Why are there so many price indexes?

Various measures of prices and inflation have been constructed for different purposes and, therefore, reflect differing emphases. For example, the Consumer Price Index (CPI) was designed to adjust pensions for WW II veterans. It measures changes in prices for a fixed basket of goods that is intended to reflect the typical urban consumer. Although the market basket is periodically adjusted, the fixed shares make it possible to leave past data unrevised. These properties make the CPI useful for indexing items like Social Security payments, wage contracts and inflation-adjusted bonds.

The Personal Consumption Expenditures Index (PCEPI) was designed to measure the real, inflation-adjusted consumption component in the National Income and Product Accounts. Therefore, the PCEPI is a more comprehensive measure than the CPI. The PCEPI also differs from the CPI by using expenditure shares that change over time as consumers adjust their purchases in response to relative price changes—buying more apples when orange prices rise, for example.

Other price indexes are designed to measure prices of specific economic activities. The Producer Price Index (PPI) tracks the prices of materials as they move through the production process toward finished-good status. The Import Price Index, as the name implies, measures changes in the prices of imported goods.

For both the CPI and PCEPI, it is common to consider “core” measures, for which the food and energy components are eliminated. Because these two components tend to be more volatile than others, their omission leaves a measure that is thought to more accurately reflect long-term trends in inflation. A similar motivation lies behind the construction of the “median” and “trimmed mean” measures of the CPI that are published by the Federal Reserve Bank of Cleveland.

The Federal Open Market Committee (FOMC) has, in recent years, cast its inflation forecasts in terms of the core PCEPI. On Nov. 14, 2007, Fed Chairman Ben Bernanke announced that the FOMC would begin making quarterly projections for headline PCEPI inflation (which includes food and energy—important items in the consumer’s budget) and for core inflation (because it is a better short-run indicator of where headline inflation is likely to end up in the long run).

Submit your question in a letter to the editor. (See Page 2.) One question will be answered by the appropriate economist in each issue.