Joe Levy
Economics Homework

RPI - The Retail Price Index is the main measure of inflation in the UK. It shows the amount prices have increased for spending on an average basket of goods. It is weighted to reflect the fact some price changes are more important than others. The weights are based on the Family Expenditure Survey which surveys a wide range of families to see how they spend their money. Like all index numbers it has a base year, and all changes are expressed as percentage changes around that base.

RPIX - RPIX is an adjusted measure of inflation. It is often alternatively known as the "underlying rate of inflation". It is the basic Retail Price Index adjusted for the effects of changes in interest rates. As interest rates are increased (to counter inflation), this will tend to lead to an increase in mortgage rates. Because mortgage costs are included in the RPI as a measure of the costs of housing, this will lead to an increase in the RPI. So increasing interest rates to reduce inflation leads to an increase in inflation! RPIX removes this effect to give a better picture of underlying inflation.

RPIY - RPIY is an adjusted measure of inflation. It is the basic Retail Price Index, adjusted for the effects of changes in interest rates and indirect taxes. Both of these changes can distort the Retail Price Index, and so RPIY can provide a useful measure.

Labour Force Survey – This is a survey of 60,000 households in the U.K. It is based on those who are out of work who are seeking employment over the previous four weeks but who are able to start working in two weeks.

Claimant Count – This is calculated by all those who register as unemployed and claim job seekers benefit.

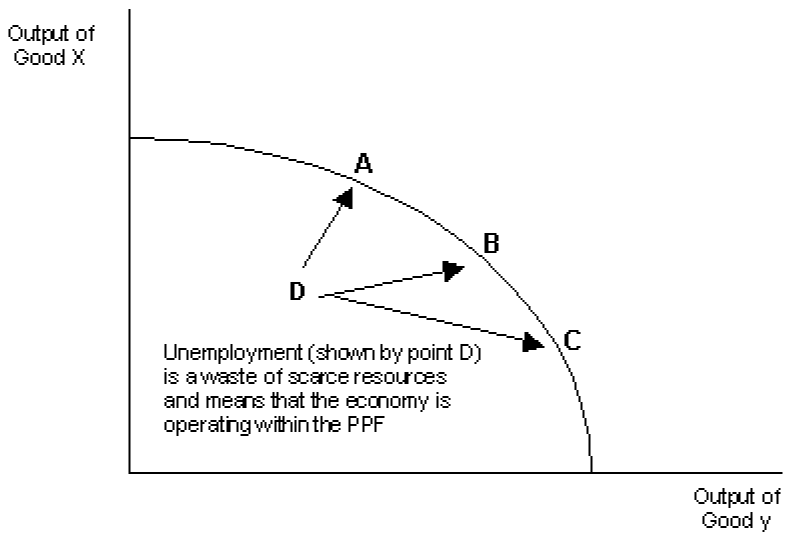
Deflationary Period – The features of this are that there are 6 months of no GDP growth, there is high unemployment, businesses shut, confidence is low, aggregate demand is low, there is deflation, and interest rates are low.

'Boom' – In a boom there will be high GDP growth, high Aggregate demand, low unemployment, inflation, and high interest rates

Economic problems of Inflation – There is an effect on UK competitiveness - if the UK has higher inflation than the rest of the world it will lose price competitiveness in international markets. This assumes a given exchange rate. If the exchange rate depreciates, this may help to restore some of the lost competitiveness. This rise in relative inflation leads to a fall in the world share of UK exports and a rise in import penetration. Ultimately, this will lead to a fall in the rate of economic growth and the level of employment. The problems of a wage-price spiral – price rises can lead to higher wage demands as workers try to maintain their real standard of living. Higher wages over and above any gains in labour productivity causes an increase in unit labour costs. To maintain their profit margins they increase prices. The process could start all over again and inflation may get out of control. Higher inflation causes an upward spike in inflationary expectations that are then incorporated into wage bargaining. It can take some time for these expectations to be controlled. Higher inflation expectations can cause an outward shift in the Phillips Curve. Consumers and businesses on fixed incomes will lose out. Many pensioners are on fixed pensions so inflation reduces the real value of their income year on year. The state pension is normally updated each year in line with average inflation so that the real value of the pension is not reduced. Shoe leather costs - when prices are unstable there will be an increase in search times to discover more about prices. Inflation increases the opportunity cost of holding money, so people make more visits to their banks and building societies (wearing out their shoe leather!). Menu costs - extra costs to firms of changing price information. This can be important for companies who rely on bulky catalogues to send price information to customers. (Note there are also significant menu costs associated with any future transition to the European Single Currency)

Economic problems caused by Unemployment -

Most economists agree that high levels of unemployment are costly not only to the individuals and families directly affected, but also to local and regional economies and the economy as a whole. We can make a distinction between the economic costs arising from people out of work and the social costs that often result. Unemployment causes a waste of scarce economic resources and reduces the long run growth potential of the economy. An economy with high unemployment is producing within its production possibility frontier. The hours that the unemployed do not work can never be recovered.



But if unemployment can be reduced, total national output can rise leading to an improvement in economic welfare. High unemployment has an impact on government expenditure, taxation and the level of government borrowing each year an increase in unemployment results in higher benefit payments and lower tax revenues. When individuals are unemployed, not only do they receive benefits but also pay no income tax. As they are spending less it contributes less to the government in indirect taxes. This rise in government spending along with the fall in tax revenues may result in a higher government borrowing requirement (known as a public sector net cash requirement). Unemployment wastes some of the scarce resources used in training workers. Furthermore, workers who are unemployed for long periods become de-skilled as their skills become increasingly dated in a rapidly changing job market. This reduces their chances of gaining employment in the future, which in turn increases the economic burden on government and society. See the revision page on long term unemployment. Rising unemployment is linked to social and economic deprivation - there is some relationship between rising unemployment and rising crime and worsening social dislocation (increased divorce, worsening health and lower life expectancy). Areas of high unemployment will also see a decline in real income and spending together with a rising scale of relative poverty and income inequality. As younger workers are more geographically mobile than older employees, there is a risk that areas with above average unemployment will suffer from an ageing potential workforce - making them less attractive as investment locations for new businesses. It is clear therefore that unemployment carries substantial economic and social costs. These costs are greatest when long-term structural unemployment is high. Indeed many governments focus their Labour market policies on improving the employment prospects of the long-term unemployed.