TOPIC: INFLATION AND CONSUMER PRICE INDEX (CPI)

Inflation

- **Inflation** is the general and sustained rise in the level of prices in an _____ economy.

Good	Year 1	Year 2
Basket (Combination of widgets, gizmos, thingamabobs, and doodads)	$100	**$105**

Inflation? **Yes** | **No** | **Can't Tell**

Good	Year 1	Year 2
Widgets	$5	**$10**
Gizmos	$12	**$12**
Doodads	$7	**$6**

Inflation? **Yes** | **No** | **Can't Tell**

- Relative changes in prices represent changes in equilibrium in the supply-and-demand model, not inflation.
- The **inflation rate** is the percentage change in the price _____ in an economy.

$$\textbf{Inflation Rate} = \frac{\textit{Price Level in Year 2} - \textit{Price Level in Year 1}}{\textit{Price Level in Year 1}}$$

Consumer Price Index (CPI)

- ***Consumer Price Index (CPI)*** – measure of the average change in prices of a typical family's "basket of goods"

□ Step 1: The government surveys households to see what kind of goods are typically purchased → the "basket"

A typical family in Simple Land purchases these items during a given year: 50 jugs of Water™ and 75 pounds of Food™

□ Step 2: The prices of the goods in the "basket" are determined

Year	Price of Water™	Price of Food™
2	$5	$20
4	$5.05	$22
6	$5.20	$25

□ Step 3: The total cost of the "basket" is computed

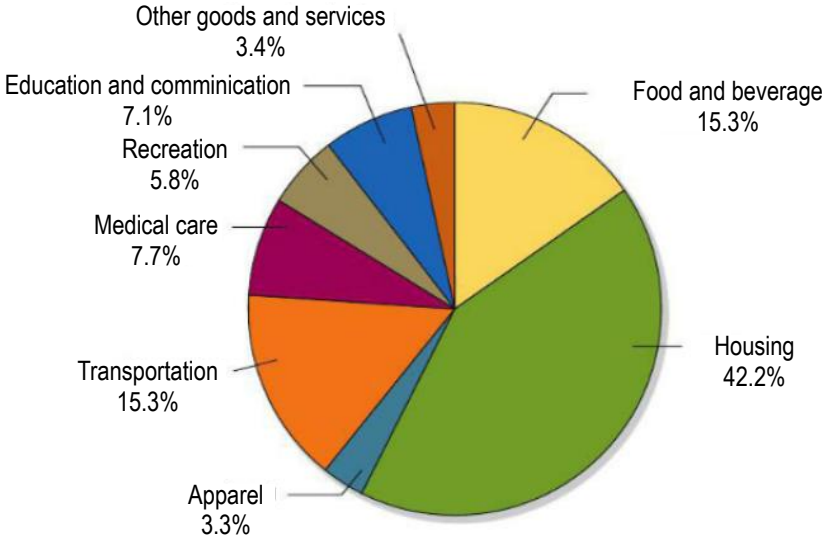
2017 Cost of Basket =
2018 Cost of Basket =
2019 Cost of Basket =

□ Step 4: The cost of the "basket" is compared to the chosen base-year → CPI is calculated

Formula	CPI for 2017	CPI for 2018	CPI for 2019
$CPI_{CY} = \frac{Basket\ Cost_{CY}}{Basket\ Cost_{BY}} * 100$			

□ Step 5: The CPI is used to calculate inflation rate (changes in prices over time)

Formula	CPI for 2017	CPI for 2018	CPI for 2019
$Inflation_{CY} = \frac{CPI_{CY} - CPI_{PY}}{CPI_{PY}} * 100$			



The typical family's spending habits used to construct the "basket of goods" comes from a government survey of 14,000 households

Source: U.S. Bureau of Labor Statistics