Aiming off: cost-push inflation and second-round effects

Why the MPC may not bring inflation straight back to 2% after an energy shock. Every step has its reason.

Builds on topics 2.6.2, 2.6.4, 2.1.2, 4.4.3 and 2.3
the flexible 2% target; first- and second-round effects; looking through, aiming off and what each costs

1 The big idea

An energy shock is **cost-push**: SRAS shifts left, so the price level **rises** while real output **falls**, and one interest rate cannot push inflation down and growth up at once (the MPC's **dilemma**). The first jump is a **one-off** that fades by itself; the danger is the **second round**, so the MPC may **look through** the first round and **aim off** the usual path back to 2%: returning more slowly to protect output, or tightening more to lean against the second round.

Why it matters: "Should rates rise against cost-push inflation?" is a classic **12–25 mark** question; first v second round, lags and credibility are the **evaluation**.

✕ Common mistakes

- ✕ Higher energy prices mean inflation stays high → ✓ a one-off rise drops out after 12 months, because CPI compares with a year ago.
- ✕ Looking through means ignoring inflation → ✓ it means not reacting to the first round while watching hard for the second.
- ✕ A rate rise lowers oil prices → ✓ it cuts UK demand, because rates work on AD, not world supply.
- ✕ Missing 2% breaks the rules → ✓ the remit expects misses after shocks, because holding 2% regardless would swing output.
- ✕ Second-round effects are the indirect effects → ✓ indirect effects are still first round (costs passed on); the second round is pay and prices reacting to inflation itself.

2 The framework: why the 2% target is flexible

2%, symmetric, at all times	The government's CPI target. **Why symmetric?** 1% is as much a miss as 3%: low inflation matters as much as high.
"In the medium term"	The MPC aims to get back to 2% sustainably over time. **Why not at once?** Rates take about 18–24 months to work, so it steers by its forecast about two years ahead.
Misses are expected	The remit accepts inflation will depart from 2% after shocks. **Why?** Holding 2% regardless "may cause undesirable volatility in output".
Flexible targeting	So the MPC chooses **how fast** to return to 2%. **Why?** It weighs inflation against lost output and jobs.
Open letter	If CPI is more than 1 point from target, the Governor writes to the Chancellor: why, what the MPC is doing, how long the return will take and the trade-off with output. **Why?** Flexibility with **accountability**, which protects credibility.

TODAY'S DECISION (5 NOV 2026)
CPI 3.5%, Bank Rate 3.75% (data on side 2). Markets and most economists expected a rise to 4%. **The MPC's decision: Up to 4%, voted 8–1 (Mann wanted 4.25%). Little sign of second-round effects yet, but the risk had risen, so the MPC leaned against it.**

3 Build it step by step: from an oil shock to persistent inflation

FIRST ROUND · A ONE-OFF RISE IN THE PRICE LEVEL

1 World energy prices jump. **Why?** Fear of lost oil supply raises the world price; the UK is a price taker and cannot change it.

2 SRAS shifts left. **Why?** Energy is a cost for almost every firm, so each level of output now costs more to produce.

3 Direct effect: fuel and energy bills in the CPI basket rise. **Why?** Petrol, diesel, gas and electricity are items in the basket, so CPI jumps at once.

4 Indirect effect: other prices rise. **Why?** Over months firms pass on dearer fuel, transport and materials: food, travel and goods.

5 On its own, inflation then falls back. **Why?** CPI inflation compares prices with **12 months earlier**. Once the higher price is in both months, it adds nothing more: the **base effect** drops out. A one-off jump raises the price **level**, not inflation for ever, so it needs no policy response by itself.

SECOND ROUND · INFLATION THAT FEEDS ON ITSELF

6 Workers bargain for higher pay. **Why?** Prices rose faster than pay, so real pay fell; they want it back.

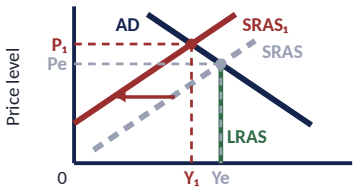
7 Firms raise prices to protect margins. **Why?** Pay is their biggest cost: a **wage-price spiral**; SRAS keeps shifting left.

