Measuring Inflation

Economics

How a price index is built, and where it goes wrong.

Construction and known biases.

How it works

- Define a representative basket
- Weight by share of spending
- Price the basket each period
- Index against a base year
- Reweight periodically

Known biases

- Substitution — people switch when prices rise
- Quality change hard to separate from price
- New goods enter the basket late
- Outlet substitution to cheaper sellers

Different households face different inflation. A published average conceals wide variation by income and spending pattern.