

DIFFERENCE BETWEEN GDP DEFLATOR AND CPI

The GDP deflator and the CPI give somewhat different information about what's happening to the overall level of prices in the economy. There are three key differences between the two measures.

The first difference is that the GDP deflator measures the prices of all goods and services produced, whereas the CPI measures the prices of only the goods and services bought by consumers. Thus, an increase in the price of goods bought only by firms or the government will show up in the GDP deflator but not in the CPI.

The second difference is that the GDP deflator includes only those goods produced domestically. Imported goods are not part of GDP and do not show up in the GDP deflator. Hence, an increase in the price of a Toyota made in Japan and sold in this country affects the CPI, because the Toyota is bought by consumers, but it does not affect the GDP deflator.

The third and most subtle difference results from the way the two measures aggregate the many prices in the economy. The CPI assigns fixed weights to the prices of different goods, whereas the GDP deflator assigns changing weights. In other words, the CPI is computed using a fixed basket of goods, whereas the GDP deflator allows the basket of goods to change over time as the composition of GDP changes.

The following example shows how these approaches differ.

Suppose that major frosts destroy the nation's orange crop. The quantity of oranges produced falls to zero, and the price of the few oranges that remain on grocers' shelves is driven sky-high. Because oranges are no longer part of GDP, the increase in the price of oranges does not show up in the GDP deflator. But because the CPI is computed with a fixed basket of goods that includes oranges, the increase in the price of oranges causes a substantial rise in the CPI.