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Hormuz Shock: War, Inflation and the Central Banks' Dilemma

How the ECB, Fed and BoE reaction functions differ under three scenarios

- Key policy question for central banks is not the peak in Brent, but whether higher delivered energy costs — via gas, freight, insurance and physical disruption — persist long enough to entrench inflation
- Our baseline is a negotiated reopening with persistent friction: crude may retrace, but slow normalisation in flows should keep gas and freight costs sticky and inflation above target for longer
- The shock transmits through three channels — direct energy effects, indirect pass-through and second-round effects — with the first fully open, the second building and the third not yet apparent
- ECB is the most constrained: high energy exposure and a heightened concern for its credibility after the 2021–22 inflation overshoot leave it least able to look through the shock, even as fragmentation risks complicate how far tightening can go
- Fed has the most room to look through the shock as the US is less exposed to Hormuz, but tariffs complicate things by adding a second supply-side inflation impulse
- BoE sits between the two: the Q3 regulatory energy price reset creates a mechanical inflation step-up, while sticky services inflation leaves the UK more exposed to second-round risks than the euro area or the US

Introduction

The market continues to trade the US-Iran conflict as a series of binary geopolitical headlines — escalation versus de-escalation, closure of the Strait of Hormuz versus reopening. But for central banks, the relevant question is not the peak in Brent or the timing of any ceasefire, but whether delivered energy costs — incorporating gas, freight, insurance and physical frictions — remain elevated for long enough to shift inflation from a temporary relative-price shock into a broader and more persistent process.

That distinction between peak and duration is already visible in the data. Crude prices have repeatedly retraced on headlines about the ceasefire and progress in talks, while the increase in European gas prices

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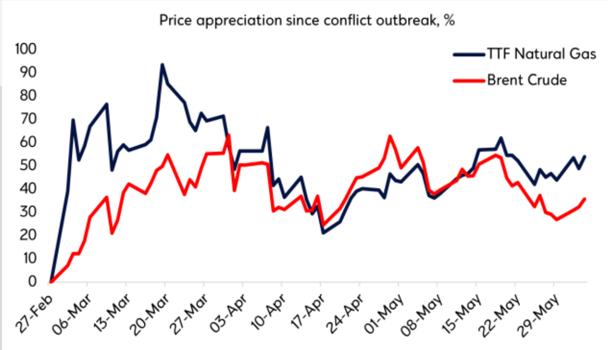
and freight costs have remained more persistent, pointing to a decoupling between headline oil and delivered energy costs. At the same time, the direct impact on headline inflation in the euro area and the UK is evident, while survey indicators suggest that indirect pass-through is building.

Figure 1: Beyond Brent, higher natural gas prices better reflect shortages faced in Europe



Source: Bloomberg, Eurobank Research

Against that backdrop, central banks are increasingly framing the shock not as a transient disruption but as a potentially persistent supply-side squeeze, with implications that depend on duration, institutional settings and the impact on inflation expectations. Rather than how high energy prices go, the key question is whether they will stay elevated for long enough to alter price-setting behaviour and anchor monetary policy at a more restrictive stance.

Three scenarios

We frame the outlook through three scenarios that differ primarily in the duration and degree of physical disruption instead of how high oil prices spike. At the core is a baseline of negotiated reopening of the Hormuz with persistent friction, where physical constraints and residual risk premia keep delivered energy costs elevated even as headline crude prices partially retrace. Around this, we consider a more adverse scenario of prolonged or partial closure and a tail scenario of full re-escalation of the conflict and prolonged closure, each implying progressively stronger and more persistent inflationary pressures.

We focus on the European Central Bank, the Federal Reserve and the Bank of England because they face the same energy shock with sharply different exposures — from the gas-dependent euro area to the largely insulated US. Japan, a large net energy importer, is highly exposed to the shock, but the Bank of Japan has been normalising monetary policy from an ultra-easy stance after a decades-long fight against deflation, putting it out of sync with other developed economy central banks. China runs a managed regime with administered energy prices, and most emerging-market central banks are responding through the exchange rate.

