Inflation and the Price Level

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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 quantity 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