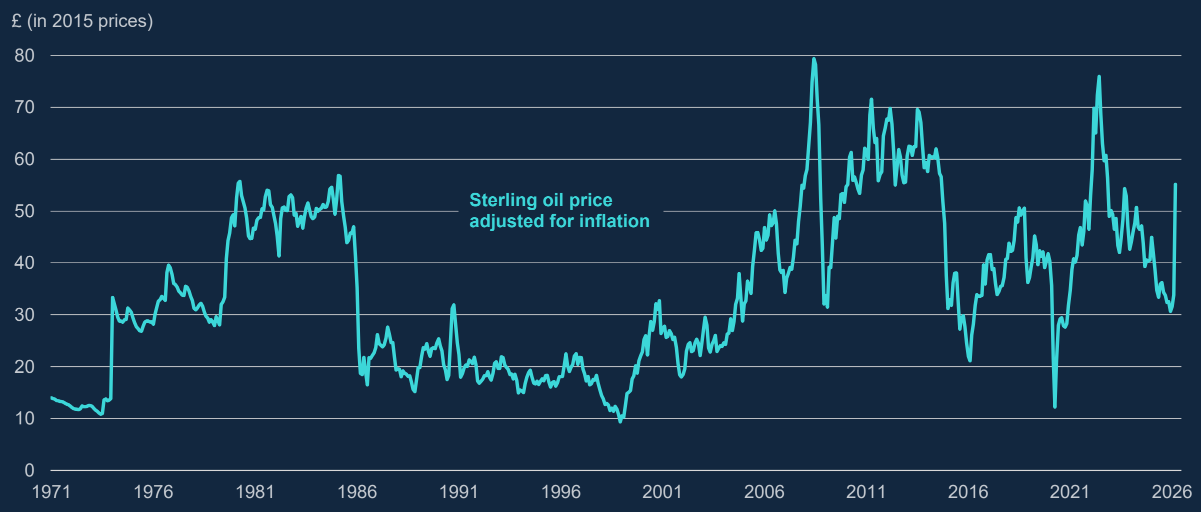
Thus, faced with the current supply shock, and the abrupt rise in energy prices, the MPC must again reach for these key principles, and we must judge the appropriate path for policy, taking into account the likely amplitude and duration of the shock, the lags in monetary transmission, and the disparate and persistent costs that may accumulate in response for several years into the future.

I will return to discuss these trade-offs using scenarios at the end of my speech.

5. Geopolitical and energy price shocks

To begin with the obvious, the potential for geopolitical and energy price shocks matter. This was obvious to anyone old enough to have lived through the 1970s, even if it may have been forgotten by those who pay insufficient attention to history.

Chart 11: Sterling price of oil adjusted for inflation
£ in 2015 prices



Source: Office for National Statistics, LSEG, and Bank calculations. Latest observation: 17 March 2026.

And then, as now, these geopolitical and energy-price shocks remain highly salient for the UK and present major challenges for the Bank of England (**Chart 11**).

Like everyone, we were brutally reminded of this in 2022. The Russian invasion of Ukraine triggered a surge in global energy prices, contributing significantly to the UK's inflation spike. Although energy prices have since moderated, the risk of renewed volatility remains high.

And since, as noted earlier, the Bank does not have immediate direct control of price levels (nor should it), these price disturbances, especially the large ones, must inevitably bleed into measured inflation and propagate through the economic system. Inflation is not everywhere and always a monetary phenomenon, at least not in the short run – whatever the textbooks might say.

In the UK, as in many economies, although oil embedded in fuels still plays an important role today, its effect is smaller than in 1970s. The UK is now particularly exposed to energy price shocks via its electricity sector due to its reliance on imported natural gas (and limited storage capacity), the composition of its electricity supply from different sources, and the nature of its regulated market design. Energy costs feed into inflation not only directly through household bills but also indirectly through production costs for businesses. Admittedly, the extent of this pass-through is not a given parameter and it varies greatly across different economies; that said, the MPC must take the UK energy pricing framework as given and set policy accordingly.[2]

So how bad is the current energy price shock, as far as we can gauge it at this point.

