BANK OF CANADA

The Consumer price Index

BACKGROUNDER

The consumer price index (CPI) provides a broad measure of the cost of living in Canada. While there are other ways to measure price changes, the CPI is the most important indicator because of its widespread use, for example, to calculate changes in government payments such as the Canada Pension Plan and Old Age Security.

Through the monthly CPI, Statistics Canada tracks the retail price of a CPI shopping basket made up of about 600 goods and services from the general categories of an average household's expenditure - food, shelter, furniture, clothing, transportation, and recreation.

The percentage of the total basket that any item occupies is termed the "weight" and reflects typical consumer spending patterns. Since people tend to spend more on food than clothing, changes in the price of food have a bigger impact on the index than, for example, changes in the price of clothing and footwear.

Calculating the CPI

Prices are measured against a base year. The base year is currently 1992 and the basket for that year is given the value of 100. In 1997, the CPI had reached 107.6, which means that what you could buy for $100 in 1992 cost $107.60 in 1997. The Bank of Canada Web site has an interactive *Inflation Calculator* that uses monthly CPI figures from 1914 to the present to show users the impact of inflation on purchasing power.

The rate of increase of the CPI is typically reported as the percentage increase in the index over the past 12 months. To provide a reliable picture of the short-term trend of inflation, comparisons of month-to-month changes in the index are adjusted to reflect predictable seasonal price changes.

Updating the CPI

The CPI basket is updated from time to time by Statistics Canada to reflect broad changes in consumer spending habits, as well as to take account of changes in products and services.

Because of the difficulties of measuring price changes due to changes in quality of products as well as other variables, the CPI may contain a certain *measurement bias* that prevents it from giving a completely accurate picture of inflation. Recent studies of this bias suggest that the CPI may overstate inflation by about 0.5 percentage points.

The Bank of Canada monitors changes in the CPI in deciding when to take action to adjust *monetary conditions* to keep inflation within the range of the *inflation-control targets* it has set. To assess the trend of inflation, the Bank keeps an eye on the "core CPI," which excludes food and energy costs (because these elements tend to be volatile) as well as the effects of indirect taxes.