What is the Inflation-Unemployment Tradeoff?

Worksheet

The inflation-unemployment tradeoff is an inverse relationship where lower unemployment pushes inflation up, and higher unemployment pulls inflation down. Policymakers must choose between these competing goals.

Questions

1. The inflation-unemployment tradeoff is…

A) always stable
B) an inverse relationship
C) a positive correlation
D) only theoretical

2. If unemployment is very low (2%), inflation is likely to be…

A) low
B) high
C) zero
D) negative

3. A central bank wants to fight inflation. What employment consequence should it expect?

A) lower employment
B) higher unemployment
C) wage increases
D) no change

4. The Phillips Curve shows a relationship between…

A) price and quantity
B) inflation and unemployment
C) supply and demand
D) growth and interest rates

5. An economy reduces unemployment from 5% to 3%. What typically happens to inflation?

6. A central bank raises interest rates to combat 6% inflation. What is the employment effect?

7. An economy faces 8% unemployment and 1% inflation. Which policy tradeoff should policymakers consider?

8. Define: What is the inflation-unemployment tradeoff?

9. Define: Who first documented this relationship?

10. Define: Why does lower unemployment raise inflation?

Answer Key

1. B) an inverse relationship — When unemployment falls, inflation rises. This inverse relationship is the core of the Phillips Curve.

2. B) high — Tight labor markets push wages up, companies raise prices, so inflation rises.

3. B) higher unemployment — Fighting inflation (via higher rates) slows hiring and increases unemployment in the short run.

4. B) inflation and unemployment — The Phillips Curve plots inflation on one axis and unemployment on the other.

5. When unemployment drops to 3%, labor markets tighten. Workers have more bargaining power, wages rise. Companies raise prices to cover higher labor costs. Inflation typically increases (e.g., from 2% to 4%).

6. Higher rates cool spending and investment. Business hiring slows, unemployment rises. With fewer jobs available, wage pressure eases. Inflation falls to 3%, but unemployment may rise to 5%.

7. High unemployment = slack in the labor market, low inflation. Stimulating the economy (lower rates, more spending) could reduce unemployment to 5%. But inflation would likely rise to 3–4%. Policymakers must weigh job creation vs. price stability.

8. An inverse relationship: lower unemployment tends to raise inflation, and higher unemployment tends to lower inflation.

9. Economist A.W. Phillips, in his 1958 study of wage and unemployment in the UK.

10. Tight labor markets increase wage demands, companies raise prices to cover costs, pushing inflation up.