In this chapter, look for the answers to these questions:

§ What is the Consumer Price Index (CPI)? How is it calculated? What’s it used for?
§ What are the problems with the CPI? How serious are they?
§ How does the CPI differ from the GDP deflator?
§ How can we use the CPI to compare dollar amounts from different years? Why would we want to do this, anyway?
§ How can we correct interest rates for inflation?

The Consumer Price Index (CPI)

§ measures

§ the basis of
How the CPI Is Calculated

1. The Bureau of Labor Statistics (BLS) surveys consumers to determine what's in the typical consumer's “shopping basket.”

2. The BLS collects data on the prices of all the goods in the basket.

3. Use the prices to compute the total cost of the basket.

4. Choose a base year and compute the index. The CPI in any year equals

5. Compute the inflation rate. The percentage change in the CPI from the preceding period.

EXAMPLE

<table>
<thead>
<tr>
<th>year</th>
<th>price of pizza</th>
<th>price of latte</th>
<th>cost of basket</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>$10</td>
<td>$2.00</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>$11</td>
<td>$2.50</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>$12</td>
<td>$3.00</td>
<td></td>
</tr>
</tbody>
</table>

Compute CPI in each year using 2007 base year:

2007:
2008:
2009:
**ACTIVITY 1**

**Calculate the CPI**

<table>
<thead>
<tr>
<th>Year</th>
<th>Price of Beef</th>
<th>Price of Chicken</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$4</td>
<td>$4</td>
</tr>
<tr>
<td>2005</td>
<td>$5</td>
<td>$5</td>
</tr>
<tr>
<td>2006</td>
<td>$9</td>
<td>$6</td>
</tr>
</tbody>
</table>

The CPI basket cost $120 in 2004, the base year.

A. Compute the CPI in 2005.

B. What was the CPI inflation rate from 2005-2006?

**ACTIVITY 1**

**Answers**

What's in the CPI's Basket?

- Housing 43%
- Transportation 6%
- Food & Beverages 6%
- Medical care 6%
- Recreation 6%
- Education and communication 15%
- Apparel 17%
- Other 4%

**MEASURING THE COST OF LIVING**
Substitution bias

<table>
<thead>
<tr>
<th></th>
<th>beef</th>
<th>chicken</th>
<th>cost of CPI basket</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$4</td>
<td>$4</td>
<td>$120</td>
</tr>
<tr>
<td>2005</td>
<td>$5</td>
<td>$5</td>
<td>$150</td>
</tr>
<tr>
<td>2006</td>
<td>$9</td>
<td>$6</td>
<td>$210</td>
</tr>
</tbody>
</table>

2004-5: Households bought CPI basket.

2006: Households bought (5 lbs beef, 25 lbs chicken).

A. Compute cost of the 2006 household basket.
B. Compute % increase in cost of household basket over 2005-6, compare to CPI inflation rate.

Problems with the CPI: Substitution Bias

- Over time, some prices rise faster than others.
- Thus, the CPI overstates increases in the cost of living.
Problems with the CPI:
Introduction of New Goods

- The introduction of new goods
- The CPI misses this effect because it uses a fixed basket of goods.
- Thus,

Problems with the CPI:
Unmeasured Quality Change

- The BLS tries to account for quality changes but probably misses some, as quality is hard to measure.
- Thus, the CPI overstates increases in the cost of living.

Problems with the CPI

- Each of these problems causes
- The BLS has made technical adjustments, but the CPI probably still overstates inflation by about
- This is important because
Contrasting the CPI and GDP Deflator

In each scenario, determine the effects on the CPI and the GDP deflator.

A. Starbucks raises the price of Frappuccinos.
B. Caterpillar raises the price of the industrial tractors it manufactures at its Illinois factory.
C. Armani raises the price of the Italian jeans it sells in the U.S.
Correcting Variables for Inflation: Comparing Dollar Figures from Different Times

Inflation makes it harder to compare dollar amounts from different times.

Example: the minimum wage

- $1.15 in Dec 1964
- $5.85 in Dec 2007

Did min wage have more purchasing power in Dec 1964 or Dec 2007?

To compare,

In our example,

- year \( T = 12/1964 \)
- "today" = 12/2007
- Min wage = $1.15 in year \( T \)
- CPI = 31.3 in year \( T \), CPI = 211.7 today

Researchers, business analysts and policymakers often use this technique to convert a time series of current-dollar (nominal) figures into constant-dollar (real) figures.

They can then see how a variable has changed over time after correcting for inflation.

Example: the minimum wage, from Jan 1950 to Dec 2007…
The U.S. Minimum Wage in Current Dollars and Today’s Dollars, 1950-2007

Annual tuition and fees, average of all public four-year colleges & universities in the U.S.
- 1986-87: $1,414 (1986 CPI = 109.6)
- 2006-07: $5,834 (2006 CPI = 203.8)

After adjusting for inflation, did students pay more for college in 1986 or in 2006? Convert the 1986 figure to 2006 dollars and compare.

ACTIVE LEARNING 4
Converting to “today’s dollars”

ACTIVE LEARNING 4
Answers
Correcting Variables for Inflation: Indexation

For example, the increase in the CPI automatically determines

Correcting Variables for Inflation: Real vs. Nominal Interest Rates

The nominal interest rate:

The real interest rate:

Real interest rate

Example:

Deposit $1,000 for one year.
Nominal interest rate is 9%.
During that year, inflation is 3.5%.
Real interest rate
Real and Nominal Interest Rates in the U.S., 1950-2007

Nominal interest rate — Real interest rate