To put things into perspective (see **Chart 12**):

- In the 2011 window (between the first half of 2010 and mid-2011), oil prices in Sterling terms rose by about 40% while gas prices went up 70%. This mapped into a peak annual inflation rate in energy prices in the CPI of 20% (in August 2011).

- In contrast, in the 2022 window (between the first half of 2021 and 2022), Sterling oil prices went up maybe 70%, with some volatility. Gas prices, on the other hand, were up seven or eight-fold at times (so percent changes of 600 or 700%). Overall, this mapped into, roughly, a doubling of energy prices in the CPI, and a peak annual increase of about 50% (in July 2022).

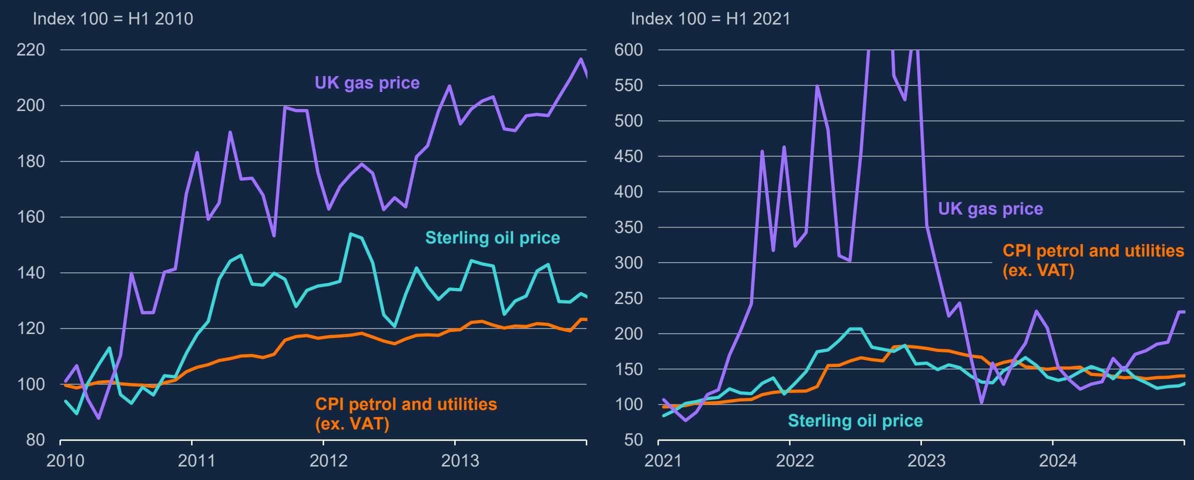
- Currently, based on futures pricing as of last week, both oil and gas prices are **expected** to rise about 60% above their 2025 average in the near term. This might then be **expected** to map into a change in the energy component of CPI of again some 20%. However, because of backwardation, one would also expect energy price inflation to symmetrically turn sharply negative in 2027, leading energy prices to become a drag on headline inflation from 2027 onwards.

Hence, as of now, this shock looks more like 2011 than 2022 in terms of magnitude, and is also akin to 2011 in that it occurs at a moment of economic weakness and labour market slack.

[2] In recent years, not all countries have suffered quite the same rate of growth or volatility in electricity prices, and one can compare the recent experience of the UK with other countries such as, say, France, Switzerland, or Norway. Different composition (more nuclear or hydro) and different regulated pricing mechanisms have led to different first and second moments. It is far outside the scope of this speech to ask why, and the Bank takes the UK situation as it is – changes in parameters are policy choices for government and a matter for the longer term.

Chart 12: Wholesale energy prices and energy in the CPI around the 2011 and 2022 shocks

Index



Source: ONS, LSEG, and Bank calculations.

And more broadly, of course, geopolitical risks extend beyond energy, so there are many other things that could keep us awake. The world economy has many chokepoints which could be exploited, now and in the future. Globally, the supply of many commodities and products remains vulnerable to disruptions, whether from conflict in the Middle East, tensions in the South China Sea, or trade restrictions between major economies. These shocks can raise import prices, disrupt production, and create uncertainty for businesses.

