ANSWER KEY · PRINT SEPARATELY

Aiming off · Answers

Model answers to the tasks on side 2. Where a task has more than one good answer, the key gives the strongest and says what else would earn credit.

For tutors and self-marking

1 The target is 2% at all times, but a supply shock pushes inflation up and output down at the same time. Bringing inflation straight back to 2% would need a large rate rise, which would cut output and jobs sharply: the remit says this "may cause undesirable volatility in output". So the MPC may return to target over the **medium term**. The **open letter** (inflation more than 1 point from target) keeps it **accountable**: the Governor must explain why, what the MPC is doing and how long the return will take, which protects **credibility** so that expectations stay near 2%.

2 CPI inflation is the % change in the price level over **12 months**. When energy prices jump, this month's prices are compared with lower prices a year ago, so inflation rises. A year later both months include the higher energy prices, so the jump no longer appears in the 12-month comparison: the **base effect** drops out. A one-off rise raises the price **level** once; it keeps inflation up only if energy prices keep rising or the shock feeds into pay and other prices (second round).

3

Event	Type	Reason
Petrol up 30%	D	Fuel is itself in the CPI basket
Bakery: delivery costs	I	Energy cost passed on in another price
Union wins 6%	S	Pay reacting to past inflation
Gas and electricity bills	D	Household energy is in the basket
Café: staff costs	S	Prices reacting to higher pay
Fuel surcharge on fares	I	Fuel cost passed on in fares

4 **a.** 3.75 − 3.5 = **0.25%**. **b.** 3.5 − 2 = **1.5 percentage points**; more than 1 point, so yes, the remit requires an open letter. **c.** 3.7 − 3.5 ≈ **0.2%** (real pay just rising). **d.** Year 1: (104 − 100) ÷ 100 × 100 = **4.0%**. Year 2: (106.08 − 104) ÷ 104 × 100 = **2.0%**. The shock raised the price level once; in year 2 it is in both years' prices, so the base effect has dropped out and inflation returns to its underlying 2%.

5 Axes: price level and real GDP. AD, SRAS and LRAS meet at Pe, Ye (full capacity). **First round:** SRAS shifts left to $SRAS_1$: price level up to P_1, real GDP down to Y_1 (below LRAS: a negative output gap). **Second round:** pay rises shift $SRAS_1$ further left to $SRAS_2$: P_2 higher still, Y_2 lower still. Arrows show both shifts; AD unchanged.

6 Bank Rate works on **demand**: it shifts AD left. It cannot raise energy supply or lower world oil prices, so it lowers inflation only by cutting **output and jobs further**, when the shock has already cut real incomes. It hits all borrowers, mortgage holders and investment, not just energy users, and works with **lags** of 18–24 months, slowed by **fixed-rate** mortgages, so it may bite after the shock has faded. The one channel that lowers import prices: higher rates attract **hot money**, the **£ appreciates**, and oil and other imports cost less in pounds.

7 **Against** second-round effects: **core** inflation (2.8%) is well below headline (3.5%), so most of the rise is energy; regular pay growth (3.7%) is only just above inflation, not racing ahead; unemployment at 4.7% weakens workers' bargaining power. **For**: **services** inflation (3.7%) is above headline, and services track labour costs; pay growth that matches inflation leaves little room for prices to slow. **Judgement:** little sign of a spiral yet, but services and the next pay round are the ones to watch; expectations data would settle it.

8 **In this case** households expect inflation of 4% over the next year, up from 2%. **This is because** they have seen petrol and energy bills jump, and judge future inflation by the prices they pay most often. **As a consequence** workers ask for bigger pay rises and households bring purchases forward, so firms' costs and demand both rise. **This might mean** firms raise prices more, inflation persists after the energy shock fades, and the MPC must raise rates further, costing output and jobs. **However** expectations may fall back quickly. **This is because** the MPC is independent and credible, and says clearly that it will act if the second round appears. **As a consequence** pay deals reflect the expected return to 2%, not the past spike. **This might mean** the shock stays a one-off and the MPC can look through it at little cost.

