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Why raise interest rates when the problem is expensive energy?

How rising energy costs complicate the balance between inflation and growth



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Why raise interest rates when the problem is expensive energy?

By Abhinav Goyal | 7 min read

When energy becomes more expensive, raising interest rates might seem like an unusual response. Higher borrowing costs do not directly lower global oil and gas prices or reverse the immediate increase in electricity costs. Yet central banks may still choose to raise rates, even as households and businesses struggle with rising energy bills.

On 5 November 2026, the Bank of England raised its benchmark interest rate, which influences borrowing costs across the UK economy, from 3.75% to 4%. Eight of its nine Monetary Policy Committee members supported the increase, while one favored a larger rise. UK inflation had reached 3.5% in September 2026, and the Bank of England projected that it would approach 5% by mid-2027. Economic activity had also proved stronger than expected, raising concerns that the effects of expensive energy could spread more widely. But if higher energy costs were already squeezing businesses and households, why make borrowing also expensive?

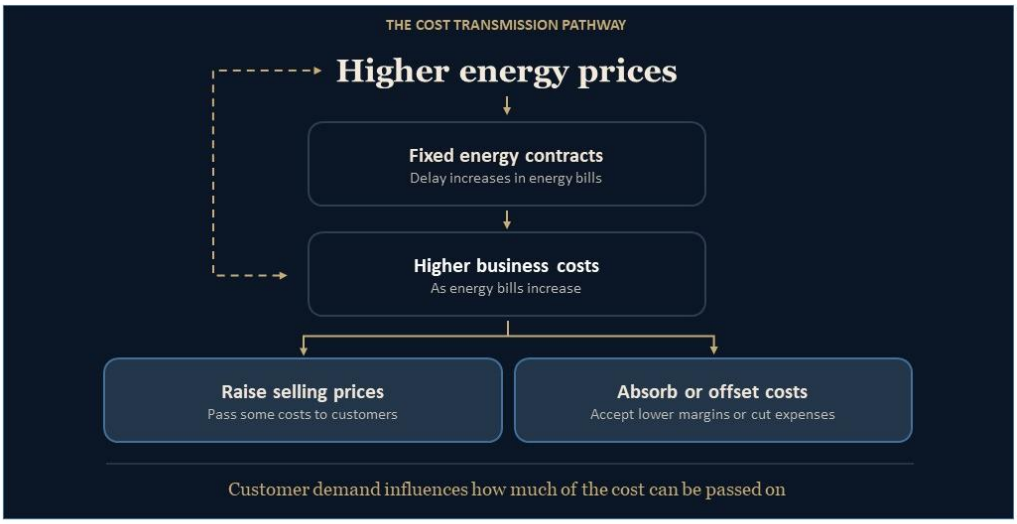
The timing of these pressures matters just as much as their scale. What happens when higher borrowing costs begin affecting customers before businesses face the full increase in energy bills? Drawing on UK manufacturing data, business surveys and an illustrative financial scenario, this article examines how these pressures could affect prices, profits and employment, and what they mean for the Bank of England's balancing act between inflation and growth.

Why make borrowing expensive when energy already is?

Consider a bakery whose electricity contract is about to expire. Its ovens still need power, but its customers may be unwilling or unable to pay more for bread. If the bakery's electricity bill increases, raising interest rates will not make that electricity cheaper. Instead, higher borrowing costs can discourage spending across the economy, making customers more cautious about their purchases. This may help contain inflation, but it could also make it harder for the bakery to cover its rising costs.

Bank of England's concerns extended beyond the immediate increase in energy costs. Its November 2026 assessment found that UK economic activity had been stronger than expected, supported partly by resilient consumer demand, stronger exports and investment linked to artificial intelligence. This suggested that businesses might have more room to pass rising costs on to customers, increasing the risk that inflation could remain elevated. The Bank also noted that services inflation and wage growth, both of which had previously been slowing, were showing signs that their decline was losing momentum. These developments raised concerns that businesses could continue raising prices to cover energy and labor costs, making inflation harder to control even after energy prices began to ease. The Bank therefore chose to raise interest rates to reduce this risk, while recognizing that higher borrowing costs could weaken spending and add to the pressure on businesses.

