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Inflation: Key Measures to Understand

Inflation and the Economy

Inflation is one of the most important and frequently discussed economic topics. Economists, policymakers, and the public care about inflation because it leads to the same amount of money in your pocket being worth less over time. If wages don't keep up with rising inflation, then it can lead to a decrease in purchasing power. And when inflation becomes volatile and unpredictable, it can make everyday activities like budgeting, lending, and borrowing more challenging. Policies to address inflation are often imperfect and can be difficult to apply.

While it has become a salient issue in recent years, the concept of inflation is not always clearly understood. To better understand inflation, it is important to know the ways it's measured, what drives it, its history, and how policymakers try to keep it at bay.

What Is Inflation?

Inflation is the general increase in the prices of goods or services over time and has a significant effect on both consumers and businesses.

For consumers, inflation increases the price of products and services, making them more expensive to purchase. If their wages don't rise to keep up with increasing prices, consumers' purchasing power declines, reducing their standard of living.

For businesses, inflation can increase the cost of inputs, including paying workers higher wages. If businesses absorb these higher costs, their profits may decrease. If they pass the higher costs on to consumers, it can lead to lower demand and lower business profits. Businesses prefer low, steady inflation because it is predictable, making it easier to forecast input costs and consumer demand. Businesses and investors face a harder time making decisions in periods when inflation is rising or volatile.

Understanding How Disinflation and Deflation Differ from Inflation

In addressing inflation, there is often confusion between the aim of lowering the rate of price increases versus lowering prices.

- **Disinflation** is when the rate of inflation is reduced, with the goal of achieving price stability at a lower rate of inflation. In the current environment, the Federal Reserve aims to reduce the inflation rate to its established goal of 2 percent.^a Price stability is important because it provides certainty in the economy and allows consumers and businesses to confidently engage in economic activity.
- **Deflation** is when there is a sustained decrease in the price level. Deflation can be extremely dangerous for the economy. If consumers think prices could decline in the future, they could put off purchasing goods and services in pursuit of lower prices, causing a drop in demand. Shrinking demand could ultimately slow economic growth and cause a recession.

^a The Federal Reserve, “FAQs: Why does the Federal Reserve aim for inflation of 2 percent over the longer run?” updated August 22, 2025, https://www.federalreserve.gov/faqs/economy_14400.htm.

Measuring Inflation

Overall inflation at the consumer level is measured by calculating the average price for a basket of goods and services across the whole economy. Two main surveys measure the price level: **the consumer price index (CPI)**, and **the personal consumption expenditures (PCE) price index**. (See Figure 1.)

The CPI measures the dollar cost over time of a specific list of goods and services that an urban consumer would purchase.¹ This index is the ratio between the price of a basket of goods and services in the current year and the price of the same basket in the previous year. The year-over-year percentage change is the inflation rate.

The PCE is similar to the CPI but differs in a few key ways. First, the PCE includes certain indirect purchases that are not in the CPI, such as medical care paid for by insurance. The PCE also covers rural and urban consumers, nonprofits, and items bought on behalf of consumers such as fringe benefits. Second, and most importantly, the PCE’s formula reflects the fact that consumers react to rising prices by changing their buying habits, substituting lower-cost goods or services for those that cost more. While the PCE formula captures this substitution effect on an ongoing basis,² the CPI only updates its basket of goods and services every two years.³

What Are The Different Measures of Consumer Inflation?

Inflation measures calculate the average price for a “market basket” of goods and services across the whole economy.

Two main surveys measure inflation:

Consumer Price Index (CPI)

- Measures the dollar cost of a fixed market basket of goods and services over time that an urban consumer would purchase.
- Updates market basket every two years

Personal Consumption Expenditures (PCE) price index

- Measures overall spending, including spending on behalf of a consumer (such as medical care paid for by insurance)
- Covers rural and urban consumers as well as nonprofits
- Updates on a quarterly basis to account for changes in spending behavior

Understanding Core Inflation

Both CPI and PCE indexes also report “core” inflation numbers that exclude food and energy prices. Food and energy prices can be volatile due to temporary factors, such as weather conditions or political upheaval, rather than to the inflation trend of the broader economy.

