The Consumer Price Index and Inflation

- Quantities that are measured in dollars (or other currency units) and then adjusted for inflation are called real quantities.
- Consumer Price Index (CPI): for any period, a measure of the cost in that period of a standard basket of foods and services relative to the cost of the same basket of goods and services in a fixed year, called the base year.
  - CPI = (Cost of base-year basket of goods and services in current year)/(Cost of base-year basket of goods and services in base year)
  - The base-year CPI is always equal to 1
  - No unit of measurement
- Price Index: a measure of the average price of a given quality of goods or services relative to the price of the same goods or services in a base year.
- Rate of Inflation: the annual percentage rate of change in the price level, as measured, for example, by the CPI.
  - (New CPI - Old CPI)/Old CPI
- Deflation: a situation in which the prices of most goods and services are falling over time so that inflation is negative.
- Core Rate of Inflation: the rate of increase of all prices except energy and food.
  - Energy and food are frequently responsible for short-run fluctuations in the inflation rate.
  - Core inflation excludes the sources of the most volatile price changes, so is a long-term measure of the inflation trend.

Adjusting for Inflation

- CPI can be used to convert quantities measured at current dollar values into real terms, a process called deflating.
- CPI can also be used to convert real quantities into current-dollar terms, a process called indexing.
- Nominal Quantity: a quantity that is measured in terms of its current dollar value.
- Real Quantity: a quantity that is measured in physical terms - for example, in terms of quantities of goods and services.