Chapter Eight Major Economic Problems Inflation and unemployment

1 Price inflation

Price inflation is an increase in the price of a standardized good/service or a basket of goods/services over a specific period of time (usually one year).

- Price inflation is an increase in the price of a collection of goods and services over a certain time period.
- Strong demand and supply shortages tend to cause price inflation.
- Price inflation can also be caused by the cost of inputs to the production process increasing.
- Price inflation is a critical measure for central banks when setting monetary policy.
- The consumer price index (CPI) is the most common measure of price inflation in the U.S. and is released monthly by the Bureau of Labor and Statistics (BLS).

Understanding Price Inflation

The nominal amount of money available in an economy tends to grow larger every year relative to the supply of goods available for purchase. This overall demand-pull tends to cause some degree of price inflation—when there's not enough supply to satisfy demand, prices usually move upward.

Price inflation can also be caused by cost-push, which is when the cost of inputs to the production process increases. If a company has to pay higher wages and more for the raw materials it uses to make the final product, a large chunk of these extra expenses will likely be passed on to the customer in the form of higher prices.

How Do You Calculate the Inflation Adjusted Price?

Prices are adjusted for inflation by dividing the price index for the current period by a previous period and then multiply that ratio by the unadjusted price. For example, the Consumer Price Index urban consumers (CPI-U) was 258.8 in 2020 and 271.0 in 2021. The price of the item you are adjusting for was $2,000 in 2020. The inflation adjusted price of this item would be (271.0 / 258.8) * $2,000, or $2,094

2 The Unemployment?

The term unemployment refers to a situation where a person actively searches for employment but is unable to find work. Unemployment is considered to be a key measure of the health of the economy.

The most frequently used measure of unemployment is the unemployment rate. It's calculated by dividing the number of unemployed people by the number of people in the labor force.1

Many governments offer unemployment insurance to certain unemployed individuals who meet eligibility requirements.

KEY TAKEAWAYS

- Unemployment occurs when workers who want to work are unable to find jobs.
- High rates of unemployment signal economic distress while extremely low rates of unemployment may signal an overheated economy.
- Unemployment can be classified as frictional, cyclical, structural, or institutional.
- Unemployment data is collected and published by government agencies in a variety of ways.
- Many governments offer unemployed individuals a small amount of income through unemployment insurance, as long as they meet certain requirements.

Types of Unemployment

Both voluntary and involuntary unemployment can be broken down into four types.

Frictional Unemployment

This type of unemployment is usually short-lived. It is also the least problematic from an economic standpoint. It occurs when people voluntarily change jobs. After a person leaves a company, it naturally takes time to find another job. Similarly, graduates just starting to look for jobs to enter the workforce add to frictional unemployment.

Frictional unemployment is a natural result of the fact that market processes take time and information can be costly. Searching for a new job, recruiting new workers, and matching the right workers to the right jobs all take time and effort. This results in frictional unemployment.3

Cyclical Unemployment

Cyclical unemployment is the variation in the number of unemployed workers over the course of economic upturns and downturns, such as those related to changes in oil prices. Unemployment rises during recessionary periods and declines during periods of economic growth.

Preventing and alleviating cyclical unemployment during recessions is one of the key reasons for the study of economics and the various policy tools that governments employ to stimulate the economy on the downside of business cycles.3

Structural Unemployment

- Structural unemployment comes about through a technological change in the structure of the economy in which labor markets operate. Technological changes can lead to unemployment among workers displaced from jobs that are no longer needed. Examples of such changes include the replacement of horse-drawn transport with automobiles and the automation of manufacturing.

Retraining these workers can be difficult, costly, and time-consuming. Displaced workers often end up either unemployed for extended periods or leaving the labor force entirely.

- **Institutional Unemployment**

Institutional unemployment results from long-term or permanent institutional factors and incentives in the economy.4 The following can all contribute to institutional unemployment:

- Government policies, such as high minimum wage floors, generous social benefits programs, and restrictive occupational licensing laws
- Labor market phenomena, such as efficiency wages and discriminatory hiring
- Labor market institutions, such as high rates of unionization