CONCEPT: PROBLEMS WITH THE CONSUMER PRICE INDEX

● The Consumer Price Index (CPI) as a measure of inflation can run into biases that tend to overstate inflation:

- □ ***Substitution Bias*** – CPI assumes that the same amount of each product is purchased each month
  - > However, customers are likely to buy fewer of products that increase in price (and vice versa)
  - > Example: Apple prices rise significantly, orange prices rise slightly → Substitute apples with oranges
  - > Since the CPI assumes apple purchases remain constant, the CPI will overstate the actual basket price
- □ ***Quality Bias*** – Over time, items in the basket improve in quality
  - > Example: faster computers; safer cars
  - > Higher quality items will have these quality improvements embedded into the price
  - > Thus, although prices may have increased by inflation, they may have increased due to quality as well
- □ ***New Product Bias*** – New products introduced since the last "basket" will not be included in the "basket
  - > Example: Cell phones were not included in CPI until the late 1990s, though millions were in use
  - > Price decreases tend to happen in years following new technology (i.e. DVD players, HDTVs)
  - > If the technology is not included in the basket, then these price decreases will not reflect in CPI
- □ ***Outlet Bias*** – The way people shop has changed over the years
  - > CPI was consistently calculated at full-retail prices available in stores
  - > However, consumers also purchased at discount chains (Costco, Sam's Club) and online
  - > The prices used could overstate the actual prices paid by consumers depending on the chosen outlet