For the MPC, looking out from a small island at this risk-strewn landscape, the challenge is distinguishing between temporary shocks to the price level and persistent inflationary pressures. If energy prices spike temporarily, tightening policy too aggressively may be counterproductive. But if shocks lead to sustained changes in inflation expectations or wage-setting behaviour, the MPC must respond decisively. This is our conundrum.

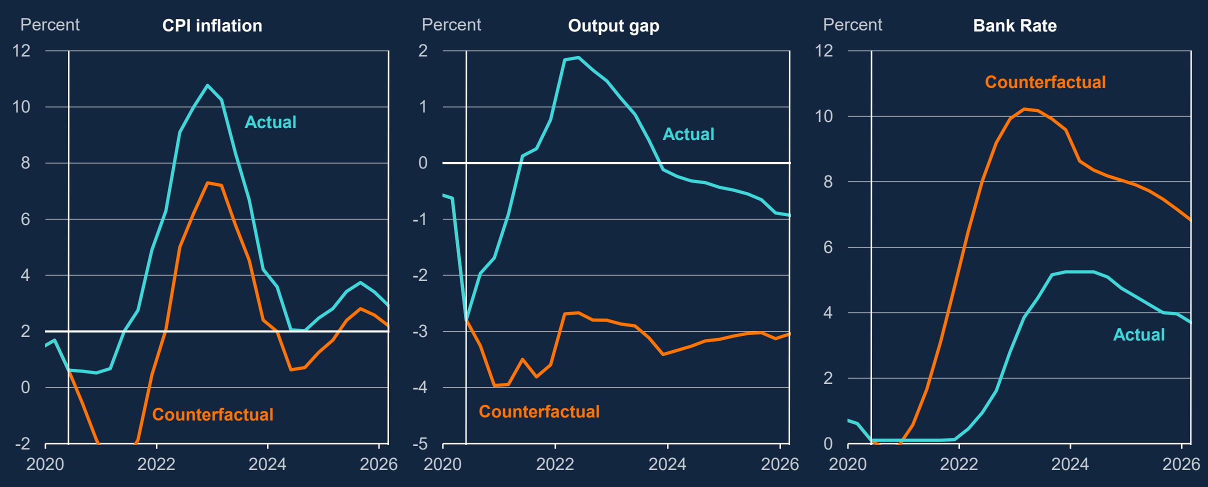
The current conjuncture

Let me now turn to discuss the current conjuncture.

1. What are the scenarios?

To set the stage for how I think about the current conjuncture, let me briefly show you some pictures that I showed in **Oslo** last month, before all of this kicked off (**Chart 13**).

Chart 13: Inflation stabilisation under perfect foresight – post-Covid inflation
Percent



Notes: The three panels show, in aqua, outcomes for UK CPI inflation, the output gap, and Bank Rate between 2020 and 2026. The orange lines show counterfactual paths for these variables under a different monetary policy stance constructed following **Alati et al. (2025)**. The first vertical line denotes the second quarter of 2020, after which the counterfactual is allowed to diverge from realisations. The vertical dotted line denotes 2026 Q1, the nowcast quarter of the February 2026 MPR forecast, which we treat as data. Latest observation: 2026 Q1.

This set of charts show an update of a thought experiment first done by my predecessors on the MPC, Ben Broadbent and Silvana Tenreyro. It asks what a policymaker who had perfect foresight of the future (until February of this year) might have done in 2020 (and beyond) to return inflation to target more quickly.[3]

The aqua lines are realisations of CPI inflation, the output gap, and Bank Rate from 2019 until now. We tell our synthetic policymaker to take these paths as given and then design an alternative policy stance. We further tell our synthetic policymaker to only care about inflation and to pay no heed to trade-offs or output stabilisation.

