HOW CONSUMER PRICE INDEX MEASURES INFLATION

The CPI is the most closely watched indicator of inflation around the world. The consumer price index estimates the change in prices for a basket of goods and services that represents the average household spending. Calculations made from that basket are used to make decisions that will have an impact on consumer spending. Some of these decisions are about adjusting tax brackets and benefits like Social Security.

But how is this basket selected and used to calculate the CPI? The department in charge of the index, the Bureau of Labor Statistics, looks at several categories, each given a different importance to compute the month's percent change. Some of the most important categories are food, transportation, and housing.

Bureau of Labor Statistics gives each category its relative importance based on a survey of what consumers buy. The job of BLS's price checkers is to keep track of all of those items people spend money on and their prices changes month to month. To make sure products they are price tracking haven't changed, they compare the product to a list of data points from the month before.

This process helps to ensure the CPI's accuracy. The BLS is basing those calculations off of an urban consumer paying out of pocket. The formula excludes non-direct spending, like payments from non-profit organizations that provide services to households, Medicare, and employer-sponsored healthcare plans. This is just an average calculation as inflation affects different people differently. How you feel inflation depends a lot on what's in your spending basket, and how that differs from the average person's as captured in the CPI.

And the index doesn't include everything. For this reason, the Federal Reserve prefer to use broader indexes like the Personal-Consumption Expenditures Price Index, or PCE. One of the reasons why this index is preferred is that the CPI only transitions items in and out of the basket every two years, while the PCE changes its basket month to month based on consumer trends. The variations in how CPI and PCE are calculated mean that the two indexes can reflect inflation slightly differently, but the authorities take both into account.

Looking at multiple indexes gives a broad picture of inflation. And rising inflation of vital items, especially over long periods of time can cause more issues, like inflation becoming embedded in the economy. When inflation remains high for too long, consumers begin to change their behavior in ways that can keep prices elevated. By looking at changes to