Exam-style questions and what earns the marks

try each one first: cover the mark points

1. Define the term 'second-round effects' of inflation. (2) the further rises in pay and prices (1) caused by people and firms reacting to the initial rise in inflation, e.g. pay claims to restore real wages (1).

2. In Sept 2026 CPI inflation was 3.5% and Bank Rate 3.75%. Calculate the real interest rate. (1) 3.75 − 3.5 = 0.25%.

3. By how many percentage points was CPI (3.5%) above target, and was an open letter required? (2) 1.5 percentage points (1); yes, more than 1 point from target (1).

4. With reference to the data (CPI 3.1% → 3.5%; motor fuels +29.8%), explain why the rise in inflation is mainly a first-round effect. (4) motor fuels +29.8% are in the CPI basket: a direct effect of energy prices (1); transport contributed 0.94 points (1); core (2.8%) is below headline, so the rise is concentrated in energy (1); it is a one-off rise in the price level, which drops out after 12 months unless pay and prices respond (1).

5. Explain how second-round effects could turn a one-off rise in energy prices into persistent inflation. (5) energy shock raises CPI (1); real pay falls, so workers seek higher pay (1); firms' costs rise, so they raise prices to protect margins (1); expectations rise, built into pay and price setting (1); SRAS keeps shifting left / SRPC shifts up: inflation persists, a wage-price spiral (1). Also credit: higher money pay raises incomes and consumption, so AD shifts right too (demand-pull on top), by much only if real pay rises.

6. Examine why the MPC may choose to 'look through' the first-round effects of higher energy prices. (8: KAA 6, evaluation 2) first-round effects are a one-off rise in the price level that drops out after 12 months; rates take 18–24 months to work, so a rise would bite after the shock fades; it would add an output loss on top of the supply shock; the remit allows a temporary miss. **Evaluate**: only safe while expectations stay anchored; if the shock is large or persistent (CPI forecast over 4%) or pay and services inflation rise, the MPC may need to act.

7. Assess the likely effects of a rise in Bank Rate on UK real GDP and inflation when inflation is caused by higher energy prices. (12: KAA 8, evaluation 4) AD/AS: SRAS has shifted left; a rise shifts AD left via borrowing, mortgages, saving, the £; the price level falls relative to otherwise but real GDP falls further and unemployment rises; stronger £ lowers import prices. **Assess**: lags and fixed mortgages delay it; size depends on the output gap (unemployment 4.7%); it may prevent second-round effects (a smaller loss later); it cannot lower world oil prices; judgement.

8. Evaluate the view that the MPC should accept a slower return of inflation to 2% after an energy price shock. (15: KAA 9, evaluation 6) KAA: flexible targeting and the remit; the dilemma on AD/AS; fast return needs a deep fall in output; a slower path protects jobs; base effects mean a one-off shock fades. **Evaluate**: risk of de-anchored expectations and a wage-price spiral (1970s), so a later, bigger rise; depends on credibility, pay and services data, the size and persistence of the shock and the output gap; the open letter keeps it accountable; judgement.

9. Evaluate whether the MPC should raise interest rates in response to cost-push inflation. (25: KAA 16, evaluation 9) KAA: cost-push on AD/AS; first v second round; transmission mechanism and its effects on output, jobs and the price level; the Phillips curve and expectations; data (CPI 3.5%, core 2.8%, services 3.7%, Bank Rate 3.75%, the 6–3 vote in Sept 2026). **Evaluate**: size and persistence of the shock; evidence of second-round effects; credibility; the output gap; lags of 18–24 months and fixed mortgages; the exchange rate channel; fiscal support and supply-side policy as better tools; 2022–23 (CPI 11.1%, Bank Rate 5.25%) as a case where the MPC had to act. **Judgement**: look through the first round, but lean against (raise) if the second round shows in pay, services or expectations.