For more information, see CBPP, “Inflation: Key Measures to Understand”

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The headline CPI and the PCE inflation numbers reflect the entire basket of goods and services covered by these indexes, but both also report a “core” version that excludes food and energy prices, which can be volatile. Economists sometimes look at core inflation because sharp changes in food or energy prices may not be related to the inflation trend of the broader economy.⁴ Changes in food and energy prices are often related to temporary factors unrelated to the underlying economy, such as poor weather conditions or political upheaval.⁵

There are other broad measures of inflation, including the **Producer Price Index**, which measures changes in prices that producers receive for selling their output, as well as inflation measures that look at smaller sets of goods and services, such as food prices.

Inflation Drivers

The overall **price level** for consumers depends on the supply of and demand for goods and services available in the economy. Demand reflects the total amount of goods and services consumers are willing and able to purchase at a given price. Supply reflects the total amount of goods and services that businesses are willing and able to supply at a given price.



Demand-pull inflation and cost-push inflation are the two most common types of inflation.

The most common type of inflation is **demand-pull inflation**, which occurs when demand for goods and services rises relative to their supply in an economy. This can occur during periods of high economic growth, when unemployment and interest rates are low and people have more money to spend on goods and services, but production of those goods and services have not caught up to the increased demand.

Another type of inflation is **cost-push inflation**, which occurs when businesses raise prices due to an increase in their input costs, such as wages or raw materials.⁶ Consumer prices rise because input prices have risen, generally because the availability of inputs is constrained or interrupted.

A **wage-price spiral** occurs when rising wages and prices become mutually reinforcing, generating even higher prices. For instance, if workers demand higher wages in reaction to higher prices, then higher wages can increase production costs for businesses. In turn, businesses may further raise the price of their goods and services.

Inflation expectations can also be a driver of current inflation.⁷ Inflation expectations refer to the inflation rate that consumers, businesses, and investors believe they will face in the future. If they think that inflation will be higher in the future, they may act now to try to counter it. For instance, if consumers think the cost of goods will be significantly higher in the future, they may purchase more of them now in advance of the price hike. But that boosts demand and puts upward pressure on prices, effectively helping fuel the expected higher level of inflation. In contrast, if inflation expectations are “anchored” at a lower level, it can help dampen reactions to price increases, leaving time for producers to adjust supply and for policymakers to address inflation through changes in monetary policy.

Inflation Over Time

The United States has seen some notable periods of high inflation in the past, specifically during the 1970s and the early 2020s. (See Figure 2.) In 1974, the CPI inflation rate reached 12 percent, and then dropped to around 5 percent by 1976. After subsiding largely by itself,⁸ inflation rose again in 1980 to almost 15 percent. This volatility was driven by a number of factors including two oil shocks, the first being the 1973 oil crisis, which created an oil shortage and pushed up oil prices for consumers and businesses. The second one was the oil shock of 1978–79, which was caused by the Iranian Revolution and the subsequent collapse of Iranian oil production.

The most recent spike in inflation was in 2021–23, when the CPI inflation rate reached 9.1 percent.⁹ There has been a lot of speculation about the drivers of inflation over this period, but recent analyses show that higher commodity prices (particularly energy) and tight global supply chains along with shifts in the composition of consumer spending were the major causes of this inflation spike.¹⁰ Pent-up consumer demand after the pandemic as well as fiscal stimulus from multiple COVID-relief packages helped boost aggregate demand. Energy prices rose in response to higher demand as well as the effects of the Russian invasion of Ukraine. Moreover, consumer spending shifted from services to durable goods. With tight global supply chains, not enough goods were available to meet the higher demand, so goods prices rose

