Chapter 24: Measuring the Cost of Living
Principles of Economics, 8th Edition
N. Gregory Mankiw
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1. *Introduction*
   a. *This is a straight forward and readable chapter, so we will cover it fairly quickly in class.*
   b. *It is an important chapter because the CPI is used as the measure of inflation that is used to "adjust" current data to real figures.*
   c. *However, since the CPI tends to overstate the decline in the value of the dollar, it tends to make current conditions look worse than they are.*

2. The Consumer Price Index (CPI) is a measure of the overall cost of the goods and services bought by a typical consumer. P. 496.
   a. How the consumer price index is calculated
      i. There are five steps:
         (1) Fix the basket,
         (2) find the prices,
         (3) compute the basket's cost,
         (4) choose a base year and compute the index and
         (5) compute the inflation rate.
      ii. **Table 1: Calculating the Consumer Price Index and the Inflation Rate: an Example. P. 497.**
      iii. Inflation rate is the percentage change in the price index from the preceding period. P. 498.
         (1) Be careful about this concept:
            (a) the increase in a given price alone is not inflation and
            (b) increases in overall prices is evidence of inflation, but not the cause.
         (2) Remember than Mankiw in Chapter 1 said that it is due to too much money.
      iv. Core CPI is a measure of the overall cost of consumer goods and services excluding food and energy. P. 499.
      v. Producer price index is a measure of the cost of a basket of goods and services bought by the firms. P. 499.
   b. Problems in Measuring the Cost of Living
      i. **FYI: What is in the CPI's Basket?**, **P. 498.**
         (1) **Figure 1: The Typical Basket of Goods and Services. P. 498.**
      ii. **In the News : Monitoring Inflation in the Internet Age, P. 500.**
      iii. Substitution bias,
      iv. introduction of new products and
      v. unmeasured quality changes.
      vi. Several studies in the 1990s concluded that the CPI overstated inflation by about one percent per year.

(1) With some changes, many believe that it is off by about .5 percent.

vii. If the CPI overstates the cost of living by 1 percent per year, instead of falling by 8%, real hourly earnings have risen by 28 % from 1973 to 2014.

c. The GDP Deflator Versus the Consumer Price Index

i. GDP is strictly domestic, while the CPI is all consumer expenditures.

ii. The GDP Deflator holds prices constant, while the CPI holds quantities constant..

iii. **Figure 2: Two Measures of Inflation. P. 503.**

(1) The gap is due to oil prices (imported goods).

3. Correcting Economic Variables for the Effects of Inflation

a. Dollar figures from different times

b. Indexation is the automatic correction of a dollar amount for the effects of inflation by law or contract. P. 506.

c. **FYI: Mr. Index Goes to Hollywood, P. 504.**

d. Case Study: Regional Differences in the Cost of Living, P. 505.

i. NM is slightly below average.

e. Real and Nominal Interest Rates

i. Economic decisions are based on the expected real interest rate.

ii. Other than cash flow considerations, you should be indifferent about the mortgage rate when you buy a house.

(1) When it is low, inflation is expected to be low and your house is expected to appreciate slowly.

(2) When it is high, inflation is expected to be high and your house is expected to appreciate more rapidly.

iii. Nominal interest rate is the interest rate usually reported without a correction for the effects of inflation. P. 507.

iv. Real interest rate is the interest rate corrected for the effects of inflation. P. 507.

(1) *The equation should read: real interest rate = nominal interest rate - (expected) inflation rate.*

v. **Case Study: Interest Rates in the U. S. Economy, P. 508.**

(1) **Figure 3: Real and Nominal Interest Rates. P. 508.**

(a) This graph presents nominal rates minus current inflation.

(b) However, decisions are based on nominal rates minus expected inflation.

(c) In the mid to late 1970s, the markets under estimated expected inflation resulting in negative real rates.

(d) We bought our house in 1977 and for a while the banking was paying us to take their money: the inflation rate far exceeded the mortgage rate.

4. Conclusion

5. Summary