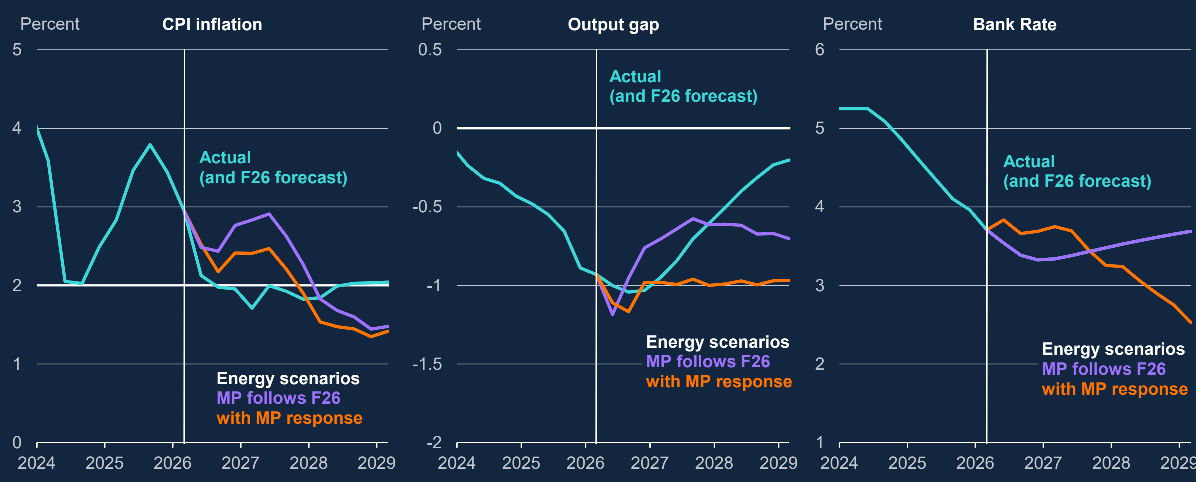
To me, this model exercise is instructive because it shows the limits of monetary policy and the need for careful judgement about the costs of inflation stabilisation.

[3] See Charts 5a and 5b in **Broadbent (2021)** as well as Chart 3 in **Tenreyro (2022)**.

Under this alternative, Bank Rate climbs to over 10% and would still be 7% around now. A deep and lasting recession ensues. But inflation still peaks over 7% in 2023, and over a long window we as often undershoot as overshoot the target.

Now, since then, the world has indeed changed, and in quite dramatic ways. Still, one may be tempted to apply the same playbook also to the situation we find ourselves in now with another energy price shock working its way through the economy. And while it is hard to be definitive about magnitudes, with futures pricing moving around daily, it is likely that energy prices will be significantly higher from here on for a significant period of time. So we can conduct similar exercises about what different policy responses to the energy shock might imply for the macroeconomic outlook.

Chart 14: VAR-based energy shock scenarios
Percent



Notes: The three panels show, in aqua, outcomes (and MPR forecasts) for UK CPI inflation, the output gap, and Bank Rate between 2024 and 2029. The purple lines show a scenario in which an energy price shock hits in 2026 Q2 (conditional on energy prices as of 3 March 2026) but monetary policy follows the F26 conditioning path for Bank Rate. The orange line shows a scenario conditional on the same energy price shock, but Bank Rate endogenously follows the path implied by a structural VAR. Latest observation: 2029 Q1.

Here, because the shock is very much in the future, we obviously cannot conduct the same perfect foresight experiment we did above. Instead, for a first pass, we use impulse response functions from an empirical macro-VAR to construct an alternative scenario around the MPC’s February 2026 forecast (**Chart 14**). Which, as you can see in the aqua lines in the chart, had inflation settle around target (in fact, below target at times), and the output gap closing towards the end of the forecast horizon. This was conditioned on a path for Bank Rate that bottomed out at 3.25% at the end of this year and then gently rose, which was market pricing at the time.

We then use the empirical IRFs to fix a path for energy prices roughly in line with futures pricing on March 3 at the start of the war (cf. purple lines in **Chart 1**) and then invoke monetary policy shocks to achieve a Bank Rate path that deviates from the one implied by the VAR (**McKay and Wolf, 2023** and **Caravello et al., 2025**). This is similar in spirit to the approach outlined by Chris Sims, who sadly passed away last week, and to whom we owe the foundations of this methodology (**Sims and Zha, 2006**).

Now, both oil and gas prices are quite a bit higher, so you may take this as being a fairly benign scenario. So this is not a forecast but an illustration. The MPC will be publishing a proper, updated forecast next month.