Across these scenarios, the key differentiator is how far the initial energy shock travels through three channels: the direct hit to headline inflation via fuel and power, the indirect pass-through into the costs of other goods and services, and the second-round effects on wages and inflation expectations. In the baseline case, pass-through remains incomplete but persistent enough to keep central banks in a tightening bias. In the more adverse scenarios, the risk shifts decisively toward broader inflation persistence, with policy trade-offs becoming more acute, particularly for the ECB and the BoE.

Table 1: Outline of three scenarios and their macroeconomic and policy implications

Scenario	Physical and market setup	Macro and policy implication
1. **Baseline scenario**: Negotiated reopening with persistent friction	The US and Iran reach some kind of deal, and the Strait of Hormuz reopens to traffic, but flows normalise only gradually. Inspections, tolls, war-risk insurance, vessel queues, mine clearance and Qatari LNG capacity loss keep delivered energy costs elevated. Brent retraces partially; TTF and freight remain sticky.	Headline inflation peaks in late 2026 but remains above target into 2027. The increase in core is limited to only the accumulated indirect pass-through, not second-round effects on wages and expectations. The ECB and BoE retain a tightening bias as inflation stays above target, while the Fed faces a sharper dual-mandate trade-off and responds more cautiously.
2. **Adverse scenario**: Prolonged closure or partial closure	No durable agreement; ceasefires repeatedly fray and transit remains materially impaired for months. Strategic reserves continue to be drawn down, while rerouting via Saudi and UAE pipelines absorbs only a fraction of pre-conflict crude flows and still leaves a residual gap. Insurance premia, security checks, longer voyage times and intermittent port disruption keep freight costs elevated, and there is no pipeline alternative for LNG, leaving European gas markets more exposed.	Energy prices stay elevated and this broadens into core inflation. Second-round risks crystallise where labour markets are tight and indexation is present. Stagflation dynamics intensify in the euro area and UK. The ECB and BoE retain a tightening bias for longer despite weakening growth. The Fed prioritises inflation expectations initially but turns more data dependent as activity softens.
3. **Severe adverse scenario**: Re-escalation to full closure or wider conflict	Renewed military action, infrastructure damage or regional spillover causes full closure and a further leg up in risk premia. Attacks on Saudi or UAE export infrastructure remove the pipeline workaround, while shipping availability drops as insurers withdraw cover and tanker operators avoid the route. Disruptions affecting LNG, refined products and petrochemicals deepen further, with restocking demand, precautionary hoarding and thinner inventories amplifying price volatility.	A further energy spike, dollar funding tightening and EM importer FX pressure. Sharper demand destruction highlights the central banks' acute inflation-versus-stability trade-off: the ECB and BoE would likely tighten only cautiously, pairing any rate action with liquidity backstops should funding strains emerge, while the Fed would prioritise market functioning and funding stability first and tolerate a slower return of inflation to target.

