# Inflation

*Inflation* is an overall increase in the price level in an economy. *Deflation* is the opposite of inflation. Deflation is an overall decrease in the price level. A change in the price of just one or a few goods does not constitute inflation or deflation. After the price level increases, a dollar will buy less than it would before. When there is going to be inflation, people are better off buying now, before prices go up. After the price level falls, a dollar will buy more than it would before. When there is going to be deflation, people are better off waiting to buy later, when prices go down.

If people anticipate inflation, they will build that expectation into their decisions. For example, workers will demand higher wages to keep their purchasing power the same if prices are expected to rise. Then, when inflation leads to higher prices, workers are not hurt or helped because their higher wages allow them to purchase the same amount of goods and services. However, when inflation is *unanticipated*, people do not build it into their decisions, and some people are hurt while others are helped. For example, when there is unanticipated inflation, borrowers are helped while lenders are hurt. People who borrow money receive a loan before prices rise, when the money will buy more. However, they pay the money back later, after prices rise, when the money won't buy as much. With inflation, the borrower gains while the lender loses.

***Student Alert:* Inflation is an increase in the price level in the economy. It does not necessarily mean that the price of every good is going up!**

## Measuring Price Changes

A *price index* is used to measure price changes in the economy. Price indices combine the prices of a bundle of goods and services and track changes in the price of that bundle over time. The Consumer Price Index, or CPI, is the most familiar price index. It measures changes in the price of a bundle of goods and services commonly bought by consumers. The CPI is based on a market basket of more than 200 categories of goods and services weighted according to how much the average consumer spends on them. Two other price indices are the Producer Price Index (PPI) and the GDP deflator. The PPI measures the average change over time in the selling prices received by domestic producers for their output. The GDP price deflator is the most inclusive index because it takes into account the prices of all goods and services produced.

To construct any price index, economists select a year to serve as the base year (the year used for comparison). The prices of other periods are expressed as a percentage of the base period. The value of a price index in the base year is 100, because prices in the base year are 100 percent of prices in that year. Inflation will raise the price of the market basket, and the price index will rise. Deflation will decrease the price of the market basket, and the price index will fall.

For the CPI, the formula used to measure price change from the base period is

$$\text{CPI} = \frac{\text{cost of market basket in current-year prices}}{\text{cost of market basket in base-year prices}} \times 100.$$