8 Expectations de-anchor. **Why?** If people stop believing in 2%, they build higher inflation into every pay deal and price: the SRPC shifts up and inflation persists.

9 And on AD too: pay lifts spending. **Why?** Higher money pay raises incomes, so C and AD rise: demand-pull too. Big only if real pay rises; pay 3.7% v CPI 3.5% is roughly flat.

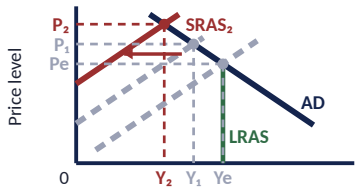
4 The diagrams: first round, second round and the cost of fighting it

1 · First round



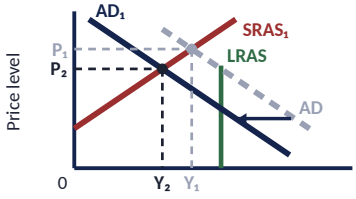
SRAS → $SRAS_1$: price level up (P_1), real GDP down (Y_1): a one-off rise in the level.

2 · Second round



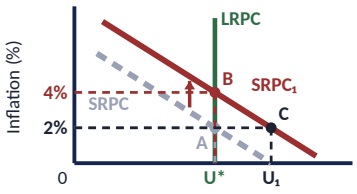
Pay chases prices: $SRAS_1$ → $SRAS_2$. The price level keeps rising (P_2): persistent inflation.

3 · Raise Bank Rate



Rates up: AD → AD_1. A lower price level (P_2) only by cutting output further (Y_2).

4 · Phillips curve



Expected inflation 2% → 4%: $SRPC_1$ (A → B). Forcing 2% now (C) costs unemployment U_1.

5 Why "look through" the first round?

Lags. A rate rise today bites in about **18–24 months**, by when the first-round jump has dropped out of the 12-month rate. It would cut output and jobs **after** the shock had faded: an extra loss for no lasting gain, like braking for a bend you have already driven round. **But only while the second round stays away:** in July 2026 members "continued to look through direct effects", with "little evidence" of second-round effects so far.

6 "Aiming off": two directions, two costs

In plain words: the MPC deliberately sets rates so that inflation is **not** brought back to 2% on the usual timetable. It aims to one side on purpose, as a walker with a map aims to one side of a bridge so they know which way to turn.

DIRECTION	WHAT THE MPC DOES, AND WHY · WHAT IT COSTS
Slower return	Accepts inflation above 2% for **longer**, so it can avoid a deep recession. Cost: inflation stays high for longer, and credibility may slip.
Lean against	Tightens **more** than its central forecast alone needs, as insurance against second-round effects. **Why?** Risk management: if the second round takes hold, doing too little costs more than doing too much. Cost: output and jobs lost now, perhaps for nothing if the second round never comes.

Careful: "aiming off" is **not** the Bank of England's phrase (it is not in the remit or the minutes). It labels the choice the remit gives the MPC over "the speed with which it aims to bring inflation back to the target". The Bank and MPC members say **look through**, **lean against**, **medium term**, **risk management**.

7 Why Bank Rate is a blunt tool here

Wrong side of the diagram: it shifts **AD**; it cannot add energy supply or lower world oil prices.

Hits everyone: borrowers, mortgage holders and firms' investment, already squeezed by dearer energy.

Long, variable lags; most mortgages are **fixed**, so a rise reaches many households only when their deal ends.

The one channel to import prices: higher rates → hot money → £ appreciates → oil and imports cheaper in £.

Better partners: fiscal support targeted at poorer households; **supply-side** policy (insulation, renewables); **energy security** (storage, more home supply).