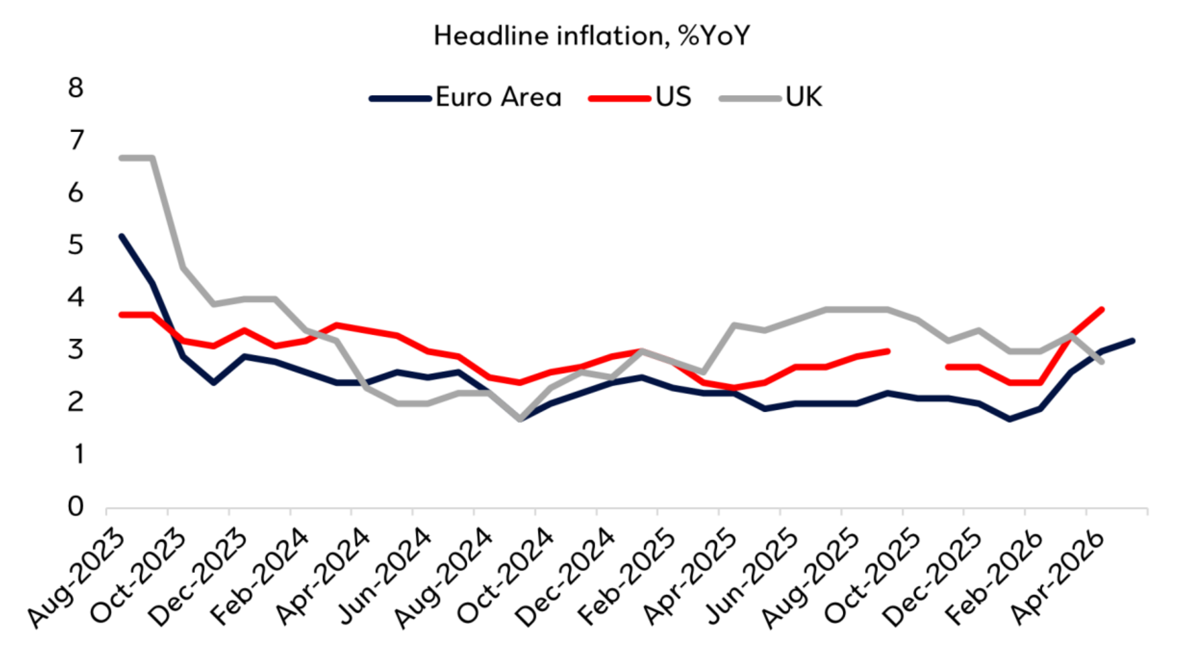
Where we are now

The current data place the shock at the upper boundary of a prolonged-disruption episode, with a tentative diplomatic path now opening. Brent closed at $72.48/bbl on the eve of the 28 February strike on Iran; it then surged to a closing high of $118.35/bbl on 31 March, retraced through mid-April and pushed back above $112 in mid-May as diplomatic progress stalled. On 25 May, Brent sold off sharply, by 7.2% to $96.14/bbl, on reports of a US-Iran ceasefire framework, and has traded in a $92-99/bbl range since then. The price path therefore describes three phases: the initial supply-shock rally, a mid-April correction, and a renewed bid into May reversing on deal signals.

Brent's moves, though, are largely headline-driven; the more informative signal for European inflation is how the European gas benchmark has behaved relative to crude. TTF traded mostly in a €30–35/MWh range pre-conflict, briefly spiked to an intraday high above €68/MWh on March 19, and has since held a €39–52/MWh range. Gas spiked far harder than crude at the outset, running well ahead of Brent through March. The two then moved broadly together through the spring before parting on the de-escalation: when Brent sold off on the late-May ceasefire framework, gas held firmer, leaving its appreciation well above crude's by month-end. The split reflects what each market is pricing: gas the unresolved Qatari LNG outage — which has no pipeline route around the strait — and lower EU reserves relative to previous years, crude the diplomacy. The oil retreat is a fading risk premium, not restored supply.

The pass-through to consumer prices is already visible in Europe. Euro area inflation, running at an average 1.8%YoY in January-February, accelerated to 3.2%YoY in May, a clean break above target. UK CPI growth entered the episode above target at 3.0%YoY in January and February and rose to 3.3%YoY in March, before it decelerated to 2.8%YoY in April, reflecting base effects and an energy price cap rather than easing pressure. Survey measures, meanwhile, point to the indirect channel starting to build, even if it has yet to feed clearly into core — a dynamic we examine in the next section.

