MONETARY AFFAIRS:

BOE Review: A More Hawkish MPC Remains on Hold in July, But Inflation Persistence Suggests Possible Policy Tightening if Geopolitical Tensions Continue

by

Brunello Rosa and Nato Balavadze

30 July 2026

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Executive Summary

- **Decision Made**: *The Bank of England (BoE) kept its Bank Rate at to 3.75%.* The MPC left Bank Rate unchanged at 3.75% for a fifth consecutive meeting in a 6-3 vote. Megan Greene, Catherine L. Mann, and Huw Pill dissented in favour of a 25bp hike amid concerns over inflation risks stemming from the Middle East conflict. The Committee stands ready to act to ensure inflation returns to the 2% target, while closely monitoring developments in the Middle East and their impact on global energy markets.

- **Policy Discussion**: *Although the MPC left Bank Rate unchanged at 3.75%, the shift in the vote split from 7-2 to 6-3 signalled a more hawkish Committee and growing concern over inflation persistence.* The wider dissent suggests policymakers are placing greater weight on geopolitical and energy-price risks, making the future policy path more uncertain. While the majority judged that tighter financial conditions, continued domestic disinflation, and limited evidence of second-round effects justified holding rates, three members favoured a 25bp hike, arguing that acting pre-emptively would better contain inflation expectations and reinforce policy credibility.

  The Committee delivered a highly conditional message, stressing that further tightening could be warranted if renewed Middle East tensions lead to persistently higher energy prices, particularly natural gas, and stronger second-round inflationary effects. Catherine L. Mann, who voted for a rate hike, cited the collapse of the US-Iran memorandum of understanding as a key reason for her more hawkish stance. At the same time, policymakers emphasised that a durable ceasefire and lower energy prices could allow underlying disinflation to resume, reopening the possibility of future rate cuts.

  Overall, the MPC maintained that Bank Rate remains "about the right level" to return inflation to its 2% target over the medium term. Although inflation slowed more than expected to 2.6%, members warned that higher energy prices could still feed into broader inflation. However, tighter financial conditions, including higher mortgage and borrowing costs, together with a softer labour market, were expected to restrain demand, moderate wage growth, and limit second-round inflationary pressures.

- **Changes to Economic Forecasts:** *The MPC judged that upside inflation risks continued to outweigh downside risks despite exceptionally high uncertainty.* The July Monetary Policy Report presented three scenarios, all conditioned on market pricing for two additional 25bp rate hikes by Q3 2027. In the central projection, inflation peaks at 3.2% in Q4 2026 before falling below target to 1.7% in early 2028 and returning to 1.9% by Q3 2029. GDP growth remains subdued at around 1.1% through 2027 before recovering to 1.6-1.7% in 2028-29, with energy prices gradually easing and second-round effects remaining moderate.

  The milder scenario assumes a more durable geopolitical de-escalation, with oil and gas prices 3% and 6% below the baseline, no material second-round effects, and inflation returning to 1.7% by 2028. By contrast, the adverse scenario assumes prolonged geopolitical tensions, with oil prices 30% and gas prices 60% above the baseline, pushing inflation to 4.1% in Q3 2027 while slowing GDP growth to 0.9% before a gradual recovery.

Key Assumptions and Judgements In Scenarios from July MPR

	Central projection	Milder scenario	Adverse scenario
Energy prices	Energy prices for wholesale oil and gas follow the market futures curves over the 15 UK working days to 20 July.	Energy future prices follow the paths around 1 July, capturing the lower prices after the signing of the Memorandum of Understanding (MoU).	Energy prices rise materially above the central projection and remain persistently higher over the forecast period.
Second-round effects from recent energy shock	Moderate additional second-round effects, consistent with some effect on short-term inflation expectations and hence wages. In addition, heightened attentiveness to inflation also contributes to second-round effects.	No new second-round effects from the recent energy shock, owing to weaker worker bargaining and firm pricing power. This partly reflects weaker demand, driven by a greater degree of saving than in the central projection.	Stronger and more persistent additional second-round effects relative to the central projection and milder scenario. This stems from a greater effect of the energy shock on long-run inflation expectations and hence wages and prices.

Source: [Bank of England]

Analysis

- **DECISION MADE**: *On July 30, in line with consensus, the Bank of England (BoE) held its Bank Rate at 3.75%.* The MPC voted 6-3 to hold the Bank Rate at 3.75% for a fifth consecutive meeting. While the majority judged tighter financial conditions and continued domestic disinflation sufficient to keep policy unchanged, three members (Megan Greene, Catherine L Mann and Huw Pill) supported a 25bp increase, citing the inflationary risks posed by renewed Middle East tensions and volatile energy prices. The BoE was widely expected to hold rates as policymakers weighed renewed US-Iran tensions against faster-than-expected easing in domestic price pressures.

  In terms of *forward guidance*, the Committee stands “ready to act” as needed to ensure inflation returns to the 2% target over the medium term. The Committee will closely monitor developments in the Middle East and their impact on global energy supply and prices.

  In terms of *balance sheet policy*, in September 2025, the BoE agreed to cut its government bond holdings by £70 billion (from £100 billion) over the next year, bringing the total to £488 billion. On 17 July, the stock of UK government bonds held for monetary policy purposes was £491 billion. At the next meeting, the MPC will make its decision on balance sheet policy for the following year, and a further reduction in the annual pace (perhaps to the tune of GBP 50bn) is a possibility.