8 Evidence the MPC watches for the second round

Pay	Pay settlements and regular pay growth (3.7%). Pay rising faster than productivity pushes up firms' costs.
Services	Services inflation (3.7%). Services are mostly labour, so they track pay, not oil.
Firms	Own-price expectations in the Bank's Decision Maker Panel (DMP) survey. What firms plan to charge next year.
Households	Household inflation expectations. What they expect goes into pay claims.
Core	Core CPI, without energy, food, alcohol and tobacco (2.8%). If core rises, the shock is spreading.

Readings: ONS, Oct 2026. July 2026 minutes: "little evidence of material second-round effects so far"; some members saw no adverse moves yet in expectations or DMP price plans.

9 Chains of reasoning

ANALYSIS CHAIN · THE SECOND ROUND

In this case workers win bigger pay rises after energy prices push CPI inflation above 4%. **This is because** prices are now rising faster than pay, so real pay is falling and unions bargain to restore it. **As a consequence** firms' wage costs rise, so they raise their prices to protect margins and SRAS shifts left again. **This might mean** inflation expectations rise and inflation stays above 2% long after oil prices have stopped rising, forcing larger rate rises later.

EVALUATION · BACK ALONG THE CHAIN

However pay may not chase prices this time. **This is because** unemployment is 4.7%, higher than in 2022, and the MPC is credible, so workers have less bargaining power and expect inflation to fall back. **As a consequence** pay deals stay moderate, so firms' costs do not keep rising. **This might mean** inflation drops back as the base effect falls out, and the MPC can look through the shock.

ANALYSIS CHAIN · A RATE RISE AGAINST COST-PUSH

In this case mortgage holders and firms cut their spending after the MPC raises Bank Rate to fight energy-driven inflation. **This is because** banks pass the rise on, so loans and variable-rate mortgages cost more each month. **As a consequence** C and I fall and AD shifts left, so the price level is lower than it would be, but real GDP falls further. **This might mean** unemployment rises during a supply shock that has already squeezed real incomes, deepening the slowdown.

EVALUATION · BACK ALONG THE CHAIN

However spending may fall only slowly. **This is because** most mortgages are fixed, so payments change only when a deal ends. **As a consequence** AD shifts left over 18–24 months, by which time the energy shock may have passed. **This might mean** the rise mainly adds an unnecessary output loss later, unless it is needed to stop expectations rising.

10 Classic: should the MPC raise rates against cost-push inflation?

YES, BECAUSE

It stops expectations de-anchoring and a **wage-price spiral**; a stronger £ cuts import prices; credibility is costly to win back (1970s inflation passed 25%); insurance if the risks are lopsided.

NO, BECAUSE

It cannot lower oil prices; **lags** mean it bites after the shock fades; it deepens the output loss; a **one-off** level rise drops out by itself; fixed mortgages slow it.

It depends on… the **size and persistence** of the shock; whether **second-round effects** are visible in pay, services and expectations; MPC **credibility**; the state of **demand** and the **output gap**; **lags**; the **exchange rate**; and whether **fiscal policy** helps. (In 2022 CPI hit 11.1% in Oct; Bank Rate reached 5.25% by Aug 2023.)

Not here: the transmission mechanism in full (2.6.2); the Phillips curve in depth (2.6.4); fiscal and supply-side policy in detail (2.6.2, 2.6.3).

Aiming off · Apply it

Name _____

Try every task without side 1, then check the answer key. **Core**: everyone; **Stretch**: top level.

Date _____

Real-world examples: the UK in autumn 2026

data for tasks 4 and 7, and for the exam-style questions on the answer key

Inflation	CPI **3.5%** in Sept 2026, up from 3.1% (CPIH 3.6%); core 2.8%, services 3.7%, goods 3.2%. Motor fuels **+29.8%** in a year; transport added 0.94 percentage points (ONS, 21 Oct 2026).
The shock	Middle East conflict involving Iran: Brent crude above $100 a barrel, over $110 by the end of Oct 2026.
Bank Rate	**3.75%**, held on 17 Sept 2026 by **6–3**: Greene, Mann and Pill voted for 4%. The Bank warned CPI could go slightly **over 4%** in early 2027.
Jobs, pay	Unemployment 4.7%; regular pay growth 3.7% (three months to Aug 2026).

