Exercise walk-through

4.3
Unemployment and inflation

International Baccalaureate · IB Diploma · Economics · SL

Measuring economic activity (5)

- In a **boom** , output is above **trend**, unemployment is low and **inflation** tends to rise.
- In a **recession** , real GDP falls. Often this means two quarters in a row of falling output. Unemployment rises.
- At the bottom (the slump), output is furthest below trend.
- In the **recovery** , output and jobs grow again.

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Macroeconomic objectives

- **Demand-pull inflation** : AD grows faster than the economy can produce (an **inflationary gap**).
- **Cost-push inflation** : firms' costs rise (oil, wages, imported materials) and SRAS shifts left. Prices rise while output falls.

$$\text{unemployment rate} = \frac{\text{number unemployed}}{\text{labour force}} \times 100$$

Key terms (2)

- **Natural rate of unemployment**: the rate of unemployment when the labour market is in equilibrium, made up of frictional, structural and seasonal unemployment.
- **Monetary policy**: the **central bank**'s use of interest rates and the **money supply** to influence **aggregate demand**.
- **Supply-side policy**: policy that aims to increase the economy's productive capacity (LRAS).

Exercises 2.1·2.2

2.1 Distinguish between structural and cyclical unemployment. [2]



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2.2 In a country, 1.8 million people are unemployed and 28.2 million are employed. Calculate the unemployment rate. [2]



labour force

Exercises 2.1·2.2

2.1 Distinguish between structural and cyclical unemployment. [2]



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2.1

structural: a long-term mismatch between workers' skills or location and the jobs available, e.g. after an industry declines; cyclical: caused by a fall in aggregate demand in a recession

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labour force

2.2

labour force = 30 million; rate = $1.8 \div 30 \times 100 = \mathbf{6}\%$

Exercise 2.3

2.3 Explain **two** costs of high inflation for an economy. [4]



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2.3

any two, explained: people on fixed incomes or savers lose purchasing power; uncertainty makes firms delay investment, slowing growth; exports become less competitive if inflation is higher than abroad; menu costs / time spent managing money

Exercise 3.1 (a)

3.1 In one country, prices fell for two years in a row.

(a) Define **deflation**. [2]

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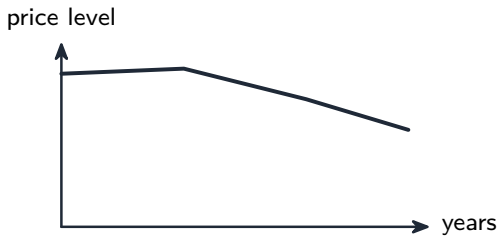
(a) Define **deflation**. [2]

(a) a sustained fall in the general price level

Exercise 3.1 (b)

3.1 In one country, prices fell for two years in a row.

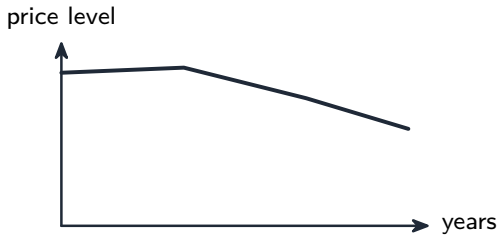
(b) Explain why deflation caused by falling demand may harm the economy. [6]



Exercise 3.1 (b)

3.1 In one country, prices fell for two years in a row.

(b) Explain why deflation caused by falling demand may harm the economy. [6]



(b) consumers delay purchases, expecting lower prices later; AD falls further, so firms cut output and jobs; a downward spiral of falling prices and spending; the real value of debts rises, so borrowers cut spending and some default; firms' profits fall, so investment falls; interest rates cannot go much below zero, so monetary policy loses power