

EC132.03
Principles of Macroeconomics

Boston College

Tuesday, February 9

Reminders and Announcements

1. Homework on the CPI – due next Monday, February 15 at 9am.

January 2010 Employment Situation

Household Survey	December 2009	January 2010	Change
Employed	137,792	138,333	+541
Unemployed	15,267	14,837	-430
Labor Force	153,059	153,170	+111
Unemployment Rate	10.0%	9.7%	-0.3%

Establishment Survey	Change in Total Nonfarm Payroll Employment
January 2009	-779
November 2009	+64
December 2009	-150
January 2010	-20

Note: All figures, except for the unemployment rate, are in thousands.

Ch 24 Measuring the Cost of Living

1. The Consumer Price Index
 - A. How the CPI is Measured ✓
 - B. Problems in Measuring the Cost of Living ✓
 - C. The GDP Deflator and the CPI ✓
2. Correcting Economic Variables for the Effects of Inflation
 - A. Dollar Figures at Different Points in Time ✓
 - B. Indexation
 - C. Real and Nominal Interest Rates

Next: Ch 25 Production and Growth

Indexation

Indexation refers to the automatic correction by law or contract of dollar amounts for the effects of inflation.

Social security benefits are adjusted every year based on CPI inflation.

Union contracts often specify **cost of living adjustments (COLAs)**, through which wages rise based on the CPI.

Real and Nominal Interest Rates

You deposit \$1,000 in a bank account that pays interest at a 10% annual rate.

After one year, you will have \$1,100: your original \$1,000 plus \$100 (10%) interest.

Your **nominal** return is 10%.

Real and Nominal Interest Rates

After one year, you will have \$1,100: your original \$1,000 plus \$100 (10%) interest.

But suppose the inflation rate over the same year is 3%.

You have 10% more dollars, but those dollars buy 3% fewer goods.

Your **real** return is only $10\% - 3\% = 7\%$.

Real and Nominal Interest Rates

With a 10% **nominal** interest rate:

- If inflation is 3%, your **real** return is $10 - 3 = 7\%$.
- If inflation is 5%, your **real** return is $10 - 5 = 5\%$.
- If inflation is 10%, your **real** return is $10 - 10 = 0\%$.
- If inflation is 15%, your **real** return is $10 - 15 = -5\%$.
- And if inflation is -5% (deflation), your **real** return is $10 - (-5) = 15\%$.

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Real Interest Rate

= Nominal Interest Rate – Inflation Rate

US Real and Nominal Interest Rates