However, the effects of higher borrowing costs and rising energy prices may not reach businesses at the same time. In its November 2026 interest rate decision, Bank of England noted that benchmark two-year mortgage rates had risen by nearly half a percentage point since early September 2026. For households taking out or refinancing mortgages, higher repayments could leave less money for everyday spending. Meanwhile, some businesses were still protected from higher energy costs through fixed-price contracts or hedging arrangements. If customers begin cutting back on spending before their energy contracts renew, businesses could face higher costs just as weaker demand makes it harder to raise prices.



Source: Margarita in the Moonlight (Research & Analysis); based on Bank of England, Monetary Policy Report (November 2026)

Why higher energy costs do not always reach customers

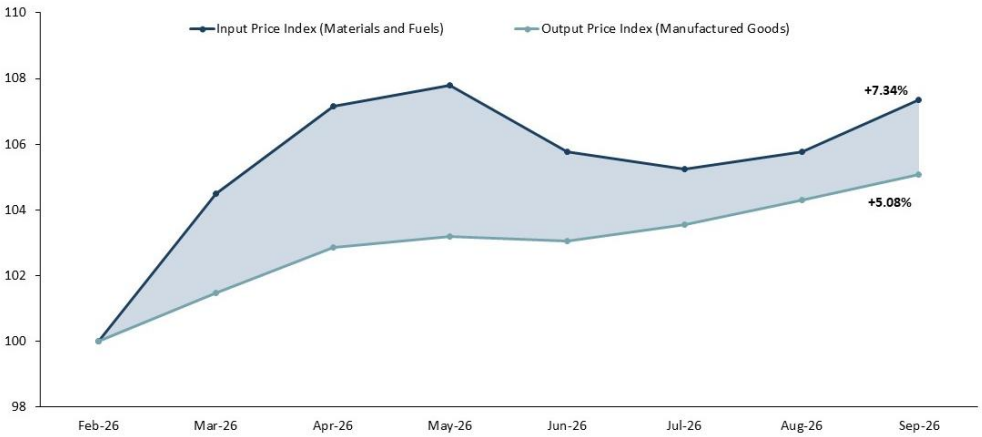
A business with a fixed-price energy contract can continue paying its agreed rate even as market prices rise, delaying any increase in its energy costs until the contract expires. In its November 2026 report, Bank of England suggested that fixed-price contracts and other protective arrangements may explain why business energy costs had risen less than expected. Some firms may also have absorbed higher costs through lower profit margins.

When fixed-price energy contracts expire, businesses may face higher energy bills, depending on the prices and terms available at renewal. Even then, they may not be able to recover the additional costs through higher selling prices. The bakery from our earlier example might raise its prices, accept lower profits or cut costs by reducing waste, adjusting production or finding cheaper suppliers. Ultimately, customer demand and competition can limit how much of the increase a business can pass on.

UK manufacturing data offers a broader view of how rising costs compare with selling prices. The Office for National Statistics publishes separate price indices tracking changes in what manufacturers pay for materials and fuels and what they receive when selling finished products. Between February and September 2026, the input-price index rose from 158.1 to 169.7, an increase of approximately 7.34%, while the output-price index rose from 143.7 to 151.0, an increase of approximately 5.08%. Manufacturers' input prices therefore rose faster than their selling prices over this period.[1]

UK: Input prices outpace manufacturers' selling prices

UK manufacturing input and output price indices, February - September 2026



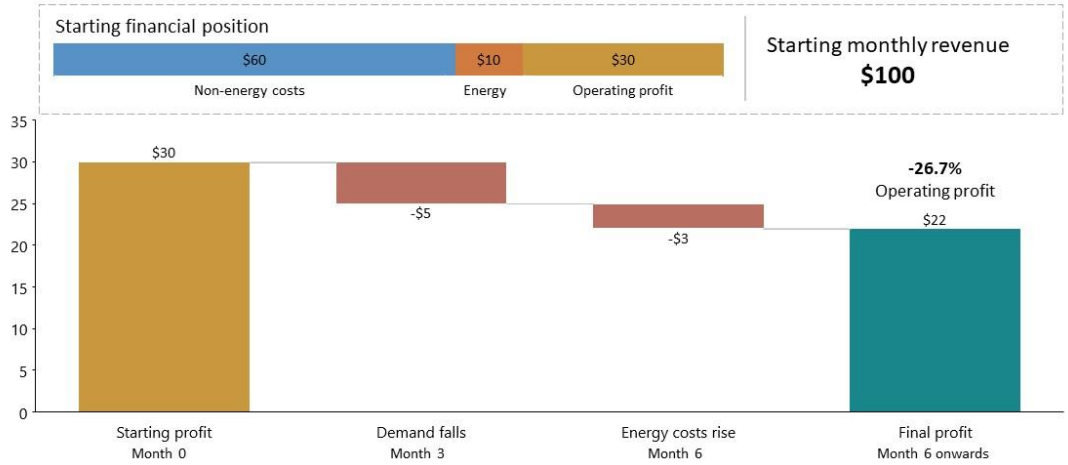
Note: Both indices are rebased to February 2026 = 100. Input prices cover materials and fuels purchased by manufacturers, while output prices represent factory-gate selling prices. The difference in their movements does not directly measure changes in profit margins.
Source: Margarita in the Moonlight (Research & Analysis); Office for National Statistics (ONS), Producer price inflation (UK: September 2026)