WORKED NUMBERS · with the Sept 2026 figures, and an illustrative base effect

- **Gap** — 3.5% − 2% = **1.5 percentage points** above target: more than 1 point, so the remit's open-letter rule applies.
- **Real rate** — Bank Rate − inflation: 3.75% − 3.5% = **0.25%**. Barely positive, so policy is only just restrictive in real terms.
- **Real pay** — Regular pay growth − inflation ≈ 3.7% − 3.5% = **0.2%**. Real pay is only just growing: the pressure behind pay claims.
- **Base effect** — Index 100 → 103.5 (inflation **3.5%**). No second round, so 103.5 → 105.6: (105.6 − 103.5) ÷ 103.5 × 100 = **2.0%**. The jump is in the level, not in next year's rate.

1 CORE · SECTION 2

Explain why the government's remit lets the MPC miss the 2% target after a shock, and why an open letter is still required.

2 CORE · SECTION 3, STEP 5

Explain why a one-off rise in energy prices raises CPI inflation for about 12 months and then stops adding to it.

3 CORE · SECTION 3

For each event, write **D** (direct first-round), **I** (indirect first-round) or **S** (second-round), and give the reason.

Event	D/I/S	Reason
Petrol prices at the pump rise 30%		
A bakery raises bread prices as its delivery costs rise		
A union wins 6% to make up for last year's inflation		
Household gas and electricity bills rise		
A café raises prices because its staff costs rose		
Airlines add a fuel surcharge to fares		

4 CORE · WORKED NUMBERS (SIDE 2 DATA)

a. CPI inflation is 3.5% and Bank Rate is 3.75%. Calculate the real interest rate. b. By how many percentage points is CPI above target? Is an open letter required? c. Regular pay grows 3.7%. Calculate approximate real pay growth. d. A price index rises from 100 to 104 after an oil shock, then to 106.08 the next year. Calculate inflation in each year and explain the change.

5 CORE · SECTION 4

Draw an AD/AS diagram, starting at full capacity, to show an energy price shock (first round) and then a second-round effect. Label AD, SRAS, $SRAS_1$, $SRAS_2$, LRAS, Pe, P_1, P_2, Ye, Y_1 and Y_2.

6 STRETCH · SECTION 7

Explain why a rise in Bank Rate is a blunt tool against inflation caused by higher world energy prices, and name the one channel that does lower import prices.

7 STRETCH · SECTION 8, REAL-WORLD DATA

Use the Sept 2026 data (CPI 3.5%, core 2.8%, services 3.7%, regular pay 3.7%, unemployment 4.7%). **Assess** whether there is evidence of second-round effects.

8 STRETCH · SECTION 9

Build a chain on **household inflation expectations rising** after an energy shock. *In this case… This is because… As a consequence… This might mean…* Then evaluate back along it: *However… This is because… As a consequence… This might mean…*

Where the marks go

1–2 marks	**Define** second-round effects or a supply shock; **calculate** a real interest rate, real pay growth or a gap from target in percentage points.
3–5 marks	**Explain** one full link: energy prices → SRAS → price level; or real pay → pay claims → costs → prices; using the data.
8–25 marks	Add **evaluation**: one-off v persistent, second-round evidence, credibility, the output gap, lags, the £, fiscal policy; reach a judgement.

- ✕ **Not all inflation is the same:** say whether it is demand-pull or cost-push before you prescribe rates.
- ✕ **Indirect ≠ second round:** passing on dearer fuel is still the first round.
- ✕ **Percentage points, not %**, for a gap between two rates.
- ✕ **"Aiming off"** is a label, not the Bank's term: tie it to the remit.

Exam-style questions: nine (2 to 25 marks), with mark points, are on the separate answer key and in step 7 of the online lesson.