Key Terms

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Please review the following key terms. (15)(17)(18)(19)

Barter — literally, trading one good or service for another, without using money.

Base year — arbitrary year whose value as an index number is defined as 100; inflation from the base year to other years can easily be seen by comparing the index number in the other year to the index number in the base year — for example, 100; so, if the index number for a year is 105, then there has been exactly 5% inflation between that year and the base year.

Basket of goods and services — a hypothetical group of different items, with specified quantities of each one meant to represent a "typical" set of consumer purchases, used as a basis for calculating how the price level changes over time.

Commodity money — an item that is used as money, but which also has value from its use as something other than money.

Consumer Price Index (CPI) — a measure of inflation calculated by U.S. government statisticians based on the price level from a fixed basket of goods and services that represents the purchases of the average consumer.

Core inflation index — a measure of inflation typically calculated by taking the CPI that excludes volatile economic variables such as food and energy prices to better measure the underlying and persistent trend in long-term prices.

Double coincidence of wants — a situation in which two people each want some good or service that the other person can provide.

Deflation — negative inflation; most prices in the economy are falling.

Fiat money — has no intrinsic value, but is declared by a government to be the legal tender of a country.

Financial intermediary — an institution that operates between a saver with financial assets to invest and an entity who will borrow those assets and pay a rate of return.

Liability — any amount or debt owed by a firm or an individual.

M1 money supply — a narrow definition of the money supply that includes currency and checking accounts in banks, and to a lesser degree, traveler's checks.

M2 money supply — a definition of the money supply that includes everything in M1, but also adds savings deposits, money market funds, and certificates of deposit.

Medium of exchange — whatever is widely accepted as a method of payment.

GDP deflator — a measure of inflation based on the prices of all the components of GDP.

Hyperinflation — an outburst of high inflation that is often seen (although not exclusively) when economies shift from a controlled economy to a market-oriented economy.

Inflation — a general and ongoing rise in the level of prices in an economy.

Money — whatever serves society in four functions: as a medium of exchange, a store of value, a unit of account, and a standard of deferred payment.

Producer Price Index (PPI) — a measure of inflation based on prices paid for supplies and inputs by producers of goods and services.

Quality/new goods bias — inflation calculated using a fixed basket of goods over time tends to overstate the true rise in cost of living because it does not take into account improvements in the quality of existing goods or the invention of new goods.

Quantity equation of money — money supply x velocity = nominal GDP

Reserves — funds that a bank keeps on hand and that are not loaned out or invested in bonds.

Substitution bias — an inflation rate calculated using a fixed basket of goods over time tends to overstate the true rise in the cost of living because it does not take into account that the person can substitute away from goods whose prices rise by a lot.

Store of value — something that serves as a way of preserving economic value that can be spent or consumed in the future.

Unit of account — the common way in which market values are measured in an economy.

Velocity — the speed with which money circulates through the economy; calculated as the nominal GDP divided by the money supply.