

PRICE, PRICE LEVEL AND THE MEASURES THEREOF

What are prices? What do we mean by the term price level?

What is the difference between the two?

How do we measure price level?

In simplified terms price is defined as the rate at which goods and services are exchanged for money. It is the amount of money received for selling or, paid for buying, one unit of a commodity (or services) in an exchange economy.

The term price level is an aggregate concept. It relates to the price of a basket of goods and services. See that we do not refer to the price of a single commodity but to a group of goods and services taken as a whole. Therefore, when we talk of a change in the price level it is always in reference to a group of commodities.

Since the prices of commodities differ, in order to measure a change in the price level of a group of commodities, it is necessary to use index numbers. More specifically, we have to use price index. Let us understand the idea of an **index number** in an elementary form.

An index number is a device for comparing the general level of magnitude of a group of distinct, but related, variables in two or more time periods. A price index is used for comparing changes in the general level of prices of a group of commodities. Generally the index number refers to changes in the prices obtained over time. It is expressed by putting a particular period (called the base) equal to 100 and the price level for other periods are expressed relative to this base. For example, when we say, the whole sale price index has gone up this year with respect to last

year, we are taking last year price level as the base or, the reference point = 100. With respect to it we measure the change in the price level this year.

The price relative of an individual item is the ratio of its current price to its price in a base period. The simplest price index for a given commodity can be expressed as:

$$I_{t,o} = 100 (p_t / p_o) \dots\dots\dots (1)$$

Where p_t and p_o denote prices in the current period 't' and the base period '0' respectively.

For instance, if price of a kilo of potato goes up from ₹ 8 in 1995 to ₹ 10 in 1996, then the price index in this case would be:

$$I_{1995, 1996} = 100 (10/8) = 125$$

This index shows a 25 per cent increase in the price of a kilo of potato. In other words, you need 25% more money to maintain your consumption of potatoes at the same old level.

Cont.