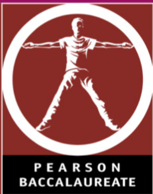

Worksheet 14.2

The Federal Reserve and the tradeoff between inflation and unemployment

In 2008, weak aggregate demand and rising costs due to high energy and food prices put the US economy in a tricky situation, one in which the Federal Reserve was forced to make the tough decision between tackling the unemployment problem (jobless rates were around 6%) or the inflation problem (price levels had also risen 5.7% that year, the highest inflation in 17 years).

The Fed (America's central bank) had lowered interest rates to 2%, and promised not to raise them despite the fear of inflation caused by higher energy prices at the time. Despite the risk of higher prices, the Fed believed that raising the interest rate would reduce consumer and firm spending, and lead to higher unemployment as a result.

In the short-run, as IB Economics students know, society faces a trade off between high inflation and high unemployment. Rising prices and rising joblessness are both harmful to the economy, but when energy and food prices drive up the price level, while weak investment and consumer spending lead to falling overall demand in the economy, the conditions exist where joblessness and prices can rise simultaneously. This was the situation in America's in 2008.

The Fed had to choose which problem to address. Ben Bernake, America's central bank chief, could have chosen to tackle rising inflation by raising interest rates, which would have discouraged new investment and reduce demand for resources by firms in the economy. Investment spending by firms and consumption by households would decline, putting downward pressure on prices across the economy.

In the short-run, however, the decline in investment and consumer spending that would result from higher interest rates would exacerbate the already weak level of aggregate demand in the economy, driving unemployment even higher.

By keeping rates low, Bernanke hopes to encourage investment and consumption, which will contribute to overall demand in the economy. By encouraging new spending and investment, however, the threat that inflation will rise even more remains present.

In the trade off between unemployment and inflation, the US central bank made it clear that unemployment was the most important problem to address by keeping interest rates at a low 2%.

Discussion questions:

1. Low interest rates are clearly a demand-side policy, since they should lead to higher investment and consumption. But how might lowering interest rates result in positive supply-side effects for the economy?

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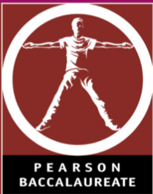

2. Why do you think avoiding a rise in unemployment is of a higher priority to policy-makers than bringing down the inflation rate? Does the fact that it's an election year matter?
3. How does the double risk of rising producing costs for the nation's firms and rising unemployment pose a particular challenge to a central bank and government policy makers? What would be an effective response to a negative supply shock caused by rising energy prices or rising wages?

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