Figure 2: The direct effects of the energy shock have already led to an acceleration in headline inflation



Source: Eurostat, BLS, ONS, Bloomberg, Eurobank Research

The US entered the shock both more resilient and more insulated. Activity rebounded in Q1, with real GDP growth of 1.6%QoQ (saar) after a shutdown-depressed 0.5%QoQ (saar) the previous quarter, supported by continued AI-related capital spending, even as consumer spending moderated. The labour market is cooling but still robust, with unemployment at 4.3% just above the Fed's estimate of neutral. The six-month average pace of payroll gains rose to 68k in April, its strongest pace since July 2025. On the physical side, US exposure to Hormuz is limited — direct crude imports from the Gulf through the strait run at only about 0.5 mb/d — so the shock reaches the US mainly through global prices rather than supply availability. The complication is that it lands on top of a pre-existing tariff-driven goods-price impulse, leaving the Fed facing a dual supply shock that is harder to read than either alone.

The demand side of the Hormuz crude trade, by contrast, sits overwhelmingly in Asia – China and India combined took about 44% of crude transiting the strait in 2025 – so much of the marginal price-setting runs through Asian importers. For energy-importing emerging markets more broadly the channel is financial as well as physical, since a stronger dollar and higher import bills tighten conditions directly.

Three constraints hamper any reopening, regardless of the diplomatic path. Mine clearance is measured in months: a Pentagon assessment reportedly estimates six months to fully clear the strait, and the IEA judges that trade flows would take a further two to three months to normalise thereafter. The Ras Laffan LNG hub sustained damage, with QatarEnergy invoking force majeure on contracted cargoes; Italy's Edison expects to receive around two-thirds of contracted volumes only within 30–45 days of any deal. And commercial shippers have signalled they will require an extended period of calm before resuming normal transits, with current traffic minimal. The physical path back to pre-conflict flows is therefore measured in months or quarters, not weeks. A deal framework would shift the scenario distribution, but the friction in our baseline has now become structural, not merely diplomatic.

Inflation pass-through effects

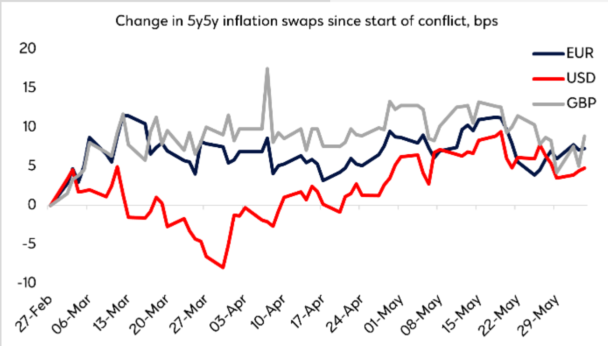
The relevant question for monetary policy is how far the energy shock travels beyond headline inflation. As noted earlier we frame transmission through three channels: direct, indirect and second-round.

The direct channel — energy feeding immediately into headline inflation via fuel, gas and electricity — is fully open. Euro area energy HICP swung from a 3.1%YoY decrease in February to a 10.9%YoY jump in May; UK energy changes moved from -1.0%YoY to +7.1%YoY over the same period. The smaller UK print reflects the energy regulator Ofgem's price cap, which defers wholesale pass-through to the quarterly reset and concentrates the adjustment into the July–October window. Exposure differs: the energy weight in HICP is around 9.5% in the euro area against roughly 5.8% in the UK. The US, where the energy weight before the Hormuz shock was about 6.4%, benefits from the offset of domestic production. Even so, energy prices have surged since the crisis, rising 17.5%YoY in April having been more or less flat in the first two months of the year. Food is a secondary direct channel, operating through fertiliser and distribution costs, and has so far remained contained — consistent with typical three-to-six-month lags, making Q3 data the test.