- **POLICY DISCUSSION:** *While the Bank left rates unchanged, the shift from a 7-2 to a 6-3 vote highlights growing concern over inflation persistence as the wider dissent suggests policymakers are placing greater weight on geopolitical and energy-price risks, making the future policy path more uncertain.* The MPC delivered a highly conditional message, indicating that further tightening remains possible if renewed Middle East tensions lead to persistently higher energy prices, particularly for natural gas. The shift to a more hawkish 6-3 vote reflected growing concern that prolonged geopolitical instability could generate stronger second-round inflationary effects, with Catherine L. Mann explicitly citing the collapse of the US-Iran memorandum of understanding as a key factor behind her decision to support a rate hike.

However, policymakers also stressed that the outlook remains highly dependent on geopolitical developments. A durable ceasefire and a sustained decline in oil and gas prices could allow underlying disinflation to resume, reopening the possibility of rate cuts if domestic inflationary pressures continue to ease.

The Committee judged that Bank Rate remains "about the right level" to return inflation to the 2% target over the medium term. While inflation eased more than expected to 2.6%, policymakers warned that higher energy prices resulting from the Middle East conflict could feed through into broader price pressures. They also noted that tighter financial conditions, including higher mortgage and borrowing costs, were already weighing on demand, while a softer labour market, with job seekers outnumbering vacancies, should help contain wage growth and limit second-round inflationary effects.

The MPC voted 6-3 to keep Bank Rate unchanged at 3.75%. The majority of the Committee argued that tighter financial conditions, continued domestic disinflation, and limited evidence of second-round effects provided sufficient justification to leave policy unchanged while monitoring incoming data. Although members acknowledged significant upside risks from higher energy prices and geopolitical uncertainty, they viewed the current policy stance as restrictive enough to respond should inflation persistence strengthen. They also noted that further easing could resume if geopolitical risks faded and underlying disinflation continued.

The three dissenting members favoured a 25 bps rate increase, arguing that persistent above-target inflation, renewed energy price shocks, and the risk of second-round effects warranted a more pre-emptive response. They maintained that acting early would be less costly than allowing inflation persistence to become entrenched and would reinforce the Bank's inflation-fighting credibility

- **CHANGES TO ECONOMIC FORECASTS**: *The Committee judged that upside inflation risks outweighed downside risks, although uncertainty remained exceptionally high.* Its central forecast assumed moderate second-round effects, while alternative scenarios ranged from persistent geopolitical tensions and stronger inflationary pressures to a more durable de-escalation, lower energy prices, and weaker demand.

The July MPR presented three scenarios, all conditioned on market pricing for two additional 25bp rate hikes by Q3 2027. **Under the central projection**, inflation peaks at 3.2% in Q4 2026 before gradually falling below target to 1.7% in Q1 2028 and returning to 1.9% by Q3 2029. GDP growth remains subdued at 1.1% through 2027 before strengthening to around 1.6–1.7% in 2028–29. The forecast assumes Brent crude declines from around $76/bbl to $71/bbl by the end of the forecast horizon, UK natural gas prices fall from just over 123p/therm to below 60p/therm, and second-round inflation effects remain moderate.

The milder scenario assumes oil and gas prices around 3% and 6% lower than the baseline, respectively, with no material second-round effects as weaker demand and a looser labour market contain wage and price pressures. Inflation peaks at 2.7% in Q4 2026 and falls to 1.7% by 2028, while GDP growth stabilises at around 1.6%.

The adverse scenario assumes prolonged geopolitical tensions, with oil prices averaging 30% above the baseline and gas prices around 60% higher. Inflation rises to 4.1% in Q3 2027 and remains elevated at 2.4% by Q3 2029, while GDP growth slows to 0.9% in 2027 before gradually recovering. The scenario also assumes stronger and more persistent second-round effects driven by elevated inflation expectations.

- **OUR TAKE:** *In our central scenario*, the BoE will remain on hold until year-end. However, if the conflict in the Middle East were to cause a new wave of higher energy prices, with an increased possibility of second round effects, and the risk of persistent inflation, we could see the MPC increasing rates in 2026, possibly a couple of times.

- **MARKET REACTION AND IMPLICATIONS**: *Markets reacted modestly to the decision.* The UK 2-year gilt yield, which is highly sensitive to monetary policy expectations, fell around 7bps to 4.38%, suggesting investors viewed the decision as slightly less hawkish than feared. At the time of the writing, 2-year gilt yield trades around 4.34%. The 10-year gilt yield also fell and at the time of the writing trades around 5.00%. *In the currency space,* the Sterling edged up 0.1% to around $1.339. *In the equity space,* market reaction was broadly positive. The FTSE 100 rose 0.40%, while the DAX and CAC 40 gained 0.25% and 0.96%, respectively.

Rosa & Roubini Associates Ltd is a private limited company registered in England and Wales (Registration number: 10975116) with registered office at 75 King William Steet, London EC4N 7BE, United Kingdom.

For information about Rosa&Roubini Associates, please send an email to info@rosa-roubini-associates.com or call +44 (0)20 7101 0718.

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