Conditional on that path for energy prices, we look at two different monetary policy reactions: one in which (despite the shock) Bank Rate *still* follows the conditioning market rate path of February 26 MPR forecast , that is, the one before the outbreak of the war (purple lines in **Chart 14**); and an alternative one which looks not unlike recent movements in the OIS curve (orange). Specifically, for the latter, we assume that the MPC holds rates for one year, and then proceeds to cut interest rates in response to the negative output gap and below-target inflation as dictated by the VAR model. So there are no hikes under this alternative scenario, just a long pause when rates are held fixed at the current moderately restrictive level.

So, what do these experiments show?

In either case, the shock is inflationary in the near term. Inflation moves to a higher path above target. But exact magnitudes depend critically on the conduct of monetary policy.

So, in our simulations, the policymaker could shift the interest rate path up or down relative to the February 26 MPR path. But what does that achieve? Higher rates, in the near term, reduce inflation but worsen output costs. Lower rates would do the opposite. This is the essence of the output-inflation trade-off in the face of external cost shocks.

As pointed out, this is a fairly benign scenario with inflation never exceeding 3% in the simulation. Could it get worse than this? Obviously it can, and in such a less-benign scenario the perturbations would grow even larger, causing an even more painful trade-off. It is, however, a feature in all of these scenarios that, given energy curves in strong backwardation, inflation significantly undershoots the target in the second half of the forecast. It is also the case that the output gap is worse relative to F26 as higher energy prices persistently depress economic activity.

And note here that, on the real side, things are much worse in the 2026 world than in 2022. We start in 2026 from a baseline path with a negative output gap and rising unemployment. In 2022, we had high inflation, but also the economy running hot and above potential. Back then we were in the good quadrant, with an obvious prescription for the direction, if not magnitude, of the correct monetary policy response. Now we are in the bad quadrant, where the trade-off bites. This time is different, and more similar to 2011, when the MPC faced an energy shock in a very weak economy, and decided to look through the shock.

2. What is the strength of the trade-off?

Now these examples illustrate the painful nature of trade-offs in the 'bad' quadrants. But how can a policymaker seek to quantify the trade-off as part of the judgement behind their policy decision? It was then-Governor Mark Carney who explored this problem in his 2017 **'Lambda'** speech, and he set out how a policymaker's trade-off between stabilising inflation and output can be formally analysed in a quantitative fashion.

The right toolkit is the textbook linear-quadratic optimal control framework. The economy is described by a dynamic stochastic system of *linear* equations that describe how the state of the economy (inflation π_t, output y_t) evolves, conditional on a control input (interest rate i_t), while *quadratic* preferences are assumed to penalise undesirable state deviations, of inflation from target and output from potential. If the weight placed on output stabilisation is denoted by the parameter λ ('lambda'), the per period loss function is written as:

$$Loss_t = (\pi_t - \pi^*)^2 + \lambda(y_t - y_t^*)^2 \, ,$$

where deviations from targets (*) define the inflation gap and output gap. The objective is to solve the resulting LQ problem: minimise the discounted sum of these losses. A lambda of zero implies exclusive focus on inflation (i.e., the 'inflation nutter' of lore), while a positive lambda reflects willingness to trade off inflation and output stabilisation, which is the configuration consistent with the MPC's remit.

Policy is constrained by the economy's structure, including how interest rates affect activity and how activity affects inflation via the Phillips curve. Lower rates raise activity, and higher activity increases inflation. In this framework, optimal policy sometimes offsets inflation overshoots with weaker activity, and vice versa. The simplest form of this relationship is:

$$\pi_t - \pi^* = -\frac{\lambda}{\kappa}(y_t - y_t^*) \, ,$$

where κ (kappa) measures how strongly the output gap influences inflation, related to the slope of the Philips curve. A higher λ means more weight on output stabilisation, allowing shocks to pass through more to inflation.

