**CPI and Inflation Practice**

**The table below shows the prices and the quantities of meat consumed in Meat-Loversville. Suppose the base year is 2003.** *Also, suppose that 2003 is the year that the typical consumption basket was determined, so the quantities consumed in 2003 are the only quantities needed to calculate the CPI in each year.*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Year | Price of Beef | Quantity of Beef | Price of Pork | Quantity of Pork |
| 2003 | $2.00 | 100 | $1.00 | 100 |
| 2004 | $2.50 | 90 | $0.90 | 120 |
| 2005 | $2.75 | 105 | $1.00 | 130 |

a. Determine the values of the basket in 2003,2004, 2005.

b. Determine the values of the CPI in 2003,2004, 2005.

c. What was the inflation rate for 2004? Why is the inflation rate for this year biased upward?

d. Suppose that the base year is changed from 2003 to 2005. Also, suppose that the typical consumption basket was now determined in 2005. What is the new CPI for 2004?

Your granddaddy decided to quit smoking cigarettes in 1995. When you ask him why he quit, you get a surprising answer. Instead of reciting the health benefits of quitting smoking, he says, “I quit because it was just getting too expensive. I started smoking in 1965 because Lt. Dan was doing it and so I just had to. At the time, cigarettes were only 45 cents a pack. The last pack I bought was $2.00 and I just couldn’t justify spending more than four times as much on cigarettes as I used to.”

**1965 CPI- 31.5 1995 CPI- 152.4**

a. What is the equivalent of a 1965 pack of cigarettes measured in 1995 prices?

b. What is the equivalent of a 1995 pack of cigarettes measured in 1965 prices?

c. Do both methods give you the same conclusion? What conclusion is that?

d. Economists refer to the preceding situation as the “money illusion.” Why do think economists use this term to describe the behavior?

In 1975, the federal minimum wage was $2.10 per hour. By 1985, it had risen to $3.35 per hour. In 1995, it was $4.25 per hour. Today, it is $7.25 per hour.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Year | 1975 | 1985 | 1995 | 2010 |
| CPI (base years 1982-4) | 53.8 | 107.6 | 152.4 | 218.8 |

After correcting for inflation, has minimum wage risen or fallen over time? To see the answer, we’ll need to convert these nominal minimum wages into real minimum wages. Here’s how we do that:

**Real income= (Nom. Income/CPI) x 100**

What minimum wage would be needed to give someone the same purchasing power as a person on minimum wage in 1975?