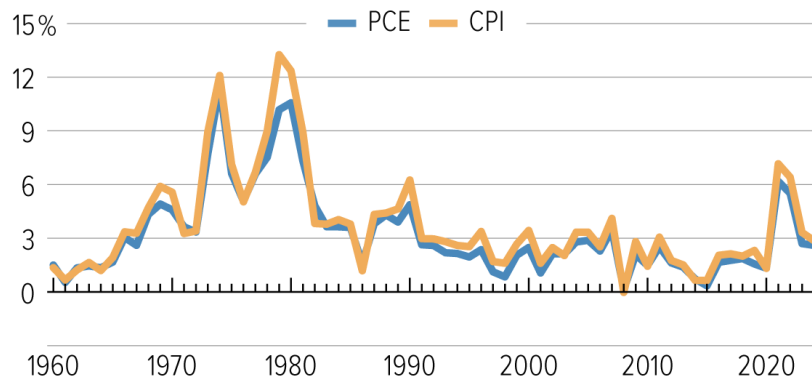
sharply. As supply chains became unsnarled and energy markets stabilized, the inflation rate started decreasing.

More recently, the CPI inflation rate was 2.7 percent¹¹ for the year ending in December 2025,¹² which is low compared to the 1970s but still elevated compared to the 2000s and 2010s. The Congressional Budget Office expects CPI inflation to be 2.7 percent in 2026, 2.3 percent in 2027, and 2.1 percent in 2028.¹³

FIGURE 2

Inflation Peaked During Late 70s and Early 80s, Has Been Relatively Stable Since

Consumer Price Index for all urban consumers, annual rate
Personal Consumption Expenditures: chain-type price index, annual



Source: Federal Reserve Bank of St. Louis

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Approaches to Curbing High Inflation

The policy responses to high inflation and price volatility available to policymakers depend on the state of the economy and the underlying causes of inflation. For instance, demand-pull inflation can occur when the economy is strong and possibly overheating. In this situation, policies would seek to slow economic growth without tipping the economy into recession, thereby easing inflationary pressures.

The Federal Reserve can address demand-pull inflation by raising interest rates. The Fed's main policy lever is the **federal funds rate**, which is the rate at which banks borrow from and lend to one another on overnight loans. The federal funds rate influences other interest rates that apply to households and businesses, like mortgage rates and credit card rates. By increasing the federal funds rate, the Fed makes borrowing more expensive, which in turn reduces demand for goods and services and stunts economic activity, slowing economic growth. The reverse is also true – when the Fed cuts the federal funds rate, that can result in increased economic activity. This is why the Fed cuts interest rates to counter an economic downturn. (Technically, the Federal Reserve sets a *target* for the federal funds rate and uses

tools primarily related to the interest rate it pays on deposits at the Fed to indirectly – and effectively – nudge the federal funds rate to its target.)

The Fed’s interest rate policy is guided by its goal of holding inflation steady and close to its 2 percent target (as measured by the PCE) and keeping unemployment low. If inflation is high and the labor market is weak, the Fed faces challenging choices. It can reduce interest rates to try to increase demand in the economy and increase employment, but that could cause inflation to accelerate. Conversely, it can raise interest rates to bring down prices, but that could further weaken the labor market, leading to higher unemployment.

Congress also has options to address demand-pull inflation. It could implement price controls, reduce government spending, or increase taxes.

Price controls can work in the short term to hold down prices, but because they do not address the root causes of the inflation, economists generally view price controls as ineffective over time – they can cause shortages, as businesses are unwilling to supply goods and services at lower prices, and inflation can return when the price controls are relaxed.¹⁴



Policy responses to high inflation
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and the underlying causes of inflation.

Reducing government spending or increasing taxes can lower demand, leading to reduced prices. These kinds of policies typically take longer to put in place and impact the economy more than action taken by the Fed to raise or lower interest rates. Like the Fed, if the labor market is weak, then lowering government spending or raising taxes could further weaken employment and economic growth. Depending on what government spending is cut or whose taxes are raised, these actions can have significantly different impacts on households at different parts of the income distribution.

Supply limitations drive cost-push inflation, which is harder for the Federal Reserve to address by changing interest rates. Executive and congressional action, such as reducing the regulatory load on businesses or increasing subsidies for a particular set of goods or sectors, could lower production costs, boost supply, and lead to lower prices over time. These can take time to implement, and so they are unlikely to be a quick fix to cost-push inflation. Similarly, it is difficult for governments to quickly address supply disruptions, due to the long-term nature of infrastructure projects as well as the global nature of the supply chain.¹⁵ The Fed can raise interest rates and lower demand overall, but that could lead to reduced employment broadly, imposing significant economic pain for what could be a temporary supply disruption.