The faster rise in input prices suggests that manufacturers' purchasing costs may have been increasing more quickly than the prices they received for their products. However, the two indices cover different baskets, while profits also depend on wages, operating expenses and sales volumes. The figures therefore cannot establish whether individual manufacturers absorbed higher costs, how much energy contributed to the increase or how their profits changed.

A hypothetical business scenario helps illustrate how weaker revenue and higher energy costs can affect profitability when they arrive at different times. The firm starts with $100 in monthly revenue, $60 in non-energy operating costs and $10 in energy expenses, leaving $30 in operating profit. Assuming non-energy operating costs remain constant throughout, a 5% decline in revenue in Month 3 reduces profit to $25. When its energy contract renews at a 30% higher cost in Month 6, profit falls further to $22.

Scenario analysis: When demand falls before costs rise

Illustrative monthly revenue, costs and operating profit, USD



Note: Illustrative scenario, not a forecast. Assumes initial monthly revenue of $100, fixed non-energy costs of $60 and energy costs of $10. Weaker demand reduces revenue by 5% at unchanged selling prices in Month 3; energy costs rise 30% in Month 6. No other adjustments are assumed.

Source: Margarita in the Moonlight (Research & Analysis); illustrative scenario calculations

Together, these pressures reduce monthly operating profit from $30 to $22, a decline of 26.7%, despite revenue falling by only 5%. In this scenario, the business is already earning less when its energy contract renews, leaving it with less room to absorb higher costs. Reversing the order of the shocks would not change the final $22 profit under the same assumptions, but it would change when each pressure is felt. The example shows how weaker demand and rising energy costs can affect profitability at different times. It illustrates the potential financial pressure on businesses rather than measuring the actual impact of the Bank of England's November decision.

Charging more can still mean earning less

Higher selling prices do not necessarily mean healthier businesses. The Bank of England's October 2026 Decision Maker Panel survey highlights this problem. In October 2026, 68% of businesses expected to raise prices in response to the energy shock, compared with 57% in September 2026. Yet 71% also expected their profit margins to decline over the following year. Rising costs can leave firms worse off even when they charge customers more.

Household spending also matters because businesses depend on customers being able and willing to buy their products. According to the Office for National Statistics, UK household consumption grew by 0.3% in real terms in the second quarter of 2026, slowing from 0.6% in the previous quarter. Although spending was still increasing, its slower growth raised questions about how much additional pressure households could absorb as energy bills and borrowing costs rose.

How businesses respond depends partly on their customers and the competition they face. Firms with stronger demand or fewer competitors may find it easier to raise prices without losing sales. Others may have to absorb more of their rising costs to keep customers. Cutting expenses or improving efficiency could offer some relief, but the October 2026 survey suggests that many businesses still expect their profit margins to come under pressure.

Employment figures offer further evidence of the pressures facing businesses. In the Bank of England's October 2026 Decision Maker Panel survey, firms reported an annual employment decline of 0.5%, compared with a decline of 0.2% in September, based on three-month averages. Employment was therefore weakening among surveyed businesses, even as overall economic activity remained stronger than the Bank had expected. Stronger activity suggested that some firms might still have room to raise prices, while weaker employment and pressure on profits pointed to a different experience for others. This contrast raises a broader question about whether the economy's apparent resilience reflects the conditions facing businesses more widely.

Could higher prices shape wage expectations?