The indirect channel — energy entering the production costs of non-energy goods and services — is building but has not peaked. Euro area services inflation eased to 3.0%YoY in April from 3.4%YoY in February and UK core CPI to 2.5%YoY from 3.2%YoY, so the channel has not yet overwhelmed the pre-existing disinflation trend. In the US, headline CPI growth reached 3.8%YoY in April against a 2.4%YoY January–February average, while core inflation rose more moderately to 2.8%YoY. The widening headline-core gap shows the direct channel dominating so far, but firm April PPI (+6.0%YoY) and import price growth (+4.2%YoY) point to upstream cost pressure that raises the risk of further pass-through to core. A key analytical assumption is asymmetry: euro area pass-through to core was large and persistent in the 2021–2023 episode, and much less significant in the US. The indirect channel might therefore be expected to build more substantially in the euro area and UK than in the US. The FX channel, historically an amplifier for European importers, has been muted: EUR/USD has held a 1.14–1.18 range and GBP/USD 1.32–1.36, providing neither amplification of the shock nor a disinflationary cushion.

The second-round channel — headline inflation feeding wage demands, services prices and expectations — remains the open question. Wage data are so far suggesting squeezed incomes rather than feeding a wage-price spiral: US average hourly earnings growth decelerated to 3.6%YoY in the first four months of the year from an average of 4% in 2025, running below headline inflation. In the UK, BoE officials have said that second-round effects are less likely than in 2022. Long-run inflation expectations give the cleanest read, and what matters is both the move during the shock and the level it sits at. The good news for all three central banks is that the shock has not yet led to any additional de-anchoring. The 5y5y inflation swap rate is the gauge that policy makers use, and the US, euro area and UK rates all stand just 6-8bps higher than on February 27, with the UK swap having risen the most in this period – by 18bps on April 7.

Figure 3: Long-term inflation swaps, a market-based expectations metric, are anchored for now



Source: Bloomberg, Eurobank Research

However, while this indicator has barely moved in any of the three cases, they each have a different starting point. For the UK, which came into the crisis with a pre-existing services-inflation problem, the 5y5y swap rate stands at 3.11%, suggesting this is where the second-round risks are sharpest. The euro area swap, at around 2.15%, sits close to target but leaves the ECB little margin, given how protective it is of its credibility after the 2021–22 overshoot, while the US, at 2.44% and with the most insulated economy of the three, has the widest buffer — so the ranking of second-round risk runs UK, then euro area, then US, even though none has yet de-anchored.

Central bank reaction functions

All three central banks entered the conflict on an easing path that the shock has now interrupted — though the ECB had arguably already reached its terminal rate, having previously cut interest rates more aggressively than the other two. The ECB deposit rate has stood at 2% since June 2025, when it made the last of eight 25bps cuts of an easing cycle that began in June 2024, with the rate standing at 4%. The target range for Fed funds rate is at 3.50-3.75% after 75bp of cuts in late 2025, coming after a long pause in the easing cycle that began in September 2024 as the Fed weighed the inflationary impact of tariff increases. The BoE also began its easing cycle in the second half of 2024, from a starting point of 5.25% and until this year maintained a rough quarter pace of cuts – slower than the ECB and the Fed during their respective easing bursts – bringing the base rate down to 3.75% by December 2025. Market pricing has since moved sharply towards tightening across all three central banks, though to very different degrees.

Table 2: Summary of central banks' effective rates and market implied paths

Central bank	Effective rate (on June 3)	Next meeting (hike prob.)	Implied rate, Dec 2026	Cumulative move priced
ECB	1.93%	11 Jun 2026 (97%)	2.61%	+68bp
BoE	3.73%	18 Jun 2026 (6.4%)	4.22%	+48bp
Fed	3.62%	17 Jun 2026 (1.4%)	3.83%	+21bp

The divergence in near-term hike probability — an ECB hike is almost fully priced in by markets for June at an implied probability of 97%, 6.4% for the BoE and just 1.4% for the Fed — is instructive. It reflects three different reaction functions: the ECB constrained by credibility, the BoE data-dependent and cautious and the Fed holding a look-through posture.