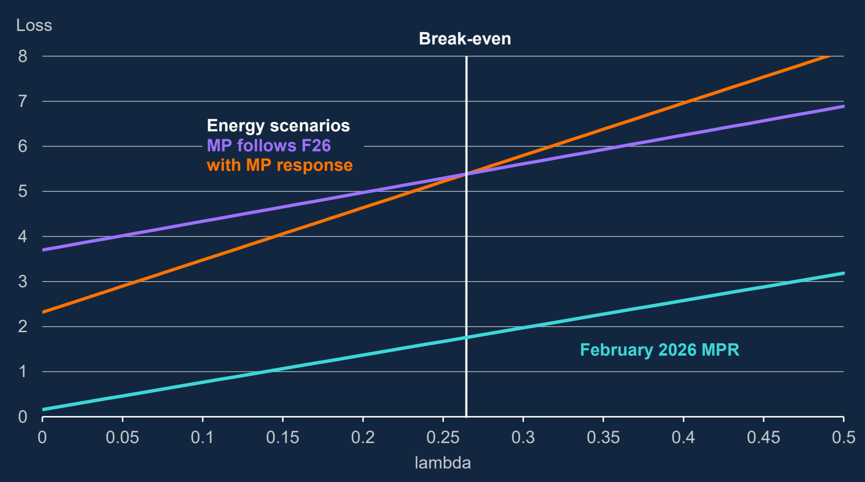
What then is the right λ ?

As Carney discussed, in the tranquil times before the 2008 crisis, empirical analysis showed that the MPC had behaved as if its λ were between 0.1 and 0.2. But in the subsequent decade of the 2010s, reflecting the starker trade-offs that emerged in the Great Recession, the MPC's λ shifted up to about 0.25, and this remains a relevant benchmark parameter in staff simulations to this day.[4] Beyond that, a higher λ equal to 0.5 is a plausible upper bound.

So it makes sense to look at a range of λ, and to recognise that for any individual, and by implication for the aggregate view of the MPC, the λ might be time varying and state-dependent now, as it has been in the past.

Taking that midrange value of $\lambda = 0.25$ as a benchmark in what follows, I will now ask what we can make of some of the new and difficult trade-offs that we now have to confront in 2026, starting from the above benign energy shock scenario to explore the question.

Chart 15: Inflation-output trade-off through the lens of a simple loss function



Notes: The chart shows the value of the policymaker's simple loss function evaluated for different constellations of the inflation and output gap path generated by the February 2026 MPR forecast and the two scenarios for the energy shock with and without the monetary policy response, and for different weights λ on output stabilisation. The colours correspond to the paths in **Chart 14**.

[4] See **Annex 2 of the February 2026 MPR** and the technical paper by **Alati et al (2025)**.

So, what is the best policy choice?

It isn't obvious. But it clearly depends on λ. The $\lambda = 0$ "inflation nutter" would obviously *raise the rate path relative to F26*, putting no weight on output costs. A path like the orange here might be one such option, or they might want to hike even further.

Conversely, if we do the math, a policymaker with a higher value of $\lambda = 0.5$ may actually do the opposite and want to *lower the rate path relative to F26*, putting a higher weight on the output costs.

And if we compute all of the hypothetical costs for all λ in the plausible range $[0, 0.5]$ then what we get is shown in **Chart 15**. First, intuitively, since the orange and purple lines are above the aqua everywhere, the situation with the energy shock is a strictly worse one than the one we thought we were going to be in. So far so obvious. Second, a low-λ policymaker, that is one that places more weight on inflation, would generally prefer the orange world to the purple and vice versa.

Third, and what is interesting here is that the trade-off becomes *perfectly balanced* when $\lambda = 0.26$ describes the preferences of the policymaker. It turns out, quite coincidentally, that in the configuration we find ourselves in today, given the starting position, and given this model, this type of policymaker is indifferent between the two alternative policy paths. And this preference parameter is at almost exactly the reference level at the Bank corresponding to recent MPC reaction functions.

Finally, don't read too much into one simple experiment. In the above argument, that reference policymaker has complete indifference between the two policies. But in the real world, the economy may evolve differently.

If inflation came in worse, or concerns emerged about that risk via expectations un-anchoring, the policymaker might prefer the path of holding for longer (or, if bad enough, even hiking). In contrast, if those risks were low, and economic activity suddenly worsened, or signals suggested an elevated risk of such a downturn, the policymaker would want to be on the F26 path (or, if bad enough, cutting harder and faster, even below neutral). Put another way, either the circumstances or λ itself could change – or both.

