

↳ Problems in calculating CPI :  
↳ CPI calculated to measure standard of living. Basket is fixed. Consumers buy those goods of ↓<sup>er</sup> price ↑ and ↑<sup>er</sup> price ↓.  
When prices change in the next YR, thus the no. of particular goods bought also changes but basket is still fixed and wrongly estimates std of living ⇒ Substitution bias

Eg: YR-1  $\rightarrow$  apples  $\downarrow$  price, pears  $\uparrow$  price  $\Rightarrow$   
 $\uparrow$  apples considered in basket of goods. YR-2,  
(next YR)  $\rightarrow$  apples  $\uparrow$  price, pears  $\downarrow$  price  $\Rightarrow$   
 ppl buy more pears but still  $\uparrow$  apples are  
considered in fixed basket of goods.

Introduction of new goods  $\rightarrow$  Consumers  $\rightarrow$  variety  
of goods  $\Rightarrow$   $\uparrow$  options  $\Rightarrow$  each dollar is worth  
 $\uparrow$  value. But, as basket of goods is fixed,  
value of dollar does not change in basket.

Eg: Cassettes vs theatres.

$\downarrow$   
emerged  $\rightarrow$  new good  $\Rightarrow$  every dollar spent  
in cassettes.

Unmeasured quality change  $\rightarrow$  fixed basket of  
goods assuming constant quality of goods. But  
quality of goods from YR-1 to YR-2

$\downarrow$  <sup>ses</sup>  
value of each  
dollar spent on the good

$\uparrow$  <sup>ses</sup>  
value of each dollar  
spent on the good  $\uparrow$  <sup>ses</sup>

$\downarrow$  <sup>ses</sup>  
This change in value of dollar also  $\rightarrow$  not  
counted.

CPI overstates the standard of living.

## GDP deflator

- reflects the prices of all goods & services bought domestically.
- Any price change in the goods bought domestically but does not belong to the basket bought by a typical consumer  $\Rightarrow$  change noted in GDP deflator but not in CPI.
- There is no fixed basket of goods. It compares prices of goods (current with base YR) -

## Consumer Price Index (CPI).

- reflects the prices of all goods & services bought by consumers
  - (included in the basket of goods bought by consumers)
- Any price change in this basket of goods, one of the goods of then CPI notes it,  $\leftarrow$  GDP deflator does not note this.
- Based on fixed basket of goods.
  - also decides no. of each good.

## WPI

- Wholesale Price Index
- Measures inflation @ each stage of production
- = Middle point of sum of all goods bought by traders
- WPI is calculated w.r.t. price in wholesale markets.
- Few countries use WPI to calculate their inflation rate.
- Has 679 elementary items some of which are insignificant prices of outdated goods.

## CPI

- Consumer Price Index.
- Measures inflation only @ final stage of production.
- = Middle point of sum of all the goods bought by consumers.
- CPI is calculated w.r.t. price @ retail level.
- ↑ countries use CPI to calculate Inflation rate.
- Has well-selected variables.