ECB: Credibility-constrained

The euro area carries the highest direct energy exposure of the three regions, the 2021–22 episode, when the ECB was slow to tighten, has left policymakers protective of their credibility, and the fragmentation constraint — the risk that tightening widens peripheral spreads — creates a two-sided problem neither the Fed nor the BoE faces in the same form. Of course, a more sluggish economy compared with the US meant that disinflation from that episode proceeded more quickly, which is why the ECB is now starting from a lower interest rate. Governing Council communication has converged on the direction of travel: Lagarde has confirmed the central bank's inflation projections will likely be revised upward in June, and a range of members from Kocher to the more dovish Stournaras have signalled that a June hike is likely, with most framing it as a credibility signal rather than the start of a sustained cycle. The Italy–Germany 10-year spread, at around 72bps, is not currently alarming, but in the most adverse scenario a tightening ECB facing member states with weakening fiscal positions could need to invoke tools like the Transmission Protection Instrument to prevent fragmentation from constraining policy.

In the baseline, the ECB delivers a 25bp hike in June and another in the autumn, before moving to a data-dependent hold, watching whether the indirect channel builds into core. Headline inflation peaks in late 2026 and recedes only slowly, eventually coming close to the ECB's target at the end of 2027, so the hold carries a tightening rather than an easing bias. The terminal rate in this scenario is 2.50%-2.75%.

In the adverse scenario, energy costs stay elevated and feed more durably into core, and the ECB extends the cycle with further hikes through the autumn, to 2.75–3.00%. Fragmentation is a live concern, but the central bank's crisis-fighting toolkit, developed during the euro crisis and pandemic shock, means that the credible promise of intervention keeps peripheral spreads contained, without the need for the ECB to invoke the TPI.

In the severe adverse scenario, the calculus inverts. The same spike that lifts inflation also destroys demand as real incomes are squeezed, while an acute risk to financial stability — sharply wider spreads, possible funding strains — comes to the fore. The ECB would likely pause after at most a token hike, with the deposit rate peaking at 2.25%. However, since the severe adverse scenario could initially look similar to the adverse scenario, there is a danger that the central bank could initially tighten too aggressively. Here, the TPI could come into play if sovereign spreads widened sharply, and a shock that tipped into a credit crunch might draw the ECB towards liquidity operations such as TLTROs, or even QE — making the balance sheet, rather than the policy rate, its primary instrument.

Fed: Look-through, with the tariff complication

The Fed sits at the look-through end of the spectrum. The US is structurally the least energy-import-exposed of the three, market measures of long-run inflation expectations have barely moved and the pass-through from oil shocks in recent decades to core inflation is modest. Slightly complicating the picture is the stance of the new Fed chair. Kevin Warsh took the helm after echoing President Trump's call for lower interest rates, but in a recent speech he cited the risks of inflation expectations becoming unanchored as a decisive consideration. The other complication is the tariff overlay: the energy shock is landing on top of a pre-existing tariff-driven goods price impulse, creating a dual supply shock that is harder to look through than either alone.

In the baseline, the Fed holds the federal funds rate unchanged at 3.50-3.75% in the coming months. With the energy shock landing on top of the tariff impulse, the risk that inflation expectations drift is Warsh's stated preoccupation, so the hold is a hawkish one, with a 25bp hike possible in December if core fails to decelerate; the terminal rate is 3.75–4.00%. Headline inflation, already running above core, stays elevated for longer than the Fed would like even as the direct effect fades.

In the adverse scenario, sustained energy price inflation broadens into core and the Fed pivots to a tightening bias by Q3, delivering one to two hikes to 4.00–4.25% — tightening into a slowing economy, with a divided FOMC and elevated policy-error risk.

In the severe adverse scenario, the priority shifts from inflation to market functioning. Demand destruction from the price spike drags on activity even as headline inflation jumps, and dollar funding stress becomes the binding concern: liquidity provision via swap lines and repo facilities takes precedence over rate action, and the funds rate could end 2026 below its current level if financial conditions tighten sharply. However, the risk of a policy error is high, as with the ECB, since difficulty of telling a prolonged closure apart from full re-escalation early on could push the Fed to move sooner and harder with more tightening than is desirable.