Higher energy costs can push up the prices of everyday goods and services, but an initial rise in prices does not necessarily lead to lasting inflation. The greater concern is that workers may seek higher wages to protect their purchasing power, prompting businesses to raise prices again to cover larger wage bills. If this process continues, inflation could remain elevated even after the original energy shock fades. By making borrowing more expensive and discouraging spending, higher interest rates can make it harder for businesses to keep raising prices, reducing the risk that inflation becomes more difficult to control.

The Bank of England's October 2026 Decision Maker Panel survey showed that businesses expected higher inflation, but had not increased their wage-growth expectations. Based on three-month averages, expected consumer-price inflation rose from 3.1% in September 2026 to 3.3% in October 2026. Expected wage growth remained at 3.4%, below the 3.9% annual wage growth businesses reported at the time. Businesses were therefore expecting prices to rise faster but not anticipating a similar acceleration in wages. This suggested that concerns about inflation had not yet translated into higher wage-growth expectations.[2]

For Bank of England, the question was whether to act before stronger wage pressures appeared. Rising inflation expectations and resilient economic activity suggested that price pressures could continue, even though the wage survey offered little evidence of an emerging cycle of repeated wage and price increases. The concern was that, if businesses and workers began adjusting their decisions around expectations of continued inflation, bringing inflation back under control could become more difficult.

These uncertainties also help explain why policymakers can support the same interest-rate decision for different reasons. Swati Dhingra and Megan Greene, both members of the Bank of England's Monetary Policy Committee, supported November's increase. Dhingra supported the increase primarily as a precaution against future inflationary pressures, while Greene believed that stronger-than-expected economic activity and the existing inflation outlook already justified higher rates. Although both supported the increase, they placed different weight on the risks facing the economy.

The Bank's decision was ultimately a judgment about the risks ahead, rather than a response to a wage-price cycle already taking hold. The October survey offers little evidence of an immediate increase in wage expectations, but it cannot rule out the possibility that sustained inflation will influence wage demands in the months ahead. Hence the question was not just whether higher rates could contain inflation, but whether the benefits of acting early would outweigh the economic costs of doing so.

Where the Lines Converge

Bank of England's November decision highlights a challenge that may become more apparent in the months ahead. Higher borrowing costs could begin affecting household spending while some businesses are still protected from rising energy prices. When their existing fixed price energy contracts expire, businesses may face higher bills at a time when their customers are already spending more cautiously. Inflation, meanwhile, may take longer to respond to higher interest rates. Businesses could therefore find themselves under greater financial pressure even before the Bank sees clear evidence that its policy is working. How these pressures develop together will be important in determining the wider economic impact of the decision.

Bank of England projected that inflation would approach 5% by mid-2027, suggesting that the pressure on prices could continue well beyond its November decision. What happens afterwards will depend partly on whether higher energy costs lead to lasting increases in wages and selling prices, or whether weaker demand limits how far businesses can pass those costs on. Both outcomes could emerge across different parts of the economy, leaving policymakers to confront elevated inflation alongside weakening business activity.

Several developments over the coming months could help clarify the outlook. The pace of energy price increases and the terms on which businesses renew their contracts will influence how much further costs rise. Consumer spending and business profitability will show whether companies have enough demand to manage those increases. Wage negotiations in 2027 will offer another important indication of whether higher living costs are translating into lasting pay pressures. Considered together, these signals will help the Bank of England judge whether inflation is becoming more difficult to control or whether higher borrowing costs are already placing enough restraint on the economy.

A sustained decline in energy prices would offer a more favorable outcome, easing pressure on businesses and households without requiring a further slowdown in spending. But even if inflation begins to fall, the reason behind that decline will matter. Lower inflation driven by cheaper energy would signal a different economic adjustment from lower inflation driven by weaker sales, reduced investment and job losses. Ultimately, the success of the Bank of England's decision should be judged not only by how quickly inflation returns to target, but also by how much economic strength remains when it does.

Notes:

1. Input prices reflect what manufacturers pay for materials and fuels, while output prices reflect what they charge for finished goods. Both indices track price changes relative to 2015, rather than actual costs or earnings. Their difference therefore cannot be used to calculate profit margins.

2. Expected inflation and wage growth describe what businesses anticipate, rather than outcomes already observed. The survey also reports wage growth experienced by businesses separately. Rising inflation expectations do not necessarily mean businesses expect wages to accelerate.