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Does CPI Tell You What You Need to Know About Inflation?

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Question: I've been seeing signs of inflation, especially at the grocery store, but the CPI figures quoted in the media seem to indicate inflation is pretty tame. What goes into CPI, and how effectively does it capture inflation?

Answer: It's no wonder that inflation has been a hot topic lately. While the Consumer Price Index numbers have been nearly flat month-to-month, the quickly rising prices of common goods and services suggest that things are not as rosy as common CPI figures would suggest. So is CPI an accurate reflection of changes in the cost of living? To make that assessment, it's worthwhile to understand what goes into the CPI calculation as well as some important caveats that go along with this commonly cited inflationary measure.

The Basics of 'Headline CPI'

The Bureau of Labor Statistics publishes myriad statistics on inflation, but the most widely reported measure of inflation is the All Items Consumer Price Index for All Urban Consumers (CPI-U) for the U.S. City Average, often referred to in shorthand as CPI. It's based on the actual expenditures of about 14,500 families living in urban areas covering about 87% of the total U.S. population and captures the rate at which a basket of approximately 80,000 goods and services has risen or fallen month to month.

The price change of each item is averaged and then weighted according to its importance in the spending patterns of a population group. To depict that the typical urban consumer spends more money on cars than baby clothing, for example, "new and used motor vehicles" have a greater weight in the CPI-U calculation than "infants and toddlers' apparel."

For more information on how the market basket is determined, the goods and services that the CPI covers, and the process by which BLS collects and reviews prices, click here.

Headline CPI Versus Core CPI

The CPI-U, also known as the headline rate of inflation, is the most widely cited measure of inflation. But it can also be a volatile measure, which is why the Federal Reserve does not look to headline CPI to track inflationary pressures and adjust monetary policy. Rather, the Fed focuses on core CPI, which excludes food and energy costs to determine the "underlying" rate of inflation. That's because food and energy prices are extremely volatile from month to month as a result of temporary supply disruptions caused by weather or political crises. By stripping out food and energy prices, the Fed can tune out short-term deviations and focus on stable price trends in order to monitor long-term changes in prices. The Fed, and many economists, consider core CPI as the more dependable measure of the supply and demand interplay (minus the supply shocks) and actual levels of inflation.

Note that neither figure should be taken strictly at face value, however. Although core CPI might be the better measure of underlying inflation, headline CPI might reflect a longer-term trend that's worth investigating--for example, a spike in commodities prices as a result of burgeoning developing economies may make it unlikely that their prices will revert to the mean anytime soon.

Core and headline CPI often diverge substantially in the near term. For example, relative to a year ago, core and headline CPI are up by 0.3% and 3.6%, respectively. The core inflation rate looks harmless, but for consumers who are susceptible to the volatility in food and energy prices, a headline CPI rate of 3.6%-- leaps and bounds above the core rate--does not look quite so benign.

Caveats of Headline CPI

Even though the widely quoted headline CPI, or CPI-U, might be a better measure of the actual consumer experience than is core CPI, bear in mind that neither measure is a perfect reflection of inflationary pressures for all individuals at various points in time.

For starters, the CPI does not consider changes in quality of goods and services. Although consumers benefit from higher-quality products, improved quality often results in an increase in prices. The CPI, however, assumes no change in quality and attributes the rise in prices to inflation.

One other caveat of CPI is that when prices go up, consumers tend to reduce consumption of more expensive products in favor of cheaper alternatives. For example, a rise in beef prices when pork prices remain stable may cause consumers to shift away from beef to pork. But because the CPI uses a fixed basket of goods and services, it assumes that people are purchasing the same basket of products regardless of price fluctuations. Therefore, consumer expenses may not be as large as the CPI figures imply.

To help address consumers' natural tendency to switch products in an effort to reduce costs, the BLS has begun to publish the Chained Consumer Price Index for All Urban Consumers (C-CPI-U). Unlike the broad CPI-U, the Chained CPI incorporates modest consumer substitution in response to changes in relative prices. It's also designed to be a closer approximation to a cost-of-living index than the traditional CPI indexes. Lately, the chained CPI has been in the news because policymakers are considering tweaking the inflation adjustment in Social Security payments to better reflect retirees' actual costs. For the answers to frequently asked questions on the Chained Consumer Price Index, click here.

CPI-U figures also do not depict the rate of inflation experienced by population subgroups like the elderly. The BLS has released an experimental index for the elderly population called the CPI-E, but given that this index has its own set of significant limitations, it should be interpreted with caution.

Finally, CPI-U might not accurately reflect inflationary pressures in varying geographic regions. The CPI-U targets the U.S. urban population, so it doesn't pick up on price changes in rural areas; nor does it reflect that people in specific areas will tend to experience price changes that aren't in effect in other areas. To help address these geographic discrepancies, the BLS publishes CPIs by area, in addition to the monthly calculations of the national CPI-U. But keep in mind that a higher CPI for one area does not mean that prices are higher there than in an area with a lower CPI. Rather, a higher index suggests that prices in that area have risen at a higher rate than in an area with a lower index.

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