The only thing that is sure is that there are tough times ahead. We are heading into trade-off territory, the shock is non-negligible, and the task of calibrating policy is going to be difficult and potentially finely balanced.

3. What does this mean for the policy outlook?

What can we take away from these various quantitative experiments?

They are a first look at the analytical challenges we will be facing in the weeks and months to come, a mere sketch of the implications of different scenarios, even when the exact trajectory we will be up against remains quite uncertain.

But the central macroeconomic message of the above analysis is not all that new.

Recall that, as we saw earlier, in Sterling terms, the real price of oil has in fact been on a fairly level trajectory since 1980, despite some volatility, and so the relative price of oil against CPI has been mean-reverting (**Chart 11**). Now think back to a very influential paper that is now essential reading.

In 'Systematic monetary policy and the effects of oil price shocks', **Bernanke, Gertler, and Watson (1997)** argued that, in the United States, much of the economic damage typically attributed to oil price shocks actually comes from the Federal Reserve's systematic tightening of monetary policy in response to those shocks – not from the oil price increases themselves. Their VAR-based decomposition showed that recessions following oil spikes are largely policy-driven rather than mechanically caused by energy costs.

Hence the Bernanke et al. paper serves as one of the foundations for the view that monetary policy, for the most part, can do little to address short-run mean-reverting energy shocks. And, hence, given the lags in the transmission mechanism, that it is better to look through the shock given the unpleasant trade-off.

Why do I bring up the Bernanke et al. paper? Because one can see echoes of its main message in the mathematics of the trade-off calculations we just explored. Under the baseline we really don't gain from taking any dramatic action. But the prevailing uncertainty means that one cannot be sure of the path ahead.

What does this mean for the MPC's policy strategy going forward?

Before the recent Middle East developments, inflation was nearly at target and slack emergent, supporting the case for rate cuts and a swift move to neutral. However, an energy shock now complicates the policy outlook.

In light of the analysis that I have presented, let me briefly comment on **last week's MPC decision**, which was a unanimous vote to hold. I believe the unanimity of the vote and the tone of the collective communications properly emphasise two important factors.

First, our need to get more information about the shock before making any big changes in our policy strategy. For now, we are on hold, as the Governor has emphasised.

Second, our collective focus on ensuring that inflation returns sustainably to the 2% target in the medium term. This is the key objective in our mandate.

In my own paragraph, I then went on to emphasise what I see as the two main possibilities that will soon come into focus for us in regard to the direction we next take.

If the shock is relatively mild, as it was in 2011, or short-lived, inflation will rise briefly before easing, with little medium-term impact. This could allow for more rate cuts once risks diminish.

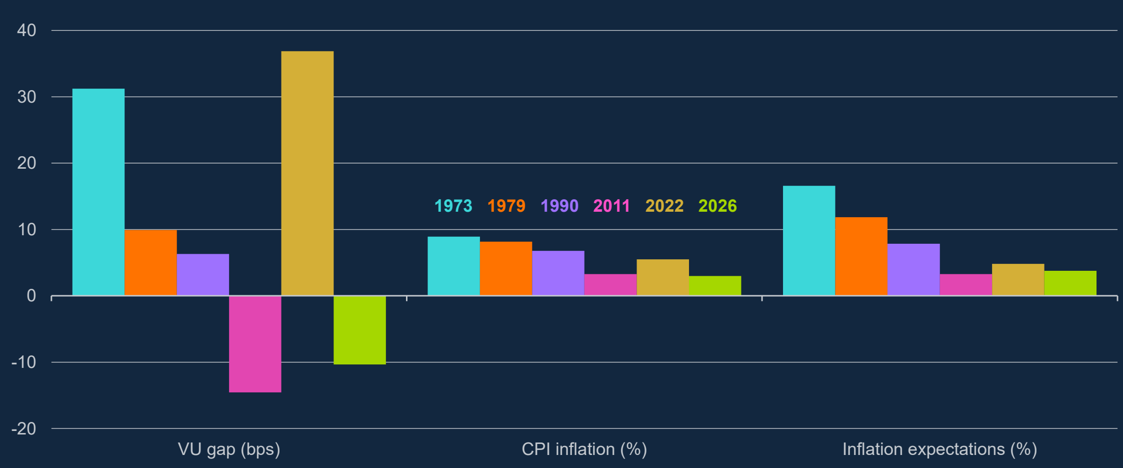
If disruptions persist and the shock grows, the MPC will face a tougher choice between high inflation and weaker growth. The rate path will depend on the trade-off, and on whether risks of de-anchoring come into play.

