CH.5 FAQ's

16) Discouraged workers are
   A) considered unemployed because they are not working.
   B) considered unemployed because they are still in the labor force.
   C) not considered unemployed because they are not actively seeking work.
   D) not considered unemployed because they are not qualified to work.

Answer: by definition, discouraged workers are people who are available and willing to work but have not made specific efforts to find a job within the previous four weeks. These workers often temporarily leave the labor force during recession. And because labor force = employed + unemployed, they are not considered unemployed. See p.131 7th edition.

17) Including discouraged workers in the calculation of the unemployment rate would
   A) change the reported rate, but in an unpredictable manner.
   B) lower the reported rate.
   C) not change the reported rate.
   D) increase the reported rate.

Answer: let UR be the unemployment rate, U be the # of unemployed, and L be labor force. So one has the unemployment rate UR = 100*(U)/(L). Let X be discouraged workers. Including X in the calculation of the unemployment rate would give the following new unemployment rate UR' = 100*(U + X)/(L + X). Therefore, the change in unemployment rate:

\[ \Delta UR = UR' - UR = 100*(U + X)/(L + X) - 100*(U)/(L) \]
\[ = 100*[\{L*(U + X) - (L + X)*U\}/[L*(L + X)]] \]
\[ = 100*(UL + XL - UL - XU)/[L*(L + X)] \]
\[ = 100*(X/L)*(L - U)/(L + X) \]

By definition, labor force L > unemployed U. Therefore, \( \Delta UR > 0 \) and one has that including discouraged workers in the calculation of the unemployment rate would increase the reported rate.
18) When an individual who has not been working but has been looking for work decides to terminate the search process, the official unemployment rate
   A) will remain unchanged.
   B) will rise.
   C) will fall.
   D) may fall or rise depending on whether or not the individual resumes his education.

Answer: again, the unemployed are people who do not have jobs but are looking for jobs. So if an individual terminates his or her job searching process, then he or she will not be part of the unemployed anymore, making him or her not part of the labor force. Note that labor force = employed + unemployed.

22) Which of the following is TRUE regarding the behavior of the average hourly real wage?
   I. Since 1961, the average hourly real wage has increased regardless of the measure used.
   II. Since 1961, the average hourly real wage might or might not have increased, depending on the measure used.
   III. No matter the measure used, growth in the average hourly real wage rate slowed in the 1970s.
   A) I only       B) III only
   C) II and III   D) I and III

Answer: See figure 6.6 p.134 7th edition. The 3 measures of real wage rate (1. wages of private manufacturing non-supervisory workers; 2. wages, salaries; 3. wages, salaries, and supplements) have increased since 1961. Also from the same figure, no matter the wage rate is measured, its growth rate slowed during the 1970s. This slowdown in wage growth coincided with a slowdown in productivity growth.

23) Suppose the money wage rate increases from $10 to $12. If nothing else changes,
   A) the real wage increases.
   B) the real wage decreases.
   C) the quantity of goods and services that an hour of work can buy increases.
   D) Both answers A and C are correct.

Answer: the real wage rate = nominal wage rate / price. So if nominal wage rate increases from $10 to $12 and nothing changes (no change in price), it must be that the real wage rate goes up. And because the real wage rate is the quantity of goods and services that an hour's work can buy, it also implies that this quantity of goods and services increases.
27) Which of the following statements about cyclical unemployment is FALSE?
   A) Cyclical unemployment exists when actual GDP is less than potential GDP.
   B) Cyclical unemployment can be negative when actual GDP exceeds potential GDP.
   C) When there is unemployment in excess of frictional and structural unemployment, it is cyclical
      unemployment.
   D) None of the above because all the statements are true.

31) Cyclical unemployment exists when
   A) real GDP is less than potential GDP.
   B) real GDP exceeds potential GDP.
   C) frictional and structural unemployment is zero.
   D) real national income exceeds potential income.

**Answer:** the fluctuating unemployment over the business cycle is cyclical
unemployment. It increases during a recession and decreases during an expansion.
Recession occurs when actual GDP is less than potential GDP. Expansion occurs when
actual GDP exceeds potential GDP. Also from the fact that unemployment breaks down
into 3 parts, i.e. frictional, structural, and cyclical, one has that $\textit{cyclical} = \textit{total}
unemployment - (frictional + structural).

35) The currently used method for calculating the CPI
   A) probably overstates inflation by about 1 percentage point.
   B) can result in government expenditures to be higher than otherwise.
   C) fails to account for people increasing consumption of a good that falls in relative price.
   D) All of the above answers are correct.

**Answer:** See p.143 7th edition for the biased CPI. The main sources of bias in the CPI
are new goods bias, quality change bias, commodity substitution bias, and outlet
substitution bias. The commodity substitution bias and the outlet substitution bias show
that CPI fails to account for substitution effects. People facing with higher price of good
x would go and consume other goods with relatively lower prices. But because in
calculating CPI, the fixed CPI basket is used, it doesn’t take into account these
substitution effects.

These biases lead to CPI overstating inflation. The congressional advisory commission
on the consumer price index chaired by Michael Boskin, in 1996, said that the CPI
overstated inflation by 1.1 percentage points a year. That is, if the CPI reports that
inflation is 3.1 percent a year, most likely inflation is actually 2 percent a year. This
inflation overstating of the CPI distorts private contracts and increases government
outlays. Many private agreements, such as wage contracts, are linked to the CPI. For
example, a firm and its workers might agree to a three-year wage deal that increases the
wage rate by 2 percent a year plus the percentage increase in the CPI (this part is to take
care of inflation). Such a deal ends up giving the workers more real income that the firm
intended. Also close to a third of federal government outlays, including social security
checks, are linked directly to the CPI (again, to take care of inflation so that the amount
of goods and services people can get is about the same). And while a bias of 1 percent a
year seems small, accumulated over a decade it adds up to almost a trillion dollars of
additional expenditures.