One caveat in the more adverse scenarios is that we assume the Fed would prioritise market functioning and dollar funding stability, even at the cost of tolerating a slower return of inflation to target. However, that assumption is subject to some degree of institutional risk under a Warsh Fed who has long criticised the central bank's post-GFC reliance on QE, large-scale balance-sheet expansion and emergency-era interventions, arguing for a smaller central-bank footprint and a narrower mandate. A full Hormuz closure would therefore test the tension between crisis pragmatism and Warsh's prior doctrine.

BoE: Between the two, with services persistence

The BoE sits between the two, in the most analytically complex position. The UK carries a pre-existing services inflation problem, a deferred energy cap shock arriving in the July Ofgem reset, and a labour market that is weakening, with unemployment having risen to 5.0% and wage growth slowing. MPC member Alan Taylor's May 21 communication defines the current reaction function: an extended hold could suffice if second-round effects do not materialise, only the most pessimistic scenario clearly justifies hikes and there will be no clear wage signal until later in the year. This stance explains why markets retreated from pricing three hikes in April to just one in May, before creeping back up to almost two by 3 June.

In the baseline, the BoE stays put on rates in June, with the July cap reset the critical decision point. Because the reset mechanically lifts headline inflation back towards 4%, the question is whether that step feeds into services and wages; if it does, the MPC pivots to a tightening bias and delivers one hike in Q3, with a high likelihood of another in Q4, for a terminal rate of 4.00–4.25%.

In the adverse scenario, second-round risks crystallise and the BoE delivers two to three hikes to 4.25–4.50%, tightening into a softening labour market — the most acute stagflationary dynamic of the three, since the UK pairs the cap-driven step up in inflation with the weakest growth backdrop.

In the severe adverse scenario the BoE, like the ECB, would tighten only cautiously — at most a token hike, with the base rate peaking around 4.00% or below — as demand destruction and financial-stability concerns take over, pairing any action with the liquidity facilities (such as its short-term repo operations) that address funding strains rather than the inflation impulse itself. Here too the early indistinguishability of the two adverse paths risks making the initial response more hawkish than the terminal rate suggests.

Table 3: ECB, Fed and BoE reactions under the three different scenarios

Scenario	ECB terminal rate	Fed terminal rate	BoE terminal rate	Key differentiator
1. Baseline	2.50–2.75%	3.75–4.00%	4.00–4.25%	ECB credibility signal; Fed look-through; BoE cap-driven lag
2. Adverse	2.75–3.00% (fragmentation risks contained)	4.00–4.25% (divided FOMC)	4.25–4.50% (MPC split)	Stagflation dynamics; ECB fragmentation; BoE services persistence
3. Severe adverse	≤2.25% (possible TPI + TLTROs/QE if credit strains)	≤3.75% (stability first)	≤4.00% (liquidity backstops)	Financial stability and demand destruction dominate; balance sheet over rate; risk of policy errors

Conclusion

For all three central banks, the question is not the peak in energy prices but the persistence of delivered costs — and on that, the physical constraints point to a shock measured in quarters. The reaction functions then diverge by the room each bank has to look through it.

The ECB's reaction function is the most constrained: it must hike to preserve credibility while managing fragmentation and has the least room to look through the shock given energy exposure and the 2021–22 precedent. The Fed has the most room to look through, but the tariff overlay makes that look-through conditional rather than unconditional. The BoE sits between, with the deferred cap shock threatening to lift headline inflation in Q3 even as demand softens, potentially forcing the MPC's hand. Only in the severe adverse scenario do all three converge — financial stability first, rate action secondary — though the instrument mix still differs.

For now, though, the baseline is common to all three: headline inflation past its peak but sticky above target, and policy held tighter, for longer, than markets priced before the strait closed.

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