Given massive uncertainty around future energy prices, and our starting point, I currently see a high bar to hiking. Holding policy steady is preferable until the impact becomes clearer.

Our latest decision should not be seen as a shift in direction; the current circumstances suggest that little change is needed at this stage. The UK faces low risks of inflation becoming unanchored, with a small shock thus far (in the grand scheme of things), a weakening labour market, and slowing wage growth. As such, it is much more like the 2011 when the labour market was similarly slack following the Global Financial Crisis (pink bars in **Chart 16**) and inflation expectations were low. We are clearly not in 1973 or any of the other inflationary episodes in the chart. The situation therefore also differs markedly from 2022, when both energy and food prices surged more, and the economy had excess demand and a tight labour market. Staff estimates suggest a 1 ¼ percentage point increase in headline inflation in Q3 from direct effects and uncertain knock-on effects (via indirect and second-round effects) after that, which is much more like 2011 than 2022.

Chart 16: Initial conditions of historical energy price shocks

Basis points and percent year-on-year



Notes: The chart shows macroeconomic conditions prevalent at the onset of different energy price shocks. The three panels show the vacancies-to-unemployment ratio relative to its equilibrium level (**Stelmach et al., 2025**, see **Chart 3**), realised CPI inflation, and 1-year ahead household inflation expectations (see **Chart 7**), respectively, for September 1973, January 1979, July 1990, November 2010, January 2022, and January 2026.

To reiterate, monetary policy is not well suited to address sudden energy shocks, which are unpredictable and outside policymakers' control. Intervention is only warranted if a large shock threatens to destabilise inflation expectations; otherwise, policy should focus on medium-term inflation targets, accommodating necessary price level adjustments.

Conclusions

The Bank of England faces a complex and evolving set of policy challenges as it seeks to return inflation to its 2% target while supporting economic stability. The most recent global energy price shock reminds us of the magnitude of that task.

But this is not news. The last two decades have thrown many economic shocks at us, the economy has suffered and the challenge for policymakers has been acute. Recent events only go to show that this relentless pressure is not over yet, and that the stresses facing the global economy have not yet abated.

I have tried to summarise the key challenges in these moments. We obviously cannot afford to be distracted by things outside our core mandate, especially at a time like this. Maintaining credibility and anchoring expectations is essential, but it is more difficult in an environment of larger and more frequent inflation shocks. Calibrating policy and holding steady in the wake of those shocks is hard with slow-moving wage and service price pressures. The growth-inflation trade-off has also recently become more acute, complicating matters further. And by their nature, geopolitical and energy price shocks, which have been the biggest threat to price and macroeconomic stability in the past, now once again continue to pose risks that are largely outside the control of monetary policy.

Navigating these challenges in the current moment will require full effort and all hands on deck; it will take the full depths of our intellectual rigour and analytical capacity; it will demand attention to difficult trade-offs, policy flexibility, and clear communication.

It is for me a technocratic goal that been democratically delegated to us for a good reason, and for good ends. And one that can be best achieved through the design of an independent central bank with a credible commitment to a clear and narrow mandate, which is where exactly where the Bank sits.

While the path ahead is uncertain, the MPC's commitment to price stability remains the foundation upon which sustainable economic growth can be built.

Acknowledgements

Thanks to Lennart Brandt and Vitor Dotta for help preparing this speech, and to Raphael Abiry, Harry Austin, Andrew Bailey, Sarah Breeden, Davide Brignone, Ruslana Datsenko, David Elliott, Giulia Gardin, Emma Hatwell, Emil Iordanov, Lien Laureys, Shane Mahen, Dooho Shin, Andrea Sisko, Michal Stelmach, Anca Stoian, Ryland Thomas, and Tim Willems for their comments and help with data and analysis.