¹ Drew DeSilver, “As inflation soars, a look at what’s inside the consumer price index,” Pew Research Center, January 24, 2022, <https://www.pewresearch.org/short-reads/2022/01/24/as-inflation-soars-a-look-at-whats-inside-the-consumer-price-index/>.

² Joseph G. Haubrich and Sara E. Millington, "PCE and CPI Inflation: What's the Difference?" Federal Reserve Bank of Cleveland, April 17, 2014, <https://www.clevelandfed.org/publications/economic-trends/2014/et-20140417-pce-and-cpi-inflation-difference>.

³ Noah Johnson, "A Comparison of PCE and CPI: Methodological Differences in U.S. Inflation Calculation and Their Implications," Bureau of Labor Statistics, November 2017, <https://www.bls.gov/osmr/research-papers/2017/pdf/st170010.pdf>.

⁴ Federal Reserve Bank of San Francisco, "What is "core inflation," and why do economists use it instead of overall or general inflation to track changes in the overall price level?" October 1, 2004, <https://www.frbsf.org/research-and-insights/publications/doctor-econ/2004/10/core-inflation-headline/>.

⁵ *Ibid.*

⁶ James Chen, "Demand-Pull Inflation: Definition, How It Works, Causes, vs. Cost-Push Inflation," Investopedia, updated July 9, 2025, <https://www.investopedia.com/terms/d/demandpullinflation.asp>.

⁷ Kristoph Naggert, Robert Rich, and Joseph Tracy, "The Anchoring of US Inflation Expectations Since 2012," Federal Reserve Bank of Cleveland, July 11, 2023, <https://www.clevelandfed.org/publications/economic-commentary/2023/ec-202311-the-anchoring-of-us-inflation-expectations-since-2012>.

⁸ Alan S. Blinder, "The Anatomy of Double-Digit Inflation in the 1970s," in *Inflation: Causes and Effects*, edited by Robert E. Hall, University of Chicago Press, 1982.

⁹ Bureau of Labor Statistics, "Consumer prices up 9.1 percent over the year ended June 2022, largest increase in 40 years," July 18, 2022, <https://www.bls.gov/opub/ted/2022/consumer-prices-up-9-1-percent-over-the-year-ended-june-2022-largest-increase-in-40-years.htm>.

¹⁰ Ben Bernanke and Olivier Blanchard, "What Caused the U.S. Pandemic-Era Inflation," *American Economic Journal: Macroeconomics*, 2025, 17(3): 1–35, <https://www.aeaweb.org/articles/pdf/doi/10.1257/mac.20230195>

¹¹ Due to the government shutdown, there were no data collected for October 2025, which led to the CPI estimate being understated. See Lucia Mutikani, "US annual consumer inflation slows in November, but report distorted by missing data," Reuters, December 18, 2025, <https://www.reuters.com/business/us-annual-consumer-prices-increase-less-than-expected-november-2025-12-18/>.

¹² Federal Reserve Bank of St. Louis, "Consumer Price Index for All Urban Consumers: All Items in U.S. City Average," updated October 24, 2025, <https://fred.stlouisfed.org/series/CPIAUCSL>.

¹³ Congressional Budget Office, "CBO's Current View of the Economy From 2025 to 2028," September 2025, <https://www.cbo.gov/publication/61738>.

¹⁴ Christopher J. Neely, "Why Price Controls Should Stay in the History Books," Federal Reserve Bank of St. Louis, March 24, 2022, <https://www.stlouisfed.org/publications/regional-economist/2022/mar/why-price-controls-should-stay-history-books>.

¹⁵ Marc Labonte and Lida R. Weinstock, "Supply Disruptions and the U.S. Economy," Congressional Research Service, May 13, 2022, <https://www.congress.gov/crs-product/IN11926>.